Highlights

China wasted no time to further reform its financial sector and tax code despite rising uncertainty from US-China trade war. Interest income for foreign investors investing in China's onshore market will be officially exempted from corporate income tax and value added tax for three years. Despite rising volatility in RMB in the past few months, the demand for China's onshore fixed income securities from foreign investors remained healthy. NCD held by foreign investors rose slightly to CNY205.3 billion in July from CNY203.8 billion in June.

In addition, China's National People's Congress approved the proposal to revamp individual income tax system via higher threshold line and more tax breaks. The income tax reform is expected to reduce China's tax revenue by CNY320 billion according to the estimation from China's deputy finance minister. We think the individual tax reform is positive and will help boost China's consumption to counter the impact of trade war.

On data, China's PMI rebounded unexpectedly in August. Nevertheless, clearly the rebound is not demand driven as new export orders and new orders continued to fall due to concerns about trade war. On the positive note, PMI for medium and small companies rose further to 50.4 and 50 from previously 49.9 and 49.3 respectively. The return of confidence from SMEs showed that China's supportive measures to SMEs financing may have taken effect.

The excitement following the announcement of counter cyclical factor in the daily RMB fixing failed to last. RMB was under pressure again last week due to two factors including the return of trade war fear and falling Chinese rates. The real enemy to RMB stability in the near term is the movement of China's rates which is the function of expectation on China's monetary policy in our view. The falling China's rates may weigh down RMB prospect.

In **Hong Kong,** the HKMA bought another HK$14.57 billion last week to defend the currency peg system. After the aggregate balance fell by 30% in Aug to HK$76.35 billion, combined with month-end effect, HIBOR edged higher on a broad basis. As a result, HKD rebounded while the HKMA took a breather. Should Meituan-Dianping open its IPO order book in early Sep, some short HKD traders may stay on the sidelines. After that, market may shift the focus to Sep FOMC. Then the expectations for wider US-HK yield differential could encourage the return of carry trade activities. As such, USDHKD may touch 7.85 again and prompt more liquidity withdrawal. On a positive note, any more liquidity drainage combined with the quarter-end will likely push up HIBOR and make short HKD traders cautious. As such, aggregate balance may hold above HK$50bn by end-Sep, which is much higher than the average of HK$4.5 billion during 1997-2007. This indicates little incentive for banks with large deposit base to lift prime rate in Sep. Elsewhere, total loans grew at the slowest pace since Jan 2017 by 9.5% yoy in July. Local loan demand may continue to take a hit due to China's slowdown, US-China trade war and prospects for higher interest rates. Besides, given the monetary policy divergence between US and China, offshore financing may become less attractive to Mainland companies. Adding on high base effect, total loans growth may decelerate to 5% by end-2018. With possible slowdown in loans growth, banks' need to scramble for funds may become less imminent. However, the pressure on the net interest margin could remain high given the strong growth of HKD fixed deposits and the expected uptrend of HIBOR. Therefore, we still believe that banks will raise prime rate by 25bps this year.

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China's National People's Congress approved the proposal to revamp individual income tax system.
The minimum income tax threshold line will be raised to CNY5000 from CNY3500, effective from 1 October.
Meanwhile, China will also increase the number of tax deduct items to further reduce the burden of income tax. Expenses such as child education, mortgage interest, rental and treatment for serious diseases will be allowed to include in the tax break.

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The income tax reform is expected to reduce China's tax revenue by CNY320 billion according to the estimation from China's deputy finance minister. Meanwhile, the number of taxpayers will drop significantly after the amendments, only accounting for 15% of total urban workforce, down from previously 44%. In addition, a simple illustration by CCTV shows that tax burden for workers with monthly salary of CNY10k will fall by 70% under the new regime.
China's individual income tax grew by 20.6% yoy in the first seven months of 2018, outpacing total tax revenue growth of 14%. This will give China room to reform its tax code without leaving a big hole in China's pocket. Meanwhile, the assessment of income tax will be based on more comprehensive system to include all sources of income other than wages, this may actually broaden tax base, offsetting the impact of rising threshold and

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	tax breaks. ▪ Overall, we think the individual tax reform is positive and will help boost China's consumption to counter the impact of trade war.
▪ China's State Council announced new measures to further support the opening of domestic bond market to foreign investors. Interest income from domestic bond market will be exempted from corporate income tax and value added tax for three years.	▪ The latest announcement is in line with China's commitment to further reform its financial market. China's President Xi JInping also reiterated on Sunday that China is still determined to reform to build an open world economy during his meeting with UN Secretary General ahead of China-Africa Summit. ▪ Meanwhile, despite rising volatility in RMB in the past few months, the demand for China's onshore fixed income securities from foreign investors remained healthy. NCD held by foreign investors rose slightly to CNY205.3 billion in July from CNY203.8 billion in June.
▪ China's economic planning agency National Development and Reform Commission reiterated to promote a more balanced supply demand in the housing market while China's banking and insurance regulator will continue to tighten lending standard to ban consumer loan to be channelled to the property market.	▪ Although China has shifted to focus more on the downside risk, China is unlikely to loosen its grip on property market as the movement of property price has been associated with China's systemic risk.
▪ Last week, the HKMA bought another HK$14.57 billion to defend the currency peg system. As a result, the aggregate balance reduces to HK$76.35 billion.	▪ This round of HKD weakness was mainly due to the active carry trade. As market sentiments improved and HK stock market rebounded, investors saw low risks of sharp capital flight from HK. Therefore, despite the continuous liquidity withdrawal, market expected the flushed liquidity to sustain for some time. This is also reflected in the decline in one-month HIBOR from 1.44% on 27 Aug to 1.43% on 28 Aug. However, as the size of liquidity withdrawal increased and led to a 30% decline in aggregate balance, adding on month-end effect, USDHKD forward swap points and HIBOR edged higher on a broad basis. 1M HIBOR rebounded by 9bps last week to 1.54% on 31 Aug. As a result, HKD rebounded and the HKMA took a breather. ▪ Moving into September, Meituan-Dianping, a Chinese group buying website for locally found consumer products and retail services, is said to open the order book in early Sep for its HKD30 billion IPO. If this is the case, some short HKD traders may stay on the sidelines in the coming sessions. After that, market may shift the focus to Sep FOMC. Then the expectations for wider US-HK yield differential could encourage the return of carry trade activities. As such, we expect USDHKD will touch 7.85 again and prompt more liquidity withdrawal. On a positive note, any more liquidity drainage combined with the upcoming quarter-end will likely push up HIBOR and make short HKD traders cautious. As such, we hold onto our view that aggregate balance to hold above HK$50bn by end-Sep, which is much higher than the average of HK$4.5 billion during 1997-2007. This indicates little incentive for banks with large deposit base to lift prime rate in Sep.

Key Economic News	
Facts	**OCBC Opinions**
▪ China's August PMI unexpected rebounded to 51.3 from 51.2 in July despite weaker demand.	▪ Demand remained weak in August with new export order decelerated further to 49.4 from 49.8 in July, below 50 for the

	third consecutive month. In addition, new order also slipped to 52.2 from 52.3. The weaker demand was mainly attributed to rising uncertainty as a result of US-China trade war. ▪ The rebound of PMI was mainly due to sharp rebound of purchasing prices, which jumped to 58.7 from 54.3. This implied that China's producer prices index may rebound again in the coming months. ▪ On the positive note, PMI for medium and small companies rose further to 50.4 and 50 from previously 49.9 and 49.3 respectively. The return of confidence from SMEs showed that China's supportive measures to SMEs financing may have taken effect. ▪ The stronger than expected August PMi suggested that the pace of decline in China's economic activity is likely to be gradual and orderly. As such, the sharp decline of Chinese economy is quite unlikely.
▪ China's industrial profit decelerated to 16.2% yoy in July from 20% in June, but still well above 10% handle.	▪ Given China's producer price index is likely to rebound in the coming months, we think China's industrial profit growth is expected to stay resilient. ▪ The strong industrial profit, which was mainly supported by oil, steel and chemical sectors, is likely to cushion the pace of deceleration of growth.
▪ HK: total loans and advances grew at the slowest pace since January 2017 by 9.5% yoy to HK$9.77 trillion in July 2018. ▪ Total deposits increased by 3.5% yoy. HKD demand and savings deposits dropped 1.8% yoy and 1% yoy respectively while HKD time deposits surged 14.2% yoy. As a result, HKD CASA (HK$4.15 trillion) to total HKD deposits ratio slid to the lowest since Jun 2014 at 61.9%. HKD fixed deposits (HK$2.56 trillion) to total HKD deposits ratio rose to the strongest since Jun 2014 at 38.1%. ▪ HKD loan-to-deposit ratio reduced slightly from 85.4% in June to 85.1% in July.	▪ The growth of loans for use in HK (excluding trade finance), which account for 64.3% of total loans and advances, decelerated to 9.2% yoy, the weakest since Dec 2016. Local loan demand may continue to take a hit amid two major factors. First, market frets that China's slowdown and US-China trade war would cloud HK's economic outlook. Second, market increasingly expects that borrowing costs will edge higher following HKMA's liquidity withdrawal and the Fed's gradual tightening. ▪ On the other hand, the growth of loans for use outside of HK, which represent 30% of total loans and advances, was barely changed at a more than one-year low of 10.4% yoy. Lately, China announced a raft of stimulus measures in an effort to spur credit expansion and provide funding supports to SMEs. This helps to reduce the onshore funding costs. In contrast, offshore borrowing costs have been rising following the Fed's gradual rate hikes. As a result, offshore financing may become less attractive to Mainland companies. Adding on high base effect, we expect total loans growth to decelerate gradually to 5% by end of this year. ▪ With possible slowdown in loans growth, banks' need to scramble for funds may become less imminent. However, the pressure on the net interest margin could remain high given the strong growth of HKD fixed deposits and the expected uptrend of HIBOR. Therefore, we still believe that banks will raise prime rate by 25bps this year.
▪ HK's RMB deposits rebounded by 4% mom or grew by 13.6% yoy to the highest since Nov 2016 at RMB607.6 billion in July 2018.	▪ Despite the cut in RMB deposit rates and a 2.5% mom depreciation in CNH against the HKD, RMB deposits rebounded. This shows market confidence in RMB assets and the sentiment for RMB is more upbeat than in 2015-2016. However, we see limited upside for RMB deposits in the near term due to the less attractive deposit rates as well as the uncertain outlook of RMB. Specifically, as the PBOC shifted from tightening bias to a easing one, flushed liquidity and lower RMB rates in the onshore market prompted offshore banks to cut the RMB deposit rates.

	In constrast, HK banks may gradually lift HKD and USD deposit rates following the Fed's tightening. As a result, customers may switch their RMB deposits to HKD or USD deposits.
▪ The growth of HK's exports and imports accelerated to 10% yoy and 14% yoy in July from 3.3% yoy and 4.4% yoy in June respectively.	▪ In terms of exports, except for Japan and Taiwan, overseas shipments to other major trading partners all registered year-on-year growth. This is mainly due to strong external demand as well as the front-loading of exports before US-China trade war officially started on 6 July. On the other hand, imports from ten major trading partners all increased notably on a yearly basis. This is partially attributed to China's reduction of tariff on some imports effective 1 July. ▪ The first round (HK$50 billion) of US-China trade war might have had limited initial impact on HK's trade activities. Besides, on the back of supportive policies, the revival of China's demand as well as the further opening up of China's market may weather some impact of trade war on the imports of both China and HK. However, export growth may slow down should trade war escalate or external demand soften on trade concerns.
▪ HK's retail sales growth decelerated to 7.8% yoy in July from 12% yoy in June.	▪ The slowdown could be attributed to four unfavorable factors, including the faded low-base effect, a stronger HKD on USD strength, China's slowdown as well as trade war concerns. By retail outlets, the sales of foods, alcohol and tobacco and those of goods in supermarkets both grew at the slowest pace since this January and were by 3% yoy and 0.7% yoy respectively. As trade fears weighed down stock market and in turn reduced wealth effect, consumer sentiments weakened. China's slowdown and US-China trade war have clouded HK's economic outlook as well as the salary prospect. This also curbs household spending. On the other hand, sales growth of clothing, footwear and allied products and that of jewellery, watches and other luxury goods decelerated to 3.6% yoy and 16.8% yoy in July from 6.2% yoy and 27.8% yoy in June respectively. As HKD followed USD strength to appreciate against major currencies while Asia's outlook was clouded by trade concerns, tourism activities and tourist spending might have been slowing down. All in all, we expect the four unfavorable factors will continue to soften the growth of retail sales in the coming months.
▪ Macau's unemployment rate held stable at the lowest level since 2015 of 1.8% over the three months through July. The employed population increased further to the highest since late 2016 at 385500. Labor force participation rate edged up to the strongest level since mid-2017 at 71.1%.	▪ These data reinforce that the labor market remained resilient. Nevertheless, there were some fluctuations in each sector's employment. The employment of gaming sector and retail sector dropped by 1.2% mom and 3.9% mom respectively. Meanwhile, the employment of hotels, restaurants and similar activities only rose slightly by 0.4% mom. This was mainly attributed to the cautious hiring sentiments on uncertain outlook of the tourism-related sectors amid US-China trade war and a stronger MOP. Despite that, we expect the labor market to remain tight as a wave of new mega project openings could bolster employment growth in the tourism-related sectors. Besides, the employment of the construction industry (+1.6% mom) may stay elevated as government stresses on infrastructure investment.

RMB	
Facts	**OCBC Opinions**

▪ The excitement following the announcement of counter cyclical factor in the daily RMB fixing failed to last. The return of trade war fear kept the USDCNY bid with the pair traded back to 6.85 range again. However, RMB still appreciated slightly against its major trading partner with the RMB index firmly stood above 93 last week.	▪ RMB was under pressure again last week due to two factors including the return of trade war fear and falling Chinese rates. ▪ President Trump said last week he wants to move ahead with a plan to impose tariffs on US$200 billion in Chinese imports. The decision may be made as early as this week. This drove down the RMB again. Nevertheless, after China has mentioned quite clearly that it will not use currency as the weapon to fight the trade war, we think the marginal impact of trade war topic on RMB could be less as compared to that in June. ▪ The real enemy to RMB stability currently in the near term is the movement of China's rates which was the function of expectation on China's monetary policy in our view. The falling China's rates may weigh down RMB prospect in the near term. ▪ Overall, we think there is no strong catalyst to drive the USDCNY higher again to 6.9. We expect the pair to be stuck in the 6.8-6.9 range in the near term.

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