Highlights

China moved ahead of its interest rate liberalization after the PBoC announced to liberalize the lending rate via the reform of loan prime rate (LPR). Instead of being referenced to the benchmark lending rate, the new loan rate will be benchmarked to the LPR, which will be referenced to the open market operation rate namely 1-year MLF rate. This is designed to help unblock the transmission mechanism from the interbank funding cost to the real economy.

For details, please see the comments below. Overall, we expect the LPR to decline gradually at a marginal pace at start to reflect the lower funding costs in the interbank market. In addition, given PBoC will include the use of LPR and setting of loan rate in the macro prudential assessment (MPA), as such, we think banks are likely to lower the funding costs to the real economy.

Nevertheless, the latest move is only half step towards interest rate liberalization as it does cover deposit rate liberalization and the use of MLF as benchmark could be temporarily due to its drawbacks such as high funding costs for banks and limited access etc.

On US-China trade talk, the USTR announced that the tariff on certain products such as cell phones, laptop computers, video game consoles, certain toys, footwear and clothing will be delayed to 15 Dec. The boost of risk sentiment by the partial delay of tariff proved to be short lived as the unilateral announcement by the USTR was only the result of concerns about the upcoming holiday spending in the US rather than signs of improvement of US-China trade talk. Market will closely monitor the development of Huawei. An extension of the general license for another 90 days is positive though it is unlikely to turn around the sentiment.

On economic growth, The Chinese economy surprised the market on the downside with three major growth data missed market forecast. On investment, property investment remained the key supporting sector while infrastructure investment was a disappointment.

In **Hong Kong**, the protests have lasted for ten straight weeks and prompted Airport Authority Hong Kong to unprecedentedly cancel flights last week. This might have added to a weaker RMB and trade tensions in weighing down the city's tourism and the already weak retail sales. Worse still, the flight cancellation might have hit the logistics as well as the economy. Elsewhere, Hong Kong sold a commercial plot in Kai Tak at the lowest price since November 2016. This indicates that the sour sentiments have spilled over from retail and residential property markets to commercial property market. Taken all together, we are concerned that the political uncertainty coupled with trade war re-escalation may lead to a technical recession in 3Q (GDP contracted by 0.4% qoq in 2Q). The government also slashed 2019 GDP growth forecasts notably from 2%-3% to 0%-1% while announcing relief measures with a total value of HK$19.1 billion to boost growth by about 0.3%. For the economy facing double whammy, a raft of local fiscal stimulus and global monetary easing may help to slightly alleviate the downward pressure and prevent a full-year recession. In a nutshell, we downgrade our 2019 GDP growth forecast to 0.6% from 1%-1.5%. **On the money market front,** longer-end liquidity got very tight and gradually drove up short-end rates as market players kept hoarding cash in anticipation of month-end, quarter-end and potential capital outflows amid ongoing social unrest, trade war and weakening economic outlook. On a positive note, stable aggregate balance indicates that there have not been massive capital outflows. Also, tariff-delay by the US may further alleviate outflow risks. In the absence of huge capital flight, we believe that USDHKD will not easily touch 7.85. Rather, the currency pair may hover in the range of 7.84-7.85 in the near term.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ PBoC announced to further liberalize China's lending rate via the reform of loan prime rate (LPR).	▪ The central bank introduced four new features to lending rate. ▪ First, instead of being referenced to the benchmark lending rate, the new loan rate will be benchmarked to the LPR, which will be referenced to the open market operation rate namely 1-year MLF rate. This is designed to help unblock the transmission mechanism from the interbank funding cost to the real economy. Going forwards, China's funding cost to the real economy will depend on two parameters including the LPR (which reflect bank's funding cost) and credit spread (which reflect the credit premium, market supply and demand matrix and risk appetite etc).

	▪ Second, other than the 1-year LPR, PBoC will introduce the 5-year LPR as the benchmark for the longer-term loan such as mortgage. However, as there is no 5-year MLF rate, it remains unclear how the 5-year LPR to be priced. ▪ Third, the number of LPR contributing banks will be increased from previously 10 big national banks to 18 banks including city commercial banks, rural commercial banks, foreign banks and private owned banks to better reflect the funding costs. ▪ Fourth, the publishing frequency of LPR however will be reduced to only once a month from previously daily rate. The LPR will be decided on the 20th of each month. According to the PBoC, the reduction of frequency will improve the quality of LPR and make banks more serious when contributing the LPR. ▪ **Impact on the real interest rate** ▪ With effective from this week, China's new lending will be encouraged to be priced in LPR. The current 1-year LPR was at 4.31%, which was 101bps above the 1-year MLF rate. We expect the LPR to decline gradually to reflect the lower funding costs in the interbank market. In addition, PBoC will include the use of LPR and setting of loan rate in the macro prudential assessment (MPA), as such, we think banks are likely to lower the funding costs to the real economy. This may help China to achieve its target to lower the funding costs to the small and micro companies by 100bps in 2019. ▪ **What to watch out for next?** ▪ The immediate focus will be whether China will lower its MLF rate to guide the LPR lower as a way to reduce the funding costs to the real economy. We see chances for China to lower its MLF rate in the coming months. However, we don't see the urgency for China to cut its MLF rate in August as China may want to take a wait-and-see approach to see how market react and digest the latest liberalization. ▪ Nevertheless, we think the chance of RRR cut is slimmer. Given the RRR cut is previously to be used to replace the MLF, the increasing role of MLF in the latest interest rate liberalization suggests that the replacement of MLF by RRR cut may pause for now. ▪ In the medium term, we think the current liberalization is only half step towards interest rate liberalization for two reasons. First, MLF rate is unlikely to be the permanent anchor for LPR and it could only be the transitory arrangement due to two flaws of LPR including higher funding costs for banks as compared to interest rate on RRR as well as limited access for smaller banks which are not the primary dealers. ▪ Second, the current liberalization focus only on the lending rate while deposit rate was left untouched. This is probably to protect banks' margin to ensure a smooth transition for lending rate. In the longer run, China may also need to loosen the setting of deposit rate.
▪ On US-China trade talk, the USTR announced on 13 August that the tariff on certain products such as cell phones, laptop computers, video game consoles, certain toys, footwear and clothing will be delayed to 15 Dec. ▪ Meanwhile, Reuters also reported that the US Commerce Department is expected to extend the	▪ The boost of risk sentiment by the partial delay of tariff proved to be short lived as the unilateral announcement by the USTR was only the result of concerns about the upcoming holiday spending in the US rather than signs of improvement of US-China trade talk. ▪ Market will closely monitor the development of Huawei. An extension of the general license for another 90 days is positive

temporary general license, which will lapse on 19 Aug, for another 90 days to allow Huawei to buy supplies from US companies.	though it is unlikely to turn around the sentiment.
▪ Hong Kong: global market has been increasingly concerned about the economic fallout from the ten consecutive weeks of protests.	▪ Last week, the protest prompted Airport Authority Hong Kong to unprecedentedly cancel flights. Besides, the survey of three HK tourism associations reveals that the average income of the respondents dropped by nearly 80% over the previous two months while the average number of tour packages has plunged by more than 70% since June. Notably, the value-added of tourism took up 4.5% of GDP in 2017. The ongoing social unrest might have added to a weaker RMB and US-China trade tensions in weighing down the city's tourism and the already weak retail sales. ▪ Worse still, as Hong Kong Airport has consistently been the worlds' busiest airport by cargo traffic since 2010 and the value-added of freight transport and storage services took up 2.9% of GDP in 2017, the flight cancellation might have hit the logistics as well as the economy. ▪ Elsewhere, after selling a residential plot in Kai Tak at the lowest price since Dec 2016, Hong Kong sold a commercial plot in Kai Tak at a price more than 11% below the low end of the market valuation and the winning bid reached the lowest price since November 2016. This indicates that the sour sentiments have spilled over from retail and residential property markets to commercial property market. ▪ Taken all together, we are concerned that the ongoing political uncertainty will continue dragging down the tourism, retail and real estate sectors. Adding on the hit from US-China trade war re-escalation, the risk of a technical recession in 3Q (GDP contracted by 0.4% qoq in 2Q) cannot be ruled out.
▪ HK's government slashed 2019 GDP growth forecasts notably from 2%-3% to 0%-1%, citing significant downward pressure. To ease the pressures, the government announced a raft of relief measures with a total value of HK$19.1 billion to boost growth by about 0.3%. ▪ Financial Secretary Paul Chan forecasted a fiscal surplus of HK$16.8 billion for 2019-20 in February. The new sweeteners may result in the first fiscal deficit since 2003.	▪ There will be seven one-off measures to relieve the burden on low-income households, students and SMEs. The government revenue will be reduced by HK$15.1 billion as a result. Specifically, the measures include 1) a 100% reduction in salaries tax, tax under personal assessment and profits tax for 2018-19 (the ceiling of HK$20,000 is unchanged); 2) one-off HK$2,000 worth of electricity charge subsidy, 3) an extra one-month allowance to social security recipients; 4) one-off grant of HK$2,500 for students in kindergarten, primary school and secondary school; 5) one-month's rent payment for public rental housing tenants; 6) waiving 27 types of fees and charges for 12 months for sectors including logistics, retail, catering, tourism and construction and 7) a 50% reduction in the rental for six months for short-term tenancies of government land. Furthermore, the government will add new loan guarantee product under the SME Financing Guarantee Scheme. The Community Care Fund is considering providing one-off living subsidy for the N have-nots households. Other authorities including Housing Authority, Airport Authority and Science Park are also working on stimulus measures. On top of these, HK's Chief Executive Carrie Lam also hinted at "bold" measures to shore up growth which will be announced in October's Policy Address. ▪ As the economy is now facing double whammy from trade war re-escalation and local political uncertainty, a raft of local fiscal stimulus may help to slightly ease the downward pressure on growth and prevent a full-year recession. Though

	a fiscal deficit is possible for 2019-20, it is manageable given the sizeable fiscal reserve of HK1.16 billion which will allow the government to maintain the accommodative fiscal policy in the coming years.
▪ HKD rates moved up due to concerns about capital outflows on ongoing social unrest. ▪ Some large commercial bank cut the cash rebate to 1% for HK$100 million or below home loans and lifted the prime cap of HIBOR-based mortgage loans from 2.375% to 2.475%.	▪ Longer-end liquidity got very tight and gradually drove up short-end rates as market players kept hoarding cash in anticipation of month-end, quarter-end and potential capital outflows amid ongoing social unrest, trade war and weakening economic outlook. On a positive note, stable aggregate balance indicates that there have not been massive capital outflows. Also, tariff-delay by the US has supported a rebound in HK stock market and the RMB and further alleviated outflow risks. In the absence of huge capital flight, we believe that USDHKD will not easily touch 7.85. Rather, the currency pair may hover in the range of 7.84-7.85 in the near term. ▪ Going forward, though Alibaba is said to postpone its second listing in HK, in the face of potential capital outflow risks as well as upcoming month-end and quarter-end, market players may still buy in dips to collect HKD liquidity. As such, HIBORs' downside may be capped and continue to compress commercial banks' mortgage net-interest-margin. This helps to explain the move taken by some large commercial bank. With mortgage rates elevated and investment sentiments souring on internal and external headwinds, we expect housing transaction to shrink and housing price to drop gradually in the coming months.

Key Economic News	
Facts	**OCBC Opinions**
▪ Foreign ownership of Chinese bonds continued to go higher in July. Foreign investors net purchased CNY7.15 billion government bonds and CNY40.4 billion policy bank bonds respectively.	▪ The ongoing inflows into China's capital market showed that foreign interest in Chinese assets remained strong despite the weak currency. Although it could be too early to argue that Chinese bond might be the safe haven assets, the relative wide yield differential between China and rest of the world during the global easing cycle signals that China's capital market may remain attractive to foreign investors. As such, we think the persistent capital inflows may help counter the RMB weakness from the trade war.
▪ The Chinese economy surprised the market on the downside with three major growth data missed market forecast. ▪ Industrial production decelerated to 4.8% yoy in July from 6.3% yoy in June. ▪ Fixed asset investment growth slowed down slightly to 5.7% yoy in the first seven months from 5.8% yoy in the first half. ▪ Retail sales growth also slowed down to 7.6% yoy from 9.8% yoy.	▪ On investment, property investment remained the key supporting sector although its growth slowed down to 10.2% yoy from 11%. Investment in manufacturing sector remained weak at 3.3% yoy albeit it rebounded slightly from 3% in the first half of the year. The main disappointment came from the infrastructure investment, which decelerated further to 3.8% yoy in the first seven months from 4.1% yoy in the first half, despite the increasing issuance of local government special bond. This shows that the local government funding remained the key constraints to China's growth. ▪ The slowdown of retail sales was in line with expectation as it could be distorted by the frontloading of car sales in June ahead of the implementation of stricter emission rule from July. Car sales in July fell by 2.6% yoy after growing strongly by 17.2% yoy in June.
▪ HK's 2Q GDP growth is revised down from 0.6% yoy to 0.5% yoy, the weakest since 3Q 2009 due to sour external and internal demand. The seasonally	▪ Going forward, the trade war re-escalation may further drag down the exports of goods (-5.6% yoy) and transport services (-3.5% yoy). Trade tensions coupled with the ongoing social

adjusted qoq growth of the GDP was also revised lower from -0.3% to -0.4%.	unrest could continue to dent consumer/investment sentiments. Besides, the local political uncertainty has been weighing down the export of travel services (+2.0% yoy). Worse still, the recent correction in housing market and the completion of mega infrastructure projects signal that fixed investment (-11.6% yoy) would keep weakening. As such, despite the abating high base effect, we believe that the economic growth will remain sluggish in 2H19. On a positive note, local fiscal stimulus (including the sweeteners just announced by the government) and global monetary easing may help to prevent a full-year recession. In a nutshell, we downgrade our 2019 GDP growth forecast to 0.6% from 1%-1.5%.

RMB

Facts	**OCBC Opinions**
▪ RMB recovered last week after the news that the USTR will delay tariff on some Chinese products to mid-December. The USDCNY retreated to below 7.05 while RMB index rebounded to 92 level.	▪ The surge of CNH in the offshore market by 1000bps last Tuesday following the news of partial tariff delay showed that RMB is still the function of progress of trade talk. This may remain the case for the upcoming sessions. China's interest rate reform, which was designed to lower the funding costs to the real economy, may be supportive of bond market. However, it is unlikely to weigh down on RMB amid the global easing cycle.

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