CNY Offshore NDF and onshore bond markets

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Outline

- Offshore CNY derivatives
  - NDF
  - Cross currency swap
  - NDF Currency option
- Domestic bond market
  - Primary market
  - Secondary market
  - Potential opportunities after QFII

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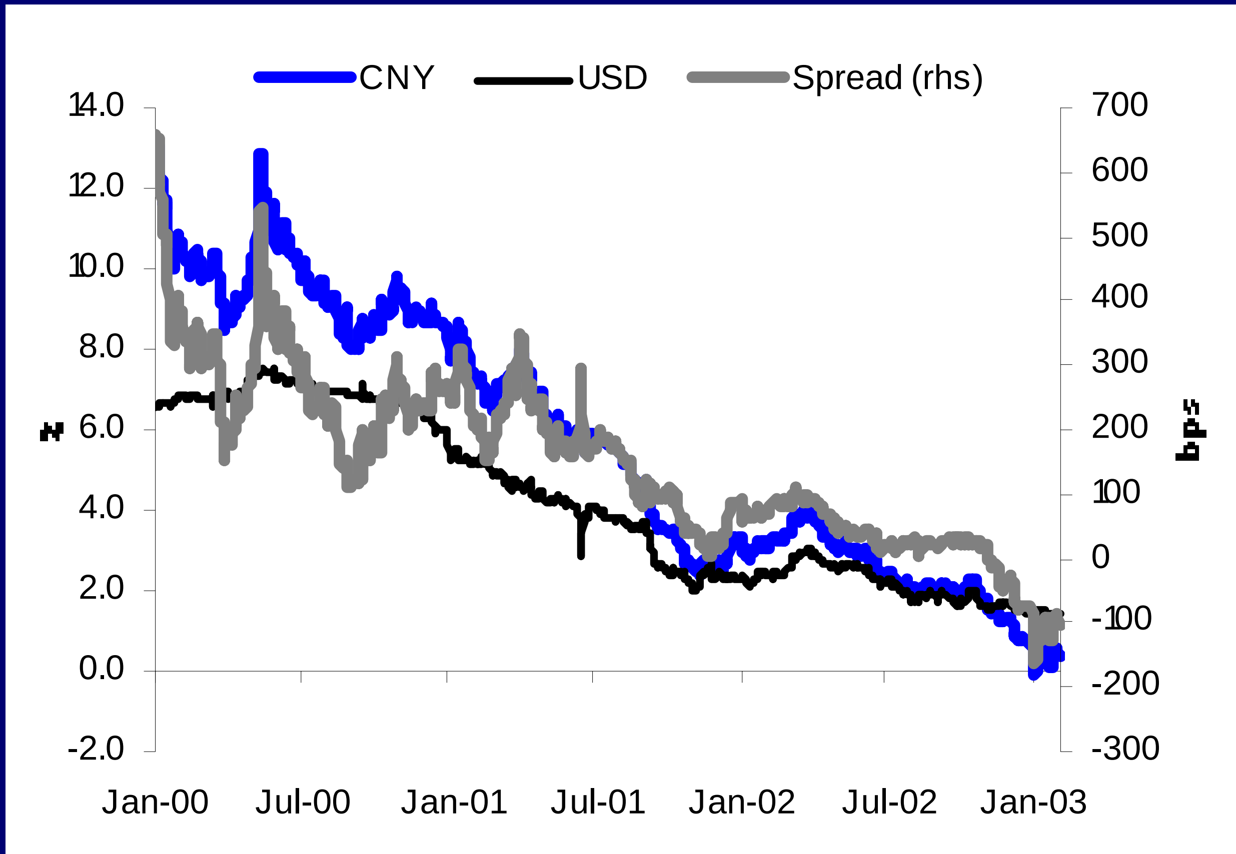
CNY NDF

- NDF can be traded up to 3-year tenor but tenors below 1Y are the most liquid.
  - Daily trading volume is about USD 100mn
  - On occasion the daily volume reaches USD400-500mn
- NDF settles against Reuters Page <SAEC>
- Pricing reference pages
  - Reuters page <DBNDF>
  - Reuters page <PNDF>
- Negative spreads against USD rates reflect the market expectation of an appreciation in CNY.

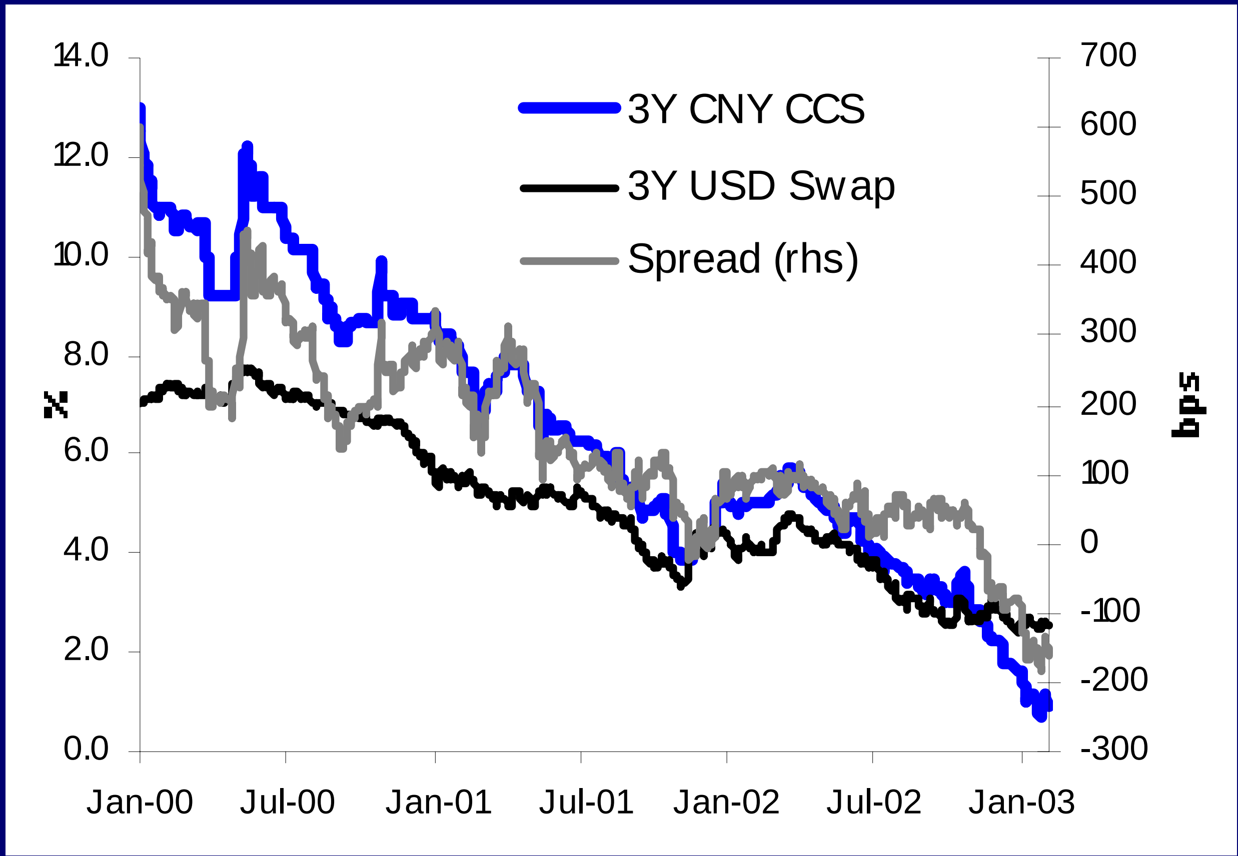
12M CNY Implied Yield vs. 12M USD LIBOR



USD/CNY Cross Currency Swap

- Receive fixed in CNY and pay floating in 6M USD LIBOR
- Settle in USD every six months just like NDF contracts
- Some liquidity up to 3Y, only indication beyond 3Y
- Normal ticket size about USD3mm
- Reuters Page <PNDS>
- The difference between a cross currency swap and a NDF is similar to the difference between a coupon bond and a zero coupon bond.

3Y CNY Cross Currency Swap vs. 3Y USD Swap Rate



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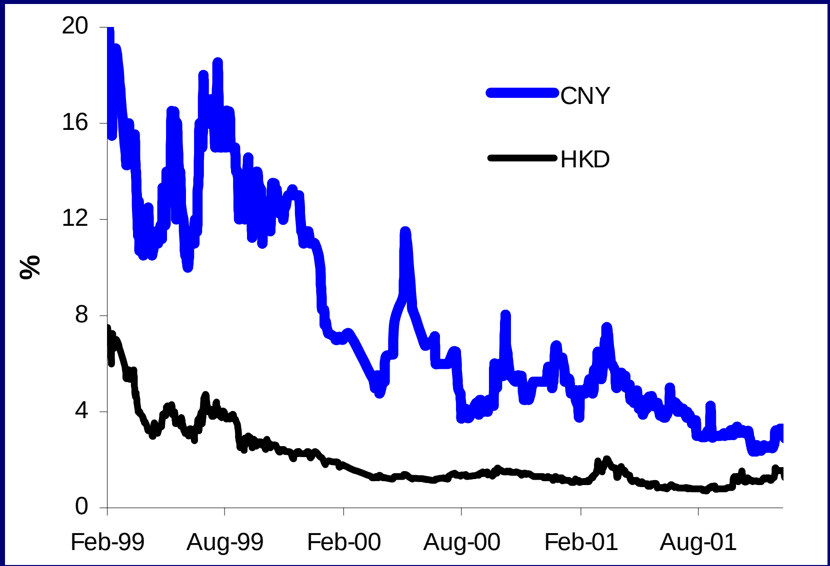
CNY NDF Currency Option

- Daily trading volume is about USD200mn
- Liquid up to 1Y and prices available up to 3Y
- Average ticket size USD20mn
- Bloomberg page <PYRG4>
- Changing perception on the risk of the HKD peg and CNY “peg”.
  - Buying put on HKD and selling put on CNY?

1Y Implied volatility of the HKD peg and the CNY "peg" before 2002 and after 2002



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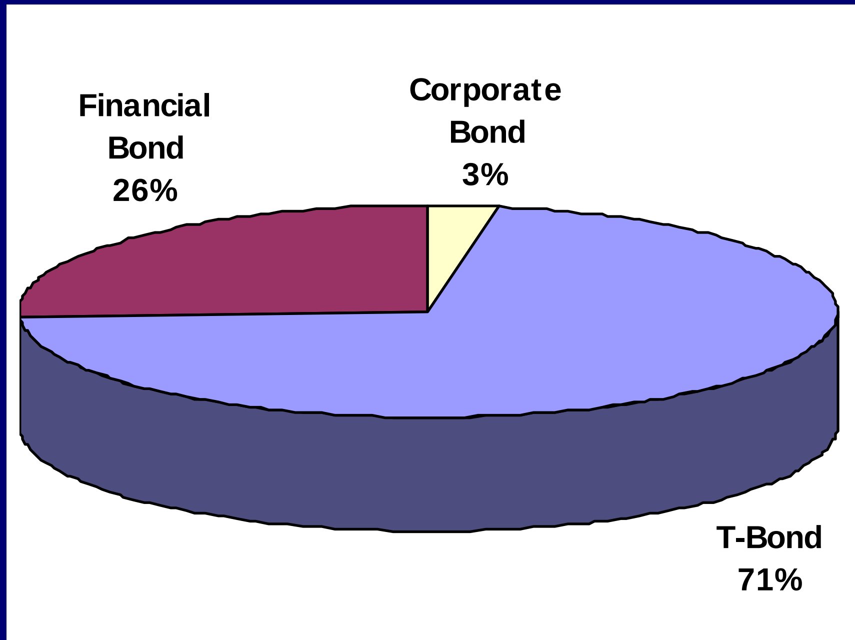
Domestic bond market is dominated by Treasury bonds

- Total outstanding amount of bonds is CNY3.0tn -- 2.1tn Treasury bonds, 0.78tn financial bonds, and 0.08tn corporate bonds
- 30% of Treasury bonds are voucher bonds and non-negotiable
- The big-4 banks own 75% of Treasury bonds
- So far there is no regular auction schedule for Treasury bonds yet
- Last year the government issued the first 30Y bond
- Very few issuance below 5Y.
- Coupon income not taxed



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Financial bonds

- Issued by three state level development banks (China Development Bank, Import & Export Bank, and Agricultural Development Bank)
- Must be approved by PBOC
- The latest issuance: 3.39% 2013 of China Development Bank, about 53 bps above the 10Y T-bond yield.

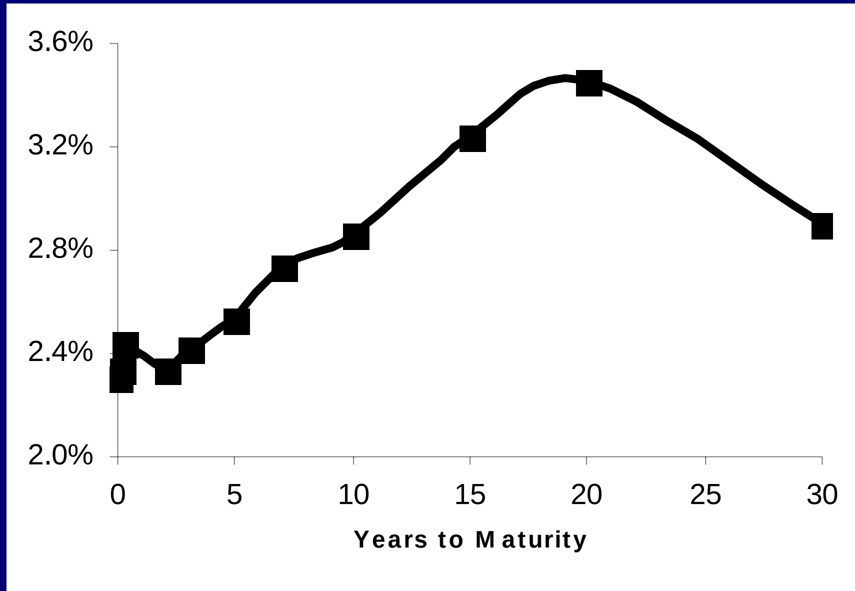
Corporate bond market

- Extremely restrictive process -- approval is required from SDPC, PBOC, and CSRC.
- Although late last year the SDPC announced it would relax the restrictions by allowing private companies to sell bonds, immediate attention is being focused on the stock market.
- Still potential issuance for 2003 may be around CNY50bn vs. 32bn in 2002
- Corporate bonds are often in high demand due to small supply
  - wider spreads (30-70 bps)
  - vital state-owned enterprises
  - often guaranteed by the big-4 commercial banks explicitly and assumed guarantee from the government
  - extremely illiquid in secondary market
- Coupon income is taxed on corporate bonds

Treasury bond yield curve

- Trading is through interbank and stock exchanges (Shanghai and Shenzhen).
- Liquidity tends to shift to different sector of the curve along with investors' view on interest rates
- 5Y-7 Y tends to be the most actively traded part of the curve
- 30Y was especially rich only because of no trading in the bond
  - It was issued when yields were at the bottom last year
  - No mtm allows banks to avoid booking loses

Treasury yield curve in interbank market



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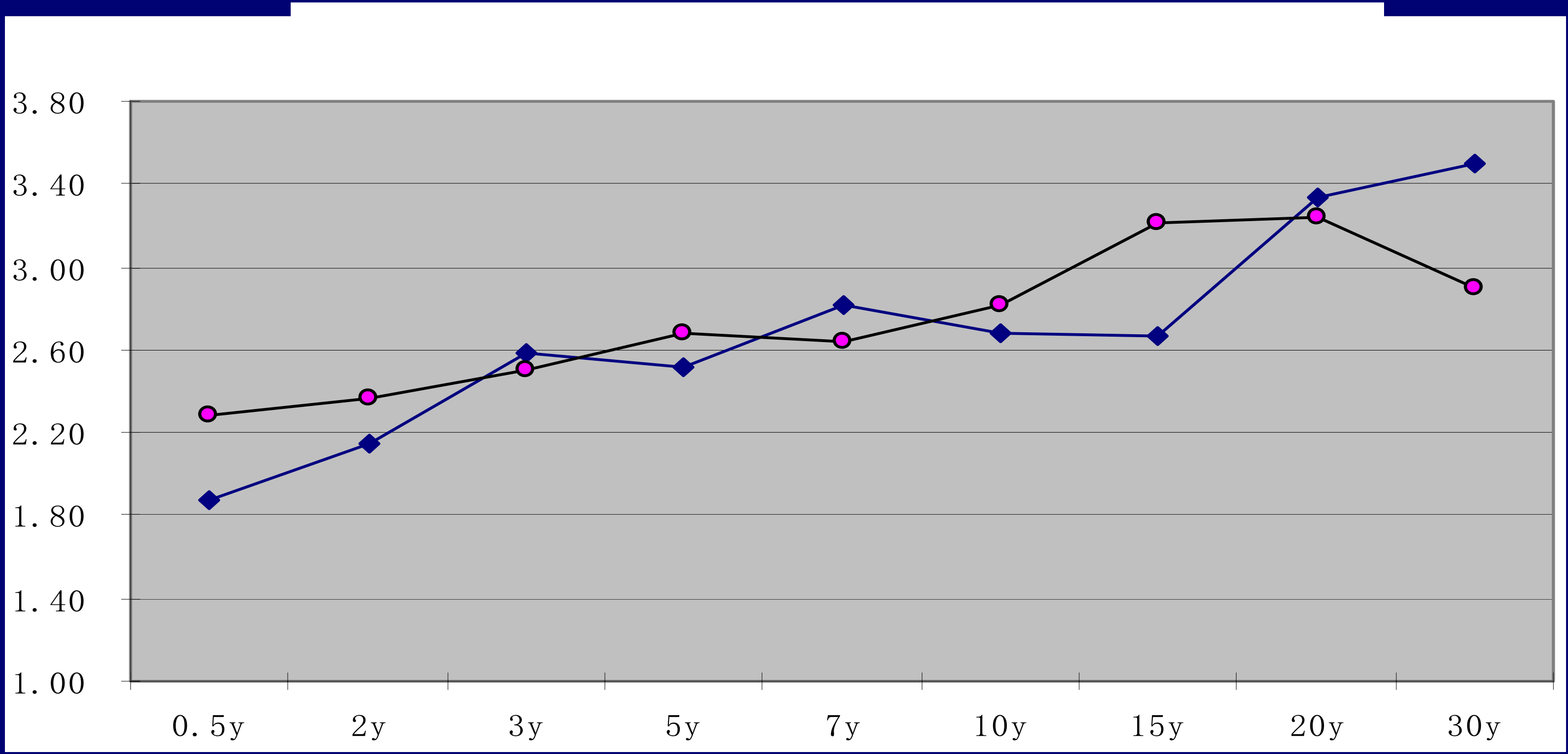
Difference between interbank market and stock exchanges

- The custodian volume of T-bonds in the interbank market is about CNY1.9tn, but only CNY0.2 on the exchanges
- Despite the huge difference in the custodian volume, the daily turnover of the interbank market is only about twice of that of the exchanges
- Bonds in the interbank custody is often not marked-to-market. Bonds in the custody of the exchanges are marked-to-market. This often creates significant distortion in the yield curve when interest rate movements are substantial. Pricing between the 2 markets can be quite different although it has been converging with the development of bond funds etc that can access both markets.
- Commercial banks are not allowed in the exchange market

Pricing difference between interbank market and stock exchanges (blue: exchanges, red: interbank)



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Some ad-hoc trade in derivatives

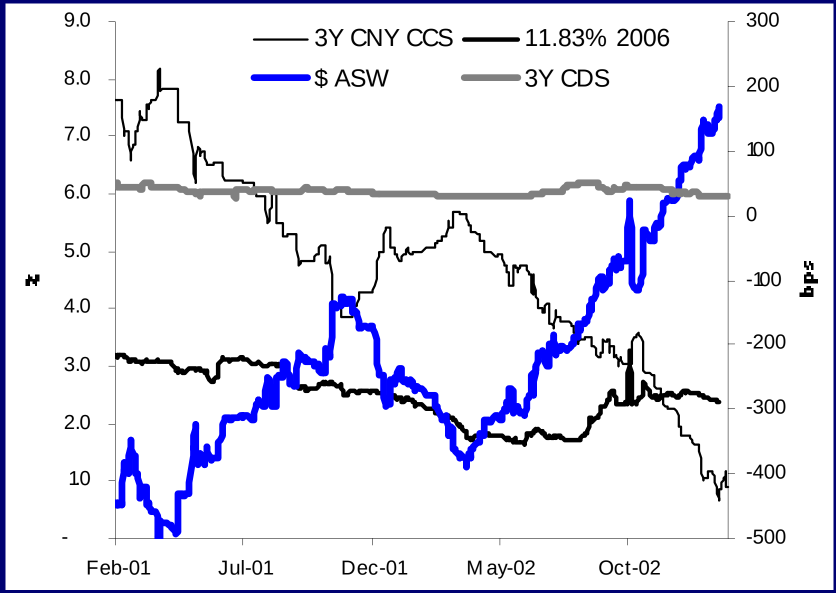
- In the OTC market, between securities houses, there have been some experiments in fixed income derivatives
  - swaps with the floating leg set to the lending rate fixed by the government
  - some forward trading
  - still short-selling is not allowed

Domestic interest rate structure still highly regulated

- Although bond market is developing rapidly, PBOC still sets most interest rates for banks
  - all deposit rates
  - Lending rates
    - banks can decide on a spread of up to 30% above the lending rates

Potential opportunities for offshore investors

- After QFII, investors will have access to bonds listed on the exchanges
- Domestic bond yields are much higher than NDF implied yields
- Potential cross currency asset swap opportunities -- $L+160 bps of domestic T-bond vs CDS at less than 50 bps
- Various technical difficulties for such trades including high funding cost onshore and required holding period



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