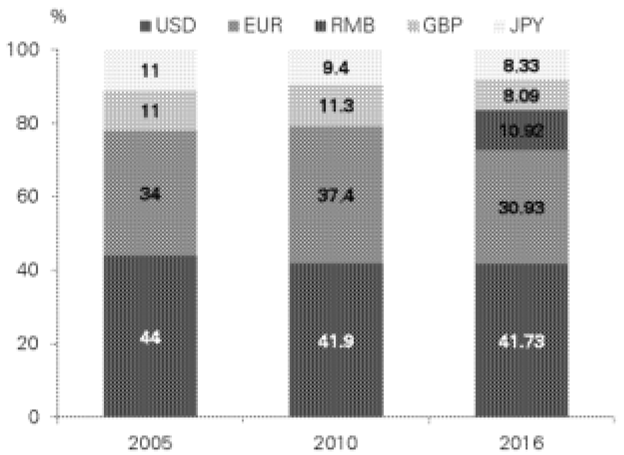
SDR basket



Source: IMF, Deutsche Bank

The SDR inclusion of the RMB is a structurally positive development for China. The most significant macro implication is on reform outlook. The progress of structural reforms has been slow. There is doubt among investors if China truly has the commitment to market oriented reforms. Such doubt heightened in the summer after what happened in the equity market. The SDR inclusion may work as a catalyst to boost the momentum of reforms in China. It indicates that the authorities are keen to integrate China's economy further with the global economy, which may help to better align China's domestic market operations with international best practices.

The SDR inclusion is also positive from a global perspective. The global economy needs better policy coordination among the major economies. This is particularly important as the US is moving to exit QE and China's economy is slowing down. The SDR inclusion shows an encouraging sign that the policy makers are working collaboratively. The positive gesture from the international community will help China to play a constructive role as a global economic power. The world is better off with China and the other global powers working together.

The size of capital inflows in the short term may not be high, as the SDR inclusion itself will only start effectively on Oct 1 2016. But China has opened its fixed income and foreign exchange markets to foreign central banks and sovereign wealth funds this year. We expect these institutions will start investing in 2016. Some argue that the market expectation of RMB depreciation may jeopardize the inflows. We do not think this is the key constraint, as central banks hold Euro and Yen assets despite these currencies also face depreciation expectation. In our mind the key constraint is that the domestic market is not ready for foreign reserve managers yet. Infrastructure needs to be set up, liquidity condition needs to improve, and rules need to be revised to facilitate trading. This will take time, but we have no doubt it is doable.

We maintain our view that the Chinese government will not allow sharp RMB depreciation in the rest of the year. As the market expectation for December rate hike heightens, RMB depreciation would cause high volatility in the financial market which is damaging to China's economy. We believe the PBoC may want to wait for the Fed to hike rate first and see how risks in the emerging markets evolve, before it takes the next move on the exchange rate.

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Investment strategy

Fixed Income Strategy: Maintain long bias in 2016

We maintain our long bias on RMB bonds/rates market in 2016 as we believe the overall demand and supply balances remain favorable. Specifically, we argue the following factors:

- Liquidity outlook: We maintain our view that the central bank will keep domestic liquidity flush to help stabilize growth and support economic structural rebalancing. In addition to the four RRR cuts and 50bps cuts in policy rates that our economist is calling for during 2016, we also expect the PBoC to actively use its open market liquidity tools (SLF, MLF, PSL and open market auctions) to smooth liquidity volatility (with interest rate corridor framework) and to provide liquidity to targeted sectors. We forecast that the overnight repo rate to ease towards 1.25%-1.5% and the 7D repo rate to 1.75%-2% in 2016.
- Government bond supply outlook: We expect fiscal deficit to be financed by a combination of CGB and municipal bond issuance. We forecast 2016 net supply of CGBs at about RMB1560bn, up by 39% YoY from 2014, and 2016 net supply of municipal bonds at RMB800bn, up by 33% YoY. Supply of policy bank bonds. We expect the MoF continues to carry out local government debt swap program in 2016 with about RMB3.5trn-4trn to municipal bond issuance as a result of the debt swap.
- Volatilities to remain subdued in H1 and to normalize in H2. In 2015, volatilities across all RMB assets (equities, bonds, and FX) rose substantially during Q2-Q3 due to excessive leverages in the equity market and RMB exchange rate reform measures. With regulators imposing various temporary measures to clean up/reduce equity leverages, the macro prudential measures on the FX market and monetary easing measures, asset volatilities are currently at relatively low levels comparing with where they were over the past 12