



months. We expect RMB asset volatilities in H1 to remain subdued when most of these temporary market stabilization measures will be relaxed/removed over the next one to two quarters, and asset volatilities to renormalize in H2.

- **Balanced allocation between fixed income and equity market:** While the asset allocation shift between equity and fixed income market should be largely driven by valuation, investment flows at domestic fund houses and banks (wealth management products) were quite volatile and extreme in 2015 with sizeable inflows to bond funds in Q3, however, the lesson from the equity market turmoil in July 2015 is that asset allocation by both institutional and retail investors needs to be more balanced between the equity and fixed income assets. In addition, considering growth fundamentals will remain sluggish, we expect both equity and fixed income market to benefit from flush liquidity and asset allocation demand. Furthermore, we expect the basis between the repo rates in the Stock Exchanges and the interbank market to narrow as the new IPO funding rules will be implemented in 2016 which reduces the risk of liquidity squeeze in the money market. As such, even in the event of equity market rally, we believe we are unlikely to see large outflows from the fixed income market into the equity market in 2016, which is supportive to demand in the fixed income market.
- **Reserve diversification inflows to RMB bond market.** With RMB inclusion into the SDR basket effective on October 1 2016, and China having liberalized access to the interbank bond and FX market by foreign monetary authorities, supranational agencies and foreign governments, we are likely to see growing reserve diversification inflows to the RMB fixed income market. We also expect inflows by foreign institutional investors as RMB QFII program continues to expand. We forecast about RMB500bn bond market inflows from foreign investors in 2016.
- **Credit risk remains high amid supply risk in 2016.** We believe the ongoing pressure of capacity reduction in certain sectors makes credit events in the bond market, the trust market and the bank loan market inevitable in 2016. On the other hand, measures to simplify issuance procedures and promoting direct financing (recently by the NDRC) in the corporate bond market allow more corporations to access the corporate bond market for financing. In our view, the combination of credit event risks and supply risk will keep investors highly selective in credit exposures.
- **Offshore RMB CCS market:** We expect the tightness in offshore RMB liquidity to persist for some time and we expect the basis between onshore and offshore money market rates to

narrow only after positioning in the offshore RMB FX market becomes more balanced. Offshore RMB liquidity renormalization is the key in reviving financing activities in the offshore RMB bond market. We forecast net issuance in the offshore RMB bond market to be modest at RMB50-100bn in 2016.

Trading strategy:

We forecast 10Y CGB yield to trade between 2.7-3.2%, 10Y CDBs between 3.1%-3.6% in 2016 and 5Y NDIRS to range between 2.2-2.8%. Our curve risk is neutral to slight steepening considering liquidity and growth risk. We recommend trade the cash CGBs and rates in these ranges with a long bias. We expect cash bond market demand to be supported mainly by commercial banks/policy banks, fund houses and insurance companies. On onshore credit, we expect IG sector to outperform and recommend add allocation of liquid IG names.

RMB weakness to continue into 2016

Following the 11 August devaluation, the PBoC has resisted currency depreciation via various measures ranging from FX interventions to the introduction of macro-prudential measures to limit outflows. In addition, various SAFE and PBoC officials have mooted the idea of introducing a "Tobin Tax" to discourage speculative trading. All are strong signals of the intensified official efforts to dampen speculation on the currency and slow capital outflows which have indeed been effective in the onshore market. Net FX purchases by financial institutions (including the PBoC) and net FX settlements and sales by Chinese banks on behalf of clients show that capital outflows have been decreasing. In October, net FX purchases by FIs increased by \$2bn during the month. Adjusting this series for "fundamental" flows (October net trade balance and net FDI transacted in foreign currencies) suggests China's FX outflow in October was \$49.3bn. This represents a third of the outflow during September and is the smallest outflow since July.

Despite the slowdown in outflows in the onshore market, USD/CNH continues to trade weaker than onshore spot CNY, particularly in recent weeks. In addition, CNH volatility and risk reversal skew remain high. This is because the market continues to believe the authorities' resistance to CNY depreciation is inconsistent with the country's weak underlying fundamentals, monetary easing bias and capital account liberalization plan

Hence, into 2016, we believe RMB depreciation will persist, albeit on a gradual basis. Why? First, despite the government efforts to slow outflows, we do believe onshore corporates will continue to remain active in repaying their external debt. This is due to (1) worry that RMB depreciation will persist and (2) ongoing