China Economy

We believe this is the best time for the bond market

Despite market hesitancy, we believe now is the best time for the bond market. The 10-year Treasury bond interest rate could fall to around 2.6%.

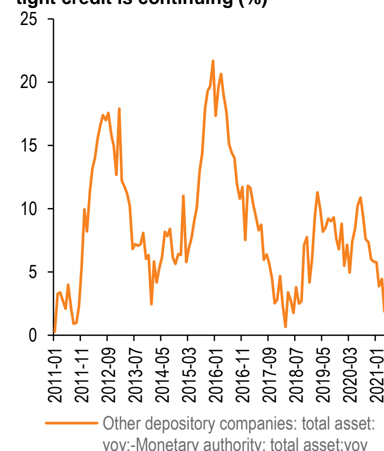
In our view, monetary easing has just begun and there is still room to break the lower limit to short-term interest rates. As fiscal transition requires policy coordination, the tight credit conditions are unlikely to change any time soon and should continue to dominate the short-term structure. We see allocation pressures at institutions due to asset shortages. The historical interest rate spread between the US and China is within the 70th percentile based on the past 10 years, while the term spread is in the 65th percentile. US short-term interest rates have continued to fall. While the Chinese economy and inflation rates have declined moderately, US interest rate and term spreads still hold compression room.

The market has yet to reach a consensus on the continuation of monetary easing. When monetary policy shifts toward a consensus, it would mean new downside potential in interest rates. When subsequent financial and credit policies are implemented, interest rates could begin to rebound.

Our asset allocation system increased bond interest rates three times in March, May and July 2021. Since an overall cut in the Deposit Reserve Ratio (DRR) in July, interest rates have fallen 25bp and market sentiment has grown apprehensive, due to concerns over fiscal policy and an acceleration in the supply of interest rate bonds. While the market continues to hesitate, we believe this is the best time for the bond market. We expect the 10-year Treasury bond interest rate to fall to about 2.6%.

Risks include: US currency contraction exceeding expectations; China's economic performance exceeding expectations; and the effects of fiscal policy relaxation exceeding expectations.

Bank-Central bank, B/S growth rate shows tight credit is continuing (%)



Source: Wind, Tianfeng Securities

The term spread is in the 65th percentile (%) (ten years vs one year)

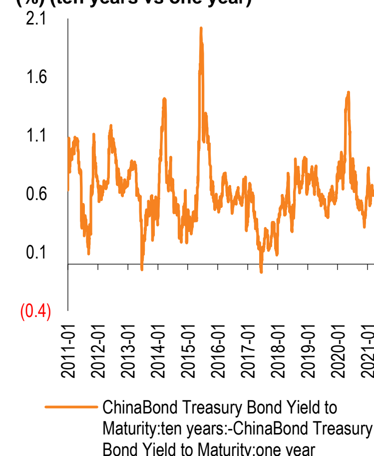


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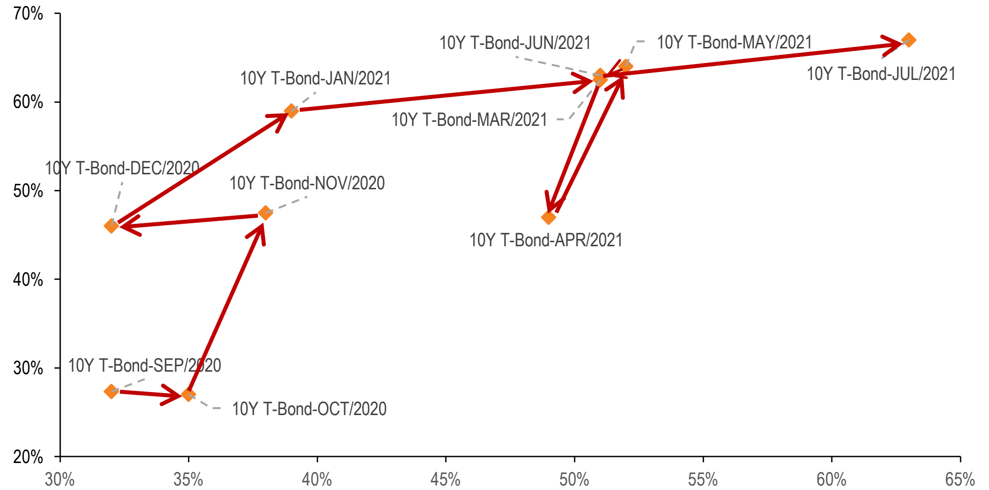
Chart 1: 10Y T-Bond Win rate vs Odds



Source: Wind, Tianfeng Securities

Monetary easing has just begun; downside potential to short-term interest rates

A shift toward macro-economic policy that factors in 2022E downside pressure

This is reflected in several recent key meetings. At the Economic Forum on 12 July, the Prime Minister noted "good cross-cyclical regulations are necessary to deal with cyclical risks for overall economic growth in 2H21 and 2022". At the 30 July Politburo meeting, the phrase "a window period with less pressure in order to stabilize growth" was deleted, while the new emphasis was to "do a good job in cross-cyclical adjustments and coordinate macroeconomic policy convergence over the next two years" and that monetary policy should "maintain reasonable and sufficient liquidity".

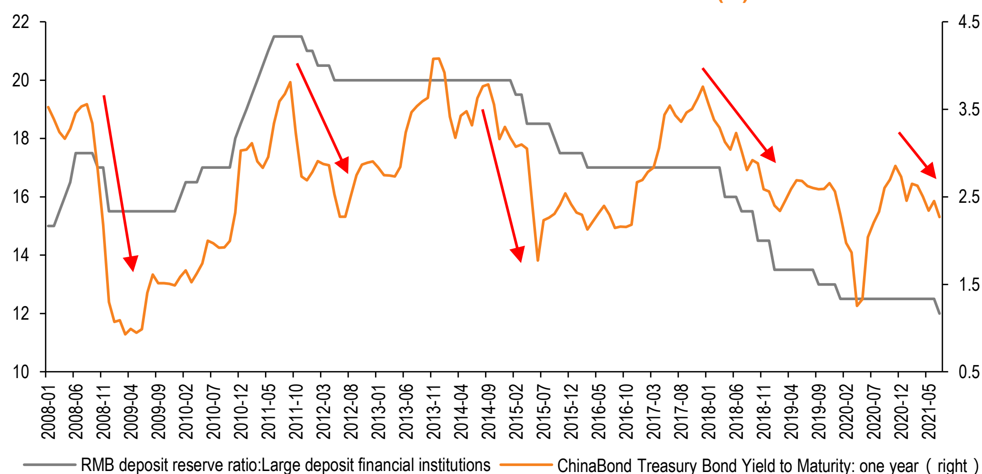
Forward-looking monetary policy, with a gradual relaxation in 2H21E

We expect an RRR cut in 2H21E, mainly to replace a large number of expiring MLFs, optimize the liability structure of financial institutions, and provide favorable conditions for credit easing. A decline in LPR quotations in 2H21 would only be a matter of time. While it would also be possible for the policy interest rate to be lowered in order to reduce corporate financing cost, the timing would be later than the RRR cut, which requires the confirmation of signs of increased downward pressure on the economy.

RRR and interest rate cuts could add downside potential for short-term interest rates

We note the one-year downside potential in treasury bond interest rates before and after the previous RRR cut cycle. RRR reduced 200bp from August 2008 to January 2009, and interest rates fell 249bp; RRR reduced 150bp from September 2011 to June 2012 and interest rates fell 154bp; RRR reduced 300bp from December 2012 to March 2016 and interest rates fell 117bp; RRR reduced 350bp from December 2017 to February 2019 and interest rates fell 142bp.

Chart 2: Maximum downside of short-end interest rates after RRR cut (%)



Source: Wind, Tianfeng Securities

Besides directly lowering policy interest rates, interest rate cuts could also take the form of targeted rate cuts

At a 2H work conference, China's central bank stated that it would "promote the implementation of carbon emission reduction support tools, provide low-cost funds to qualified financial institutions, and guide financial institutions to provide preferential interest rate financing for key areas with significant emission reduction effects."

One form is similar to the Targeted Medium-term Lending Facility (TMLF) in 2018, which complies with medium and large-sized commercial banks to provide long-term money below the rate of the Mid-term Loan Facility (MLF), the amount for which depends on the support power of carbon reduction efforts. Another form is low-interest re-loans, targeting small and medium-sized commercial banks to increase their support for carbon emission reduction.

Tight credit conditions unlikely to change any time soon

A Politburo meeting on 30 July stated that "a proactive fiscal policy enhances the effectiveness of the policy, factors in the schedules of budget investment and local government bond issuance, and promotes the physical workload early next year." Thus, the market has loosening fiscal policy expectations for 2H21.

We don't expect a fast fiscal policy turnaround in 2H21; credit could remain structurally tight

A fiscal policy shift is not as simple as accelerating the issuance of special purpose bonds. Special purpose bonds increased by RMB3.75tr in 2020 with RMB1tr more special purpose treasury bonds, but the annual infrastructure growth rate was only 3.4%, slightly higher than 3.3% in 2019 years. The reason was that the general environment for regulating and rectifying local fiscal discipline had not changed, and financial regulatory policies that were indirectly related to local government investments, such as new asset management regulations restricting shadow banking and tightening of the real estate sector, had not changed. The result is that the scale of fiscal debt is large but the expenditure progress is slow with rising fiscal deposits.

A fiscal policy shift requires coordination of financial supervision and local government assessment guidance, among other things

This year, the Ministry of Finance issued the "Local Government Special Bond Project Fund Performance Management Measures", China Banking Regulatory Commission No.15 and other standardized documents. The new asset management regulations are in the last year of the transition period, and the real estate policy is still under strong pressure. Currently, as the economy's downtrend is not obvious, the probability of a series of policy changes in the

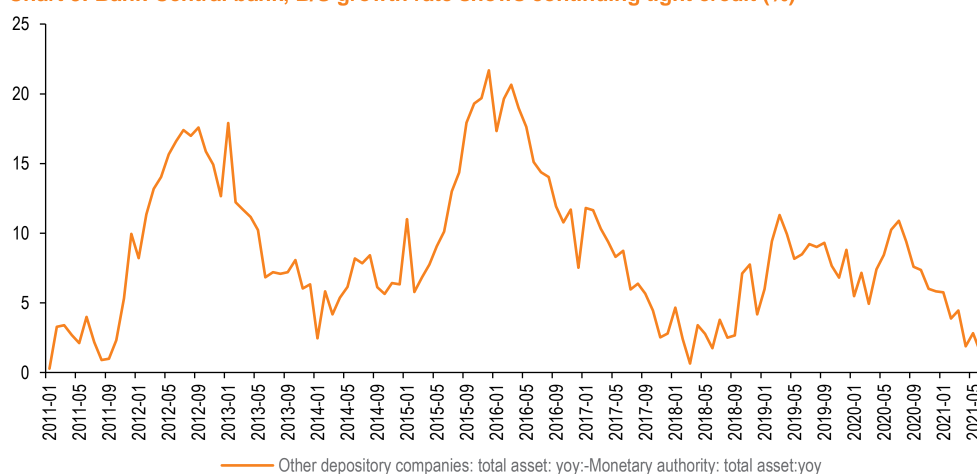
short term is unlikely, so we believe structurally tight credit will continue. If there were to be a policy shift, we would expect to observe more visible signals.

Marginal shift in fiscal policy likely to occur end-2021/early 2022 in view of economic downward pressure in 2022E

According to 21st Century Business, the National Development and Reform Commission issued a notice in mid-July to local governments about to the "early issuance and usage of special purpose bonds next year and to structure physical workloads so as to promote stable growth in investment". Therefore, the key to fiscal policy is not "post-active this year" but "pro-active next year".

In a structurally tight credit environment, interest rate bonds are in short supply. Bank allocation pressure leaves little room for an interest rate rebound. Even if the issuance of special purpose bonds accelerates in 2H21, considering monetary policy, supply would have no influence on interest rate trends. When fiscal and credit easing policies are implemented, demand factors would have an impact on interest rate trends.

Chart 3: Bank-Central bank, B/S growth rate shows continuing tight credit (%)



Source: Wind, Tianfeng Securities

Inflation and US debt have both declined, so there is room for further spread compression between maturity and China-US interest rates

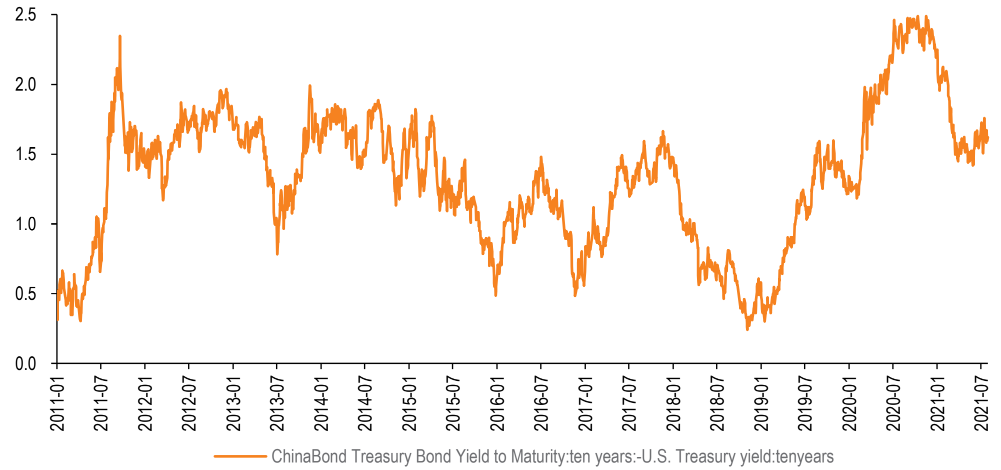
According to China Central Depository & Clearing, foreign inter-bank domestic bond holdings increased by RMB490bn from January to July this year, and the proportion of debt holdings increased to 4.3% from 3.9% at the end of last year. This included an increase in holdings of RMB75.3bn in July alone. Foreign investments have accelerated the allocation of Chinese bonds. China-US spreads are at a high level, with the current 10-year Treasury bond spread above 160bp, while historically it has been within the 70th percentile in the past decade, with greater compressible margins. The China-Germany 10-year treasury spread is above 300bp.

US interest rates may not bottom out in the short term

Due to a clear decline in credit derivation capacity, liquidity from a closed-loop structure-fiscal expansion (issuance of bonds) have reduced Treasury General Accounts (TGA), the Fed has expanded the forms of debt purchases, transformed fiscal investment into bank reserves and money market funds through deposits of residents and corporates, which ultimately flow back into the Federal Reserve through overnight reverse repurchases. The TGA pressure drop, QE purchases and reduction in the issuance of Treasury bonds — these three moves have jointly exacerbated the shortfall in US debt supply and accelerated the decline in interest rates. Before the above-mentioned environment changed the closed-loop liquidity structure, US bond interest rates had been mainly facing short-term downward pressure.

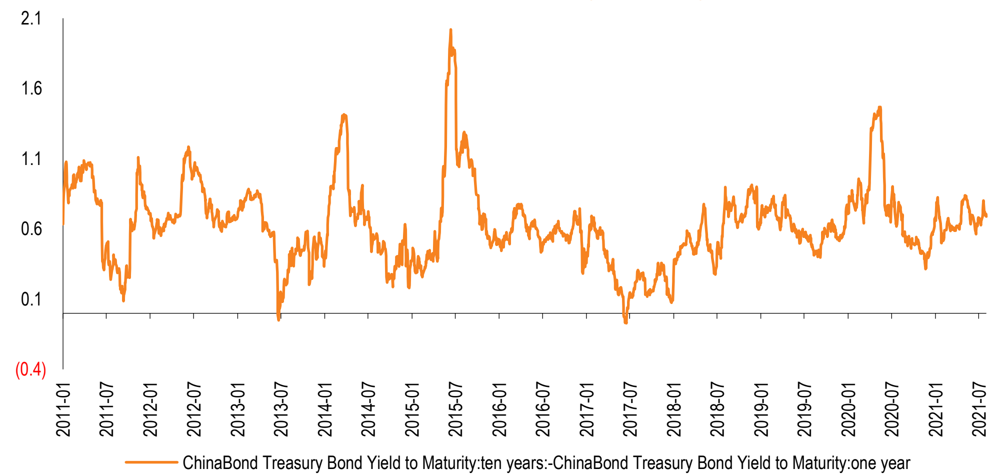
For China, we expect the economy and inflation rates to decline moderately in 2H21. The spread between 10-year and 1-year Treasury bonds has been in the 65th quintile over the past 10 years. There is also room for compression of the maturity spread. WE expect the 10-year Treasury bond interest rate to drop to about 2.6%.

Chart 4: The historical interest rate spread between the US and China is within the 70th percentile based on the past 10 years (%)



Source: Wind, Tianfeng Securities

Chart 5: The term spread is in the 65th percentile (%) (10 years vs 1 year)



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