

Understanding the Global Financial Markets



Trading Jargon

- Long vs short
- Bulls VS Bears
- Hawks VS Doves
- Risk On/ Risk Off



FTSE MIB, FTSE 100, DAX, CAC 40, S&P 500, NASDAQ 100,
DJ INDUSTR AVERAGE, NIKKEI 255, S&P/ASX 100, SMI,
IBEX35, BOVESPA, BUENOS AIRES MERVAL, IPC, MUMBAI
SENSEX

- Short Squeeze.
- Bernanke Put
- Safe Haven/ Flight to quality

Global Markets

Smart
Money

Dumb
Money

Fixed
Income

Commodity

FX

Equity

Simple Market Model

- Risk- ON

- Equity



- Bond Yields



- Commodities



- USD



- Risk- Off

- Equity



- Bond Yields



- Commodities



- USD



QUOTABLE QUOTES

- "Bulls make money, bears make money, pigs get slaughtered"

Anon

- "This is worse than a divorce. I lost half my wealth and I've still got my wife"

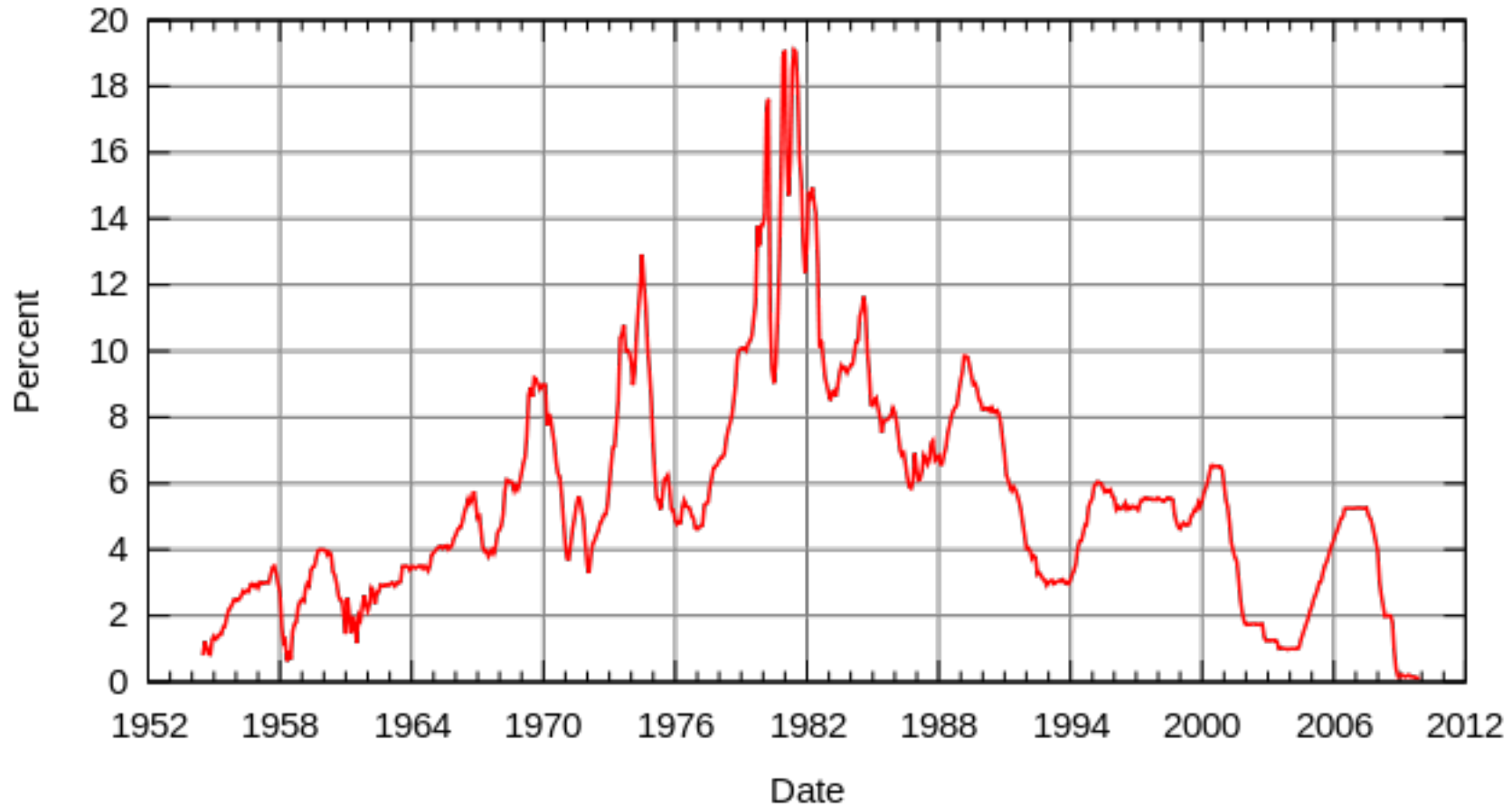
Anonymous Trader on Financial Crisis.

The FED

DON'T FIGHT THE FED

Fed Funds Rate: US policy rate

Federal Funds Rate (effective)
July 1954 to December 2009



Recent Financial Crises

- European Debt Crisis (2010 till ??)
- Global Financial crisis (2008 till ??)
 - Subprime/ Lehman Brothers
- Dotcom Bubbles(1995-2000)
- Asian Financial Crisis (1997-1998)

Subprime Crisis Explained in 5 mins

- [Subprime BBC](#)
- What exactly is subprime mortgage?
- Did Lehman Brothers cause the financial crisis?

Legacy of the market efficiency

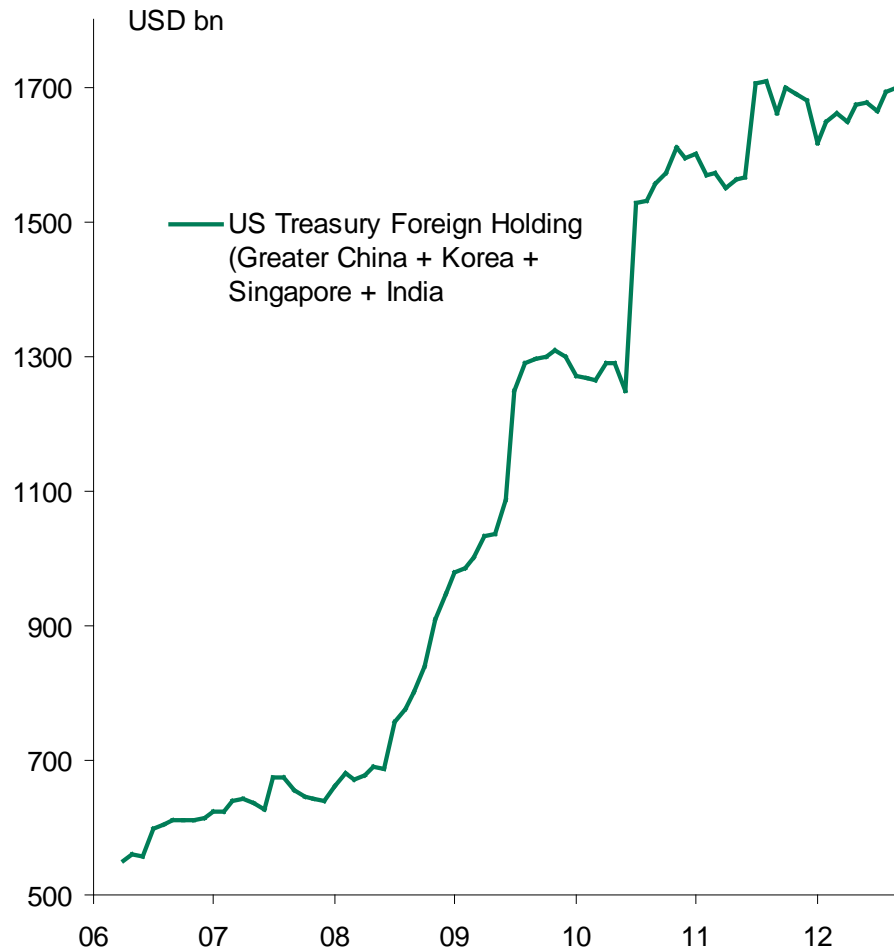
THE GLOBAL FINANCIAL CRISIS. (2007- 20XX)

THE GFC in a nutshell

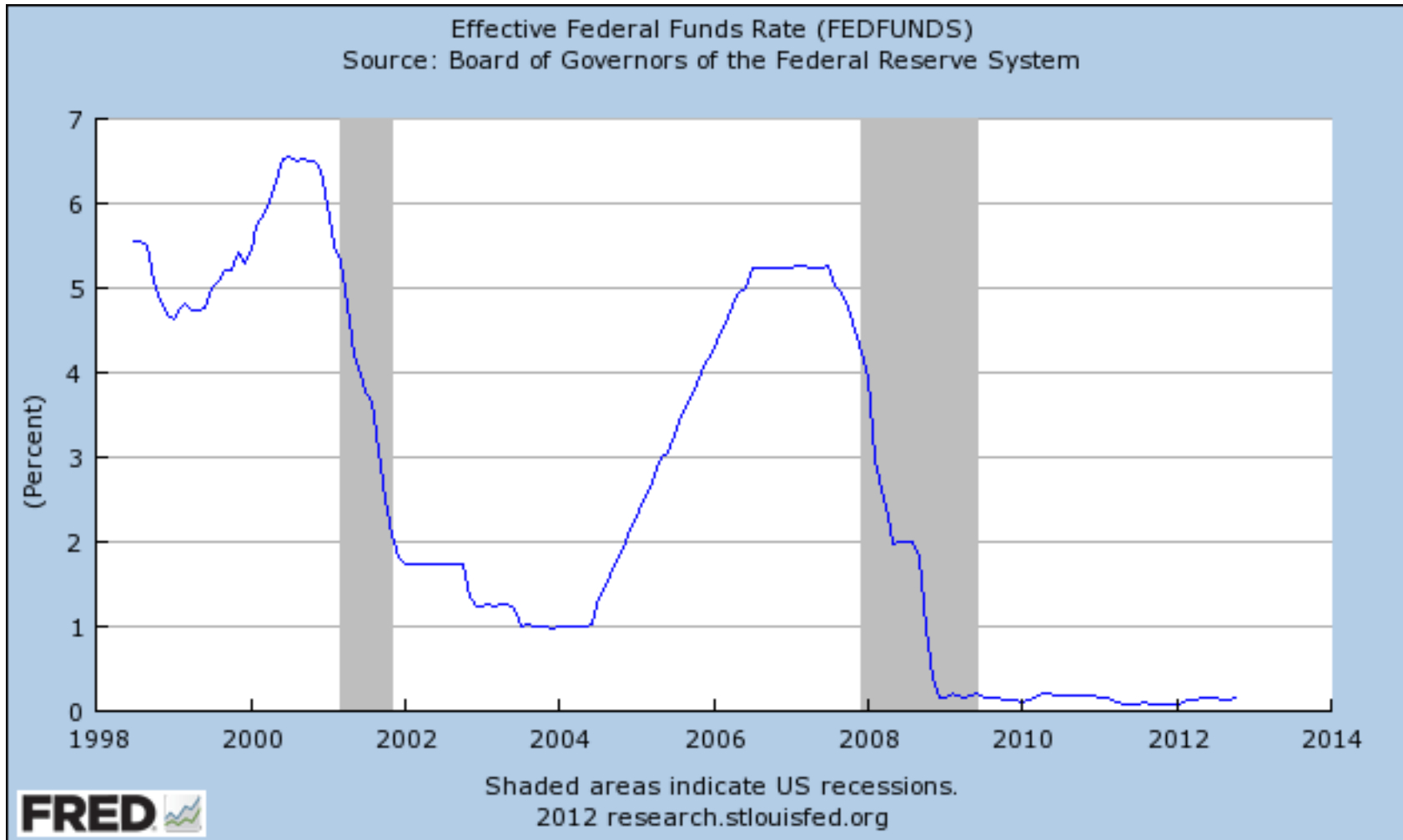
- Policy Rate remained too low for too long
 - This was called the Greenspan Put
 - Housing Boom and Credit Boom
 - lowering credit standards (NINJA)
 - Foreign Central Banks played a key role in keeping treasury yields down (why?)



The US relies on the kindness of strangers

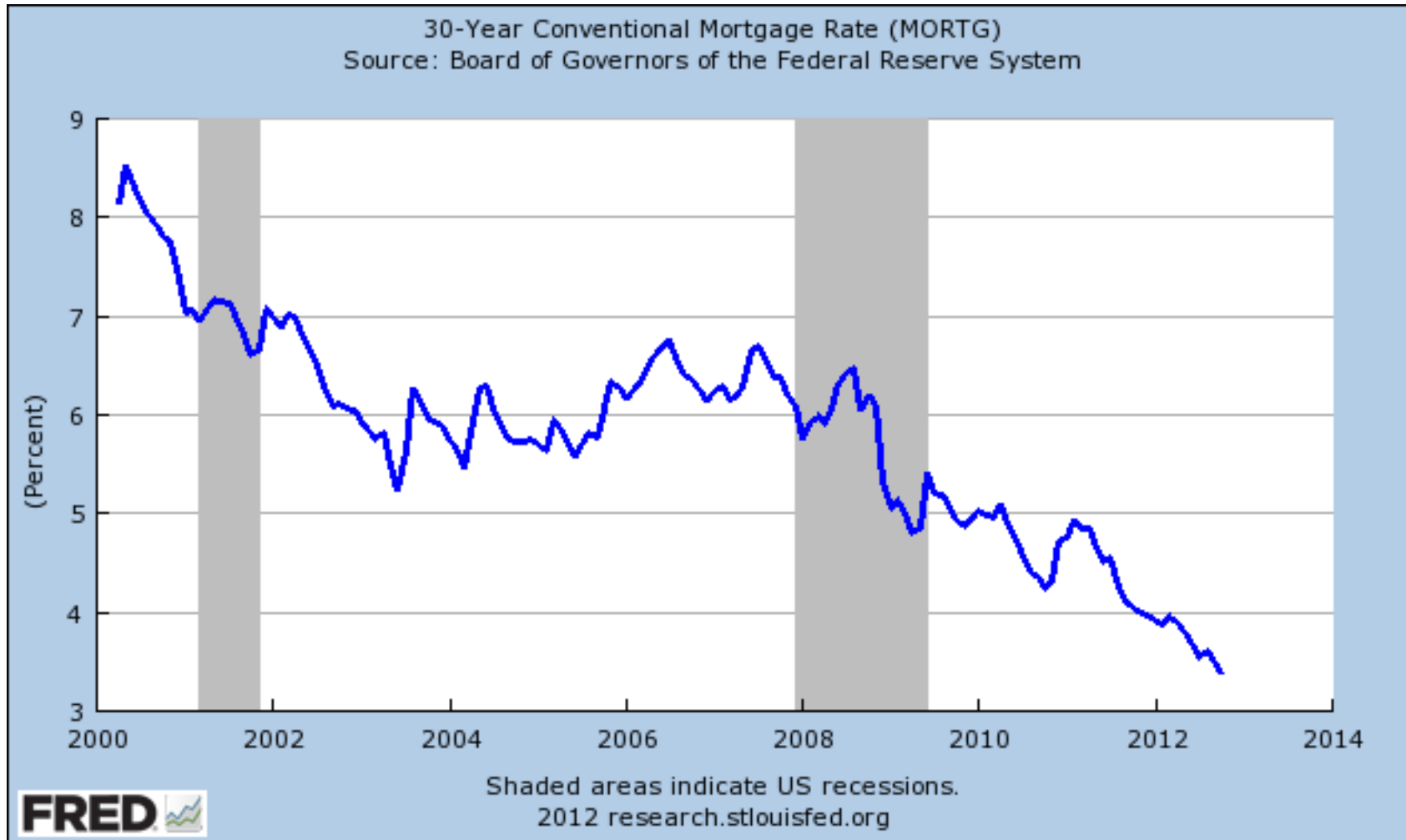


Policy Rate: too low for too long

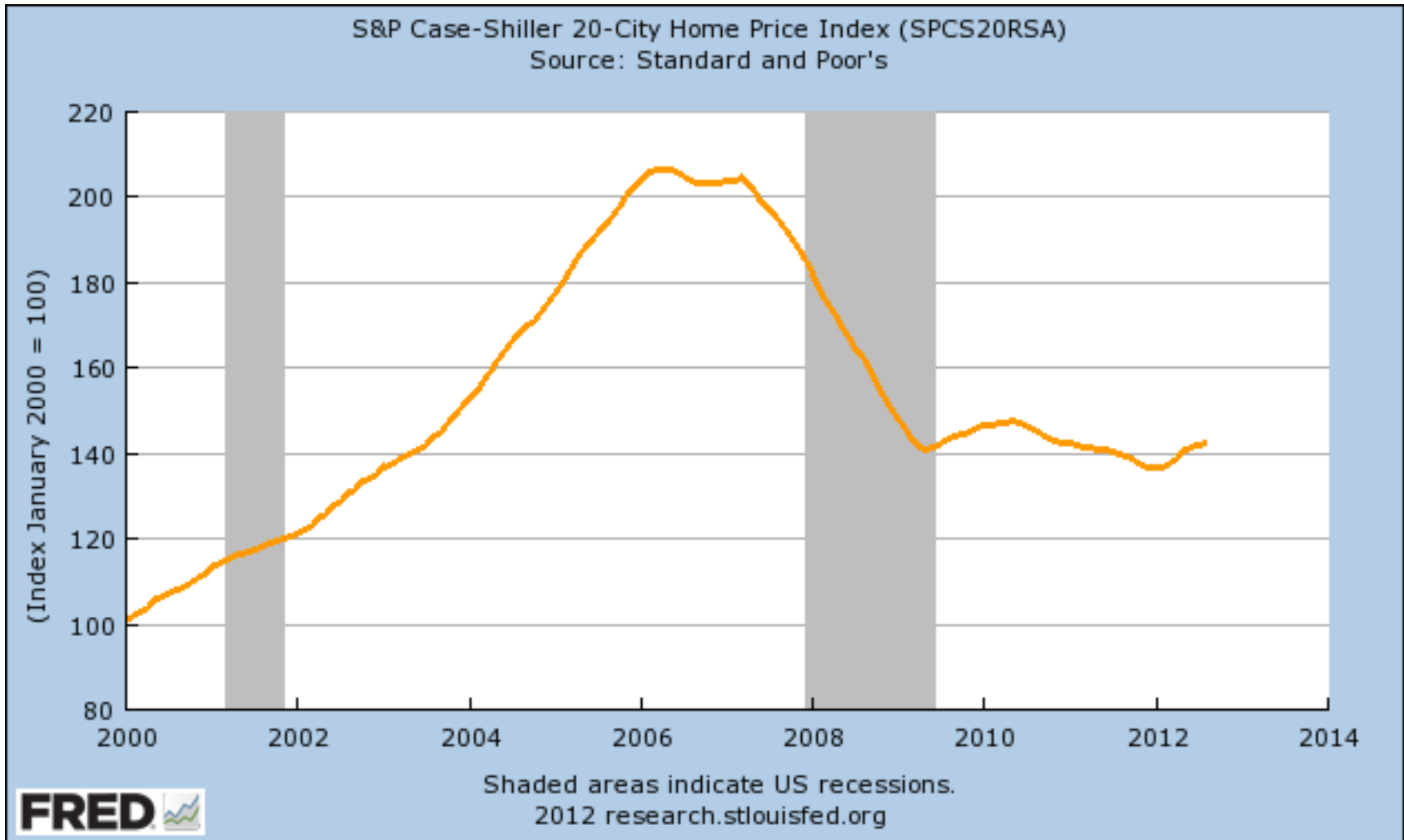


Always behind the curve

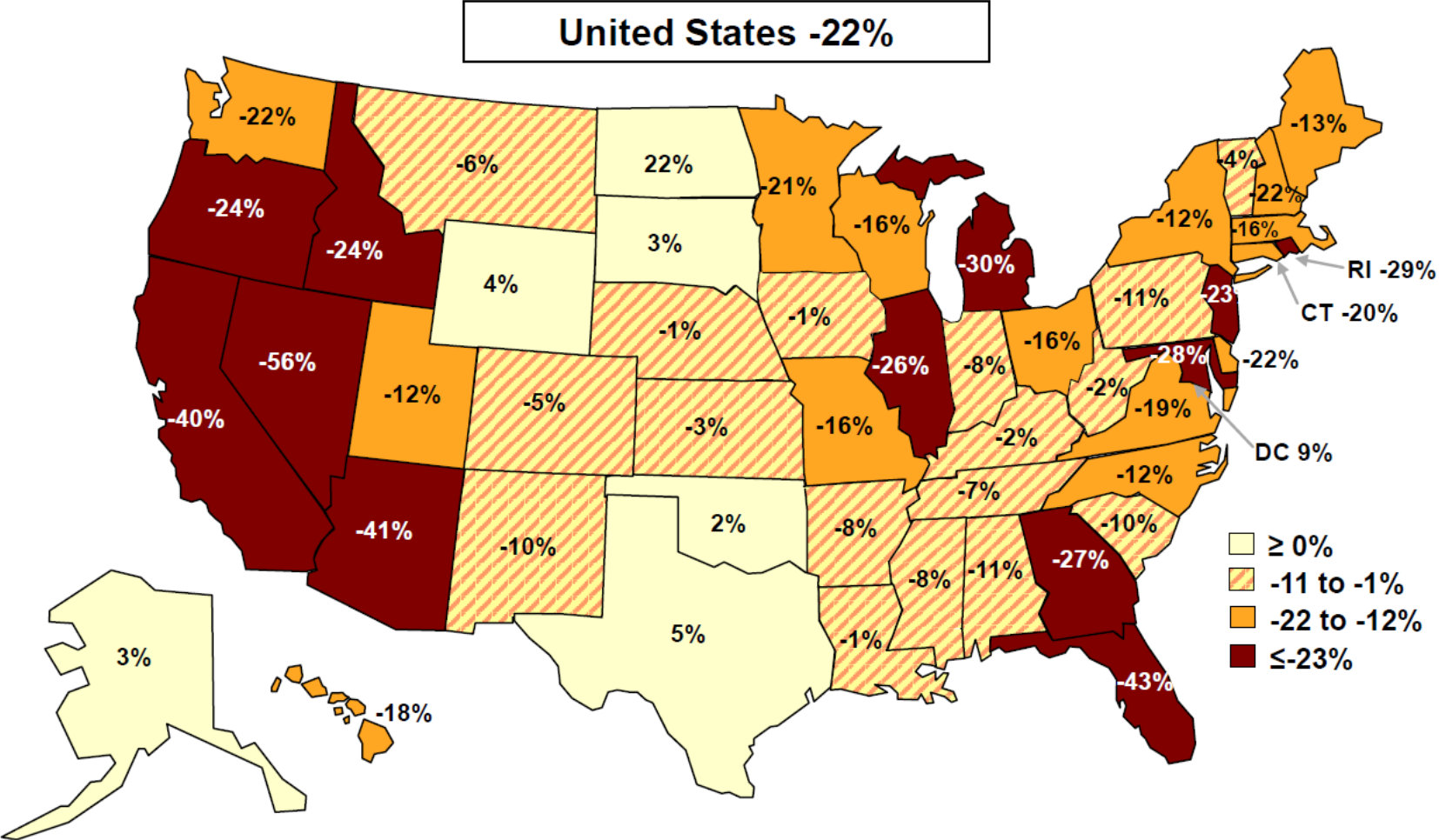
Fed-induced Mortgage Boom



House Prices: Boom and Bust



Home Price June2006- September2012



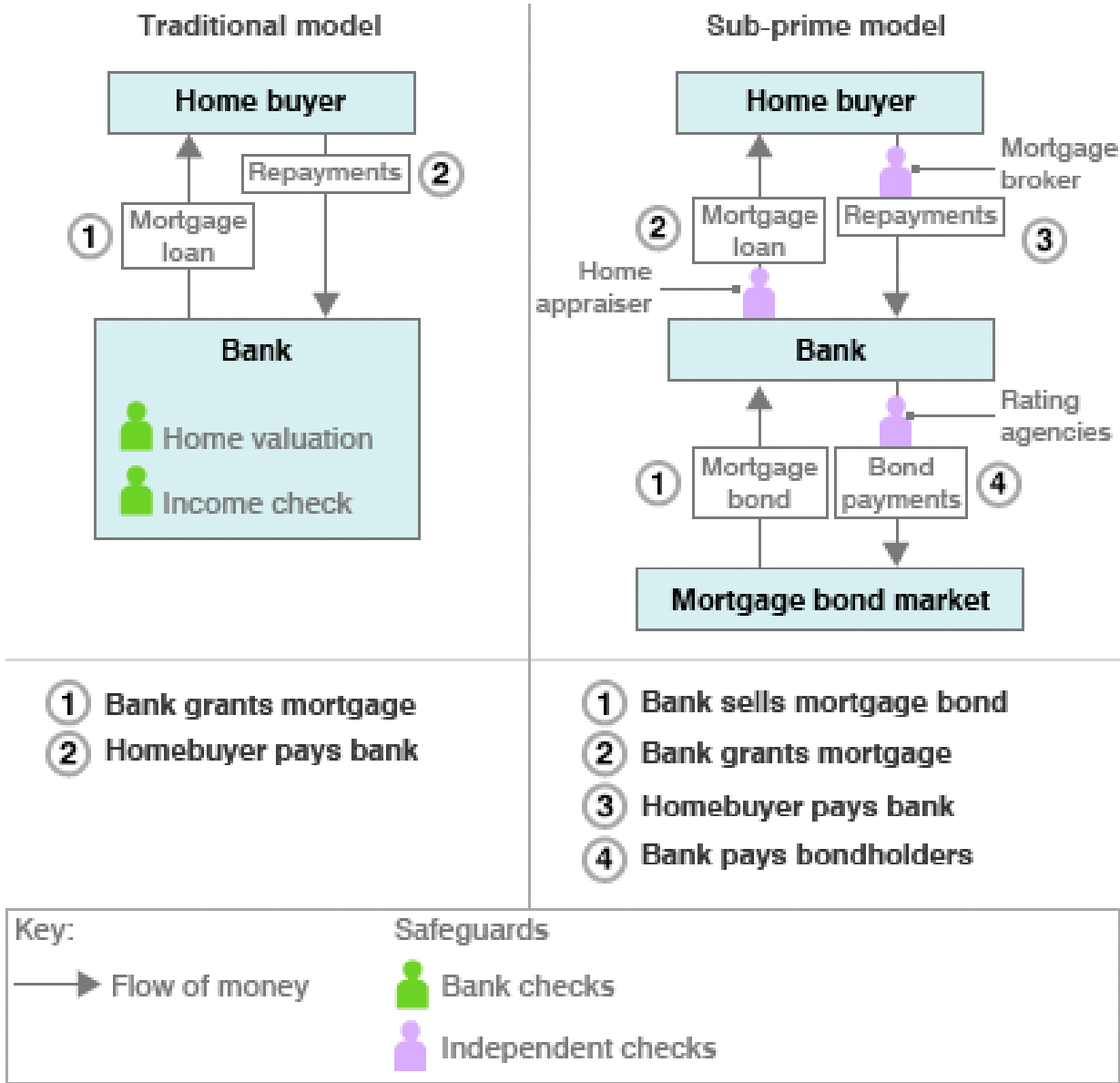
Prices have yet to recover to pre-crisis level

- Securitization

- Banks can “outsource and sell risks” instead of holding the loans

- Mortgage backed security

Securitisation

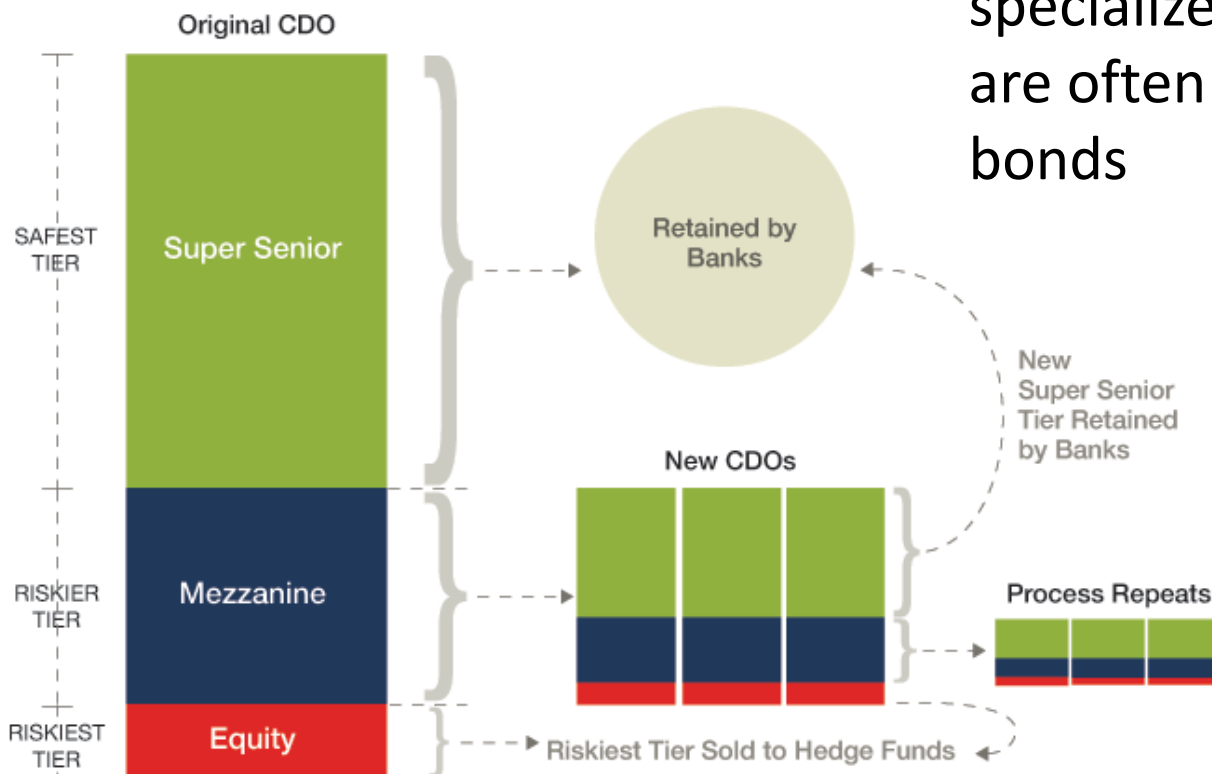


- Banks earned fees instead of interests on mortgages
- Therefore, no incentives to be thorough with applicants.
- Rating Agencies received fee for stamping approval seals on these “dodgy” mortgages.
- None were held accountable for losses

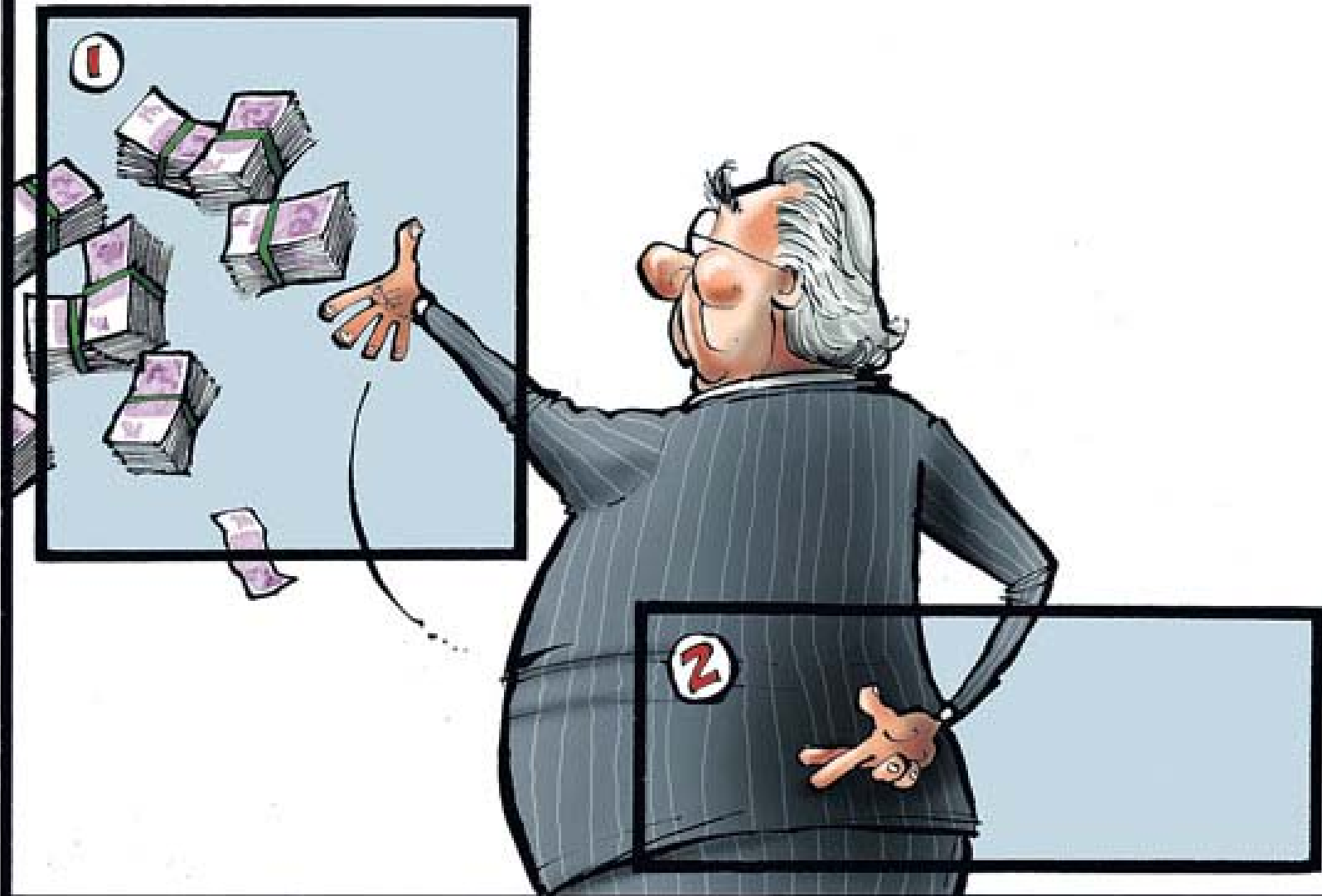
- CDO (Collateralized Debt Obligations)
 - Credit Rating Agency helped legitimize the “slicing and dicing”
 - Theoretically risks were spread as opposed to concentrated
 - Instead, risks were unidentified and widespread
- CDS (Credit Default Swaps) hedging
 - AIG collapse would have led to a complete meltdown
 - Financial Weapons of Mass Destruction
- Reckless Lending and Borrowing led to a credit crunch.

CDO- collateralized debt obligation

An investment-grade security backed by a pool of bonds, loans and other assets. CDOs do not specialize in one type of debt but are often non-mortgage loans or bonds



QUANTITATIVE EASING EXPLAINED:



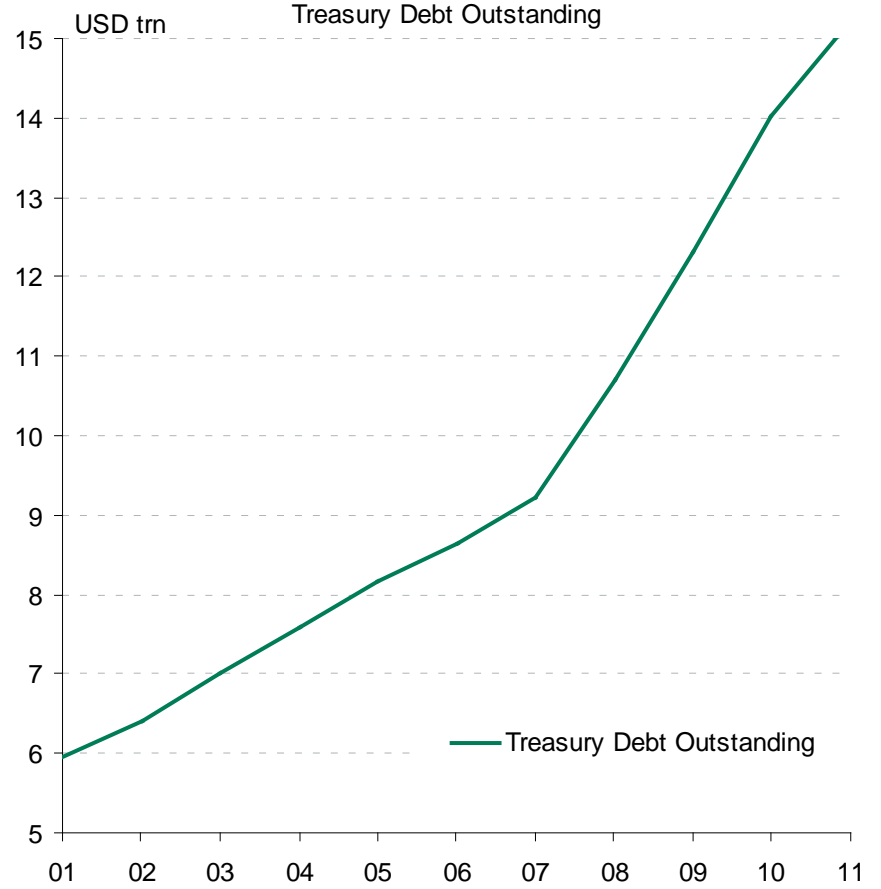
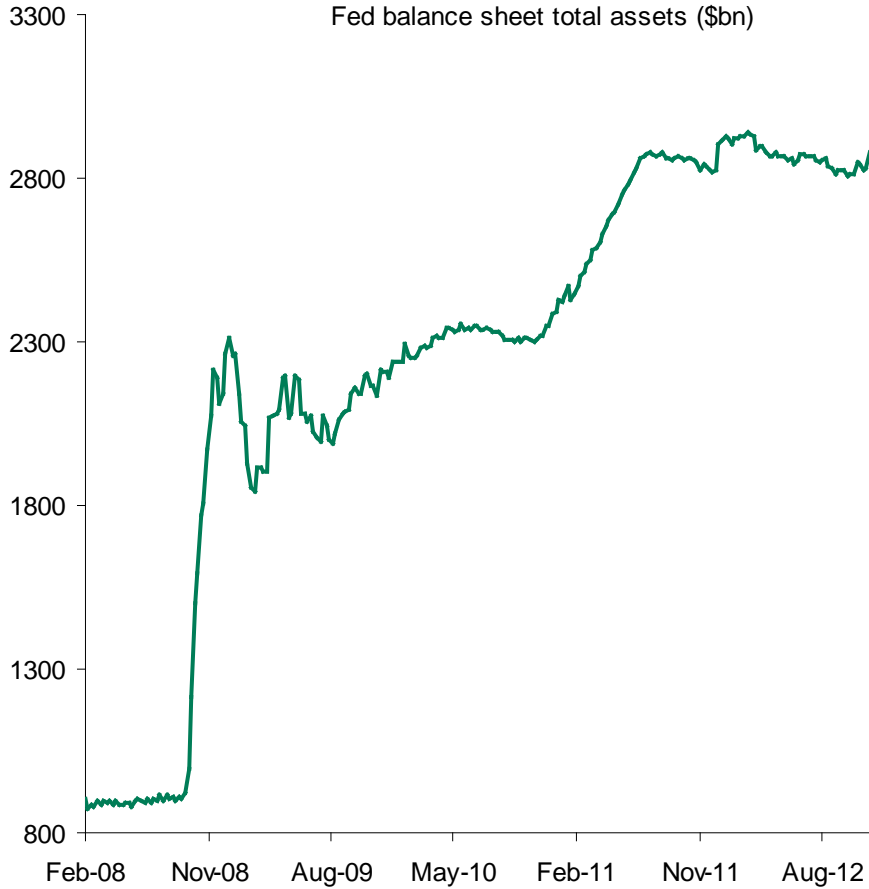
Adams 09

How did we get from “conventional” to “unconventional” ?

- The question is will the unconventional become conventional?
- The Bank of Japan has done quantitative easing for 17 times since 1990
- What separates conventional from unconventional?

- Conventional : interest rate policy
- Do banks follow the central bank rate announcement?
- Open Market Operations.
- Interest Rates went to practically zero (Pushing on a string) in the process of stimulating the economy
 - Bernanke Put (2008) , Greenspan Put (2000)
- Unconventional : Policy rate at zero or negative
- Quantitative Easing- Fed prints money to buy assets (Treasuries, MBS)
- Balance Sheet instrument (if in doubt, keep on buying)

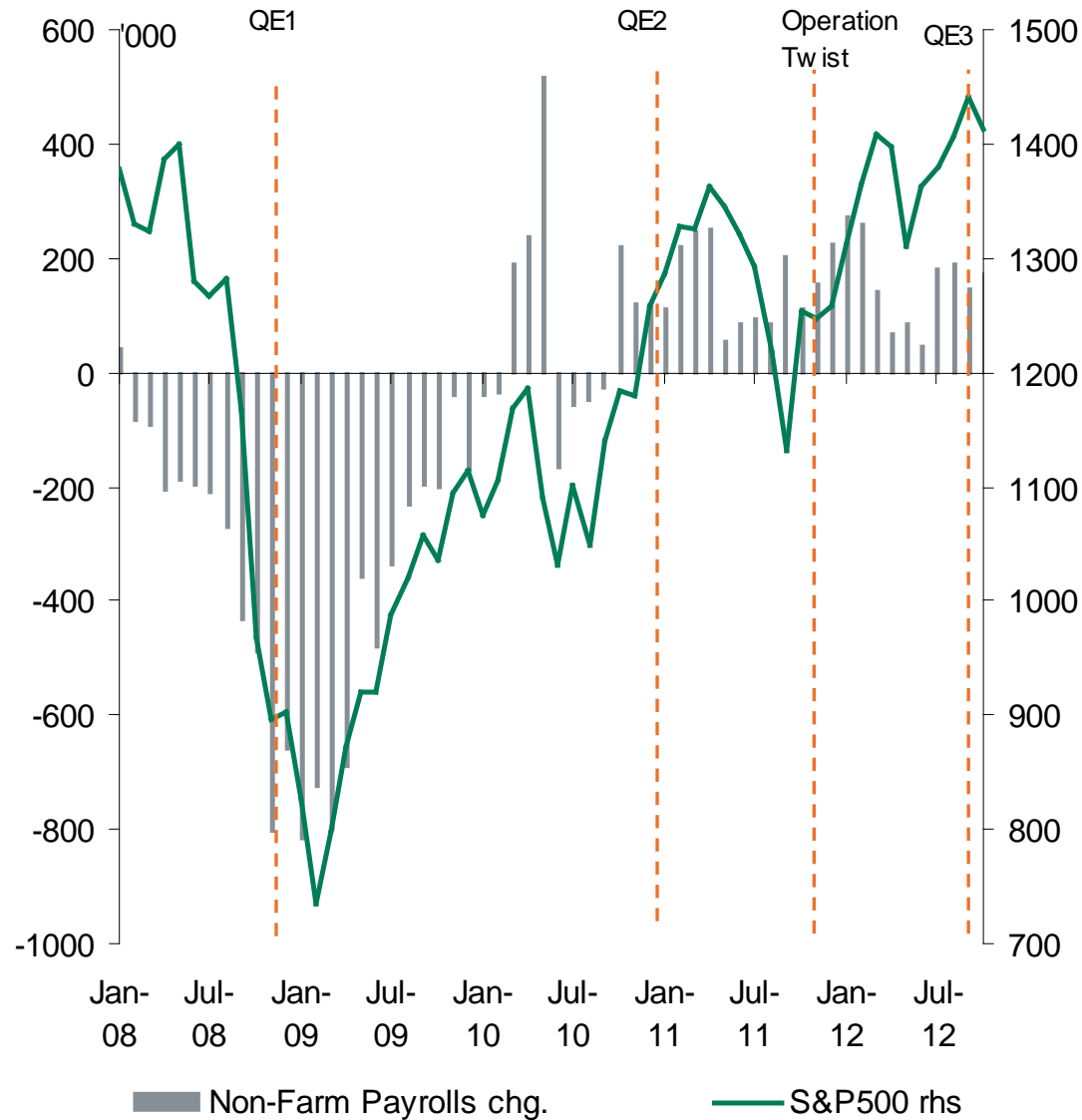
Fiscal and Monetary Stimulus



5 years on: are we out of the woods yet?

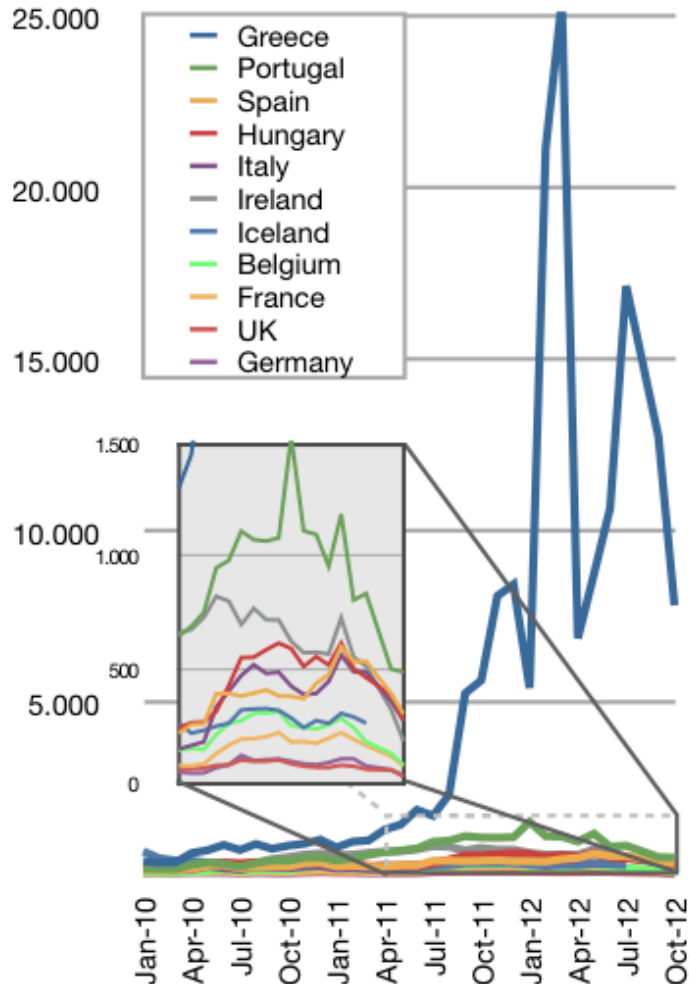
- The FED has started reducing the asset purchase or tapering.
- Are markets addicted to “free” money?
- Bad news is good news in the unconventional world !!!! (markets wanted more QE)

Markets love the QE



European Crisis

Sovereign Credit Default Swaps



A **credit default swap (CDS)** is a financial swap agreement that the seller of the CDS will compensate the buyer in the event of a loan default or other credit event.

The buyer of the CDS makes a series of payments (the CDS "fee" or "spread") to the seller and, in exchange, receives a payoff if the loan defaults.

Endangered Currency

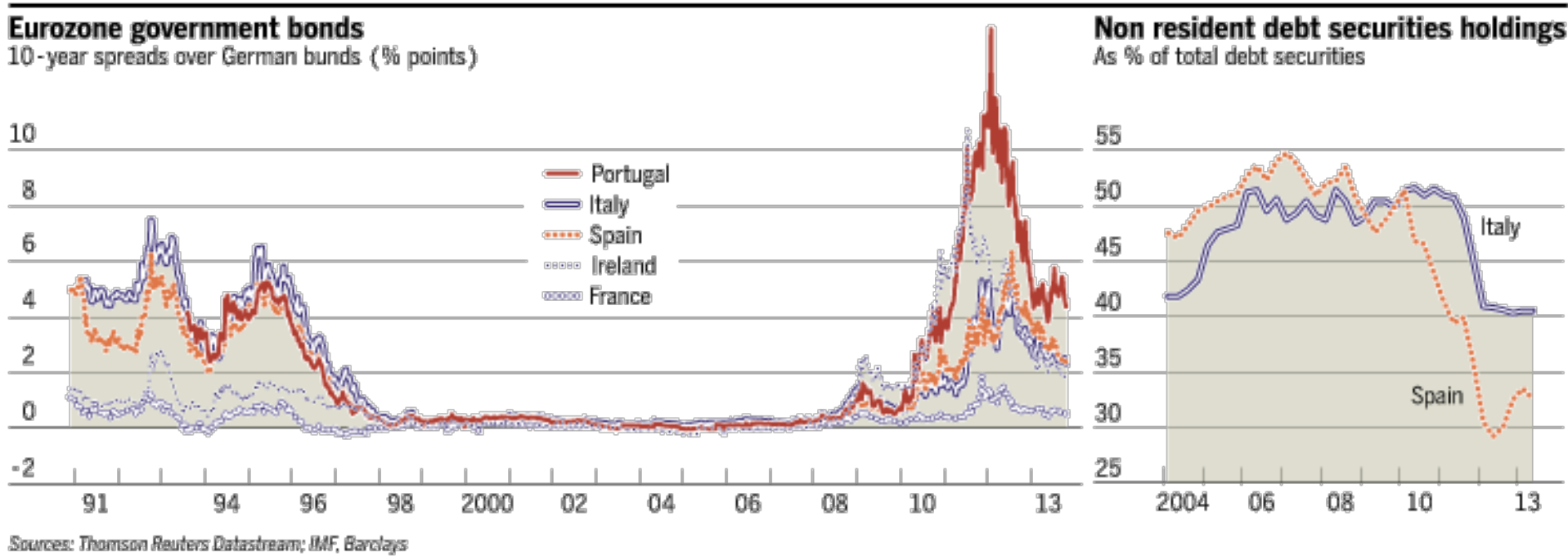
First Greece -- then Ireland, Italy, Spain and Portugal: The European common currency has come under pressure from large national debts and the effects of the global financial crisis, ultimately requiring a rescue package close to a trillion euros.



DPA

THE EURO CRISIS

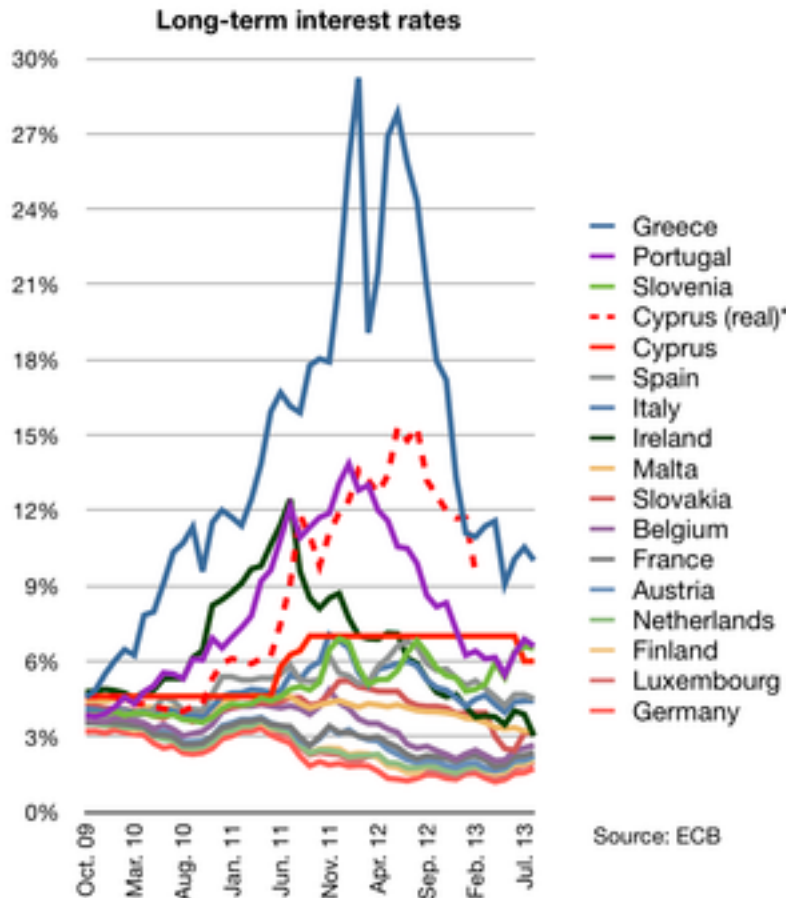
Convergence No More



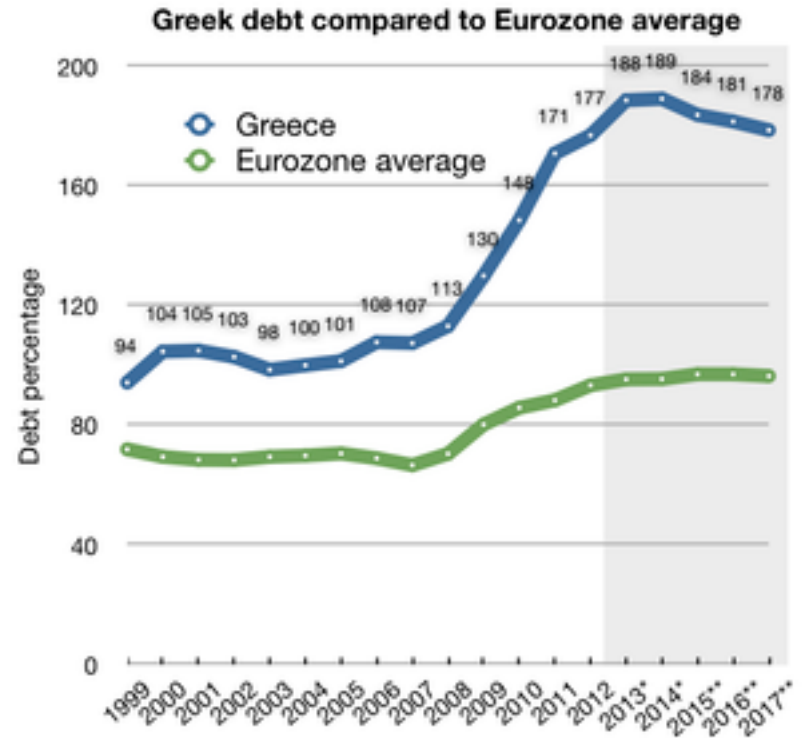
The euro's launch in 1999 was the biggest achievement in Europe's post second world war drive to bring together the region's economies. The impact on sovereign bond markets was dramatic. During the late 1990s yields converged as investors began to think in terms of a single eurozone market. The risks of a country defaulting, or exiting the eurozone, were ignored.

The complacent mood was shattered in 2009 when the escalating debt problems of Greece erupted into a crisis. Soaring "spreads" on the debt of governments in the eurozone "periphery" – southern Europe and Ireland – threatened the sustainability of public finances. They prompted sweeping changes by policy makers, including the launch of an emergency government bailout fund.

Can a country go bust?



* actual market trade values without cut-off yield



Source: Eurostat (1/2013)

*estimates

**estimates from Ernst & Young using data from Oxford Economics (3/2013)

ART BY [unreadable]

"PIIGS"



Why couldn't they do QE and bail the greeks out?

- The Germans wouldn't have it. (why)
- Bundesbank and the Weimar Republic



- ECB is not allowed to purchase bonds directly (Monetisation)
- Explicit Bailouts are not allowed in the EU constitution

Whatever it takes, even if it s a bluff



French Bank Experience

- Credit Agricole had trouble raising USD funding in 2011
- CA had to shut down many international branches including Thailand
- CA had to pay excessively high rates to obtain USD deposits
- SocGen and Hermes

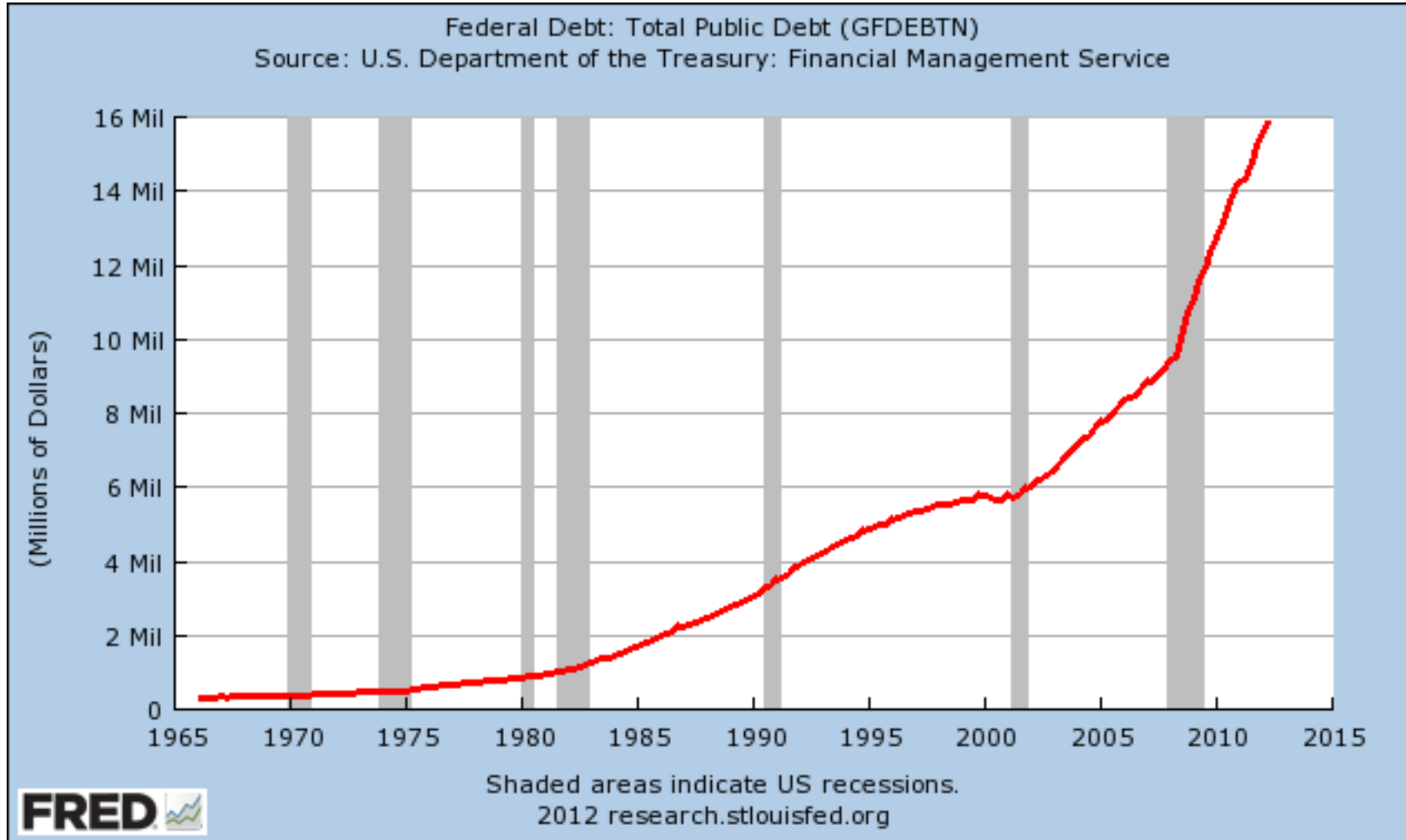


Is the crisis over?

- So Far the markets believed the Draghi “whatever it takes”
- No one knows how it is going to pan out
- Will the europeans stick to tough reforms?
 - (Hollande is currently highly unpopular in France 23% Approval rating)
- Watch the spreads (Spain-Germany, Italy- Germany)

Current market environment

Another Debt Ceiling will be reached soon (dec 12)



Debt Ceiling (again!!)

- [US DEBT](#)

October 9, 2013 9:12 am

Collateral crunch feared as T-bill yields leap

The flight from near-term bills could have major repercussions for key [financing markets](#) as Treasury collateral is widely used by central banks, sovereign wealth managers, banks, custodians and other investors for borrowing short-term cash and supporting derivatives positions and other types of trading.

The longer the stand-off in Washington continues, so the risk grows that certain Treasury securities start to be seen as too risky to take as collateral for the short-term loans that underpin this financing, via the vast “repo market”.

- If US creditworthiness becomes suspect, current uses of Treasury securities as collateral in the repo market may become impaired. The current debt ceiling impasse is evident in the repo futures market pricing. Disruptive interest rate dynamics could make it difficult for levered fixed-income investors to hold their positions. This creates potential for disorderly unwinding in a low liquidity environment.

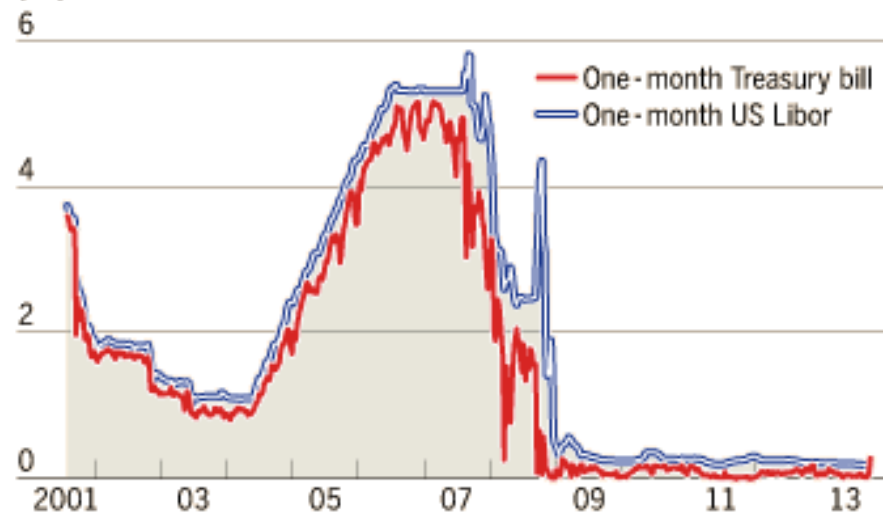
Burgeoning disruptions are already evident in a variety of technical financial markets. The yield on one-month T-bills has overtaken the one-month interbank lending rate, known as Libor, for the first time in a dozen years.

The curve in credit default swaps (CDS) on US debt has also inverted – indicating that purchasers of the derivatives are, in theory, pricing in a higher risk of default in the short term than in the longer term.

CDS on US government debt has doubled in the past month and trading volumes have jumped as a growing number of investors have bought the instruments, seeking protection against a potential default or making bets on **subtle movements** in the derivatives.

T-bill yields overtake Libor for first time in dozen years, while US sovereign CDS costs double in past month

US interest rates
(%)



Sources: Thomson Reuters Datastream; Markit

Cost of insuring against US government default
(CDS spreads, basis points)

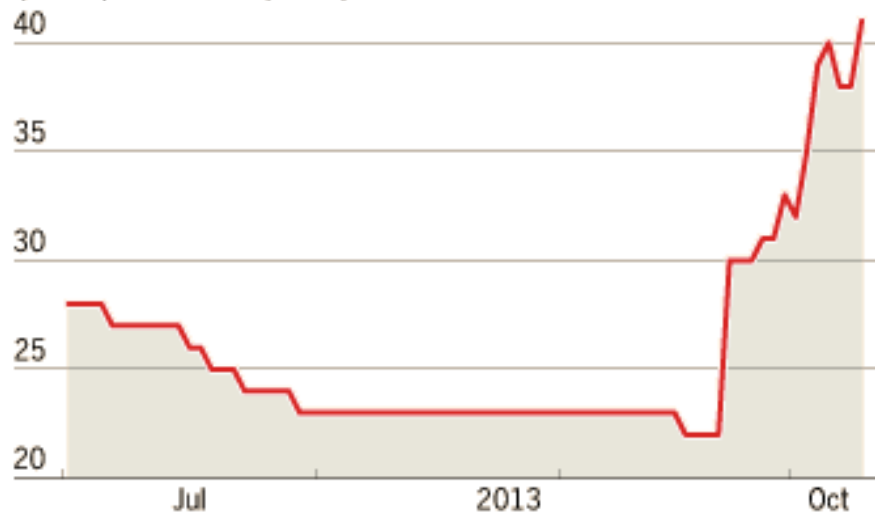
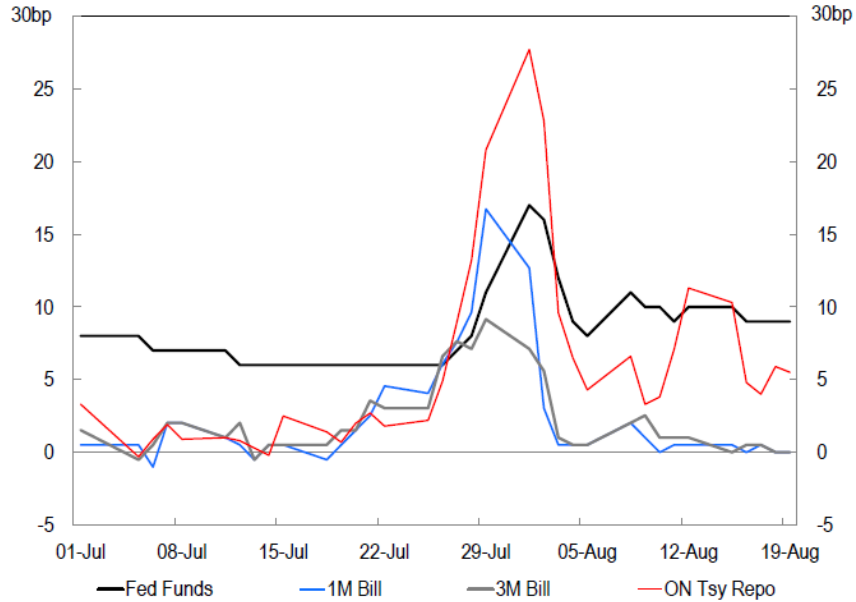
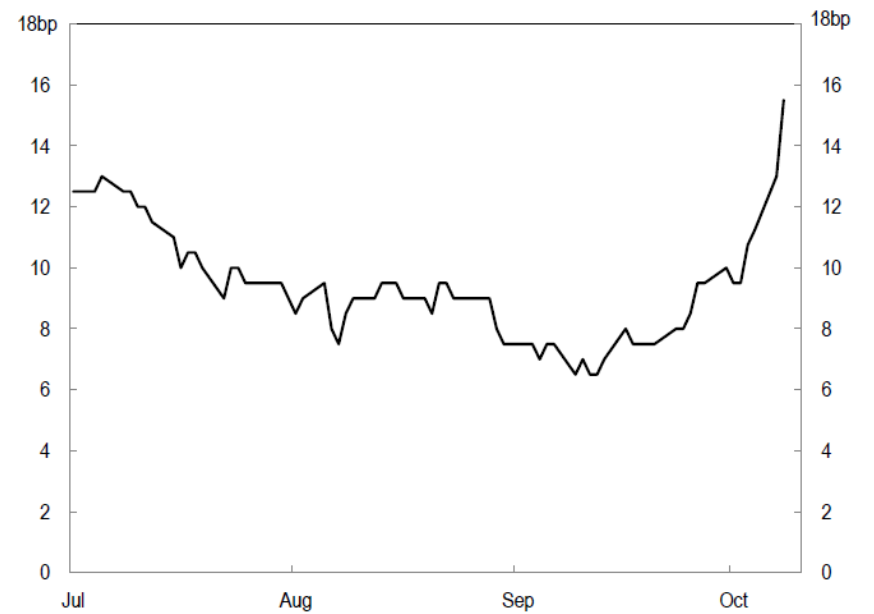


Figure 2. Short-Term Interest Rate Reaction to Debt Ceiling Debate, 2011



Source: Bloomberg.

Figure 3. October Treasury Repo Futures Yield, Jul 13-8 Oct 13



Source: Bloomberg.

Repo- Repurchase Agreement

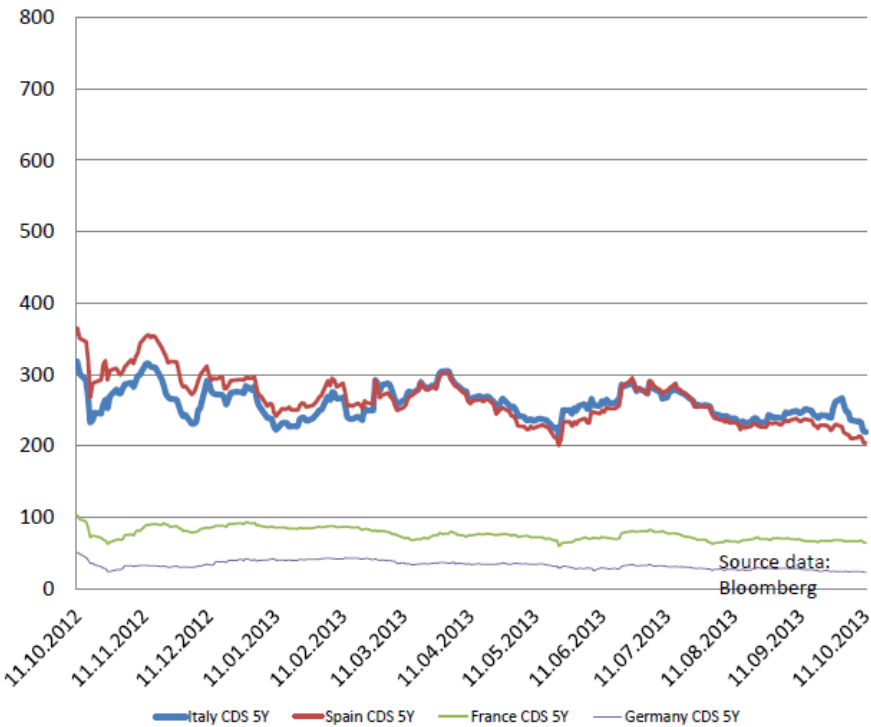
- Collateralised lending
- Repo Rate is normally lower than Libor. (why)
- Can repo rate be negative? Why
- Traders use repo to fund their positions.

CDS

- Credit Default Swap: cost of protection against a credit event. (a bit like a car insurance, fire insurance)
- Single name CDS (e.g. Lehman Brothers)
- Index CDS: iTraxx (EU) and CDX (US)
- Ban on naked CDS (imagine buying a fire insurance on your neighbour's house)

CDS

5-Year Government CDS (in bps)



5-Year European CDS indices (in bps)



<HELP> for explanation, <MENU> for similar functions.
 Screen Printed

97) Settings		99) Feedback		CDS Index Monitor							
						Data Range	Spread	3 Months			
Market Indices	Spread	Change Spread	Basis	Roll	Low	Range	High	Avg	+/-	3M Chg	
1) Americas						◆ Avg ● Now					
10) CDX Investment Grade	78.95	+0.12	-3.8	8.8	69.9	—	84.8	78.6	+0.3	-2.8	
11) CDX High Yield	105.21 *	-0.50	-0.5	1.3	103.4	—	106.8	105.2	+0.0	+0.9	
12) MCDX	155.42	+0.00	N.A.	13.1	129.2	—	155.8	142.2	+13.2	+13.8	
13) CDX Latin America		N.A.	N.A.	N.A.	N.A.	—	N.A.	N.A.	N.A.	N.A.	
2) EMEA											
20) iTraxx Europe	94.74	-1.51	0.6	9.1	89.6	—	108.0	100.5	-5.8	-14.9	
21) iTraxx HIVOL	148.41	-1.26	8.7	11.8	141.3	—	165.2	155.9	-7.5	-16.9	
22) iTraxx Crossover	380.96	-4.29	11.8	53.7	367.3	—	439.8	405.9	-24.9	-61.8	
23) iTraxx Sr Financial	129.54	-1.75	1.7	13.8	126.1	—	161.2	142.8	-13.3	-29.2	
24) iTraxx Sub Financial	190.25	-2.97	-5.8	21.3	188.6	—	242.6	217.4	-27.1	-54.4	
25) iTraxx Corp CEEMEA	260.48	N.A.	N.A.	22.1	245.4	—	307.4	273.1	-12.6	-26.5	
26) iTraxx SOVX W Europe	84.35	-0.44	4.9	N.A.	83.7	—	99.3	90.6	-6.2	-12.6	
27) iTraxx SOVX CEEMEA	227.12	N.A.	N.A.	2.7	213.3	—	231.4	221.5	+5.6	-5.3	
3) Asia											
30) iTraxx Japan	93.66	-2.45	-5.5	11.9	78.1	—	102.8	94.4	-0.7	-9.8	
31) iTraxx Asia Ex Japan IG	153.13	N.A.	13.8	32.9	119.3	—	169.6	145.8	+7.4	-6.7	
32) iTraxx Australia	115.87	-4.30	4.2	9.7	104.4	—	129.5	120.1	-4.3	-20.3	
Emerging Markets											
40) CDX Emerging Market	110.33 *	-0.06	2.7	-1.5	106.5	—	111.3	108.8	+1.6	+3.1	

* These securities are price quoted

Last updated: October 15, 2013 5:47 pm

US Treasury bill demand slumps at auction

Demand for the sale of \$35bn three-month bills that mature in January was 3.13 times, the lowest since July 2009

Bid-Cover Ratio

- Bond Auction!! (Italy and the political uncertainty) markets relieved after the bond market bought the bond enthusiastically
- Bid-Cover ratio as a guage of market sentiment
- Bid-Cover less than 1 is a failed auction. Why?

There was also some negative reaction in the markets to developments in Washington. One-month Treasury bills maturing on October 31 shot up 21 basis points to a new debt ceiling peak of 53 bps late on Tuesday, as investors grew alarmed by the lack of a deal.

“We are seeing a lack of liquidity in the bill market and that is exacerbating the move in yields,” said John Brady, senior vice-president at RJ O’Brien. “People are stepping away from the market.”

Long-dated Treasuries unbowed by debt tensions

The volatility in stocks and T-bills is not being replicated in longer term US paper, however.

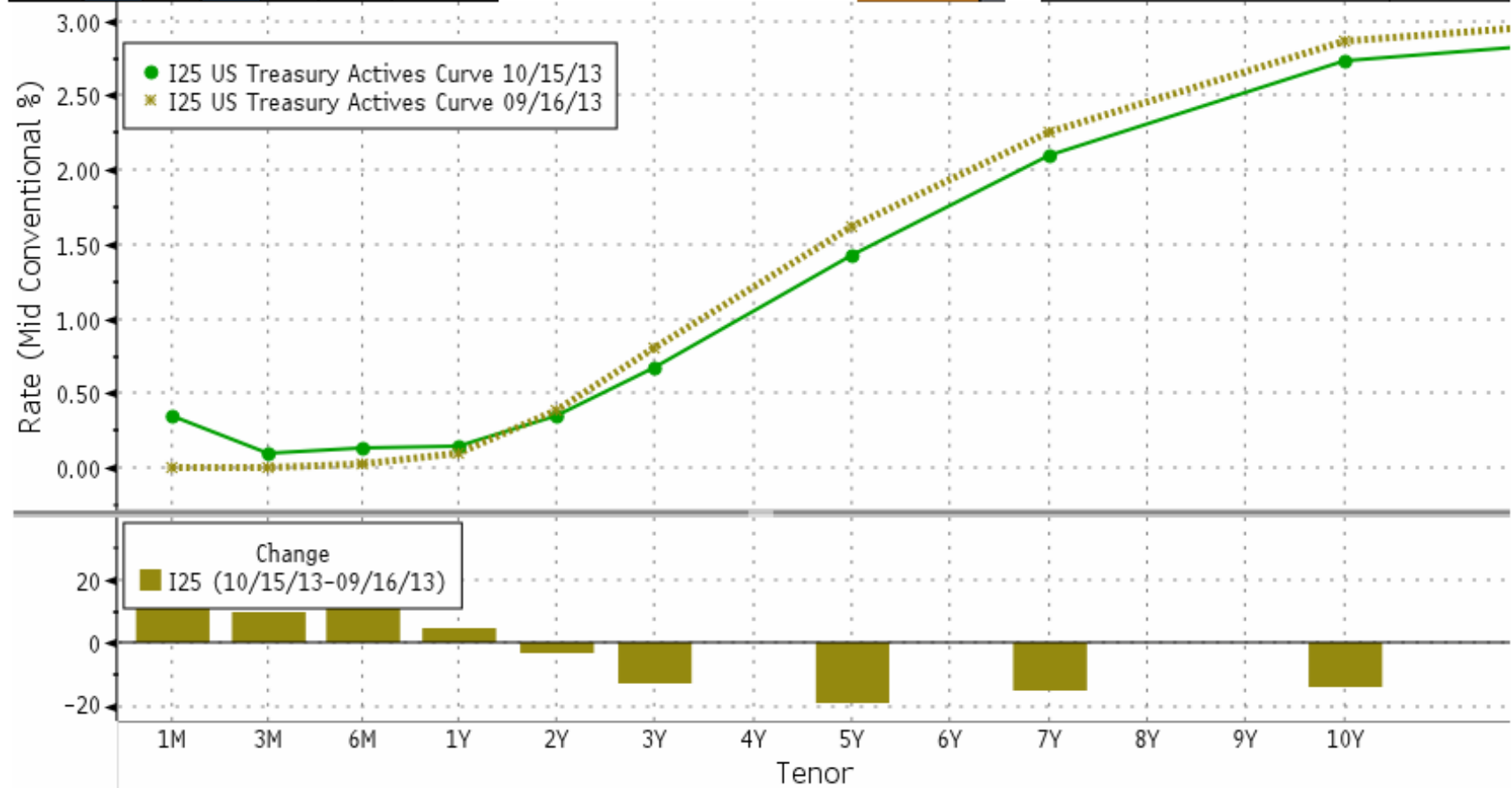
The US 10-year yield has been stuck between 2.6 per cent and 2.7 per cent for the past three weeks, even as fears about US creditworthiness – as measured by higher CDS spreads – have been building.

<HELP> for explanation.

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US TREASURY ACTIVES CU 97) Actions 98) Table 99) Feedback Graph Curves

Last 1D 1W 1M 5W 12M Date Lower Chart Hist Chart Curves & Relative Value



<HELP> for explanation.

United States 1) Actions 2) Tools 3) Settings Fixed Income Trading

19:25

4) Actives	5) Bills	6) Notes	7) TIPS	8) Strips	9) Spreads	10) Curves	11) WI	12) Bfly
	BidPx / AskPx	AskYld	PxChg		BidPx / AskPx	AskYld	PxChg	
31) 10/17/13	0.215 / 0.210	0.213	-0.105	50) 01/30/14	0.110 / 0.105	0.106	+0.015	
32) 10/24/13	0.555 / 0.550	0.558	+0.090	51) 02/06/14	0.125 / 0.120	0.122	+0.005	
33) 10/31/13	0.625 / 0.620	0.629	+0.090	52) 02/13/14	0.125 / 0.120	0.122	+0.015	
34) 11/07/13	0.445 / 0.440	0.446	+0.100	53) 02/20/14	0.120 / 0.115	0.117	--	
35) WI 1MTH	0.375 / 0.370	0.375	+0.125	54) 02/27/14	0.125 / 0.115	0.117	+0.005	
36) 1M ROLL	6.500 / -7.500			55) 03/06/14	0.120 / 0.115	0.117	-0.005	
37) 11/14/13	0.355 / 0.350	0.355	+0.090	56) 03/13/14	0.120 / 0.115	0.117	--	
38) 11/21/13	0.150 / 0.145	0.147	+0.035	57) 03/20/14	0.115 / 0.110	0.112	+0.010	
39) 11/29/13	0.180 / 0.175	0.177	+0.005	58) 03/27/14	0.110 / 0.105	0.107	+0.010	
40) 12/05/13	0.150 / 0.145	0.147	+0.025	59) 04/03/14	0.120 / 0.115	0.117	+0.005	
41) 12/12/13	0.145 / 0.140	0.142	-0.010	60) 04/10/14	0.130 / 0.125	0.127	--	
42) 12/19/13	0.120 / 0.115	0.117	--	61) 04/17/14	0.160 / 0.155	0.157	+0.003	
43) 12/26/13	0.140 / 0.135	0.137	--	62) WI 6MTH	/			
44) 01/02/14	0.090 / 0.085	0.086	--	63) 6M ROLL	/			
45) 01/09/14	0.090 / 0.085	0.086	-0.015	64) 05/01/14	0.110 / 0.105	0.107	+0.005	
46) 01/16/14	0.145 / 0.135	0.137	+0.005	65) 05/29/14	0.110 / 0.105	0.107	--	
47) WI 3MTH	/			66) 06/26/14	0.110 / 0.105	0.107	--	
48) 3M ROLL	/			67) 07/24/14	0.120 / 0.115	0.117	+0.005	
49) 01/23/14	0.105 / 0.100	0.101	+0.015	68) 08/21/14	0.130 / 0.125	0.127	+0.005	

TIPS

Investors may be surprised to hear that concerns about excessively low inflation may be back on the Fed's radar screen. After all, breakeven inflation expectations in the bond market have been fairly stable at above 2 per cent. But the Fed leadership

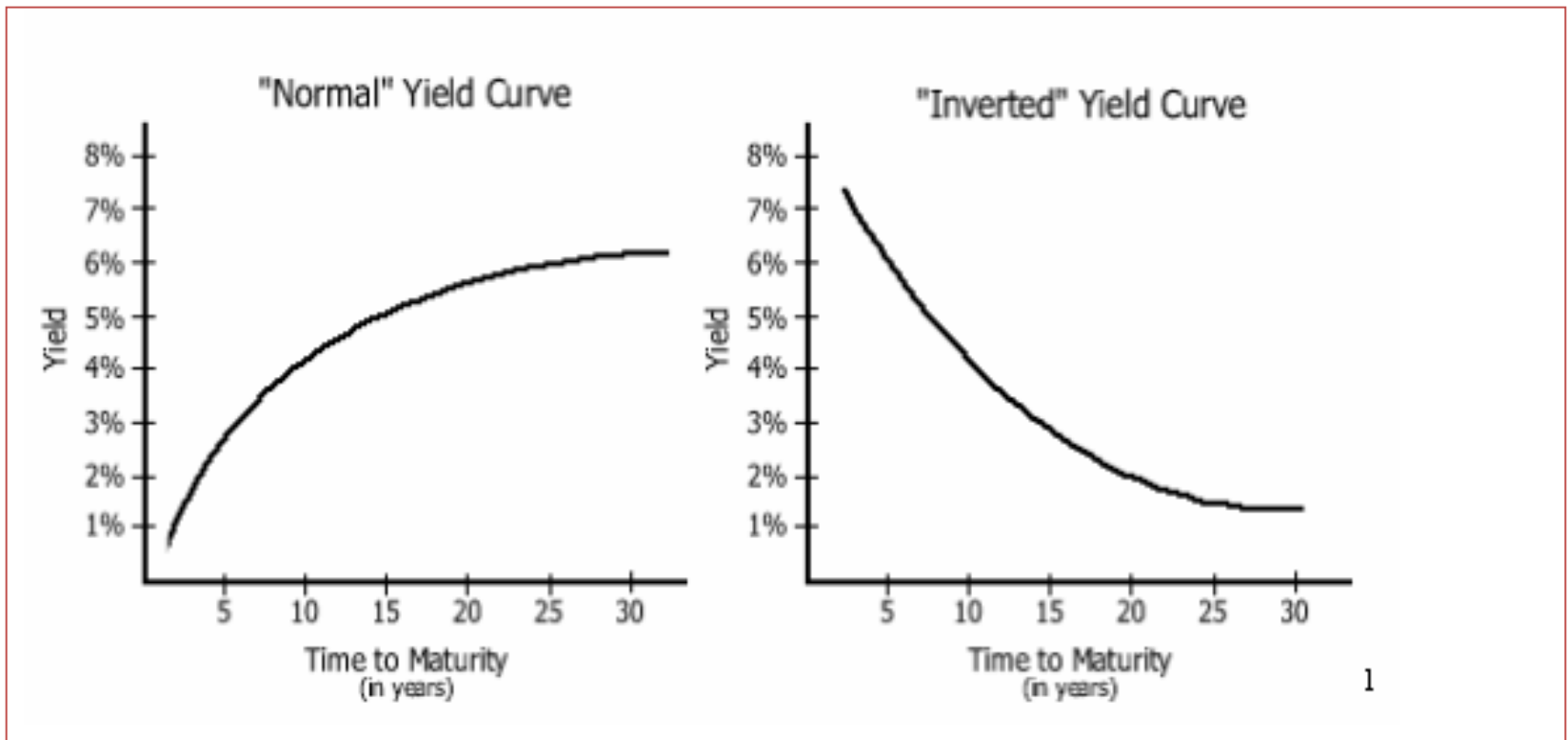
Treasury Inflation protected Securities

- Nominal Bond Yield = TIPS yield + Breakeven inflation
- For example, if the current 10-year treasury note is yielding 3% and the current 10-year TIPS yield is 1%.
- Markets are implying that inflation expectations should be 2% on average for the next 10 years

- Therefore, Breakeven inflation is 2%.
- TIPS investors will break even (not lose out) if inflation is 2% for the next 10 years.
- It can be used as a gauge for inflation expectations (market based as opposed to the survey based approach)

Term Structure of Interest rates

- Normal Yield Curve
- Inverted Yield curve: “ harbinger of an economic slowdown?”



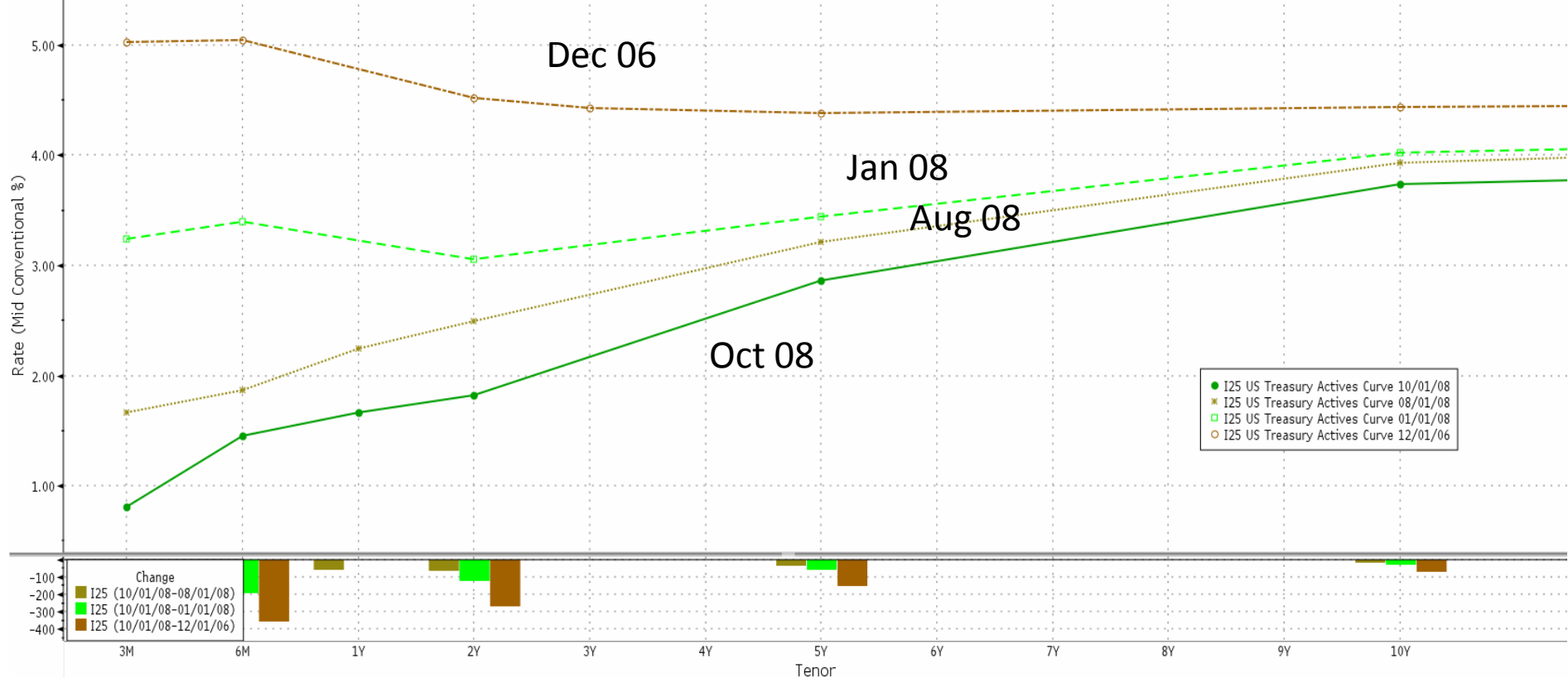
Yield Curve History

<HELP> for explanation.

Run LOGZ to Express Login or you will be logged off in 3 minutes.

US TREASURY ACTIVES CURVE 97) Actions 98) Table 99) Feedback Graph Curves

Last 1D 1W 1M 08/01/08 10/01/08 Date Lower Chart Hist Chart Curves & Relative Value



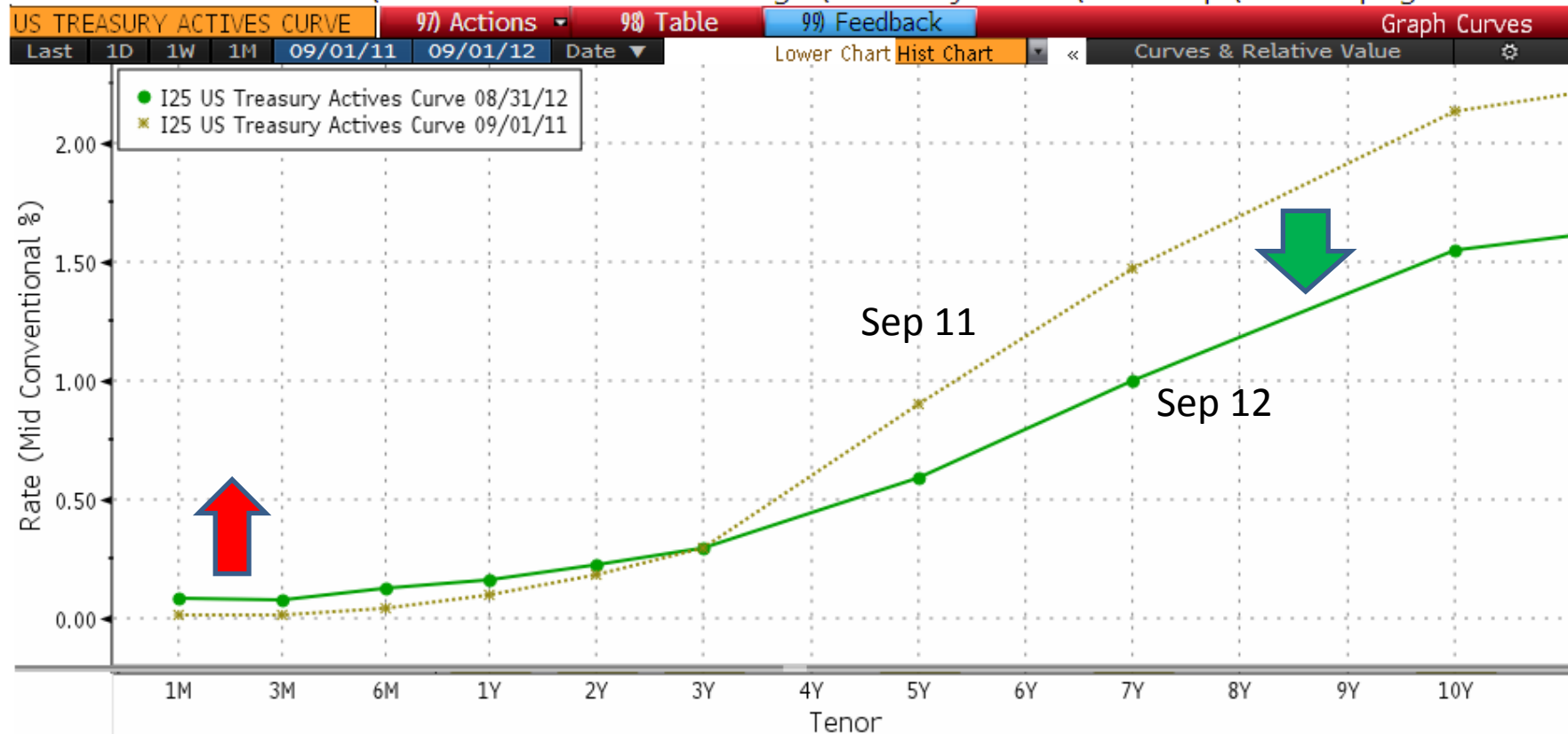
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000
 Copyright 2013 Bloomberg Finance L.P.
 SN 826457 ICT GMT+7:00 H723-1055-0 16-Oct-2013 19:36:36



Operation Twist

<HELP> for explanation.

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CRISIS INDICATOR

A measure of liquidity/ market dysfunction

- Bid-ask spread... a very important indicator



Yield Spreads

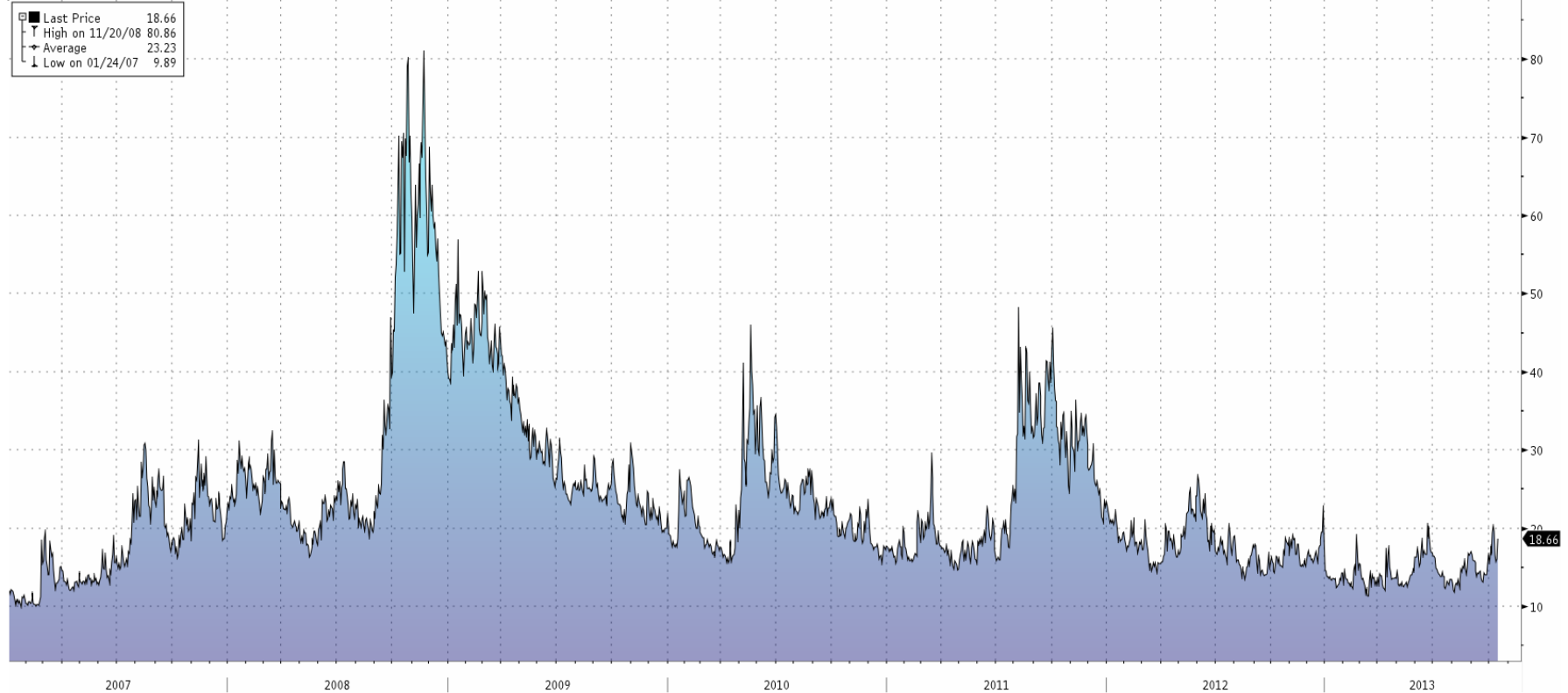
- Yield Spread between two securities (bonds)
- Represents credit risk, term premium
- TED spread

Nothing to fear but fear itself

VIX C 18.66 +2.59 -- / --
 On 15 Oct d O 16.41 H 18.67 L 16.16 Prev 18.66

VIX Index 95) Save As 96) Actions 97) Edit 98) Table Line Chart
 01/03/2007 - 10/16/2013 Last Price Line 11) Compare Mov. Avgs No Lower Chart USD
 1D 3D 1M 6M YTD 1Y 5Y Max Daily Security/Study Event

Last Price 18.66
 High on 11/20/08 80.86
 Average 23.23
 Low on 01/24/07 9.89



Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2013 Bloomberg Finance L.P.
 SN 826457 ICT GMT+7:00 H723-1055-3 16-Oct-2013 17:31:51

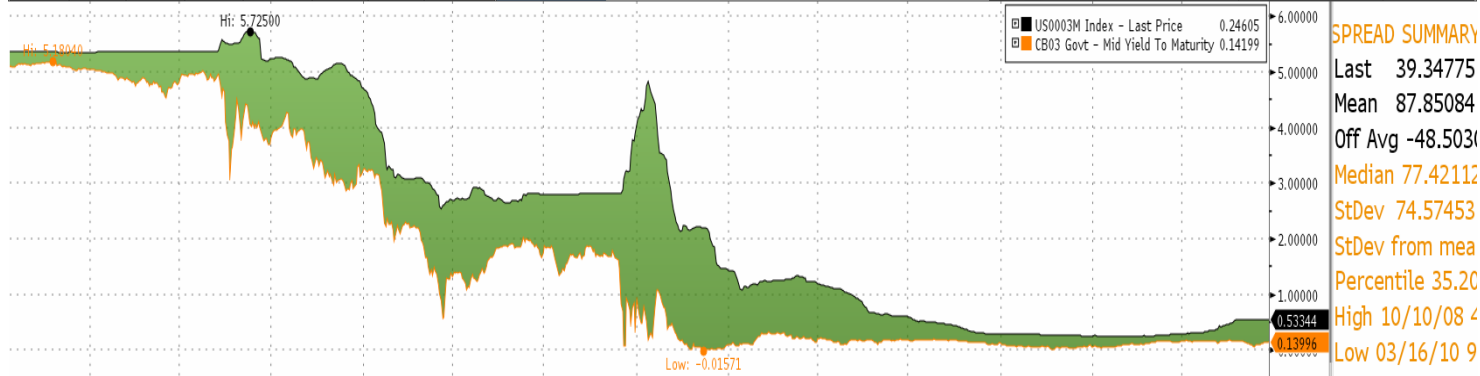


TED spread

<HELP> for explanation.

1<Go> to View Spread, 11<Go> to Save as Index, 12<Go> to View Regression

Buy	US0003M Index	-	Sell	GB03 Govt	96 Actions	97) Edit	Custom Spread
Data Field	Last Price		Data Field	Mid Yield To Maturit	01/02/2007	10/16/2013	Regression
Mult.	1.0	Constant	0.0	Mult.	1.0	Constant	0.0
						Normalize by	Factor
							100.0
							Calc.
							Percent
							Local CCY
							120
1D	3D	1M	6M	YTD	1Y	5Y	Max
							Daily
							Security/Study
							Event



SPREAD SUMMARY

Last	39.34775
Mean	87.85084
Off Avg	-48.5030
Median	77.42112
StDev	74.57453
StDev from mea	
Percentile	35.20
High	10/10/08 4
Low	03/16/10 9

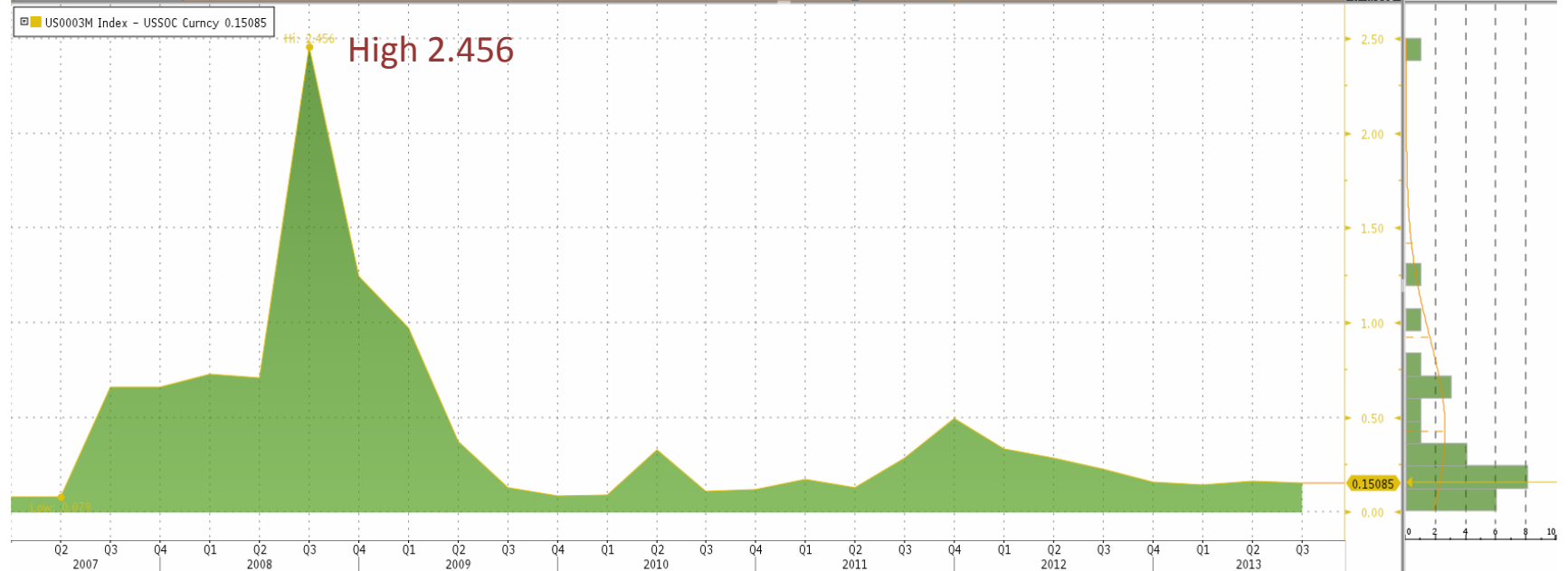


LIBOR-OIS

<HELP> for explanation.

1<Go> to View Spread, 11<Go> to Save as Index, 12<Go> to View Regression

Buy	US0003M Index	-	Sell	USSOC Curncy	9) Actions	97) Edit	Spread Analysis
Data Field	Last Price		Data Field	Last Price	03/30/2007	09/30/2013	Regression Corr. 120
Mult.	1.0	Constant	0.0	Mult.	1.0	Constant	0.0
				Normalize by	Factor	100.0	Calc. Percent Local CCY
1D	3D	1M	6M	YTD	1Y	5Y	Max
					Quarterly		
						Security/Study	Event



Australia	61	2	9777	8600	Brazil	5511	3048	4500	Europe	44	20	7330	7500	Germany	49	69	9204	1210	Hong Kong	852	2977	6000
Japan	81	3	3201	8900	Singapore	65	6212	1000	U.S.	1	212	318	2000	Copyright 2013 Bloomberg Finance L.P.								
														SN	826457	ICT	GMT+7:00	H723-1055-0	16-Oct-2013	19:18:22		

Short term bills at the center of the storm

	10-Oct-13	26-Sep-13	Change
	Level (% or points)		(bp or % change)
US T-bills			
T-Bill 31-Oct-13	0.33	0.03	29.9
T-Bill 07-Nov-13	0.27	0.02	25.6
T-Bill 09-Jan-14	0.04	0.00	4.6
Libor-OIS and swap spreads			
USD 3M Libor-OIS	13.5	15.1	-1.6
USD 1Y Libor-OIS	19.6	18.1	1.5
USD 2Y swap spread	12.6	13.1	-0.5
EUR 2Y swap spread	40.7	37.7	3.0
FX and cross currency basis			
EUR/USD FX	1.3521	1.3473	0.4%
USD/JPY FX	97.8	99.05	-1.3%
Trade weighted USD	69.03	69.04	0.0%
EUR/USD 1Y basis	-10.7	-9.6	-1.1

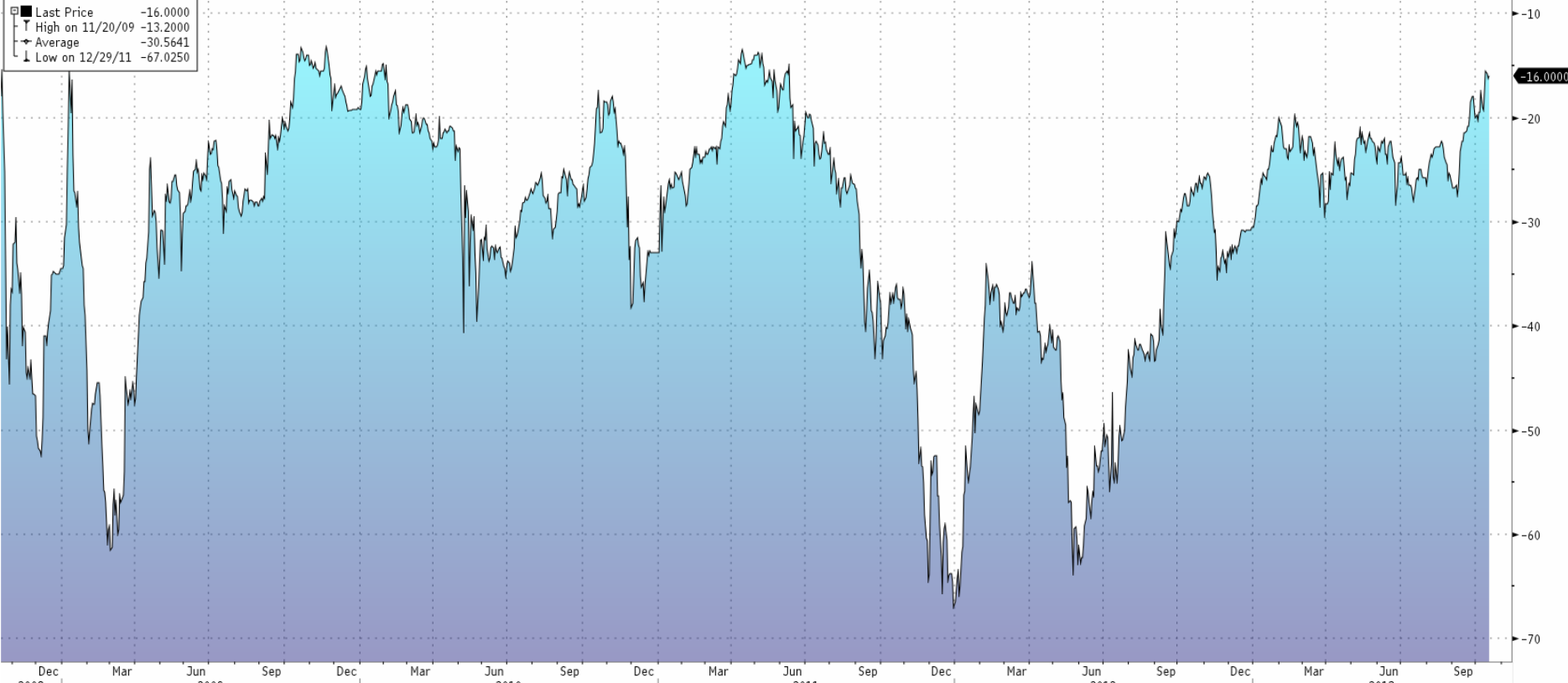
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USD/JPY FX	97.8	99.05	-1.3%
Trade weighted USD	69.03	69.04	0.0%
EUR/USD 1Y basis	-10.7	-9.6	-1.1
S&P 500	1656.4	1698.7	-2.5%
VIX	19.6	14.1	5.5
Eurostoxx 600	296.6	295.8	0.3%
Spain-Germany 10Y	250.4	251.2	-0.7
Gold	1299.5	1324.1	-1.9%

Source: Deutsche Bank

EURO BASIS SWAP

EUBS5 CMPT -16.0000 +.3000 ANON -18.0000 / -14.0000 ANON
At 16:26 Op -16.0000 Hi -15.0000 Lo -16.3000 Close -16.3000

EUBS5 CMPT Curren**cy** 95) Save As 96) Actions 97) Edit 98) Table Line Chart
 10/17/2008 - 10/16/2013 Last Price CMPT Line 1) Compare Mov. Avgs No Lower Chart EUR
 1D 3D 1M 6M YTD 1Y 5Y Max Daily Security/Study Event



Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000
 Copyright 2013 Bloomberg Finance L.P.
 SN 826457 ICT GMT+7:00 H723-1055-3 16-Oct-2013 17:29:47

To Taper or Not to Taper

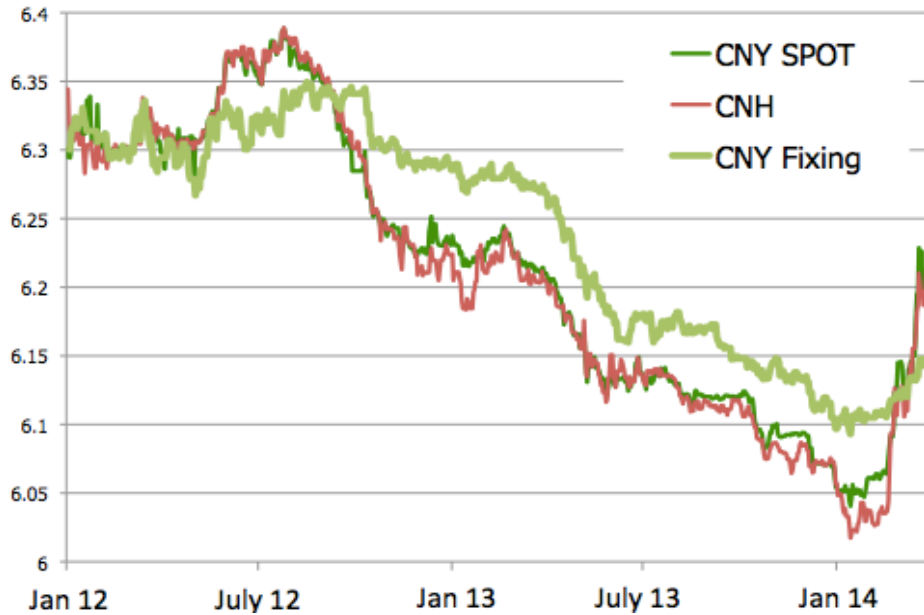
EDM5 **99.235** -.005 ↑ ic99.235 / 99.240 ic 833x1727 Prev 99.240
 At 17:14 d Vol 13310 Op 99.235 Hi 99.240 Lo 99.225 OpenInt 821265

EDM5 COMB Comdty 95 Save As 96 Actions 97 Edit 98 Table Line Chart
 10/16/2012 - 10/16/2013 Ask Yield Line Compare Mov. Avgs No Lower Chart USD
 1D 3D 1M 6M YTD **1Y** 5Y Max Daily Security/Study Event

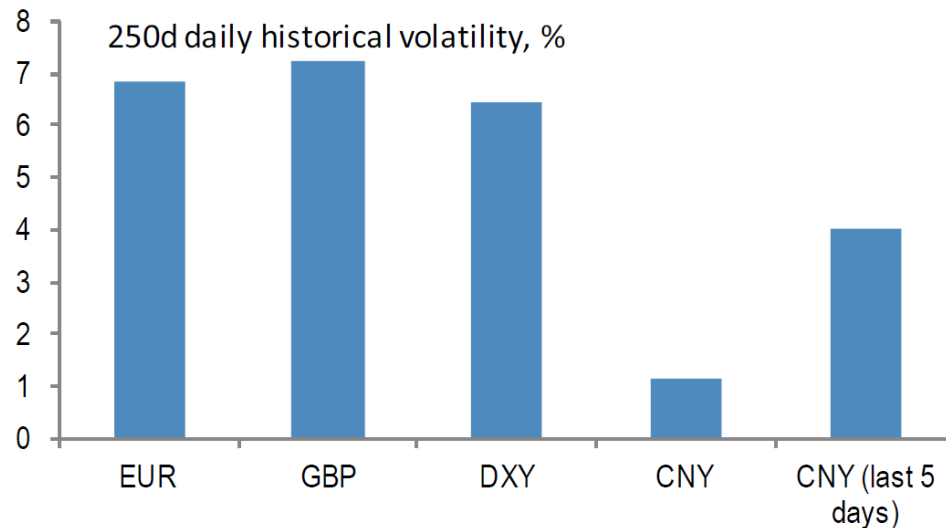


Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000
 SN 826457 ICT GMT+7:00 H723-1055-1 16-Oct-2013 17:26:36

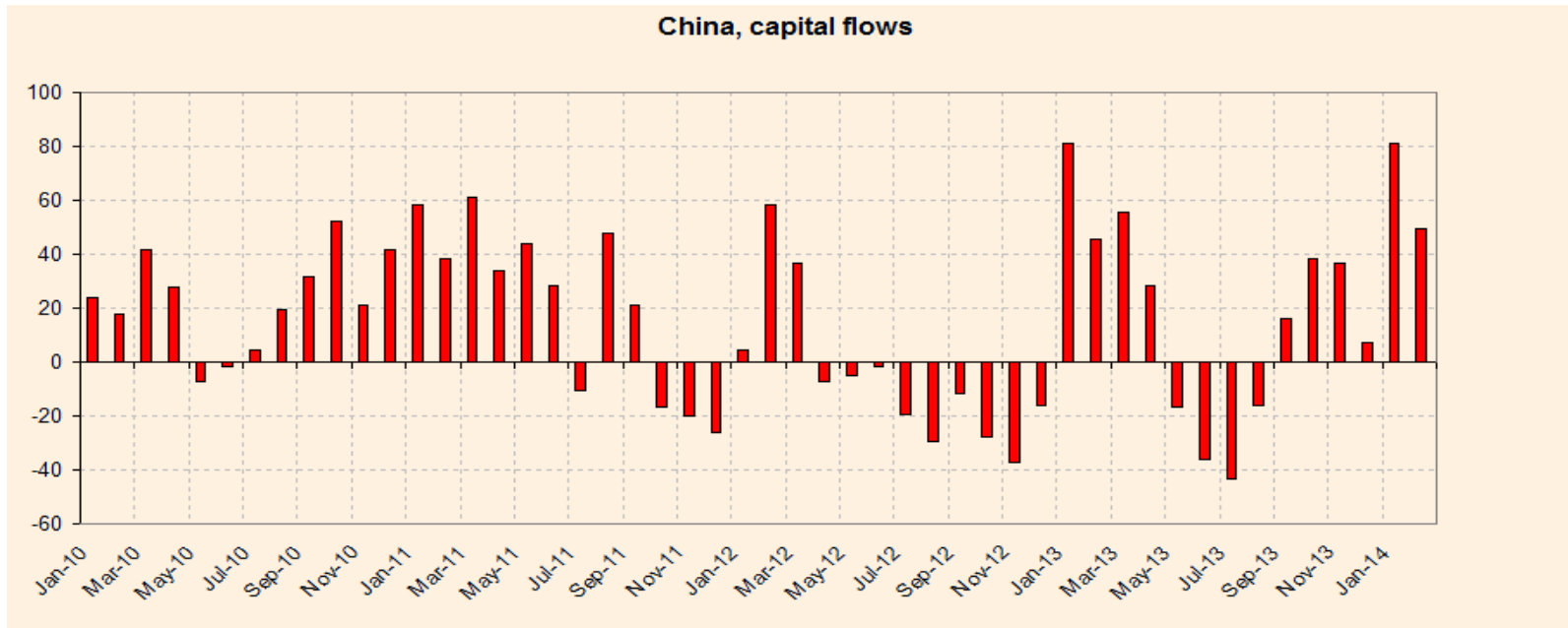
CNY –one way appreciation



- CNY offered the best **Sharpe Ratio** for a carry trade in 2013(high yield and low vol)
- CNY appreciated almost uninterrupted since **August 2012**
- PBOC aimed to deter speculators by engineering a **two-way volatility** into the currency
- Speculative inflows into China led to a huge increase in the **shadow banking** system and speculation in property
- A loss of confidence in the shadow banking system could potentially cause a **systemic risk** in the financial system



Foreign Speculative inflows

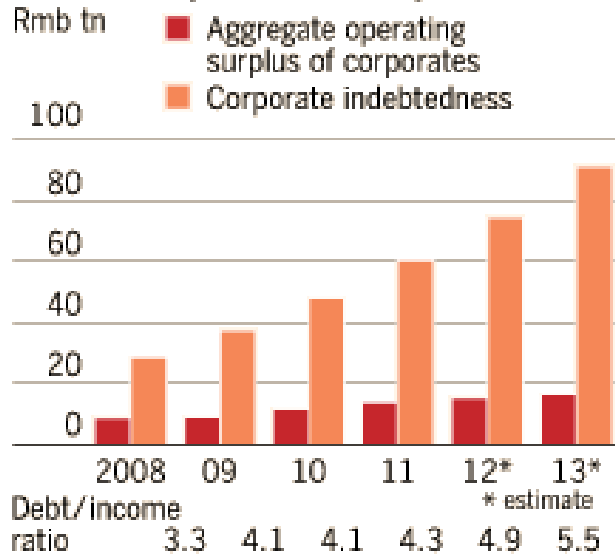


- China FX reserves meanwhile rose by USD 500 bn which incurs negative carry costs for the government
- In January 2014 China saw a \$76bn inflows
- Net Foreign Debt increase in china in 2013 is \$126 bn compared with \$46bn in 2012
- Outstanding Foreign Debt is \$863 bn



Carry Trade and Leverage

Trends in corporate debt and profit



Source: Fitch

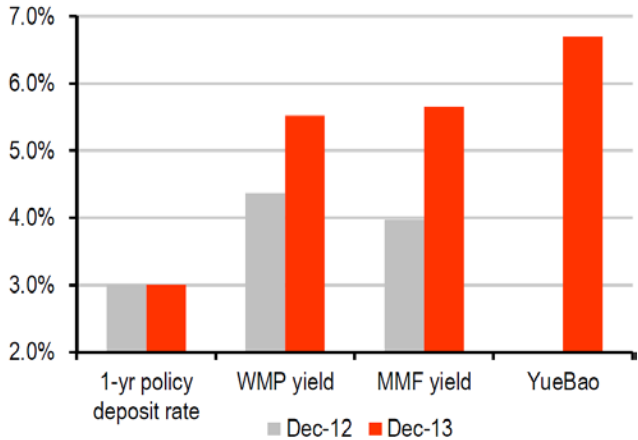
Table 1: 'Guesstimated' long RMB position from onshore and offshore actors

On/offshore	Market	Community	Size \$bn	Source/Data/Methodology
Onshore	Spot & forward CNY onshore	Corporates	614	Corporate spot & fwd flow data
Onshore	Options	Corporates	10	minus trade data
Offshore	CNY NDF outright forwards outright	Institutional Investors	25	Estimates
Offshore	CNH spot & forward outright	Institutional Investors	75	Estimates
Offshore	CNH options & structures (mainly TARN)	Private Bank/Corporates	100	Estimates
Offshore	CNY NDF options & structures (mainly TARN)	Private Bank/Corporates	25	Estimates
Total			849	
			452%	% of C/A (2013e)
			22%	% of FX reserves

- JPM estimates that onshore carry trade is around \$614 bn
- Credit/GDP in China rose to 221% as of Dec2013
- Corporate indebtedness to income increased to 5.5 in 2013 from 3.3 in 2008
- CNY depreciation would cause serious losses among the onshore corporates who borrow heavily to engage in carry trade

Shadow banking offers huge returns

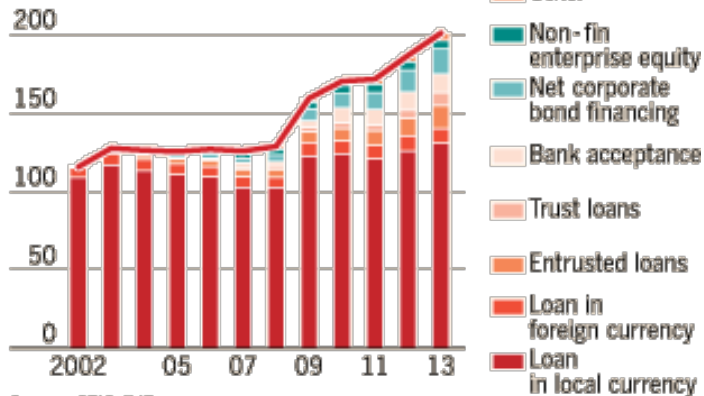
Fig.1 Yield spike for WMP and money market funds



* MMF yield is the average of China AMC and Boreasa money market fund
 YueBao is also a MMF, but with 92% of funds placed with banks
 Source: PBOC, Wind, HSBC, China AMC, Boreasa, YueBao, Eastmoney

- Shadow banking represents around 30% of the credit system in China (36 trn CNY : source HSBC)
- Its rapid growth could be attributed to a much higher rate than normal deposits at banks(6% for YueBao VS 0.36% for floating account)
- YueBao is an online money market fund (Alibaba) with **500bn CNY** deposits and has **81m** users within a year.
- Banks are forced to compete for deposits at a higher rate by issuing their own online MMF , therefore the costs of funding will rise and ,as a result, will be damaging to the real economy.
- PBOC wishes to have control over the financial system. Shadow banking will prove a real threat to the financial stability , should a loss of confidence occurs in shadow banking

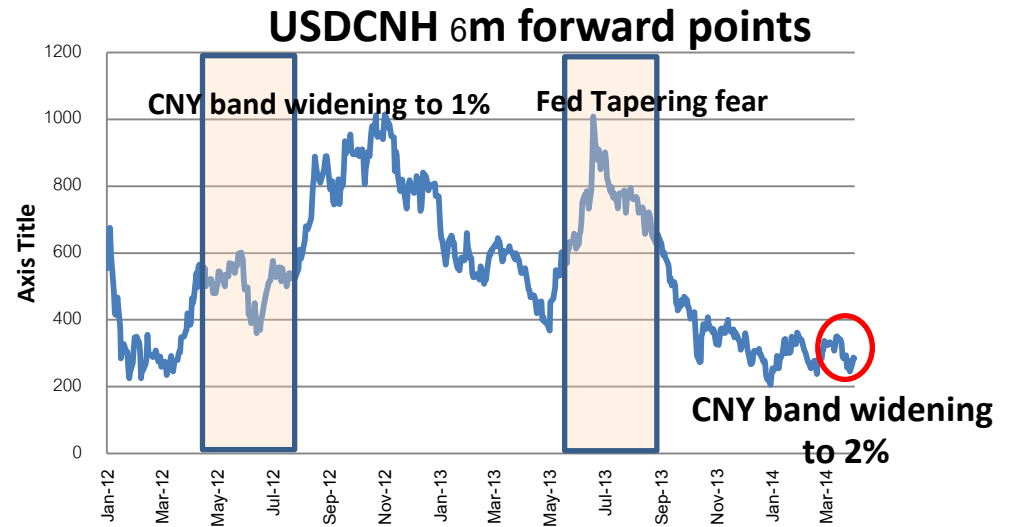
Social financing outstanding
 % of GDP



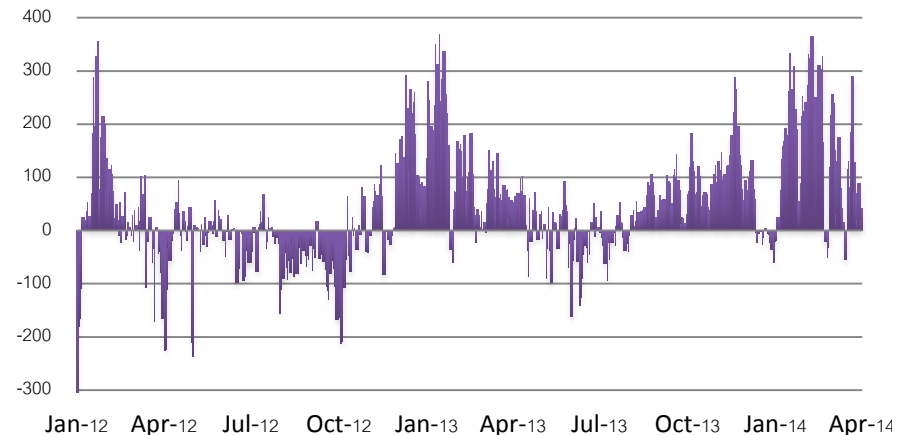
Source: CEIC, IMF

CNY band widening

- The trading band was widened to 2% from the CNY fixing (mid rate) on March 17
- PBOC intervened heavily in the FX market and guided the USDCNY fixing higher to engineer a volatility in order to reduce the excessive leverage
- FX liberalisation is part of the internationalisation plan of the RMB
- CNH swap points did not rise like in previous episodes , indicating that investors did not unwind their long CNH forward positions.
- Investors did not panic and sell CNH. **CNH is still trading at a premium to CNY**. Investors continue to believe in an appreciation of the CNY despite the recent increase in volatility



CNY-CNH premium



conclusions

- Year-end forecasts still point to an appreciation of CNY spot (Q4 2014, USDCNY =6.01)
- CNY **gradual appreciation** will help foster a transition for the Chinese economy from export-driven to domestic consumption.
- For RMB to become more internationalised, it must be a resilient and strong currency
- However, a rise in volatility of the exchange rate is needed to drive out speculation.
- Therefore, we expect **greater volatility** in the short term (3-6 months) before the CNY gradually **appreciates** with the **stronger macroeconomic fundamentals**.

Questions

