PBOC Switch to Drain Cash Turns Citigroup Bearish: China Credit
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By Bloomberg News
Feb. 21 (Bloomberg) -- The People's Bank of China's first draining of cash since June, seeking to damp a property-market revival, is prompting Citigroup Inc. to predict one-year yields will rise faster than longer-term rates.
The central bank sold repurchase agreements for the first time in eight months on Feb. 19, withdrawing capital from banks after they lent the most money in two years in January. The gap between one- and 10-year government yields has widened 26 basis points in the past four months to 86, after touching 88 on Feb. 19, the highest level since August 16, according to Chinabond. Comparable spreads across the so-called yield curve are 172 basis points in Brazil, 154 in Russia and one in India.
"The PBOC regards the current liquidity conditions as overly loose," said Weisheng He, a strategist in Shanghai at Citigroup. "Going into April, I expect the bond curve to bear-flatten," he said, predicting the one-year yield will rise to 3 percent this year from 2.69 percent today.
The outlook for a flattening yield curve reflects the risks that excessive lending may fuel inflation in the world's second-largest economy and lead to a property-market bubble. The central bank said on Feb. 6 that China must be alert to changes in price expectations and to imported inflation.
China's banks extended 1.07 trillion yuan ($172 billion) of loans in January, compared with 738 billion yuan a year earlier, the PBOC said on Feb. 8. Aggregate financing, which includes non-bank lending, climbed 914 billion yuan last month to a record 2.54 trillion yuan, central bank data show.

Flatter Curve

"It was probably the rapid increase in loans that prompted the central bank to fine-tune monetary policy," said Chen Qi, co-head of fixed-income research at UBS Securities Co. in Shanghai. "Liquidity won't be as ample as before, which will help push up short-term yields. It's possible that the curve will flatten."
The yield on 10-year government bonds dropped one basis point to 3.55 percent, according to the National Interbank Funding Center. The rate on one-year debt climbed three basis points. The Shanghai Composite Index plunged 3 percent, the most in 14 months, on speculation more restrictions on the property

industry will hurt demand for bank loans.
Chinese developers were able to improve their liquidity at favorable costs because funding channels reopened, Standard & Poor's said a report released yesterday. Home sales in China's 10 biggest cities almost quadrupled to 8.5 million square meters (91.5 million square feet) in the first five weeks from last year, property data and consulting firm China Real Estate Information Corp. said on Feb. 19.

Tighter Policy

"The PBOC will try to tighten liquidity this year to counter rises in home prices and also to curb inflationary pressures at the consumer level," said Dariusz Kowalczyk, a Hong Kong-based strategist at Credit Agricole CIB. "It will try to drain liquidity via open-market operations such as repos and bill sales. I also expect yields it offers in these operations to be increased."
The PBOC drained a net 910 billion yuan of capital this week, the biggest withdrawal since Bloomberg started compiling the data in 2008, after issuing 40 billion yuan of 28-day repurchase contracts and 10 billion yuan of 91-day repos. By contrast, the monetary authority pumped in a record 662 billion yuan of funds during the five days through Feb. 8, as cash demand surged before the Chinese New Year holiday.
The seven-day repurchase rate, a gauge of interbank funding availability, climbed four basis points, or 0.04 percentage point, 3 percent, according to the National Interbank Funding Center. The overnight rate jumped 16 basis points, the most since Feb. 6, to 2.10 percent.

Stimulating Growth

China "won't tighten policy too much" as the government aims to shift the focus of the economy to domestic consumption, according to Stephane Monier, deputy global chief investment officer at Lombard Odier Asset Management, which manages $200 billion. The Geneva-based private bank is bullish on sovereign debt because of the prospects for yuan appreciation, he said.
"There's not a very strong argument for strong tightening," Monier said in an interview yesterday in Hong Kong. "What would be wise for them is to continue the tightening by a moderate appreciation of the currency."
The finance ministry yesterday issued 26 billion yuan of 10-year government bonds at a yield of 3.52 percent, according to Chinabond. That compared with the median estimate of 3.565 percent in a Bloomberg News survey. The sale drew bids worth 2.86 times the amount on offer, the highest for the maturity

since 2005, according to China International Capital Corp. data.

Bond Demand

"The strong demand for bonds in the primary market
reaffirms the fact that the financial system is flooded with
cash," said Chen Jianheng, a bond analyst in Beijing at CICC,
the nation's biggest investment bank. "The resumed repo sales
are only used to make liquidity not excessively loose. The
central bank isn't sending a tightening signal."
Consumer prices rose 2 percent from a year earlier in
January, compared with 2.5 percent in the previous month, the
statistics bureau said on Feb. 8. Ba Shusong, a researcher at
the State Council's Development Research Center, said inflation
may accelerate to 3 percent in February, the China National
Radio reported on the same day.
Confidence in China's economy has improved this month.
Five-year credit-default swaps protecting China's sovereign
notes against non-payment fell 4.5 basis points in February to
64.5 as of Feb. 20 in New York, according to data provider CMA,
which is owned by McGraw-Hill Cos. and compiles prices quoted by
dealers in the privately negotiated market. The yuan weakened
0.05 percent to 6.2405 per dollar today.

So Far, So Good

The world's second-biggest economy expanded 7.9 percent in
the fourth quarter, compared with 7.4 percent in the previous
three months, China's statistics bureau said on Jan. 18.
The central bank will "mildly" drain capital from the
financial system because the economic recovery is good so far,
said Shi Lei, head of fixed-income research at Ping An
Securities Co., a unit of the nation's second-biggest insurance
company.
"The seven-day repo rate may rise to 3.3 percent after the
PBOC resumed repo sales," said Shi. "The rising funding costs
will help damp companies' demand for money a bit."

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