Research

FTSE Russell China Bond Research Report

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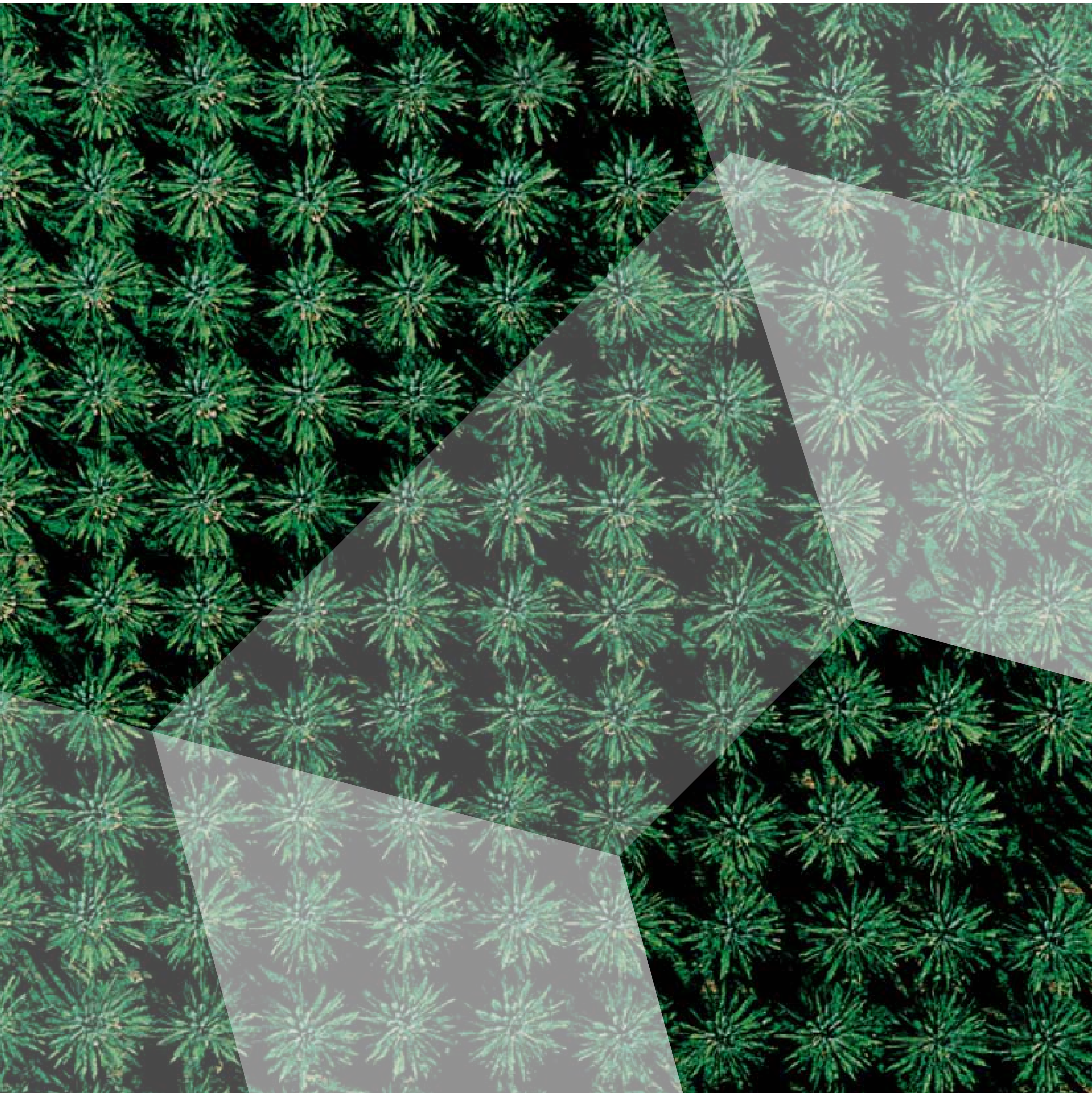

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Highlights

- China attracted 346 billion RMB ($55 billion) of foreign funds into mainland bonds in 2017, central bank data showed. Roughly 33 percent of the flows since July of last year came via the Bond Connect, according to Bank of China (HK), marking a 41 percent increase from 2016.[1]
- Despite the continued evolution of China's capital markets, policymakers are trying to limit spiralling debt levels and enter a period of more stable, and sustainable, growth. For example, Beijing is no longer tolerant of off-balance sheet municipal borrowing, and in 2018 might for the first time allow a default by a local government financing vehicle (LGFV).[2]
- While appetite for China bonds is increasing, foreign investors still hold less than 2 percent of China's domestic debt, according to Bloomberg. By way of comparison, foreigners hold 11 percent of Japan's debt. However, holdings of onshore Chinese bonds by foreign institutional investors have increased by about 60 percent since December 2016.[3]

1 Bloomberg. February 2018.
2 Reuters. January 2018.
3 Financial Times. January 2018; Bloomberg. February 2018.

Chapter 1: Overview

Foreign investment in onshore bonds rising as Bond Connect programme gradually takes flight

As Q1 gives way to Q2, it's clear the world's second largest economy is likely to continue delivering surprises to investors both in Asia and around the world. On the political front, China's government startled international investors in recent weeks when it removed term limits on the country's presidency, paving the way for current president Xi Jinping to hold the position for more than two terms. Meanwhile in the markets, China's policymakers continue to initiate significant reforms, boosting the renminbi (RMB), and spurring demand among international market participants for RMB-denominated assets.

The 2017 data from China's roughly $12 trillion onshore bond market paints a clear picture of renewed confidence: it attracted 346 billion RMB ($55 billion) of foreign funds last year, according to central bank data. Around 33 percent of that volume came via the Bond Connect programme launched in Hong Kong in July that year, according to Bank of China (HK), marking a 41 percent increase from 2016.[4]

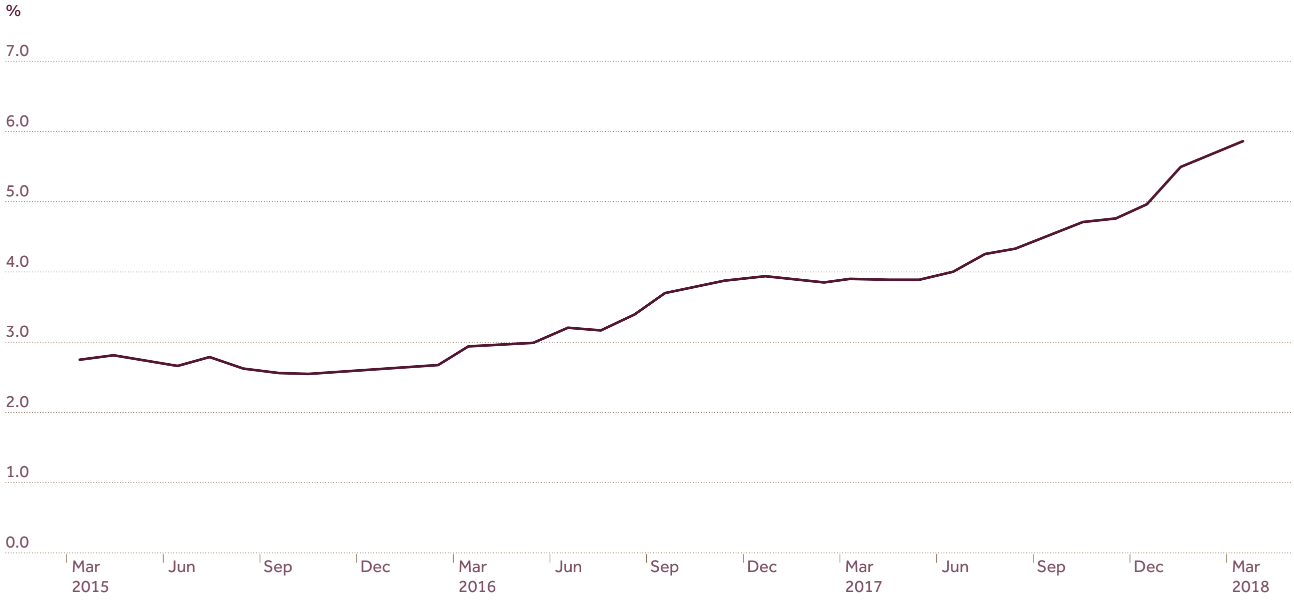
Growth is expected to continue according to some estimates: Deutsche Bank predicts further inclusion of China bonds into global indexes may attract $700 billion to $800 billion of overseas funds over the next five years. About 60 percent of that volume is expected to come from public funds, such as central bank purchases.[5]

"The further opening up of China's onshore bond market via the Bond Connect channel is certainly a big factor in driving some foreign funds into China," says Zhanying Li, Director, Fixed Income Indexes at FTSE Russell. "Just look at the numbers this year. By the end of March 2018, we have already seen 288 clients/products approved for Bond Connect access. At the same time, the number of foreign investors accessing the market via China interbank bond market (CIBM) direct continues to increase as well. The main macro factor that supports this growth is the appreciation of the RMB in 2017 (up 6.7 percent vs USD). That trend has continued in 2018: the RMB appreciated 3.5 percent vs USD for Q1 this year."

However, despite increasing volumes of investment from abroad, foreign investors still hold less than 2 percent of China's domestic debt, according to Bloomberg. By way of comparison, foreigners hold 11 percent of Japan's debt. But that low level of China holdings – especially government bonds – may expand in coming years, given that onshore Chinese bonds held by foreign institutional investors have increased by about 60 percent since December 2016.[6]

4 Bloomberg. February 2018.
5 Bloomberg. February 2018.
6 Financial Times. January 2018; Bloomberg. February 2018.

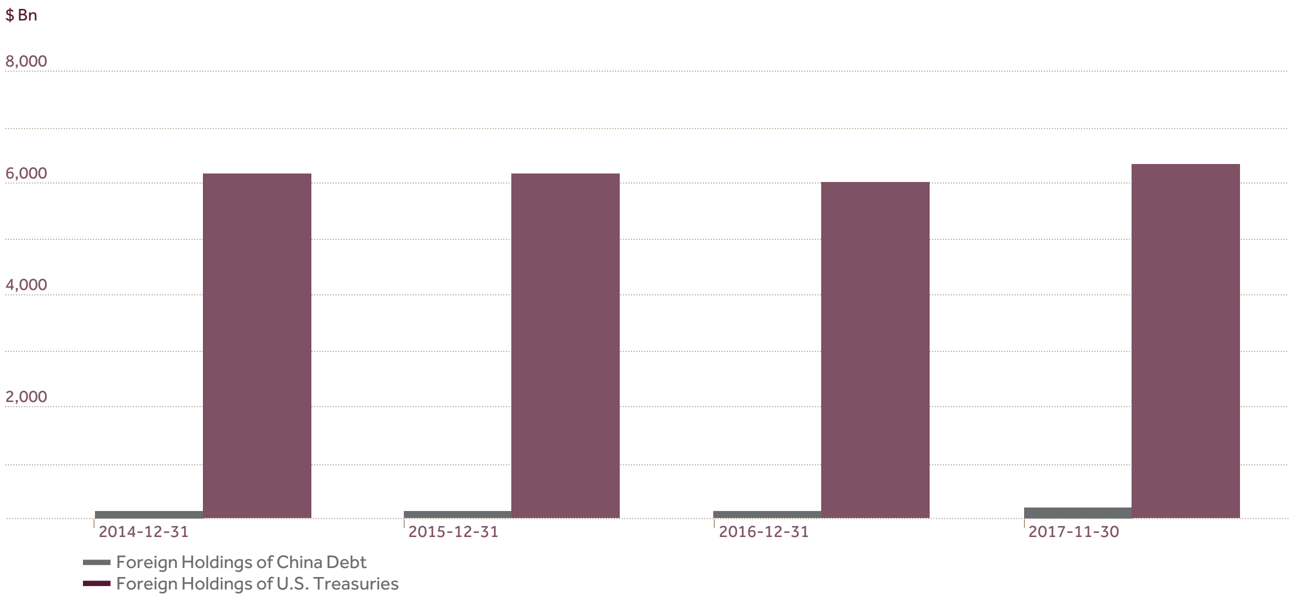
Foreign Ownership of China Government Bonds (%)



Source: WIND; FTSE Russell, March 2018.

"Foreign holdings of China bonds are still relatively low compared to Japan and many other countries, but if we pay attention to which type of bonds are held by foreign investors and the change in holdings, it reveals a different story," says FTSE Russell's Li. "Based on data from WIND, foreign investor holdings of China government bonds is 5.9 percent by end of March 2018. This number more than doubled within the last three years. If that trend continues, foreign ownership of China government bonds could be over 10 percent within 2-3 years."

Small But Growing



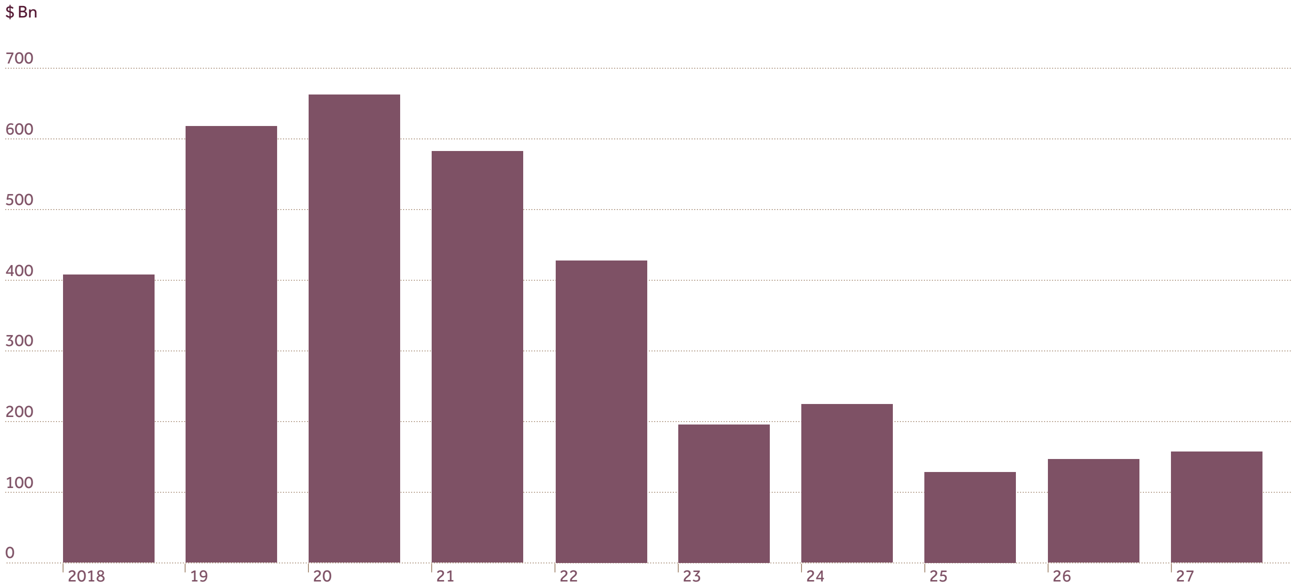
Sources: People's Bank of China; U.S. Treasury; Bloomberg, February 2018.

Chapter 2: The Refinancing Challenge

Even though the macro outlook has stabilised somewhat for the time being, China's bond markets may face significant hurdles in the near future – especially when it comes to refinancing. In fact, a reckoning may be just around the corner: over the next five years a significant portion of the country's outstanding debt is due to mature, raising default concerns in the market.[7]

In total there's $409 billion of onshore and offshore bonds maturing in 2018, followed by $619 billion in 2019 and $664 billion in 2020, according to Dealogic (see graph below).[8]

China Outstanding Debt (Bonds)



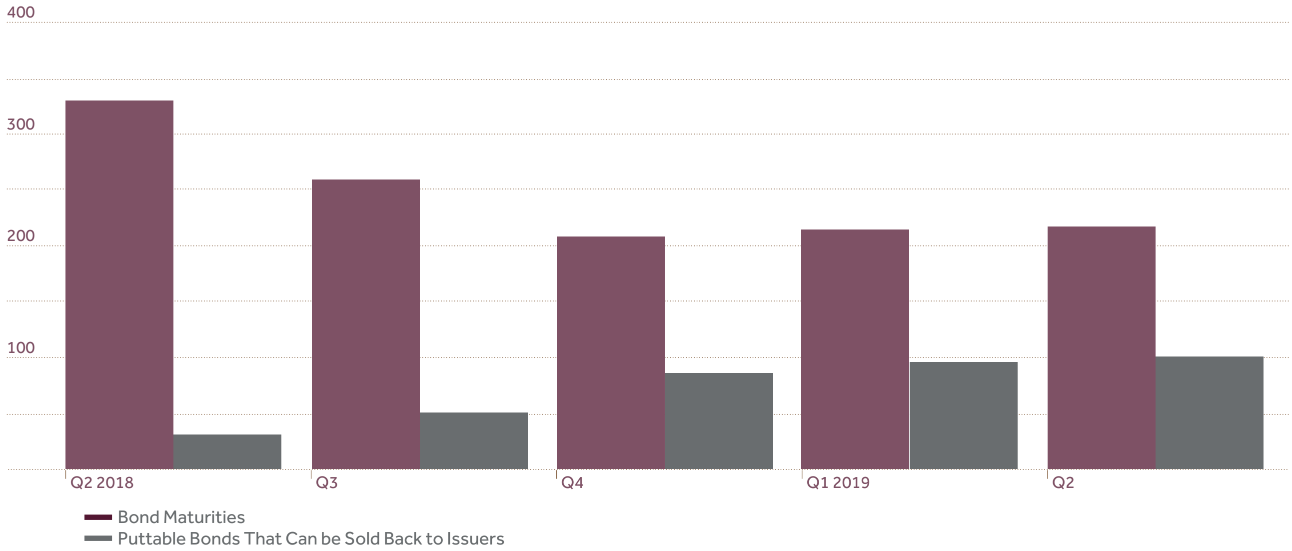
Sources: Dealogic; Financial Times, January 2018.

Treading cautiously, China's policymakers are still trying to limit spiralling debt levels via the government-backed anti-leverage campaign launched in 2017. And it's not only corporate borrowing that's falling under tighter scrutiny. Policymakers are also no longer tolerant of off-balance sheet municipal borrowing. In fact, according to some analysts, 2018 might see the first default by a local government financing vehicle (LGFV)[9] – which would mark a major milestone in the market's evolution.

7 Financial Times. January 2018.
8 Financial Times. January 2018.
9 Reuters. January 2018.

Will a LGFV Default for the First Time?

RMB Bn



Source: Bloomberg, March 2018.

While allowing defaults of LGFVs would be surprising, the development could also boost confidence in China's onshore bond markets according to some analysts, as it would signal a move toward allowing a greater role of market forces to determine the winners from the losers, regardless of the borrower's status. Such developments – when supported by increasing inclusion of China bonds in global indexes – could ultimately drive more international participation in the domestic market.

"China onshore bonds are still largely classified as non-benchmarking investing, so it is a tactical allocation rather than a structural allocation for many asset owners and asset managers," says FTSE Russell's Li. "Very often investing in onshore bonds is still considered more of an FX play. This could change in the future once China bonds are part of mainstream indexes, particularly with the growing trend of more inflow into passive funds."

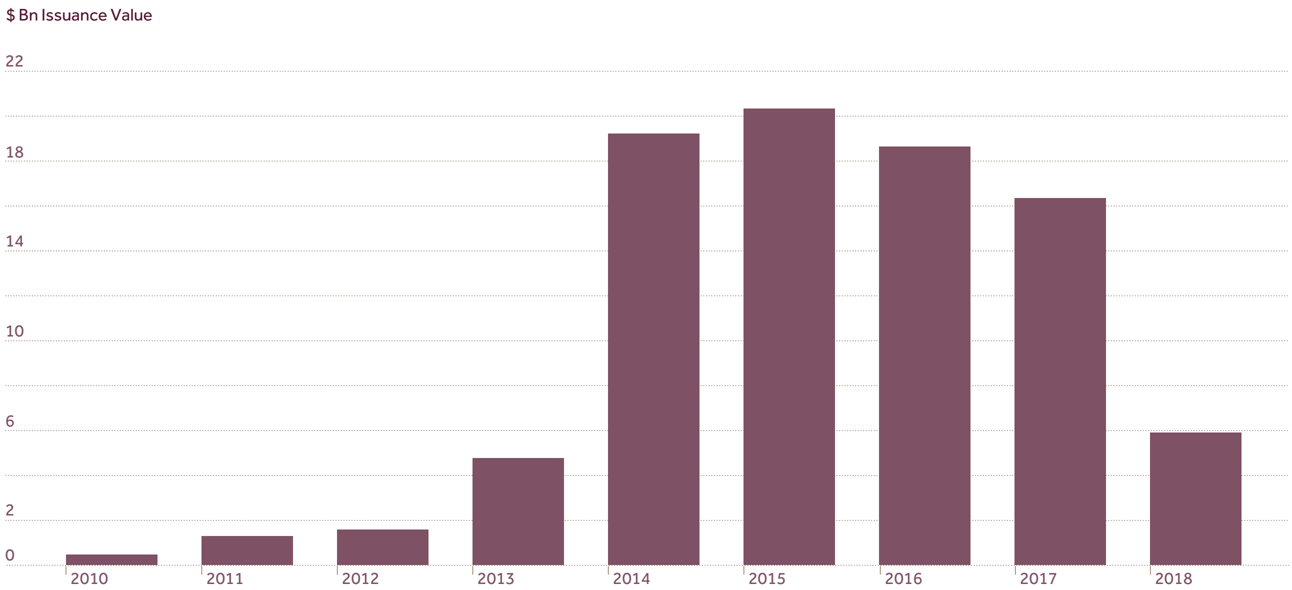
Chapter 3: Dim Sum Shows Signs of Life

While investor interest in the onshore market accelerates, many issuers are also confident they will currently find appetite in the offshore – or, 'dim sum' – market, reversing that market's downward trend in recent years. Dim sum issuance had withered to record lows following the RMB devaluation in 2015, and the opening of the onshore interbank market. But now a combination of factors is spurring issuances offshore, including tighter lending conditions on the back of the anti-leverage campaign, rising US interest rates, and the potential for the RMB to strengthen further.[10]

In January this year, Australia's Westpac Banking Corp sold a 500 million RMB ($77 million) three-year bond, and India's IL&FS Transportation Networks Ltd. quickly followed suit with its 900 million RMB 2021.[11]

And it's not only foreign firms getting in on the dim sum action. In February, the Macao branch of the Bank of China priced the largest dim sum bond in two-and-a-half years, in a 4 billion RMB ($634 million) deal.[12] In recent weeks, Shimao Property said it will issue 950 million RMB ($149.7 million) dim sum bonds, the fourth Chinese developer to tap the offshore market in 2018.[13]

Dim Sum Regains Some Lost Ground



Source: Bloomberg, March 2018.

According to Standard Chartered, dim sum and certificates of deposit issuance offshore is on track for a strong year and may hit 310 billion RMB, nearly doubling the 167 billion RMB of 2017.[14]

10 Reuters. March 2018.
11 Global Capital. January 2018.
12 Financial Times. February 2018.
13 Reuters. March 2018.
14 Financial Times. February 2018.

It is worth noting that Hong Kong's government has announced a package of measures to develop the city's bond market by launching a HKD2.5 million three-year pilot bond grant scheme to attract more first-time corporate issuers, which is likely to boost the supply of dim sum bonds in Hong Kong this year. The FTSE Dim Sum (Offshore CNY) Bond Index has already seen an 8 percent increase in market size between end-January and end-March this year.[15]

Given this trend, it appears China's bond markets – both onshore and off – will continue to offer international market participants a diversified range of opportunities in the short-term, each option suiting different risk appetites and investor types.

"In terms of bonds that are attractive to foreign investors, government and policy bank bonds may continue to be appealing from the perspective of higher yields for similar credit rating sovereigns, and lower risks and relatively stable CNY outlook for real money investors," says FTSE Russell's Li. "Even after hedging for currency risk, the hedged return may still be relatively attractive. While for hedge funds, certificates of deposit (CDs) have been attractive so far and may continue to be the target for carry trades."

15 FTSE Russell. April 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Chapter 4: Performance of FTSE Russell China Bond Indexes

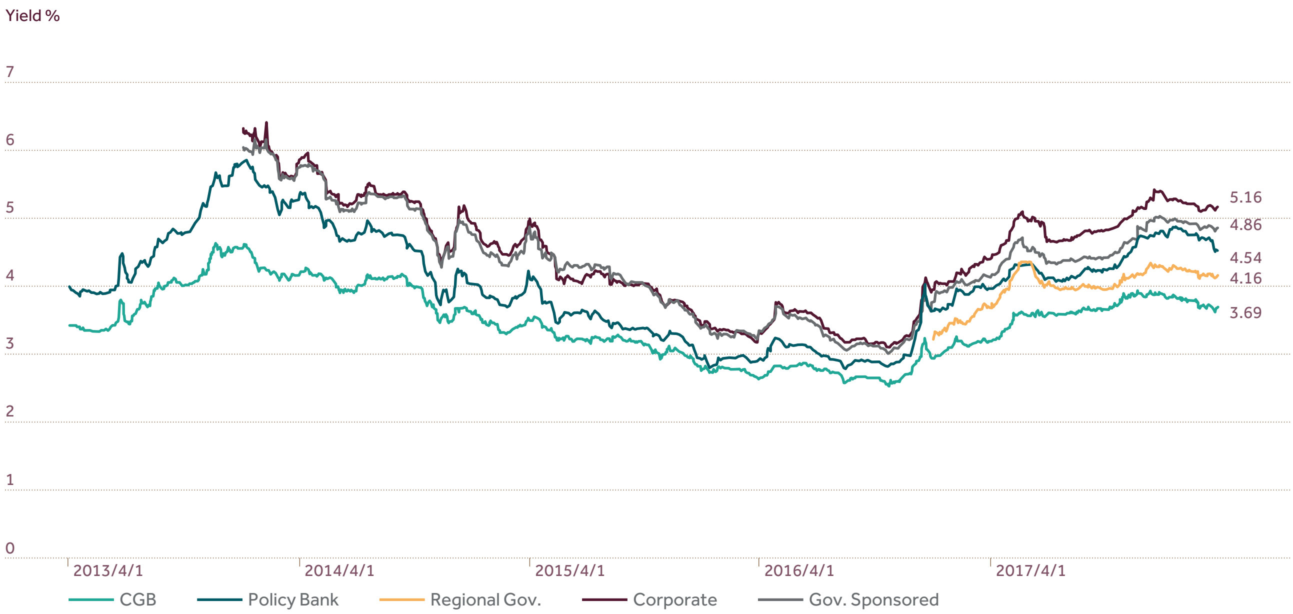
Onshore Report

Yield

Five major sectors are covered in FTSE Chinese (Onshore CNY) Broad Bond Index (CNYBBI). The yield of the CNYBBI as of end-March was 4.31%. Among the five major sectors, the Government Bond (CGB) sector was at 3.69%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 4.54%; the Regional Government sector was at 4.16%; the Corporate sector was at 5.16%; the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 4.86% as shown in the chart below.

For 2018 Q1, the yield of CNYBBI decreased by 21.79bps with corporate spread tightened by 3.50bps.

Chart 1. The Historical Yield of 5 Sectors in CNYBBI Sectors



Source: FTSE Russell, data as at 31 March 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Total Return

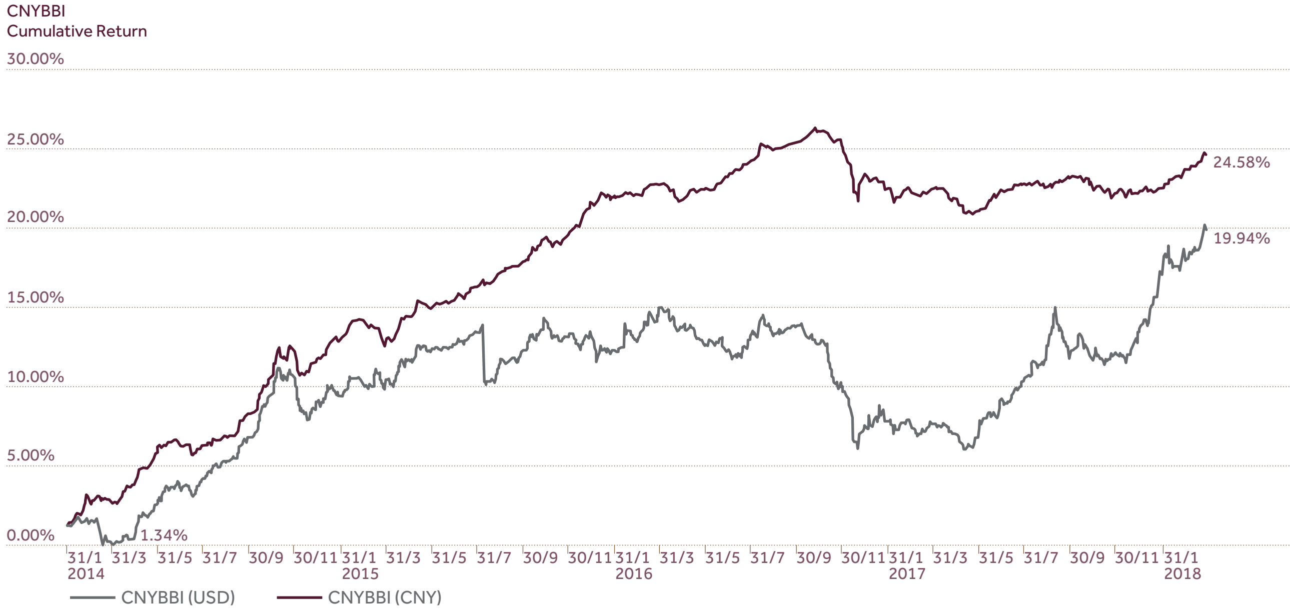
The CNYBBI in USD unhedged terms finished up 5.41% while its return in CNY finished up just 1.86% during the last quarter. CNY appreciation was the main driver in the same period. The returns of some sectors are shown in Table 1 and the cumulative return in USD and CNY are shown in Chart 2.

Table 1. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD, unhedged)					Anualized Volatility (USD, unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
CNYBBI	5.41	6.72	11.36	9.02	NA	3.99	3.65	NA
CGB	5.37	7.29	10.72	8.15	17.39	4.13	3.83	3.49
Policy Bank	5.64	6.24	11.45	8.69	18.67	4.06	3.82	3.55
Corporate	5.43	7.15	12.43	11.48	NA	3.90	3.52	NA

Source: FTSE Russell - total return data in USD, as at 31 March 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Chart 2. CNYBBI Performance in USD vs in CNY Since Inception Date on 2013/12/31



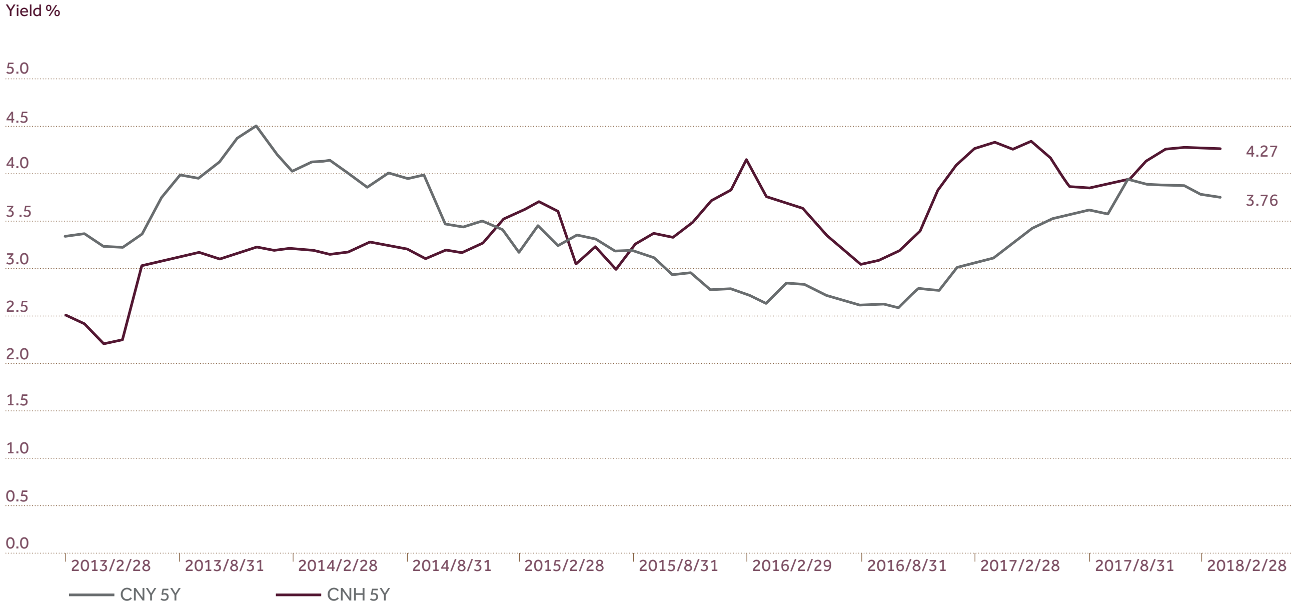
Source: FTSE Russell - total return data in USD and CNY, as at 31 March 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds

Yield

The yield of onshore 5 year Sovereign bonds was at 3.76% and the yield of offshore 5 year Sovereign bonds was at 4.27% as of end of Q1. The spread widened by 13bps for Q1 of 2018 as shown in Chart 3.

Chart 3. Onshore 5 Year Yield vs Offshore 5 Year Yield



Source: FTSE Russell as at 31 March 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

As of end of Q1 2018, the Offshore Chinese Treasury Yields were higher than the Onshore Chinese Treasury Yields over the entire curve. The short end curve 1 year spread was 77bps and the long end curve 10 year spread was 57bps.

Total Return

The FTSE Chinese Government Bond Index outperformed the FTSE Offshore counterpart during Q1 2018 as shown in Table 2. The major contribution for their return in USD was CNY appreciation.

Table 2. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD Unhedged)					Anualized Volatility (USD Unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Chinese Government Bond Index (Onshore CNY)	5.37	7.29	10.72	8.15	17.39	4.13	3.83	3.49
FTSE Chinese Government Bond Index (Offshore CNY)	4.75	6.80	14.34	8.16	10.35	4.09	4.48	3.80

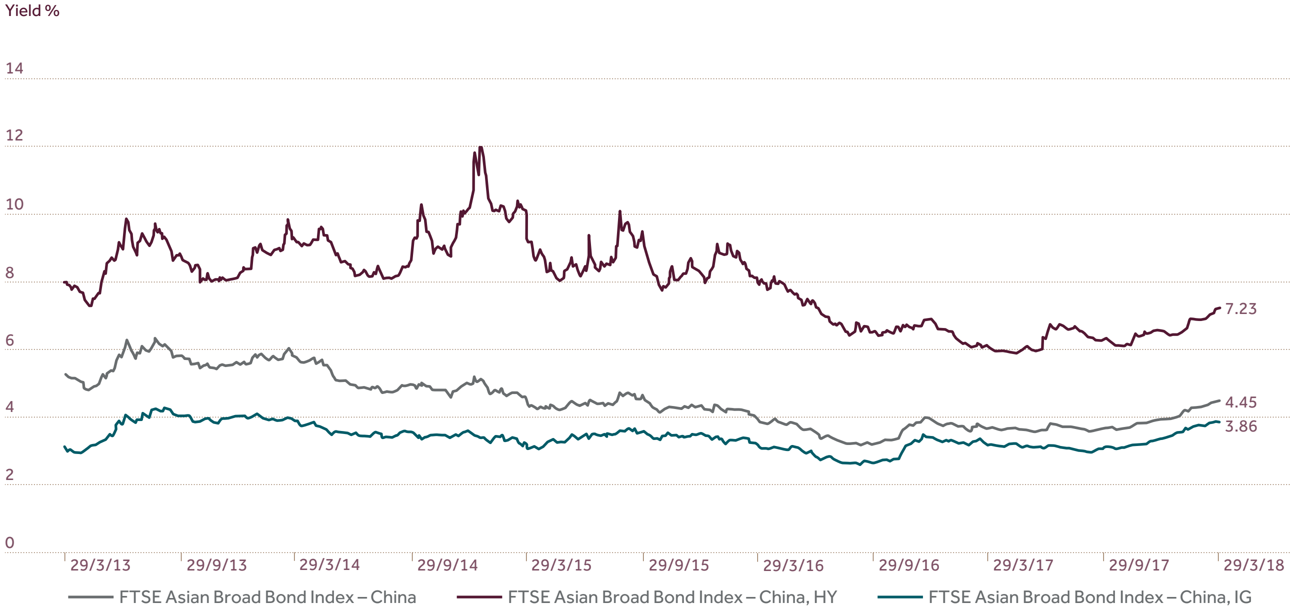
Source: FTSE Russell, total return data in USD, as at 31 March 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures. FTSE Chinese Government Bond Index (Offshore CNY) is a sub-index in the FTSE Dim Sum (Offshore CNY) Bond Index.

USD Bonds Issued by Chinese Issuers

Yield

The yield of the FTSE Asian Broad Bond Index - China was at 4.45%. Among the 2 sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade Index was at 3.86%; the FTSE Asian Broad Bond Index – China, High-Yield Index was at 7.23% as shown in the below chart.

Chart 4. The Yield of FTSE Asian Broad Bond Index - China and Sub-Indexes



Source: FTSE Russell - total return data in CNY, as at 31 March 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Total Return

The FTSE Asian Broad Bond Index-China finished down 1.24% during the last quarter, with its Investment-Grade sub-index down 1.39% and its High-Yield sub-index down 0.5%.

Table 3. Performance and Volatility – Total Return

	Cumulative Return in USD (%)					Anualized Volatility		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Asian Broad Bond Index – China	-1.24	-0.84	1.81	12.16	22.81	1.38	2.10	2.58
FTSE Asian Broad Bond Index – China, IG	-1.39	-1.15	1.42	8.47	17.06	1.62	2.32	2.86
FTSE Asian Broad Bond Index – China, HY	-0.50	0.58	3.53	31.30	44.02	1.70	3.37	4.25

Source: FTSE Russell - total return data in USD, as at 31 March 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

For more information about our indexes, please visit ftserussell.com.

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