Research

FTSE Russell China Bond Research Report

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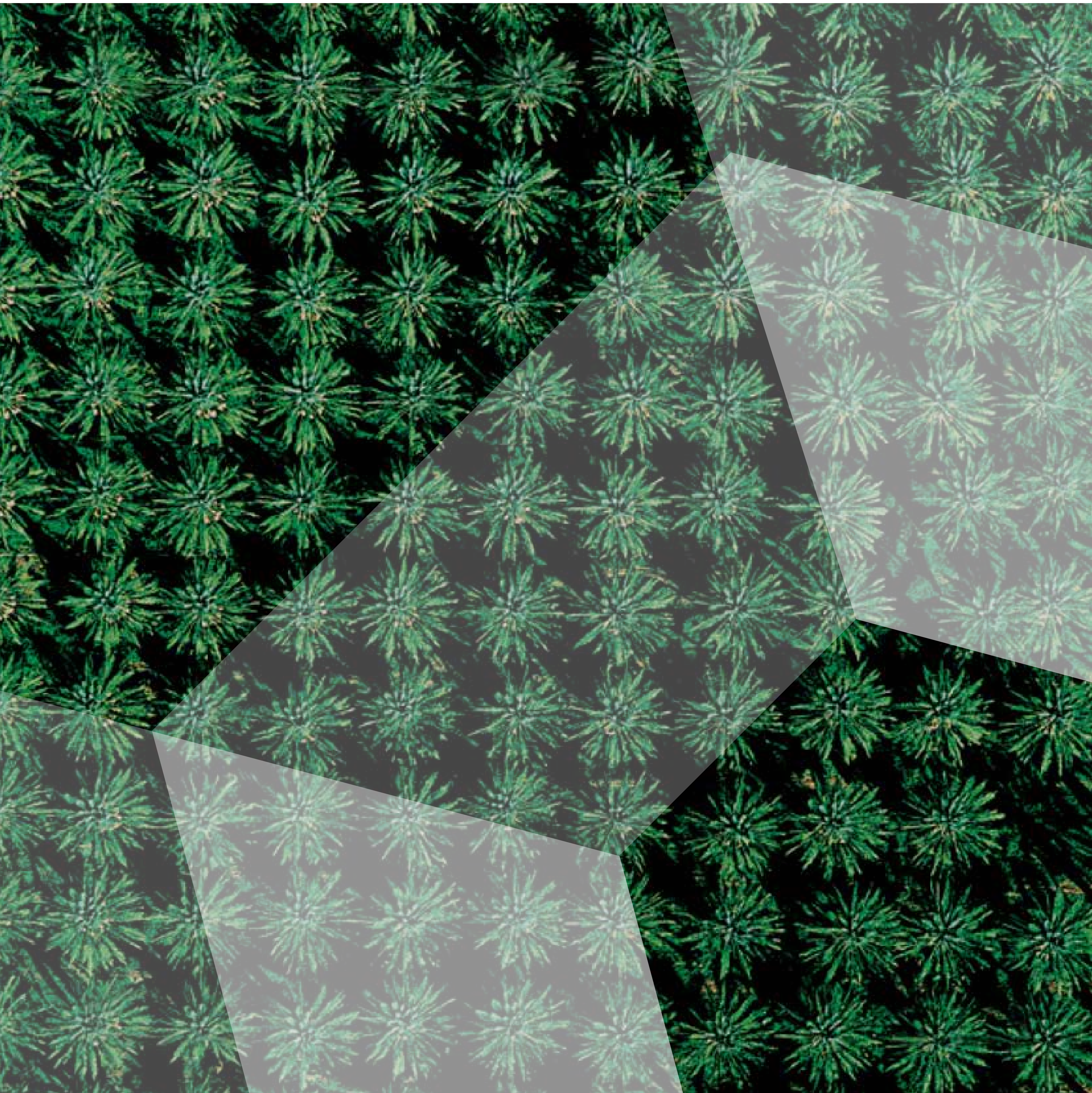

FTSE Russell China Bond Research Report

Highlights

- China's US$12 trillion bond market is projected to double in size in the next four years to about US$24 trillion, according to Goldman Sachs. Chinese Government Bonds (CGBs) are forecast to account for an estimated US$4 trillion of that market by the end of 2022.[1]
- Despite growth in its bond market, China's currency – the renminbi (RMB) – is depreciating on the back of trade tensions and slower macroeconomic growth. The RMB hit a 10-year low in late October 2018; and the interest rate gap between China and the US narrowed due in part to the Federal Reserve's tightening policies.[2]
- Meanwhile, yields on sovereign debt continue to fall in China at a time when yields on similar debt of many other major economies are rising due to an uncertain outlook for the global economy. As of end-2018, the yield on China's 10-year sovereign notes had tumbled 63bps since the beginning of last year.[3]

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1 Bloomberg. December 2018.
2 Reuters. November 2018.
3 Yield Book by FTSE Russell. December 2018.

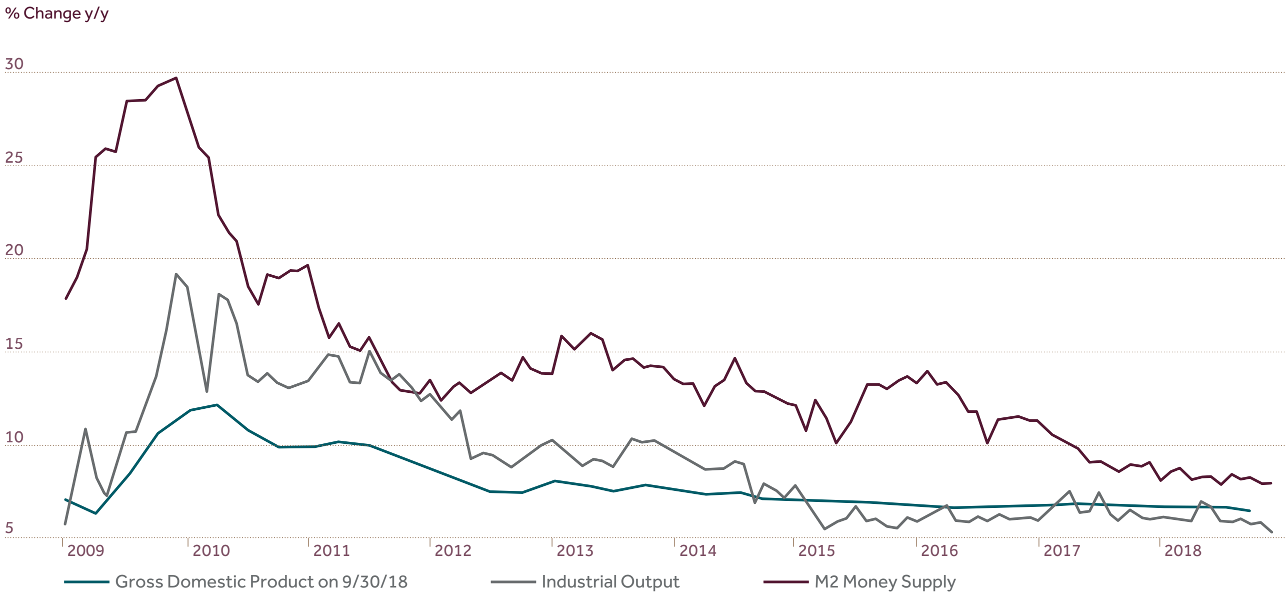
Chapter 1: Overview

Growth projections for China's bond market remain strong even as the RMB weakens amid trade tensions

China's bond markets are set to evolve at a rapid pace in 2019 – even if fears of prolonged trade tensions between the US and China are dominating headlines. By some estimates the Asian giant's US$12 trillion bond market is projected to double in size in the next four years to about US$24 trillion; and Chinese Government Bonds (CGBs) are forecast to make up US$4 trillion of that market by the end of 2022.[4]

Such growth won't be easy to pull off, given the uncertain macroeconomic outlook for 2019. What is more, the residue of 2018 – which saw slowing macroeconomic expansion, currency depreciation, and a sharp loss in value in Chinese stocks – could linger and further dampen risk appetite among international investors.[5]

China's Macroeconomic Growth is Slowing

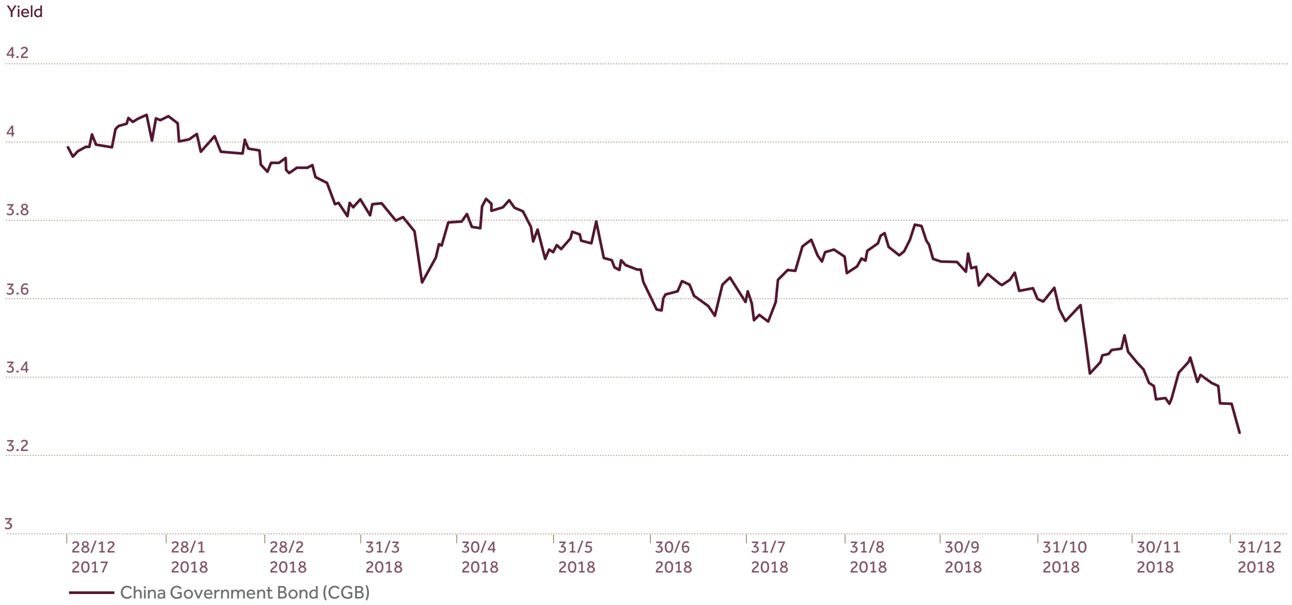


Source: Bloomberg, November 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

At the same time, there's good news for China's bond markets – especially sovereign debt: CGBs saw one of the strongest government-bond rallies in the world in late 2018, due in part to their 'safe-haven status' during turbulent times[6] for both domestic and international investors. Yields continue to fall on sovereign debt, while costs on similar debt of many other major economies are rising. As of end-2018, the yield on 10-year sovereign notes had tumbled 63bps for the calendar year.[7]

4 Bloomberg. December 2018.
5 Bloomberg. December 2018.
6 Bloomberg. December 2018.
7 Yield Book by FTSE Russell. December 2018.

10 Year CGB Yield



Source: Yield Book by FTSE Russell, December 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Chapter 2: Playing the long-game

International appetite for CGBs is also increasing in line with continued market reforms in China. Holdings of government bonds by foreigners reached US$155 billion at the end of December 2018; and foreign net purchases of CGBs hit US$70 billion in the twelve months to December. Many investors in CGBs continue to be long-term holders of assets, including currency reserve managers, pensions and large state-backed investor groups such as sovereign wealth funds.[8]

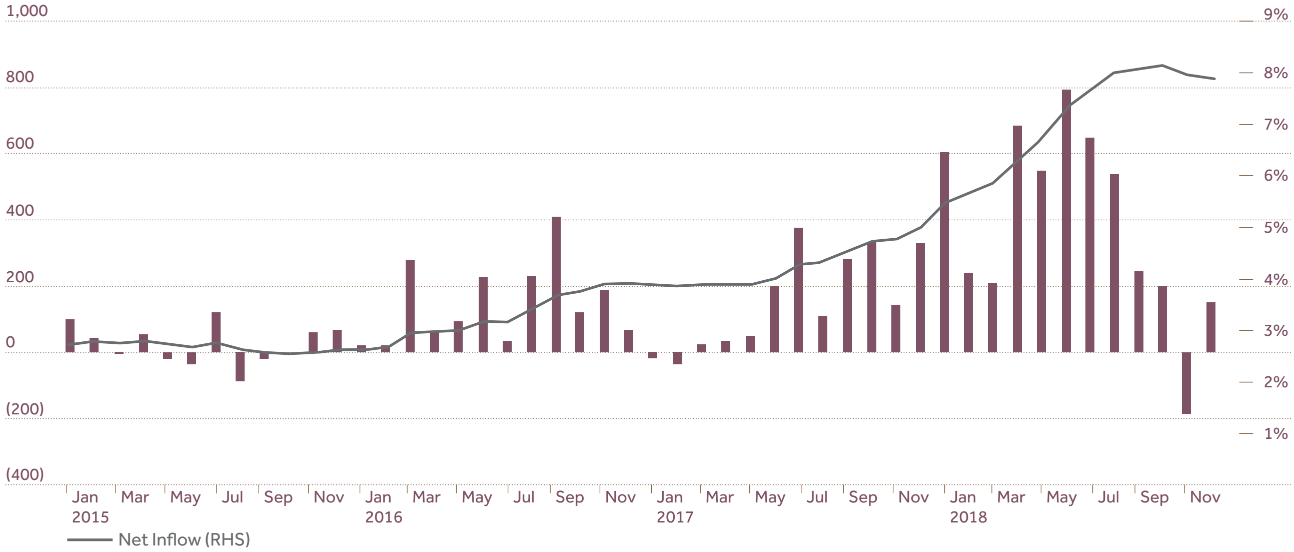
At the same time, China's regulators also continue to play the long game and issue a raft of new policies to draw more international investors into the market. On that basis, in November 2018 China's cabinet said that foreign onshore bond market investors will enjoy tax exemption on interest income earned in the domestic bond market for a period of three years effective November 7, 2018.[9]

Months earlier in September 2018, offshore investors raised holdings of bonds issued by policy banks by 11.5 billion RMB to 342 billion RMB (US$49.43 billion), the highest on record, according to Reuters calculations based on data from China Central Depository and Clearing Co (CCDC).[10]

8 Wind. December 2018.
9 China Ministry of Finance. November 2018.
10 Reuters. November 2018.

Net Inflow - China

Bonds (in 100 Millions RMB)

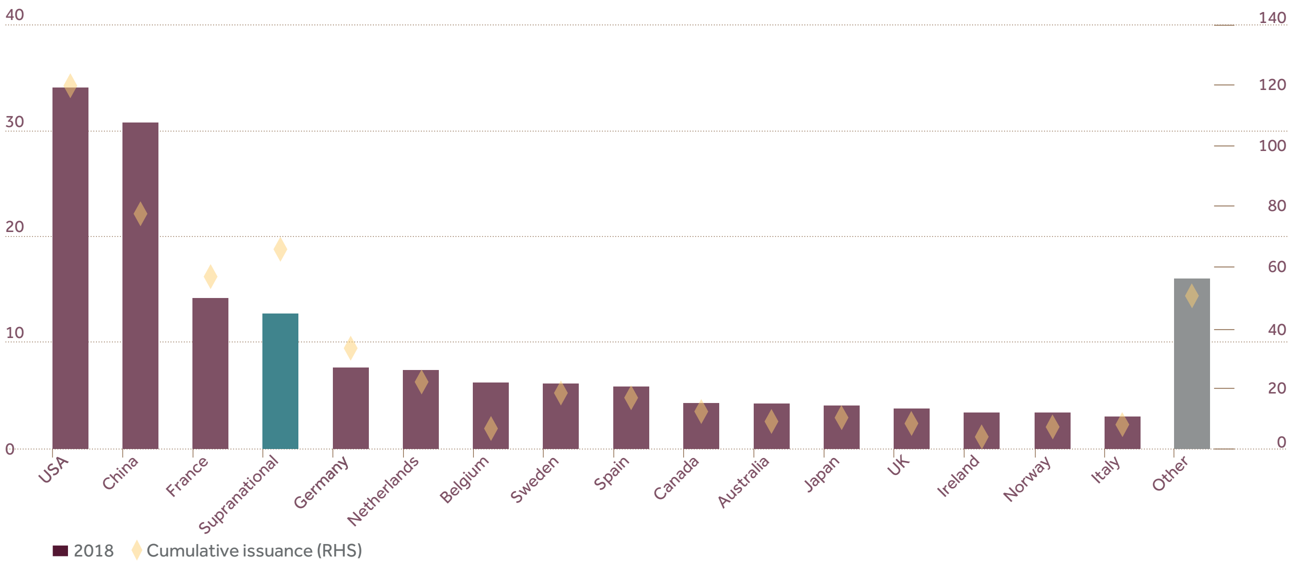


Source: WIND, CCDC. January 2019.

Meanwhile, China will likely continue to play a pivotal role in the evolution of 'green finance' in 2019. In 2018, onshore green bond issuance hit US$41.4 billion (of which US$10.5 billion did not align with international definitions), representing 25% of global green bond issuance in 2018. China is currently the 2nd largest green bond market right after the US.

Green Bond Issuance: Top 15 Countries (2018)

USD Bn



Source: Climate Bonds Initiative, January 2019.

Chapter 3: What lies ahead

Looking ahead into 2019, so-called 'safe-haven' assets could remain in focus due to trade tensions and slowing macroeconomic growth. Macroeconomic data released in mid-November – from credit growth to retail sales – missed economists' estimates;[11] while data released in December revealed manufacturing gauges fell into contraction, the weakest since 2016.[12]

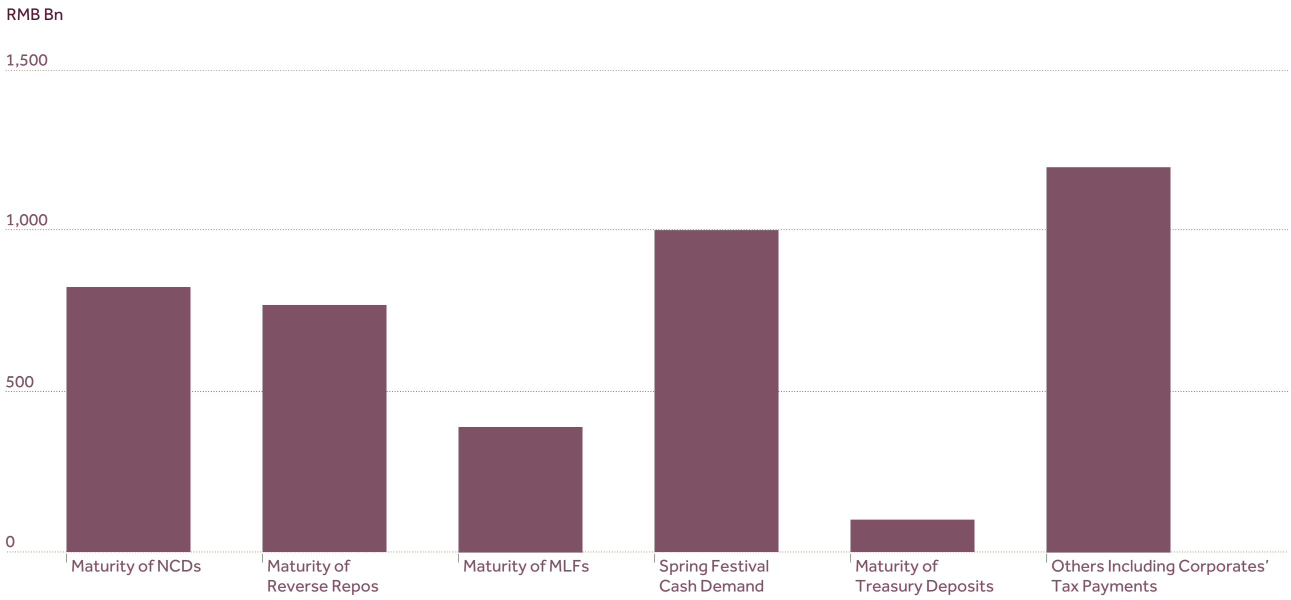
RMB vs US Dollar (2018)

Source: Bloomberg, December 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

In response to these trends, PBOC policymakers said in early January lenders will be allowed to cut reserve cash (RRR) by 1 percentage point, which in turn, could unleash an estimated 800 billion RMB of liquidity, by some estimates.[13]

11 Bloomberg. November 2018.
12 Bloomberg. January 2019.
13 Bloomberg. January 2019.

Does China Face a Looming Cash Squeeze in 2019?



Source: Bloomberg, Citic Securities. January 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

According to some analysts, the stimulus will help but few experts see China's economy returning to previous growth levels in the short-term. Nevertheless, predictions abound that foreign inflows into China's bond market will accelerate in 2019 on the back of continued liberation and opening up of the market, even despite slower macroeconomic growth.[14]

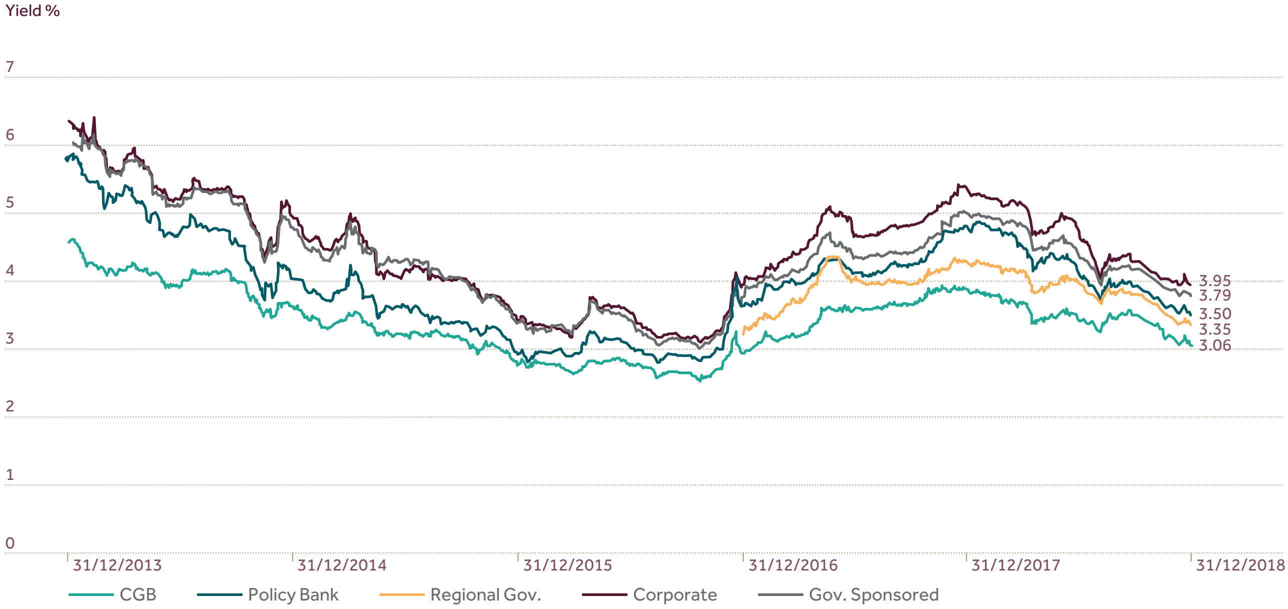
Chapter 4: Performance of the FTSE Russell China Bond Indexes

Yield

Five major sectors are covered in FTSE Chinese (Onshore CNY) Broad Bond Index (CNYBBI). The yield of the CNYBBI as of end-December was 3.41%. Among the five major sectors, the Government Bond (CGB) sector was at 3.06%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 3.50%; the Regional Government sector was at 3.35%; the Corporate sector was at 3.95%; the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 3.79% as shown in Chart 1. For 2018 Q4, the CNYBBI decreased by 42bps while corporate spread widened by 10bps.

14 Bloomberg. January 2019.

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



Source: FTSE Russell, data as of December 31, 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

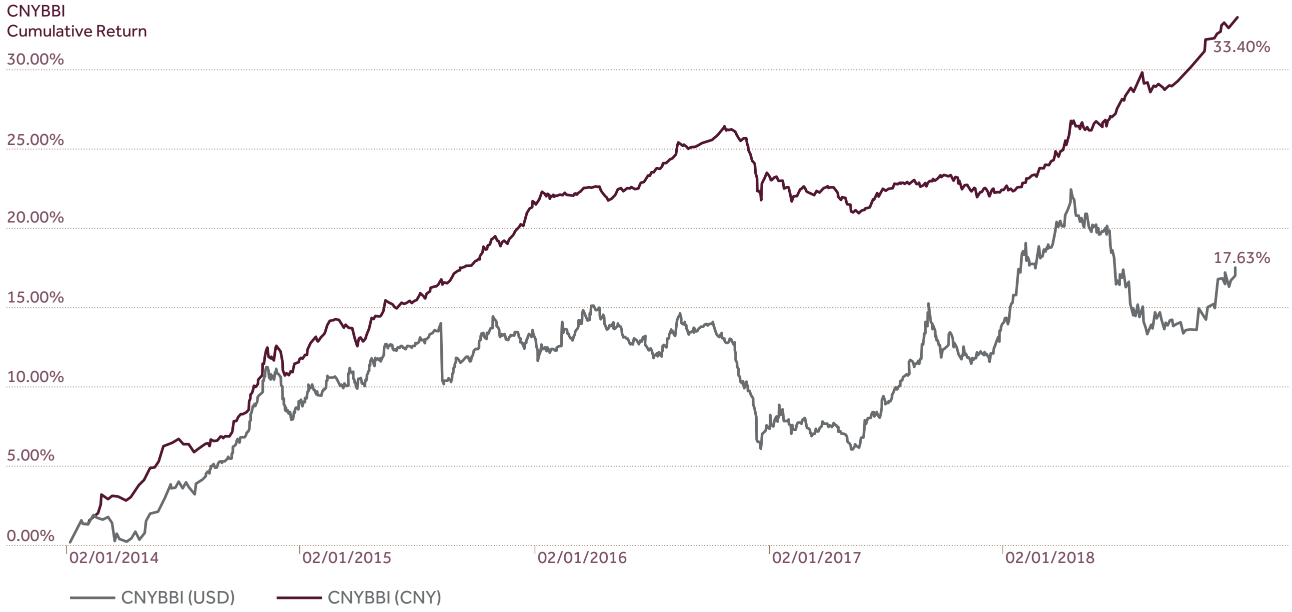
The CNYBBI in USD unhedged terms finished up 3.27% while its return in CNY finished up 3.05% during the last quarter. The returns of some sectors are shown in Table 1 and the cumulative return in USD and CNY are shown in Chart 2.

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

	Cumulative Return (USD, unhedged)					Annualized Volatility (USD, unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
CNYBBI	3.27	0.90	3.44	3.72	NA	4.71	3.98	NA
CGB	3.64	0.31	2.62	3.06	15.25	4.90	4.15	3.83
Policy Bank	3.30	1.26	4.51	3.98	18.88	4.84	4.14	3.87
Corporate	2.31	0.76	3.12	5.48	NA	4.50	3.80	NA

Source: FTSE Russell – total return data in USD, as of December 31, 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 (31/12/2013)



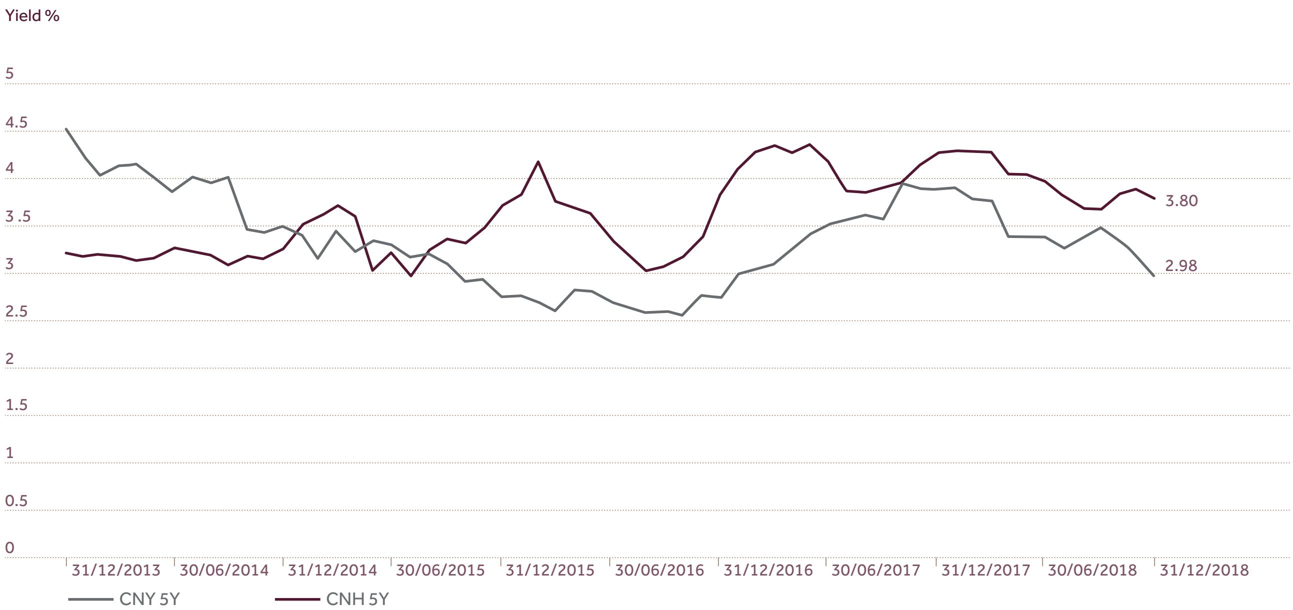
Source: FTSE Russell – total return data in USD and CNY, as of December 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds

Yield

The yield of onshore 5 year Sovereign bonds was at 2.98% and the yield of offshore 5 year Sovereign bonds was at 3.80% as of the end of Q4. The spread widened by 62bps for Q4 of 2018 as shown in Chart 3.

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



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

As of the end of Q4 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 91bps and the long end curve 10-year spread was 45bps.

Total Return

The FTSE Chinese Government Bond Index outperformed the FTSE Offshore counterpart during Q4 2018 as shown in Table 2.

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

	Cumulative Return (USD, unhedged)					Annualized Volatility (USD, unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Chinese Government Bond Index (Onshore CNY)	3.64	0.31	2.62	3.06	15.25	4.90	4.15	3.83
FTSE Chinese Government Bond Index (Offshore CNY)	0.98	-1.19	0.09	6.94	2.91	5.26	4.52	4.23

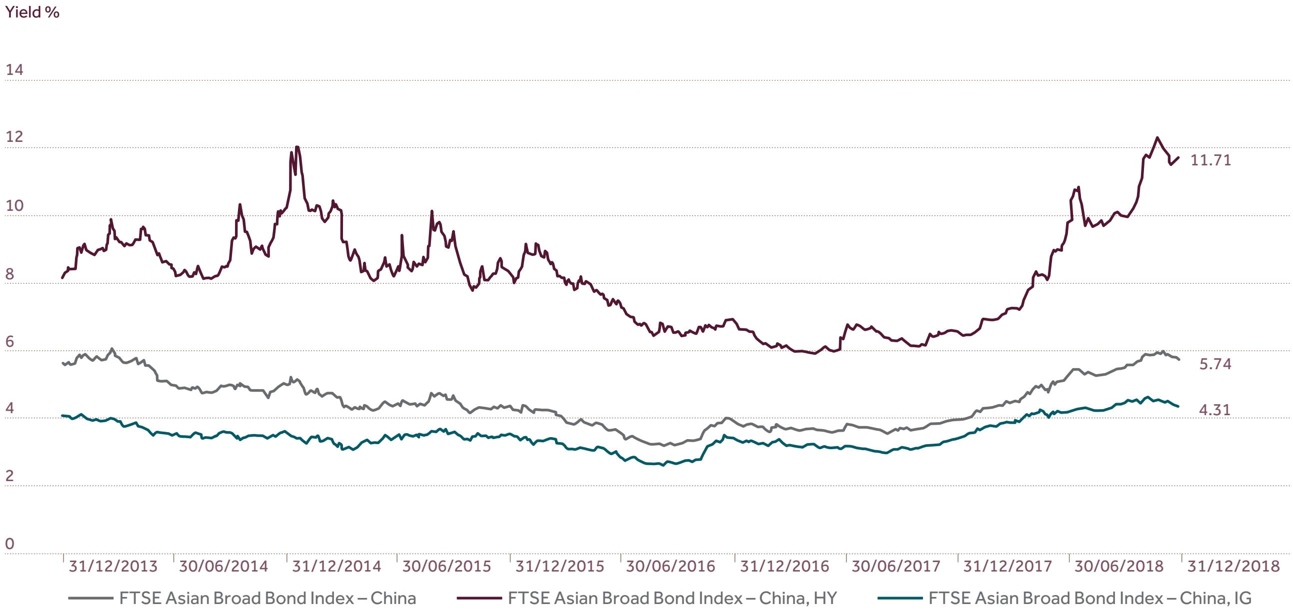
Source: FTSE Russell, total return data in USD, as of December 31, 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures. FTSE Chinese Government Bond Index (Offshore 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 5.74%. Among the two sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade was at 4.31%; the FTSE Asian Broad Bond Index – China, High-Yield was at 11.71% as shown in Chart 4.

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



Source: FTSE Russell – total return data in CNY, as of December 31, 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 up 0.97% during the last quarter, with its Investment-Grade sub-index up 1.50% and its High-Yield sub-index down 1.34%.

Table 3. Performance and Volatility – Total Return

	Cumulative Return (USD, unhedged)					Annualized Volatility (USD, unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Asian Broad Bond Index – China	0.97	1.69	-0.36	10.59	24.39	1.55	1.81	2.17
FTSE Asian Broad Bond Index – China, IG	1.50	1.91	0.51	9.89	23.56	1.66	2.03	2.34
FTSE Asian Broad Bond Index – China, HY	-1.34	0.70	-4.17	15.24	32.54	3.13	2.59	4.11

Source: FTSE Russell – total return data in USD, as of December 31, 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.

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