Research

FTSE Russell China Bond Research Report

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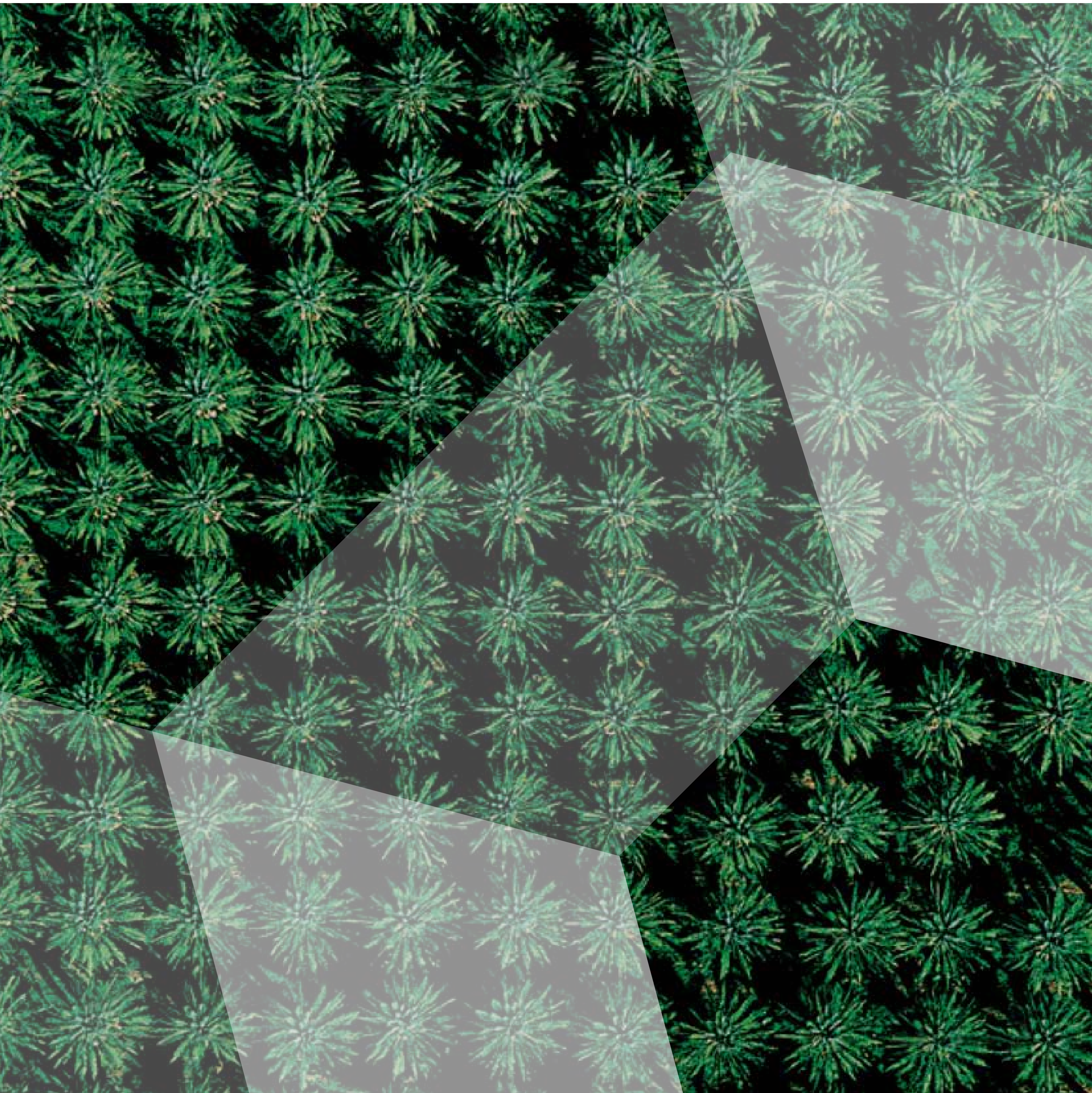

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Highlights

- Offshore holdings of Chinese government bonds hit a record high in June following their inclusion in a major global index. Foreign investors held a total of 1.16 trillion RMB (US$169.2 billion) bonds at the end of June, marking a 71.66 billion RMB increase over the previous quarter's record, according to data from China Central Depository and Clearing Co (CCDC), China's main bond clearing house.[1]
- In the corporate bond space, a lack of ratings from international agencies has been a major obstacle for foreign investors to increase holdings, given that China's domestic ratings regime is distinct, and not directly aligned with international credit-rating methods. Almost 75% of issuers ranked by domestic agencies are graded AA or above.[2] Furthermore, a 2017 white paper published by the Bank for International Settlements found global agencies graded Chinese offshore bonds lower than bonds issued onshore.[3]
- According to some media reports Chinese regulators could be close to releasing new green bond standards that would exclude polluting fossil fuel projects from corporate financing channels designed to lift environmental standards. Of the US$42.8 billion of green bonds issued in China in 2018, roughly US$31.2 billion met international criteria, said a report published by the Climate Bonds Initiative (CBI).[4]

1 FTSE Russell; CCDC. July 2019.
2 FTSE Russell; Wind; CCXI. July 2019.
3 Financial Times. April 2019.
4 Reuters. March 2019.

Chapter 1: Overview

Offshore holdings of Chinese government bonds rose in Q2, as ratings standards come into focus for corporate bonds

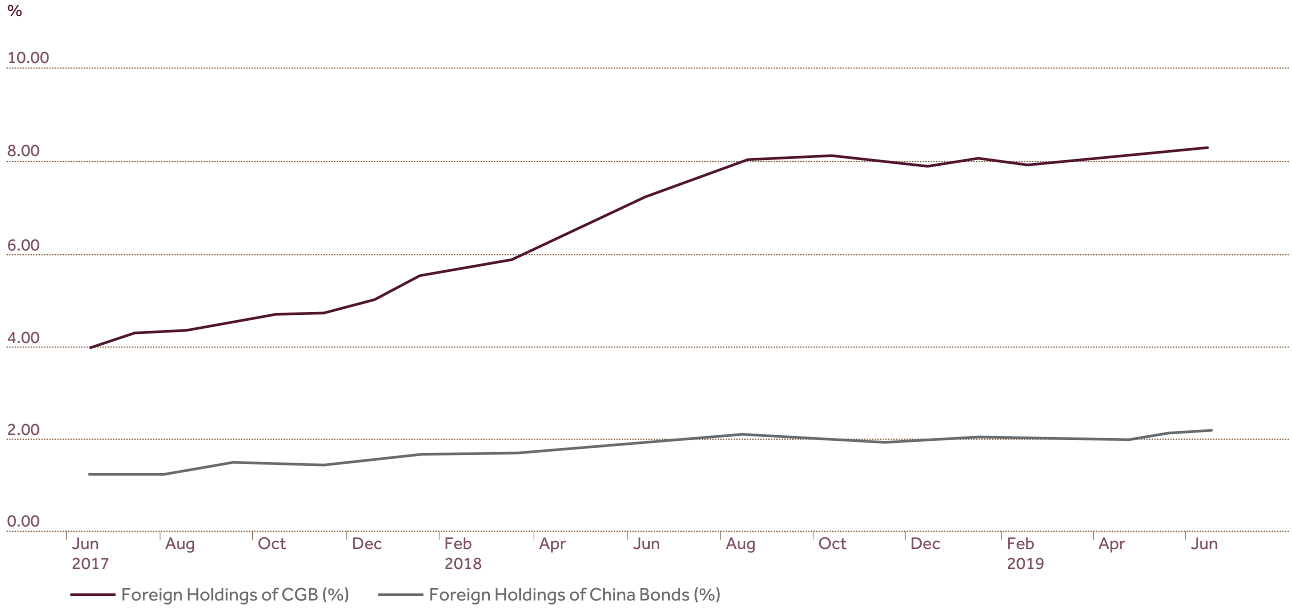
China's bond market continues to evolve as Q2 gives way to Q3 -- and it is attracting more interest from international participants eager for exposure to the world's second largest economy.

Offshore holdings of China's government bonds hit a record high in June following their inclusion in a major global index earlier in the quarter. Foreign investors held a total of 1.16 trillion RMB (US$169.2 billion) bonds at the end of June, marking a 71.66 billion RMB increase over the previous quarter's record, according to data from China Central Depository and Clearing Co (CCDC), China's main bond clearing house.[5]

Meanwhile, recently compiled data shows that as of end-Q2 2019, foreign investors held approximately 1.95 trillion RMB of China's domestic fixed income assets. That is roughly 2.2% of the total domestic bonds market, compared with 8.3% of foreign ownership of China government bonds as presented below.[6]

It is also clear that foreign investors, at least as of now, are still mostly investing in China government and policy bank bonds (82% in total), with relatively minor allocations in the corporate bonds space, as illustrated by the second chart.

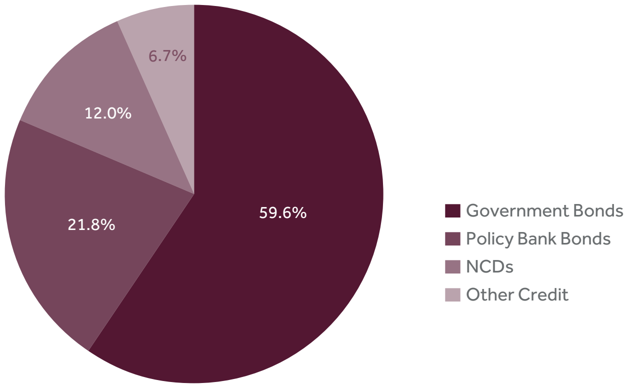
Foreign investors' holdings of CGB and China bonds



Source: CCDC; SCH; Wind; FTSE Russell, July 2019.

5 FTSE Russell; CCDC. July 2019.
6 FTSE Russell; CCDC; SCH. July 2019.

Type of Bonds Held by Foreign Investors



Source: CCDC; SCH; Wind; FTSE Russell, July 2019.

Despite the bond market's overall positive trajectory, China's policymakers are aware of the challenges presented by geopolitical issues at this time, and on that score are actively reassuring international market participants that China is still eager for more foreign investment, and will press on with financial reforms. In April, Wang Chunying, spokeswoman for the State Administration of Foreign Exchange (SAFE), said "China will become an important destination of diversified asset allocation for global investors in the future, under the policy of further opening up and facilitation."[7]

Even so, despite China's status as the world's second-largest bond market,[8] some international market participants have said that – when compared to more developed markets – the relative lack of liquidity for "off the run bonds" is a concern due to the tendency of China's commercial banks to "hold to maturity."

On that basis, some market participants anticipate China's policymakers may enact more regulatory changes in the near future. For example, policymakers could extend the treasury futures market to banks, which will provide additional hedging tools to enable more active market making, and in turn, enhance bond market liquidity in the long run.

Many changes are already underway. In May the PBOC published a draft consultation paper to introduce fungibility of different access channels, allowing QFII and RQFII investors to transfer to CIBM direct or bond connect on a non-transaction basis without the need for portfolio liquidation.[9]

7 Reuters. April 2019.
8 BIS. December 2018.
9 PBOC. May 2019.

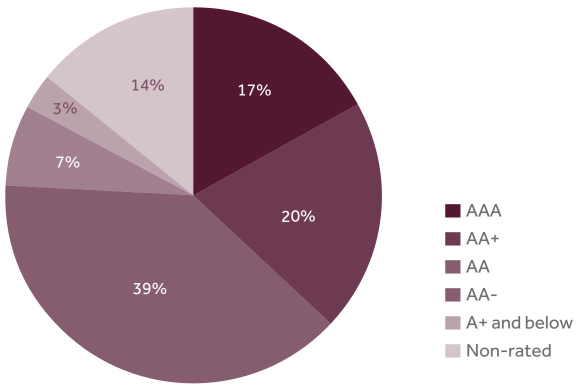
Chapter 2: Domestic ratings regime in focus

While appetite for China's government bonds grows on the back of global index inclusion, international market participants are also asking more questions about China's vast corporate bond market, especially China's domestic ratings regime.

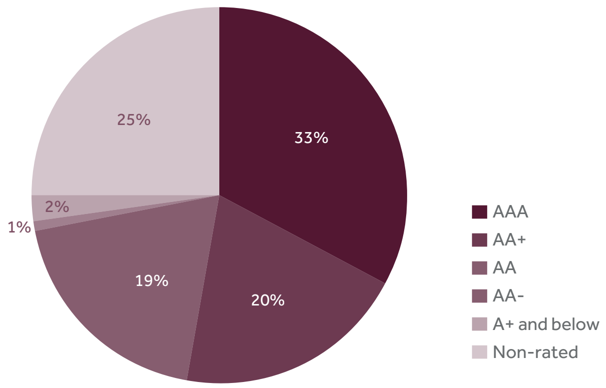
One persistent conception of foreign investors is that risk is not accurately priced and ratings are too high for many corporate bonds. For example, a white paper published by the Bank for International Settlements found global agencies such as Moody's and Fitch graded Chinese offshore bonds lower than bonds issued onshore, due in part to the application of different rating scales.[10]

Almost 75% of issuers ranked by domestic Chinese agencies are graded AA or above. However, one reason for this is corporations are not allowed to issue bonds if the issuer's rating is below AA-. Ratings below AA- are downgrades after issuance and the non-rated issuances are mainly private placements where ratings are not disclosed publicly, as illustrated in the chart below.[11]

Issuer Rating Distribution (by number of issuers)



Bond Rating Distribution (by number of bonds)



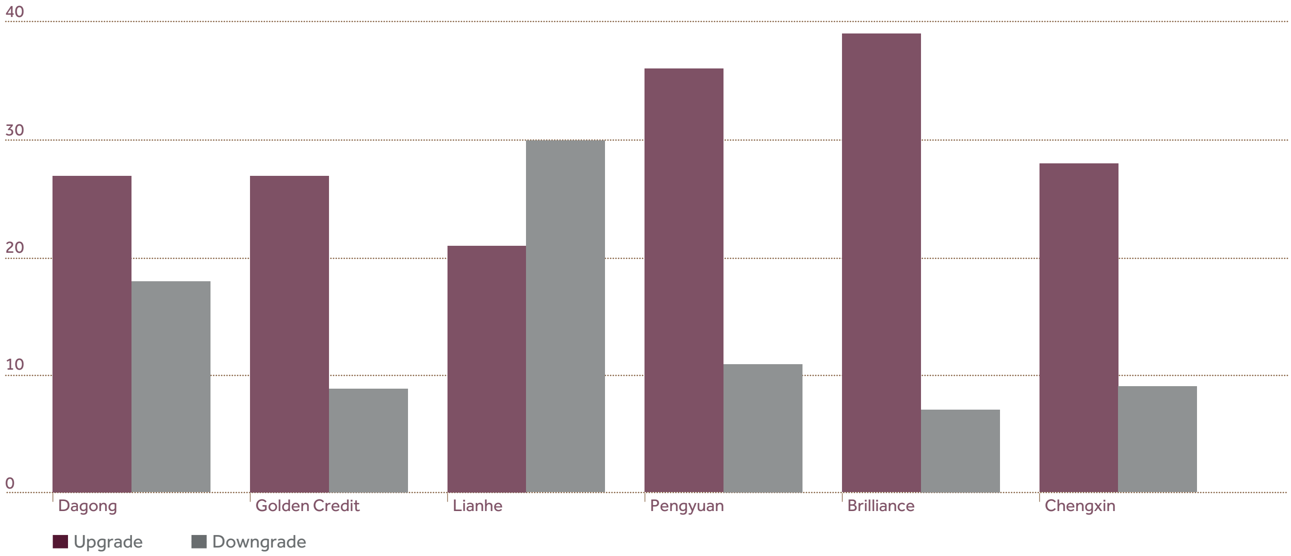
Source: Wind and CCXI. Data as of 31 March 2019.

Another challenge for the corporate market is that private enterprises in China struggle to issue bonds[12] and establish credit histories due to high regulatory barriers. Last October, the PBOC and CSRC released policy guidance for private enterprises to raise capital with additional credit support in the form of CRMW (credit risk mitigation warrants). So far for the first 6 months of this new initiative, 56 private enterprises have raised 39.86 billion RMB (US$5.8 billion) through 87 CRMWs.[13]

10 Financial Times. April 2019.
11 FTSE Russell. July 2019.
12 FTSE Russell. June 2019.
13 PBOC. May 2019.

The focus on domestic ratings also comes at a time when growing numbers of firms are defaulting due in part to slowing macroeconomic growth. In 2018, 45 corporate issuers defaulted on bonds with a combined face value of US$17 billion, according to Fitch. However, according to some reports, China's domestic ratings agencies issued double the number of upgrades versus downgrades during the same time period,[14] illustrating a potential disconnect between ratings and creditworthiness as the market evolves and matures.

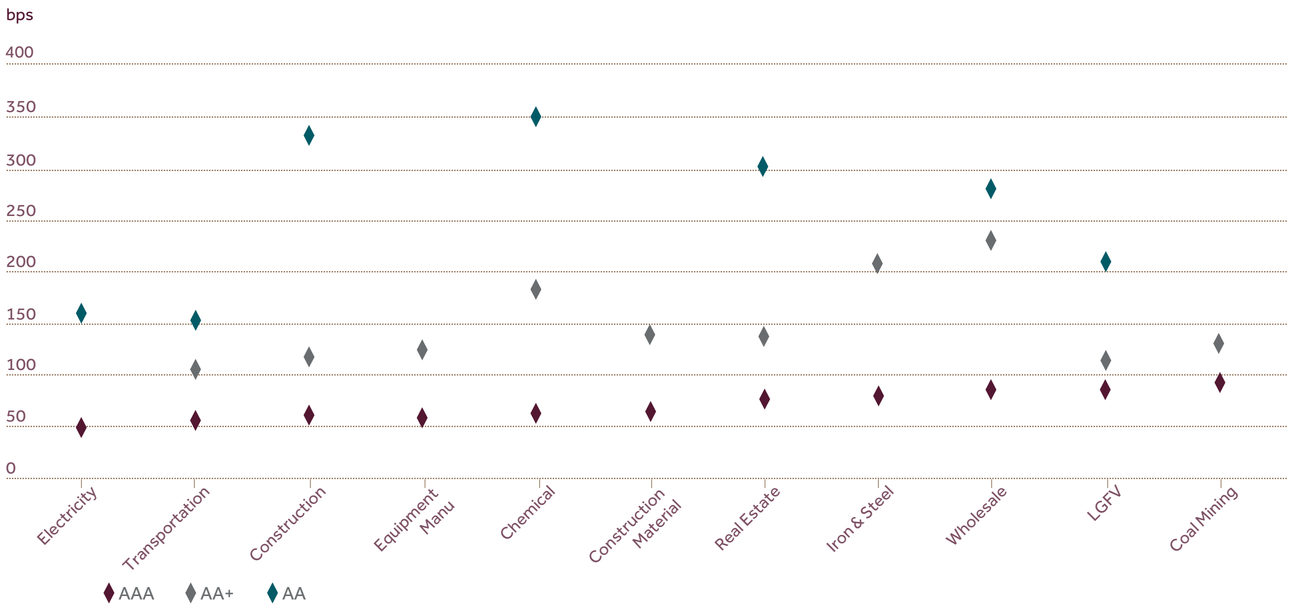
Number of Changes to Issuer Ratings by Major Chinese Credit Ratings Agencies in 2018



Source: Financial Times, April 2019.

At the same time, from another point of view it is also noticeable that credit spreads may be reasonably aligned with local credit ratings in most sectors, as illustrated in the chart below.

Medians of Credit Spread by Sectors (May 17 to June 14 of 2019, in bps)



Source: Wind and CCXI. Data for the period May 17-June 14.

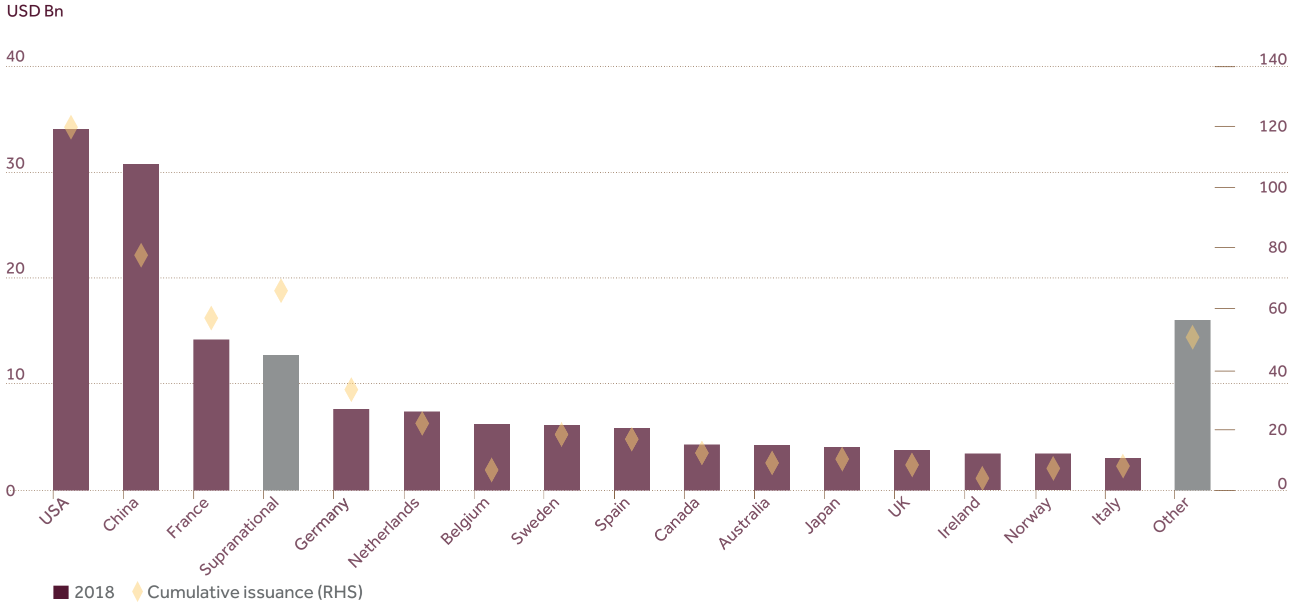
14 Financial Times. April 2019.

Chapter 3: New green bond standards

Another strong area of interest for international investors is China's continued leadership in the area of 'green bonds.' In recent years, Chinese regulators have staked a claim as leaders in green finance, and according to some reports, they are close to releasing new 'green bond' standards that would not include polluting fossil fuel projects from corporate financing channels designed to lift environmental standards, according to Reuters.[15]

According to a report published by the Climate Bonds Initiative (CBI), roughly US$31.2 billion of the US$42.8 billion worth of green bonds issued in China last year, would have met international criteria.[16]

The USA, China and France Record Top 3 Country Volumes in 2018



Source: Climate Bonds Initiative, March 2019.

The upward trend continues. For the first half of 2019, China has issued US$20.4 billion of green bonds (meeting both local and international green definitions) which is a 25% increase from the same period in 2018.[17]

15 Reuters. March 2019.
16 Climate Bonds Initiative. March 2019.
17 Climate Bonds Initiative. June 2019.

Chapter 4: Performance of the FTSE Russell China Bond Indexes

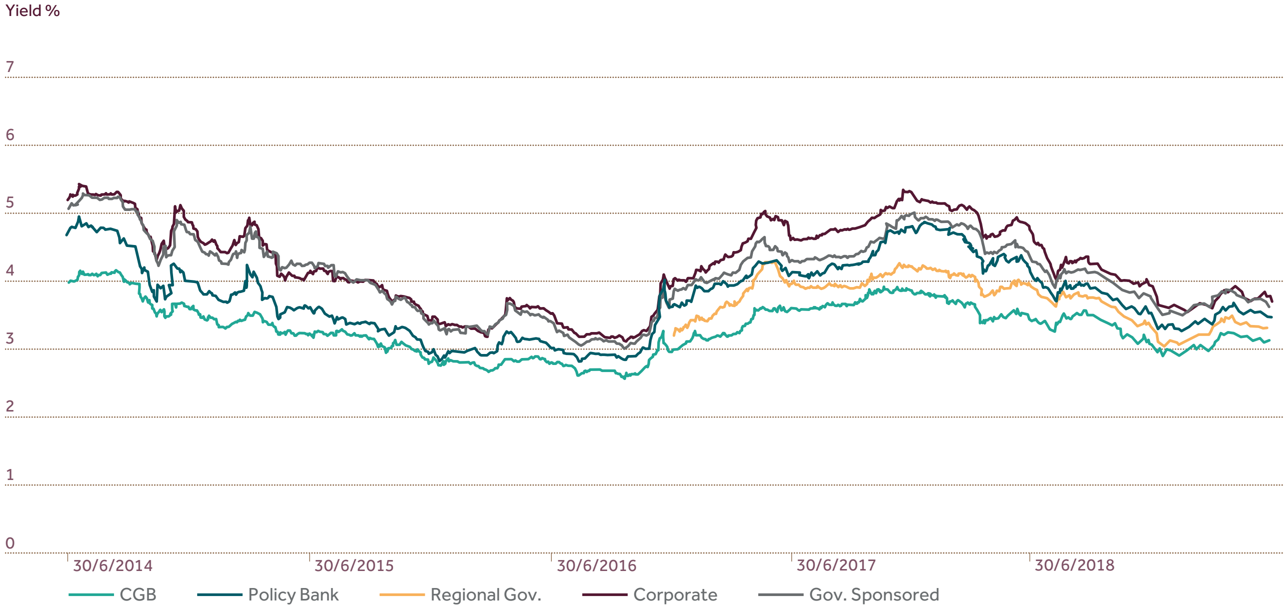
Onshore Report

Yield

Five major sectors are covered in FTSE Chinese (Onshore CNY) Broad Bond Index (CNYBBI). The yield of the CNYBBI as of end-June was 3.36%. Among the five major sectors, the Government Bond (CGB) sector was at 3.13%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 3.46%; the Regional Government sector was at 3.32%; the Corporate sector was at 3.70%; the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 3.63% as shown in the chart 1.

For 2019 Q2, the yield of CNYBBI increased by 11.30 bps, with corporate spread tightened by 6.77 bps.

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



Source: FTSE Russell, data as of June 28, 2019. 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

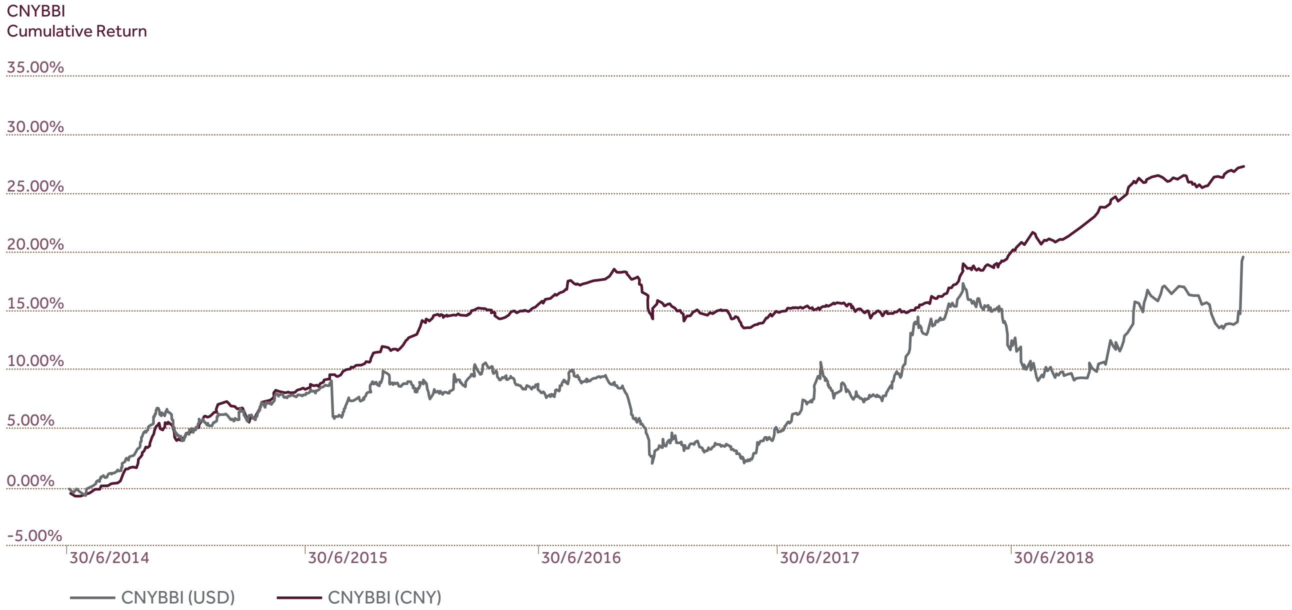
The CNYBBI in USD unhedged terms finished down just -1.66%, while its return in CNY finished up 0.50% during the last quarter. CNY depreciation was the main driver in the same period. The returns of some sectors are shown in Table 1 and the cumulative return in USD and CNY are shown in Chart 2.

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

	Cumulative Return (USD, unhedged)					Annualized Volatility (USD, unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
CNYBBI	-1.66	1.69	2.60	6.44	15.04	4.42	4.09	3.76
CGB	-2.21	1.16	1.48	5.25	12.85	4.71	4.30	3.96
Policy Bank	-1.35	1.92	3.21	6.98	15.91	4.46	4.24	3.97
Corporate	-1.34	2.39	3.17	8.89	17.47	4.22	3.87	3.60

Source: FTSE Russell – total return data in USD, as of June 28, 2019. 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 of June 28, 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

FTSE Chinese (Onshore CNY) Green Bond Index Series

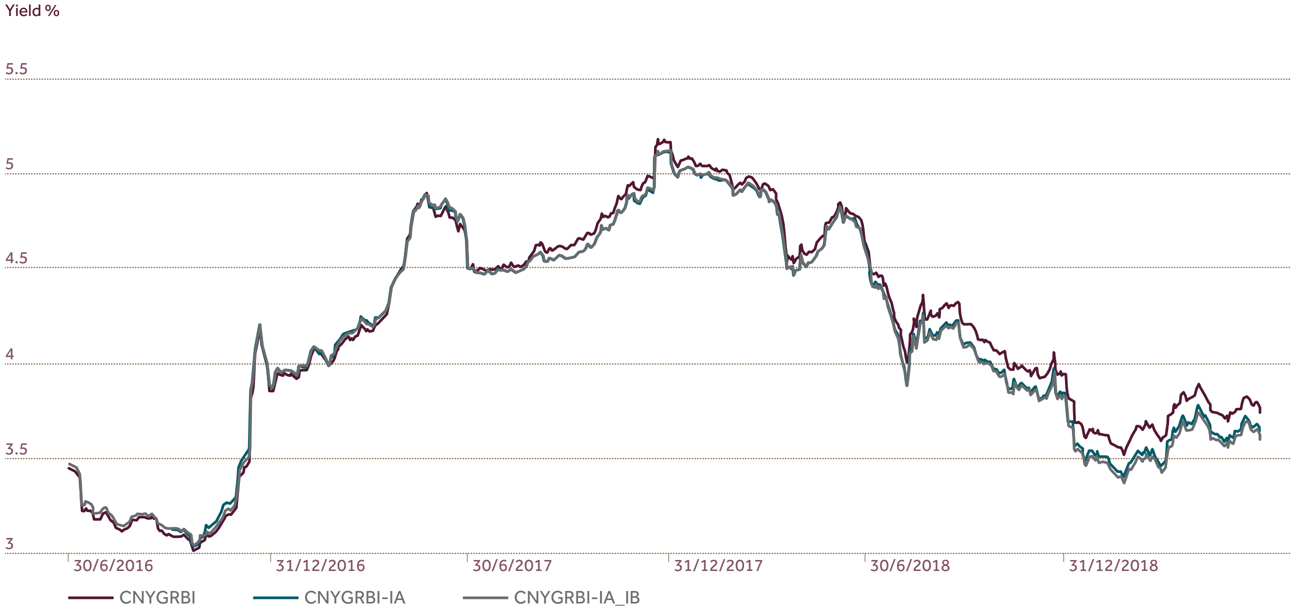
Yield

There are three indexes within the series:

1. FTSE Chinese (Onshore CNY) Green Bond Index (CNYGRBI)
2. FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index
3. FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index—Interbank.

The yield of the CNYGRBI as of end-June was 3.74%. FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index was at 3.62%; FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index – Interbank was at 3.59%, as shown in chart 3. For 2019 Q2, the yield of CNYGRBI increased by 14.88bps.

Chart 3. The Historical Yield of China Green Bond Index



Source: FTSE Russell, data as of June 28, 2019. 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 Chinese (Onshore CNY) Green Bond Index finished down 1.47% during the last quarter, with Internationally Aligned version down 1.51% and Internationally-Aligned – Interbank version down 1.53%.

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

	Cumulative Return (USD, unhedged)				Annualized Volatility	
	3M	6M	1YR	3YR	1YR	3YR
Chinese Bond Index	-1.47	2.43	2.97	8.40	4.21	3.90
Chinese Bond Index – Internationally-Aligned	-1.51	2.36	2.85	8.03	4.22	3.91
Chinese Bond Index – IA – Interbank	-1.53	2.35	2.75	8.14	4.22	3.92

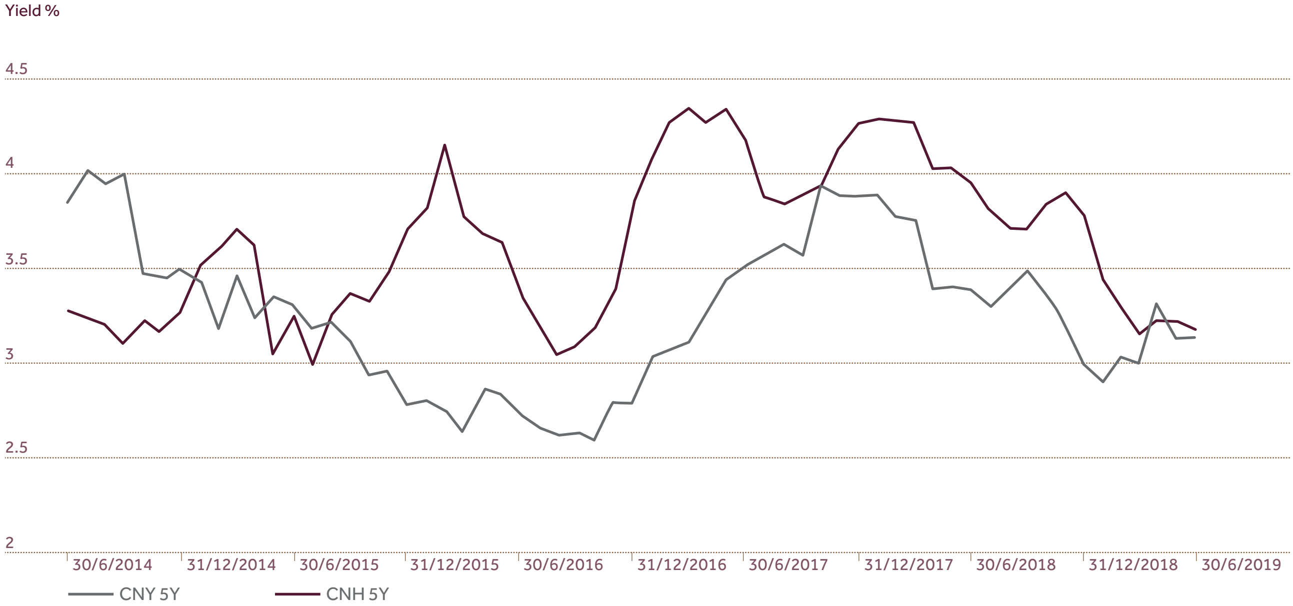
Source: FTSE Russell – total return data in USD, as of June 28, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds

Yield

The yield of onshore 5 year Sovereign bonds was at 3.13% and the yield of offshore 5 year Sovereign bonds was at 3.18% as of end of Q2. The spread tightened by 10bps for Q2 2019 as shown in Chart 4.

Chart 4. Onshore 5 Year Yield vs Offshore 5 Year Yield



Source: FTSE Russell as of June 28, 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

As of end-Q2 2019, 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 22bps and the long end curve 10 year spread was 23bps.

Total Return

The FTSE Chinese Government Bond Index underperformed the FTSE Offshore counterpart during Q2 2019 as shown in Table 3.

Table 3. 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)	-2.21	1.16	1.48	5.25	12.85	4.71	4.30	3.96
FTSE Chinese Government Bond Index (Offshore CNY)	-1.57	3.30	2.07	8.70	7.29	4.96	4.44	4.33

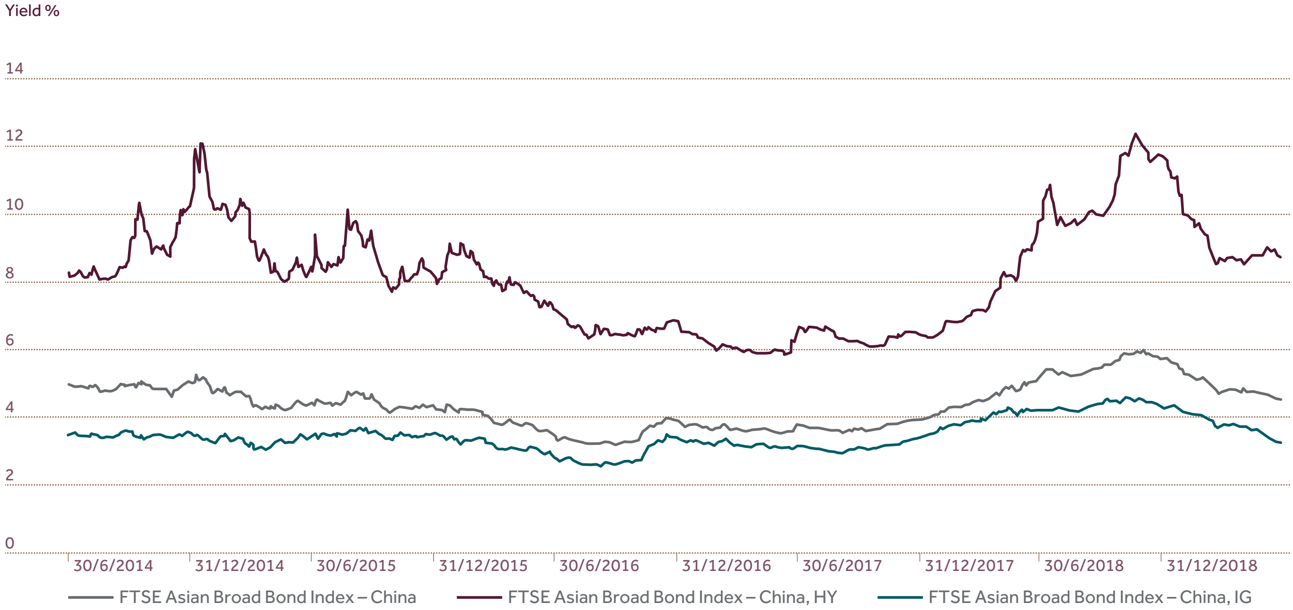
Source: FTSE Russell, total return data in USD, as of June 28, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures. FTSE Chinese Government Bond Index (Offshore CNY) 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 4.51%. Among the two sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade Index was at 3.26%; the FTSE Asian Broad Bond Index – China, High-Yield Index was at 8.73% as shown in chart 5.

Chart 5. The Yield of FTSE Asian Broad Bond Index – China and Sub-Indexes



Source: FTSE Russell - total return data in CNY, as of June 28, 2019. 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 2.68% during the last quarter, with its Investment-Grade sub-index up 2.99% and its High-Yield sub-index up 1.59%.

Table 4. 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	2.68	7.64	9.46	12.71	27.28	1.54	1.71	2.09
FTSE Asian Broad Bond Index – China, IG	2.99	7.02	9.06	11.68	25.11	1.68	1.91	2.25
FTSE Asian Broad Bond Index – China, HY	1.59	10.39	11.16	18.44	39.83	3.10	2.40	4.01

Source: FTSE Russell - total return data in USD, as of June 28, 2019. 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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