

Chinese bonds – what's the big deal?

Opportunities in a transforming market



China's bond market has grown rapidly in recent years and is currently the world's third largest. Over the next 5 years we believe the market will double in size to become the second largest, behind the US. In this paper, we discuss the transformation in China's bond market and the implications for global investors.

A meaningful change

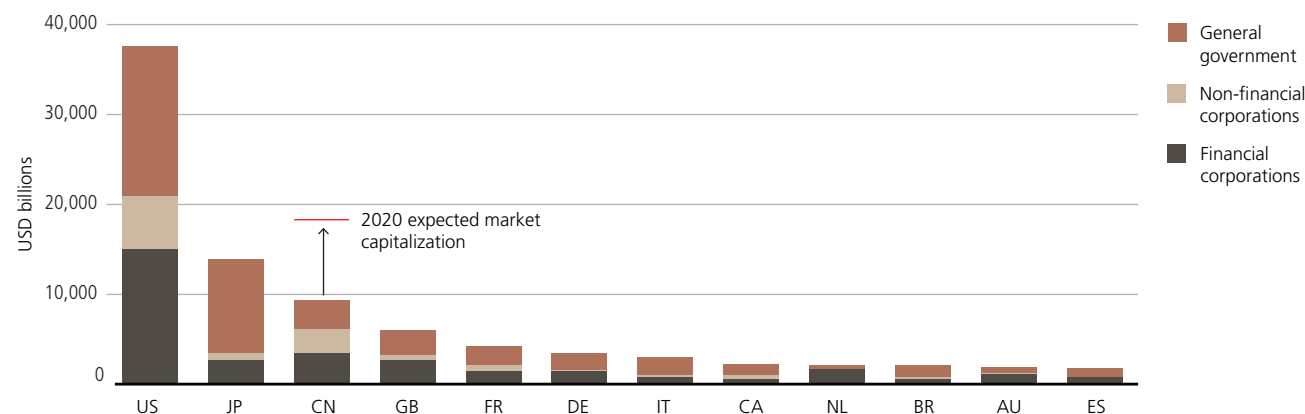
Capital markets are undergoing a dramatic change. At USD 9 trn and growing, China's bond market is the world's third largest, behind the US and Japan (Chart 1). However, we believe there is room for additional growth as the market deepens and diversifies. We expect that within five years it will overtake Japan to become the second largest bond market globally. Key to this rapid expansion has been new rules implemented in 2015, requiring provinces to borrow in the local government bond market rather than solely relying on bank financing. During this time, we believe more and more Chinese entities will raise capital in the onshore bond market, given that the domestic market is already large and liquid enough to attract new investors.

Despite its size, global investors remain under-invested in China. The domestic bond market has been largely off-limits to foreign investors due to China's capital controls. But this has changed with the implementation of reforms which allow international investors direct participation. Previously investors required quotas to access the bond market: as of this year international investors can directly access the bond and currency market, just as they do any other international bond market. The continued efforts to improve access are paying off with two major global index providers,

Bloomberg and Citibank, announcing the inclusion of Chinese onshore bonds within several of their market indices. And it is likely only a matter of time before Chinese bonds are included in major bond indices such as the Bloomberg-Barclays Global Aggregate Index and the World Government Bond Index. Furthermore, inclusion within emerging market bond indices, such as the J.P. Morgan GBI-EM Global Diversified series, a frequently used bond index in the local EM space, represents further potential demand from offshore investors for onshore China bonds. This is the first time a bond market has been included in both a developed market index and emerging market indices.

Foreign investors, including central banks and sovereign wealth funds (SWFs), currently own less than 2% of the domestic bond market. Foreign holdings of onshore bonds, however, increased in 2016¹; in our view, this was driven by measures to open up the onshore bond market to qualified foreign investors as well as the renminbi's inclusion in the Special Drawing Rights (SDR) basket in October last year, which likely served as a catalyst for central bank and/or SWFs allocation of reserves to the renminbi, by investing in onshore government bonds.

Chart 1: China's bond market set to double in size



Source: Standard Chartered Bank. As at 3Q (Brazil 2Q) 2016 from data available May 2017

¹ Source: WIND, May 2017

China's bond market opening

Existing onshore market access schemes

Qualified Foreign Institutional Investor (QFII)

- Sovereign, central bank and institutional investors
- Quota-based
- Restrictions with respect to minimum equity allocation and FX conversions

RMB Qualified Foreign Institutional Investor (RQFII)

- Sovereign, central bank and institutional investors
- Quota-based
- Ability to allocate to a single asset class
- Access to the China interbank bond market (CIBM)

Important recent developments

Central banks and sovereigns – direct CIBM access in 2016

- **Overseas financial institutions** able to invest in the CIBM without the need for **quota limits**

Institutional direct CIBM access in 2017

- **Foreign investors** in the CIBM: access to the **onshore FX derivatives market** to **hedge bond exposure**

Hong Kong Exchanges and Clearing Limited (HKEX) introduced a 5-year Bond Futures contract in 2017

- Underlying bond: onshore 5-year China MOF Treasury Bond
- Non-deliverable, cash settled

Hong Kong-China Bond Connect in 2017

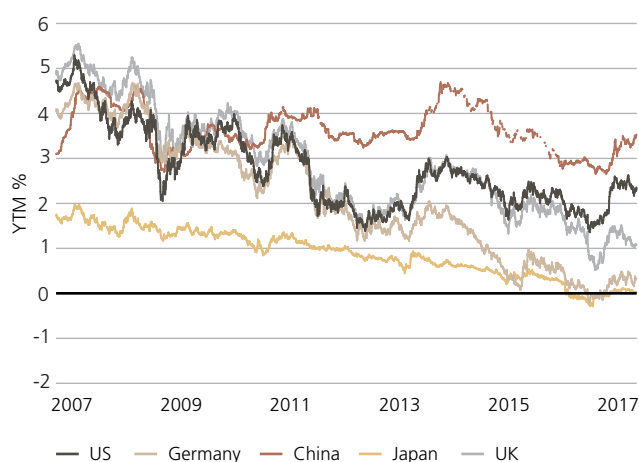
- Mutual bond market access between HK and mainland China
- Qualified foreign investors can make use of offshore financial infrastructure to invest in the onshore bond market
 - CIBM access and FX clearing without having to establish onshore custodian account
- Expect formal launch 1st July (20th anniversary of HK handover)

Why it matters

In the aftermath of the global financial crisis, unorthodox monetary policy led to asset price inflation in all traditional asset classes. This in turn has created yield compression, with the amount of negative-yielding sovereign debt globally estimated at USD 8.6 trn, according to Fitch Ratings (March 2017). By contrast, Chinese bonds offer attractive yields on both a nominal and real basis.

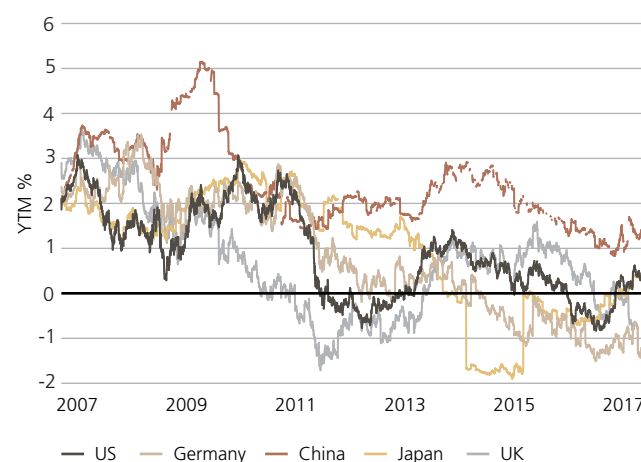
As shown in Chart 2, yields on Chinese bonds compare favorably against global developed market bonds. In addition to income return, there remains the potential for capital gains should bond yields move lower from their current levels. The defensive characteristics, i.e. investment grade and a net creditor country also make Chinese bonds attractive in a portfolio context.

Chart 2. Getting real
Nominal yields (10-yr govt)



Source: Bloomberg. As at 18 May 2017

Real yields (10-yr govt)



Source: Bloomberg. Real yields based on Core CPI. As at 18 May 2017

What's the story?

Food and energy security ...

Economic and food security are key considerations for any country, especially one with a population as large as China's. The global financial crisis brought into sharp relief the vulnerability to a disruption in global capital flows that countries, whose economies have significant dependence on trade, face.

But more importantly, financial markets' security

As China continues to flex its economic muscle, it increasingly prefers to use the renminbi for trade settlement as opposed to the US dollar. In 2010, the offshore renminbi market (CNH) was created, allowing foreign investors to trade freely in the currency. According to SWIFT, the renminbi is now the sixth most active currency for world payments by value. Given the strong trade linkages and geographical proximity to other Asian countries, we expect the renminbi to be increasingly used as a trade settlement currency in Asia and for its use to spread globally through time.

China's leaders have actively been pushing for the internationalization of the currency and their efforts have been recognized with inclusion of the renminbi in the IMF SDR basket. In 2015, the International Monetary Fund (IMF) announced that the renminbi would be added to the Special Drawing Rights (SDR) basket. In October 2016 the renminbi joined the US dollar, euro, Japanese yen and British pound as the fifth currency, thereby formally endorsing it as a reserve currency. The IMF acknowledges the progress made in China's reform measures and believes the inclusion of the renminbi

in the SDR basket will further support its increasing use and trade internationally. We believe the renminbi could attempt to mount a challenge to the US dollar's dominance as the global reserve currency in the same way that the British pound and Japanese yen have done in the past, given the size of China's economy and its very large share of global trade.

Why is it important for China to liberalize financial markets?

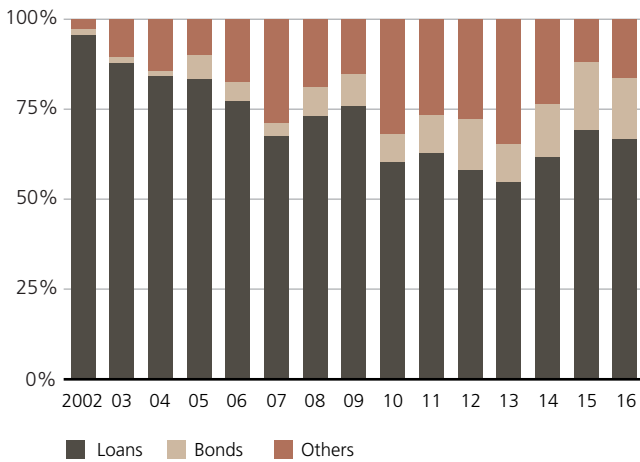
Even though China recognizes the importance of stable financial markets, it has taken a structured and progressive liberalization approach to open its bond markets to foreign participation as one element of its financial reform agenda. Financial repression and the lack of saving options have led investors to pour their savings into the housing market for higher returns. With the increasing liberalization of financial markets, there is a more efficient allocation of capital as private enterprises compete for funding, thereby offering savers a greater choice of investment options.

At the same time, the Chinese government wants to lower systemic risk in the banking sector. It has been common practice for local provinces and cities, via local government financing vehicles (LGFVs), to borrow heavily from banks to finance infrastructure projects and keep economic growth on track. But the surge in local debt and non-performing loans – due to unprofitable infrastructure projects – raised concerns with the country's regulators.

In 2015, a new budgetary law was passed whereby local provinces and cities could no longer borrow from banks, but instead were required to borrow in the publicly traded bond markets. In the US, the debt market consists of 30% bank loans and 70% publicly traded bonds. By contrast, in China only 12% of debt issued is in the form of bonds, with 88% comprising bank loans. This explains China's push to transfer the risk from banks to the public bond market. (See Chart 3.)

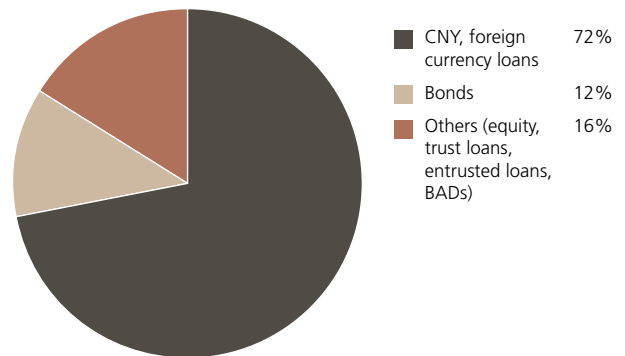
By adhering to international standards through reforms to its financial markets, China is also seeking increased foreign investors' participation in its onshore bond markets. A publicly traded bond market with global best practices gives international investors a higher sense of comfort.

Chart 3. Mandated loan to bond market shift underway
Bond's share of TSF¹



Source: Standard Chartered Bank. As at 4Q 2016 from data available May 2017
¹ Total social financing (TSF) is a broad measure of credit and liquidity in the economy

Bond's share of cumulative TSF¹



Changes within the domestic debt capital markets

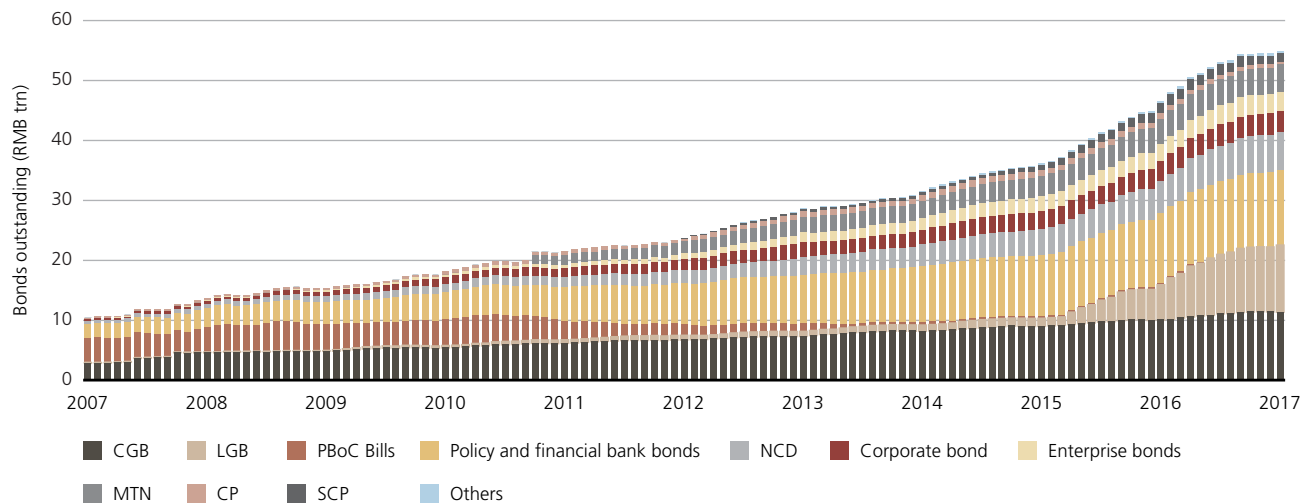
China's bond market is large and sophisticated, but also unique. Treasury bonds are issued by the Ministry of Finance, while policy bank financial bonds are issued by three policy banks: China Development Bank, Agricultural Development Bank of China and Export-Import Bank of China.

In 2015, a new law was passed allowing local provinces and cities to raise funding via public debt markets where previously borrowing from banks was effected with local government financing vehicles (LGFVs). The

debt issued by the local provinces and cities in China are broadly analogous to the municipal bonds or local government bonds issued in other bond markets globally. In the US, the municipal debt market is worth an estimated USD 3.8 trn.² We expect that China's local government bond market will grow to more than USD 3 trn in the next three years, rising from its current level of USD 1 trn.³ This would make it comparable in size to the US market with funding in both renminbi and US dollar terms.

² SIFMA as of Q4 2016, per data available March 2017
³ WIND May 2017

Chart 4: The world's 3rd largest bond market, set to double in size



Source: WIND. Data as of May 2017

Where to invest in China?

Investors who perceive Chinese bonds as attractively priced and who are looking to invest in China's renminbi bond markets for the first time might consider central government bonds and relatively better credit quality policy bank issuers. Investors with the ability to accept higher credit risk may also look at investing in select state-owned enterprises (SOEs), local government bonds, LGFVs and corporate issuers – those that have better visibility in their balance sheets; bonds issued by China's five largest banks can offer attractive opportunities as well.

Invest in broader EM debt or Asia/China bond markets?

There is significant macro dispersion within emerging markets. The Latam/EMEA markets possess different characteristics compared to Asia and China in particular. For example, many countries in Asia are net creditors compared to those in other EM regions; in addition, Asia broadly and China especially, are moving up the value chain to avoid the middle income trap, something which is happening at a much slower pace in Europe and Latam, as we outline below. Further, there has been more in terms of regional integration in Asia and China compared to other EM regions.

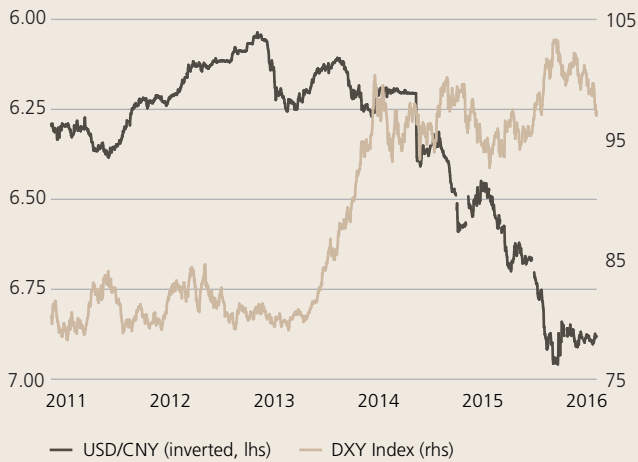
Market diversification

There are potential benefits from having Asia/China exposure within a portfolio – notably, increased market diversification. Given the relative size of China and Japan's economies, the Asian region 'centers' around the renminbi and Japanese yen, whereas the Americas center around the US dollar. The US Federal Reserve is currently in a rate hike cycle whereas most Asian central banks see current monetary policy settings as appropriate for their respective economies and it is therefore considered unlikely that they will hike rates in the near term.

As a result, we believe there is a case for all investors, regardless of whether they are already invested in broader EM debt, to invest a portion of their portfolio into Asia/China bonds on a standalone basis, as opposed to establishing China geographical exposure via broad EM debt exposure instead.

Currency

CNY spot and US Dollar Index (DXY)



Source: Bloomberg. As at 25 May 2017

Recently allowing RMB to depreciate to the CFETS CNY basket



The US Dollar Index (DXY) saw a strong rebound shortly after Trump's election last year, but it has weakened since the start of 2017. As shown in the chart below, this sell-off has coincided with a period of stability in the renminbi relative to the US dollar. Against the trade-weighted CFETS basket, the renminbi has actually been depreciating. At the time of writing (end May), the PBoC announced that the formula for calculating the daily yuan reference rate will have a "counter-cyclical adjustment factor". While there are few details available

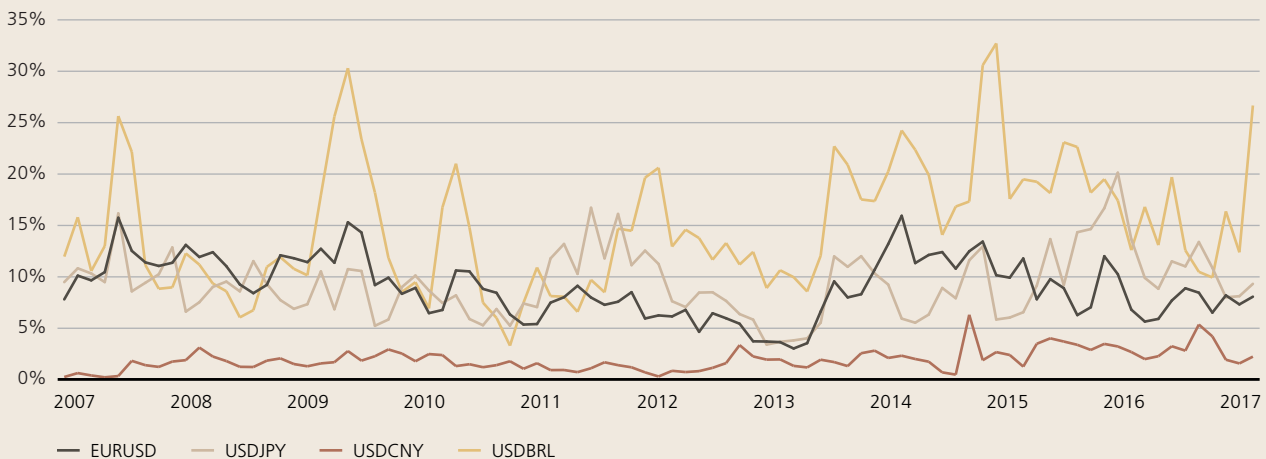
regarding this new factor, we speculate that the goal is to stop the currency depreciating and instead to strengthen the yuan to around the 95 level based on the CFETS RMB Index.

Needless to say, politics has a close relationship with the currency market. In our view the likelihood that the US government will label China as a currency manipulator is small, and serious US-China trade frictions will be delayed. With China's economic growth on a solid footing, tighter capital outflow controls, higher onshore yields and

moderate current account surplus, we think that the renminbi will be stable against the USD in the near term. It is worth pointing out that the renminbi is relatively less volatile compared to other developed and emerging market currencies, as shown in the chart.

In the long term, we believe the renminbi looks attractive given the interest rate differential relative to US, Europe and Japan. Even if the currency does not appreciate, the higher nominal yield makes the renminbi an attractive carry trade.

30 day currency volatility



Source: Bloomberg, UBS Asset Management

Reforms

Moving away from supply side economics

The fear of falling into the middle income trap has prompted the Chinese leadership to steer the economy away from its heavy reliance on investment and exports, towards high value-added manufacturing, consumption and services. In May 2015, the Chinese leadership further unveiled the details of the 'Made in China 2025' strategy. It aims to give its manufacturing sector a radical makeover and transform China into a leading high quality and value-added manufacturing powerhouse by 2049.

Chinese leaders have also been pushing for reform of State Owned Enterprises (SOEs) by closing long-term loss making SOEs, and consolidating to increase profitability and reduce costs in this sector. The SOE reforms are aimed at improving productivity, generating superior returns and boosting private investment. A more efficient distribution of capital and the break-up of industries (dominated by the state-controlled enterprises) would empower private entrepreneurs with funds and enable the ease of doing business.

Equity markets

As mentioned earlier, China is keen to have more foreign investors participating in domestic markets to lower the systemic risk. Specifically for equity markets, China has implemented several reforms over the years, the most recent being the Shenzhen Hong Kong stock connect launch in December 2016. The trading link further widens the mutual market access between Hong Kong and China. In effect, over 70% of the total market value of China A-share and 85% of that in Hong Kong is mutually open to investors.

Private sector

As China's economy matures, growth is likely to trend towards a structurally more stable pace. The government is seeking new channels of growth and is doing so when some of its developing neighbors are experiencing rapid domestic demand. Against this backdrop, China has launched the Asia Infrastructure Investment Bank (AIIB), and the 'One Belt One Road' initiative. The latter will present previously untapped trade and investment opportunities in sectors such as infrastructure, construction services, and equipment. The project also aims to transfer China's overcapacity in heavy industries such as steel, cement and aluminum.

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¹ Data as of 31 March 2017

² Thereof around 1,200 from Corporate Center. Data as of 31 March 2017

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