Index inclusion

Three views from Shanghai, Hong Kong and London

China onshore bonds will be added to the Bloomberg Barclays Global Aggregate, Global Treasury, and EM Local Currency Government indices in a staged, gradual process from April 1, 2019.

We sat down with our fixed income teams across the world to understand just how significant this event is and what opportunities it will create for investors.
Key takeaways

- The inclusion of China onshore bonds into these indices is a major change for global capital markets and will soon propel the onshore market past Japan as the second largest in the world;

- Inclusion is also a huge opportunity to diversify sources of alpha, since the market is attractive from a yield pick-up, duration, and correlation point of view compared to other more developed bond markets;

- Now offers an excellent entry point into China fixed income because the inflows implied by index inclusion, plus the prospect of China’s economy being in a long L-shaped recovery, puts lower yields in prospect later in 2019;

- China’s onshore markets are more accessible than ever and investment opportunities are compelling, but on-the-ground resources and knowhow remain vital to unlocking value.
Index inclusion means inflows into China and that will have three specific effects on the domestic market.

1. **Higher liquidity** - inflows likely mean higher market liquidity, and we see this as helping the local market become more stable and rational. Liquidity in the interest rates market is relatively good, but liquidity in the credit market still lags because the onshore market lacks market making mechanisms for credit bonds.

2. **Improved standards** - the authorities are opening up not just to boost inflows but to promote competition and impose stronger standards on the local market. What that likely is better standards of corporate disclosure but, more importantly, the onshore regulator will set higher standards for local fixed income trading activities across different financial institutions including stricter internal control processes. These changes are positive because they have potential to bring the domestic market in line with global standards.

3. **A bigger market** - China’s onshore market is already approaching the size of Japan’s market, and we believe it will soon overtake it because of the size of the inflows implied by index inclusion and China’s ongoing shift away from a bank-dominated financial system to a more diversified one.

**Exhibit 1:**
Bond markets compared (USD trillions) June 30, 2018

Source: Bank for International Settlements (BIS), November 2018
All these trends rest on local-level operations being adequate to handle the flows and there are important distinctions to make here.

The rates markets can manage the flows and, in fact, they have been for some time because they have been operating with channels like Qualified Foreign Institutional Investor, RMB Qualified Institutional Investor, the China Interbank Bond Market and Bond Connect.

We’re also seeing local banks and securities firms hire sales and trading teams to serve international investors as well.

In contrast, credit markets are still relatively underdeveloped, and it’s hard for offshore investors to trade credits with local partners as ask-bid spreads can vary. For there to be wider inclusion into global indices to cover a wider range of asset classes we want to see changes to the following:

- Development of Asset-backed Securities/Mortgage-backed securities or fixed income derivatives to make it more convenient for investors to hedge FX and rates exposure through derivatives;
- For credit, better market making mechanisms and more transparent corporate default processes for offshore investors

More than that, the development of onshore ratings will be absolutely key. China’s authorities have made big steps to bring foreign ratings companies into the China market and have recently allowed S&P Global to issue ratings.

There’s a big difference between how domestic and overseas ratings companies operate, with arguably less nuance in how domestic China companies rate debt. How this industry develops will be key to understanding and weighing risks in the China market.

**Exhibit 2:**
China’s bond market size (RMB tn), December 2008–December 2018

Source: WIND. As of end December 2018

Note: NCD: negotiable certificates of deposit; CP: corporate paper; SCP: short-term commercial paper; MTN: medium-term notes; PBoC Bills: bills issued by the People’s Bank of China
**Market prospects**

Aside from flow and structural changes, investors need to understand what index inclusion means for the market in 2019.

We see compelling reasons outside of index inclusion for investors to be positioned in onshore fixed income now. Inflows from index inclusion will likely contribute to what we expect will be an improvement in bond prices through 2019, and a rally in yields.

The RMB basket was volatile in 2018 but not any more so than emerging markets currencies, more broadly. Foreign flows have been mixed with investors cautious on equity but largely supportive on fixed income.

In the medium-term, we expect foreign inflows to continue to provide support for the currency, with the inclusion of China A-shares in MSCI’s emerging indices and growing offshore interest in China’s bond markets.

So, we expect index inclusion to speed up inflows from overseas investors and drive the growth of the onshore market.

More importantly, from a local perspective, offshore funds bring new investment strategies and different logic, as well as diversified flows to the onshore market, which will likely be very different to onshore investor behaviour.

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**Exhibit 3:**

Domestic vs offshore credit ratings dispersion compared, June 2018

![Credit Ratings Chart]

Source: QIC, June 2018
The view from Hong Kong

We have been investing in China onshore markets for some time now, so index inclusion itself won’t drastically change how we invest.

That doesn’t mean index inclusion isn’t significant. In fact, we believe it’s one of the biggest changes in global capital markets that we have seen for some time.

China bonds: the next 18 months
Looking to more immediate prospects, we’re expecting index inclusion to be part of the following trends we believe will play out in China in the next 18 months:

• Continued strong inflows – overseas investors will likely continue to increase their presence in onshore markets, continuing a trend we have seen during the past 3 years where they have approximately tripled their onshore holdings to reach RMB 1.7 trillion at the end of 2018.

• Further rally in bonds – the bond market rallied very strongly in 2018 but we are expecting yields to continue rallying through 2019 as increased inflows, looser monetary policy and stabilization in the economy in H2 2019 play out. As such, we believe now is an excellent time to position in China fixed income assets.

A supported RMB – we expect demand for RMB assets to strengthen, which should feed through into a new support for the RMB in 2019. In fact, we are already seeing this play out, with a massive increase in Northbound flows on Stock Connect in Q1 2019, and we’re expecting to see strong levels through 2019.

• China will have a sterilization problem – while the Chinese authorities have been worried about outflows, we are more concerned about inflows. The inflows implied by index inclusion and stronger investment sentiment for China assets amid an improving economy are going to be substantial.

Thinking regionally, we see index inclusion as impacting markets in Asia and EM more widely. That’s because investors will have to reallocate to China fixed income, and will most likely shift out of holdings in other APAC markets, like Thailand, Malaysia and South Korea.

Exhibit 4:
Overseas investors’ onshore China fixed income holdings (RMB Trillions), Feb 2016–Dec 2018

Source: People’s Bank of China, February 2019
Rebalancing to China
These immediate trends fit into bigger more structural changes that we believe will put more investor emphasis on China and more widely, the Asia Pacific region.

It’s well known that the world has been underinvested in China. In the past ten years, China has grown to be a significant player in the global economy, but financial markets haven’t caught up.

Now that onshore bonds and equities are going into global aggregates this situation will undoubtedly change and that’s one of the reasons why we say the inclusion of China onshore bonds in Bloomberg Barclays Global Aggregate is one of the biggest changes in global capital markets we have seen for some time.

Index inclusion into the Bloomberg Barclays Global Aggregate alone is estimated to bring in between USD 250bn to USD 500bn of inflows just from passive money, and that’s just from one index provider. When FTSE Russell and JP Morgan bring China bonds in, as expected, passive flows will likely be much greater.

Watch out as Sovereign Wealth Funds (SWF) and central banks get pulled into China’s orbit
But it’s more than just about passive money. We are expecting central banks and sovereign wealth funds to all begin moving part of their allocations onshore, and that raises the prospect of much bigger inflows than that estimated just for passive money, and we are already seeing evidence of this happening with German and Russian central banks recently announcing sizeable purchases of RMB assets.

What this ultimately means is that the processes of reform and index inclusion are bringing global investors across all asset classes and styles into China’s orbit and rebalancing global asset allocation toward Chinese markets.

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Exhibit 5:
USD/CNY spot exchange rates, Dec 18, 2007-Mar 7, 2019

Exhibit 6:
Contribution to Global GDP PPP Growth, 2019 (f)

Source: IMF, Visual Capitalist, March 15, 2019
People’s Bank of China, March 2019
Hong Kong Exchange, March 2019
The end-game: 3 investor blocs
Looking further out, we believe the end game is that we will end up with three big investor blocs. One is euro-, Swiss franc- and sterling-denominated, allocated to equity and debt from a regional perspective. Then there is the dollar-denominated bloc and includes Canada and the Americas.

And then we assume the RMB will dominate in Asia Pacific. The RMB will move quickly to reserve currency status in the region because the People’s Bank of China (PBoC) is the new liquidity provider within the region. Moreover trade in Asia is getting re-regionalised as they move up the value-added chain and becoming more interconnected with the Chinese macroeconomic cycle. The sheer size of the debt and equity market means China has an ever-increasing percentage weight in allocations and will likely dominate.

China as a standalone allocation
That is the long-term picture, but the important thing is people start breaking down the EM connotation which really does not make a lot of sense. Increasingly, investors will have to think about a standalone allocation to China.

China’s growing clout in the world economy and the sheer range of investment opportunities in domestic markets mean that, eventually, a standalone allocation to China will make more sense than just including it through a comparatively restrictive index allocation.

So, in summary, we see index inclusion as a major change that will recast global capital markets as we currently know them. While that’s an important long-term development, there are also plenty of compelling reasons that make onshore bonds an attractive investment now.
The view from London

Kevin Zhao
Lead Portfolio Manager, Global Sovereign and Currency strategies
UBS Asset Management

A huge opportunity to diversify alpha
As global fixed income investors, we’re excited about the inclusion of China onshore bonds in the Bloomberg Barclays indices. We’re always looking for ways to add value and we think this is potentially a huge opportunity to diversify sources of alpha.

China onshore bonds will be the fifth largest constituent by currency, with more than 300 issues within the index, which gives us plenty of opportunities and flexibility to express our views from a bottom-up perspective.

From a top-down perspective, the inclusion of China onshore bonds is also an additional source of duration, giving us more ways to take advantage of the relative value across markets. In particular, China’s central bank may adopt a divergent policy approach from other global central banks, representing an additional layer of opportunity.

Onshore China bonds offer many benefits
And we think valuations within China are currently attractive. Compared to the broad global bond market, the average duration on Chinese onshore bonds is lower, and the yield pick-up is often compelling.

For example, the average duration of Chinese Government and Policy Bank bonds is 5.5 years and the average yield is 3.2% compared with almost 7 years duration and a yield (unhedged) of 1.9% on the current Bloomberg Barclays Global Aggregate index, as at 31st January 2019.

We see this as an attractive opportunity set because of the unique characteristics of the bonds being added to the index. This will help to further diversify risk and return sources, offering a potential yield pickup as well as a relatively low correlation to other fixed income markets.

China’s macro outlook is improving, some risks remain
Looking at the macro outlook for China, policy loosening is beginning to stabilize the downturn seen in Q4 2018 and we expect further support of the economy through 2019.

This factor, combined with the additional global demand, is beginning to stabilize the downturn seen in Q4 2018 and we expect further support of the economy through 2019.

Looking further ahead, we expect Government and Policy Bank debt index inclusion to be a catalyst to further open up Chinese bond markets to international capital markets. This will help build investor confidence, and improve credit scrutiny.

As market participants become more comfortable with investing in China, bottom-up issue selection will be key, as idiosyncratic risks will be prevalent and that’s where investors can benefit from having on-the-ground local presence and knowledge.

Looking longer-term we want to see further reforms in China, such as making central bank monetary policy independent from political influence, and to be mainly guided by maintaining inflation below 3% over the medium term.

Finally, we want to see the authorities let the market determine bond yields, lending rates and deposit rates, with the central bank only controlling the overnight or 7-day repo rate.

In summary, there are lots of ways the market can still be improved, but we see the benefits from the index inclusion process as being too compelling to ignore and we’ll likely be participating in the market from day one.

Alexander Wise
Investment Specialist
UBS Asset Management

China’s bond market is already very significant and large in size. Staggered inclusion into the Bloomberg Barclays Global Aggregate index will bring international investors to the market, especially with passive funds having to initiate their exposure.

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Bottom-up selection and local knowledge will be key
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Putting our views together

Putting all these views together, we are clear that the inclusion of China bonds in the Bloomberg Barclays indices is a major event in global capital markets that every investor should be prepared for.

**Index inclusion is a process**

In part, that’s because of the nature of what Bloomberg is proposing. The inclusion starting in April means China bonds go straight into a global benchmark, not a regional one. That reflects just how significant the onshore China market has become in terms of size and how much it is expected to grow in the coming years.

Additionally, the inclusion is part of what we believe is a bigger process that we expect will mean that other index providers, like FTSE Russell and JP Morgan, will soon announce that they will bring China bonds into their indices too, which will spark additional capital flows into the onshore China market.

But it’s not just about the weight of passive money that track benchmark indices, active investors will have to track the benchmark too, and central banks and sovereign wealth funds will also have to increase their China allocations as the world rebalances to China.

What this means for domestic markets is more liquidity and pressure on local operators to move quickly to adapt to the standards of corporate disclosure and trading that international investors expect. China still has to make progress here but we detect a constructive attitude from regulators we speak to and a strong incentive – purely through the size of the opportunities created by index inclusion – for local operators to adapt.

**Onshore market offers attractive opportunities for investors**

Following inclusion, China onshore bonds will be the fifth largest constituent by currency, with more than 300 issues within the index\(^1\), which offers plenty of opportunities and flexibility to express investment views from a bottom-up perspective.

From a top-down perspective, the inclusion of China onshore bonds is also an additional source of duration, offering more ways to take advantage of the relative value across markets. In particular, China’s central bank may adopt a divergent policy approach from other global central banks, representing an additional layer of opportunity.

And valuations within China are currently attractive. Compared to the broad global bond market, the average duration on Chinese onshore bonds is lower, and the yield pick-up is often compelling.

As such, we see this as an attractive opportunity set because of the unique characteristics of the bonds being added to the index. This will help to further diversify risk and return sources, offering a potential yield pickup as well as a relatively low correlation to other fixed income markets.

\(^1\) Bloomberg, January 2019
Investors won’t be able to ignore the Chinese market and global capital allocation will shift to China
Looking at the bigger picture, we believe index inclusion across China’s bond and equity markets is highly likely to force a process of rebalancing of global capital to China. China continues to drive the world economy - delivering 33% of additional GDP growth in 2019\(^1\) – but China’s markets account for less than 5% of invested capital globally.\(^2\)

This rebalancing process is happening, with inflows into equity and fixed income markets seeing a marked increase during the past 18 months as the index inclusion processes have started to take effect. As China accounts for larger shares of global benchmarks, as we expect, flows into China will continue to grow.

Furthermore, China’s growing clout in the world economy and the sheer range of investment opportunities in domestic markets mean that, eventually, a standalone allocation to China will make more sense than just including it through a comparatively restrictive emerging markets index allocation.

We speculate that as China’s weight in the world’s financial markets grows, its weight as a currency bloc will grow too. We live in a world dominated by the USD and Euro. But with China’s steady move to internationalize its currency - through opening its financial markets, pricing oil and other imports in RMB, promoting Belt & Road, and taking a much more influential role as a trading nation in the APAC region – as well as China’s huge weight in the global economy, we believe the world will evolve into a 3 bloc model: one that is euro-, Swiss franc- and sterling-denominated; one RMB-denominated in the Asia-Pacific region; and one USD-dominated.

\(^1\) IMF, Visual Capitalist, March 2019
\(^2\) IMF, July 2018
But China still presents challenges

For all that we see positive aspects from the index inclusion process, China still presents challenges for investors - and being mindful of these is vital.

Access has improved dramatically, but the market has not been through continuous credit quality scrutiny in the same way that developed market bonds have been. There’s also a big difference between how domestic and overseas credit ratings companies rate issuers, investors will have to be mindful of these differences and watchful of how overseas raters are allowed to develop their businesses and capacity in China.

Additionally, while the rates markets are relatively well-established, credit markets are still relatively underdeveloped, and it’s hard for offshore investors to trade credits with local partners as ask-bid spreads can vary significantly. For credit, better market making mechanisms and more transparent corporate default processes are also necessary for offshore investors.

Looking longer-term we want to see further reforms in China, such as making central bank monetary policy independent from political influence, and to be mainly guided by maintaining inflation below 3% over the medium term. Finally, we want to see the authorities let the market determine bond yields, lending rates and deposit rates, with the central bank only controlling the overnight or 7-day repo rate.

So investors need to be mindful of both the challenges and investment challenges and the differences between China and more developed markets. In this important respect, onshore resources and market knowhow are going to be absolutely vital to unlock opportunities and interpret the market.

Despite challenges, we believe the opportunities from China’s continued development remain compelling, and index inclusion will add further weight to a process that, more than ever, will make China just too big to ignore for investors across the world.

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