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Another Breakthrough Year for China Bonds

When we wrote our paper introducing China's onshore bonds in April 2018, we were reflecting on an important year for the asset class: 2017 had seen the launch of "Bond Connect", the new trading channel that greatly improved accessibility for foreign investors.[1]

That innovation set off a wave of activity that made 2019 another notable year. We saw developments in the global indexation and the tax treatment of onshore bonds, as well as in the regulation of foreign asset management within China. At the same time, however, 2019 was a record year for onshore corporate bond defaults.

With the asset class set to reach a higher profile than ever in 2020, we decided to take stock of recent events and re-state the investment case for China's large onshore bond market.

China's renminbi-denominated onshore bond market, at more than $13 trillion, dwarfs the $500bn market in dollar-denominated bonds and renminbi-denominated "Dim Sum" bonds that are traded and cleared offshore.

Citi estimates that the onshore bond market attracted more than $70bn of foreign investment in 2019 and could see more than $100bn in 2020.[2] Some key events last year help to explain why.

[1] Peter Ru, "Welcome to the Real China Bond Market" (April 2018), at https://www.nb.com/_layouts/www/transfer.aspx?URL=/insights/welcome-to-the-real-china-bond-market.
[2] Lu Sun and Gaurav Garg, China FX & Rates Strategy Focus (January 10, 2020).

Opening Up

In January, Bloomberg announced that it would phase 363 China onshore bonds into the benchmark Bloomberg Barclays Global Aggregate Index by October 2020.[3] They already account for 3% of the index, leaving those who choose not to invest with meaningful tracking error, and that weight will grow to 6% by the end of this year.

In September, the indexation story continued as JPMorgan announced in its annual index review a similar phased inclusion of China bonds into its GBI-EM Global Diversified Indices, capped at 10% and beginning in February.

FTSE Russell is still reviewing whether China's bonds qualify for the FTSE World Government Bond Index (WGBI).[4] The size and credit quality of the market do not pose a problem. However, FTSE Russell still questions whether these bonds offer the liquidity and foreign exchange hedging to make them genuinely accessible to foreign investors and keep its index genuinely trackable.

Given the size and depth of the market, and the fact that the renminbi is one of the world's most highly-traded currencies, we believe that inclusion in all of the major global bond indices is just a matter of time.[5] Clarification from the State Council of the People's Republic of China that interest will be exempt from Withholding Tax and Value Added Tax until at least November 2021 also removed an obstacle from foreign investment.

Beyond fixed income markets, China took other significant moves to open up its financial markets in general last year. In August, the Asset Management Association of China confirmed that private fund manager wholly foreign-owned entities (PFM WFOEs) can be converted to fund management companies (FMCs) for public fund business, enabling WFOEs to access the mainland China retail investor market for the first time.[6]

Then, in October, the China Securities Regulatory Commission confirmed that foreign institutions will be able to apply for 100% ownership of onshore businesses—with futures firms getting the go-ahead already and asset management firms being eligible from April. This will fully open up the onshore retail market and grant foreign asset managers access, for the first time, to domestic institutional investors, such as insurance companies, pension funds and domestic sovereign wealth funds, which invest in renminbi bonds.[7]

Defaults Become a Feature

If 2019 was another important year for the opening up of China's bond markets, it was also another record-breaking year for corporate bond defaults. After hitting RMB122bn in 2018, onshore corporate defaults passed the Rmb130bn ($18.6bn) mark during the final weeks of 2019.

We wrote about the likelihood of rising defaults in our 2018 paper introducing the onshore bond market.[8] We regard this as a positive trend, ultimately, as it results from a clampdown on opaque shadow banking and a greater willingness to allow market forces to determine the cost of capital in non-systematic and non-strategic sectors.

Nonetheless, investors have grown concerned about the apparent vulnerability of even state owned enterprises (SOEs), shown most recently in a default on offshore U.S. dollar bonds by the commodities trader Tewoo Group. We would point out that there is rarely the same guarantee of government support in the language of offshore dollar bonds as we find in some onshore renminbi bonds. Issuing in the offshore market without also issuing onshore, as Tewoo did, is often a sign that the issuer has no access to the onshore market: Tewoo was a weak credit owned by a financially weak local government.

We would always emphasize that credit analysis is important, and that an SOE should be assessed on its strategic importance, the fiscal health of its supporting local government and the administrative level of its support.

[3] Press release, "Bloomberg Confirms China Inclusion In The Bloomberg Barclays Global Aggregate Indices" (January 31, 2019).
[4] Press release, "FTSE Russell announces results of Country Classification Review for Equities and Fixed Income" (September 26, 2019).
[5] Peter Ru, "China Local Bonds Go Global" (April 2019), at https://www.nb.com/_layouts/www/transfer.aspx?URL=/insights/china-bonds-go-global.
[6] AMAC confirmed details contained in the "UK-China 10th Economic and Financial Dialogue: Policy Outcomes" (June 17, 2019).
[7] Press release, "CSRC announces timetable to remove equity cap in foreign-invested securities and fund management firms" (October 15, 2019).
[8] Peter Ru, "Welcome to the Real China Bond Market" (April 2018), at https://www.nb.com/_layouts/www/transfer.aspx?URL=/insights/welcome-to-the-real-china-bond-market.

We would also urge investors to put recent defaults in perspective. There are more than 5,000 corporate onshore bond issuers in China, and outstanding issuance is worth almost $6 trillion. Fewer than 150 have defaulted since 2006 (14 of which were SOEs), totaling less than $50bn. While it is true that more than 70 of those defaults, accounting for $30bn of issuance, occurred in 2018 and 2019, we would reiterate that we think this is a positive sign that the authorities are allowing market forces to get to work.

Investors must take their fundamental credit work seriously, and we believe local presence and knowledge is a distinct advantage.

The Five Key Points in the Case for China Bonds

With 5.8−6.0% GDP growth anticipated in 2020, a continuation of loose fiscal policy and accommodative monetary policy, a focus on financial stability from the authorities, and a willingness to allow for only moderate counter-cyclical depreciation in the renminbi if it is required, we therefore believe that the five key points in favor of China onshore bonds are as strong now as they were when we set them out two years ago.

1. The China onshore bond market, in our view, is too big to ignore

At **more than $10 trillion and 5,000 issuers,** the market is of strategic importance to international central banks and other investors.

2. This market represents exposure to the "real China"

Financials, real estate and technology companies account for almost 80% of China's offshore bond markets, whereas they account for less than 60% of the onshore market. Much of the balance in **the onshore market is made up from the industrial, infrastructure and diversified sectors,** indicating its greater exposure to the domestic economy. Utilities, consumer and transport companies are also well represented onshore. Moreover, we estimate that slightly less than a third of the corporate-bond and state-owned enterprise issuers represented there also issue into the offshore market—leaving two-thirds inaccessible except onshore.

3. Foreign investment in the market has only just begun

The liberalization of China's financial markets since the introduction of the Qualified Foreign Institutional Investor program (QFII) in 2002 has advanced such that global index providers are now able to include China onshore bonds in their benchmarks. Nonetheless, **foreign investors still own less than 4% of the total market,** according to research from Citi. The People's Bank of China (PBoC) estimates that this could rise to 15%. The average foreign ownership of other major developed and emerging bond markets sits at around 40%. Investment banks such as Goldman Sachs have estimated that global indexation could unlock more than $300bn of foreign investment flows into China onshore bonds. There is still an opportunity to get ahead of those flows.

4. Yields are generally attractive, especially relative to credit quality

Despite the fact that China's 60% sovereign debt-to-GDP ratio compares well with the U.S.'s ratio of more than 100%, and it's A+ credit rating from Standard & Poor's stands up well against the world's strongest sovereigns, China's 10-year debt still tends to trade with **more than 100 basis points of extra yield** compared with the U.S. 10-year Treasury. China is now the second-largest economy in the world and while its growth rate is slowing, its contribution to global aggregate demand continues to expand and to move from fixed-asset investment and heavy industry to consumption, services and technology.

5. China onshore bonds is a genuinely uncorrelated asset class

China bonds can **act as a diversifier** even against a portfolio of emerging markets local currency debt.

ASSET CLASS CORRELATION (OCTOBER 2005 – OCTOBER 2019)

	US Equities	Global Equities	EMD HC Bonds	US HY Bond	US Treasury	EMD LC Bonds	US IG Bonds	Global Bond	Asian HC Bonds	China Bonds
China Bonds	-0.01	0.0	0.02	-0.11	0.20	0.20	0.01	0.28	-0.06	1.00
Asian HC Bonds	0.50	0.57	0.93	0.71	0.26	0.68	0.80	0.45	1.00	
Global Bond	0.12	0.21	0.49	0.18	0.63	0.56	0.56	1.00		
US IG Bonds	0.32	0.40	0.78	0.60	0.48	0.54	1.00			
EMD LC Bonds	0.58	0.68	0.80	0.61	0.09	1.00				
US Treasury	-0.31	-0.29	0.22	-0.24	1.00					
US HY Bond	0.72	0.77	0.75	1.00						
EMD HC Bonds	0.55	0.63	1.00							
Global Equities	0.97	1.00								
US Equities	1.00									

Source: Bloomberg; Correlations are based on total returns in USD.
Asset Classes are represented by the following indexes: JPM JADE Broad China Onshore Index (China Bonds), JPM Asian Credit Index (Asian HC Bonds), Citi WGBI (Global Bonds), Bloomberg Barclays US Agg Corporate Index (US IG Bonds), J.P. Morgan GBI-EM Global Diversified (EMD LC Bonds), Bloomberg Barclays US Agg Treasury Index (US Treasury), Bloomberg Barclays US Corporate HY (US HY Bonds), JPM EMBI Global Diversified (EMD HC Bonds), MSCI World (Global Equities), and S&P 500 (US Equities). Past performance is no guarantee of future results. Indexes are unmanaged and are not available for direct investment. Actual investment results will vary. As with any investment, there is the possibility of profit as well as the risk of loss.

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