Research

FTSE Russell China Bond Research Report

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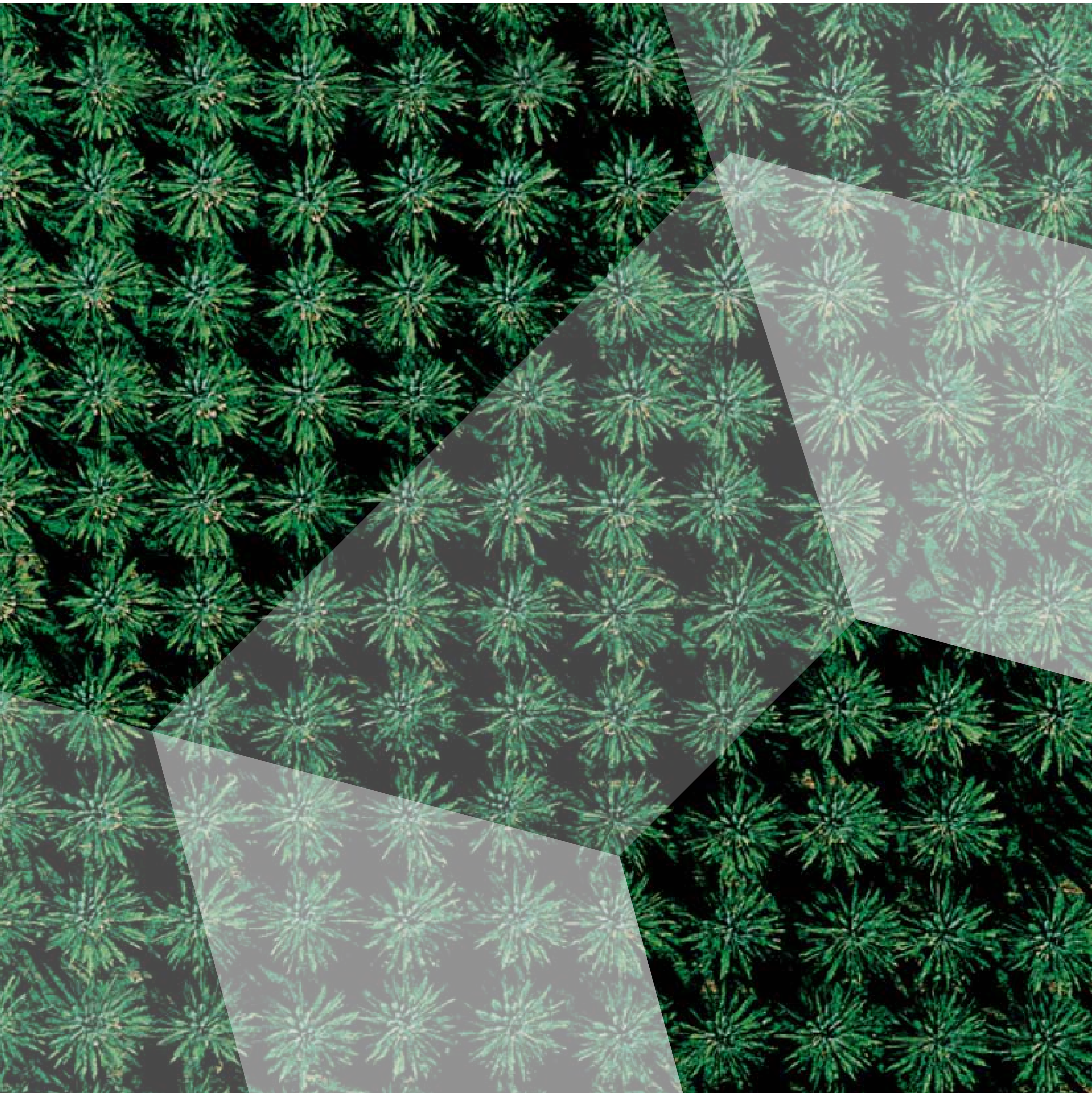

FTSE Russell China Bond Research Report

Highlights

- Holdings of RMB-denominated bonds by offshore investors hit 2 trillion RMB for the first time in Q3, official data showed. Offshore investors held Chinese interbank market bonds worth a total of 2.12 trillion RMB ($296.54 billion) as of end-September. Offshore investors also held a record 1.24 trillion RMB of China government bonds as of end-September.[1]
- Despite macroeconomic headwinds, in July China's regulators announced more liberalisation measures to open up its financial markets. Out of the 11 broader strategic measures released by the State Council, three are directly related to further liberalisation of the interbank bond market.[2]
- While policymakers continue to implement market liberalisation measures, Chinese bond prices have reached multi-year highs in early September – while the yield on 10-year Chinese government bonds touched 3.1%, its lowest level since January 23rd, 2017. For this reason, many investors are increasingly interested in high-yield USD bonds from China. For new issuance in 2019, the Chinese high yield issuers have an average coupon of 8.5% -- with some new issuances offering well over 10%.[3]

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1 CCDC. October 2019.
2 State Council. July 2019.
3 FTSE Russell. October 2019.

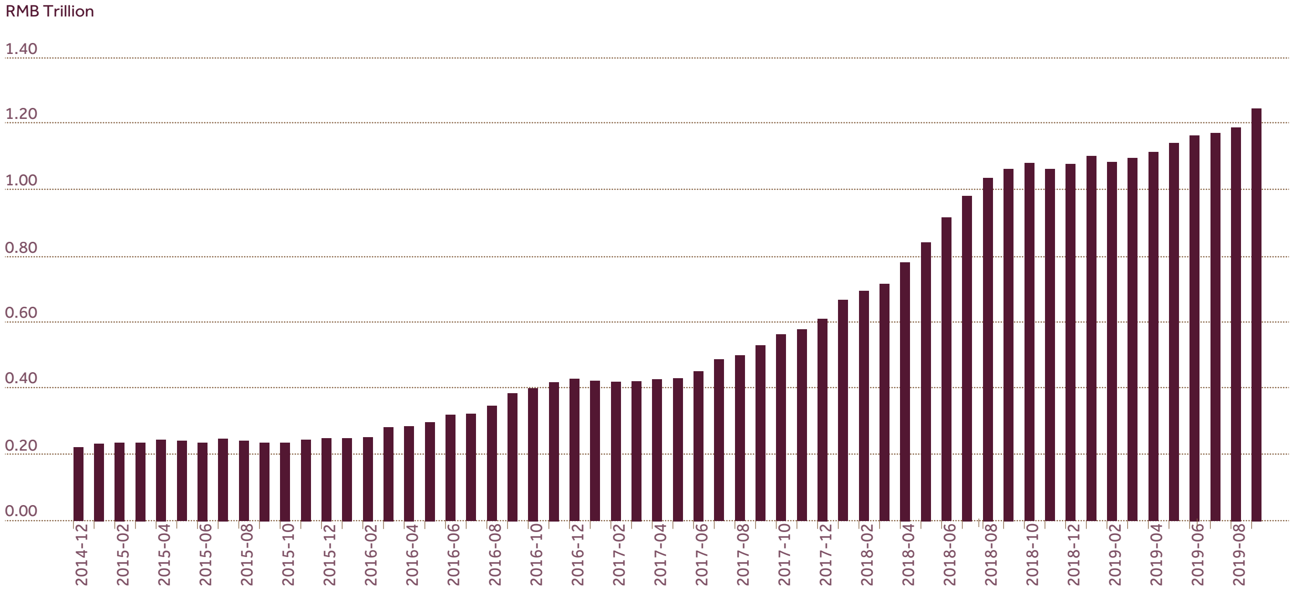
Chapter 1: Overview

Holdings of China bonds by foreign investors hit high in early Q3 on the back of global index inclusion

Although China-US trade tensions continue to dominate headlines, September data from the Bond Connect trading scheme – which grants international investors access to China's interbank bond market – revealed trading volumes hit a record high of 296.3 billion RMB in September. Total trading volume of bonds registered with China Central Depository & Clearing Co. Ltd, (CCDC) also hit a record high of 13.96 trillion RMB in August.[4]

Against this backdrop, foreign appetite for China's government debt continues to expand. Offshore investors held Chinese interbank market bonds worth a total of 2.12 trillion RMB ($296.54 billion) at the end of September, and they also held a record 1.24 trillion RMB of China government bonds as of end-September.[5]

Foreign Ownership of CGBs

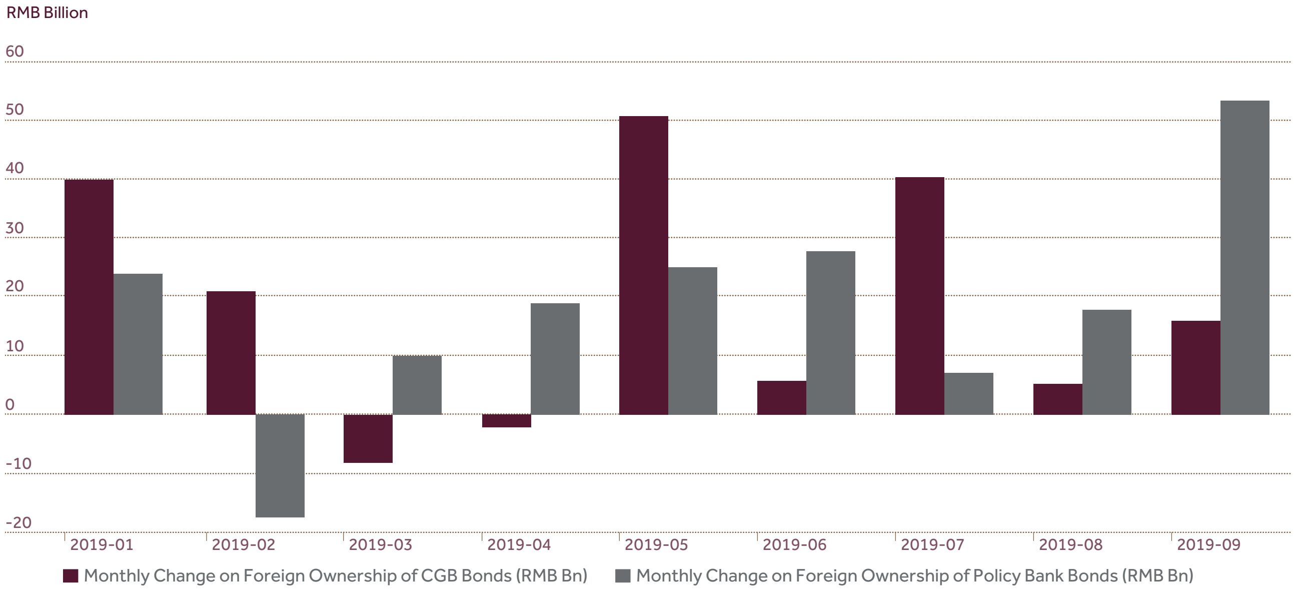


Source: CCDC, September 2019.

By end-September, holdings of China government bonds (CGBs) by foreign investors accounted for roughly 8.5% of total CGBs, while holdings of policy bank bonds by the same group was approximately 3.2% of total outstanding policy bank bonds. It is interesting to note that in the first three quarters of 2019, the net increase of policy bank bonds held by foreign investors was slightly more than that of CGBs (168 billion RMB for policy bank bonds versus 166 billion RMB for CGBs).[6]

4 CFETS. October 2019.
5 CCDC. October 2019.
6 FTSE Russell; CCDC. October 2019.

Monthly Change in Foreign Ownership of Policy Bank Bonds and CGBs



Source: CCDC, September 2019.

According to some analysts, one reason for this pick-up in appetite is inclusion in global indexes such as the Bloomberg Barclays Global Aggregate Bond Index.[7] On that note, starting in February 2020 JPMorgan will add Chinese government bonds to its emerging market local currency bond index. Nine Chinese local currency bonds will be included in the bank's Government Bond Index Emerging Markets (GBI-EM) suite over a 10-month period. China's weighting will be capped at 10% in the main index, the bank said.[8]

At the same time, some investors have said that they would like to observe further improvements in secondary market liquidity, and increased flexibility in FX execution and the settlement of transactions. On that basis, FTSE Russell decided in September to keep China on the watch list for potential inclusion in its flagship FTSE World Government Bond Index (WGBI) – and will continue to monitor market developments on an ongoing basis.[9]

Chapter 2: Liberalisation measures continue

While indexes are making moves to include China bonds, Chinese policymakers continue to deliver market reforms in a bid to attract more international investment. In late July, the Chinese State Council's Financial Stability and Development Committee announced 11 broad strategic initiatives to further open China's financial markets to foreign companies. Out of the 11 initiatives, three are directly related to bond market liberalisation, such as granting international ratings agencies the right to rate all China onshore bonds; and allowing type A principal underwriting licenses for foreign banks.[10]

7 Reuters. September 2019.
8 Reuters. September 2019.
9 FTSE Russell. October 2019.
10 State Council. July 2019.

SAFE also announced the removal of QFII/RQFII quotas on September 10th – a move widely welcomed by foreign investors. Given that QFII/RQFII investors were the early entrants in China's markets, the existence of quotas put them at a disadvantage relative to later entrants who accessed the market via the CIBM Direct Scheme and via the Bond Connect channel (which have no quota restrictions).[11]

QFII/RQFII entrants are now also allowed to transfer their bond investments to the CIBM Direct Scheme without liquidating their portfolios, further reducing gaps between various investment channels.[12] In terms of operational enhancements, regulators implemented T+3 settlement for international investors in August, which simplifies settlement of bond trades across the border.

Last but not least, China's regulators are also addressing the need to reform China's domestic ratings regime. Back in January, Standard & Poor's was granted a full license to rate China onshore bonds -- and so far the firm has rated two domestic issuers, according to the S&P Global (China) Ratings' China scale.[13]

Although this is only the beginning for foreign rating agencies to have fully owned operations in China, the move could open a new chapter for China's corporate bond space. To date, international investors hold only around 2% of China's USD$13 trillion bond market.[14]

Chapter 3: Interest in China high yield grows

Against this backdrop of market liberalisation measures, Chinese bond prices hit multi-year highs in early September – while the yield on 10-year China government bonds touched 3.1%, its lowest level since January 23rd 2017.[15] For this reason, many investors are increasingly interested in high-yield USD bonds from China. For new issuance in 2019, the Chinese high yield issuers have an average coupon of 8.5% -- with some new issuances offering well over 10%.[16]

11 SAFE. September 2019.
12 PBOC; FTSE Russell. September 2019.
13 S&P. October 2019.
14 CCDC. October 2019.
15 FTSE Russell. October 2019.
16 FTSE Russell. October 2019.

CGBs 10 Year Yield

Source: FTSE Russell, October 2019.

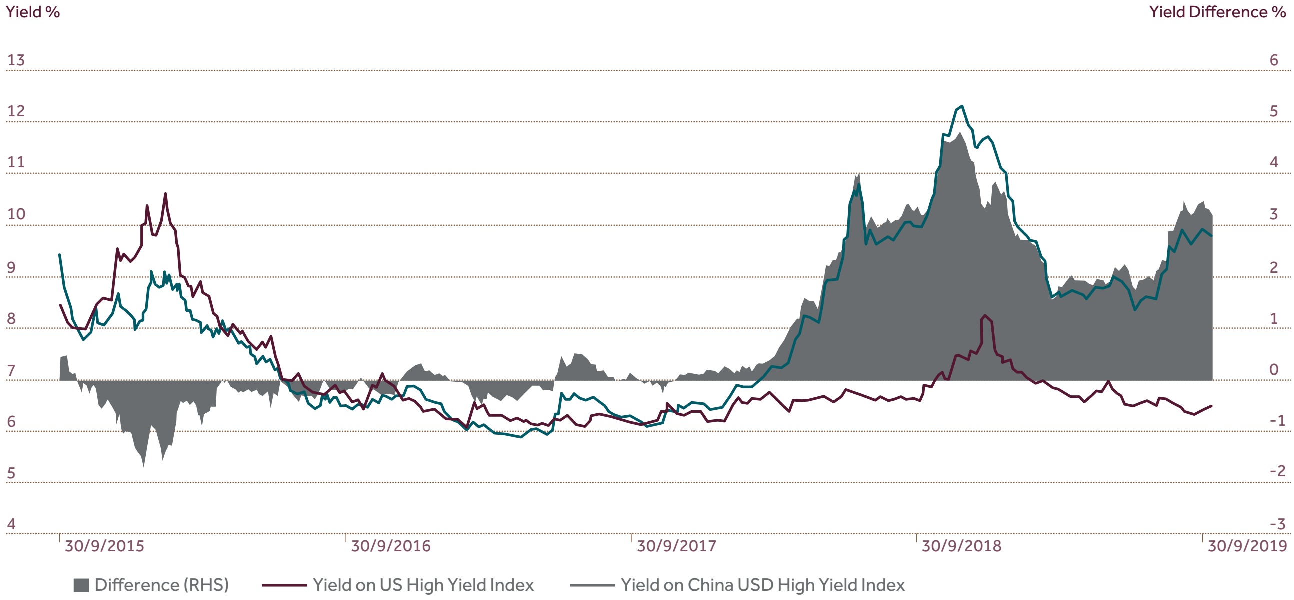
Chinese companies make-up about USD$38 billion of Asian dollar-denominated high yield debt – or, more than two-thirds of the USD$59 billion raised in 2019, Refinitiv data shows.[17]

Since early 2018, spreads between China's USD high yield sector and the US high yield sector have widened drastically (as shown in chart below). As of end-Q3 2019, the spread was around 3.5%, compared to only 0.2% at the beginning of 2018.

Spreads are widening mainly due to two reasons: 1) the average rating for China's high yield sector is lower than the average rating of the US's high-yield sector for the last couple of years; and 2) China's high yield sector is dominated by property developers (accounting for roughly three quarters) -- and there is higher perceived credit risk with the property sector in China.[18]

17 FTSE Russell; Wall Street Journal. July 2019.
18 FTSE Russell. October 2019.

Yield Difference Between China USD High Yield Index and US High Yield Index

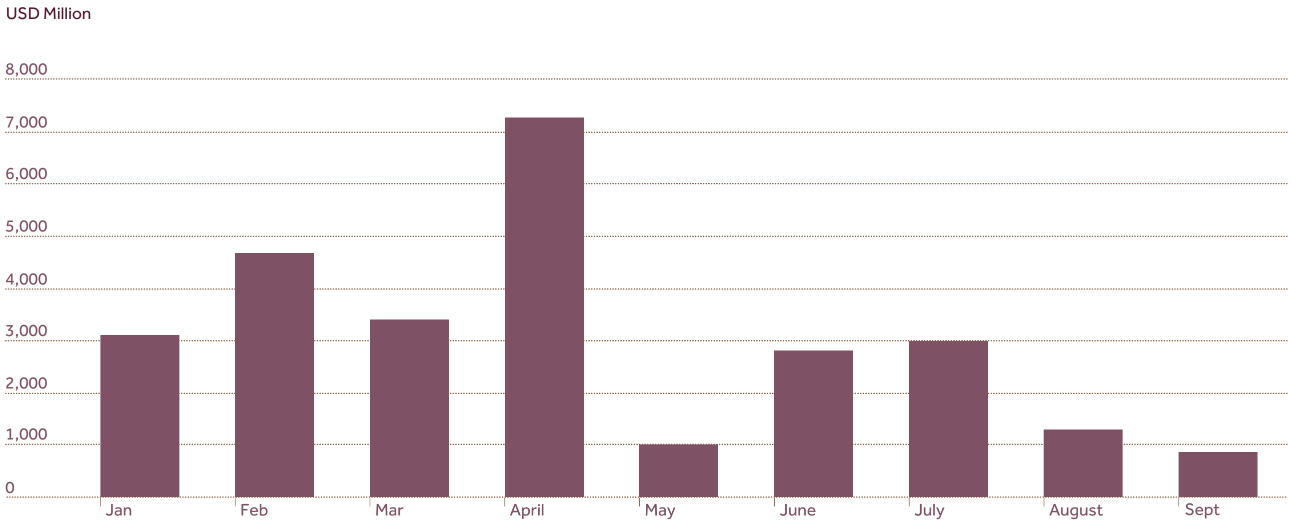


Source: FTSE Russell, October 2019.

It is worth noting that the net new issuance for Chinese property developers fell in Q3 due to tighter regulations released in early July by NDRC. Based on the new rules, Chinese developers can only issue USD bonds in the offshore market for the purpose of redeeming existing outstanding bonds with less than one-year maturity.[19]

As a result, new issuances in August and September dropped drastically – and further tightening is expected in the near future. The chart below illustrates index eligible USD bonds in 2019 issued by Chinese property developers, including both investment grade and high yield issuances.[20]

2019 USD Issuance Amount from China Property Developers



Source: FTSE Russell, October 2019.

19 NDRC. July 2019.
20 FTSE Russell. October 2019.

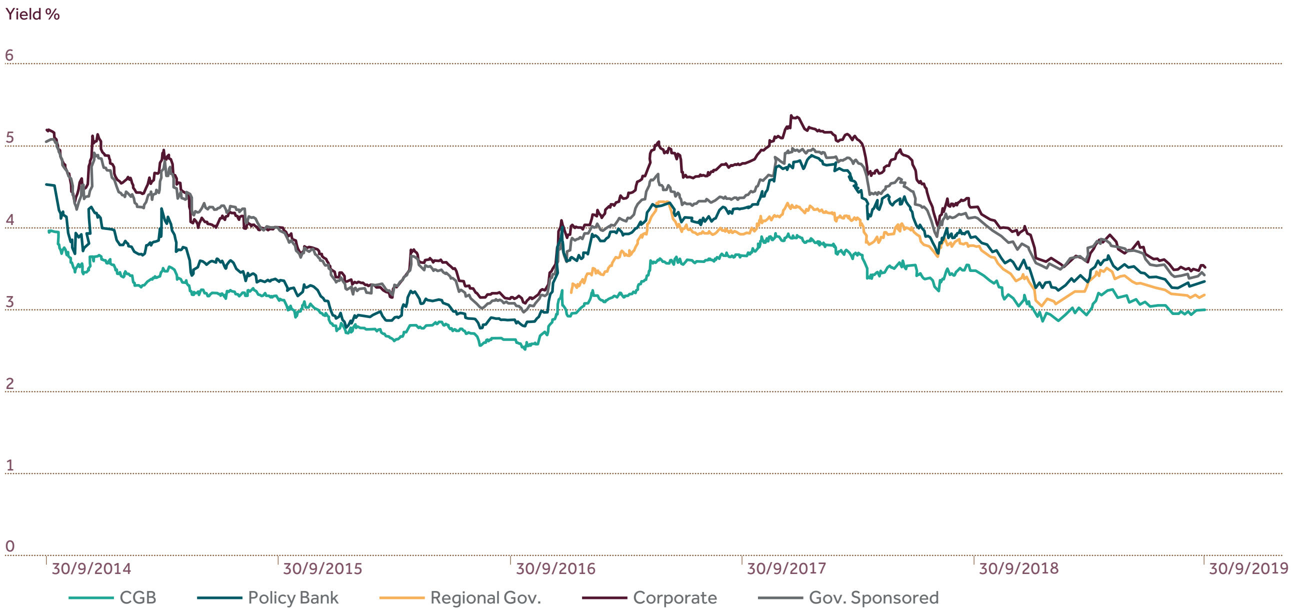
Chapter 4: Performance of the FTSE Russell China Bond Indexes

Onshore Report

Yield

Five major sectors are covered in the FTSE Chinese (Onshore CNY) Broad Bond Index (CNYBBI). The yield of the CNYBBI as of end-September was 3.23%. Among the five major sectors, the Government Bond (CGB) sector was at 2.99%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 3.36%; the Regional Government sector was at 3.18%; the Corporate sector was at 3.52%; and the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 3.44% as shown in the chart below. For 2019 Q3, the yield of CNYBBI decreased by 13.47bps with corporate spread tightened by 4.23bps.

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



Source: FTSE Russell, data as of September 30, 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 -2.35% while its return in CNY finished up 1.49% 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		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
CNYBBI	-2.35	-3.97	2.55	2.58	9.41	4.32	4.26	3.88
CGB	-2.29	-4.45	2.44	1.55	8.01	4.61	4.47	4.08
Policy Bank	-2.50	-3.81	2.66	3.16	9.39	4.34	4.39	4.08
Corporate	-2.40	-3.71	2.24	4.51	11.82	4.09	4.04	3.72

Source: FTSE Russell – total return data in USD, as of September 30, 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 for the past 5 years

Source: FTSE Russell – total return data in USD and CNY, as of September 30, 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

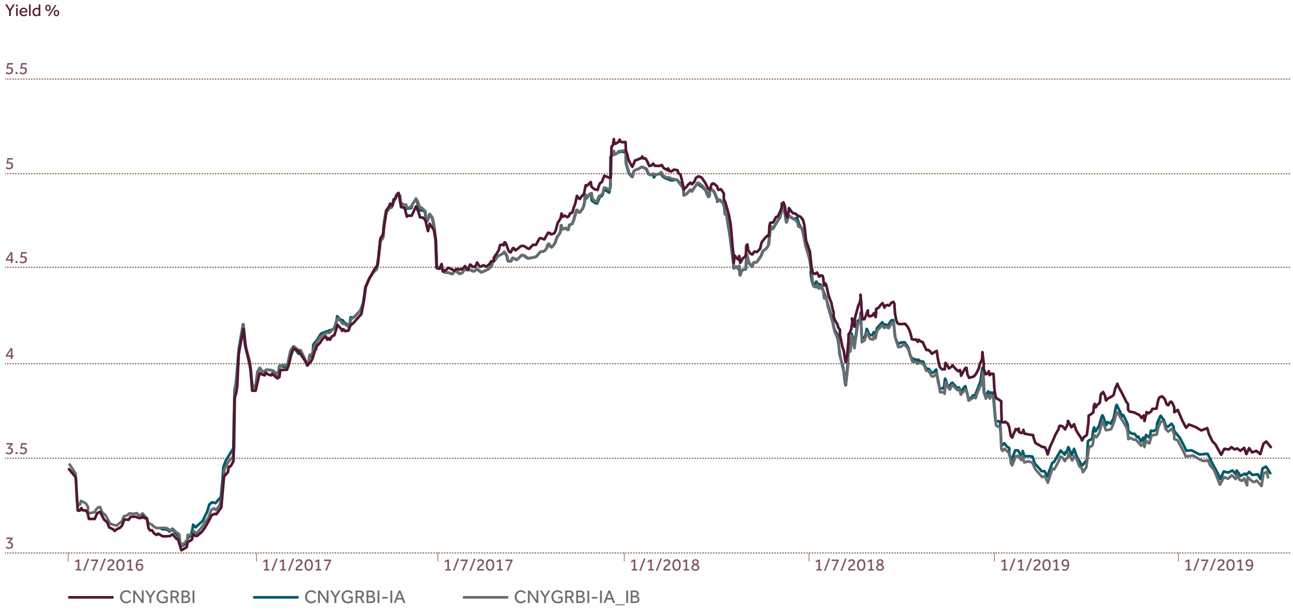
FTSE Chinese (Onshore CNY) Green Bond Index

Yield

There are three different versions of the FTSE Chinese (Onshore CNY) Green Bond Index (CNYGRBI): CNYGRBI, FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index, and FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index – Interbank. The yield of the CNYGRBI as of end-September was 3.54%. Among the sub-indexes, the FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index, was at 3.40%; the FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index – Interbank was at 3.37%, as shown in the chart 3.

For 2019 Q3, the yield of CNYGRBI decreased by 19.47bps.

Chart 3. The Historical Yield of China Green Bond Index



Source: FTSE Russell, data as of September 30, 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 2.40% during the last quarter, with its Internationally-Aligned sub-index down 2.47% and its Internationally-Aligned – Interbank sub-index down 2.48%.

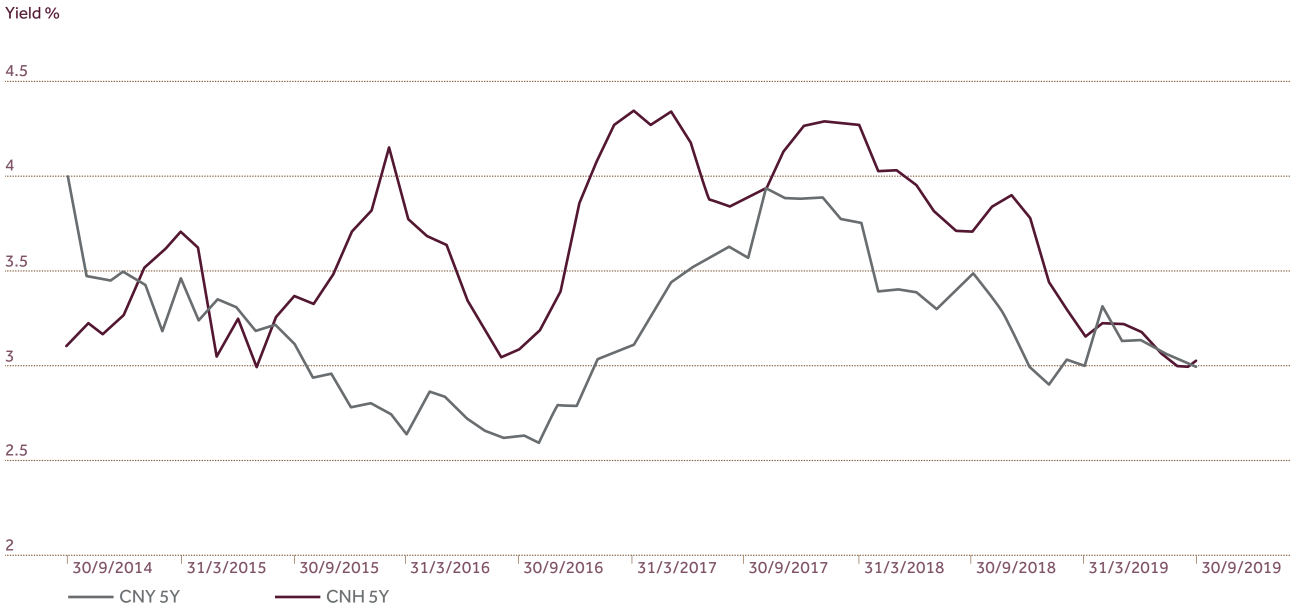
Table 2. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD, unhedged)				Annualized Volatility	
	3M	6M	1YR	3YR	1YR	3YR
Chinese Bond Index	-2.40	-3.83	2.10	4.19	4.09	4.07
Chinese Bond Index – Internationally-Aligned	-2.47	-3.94	1.77	3.79	4.11	4.09
Chinese Bond Index – IA – Interbank	-2.48	-3.97	1.70	3.88	4.11	4.09

Source: FTSE Russell – total return data in USD, as of September 30, 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

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



Source: FTSE Russell as of September 30, 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Total Return

The FTSE Chinese Government Bond Index outperformed the FTSE Offshore counterpart during Q3 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)	-2.29	-4.45	2.44	1.55	8.01	4.61	4.47	4.08
FTSE Chinese Government Bond Index (Offshore CNY)	-2.31	-3.84	1.90	4.92	3.81	4.75	4.73	4.52

Source: FTSE Russell, total return data in USD, as of September 30, 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 4.59%. Among the two sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade Index was at 3.03%; the FTSE Asian Broad Bond Index – China, High-Yield Index was at 9.94% as shown in the chart below.

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

Source: FTSE Russell - total return data in CNY, as of September 30, 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 1.61% during the last quarter, with its Investment-Grade sub-index up 2.40% and its High-Yield sub-index down 0.90%.

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	1.61	4.33	10.44	12.17	28.07	1.58	1.69	2.07
FTSE Asian Broad Bond Index – China, IG	2.40	5.47	11.24	12.23	27.03	1.89	1.93	2.25
FTSE Asian Broad Bond Index – China, HY	-0.90	0.67	7.92	13.67	36.81	2.82	2.48	4.02

Source: FTSE Russell - total return data in USD, as of September 30, 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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FTSE Russell is a leading global index provider creating and managing a wide range of indexes, data and analytic solutions to meet client needs across asset classes, style and strategies. Covering 98% of the investable market, FTSE Russell indexes offer a true picture of global markets, combined with the specialist knowledge gained from developing local benchmarks around the world.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create investment funds, ETFs, structured products and index-based derivatives. FTSE Russell indexes also provide clients with tools for asset allocation, investment strategy analysis and risk management.

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EMEA
+44 (0) 20 7866 1810

North America
+1 877 503 6437

Asia-Pacific
Hong Kong +852 2164 3333
Tokyo +81 3 3581 2764
Sydney +61 (0) 2 8823 3521