Research

FTSE Russell China Bond Research Report

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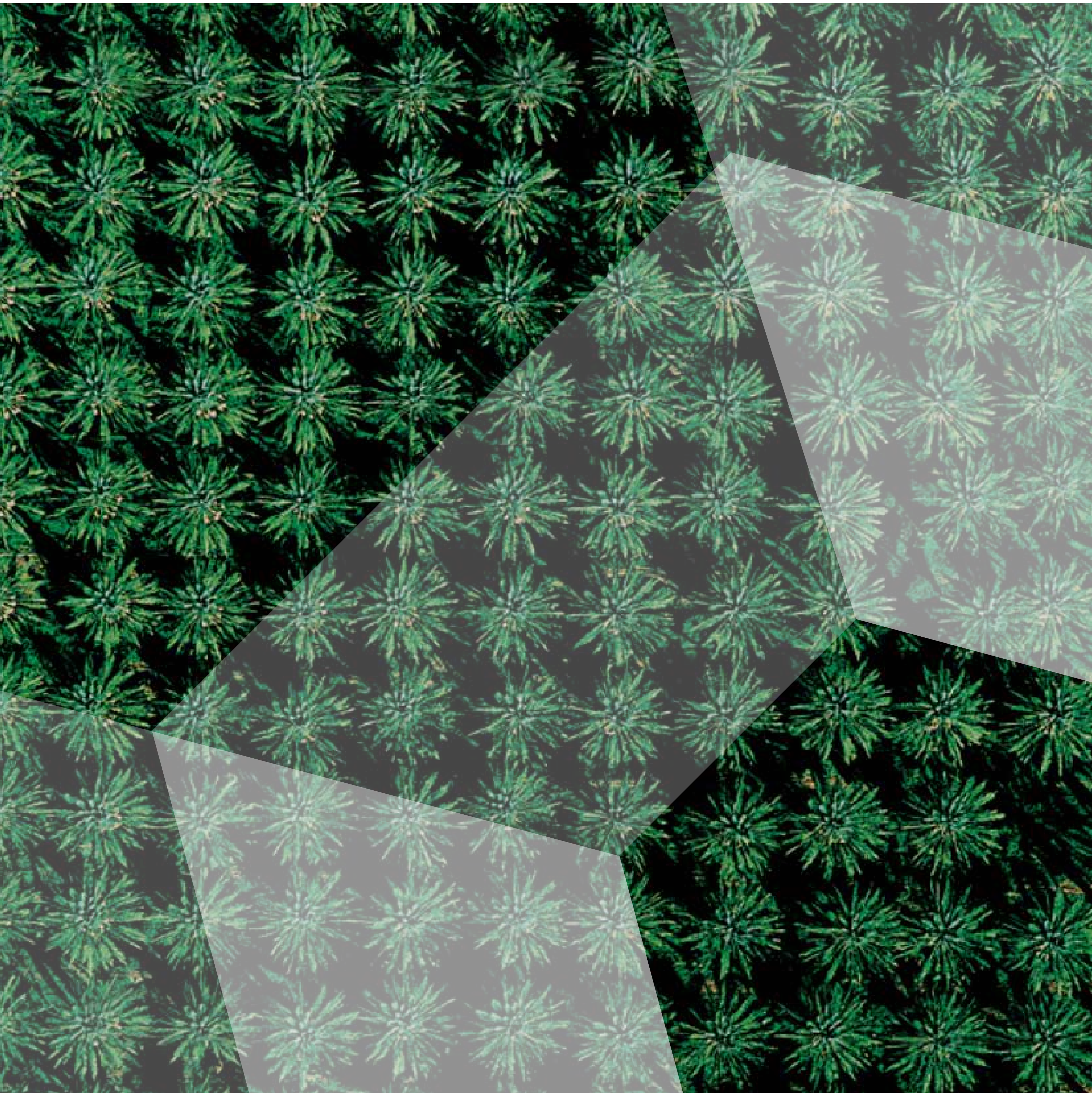


FTSE Russell China Bond Research Report

Highlights

- Foreign investors held a record amount of China bonds – 2.51 trillion RMB ($354.5 billion) – at the end of June, according to FTSE Russell calculations using official data from China Central Depository and Clearing Co and the Shanghai Clearing House. Despite the coronavirus, in H1 2020 foreign buyers increased their RMB bond holdings by 14.6%.[1]
- As 2020 enters its back half, the People's Bank of China (PBOC) continues to maintain its steady approach in an effort to avoid another credit crunch such as the world saw in the global financial crisis (GFC). On that score, China has only cut interest rates modestly (by 30bps to 2.95% on the one-year medium-term lending facility) since the Covid-19 crisis began.[2]
- China officially scrapped quota restrictions on qualified foreign institutional investors (QFII) and RMB qualified foreign institutional investors (RQFII). Effective June 6, the quota removal is expected to motivate more international market participants to invest in China's financial markets.[3]

1 FTSE Russell; CCDC. July 2020.
2 FTSE Russell. July 2020.
3 PBOC; SAFE. July 2020.

Chapter 1: Overview

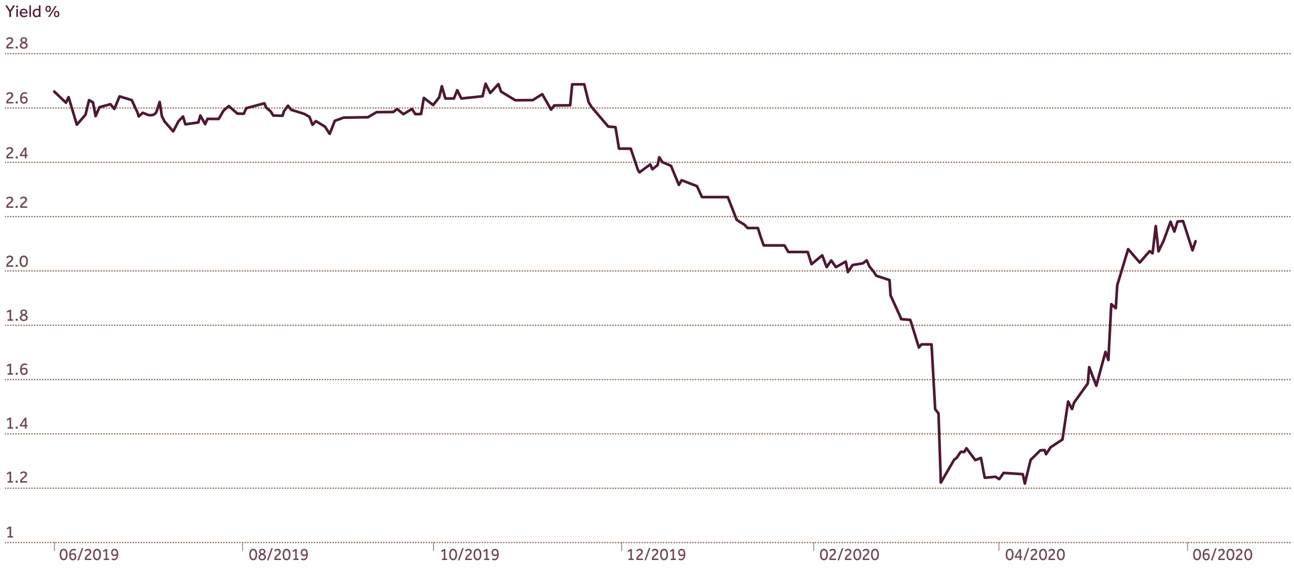
Capital inflows rise despite a challenging time for China and other emerging markets

Despite the ongoing uncertainty unleashed by the coronavirus, yield premiums continued to pull investors into China's bond market, with foreign investors holding a record amount of RMB bonds – 2.51 trillion RMB ($354.5 billion) – at the end of June, up by 14.6% in H1 2020, according to FTSE Russell calculations using official data from China Central Depository and Clearing Co and the Shanghai Clearing House.

Chinese government bonds, in particular, registered a record volume of 1.49 trillion RMB ($210.96 billion) owned by international investors by end-June, pushing the foreign ownership of the country's government bonds outstanding in the market to nearly 9.1% for the first time. Up by 148.7 billion RMB in Q2 2020, it was the biggest quarterly gain since the second quarter of 2018.[4]

Against this backdrop, the financial impact of the coronavirus crisis is accelerating efforts by China's regulators to control the spread of risky credit throughout the country's financial system. On that score, in June one-year government bond yields hit their highest levels in months after the PBOC declined to further lower its short-term loan rates to banks.[5] As shown below, the yield on one-year government bonds spiked to a 5-month high of 2.19% on June 22nd, surging more than 60 basis points in a single month.

The Recent Climb in One-Year Yields on China's Government Bonds



Source: FTSE Russell, June 30th, 2020.

Despite these efforts by regulators to maintain a steady hand, turbulence in the market hasn't subsided: Following quickly on the heels of Q2, July 6 saw the worst sell-off of China's government bonds in the roughly four years since 2016, as a surge in risk appetite motivated investors to push the Shanghai Composite Index to hit its biggest single-day gain in five years. The fixed-income markets also took a hit over investor jitters after the central bank net drained cash from the financial system for eight straight sessions.[6]

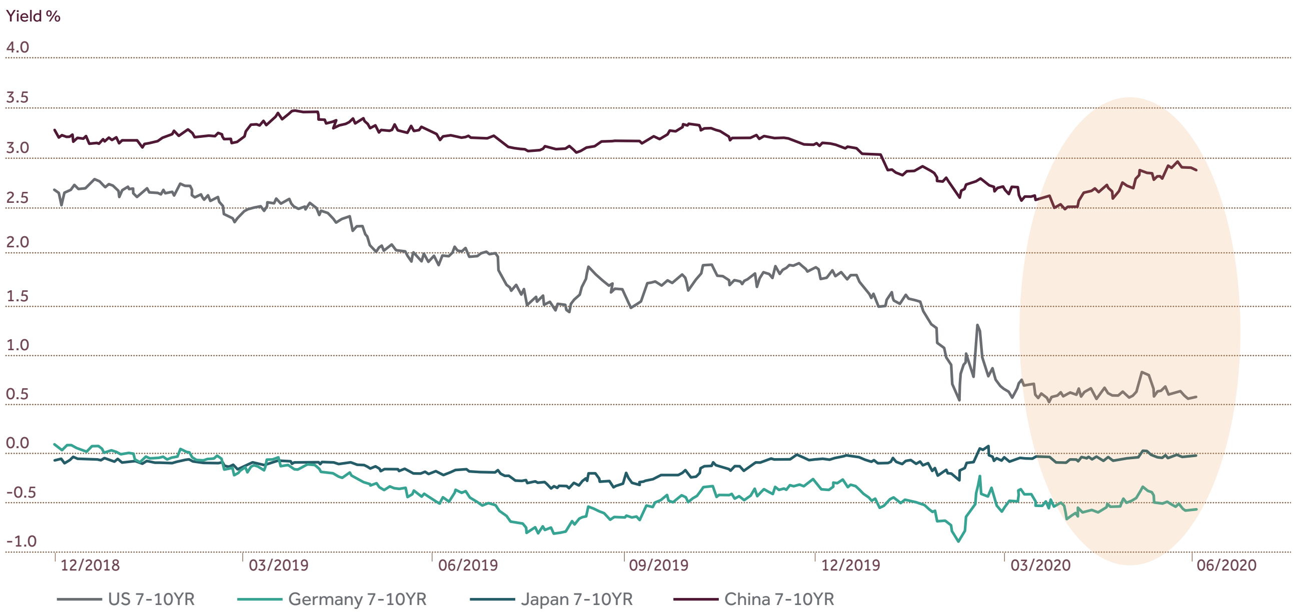
4 FTSE Russell. July 2020.
5 Reuters. June 2020.
6 Bloomberg. July 2020.

Chapter 2: Yields back up in Q2

As 2020 enters its back half, the PBOC continues to maintain its steady approach in an effort to avoid another credit crisis such as the world saw in the global financial crisis (GFC). To date, China's central bank has only cut interest rates modestly (by 30bps to 2.95% on the one-year medium-term lending facility) since the Covid-19 crisis began.[7] Earlier this year, PBOC Governor Yi Gang said "the normal monetary policy should be kept as long as possible,"[8] causing yields to back up in Chinese government bonds in Q2, even though they remain well below end-2019 levels.

The recent back-up in yields has also widened the yield differentials in favour of Chinese government bonds, versus G7 markets, as the chart below shows.[9]

Chinese Government Bond Yields Backed Up in Q2



Source: FTSE Russell, June 2020.

Chapter 3: Despite challenges, reforms continue

While the market outlook is uncertain, China's regulators continue to make a number of capital market reforms in an effort to better facilitate foreign investors' participation in China's financial market during this challenging time. These reforms include:

Quota limit removed for QFII and RQFII

In a major move to promote further opening-up of China's financial market, the People's Bank of China (PBOC) and the State Administration of Foreign Exchange (SAFE) jointly issued the Regulations on Funds of Securities and Futures Investment by Foreign Institutional Investors on May 7. Quota restrictions on the investment quota of qualified foreign institutional investors

7 FTSE Russell; PBOC. July 2020.
8 Economic Research. April 2020.
9 FTSE Russell. June 2020.

(QFII) and the RMB qualified foreign institutional investors (RQFII) are removed, and qualified investors shall entrust their main custodians to make a registration with the SAFE. Effective June 6, the standardized/simplified administrative requirements - on the remittance and repatriation of funds and currency exchanges by foreign institutional investors - are expected to motivate more international market participants to invest in China's financial markets.[10]

Fitch enters China's bond market

In late May, Fitch (China) Bohua Credit Ratings Ltd. received approval from the PBOC and the National Association of Financial Market Institutional Investors to operate in China – a development that illustrates China's long-stated goal of granting more market access to international ratings agencies.

However, restrictions do apply. The license grants Fitch the authority to only issue ratings on financial institutions, including banks, non-bank financial institutions and insurers, and their securities, and structured finance bonds in China's interbank market.[11]

Fitch's entry into the Chinese interbank bond market as the second wholly foreign-owned credit rating agency in the country is a step toward increasing transparency and governance throughout corporate China and boosting best practices within the nation's ratings industry, experts say.[12]

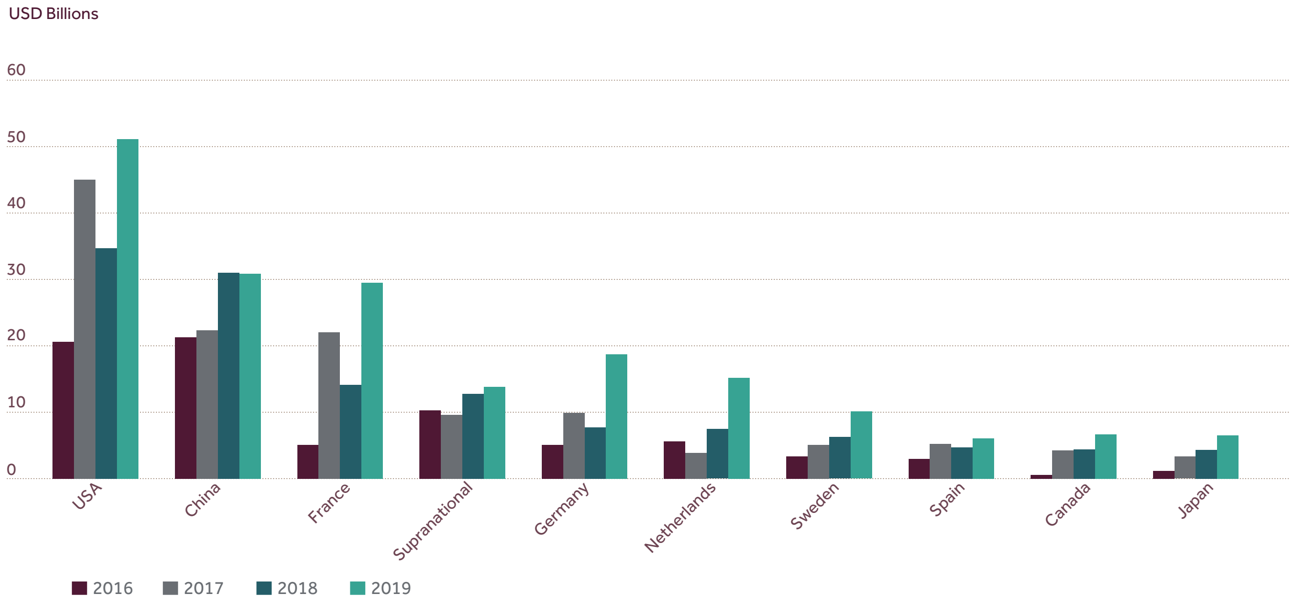
China proposes removing clean coal projects from list eligible for green bonds

Last but not least, China continues to stake its claim as a global leader in green finance – and on that basis is slowly adopting standards in line with global guidelines. In a recent consultation paper on the new Green Bond Endorsed Project Catalogue, published in early July by PBOC and other regulatory bodies, policymakers argued to remove "clean coal" from China's 'green' classification, and make China's definitions more consistent with global standards and the Paris Agreement. "It's a hugely significant step that will be welcomed by international investors. Removal of fossil fuels brings closer alignment with international practices," Sean Kidney, chief executive officer of the Climate Bonds Initiative, told Reuters.[13]

As shown in the chart below, China has remained the second largest issuer in the global green bond market, over years following the official launch of its domestic green bond market in December 2015. China's issuance of over 30 billion USD of green bonds in 2019 surpassed the volume issued in the US green bond market, if the green mortgage-backed securities (MBS) are taken out from the total – about 22 billion USD of MBS issued by Fannie Mae.

10 PBOC; SAFE. July 2020.
11 Fitch; FTSE Russell. May 2020.
12 S&P Global Ratings. May 2020.
13 Reuters. May 2020.

Green Bonds Issuance in Global Top 10 Markets



Source: Climate Bonds Initiative, May 2020. Green bonds are defined as bonds that are aligned with the Climate Bonds Taxonomy and included in the CBI green bond database.

Chapter 4: Performance of the FTSE Russell China Bond Indexes

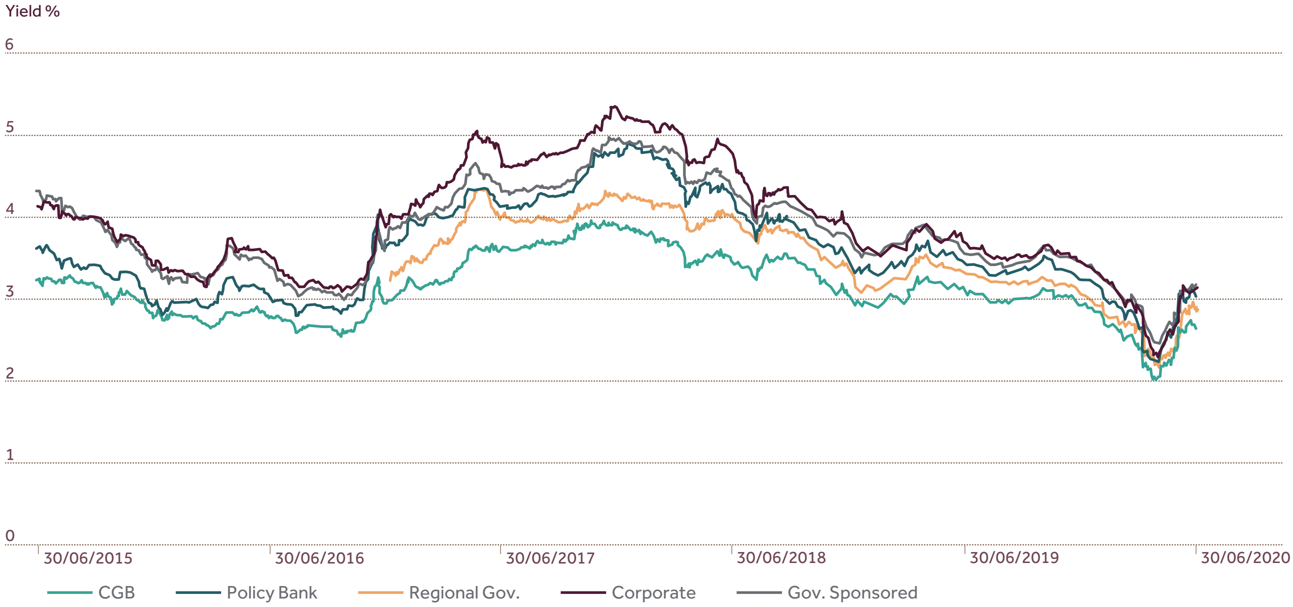
Onshore Report

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 2.87%. Among the five major sectors, the Government Bond (CGB) sector was at 2.63%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 3.01%; the Regional Government sector was at 2.83%; the Corporate sector was at 3.12%; the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 3.14% as shown in the chart below.

For 2020 Q2, the yield of CNYBBI increased by 27.01bps with corporate spread widened by 0.06bps.

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



Source: FTSE Russell, data as of June 30, 2020. 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 -0.28% while its return in CNY finished down -0.55% during the last quarter. The returns of some sectors are shown in Table 1.

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

	Cumulative Return (USD, unhedged)					Annualized Volatility		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
CNYBBI	-0.28	0.95	2.36	11.98	8.62	4.28	4.36	4.04
CGB	-0.51	1.14	2.48	10.89	7.49	4.50	4.58	4.26
Policy Bank	-0.40	0.90	2.27	12.50	8.89	4.28	4.41	4.14
Corporate	0.27	0.59	1.63	12.08	9.89	4.23	4.20	3.88

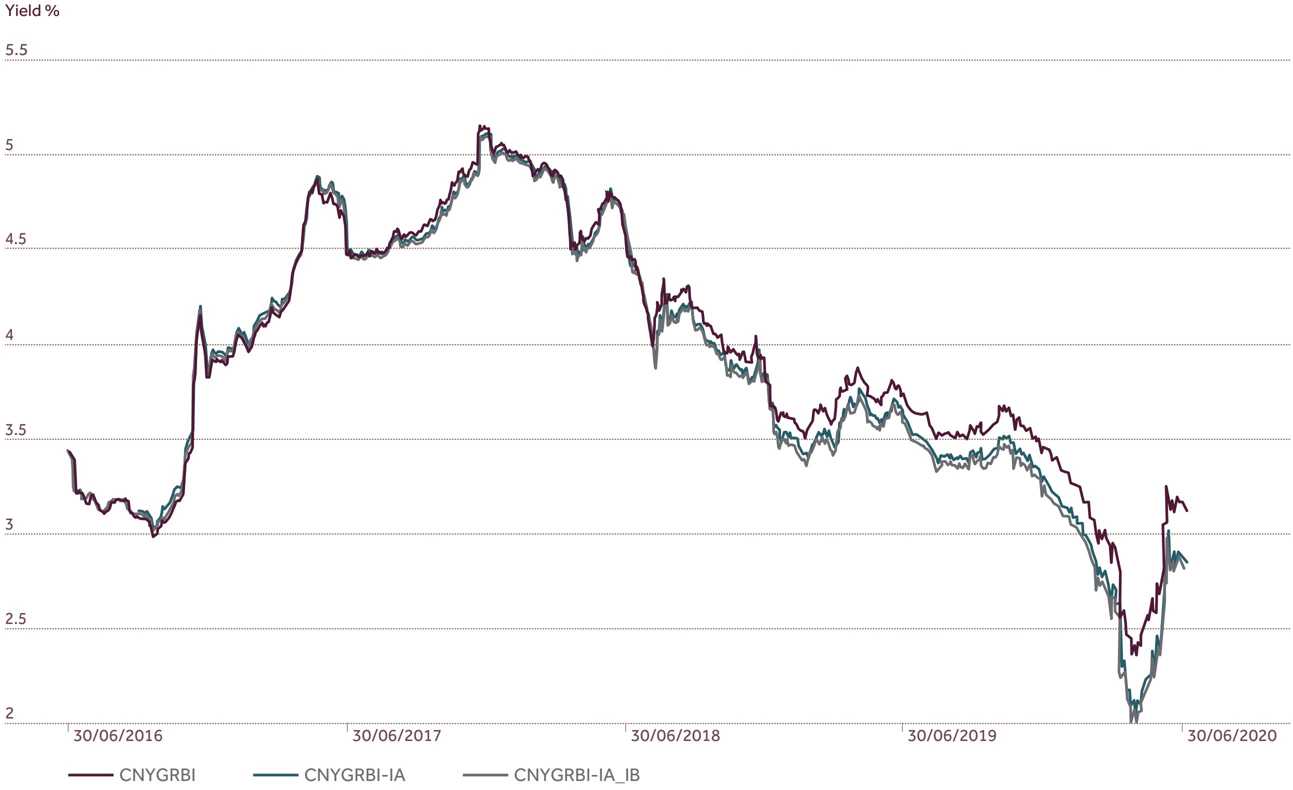
Source: FTSE Russell – total return data in USD, as of June 30, 2020. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

FTSE Chinese (Onshore CNY) Green Bond Index

Yield

There are three different versions of 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 CNYGBRI as of end-June was 3.16%. Among the sub-indexes, FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index, was at 2.87%; FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index – Interbank was at 2.83%, as shown in the chart below. For 2020 Q2, the yield of CNYGRBI increased by 21.45bps.

Chart 2. The Historial Yield of China Green Bond Index



Source: FTSE Russell, data as of June 30, 2020. 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

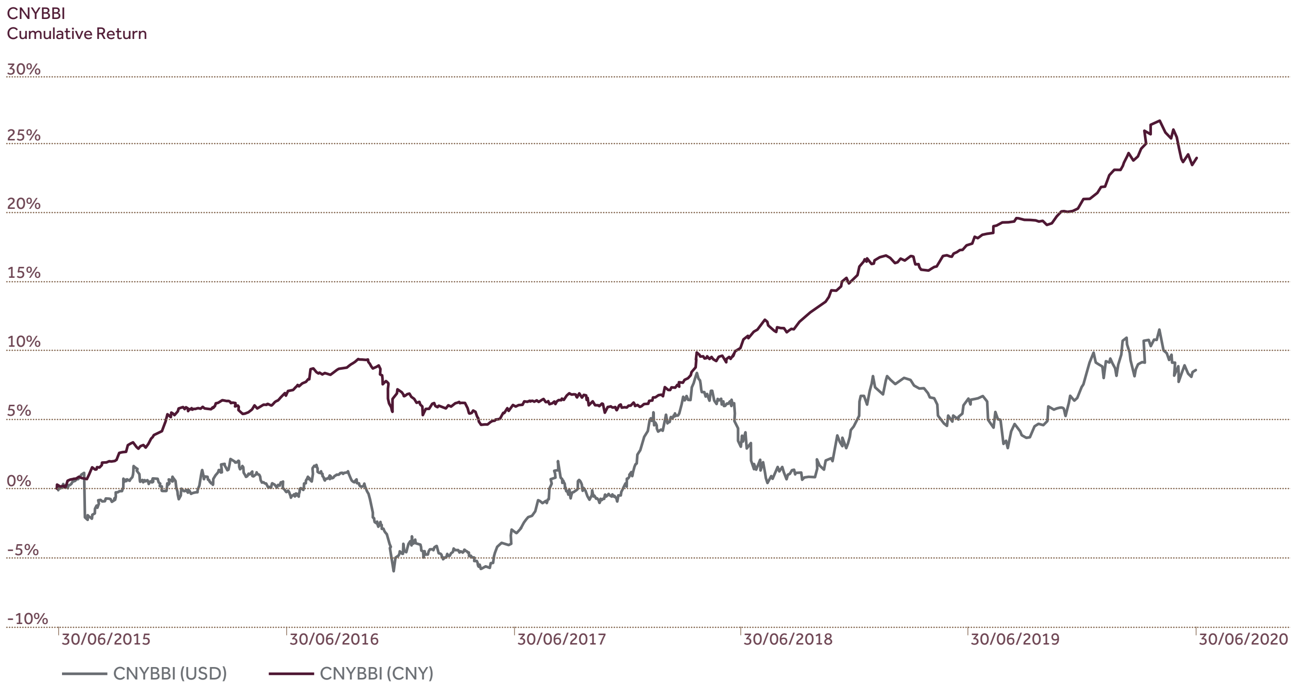
The FTSE Chinese (Onshore CNY) Green Bond Index finished up 0.52% during the last quarter, with its Internationally-Aligned sub-index up 0.60% and its Internationally-Aligned – Interbank sub-index up 0.60%.

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

	Cumulative Return (USD, unhedged)				Annualized Volatility	
	3M	6M	1YR	3YR	1YR	3YR
China Green Bond Index	0.52	0.80	2.03	12.32	4.18	4.18
China Green Bond Index – International Align	0.60	0.69	1.77	11.78	4.22	4.19
China Green Bond Index – IA – Interbank	0.60	0.69	1.75	11.76	4.22	4.19

Source: FTSE Russell – total return data in USD, as of June 30, 2020. 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 3. CNYBBI Performance in USD vs in CNY for the Past 5 Years



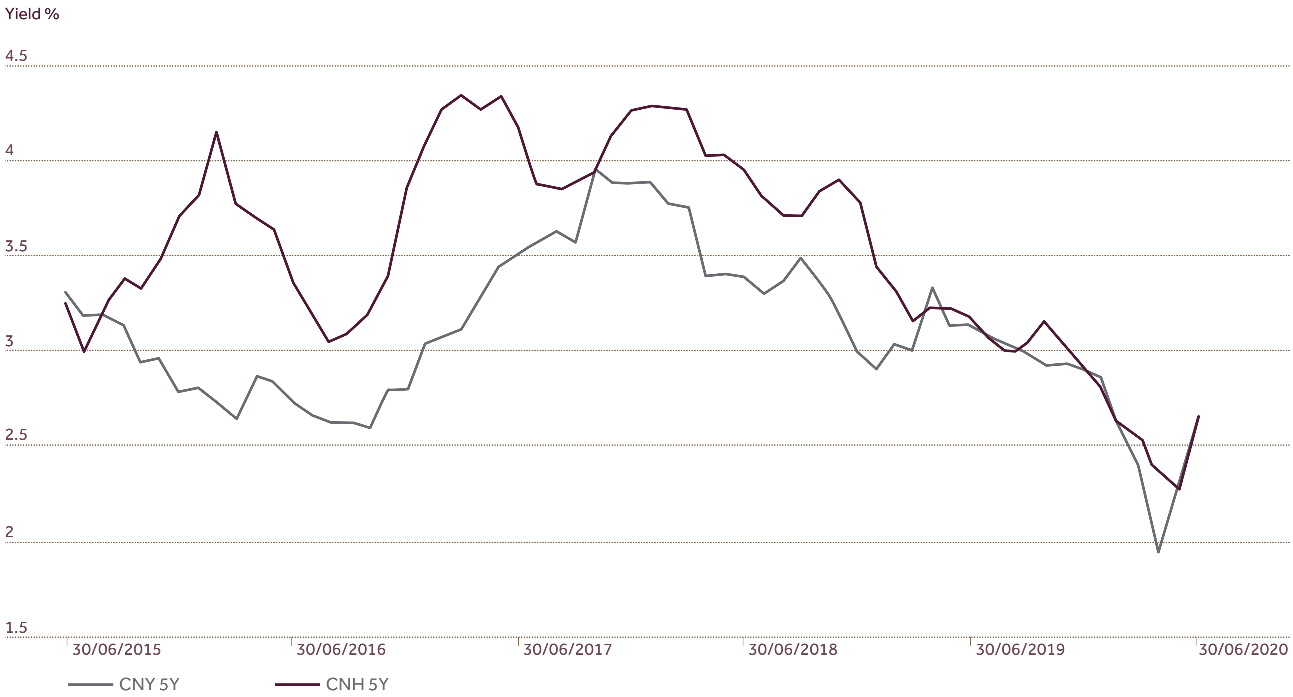
Source: FTSE Russell – total return data in USD and CNY, as of June 30, 2020. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds

Yield

The yield of onshore 5-year Sovereign bonds was at 2.65% and the yield of offshore 5-year Sovereign bonds was at 2.64% as of end of Q2. The spread tightened by 14bps for Q2 of 2020 as shown in Chart 4.

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



Source: FTSE Russell as of June 30, 2020. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

As of end-Q2 2020, 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 10bps and the long end curve 10-year spread was 15bps.

Total Return

The FTSE Chinese Government Bond Index underperformed the FTSE Offshore counterpart during Q2 2020 as shown in Table 3.

Table 3. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD, unhedged)					Annualized Volatility		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Chinese Government Bond Index (Onshore CNY)	-0.51	1.14	2.48	10.89	7.49	4.50	4.58	4.26
FTSE Chinese Government Bond Index (Offshore CNY)	0.74	0.86	1.93	11.65	6.02	5.11	4.80	4.78

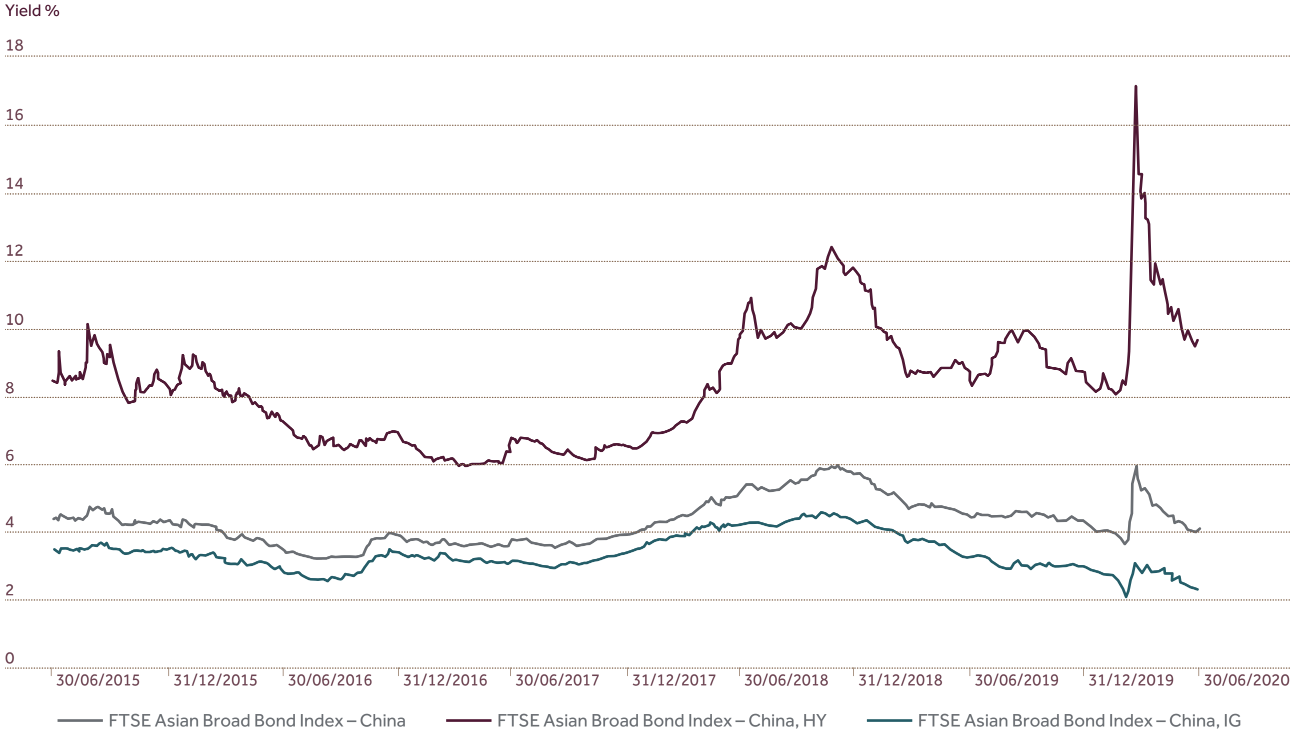
Source: FTSE Russell, total return data in USD, as of June 30, 2020. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures. FTSE Chinese Government Bond Index (Offshore CNY) 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 3.97%. Among the two sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade Index was at 2.31%; the FTSE Asian Broad Bond Index – China, High-Yield Index was at 9.63% as shown in the below chart.

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



Source: FTSE Russell, data as of June 30, 2020. 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 4.93% during the last quarter, with its Investment-Grade sub-index up 2.80% and its High-Yield sub-index up 12.85%.

Table 4. Performance and Volatility – Total Return

	Cumulative Return (USD, unhedged)					Annualized Volatility		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Asian Broad Bond Index – China	4.93	3.85	7.08	17.02	30.11	3.86	2.56	2.44
FTSE Asian Broad Bond Index – China, IG	2.80	4.48	7.64	17.41	28.49	3.43	2.42	2.44
FTSE Asian Broad Bond Index – China, HY	12.85	1.95	5.50	16.14	40.48	8.45	5.34	4.77

Source: FTSE Russell - total return data in USD, as of June 30, 2020. 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 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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