Research

FTSE Russell

FTSE Russell China Bond Research Report

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Highlights

- On July 3 China proceeded with the further opening of the mainland bond market via the long-awaited 'Bond Connect' programme, a Hong Kong link that provides foreign investors access to the country's $9 trillion debt market, even if they lack an onshore account. The People's Bank of China (PBOC) and Hong Kong Monetary Authority (HKMA) said that during the programme's early stages flows would only go northbound from Hong Kong to the mainland.[1]
- China's anti-leverage campaign continues. In May, the five-year sovereign yield was higher than that on ten-year debt, the first time the curve has inverted since 2006.[2] At the same time, a number of stringent new regulatory measures introduced since the appointment of a new senior regulator in March, coupled with rising short term borrowing costs and growing fears of defaults, have increased the propensity for domestic banks to off-load short term bonds.[3] In aggregate, Chinese corporate and government bond prices have decreased about 6 percent in the first half of 2017.[4]
- International appetite for Chinese debt may be diminishing, according to some media reports. For example, analysis of offshore RMB-denominated bond funds compiled by Morningstar reveals total assets under management shrank by roughly half in the past year to about $11.6 billion.[5]

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1 Bloomberg. July 2017.
2 Bloomberg. May 2017.
3 FTSE Russell. July 2017.
4 Bloomberg. May 2017.
5 Reuters. May 2017.

Chapter 1: Overview

Will the Bond Connect launch provide the catalyst to unleash China's latent onshore debt market?

The long awaited Bond Connect programme, which launched on July 3, aims to spark more demand for Chinese bonds among international market participants, who collectively hold less than two percent of onshore Chinese debt, despite China being home to the world's third largest bond market.[6]

In theory, Bond Connect – which will allow foreign investors to trade onshore debt via Hong Kong domiciled accounts, rather than through opening accounts onshore – will help to further spur the market toward an open and transparent structure[7] and remove the bulk of the cumbersome procedures often associated with the onshore market.[8]

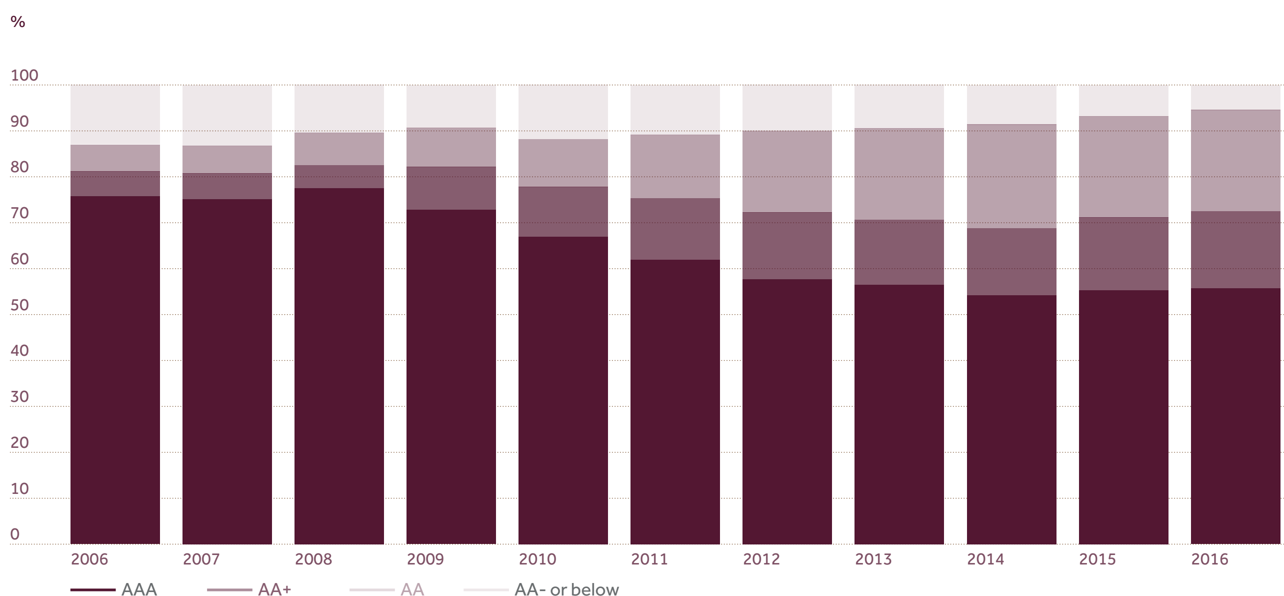
China's regulators, who aim to further liberalise the country's capital markets and attract more international investment, will roll out the full programme over time. The PBOC and HKMA said on May 16 that the Bond Connect system would be one-way at its start, with flows only going northbound from Hong Kong to the mainland.[9]

"Bond Connect is significant in terms of offering greater levels of accessibility to China bonds for international investors – and it will likely impact their asset allocation strategies," says Eddie Pong, Director of Research and Analytics at FTSE Russell. "At the same time, appetite will depend on a variety of factors, including views on the renminbi (RMB), China's macro environment, and the yield curves compared to other markets."

Complementing the roll out of Bond Connect are a number of liberalisation measures, which are continuing in earnest. In recent weeks, for example, China has promised to allow US ratings agencies to enter the domestic bond market as part of a bilateral trade deal, potentially alleviating concerns among some international market participants that China's domestic ratings agencies do not accurately value risk,[10] owing to significant differences in rating methodologies between domestic and international rating agencies. Domestic rating agencies rarely rate bonds below AA-,[11] which is remarkable for such a large and diverse fixed income market.[12]

6 Reuters. May 2017.
7 Reuters. May 2017.
8 FTSE Russell. July 2017.
9 Bloomberg. May 2017.
10 Financial Times. May 2017.
11 WIND. July 2017.
12 FTSE Russell. July 2017.

Outstanding Principal of Corporate Bonds by Issuer's Rating



Source: WIND, July 2017.

In response to liberalisation initiatives such as Bond Connect, index providers have moved to include Chinese bonds in their respective emerging markets indexes. For example, Citigroup became the first fixed income index provider to include Chinese onshore bonds in its Emerging Markets Government Bond Index, Asian Government Bond Index and Asia Pacific Government Bond Index, with China's weight in all three to be gradually increased over a three-month period from March next year.[13]

Chapter 2: Anti-Leverage Measures Start to Bite

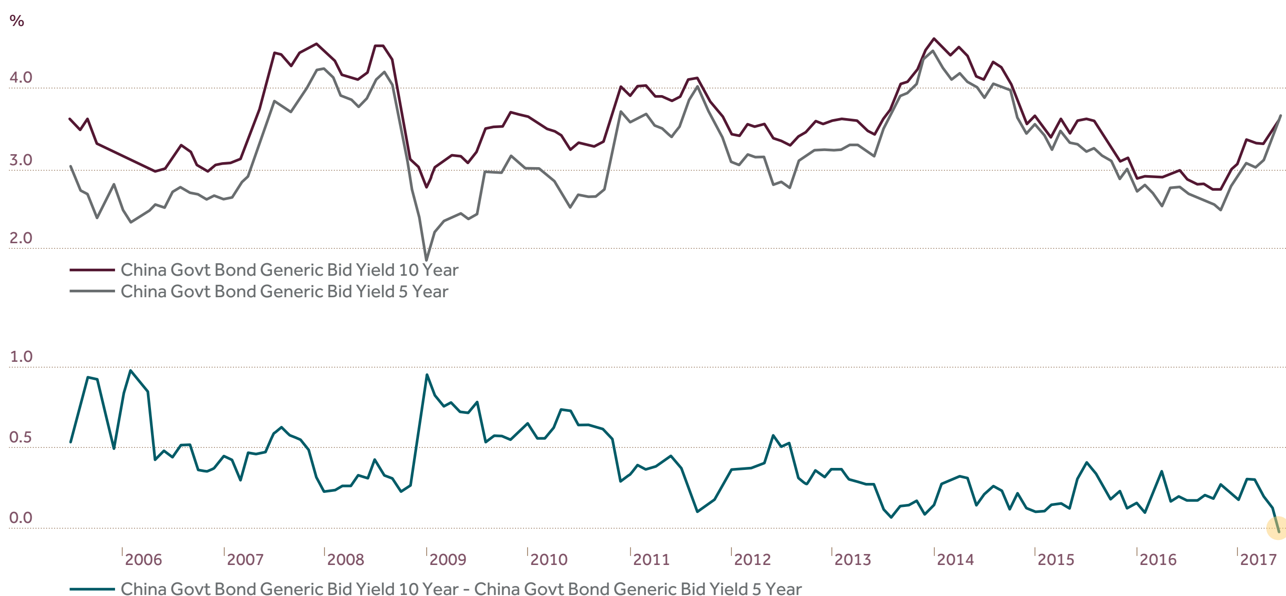
Bond Connect is an important step forward along the path of market liberalisation, as it makes foreign investment within the domestic onshore debt market significantly less cumbersome. However, in and of itself, Bond Connect may not spur demand, as there are other variables which may be considered, such as index inclusion and excess leverage.[14]

Indeed, the numbers in 2017 reveal that a bit of realism is merited as international appetite for Chinese debt appears to be declining on the back of China's campaign to reduce excess leverage from the economy and more closely regulate lending to poor-quality firms in industries suffering from overcapacity. An analysis of offshore RMB-denominated bond funds compiled by Morningstar shows total assets under management shrank by nearly half in the last year to about $11.6 billion.[15]

13 FTSE Russell. July 2017.
14 FTSE Russell. July 2017.
15 Reuters. May 2017.

At the same time, the anti-leverage campaign is impacting yields on sovereign debt. As of May, the five-year sovereign yield was higher than that on the 10-year tenor, the first time the curve has inverted since 2006, due in part to economic growth concerns.[16] More significant however is the introduction of new regulatory measures that have curbed short-term lending, increasing the supply at the 5-year tenor, whilst simultaneously driving down the yields at the 10-year tenor, a part of the curve that has notoriously been under-supplied.[17] The 5-10 year inversion is depicted in the graph below.

Inverted Yield Curve



Source: Bloomberg, May 2017.

"The yield curve inversion can be attributed to the disequilibrium between short and longer dated bonds," says Scott Harman, Managing Director, Fixed Income & Multi-Assets, FTSE Russell. "China's resolve to deleverage the financial system has been demonstrated by a number of key new measures introduced since the appointment of a new senior financial regulator in March this year. These measures, coupled with rising short term borrowing costs, have increased the propensity for domestic banks to off-load short term bonds, increasing the supply of short-term bonds. At the same time, demand for longer-term, maturity-matching liability driven investments has remained strong, but this end of the curve is notoriously under supplied, which has resulted in suppressing ten-year yields."

In this challenging environment, Chinese corporate and government bond prices have decreased about 6 percent in the first half of 2017. The declines were triggered by policymakers' shift towards deleveraging the economy, and a lack of trading counterparties, according to some analysts.[18]

In May, Chinese government bonds posted their second monthly decline in a row, driving yields higher. The 10-year yield advanced 17 basis points in May to 3.65 percent, according to data compiled by Bloomberg. That followed an increase of 18 basis points in April, as illustrated by the graph below.[19]

16 Bloomberg. May 2017.
17 FTSE Russell. July 2017.
18 Bloomberg. May 2017.
19 Bloomberg. May 2017.

Rising Yields on China's 10-Year Sovereign Bonds

Source: Bloomberg, May 2017.

"The main purpose of the anti-leverage campaign is to channel capital flows into the real economy instead of financial assets," says Pong. "However, it's not the only reason bond market prices declined last year. In other parts of the world, especially developed markets, more normalised monetary policies have impacted the markets. For example, the Fed has raised interest rates. This will also have certain implications for the monetary policy in China. China may have to adjust its interest rate policy with an eye on developments in the global macro environment."

Concerned about their prospects in a turbulent market, Chinese companies have cancelled about 318 billion RMB of bond sales this year, as of May.[20] Meanwhile, 5.3 trillion RMB of corporate debt is coming due in 2017. That means the number of maturing bonds surpasses new issuance: the monthly average net financing by corporate bond sales was a negative 26 billion RMB ($3.8 billion) in the first four months of 2017.[21]

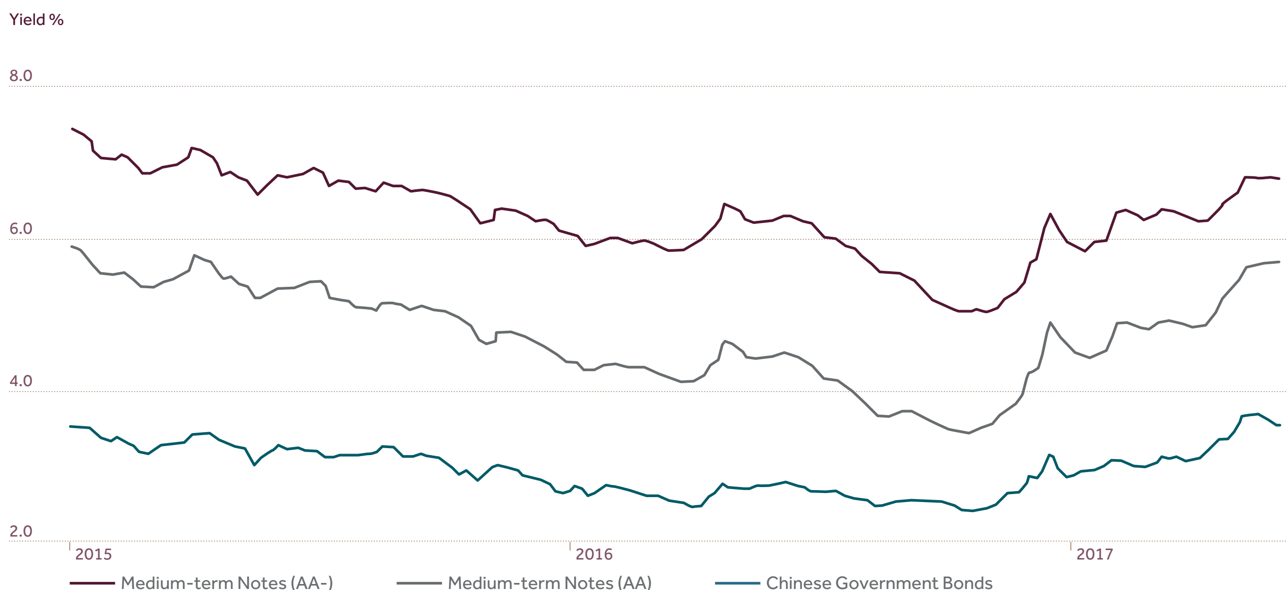
"The onshore corporate market has begun to show signs of a slight correction as new regulatory measures begin to bite, with maturities exceeding new issuance again in June - the fourth month in H117 in which net bond financing was negative," says Harman. "A combination of tighter liquidity in short term markets and a regulatory crackdown on leveraged investment in bonds have pushed up borrowing costs, leading non-bank corporates to cancel over 184 billion RMB of bond sales in Q2 2017 alone."

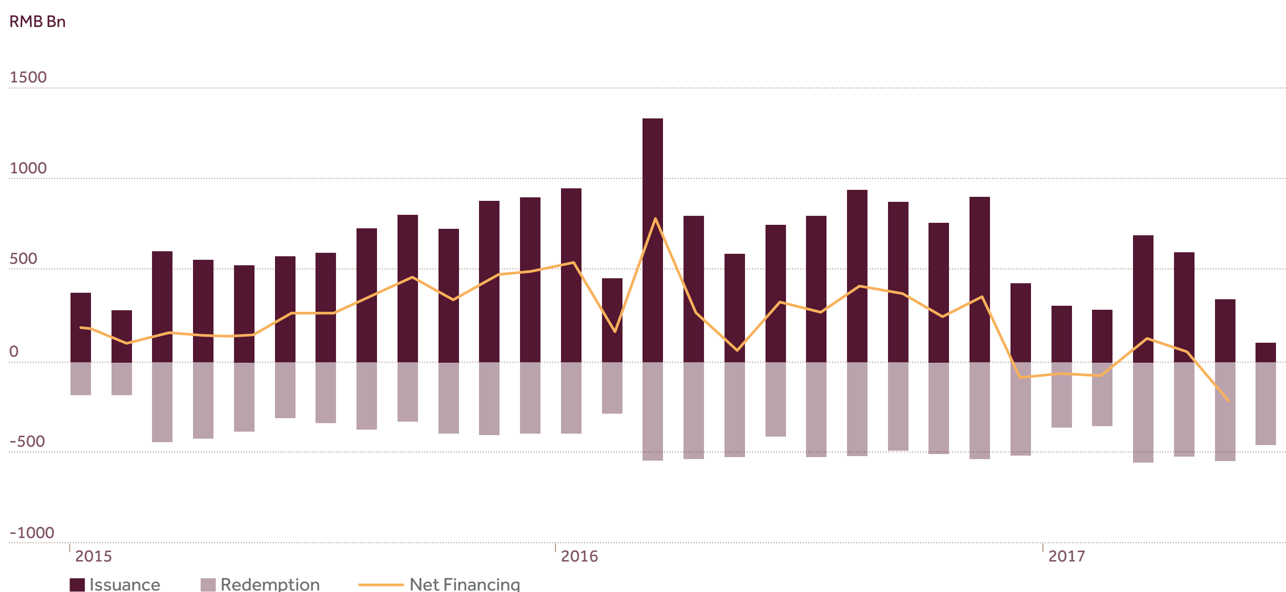
Exacerbating matters further is the perception among some analysts that China is in for even tougher times in the immediate future. In late May, Moody's Investors Service downgraded China's credit ratings for the first time in roughly three decades – to A1 from Aa3 – predicting that the Asian giant's economic strength will weaken in coming years as policymakers struggle to reconcile China's debt pile with slower economic growth.[22]

20 Bloomberg. May 2017.
21 Bloomberg. May 2017.
22 Reuters. May 2017.

"Concurrently, the anti-leverage campaign has also caused a tightening of short term liquidity, pushing up yields and fuelling fears of a spike in defaults," Harman says. "The selloff in the corporate market in early 2017 was spurred by tighter money-markets in recent months, pushing the five-year AA rated corporate bond yield premium over sovereign issues to its highest level since late 2015.[23] The period of tight liquidity has pushed up corporate bond yields (see graph below), at a time when the new Macro Prudential Assessment framework has limited banks' freedom to increase loans, and shadow-bank financing is also being curtailed by regulatory tightening."

Tight Liquidity Driving Higher Yields





Source: China Central Depository and Clearing; Wind Info; Financial Times, June 2017.

23 Bloomberg. May 2017

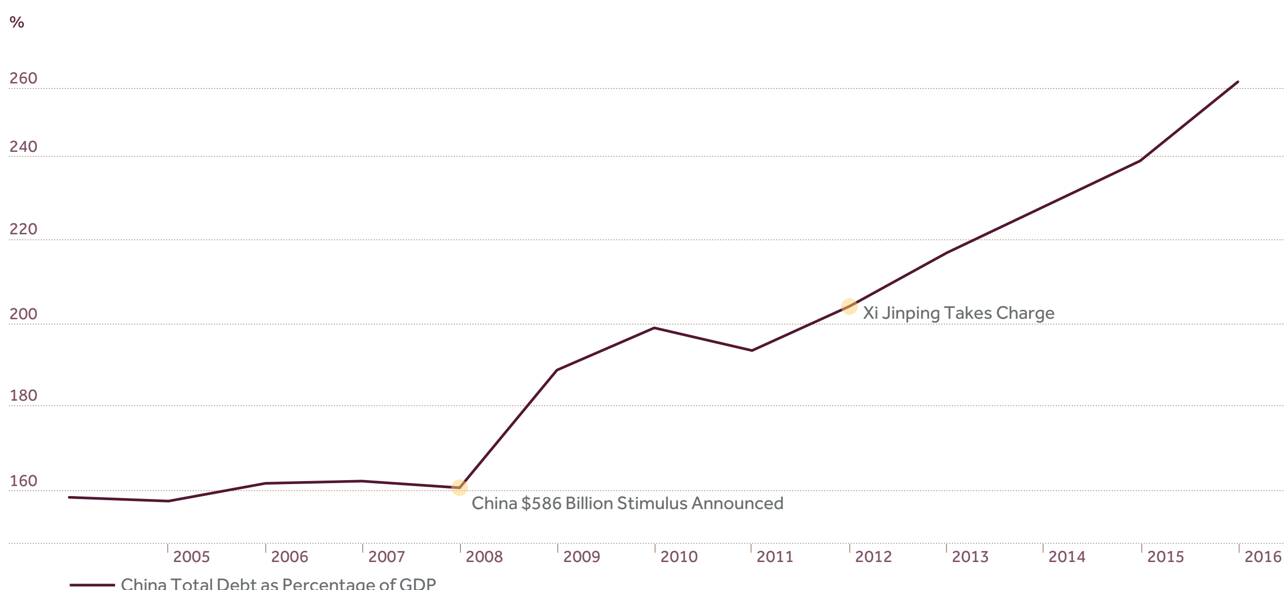
Chapter 3: A Credit Boom and a Steadier Currency

Despite these significant challenges, China's banks are still issuing credit, extending 1.54 trillion RMB in net new RMB loans in June, up from 1.38 trillion RMB one year ago, and above the 1.3 trillion RMB analyst consensus.[24]

However, the numbers do not necessarily indicate a healthier domestic bond market. In fact, bonds, which account for only 11 percent of total outstanding corporate and household debt, are not the driver of China's credit boom – according to the central bank. Bank loans comprise 72 percent of credit, while shadow bank credit accounts for 16 percent.[25]

Chinese policymakers are ostensibly committed to a deleveraging campaign, and will likely pursue a strategy of closely regulating lending for the foreseeable future.[26] The task is clearly a challenging one, given that credit has fuelled China's historic growth rates in recent years, as illustrated by the chart below.[27]

Rising Debt Levels



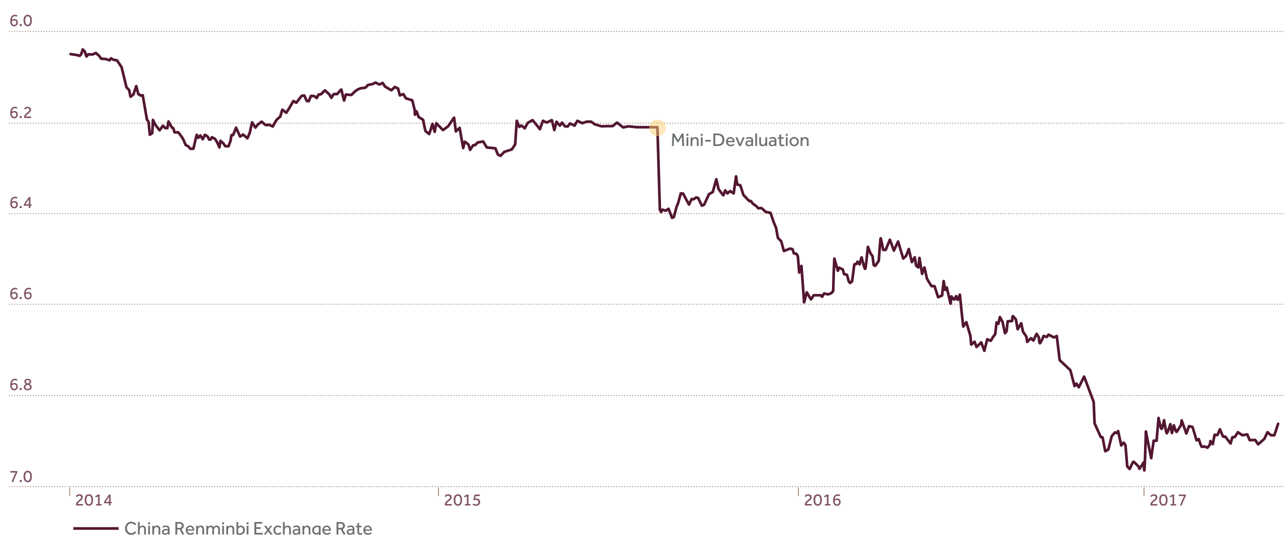
Source: Bloomberg, May 2017.

In addition to their attempts to monitor lending, China's regulators have also signalled they are keen to stabilise the RMB, which has decreased against the dollar in recent years on the back of China's macroeconomic slowdown, and on concerns that Chinese policymakers will struggle to navigate the dynamics exposed by the country's ambitious financial reform programme.

The RMB is currently restricted to moves of no more than 2 percent against the dollar on either side of the daily reference rate. But toward the end of May, China said it might change the way it calculates the daily reference rate, in an effort to stabilise the currency in the short term. This move, on one hand, might reduce RMB volatility; on the other it would represent a significant backwards step away from full RMB convertibility – a key long-term objective of China's regulators.[28]

24 Reuters. May 2017.
25 Financial Times. April 2017.
26 Bloomberg. May 2017.
27 Barclays. June 2017.
28 Bloomberg. May 2017.

A Steadier Currency



Source: Bloomberg, May 2017.

"In summation, the challenges associated with China bonds in the second half of 2017 are still in the areas of liquidity tightening, default rates and the global macro environment," says Pong. "As the market opens up further, the rate of bond defaults may pick up as a result. International market participants will have to pay more attention to credit risks. Nevertheless, a relatively realistic rate of defaults indicates that risk is more accurately priced. Finally, the recent trend in US interest rate increases and potential Fed balance sheet shrinkage may potentially influence China's monetary policy, especially interest rates."

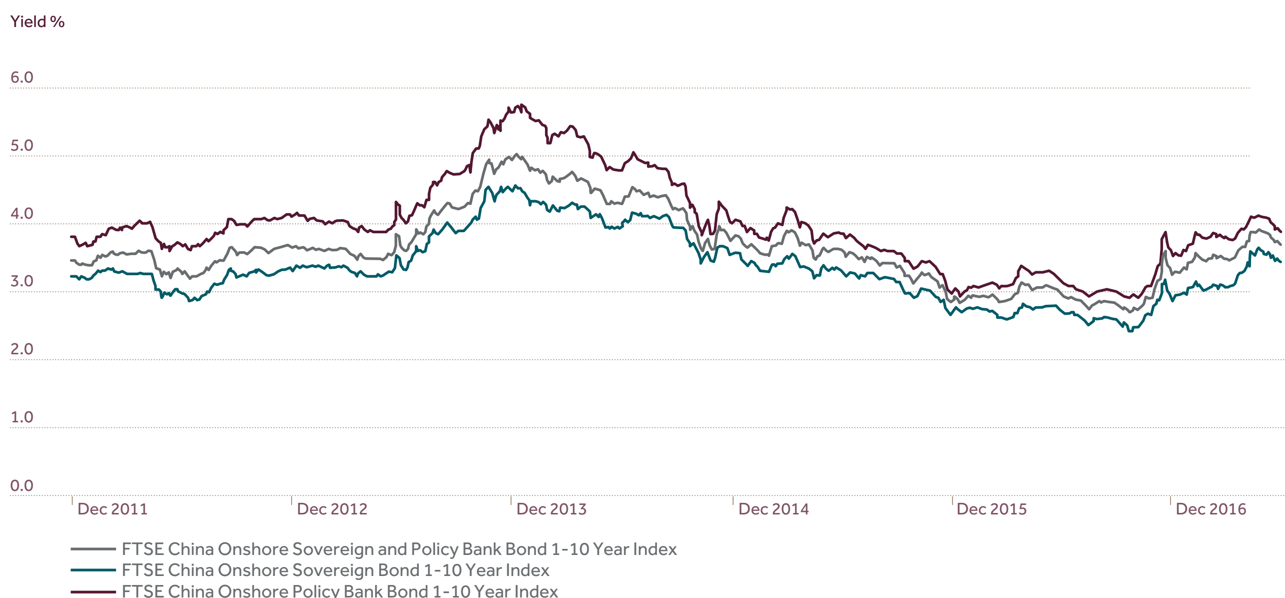
Chapter 4: Performance of FTSE Russell China Bond Indexes

I. Onshore Report

Redemption Yield

The market value duration weighted average redemption yield of the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index in June was at 3.69 percent. Among the two sub-indexes the FTSE China Onshore Sovereign Bond 1 - 10 Year Index was at 3.43 percent; and the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index was at 3.87 percent.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 30 June 2017. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document.

After March, the yield for the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index rose 0.20 percent to 3.69 percent by the end of June. The yield rose 0.37 percent for the FTSE China Onshore Sovereign Bond 1 - 10 Year Index; and rose 0.07 percent for the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index.

Total Return

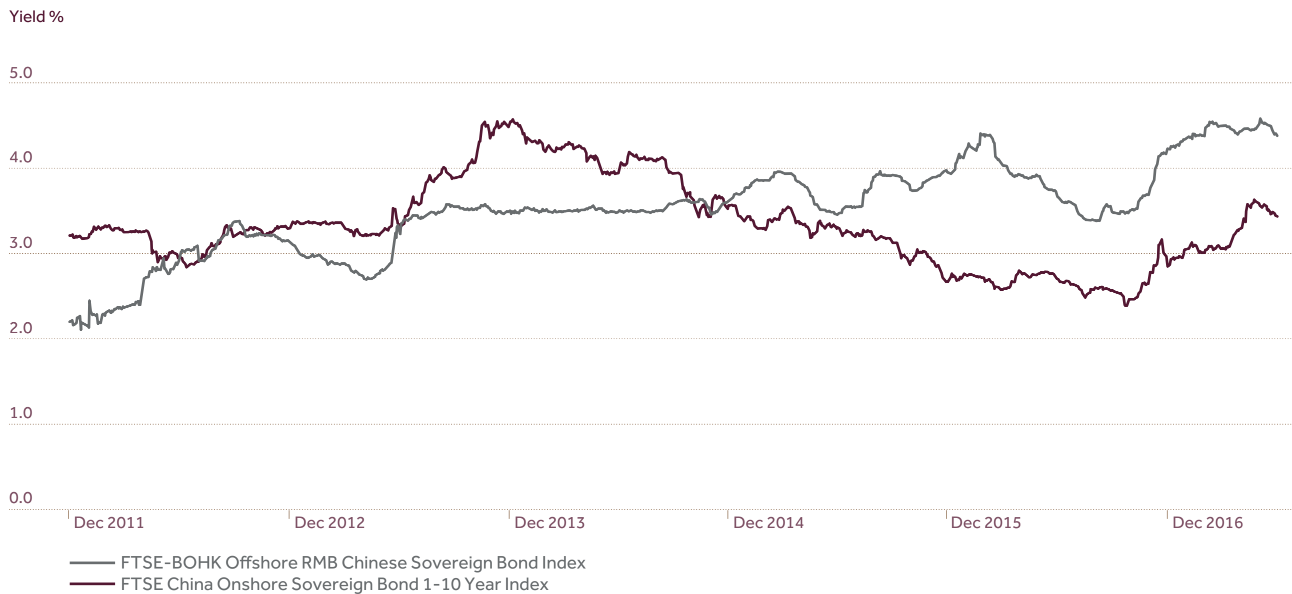
The FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index finished up 0.07 percent during the last quarter (April - June), with the FTSE China Onshore Sovereign Bond 1 - 10 Year Index down 0.62 percent; and the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index up 0.57 percent as shown in the following table.

Performance and Volatility – Total Return (CNY)

Index	Return %						Volatility %*		
	3M	6M	YTD	12M	3YR	Since Inception	1YR	3YR	Since Inception
FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index	0.07	-0.25	-0.25	-0.21	13.58	19.59	1.60	1.53	1.55
FTSE China Onshore Sovereign Bond 1 - 10 Year Index	-0.62	-0.74	-0.74	0.11	13.02	18.37	1.70	1.59	1.63
FTSE China Onshore Policy Bank Bond 1 - 10 Year Index	0.57	0.11	0.11	-0.44	14.22	21.03	1.69	1.66	1.69

Source: FTSE Russell. *Volatility - 1YR, 3YR, Since Inception based on daily data, total return data in CNY, as at 30 June 2017. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document. The general position is that data charts should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another

Yield comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds



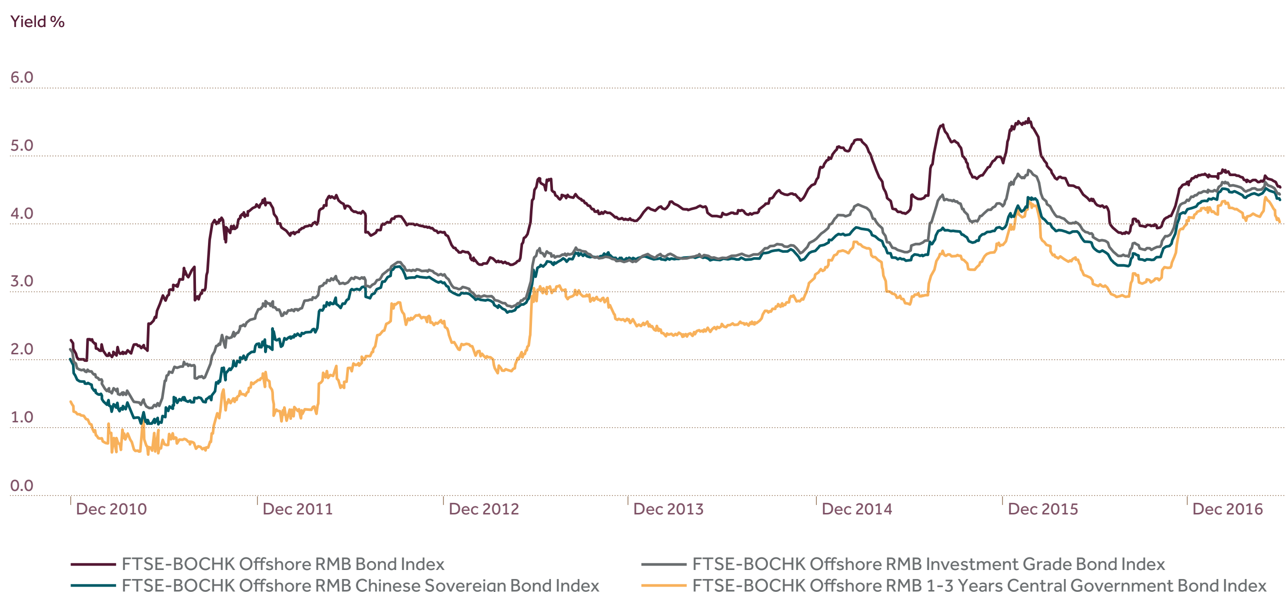
Source: FTSE Russell, data as at 30 June 2017. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document.

II. Offshore Report

Redemption Yield

The market value duration weighted average redemption yield of the FTSE-BOCHK Offshore RMB Bond Index in June was at 4.54 percent. Among the three sub-indexes the FTSE-BOCHK Offshore RMB Investment Grade Bond Index was at 4.44 percent; the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index was at 4.36 percent; the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index was at 4.04 percent.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 30 June 2017. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document.

After March, the yield for the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index dropped 0.11 percent to 4.36 percent by the end of June. The yield dropped 0.19 percent for the FTSE-BOCHK Offshore RMB Bond Index; dropped 0.13 percent for the FTSE-BOCHK Offshore RMB Investment Grade Bond Index; and dropped 0.20 percent for the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index.

Total Return

The FTSE-BOCHK Offshore RMB Bond Index finished up 1.59 percent during the last quarter (April - June), with the FTSE-BOCHK Offshore RMB Investment Grade Bond Index up 1.52 percent; the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index up 1.54 percent; and the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index up 1.40 percent as shown in the following table.

Performance and Volatility - Total Return (CNH)

Index	Return %						Volatility %*		
	3M	6M	YTD	12M	3YR	Since Inception	1YR	3YR	Since Inception
FTSE-BOCHK Offshore RMB Bond Index	1.59	2.21	2.21	2.64	11.16	22.13	0.78	0.98	1.12
FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index	1.54	1.43	1.43	0.80	7.55	13.34	1.15	1.08	1.19
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	1.52	1.79	1.79	1.70	8.55	16.78	0.87	0.88	0.90
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	1.40	1.98	1.98	1.77	6.91	11.92	0.87	0.84	1.28

Source: FTSE Russell. *Volatility - 1YR, 3YR, Since Inception based on daily data, total return data in CNH, as at 30 June 2017. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document. The general position is that data charts should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another.

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