Research

FTSE Russell

FTSE Russell China Bond Research Report

ftserussell.com

April 2017

FTSE Russell China Bond Research Report

Highlights

- The internationalisation of China's $8 trillion bond market continues at a steady pace on the back of tangible efforts to liberalise the onshore investment environment. Onshore government bonds will now be included in a selection of major regional indexes, such as Citigroup's Emerging Markets Government Bond Index (EMGBI), Asian Government Bond Index (AGBI) and Asia Pacific Government Bond Index (APGBI).[1]
- China's treasuries appear relatively steady and reliable, consistently yielding between 3.5 and 4 percent over the past 10 years. In comparison, treasuries from other emerging markets are much more volatile.[2]
- In March, China's premier Li Keqiang told the National People's Congress that protecting the country's sprawling financial system from excess leverage is a major priority, on par with economic growth. On that basis regulations around capital raising are increasing.[3]

1 Markets Insider. March 2017.
2 FTSE Russell. April 2017.
3 FT Alphaville. January 2017; Financial Times. March 2017.

Chapter 1: Overview

Bond market growth ambitions merge with China's newly announced deleveraging policy

While increasing political and economic uncertainty continues to shape the first half of 2017, China is still busy balancing a range of competing forces, as policymakers attempt to spur consumption growth and reform the financial system while preserving a high level of stability and control.

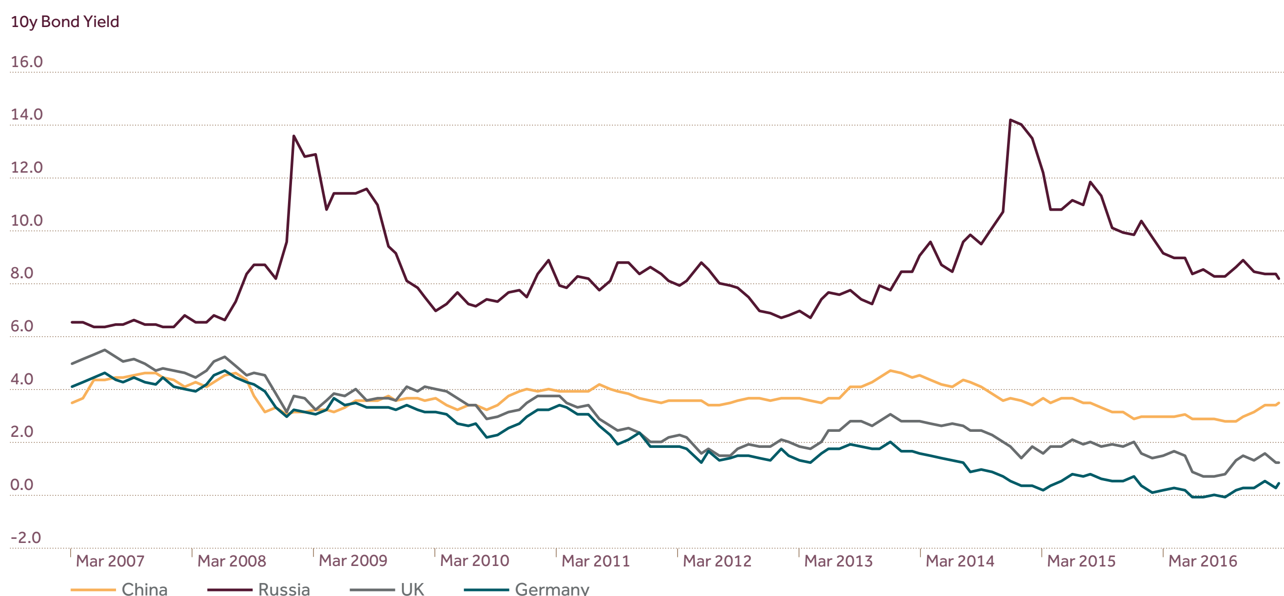
China's $8 trillion bond market continues to play a major role in the country's financial reform agenda. As Q1 gives way to Q2, China's policymakers are trying to rein in lending, especially to poor quality firms in industries suffering from overcapacity. At the same time, China is determined to move forward with market liberalisation, and aims to attract ever-larger volumes of international investment.

China's intent to pursue higher quality growth via tighter controls couldn't be clearer. In March at the National People's Congress meeting, premier Li Keqiang said deleveraging was now as important as growth.[4] On top of capital-raising controls for highly-leveraged firms, China is also drafting new regulations that may include banning third-party asset managers from investing some funds in other firms' products, aiming to further reduce leverage in the country's financial system.[5]

Even so, most of the new regulations are targeting inefficient state-owned enterprises and risky private companies – and are impacting the bond market accordingly. For their part, China's treasuries appear relatively steady and reliable, consistently yielding between 3.5 and 4 percent over the past 10 years.[6] In comparison, treasuries from other emerging markets have been much more volatile over this period.[7]

4 FT Alphaville. January 2017; Financial Times. March 2017.
5 Bloomberg. February 2017.
6 FTSE Russell. April 2017.
7 FTSE Russell. April 2017.

CNY 10-Year Yield vs. Russia, UK and Germany



Source: Thomson Reuters. March 2017.

The recent tightening measures have also caused yields on some corporate debt to soar, with the spread between five-year AAA rated company debt over government notes rising 77 basis points since September 30 – illustrating that some low quality issuers are struggling to find financing.[8]

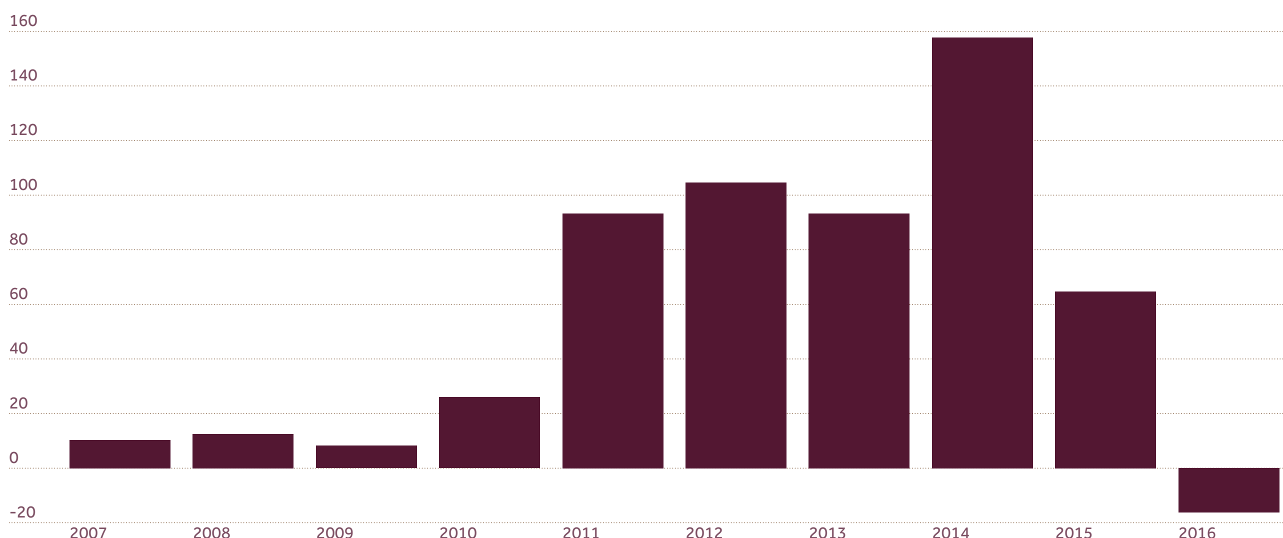
Despite the volatility, however, some analysts believe that short-term turbulence is required for China to ultimately develop a debt market where risk is priced according to international standards.

"The deleveraging policy is consistent with the objective of liberalising the onshore market," says Scott Harman, Managing Director, Fixed Income & Multi-Assets, FTSE Russell. "It seeks to diversify the lending away from the opaque shadow banking market towards an open and transparent bond market. This is exemplified by the swapping of local government funding debt into municipal bonds, which enhanced transparency and also replenished gaps in the existing yield curve, solving a maturity mismatch problem.[9]"

In this environment, the offshore – or 'dim sum' – China bond market continues to attract international market participants and multinationals, given that market's liquidity, its higher yields, and its integration with the global financial system. However, appetite for and issuance of dim sum bonds may be affected by the declining RMB and the opening of the far larger, and much more diverse, onshore market.

8 Bloomberg. February 2017.
9 FTSE Russell. April 2017.

Net Issuance of Dim Sum Bonds Negative in 2016



Source: Bloomberg. March 2017.

Chapter 2: No Stopping the Liberalisation Train

While China's deleveraging policy attracted the big headlines in Q1, smaller developments have moved the market forward behind the scenes. Next year, China's onshore government bonds are set to join a number of international indices – a first step toward integrating the market into the global financial system, with further inclusions in other indices likely to follow.

Citigroup said in early March that it would include China's onshore bonds in three of its government bond indexes from March 2018 – EM Government Bond Index (EMGBI), Asian Government Bond Index (AGBI) and Asia Pacific Government Bond Index (APGBI).[10] The move by Citi may potentially drive more international appetite for Chinese bonds, while their inclusion in global indexes may pressure China to ensure international norms and standards exert a greater influence on the onshore market's evolution.[11]

"China local currency assets are almost entirely absent from mainstream global fixed income indexes; remarkably this also includes flagship emerging market fixed income indexes," says FTSE Russell's Harman. "The omission may appear curious to some market participants when they consider the fact that onshore Chinese treasury bonds carry an investment grade credit rating from international rating agencies and that the Chinese local currency bond market is the third largest in the world, behind the USA and Japan, respectively. But now, with the quota system abolished, inclusion in a range of global indexes is only a matter of time."

10 Markets Insider. March 2017.
11 FTSE Russell. April 2017.

China's capital markets are becoming more intertwined with the global financial system in other ways, too – with some investment banks beginning to underwrite Chinese debt issuances. On that basis, JPMorgan Chase recently won approval to underwrite domestic corporate debt, including commercial paper and medium-term notes from non-financial companies.[12]

Meanwhile, new investment schemes such as the 'Bond Connect' – which will not require foreign investors to open accounts onshore, and will allow them to trade onshore debt via Hong Kong domiciled accounts – will help to further spur the market toward an open and transparent structure. International ratings agencies are also increasingly leaving their mark on China, easing some of the governance fears of international market participants, who still only hold roughly two percent of China's onshore debt.

"The watershed moment for onshore corporates will arrive when the coverage of credit ratings by international agencies is increased significantly," says FTSE Russell's Harman. "At present approximately 10 percent of the onshore corporate sector is rated by at least one of the big three international agencies. Foreign investors are not familiar with the onshore Chinese rating agencies, whose rating scales are considerably different than the international models, and as a result the spreads to treasuries of AAA onshore corporates deviate significantly."

In the meantime, the renminbi (RMB) continues to march toward greater internationalisation following its recent inclusion in the IMF SDR basket, and despite its gradual weakening trend against the US dollar on the back of China's slowdown in GDP growth to levels below 7 percent. Twenty years ago, the RMB accounted for barely a sliver of global over the counter (OTC) foreign exchange turnover. In 2013, the currency reached 2.2 percent, and just three years later nearly doubled that share to 4 percent – ending 2016 in eighth place overall, as illustrated by the table below. By 2020, the RMB could viably overtake AUD, CAD and CHF, according to more bullish estimates.[13]

Currency Distribution of OTC Foreign Exchange Turnover – Top 10

Year	2001		2004		2007		2010		2013		2016	
FX	Share	Rank	Share	Rank	Share	Rank	Share	Rank	Share	Rank	Share	Rank
USD	89.9	1	88	1	85.6	1	84.9	1	87	1	87.6	1
EUR	37.9	2	37.4	2	37	2	39	2	33.4	2	31.4	2
JPY	23.5	3	20.8	3	17.2	3	19	3	23	3	21.6	3
GBP	13	4	16.5	4	14.9	4	12.9	4	11.8	4	12.8	4
AUD	4.3	7	6	6	6.6	6	7.6	5	8.6	5	6.9	5
CAD	4.5	6	4.2	7	4.3	7	5.3	7	4.6	7	5.1	6
CHF	6	5	6	5	6.8	5	6.3	6	5.2	6	4.8	7
CNY	0.0	35	0.1	29	0.5	20	0.9	17	2.2	9	4.0	8
SEK	2.5	8	2.2	8	2.7	9	2.2	9	1.8	11	2.2	9
NZD	0.6	16	1.1	13	1.9	11	1.6	10	2	10	2.1	10

Note: Net by Net basis, percentage share of average daily turnover, April Month end.
Source: Bank for International Settlements, Triennial Central Bank Survey, Foreign Exchange Turnover, April 2016.

12 The Street. February 2017
13 FTSE Russell. April 2017.

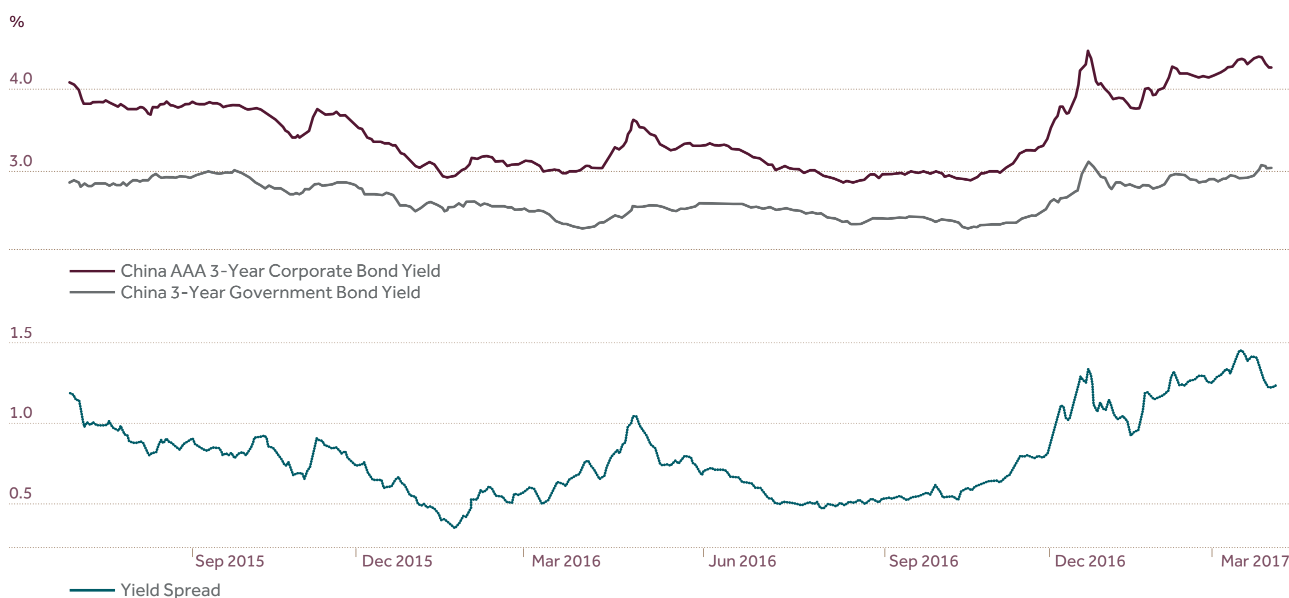
Chapter 3: More Defaults Lead to More Stability?

Despite the internationalisation trend, China still has a way to go if it wants to nurture a large international appetite for domestic bonds, especially in the riskier corporate market. Recent incidences of forged seals, fake letters and other scandals[14] isn't helping matters, from both an issuance and a demand perspective.

Corporate bond issues have slowed on the back of increasing default rates and volatility -- net issues were negative for a second month in a row in January. In turn, a rise in off-balance sheet lending to compensate for the lack of financing options may trigger more tightening measures, according to some banking analysts.[15]

According to 75 out of 100 analysts and traders surveyed by Bloomberg, 2017 may eclipse 2016 in terms of defaults. A total of 29 notes defaulted in 2016, up from seven in 2015.[16] As of April 3 this year, seven companies have defaulted on a total of nine onshore bonds.[17] Such developments may continue to drive yield premiums in the corporate sector, as illustrated in the chart below.

China Corporate Bond Premiums Climbing



Source: ChinaBond; Bloomberg. March 2017.

Even so, defaults in the onshore market tend to be concentrated in sectors where there is overcapacity, such as steel, coal, shipping, cement, renewables or non-core subsidiaries.[18] Letting such firms close can be construed as a sign that the economy is on its way to a more balanced and sustainable growth trajectory.

"Whilst there has been a number of defaults over the past two years in both the corporate and state-owned enterprise (SOE) sectors, the level of defaults isn't alarming and should be perceived as a necessary step along the liberalisation process," says FTSE-Russell's Harman. "It's a positive step that China is allowing defaults as it reflects a desire to allocate capital efficiently."

14 Bloomberg. January 2017.
15 Reuters. February 2017.
16 Bloomberg. January 2017.
17 Bloomberg. April 2017.
18 FTSE-Russell. April 2017.

At the same time, it is unlikely the impact of the defaults will be severe enough to pose a systemic risk, as the government aims to ensure market stability and attract more foreign capital.

"Recent developments signal that the tide is changing, with the Chinese authorities looking to allow unconstrained access for long-term foreign investors with the ultimate goal of achieving membership of global fixed income indices," says Harman. "The tangible efforts already made have caught the attention of index providers and the recent announcements signal that full inclusion is edging closer."

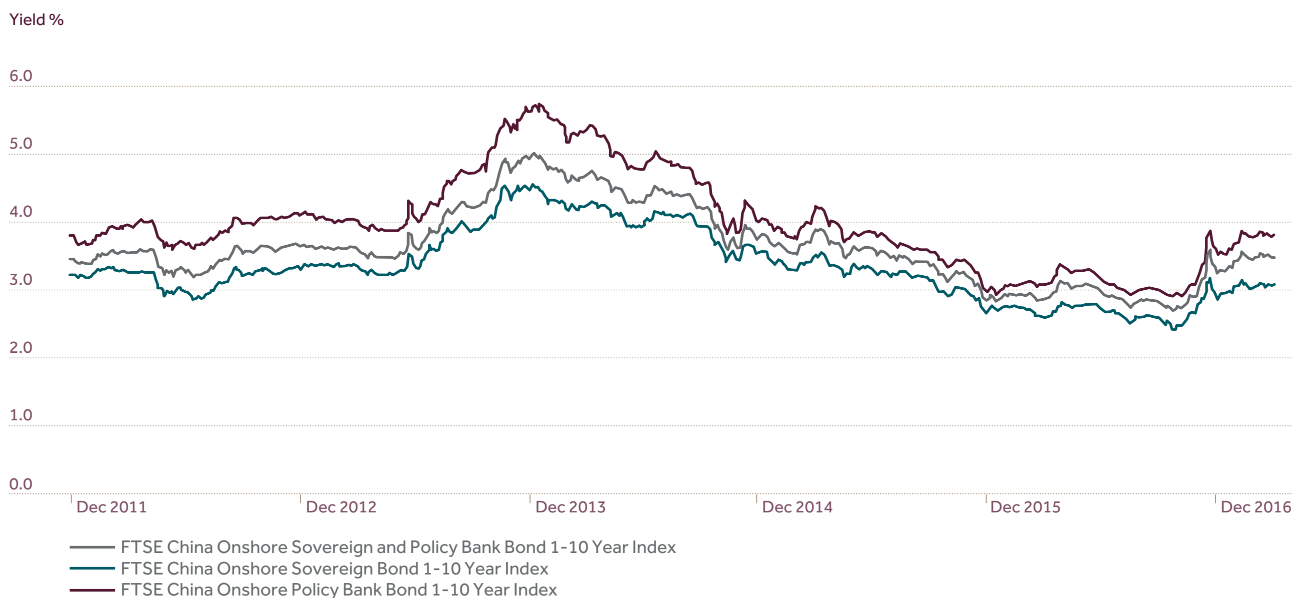
Chapter 4: Performance of FTSE Russell China Bond Indexes

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 March was at 3.48 percent. Among the two sub-indexes the FTSE China Onshore Sovereign Bond 1 - 10 Year Index was at 3.07 percent; the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index was at 3.80 percent.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 31 March 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 December, the yield for the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index rose 0.24 percent to 3.48 percent by the end of March. The yield rose 0.22 percent for the FTSE China Onshore Sovereign Bond 1 - 10 Year Index; and rose 0.24 percent for the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index.

Total Return

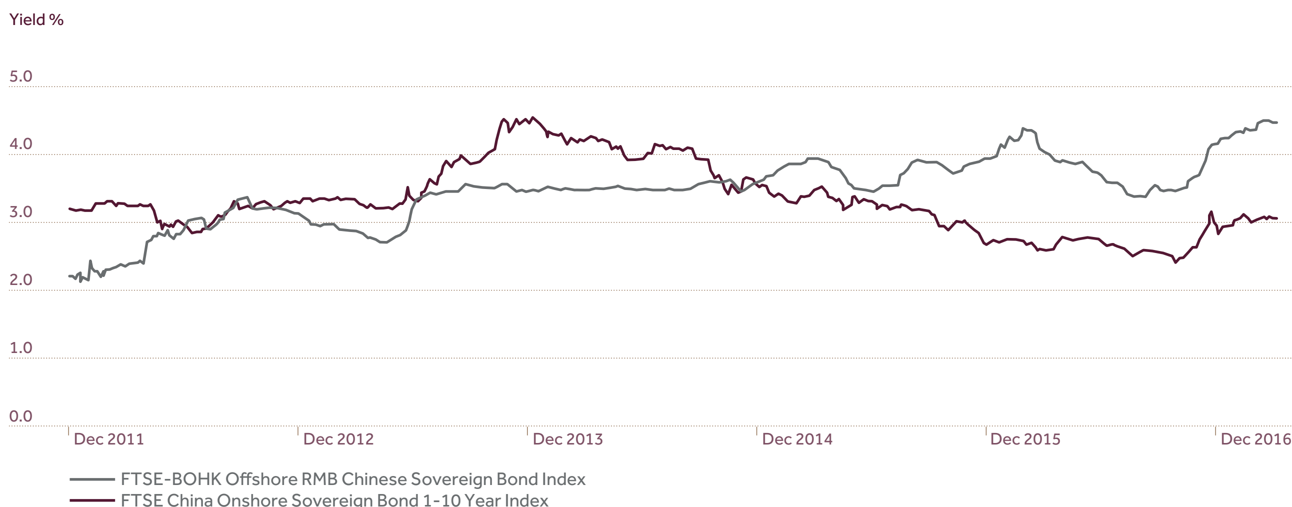
The FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index finished down 0.31 percent during the last quarter (January-March), with the FTSE China Onshore Sovereign Bond 1 - 10 Year Index down 0.12 percent; and the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index down 0.46 percent as shown in the table below.

Performance and Volatility of the Index – 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	-0.31	-1.64	-0.31	0.17	16.81	19.51	1.54	1.55	1.56
FTSE China Onshore Sovereign Bond 1 - 10 Year Index	-0.12	-0.57	-0.12	0.91	16.52	19.11	1.50	1.59	1.61
FTSE China Onshore Policy Bank Bond 1 - 10 Year Index	-0.46	-2.42	-0.46	-0.38	17.50	20.34	1.70	1.70	1.72

*Volatility - 1YR, 3YR, Since Inception based on daily data. Source: FTSE Russell - total return data in CNY, as at 31 March 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



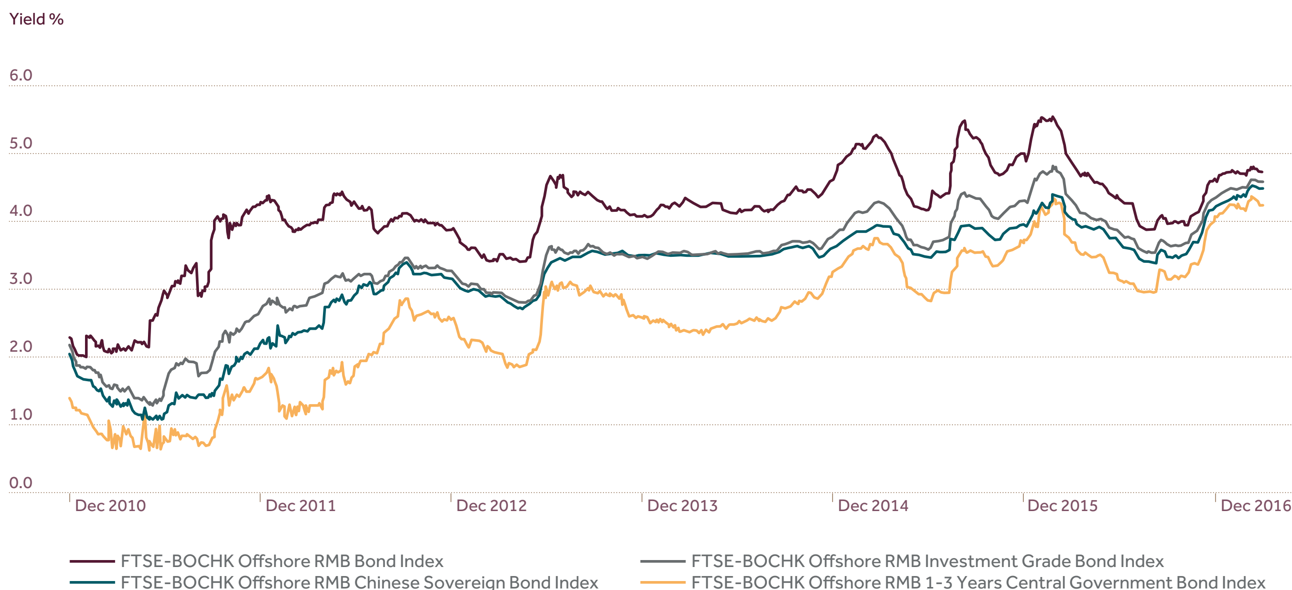
Source: FTSE Russell, data as at 31 March 2017. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document.

II. Offshore Report

Redemption Yield

The market value duration weighted average redemption yield of the FTSE-BOCHK Offshore RMB Bond Index in March was at 4.73 percent. Among the 3 sub-indexes the FTSE-BOCHK Offshore RMB Investment Grade Index was at 4.57 percent; the FTSE Chinese Sovereign Bond Index was at 4.48 percent; the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index was at 4.24 percent.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 31 March 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.

Since December 17, the yield for the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index rose 0.26 percent to 4.48 percent by the end of March. The yield rose 0.11 percent for the FTSE-BOCHK Offshore RMB Bond Index; rose 0.21 percent for the FTSE-BOCHK Offshore RMB Investment Grade Bond Index; and rose 0.18 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 0.61 percent during the last quarter (January - March), with the FTSE-BOCHK Offshore RMB Investment Grade Bond Index up 0.27 percent; the FTSE Chinese Sovereign bond Index down 0.11 percent; and the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index up 0.57 percent as shown in the following table.

Performance and Volatility of the Index - Total Return (CNH)

Index	Return %						Volatility %*		
	3M	6M	YTD	12M	3YR	Since Inception	1YR	3YR	Since Inception
FTSE-BOCHK Offshore RMB Bond Index	0.61	-0.47	0.61	3.55	10.94	20.21	0.81	0.97	1.14
FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index	-0.11	-2.07	-0.11	1.64	6.77	11.62	1.15	1.06	1.20
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	0.27	-1.10	0.27	2.67	7.97	15.04	0.88	0.87	0.91
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	0.57	-0.32	0.57	2.25	5.88	10.37	0.84	0.83	1.30

*Volatility - 1YR, 3YR, Since Inception based on daily data. Source: FTSE Russell - total return data in CNH, as at 31 March 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.

For more information about our indexes, please visit ftserussell.com.

© 2017 London Stock Exchange Group companies.

London Stock Exchange Group companies includes FTSE International Limited (“FTSE”), Frank Russell Company (“Russell”), MTS Next Limited (“MTS”), and FTSE TMX Global Debt Capital Markets Inc (“FTSE TMX”). All rights reserved.

“FTSE®”, “Russell®”, “MTS®”, “FTSE TMX®” and “FTSE Russell” and other service marks and trademarks related to the FTSE or Russell indexes are trade marks of the London Stock Exchange Group companies and are used by FTSE, MTS, FTSE TMX and Russell under licence. 中銀香港 BOCHK® is a trade mark of Bank of China (Hong Kong) Limited.

All rights in and to the FTSE-BOCHK Offshore RMB Bond Index Series vest in FTSE TMX, Bank of China (Hong Kong) Limited and/or its relevant partners.

All information is provided for information purposes only. Every effort is made to ensure that all information given in this publication is accurate, but no responsibility or liability can be accepted by the London Stock Exchange Group companies, TSX Inc, nor its licensors (including Bank of China (Hong Kong) Limited) for any errors or for any loss from use of this publication.

Neither the London Stock Exchange Group companies nor TSX Inc. nor any of their licensors (including Bank of China (Hong Kong) Limited) make any claim, prediction, warranty or representation whatsoever, expressly or impliedly, either as to the results to be obtained from the use of the FTSE-BOCHK Offshore RMB Bond Index Series or the fitness or suitability of the Index Series for any particular purpose to which it might be put.

The London Stock Exchange Group companies do not provide investment advice and nothing in this document should be taken as constituting financial or investment advice. The London Stock Exchange Group companies make no representation regarding the advisability of investing in any asset. A decision to invest in any such asset should not be made in reliance on any information herein. Indexes cannot be invested in directly. Inclusion of an asset in an index is not a recommendation to buy, sell or hold that asset. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

No part of this information may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission of the London Stock Exchange Group companies and BOCHK Asset Management Limited. Distribution of the London Stock Exchange Group companies' index values and the use of their indexes to create financial products require a licence with FTSE, FTSE TMX, MTS and/or Russell and/or its licensors.

The Industry Classification Benchmark (“ICB”) is owned by FTSE. FTSE does not accept any liability to any person for any loss or damage arising out of any error or omission in the ICB.

Past performance is no guarantee of future results. Charts and graphs are provided for illustrative purposes only. Index returns shown may not represent the results of the actual trading of investable assets. Certain returns shown may reflect back-tested performance. All performance presented prior to the index inception date is back-tested performance. Back-tested performance is not actual performance, but is hypothetical. The back-test calculations are based on the same methodology that was in effect when the index was officially launched. However, back- tested data may reflect the application of the index methodology with the benefit of hindsight, and the historic calculations of an index may change from month to month based on revisions to the underlying economic data used in the calculation of the index.

This publication may contain forward-looking statements. These are based upon a number of assumptions concerning future conditions that ultimately may prove to be inaccurate. Such forward-looking statements are subject to risks and uncertainties and may be affected by various factors that may cause actual results to differ materially from those in the forward-looking statements. Any forward-looking statements speak only as of the date they are made and neither London Stock Exchange Group companies nor their licensors assume any duty to and do not undertake to update forward-looking statements.

Bank of China (Hong Kong) Limited and FTSE launched the FTSE-BOCHK Offshore RMB Bond Index Series in October 2013.

About FTSE Russell

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. More than $10 trillion is currently benchmarked to FTSE Russell indexes. 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.

A core set of universal principles guides FTSE Russell index design and management: a transparent rules-based methodology is informed by independent committees of leading market participants. FTSE Russell is focused on index innovation and customer partnership applying the highest industry standards and embracing the IOSCO Principles. FTSE Russell is wholly owned by London Stock Exchange Group.

For more information, visit ftserussell.com

To learn more, visit www.ftserussell.com; email index@russell.com, info@ftse.com; or call your regional Client Service Team office:

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