China's Onshore Bond Market: Looking Beyond Bond Index Inclusions

Onshore Chinese government bonds and policy bank bonds will be included in the Bloomberg Barclays Global Aggregate Index on 1 April 2019. This marks an important milestone in the integration of Chinese debt markets into the global financial system. Looking beyond the bond index inclusion, we share our views on why international investors should consider allocating to the onshore Chinese bond market.

Executive Summary

- China's onshore bond market is set to become the second largest bond market globally.
- Despite its sheer size, onshore Chinese bonds are grossly under-represented in bond indices, with the first major index inclusion only in April this year. Potential bond index inclusion will spur significant passive inflows.
- Onshore Chinese bonds exhibit low or negative correlation to major bond and equity markets, boosting their appeal to international investors.
- With US$10 trillion of government debt in negative territory currently, we believe onshore Chinese government bond offer compelling yields.
- Foreign investors currently benefit from preferential tax status while modes of access have been simplified.
- CNY credit markets are becoming more efficient but the importance of credit research capabilities cannot be underestimated.
- China's broadly accommodative monetary policies will provide support for the Chinese bond markets.
- Stability in the CNY will be a key priority for Chinese policymakers, in turn providing an anchor to Chinese assets.

Too big to ignore

China's US$12.4 trillion[1] onshore bond market is the third largest bond market globally. It will soon surpass Japan to become the world's second largest, after the United States. Despite its sheer size, onshore Chinese bonds are grossly under-represented in bond indices, with the first major bond index inclusion scheduled for April this year.

In 2018, Bloomberg announced it will include onshore Chinese government bond and policy bank bonds into the Bloomberg Barclays Global Aggregate Index from 1 April 2019. The inclusion will be progressively done over a period of twenty months, and will last till November 2020. At the time of full inclusion, China's weight will exceed 5% of the index, and the Chinese yuan will become the fourth-largest index component after the US dollar, the euro, and the Japanese yen. This will lead to estimated inflows of US$90 billion to US$130 billion[2] during the phasing-in period.

Further bond index inclusions by the major index providers FTSE (which owns the widely followed FTSE World Government Bond Index) and JP Morgan (JP Morgan Government Bond Index-Emerging Markets) could be on the cards this year. This will likely spur passive foreign inflows of additional US$130 billion to US$180 billion[2], once the inclusions are approved.

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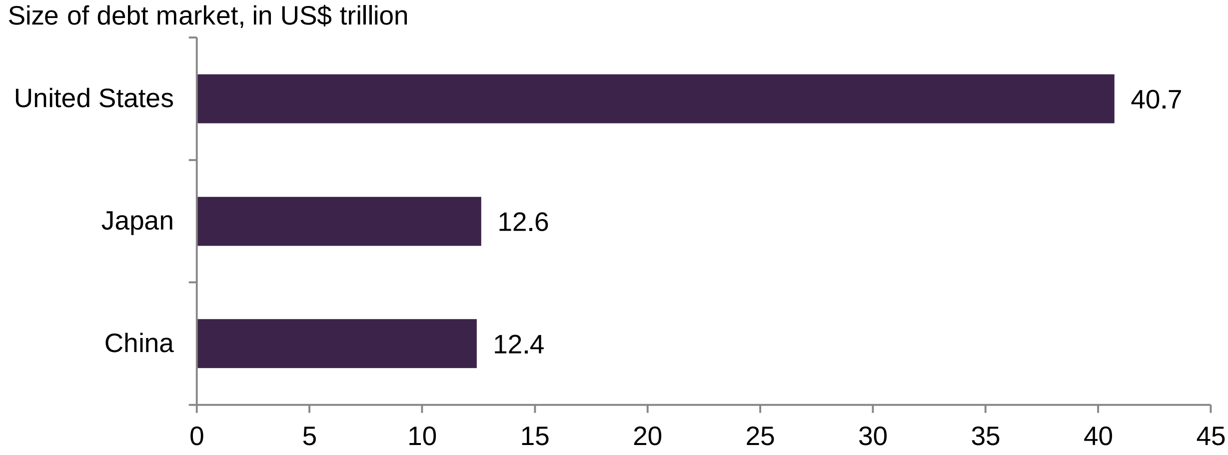
Chart 1: China to surpass Japan as the world's second largest bond market



Source: Bank of International Settlement, as of data available on 26 March 2019

Low correlation to major bond and equity indices

Unique to China, the onshore Chinese bond market is dominated by domestic investors, with foreign ownership at about 2%[3] currently. As a result, the onshore Chinese bond market exhibits very low, or even negative correlation, to major bond and equity markets, increasing its appeal to international investors looking to diversify from their core asset classes.

This was best exhibited last year when the Chinese stock market nosedived amidst reports of slowing economic growth – domestic investors flocked to the sovereign debt market, driving Chinese government bond yields lower. Chinese government bonds registered a return of more than 8%[4] (in CNY terms) in 2018, and were one of the few asset classes to generate a positive return last year.

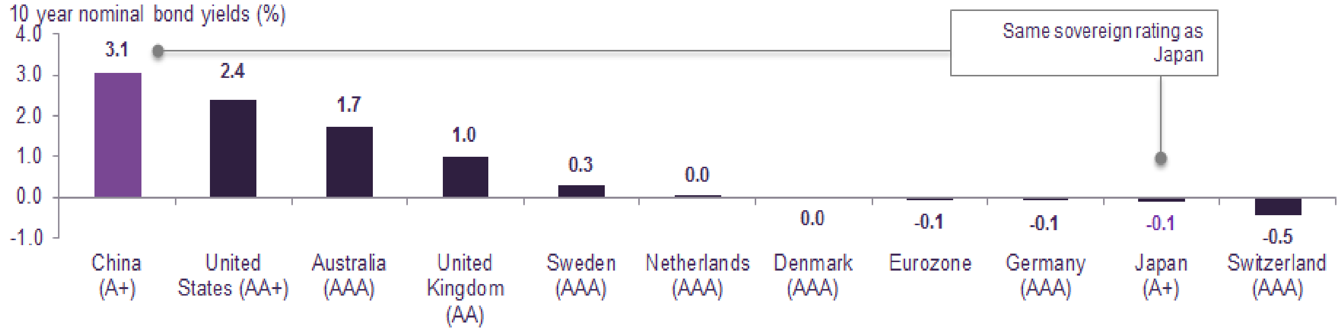
Unlike other Asian local currency bond markets such as Indonesia and Malaysia where foreign ownership is significant – often exceeding 30% – onshore Chinese bonds are less susceptible to external portfolio headwinds. With ownership of onshore Chinese bonds still dominated by domestic investors, correlation will continue to stay low; on the flipside, there is significant room for that figure to grow.

Onshore Chinese government yields are compelling at 3%[5]

10-year Chinese government bond yields are at around 3%[5] – compared with 2.4%[5] and -0.1%[5] on equivalent US and Japanese sovereign notes, they offer fair yield pick-up versus major developed markets, even after adjusting for inflation.

This is further amplified by the significant amount of government debt – currently estimated at US$10 trillion[6] – in negative territory according to Bloomberg data.

Chart 2: Onshore Chinese government bond nominal yields vs major developed markets



Source: Bloomberg, based on generic 10 year government bond yields, as of 28 March 2019

Chart 3: Onshore Chinese government bond real yields vs major developed markets

Source: Bloomberg, data available as of March 2019. Real yields take into account headline inflation data.

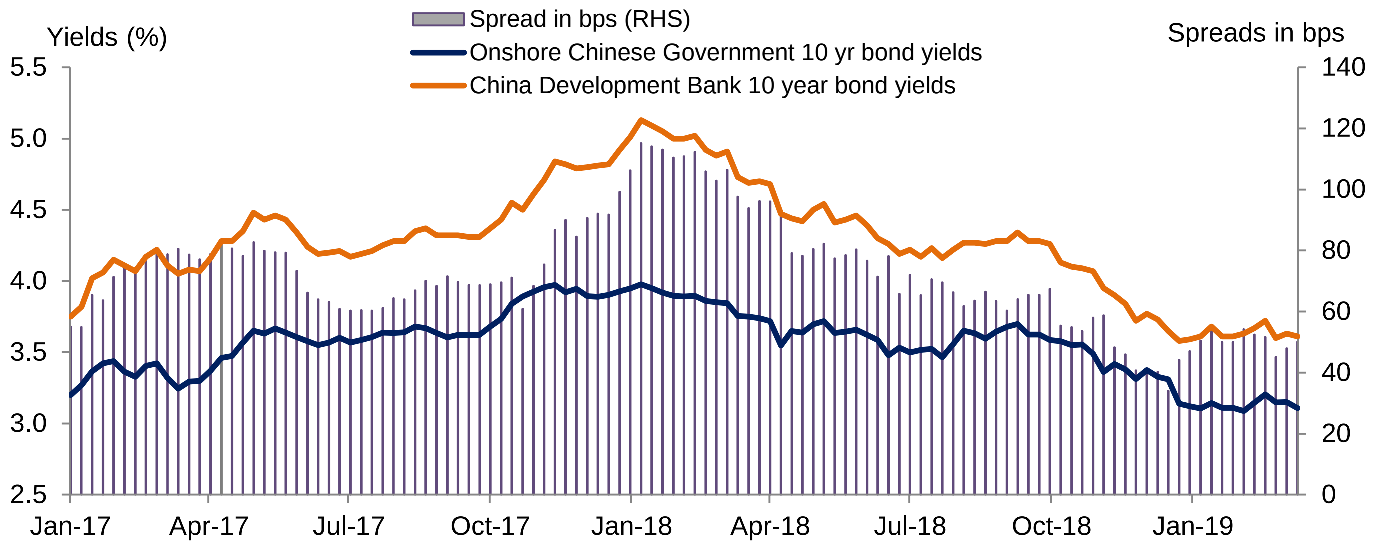
Foreign investors benefit from preferential tax status

In an effort to further internationalise the domestic capital markets, foreign investors investing in the onshore Chinese government bond market are currently exempted from withholding tax and value-added tax on capital gains as well as income. Tax exemptions also apply to investment in Chinese policy banks through to 2021, further boosting their appeal to international investors. Chinese policy banks such as China Development Bank, Agricultural Development Bank of China and the Export-Import Bank of China, enjoy the same Chinese sovereign rating but offer investors some potential yield pick-up over their Chinese government bond peers.

Table 1: Foreign investors enjoy preferential tax status currently

	Income Tax		VAT	
	Capital Gain	Interest	Capital Gain	Interest
China Government Bonds & Local Government Bonds	Exempt	Exempt	Exempt	Exempt
Policy Bank Bonds	Exempt	Exempt for 3 years *(as announced in August 2018, was previously 10%)*	Exempt	Exempt for 3 years *(as announced in August 2018, was previously 6%)*

Chart 4: Yield pick-up from investing in Chinese policy banks



Source: Bloomberg, as of 22 March 2019

Onshore bond market access made easy

With the development of various access schemes from China Interbank Bond Market (CIBM) Direct to Bond Connect, it is easier than ever before to access the onshore Chinese bond market. Investors who require access to CNY derivatives such as interest rate swaps and bond repo, should consider the CIBM Direct scheme where a wider range of onshore instruments are made available. Investors, particularly the likes of sovereign wealth funds or central banks who are less comfortable with the omnibus account structure of the Bond Connect scheme (where assets are commingled with that of other clients) may also prefer the CIBM Direct scheme.

That said, application for market access via Bond Connect is widely touted to be less cumbersome and timelier compared to the earlier schemes. More recently, the availability of Bond Connect via the Bloomberg trading platform will further enhance its appeal.

China's credit market is becoming more efficient but credit research remains key

Looking beyond the onshore Chinese government and policy bond markets, a significant portion of the onshore Chinese credit market is rated AAA by domestic rating agencies, with little credit differentiation between the higher quality issuers and those with less financing flexibility. This is in stark contrast to other markets such as the United States where credit differentiation across issuers is widely spread across the full credit spectrum. Investors are also more attuned to the underlying credit risk. As such, having significant credit research capabilities to separate the wheat from the chaff in the onshore Chinese credit market is key, and its importance cannot be underestimated.

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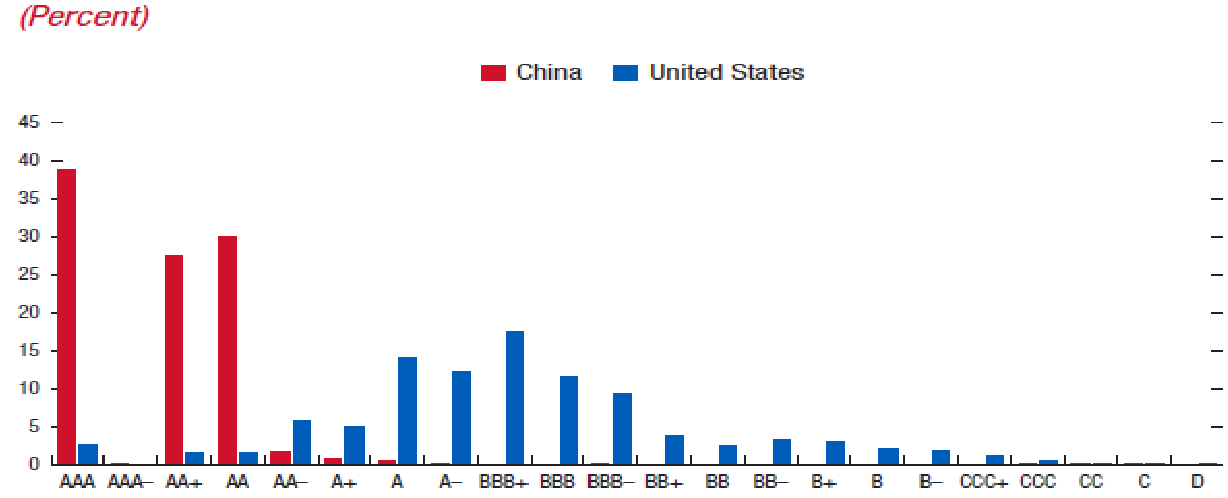
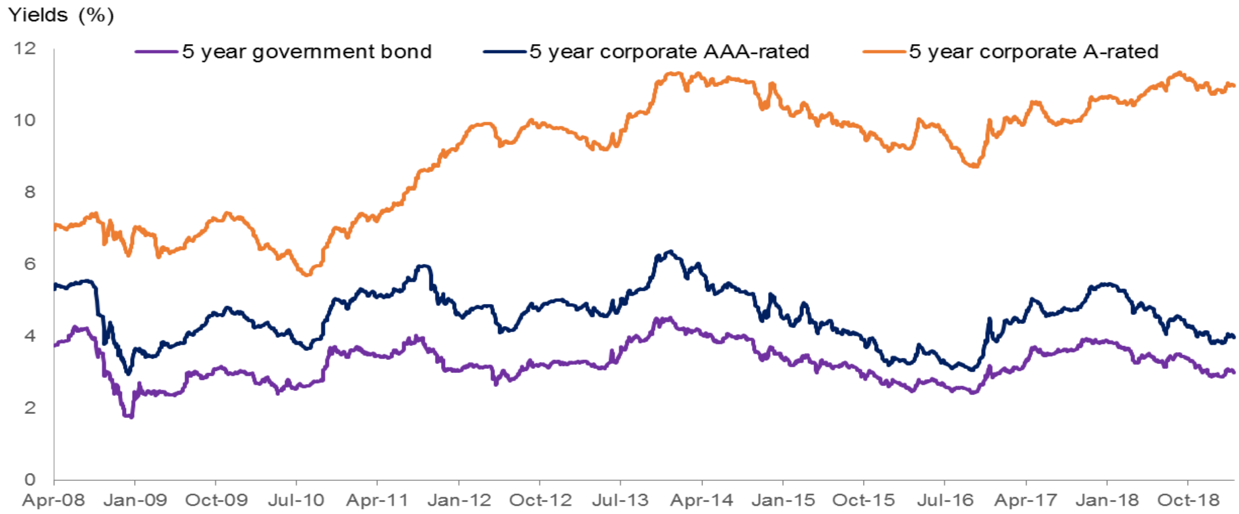
Chart 5: Credit bond ratings distribution: China and the United States



Source: Bloomberg L.P. 2017, from IMF: The Future of China's Bond Market, 2019

However, we are comforted that the onshore Chinese credit market is increasingly showing signs of efficiency, as demonstrated by the widening credit premium for many issuers. Additionally, Standard & Poor's Global became the first foreign credit rating agency to rate the country's domestic bonds in January this year, after receiving approval from the Chinese authorities. This was done in an effort to boost market efficiency and attract more foreign investment. Fitch Ratings is also in the process of seeking an onshore China rating license and Moody's is likely to follow in due course.

Chart 6: Signs of increasing credit differentiation



Source: Wind, as of 27 March 2019

Supportive macro policy backdrop

Broadly, we see the year in two halves, with macro growth and credit indicators bottoming out by the end of the first half. The second half of the year is poised for a moderate recovery, benefitting from China's domestic fiscal stimulus, supportive monetary policies by the major central banks and potentially constructive policy outcomes from the US-China trade negotiations.

Asian monetary policy is likely to be more supportive of growth this year as regional inflation remains under control. Recent US Federal Reserve comments have reinforced a dovish stance with a pause on rate hikes, followed in step by the European Central Bank's recent commitment to keeping interest rates lower for longer. This in turn opened the doors for Asian central banks, including China, to cut interest rates and lower borrowing costs, in a sharp reversal of last year's trend.

In China, measures ranging from larger-than-expected tax cuts, accelerated infrastructure spending to the possibilities of further reserve requirement ratio cuts from Beijing, in an effort to combat a slowdown in growth, would also underpin investors' sentiments towards Chinese assets. Interest rate cuts and lower repo rates are also possibilities and will provide support to the onshore Chinese bond markets. Stability in the CNY on a trade-weighted basis is likely to remain a key priority for Chinese policymakers and this should in turn provide an anchor to wider asset markets both in China fixed income and the rest of Asia.

Proven Expertise in China Fixed Income

Fullerton Fund Management ("Fullerton") has built an on-the-ground presence in China since opening our first foreign representative office in China in 2007.

Fullerton's award-winning[7] Asian Fixed Income team has been managing China bonds for over a decade. In 2008, Fullerton became one of the first foreign institutional investors to invest in the onshore Chinese bond market. Subsequently in 2012, we launched a dedicated offshore RMB Bond Fund, shortly after the market opened up in July that year. The launch of a dedicated onshore RMB Bond Fund quickly followed suit in the following year. Significantly, Fullerton Investment Management (Shanghai) was the first Asian fund house to receive its Private Fund Management (PFM) approval from the Asset Management Association of China in 2017. With the PFM approval, Fullerton is now able to offer onshore investment products to institutional and high net worth investors in China.

In our view, the continued opening up of China offers unprecedented investment opportunities for international investors seeking to participate in the country's growth, through its fast growing bond markets.

[1] Source: Bank of International Settlement, as of data available on 26 March 2019
[2] Source: IMF: The Future of China's Bond Market, 2019
[3] Source: Bloomberg, http://www.pbc.gov.cn/diaochatongjisi/resource/cms/2018/10/2018101816421369745.htm
[4] based on the iBoxx ALBI China Onshore Bond Index, in CNY
[5] Source: Bloomberg, as of 28 March 2019.
[6] Source: Bloomberg, based on the Bloomberg Barclays Global Aggregate Negative-Yielding Debt Index as of 27 March 2019
[7] Fullerton's investment expertise in onshore and offshore bonds is equally well-regarded, and has been recognised with numerous industry accolades, including Best Singapore Group – Bonds Chinese Yuan category of the Citywire Asia Awards 2018. Please refer to our website for the full list of awards. Past performance of the Manager is not indicative of future performance.

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