

# Participating in China's bond market

Navigating an evolving landscape





The Chinese government began dismantling the barriers to foreign investment in its bond market in 2016 and has since launched China Interbank Bond Market Direct (CIBM) in 2016 and Bond Connect 2017, which offer more flexible market access.



These schemes, along with the inclusion of Chinese bonds within major global bond indices, have attracted growing investor interest, yet foreign ownership of Chinese debt still represents a little over 2 percent of the \$13 trillion total market value, which is very low compared to foreign investor holding of developed market debt.<sup>1</sup>



Given that Chinese bonds offer higher yields compared with most regional aggregate bonds and have historically shown low correlation with global bonds, there is a clear case for foreign investors to consider increased allocation.



As China's bond market and regulatory landscape continues to evolve at pace, foreign investors must be equipped for the challenges ahead if they are to maximize the benefits of participation.

<sup>1</sup> China's \$13 trillion bond market marks a milestone. Here's what it means, CNBC, April 2019

## Opening up of China's bond markets paves way for index inclusions

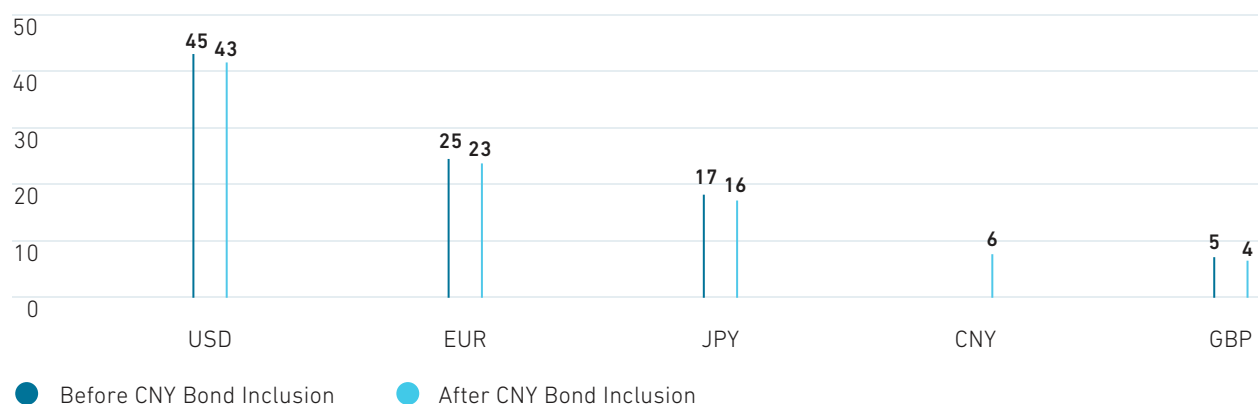
**The Chinese government has taken considerable steps to open up its bond markets to overseas investment in recent years. In 2016, the launch of the China Interbank Bond Market (CIBM) Direct scheme enabled foreign investors to trade onshore bonds directly through banks that held a Type A license in Mainland China.**

The government followed this up in July 2017 by introducing the Bond Connect scheme, which allows foreign institutional investors to lever Hong Kong's market infrastructure to trade Chinese sovereign and local government bonds, policy bank bonds, Negotiable Certificates of Deposit (NCD's) and corporate debt.

These moves eased the path to foreign investment in Chinese debt, relaxing longstanding quota restrictions and has subsequently spurred two prominent global bond indices to set about incorporating onshore CNY bonds.

In April 2019, the Bloomberg Barclays Global Aggregate Index became the first major market benchmark to incorporate onshore CNY bonds<sup>2</sup>. Chinese government and policy bank bonds will be added to the index over a 20-month period, and are expected to become the fourth-largest constituent of the index, eventually accounting for around 6 percent of the index weight (see Figure 1). Over the longer term, China could account for an even greater proportion of the index given its higher than expected growth relative to developed markets.

**Figure 1. Estimated impact of Chinese bond inclusion in Bloomberg Barclays Global Aggregate Index**



State Street Global Advisors, Point, based on the index currency allocation as of December 31, 2018, Projections are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

<sup>2</sup> Explainer: Why China's inclusion in global bond benchmarks matters, Reuters, March 2019

JP Morgan has also announced its plan to include Chinese government bonds in its series of Government Bond Index-Emerging Markets (GBI-EM) indices as of February 2020. The bank will also take a phased approach, over a 10-month period.<sup>3</sup>

Propelled by these index inclusions, the People's Bank of China (PBoC) estimates that 15 percent of the country's onshore bond markets could become foreign-owned. This compares to around 30 percent in the US, 10 percent in Japan, 40 percent in Indonesia and 31 percent in the Philippines.<sup>4</sup>

### **The growing attraction of Chinese bond markets**

The relaxation of some market restrictions and the inclusion of Chinese bonds within major market indices have already helped to drive more foreign investment. Data from the China Central Depository and Clearing Co. Ltd. showed that allocations by overseas institutional investors to all Chinese bonds reached a record US\$282 billion in July 2019, up 25 percent from the year before.<sup>5</sup>

Other factors are creating a more compelling case for increased allocation too. Chinese bond yields remain high compared with most developed markets. For instance, the China 10-year Bond Yield was around 3.2 percent in January 2020, compared to around 1.6 percent for the US-10 year Bond Yield.<sup>6</sup> The comparison is even more favorable

with low-yielding Australian Bonds and negative yielding German and Japanese bonds.

The Chinese government is working hard to improve the market infrastructure and the governance of domestic companies too.

In 2018, regulators suspended Dagong, one of China's three largest bond rating agencies, after identifying flagrant conflicts of interests and lax corporate governance.<sup>7</sup> This highlights the regulator's hardline approach towards poor corporate governance and will increase investor confidence about the integrity of China's local ratings system.

In 2019, US-based S&P Global became the first foreign credit assessor to receive PBoC approval to operate. Although S&P's ratings are currently based on a China market-specific scale, that differs from the company's global rubric for international debt issuers, the introduction of an international rating firm indicates that convergence between local and global rating standards will likely speed up.

Recent reforms of China's State-owned Enterprises (SOEs), including mixed ownership reforms and corporate governance-related reforms are expected to help contain further increased leverage of these firms, indicating regulators' commitment to developing a healthy bond market.<sup>8</sup> And while China's onshore bond defaults exceeded \$17 billion in 2019, this amounts to less than half a percent of its \$4.4 trillion onshore corporate bond market.<sup>9</sup>

<sup>3</sup> JPMorgan Says China to Be Included in Benchmark Bond Indexes, Bloomberg, September 2019

<sup>4</sup> China insight: China's bond market is too-big-to-ignore, Bloomberg Economics, April 2019

<sup>5</sup> Chinese bonds seen as haven in a down economy, Pensions & Investments, September 2019

<sup>6</sup> China Government Bond 10Y, Trading Economics, January 6, 2020

<sup>7</sup> China's Dagong rating agency taken over by state-owned investor, FT, April 2019

<sup>8</sup> State-owned firms behind China's corporate debt, OECD Economics Department Working Papers No. 1536, February 2019

<sup>9</sup> China's \$17 Billion Default Wave Is About to Break a Record, Bloomberg, December 2019

## Access channel trends

Bond Connect gathers momentum



Monthly volume data shows Bond Connect overtook the CIBM Direct channel in August 2019 with **56%** of total CIBM trading.



By December 2019, the number of accounts opened in CIBM Direct and Bond Connect reached **988** and **1601** respectively, representing a year to date increase of **25%** and **218%**.



China Foreign Exchange Trade System (CFETS) reported that throughout 2019 trading volume for overseas investors increased **66%** on the previous year.



CIBM direct turnover reached **RMB2.68 trillion** vs Bond connect which was **RMB2.63 trillion**. Trading volumes via Bond Connect went from **884 billion** in 2018 to **2.63 trillion** in 2019, representing an increase of **198%**.

Source: Bond Connect Company Limited (BCCL) and China Foreign Exchange Trading System (CFETS)

## Ongoing challenges to market participation

China's bond markets may be becoming more open to foreign investors, but access does not come without its challenges.

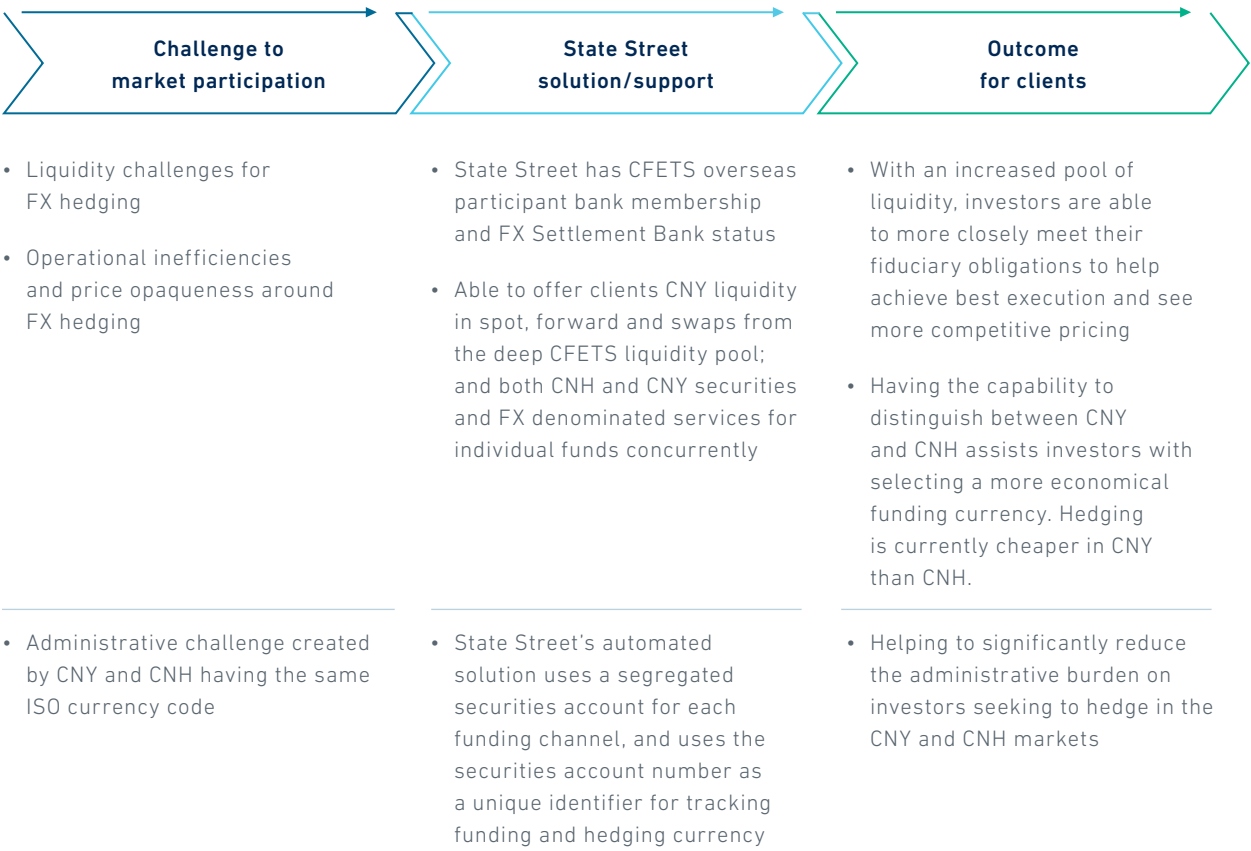
One of the key pain points impeding investors' participation is foreign exchange. The mechanics of hedging Chinese currency

exposures are different to developed market currencies. While CNY (domestic currency) and CNH (currency for offshore use) are acceptable as funding currencies for investing in Chinese bonds, different FX spot rates, as well as operational flow and regulatory monitoring requirements, means it is necessary to distinguish between the two.

Historically, positions have been hedged in the CNY market using non-deliverable forward contracts (NDFs). More recently, we have seen investors start to hedge using the CNH market rather than the CNY market. CNH is a fully deliverable currency and the mechanics of hedging are the same as for traditional developed market currencies. The problem is that both CNY and CNH have the same International Organization for Standards (ISO) currency code, creating an administrative challenge for investors.

Another persistent challenge is fixed income market liquidity and transparency. Despite substantial improvements on this front, the onshore China bond market still lags behind developed market peers. The liquidity gap between newly-issued bonds and older bonds remains an issue that is impacting more active participation.

**Figure 2. How State Street is helping clients to navigate market challenges**



### **The road ahead for China's bond markets**

Beijing is committed to widening foreign investor access to China's capital markets and has announced the roll-out of additional reforms to the Bond Connect scheme.

Although the timeline for increased allocations on Southbound trading (i.e. permitting onshore Chinese investors to purchase debt offshore) remains unclear, regulators are expanding Northbound trading options to include more market makers and allow bond index products to participate.

As the regulatory landscape continues to evolve in China, international investors will be further enabled by the increasing number of portfolio diversification opportunities.

They will need to proceed gradually, however, as the operational challenges of connecting onshore trading activities with global back and middle office records remain. Investment considerations and compliance requirements may evolve too. As China integrates more with global capital markets, the correlations between Chinese bonds and global bonds may begin to increase over time.



15%

**of China's onshore bond market  
could become foreign-owned**



US\$282 bn

**of allocation to Chinese Bonds by  
overseas institutional investors**



66%

**year on year increase in trading  
volumes for overseas investors**

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