China’s Bond Market

‘What and Why and When…’

October 2018
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Our Thinking:
Thought Leadership
Our thought leadership papers deliver thought-provoking analysis of key investment themes. Through focused and unique insights into topical issues, we aim to provide investors with a deeper understanding of the challenges and opportunities within global investment markets.
Which country has the third-largest bond market in the world after the US and Japan? Few people would guess it is China. For many years this US$12 trillion market was largely off-limits to foreign investors, which meant local-currency Chinese bonds were practically ignored by the major bond indices.

This may soon change, as international benchmarks contemplate adding these securities to the ones they already track, following efforts to make the bond market more investable. This, potentially, is a watershed moment for Chinese bonds. So what do investors need to know?

For investors new to the market, we employ Rudyard Kipling’s six honest serving men ‘(they taught me all I knew); their names are What and Why and When, and How and Where and Who’.

For investors looking for a deeper understanding, we analyse China’s debt burden, decipher domestic credit ratings and explain the pros and cons of the rise in defaults.
Executive summary

For many years China’s US$12 trillion bond market was largely off-limits to foreign investors. This could soon change as international benchmarks contemplate adding these securities to the ones they already track, following efforts to make the market more investable. Once this happens the market will become too important to ignore. For investors willing to do their homework, Chinese bonds can potentially offer attractive returns and a way to diversify portfolio risk. However, these opportunities come with risks which need to be thoroughly understood.

The key onshore markets are the China Interbank Bond Market (CIBM) and the Exchange Market. Some 90 per cent of all domestic bonds are traded on the CIBM. Domestic financial institutions dominate bond ownership, with commercial banks owning around two-thirds of outstanding Chinese government bonds. However, home grown asset managers are becoming increasingly involved. Foreign investors are underrepresented with just over 2 per cent of the market.

The Bloomberg Barclays Global Aggregate Bond Index is expected to include onshore Chinese bonds from April 2019. If everything goes smoothly, the FTSE World Government Bond Index, as well as JPMorgan’s Government Bond Index-Emerging Markets Global Diversified, a local currency benchmark, will likely follow suit. This could attract some US$250 billion - US$350 billion in passive funds.2 Years of isolation and a heavily-managed currency mean onshore bonds exhibit low correlation with other bond markets. They also offer an attractive yield pickup to comparative paper issued in developed markets.

Although foreign investors don’t have the same market access as their local counterparts, it has never been easier to trade onshore Chinese bonds. Recent initiatives – direct access to CIBM and Bond Connect – have slashed red tape and reduced restrictions for overseas investors. That said, this is a market that needs to be approached with caution. Potential risks include illiquidity, inadequate hedging options and an immature legal process for handling default and recovery.

New investors may be surprised by what they find. Domestic credit rating agencies rarely award anything other than the top two ratings. This bond market had never experienced a default until 2014. Implicit government guarantees can still exert an influence on bond pricing.

The opening up of the world’s third-largest bond market after the US and Japan should be a cause for celebration. A fully functioning market will help China’s companies reduce their excessive reliance on bank loans and help fuel the next stage of the country’s growth. Foreign investors can play an important role in this process.

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1BIS, 31 Dec 17
2Aberdeen Standard Investments estimate, 31 Aug 18
“For investors willing to do their homework, Chinese bonds can potentially offer attractive returns and a way to diversify portfolio risk. However, these opportunities come with risks which need to be thoroughly understood”
Part I

What is this market?

Different markets

China needs to develop viable capital markets that provide a safe place to park long-term investments as its population ages and funding pensions becomes a national priority. Renminbi-denominated onshore bonds are important and becoming more so.

Policymakers also want to create an alternative source of funding for borrowers, relieving the burden on bank loans and avoiding an unhealthy concentration of risk within the banking sector. That’s why China’s nascent bond market – the Communist government issued its first bond in 1981 – has been forced to grow up fast.

There are two key markets: the China Interbank Bond Market (CIBM) and the Exchange Market. Some 90 per cent of all domestic bonds are traded on the CIBM, which boasts the highest trading volumes. Bonds traded here include central government bonds, central bank bonds, policy bank bonds, financial bonds, enterprise bonds issued by state-linked firms, local government bonds, medium-term notes and commercial paper.

The Exchange Market refers to bonds traded on stock exchanges, which account for the lion’s share of the balance of bonds in the domestic market. These include government bonds, enterprise bonds, medium-term notes and corporate bonds. The rapid growth in issuance of corporate bonds in recent years has helped boost transaction volumes on exchanges.

Local investor base

Local investors dominate this market and China’s banks are the biggest holders of domestic bonds. For example, nearly 67 per cent of outstanding Chinese government bonds and some 63 per cent of paper issued by the country’s policy banks, were owned by the commercial banks, according to data compiled by Wind, a Chinese financial information provider. Policy banks are government-controlled lenders that finance government-directed investments.

So if a key reason for developing a domestic bond market is to spread risk away from the banking sector and to place it in the hands of other investors, a lot more needs to be done before this goal is achieved.

Asset managers are becoming increasingly involved in the market and investment funds are the largest holders of corporate bonds. The anticipated growth of pension funds holds great potential for fund managers. Demand for domestic bonds will grow, along with a broadening of the investor base, as the financial industry develops more products for savers.

Few foreign investors

Foreign investors – mostly central banks – account for just over 2 per cent of the domestic market, with investments focused around the same government and policy bank bonds favoured by China’s commercial banks.

This underrepresentation is a legacy of past policies that imposed complicated registration requirements on foreign investors, capped the size of their investments via quotas and restricted their ability to repatriate profits.

That’s why most foreign investors stayed away, while the providers of major international indices – including the JPMorgan Government Bond Index–Emerging Markets Global Diversified, the FTSE World Government Bond and the Bloomberg Barclays Global Aggregate Bond – excluded this market because of capital controls that engendered concerns around the repatriation of profits.

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3Wind, 8 Dec 17
Chart 2: Who are the investors?

**China Government Bond investors**

- Commercial bank: 66.8%
- Clearing house: 1.5%
- Asset management companies: 4.6%
- Overseas agencies: 4.7%
- Stock exchange: 4.7%
- Insurance companies: 2.4%
- Others*: 1.6%
- Source: Wind, 8 Dec 17

* Others include Trust cooperatives: 0.7%, Securities firms: 0.6%, Non-bank financial institutions: 0.3%

**Policy bank bond investors**

- Commercial bank: 62.9%
- Asset management companies: 24.9%
- Overseas agencies: 3.9%
- Stock exchange: 4.4%
- Insurance companies: 4.4%
- Trust Co-operative: 1.6%
- Others*: 2.4%
- Source: Wind, 8 Dec 17

* Others include Securities firms: 0.7%, Clearing houses: 0.5%, Non-bank financial institutions: 0.3%, Retail investors: 0.1%, Non-financial institutions: 0.1%

Chart 3: Low but rising foreign ownership of Chinese bonds

- Jul 2015: PBOC allows foreign official institutions to directly access the CIBM
- Feb 2016: Other "mid-term or long-term institutional investors recognised by PBOC" are allowed to access the CIBM
- Jul 2017: Launch of the Bond Connect

Source: Barclays Research, 28 Feb 18
Digging deeper:
Why defaults are good

Defaults were unknown in China prior to 2014, encouraging lax lending standards. Defaults are now on the rise, bringing increasing discipline to the market and creating the need for fundamental credit analysis. However, default rates are still low and some ‘strategic’ borrowers continue to enjoy government guarantees.

There was a time, not so long ago, when bond defaults were unknown in China’s domestic market. That’s not a testament to the quality of borrowers, but a reflection of routine government bailouts and the rolling over of loans from government-controlled banks when default looked imminent.

The government intervened for several reasons. Most borrowers can claim some sort of government link, however tenuous that may be. Many borrowers are local governments. But even commercial businesses that offer no public benefit may be owned or operated by some branch of government.

Policymakers are sensitive to the need for social and financial stability. The legitimacy of China’s rulers is linked to delivering economic benefits that lead to tangible improvements in people’s lives. Finally, there was a desire not to scare investors away from a nascent bond market that is considered critical to the country’s long-term development.

Unfortunately, this safety net created moral hazards. When bonds couldn’t default, issuers secured funding, or cheaper funding, despite blatant credit concerns. This, in turn, encouraged investors to take excessive risks, distorted asset prices and made credit analysis redundant.

That is why in 2014, not long after President Xi Jinping was appointed to China’s top job, the authorities started letting distressed debt go under. A year later, the first state-owned enterprises defaulted. Since then, bond issuers have had to demonstrate some sort of ‘strategic’ value (political and/or economic) to qualify for a valuable government guarantee.

Elsewhere, there was a broader push to ensure investors learn to appreciate risk. Measures included prohibiting banks from bailing out products that failed to hit investment targets, while asset managers were forced to disclose risks associated with new products with greater transparency.

Bond defaults are on track to beat last year’s tally, according to data compiled by Wind and our own calculations. Twenty seven bonds with a face value of some 27.1 billion yuan (US$3.9 billion) have defaulted year-to-date (as of August 10, 2018) compared to 48 bonds worth some 37.6 billion yuan in 2017. These numbers are down from the 60 bonds worth 39.3 billion yuan that defaulted in 2016.

That said, default rates, as a percentage of bonds outstanding, are still low. For example, the default rate for riskier high yield bonds is 0.22 per cent in the year-to-August 10, while the default rate for all corporate bonds (excluding policy bank and municipal bonds) is just 0.08 per cent. By comparison, the default rate for US high yield bonds is more than 2 per cent and rising.

Bonds need to be allowed to default if the market is to function properly. Capital needs to be allocated efficiently on the basis of risk and reward. A bond market with no defaults creates the wrong incentives for borrowers and investors.

That’s why more defaults, somewhat perversely, are actually a good thing. China’s bond market needs to learn that dealing with failure is an important part of growing up.
Chart 4: More defaults, moral hazard addressed

Nominal value of bond defaults

Number of bond defaults

Source: Wind, 30 Jun 18
Part II

Why you should care

Index inclusion
If all goes to plan, the Bloomberg Barclays Global Aggregate Bond Index is expected to include onshore Chinese bonds from April 2019. The weighting may increase to some 5.5 per cent over a period of 20 months.

Other influential indices, such as the FTSE World Government Bond Index and JPMorgan's Government Bond Index-Emerging Markets Global Diversified, are expected to follow suit with eventual weightings of 5 per cent and 7 per cent respectively, compared to zero exposure right now.

We estimate the domestic market could attract some US$250 billion - US$350 billion in passive funds, in the same way the addition of Chinese A-shares into MSCI's Emerging Markets Index is expected to siphon offshore capital into local-currency stocks.

Foreign investors who never imagined themselves with exposure to renminbi-denominated Chinese debt may find themselves invested by default, although there will be investors who would opt to reallocate capital to avoid China exposure.

Low market correlation
With low foreign investor participation, the onshore bond market is domestically driven and has exhibited low correlation with global markets and sentiment. This is one reason why global shocks tend not to be transmitted with the same intensity as in other bond markets. Chinese bond valuations more closely reflect domestic factors, such as inflation and monetary policy.

Foreign investors account for slightly more than 2 per cent of the entire bond market, and some 6.8 per cent of the market for government bonds. By comparison, another Asian bond market that is primarily driven by domestic factors is India, and yet foreigners account for some 4 per cent of that market.

This contrasts with bond markets elsewhere in the region that are heavily dependent on offshore liquidity, such as South Korea, where foreign investors account for some 14 per cent, and Thailand, where it's closer to 11 per cent.

Currency stability
Another source of market stability has been China's currency. China has made efforts in recent years to internationalise the renminbi, or yuan, so that it can become a viable alternative to the US dollar as the currency of global trade and, further down the road, as a reserve currency.

The renminbi remains one of the more heavily-managed currencies in the world. Technically, the renminbi onshore rate (CNY) – there's a separate CNH rate for renminbi traded offshore – is allowed to move within 2 per cent of a reference rate that's set every day. But it's an open secret the government influences the daily fixing of this reference rate.

Government-linked banks will intervene in the onshore market whenever currency volatility spikes. The central bank, the People's Bank of China (PBOC), also monitors the movement of the renminbi against a basket of the 24 currencies of China's main trading partners, in addition to the CNY's relationship with the dollar, and is prepared to intervene when needed.

What's more, capital controls act as a secondary line of defence in keeping the currency stable. While Chinese people seeking ways to move money offshore have found loopholes, it remains very difficult in China to sell the yuan and purchase foreign currencies in sufficient amounts to weaken the Chinese unit.

That's why, even during periods of severe currency volatility in both developed and emerging markets, the renminbi has managed to stay relatively stable. For example, the CNY was the least volatile of the more than 20 currencies we tracked during the three- and five-year periods to end-June 2018.

Over the long term, the continued use of capital controls is inconsistent with the objective of gaining reserve currency status, but we do not expect a change away from a managed exchange rate in the foreseeable future.

Relative value
Chinese bonds potentially offer a higher yield relative to comparable bonds issued in the major developed bond markets, but not compared to the average emerging market. This reflects the relatively low volatility of both bond prices and the currency compared to the average emerging market.

Both the central bank and the State Council, which sits at the top of China's massive bureaucracy, indicated their support for a less aggressive monetary policy. This, we believe, is the start of a cycle of lower interest rates for the foreseeable future, which is potentially good for bonds.

Over the medium and longer term, however, it is likely that China's growth will outpace that of the US and Europe so that Chinese interest rates will need to be structurally higher to counter inflationary pressures. That said, it should be noted that China's economic and interest rate cycles don't always move in tandem with the US and Europe. This helps explain the low correlation to the US and European markets.

Investors will receive some 3.6 per cent from Chinese 10-year government bonds and around 4.3 per cent from 10-year bonds issued by the country's policy banks. That's an attractive yield pickup on 10-year sovereign debt issued by governments in developed markets.

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*Wind, 3 Oct 18
*Finding Foreign Flow Imbalances in EM LCY Debt, Standard Chartered, 26 Sep 18
*Bloomberg, Aberdeen Standard Investments, 30 Jun 18
*Bloomberg, 3 Oct 18
Chart 5: Global bond indices have ignored China, but not for long

FTSE WGBI (top 10)

- United States of America: 35.28%
- Japan: 1.69%
- Germany: 2.04%
- France: 4.79%
- Italy: 5.75%
- China: 0% to 5%
- Great Britain: 2.88%
- Spain: 5.29%
- Belgium: 5.50%
- Netherlands: 6.23%
- Australia: 17.27%

Bloomberg Barclays Global Aggregate (top 10)

- United States of America: 37.52%
- Japan: 17.27%
- France: 6.23%
- Great Britain: 5.59%
- Germany: 5.29%
- China: 0% to 5.5%
- Italy: 5.07%
- Spain: 4.79%
- Belgium: 4.09%
- Netherlands: 4.79%

JPM GBI-EM Global Diversified (top 10)

- Brazil: 10.00%
- Mexico: 5.73%
- Indonesia: 8.89%
- Poland: 9.70%
- South Africa: 9.26%
- China: 0% to 7%
- Thailand: 8.95%
- Russia: 8.89%
- Colombia: 7.90%
- Turkey: 6.57%
- Malaysia: 5.73%

Source: FTSE, Bloomberg, JP Morgan, 30 Jun 18

Chart 6: Low correlation* with other markets

3-year correlation vs major bond indices

ML US Treasury
FTSE WGBI
ML Japanese Gov
Barclays Global Agg
JPM EMBI GD
JPM GBI-EM GD
IBOXX ALBI

1 = perfect positive correlation
0 = no correlation
-1 = perfect negative correlation

*Denominated in USD, based on weekly returns of WGBI China 1-10y index.

Source: Aberdeen Standard Investments, Bloomberg, 30 Jun 18

Chart 7: CNY historical volatility vs emerging market currencies

5 year volatility

3 year volatility

Source: Aberdeen Standard Investments, Bloomberg, 30 Jun 18
Digging deeper: Deciphering domestic ratings

Domestic credit ratings are wildly optimistic and of little use when gauging the ability of a borrower to repay debt. However, Chinese rating agencies do a surprisingly good job looking under the hood of bond issuers and their research can play an important role in any independent credit analysis.

China’s big four credit rating agencies – China Chengxin International Credit Rating, China Lianhe Credit Rating, Shanghai Brilliance Credit Rating & Investors Service and Dagong Global Credit Rating – don’t have a great reputation for their ratings.

Even though Chengxin and Shanghai Brilliance are tie-ups with Moody’s and S&P respectively, it’s rare for the domestic agencies to issue anything other than the top two ratings. This makes it impossible to gauge the ability of a borrower to repay debt from the rating alone.

For example, some 85 per cent of rated onshore bonds issued by companies are awarded domestic ratings of AAA and AA+.\(^*(\) China’s sovereign rating in international markets is A1/A+/A+ (Moody’s, S&P, Fitch) which means no bonds issued offshore by Chinese companies can be rated higher. The best of those offshore bonds, some 47 per cent, received international ratings of A, based on the securities tracked by the JPMorgan Asia Credit Index.

That said, we study reports published by these rating agencies because they have better insights into the businesses of many state-owned companies.

In China, reliable information is hard to come by. Something that ought to be simple, like understanding the breakdown of a company’s businesses, can often be difficult if the company isn’t listed or if the company decides only to share the bare minimum required under regulatory disclosure.

The onshore rating agencies tend to be better at looking under the hood of Chinese firms, as well as understanding their relationship, if any, with the local and central governments. They also understand whether individual companies benefit from ever-shifting national priorities that can mean support for some industries but not others.

This is important because government support – bailing out bonds at risk of default – is a feature of the onshore market for borrowers deemed too important to fail. However, this will become less common as policymakers tackle the market distortions created by moral hazard.

Foreign investors tend to use the opinions of Moody’s, Fitch and S&P for an alternative reference point. The global agencies’ experience of reviewing thousands of companies across different industries and countries makes them better suited to judge where a Chinese firm stands relative to its peers.

Meanwhile, the international perspective these agencies bring can be useful when trying to assess the implications to a Chinese company of an overseas acquisition or merger.

Domestic ratings may be meaningless, but the accompanying analysis is indispensable. The opinions of Chinese rating agencies must be considered in conjunction with those of the big international agencies. Only then can investors make an informed decision, especially when an implicit government guarantee can still exert an influence on bond pricing.

\(*\)Wind, Aberdeen Standard Investments, 31 Aug 18

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**Chart 8: Market profile**

- **Central government**: 11%
- **Local government debt**: 18%
- **Policy bank debt**: 33%
- **Corporate**: 20%
- **Certificate of deposit**: 18%

Source: Wind, 8 Dec 17
Part III

When did it open?

Red tape slashed
The providers of major international bond indices are working towards including onshore bonds in their benchmarks because of China’s efforts to make the domestic market more investable.

As recently as 2016, foreign private sector investors who wanted to access this market had to get either a Qualified Foreign Institutional Investor (QFII) or Renminbi Qualified Foreign Institutional Investor (RQFII) licence. Following a lengthy application and approval process, investors were subject to investment quotas as well as restrictions on the repatriation of profits. Public sector investors – foreign central banks, supranationals and sovereign wealth funds – were governed by separate rules.

Private sector investors now have two more options: a programme that confers direct access to the CIBM; and the Bond Connect platform. Both offer more convenience in terms of a streamlined approval process, no limits on investments and repatriation of profits, and the ability to hedge foreign exchange risks at the onshore yuan rate.

Investors who choose to invest directly in the CIBM will have to appoint a local settlement agent to trade onshore bonds but those accessing the market through Bond Connect won’t.

Residual impediments
Although foreign investors don’t have the same market access as their local counterparts – we can’t trade onshore China Government Bond futures – it has never been easier to trade onshore bonds. Direct access to CIBM and Bond Connect are, by far, the most convenient ways for foreign investors to participate in this market.

That still doesn’t mean it’s easy to invest in this market. After all, these are bonds with ‘Chinese characteristics’ which means some market dynamics are unusual and perhaps even unique. Market novices need to understand the idiosyncrasies of on-the-run/off-the-run government bond pricing. The government issues new bonds rather than tap existing issues, which means there are numerous relatively small bonds in existence. This translates into a higher premium for new bonds and less liquidity in the secondary market.

Index construction and passive strategies that attempt to track indices also face challenges. Numerous bonds qualify for index inclusion, but are so illiquid they will trade with a wide bid/offer spread, increasing transaction costs. Many indices exclude opportunities outside of the government bond market. Or if they include non-sovereign credit, they fail to discriminate between good and bad quality, ignoring the changing nature of liquidity and valuation opportunities over time.

“Direct access to CIBM and Bond Connect are, by far, the most convenient ways for foreign investors to participate in this market”
Chart 9: Main channels to invest in China’s bond market

**Qualified Foreign Institutional Investor (QFII)**
- Currency: USD
- Time: 2002
- No. of Investors: 283 (as at 30 Jun 17)
- Total quota: USD 92.7bn (as at 30 Jun 17)
- Regulator: CSRC, SAFE, PBoC

**Direct CIBM Access Program**
- (Eligible Offshore Investors include commercial banks, insurers, security houses, asset managers, charitable funds, retirement/pension funds & other long term investors approved by PBoC.)
- Currency: RMB and FCY
- Time: 2016
- Regulator: PBoC

**Interbank Bond Market**

**Exchange Bond Market**

**Domestic Equity Market**

**Bonds Connect**
- For long-term foreign institutional investors
- Currency: RMB and FCY
- Time: 2017
- Regulator: PBoC, HKMA

**RMB Qualified Foreign Institutional Investor (RQFII)**
- Currency: RMB
- Time: 2011
- No. of Investors: 184 (as at 30 Jun 17)
- Total quota: CNY 773.1bn (with HK expanded to CNY 500bn)
- Regulator: CSRC, SAFE, PBoC

**Shanghai - Hong Kong Stock Connect**
- Currency: RMB
- Time: 2014
- Daily Quota: SH to HK RMB 13bn
- HK to SH RMB 10.5bn (as at early Apr 14)
- Regulator: CSRC, SFC

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**Key Terms**

- **CSRC**: China Securities Regulatory Commission
- **PBoC**: People’s Bank of China
- **SAFE**: State Administration of Foreign Exchange
- **SFC**: Securities and Futures Commission
- **HKMA**: Hong Kong Monetary Authority

**Source**: SAFE, PBoC, CSRC, BNP Paribas, 31 Aug 17
Digging deeper:
China’s debt burden

China’s debt ballooned following the global financial crisis with corporate debt in particular growing to a size that is unprecedented. How China deals with this has implications for everyone because of the size of the economy. It is making progress but more needs to be done.

Debt growth in China following the global financial crisis has been so significant that it accounts for almost half (46 per cent) of the expansion in global debt since 2009.

After the collapse of Lehman Brothers in September 2008, China's government responded with a 4 trillion yuan (US$ 587 billion) stimulus package that was largely financed by the banking sector. We estimate that once local government debt was included, that number rose to some 16 trillion yuan. The plan worked in helping sustain economic growth, but it also came with tremendous risks.

In any debt boom, the risk is that capital is misallocated, leading to non-performing loans and sparking a banking crisis. Even without a banking crisis, capital misallocation reduces future growth potential.

China’s debt reached some 274 per cent of GDP in mid-2017, more than doubling from 134 per cent in 2008, according to data compiled by Deutsche Bank. Debt attributable to state-owned enterprises represented the single biggest component of China’s debt burden in mid-2017, accounting for more than 31 per cent of the total amount. However, what’s not immediately apparent in this dataset is the role played by corporate debt in all forms which, in percentage and absolute terms, was the main source of debt growth within this period.

How China deals with its debt has implications for everyone. Kicking the can down the road by allowing cheap capital to finance debt at unproductive firms would sap the productivity and growth potential in China’s economy. This would be similar to Japan’s handling of its own debt problem in the 1980s, but with broader global implications given the size of China’s economy.

Following the latest round of stimulus in 2015 and 2016, the International Monetary Fund and others suggested China needs to urgently do three things to avoid a globally disruptive unwind. First, reduce credit growth and force banks to acknowledge non-performing loans; second, reduce the size of the unofficial shadow banking industry in order to better regulate the market; and third, create a system to dispose of bad loans.

So how is China doing? The government realises this much debt is undesirable, and unsustainable, and so on all accounts it is making progress – credit growth has slowed significantly, and the campaign against shadow banking is showing results. In this context, rising defaults in China should largely be viewed as a positive. Allowing over-leveraged entities to default removes moral hazard and helps to improve credit allocation and risk assessment.

However, more work needs to be done, especially regarding off-balance sheet local government debt and debt that’s attributable to state-owned enterprises, but this near-term pain could bring about longer-term gain.

Investors concerned about some sort of Asian crisis-style blow up with foreign currency debt at its epicentre need not fear. China’s foreign currency-denominated external debt is US$1.8 trillion, based on data compiled by the State Administration of Foreign Exchange (SAFE). This compares with the some US$19.2 trillion owed by the US, according to the US Department of the Treasury. The fact that most of China’s debt is domestic gives the government greater flexibility to control the pace of deleveraging.

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9China Seeks Stimulation, The Economist, 10 Nov 08
10Deutsche Bank, 31 Aug 18
11www.home.treasury.gov/
Chart 10: Stimulus has doubled China’s debt

China’s debt-to-GDP ratio (%)


Source: Deutsche Bank, 31 Aug 18
Part IV

What are the risks?

Illiquidity

Even though China is the third-largest bond market in the world, it is one that is still finding its feet. This is an immature market that, in some instances, can be illiquid. We ranked the turnover ratio of government bonds in seven regional markets – Japan, Hong Kong, Thailand, Korea, Singapore, China and Malaysia. The onshore Chinese market was the second most illiquid after Malaysia, according to data compiled by AsianBondsOnline. Poor liquidity can be attributed to a number of factors: low turnover in the corporate bond market; limited appetite for bonds with maturities of more than 10 years; and excessive issuance of government bonds. That said, on-the-run paper issued by the central government and the policy banks tend to be much more liquid.

Food inflation

The unpredictability of food inflation, and its outsized effect on broader inflation, is a risk. Despite food price stability in recent years, an outbreak of African swine fever in China at the time of writing pushed up pork prices and bond yields subsequently rose on inflation concerns. Food accounts for a big component in the basket of goods used to calculate the consumer price index (CPI) in many emerging markets. In China, it accounts for some 32 per cent of CPI.12 This compares with developed markets where food exerts less influence on inflation. For example, it is some 13 per cent of the CPI basket in the US, in the European Union it’s around 15.5 per cent, whereas in Australia it’s just over 16 per cent.13

Default and recovery

Bond documentation drafted under local laws are generally light on what happens in the event of a default and do not contain standard event of default and enforcement provisions. Enforcement in China involves uncertainties because of the unpredictability of the courts and their interpretations of the law, the untested nature of enforcement (especially against state-owned enterprises), while prior court decisions have little precedential value and can only be used as a reference. Holders of paper issued by Dongbei Special Steel Group received 22 cents on the dollar after the firm defaulted in 2016. This is the only case that has been disclosed to the public in which creditors took a haircut based on a court ruling.14 However, the same uncertainties exist in other emerging markets. We have seen markets that are less creditor friendly – guarantees and debt held by foreign investors have been disregarded by courts in Indonesia – or more creditor friendly, such as in Latin America, where insolvency procedures are modern and established.

Hedging options

Hedging tools are not as sophisticated as those available in more developed bond markets. For example, we can’t hedge interest rate risk for all the bonds in this market. Onshore China Government Bond futures are the most effective hedging tool right now but are off limits to foreign investors. The offshore non-deliverable interest rate swaps market isn’t very efficient. This could make it difficult for foreign investors to quickly adjust the risk profile of a portfolio without selling any of the underlying bonds. Furthermore, there is no inflation-linked bond market to speak of.

Capital controls

Capital controls pose a risk, albeit a small one. We’ve discussed elsewhere how the renminbi is a heavily managed currency and there are restrictions on the cross-border movement of money. However, we believe any sustained attempt to prevent foreign investors from repatriating profits will damage China’s goal of opening up its capital market to overseas investment. When Thailand imposed capital controls a decade ago, the move scared off foreign investors who were slow to return even after restrictions were lifted. Policymakers around the region would have learned that lesson well. Direct access to CIBM and Bond Connect have also made capital repatriation much easier.

Other risks

Standard risks that are common to other markets include: bad debts due to the property cycle; debt levels (as covered in China’s debt burden); and poor environmental, social and governance (ESG) standards – ESG analysis is not simply driven by the desire to do the right thing, but there is evidence of a link between good management of ESG risk and good management of the financial risks that determine the creditworthiness of a bond. There are also ad-hoc risks such as the global tilt towards protectionism which has soured investor sentiment towards emerging markets.

12 www.tradingeconomics.com/china/inflation-cpi
14 Xi Jinping’s Debt-Relief Recipe: How China’s Biggest Bond Defaulter Unloaded its Liabilities, South China Morning Post, 15 Oct 17
Chart 11: Illiquidity is risk in China

Asian markets by turnover ratio

Source: AsiaBondsOnline, 31 Dec 17
China’s onshore bond market has made great leaps forward in a short space of time and become a market that is too important for international investors to ignore.

But investing in a market that’s still developing poses tough challenges. This is a market where rigorous credit analysis is the exception rather than the rule. Even basic measures of relative value – the yield spread over sovereign bonds, spread duration comparisons – are considered innovative. This creates opportunity for active managers, with patient capital, employing fundamental analysis.

This is clearly not a market for everyone. Even if everything proceeds smoothly, there are plenty of bond investors around the world who will not be comfortable investing in China and may opt for an alternative index to base asset allocation – one that omits Chinese securities. That’s why index inclusion shouldn’t be the only reason for investing.

That said, the opening up of the world’s third-largest bond market should be a cause for celebration. A fully functioning bond market will help China’s companies reduce their excessive reliance on bank loans and help fuel the next stage of the country’s growth. Foreign investors can play an important role in this process.

For those investors willing to do their homework this is a market that can potentially offer attractive returns and a way to diversify portfolio risk. However, there is no room for complacency.
“China’s onshore bond market has made great leaps forward in a short space of time and become a market that is too important for international investors to ignore”
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*as at 30 Jun 2018

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