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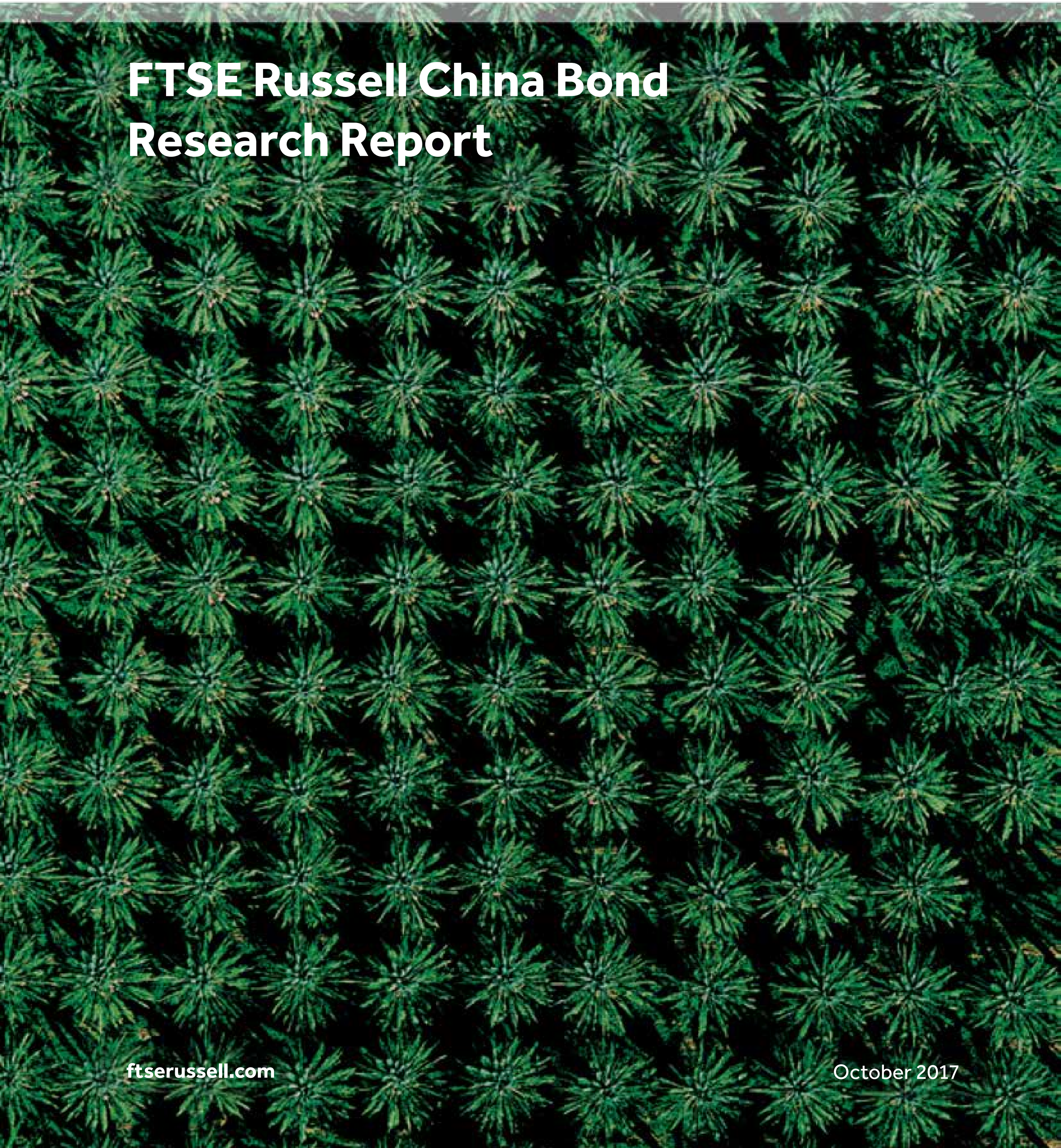

FTSE Russell China Bond Research Report

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Highlights

- Despite the potential for new policy announcements at China's 19th Party Congress in October, the People's Bank of China (PBOC) is expected to continue its attempts to simultaneously balance competing goals: controlling excess leverage in the economy by clamping down on excessive lending, while also trying to protect against a protracted economic slowdown. According to 60 percent of economists in a Bloomberg survey conducted in August, the PBOC's broad policy stance will remain unchanged through the end of the year.[1]
- At the same time, in August offshore investor trading in short-term debt via China's Bond Connect spiked on the back of a stronger RMB – an uptick in trading that follows a slow start to the new programme. According to data from the Shanghai Clearing House, the total settlement value of Bond Connect transactions it received nearly quadrupled in the week of August 21 to 11.8 billion RMB ($1.8 billion) compared to the previous week.[2]
- Meanwhile, bond yields are rising onshore: the yield on China's 10-year government bond rose to 3.62 percent in August, widening the gap with US Treasuries of similar maturity, which declined to 2.2 percent. And the RMB is starting to recoup recent losses due to a range of factors, including China's restrictions on capital outflows and US dollar weakness. On August 29, the RMB strengthened beyond 6.6 per US dollar for the first time since June 2016.[3]

1 Bloomberg. August 2017.
2 Reuters. August 2017.
3 Bloomberg. August 2017.

Chapter 1: Overview

China bond trading picks up as PBOC balances competing forces ahead of 19th Party Congress in October

While much of China's 19th Party Congress remains shrouded in mystery, one thing is clearly observed: the challenges of reforming Asia's largest economy remain formidable. China's policymakers are still trying to find innovative ways to manage slower economic growth while they also try to rein in excessive lending and the shadow banking industry.

On that basis, and according to 60 percent of economists in a Bloomberg survey conducted in August, the PBOC's broad policy stance will remain unchanged through the end of the year: the central bank will attempt to control excess leverage in the economy, while also trying to protect China's economy from a protracted economic slowdown.[4]

"We expect the overall status quo to remain unchanged after the 19th Party Congress and current policy trends, including neutral monetary policies and proactive fiscal policies to continue," says Ben Yuen, CIO, Fixed Income, BOCHK Asset Management Limited. "Moreover, we expect supply-side structural reforms and renminbi (RMB) internationalisation will continue to be implemented at a gradual pace."

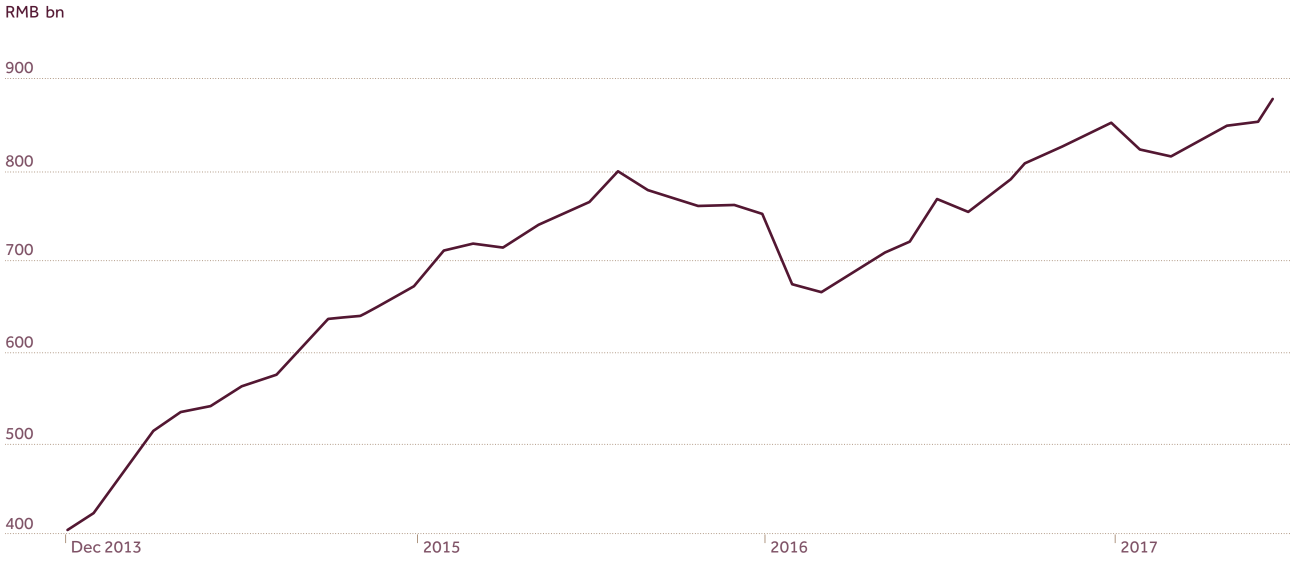
As 2017 enters its final quarter, these 'more of the same' expectations seemed to have helped boost confidence in China's debt markets. The Bond Connect programme, launched in July 2017 following a long period of anticipation, picked up steam in August after a slow start, with trading by offshore investors in short-term debt spiking sharply. The total settlement value of Bond Connect transactions received by the Shanghai Clearing House nearly quadrupled in the week of August 21 to 11.8 billion RMB ($1.8 billion) from the week before, data showed.[5]

Meanwhile, issuances are also increasing again, despite the government's anti-leverage campaign. Chinese companies sold 723 billion RMB of onshore notes in July, the most since November, according to Bloomberg data. And overseas investors increased their China onshore bond holdings by 62 billion RMB ($9.3 billion) in the second quarter after a reduction of 22 billion RMB in the first three months of this year, according to central bank data.[6]

In June, foreign ownership of China's bonds reached a record high, as illustrated in the following graph. Some estimates project foreign holdings of onshore bonds may exceed 1 trillion RMB in the third quarter.[7]

4 Bloomberg. August 2017.
5 Reuters. August 2017.
6 Bloomberg. August 2017.
7 Bloomberg. August 2017.
Please see the end for important legal disclosures regarding forward-looking statements.

Foreign Investors Buy More China Bonds in June



Source: Bloomberg and PBOC, data from December 2013 to August 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

"After the launch of Bond Connect, it's likely the capital inflow from international investors will drive up the onshore China bond market, creating a virtuous cycle where capital attracts more capital," says Michael Chow, Managing Director, Head of International Business, Fullgoal Asset Management (HK).

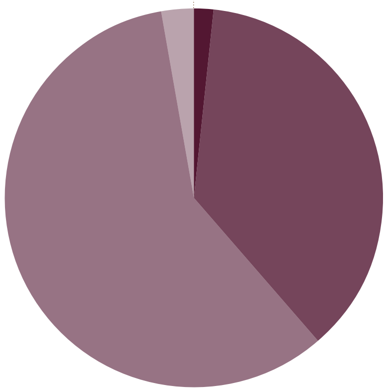
"Historically, it is more convenient for international investors to invest in the offshore China bond market. But in recent years China has strengthened the regulation and supervision of financial markets and institutions. As a result, the onshore bond market has experienced a large correction since November last year. Of course, there are still some necessary policies yet to be launched, and we might see more volatility in the China bond market in the near term."

Against this backdrop, higher bond yields onshore continue to attract more international market participants. Yield on China's 10-year government bonds reached 3.62 percent in August, widening the gap with 10-year US Treasuries, at 2.2 percent.[8]

Despite the uptick, however, a certain amount of skepticism about the onshore market persists among international market participants due to a range of factors. For example, the vast majority of onshore bonds are still highly rated, especially corporate bonds – as illustrated in the graph below where 95.4% of bonds are rated AA or above.

8 Bloomberg. August 2017.

Onshore corporate bond market credit ratings breakdown



Source: Wind, BOCHK Asset Management Ltd., as of September 15, 2017.

"Market perception is that local agencies do not rate bonds to the same standards as international agencies," says Scott Harman, Managing Director, Fixed Income & Multi Assets, FTSE Russell. "Local Chinese agencies are perceived to place greater emphasis on the implicit government support on state-owned companies. You see this also reflected in pricing, with yields on locally-AAA-rated corporates only 100-200 bps above CGBs. There is an expectation amongst investors that, in the event of a default, many companies can rely on governmental support, given their systematic importance to the Chinese economy."

Nevertheless, moving into 2018, international appetite for onshore bonds as an asset class is expected to increase over time, though uncertainty over domestic ratings may continue to put investors off corporate bonds in the short term.

"There are several factors that may have increased the international appetite for the CNY bond market," said BOCHK's Yuen. "One is easier market access after the launch of Bond Connect northbound; two is the stabilisation of RMB exchange rates helping to increase foreign investor confidence; and three is the fact that lower hedging costs in the onshore CNY market are enhancing the attractiveness of currency hedging. However, foreign investors' CNY bond holdings are still dominated by government bonds and bank negotiable CDs, indicating hesitation to participate in the corporate bond market."

Chapter 2: Internationalisation and a Stabilising RMB

While demand among international market participants for onshore bonds is picking up, index providers are considering including Chinese bonds in their emerging markets indexes. Earlier this year, 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.[9]

9 FTSE Russell. July 2017. Citi Fixed Income Indices and The Yield Book were acquired by London Stock Exchange Group plc in August 2017. https://www.yieldbook.com/m/indexes/citi-indices/message.shtml?id=0058

"When considering potentially eligible countries for index inclusion, index providers consider a range of quantitative and qualitative criteria," says FTSE Russell's Harman. "The former include market-size, credit-rating and minimum issue size requirements, which vary across markets and are straight-forward to measure. In the case of the later, the qualitative assessment hinges around the ease in which a foreign investor can access the domestic market and is normally evaluated by index providers at external governance forums. Optically, China appears to meet the quantitative requirements, with ~$9 trillion debt outstanding – including ~$1.7 trillion of CGBs – and investment grade ratings from all three international agencies, but the softer qualitative criterion is harder to assess and satisfy."

As the internationalisation of China's capital markets continues apace, the RMB is starting to recoup recent losses due to a range of factors, including China's restrictions on capital outflows and US dollar weakness. On August 29, the RMB strengthened beyond 6.6 per US dollar for the first time since June 2016. The offshore RMB climbed 0.2 percent to 6.6027, rising for a 10th day, the longest streak in almost seven years, according to Bloomberg.[10]

"In our view, one important driving force in the RMB's gains is the demonstrated resilience of China's economy, despite significant challenges. Another important driving force is the increased uncertainty of US policies and the slowdown of US economic recovery, driving down the USD exchange rate," says Fullgoal's Chow.

"That means the relative improvement of China's economy over the US economy is the main reason for the RMB's gain."

The RMB Surges in Q3

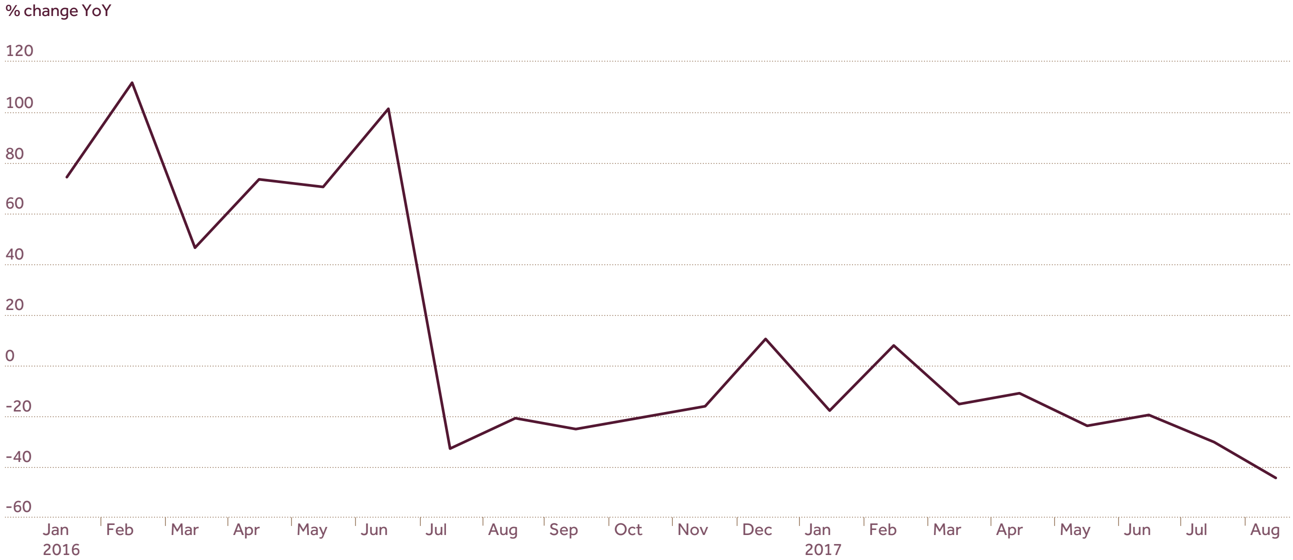
Source: Bloomberg, data from August 2016 to August 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

To be sure, signs of improvement are rippling through China's economy, many of them policy driven. For example, the government's anti-leverage campaign, announced earlier this year, seems to be having an impact on excessive lending.[11]

10 Bloomberg. August 2017.
11 BOCHK Asset Management. September 2017.

"The government has achieved a certain level of success in its ongoing anti-leverage campaign," says Yuen of BOCHK. "The growth of money supply M2 has been declining rapidly, reaching a historical low level of 8.9 percent in August. More importantly, from the structure perspective, deposit growth in non-bank financial institutions has declined to fairly low levels, which could reflect the result of the deleveraging process. On the demand side, loans to non-bank financial institutions have decreased drastically since 2016 H2, also reflecting the process of financial deleveraging."

Loans to Chinese non-bank financial institutions



Source: Wind, BOCHK Asset Management Ltd. Data from January 2016 to August 2017.

Chapter 3: Dim Sum Holding On

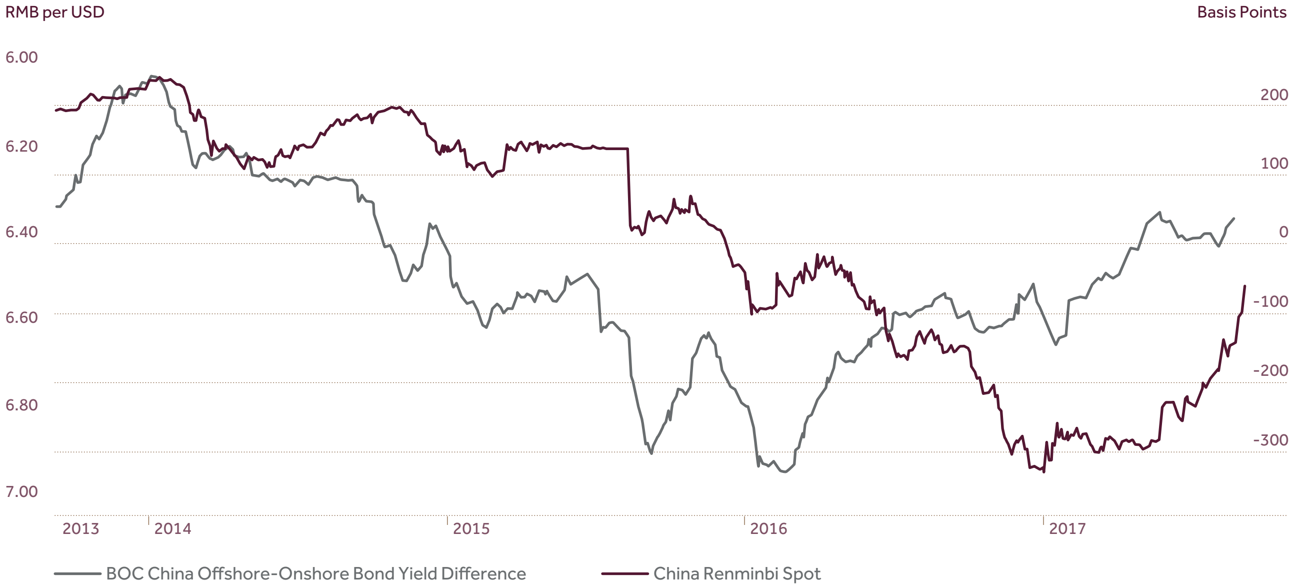
Although the onshore markets seem to be gathering speed following a stronger Q2, the appetite for offshore China, or 'dim sum' (CNY), bonds is diminishing given the diversity offered by China's immense domestic market. Sales of offshore RMB bonds dipped to 27 billion RMB ($4.1 billion) in 2017 as of September 5, equaling less than 10 percent of 2014's record 297 billion RMB, according to Bloomberg.[12]

Despite this drop, dim sum bonds have retained some benefits, such as higher yields compared to CNY bonds. Also, credit differentiation is much clearer in the dim sum bond market as the bonds are exclusively rated by international ratings agencies and the bulk of the issuance is derived from offshore issuers, which is in contrast to the onshore interbank corporate bond universe, where over 90 percent of bonds are rated AA or above.[13]

12 Bloomberg. September 2017.
13 BOCHK Asset Management. September 2017.

Positive expectations regarding the government's management of the RMB exchange rate in the lead up to the 19th Party Congress are also helping the offshore RMB, which marked 14 days of straight gains as of September 4, the longest run of gains in Bloomberg-compiled data going back to August 2010.[14] Such gains are seen as supporting dim sum appetite, which is often driven by expectations of currency appreciation.

Rising RMB Boosts Dim Sum Debt



Source: Bloomberg. Data from September 2013 to August 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Also, despite many predictions that the dim sum market might fall in tandem with the further opening and development of the onshore market, some analysts predict that the rising tide of China's domestic bonds will lift all proverbial boats, while others predict the dum sum market is unlikely to return to previous heights.

"As Bond Connect makes investing in onshore China bonds more convenient for international investors, it will impact the international investors' allocation level to dim sum bonds to some extent," says Fullgoal's Chow. "However, the launch of Bond Connect will also focus international attention on the Greater China market, including Hong Kong, and therefore could increase the trading activities of offshore bonds and eventually increase the allocation value of dim sum bonds."

14 Bloomberg. September 2017.

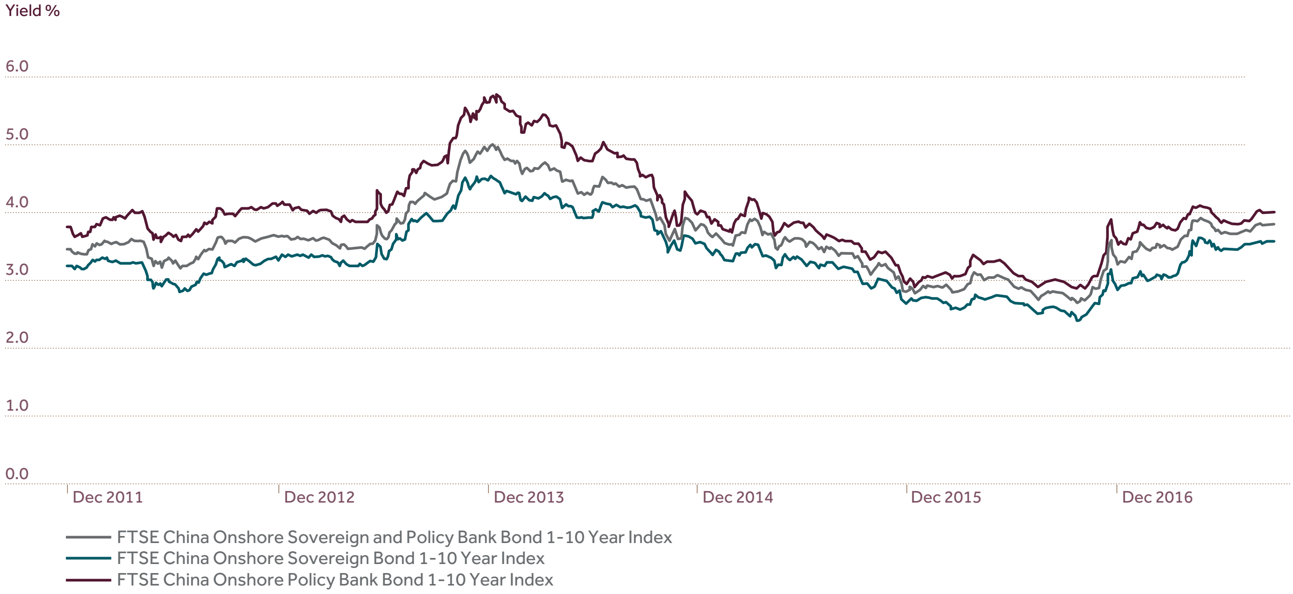
Chapter 4: Performance of FTSE Russell China Bond Indexes

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 September was at 3.83 percent. Among the 2 sub-indexes the FTSE China Onshore Sovereign Bond 1 - 10 Year Index was at 3.58 percent; the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index was at 4.01 percent.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 29 September 2017. Past performance is no guarantee of future results. Please see important legal disclosures at the end of this document.

After June, the yield for the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index rose 0.14 percent to 3.83 percent by the end of September. The yield rose 0.14 percent for the FTSE China Onshore Sovereign Bond 1 - 10 Year Index; and rose 0.14 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 0.52 percent during the last quarter (July - September), with the FTSE China Onshore Sovereign Bond 1 - 10 Year Index up 0.31 percent; and the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index up 0.67 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	0.52	0.59	0.27	-1.06	12.48	20.21	1.57	1.49	1.51
FTSE China Onshore Sovereign Bond 1-10 Year Index	0.31	-0.31	-0.43	-0.88	12.26	18.74	1.68	1.56	1.59
FTSE China Onshore Policy Bank Bond 1-10 Year Index	0.67	1.24	0.78	-1.20	12.66	21.84	1.67	1.62	1.64

Source: FTSE Russell. *Volatility - 1YR, 3YR, Since Inception based on daily data, total return data in CNY, as at 29 September 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures. 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

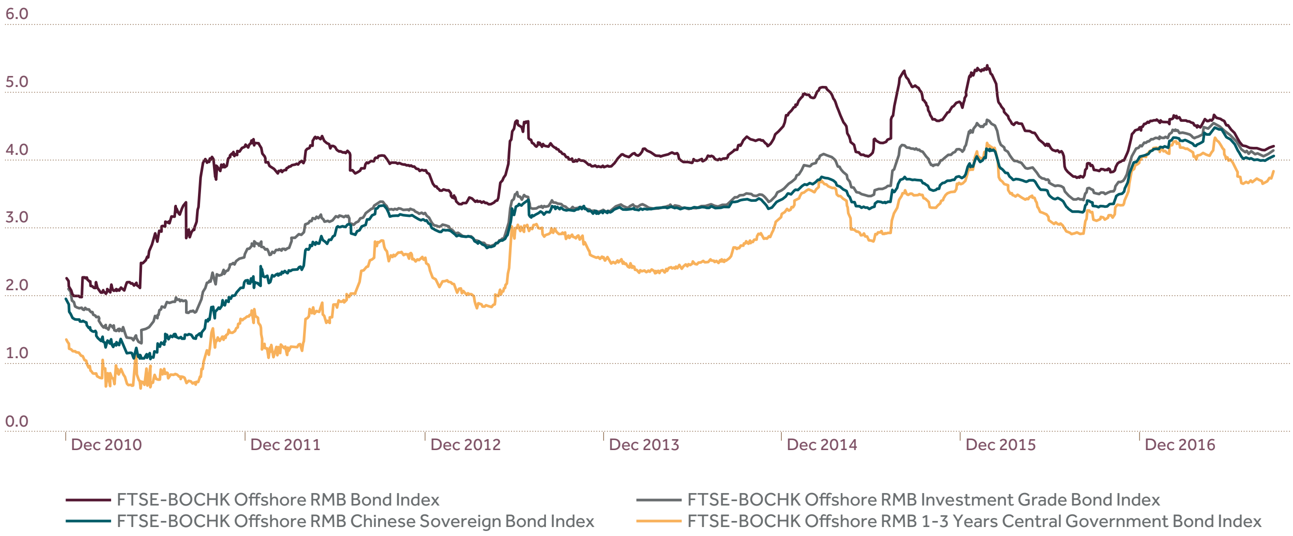
Source: FTSE Russell, data as at 29 September 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

II. Offshore Report

Redemption Yield

As of end-September, the market value duration weighted average redemption yield of the FTSE-BOCHK Offshore RMB Bond Index in September was at 4.20 percent. Among the 3 sub-indexes the FTSE-BOCHK Offshore RMB Investment Grade Bond Index was at 4.13 percent; the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index was at 4.06 percent; the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index was at 3.82 percent.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 29 September 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

After June, the yield for the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index dropped 0.27 percent to 4.06 percent by the end of September. The yield dropped 0.29 percent for the FTSE-BOCHK Offshore RMB Bond Index; dropped 0.27 percent for the FTSE-BOCHK Offshore RMB Investment Grade Bond Index; and dropped 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 1.85 percent during the last quarter (July - September), with the FTSE-BOCHK Offshore RMB Investment Grade Bond Index up 1.87 percent; the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index up 2.03 percent; and the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index up 1.35 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	1.85	3.47	4.10	2.98	12.26	24.38	0.73	1.00	1.12
FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index	2.03	3.61	3.50	1.46	9.00	15.65	1.10	1.11	1.19
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	1.87	3.41	3.70	2.28	10.02	18.96	0.82	1.11	0.91
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	1.35	2.77	3.35	2.44	8.07	13.43	0.81	0.86	1.28

Source: FTSE Russell. *Volatility - 1YR, 3YR, Since Inception based on daily data, total return data in CNH, as at 29 September 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures. 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.

Views expressed by Ben Yuen, Michael Chow, and Scott Harman are subject to change. These views do not necessarily reflect the opinion of FTSE Russell or the London Stock Exchange Group.

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

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