Research

FTSE Russell China Bond Research Report

FTSE Russell

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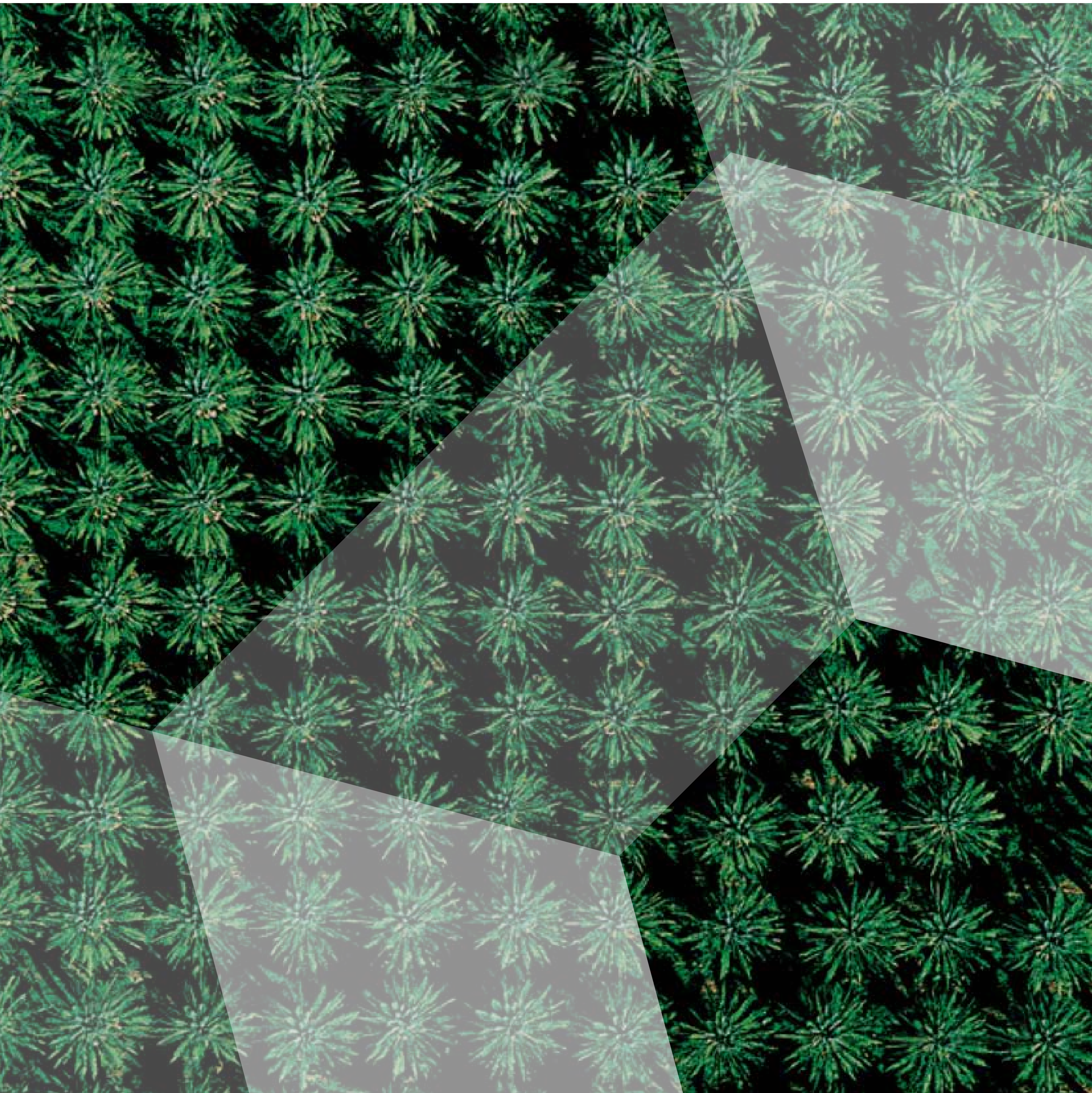

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Highlights

- China's debt markets declined on the back of selling pressure after the country's 19th National Congress in mid-October, with shorter-tenor notes leading the sell-off, pushing the yield curve inversion to its steepest level since at least 2006, according to Bloomberg.[1]
- Yields on China bonds are rising across the board. Short-term instruments such as AAA-rated three-month paper yielded 5 percent as of end November, up 57 basis points that month; the yield on Chinese 10-year treasury bonds stood at 3.979 percent during the same time period. Corporate bond yields are also rising: yields on five-year top-rated local corporate notes jumped about 33 basis points to a three-year high of 5.3 percent as of November 23.[2]
- Meanwhile, the short-term macro view on China's credit markets is turning bearish for some fund managers, due in part to rising yields and fears of near-term macroeconomic instability. For example, Lu Jun of Shanghai Congrong Investment Management said in October he was shorting Chinese bonds as of end-2017 on the back of rising borrowing costs and inflation fears.[3]

1 Bloomberg. October 2017.
2 Bloomberg. November 2017.
3 Bloomberg. October 2017.

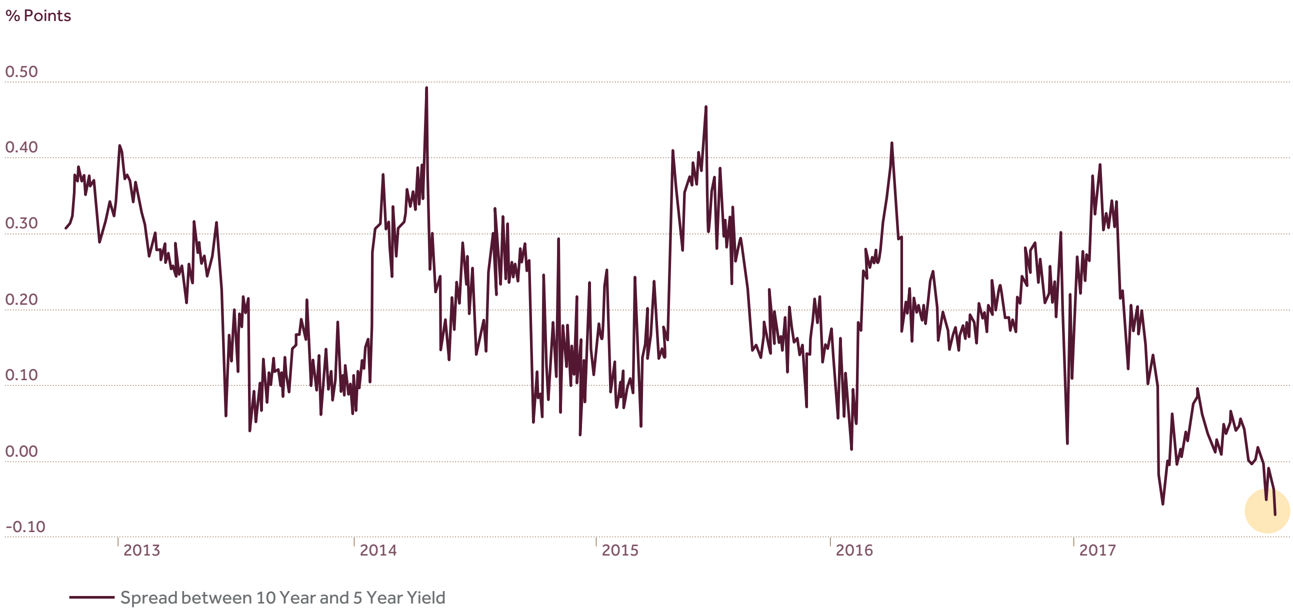
Chapter 1: Overview

Selling pressure following 19th National Congress reveals an uncertain year ahead for China's debt markets

China's 19th National Congress in mid-October made one thing clear: policymakers will continue in their attempts to further liberalise the country's sprawling financial system in 2018, but the road ahead is full of challenging and unavoidable contradictions for China's leaders – such as the desire for stronger growth, while they also attempt to limit the spread of credit and leverage throughout the financial system.

On that basis, concerns about reform-related pain lurking on the horizon, in addition to an uncertain interest rate outlook, helped trigger a sell-off in China's debt markets immediately after the Congress concluded, pushing the yield curve inversion – in which shorter term debt instruments have higher yields than longer-term instruments – to its steepest level since at least 2006, according to Bloomberg.[4]

Steepest Yield Curve Inversion on Record



Source: Bloomberg, October 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Yields on short-term instruments, such as AAA-rated three-month paper, yielded 5 percent as of end-November, up 57 basis points that month. Meanwhile, the yield on Chinese 10-year treasury bonds stood at 3.979 percent during the same time period;[5] and yields on five-year top-rated local corporate notes were up about 33 basis points to a three-year high of 5.3 percent as of November 23.[6]

Yield curve inversions are often predictors of economic recessions, given that longer dated bonds typically have higher yields due to their riskier nature. To that end, China's government acknowledged the challenge and in Q4 dipped into the market to ease the selling pressure and contain surging yields on government bonds, as illustrated in the graph below.

4 Bloomberg. October 2017.
5 Reuters. November 2017.
6 Bloomberg. November 2017.

Bond Selloff Pauses Following Government Intervention

Source: Bloomberg, October 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Despite China's efforts to manage yields on government bonds, it will have a tougher time enacting policies that control corporate yields, which continue to rise. For example, Jiangsu Communications Holding's five-year AAA-rated corporate bonds were quoted at 5.201 percent in late November, up 38.5 basis points since the end of October.[7]

Against this backdrop, the consumer price index was relatively stable at 1.6 percent as of October. But core inflation – or, inflation that strips out food and energy prices – was at 2.3 percent, marking a record for the past six years.[8]

Given the above circumstances – fears of reform pain, yield curve inversion, and inflation risk – the short-term macro view on China's bond markets is turning bearish for some fund managers. For example, Lu Jun of Shanghai Congrong Investment Management said in October he was shorting Chinese bonds as of end-2017 on the back of rising borrowing costs and inflation fears.[9]

"The onshore market is evolving rapidly," says Zhanying Li, Director, The Yield Book by FTSE Russell. "But in a way, the risks of the China bond market are the same as always, despite recent developments. First there is currency risk. The RMB recovered roughly what it lost in 2016 against USD, so the benefits and costs of hedging may need to be considered. Secondly, there are unknowns in regards to the rate environment – US policymakers may raise rates again. And lastly, default risk has been picking up in the corporate space. But in many ways that can be considered a positive development. Without defaults, it's impossible to price risk. Defaults tend to indicate the onshore market is developing in a healthy direction."

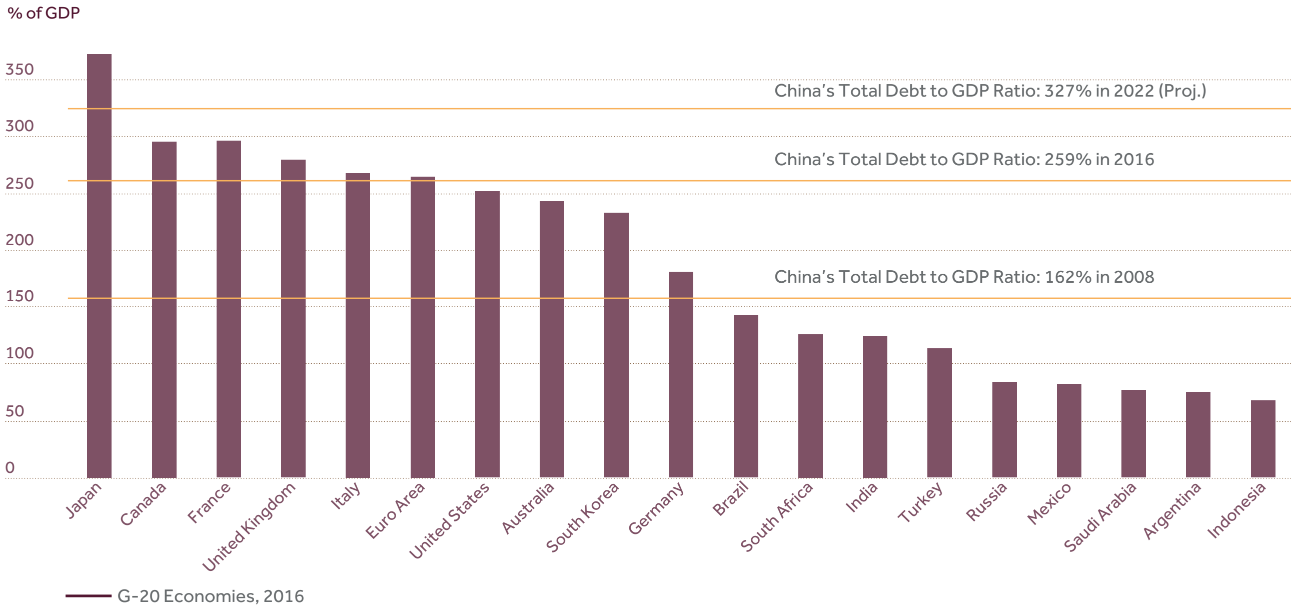
7 Reuters. November 2017.
8 Bloomberg. October 2017.
9 Bloomberg. October 2017.

Chapter 2: More defaults and fewer issuances

Even though defaults may signal a more accurate pricing of risk for the onshore market, in 2018 China's policymakers will likely remain determined to contain the spread of excess credit and leverage throughout the country's financial system.

2017 was marked by a rigorous 'anti-leverage' campaign by China's regulators. According to some analysts, in 2018 the Chinese government will continue its attempts to manage the country's spiralling debt pile, with China's debt-to-GDP ratio projected to reach 327 percent by 2022, up from 259 percent as of the end of 2016, according to Bloomberg and the graph below.[10]

China's Rising Debt Pile



Source: Bloomberg, November 2017.

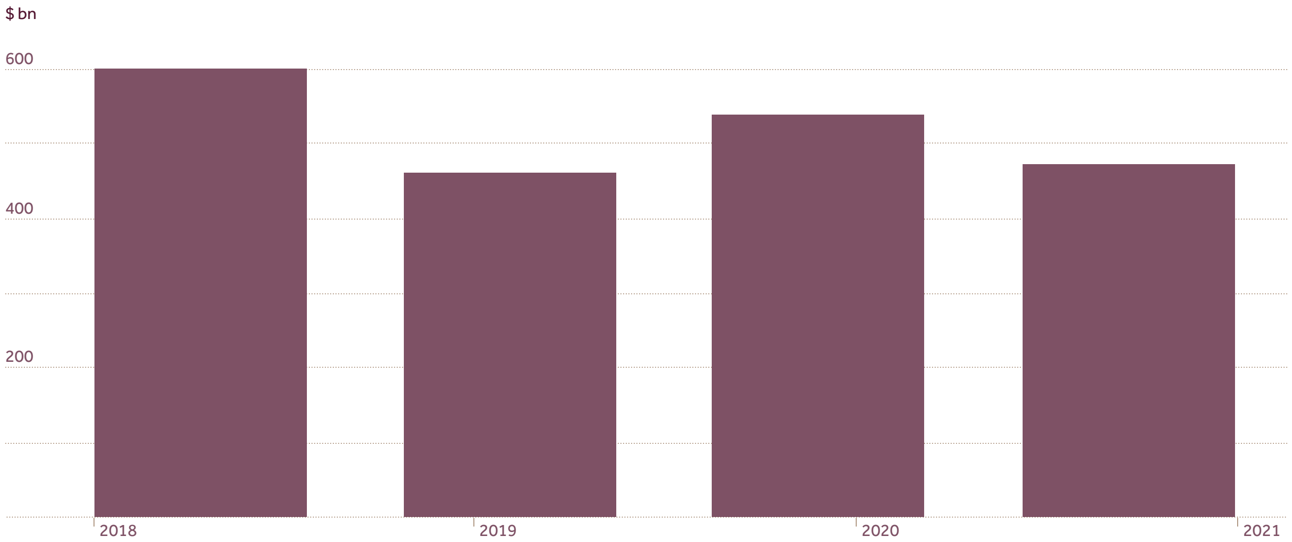
On the corporate side, many Chinese companies have bonds to repay in 2018 (see chart below). That leaves two major questions for Chinese policymakers in the months ahead: will they be able to contain yields on government bonds? And in the corporate space, will China let more underperforming companies go bankrupt, causing even more defaults?[11]

Over the summer before the 19th National Congress in October, there was a boom in new issuances. Chinese companies sold 723 billion RMB of onshore notes in July, the most since November 2016, 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.[12]

Months later in Q4, however, issuance of NCDs fell by more than 300 billion RMB ($45.39 billion) in October, according the Rhodium Group. Roughly 5 trillion RMB worth of this short-term debt is expected to mature in the last quarter of the year, indicating more funding pain for the banks ahead.[13]

10 Bloomberg. November 2017.
11 Bloomberg. November 2017.
12 Bloomberg. August 2017.
13 Wall Street Journal. November 2017.

Many China Bonds Will Reach Maturity in 2018



Source: Bloomberg, November 2017.

Due to these uncertainties, participation of international investors in the highly anticipated Bond Connect scheme between Hong Kong and mainland China has been light – especially for investors outside of Hong Kong and Singapore. And in addition to the macro-concerns, there are unresolved technical and administrative issues linked to the Bond Connect, such as insufficient delivery versus payment (DVP) settlement procedures, a lack of clarity around taxes, and the inability of investors to make block trades.[14]

"Participation of international investors in Bond Connect may pickup in 2018 if some of these technical issues are resolved," says FTSE Russell's Li. "At the same time, appetite may remain focused on government and policy bank bonds. Chinese corporate bonds are not yet rated by international agencies, which may put off international investors in the short term. The good news is that China's policymakers have made it very clear they are open to investor feedback and will reduce barriers to entry over time."

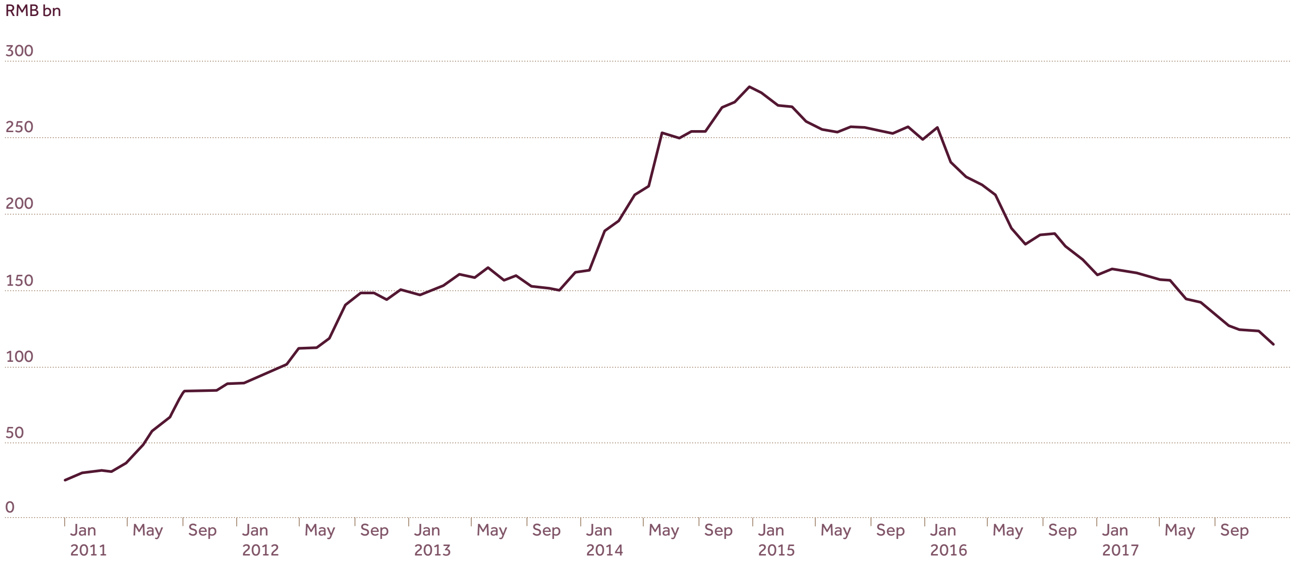
14 FTSE Russell. December 2017.

Chapter 3: Onshore and offshore convergence accelerates

While the onshore China bond markets continue to evolve, offshore a different story is unfolding: the CNH, or 'dim sum' bond markets continue to shrink – and that trend is expected to accelerate in 2018 and beyond.[15]

The numbers paint a compelling portrait. As of end December 2014 – a record year for the dim sum market – eligible bonds for the FTSE (ex-Citi) Dim Sum (Offshore CNY) Bond Index consisted of 156 bonds valued at 282 billion RMB. But as of December 2017, the Index includes only 61 bonds, valued at 115 billion RMB – less than half of its end-December 2014 size and value. What is more, 2017 saw only 10 new dim sum issuances that are eligible for index inclusion, and not a single non-bank corporate issue bonds in the dim sum market.[16]

Dim Sum Market Value



Source: FTSE Russell, December 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

"Fewer Chinese corporates see the need to tap the dim sum market now," says FTSE Russell's Li. "The main reason is they can issue bonds with lower funding costs in the onshore market. Previously, Chinese corporates accounted for about 70 percent of the dim sum market, but that segment is gone. Many of them are now tapping the US dollar bond markets if they want to raise funds offshore. Nowadays the onshore issuing process is simplified – which means convergence between the onshore and offshore China bond markets is accelerating faster than originally anticipated."

15 FTSE Russell. December 2017. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

16 FTSE Russell. December 2017. Citi Dim Sum (Offshore CNY) Bond Index was part of Citi Fixed Income Indices which was acquired by London Stock Exchange Group plc and is now part of FTSE Russell.

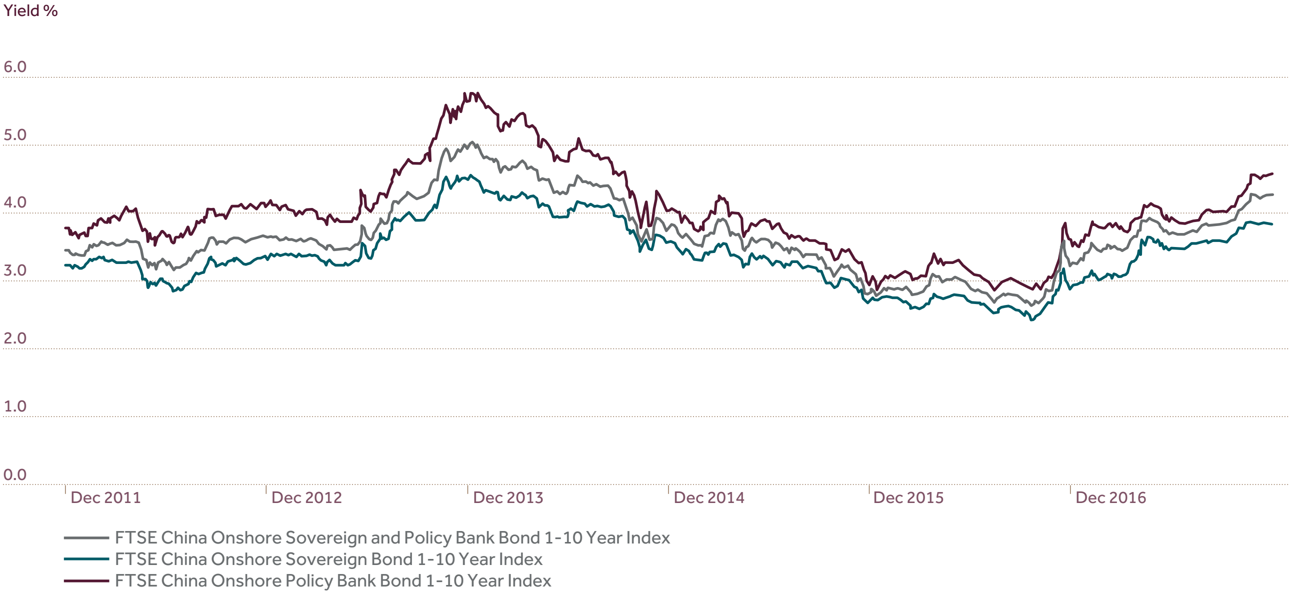
Chapter 4: Performance of FTSE Russell China Bond Indexes

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 December was at 4.25 percent. Among the 2 sub-indexes the FTSE China Onshore Sovereign Bond 1 - 10 Year Index was at 3.83 percent; the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index was at 4.56 percent as shown in the below chart.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 29 December 2017. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see the end for important legal disclosures.

After September, the yield for the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index rose 0.42 percent to 4.25 percent by the end of December. The yield rose 0.25 percent for the FTSE China Onshore Sovereign Bond 1 - 10 Year Index; and rose 0.55 percent for the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index as shown in the above chart.

Total Return

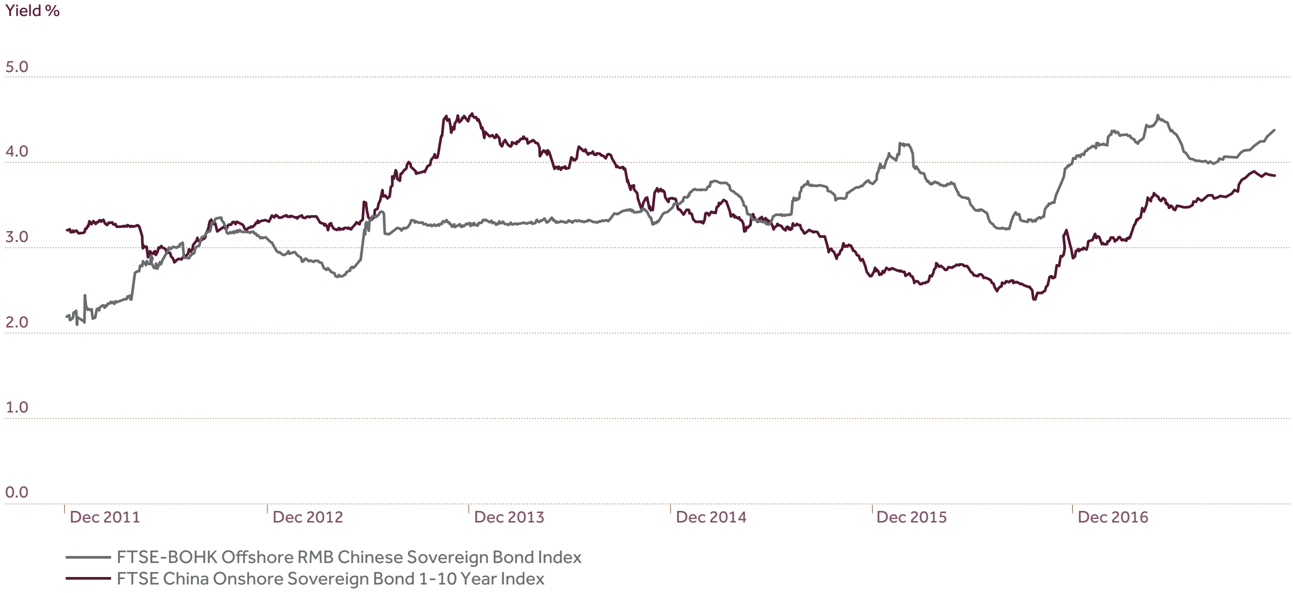
The FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index finished down 0.63 percent during the last quarter (September - December), with the FTSE China Onshore Sovereign Bond 1 - 10 Year Index down 0.07 percent; and the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index down 1.04 percent as shown in Table 1.

Table 1. 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	-0.63	-0.12	-0.37	-0.37	8.66	19.45	1.13	1.32	1.49
FTSE China Onshore Sovereign Bond 1-10 Year Index	-0.07	0.24	-0.50	-0.50	9.27	18.66	1.27	1.39	1.56
FTSE China Onshore Policy Bank Bond 1-10 Year Index	-1.04	-0.38	-0.27	-0.27	8.19	20.57	1.21	1.41	1.62

*Volatility - 1YR, 3YR, Since Inception based on daily data,
Source: FTSE Russell - total return data in CNY, as at 29 December 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



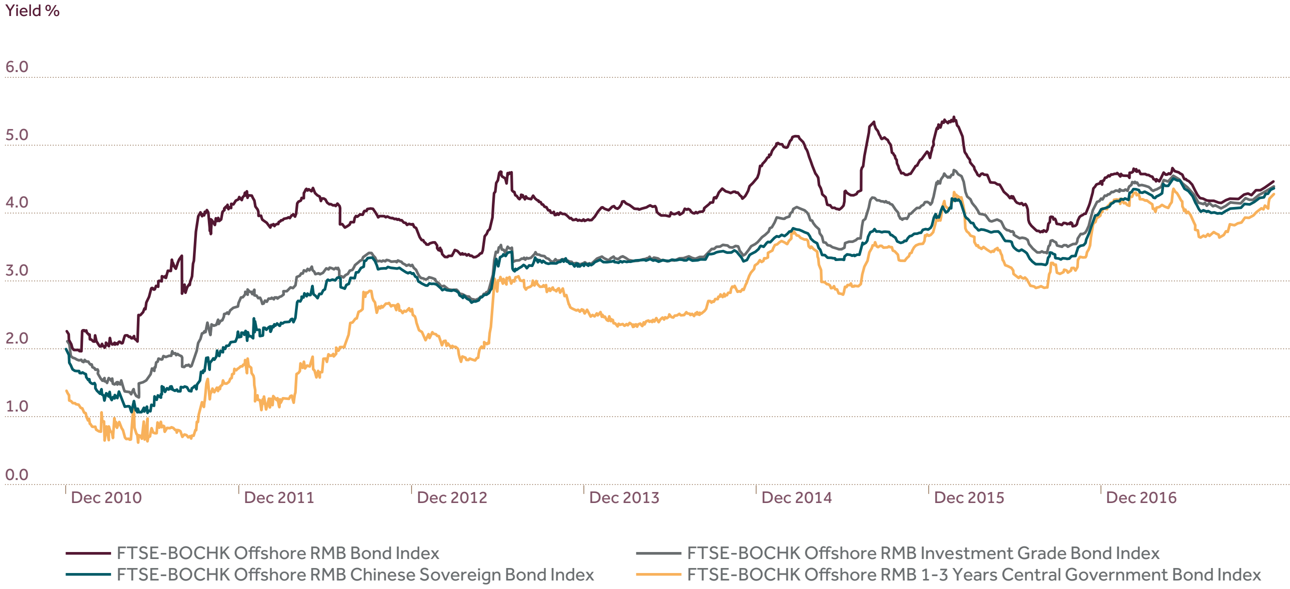
Source: FTSE Russell, data as at 29 December 2017. Past performance is no guarantee of future results. . Returns shown may reflect hypothetical historical performance. Please see the end for important legal disclosures.

II. Offshore Report

Redemption Yield

The market value duration weighted average redemption yield of the FTSE-BOCHK Offshore RMB Bond Index in December was at 4.44 percent. Among the 3 sub-indexes the FTSE-BOCHK Offshore RMB Investment Grade Index was at 4.38 percent; the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index was at 4.36 percent; the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index was at 4.25 percent as shown in the below chart.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 29 December 2017. Past performance is no guarantee of future results. . Returns shown may reflect hypothetical historical performance. Please see the end for important legal disclosures.

After September, the yield for the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index rose 0.30 percent to 4.36 percent by the end of December. The yield rose 0.24 percent for the FTSE-BOCHK Offshore RMB Bond Index; rose 0.25 percent for the FTSE-BOCHK Offshore RMB Investment Grade Bond Index; and rose 0.43 percent for the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index as shown in the above chart.

Total Return

The FTSE-BOCHK Offshore RMB Bond Index finished up 0.24 percent during the last quarter (September - December), with the FTSE-BOCHK Offshore RMB Investment Grade Bond Index up 0.14 percent; the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index down 0.08 percent; and the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index up 0.24 percent as shown in Table 2.

Table 2. 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	0.24	2.08	4.34	4.34	12.09	24.67	0.61	0.99	1.10
FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index	-0.08	1.95	3.41	3.41	8.18	15.55	0.91	1.11	1.17
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	0.14	2.01	3.84	3.84	9.66	19.13	0.67	1.11	0.89
FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index	0.24	1.60	3.60	3.60	8.68	13.71	0.70	0.85	1.26

*Volatility - 1YR, 3YR, Since Inception based on daily data.
Source: FTSE Russell - total return data in CNH, as at 29 December 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.

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.

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