Research

FTSE Russell China Bond Research Report

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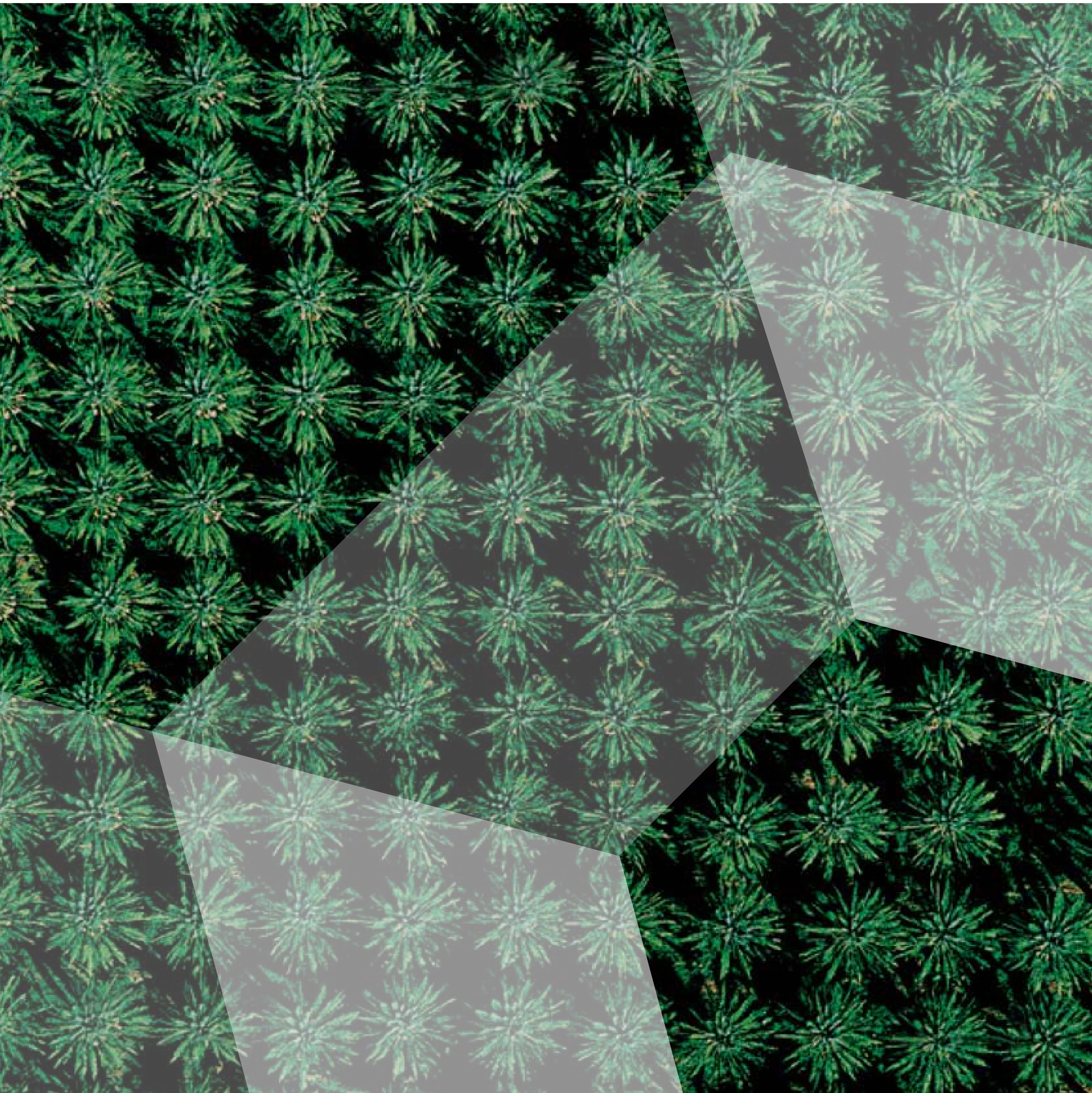


FTSE Russell China Bond Research Report

Highlights

- On August 24 China implemented real-time delivery-versus-payment (DVP) settlement – cleared through China Central Depository and Clearing Co (CCDC) – for the Bond Connect programme. This decision marks the removal of a significant barrier to offshore investment via the scheme for the European Undertakings for Collective Investment in Transferable Securities (UCITS), among other funds, institutions and investor groups.[1]
- The appeal of China government bonds may be increasing as trade tensions are causing capital flight to safer assets, and as China's policymakers support more liquidity in the country's financial system. However, over the past 3 months the benchmark 10-year yield has rebounded by over 15 bps from its early August low point to reach 3.7% at end of September on the back of rising borrowing costs and newly issued government debt.[2]
- Against this backdrop, China may seek to maintain a leading position in green bond issuance, while attempts to harmonise 'green' standards between various regulatory jurisdictions continues. According to a report published by Climate Bonds, global green bond issuance accelerated in Q2 2018, and total aligned issuance worldwide reached USD $76.9 billion for H1 2018. China accounted for 12 percent of the global market over that period – issuing USD $9.3 billion worth of green bonds aligned with international green bond definitions.[3]

1 Reuters. August 2018.
2 FTSE Russell. October 2018.
3 Climate Bonds. June 2018.

Chapter 1: Overview

DVP settlement scheme could boost Bond Connect following slow start

Now more than a year old, China's recently opened Bond Connect access channel fostered a new sense of optimism among international investors when it launched in July 2017, but the programme got off to a slow start due in part to the challenge of linking jurisdictions with different administrative rules and governance standards.

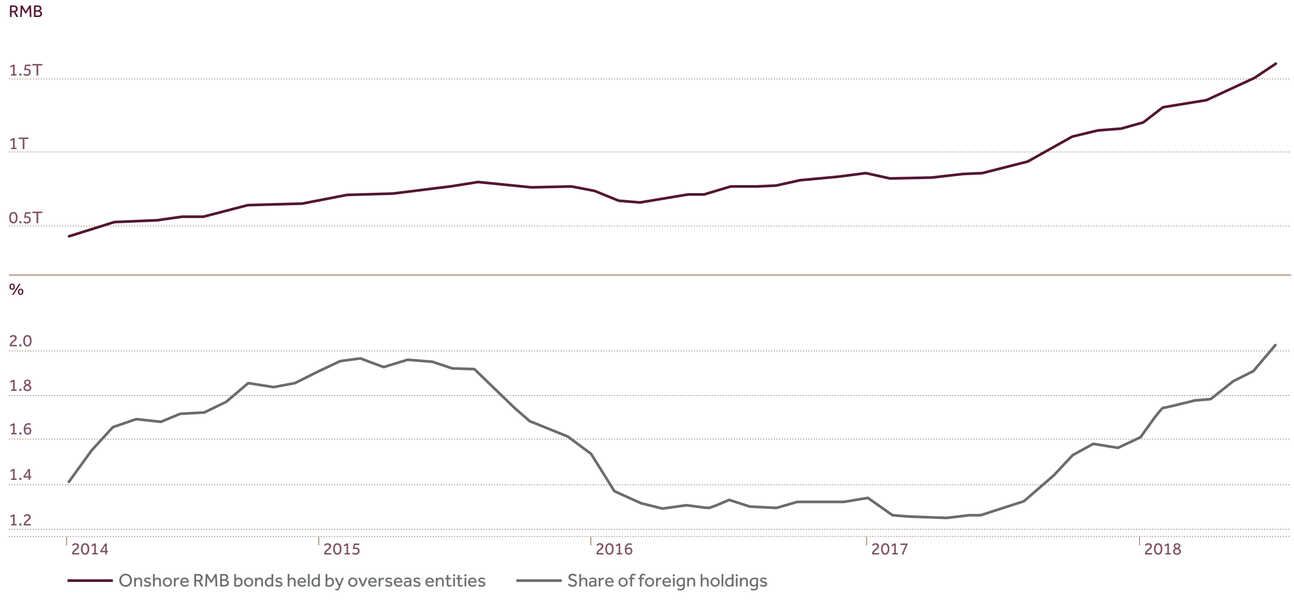
Moving into 2019, that may change due to new reforms. On August 24, China implemented real-time delivery-versus-payment (DVP) settlement – cleared through CCDC – for the cross-border investment programme. This decision marks the removal of a significant barrier to offshore investment via Bond Connect for the European Undertakings for Collective Investment in Transferable Securities (UCITS), among other funds, institutions and investor groups.[4]

The move could potentially increase foreign appetite for China's debt, as investors will no longer have to "prefund the onshore broker before delivery."[5] With payment upon delivery, settlement risks could be reduced significantly.[6] At the same time there are also other positive announcements around the availability of block trading as well as clarification that income tax and VAT would be exempted for 3 years for non-government bonds. (Note that tax exemption for government bonds and local government bonds had been clarified previously). Against this backdrop of market operational enhancements and tax framework clarity, investors who are interested in the China government bond market are also keeping a close eye on the practicalities of bond liquidity and currency hedging.

On the foreign access channel front, as of end-July roughly 400 foreign accounts were registered with the Bond Connect.[7] Meanwhile, foreign investors in Q3 boosted their positions in China government bonds by 143.8 billion RMB to 1.06 trillion RMB ($153 billion). Offshore holdings of China's government bonds breached 1 trillion RMB for the first time to a record high in August.[8]

4 Reuters. August 2018.
5 The Trade News. August 2018.
6 The Trade News. August 2018.
7 Bloomberg. August 2018.
8 Wind. October 2018.

Foreign Holdings of RMB Bonds on the Rise



Source: Bloomberg, September 2018.

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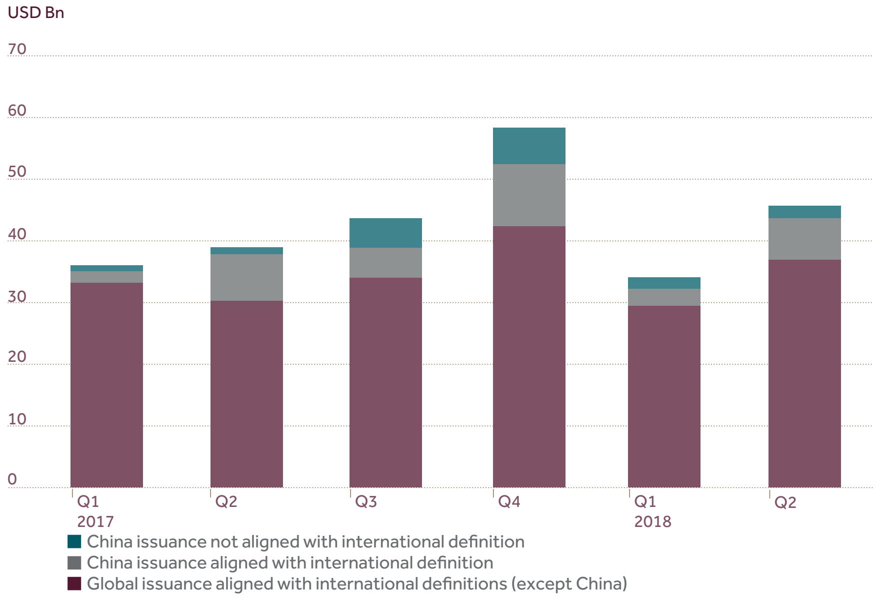
9 FTSE Russell. October 2018.

Chapter 2: Multiple shades of green

As interest in and access to China bonds increases, China's green bond sector may also benefit. This year China topped the green bond country ranking in terms of amount outstanding ahead of the US according to a market report published by Climate Bonds (excluding MBS securities).[10] In terms of new green bond issuance, global green bond issuance accelerated in Q2 2018, and total aligned issuance worldwide reached USD $76.9 billion for H1 2018. China accounted for 12 percent of the global market over that period – issuing USD $9.3 billion worth of green bonds aligned with international green bond definitions.[11]

China vs. Global Green Bond Issuance



Source: Climate Bonds, June 2018.

At a glance

Total H1 Chinese issurance:
USD 13.02bn/RMB84.4bn
Onshore issuance:
USD 7.77bn/RMB49.4bn
Offshore issuance:
USD5.25bn/RMB35bn
Issuance that meets international definitions:
USD9.29bn/RMB60.75bn
Certified Climate Bonds:
USD2.57bn/RMB17.33bn
Largest issuer:
Industrial and Commercial Bank of China (London)
Largest issuing sector:
Renewable Energy

Currently the PBOC and NDRC grant the 'green' designation to a range of projects that do not conform to international standards, including (1) retrofits to fossil fuel power stations; (2) 'clean' coal; (3) electricity grid transmission; (4) infrastructure that carries fossil fuel as well as renewable energy; and (5) large (>50 MW) hydropower electricity generators.[12]

However, despite these challenges, moving into 2019 China's policymakers would likely continue with their attempts to harmonise the varying definitions of 'green' to boost investor appetite for the asset class, and raise China's status as a pioneer in green finance.

On that basis, China's policymakers have recently committed to a raft of new policies. In March, for example, the PBOC tightened the supervision of green bonds issued by financial institutions. Only a few months later in June, the PBOC said the Medium-Term Lending Facilitation (MLF) will include green bonds and green loans as eligible collateral, allowing green bonds to take their place among policy bank bonds, central bank bills, and AAA corporate bonds, among other accepted forms of collateral.[13]

10 Climate Bonds. October 2018.
11 Climate Bonds. June 2018.
12 Climate Bonds. January 2017.
13 Climate Bonds. June 2018.

Chapter 3: Defaults and rising yields

While they launch 'green' reforms and other reform initiatives, China's policymakers are also trying to control the spread of excessive lending and leverage at a time when both yields and corporate defaults are rising. According to Wind, Chinese companies have defaulted on USD $11.5 billion worth of bonds this year through the first three quarters, nearly doubling the value of the entire year in 2017.[14]

In addition to corporate defaults, a government-linked holding company has also registered its first default. This default came in August, when an investment arm of China's Xinjiang region, the Sixth Agriculture State-Owned Assets Management Co, failed to repay a 500 million RMB ($73m) bond.[15]

Meanwhile, according to some analysts, rising yields for lower rated companies (AA-) – now nearing seven percent – may make it difficult for companies to refinance maturing debt given the borrowing costs.[16]

Yields Rising on AA- Debt

Source: Bloomberg, July 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

14 Wind. September 2018.
15 Financial Times. August 24.
16 Bloomberg. July 2018.

Chapter 4: Performance of FTSE Russell China Bond Indexes

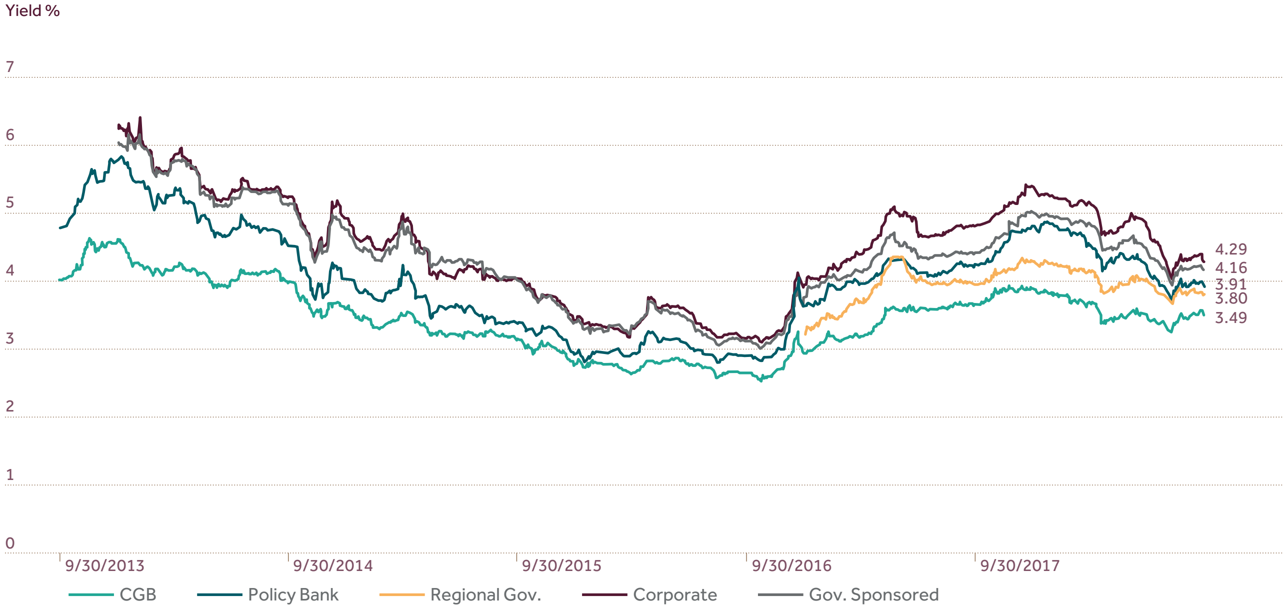
Onshore Report

Yield

Five major sectors are covered in FTSE Chinese (Onshore CNY) Broad Bond Index (CNYBBI). The yield of the CNYBBI as of end-September was 3.83%. Among the five major sectors, the Government Bond (CGB) sector was at 3.49%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 3.91%; the Regional Government sector was at 3.80%; the Corporate sector was at 4.29%; the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 4.16% as shown in the chart below.

For 2018 Q3, the yield of CNYBBI decreased by 18.94bps with corporate spread tightened by 55.29bps.

Chart 1. The Historical Yield of 5 Sectors in CNYBBI Sectors



Source: FTSE Russell, data as of September 28, 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Total Return

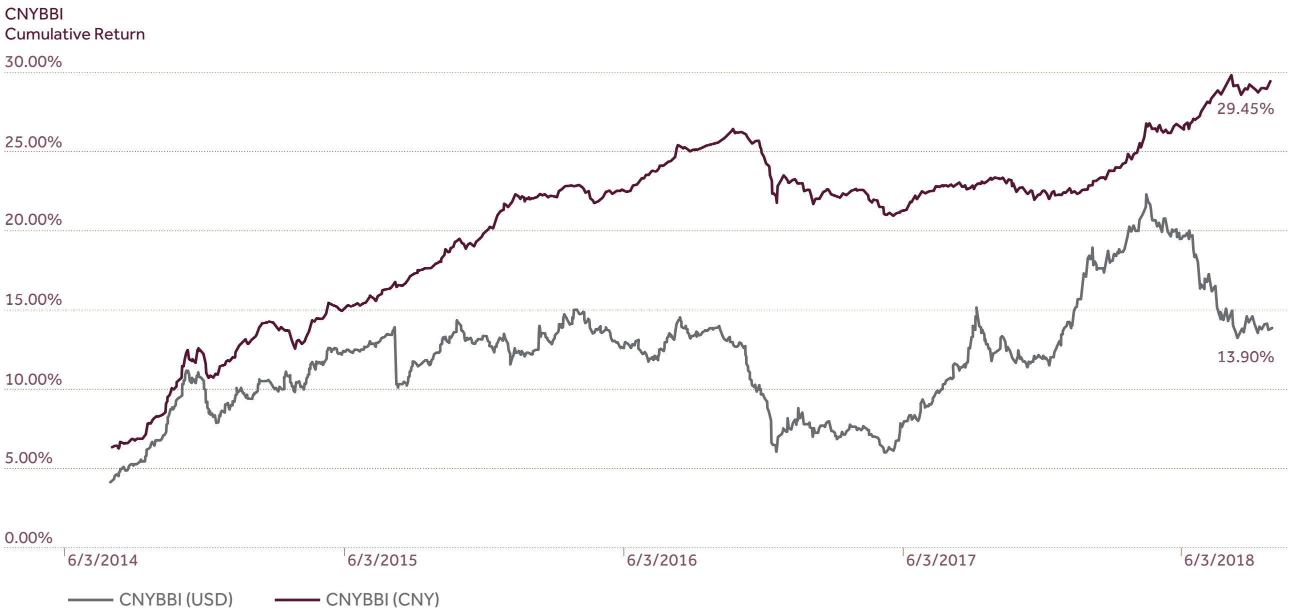
The CNYBBI in USD unhedged terms finished down just -2.30% while its return in CNY finished up 1.46% during the last quarter. CNY deppreciation was the main driver in the same period. The returns of some sectors are shown in Table 1 and the cumulative return in USD and CNY are shown in Chart 2.

Table 1. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD, unhedged)					Annualized Volatility (USD, unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
CNYBBI	-2.30	-4.98	1.40	1.46	NA	4.48	3.85	NA
CGB	-3.21	-6.03	0.82	0.47	10.10	4.63	4.03	3.73
Policy Bank	-1.97	-4.24	1.74	1.55	12.96	4.57	4.02	3.79
Corporate	-1.51	-4.40	2.44	3.95	NA	4.35	3.69	NA

Source: FTSE Russell - total return data in USD, as of September 28, 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Chart 2. CNYBBI Performance in USD vs in CNY Since Inception Date on 2013/12/31



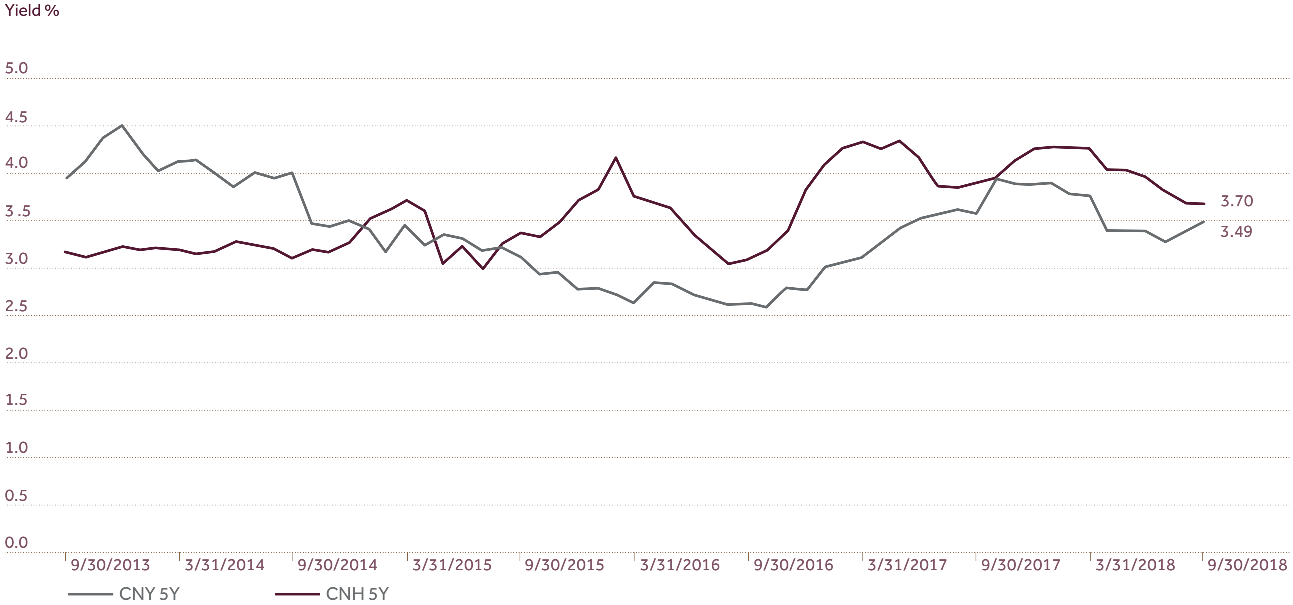
Source: FTSE Russell - total return data in USD and CNY, as of September 28, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds

Yield

The yield of onshore 5 year Sovereign bonds was at 3.49% and the yield of offshore 5 year Sovereign bonds was at 3.70% as of end of Q3. The spread tightened by 37bps for Q3 of 2018 as shown in Chart 3.

Chart 3. Onshore 5 Year Yield vs Offshore 5 Year Yield



Source: FTSE Russell as of September 28, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

As of end of Q3 2018, the Offshore Chinese Treasury Yields were higher than the Onshore Chinese Treasury Yields over the entire curve. The short end curve 1 year spread was 54bps and the long end curve 10 year spread was 28bps.

Total Return

The FTSE Chinese Government Bond Index underperformed the FTSE Offshore counterpart during Q3 2018 as shown in Table 2.

Table 2. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD, unhedged)					Annualized Volatility (USD, unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Chinese Government Bond Index (Onshore CNY)	-3.21	-6.03	0.82	0.47	10.10	4.63	4.03	3.73
FTSE Chinese Government Bond Index (Offshore CNY)	-2.15	-5.37	1.07	2.96	4.15	5.15	4.50	4.13

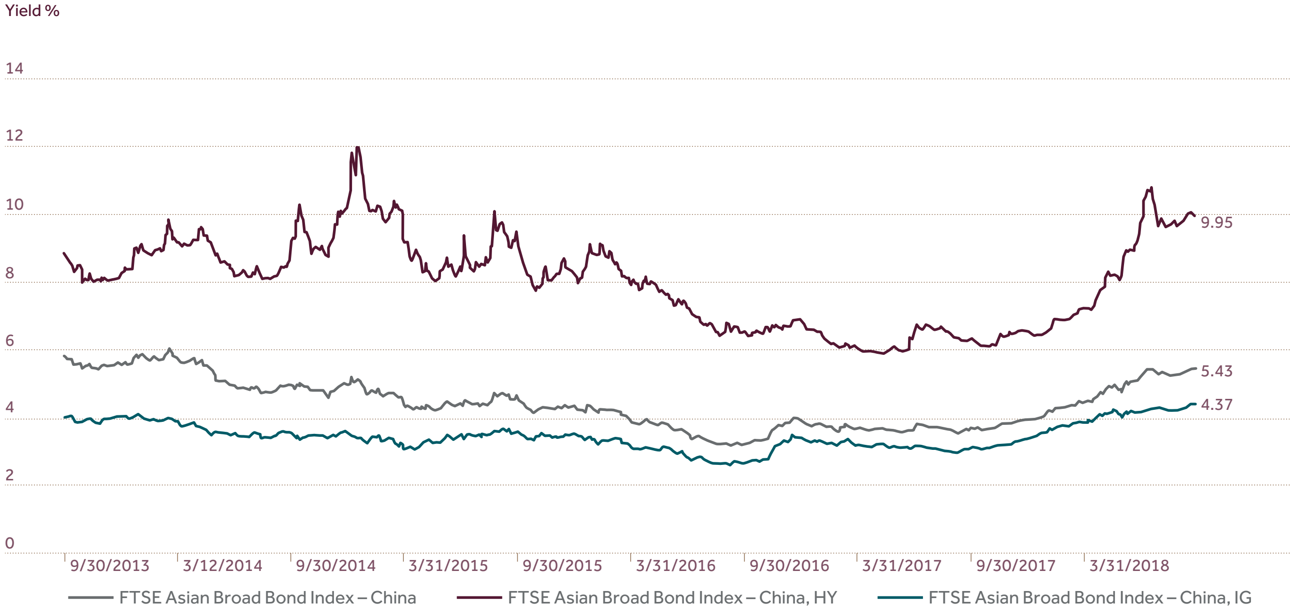
Source: FTSE Russell, total return data in USD, as of September 28, 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures. FTSE Chinese Government Bond Index (Offshore CNY) is a sub-index in the FTSE Dim Sum (Offshore CNY) Bond Index.

USD Bonds Issued by Chinese Issuers

Yield

The yield of the FTSE Asian Broad Bond Index - China was at 5.43%. Among the two sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade Index was at 4.37%; the FTSE Asian Broad Bond Index – China, High-Yield Index was at 9.95% as shown in the below chart.

Chart 4. The Yield of FTSE Asian Broad Bond Index - China and Sub-Indexes



Source: FTSE Russell - total return data in CNY, as of September 28, 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Total Return

The FTSE Asian Broad Bond Index-China finished up 0.71% during the last quarter, with its Investment-Grade sub-index up 0.40% and its High-Yield sub-index up 2.07%.

Table 3. Performance and Volatility – Total Return

	Cumulative Return (USD, unhedged)					Annualized Volatility (USD, unhedged)		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Asian Broad Bond Index – China	0.71	-0.09	-0.93	11.66	25.54	1.48	1.85	2.22
FTSE Asian Broad Bond Index – China, IG	0.40	0.42	-0.73	9.60	22.84	1.63	2.07	2.42
FTSE Asian Broad Bond Index – China, HY	2.07	-2.73	-1.80	22.92	39.10	2.73	2.63	4.

Source: FTSE Russell - total return data in USD, as of September 28, 2018. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

For more information about our indexes, please visit ftserussell.com.

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