Guide to the Chinese Fixed Income Markets

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A Guide to the Chinese Fixed Income Markets

Investors around the world are increasingly curious about the Chinese fixed income market, which at USD 13.5trillion is now the world's second largest[1]. Many investors will also find themselves owning Chinese bonds as funds tracking global bond benchmarks incorporate Chinese bonds, which many have announced they plan to do.

Chinese fixed income instruments will be more prevalent in international investors' portfolios. However, many are unfamiliar with the rapidly changing dynamics in parts of the market, as well as with the feasibility of adding these instruments to a portfolio. To aid in this conversation, and to share our insights on the Chinese fixed income universe, we present this series of papers. These pieces can be read individually to shed light upon a particular aspect of Chinese fixed income investing, or taken collectively, they offer a more complete exploration of the Chinese fixed income market for the international investor.

We divide this conversation into the following topics:

1. The executive summary: 10 reasons to explore Chinese onshore bonds
2. Bond market basics: What is the Chinese fixed income universe?
3. Characteristics of Chinese bonds
4. Chinese bonds go global
5. Common questions about the Chinese fixed income market

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[1]Source: Bloomberg Global Debt Map, October 2019.

EXECUTIVE SUMMARY

In Brief

- China's fixed income landscape is vast: The market represents USD 13.2trillion in value[2].
- Investors have been able to access the offshore and foreign currency listed portions of this market for many years now, but are gaining access to the onshore market. Onshore bonds represent over 90% of this market[2].
- Changes to access, ratings, and investor needs make portions of this onshore market relatively attractive.
- This market is rapidly changing, making constant monitoring and thorough research essential to successful investing in China's fixed income market.

Behind the headlines

Chinese debt has made headlines in recent years, although rarely for good reasons. Concerns have risen about the absolute level of debt outstanding. Estimates currently place China's total borrowing as a percent of nominal gross domestic product (GDP) at 259%[3]. This level is comparable to a number of developed markets and, as a solitary statistic, is not an outright concern.

What worries some investors, and generates the majority of headlines, is the speed with which China's debt burden has risen to this level. The stimulus efforts undertaken in response to the 2008 Global Financial Crisis (GFC) spurred a rise in China's debt level from 140% of GDP in 2007 to today's present heights.

The speed of this increase, combined with the fact much of this debt has been created in the more opaque shadow banking system, prompted worries about financial stability, specifically, China's ability to pay back these liabilities at a time when growth is slowing. These rising fears and greater international access may seem like the worst possible backdrop against which to begin a conversation about investing in Chinese fixed income. However, the twin efforts of promoting financial liberalization and financial stability with an already high debt load have created an opportunity for investors. Further liberalization will mean yields are likely to remain above those offered on many other countries' similarly rated sovereign debt, even as yields remain low around the world in coming years.

The efforts to promote financial stability in a high debt society will support issuance in the bond market in the years to come—only a fraction of China's debt is currently in the form of bonds—and greater investor ownership of this debt as it is securitized and listed will further China's financial liberalization. As contradictory as these views seem, an understanding of Chinese debt and the Chinese bond markets (which are different things), and how asset markets in China will change over the next few years, requires consideration of different dynamics in each.

These factors combine to create a relatively attractive emerging bond market from a diversification, if not overall return, standpoint for foreign currency-based investors. That is, if you narrow the fixed income universe available in China down substantially.

Today's market

Several recent changes in China have furthered the investability of onshore bonds, which over time will be part of the tools China uses to promote financial stability, while also offering a new investment frontier to global fixed income investors. Notably, among these developments we will highlight: the efforts of the Chinese regulators to increase the accessibility of the onshore bond market to foreign investors since 2002, the ongoing internationalization of the Chinese renminbi, recognition of international ratings agencies and the gradual inclusion of Chinese onshore bonds into major fixed income benchmarks.

Yet, international investors still face hurdles in making significant allocations to onshore Chinese bonds. Offshore bonds also present several of their own challenges.

In summation, China's market looks more attractive and is more accessible for long-run-focused investors than it has been at any point before, but international investors may want to proceed with caution.

This is only the first step in understanding Chinese fixed income. We provide our key takeaways on the following pages, and upcoming papers will explore these topics further.

We have identified ten key considerations for investing in the Chinese fixed income universe.

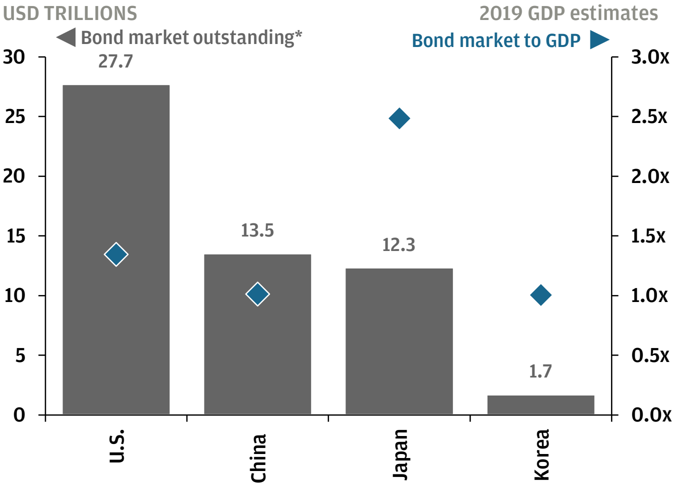
[2]Source: ASIFMA, Bloomberg Finance L.P., J.P. Morgan Asset Management. Data as of December 31, 2018.
[3]Source: Bank for International Settlements data on total credit. As of 1Q19.

10 key considerations for investing in the Chinese fixed income universe

1. **It's just too big to ignore**: China is a country of many superlatives. It is the second-largest world economy and may soon become the first, it is the first contributor to global growth, and it already has the second-largest bond market in the world.

China's bond market is the world's second largest

EXHIBIT 1: BOND MARKET SIZE IN VALUE AND AS % OF GDP



Source: Bloomberg Finance L.P., International Monetary Fund, J.P. Morgan Asset Management. *Bond market outstanding refers to the total U.S. dollar value of bonds (corporate and government) in the market and does not reflect mandatory prepayment. Data reflect most recently available as of 31/10/19.

Its bond market is big, but bonds and debt are different things. And China's bond market represents a small share of China's total debt, which is an important nuance when considering investing in the public bond market.

Additionally, there is a nuance within China's bond market: it's actually three different markets. Investors can buy Chinese bonds listed onshore and priced in Chinese renminbi. This market is the largest by far, valued many multiples the other two segments of the market combined. Investors can also buy Chinese debt issued in offshore Chinese renminbi, listed in an offshore clearing center like Hong Kong. The third market is the foreign currency segment of China's debt universe. These bonds, largely denominated in USD, are overwhelming corporate issuers and make up a significant portion of the Asian high yield credit universe, although they do not represent a large portion of China's overall bond market.

2. **China is being added to major equity and fixed income benchmarks:** Over the last two years, major benchmark providers have started to include China into their benchmarks. As a result, flows into Chinese domestic equity and bond markets combined are expected to reach approximately USD 450billion[4]. The bond market will be the biggest recipient of these flows (we estimate around two-thirds). These flows will follow the planned increase of China's weight in global bond aggregates. According to Bloomberg Barclays' plans for incorporating Chinese bonds into its commonly referenced Global Aggregate Bond Index, China's weight will reach roughly 6% by the end of 2020. China's weight in emerging market-specific indices will be even higher.

3. **Higher allocations to Chinese assets mean greater currency diversification:** Getting exposure to domestic Chinese asset markets means getting Chinese renminbi exposure. The Chinese renminbi became a reserve currency in 2015, but so far has not gained significant traction in terms of usage. This could change now that investors have access to several assets priced in Chinese renminbi. The flows triggered by benchmark inclusions should support the currency over time.

4. **Increasing accessibility for foreign investors:** The relatively new Bond Connect scheme represents a major breakthrough as it allows foreign investors to trade Chinese bonds more easily and freely than ever before. They can now proceed through an offshore account and are no longer subject to restrictions like quotas or lock-up periods.

   Presently, the number of international investors using the Bond Connect scheme has risen well above the number of investors using previous programs. Some of these older programs, such as the Qualified Foreign Institutional Investors (QFII) and the RMB Qualified Foreign Institutional Investors (RQFII), are also undergoing reforms. Recently, investment limits were lifted for both the QFII and the RQFII.

[4]Source: International Monetary Fund Global Financial Stability Report, April 2019.

5. **International rating agencies are increasing their onshore coverage:** Standard & Poor's Global Ratings, Moody's Investor Services and Fitch Ratings have covered China's central government debt for some time, but their coverage has not extended to most onshore issuers due to regulations barring their involvement in the onshore market.

   This is about to change as S&P has become the first international rating agency to be given access to the Chinese market, while Moody's and Fitch are applying for licenses as well. Over time, this should reinforce the transparency of the Chinese onshore markets and be a standardizing influence on locally provided credit ratings.

   Investors will need to keep in mind that such agencies will still be operating within the domestic market and subject to the same regulatory landscape of the Chinese companies they rate, which will necessarily require some adjustment to their evaluations to take into account local dynamics. However, in our view, the biggest benefit of the major international agencies having a presence in the local market is the additional confidence they can offer international investors in interpreting locally issued ratings and in appropriately pricing the known risks.

6. New duration opportunities: China's Ministry of Finance manages the Chinese yield curve actively through frequent auctions of Chinese Government Bonds (CGBs) all along the curve from three months up to 50 years. This is not the case in every emerging market (EM), where action can be less frequent and maturities issued are not as evenly distributed. However, trading activity is overwhelming concentrated in the 3-month to 3-year portion of the yield curve. In this context, CGBs may offer a convenient way for EM bond investors to manage the duration of their portfolios. Duration management requires tradability across different tranches of the yield curve, and many EM sovereign bonds are more represented in the mid-maturity segment of the market.

7. **Management of risks is largely possible, since many risks are identifiable:**

   a) Sovereign debt sustainability: At a country level, Chinese debt sustainability looks higher than that of many of its EM and developed market (DM) peers. This is reflected by China's long-term credit rating, which remains firmly in investment grade territory, as judged by the three main international rating agencies. Additionally, the lack of foreign currency debt maintains stability in government accounts compared to other Asian EMs. Government debt is not the source of debt worries in China.

   b) Liquidity: Currently, the liquidity of the CGBs market is much lower than for other major bond markets. According to the China Foreign Exchange Trade System (CFETS) trade volume data, 60% of trading activity in the interbank CGBs market is in newly issued bonds, meaning liquidity dissipates when bonds are no longer on the run.

   c) Currency: A volatile Chinese renminbi has certainly spooked many investors this year. But the government's tolerance for truly large swings in short order is limited and the government seems unlikely to loosen the reins in the foreign exchange market. Rising portfolio inflows as a result of benchmark inclusions and increasing internationalization should also support the Chinese renminbi.

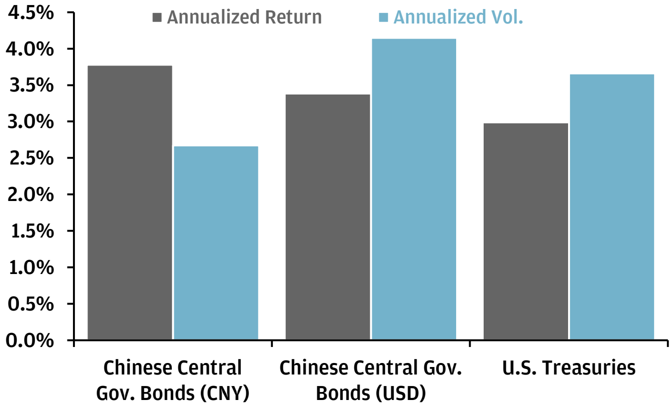
   d) Corporate credit risk: This is probably the biggest risk facing investors in the Chinese onshore bond market. The arrival of international rating agencies in China should help investors better monitor credit risks in the future. In the meantime, conducting thorough research into each individual issuer is an absolute must. That is, if an investor can even gain access to corporate bonds. Extremely low liquidity means the secondary market is tiny in comparison to the size of the corporate securitized debt market.

8. **Risk and return profile**: Over the last 10 years, Chinese bond prices proved to be less volatile than those of U.S. Treasuries with similar maturities while offering similar returns, as shown in **Exhibit 2**. Investors should note that this holds true for local currency returns. Chinese bond investment returns translated back into U.S. dollars, while higher than in onshore Chinese renminbi, provide a more variable volatility outlook due to the fluctuations of the renminbi. How this consideration applies to individual investors will depend on which currency investors plan to bring their returns home in and whether or not they have access to currency hedging strategies.

Chinese central government bonds offer higher returns, volatility depends on currency

EXHIBIT 2: GOVERNMENT BONDS ANNUALIZED RETURN AND VOLATILITY

CHINESE CENTRAL GOVERNMENT BONDS, U.S. TREASURY BONDS, TOTAL RETURN INDEX



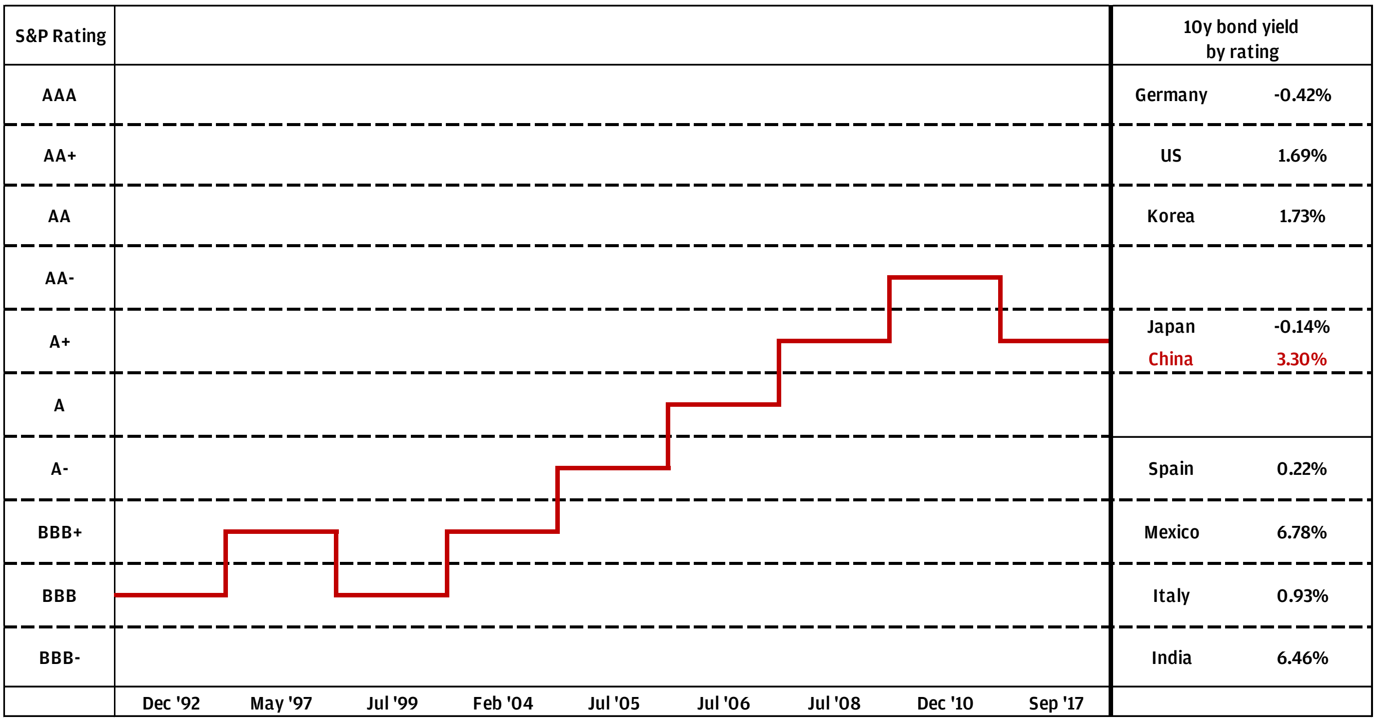
Source: Bloomberg Finance L.P., J.P. Morgan Asset Management. Total return indexes are unhedged. Returns shown are 01/01/10 to 31/10/19. Past performance is not a reliable indicator of current and future results. Data reflect most recently available as of 31/10/19.

The return potential of the Chinese onshore bond market is likely to increase as foreign portfolio flows, driven by benchmark inclusions, could support bond prices and further develop the market for longer maturities. China generally offers higher yields than similarly rated peers, another factor pulling in foreign investment.

Chinese government bonds carry higher yields than similarly-rated peers

EXHIBIT 3: EVOLUTION OF CHINA'S SOVEREIGN RATING AND SELECTED 10-YEAR GOVERNMENT BOND YIELDS

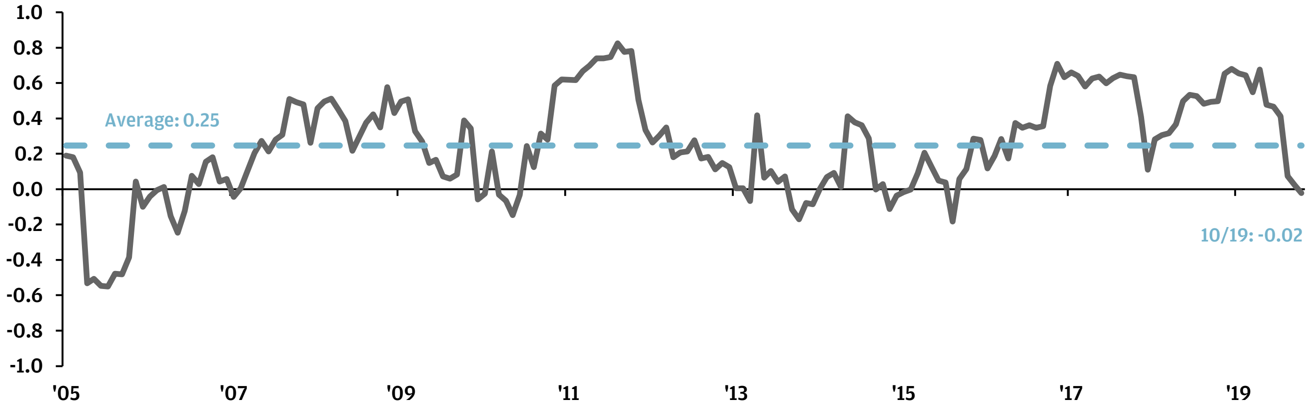
RATING OF CHINA'S LONG-TERM GOVERNMENT DEBT



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Data reflect most recently available as of 31/10/19.

9. **Diversification**: An allocation to Chinese onshore government bonds would generally have provided a decent level of diversification to foreign investor fixed income allocations. Indeed, as shown in Exhibit 4, the correlation between CGBs and global government bonds has, on average, hovered around 0.25 over the past 15 years.

Diversification is an attractive element of Chinese government bonds
EXHIBIT 4: CORRELATION BETWEEN CHINESE AND GLOBAL GOVERNMENT BONDS
Unhedged USD total return index*, 12-month rolling correlations



Source: Bloomberg Finance L.P., J.P. Morgan Asset Management.
*Indexes are Bloomberg Barclays Global Government Bond Index and Bloomberg Barclays China Onshore Government Bond Index. Past performance is not a reliable indicator of current and future results. Past performance is not a reliable indicator of current and future results. Data reflect most recently available as of 31/10/19.

10. **Active outperformance potential**: Active management tends to thrive in inefficient and immature markets, two characteristics of the Chinese onshore bond market. On one hand, the market is evolving rapidly and becoming ever more accessible to individual investors. On the other hand, these changes are happening unevenly across different segments of the market and there are many China-specific dynamics to the fixed income market that may require specialists to navigate.

    Even though this market is already the second-largest bond market in the world, it has remained almost entirely contained onshore, closed to all but the largest institutional foreign investors. As a result, market dynamics often operate in ways unique to China, which require deep research and expert management to successfully take advantage of the opportunities present onshore.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions.

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