An introduction to China fixed income

Key Takeaways

- China fixed income is a significant part of the global bond market and is now too big to ignore for many fixed income investors.
- China offers a diverse range of opportunities across its hard currency offshore market, its local currency offshore "Dim Sum" market, and its fast expanding local currency onshore market.
- The domestic bond market, which is China's largest and least well known internationally, is biased towards local policy banks, local governments and state-owned corporates, providing a differentiated opportunity set to China's offshore bond market, which is home to many multinational and private company issuers.
- While the potential impact of structural reforms and new regulations, as well as liquidity risks, are concerns, China's onshore bond market provides a compelling yield-to-volatility opportunity, helping investors diversify portfolios without compromising income.

Foreign capital has played a vital role in China's ascendence to the second largest economy in the world[1]. We believe that it will also play an important role in China's future success as well. While the country's equity story is well known to investors, the fixed income opportunity's continued evolution increasingly demands attention.

Defining the opportunity in China fixed income

The development of Chinese bond markets has tracked that of the country's wider economy. As China's economy has grown, so too has its bond market capitalisation, both in onshore and offshore markets. The rapid nature of this growth, combined with China's closed capital account, has created structural idiosyncrasies that reflect a complex marketplace.

Offshore hard currency	Offshore local currency	Onshore
Generally investment grade issuers.	Dominated by rates products, such as sovereign bonds and PBOC bills.	Diverse range of issuers, with a growing corporate weighting.

One country, three bond markets

Today, China's bond market is really three markets in one: an offshore hard currency market, an offshore local currency market, and an onshore local currency market. The three markets that compose the Chinese fixed income opportunity are distinct from one another. The offshore hard currency market offers Chinese issuers the ability to access hard currency, while the offshore local currency market is relatively small and dominated by sovereign issuers. The onshore local currency market, meanwhile, forms part of the domestic financial system's core infrastructure. At present, there is a scale difference in issuance between the local and offshore markets, with local government, policy banks and local corporate issuers all tapping the domestic option.

Bond Connect

Unsung in the development of China's debt markets is Bond Connect, the country's mechanism for onshoring international capital flows. The platform's introduction in 2018 smoothed international access to the domestic fixed income market, thus enabling greater international capital allocation to Chinese onshore bonds. Widely embraced by international investors, Bond Connect's success has resulted in steadily increasing transaction volumes since its introduction. In March 2022, Bond Connect reached 3,500 investors transacting RMB 648 trillion in flows, having reached an all-time high of RMB 781 trillion in January 2022[2].

[1] Source: World Bank, 2021
[2] Source: HSBC, May 2022.

China offshore hard currency

USD 558 billion
Offshore China JACI issuance[2].

The most established of China's three bond markets, in the eyes of international investors, is the Chinese offshore hard currency credit market. Tracked by a widely followed index (JACI – the J.P. Morgan Asia Credit Index), the market offers opportunities in US dollar bonds issued by Asian sovereign, quasi sovereign and corporate borrowers. The offshore hard currency market reflects the wider China sphere and includes issuance from China, Hong Kong, Macau, Philippines, Taiwan and others. JACI China, a dedicated sub index devoted exclusively to Chinese issuers, represents around 45% of the total market capitalisation of the Asian hard currency credit opportunity. The market has some 985 issuers, with an average maturity of just under seven years and a yield to maturity of 6.2%, as of May 2022[4]. Like JACI as a whole, the bulk of JACI China is investment grade corporate issuance.

China offshore local currency (Dim Sum)

Of the three markets that present the Chinese fixed income opportunity, the offshore local currency market is the smallest. Sometimes called the "Dim Sum" market, this space is composed of bonds issued in offshore Renminbi – CNH – as opposed to the onshore market's CNY. In recent years, the CNH market has become dominated by rates products, with sovereign bonds and PBOC (People's Bank of China) bills gaining market share. Similar to local currency bonds everywhere, Dim Sum bond returns are a function of both local rates and the performance of the currency. The space's smaller size can sometimes contribute to it being overlooked, and although the overall market size is declining, it does provide selected opportunities that should not be ignored.

China onshore local currency

RMB 135 trillion
Onshore China total bond issuance[2].

China's onshore bond market is the largest of the three components, though simultaneously the least well known among international investors. It is a higher yielding, largely investment grade marketplace used by issuers as diverse as local policy banks, local governments and corporates. Nevertheless, the market remains less efficient than comparable international markets. Of the market's RMB 135 trillion total issuance, government and policy bank issuers account for some RMB 111 trillion[3], though the corporate component is growing rapidly. As a result of strong domestic institutional sponsorship, Chinese onshore bonds offer a compelling yield-to-volatility opportunity, which helps institutions diversify risk without compromising income.

Perhaps the most interesting arena within the onshore market is the corporate space. At present, it is almost entirely composed of bonds issued by state owned enterprises, representing RMB 20 trillion of the RMB 21 trillion[3] market. In this regard, the onshore market presents a totally different profile to the Chinese offshore market, which includes multinationals, private companies, and

2. Source: HSBC, May 2022.
3. Source: HSBC, December 2019.
4. Source: JPMorgan Chase, May 2022.

other issuers in a greater proportion. Many onshore, state-owned enterprises are industrials or infrastructure companies, reflecting the Chinese government's focus on generating growth through development. Of these, ratings are heavily skewed to investment grade: some RMB 39 trillion in issuance is locally rated AAA, versus only RMB 16 trillion that is locally rated BBB+ or below; this includes RMB 4 trillion of locally unrated debt[3].

In our view, the domestic bond market is likely to develop further as it enables Chinese banks and corporate buyers to access capital more efficiently. For this reason, we think it likely that China will continue to welcome foreign investors, and the rating agencies that accompany them, though we expect local and international ratings to continue their divergence in the near term.

Divergent performance profile

China's prevalent diversity in fixed income reflects the different investor bases and thus leads to different performances, as illustrated in the first half of 2022, when the country's zero tolerance approach to Covid-19 and severe lockdowns in both Beijing and Shanghai impacted Chinese assets. The Beijing-Shanghai industrial corridor is one of the world's leading economic engines, meaning the policy has had a negative impact on global growth.

8%

China's weighting in the Bloomberg Barclays Global Aggregate Index[2].

The developments in the first half of 2022 had divergent impacts on Chinese fixed income assets, and the resulting performance helps illustrate their distinctions. The offshore hard currency JACI China slipped 8.2% for the year through to end April 2022[4], underperforming CNY and the CNH bonds ("Dim Sum") as local sentiment remained more supportive of onshore fixed income. Investor pessimism appeared more heavily resident in the offshore space, as onshore investors continued to show a positive bid for both AAA and AA rated Chinese corporate bonds, which also outperformed Chinese local government bonds in the period.

Within the hard currency space, investment grade showed greater resilience than equivalent high yield names. The spread between offshore Chinese investment grade bond yields and onshore AA rated China Bond yields widened as a result – by mid May 2022, spreads had reached 154 basis points (Bloomberg, May 2022), one of the widest levels we have seen in seven years. A key feature of this onshore resilience is that new issuance in the market continued, with April 2022 onshore issuance reaching RMB 11 trillion[4], roughly the same as a year earlier.

This divergence between onshore and offshore marketplaces creates an opportunity for global asset allocators. China today represents just under 8% of the Bloomberg Barclays Global Aggregate, making it too large for international asset allocators to ignore. For institutional aggregate managers operating with relatively low levels of tracking error, China is a new and sometimes challenging marketplace. Aggregate managers are coming to see Chinese onshore bonds as a source of attractive yield at relatively lower volatility, but what may lead them to allocate is the lower correlation with other members of the index. While this quality may erode as inflows increase, at present, it may elevate interest in the space.

2. Source: HSBC, May 2022.
3. Source: HSBC, December 2019.
4. Source: JPMorgan Chase, May 2022.

Accessing the opportunity

For investors seeking to access the Chinese bond market opportunity, we see several potential avenues. Given the size, complexity, and less researched nature of the onshore opportunity, we think it makes sense to access the onshore market through either actively managed or quantitative strategies.

For many investors, the complexity of securing an account with Bond Connect may elevate the appeal of a pooled or fund route. While this approach reduces the ability of the investor to fine tune the available beta, the ability to rapidly access the market may outweigh this.

For retail investors seeking to gain exposure to the space, we think a strategy that offers the ability to select from all three of the major components may provide an attractive way to access the opportunity. For institutional investors, an aggregate strategy that focuses on more liquid, internationally rated issuers should prove well positioned to adapt to future developments, especially as the market for Chinese corporates continues to increase in profile.

What next for Chinese bonds?

In our view, Chinese bond markets are likely to continue to develop at an accelerated pace. A stated Chinese policy goal sees the country attaining a middle-class income level by 2050, a pace of growth that requires material levels of investment to achieve. Consistent with this goal is China's desire to become the largest economy in the world, an objective which requires doubling its GDP per capita over the next decade. As a result, China will support high growth areas of the economy while enacting reforms on other areas that need to be constrained. Chinese policymakers recognise the importance of both bond markets and foreign portfolio investment in meeting these objectives.

While the investment case for Chinese fixed income is strong, it is not risk free. Among the key factors that could affect our long-term assumptions for Chinese assets are the pace of structural reforms, policies seeking to rebalance efficiency and equality in the economy, liquidity, and the external environment. For investors looking for sustainable fixed income exposure, China remains a selective arena, though new issuance is creating more opportunities. Within the ESG (environmental, social and governance) space, China's policies have demonstrated some progress, and as more local corporates seek international ratings, we expect greater levels of ESG awareness to develop within the corporate community.

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