



BlueBay
Asset Management

Accessing China's bond markets

THE BLUEBAY GLOBAL MACRO INVESTMENT TEAM



In February 2020, JP Morgan began including Chinese government bonds in its Global Diversified Index – Emerging Markets Global Diversified (GBI-EM) at a rate of 1% per month until China reaches the single-country ceiling of 10% in November 2020. China is the 20th country to feature in the index. Since April 2019, Barclays Global Aggregate Index also began including Chinese government bonds with China's weighting expected to reach 6% by the end of 2020.

Our team of macro experts talk through the logistics around the inclusion and the potential implications for bond market investors.



ZHENBO HOU
EM SOVEREIGN STRATEGIST



Does the opening of the Chinese bond market imply a relaxation of capital controls?

We believe the opening of China's bond market is integral to its broader capital account liberalisation strategy, which has been gradual, sequenced and asymmetric. According to IMF forecasts (WEO Sept 2019), China's current surplus as a percentage of GDP might fall below 1% in 2020, from close to 10% in 2007, due to a healthy rebalancing of the economy from exports to consumption and the inevitable rise of overseas tourism spending and so on.

The development of China's bond market and its opening to offshore participation is crucial, in our view, as China's current account turns from surplus to flat over the next few years. In the long run, we believe the Chinese government is keen to push more market-oriented reforms and prevent market disruptions – this being particularly true for China's financial sector.

We believe the opening of China's bond market is integral to its broader capital account liberalisation strategy

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What are the implications of index inclusion from a valuations perspective for emerging market (EM) and developed market (DM) investors?

EM

When we think about the valuation angle from an EM investor's perspective, we inherently think about what China inclusion into the GBI-EM means for the underlying return potential of the index. We believe it increases the attractiveness of this asset class to our investor base.

As seen table 1, the index yield drops by 18bps to 4.82% due to the average yield of the Chinese government bonds (CGBs) going into the index being 2.93%, which is materially lower than the 4.99% existing yield of the index.

Duration remains relatively stable, even though China itself has a slightly higher duration than the existing index duration, as the markets that are materially reducing in weight are some of the longer-duration markets in the index.

From an FX perspective, the beta of the Chinese yuan is on the lower end of the spectrum, comparable to Peruvian sol, and only higher than the Philippines peso, Malaysian ringgit and Thai baht, so it has the benefit of diversifying the index further while reducing volatility through the FX channel.

DM

For a long time, dabbling in the Chinese bond market was seen as a nice-to-have option for global investors. But not anymore. The tradable Chinese fixed income market stands at USD4 trillion, compared to the US bond market at USD26 trillion, the European market at USD17 trillion and the UK at USD3 trillion.

What's even more important is the onshore Chinese debt market is growing fast and offers significant potential as the Chinese economy expands and wholesale funding market matures.

In recent months, China has become an increasingly important part of global bond indices. By the end of 2020, debt issued by Chinese policy banks and Treasury is forecast to make up 6% of the USD54 trillion Barclays Global Aggregate Bond Index. The inclusion of local Chinese debt is also under consideration by the FTSE World Government Bond Index.

Once liquidity and rating profiles improve, the Chinese corporate bond market may also look to enter major global indices and thereby further increasing its weight.

In terms of relative value, we believe the Chinese bond market offers a unique value proposition. It

Looking ahead, once liquidity and rating profiles improve, the Chinese corporate bond market may also look to enter major global indices and thereby further increasing its weight

TABLE 1: GBI-EM BEFORE AND AFTER CHINESE GOVERNMENT BOND INDEX INCLUSION

	Weight %	Yield %	Change	Duration	Change
Before	0	4.99		5.44	
After	10	4.82	-18bps	5.43	-0.01

Source: JP Morgan, as at February 2020

adds diversification to a global portfolio. Correlation with major bond indices remains remarkably low. Taking weekly returns data for the past 10 years, the correlation of the China onshore bond market with the US Treasury market is only 0.1; the correlation with the Barclays Global Aggregate Index is roughly 0.2. Another point of attraction is that China offers higher yields on a currency unhedged basis and pockets of opportunity exist in a variety of sectors.

In the domestic agency space, state-owned development banks offer a healthy pick-up in yields over CGBs due to the tax advantages afforded to international investors. The agency sector trades at roughly 50bps over government bonds. In Europe and the US, comparable agency debt offers a negligible pick-up over its government debt.

Furthermore, China also has a vibrant money market and offers opportunities to sophisticated investors with expertise in credit research. Local government bonds issued by credible provincial and regional authorities with solid economic profiles provide an alternative to Chinese government bonds. Though less liquid than CGBs, they offer a pick-up of roughly 20-25bps.

We also see opportunities in the Panda bond market (renminbi-denominated bonds from non-Chinese issuers) issued by well-known sovereign and supranational entities. For example, Portugal became the first eurozone country to issue renminbi-denominated bonds in 2019. CNY-denominated Portugal bond offers close to 80 bps carry over its EUR equivalent. Other investment-grade countries such as Poland, Hungary and South Korea have also issued panda bonds onshore.

Another point of attraction is that China offers higher yields on a currency unhedged basis and pockets of opportunity exist in a variety of sectors



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How does this opportunity set compare with others in terms of size, liquidity and challenges?

China local bonds have the most robust liquidity profile within the EM local currency universe. The normal ticket size for bonds in the market is around CNY50-100 million per ticket. The bid/offer spread is usually within 0.25-0.5bps for this size. For the very liquid tenors of CGBs, CNY200-300 million could be easily absorbed, in our view. The bid/offer spread would be 1bps or slightly wider.

Compared to traditional developed markets, we believe Chinese government bond's bid-ask spread and monthly turnover ratio are also reasonable.

Challenges

Interest rate hedging instruments are not as developed and readily available as in DM. Onshore bond futures are not yet available to foreign investors. The offshore non-deliverable interest rate swap market is not a perfect substitute either. However, we believe as the market evolves, more hedging options will become available to offshore investors.

Compared to the US, **local ratings in China are highly skewed to AAAs and AAs**. Roughly 40% of Chinese credit bonds are AAA-rated and 55% are AA or AA+ rated. The limited classification of ratings is still a constraint for the Chinese bond market though and creates a roadblock to the inclusion of Chinese corporate bonds into global indices. Greater transparency via the introduction of more global rating agencies in China should further the attractiveness of China bond market, in our view.

There is a big distinction **between on-the-run and off-the-run government bonds in China and along different parts of the curve**. Transaction costs could materially escalate once the bond becomes off-the-run. Therefore, we believe staying on top of the issuance calendar and liquidity management are key to reducing transaction costs.

TABLE 2: GOVERNMENT BONDS

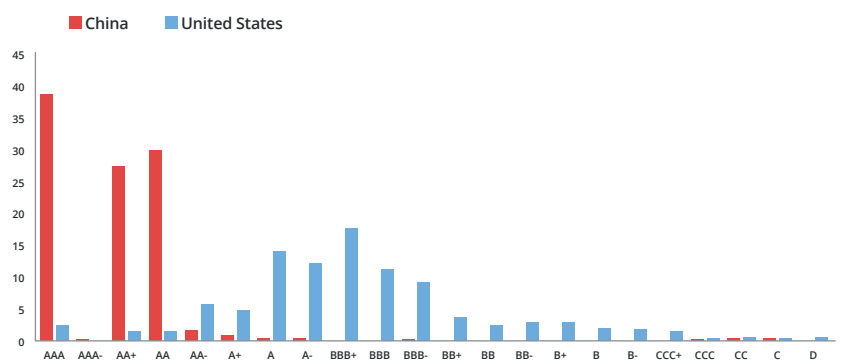
Country	Bid-ask spread	Monthly turnover ratio
China	1-4 bps	0.2
US	0.05-0.1 bps	0.8
Germany	0.1bp – 0.2bps	0.3
United Kingdom	0.1bp – 0.2bps	0.4
Japan	1-2 bps	0.6

Source: BlueBay estimate, IMF, UK DMO, ESMA, AFME, BIS, SIFMA, JSDA, as at January 2020

On this note, certain parts of the government curve are not as liquid as others. For example, the 7-year part of the CGB curve is less liquid and trades with wider bid-ask spread than equivalent 5-year and 10-year bonds.

The administration behind trading the China bond market has scope for improvement. Asia has varying settlement procedures across the constituent countries, with only a few using the same process. At BlueBay, we currently access China via the China Interbank Bond Market (CIBM Direct). CIBM Direct requires a CFETS matching system which has a strict cut-off time of 9am London time.

CHART 1: CHINA VS US CREDIT RATINGS



Source: IMF 2019, Bloomberg 2017

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ZHENBO HOU
EM SOVEREIGN STRATEGIST



What is your view on the fundamental outlook for the Chinese economy?

Three factors currently characterise the Chinese economy:

1. It is transitioning from a high-speed growth model with GDP growth per annum of 6–10% to an economy that grows at approximately 4–6% per annum.
2. It is battling with structural challenges as it transitions from an export and investment-led growth model to a more consumption-based one.
3. Perhaps most importantly, it is still digesting the policy side effects of previous stimulus efforts that led to overinvestment, housing bubbles, excessive industrial capacity, deflation and moral hazards on local government debt.

Facing these internal challenges, the policy mix in China has, in our view correctly, been focused on tackling these systemic financial risks since late 2017 by containing the macro leverage of the economy to a more sustainable level. Deleveraging policies were implemented to curb excessive risk-taking through the shadow banking sector, albeit in hindsight the authorities underestimated the disproportional credit squeeze such policies would have on the private sector.

We agree with the Chinese authorities on their diagnosis regarding the structural challenges facing the economy. Therefore, we believe supply-side reforms are more valid policy responses than demand boosts at this juncture. This is even truer when analysing China's reform record over the past four decades, where demand management policies only provided short-term breathing space and rarely solved the medium to long-term challenges they faced.



Accessing information is a challenge for all emerging markets and China is no exception. While the spread of the internet, smartphones, social media and big data have significantly improved the transparency and reliability of data in China, we believe there is still notable scope for improvement.

Contacts to policymakers and local market participants are crucial. We have found our engagements with policymakers in China productive and continue to encourage them to engage with market participants on a regular basis.

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BEN THOMPSON
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ADRIAN HALL
ASSISTANT PORTFOLIO MANAGER



CIBM and Bond Connect are the two main channels for offshore participants to access the Chinese local market. Why does BlueBay favour CIBM?

The CIBM avenue of market access was opened to offshore investors in February of 2016.

As early adopters in the Chinese local market we immediately began the process of onboarding our flagship funds using CIBM.

When Bond Connect was launched in July 2017, CIBM liquidity was ample and our operational procedures were already in place. As such, the decision was taken not to onboard additionally via Bond Connect.

Since this initial launch, improvements have been made to the Bond Connect platform and liquidity had increased. As such, we will continue to monitor developments and evaluate our method of Chinese market access on an ongoing basis.

Trading volumes

In 2019, there was a total trading volume of RMB5.3 trillion by foreign participants. CIBM amounted to RMB2.7 trillion and Bond Connect was RMB2.6 trillion.

Operationally, the key remaining distinctions between the two access methods are that:

1. Bond Connect only allows trading of cash bonds, whereas CIBM allows access to additional products - including IRS, NCD and commercial paper.
2. Bond Connect cash accounts are located in Hong Kong (provided by global custodian banks), whereas CIBM cash accounts are located onshore in Shanghai (with a local custodian bank).
3. Bond Connect trading is fully electronic (RFQ) whereas CIBM trading can be completed via traditional methods (Voice/IB chat)

For asset managers like BlueBay that want to actively manage their renminbi portfolio, we believe CIBM is the more attractive route, given that it provides access to a fuller suite of investment products and can be more cost efficient.

Conversely, passive funds may continue to favour Bond Connect as it features a simpler onboarding process and streamlined trading and operational procedures.

For asset managers like BlueBay that want to actively manage their renminbi portfolio, we believe CIBM is the more attractive route, given that it provides access to a fuller suite of investment products and can be more cost efficient



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