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The appeal of fixed income markets in China for foreign investors

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GEOPOLITICAL ISSUES WITH THE UNITED STATES AND A RECENT CRACKDOWN ON CONSUMER TECHNOLOGY FIRMS BY THE CHINESE GOVERNMENT HAVE CREATED SIGNIFICANT VOLATILITY IN THE CHINESE EQUITY MARKETS AND ATTRACTED GLOBAL ATTENTION. HOWEVER, MUCH LIKE IN THE DEVELOPED MARKETS IN THE WESTERN HEMISPHERE, THE DEBT CAPITAL MARKETS IN CHINA ARE ALSO WITNESSING A TECTONIC SHIFT. AT US\$17.4 TRILLION ACCORDING TO S&P AND WITH AN ANNUALISED GROWTH RATE IN THE DOUBLE DIGITS SINCE 2000, DEBT MARKETS HAVE GROWN IN LINE WITH THE ROBUST GROWTH OF THE LOCAL ECONOMY. IN 2000, THE CHINESE DEBT MARKET WAS ONLY 4.5% OF THE SIZE OF JAPANESE MARKET AND THREE-QUARTERS THE SIZE OF THE COMBINED ASEAN MARKETS. TODAY IT IS 120% OF THE JAPANESE MARKET AND SEVEN TIMES LARGER THAN THE ASEAN MARKETS. IN FACT, THE CHINESE BOND MARKET NOW STANDS SECOND ONLY TO THE US IN SIZE. IT IS SIMPLY TOO BIG TO BE IGNORED.

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Why China?

Size aside, there are several other factors that explain why investors of all stripes are focusing on the fixed income markets in China. Start with access to the onshore market. Foreign investors can now access the onshore market through different channels, including directly as qualified foreign institutional investors, via the interbank market, or from the offshore market in Hong Kong using Bond Connect. Liquidity in the onshore market has always been significantly deeper relative to the offshore market and with less volatility. Thanks to easing regulations, this market is now available to many institutional investors.

Another factor driving international interest is yields. With the amount of global debt offering negative yields now at more than US\$16 trillion, investment opportunities in

Chinese bonds can be an attractive value proposition.

The Chinese Renminbi (CNY) offers the highest nominal yield compared to other reserve currencies. For overseas investors, yields, in many cases, are also attractive when considered on an asset swap basis.

Two key factors have driven interest in domestic Chinese bond markets from central banks and official institutions. First, the inclusion of the CNY in the IMF's Special Drawing Rights (SDR) basket in 2016, created automatic demand from central banks that had traditionally only held reserves in the US Dollar, the Euro, the Pound Sterling, and the Japanese Yen. A second important factor has been the emergence of China as a significant trading partner over the last decade for countries across the globe. These trade relationships, combined with China's policy of currency liberalisation, have made Renminbi an increasingly

internationalised currency. As a result, more individuals and institutions around the world hold Renminbi to use for portfolio investment

In contrast, the motivations are a little different for asset managers. The inclusion of the Renminbi in many of the major indices, such as the Bloomberg Global Aggregate Bond Index and the JP Morgan GBI-EM Index, has created a natural demand from many global bond portfolios. For example, an estimated US\$2.5 trillion in assets track the Bloomberg index and China now holds a roughly 6% index weight, implying roughly US\$150bn of investment due to inclusion in that one index alone. Similarly, the inclusion of Chinese government bonds in the FTSE World Government Bond Index beginning in October 2021 will drive an estimated US\$130bn of investment to that segment of the market.

Diversification is another key factor. Given the large size, and the varied pool of securities now on offer from across different ends of the credit spectrum, and with more than 6,000 issuers, local bond markets offer something to every type of investor. Studies have also shown that the Chinese market has a low correlation with other major fixed income markets. This low correlation has been shown against both risk-on asset classes (e.g. major market equity and high yield indices) and risk-off asset classes (e.g. US Treasuries). Chinese bonds therefore provide diversification benefits to foreign investors almost irrespective of their portfolio composition.

Challenges

While the case to invest in local Chinese bond markets is compelling, it comes with its own sets of challenges. Despite significant changes over the last few years that have made it easier for foreign institutional investors to participate, the domestic market remains heavily regulated. Domestic reporting and settlement infrastructure, while designed with a view to make the process more robust, is more onerous and differs markedly from other developed markets. Many of the large domestic banks have the expertise and the desire to serve as agents and counter parts to help foreign investors navigate these requirements.

Language remains an issue, however. Foreign investors now have the option to work with a select group of international banks that have been authorised to offer custody and settlement services in the domestic market. Most international banks do not have the necessary approvals however and instead rely on partnerships with local banks, a set-up that creates inefficiencies and increased documentation requirements. Furthermore, unlike in other markets, investors cannot rely on their global custody relationships and are instead required to sign direct bilateral contracts with local sub-custodians and settlement agents.

Another challenge is created by the relatively short maturity profile of Chinese bonds. According to Fitch Ratings, Chinese bonds issued during the first quarter of 2021 had an average tenor of 3.02 years, down from 3.22 years in 2020 and well below the average tenors seen in the US, Japan, and Europe. For example, the average maturity of newly issued corporate bonds during the first quarter of 2021 was around 17 years in the US and more than 10 years in Japan.

Shorter tenors mean that refinancing risk is a frequent concern for Chinese issuers and create rollover issues for the market in general. For example, during the second half of 2021, US\$900bn of Chinese corporate bonds will mature, 30% more than in the US and 63% more than in all of Europe.

Credit ratings are a challenge as well. Domestic credit rating agencies have been restricted by various policies from assigning non-investment grade ratings, resulting in a system characterised by perceived “ratings inflation.” By some estimates, more than 80% of Chinese domestic bonds are rated double-A or above.

With so many securities having the same high rating, investors are forced to do more of their own credit analysis to determine relative risk and value among them. In carrying out such analysis, investors must contend with Chinese language documentation and unfamiliar disclosure standards as well as the difficulty at times in deciphering the extent of the implicit state guarantee provided to state supported issuers.

The case for continued growth

While the Chinese bond market has experienced remarkable expansion over the last decade, there remains significant room for it to grow further. The credit market in China is still dominated by bank financing, and, as a percentage of GDP, the capitalisation of the Chinese bond market is small compared to the US. In fact, if the Chinese bond market were to be at the same level relative to the United States in terms of the share of credit provided by securities as opposed to bank lending, the Chinese market would be roughly double its current size.

Most of the future growth of the market will be driven by domestic investors. However, for the market to live up to its full potential, there will need to be an increase in the number of foreign investors that are active in Chinese bonds as well. Foreign investors provide additional liquidity to a market, but that is not their only benefit. Often, they also bring a focus on sound corporate governance that can create a virtuous circle in which the governance standards imported by some foreign investors attract even more investors to follow them into the market.

One factor that could meaningfully increase foreign participation in the market is the potential eligibility of Chinese government bonds as collateral for cross-border derivatives. Such use of these bonds is currently constrained by the operational and infrastructure issues we outlined above, as well as by legal issues related to the enforcement of close-out netting provisions in China. However, efforts have been initiated by the International Swaps and Derivatives Association and the China Central Depository and Clearing Co., Ltd. to address these challenges. Given the general dearth of eligible collateral in Asia, if these efforts are successful, collateral eligibility could create further and significant demand for Chinese fixed income securities.

Green and sustainable financing

So, what additional types of developments could attract such increased foreign interest? For one thing, we believe that the growth of a large and thematically diverse sustainable bond segment of the Chinese market would make it even more attractive to overseas money. For this

purpose, we define a “sustainable bond” as a bond for which the use of proceeds will make a positive contribution to sustainable development as described by the Sustainable Development Goals adopted by the United Nations.

Motivated both by altruistic feelings and the recognition that issues such as climate change, bio-diversity loss and inequality pose significant, long-term economic threats, investors around the world are increasingly seeking out sustainable bonds. According to the Climate Bonds Initiative, for example, the overall sustainable bond market (including green bonds) grew 131% in 2020 despite the impact of the pandemic (compared to an overall global bond market increase of only 16.5% for the year).

Looking at just non-green sustainable bonds (i.e. bonds that impact areas other than the environment), Moody’s projects that market to increase by more than 30% in 2021 and to exceed more than US\$650bn by the end of 2021.

Whichever statistics are used, it is clear the sustainable bond movement is a wave that shows no sign of cresting. It is also an area where we believe China has a competitive advantage since it has already established itself in this area. The Chinese market is the world leader in the



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issuance of green bonds. In just the first quarter of 2021 (during which the Chinese market grew by approximately US\$262bn), Chinese issuers sold US\$15.7bn of green bonds, which was almost US\$1bn more than was sold by all U.S. issuers during the same time-period.

Most buyers of Chinese green bonds to date have been domestic investors, and some foreign investors have been reluctant to invest in green bonds that are aligned only with domestic, and not international, standards. Therefore, we cannot claim that green bonds currently are a major driver of foreign portfolio investment. However, the sheer issuance volumes of these bonds speak to the level of attention green finance has received in China.

The Chinese government has introduced many policies and guidelines (including a green project catalog/taxonomy) and incentives to promote the development of the green bond market. A similar focus on the wider area of sustainable bonds, coupled with increased transparency around use of proceeds and impact reporting in alignment with international best practice, could lead to China becoming one of the world's leading investment destinations for such bonds in the years to come.

We also believe the Chinese market, given its size and geographic location, can play an important role in promoting a specific sub-segment of sustainable bonds, known as catastrophe or “cat” bonds. These are bonds that expose investors to the risk of loss of principal upon the occurrence of a specific insured event or level of insured losses, and, in return, pay investors insurance premium enhanced coupons.

Because of the dual impact of climate change and increasing urban density on coasts and flood plains, natural disaster related losses are increasing all around the world, but nowhere more so than in Asia. The Asian continent experiences the largest number of natural catastrophe events, with roughly one-third of natural catastrophes worldwide occurring in the region. The Northwest Pacific Ocean, for example, is the most active area in the world for tropical cyclone activity, and much of Asia sits along the so-called “Ring of Fire” (the origin of 90% of the world's earthquakes).

Catastrophe bonds are a way to provide insurance companies, corporations, and governments with significant additional insurance capacity against such disasters. And, given Asia is the largest source of global natural catastrophe losses (both in terms of human life and financial costs) and China is that continent's largest bond market, it would seem to be a natural fit for China to become a world leader in catastrophe bonds.

Conclusion

While the challenges outlined above can appear to be daunting at times, the case for an overseas investor to participate in domestic bond markets in China remains compelling. Thanks to easing regulations and a gradual opening of the domestic market, a growing number of foreign institutional investors can now invest locally.

China is no longer a niche market and it is not implausible that it will very soon be regarded as a premier investment destination, just like the developed markets in the west. China's strong track record in green financing, and the opportunity to play a leading role in the market for sustainable and catastrophe bonds will only accelerate that trend.

Notes:

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