Research

FTSE Russell China Bond Research Report

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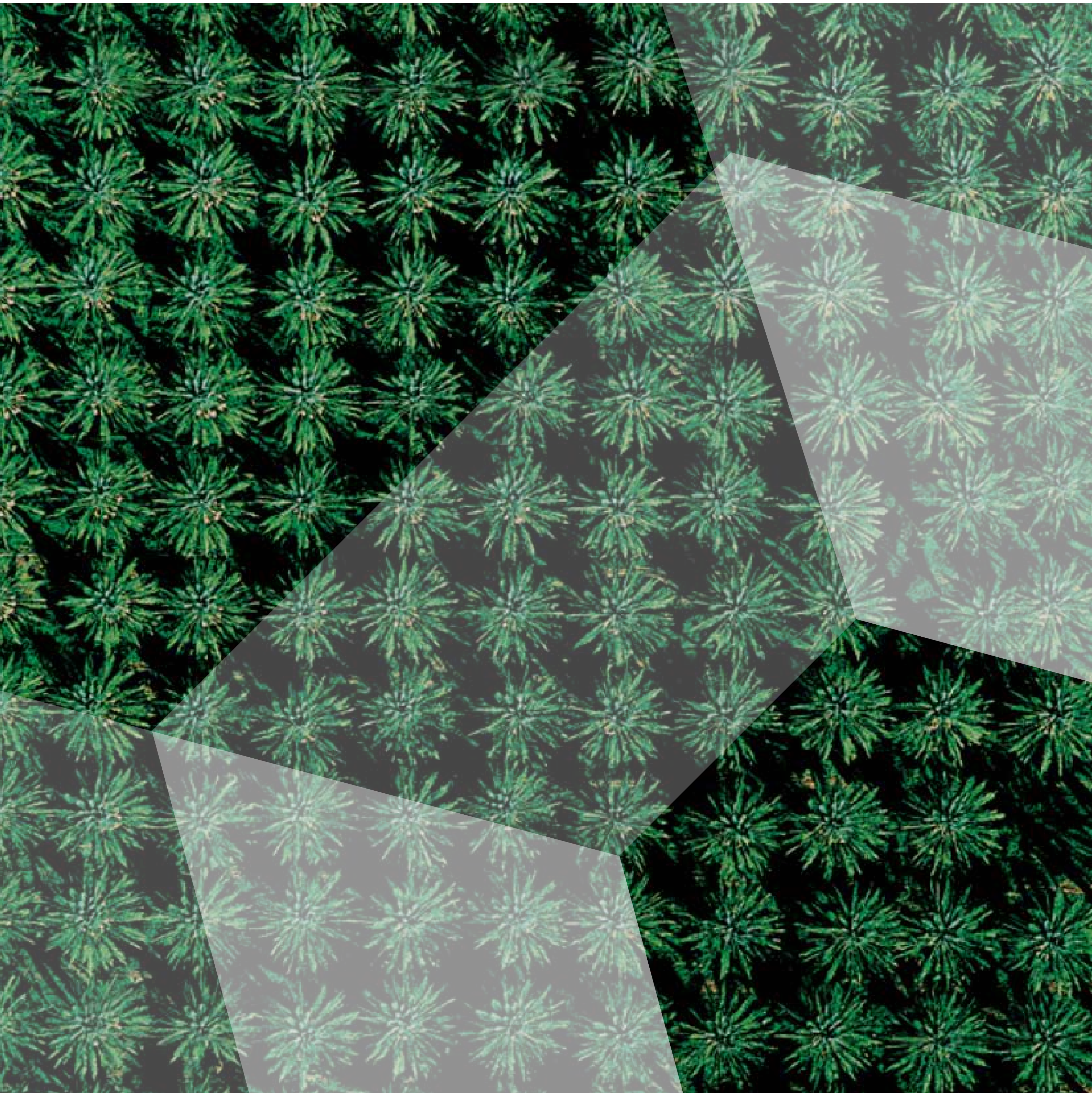

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Highlights

- Total holdings of Chinese bonds by offshore investors rose in Q1 of 2019. Offshore investors held 1.76 trillion RMB (US$263 billion) worth of bonds at the end of March, according to data released by Shanghai Clearing House and China Central Depository and Clearing Co, marking a 34.3 billion RMB (US$5.1 billion) rise compared to end-December 2018.[1]
- Some of China's largest companies have defaulted on their debt in Q1. Three large Chinese borrowers -- Qinghai Provincial Investment Group Co., China Minsheng Investment Group Corp. and Beijing Orient Landscape & Environment Co. -- missed repayment deadlines.[2]
- Against this backdrop, interest in China's small convertible bond market is growing – driven for the desire among investors for higher returns. Citic Bank Corp's offering in March saw orders eclipse supply by 5,500 times, according to Bloomberg. Convertible bond issuers have raised US$13 billion via convertible bonds in 2019, more than four times the value of Chinese IPOs during the same time period.[3]

1 FTSE Russell. April 2019.
2 Bloomberg. March 2019.
3 Bloomberg. March 2019.

Chapter 1: Overview

Slower macro growth resulting in bond forecast cuts, even as more benchmarks continue to add Chinese bonds

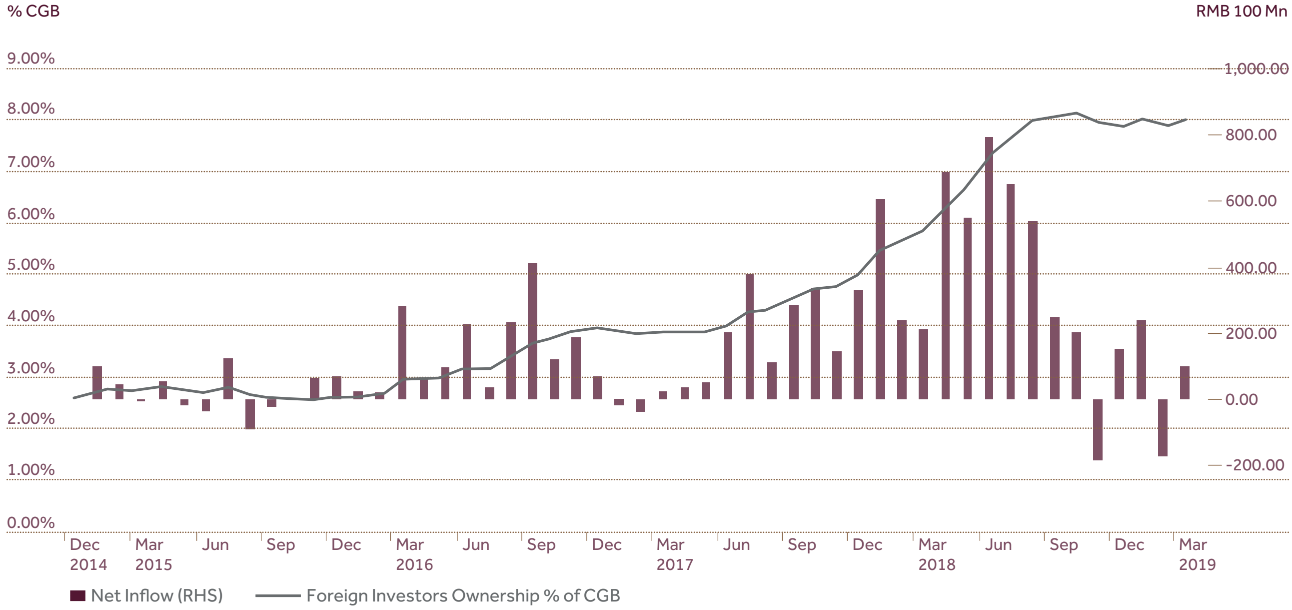
As Q2 gets underway, it's clear that 2019 will continue to be a challenging year for China's bond market as the macroeconomic outlook dims on the back of ongoing trade negotiations, and a significant slowdown in domestic consumption growth pushes China sentiment to its lowest level in a decade.[4]

On the back of decreasing appetite for Chinese bonds, US investment banking giant Goldman Sachs cut its forecast for growth in the domestic bond market -- even as more global benchmarks include Chinese bonds. According to Goldman Sachs, the views of some clients – stretching across Asia, Europe, and the US -- revealed unease about Chinese bonds; and some clients even planned to rely on benchmarks that do not incorporate Chinese bonds.[5]

Despite the slump in sentiment, total holdings of Chinese bonds by offshore investors rose in Q1. Offshore investors held 1.76 trillion RMB (US$263 billion) worth of bonds at the end of March, data released by Shanghai Clearing House and China Central Depository and Clearing Co, marking a 34.3 billion RMB (US$5.1 billion) rise compared to end-December 2018.[6]

A degree of optimism remains when it comes to the long-term potential of China's bond market. Ownership of Chinese bonds among international market participants – especially sovereign debt – continues to inch up as the bonds make their way onto more international benchmarks, despite the challenging macroeconomic environment.[7]

Foreign Investors' Holdings of CGB



Source: FTSE Russell and Wind, April 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

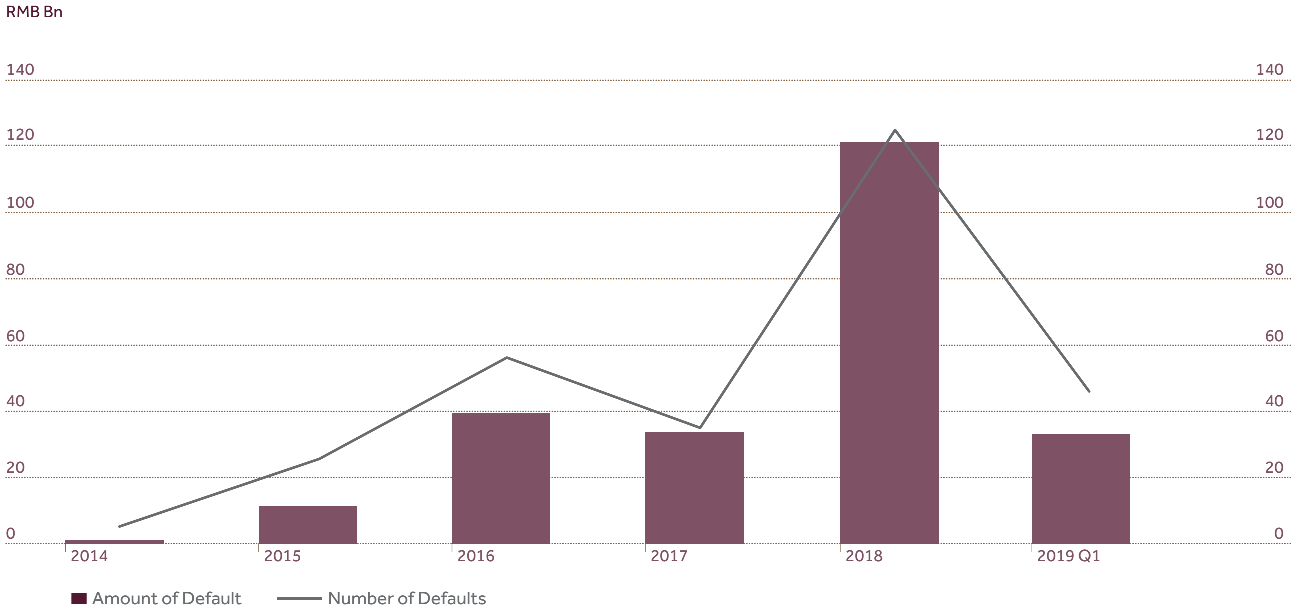
4 Bloomberg. March 2019.
5 Reuters. February 2019.
6 FTSE Russell. April 2019.
7 Financial Times. March 2019.

Chapter 2: The reality of rising defaults

Even though China's macro outlook could be impacting appetite for RMB debt, the allocation of Chinese government bonds by foreign investors is increasing. But in the corporate bond space, foreign investors are not too keen to increase allocations, particularly due to lack of international credit ratings as well as increasing instances of defaults.[8] In Q1, three large Chinese borrowers -- Qinghai Provincial Investment Group Co., China Minsheng Investment Group Corp. and Beijing Orient Landscape & Environment Co. – missed repayment deadlines, although some of the defaults were technical defaults where payment was made shortly after.

Indeed, bond defaults are necessary for the development of a healthy bond market. The existence of defaults will enable more efficient pricing and price discovery for different credit risks investors are taking. Since the first default case in 2014, defaults have been on the rise. So far in 2019, the market has seen 46 defaults, totalling around 30 billion RMB for Q1 of 2019 -- which is roughly aligned with defaults in 2018 (125 defaults with 121 billion RMB for the whole year of 2018).[9]

Chinese Corporate Defaults for Past 5 Years



Source: FTSE Russell and Wind, April 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

To guard against the potential for systemic risks, China's National Development and Reform Commission (NDRC) -- which oversees bond issuance by the country's biggest state-owned enterprises – has recently launched a countrywide debt inspection campaign. Provincial level NDRC representatives are tasked with inspecting corporate bonds under duration and check the size of their liabilities, and the progress of projects funded by the proceeds, according to a statement on the NDRC's website.[10]

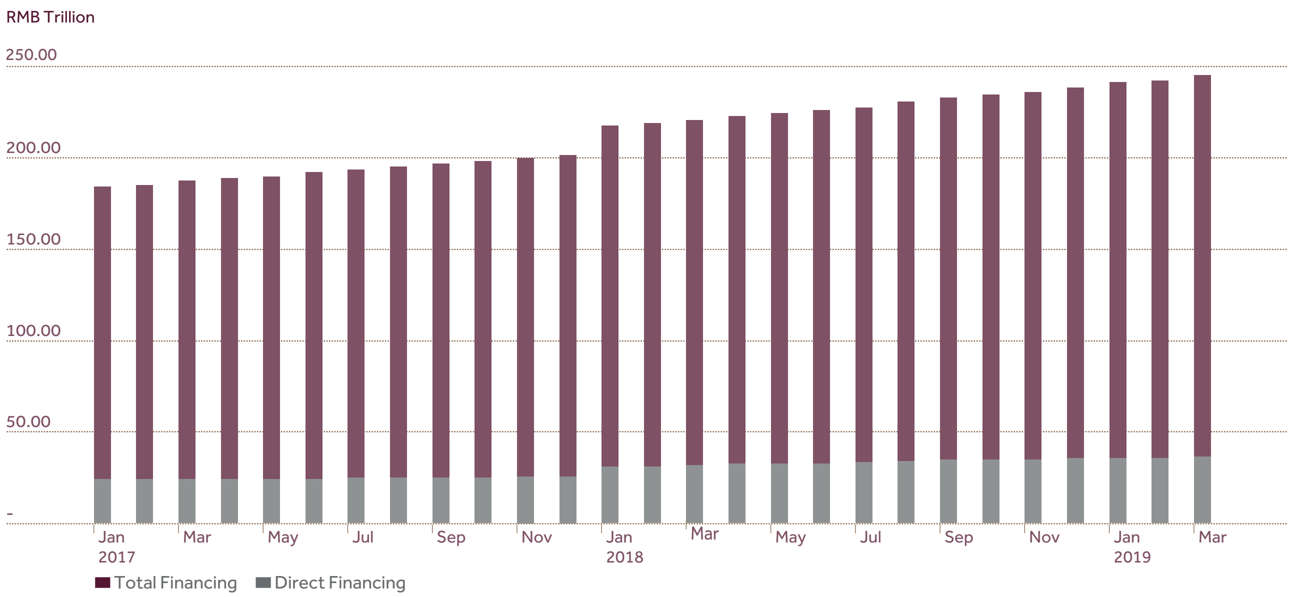
8 FTSE Russell. April 2019.
9 Wind. April 2019.
10 South China Morning Post. February 2019.

Chapter 3: Encouraging more issuance

While China's debt market has grown rapidly for the last 10 years with an annual growth rate of 23%, it still has more much room to grow relative to the country's GDP (currently at roughly about 95% of GDP). This is especially true when China is compared to more developed countries such as Japan, the UK, and the US where that figure is as high as over 200% of GDP.[11]

As such, debt and equity financing in China is still a relatively small portion of total social financing. Moving forward, regulators may encourage more bond issuance to shift financing towards capital markets and away from bank loans – which carry more risks to the banking system. Based on data released by PBOC in 2018, direct financing via debt and equity is around 4.63 trillion RMB which is roughly a quarter of the net increase of total financing (19.26 trillion RMB). This is actually higher than the historical average, as debt and equity financing have accounted for less than 20% of total social financing for the last few years.

China Social Financing Profile

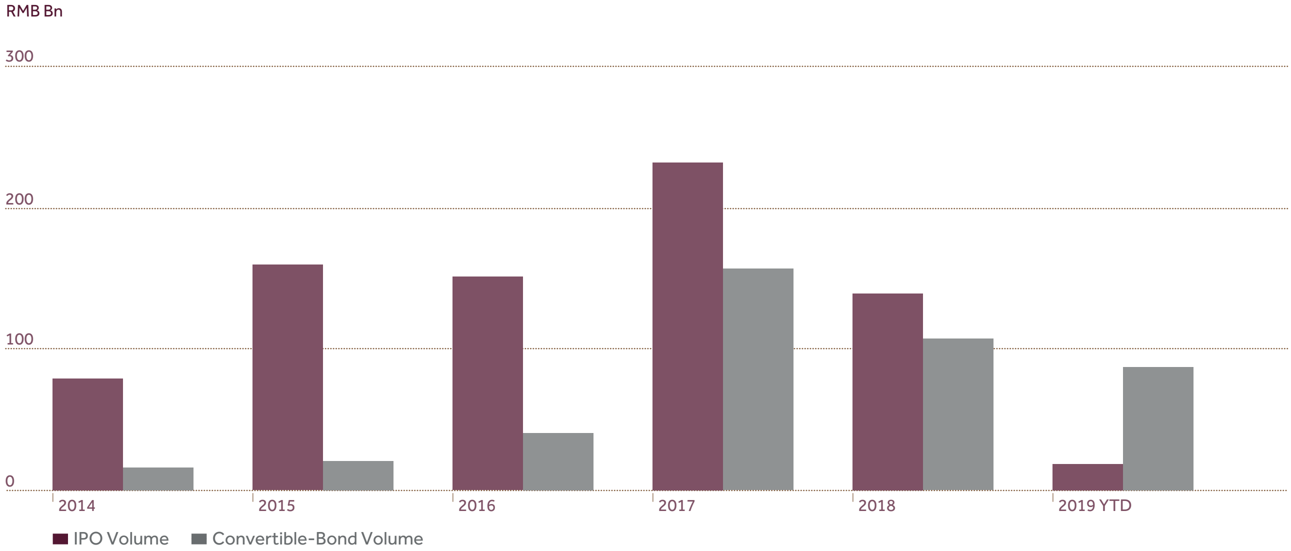


Source: PBOC, March 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

11 Wind; IMF; BIS. 2019

One strong area in recent months is China's relatively young convertible bond market. International investors are not only seeking safe havens, but also higher returns when it comes to RMB-denominated assets. On that basis, interest in China's convertible bond market is growing at a faster clip in 2019. The numbers paint a compelling picture: Citic Bank Corp's offering in March saw orders eclipse supply by 5,500 times, according to Bloomberg; and convertible bond issuers have raised US$13 billion in 2019 – accounting for more than four times the value of IPOs in China during the same period.[12]

China's Convertible Bond Issuance and IPO Volume



Source: Bloomberg, March 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

12 Bloomberg. March 2019.

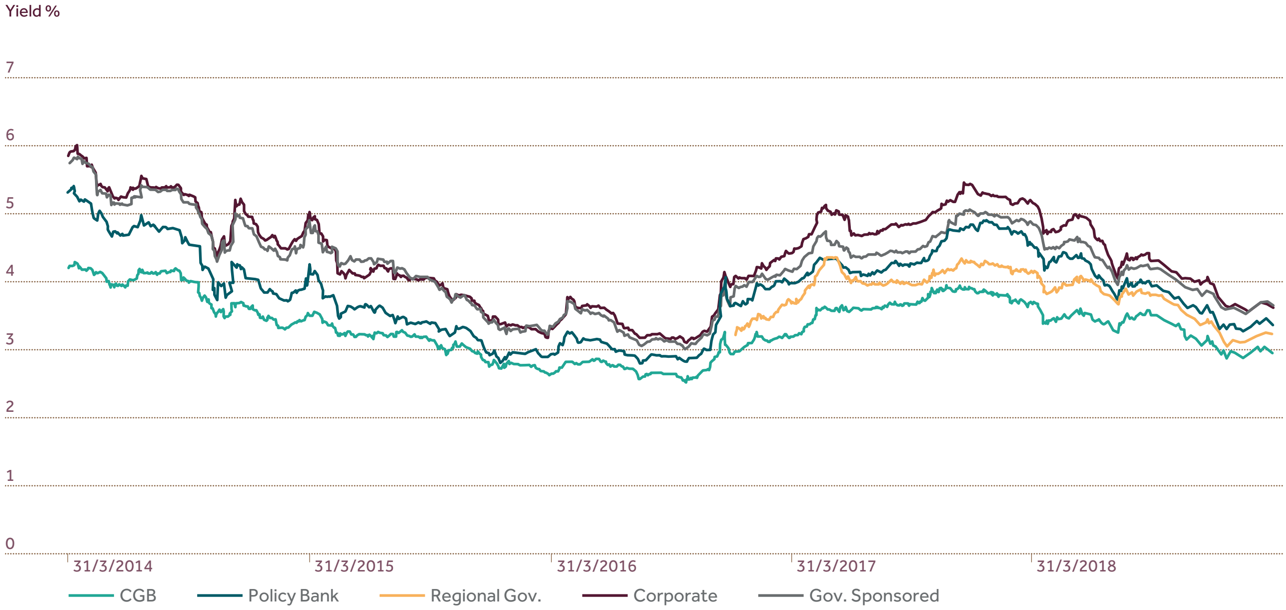
Chapter 4: Performance of the FTSE Russell China Bond Indexes

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-March was 3.27%. Among the five major sectors, the Government Bond (CGB) sector was at 2.95%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 3.38%; the Regional Government sector was at 3.23%; the Corporate sector was at 3.63%; and the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 3.66% as shown in the chart below. For 2019 Q1, the yield of CNYBBI decreased by 13.75 bps with corporate spread tightened by 22.27 bps.

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



Source: FTSE Russell, data as of March 29, 2019. 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

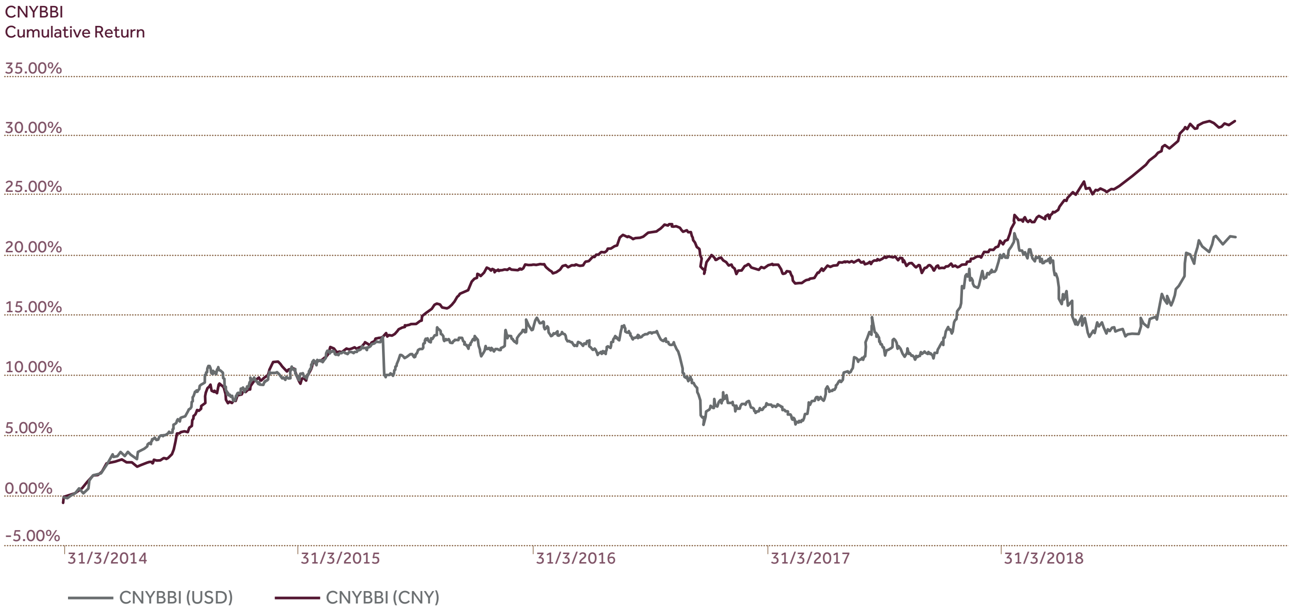
The CNYBBI in USD unhedged terms finished up 3.41% while its return in CNY finished up just 1.22% during the last quarter. CNY appreciation was the main driver during the same period. The returns of some sectors are shown in Table 1 and the cumulative return in USD and CNY are shown in Chart 2.

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	3.41	6.80	1.48	5.85	21.44	4.52	3.99	3.69
CGB	3.45	7.21	0.75	4.98	19.43	4.74	4.16	3.88
Policy Bank	3.31	6.72	2.20	6.35	22.14	4.61	4.15	3.92
Corporate	3.78	6.18	1.51	7.71	23.44	4.28	3.80	3.55

Source: FTSE Russell – total return data in USD, as of March 29, 2019. 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



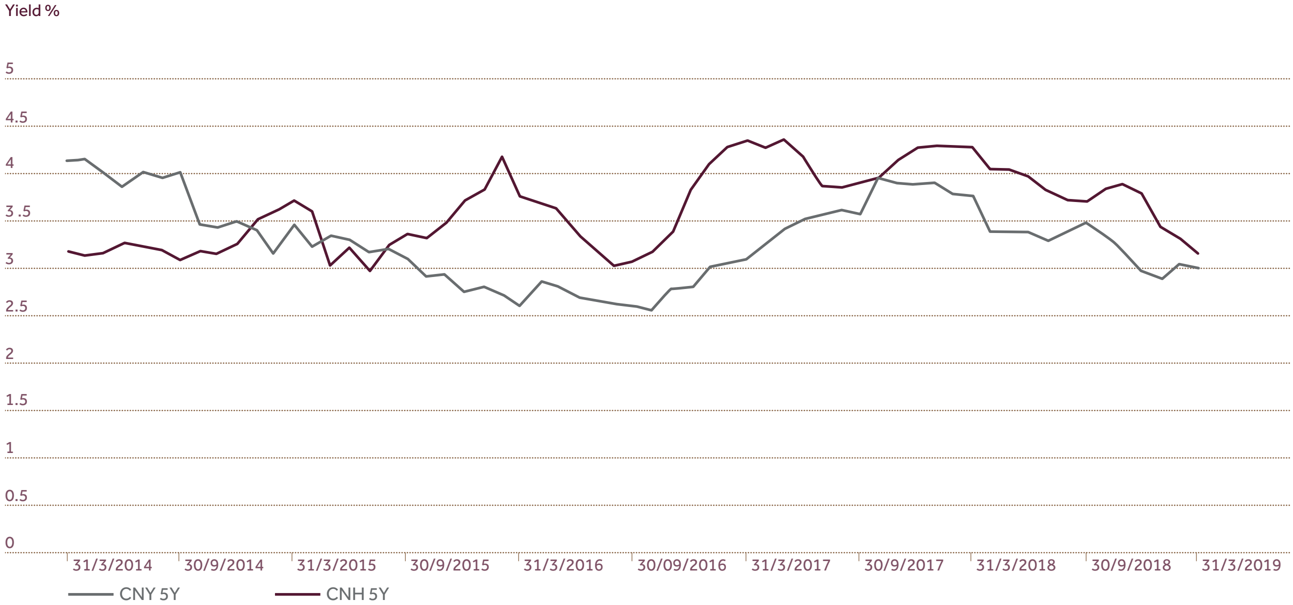
Source: FTSE Russell – total return data in USD and CNY, as of March 29, 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds

Yield

The yield of onshore 5-year Sovereign bonds was at 3.00% and the yield of offshore 5-year Sovereign bonds was at 3.15% as of end-Q1. The spread tightened by 67 bps for Q1 of 2019 as shown in Chart 3.

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



Source: FTSE Russell as of March 29, 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

As of end-Q1 2019, 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 37 bps and the long end curve 10-year spread was 35 bps.

Total Return

The FTSE Chinese Government Bond Index underperformed the FTSE Offshore counterpart during Q1 2019 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)	3.45	7.21	0.75	4.98	19.43	4.74	4.16	3.88
FTSE Chinese Government Bond Index (Offshore CNY)	4.94	5.97	0.28	9.54	10.09	4.97	4.40	4.28

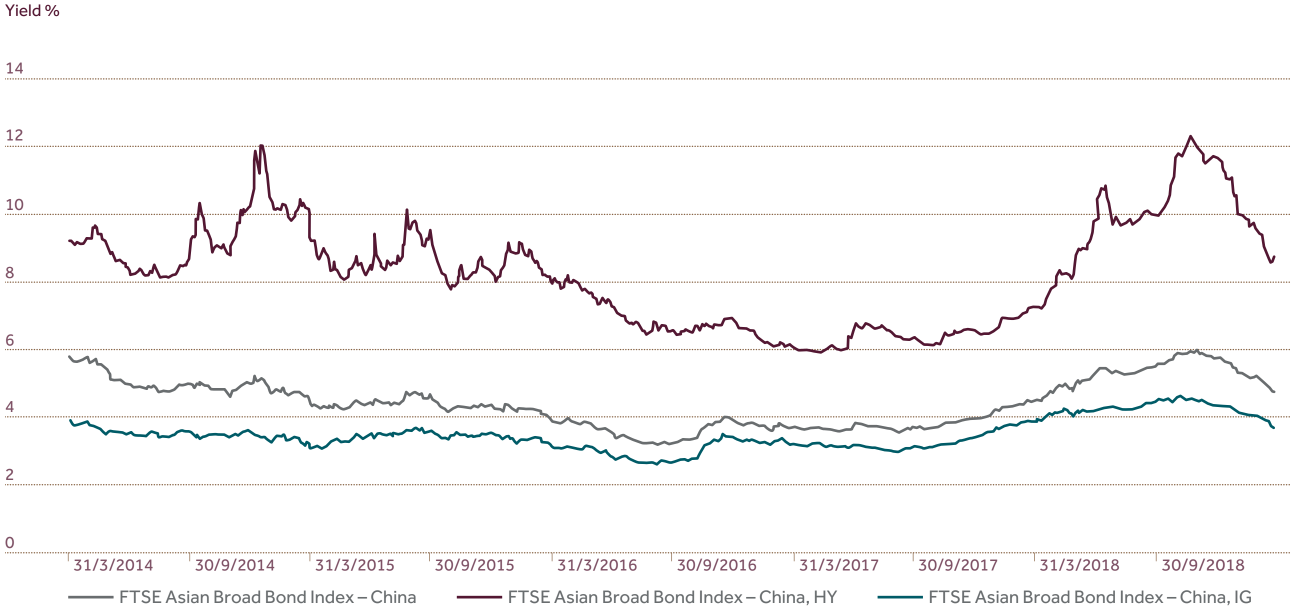
Source: FTSE Russell, total return data in USD, as of March 29, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures. FTSE Chinese Government Bond Index (Offshore CNY) 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 4.75%. Among the two sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade was at 3.71%; the FTSE Asian Broad Bond Index – China, High-Yield was at 8.70% as shown in the chart below.

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



Source: FTSE Russell - total return data in CNY, as of March 29, 2019. 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 4.83% during the last quarter, with its Investment-Grade sub-index up 3.91% and its High-Yield sub-index up 8.66%.

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	4.83	5.85	5.76	12.67	28.84	1.59	1.73	2.12
FTSE Asian Broad Bond Index – China, IG	3.91	5.47	5.91	10.98	25.62	1.64	1.93	2.27
FTSE Asian Broad Bond Index – China, HY	8.66	7.20	4.65	21.58	44.78	3.45	2.48	4.06

Source: FTSE Russell - total return data in USD, as of March 29, 2019. 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.

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