Still a draw

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By Hui Ching-hoo

Despite headwinds, China's onshore bond market attracts investors

In spite of headwinds China faces from a weaker currency and a trade war with the US, its onshore bond market has remained a draw for foreign capital, thanks to the bond connect channel that allows investors in Hong Kong and the Mainland to trade in each other's markets.

And fund managers believe this will continue with the upcoming inclusion of Chinese bonds into global bond indexes, particularly as passive investors look to increase exposure to track their benchmarks.

Jim Veneau, head of fixed income Asia at AXA Investment Managers, describes the pace of foreign purchases of Chinese government bonds as "really quite remarkable", with foreign ownership of Chinese government bonds up from 5.73% of total government debt in the market in April to about 8% in August. He says this was largely due to the launch of the bond connect in July 2017.

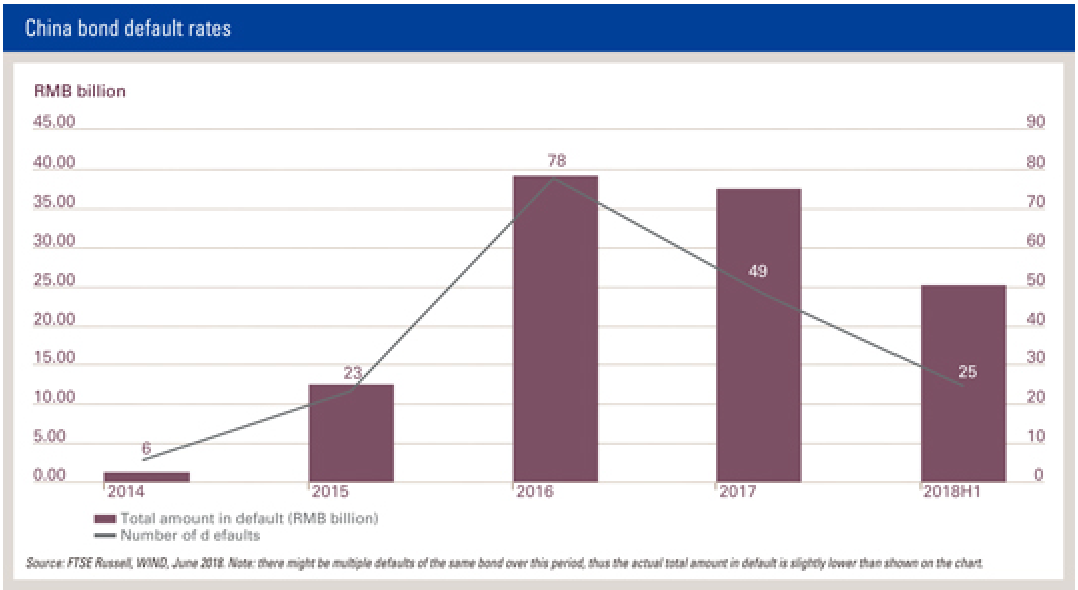
"We do anticipate the recent robust growth to continue as the Chinese government makes it easier for foreign investors (to access the domestic capital market), and investors continue to anticipate index inclusion (of Chinese bonds) by JP Morgan's Global Bond Index – Emerging Market and Citi's World Government Bond Index," Mr. Veneau adds.

Karan Talwar, senior investment specialist for emerging-market debt at BNP Paribas Asset Management, observes that foreign investors' share of onshore Chinese bonds has been "extremely low" compared to other markets, both emerging and developed.

"As such, we expect the trend and direction of flows to continue to increase," he says. He also notes that the bond connect programme recently underwent some key enhancements, including the ability for delivery versus payment, which allows payment at the time of delivery, thus reducing settlement risk. Mr. Talwar says this will continue to make bond connect popular with foreign investors.

According to Andy Seaman, partner and chief investment officer of London-based fixed income manager Stratton Street, bond connect "has to be considered a major success now that the number of international investors (for the programme) has broken through the 400 mark".

"From next year, the Bloomberg Barclays Global Aggregate Bond Index will include the Chinese bond market with roughly 5.5% weighting. This is significant because it will mean for the first time that passive investors will have to hold Chinese bonds if they want to continue to track that index," Mr. Seaman says.



Currency and default risks

From an asset allocation standpoint, Brad Gibson, a portfolio manager for Asia Pacific fixed income at AllianceBernstein, believes foreign investors' appetite for renminbi (RMB) bonds will be sustained into 2019 because they are "underweight to this large market that exhibits attractive diversification benefits for a global bond allocation".

He plays down the impact of the increasing RMB fluctuation, arguing that currency movements "that can be justified on fundamental economic changes should not necessarily deter long-term investors".

According to Mr. Gibson, the next wave of investors in 2019 may be more likely to hedge their RMB exposure.

"For these investors, the hedging costs will be more important than the direction of the RMB," he says.

Mr. Veneau says foreign investors are happy to take on China's macro risks, including those related to foreign exchange, but are not comfortable yet with risks in the corporate sector, where about two-thirds of China's debts are concentrated.

"So, despite a ramp-up in trade war rhetoric and a nearly 8% depreciation in the RMB since the end of April, foreign ownership of (Chinese government bonds) has increased 32.4% from 780 billion RMB [US$112.49 billion] to 1.03 trillion RMB (currently)," he says. But corporate bonds stands at only 4.5% of total foreign holdings.

Ong Guat Cheng, head of fixed income of Fullerton Fund Management, believes investors in the onshore RMB bond markets are long-term strategic investors who can withstand the currency's "near-term gyrations".

She points out that foreign investments are mostly concentrated in the onshore government bond market and describes default risks of Chinese policy banks – which are responsible for state-invested projects – as "negligible".

According to Mr. Seaman, active and passive foreign investors have very different attitudes to RMB bonds. While the currency's depreciation is typically irrelevant for passive investors who closely track their benchmark indexes, active investors take both currency risk and default risk into account.

As such, he says both active and passive investors will look to invest in Chinese bonds with at least a single A rating, which is equivalent to triple-B rated debt in Spain and Italy.

Mr. Seaman believes China's relatively stable economic fundamentals mean that the likelihood of bond defaults is less than in highly indebted European nations.

But others are less sanguine. Mr. Talwar, for one, anticipates a higher proportion of Chinese onshore bond defaults and a repricing of credit spreads over the medium term as policymakers look to reduce leverage and cut reliance on debt. But he expects the process to be well-managed and not trigger systemic risk, which would have a negative impact on the economy.

"The second half of 2017 and early 2018 had indeed seen a pick-up in defaults both onshore and offshore; however recent trade tensions have caused Chinese policymakers to pull back on their deleveraging reform initiatives, at least for the time being," he says.

Mr. Gibson expects Beijing to face a difficult balancing act as it attempts to reform the credit markets while maintaining sufficient liquidity to allow refinancing. He believes bond issuance will slow in some sectors, but that it will be hard to cut overall leverage or change a "strongly held onshore view" that the government will bail out most borrowers if they run into difficulties.

Jim Veneau Karan Talwar Andy Seaman Brad Gibson Ong Guat Cheng

Investment strategy

As far as investment strategy is concerned, Mr. Veneau is overweight policy bank bonds versus Chinese government bonds. This, he says, is based on “attractive yield pickup of 40-plus basis points for essentially the same sovereign credit quality (and) similar liquidity levels as (government bonds)”.

“Negotiable certificates of deposit may also be interesting as this 1-year paper offers about 55-plus basis points spread over Chinese government bonds with no tax implications,” he adds.

According to Ms. Ong, valuations of onshore Chinese government bonds have become more attractive after yields corrected in the third quarter of 2018. The market is also supportive from a technical perspective, with lower supply headwinds expected in the current quarter, she says.

She expects Beijing to take more “proactive broad-based” policy measures such as corporate and personal tax cuts and a reduction of the reserve requirement ratio in order to maintain growth and market stability, which would be positive for the government bond market.

The reserve requirement ratio is the minimum amount of reserves that commercial banks must hold.

“We also have a bias towards Chinese policy banks but are more selective in the (onshore RMB) credit sector given tighter financing conditions and higher refinancing risks,” Ms. Ong says.

Fading dim sum

Prospects for offshore RMB bonds or dim sum bonds appear to be diminishing.

According to Mr. Seaman, the dim sum market “has tended to move in and out of favour depending on the strength of the RMB, or more accurately the weakness and strength of the US dollar”.

“In the longer term though, we see the dim sum market as having the potential to perform the same role as the eurodollar market,” he says. “Most international investors will have exposure to US dollars but many of them will hold eurodollars rather than holding dollar assets in the US.”

Eurodollars are US dollar-denominated time deposits held in banks outside of the US.

Mr. Seaman says investors will begin to look for higher yielding assets once they are forced to start allocating to Chinese government bonds when Chinese debt is included in global indexes. This is where the dim sum bond market, which offer higher yields, can play an important role, he says.

He believes the small size of dim sum issuances is one of the key reasons for this market’s lacklustre growth, noting that benchmark offerings in the US dollar bond market usually start at $500 million and often top $1 billion.

Total dim sum bond issuance in Hong Kong in 2017 was $13.2 billion, less than half the figure in 2016, according to a *Bloomberg* report on December 28, 2017.

Mr. Seaman expects dim sum bond issuances to pick up after the inclusion of Chinese government bonds into major benchmarks.

But others disagree. Mr. Gibson thinks dim sum bonds are unlikely to gain traction anytime soon because of low liquidity and sporadic issuance.

“So long as China seeks to maintain an onshore and offshore market there is probably a role for the dim sum market,” he says. “Ultimately though, large global asset owners may want access to the onshore market to gain exposure to the Chinese monetary and economic cycle. Allocation to the dim sum market, outside of (offshore RMB) deposit centres like Hong Kong, are likely to be opportunistic at best.”

Mr. Talwar also doesn’t see the dim sum market regaining lost ground or becoming a prominent market.

“As China has opened up access to its onshore financial markets to foreign investors, and as the (onshore RMB) has become more freely tradable, we expect the relevance of the offshore RMB market to diminish,” he says.

He expects global RMB foreign reserves to increase over time, noting that onshore RMB now has a weighting of over 10% in the International Monetary Fund's (IMF) special drawing rights (SDR) basket following its inclusion two years ago.

"We have even seen more global issuers such as Philippines issue in the panda bond market and hence expect this to be the more prominent trend going forward, instead of the dim sum market," Mr. Talwar says. Panda bonds are RMB-denominated bonds sold by non-Chinese issuers.

The SDR acts as a supplementary reserve asset to the official reserves of IMF member countries. The RMB was added to the SDR basket in October 2016, joining the US dollar, euro, Japanese yen, and pound sterling.