October 2017

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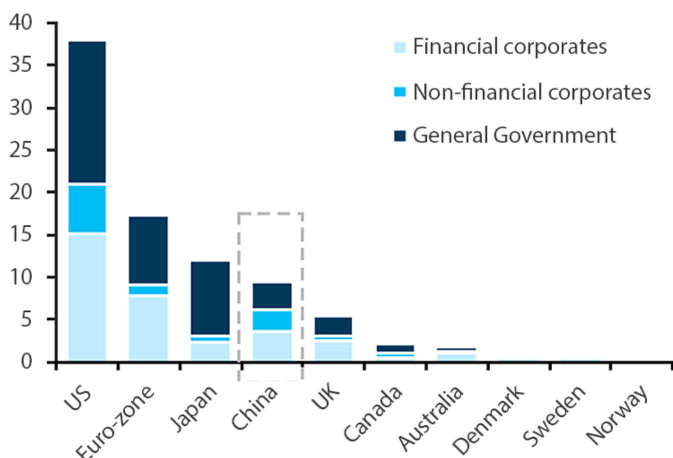
WILL INVESTORS BE READY WHEN CHINESE BONDS GO GLOBAL?

In June, MSCI announced the inclusion of Chinese A-shares into the MSCI Emerging Markets index. The weight of yuan-denominated A shares will be 0.7% and the inclusion will follow a two-step process, with the first step taking place in May 2018 and the second in August 2018. Investors had waited for this decision for years but restrictions on dealing, foreign ownership and opaque corporate structures prevented MSCI from including them.

Nevertheless, the index provider finally decided to recognize China's financial market reform efforts and include them on a limited scale. Higher index weights can be expected if one of the largest economies in the world continues its reform path. According to Goldman Sachs, China's stocks could account for 9 per cent of the MSCI EM Index or USD 230bn worth of investments into China mainland over the coming 5 years.

But what about bond indices? Until recently, the world's fourth largest bond market (Figure 1) with a market value of approximately USD 10 trillion was not included in any of the investable global bond indices.

Figure 1: Debt securities outstanding (USD trn)



* Note that "Treasury bonds" include local government debt.

Source: BIS, Haver Analytics, Barclays Research

Similar to MSCI, Citigroup decided in June to add Chinese government, agency and corporate bonds to some of their indices. Other major index providers made similar moves, as Bloomberg Barclays Indexes launched a "+ China" version of its Global Aggregate Index and JP Morgan included Chinese government bonds in its local currency indices. The changes came on the back of China's capital market liberalisation.

While China opened its domestic bond market many years ago, the pace of market liberalization only accelerated in the recent two years. The Qualified Foreign Institutional Investor (QFII) program in 2002 was the first step taken to open up the market but it came with various restrictions ranging from quotas, access to the onshore forex market and fund repatriation. The RMB Qualified Foreign Institutional program (RQFII) followed much later in 2011 with more relaxed rules on fund repatriation but quotas and forex restrictions remained.

In 2016 a new program, the CIBM (China Interbank Bond Market) program, was launched, which directly gave foreign investors access to the CIBM with investment quotas and repatriation limits abandoned for the first time. This "free" access program was already offered to foreign governments, central banks and sovereign wealth funds two years earlier but had a binding condition then that required the choice of PBOC as the custodian.

Lastly, in June this year, officials introduced the "Bond Connect" program that allows foreign investors to purchase onshore bonds through a trading link with the Hong Kong exchange, settling and customizing their holdings in Hong Kong. In addition, the CIBM program was further relaxed to permit investors to hedge currency risk onshore, which is a significant improvement for investment managers.

After all the progress on market liberalisation, index providers are still hesitating to include Chinese bonds into their major benchmark indexes, as there remain some major hurdles for the main index trackers. Some have difficulties handling the unique non-ISIN identifiers on the onshore CNY bonds in their systems while others struggle with the separate currency codes for the onshore bonds as CNY and the offshore dim sum bonds as CNH. In addition, index providers and trackers look for reassurance from Chinese regulators that there will be no backtracking on their recent liberalisation efforts, in particular the restriction on fund repatriation in case of a market sell-off.

However, most market participants agree that probably in the coming year, index providers will include Chinese bonds in the major benchmark indices, which will then present a challenge to most investment managers. This will particularly be the case for Global bond and Global credit portfolios, which mostly have yet to invest in the market. The Global Aggregate + China Index weight of Chinese bonds currently exceeds 5%, ranking the market fourth, behind U.S. dollar, Euro and Japanese Yen.

Most investors are significantly underinvested in Chinese bonds, as foreign investors own currently less than 2% of the China onshore market and would have to launch a significant investment spree to match the index weight. Even more dramatic would be the inclusion for EM investors benchmarked against the J.P. Morgan GBI-EM Global Diversified Index. Investors would suddenly face a weight of more than 35% in the uncapped version and 10% in the capped version as well as reducing the weight of all other countries.

Market liquidity might not be the main challenge for portfolio managers as the China onshore bond market is fairly deep and liquid. Rather, the challenge will be a lack of analytical resources to research the Chinese onshore market. Some might decide to remain underweight for the time being as they ramp up research resources, while others might just buy Chinese bonds because "they are in the benchmark". Yet some investors will see this change as an opportunity to unlock a hidden new alpha source. The latter group are investment managers that have long had expertise in the Asian Fixed Income market and feel confident to utilise their proven additional expertise in Global portfolios. For the other market players, there seems little time left to build up such expertise as some index providers are likely to proceed with the inclusion as early as 2018.

Investments in the Chinese market would be interesting for three main reasons. The first would be its yield advantage vs. global developed markets, and its defensive characteristics due to China's status as a net creditor country. Secondly, as its economy is still at a developmental stage, China's growth path is on a different level from that of the matured G10 markets and its bond market thus trades quite differently from the G10 markets. Hence, from a diversification angle, CNY bonds would be very attractive for the global investors.

Lastly, the CNY has the potential to challenge the USD as a world reserve currency in the long run, succeeding in a way that the JPY failed in the 1980s because the Japanese economy's share of world GDP and trade then was far lower than China's share today. Given that China is the world's second largest economy and the world's biggest trading partner, the IMF had to give the CNY the third largest weight of 10.92% in its SDR basket out of five components when it included the CNY into the basket in 2015. The SDR membership lays the foundation for the CNY to realize its reserve currency potential.

Conclusion

Most bond index providers have started to recognize China's financial market liberalisation and reform efforts, and have included Chinese onshore bonds at least in some indices. We think, if not in 2018, it is only a question of time when these bonds will also get included in the main benchmark indices. Such a move will become a challenge particularly for investors focused on Global Credit and Global Core.

A widespread shortage of research capability to analyse the Chinese onshore market will leave most managers only with limited options. Either they will not invest or they will take small but not actively researched exposure to limit their tracking error risk.

However, investors who already have an in-depth expertise in this market will have the opportunity to add a powerful new alpha source to their investment universe.

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