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Around THE Curve

Where Angels Fear to Tread: China's Onshore Bond Market

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To most global bond investors who scour the four corners of the earth for attractive opportunities in the current low-yield and low-growth environment, China remains a half-closed frontier where angels fear to tread among the many risks and unknowns. As China's economy has become the second largest in the world, its ambition to internationalize its currency, liberalize its capital account, and assume a leading role in the global economy has risen commensurately. However, as they fight an uphill battle to arrest the capital outflow and downward pressure on the renminbi (RMB) triggered by the lack of investment returns, slowing domestic growth, investment diversification needs, and an upcoming U.S. Federal Reserve (Fed) rate hike cycle, China's policymakers face a potential setback to their commitment to a gradual opening of the country's capital account. However, we believe China's secular rise in the global economy and its resolve to integrate more into global capital markets are irreversible. Developing a mature, liquid, deep, and open bond market is critical for China to manage its financial risk and rein in its runaway credit growth. In February 2016, China finally finished throwing open the door to its onshore bond market, providing broad access to foreign investors. Now, as the world's third-largest bond market, behind only the U.S. and Japan, China's onshore bond market is one that we believe global investors must not overlook.

Open, Sesame: Finally, China Opens Onshore Bond Market with a Bang

Beginning with characteristic gradualism, the opening of the China Interbank Bond Market (CIBM), China's onshore bond market, can be divided into three stages:

- **From 2005-2010, the CIBM was only open to three types of investors: Asian/China debt funds, foreign central banks, and RMB settlement banks in Hong Kong and Macau.**
- **From 2011-2015, the market opened slightly further to subsidiaries of Chinese fund management and securities companies based in Hong Kong and insurance companies in Hong Kong, Singapore, and Taiwan. The Qualified Foreign Institutional Investor (QFII) and RMB QFII quota schemes allowed foreign investors to invest with strict quota limits, subject to People's Bank of China (PBOC) pre-approval and repatriation limits.**
- **From 2015 to the present, the market was broadly opened to medium- and long-term foreign investors. In July 2015, PBOC first loosened the rules for foreign central banks and sovereign wealth funds, granting them registration in lieu of pre-approval and forgoing the quota limits. In February 2016, policymakers announced the CIBM was open to all types of mid-term and long-term foreign institutional investors, including commercial banks, insurance companies, securities firms, asset managers, pension funds, and publicly and privately launched products.**

The "grand opening" of the CIBM market, free of quota limits and accessible to a wide range of foreign investors, was a watershed event for China, significant with respect to the following:

- **Breadth of foreign investors is improved.**
- **Quota restrictions are removed and the lengthy, cumbersome prior approval process is replaced with a simple, timely registration process.**

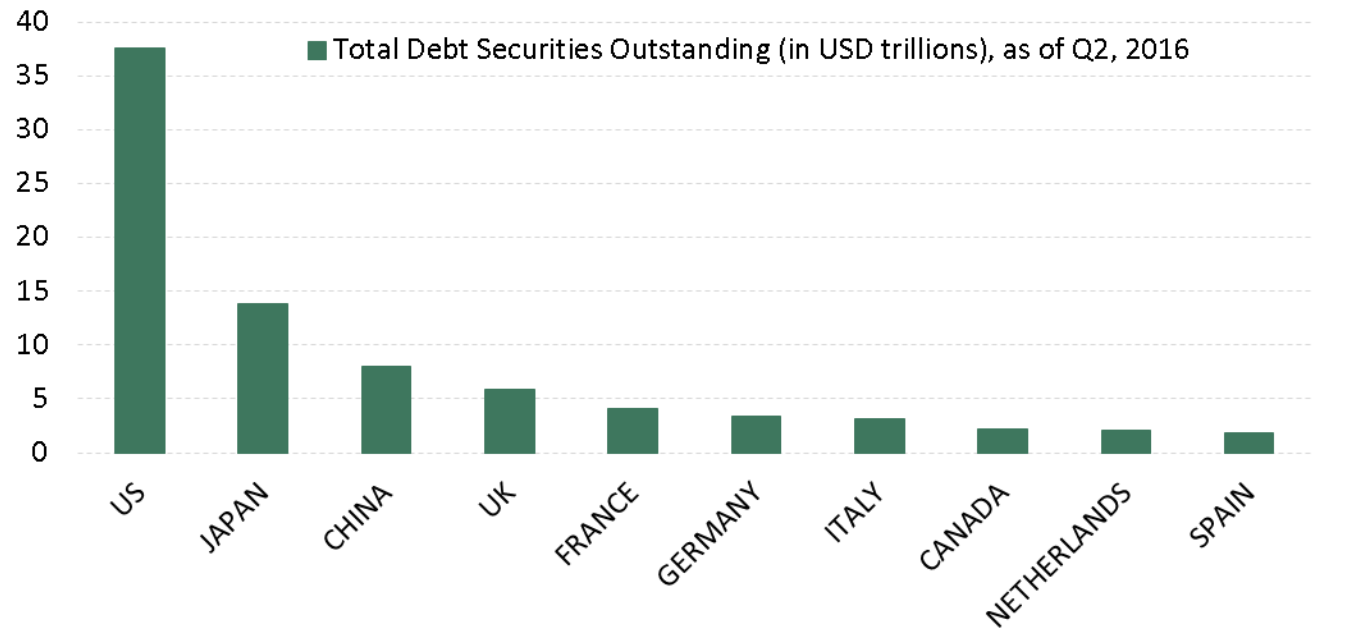
- Applicable products are now broadened to include interbank market cash bonds, interest rate swaps, forward interest rate products, bond lending, and bond forwards for hedging purposes, accessible to all investors. Foreign central banks and commercial banks can also access the repo market.
- There is no lock-up period or restriction on repatriating investment principal, except that the ratio of RMB to foreign currency should be the same as the initial investment (with maximum 10% deviation). Daily repatriation is allowed.

Why Should Investors Care about the CIBM?

1. Large Market with Growth Potential

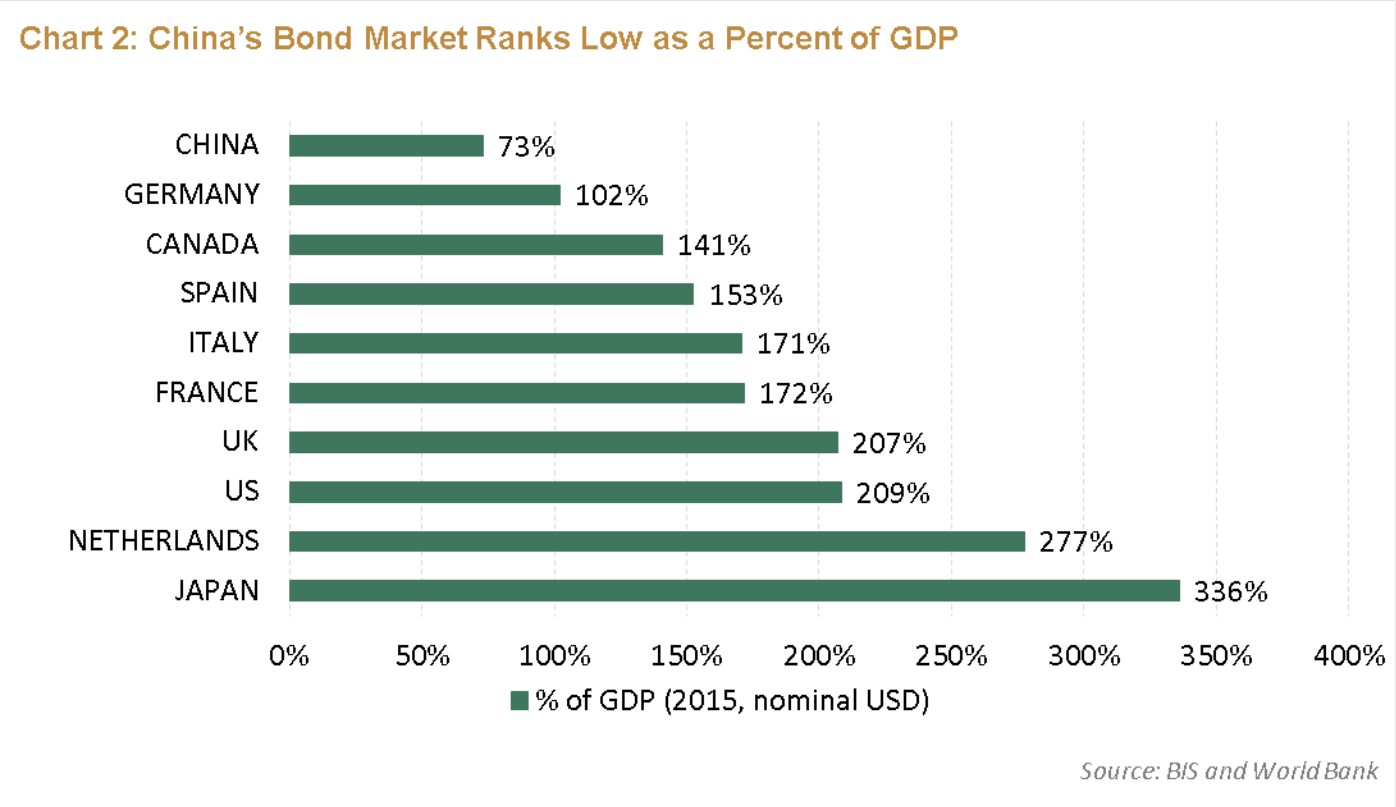
With approximately $8.1 trillion (USD) in market value, China's onshore bond market ranks as the world's third largest, behind only those of the U.S. and Japan. In terms of size, we believe it is a market global investors should not overlook (see Chart 1). HSBC forecasts that China's bond market will double in value by 2020. China's onshore bond market has two platforms: the CIBM and Exchange bond market (bonds that are traded on the Shanghai and Shenzhen exchanges). The CIBM makes up 90% of the market, totaling around $7 trillion, whereas the Exchange bond market makes up the remaining 10%.

Chart 1: China Is the Third-Largest Bond Market *As of 6/30/2016*



Source: BIS

If we put China's bond market size in perspective, it ranks last among the major bond markets as a percentage of respective gross domestic product (GDP). China's bond market at 73% of GDP contrasts sharply to Japan's bond market at 336% of its GDP (see Chart 2). This differential suggests China's bond market has huge growth potential. In particular, policymakers have a strong resolve to develop direct financing to replace the opaque "shadow banking" market. In China, this objective is referred to as "Closing the back door while opening the front door." By diversifying lending, a well-developed bond market can improve the efficiency of capital allocation, reduce systemic risk in China's banking system, help develop its yield curve, improve the pricing of risk, and provide long-term financing for infrastructure projects. One case in point is the well-known swap of Local Government Funding Vehicle (LGFV) debt into municipal bonds. The swap program improved transparency and also alleviated the maturity mismatch problem.



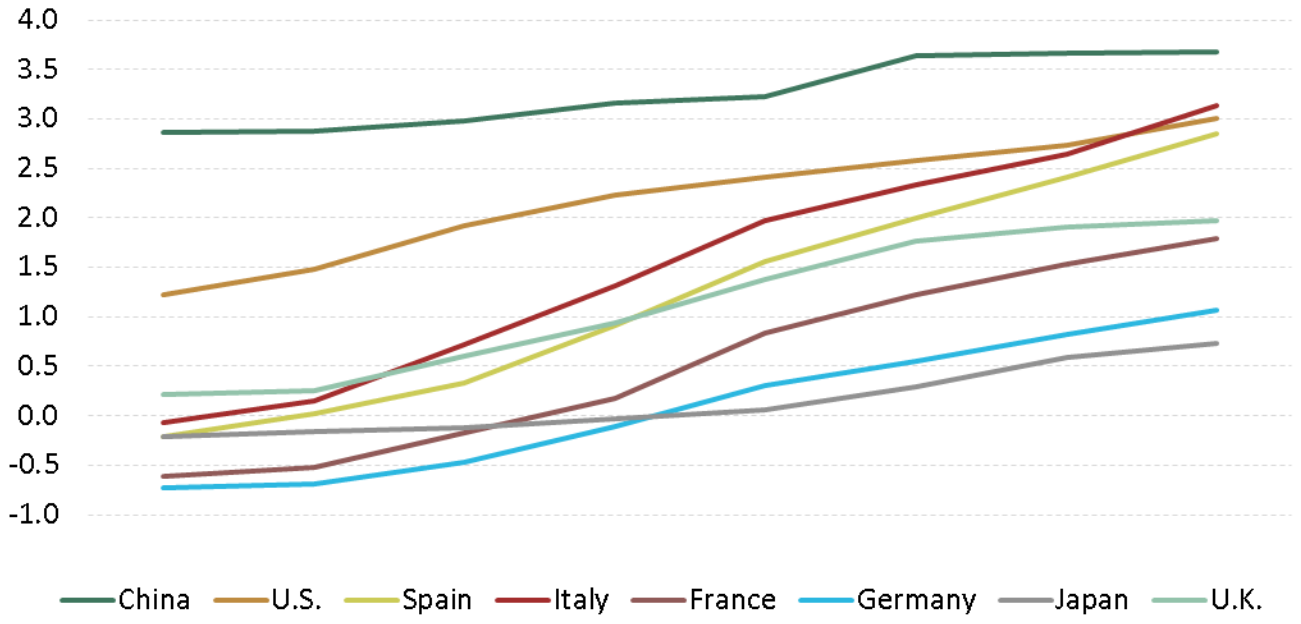
2. An Underowned Market by Foreign Investors

According to ChinaBond statistics, at the end of 2015 there were more than 300 foreign institutions that opened accounts, holding RMB bonds totaling over RMB 600 billion. Despite the exponential growth in foreign investors, foreign holdings represent only about 1.72%. In comparison, foreign investors own almost 50% of the U.S. bond market and 38% in Mexico. Furthermore, government bonds account for 82% of foreign holdings, indicating the degree of foreign investors' risk aversion. In contrast to China's equity market, which is dominantly owned by individual investors, most onshore bonds are held by commercial banks via leverage in interbank funding. China remains underweight in international bond portfolios, but major bond indices, like the J.P. Morgan GBI Emerging Market Global Diversified Index, Bloomberg Emerging Markets Local Currency Government Index, Bloomberg Global Aggregate Index, Citigroup Emerging Markets GBI Index, and Citigroup World Government Bond Index, are in the process of reviewing the market for inclusion. With inclusion likely by 2018, China's onshore bond market could see significant inflows, improving creditability and liquidity. The weighting would likely be relatively large considering the size of China's market. If index weightings are proportional to the International Monetary Fund Special Drawing Right's (IMF SDR) 10% range, the inclusion may bring in approximately $350-500bn to China's bond market.

3. Attractive Relative Value

Despite the low interest rate environment, Chinese onshore bonds have offered higher yields than many other major developed market sovereign bonds with comparable ratings (see Chart 3).

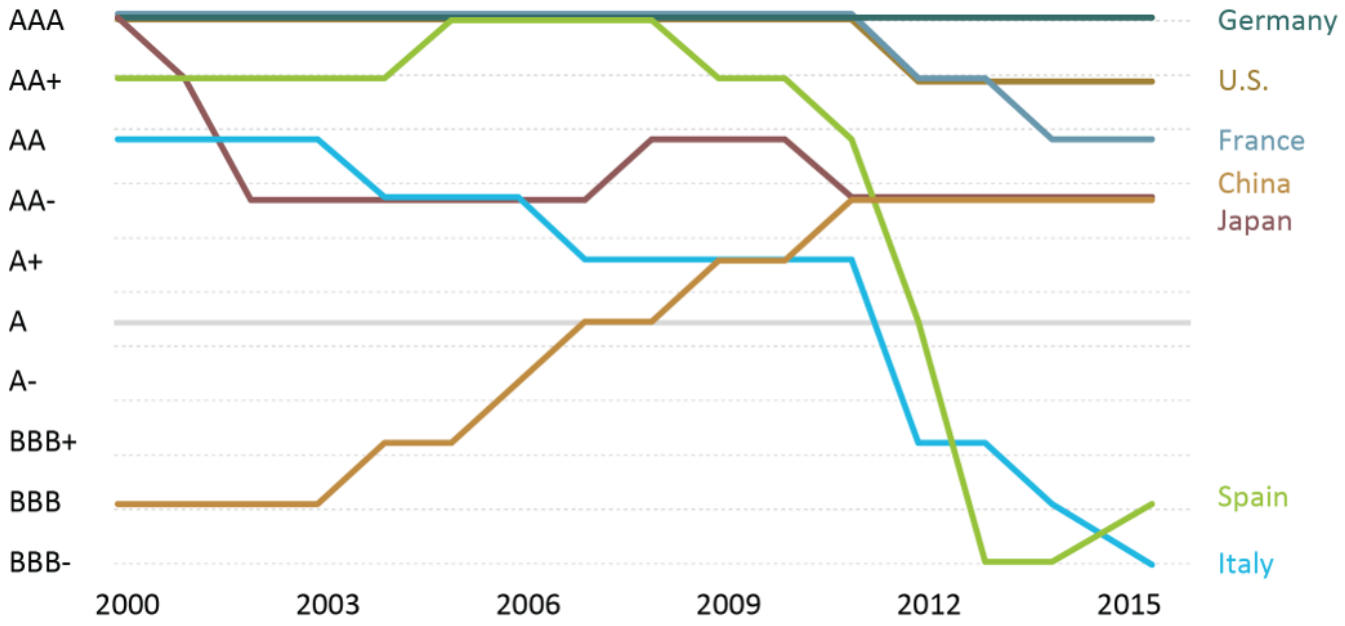
Chart 3: Comparison of Government Bond Yields *(%); As of 1/06/2017*



Source: Thomson Datastream

In addition, Chinese bonds have been on an upgrade trend relative to other countries (see Chart 4).

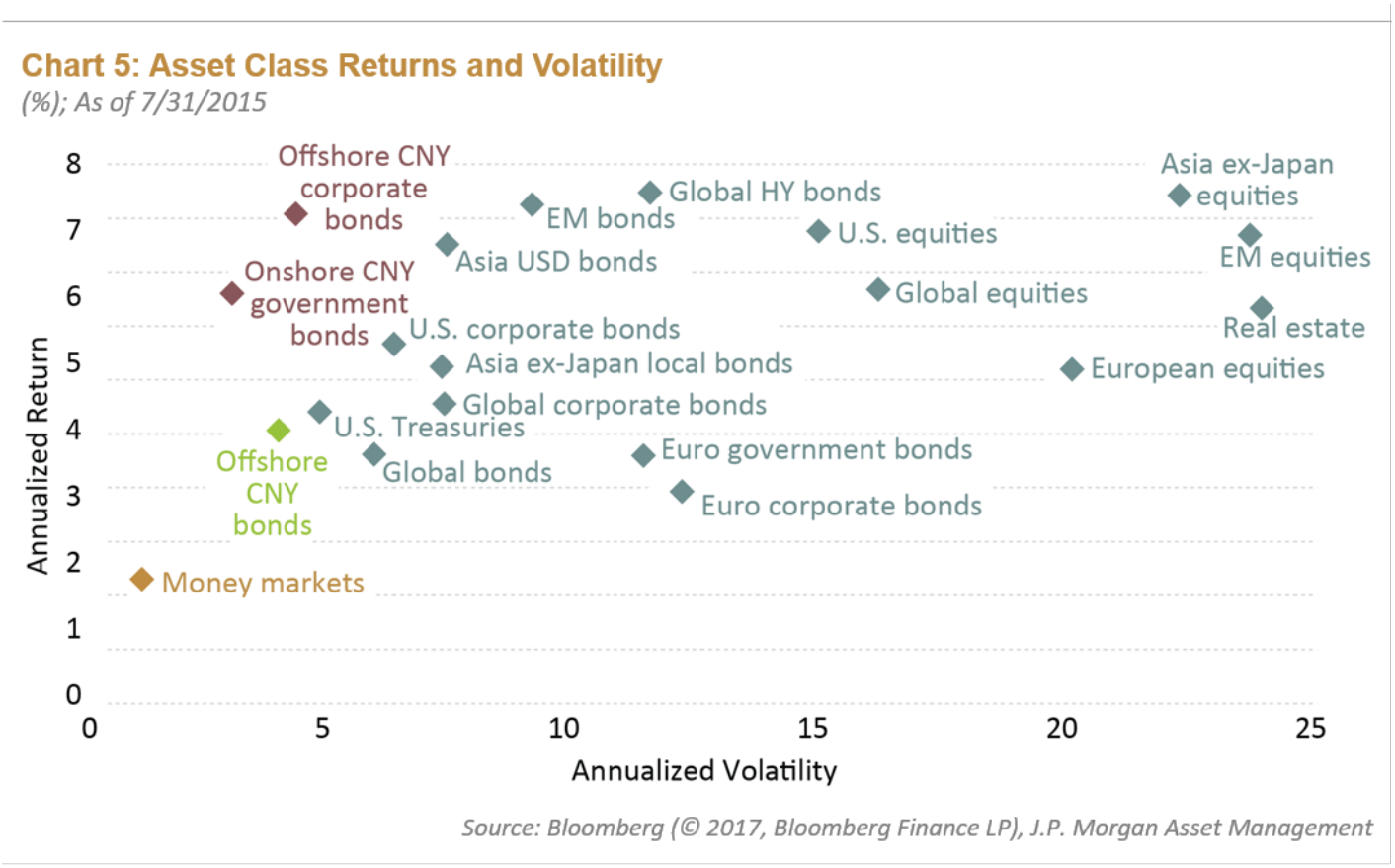
Chart 4: Chinese Government Bonds Have Seen Progressive Ratings Upgrades
As of 7/31/2015



Source: Bloomberg (© 2017, Bloomberg Finance LP), S&P, J.P. Morgan Asset Management

According to data on asset class returns and volatility, Chinese bonds have delivered higher risk-adjusted

returns compared to other major asset classes from July 2005 to July 2015 (see Chart 5).



4. Diversification Benefits

In addition to favorable risk/return profiles and quality trends, Chinese government bonds exhibit low correlations with other major developed market countries, which should provide diversification benefits to investors' portfolios (see Chart 6).

Chart 6: Government Bond Correlation Matrix

Percent; As of 7/31/2015

	U.S.	Germany	Japan	China
U.S.	1.00	0.88	0.85	0.12
Germany	0.88	1.00	0.96	0.08
Japan	0.85	0.96	1.00	-0.09
China	0.12	0.08	-0.09	1.00

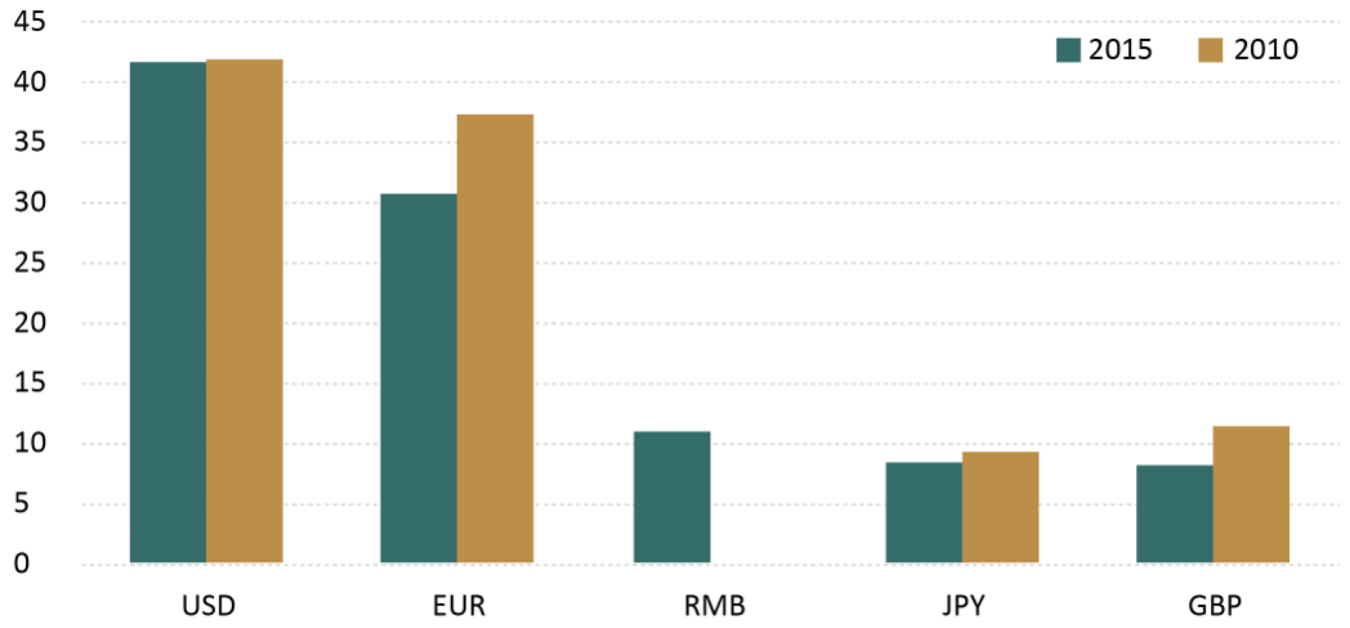
Correlations are based on monthly 10-year sovereign bond yields from July 2005 to July 2015.
Source: FactSet, J.P. Morgan Asset Management

5. Benefit from Increased RMB Demand

With the goal to establish RMB as a global reserve currency, China has encouraged use of its currency in international trade and finance. Now, RMB has become the second-largest global trade financing currency and the fifth most-used global payment currency. Its inclusion and roughly 11% weighting in the IMF SDR is expected to facilitate greater use of the currency and drive demand for onshore government debt and corporate credit (see Chart 7).

Chart 7: Currency Compositions of IMF's SDR Basket

(%); As of 12/31/2015



Source: Bloomberg (© 2017, Bloomberg Finance LP)

6. Full Menu of Bond Options

The CIBM offers investors a wide variety of onshore bond products, including:

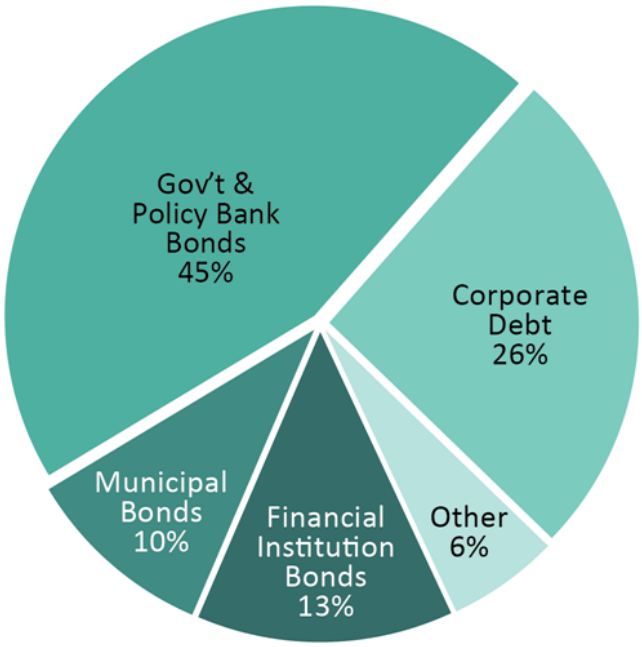
- **Government bonds**
- **PBOC bills**
- **Municipal bonds**
- **Government-backed agency bonds**
- **Financial bonds (issued by commercial banks and non-bank financial institutions)**
- **Corporate credit bonds**
- **Asset-backed securities**
- **Interbank CDs**
- **Panda bonds (bonds issued in China by foreign institutions and banks)**

7. Expected Credit Market Expansion

Corporate bonds are becoming the fastest-growing share of China's bond market. Government and policy bank bonds account for 45% of the total market, followed by corporate bonds and municipal bonds (see Chart 8). But, with the fast-increasing issuance of financial and non-financial corporate bonds, including medium-term notes, enterprise bonds, and commercial papers, corporate bonds have grown to around 30% of the current market (see Chart 9).

Chart 8: Composition of Outstanding Bonds

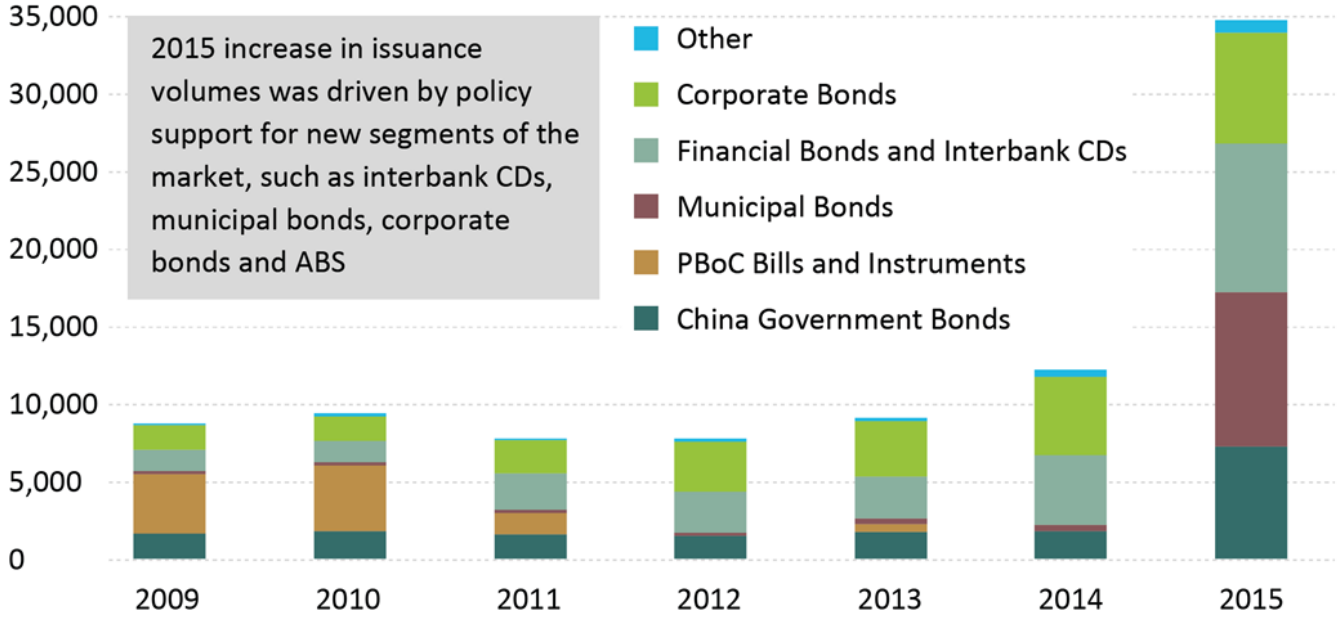
RMB 48.5 Trillion; As of 12/31/2015



Source: Deutsche Bank

Chart 9: Domestic Issuance Volumes Surged in 2015

Billions of RMB; As of 12/31/15



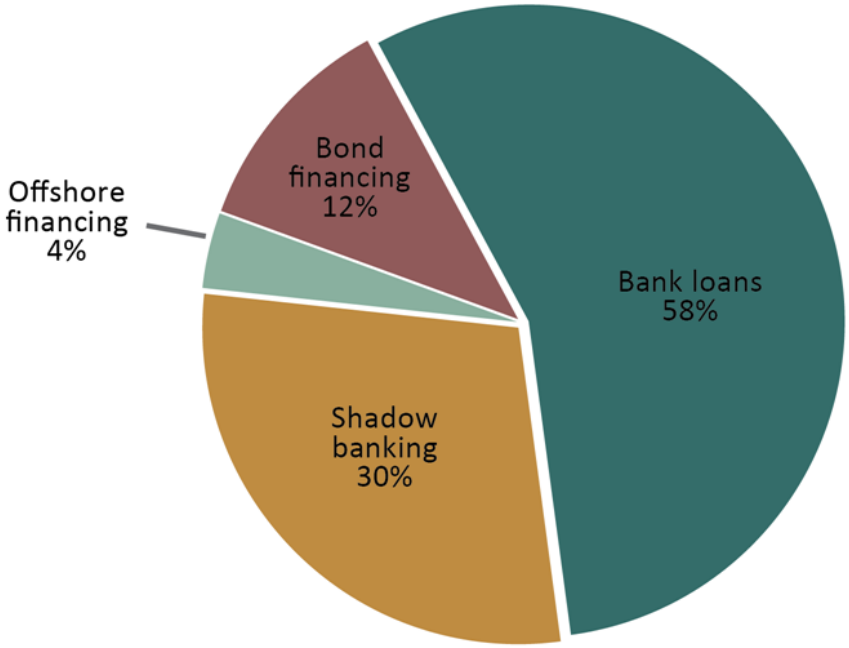
Source: Deutsche Bank

Putting the growing corporate bond sector into perspective, bond financing still accounts for only 12% of

China's corporate debt (see Chart 10). A large and deep bond market that accurately prices risk could help the Chinese financial system to become less bank-dependent, more transparent, and more efficient.

Chart 10: China's Corporate Sector Debt

As of 12/31/2015



Source: IMF, Deutsche Bank

A Great Wall of Fear

While China offers growing opportunities, investors must also confront some significant risks:

1. Fear of a hard landing: We think the risk of a hard landing for China's economy due to the debt overhang or a potential credit bust is very remote in the near term. The economy is diversified and shows considerable vitality. Furthermore, policymakers still have the wherewithal to stimulate growth if needed, with safeguarding stability their primary goal.
2. Fear of RMB devaluation and volatility: Despite a recent depreciation trend and increased volatility due to a wider trading band, RMB is still one of the most stable currencies with a low beta. While another marked devaluation remains a fat-tail risk, we do not believe such a move is in China's best interest as it would further dampen confidence in the currency. With leadership transitioning to the 19th Congress, no one wants to be blamed for a potential mistake.
3. Fear of lack of market infrastructure: The mishandling and intervention in China's A-share equity market overshadows the CIBM market. However, we believe policymakers should adopt better risk management mechanisms in the bond market. Unlike the equity market, which is driven by retail investors, the bond market is dominated by institutional banks with low turnover and lower volatility. According to Bloomberg, annual trading as a ratio of total outstanding bonds in China is only 1.9x, compared to 4.7x in the U.S.
4. Fear of lack of data transparency and reliability: Credibility of data is a common complaint, which requires investors in China to conduct more on-the-ground due diligence. As an emerging economy with an early-stage bond market, China needs to address liquidity, transparency, and credit and default risks. Suffice it to say that we see considerable improvements on many fronts, as more and more foreign

investors start to invest in China's market. There are a dozen indices set up by both ChinaBond and foreign investors like J.P. Morgan Asset Management to track bond performance. The market will become more mature upon its opening to foreign investors. Corporate governance will also improve gradually along with state-owned enterprise (SOE) reform.

5. Fear of inability to price default risk: Policymakers have been working on establishing a depositor-protection mechanism like FDIC insurance in the U.S. and formalizing bankruptcy law, to help move the government away from the dysfunctional impact and moral hazard of implicit guarantee. China has been allowing some SOEs to default, and the market is gradually learning how to accurately price the default risk.
6. Fear of non-standard quality ratings: Regarding credit risks, there is a clear inconsistency between Chinese ratings agencies and international ratings agencies, including Fitch, Moody's, and Standard & Poor's. According to BNP Paribas statistics, among 4,000 corporate issuers, 51% of them are rated AAA by China's domestic rating agency, with only 1% rated A and below. These statistics are in sharp contrast to the U.S. market, where only two companies remain AAA-rated. According to the Bank of America Merrill Lynch China Broad Index, 22.5% of the onshore bond market remains unrated by recognized ratings agencies. The large discrepancy between local Chinese rating agencies and international rating agencies is an issue for foreign investors, which is further complicated by the lack of default history in the Chinese bond market. As Chinese policymakers challenge the assumption of implicit guarantee and allow more companies to default, the resolution of defaults will become more standardized.

Conclusion

Despite the obstacles that challenge foreign investors' participation in China's onshore bond market, we do not believe any of these are deal breakers. These issues are common to emerging markets, and typically correspond to a developing country's market development stage. We believe the benefits outweigh the risks. Global investors should recognize the significant and unprecedented opportunities afforded by the "grand opening" of China's onshore bond market. They should become more familiar with the market by performing due diligence on both country fundamentals and individual credit risk analysis. Should China's bond market be included in major bond indices, we believe the weighting and impact would be significant. At that point, it would no longer be at the discretion of foreign investors whether to recognize the market or not. That said, China's onshore bond market is not for the faint-hearted. Closely monitoring government policies is equally critical as fundamental analysis. However, given the learning curve required, trail-blazing investors who take the early steps will likely have first-mover advantages.

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