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Matthews Asia

Q&A with Teresa Kong, Portfolio Manager

Mainland China-Hong Kong Bond Market Connect

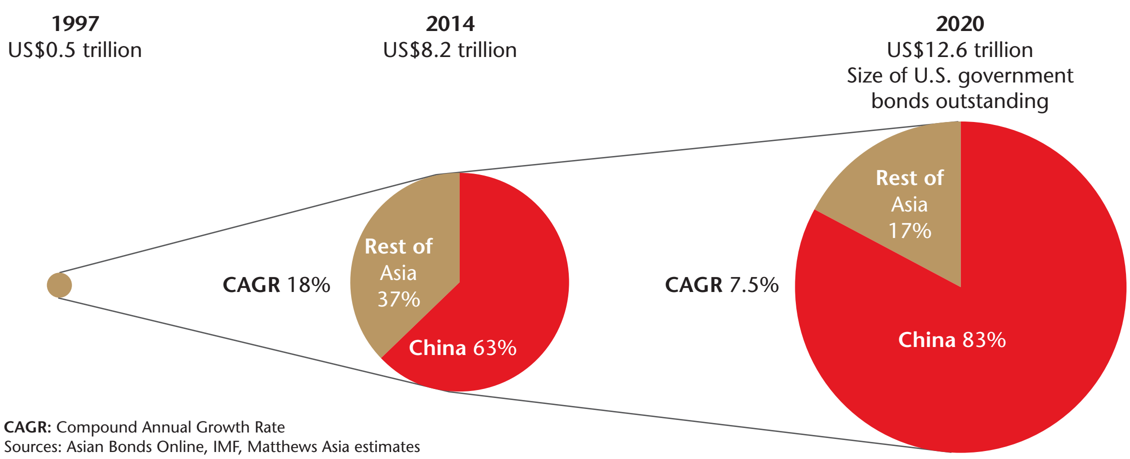
Given the recent flurry of announcements relating to the inclusion of Chinese bonds in various global bond indices and the announcement of the upcoming Mainland China-Hong Kong Bond Connect, we sat down with Teresa Kong to get a better understanding of the context and implications of these developments.

Teresa Kong, CFA
Portfolio Manager

Can you outline the composition of China's bond market?

The Chinese onshore market is the third largest in the world, after the United States and Japan. The total size of the market as of the third quarter of 2016 was over US$7 trillion (RMB 48 trillion). While most corporate bonds trade on the stock exchange, Chinese government bonds and policy bank bonds trade on the larger and more liquid China interbank bond market (CIBM). The largest issuers in the CIBM are the Chinese government and the Chinese policy banks: Agricultural Development Bank of China (ADBC), China Development Bank (CDB) and the Export- Import Bank of China (Chexim). There is also another Chinese bond market that trades offshore, known as the "dim sum" market where International bond investors can buy bonds that clear through international clearing houses like Euroclear and Clearstream. The dim sum market was a natural outgrowth of the Chinese government granting Hong Kong-based banks the ability to take renminbi (RMB) deposits. As demand for RMB-denominated deposits grew, banks needed to invest the RMB deposits in RMB-denominated assets. At the same time, offshore companies, including Chinese companies that listed offshore were given the ability to issue bonds in RMB offshore. As supply and demand for offshore RMB-denominated bonds grew, the dim sum market also grew. Since the first dim sum bond was issued in 2007, it has grown into a US$75 billion (RMB 578 billion) market.

Figure 1. Asian Bonds Outstanding



CAGR: Compound Annual Growth Rate
Sources: Asian Bonds Online, IMF, Matthews Asia estimates

How have international investors been accessing China's bond market?

The dim sum market is readily accessible and does not require local accounts or any additional local registration. Access to China's onshore bond market has traditionally been granted through the country's Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programs. Since 2016, international investors have been able to access CIBM through a new scheme that is less onerous than QFII or RQFII, but still requires registration. The newly announced Mainland China-Hong Kong Bond Market Connect promises to further streamline this process. Expected to launch later this year, it is likely to give international investors access to China's bond market.

Recently, both Citigroup and Bloomberg announced they would be making changes to some of their bond indices. Can you explain what those changes are?

Citigroup announced that it was adding Chinese onshore bonds to its emerging market and regional government bond indices, and creating a new version of its popular World Government Bond Index (WGBI), called WGBI-Extended, that doesn't have strict rules against barriers to entry for investors. This follows Bloomberg's move in January to launch a new version of its Global Aggregate (Global Aggregate + China) Index that includes Chinese onshore debt, and J.P. Morgan's announcement in March 2016 that it was putting China under review for potential inclusion in its Government Bond Index-Emerging Markets (GBI-EM Broad).

What does the index inclusion mean for global investors?

The trend among established bond indices is clear. As China continues to liberalize its financial markets, mainstream benchmarks used by investors globally will move to bring onshore Chinese debt into indices. China is home to the world's third-largest bond market, so it stands to become a large part of investors' portfolios over the next few years. This means investors will need to gain deeper knowledge and understanding of the onshore bond market so they can effectively evaluate and invest in Chinese issuers.

What are some of the hurdles for global investors in allocating to Chinese debt?

Two challenges that offshore investors face are access to markets and pricing of risk. Barriers to entry are being lifted, but global investors still need to meet regulatory requirements outlined in the various schemes, to be able to buy and sell bonds onshore. Pricing risk in onshore bonds is another challenge that investors need to overcome. For the large portion of the market consisting of state-owned entities, credit analysis historically has been about understanding the policy priorities of the government, the strategic importance of the industry, and the strength of a company's ties to the local, provincial, or central government. Companies will need to have disclosures and transparency for offshore investors to evaluate the potential risk and return of an investment.

Can you explain why the Chinese government controls the flow of capital?

I like to compare the flow of capital in and out of China to the human circulatory system. We have a delicate circulatory system consisting of arteries that carry blood from the heart and veins that carry blood to the heart. If the pressure is too high, we can have a heart attack! Until 2015, the pressure has come from foreign investors seeking to invest capital onshore to take advantage of the appreciating Chinese renminbi and the high onshore interest rates. Since 2015, the renminbi has been depreciating relative to the USD and interest rates have been falling. As a result, the pressure is now coming from Chinese capital wanting to invest overseas. The Chinese government monitors these pressures very closely and most capital controls can be understood with this framework.

When there's greater demand for outflows as there has been for the last couple of years, policies will tend to facilitate inflows and discourage outflows. We see policies and regulations adapting to market conditions and not driven by ideology or politics.

How do capital controls impact foreign investors wanting to buy domestic Chinese debt?

While we do not yet have complete details for the Bond Connect, we have some expectations based on our experience in trading equities through QFII versus Stock Connect. As you can see from the table, the bond connect offers the main advantage that the bonds would be held in custody in a Hong Kong account without any type of holding period restrictions. QFII has explicit restrictions based on the quota granted in terms of how much you might be repatriated over a specific period. The exchange rate used would also be slightly different as QFII investors would get the onshore rate CNY (onshore currency) while the bond connect investor would be getting the offshore rate CNH (offshore currency). The difference between the onshore and offshore rate reflects the difference in the supply and demand and is typically limited to less than 5 cents. Finally, we expect the bond connect to have some type of daily quota system similar to that of the Shanghai-HK and Shenzehn-HK direct connects for equities.

	QFII	Bond Connect
FX Rate	USD/CNY	USD/CNH
Liquidity	Rules surrounding holding period	Daily quota
Custody	Mainland China	Hong Kong
Repatriation	Specific rules limiting repatriation	None

Does Matthews Asia currently invest in onshore China debt?

While we don't currently invest in onshore China debt, we expect to in the future. Accessing the market has been operationally difficult and credit risk onshore hasn't been priced properly. This is changing as China starts to allow more companies to default onshore, leading to the market-driven pricing of credit risk. We have invested in the offshore dim sum market when certain bonds have offered adequate spread premium for credit risk.