

IN

DEPTH

Onshore RMB bonds:
promising growth,
untapped potential

JUNE
2018

Overview

China's onshore RMB-denominated bond market, the world's third largest, is poised for rapid growth as the country opens its doors more widely to foreign investors.

Onshore RMB-denominated bonds: potential for promising growth

The journey of a thousand miles has already begun. China's onshore bond market denominated in renminbi (RMB) has grown to around RMB70 trillion (USD11 trillion), more than 10 times bigger than it was in 2002.¹ This odyssey will not end here.

Over the next decade, this market is likely to expand even more rapidly to satisfy the financing needs of the world's second largest economy, which is both urbanising at an unprecedented speed and gradually opening up its capital markets. China's economy is on track to surpass that of the euro zone sometime this year and match the US in the next few decades; its bond market is likely to follow a similar path.

Trading dominated by interbank, domestic players

Today, interest rate-related instruments – as opposed to credit products – make up more than half of the bonds traded in the onshore market. These include:

- Central government bonds: issued by the Ministry of Finance to fund government spending.
- Policy Bank/Financial bonds: issued by state-owned banks such as China Development Bank, which carry out policy roles.
- Local government bonds: issued by provincial governments.
- Corporate bonds: issued by Chinese companies, these make up a third of total bonds traded, yet many of the issuers are state-owned enterprises – only 4 per cent of corporate bonds are issued by private companies.

More than 90 per cent of bond trading, or around RMB61.9 trillion, takes place in the interbank market.² Established in 1997, it is a quote-driven over-the-counter market regulated by the People's Bank of China (PBOC). The make-up of the participants has become more diversified in the past few years as Beijing opened up the market to attract foreign investors and boost inflows. From March 2017, the government has allowed selective overseas investors to hedge their foreign exchange exposure via cheaper and more liquid onshore derivatives. Later in the year, Chinese authorities launched the "Bond Connect" programme in Hong Kong, marking the most significant improvement in access to the onshore bond market for foreign investors.

The rest of trading takes place in Shanghai and Shenzhen stock exchanges, an order-driven marketplace governed by the China Securities Regulatory Commission. Exchange trading is dominated by small to medium trading houses and individual investors.

Bonds are traded mainly by domestic investors. Commercial banks dominate, accounting for more than half of trading volume (FIG. 3). This is mainly because the primary investment channel for Chinese savers is bank deposits, and cash-rich banks need to reinvest these funds. Foreign institutions currently make up less than 2 per cent of the market, but their share is growing.²

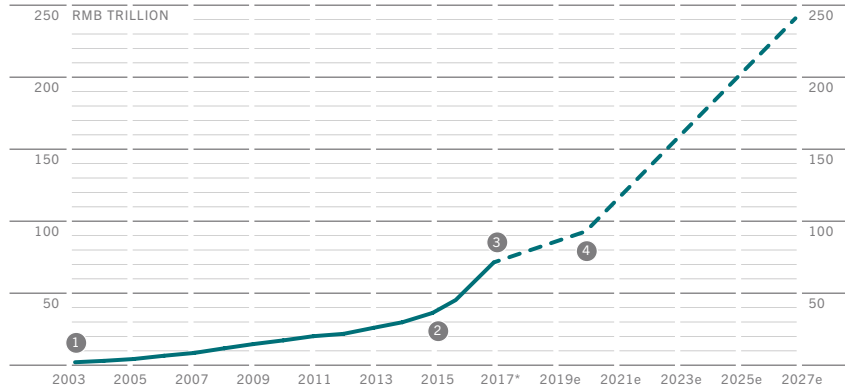
¹ ChinaBond, JP Morgan as of 29.12.2017

² BNP Paribas as of 31.06.2017

Onshore RMB bond markets have grown rapidly

FIG. 1

Growth of China's onshore RMB bond market



* As of 30.06.2017
 ** Qualified Foreign Institutional Investors

1981	China introduces Treasury interbank market to fund national deficit
2003 ①	QFII** starts, foreign banks start to receive investment quota
2015 ②	IMF adds RMB as reserve currency
2017 ③	PBOC and HKMA launches Bond Connect, allowing foreign investors to trade without onshore accounts
2020 ④	Expected to match US bond market

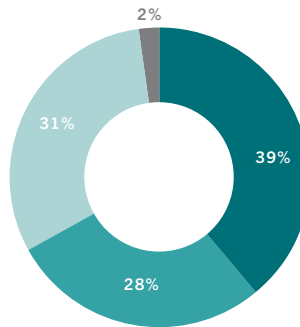
Source: PBOC, Wind, BNP Paribas

FIG. 2

The RMB bond market in numbers

Total bonds outstanding*

■ CENTRAL GOVERNMENT AND MUNICIPAL BONDS
 ■ FINANCIAL SECTOR BONDS
 ■ CORPORATE SECTOR BONDS
 ■ OTHER



* as of 31.12.2016
 ** as of 30.06.2017
 *** as of 29.12.2017
 **** Benchmark China Bond Index, data covering period 03.03.2015 – 29.12.2017

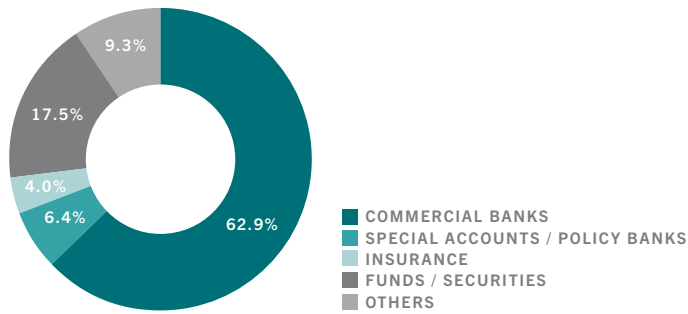
Compound annual growth rate since 2002	20%
Total debt securities to GDP ratio**	87%
Total amount of RMB bonds held by foreign investors**	RMB796bln 2% of the market
Outstanding RMB bonds breakdown by market**	Interbank 90% Exchange 10%
Duration as of 29.12.2017***	3.8 years
Annualised volatility****	3.1%

Source: BNP Paribas, Goldman Sachs, ChinaBond, JP Morgan, BIS

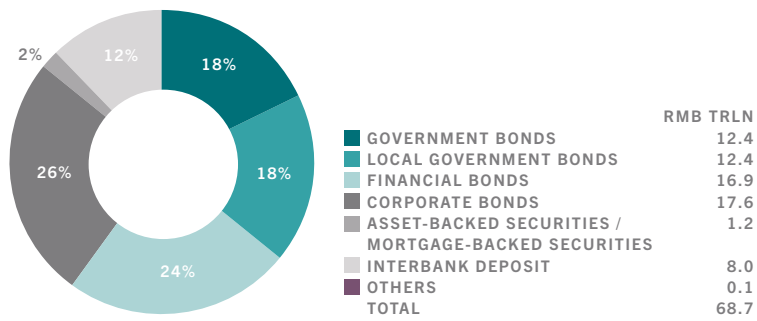
Commercial banks
dominate onshore
bond trading

FIG.3

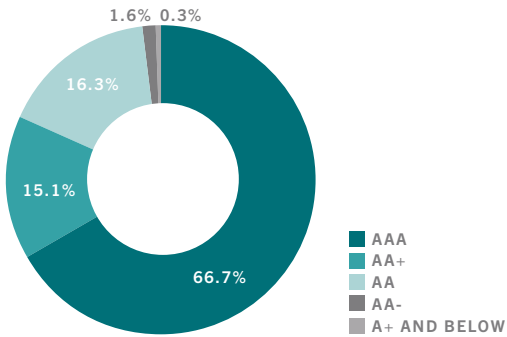
**RMB onshore bonds trading
Investor base**



Breakdown of bond types



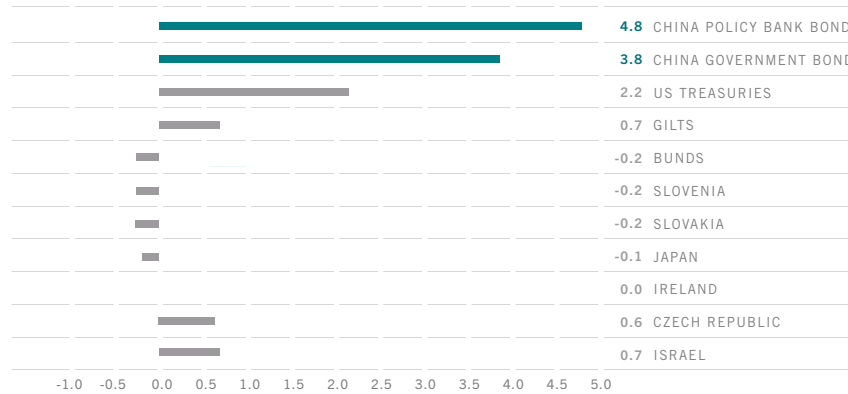
Ratings breakdown



Source: BNP Paribas, JP Morgan, as of 30.06.2017

FIG.4

5-year government bond yields



Source: Bloomberg, data as of 29.02.2016

Chinese government bonds offer higher yields than developed market sovereign debt

Why invest in onshore RMB bonds?

In the current low-return environment, onshore RMB bonds offer attractive yields, diversification and exposure to a currency with potential for appreciation. Yields on Chinese government bonds are higher than those of equivalent US paper, as well as debt issued by countries with similar credit ratings (FIG.4). What is more, they have a low correlation with other asset classes (FIG.5).

The relatively low volatility – an annualised reading of just 3.5 per cent – compared with other asset classes is another benefit (FIG.6). Significantly, Beijing’s measures to open up the onshore bond market could help China’s case for inclusion in the major global bond indices – an important step in the market’s evolution into a strategic asset class. Bloomberg has announced that it will start adding onshore RMB bonds to its benchmark Global Aggregate Index from April 2019. If the rest of major benchmark providers – JP Morgan and Citigroup – followed suit, it could generate as much as USD286 billion of fresh inflows.

FIG.5

Correlation analysis

	CHINA ONSHORE RMB BONDS	EMERGING LOCAL BONDS	ASIA USD BONDS	ASIA LOCAL BONDS	EMERGING USD BONDS	EMERGING CORP. BONDS	US GOVT BONDS	EURO AGG BONDS*	GLOBAL HIGH YIELD BONDS	EUROPEAN EQUITIES*	US EQUITIES	EMERGING EQUITIES	ASIA EX-JAPAN EQUITIES	SHANGHAI COMPOSITE	COMMODITIES
CHINA ONSHORE RMB BONDS	1.00	0.37	0.21	0.42	0.26	0.20	0.19	0.14	0.09	0.10	0.25	0.30	0.42	0.13	0.06
EMERGING LOCAL BONDS		1.00	0.72	0.90	0.82	0.75	0.15	0.19	0.62	0.44	0.60	0.84	0.66	0.22	0.52
ASIA USD BONDS			1.00	0.71	0.91	0.91	0.35	0.45	0.57	0.36	0.35	0.62	0.42	0.22	0.23
ASIA LOCAL BONDS				1.00	0.79	0.65	0.29	0.26	0.55	0.35	0.52	0.75	0.58	0.16	0.33
EMERGING USD BONDS					1.00	0.87	0.29	0.40	0.65	0.42	0.42	0.68	0.47	0.19	0.32
EMERGING CORP. BONDS						1.00	0.17	0.34	0.68	0.49	0.46	0.70	0.49	0.29	0.38
US GOVT BONDS							1.00	0.55	-0.31	-0.32	-0.31	-0.18	-0.19	-0.20	-0.34
EURO AGG BONDS*								1.00	0.05	0.15	-0.03	0.03	0.00	0.03	-0.26
GLOBAL HIGH YIELD BONDS									1.00	0.67	0.62	0.74	0.54	0.27	0.52
EUROPEAN EQUITIES*										1.00	0.77	0.63	0.49	0.24	0.38
US EQUITIES											1.00	0.77	0.62	0.31	0.56
EMERGING EQUITIES												1.00	0.80	0.44	0.63
ASIA EX-JAPAN EQUITIES													1.00	0.42	0.45
SHANGHAI COMPOSITE														1.00	0.21
COMMODITIES															1.00

Source: ChinaBond, JP Morgan, HSBC, Bloomberg / * in EUR
All indices are total return and in USD unless otherwise stated.
Based on monthly data from 31.10.2008-29.02.2016

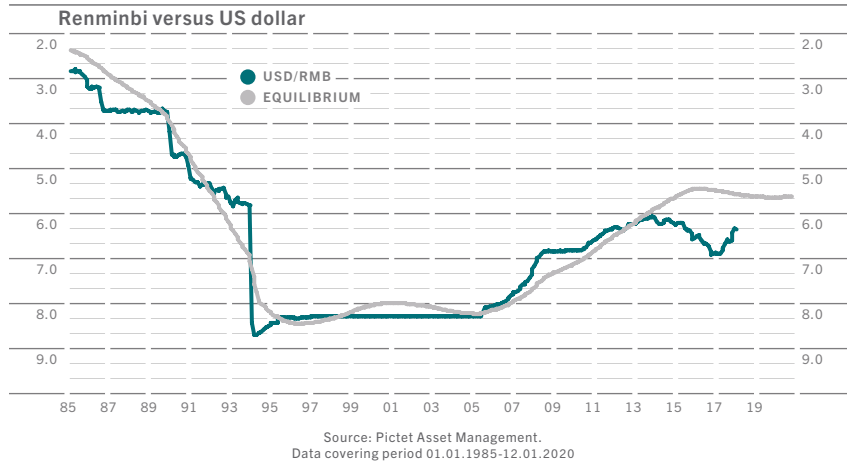
RMB onshore bonds have attractive risk-adjusted returns

FIG.6



RMB could extend its recent ascent in the next five years

FIG.7



A maturing economy

Investment in RMB onshore debt also allows investors to benefit from long-term structural changes within China's economy.

Beijing is steering the economy away from an export-oriented model to one driven by consumer demand at home. As a result, headline economic growth is likely to slow to a more sustainable 5.5 per cent a year, from an average of around 10 per cent seen in the past decade.

Inflation is likely to remain contained, providing a favourable environment for fixed income investors – our economics team expects it to stay below the central bank's target of 3 per cent over the next five years.

Government support

The government is supportive of developing the bond market for a number of reasons. For one, it wants to open up a new source of financing for local companies which have become over-reliant on bank loans. Authorities are thus promoting better disclosure and transparency from issuers, which is beneficial for investors in the long term.

The authorities are also keen to tap the bond market to finance urban infrastructure and construction projects to drive the next wave of growth as more workers migrate to cities.

World Bank expects China needs to invest USD1.9 trillion in infrastructure by 2040 to keep pace with economic and demographic changes. At least three quarters of the population is expected to live in urban areas by 2050, more than double the share seen at the start of this century.³

RMB internationalisation

As the economy matures, the authorities are committed to gradually opening the financial market further, liberalising its capital account and promoting the greater use of the Chinese currency abroad.

Chinese companies are increasingly settling their goods and services and foreign direct investments in the RMB. Transactions settled in the RMB have been grown at an annual rate of about 40 per cent since January 2012.⁴

The IMF's landmark decision to include the RMB in its benchmark basket of currencies (known as Special Drawing Rights), effective October 2016, marked an important milestone in the currency's internationalisation. The move recognised Beijing's economic reform and raised the RMB's profile as an international reserve currency.

As Beijing continues to loosen restrictions placed on the flow of capital across its borders investment flows in China is likely to grow further, leading to a gradual appreciation of the RMB (FIG.7).

According to our long-term fair value model, we expect that the RMB could strengthen from the current USD6.3 in the next five years. In this case, currency appreciation is likely to contribute strongly to the return on the bond portfolios.

³ UN World Urbanization Prospects 2014

⁴ Pictet Asset Management, CEIC, Thomson Reuters Datastream

The risk from China's private debt is limited

FIG. 8

Excess private debt risk in EM

	PRIV. DEBT GAP**) %GDP	DOM. BANK CREDIT GAP***) %GDP	PROPERTY PRICES GAP***) %	EXTERNAL DEBT %GDP	CURRENT ACCOUNT %GDP	PRIVATE SAVING %GDP	NET FOREIGN ASSETS %GDP	GOOD MINUS BAD SIGNALS
SELECTED PAST FINANCIAL CRISIS								
JAPAN (1988)	15.0	11.1	36.8	33.0	2.6	32.0	18.0	+1
THAILAND (1996)	29.3	29.4	-5.6	67.0	-7.3	32.0	-112.0	-3
US (2006)	11.0	6.2	21.8	76.2	-5.8	19.0	-40.0	-6
IRELAND (2006)	25.0	41.3	21.0	696.7	-3.6	20.8	-76.0	-6
SPAIN (2006)	36.8	35.7	19.0	131.2	-8.9	19.3	-108.7	-7
COUNTRIES WITH CURRENT SIGNIFICANT EXCESS PRIVATE CREDIT								
CHINA	19.3	9.5	-0.9	13.2	1.3	49.9	21.7	+4
INDIA	-7.5	-5.5	4.3	19.6	-1.0	29.9	-19.7	+4
THAILAND	8.1	6.3	6.7	30.9	12.0	35.4	17.4	+4
BRAZIL	-6.5	-7.8	-23.7	15.3	-0.6	22.8	-17.8	+3
INDONESIA	7.6	4.0	9.8	33.5	-1.8	33.0	-29.9	+2
MALAYSIA	5.2	2.8	12.9	64.0	3.7	31.7	49.0	+1
TURKEY	5.5	5.0	-0.4	49.3	-4.6	15.3	-57.7	-4

Source: Pictet Asset Management, BIS, CEIC, Datastream.
Bottom table uses data between Q1 and Q4 2016

* Difference between private debt to GDP ratio and its long-term trend (one-sided HP filter)
** Difference between domestic bank credit to GDP ratio and its long-term trend (one-sided HP filter)
*** Difference between real property prices and its long-term trend (one-sided HP filter)

Debt levels are manageable

China public debt levels remain low, at around 46 per cent of GDP. However, the country's private debt (held by non-financial corporates and household) stands at 200 per cent of GDP, the highest in the emerging world.

Notwithstanding the headline figures, in our view, concerns over China's debt position appear exaggerated for many reasons.

First, most private debt is held by state-owned or quasi state-owned companies. Second, debt is mostly held at home, with external debt to GDP ratio standing at just 13 per cent (FIG. 8).

Third, the market is also cushioned by ample domestic savings – China's savings ratio is the highest in the world at almost 50 per cent of GDP – and therefore is less exposed to foreign investment flows.

Fourth, according to our proprietary debt gauges, which measures countries' credit standing via metrics such as property prices and savings rates, China's private debt fundamentals are in good shape.

Indeed, China is better placed than EM peers such as Brazil and Turkey and is nowhere near the kind of debt bubbles that felled Japan in the late 1980s and plagued the euro zone and the US in the late 2000s.

Fifth, we think the People's Bank of China has demonstrated its willingness to support growth and ensure liquidity, with multiple policy instruments such as reserve requirement ratio for banks, targeted easing measures including SLF (Standing Lending Facility), MLF (Medium-term Lending Facility) and repo rates. These are aimed at providing ample liquidity to the system and underpinning economic growth, which we believe will lead to a favourable climate for RMB onshore bond investors.

Finally, we believe Beijing's initiatives to cut private-sector debt and reduce financial sector risks should help improve China's economic fundamentals.

Risks surrounding RMB bonds

Ratings discrepancies

There is a huge discrepancy in the ratings of Chinese bonds between domestic and international agencies. Domestic agencies give AA ratings and above to about 97 per cent of locally issued bonds and BBB and below to less than 1 per cent.⁵

On the other hand, a substantial proportion of Chinese bonds are unrated by more widely accepted international agencies (S&P, Moody's and Fitch), whose criteria and methodology may differ from those used by local counterparts.

Given these discrepancies, it is especially important for investors to conduct thorough credit analysis on each individual bond.

Transparency issues

As China's bond market is still in development, investor relation teams are not widely developed, while almost all the financial filings are in Chinese. The penetration of sell-side research is relatively low. This puts a high premium on local knowledge, which may be difficult for overseas investors to obtain.

Default concerns

Investor concerns about the debt levels of Chinese corporates and risks to the bond market have been growing, after private-owned Chaori Solar became the first issuer to default on a RMB bond in March 2014, followed by state-owned Baoding Tianwei in 2015.

Defaults and credit events are unlikely to disappear in the next few years as Beijing cuts overcapacity in non-strategic and unproductive sectors as part of its deleveraging campaign. This underscores the importance of using independent credit analysis, rather than local ratings, to properly price debt risks.

That said, China's default rate – at less than 0.03 per cent – remains low compared with developed and other emerging markets. In the US, about 1.8 per cent of corporate bonds defaulted in the 12 months to January 2018.⁶

In China, 2017 saw seven cases of onshore bond defaults, the lowest since 2015, with the aggregate amount of bonds outstanding at RMB17.5 billion.

⁵ Wind, BNP Paribas

⁶ Trailing 12-month issuer default rate as of 31.01.2018, Moody's

Conclusion

As one of the world's biggest bond markets with a largely untapped potential, we believe onshore RMB-denominated bonds have a promising future. With improved access, foreign investors are increasingly able to tap into its attractive valuations, relatively limited volatility and low correlation to other asset classes and diversify their fixed income holdings. Moreover, the potential for the RMB appreciation paint a favourable investment climate.

Want to find out more?

web: assetmanagement.pictet
linkedin: [Pictet Asset Management](#)
twitter: [@PictetAM](#)

This marketing material is issued by Pictet Asset Management (Europe) S.A. It is neither directed to, nor intended for distribution or use by, any person or entity who is a citizen or resident of, or domiciled or located in, any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation. Only the latest version of the fund's prospectus, KIID (Key Investor Information Document), regulations, annual and semi-annual reports may be relied upon as the basis for investment decisions. These documents are available on assetmanagement.pictet or at Pictet Asset Management (Europe) S.A., 15, avenue J. F. Kennedy, L-1855 Luxembourg.

The information and data presented in this document are not to be considered as an offer or solicitation to buy, sell or subscribe to any securities or financial instruments.

Information, opinions and estimates contained in this document reflect a judgment at the original date of publication and are subject to change without notice. Pictet Asset Management (Europe) S.A. has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor and this document is not to be relied upon in substitution for the exercise of independent judgment. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Before making any investment decision, investors are recommended to ascertain if this investment is suitable for them in light of their financial knowledge and experience, investment goals and financial situation, or to obtain specific advice from an industry professional.

The value and income of any of the securities or financial instruments mentioned in this document may fall as well as rise and, as a consequence, investors may receive back less than originally invested. Risk factors are listed in the fund's prospectus and are not intended to be reproduced in full in this document.

Past performance is not a guarantee or a reliable indicator of future performance. Performance data does not include the commissions and fees charged at the time of subscribing for or redeeming shares. This marketing material is not intended to be a substitute for the fund's full documentation or any information which investors should obtain from their financial intermediaries acting in relation to their investment in the fund or funds mentioned in this document.

© Copyright 2018 Pictet
Issued in June 2018

assetmanagement.pictet