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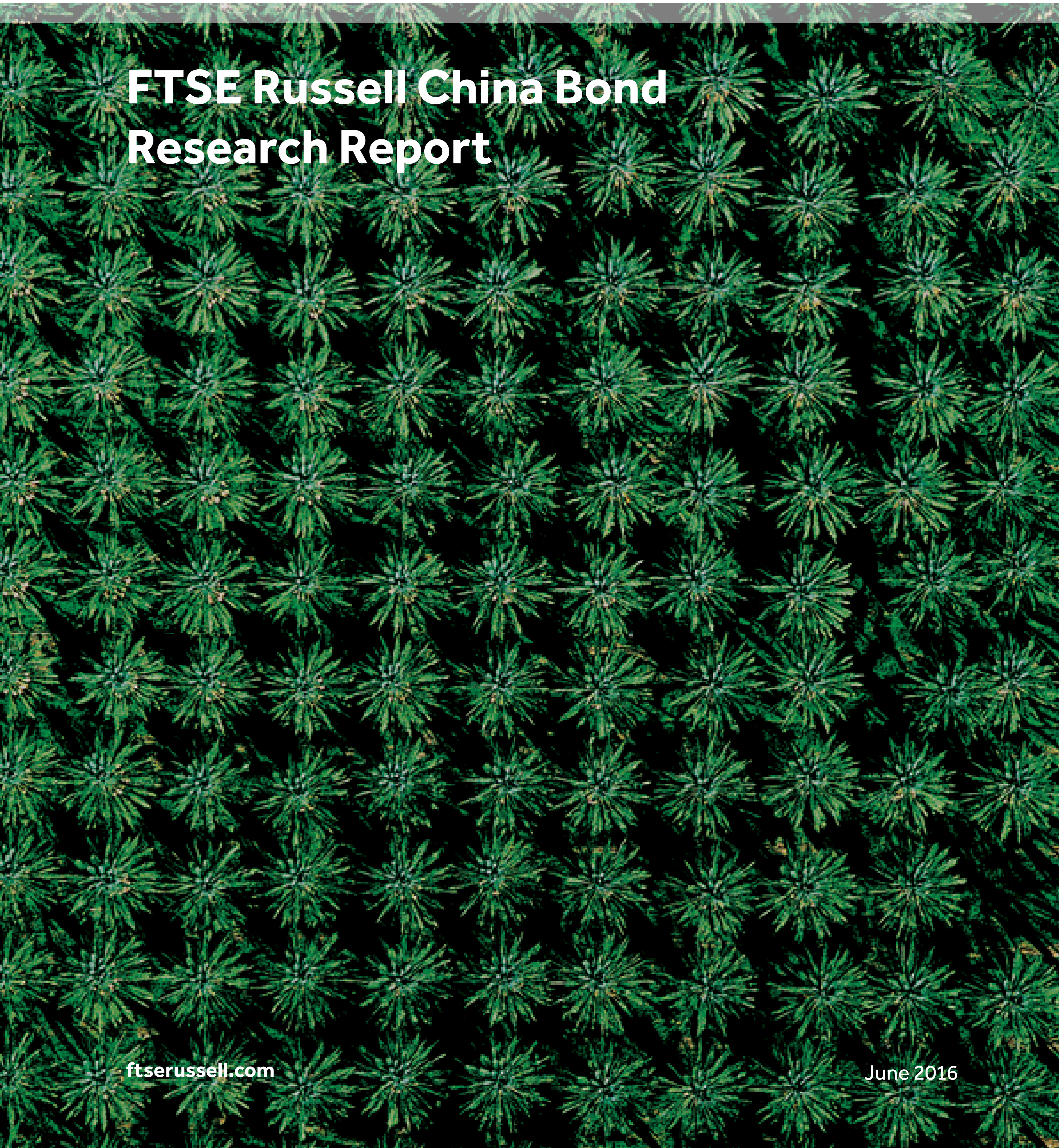

FTSE Russell China Bond Research Report

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FTSE Russell China Bond Research Report

Highlights

- China opened its domestic bond markets in February 2016 to a wider range of international market participants to further liberalise the capital account and attract more foreign investment. But foreign appetite for domestic Chinese debt is still limited: Of the 48.8 trillion RMB ($7.5 trillion) in outstanding onshore bonds at the end of December 2015, international market participants held less than 2 percent, according to ChinaBond.[1]
- Wide discrepancies persist between onshore and offshore credit ratings as well as mainland and international approaches to risk evaluation. For example, the bond of a major Chinese property developer is rated B+ on fundamentals, but is afforded the top AAA rating by some onshore credit agencies. These differences may be dampening international enthusiasm for onshore bonds.[2]
- China's policymakers are currently tasked with further explaining the tax rules that govern onshore bonds to make them more attractive to foreign market participants, who may not be fully informed of the regulations governing onshore investments. At the same time, some analysts suggest China should unify and consolidate the numerous onshore regulatory agencies to ensure legal consistency across the diverse mainland market.[3]
- The offshore RMB bond – or 'dim sum' – market continues to evolve despite significant setbacks in 2015 due to a rising number of missed payments among issuers and the sudden RMB devaluation in August. But a massive shift from the offshore to the onshore markets by international market participants is unlikely anytime soon, according to some analysts, especially as hedge funds and speculators are currently excluded from the onshore bond market opening.[4]
- In the last quarter, the bond market value of the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index increased by 2.29 percent from 12,635,774 to 12,924,958 RMBm just before the December 2015 and March 2016 rebalances; whereas that of the FTSE-BOCHK Offshore RMB Bond Index decreased by 9.75 percent from 287,850 to 259,783 RMBm.[5]

1 Bloomberg. February 2016; Reuters. March 2016.
2 FinanceAsia. March 2016.
3 FinanceAsia. March 2016.
4 Asian Investor. March 2 016.
5 FTSE Russell, data as at 31 March 2016.

Chapter 1: Overview

Dim sum bonds retain appeal as China's onshore market wrestles with regulatory and risk-pricing hurdles

I. Advent of a New Normal

China's decision to open its $7.5 trillion domestic bond market to a wider range of international market participants is widely seen as a positive development for both Chinese corporates aiming to raise funds and buyers looking for more exposure to China's growth trajectory and the country's currency, the renminbi (RMB). However, convergence between the onshore and offshore RMB debt markets, while likely in the long term, is still many years off given the significant governance and risk pricing challenges facing mainland assets.

Chinese policymakers certainly don't have it easy in 2016: they are wrestling with a number of difficult issues at a time when global confidence in the world's second-largest economy has slipped due to recent market events. The dip in confidence in China follows a range of major developments in recent months, including the after effects of a domestic stock market plunge in July 2015, sustained pressure on the RMB since a sudden devaluation last August and an overall economic slowdown as China shifts from an investment-led to a consumer-driven growth model. China's 'new normal' annual GDP growth rate of under 7 percent – while still strong compared to developed markets – is a far cry from the double-digit rates seen in the earlier years of its historic economic transformation.

Although China's challenges are significant, the onshore bond market offers new opportunities for international market participants – whether institutions, pension funds, commercial banks or asset managers – looking for more exposure to the RMB. Over the long term, China's domestic credit market is expected to become one of the world's largest with inflows of around US$2.5 trillion, according to some analysts.[6]

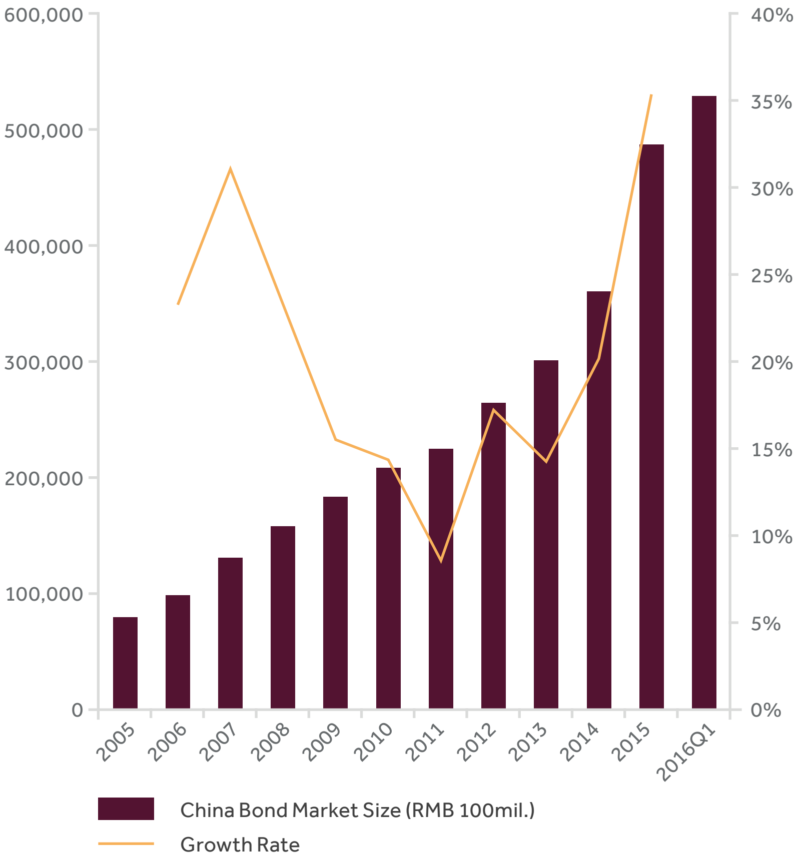
"Until recently banks made up the majority of investors in the onshore bond market, and they mostly buy and hold," says Michael Chow, Managing Director, Head of International Business, Fullgoal Asset Management (HK).

"Foreign participation in the onshore market is still very minimal. This is due to both the previous quota restrictions and the fact that mainland corporate bonds are rated by domestic agencies, which use very different methodologies compared to international agencies. That's why the offshore bond market still has its own edge – international investors enjoy easy access, and international agencies issue the ratings. Still, the onshore market is much bigger, and over time the markets will likely merge, but everyone has their own guess when that might happen."

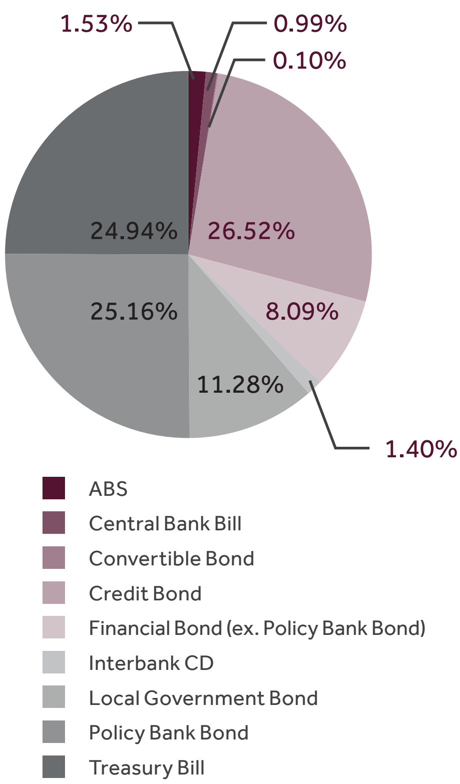
6 Financial Times. March 2016.

Growth of China's Bond Market

China's bond market has rapidly increased from 8 trillion RMB in 2005 to more than 50 trillion RMB in Q1 2016



Proportion of Different Bonds in 2015



Source: Fullgoal Asset Management; Wind. Data as at end-Q1 2016.

II. Feeling the Squeeze

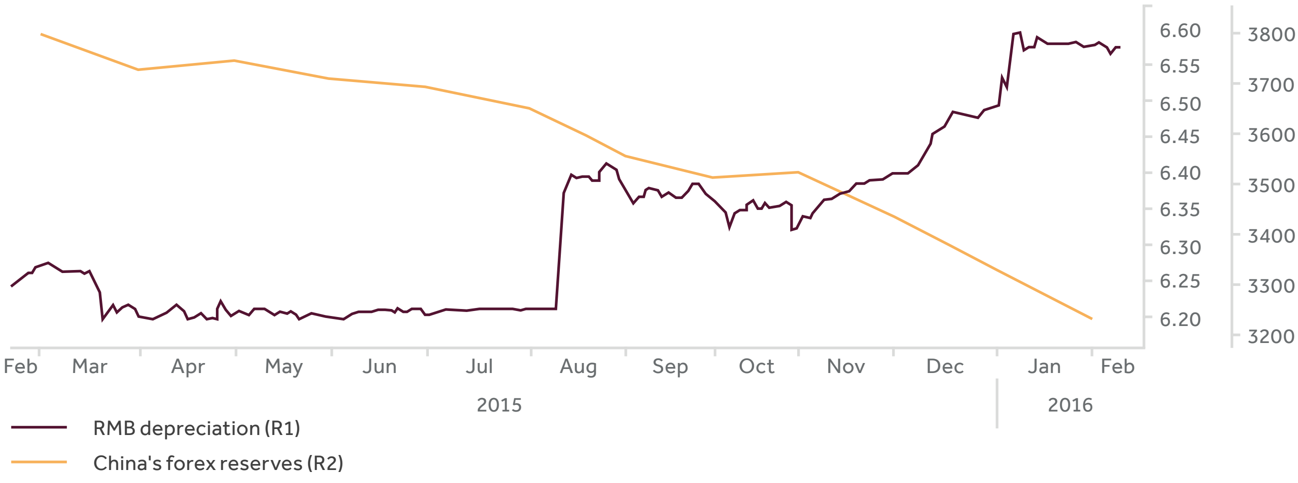
Despite the onshore market's long-term potential, storm clouds linger on the near horizon for China's investment landscape. The RMB is struggling to regain ground lost due to the international community's recently modified – and in some cases lowered – expectations. As capital markets enter the latter half of 2016, belief among market participants that the RMB will continue to rise in value on the back of China's growth trajectory appears to have given way to a more balanced and bearish view that the country's significant financial reform program will continue to encounter setbacks and contradictions. For example: to protect against further downward pressure on the RMB, the People's Bank of China spent nearly US$300 billion of the nation's foreign-exchange reserves in early 2016, whilst the leadership continued with its efforts to open up the domestic markets by offering a wider range of RMB-denominated assets to more international investors.[7]

"Moving forward, China's government will likely take the balance of foreign currency reserves and the stability of the RMB into account," says Eddie Pong, Director of Research Analytics, FTSE Russell. "If foreign currency reserves drop at a relatively quick pace, investors may have concerns. But the government has used other channels to stabilise currency flows recently, including flow controls and currency exchange limits. Foreign currency reserves appeared to have stabilised in recent months."

7 Bloomberg. February 2016.

Reserves Drop as RMB Weakens

Currency trades near five-year low



Source: Bloomberg. February 2016. Past performance is no guarantee of future results.

China's onshore debt markets, in particular, are feeling the squeeze of the country's economic slowdown. Many domestic Chinese firms are delaying their fundraising initiatives as they wait for signs of a more durable market to return. At least 62 Chinese firms postponed or abandoned 44.8 billion RMB (US$7 billion) of planned note sales in March, compared with 23 companies abandoning 15.7 billion RMB of note sales the same month last year, according to Bloomberg data.[8] One of the country's leading air carriers, China Eastern Airlines Corp., cancelled the issuance of 3 billion RMB of short-term bills on April 1. Some market participants predict more onshore issuance cancellations in the months ahead as Chinese policymakers juggle the complex and interwoven matrix of tensions and structural contradictions that complicate the country's financial reform drive.[9]

"It takes time, but the Chinese government cannot move too fast," says Fullgoal's Michael Chow. "Look at the Qualified Foreign Institutional Investor (QFII) program launched in 2003. Now it has spread all over the world. The speed of China's financial reform is accelerating, particularly on the equity side. But on the bond side, things have moved a little slower. Policymakers need to move in different directions simultaneously to make these reforms work. Of course there will be challenges. Just as China's policymakers need to navigate complexity, international investors need time to figure out how China really works."

Chapter 2: Turbulent Skies for the RMB

I. Balanced on a Slippery Slope

Any evaluation of the RMB bond market – both onshore and offshore – inevitably begins with an analysis of the near-term prospects for China's currency as the country's slowest economic growth in a quarter-century drives funds abroad. Given that the current outlook for China is more challenging than in recent years, some analysts predict the RMB could slide another 6 percent

8 Bloomberg. April 2016.
9 Bloomberg. April 2016.

over the next 12 months as policymakers and international market participants evaluate the after effects of China's slowdown and take a cautious approach to capital allocations.[10]

A few currency experts estimate the US dollar will buy 7.00 RMB in 12 months' time.[11] Further depreciation is predicted by the end of 2017, when the US dollar is expected to buy 7.30 RMB on the back of additional macroeconomic challenges and further erosion of confidence, according to some analysts. At the same time, China's excessive money supply may continue to exert more downward pressure on the RMB.[12]

"The RMB will depreciate because of the money supply, but in a controlled and gradual manner," notes a representative from a FTSE Russell client. "Of course, external money is welcome. China needs to internationalise – but that's more of a symbolic achievement rather than representative of real cash needs. In a way, China faces the dual needs of appreciation and depreciation. A lower RMB is beneficial for exports, that's for sure. But for the government's new 'One Belt One Road' development initiative, a stronger RMB is certainly preferred."

II. Internationalisation Continues

Although the RMB may depreciate at a gradual pace over the next year, the currency's march toward becoming the de facto barometer of value across Asia – as well as its further internationalisation – is set to continue throughout 2016, albeit at a slower pace when compared to recent years. In late 2015, the United States made an unprecedented move to set up RMB trading and clearing centres,[13] adding to the numerous centres already operating across Asia, Europe and the Middle East. The move contributed additional momentum to the currency's internationalisation drive following the International Monetary Fund's (IMF) historic decision in November to include the RMB in its Special Drawing Rights (SDR) currency basket.[14]

While new RMB clearing centres have opened up additional pools of RMB liquidity around the world, foreign governments from the United Kingdom to Mongolia have issued dim sum bonds to diversify their portfolios, hedge currencies and offer a vote of confidence in the RMB. China's policymakers seem intent on capitalising on the knock-on effects of the IMF's decision, and to hasten the currency's adoption across the world.

"Even in the short-term, the IMF's move will likely serve as a vote of confidence in China's potential," says FTSE Russell's Eddie Pong. "What is more, the IMF recently raised its forecast for China's economic growth in the near term and believes that a successful rebalancing of its economy is likely, which signals a degree of global confidence in China's economic outlook."[15]

Moving into the latter half of 2016, relatively new investment schemes such as the Shanghai-Hong Kong Stock Connect and Mainland-Hong Kong Mutual Recognition of Funds may gather momentum, increasing cross-border investment flows and liquidity. Furthermore, index providers have suggested that greater access to China's domestic bond markets should lead to the

10 MarketWatch. January 2016.
11 MarketWatch. January 2016.
12 MarketWatch. January 2016.
13 Bloomberg. November 2015.
14 International Monetary Fund. November 2015.
15 International Monetary Fund – World Economic Outlook. April 2016.

inclusion of RMB bonds in global benchmarks, boosting China's market transparency for a more diverse range of global market participants.[16]

At the same time, the RMB's continued internationalisation is unlikely to be a case of perfectly smooth sailing in the months ahead. China's task of not only preserving but increasing international appetite for the RMB and RMB-denominated assets will not be easily achieved, given lowered expectations for the RMB and the slip in confidence in China's ability to emerge from this challenging reform period unscathed.

Moody's recently cut its outlook on the Chinese government's credit rating, making it the second major ratings firm to take a dimmer view of China's creditworthiness in just a few weeks.[17] Meanwhile some leading macroeconomic indicators signal tougher times ahead. Factories and retailers in the country both delivered weaker-than-expected performances early in the year, according to reports.[18]

Moody's China Credit Ratings

Rating	Outlook	Date
Aa3	negative	Mar 02 2016
Aa3	stable	Apr 16 2013
Aa3	positive	Nov 11 2010
A1	positive	Nov 09 2009
A1	stable	Jul 26 2007
A2	positive	May 30 2007
A2	stable	Oct 15 2003
A3	positive	Nov 22 2002
A3	stable	Aug 14 2001
A3	negative	Feb 19 1998
A3	stable	Sep 10 1993
Baa1	stable	Nov 08 1989
A3	stable	May 18 1988

Source: Trading Economics. May 2016.

"Sooner or later, the RMB is going to stabilise," says Fullgoal's Michael Chow. "China is undoubtedly slowing as it enters a transition period, shifting from investment-led to consumption-led growth. And the sudden RMB depreciation last August shocked the market. Many investors took a negative view, and they think there will be further depreciation. But China's policymakers will learn the lessons from that incident and they will look to control the supply side. Of course, the RMB's near-term fate is also dependent on the overall performance of China's economy."

16 Bloomberg. February 2016.
17 Bloomberg. March 2016.
18 Wall Street Journal. March 2016.

Chapter 3: All Eyes on the Onshore Market

I. Onshore Jitters and Cancellations

Given the complex range of headwinds impacting the RMB, China's onshore bond market could continue to experience a chilly reception from international market participants for the rest of 2016 and into 2017. First, over 40 percent of onshore RMB bonds outstanding mature in less than three years, according to Bloomberg – making the market relatively immature compared to those in more developed economies. Meanwhile, issuance cancellations are also accelerating in the current environment as fundraisers decide to wait for more cues from China's policymakers and for sentiment to stabilise. On that note, Fujian Electronics & Information Group Co. cancelled a 300 million RMB planned bond offering on March 31, while Huafang Ltd. abandoned plans for a 150 million RMB issuance of debentures.[19]

At the same time, onshore yields are dropping due to the People's Bank of China cutting rates and injecting fresh liquidity into the market. Exacerbating matters further is the fact that company balance sheets are weaker in the mainland as Chinese corporates, particularly property developers, take on more leverage to weather a downturn in the economy and seize expansion opportunities at the bottom of the market.[20]

"The historic default rate is minimal," says Fullgoal's Michael Chow. "But in 2016 we expect that there will be a higher rate of corporate defaults. There has to be for the market to evolve. That means China's policymakers will allow more defaults to happen. They will likely let go of the companies that aren't doing well and can't survive – that's the trend. But they will let the defaults occur in a coordinated, or, some would say, a controlled fashion. How much will the default rate increase? We'll have to wait and see."

In April, investors in RMB-denominated notes drove up yields and triggered the biggest selloff in onshore junk bonds since 2014 after defaults from state-owned enterprises (SOEs), according to Bloomberg. Meanwhile, state-backed Baoding Tianwei Group Co., a maker of electrical transformers that first defaulted in 2015, said on April 14 it may not be able to repay principal and interest on five-year bonds. Amid the turmoil in the first two and a half weeks of April, local issuers cancelled 61.9 billion RMB (US$9.6 billion) of new bonds.[21]

19 Bloomberg. April 2016.
20 FinanceAsia. March 2016.
21 Bloomberg. April 2016.

Recent Onshore Default and Breach of Contract Incidents

Bond Type	Time	Bond Name	Volume (100 Million)	Credit Rating	Default Classification	Latest Results
Corporate Debt	1/3/2014	11CHAORIZHAI	10	C	Interest Default	Got exterior credit guarantee and paid in full on 2014 Dec. 22
	1/4/2015	12XIANGEZHAI	4.8	CC	Maturity Default	Could not repay principal in full an d closed from 2015 Jun. 1
	1/5/2015	12ZHONGFU01	5.9	CC	Maturity Default	Mortgaged land to get bank loan and pay the debt
	3/10/2015	10ZHONGGANGZHAI	20	B	Extension	Declared payment extension on 2015 Oct. 19
Medium Term Note	1/4/2015	11TIANWEIMTN2	15	C	Interest Default	Planned to apply for reorganisation and bankruptcy on 2015 Sep. 18
	1/10/2015	10YINGLIMTN1	10	C	Maturity Default	Payment still processing

Source: Wind; CITIC Securities. Data as of 30 October, 2015.

Breach of contract

Actual breach of contract/Cumulative bond issuance volume: 0.00148%

	Bond	Issue amount (100 Million RMB)	Issuance date	Issue rating	Issue rating	Default category	Bond type
1/3/2014	11 Shanghai Chaori Solar Energy Science & Technology Co. Bond	10	7/3/2012	C	C	Default on interest	Corporate Bond
1/4/2015	12 Cloud Live Technology Group Co. Bond	4.8	5/4/2012	CC	CC	Default on principal	Corporate Bond
1/4/2015	11 Tianwei MTN2	15	20/4/2011	C	C	Default on interest	Medium-term Note
1/5/2015	12 Zhuhai Zhongfu Enterprise Co. Bond 01	5.9	28/5/2012	CC	CC	Default on principal	Corporate Bond
1/9/2015	08 China Erzhong Group (Deyang) Heavy Industries Co. Bond	8	14/10/2008	C	C	Default on early repayment	Enterprise Bond
	12 China Erzhong Group (Deyang) Heavy Industries Co. MTN 1	10	25/9/2012	C	C	Default on principal	Medium-term Note
1/10/2015	10 Baoding Tianwei Yingli New Energy Co. MTN 1	10	11/10/2010	C	C	Default on principal	Medium-term Note
3/10/2015	10 Sinosteel Engineering & Technology Co. Bond	20	20/10/2010	CC	B	Postponement of repo and interest	Corporate Bond

Source: Wind. Data as of 30 October, 2015.

Risk events

	Bond	Issue amount (100 Million RMB)	Issuance date	Issue rating	Issue rating	Default category	Bond type
1/7/2014	13 Huatong Road & Bridge Corporation CP001	4	22/7/2013	BB+	B	Not default	Short-term Commercial Paper
1/12/2014	11 Sinovel Wind Group Co. 01	26	27/12/2011	A	A	Not default	Corporate Bond
1/6/2015	12 Guangxi Non-ferrous Metal Group Co. MTN1	13	12/6/2012	BB	BB	Not default	Medium-term Note
1/8/2015	12 Jiangsu Feida Group	8	30/8/2012	BB+	AA	Not default	Corporate Bond
2/10/2015	12 China Yurun Food Group MTN1	13	17/10/2012	A	A	Not default	Medium-term Note

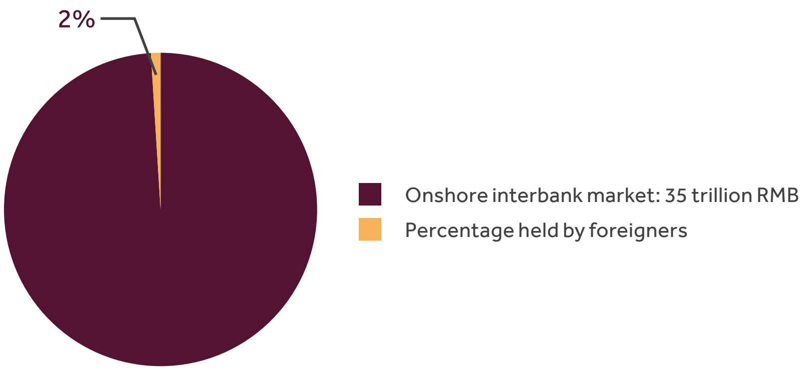
Source: Wind. Data as of 30 October, 2015.

"A recent default event from a central SOE further surprised the investors who until recently believed that the central government would back central SOEs at all times," says FTSE Russell's Eddie Pong. "Yet so far the number of bonds defaulted has amounted to less than 30[22], a tiny amount compared to the whole market. Thus the recent attention on default events is more about the change in expectations than the severity of default risk."

II. Regulatory Headaches and Dilemmas

To allocate funds to the domestic market in the current environment, international market participants first want to see China's authorities clarify accounting rules, according to some analysts.[23] Recent figures illustrate a demonstrable lack of foreign appetite: the amount of bonds outstanding in China totalled 48.8 trillion RMB ($7.5 trillion) at the end of December; the interbank market amounted to 35 trillion RMB as at end-January, but foreign market participants held less than 2 percent of that debt, according to ChinaBond. In fact, foreign holdings of Chinese bonds decreased by a record 49.6 billion RMB ($7.58 billion) in January 2016.[24]

Percentage of Onshore Interbank Bonds Held by Foreign Investors



Source: Bloomberg. February 2016.

22 Wind. April 2016.
23 FinanceAsia. March 2016.
24 Bloomberg. February 2016; Reuters. March 2016.

One major sticking point for international market participants is that wide discrepancies in valuation methodologies continue to distinguish onshore and offshore credit ratings. For example, a major Chinese property developer may be rated B+, but given the top AAA rating by some domestic credit agencies.[25] Chinese credit rating agencies often consider a range of factors that aren't evaluated by their international counterparts, such as a company's links to the government – and whether the government likely believes the company is too big to fail, potentially protecting creditors against default and liquidation.

"The onshore market is on the way to becoming the second-largest debt market in the world, given the size of the money supply and the GDP," says the FTSE Russell client. "To attract international investors and to make the market grow healthily, the government needs stability. On the other hand, if there are zero defaults, international investors won't have the confidence in the market. So the government has to manage the volatility. At the same time, China's domestic rating agencies need to change. As companies will have decreasing government support, the domestic rating agencies will eventually embrace a fundamental bottom-up evaluation approach, rather than a top-down approach."

Despite the challenges, optimism regarding the onshore market's potential over the long haul still reigns. According to some estimates foreign ownership of onshore RMB bonds could rise to 8 to 10 percent of the total over the next five years as the kinks in the domestic regulatory regime are ironed out, with inflows into China's bond market from abroad potentially totalling 300 billion RMB ($46 billion) this year.[26] The potential yields – especially on government bonds – are also seen as attractive. Chinese five-year government bonds currently yield more than 2.5 percent in nominal terms, while the five-year bonds denominated in other currencies in the IMF's SDR basket offer negative yields.[27]

"The first benefit of the onshore market is its size – it's too big to ignore," notes Fullgoal's Michael Chow. "The second benefit is certainly a yield pick-up – for some European markets there are 10-year Treasury bonds offering zero or negative yield. For China, there's a yield pick-up. Lastly there's the diversification play. Many state funds, for example, want exposure to the RMB because the currency has been selected by the IMF to be a part of the SDR basket."

Chapter 4: Dim Sum Still on the Menu – For Now

I. Panda vs. Dim Sum

As the onshore bond market wrestles with regulatory challenges and policymakers try to address the concerns of international market participants, the offshore RMB – or dim sum –bond market continues to evolve beyond China's borders. Multinationals from Caterpillar to McDonald's have issued dim sum bonds in recent years to gain exposure to the RMB and to hedge currency risks. According to some analysts, that trend is likely to continue, given the appeal of issuing RMB bonds in markets governed according to international regulations and standards. There are also limits to the opening of the onshore

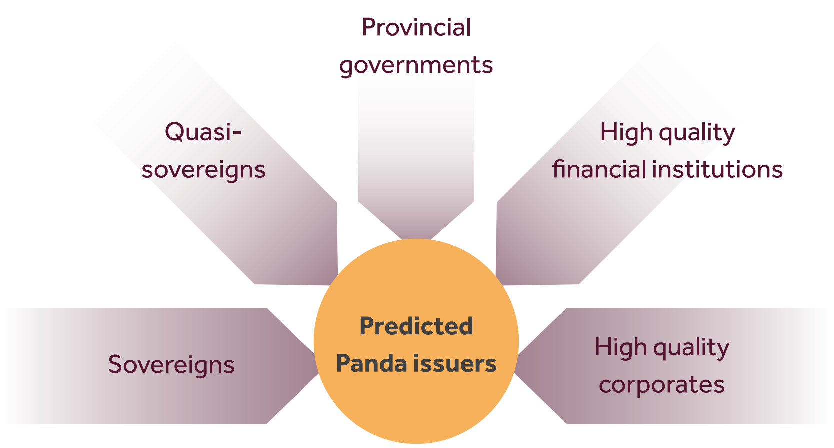
25 FinanceAsia. March 2016.
26 Wall Street Journal. February 2016.
27 Financial Times. March 2016.

market as hedge funds and speculators are currently excluded from the mainland, making a seismic shift from the offshore RMB bond (CNH) market into the onshore (CNY) one by international market participants unlikely anytime soon.[28]

At the same time, panda bonds – or onshore RMB bonds issued by foreign entities – are slowly rising to compete with dim sum bonds, as more multinationals seek to raise RMB onshore to benefit from cheaper funding costs and to fund onshore expansion strategies and acquisitions. In March 2016, Singapore's DBS (Hong Kong) met investors for a proposed 400 million RMB panda bond, which will make it the fourth offshore bank following HSBC (HK), Bank of China (HK), and Standard Chartered (HK) to tap the panda market.[29] Beyond regional banks, the government of Nigeria is evaluating the prospect of issuing a panda bond to help finance a budget deficit of about US$11 billion, according to its finance minister.[30]

One major concern facing issuers evaluating the panda market is the difficulty they may face in trying to transfer the proceeds of the fundraising offshore due to China's capital controls. China's policymakers and the People's Bank of China are expected to further clarify the rules around such transactions in the coming months. Meanwhile, divergent accounting standards present another major obstacle, especially for potential issuers from the United States. China's Ministry of Finance currently favours Hong Kong and European accounting standards, making it difficult for issuers from other jurisdictions to meet the requisite disclosure requirements.[31] Even so, panda bonds are expected to become a US$50 billion market by 2020, according to the IFC.[32]

Predicted Range of Panda Bond Issuers



Source: Dagong (Hong Kong). February 2016.

28 Asian Investor. March 2016.
29 Reuters. March 2016.
30 Financial Times. April 2016.
31 Reuters. March 2016.
32 Reuters. February 2016.

II. Dim Sum on the Rebound

While panda bonds are emerging as a new option for international issuers seeking RMB funds, dim sum bonds are recovering from a 2015 slump, during which offshore RMB bond issuance plummeted to US$17 billion after hitting a record US$33 billion in 2014, according to Dealogic.[33] The RMB's depreciation and jitters over China's financial reform are among the factors that analysts have cited for the loss of appetite. What is more, missed payments by Chinese issuers have become more common in both the onshore and offshore bond markets, jolting market confidence in China's corporates.[34]

Even so, the dim sum bond market is on the upswing in early 2016 as China shows signs of stabilisation and takes more steps to manage global expectations for slower growth in the years ahead. Sales of offshore RMB debt jumped to 26.4 billion RMB ($4.08 billion) in March, more than double January and February's combined 12 billion RMB, according to Bloomberg. The average yield on offshore RMB bonds climbed to a record 6.18 percent on January 28.[35]

In summary, the dim sum market looks set to persevere – at least for the time being – as China's regulators tackle the challenges and contradictions that hamper the evolution of the onshore market. To be sure, high currency swap rates onshore make that option the most affordable for foreign companies aiming to borrow in RMB and exchange the proceeds into US dollars or other currencies. However dim sum bonds remain more attractive overall for international borrowers despite higher funding costs, given that the international regulatory regimes which govern the dim sum market make conversion and the realisation of proceeds much easier.[36]

"There has been confusion about how Chinese policymakers manage the risks, but it will get better," says the FTSE Russell client. "While the onshore market needs to strengthen the fundamentals, the international market also needs to recognise the important role the Chinese government plays in managing risks. In my view, in the next few years it's likely that international investments into China will be a cautious process."

Chapter 5: Performance of FTSE Russell China Bond Indexes

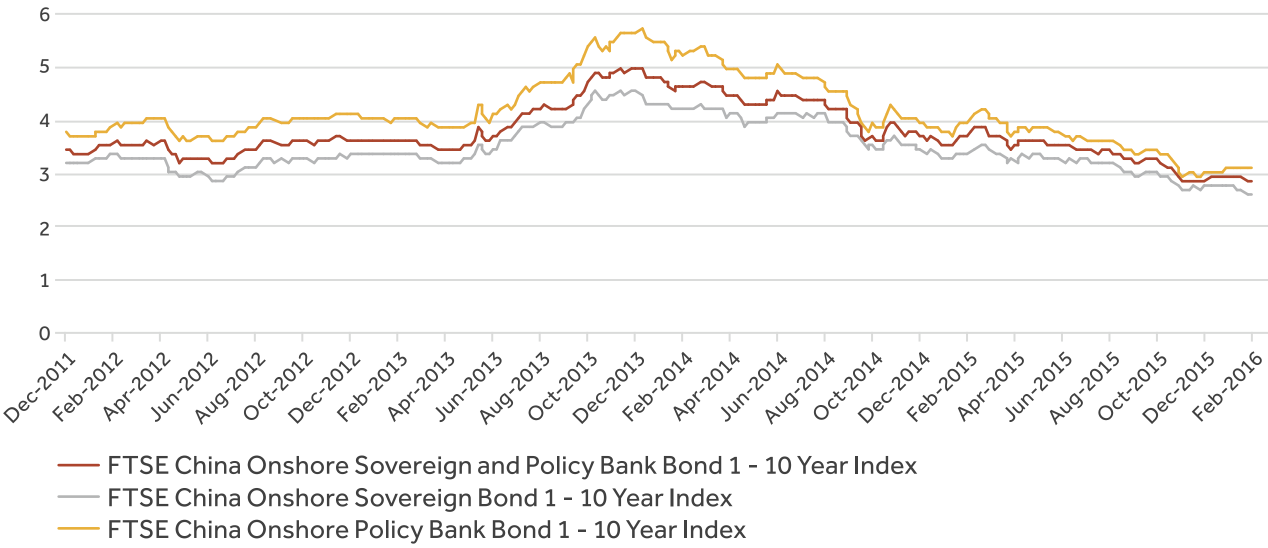
I. FTSE China Onshore Bond Index Series

Redemption Yield

The market value duration weighted average redemption yield of the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index in March was at 2.86 percent. Among the two sub-indexes the FTSE China Onshore Sovereign Bond 1 - 10 Year Index was at 2.59 percent; the FTSE China Onshore Policy Bank Bond 1 – 10 Year Index was at 3.07 percent.

33 Financial Times. March 2016.
34 Financial Times. March 2016.
35 Bloomberg. March 2016.
36 Reuters. March 2016.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 31 March 2016. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document. The general position is that graphs should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another.

Compared with three months ago, the yield for the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index rose 0.02 percent to 2.86 percent. The yield dropped 0.10 percent for the FTSE China Onshore Sovereign Bond 1 - 10 Year Index; and climbed 0.11 percent for the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index.

Total Return

The FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index finished up 0.69 percent during the past three month period (January - March), with the FTSE China Onshore Sovereign Bond 1 - 10 Year Index up 1.11 percent; and the FTSE China Onshore Policy Bank Bond 1 - 10 Year Index up 0.40 percent as shown in Table 1.

Table 1. Performance and Volatility – Total Return (CNY)

Index	Return %						Volatility %*		
	3M	6M	YTD	12M	3YR	Since Inception	1YR	3YR	Since Inception
FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index	0.69	3.63	0.69	7.88	16.16	19.31	1.22	1.72	1.55
FTSE China Onshore Sovereign Bond 1 - 10 Year Index	1.11	3.83	1.11	7.39	15.02	18.03	1.34	1.81	1.64
FTSE China Onshore Policy Bank Bond 1 - 10 Year Index	0.40	3.50	0.40	8.25	17.49	20.80	1.28	1.93	1.71

*Volatility - 1YR, 3YR, Since Inception based on daily data. Source: FTSE Russell - total return data in CNY, as at 31 March 2016. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document. The general position is that data charts should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another.

Index Characteristics

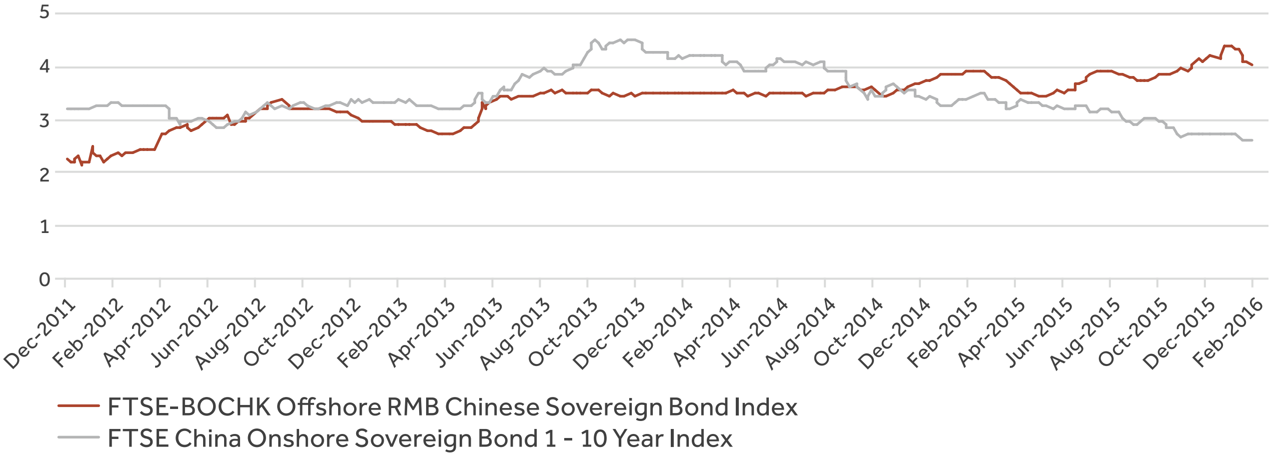
	FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index	FTSE China Onshore Sovereign Bond 1 - 10 Year Index	FTSE China Onshore Policy Bank Bond 1 - 10 Year Index
Number of bonds	333	93	240
Nominal Amount (RMBm)	12,167,569	5,053,960	7,113,609
YTM %	2.86	2.59	3.07
Mod. Duration	3.88	4.16	3.68
Convexity	23.73	25.47	22.52

Source: FTSE Russell, data as at 31 March 2016. The general position is that charts should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another.

Index Changes in the Last Quarter

In the last quarter, the bond market value of the FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index increased by 2.29 percent from 12,635,774 to 12,924,958 RMBm just before the December and March rebalances. The FTSE China Onshore Sovereign and Policy Bank Bond 1 - 10 Year Index modified duration was shortened from 3.91 years to 3.88 years, decreasing its sensitivity to the yield curve shift. On the other hand, the convexity of the index dropped by 0.33 when compared to that of the last quarter.

Yield comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds



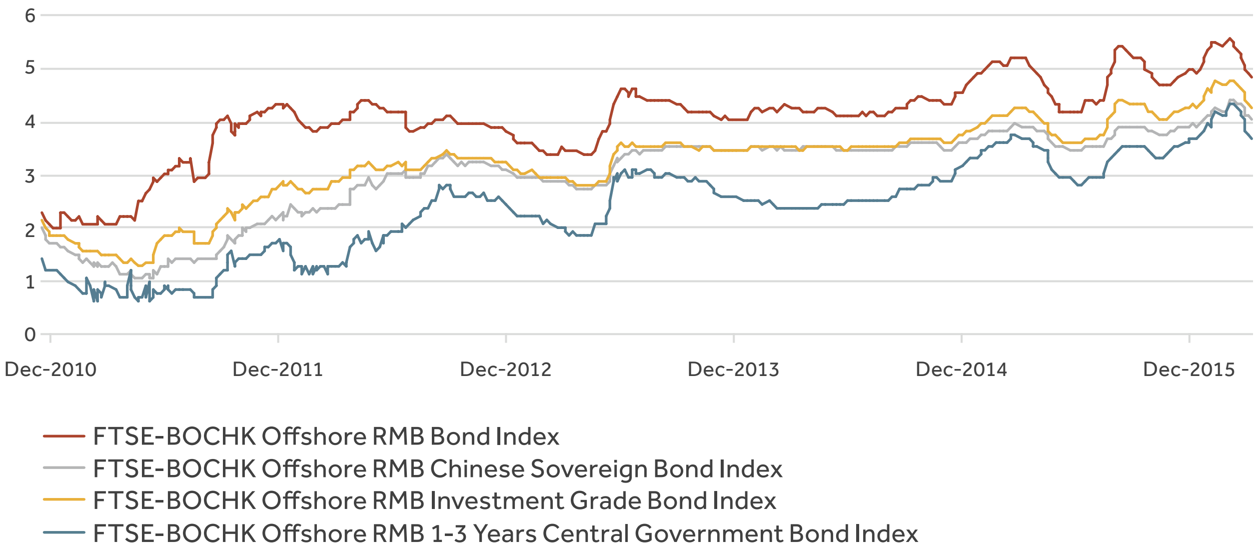
Source: FTSE Russell, data as at 31 March 2016. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document. The general position is that graphs should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another.

II. FTSE-BOCHK Offshore RMB Bond Index Series

Redemption Yield

The market value duration weighted average redemption yield of the FTSE-BOCHK Offshore RMB Bond Index in March was at 4.85 percent. Among the 3 sub-indexes the FTSE-BOCHK Offshore RMB Investment Grade Index was at 4.29 percent; the FTSE Chinese Sovereign Bond Index was at 4.02 percent; the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index was at 3.69 percent.

Market Value Duration Weighted Average Redemption Yield %



Source: FTSE Russell, data as at 31 March 2016. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document. The general position is that graphs should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another.

Compared with three months ago, the yield for the FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index rose 0.08 percent to 4.02 percent. The yield dropped 0.14 percent for the FTSE-BOCHK Offshore RMB Bond Index; dropped 0.01 percent for the FTSE-BOCHK Offshore RMB Investment Grade Bond Index; and remained unchanged for the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index.

Total Return

The FTSE-BOCHK Offshore RMB Bond Index finished up 1.14 percent during the past three-month period (January -March), with the FTSE-BOCHK Offshore RMB Investment Grade Bond Index up 0.91 percent; the FTSE Chinese Sovereign Bond Index up 0.54 percent; and the FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index rose 0.87 percent as shown in Table 1.

Table 1. Performance and Volatility - Total Return (CNH)

Index	Return %						Volatility %*		
	3M	6M	YTD	12M	3YR	Since Inception	1YR	3YR	Since Inception
FTSE-BOCHK Offshore RMB Bond Index	1.14	3.06	1.14	4.94	9.75	16.09	1.35	1.02	1.19
FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index	0.54	1.37	0.54	3.10	5.58	9.82	1.31	1.07	1.21
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	0.91	2.15	0.91	3.70	6.82	12.05	1.14	0.86	0.92
FTSE-BOCHK Offshore RMB Investment Grade Bond Index	0.87	1.46	0.87	3.19	5.66	7.95	0.99	0.93	1.37

*Volatility - 1YR, 3YR, Since Inception based on daily data. Source: FTSE Russell - total return data in CNH, as at 31 March 2016. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see important legal disclosures at the end of this document. The general position is that data charts should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another.

Index Characteristics

	FTSE-BOCHK Offshore RMB Bond Index	FTSE-BOCHK Offshore RMB Chinese Sovereign Bond Index	FTSE-BOCHK Offshore RMB Investment Grade Bond Index	FTSE-BOCHK Offshore RMB 1-3 Years Central Government Bond Index
Number of bonds	195	49	126	9
Nominal Amount (RMBm)	261,496	90,000	169,682	41,950
YTM %	4.85	4.02	4.29	3.69
Mod. Duration	2.59	3.84	3.08	1.79
Convexity	14.61	30.13	20.09	4.44

Source: FTSE Russell, data as at 31 March 2016. The general position is that data charts should be used as a helpful way to present performance and assist readers in understanding the effects of different methodologies for different indexes. They should not be used as a way of suggesting that one index is better suited to a client than another.

Index Changes in the Last Quarter

In the last quarter, the bond market value of the FTSE-BOCHK Offshore RMB Bond Index decreased by 9.75 percent from 287,850 to 259,783 RMBm just before the December and March rebalances. As of 31 March 2016, corporate and enterprise bonds continued to have the largest weighting in the index at 56.22 percent, a 4.16 percent decrease compared to three months ago.

The number of constituents in this category decreased from 141 to 123. Unlike corporate and enterprise bonds, the weight of the bonds issued by China's government increased by 6.85 percent compared to the last quarter, arriving at 30.08 percent; and the weight of the bonds issued by policy banks decreased by 1.20 percent, arriving at 10.36 percent after the latest review.

The percentage of investment grade bonds in the index increased to 64.56 percent compared to 60.54 percent on 31 December 2015. The FTSE-

BOCHK Offshore RMB Bond Index modified duration was lengthened from 2.47 years to 2.59 years, increasing its sensitivity to the yield curve shift. On the other hand, the convexity of the index rose by 1.56 when compared to that of the last quarter.

Table 4. New Additions in the Past 3 Reviews

Review	Bond	Nominal Amount (RMBm)	ICB Supersector
January 2016	China Construction Bank Asia Corp Ltd Nov-2017 4.00%	1,000	Banks
January 2016	China Government Bond Dec-2017 3.45%	2,000	Nation and Treasury
January 2016	China Government Bond Nov-2018 3.29%	7,000	Nation and Treasury
January 2016	China Government Bond Nov-2020 3.40%	3,000	Nation and Treasury
January 2016	China Government Bond Dec-2025 3.31%	1,000	Nation and Treasury
January 2016	China Government Bond Nov-2035 4.00%	1,000	Nation and Treasury
January 2016	Huarui Investment Holding Co Ltd Nov-2018 5.25%	1,500	Financial Services
January 2016	Korea Development Bank/The Jun-2018 4.04%	500	Agency and Semi-Government
January 2016	Korea Development Bank/The Dec-2018 4.20%	1,300	Agency and Semi-Government

Source: FTSE Russell, data as at 31 March 2016.

Table 5. New Deletions in the Past 3 Reviews

Review	Bond	ICB Supersector
January 2016	China Power New Energy Development Co Ltd Jan-2017 6.50%	Utilities
January 2016	Agricultural Development Bank of China Jan-2017 3.28%	Agency and Semi-Government
January 2016	Bank of China Ltd/London Jan-2017 3.45%	Banks
January 2016	China Electronics Corp Holdings Co Ltd Jan-2017 4.70%	Technology
January 2016	Export-Import Bank of China/The Jan-2017 3.25%	Agency and Semi-Government
January 2016	Kunzhi Ltd Jan-2017 5.875%	Technology
January 2016	Modern Land China Co Ltd Jan-2017 11.00%	Real Estate
January 2016	Starway Assets Enterprises Inc Jan-2017 4.10%	Financial Services
January 2016	Trade & Development Bank of Mongolia LLC Jan-2017 10.00%	Banks
January 2016	Gazprombank OJSC Via GPB Eurobond Finance PLC Feb-2017 4.25%	Banks
January 2016	Universal Number One Co Feb-2017 5.70%	Financial Services
January 2016	Value Success International Ltd Feb-2017 4.15%	Insurance
January 2016	International Finance Corp Jan-2017 2.00%	UN Organization
February 2016	Central Plaza Development Ltd Feb-2017 5.75%	Real Estate
February 2016	Agile Property Holdings Ltd Feb-2017 6.50%	Real Estate
February 2016	China CITIC Bank Corp Ltd Feb-2017 4.125%	Banks
February 2016	Mitsubishi UFJ Lease & Finance Co Ltd Feb-2017 3.28%	Financial Services
February 2016	Shui On Development Holding Ltd Feb-2017 6.875%	Real Estate
February 2016	Caisse d'Amortissement de la Dette Sociale Feb-2017 3.80%	Agency and Semi-Government
February 2016	KFW Feb-2017 3.61%	Agency and Semi-Government
March 2016	Shanghai Baosteel Group Corp Mar-2017 4.15%	Basic Resources
March 2016	Mitsui & Co Ltd Mar-2017 4.25%	Industrial Goods & Services
March 2016	China Development Bank Corp Mar-2017 3.35%	Agency and Semi-Government
March 2016	Eastern Air Overseas Hong Kong Corp Ltd Mar-2017 4.80%	Travel & Leisure
March 2016	Gemdale Asia Investment Ltd Mar-2017 6.50%	Real Estate
March 2016	Ocean Wealth Ltd Mar-2017 5.20%	Agency and Semi-Government

Source: FTSE Russell, data as at 31 March 2016.

For more information about our indexes, please visit ftserussell.com.

Bank of China (Hong Kong) Limited and FTSE launched the FTSE-BOCHK Offshore RMB Bond Index Series in October 2013.

About FTSE Russell

FTSE Russell is a leading global provider of benchmarking, analytics and data solutions for investors, giving them a precise view of the market relevant to their investment process. A comprehensive range of reliable and accurate indexes provides investors worldwide with the tools they require to measure and benchmark markets across asset classes, styles or strategies.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create ETFs, structured products and index-based derivatives.

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