Manulife Asset Management

China bonds inclusion in global bond indices

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For agents, distributors, professional & institutional investors

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On 1 April 2019, onshore China Government Bonds (CGBs) and policy-bank bonds will be included in three Bloomberg bond indices. Other global fixed-income index providers are also considering the inclusion of China bonds this year. In this Q&A, **Paula Chan**, Senior Portfolio Manager, Fixed Income, and, **Eric Liu**, Portfolio Manager, Fixed Income, offer their perspectives on the opportunities for global investors in China's fast-growing bond market, and their latest views on China.

I. China bond market developments

1. What is the latest update on China bonds index inclusion?

On 1 April 2019, onshore China Government Bonds (CGBs) and policy-bank bonds[1] will be included in three Bloomberg bond indices, including the widely-followed Bloomberg Barclays Global Aggregate Index (BBGA). Index inclusion will be gradually phased in over a 20-month period, with a 5% scaling factor until 100% of the target weight (around 6.1% of the BBGA Index) is reached by November 2020[2].

Other global bond index providers are also considering including China bonds[3]. FTSE Russell, provider of the FTSE Russell World Government Bond Index, is conducting its own review and may announce index inclusion for Chinese sovereign bonds by the second-half of 2019[3]. FTSE Russell has also indicated that it is considering inclusion of onshore Chinese corporate credits into its World Broad Investment-Grade Bond Index, which could follow towards the end of 2019. J.P. Morgan, meanwhile, has yet to make any formal announcement on the inclusion of China bonds in its GBI-EM indices[4]. It will likely observe the market's reaction to China bonds joining the BBGA Index before finalising its plans.

2. How will index inclusion impact demand for China sovereign and policy bank bonds?

We estimate that active funds comprise around 80-90% of funds tracking the BBGA[5]. As there is no definitive timeline, flows into CGBs and policy banks are likely to be uneven and spread over the 20-month index inclusion period. While demand from some global investors may be front-loaded,

[1] Based on the published list of China bonds that will be included in the Bloomberg Barclays Global Aggregate Index, there are a total of 364 China bonds: 159 are China government bonds, while the remaining 205 bonds are issued by policy banks, including China Development Bank, Agricultural Development Bank and the Export-Import Bank of China
[2] Bloomberg, 31 January 2019.
[3] Bloomberg, 13 March 2019.
[4] The inclusion of China into global bond indices: Current status and future development, HKEX, June 2018. Since March 2016, J.P. Morgan has put China on "Index Watch" for potential inclusion in the GBI-EM index suite.
[5] Manulife Asset Management (MAM) estimates, March 2019.

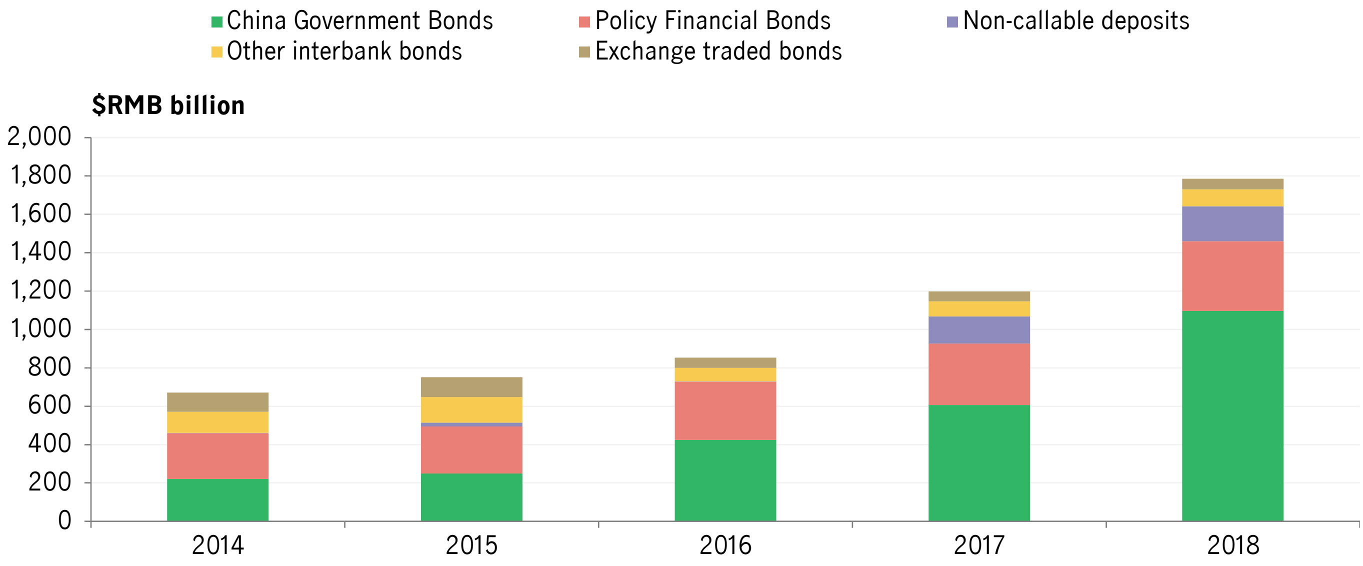
participation from others will be back-loaded, as investors may not be operationally ready to participate in the market.

Overall, foreign-investor participation in the local China bond market has increased despite a backlog in the approval process for access to Bond Connect:

- Foreign-investor holdings in local China bonds increased from RMB$1.2 trillion (roughly US$178 billion) at the end of 2017 to RMB$1.8 trillion (roughly US$266 billion) by the end of 2018.[6] According to estimates, total foreign holdings of local China bonds could total RMB$2.8 trillion (US$409 billion) by the end of 2019[6].
- Foreign-investor holdings in CGBs - increased from RMB$606 billion (roughly US$90.3 billion) at the end of 2017 to RMB$1.1 trillion (roughly US$163 billion) at the end of 2018[6].
- Foreign demand for Chinese policy-bank bonds has already shown a clear pick-up. Foreign-investors bought US$6.2 billion of Chinese policy-bank bonds in 2018 compared with US$2.4 billion in 2017[7]. The strong demand has translated into narrowing policy-bank spreads against CGBs, from 120-140 basis points (bps) in 2016 to 20-50bps currently[8].

Over the long-term, we believe as much as US$600 billion of inflows can be expected in this asset class as China bonds fully join global bond indices[8].

Chart 1: Foreign holdings of China onshore bonds[9]



3. Why should global investors be thinking about investing in the local China bond market?

We believe there are four reasons:

- Potentially attractive real yields and low correlation with other asset classes – Among single A-rated sovereigns, China offers one of the most compelling real yields; 10-year CGBs currently

[6] Source: Standard Chartered, as of March 2019.
[7] Source: HSBC, as of March 2019.
[8] Source: MAM, as of March 2019.
[9] Source: Standard Chartered, as of March 2019.

boast a real-yield of 1.68%, which places it ahead of other developed bond markets such as the US, Australia, Japan, UK and Germany[10]. The low historical correlation of China bonds with other major fixed-income assets and equities (see Chart 2) also make China bonds an attractive asset class for diversification opportunity.

Chart 2: China Government Bonds exhibit low correlation with other asset classes[11]

- People's Bank of China (PBoC) maintains an easing bias – As China seeks annual GDP growth of 6.0-6.5% in 2019, we believe there is room for the PBoC to reduce interest rates further this year and promote greater market liquidity. This can help the performance of China rates, while credit will also benefit from more flexible financing options.

- Inclusion in global benchmark fixed-income indices – As highlighted earlier, China bonds will join the BBGA in April this year. Additional inclusion announcements by fixed-income index providers later this year may further boost demand from overseas investors for onshore China bonds.

- Policy support on financial market reform – We strongly believe the Chinese government is committed to liberalising its financial markets (see Question 3 in the second section of this Q&A). This should make it easier and more attractive for foreign investors to participate in this fast-growing and increasingly important financial market.

[10] Source: MAM and Bloomberg, as of 28 February 2019.
[11] Source: Bloomberg, data based on index monthly returns from 30 December 2008 to 30 December 2018 in US dollar terms unless otherwise noted. Asian bonds (ex-Japan) = 50% Markit iBoxx ALBI + 50% JPMorgan Asia Credit Index; Asian equities (ex-Japan) = MSCI AC Asia Pacific ex Japan Index; China bonds= Bank of America Merrill Lynch China Government Index; Emerging market debt (local) = JPMorgan GBI-EM Global Diversified; Euro government bonds = Bank of America Merrill Lynch Euro Government Index; Global aggregate bonds = Bloomberg Barclays Global-Aggregate Total Return Index; Global corporate bonds= Bank of America Merrill Lynch Global Corporate Index; Global equities = MSCI World; Global high yield = BofA Merrill Lynch Global High Yield Index; Money markets (cash) = BofA Merrill Lynch US Dollar 3-Month Deposit Offered Rate Average Index; Real estate = Dow Jones Composite REIT Total Return Index; US equities = S&P 500 Index; US Treasuries = BofA Merrill Lynch US Treasury Index. Past performance is not indicative of future results.

4. Are there any recent developments regarding Bond Connect / CIBM?

Foreign investors can now invest in onshore China bonds via Bond Connect or CIBM, settling trades via Delivery versus Payment (DVP). They are also able to access the onshore foreign-exchange spot and forward markets for hedging.

On 22 March 2019, the Central Bank of Ireland gave the green light for Irish Undertakings for Collective Investments in Transferrable Securities (UCITS) and Alternative Investment Funds (AIFs) to invest in the Chinese interbank bond market via Bond Connect. This is a positive development, as it recognises Bond Connect as an efficient facility to access the China interbank bond market and allows funds on the Irish UCITS and AIF platforms to potentially participate in this market.

5. What are your return expectations for China bonds in 2019?

In 2018, five-year CGBs returned 8% in renminbi terms on the back of a strong market rally as five-year rates declined from 3.8% to 3.0%[12]. Given the PBoC's current accommodative monetary policy stance, we anticipate returns of around 4% p.a. for five-year CGBs, while composite high-grade bonds could likely return 5.0-5.5% in renminbi terms this year.

For currencies, we expect the USD/CNY exchange rate to remain relatively stable in a range from 6.60 to 6.80 in 2019.

II. Latest views on China

1. What were your main takeaways from the National People's Congress (NPC) held earlier in March?

One of the key takeaways from this year's NPC was increased clarity around PBoC policy. PBoC may continue on its monetary easing path and may cut money-market rates further this year, which is positive for local fixed-income assets. Premier Li Keqiang emphasised that the government would implement multiple measures to lower funding costs for smaller companies and to support the real economy.

Private companies currently face problems obtaining funding. Funding costs for higher-quality private companies are around 6-7% p.a. compared with 3-4% p.a. for Chinese state-owned enterprises. We believe lower interest costs and greater credit availability to private firms should translate to tighter credit spreads overall, which is bullish for China bonds.

2. As this round of Sino-US trade talks reaches a conclusion, what are the prospects for an agreement?

On the surface, US-China trade talks may be nearing an end. While we do anticipate that a deal will emerge from these negotiations, we also believe that negotiations around longer-term structural issues (e.g. industrial policy, technology and intellectual property issues) will not be addressed by a

[12] Source: Bloomberg, 31 December 2018.

quick fix. Rather, these structural issues run much deeper and will likely require a long-term approach to solve beyond what may be announced at the end of the current trade talks.

3. How committed is China to opening up its financial markets? What developments do you expect on this front?

We are encouraged by the following recent quotes from senior Chinese government officials that emphasise their continued focus and commitment to opening up China's financial markets:

- *8th April 2018, Boao Forum for Asia* – President Xi Jinping highlighted China's intention to further open up its financial system[13].
- *5th March 2019, Report on the Work of the Government, National People's Congress* – Premier Li Keqiang stated that the government will make efforts to "develop a multi-tiered capital market and promote the development of the bond and futures market[14]".
- *10th March 2019, National People's Congress* – PBoC Governor Yi Gang stated: "We believe the opening up of China's financial market is conducive to both China and the world[15]".

Given the strong support for continued financial-market reforms emphasised by government officials, we anticipate further opportunities for foreign investors to benefit from this policy direction. The PBoC has pledged to focus on providing more hedging tools to help investors manage financial risks in 2019. The government is also seeking to attract more foreign expertise and capital to promote more efficient asset-allocation and risk-management outcomes. The decision to exempt foreign investors from tax on China bonds for the next three years[16] is also an example of how foreign investors can benefit from the government's pursuit of greater financial reforms.

[13] Source: "Highlights of Xi's keynote speech at Boao Forum", China Daily, 10 April 2019.
[14]Source: "Report on the work of the Government", Li Keqiang, Premier of the State Council, March 2019.
[15] Source: "PBoC, China to firmly advance financial market opening-up", 10 March 2019.
[16] Source: "China announces 3-year tax exemption on interest gains for overseas investors," 22 November 2018.

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