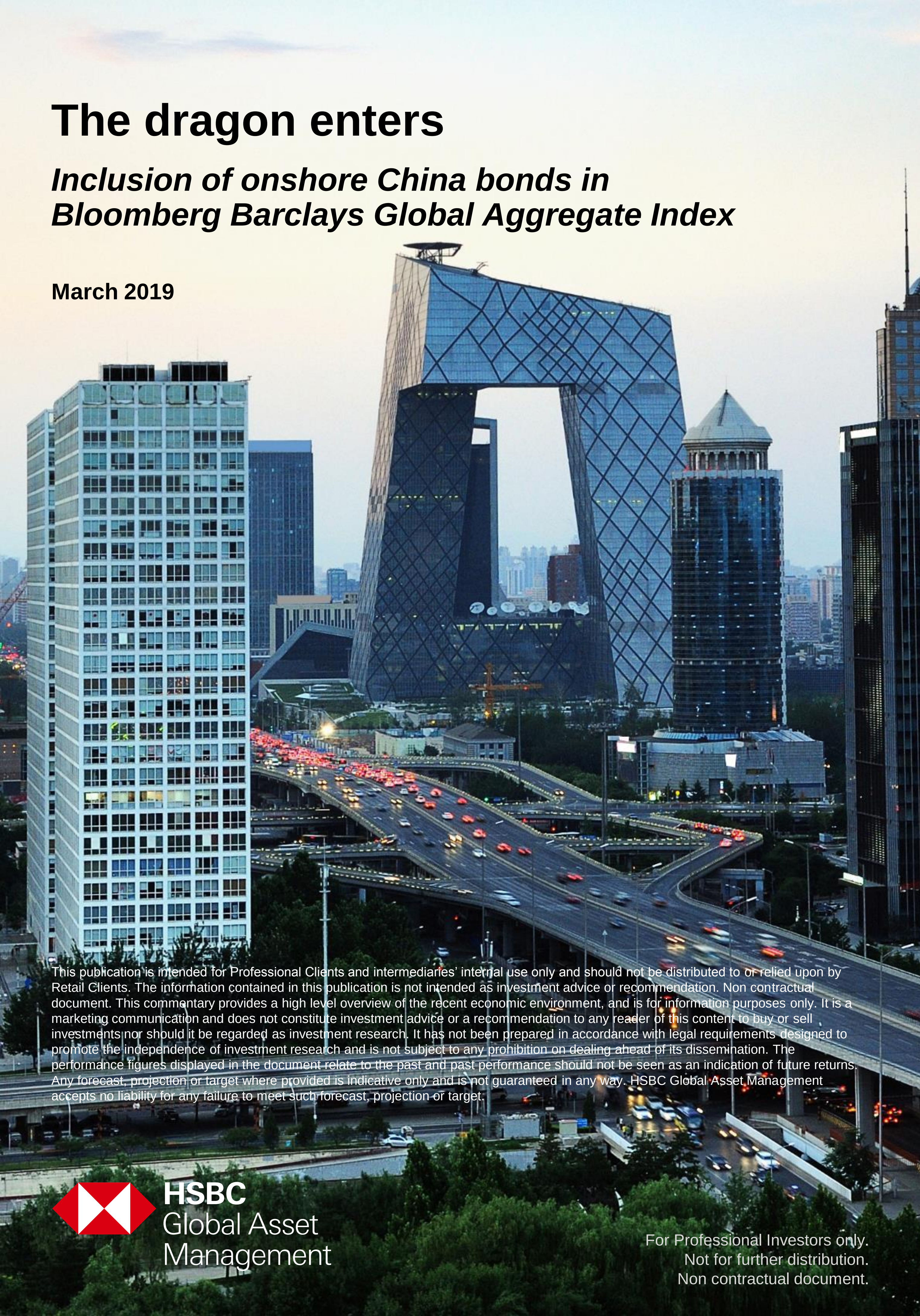
The dragon enters

Inclusion of onshore China bonds in Bloomberg Barclays Global Aggregate Index

March 2019



HSBC
Global Asset
Management

Contents

China onshore bonds go mainstream

China is a huge global economic powerhouse, accounting for 19% of the world's GDP and wielding an indisputable influence on everything from global trade flows to technology shifts. Yet China's onshore bond and equity markets are only now beginning their integration into global capital markets. China's steady efforts to open up its capital markets to global investors and implement reforms in its financial markets are being recognized by a major index provider as onshore bonds are about to be included in one of the most widely followed global bond indices.

Previously, it was easier for global bond portfolios to opt out of investing in onshore China, particularly because onshore bonds were not a part of any major global bond index. But in April 2019, China will be propelled into the Bloomberg Barclays Global Aggregate Index, which is estimated to have tracking assets of USD 2.5 trillion. Onshore Chinese bonds would no longer be an off-benchmark option for index following investors, but would, by default, have an allocation of 6% by the end of the phased-in inclusion period in November 2020. This also means that index following investors holding nothing in onshore China would then be 6% underweight this market, or would have to consider shifting to an ex-China index alternative for a global bond product.

China's entry into the index was only possible after its regulators acted to clear the roadblocks to inclusion, by addressing issues such as facilitating block trades and clarifying tax policies. Index inclusion is expected to play a significant role in China's broader programme to open up its financial markets, as it would attract higher foreign participation in China's bond market and positively advance RMB internationalisation.

There perhaps exists a perception that investing in China can be a risky option, and many consider the onshore markets, in particular, as a volatile and unfamiliar investment environment. But, as we outline in this publication, China onshore bonds have the potential to enhance yields, offer diversification, improve returns and even lower volatility of a global bond portfolio.

Sized at USD 12 trillion, China's onshore bond market is enormous and the third largest in the world after the US and Japan. And now this long-awaited inclusion is about to change the way that China bonds are represented, marking not only China's debut in the global bond markets but also a tipping point for global fixed income investing.

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Bloomberg Barclays China bond inclusion

Overview

What is happening?	What will change?	What is being added?
◆ Bloomberg will add China onshore securities to the Bloomberg Barclays Global Aggregate (BGA) for the first time, beginning in April 2019. This inclusion will also impact other Bloomberg indices (See Figure 2) ◆ The inclusion period will be phased over 20 months and will be completed in November 2020	◆ China securities denominated in CNY are expected to make up 6.1% of BGA upon completion of the inclusion period in November 2020 ◆ Other existing currencies within BGA will see a reduction in market value weight in the index (See Figure 3 & Appendix I)	◆ BGA will include 364 CNY-denominated Chinese government bonds and policy bonds (See Figure 1). The inclusion represents CNY 21.4 trillion in market value (USD 3.3 trillion), or 6.1% of the BGA index* ◆ Eligible bonds include China government bonds and policy bonds. Chinese corporate bonds are not currently eligible for this inclusion

Figure 1: Securities to be included in BGA upon completion of inclusion period (Nov 2020)

Issuer	Credit Rating (S&P / Fitch)	Number of securities	Amount O/S (USD in billion)	Duration (years)	Yield to worst (%)
China Government Bond	A+ / A+	159	1490.2	6.69	3.00
China Development Bank	A+ / A+	102	935.4	4.78	3.37
Agricultural Development Bank	A+ / A+	58	476.1	4.08	3.33
Export-Import Bank of China	A+ / A+	45	287.3	3.86	3.31
Total	A+ / A+	**364**	**3,189**	**5.49**	**3.19**

Figure 2: Bloomberg Barclays indices impacted by China bond inclusion

Projected market value of China CNY bonds (in Nov 2020) of Bloomberg Barclays indices

* Using data as of 31 January 2019
Source: Bloomberg, as of 31 January 2019.

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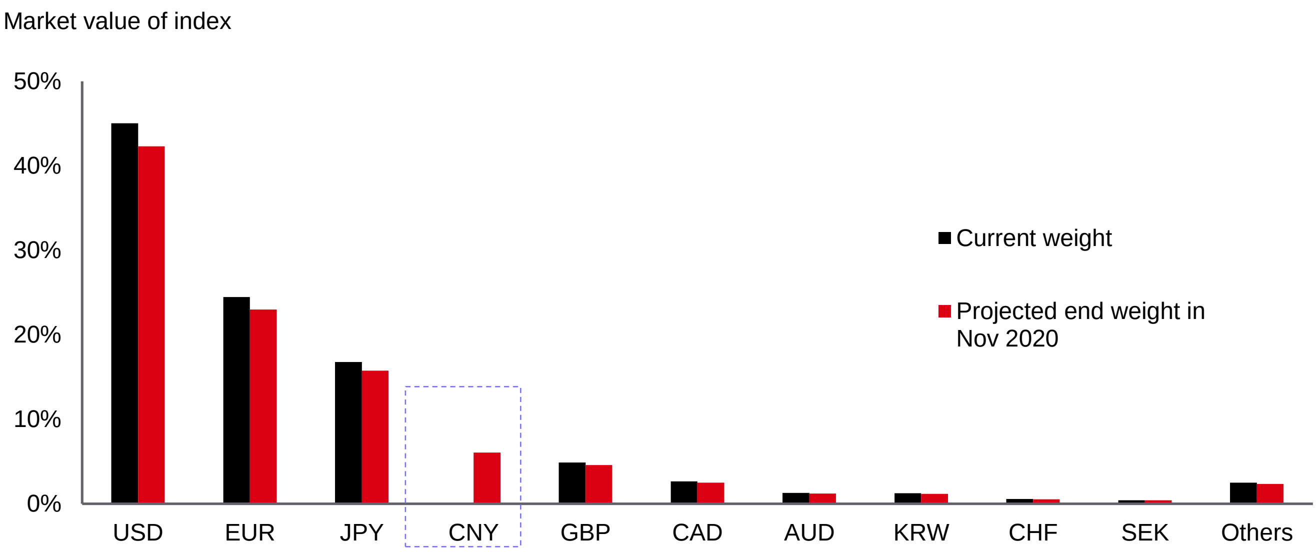
Bloomberg Barclays China bond inclusion

Pro forma impact

Figure 3: Pro forma impact on currency breakdown after China inclusion in BGA (top 10 currencies shown)



Difference in market value between current weight and projected end weight in 2020										
USD	EUR	JPY	CNY	GBP	CAD	AUD	KRW	CHF	SEK	Others
-2.73%	-1.48%	-1.02%	**+6.06%**	-0.30%	-0.16%	-0.08%	-0.08%	-0.03%	-0.03%	-0.16%

Source: Bloomberg, as of 31 January 2019. The above is currency breakdown of the top currencies only. To see all currencies, please see Appendix I. For a country breakdown, please also see Appendix I.

Figure 4: Characteristics of BGA pre- and post- inclusion

	BGA including China onshore bonds at full weight (in Nov 2020)	BGA (pre-inclusion)	China onshore bonds to be included
Yield to worst (%)	2.06	1.98	3.28
Duration (years)	7.06	7.06	5.59

Source: Bloomberg, as of 5 March 2019.

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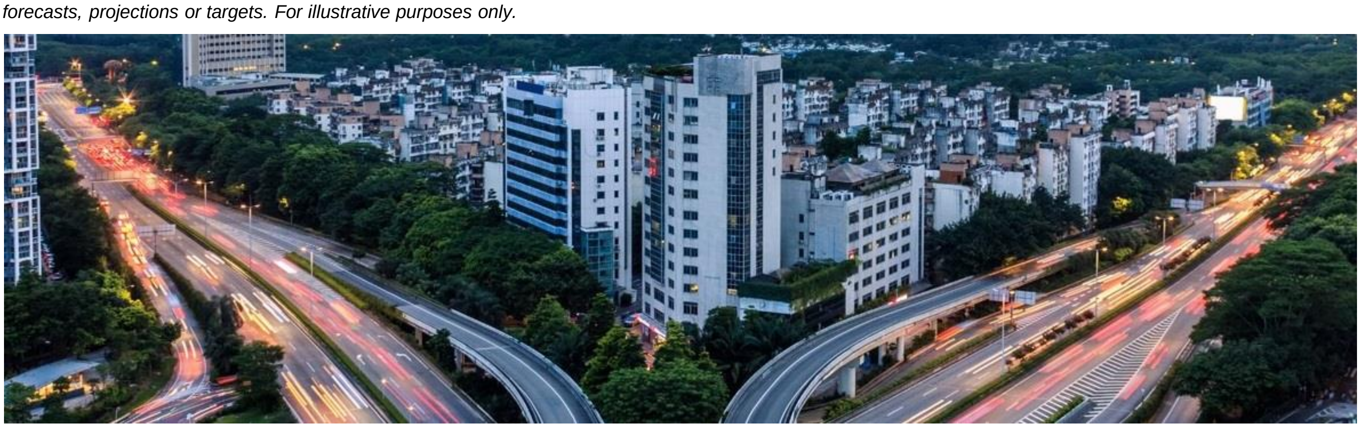


Long-term diversification benefits of China bonds

Diversification benefit

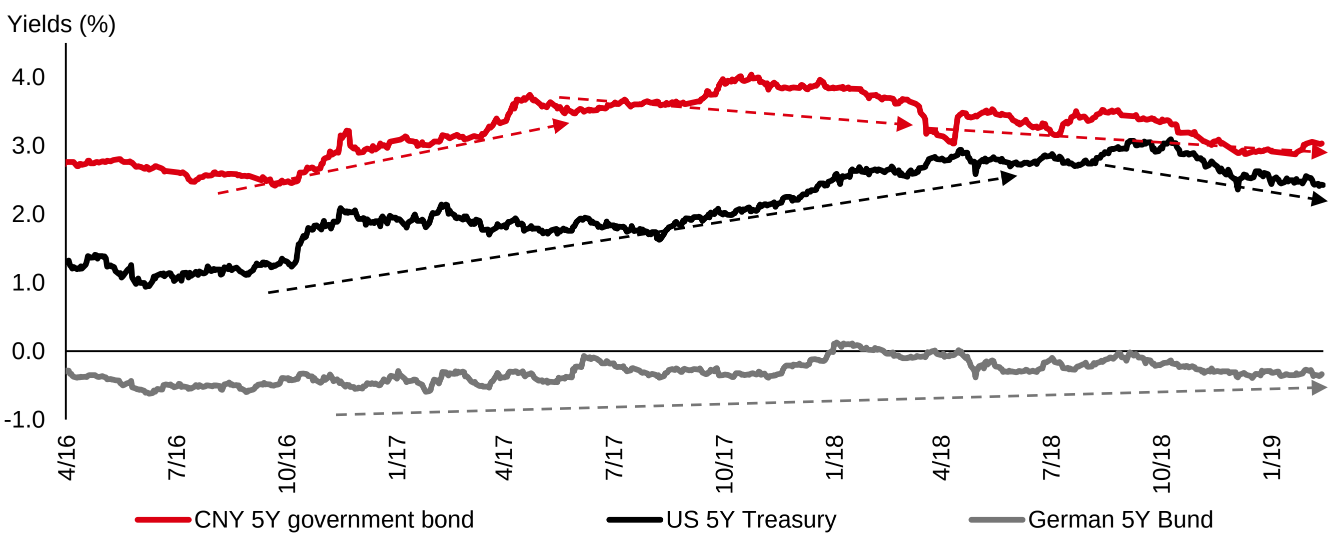
- China RMB onshore and offshore bonds have very low correlation to other credit and sovereign markets and also with each other
- Diversification is the "silver bullet" argument for investing in RMB bonds. Onshore bonds are largely driven by domestic policies and onshore supply and demand, and do not necessarily coincide with the rest of the world. Investing in Chinese assets can also help capture distinct investment opportunities, particularly as China is in a unique economic developmental stage

Figure 5: Low correlation to other asset classes

Correlation of returns

	Offshore RMB bond	Onshore RMB bond	Global bond	US bond	EM bond	Asian bond	US high yield bond	Asian high yield bond	US Treasury	Euro government
Offshore RMB bond	1.00									
Onshore RMB bond	0.51	1.00								
Global bond	0.44	0.00	1.00							
US bond	0.39	-0.04	0.79	1.00						
EM bond	0.29	0.26	0.73	0.50	1.00					
Asian bond	0.53	0.05	0.77	0.85	0.62	1.00				
US high yield bond	0.43	-0.04	0.32	0.23	0.36	0.56	1.00			
Asian high yield bond	0.47	0.05	0.51	0.49	0.59	0.83	0.70	1.00		
US Treasury	0.26	-0.04	0.72	0.96	0.40	0.70	-0.03	0.27	1.00	
Euro government	0.28	0.09	0.51	0.54	0.34	0.45	0.03	0.21	0.57	1.00

Figure 6: China vs US vs German government bond yields



Source: Bloomberg, JP Morgan, BAML, HSBC Global Asset Management as of March 2019.
Correlation calculated in base currency, for the period from February 2016 to February 2019
Offshore RMB Bond: Markit iBoxx ALBI China Offshore Index, Onshore RMB bond: Markit iBoxx ALBI China Onshore Index, Global Bond: Bloomberg Barclays Global Aggregate Index, US bond: Bloomberg Barclays US Aggregate Index, EM bond: JP Morgan GBI-EM Global Composite Index, Asian bond: JACI Composite Index, US high yield bond: BofAML US High Yield Index, Asian high yield bond: JACI Non-Investment Grade Corporate Bond Index, US Treasury: Bloomberg Barclays US Treasury Index; Euro government: BofAML Euro Sovereign Index

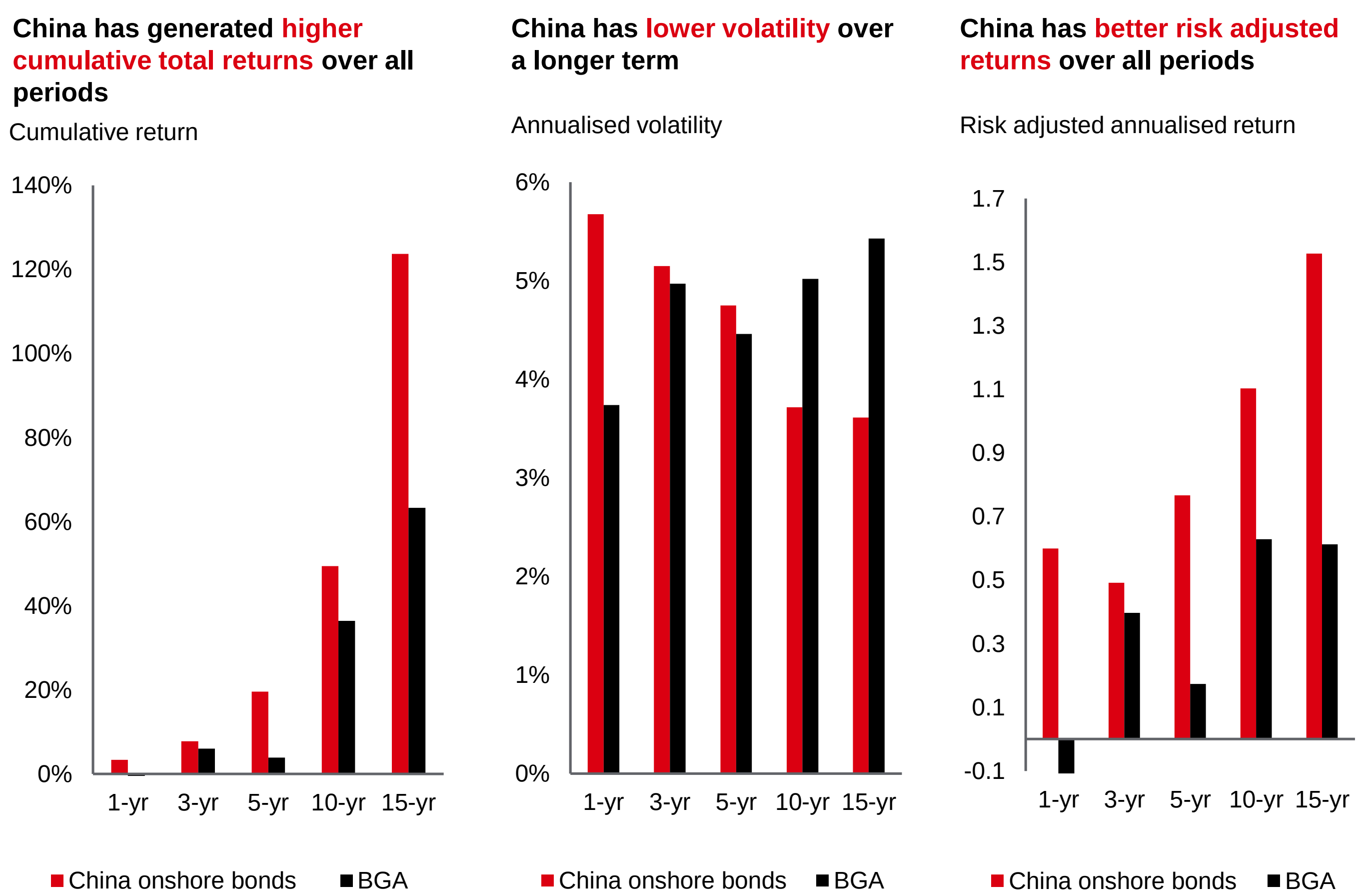
Investment involves risks. Past performance is not indicative of future performance. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets. For illustrative purposes only.

Comparison of risk return profile of China vs. global bonds

Potential to improve risk return profile

- The risk return profile of a portfolio can be potentially enhanced with China onshore bonds. China onshore bonds have achieved better risk adjusted returns over various periods (see Figure 7). We expect more investors to take advantage of this as China enters the Bloomberg Global Aggregate Index and becomes part of the mainstream
- The Bloomberg Barclays China Treasury and Policy Bank Index contains the full universe of securities that are eligible for the China bond inclusion, thus serves as a good proxy to analyse the historical returns and volatility of the China onshore market in the context of this inclusion. Below is an analysis that uses the Bloomberg Barclays China Treasury and Policy Bank Index, in USD terms

Figure 7: China has achieved a higher risk adjusted returns historically



Indices used: Bloomberg Barclays China Treasury and Policy Bank Total Return USD Index, Bloomberg Barclays Global Aggregate Total Return Unhedged USD Index. Source: Bloomberg, HSBC Global Asset Management, as of 28 February 2019

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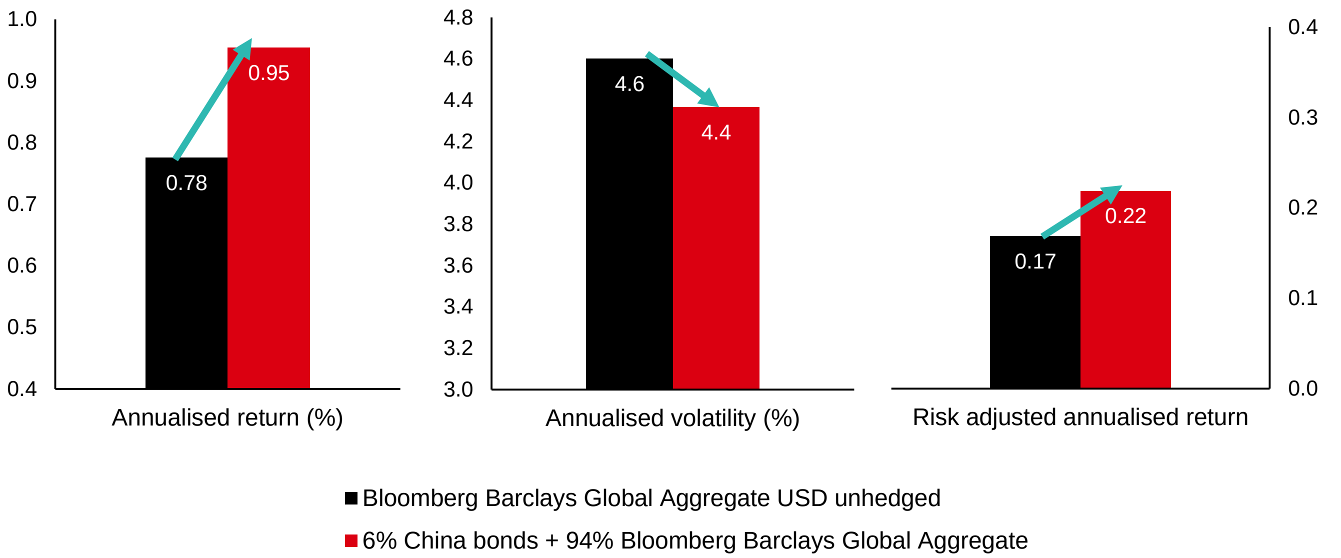
Quantifying the inclusion impact

What impact would a 6% exposure to China bonds have had in the past?

- In a low return fixed income environment over the last 5 years (in USD terms), the Bloomberg Barclays Global Aggregate Index returned 0.78% in annualised terms
- By adding 6% exposure in China onshore bonds (using the Bloomberg Barclays China Treasury and Policy Bank Index), we find that annualised returns would have increased by 18bp. Meanwhile annualised volatility is lowered by 24bp. As a result, the risk adjusted returns of a global bond portfolio which includes China onshore bonds are improved

Figure 8: Adding 6% China onshore bonds to a global bond portfolio would have improved risk adjusted returns (in USD terms)



Indices used: Bloomberg Barclays China Treasury and Policy Bank Total Return, Bloomberg Barclays Global Aggregate Total Return Unhedged
Source: Bloomberg, as of February 2019
Based on the assumption of no transaction costs and portfolio rebalancing. Investment involves risks. Past performance is not indicative of future performance. Hypothetical analysis is for information purpose only and should not be relied on as indication for future result.

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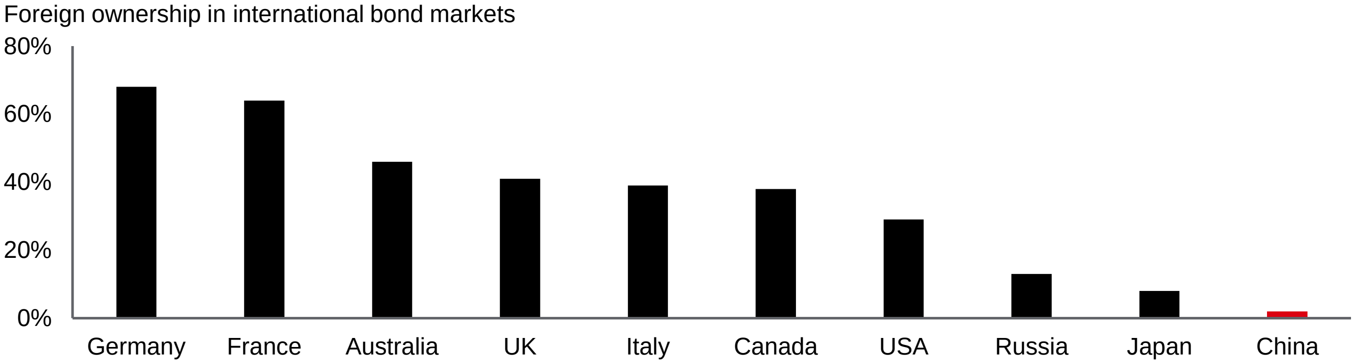
Medium-term investment drivers of China bonds

Positive medium term support with foreign flows expected to increase

- BGA's tracking AUM is estimated at around USD 2.5 trillion. The China bond inclusion into BGA is expected to translate into USD 150 billion of flows into the Chinese onshore bond market by the end of the inclusion period in November 2020. Other major index providers could potentially also include China onshore bonds into their key global indices. These include FTSE World Government Bond Index (WGBI) and JP Morgan Government Bond Index Emerging Markets (GBI-EM), which are estimated to have tracking AUM of around USD 2.5 trillion and USD 220 billion respectively
- As compared to other markets, China's foreign ownership is very low, at only around 2%-3%. However, this is set to progressively change as the China bond inclusion gets underway. We have already seen foreign investors increase their holdings of onshore bonds in 2018 by USD 65 billion to USD 248 billion

Figure 9: Foreign participation in China's bond market set to rise

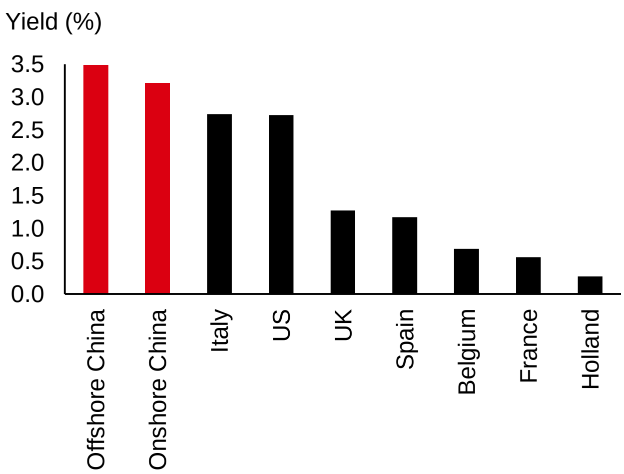


Source: Bank for International Settlements, HKEX as of January 2019.

Attractive valuations and sound fundamentals

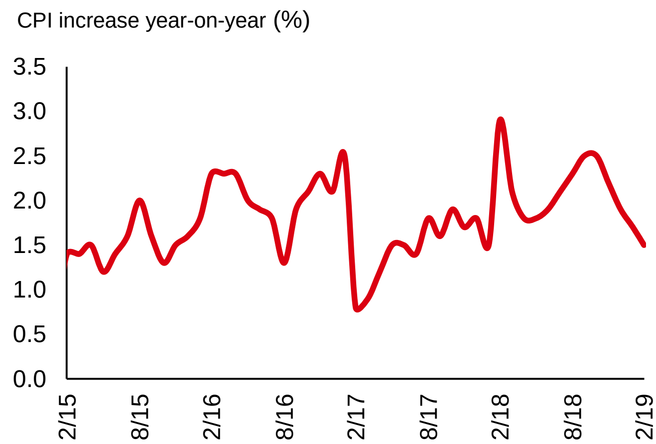
- RMB government bonds yield higher than those in other markets of a similar size and rating
- The Chinese government's fundamentals are very sound with by far the largest foreign exchange reserves in the world and manageable debt levels. Meanwhile, inflation remains low

Figure 10: 10-year government bond yields of the world's largest bond markets



Source: Bloomberg, as of 4 March 2019.

Figure 11: CPI likely to stay below the government's target



Source: Bloomberg, as of February 2019.

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Choices for foreign investors in Chinese fixed income

Key products

'All China' bond	Passive onshore bond*
'Go anywhere' total return active strategy concentrating on all Chinese bond and credit markets	Low cost fulfilment of BGA inclusion, concentrating on relatively efficient sovereign and policy bank bonds

Segregated mandates

Bespoke active or passive strategies encompassing desired investment universe, credit quality, liability matching etc

*Launch date is expected to be in 2019
Source: HSBC Global Asset Management as of March 2019.
For reference only. Information may be changed from time to time without notice.

Why HSBC Global Asset Management?

HSBC Global Asset Management is a pioneer in Chinese investments, with deep experience in investing in both offshore and onshore Chinese securities.

Recognised leadership

- Award winning investment team in Asian and China fixed income
- Long track record in Asia fixed income dating back to 1996
- Full set of China fixed income product offering, including onshore and offshore investment capabilities, passive/active and rates/credit

Proven investment approach

- An integrated approach towards fundamental research and local insight that marries rigorous credit selection with stringent risk controls
- Robust risk management process that optimises returns in volatile markets while maintaining diversification

Best use of global resources with local insight

- Leverage local expertise from an on-the-ground team in Shanghai
- Collective thinking on global investment risks and themes
- Shared systems and resources
- Local decision-making to ensure empowerment and flexibility

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Best RMB Manager awarded to HSBC Global Asset Management
Asia Asset Management Best of the Best Awards 2019 (Asia)

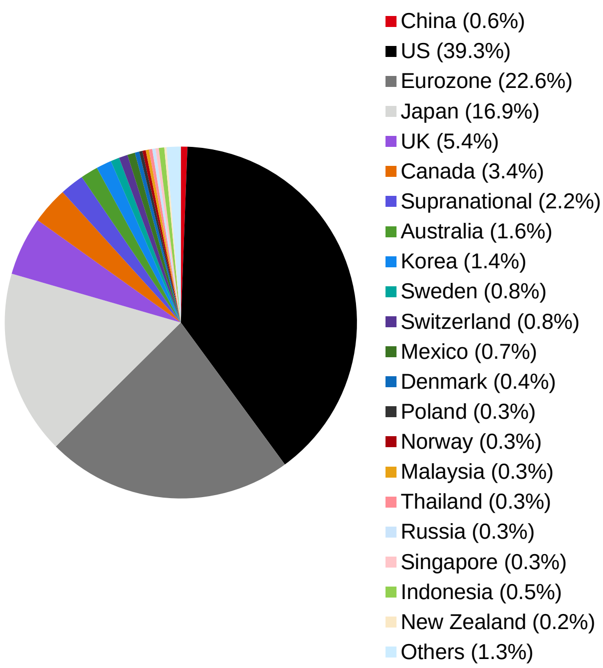
BEST OF THE BEST AWARDS 2019
Asia Asset Management

Source: HSBC Global Asset Management as of March 2019.

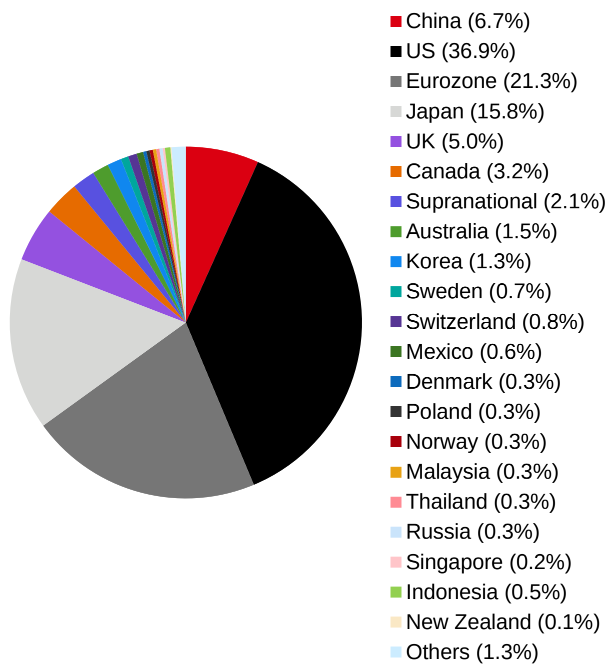
Appendix I: Country and currency breakdown of Bloomberg Barclays Global Aggregate before and after

Bloomberg Barclays Global Aggregate: Country breakdown

Current weight

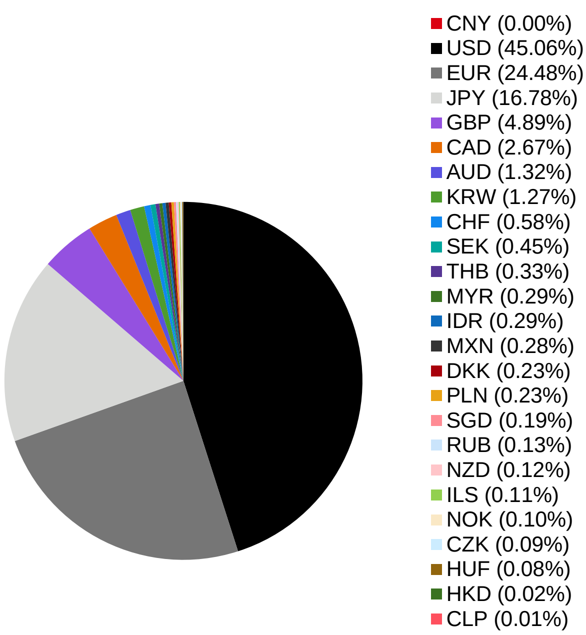


Projected weight after inclusion (Nov 2020)

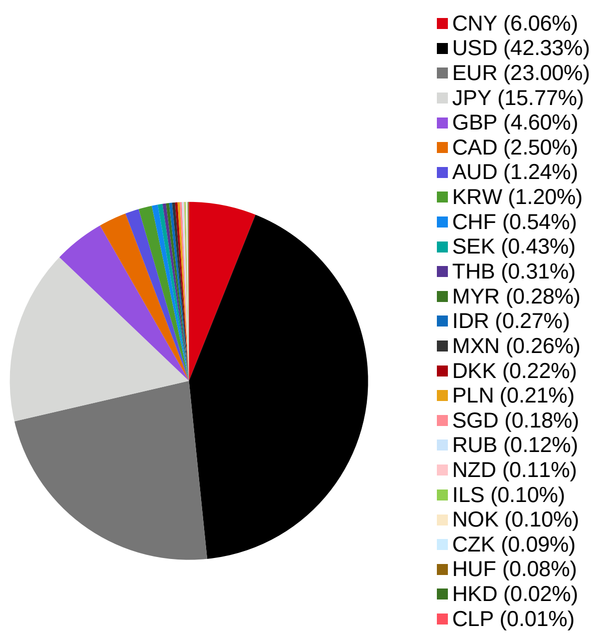


Bloomberg Barclays Global Aggregate: Currency breakdown

Current weight



Projected weight after inclusion (Nov 2020)



Source: Bloomberg, HSBC Global Asset Management, data as of January 2019

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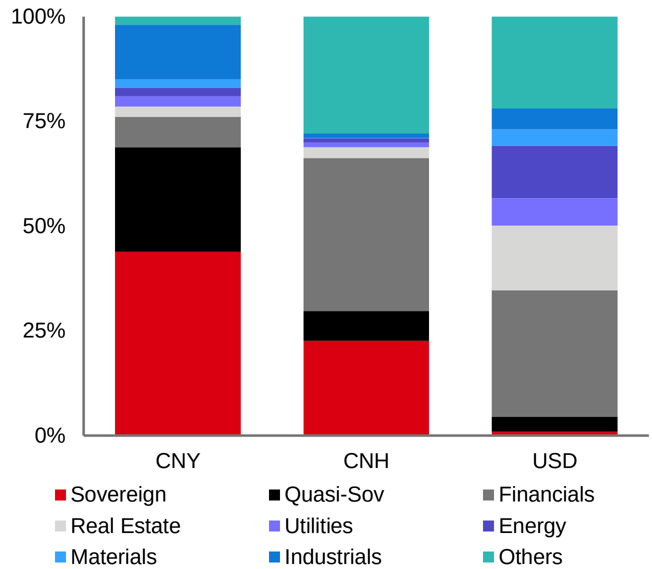
Appendix II: Chinese bond markets structure

Market structure of onshore and offshore bond markets

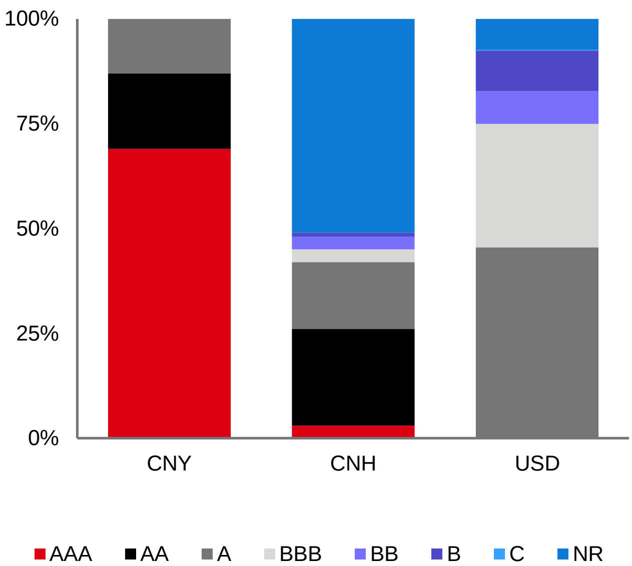
Characteristics

	Onshore CNY	Offshore CNH	Offshore USD
Bonds O/S (USD)	12 trillion	77 billion	800 billion
Number of issues	37,374	1,200	3,600
Yield (%)	3.37	4.17	4.53
Duration (years)	6.64	3.35	3.52
Average rating	AAA/AA*	A+/A	A-/BBB+

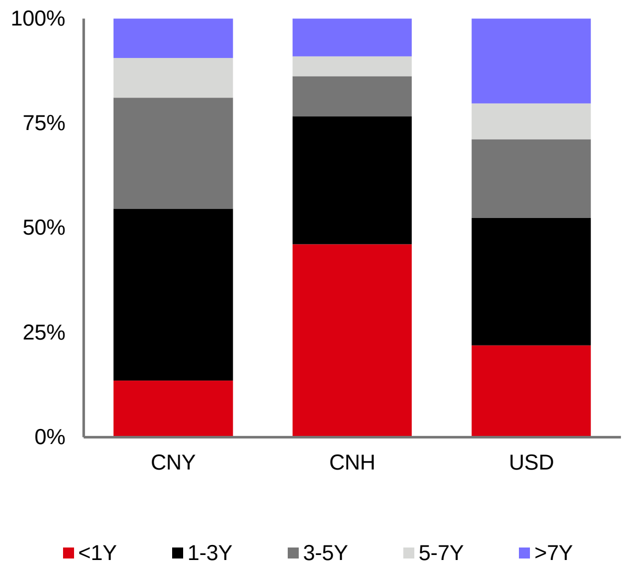
Breakdown by sector



Breakdown by rating*



Breakdown by tenor



* The rating criteria and methodology used by Chinese local rating agencies may differ from those adopted by established international credit rating agencies. Therefore, the Chinese local credit rating system may not provide an equivalent standard for comparison with securities rated by international credit rating agencies

Source: PBoC, ChinaBond, Markit, JPMorgan, Bloomberg, HSBC Jintrust, HSBC Global Asset Management, data as of January 2019
Unless specified otherwise, using Bloomberg for sector, years to maturity and rating breakdowns for CNH and USD bond markets
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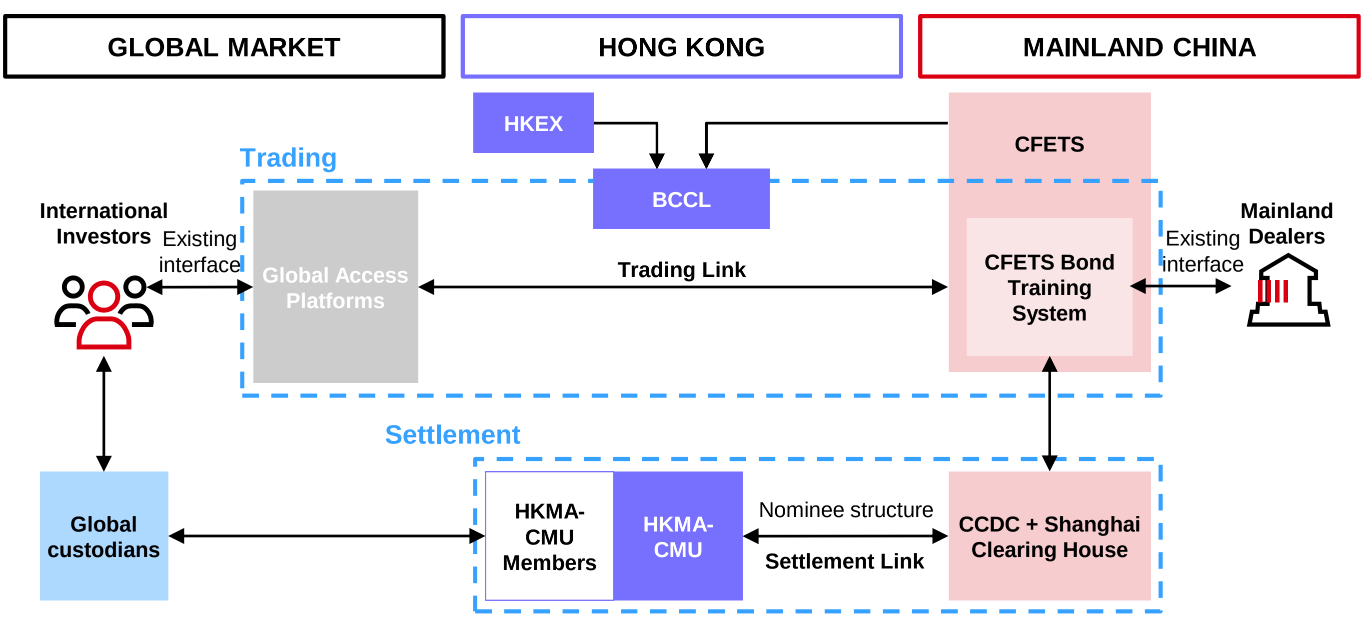
Appendix III: Accessing the onshore bond market

China Interbank Bond Market (CIBM) Direct and Bond Connect

	CIBM Direct	Bond Connect (Northbound)
Launch	◆ 2016	◆ 2017
Quota	◆ None. Pre-file amount to invest	◆ None. Also no pre-filing with PBoC
Available instruments	◆ Interbank market cash bonds, repo and FX, interest rate and bond derivatives	◆ Interbank market cash bonds and FX derivatives
Eligibility	◆ Sovereign entities, financial institutions and their products, and other eligible mid/long term investors	◆ All institutional and retail investors
Currency	◆ Offshore RMB or other currencies	◆ Offshore RMB or other currencies
Settlement cycle	◆ T+0, T+1 or T+2	◆ T+0, T+1 or T+2
Lock-up period	◆ **No**	◆ **No**
Repatriation limit	◆ **No**	◆ **No**
Market entry timeframe (indicative only) and process	◆ 6-11 weeks for non-sovereign entities ◆ 7-15 weeks for sovereign entities ◆ Assessment by settlement agent ◆ Registration with PBoC ◆ Account opening with intermediaries	◆ Abide to international laws and trading practices ◆ Use of offshore infrastructure from Hong Kong to access onshore bonds ◆ No onshore filing and account opening with onshore custodian
Recent developments	◆ Bloomberg as trading platform available	◆ Block trade is allowed ◆ Implementation of real-time delivery versus payment ◆ Bloomberg as trading platform available

Bond Connect trade flow illustration



Source: HKEx, BCCL, HSBC Securities Services, HSBC Global Asset Management, data as of February 2019

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Key Risks

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested.

- Exchange rate risk: Investing in assets denominated in a currency other than that of the investor's own currency perspective exposes the value of the investment to exchange rate fluctuations
- Liquidity risk: Liquidity is a measure of how easily an investment can be converted to cash without a loss of capital and/or income in the process. The value of assets may be significantly impacted by liquidity risk during adverse market conditions
- Emerging market risk: Emerging economies typically exhibit higher levels of investment risk. Markets are not always well regulated or efficient and investments can be affected by reduced liquidity
- Derivative risk: The use of derivatives instruments can involve risks different from, and in certain cases greater than, the risks associated with more traditional assets. The value of derivative contracts is dependent upon the performance of underlying assets. A small movement in the value of the underlying assets can cause a large movement in the exposure and value of derivatives. Unlike exchange traded derivatives, over-the-counter (OTC) derivatives have credit and legal risk associated with the counterparty or the institution that facilitates the trade
- Operational risk: The main risks are related to systems and process failures. Investment processes are overseen by independent risk functions which are subject to independent audit and supervised by regulators
- Concentration risk: Funds with a narrow or concentrated investment strategy may experience higher risk and return fluctuations and lower liquidity than funds with a broader portfolio
- Interest rate risk: As interest rates rise debt securities will fall in value. The value of debt securities is inversely proportional to interest rate movements
- Derivative risk (leverage): The value of derivative contracts depends on the performance of an underlying asset. A small movement in the value of the underlying can cause a large movement in the value of the derivative. Over-the-counter (OTC) derivatives have credit risk associated with the counterparty or institution facilitating the trade. Investing in derivatives involves leverage (sometimes known as gearing). High degrees of leverage can present risks to sub-funds by magnifying the impact of asset price or rate movements
- Emerging market fixed income risk: Emerging economies typically exhibit higher levels of investment risk. Markets are not always well regulated or efficient and investments can be affected by reduced liquidity, a measure of how easily an investment can be converted to cash without a loss of capital, and a higher risk of debt securities failing to meet their repayment obligations, known as default
- High yield risk: Higher yielding debt securities characteristically bear greater credit risk than investment grade and/or government securities
- Contingent Convertible Security (CoCo) risk: Hybrid capital securities that absorb losses when the capital of the issuer falls below a certain level. Under certain circumstances CoCos can be converted into shares of the issuing company, potentially at a discounted price, or the principal amount invested may be lost

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