Chinese bonds have been in the spotlight over the past few years, with China’s currency and capital markets gradually opening up. Interest in the asset class soared, most notably, around the launch of the much-anticipated Bond Connect programme on 3 July 2017. While offshore RMB bonds offer relatively higher yields at present, in the longer run foreign investors will increasingly turn to the much broader and deeper onshore market to gain exposure to the asset class. While gaining access to the onshore market has become a relatively painless process, the market still remains somewhat challenging for international investors because of the unique features that characterise Chinese bonds. In this guide we attempt to demystify this increasingly important asset class that can be used as a diversification tool to improve the risk-adjusted returns of a global bond portfolio.

The RMB bond market is the third largest in the world, at USD7.1 trillion. However, foreign participation in the market is only at 3%. As China opens its arms to international investors, with complete access to the bond market on the horizon, foreign holdings could triple by 2020, an amount equivalent to 8.5% of China’s GDP.

Source: CEIC, HSBC, Sifma Statistics, Asian Development Bank, JP Morgan, as of December 2016; HKEx, as of May 2017
Game changing developments for RMB bonds

Before 2010 – RMB bond market was closed to most foreign investors

Internationalisation of offshore RMB bonds
- For the first time, fund raisers were able to issue dim sum bonds, which were denominated in the offshore currency ‘CNH’. This development bridged the gap between local Chinese bond issuers and foreign investors. CNH bonds are generally issued with international standard documentation and governed by foreign laws.

Opening of China Interbank Bond Market Direct (CIBM Direct)
- The scheme offers almost all “real money” investors access to the third largest bond market in the world.
- This was a game changer as previously foreign investors who were keen on the onshore bond market, had zero or very limited exposure to it, due to the prevailing quota system which made timing and size of investments more difficult to control.

Inclusion of RMB in Special Drawing Right basket
- RMB was introduced into the IMF’s SDR valuation basket on 1 October 2016 as a fifth currency, providing a major shot in arm for RMB internationalisation.
- The inclusion is expected to lead to greater use of the RMB in global trade and finance, and encourage increased allocation into RMB assets.
- The development, along with the opening up of CIBM, supported the subsequent inclusion of onshore bonds into Citi and Bloomberg-Barclay’s new global bond indices in March 2017.

Launch of Bond Connect
- Launched in July 2017, the scheme allows offshore investors access to onshore Chinese bonds through Hong Kong. Details revealed that this will cover the CIBM with no quota, thus facilitating a full opening up of the onshore bond market, to all types of investors, including the retail segment.
- One of the key advantages of this scheme is a more simplified registration and account opening process, which is much quicker and does not require setting up of onshore accounts or signing onshore legal documents. In the past, foreign investors were likely put off by the cumbersome processes involved in accessing the market.
- However, Bond Connect will not allow investors to use onshore derivatives, so hedging would have to be done via offshore instruments, unlike the existing CIBM scheme for institutional investors where hedging is already available.

Source: IMF, HSBC Global Asset Management, data as of July 2017

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Factors to consider when investing in RMB bonds

Credit selection is key to success in RMB bond investing

General security selection criteria
- Credit quality
- Repayment ability
- Relative value

In depth analysis of unique factors that affect the researched securities

Identify securities with highest reward potential for a given level of risk

State-owned enterprises require special attention
- China is a unique market in many ways. One aspect that makes this market stand out is the government's ownership of a large number of Chinese companies, which are collectively referred to as state-owned enterprises (SOEs)
- Until recent years, there were virtually zero default cases in the onshore bond market. This created the myth of an “implicit guarantee” of bonds from the government
- However, recent bond defaults by SOEs have made it clear that these companies are not immune to delinquencies, and that investors cannot simply make investment decisions based on the ownership of the issuer. In fact, many private enterprises are very well managed and generally have much lower leverage, making them more suitable investments from a credit quality standpoint
- “Strategically important” sectors or companies, which are at the heart of the country’s development agenda, are usually well supported by the government given the role they play in facilitating key initiatives
- For example, power generation companies are strategically important as China continues expand its electricity network, especially for rural development. Companies, such as subway developers and operators, are also a part of the government’s key focus in building China’s infrastructure, and they cannot be replaced by private companies easily
- Under the ongoing SOE reforms, companies saddled with overcapacity issues may see their outlook deteriorate even faster given the Chinese government’s goal of economic transformation

SOEs tend to have higher leverage than private enterprises

SOEs continue to dominate the corporate bond market

Source: CEIC, WIND, HSBC Global Research, HSBC Global Asset Management, data as of June 2017
Factors to consider when investing in RMB bonds

Regional economic differences
- Economic and social conditions in various Chinese provinces can have a significant influence on credit development
- Eastern coastal regions generally have much higher GDP levels, much better infrastructure, more foreign investments, and higher education levels than western inland regions
- These factors would influence the credit outlook of companies that operate in the relevant regions. They would also impact the willingness and ability of the government, at various levels, to support the borrowers

Onshore/offshore funding channels
- Companies with access to additional funding channels in overseas markets may have a credit advantage over companies which depend solely on onshore funding sources
- Additional funding options make companies less susceptible to potential liquidity squeezes in China. Offshore funding sources include overseas equity listings, offshore bond market issuances and borrowing from foreign banks

Looking past credit ratings
- Credit selection process is paramount when investing in onshore Chinese corporate bonds
- 99% of onshore bonds are rated AA and/or above by local credit rating agencies. This number shows that there is little differentiation between different quality issuers at present
- However, these credit ratings should not be taken at face value, as standards and methodology adopted differ materially from international rating agencies
- With the launch of the Bond Connect, China’s bond-rating industry now faces full-blown foreign competition for the first time and this should lead it to step up its own differentiation efforts

Macro trend and foreign fund flows
- Combining an understanding of macro trends, which are vital to the Chinese bond market, with a bottom up research process is crucial to credit selection
- For example, money market rates, which are an indicator of liquidity, are relatively volatile in China and have a significant bearing on both onshore and offshore RMB bond prices
- As the offshore CNH bond market is still relatively small and dominated by foreign investors, fund flows, driven by factors such as monetary policies or currency movements, could have a meaningful impact on the market

Regional economic differences

Onshore/offshore funding channels

Looking past credit ratings

Macro trend and foreign fund flows

Five provinces account for over 40% of China’s GDP in 2016

Source: Bloomberg, NBS, HSBC Global Asset Management, HSBC Jintrust, data as of June 2017
RMB bonds offer attractive yields
- Investors can diversify their portfolios using Chinese bonds to improve potential returns for a given level of risk (refer to table below).
- Chinese 10-year government bonds offer yields above 3.5%, which is attractive in absolute and relative terms, considering how low global yields remain.
- Along with better access to the market with the opening up of CIBM, the RMB’s SDR inclusion and the launch of Bond Connect, current valuations also present attractive entry points for investors.

<table>
<thead>
<tr>
<th>Country/Region</th>
<th>Offshore Bond</th>
<th>Onshore Bond</th>
<th>US</th>
<th>UK</th>
<th>Euro</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yield (LHS)</td>
<td>4.0%</td>
<td>3.0%</td>
<td>2.0%</td>
<td>1.0%</td>
<td>0.3%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Duration (RHS)</td>
<td>12</td>
<td>9.0</td>
<td>6.0</td>
<td>3.0</td>
<td>3.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

China government bonds have lower duration and higher yield compared to those from other largest bond markets.

Corporate bonds for additional carry
- Allocation to corporate bonds and credit selection efforts might further boost portfolio returns. Corporate bonds provide attractive yield carry and decent capital upside. Demand for corporate bonds have increased, as the market standard improves, as investors have gradually become more familiar with the issuers and market dynamics, and as we remain in a “search for yield” investment environment.

Corporate bonds offer attractive yield carry

### Adding RMB bonds to improve potential return for a given level of risk

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>100% Global Equity</td>
<td>6.0%</td>
<td>10.9%</td>
<td>0.55</td>
</tr>
<tr>
<td>80% Global Equity, 20% Onshore Bond</td>
<td>6.7%</td>
<td>8.8%</td>
<td>0.76</td>
</tr>
<tr>
<td>80% Global Equity, 20% Offshore Bond</td>
<td>6.5%</td>
<td>9.1%</td>
<td>0.72</td>
</tr>
<tr>
<td>100% Global Bond</td>
<td>0.3%</td>
<td>5.2%</td>
<td>0.06</td>
</tr>
<tr>
<td>80% Global Bond, 20% Onshore Bond</td>
<td>1.9%</td>
<td>4.2%</td>
<td>0.45</td>
</tr>
<tr>
<td>80% Global Bond, 20% Offshore Bond</td>
<td>1.8%</td>
<td>4.3%</td>
<td>0.41</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Markit, ChinaBond, HSBC Global Asset Management, data as of July 2017. The figures are calculated according to the total return, volatility, risk-adjusted return and correlation of the relevant indices during the period from 29 August 2014 to 31 July 2017. Relevant indices used as examples: Global Equity = MSCI AC World; Global Bond = Barclays Global Aggregate; RMB Onshore Bond = ChinaBond New Composite; RMB Offshore Bond = Markit iBoxx ALBI China Offshore. For illustrative purpose only. Investment Involves risk, past performance is not indicative of future performance.

### How credit selection can add value to corporate bond investors
- As the market develops further, pricing differentiation (which is currently very limited) might become more pronounced between low and high quality bonds, and high quality issuers are expected to benefit from this trend.
- To capture investment opportunities in the Chinese bond market, investors need not only a rigorous bottom-up selection process, but also an on-the-ground understanding of the local market.
- Therefore, it is not unusual for investors to delegate the credit selection task to a “glocal” asset manager, which combines global credit selection standards with local research, thus blending unique market factors into the investment process.
- Professional asset managers could benefit from adopting processes which are specific to this unique market. For example, by developing a proprietary SOE framework that classifies companies into different tiers and takes key factors, including a company’s strategic importance to the government and guarantor’s fundamentals, into consideration before making an investment decision.
- A tailored approach for Chinese bond market allows an investor to screen attractive companies efficiently and identify opportunities that may arise from market mispricing.

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Near term challenges and opportunities

- The biggest challenge to the offshore CNH bond market has been the change in view towards the RMB, which was previously considered a one-way appreciating currency and is now seen as a currency with two-way volatility.
- However, as the market evolves, investors increasingly appreciate it as a credit market rather than a pure play on the currency, especially as they begin to analyse both the offshore and onshore RMB bond markets in tandem.
- The market will continue to develop as more foreign investors look for RMB bond exposure, following RMB’s SDR inclusion and the launch of Bond Connect. Additionally, and perhaps more importantly, the RMB bond market’s potential inclusion into major global bond indices will further encourage foreign investors to look at this asset class from a long term perspective.

What next?

- While the opening up of the onshore bond market has certainly presented investors with interesting opportunities, current investor exposure is low and knowledge of the market is limited.
- Asset managers with experience in Chinese bond investing, who can combine a robust investment framework with a rigorous credit selection process, are the necessary bridge for international investors who wish to enter this exciting and complex market.

China: the third largest bond market globally
Market size: USD7.1 trillion

Foreign participation: 3%
Potential capital inflow upon full index inclusion: USD155 billion
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