March 2018

Matthews Asia

Matthews Asia Perspective
China’s Bond Market Matures with Inclusion in Global Index

Teresa Kong, CFA
Portfolio Manager
Matthews Asia

For most of us, our 21st birthday was a milestone. It meant we were finally adults—in our own eyes and by the laws of society. Bloomberg’s recent announcement that it will include China into the Bloomberg Barclays Global Aggregate Bond Index (Global Agg) is like China’s bond market turning 21. The most widely used fixed income index provider is recognizing that China has a developed bond market. It affirms it has reached a maturation level equivalent to other developed markets and is no longer just another developing or emerging market.

Bloomberg said Chinese renminbi-denominated government and policy bank bonds will be included in the Global Agg starting in April 2019. The inclusion is subject to some operational enhancements, the ability to allocate block trades across portfolios and clarification of tax treatment of the bonds. The weight will scale up slowly over a 20-month period, with China’s weight reaching 5.49% of the overall index. When fully included, China will represent the fourth-largest currency weight, after that of the U.S. dollar, the euro and the Japanese yen. This scaling-in period is longer than typical and is meant to allow investors time to put in place any administrative and operational requirements.

Assuming that the assets managed to the Bloomberg Barclays Global Aggregate Bond Index stay flat, we estimate that approximately US$100 billion would be flowing into China’s bond market just from passive flows. This will be a game changer for a market that has seen little foreign participation despite having grown to become the third-largest bond market in the world. Part of this has been due to historically high barriers to entry, many of which have been dismantled over the past decade.

After decades of reform, China bonds will finally meet all the eligibility criteria for the Global Agg inclusion: securities must be rated investment-grade and its currency must be freely tradable, convertible, hedgeable and free of capital controls.

Benefits for Investors

China’s investment-grade bonds offer attractive investment characteristics that can help diversify and enhance global portfolios. The chart below, for example, illustrates the current yield, currency return, and volatility of a five-year government bond of the top constituents of the Global Agg:

	Yield	*Currency Return*	*Currency Volatility*
U.S.	2.60%	—	—
Euro (Bund)	-0.09%	14.2%	7.2%
Japan	-0.11%	4.6%	7.4%
China	3.65%	9.0%	3.5%

Source: Bloomberg. Yield as of 3/27/18. Currency return and volatility calculated from 3/28/17–3/27/18.
Past performance is no guarantee of future results.

Chinese bonds present an opportunity to reap the returns of the yield and the currency appreciation. As such, we believe China bonds are attractive not only from a yield perspective, but also from a currency appreciation standpoint. Moreover, given their low historical volatility, we have found that they provide attractive risk-adjusted returns as well.

The Matthews Asia Approach

China's bond market offers attractive return potential, as well as risks. These risks can include currency, credit and interest rate risks. Notably, these risks are also the very same drivers of return for Asia fixed income. At Matthews Asia, we take an active approach to building Asia fixed income portfolios that closely examines and considers both financial risks and opportunities for generating returns in the portfolio selection process. In the current environment of rising interest rates, for example, we are keeping duration (a measure of interest rate risk) lower than the benchmarks for our strategies. We also closely consider the creditworthiness of individual issuers and currency trends of individual countries when buying and selling bonds for our portfolios.

Our firm was founded with a strong belief in the long-term growth potential of Asia's regional economies and capital markets. The inclusion of China into the Global Agg marks an important coming of age for China's bond markets. It provides positive re-enforcement for the market reforms and steps toward liberalization that the Chinese government has undertaken. It is validation that Chinese bonds are investable and investment-worthy. We believe Asian fixed income—including Chinese bonds—should be an integral part of a globally diversified bond portfolio.

HISTORY	
2002	Qualified Foreign Institutional Investor (QFII) mechanism launched to give foreign investors access to trade equities and bonds in China's mainland exchanges
2010	Another pilot program launched to allow three types of offshore institutions to invest in China's Interbank bond market, including: foreign central banks, certain lenders in Hong Kong and Macau
2011	Renminbi Qualified Foreign Institutional Investor (RQFII) was introduced as an extension of QFII program. RQFII allows qualified financial institutions to establish yuan-denominated funds in Hong Kong, Singapore, Taiwan, London, etc.
2012	China Securities Regulatory Commission grants QFII access to the interbank bond market
2015	China opens onshore repo market to overseas banks. This should lead to convergence in the onshore and offshore short term rates markets
2015	International Monetary Fund includes renminbi in the Special Drawing Rights (SDR) basket
2016	China announces scheme for foreign participation in the China interbank market
2017	Foreigner investors are allowed to trade onshore deliverable foreign currency exchange
2017	China announces direct Bond Connect scheme
2018	Bloomberg announces inclusion of China onshore bonds into its Barclays Global Aggregate Bond Index

Source: Bloomberg

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

Fixed income investments are subject to credit, currency, and interest rate risks. Credit risk is the change in the value of debt securities reflecting the ability and willingness of issuers to make principal and interest payments. Currency risk is a decline in value of a foreign currency relative to the U.S. dollar which reduces the value of the foreign currency and investments denominated in that currency. Interest rate risk is the possibility that yield will decline due to falling interest rates and the potential for bond prices to fall as interest rates rise.