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# REPORT
# RMB Bond Market
# Why global investors should care

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On Thursday, I hosted a half-day virtual forum on the future of Chinese capital markets. We had panels on the RMB Bond Market, Global Macro Opportunities, Hong Kong's role in Chinese capital formation, and a fascinating discussion on the history and legality behind the future of Chinese listings on U.S. exchanges. As fate would have it, September 24th was also when FTSE Russell announced that it would include Chinese government bonds (CGBs) to its flagship WGBI index. Estimates from Goldman Sachs predict that the eventual weighting will be 5.7%, which implies $140bn of inflows over the next several years based on the approximately $2.5tn of funds that are benchmarked to this index.

Why should this matter to everyday investors? Most U.S. and European investors have tiny allocations to China, and few outside of the mainland have an exposure that reflects China's economic might. The global monetary policy response to COVID-19 has solidified the era of zero and negative interest rates, and this announcement shines a light on the key advantage of holding Chinese fixed income, which is yield. While the yield advantage that Chinese bonds have over the rest of the developed world didn't play a role in the decision by FTSE to include China, it is the critical narrative to the global investment community that is starved for high-quality sovereign returns.

The following is a detailed synopsis of the RMB bond market panel, which included participants with intimate knowledge of the workings of this nuanced and distinctly Chinese asset class.

Edmund Ng – Founder of Eastfort Asset Management and former HKMA Reserve Manager.

David Loevinger –Managing Director in the Emerging Markets Group of TCW. Before joining TCW in 2012, he was the U.S. Department of Treasury's Senior Coordinator for China Affairs.

Phoebe Leung – Representative of the Bond Connect Company Limited, a joint venture established by China Foreign Exchange Trade System (CFETS) and Hong Kong Exchanges and Clearing Limited (HKEX). The vehicle for foreign investors to access RMB bonds.

Keith Berlin - Senior Vice President / Director of Global Fixed Income and Credit for the Fund Evaluation Group.

U.S. or European centric investors may have very little interest in Chinese bonds near term. Still, as their sovereign bonds cease to be relevant because 25% of global sovereign bonds have a negative yield, alternative sources of high quality, low volatility returns will be sort after. At a minimum, you will need to know the workings of the world’s second-largest bond market.

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## The RMB Bond Market – A Little Background

Please provide a little bit of background on the size, scale of the Chinese bond market, and some of the nuances surrounding investment in Chinese fixed income.

**Phoebe Leung:** The Chinese bond market is the world's second-largest, exceeding Japan back in 2017.

The China bond market is divided into two different markets. Firstly, the exchange market has 10% of the total market liquidity—the second being the China interbank bond market or CIBM. This interbank bond market contains all the institutional investors and addresses 90% of the total market liquidity. It oversees all the relevant securities effectively for international investors, such as government bonds (CGB), policy banks, and even for some aggressive investors, credit.

In the last fifteen years, there have been many different access platforms that the regulators have established—for example, the older quota systems, which we call the QFII and RQFII. And more recently, ten years ago, central banks and some sovereign wealth funds have utilized the CIBM quota system. Bond Connect is the latest access platform to introduce all the different international institutional investors into the onshore market.

When the PBOC approached the Bond Connect in 2015, they were given a task to expand the international participation below 2% to 15% by 2025. The Bond Connect designed an access platform that allows the ease of access, be it trading or settlement and custody for international investors.

But essentially, they are the platform leading all the international investors into the onshore China bond market. And at the moment, we're running at about 2.8% of international participation. And we're likely going to be looking at more enhancements to improve the access platform.

## Are Chinese bonds underrepresented in global portfolios?

China is the world's second-biggest economy with the world's second-biggest bond market that isn't truly represented in global bond portfolios. Are Chinese bonds underrepresented?

**David Loevinger**: It's an important point. I think investors need to know that they will be holding many more Chinese assets in their portfolios over the next decade. China has been opening up rapidly, and foreign investment has been pouring into equity and fixed income markets. There are many reasons for that, but the most crucial reason is that China is being included in all of the major equity and fixed income indices.

Some analysts have called China's index inclusion as the financial equivalent of China's WTO accession. The fact is that global investors are massively underweight Chinese assets, and that's going to change swiftly. We've been increasing our investment in Chinese assets a lot this year. There's a lot to like about investing in China. You mentioned yield. We're in a world where zero is the new positive. Zero is not that bad. 25% of investment-grade sovereign bonds have negative yields. So, if you can get 3% on an A-rated sovereign, that's attractive.

As a dedicated emerging market investor, what's attracted to us is not just the yield but the volatility adjusted yield. Both Chinese bonds and China's exchange rates are a relatively low volatility asset. That's particularly appealing to us in a cautious context. So, as a dedicated emerging market investor, we see Chinese assets as being attractive in a defensive environment. There are lots of other advantages. China provides many diversification benefits. Many markets that we invest in are tied more to the U.S. or European economic and credit cycle. China helps with that.

China is the second-largest bond market in the world. It is a market where you can trade in scale. And there's lots of liquidity, mainly if you stick to on-the-run issues. And lastly, China has some strong fundamentals, which we think justify its single-A rating.

Does that apply not only to dedicated funds but to crossover funds as well? Where does China have a role in crossover vehicles?

**David Loevinger**: I think the difference is the main attraction for crossover investors is, one, the yield because given that 25% of investment-grade sovereigns have negative yield and you can get 3% out of China. It's diversification. It's the scale. For emerging market investors, when we're bullish fixed income, we want to be in higher beta markets, Brazil, Indonesia. It's when we want to get defensive that China becomes particularly attractive for us.

## The role of RMB bonds in global asset allocation

Chinese fixed income's role in terms of asset allocation and portfolio construction. Discuss the evolution of Chinese fixed income and Chinese fixed income as an essential part of any global asset allocation scenario.

**Edmund Ng**: We have seen an evolution that justifies Chinese bonds within a global asset allocation framework.

- Since 2015, the RMB has been part of the Special Drawing Rights (SDR) currency basket. This facilitates a lot of central banks to consider moving part of their reserves into RMB.
- Scale. To large asset owners, the investable universe is relatively small. Depth and liquidity have never been more critical to large pools of capital. The RMB bond market ticks this box. There are some concerns about the uniqueness and trading nuance. In 2016, before the Bond Connect, the regulators changed the quota system to a

registration system. Now, there's no more quota to limit the size of your investment. Investors can enter and exit the bond market via the Bond Connect as they see fit

- A sovereign credit rating of A+ by S&P.
- Portfolio diversification is also essential. Currently, we have seen that the correlation is relatively low against either the D.M. bond market or the Yen bond market, which gives you the diversification benefit.
- Volatility. Chinese bonds give you a reasonable risk-adjusted return. Even during the second quarter, when the market was quite volatile, the CGB volatility was slightly higher than the JGD market. It gives you a compelling risk-adjusted return over your bond portfolio.

All these points make ownership compelling.

What are the arguments that are made by the skeptics

**Keith Berlin:** Convincing U.S. investors to engage in Chinese fixed income directly as a substitute for Treasuries, even with U.S. yields at negligible levels, will be difficult. While neutral index weightings of 5.7% are likely, deviation from these levels would be rare. The U.S. investor base doesn't have to knowledge about China to be confident in deviating from the benchmark, regardless of yield.

Worsen US-China relations and the potential for force divestiture is a constant and growing concern.

What is the correct risk premium for those risks to get us excited? Is that risk premium over a comparable treasury worth taking?

From a fixed income portfolio that's already well-diversified, adding China in some incremental way, it's not going to move the needle much one way or the other. Would we start taking a dedicated direct allocation to China at the asset allocation level? Probably not, but would we allow folks like David and other emerging market and global bond managers to consider those things within the context of their portfolios? Yes.

## The nuances and challenges of the RMB Bond Market

Discuss the structures of the market and alleviate some of the trading, the settlement, and custody concerns that people have for a market that isn't your garden variety bond market?

**Phoebe Leung:** China is still in the process of opening up and is in the middle of its RMB internationalization program. Traditionally, China was a market that is harder to enter and had higher barriers to entry. It's about trading. settlement and the custody.

Previously, with the CIBM agent model, it was a quota system with repatriation restrictions. And for programs like the QFII and RQFII before, it limited investors from certain jurisdictions

The Bond Connect has largely eliminated many of the barriers of entry. For example, when offshore investors do any trading using their onshore agents, they can trade Interbank against their onshore market makers. However, they will need to rely on a bond settlement agent onshore, their onshore custodian.

With a Bond Connect platform launching, we decided that investors can use e-trading platforms such as Bloomberg or Tradeweb, or we do have some other third party e-trading platforms that are going to join us soon. With the e-trading platforms, the investors can now conduct RFQ trading against the onshore market makers. These Bond Connect market makers are carefully selected under strict assessment by the different onshore regulators.

From this perspective, investors can trade effectively how they trade in the developed markets. That barrier to entry is being eliminated. With the e-trading platforms, this would be able to guarantee the investors have full autonomy, full control in the trade execution, and the speed and the accuracy of all the trade inputs as well.

On the settlement and custody side, the second barrier to entry was the fact that investors traditionally needed to open all the accounts with a local onshore custodian. All the bond and cash accounts are being opened onshore, which many investors were not entirely comfortable with. With Bond Connect, the investors are not required to open any accounts in China for their holdings. Instead, they own all their CIBM bonds through the global custodian. Global custodians can use their existing global multi-tier custodian framework when trading in Bond Connect.

The Hong Kong Central Moneymarkets Unit (CMU) has a centralized nominee account being opened in the onshore depositories, which is the CCDC that clears all the rates bonds and the Shanghai Clearinghouse that clears all the credit bonds. So, the CMU effectively, which is part of the Hong Kong Monetary Authority, investors can enjoy full beneficiary ownership without physically opening these bond accounts onshore.

Having the global custodian framework will also allow the investors to open all the cash accounts offshore rather than in China. So, at no point in time, will offshore investors have any cash exposure in China, which will also eliminate any tax implications. This is vital to many offshore investors because they don't need to worry about potential repatriation issues. Effectively, this makes Bond Connect a more direct, more accessible, and faster access route for investors.

The third point is about registration and filing. Historically, when offshore investors need to participate in the China Interbank Bond Market, the registration process in the traditional platforms has taken some investors for months, even half a year to one year, for like the CIBM agent model RQFII systems. For Bond Connect, the investors can complete all that filing in between two to four weeks.

In short, many of the barriers of entry that are related to the structure of the China bond market, how it allows offshore investors to enter this market specifically, has mostly been eliminated by the establishment of Bond Connect and the designed of the whole architecture.

## The risk of investing in Chinese debt

Despite many positive developments, what are some of the improvements that you would like to see? What are some of the challenges that you face from a sales and marketing perspective, convincing skeptical clients that this is a bond market that is safe and secure when compared to developed market equivalents?

**David Loevinger:** Several Points:

- Long term clarity on tax treatment: China agreed to temporarily waive the withholding tax on interest from policy bank bonds, but more certainty on that would help.

- Poor data and policy transparency. I don't understand how China can do so many incredible things and still have such poor quality data, particularly for national income and fiscal accounts. Even though China has made a ton of progress in the last ten years, they are way behind, not just developed market but emerging market counterparts, in communicating with and guiding markets. The PBOC should have a spokesman who regularly speaks about monetary and exchange rate policy that investors know when that person speaks, they're representing the Chinese authorities.

- A lack of free expression and the lack of independent news sources is a significant risk of investing in China. For global investors to make decisions, they need to know what's going on. Data is part of it, but journalists, analysts, and strategists being able to independently explain to the rest of the world what's going on are critical. These concerns are now extending from the mainland to Hong Kong.

- Rating agencies: It is exciting that global rating agencies will operate fully-owned subsidiaries in China. Chinese rating agencies have no credibility for most foreign investors. But the question is, will rating agencies be able to call it as they see it in China? And, will they be able to have a viable business model?

- Credit risk: Foreign investors in China fixed income markets are almost entirely in three assets, government bonds, policy bank bonds, and triple-A negotiable certificates of deposits of the biggest and most creditworthy banks. Onshore foreign investors are unwilling to take credit risk. And I think there are several reasons for that. One is explicit, and implicit guarantees have distorted the pricing of credit risk. The regulators are trying to pull back these guarantees, which is the right thing to do.

But the fact is, in the years ahead, investors are going to wake up and realize that credits that they thought were being backed by the government are not. It is very opaque. There are going to be more defaults given China's level of indebtedness. More defaults in China is a good thing because that is what happens in regular economies. There haven't been enough defaults. The bankruptcy system in China and creditor rights, particularly foreign creditor rights, remain very untested when we get into a credit downturn.

A decade ago, we could have had this same conversation about credit quality, rising default rates, the state of bankruptcy laws, etc. Not a lot has changed. Is this just China being China? Have we, as foreign investors, overestimated the risks you've alluded to because China's just China?

**David Loevinger:** China is so much bigger and has such a more significant impact on global financial markets than in 2012. China is a much more significant part of investor portfolios today than it was in 2012, and it will only grow over time

So, Chinese policymakers are so bad in communicating with markets is a much bigger problem for global investors today than in years past. China's level of indebtedness was high in 2012; it's much higher today. Trees don't grow to the sky. At some point, China will have significant debtor distress, and we don't know how it will play out.

**Edmund Ng on risks:**

Credit risk: Eastfort AssetManagement does not invest anything that is not rated by S&P, Moody's, or Fitch. From a pricing perspective, if I buy Sinopec or CNOOC on an access swap basis, if I could do as a swap onshore and when I compare the U.S. dollar Sinopec and CNOOC versus onshore asset swap, the offshore in dollars is always 50 or 75 basis point higher. So, taking credit risk onshore, to me, is expensive or relatively expensive versus offshore.

Before 2014, there was no credit default in China. Since 2014, the government or the regulators want to push for a more internationalized bond market. They started to allow a more controlled type of credit default cycle. And because of that, there has been a credit differentiation cycle in China. And that's the reason why that for us, we take much less credit risk. We prefer to take more liquid market risk because of durations to F.X. and spreads and the curve. You can still make some money or generate return rather than taking credit risk.

International credit rating agency. S&P only started last January, and they have come up with about 50 companies onshore under the S&P rating model. And I think that it will take them another year before they can have a pool of maybe 400 to 500 names. It is improving but certainly has a long way to go.

International agencies are not a panacea. Numerous global crises in the past 25 years have shown that there are flaws in the rating agency model.

On the point of communication, the government realized that there was a problem. In the past, too many different regulators. You have CBRC, CRRC, PBOC, SAFE, and CSRC. And they would not want to coordinate in the past. Many mixed messages  Now we have super-regulators through mergers. Not perfect, but got better in the past five years.

The regulators have limited experience in dealing with international investors. For example, announcements are always in Chinese but sometimes, they don't even translate a day or two later, which is not an acceptable transparency policy. They are trying to enhance that process, but it would take time.

Greater transparency will take time because this is a new market, which just opened recently about three years ago to the rest of the world. And so, the world has learned about this market, same as the regulators onshore have to learn more about what the foreign investor want. For example, we could not hedge the onshore F.X. in the past. We could only hedge it offshore. Now, we can hedge onshore, and that means a more stable and cheaper hedging strategy.

## Market Deficiencies

Let us discuss some market deficiencies, such as the absence of a repo market, asset swaps not being as easy, complaints about the necessity to use a third party F.X. transaction, and the like.

- Repo:  No repo offering to the foreign investor. Chinese regulators are looking at repo as a way of providing leverage. For international investors, this is a tool to manage liquidity. For example, your fund has $1 billion going out this week. Yet, you know that in the next couple of weeks, you will have $1 billion coming in.  Without repo, the only thing that you can do as a manager is to sell $1 billion of bonds, get the cash, meet the redemption, and then wait for the money to come in and buy again. This is expensive. Repo avoids this.

- This is a different perspective, but the regulators are listening. They will be able to allow repo for the foreign investor going forward just as they allow us to use ISDA. And I'm sure that many other foreign investors would be able to use ISDA to conduct the offshore IRS or onshore derivatives.

- Asset swaps: This needs to develop. The swap curve only goes up to five years. But bond maturities go out 50 years. So, unlike in the U.S., Japan, or Europe, asset swaps are lacking in China. The onshore regulators are also looking at it, but they have too many priorities. They need to prioritize which one will be delivered.  Repo will come first, hopefully in the next few quarters.

- We were pushing regulators to allow foreign investors to use ISDA to conduct derivatives onshore. They were pushing back for two, three years. But we were fortunate that since last Friday, the China Foreign Exchange Trade System (CFETS) announced the use of ISDA to conduct onshore derivatives. In this case, they are listening.

## Will China's closed capital account be a hindrance to growth?

I have argued for the longest time that China has very little interest in an open capital account or for the RMB to be a rival to the USD. SDR inclusion was a symbolic measure. For China to be a dominant part of global bond indices, does it need to have an open capital account?

**Edmund Ng**: If you're talking about just regular asset managers, pension funds, or insurance companies, they might not be allocating or investing according to SDR. But as a reserve manager of a central bank, they probably can. And it might not be 100% according to their ratio, but that means you give them an option to do so if they are willing to.

Foreign ownership has increased over time to about $300 billion. Most of those inflows are from central banks. In contrast, pensions and private allocators might not need to allocate to RMB or China bonds. The data should reflect that the central banks of the world have already started to do so. Eventually, this will trickle down to other investor types.

Regarding the capital account, there are only three items that are not open. It is more for the onshore funds that limit household transactions.

Fixed Income Investors can go in and out, and there was no question asked even in 2017 when there were a trillion dollars of outflows. Corporates, particularly foreign corporates, face different guidelines, but bond investors can move capital freely.

**David Loevinger:** Being in the SDR doesn't make a currency a reserve currency. Tens of millions of investors have to decide whether they want to hold Yuan assets. That's what makes a currency a reserve currency. What the SDR was all about was a cagey political move by PBOC Governor Zhou to use the SDR as a way to get political approval for a whole set of financial and capital account reforms that have opened up China.

Yes, China isn't as open. Its capital account isn't as open as Japan's. But compared to ten years ago, the difference between night and day.

But I would put it differently. I wouldn't say, "Does China want to be a reserve currency?" I would say, "Does China want to promote the use of the Yuan in settlement of trade and financial transactions to a much greater extent in the years ahead?" Absolutely. And there are two reasons. U.S. companies have a considerable advantage that the dollar is the primary currency for settling trade and finance. They can do most of their transactions in their home currency.

We saw what this advantage meant back in February and March when there was a mad scramble across the world for global liquidity. And the companies in the best place were U.S. companies because the Fed could most easily just provide dollar liquidity to the U.S. banking system. And then, the U.S. banking system could provide dollar liquidity to U.S. companies. There was a much bigger scramble for dollar funding overseas than there was in the U.S.

But I think there's a much bigger geopolitical issue for China. You talked about the changing relationship between the U.S. and China. China sees much more significant risks going forward. It's evident to China that it has two significant vulnerabilities. One is in technology, in core technologies. And the other is its vulnerability to financial sanctions from the U.S. and being cut off from settlement of both trade and financial transactions in dollars i.e. being cut off from the U.S. financial system.

And I thought a couple of years ago, the concern was the U.S. might target particular bad actors for trading with North Korea or Iran. I think the concern much more now is that the U.S. could use financial sanctions to destabilize and weaken China. So, my sense is there's a much greater urgency to set up systems where China can trade and invest and bypass the U.S. financial system.

## What do the next five years look like for the Bond Connect?

The Bond Connect is uniquely Chinese in that it handles the settlement of bond transactions. What are we likely to see from your organization over the course of the next five years?

**Phoebe Leung**: Near term, there are a couple of initiatives that we are looking into. We are trying to focus on more of the initiatives that would drive the technology changes or, for example, derivatives and introductions required to achieve RMB internationalization.

Inflows from international investors have already doubled from last year. So, now we're seeing at around 20 billion RMB a day on average. And on Monday, when we extended our trading hour from 4:30 PM to 8:00 PM, which is going to extend further in the future, we are seeing close to 30 billion RMB trading in one single day.

So, what needs to drive this even further? The introduction of bond futures is the one thing that many of our investors need. And this is something that we are still working in the pipeline because this is only being offered in the exchange. Not many offshore investors can trade these.

The second thing is the third party F.X. It has already been announced today that offshore investors can hedge their F.X. needs with multiple F.X. counterparty. We need to focus on Repo, Asset Swap, and other products to ensure the ease of trading, settlement, and custody as international participation grows.

Paul Krake: Thank you,

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