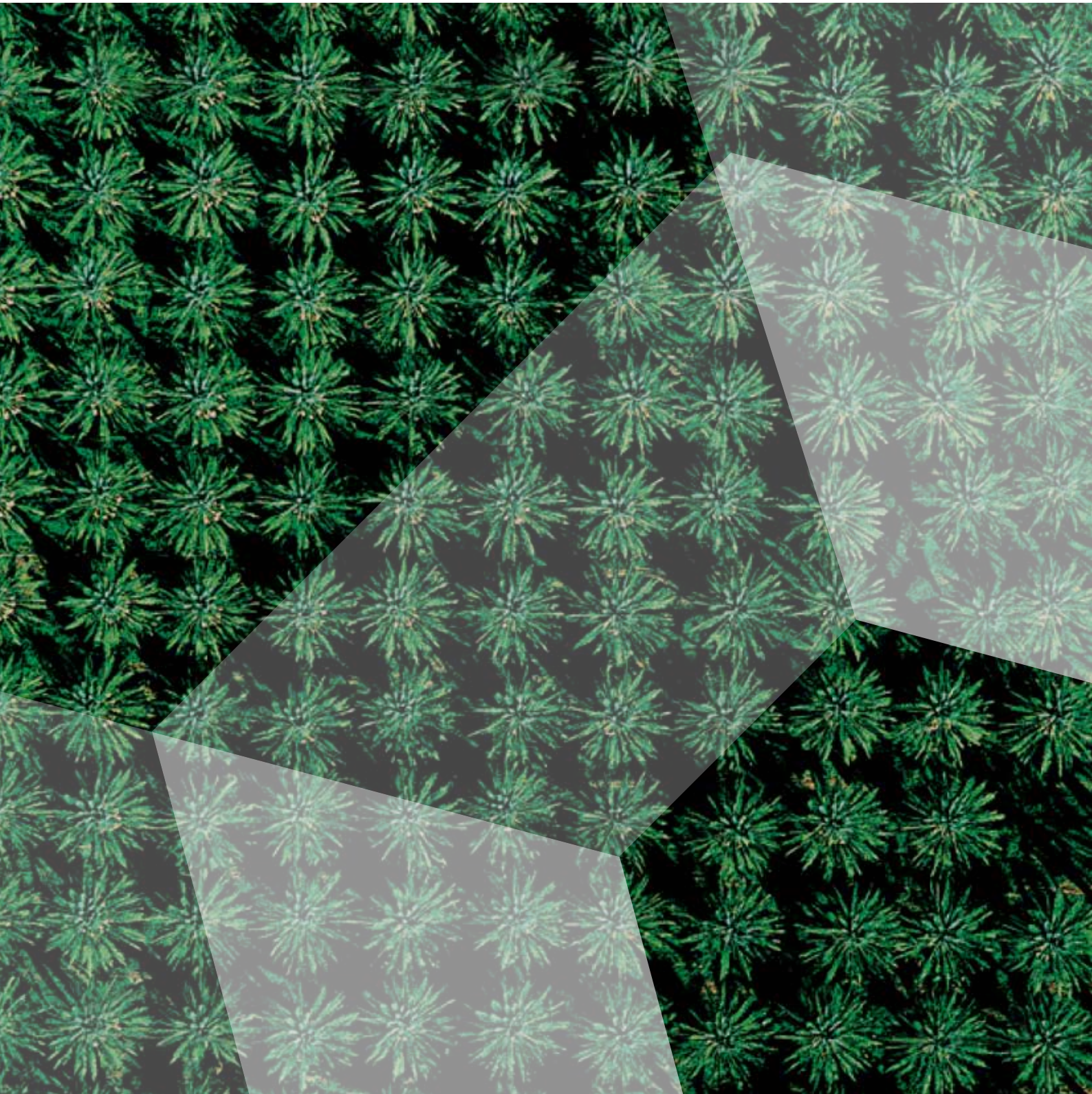


Research

FTSE Russell China Bond Research Report



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FTSE Russell China Bond Research Report

Highlights

- A degree of optimism has returned to China's USD13.8 trillion bond market as 2020 gets underway, with some analysts predicting China will "stand out" as a top bond market this year, boosted by rate cuts and increasing foreign appetite.¹ Net foreign inflows to China's interbank bond market surged in Q4.
- Towards the end of December, policymakers from the central bank published draft rules to govern corporate bond default disposal in order to help the financial system guard against systemic risks; and they also made it clear that punishments will be doled out for intentionally missed payments and other "malicious acts." One additional goal of the new rules is to assist the development of China's credit derivatives market.²
- Despite default risks, China's credit growth is expected to hit 13-13.5 trillion CNY in 2020, up from 11.9 trillion in 2019, China Chengxin International Credit Rating Company predicts. Local government financing vehicles (LGFVs) are expected to drive new credit issuance in 2020, with LGFV issuance estimated to grow by 3.7 trillion CNY this year.³

1 CNBC. December 2019.

2 Reuters. December 2019.

3 China Chengxin International Credit Rating Company. December 2019.

Chapter 1: Overview

Optimism reigns on the back of rate cuts globally, while regulators seek to provide more flexibility to foreign exchange trading

A degree of optimism has returned to China's more than 97.1 trillion CNY (USD 13.8 trillion) bond market in 2020, with some analysts predicting China will "stand out" as a top bond market this year, boosted by rate cuts globally outside of China, and increasing foreign appetite. Foreign holdings of China bonds have grown at an annual compounded rate of 38% in the past two years, from 1.1 trillion CNY as of December 2017, to 2.2 trillion CNY by December 2019.⁴

Despite ongoing uncertainty over trade relations, net foreign inflows into China's interbank bond market continued growing in Q4 on the back of a stabilising CNY, as well as attractive yields, considering there's a significant volume – around 12.5 trillion USD⁵ - of debt outstanding with sub-zero yields in the global bond market. The net inflows into China's bond market grew around USD10 billion in the fourth quarter of 2019 from the third quarter, bringing the total foreign holdings of onshore bonds to USD311.3 billion at the end of 2019, although at a slower pace than the increase of USD22.7 billion in Q3.⁶

This upward trend is expected to persist in 2020 as China continues the efforts to attract more foreign capital and boost its bond investment inflow at a time of slowing macroeconomic growth. In November, the State Administration of Foreign Exchange (SAFE) released a policy consultation paper on further flexibility for foreign investors to trade and manage foreign exchange risks in the interbank bond market with the final paper released in mid-January this year.

The new policy allows foreign investors to trade FX with up to three counterparties, which facilitates the best execution to fulfil fiduciary duties. It is another enhancement to support accessibility to China's bond market for foreign investors, following the fungibility measures released in October that allow foreign investors to do non-transaction transfer from QFII/RQFII accounts to accounts under the CIBM direct schemes.

⁴ China Central Depository & Clearing; Shanghai Clearing House. December 2019.

⁵ Reuters. November 2019.

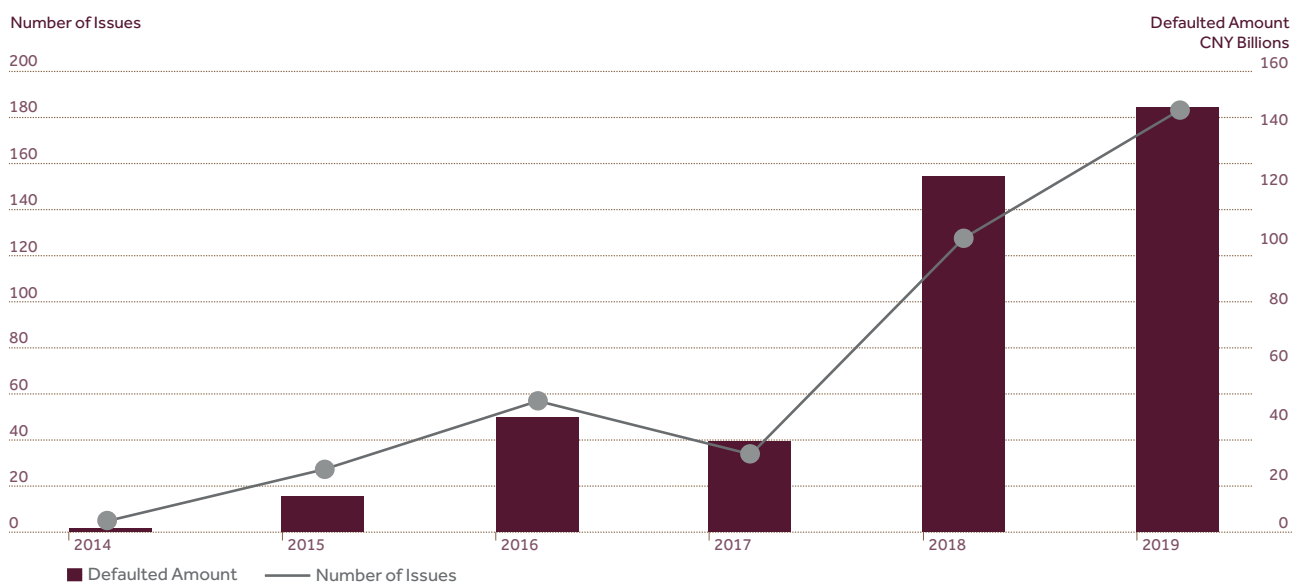
⁶ China Central Depository & Clearing; Shanghai Clearing House. December 2019.

Chapter 2: Defaults in focus

Against this backdrop of growing foreign appetite, China's policymakers are doubling down on their efforts to control defaults and the spread of high-risk credit throughout the country's financial system.

China's bond market has now reached 97.1 trillion CNY (USD13.8 trillion), second to the United States in the world bond market, according to statistics released by BIS in December. The market size of credit bonds also ranks the second, amounting to more than 20 trillion CNY by the end of 2019.⁷ It was not until 2014 that bond defaults were observed in China's corporate bond market, but defaults remained subdued until 2018, when the market saw 125 bonds in default valued at 120.9 billion CNY in notional amount. Defaults – especially among private enterprises – have surged between 2017 and 2018 on the back of a slowdown in China's macroeconomic growth, and the volume of defaults continued growing in 2019. The amount of Chinese corporate bonds in default reached 144.4 billion CNY as of the end of 2019, surpassing the 120.9 billion CNY in 2018.⁸

A Rising Number of Defaults



Source: Wind, December 2019.

More than three-quarters of the 179 bonds that defaulted in 2019 were rated below BBB immediately prior to the default by local rating agencies. The number of bonds below BBB, otherwise known as high-yield bonds, amounted to 138 in total with roughly one quarter rated still as investment grade immediately before default.

In addition, data shows that the number of bonds rated as high-yield immediately prior to default is growing at a faster pace – reaching 138 in 2019, up from 89 in 2018. This trend partially reflects an improvement of the responsiveness of credit rating agencies to local market conditions in 2019 compared to 2018.⁹

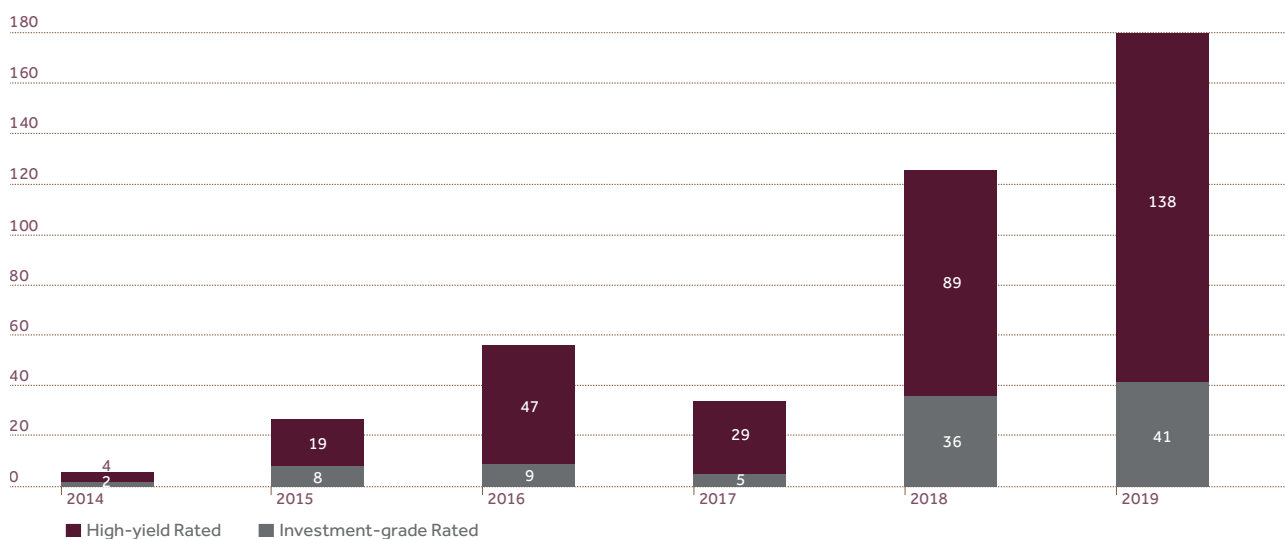
⁷ Wind, December 2019.

⁸ Wind, December 2019.

⁹ Wind, December 2019.

Prior-to-Default Credit Quality Breakdown Since 2014

Number of Issues



Source: Wind, December 2019.

A major concern shared by Chinese bond investors is that the process of handling bond defaults is slow and complex in China at this stage. According to domestic rating agency China Bond Rating Co., only 53 out of 329 defaulted bonds were disposed of under proper procedures, with 228 defaulted bonds still in the middle of the disposal process, as of end of August 2019. Haitong Securities estimated that the aggregate average recovery rate on defaulted bonds in China was as low as 12~13 %, measured as total recovery amount divided by total defaulted amount in the market.

In an effort to address investors' concerns, the central bank published a consultation paper on December 27th to govern credit bond default disposal in order to help the financial system guard against systemic risks. Policymakers also made it clear that punishments will be doled out for intentionally missed payments and other "malicious acts."¹⁰ One additional goal of the new rules is to assist the development of China's credit derivatives market as transparency and price discovery of corporate bonds will facilitate efficient pricing of credit risks, which is essential for the development of the credit derivatives market.

From an opposite perspective, it's also important to take effective measures to manage and resolve risks ahead of the default, Liu Guoqiang, the Deputy Governor of the People's Bank of China, said during a forum focusing on default cases in late December.

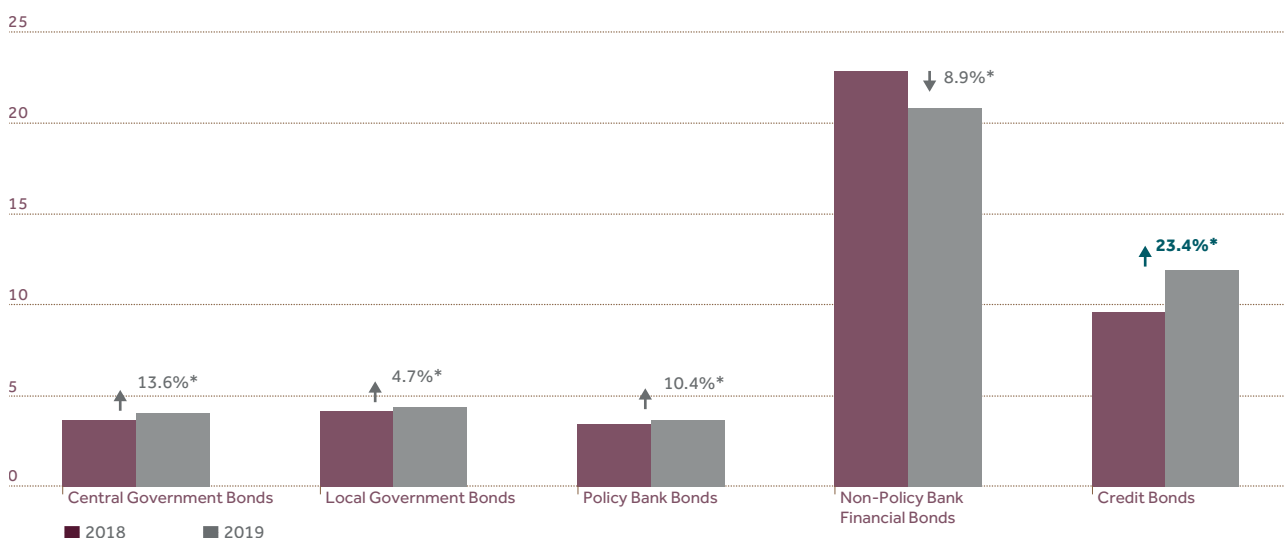
¹⁰ Reuters. December 2019.

Chapter 3: Local government financing vehicles (LGFVs) to lead credit issuance

Even despite government moves to control defaults and the spread of risk throughout China's financial system, credit growth is expected to hit approximately 13-13.5 trillion CNY in 2020, with the net issuance around 4.5 ~ 5 trillion, according to China Chengxin International Credit Rating Company. The total issuance volume of credit bonds¹¹ rose by 2.25 trillion CNY ending with 11.91 trillion CNY in 2019 versus 9.65 trillion CNY issued in 2018 – marking 23.4% growth, as illustrated in the chart below. The credit bond net issuance amounted to 3.83 trillion CNY by the end of 2019.¹²

Credit Bonds Total New Issuances Rose by 2.25 Trillion CNY in 2019

CNY Trillions



*Annual growth in new issuance amount from 2018 to 2019.

Source: CCDC; Shanghai Clearing House. December 2019.

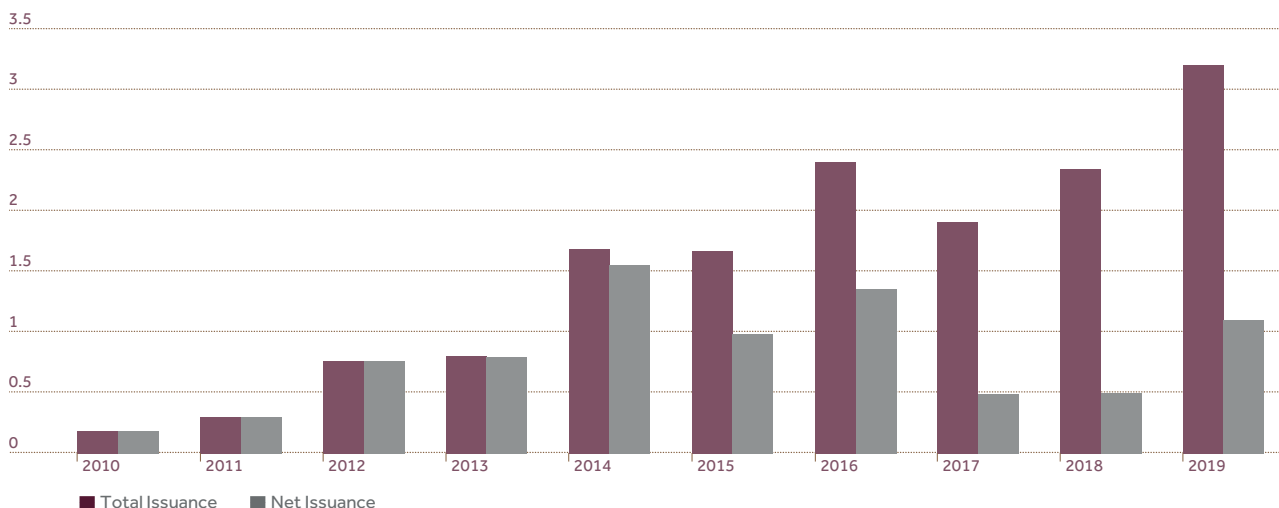
One of the main drivers for credit issuance growth in 2019 was the local government financing vehicles (LGFVs). LGFV issuance in 2019 set a new record of 3.17 trillion CNY (for the most recent 10 years) as shown in the chart below, with a net issuance of 1.1 trillion – recovering from the trough in 2017 when stricter rules were adopted by regulators on LGFV debt issuance. LGFV issuance will continue to play an important role in China's infrastructure development, which is expected to grow steadily to 3.7 trillion in 2020 – according to CSCI Pengyuan Credit Rating.

11 Please note that 'credit bonds' include super & short-term commercial paper, medium-term notes, enterprise bonds, corporate bonds, private placement notes, ABSs, convertible bonds, government sponsored bonds, international bonds, etc.

12 CCDC & Shanghai Clearing House. December 2019

LGFVs Total Issuance Peaked in 2019

CNY Trillions



Source: Wind. December 2019.

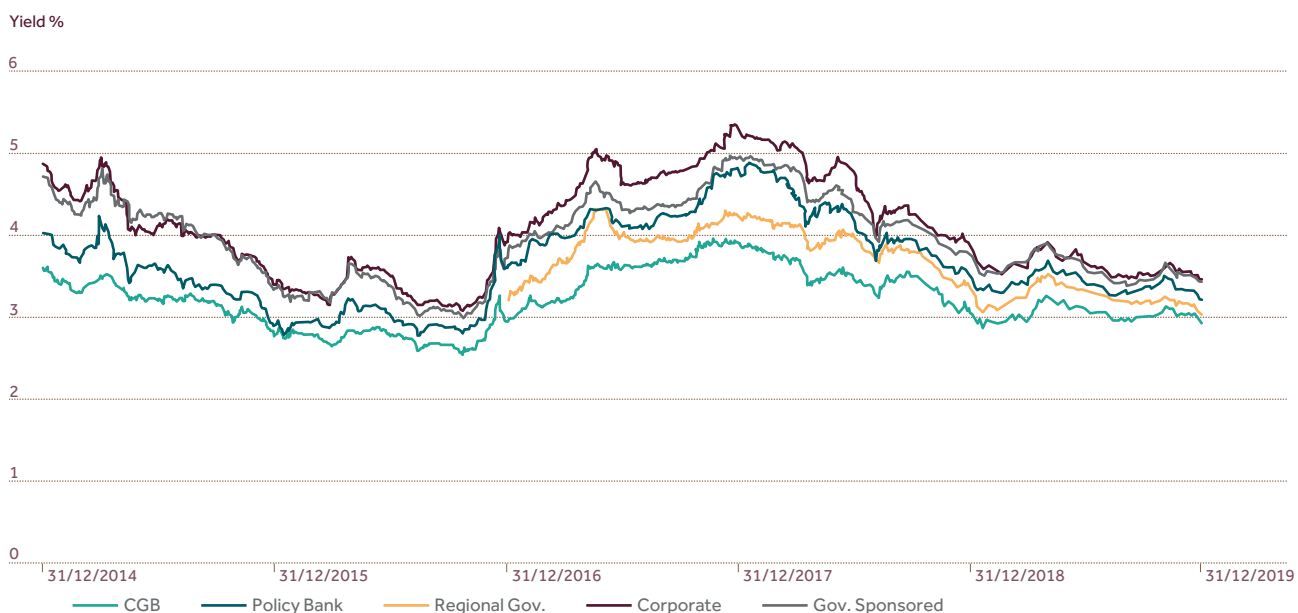
Chapter 4: Performance of the FTSE Russell China Bond Indexes

Onshore Report

Yield

Five major sectors are covered in the FTSE Chinese (Onshore CNY) Broad Bond Index (CNYBBI). The yield of the CNYBBI as of end-December was 3.11%. Among the five major sectors, the Government Bond (CGB) sector was at 2.91%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 3.20%; the Regional Government sector was at 3.03%; the Corporate sector was at 3.47%; and the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 3.41% as shown in the chart below. For 2019 Q4, the yield of CNYBBI decreased by 11.65bps with corporate spread widened by 3.09bps.

Chart 1. The Historical Yield of 5 Sectors in CNYBBI Sectors



Source: FTSE Russell, data as of December 31, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Total Return

The CNYBBI in USD unhedged terms finished up 3.83% in 4Q while its return in CNY finished up just 1.32% during the last quarter. CNY appreciation was the main driver in the same period. The returns of some sectors are shown in Table 1.

Table 1. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD, unhedged)					Annualized Volatility		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
CNYBBI	3.83	1.40	3.11	12.81	11.21	4.00	4.17	3.85
CGB	3.69	1.32	2.49	10.73	9.53	4.23	4.37	4.05
Policy Bank	3.95	1.36	3.31	14.22	11.14	3.99	4.25	4.00
Corporate	3.52	1.03	3.45	14.34	14.13	3.92	4.02	3.70

Source: FTSE Russell – total return data in USD, as of December 31, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

FTSE Chinese (Onshore CNY) Green Bond Index

Yield

There are three different versions of the FTSE Chinese (Onshore CNY) Green Bond Index (CNYGRBI): CNYGRBI, FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index, and FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index – Interbank. The yield of the CNYGRBI as of end-December was 3.48%. Among the sub-indexes, the FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index was at 3.31%; the FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index – Interbank was at 3.27%, as shown in the chart below.

For 2019 Q4, the yield of CNYGRBI decreased by 6.51bps.

Chart 2. The Historical Yield of China Green Bond Index

Yield %



Source: FTSE Russell, data as of December 31, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Total Return

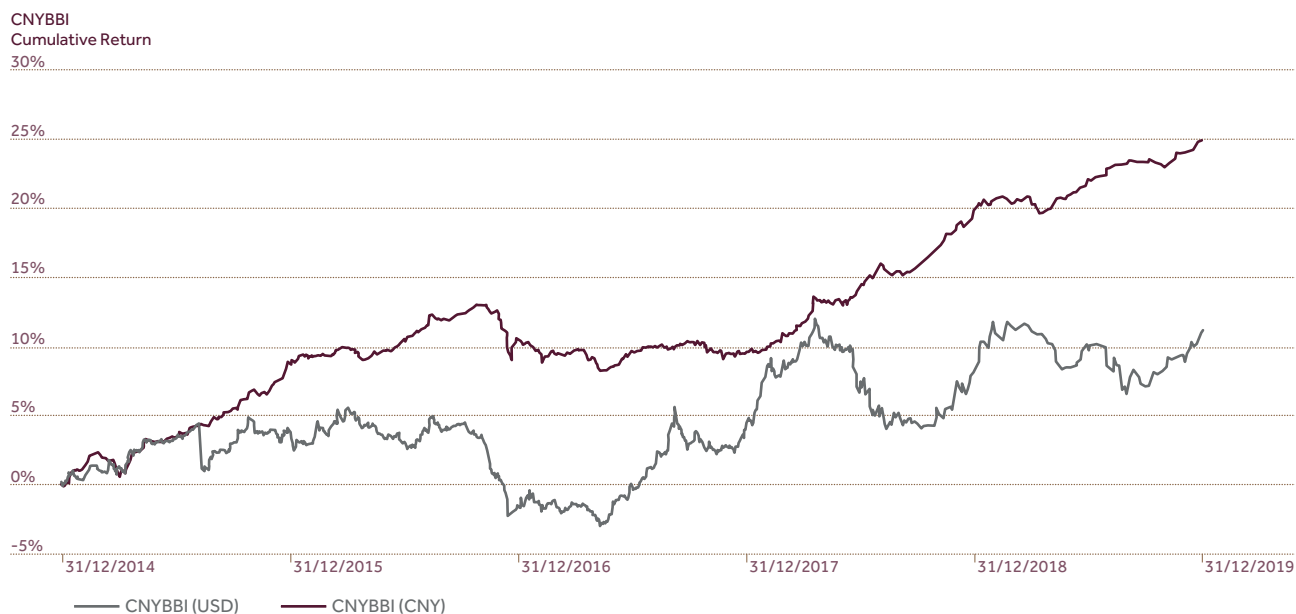
The FTSE Chinese (Onshore CNY) Green Bond Index finished up 3.70% during the last quarter, with its Internationally-Aligned sub-index up 3.62% and its Internationally-Aligned – Interbank sub-index up 3.62%.

Table 2. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD, unhedged)				Annualized Volatility	
	3M	6M	1YR	3YR	1YR	3YR
Chinese Bond Index	3.70	1.22	3.68	14.15	3.92	4.01
Chinese Bond Index – Internationally-Aligned	3.62	1.07	3.45	13.70	3.94	4.02
Chinese Bond Index – IA – Interbank	3.62	1.06	3.43	13.81	3.94	4.02

Source: FTSE Russell – total return data in USD, as of December 31, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Chart 3. CNYBBI Performance in USD vs in CNY for the past 5 years



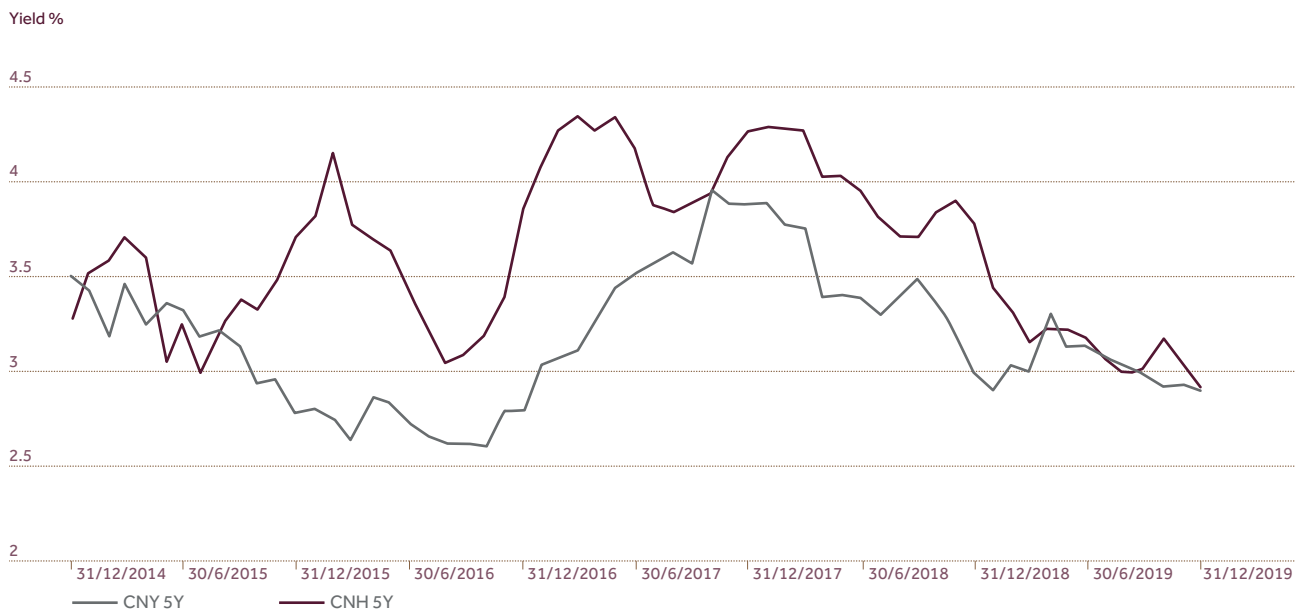
Source: FTSE Russell – total return data in USD and CNY, as of December 31, 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Comparison of Offshore Sovereign Bonds and Onshore Sovereign Bonds

Yield

The yield of onshore 5 year Sovereign bonds was at 2.92% and the yield of offshore 5 year Sovereign bonds was at 2.91% as of end-Q4. The spread tightened by 3bps for Q4 of 2019 as shown in Chart 4.

Chart 4. Onshore 5 Year Yield vs Offshore 5 Year Yield



Source: FTSE Russell as of December 31, 2019. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Total Return

The FTSE Chinese Government Bond Index outperformed the FTSE Offshore counterpart during Q4 2019 as shown in Table 3.

Table 3. Performance and Volatility – Total Return (USD)

	Cumulative Return (USD, unhedged)					Annualized Volatility		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Chinese Government Bond Index (Onshore CNY)	3.69	1.32	2.49	10.73	9.53	4.23	4.37	4.05
FTSE Chinese Government Bond Index (Offshore CNY)	3.44	1.05	4.39	15.00	7.66	4.62	4.72	4.55

Source: FTSE Russell, total return data in USD, as of December 31, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures. FTSE Chinese Government Bond Index (Offshore CNY) is a sub-index in the FTSE Dim Sum (Offshore CNY) Bond Index.

USD Bonds Issued by Chinese Issuers

Yield

The yield of the FTSE Asian Broad Bond Index - China was at 4.34%. Among the two sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade Index was at 3.02%; the FTSE Asian Broad Bond Index – China, High-Yield Index was at 8.65% as shown in the chart below.

Chart 5. The Yield of FTSE Asian Broad Bond Index – China and Sub-Indexes



Source: FTSE Russell - total return data in CNY, as of December 31, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

Total Return

The FTSE Asian Broad Bond Index – China finished up 1.47% during the last quarter, with its Investment-Grade sub-index up 0.61% and its High-Yield sub-index up 4.42%.

Table 4. Performance and Volatility – Total Return

	Cumulative Return (USD, unhedged)					Annualized Volatility		
	3M	6M	1YR	3YR	5YR	1YR	3YR	5YR
FTSE Asian Broad Bond Index – China	1.47	3.11	10.99	16.32	28.68	1.58	1.55	2.02
FTSE Asian Broad Bond Index – China, IG	0.61	3.02	10.25	16.03	25.31	1.99	1.79	2.22
FTSE Asian Broad Bond Index – China, HY	4.42	3.48	14.23	17.67	46.33	2.37	2.49	3.83

Source: FTSE Russell - total return data in USD, as of December 31, 2019. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures.

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