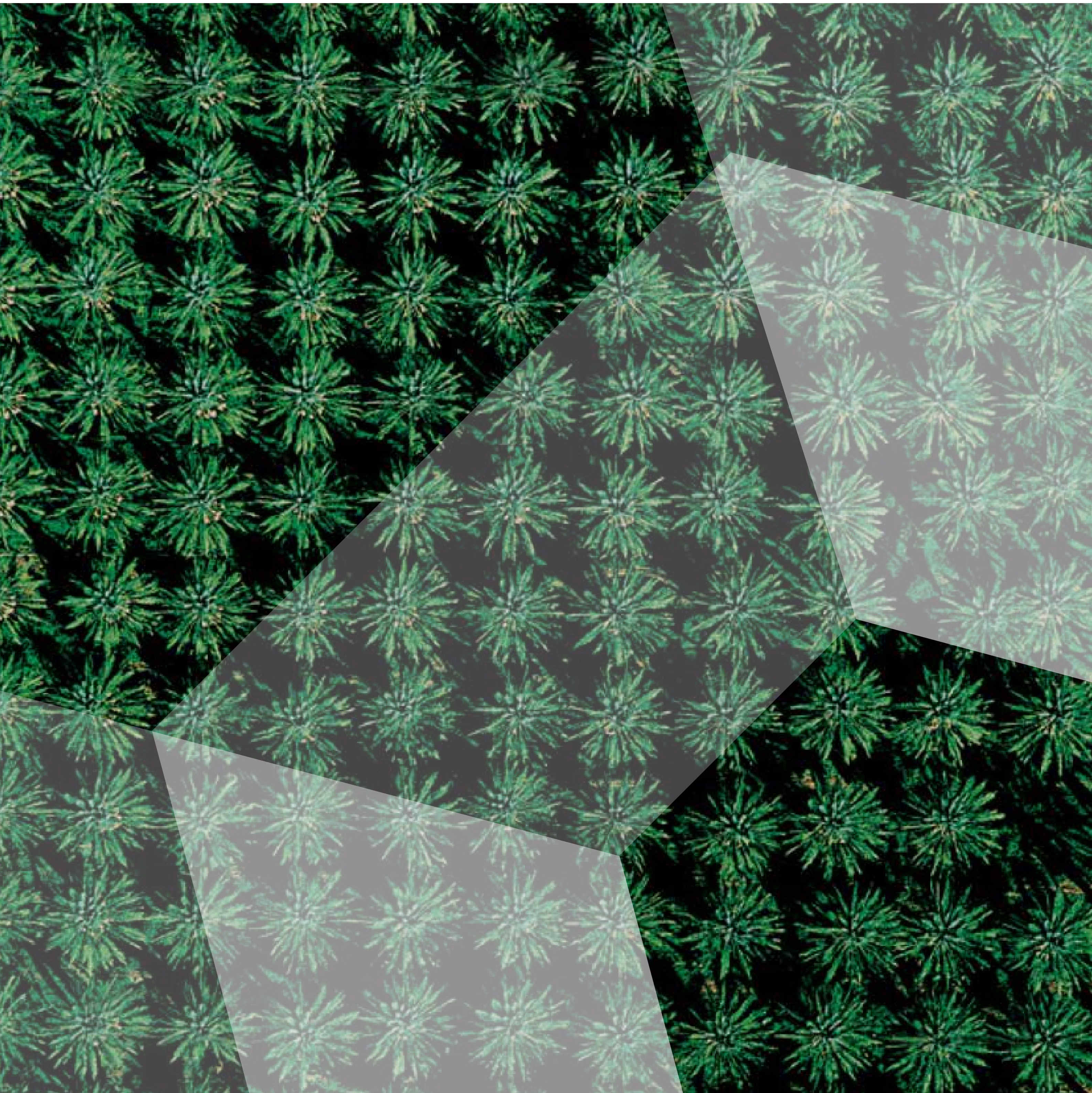
Research

FTSE Russell China Bond Research Report

FTSE Russell

November 2020 | ftserussell.com



FTSE Russell China Bond Research Report

Highlights

- FTSE Russell is set to add Chinese government debt to its World Government Bond Index (WGBI) in 2021 subject to further confirmation in March 2021,[1] a move that some analysts predict could attract more than US$100 billion of foreign capital into the world's second largest economy.[2] The decision follows FTSE Russell's assessment of improvements in market liquidity, foreign exchange and settlement flexibility in China bond markets, among other factors.
- The internationalisation of China's debt markets is accelerating and has unleashed a flood of inbound investment in 2020, especially investment into China's policy bank bonds. Net inflows into policy bank bonds totalled RMB347 billion (US$51 billion) in the first three quarters of the year, versus inflows of RMB350 billion (US$55 billion) into government bonds within the same period of time.[3]
- In addition to announcing other new measures, China's regulators extended bond trading by three hours in its interbank market from end-September, in a move aimed at making trading convenient for investors outside of China time zone. From 21 September, trading was extended until 8:00 p.m. (1200 GMT) from 5 p.m., China's main interbank market clearing house said in a statement.[4]

1 FTSE Russell. September 2020.
2 Wall Street Journal. September 2020.
3 CCDC. September 2020.
4 Reuters. September 2020.

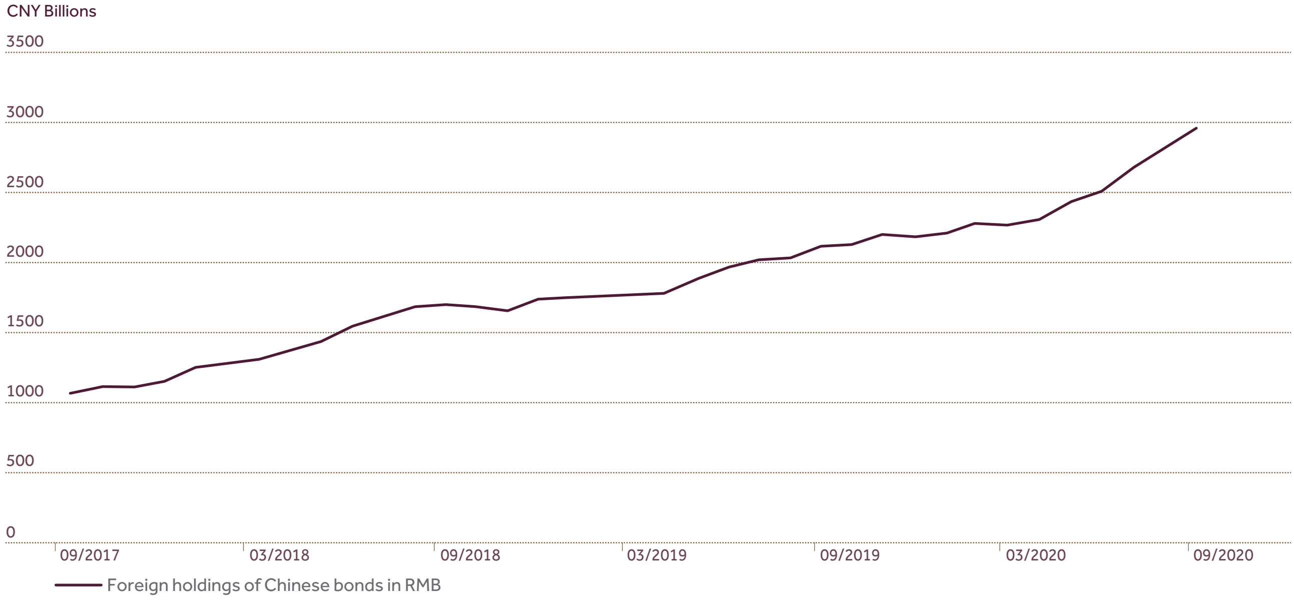
Chapter 1: Overview

More indexes will include Chinese government debt while foreign appetite grows as reforms accelerate

FTSE Russell is set to add Chinese government debt to its World Government Bond Index (WGBI) in 2021 subject to a further confirmation in March 2021,[5] a move that some analysts predict could attract more than US$100 billion of foreign capital into the world's second largest economy.[6]

Inclusion of China's bonds in global indexes has triggered a surge in interest among foreign investors (see chart below). On that note, following its annual country classification review in September, FTSE Russell's announcement of Chinese government bonds inclusion into World Government Bond Index comes after China's policymakers had made significant strides in improving market liquidity and foreign exchange and settlement flexibility.

Foreign holdings of Chinese bonds in RMB have tripled in the last three years, with the recent rise being well correlated with the inclusion in global indexes



Source: CCDC, Shanghai Clearing House; September 2020.

FTSE Russell's positive assessment of China's market reforms was reconfirmed in the September announcement revealing the inclusion: "FTSE Russell is pleased to announce that China is poised for inclusion in the FTSE World Government Bond Index (WGBI) from October 2021," said Waqas Samad, CEO, FTSE Russell and Group Director of Information Services, LSEG.

"The Chinese authorities have worked hard to enhance the infrastructure of their government bond market. Subject to affirmation in March 2021, international investors will be able to access the second largest bond market in the world through FTSE Russell's flagship WGBI. We look forward to engaging with investors and regulators in the coming months in applying this process." [7]

5 FTSE Russell. September 2020.
6 Wall Street Journal. September 2020.
7 FTSE Russell. September 2020.

FTSE Russell identified the following ongoing achievements by China's regulators, which helped the firm decide in favour of inclusion:

- Improving secondary market bond liquidity through significantly more re-openings of existing bonds and ensuring new issues are larger, encouraging more market making services to foreign investors
- Enhancing the foreign exchange market structure by introducing regulation that allows investors to trade spot and forward FX with third parties for currency conversion and FX hedging purposes under both CIBM direct and Bond Connect; and
- Developing global settlement and custody processes by implementing a facility for foreign investors to have the option to choose a settlement cycle beyond T+3, as agreed between counterparties, without the need for submitting an application and, in the case of failed settlements, permitting three additional days to resettle the trades with the original trade terms.[8]

According to some estimates, FTSE Russell's inclusion of China government bonds in the WGBI has the potential to make China's debt markets a greater part of the 'financial mainstream' – even despite the challenging environment due to the coronavirus and ongoing trade negotiations between the US and China.[9]

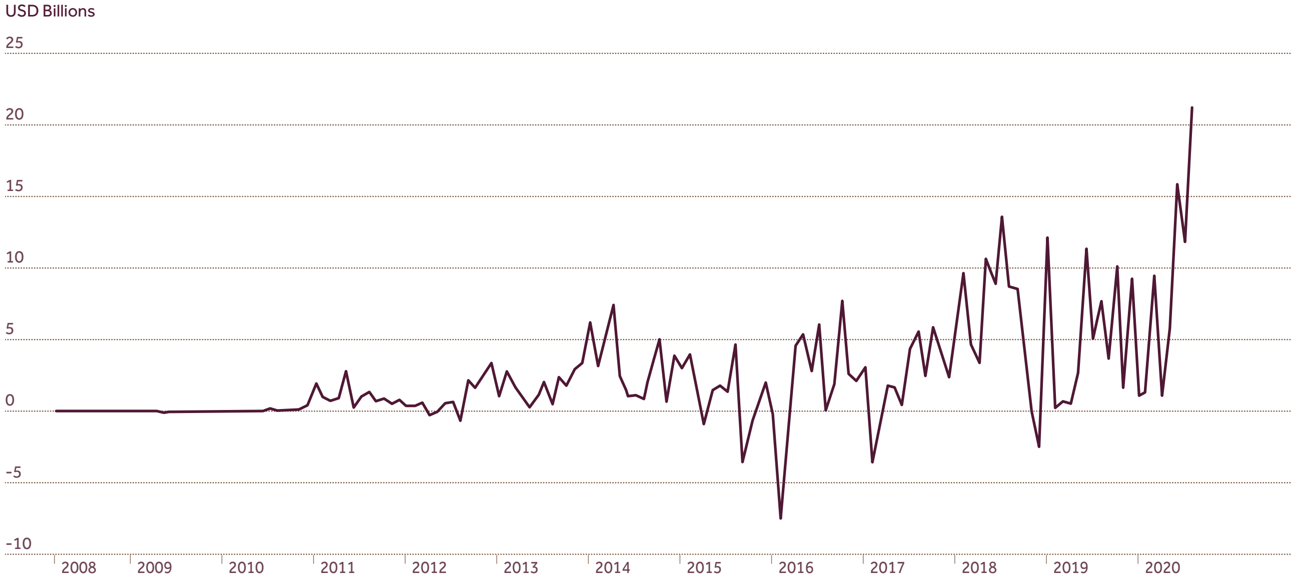
Chapter 2: Foreign appetite remains resilient

The increasingly rapid internationalisation of China's debt markets has seen a flood of inbound investment in 2020, especially in regards to China's policy bank bonds.

According to some analysts, this appetite is in part due to China's relatively fast economic recovery from the coronavirus crisis. Net inflows into policy bank bonds totalled RMB347 billion (US$51 billion) in the first three quarters of the year, versus inflows of RMB350 billion (US$55 billion) into government bonds within the same period of time.[10]

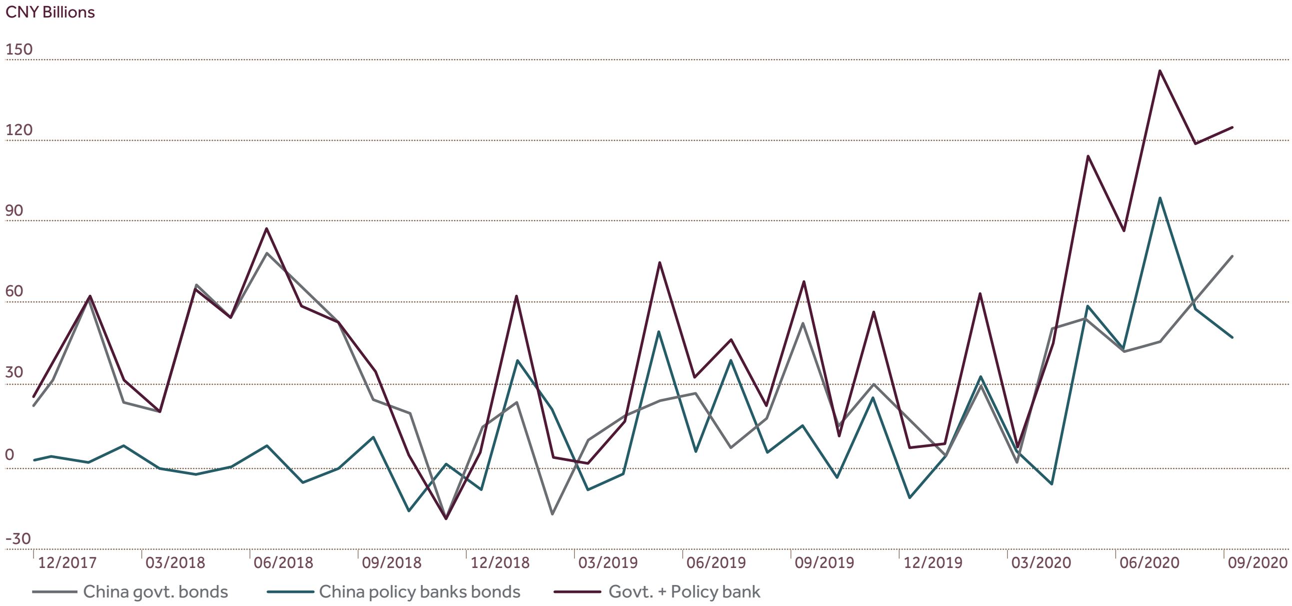
8 FTSE Russell. September 2020.
9 Wall Street Journal. September 2020.
10 CCDC. September 2020.

Inflows into China's bond market hit records



Source: Exante Data; MarketWatch, August 2020.

Foreign capital inflows into China government and policy bank bonds



Source: CCDC, September 2020.

Despite this uptick in foreign appetite, however, Chinese government bonds retreated for five straight months as of late September as liquidity concerns resurfaced. At the same time, China's central bank has not cut interest rates; and demand among global investors for higher risk assets is growing as economies emerge from the coronavirus crisis.[11]

11 Bloomberg. September 2020.

Chapter 3: Reforms accelerate, despite the uncertain outlook for macroeconomic growth

While the near-term macroeconomic outlook may be uncertain, China's policymakers continue to enact a raft of reforms to attract more foreign investment – even despite the challenging external environment, and the turbulence unleashed by the coronavirus crisis.

For starters, China extended bond trading by three hours in its interbank market from end-September, in a move aimed at making investment convenient for investors outside of China local time zone. From 21 September, trading was extended until 8:00 p.m. (1200 GMT) from 5 p.m., China's main interbank market clearing house said in a statement.[12] This change comes at a time when international investors are increasingly attracted to the yields offered by China bonds, given the low yields in other major markets.

China yield spread versus US has rallied since Q4 2018, as the Fed eased rates by about 250bp since then

Source: FTSE Russell, September 30, 2020.

In addition, the People's Bank of China (PBOC), China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE) recently unveiled the draft version of the "PBOC, CSRC and SAFE Public Announcement Concerning Arrangements in Relation to Offshore Institutional Investors Investing in the Chinese Bond Market." The announcement calls for "further strengthening the systemic, integrated and coordinated nature of external opening of the Chinese bond market, and facilitation of offshore institutional investors making allocations to renminbi bond assets." [13]

12 Reuters. September 2020.
13 China Banking News. September 2020.

Among the reform measures included in the announcement is 1) the unification of forex exchange and forex risk for offshore institutional investors investing in China's bond market; 2) simplifying market entry procedures for settlement agency models; and 3) deepening cross-departmental regulatory cooperation.[14]

Meanwhile, CSRC, PBOC, and SAFE said that China will combine the QFII and RQFII investment programmes starting from 1 November. (China launched RQFII in 2011 and QFII nine years earlier in 2002). Both programmes granted qualified foreign institutional investors the ability to trade and invest in the country's capital markets on the basis of defined quotas.[15]

Regulators also announced China had amended bond trading rules and that now foreign investors will have the flexibility to choose their settlement period without prior notification to authorities. "Both parties will not need to submit an application to independently choose to achieve T+N transactions," the Shanghai Clearing House said in a statement.[16]

Finally, China Foreign Exchange Trade System (CFETS) improved arrangements for foreign institutional investors who participate in the Bond Connect Northbound Trading scheme, and who also participate in the Bank-to-Customer Market. Investors can now trade directly with Hong Kong SAR Settlement Banks. Bond Connect investors can select up to three Hong Kong SAR settlement banks for currency conversion and foreign exchange hedging services.[17]

14 China Banking News. September 2020.
15 Regulations Asia. September 2020.
16 Asia Times. September 2020.
17 CFETS. September 2020.

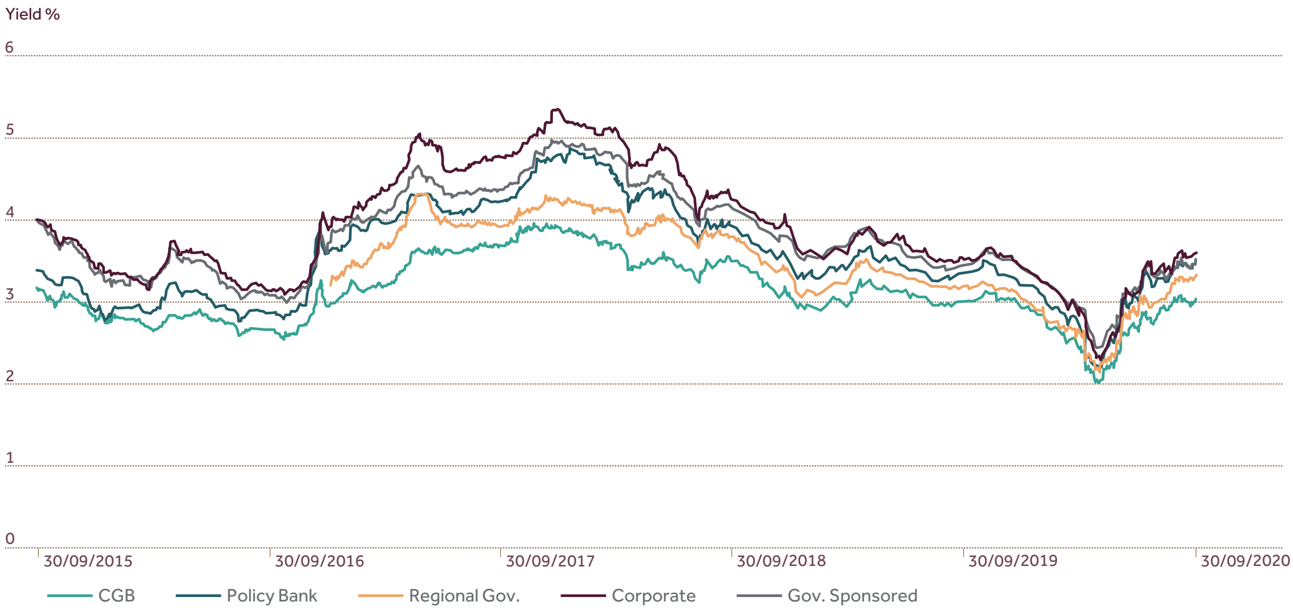
Chapter 4: Performance of the FTSE Russell China Bond Indexes

Onshore Report

Yield

Five major sectors are covered in FTSE Chinese (Onshore CNY) Broad Bond Index (CNYBBI). The yield of the CNYBBI as of end-September was 3.34%. Among the five major sectors, the Government Bond (CGB) sector was at 3.03%; the Policy Bank sector (issued by Agricultural Development Bank of China, China Development Bank and The Export-Import Bank of China) was at 3.48%; the Regional Government sector was at 3.33%; the Corporate sector was at 3.61%; the Government Sponsored (issued by China Central Huijin Ltd. and China Railway Co.) was at 3.50% as shown in the chart below. For 2020 Q3, the yield of CNYBBI increased by 46.31bps with corporate spread widened by 9.63bps.

Chart 1. The historial yield of 5 sectors in CNYBBI sectors



Source: FTSE Russell, data as of September 30, 2020. 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 2.83% while its return in CNY finished down just -1.00% 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	2.83	2.54	7.78	12.08	12.14	3.93	4.24	3.96
CGB	2.61	2.09	7.61	11.15	10.76	4.12	4.46	4.17
Policy Bank	2.84	2.43	7.86	12.65	12.45	4.00	4.31	4.08
Corporate	3.64	3.93	7.92	13.03	14.70	3.86	4.10	3.81

Source: FTSE Russell – total return data in USD, as of September 30, 2020. 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 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-September was 3.65%. Among the sub-indexes, FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index, was at 3.43%; FTSE Chinese (Onshore CNY) Internationally-Aligned Green Bond Index – Interbank was at 3.39%, as shown in the chart below.

For 2020 Q3, the yield of CNYGRBI increased by 49.16bps.

Chart 2. The historial yield of China Green Bond Index

Source: FTSE Russell, data as of September 30, 2020. 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

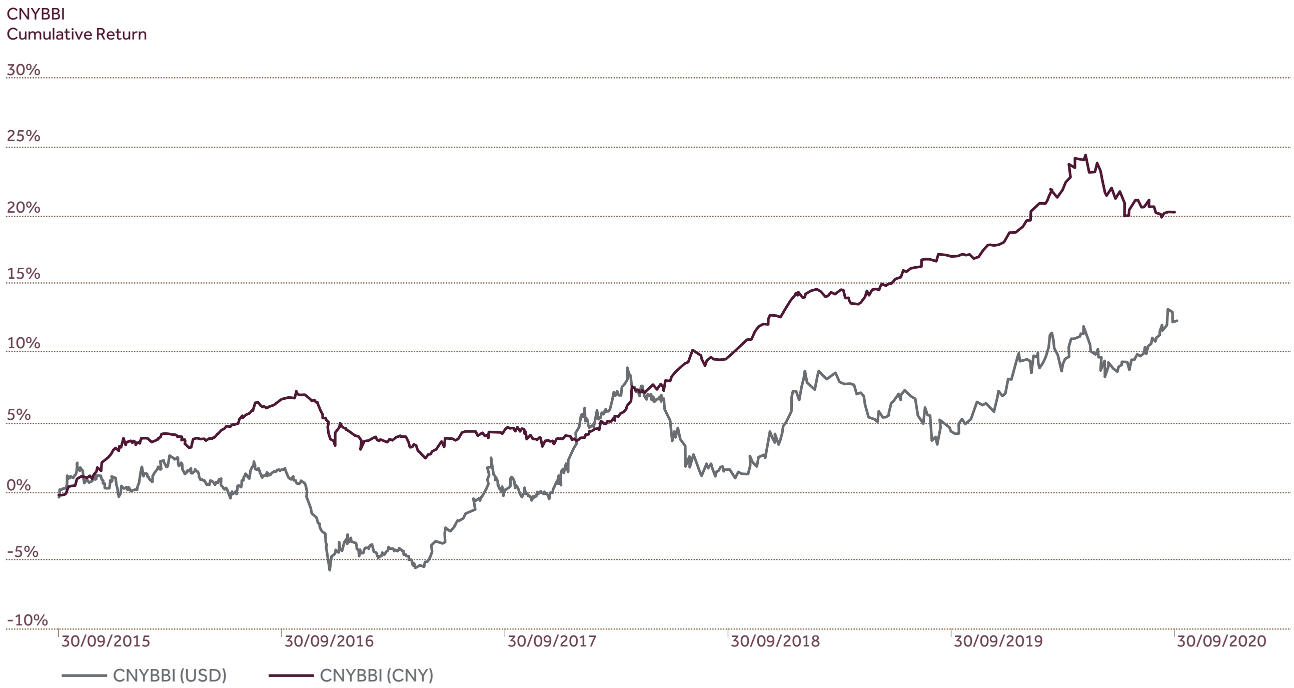
The FTSE Chinese (Onshore CNY) Green Bond Index finished up 3.78% during the last quarter, with its Internationally-Aligned sub-index up 3.77% and its Internationally-Aligned – Interbank sub-index up 3.74%.

Table 2. Performance and volatility – total return (USD)

	Cumulative Return (USD, unhedged)				Annualized Volatility	
	3M	6M	1YR	3YR	1YR	3YR
China Green Bond Index	3.78	4.32	8.49	13.14	3.82	4.08
China Green Bond Index – International Align	3.77	4.39	8.28	12.59	3.84	4.09
China Green Bond Index – IA – Interbank	3.74	4.37	8.24	12.54	3.84	4.09

Source: FTSE Russell – total return data in USD, as of September 30, 2020. 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



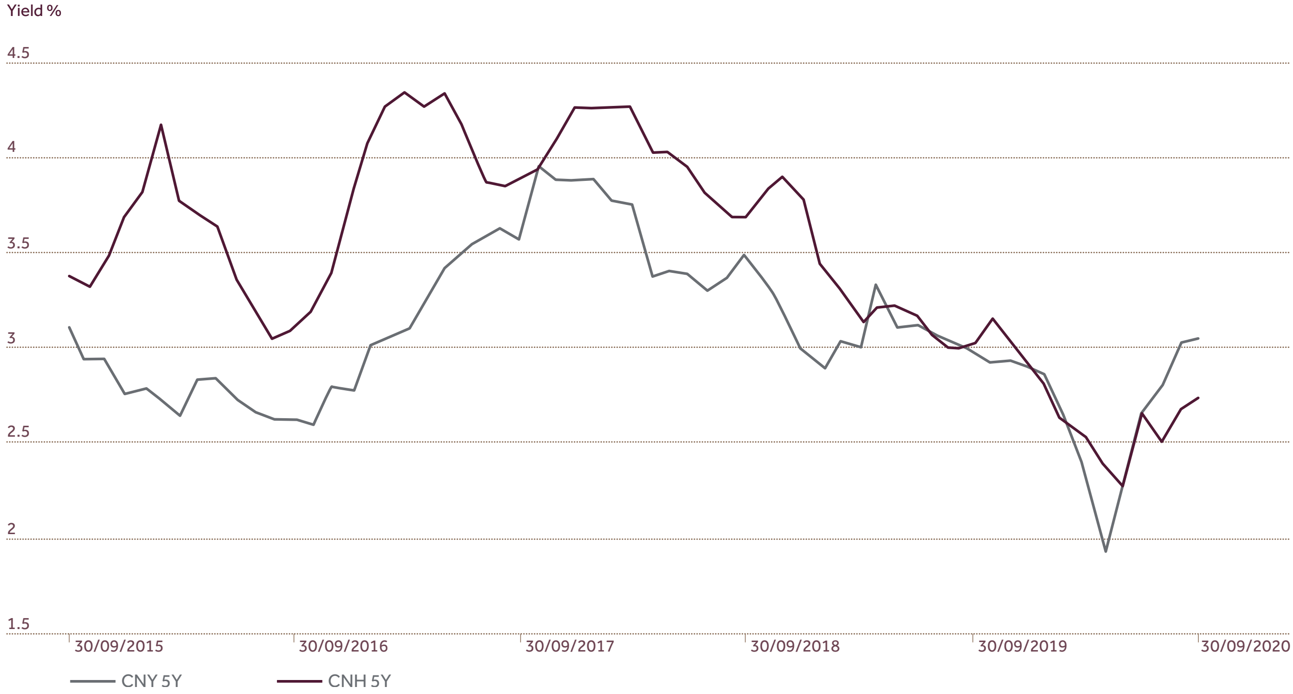
Source: FTSE Russell – total return data in USD and CNY, as of September 30, 2020. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Comparison of offshore Sovereign bonds and onshore Sovereign bonds

Yield

The yield of onshore 5-year Sovereign bonds was at 3.06% and the yield of offshore 5-year Sovereign bonds was at 2.74% as of end of Q3. The spread tightened by 31bps for Q3 of 2020 as shown in Chart 4.

Chart 4. Onshore 5 year yield vs offshore 5 year yield



Source: FTSE Russell as of September 30, 2020. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

As of end of Q3 2020, the Offshore Chinese Treasury Yields were lower than the Onshore Chinese Treasury Yields over the entire curve. The short end curve 1-year spread was -7bps and the long end curve 10-year spread was -26bps.

Total Return

The FTSE Chinese Government Bond Index underperformed the FTSE Offshore counterpart during Q3 2020 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)	2.61	2.09	7.61	11.15	10.76	4.12	4.46	4.17
FTSE Chinese Government Bond Index (Offshore CNY)	4.43	5.20	8.95	12.21	14.31	4.61	4.84	4.57

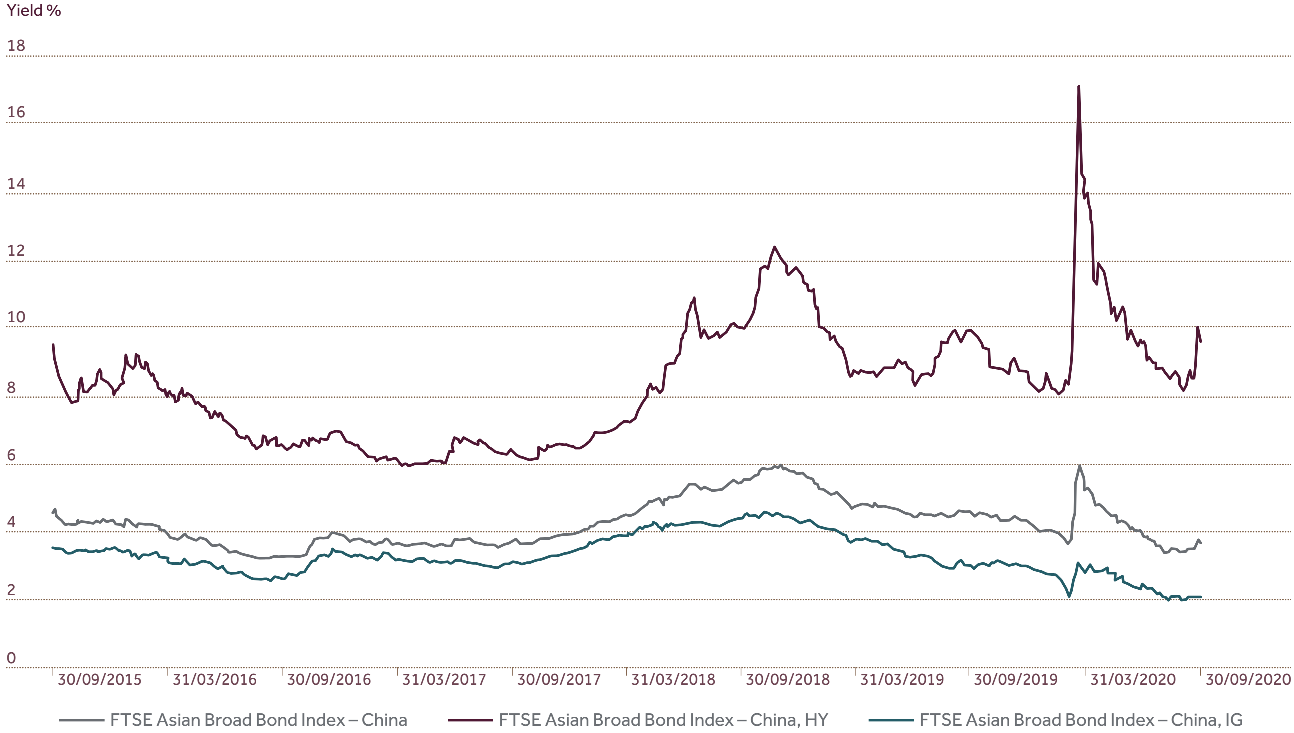
Source: FTSE Russell, total return data in USD, as of September 30, 2020. Past performance is no guarantee of future results. Returns shown prior to index launch reflect hypothetical historical performance. Please see the end for important legal disclosures. FTSE Chinese Government Bond Index (Offshore 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 3.67%. Among the two sub-indexes the FTSE Asian Broad Bond Index – China, Investment-Grade Index was at 2.10%; the FTSE Asian Broad Bond Index – China, High-Yield Index was at 9.49% as shown in the below chart.

Chart 5. The yield of FTSE Asian Broad Bond Index – China and sub-indexes



Source: FTSE Russell, data as of September 30, 2020. 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 1.74% during the last quarter, with its Investment-Grade sub-index up 1.69% and its High-Yield sub-index up 1.93%.

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	1.74	6.75	7.21	17.31	32.21	3.90	2.59	2.37
FTSE Asian Broad Bond Index – China, IG	1.69	4.54	6.89	18.03	30.31	3.34	2.42	2.36
FTSE Asian Broad Bond Index – China, HY	1.93	15.02	8.51	15.00	43.95	8.73	5.53	4.58

Source: FTSE Russell - total return data in USD, as of September 30, 2020. 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.

For more information about our indexes, please visit ftserussell.com.

About FTSE Russell

FTSE Russell is a leading global index provider creating and managing a wide range of indexes, data and analytic solutions to meet client needs across asset classes, style and strategies. Covering 98% of the investable market, FTSE Russell indexes offer a true picture of global markets, combined with the specialist knowledge gained from developing local benchmarks around the world.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create investment funds, ETFs, structured products and index-based derivatives. FTSE Russell indexes also provide clients with tools for asset allocation, investment strategy analysis and risk management.

A core set of universal principles guides FTSE Russell index design and management: a transparent rules-based methodology is informed by independent committees of leading market participants. FTSE Russell is focused on index innovation and customer partnership applying the highest industry standards and embracing the IOSCO Principles. FTSE Russell is wholly owned by London Stock Exchange Group.

For more information, visit ftserussell.com

To learn more, visit www.ftserussell.com; email index@russell.com, info@ftse.com; or call your regional Client Service Team office:

EMEA
+44 (0) 20 7866 1810

North America
+1 877 503 6437

Asia-Pacific
Hong Kong +852 2164 3333
Tokyo +81 3 3581 2764
Sydney +61 (0) 2 8823 3521