China's Bond Market Opens For Business

The inclusion of renminbi securities in a major global bond index is an important development.

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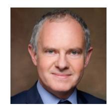
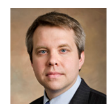


Quentin Fitzsimmons
Portfolio manager



Christopher Kushlis
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KEY INSIGHTS

- The inclusion of Chinese local currency bonds in the Bloomberg Barclays Global Aggregate Bond Index will include representation in the global fixed income market.
- Foreign ownership of Chinese bonds is likely to increase, which will support the renminbi but will also subject China's bond market to greater external discipline.
- We believe that Chinese bonds are currently undervalued as collateral in the Chinese capital market system and therefore represent a good buying opportunity.

The forthcoming inclusion of Chinese local currency bonds in the Bloomberg Barclays Global Aggregate Bond Index (Global Aggregate Index) will significantly open up China's bond market, bringing greater diversity and representation to the global fixed income universe. It will also mark an important stage in China's progress toward more open and transparent capital markets. For investors, this will provide an opportunity to invest in a vast and important bond market that has until now been very difficult to access.

Chinese RMB-denominated government and policy bank bonds will be phased into the Global

(Fig. 1) Estimated Weight by Currency of Denomination with China Inclusion

Bloomberg Barclays Global Aggregate Bond Index

	As of January 31, 2019	With China Inclusion
U.S. Dollar	45.3%	42.4%
Euro	24.4	23.0
Japanese Yen	16.7	15.7
Chinese Renminbi	—	6.1
UK Sterling	4.9	4.6
Other	8.7	8.2

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6.1%

The expected eventual weight of Chinese bonds in the Bloomberg Barclays Global Aggregate Bond Index.

T. ROWE PRICE BEYOND THE NUMBERS

We were "early adopters" of Chinese bonds, and this has given us a wealth of insight into China's fixed income market. For many years, our Hong Kong-based research team of credit analysts and our dedicated sovereign research team have been conducting fundamental research for a number of years on China. Our local trading presence allows us to pursue best execution in situ and to take advantage of differences in regional market liquidity as well as helps us to maintain a global trading capability.

Aggregate Index over a 20-month period beginning in April, and the weight will ultimately increase gradually to around 6% of the index. In total, more than 300 issues denominated in Chinese renminbi will enter the index universe. The move follows extensive work from the Chinese government and the People's Bank of China to enhance and strengthen the country's bond market. In the past, China's determination to remain in control of its currency and to supervise the flow of capital into the country has meant that its bond market has not operated as efficiently and transparently as those of most developed market countries. As such, foreign ownership of China's onshore market has been very low—around 3% versus an average of more than 25% across developed country markets.

Foreign Ownership Is A Carrot—And A Stick

To qualify for inclusion in the Global Aggregate Index, China has implemented a number of measures to improve access to its fixed income market via its Bond Connect program through which foreign investors can invest in Chinese bonds through investment links between Hong Kong and the mainland. Specific enhancements to the program have included the implementation of a new delivery versus payment settlement system for transactions and the ability to allocate block trades across portfolios.

The inclusion of Chinese bonds in the Global Aggregate Index will significantly increase foreign ownership of those bonds, which means the authorities will be forced to hand over a certain amount of control of its capital markets to overseas investors. Active bond investors will be able to sell Chinese bonds if they have a negative view on China, and even short them if there is a functioning futures market. As such, the inclusion of Chinese bonds in the Global Aggregate Index functions as both a carrot and a stick for the Chinese government: the carrot is that China will be able to attract capital, which will underpin the currency and diversify against the risk of domestic outflows; the stick is that if the foreign investors disagree with the path of monetary policy followed by the People's Bank of China (PBoC), they will be able to quickly disengage from the Chinese bond market.

A last point to note is that the decision by Bloomberg to include China in its flagship aggregate index is likely to be followed by other fixed income benchmark providers. We estimate that the inclusion of China by FTSE would potentially represent a weight of 5% in its World Government Bond Index (WGBI), while J.P. Morgan is likely to include China in its Global Bond Index Emerging Market Global Diversified with a weight of 10%.

An Enhanced Opportunity Set

The presence of Chinese bonds in the Global Aggregate Index is likely

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to have an immediate impact on its risk and return profile. If Chinese bonds were included now, for example, the result for the index would be a slightly shorter duration profile and a marginally higher yield compared with current levels—both positive developments from a bond investor's point of view. From a cyclical perspective, we expect Chinese onshore rates to perform given that the PBoC is currently embarking on an easing cycle. Ultimately, renminbi-denominated Chinese bonds are likely to act as a strong diversifier in global portfolios if China's policy cycle diverges from the U.S. and EU.

Overall, we believe that Chinese bonds are currently undervalued as collateral in the Chinese capital market system—in other words, they have the potential to perform better than other Chinese assets over time. As a result, T. Rowe Price is already invested in local Chinese government bonds, ahead of their inclusion in the index, across our mandates and investment vehicles, including our range of mutual funds and SICAVs (Société d'investissement à capital variable)—open-ended collective investment funds. As things stand, our inclination is to adopt a longer position than the opening weight of Chinese bonds in the index as we believe that there will be significant demand for the bonds from investors looking for diversification. At present, the 10-year yield is 3.1% and inflation is under control, so Chinese bonds look reasonably attractive.

The Importance Of Local Knowledge

At T. Rowe Price, we have the capability to invest in onshore (CNY) as well as offshore (CNH) currency markets in addition to markets in Hong Kong. Our office in Hong Kong gives us a local presence, enabling our team of research analysts and traders to gain on-the-ground insights into this evolving and increasingly prominent market. From an implementation and trading perspective, of the prevailing investment programs, we have favored Bond Connect as our preferred mechanism as its setup procedures are less onerous than others available.

Trading Chinese bonds is likely to be focused on China government bonds and on core policy bank bonds, which are included in the broadened Global Aggregate Index. From a credit viewpoint, we are likely to put more emphasis on issuers that provide robust disclosures and already issue overseas. We are likely to avoid most onshore credit bonds and Local Government Funding Agency bonds for the time being as transparency can sometimes be lacking and reporting standards can be less comprehensive.

Overall, we believe that the inclusion of Chinese locally denominated bonds in the Global Aggregate Index is a positive evolution for fixed income investors and that T. Rowe Price is well prepared for this transition given our dedicated research and trading resources in Hong Kong.

WHAT WE'RE WATCHING NEXT

The initial 6.1% weighting is material, but it does not reflect China's true weight in terms of capitalization. Whether—and when—China's weighting increases will depend on how accessible, reliable, and transparent its debt market proves to be. Geopolitics—specifically China's trading relationship with the U.S.—will also be a factor.

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