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China's Local Bond Market

A market that we believe demands global investors' attention

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LGIM

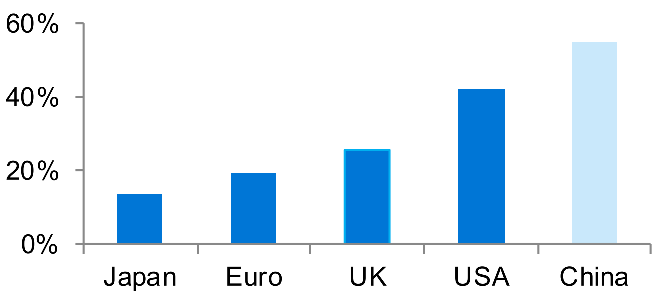
China's local bond market | Overview

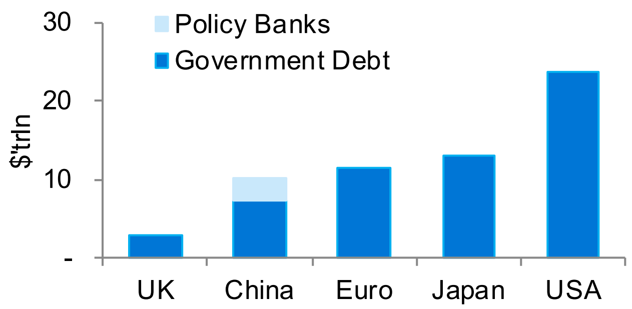
A relatively young emerging market for global investors is on the rise and we believe it demands attention.

The Chinese onshore bond market is growing at a rapid rate. Issuance is notably higher than for the rest of the world (RoW), with China's government debt market boasting an average annual growth rate of greater than 50% over the past decade. This growth rate is significantly higher than many of the other large government bond markets (see graphs 1 & 2 below). In addition to government bonds, China has a second sizeable and liquid onshore bond market, known as Policy Bank bonds, which is similar in size to the French government bond market. There are three Policy Bank bond issuers: the Export-Import Bank of China, the Agricultural Development Bank of China, and the China Development Bank.

Alongside this growth, China has been progressively liberalising access to its onshore bond markets for foreign investors as it seeks to internationalise the renminbi and become a key player in global capital markets. Recent years have brought the launch of new access routes for investors such as CIBM (China Interbank Bond Market) direct and China Bond Connect, as well as a number of other improvements in areas such as bond settlement and trading hours

Graph 1 & 2: 10-year average annual growth rate of government debt and market size





Source: LGIM, Bloomberg, June 2021

Figure 1: China government debt market – current statistics

$10 trillion China government and Policy Bank bonds outstanding	**3.2% yield** (10-year government bond)	**0.39 correlation** (to developed market local currency government*)	**>45%** of total emerging market government and Policy Bank bonds outstanding	Foreign ownership accounts for **<10.5%** of China government and **<5.5%** of Policy Bank debt**

Source: LGIM, Bloomberg, June 2021

*Five-year total return correlation for DM Local Ccy Govt (GBI-DM Dlv) vs JPMorgan China Custom Liquid ESG Capped Local Currency Index. **Source: China Central Depository & Clearing, May 2021

Improving the ability of foreign investors to access its market has put China on a path to inclusion across the industry's major fixed-income indices, including the Bloomberg Barclays Global Aggregate Bond index and JPMorgan GBI-EM Global Diversified index. FTSE Russell has also given the green light for Chinese sovereign bonds to be included in its flagship government bond index (WGBI) from later this year. We expect these steps to set the tone for billions of dollars of international inflows into the world's second-largest economy. We estimate the FTSE WGBI inclusion could potentially equate to over $125 billion of inflows due to the value of assets tracking it.

Figure 2: Timeline of market improvements for international investors

2016	2017	2019	2020	October 2021
CIBM direct access launched	China Bond Connect is launched	China's inclusion in Bloomberg Barclays Global Aggregate index begins	China included in JPMorgan GBI-EM Global Diversified index	China inclusion in FTSE World Global Bond Index (WGBI) expected to begin

China's local bond market | Diversification

We believe China's local bond market can offer investors a combination of high yields and low correlation to other fixed-income assets.

China's local currency bond market is increasingly becoming a region of interest for foreign investors. This is understandable given the large size of the market and the potential diversification benefits that a low historical correlation to many other fixed-income universes can bring (see table 1 below).

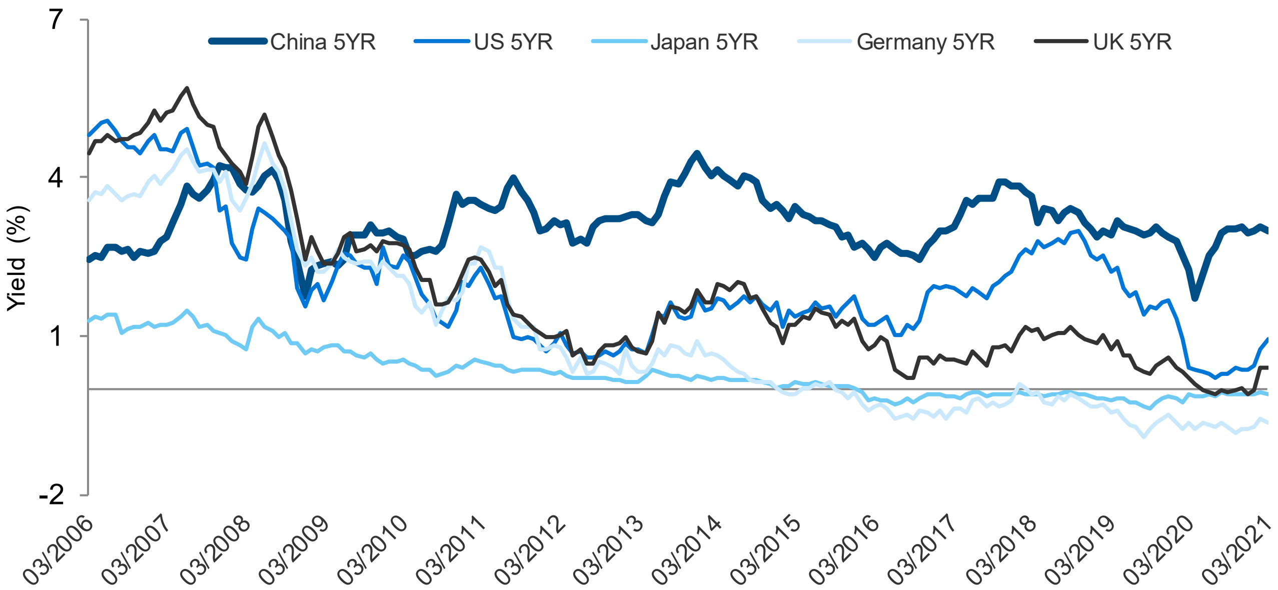
In an environment where investors are often searching for yield, China's bonds currently offer a relatively high sovereign yield. Yields have come off their highs in recent years, but remain high relative to other sovereign issuers (see graph 3 below). Arguably, this could be attributed to China's swift economic turnaround from the peak of the COVID-19 pandemic in the country.

Table 1: Cross-correlation matrix – monthly local total return correlation, five-year period ending 28 May 2021, USD denominated

	China Agg	EM Sovereign	EM Corporate	EM Sovereign ex. China	DM Sovereign	US Treasury	Japan Govt Bonds	EMU Govt Bonds	IG Credit (Euro in USD)	IG Credit (US in USD)
China Agg	1.00	0.18	0.18	0.42	0.39	0.01	0.36	0.36	0.39	0.17
EM Sovereign	0.18	1.00	0.95	0.81	0.47	-0.02	0.30	0.58	0.67	0.82
EM Corporate	0.18	0.95	1.00	0.75	0.34	-0.14	0.22	0.46	0.58	0.83
EM Sovereign ex. China	0.42	0.81	0.75	1.00	0.53	-0.09	0.37	0.68	0.81	0.58
DM Sovereign	0.39	0.47	0.34	0.53	1.00	0.66	0.83	0.87	0.81	0.63
US Treasury	0.01	-0.02	-0.14	-0.09	0.66	1.00	0.60	0.33	0.21	0.36
Japan Govt Bonds	0.36	0.30	0.22	0.37	0.83	0.60	1.00	0.58	0.54	0.47
EMU Govt Bonds	0.36	0.58	0.46	0.68	0.87	0.33	0.58	1.00	0.96	0.96
IG Credit (Euro in USD)	0.39	0.67	0.58	0.81	0.81	0.21	0.54	0.96	1.00	0.62
IG Credit (US in USD)	0.17	0.82	0.83	0.58	0.63	0.36	0.47	0.55	0.62	1.00

Source: LGIM, JPMorgan, June 2021

Graph 3: Relatively high yield with low correlation to other government bonds



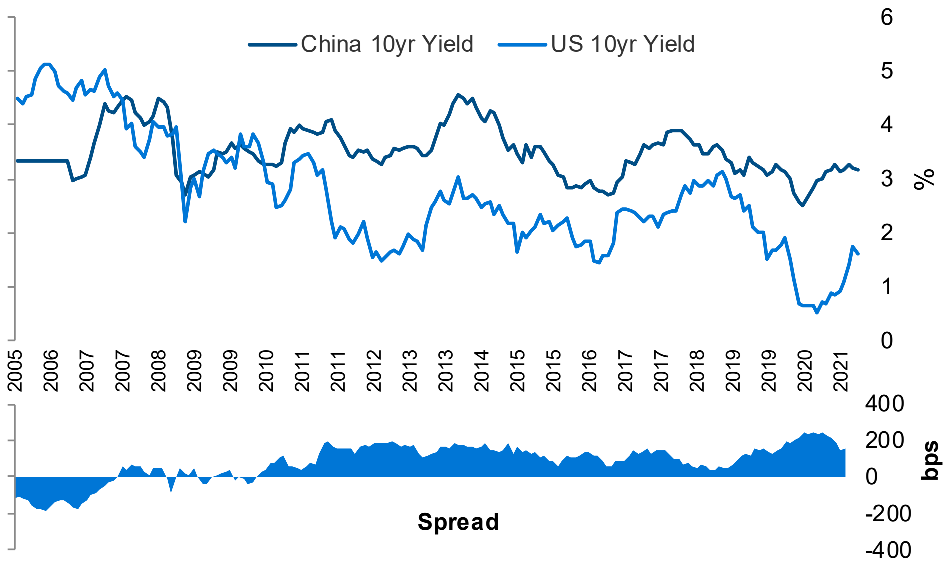
Source: LGIM, Bloomberg, June 2021. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

China's local bond market | Risk profile

We believe China's local bond market can offer investors a combination of high yields and low correlation to other fixed-income assets.

China's high relative yield becomes apparent when looking at the yield differential between the global economy's two largest powerhouses. Over the course of the COVID-19 pandemic, the additional yield offered by China's 10-year bonds increased as the US Federal Reserve cut rates in a more aggressive fashion followed by a faster normalisation of yields in China. At its peak, this yield pickup reached 327 basis points in October 2020. Despite narrowing thus far in 2021, it continues to offer a pickup, currently sitting at 153 basis points in June 2021.

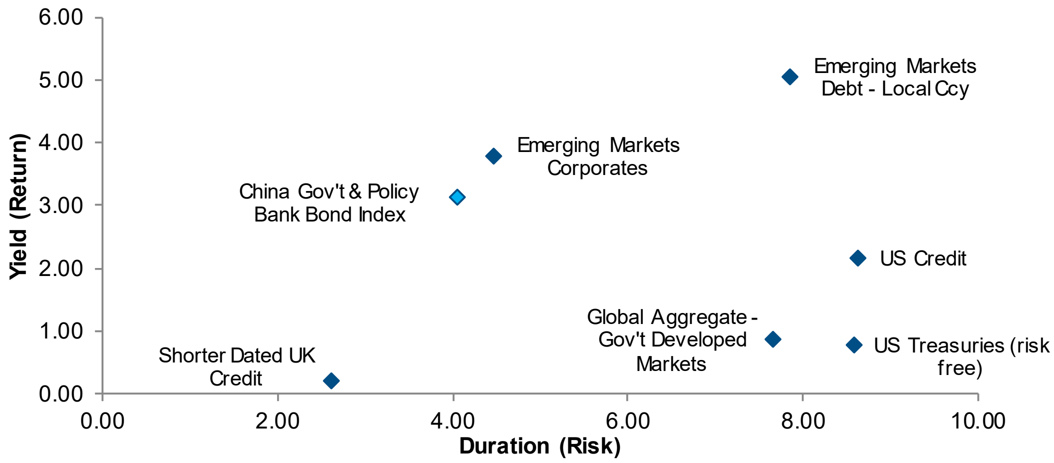
Graph 4: Yield comparison between China 10-year government bonds and US 10-year government bonds



Source: LGIM, Bloomberg, June 2021

Widening the scope to China's full bond universe, we can see it not only offers the higher yield discussed above; it also does this while having a duration less than half that of US Treasuries. When compared against other fixed-income indices, China exhibits a higher yield per unit of duration than many others (see Graph 5 below).

Graph 5: Risk (modified duration) / return (yield) profile covering a range of fixed-income indices and asset classes



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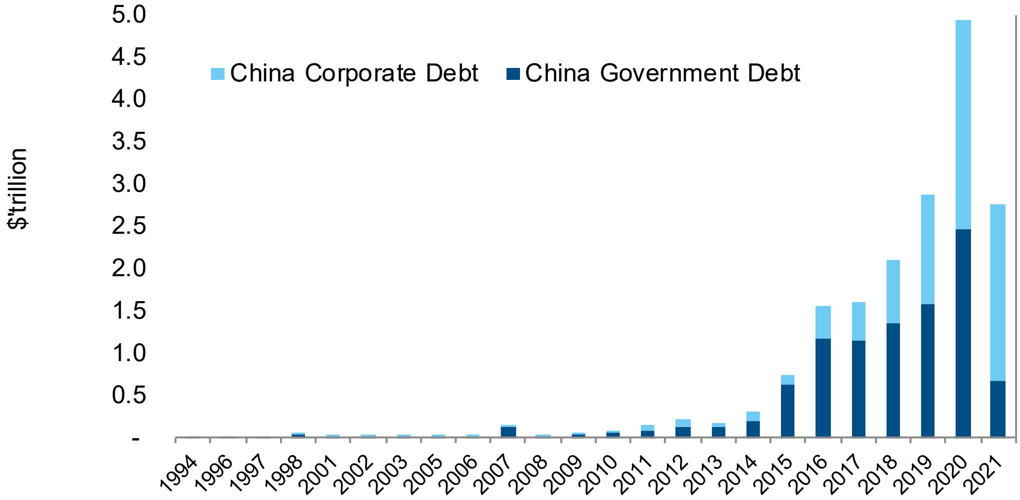
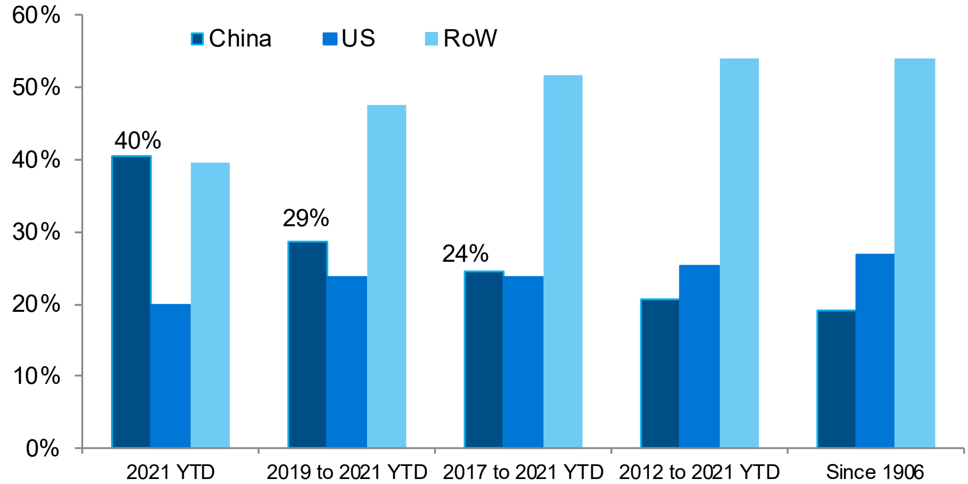
China's local bond market | Index trends

The inclusion of China's corporate bond universe in bond indices.

As it stands today, only China's government and Policy Bank bonds are included in major fixed-income indices. Looking ahead, we believe it's reasonable to expect that, with continued liberalisation of onshore markets, the Chinese corporate bond market could move towards inclusion in mainstream indices in the coming years. China's investment-grade credit market continues to grow at a rapid rate, with issuance exceeding government bond issuance over the past two years (see graphs 6 and 7 below).

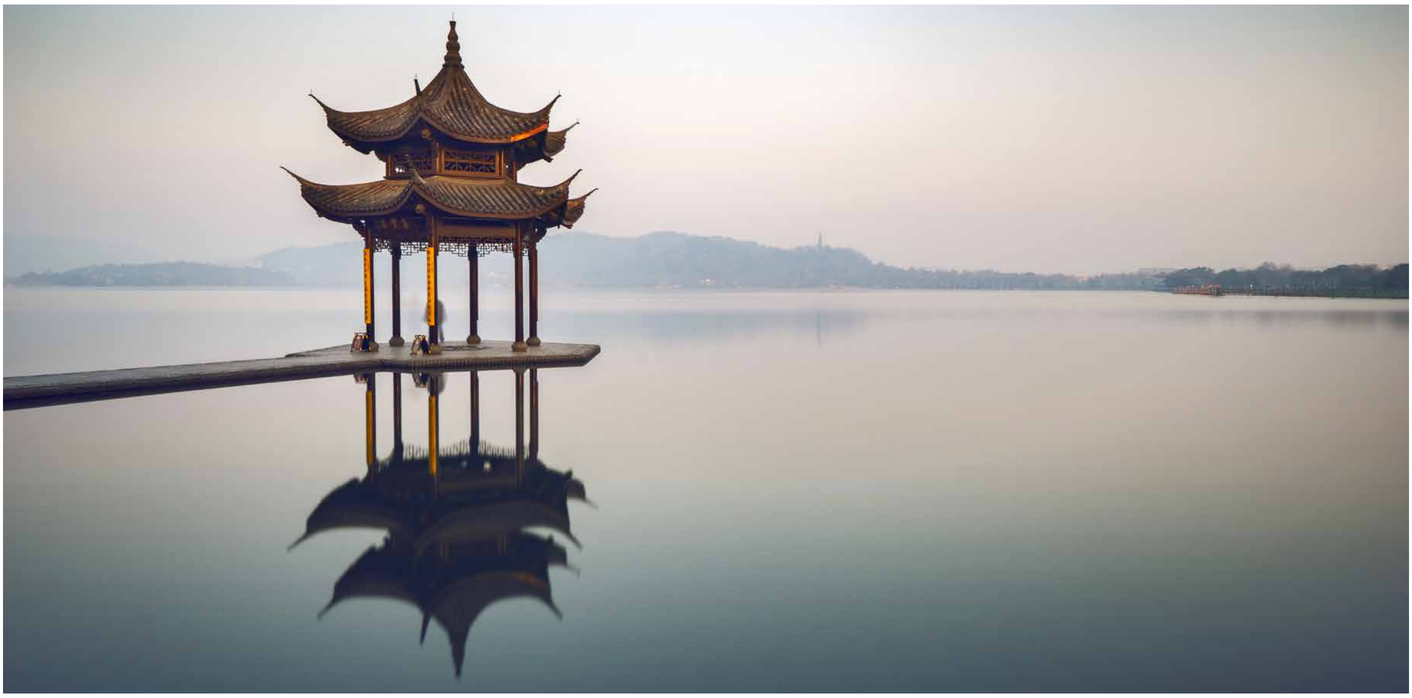
Graph 6 and 7: Annual total issuance of China debt (sovereign and corporate debt) and corporate debt market growth





Source: LGIM, Bloomberg, June 2021

A further sign of progress is occurring with credit ratings. Historically, the main international ratings agencies' coverage in the local Chinese market has been limited, which has naturally led to concerns for some foreign investors. Fitch Ratings has now secured a licence (the second foreign company to do so) to rate fixed-income securities in China's interbank market. This easing of restrictions against foreign-owned ratings agencies has been warmly welcomed by global investors, which we believe should ultimately enhance transparency and provide an easier comparison against other corporate bond markets with well established coverage by the largest rating agencies.



China's local bond market | Index trends

For illustrative purposes, Table 2 below estimates the change in the risk profile of the Chinese Yuan in the Bloomberg Barclays Global Aggregate Bond index if the index was to include China's corporate bonds. While only a modest increase of less than 1% in overall weight, this could still result in approximately $19 billion of inflows based on estimated assets following the Global Agg index.

A significant proportion of the universe of Chinese corporate bonds would not currently be eligible for mainstream indices, however. Many, for example, are simply too small to meet minimum issue sizes. But as the corporate bond market progresses towards future inclusion, and foreign investors' participation increases, in our view issuers would become more conscious of the requisites for a bond to be index eligible, ultimately increasing the potential additional investor base that would naturally have interest in issuance that meets the index criteria.

Table 2: Change in risk profile when China corporates are included in the Bloomberg Barclays Global Aggregate Bond Index

	Bloomberg Barclays Global Aggregate Bond Index (Global Agg)					Global Agg + China (Full Weight)				
	Bonds (#)	Market Value (%)	Market Value ($bn)	Duration (yrs)	Yield (%)	Bonds (#)	Market Value (%)	Market Value ($bn)	Duration (yrs)	Yield (%)
United States Dollar	15,311	41.27%	27,782	6.34	1.61	15,311	41.01%	27,805	6.46	1.63
European Euro	6,127	23.83%	16,044	7.57	0.17	6,135	23.63%	16,023	7.65	0.18
Japanese Yen	1,022	13.52%	9,101	9.59	0.1	1,007	13.38%	9,071	9.64	0.1
Chinese Yuan	**304**	**6.91%**	**4,652**	**5.78**	**3.11**	**547**	**7.66%**	**5,195**	**5.54**	**3.16**
Pounds Sterling	1,206	5.06%	3,405	11.24	1.07	1,204	5.02%	3,404	11.26	1.07
Canadian Dollar	1,446	2.89%	1,943	7.70	1.63	1,459	2.86%	1,936	7.78	1.64
Australian Dollar	426	1.50%	1,012	6.37	1.15	424	1.49%	1,012	6.41	1.15
Total	27,102	100.00%	67,313	7.34	1.16	27,317	100.00%	67,793	7.40	1.19

Source: LGIM, Bloomberg, June 2021

Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.

China's local bond market | Summary

The practicalities of accessing the onshore China bond market for foreign investors have been greatly improved in recent years, with new access routes such as China Bond Connect and a number of enhancements to the way foreign investors can trade. This has led to China becoming part of many flagship fixed-income indices, with further inclusions expected to drive a significant increase in foreign ownership. Allowing major credit rating agencies to evaluate Chinese issuers is also improving transparency for foreign investors, in our view.

Already one of the world's largest bond markets by size, the rate of growth continues apace and, looking forwards, we believe it is reasonable to expect that China will become an increasingly large part of the indices in which its bonds reside. It would seem inevitable, in our view, that at some point in the future Chinese corporate bonds will also transition into indices, providing a further kick in country weight.

In our view, the case for the China bond market is compelling and could be considered as an addition to a global fixed-income exposure. We believe incorporating China bonds can offer diversification benefits by way of low correlation to other fixed-income asset classes and an attractive yield compared with many of the other largest government bond markets.

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