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9 things to know about China's bond markets

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China's bond markets have historically been underutilised by many foreign investors, but things are changing. Steady reforms, an increasingly internationalised currency and attractive yields are resulting in increased inflows. Read these nine tips to understand the essentials of investing in China's fixed-income marketplace.

1 There are three main ways to access China's bond markets

China's fixed-income marketplace isn't monolithic, but it is massive. The onshore RMB segment alone is bigger than those in France, Germany and the UK combined (see Exhibit 1).

Exhibit 1: three different investable markets for Chinese bonds

Onshore RMB bond market	Offshore RMB bond market	Offshore USD bond market (China)
Market size: USD 15.5 trillion (second-largest bond market globally[1]	Market size: USD 17 billion[2]	Market size: USD 608 billion (China makes up more than 50% of the overall USD bond market in Asia)[3]
Dominated by "rates" bonds (bonds from governments and policy banks)	Mostly corporate issuers	Predominantly corporate issuers
Denominated and traded in the "onshore" currency (CNY)	Denominated and traded in the "offshore" currency (CNH); mostly traded in Hong Kong . (Also known as the "dim sum" bond market.)	Accessed by international investors
Restricted access previously prevented many foreign investors from buying and selling onshore bonds, but regulatory reforms opened China's capital markets	Gives non-mainland China investors a way to invest in RMB-denominated bonds	Chinese companies can issue USD and RMB-denominated bonds; the USD bond market is more liquid and well-traded
Today, foreign participation in the onshore RMB bond market is expected to continue increasing as it finds favour with international investors	Market cap has been shrinking, as has its importance for investors seeking exposure to RMB-denominated investments	

2 China's currency has several names, but "renminbi" is arguably more important for bond investors

Outside of Asia, "yuan" is generally the term used to describe China's currency. But "renminbi" (abbreviation: RMB) is the official legal name of China's currency, and the term used the most in China and in Asia overall. Bond investors should be aware of the two kinds of renminbi (see Exhibit 2) used in financial transactions.

- In "onshore" China (sometimes called mainland China), transactions are done using the onshore traded renminbi (abbreviation: CNY). This is where "onshore RMB"/"onshore CNY" bonds get their name.

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– In "offshore" regions (those outside of mainland China), transactions are done using the offshore traded renminbi (abbreviation: CNH). This is where "offshore RMB"/"offshore CNH" bonds get their name.

China's regulators are intent upon making the onshore RMB currency (the CNY) a more "internationalised" one – similar to how the US dollar (USD) is used around the world to conduct transactions. That makes the onshore RMB bond market increasingly important

Exhibit 2: key renminbi facts for fixed-income investors

Why use renminbi vs yuan?	– Renminbi is the official name of China's currency – and the term used most in Asia – Yuan is the term used most **outside Asi**a, but it still essentially refers to the renminbi
What is the CNY vs CNH?	– **CNY:** renminbi that is circulated (and used for transactions) **within mainland China** (ie, "onshore") – **CNH:** renminbi that is circulated (and used for transactions) **outside of mainland Chin**a (ie, "offshore")
Do the CNY and CNH have different prices?	Prices of the CNY and CNH are usually very similar, but they can sometimes diverge. – The value of the CNY is set by the People's Bank of China, and the spot USD/CNY is allowed to trade within a ±2% band from the "daily fixing rate" – The CNH's value is determined by the offshore investors who trade it The net result is that **while China has one currency (the RMB), there are two prices for it (the CNY and CNH**).

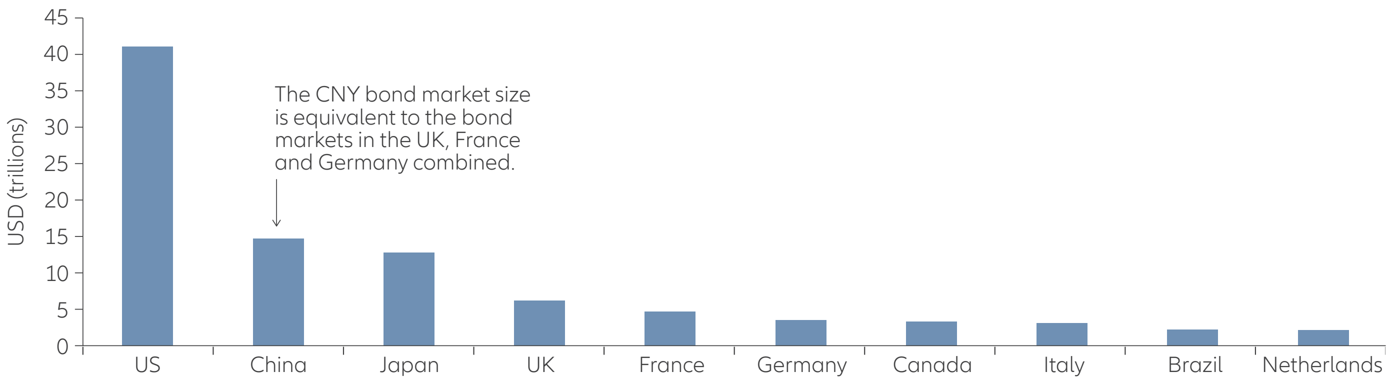
3 China's onshore RMB bond market is large and growing

The total value of China's onshore RMB bond market reached USD 15.5 trillion at the end of 2020, and many market participants are expecting the market to grow significantly in the coming years (see Exhibit 3).

China's onshore RMB bond market is also diverse, with three main segments of the market: money market instruments, "rates" and "credits".

– Rates bonds form the largest segment of the onshore RMB market (55% as at 30 June 2020). This group broadly consists of central government bonds (CGBs), local government bonds (LGBs) and bonds from policy financial banks (PFBs, which are large financial institutions owned by the Chinese government).
– Credit bonds encompass issues from government-linked financing entities, state-owned enterprises (SOEs), financial institutions (such as banks and insurers) and privately owned (non-government) corporations. Credits make up about a quarter of the onshore RMB market.
– Money market instruments issued by banks and corporations make up the rest of the onshore RMB bond market.

Exhibit 3: outstanding bonds by market

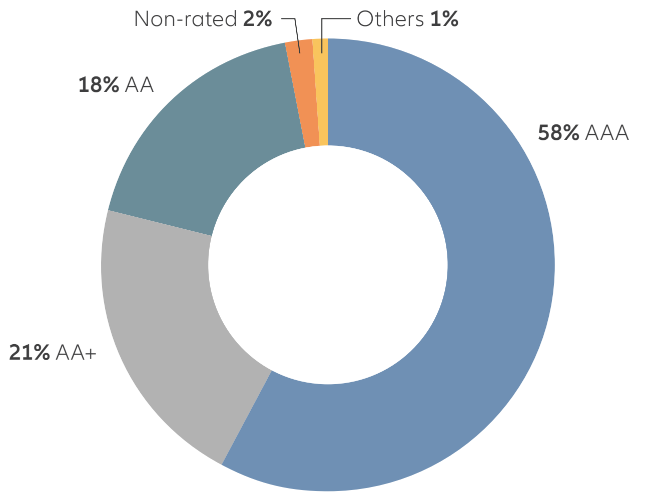


Source: Chinabond, Chinaclear, Wind, Standard Chartered Research. Data as at 30 June 2020.

4 The creditworthiness of onshore RMB bonds can vary widely

When investing in the onshore RMB bond market, it's important to work with a partner who can help you assess the creditworthiness of an issuer. The credit quality of bonds issued by LGBs, SOEs and private companies can vary widely. Moreover, China's onshore credit rating system differs from international rating conventions. For example, onshore bonds rated AA+ would typically be rated as "high yield" on an international scale (see Exhibit 4).

Exhibit 4: onshore RMB bonds' breakdown by credit ratings



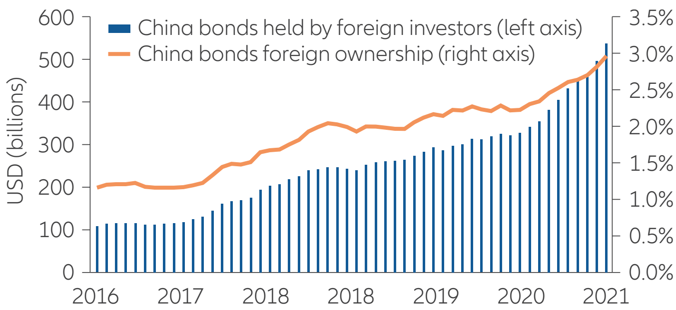
Source: Wind, Standard Chartered Research. Data as at 30 June 2020.

5 Foreign ownership of RMB bonds is rising

China has been making it easier for non-mainland China investors to access to its domestic capital markets. This has paved the way for Chinese bonds to be included in global benchmark indices – with the latest being the FTSE Russell WGBI in November 2021. China is also working to make the renminbi a more "internationalised" currency. Together, these factors should help international investors' holdings of RMB bonds to rise over time.

But international investors still own less than 3% (about USD 540 billion) of the entire RMB bond market (see Exhibit 5). This is significantly lower than the 10%-25% foreign bond ownership range observed in other emerging-market nations. It is also lower than China's representation in major global bond indices. This indicates that foreign interest will likely keep growing in the coming years.

Exhibit 5: foreign ownership of China bonds



Source: CEIC, Wind, Citi Research. Data as at 31 January 2021.

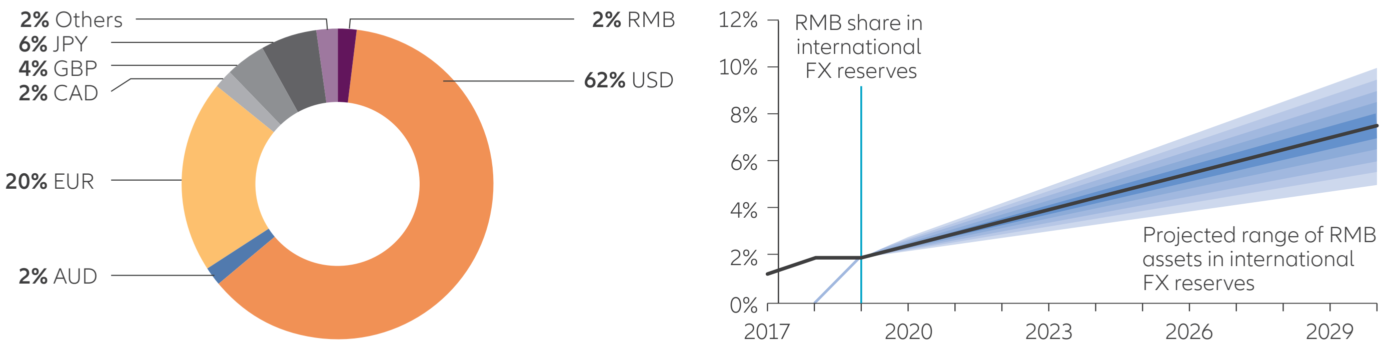
6 Rising demand for the RMB may help RMB-denominated bonds to appreciate in value over time

In recent years, governments and companies have grown increasingly comfortable using the renminbi to conduct international transactions (see Exhibit 6). This can help these institutions eliminate currency risk, since one currency doesn't need to be exchanged for the other – a process that can cause fluctuations in value.

Another factor making the renminbi attractive to international investors is the way China's central bank – the People's Bank of China, or PBoC – has resumed using conventional tools (such as adjusting the short-term interest rate) to enact its monetary policy. Compare this with the unconventional tools that other large central banks are using, such as the massive bond purchases known as "quantitative easing". Some investors consider these tools to be less sustainable and possibly riskier. That makes the PBoC's more conventional approach – and China's renminbi – more attractive to many international investors.

As the international community turns to the renminbi, there should be a corresponding need for investors to seek investment assets denominated in renminbi. This may help lift the value of RMB bonds over time, which would likely benefit investors who already own these bonds.

Exhibit 6: global central bank reserves (as at 2Q 2020) and projected growth of RMB usage in global reserves by 2030

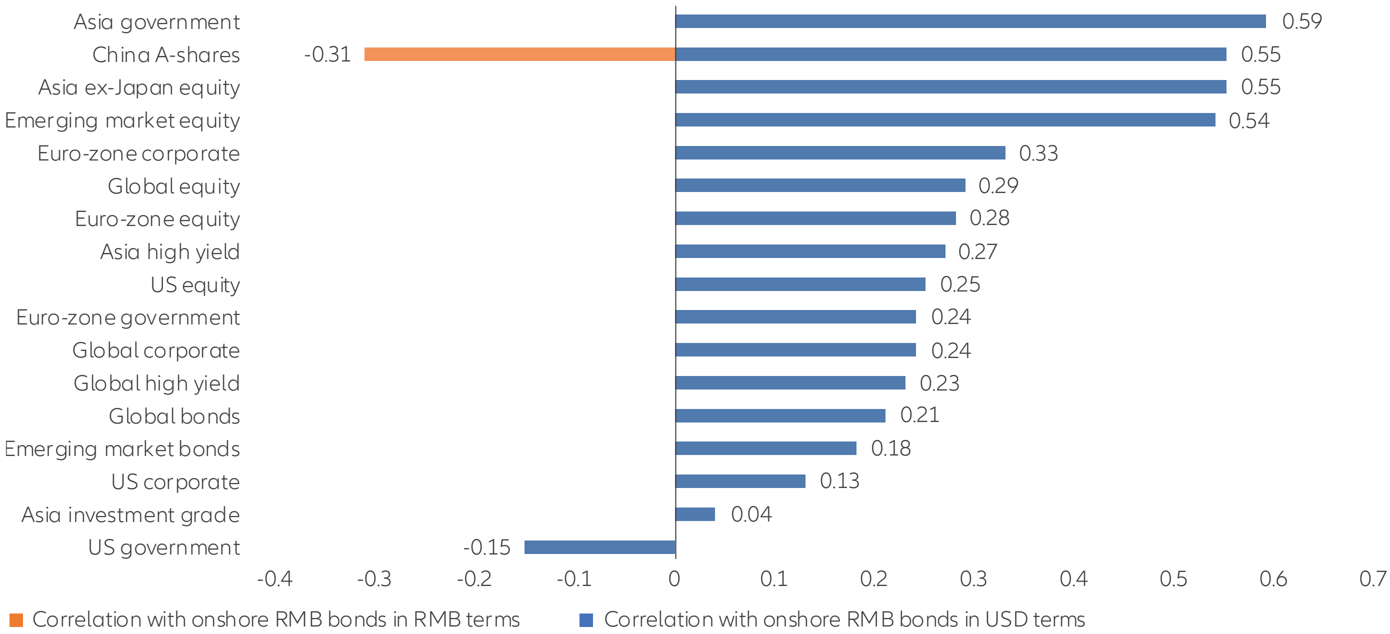


Source for global central bank reserves: IMF, JP Morgan Asset Management. Data as at 31 October 2019. Source for projected growth of RMB: Morgan Stanley Research, Haver

7 Onshore bonds can bring diversification benefits

Onshore RMB bonds have exhibited low correlations to other asset classes (see Exhibit 7). Case in point: onshore RMB bonds moved in the same direction as global bonds only 22% of the time. As a result, holding onshore RMB bonds in a global portfolio may improve overall diversification.

Exhibit 7: 3-year return correlation of onshore RMB bonds vs other major asset classes

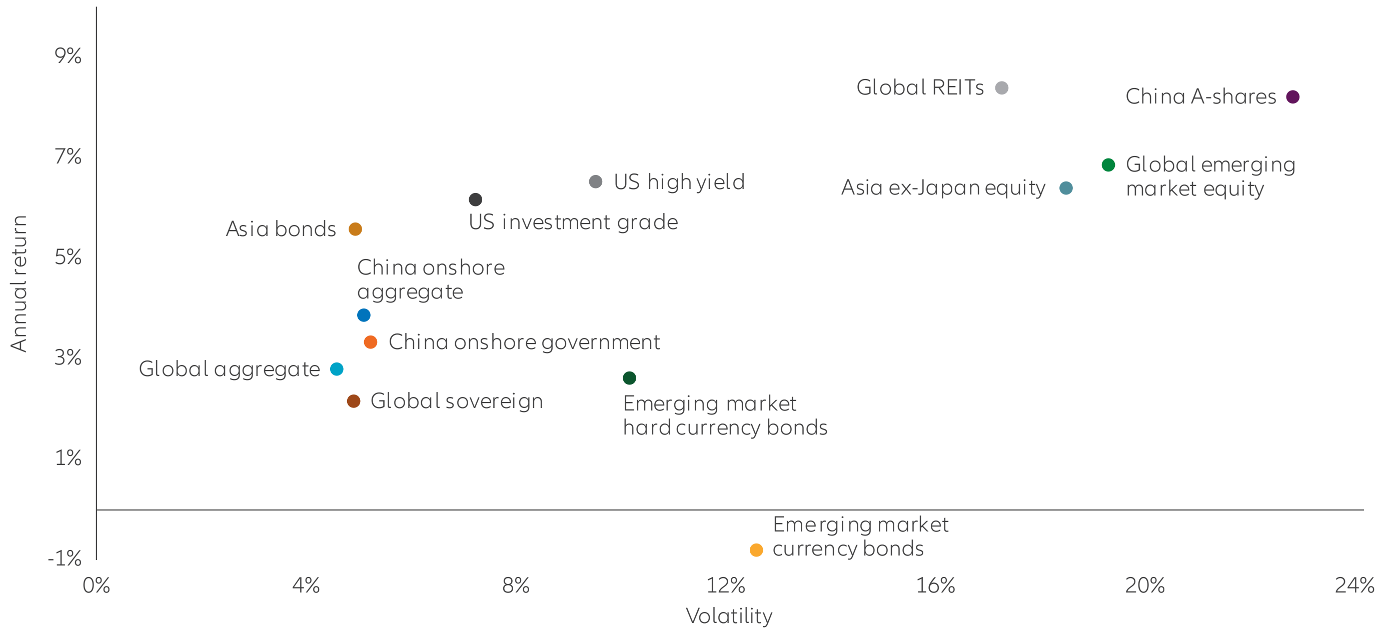


Source: Bloomberg. Data as at 31 December 2020.

8 Adding onshore RMB bonds can enhance the risk/return profile of investors' portfolios

Over time, the returns of onshore RMB bonds have been steady. Moreover, their volatility has remained low, meaning there have been relatively few large swings either up or down. When these two metrics are taken together, they can be expressed as a "risk/return" profile. And as Exhibit 8 shows, onshore RMB bonds have an attractive risk/return profile compared with other major asset classes. That can make onshore RMB bonds a helpful addition to a range of portfolios.

Exhibit 8: 3-year risk/return profile (in USD)

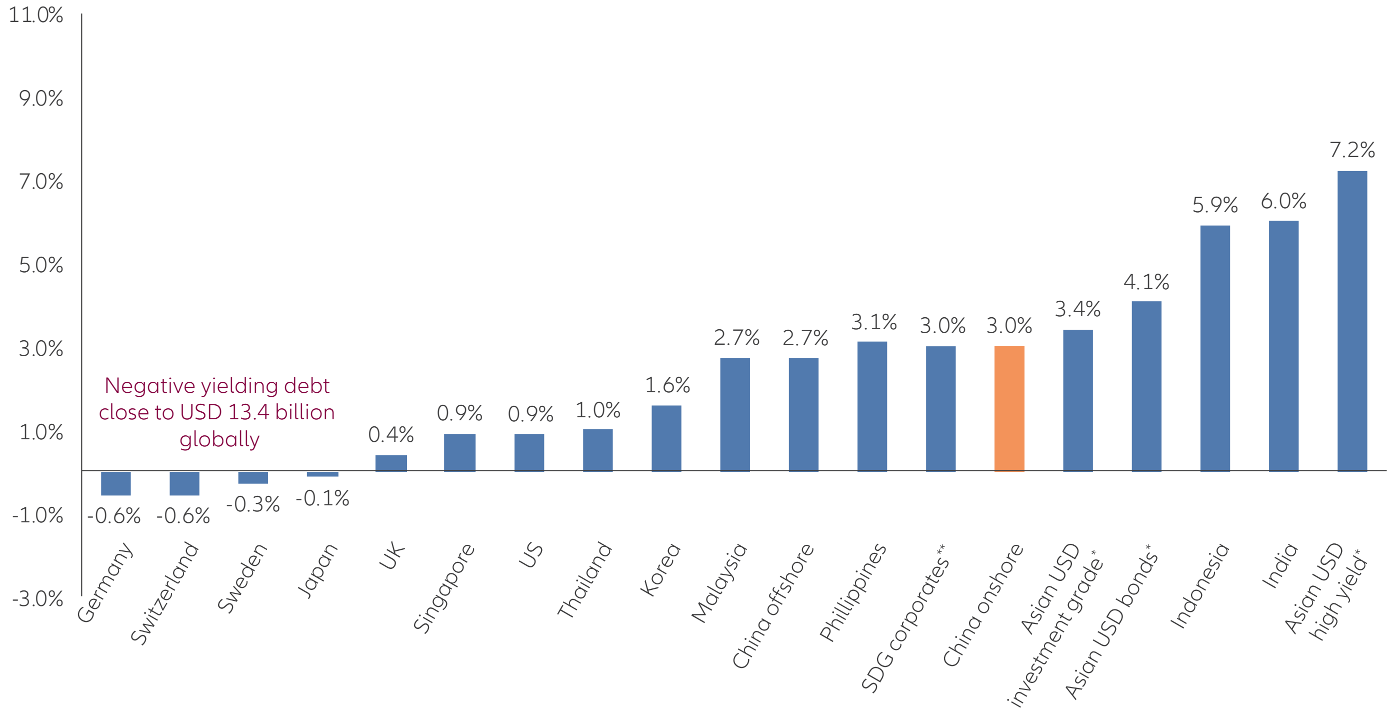


Source: Bloomberg, Allianz Global Investors. Data as at 31 March 2021. Please see the disclosure at the end of this document for important index information.

9 China's onshore bonds offer added yield potential in today's low-yield environment

Interest rates in developed economies have been low or even negative for some time. This has contributed to low to negative yields for many types of bonds, as the accompanying chart shows. Moreover, given that the global economic environment continues to be somewhat weak, we expect interest rates to remain at the suppressed levels for some time. That makes it all the more important for investors to pursue sufficient sources of yield potential. Onshore RMB Chinese government bonds (CGBs) have a higher yield than most developed-market government bonds (see Exhibit 9). Moreover, CGBs offer an average credit rating of A+. That means investing in CGBs can provide investors with solid credit quality and attractive additional yields.

Exhibit 9: 5-year government bond nominal yields



Source: Bloomberg, Markit IBoxx, JP Morgan, Allianz Global Investors. Data as at 31 December 2021.
*Based on JP Morgan Asia Credit Index. Refers to yield-to-maturity (YTM). **Based on Markit iBoxx SGD Corporate Bond Index. Refers to annual yield.

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Data as at 31 March 2021

1. Asian Bonds Online. Data as at 31 December 2020.
2. FTSE Russell. Data as at 31 December 2020 (updated quarterly). FTSE Dim Sum Bond Index is an unmanaged index considered representative of the China offshore CNH bond universe.
3. JP Morgan. Data as at 31 December 2020. JP Morgan Asia Credit Index (JACI) is an unmanaged index considered representative of the Chinese USD denominated bond universe.

Index information for Exhibit 8: Asia ex-Japan equity is represented by MSCI AC Asia ex. Japan Index; Asia bonds by J.P. Morgan JACI composite Total Return; China onshore government by Markit iBoxx ALBI China Onshore Government (USD Unhedged) TRI; China onshore aggregate by Bloomberg Barclays China Aggregate TR Index; China A-shares by MSCI China A Onshore Net Total Return Index USD; emerging-market hard-currency bonds by J.P. Morgan EMBI Plus Composite; emerging-market local-currency bonds by J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD; US investment grade by ICE BofA US Corporate Index; US high yield by ICE BofA US High Yield Index; global sovereign by J.P. Morgan GBI Global Unhedged USD; global aggregate by Bloomberg Barclays Global Aggregate Total Return Index Value Unhedged USD; global equity by MSCI ACWI Index; global emerging-market equity by MSCI Emerging Markets Gross Total Return USD Index; global REITs by MSCI World Real Estate Total Return USD Index. Investors cannot invest directly in an index.

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