PICTET
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Asset Management

China Bonds under the Radar

- ONSHORE VS OFFSHORE CHINA BONDS

"China Bonds under the Radar" series aim to provide insights into the 2nd largest bond market in the world - China onshore bond market. In this month's piece, we provide a brief comparison of China's onshore and offshore bonds markets, and discuss the differences and connections between the two.

TWO DISTINCTIVE MARKETS WITH NEGATIVE CORRELATION

Contradictory to a lot of investors' perception, China onshore (RMB) and offshore bonds (USD) markets have negative correlation (Figure 1). There are multiple structural reasons behind this:

- **Difference in size and issuer constituents:** onshore market size is > 10 times bigger than offshore markets; half of the onshore market are "rates" instruments, i.e. government bonds etc., while offshore markets are mainly dominated by credit;

- **Different market drivers:** onshore markets are impacted by domestic monetary policy/Chinese base rates movement, local credit spread and currency volatility (for non-RMB based investors), while offshore markets are more impacted by US base rates movement, global risk sentiment and credit spread change;

- **Difference in stakeholders:** commercial banks are the biggest investors in onshore bonds, while asset managers (mutual funds) are the biggest investors in offshore bonds; their risk appetites, liquidity requirements and investment objectives can be different.

Figure 1: Comparing China onshore and offshore bonds

	Onshore (Bloomberg Barclays China Composite Index)	Offshore (JPMorgan JACI China Index)
Size (USD bn)	5,956	587
Average Yield (%)	3.44%	3.08%
Average duration (years)	4.0	3.9
Number of issues	2000+	900+
Currency denomination	RMB	USD
Top sectors	**Sov: 50%** · Central Government: 16% · Quasi Sovereigns: 22% · Local governments:12% **Credit: 50%** · Financials: 27% · Transportation: 13% · Industrials: 5%	Quasi Sovereigns: 26% Financials: 26% Real Estate: 24% TMT: 8% Oil and Gas: 5%
Average rating	**International rating scale:** A / A- (estimated) **Domestic rating sale:** AAA	**International rating scale:** BBB+
Credit rating coverage	Most issuers ONLY rated by domestic rating agencies, not international rating agencies	Most issuers rated by S&P, Moody's, Fitch
Credit rating breakdown	**Estimated international scale:** IG: ~ 90%* HY: ~10% **Domestic scale:** AAA: 64% AA: 27% A and below: 0% NR: 9%	**International scale:** IG: 76% HY: 24%
Risk / Return profile	**Annualised return:** 5.01% (in USD terms) **Annualised volatility:** 3.69% (in USD terms)	**Annualised return:** 5.96% **Annualised volatility:** 8.58%
	Correlation: -0.03	
Correlation with Global Aggregate Bonds	0.24	0.49
Risk exposure	China local rates Credit spread Currency	US treasury rates Credit spread
Main type of investors	Commercial Banks (50%) Asset Managers (23%) Insurance / Financial Instituti-ons (4%) Policy banks (3%)	Asset Managers (48%) Banks (32%) Insurance / pension funds (6%) Private banks / retail (7%)
Foreign ownership %	< 3%	11%

Source: Pictet Asset Management. Yield as of Jan 2021. Risk/return profile and correlation based on monthly data between Sep 2005 to May 2020, ChinaBond composite index, JPMorgan JACI China index. Investor types: HSBC for onshore, JPMorgan for offshore (based on new issuance allocation data for 2020).
*Estimated based on 2019 S&P survey.

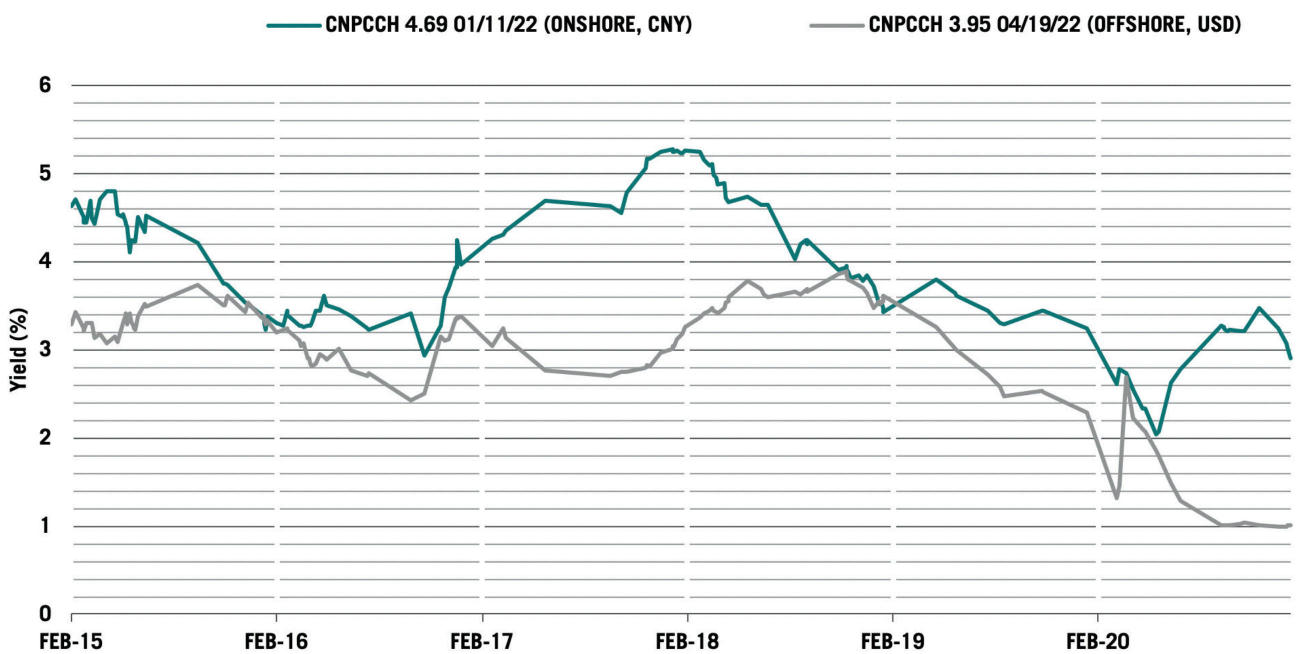
THE CONNECTION & OPPORTUNITIES

From fundamental perspective, onshore is the major operational base for most offshore China issuers. Therefore, developments of local markets/regulations play an important role in offshore issuers' business operation. Local investors and local banks are also major funding channels for these issuers, thus their risk appetite and relevant policies will have an influence on issuers' financing capability. At the moment there are around 150 issuers offshore who also have onshore bonds. Therefore, **onshore liquidity environment and funding cost could be key factors** impacting these offshore issuers. When onshore funding cost exceeds offshore funding cost, for example, issuers may shift the re-financing to offshore market via issuing USD bonds, subject to regulator's approval. From a broad technical perspective, as cross-border flows from onshore investors are playing a more important role in offshore China bonds market, their preference and constraints will also have an impact to offshore market.

On the other hand, we believe offshore China bonds market, which has developed into an integrated part of the global asset allocation, **offers a future development path for onshore credit market.** Most offshore USD bonds are in global emerging market debt indices, have international credit ratings and decent research coverage, and are also supported by an investor base who generally focus on individual credit fundamentals rather than implicit government support. This is in line with what the authorities aim for onshore credit market: letting go the implicit "government guarantee umbrella", better credit differentiation, more market -oriented pricing and bankruptcy system. Hence managers with offshore investment expertise will benefit from this longer term "catching-up" trend compared with pure onshore investors.

Distinctions of the two markets also produce tactical cross market opportunities of the same issuers. Take CNPCCH's 2022 onshore and offshore bonds for example. CNPCCH (China National Petroleum Corporate) is a solid central SoE (state-owned-enterprise). Despite subjecting to the same credit risk from a bottom up perspective, yields of CNPCCH's onshore and offshore bonds with same tenor could diverge from time to time, due to macro factors - different monetary policy cycles of China's PBoC and the US Federal Reserve being one of them. From Q4 2016 to end 2017, PBoC has maintained a tightening bias while the US Fed remained accommodative, which resulted in a higher yield in onshore bonds; while in 2018, PBoC began to ease amid trade frictions while the US Fed started to hike, and offshore bond yield went up; in 2020, as Chinese economy rebounded earlier and faster, the PBoC has resumed to a neutral stance before the other major central banks, which resulted in higher onshore base rate therefore higher yield in onshore bond vs the same issuer's offshore bond.

Figure 2: onshore and offshore yield for China National Petroleum Corporation



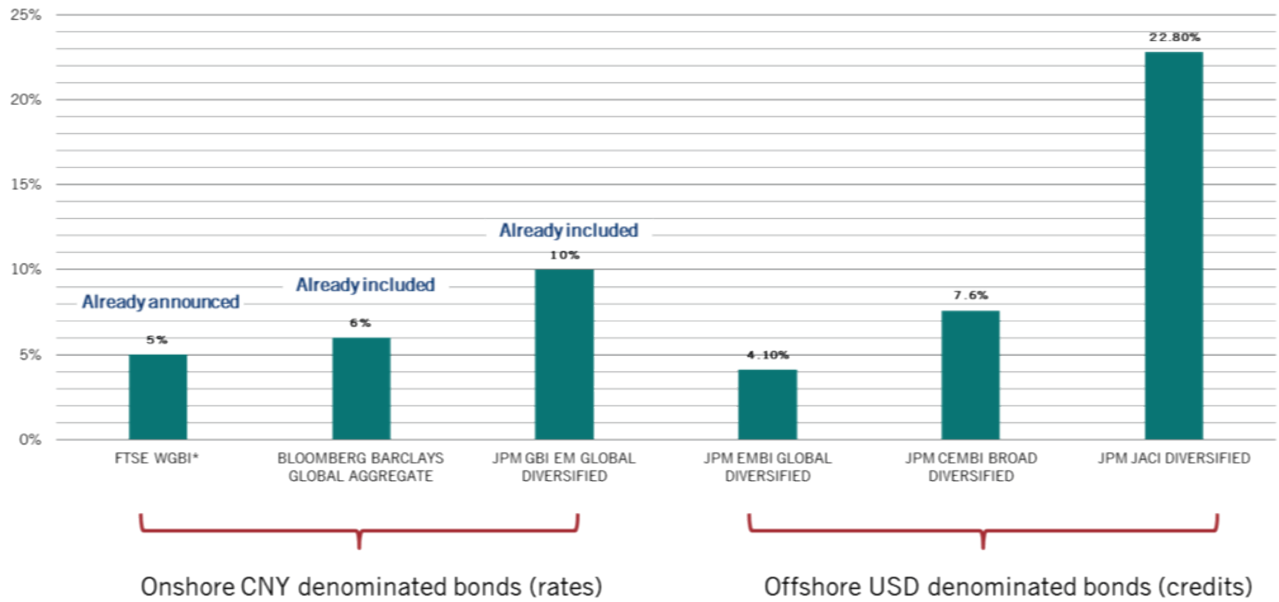
Source: Pictet Asset Management, Bloomberg, as of Jan 2021.

IN A GLOBAL CONTEXT

Offshore USD China bonds (mostly quasi sovereigns and corporates) have been part of the global emerging markets corporate and sovereign bonds indices, via which international investors get exposures in their global emerging markets fixed income or Asian fixed income strategies.

For onshore China bonds, at the moment there are three major global indices that have included or announced that they are going to include onshore China government bonds and quasi sovereign bonds. However **onshore China corporate bonds**, a big and fast-growing part of the market, **are not included in any global bond indices yet.**

Figure 3: China bonds in global indices



Source: Pictet Asset Management, JPMorgan, as of October 2020.
*estimate

CLOSING REMARKS

In our view, China onshore and offshore bonds offer different risk/return dynamics, therefore can play **different roles in asset allocation, depending on bespoke investment objectives**. For international investors with low-yielding home markets, both offer attractive yields. In addition, China onshore bonds have relatively lower volatility and lower correlation with traditional assets, hence offer great **diversification benefit**, while offshore markets offer great credit selection opportunities for total return enhancement.

Nevertheless, as investment managers, understanding the shifting supply-demand dynamics between onshore and offshore markets as well as the difference in market drivers is key. It not only enables managers to form **a holistic view on issuers' fundamentals**, but also to capture **potential cross market opportunities.**

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