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Media briefing on China bond inclusion in Bloomberg's index

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Bloomberg will include China onshore bonds in its Bloomberg Global Aggregate Index from April 1, 2019.

UBS Asset Management sees this event as a highly significant one in the opening of China's financial markets and to the eventual rebalancing of global capital allocation to China.

We have produced a range of content around the event which will soon be published; here we highlight Hayden Briscoe's key views.

1. You say that index inclusion of onshore bonds is the biggest change in global capital markets in anyone's lifetime. What do you mean by that and why?

Firstly, it's about the weight of money coming in - between USD 250bn to USD 500bn[1] has been estimated from this phase of inclusion, and that's just passive money. When we also consider the active investors, central banks and sovereign wealth funds will also have to factor in China bonds after index inclusion begins, the number will be much greater, possibly in the trillions.

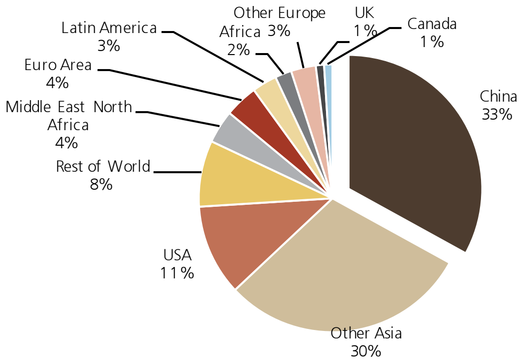
Secondly, index inclusion is about rebalancing global capital markets. It's a fact that the world is underinvested in China, certainly compared to China's weight in the world economy (33% of global GDP).

Index inclusion is making asset allocators sit up and take notice of China, and that's going to see capital allocations rebalanced around the world to factor in China.

So purely from the weight of money and the shift in global capital markets, this is the biggest change in global capital markets that we have seen for some time, and we believe it is something that all investors should be paying attention to.

[1] UBS Asset Management, January 2019

Contribution to Global GDP Purchasing power parity Growth, 2019 (forecast)



Source: IMF, Visual Capitalist, March 15, 2019

2. For global investors, what's the benefit of investing in China onshore bonds?

Compared to the broad global bond market, the average duration on Chinese onshore bonds is lower, and the yield pick-up is often compelling.

For example, the average duration of Chinese Government and Policy Bank bonds is 5.5 years and the average yield is 3.2% compared with almost 7 years duration and a yield (unhedged) of 1.9% on the current Bloomberg Barclays Global Aggregate index, as at 31st January 2019[2].

Onshore bonds are an attractive opportunity set because of the unique characteristics of the bonds being added to the index. This will help to further diversify risk and return sources, offering a potential yield pickup as well as a relatively low correlation to other fixed income markets.

3. You say index inclusion has brought changes and reforms, what are they and why are they good for global investors?

China had to make changes just to be considered for index inclusion, with the most notable ones being the opening of the China Interbank Bond Market and Bond Connect, which brought direct access to onshore markets.

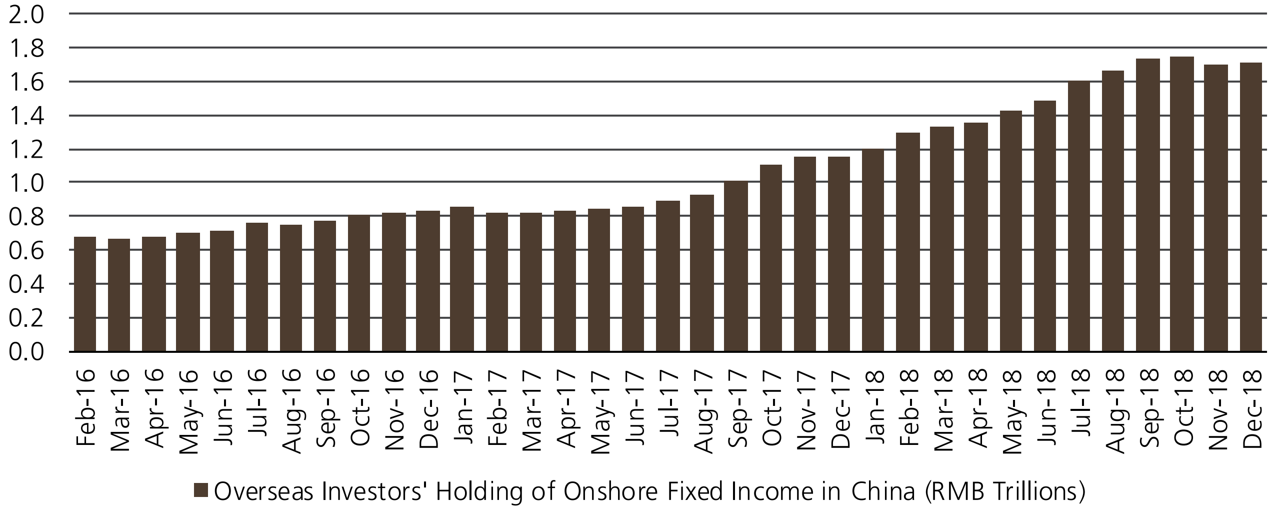
Additional changes have come in to make trading more efficient, including fully implemented real-time delivery vs payment on Bond Connect, tax holidays for overseas investors trading in China, and block trading processes.

4. How will index inclusion impact onshore China bond markets in 2019?

Principally, it's about inflows. We expect overseas investors will continue to increase their presence in onshore markets, continuing a trend we have seen during the past 3 years where they have approximately tripled their onshore holdings to reach RMB 1.7 trillion at the end of 2018[3].

[2] Bloomberg, February 1, 2019
[3] People's Bank of China, February 2019

Overseas investors' onshore China fixed income holdings (RMB Trillions), Feb 2016-Dec 2018



Source: People's Bank of China, February 2019

We see yields continuing to drift lower after rallying strongly in 2018. The global inflow will add a bid to the bond market and we are expecting yields to rally through 2019, while looser monetary policy and stabilization in the economy in H2 2019 plays out. As such, we believe this means now is an excellent time to position in China fixed income assets.

In addition we expect the RMB to strengthen as demand for RMB assets grows.

In fact, we are already seeing this play out, with a massive increase in Northbound flows on Stock Connect in Q1 2019, and we're expecting to see strong levels through 2019.

5. What do you mean when you say index inclusion is a process and what does it mean for investors?

We expect other index providers, like FTSE Russell and JP Morgan, will also bring China into their global bond aggregates, which will also force investors to follow their benchmarks by upping their China allocations.

Also, Bloomberg is only bringing in part of the China bond market into the Bloomberg Barclays Global Aggregate. When the other categories, like corporate debt, qualify there will be a larger degree of inclusion than what we are seeing now.

That's what we mean when we say index inclusion is a process. Bloomberg's inclusion is one step in this process, there are others to come and investors need to be prepared.

6. What's your outlook for China in 2019?

We're expecting China's economy to stabilize in H2 2019 or an L-shaped recovery which is a supportive backdrop for Chinese bonds.

The government applied explicit policy support in late-2018 and early 2019 and that will likely take six-to-nine months to show up in the official government figures, which means we're really just expecting this has put a base under the economy for now.

At the March 2019 National People's Congress meeting the party for the first time said credit growth wouldn't be higher than inflation plus real GDP, which implies there is little room to lift lending beyond current levels.

Total social financing (TSF), is already around 10%. Don't expect a credit expansion bonanza like 2015-2016 to save the world.

7. Are there any other impacts of this global capital rebalancing?

In the future we see three currency blocs. China's equity and debt markets are going to be so large, and Asia Pacific trade so interlinked and dependent on the Chinese economy, that we'll have a RMB-denominated currency bloc with China at the centre of it, as well as a Euro dominated bloc and a USD dominated bloc, which we have today.

8. How does UBS-AM see index inclusion as an opportunity?

We are already seeing a shift in global capital to China and the index inclusion processes we discussed before are only going to accelerate that.

We have been building our onshore capacity in China to prepare for this, as well as developing the knowhow and products to meet investors' needs for China exposure.

So we see index inclusion as a massive opportunity and we've been preparing for it for years.

9. You say China government bonds are becoming a safe haven asset, why?

China government bonds are starting to behave exactly the way you would expect safe haven assets to during times of heightened volatility.

During historic spikes in the widely-used Volatility Index (VIX), yields on China government bonds yield drop, indicating that investors increasingly look at the asset class as a safe haven.

And there are two principal reasons for this:

- **China is a net creditor country:** with current account surpluses and foreign exchange reserves of close to USD 3 trillion[4], China has an exceptionally strong external position. Furthermore, China's level of government debt as a % of GDP (65.1%) is far lower than the 116.9% in the US, and 235.4% in Japan[5].

- **China government bonds offer attractive yields and low correlation**: at the time of writing, China government bonds offer a real yield pick-up of between 80-200bps[6] compared with similar assets in US, Japan, German, and UK. Additionally, China government bonds have low correlation ranging between 0.03 and 0.23 against other major global aggregate benchmarks.

And we see three specific trends that will bolster the position of China government bonds as safe haven assets in the future, namely:

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[4] Bloomberg, January 2019
[5] IMF World Economic Outlook, October 2018
[6] Bloomberg. Real yields based on Core CPI. As of end December 2018 from data available February 2019. Assets compared are 10-year government bonds issued by the respective governments.

- **Ongoing reforms and improving accessibility**: we've seen tax exemptions and the introduction of block trading in the past 12 months, and we expect further moves from the Chinese government like widening the Bond Connect system to continue opening up the onshore market to international investors.

- **The process of index inclusion:** Bloomberg's inclusion of Chinese bonds is, we believe, the start of a process through which over index providers, like FTSE Russell and JP Morgan, bring onshore bonds into their indices, with China government bonds likely being only the first bond class to be included.

- **The rise of the RMB as a reserve currency**: Though the USD is a dominant reserve currency, a number of trends are playing out that will boost the RMB as an alternative. Specifically, the closer integration of Chinese onshore markets with the global financial system, the process of index inclusion, the growing role of RMB-denominated oil payments, and the rise of CHAPS as an alternative to the USD-dominated SWIFT payment system.

So with these trends in mind, plus compelling fundamentals, we believe that China government bonds may continue to emerge as a go-to, safe-haven asset, and that's something that all investors should be aware of.

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