CHINA JOINS THE GLOBAL AGGREGATE: A PRACTICAL GUIDE FOR INVESTORS

China will join a major global fixed-income benchmark on April 1, 2019, when Bloomberg adds renminbi-denominated government and policy bank bonds to the Bloomberg Barclays Global Aggregate Bond Index. The company has said it will phase in 363 securities over a 20-month period. When the phase-in is complete, Chinese bonds will account for just over 6% of the $54.07 trillion index, based on data as of January 24, 2019.

Index inclusion is a milestone for China and its efforts to open its capital markets, boost demand for its currency and attract overseas investment. It also represents a pivotal change for global bond markets and an opportunity for global investors, who will have greater access to the world's third-largest government bond market.

We have been investing in China's fixed-income markets since 2011. But that makes us a minority among foreign investors. Despite rapid growth in the size of China's bond market over the last decade, foreign investors have remained bit players. According to Chinese financial data provider Wind, foreign institutional investors held just 4% of the broad market (excluding money-market instruments) as of December 31, 2018 (*Display 1*).

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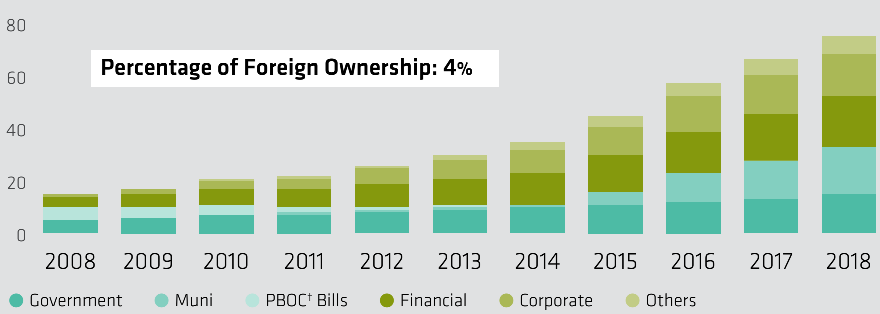
DISPLAY 1: DESPITE RAPID GROWTH, CHINESE BONDS STILL OFF GLOBAL INVESTORS' RADAR

Annual Market-Size Trend*; RMB, Trillion



***** Excludes money-market instruments
† PBOC: People's Bank of China
As of December 31, 2018
Source: Wind and AB

That's about to change. China's inclusion in the Bloomberg Barclays Global Aggregate will effectively redraw the world map of fixed-income investment. Our research suggests that the move will trigger a wave of portfolio reallocation totaling about $110 billion and bring a new class of investor to China's $11 trillion (RMB75 trillion) onshore bond market.

Global bond investors will soon have to decide whether they will continue to use the Global Aggregate as a benchmark or adopt the Global Aggregate ex-China. And they will have to take several practical steps no matter which decision they make.

This FAQ flyer is intended to provide guidance as you make your decision. It answers the most common questions we receive about the benefits and risks of investing in China, the effects of Chinese index inclusion on the global bond market and whether to hedge out Chinese-currency exposure. We'll also address tax implications, questions about trading systems and other operational considerations.

WHICH BENCHMARK SHOULD I USE—THE GLOBAL AGGREGATE OR THE GLOBAL AGGREGATE EX-CHINA?

We encourage investors who use the Global Aggregate as a benchmark not to exclude Chinese bonds, which offer attractive diversification benefits (for more on the advantages, see question 4). Once fully integrated into the index, local-currency Chinese bonds will be the fourth-largest index component, following debt denominated in the US dollar, euro and yen.

Investment managers who want to vary the size of their allocation to China over time can still take an underweight position when China appears less attractive and shift to an overweight when exposure to Chinese bonds is more attractive. And there's nothing to prevent a manager from shifting to a 0% exposure.

But we think it's important to maintain the ability to invest in China when it's desirable to do so. For example, Chinese government bonds were among the world's best performers in 2018 in renminbi terms. Unless subject to specific investment guidelines that prohibit China exposure, we think investors should think twice before deciding to limit themselves to a global index that excludes the bond market of the world's second-largest economy. Even if China were not about to enter the Global Aggregate, we would recommend that active investors consider investing in Chinese fixed-income because it is an attractive potential source of alpha and diversification.

WHAT ARE THE IMPLICATIONS FOR MARKET LIQUIDITY? WHAT TYPES OF FOREIGNERS WILL INVEST AND HOW WILL THEY BEHAVE?

Though it's the third largest in the world as measured by debt outstanding, China's government bond market isn't as liquid as other large markets in the US or Japan. Until recently it's been dominated by Chinese banks that are required to buy and hold government bonds for a range of regulatory reasons. Foreign investment over the last year was strong and now accounts for about 8% of the government bond market. But a large share of existing foreign investors are central banks and sovereign wealth funds that invest primarily to diversify their currency reserves. This has kept secondary market turnover low.

Chinese index inclusion will change that. The entrance of a wide variety of institutional investors, including insurance companies and global asset managers, will alter the market's ownership structure by introducing more diversity. That should improve overall liquidity, as different types of investors will hold bonds for different reasons and periods of time, creating more trading volume. Active asset managers, who often make tactical allocations, will create liquidity by the very nature of how they invest.

CHINA'S INCLUSION IN THE GLOBAL AGGREGATE WILL EFFECTIVELY REDRAW THE WORLD MAP OF FIXED-INCOME INVESTMENT.

We'd also add that it's not just the arrival of the foreign investor that will increase market turnover. The domestic ownership structure of the market is rapidly changing, too. While banks are still the largest holders, the arrival of insurance companies, local asset managers and securities houses is likely to affect market development. We see this as more evidence that China's financial markets are becoming deeper and more sophisticated.

The flow of capital into China's market will come at the expense of other major government bond markets in the index, including those in the US, Europe, the UK and Japan. But we do not expect this to have a material effect on liquidity or near-term performance in these markets. Nevertheless, there may be some impact in smaller markets, particularly those within Asia. For example, foreign investors may reduce the size of their allocations to bond markets in South Korea, Malaysia, Australia and Thailand, to name a few.

Will there be periods of illiquidity in certain segments of the Chinese government bond market? Probably. For instance, we expect foreign investors to favor recently issued on-the-run bonds, making these assets much more liquid than older and off-the-run issues. This could present challenges for investors trying to match the benchmark.

Investors planning to enter China's bond market will also have to consider transaction costs. The standard size of a block trade on China's government bond interbank bond market is 10 million renminbi, or about $1.5 million. Foreign investors that wish to buy and sell in smaller parcel sizes would likely be subject to higher transaction costs. If those costs make it harder for them to trade, they could periodically reduce overall market liquidity. We would expect these costs to come down as volumes and participation pick up.

More foreign portfolio investment may also increase currency volatility because investors are likely to adjust overall exposure to the onshore Chinese market more frequently than their domestic counterparts.

HOW MEANINGFUL IS CURRENCY RISK? SHOULD INVESTORS HEDGE OUT THE RENMINBI OR NOT?

Investors who already hedge their global bond portfolios can continue to do so when it comes to the renminbi. But the cost of hedging in China can be hard to predict. This is because the implied forward rate—what investors pay to hedge out their renminbi exposure—is more volatile in China than in more developed markets. While investors shouldn't change their approach to hedging, they should factor in the potential for higher costs.

THE COST OF HEDGING IN CHINA CAN BE HARD TO PREDICT.

Another thing to keep in mind: for now, foreign investors must hedge their onshore renminbi exposure with their custodian or settlement agency bank. This, too, can drive up costs; other markets allow foreign investors to use multiple counterparties, which allows them to shop around for the best forward rate. We don't consider this an insurmountable obstacle, but it's one investors should be aware of.

Investors may choose to hedge their currency exposure in the offshore currency—or CNH—market, which China created in 2010 to promote international use of the renminbi. However, this market is smaller and less liquid than the onshore one, and the implied forward rates in the two markets sometimes diverge. While active investors may be able to take advantage of this, it can expose those who are trying to match an index denominated in the onshore renminbi to basis risk.

As with any type of currency, some investors may wish to take small amounts of opportunistic exposure to the renminbi. Beyond the willingness to assume the currency risk, there are no impediments to doing so.

DISPLAY 2: THE RISK-REDUCING POTENTIAL OF CHINESE GOVERNMENT BONDS
Monthly Returns, January 1, 2005–December 31, 2018 (Percent)

Historical analyses do not guarantee future results.
Risk-off includes monthly data from the following periods during which S&P 500 Index returns were negative: November 2007 to February 2009, May 2010 to August 2010, June 2011 to September 2011, June 2015 to September 2015, December 2015 to February 2016, August 2016 to October 2016, February 2018 to March 2018, and October 2018 to December 2018. Global Treasury is represented by Bloomberg/Bloomberg Barclays Global Treasury Index (hedged to USD), China Government Bonds are represented by Bloomberg/Bloomberg Barclays China Treasury Index (hedged to USD).
As of December 31, 2018
Source: Bloomberg and AB

US DOLLAR–HEDGED CHINESE BONDS HAVE HISTORICALLY DELIVERED SUPERIOR RISK-ADJUSTED RETURNS DURING RISK-OFF PERIODS.

WHAT ARE THE BENEFITS OF INVESTING IN CHINA?

Chinese government bonds currently offer investors relatively high nominal and real yields. They can also help to diversify economic and interest-rate risk and reduce overall portfolio volatility. This is largely because China's large pool of domestic savings and its status as a net creditor country give its government bonds defensive characteristics that can cushion investment portfolios in times of market and economic stress and provide protection against equity sell-offs. Consider 2018: slower Chinese growth weakened the equity market but government bonds were strong performers.

We have witnessed this behavior across market cycles. As *Display 2* illustrates, an allocation to US dollar–hedged Chinese bonds between 2005 and 2018 would have delivered superior risk-adjusted returns during risk-off periods.

This suggests that investors who diversify their global exposure by allocating some of their assets to China bonds may improve overall risk-adjusted returns.

WHAT ARE THE OPERATIONAL CONSIDERATIONS FOR INVESTORS?

Let's start with taxes. At present, foreign investors enjoy a three-year exemption from value-added and withholding taxes on all onshore bonds, including policy bank bonds. These securities, particularly those issued by the State Development Bank of China, tend to be more liquid than Chinese government bonds, and the tax exemption makes them attractive to foreigners because they typically offer higher yields to compensate local investors, who are subject to taxation. However, it's unclear what will happen when this tax waiver expires, making this an outstanding issue that the government will have to address.

Investors should also familiarize themselves with China's many different trading systems. China is the only large market that has multiple routes investors can use to gain access, and there are pros and cons for all of them. The administration and processing of transaction costs associated with the China–Hong Kong Bond Connect scheme, for instance, are an issue, though we expect this to be resolved as participation increases. Meanwhile, investors who use the China Interbank Bond Market Direct program must appoint a settlement agent, who forms part of a tri-party agreement with the investor and their custodian bank. This adds a layer of operational complexity.

Which system to use will depend largely on investor type, priorities and objectives. At AB, we will use multiple routes to access the market, depending on individual client needs and requirements. We recommend that investors contact their investment manager or custodian bank to discuss what best suits their needs.

SUMMING IT UP

Operational issues aside, the inclusion of Chinese government bonds in the Global Aggregate is a historic opportunity for global investors. Chinese bonds offer relatively high yields (nominal and real), and attractive diversification benefits. And index inclusion gives global investors an easier way to access the world's third-largest government bond market and second-largest economy.

Accordingly, we encourage investors to benchmark against the full Global Aggregate—including China. Over time, as market access improves, investors will increasingly view China as an essential investment destination alongside the US, Europe, Japan and other developed markets. In the meantime, we encourage readers to contact us directly if they have additional questions about either making the decision to include China or the practical steps required to do so.

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