SEI New ways. New answers.®

China's Local Bond Market Goes Global

DECEMBER 2020

Hardeep Khangura, CFA
Portfolio Manager

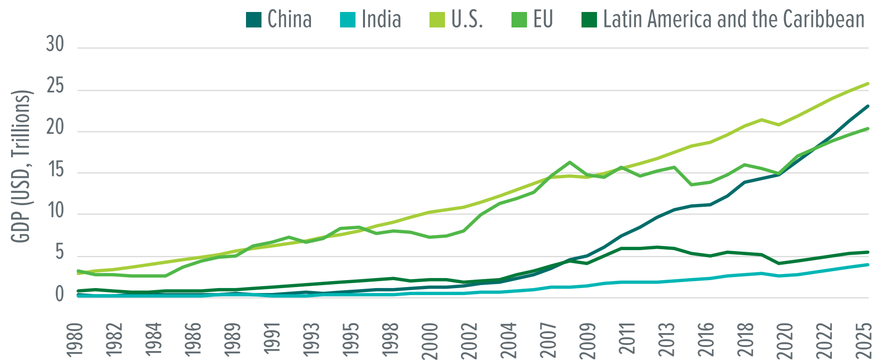
James Brandolini, Analyst
Portfolio Management Team

Snapshot

- China has (not so) quietly become the second-largest public bond market in the world[1], behind only the U.S., and it continues to grow at a rapid pace.
- Although accessing onshore Chinese government and corporate debt still remains operationally burdensome, barriers have been reduced through the adoption of globally recognized trading practices.
- With renminbi-denominated bonds already being phased in to major benchmark indexes, now is a good time to take a closer look at the Chinese bond market, why it has become more popular lately, and how it might affect global bond indexes moving forward.

China has made a rapid ascent to become one of the largest global economies as measured by gross domestic product (GDP). The country is forecast to surpass the size of the entire European Union in 2020 or 2021, and to reduce the gap between itself and the U.S. to $2 trillion by 2025 given China's higher growth rates. While classified as an emerging economy, its size eclipses any other emerging market and most regions.

Exhibit 1: Rapid Growth in China



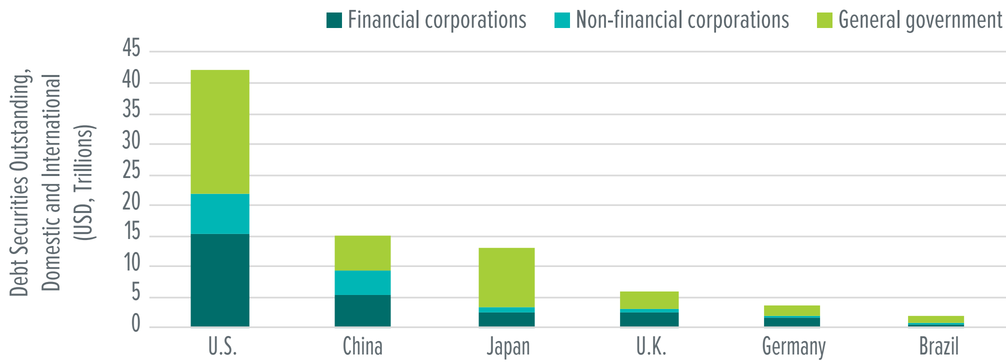
Source: International Monetary Fund (IMF). Data as of 12/31/2019. IMF forecasts for 2020-2024.

China's debt market is around $15 trillion, slightly less than one-third of the size of the debt market in the U.S. More than $13 trillion of public Chinese debt securities are onshore, issued in the local currency. Despite the market's large size, however, local-currency-denominated Chinese bonds have only recently seen a significant increase in foreign ownership and begun to be included in major global bond indexes. It is this large onshore market that has been historically difficult to access.

[1]Source: Bloomberg

Exhibit 2 charts the value of domestic (local currency) and international (hard currency) outstanding debt.

Exhibit 2: Significant Onshore Market



Source: Bank of International Settlements. Data as of 3/31/2020.

It is noteworthy that the size of outstanding debt in China equates to about the size of the entire Chinese economy. Debt sustainability must be discussed from a multitude of angles, although the size of debt relative to the size of the Chinese economy is not concerning by itself. At the issuer level, pockets across corporate and state-owned sectors will have varying challenges and tailwinds, presenting opportunities where we believe active management will likely be best suited.

Accessing the local market

Operating under a quota system, investors have historically had to apply for the ability to trade Chinese debt as a Qualified Foreign Institutional Investor or RMB Qualified Foreign Institutional Investor. The Chinese government's 1997 introduction of the China Interbank Bond Market (which required commercial banks to move bond trading to an electronic trading system) and the 2017 launch of Bond Connect (a platform that enables investors from China to trade in foreign bond markets and enables foreign investors to access China's bond market) avoid several of the operational barriers, remove the quota limits and improve access to liquidity for trading onshore Chinese fixed-income instruments.

Bond Connect brings a greater alignment for best trading practices typically required by foreign investors. Block trading, which was already available to onshore foreign investors, became accessible to offshore foreign investors in 2018[2]. The Chinese government also removed a 20% repatriation cap and canceled its three-month lock-up period in 2018[3]. In 2019, a less frequent auction schedule for new benchmark bonds (important for ease of inclusion to bond indexes) was adopted, and Irish regulators approved access to Bond Connect for UCITS funds[4]. The lifting of these restrictions has improved the transparency and liquidity of the onshore bond market, subsequently attracting the confidence of major index providers to begin including them in their benchmarks. The primary indexes commonly used as bond portfolio benchmarks are shown in Exhibit 3.

[2]Source: www.chinabondconnect.com/en/Newsroom/News-Release/Launches-Block-Trade-Allocations.html
[3]Source: www.citibank.com/mss/docs/China-Roadshow-deck.pdf
[4]Source: www.chinabondconnect.com/en/Data/Flash-Report/Flash-Report-March-2019.html

Exhibit 3: Index Inclusion

Benchmark provider	JP Morgan	FTSE Russell	Bloomberg Barclays
Index	Government Bond Index–Emerging Markets Global Diversified (GBI-EM GD) (emerging local debt)	World Government Bond Index (global governments)	Global Aggregate Bond Index (corporates, securitized and governments)
Index inclusion date	February 2020	October 2021 (subject to final review March 2021)	April 2019
Methodology for inclusion	Phase in at 1% per month; inclusion was paused for one month in March 2020	12-month phasing; implementation details expected March 2021	20-month phase-in
Final weight/Current weight	10% / 8%	6% / 0%	6% / 5.5%

Source: JP Morgan, FTSE Russell, Bloomberg Barclays. Current weights as of 10/31/2020.

The first major benchmark to include Chinese local-currency bonds was the Bloomberg Barclays Global Aggregate Index, which began a 20-month phased inclusion of government and policy bank securities in April 2019. It was originally projected that Chinese securities would represent around 6% of the more than $54 trillion index[5]; and appeared to be heading toward that level as of October 31, 2020, with a weight of 5.5%. The phase-in is scheduled to be complete at the end of November.

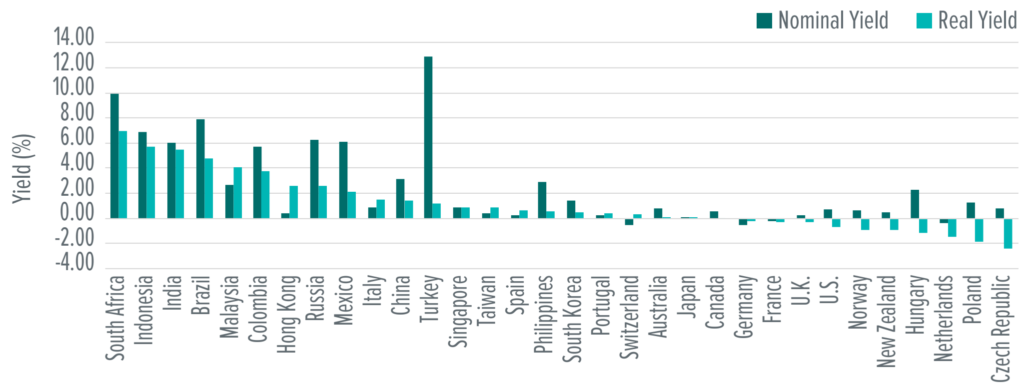
JP Morgan began adding Chinese government bonds to its indexes—including the GBI-EM GD index, which SEI uses as a benchmark for its local-currency emerging-market debt sub-advisors in our SIT and SIIT Emerging Market Debt Funds—in a 10-month phased inclusion beginning February 2020. Bonds entering the GBI-EM GD index were originally expected to have an average yield of 3.13% and average duration of 5.19 years as of October 31, 2020[6]. Inclusion was projected to lower the index yield by 18 basis points but have no material impact on duration[7]. At full implementation by the end of 2020, China will represent 10% of the index's market weight and give the Asia region the largest share of the total index.

Chinese government bonds

Chinese government bonds have seen a reduction in nominal yield as global bond yields have fallen. The reported yield at the end of September 2020 remained notably more positive at 3.16%[8], compared to near-zero nominal yields for the majority of developed-market government bonds. We also compare the inflation-adjusted yield, known as real yield. Chinese government bonds remained marginally positive, sitting broadly in the middle of classic emerging markets and G7 countries[9]. This means China's inclusion in mainstream FTSE Russell and Bloomberg Barclays indexes should likely lift the benchmark yields higher, while it should simultaneously decrease reported yields on emerging-market indexes.

[5] Source: Bloomberg
[6] Source: JP Morgan
[7] Source: JP Morgan
[8] Source: Bloomberg
[9] The Group of Seven (G7) is an intergovernmental organization made up of the U.S., U.K., Japan, Canada, France, Germany and Italy.

Exhibit 4: Nominal Yields vs Real 10-Year Yields



Source: FactSet. Data uses 10-year nominal government bond yield less reported CPI as of 9/30/2020.

Portfolio impact

Local Chinese bonds have exhibited a low correlation with major risk asset classes such as other locally-denominated emerging-market bonds, USD-denominated emerging-market bonds, global developed-market bonds, global developed-market equities, and global emerging-market equities. This low correlation is partially explained by China's growth and inflation dynamics being driven primarily by domestic factors, whereas smaller emerging-market countries can be more influenced by global trends.

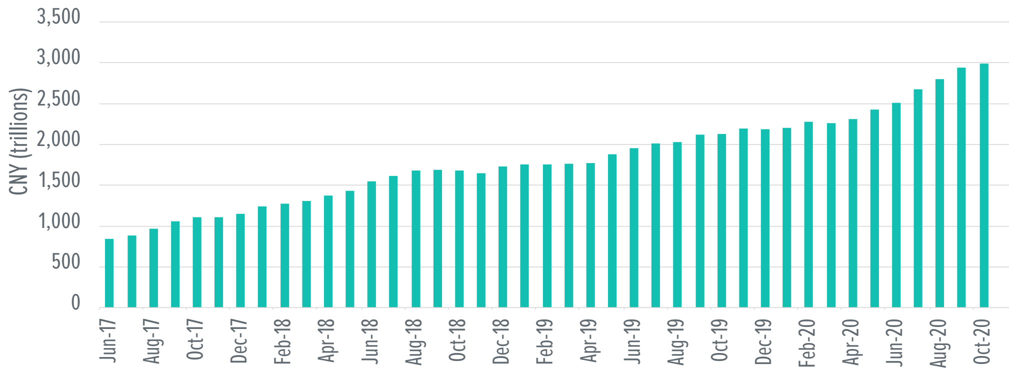
These properties of Chinese government bonds mean they typically behave as a diversifying asset to global fixed-income portfolios. The correlation matrix in Exhibit 5 looks at a 10-year history for several mainstream bond indexes. We have included the Bloomberg Barclays Treasury and Policy Bank Bond Index reported in USD, unhedged, as well as local-currency CNY. The latter removes the currency risk and effectively looks at interest-rate volatility. Whether analyzing the currency component within a portfolio, or looking purely at rates, we can observe that a global investor will acquire an asset that diversifies from the current allocation.

Exhibit 5: Diversification is Important

	Bloomberg Barclays Global Aggregate Bond Index (USD, unhedged)	Bloomberg Barclays Global Government Bond Index (USD, unhedged)	Bloomberg Barclays EM Local Currency Government Index (USD, unhedged)	Bloomberg Barclays US Treasury Index (USD)	Bloomberg Barclays China Treasury + Policy Bank Bond Index (USD, unhedged)	Bloomberg Barclays China Treasury + Policy Bank Bond Index (CNY)
Bloomberg Barclays Global Aggregate Bond Index (USD, unhedged)	1.00					
Bloomberg Barclays Global Government Bond Index (USD, unhedged)	0.97	1.00				
Bloomberg Barclays EM Local Currency Government Index (USD, unhedged)	0.69	0.57	1.00			
Bloomberg Barclays US Treasury Index (USD)	0.42	0.51	-0.07	1.00		
Bloomberg Barclays China Treasury + Policy Bank Bond Index (USD, unhedged)	0.30	0.26	0.34	0.05	1.00	
Bloomberg Barclays China Treasury + Policy Bank Bond Index (CNY)	0.06	0.08	0.01	0.25	0.49	1.00

Source: Bloomberg Barclays. Data spans 1/1/2010 to 10/31/2020.

Exhibit 6: Foreign Ownership of Onshore ¥ Bonds



Source: Bond Connect, China Central Depository & Clearing, Shanghai Clearing House. Data as of 10/31/2020.

Closing thoughts

The exposure to currency fluctuations will be a significant driver of returns in onshore government bonds and present risks for a long-term investor. The CNY is managed by state-owned banks on behalf of the People's Bank of China. Given possible government intervention, the CNY is less likely to freely adjust to a long-term fair value; thus, the cost to hedging this exposure may be unrewarded.

The quality of reported data has also historically been poor in comparison to that available for developed-market investors and presents a possible challenge to onshore investments in China. SEI funds will take long and short views on the currency depending on such factors as the competitiveness of the economy at a given time.

Onshore Chinese debt now qualifies for inclusion in many mainstream indexes, after having improved the standards for trading local securities. As one of the largest economies in the world, this opens up a public fixed-income market in excess of $15 trillion to overseas investors. Here at SEI, we are operationally ready to trade onshore Chinese bonds within the SIT and SIIT Emerging Market Debt Funds and are prepared to utilize this growing bond market as it continues to develop.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice.

Index returns are for illustrative purposes only and do not represent actual investment performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Investing involves risk including possible loss of principal. Diversification may not protect against market risk. Bonds and bond funds will decrease in value as interest rates rise. International investments involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. There is no guarantee any strategy discussed will be successful.

For those SEI products which employ a multi-manager structure, SEI Investments Management Corporation (SIMC) is responsible for overseeing the sub-advisers and recommending their hiring, termination, and replacement. References to specific securities, if any, are provided solely to illustrate SIMC's investment advisory services and do not constitute an offer or recommendation to buy, sell or hold such securities.

SEI Investments Management Corporation (SIMC) is the adviser to the SEI Funds, which are distributed by SIMC's affiliate, SEI Investments Distribution Co. (SIDCO). SIMC and SIDCO are wholly owned subsidiaries of SEI Investments Company (SEI).

Certain economic and market information contained herein has been obtained from published sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such sources are believed to be reliable, neither SEI nor its subsidiaries assumes any responsibility for the accuracy or completeness of such information and such information has not been independently verified by SEI.

To determine if the Fund is an appropriate investment for you, carefully consider the investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Fund's summary and full prospectuses, which may be obtained by calling 1-800-DIAL-SEI. Read it carefully before investing.