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Talking Point

Offshore RMB bond market: where to from here?

Angus Hui, Fund Manager, Fixed Income

With strong growth in the newly-developing offshore renminbi (RMB) bond market over the past 18 months driven largely by expectations for RMB currency appreciation, what is the investment proposition for offshore RMB bonds as near-term expectations of currency appreciation fall?

Our RMB currency view

In July 2005, the Chinese authorities announced a one-step revaluation of the USD/RMB exchange rate of 2%. Since that time, the RMB has appreciated 24% (~4% per annum). The currency has also exhibited very low volatility during periods of financial market stress. After a period of strong currency appreciation against the US dollar following the July 2005 currency reform, the market's near-term expectation for RMB appreciation has somewhat reduced in recent months. This reflects China's more balanced trade positions, and suggestions by Chinese central bank officials that the RMB is no longer significantly undervalued. Premier Wen's comments that the RMB is now close to the "equilibrium level", was interpreted that the trend of RMB appreciation has run its course.

From a policy development perspective, a gradual capital account liberalisation suggests that policy makers in China are now more confident to introduce more two-way fluctuations in the RMB, which is a key milestone for RMB internationalisation. In the medium-to-longer term standpoints, one of the ultimate objectives of RMB internationalisation is to have a free floating currency. However, this does not mean the RMB will no longer appreciate from the current level.

> "With ultra-loose monetary policies in most developed markets, offshore RMB bonds offer a combination of attractive yield and low volatility for investors who want to diversify away from US dollar assets, which are likely to suffer from a structural declining trend."

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From a cyclical standpoint, the slowdown of Chinese economies and lower inflation expectations suggests that the pace of RMB appreciation against the US dollar should slow down. Having said that, a persistent depreciation is unlikely in our view as this undermines efforts to internationalise the currency. While we do not think that adjustments of RMB exchange rates could help in addressing the US-China trade imbalance, political pressure from the US is still an important consideration, especially during an election year, so it is still unrealistic to expect significant depreciation of the currency. This makes the RMB currency an interesting proposition for international investors. While the US dollar has been quite strong recently, the RMB still makes sense for Asian investors who may be less certain about the outlook of their own currencies against the US dollar. In this environment, RMB could outperform other currencies in the region while offering an attractive reward versus risk trade-off given its lower volatility.

Over the longer term, the RMB should continue to experience an appreciation trend and we expect it to continue as a strong currency, as structural fiscal concerns in most major developed markets remain a long term concern. Capital tends to go to where growth is stronger and fiscal balances more robust. With China's healthy fiscal position, the RMB offers investors, such as reserve managers and institutional investors, an alternative source of value. A stronger currency would also be conducive to China's structural changes in the medium term by encouraging growth in consumption, which is critical to address structural imbalances in China, as well as to help contain inflationary pressures.

What does this mean for the offshore RMB bond market?

Looking from the perspective of the offshore RMB bond market, a reduced expectation for RMB appreciation is a healthy development. Expectation of a continued appreciation in the RMB was one of the key reasons that the "dim-sum bond market" took-off in 2010. With investors factoring in a high expectation of currency appreciation, they were willing to accept a lower yield level as a result. One and a half years into the significant reform of this market, internationalisation has made good progress with a significant increase of RMB liquidity outside of mainland China, and the market now offers an active platform for bond issuers to raise capital. With much more balanced supply and demand, valuation in the RMB market has become more attractive. Investors are no longer investing in the offshore bond market simply because of the currency appreciation potential.

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Furthermore, we have been encouraged to see that new issuances have performed fairly well recently despite the weakening expectation for RMB appreciation. The average yield in the non-government bond sector is around 4.5%, which is relatively attractive given a low interest rate environment across most markets globally. On top of this, the

RMB offers additional potential returns from the potential currency appreciation with much lower downside risk than many other currencies.

With investors becoming increasingly confident that this market will continue to grow, we have seen increasing structural demand for offshore RMB bonds from institutional and private investors:

- ***Pension funds***: An offshore RMB Bond Fund makes sense for retirement scheme investors in Hong Kong as a store of value given the Hong Kong economy is becoming increasingly correlated to the Chinese economies. RMB bonds also generally offer better yield pick-up than Hong Kong dollar bonds.

- ***Institutional investors***: Many view RMB bonds as an alternative fixed income asset class to diversify away from developed markets. Similar to the development of other markets, institutional demand generally increases as the size of the market expands.

- ***Asian bond investors****:* Offshore RMB credits are now a key component of Asian credit markets, which offer diversification and value-adding opportunities from the traditional Asian USD credit market. As an example, allocations to offshore RMB bonds across our pan-Asian bond portfolios have increased over the past 12 months along with the developments and opportunities in the offshore RMB bond market.

- ***Global investors****:* As interest from good quality and well-known issuers from around the world seek to tap this market, we will gradually see a broadening of the investor base for this asset class, outside of Asia.

Market outlook and strategy

In terms of the near term outlook, we expect strong support in offshore RMB bonds over the next few months for the following reasons:

- China's economic trend is an important driver. Recent economic data continued to point towards weakening and soft-landing, rather than hard-landing risks in China. As we see more evidence of soft-landing in China, we expect further support to offshore RMB credits.

- Overall, supply concerns have lowered as easing monetary policy in China and rising yields in the offshore market have somewhat reduced Chinese corporates' incentives to issue bonds in the offshore market.

In terms of sector allocation, we prefer quasi-sovereigns to government sectors, reflecting a significant pick-up of spread, steep yield curve and limited supply from quasi-sovereign issuers. In the investment grade corporate space, many solid state-owned enterprises, that enjoy good support from the government, are trading at over 200bps above the government yield, offering good investment value. A few high quality multi-national issuers also offer value, especially via the primary market with strong support from investors in the US and Europe. For some of the recent European CNH corporate bond transactions, we have seen more than 40% placed outside the region. In the high yield sector there have been some selective short-dated high yield opportunities, which offer diversification benefits to the Asian high yield corporate markets that are typically denominated in US dollar.

Conclusions

RMB internationalisation will be a key theme for the years to come, offering a serious avenue for offshore investors to invest in China's growing fixed income market. As the market continues to develop, it is encouraging to see that demand for offshore RMB bonds is no longer primarily driven by expectations for currency appreciation. With ultra-loose monetary policies in most developed markets, offshore RMB bonds offer a combination of attractive yield and low volatility for investors who want to diversify away from US dollar assets, which are likely to suffer from a structural declining trend.

Schroder Investment Management (Hong Kong) Limited
Suites 3301, Level 33, Two Pacific Place, 88 Queensway, Hong Kong
Telephone +852 2521 1633 Fax +852 2524 7225