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WILL BLOOMBERG'S INDEX BECOME THE FIRST PROVIDER TO INCLUDE CHINESE BONDS?

Bond Inclusion

In our publication "Will Investors be ready when Chinese bonds go global?" last October we raised the expectation that Chinese bonds could become eligible for inclusion in major bond indices. In March 2018, Bloomberg announced a conditional decision to include Chinese bonds in its flagship bond index: Bloomberg Barclays Global Aggregate, starting from April 2019. The index provider also intends to include China in the Global Treasury and the EM Local Currency Government Index.

At the start, it will only add government and policy bank bonds, which currently represent 45% of the universe. Bloomberg will phase-in the Chinese securities over a 20-month period starting from April 2019. After this, the bonds should represent 5.5% of the index. The phase-in will be conducted in 5% steps, adding 27.5 bps index weight every month. To fund the inclusion, other bond markets like the U.S., Eurozone and Japan will see reductions. The index weight of USD-denominated bonds will see the biggest decrease, dropping by more than 2%.

Bloomberg's inclusion criteria consist of an Investment Grade rating, a freely tradable, convertible as well as hedgeable currency, and freedom from capital controls. However, some additional enhancements still have to be delivered to see the index provider finally going ahead with Chinese bonds.

Issues Remain

Bond Connect, the scheme under which eligible institutional investors in Hong Kong and abroad can buy bonds without quotas and an onshore custody setup, has to implement a delivery versus payment (DVP) settlement procedure. Furthermore, a trader must be able to allocate block trades across portfolios and clarification on tax collection policies is still needed. It is expected that the implementation of DVP as well as block trades will happen over the summer. The tax matter is still awaiting an answer from the tax bureau.

Some index providers are more reluctant than Bloomberg to include Renminbi-denominated securities in their major indices. They haven't been included in the JPM Emerging Market Bond Index yet, despite being on review for inclusion since 2016. When this happens, it will give Chinese bonds a weight of 35% in the uncapped index version and 10% in the capped index version.

FTSE Russell's (previously, Citigroup) World Government Bond Index (WGBI) is more likely to start including Chinese bonds, as a resolution of the tax issues is not an inclusion criterion and as China has exempted its treasury bonds from taxes for all investors. Therefore, only the DVP and the block trading issues need to be addressed in the WGBI's case. Considering this, one cannot rule out that the FTSE Russell team races ahead of Bloomberg as soon as these two issues are resolved, as they do not have to wait for the tax clarification, unlike Bloomberg.

However, not every asset owner will be comfortable with investments in China. Therefore Bloomberg will also provide indices excluding Renminbi bonds and cap exposure. Areas where investors feel uncomfortable are market liquidity, transparency and financial disclosure, as well as a lack of international credit ratings. Nevertheless, some major investment banks estimate that the index changes could lead to inflows between $250 billion to $286 billion.

Given China's higher growth prospects and bond yields compared with other G7 nations, its bond market is hard to ignore. In addition, the offshore market has experienced only low volatility compared with other markets as well as low correlation, which makes Chinese bonds a good diversifier for global bond portfolios.

Asia-Centric Managers

Nonetheless, question marks remain on the research capabilities of the buy-side. A lot of asset managers have yet to build up expertise in this field, as they were historically more focused on developed markets. The latter gives an advantage to Asia-centric asset managers, which already have deep expertise in this part of the world. This is particularly important during a challenging period, as China has to weather the current disputes in global trade relationships as well as continue its efforts to change its economic model and further open up its market.

Given the pros and cons of investing in the Chinese onshore market, next year will be very interesting to see how investors will adapt to the changing index universe. In the event that initial interest to take exposure is limited, we still expect Chinese bonds to become an important market segment within the global bond universe over time.

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