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Asia's International Bond Market: China

China's rapid industrialization and impressive economic growth have been accompanied by an increased appetite for international bonds[1] issued by Chinese companies eager to tap global capital markets. As debt instruments from China account for a growing percentage of international bond indices, established analytical data points and methods such as Option Adjusted Spread ("OAS"), Credit Default Swaps ("CDS") and CDS Bond Basis are increasingly relevant to assess the risk-return profile of Chinese bonds.

China emerges as the dominant Asian issuer outside of Japan

Data from the Bank of International Settlements ("BIS") shows that the International Bond Market has been growing steadily since the 2008 financial crisis. COVID did not dent this upward trajectory, with the market growing at a compound annual growth rate ("CAGR") of 2.8% between 2007 and 2020 to reach close to USD27 trillion at the end of 2020.

While growth in the mature markets of Europe and America was marginal, Asia – especially with Mainland China and Hong Kong SAR recording CAGR of 19.5% and 15% respectively – delivered much of the headline growth as shown below:

International Bond Market Outstanding from 2007 to 2020[2]

International Bond Market In billions of US dollars	2007	2009	2011	2013	2015	2017	2019	2020	14-Year CAGR
UK	3,143	3,683	3,442	3,408	3,001	3,118	3,234	3,334	0.4%
US	2,537	2,530	2,164	2,063	2,260	2,411	2,345	2,438	-0.3%
Netherlands	1,570	1,866	1,946	2,152	1,794	2,053	2,080	2,304	2.8%
Germany	1,442	1,352	1,343	1,347	1,109	1,263	1,258	1,362	-0.4%
France	1,195	1,508	1,626	1,677	1,370	1,499	1,405	1,515	1.7%
Mainland China, Hong Kong SAR	**70**	**73**	**117**	**209**	**303**	**462**	**542**	**588**	**16.4%**
Australia	458	514	545	623	582	606	589	565	1.5%
Japan	164	167	174	201	253	390	476	510	8.4%
Korea	105	122	148	177	173	181	214	220	5.4%
Singapore	55	51	64	106	110	144	182	186	9.1%
Others	7,656	8,956	9,340	10,615	9,949	11,358	12,477	13,916	4.4%
Global Total	18,396	20,823	20,909	22,580	20,907	23,489	24,829	26,970	2.8%
Hong Kong SAR	*51*	*52*	*92*	*163*	*220*	*293*	*341*	*359*	*15.0%*
Mainland China	*19*	*21*	*25*	*46*	*83*	*169*	*201*	*229*	*19.5%*

[1]As per the BIS, International debt securities (IDS) are securities issued outside the local market of the country where the borrower resides. They include issues conventionally known as eurobonds and foreign bonds but exclude negotiable loans. IDS statistics are compiled from a security-by-security database built by the BIS, using information provided by commercial data providers. Amounts are presented at face value. https://www.bis.org/statistics/about_securities_stats.htm?m=6%7C33%7C638

[2] See https://stats.bis.org/statx/srs/table/c1?p=20204&c= and https://www.bis.org/statistics/about_securities_stats.htm?m=6%7C33%7C638. Ordered by 2020 outstanding market size and by two categories: top developed markets and APAC markets.

Thus, while mature markets remain the largest issuers in absolute amounts, the combined size of Mainland China and Hong Kong SAR rose more than eightfold from US$70 bln in 2007 to US$ 588 bln in 2020. The aggregate size of international debt issued by Mainland China and Hong Kong SAR has now surpassed Australia and Japan, making it the largest issuing territory in Asia Pacific.

The popularity of Mainland China and Hong Kong SAR international bonds is reflected in their increasing weight across all major indices. Designed to reflect the fundamental features of a given market, indices are an ideal proxy to assess both the impact and liquidity of their underlying constituents. Data from iBoxx – an investment solution widely used by investment banks, ETF issuers, buy-side investment firms and third-party vendors to benchmark portfolio performance and risk globally – provides a powerful illustration of how Mainland China and Hong Kong SAR have transformed the Asian bond landscape: representing 28% of the iBoxx USD Asia ex-Japan indices in 2007, bonds from Mainland China and Hong Kong SAR made up 64% of the index in 2021 as illustrated below.

iBoxx USD Asia ex Japan – top Asian bond market weightage evolution from 2007 to 2021[3]

Country of Risk	2007	2009	2011	2013	2015	2017	2019	2020	2021
Mainland China	12%	12%	18%	27%	40%	50%	56%	56%	55%
Hong Kong SAR	16%	16%	13%	12%	10%	8%	8%	8%	9%
Korea	31%	35%	27%	22%	16%	14%	10%	9%	10%
India	7%	6%	9%	10%	10%	8%	7%	7%	7%
Indonesia	6%	6%	9%	8%	7%	7%	6%	6%	6%
Singapore	12%	11%	5%	5%	4%	3%	3%	3%	3%
Philippines	1%	2%	6%	4%	3%	2%	3%	4%	3%

The growth of Asia's debt market enables deeper data analysis

The increase in size, diversity, quality and tenor of Asian international bonds provide investors with the data needed to better assess Asian bonds across key risk and return metrics. Given the additional uncertainty caused by COVID, investors increasingly rely on innovative data solutions and datasets to identify market signals that can help inform investment decisions, maintain portfolio flexibility and preserve liquidity. Already widely used in developed markets, data driven tools like OAS and CDS spread analysis are increasingly applicable to Asia's debt instruments and indices too.

<u>Check the Spread for a Macro Overview</u>

For the better part of a decade-long bull run in the bond market, investors sought to compensate for a low interest rate environment by increasing allocations to high yield (HY) instruments in a desperate chase for yields across global markets, a trend evidenced by credit spread compression prevailing across markets (credit spread compression indicates investors' willingness to take ever higher risk in exchange for increasingly marginal yield gains).

Using the OAS of different iBoxx USD indices to compare Asia with its global peers, it seems that Asia debt has seen less spread compression and therefore perhaps provides more room for compression today, especially in the HY segment. This suggests that Asian high yield bonds denominated in US$ – including those from Mainland China – may be priced more conservatively than global peers, a trend also apparent for investment grade Asian debt instruments denominated in US$.

Focusing on the iBoxx USD Asia ex-Japan Corporates High Yield versus iBoxx USD Liquid High Yield[4], we assessed the impact of spread compression in the high-yield space over 3 periods: 2015-2019, COVID 2020-to July 2021, and June-July 2021.

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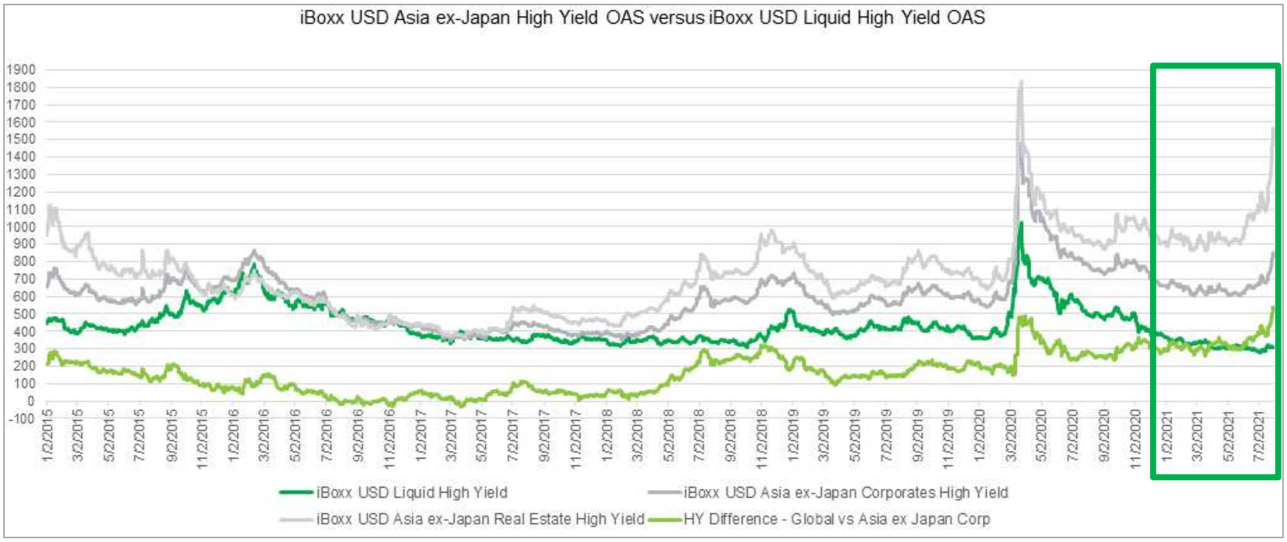
[3] It is important to note the difference in allocating bonds to markets – BIS uses the borrowers' place of incorporation whereas iBoxx uses the "country of risk" approach. BIS HK issuance includes bonds issued by HK subsidiaries of Mainland China issuers, that are classified as Mainland China issuance under iBoxx's "country of risk" approach.

[4] We have used iBoxx USD Liquid High Yield index to represent USD Global Corporate universe as North America and EMEA corporates accounted for more than 90% of the index constituents.

iBoxx USD Asia ex Japan – OAS Average

Period/OAS Average	iBoxx USD Liquid High Yield	iBoxx USD Asia ex-Japan Corporates HY	iBoxx USD Asia ex-Japan Real Estate HY	Δ OAS USD Asia ex-Japan - USD LQ High Yield
2015 - 2019	429	547	634	118
2020 - July 2021	450	755	984	305
June - July 2021	299	691	1141	391



The instruments in the iBoxx USD Liquid High Yield index were very volatile during the COVID 2020-to-July 2021 period, as the index recorded both its highest point (1025bps) and its lowest level (281bps) since 2015. Spread compression, ongoing since March 2020 from the height of the COVID risk, gradually resulted in a lower OAS of 299bps for the June-July 2021 period. By contrast, the spread of iBoxx USD Asia ex-Japan High Yield consistently remained at the high end, moving within the 650-850bps range for the recent June-July 2021 period, compared with an average OAS of 500-600bps pre-COVID.

Interestingly, the spread differences of iBoxx USD Asia ex-Japan Corporate High Yield index and iBoxx USD Liquid High Yield index currently exceeds the iBoxx USD Liquid High Yield index OAS, which stood at 536bps as of 31 July 2021. This could be due to Asia lagging the spread compression seen in US and Global peers or may reflect investors' beliefs that Asian debt instruments warrant a higher spread because they are fundamentally riskier.

What may explain such differences?

Sage Patel, Head of Pricing, Valuations and Reference Data, Asia Pacific at IHS Markit says, "Market signals like these might prompt investors to investigate macro-related attributes or perform additional idiosyncratic analysis on specific issuers."

From a macro perspective, the performance of certain sectors may have a disproportionate impact on a particular index. For example, the upward trend in spread of iBoxx USD Asia ex-Japan Corporate High Yield index recorded since early June – with average OAS standing at 691bps for the June-July 2021 period – may be partly attributed to the fact that real estate firms accounted for more than 50% of the constituents of the index as of June 2021, a view supported by the upwards trending spread of the iBoxx USD Asia ex-Japan Real Estate High Yield index over the same period, with its OAS standing above 1000bps. Following comments from China's housing ministry in July that the country was aiming to clean up irregularities in China's property sector within three years, the OAS for iBoxx USD Asia ex-Japan Real Estate High Yield index (90% of its constituents are Mainland Chinese real estate companies) spiked at 1565bps as of 31 July 2021 (for comparison the COVID high was 1834bps). By contrast, the two largest sectors of the iBoxx USD Liquid High Yield index – Oil & Gas and Industrial Goods & Services – accounted for 29% of the index as of June 2021, while real estate issuers only comprised 4% of the index.

Try CDS for Assessing the Credit Risk of Companies

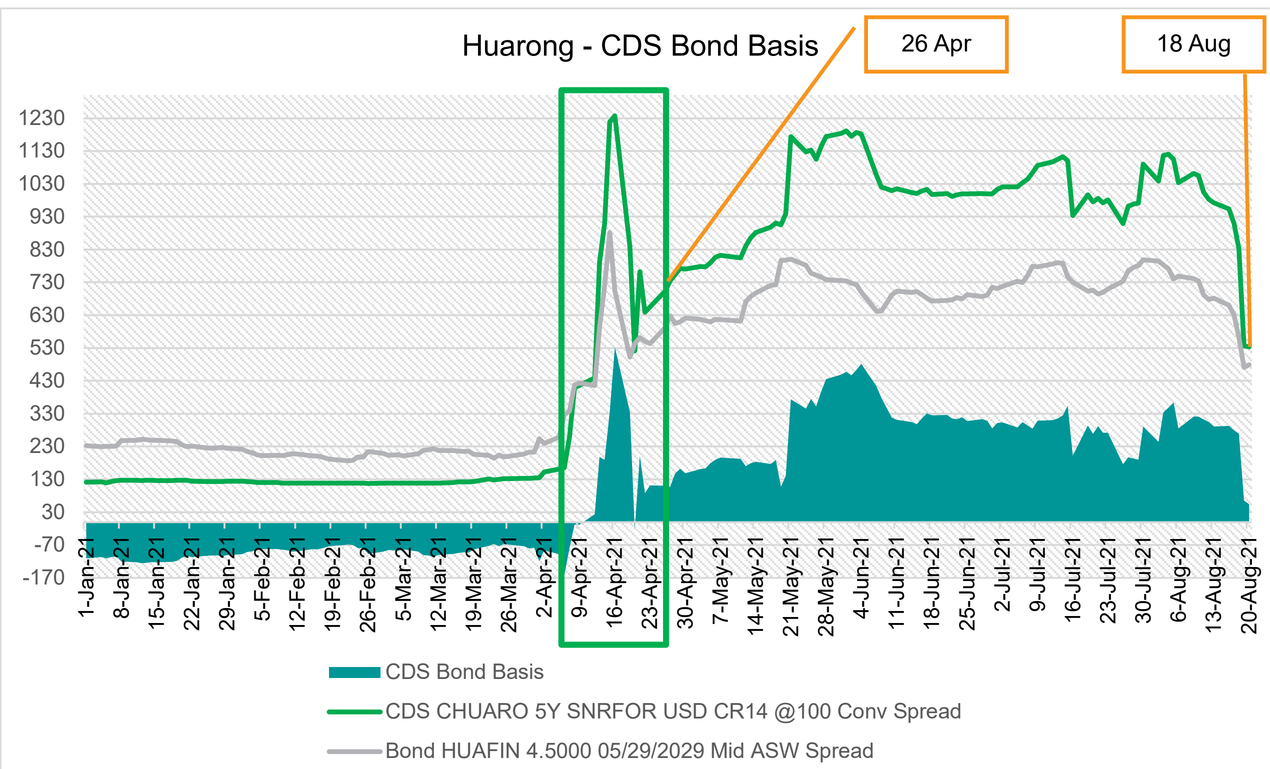
Patel says, “Data from CDS has become an effective tool to explore idiosyncratic behavior, with CDS Bond Basis emerging as a key market indicator for performing credit risk assessment as well as an instrument to inform trading strategies.”

CDS pricing performance coupled with bond pricing movement can generate new insights on credit risk. While analysts remain divided, differences in CDS and bond movements occurring before the credit of an issuer deteriorates may be attributed to investors that are hedging or speculating on certain securities. Since CDS Bond Basis – calculated as CDS spread minus Bond spread on instruments of similar maturity and risk issued by the same firm – tend to be negative (as Bond spreads incorporate components such as inflation expectation, liquidity and credit premium while CDS mostly reflect credit risk), a positive CDS Bond Basis may emerge after some investors react to soft credit events, adverse news or restructuring rumors about an issuer.

Comparing Bond/CDS spreads can be particularly revealing when major market or corporate events are unfolding. We can look at two recent examples for context: China Huarong and Tencent.

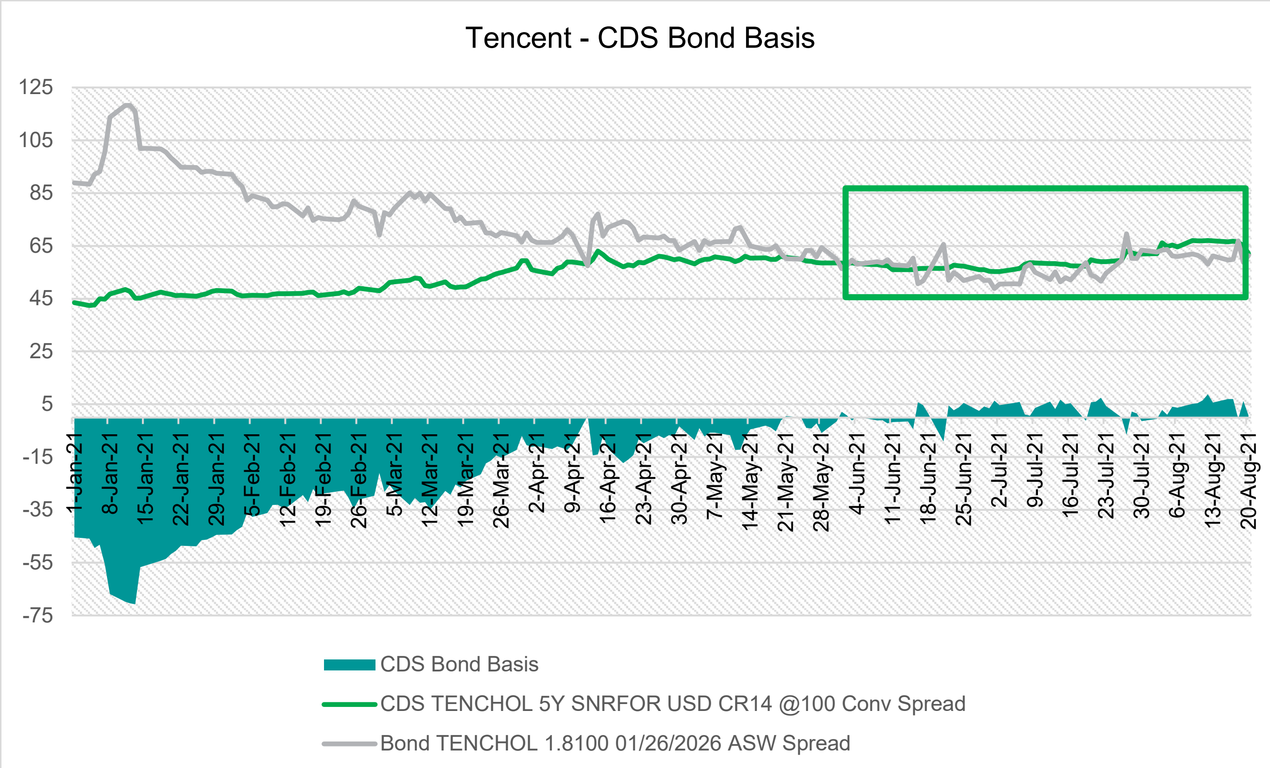
Huarong’s wild ride

On April 26, asset manager Huarong’s rating was downgraded by Fitch, a move followed by Moodys’ on April 29. Even before the downgrade occurred, there was already a clear spike in the company’s CDS, causing large movements in the average monthly CDS Bond Basis on Huarong instruments, which went from negative 90bps as of April 9 before turning positive to an average monthly CDS Bond Basis of 170bps. Huarong’s CDS Bond Basis stayed positive around 270-300bps over much of July and August and reduced significant to just over 50bps as of August 20, following the announcement made on August 18 that the company would be bailed-out by government-backed institutional investors. Interestingly, the downward trend for both CDS and bond credit spread began in early August, before the official bailout announcement.



Keeping up with Tencent

Movements in the spread of Tencent – a major tech company from Mainland China – illustrates how the market reacted to perceived changes in the credit risk of the company and how data can provide actionable signals to investors. In the chart below, the green rectangular period highlights a positive CDS Bond Basis resulting from unusual movements in the bonds and CDS of Tencent. These swings were most likely triggered by adverse news about Mainland China’s technology sector in general as well as speculations that the video gaming segment in particular, in which Tencent is a major player, might be next in line for a regulatory crackdown. The opposite trend between bond and CDS might also be worth exploring, particularly during the period of March to April 2021.



Conclusion

As the economic weight of Asia continues to grow, Asian issuers increasingly turn to the international markets to attract global investors in search of better yield. Over the last decade, Mainland China and Hong Kong SAR have emerged as the dominant force in Asia's debt market outside Japan across metrics like index weight and international bond issuance.

Based on credit spread from bond indices, Asian international bonds appear to be lagging their global peers and may have room for further spread compression. This also suggests investors may be pricing Asian debt instruments more conservatively, perhaps because Asian bonds are seen as inherently riskier. In any event, the region's deepening CDS markets increasingly generate the data needed to identify insightful market signals that could further inform investment decisions. Already used in markets like the US and Europe, CDS Bond Basis trading strategies may also prove suitable in Asia as liquidity improves further.

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