EXPERT VIEWPOINT

Enter the Dragon

Renminbi bonds give portfolios unprecedented access to China

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China's once-closed capital markets are gradually opening up, as the world's second-largest economy courts foreign investors. A big part of this process has been the introduction of the offshore Renminbi bond. Also known as "dim-sum bonds," they are denominated in the Chinese currency and available to non-Chinese investors. For those eager to gain access to China, offshore Renminbi bonds represent a good way to invest in a market that is set to become one of the most important in the world. To provide more insights into this exciting new space, we spoke with Geoffrey Lunt, Senior Asian Fixed Income Product Specialist with HSBC Global Asset Management, who tells us why he thinks Canadian plan sponsors should consider Renminbi bonds as a source of diversification as well as a key entry point to gain exposure to an increasingly important global currency.

When did the so-called "dim-sum bonds" first appear and what was the Chinese government's motivation for opening its bond market to international investors?

The offshore Renminbi bond market began in earnest in the second half of 2010, when certain legislation made it both feasible and desirable for institutions to issue in Renminbi through the Hong Kong market. In order for the Renminbi to become a prominent global currency, it has to eventually become a major reserve, trading and investment currency. The establishment of the offshore market has enabled global issuers and investors to become comfortable with the concept of issuing and investing in Renminbi, while enjoying Hong Kong's developed market standards. Eventually, we believe that the Renminbi bond market will become one of the most important in the world and that the development of the offshore market is an important step along that road.

How does China's fixed-income market differ from that of other emerging markets?

China's bond markets are split between an onshore market, which isn't yet readily accessible to many foreign investors, and an offshore market based mainly in Hong Kong. The offshore market is, for now at least, mainly a credit market. It has also attracted issuance from major institutions across the globe, giving it an international flavour, which is unique among emerging markets.

How has the Chinese bond market performed?

The offshore market was heavily in demand in its early days because international investors were very keen to gain access to the Renminbi, which previously had been very difficult or impossible. This meant that yields fell to very low levels and didn't accurately represent the credit risks investors were taking on. Since then, yields have risen substantially and the offshore market has become much more fairly priced. In fact, today we believe it represents good value compared to other fixed-income markets.

Is Renminbi fixed income a good opportunity for Canadian plan sponsors?

For pension funds looking for diversification, yes, this market should be attractive. At the moment it is a high-quality, low-duration, decently yielding market

International Reserves

	Country	Current (USD bn)	% of world
	US	148	2%
€	Eurozone	813	9%
	Japan	1,295	14%
	China	3,181	34%

Source: IMF, ECB, MoF Japan, PBoC December 31, 2011, IMF World Economic database as of April 30, 2012.

in a currency that has the potential for long-term appreciation. On top of this, the market is likely to develop into one of the most important in the world over the coming years.

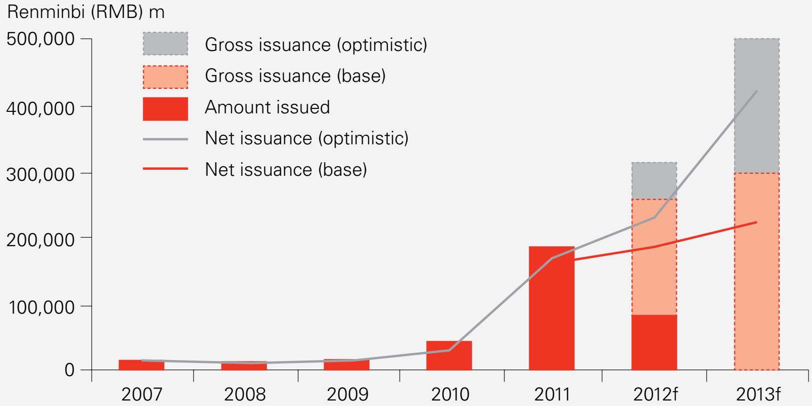
What are the risks involved in investing in Renminbi fixed income?

The broad risks in terms of duration, credit and currency are similar to those that investors face in other bond markets. However, the political dimension is always important when investing in Chinese assets. The offshore bond market and the opening up of the capital markets is a political project. Although we strongly believe that the political sponsorship of these reforms will continue, there are risks associated with this.

What about China's slowing growth?

The slowdown in Chinese growth will inevitably have some impact on the market, although we are not expecting a very stressful scenario for the Chinese economy. As such, most Chinese credits are strong enough to survive a modest slowdown. Slower growth has probably also contributed to the slightly weaker Renminbi-U.S. dollar exchange rate in recent months, although risk aversion during the eurozone debt crisis has made the U.S. dollar appreciate against most currencies.

Offshore RMB Bond Issuance



Source: HSBC Markets Inc. as of April 30, 2012.

Emerging-markets fixed income is on the radar of many plan sponsors in North America – how do Renminbi bonds fit in a pension fund's asset allocation?

Adding emerging-market debt to a plan's strategic allocation is a positive first step to capturing some of the yield and growth potential in emerging markets, though exposure to offshore Renminbi bonds may typically only represent a minor portion of that allocation given the current size of the offshore Renminbi bond market (US$58.8 billion[1], or less than 1% of the total emerging-market bond market). However, for larger plans, the diversification and potential offered by this market warrants attention. Over time, it seems very likely that all types of global investors will at least have to consider some form of allocation.

Where do you see the Chinese market evolving in the future – is there further room to open up to international investors?

Absolutely. The onshore Chinese bond market is becoming available to an increasing number of global investors and it seems inevitable that this momentum will continue. China is embarking on a period of financial liberalization on many fronts, including exchange rate and interest rate policy. The bond market is an important piece of the jigsaw puzzle and more freedom of access will greatly promote the goal of full convertibility of the currency and the opening of the capital account. We believe Chinese Renminbi bonds, and exposure to the Renminbi currency, will very likely become a key asset class in the years to come.

[1] HSBC Research, August 9, 2012

For more information on Renminbi fixed-income investing, contact us at institutionalteam@hsbc.ca or call 1-888-390-3333.