RWR ADVISORY GROUP

The Risk Exposure of U.S. Investors Holding Chinese Sovereign Bonds

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Introduction

On October 14, 2020, China's Ministry of Finance sought to raise $6 billion through the issuance of U.S. dollar-denominated sovereign bonds in Hong Kong. The debt offering – which was oversubscribed by 4.7 times the size of the original amount – attracted $27.2 billion in orders. Lead underwriters in the sale reportedly consisted of thirteen international and Chinese banks, including: Bank of America Securities, Deutsche Bank, Citigroup, and units of JPMorgan Chase and Goldman Sachs, alongside Chinese lenders including Bank of China, China Construction Bank, and China International Capital Corporation (CICC).[1] This offering marked China's fourth sale of dollar-denominated sovereign bonds since 2017, when the country returned to selling offshore debt with a $2 billion offering in Hong Kong after a 13-year hiatus.

Background

China has issued five foreign currency-denominated bond offerings since reinstating its offshore debt sales in 2017, four of them in dollars. China's $2 billion dollar-denominated offering in 2017, reported on at the time by RWR, was oversubscribed to $10 billion and was led by the following international and Chinese domestic lead managers or "bookrunners": Citigroup, Bank of China, Bank of Communications, Agricultural Bank of China, China Construction Bank, CICC, Deutsche Bank, HSBC, ICBC, and Standard Chartered Bank.[2]

[1] https://www.wsj.com/articles/china-raises-6-billion-in-dollar-bond-sale-11602739658
[2] https://www.cnbc.com/2017/10/25/chinas-first-dollar-denominated-state-bonds-in-over-a-decade-have-already-booked-10-billion.html

In 2018, a $3 billion dollar-denominated offering, which was oversubscribed to $13 billion, was led by a similar group of international and Chinese bookrunners, including: JPMorgan Chase, Goldman Sachs, Deutsche Bank AG, Credit Agricole Corporate & Investment Bank, HSBC, Standard Chartered, and Bank of China.[3] The 2019 $6 billion offering, which ultimately attracted $20 billion in orders, was led by Bank of America Securities, Goldman Sachs, JP Morgan, Bank of China, Bank of Communications, China Construction Bank, China International Capital Corporation, Credit Agricole, CTBC Bank, Deutsche Bank, HSBC, Mizuho Securities, and Standard Chartered Bank.[4] Finally, a Eurobond offering in 2019 – China's first in fifteen years – of €4 billion ($4.45 billion), was oversubscribed to €20 billion.

China's most recent successful offering demonstrates a continued upward trend in demand during a period of near-zero to negative returns on most sovereign bonds, led by the typical combination of Chinese domestic and international banks, with the notable exception of HSBC. Its exclusion from the lead manager group is widely suspected to be retaliation by Beijing for the bank's role in the U.S. investigation of Huawei Technologies, as well as its delay in expressing support for the enactment of the National Security Law in Hong Kong.[5]

U.S. Investor Exposure

When considering Chinese sovereign bond issuances in offshore markets, it is useful to remember the underlying fundamentals of a bond offering: it is basically offering an IOU from Beijing (with a maturity date and interest rate) in exchange for cash that is made available to the country's government for its discretionary use. As China is ruled by the Chinese Communist Party (CCP), these debt instruments could be colloquially described as "CCP Bonds."

Despite the political and reputational risk exposure associated with the CCP, foreign access to Chinese sovereign bonds has increased markedly since 2017, as Beijing seeks to establish a dollar yield curve – a piece of financial infrastructure that helps to ensure a stronger market for its future

[3] https://www.wsj.com/articles/china-aiming-to-borrow-as-cheaply-as-apple-and-microsoft-launches-u-s-dollar-debt-offering-1539231229
[4] https://www.wsj.com/articles/china-readies-big-dollar-bond-sale-11574769337
[5] https://www.business-standard.com/article/international/hsbc-holdings-is-left-off-first-china-dollar-bond-deal-since-2017-120101400079_1.html#:~:text=HSBC%20Holdings%20Plc%20was%20left,big%20annual%20deals%20in%202017.&text=A%20Hong%20Kong%2Dbased%20spokesman,comment%20on%20any%20specific%20deals.

offshore debt sales. This strategy likely enjoys high priority among Chinese leadership, despite it being a more muted issue with the CCP. The sharply increased credit exposure of a sizable portion of American individual and institutional investors has the additional benefit to Beijing of creating an ever-growing vested financial interest on the part of tens of millions of American holders of Chinese bonds and equities – a kind of vast *"China Capital Markets Lobby."* This introduces the potential for quickly mobilizing opposition among these investors to U.S. government actions against Beijing (e.g., sanctions and other penalties) that could well be viewed as damaging the value of their investment portfolios.[6]

This recent issuance of October 14 marked the first time in almost 25 years that Chinese dollar-denominated bonds were sold in both the 144a format (which allows foreign debt to be sold to U.S. investors) and in the Regulation-S format, a regulatory framework (read: loophole) for international debt offerings that carries limited disclosure requirements. The Chinese government had not issued dollar bonds in the 144a format since 1996.[7] Prior to the introduction of 144a and Regulation-S bond offerings, Chinese sovereign debt was sold to Americans on secondary markets of the U.S. via pension funds, mutual funds, Exchange-Traded Funds and other investment vehicles.

This combined offering format not only significantly expands China's investor base for this bond sale, but it also opens direct access by Beijing to the undisciplined cash of American retail and institutional investors. This was also the first time that China's Ministry of Finance has marketed sovereign debt offerings directly to U.S. institutional investors, as opposed to using institutional intermediaries. This strategy is likely intended to pave the way for a number of similar sovereign CCP bond issuances in the period ahead.

Chinese dollar-denominated bond offerings have clearly met with strong demand from U.S. investors, who reportedly accounted for $4.2 billion, or about 15% of the latest sale, including nearly half (47%) of the 30-year bond offering, at some $235 million alone.[8] According to China's

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[6] https://www.rwradvisory.com/chinas-return-to-u-s-bond-market-exposes-lack-of-security-minded-diligence/
[7] https://www.wsj.com/articles/china-raises-6-billion-in-dollar-bond-sale-11602739658
[8] https://www.reuters.com/article/us-china-bonds-dollar/china-raises-6-billion-as-u-s-investors-look-past-political-tensions-idUSKBN270183

central bank, "International investment in China's bond markets has surged at an average annual rate of nearly 40% in the past three years."[9]

Rising Popularity of China's Bond Market Among Foreign Investors

The popularity of Chinese dollar bonds among foreign investors has risen in recent years, particularly relative to its onshore RMB bond market, due to favorable yield differentials between the two.[10] This trend is expected to continue given the bonds' yield performance in 2020 relative to falling global yield curves. These curves dipped into low and even negative territory due to aggressive monetary policy by many central banks in response to the coronavirus pandemic.[11]

Executives of major banks and asset managers, including Société Générale SA and UBS Asset Management, have expressed confidence in the high yield and relative stability of China's financial markets. Stephanie Monier, the Chief Investment Officer at Switzerland-based Lombard Odier, told the *Wall Street Journal* that the private banking group views China as a "safe haven for government bond issues" and have recently increased holdings of Chinese sovereign bonds, which now comprise between 2% and 3% of "several multibillion-dollar portfolios."[12]

The value of dollar-denominated corporate bond issuances by Chinese companies has been on an even steeper incline, reportedly growing to $700 billion since the establishment of a Bond Connect program in 2017 that allows international investors quota-free access to China's onshore bond market through Hong Kong. This number, however, represents only a small portion of China's $10.3 trillion bond market, $6.6 trillion of which is RMB-denominated sovereign debt.[13]

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[9] https://news.cgtn.com/news/2020-09-25/China-to-be-added-to-FTSE-global-bond-benchmark-in-2021-U46AQUGplm/index.html
[10] https://www.invesco.com/apac/en/institutional/insights/china/asias-us-dollar-bond-market-a-new-asset-class.html
[11] https://www.alliancebernstein.com/library/chinas-higher-bond-yields-buck-the-global-trend.htm
[12] https://www.wsj.com/articles/investors-find-new-safe-place-to-hide-chinese-bonds-11594632600
[13] https://www.seafarerfunds.com/commentary/the-evolution-of-chinas-bond-market/

Potential Sources of Controversy

Despite the formidable national security, human rights and fiduciary risks inherent in funding the projects and purposes of the CCP – including, for example, the construction and/or equipping of prison camps and elaborate surveillance networks being used to oppress the populations of Xinjiang and Tibet, the militarizing of Beijing's illegal islands in the South China Sea, the funding of nuclear ICBMs and SLBMs targeting American cities and other advanced PLA weapons systems – China has faced little, if any, push-back with regard to its sale of U.S. dollar-denominated bonds in international markets, including in the United States. As these and other areas of disagreement and conflict gain in prominence, however, the market's dismissive attitude toward them could change.

On a more technical note, there is also potential for controversy in the fundamental differences in methodology underpinning China's bond market rating system, compared to internationally established standards. China's bond market rating system, which relies mostly on domestic rating firms (including Chinese subsidiaries of S&P and Fitch), has been found to award triple-A ratings on an unjustified, outsized basis. Triple-A ratings are reserved in many other countries for only the strongest established debt issuers.[14] The skewed ratings scale, which has consistently upgraded ratings on the debt of state-owned enterprises and those controlled by local governments, opens Beijing up to accusations that the Chinese government is manipulating the debt market as a tool to finance CCP and government spending.[15]

It should also be noted that some in the Trump Administration are examining the issue of China's pre-WW II defaulted sovereign debt from the then-Republic of China that the British received payment on in 1987, but that remain unpaid to the U.S. holders of these same bonds. Senate and House Resolutions have been introduced on this issue (Senate Concurrent Resolution 43) on behalf of some 20,000 American families that are bondholders who argue persuasively that the successor government doctrine applies concerning these sovereign debt obligations.[16] This matter could become a source of controversy, especially with the continued

[14] https://www.wsj.com/articles/off-the-scale-s-ps-china-ratings-plan-risks-too-many-triple-as-1536232943
[15] https://www.wsj.com/articles/more-corporate-bonds-are-rated-triple-a-in-china-despite-coronavirus-pandemic-11603272614

[16] https://www.mcsally.senate.gov/imo/media/doc/Final%20McSally%20China%20Debt%20Resolution.pdf

issuance of PRC sovereign bonds and their inclusion in the fixed-income investment portfolios of tens of millions of unwitting American retail investors.

Index Inclusion and Bond Market Internationalization

Chinese debt has been added to key bond indexes over the past year, beginning with the Bloomberg Barclays Global Aggregate Bond Index (BGAI) in April 2019 and JP Morgan Chase's Government Bond Index-Emerging Markets Global Diversified Index (GBI-EM) in February 2020. FTSE Russell's World Government Bond Index (WGBI) is expected to follow suit in October 2021.[17]

- China's RMB-denominated government and policy bank securities were added to the Bloomberg Barclays Global Aggregate Bond Index on April 1, 2019, in a move that was estimated to have steered about $120 billion into China's onshore bond market, according to Deutsche Bank strategists.[18] The inclusion of 363 Chinese securities represents 6.03% of the $54.07 trillion index (the amount of total bond issuances outstanding).[19]

- JP Morgan began including Chinese sovereign debt in its dollar-denominated Government Bond Index Emerging Markets (GBI-EM) family of indexes in February 2020. The inclusion period for the nine eligible Chinese bonds will end in December of this year. With the addition of three bonds from the latest tranche, the GBI-EM Diversified Index, which has $202 billion benchmarked against it, will be weighted 10% to China and direct billions of dollars into China's bond market.[20]

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[17] https://www.wsj.com/articles/chinas-huge-bond-market-is-coming-to-an-etf-near-you-soon-11553428802; https://www.wsj.com/articles/jpmorgan-to-add-china-to-bond-indexes-11567590569; https://news.cgtn.com/news/2020-09-25/China-to-be-added-to-FTSE-global-bond-benchmark-in-2021-U46AQUGplm/index.html

[18] https://www.caixinglobal.com/2019-04-03/bloomberg-begins-adding-china-bonds-to-its-global-index-101400289.html

[19] https://www.bloomberg.com/company/press/bloomberg-confirms-china-inclusion-bloomberg-barclays-global-aggregate-indices/

[20] https://www.nasdaq.com/articles/jpmorgan-to-add-china-bonds-to-gbi-em-indexes-from-february-2020-2019-09-04-0

- FTSE Russell became the latest major index provider to announce its intention to include China bonds (one year after deciding against such inclusion) when it announced on September 24, 2020 that it plans to add Chinese government debt to its flagship World Government Bond Index beginning in October of next year.[21] The addition of Chinese debt to the benchmark may add as much as $170 billion to China's bond market by the end of 2022, according to a Standard Chartered Bank estimate.[22]

[21] https://www.bloomberg.com/news/articles/2019-09-26/ftse-russell-demurs-on-adding-china-bonds-to-flagship-index
[22] https://www.yicaiglobal.com/news/ftse-russell-postpones-decision-on-china-bond-inclusion-till-next-march-