Supersized value pocket

Market Insight

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China's onshore bond market is the third largest in the world, behind only the US and Japan. Having been tantalisingly difficult for international buyers to trade historically, new access routes create a supersized value opportunity. Index diversification and a quality primary issuance pool await investors seeking alpha off the beaten track.

We have seen emerging markets (EM) established themselves as prosperous hunting grounds for investors looking to go off the beaten track in search of growth and value. Careful navigation has always been essential as EM slowly transition from young economies into well-governed investable markets, enduring challenges and turbulence along the way.

As globalisation increases, investors must continually think ahead in an effort to find rewarding opportunities. Among the most successful have been those able to identify pockets of value in EM in order to generate alpha – outperforming the base return of the relevant benchmark index. These pockets might typically comprise of timely holdings in individual sectors or companies, unexploited by the masses for reasons ranging from a lack of analyst coverage to geopolitical nervousness: promising EM pockets can easily be overlooked or misunderstood.

Supersized value pocket

Somewhat ironically, we foresee the latest 'pocket' of EM value for fixed income investors in the form of a 9.5 million square kilometre landmass with a population of 1.4 billion and an economy worth USD 10 trillion: China has greatly improve the accessibility of its onshore bond market to international investors and we believe the alpha generation potential is vast for those who can gain access.

While China has been an EM investment hub for years, made famous to equity investors by Jim O'Neill's 'BRICS' acronym, for those in the fixed income markets, access has largely been via the offshore, Hong-Kong-based bond market, due to the onerous nature of gaining onshore access. The colloquially known offshore *'dim sum'* market is small (approximately USD 123 billion across some 200 issuers) compared to its onshore equivalent, but historically has been the dominant international access route to Chinese debt.

In looming contrast, the onshore market – officially known as the China Interbank Bond Market (CIBM) – is the third-biggest bond market in the world, behind only the US and Japan. Valued at around USD 7.5 trillion – the equivalent of the rest of the emerging market bond universe combined – its 3,000 or so issuers (according to Moody's estimates) were almost exclusively traded by domestic Chinese investors until February 2016, when China took significant steps forward in opening up its mainland bond market to international buyers

Such a vast market, which enjoys high liquidity and relative currency stability, inherently holds untapped value due to its scope, but the real alpha opportunity is the diversification potential away from bond market index constituents.

As both EM and global bond indices largely make up their China component through offshore market issues, investors with onshore access have the chance to build their allocations with off-benchmark names, increasing diversification within their portfolios.

Finding alpha off-piste

What makes the opening of the onshore market so appealing to us is the potential for active investors to build their exposure to Chinese debt through issues not commonly held or featuring in global benchmarks. We believe this deviation away from the main indices is the key to return generation. When onshore issuers deliver, the return is pure alpha.

With only around 1.3% of the CIBM currently held by foreign investors, we feel the opportunity set is ripe. While ownership will likely grow now that the market is fully open, access is license-dependant, naturally controlling the flow of players in the marketplace. Other barriers to entry, including limited analyst coverage, credit risk and Mandarin being an unfamiliar language to most European investors, make it most palatable to specialist fixed income professionals.

The network effect

For those who can crack the language barrier, the brokerage relationship with local banks may prove as valuable as holding the securities themselves. On-the-ground research is a key component of rigorous active management, with a direct line of communication to analysts and brokers at local banks broadening and strengthening market understanding.

While capacity is not a concern, those set to benefit most are the investors who establish their positions while the opportunity set remains niche. Here at BlueBay, we are one of very few global investment managers to be granted a trading license, meaning we can offer our clients exposure to what in our view is an untapped opportunity set. We are actively looking for attractive potential onshore opportunities as allocation alternatives to offshore exposures.

While this is new territory for the international community, it does not come with the usual raft of new EM teething problems. The liquidity profile of the onshore market is better than its offshore counter thanks to its huge breadth of issuers, offering both government and corporate issues. Issuance is typically high quality and many of the names that we follow in the offshore format are also onshore listed: to us, this is a win win scenario.

First bite at the pie

Primary issuance – new debt – uptake by international buyers has been modest in the offshore market, primarily due to geographic constraints. While available to all, marketing efforts by issuing companies typically target Hong-Kong and Singapore, meaning those in the West tend to come across issues closer to their release dates, leaving little time to conduct thorough credit research. While timing constraints remain the same for the onshore market, the pool of new issues increases greatly.

Many high-quality issuers have never needed to venture across to the dim sum market as they can comfortably raise funds through the domestic buyer-base, meaning the offshore primary issuance market contains more high yield and fringe names. Those investors who gain onshore access can expect both a bigger and higher-quality issuance pool.

Real estate is a sector that we find particularly appealing via onshore primary issue. China’s property market – historically banned from issuing onshore debt – has been subject to bubble scares and bad press, but we see value in the unloved sector and the fundamentals look healthy, making it appealing at the right price.

Lifting the ratings curtain

With all this upside there must always be downside, and for onshore Chinese debt, ratings, defaults and volatility have proven the three big challenges facing trailblazing investors.

The market has to-date been solely rated by Chinese agencies, leading to generous results with half of all outstanding corporate bonds having AAA ratings at the end of 2016, according to Wind Info. Deep fundamental analysis is required to accurately sort the wheat from the issuance chaff, but pressure by the Trump administration around unfair trade practices has led to the promise of US ratings agencies being allowed to rate the market as part of a package of trade agreements between the two superpowers.

In a related move, the Chinese government is now allowing onshore companies to default. Up until 2014, there were no defaults, while 2015 saw 23, rising to 79 in 2016. The state historically bailed everyone out in order to appease both the local and international market. The allowance of defaults has aided a move toward true capital market conditions; the result is more prominence of credit fundamentals and greater dispersion between attractive and unattractive prospects – a positive for the alpha hungry.

On volatility, we expect it to calm as the renminbi becomes a more globally recognised investment currency. Here, the gradual increase in international investors could prove to have a silver lining.

The opening of the market marks a pivotal step forward in China’s positioning in the global fixed income universe, while strengthening the global prominence of EM. The value potential is plain to see, while the access challenges are proving themselves an exclusivity silver lining for those ahead of the curve and early to the opportunity set. In the case of onshore bonds, we believe the early bird will catch the juiciest worm, and we are excited to take our investors off the beaten track in the name of alpha trailblazing.

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