

Investors set to bond with the renminbi

AT A GLANCE

- In 2010, China relaxed currency regulations extensively to promote the internationalisation of the renminbi (RMB). One key outcome of reduced currency controls has been the evolution of an offshore Chinese bond market.
- The offshore (CNH) Chinese bond market is the fastest growing credit market in the world and has the potential to become an important funding source for Chinese corporations and multi-nationals.
- This relatively new market is set to develop into a fully-functioning bond market, providing investors with direct exposure to the RMB and broader diversification opportunities within the Chinese corporate bond market.
- Development of this market is in its early stages and investors need to be mindful of the fundamental investment credentials of each new offering.

The offshore Chinese bond market is rapidly developing due to the promise of yield and direct RMB currency exposure. This *In Perspective* provides an overview of the market's major developments to date and discusses its potential to become a more important asset class for investors in the future.

A NEW WAY TO GAIN EXPOSURE TO THE RMB

The offshore Chinese bond market, formally known as the CNH bond market or more colloquially as the 'dim sum' bond market, has grown at an impressive rate over the past 12 months to become the fastest growing credit market in the world. From being largely non-existent just under two years ago, issuance in the CNH bond market has grown to RMB 70 billion (US\$11 billion).¹

The relaxing of currency regulations in 2010 to internationalise China's currency, the renminbi (RMB), has facilitated the opening of the CNH currency market - an offshore deliverable RMB currency market in Hong Kong. Subsequently, this has produced the rapid issuance of CNH-denominated bonds.

For the time being, the CNH bond market predominantly remains a cash bond market with more sophisticated CNH-related derivatives developing at a slower pace.

ATTRACTING INVESTORS OUTSIDE THE MAINLAND

Unlike the restrictions associated within the domestic RMB market, the CNH bond market is open to offshore investors looking for direct exposure to Chinese currency bonds. Investor interest in Chinese currency exposure has been high, given bullish expectations for value appreciation over the medium term as well as relatively higher interest rates in China than those available in Hong Kong.

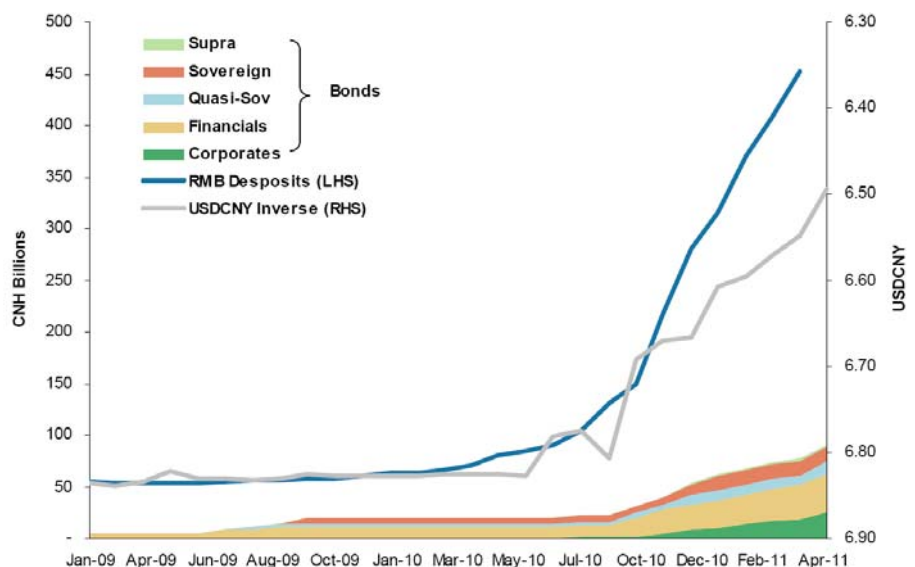
Demand for dim sum bonds has come mainly from mutual funds and banks, followed closely by retail / private banking clients. A considerable number of funds have launched in the past six months on the back of strong underlying retail investor interest.

The strong participation of banks in the CNH market means banks have been keen to invest in CNH bonds due to the growing amount of RMB on their balance sheets, the need to get returns on that RMB, and their struggle to make enough CNH loans to keep up with their growing deposit base.

One currency, many applications...

RMB	Renminbi – official name of the Chinese currency unit. Derived from Ren Min Bi, or 'the People's Money'.
CNY	Yuan – the base unit of the Chinese currency. Also represents the currency code used in Financial markets.
CNH	Currency code used to represent the exchange rate of RMB that trades in Hong Kong.

WAVE OF CASH CHASING CHINESE YIELDS



Source: Morgan Stanley, "CNH Bonds: The Birth of a Global Chinese Corporate Bond Market", 6 May 2011. Data sourced from Bloomberg, HKMA, Morgan Stanley Research.

1. Source: Morgan Stanley

MILESTONES FOR THE DIM SUM BOND MARKET IN 2010

July 2010	Hopewell Highway Infrastructure became first non-financial issuer and the first Hong Kong-incorporated entity to issue a CNH bond
Sept 2010	Fast-food conglomerate, McDonald's, became the first foreign, non-financial corporate to issue a CNH bond
Oct 2010	The Asian Development Bank became the first supranational to issue an Aaa-rated CNH bond
Dec 2010	Galaxy Casino became the first high-yield issuer in the CNH market
Dec 2010	Russian bank, VTB, was the first financial institution based in an emerging market outside China to issue in the CNH market

WHO ARE THE ISSUERS?

In its early stages of development, CNH issuance was dominated by Chinese government, quasi-government and financial institutions. More recently, the market has seen rapid growth in issuance from non-financial corporations. Corporate bonds now account for almost 90% of total CNH bond issuance. Investment grade issuers make up approximately 68% of the CNH bond universe, while high-yield issuers account for the remaining 32% of the market. Interestingly, around 50% of new issues since March have come from high-yield companies, which illustrates the rapidly evolving nature of the CNH bond market.² As can be expected, issuance has also been dominated by Chinese and Hong Kong-based corporates, making up over 93% of new issues, compared to the remaining 7% issued by offshore entities.³

Longer term, the CNH bond market is expected to gradually develop into an important alternative to onshore funding options for Chinese issuers. In time it may become a viable capital raising alternative to more established international hard currency bond markets.

While the market has already seen a number of deals by high profile multinationals, McDonalds and Caterpillar among them, issuance by non-Chinese corporates is still likely to be relatively limited over the short term given the numerous fund raising options available through international bond markets. Although the cost advantage for Chinese issuers raising funds in the CNH market may not necessarily hold true for non-Chinese corporates, some multinationals which have extensive operations in China will find the ability to match their needs for Chinese currency funding by issuing in CNH attractive.

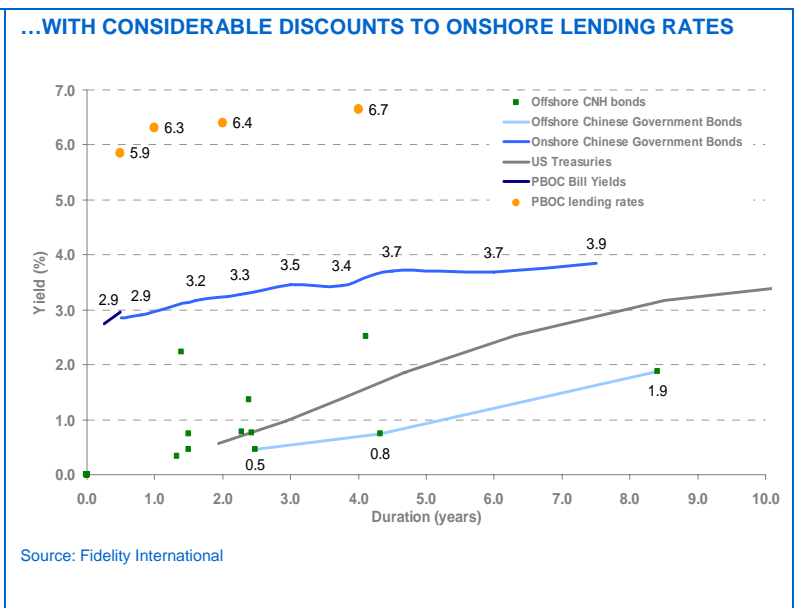
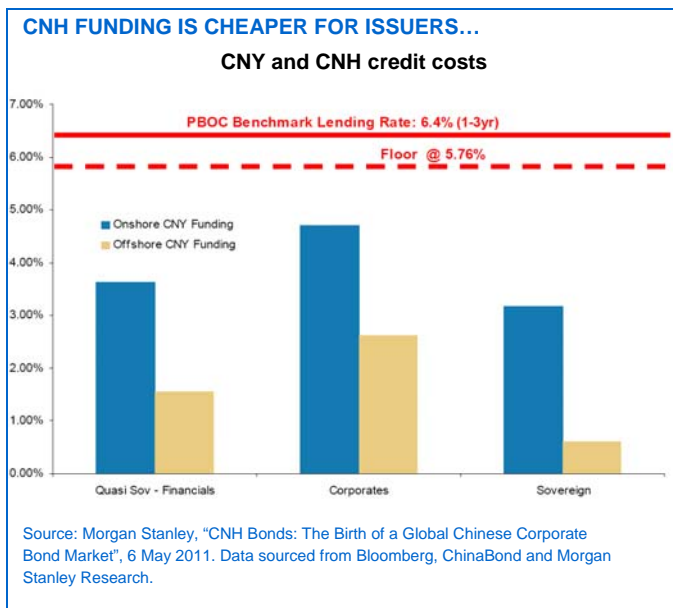
CONSIDERATIONS FOR ISSUERS - OFFSHORE VS ONSHORE FUNDING

In addition to overwhelming investor demand, the growth in CNH issuance over the past year has also been driven by financing considerations for Chinese corporates, taking into account tighter onshore credit conditions and the lower cost of capital for CNH versus onshore funding alternatives.

Onshore benchmark loan rates are regulated by the PBOC and banks can offer a maximum discount of 10%. Based on the current 1-3 year interest rate of 6.4%, the cheapest bank loan rate applicable to Chinese corporates is around 5.76%. By contrast, CNH bond yields are on average 2.1% less across all issuer categories.³ This means CNH issuance is a cheaper funding source compared with loans from onshore banks.

2. Source: FIL Limited

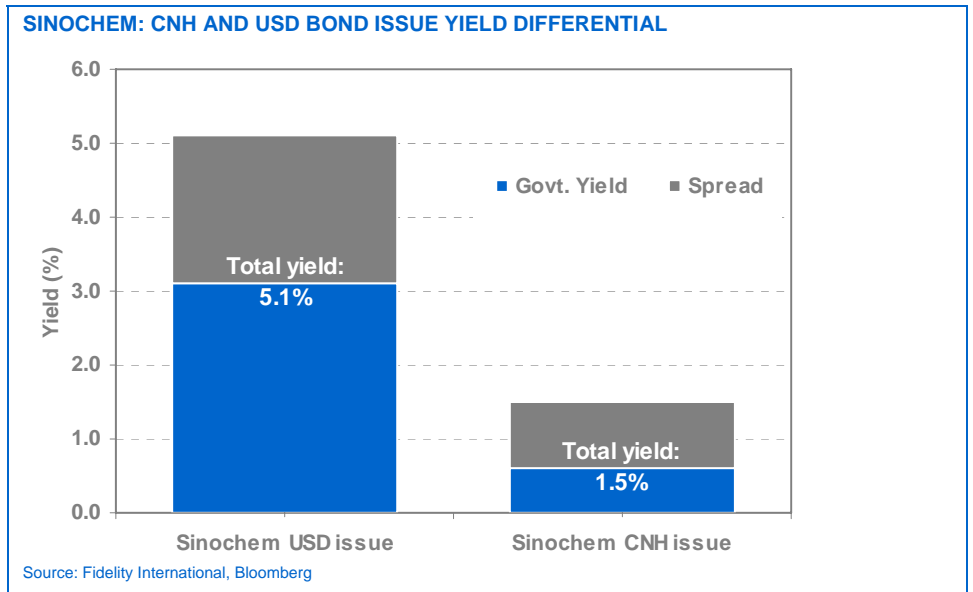
3. Source: Morgan Stanley



NARROWING CREDIT SPREADS

Strong demand for CNH bonds has allowed Chinese companies to raise capital in the CNH market at lower yields than the onshore Chinese government bond rate. In other words, it costs more for the Chinese government to borrow onshore than for companies borrowing offshore through the CNH bond market, reflecting just how tight CNH bond yields have become.

The tightness of the CNH bond market is evident when comparing the USD and CNH bond issues from Sinochem, a Chinese company with multiple business lines. The CNH bond has a credit spread of around 0.9% versus the offshore CNH Chinese Government Bond curve to give a total yield of around 1.5%. By contrast, the USD issue trades at a spread of around 2% versus US Treasuries, giving a total yield of 5.1%⁴.



To put the tightness of the CNH market in further perspective, Sinochem's CNH issue has a lower yield than the onshore Chinese government bond yield for the equivalent term. The yield for a 4-year onshore Chinese government bond is around 3.5% versus a yield of only 1.4% for the equivalent offshore Chinese government bond.

CURRENCY APPRECIATION AND DIVERSIFICATION

Although credit spreads are tight in the CNH market, investors may justify the yield differential through currency appreciation expectations. Based on 1-year CNY offshore currency forwards, the implied currency appreciation adds a further 2 - 2.5%⁴ to the bond's yield, thereby giving some justification to the tighter credit spreads in dim sum bonds. Although markets expect the CNY currency to appreciate over time, this is by no means assured and the pace of any appreciation is difficult to predict.

Currency valuations aside, the CNH bond market is providing investors with the benefit of greater diversification. So far, we are seeing a wide range of Chinese companies issuing in the CNH market, giving investors exposure across a growing collection of sectors and businesses.

4. Source: Morgan Stanley

THE SYNTHETIC ALTERNATIVE: CNY-LINKED BONDS

As an alternative to CNH bonds, synthetic CNY-linked bonds provide another way for investors to gain exposure to the Chinese currency. These are effectively USD-settled bonds linked to the CNY which are issued by Chinese corporates. While similar to dim sum bonds, CNY-linked bonds have tended to be issued mostly by high-yield Chinese property issuers. With average issuance sizes of between US\$500-800m and durations of 3-5 years, these bonds have appealed mainly to offshore institutional investors as an alternative to physically owning RMB. As the CNH market grows in scale however, it can be argued that synthetic CNY-linked bonds will become less relevant for investors.

SMALL BUT RAPIDLY EVOLVING MARKET

The pace of growth has been impressive but the CNH bond market remains a small local currency bond market for now. Typical of these smaller markets, the dim sum bond market is characterised by thin secondary market liquidity as well as valuation distortions between the offshore and onshore markets. Secondary market liquidity has been restricted by the strong presence of 'buy-and-hold' investors (including banks and private bank clients), thereby limiting the amount of secondary trading. This has resulted in relatively wider bid/ask spreads, increasing the premium required to transact.

China's policy separation for the onshore RMB and offshore CNY markets, together with the lack of freely-flowing capital between the two markets means currency and interest rate valuation distortions may persist. More recently however, RMB and CNY currency rates are now trading much more in line with each other than in the past. We are also seeing signs of secondary market liquidity picking up as the market expands.

Due to the strong investor interest in the asset class, we have seen a considerable number of first-time issuers successfully raising capital in the CNH bond market. Strong demand will attract new issuers to the market, expanding the industry representation. While an expanding investment universe is generally healthy, investors will need to carefully consider the credit fundamentals of each issue to understand the underlying investment exposure and their inherent risks.

THE MARKET'S POTENTIAL AND FIDELITY'S INVOLVEMENT

Clearly, there is a lot of promise in the fast-developing dim sum bond market. Unrestricted access to Chinese corporate and government bonds as well as direct exposure to the RMB are clear attractions for offshore investors. While there are a number of limitations, including the large imbalance between supply and demand for CNH bonds and relatively thin secondary market liquidity, the fast pace of development witnessed over the past 12 months suggests that the CNH bond market will likely evolve into a large and diversified bond market over time.

In a related development, we have recently seen the first CNH equity initial public offering launch in Hong Kong. The Hui Xian Real Estate Investment Trust, a spin-off of Hong Kong's Cheung Kong Holdings, raised CNH 10.5 billion (US\$1.6 billion) in April this year. The equity raising may be seen as an important early milestone in the development of a CNH equity market to complement the existing market for CNH bonds. There has also been some discussion among market participants on Singapore's potential to become a second RMB offshore trading centre as internationalisation of the Chinese currency gathers pace.

Fidelity has been monitoring developments in the CNH bond market and has been selectively investing in CNH bonds on behalf of our existing Asian bond fund investors. Given our strong Asian credit research coverage, trading capabilities and extensive experience in Asian bond markets, Fidelity is well-positioned to expand our direct involvement in the CNH bond market at the opportune time.



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