FFTW

A BNP Paribas Investment Partner

Weekly commentary

The Eastern Migration

by Jean-Charles Sambor
Deputy Head
Emerging Markets Fixed Income
jc.sambor@bnpparibas.com

October 3, 2016

Key takeaways

- For bond investors, there has been a gaping hole on the map.
- This year, all quota restrictions on foreign investors were lifted in China.
- Obstacles still need to be addressed in order to secure China's preeminent place in investor portfolios

Full commentary

For bond investors, there has been a gaping hole on the map. Two of the largest bond markets in the world have not been readily accessible to foreign investors: China and India. The cumbersome quota system of India and the complex capital controls of China have, until recently, kept most foreign investors at bay. As a result, the emerging Asia opportunities have been considerably under-represented in the global bond indices.

China, in particular, has long been the elephant on the trading floor. With a market capitalization of USD 8 trillion, China has represented the most under-owned and under-traded market by global investors. Even today, China represents only two percent of foreign bond portfolio ownership.

This year, all quota restrictions on foreign investors were lifted in China. While full representation of the Chinese bond markets in fixed income indices are likely to take some time due to the further progression of necessary regulatory changes, the Chinese onshore bond market may be on the cusp of benefitting from a wave of foreign interest. It now appears attractive and is one of the most exciting investment opportunities in emerging markets.

Growth has impressed recently. However, with a market capitalization of 65% of gross domestic product (GDP), China still presents ample room to grow compared to developed markets, which are already in excess of 200% of GDP. With an expansionary fiscal policy, sharply rising provincial and infrastructure bonds issuances, and a strong commitment to deepen its local financial markets, the Chinese bond investment universe should gain in both breadth and liquidity. Additionally, the opening of the onshore bond market to foreign institutional investors – the so called "interbank" market – is a major milestone in capital account and interest rate liberalization.

However, a few obstacles still need to be addressed in order to secure China's preeminent place in investor portfolios. First, multiple layers of regulations between the People's Bank of China, the China Banking Regulatory Commission (CBRC), and the China Securities Regulatory Commission (CSRC) complicate the investment process. Second, price discovery is still an issue. In most cases, credit risk has yet to be fully priced in for both genuine corporate bonds and sub-sovereign issuers. Chinese policy makers are walking a fine line between the need to inject more credit risk in the system – indeed default rates have increased sharply since the beginning of the year for both corporates and quasi-sovereigns – while avoiding a systemic risk event if the adjustment is too abrupt. More differentiation is needed based on bottom-up credit risk research, and we do not expect an efficient and unified rating methodology in the near future. Third, the issuer base has yet to diversify. Banks remain too dominant despite the rapid growth of the onshore insurance and asset managers' investor base. The lack of diversification hampers liquidity and price discovery, and creates tail risks such as sudden falls in bond prices. Finally, policy makers still have to clarify precisely who meets the strict criteria of an institutional investor eligible to access the onshore bond market.

This week's market developments

Monday, September 26

- US New Home Sales growth decreased to 609,000 (s.a.a.r.) for August

Tuesday, September 27

- US Markit Services PMI (prelim estimate) increased to 51.9 for September
- US Consumer Confidence Index increased to 104.1 for September

Wednesday, September 28

- US Durable Goods Orders growth (prelim estimate) decreased to 0.0% m.o.m. (s.a.) for August

Thursday, September 29

- UK Mortgage Approvals growth decreased to 60,100 for August
- US Wholesale Inventories growth decreased to -0.1% for August
- Japan Industrial Production growth (prelim estimate) increased to 1.5% m.o.m. (s.a.) for August

Friday, September 30

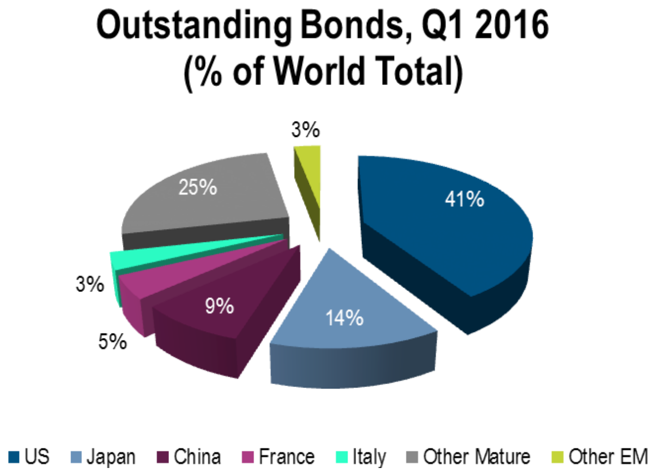
- Germany Retail Sales growth decreased to -0.4% m.o.m. for August
- Eurozone Unemployment Rate remained at 10.1% for August
- US Personal Income growth decreased to 0.2% m.o.m. for August
- US Personal Spending growth decreased to 0.0% m.o.m. for August

Source: Bloomberg, as of October 3, 2016

Hopes of Chinese onshore market inclusion have frequently been dashed, both on the equity and fixed income sides, and we do not see how this time will be different. The headline trillion dollar inflows advertised by many institutions is still unrealistic, in our opinion. However, if and when the Yuan uncertainties are removed and China's FX regime is clarified, China may indeed become the next big thing in local currency markets. We are, however, only at the early stages of the eastern migration!

Chart of the week

Outstanding Bonds in 2016



Source: BBIS, BNP Paribas Investment Partners. Includes domestic and international debt securities. October 2016

Central Bank watch

	Last move	Date of move	Current policy rate	Implied3mrateonDecember 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.49 %	November 2, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.21 %	October 20, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.04 %	November 1, 2016
BoE	-25 basis points	August 4, 2016	0.25 %	0.35 %	November 3, 2016

Source: Bloomberg, as of October 3, 2016

Next week's market developments

Monday, October 3

- Markit Eurozone Manufacturing PMI is expected to decrease to 52.1 for September
- US ISM Manufacturing is expected to increase to 50.4 (s.a.) for September

Tuesday, October 4

- Markit UK Construction PMI is expected to decrease to 49.0 (s.a.) for September

Wednesday, October 5

- Markit UK Services PMI is expected to decrease to 52.2 (s.a.) for September
- US Factory Orders growth is expected to decrease to -0.2% m.o.m. (s.a.) for August
- US ISM Non-Manufacturing Composite is expected to increase to 53.0 for September

Thursday, October 6

- Germany Factory Orders growth is expected to increase to 0.3% m.o.m. (s.a.) for August

Friday, October 7

- Germany Industrial Production growth is expected to increase to 1.0% m.o.m. (s.a.) for August
- UK Industrial Production growth is expected to remain at 0.1% m.o.m. (s.a.) for August
- UK Manufacturing growth is expected to increase to 0.4% m.o.m. (s.a.) for August
- US Change in Nonfarm Payrolls is expected to increase to 173,000 (s.a.) for September
- US Unemployment Rate is expected to remain at 4.9% for Septembe

Source: Bloomberg, as of October 3, 2016