

## Too big to ignore: the internationalisation of Chinese balance sheets

‘Given the scale of China’s economy and the sheer magnitude of China’s US\$9.4 trillion domestic debt market, the coming participation by international investors in this asset class will have a huge impact on global investing’

PUBLISHED : Saturday, 26 August, 2017, 8:31am

UPDATED : Sunday, 27 August, 2017, 6:27pm

**Andrew Brown**

Under Zhu Rongji, China decided to go international with its equity offerings in the early 2000’s, starting a long-term developmental process of internationalising their balance sheets and opening up to global capital markets.

Importantly, it also began a process of China’s under-managed state-owned enterprises beginning to adopt international discipline. By this I mean pre-IPO restructurings, experiencing underwriting and due diligence proceedings, meeting exchange listing requirements, producing audited financial statements, and engaging institutional investors.

At the same time, this also permitted SOEs to raise large amounts of international capital while Beijing too steps toward opening up the current account. Some of the largest Chinese SOEs became listed companies as a result of this programme. Granted, there are still corporate governance and transparency improvements to be made, but the directional shift is significant and is now gaining momentum.

Tagging on the coattails of this policy trend, many private Chinese companies, including many VC-backed tech firms that would never have been able to list domestically, also went public internationally. This was the genesis of some of the leading Chinese tech companies of today, including Sohu, Sina, NetEase, Alibaba Group, Tencent Holdings, among others.

The result was that Hong Kong became the largest IPO market in the world. Chinese companies became a significant proportion of the Hong Kong stock index, and Chinese IPOs were also a leading line of business for US and other international stock markets. Today, although Chinese international IPOs have quieted, Chinese equities continue to be a very important component of secondary trading in international equity markets. Indeed, the Hang Seng China Enterprises Index -- a free-float capitalisation-weighted index comprised of H-Shares -- has a market cap of HK\$2.94 trillion (US\$376 billion), comprising 34 per cent of the overall Hang Seng Index.

As we flagged in this column on May 20, China is now taking its debt markets international too. The modalities of this macro trend will be different from equities, but the end result will be similar. And given the scale of China's economy and the sheer magnitude of China's US\$9.4 trillion domestic debt market, the coming participation by international investors in this asset class will have a huge impact on global investing.

What are the channels by which China will allow international investors to access China's debt markets? It is a deliberately stepped-process of development and access. It started with quotas under the Qualified Foreign Institutional Investor programme, then last year the China Interbank Bond Market permitted unrestricted purchases by foreign institutional investors. And now we have Bond Connect, which permits offshore investors to access the domestic debt markets without the constraints of quotas.

To be sure, Bond Connect is another step in the right direction of opening up China's capital markets, and in its early days resembles the successful Stock Connect programme in that it allows for a single settlement and trading platform offshore in Hong Kong.

But unlike Stock Connect, it is very restrictive in its current form. Firstly, it only allows for northbound investment. For example, foreigners can buy Mainland Chinese-issued bonds via Hong Kong, but Mainland investors cannot buy overseas bonds. We fully expect a "Southbound Connect" to follow in due course.

Secondly, it limits investments to only Chinese government securities, local government bonds (municipal bonds), and commercial bank bonds. It does yet not include the rapidly growing US\$2 trillion domestically-issued, yuan-denominated corporate bond market. We believe this will also come in due course as the bond market continues to institutionalise.

For now, foreign investors are very underweight the Chinese bond market, as the risk curve is still far from perfect, meaning yield differentials among corporate issuers do not yet adequately reflect differences in balance sheet risk and are not reflected by domestic credit ratings, in our view.

We believe Chinese authorities are acutely aware of this. It is a developmental process on their part, which will continue to improve as the ratings industry becomes more rigorous and internationally accepted, global bond index inclusion occurs (which is slowly occurring), and the overall debt markets are more appropriately institutionalised, including further participation by professional fixed income asset managers, which Bond Connect will facilitate.

Regarding credit ratings, the establishment of the China Securities Credit Investment Corporation to expedite internationally acceptable credit ratings is also an integral part of this process.

The implications are profound. Currently, only 1.7 per cent of the Chinese bond market is held by foreigners, as against a probable benchmark of 11 per cent using the weighting of the yuan in the IMF's Special Drawing Rights baskets as a proxy for a full-market weighting for Chinese bonds.

This implies that US\$1.5 trillion of foreign capital inflows would be necessary to achieve a neutral weighting by foreign fixed income investors over the next several years, which also helps significantly from a currency management perspective.

We are not suggesting this reweighting will happen quickly, but rather that Bond Connect is another step toward developing the necessary infrastructure.

Once all of this is worked out, the end point will be that we will see much more balanced participation by international investors in Chinese company balance sheets, both in equity and debt.

China's capital markets are already too big to ignore. And it's only going to get bigger from here.

*Andrew Brown is a partner for macro and strategy at ShoreVest Capital Partners*

Source: <http://www.scmp.com/business/investor-relations/article/2108325/chinas-corporate-debt-market-will-soak-us15-trillion-it>