May 2016

Z-Ben Advisors presents

A Strategic Outlook

RMB Fixed Income

Open for business

RMB Fixed Income

Executive Summary

The sudden opening of the CIBM – no quotas, no approval – has highlighted rampant doubts around the development of RMB credit.

- **Bonds are just a short-term backup:** Some foreign managers may see the bond-equities trade-off of early 2016 as a naïve race to the bottom, with sliding stocks having pushed investment into bonds, in spite of falling yields and a slew of recent defaults, not to mention ominous headlines that warn of industry overcapacities. Besides which, an improvement in equity returns could further detract from (il-)liquidity in fixed income markets.

- **Disincentive to invest in building credit capacity:** With China fixed income already looking like an unsafe bet, macroeconomic debates have further shaken confidence and curtailed commitments to the development of onshore credit capabilities, at least until greater market clarity can be achieved – ever-evasive as that may be.

- **Too few managers to handle imminent inflows:** This leaves but a few balkanized managers to sort through growing onshore demand for credit in the world's third largest credit market – which already accounted for 40% of regional issuance in 2015.

These concerns are understandable, but a closer look at underlying dynamics shows a movement towards market-oriented pricing. A move away from bailouts will challenge market expectations, at the same time as investor diversity and fund manager capabilities could see greater issuance, risk pricing and possibly even liquidity.

Naysayers, truth-sayers

Betting against China has proven popular. But popularity doesn't equate with probability.

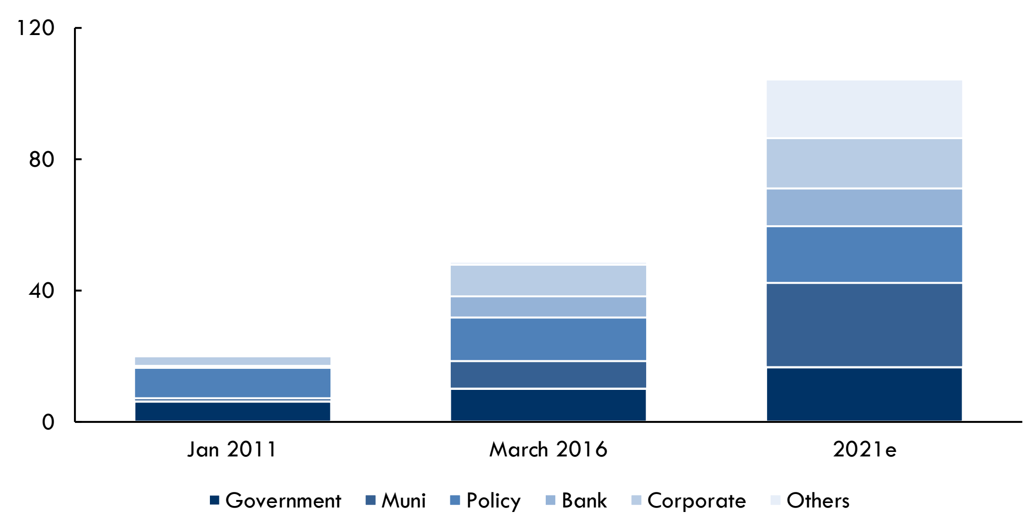
Even among China naysayers, the long-term potential of RMB fixed income is little debated – it's the uncertainty of the market's transition to realizing that potential which has largely sidelined foreign participation to date. Debates around interest rates, savings rates, default, duration, credit risk and frictional costs of transactions, among others, have only shaken already rickety confidence. Meanwhile, fear, exacerbated by a lengthening list of bond defaults, has overshadowed the demand for RMB fixed income implicit in SDR and (imminent) bond index inclusion, not to mention the lifting of the interbank bond market (CIBM) levy.

New CIBM rules issued at the end of May now allow a broader spectrum of eligible traders to enter the market, using any currency and just a 20-day registration process, with ready-repatriation. Essentially, the rules call for limitless CIBM access: no quota, very light repatriation restrictions, virtually no approval time and the added ability to inject in any currency while allowing for derivatives to further hedge risks.

This move comes at a time of real need for credit in the Mainland – China's overall credit demand has grown consistently: 27.7% CAGR over four years – and plays directly into the government's desire to channel more credit activity from commercial lending into market financing. Right now, it takes approximately three RMB of debt to create one RMB of economic growth. The government sees greater efficiency to be had from sourcing growth financing in markets, and facilitating access by institutional investors – foreign or otherwise (domestic insurers and pension funds come to mind) – who may wish to invest in bonds at a 10:1 ratio to equities. In time, as credit markets are legitimized, inclusion in the Citigroup and JP Morgan bond indices could see trillions of dollars in inflows which, at current yields, could offer investors substantial diversification benefits from developed market assets (unhedged). Too risky? No matter – naysayers step aside. China's credit market ranks as the third largest in the world with less than 2% of investments attributed to foreign participation. It is the other 98%+ that will guide the market's transition.

China's interbank bond market structure

Value of bonds per issuer type (2011 – 2021, RMB tr)



Source: Z-Ben Advisors

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As head of Z-Ben Advisors' research department, Mr. Shi is responsible for overseeing the firm's analysis and thought leadership on a variety of topics, including China's asset management industry, financial institutions and financial markets, in addition to macroeconomic and policy developments. During his nine years with Z-Ben Advisors, Mr. Shi has had the opportunity to work extensively on both research and advisory work, where he specializes in examining regulatory developments and confers frequently with domestic policymakers as well as the IMF, US Treasury and UKTI, among others. Prior to joining the firm in 2007, Mr. Shi served as the personal research assistant to American journalist and political commentator, James Fallows, investigating policy and social reforms.

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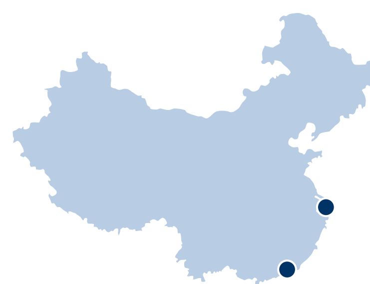
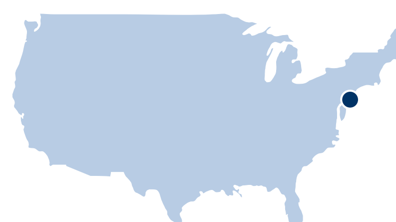
Mr. Fang currently works at Z-Ben Advisors as a senior research analyst covering cross-border investments, Greater China funds and the domestic fixed-income market. Prior to working at Z-Ben Advisors, Mr. Fang worked for Caitong Securities as a securities analyst where he supported the investment advisory team, maintained the company's information service, and analyzed market data. He was also responsible for writing strategic reports with the aim of providing investment advice to investors. Mr. Fang has a Bachelor's of Science degree from Zhejiang University, where he majored in Computational Mathematics.





ABOUT Z-BEN ADVISORS

Z-Ben Advisors is a Shanghai-based consulting firm that helps global financial institutions capitalize on the fast-growing business opportunities presented by the Chinese and Greater China markets. Our business foundation is bottom-up, on the ground research; our services translate that research into actionable intelligence, recommendations and advice. The firm has permanent presences in Hong Kong and New York, with the majority of its staff based on the ground in Shanghai.

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