Event Report
China's Bond Market: The Next Big Bang

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The third annual China Business Conference, held at Columbia Business School in April 2010, took as its theme "Fueling China's Sustainable Growth." A panel discussion on Capital Markets focused on China's still-developing debt market. But with a diverse group of speakers, the talk ranged widely, tackling topics such as the appreciation of the yuan, corporate bond issues and the outlook for commodity prices. Panelists included Robert Fallon, a finance professor and Asia expert at Columbia Business School; Dr. Jay Guo, Global Head of Fixed Income Quantitative Methodology for Interactive Data Co.; Dr. Yong Li, managing director at Midway Group; Shanquan Li, managing director at Oppenheimer Funds; and Pengfei Xie, a partner at hedge fund EIM.

There was general agreement among the panelists that the yuan, or RMB, should appreciate relative to the dollar. The panelists also agreed, however, that the United States shouldn't make public demands that China loosen the reins or brand the country a "currency manipulator."

Mr. Fallon first visited China in the late 1970s and has lived in Asia for 31 years. "When you have a problem with a friend, you don't publicly accuse that friend," Mr. Fallon said. "You cause them to lose face and they harden their position." He urged against trade sanctions, which "repudiate the reality that China and the United States are so interdependent economically," Mr. Fallon said. "Neither side really understands the degree to which this is true."

Sounding a similar note, Shanquan Li warned against an aggressive posture — only his advice was for China. He argued that China shouldn't use its massive position in U.S. Treasuries as a "weapon." A major sell-off by China would depress Treasury prices, and whatever asset the

Chinese chose to buy with the diminished proceeds would shoot sky-high in value. He called for a more rational approach: "Trade problems should require a trade approach to solve," he said.

At roughly $2.5 trillion, China's bond market is the largest among developing nations, and the sixth largest in the world overall, according to Dr. Guo, who also teaches at the Zicklin School of Business at City University of New York. The China bond market has seen rapid growth in volume — an average annual rate of 34 percent since 2005. Most strikingly, China has seen a dramatic rise in corporate issues. In 2009, the volume of corporate bond issues increased by 78 percent, snatched up by a combination of insurance companies, mutual funds and banks.

Yet in contrast with the United States, which has a $35 trillion debt market, China's features fewer instruments and less liquidity. Until the recent crisis, mortgage-backed securities were the largest instrument in U.S. credit markets. China's debt market, despite the growth of domestic corporate bonds, still is dominated by government issues, which make up some 85 percent of the total. The development of asset-backed securities will require regulatory changes.

Returns have been handsome, according to Dr. Guo's data. From 2003 to 2008, investors in Chinese bonds would have made an annualized return of just more than 8 percent, far outpacing returns over the same period for U.S. bonds and Euro-zone bonds. What's more, the annualized volatility of the Chinese bond market was about 2 percent, much lower than in the United States or Europe.

Nonetheless, the Chinese fixed-income market is still a work in progress, the panelists agreed. Yong Li, of Midway Group, said that the bond market is "still at the beginning stage" of its development — "there is not much of a high-yield debt universe," for example. According to Dr. Li attaining such an environment would necessitate a history of corporate actions such as defaults and recoveries, and the establishment of ratings agencies to do credit analysis, as well as the issuance of upgrades and downgrades of corporate debt.

As a result of the lack of high-yield or distressed debt, hedge funds have not had that many investment strategies available to them, Mr. Xie said. The size of the market is large, but there are few opportunities to exploit mispricing or arbitrage. One reason: The holders of Chinese debt are mostly banks, insurance companies, and big investment funds, mostly long-term, buy-and-hold investors. Therefore, the trading volume on the assets is low. "If you compare the turnover to the U.S., it's only a small fraction," Mr. Xie said.

In any case, Mr. Xie pointed out, a long-only, passive investment in the local bond market would have done well: "Eight percent [returns] in U.S. dollar terms, at one or two percent annualized volatility, to me I think that's pretty good, especially if the correlation is very low to the S&P 500 or the Japanese equity market."

However it's played, one of the key takeaways from the panel was that China would increasingly become a global financial center. Mr. Fallon pointed to the more than $20 billion public offering of Chinese bank ICBC on the Hong Kong exchange — the largest ever. "It was clearly a wake-up call to financiers in other capital markets — Tokyo, London, New York, Frankfurt — that China was emerging as a capital market as well," he said. "Anybody who is going to be a practitioner in the capital markets … has to recognize that China's capital market will continue to grow even more significant in the future."

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