

## Next Stop: Mainland-HK bond connect

### Bond Connect to be launched within the year

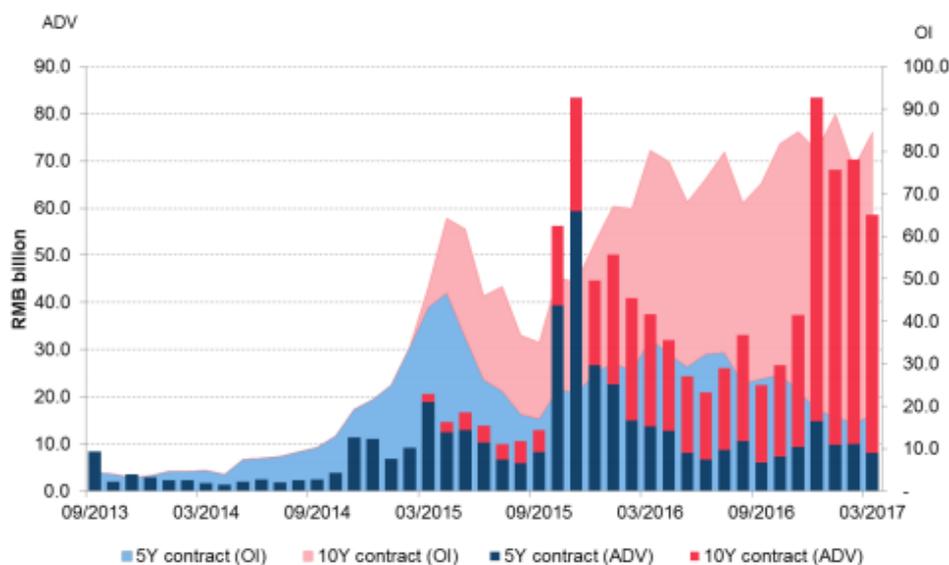
On March 15<sup>th</sup>, Premier Li Keqiang said that China is considering for the first time establishing a bond market connect between the Hong Kong and the mainland, allowing foreign capital to buy mainland bonds from overseas and Hong Kong will be the first to benefit from such an arrangement

HKEX (Hong Kong Exchange and Clearing) welcomed Li's announcement, saying the Bond Connect is "a major breakthrough" in China's capital market development and further strengthens Hong Kong's role as a gateway between the mainland and international markets. Such move will also help Hong Kong maintain its status as an international financial center and provide Hong Kong residents more investment channels.

### A prelude: Offshore treasury future debuted in HK

On April 10th, HKEX launched the five-year china ministry of finance treasury bond futures -The world's first RMB bond derivatives accessible to offshore investors. If China implements the pilot Bond Connect scheme between Hong Kong and the Mainland in the near future, the increased foreign investment in Chinese bonds would result in a surging demand for related risk management. The listing of the 5-year treasury future serves to address such concerns.

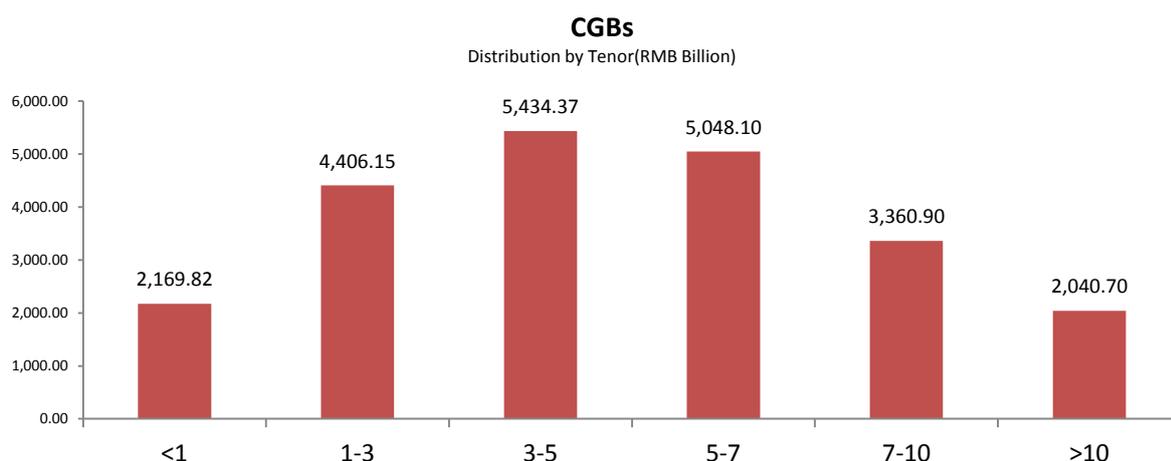
Exhibit 1: Turnover of 5-year and 10-year treasury futures listed on CFFEX



The freshly debuted HKEX Treasury future has a contact tenor of 5-years, which echoed the empirical experience of the rolling of CBOT US treasury futures and CFFEX's (China Financial Futures Exchange) domestic treasury futures. In each case, the 5-year contracts were launched prior to the 10-year. From the trading volume stance, daily trading volume has reached 9.5 Billion RMB or 9500 contracts with open interest at 15,000 contracts for the 5-year TF in the onshore market.

On the spot market, treasury bonds with tenor 3-7 years made up more than 40% of the market with ample liquidity. Hence, 5-year naturally becomes the tenor of choice when HKEX was designing its first TF contract.

**Exhibit 2: Distribution of CGBs by tenor**



Source: Wind, ChinaAMC

One of the key differences is the settlement methods. HKEX TF contracts use cash settlement while the domestic versions use physical delivery. This is the reflection of the fact that, domestic investors dominate the spot bond market and owns most of the cash bonds outstanding. In addition, physical delivery calls for the connectivity between HKEX and CCDC (China Central Depository and Clearing), which could be a costly and length process to set up. Cash settlement bypasses such hurdle and could theoretically trade a large number of contracts without the risk of being short squeezed.

**Exhibit 3: Comparison of offshore and onshore treasury futures**

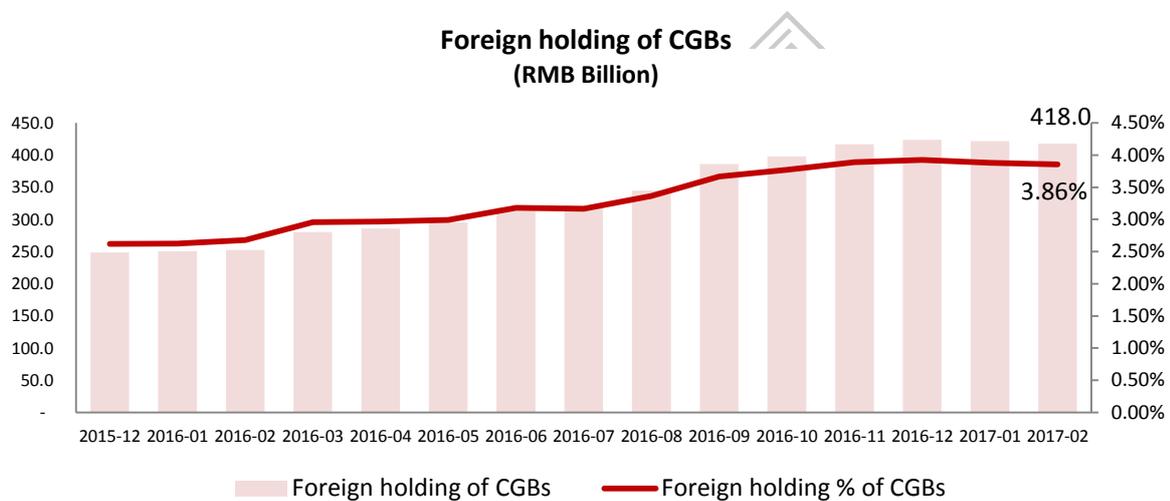
Index	HKEX Treasury Futures	CFFEX Treasury Futures
Ticker	HTF	TF
Reference Bond	MOF issued 5-year treasury bond, with 3% annual coupon, in practice a basket of bonds	MOF issued 5-year treasury bond, with 3% annual coupon, in practice a basket of bonds
Contract face value	RMB 500,000	RMB 1,000,000
Contract Months	Two nearest quarters (Mar, Jun, Sep, Dec)	Three nearest quarters (Mar, Jun, Sep, Dec)
Quotes	% of face value , 3 decimals	Clean price of 100 RMB, 3 decimals

Trading time	9:00-12:00; 13:00-16:00	9:15-11:30; 13:00-15:15
Limit up/downs	Minimum tick of 0.002% of face value No Limit up/downs	Minimum tick of 0.005 RMB Limit up/downs of +/- 1.2%
Settlement	Cash Settlement	Physical Delivery

Source:HKEX

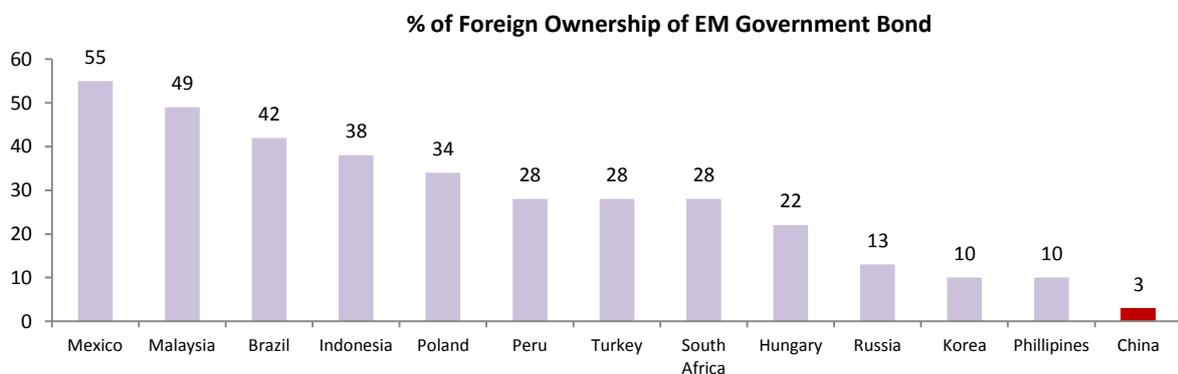
As of Feb 2017, foreign institutional holdings of CGBs have risen to 418 Billion RMB, a record high. Yet, among its emerging market peers, it still lags by a wide margin. Lacking hedging instrument could be one of the obstacles that are keeping foreign investors' appetite from rising further.

**Exhibit 4: Foreign ownership of Chinese Treasury Bonds (CGBs)**



Source:Wind, ChinaAMC

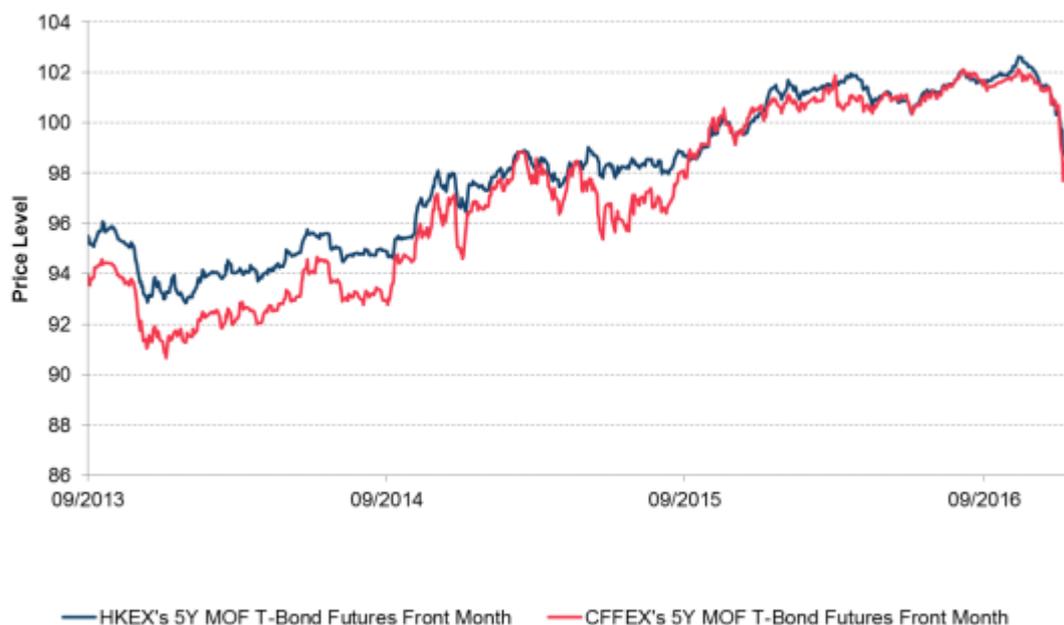
**Exhibit 5: Yet...such ownership was dwarfed by other EM countries**



Source: Standard Chartered

According to HKEX research, the reference price of the HKEX's pro-forma futures has an annualized correlation of 92.1% against CFFEX's futures (September 2013- December 2016), which is based on a physically delivered design . Therefore, it could facilitate international investors to effectively address the growing interest rate risk management demand. Banks, asset management companies, brokerage firms and insurance companies will be the main target users of this product.

**Exhibit 6: Pro-forma correlation analysis of HKEX treasury futures vs. CFFEX treasury futures**



Source: Standard Chartered

In addition, HKEX's Treasury Futures could be regarded as a proxy for the RMB bond yield index due to the high degree of correlation between the two. HKEX's pro-forma futures bond basket yield tracks closely the Sovereign Bond Yield (5Y) published by ChinaBond. The yield-to-maturity (YTM) of the two series has an annualized correlation of 98.3% over the past six years (2011-2016). Therefore, HKEX's T-Bond Futures provide a relatively convenient tool for the market to evaluate Chinese bond assets.

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