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WHAT A DIFFERENCE TWO DECADES MAKE: FROM BANK DEBT AND CURRENCY CRISIS TO BOND CONNECT AND CHINA RESURGENCE!

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It's been 20 years since Hong Kong's reunification with China. But from an Asian markets perspective, a more important anniversary of the same weekend was the 18% Thai Baht devaluation of 2 July 1997. A few months later, the Asian Crisis was in full swing with the regional equity index ultimately falling 66%. Debt-fueled asset price bubbles in property and stock markets ended in a blaze of currency depreciations and banking calamities.

Fortunately, we've come a long way since then.

As I write, 7 of the 11 regional stock markets are still trading below their pre-Asian Crisis peak in US Dollar terms and 8 of the 11 regional currencies remain below their value versus the US Dollar of 20 years ago. The broad Asian dollar index also remained 1.5% below pre-crisis levels on the 1 July anniversary.

For Hong Kong specifically, and the region more broadly, the good news is that equity valuations remain around neutral levels (1.5-1.6 times book). Prior to the crisis in 1997, Hong Kong was trading at more than 2.2 times book – or two standard deviations into expensive territory.

NOW AND THEN

Perhaps the biggest change is the rise of China as a top global geopolitical and economic power. Looking at China in comparison with Hong Kong, the difference between 1997 and 2017 is striking.

In 1997, Hong Kong was the biggest port on the China Coast.

Today, Shanghai, Shenzhen and Ningbo each ships a greater number of containers. Hong Kong as a percentage of China's GDP was 18.4% versus 2.8% today. The Hong Kong-China trade as a percentage of Hong Kong's total trade was 36% versus more than 50% today. In 1997, only 2.3 million Mainland Chinese tourists visited Hong Kong – a tiny slice of the more than 42 million visiting in 2017. Finally, Hong Kong market cap was HKD3.3 trillion versus HKD28 trillion today.

For Asia overall, economies have noticeably reduced their vulnerability compared with 1997 in several dimensions. Domestic demand, for example, is stronger and for most countries dependency on

exports is now more balanced. Other key factors, such as larger foreign exchange reserves, the importance of capital markets, especially bond markets, and increased intra-regional trade, also point to a more balanced environment for the Asian economies.

In fact, foreign exchange reserves have increased by many multiples – as shown in the table below.

Country	1997 (USD)	2017 (USD)	Multiple
South Korea	97 bn	371 bn	3.8x
Thailand	38 bn	171 bn	4.5x
Philippines	11 bn	80 bn	7.2x
Indonesia	19 bn	116 bn	6.1x

Unlike the Asian currency and bank debt crisis of 1997-1998, improvements in Central Bank reserves, swap lines, bank supervision and liquidity allowed Asian financial institutions to weather the Global Financial Crisis (GFC) much better in 2008-2010, sufficiently containing severe currency fluctuations.

Asia's local currency debt capital markets have also developed since 1997, now offering corporate issuers the opportunity to fund domestic currency obligations with long-term money, while institutional investors can find long-term income streams for pension and insurance funds.

BOND CONNECT SURGES INTO ACTION

China opened its Bond Connect program for overseas investors on 3 July 2017, kicking off with RMB7 billion (USD1 billion) of trading, according to the central bank.

The formal opening of the interbank market alongside the twin Shanghai-Shenzhen stock connects allows investors a multitude of ways to build portfolios.

In contrast to the two stock connects, the bond connect will be linked directly to the Chinese interbank bond market via China Foreign Exchange Trade System (CFETS). While the two Mainland listed exchanges also trade government bonds, the underlying trading turnover would be insufficient to support institutional demand.

The Bond Connect program adds another channel for investors to access the interbank bond market and may help investors manage RMB offshore hedging by offering a currency exposure option to cash.

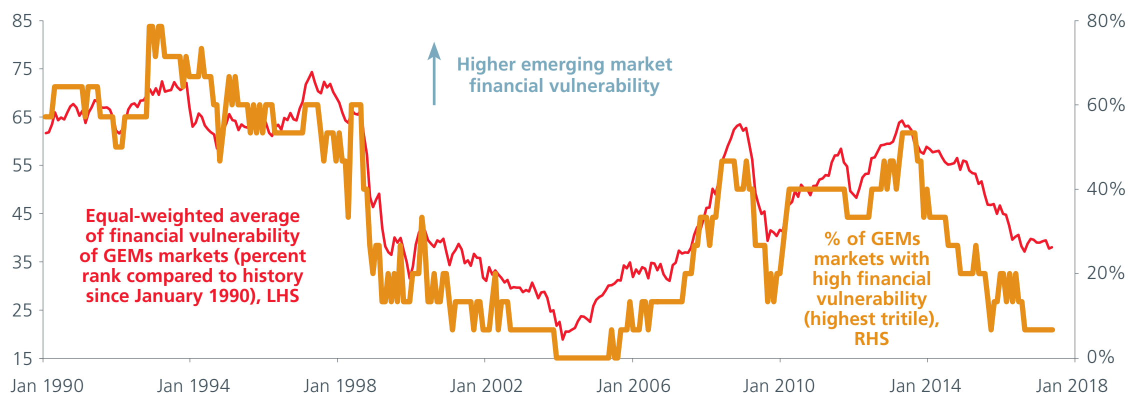
Although foreign institutions have been able to access Chinese bond markets previously, varying degrees of regulatory approval were needed beforehand. Bond Connect has made other conduits largely irrelevant.

With Chinese 10-year government bonds yielding 3.5% and China Development Bank Bonds yielding 4.2%, the market offers some positive carry relative to US, Japanese and European sovereign bond markets. The currency has stabilized recently and is probably undervalued in the near term relative to interest rate carry.

At USD9.6 trillion in issuance, China's bond market is the third largest in the world after the US and Japan, and is expected to double in size in the next 10 years. 61% of China's bonds are Fixed Rate.

The China sovereign bond market foreign ownership was 3.93% at the end of 2016, well below the average 39% international participation for large

Fig.1. Breadth and intensity of financial vulnerability has dropped sharply since 2003



Source: Bank of America Merrill Lynch Global Research.

bond markets. Given the target is 15%, we expect to see international interest and eventual flow into the market.

The acceptance of China's bonds by a wider circle of international investors gives China another tool to enact monetary policy and promote financial stability. It should help issuers get long-term money at reduced costs and could eventually promote more transparency around risk and yield curves.

Bond Connect is another important step in migrating risk from banks to corporates, from moving indirect bank financing to direct bond financing, to making improvements in bond issuance and disclosure standards and onshore credit rating reforms, to matching tenor of debt with its purpose.

It also advances the eventual inclusion of China bonds in the three major bond indices:

- **JPMorgan's Government Bond Index – Emerging Markets (GBI-EM)**
- **Bloomberg-Barclays Global Aggregate Index**
- **Citibank's World Government Bond Index (WGBI)**

This will bring what a major bond trading house expects to be about USD250 billion in passive flows over the next few years from investors.

To this point, the development of China's bond markets could aid funding for its long-term infrastructure projects (e.g., One Belt One Road (OBOR) and the Greater Bay Area).

From an investor's viewpoint, the China bond market presents portfolio diversification in geographical and asset class, as it has shown a low correlation with both developed and emerging markets and potentially opens up more Green-bond opportunities.

Bond Connect may help accelerate China's inclusion into major global bond markets and to further promote the yuan as a major currency.

The RMB became the fifth of the International Monetary Fund (IMF's) reserve currencies in October 2016 (joining the US Dollar, Japanese Yen, the Euro and the British Pound), which means it is now included in IMF Special Drawing Right (SDR) baskets.

ASIAN STRUCTURAL ADAPTATION

In conclusion, while the global economy is still carefully adapting to the post crisis environment, with lower growth and abnormally low interest rates, Asia has transformed itself structurally, in light of both the 1997 Asian crisis and the 2008 Global Financial Crisis (GFC).

It has come out of these crises stronger and in many ways more integrated, despite some geopolitical tensions.

An increased role in bond markets across the region will support a more balanced financing model and the role of China in this area will continue to be very important.

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