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## The Big Picture: What's next for the Dim Sum bond market?

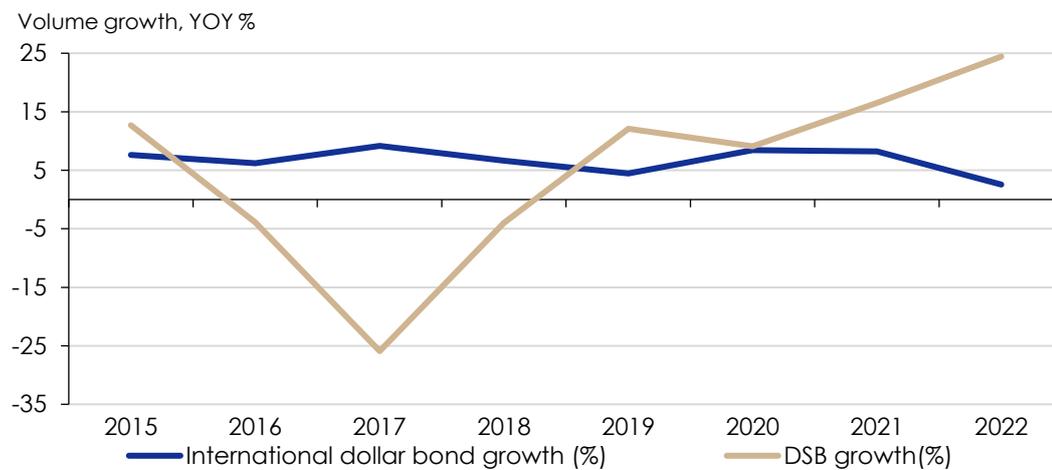
- The Dim Sum bond (DSB) market was a bright spot in the global fixed income market last year. The record issuance was led by foreign financials, reflecting the more favorable interest rate of renminbi on the back of sharp global monetary tightening. Demand was supported by the accelerating purchases via the Southbound Bond Connect and improvements to offshore market infrastructure, which boosted market liquidity. Issuance of Chinese entities was relatively limited due to the soft domestic economy and deleveraging, but held up better than their USD bond issuances.
- We expect solid DSB issuance to continue. In coming years, the normalization of global rates, modest releveraging of the domestic economy, and continued diversification needs of global investors and regional expansion of Chinese trade and investment will generate tailwinds for DSB issuance. We estimate annual DSB issuance could triple in the next three years, rising to RMB1.2-1.5t by 2025F.
- DSBs complement China's capital account liberalization as the offshore market is conducive to attracting global investment into China's corporate bond market. The expansion of DSB facilitates more renminbi denominated outflows and is supportive for USDCNY despite the onshore-offshore interest rate differential, consistent with our positive view about the renminbi exchange rate. A deep DSB market would strengthen the renminbi's role as a global funding currency while increasing offshore renminbi liquidity.

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### Record issuance volume in 2022 against a challenging market backdrop

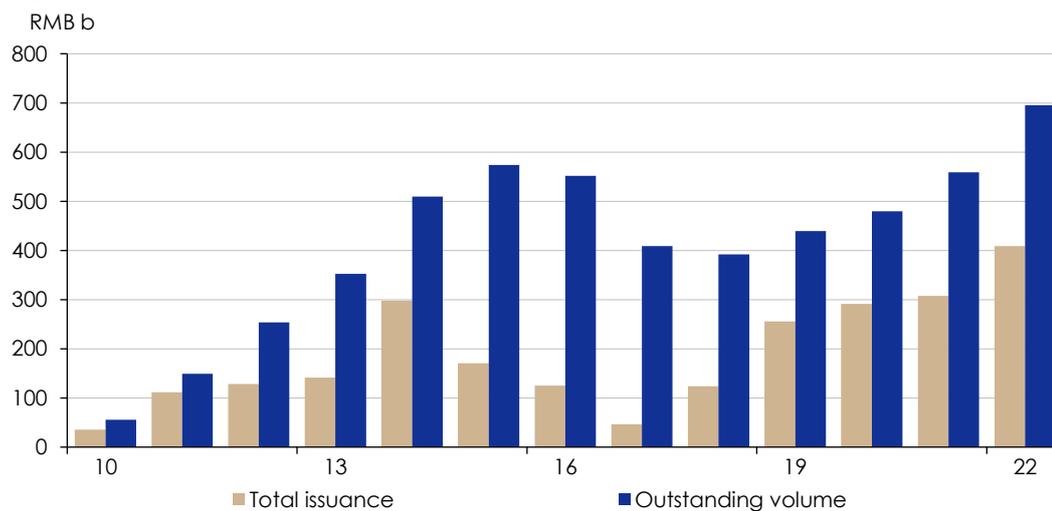
International bond issuance plummeted in 2022 due to the surge in yields and credit concerns, and the dollar bond market registered the slowest growth in years (Fig 1). The S&P [estimates](#) that global bond issuance shrank by about 20% in 2022. Bloomberg estimates that dollar bonds issued by the corporate sector declined nearly 30% YoY during the first three quarters of 2022, marking the lowest level of issuance since at least 2015. By contrast, Dim Sum bond (DSB) issuance accelerated, marking DSB as one of the bright spots of international borrowing. According to data compiled by Bloomberg (Fig 1), total issuance of RMB409b has surpassed the 2021 issuance figure, marking 2022 as a record year for new DSB issuance. Total outstanding DSB volume has increased steadily since 2018, to reach around RMB700b by end-2022, the highest level since the launch of the market about a decade ago (Fig 2).

**Fig 1: Dim Sum bonds outpacing international dollar bond issuance**



Source: Bloomberg, CCBIS

**Fig 2: Record Dim Sum bond issuance in 2022**

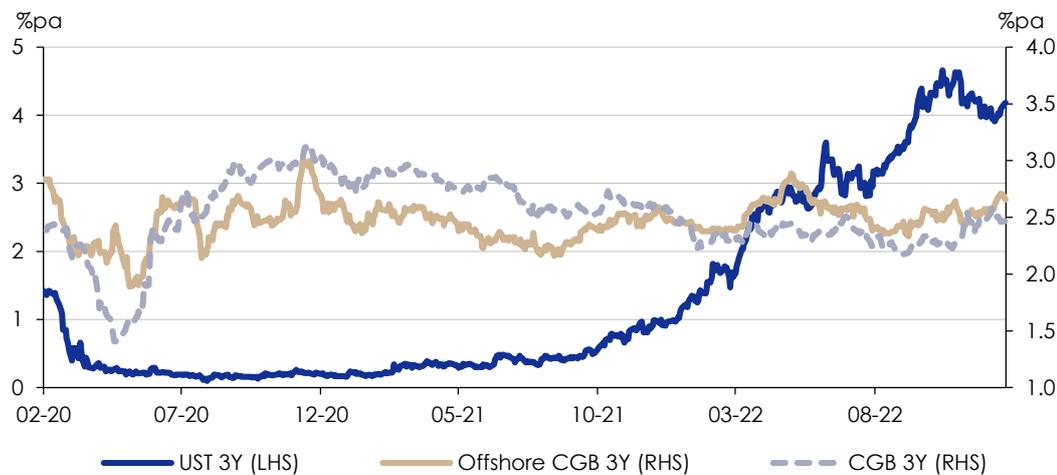


Source: Bloomberg, CCBIS

## Surging global rates have made CNH funding more attractive for non-Chinese borrowers

The global rate environment has been instrumental in the surge in DSB issuance. Rising DSB issuance has coincided with declining dollar and euro bond issuance in the global market, reflecting the significant reversal in issuance cost advantage of the dollar and euro relative to the renminbi. The Fed and ECB tightened monetary policy aggressively to counter the highest inflationary pressure in 30 years, pushing up rates to a level similar to that before the GFC. By contrast, the PBoC has maintained an accommodative monetary policy in 2022 to support growth. During the year, the rate on the 1-year Medium-term Lending Facility was cut twice by 10bps each time and the RRR was also cut further. As a result of divergent monetary policy, Chinese bond yields have moved lower in contrast to rapidly higher US Treasury yields (Fig 3), making the renminbi more appealing as a vehicle of borrowing.

**Fig 3: Yield pick-up with little additional risk**

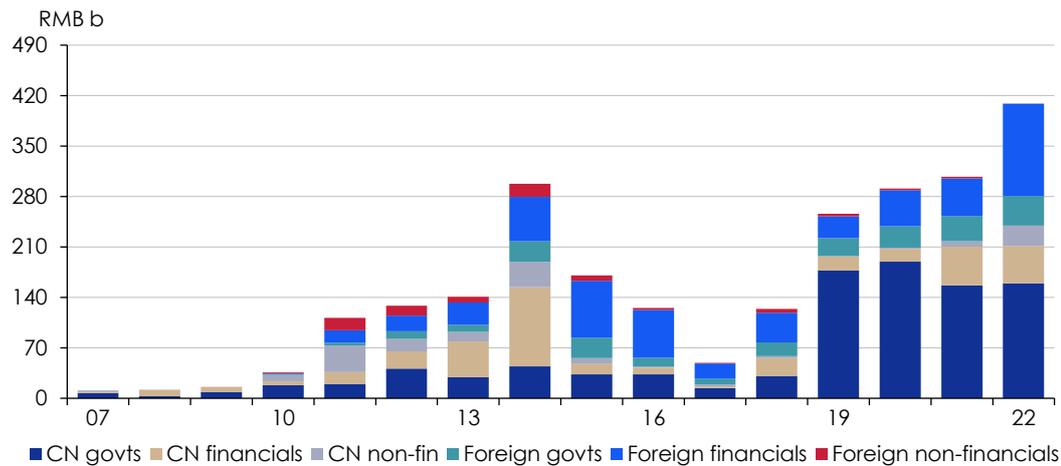


Source: Bloomberg, CCBIS

Foreign issuers, particularly international banks, have been key contributors to rising DSB issuance this year (Fig 4). Major international banks have an established presence in Hong Kong and are familiar with the Hong Kong financial system. The more attractive CNH funding cost is particularly important for global banks, which in recent years have increasingly relied on FX swaps for liquidity management. They took advantage of relatively easy financial conditions in the offshore renminbi markets and cheap CNH borrowing costs to meet their funding requirements. In 2022, total DSB issuance by foreign financials jumped 143% to RMB128b in 2022. Foreign sovereigns, policy banks, and multinational organizations have been a steady and growing source of DSB issuance, led by financial institutions in the UK, Germany, France, South Korea, and Canada. By 2022, DSB issuance by this type of issuers had risen to a record high of about RMB42b.

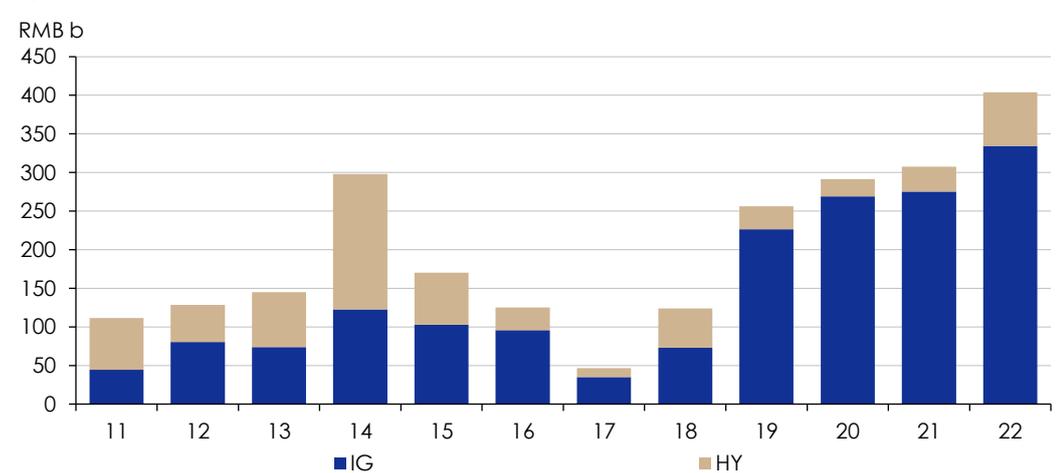
Reflecting the large bank and government borrowers in the market, the DSB market in recent years has been primarily used for IG issuance (Fig 5).

**Fig 4: Record Dim Sum bond issuance in 2022**



Source: Bloomberg, CCBIS

**Fig 5: IG dominates Dim Sum bond markets**

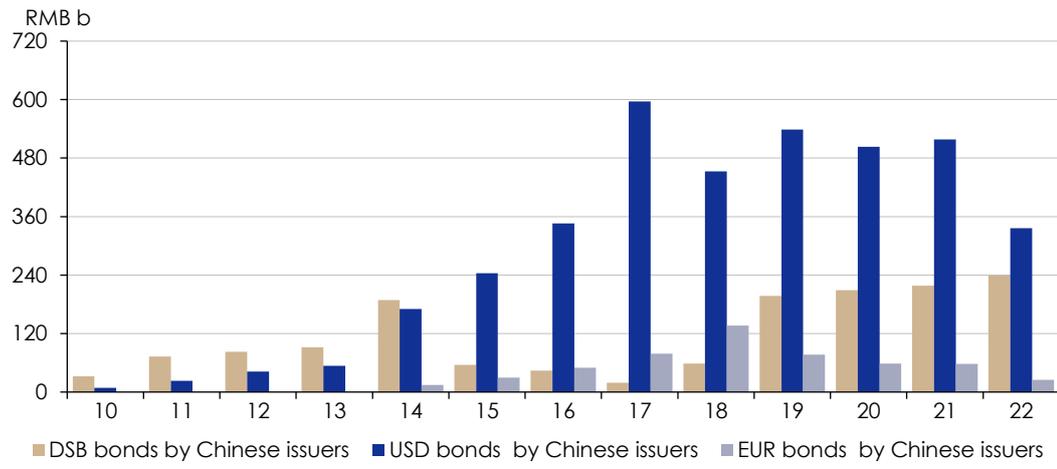


Source: Bloomberg, CCBIS

Chinese DSB issuance was less buoyant and accounted for just below 60% of the total in 2022, compared to around 80% of market share in the past three years. The PBoC's international notes have dominated China's public sector's DSB issuance since 2019, in contrast to 2011-2013 when non-government issuers, such as financials, were the most prominent Chinese issuers.

Still, DSB issuance by Chinese institutions held up when compared to their more sluggish USD and EUR bond issuance (Fig 6). Chinese non-government entities have been constrained by the domestic deleveraging process and more attractive onshore rates. The two main sectors of offshore private issuance, property and LGFVs, are either under financial stress or policy restrictions, and thus face greater obstacles in raising offshore funding. Very few Chinese property names have issued offshore DSBs or USD bonds. Players still able to borrow have turned to the onshore market as domestic financial conditions are more attractive than conditions offshore. Meanwhile, offshore issuance by LGFVs have increased, in part reflecting the significant refinancing needs. Similar to a modest rise in US dollar bond issuance by LGFVs, DSB issuance by LGFVs also rose, but the total remains fairly small.

**Fig 6: Offshore bond issuance by Chinese institutions weakened across currencies**



Source: Bloomberg, CCBIS

## Market opening and infrastructure refinement improving liquidity for DSBs

In addition to rate differentials, relaxation of cross-border bond inflows have increased for offshore renminbi liquidity, supporting portfolio demand for DSBs.

The launch of the SBC between mainland China and Hong Kong on 24 Sep 2021 offered qualified onshore institutional investors a direct link to invest in Hong Kong (HK) bond markets, including the DSB market. Compared with the existing Qualified Domestic Institutional Investor scheme (QDII), the SBC is a more direct outbound investment channel with lower costs and offering greater flexibility in the investment process. South bound accumulated inflows have amounted to RMB368b since the launch in Sep 2021, adding meaningfully to DSB demand.

Demand from onshore investors is being supported by the attractive offshore rates. For example, the yield on 3Y Chinese Government Bonds (CGB) was higher than it was for their onshore counterpart. In addition, the DSB market offers an opportunity for onshore investors to diversify their bond holdings in terms of geography, credit risk, and other considerations. In contrast to Kungfu bonds, highly rated DSBs appear particularly suitable for southbound investors, mainly banks, seeking diversification with some yield enhancement.

The overall size of the SBC remains small at this stage, as an annual aggregate investment quota of RMB500b and a daily investment quota of RMB20b has been imposed on the SBC scheme, and eligible participants include qualified mainland investors (including large domestic banks and QDII investors) onshore and Hong Kong designated institutions offshore. Further expansion of outward investment including an increase of the investment quota and broadening of the participation of institutions, could increase liquidity inflows into HK markets.

Apart from the SBC, the Wealth Management Connect (WMC) scheme launched in Sep 2021, is expected to offer a flexible channel for residents in the Greater Bay Area (GBA) seeking to invest in cross border wealth management products including DSB products. Expansion of the scheme has been hampered by the Covid pandemic and restrictions on cross-border transactions. With the relaxation of Covid-related travel restrictions, the WMC is likely to become an additional source of demand for DSBs, which would see the scope of investment products expand.

### Improvement in offshore market infrastructure

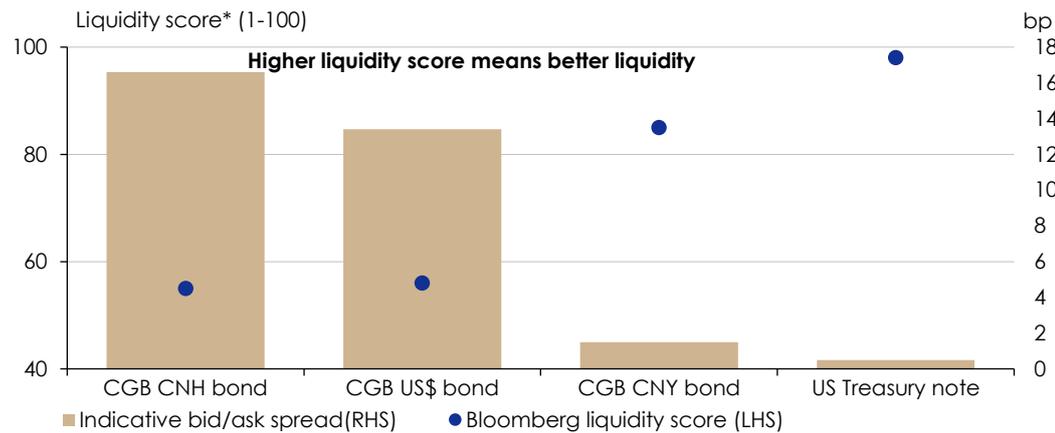
Several policy initiatives have laid the groundwork for improvements to the market infrastructure of the offshore market in order to make it more attractive to investors. Recent initiatives have included development of an offshore renminbi yield curve and strengthening the liquidity backdrop in the offshore market.

- **Government bond issuance to support yield curve formation.** The Mainland and HK governments have committed themselves to supporting DSB market development. These efforts have accelerated in recent years. China's Ministry of Finance is a regular DSB issuer with an annual volume of RMB15b over the past five years. HK government-related entities, such as the Hong Kong Mortgage Corporation, are also regular DSB issuers. The PBoC has issued a large amount of CNH international notes since 2019 with a view of offering quality assets to CNH holders. In 2021, the Shenzhen municipal government was the first local government to tap DSBs, including green bonds in line with the HK government's green initiatives. More local governments, in particular those from coastal provinces with strong credit profiles, are expected to explore opportunities in offshore bond issuance with a view of diversifying their funding sources and obtaining access to international investors. These high quality bonds help support liquidity and build pricing benchmarks in the DSB market.
- **Improving offshore renminbi liquidity.** In recent years, the PBoC has introduced bilateral currency swap arrangements with regional central banks. The scheme has expanded steadily. The establishment of an RMB Liquidity Arrangement by the PBoC and the BIS, announced in Jun 2022, introduced the first multi-lateral reserve pooling denominated in renminbi. The pool can be accessed by participating central banks in the APAC region. Lending further support to the offshore renminbi market, the HKMA established its offshore RMB Liquidity Facility in Jun 2012. In the intervening years the system has been refined, with the most recent upgrades being made in Jul 2022. Enhancements include expanding eligible collateral, streamlining the operational process of the RMB

Liquidity Facility, and improving the terms of lending. Improving the liquidity backdrop in this manner is helping to smooth market functioning and encourage market participation.

Still, liquidity of dim sum bonds market is low, well below that of the U.S. bond and domestic RMB bond markets, as well as Chinese dollar bonds (Fig 7). Most investors hold to maturity, and the trading volume in the secondary market is low. Several factors, including the small market size, a lack of market making participation, narrow range of investors, and limited risk management tools, are likely behind this. The dim sum bond curve by the Chinese Central Government contains only a limited number of tenors, reflecting the limited outstanding volume and a lack of market-makers' participation.

**Fig 7. Liquidity comparison of DSB with other bond markets**



Source: Bloomberg<sup>1</sup>, CCBIS

<sup>1</sup> The Bloomberg liquidity score evaluates the relative liquidity of an instrument in the covered universe on a scale of 1 to 100 (100 being the most liquid). Liquidity in this sense is the ability to sell a security at the lowest cost for a comparable range of volumes.

## Outlook for DSB – continued expansion expected, underpinned by the domestic and global environment

A number of economic and policy conditions are conducive to continued expansion of DSB issuance:

- **Higher global rates will continue to make the renminbi an attractive funding currency in the international market.** Current interest rate differentials between CGBs and USTs are likely to narrow in 2023F once the Fed starts to shift monetary policy while the Chinese economy recovers meaningfully hand-in-hand with the exit from Covid controls, which has accelerated in recent months. However, the advantage of Chinese rates well above those of the global markets, as the case before the pandemic, is unlikely to repeat in coming years. As global central banks are now more wary of inflation risk, they have become more tentative of broad monetary easing, even though occasional financial intervention through sector specific QEs cannot be ruled out. The average long-term US interest rate is likely to be much closer to a 2% growth rate in real terms, and fluctuate in the 3-5% range in nominal terms for the next few years. For China, the real interest rate has averaged around 2% since the GFC as monetary policy expansion has been restrained. We forecast a cyclical recovery is likely to see the renminbi nominal rate top 3% in 2023F and beyond. In short, nominal rates in China and in the US are likely to fall in a similar range in the medium-term, although the cyclical picture in the near term suggests that Chinese rates will remain lower by comparison. DSBs would remain an attractive funding currency, especially for foreigners.
- **Releveraging in China will increase borrowing needs, including through the offshore market.** While the deleveraging process in China has seen a slump in offshore issuance by Chinese entities last year, we look for the Chinese leverage cycle to rise modestly in coming years, driven by government borrowing and expansion into new areas.

Government financing needs have increased as a result of the pandemic. We expect government bond issuance to remain in the RMB7-8t range each year in the next few years, or about 7-8% of GDP. At present, only a tiny fraction of government bond issuance was conducted in DSB markets. More issuance could be conducted offshore at a slightly more attractive rate for foreign investors, to reduce pressure on domestic financial institutions, and promote renminbi internationalization.

Among private borrowers, deleveraging in the property sector has been the dominant theme and has curbed corporate debt growth in recent years, although borrowing in some of the industrial sectors began to pick up 2022, marking the first year that corporate leverage rose since 2015, mainly in the downstream and mid-stream sectors, in line with industrial upgrades and supply chain reconfiguration. The leading sectors of investment expansion, such as energy, utilities, and equipment, may increase their borrowings to fund growth. These sectors account for about 12% of non-financial corporate bond issuance, or about RMB600-1t net bond issuance. Funding for these capital intensive sectors requires the participation of the capital markets for the sake of risk diversification. DSBs provide a much-needed funding channel for these needs. We forecast these new growth areas could add about RMB200b in annual borrowing to the DSB market by 2025F.

Domestic releveraging tends to spill into the offshore market. Chinese companies, especially HY names, are already active borrowers in the offshore US dollar bond market. Such borrowing has helped the companies concerned to raise funding from overseas and access diverse investors, although dollar borrowing has also increased the currency mismatch of some of the borrowers whose income are mainly from domestic sources. On the investor side, global investors are investing in offshore corporate bonds rather than the onshore corporate bond market, suggesting market-oriented pricing in the offshore market and attractive yields have been conducive to foreign participation. Even so, China's offshore bonds account for less than 10% of its overall bond market, well below the approximate 20% share for Asian economies and 40% globally, as estimated by ADB. Subgrade borrowers in particular still rely heavily on banks.

The DSB market will be attractive for Chinese companies looking to access offshore funding without a currency mismatch. From a policy standpoint, encouraging more DSB issuance by Chinese issuers could diversify the funding sources for Chinese firms, increase their access to global investors, and help price discovery, despite the likely

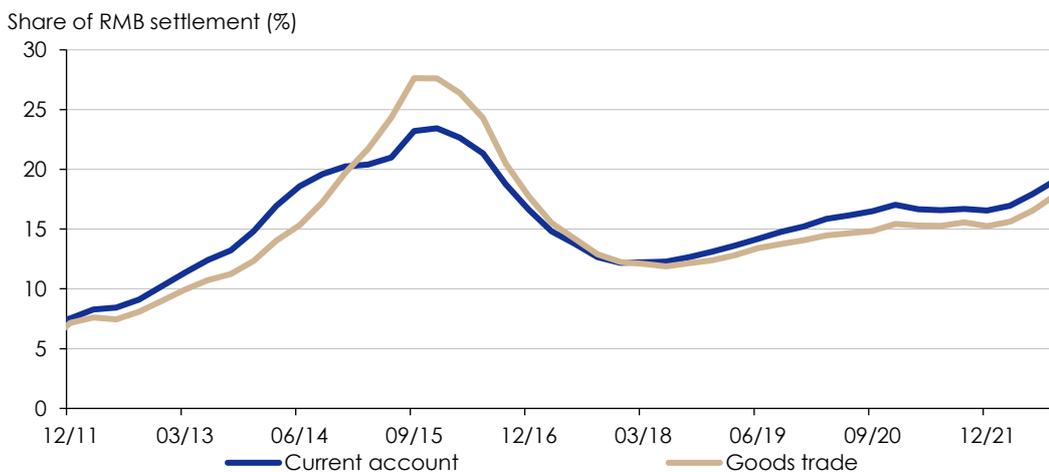
more favorable domestic rates. Continued offshore market development supported by financial products enabling interest rate and exchange rate risk hedging and strong liquidity management, could boost the participation of Chinese corporate issuers and more international investors in the DSB market.

- **Geopolitical and concentration risk highlight need for diversification.** Low interest rates are not sufficient on their own to drive offshore renminbi growth. For instance, the euro and the yen have both had lower interest rates than US dollar since the GFC, but international borrowing in these currencies were behind that of dollar in most years. The dollar's position was propelled by the expansion of America's international securities market, while balance sheet difficulties of the European banks and the stagnant Japanese economy limited the role of the euro and yen. In fact, over 70% of international borrowing is now denominated in US dollars, up since the GFC.

Dollar dominance has brought with it rising risk. Surging debt and high inflation could result in unwanted tightening in global liquidity as the recent market developments have shown. In addition, ratcheting geopolitical tensions have given rise to concerns about the dollar-based funding structure in international financial markets. These and other forces could push issuers and investors to look for alternative funding currencies for diversification purposes, which would be positive to DSB market expansion.

In this connection, regional trade and investment linkages could increase renminbi liquidity needs by regional borrowers. Despite steady improvement in recent years, the share of current accounts settled in renminbi still has ample room to grow (Fig 8). The share of renminbi used in trading with ASEAN countries remains less than 20%. Rising regional demand and strengthening regional links are paving the way for rising renminbi liquidity and funding needs.

**Fig 8: The share of current account settled in RMB**

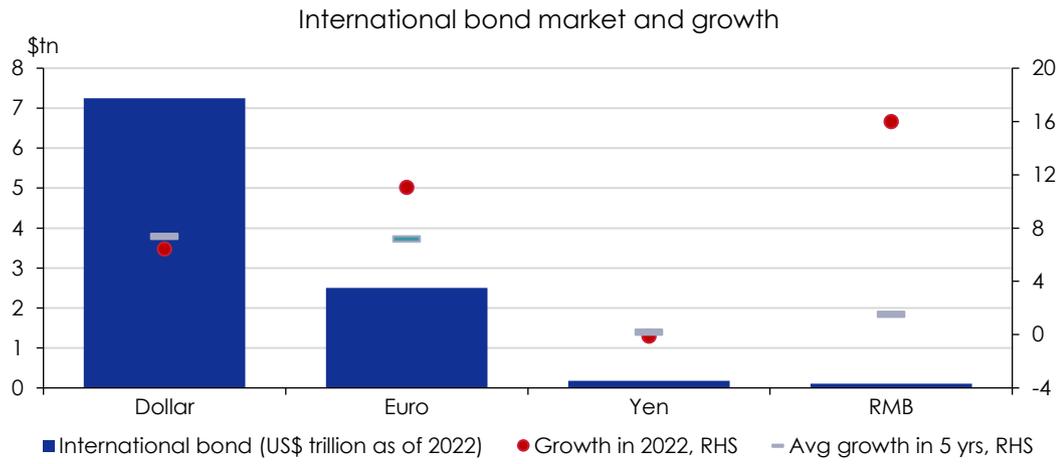


Source: Bloomberg, CCBIS

We estimate that annual DSB issuance could reach RMB1.2-1.5t by 2025F, tripling the 2022 issuance volume. DSB issuance is likely to continue to outpace issuance growth of regional US dollar bonds and the onshore bond market. Foreign financials are likely to remain the driving force as liquidity management at the major banks has come to increasingly rely on FX swaps. In addition, releveraging in select areas among onshore corporate issuers, especially utilities, energy, industrials, and other capital intensive sectors, could tap the DSB market. Other countries could also issue DSBs for diversification purposes, including to raise funding for long-term investment.

In short, the DSB market will remain one of the fastest growing international bond markets. To be sure, despite fast growth of late, it remains small relative to other international bond markets (Fig 9). In the next three years we expect the DSM to grow to an outstanding size of around RMB1.7-2.0t, well below the size of the international US dollar market and still a fraction of outstanding onshore renminbi bonds.

**Fig 9: DSB market is small but growth has accelerated**



Source: BIS, CCBIS

## Implications for China's capital account opening, USDCNY, and RMB internationalization

DSB will facilitate China's capital account opening, giving rise to more fund raising channels for domestic institutions and overseas asset allocation in renminbi by onshore investors. It will enhance the international use of the renminbi.

**The expansion of DSB markets will support capital account opening up and increase cross-border portfolio flows.** In recent years, China has accelerated the opening-up of onshore markets. Foreign investor exposure in China's bond market has climbed to over 3.0% last year before easing to 2.7%, driven by modest outflows on the back of rising global rates. Global investment in onshore fixed income products concentrates in government and financial bonds and is particularly sensitive to benchmark interest rate changes.

With Chinese interest rates becoming less attractive from a yield enhancement perspective at this cyclical juncture, a broader investment space for foreign investors would help to attract continued global investment in renminbi assets. Given the different pricing and investor mix between the offshore market and the onshore countermarket, the offshore market stands to attract more global investors in corporate bonds than the onshore market.

As well, a broader set of renminbi denominated products would allow onshore entities to invest abroad as the recent experience of the SBC shows. Such investments would enable onshore entities to take on foreign credit risk without concomitant exchange rate risks, and would allow onshore entities to diversify their portfolios.

**DSBs would reduce the impact of net portfolio outflows on renminbi exchange rate.** Rising global rates and the soft domestic economy have put pressure on portfolio investment into China, with net outflows the largest since the GFC. We estimate southbound investment accounted for about one-third of China's outward portfolio investment this year. We expect net bond outflows to continue given the relative rate difference. Downward pressure on the renminbi exchange rate was limited last year, given the much larger current account surplus and strong FDI inflows.

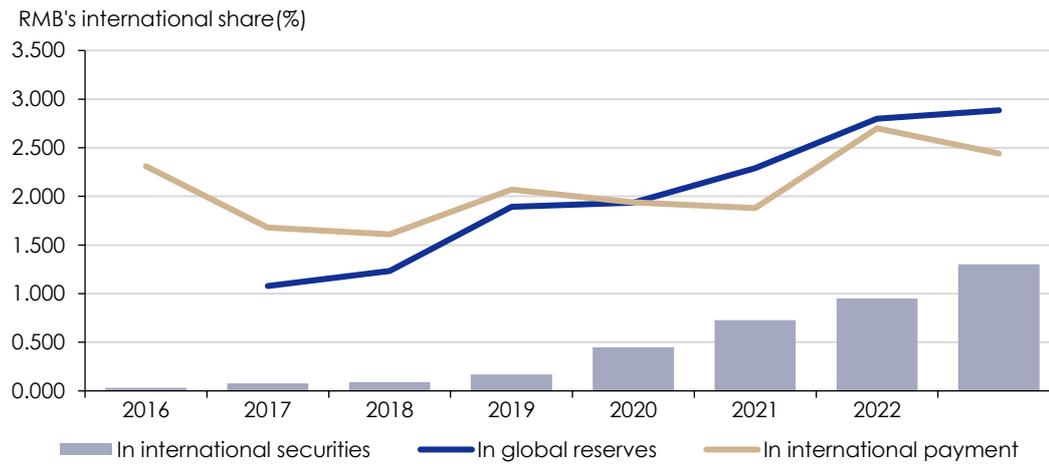
As portfolio outflows continue, a shift in composition towards DSB would enable qualified institutional onshore investors to build external assets without downward pressure on the exchange rate, supporting our view that the renminbi will appreciate modestly against a weaker US dollar in the coming years, despite the lower domestic interest rate compared with the global market.

**A deep offshore bond market is critical to RMB internationalization.** Despite the recent surge in DSB issuance, the DSB market remains very small by international standards (Fig 9), consistent with the still limited role of renminbi as a global funding currency. The renminbi is now the fifth-largest reserve and international payment currency thanks to the opening up of the onshore capital market and the liberalization of the renminbi, specifically the use of renminbi for trade settlements. By contrast, renminbi accounts for only about 1% of the international bond market (Fig 10).

The expansion of the DSB market should help to stimulate broader internationalization of renminbi. Offshore renminbi deposits have surged this year (Fig 11), despite low CNH interest rate, suggesting that the offshore use of the renminbi have improved the offshore renminbi liquidity. The 2022 BIS Triennial Central Bank Survey suggests that in 2022, the renminbi's share of global foreign exchange turnover picked up to a record high of 7.0% out of 200.0%, compared with 4.3% three years earlier, driven by HK and offshore financial centers (Fig 12). DSB can help to develop the offshore FX trading in renminbi. For instance, the proceeds of foreign borrowing through renminbi bond issuance are likely to be swapped into dollars, supporting expansion of the FX swap market.

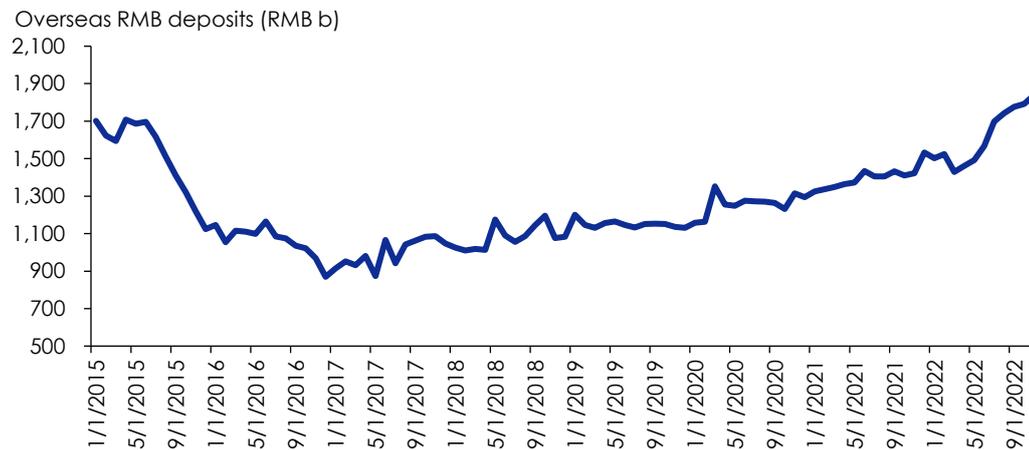
A bigger DSB market, coupled with further liberalization of cross-border flows in China, will lay the foundation for a more active secondary market for DSB and improve its liquidity.

**Fig 10: RMB as a funding currency lagged other internationalization measures**



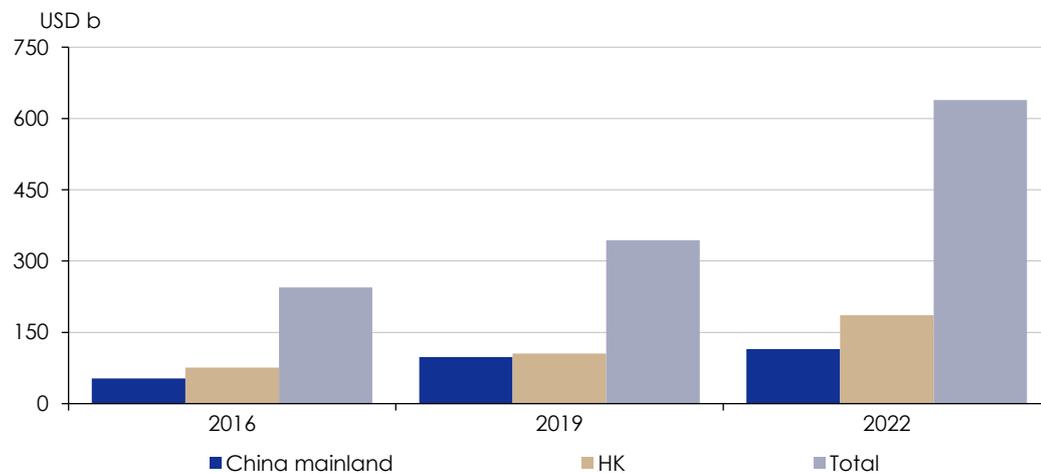
Source: BIS, Bloomberg, CCBIS

**Fig 11 :Overseas RMB deposits surged this year, surpassing the previous high**



Source: PBoC, Bloomberg

**Fig 12: Offshore market led the more active FX trading in CNY**



Source: BIS, CCBIS

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