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China green bonds: Too big and attractive to ignore

A market offering yield, diversity, and a chance to make a difference

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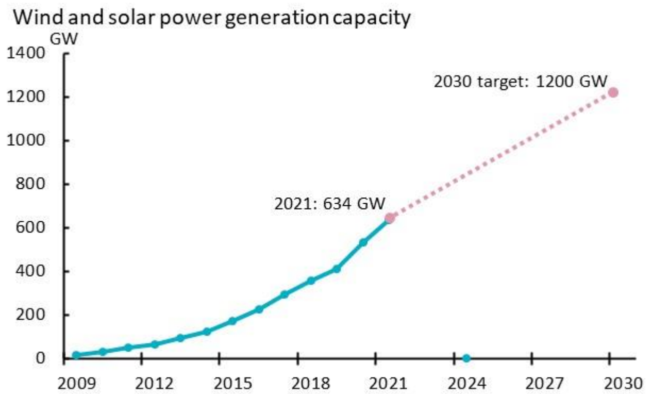
Key points

- The ambition to decarbonise the world's largest greenhouse gas emitter has fuelled tremendous growth in China's burgeoning green bond market. As the world's second largest supplier of these bonds, China offers several attractions to global ESG-focused investors.
- First, as a platform for financing a key national development objective, the green bond market will likely continue to receive strong policy support. It could serve as a haven for investors who have been through a hard time investing in China due to regulatory uncertainties.
- Second, global demand for green assets has grown strongly. While China is a latecomer to ESG investing, the theme has caught on fast with local investors reflected by the boom in ESG-focused funds in recent years.
- Third, China's size is striking when it is seen in the Emerging Market (EM) context. With a 90% market share in local currency bonds, China cannot be overlooked by any investors who seek to earn an extra yield on their green investments.
- Finally, China green bonds are attractive from both green and financial perspectives. The former is due to a closer alignment between local and international green bond standards. As for the latter, China bonds are generally higher yielding, shorter in duration and have delivered competitive performance on a gross and risk-adjusted basis in recent years.

Beijing's ambition to reach carbon neutrality by 2060 has set the world's largest greenhouse gas (GHG) emitter on a fast track to decarbonisation. Renewable power generation capacity has nearly tripled in the last five years, while sales of electric vehicles – of which China is the world's largest producer and consumer – hit 20% of total car sales, well ahead of the official target in the 14th Five Year Plan. But all of this represents just the beginning of a long journey (Exhibit 1). To achieve net zero by 2060, hundreds of trillions of yuan's worth of new investments will be needed to transform China's economy and energy system to wean the nation off its fossil fuel reliance.

Exhibit 1: Green transition has a long way to go



Source: CEIC, Government Report and AXA IM Research, as of April 2022

Financing this transformation will be an arduous task, but Beijing is rising to the challenge. Amid the boom in green financing, the green bond market has emerged as a bridge connecting capital and investments that are both environmentally friendly and financially attractive. With rapid growth supported by policy tailwinds, China has rapidly become the world's second-largest green bond market by value outstanding, with annual issuance frequently topping the global table in recent years.

We have published extensively on China's green bond market, covering its development history[1], market characteristics, regulatory backdrop[2] and its role in China's green transformation[3]. In response to increased investor interest, this paper will take a practitioner's angle by discussing four key attractions of the asset class in the current macro environment.

1: A market supported by policy tailwinds

There are multiple structural and cyclical supports for a continued expansion of the green bond market. As highlighted above, the market provides a critical funding platform for aiding China's green transformation. Compared to direct lending by banks, green bonds are more liquid, transparent, and standardised market-based instruments, governed by regulations that are increasingly aligned with international standards. The latter means that foreign capital can also be attracted to assist in the nation's decarbonisation fight.

In addition, Beijing's focus on energy security has likely been strengthened by last year's power shortage and the current geopolitical tensions. The former rang an alarm bell by exposing the nation to the danger of a hastened breakaway from fossil fuels without establishing a reliable replacement energy source. In response, Beijing has taken out some short-term insurance against another potential power crisis, by de-emphasising the energy reduction target in this year's Government Work Report and ordering the reopening of some coal-fired power plants to ensure stable electricity supply. However, its long-term desire for energy self-sufficiency – supported by a move towards renewable power – must also have been strengthened by the debacle.

Further cementing this desire is likely the current war between Russia and Ukraine. As the world's largest energy importer, skyrocketing oil, gas, and metals prices will worsen China's trade balances and contribute to a stagflationary shock to the economy. Apart from higher energy bills, the threat of sanctions against its purchase of Russian energy could push China to fast-track its development of self-reliant renewable energy, which will require the support of a deep and liquid green bond market.

Understanding the above is important for investing in China green bonds. For global investors, China has not been an easy market to invest in lately due to heightened regulatory uncertainties. Fears of government crackdowns on many fast-growing industries have led investors to shy away from the market despite starting from an underweight position.[4]

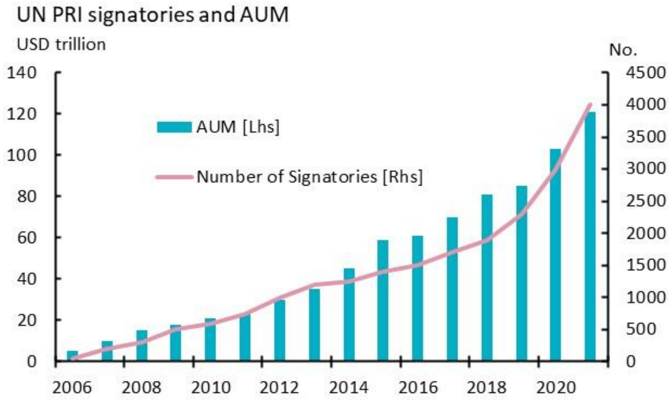
However, not all sectors and industries have faced regulatory headwinds. As resources were drained from real estate and big tech monopolies under China's 'common prosperity' policies, green-related sectors, such as renewable energy and electric vehicles, have benefitted from tremendous investment and policy supports, fuelling exceptional growth and asset price appreciation.

Being selective is, therefore, key for navigating China's changing policy and macro landscape. We think the green bond market offers an opportunity for global investors to *'invest with'* Beijing on an important, long-term development theme, which should ensure more policy tailwinds than headwinds.

2: Surging demand for green assets

Apart from the conducive supply-side dynamics, demand for green assets has also grown strongly. Currently there are around 4,000 investors with global assets under management (AUM) of US$121trn that have signed the United Nations' Principles for Responsible Investment (UN PRI, Exhibit 2). Asia has seen particularly fast growth in PRI signatories among large asset managers in recent years. China is a late comer to Environment, Social and Governance (ESG) investing but has caught up on the theme fast. Since its first signatory in 2019, eight more large institutions – mostly managing assets over $50bn – joined the PRI alliance in 2020.

Exhibit 2: Surging demand for ESG assets globally



Source: United Nations, Morgan Stanley and AXA IM Research, as of April 2022

[1] Yao, A. and Shen, S "China: Powering growth in global green bonds" AXA IM Research & Strategy Insights, 30 January 2018

[2] Yao, A. and Shen, S. "China: Riding the green wave" AXA IM Research & Strategy Insights, 27 October 2021

[3] Yao, A. and Shen, S. "China: Financing the Green transformation" AXA IM Research & Strategy Insights, 29 April 2021

[4] Yao, A. and Shen, S. "Five Reasons why China should be standalone in global asset allocation" AXA IM Research & Strategy Insights, October 2019

Domestically, China has also experienced a boom in ESG-focused funds. As of Q3 last year, there were 127 funds with a sustainability investment theme according to Morningstar. About a third of them were launched in 2021, more than double that in the previous year, taking the industry's AUM to a record $47.5bn.

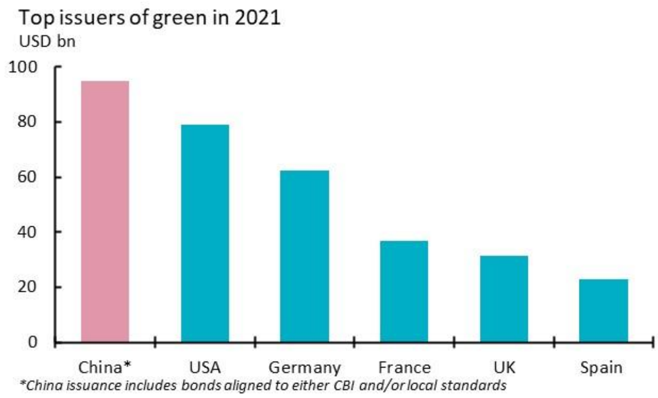
The gravitation towards ESG investing by large institutional investors likely reflects their growing awareness of environmental risks and the need to heed Beijing's call for supporting the nation's green transformation. The Asset Management Association of China – the industry's self-regulatory body – has long been an advocate for green investing and encouraged members to introduce ESG products to the public. For retail investors, the recent strong performance of 'green assets' – notably stocks of renewable energy and electric vehicle companies – has been a powerful draw for capital inflows.

Finally, the role of regulation cannot be overlooked. The launch, and its subsequent growth, of the onshore green bond market would not have been possible without the policy push from the People's Bank of China (PBoC). More recently, other regulators – the National Development and Reform Commission (NDRC) and China Security Regulatory Commission (CSRC) – have also joined forces to bring together non-financial issuers and investors to add depth and diversity to the market. These are important developments for laying the foundation for a healthier and more sustainable development of the green bond market.

3: Too big to ignore

Size matters when it comes to assessing the investability of a market. Despite starting late, China's green bond market has caught up with its developed market (DM) peers. Since its first bond sale in late 2015, China has frequently topped the global issuance table and grown its market to be the world's second largest after Europe today (Exhibit 3).

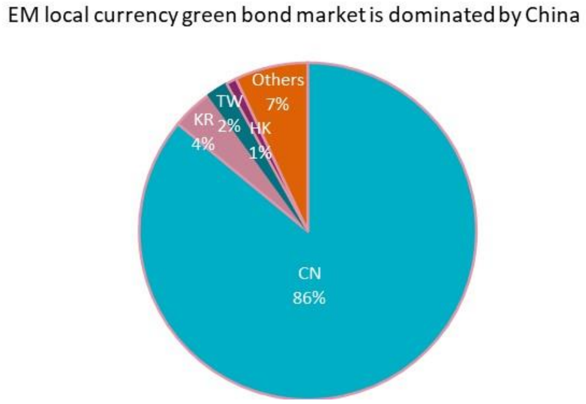
Exhibit 3: China regained top issuer position last year



Source: CBI, WIND and AXA IM Research, as of April 2022

Putting China's size in a proper context, Exhibit 4 shows the country's dominant position in the emerging market (EM) corporate green bond universe. Including bonds from Hong Kong and Taiwan, the greater China region accounts for about 90% of all EM green bonds denominated in local currencies. China also dominates in the hard currency space, making up over 50% of USD bonds in Asia. Hence, for global investors who want to earn an extra yield on green bonds – or avoid paying a 'greenium' in DM – China is simply too large to ignore.

Exhibit 4: China dominates in EM green bonds



Source: Bloomberg, WIND and AXA IM Research, as of April 2022

4: Attractive bonds becoming greener

A green bond is effectively a conventional debt instrument financing specified green projects. Hence, there are two common questions about China green bonds: 1) are they 'green' enough as ESG instruments and 2) are they attractive enough as investable assets? On the former, the removal of all fossil fuel projects in the 2021 edition of China's Green Bond Catalogue has led to an almost complete convergence in green bond standards between China and DM. For the remaining differences – mainly concerning the use of proceeds – our experience as a market practitioner suggests there is adequate information disclosure for bond screening based on most customised standards. Even under our strict green bond framework, AXA IM has found no major impediments to keeping the 'greenwashing' risk low in our portfolio.[5]

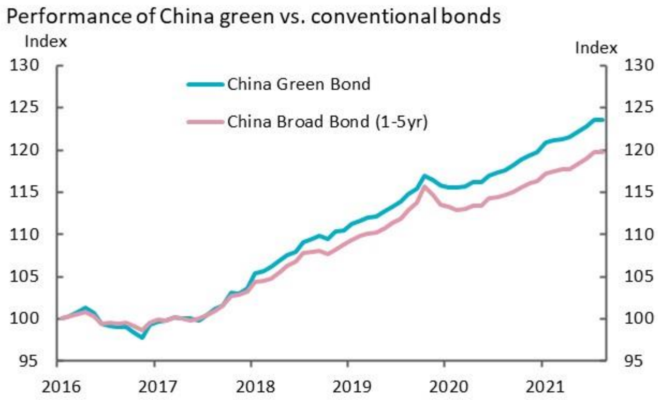
As an investment, China green bonds can be compared to both China conventional bonds and global green bonds. The former is best applied to investors who need to allocate to China but are under no obligation to buy green bonds. Table 1 shows that green bonds tend to offer higher yields (about 20 basis points) than conventional bonds with similar maturity and duration. This is consistent with our previous study[6] showing that not only is there no pervasive evidence of a 'greenium' in the Chinese market, but investors are often getting paid to

[5] For more details on how AXA IM manages greenwashing risk in China, please see: Yao, A. and Shen, S. "China: Riding the green wave" AXA IM Research & Strategy Insights, 27 October 2021

[6] Yao, A. and Shen, S. "China: Riding the green wave" AXA IM Research & Strategy Insights, 27 October 2021

'hold green'.[7] This, in turn, helps to explain the consistent outperformance of green bonds over their conventional peers on both gross and risk-adjusted basis (Exhibit 5, Table 1 on Sharpe Ratio).

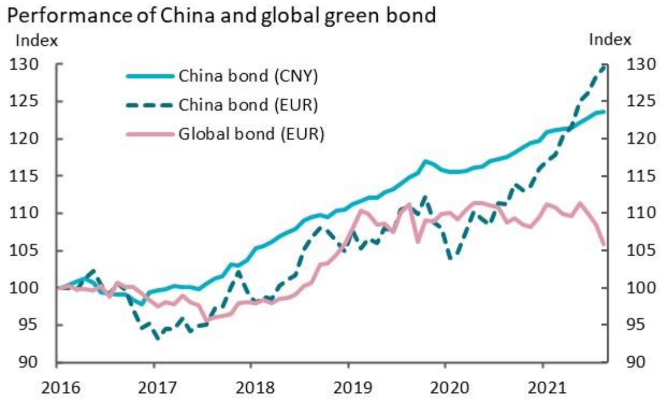
Exhibit 5: China green bonds outperform normal bonds



Source: FTSE, Bloomberg, BofA ICE and AXA IM Research, as of April 2022

As for global investors who have a mandate to invest in only green assets, it makes sense to compare China's green bonds with global green bonds. Table 1 shows that Chinese bonds are shorter in maturity and duration but offer higher yields (more than 100 basis points). These yields, however, are denominated in local currencies – yuan and euros – meaning that foreign investors have to bear FX risks to earn the premium[8]. Exhibit 6 shows China bonds have delivered significantly better performance in both yuan and euros over the past six years. The performance difference is even starker once the volatility of returns is considered, as seen in the Sharpe ratios in Table 1.

Exhibit 6: China green outperforms global green



Source: FTSE, Bloomberg, BofA ICE and AXA IM Research, as of April 2022

To conclude, China green bonds is an attractive asset class given its improved green features – following the removal of regulatory loopholes – and strong performance as an investment in recent years. The market is already too big to ignore and is set to grow even bigger and more liquid thanks to strong investor demand and policy support. The latter could offer a potential haven for investors who are concerned about regulatory uncertainties in China. Perhaps most importantly, for those who are committed to protecting the environment, investing in the green transformation of the world's largest greenhouse gas emitter could offer a chance to make a real difference on climate sustainability.

Table 1: China green bonds are higher yielding, shorter duration, and competitive in performance

	FTSE Onshore China Green Bond Index	Bloomberg Global Green Bond Index	ICE BofA China 1-5 year Broad Bond Index
Market value weighted duration	2.45	8.19	2.51
Average yield to maturity (%)	2.78	1.72	2.59
Average maturity (year)	2.81	9.25	2.68
Gross Return (%, since inception)	23.6 (CNY), 29.5 (EUR)	5.8 (EUR)	19.7 (CNY)
Standard deviation (% since inception)	1.8 (CNY), 5.8 (EUR)	4.3 (EUR)	1.6 (CNY)
Sharpe Ratio	1.1 (CNY), 0.8 (EUR)	0.4 (EUR)	0.8 (CNY)

Source: FTSE, Bloomberg, BofA ICE and AXA IM Research, as of April 2022

[7] This could be because the Chinese market was jump-started by supply forces, which have remained strong relative to demand despite the latter gaining momentum in recent years. At the time when green bond investing has yet to become mainstream, issuers have to offer higher yields to entice buyers, resulting in a yield premium (or price discount) for green bonds relative to conventional bonds. The situation in Europe is the opposite, with green bond demand outstripping supply leading to buyers paying a 'greenium' for bonds.

[8] The currency hedging market in China is in early stages of development and accessibility for foreign investors is rather limited. The lack of market depth and instruments means that hedging costs can be punitive. The current pricing of three-month currency forwards and cross-currency swap suggests the hedging costs for CNY/EUR can be as high as 350 basis points, resulting in a negative hedged yield for euro-based investors.

Our Research is available online: http://www.axa-im.com/en/insights

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