China Debt Dynamics

China Bonds included in new global index for first time

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- **New Global Bond Index** - Bloomberg Barclays Fixed Income indices have created a new global index that will have a **China element for the first time, with a 5.4% weighting (as compared to 1.5% foreign holdings of bonds)**.
- **Launch 01 Mar 2017** - it combines the existing "Global Aggregate Index" with the *government* components of the "China Aggregate Index", with the ticker I32751US.
- **Potential US$1.5tn Impact** – A 5.4% weighting compares with an 11% weighting of the RMB in SDR (special drawing rights) baskets. Moving from the current 1.5% foreign ownership to full 11% weighting would require US$1.5tn of FX inflows, which would help in managing RMB weakness.
- **Next Step in Bond Development** - Index inclusion is the next step in the continued development of the bond market and the formation of a risk curve; both of which are structurally important for an orderly resolution of credit excesses in China.
- **Positive** - We view this as **positive for the distressed debt universe** in which ShoreVest operates as it improves structure and segmentation of risk-pricing for underwriting purposes.

Chinese Gov't bonds included in new index reflects size and global relevance

The Chinese bond market has grown by almost three-fold since 2010, quickly becoming the **third largest bond market in the world at US$8.8tn**, just behind Japan at US$9.0tn and the US at US$40tn. And given the rapid pace of new issuance, it is on track to soon be the second largest. Given its sheer **size and global relevance**, inclusion into global bond indices was imminent.

The Bloomberg Barclays **Global Aggregate Index is widely recognized** as a benchmark for global bond investors. It covers bonds in **24 currency markets** around the world including both developed and emerging markets, but for now **excludes RMB-denominated bonds** - despite RMB bonds being fully opened last year to foreign investors for purchase and trading in the China Interbank Bond Market.

But now, beginning on 01 March 2017, a new global index is established that combines the well-followed Global Aggregate Index with the government bond and policy-bank bond components of the China Aggregate Index (which has multiple components, including corporate bonds). It is called the "Bloomberg Barclays Global Aggregate + China TR Unhedged USD" and is under the Bloomberg ticker I32751US.

Transitional process - corporate bonds next

With a 5.4% weighting -- as compared to the RMB having an 11% weighting in SDR (Special Drawing Rights) currency baskets -- we presume the time-lapse since last year's market opening to foreigners was deliberate to allow Bloomberg officials time for due-consideration to **implement Chinese bond inclusion on a transitional basis** (i.e., increasing over time both the weighting and breadth of types of bonds in the index).

For example, the constraint that the China component of this new global index be **limited for now to only government bonds and policy bank bonds** (i.e., it excludes corporate bonds), implies that this inclusion will be done on a progressive basis.

Additionally, regarding inclusion in the China Aggregate Index, Bloomberg has also **raised the minimum issuance** for government bonds to RMB5bn (US$729m) from RMB1bn, and for corporate bonds to RMB1.5bn (US$219m) from RMB1bn to **ensure ample liquidity for global index inclusion**.

The establishment of a new global bond index to include Chinese RMB-denominated bonds is a **natural next step in the process of the rapid development of the bond market** in recent years.

China's Bond Market – a deliberately rapid expansion

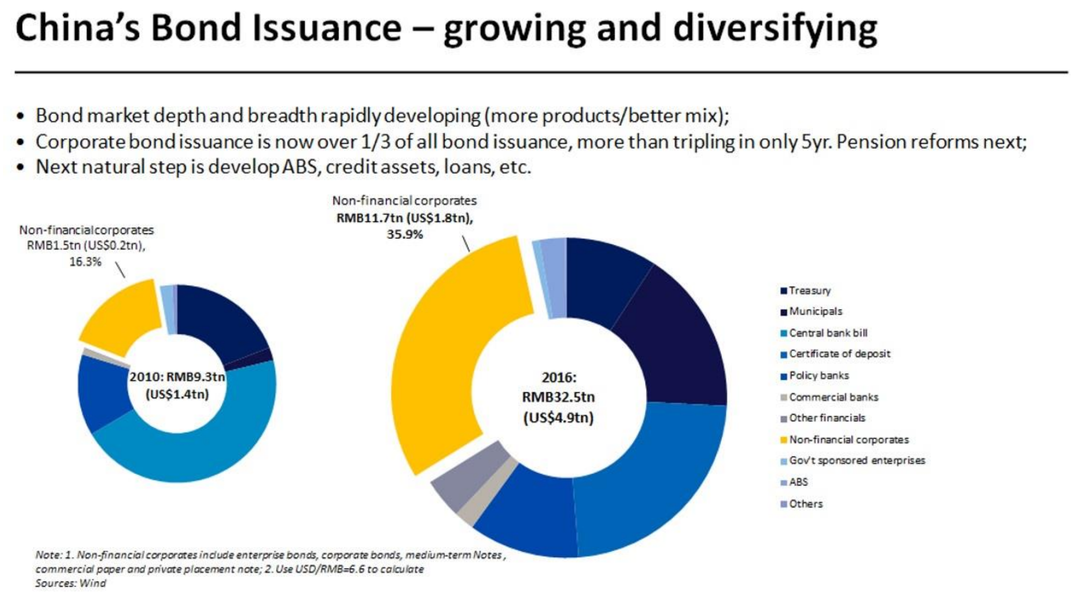
We believe the **rapid development** in China's debt capital markets is necessary and is **deliberately being coordinated** by authorities to achieve four key objectives:

- **Risk Diffusion** - diffuse credit risk away from bank balance sheets to reduce concentration/systemic risk;
- **Amend and Extend** - better align debt amortization schedules with cash flows of borrowers;
- **Create Long-duration Assets** - long-duration asset pools are necessary for pension reforms (which we believe are imminent);
- **Attract Foreign Capital** - Chinese bonds are very under-owned by foreign investors. Bloomberg Barclays Global Index inclusion will attract foreign capital, which also helps with RMB foreign exchange management;

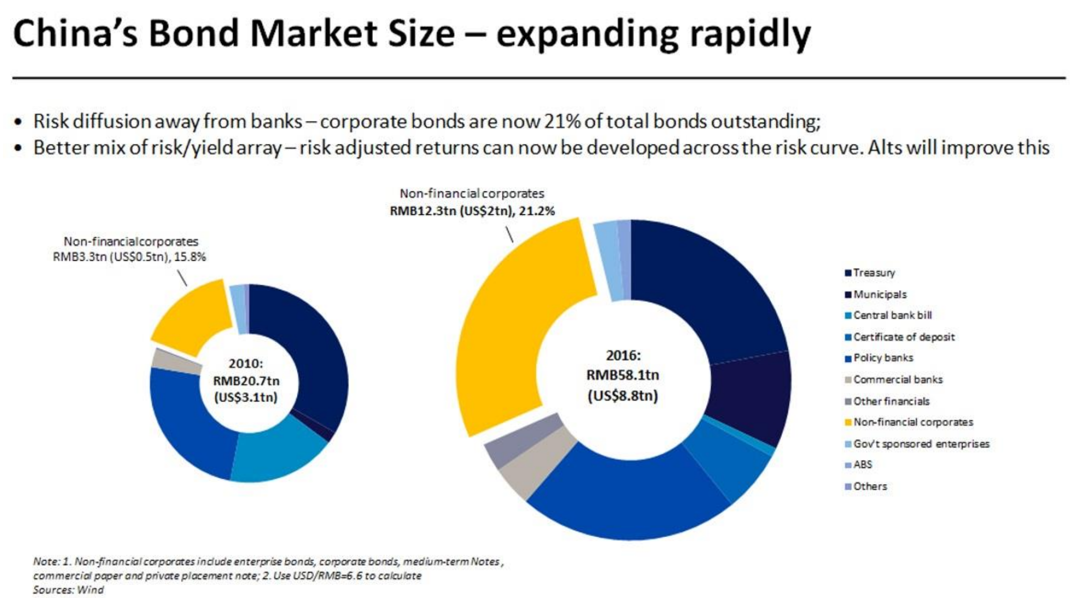
China's bond issuance has been torrid in recent years. In 2016 alone, the issuance of new bonds was equivalent to **US$4.9trillion**, **and the depth and breadth is developing rapidly**-- more products are being issued and with a better mix (see below).

Also, corporate bond issuance is now over 1/3 of all bond issuance when taking into account the Local Government Financing Vehicle (LGFV) debt swap program which refinances the maturing corporate loans of LGFV's.

The next natural step is the development of the ABS market, credit assets, loans, etc. in order to **establish a risk curve** (i.e., a proper term structure of interest rates).



With such a rapid increase in the issuance of bonds, the size of the bond market has **increased three fold to now US$8.8tn in outstandings** (see below). The risk diffusion away from bank balance sheets has been effective, with corporate bonds now 21% of total bonds outstanding. And this helps achieve a better mix of risk and yield array, meaning risk adjusted returns can now be benchmarked across the risk curve.



FX inflows – new index encourages capital inflows

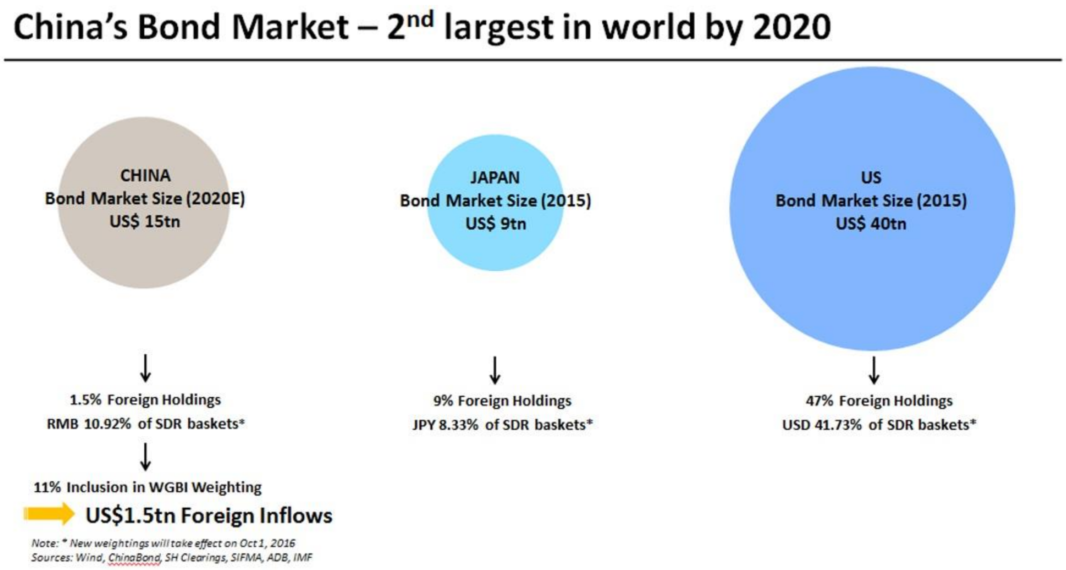
This creation of a global index that includes Chinese bond weightings, with the Bloomberg Barclays index pedigree, should certainly **encourage foreign institutional investors to increase exposure to Chinese bonds**, particularly global passive money given their benchmark requirements.

This new global index is a key element in the continued opening of Chinese capital markets, and importantly **creates a mechanism for foreign capital inflows** at a time when FX outflows have been increasingly challenging.

Indeed, China's foreign exchange reserves announced for the month of January, 2017, **fell below US$3tn for the first time since 2011**, illustrating the challenge of capital outflows that have been occurring.

The Chinese **bond market is already the 3rd largest in the world** at US$8.8tn and heading to approximately US$15tn by 2020 given the pace of issuance, **yet is only 1.5% held by foreigners**.

Using the 11% weighting of the RMB in Special Drawing Rights (SDR) baskets as a proxy for a full-market weighting for Chinese bonds, this **implies that US$1.5tn of foreign capital inflows** would be necessary to achieve a neutral weighting by foreign fixed income investors (over time).



Orderly process – good for ShoreVest's investments

In our view, this step toward more institutionalization of the Chinese bond market does not detract from the NPL opportunity set and **addressable universe for ShoreVest; rather, it augments it.**

We believe the confluence of the above topics improves the environment for ShoreVest in the distressed/NPL space, as in combination they reduce the probability of a systemic risk event, and therefore reduce volatility in asset prices which allows better clarity on underwriting and pricing decisions to more predictably achieve our targeted high-teens net IRRs.

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