Testimony of Teresa Kong to the U.S.-China Economic and Security Review Commission Hearing on ***"U.S. Investment in China's Capital Markets and Military-Industrial Complex"***

Thank you for the opportunity to appear before the Commission today.

My testimony today is based on over 25 years of working in the debt capital markets, advising international sovereigns and companies on how to borrow, as well as investing in these markets on behalf of global investors. It is structured to address three key questions: What are the motivations and risks for a U.S. investor investing in the China bond market? How does a U.S. investor invest in the China bond market? And finally, what are the implications of these U.S. investments in China?

I. Motivations Behind U.S. Investments in China Bond Market

The primary components of return and risk for Chinese debt are interest rates, currency, and credit. First, in terms of government credit, China has an A1/A+/A+ rating from the three major international rating agencies. Second, interest rates in China have more room to fall than to rise as inflation remains subdued. Finally, the Chinese renminbi (RMB) might continue on its appreciation path relative to the U.S. dollar. As an example, if we start with a yield of 3%-4% for a China government bond, add potential 1%-2% appreciation and 1% for credit spread for an investment grade corporate, that could potentially mean 5% -7% total return for a U.S. dollar-based investor.[1]

However, returns come with risks. The RMB can depreciate and interest rates can rise, eroding returns. The biggest risk in investing in Chinese corporates is credit—what is the probability of default? While the overall default rate in China is rising, it is still low relative to other markets and it is likely to remain in the in low single digits given China's remarkable COVID-19 recovery and its economy is healthy. By our estimates, the default rate for 2020 stood at ~0.8%. The U.S. high yield default rate, for comparison, is around 6% on a 12-months trailing basis.[2]

In our view, the relatively low default rate can be attributed to the following reasons:

- Companies who issue bonds in China tend to be the best in their respective industries and are not representative of the entire Chinese economy. Hence, there is a sampling bias.

[1] Source: Bloomberg. As of March 11, 2021 a 10 year US Treasury bond, denominated in USD, currently yields ~1.5% while a China Government bond, denominated in CNY, currently yields ~3.2%.

[2] Source: BOFA, Data as of February 28, 2021

- The large presence of State Owned Enterprises (SOEs), which enjoy relatively easy access to liquidity. The bond market is usually just one of the many channels of financing the SOEs have access to, reducing the likelihood of default.
- Government support of key sectors such as banking, resulting in very low default rate of Chinese banks.

Over time, we expect some of the structural forces like government support of certain sectors or companies to diminish, paving the way for default rate to gradually increase.

Defaults are indeed a necessary evil. They are signs of a maturing capital market where participants have to be sophisticated analysts of credit risks to generate superior returns. Investors can no longer just rubber stamp an investment because it has a guarantee or a keepwell agreement from a state owned enterprise—even for companies of strategic importance.

The recent defaulted companies share commonalities of weak corporate governance, poor financial performance and a track record of making questionable investments. By allowing poorly managed companies or ones with unsustainable capital structures to default, the Chinese government is preventing moral hazard and enforcing good governance and fiscal discipline. This has been a consistent goal of Chinese policymakers for over a decade.

Another question that often arises is whether U.S. investors can trust the local market credit ratings? Why are there so many domestic rated AAA companies?

The Chinese domestic ratings are derived from historical domestic default data. International ratings are derived from a substantially longer data set, over multiple credit cycles across a broad set of countries and industries. Thus, the resulting ratings are different. Since default rates have been low in China for the reasons discussed, most companies get an AA or above domestic rating.

With international rating agencies now able to enter and compete in the domestic market, we expect greater transparency into the credit worthiness of Chinese companies. Over time, we expect domestic ratings to gradually be calibrated closer to an international rating scale with longer histories for companies with similar credit metrics.

II. How Does a U.S. Investor Access the China Bond Market?

The "External" or "Offshore" bond market

Of these three key dimensions of credit, currency, and risks, if I want to take on only the credit risk of a corporate, I can buy a USD-denominated bond issued by a corporate. This is known as an "external" or "offshore" bond. Offshore bonds are custodied in an international clearing house like Euroclear, issued under foreign laws (e.g. English or New York law)[3], traded over-the-counter by international and domestic broker dealers, and are primarily held by global institutional investors.

The total notional debt issued by Chinese corporates in the offshore market is approximately US$611 billion, or approximately two-fifth of the U.S. high yield market.[4] U.S. investors typically have some exposure to this offshore market if they own a global or emerging market bond mutual fund or ETF.

The China "Local" or "Onshore" bond market

To gain exposure to all three dimensions of credit, currency, and interest rates, one could invest in China's "local" or "onshore" bond market. Onshore bonds are held in local custody in a domestic Chinese bank, are issued under Chinese law, traded mostly by domestic broker-dealers and are primarily held by Chinese institutional investors.

China's onshore bond market is currently the second largest in the world with approximately RMB 100 trillion notional outstanding (~US$ 15 trillion notional outstanding).[5] It is about 35% of the size of the U.S. bond market, which continues to be the largest bond market globally.[6]

Ownership by international investors is still relatively low, around 3% percent of the overall China bond market, and around 9% percent for government bonds. Ownership has been historically low because of limited market access. But as the Chinese government has liberalized access, the global bond indices have begun to include China bonds into their indices. As we speak, China is about 6% of the Bloomberg Barclays Global Aggregate Index. It is 10% of the JP Morgan Global Bond Index (GBI-EM). Finally, it is slated to be included in the FTSE Russell Global Bond Index in October 2021. As a result, we would expect international investor ownership of Chinese bonds to rise in the coming years.

Based on our estimates, assets benchmarked to just these three indices alone total about US$4 - 5 trillion. Thus, even a 6% - 10% inclusion over the next couple of years could amount to approximately US$200 - 400 billion of additional global inflows.

[3] Source: Bond Prospectus
[4] Sources: JPM Asia Credit Index (JACI), BAML US HY Master Index; Data as of February 28, 2021
[5] Source: AsiaBondOnline; Data as of December 2020
[6] Source: SIFMA 2020 Capital Markets Fact Book; Data as of December 2019

The initial foray by international investors into onshore China bond market has largely been in government bonds. This is because the government bond market is large (representing about one-third of the total bond market), liquid, and can fit neatly into the responsibilities of an existing sovereign analyst. Investment in onshore corporates has been more limited due to the infrastructure demands inherent in investing in corporates—researching, trading, managing, and monitoring of hundreds of distinct companies. Furthermore, corporate bonds are typically less liquid and have shorter maturities of three years or less. Other than specialists like Matthews Asia and the largest dozen or so U.S. asset managers, most investor firms cannot afford the human and capital investments necessary to have credible investment capability in this nascent market. Hence, most retail U.S. investors have zero exposure to the domestic onshore China corporate bond market.

III. Implications of U.S. Investments in China

As a portfolio manager, it is my fiduciary duty to invest prudently to maximize returns while minimizing risks. Investing responsibly is one way to minimize risks. We do this via active engagement of our portfolio companies to assess their environment, social and governance (ESG) track record.

To provide one example, we are invested in a global ports operator with a mixed track record on labor relations and worker safety. When we brought up the issue of employee treatment several years ago, company management was defensive. Any criticism was brushed off as incomplete and biased media coverage. Reports of union busting at some of the company's ports were said to have mischaracterized its actions, and that worker fatalities like when a container fell and crushed a truck were a one-off. As we and other investors continued to bring up the same topic year after year, the company shifted its stance. They acknowledged that they are new to the journey of ESG, but have been working to steadily collect data and improve disclosure on a port-by-port basis. Once they hone their ability to track and measure relevant environmental and social metrics, they intend to turn them into real policies that positively impact their employees on the job. This company has slowly begun to see strength in ESG as an investment that will generate a return, rather than a cost.

This leads me to my belief that U.S. policy towards China has to be grounded in the principles of engagement and multilateralism. As more global investors with shared values invest more in China, we can incentivize them to adopt good policies and behaviors. Similarly, as Chinese companies rely more deeply on the global capital markets, they have more skin in the game.

The second tenet of multilateralism is driven by necessity. My lonely voice as one institutional investor would be unlikely to impact the labor practice of any company. However, when a chorus of investors sing the same tune, we can influence with a carrot instead of a stick. China is already too big for any one

country acting alone to have material impact. Unilateralism, absent coordination with our allies, could be counterproductive to our policy goals. It might end up putting U.S. investors at a disadvantage by limiting our opportunities in the global capital markets or even lead to losses to investor portfolios.

Going down the path of sanctions and prohibitions alone can be counterproductive—including the executive orders (EOs) announced in the last quarter of 2020 targeting U.S. investments in Communist Chinese Military Companies (CCMCs). Since "U.S. persons" is a broad term that could include any U.S. person in facilitating a transaction, several broker dealers took the safest route and stopped making markets altogether while waiting for further clarification, resulting in mark-to-market losses.

In my professional opinion, prohibiting "U.S. persons" from being able to invest in "public securities"[7] of loosely defined CCMCs is detrimental to U.S. investors. It hampers asset managers from fulfilling fiduciary duties to the best of their abilities. Entities that are directly responsible (DRE, Directly Responsible Entity) for producing military equipment for the PLA (People's Liberation Army) are often not listed and do not have any publicly traded securities. These characteristics of DREs make sanctions on "public securities" less than effective, rendering the policy ineffective in achieving its objective of limiting capital to Chinese military companies. An analogous hypothetical example would be to limit any "U.S. persons" from being able to invest in General Electric (GE) because GE Aviation produces goods for the U.S. military.[8] Here, the DRE is GE Aviation but GE Aviation does not have any publicly traded equity or bond securities[9]. By instituting a general prohibition on investments in General Electric, the policy prevents investors from being able to invest in a great company like GE. Even more importantly, it does not achieve the policy objective of prohibiting development of GE Aviation or related military technologies. If the U.S. deems that it is absolutely necessary to impose sanctions or prohibitions, then targeting specific commercial transactions between "U.S. persons" and DREs might be a more effective way to achieve its policy objective.

To conclude, I believe U.S. policy towards China has to be grounded in engagement and multilateralism. It lies in being more deeply invested in China so that we can influence with a carrot instead of stick. It lies in liaising with our allies with similar values to find common ground and pursue common policy goals. We change people through conversation, not censorship. We change policy through engagement, not sanctions. I trust that the Commission can help the

[7] Source: Executive Order 13959
[8] Source: GE Aviation
[9] Source: Bloomberg

Congress and the President to work with our allies towards constructive engagement with China.

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