China fixed income

Finding potential in the increasingly important asset class

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Key takeaways:

- Despite FTSE Russell's decision to not include onshore RMB Chinese government bonds into its flagship index, we expect onshore assets will continue becoming more mainstream. Regardless of the timing of index inclusion, we believe investors should continue to concentrate on the drivers of fixed income returns
- Onshore RMB government bond yields reflect expectations of future interest rates and domestic supply-and-demand conditions. In this way, Chinese government bonds behave more like those of a developed market than an emerging market
- China is keen to maintain at least a relatively stable currency to support domestic demand, which is now by far the biggest contributor to economic growth, while also encouraging greater inward investment
- Because short-term interest rates in China have fallen more quickly in China than in the US, Europe and Japan, the cost of hedging has come down considerably. Investors hedging RMB Chinese government bonds into these domestic currencies still enjoy a yield pick-up, while continuing to benefit from of a diversified interest rate cycle

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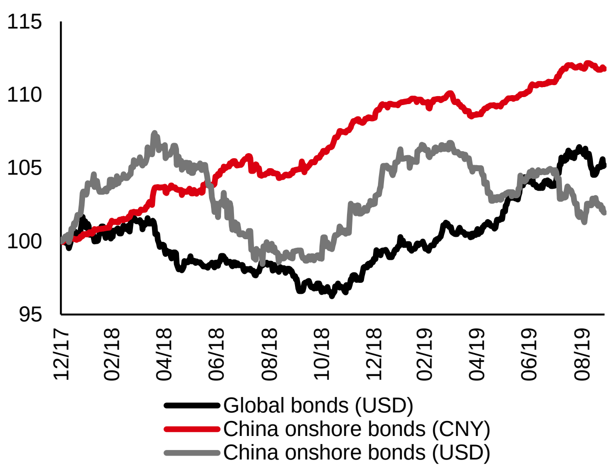
In its September 2019 annual review, FTSE Russell decided not to include onshore RMB Chinese government bonds into its flagship index. The index provider cited secondary market liquidity as well as currency exchange execution and settlement of transactions as areas where index users would like to see improvements. FTSE acknowledged the cooperation of the People's Bank of China and stated that it would continue to engage with the central bank on how to best address the outstanding criteria. We believe that despite this decision, it remains clear that China has been making efforts to advance its financial market reforms and expand access to its capital markets. These efforts have been recognized by both Bloomberg as well as JP Morgan, both having announced or already begun the inclusion of Chinese onshore bonds into their widely-tracked indices this year, providing further evidence that this asset class is becoming more mainstream. We believe that investors should continue to concentrate on the drivers of fixed income returns. With over a quarter of global investment grade debt trading at negative yields, it remains an opportune time to look for ways to diversify their portfolios.

The conventional belief is that if there is a slowdown in an economy, asset prices will suffer. Looking at China, the slowing Chinese economy is precisely the reason why the yield of high-quality RMB bonds has been falling fairly consistently since the beginning of last year and would have provided an excellent foil to the rising US Treasury yields which wreaked havoc on global bond portfolios in 2018. In fact, China was one of the best-performing government bond markets in the world in 2018, on a hedged and unhedged basis. Any surprise at this statistic is likely to stem from the erroneous assumption that in a year of negative economic headlines, Chinese assets performed poorly.

Fig. 1: Performance of China bonds vs global bonds

12/31/2017=100

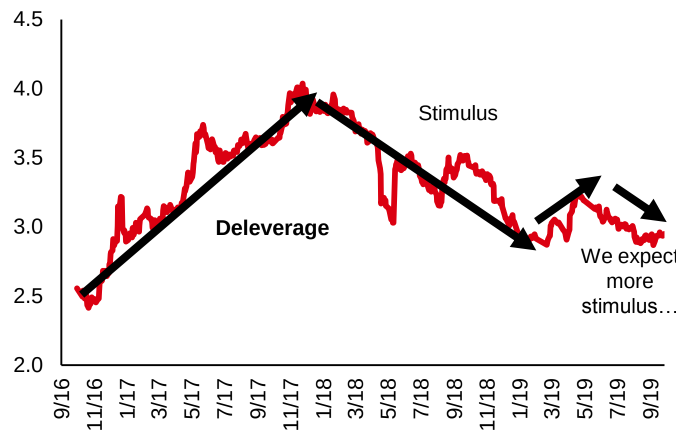


Source: Markit, Bloomberg as of September 26, 2019. Past performance is no guarantee of future results.

Onshore RMB government bond yields reflect expectations for future interest rates and domestic supply and demand conditions. In this way, Chinese government bonds behave more like that of a developed market than of an emerging market, although it is probably fair to say that making any general characterization of these two is becoming increasingly difficult. The Chinese government is rated A+/A1, which implies relatively lower credit risk, so its peers lie more in the developed markets than emerging economies.

Fig. 2: China domestic yields driven by domestic rate expectations and supply and demand

CNY 5-year government bond yield (%)



Source: Bloomberg as of September 26, 2019. Past performance is no guarantee of future results.

Meanwhile, the low participation of foreign investors, which is a legacy of previously closed markets and low benchmark weightings, means that this asset class is far less impacted by global capital flows and risk sentiment. This can provide unique potential diversification benefits.

Fig. 3: RMB bonds: Low correlation to other asset classes

Correlation of returns

	Offshore RMB bonds	Onshore RMB bonds
Global bonds	0.201	0.199
US bonds	0.18	0.195
EM bonds	-0.008	0.199
Asian bonds	0.206	0.119
US Treasury	0.165	0.191
Euro government	0.194	0.128

Source: Bloomberg as of September 2019.

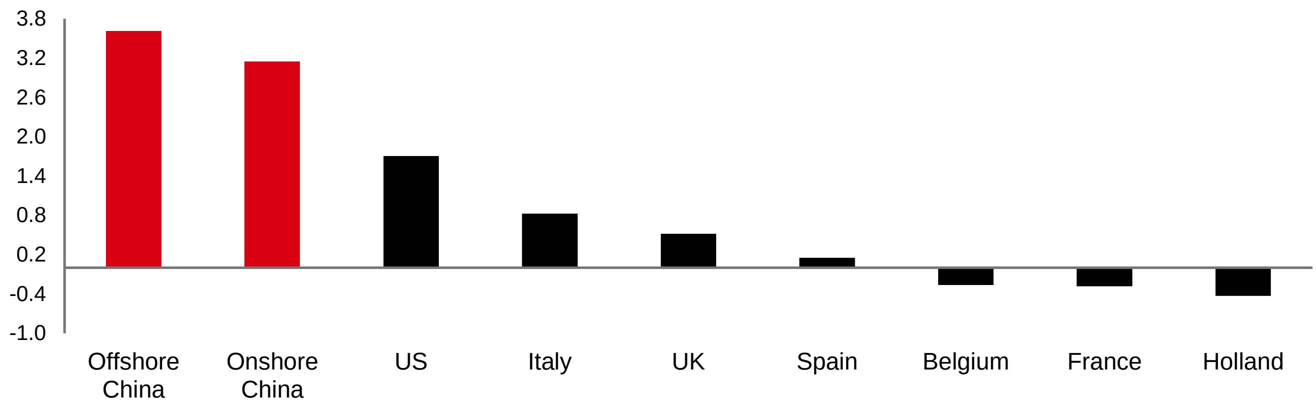
But what about the currency? Many investors believe that this is how anything which limits Chinese growth will impact asset prices, especially for the many investors who take unhedged foreign exchange risk when investing in emerging market bonds - and therefore enjoy the higher yields. The more nuanced issue here is the incentives of the Chinese government. China is keen to maintain at least a relatively stable currency to support domestic demand, which is now by far the biggest contributor to economic growth, while also encouraging greater inward investment. It especially wants to avoid a repeat of 2015, when a weaker currency led to significant outflows, which in turn led to further currency weakness, creating a vicious circle. This makes China unusual in a world where many governments would prefer a weaker currency in order to support foreign demand. But in the medium- to long-term, it make s a case for a stronger RMB.

For investors who choose to hedge their currency risk, the prospect of investing in RMB bonds has also become more attractive. Because short-term interest rates have fallen more quickly in China than in the US, Europe and Japan, the cost of hedging has come down considerably. This means that investors hedging RMB Chinese government bonds into these domestic currencies may still enjoy a yield pick-up, while continuing to enjoy the benefits of a diversified interest rate cycle.

In essence, diversification in investment returns comes from differences in fundamentals. If all the world were the same, then assets from different regions and countries would give the same types of return. We cannot emphasize enough the unique nature of the integration of Chinese markets into the global financial system. Despite FTSE's decision this year, it is only a matter of time before they begin including onshore bonds. To have such a huge pool of uncorrelated liquid assets become suddenly available to investors is not something which has happened before and may not happen again. As a result, we see embracing this opportunity as simply accepting the future and what may soon be commonplace. In the meantime, the potential benefits to portfolio returns could be substantial.

Fig. 4: 10-year government bond yields of largest global bond markets

10-year government bond yield (%)



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