# One-on-one interview

## China fixed income: Going whole hog on China bonds in 2019

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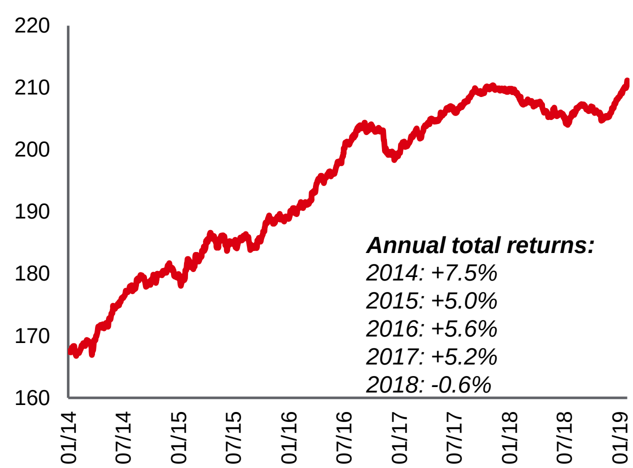
What can international bond investors expect from the Chinese bond market in 2019? The previous year was marked by a number of uncertainties that clouded market sentiment, including concerns over slowing economic growth, default risks, geopolitical uncertainties, a rising US dollar and emerging market (EM) vulnerabilities. But even despite these, the Chinese USD bond market ended the year down by only 60bps, outperforming many other asset classes. In this interview, Gregory Suen, Investment Director, Fixed Income, discusses whether these concerns will carry on in the Year of the Pig, shares his views on what will define the China fixed income market in the coming year and highlights the investment opportunities he is seeing.

**Are you expecting a better year for the China fixed income market in 2019 after a challenging 2018?**

Last year was difficult for many asset classes, including Chinese USD bonds, which fell in 2018 by 0.6%. This follows six years of positive total returns for the asset class. However, we expect a better year for Chinese offshore bonds in 2019, given that the two main factors that dragged down the market in 2018 have already turned positive. First, the markets in 2018 were concerned about the US Fed rate hiking cycle, which was one of the main events that hurt market sentiment; however, that has almost completely reversed, as most investors are anticipating a slower rate hike pace in 2019. Secondly, Chinese USD credits traded weaker in 2018 as deleveraging in China resulted in much tighter liquidity and raised concerns of increasing defaults in China; again, the story has changed now as maintaining economic growth appears to be the priority of the government, which means that liquidity is much looser now. The market has also been flooded with liquidity with the recent, and rather aggressive, cut in the Reserve Requirement Ratio (RRR) in the beginning of 2019, which has been positive for the Chinese credit market.

**Fig 1: Chinese USD bonds weakened in 2018 following years of steady returns**

JP Morgan China Total Return Index (USD)




Source: JP Morgan as of January 25, 2019. Past performance is not indicative of future performance.



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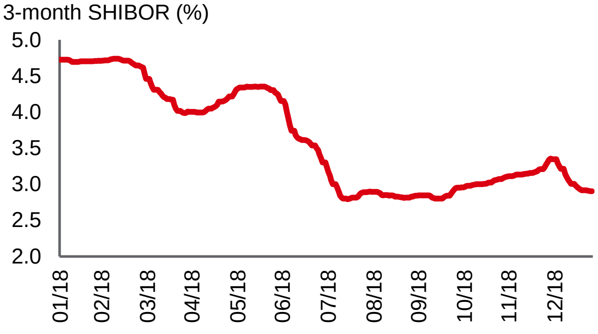
### In what ways has the liquidity situation improved in China? How will this play into the new issuance market in 2019?

We began 2019 with a PBoC announcement of a 100bp cut in the RRR, carried out in two phases – 50bps on January 15 and 50bp on January 25. The PBoC estimates that this move injects CNY1.5 trillion of liquidity into the system, helping with the liquidity needs ahead of the Chinese New Year holidays. The RRR cut provides support to the private sector and signals the government's commitment to economic growth.

SHIBOR, which is a good indication of money market liquidity, has come down meaningfully, showing that liquidity conditions have loosened a lot in China. We are seeing this translate directly into an improved refinancing environment for onshore bonds. For a while, new issuance in the onshore bond market had been declining due to negative sentiment surrounding China's deleveraging campaign and high corporate funding costs. However, that focus has now changed, as we saw monetary policies turn more accommodative in the second half of 2018. With the improvement in onshore refinancing conditions, we have seen the new issuance bond market onshore pick up and return to more normal levels – this shows that refinancing channels are still available, and concerns of refinancing risks should soften quite a bit.

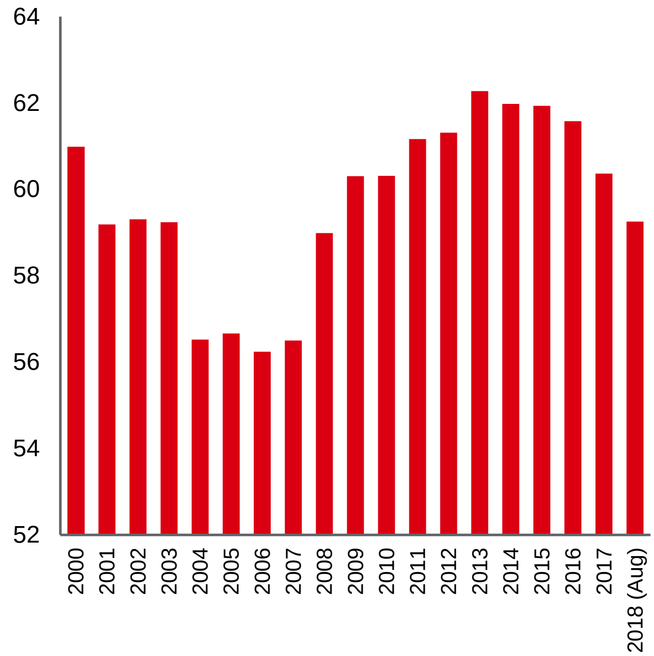
In the offshore space in 2018, we saw USD246.9 billion in new issuance in Asia, of which 66% came from China. In the global EM space, China also made up a significant portion (44%) of the 2018 supply. While onshore refinancing needs still remain elevated, the prospect of better onshore liquidity can be expected to translate to lower Chinese offshore issuance in 2019, which should improve the supply demand dynamics.

**Fig 2: SHIBOR rates have declined, signaling looser liquidity in China**




Source: Bloomberg as of January 25, 2019. Past performance is no guarantee of future results.

**Fig 3: SOEs leverage has been reduced**




Source: BIS, Bloomberg, CEIC, HSBC Global Asset Management, October 31, 2018. Past performance is no guarantee of future results.

### Have some of the concerns surrounding the Chinese property bond market eased?

The Chinese property bond market found support at the end of 2018, as the National Development and Reform Commission (NDRC) released guidelines, easing rules on onshore bond issuance by high-rated/quality firms. This resulted in a large increase in onshore issuance in December from high-quality developer names, as well as lower-quality ones. This is among one of the moves by Chinese authorities to loosen their regulatory grip in the onshore funding market. Such market conditions should benefit property developers generally.

Sentiment for Chinese property bonds in 2018 had been affected by concerns over refinancing risks as well as tightening of onshore liquidity. With this, we also saw Chinese developers tap the offshore dollar market, thereby helping mark 2018 as the record year for the largest amount of primary issuance of offshore Chinese property bonds. However, we do expect the 2019 gross and net issuance supply to come down from the 2018 levels.

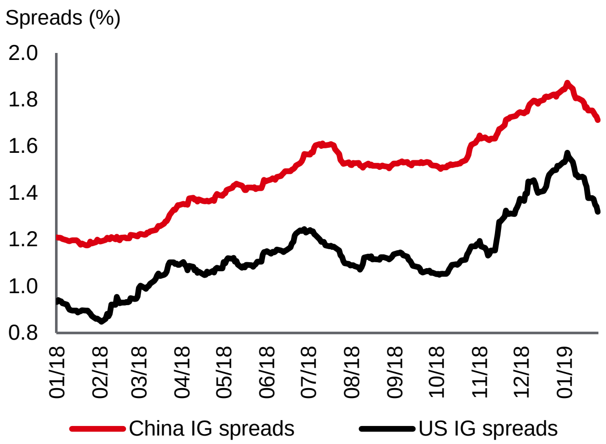
**What is your view on valuations for Chinese bonds now?**

Valuations of Chinese USD bonds have cheapened, with yields having widened by 92bps since the beginning of 2018 and are now trading at 582bps (as of January 25). At these levels, yields are trading at 62bps above their 5-year average.

On a relative basis, Chinese USD bonds are also attractive: Chinese USD investment grade bonds offer a 39bp spread pick-up over US investment grade bonds.[1] Versus the Asia ex-Japan universe, Chinese USD bonds are offering a spread pick up of 40bps.[2]

Given that liquidity would remain loose in China and with the improved refinancing environment, there is room for market yields to come down, leading to potential price gains for corporate bonds.

**Fig 4: China USD bonds trading at attractive spread levels**




Source: Bloomberg as of 25 January 2019

**How do Chinese bonds measure up against the Asian credit universe? What opportunities are you seeing both offshore and onshore?**

Broadly speaking, within the Asian credit universe, we prefer Chinese issuers mainly because they offer the most potential for spread compression as well as providing relatively more attractive yield carry. For example, the top tier Chinese SOEs are yielding more than some lower rated issuers from other Asian markets. Also, as there is now reduced focus on deleveraging in China, the environment is more favorable for these Chinese issuers, especially as they have underperformed in 2018 due to this same factor.

More specifically, we still favor the strongest of the SOEs as they are fundamentally solid companies and enjoy a lot of support from the government. We also like select Chinese property developers, particularly as the much-improved funding conditions is beneficial for the sector.

Turning to the RMB bond market, we are constructive on RMB bonds from a fundamental and valuation perspective, even after the meaningful rally in 2018. Economic growth is moderating and inflation remains benign, which together form a favorable backdrop for RMB bonds. Thus, we prefer the longer end of China Government Bonds (CGBs) in anticipation of a further decline in government bond yields. Also, policy bank bonds are especially attractive now with the tax exemption (previously, CGBs were tax free while policy bank and corporate bonds were taxable) and with their high yield pick-up over CGBs given the extremely close connection with the government. In the corporate bond space, we only prefer higher-quality issuers as the onshore credit curve is still fairly flat. At the same time, the offshore CNH market is also an attractive alternative given the yield premium in certain sectors.

**What are the implications of the upcoming onshore China bond inclusion into Bloomberg Barclays Global Aggregate Index?**

Bloomberg Barclays Global Aggregate Index will start adding onshore Chinese bonds in April 2019, phased over a 20-month period. This is a significant development for the asset class and would add approximately a 5.5% index weighting for Chinese onshore bonds while bringing about USD140 billion to the market. This suggests that flows from global investors into the domestic Chinese bond market over the inclusion period would be significant even if fund managers underweight the Chinese market. There remains huge potential for growth in the onshore market, as foreign ownership of onshore bonds currently totals only about 1.7% of the market size. The implementation appears on track as China has addressed some of the outstanding issues to confirm the inclusion, such as dealing with block trades and announcing a three-year tax exemption for foreign investors of onshore bonds.

[1]Bloomberg Barclays indices, as of January 25, 2019.
[2]Markit iBoxx, as of January 25, 2019.

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