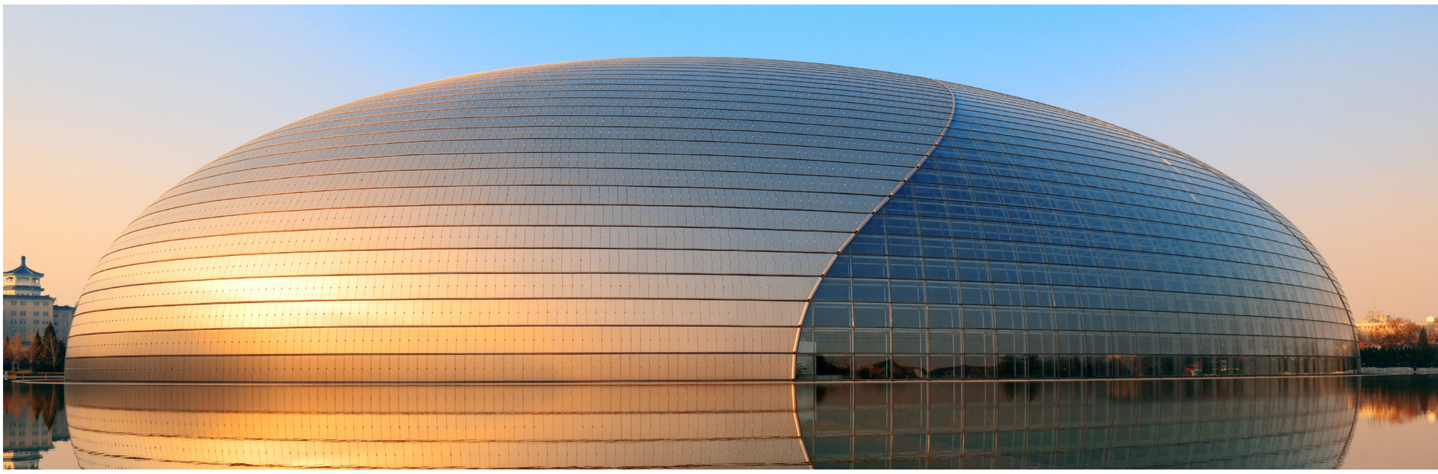


Why China bonds offer good value

William Xin, Head of Fixed Income, Eastspring Investments, China

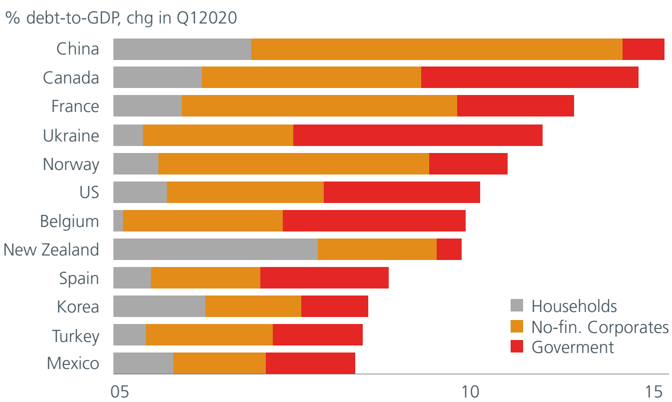
China's yuan-denominated bond market offers plenty of investment options for global investors seeking diversification and attractive yield pick-up over low-yielding developed markets. However, its unique market dynamics warrants an active approach for better outcomes.

Chinese policymakers have steadily pursued reforms to open up the domestic bond market, cognisant that a vibrant domestic debt capital market is critical to power China's economic growth. Offshore investors' participation in this market has steadily increased over the past few years, following the set up of the China Interbank Bond Market Direct Access in 2016, the start of the Bond Connect trading platform in 2017 and finally the inclusion of the Chinese bonds in the Bloomberg Barclays Global Aggregate Index in 2019. Accessibility aside, China's bond market is attractive for several reasons.

TOO BIG TO IGNORE

The speed of China's bond market growth underscores the country's desire to develop its capital markets. The China bond universe has grown from just USD 286 billion in 2000 to over USD14.9 trillion as of June 2020[1]. It is the world's 2nd largest after the US. And there is more room to grow given that its government debt to GDP still trails developed markets. All in, global investors cannot afford to ignore the growing investment opportunities in China's rapidly developing and steadily internationalising bond market.

Fig 1: China's government debt is low compared to developed markets



Source: IIF, BIS, IMF, National sources as at July 2020.

Source: [1]Wind, June 2020

DIVERSIFICATION BENEFITS

Chinese bonds form a good diversifier for global fixed income investors due to its low correlation with other fixed income markets. The low correlation is because the bond market is more influenced by domestic factors rather than global events. The market's large local investor base, with relatively low share of foreign investors, also means that domestic investors' expectations and demand tend to be a bigger bond market driver.

Another factor worth noting is the Renminbi's relative stability. For example, the Renminbi has largely remained resilient throughout this pandemic. In contrast, some G10 and emerging market currencies have fallen sharply against the US dollar. Although the Renminbi is managed by the Chinese authorities, other factors have also contributed to its stability. First, China is expected to post economic growth versus a US in recession in 2020. Second, the country's current account balances are improving owing to lower oil prices and third, the People's Bank of China (PBOC) has always maintained its commitment to a stable currency and is unlikely to pursue currency devaluation especially given the already strained US-China relationship.

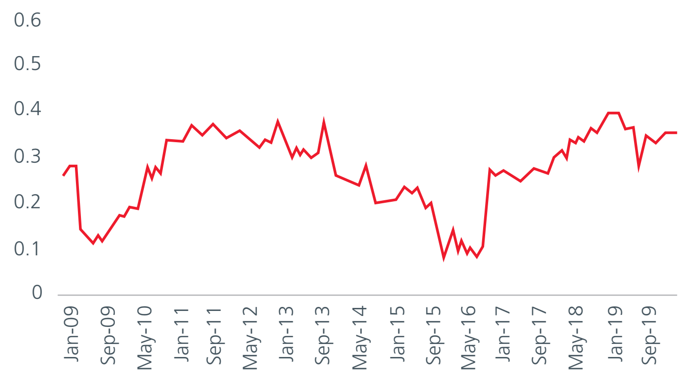
Nevertheless, Chinese bonds are not immune to bouts of volatility; these bonds were resilient compared to global and Asian bonds through March and April, but volatility rose in May and June partly due to supply concerns. However, as investors such as central banks and foreign institutions tend to hold yuan bonds as part of their long-term asset allocation and diversification purpose, short-term fluctuations tend to be less of a concern for these institutional investors.

COMPELLING YIELDS

Despite the declines in global government bond yields, foreign investor interests in China yuan-denominated bonds remain strong. Although the yields on Chinese government bonds, too, have fallen to near record lows, they still held a significant advantage over similar tenured US and developed markets' debt. Given forecasts that the US Federal Reserve will keep rates anchored at the low end for some time, this yield pick-up offered by Chinese bonds will continue to draw in investors.

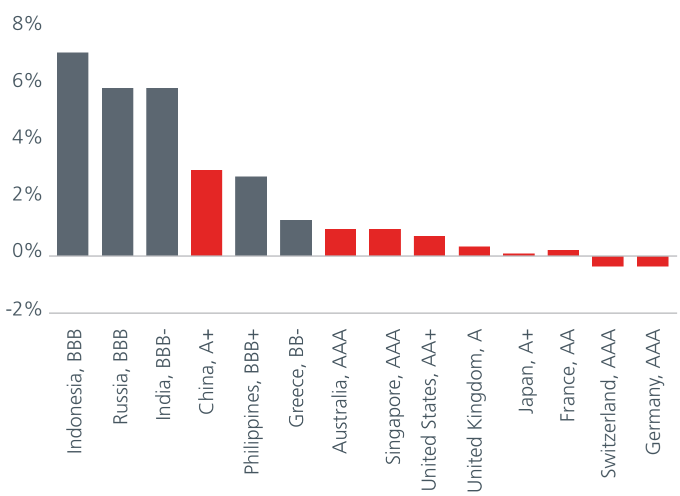
Apart from the allure of yields, there is also increasing evidence of the use of Renminbi as a reserve currency; a number of central banks have increased the RMB reserve targets in a move to diversify away from the US dollar and euro blocs to a more tripolar system.

Fig 2: Five-year rolling correlation between China rate bonds and global government bonds



Source: Bloomberg, BofA Global Research as at May 2020. Returns correlation is measured by Bloomberg Barclays China Treasury & Policy Bank USD unhedged index and FTSE WGBI USD unhedged index.

Fig 3 : Comparative yields on 10 -year government bonds



Source: Bloomberg as at June 2020. Country ratings refer to the long-term local currency ratings by Standard & Poor's.

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PLENTY OF CHOICE

The breadth of issuers ranging from central government, local government and quasi-goverment to investment and sub investment grade credits offers plenty of opportunities for active investors. While there is a variety of onshore Chinese bonds and issuers, the market is still clearly dominated by government bonds and policy bank bonds; the latter is issued by China Development Bank, Agricultural Development Bank of China, and The Export-Import Bank of China. Policy banks are fully owned by the government of the People's Republic of China to facilitate the implementation of certain financial policies or cooperation with the government for certain financing activities. There is also a choice of corporate credit bonds issued by private companies.

Despite the choice of issuers, foreign investors tend to invest predominantly in government and policy bonds due to lack of familiarity of the market and the challenges highlighted in the section below; as of 1Q 2020, their holdings of these two bond segments reached CNY1.34 trillion and CNY0.54 trillion, respectively, making up about 60% and 24% of their China onshore bond portfolios.

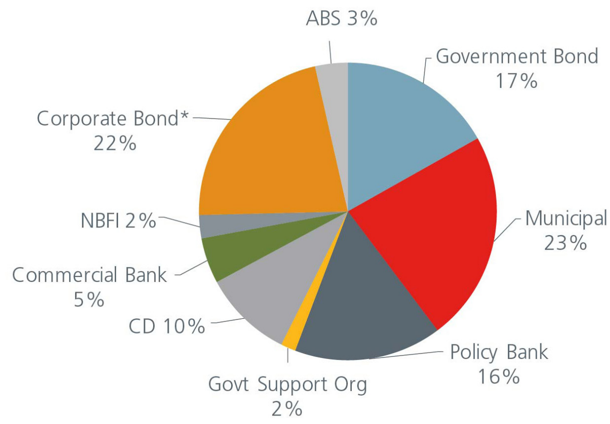
BE AWARE OF THE TRADE-OFFS

Like any investment, onshore Chinese bonds have their share of risks such as poorer market liquidity, dubious credit ratings, and an immature legal process to handle default and recovery.

The liquidity concern stems from the fact that domestic investors, such as commercial banks and insurance companies, still hold majority of the onshore bonds. The domestic commercial banks are required under regulations to hold bonds on either the ‘trading book’ or the ‘hold to maturity book’. Under the former, a bond must be traded within 90 days. As such the preference is for the banks to hold the bonds till maturity, resulting in lower liquidity in the secondary market. Hence, apart from the more liquid parts of the bond market i.e. the government bonds and policy bonds that have been included in the Bloomberg Barclays Global Index, liquidity of other segments of the market remains poor. However, we believe that this will improve with time as the market grows in terms of breadth and depth.

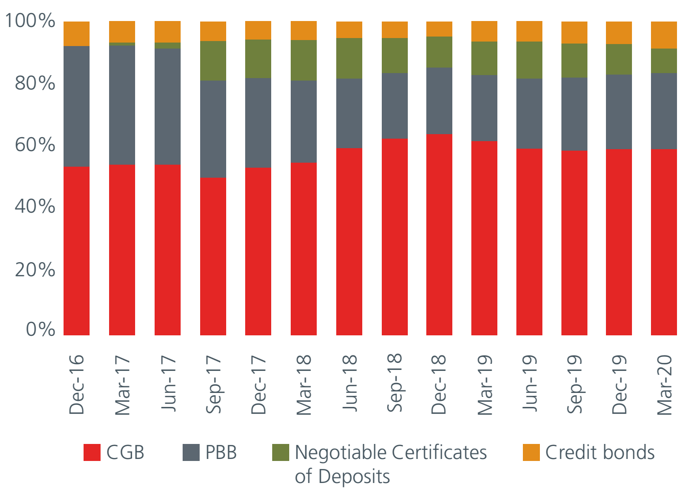
Likewise, credit ratings and defaults pose challenges to investors. Prior to 2014, the concept of default was non-existent which in turn compromised lending standards. That has since changed, and

Fig 4: Composition of outstanding China onshore bonds



Source: WIND as at June 2020 *Corporate bonds include enterprise bonds, medium-term notes, commercial paper and private placement note.

Fig 5: Composition of offshore investors’ China onshore bond portfolio



Source: ChinaBond, CEIC, BofA Global Research as at May 2020.

defaults are trending up. Relying on domestic credit rating agencies can be tricky as most of the ratings tend to have a positive bias. The issuers are also getting more diversified, with more non-government entities issuing bonds. However, credit differentiation by local rating agencies remains weak, with most credits still rated AAA onshore, which is on par with China government bonds. Nonetheless, onshore default rate is expected to remain manageable given the relatively stable footing of the Chinese economy and the government's inclination to avoid systemic instability. Currently, the default rate is still low at 1.2 % of the total domestic bond market size and it is projected to rise to 1.5% in 2020.[2]

Understanding these risks is thus key to participating in this market. An active fixed income manager with deep local insights can successfully navigate the unique market dynamics.

ACTIVE MANAGEMENT IS CRUCIAL

Eastspring Investments' fixed income team has been actively investing in both offshore and onshore Chinese bond markets, augmented by the expertise of one of the largest and most experienced Asian credit analyst team. The team also draws on the knowledge of local specialists including a team of local Chinese analysts based in Shanghai with relevant offshore experience and proven track record of covering Chinese credits and macroeconomics.

For our China onshore bond strategy, the team selectively invests in high quality central state-owned enterprises (SOEs), local government financing vehicles (LGFV) and local SOEs with strategic importance and proven track record, and property developers that have strong financial metrics. The credit selection process allows us to enhance portfolio yield over the medium- to long-term, given the sector's attractive carry over central government bonds.

At the same time, we adopt an active yield curve positioning and duration management strategy, which is expressed mainly via China government bonds and policy bank bonds. We believe an active duration positioning is warranted especially in the current environment. Given that there are more geopolitical risks and that China's economic growth is less certain than in the past, absolute yields are lower and market views are more divergent. We therefore believe a trading strategy for rates will create value in this low interest rate environment.

Source: [2]China Chenxing, 1Q2020.

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