China bonds:

Watch this space

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China's onshore bond market has evolved greatly since our 2018 introductory piece. The market has grown in scope and scale, and local regulators have taken steps to increase its acceptance by the international investment community. Foreign investors, however, remain underexposed to Chinese assets. On the equity side, we have recently advocated for a dedicated China exposure. In this piece, we examine whether a dedicated exposure to China bonds makes sense for global investors.

Onshore Chinese bonds are frequently underrepresented, provide a unique risk profile and offer potential diversification benefits in portfolio construction. However, after hedging, defensive implementations have minimal yield pick-up to developed market alternatives. As the main return driver is the currency exposure, we need to assess where best to spend Renminbi (CNY) exposure. We believe a long CNY exposure is better spent in the equity portfolio, specifically Chinese A-shares, where investors can reap the benefits of China reorienting its economy. Other Chinese bond options, such as onshore or offshore corporates, are either too illiquid or have issues regarding ratings and financial reporting transparency to be considered on a standalone basis. We expect these areas to improve in the coming years.

Establishing a framework

Advocating for a new dedicated exposure requires some combination of three core elements:

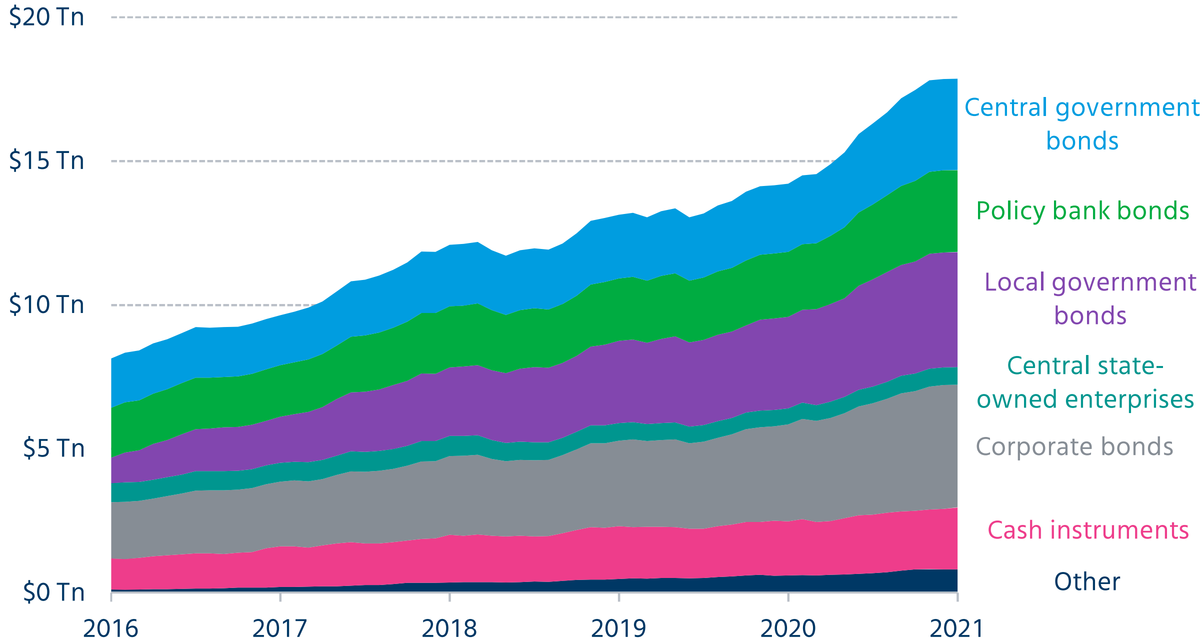
- **Underrepresented** Is lacking in portfolios due to benchmark construction
- **Unique** Provides a fundamental or factor exposure not found elsewhere in the portfolio
- **Attractive** Improves portfolio risk-adjusted returns (even if exposure is not unique)

The first two factors (**underrepresented** and **unique**) help argue whether an asset or sub-asset class deserves to be seen as an independent allocation in a portfolio context. If the potential new exposure passes the first two screens, the final factor (**attractive**) addresses whether it warrants an allocation on a strategic basis.

Dedicated or uncommitted

Starting with **underrepresented**, most institutional investors would only have exposure to the onshore Chinese bond market if they had an allocation to either Global Aggregate[1] (7% weight) or Local Currency Emerging Market Debt[2] (10% weight). The standard index for Global Sovereigns[3] will only start incorporating Chinese Government Bonds (CGBs) in late 2021. Contrast China's weight in these benchmarks with its economic importance (16% of Global GDP, 44% of EM GDP)[4] or the fact that its onshore fixed income market is the second largest in the world. Indeed, foreign investors make up only 10% of investments in Chinese sovereign debt and 3% of the overall onshore market.[5]

Figure 1. China's onshore bond market



Source: WIND. Data as of March 2021.

[1]Global Aggregate; Bloomberg Barclays Global Aggregate Index
[2]Local Currency Emerging Market Debt; JP Morgan GBI-EM Global Diversified Index
[3] FTSI WGBI
[4] World Bank
[5] CCDC, PBOC

While GDP and market size should not necessarily be a guide for making allocations, especially in a fixed income portfolio, representation of China's large economy and fixed income market is low in standard fixed income benchmarks. If higher China bond exposure is justifiable — based on the **unique** and **attractive** criteria discussed below — underrepresentation in benchmarks and typical portfolios could be addressed with a dedicated China bond allocation.

Figure 2. Largest bond markets

Country	Market size (USD trillions)
US	$46
China	$17
Japan	$14
UK	$7
France	$5
Germany	$4
Canada	$4

Source: BIS. Data as of end November 2020.

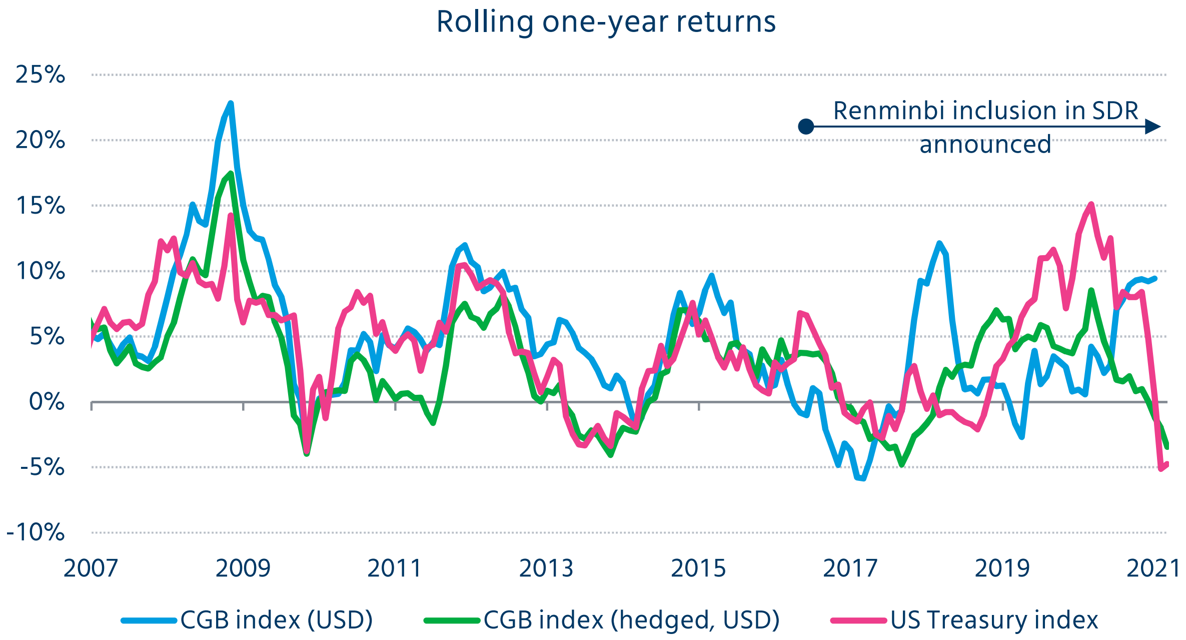
A world unto itself

The onshore bond market[6] has also shown itself to be **unique** in the broader fixed income universe, at least historically. Compared to the local currency emerging markets debt universe, China's average pairwise correlation to the other countries is only 0.2. This is because China's currency and rates markets do not exhibit the same pro-cyclical impulses suffered by the rest of emerging markets (EM). Similar to large developed countries, China can generate its own counter-cyclical impulses somewhat independent of, or counter to, what is going on in global risk assets. In other words, during market downturns China's rates markets behave more like developed markets, with rates typically falling.

Although it appears differentiated from the rest of emerging markets, China does not screen out as developed either. China has a real policy rate around +1% versus 0% to -2.25% for developed market (DM) sovereigns, once COVID-19 distortions pass. Additionally, returns on CGBs have grown increasingly inconsistent in their correlation with developed markets. Unsurprisingly, this has occurred in line with China gradually liberalizing its FX management and capital account.

[6] Offshore, USD-denominated Chinese corporate bonds trade more similarly to other spread products due to shared interest rate exposure and being traded more on a relative value basis with other spread products.

Figure 3. US Treasuries and Chinese government bonds increasingly diverging as China liberalizes its financial markets



Source: J.P. Morgan's GBI index family. Data as of April 30, 2021.

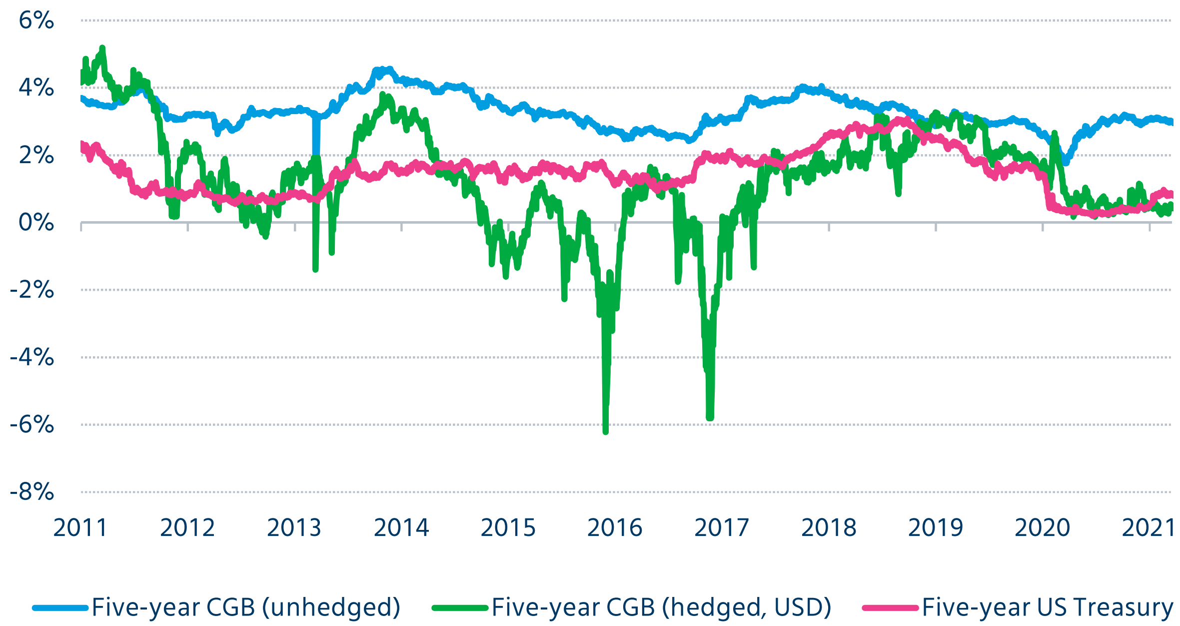
China is thus unique, because it is a world unto itself, sitting between, or rather at the nexus of, EM and DM. As a very large, relatively closed economy that functions without heavy dependence on outside capital flows, it has greater control over its currency and rates, which are generally the driving risk factors for foreign currency denominated sovereign debt. Whether this persists in the future — as China continues to liberalize its capital account and move to a more free-floating currency — remains to be seen. As developed market investors buy into a larger share of Chinese equity and debt markets, investors could rightly worry about the currency becoming more pro-cyclical. However, there is plenty of room for international investment before it becomes a swing factor.

Therefore, Chinese fixed income is both **underrepresented** and **unique**. That leaves investors needing to answer the final, critical question: Is it attractive?

Is now the time?

Within onshore Chinese fixed income, there are both defensive and growth-oriented subsectors. Current five-year yields in the defensive segment of the market (Chinese government and policy bank bonds) at around 3% offer an attractive yield pick-up to developed market safe haven assets, especially considering China's investment grade credit rating (A+/A1). However, higher short-term rates drive the yield advantage rather than a steeper yield curve. As currency hedging costs are driven by short-term rate differentials, the apparent yield advantage for investing in CGBs disappears — or even turns negative — if a currency hedge is applied.

Figure 4. Yields on five-year Chinese and US government bonds



Source: J.P. Morgan. Data as of April 30, 2021.

Although we have a positive view on the CNY in our capital markets assumptions over the medium- and long-term, we believe the best way to spend CNY risk for long-term investors is in equity markets.[7] Transformation stories, such as China's technological evolution or general shift to a more domestically oriented economy, are best accessed in those areas of the market that gain the most from the transformation.[8]

Figure 5. Comparing five-year yields vs hedged CGBs

Country	5-year yield sovereign	5-year CGB after hedge	Yield pick-up after hedge
China	*2.99%*	*n/a*	*n/a*
Australia	0.73%	0.31%	-0.42%
Canada	0.95%	0.40%	-0.54%
Germany	-0.57%	-0.28%	0.30%
Japan	-0.10%	0.16%	0.25%
UK	0.28%	0.37%	0.09%
US	0.85%	0.46%	-0.39%

Source: JP Morgan. Data as of April 30, 2021.

Still, for investors with more fixed income-oriented portfolios or for those looking for CNY exposure beyond what they are getting via their equity or broader fixed income exposure, Chinese government and policy bank bonds do offer attractive real yields, albeit with currency risk, and minimal credit risk.

The other option for accessing onshore Chinese fixed income is via credit markets. Again, on the surface, things look promising with corporate credit spreads meaningfully higher than comparably rated developed market corporates. Unfortunately, looks can deceive.

1. Ratings inflation is rampant among domestic rating agencies. A company rated AAA onshore, might be rated as high yield offshore. Indeed, one of the most high-profile defaults of 2020 in China, Yongcheng Coal and Electricity, had been reaffirmed at AAA earlier in the year. Although the onshore default rate was only 1.8% in 2020, it has been on a steady uptrend as authorities slowly reduce the implicit guarantee of state-owned enterprises (SOE). In fact, 2020 was the first year SOE defaults outnumbered private defaults.

[7] For public equities see: https://www.mercer.com/content/dam/mercer/attachments/global/gl-short-em-and-china.pdf
Mercer will publish a paper on private market opportunities in China later this year.

[8] China's current (14th) five-year plan focuses on boosting domestic consumption through implementation of the "dual circulation" policy. The changes are meant to lead to domestic demand growth, import substitution and technological self-sufficiency.

2. Credit markets in China are relatively illiquid, as much of the buyer base is buy-and-hold oriented. Corporate bond turnover (23%) is less than one-third the rate of turnover in the US investment grade debt (73%) and less than one-sixth that of US high yield (154%).[9]

Figure 6. Bond market liquidity concentrated in more defensive sectors

Type	Amount outstanding (CNY bn)	Daily trading (CNY bn)	Annualized turnover
Policy banks	17,600	500	713%
NCDs	11,100	250	565%
Other financial	4,000	10	63%
Medium-term notes	7,400	25	85%
Commercial paper	2,100	2	24%
Enterprise and corp. bonds	11,000	10	23%

Source: HSBC, Wind, CCDC, SCH, CSDCC via Ashmore. NCDs – Negotiable Certificates of Deposits. Data as of December 2019.

3. Credit spreads have historically been relatively tight compared to fundamentals due to the implicit sovereign guarantee, leaving little to no institutionalization premium to be captured and little compensation for illiquidity.
   - *Corporate credit markets in China have been undergoing an upward repricing of credit risk as the perception of sovereign support is being reassessed in light of a number of large SOEs defaulting in 2020 and 2021.*

4. Debt markets, especially credit markets, tend to reflect how the economy has looked in the past, rather than how it will look in the future. SOEs representing the "old" economy account for a large share of the universe. Given the changing shape of China's economy, we would rather take risk in those areas with the most to win, rather than those with the most to lose.

The active management solution to these issues has been the developing universe of total return-oriented strategies. These specialist strategies access both onshore rates and credit markets along with offshore credit markets. To date, the universe has shown the ability to add alpha, capitalizing on the inefficiencies that remain in onshore markets via dynamic exposures.

[9] JPMorgan; TRACE

What next's?

Although Chinese fixed income is underrepresented and unique, we do not see it as the optimal way to invest in onshore Chinese markets at present. Real yields in CGBs and policy bank bonds are certainly attractive, especially given ongoing financial repression in the developed world, but critically they require accepting currency risk.

For more return-seeking bond allocations, onshore credit markets are still liquefying and institutionalizing, but without the normal illiquidity or institutionalization premium for early adopters to capture.

Overshadowing the fixed income options, Chinese A-shares appear to offer a better usage of CNY risk given the alignment with China's ongoing transformation to a more domestically oriented, consumption-based economy.

However, potential for the future remains. Regulatory steps are being taken to support market functioning in both fixed income and currency markets. Additionally, the lessening of the perceived sovereign support, while negative for returns in credit markets in the near-term, is long-run positive. The changes being put in place should push the market to require more appropriate compensation for credit risk and result in more efficient allocation of capital. The continuing development of Chinese financial and fixed income markets will remain an important topic for institutional investors well into the future.

Nathan Struemph
Senior Strategic Research Specialist

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