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Ashmore

The usefulness of Chinese bonds

By Jan Dehn

Chinese bonds have done better than developed market bonds even during bouts of severe China pessimism and negative Emerging Markets (EM) sentiment. This suggests an important role for Chinese bonds both within developed market and EM portfolios. Zuma has departed for 'Loserville' in South Africa, Poland is reforming the pension system, reserve ratios are cut in the Philippines, there are new Mexican polls and macroeconomic developments in India. The global macro backdrop section discusses the reasons why the Dollar is performing so badly.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.6	–	5.03%
MSCI EM Small Cap	11.6	–	3.00%
MSCI Frontier	11.4	–	3.26%
MSCI Asia	12.0	–	4.24%
Shanghai Composite	10.7	–	-3.33%
Hong Kong Hang Seng	7.2	–	1.25%
MSCI EMEA	10.5	–	7.89%
MSCI Latam	12.8	–	5.70%
GBI-EM-GD	6.07%	–	2.47%
ELMI+	3.50%	–	1.48%
EM FX spot	–	–	2.01%
EMBI GD	5.69%	280 bps	0.42%
EMBI GD IG	4.45%	156 bps	0.34%
EMBI GD HY	6.95%	409 bps	0.49%
CEMBI BD	5.40%	257 bps	0.12%
CEMBI BD IG	4.48%	166 bps	-0.09%
CEMBI BD Non-IG	6.52%	368 bps	0.39%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	4.37%
1-3yr UST	2.19%	–	-0.19%
3-5yr UST	2.63%	–	-0.40%
7-10yr UST	2.88%	–	-0.43%
10yr+ UST	3.13%	–	0.03%
10yr+ Germany	0.72%	–	0.24%
10yr+ Japan	0.06%	–	0.41%
US HY	6.17%	341 bps	0.80%
European HY	2.83%	358 bps	0.16%
Barclays Ag	–	249 bps	-0.12%
VIX Index*	19.46	–	-9.60%
DXY Index*	89.23	–	-0.98%
EURUSD	1.2398	–	0.86%
USDJPY	106.63	–	-1.87%
CRY Index*	193.58	–	5.07%
Brent	65.2	–	4.23%
Gold spot	1347	–	1.82%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Market

- **Chinese bonds:** As yields rise in the US Treasury market, other developed bond markets will come under pressure and investors who are exclusively invested in developed market fixed income will struggle due to high correlations between all these markets. Government bonds in EM offer an obvious solution. Yields on EM local currency government bonds are currently trading a mere 65bps lower than at the end of 2006, when the Fed funds rate was 5.25% (6.07% today versus 6.72% in 2006). In other words, EM local bonds are in effect pricing a Fed funds rate of 4.60% (5.25% minus 65bps), while the actual Fed funds rate is currently only 1.5%. By contrast, US 5 year government bonds are currently trading at 2.63%, which is 206bps lower than in 2006. German 5 year bonds trade 384bps lower than in 2006. Clearly, EM local currency bonds have a comfortable yield cushion, while developed market bonds do not. EM currencies are also providing an important tail wind, while the absolute higher yields provide income.

Despite the obvious attractions of EM bonds compared to developed markets bonds, many fixed income investors still pay heed to an Apartheid-like regime, which still permeates the financial industry, whereby government issuers are divided into arbitrarily defined 'risky' and 'risk-free' countries. Due to this distinction many investors, including central banks, will simply not consider the EM option. This is a shame, especially for underlying stake-holders. Nevertheless, there is one way to obtain EM exposure, while remaining within the cushion confines of the world of global reserves currencies: namely, by increasing exposure to Chinese bonds. Granted, China's vast bond market is still not part of the JP Morgan GBI EM GD benchmark index, but China's currency has already been admitted to the Special Drawings Rights (SDR) club of reserve currencies and there are reasonable expectations that Chinese bonds will be included in the main fixed income indices in the not-so-distant future (see below). As it turns out, Chinese government bonds have performed far better than developed market bonds, even during a period of exceptionally negative sentiment towards China.

Continued overleaf

Emerging Markets

Figure 1 shows the performance of Chinese 5yr government bonds compared with 5yr government bonds in the other major countries, which form part of the SDR basket. Returns have been calculated in the terms of the respective currencies of the non-China SDR member currencies in order to better facilitate a comparison.

Figure 1: **Returns to Chinese bonds vs developed market bonds**

	Returns			
	USD	**EUR**	**GBP**	**JPY**
China 5yr	10.6	16.7	21.3	19.8
US 5yr	-1.6			
German 5yr		1.3		
UK 5yr			-1.7	
JPY 5yr				1.7
China vs DM (absolute outperformance %)				
Total	12.3	15.4	23.0	18.1
Annualised (%)	*2.5*	*3.2*	*4.8*	*3.8*
FX contribution				
FX	*-2.9*	*3.1*	*7.8*	*6.3*

Source: Ashmore, Bloomberg. Data as of February 2018.

Figure 1 shows that during the period from April 2013 to today, that is, a period of extreme bearishness towards both China and EM, Chinese bonds have:[1]

- Strongly outperformed government bonds in all the other SDR markets. Chinese bonds have outperformed US bonds in Dollar terms by 12.3%, German bonds by 15.4% in EUR terms, British bonds by 23% in GBP terms and Japanese bonds by 18.1% in JPY terms. This translates into annualised outperformance of Chinese bonds between 2.5% and 4.8% against other SDR bond markets, mainly due to much higher yields.
- Made FX gains versus EUR, GBP and JPY. The modest FX loss (-2.8%) suffered against the USD only cancels a fraction of the positive return from yields.

It is difficult to escape the conclusion that Chinese bonds have been an excellent place to invest as an alternative to developed market bonds, even during EM and China bear markets. This means that Chinese bonds also have an important role to play within an EM local currency bond strategy. Since Chinese bonds have outperformed developed markets bonds during EM bear markets they have also outperformed EM bonds during such periods. On the other hand, non-Chinese local EM markets have outperformed Chinese bonds during EM bull markets. In short, Chinese bonds offer a 'within-EM safe haven' destination for EM fixed income investors, who can do better by seeking refuge in China than in developed markets during bouts of risk aversion.

To take advantage of these attractive features of Chinese bonds, investors will need to be prepared to go off-benchmark because, remarkably, Chinese government bonds have still not been included in the JP Morgan GBI EM GD index. However, the signs all point to the conclusion that China's bonds will soon be included. For example, PBOC announced last week that it has appointed JP Morgan as the clearing bank for CNY denominated securities in the US, which makes JP Morgan the first non-Chinese bank to be appointed as clearing bank for CNY denominated assets outside of China. This arrangement will clearly improve the internationalisation of Renminbi, which we expect to accelerate as the Dollar declines, but we also think that the deepening relationship between China and JP Morgan will be positive for index inclusion at the margin. Last year JPMorgan won approval to underwrite corporate bond sales in China's interbank market.

- South Africa: Jacob Zuma resigned and Cyril Ramaphosa was sworn in as South Africa's President in his place. South Africa's institutions worked as they should and a peaceful transition of power took place. Ramaphosa's ascent to power is not just a change of President; it represents a marked shift in policy away from corruption and discretion towards transparency and reforms. Ramaphosa will also lead the ANC into the next general election, which he is likely to win. So the outlook for South Africa is now significantly brighter, not just for now but over the medium term. South Africa desperately needs this change. The country needs reforms, new ideas, less corruption and a boost to business confidence. Ramaphosa has the potential to deliver all this. Ramaphosa's rise to power in South Africa also illustrates another 'truth' about politics in EM countries, namely that EM presidents generally do not survive politically for very long if they start to mess with the economy. This is because the vast majority of people in EM countries are poor with no inflation hedges or unemployment benefits, that is, no means of protecting themselves against macroeconomic volatility. Therefore, they have a strong preference for stability and growth. The only governments in EM where presidents are able to hang on

[1] April 2013 was the month immediately prior to the Taper Tantrum of May 2013. The period between April 2013 and today includes China's de-pegging from the Dollar as well as the Taper Tantrum, the 45% rally in the Dollar versus EM currencies, the crash in commodity prices and the start of the Fed hiking cycle.

Continued overleaf

Emerging Markets

despite bad policies tend to be countries, where presidents are backed by the resources from other countries, usually one of the Superpowers, or where presidents control vast oil wealth. We say good riddance to Zuma, who can now go and join Dilma Rousseff, Cristina Kirchner and other discredited EM leaders in "Loserville".

- Poland: The government has launched a new voluntary pension scheme, which will further boost the local bond market and reduce dependence on foreign capital. The development of pension funds has been the single most important structural change in EM since the end of the Cold War. Pension funds are buyers of last resort, when fickle foreign investors sell in response to risk aversion events. The establishment of pension funds has put an end to so-called "Soros Reflexivity", that is, the capacity of foreign investors to cause economic crises simply by selling EM assets. This is because pension funds now pick up the bonds, which prevents yields from rising to levels, where they pose a serious risk to the overall macroeconomy. The new Polish pension scheme will be funded by employee contributions with matching employer contributions. The pension scheme will increase savings rates and support the domestic bond market. In other news, the real GDP growth rate increased from 4.9% yoy in Q3 2017 to 5.1% yoy in Q4 2017. The rate of CPI inflation was 1.9% yoy in January, in line with expectations.

- Philippines: The central bank reacted to outflows from the Philippines by cutting the reserve ratio by 1% to 19% for local banks. The move undoes macroprudential measures put in place last year when inflows threatened to increase bubble risks in the domestic economy. Inflation has recently spiked in the Philippines due to the introduction of new taxes. However, such spikes in inflation are usually temporary. Meanwhile, the outflows from the Philippines market stand in sharp contrast to other EM local markets, where inflows are rising. This is partly technically driven, partly a reflection of the widening current account deficit and the current higher than normal rate of inflation.

- Mexico: Voting intentions in favour of Ricardo Anaya of PAN surged from 24% to 32% in the latest poll conducted by Reforma, a newspaper. Andres Manuel Lopez Obrador (aka AMLO), a left-wing populist feared by the market, also increased his share of voting intentions, but by a smaller margin of 2% to 42%. PRI candidate Meade slipped from 22% to 18% of voting intentions. PRI is currently in power and President Pena Nieto is unpopular and his administration has been dogged by political setbacks. PRI's political weakness is hurting Meade, which suggests that, as of now, this election will be a battle between Anaya and AMLO. The market will love Anaya, loathe AMLO. Hence, if AMLO maintains his lead, the market is likely to massively oversell Mexican assets leading up to the election, which is due to take place on 1st July 2018.

- India: The trade deficit widened to USD 16.3bn in January from USD 14.8bn in December due to higher oil prices pushing up imports. Imports increased at a rate of 26.1% yoy, while exports increased at a rate of 9.1% yoy. We do not expect oil prices to sustain strong appreciation going forward, while rising global growth and greater competitiveness of Indian exporters due to domestic reforms should improve going forward. The rate of CPI inflation was 5.1% yoy in January, down from 5.2% yoy in December, while industrial production grew strongly at a rate of 7.1% yoy. There were two setbacks for investor sentiment last week. First, Indian stock exchanges restricted data feeds to overseas exchanges. This will hurt liquidity in Indian bonds and MSCI, the index provider, may reduce the weighting to Indian stocks. Second, Punjab National Bank was caught up in a USD 1.8bn fraud between 2011 and 2017, according to Reuters.

Snippets:

- Argentina: The rate of CPI inflation was 25% yoy in January. The central bank left the policy rate unchanged at 27.75%.
- Brazil: Following its decision to cut the policy rate by 25bps to 6.75%, the minutes from the COPOM meeting indicated that members of the monetary policy committee were still quite dovish. This seems to be justified as inflation continues to be very benign.
- Colombia: The economy expanded 1.8% in real terms in 2017, down from 2% real GDP growth in 2016, partly due to weak retail sales in the last quarter of the year. The growth rate of the Colombian economy is likely to double in 2018 relative to 2017 as the adjustment to the fall in oil prices finally reaches completion.
- Czech Republic: The real GDP growth rate accelerated marginally to a very strong 5.1% yoy in Q4 2017. The yoy rate of inflation declined to 2.2% in January from 2.4% in December.
- Egypt: The central bank cut the policy rate by 100bps to 17.75%. Inflation has halved after peaking above 30% last year. Fiscal balances are also improving.
- Hungary: Real GDP growth accelerated to 4.8% yoy in Q4 2017 from 4.2% yoy in Q3 2017. January inflation was 2.1% yoy, unchanged from December.
- Indonesia: The central bank left the policy rate unchanged at 4.25%.
- Malaysia: The rate of growth surprised to the upside in Q4 2017. Real GDP was 5.9% higher than in Q4 2016 versus 5.8% yoy expected.
- Peru: The real economy expanded 0.7% in the month of December. This represented acceleration relative to the real GDP growth rate of 0.3% in November.
- Romania: Real GDP growth slowed to a stronger than expected rate of 6.9% yoy in Q4 2017 from 8.8% yoy in Q3 2017. Inflation rose sharply to 4.3% yoy in January from 3.3% yoy in December. The current account deficit narrowed to EUR 0.5bn in December 2017 compared to EUR 0.6bn in December 2016.

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Benchmark performance

- **Russia:** Industrial output was far stronger than expected in January, rising at a rate of 2.9% yoy versus -0.5% yoy anticipated by market participants. The central bank cut the policy rate by 25bps to 7.5%, accompanied by a dovish statement.
- **Singapore:** January's non-oil domestic exports surged higher at a rate of 13% yoy versus 8.9% yoy expected. The rate of real GDP growth was 3.6% yoy in Q4 2017 versus 2.9% yoy expected.
- **Thailand:** The central bank left the policy rate unchanged at 1.5%. Q4 2017 GDP was 4.0% yoy, slightly shy of expectations due to slower than anticipated execution of government projects.
- **Turkey:** Turkey's current account deficit widened to USD 7.7bn in December from USD 4.4bn in November. The market had expected a deficit of USD 7.5bn.
- **Venezuela:** The Emerging Markets Traders Association (EMTA) changed the trading convention for PDVSA bonds to flat.

Global backdrop

Should the Dollar be rising? Some think so. They point to the fact that US growth has been ok, the Fed is hiking rates, the stock market has (until recently) been setting new highs on a daily basis and President Trump has just passed a tax reform designed to lure hundreds billions of Dollars of corporate balance sheet money back to the US. Protectionism is on the rise and US real yields are going up too. Yet, the fact of the matter is that the Dollar is not performing very well at all, with the broad Dollar index (DXY) down more than 3% ytd. What, then, is pushing the Dollar lower? First, the Trump Administration has not made a secret of its desire to see the Dollar lower. Second, it has not escaped anyone's attention that the twin-deficits are back with a vengeance and likely to get worse as the Trump Administration abandons all pretence at fiscal probity. The unfunded Trump tax cut in particular qualifies as one of the most gratuitous examples of irresponsible fiscal policy undertaken by any Western government in a long time and US debt to GDP ratios will rise sharply in the coming years. Third, positioning poses a more immediate challenge to the Dollar. Investors the world over have been bullish Dollars for many years and are still positioned accordingly. In fact, few have room to buy any more Dollars, so the Greenback does not even respond when fundamentals are positive. This situation is a consequence of an unfortunate practice employed across financial markets of buying when prices rise. Investors now find themselves limit-long Dollars at the top of the market. So while investors cannot buy, they most certainly can sell. Investors, who are still long Dollars must therefore be hoping that the US economy holds up and that the Fed continues to hike and that those hikes do not crush the stock market or the economy. After all, any major setback in the economy or stocks means that all the money that entered the Dollar in anticipation of higher growth and higher rates than elsewhere is clearly in the wrong place. Ashmore described the likely path of the Dollar in September 2015.[2]

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.31%	3.65%	30.13%	9.76%	5.24%
MSCI EM Small Cap	-4.85%	0.67%	23.09%	8.17%	4.96%
MSCI Frontier	-2.13%	3.48%	26.85%	7.37%	8.21%
MSCI Asia	-5.35%	1.79%	31.87%	10.40%	8.19%
Shanghai Composite	-8.09%	-3.25%	1.48%	1.85%	8.16%
Hong Kong Hang Seng	-7.57%	7.06%	24.93%	5.53%	5.16%
MSCI EMEA	-0.10%	6.04%	25.34%	6.56%	1.14%
MSCI Latam	-2.39%	10.46%	20.41%	8.67%	-1.47%
GBI EM GD	0.11%	4.59%	15.66%	4.18%	-0.89%
ELMI+	-0.21%	2.67%	10.94%	3.67%	-0.18%
EM FX Spot	-0.16%	3.37%	6.66%	-2.37%	-6.42%
EMBI GD	-2.06%	-2.10%	5.17%	5.93%	4.46%
EMBI GD IG	-1.95%	-2.60%	3.92%	3.50%	3.15%
EMBI GD HY	-2.17%	-1.65%	6.41%	8.84%	5.97%
CEMBI BD	-0.99%	-0.92%	4.74%	5.47%	4.32%
CEMBI BD IG	-1.13%	-1.33%	3.29%	3.48%	3.54%
CEMBI BD Non-IG	-0.83%	-0.39%	6.79%	8.66%	5.33%

[2] See *'The View from Kilimanjaro'*, The Emerging View, September 2015.

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-3.09%	2.45%	18.71%	11.48%	14.79%
1-3yr UST	-0.06%	-0.37%	-0.11%	0.43%	0.49%
3-5yr UST	-0.26%	-1.24%	-0.50%	0.68%	0.81%
7-10yr UST	-1.11%	-3.25%	-1.01%	0.21%	1.08%
10yr+ UST	-3.22%	-6.34%	1.10%	0.04%	2.88%
10yr+ Germany	-0.76%	-2.28%	-2.61%	-0.75%	5.21%
10yr+ Japan	0.49%	0.28%	2.91%	4.93%	5.11%
US HY	-1.07%	-0.48%	4.68%	5.50%	5.38%
European HY	-0.65%	-0.46%	4.19%	4.83%	6.71%
Barclays Ag	-1.05%	-1.71%	3.37%	2.81%	3.60%
VIX Index*	43.72%	76.27%	69.36%	27.27%	58.08%
DXY Index*	0.11%	-3.14%	-11.61%	-5.48%	10.89%
CRY Index*	-1.92%	-0.15%	0.76%	-14.44%	-35.12%
EURUSD	-0.13%	3.27%	16.82%	9.06%	-7.39%
USDJPY	-2.34%	-5.38%	-5.72%	-10.35%	13.95%
Brent	-5.52%	-2.44%	16.90%	8.35%	-44.49%
Gold spot	0.12%	3.36%	8.74%	11.60%	-16.09%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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