Ashmore

How Chinese bonds can enhance your portfolio

By Jan Dehn

Despite the size of the Chinese onshore fixed income market, most investors are not involved. Chinese bonds have yet to enter the most commonly used global and Emerging Markets (EM) fixed income indices, and there are still technical obstacles, which impede trading. But change may be afoot. President Xi Jinping recently acquired significantly more domestic political capital, which will enable him to push forward, with renewed vigour, the Chinese economic reform agenda, including addressing the remaining obstacles to market access. We also expect index providers to eventually fully admit China into the benchmark indices, possibly within a relatively short period of time.

Investors should rejoice at the prospect of greater access to Chinese fixed income. The report uses data from 2004 until February 2018 to demonstrate some extremely enviable characteristics of Chinese bonds. In our opinion, they are superior to US Treasury bonds in terms of their 'safe haven' characteristics and this important advantage will only grow over time in light of the growing twin-deficit challenges facing the US.

Chinese bonds have lower volatility, yet attractive yields as well as low correlations with both US and EM local currency markets. This means that EM and developed market bond investors alike can benefit from allocating to onshore Chinese government bonds.

One implication of greater access to Chinese bonds is that the 'safe haven' bid for US bonds and the Dollar may fall over time. This would be good for the world, because the Dollar would become far less volatile, which in turn would make EM local currency bonds more attractive to long-term institutional investors.

Introduction

One could be forgiven for ignoring onshore Chinese government bonds.[1] They still only make up a small part of sovereign wealth fund and central bank FX reserve portfolios and they barely feature yet within most pension and insurance company bond portfolios. China is partly to blame for the low exposure. There are still important impediments to investing in the Chinese bond market, though these impediments are rapidly diminishing. Fixed income benchmark index providers also have to take part of the blame, because they have yet to include Chinese government bonds into the most commonly used global and EM fixed income benchmark indices. Finally, there is no shortage of prejudice and misinformation about China among ordinary investors.

Still, we believe these obstacles will soon disappear. The Chinese authorities are actively addressing the remaining problems, while index providers are actively looking at ways to include Chinese bonds in their indices. Once China's bonds are in the main benchmark indices, investors will follow, and as they get actively involved, their preconceived notions about China will soon evaporate.

The most important reason for optimism about a greater access to Chinese bonds is that President Xi Jinping has acquired a significant boost to his domestic political capital following a successful Communist Party conference last year. This puts President Xi Jinping in a very strong position to pursue economic reforms with renewed vigour.

The world's fixed income, currency and stock markets will benchmark against China's markets within the next 30 years. This timeframe falls within the investment horizon of most institutional investors, so everyone will have to increase exposure to China significantly

We believe that President Xi Jinping's ambition is bold and long-term, namely to realise China's destiny to become the backbone of the global economic and financial system.

Financial integration is key to realising this ambition. We expect China's economy to be orders of magnitude larger than that of the United States and the European Union by 2050. While the US and EU will still be important players on the global economic stage in 2050, China will undisputedly be the largest. And size matters, especially in finance. Financial markets benchmark themselves against the largest markets, because they are the most liquid. A mere thirty years from now – well within the investment horizon of most institutional investors – we expect all of the world's fixed income and currency markets to look to the Chinese government bond market and Renminbi (CNY) as their primary benchmarks for fixed income and currency, respectively. The implication, of course, is that investors will need to increase exposure to China significantly.

[1] See Appendix 1 for an overview of the onshore Chinese bond market.

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The purpose of this report is to draw attention to the opportunities presented by the approaching integration of Chinese government bonds into global fixed income markets. Using data from 2004 to February 2018 we analyse in detail how access to the Chinese government bonds market could impact EM local currency portfolios and how Chinese government bonds might rival or even outperform US Treasuries as a 'safe haven' destination. We conclude that Chinese bonds have surprisingly attractive features, which means that demand will be large when the market opens up in earnest. Hence, there will be a clear advantage to getting involved early.

This report on the Chinese bond market should be seen as complimentary to Ashmore's previous reports on China, including 'China Roadmap',[2] which outlines the rationale for China's liberalisation of prices, interest rates and the capital account, and 'Chinese reforms and American populism',[3] which contrasts the current policy directions taken in President Xi Jinping's China and President Donald Trump's United States.

Index problems

There are still technical obstacles to investing in the Chinese bond market. For one, the Chinese government bond market is still not part of the main global and EM fixed income benchmark indices. Some USD 4trn of investments follow the Citi World Government Bond Index (WGBI) and the Bloomberg Barclays Global Aggregate Index (Agg), while a further quarter of a trillion Dollars follow the JP Morgan's Global Bond Index-Emerging Markets Global Diversified (GBI-EM GD).

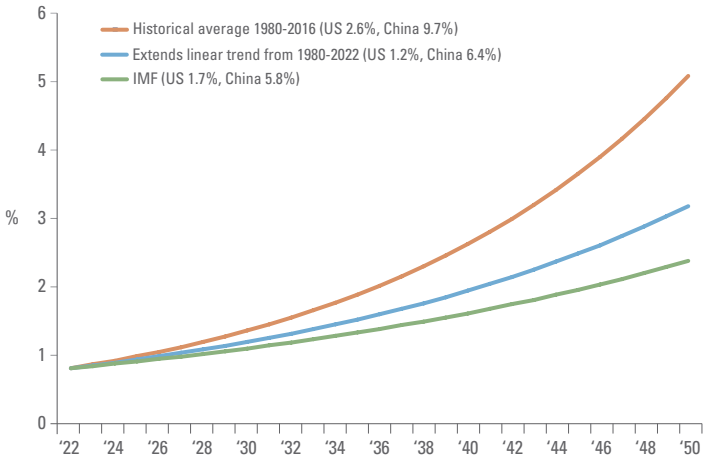
China wants to join these indices, although there is little doubt that the Chinese authorities care more about joining the global benchmarks than the EM indices. The Chinese rightly see themselves as competing with G7 in global asset allocation pool. Still, as we shall show Chinese bonds have important diversification benefits, which means that their inclusion in the GBI-EM GD will confer important advantages to EM investors even if China's inclusion in the GBI-EM GD will lower the average yield and take market share away from other index members.

We cannot offer any special insights about the exact timing of index inclusion, which is non-public market sensitive information. However, we believe that investors should already prepare. For example, it is clear that China is continuously deepening its relationship with investors and the main index providers[4] and the recent strengthening of President Xi Jinping's domestic political standing reinforces the case for expecting even faster economic reforms, including efforts to get China included in the benchmark indices.

It is important to realise the full scope of President Xi Jinping's ambition. He knows that China's destiny is to become the world's undisputed economic and financial hegemon and he wants to lay the foundation stones during his time in office. Consider Figure 1, which shows scenarios for the ratio of Chinese to US GDP under three different growth scenarios: current IMF projections, long-term historical average growth rates, and long-term linear growth trends. Regardless of one's choice of growth rate, China's economy is on track to be between two and five times larger than the US by 2050

Hence, in the same way that the US usurped the UK markets' erstwhile status as global benchmarks for stocks, bonds and currencies during the inter-war years, so China now stands to do the same to the US over the next three decades. 30 years is not a long time in the long investment horizons of most institutional investors.

Fig 1: **Projections for Chinese GDP relative to US GDP to 2050**



Source: Ashmore, IMF.

We are therefore confident that China will continue to address the remaining obstacles to accessing the onshore market. The remaining obstacles fall into four categories:

a) **Regulatory instability:** The Chinese markets suffer from the existence of a plethora of regulators, whose rules all impinge on the local market. The good news is that moves are now afoot to appoint a super regulator with overall control, so this raises the prospect of more streamlined regulation.

b) **Changing access vehicles:** Access to the Chinese market is evolving, but it has not yet found its final form. Access has evolved via QFII, RQFII, CIBM and Bond Connect. Eventually it is likely that direct access to CIBM will become the standard. Once this is achieved liquidity will improve sharply.

c) **Settlement:** Investors can still not settle transactions on DVP basis. This means that funds have to be sent the day before settlement, increasing risk. Settlement is manual, slow and cumbersome. This problem can very easily be resolved, because efficient settlement systems are available off the shelf.

d) **Liquidity:** Liquidity tends to be concentrated in on-the-run bond issues. The moment a new bond is issued, the erstwhile on-the-run bond quickly disappears into buy to hold portfolios and liquidity drops sharply. This forces investors, who wish to remain in liquid bonds, to trade frequently with resulting higher costs. There are many ways to solve this problem. The most effective way is to develop a repo market. State banks can also be forced to participate. The growth of the asset management industry in China will also help to increase secondary market liquidity.

Investors should put these obstacles into an appropriate context. China is still a developing country and to expect her markets to be fully developed is to forget this fact. China is often held to standards, which we typically associate with far more advanced economies. As we shall show now, however, the benefits of holding Chinese bonds are so considerable that investors are likely to be handsomely compensated for accepting a few temporary teething problems.

[2] See *'China roadmap'*, Market Commentary, June 2015.
[3] See *'Chinese Reforms and American Populism'*, The Emerging View, 30 November 2016.
[4] See *'The usefulness of Chinese Bonds'*, Weekly Research, 19 February 2018.

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Features of Chinese bonds – using past data

The challenges outlined in the previous section means that most investors, even to this day, have very little exposure to onshore Chinese fixed income, if any at all. With access improving, however, now is a good time to examine how Chinese bonds could augment the performance of a typical portfolio of EM local currency bonds on a forward-looking basis.

To this end, we use data on Chinese and EM local currency bonds from 2004 to February 2018 to analyse how access to the Chinese market over this period could have augmented the performance of a typical EM local currency bond portfolio over different time periods and under different market circumstances. While this analysis is clearly hypothetical – in the sense that very few investors were actually involved in China over this period – the analysis nevertheless provides a powerful insight into how Chinese bonds may augment performance of EM portfolio on a forward-looking basis. Later we take a stab at an explicit forward-looking analysis.

Figure 2 summarises the returns and volatilities of Chinese bonds and EM local currency bonds for various periods since 2004 as well as the correlations between them.[5] The big message is that the hypothetical efficient ex-post allocations to Chinese bonds within an EM local currency bond since 2004 has been a whopping 87% ('Efficient weights' in Figure 2). The efficient weight to Chinese bonds changes over different sub-periods, but has consistently ranged between 100% during the largest drawdowns in EM to 70% more recently.[6]

Why have the efficient, albeit hypothetical, allocations been so high? First, Chinese bonds have had decent returns. Since 2004 the average annual return on Chinese government bonds has been 5.4% in US dollar terms, which is only 1.2% lower than the average annual return on EM local currency bonds (6.6%). On the other hand, Chinese government bonds have only had a third of the volatility of EM bonds (3.8% versus 10.0%). Notice also from Figure 2 how Chinese bonds have been significantly less volatile than EM local currency bonds in all sub-periods – see Box for reasons why Chinese bonds are less volatile.

Fig 2: **Return, volatility and correlations: EM local currency bonds vs Chinese bonds (in USD terms)**

		EM	China	Correlation
Since 2004	Return	6.6%	5.4%	11.1%
	Volatility	10.0%	3.8%	
	Efficient weight	13.0%	87.0%	
10 years	Return	6.6%	4.8%	16.1%
	Volatility	10.7%	3.1%	
	Efficient weight	7.0%	93.0%	
5 years	Return	-1.0%	2.9%	24.0%
	Volatility	9.4%	3.3%	
	Efficient weight	0.0%	100.0%	
3 years	Return	5.8%	2.2%	28.6%
	Volatility	9.6%	3.6%	
	Efficient weight	27.0%	73.0%	
1 year	Return	15.9%	10.0%	24.0%
	Volatility	6.9%	3.9%	
	Efficient weight	30.0%	70.0%	

Source: Ashmore, Bloomberg, JP Morgan.

The other reason why ex-post efficient allocations to China have been so high is that Chinese bonds have had very low correlations with other EM local currency bonds: correlations have ranged from a low 11.1% to a very modest 28.6%.

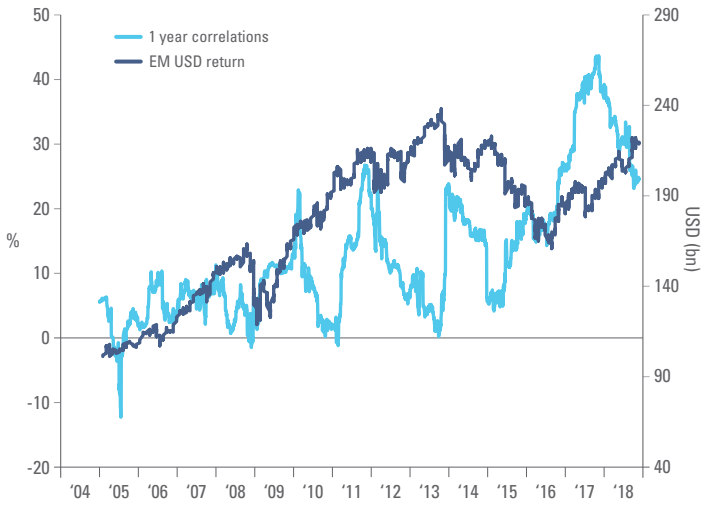
Figure 3 adds a bit more colour by showing how 1-year correlations have changed under different market conditions. The first observation is that correlations have gradually increased over time from close to zero in the early to mid-2000s to about 25% today, which is still a relatively low correlation.

The prospect of better access to Chinese onshore bonds in the future promises to give EM investors a genuine 'safe haven' destination within the EM local currency government bond universe

The second observation is that correlations have tended to collapse during periods of large drawdowns in EM local currency bond markets, such as the Subprime Crisis of 2008/09, the European Debt Crisis of 2011/12 and the Taper Tantrum/Dollar Rally/Commodity Shocks/Fed Hike bear market between 2013 and the end of 2015. This is an extremely important feature, which shows that had investors had access to Chinese bonds, they would have had a genuine 'safe haven' destination within the EM asset class. In other words, they would have been able to re-allocate within their EM local currency bond funds in risk-off episodes instead of redeeming.

In a later section, we ask whether Chinese bonds have, in fact, been better 'safe haven' destinations than US Treasury bonds in major EM drawdowns.

Fig 3: **EM-China return correlations and GBI returns (in USD)**



Source: Ashmore, Bloomberg, JP Morgan.

[5] For purpose of this report, we use the following data: (a) To proxy EM local currency bond markets we use the JP Morgan GBI-EM Global Diversified index (Bloomberg code 'JGENVUUG Index'). The duration of this index is 5.09 years; (b) To proxy the Chinese bond market we use the China segment of the JP Morgan GBI-EM Broad index (Bloomberg code 'JGCHUUSD Index'). The duration of this index is 4.47 years; (c) As proxy for the US bond market, we use an equal-weighted average of the 3-5 year and 5-7 year Bloomberg Barclays US government bond indices (Bloomberg codes 'BEUSG2 Index' and 'BEUSG2 Index', respectively). The duration of this weighted average is 4.78 years. All indices calculate returns in Dollars. The data series starts in January 2003, but all analysis starts from January 2004 in order to have at least a full year of volatility data at the starting point of the analysis. All the data is from JP Morgan and Bloomberg and up to February 2018.

[6] By efficient allocation, we mean the allocation, which maximises the ratio of return to volatility. This implies that volatility is risk, which is patently not the case. Most of the volatility in EM markets has not been associated with large permanent losses in bond markets. Indeed, not a single local currency bond market has suffered defaults in the period since 2004. However, investors continue to care about volatility, which they regard as a good proxy for riskiness.

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Why are Chinese bonds less volatile than other EM bonds?

Why have Chinese bonds been less volatile than a whole basket of EM bonds? One reason is that the onshore Chinese bond market was more stable than onshore EM local bond markets.

Panel 1 of Figure A shows volatilities in local currency terms, that is, without FX-related volatility. Chinese bonds have only had a fraction (59% to 75%) of the volatility of EM bond markets all periods with the sole exception of the full period since 2004 over which the Chinese bond market was marginally more volatile than the EM local bond market. The remarkable stability of the onshore Chinese bond market flies in the face of the hysteria, which often surrounds China's financial markets.

Panel 2 in Figure A shows the other reason why Chinese bonds were less volatile. This was because CNY was stronger and more stable than other EM currencies. Panel 2 shows relative volatility in Dollar terms, i.e. after including volatility arising from currency movements. In Dollar terms, China's bonds only suffered between 29% and 56% of the volatility of EM local bond markets.

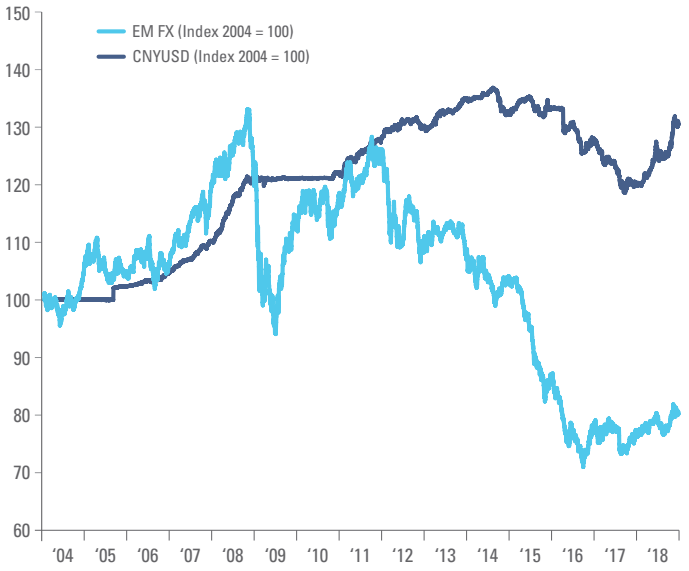
Fig A: **Decomposing volatility in China versus EM local bond markets**

	Panel 1: **Volatility in local terms**			Panel 2: **Volatility in USD terms**		
	China vs EM	**China**	**EM**	**China vs EM**	**China**	**EM**
1yr ann. vol	63%	1.1%	1.7%	56%	3.9%	6.9%
3yrs ann. vol	59%	1.4%	2.4%	38%	3.6%	9.6%
5yrs ann. vol	67%	1.9%	2.8%	36%	3.3%	9.4%
10yrs ann. vol	75%	2.2%	2.9%	29%	3.1%	10.7%
Since 2004	123%	3.2%	2.6%	38%	3.8%	10.0%

Source: Ashmore, Bloomberg, JP Morgan.

Figure B illustrates the same point in a more visceral fashion; EM currencies declined by a massive 45% against the US dollar during the period of maximum Quantitative Easing (QE) between 2010 and 2015, while over this and other periods CNY held up far better.

Fig B: **Non-China EM FX versus CNY**



Source: Ashmore, Bloomberg, JP Morgan.

Forward-looking analysis

The historical analysis above is hypothetical, since, barring perhaps some central banks and sovereign wealth funds, no investors have actually been able to make the efficient allocations to China due to lingering limitations on access to the market.

Access is now improving, however, so a meaningful allocation to China is now gradually becoming feasible.[7] For example, in principle, most institutional investors can now access the Chinese interbank market (CIBM) with a modest investment of time and some paperwork. How much China exposure should such investors now aim to have within their EM local currency bond portfolio on a forward-looking basis?

The answer is less than the hypothetical exposure in the past, but more than the early movers have today. There is no doubt that correlations with other markets will increase as China gets integrated into global markets. The volatility of the Chinese bond market and CNY may also rise. Besides, EM local markets are more attractive now than they have been for some time. EM currencies started to rally against the US dollar in early 2016 and EM local bond yields are high after the sell-offs between 2013 and 2016. In general, EM local currency bonds perform better than Chinese bonds during broad EM bull markets. EM local bond indices are also slowly improving with more countries joining (e.g. GBI-EM GD now has 18 countries compared to 15 at the end of 2016). All these factors all justify a larger allocation to EM local currency bonds relative to Chinese bonds compared to the past.

Even so, we find that a surprisingly large allocation to China is still justified. Figure 4 illustrates this point by showing optimal allocations to Chinese bonds in a passively managed EM local currency bond portfolio on the (admittedly simple) assumptions that (a) the volatility (in USD terms) over the past twelve months is a good proxy for future volatility and that (b) current yields are a good indicator of returns going forward. Based on these assumptions the efficient allocation to Chinese bonds in a China-enhanced EM local currency bond portfolio is still a very high 69%. In a scenario where EM currencies outperform CNY by 4% in the next year, the efficient allocation to Chinese bonds drops to a still material 49%. These large efficient allocations testify to the enormously attractive characteristics of Chinese bonds.[8]

Fig 4: **Efficient allocations to Chinese bonds today**

		EM	**China**	**Correlation**
Forward-looking	Expected Return (Yield-to-Maturity)	6.1%	3.9%	24.0%
	1 year vol	6.9%	3.9%	
	Efficient weight	31.0%	69.0%	
Forward-looking with 4% EM FX appreciation	Expected Return (Yield-to-Maturity)	10.1%	3.9%	24.0%
	1 year vol	6.9%	3.9%	
	Efficient weight	51.0%	49.0%	

Source: Ashmore, Bloomberg, JP Morgan.

[7] It is important to stress that this analysis compares two indices, i.e. not actively managed portfolios. Active managers such as Ashmore would typically have large underweights to China in EM bull markets in the expectation of outperforming benchmark indices. There is far more scope for generating alpha in EM because much of the volatility in EM local markets is created by investor behaviour rather than credit weakness.

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Chinese bonds as a 'safe haven' alternative to US Treasuries

Analysis of past data can also generate important insights about how Chinese bonds have stacked up as 'safe haven' destinations during big bouts of global risk aversion. Figure 5 shows that the efficient allocation to Chinese bonds in a portfolio of US and Chinese bonds since 2004 was a remarkably high 65%. Not only was the average annual return of 3.4% on US bonds over this period lower than the return of 5.4% on Chinese bonds, but the volatility of Chinese bonds was lower at 3.8% compared to 4.1% for US bonds. The efficient allocation to Chinese bonds was a massive 87% over the past year, because Chinese bonds returned 10% in Dollars compared to a measly 0.3% for US bonds, while Chinese bonds were only somewhat more volatile than US bonds. This result generalises to all periods, however. At no point since 2004 has the efficient allocation to Chinese bonds been lower than 65% and, if anything, the efficient allocation to Chinese bonds versus US bonds has tended to rise over time.

Fig 5: **Chinese bonds compared to US bonds**

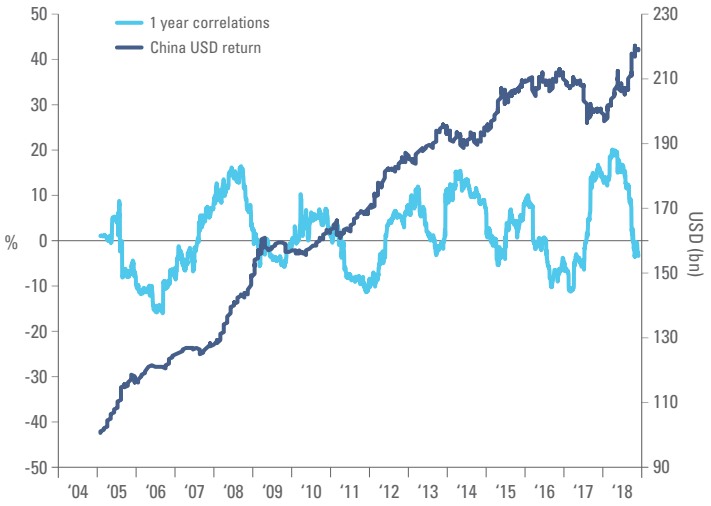
		GBI	China	Correlation
Since 2004	Return	5.4%	3.4%	0.7%
	Volatility	3.8%	4.1%	
	Weight (most efficient Return/Vol portfolio)	65.0%	35.0%	
10 years	Return	4.8%	2.9%	0.8%
	Volatility	3.1%	4.2%	
	Weight (most efficient Return/Vol portfolio)	76.0%	24.0%	
5 years	Return	2.9%	0.9%	3.4%
	Volatility	3.3%	3.2%	
	Weight (most efficient Return/Vol portfolio)	78.0%	22.0%	
3 years	Return	2.2%	0.8%	1.6%
	Volatility	3.6%	3.1%	
	Weight (most efficient Return/Vol portfolio)	69.0%	31.0%	
1 year	Return	10.0%	0.3%	-3.9
	Volatility	3.9%	2.4%	
	Weight (most efficient Return/Vol portfolio)	87.0%	13.0%	

Source: Ashmore, Bloomberg, JP Morgan.

The correlation characteristics between US bonds and Chinese bonds are also extremely favourable. Indeed, in our frequent discussions with EM central banks the low correlations between Chinese bonds and bonds in other members of the club of global reserve currencies are often cited as their most appealing feature. Specifically, correlations since 2004 have been extremely low (0.7%) and in the past twelve months, when US Treasury yields have increased, the correlation with Chinese bonds has actually been outright negative (-3.9%). This seems important as the 30-year US bond market rally draws to a close. Figure 6 shows that correlations between the two markets have been both low and very stable over time, though there is some evidence of late that correlations may be getting a bit more pro-cyclical, especially after China de-pegged from the Dollar.

In general, we would expect correlations to rise somewhat over time as China's markets open up further, not least because the Chinese bonds and CNY will become more widely used in global pension fund and insurance company portfolios.

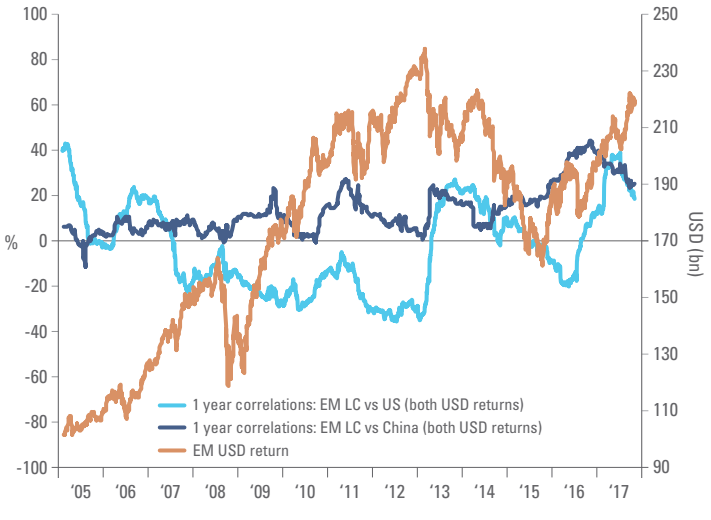
Fig 6: **Correlations and returns: Chinese and US bonds (4.5 years of duration)**



Source: Ashmore, Bloomberg, JP Morgan.

What do these observations tell us about the 'safe haven' characteristics of Chinese bonds from the perspective of EM local currency bond investors? Figure 7 tries to answer this question by charting the performance of EM local bonds in Dollar terms alongside correlations with both US bonds and Chinese bonds. The first point to note is that EM-China correlations have been more stable over time than the EM-US correlations, which means that the interplay between the two markets is more predictable, which is clearly a favourable characteristic. The second point to note is that US bonds have not offered a reliable 'safe haven' destination during some large EM drawdowns. For example, while correlations were negative in 2008/2009 they spiked during the early stages of the Taper Tantrum in 2013, implying that US bonds were not a desirable place to hide.

Fig 7: **China vs US bonds as 'safe haven' material**



Source: Ashmore, Bloomberg, JP Morgan.

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Enter macroeconomics

One of the major deficiencies in modern portfolio theory is the absence of an explicit link to macroeconomics.[8] Today the outlook for US bonds is deteriorating and investors are well advised to take macroeconomic circumstances into account, when they evaluate the usefulness of US bonds as a 'safe haven' going forward.

The recent Trump tax cut implies a much greater supply of US government notes and bonds in the coming years, and the current account deficit looks set to widen partly due to higher interest payments on debt, partly due to rising protectionism.

Credible estimates suggest that the US bond market will have to absorb 5-6% of US GDP of additional supply of notes and bonds in the coming years.[9] The problem is that demand for government bonds within the US is largely saturated at current prices, while overseas EM central banks – which control close to 80% of global FX reserves – are already limit-long US dollar assets. Hence, the additional supply coming on line will likely force the US government to choose between either accepting a repricing of the entire US yield curve to encourage new buyers with all the problems that come with that, or to let the Dollar fall.

The recent sensitivity of the US stocks to inflation (i.e. the prospect of higher rates) shows that repricing of bonds could be very painful for the stock market, and even potentially usher in a recession. A lower Dollar on the other hand would help US exporters and create a rally in EM currencies on the back of capital inflows, which would then encourage many EM central banks to intervene and increase their reserves, thereby increasing their capacity to buy more Treasury bonds and notes.

Based on the past relationship between EM currencies and EM central bank reserve accumulation, we estimate that a 10% fall in the US dollar versus EM currencies could increase demand for US Treasuries by EM central banks by nearly a

Chinese markets offer a superior alternative to the US bond market as a safe haven destination and the advantages of Chinese bonds versus US Treasuries will only increase as US fiscal and current account deficits widen alongside rising populism and protectionist policies

trillion Dollars (Figure 8).[10] In other words, a lower Dollar means that EM central banks can help to keep US yields lower than what they would otherwise be, and faced with a choice between a lower Dollar or rising real bond yields, we think the US government would prefer the former.

Fig 8: **Projections for EM FX reserve accumulation under different currency scenarios**

Expected change in EM FX	Expected level of reserves (index weighted, USD bn)	Expected level of reserves (total USD bn)
-10%	156	2,166
-8%	157	2,183
-6%	158	2,199
-4%	159	2,216
-2%	161	2,232
0%	**162**	**2,249**
2%	174	2,424
4%	187	2,598
6%	199	2,773
8%	212	2,948
10%	225	3,122

Source: Ashmore, Bloomberg, JP Morgan.

Conclusion

The prospect of better access to the Chinese government bond market should make EM bond investors lick their lips. Based on past data Chinese bonds would have significantly enhanced the performance of conventional EM local currency bond portfolios had Chinese bonds actually been available.

Access to Chinese bonds is now improving every day. In our opinion, Chinese bonds are superior to US government bonds as a 'safe haven' destination for EM investors during major episodes of risk aversion, so by accessing Chinese bonds during bouts of risk aversion EM investors no longer need to pull money out of the asset class when they get scared. This means that China's entry into the global fixed income benchmarks will also help to reduce the violent instability of the Dollar caused by the heavy one-way traffic in and out of the Greenback around bouts of risk aversion.

China's full integration into global fixed income markets also poses a direct challenge to the US. It is clearly enormously valuable to the US that investors the world over immediately liquidate all their overseas investments and repatriate funds to the US whenever they get scared, even, amazingly, when the sources of risk aversion emanate from within the US itself.

As investors in the future increasingly turn to Chinese bonds in moments of fear the traditional 'flight to safety' financial insurance, which has so shored up US financial markets during crises will weaken.

Active management will continue be very important in EM local currency bond portfolios, even with the rise of China. Until China is formally admitted to the GBI-EM GD index, investors can only take exposure to China via off-benchmark allocations, which are not available to passive investors. Even after China is included in the index, however, it will still be important to be active, because China's weight will only be 10% due to diversification rules. The real value of China's inclusion in the GBI-EM GD index, however, is that EM markets will have their own 'intra-EM' 'safe haven' destination, obviating the need to redeem during risk aversion events. The full benefit of this augmentation to the asset class will only be realised by those investors, who are willing and able to adjust exposures to China from underweight positions during EM bull markets to overweight during EM bear markets, i.e. to those who are genuinely active.

[8] For a broader discussion of this topic see Jerome Booth's book *'Emerging Markets in an Upside Down World: Challenging Perceptions in Asset Allocation and Investment'*, The Wiley Finance Series, 2014.

[9] See https://www.cfr.org/blog/how-will-us-fund-its-twin-deficits

[10] In reality EM central banks will diversify away from the Dollar but only slowly. The bulk of the funds will go into US Treasuries. See *'Get read for EM reserve accumulation'*, The Emerging View, February 2018.

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Appendix 1

The onshore Chinese bond market is huge. As of January 2018 the market measures CNY 74.6trn (USD 12trn) with government issuers of various hues accounting for 58% of total outstanding.[11] The biggest sectors are conventional government bonds, municipal bonds, policy bank bonds and corporate credit in addition to a bunch of smaller segments, such as government-sponsored issuers, ABS and other financial sector bonds. Foreigners own only about 2% of the Chinese fixed income market and a mere 5.5% of Chinese government bonds with central bank and sovereign wealth funds the main overseas holders. The government yield curve goes out to 50 years with roughly one third of the bonds 5 years or longer tenor. Commercial banks hold 56% of all fixed income, but domestic bond funds are growing rapidly and now manage just over a quarter of all bonds. The total fixed income market is growing at a rate of roughly 15% per year in nominal terms, slowing from a peak of 45% per year in 2016. The domestic market is complemented by a deliverable CNY settled IRS market, a Dollar settled non-deliverable IRS market and an offshore CNY denominated cross-currency swap market.

[11] Data from Deutsche Bank.

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