Ashmore

Probably the best bond market in the world

By Jan Dehn

Introduction

China's domestic bond market offers a compelling diversification opportunity in a world otherwise struggling with a bearish outlook for fixed income as the Fed slowly moves towards monetary policy normalisation.

The market offers a genuinely attractive alternative to core fixed income markets in the developed world, and one that pays better and has lower volatility. The general direction of macroeconomic policy in China is likely to provide a supportive backdrop for local fixed income as the economy transitions to domestic demand-led growth and capital account liberalisation. Hardly anyone has exposure to China's USD 4.4trn domestic bond market, so the technicals are mind-boggling, in our view.

China's domestic bond market just may be the greatest fixed income opportunity available today.

China's leadership has placed its chips

The case for Chinese domestic fixed income is best understood in the context of China's dramatic reforms. As we outlined in *"Bull in a China shop"* (The Emerging View, March 2014) China's growth model, based on exchange rate manipulation, forced saving to finance investment and supported by excessive debt-fuelled consumption in the West has become obsolete. The West is deleveraging and over the next few years China will find it increasingly challenging to weaken its currency more than those of QE economies.

Currency effects

China has accumulated nearly USD 4trn of FX reserves and will likely have to diversify this pool of capital in order to protect its purchasing power. The resulting sale of US dollars will unambiguously push USDCNY lower, regardless of what currencies China decides to buy instead. We think the Renminbi could double in value against the Dollar over the next ten years. This will sink the final nail into the coffin of China's erstwhile export-led growth model.

Currency appreciation will have a powerful and protracted deflationary effect on the Chinese economy. This should ensure deflationary pressures in China for a long time, ensuring a broadly dovish stance from the PBOC and even the potential for further rate cuts.

New levers of macroeconomic control

To the Communist Party of China, as to most other EM governments, the ability to control the temperature of the economy is more important than growth itself. China is largely a closed economy – exports are only 26% of GDP. China's transition to domestic demand-led growth will require a brand new set of policy levers. Out goes FX management and policies aimed at directing credit towards investment and in their place comes consumption and interest rate management. Consumer spending is far more efficiently controlled with interest rates than with currencies.

This is precisely why China is liberalising interest rates and, by implication, why the development of China's domestic bond market – destined to be the central transmission mechanism for PBOC rate decisions to the broader economy – is so very important.

The role of the bond market

To effectively transmit monetary policy signals, the bond market must be efficient. This is why China is:

- liberalising interest rates
- developing benchmark bonds at local government level
- growing the mortgage market
- developing a mutual fund industry
- allowing foreign institutional investors into the onshore bond market.

Bond market development also serves two other purposes central to a successful economic transition:

First, bond markets will help to discipline local governments. Going forward, funding for local governments will increasingly come from bond issuance rather than directed bank credit. This means that local governments will face market discipline; if they borrow too much or if they are too opaque they will find their funding costs rising.

Second, the bond market will stimulate consumption. Savers in China today can only invest in deposits that pay next to nothing, or in stocks, property and trust fund products all of which are highly pro-cyclical instruments – whose value fluctuates with the economic cycle. This is not what you want in a stable savings portfolio.

What is missing is bonds! Bonds typically behave differently from most other assets. The introduction of bonds into savings portfolios will stabilise the overall savings pool over the cycle and thus help to lower precautionary savings rates (China's savings rate is around 50% compared to a global average of c.20%), which in turn raises the level of consumption (central to domestic demand-led growth).

Supportive backdrop for fixed income

The macroeconomic backdrop for Chinese fixed income is likely to be benign for the foreseeable future. Interest rate liberalisation is resulting in tighter liquidity, and the transformation of China from an export economy to a domestic demand-led economy is also producing drags. This is why the Chinese economy is likely to continue to steadily slow over the next few years, while at the same time China is putting in place the basis for its next phase of growth. While a slowing economy is benign for fixed income, the ongoing structural reforms in the Chinese economy are also likely to throw up new and exciting opportunities in equities.

Bond markets link directly to the capital account

The liberalisation of interest rates and the development of the domestic bond market are not divorced from the process of capital account liberalisation. Once domestic rates have found their natural level the capital account can be opened to allow capital to flow freely across borders without creating huge destabilising surges in cross-border portfolio flows. The lead-up to capital account liberalisation is accompanied by rapid financial sector development, notably the establishment of benchmark bond issues at local government level, creation of a mutual fund industry and selective admission of overseas institutional investors into the onshore market, starting with long-term institutional investors.

High yields for a high quality sovereign

Chinese government bonds yields are more than twice as high as US bond yields, and half as volatile, as shown in the table below. Given China's very strong sovereign fundamentals, Chinese domestic bonds should be viewed as a better-paying and lower volatility substitute for so-called core bond markets in Europe and the US. In addition, the correlation between Chinese domestic bonds and other global bond markets is low. For example, the correlation between the total return of the 5-year Chinese government bond and the 5-year US treasury bond is -1.0%, while the yield correlation is -0.5%.

Fig 1: **China domestic bonds: Comparative statistics**

Markets	Standard deviation (%)	Yield (%)
5-year US treasuries	1.3	1.8
5-year Bund	1.3	0.2
GBI EM GD	0.6	6.6
5-year China domestic bonds	0.6	4.0

Source: Bloomberg.

Fig 2: **3-month rolling correlations**

Markets	Yield correlation	Total return correlation
GBI EM GD vs 5-year US treasuries	4.9%	-3%
5-year China vs 5-year US treasuries	-0.5%	-1%
5-year US treasuries vs 5-year Bunds	55.4%	27%

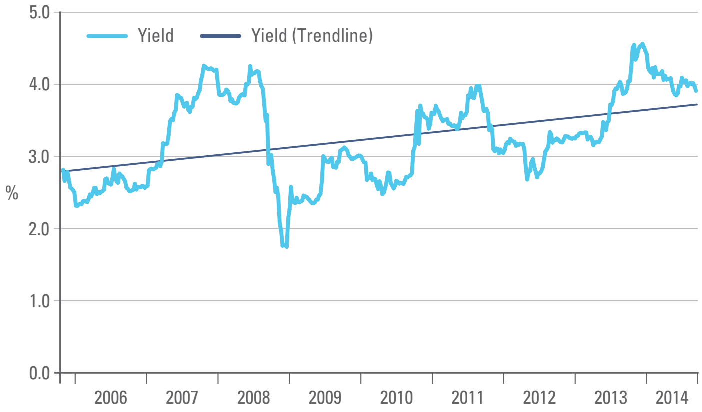
Source: Ashmore, Bloomberg.
3-month rolling correlations based on 90 days of daily data from 2003-2014.

Attractive entry points

For long-term fixed income investors the current gradual increase in Chinese bond market yields triggered by the government's policy of interest rate liberalisation offers an attractive entry point.

For shorter-term investors, there are also convergence opportunities vis-à-vis the offshore CNH market. On-shore CNY bonds today trade at yields that are about 150bps wider than off-shore bonds. We think this spread will first go to zero and then become negative due to much better liquidity in the onshore market.

Fig 3: **China 5-year benchmark bond yield**



Source: Bloomberg.

Mind-boggling technicals

China's onshore bond market is the largest bond market in EM and one of the largest fixed income markets in the world with a volume of outstanding bonds close to USD 4.4trn (equivalent to roughly 25% of US GDP). Given China's faster growth rate compared to almost any other country on earth, the Chinese bond market has more than doubled in absolute terms over the past seven years. The market is highly liquid with tight bid/offer spreads and long tenors.

The technicals are mind-boggling: China's domestic bond market does not yet feature in any of the main benchmark indices due to capital controls. The only foreign players to participate in this market so far are mainly foreign central banks with FX swap arrangements, CNY clearing banks in Hong Kong and Macau and off-shore CNY settlement banks.

Only recently has China begun to grant access to portfolio investors on a selective basis via the QFII programme and daily dealing SICAV structures offered by managers with RQFII quotas (such as Ashmore).

Domestic technicals are also strong. Savings rates in China are high and real bonds yields are positive; greater access to fixed income via mutual funds will naturally lead to material domestic allocations to bonds, in our view.

Interesting prospects for corporate bonds

Greater foreign participation in the government sector of the domestic bond market should lead to significant growth in the local currency corporate bond markets as well. Private bonds, notes and other paper comprise only about 22% of total bonds in China, a much lower percentage than in developed economies as well as in other EM countries such as Brazil and South Korea. China's corporates have relied more heavily on bank lending, but this is now changing as Beijing lets interest rates play a bigger role in the allocation of capital. While interest rate liberalisation will initially cause default rates for Chinese corporates to rise, we think this is a healthy development. Unless and until default rates rise at least to the level of corporate defaults in other countries we see no reason to be concerned.

Fig 4: **China's domestic bond market**

	RMB bn	USD bn
Total fixed income	**26,816**	**4,375**
Total government	20,875	3,405
Interbank and exchange traded	7,352	1,199
Local government	663	108
Other government	422	69
PBOC bills	995	162
Policy bank notes	8,397	1,370
Enterprise bonds	2,236	365
Government sponsored agency debt	**810**	**132**
Total private	5,941	969
Corporate bonds	665	108
Convertible bonds	214	35
Medium-term notes	2,757	450
Commercial paper	938	153
Commercial bank paper	1,329	217
Others	38	6

Source: HSBC, Ashmore (as of June 2013).

Local currency opportunities in Emerging Markets beyond China

EM countries passed an important test last year. EM government yield curves re-priced by 200bps with no discernible impact on growth, balance of payments, default rates, or other important macroeconomic fundamentals. The 'Fragile Five' became the 'Frugal Five', China did not have a hard landing, etc. By contrast, a similar 200bps re-pricing of government yield curves in developed market yield curves would likely have proven disastrous, in our view. EM is fundamentally much more resilient.

The 2013 sell-off had three key effects:

- Technicals are much better: Speculative positioning into overbought markets contributed to the large sell-off in EM local markets last year with more than 30% of 'fast money' leaving EM local markets. This money has not returned, rendering positioning far less pregnant.
- More attractive valuations: In January 2014, local bond yields traded at 7.25%, 200bps wider than before the 2013 sell-off. Today, yields are still more than 125bps wider than last year and not far below the average yield of 6.9% that prevailed prior to the 2008/2009 Subprime Crisis. Current nominal yields are materially higher than average inflation rates in EM.
- The Fed is keen to avoid another aggressive treasury market sell-off: The first experiment with tapering failed as the US treasury market overreacted, forcing the Fed to U-turn. The Fed is likely to be more gentle this time, aware that sharp rises in yields can be very damaging to a heavily indebted economy. This suggests a somewhat less disorderly reaction in the treasury and currency markets and hence less fear and milder kneejerk reactions in the EM fixed income markets.

Diversification not just for wimps

We may be at the end of a 30 year rally in bonds. The Fed is now widely expected to start hiking rates in 2015. The prospect of a world with less money and more expensive money is now very clear and present. Uncertainty about the pace of tightening is already causing short-term volatility in EM, but institutional fixed income investors would be well advised to look beyond the near-term speculation surrounding every Fed statement. A far better strategy would be to think through the likely path to economic normalisation and to position accordingly.

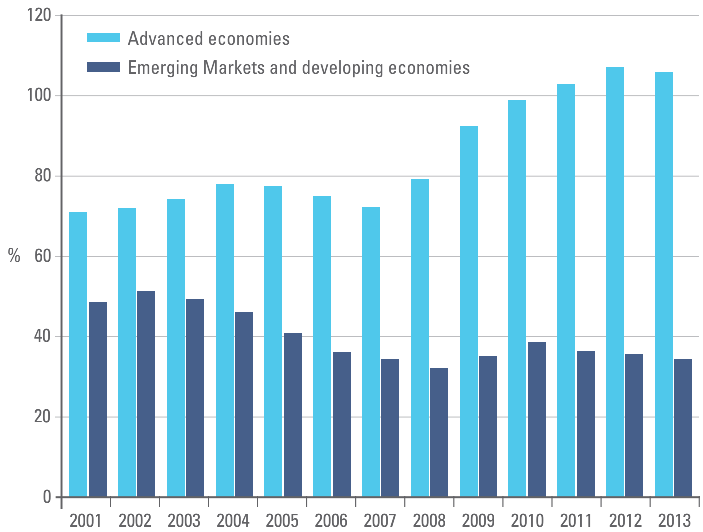
We think imbalances and fundamental vulnerabilities in today's developed economies will soon show that diversification has been overlooked.

Many institutional investors today have less than 5% exposure to EM fixed income despite EM's 50% share of global GDP. The structure of the investor base in developed bonds has become more concentrated and therefore more vulnerable. Central banks today hold more than 50% of all US government debt. Liquidity can drop sharply.

Debt dynamics in developed economies are poor; today developed economies account for 87% of the world's government and corporate debt.

Gross government debt in developed economies has risen from 72.5% to 106.3% of GDP since 2007, according to the IMF. EM countries have reduced their debt stocks over the same period. Private sector debt stocks in developed economies are many times larger.

Fig 5: **Gross government debt to GDP**



Source: IMF World Economic Outlook, April 2014.

High correlations

Developed bond markets are also far more correlated to Treasuries than EM markets. As we showed in the tables earlier, yield correlations between US 5-year bonds and the GBI EM GD index – two markets with the same duration – is just 4.9% compared to 55.4% between US and German 5-year bonds. Total return correlations – which also take into account FX returns – are even lower at *negative* 3% compared to positive 27% between German and US 5-year bonds.

Local EM bonds today offer 6.7% yield compared to 1.8% for US 5-year bonds. This spread of 490bps is high by historical standards – the average is 263bps and the median is 250bps since GBI indices began. Spreads have generally declined when US treasury yields have risen – the likely direction of travel going forward. This suggests the potential for significant relative outperformance of EM bonds versus US government bonds.

We believe the Fed will allow inflation to rise and will raise nominal policy rates very slowly. Inflation will naturally resurface around mid-2016

What about FX?

The outlook for EM FX depends on your view of the process of global rebalancing. The consensus holds that the US economy will revert to long-term trend growth and normal monetary conditions without any intervening period of inflation and business cycle volatility. This justifies a bear-flattening view of the US yield curve due to Fed rate hikes in the context of low inflation. The same view points to a bullish view of the Dollar due to prospects for higher growth and higher real rates.

For EM, this view implies higher external borrowing costs and weaker currencies. The risks of capital flight and pass-through inflation can only be mitigated with higher domestic interest rates, so growth slows, which makes EM FX even less attractive. The only sustainable way for EM to restore growth is to be extremely prudent and to undertake reforms.

We beg to differ

We think the consensus view ignores some very material facts, including the large debt stock in developed economies and the difficulties central banks in developed economies are likely to face in unwinding the extremely easy monetary conditions they have created. We think tightening can quickly hurt the US treasury market. And hurting the US treasury market soon threatens the recovery due to the debt stock. Higher rates also hurt stock markets due to their dependence on cheap money.

Inflation is not dead, it is just sleeping

Inflation is likely to arrive before deleveraging has been completed, so the Fed will face an unpleasant choice: Drive real rates higher to crush inflation or allow real rates to decline in a temporary accommodation of higher inflation to help reduce the stock of outstanding debt.

Inflation is a social choice as Kenneth Rogoff noted recently. Inflation in heavily indebted economies drives down real borrowing costs, helps to inflate the debt away and weakens the currency to allow exports to flourish at the expense of other countries. And the opportunity cost of inflation – forgone investment – is low anyway.

Fed dilemma

We think the Fed will try to straddle the horns of this dilemma by variously allowing inflation to rise, but at the same time raising nominal policy rates very slowly. We think inflation will naturally resurface around the middle of 2016 when (a) household deleveraging is over; (b) unemployment is materially lower than today; and (c) the drag from negative equity eases for home owners.

EM in a world of developed market inflation

This view contrasts sharply with the consensus. It also has dramatically different implications for EM local markets. Instead of experiencing financial tightening principally via higher real external borrowing costs, EM suffers mainly through stronger currencies. Stronger FX handicaps EM export growth and forces countries to rely more on domestic demand-led growth. EM can only increase domestic demand sustainably by raising productivity, i.e. to reform, but EM must also invest in domestic infrastructure, promote local currency corporate bond markets, etc. EM central banks cut rates as they slow. Local currency investments will be increasingly attractive in this scenario. Shorter duration exposures are preferred due to greater business cycle volatility in the US, which in turn requires higher long-term yields.

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