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MARKET COMMENTARY

Chinese government bonds: Temporary domestic technical headwinds offer springboard for greater foreign participation

By Jan Dehn

Despite the numerous attractions of Chinese government bonds (CGBs), foreign investors still own relatively little. Index providers were initially slow to include China in key indices, but this is now changing and foreign demand for Chinese fixed income is rising sharply and likely to continue to grow, in our view.

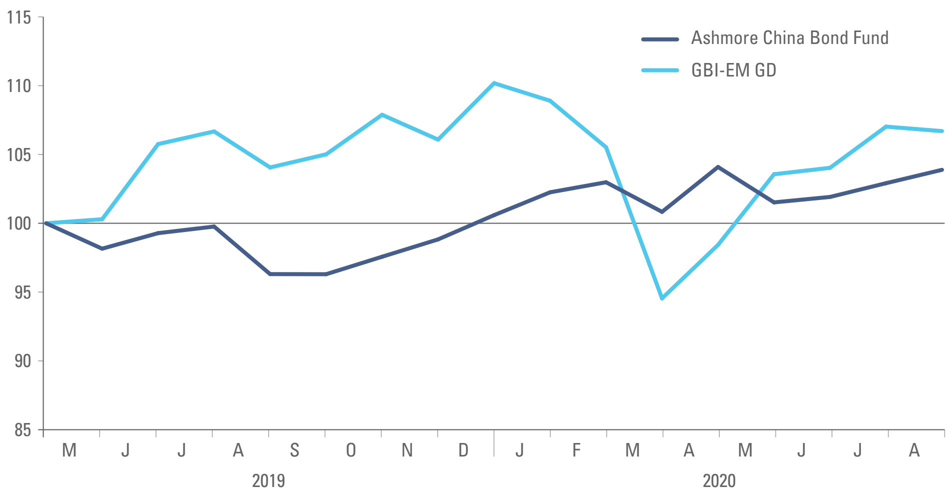
As they seek to increase their overall exposure to China, tactically foreigners need to pay particular attention to technicals in the Chinese local market, since the direction of the Chinese bond market is entirely set by locals. The local bond market in China is currently experiencing an interesting – and transitory – imbalance between demand and supply, which is pushing up yields. While this hurts local investors, who are very long CGBs, it also creates an interesting opportunity for foreign investors with very little exposure to CGBs add to their inadequate positions at attractive yields.

Chinese bonds

Chinese bonds make up 13% of the global fixed income, 52% of EM fixed income, and 74% of Asian fixed income

It has been established beyond dispute that it is efficient to introduce Chinese bonds into global bond portfolios due to a combination of low correlations, low volatility, and, especially versus Developed Market (DM) bonds, relatively high yields. In Emerging Markets (EM) local currency bond portfolios, Chinese bonds additionally introduce an important safe haven feature, which becomes especially valuable during bouts of risk aversion, while at the same time paying a higher yield than is available on so-called safe haven bonds in DMs. This can be seen from Figure 1, which shows the performance of the main EM local currency government bond benchmark, the JP Morgan GBI-EM GD, and Ashmore's China Debt Fund. Chinese bonds produce lower returns, but have much lower volatility as well as very low correlation with the rest of EM markets. An added advantage of Chinese bonds is that there is plenty for investors to buy. Already the second largest bond market in the world, Chinese bonds make up 13% of the global fixed income, 52% of EM fixed income, and 74% of Asian fixed income.[1] The features of Chinese bonds justify sizeable allocations to in both EM and DM bond portfolios.[2]

Fig 1: **Chinese bonds and EM local currency bonds (index April 2019=100)**



Source: Ashmore, Bloomberg.

[1] As of end-2019, the global fixed income market was USD 117.9trn. EM is 25% of global fixed income. Asian fixed income is 70% of EM fixed income. Source of this data is Bank of International Settlements. For more details please see: *"The EM fixed income universe version 9.0"*, The Emerging View, 4 August 2020.

[2] See: *"How Chinese bonds can enhance your portfolio"*, The Emerging View, 16 March 2018, and *"Chinese bonds in Developed Markets bond portfolios"*, The Emerging View, 18 May 2018.

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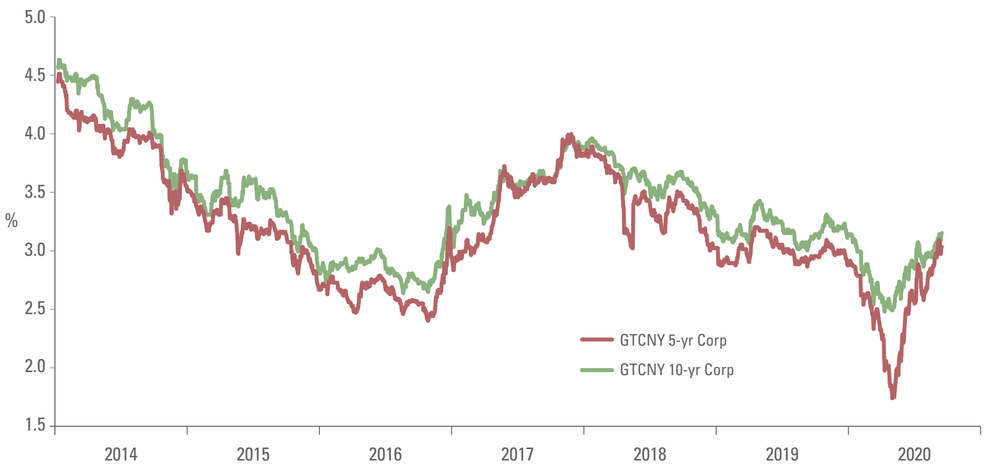
Domestic technical headwinds

After a strong rally at the height of the coronavirus pandemic in Q1 2020, Chinese government bonds (CGB) have been on the back foot since April with yields rising back towards pre-coronavirus levels (Figure 2). The People's Bank of China (PBOC) has recently put the brake on banks' use of balance sheet, while the level of excess reserves is low, so the ability of commercial banks to absorb significantly volumes of bonds has been curtailed. In fact, many have turned sellers. Chinese regulators, including PBOC, have also continued to improve oversight and containment of financial system imbalances. One such imbalance was the supply of structured (leveraged) deposits, which grew very strongly during H1 2020. The regulators have since laid down aggressive targets for such products to be reined in before the end of the year. While prudent, these measures add to the liquidity and funding stresses for banks at a time when government bond supply to finance greater spending is extreme. Supply is going to remain heavy until year-end. However, this is an anomaly. Supply is likely to moderate sharply in 2021, in our view.

Locals are now finding themselves with too much fixed income on their hands and too little equity

This is happening against the backdrop of a stronger than expected recovery in Chinese growth. Both reduce the likelihood of significant additional monetary easing. To make matters worse, Chinese stocks are doing very well. Locals are therefore now finding themselves with too much fixed income on their hands and too little equity. The excess exposure to bonds is leading to selling, which in turn pushes up bond yields. This may continue for a few months, in our view.

Fig 2: **5-year and 10-year nominal government bond yields**



Source: Ashmore, Bloomberg.

One investor's pain, another investor's gain

In sharp contrast to local investors, foreigners are under-exposed to Chinese fixed income

In sharp contrast to local investors, foreigners are under-exposed to Chinese fixed income. We estimate that foreigners currently own about 2% of the total Chinese fixed income market. Foreign ownership is concentrated in the CGBs (foreigners own approximately 9.2%, or USD 234bn). Liquidity and transparency in most of the corporate bond space is lower than in the CGB space. Foreign investors are likely to continue to allocate strategically to China as her markets grow and become more accessible. Tactically, they will also add anytime negative technicals appear in the local market, such as now, when yields temporarily get pushed higher, since this gives a more attractive entry point.

Index tail winds

In addition to the interesting technical situation within China's domestic bond market, foreign investors are also looking at China due to ongoing and upcoming index changes. China's weight in key benchmark indices looks set to increase significantly. China joined JP Morgan's GBI-EM GD this year with a current index weight of 6%, but this weight will reach 10% by year end. Even more important, there is now a 70% probability, in our view, that FTSE will announce the inclusion of Chinese bonds in the World Government Bond Index (WGBI) on 24 September 2020. If so, Chinese bonds should enter this important global benchmark index starting around October 2021 with resulting inflows of between USD 120bn and 170bn, although some conservative estimates

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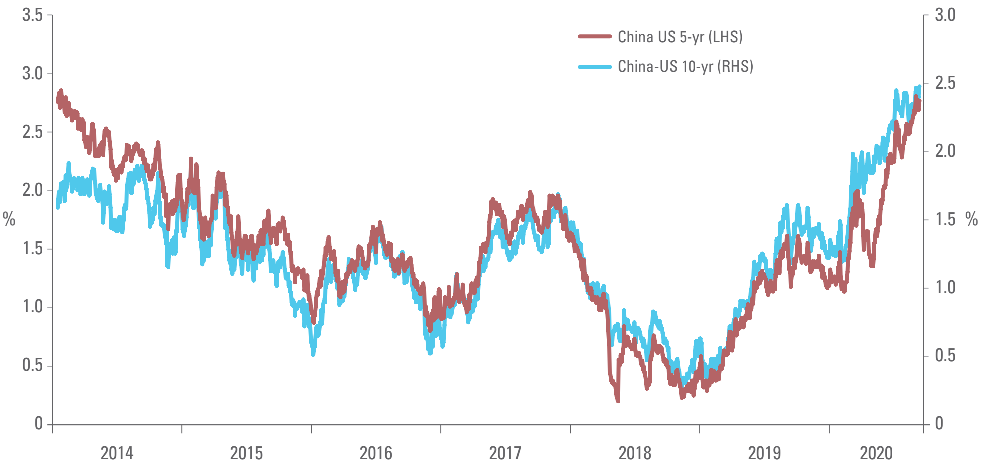
place this figure as low as USD 100bn. For example, some investors, including some US, Taiwanese, and Japanese pension funds may be reluctant to add as quickly and may even opt for WGBI ex-China versions of the benchmark, although this will not preclude them from taking off-benchmark allocations to CGBs.

Absolute and relative valuations

Foreign investors are also attracted by valuations, both absolute and relative. The nominal yield differential versus US government bonds has recently shifted sharply in favour of Chinese bonds as shown in Figure 3. The Chinese 10-year bond now pays a yield of around 3.1% against a backdrop of 2.4% inflation, which implies a positive real yield of about 70bps. This compares to the negative real yield of about 0.9% for the US 10-year bond. The US-China 10-year real yield differential has only been this wide on about 20% of occasions since 2014.

The nominal yield differential versus US government bonds has recently shifted sharply in favour of Chinese bonds

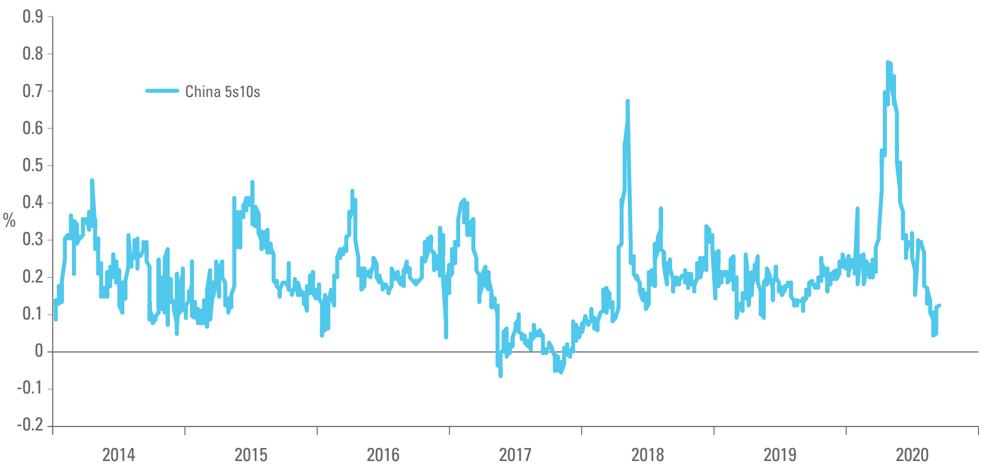
Fig 3: **China-US yield differential**



Source: Ashmore, Bloomberg.

Foreign investors should aim to enter over-weight duration positions in China, in our view. The CGB curve is currently very flat as yields at the short end have increased sharply in recent months in response to China's strong recovery from the coronavirus crisis, thus pushing CGB 5s10s towards the low end of the range (Figure 4). Bull steepening of the curve and associated roll-down of longer-dated bonds seems a reasonable expectation going forward as the initial burst of economic activity from the lifting of lockdowns gradually dissipates.

Fig 4: **China government yield curve shape: 5s10s**



Source: Ashmore, Bloomberg.

Ashmore

Longer-term perspectives

The favourable valuations and technicals in the Chinese bond market at this moment in time will of course not last. As such, they merely present a tactical opportunity to enter the market at a particularly attractive point. Meanwhile, the strategic case for allocating to China remains compelling. China's economy is on track to exceed that of the US economy by a factor of two to three times within the next 2-3 decades, that is, within the investment horizon of pension funds, insurance companies, and sovereign wealth funds.

As China's economy grows larger than all other economies, her markets too become larger and more liquid than all other markets. The superior liquidity should, in our view, gradually ensure that CGBs replace US Treasuries as the preferred global benchmark for fixed income over the longer term. In this view, it is clear that everyone will have to buy far more CGBs than most people today can even imagine.

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