**Issued:** 26 February 2020

MARKET COMMENTARY

Ashmore

# Chinese bonds deliver in bear markets

By Jan Dehn

At the end of this month, Chinese local currency government bonds enter JP Morgan's EM local bond index, the GBI-EM GD. Between end-February and November 2020, the weight of Chinese bonds in the GBI-EM GD will rise to 10%. In a 2018 report anticipating this event, we argued that index inclusion for Chinese bonds would be a game changer for investors in Emerging Markets local (EM) currency bond markets.[1]

The reason for this bold statement was not that Chinese bonds yield more than other EM local markets. Moreover, we would not even ordinarily advocate an overweight exposure to Chinese bonds in normal market conditions and particularly not during bull markets in EM local markets. Rather, the real value of being able to invest in China lies in the fact that Chinese bonds tend to perform far better than other EM local currency bonds during bouts of risk aversion and/or EM bear markets.

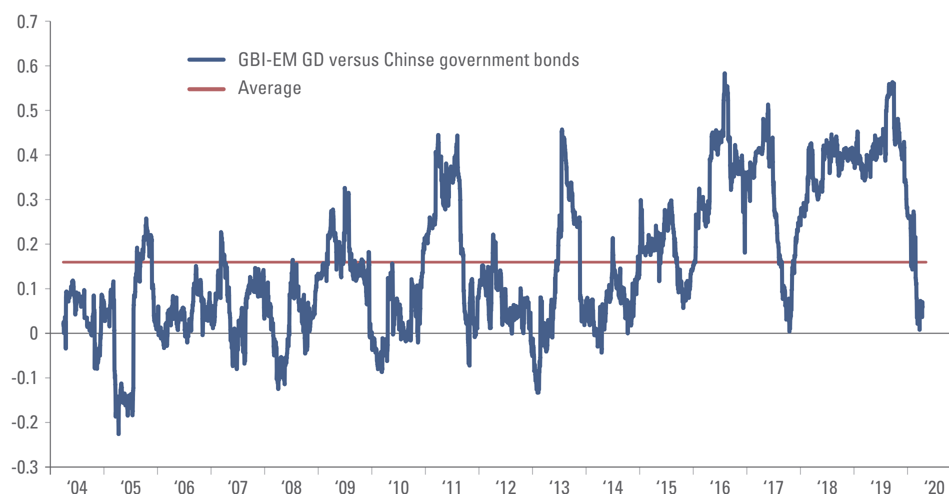
In other words, Chinese bonds can act as a *de facto* 'safe haven' asset within the EM local currency universe. Until now, EM local markets have not had such an asset.

The real value of investing in Chinese bonds is that they perform far better than other EM local currency bonds during bouts of risk aversion

## Recent performance

The performance of Chinese bonds relative to the GBI-EM GD year to date illustrates this point exactly (Figure 1). Global financial markets have been gripped by Coronavirus trepidation since the start of 2020. The correlation between GBI-EM GD and Chinese government bonds  collapsed to zero at the start of 2020, which is precisely what you want from a safe have asset as other EM local bond markets get caught up in the usual mindless selling that typically accompanies risk-off environments.

Fig 1: **3 month rolling correlation (GBI-EM GD versus Chinese government bonds)**




Source: Ashmore, Bloomberg, JP Morgan.

Figure 2 summarises the other aspect of performance in 2020 so far. The GBI-EM GD is down 2.18% in US dollar terms, while Chinese government bonds are up 0.77% (also in Dollar terms). Chinese bonds have been less volatile too, with a positive Sharpe Ratio. In short, Chinese bonds are doing exactly what it says on the tin, i.e. what we argued they would do back in the 2018 report. So far, based on two months of data in 2020, in our view, it would have been optimal for investors to have 100% of their GBI-EM GD portfolio invested in Chinese bonds.

[1] See: '*How Chinese bonds can enhance your portfolio*', The Emerging View, 16 March 2018.

*Continued overleaf*

Fig 2: **Performance of Chinese bonds versus GBI-EM GD in 2020 (Dollar terms)**

| | China | GBI-EM GD |
|---|---|---|
| **Return** | 0.77 | -2.18 |
| **Standard deviation** | 0.26 | 0.30 |
| **Sharpe Ratio** | 2.06 | -8.00 |
| **Correlation** | 0.5% | |

Source: Ashmore, Bloomberg, JP Morgan.
Risk-free rate based on US overnight Libor (1.57%). Sharpe Ratios have been calculated for the period in question, i.e. the first 55 days of 2020. All data as at 25 February 2020.

## Longer-term performance history

Flows into the Chinese government bonds due to index inclusion will not impact the performance of the enormous Chinese market

Flows into the Chinese government bond market triggered by its inclusion in the relatively small GBI-EM GD will not impact the performance of the market, in our view. After all, at USD 12.5trn the Chinese domestic market is enormous. Rather, the real value of investing in China is how owning Chinese bonds will impact the performance of a broad EM local bond portfolio over the cycle. To illustrate this point, consider how the optimal allocation to Chinese bonds has shifted over the past ten years depending on the circumstances, which prevailed in various sub-periods. The results are summarised in Figure 3.

- **The last 10 years:** This period is still entirely dominated by the most severe headwinds facing EM local bond markets in their history, including a 50% fall in EM FX between 2011 and 2015, the 2013 Taper Tantrum, the halving of commodity prices in 2014 and trepidation leading up to the start of the Fed hiking cycle in December 2015. Indeed, so negative was the environment for EM local bonds during this period that the optimal allocation to Chinese bonds over the last ten years was a stunning 100%.
- **The last 5 years:** In sharp contrast with the earlier violent 2011-2015 period, the years from 2016 through 2019 have seen a stabilisation of EM local bond markets. EM bond yields have declined against a backdrop of falling inflation rates. EM currencies have still been volatile, but they have outperformed the US dollar in three of the last four calendar years (2016, 2017 and 2019). Taken together, EM local government bonds have managed to deliver a solid annualised return of 11.4% in Dollar terms over 2016-2019. It was therefore optimal to have 100% in non-China GBI-EM GD over this sub-period and to have nothing at all in Chinese government bonds.
- **The last 12 months:** This last twelve months have once again been somewhat mixed for EM local markets due to considerable volatility arising from US President Donald Trump's trade war with China, slower US growth, a couple of inversions of the US yield curve and the very weak start to 2020 due to Coronavirus. Still, returns in EM local markets were very strong in 2019 (13.5% in USD terms), which has been strong enough to warrant a 100% allocation to GBI-EM GD (nothing in China) despite the weakness in early 2020. Of course, as noted above, the performance in 2020 alone has justified an optimal allocation to Chinese bonds of 100%.

Chinese bonds have the potential to significantly impact the performance of a broad EM local currency bond portfolio over the cycle

Fig 3: **Optimal allocations to Chinese bonds in a GBI-EM GD portfolio over various periods**

| | Investment horizon (ex-post) | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1 year | | | | 5 years | | | | 10 years | | | |
| **Sharpe Ratio** | 0.8 | | | | 0.1 | | | | 0.6 | | | |
| **Portfolio return** | 6.2% | | | | 2.5% | | | | 3.5% | | | |
| **Portfolio volatility** | 5.9% | | | | 8.8% | | | | 3.3% | | | |
| | Optimal allocation | USD annual-ised return | Annual-ised volatility | Correl-ation | Optimal allocation | USD annual-ised return | Annual-ised volatility | Correl-ation | Optimal allocation | USD annual-ised return | Annual-ised volatility | Correl-ation |
| **GBI EM GD** | **100%** | 6% | 6% | 32% | **100%** | 2% | 9% | 31% | **0%** | 2% | 9% | 23% |
| **China** | **0%** | 0% | 4% | | **0%** | 1% | 4% | | **100%** | 3% | 3% | |

Source: Ashmore, Bloomberg, JP Morgan. Data as at 25 February 2020.

*Continued overleaf*

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Chinese bonds are distinct enough from the rest of local markets in EM that they offer genuine diversification benefits

## Allocations to Chinese bond going forward

It is also possible to estimate the optimal allocation to Chinese bonds in a China-enhanced GBI-EM GD portfolio going forward. Assuming that Chinese bonds and the rest of the bonds in the GBI universe return their current yield to maturity, and that the volatility and correlation of the past 12 months offers a good guide to the future, then the optimal allocation to Chinese bonds is 37% of the portfolio (Figure 4). Of course, in reality markets will move around with the usual over- and under-shooting of asset prices, so the optimal allocation too will change. Still, the allocation in Figure 4 makes it clear that the Chinese bond markets are distinct enough from the rest of local markets in EM that they offer genuine diversification benefits.

Fig 4: **Optimal allocations to China in a GBI-EM GD portfolio going forward**

| | Forward looking |
|---|---|
| **Sharpe Ratio** | 0.6 |
| **Portfolio return** | 4.2% |
| **Portfolio volatility** | 4.4% |

| | Optimal allocation | USD annualised return | Annualised volatility | Correlation |
|---|---|---|---|---|
| **GBI EM GD** | **63%** | 5% | 6% | 32% |
| **China** | **37%** | 3% | 4% | |

Source: Ashmore, Bloomberg, JP Morgan. Data as at 25 February 2020. Forward analysis assumes currencies do not move.

Greater appreciation of the 'safe haven' characteristics of Chinese over time should result in more stable EM currencies versus the Dollar and more liquid exchange rates between RMB and other EM currencies

## Beyond the near-term future

Looking beyond the immediate time horizon, we expect the 'safe haven' characteristics of the Chinese bond market to become ever more appreciated by investors. As investors grow more comfortable with the idea of sheltering from bouts of volatility in China, the inane practice of redeeming from EM local markets at every outbreak of risk aversion is likely to begin to wane, in our view. After all, access to Chinese bonds makes it possible to buffer performance considerably at such times as we have seen on several occasions in recent years. Over time, this should result in more stability of EM currencies versus the Dollar and more liquid crosses between EM currencies and Renminbi. This, of course, is the very early stage of a process, which, over the much longer term, will see Renminbi replace the Dollar as the world's dominant reserve currency.


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