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MARKET COMMENTARY

Ashmore

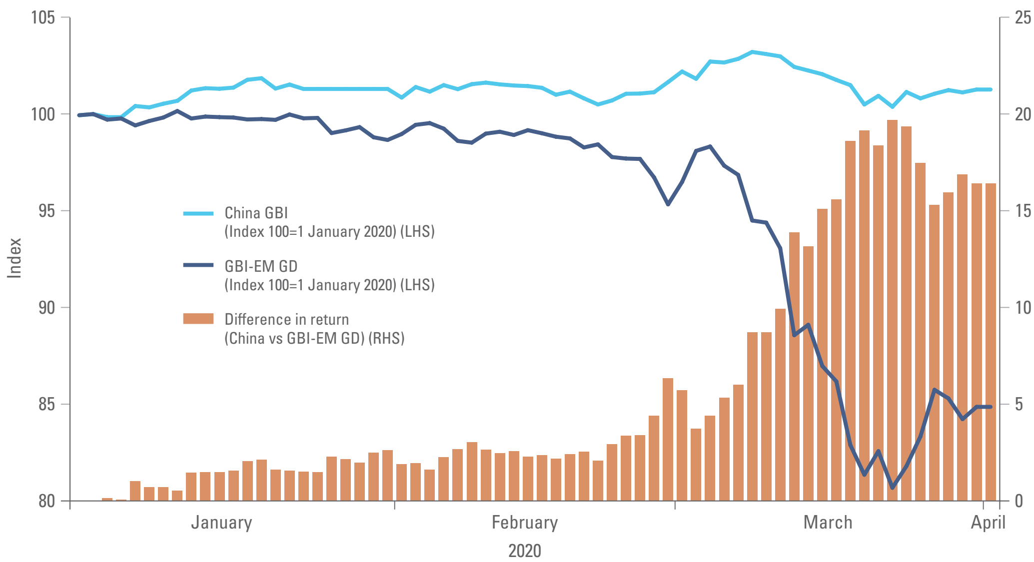
Chinese bonds challenge Treasuries as 'safe haven' destination

By Jan Dehn

One of the arguments put forward in favour of including Chinese government bonds in the Emerging Markets (EM) local currency government bond index (GBI-EM GD) was that investors in this often volatile asset class would gain a potential new 'safe haven' destination within the asset class itself. If so, they might no longer mindlessly have to redeem in favour of Dollars at every outbreak of risk aversion, provided, of course, that managers actively allocate to China at such times.

The enormous pullback in global financial markets this year in response to the coronavirus emergency has presented an opportunity to assess the 'safe haven' credentials of Chinese government bonds. Figure 1 shows the year to date performance of Chinese government bonds and GBI-EM GD as of 1 April 2020. Chinese government bonds have returned 1.3%, while the GBI-EM GD is down about 15.5%, both in US dollar terms. The magnitude of this return differential in favour of Chinese bonds should not go unnoticed; it demonstrates amply that Chinese bonds do indeed appear to display significant 'safe haven' characteristics during bouts of risk aversion compared to other EM bonds.

Fig 1: **The value of Chinese bonds as an intra-EM safe haven destination**



Source: Ashmore, Bloomberg. All returns in USD terms. Data as at 1 April, 2020.

Indeed, the return differential is so large that it may make little sense for investors to redeem from EM local currency government bond mandates during risk aversion events as long as managers actively allocate to Chinese bonds at such times. This is particularly the case if one takes into account the considerable cost of redeeming during risk aversion events, when EM bonds trade with very large bid-offer spreads due to low liquidity, the Dollar is at its most expensive and EM currencies trade near their low points. Moreover, any process of redemption tends to include significant administrative expenses associated with terminating mandates and having to find new ways to allocate, new managers, etc. These losses are crystalised forever, without any chance of ever recouping them.

However, the case for seeking shelter in Chinese bonds would not be complete without taking into account how Chinese bonds stack up against US bonds in risk aversion events. This year, US 5-year government bonds have returned more than Chinese bonds so far. For example, the US 3-5 year index (BEUSG2 Index) is up 5.4% year to date, thus beating Chinese bonds. However, the strong

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performance of US bonds may prove to be a bit of a one-off attributable to the launch of 'QE infinity' by the US Federal Reserve. The US 5-year bond yield has fallen from 1.65% at the start of the year to just 35bps. A repeat performance from this point onwards would require investors to want to buy US bonds with yields plunging into deeply negative territory. By contrast, the yield is still a reasonable 2.24% for the Chinese 5-year bond. Hence, going forward investors will earn 1.9% more in Chinese bonds than in US 5-year bonds per year, solely due to the yield differential.

In reality, holders of Chinese bonds may do even better. The Dollar has pushed sharply higher in the usual kneejerk fashion as a result of the coronavirus pandemic. It is likely to weaken once risk sentiment normalises. Indeed, the Dollar typically declines in US recessions, such as after 2008/2009 and after the collapse of the Dotcom Bubble. Of course, when risk appetite returns investors should ideally position back in non-China EM local currency bonds, which will perform best, but Chinese bonds are still likely to outperform US bonds in any recovery given the very low starting point for US yields.

The establishment of China as a 'safe haven' within EM is welcome news for EM investors. At the very least, they should now call into question the wisdom of erstwhile practises of mindlessly redeeming from EM local bond mandates in favour of US bonds during bouts of risk aversion. Over time this should reduce the volatility of EM currencies versus the Dollar and possibly increase the flows between China and other EM countries. The fact that Chinese bonds maintain their yield well should prove important going forward in terms of the attractiveness of Chinese bonds vis-à-vis US government bonds. As US bonds now price in 'QE infinity' they are unlikely to repeat their strong performance this year, while, going forward, they should, at current yields, lag Chinese bonds to the tune of about 2% per year.

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