Chinese bonds as safe havens

By Gustavo Medeiros

Chinese Fixed Income was one of the few safe haven markets amidst the turbulent interest rate environment in in Q1 2021. Chinese bonds will be included in the FTSE Russell World Government Bond Index (WGBI) starting in October 2021. The Brazilian Senate leader said he expects a faster pace of vaccinations in Q2 2021. The Ecuadorian parliament advanced the bill granting independence to the central bank. The Peruvian parliament approved another pension fund withdrawal. South Africa's president said government members accused of corruption must step down by the end of April. Pakistan lowered taxes on Indian products. Tensions are rising in Eastern Ukraine. Morocco was downgraded to sub-investment grade by S&P.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	13.4	–	2.22%
MSCI EM Small Cap	10.8	–	1.68%
MSCI Frontier	10.1	–	2.61%
MSCI Asia	14.6	–	1.83%
Shanghai Composite	11.6	–	1.93%
Hong Kong Hang Seng	9.9	–	4.40%
MSCI EMEA	9.9	–	2.57%
MSCI Latam	11.2	–	3.93%
GBI-EM-GD	4.97%	–	1.10%
China GBI-EM GD	3.25%	–	-0.03%
ELMI+	2.75%	–	0.56%
EM FX spot	–	–	0.93%
EMBI GD	5.23%	344 bps	0.16%
EMBI GD IG	3.36%	152 bps	0.20%
EMBI GD HY	7.66%	593 bps	0.12%
CEMBI BD	4.46%	294 bps	0.06%
CEMBI BD IG	3.21%	169 bps	-0.03%
CEMBI BD HY	6.12%	460 bps	0.17%

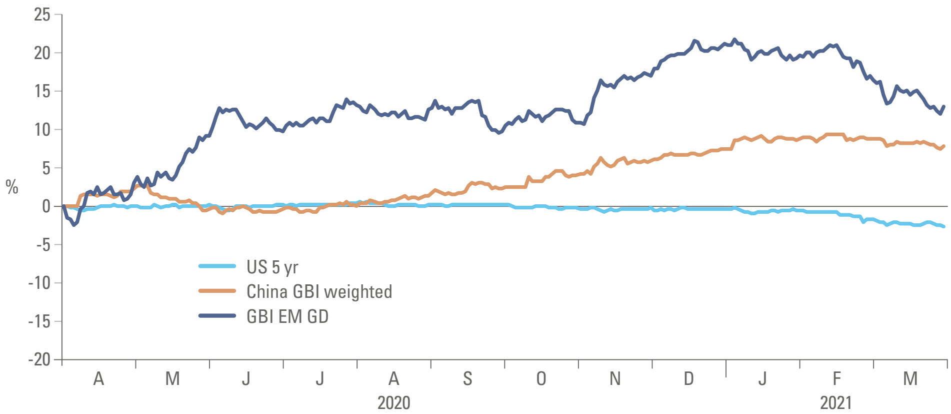
Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	20.4	–	2.63%
1-3yr UST	0.17%	–	-0.06%
3-5yr UST	0.92%	–	-0.26%
7-10yr UST	1.69%	–	-0.40%
10yr+ UST	2.34%	–	0.27%
10yr+ Germany	-0.33%	–	-0.82%
10yr+ Japan	0.69%	–	-0.81%
US HY	4.04%	295 bps	0.65%
European HY	3.18%	366 bps	0.28%
Bloomberg-Barclays	1.15%	-54 bps	0.06%
VIX Index*	17.91	–	-0.95%
DXY Index*	92.62	–	-0.32%
EURUSD	1.181	–	0.77%
USDJPY	110.23	–	-0.12%
CRY Index*	184.1	–	-3.65%
Brent	62.5	–	-3.76%
Gold	1,736	–	3.02%
Bitcoin	58,989	–	0.54%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

- **Chinese government bonds:** Over the past 12 months to 31 March, Emerging Markets (EM) local currency bonds (GBI-EM GD) returned 13.0% vs 7.8% for Chinese government bonds (CGBs) and -1.7% for US 5yr bonds, all in USD terms (Figure 1). Over the same period, the respective volatilities for the three assets were 9.0%, 4.2% and 1.9%, which means that Sharpe Ratios strongly favoured GBI-EM GD and CGBs (1.7 and 2.5 respectively) over US bonds (-1.3).

Fig 1: **GBI-EM GD versus Chinese government bonds and 5-year US Treasury bonds**



Source: Ashmore, Bloomberg, JP Morgan. Data as at 31 March 2021.

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Emerging Markets

Sentiment changed from mid-February this year as the transition from Covid-19 crisis to normality has led to turmoil. The transition, although positive in nature, created considerable uncertainties about the scale of the coming changes in economic performance, monetary and fiscal policies, and shifts in investor positioning. Investors sold US Treasury bonds and bought the Dollar, producing a sharp pull-back in EM local bond markets with the GBI-EM GD down 6.7% in Q1 2021, partly due to the sell-off in US rates, partly due to Dollar appreciation. This is not unusual. Transitions typically give rise to nervousness in markets, which in turn leads to liquidation of positions in EM local markets. What is more novel in the ongoing transition, however, is the performance of CGBs, which only entered the GBI-EM GD about a year ago. Having already delivered a solid performance during the recovery from the peak of last year's Covid-19 shock and unlike both EM local bonds and US treasury bonds Chinese fixed income also performed well during the challenging conditions of Q1 2021. Specifically, with a positive return of 0.3% and annualised volatility of 3.9% CGBs outperformed US bonds (5yr return -2.3%, volatility 2.7%) and other EM local bonds this period, making them the best 'safe haven' destination for EM investors in Q1 2021.

This is not the first time that CGBs have performed better than US bonds, but the full implications of Chinese fixed income's emerging safe haven status have yet to be fully internalised by most investors.[1] The fact that EM local bond markets now have a 'safe haven' asset within the asset class itself means that investors can swing to CGBs during bouts of volatility with a view to returning to the rest of EM once conditions improve rather than redeem from the asset class during bouts of risk aversion.

Exploiting the 'intra-EM' safe haven offered by Chinese fixed income to cope with bouts of volatility is not only more profitable than shifting into US fixed income or cash, but also far more efficient than the alternative of redeeming from the asset class. Beyond these short-term cost considerations, the rise of CGBs as a safe haven destination also has two additional implications. For one, as managers gradually realise the 'safe haven' benefits of CGBs, the volatility of USD-EM FX currency crosses should gradually decline, while CNY-EM FX volatility could rise, although the latter would, to some extent, be offset by greater liquidity as trading volumes rise. The other implication of China's emergence as a new and credible safe haven destination for bond holders should gradually chip away at the status of the Dollar and US Treasuries as the only safe place to hide during risk off events. This is welcome news, because the Dollar is overvalued and the trajectory for the US debt stock increasingly weighs on the outlook for US bonds.

- China: FTSE Russell confirmed the inclusion of CGBs in its World Government Bond Index (WGBI) with a 5.25% weight starting on the 29 October 2021 and with a 36 months ramp up period. The FTSE Russell WGBI is tracked by as much as USD 2tn of passive strategies, so inclusion in this index should trigger an inflow of at least USD 100bn to CGBs. In economic news, Markit's purchasing managers index (PMI) surveys were better than expected: service PMI rose 4.9 to 56.3 in March as the construction index moved to 62.3 from 54.7. Manufacturing PMI increased 0.6 to 51.2 mostly due to higher purchasing prices (up 2.7 to 69.4) and producer prices (up 1.3 to 59.8). In other news, China announced a programme aiming to vaccinate 40% of its population by the end of June as the daily vaccination rate reached 5 million per day last week. China has also entered into agreement with Malaysia regarding mutual recognition of digital vaccine certificates in order to facilitate travel and business between the two countries.

- **Brazil:** Senate Leader Rodrigo Pacheco said in an interview to CNN that April will be another difficult month for Brazil with more deaths from coronavirus, but that he expects 1 million vaccine shots being delivered daily during the month of April, rising to 2 million in May (compared to the current rate of 0.5m per day). Brazil has purchased 565 million doses of vaccines from seven different pharmaceutical companies and expects more than 45 million vaccines to be delivered from April to June. In other news, Central Bank Governor Roberto Campos Neto reaffirmed that the pace of vaccination rollout and fiscal account deterioration are the two most important risks in Brazil at the moment. Campos Neto also said that a faster pace of hikes could mean fewer hikes overall. In economic news, the trade surplus was USD 1.5bn in March compared to USD 1.2bn in February, although below the consensus expectation of USD 3.0bn.

- Ecuador: An important committee of the parliament approved a bill to grant independence to the Central Bank of Ecuador (CBE). The bill prohibits CBE from directly or indirectly financing the government and introduces a Monetary Policy and Financial Policy Board to strengthen dollarization, with powers granted to members of the National Assembly to remove board members. In political news, a poll by Click Research covering the two major cities of Quito and Guayaquil showed Guillermo Lasso leading with 40.0% of voting intentions compared to 37.7% in favour of Andrez Arauz. Another poll by Face-to-face had Lasso with 51% of the valid votes vs Arauz at 49%. Other polls show Arauz leading. For example, Perfiles de Opinion shows Arauz with 37.9% of voter intensions compared to 30.2% for Lasso. The run-off between the two men is scheduled for 11 April 2021.

[1] See: *'How Chinese bonds can enhance your portfolio'*, The Emerging View, 16 March 2018, *'Chinese Government Bonds: Temporary domestic technical headwinds offer springboard for greater foreign participation'*, Market Commentary, 15 September 2020.

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Emerging Markets

- **Peru:** Congress approved another round of pension fund withdrawals which could exceed PEN 40.0bn (USD 10.6bn), or about one-fourth of the total assets of the pension system. In other news, a poll from Ipsos released last week suggested that Peru's general election scheduled for 11 April will be the most fragmented in Peru's modern history. Voting intentions for the front-runner centre-left candidate Yohny Lescano have declined to 14.7% from 21.0% three weeks earlier, while support for market-friendly candidate Hernando de Soto has surged to put him in second position with 13.9% compared to 5.9% in the previous poll. Support for far left candidate Veronica Mendoza rose to 12.4% from 10.4%, while George Forsyth, another market friendly candidate, saw his support decline to 11.9% from 13.9%. Populist candidate Keiko Fujimori rose to 11.2% from 10.6%, while far-right candidate Lopez Aliaga's support dropped to 8.2% from 11.6% previously.

- **South Africa:** President Cyril Ramaphosa said any African National Congress (ANC) party members accused of corruption must step down from government positions by the end of April. The action would remove from the government ANC members that have been blocking President Cyril Ramaphosa's structural reforms, including ANC General Secretary Ace Magashule.

- **Pakistan:** Newly appointed Finance Minister Hammad Azhar lifted a ban on the import of sugar and cotton from India on the grounds that sugar is 15% to 25% cheaper in India than in Pakistan. The liberalisation of trade between the two countries also has political benefits as it increases the odds of a truce between the two countries. A more prolonged peace agreement would allow Pakistan to reduce spending on military, boosting the economy's potential GDP growth rate.

- **Ukraine:** Tensions have been rising in Eastern Ukraine following the introduction of US, UK and European Union sanctions on Russia. Ukraine alleges a build-up of Russian troops in the area. Last week, US President Joe Biden offered support to Ukrainian President Volodymyr Zelenskiy. This morning Russia said it has had high-level discussions with the United States.

- **Morocco:** The rating agency S&P downgraded Morocco's sovereign rating to BB+ from BBB- with a stable outlook, the last agency to lower the rating below investment grade. The decision was anchored around a negative revision to the country's budget deficits until 2024 (between 6.5% of GDP and 4.6% of GDP) despite the rapid vaccination campaign and expected economic rebound.

Snippets:

- **Chile:** The Central Bank of Chile kept its monetary policy rate unchanged at 0.5% in line with consensus expectations.
- **Colombia:** The yoy rate of consumer prices index (CPI) inflation declined to 1.5% in March from 1.6% in February, in line with consensus expectations, while yoy core CPI inflation rose to 1.1% from 0.9% over the same period.
- **Ghana:** Ghana raised USD 3bn in a four tranche Eurobond issue, which included a USD 500m 4-year zero coupon bond.
- **Hungary:** Prime Minister Viktor Orban announced a timetable for relaxing mobility restrictions will be maintained in spite of the one of the highest coronavirus death rates in the world. Stores will reopen after Easter, followed by schools, restaurants and hotels.
- **India:** The current account moved into deficit to the tune of USD 1.7bn (0.2% of GDP) in Q4 2020 following a USD 34.1bn surplus (3.0% of GDP) in the previous quarter. The trade deficit widened to USD 14.1bn in March. Markit's manufacturing PMI declined to 55.4 in March from 57.5 in February.
- **Indonesia:** The yoy rate of CPI inflation was stable at 1.4% in March, while core CPI inflation declined to 1.2% yoy in March from 1.5% yoy in February, both indices are tracking below the inflation target range of 2.0% to 4.0% pursued by Bank Indonesia. Manufacturing PMI rose to 53.2 in March from 50.9 in February.
- **Kenya:** The IMF approved a USD 2.3bn three-year funding plan for the country allowing for USD 307m immediate disbursement for budget support and USD 404m in June with the balance released every six months upon compliance to the programme's targets.
- **Malaysia:** Exports rose at a yoy rate of 17.6% in February compared to 6.6% yoy in January, pushing the trade surplus to MYR 17.9bn from MYR 16.6bn over the same period. Markit's manufacturing PMI rose to 49.9 in March from 47.7 in February.
- **Mexico:** A monthly poll from El Financiero showed the approval rating of president Andrez Manuel Lopez Obrador declined to 61% in March from 63% in February.
- **Romania:** The yoy rate of retail sales improved to -1.2% in February from -2.6% yoy in January.
- **Russia:** Markit's services PMI rose to 55.8 in March from 52.2 in February, thereby lifting the composite PMI to 54.6 from 52.6 over the same period.

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Emerging Markets

- **South Korea:** Exports rose at a yoy rate of 16.6% in March, from an average gain of 10.5% yoy in January and February. Industrial production was 4.3% higher in February after declining 1.2% in January, buoyed by stronger activity in the chemical, metal and electronic industries.
- **Taiwan:** Chipmaker TSMC announced it will invest USD 100bn over the next three years to boost its capacity to produce semi-conductor chips. This was TSMC's second increase in capex guidance in less than six months.
- **Thailand:** The yoy rate of CPI inflation rose to -0.1% in March from -1.2% in February, while the yoy rate of core CPI rose to 0.1% from 0.0% over the same period.
- **Turkey:** The yoy rate of CPI inflation rose to 16.2% in March from 15.6% in February, in line with consensus expectations, while the rate of core CPI inflation rose to 16.7% yoy from 16.2% over the same period.
- **Uruguay:** The yoy rate of CPI inflation declined to 8.3% in March from 9.1% yoy in February.

Global backdrop

- **Coronavirus:** France and Italy announced a third lockdown to curb the rise of Covid-19. In contrast with the US and the UK that vaccinated 32% and 47% of their populations, the European Union vaccinated only 13% of its people and is suffering the impact from the new strains, mostly the UK strain.

- **United States:** President Joe Biden announced an infrastructure plan worth USD 2.25tn to be spent over eight years. Some USD 621bn is earmarked for transportation infrastructure. The plan will be funded by an increase in the corporate tax rate from 21% to 28% (compared to 35% prior to former President Donald Trump's tax cuts). The US government will also support a 21% minimum global corporate tax rate and end all tax breaks in fossil fuels. The Speaker of the House Nancy Pelosi has set a deadline of 4 July for passage of the infrastructure bill, which would give the Senate until early August to pass the required legislation. Senate opposition leader Mitch McConnell said that the Republican Party wanted no part in the proposed tax hikes. It also remains to be seen if the Biden Administration can build a global coalition in favour of its minimum global corporate tax proposal. One possibility is that parts of the bill will be approved with bipartisan support, including investment in infrastructure.

The US economic news was positive. ISM manufacturing rose to 64.7 in March from 60.8 in February, which is the highest level since 1983, while ISM services rose to 63.7 versus 59.0 expected (the highest reading on record). The Chicago PMI rose to 66.3 in March from 59.5 in February, but Markit's PMI manufacturing rose more modestly to 59.1 from 59.0 over the same period. The Conference Board consumer confidence index rose to 109.7 in March from 90.4 in February. Labour market data was also stronger than expected with 916k new jobs created in March versus the median expectation of 660k, but average hourly earnings declined 0.1%. The rate of unemployment declined to 6.0% from 6.2%. Data on credit card spending from Bank of America showed spending rising by 80% from last year's trough and 20% more than two years ago as of the week ending in 27 March, undoubtedly reflecting a combination of pent-up demand and recent government stimulus cheques. At the same time, mortgage applications declined 2.2% in the week of 26 March from 2.5% in the previous week. Backward-looking hard data, such as durable goods orders, construction spending and factory orders declined 1.2%, 0.8% and 0.9% respectively in February.

- **European Union:** PMI's in Europe were strong. At EU level PMIs increased to 62.5 in March from 57.9 in February. German's PMI hit 66.6, which is the highest reading ever recorded. In the UK, PMI rose to 58.9 from 55.1. Euro Area economic confidence also improved sharply to 101.0 in March from 93.4 in February. The yoy rate of Euro Area core inflation was 1.4% in March compared to 1.2% in February. EU-harmonized CPI inflation reached 2.0% yoy in Germany compared to 1.6% in February.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	1.71%	1.71%	3.96%	64.78%	7.56%	13.51%
MSCI EM Small Cap	0.83%	0.83%	8.58%	92.62%	5.59%	10.25%
MSCI Frontier	2.06%	2.06%	2.89%	43.05%	-0.49%	7.25%
MSCI Asia	1.72%	1.72%	4.37%	63.53%	10.09%	15.06%
Shanghai Composite	1.23%	1.23%	0.33%	28.27%	5.77%	5.31%
Hong Kong Hang Seng	2.24%	2.24%	4.46%	24.00%	1.64%	9.09%
MSCI EMEA	1.22%	1.22%	9.44%	53.07%	0.23%	6.79%
MSCI Latam	1.36%	1.36%	-3.99%	62.05%	-5.77%	5.63%
GBI-EM-GD	0.53%	0.53%	-6.18%	16.52%	-0.54%	3.46%
China GBI-EM GD	-0.23%	-0.23%	0.06%	7.48%	na	na
ELMI+	0.24%	0.24%	-2.33%	10.16%	-0.49%	2.27%
EM FX spot	0.36%	0.36%	-3.25%	8.73%	-6.14%	-3.00%
EMBI GD	0.37%	0.37%	-4.19%	17.10%	4.08%	5.13%
EMBI GD IG	0.31%	0.31%	-5.01%	9.97%	6.38%	5.39%
EMBI GD HY	0.44%	0.44%	-3.23%	26.58%	1.53%	4.79%
CEMBI BD	0.09%	0.09%	-0.71%	18.46%	6.12%	6.14%
CEMBI BD IG	0.05%	0.05%	-1.64%	12.31%	6.27%	5.17%
CEMBI BD HY	0.15%	0.15%	0.56%	27.69%	5.92%	7.67%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	2.66%	2.66%	8.99%	66.62%	17.44%	17.05%
1-3yr UST	-0.03%	-0.03%	-0.08%	0.27%	2.81%	1.71%
3-5yr UST	-0.04%	-0.04%	-1.38%	-0.68%	4.14%	2.20%
7-10yr UST	0.16%	0.16%	-5.59%	-6.43%	5.23%	2.28%
10yr+ UST	0.95%	0.95%	-12.69%	-17.41%	6.79%	3.06%
10yr+ Germany	0.55%	0.55%	-5.75%	-3.26%	5.52%	2.72%
10yr+ Japan	-0.36%	-0.36%	-1.12%	-2.80%	0.80%	0.21%
US HY	0.38%	0.38%	1.23%	26.78%	6.88%	8.15%
European HY	0.21%	0.21%	2.05%	23.89%	3.67%	4.72%
Bloomberg-Barclays Agg	0.22%	0.22%	-4.26%	5.28%	3.06%	2.62%
VIX Index*	-7.68%	-7.68%	-21.27%	-60.41%	-16.66%	27.11%
DXY Index*	-0.66%	-0.66%	2.98%	-8.01%	2.79%	-1.92%
CRY Index*	-0.48%	-0.48%	9.70%	43.74%	-4.25%	9.88%
EURUSD	0.66%	0.66%	-3.36%	9.40%	-3.86%	3.58%
USDJPY	-0.44%	-0.44%	6.76%	0.92%	3.10%	0.40%
Brent	-1.57%	-1.57%	20.73%	89.23%	-6.81%	56.98%
Gold	1.66%	1.66%	-8.54%	4.53%	30.18%	42.02%
Bitcoin	0.05%	0.05%	103.44%	715.76%	793.16%	13,884.04%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.

Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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