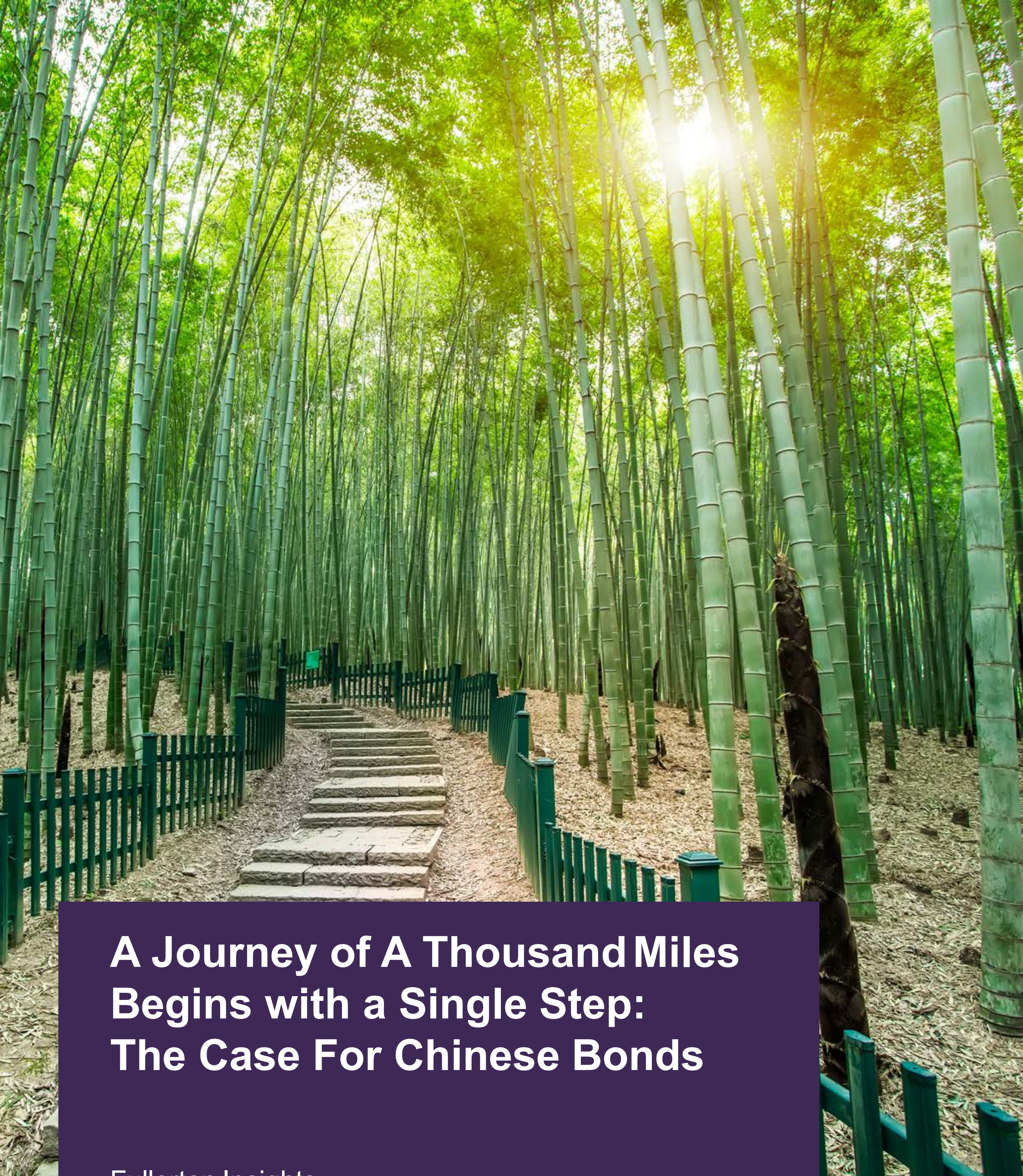

A Journey of A Thousand Miles Begins with a Single Step: The Case For Chinese Bonds

Fullerton Insights
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Executive Summary

As China accelerates the pace of its capital reforms, and continues its shift toward domestic consumption and services, its vast capital markets offer investors a chance to participate in the country's attractive long-term growth potential. We expect the demand for Chinese bonds to continue growing as the index inclusion theme plays out and attracts more substantial fund flows, as foreign investors remain under-invested in the asset class.

We believe a dedicated Chinese bond strategy, with the ability to incorporate various elements into the overall portfolio mix, can help investors capture attractive risk-adjusted returns and provide diversification benefits. In a persistent zero interest rate world, a 2-3% yield in a liquid bond market is becoming increasingly attractive. The continuing evolution of China's bond markets adds to their appeal and is increasingly an important allocation in global bond portfolios.

This paper examines the development of China's onshore bond markets, their significance and implications for global investors. We also discuss the cyclical and structural changes affecting the country's bond markets, including the impact of the global pandemic. As China's bond markets continue to grow in size and importance, we look at key considerations for investors exploring an allocation to Chinese bonds, and explain why active management and currency deliberation matter.

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Evolution of China's onshore bond markets

China's onshore renminbi bond market is the second largest in the world after the U.S. Though foreign ownership in the country's bond market has been growing, it remains relatively small, compared to that of Emerging Market (EM) and G10. Currently, foreign investors enjoy preferential tax advantages which were announced in late 2018 (and are applicable for the next three years). While multiple programs grant access to the Chinese bond markets, there are some marked differences.

Asset allocation considerations when investing in Chinese onshore bonds

There is a compelling case for foreign investors to make a dedicated allocation to Chinese onshore bonds, as they offer low correlation dynamics, diversification benefits, and compelling risk-adjusted returns. The low correlation dynamic, which is partly driven by the asynchronous economic cycles between China and other major economies will likely persist, even as foreign bond ownership rises.

Given China's significance, we believe a higher allocation to the country's bond markets than what is currently assigned in the key global bond indices, is justified. Active managers are also in a better position to harness the investment opportunities within the Chinese bond markets compared to passive strategies which have mostly overlooked the country's non-rate sectors. Currency hedging costs, which can have a material impact, should be given sufficient consideration. Long-term investors may prefer to leave the renminbi exposure unhedged to capitalise on the structural changes happening in China's capital markets.

Cyclical and structural changes in China's onshore bond markets

The pandemic will accelerate de-globalisation trends, China's digital transformation and its capital market reforms which are playing out even in the domestic credit markets. Early investors in China's onshore bond markets are also likely to benefit from the secular decline in real interest rates, as the nation's population ages. China's growth, interest rate, and current account edge will lend support to a stable renminbi and further anchor Chinese bonds as an alternative safe-haven asset class as the country's exceptionalism rises.

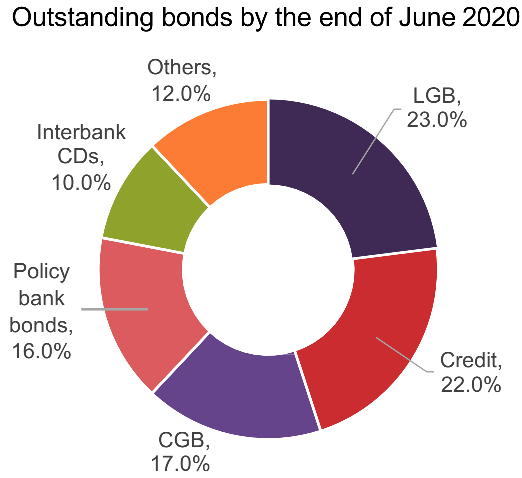
Table of Contents

Evolution of China's onshore bond markets

The growth and intricacies of the onshore renminbi bond market

The onshore renminbi bond market, which stands at US$14.1 trillion[1], is the second-largest single bond market globally, after the U.S. The onshore renminbi bond market consists of mostly Chinese government bonds, policy bank bonds, local government bonds, and credit bonds (Chart 1).

Chart 1: Breakdown of the onshore renminbi bond market



Source: Deutsche Bank

- **Chinese government bonds (CGBs)** are issued by the central government to finance its deficits, and the Ministry of Finance is responsible for the issuance process.
- **Provinces, cities and municipalities** issue local government bonds (LGBs) as an official channel of financing. LGBs are held predominantly by commercial banks, followed by policy banks. Given the narrow investor base, trading in LGBs is more limited. Liquidity in the secondary market is weak, and as a result, they are less popular with foreign investors and asset managers. Although they are legal liabilities of local governments, LGBs are somewhat perceived as backed by the central government and generally viewed as quasi-sovereign but with additional yield pick-up.
- **Chinese policy bank bonds** are issued by the "big three" policy banks (China Development Bank, Agricultural Bank of China, and Export and Import Bank of China) to fund large infrastructure projects. Chinese policy banks benefit from implicit support from the Chinese sovereign and offer some yield pick-up over CGBs. They are also more liquid than CGBs in general. China Development Bank bonds are often ranked among the most traded securities in the Chinese interbank bond market.

Breakdown of the onshore credit universe

Within the onshore renminbi credit universe, there are a few main sub-categories. Financial institutions issue financial bonds. Corporate bonds include bonds that are issued by private entities and listed corporations. Enterprise bonds are predominantly issued by state-owned enterprises (SOEs). Local government financial vehicles (LGFVs) are a large subset of enterprise bonds. These are entities set up by local governments to seek financing for general expenditure and special infrastructure projects. Other onshore Chinese (CNY) credit instruments include medium-term notes, commercial paper, asset-backed securities, and private placement notes. A significant percentage of CNY credit is rated AA to AAA domestically.

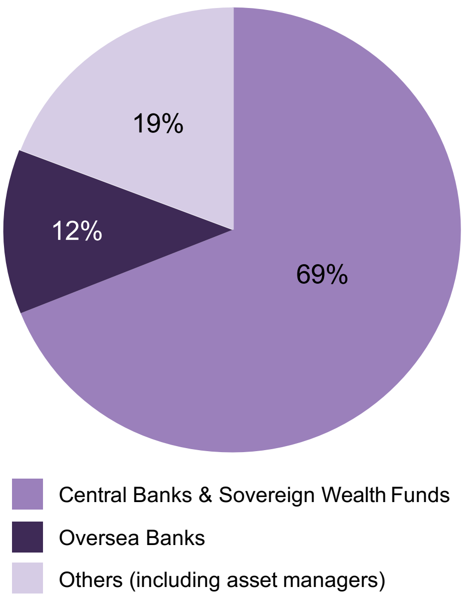
[1] Source: CEIC and Fullerton, December 2019

The rise of foreign investors in China's bond markets

Traditionally, Chinese government bond ownership is heavily skewed towards domestic commercial banks as the banking sector is a large part of the overall financial system. Other local investors include securities companies, mutual funds, and wealth management products. Life insurance companies are also especially keen buyers of longer-dated Chinese government bonds.

Foreign investors' ownership of China's bond market remains small but has indeed been proliferating. The inclusion of the renminbi (RMB) currency in the Special Drawing Rights (SDR) basket in late 2016, marked an important milestone in the trading of the RMB internationally. Indeed, it is probable that the rise in foreign ownership of local Chinese bonds since 2017, coincided with the increase in the share of global FX reserves held in RMB. Central banks and sovereign wealth funds are the leading foreign investors in China's bond market today (Chart 2).

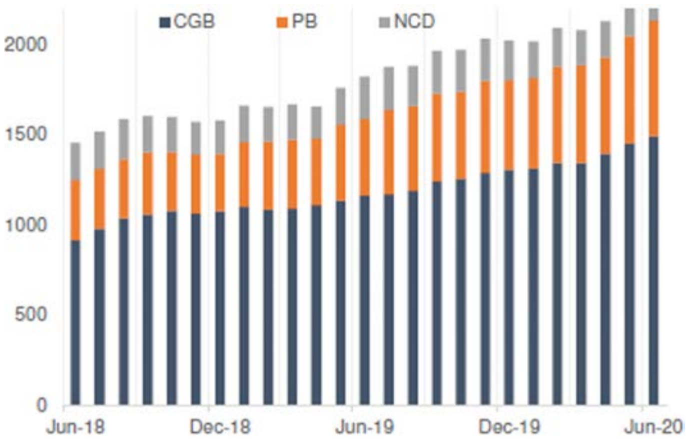
Chart 2: Breakdown of foreign ownership in CGBs - Central banks and sovereign wealth funds are the leading foreign investors in China's government bonds



Source: Morgan Stanley June 2020

So far, foreign ownership is mostly concentrated in Chinese government bonds and policy bank bonds (Chart 3). CNY credits are generally less favoured, partly due to the perceived lack of credible credit ratings with more than half of the Chinese corporate rated AA and above by onshore credit rating agencies. CNY credit is also less liquid versus the Chinese government bonds and policy bank bonds.

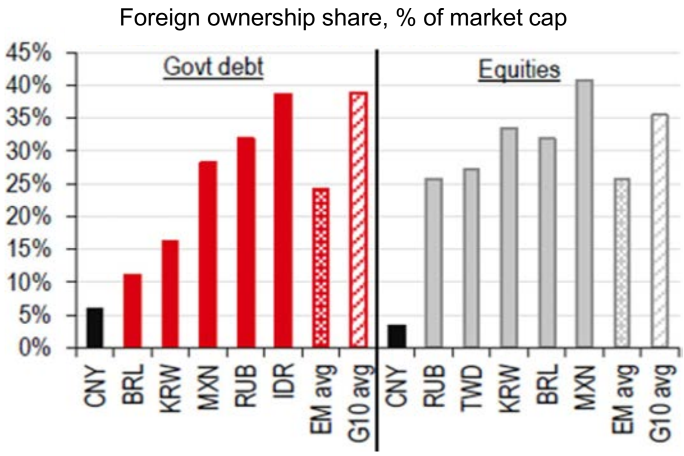
Chart 3: Foreign institutions' key bond allocations are concentrated in Chinese government bonds and policy bank bonds



Source: Deutsche Bank Research, June 2020

Notably, foreign ownership in the Chinese bond market is still very low, at under 5% currently. This is especially so when compared to that of the EM market where foreign ownership average around 25% and the G10, which average around 40% (Chart 4).

Chart 4: Foreign ownership in onshore China assets remains low compared to other emerging markets and developed markets



Source: HSBC, December 2019

Tax status for foreign investors

Currently, foreign investors enjoy preferential tax advantages, which were announced in late 2018, applicable for the next three years (i.e. to November 2021). Foreign investors in the onshore Chinese bond markets are currently exempted from income tax, value-added tax on capital gains and coupon income. This includes overseas investment in Chinese government bonds, PBOC bills, policy bank bonds, corporate bonds, and local government bonds.

A variety of market access schemes to serve the foreign investor communities

Foreign investors are able to access China's bond markets through various schemes. While the multiple programs, namely – Qualified Foreign Institutional Investor (QFII), Renminbi Qualified Foreign Institutional Investor (RQFII), China Interbank Bond Market Direct (CIBM Direct), Bond Connect – grant access to primarily the same Chinese bond markets, there are some marked differences predominantly in three key areas - i) speed to market access; ii) how the bonds are held; and iii) availability of financial instruments (Chart 5).

- **Bond Connect**, established in Hong Kong, offers a more convenient and often speedier way for foreign investors to purchase onshore bonds without opening an account in the Mainland. In the Hong Kong Monetary Authority's (HKMA) Central Moneymarkets Unit (CMU), bonds are held offshore via an omnibus account structure, akin to international global custodian standards. For the remaining schemes, foreign investors are required to open an account onshore, and appoint an onshore settlement agent, which is often more time-consuming. Bonds are also held domestically by the onshore settlement agent.
- In terms of the availability of financial instruments, the **CIBM Direct** scheme stands out with its broader suite of derivatives offerings such as onshore interest rate swaps, and onshore repos (available to select institutional investors).
- The earliest schemes – **QFII and RQFII** – were subjected to more onerous license and quota requirements in the past. That said, all access schemes, including the earlier QFII and RQFII schemes, are no longer bound by investment quotas. To encourage greater foreign participation and streamline processes, we expect further relaxations of regulations, such as the availability of bond futures.

Chart 5: Types of market access schemes

	Bond Connect	CIBM Direct	QFII/RQFII
Inception year	2017	2016	2002/2011 for exchange markets, 2013 for interbank markets
Speed to market	Typically faster	Tend to be more onerous	Very onerous in the past
Custody account location	Hong Kong (offshore) via the Central Moneymarkets Unit of HKMA	China (onshore), through eligible agent	China (onshore) through eligible agent
Availability of financial instruments	Cash bonds	Cash bonds IRS for hedging purposes Repos (for selective institutional investors)	Cash bonds IRS for hedging purposes
FX hedging	Yes	Yes	Yes
Bond futures	No	No	No
Quota restrictions	No	No	No

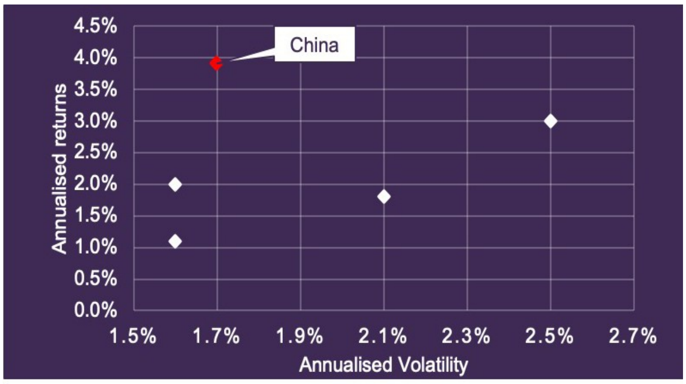
Source: HSBC December 2019

Asset allocation considerations when investing in Chinese bonds

Low correlation dynamics, diversification benefits, and compelling risk-adjusted returns are some of the most commonly cited reasons for taking an interest in China's bond markets. Onshore Chinese government bonds offer an exciting investment proposition, especially on a risk-adjusted basis. They also offer more compelling Sharpe ratios, for traditional developed market bond investors (Chart 6).

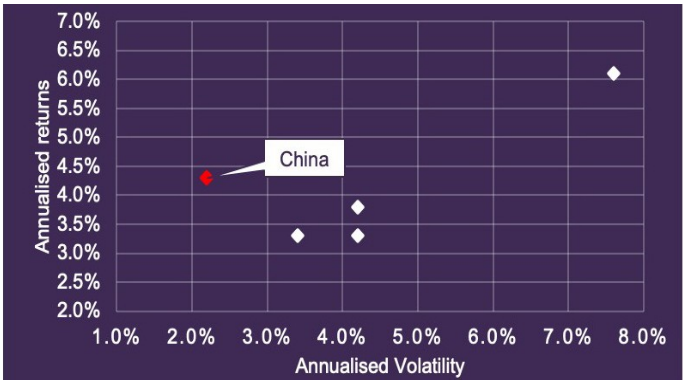
Chart 6: China government bonds are likely to offer attractive risk-adjusted returns compared with developed market government bonds

Risk-adjusted local currency returns based on the 3-5 year maturity bucket (over the last 5 years)



3-5 year maturity	Annualised Returns	Annualised Volatility	Risk-adjusted return ratio
Europe GBI	1.1%	1.6%	0.7
UK GBI	1.8%	2.1%	0.9
US GBI	3.0%	2.5%	1.2
World GBI	2.0%	1.6%	1.3
China Onshore	**3.9%**	**1.7%**	**2.3**

Risk-adjusted local currency returns based on the overall indices (over the last 5 years)



Overall Indices	Annualised Returns	Annualised Volatility	Risk-adjusted return ratio
Europe GBI	3.3%	4.2%	0.9
UK GBI	6.1%	7.6%	0.9
US GBI	3.8%	4.2%	0.9
World GBI	3.3%	3.4%	1.0
China Onshore	**4.3%**	**2.2%**	**1.9**

Source: Bloomberg, 5 Jun 2020 using FTSE WGBI indices for the developed markets' returns and the iBoxx China indices for the onshore China bond returns

With ownership dominated by domestic investors, the onshore Chinese bond market also exhibits very low or negative correlation to major bond and equity markets, further increasing its appeal to international investors looking to diversify outside of their core asset classes (Chart 7).

Chart 7: Historical correlations between China's government bonds and major bond markets

Period	Global Equities	US Equities	Global Govt Bonds	US Treasuries	Euro Aggregate	UK Gilts	Swiss Govt	EM local currency govt bonds	EM corporate
3 years	-0.03	-0.02	0.17	0.21	0.08	0.17	0.11	0.19	0.02
5 years	-0.03	-0.03	0.16	0.18	0.09	0.16	0.13	0.14	0.03
10 years	-0.00	0.01	0.10	0.12	0.10	0.12	0.12	0.15	0.07

Source: Bloomberg based on weekly correlation from the respective period to 8th June 2020. Indices used are MSCI World Index (Global equities), S&P 500 (U.S. equities), FTSE World Government Bond Index (Global government bonds), Bloomberg Barclays U.S. Treasury Total Return (U.S. Treasuries), Bloomberg Barclays Euro Aggregate Total Return Index in EUR (Euro aggregate), Bloomberg Barclays Switzerland Government All > 1 Year Bond Index in CHF (Switzerland Government), Bloomberg Barclays U.K. Government All Bonds Total Returns in GBP (U.K. Gilt), JPM GBI-EM Global Diversified Index in USD (Emerging market local currency government bonds), JPM CEMBI Broad Diversified Index in USD (Emerging market corporate), IBoxx CNY Onshore Bond Index in CNY (onshore China government bonds). Past performance is not necessarily indicative of future returns.

Will Chinese bonds continue to be a good diversifier?

Arguably, the low correlation characteristic could eventually fade as foreign participation increases over time. That said, the low correlation dynamic is also driven by the asynchronous economic cycles between China and other major economies. This is especially pronounced in the current market cycle affected by the pandemic. China is the only major economy expected to post positive growth this year. The International Monetary Fund (IMF) projects that China's gross domestic product will expand 1% in 2020 while the U.S., Germany, and Japan are expected to contract more than 5% this year.[2] While most major economies have cut rates to historical lows, China has taken a much more calibrated approach and has been slow to ease. Similarly, most major economies have unleashed record fiscal stimulus to cushion the economic slowdown; China has shown much more restraint.

Interestingly, when the pandemic engulfed global financial markets in March, the onshore Chinese government bond markets posted modestly negative returns of -0.1% (Markit iBoxx ALBI China Onshore Bond Unhedged Index, in USD), which was largely in line with the average Developed Market (DM) bond market return of -0.6% (as measured by the FTSE World Government Bond Index, in USD). However, it was significantly better than the performance of the Asian local currency bond markets, which fell -4.0% on average (Markit iBoxx Asian Local Currency Bond Market in USD) and the emerging markets which fared worst and declined -11.1% (JPM GBI-EM Global Diversified Composite Unhedged Index, in USD).

Dedicated allocation to China's bond markets is needed to gain an "economically representative" exposure that matches the country's stature

China already has the world's second-largest equity market and bond market (behind the U.S.). As China's markets continue to grow, they will ultimately become critical pillars of the EM and DM investment space. Given China's significant global footprint, index investors would not be able to gain an 'economically representative' exposure until China's weight in key global benchmark indices reaches the high double-digits. Currently, China's weightage in major bond indices ranges from around 6% to a cap of 10%. Given China's importance on the global stage, we believe a higher allocation of at least double digits to the country's bond market, is justified.

Active managers are in a better position to harness the investment opportunities within the Chinese bond markets compared to their passive peers

Given the intricacies and lack of credible credit ratings in the onshore Chinese bond market, passively managed Chinese bond strategies are almost entirely invested in the Chinese government and policy bank bond space currently[3]. Other noteworthy sectors such as government-linked or state-owned enterprises (SOE) bonds are overlooked.

While we believe the Chinese bond markets are generally efficient, some inefficiencies could be harnessed through active management and a rigorous investment process. Pockets of the CNY bond markets, such as in the SOE or credit sector, are still under-researched compared to developed markets and offer attractive investment opportunities for fundamental-based investment managers.

Actively managed portfolios enable one to identify and resolutely overweight sectors that will benefit from China's continuing structural changes. For example, consumer (goods and services) or technology companies could outperform over the next 5-10 years as China shifts towards a consumption-led economy, and prioritises technology prowess. Government-linked and SOE issuers could also emerge as winners due to more substantial policy support and their inherent domestically-driven business models.

There are other market efficiencies even within the Chinese government bond markets. "On-the-Run" Chinese government bonds are newly issued bonds that remain "on the run" during the year and are well-supported by the domestic Chinese investors. They have better liquidity and typically higher bid prices. The "off-the-run" bonds which are issued earlier, having been replaced by newer "on-the-run" issuances, are priced at wider bid/ask spreads and are often less liquid. Strategic long term investors can take advantage of the "on-the-run" and "off-the-run" liquidity premia.

[2] https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020
[3] Based on ETF listed in Bloomberg of at least US100 million in asset size

Currency hedging considerations are critical and have a material impact on the overall investment experience

One should also be mindful and give sufficient consideration to the currency hedging costs. The overall investment returns will be materially lower should investors, especially in the negative-yielding currencies such as Swiss Franc (CHF) and Euro (EUR), fully hedge away the RMB currency exposure. Investors can also consider applying an appropriate hedge ratio, as illustrated in Chart 8, to partially hedge away the currency risk but, at the same time, benefit from potential renminbi appreciation.

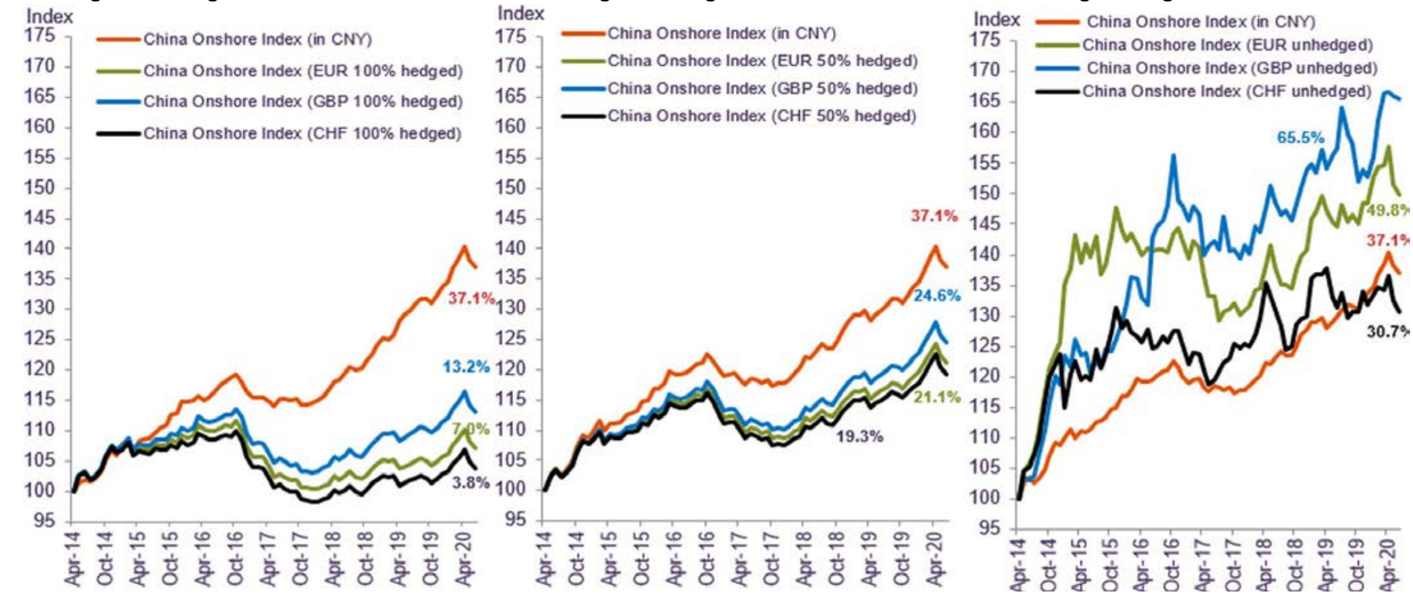
However, long-term investors may prefer to leave the renminbi exposure unhedged to capitalise on the structural changes happening in the Chinese capital markets. The growth of the RMB as an international currency together with structural capital inflows into the country will provide strong medium-term support to the currency.

According to the IMF, China is projected to be the only major economy to return a positive full-year growth for 2020, which will even further anchor the renminbi in the near term. Potential forex gains over the medium term against a weakening USD regime, with the U.S. Federal Reserve committed to keeping rates at current low levels until possibly the end of 2022 at least, is also a positive. Even on a Real Effective Exchange Rate (REER) basis, the fundamental valuation of the renminbi remains cheap to fair.

Chart 8: Cumulative index return comparisons between hedged, unhedged and partially hedged portfolios since 2014

Based on the Markit iBoxx ALBI China Onshore Index

assuming 100% hedge ratio **...assuming 50% hedge ratio** **...assuming unhedged**



Source: Fullerton, Bloomberg 30th June 2020,based on rolling 1 month currency forward. China Onshore Index is represented by the Markit iBoxx ALBI China Onshore Index

Cyclical and structural changes in China’s bond markets

The pandemic will accelerate de-globalisation trends and anchor the diversification benefits of investing in the Chinese bond markets

The post-COVID-19 world is likely to be marked by tighter cross-border restrictions on goods, services, capital, labour, and technology. The United States and China will decouple faster by adopting more protectionist policies to shield domestic companies and employees from global disruptions. We are already seeing these happening in sectors such as healthcare, as governments impose export restrictions and protectionist measures, in response to the crisis.

Geopolitical dynamics are shifting, particularly between the two largest economies in the world – China and the United States. The decoupling in trade, technology, investment, and healthcare between the two countries are likely to accelerate and intensify from hereon.

With U.S.-China tensions not abating anytime soon, foreign investors are re-assessing the nature of their China operations and adopting long-term coping strategies. American manufacturers are increasingly redirecting their focus towards primarily selling to the Chinese market, as a way to circumvent the U.S.-imposed tariffs on Chinese exports. Essentially, this means that foreign investors are reorienting their China factories to specifically serve Chinese consumers while factories are set up in other low-cost producing countries such as Vietnam, to serve the broader international markets.

The shift away from using China as a low-cost manufacturing hub works favourably for the Chinese government who is determined to upgrade its industries, move up the value-added chain, and push for higher wages. Increased worker income will, in turn, boost consumer spending, as the country pivots away from an export and investment-led economic model to one that is consumption-driven. The government is counting on this shift to stabilise its slowing economy. Furthermore, the current labour structure, with more educated youth, fewer rural migrant workers, and an aging population, would not support its low value-added factories for much longer.

Looking ahead, we expect the Chinese economy to be increasingly driven by domestic factors, as the geographical bifurcation between China and the U.S. leads to a pickup in the de-globalisation momentum. This will continue to anchor the low correlation dynamics and diversification benefits of investing in the Chinese bond markets.

China’s digital transformation, spurred by the pandemic, will enhance productivity and counter the drag on the country’s growth

As part of the policy responses to coping with COVID-19, Chinese policymakers have refocused their attention towards technology, digital transformation, and innovation. They have launched a “New Infrastructure” plan, focusing on seven areas including 5G networks, intercity transportation, inner-city rail systems, data centres, and artificial intelligence. The continuing push towards technology will boost workforce productivity over the medium term. This is particularly critical and will counter the drag on growth from a greying population, higher overall debt, and a weaker post-pandemic global growth environment, which could take several years to return to pre-COVID-19 levels.

Early investors of the Chinese bond markets benefit from the secular decline of real interest rates

Aging demographics may lead to a secular decline of real interest rates in China, as we have seen in Asian countries such as Japan. The country saw a surge in national pension fund assets as the nation’s population aged. In that same vein, long-dated Chinese bond yields are likely to be pushed lower, given the demand from Chinese pension funds and life insurers for these instruments to match their long-dated liabilities. After spending the last two decades recording annual GDP growth of around 9%[4] on average, China’s growth momentum will inevitably slow as the country’s population ages, which will also lead to a structural down shift in interest rates over time.

The COVID-19 pandemic could also have a long-lasting impact to behavioural patterns. Under a new normal, saving rates could potentially be higher as uncertainties rise and consumer sentiments falter. In turn, this could push real rates lower, as we have experienced in previous pandemics.

[4] Source: World Bank June 2020

China's capital market reforms to accelerate and counter the country's economic challenges

For years, China has been looking to improve the efficiency of capital allocation. As future growth becomes more challenging, there is little room to waste hard earned savings. The U.S.-China trade tensions and pandemic-induced slowdown have accelerated China's capital reforms. Deteriorating relations also creates the need for China to open its financial markets more quickly, while the pandemic's effect is pressuring Chinese authorities to create more channels for the private sector to raise funds and keep employment intact.

We are starting to see this happen in the equity markets. Concerns over Chinese companies' reliance on U.S. capital markets for fundraising are driving actions to increase the allure of homegrown bourses, such as the Hong Kong stock exchange, which has seen a resurgence of secondary listings by mainland Chinese firms.

Similarly, Beijing has also unveiled a series of measures in the domestic bond market in recent months. China has allowed some of its biggest banks – including commercial banks who are the largest holders of government cash bonds – to trade bond futures for the first time since 2013, a step toward luring more investors to its government-debt market. It is widely expected that foreign investors will also be granted access, possibly by the end of this year. The opening up of the onshore futures market to a broader pool of investors leads to higher turnover, boosting liquidity in both the bond futures and the government cash bond market, which are positives for foreign investors.

Other measures in the debt market included streamlining the current stringent approval system with a registration-based method for companies looking to issue debt in the domestic CNY bond market. This helps to prevent liquidity pressures from building up and keeps the flow of credit intact. Indeed, Chinese real estate developers have diverted their bond issuance towards the cheaper onshore CNY primary market over the last few months, and we expect this phenomenon to continue for the rest of this year.

Likewise, structural interest rate reforms have also accelerated as the Chinese policymakers attempt to guide the cost of financing lower and improve monetary policy transmission to the real economy, to cushion the pandemic's economic challenges. Increasingly, Chinese officials have grown concerned over the side effects of unleashing cuts to old broad-based benchmarks, which sent property prices through the roof in the previous rounds of easing. The introduction of the Loan Prime Rate (LPR) earlier this year will help improve the transmission of monetary policies to the real economy. LPR is a hybrid rate that is shaped by the commercial banks as well as the central bank. LPR is based on a spread (derived from 18 commercial banks' average lending rate) added to the medium-term lending facility (MLF) rate set by the central bank.

Onshore credit market practices are improving and mirroring those of international standards

We estimate that a vast majority of the onshore credits are currently rated AA and above by the domestic rating agencies, but their international ratings can be far more wide-ranging. A local AAA-rated credit can also be rated as high yield internationally. Due to the lack of reliable, comparable ratings with international standards and little credit differentiation, foreign investors have mostly sidelined the onshore CNY credit markets.

Chart 9: Breakdown of Chinese issuers with both domestic and international ratings

International issuer rating

Domestic issuer rating	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC+	CCC	CCC-	CC	Total
AAA	10	12	25	26	34	24	5	4	6	4	4	0	1	0	0	0	155
AA+	0	0	0	6	3	16	17	5	5	5	8	7	3	1	0	0	76
AA	0	0	0	0	1	2	1	8	6	5	2	6	2	0	0	0	33
AA-	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
BBB	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	0	1
CCC	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1
NR	0	0	1	0	0	0	0	0	0	0	0	0	0	0	0	0	1
Total	**10**	**12**	**26**	**32**	**38**	**42**	**23**	**17**	**17**	**14**	**14**	**13**	**6**	**1**	**1**	**1**	**267**

Source: HSBC, December 2019

Chinese regulators are not ignoring the domestic credit markets' problems and have been putting more emphasis on improving the credibility of onshore ratings. Last year, the regulator banned Dagong Global Credit Rating Company from providing false information and charging borrowers high consulting fees, which violates its independence as a rating firm. S&P Ratings Company has also been approved recently as the first wholly foreign-owned credit rating agency to issue credit ratings onshore, followed by Fitch Ratings Company.

China has recently committed to improving bond default mechanisms by exploring the establishment of market-based platforms for issuers and investors, according to a guideline released by the People's Bank of China. The directive, which will take effect in August, urges fair treatment for bondholders in defaults. Bond trustees and bondholders' meetings will be given key roles in handling bond defaults, similar to international standards.

It is also interesting to note onshore default rates, particularly in the private sector, have been rising in recent years. While painful in the near term, the rise in onshore defaults also signals the Chinese authorities' willingness to move towards a more efficient market-driven credit market. That said, we expect the trend to reverse somewhat this year, given the pass-through from augmented policy support and easier credit conditions.

Demand for Chinese bonds will grow as the index inclusion theme plays out and attracts more substantial fund flows

Undoubtedly, the steady increase in foreign portfolio flows into the Chinese bond markets in recent years was partly due to the inclusion of the onshore Chinese government bond and policy bank bonds in leading bond indices.

Currently, onshore Chinese government bonds are included in two out of the three major bond indices.

- **The Bloomberg Barclays Global Aggregate Index** (which has also included Chinese policy bank bonds) has started a progressive inclusion over twenty months from April 2019 – onshore Chinese government bonds will have an index weight of around 6% at full integration. The inclusion is estimated to lead to inflows of some US$120 billion over time.
- The **JP Morgan Government Bond Index-Emerging Markets (GBI-EM)** has begun the inclusion process from February 2020, over a period of ten months. At full inclusion, China's weight will be capped at 10% and could attract US$20 billion of inflows during the phasing-in period.
- Further index inclusion, potentially sometime in the fall, by FTSE, which owns the widely-followed **World Government Bond Index (WGBI)**, will likely spur passive foreign inflows of around US$150 billion.

Despite China's rising weight in global investment indices, it is still relatively low, considering China's large share of trade activities and GDP globally, and there is ample room to grow. China is the world's largest economy by purchasing power parity, and the second-largest by nominal GDP, behind the U.S. China also accounts for around 40% of Emerging Market GDP[5].

The growing foreign portfolio flows will also absorb the increase in China's government bond supply, which is necessary to support greying demographics, counter external growth headwinds, and underpin domestic consumption. The increasing foreign ownership will also lend support to the renminbi.

China's growth, interest rate, and current account edge lend support to a stable renminbi

A key priority of the Chinese government is to maintain stability and this drives the country's policies, including that of the renminbi. The Chinese authorities are acutely aware that the renminbi's stability is critical in cementing the currency's status as a global reserve and trading currency. With the renminbi currently managed against a basket of trading partners, the improved stability of the currency has lowered the probability of a repeat of past episodes of capital outflows weighing on total returns for foreign investors.

Separately, China's services deficit is likely to continue to shrink due to restrictions on travel overseas. Together with the collapse in commodity prices, an increase in the country's exports of medical supplies amidst the COVID-19 pandemic will boost the country's current account balances and provide a buffer to guard against external shock and prevent any disruptive renminbi depreciation.

Renewed U.S.-China tensions have ignited a fresh push by China to reduce reliance on the greenback and promote the renminbi's global use. In June, the Wealth Management Connect, which facilitates cross-border investments among residents of Hong Kong, Macau and southern China, was announced. More recently in July, a top Chinese official said the country would introduce direct trading between the renminbi and additional currencies, providing a further boost to the international use of the renminbi.

Renminbi fundamentals in terms of growth differentials and rate gaps are also improving versus its trading partners. China has recovered sooner than the rest of the global economy, and the latest PMI data for China points to further expansion. Separately, US Treasury-CGB yield spreads are currently at more than 200bps, close to the multi-year highs, and are also moving in favour of the yuan. While tail risks around elevated US-China tensions heading in the U.S. election season could cause USDRMB volatility to surge, we think it does not morph into a sustained depreciation spiral or derail our positive medium-term outlook on the currency.

Targeted monetary policy easing is necessary to support employment, in response to the crisis

For the first time in decades, stabilising employment dominated the Chinese government's agenda. In this year's NPC meeting, China abandoned the traditional GDP growth target but retained the annual unemployment target. This significant regime change confirms China's rise towards developed market status. None of the developed market economies targets a specific growth rate. While China's growth is rebounding, employment will lag. With unemployment likely to remain elevated for a while, consumer spending will take longer to recover to pre-COVID levels.

In a sharp contrast to prior crises, the services sectors have been hit more severely than manufacturing due to widespread containment measures. It will take longer for the service sector, which has been a critical creator of new jobs in recent years, to normalise as some degree of social distancing restrictions and behavioral caution will linger. A record number of college graduates who are about to enter the workforce over summer, are also more suited for the service sectors than manufacturing jobs; this could again pose headwinds for the country's employment target.

[5] Source: IMF, Q4 2019

We believe recent speculation of whether the accommodative monetary policy in China might be nearing its end, are overdone. We think the policymakers' reticence is partly due to increasing concerns about corporates arbitraging between cheap funding costs and higher returns from investment in structured deposits. We expect monetary easing to continue, but it will be more calibrated to stabilise employment and avoid the risk of another debt-fuelled asset bubble as we had experienced in the past. To that end, the People's Banks of China (PBoC) recently expanded the re-lending and re-discounting facilities to provide more targeted support to small and micro-sized companies, who are responsible for most of the employment in China today.

An alternative safe-haven asset class as China exceptionalism rises

A likely sustained period of loose monetary policies in the U.S., Europe, and Japan, should push investors to look elsewhere for alternative DM-like assets but with possibly higher yields. China stands out thanks to its better economic fundamentals but still attractive yields. 10-year Chinese government bond yields are at close to 3%[6] – compared with under 1%[6] and around 0%[6] on equivalent U.S. and Japan government notes. The same holds, even after adjusting for inflation. Incidentally, Japan shares the same A+ sovereign rating as China.

China is running with a current account surplus which will only increase this year and the nation has a high national savings rate. The country's sovereign debt is less than 60% of GDP compared to a debt-to-GDP level of more than 100% in many developed markets. Although China's consolidated fiscal deficit is expected to widen this year, overall government debt levels are still low compared to developed markets. And with China leading the economic recovery against COVID-19, this will further reduce the debt-to-GDP ratio at a quicker pace than most Western countries. Overall, the debt overhang in China will anchor the country's monetary policies and ensure the positive yield pick-up investment proposition over the DM markets is intact.

Unlike many DM economies, China has not resorted to unconventional measures such as cutting interest rates to zero lower bound, direct purchase of credit debt in the primary markets, or large scale quantitative easing measures to provide support. This underscores a clear regime shift in the country from previous crisis episodes of broad interest rate cuts, which inevitably resulted in financial excesses and undesirable consequences. To that end, China is demonstrating more prudence in monetary easing, more restraint on stimulus spending than past downturns, and versus that of the developed markets.

[6] Source: Bloomberg 22 July 2020