Ninety One

Previously Investec Asset Management

China Fixed Income

A welcome addition to the mainstream

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The fast view

- China's bond markets cover a large and increasingly diverse opportunity set, offering a range of potential benefits to investors.
- The opening of these markets to foreigner investors in recent years has spurred a trend for increased allocations.
- This shifted up a gear in February, when liquid CNY-denominated China government bonds joined JP Morgan's suite of emerging market indices.
- Although it is growing, exposure to China fixed income is still relatively low in global bond portfolios.
- Yet the asset class brings various potential benefits to investors' portfolios, including a higher risk premium relative to other bond markets and a low correlation with other asset classes.
- We believe the structural shift of investment allocations towards the asset class is likely to accelerate as China's debt markets become increasingly integrated into the global mainstream.

Please see Appendix for asset class definitions.

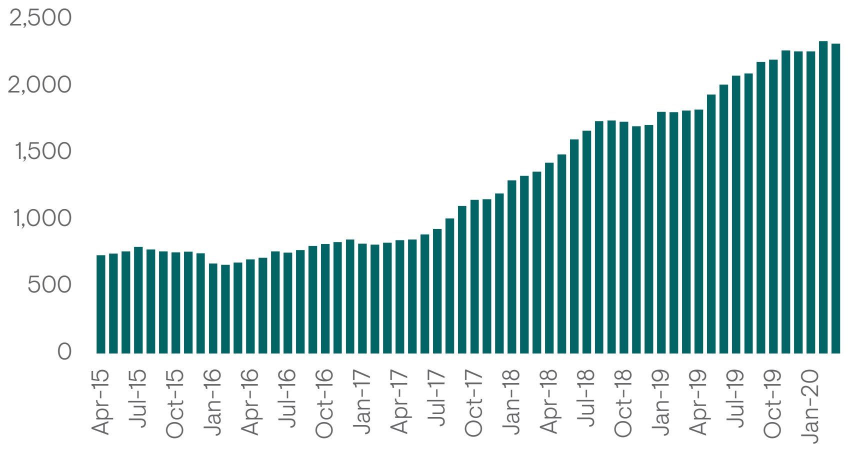
A structural asset allocation shift in progress

Even before Chinese bonds started to enter mainstream market indices, improved foreign investor accessibility has spurred an increase in the number of overseas investors allocating to the asset class.

Central banks and sovereign wealth funds started this trend, but today the investor base has expanded to include the wider global asset management community. This is thanks to a combination of improved market access and increased awareness among investors of the potential benefits to their portfolios of allocating to the asset class.

By the end of the first quarter of 2020, foreigners' investments accounted for CNY 2.3 trillion (USD 328 billion) of the onshore CNY bond market, more than three times the amount seen five years ago.

Figure 1. Onshore CNY bonds held by overseas entities, CNY billions



Source: People's Bank of China. As at March 2020.

Although it is growing, exposure to China is still relatively low in global bond portfolios. As foreigner investors gain more insight and comfort in this asset class, we believe that China bonds will feature increasingly in their portfolios. Therefore, we expect fixed income inflows into China to be a structural phenomenon in the years ahead.

Driving this is the mainstreaming of the asset class, evidenced by the inclusion of China to major bond indices such as the Bloomberg Barclays Global Aggregate and JP Morgan GBI EM Global Diversified.

> "Staying on the side-lines with respect to China will become increasingly untenable given the trajectory of China's growth as a driver of financial markets and global GDP"

Crafting the Optimal China Allocation Strategy, Q2 2020, Greenwich Associates.

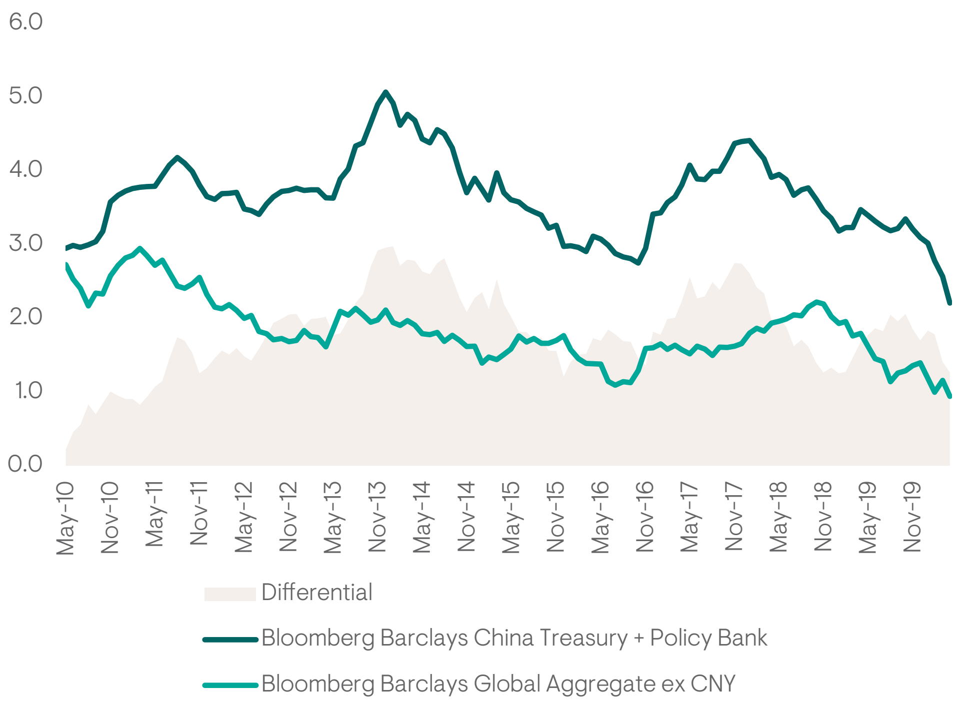
Providing differentiated and diversifying return potential

To be considered a distinct asset class, each core building block of a balanced portfolio should offer a positive risk premium over the long term and behave sufficiently independently from the rest of the portfolio. Both China's onshore CNY and offshore USD bond markets meet these criteria, as we outline below.

An attractive risk premium

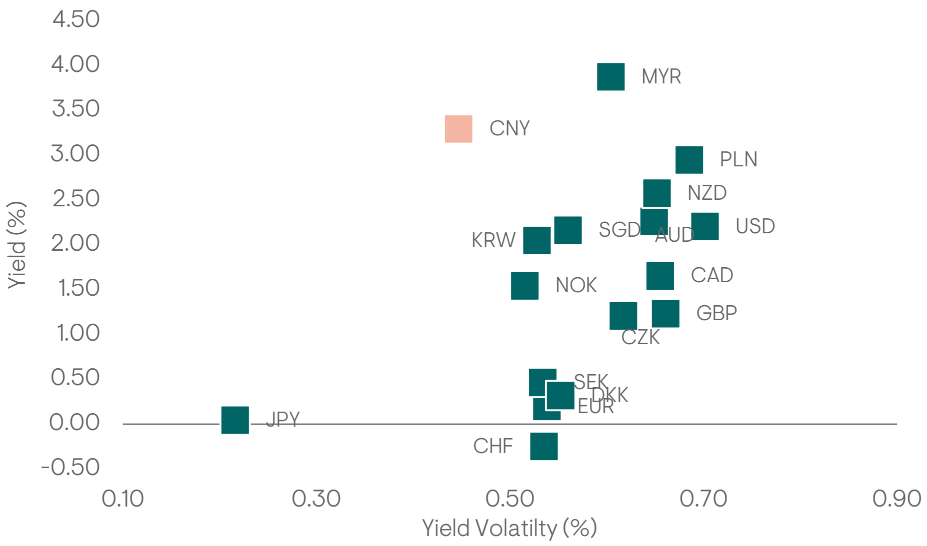
Onshore CNY bonds generally yield more than the large global peers. They have also tended to be less volatile than other bond markets, offering one of the strongest risk-return profiles.

Figure 2. Onshore CNY bond yields versus global bond yields (%)



Source: Bloomberg. As at April 2020. For further information on indices please see Important Information section.

Figure 3. Average 10-year gov't bond yields vs. annualised volatility (5-yrs to 31 March 2020)



Source: Bloomberg, Ninety One calculations. As at April 2020.

The defensive characteristics of onshore CNY bonds reflects China's high creditworthiness. This is also mirrored in the sovereign ratings assigned by the major rating agencies.

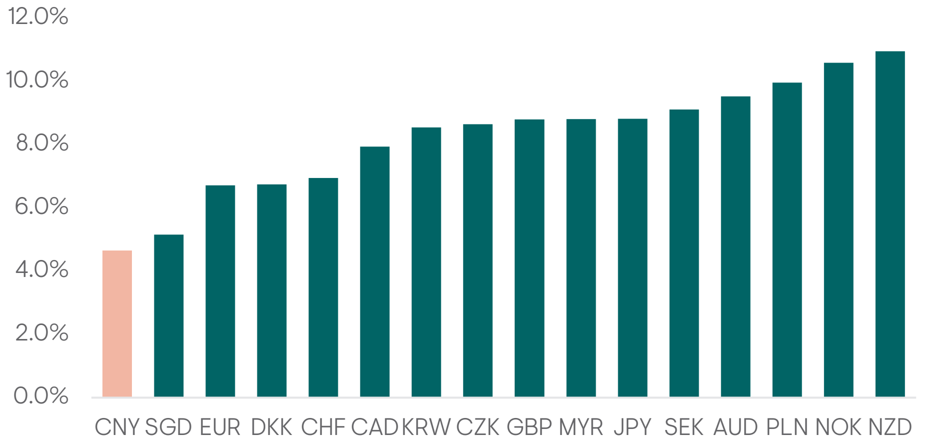
Table 1. Sovereign credit ratings

	Moody's	S&P	Fitch
Canada	Aaa	AAA	AAA
Germany	Aaa	AAA	AAA
US	Aaa	AA+	AAA
France	Aa2	AA	AA
UK	Aa2	AA	AA-
S Korea	Aa2	AA	AA-
China	A1	A+	A+
Japan	A1	A+	A
Poland	A2	A-	A-
Malaysia	A3	A-	A-
Mexico	Baa1	BBB	BBB-
Italy	Baa3	BBB	BBB-

Source: Bloomberg. As at May 2020.

At the same time, the currency has exhibited low spot volatility, measured against the US dollar, as shown in Figure 4.

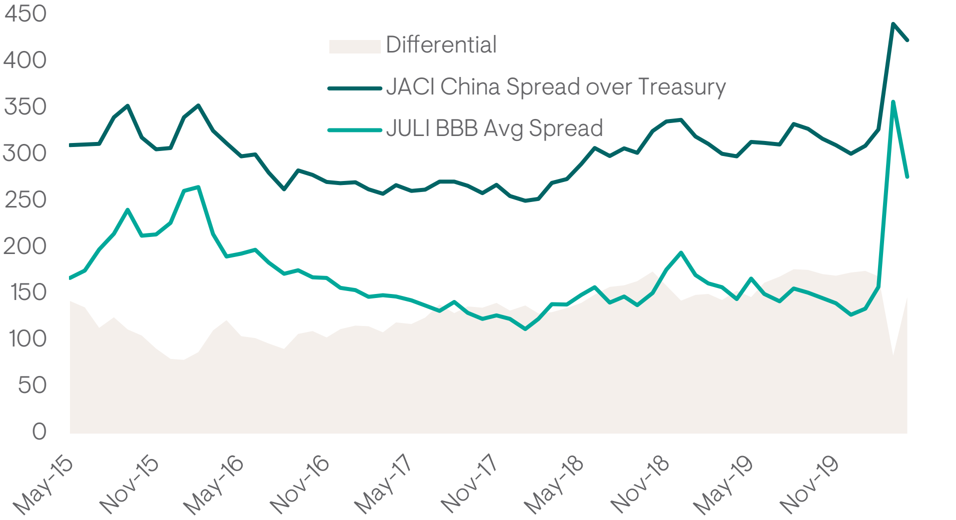
Figure 4. Annualised USD-Spot FX Volatility (5-yrs to 31 March 2020)



Source: Bloomberg, Ninety One calculations. As at March 2020.

China's offshore USD bond market also offers investors an attractive risk premium. Credit spreads of Chinese companies have generally been 80-190 basis points more than the US BBB rated peer group, i.e. at spread multiples of 1.4-2.5 times, as shown in Figure 5. In addition to providing higher absolute returns, China's offshore USD bond spreads have also tended to outperform US credit spreads in sell-offs.

Figure 5. China offshore USD credit spreads versus US BBB credit spreads (bps)



Source: JP Morgan. As at April 2020. JACI: JP Morgan Asia Credit Index. JULI: JPM US Liquid Index.

A diversifying allocation

Diversification is a cornerstone of investing yet increasingly hard to achieve.

Historically, China's bond markets have exhibited low correlation with major risk asset classes. Domestic factors tend to determine China's growth and inflation dynamics to a greater extent than in many other smaller markets that can be influenced more by global trends.

These correlations demonstrate that an allocation to China fixed income can improve the efficient frontier for all investors, potentially enhancing a portfolio's risk-reward characteristics by reducing overall portfolio volatility while potentially increasing returns.

Table 2. Correlations between China's bond markets and other asset classes

	Offshore USD China bonds	Global developed market bonds	Global developed market equities	Global emerging market local bonds	Global emerging market USD bonds	Global emerging market equities
Onshore CNY bonds	0.2	0.3	0.2	0.4	0.3	0.4
Offshore USD China bonds		0.3	0.5	0.6	0.6	0.6
Global developed market bonds			0.1	0.5	0.5	0.3
Global developed market equities				0.7	0.6	0.8
Global emerging market local bonds					0.8	0.8
Global emerging market USD bonds						0.7

Source: Onshore CNY Bonds: Bloomberg Barclays China Treasury + Policy Bank Total Return Index USD; Offshore USD China Bonds: JP Morgan Asia Credit Index China TR; Global DM Bonds: JP Morgan Government Bond Index Global Unhedged USD; Global DM Equities: MSCI World Index; Global EM Local Bonds: JP Morgan GBI-EM Global Diversified Composite Unhedged USD; Global EM USD Bonds: JP Morgan EMBI Global Diversified Composite; Global EM Equities: MSCI Emerging Markets Index. Bloomberg, March 2020. Correlations calculated based on monthly returns data, from 2Q10 to 1Q20.

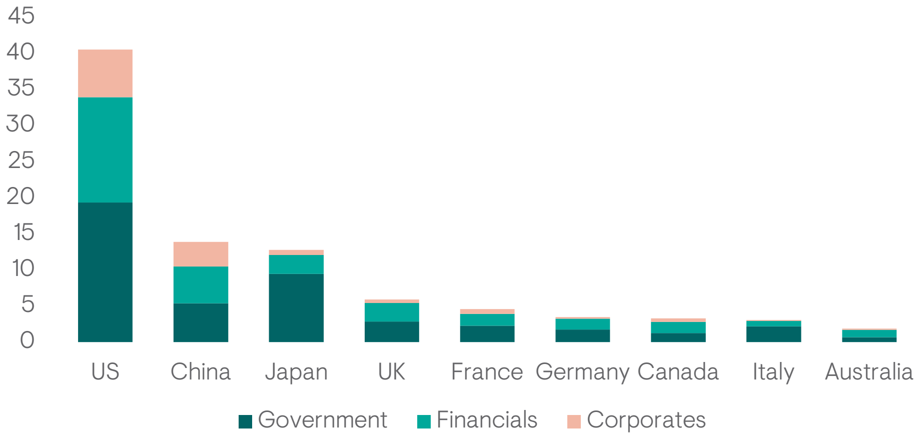
Focusing on returns, in the volatile first quarter of 2020, onshore CNY bonds returned +1.7% and Offshore USD China bonds -1.3%; while Global Developed Market (DM) bonds returned +3.1%, Global DM equities -21.4% and Global EM Equities -23.9%.[1]

[1] Past performance is not a reliable indicator of future results. Source: Bloomberg, March 2020.

A sizeable and accessible market

China's onshore CNY bond market has grown significantly and is now the second largest bond market globally. Growing from USD 2.7 trillion at the start of 2010, the stock of bonds – government, financial and corporate included – stood at USD 14 trillion in September 2019.

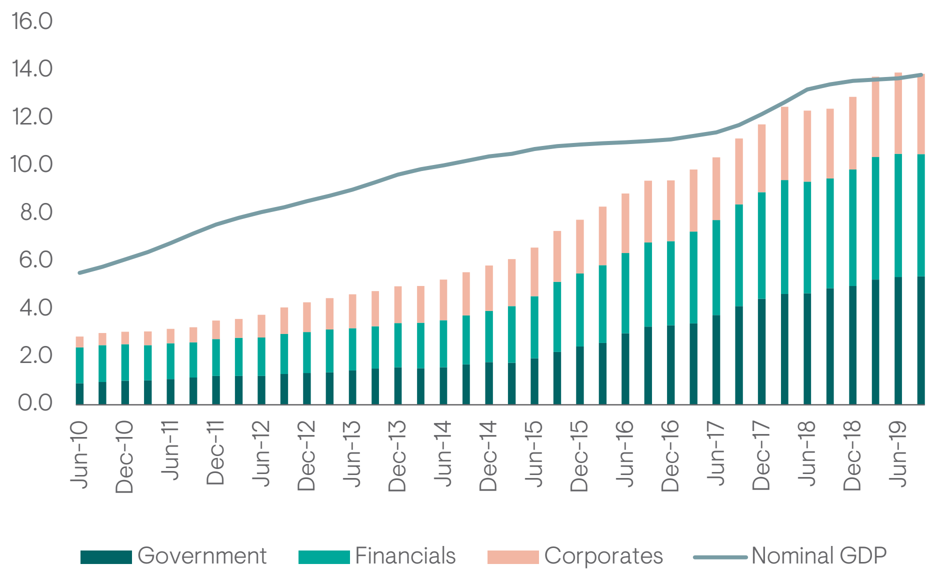
Figure 6. Size and composition of major global bond markets, USD trillion



Source. Bank for International Settlements. As at September 2019.

While part of this growth took place alongside high nominal GDP growth, it also reflected the deepening of China's capital markets as borrowers turned to the bond market for their financing needs.

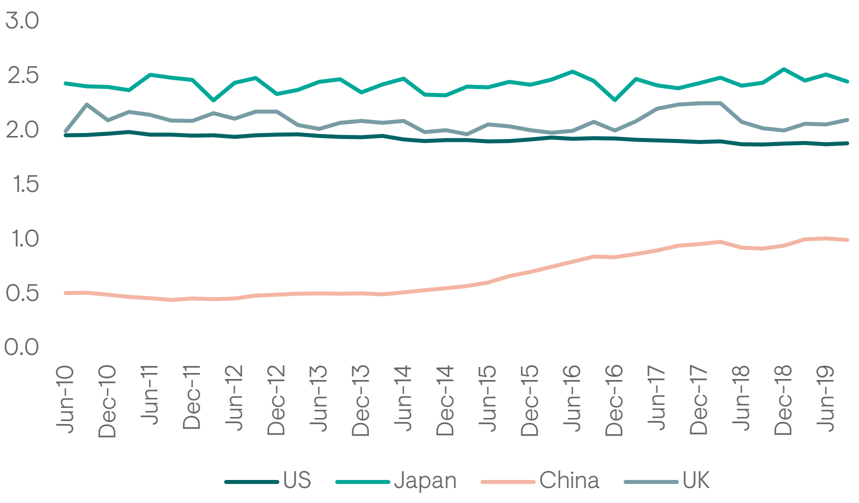
Figure 7. China's bond market by issuer type, USD bn



Source: Bank for International Settlements, Bloomberg. As at September 2019.

There is still room for growth. In context, outstanding debt securities in China as a proportion of nominal GDP is still significantly less than that in the US, Japan and the UK.

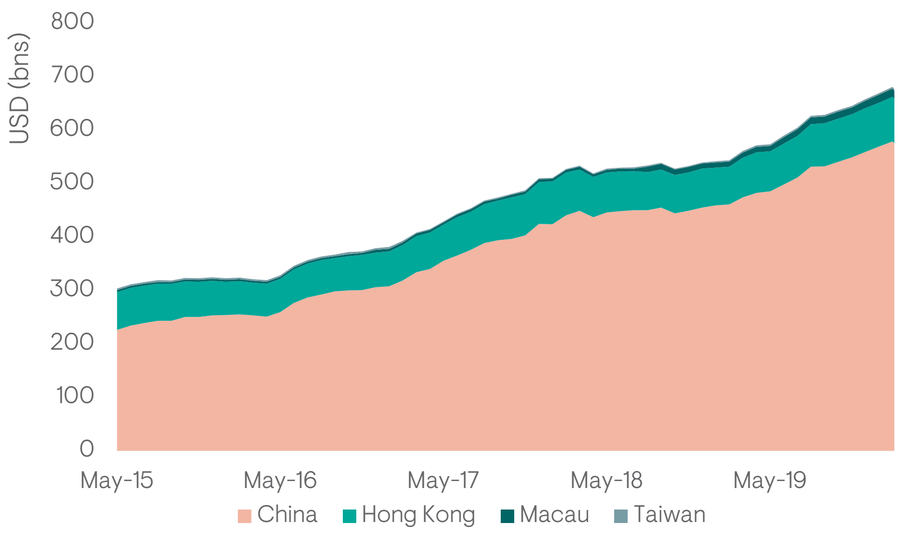
Figure 8. Size of bond market relative to nominal GDP (multiples)



Source: Bank for International Settlements, Bloomberg, Ninety One calculations. As at September 2019.

Likewise, the China offshore USD bond market has seen significant broadening and deepening of issuance.

Figure 9. Market capitalisation of USD Greater China bonds – JPMorgan Asia Credit Index



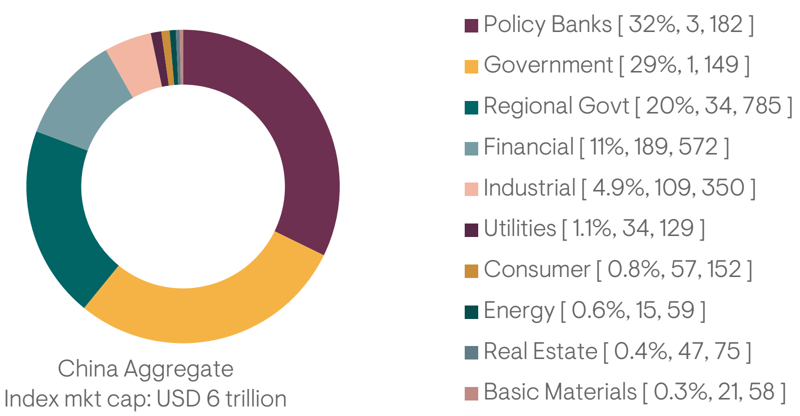
Source: JP Morgan. As at April 2020.

A rich opportunity set

China fixed income is an asset class with a surprising breadth of investment opportunity.

The onshore CNY bond market comprises issuances primarily by the sovereign, three policy banks, regional governments, banks and large state-related-enterprises. Represented in just the Bloomberg Barclays China Aggregate Index[2] with a market capitalisation of USD 6 trillion are more than 2,500 bonds issued by over 520 entities.

Figure 10. Onshore CNY bond sector composition [% of market capitalisation, number of entities, number of bonds]



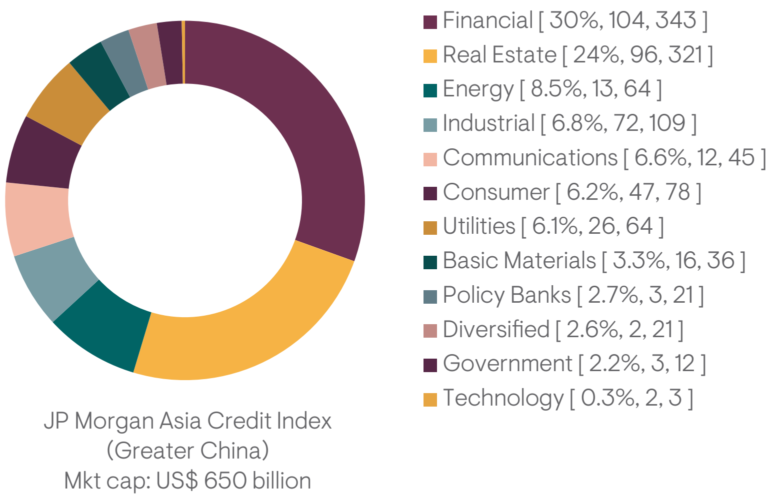
Source: Bloomberg. As at April 2020.

While the onshore market is dominated by government-related issuances, China's offshore USD bond market is characterised by a broader mix of corporate borrowers. The majority are rated internationally by Moody's, S&P and/or Fitch. For further context, represented in the JP Morgan Asia Credit Index[3] alone are more than 1,100 bonds by almost 400 issuers out of Greater China, with a market capitalisation of USD 650 billion.

[2] Launched in 2004 and adopting the best practices of the flagship Bloomberg Barclays Global Aggregate Index, the China Aggregate Index ring-fences larger-sized fixed-rate treasury, government-related and corporate securities listed on China's interbank bond market. Excluded are floating-rate; zero coupon; convertibles; inflation-linked; derivatives; structured products; securitised; warrants; private placements; retail bonds; bonds issued on Shanghai and Shenzhen exchanges; special bonds issued by Ministry of Finance.

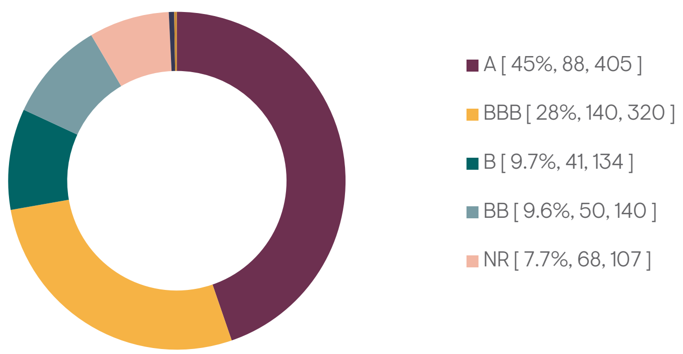
[3] The JP Morgan Asia Credit Index was launched in 2006 and follows a traditional market capitalization technique to capture fixed-rate USD denominated bonds issued in the Asia ex-Japan region.

Figure 11. Offshore USD bond sector composition [% of market capitalisation, number of entities, number of bonds]



Source: Bloomberg, JP Morgan, Ninety One calculations. As at April 2020.

Figure 12. Offshore USD bond ratings composition [% of market capitalisation, number of entities, number of bonds]



Source: Bloomberg, JP Morgan, Ninety One calculations. As at April 2020.

In addition to the main onshore CNY and offshore USD bond markets detailed above, investors should also consider the smaller Dim Sum (offshore CNH denominated bonds) and Panda (onshore CNY denominated bonds issued by foreign entities) bond markets.

Asset class returns

The charts below show how an inclusion of CNY bonds (represented by the Bloomberg Barclays China Treasury + Policy Bank Index) might influence overall risk-return profiles of bond portfolios in various currencies.

Each chart shows a range of modelled return and volatility results from a hypothetical portfolio comprising different proportions of CNY bonds to: European bonds (Bloomberg Barclays Global Aggregate – European Euro Index); Swiss bonds (Bloomberg Barclays Global Aggregate – Swiss Franc Index); and UK bonds (Bloomberg Barclays Global Aggregate – Pounds Sterling Index). We show the five year period from April 2015 to April 2020.

Figure 13. Return and volatility comparison – China CNY bonds and European bonds

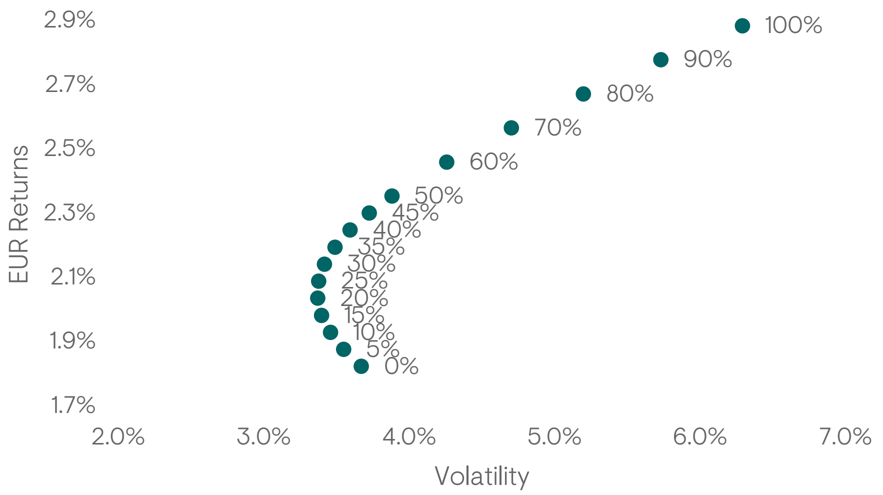


Figure 14. Return and volatility comparison – China CNY bonds and Swiss bonds

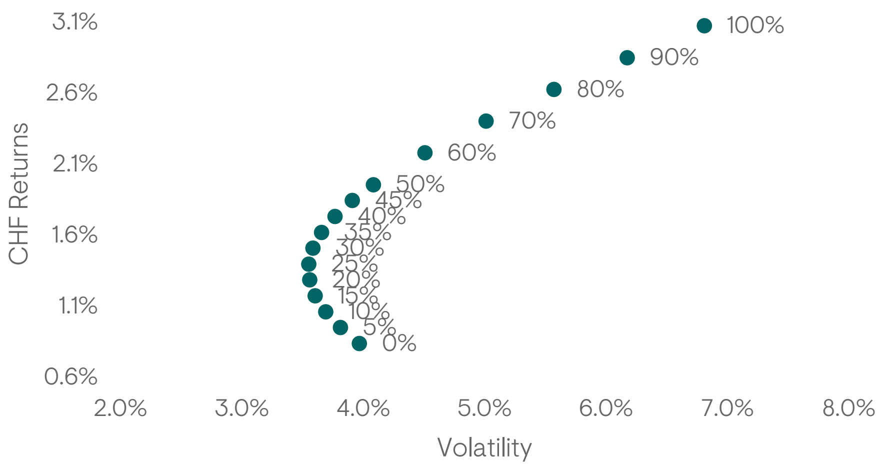
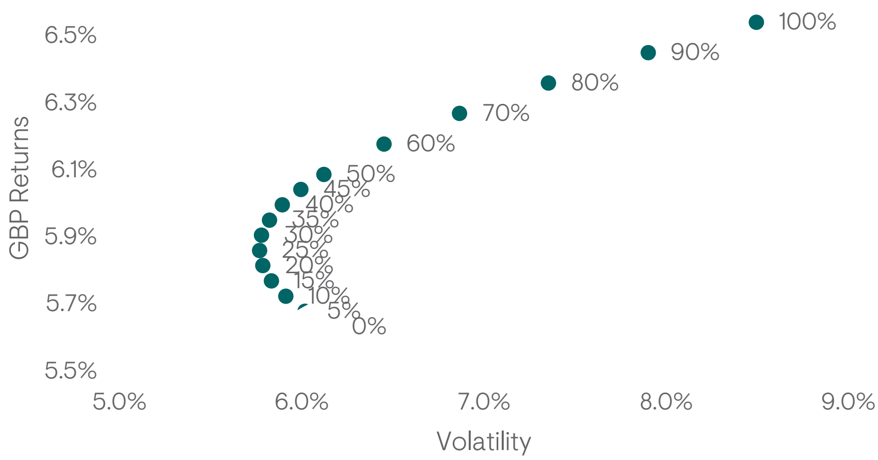


Figure 15. Return and volatility comparison – China CNY bonds and UK bonds



Source. Bloomberg, Ninety One calculations. As at April 2020.

Concluding remarks

This richly diverse asset class brings a range of potential benefits to investors' portfolios. We believe the structural shift of investment allocations towards China's bond markets is likely to accelerate as the asset class become increasingly integrated into the global mainstream.

Appendix

China's bond markets

Onshore bonds	Dim Sum bonds
Issued onshore, by Chinese entities	Issued offshore, by Chinese entities
CNY* denominated	CNH* denominated
Panda bonds	**Kung Fu bonds**
Issued onshore, by non-Chinese entities	Issued offshore, by Chinese entities
CNY denominated	USD denominated

* CNH and CNY: Chinese yuan for the offshore and onshore markets respectively.

Important information