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Ninety One

China Fixed Income

Asset class update

Foreword

In this paper we provide an update on the China Fixed Income asset class, outlining its characteristics and the role it plays in an increasing number of investors' portfolios. But before we launch into the structural arguments, let's first consider the current cyclical picture and recent developments.

Uncertainty around various themes – not least policy developments – drove volatility in China's offshore US dollar bond market in 2021, with turmoil in the real estate sector continuing into 2022. A policy turning point came in March, with a shift towards a more moderate stance as China's authorities recognised that they had achieved the desired effect of cooling the property market and the focus moved toward underpinning economic stability ahead of the 20th Party Congress later this year. While the near-term challenge of COVID-19 in the country has put renewed pressure on the real estate sector as many cities remain under strict lockdown, we believe the authorities have shown willingness to ease their stance on the sector. We think this should be supportive for asset prices over the medium term, although the path to recovery is likely to be uneven.

By adding to uncertainty globally, Russia's invasion of Ukraine serves as a reminder that this is an asset class for investors with a long-term horizon and tolerance for some volatility in the short-to-medium term. Furthermore, the shifting geopolitical order and commodity-driven supply chain shock will result in winners and losers, underscoring the importance of active management and selectivity.

Considering the structural investment case, we firmly believe this increasingly mainstream asset class has an important role to play in global investors' portfolios. The fact that most global bond markets now face a backdrop of a rate-hiking cycle, while China (where inflation remains benign) is loosening policy, highlights how China's economy and bond market differs from the rest of the world, introducing valuable diversification potential. Long-term investors should also not forget that the yield pick-up on offer in China's bond market has empirically come with generally lower, not higher, currency and bond price volatility, and recent market volatility in China's onshore bond market is significantly lower than that seen in major global bond markets.

We hope this paper helps readers to look through the noise for a clear assessment of the asset class in this new chapter for global bond markets.

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Please see Appendix for asset class definitions.

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Clarifying the China conundrum

China differs significantly from other countries and economies across a range of fundamental dimensions. An understanding of these differences is vital for gaining a clear picture of the characteristics of the Chinese fixed income asset class and for a robust assessment of the role it might play in a global investment portfolio.

A divergent economic cycle and different policy tools

Run as a socialist market economy, fiscal and macro-prudential policies overarchingly guide markets and investment behaviour in China. While other major economies were – until the middle of 2021 – using extensive quantitative easing to stimulate growth, China was tempering growth, largely via conventional monetary policy tools – including through the COVID crisis. And while many of the world's central banks are now trying frantically to control inflation and hiking rates, China's policymakers have turned more accommodative, against a backdrop of relatively contained domestic inflation and policy-induced growth headwinds. This is likely to see the onshore CNY bond market relatively well supported over coming months.

Shared regulatory challenges but different execution of policy

China began to adopt a more proactive regulatory stance in early 2021. The underlying driver of this, which started with internet platforms before moving to the private tutoring sector and property market, is the desire by China to forge a sustainable and inclusive growth path. Other notable policy moves in China over the past 18 months include deleveraging the financial sector to reduce the risk of over-heating; efforts to tackle carbon emissions via production curbs on the heaviest emitters; and action to tackle privacy concerns in the technology sector. The swift crackdown on internet platforms, video gaming, fintech, ride-hailing, data privacy, food delivery, crypto mining, and carbon-intensive industries, as well as the recent focus on the property market, have dominated the headlines. However, viewed through a broader lens, these regulatory challenges are shared globally. For instance, with the proliferation of technology and increasing concerns over potential abuse of market power and data security, the EU has been active in taking technology companies to task. In many respects, China's regulatory intentions and goals are not that dissimilar to those of others.

What makes China different is its willingness and unique ability to push through reforms in order to transform and upgrade its behemoth economy. As it does so, we think it important that investors examine how they can benefit from the China fixed income investment opportunity for what it presents. It is also important to note that relative to equity holders, bondholders in Chinese technology firms are less vulnerable to changes in companies' top-line growth or profit margins, given the strong balance sheets and higher-grade credit quality of these firms; as debt servicing is senior to equity distributions, regulatory changes that may have significant implications on companies' equity valuations need not necessarily impact their ability to service debt.

The next chapter

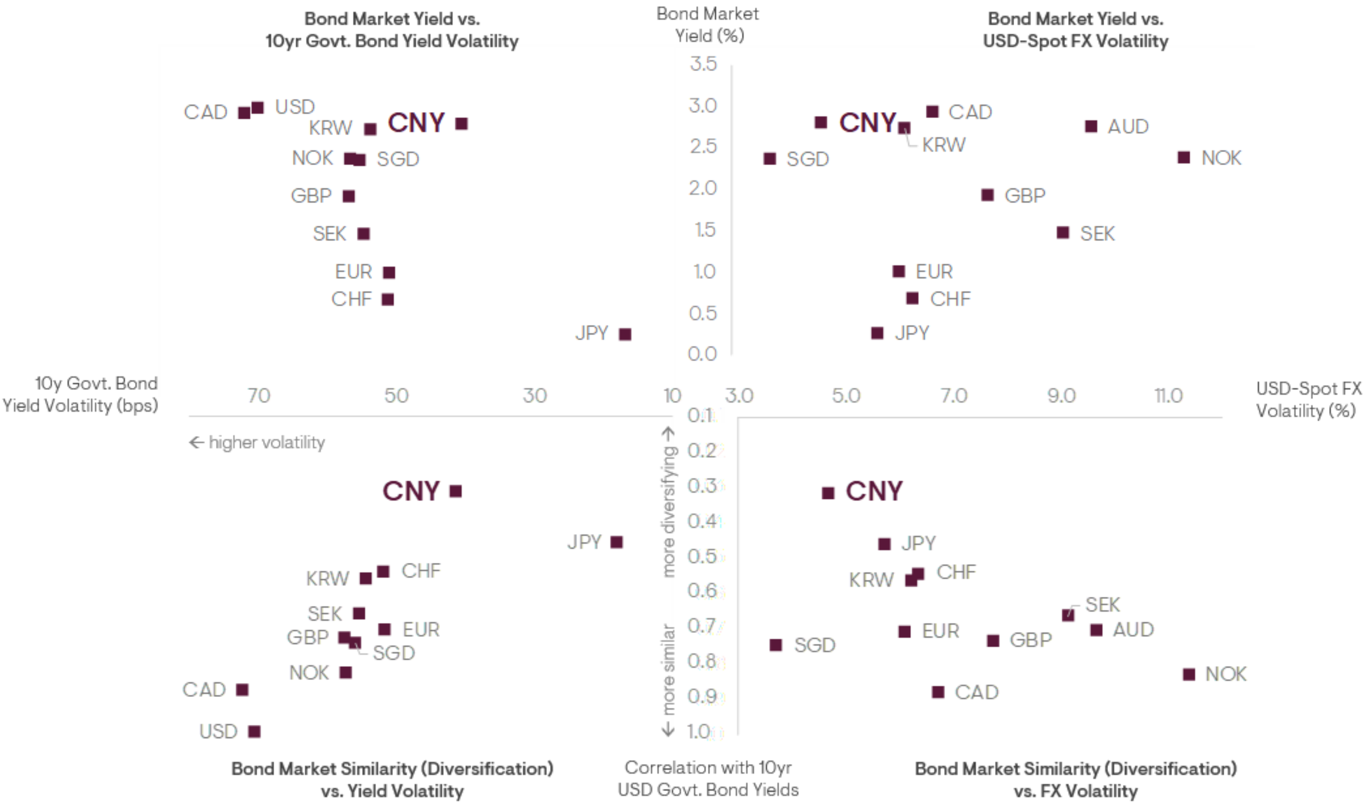
Being the world's largest official creditor with low external debt requirements, China is no longer a typical emerging market. Taking out the headline noise and observing ex-post behaviour of the asset class, we contend that onshore Chinese bonds behave much more like their developed market fixed income counterparts and offer useful characteristics, particularly during periods of market stress.

As policymakers in the country are now shifting to a more supportive stance, with a somewhat less pronounced focus on deleveraging, we think the debate should now be over where best – given increasing dispersion between winners and losers – and how to invest in China.

China's onshore bonds offer yield pick-up with lower volatility

Among the world's major bond markets, China onshore CNY bonds still provide some of the highest yields available. Stacked against global peers, this yield pick-up has empirically come with generally lower, not higher, currency and bond price volatility. At the same time, the currency has exhibited low spot volatility, measured against the US dollar, as shown in Figure 1.

Figure 1. Average yields on 10-year govt bonds versus annualised volatility (over five years to 31 March 2022)



Source: Bloomberg, Ninety One calculations, monthly data, 5 years to 31 March 2022.

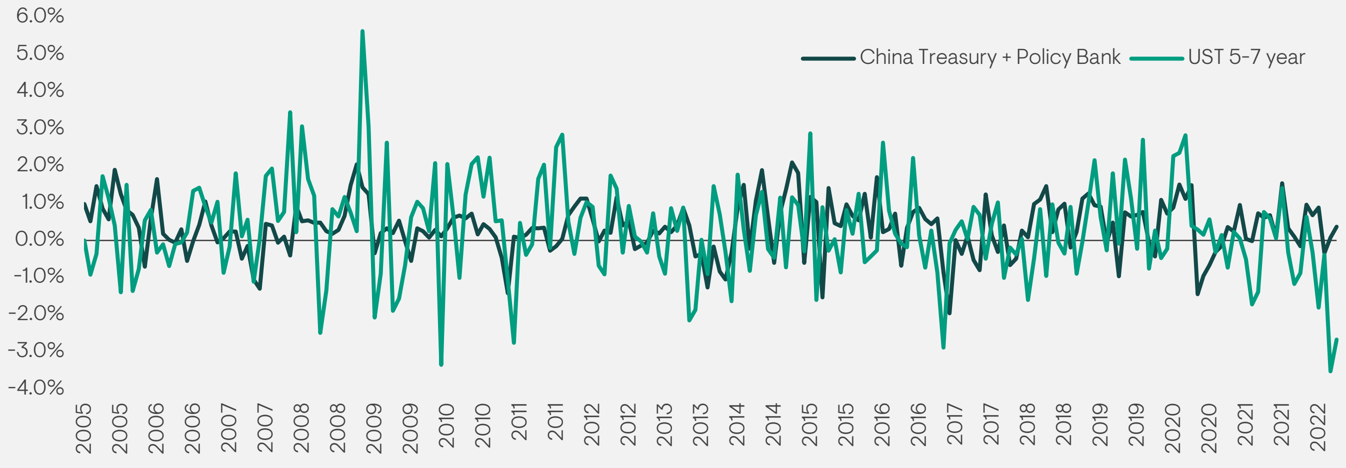
Making sense of recent market moves

It is perhaps a common misconception that all assets in China are highly volatile, especially given headlines surrounding increased regulation in the technology sector, volatility in Chinese equities, and issues in the real estate sector. But investors should consider each of China's three distinct asset classes (equities, onshore CNY bonds and offshore US dollar credit) in its own right. While there has undoubtedly been heightened volatility in Chinese equity and offshore credit markets, the picture is quite different for onshore debt.

Onshore CNY bonds

Figure 2 shows how the volatility of China's onshore CNY bond market has generally remained lower than to the (equivalent-duration) US Treasury index. Extending this view, it can also be seen that since 2005, the volatility of China onshore CNY bonds is nearly half that of their US counterparts. This makes sense when you consider that in the US, adjusting interest rates tends to be the primary monetary policy lever, while the People's Bank of China (PBoC) tends to adopt other non-interest rate tools such as loan quotas, macro-prudential measures and moral suasion to achieve its policy objectives.

Figure 2. Monthly returns of the China Treasury and Policy Bank index (onshore) vs. the US 5–7-year Treasury market



	US Treasuries	China local bonds
Long run volatility*	4.52%	2.41%
3-year volatility	4.83%	2.35%
12-month volatility	4.91%	1.85%

Source: Bloomberg, Ninety One calculations using monthly data, 30 April 2022. China local bonds = China Treasury + policy bank index; US Treasuries = US Treasury 5-7 year (chosen to match the duration profile of the China Treasury index). *From October 2005. For further information on indices, please see the Important information section.

Offshore USD credit

Considering the offshore US dollar market, despite heightened real estate sector volatility discussed below, for the overall universe both the 12-month and comparable long-run volatility are lower than both the US high yield and US investment grade markets, as duration (interest rate risk) of the former is around half. So, while volatility in China fixed income has risen over recent months, it has remained lower than other key global bond markets.

	US high yield	US investment grade	China & Hong Kong offshore USD credit
Long run volatility*	7.62%	6.46%	3.81%
3-year vol	9.49%	8.18%	4.59%
12-month vol	5.46%	6.86%	4.58%

Source: Bloomberg, Ninety One calculations based on monthly data, 30 April 2022. US high yield = BofA US High Yield (HUC0); US investment grade = BofA US Investment Grade (C0A0); China & Hong Kong offshore USD credit = JP Morgan Asia Credit China & HK Index. *This row shows the long run volatility for the three indices from the same start date (December 2016) as the JACI China and HK to improve comparability. For further information on indices, please see the Important information section.

Offshore USD – real estate sector focus

Policy developments drove volatility in China's bond market in 2021, with turmoil in the real estate sector continuing into 2022 and dominating discussions around the asset class. A policy turning point came in March, with a shift towards a more moderate stance as China's authorities recognised that they had achieved the desired effect of cooling the property market and the focus moved toward underpinning economic stability ahead of the 20th Party Congress later this year. While the near-term challenge of COVID-19 in the country has put renewed pressure on the real estate sector as many cities remain under strict lockdown, we believe the authorities have shown willingness to ease their stance on the sector. We think this should be supportive for asset prices over the medium term, although the path to recovery is likely to be uneven. We currently see extremely low valuations in some high-quality property firms that we think should benefit significantly from positive policy shifts.

Low volatility of the onshore bond market is underpinned by high creditworthiness

The defensive characteristics of onshore CNY bonds reflect China's high creditworthiness, as evidenced by the sovereign ratings assigned by the major rating agencies.

Table 1. Sovereign credit ratings

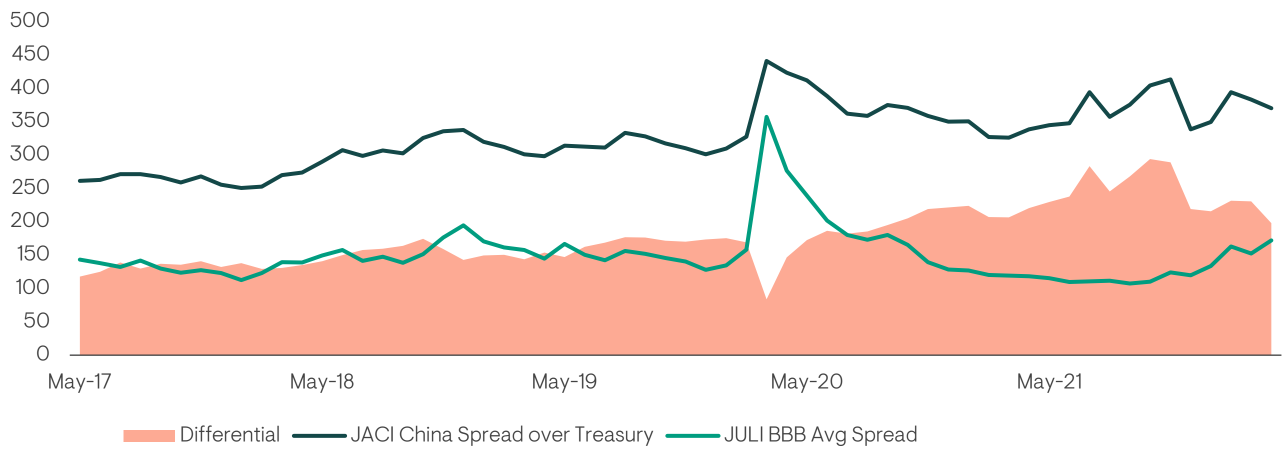
	Moody's	S&P	Fitch
Germany	Aaa	AAA	AAA
Canada	Aaa	AAA	AA+
US	Aaa	AA+	AAA
France	Aa2	AA	AA
S Korea	Aa2	AA	AA-
UK	Aa3	AA	AA-
China	A1	A+	A+
Japan	A1	A+	A
Poland	A2	A-	A-
Malaysia	A3	A-	BBB+
Mexico	Baa1	BBB	BBB-
Italy	Baa3	BBB	BBB

Source: Bloomberg, March 2022.

Offshore bonds offer an attractive risk premium

China's offshore US dollar bond market also offers investors an attractive risk premium. Credit spreads of Chinese companies have generally been 80-260 basis points (bps) higher than the US BBB rated peer group, i.e., at spread multiples of between 1.1 and 3.1 times, as shown in Figure 3.

Figure 3. China offshore USD credit spreads versus US BBB credit spreads (bps)



Source: JPMorgan, April 2022. JACI: JPM Asia Credit Index. JULI: JPM US Liquid Index. For further information on indices, please see the Important information section.

China bonds offer valuable diversification properties

Aside from size and the other characteristics outlined above, what makes China bonds truly interesting is that they are different.

A fundamental tenet of modern portfolio theory is that in order 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. China's onshore CNY and offshore US dollar bond markets meet these criteria. In particular, the former is highly diversifying, reflecting the greater importance of domestic factors on China's growth and inflation dynamics, in contrast to other smaller markets, which may be influenced more by global trends.

Allocating to China fixed income can help diversify overall portfolio returns because China's interest rate movements are predominantly determined by domestic factors.

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

	Offshore USD China Bonds	Global DM Bonds	Global DM Equities	Global EM Local Bonds	Global EM USD Bonds	Global EM Equities
Onshore CNY Bonds	0.2	0.2	0.2	0.4	0.2	0.4
Offshore USD China Bonds		0.5	0.4	0.6	0.8	0.5
Global DM Bonds			0.1	0.5	0.5	0.3
Global DM Equities				0.6	0.6	0.8
Global EM Local Bonds					0.8	0.8
Global EM USD Bonds						0.7

Source: Bloomberg, March 2022. Onshore CNY Bonds: Bloomberg China Treasury + Policy Bank Index; Offshore USD China Bonds: JP Morgan Asia Credit Index China; 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.* Correlations calculated based on monthly returns data, from 1Q2012 to 1Q2022.

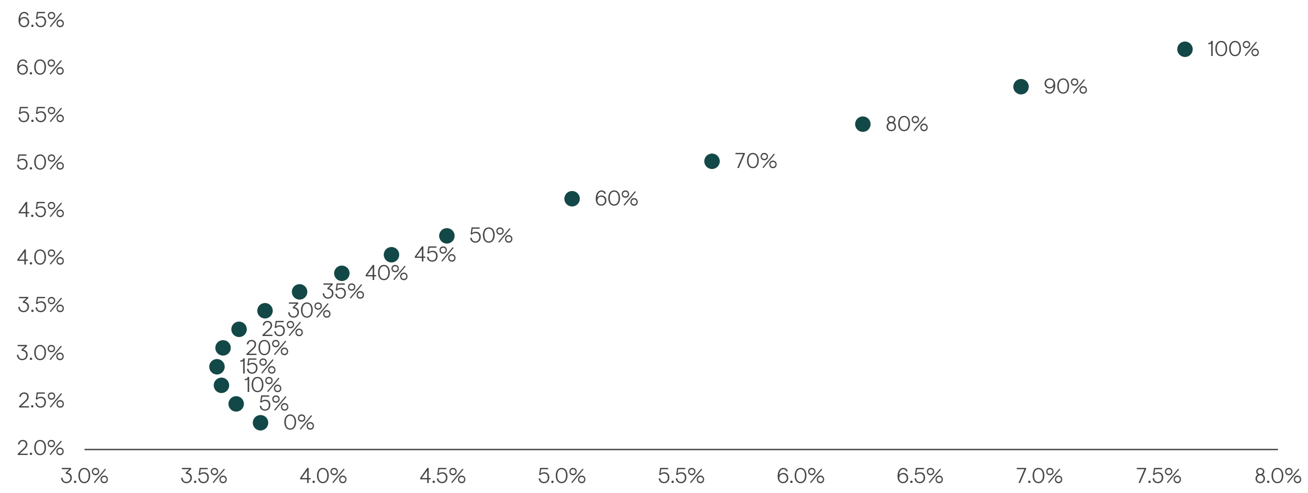
The highly diversifying and potentially risk-reducing nature of China bonds, coupled with the higher starting level of yields on onshore CNY bonds versus global bonds, implies that a significant allocation to China fixed income can materially improve the overall risk-reward experience for investors.

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; showing a range of modelled return and volatility results from a hypothetical portfolio comprising different proportions of CNY bonds to: European bonds (Bloomberg Euro Aggregate); and US bonds (US Aggregate).

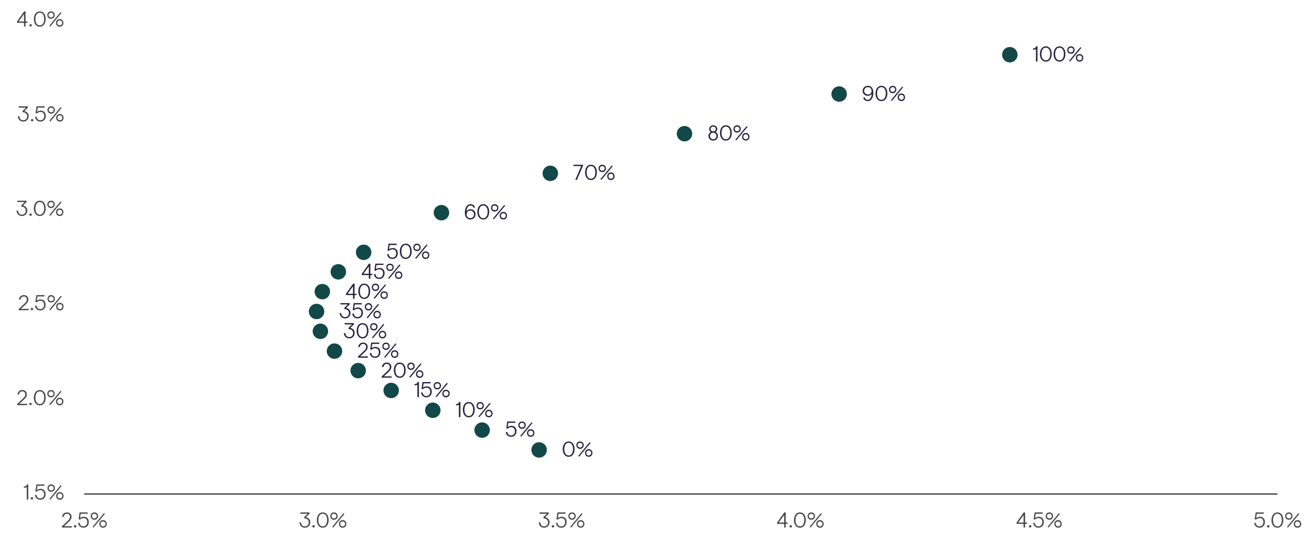
In many instances, an allocation to China would have materially improved overall portfolio returns for the same level of overall risk/volatility.

Figure 4. Return and volatility comparison – China CNY bonds and European bonds



Source: Bloomberg, Ninety One calculations as at 30 April 2022. EUR Returns & Volatility: x% in CNY bonds, 1-x% in EUR bonds. For illustrative purposes.

Figure 5. Return and volatility comparison – China CNY bonds and US bonds



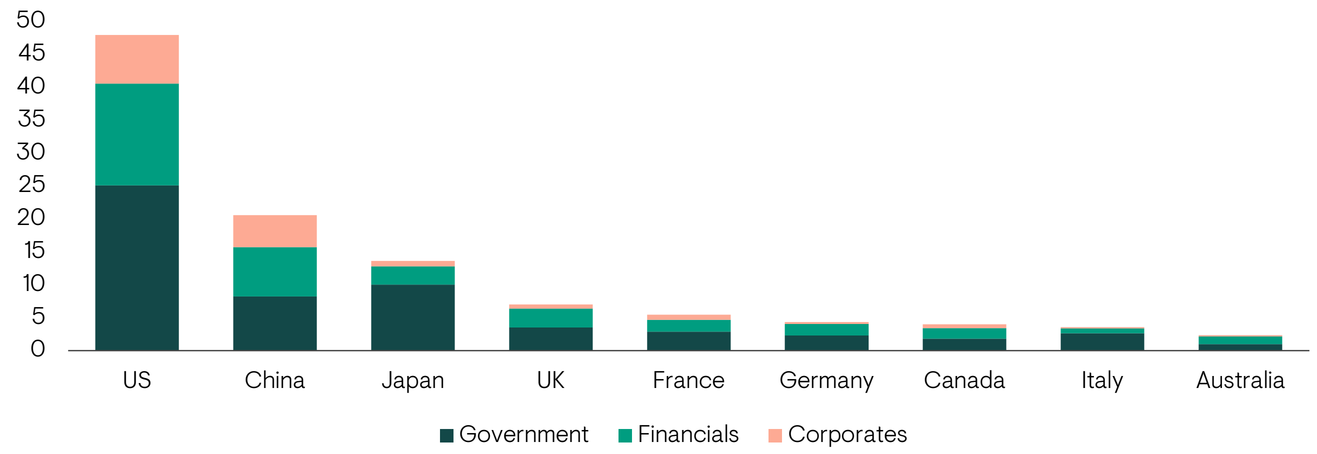
Source: Bloomberg, Ninety One calculations as at 30 April 2022. US Returns & Volatility: x% in CNY bonds, 1-x% in USD bonds. For illustrative purposes.

The large and rich opportunity set

The China fixed income opportunity is huge. Increasing in breadth and depth, the opportunity comprises both China's onshore CNY and offshore US dollar bond markets at c. US$21 trillion and US$640 billion respectively. Investor accessibility has been on the rise and today China's bond markets cover a large and increasingly diverse opportunity set, offering a range of potential benefits to investors.

China's onshore CNY bond market has grown significantly and is now the second largest bond market globally. Growing from US$2.7 trillion at the start of 2010, the total of bonds – government, financial and corporate included – stood at US$21 trillion in September 2021.

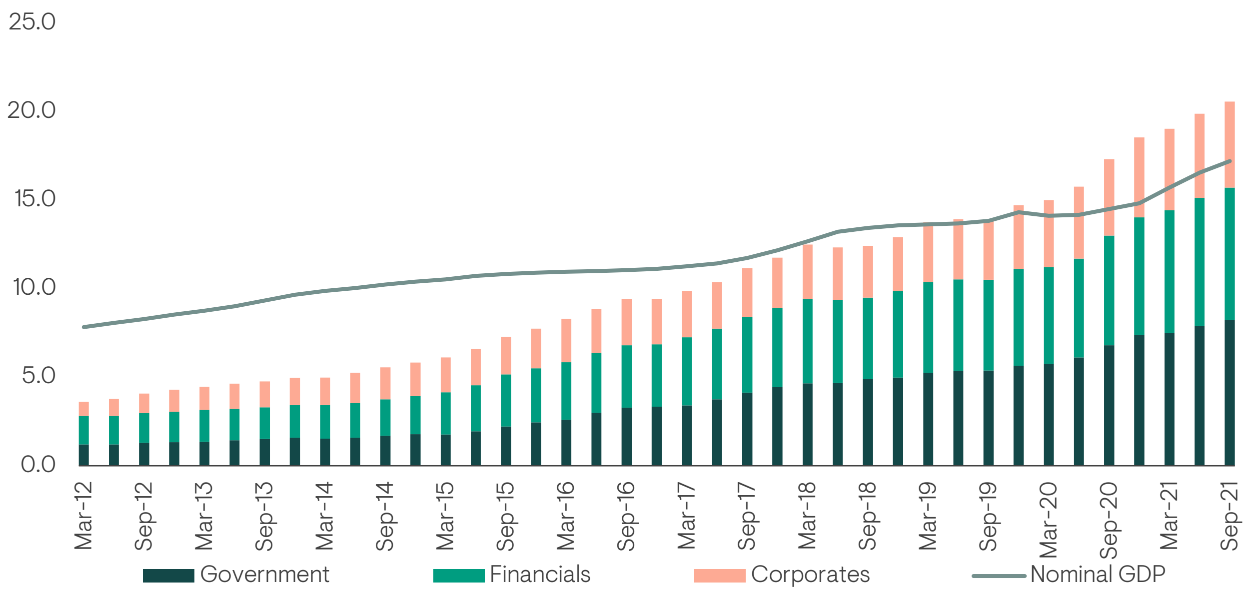
Figure 6. Size and composition of major global bond markets, USD trillion



Source: Bank for International Settlements, 30 September 2021.

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.

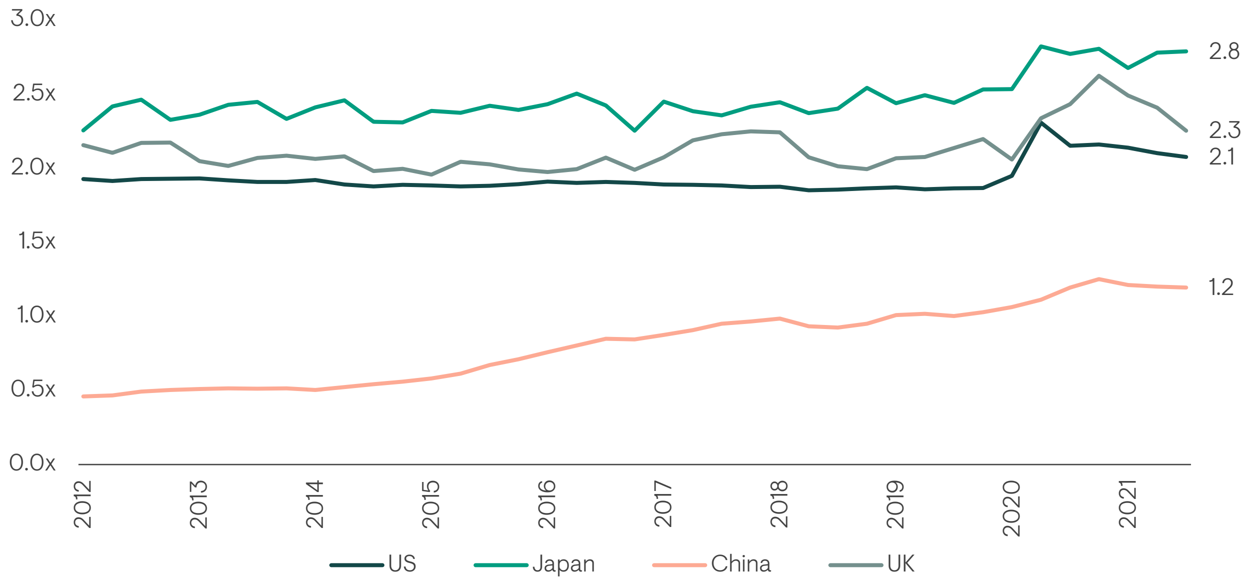
Figure 7. China's bond market by issuer type, USD trillion



Source: Bank for International Settlements, 30 September 2021.

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, as shown in Figure 8.

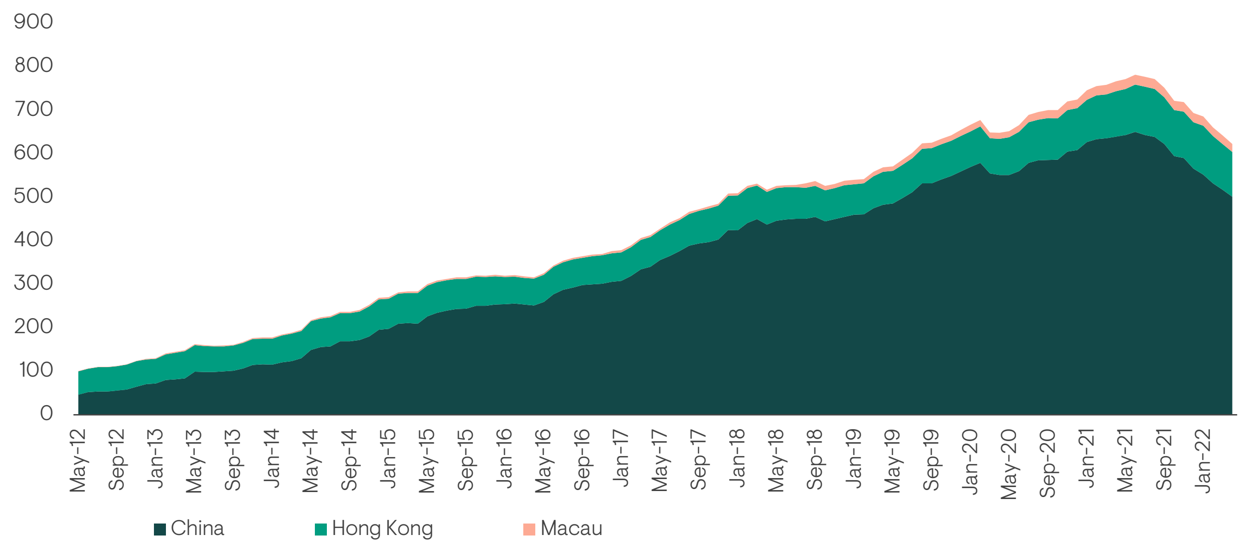
Figure 8. Size of bond market relative to nominal GDP (multiples)



Source: Bank for International Settlements, Bloomberg, Ninety One calculations, 30 September 2021.

The offshore China US dollar bond market has also seen significant growth over the past 10 years.

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

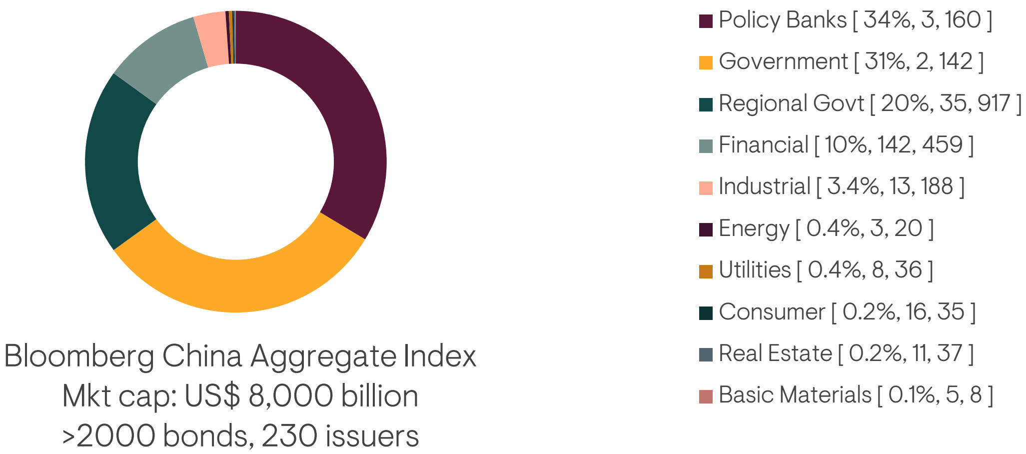


Source: JP Morgan. As at March 2022.

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[1] with a market capitalisation of US$8 trillion are more than 2,000 bonds issued by 230 entities.

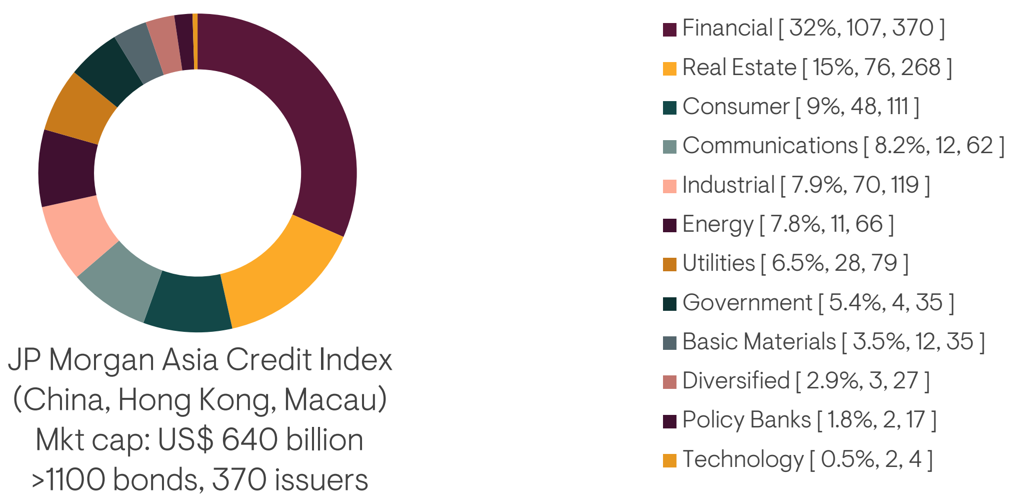
Figure 10. Onshore CNY bond sector composition [% of market capitalisation, number of entities, number of bonds]



Source: Bloomberg, JP Morgan, 31 March 2022.

While the onshore market is dominated by government-related issuances, China's offshore US dollar 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[2] alone are more than 1,100 bonds by over 370 issuers out of Greater China, with a market capitalisation of US$640 billion.

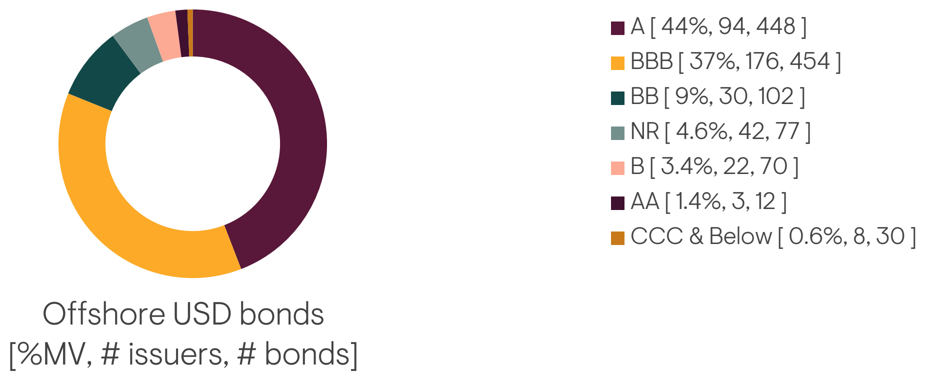
Figure 11. Offshore USD bond sector composition [% of market capitalisation, number of entities, number of bonds]



[1] 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.

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



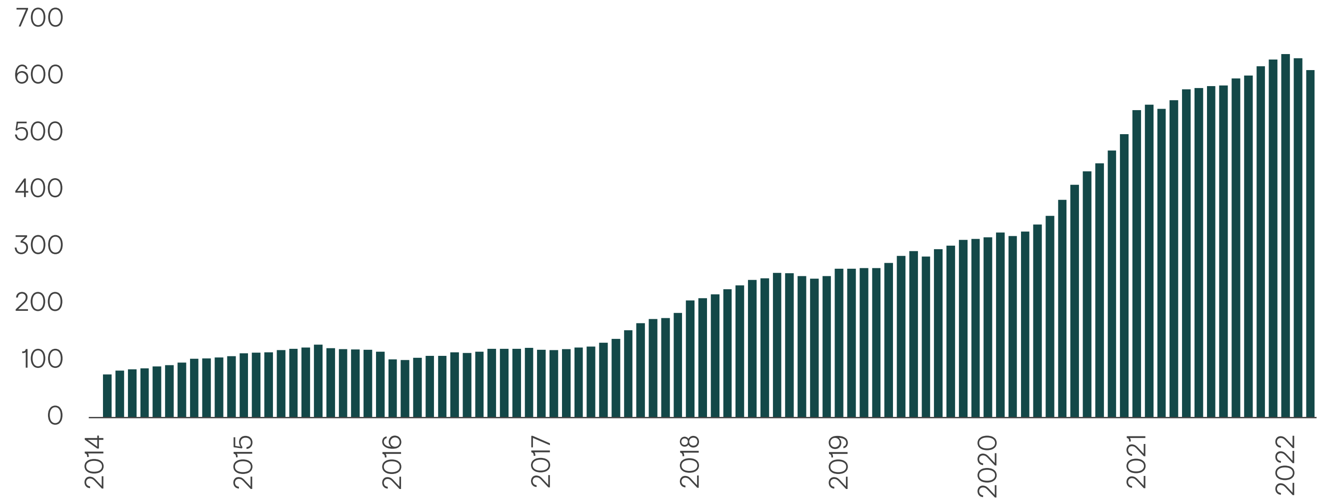
Source: Bloomberg, JP Morgan, 31 March 2022. Credit rating based on lowest of S&P, Moody's and Fitch issue/issuer ratings. Ninety One calculations. For further information on indices, please see the Important information section.

In addition to the main onshore CNY and offshore US dollar 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.

A more mainstream asset class

The widening of these markets to overseas investors in recent years has spurred a trend for increased allocations, with foreign investors pouring c.US$360 billion into onshore CNY bonds since 2019. Chinese renminbi-denominated government and policy bank securities were included to the Bloomberg Global Aggregate from April 2019, with China's current weight as at 31 March 2022 at 8.0%. Government bonds were added to JP Morgan's flagship GBI-EM bond indices from February 2020, and to the FTSE Russell World Government Bond Index from October 2021, continuing the mainstreaming of this asset class. Although it is increasing, exposure to China fixed income is still relatively low in global bond portfolios.

Figure 13. Foreign holdings of onshore CNY bonds (US dollar, billions)



Source: People's Bank of China, China Central Depository & Clearing, Shanghai Clearing House, 31 March 2022.

Conclusion

Investors that are able to look beyond the short-term headlines and consider what the China Fixed Income asset class truly is can find a compelling opportunity set.

Key features of China fixed income include its low correlation to other financial markets, providing attractive portfolio diversification, and yield pick-up compared to global developed market bonds.

China does things differently, and it is this difference that makes the China Fixed Income asset class interesting. The highly diversifying and potentially risk-reducing nature of China bonds, coupled with relatively high positive premia, imply that a significant allocation to China Fixed Income can materially improve the overall risk-reward experience for most investors. For as it is commonly said, portfolio diversification is the only true free lunch in our industry.

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