One-on-one interview

China fixed income in the Year of the Ox

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- As policy measures normalise and implicit government support wanes, credit differentiation is set to assume a pivotal role in China's bond market, underscoring the importance of credit fundamentals
- China bonds' attractive yield pickup over developed market peers which drew a record USD155 billion inflows in 2020, is likely to continue in 2021
- Currency (RMB) strength is expected to persist, underpinned by the strong exports sector and overall economic recovery

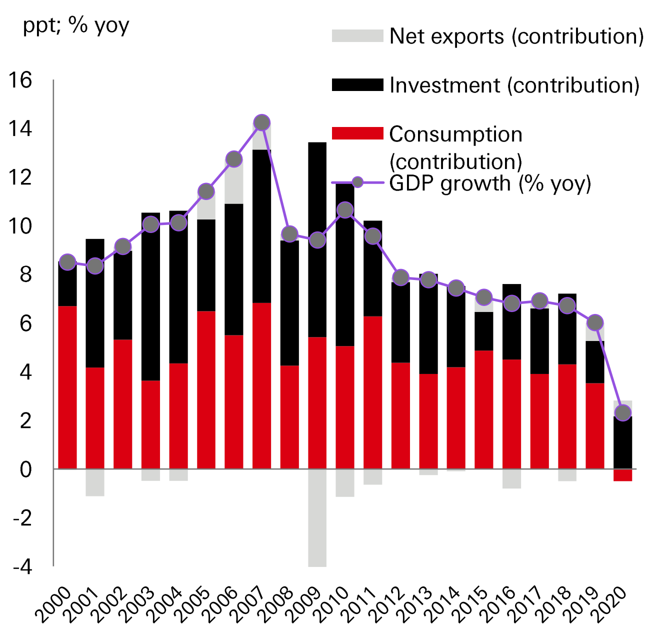
Amidst a mixed bag of headlines - strong growth rebound, policy normalisation and property sector tightening - what's your top-down view on the outlook for China bonds in the Year of the Ox?

Ming: 2020 has been one of the most volatile years in recent history for the global financial market, as the impact of the coronavirus led to one of the sharpest contractions in recent decades. Major central banks and policymakers have launched unprecedented measures to tackle the pandemic-hit economy, leading to a strong rebound in financial markets. In the China USD bond market, credit spreads have compressed substantially from a peak reached in March, but have not reached their pre-covid19 level.

In our view, China bonds remains an attractive asset class, given the supportive currency outlook, significant yield pick-up against developed market peers and solid economic rebound.

China is the first G20 country to recover from the pandemic and we expect the risk of another wave of infections to be relatively low. The 2021 GDP growth is expected to expand by 8.5%, accelerating from 2.3% in 2020. (See Fig 1) Domestic consumption and a rebound in global demand will be the key contributors. Still, the lack of inflation and pockets of uneven recovery in the economy will likely lead the People's Bank of China (PBoC) to stay accommodative while using its monetary policy tools, such as the open market operations and repos, to manage market liquidity. Compared with other economies, we expect a smaller fiscal deficit which should translate into a more moderate supply of government bonds, a technical support for the bond market.

Fig 1: China records positive GDP growth in 2020



Source: CEIC, NBS, data as of January 2021

Investment involves risks. Past performance is not indicative of future performance

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Ming: With Chinese authorities shifting back into a credit cleanup mode in recent months, a number of tightening measures targeting the property sector have been introduced. These include the "Three Red Lines" control on developers' leverage and new regulations capping bank lending to property developers and home buyers. In our view, we expect the policy tightening to be handled programmatically and the trend of broadly stable property sales and home prices to persist , given the importance of the sector to the banking industry and households. Against this backdrop, we expect consolidation to continue and credit differentiation will be important within the high-yield universe.

On the corporate side, China dollar bonds still enjoy the so-called "Asian Premium" as they offer attractive valuations, good liquidity with a shorter duration, when compared with the US credit market, USD emerging market or Euro credit. According to data from Bank of America, China's investment-grade and high-yield debt is trading 180bps and 760bp over US Treasury notes, offering strong incentives for yield-hungry investors. (See Fig 2)

What major markets events should China bond investors look out for over the next 12 months?

Ming: The meteoric rise of China's bond market to become the world's second largest is largely driven by local investors. The next stage of growth is expected to see greater participation from foreign investors who seek diversification and growth opportunities in the Chinese bond market. Amidst the low interest rate environment globally, we expect inflows into China's onshore bond market to continue, driven by the search-for-yield and index inclusion.

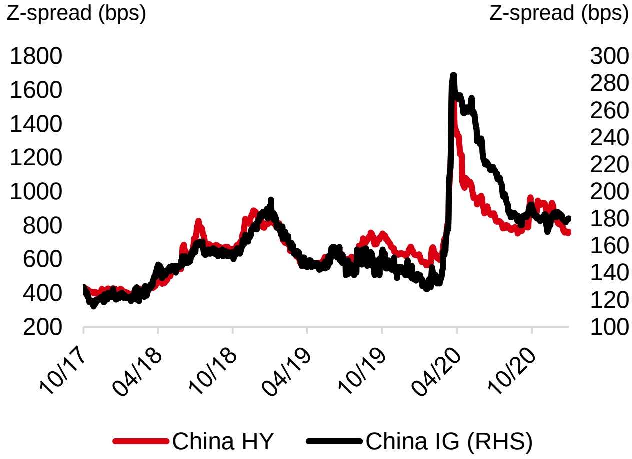
The onshore bond market received USD155 billion inflows in 2020, more than double the USD66 billion inflows in 2019, largely from long-term institutional investors. We believe the currency strength and enlarged yield spread with developed markets such as US and Eurozone is likely to persist in the next 12 months and prompt more inflows from a wider group of investors over the long run.

According to IMF data released in December, central banks globally increased their Chinese assets – primarily in long-term debt – by USD30 billion in the first nine month of 2020, underscoring the strong appeal of RMB-denominated assets among long-term focused reserve managers. Meanwhile, foreign ownership of onshore Chinese bonds stood at USD498 billion, or 2.8% of the total outstanding by 2020. Chinese government bonds remained the most invested debt by category for foreign investors with USD287 billion worth of holdings, followed by USD141 billion worth of policy bank notes – a form of a quasi-government bonds. (See Fig 3)

Looking ahead, we believe the China's inclusion in FTSE WGBI index is likely to be confirmed in March 2021 and the process will formally begin in October, driving a new wave of passive inflows into the onshore market. According to our estimates, the index inclusion by FTSE is expect to draw USD140-150 billion inflows into the onshore market, roughly USD7 billion of inflows per month, over a 20-month period.

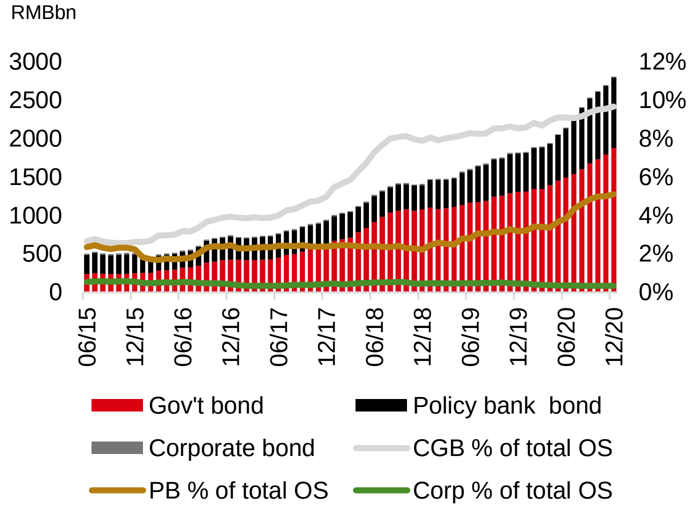
Prior to FTSE, the Bloomberg Barclays Global Aggregate Index started a 20-month phased inclusion of Chinese government and policy bank bonds in April 2019, and JP Morgan began its 10-month inclusion of Chinese government bond in its government bond index Emerging Markets in February 2020.

Fig 2: China USD bonds offer attractive yield pickup



Source: BofA as of December 2020

Fig 3: Surging foreign ownership of onshore bonds



Source: Wind as of December 2020

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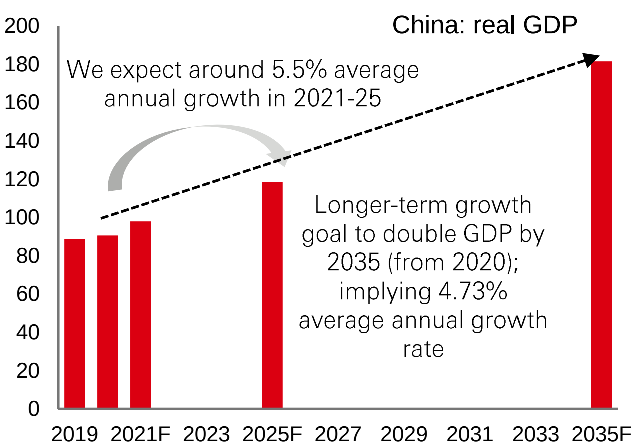
Domestically, Chinese policymakers are expected to accelerate the pace of structural reform in order to achieve more sustainable and higher quality growth over the long-run. The so-called "Dual Circulation" strategy and the new Five-Year Plan (2021-2025) aimed at doubling China's GDP by 2035 will bring the reform focus to areas such as technology, domestic consumption and financial market liberalisation. (See Fig 4) We expect policymakers to lay out their economic goals and strategic priorities after the annual parliament meetings of the National People's Congress and the Chinese People's Political Consultative Conference in early March.

In addition to its financial market liberalisation, the country's increasing efforts to promote sustainable development and combat climate change has led to a strong issuance of green bonds. According to PBoC, the country's outstanding green lending exceeded RMB11 trillion (USD1.7 trillion) in June of 2020, the world's biggest, while its green bonds reached RMB1.2 trillion, the world's second largest.

Sectorally speaking, we think the focus could shift from cutting (idle) capacity in high-polluting materials and heavy industries, such as coal and fossil fuel, as in the previous Five-Year Plan (2016-2020) to investing more in environment-related equipment, infrastructure, and services. China, the world's largest producer of greenhouse gases, has set the goal of peak greenhouse gas emissions before 2030 and carbon neutrality by 2060, and this should prompt more investments in renewable energy in the long-run.

Fig 4: The goal of doubling GDP by 2035 implies 4.7% average annual growth in 2021-35



Source: HSBC Global Asset Management as of January 2021

What is your outlook for onshore defaults in China?

Ming: Recent defaults by a number of state-owned enterprises in China has led to renewed concerns over credit risks and the implicit government support. However the default scenario was manageable. According to data from Bank of America, China's onshore default rate is still relatively low and significantly lower than the default rates in the US and emerging markets overall. (See Fig 5)

For 2021, we think policymakers will allow market forces to play a larger role in risk assessment and in driving credit differentiation, while stepping in to prevent any systemic risks. This will be the continuation of a healthy theme. On the whole we expect policy normalisation to lead to a steady rise in defaults, despite our expectations for an economic rebound.

In our view, active managers can take advantage of arbitrage opportunities between the onshore and offshore markets.

What's your view on the RMB?

Ming: We hold a constructive view on RMB appreciation. As discussed previously, a strong exports sector and rising rates differential underpins the Chinese currency, which has advanced 1% so far this year. By 2030, the RMB could potentially make up 5% to 10% of global reserve assets translating into an estimated USD 3 trillion flows over the next decade, as the currency regime continues to be reformed. The RMB was the fifth most active currency for global payments by value in 2020. While its 2.00% share is relatively low, over the long run, the Belt and Road initiative, the recently signed regional trade agreements and the digitalisation of the currency should boost the international usage of the RMB.

Fig 5: China's onshore default remains manageable

Source: BofA, data as of December 2020

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