Time to reconsider Chinese bonds

Chinese bonds offer a valuable source of diversification from a global portfolio perspective

Ian Chong, Senior Portfolio Manager
Chris Rands, Senior Portfolio Manager
Naomi Fink, Chief Global Strategist

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Global markets may be missing the obvious, quieter China trade

China has been making headlines lately, but not all of it has been positive. The country is facing challenges such as the rise in global trade barriers, excess inventories of industrial materials (ranging from copper to solar panels), a sluggish property market and slowing consumer demand. As a result, the stock market has been subdued. However, there may be an opportunity for investors to consider. Despite the negative news, global markets may have overlooked something important.

We believe **that China's bond market offers global investors much more than** what is immediately apparent. In our view, Chinese bonds are an asset class that provides good diversification opportunities within a global portfolio. They also represent a relatively **"safe" asset**, thanks to **China's** current account surplus and efforts to generate consumer price rises in a world where others are struggling to keep inflation contained. As a result, it could be an error to overlook Chinese bonds—and indeed renminbi (RMB)-denominated bonds—within a global portfolio when considering both Chinese and global market dynamics.

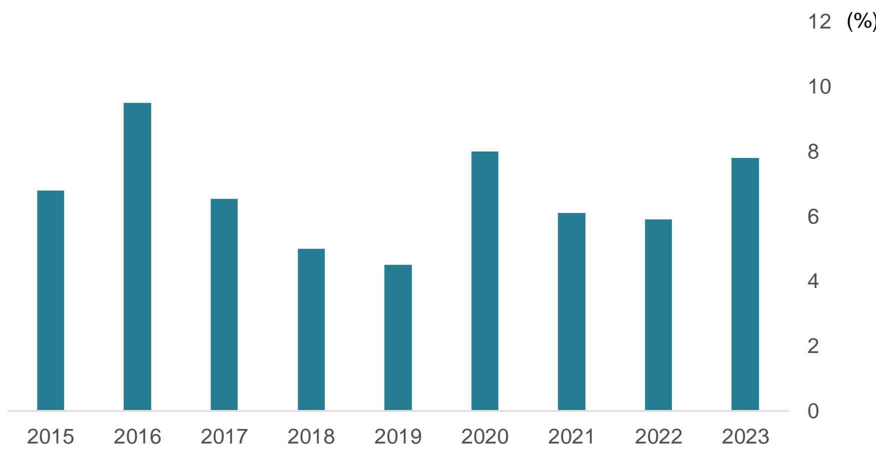
China's bond-friendly domestic dynamics

For retail investors, slower economic growth and low to negative inflation may not be appealing for equity investments. However, these conditions can actually make bonds a more attractive option. Here are a few reasons why:

— Slow Chinese growth**: China's economy is** currently undergoing government-led restructuring, moving away from real estate towards **"new" economy sectors such as electric vehicles, artificial intelligence and advanced** manufacturing. Although this transition is expected to impact overall growth for now, it may be necessary given the much larger size of the economy compared to the previous decade and an ageing population. As a result, **China's growth will be** inherently slower than we have been used to.

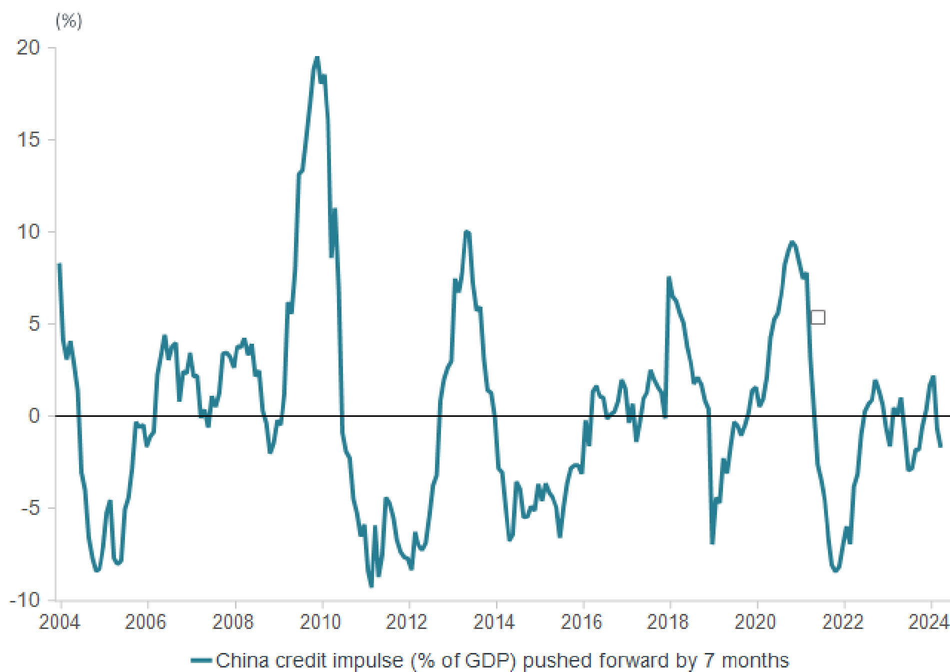
— Low inflation: The impact of economic restructuring (especially the negative wealth effect and sentiment related to falling home prices) and the lack of direct cash transfers to households during the pandemic have led to slower demand and lack of inflationary pressures. Despite the slowdown over the last few years, China has still managed to reserve room for monetary policy to support growth, should the need arise.
— Measured fiscal stimulus: Fiscal policy is accommodative but measured, and we believe that the market could absorb a slightly higher supply of government bonds without causing excessive volatility.
— Very low probability of default: The likelihood of default, either externally or internally, by Chinese government entities is very low, given factors such as high external surpluses. Although China's gross debt-to-GDP (Gross Domestic Product) is high, much of this is denominated in local currency. Moreover, domestic indebtedness has slowed, as indicated by China's credit impulse (see Charts 1 and 2).

Chart 1: China's net debt issuance has remained relatively controlled in recent years



Source: WIND, Bloomberg, NBS, June 2024

Chart 2: China's credit impulse shows domestic indebtedness has slowed

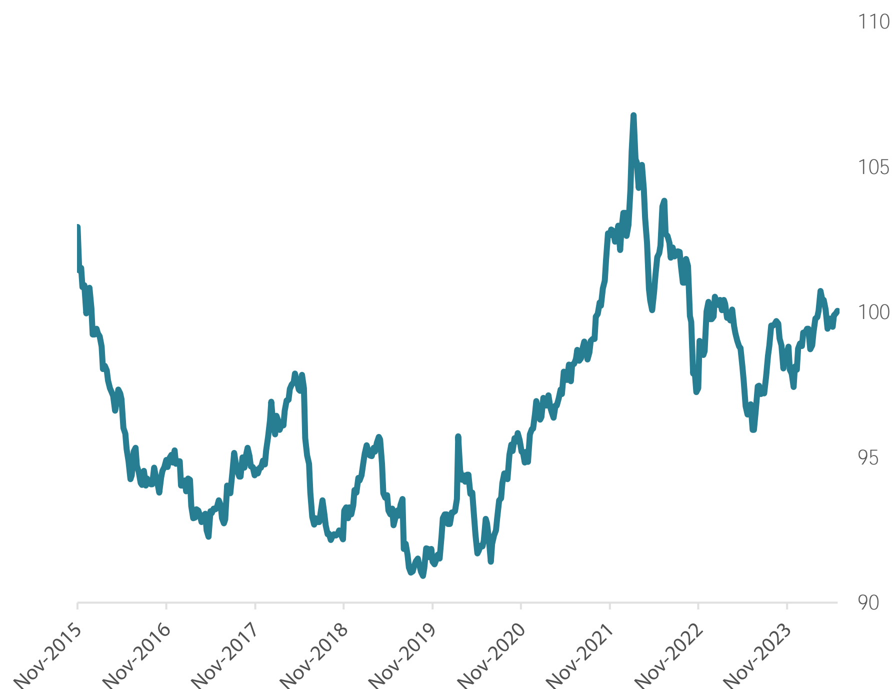


Source: Macrobond, June 2024

Currency advantages: positive fundamentals for the RMB

The RMB benefits from China having a current account surplus, which can help it weather periods of investment outflows. The currency has already corrected somewhat in 2022 against the CFETS (China Foreign Exchange Trade System) index (a trade weighted currency basket) when China was hit hardest by the COVID-19 pandemic (Chart 3). Additionally, the Chinese government has taken measures to mitigate volatility, creating more favourable conditions for risk/return. Despite these advantages, the RMB is under-represented in global reserves. Therefore, the Chinese government's desire to strengthen the domestic bond market could help support the recovery of Chinese domestic demand and further support the currency's recovery.

Chart 3 : RMB vs CFETS (trade partner) basket



Source: Macrobond, June 2024

Trade tensions between the US and China may be on the rise, but there are signs of strengthening trade ties within Asia (including Japan), which might also increase demand for RMB-denominated assets among reserve-holding economies in the region.

Portfolio advantages: diversification through Chinese bonds

Nikko AM's risk model (Table 1) depicts the unique characteristics of the Chinese bond market, with correlations staying negative against most equity markets and only marginally positive against the traditional sovereign bond markets. Over the past three years, the Chinese monetary policy cycle has decoupled from the developed world, with falling cash rates in China enabling its bond market to play a more traditional role in defensive portfolio allocation. Additionally, as described above, the low inflation levels, slowing property sector and reduced growth trend imply that these defensive characteristics are likely to persist as Chinese monetary policy will remain decoupled from Western countries.

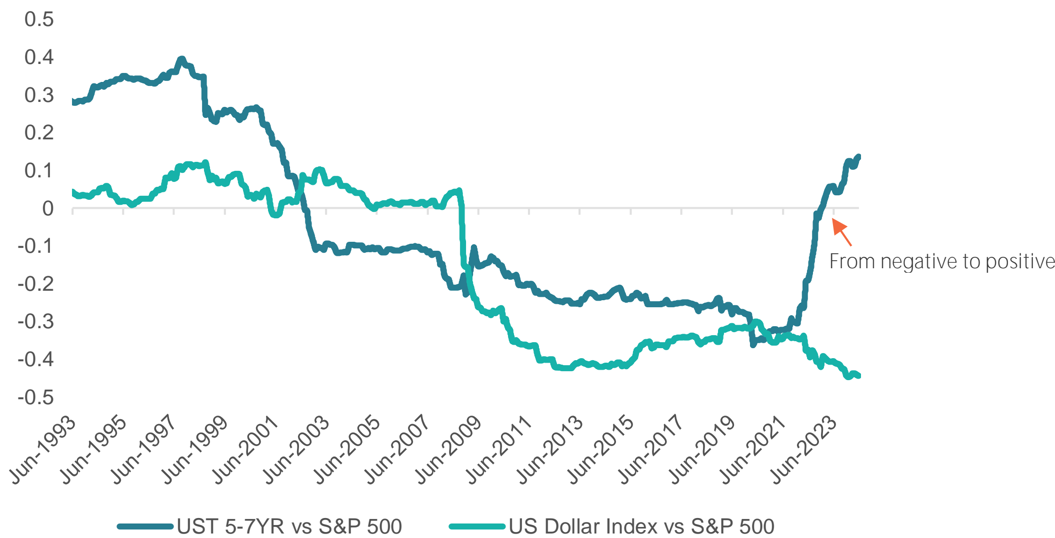
Table 1: Chinese bonds are a good diversifier

Asset	S&P500	MSCI EU	FTSE100	TOPIX	ASX200	MSCI LATAM (unhedged)	MSCI ENR	US HY	EU HY	USTs 5-7YR	Germany 5-7YR	Japan 5-7YR	China 5-7YR	EM LC (unhedged)	Gold
S&P500	100.0%	84.0%	69.0%	66.4%	76.5%	61.4%	58.6%	78.5%	70.8%	11.6%	17.2%	14.5%	-6.5%	54.9%	8.8%
MSCI EU	84.0%	100.0%	82.3%	70.5%	77.4%	60.6%	62.6%	74.6%	75.3%	3.1%	7.1%	7.1%	-12.4%	56.8%	3.0%
FTSE100	69.0%	82.3%	100.0%	56.3%	72.8%	60.0%	71.5%	64.7%	65.7%	-4.7%	-3.2%	-0.3%	-10.0%	48.8%	7.7%
TOPIX	66.4%	70.5%	56.3%	100.0%	56.8%	57.0%	49.5%	51.3%	53.6%	-23.6%	-16.4%	-16.8%	-15.0%	68.8%	7.9%
ASX200	76.5%	77.4%	72.8%	56.8%	100.0%	59.0%	56.9%	73.4%	72.2%	4.8%	12.6%	14.9%	-14.6%	50.6%	6.5%
MSCI LATAM (unhedged)	61.4%	60.6%	60.0%	57.0%	59.0%	100.0%	62.8%	62.2%	59.5%	-23.8%	-19.2%	-0.7%	-8.0%	70.3%	24.9%
MSCI ENR	58.6%	62.6%	71.5%	49.5%	56.9%	62.8%	100.0%	53.5%	51.7%	-23.9%	-16.5%	-10.7%	-2.5%	39.9%	4.5%
US high yield	78.5%	74.6%	64.7%	51.3%	73.4%	62.2%	53.5%	100.0%	90.6%	17.5%	23.4%	20.1%	-11.8%	46.8%	5.7%
EU high yield	70.8%	75.3%	65.7%	53.6%	72.2%	59.5%	51.7%	90.6%	100.0%	4.2%	13.6%	9.8%	-13.0%	48.3%	6.2%
USTs 5-7YR	11.6%	3.1%	-4.7%	-23.6%	4.8%	-23.8%	-23.9%	17.5%	4.2%	100.0%	77.4%	55.1%	16.2%	-21.0%	-3.0%
Germany 5-7YR	17.2%	7.1%	-3.2%	-16.4%	12.6%	-19.2%	-16.5%	23.4%	13.6%	77.4%	100.0%	58.4%	17.5%	-19.7%	-7.2%
Japan 5-7YR	14.5%	7.1%	-0.3%	-16.8%	14.9%	-0.7%	-10.7%	20.1%	9.8%	55.1%	58.4%	100.0%	12.6%	-4.7%	-4.1%
China 5-7YR	-6.5%	-12.4%	-10.0%	-15.0%	-14.6%	-8.0%	-2.5%	-11.8%	-13.0%	16.2%	17.5%	12.6%	100.0%	-10.4%	-9.5%
EM LC (unhedged)	54.9%	56.8%	48.8%	68.8%	50.6%	70.3%	39.9%	46.8%	48.3%	-21.0%	-19.7%	-4.7%	-10.4%	100.0%	34.1%
Gold	8.8%	3.0%	7.7%	7.9%	6.5%	24.9%	4.5%	5.7%	6.2%	-3.0%	-7.2%	-4.1%	-9.5%	34.1%	100.0%

Source: Nikko AM, June 2024

This can be compared to the correlation between risk assets and US Treasuries, where the correlation to the S&P 500 has gone from negative to positive (Chart 4). Contrary to China, high inflation and rising cash rates in the US have resulted in the performance of all financial assets becoming more similar, meaning that the traditionally defensive asset once used to diversify risk is now contributing to an increase in portfolio volatility. Should inflation prove to be stickier than the market currently expects, it would be reasonable to expect that this would keep the correlation higher than it was over the past 20 years, leading to a more consistent relationship between equity and bonds that that is similar to what occurred in the 1990s. Chart 4 below depicts the shift that has occurred in the US Treasury market over the past three years, compared to the US dollar, which has become a more defensive alternative.

Chart 4: Correlation between US Treasuries and the S&P 500 according to Nikko AM's long-term risk model



Source: Nikko AM, June 2024

Hedged or unhedged?

Currency-hedged bonds currently yield only marginal returns. Chinese bonds are no exception; for example, the 10-year CGB yields approximately -0.40% for a Japan-based investor when hedged back to yen[1]. However, because the Chinese yuan is managed against a basket of currencies with a high weighting for the dollar, the currency shows more resilience against the strength of its US counterpart. Importantly, while US Treasuries have increased their correlation to risk assets over the past three years, the dollar has retained its negative correlation as depicted above.

This implies that holding unhedged Chinese bonds can lead to increased diversification, depending on the base currency used by the investor. Table 2 below shows the effect of unhedged as well as hedged Chinese bonds for both Japanese yen and Singapore dollar investors. Interestingly, for the investor using the Singapore dollar, removing the hedge on Chinese bonds leads to improved diversification against risk assets, while for the investor using the yen, it results in strong levels of diversification against interest rate duration risk (notably US 5 to 7-year). This can offer additional protection in the portfolio depending on the asset mix and can help improve yield by reducing hedging costs.

Table 2: Effect of hedged, unhedged Chinese bonds according to Nikko AM's long-term risk model

Asset	S&P500	MSCI EU	FTSE100	TOPIX	ASX200	MSCI LATAM (Unhedged)	MSCI ENR	US HY	EU HY	US 5-7YR	Germany 5-7YR	Japan 5-7YR	EM LC (Unhedged)	Gold
China 5-7YR (Hedged - JPY Investor)	-6.5%	-12.4%	-10.0%	-15.0%	-14.6%	-8.0%	-2.5%	-11.8%	-13.0%	16.2%	17.5%	12.6%	-10.4%	-9.5%
China 5-7YR (Unhedged - JPY Investor)	7.6%	11.2%	9.4%	45.9%	4.0%	24.8%	13.8%	-12.0%	-3.8%	-48.8%	-33.9%	-29.7%	53.9%	21.8%
China 5-7YR (Unhedged - SGD Investor)	-33.9%	-32.9%	-32.7%	-24.8%	-32.2%	-37.4%	-26.8%	-37.4%	-34.5%	6.3%	12.9%	-5.8%	-19.7%	-3.7%

Source: Nikko AM, June 2024

Note: this figure presents a heat map of diversification benefits in terms of weighted correlation between individual indices and an index of Chinese 5 to 7- year sovereign bonds, either (a) fully hedged into Japanese yen (JPY) or (b) unhedged versus (i) a portfolio with base currency of JPY and hedged unless otherwise noted or (ii) a portfolio with base currency of Singapore dollar (SGD) and hedged unless otherwise noted. It is clear to see that for the SGD-denominated portfolio, holding China 5-7 year bonds un-hedged provides diversification benefits against equity risk, though less so for the JPY-denominated portfolio, which achieves better diversification benefit against equity risk from holding the bonds hedged.

Should we worry about the US fiscal position?

In the context of this report, the final point worth exploring is whether the US fiscal balance is sustainable with respect to US Treasuries. Currently, the US government is running a fiscal deficit exceeding 5% of the GDP[2], a deficit level that has historically been seen only during recessionary periods. This high level of deficit will increase the government's debt burden, leading to greater bond issuance. As the International Monetary Fund (IMF) describes, this may make the last mile of disinflation harder to achieve. If inflation remains high and the US government needs to issue a large amount of bonds, it may be prudent to continue diversifying away from US Treasuries to avoid higher financing costs which could make the debt trajectory unsustainable.

On the other hand, although China also has relatively high levels of debt, its general government debt-to-GDP ratio remains lower than that of the US. Moreover, China's lower interest rates make servicing of interest costs more manageable. While it remains unclear whether the US debt load will become unsustainable, from a global portfolio perspective we believe that the diversification benefits on offer and China's low inflation environment make the country's bonds a key market to explore as an alternative to US Treasuries.

Conclusion: Chinese bonds offer a valuable source of diversification

As we have outlined above, there is not only a compelling case for Chinese bonds on their own merits, but also as a valuable source of diversification in a global multi-asset portfolio. Chinese bonds can provide diversification against risk assets where traditional "risk free" assets (developed market government bonds) have recently underperformed.

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[1] Source: Bloomberg, June 2024
[2] Source: US Congressional Budget Office, June 2024

There is also a significant probability that Chinese bonds will continue providing good diversification value in the future. This is due to the diverse macroeconomic dynamics between China and many developed bond markets, notably the US. Meanwhile, the RMB may provide diversification in its own right. However, we believe that the currency diversification value it offers depends on the currency denomination of the underlying portfolio.

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