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Chinese bonds

All you need to know

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Riding the waves will prepare you for opportunities in 2018

As we move into 2018, we're reflecting on air miles clocked up and numerous client meetings all over the world in 2017. Importantly, we're evolving our understanding of how China's new five-year plan will impact the macro outlook of the world for the foreseeable future. Our clients have asked the same questions repeatedly on China's bond market opening up; hence we will focus on highlighting the opportunities for the year ahead.

Are onshore bonds freely tradeable?
Yes. Access has changed during the past year and institutional investors have unlimited access to China's markets. This marks a major change from 2016, when free access was limited to sovereign wealth funds and central banks. You no longer need to apply for quotas.

The Bond Connect, started in July 2017, offers an alternative for smaller investors to invest in China's onshore bond market, and marks the latest stage of China's integration with global financial markets.

Will the RMB internationalize any time soon?
Yes, the inclusion of the Renminbi (RMB) in the IMF's SDR basket from September 2016 was a milestone development. Additionally, reforms to the domestic money market, opening of the stock and bond markets through the Connect programs, introduction of a RMB-denominated international payments system, expansion of Free Trade Zones across China, new overseas centers for RMB clearing, and new currency swap agreements, show RMB internationalization is progressing.

Notably, the birth of "PetroYuan" is upon us. China is pushing ahead with its plans to launch oil trading futures on Chinese stock exchanges as an alternative to Brent or West Texas and price oil contracts in RMB rather than USD. China is the biggest oil importer globally, and it wants to reflect this by pricing contracts in its own currency.

If successful, and more widely adopted, it means wider use of the RMB globally and a greater push for it as a reserve currency. We assume many large oil producing countries, under the strain of sanctions or where they are geopolitical competitors of the US, will quickly gravitate towards this new PetroYuan regime.

The "Belt and Road Initiative," which involves Chinese companies, also serves to increase China's economic influence. Payments could eventually involve the RMB, as could financing, which would help to further internationalize the currency.

So we see RMB internationalization as a case of 'when' not if, and with steady progress through the above supporting measures, investors need to get prepared for the RMB to play a bigger role on global currency and trade markets.

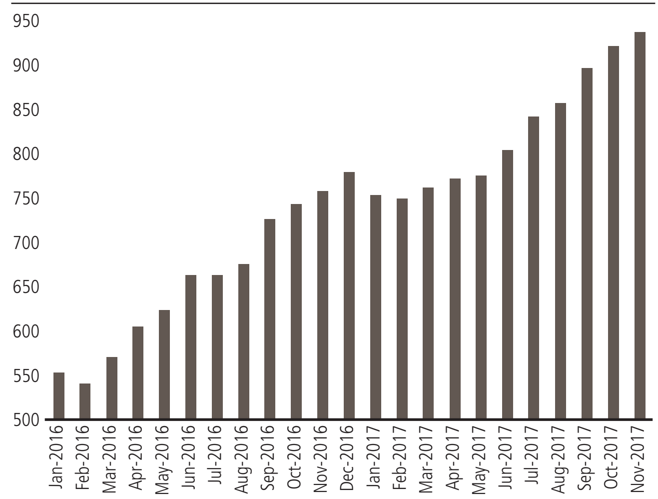
Indeed, overseas institutional investors are already preparing for this coming reality – have steadily and significantly upped their holdings of RMB-denominated onshore bonds.

What yield can I get on Chinese bonds?

Chinese government bonds offer some of the best value on the market right now and have seen a substantial yield lift through 2017. More significantly, a large wedge since 2008 has opened up between the yields of Chinese government bonds and those offered in other key bond markets, namely Japanese and European government bonds.

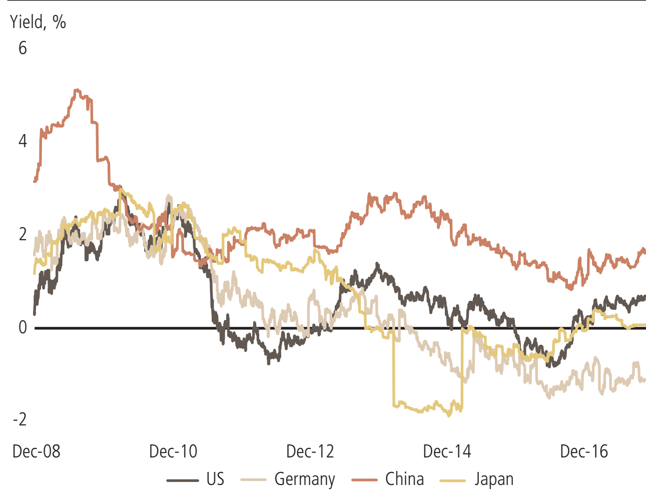
From a long-term perspective, Chinese 10-year government bonds have been more stable than those in more developed markets. Post-2009, we have seen a structural break emerge on international bond markets as global central banks have flooded markets with liquidity and cut interest rates.

Fig. 1: Overseas institutional holdings of onshore bonds (RMB billions), Jan 2016-Nov 2017



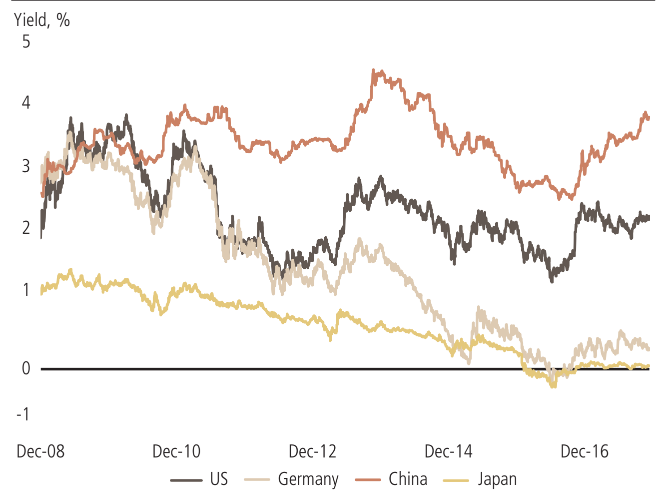
Source: Bloomberg, December 2017

Fig. 2: Real 10-year yields compared, Dec 2008-Dec 2017



Source: Bloomberg, December 2017

Fig. 3: Nominal 10-year yields compared, Dec 2008-Dec 2017



Source: Bloomberg, December 2017

We see no realistic prospect of a meaningful change in the low-yield situation with Japanese and European bonds anytime soon given their continued loose monetary policy, while US bonds relative to Chinese bonds offer little in the way of value due to low real and nominal yields.

In comparison, Chinese government bonds offer high nominal yield in the world's third largest bond market. The onshore market is liquid – seeing RMB 100 trillion of turnover YTD at the end of November 2017 – and represents a safe investment since China is the second largest creditor nation in the world. In the world of fiat currencies finding a country that's a net creditor nation is a rarity!

The outlook for 2018

Deleveraging – China's political economic cycle
Preventing and defusing major risks is one of three core tasks for 2018 and the people and policies have been lined up to rein in credit growth and cut China's debt pile.

New bodies, such as the Financial Stability and Development Committee, have been set up to lead a sustained debt crackdown in 2018.

So far, we have seen curbs on wealth management products and controls on local government debt issues. Recently announced policies have regulated the asset management sector, forced banks to improve liquidity management, cracked down on micro-lending, pushed zombie companies into bankruptcy, and slapped misbehaving banks and executives with sizeable fines.

On the infrastructure side, the Ministry of Finance tightened public private partnership (PPP) financing and investment regulations. Not only were PPP guidelines tightened on types of projects they ought to decline, the new directives even set out ones to be eliminated from the backlog of accumulated projects.

China's subtle deemphasizing of an explicit growth target and the constant stream of statements on the quality, rather than the quantity, of GDP growth tells us that deleveraging is going to continue well into 2018.

That means higher interest rates and slower growth – in line with the mini-political economic slowdown highlighted in August 2017 – will support the attractive bond yields we have been seeing in past months and well into next year.

Fig. 4: Interest rates and yields, Oct 10, 2016-Dec 5, 2017

Source: Bloomberg, December 2017

But it's still all about China

But while headline growth numbers may slow, China's contribution to the global economy will still be massive. Global growth through 2018 has China at the centre, contributing an estimated 35.2% of total growth between 2017 and 2019 according to World Bank estimates, compared with 17.9% for the US and 7.9% for the European Union.

If China is the key driving force of global growth, understanding the structural change China is striving to implement in the underlying quality of growth, very different to the past approach, will be critical to investor's global macro understanding.

New industries and medium-to-high level consumption will be at the forefront. Campaigns such as Made in China 2025 mean advanced manufacturing in the fields of robotics and artificial intelligence will be applied to existing industries, like autos and electricals, and the development of new ones.

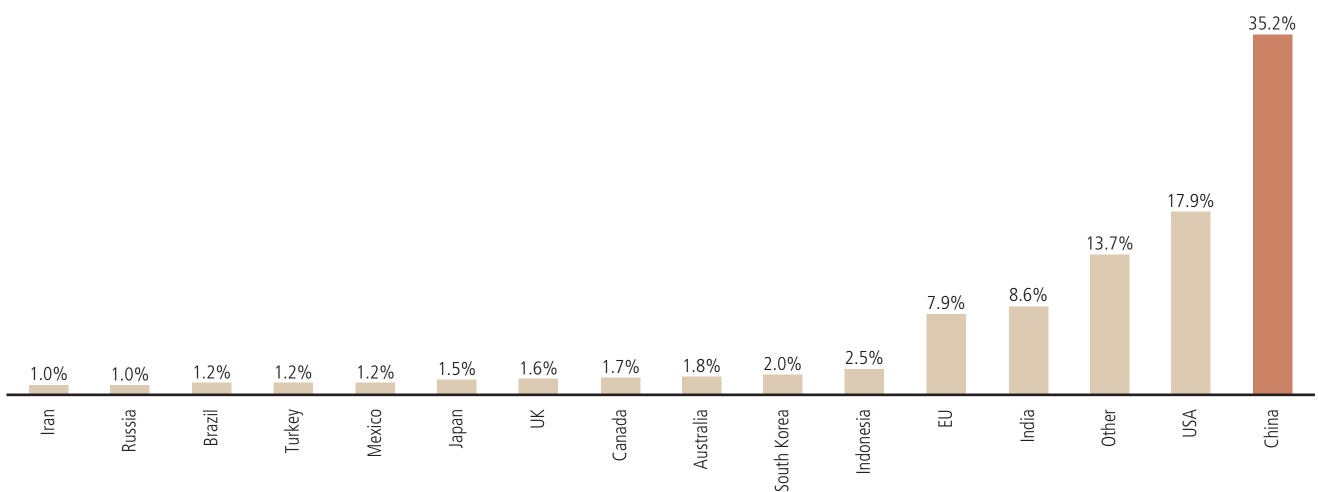
Looking over the past year, China has been proactive about damping down the growth drivers of the past by reining in money supply growth and squashing fixed asset investment, two principal drivers of China's old economy.

The real estate market has been brought under control with far-reaching policies to control speculation and instill discipline on real estate developers. New reforms to develop rental housing will offer a new model of residential development that will change the shape of the market. Despite controls, demand for housing will remain strong, driven by upgrading needs from city residents and the steady flow of migrants into China's cities as urbanization progresses.

Inefficient, heavy industry has taken a pounding from forced closures and tightened environmental protection regulations and infrastructure development – often a symbol of misguided initiatives – has been squeezed, particularly through the imposition of controls on PPP programs.

With liquidity tight at the local government level, we see little chance of a return to the old days of investment-led growth and see strong prospects for new economic drivers.

Fig. 5: Contribution to global growth, 2017-2019



Source: IMF, World Bank (2017)

The changing drivers of China's economy

M2 growth

10-yr average

15.5% yoy, p.a.

2017 YTD

9.8% yoy

Fixed asset investment

10-yr average

18.6% yoy, p.a.

2017 YTD

7.2% yoy

SUV sales

10-yr average

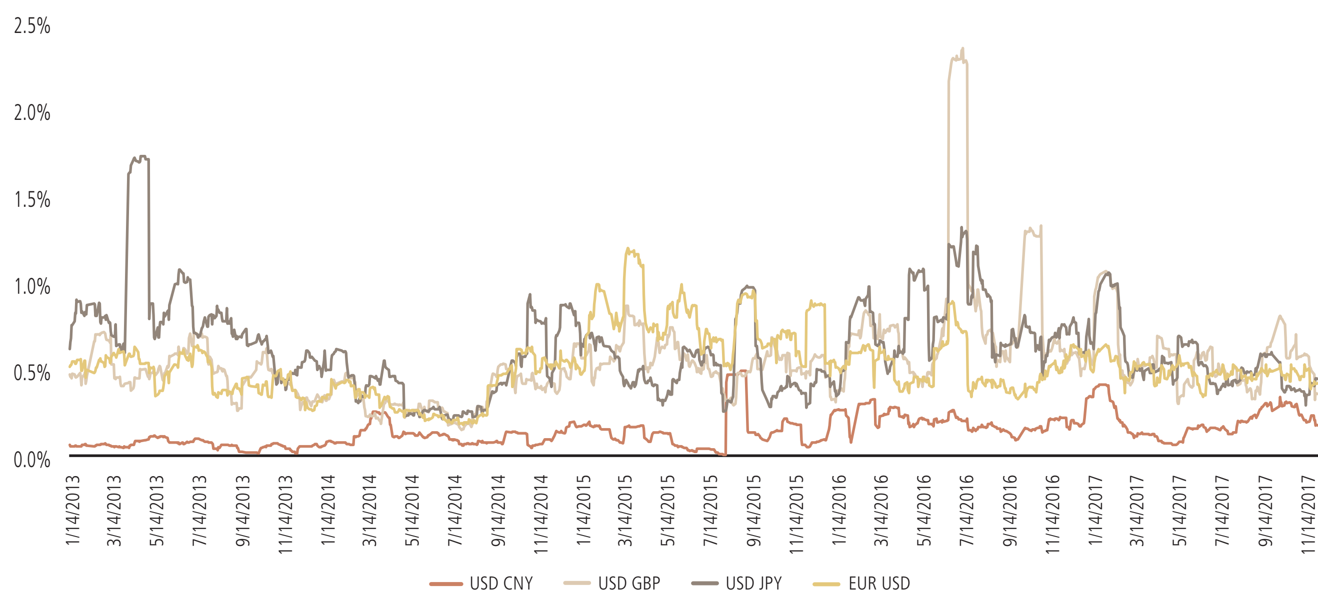
311,453 per month

2017 YTD

826,413 per month

Source: Bloomberg, December 2017

Fig. 6: Currency volatility, 2013-2017

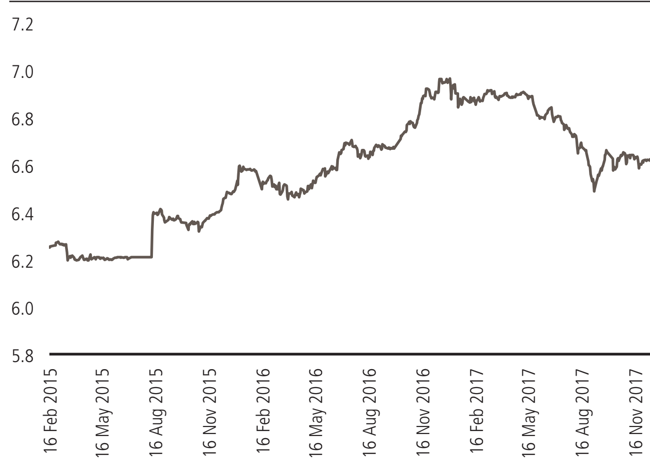


Source: Bloomberg, December 2017

Going long on RMB

RMB has staged something of a recovery this year and we're long on the RMB. This is mainly because the RMB has a proven track record of stability. Despite a one-off, policy-driven depreciation in 2015, the RMB has proven to be a low volatility currency, particularly when compared with other major cross rates globally and against the CFETS trade-weighted basket, a currency index developed by China that includes the RMB and 13 other currencies.

Fig. 7: CNY CFETS basket, Feb 2015-Nov 2017



Source: Bloomberg, December 2017

2018 indices inclusion to boost RMB holdings

International investors are steadily increasing their China allocations, particularly to the onshore bond market, and that's going to continue as global indices include China in their global benchmarks.

At the end of September 2017, overseas investors held a total of RMB 1.1 trillion in onshore bonds, up approximately 27.0% y-o-y, according to data from the People's Bank of China.

Major bond indices have already moved to include China in their index measures. Bloomberg Barclays launched their Global Aggregate plus China Aggregate Index, with a view that China will be fully integrated at some stage in the near future. Other influential index providers such Citigroup and JP Morgan have taken similar steps to include Chinese bonds.

What's unusual is that this is the first time index providers have included a bond market in both the developed and emerging market indexes. Hence the allocations will be structural in nature with the amount of passive money now tracking the indexes.

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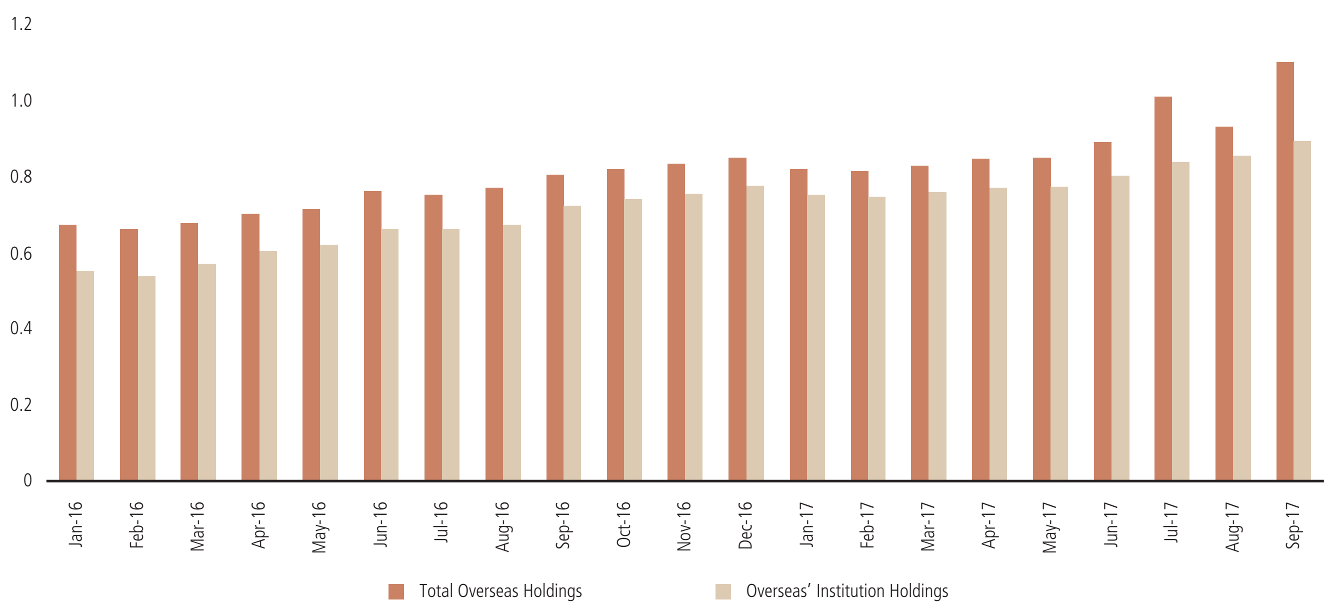
As China continues to open its financial market, it's only a matter of time before global indexes, such as the World Government Bond Index, Global Aggregate Bond index, and Government Bond Index-EM Global Diversified Index, include China in their main indices.

When they do that, we'll see a major reallocation of capital to China as companies fall in line with benchmarks. Since UBS estimates that foreign investors hold only 2.1% of the market, or an approximate USD 166.8 billion of a USD 7.6 trillion market, we see a continuation of international investor demand in the coming years.

Fig. 8: Overseas investors' holdings of onshore bonds (RMB trillions), Jan 2016-Sep 2017



Source: People's Bank of China, Bloomberg, December 2017

Conclusion

Looking back over the past year, reforms to China's bond market have made it more accessible than ever for international investors.

With China laying the foundations for the full internationalization of the RMB, China's expanding role in the global financial system is something that investors need to prepare for, particularly since we expect global indices to include China's onshore market in their benchmarks over the next 12 to 24 months.

China's mini-political economic slowdown signals slower growth, but that's because China is undergoing a structural change where advanced manufacturing and mid-to high-end consumption are taking the lead and credit-fueled investment is being slowly withdrawn.

Despite slower domestic growth, China will overwhelmingly drive the world economy in the coming years driven by a new economic model underpinned by high-tech manufacturing and consumption.

We believe that tighter monetary policies through 2018 will maintain the high yields on 10-year Chinese Government bonds at around 4% and the high nominal yields on offer mean an attractive carry trade compared to options in the US, Europe, and Japan.

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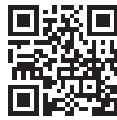

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