HSBC Global Research

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The Major bond letter

#8. Lucky number

Free to View
Fixed Income - Rates

Global

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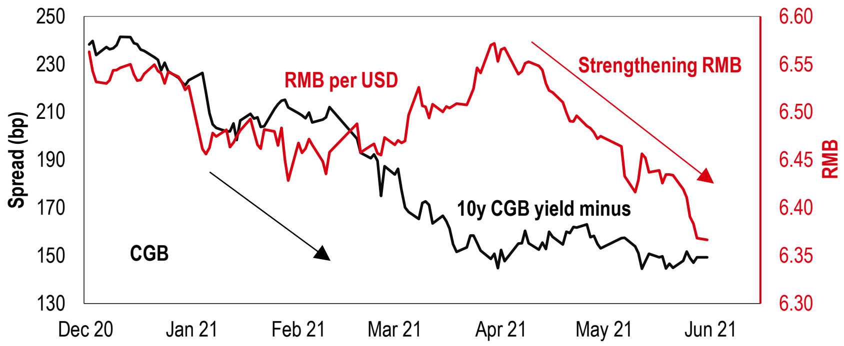
China's aggregate bond index is more than 8% ahead of the US equivalent, in dollar terms, and based on the last six months. Associated with wealth and luck, the number '8' is apparently the most favoured in modern China, so it seems fitting for this month's bond letter focuses on the market's increasing diversification into Chinese bonds.

Now, the challenge is to make the appropriate adjustments in the face of recent developments. We cannot rely on luck alone and need first to recognize where the performance will most likely come from (see our *bond letter #2*, 19 November 2020). An assessment of past relative performance will show USD-based investors that the three key moving parts have been China's currency, US Treasury yields, and the increasing pace of defaults amongst China's onshore corporates.

First, the renminbi (RMB), China's currency, has appreciated by more than 3% versus the US dollar over the last six months, with most of this strengthening in the last two months (see chart). Explanations include the strong post-pandemic recovery, along with strong inflows into bonds and equities.

Figure 1. China outperforming US – bonds and currency



Note: Daily data, last six months
Source: Bloomberg, HSBC

Second, the 10-year Chinese government bond (CGB) yield is 18bp lower than six months ago, and now stands at 3.07%, double the yield on Treasuries, and still far above other major government bond yields; e.g. German and Japanese bonds yield -19bp and 7bp respectively. Over the last six months, the Bloomberg local currency index for CGBs has returned 3.4%, and more importantly, CGBs resisted the rise in US Treasury yields, which means the 10-year spread tightened almost 100bp.

Global investors have been richly rewarded from diversification over the last six months (see chart). US Treasury returns are down about as much as Chinese equivalents are up (using Bloomberg indices). Including the currency means China government bonds generated about 10% to the USD-based investor.

Third, the higher level of corporate defaults on local bonds, is a double-edged sword. What is good for government bonds is bad for credit, hence the China aggregate index is lagging government bonds. This is because the Chinese authorities have been moving in a different direction to their counterparts in the US and Europe, where bailouts and furloughs have been used to ease the pain of the pandemic.

China's approach has been to lean against the leverage in the system, rather than add to it. According to Bloomberg data, there have already been sufficient defaults in the first five months of this year to ensure that 2021 will be the fourth consecutive year with more than RMB100bn in failed payments from onshore corporates. Yet, overseas investors will not bear the brunt of this because the overwhelming majority of the bonds are held domestically.

Where next? Investing in Chinese bonds to improve diversification is by no means a new theme but there is nothing like a tailwind to attract the attention of investors. Good fundamentals are in place, including low inflation and steady growth, along with highly credible monetary and fiscal policy. The outperformance versus the US, however, is also because of the increase in Treasury yields, so it belies the improvements taking place in the underlying fundamentals.

We should not forget that China's financial markets have either transitioned to, or are in the process of transitioning to, full developed-market status. New entrants have already been encouraged by the promise of index inclusion and improved access to the market. We think that there are more liquidity improvements to come to meet the demands of global institutional investors, and the recent developments described above are helping to increase credit differentiation, so that ratings are better aligned to the probability of default.

An 'up in quality' stance in the credit market is necessary given the authorities' current focus on leverage. Liquidity is anyway concentrated in the currency and government bonds, which is where the big calls will need to be made. Indeed, the chart shows the two key contributions to performance for USD-based investors over the last six months: the strengthening of China's currency, and consistent relative outperformance of the bond market.

We suspect that there is more news to come from China's government bonds. The lower-for-longer rates theme applies to China as much as to the US and Europe. And this goes beyond the near-term reflation narrative to consider the strong structural headwinds that are likely to remain in place.

China's 10-year benchmark yields 3.07% and the US Treasury equivalent is 1.59%. Investors are likely to ask what is more likely, a 50bp fall in Chinese or US yields? Nobody can be certain of the answer, which is why we're seeing a market that is increasing diversification into Chinese bonds.

Previous editions of *The Major bond letter*

#1. *Eurozone common issuance – a long time coming*

#2. *How to spice it up in a dull market*

#3. *New year, old narrative*

#4. *Beneath the surface*

#5. *The bond market sell-off*

#6. *Treasuries and trees*

#7. *Inflation rationality*

Disclosure appendix

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Source: HSBC

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Source: HSBC

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