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The Major bond letter

#18. China-US divergence

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Fixed Income - Rates

Global

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Bonds are supposed to be boring. So 16% is not the sort of number we normally associate with low-yielding, safe, government bonds. But that's how much China government bonds outperformed US Treasuries since the start of last year (in USD terms). Does divergence have further to go? Can bonds be boring with persistent inflation, geopolitical uncertainty, and tightening financial conditions?

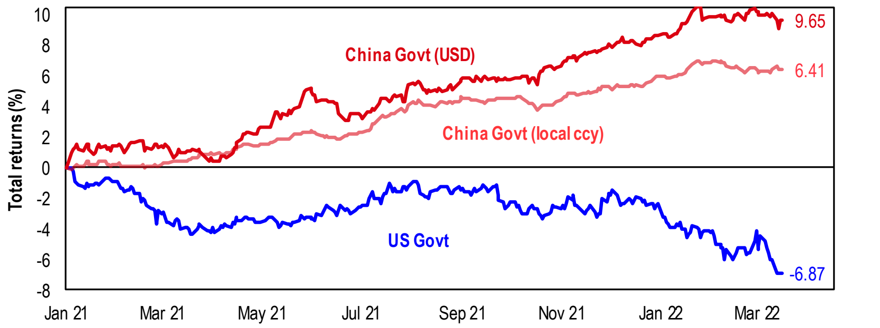
Extremely well-telegraphed US rate hikes have begun, whilst China has been moving ever so cautiously along an easing path. Since the beginning of last year the China government bond index has returned around 9% in dollar terms and the US equivalent circa minus 7% (Bloomberg). Chinese bonds represent about 10% of the key global bond indices, so for many investors they provided some welcome diversification away from what's become a broad-based downturn for bonds.

But there can also be too much of a good thing. Interest rate divergence between the two biggest economies could become a concern if it contributes to imbalances and financial instability. So where next? To answer, we first need to consider what's already in the price and whether the trend can continue. From the perspective of the bond holder, where's the potential surprise?

China's key reference rate, the one-year medium-term lending facility (MLF) was held at 2.85% on 15 March and if the recent trend continues there will be a further small decline. For both the MLF and the seven-day repo rate, swap and bond curves indicate only modest moves at best.

When the US Federal Reserve hiked by 25bp on 16 March, the Committee also presented a clear projection to hike as much as 10 more times. We can see this from the Fed's 'dot plot' of rate projections which gives the median expectation for an increase of a further 150bp increase this year, and 75-100bp more next year. So about 250bp more for the US! Comparing expectations for the key reference rates is admittedly overly simplistic. China's easing will anyway be more about liquidity provision, so in the near term analysts will be looking for moves in the reserve requirement ratio (RRR).

Figure 1. Total return of China government bonds vs US



Source: HSBC, Bloomberg indices. Total return in fixed income measures price appreciation, accrual, and coupon payments

Note: Total returns since beginning of 2021

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The US is going in the opposite direction here too, with quantitative tightening (QT) starting soon. Guiding the direction of liquidity complements rate policies, working through the credit channels and influencing financial conditions. In this regard it is difficult to calibrate in terms of basis points, because liquidity is not a direct substitute for movements in the policy rate.

Having established what's already in the price, we need to determine whether the divergence will continue.

The urgency behind US policy normalisation is related to persistently high inflation, with the next CPI prints likely to be above 8%, putting the squeeze on real disposable incomes, and likely to dent consumer confidence. China's CPI is just 0.9% and policies can now be more targeted towards boosting growth. Divergence has come from an active US policy. The chart shows how prior to September 2021, when the Fed started to change direction, the returns for China and the US moved together.

US financial conditions are already tightening, through stock market volatility and widening of spreads, seemingly because of the geopolitical situation and preparation for policy normalisation. If nothing else, this might caution the Fed not to tighten too aggressively. After the taper tantrum of 2013 there were expectations of global policy divergence[1] - albeit against the backdrop of less active fiscal policy and low inflation – but it didn't happen. This is quite possibly because, for all the apparent difference in the cyclical positions, the biggest economies face similar structural challenges.

The theme of lower-for-longer rates is not something central banks can do much about. Indeed, the trend of falling cycle peaks in rates pre-dates the pandemic and Global Financial Crisis (2008). We believe the explanation lies with ageing populations, excess leverage, disruptive technology and wealth inequality. In times of heightened uncertainty rates can sit lower than "normal" as savings increase and investment is delayed.

The government bonds of China and the US offer the combined benefits of relative safety and liquidity. Expected total returns from holding both will be low compared to other asset classes to reflect this. It is anyway sub-optimal to judge the performance of an individual bond's total return in isolation, as nobody would sensibly hold 100% of their wealth in a single asset. Bond investors use the asset class to provide ballast in a portfolio that includes higher yielding assets which carry more risk.

We don't think it's about making a choice between one or the other. China government bonds offer diversification in global bond portfolios, and a relatively low 11% are held by non-residents. Policy rates tend to be very steady in China, whilst - as we have seen - US rates can move a lot in either direction. The recent past has seen China outperform strongly but US bonds would claw some of this back if the economy is not resilient to the rate hikes and tightening of financial conditions. Divergence would return to convergence. Boring bonds would like that.

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[1] Lael Brainard: What happened to the great divergence? 26 February 2016

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