China's Sovereign Bonds

The Alternative Safe Haven

OVERVIEW

Against a dreary backdrop of low, zero, or negative yields from traditionally safe-haven bonds like U.S. Treasuries, China's sovereign bonds offer an alternative way to diversify a global portfolio. By combining higher yields, relative to developed market bonds, and lower volatility, relative to emerging market bonds, Chinese sovereign bonds have produced high risk-adjusted returns with low correlations over the past 10 years.

Within a global framework, we believe China's government bonds now compare more closely to developed markets (DM) than to emerging markets (EM). However, there are several major trends impacting the world's largest developed bond markets and reducing their ability to hedge portfolios during risk-off periods. We review these trends and demonstrate how their impact on China may differ.

We also discuss how the opening of China's onshore market equates to a "Big Bang" event in global fixed income, on par with China's 2001 entry into the World Trade Organization (WTO). Faced with the structural decline of its current account surplus, China needs more foreign capital to fund its future growth, upgrade its manufacturing value chain, and promote its currency globally. As China seeks to pivot away from an export-driven economy, its more welcoming stance could benefit foreign investors in its onshore bond market.

Lastly, we examine the information and price risks to our China safe-haven investment thesis. On the back of China's strong post-pandemic, V-shaped recovery, we expect growth momentum will taper off later in 2021 as policymakers return to the delicate process of deleveraging financial risks and asset bubbles while avoiding a policy cliff. We review what we believe are solid fundamentals and favorable valuations, plus a structural tailwind from pending China sovereign bond index inclusion—all boosting foreign momentum into the onshore market.

GLOBAL SOVEREIGN BONDS: THE CASE OF MISSING "REAL" YIELDS

Following the Global Financial Crisis (GFC), successive rounds of quantitative easing (QE) from the world's major central banks to reflate the global economy have resulted in ballooning global debts, anemic economic growth, and stubborn deflation. Driven by structural factors like high debt burdens, aging demographics, and persistent deflation, global sovereign bond yields have been on a steady decline, with over $13 trillion of bonds bearing negative yields (**Figure 1**). With nominal yields so low and real yields already negative, traditional safe havens like U.S. Treasury bonds, German bunds, Japanese government bonds, and U.K. gilts are no longer able to hedge investor portfolios during risk-off periods. The prevalent mantra of "lower interest rates for longer" also poses huge challenges for yield-starved pension funds and insurance companies.

The shock of COVID-19 has exacerbated this trend, triggering massive monetary and fiscal stimulus around the globe. Major central banks have been cutting interest rates, dusting off QE programs, and even turning to unconventional methods or new tactics, like yield curve control, modern monetary theory (MMT), and average inflation targeting, to shore up financial markets and fund more fiscal stimulus.

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These market interventions are now more the norm rather than the exception, distorting government bond valuations and diminishing or even canceling the role bond yields used to play as macroeconomic indicators and measures of an economy's true pulse.

Coordinated QE programs among central banks have also increased correlations between sovereign bond markets, making it more difficult for bond investors to diversify their bond risks. For governments, these interventions may come with an unintended consequence of a cyclical flare-up in inflation, triggering a sharp steepening of yield curves. Furthermore, governments face financial risks and an eventual reckoning from this relentless stimulus largess and explosive increase in debt. **There is, however, one government that stands out as an exception: China.**

CHINA'S YIELDS STAND OUT

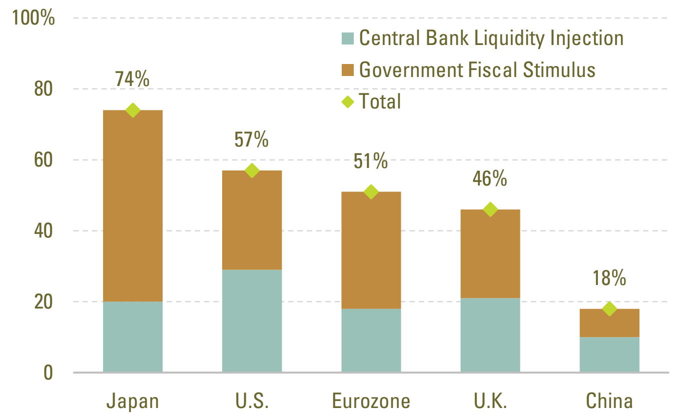
China's successful containment of the COVID-19 outbreak has given the People's Bank of China (PBOC) the freedom to be more disciplined and restrained in its stimulus measures relative to its economic peers (**Figure 2**). Indeed, the PBOC already embarked on normalizing its policies last year. At the pandemic's height, China's 10-year yield bottomed in April 2020 to a low of 2.4% but has since returned to pre-COVID levels of around 3.3% (**Figure 3**). The PBOC's more rational monetary stance renders Chinese sovereign bonds increasingly attractive, in our view, including as a potential alternative safe-haven asset.

Chinese government bond yields, however, have bucked the declining yield trend for some time. Yields on 10-year bonds have largely remained at their 2006 levels, in the low-to-mid 3% range, despite China's economy slowing from double digits to mid-single digits since that period. In stark contrast, yields on sovereign bonds from developed economies like the U.S., the U.K., Japan, and Germany have been on an incessantly declining trajectory over the past 15 years (**Figure 3**).

Figure 1 Negative-Yielding Debt Market Value
Bloomberg Barclays Global Aggregate Index; $Millions; As of 3/31/2021

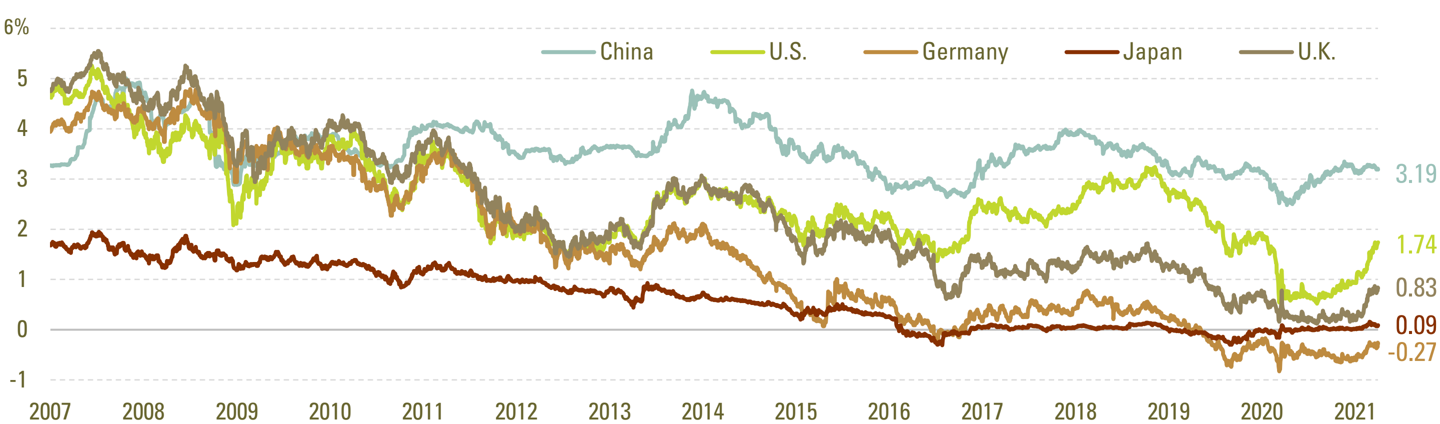
Source: Macrobond

Figure 2 Central Bank Liquidity and Government Fiscal Stimulus
February 2020 – March 2021; % of GDP



Source: Cornerstone Macro

Figure 3 Global Sovereign 10-Year Bond Yields
%; As of 3/31/2021



Source: Macrobond, U.S. Department of Treasury

Unlike its DM peers, the correlation between China's sovereign bond yields and its economic growth rate is not significant. This difference is due to China's unique quasi-monetary policy, which is driven more by the quantity of liquidity (loan quotas, etc.) that the PBOC injects into the economy, rather than the price (i.e., interest rates).

GRAVITATIONAL PULL TOWARD ZERO

Global fixed income investors must gauge the likelihood of DM bond yields rising and recoupling with China, or the probability of China's government bonds being pulled down into low-yielding territory. Structurally speaking, we do not believe China will be a long-term exception from the gravitational pull of zero interest rates, given its high debt burden, aging demographics, and deflationary forces. China is currently the only country with a debt-to-gross domestic product (GDP) ratio over 250% that is still able to defy zero-interest rates, according to J.P. Morgan research. However, this exception will not last indefinitely. China has a debt-to-GDP ratio close to 300%, and approximately 70% of its total social financing is used for interest payments. Hence, we do not think China can afford higher interest rates and expect rates to decline and approach zero in the next several years.

CHINA'S "BIG BANG" EVENT: OPENING THE ONSHORE BOND MARKET

Before China opened up its local bond market, many global investors used EM bonds of commodity-exporting sovereigns as a proxy for China's impressive growth. With new access channels for foreign investors—the China Interbank Bond Market (CIBM) in 2016 and Bond Connect in 2017—the pace of foreign inflows accelerated in 2019 when the Bloomberg Barclays Global Aggregate Index included local Chinese bonds. In 2020, the JPMorgan Government Bond Emerging Market Index followed, with the FTSE World Government Bond Index scheduled to include China bonds in October 2021. So far, central bank reserve managers and sovereign wealth funds looking for more yield diversification are the major foreign investors in China's onshore bond market. However, we estimate index inclusion could generate foreign flows of up to $400 billion into Chinese bonds over the next two to three years, also bringing along active, value-oriented bond investors attracted by China's higher yields.

PIVOTING TO CONSUMER-DRIVEN GROWTH

China's opening is by strategic design and a natural progression of its rebalancing from debt-driven modernization and export-driven manufacturing toward more organic growth from Chinese innovations and a domestic consumption-driven economy. Facing growth challenges from its aging population, inefficient allocations of capital, and an adverse geopolitical environment that restricts some exports, China needs to reform its financial markets to optimize its capital allocations. If China fails to boost productivity and compete with economic peers in higher value-chain industries, it could become stuck in a "middle-income trap."

Despite strong foreign portfolio flows last year, China's financial markets remain relatively isolated from global capital. According to a July 2020 FTSE Russell report on the Chinese bond market, foreign ownership, mostly concentrated in government bonds, is about 9% of China's sovereign bond market but only around 3% of its entire onshore bond market. To put that in perspective globally, foreign investors hold more than 25% of U.S. Treasuries and eurozone government bonds, respectively. To match the size of its economy, China needs a world-class financial market to attract more foreign capital.

EMBRACING A MARKET-BASED SYSTEM

Achieving this goal requires opening up its capital account to two-way capital flows. Currently, China encourages inflows but still tightly curbs outflows. With gradualism as its mantra, China is cautious about not losing control too fast due to the complexity of its mission. Given the structural decline of its account surplus, China needs more foreign direct investment to fund its future growth, upgrade its value chain, and promote its currency globally. Opening up its bond market also can serve as a catalyst to force difficult financial reforms. By transitioning to a more market-based system, investors can better price credit risk while China focuses on stemming the buildup of distressed and defaulted loans and nurturing productivity growth with more efficient investments in homegrown innovation.

We view China's onshore market opening as a "Big Bang" event in the global bond market, on par with China's 2001 entry into the WTO. If foreign ownership in China's bond market can match that of the U.S. bond market, which is about 25%, potential capital inflows could reach $4 trillion. If China gradually allows domestic households to invest overseas to diversify their investments, the outflows also may reach several trillion U.S. dollars. Those amounts will have significant implications for the global financial market. With the U.S. and China potentially competing for overseas capital, the PBOC will need to adjust to fluctuations in exchange rates and market interest rates more frequently.

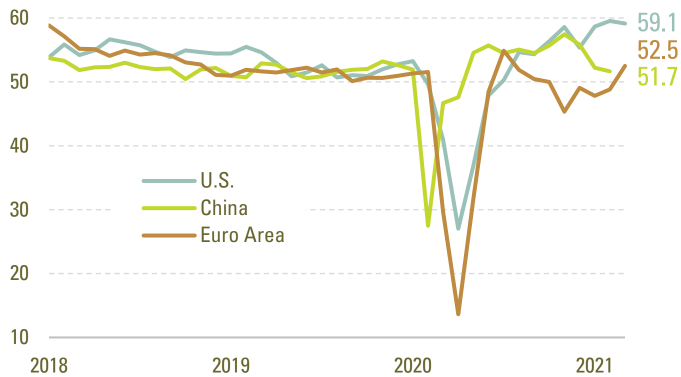
THE CASE FOR CHINA'S SOVEREIGN BONDS: HIGHER YIELDS AND SAFETY

As macro-oriented, value-driven investors, we approach any investment opportunity by first evaluating both information risks and price risks. Information risk assessment entails a deep dive into fundamental analysis, analyzing how the basis of our thesis might fail. A review of price risks requires an understanding of the valuation anomaly.

After yields bottomed in April 2020, China's government bonds sold off from April to November 2020, noticeably impacting valuations. We attribute the sell-off to the following three factors:

- China recovered from COVID-19 lockdowns faster than other regions and also generally avoided the successive waves of infections still plaguing other nations. As a result, economic activity as measured by the Purchasing Managers (PMI) Output Index rebounded sharply (**Figure 4**) in early 2020, and bond yields normalized faster.
- As China's fiscal deficit has risen by 4%–5%, we have seen a commensurate sharp increase in issuance of government bonds, policy bank bonds, and special local government bonds to finance it. This huge supply has dampened investor's demand.
- The PBOC has signaled policy normalization with no more easing. The bond market's next move will be driven by how the Chinese economy performs later in 2021 after the post-virus rebound.

Figure 4 IHS Markit, Composite PMI Output Index
Index, seasonally adjusted; As of 3/1/2021



Source: Macrobond

SLOWING GROWTH MOMENTUM

After China's V-shaped but uneven recovery, we believe China's growth momentum may start to moderate in 2021 due to policy normalization and a renewed focus on deleveraging financial risks while avoiding a policy cliff. We expect policymakers' attention will be consumed by the very challenging tasks of shifting growth drivers from infrastructure and property investments to consumption, services, and manufacturing investments. A resurgence of COVID-19 cases or an unwillingness to change the status quo ahead of the Communist Party centenary in July 2021 could dampen the pace and scale of policy tightening. Ultimately, however, we believe fiscal consolidation, a slowdown in credit growth, and macro-prudential measures to address asset bubbles and local government hidden debt will become headwinds again to growth later in 2021.

SUPPORTIVE FUNDAMENTALS: THE STRENGTH OF A DEVELOPED MARKET

Besides China's strong but measured economic prospects, its bond market is supported by solid fundamentals and structural improvements, which make it attractive to foreign investors. China's onshore sovereign bonds also lack many of the weaknesses and vulnerabilities that plague other EM sovereign bonds, calling into question whether Chinese government bonds deserve the EM risk premium. Instead, we believe China's government bonds belong more to the DM rather than EM block. The fact that the renminbi (RMB) is the only "EM currency" that gained special drawing right (SDR) status is an endorsement to our view.

FAVORABLE DEBT REPAYMENT: China has demonstrated a strong ability and willingness to service and repay its debt. While the prospect of corporate defaults is concerning for some investors, we think they are signs that the market is maturing and open to pricing credit risk more accurately. Furthermore, China's balance of payments data shows the country remains a net creditor to the rest of the world, with a significant positive net foreign asset position of approximately 15% of GDP, based on FTSE Russell research.

STRONG CREDIT RATING: The underlying creditworthiness of China's bond market is reflected by the country's A+ sovereign credit rating. China's debt growth has been fueled largely by a reallocation of domestic savings from consumption to longer-term investments aimed at boosting productivity and future growth. Modern "smart city" clusters supported by sophisticated high-speed train networks are a case in point.

STABLE OWNERSHIP STRUCTURE: Two-thirds of China's government bonds, according to the FTSE Russell report, are held by domestic commercial banks, which usually hold to maturity. The bonds are insulated from the reliance on foreign ownership and accompanying volatility.

LOW GOVERNMENT DEBT-TO-GDP: The government debt-to-GDP ratio is still relatively low, backed by a high savings rate, healthy balance of payments, and large foreign exchange reserves.

FAVORABLE MARKET TECHNICAL: China was the only major economy to post positive GDP growth in 2020. Inflation remains benign as global demand has been weak. This favorable combination of solid growth and low inflation has provided the PBOC with more monetary policy flexibility and the ability to avoid excessive money printing. Monetary policy normalization and fiscal consolidation resulted in smaller government bond issuance.

MARKET-DRIVEN MONETARY POLICY: PBOC monetary policy has become more market-driven, evolving from loan quotas and liquidity management to greater emphasis on interest-rate transmission. Until 2019, repo rates were the main indicators of the PBOC's policy stance. Now, loan prime rates (LPR) and medium lending facility (MLF) rates serve as the policy rates. We monitor these and other rates to interpret the PBOC's monetary stance.

ATTRACTIVE VALUATIONS AND YIELDS: POTENTIAL FOR FURTHER PRICE APPRECIATION

Absolute yields on China's onshore sovereign bonds are trading at compelling levels relative to global DM sovereign bonds. The bonds also are at their widest spread levels versus global sovereigns over the past 10 years, thanks to the strength of the Chinese economic recovery (**Figure 5**). We believe Chinese bonds, with yields around 3.3%, offer an asymmetric return profile, with limited downside but huge potential for price appreciation.

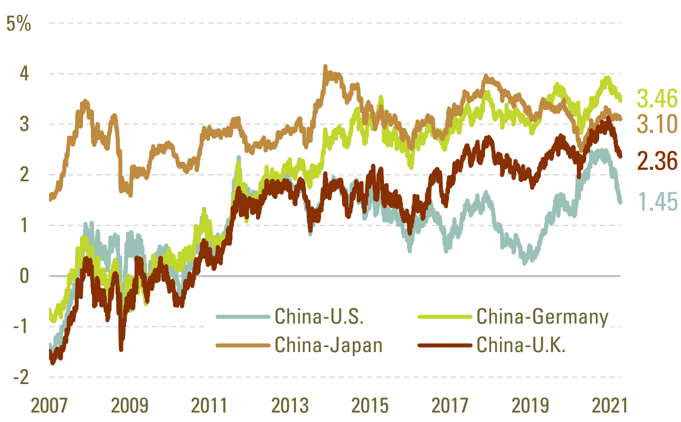
Also, the fact that Japanese and German bonds failed to offer downside protection in the first quarter of 2020 suggests their traditional role as defensive assets may be limited in the next recession with yields around 0%. China's government bonds offer a compelling alternative as a high-quality, defensive asset.

OTHER COMPELLING CHARACTERISTICS

In addition to strong fundamentals and attractive valuations and yields, Chinese sovereign bonds offer several other favorable qualifications.

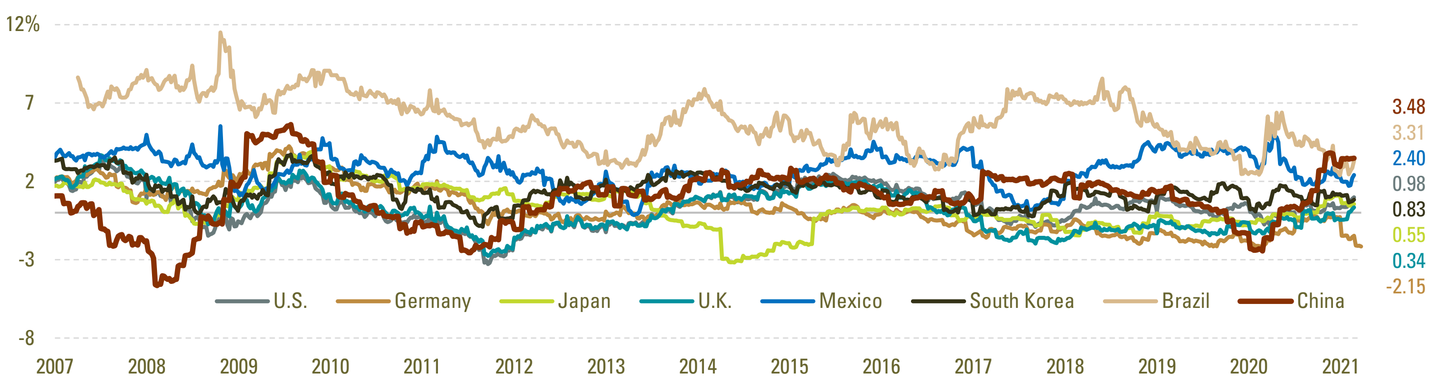
GOOD COMBINATION OF DM AND EM: China's onshore sovereign bonds stand out from other EM sovereign bonds and DM bonds. As the world's second-largest bond market, China still offers high positive real yields, comparable to some EM bonds (**Figure 6**). However, the Chinese market is generally less volatile than other EM, due to its limited reliance on foreign ownership and skew toward shorter maturities.

Figure 5 Spreads between China and Global 10-Year Treasury Yields
%; As of 3/31/2021



Source: Macrobond, U.S. Department of Treasury

Figure 6 Global Real 10-Year Government Bond Yields
%; As of 3/31/2021



Source: Macrobond

HIGH HISTORICAL RISK-ADJUSTED RETURNS: For the past 10 years, an allocation to Chinese government bonds has boosted risk-adjusted returns by increasing return and dampening volatility for global bond portfolios. Since 2010, Chinese bonds have bested many asset classes while offering a standard deviation that is among the lowest of major bond markets (**Figure 7**).

Figure 7 Long-Term Risk-Adjusted Returns of Different Assets
January 2010 – February 2021

	China Government Bonds	S&P 500	U.S. Treasury Bonds	U.S. High Yield	U.S. Investment Grade	EM Bond Index Global	EM Local Bonds	EM Equities	EM FX	MSCI EM Asia	Asia USD Credit	International Treasury Bonds
Annualized return	3.6%	14.0%	3.3%	7.5%	5.6%	6.3%	2.3%	5.2%	0.6%	8.0%	5.9%	2.4%
Annualized standard deviation	3.2%	14.0%	4.5%	12.1%	6.7%	10.0%	13.8%	25.9%	9.0%	25.6%	8.6%	6.8%
Risk-adjusted returns	1.11%	1.00%	0.72%	0.62%	0.83%	0.63%	0.17%	0.20%	0.07%	0.31%	0.68%	0.35%

Source: J.P. Morgan Research

LOW CORRELATIONS AND DIVERSIFICATION POTENTIAL: At a time when core DM bond markets, including the U.S., Germany, Japan, and the U.K., are increasingly correlated and present diversification challenges to investors, China is characterized by low correlations to most other bond markets (**Figure 8**). Furthermore, correlations among EM bond markets, including Brazil, Mexico, South Africa, and even India, are significantly higher.

Figure 8 Correlation of Weekly Local Bond Market Returns in Selected Government Bond Markets
January 2010 – February 2021

	China	India	Mexico	South Africa	U.S.	Germany	Japan	Brazil	U.K.
China	1.00	0.12	0.18	0.08	0.22	0.20	0.14	0.09	0.21
India	0.12	1.00	0.18	0.11	0.16	0.14	0.07	0.15	0.15
Mexico	0.18	0.18	1.00	0.47	0.43	0.30	0.31	0.41	0.36
South Africa	0.08	0.11	0.47	1.00	0.10	0.10	0.11	0.42	0.12
U.S.	0.22	0.16	0.43	0.10	1.00	0.74	0.50	0.20	0.78
Germany	0.20	0.14	0.30	0.10	0.74	1.00	0.47	0.14	0.75
Japan	0.14	0.07	0.31	0.11	0.50	0.47	1.00	0.16	0.46
Brazil	0.09	0.15	0.41	0.42	0.20	0.14	0.16	1.00	0.19
U.K.	0.21	0.15	0.36	0.12	0.78	0.75	0.46	0.19	1.00

Source: J.P. Morgan Research

CHINESE SOVEREIGN BONDS: A WELCOME ALTERNATIVE

Over the past decade, the utility of safe-haven sovereign bonds inside portfolios has steadily diminished. Pressured by structural forces, global bond markets have been approaching low, zero, or negative yields. Bond investors seeking both yields and safe-haven protection are discovering China's sovereign bonds offer the potential for higher yields relative to DM bonds and greater safety with less volatility relative to EM bonds. Over the past decade, high risk-adjusted returns combined with low correlations have further enhanced the portfolio diversification benefits of Chinese sovereign bonds and lent added support for an allocation within a global bond portfolio.

It is worthwhile noting that China's onshore bond market is still largely under-owned by foreigners. This ongoing trend provides a long-term structural tailwind, in our view, which should accelerate with upcoming index inclusion in the FTSE World Government Bond Index. It is a welcome development that China is determined to earn, both through prudent monetary policies and ongoing efforts to continue opening its onshore bond market and encouraging foreign investors. Against this positive macro backdrop, we believe Chinese government bonds represent an attractive opportunity over the long-term.

CHINA SOVEREIGNS: KEY RISKS AND MITIGATIONS

China's onshore bond market presents opportunities for global investors to add diversification and return potential to their portfolios. However, the market is not without risks, some of which are particularly unique to China and should be considered carefully.

Risk of debt burden: The primary risk is the massive leverage that resulted from the credit-driven investment boom since the GFC. However, this risk is being addressed by deleveraging and supply-side reform. Growth in shadow banking has turned negative and is still contracting. China continues to balance its tolerance for state-owned enterprise (SOE) defaults with safeguarding financial stability. We do not think SOE bond defaults pose a major systemic risk as policymakers have plenty of tools to maintain control of the financial market due to the relatively low government debt ratio.

Policy risk: A return to an aggressive deleveraging campaign could trigger more corporate bond defaults and lead to a broad sell-off in Chinese bonds. However, our base case is that the PBOC's intent is to avoid a policy cliff and ensure market stability.

Currency risks: Investing in China's onshore government bonds bears currency risk. Recent reforms improving foreign investors' access to foreign currency (FX) derivatives should assist in hedging this risk. The risk of a sudden policy reversal involving capital controls should be very unlikely, given the market damage this shift could trigger.

Risk of COVID-19 resurgence: An additional COVID-19 shock could impact the domestic economy and EM economies. China's vaccine rollout has been very slow. If COVID resurges, investors would need to assess the negative impact on global supply chains, weaker Chinese exports, and potential losses from China's lending to other EM economies.

ESG risks: China ranks low in environmental, social, and governance (ESG) scoring for its human rights records, corruption, and pollution levels. However, policymakers have made progress.

- **Environment:** China joined the Paris climate accord and pledged to achieve carbon neutrality by 2060 and reach peak emissions by 2025. China is gradually shifting its energy mix from coal toward clean sources like solar and wind. It dominates the green supply chain, demonstrated by its 72% market share in solar modules, 69% in lithium-ion batteries, and 45% in wind turbines, based on Societe Generale research. In addition, China has made significant improvement in energy efficiency in the past two decades, upgrading its transportation network and expanding the electric vehicle sector through generous tax cuts and government subsidies. China is also the largest green bond issuer.
- **Social:** China faces significant censure on human rights issues, but the country announced it had eliminated absolute poverty nationwide. Societe Generale research put the literacy rate at 96.84% in 2018, a 1.7% increase from 2010.
- **Governance:** The anti-corruption campaign, which lasted several years, had more than 100,000 people indicted, according to Societe Generale. China now needs to improve on due process and enforcement of laws. Disparity of development levels among urban, coastal, and rural inland areas is narrowing. Policymakers continue to encourage urban migration, fund education, and expand healthcare and transportation infrastructure for poor areas.

If the green transition helps sustain productivity growth, China's bond yields should maintain their premium, since long-term yield levels correlate with long-term growth potential.

Market transparency and liquidity risk: China's bond market is still fragmented, dominated by the interbank bond market, and supplemented by the exchange bond market. The two submarkets lack connectivity, with different trading systems, participants, and bond varieties. The regulatory framework is also fragmented. With commercial banks as the main buy-and-hold investors, liquidity can be challenging. Derivative tools are insufficient to hedge against exchange rate risk, interest rate risk, and credit risk.

Geopolitical risk: The delisting of some Chinese stocks and investment restrictions for pension funds pose additional geopolitical risk. We believe the Biden administration in the U.S. will not be friendlier to China but probably more predictable and more measured. Biden's team may take a differentiated strategy on China: competitive on trade, investment, and financial services; adversarial on technology, geopolitics, and human rights; and cooperative on COVID control, climate change, and nuclear nonproliferation. Biden likely will encourage allies to form a united front and reengage with the WTO and other global institutions. While Biden may seek greater domestic investment in science, technology, education, and infrastructure, China also may continue to engage with other trade partners to minimize the impact of further U.S.-China decoupling.