Manulife Investment Management

Why investors should consider adding China bonds to their portfolios

April 2021

Paula Chan, CMT

Senior Portfolio Manager, Asia ex-Japan
Fixed Income

China bonds' growing strategic importance as an asset class and improved accessibility for overseas investors

China's bond market, at US$15.77 trillion[1] in size, is now the second largest in the world behind the U.S. bond market and has been among the fastest growing bond markets globally, growing at a compounded average rate of 12.2% per annum over the past five years. Despite China being the second largest economy in the world and its importance as one of the top two global trading economies, global investors still have relatively low exposure to China bonds in their portfolios. In our opinion, there is significant room for overseas investors to increase their strategic allocation to China bonds.

Progress made in the opening up of China's financial sector to international investors has successfully attracted greater interest in China bonds. With the removal in May 2020 of Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investors (known collectively as Qualified Foreign Investors after November 1, 2020), quotas that were previously required to access the onshore China bond market and the introduction of the China Interbank Bond Market and Bond Connect channels in 2016 and 2017, respectively, China has made it much easier for overseas investors to directly access the onshore China bond markets.

As global bond indexes have been gradually including China onshore bonds, this has also helped drive global investors into the onshore China bond markets. The Bloomberg Barclays Global Aggregate Index and the JP Morgan GBI-EM Global Diversified Index began to phase in China bonds in 2019 and 2020, respectively, while it has just been announced that China bonds will be added to the FTSE World Government Bond Index (WGBI) progressively from October 2021.[2]

In 2020, foreign inflows to China bonds reached a record of CNY 1.06 trillion. Foreign holdings of onshore bonds have now reached CNY 3.3 trillion as at the end of 2020 with foreign ownership of China government bonds (CGBs) now above 10% at the end of February 2021.[3] The pace of inflows into China bonds is expected to continue over the next few years, partially driven by the index inclusion theme for China bonds while investors also look to take advantage of their attractive yields and diversification benefits.

Attractive nominal and real yields

In an environment of low and even negative interest rates in some developed markets, the yields for China bonds stand out at 3.19%[4] for 10-year CGBs, offering a premium of almost 1.5% against 10-year U.S. Treasury yields. Accounting for inflation, the real interest rate for China is also among the highest for similarly rated countries, that is, those that are rated single A or higher by international rating agencies, at around 1.6%[5] based on consensus forecasts for China consumer price inflation to be around 1.6% in 2021.

In our opinion, China bonds will likely maintain a yield advantage over other global markets in the medium term with China's central bank, the People's Bank of China (PBoC), striving for a balance between promoting the continued recovery of the domestic economy while also implementing fiscal consolidation and normalizing credit growth to avoid overheating in the economy. This policy stance is, in our view, unique compared with most other developed markets where interest rates remain near zero. In contrast, the PBoC has signaled that it will remain prudent on monetary policy but will continue to provide liquidity support to targeted sectors within the economy where needed. At the same time, we expect the PBoC is unlikely to rush to tighten monetary policy for now.

Lower volatility and potential diversification benefits

One of the key reasons for investors to consider adding China bonds to their portfolios is for diversification and risk mitigation purposes. Due to historically low correlations with other asset classes, China bonds, in our opinion, have the potential to reduce portfolio risk and to enhance returns for investors. Over the 10-year period to December 2020, China bonds (unhedged) returned 4.24%[6] per annum with a standard deviation of 4.48%[6] per annum in USD terms. This compares with global aggregate bonds returning 2.83%[6] per annum with a standard deviation of 4.43%[6] per annum in USD terms and European government bonds returning 3.74%[6] per annum with a standard deviation of 8.39%[6] per annum in USD terms over the same 10-year period.

Highlighting the effectiveness of China bonds acting as a safe-haven asset in times of market stress, China bonds returned 1.4% during the market sell-off during the first quarter of 2020 due to COVID-19 while European bonds and emerging-market bonds returned -3.4% and -8.6%, respectively, in USD terms over this period. China bonds have similarly weathered other major market corrections such as the 2008/2009 global financial crisis and the 2011 EU sovereign debt crisis well with positive returns of 6.7% and 4.2% during these market risk episodes.

Historically, we can see that China bonds have had much lower volatility due to China's domestic market being more closed off in nature and the dominance of domestic investors and banks as the major investors in these markets. While the domestic bond market is opening up and we expect increased participation from overseas investors, the China bond market will continue to be dominated by domestic investors for now. Similarly, correlation of China bonds with global markets will likely remain low, in our view, given the relative independence of China's economy and policy cycles that is not directly affected by the U.S. Federal Reserve.

Why now?

1 WGBI index inclusion confirmed

On March 29, 2021, FTSE Russell confirmed that China government bonds will be added to its widely followed WGBI with a weight of 5.25%. Inclusion of China bonds will start from October 2021 and will be phased in over a 36-month period. With an estimated US$1 trillion to US$1.5 trillion[7] of assets tracking the WGBI, this implies inflows into China bonds of US$53 billion to US$79 billion and monthly inflows of around US$2 billion over the 36-month phase-in period.

The index inclusion of China bonds into major fixed-income indexes has been an important driver of inflows into the asset class but is not the only driver. As noted earlier, there is considerable momentum for global investors seeking access to China bonds who are attracted by their return potential and diversification benefits. Inflows to China bonds reached a record CNY 1.06 trillion last year and could potentially reach CNY 1.3 trillion to CNY 1.5 trillion in 2021.[8] Nevertheless, confirmation by FTSE Russell that China bonds will be included in the WGBI will be supportive of the broader trend of global investors allocating to China bonds over the next several years.

2 China is among the first major economies to emerge from the pandemic

Following the National People's Congress, China announced its key economic targets for 2021 to safeguard its economic recovery. China will adopt a pro-growth policy stance for 2021 and has set a growth target above 6.0% for the year. Economic consensus forecasts expect China to grow at 8.5% in 2021[9] and should likely exceed its above 6.0% target given the low base following the sharp recession in 1Q20. The government is expected to maintain a proactive fiscal policy to facilitate a stable economic environment for 2021. While the government seeks to rein in excessive financial leverage and to mitigate against financial risks, we expect monetary policy to remain relatively stable this year with the PBoC unlikely to tighten policy rates and will continue to provide liquidity in a targeted manner. The outlook for inflation also looks to remain relatively benign and should stay within its 3.0% official target as food prices have declined from the high levels seen a year ago due to supply constraints. Overall, China is looking for a stable environment in 2021 to safeguard its economic recovery. Both nominal and real yields are expected to stay in a steady range and look likely to maintain their advantage over other developed markets. From a valuation perspective, we believe yields at current levels for China bonds look attractive for global investors.

3 Credit and currency views

The PBoC, in our opinion, is keen to avoid excessive market liquidity and monetary conditions that are too loose that could lead to financial instability. As a result, there has been some uptick in defaults to onshore bonds, including in the state-owned enterprise (SOE) sector. However, the default rate within the SOE sector remains low though at below 1.0% for the full year 2020.[10] While credit differentiation is expected to increase over time and less implicit government support will be available for weaker SOE names that are less strategic, the overall picture for credit deterioration is expected to be manageable for the market.

On the currency front, the renminbi gained 6.7% against the USD in 2020 on the back of USD weakness, strong demand for China assets, and the outperformance of China's economy in the second half of the year driven by strong global demand for exports. So far in 2021, the CNY has weakened -0.4% against the USD to the end of March but has shown strength against the euro and Swiss franc where it has gained 3.6% and 6.0%, respectively, over the same period. Looking ahead, the renminbi could see some further weakness against the USD in the near term, especially if U.S. Treasury yields continue to rise, but, in our view, is likely to maintain its strength against other currencies due to its yield advantage. Over the medium term, the renminbi is expected to be well supported by higher flows into onshore China equities and fixed-income assets.

Conclusion

In our opinion, the case to strategically add China bonds to their portfolios is a strong one for global investors as they look to take advantage of the higher yields on offer in a low-yielding world. At the same time, investors look to benefit from the diversification and risk mitigation attributes for China bonds, which is underpinned by their policy independence from U.S. monetary policy. The growing interest in China onshore assets is expected to be a multi-year theme as global investors recalibrate their portfolios to be more in line with structural changes to the global economy over the past decade and look to gain from being exposed to the growing dynamism in China's economy expected in upcoming years.

1 Bank of International Settlements (BIS), Manulife Investment Management, June 2020. **2** FTSE Russell, March 30, 2021. **3** Standard Chartered Bank, March 2021. **4** Bloomberg, March 31, 2021. **5** Bloomberg, March 31, 2021. **6** Bloomberg, Manulife Investment Management, December 2020. **7** Goldman Sachs, March 31, 2021. **8** Standard Chartered, March 31, 2021. **9** Bloomberg, March 31, 2021. **10** Goldman Sachs, March 24, 2021.

A widespread health crisis such as a global pandemic could cause substantial market volatility, exchange-trading suspensions and closures, and affect portfolio performance. For example, the novel coronavirus disease (COVID-19) has resulted in significant disruptions to global business activity. The impact of a health crisis and other epidemics and pandemics that may arise in the future could affect the global economy in ways that cannot necessarily be foreseen at the present time. A health crisis may exacerbate other preexisting political, social, and economic risks. Any such impact could adversely affect the portfolio's performance, resulting in losses to your investment.

Investing involves risks, including the potential loss of principal. Financial markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. These risks are magnified for investments made in emerging markets. Currency risk is the risk that fluctuations in exchange rates may adversely affect the value of a portfolio's investments.

The information provided does not take into account the suitability, investment objectives, financial situation, or particular needs of any specific person. You should consider the suitability of any type of investment for your circumstances and, if necessary, seek professional advice.

This material is intended for the exclusive use of recipients in jurisdictions who are allowed to receive the material under their applicable law. The opinions expressed are those of the author(s) and are subject to change without notice. Our investment teams may hold different views and make different investment decisions. These opinions may not necessarily reflect the views of Manulife Investment Management or its affiliates. The information and/or analysis contained in this material has been compiled or arrived at from sources believed to be reliable, but Manulife Investment Management does not make any representation as to their accuracy, correctness, usefulness, or completeness and does not accept liability for any loss arising from the use of the information and/or analysis contained. The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline, or other expectations, and is only current as of the date indicated. The information in this document, including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Manulife Investment Management disclaims any responsibility to update such information.

Neither Manulife Investment Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained here. All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment or legal advice. Clients should seek professional advice for their particular situation. Neither Manulife, Manulife Investment Management, nor any of their affiliates or representatives is providing tax, investment or legal advice. This material was prepared solely for informational purposes, does not constitute a recommendation, professional advice, an offer or an invitation by or on behalf of Manulife Investment Management to any person to buy or sell any security or adopt any investment strategy, and is no indication of trading intent in any fund or account managed by Manulife Investment Management. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Diversification or asset allocation does not guarantee a profit or protect against the risk of loss in any market. Unless otherwise specified, all data is sourced from Manulife Investment Management. Past performance does not guarantee future results.

Manulife Investment Management

Manulife Investment Management is the global wealth and asset management segment of Manulife Financial Corporation. We draw on more than a century of financial stewardship to partner with clients across our institutional, retail, and retirement businesses globally. Our specialist approach to money management includes the highly differentiated strategies of our fixed-income, specialized equity, multi-asset solutions, and private markets teams—along with access to specialized, unaffiliated asset managers from around the world through our multimanager model.

This material has not been reviewed by, is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the following Manulife entities in their respective jurisdictions. Additional information about Manulife Investment Management may be found at manulifeim.com/institutional

Australia: Hancock Natural Resource Group Australasia Pty Limited., Manulife Investment Management (Hong Kong) Limited. **Brazil:** Hancock Asset Management Brasil Ltda. **Canada:** Manulife Investment Management Limited, Manulife Investment Management Distributors Inc., Manulife Investment Management (North America) Limited, Manulife Investment Management Private Markets (Canada) Corp. **China:** Manulife Overseas Investment Fund Management (Shanghai) Limited Company. **European Economic Area** Manulife Investment Management (Ireland) Ltd. which is authorized and regulated by the Central Bank of Ireland **Hong Kong:** Manulife Investment Management (Hong Kong) Limited. **Indonesia:** PT Manulife Aset Manajemen Indonesia. **Japan:** Manulife Investment Management (Japan) Limited. **Malaysia:** Manulife Investment Management (M) Berhad 200801033087 (834424-U) Philippines: Manulife Asset Management and Trust Corporation. **Singapore:** Manulife Investment Management (Singapore) Pte. Ltd. (Company Registration No. 200709952G) **South Korea:** Manulife Investment Management (Hong Kong) Limited. **Switzerland:** Manulife IM (Switzerland) LLC. **Taiwan:** Manulife Investment Management (Taiwan) Co. Ltd. **United Kingdom:** Manulife Investment Management (Europe) Ltd. which is authorized and regulated by the Financial Conduct Authority **United States:** John Hancock Investment Management LLC, Manulife Investment Management (US) LLC, Manulife Investment Management Private Markets (US) LLC and Hancock Natural Resource Group, Inc. **Vietnam:** Manulife Investment Fund Management (Vietnam) Company Limited.

Manulife, Manulife Investment Management, Stylized M Design, and Manulife Investment Management & Stylized M Design are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates under license.