China fixed income: Under the microscope

China fixed income is a growing asset class, and our presentation at the 2021 Greater China Conference delved deeper into it with four sector experts and a lively Q&A session.

China fixed income: under the microscope – key takeaways

- Changes in the global economy mean it is time for investors to rethink their portfolio buckets;
- As we move into 2021, both China and Asia have an attractive set-up for fixed income investors;
- Chinese bonds - particularly in the rates space – can be said to have safe haven status, and developments in 2020 support that;
- New policies in China's real estate sector - the three red lines – could offer an attractive rerating opportunity to bond investors in 2021 and beyond.

Moderator:
Hayden Briscoe
Head of Fixed Income, Asia Pacific

Panelists:
Tom Becke
CIO, Punter Southall Wealth

Adrian Zuercher
Head of Global Asset Allocation, UBS Chief Investment Office

Brian Huang
Senior Credit Analyst, UBS-AM Asia Pacific Fixed Income

China fixed income markets and economy – a seven point overview

Hayden Briscoe started with a high-level overview of China's economy and fixed income space.

He drew attention to seven specific factors:

- China's onshore bond market has doubled in five years because of a fundamental shift away from loan financing in China's financial system and opening to foreign investors;

Sovereign yields – both nominal and real - on Chinese bonds standout in a world of low, or negative yields

- Accessibility reforms, index inclusion, and onshore opportunities are attracting global capital, but international investors still only own approximately 2.6% of the market;
- China's V-shaped recovery is levelling off but inflation looks under control – and low;
- Credit growth may slow in 2021, and that will likely mean slower growth numbers for the economy;
- Sovereign yields – both nominal and real - on Chinese bonds standout in a world of low, or negative yields;
- New policies for China real estate developers have the potential to create a rerating opportunity for bond investors;
- Asia credits currently look attractive, and there's room for a narrowing of the valuation gap vs markets in the US and Europe.

To further the discussion, Hayden then opened up the floor to our three-man panel, starting with Tom Becket, Chief Investment Officer at Punter Southall Wealth.

Tom Becket, CIO, Punter Southall Wealth

Think differently to generate returns

Towards the end of 2020, it became an uphill battle to generate the kinds of things that clients want, i.e. total return, income, and inflation protection. Further, I'd say in recent months that situation has gone from being an uphill battle to a lost war.

Valuations look expensive, just look at UK gilts – why anyone wants to lend money to the UK government at 25bps for 10 years is beyond me. I think we can extrapolate out those negative and expensive valuations to other developed markets as well - just look at investment grade and high yield credit.

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Asia: no longer 'emerging'

To us, it makes no sense whatsoever for Asia to be put into an emerging markets bucket, and I think that term is now outdated to the point of becoming pre-historic. Interestingly, I think the COVID-19 experience and the year of 2020 pushed the reference to Asia as 'emerging' way into the past.

Ultimately, what we are seeing in the developed markets now is similar to what we used to criticize emerging markets for in the past, such as the creation of huge amounts of debt and large-scale relaxation of fiscal policies. I think we are the point where people are starting to think very differently about how we see the world, and particularly about Asian fixed interest markets.

Adrian Zuercher, Head of Global Asset Allocation, UBS Chief Investment Office

China, Asia and asset allocation

It is hard to pick long-term changes and regime shifts, and we are focused on the short-term picture for markets and the political world.

That said, one of the key trends in our asset allocation strategies is the shift in economic gravity towards the East.

Let's not forget that Asia is 60% of the global population, a quarter of global GDP, 50% larger as a whole than the US, so the trend toward Asia is obvious and the growth is here. Over the next ten years, China will likely contribute around 30% of global GDP growth.

However, investors in the US and Europe are under allocated to China and Asia as a whole, despite Asian financial markets offering growth and returns.

That's largely because those investors are hesitant to embrace new asset classes. Historically, few investors bought high yield before the 1980s and pension funds didn't allocate to equities in the 1970s.

But we believe that investors are missing out if they are underinvested in Asia and China. We have been allocating quite high levels to Asia in recent years, and it has worked quite successfully for us.

China bonds offer low correlation, yield and safe haven properties

Looking at our strategy, and China fixed income in particular, we have replaced some US high-grade exposure with China central government bonds (CGBs) and other high-quality bonds.

In our confidence metrics we can see that these China fixed income assets are negatively correlated to the USD space, which is the 'holy grail' for any asset allocator.

Looking at our most recent changes amid the COVID-19 situation, we completely sold off our high-grade USD exposure in many of our solutions and moved into China CGBs because we also like the currency. We think the CNY (unhedged) currently offers value, and see further room for appreciation.

10-year CGBs are currently trading above 3%, so you are picking up between 300-400 basis points of additional return for what we consider to be a safe-haven asset.

Brian Huang, Senior Credit Analyst, UBS-AM Asia Pacific Fixed Income

China's three red lines policy and the real estate sector

China property is the key sector for the high yield asset class, and I think that over the next three-to-five years the three red lines policy will be positive for the sector.

Firstly, it will help to deleverage developers over the period and help them improve their financial discipline, which they were not really used to doing in the previous cycle.

Since the three red lines policy was announced in August 2020, we have seen some of the large privately-owned real estate developers scale back land acquisition.

To me, the policy is not just significant because of leverage improvement, but because it means that developers are improving their capital structure and moving away from some of the high-cost shadow financing channels. As they move away to lower-cost, transparent channels, we believe this is definitely positive from a credit perspective.

The last point is that under the three red lines scheme developers have to report their financial positions to the regulators, and that's important because they have to report 'hidden' off-balance sheet debt. It's almost like the regulators have done the audit on behalf of credit analysts, so that's a very big step forward for transparency around the sector.

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In the short-term, developers will feel liquidity pressure from tighter financing, but I think the majority of them will be able to get through it.

Defaults in Asia and China in 2021

The default outlook for Asia high yield will probably improve slightly in 2021 because most countries in the region will see an economic recovery, most notably countries like Indonesia.

In 2020, default rates were about 5%. In 2021, we expect that to come down to around 3.5%-3.6%, factoring in some of the high-profile cases of stress, such as in Sri Lanka.

Looking at USD space for China bonds specifically, default rates were around 3% and I expect similar levels in 2021. Two forces are playing out: firstly, continued recovery driving cashflow improvements and, secondly, tighter financing in some specific areas.

Q&A

1 Do you see the valuation gap between Asian and US and European credits closing in the future?

TB: I think the valuation gap will close and it is our job as asset allocators to be ahead of that shift. I can see real conditions in which our allocations to the Asia region will pick up, particularly given the paucity of opportunities elsewhere. I think this is one of those opportunities that will be arbitraged away pretty quickly, so I think being proactive rather than reactive is vital when it comes to Asian fixed interest.

AZ: We definitely see an upside for credit spread compression, particularly in Asian high yield. Currently, we like the property space within the USD Asia fixed income asset class. Looking at US high yield with spreads trading at around 400bps, or even slightly below, compared with Asian high yield with spreads of around 700bps, the Asian space is definitely an interesting asset class.

2 What are you expectations this year for Chinese monetary policy?

AZ: The rebound in the Chinese economy is already the most advanced. We have seen some measures that will likely mean the growth in the credit impulse will probably roll over.

But we still think some support will be needed, particularly with Europe going into lockdown and pressure coming from the external sector. But the recovery has already gone quite far, and we have already seen the Chinese government and the People's Bank of China trying to take their foot off the gas.

However, we don't expect interest rate hikes at this point and we have quite a stable outlook for the rates side of the bond market.

3 Could the RMB move to reserve status in both the Asia Pacific region and globally?

TB: Followjng the policies of isolationism over the past four years in the US, a lot of vacuums have been created that China has moved into very efficiently.

The Biden administration will change that to a certain degree, but I expect China will continue to move up in terms of influence over the short, medium, and long term.

So I think the RMB will increasingly become part of global currency usage – firstly in Asia itself, then with its trading partners in Eurasia as part of the One Belt, One Road policy.

China's influence on the economic, financial, political, and military sphere will continue to grow and that will be reflected in increasing use of the RMB. I think also there will be increased use in the West of Asian and Chinese fixed interest as part of asset allocation.

4 How do you factor politics into your overall asset construction?

TB: We definitely have to factor this in – just look at the first two weeks of 2020. For all the talk of hope and reconciliation in the US, we can see there has already been backward steps. I think it will be very difficult in the US to appease 75 million disaffected voters as we go through the next couple
of years.

The bigger problem that the West has is the increasing gap between the rich and the poor, and I think that will lead to increasingly volatile social situations that will drive increasingly extreme political decisions. So I think that is certainly a factor we need to take into account. Increasingly, from where we sit here, Asia looks a relative safe haven.

Wrapping up the session, Hayden Briscoe summarized it in four key takeaways:

- Changes in the global economy mean it is time for investors to rethink their portfolio buckets;
- As we move into 2021, both China and Asia have an attractive set-up for fixed income investors;
- Chinese bonds - particularly in the rates space – can be said to have safe haven status, and developments in 2020 support that;
- New policies in China's real estate sector - the three red lines – may offer a attractive rerating opportunity to bond investors in 2021 and beyond.

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