19 december

‘The year of Chinese bonds.’

> *“The Chinese bond market will enter the international arena in 2020, thanks to the returns offered and the current exaggerated pessimism surrounding the trade war.”*

China’s economic development remains one of the greatest success stories of the last few decades. Gross domestic product alone has doubled since 2010. However, this expansion has required significant investment, including from foreign investors. This has also caused the country’s debt to continue gradually increasing, both at the government level and at the company level.

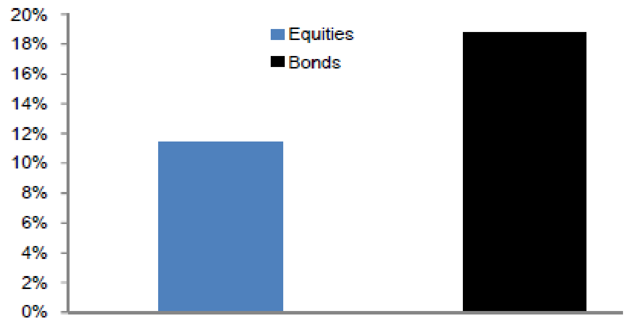
As a result, the Chinese bond market has since become the second largest in the world, after the United States. However, only few of these bonds are held by international investors because, until recently, Chinese capital markets were not accessible to external investors at all. But this is set to change in 2020.

Chinese Bonds: Own People First

It took a detour through Hong Kong to enable specialized investors to purchase non-domestic bonds. And while this situation has changed significantly in recent years, it is estimated that only 2.5% of local bonds are currently held by foreign investors – very different from the estimated 18% that these bonds represent of the total universe of outstanding bonds in the world.

International Integration

Share as % of the total universe of equities and bonds in the world with no free float adjustment.

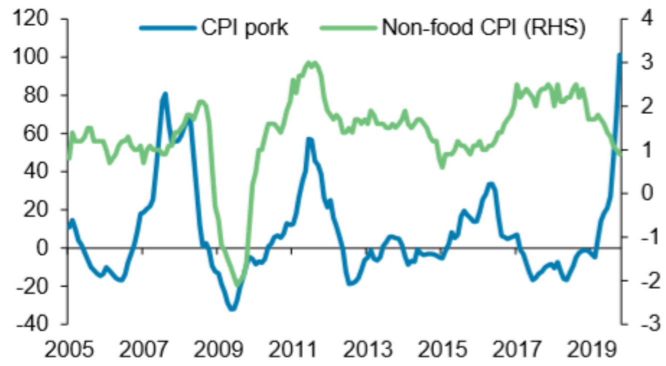


Source: J.P. Morgan.

The Chinese authorities have been trying for some time to increase the country’s integration with the global economy, which is necessary because the traditional model of cheap manufacturing for the rest of the world is increasingly coming under pressure from other low-wage countries This internationalisation also applies to the capital markets. The aim is to make the Chinese currency a strong, international currency in the long term, just like the dollar. This is the only way for China to get an economic foot in the door and compete with other global players.

In this context, China launched Bond Connect in 2017. This scheme entails the removal of quotas and offers international investors the possibility to purchase locally issued bonds directly from China. In 2020, the real breakthrough will come with the incorporation of Chinese bonds in the major global indices – a clear signal that former risks such as liquidity, quotas, settlement and the like are becoming a thing of the past. Experts predict this development will lead to an additional capital inflow of up to 300 billion dollars per year.

Index	Est. AUM ($bn)	Est. Weight	Est. Flows ($bn)
GBI-EM Global Div	202	10%	20
GBI-EM Series	24	10-15%	2-4
Crossover Global IG (Bloomberg Barclays Global Aggregate)	2,000	6- 7%	120-140
Crossover Treasury IG (FTSE World Government Bond Index)	2,000- 2,500	5-6%	114-143
Total	**4,000-4,500**		**250-300**



An Environment of Low Interest Rates

The interest rate on a 10-year government bond issued by China is currently over 3%. In a low-interest-rate environment this rate might seem attractive. Most European countries are still hovering around zero, just like Japan. At around 1.7%, only the US has a higher rate. This presents an excellent opportunity for portfolio diversification and for picking up higher interest rates.

Naturally, we also need to factor in inflation for these figures. Headline inflation in China recently increased, driven by more expensive food prices. After all, China has been struggling with a crisis in the pork sector for some time, where prices have risen by more than 100% in a year's time. However, core inflation – excluding food prices – remains relatively stable, which means real interest rates are still attractive for investors.

What about foreign exchange risk? The good news is that China is still experiencing steady growth. Outlooks are expected to be lowered slightly to 'around 6%' next year, which is still a comfortable level. Furthermore, it's a given that growth in China will gradually decline due to demographic change and because the economy is progressing towards full maturity.

The main question is whether government policy will continue to be supportive. Until further notice, we are still talking about a planned economy where the government controls just about everything. The central authorities are expected to continue to focus on debt reduction, reforms and stabilization measures. These factors combined should remain supportive for the currency.

Trade war

Much has been said and written about the trade war with the United States over the past year. This undeniably remains a negative and uncertain factor for the Chinese economy. However, we believe that most of the economic impact and general uncertainty has now been priced into the financial markets, and policy makers have consistently demonstrated that appropriate stimulus measures are taken in times of volatility. Unless the situation escalates again, we believe there is limited risk for bonds in this area.

Conclusion

Will the further opening and internationalization of the Chinese bond market lead to the year of Chinese bonds? Considering that international investors only hold these bonds to a limited extent and that global indices have started to include China, we think so. Bond returns are attractive compared to the US and Europe. The resilience of the Chinese economy and the current pessimism surrounding the trade war mean to us that, overall, downside risks are limited.

Author:	Michael Geeroms KBC Asset Management – Portfolio Manager

Tom Simonts

Senior Financial Economist
KBC Group

E-mail: tom.simonts@kbc.be
Tel: +32 2 429 37 22
Mobile: +32 496 57 90 38

Address: KBC Group
Havenlaan 2 (GCM)
B-1080 Brussels

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