Insights
**Fixed Income**

**March 2025**

# Why Chinese Government Bonds Warrant Attention… and Caution

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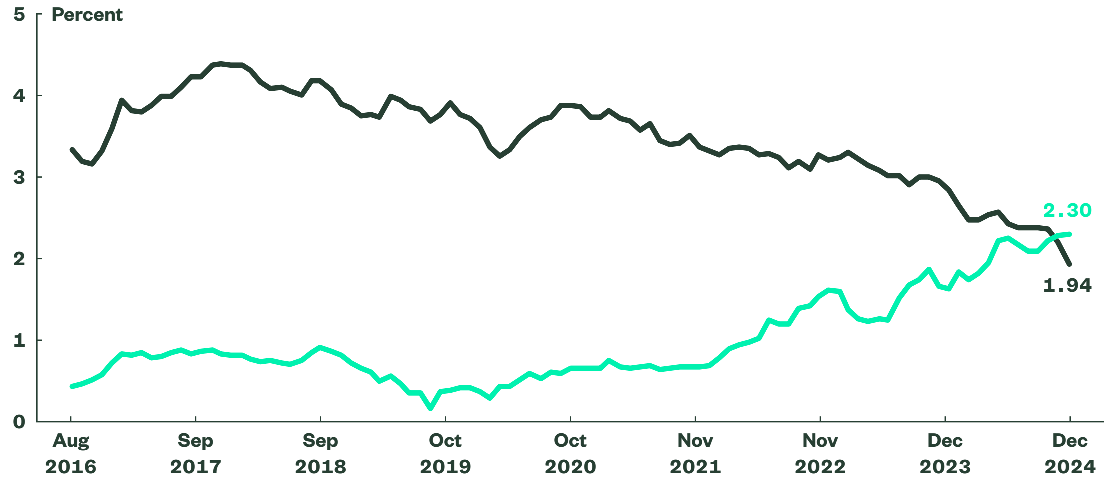
The Chinese Government Bond (CGB) market has come in recent years to resemble that of Japan's during that country's "lost decades". Notwithstanding differences in the nature and severity of the underlying structural issues, concerns have mounted that China may be experiencing its own "Japanification" scenario. With yields tracking ever lower, US dollar-hedged CGBs have outperformed the bonds of major counterparts through market cycles over the past 20 years, from both a total return and risk-adjusted perspective. However, the geopolitical risk backdrop warrants investors' attention, given the potential for China's saber-rattling around Taiwan to take a more aggressive turn.

The seemingly relentless decline in the CGB yield (Figure 1) since the turn of the current decade has come to be viewed in some quarters as symptomatic of China's losing battle against the "Japanification" of its economy and bond market. The worry is that China's deflationary cycle will persist, with the drop in interest rates mirroring falling wages and investment — something that has been compounded by stalling consumption — in the absence of strong and decisive fiscal stimulus measures. But it should be noted that large fiscal stimulus did not save Japan from the period known as its "lost decades". In the case of China, we doubt whether supply-centric stimulus spending would be effective enough when the underlying issue is a deficit in demand. For example, according to China's producer price index (PPI), factory prices have remained in deflationary territory for more than two years.[1] Moreover, the "multiplier effect" (money velocity) of stimulus usually diminishes when deflationary pressures become even more entrenched.

Figure 1
**China's Long-Term Borrowing Costs Fall Below Japan's**




Source: Bloomberg Finance L.P., as of December 31, 2024. Past performance is not a reliable indicator of future performance.

As illustrated in this article from February 2024,[2] China exhibits some of the same characteristics that pushed Japan into its lost decades. These include demographic decline, high debt levels, and a secular slump in potential growth driven by weak demand coupled with deflation. A summary of the structural issues facing China and the comparison of those with Japan's experience is provided in Figure 2. In the subsequent table (Figure 3), we consider the lessons learnt from Japan and the potential implications for China.

Figure 2
**Structural Issues: Demographics, High Debt, Low Growth**

| Debt | Japan | China |
|---|---|---|
| **Debt-to-GDP Ratio** | Approx. 250% | >250% |
| **Credit Creation Channel** | Banks, Housing Financing Co | Banks, Local Government Financing Vehicle (LGFV) |
| **Difference/Similarity** | Plaza accord<br>• Yen strength/BOJ easing<br>• Manufacturers/exporters went abroad<br>• Credit creation turned inward (services/property) | Global Financial Crisis (GFC)<br>• Fiscal spending increase<br>• Credit creation ramped up |
| **Credit Collateral** | Credit creation via banks (land collateral) | Local govt debt from land sales etc. |
| **Catalysts Triggering Bust** | • Housing affordability skyrocketed<br>• 1990: politically-led Ministry of Finance credit tightening<br>• Bank of Japan rate hikes | • "Houses are for living in"<br>• "Three red lines" policy in 2020 (regulations limiting real estate borrowing)<br>• "Non tech" technology industry crackdown<br>• Unemployment spike |
| **Bad Loan Capitalization** | Bank nationalization but considered too late (from 1998~) | Capital injections to 6 big banks, 10tr CNY hidden debt swap Q4 2024~ |

Figure 3

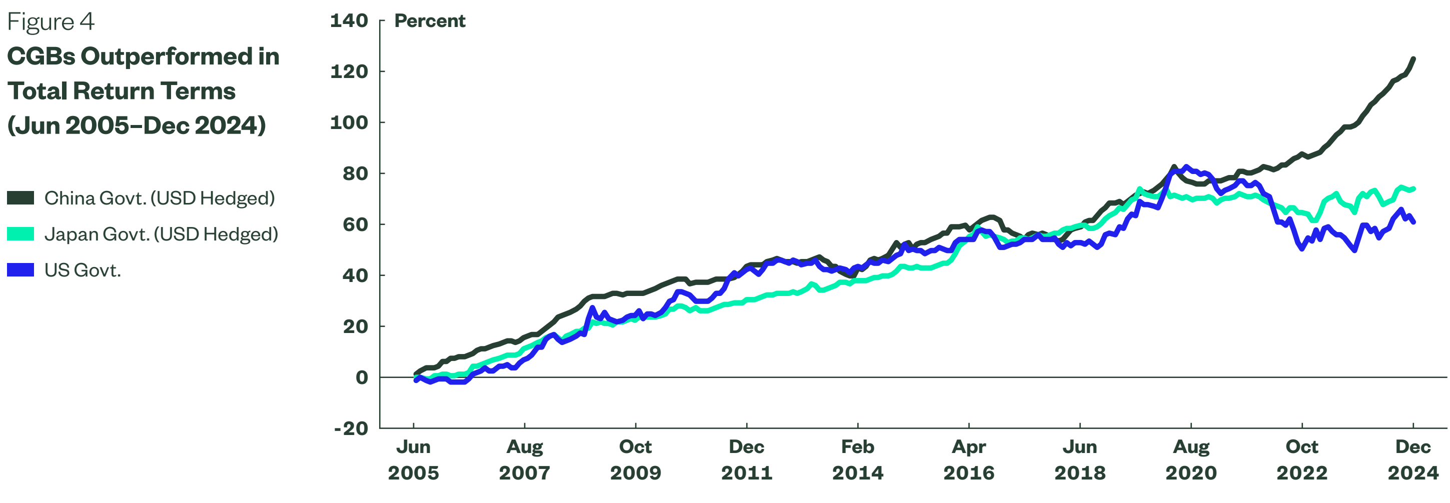
**Lessons Learnt from Japan, Potential Implications for China**

| | Japan | China |
|---|---|---|
| **Lessons Learnt** | • Supply side reform does not fix demand deficit<br>• Low levels of "real water" infrastructure fiscal spending led to productivity declines | • Backstop needed (a buyer of last resort)<br>• Delayed response but better late than never |
| **What Next?** | • Real wage growth | • Stop property price plunge<br>• New growth engine<br>• Demand boost |
| **Bright Side (for China)** | i. Manufacturing base bigger, but US-China trade spat a headwind<br>ii. Room to grow GDP per capita<br>iii. Wiggle room from policy viewpoint given single party rule in China<br>iv. State-owned banks: liquidity tap controllable, no solvency concern<br>v. Next gen growth AI, EVs, chips, semiconductors, renewables | |
| **Potential Implications** | **i. Gradual decline in potential growth from c.5% to c.3%(?)**<br>**ii. Secular decline in rates (lower credit velocity -> cash in banking system)**<br>**iii. Weaker Chinese yuan (CNY)**<br>**iv. Chinese equities still regarded by many as a trade not an investment. A nimble/tactical approach is generally favored** | |

What do these implications mean for CGB investors? When we plot the returns of USD-hedged CGBs and Japanese Government Bonds (JGB) over the last 20 years, we see the divergence of performance in the latest five-year period as CGBs outperform (Figure 4). This pickup has emerged as worries of Japanification have seen a stable CNY, accompanied by seemingly secular yield declines, help propel returns to the asset class.

Figure 4

**CGBs Outperformed in Total Return Terms (Jun 2005–Dec 2024)**




Source: Bloomberg Finance L.P., State Street Global Advisors as of December 31, 2024. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The outperformance reflected in the chart above has been evident on a local currency, USD unhedged and hedged basis, and in both absolute and risk-adjusted terms (Figure 5).

Figure 5
**CGBs Outperformed on Risk-Adjusted Basis***

| | Local | | | USD | | | USD Hedged | | |
|---|---|---|---|---|---|---|---|---|---|
| | China Govt. | Japan Govt. | US Govt. | China Govt. | Japan Govt. | US Govt. | China Govt. | Japan Govt. | US Govt. |
| **Return (%)** | 4.20 | 0.80 | 2.60 | 4.90 | -0.50 | 2.60 | 4.20 | 2.90 | 2.60 |
| **Stdev (%)** | 2.20 | 2.60 | 4.60 | 4.00 | 10.70 | 4.60 | 2.30 | 2.60 | 4.60 |
| **Return/Risk** | 1.96 | 0.31 | 0.56 | 1.23 | -0.04 | 0.56 | 1.86 | 1.12 | 0.56 |
| **Max Drawdown (%)** | -4.30 | -14.80 | -18.20 | -10.60 | -50.80 | -18.20 | -5.90 | -7.10 | -18.20 |

Source: Bloomberg Finance L.P., State Street Global Advisors, as of December 31, 2024. *Period: June 2005–Dec 2024. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Past performance is not a reliable indicator of future performance.

## The Opportunity for Investors

Figure 5 illustrates why CGBs should not be ignored by investors, particularly as their low volatility is virtually unrivalled in today's highly uncertain environment for fixed income. China bonds also add an element of diversification to investment portfolios, presenting a stark contrast to volatile and higher-for-longer rates expectations in developed markets (Figure 6). We think it is unlikely that China will pivot to stimulate growth on a massive scale, and that the most likely mid-term path forward is more rate cuts. High household savings and lower loan demands would leave banks flush with cash — that is generally a favorable environment for bond markets. Furthermore, the China bond market is arguably too big for investors to ignore at this point, as it accounted for more than 10% of the Bloomberg Global Aggregate Index at the end of December 2024.

Figure 6
**Chinese Bonds Deliver Diversification**

| | China Treasury and Policy Bank | Global Agg. | US Agg. | Euro Agg. | Japanese Agg. | Sterling Agg. |
|---|---|---|---|---|---|---|
| **China Treasury and Policy Bank** | 1.00 | 0.43 | 0.35 | 0.35 | 0.36 | 0.32 |
| **Global Agg.** | 0.43 | 1.00 | 0.83 | 0.88 | 0.71 | 0.74 |
| **US Agg.** | 0.35 | 0.83 | 1.00 | 0.57 | 0.61 | 0.61 |
| **Euro Agg.** | 0.35 | 0.88 | 0.57 | 1.00 | 0.39 | 0.69 |
| **Japanese Agg.** | 0.36 | 0.71 | 0.61 | 0.39 | 1.00 | 0.31 |
| **Sterling Agg.** | 0.32 | 0.74 | 0.61 | 0.69 | 0.31 | 1.00 |

Source: State Street Global Advisors, FactSet, Bloomberg, as of December 31, 2024. Correlation data calculated using monthly returns from May 2005 to December 2024.

## Geopolitical Risks Warrant Attention

A key factor that we believe is keeping investors away from investing in China is geopolitical risk around Taiwan. While the threat from US tariffs is known even if the extent/timing/scale of such action is unknown, the impact from any increase in Chinese aggression against Taiwan could have far-reaching implications. In such a "Grey Swan" scenario, we would expect to see a collapse in the currency and a vacuum in market liquidity. The experience of Russia in the aftermath of its 2022 invasion of Ukraine is instructive — Russian bond, currency, and stock markets ceased to function adequately after Russia lost access to the SWIFT system, hampering the ability of Russia and its financial institutions to conduct international business and settle payments. Russian debt was then downgraded to junk status, and the country continues to face severe restrictions in accessing global capital markets. Notwithstanding some movement towards negotiations, Russia's foreign exchange reserves were still frozen in February 2025, a situation that has compounded its economic isolation. Should a similar scenario play out around China/Taiwan, that might seem too big a risk to take for a sub-2.0% 10-year CGB bond yield.

## Endnotes

1 Bureau of Statistics of China, December 2024.

2 *China's future and the echoes of Japan's lost decades*, State Street February 2024.

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* Pensions & Investments Research Center, as of December 31, 2023.
†This figure is presented as of December 31, 2024 and includes ETF AUM of $1,577.74 billion USD of which approximately $82.19 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.


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ID2663000-7668166.1.1.GBL.RTL 0225
Exp. Date: 03/31/2026