Insight
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China Fixed Income: Weighing Opportunities as Access Improves

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- Easier access to China's bond market has highlighted the potential opportunity for foreign fixed income investors to participate in the country's long-term prosperity.
- The potential risk/return benefits of the China bond market outweigh recent economic and regulatory headwinds.
- The question for many investors has evolved from one of how to invest in China bonds to one of how much of an allocation to make.

For a long time, global bond investors awaited the opportunity to gain greater exposure to the remarkable Chinese economic growth story. The sustained and rapid growth trajectory has hit the occasional speedbump, but the economy has nearly always quickly re-gathered momentum. While investors found ways to play the secular growth story, such as Hong Kong-listed equities or commodities, direct access was heavily restricted. From the outside looking in, investors watched China's bond market grow almost in isolation to become the second-largest bond market globally. As recently as 2019, the China onshore bond market had remained largely off-limits for foreign investors — local regulations, ownership quotas, and trading restrictions stymied investors' hopes. Allocations to China fixed income assets were thus often considered as off-index, niche, and opportunistic.

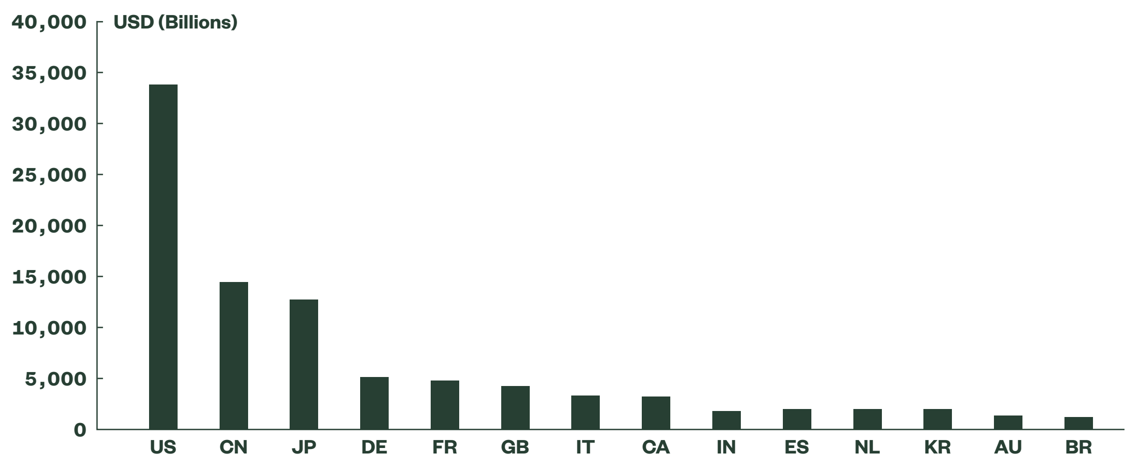
Fast forward to today and these hurdles have been dismantled, quickly and deliberately, in order to open this large market to international investors. In doing so, the China onshore bond market has now satisfied all the criteria set for index inclusion by all of the major fixed income index providers. And index inclusion is a major game-changer, as investors that take an indexed approach to bonds will be directing flows to Chinese assets to mirror the benchmark weights. An easier-to-access market also helps active investors secure their exposures, irrespective of whether they benchmark their strategies against such indices.

Chinese bonds present an attractive opportunity for yield enhancement, given the yield advantage enjoyed over the bonds of its developed market (DM) counterparts. In addition, the low correlations of Chinese bonds with DM bonds serve to highlight a significant diversification potential. Making the decision to invest in Chinese bonds is not without its challenges, as investors must establish an appropriate exposure relative to their risk appetite, incorporating the interest rate and currency risks associated with Chinese investment.

Index Inclusion: Silver Bullet?

The inclusion of Chinese bonds in major benchmark indices has thrown open the doors to foreign investors. And the evidence indicates that investors are taking up residence — foreign investors account for 3.2% of the total onshore China bond market, but this relatively small percentage represents more than a doubling since 2015. As the second largest bond market in the world (Figure 1), investors are unlikely to ignore such an opportunity. This trend seems set to continue, particularly with the incremental inclusion into the FTSE World Government Bond Index (WGBI) beginning in October 2021.

Figure 1
China Bond Market Is Now the Second Largest in the World



Source: State Street Global Advisors, Bloomberg Finance L.P., as of July 26, 2021.

Focusing the lens on China government bonds, which are the general preference of foreign investors, non-domestic ownership is closer to 10% today. The inclusion in global bond indices is a significant development in terms of attracting flows (see Table) but, based on the experience of Brazil's index inclusion, the large size of the domestic market in China means international investors are likely to remain in the minority, even when they have made full benchmark-weight allocations.

Index	Index Entry Date	Completion Date	Final China Weight (%)	Indicative AUM Tracking the Index ($bn)	Flows at Index Weight ($bn)
Bloomberg Global Agg^	Apr-2019	Nov-2020	7.2	2,000	144
JPM GBI-EM GD	Mar-2020	Dec-2020	10.0	200	20
FTSE WGBI*	Oct-2021	Oct-2024	5.6	2,500	140
Total					**304**

^ Includes China Government and Policy Bank bonds.
* Estimate.
Source: Bloomberg Finance L.P., JP Morgan, FTSE.

China is no longer viewed as an off-index, niche position in bond portfolios. Instead, it is increasingly viewed by global fixed income investors as a high-quality and relatively high-yielding alternative to traditional core government bond markets. Challenges exist, and recent developments — ranging from government regulatory actions to the financial difficulties of a major property developer — highlight those challenges, but China is being increasingly incorporated as a more permanent, strategic feature in investors' fixed income portfolios and asset allocation decisions.

Similar to equity investors, bond investors continue to debate whether China is an emerging or developed market. Our view is that China is a special-case market, one that sits between the two. We believe that the merits of investing in Chinese debt are robust, although the level of exposure that investors take on will depend on the portfolio mix and base currency, as well as portfolio-specific needs. A strong case can be made for considering a separate allocation to Chinese bonds.

The Investment Case: Attractive Yields and Low Correlations

The investment case for Chinese bonds is clear: In an environment where major developed bond market yields remain near historic lows, Chinese bonds provide an attractive yield pick-up opportunity. Meanwhile, their low correlation with other global bonds highlights strong diversification benefits. Policy Bank bonds are included here, as they are rated as highly as government bonds. Issued by China's three policy banks, these bonds enjoy implicit government support and are treated the same as government bonds in bank portfolios.

Attractive Yields, Similar Quality The yield to maturity of China Treasury and Policy Bank bonds was 2.91% at the end of September 2021, significantly higher than those of Euro Aggregate bonds (0.08%), Global Aggregate bonds (1.17%), and major regional aggregate bonds such as Sterling Aggregate (1.18%) and Japan Aggregate (0.11%). From a credit ratings perspective, the average rating of A1 for the China Treasury and Policy Bank bond index is similar to the Euro and Japanese Aggregate indices, while slightly lower than the US Aggregate, Global Aggregate, and Sterling Aggregate, but with a shorter duration.

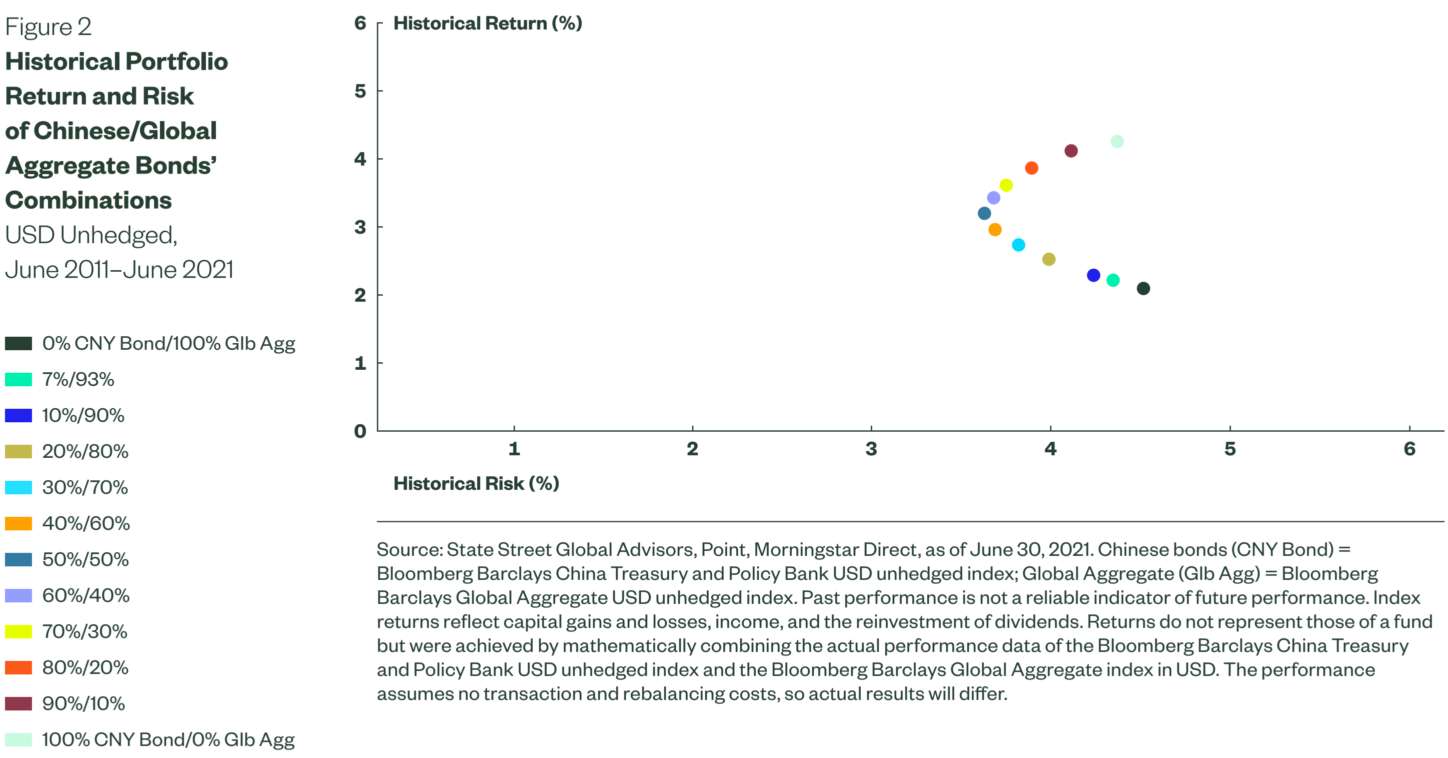
Low Correlations China Treasury and Policy Bank bonds have consistently had a low correlation relative to other major global bond markets. In USD unhedged terms,[1] the China Treasury and Policy Bank bond index had a correlation of 0.23 compared to the Global Aggregate, with even lower correlations to regional aggregate bond indices. They have also proved less volatile due to the relatively stable exchange rate with the US dollar. For euro-based investors, the correlation was 0.12 relative to the Euro Aggregate in EUR unhedged terms, although volatility was higher as a result of currency movements. (Note: Correlations were higher with global aggregate and other regional aggregate indices in EUR unhedged terms).

Historically low correlations to other major bond markets suggest that onshore Chinese bonds can deliver strong diversification benefits for fixed income portfolios. The low return correlations largely stem from the fact that China's interest rate movements are heavily driven by domestic factors, and are generally independent from those of other major economies. We think that this and the relatively early stage of its global market integration underpin the potential of Chinese bonds for the foreseeable future, although correlations may rise.

The Impact on Fixed Income Portfolios: How Much Exposure?

With easier access to China's market, investors must determine an appropriate allocation. To assess the impact of a Chinese bond allocation on fixed income portfolios, we ran an optimization using historical 10-year return and risk metrics (based on USD unhedged returns) — we established that adding Chinese bonds to a Global Aggregate bond portfolio led to a reduction in portfolio risk and an increase in portfolio return up to a 50/50 split between the two indices (see Figure 2). It is highly unlikely that investors would replace 50% of their Global Aggregate bond exposure with onshore Chinese bonds, but this analysis highlights the strong diversification benefits of even a modest allocation.

Figure 2
Historical Portfolio Return and Risk of Chinese/Global Aggregate Bonds' Combinations
USD Unhedged, June 2011–June 2021

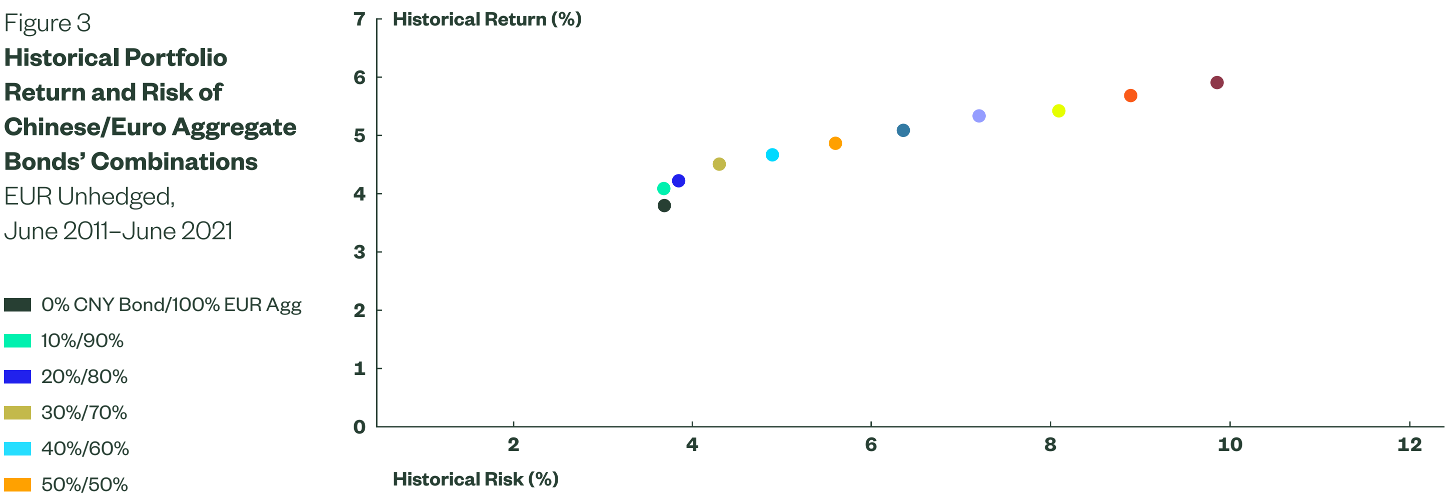


Source: State Street Global Advisors, Point, Morningstar Direct, as of June 30, 2021. Chinese bonds (CNY Bond) = Bloomberg Barclays China Treasury and Policy Bank USD unhedged index; Global Aggregate (Glb Agg) = Bloomberg Barclays Global Aggregate USD unhedged index. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Returns do not represent those of a fund but were achieved by mathematically combining the actual performance data of the Bloomberg Barclays China Treasury and Policy Bank USD unhedged index and the Bloomberg Barclays Global Aggregate index in USD. The performance assumes no transaction and rebalancing costs, so actual results will differ.

As already noted, China bond correlation and volatility levels have historically been low relative to Global Aggregate bonds on a long-run basis. Even if we bump those up in our optimization by 10–20%, we find that the diversification in a fixed income portfolio remains — in this more conservative scenario, a 40% China/60% Global combination provides the lowest theoretical portfolio volatility. Either way, this suggests that USD unhedged investors can consider an allocation to Chinese bonds that is larger than the current index weight of 7%.

In running the same optimization for Chinese and Euro Aggregate bond exposures (Figure 3), we found that a 10% allocation to Chinese bonds generated a lower portfolio risk and higher portfolio return outcome than a 100% Euro Aggregate bond portfolio. But if we increased the China allocation beyond that level, the result was both higher portfolio risk and returns. On an EUR unhedged basis, Chinese bond returns have a much higher volatility due to currency movements, resulting in a lower level of exposure from the optimization. While this is less compelling compared to our analysis for Global Aggregate bonds, a separate allocation to Chinese bonds (which are not included in the Euro Aggregate index) can help to boost returns and reduce portfolio risks for European investors.

Figure 3
Historical Portfolio Return and Risk of Chinese/Euro Aggregate Bonds' Combinations
EUR Unhedged, June 2011–June 2021



Source: State Street Global Advisors, Bloomberg, as of June 30, 2021. Chinese bonds (CNY Bond) = Bloomberg Barclays China Treasury and Policy Bank USD unhedged index; Global Aggregate (Glb Agg) = Bloomberg Barclays Global Aggregate USD unhedged index. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, incaome, and the reinvestment of dividends. Returns do not represent those of a fund but were achieved by mathematically combining the actual performance data of the Bloomberg Barclays China Treasury and Policy Bank USD unhedged index and the Bloomberg Barclays Global Aggregate index in USD. The performance assumes no transaction and rebalancing costs, so actual results will differ.

Does Currency Hedging Make Sense?

One thing that investors in China must consider is whether to hedge against moves in the Chinese yuan. Hedging Chinese bond currency exposure has become costly in recent years, to the extent that it more than eliminates the yield advantage of investing in Chinese bonds — for both USD and EUR investors. The diversification benefits are still available to the hedged investor, but we don't recommend hedging for investors who can bear currency risk.

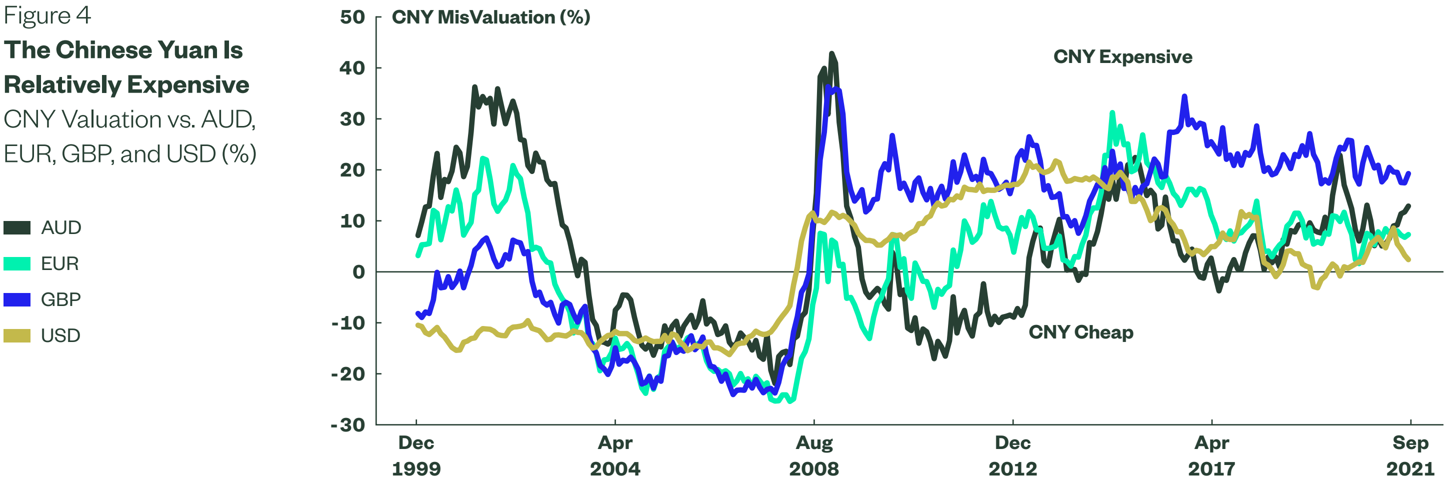
Onshore China bonds offer enticing nominal and real yields on a currency-unhedged basis relative to developed market sovereign debt. However, the currency and interest rate risks associated with such an investment warrant attention.

Currency Risk: Taking the Long-Term View

The current difference between short-term rates and long-term rates in China is around 1.0%, which is consistent with the experience in much of the developed world. It is important for developed market investors to understand that most of their return from investing in Chinese domestic bonds is coming from the short-term interest rate differentials, and therefore the currency, rather than the term premium.

We believe the Chinese yuan (CNY) will be relatively stable over the medium term, but over the longer term we consider it to be lightly to moderately expensive against most major developed markets' base currencies — our assessment is that the CNY is 3% overvalued versus the USD, 6% versus EUR, 11% versus AUD, and 16% versus GBP (Figure 4).

Figure 4
The Chinese Yuan Is Relatively Expensive
CNY Valuation vs. AUD, EUR, GBP, and USD (%)



Source: Bloomberg Finance L.P., as of September 30, 2021.

Other key considerations include:

- If the yuan depreciated back to fair value over the next three to five years, it would erode the anticipated yield pick-up achieved by switching into Chinese bonds.
- The tail risks in the event of a trade war flare-up or other geopolitical incident could conceivably result in a rapid depreciation of the kind witnessed in 2018 and 2019.
- While investors could hedge positions using the offshore deliverable forward contract, CNH, the cost of carry roughly equals the Chinese 10-year yield, eliminating much of the yield advantage.

Interest Rate Risk

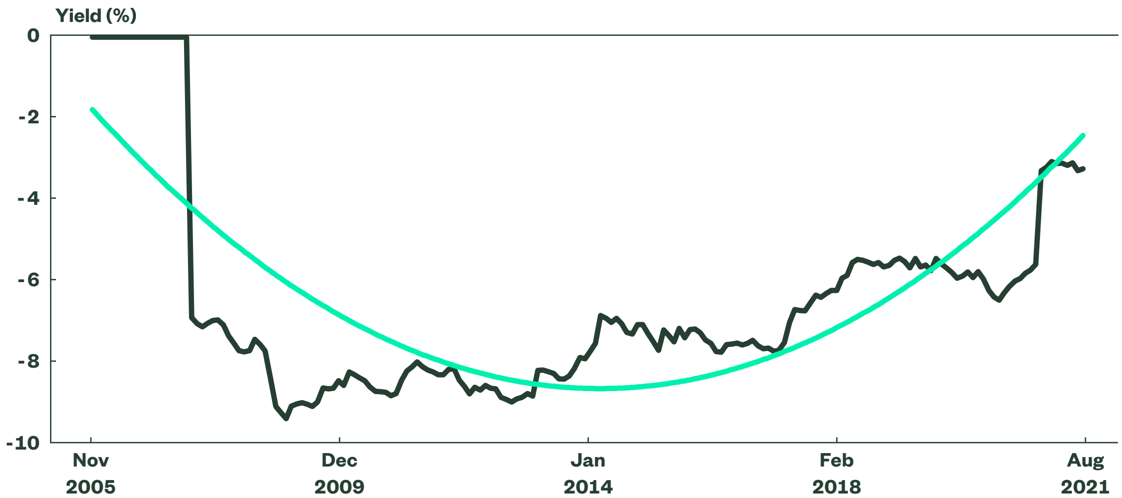
Recent rolling COVID-19 lockdowns in China have tilted expectations toward lower rates, as the Chinese government attempts to support growth via greater credit creation. However, as we move past what should be a near-term issue, there are several factors likely to influence yields over the longer term:

Secular Flows As China's continued opening of its capital market draws more investors, bond yields are further supported. Index inclusion, investors carving out specific allocations for China, and reserve banks adding China to their asset mix all indicate sustained demand for Chinese bonds.

Growth Gap The economic growth gap between China and the rest of the world is likely to narrow as the Chinese economy matures and potential growth rates fall relative to the rest of the world. This suggests that the yield differentials between China and the developed world will continue to narrow.

Interest Rate/Growth Rate Differential Domestic interest rates in China have traded well below their nominal growth rate for decades, but the differential has narrowed at an increasing rate (Figure 5). This gap is likely to keep closing. As the world gradually works through the impact of the pandemic, and as China continues to open its markets and evolve its domestic growth strategy, interest rates are likely to steadily rise as these forces place downward price pressure on Chinese bonds.

Figure 5
China Interest Rate/Growth Rate Differential Is Narrowing
10-Year Real Yield (%)



Source: Bloomberg Finance L.P., as of September 30, 2021.

Effect of China Country Risks on Bond Risk Premia

China is currently facing a cluster of risks, including government regulatory action targeting several industries, a sharp deceleration in growth resulting from COVID-related lockdowns, supply chain and electricity disruptions, idiosyncratic leverage/credit risks as seen in the Evergrande news, and surging imported commodity input costs. It is reasonable to expect higher risk premia (higher cost of capital) across all Chinese assets as a result of these stressors. While that may be true for equity markets and corporate credit, the case for a higher cost of capital via higher interest rates and a weaker currency is less clear.

Overall, nominal yields should not be rising in an environment of slower growth, even if risk spreads widen to account better for default risks. Moreover, we have to recall that China runs a heterodox monetary arrangement, with a managed exchange rate and semi-open capital account. As a result, interest and exchange rates are not fully market-driven, but rather are policy-driven.

Policy incentives favor stable to slightly lower rates alongside a stable to slightly stronger currency. The Chinese government is specifically working to reduce leverage — lower rates may boost growth in the near term, but will also undo progress in reducing leverage. A weaker exchange rate risks amplifying the acute increases in imported energy costs and could cause more harm than good.

The Transition from How to How Much

China has been an increasingly important part of the global growth story for a long time, and it is highly likely that the opening up of its markets to the rest of the world will continue. As such, investors should consider developing a framework to include China in their asset allocations that recognizes both the benefits and key risks associated.

China's fixed income market represents an intriguing opportunity to enhance the yield potential of investors' portfolios. In the space of a few years, the market has moved from one that was something of a minefield in terms of access to one that has now been included in flagship benchmark indices. Whether considered as part of an overall investment portfolio decision or as a separate, dedicated allocation, the growth of foreign ownership signals that investors are increasingly making the transition from "how?" to "how much?" when it comes to considering an allocation to China bonds.

For more information on how best to invest in the China fixed income market, please contact your State Street Global Advisors relationship manager.

Endnotes

1 Based on data between July 2004–June 2021.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.86 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 billion of 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.