Fixed Income: China, EM Come Online

In our survey of over 350 institutional investors, responses confirmed that the trend of increasing investment in Chinese and emerging markets' bonds remains in place. This paper looks at what investors are thinking when it comes to making investments in these assets.

Investor Appetite Continues to Grow

The appetite of investors for emerging market debt has increased as its higher yields and lower durations compare favourably with the low/negative yields and high duration of developed market bonds. While not without its risks in the current environment, EM debt is increasingly considered a strategic allocation within the modern fixed income portfolio.

Access to EM debt has improved immensely and structural changes in the markets and new portfolio management techniques mean that benchmark index returns can now be achieved reliably and efficiently.

It is not a surprise to us that 42% of the global institutional investors who participated in our survey say that they expect to increase allocations to EM debt over the next three years.

33%	45%	60%
North American Respondents	**European** Respondents	**Australia** Respondents

Percentage saying they expect an increase in their emerging market debt allocation over the next 3 years.

Source: State Street Global Advisors. Global n=358. **How do you expect your institutions overall allocation to the following fixed income segments to change over the next 3 years?**

This continued demand for emerging market fixed income assets — even after the past decade's growth — is remarkable. Investors can now more easily invest in local inflation-linked bonds, as well as hard currency and local currency corporate bonds. Based on our estimates, the universe of index-eligible securities stood at over US$7 trillion at the end of June 2021.[1]

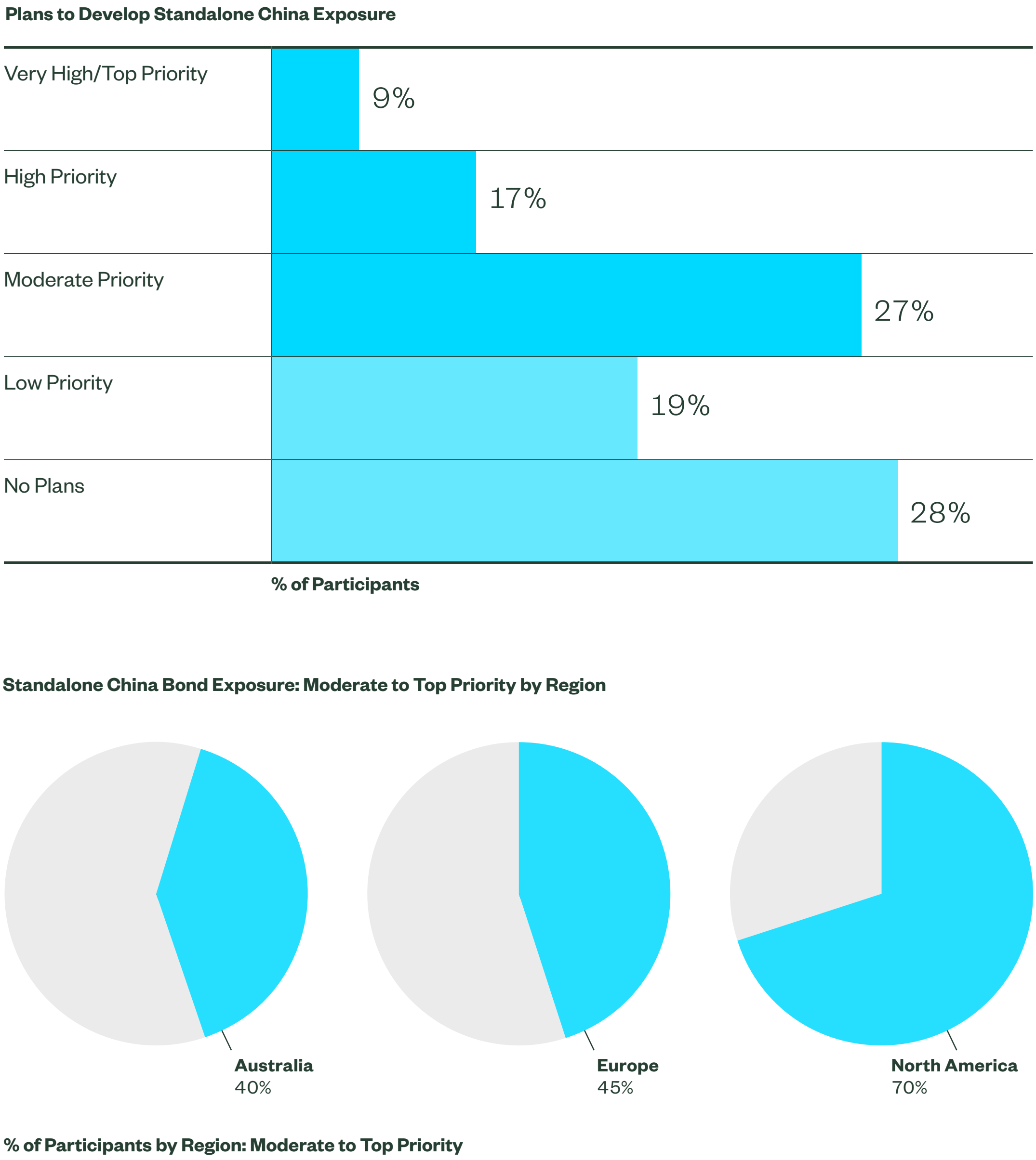
1 Source: State Street Global Advisors, JP Morgan, as of 30 June 2021.

China Bonds: An Underweight Giant

China is too big a market for investors to ignore and the inclusion in major fixed income indices in the last couple of years has focused investor attention on what has become the world's second-largest bond market. Foreign ownership of Chinese government bonds has steadily increased from less than 1.5% to over 3% in six years and it is generally expected that this will likely continue rising with their incremental inclusion in the flagship FTSE World Government Bond Index (WGBI) from October 2021.

Drilling down into our survey, it is notable that there is still a sizeable proportion of investors (28%) not planning to develop a standalone fixed income exposure for China in the next three years. At the same time, 44% have determined it to be a moderate-to-high priority, with another 9% identifying it as a top priority.

Figure 1
What Plans Do Investors Have for Chinese Bonds?



Source: State Street Global Advisors. Global n=358. **To what extent is your institution prioritising each of the following strategies for its fixed income portfolio over the next three years?**

The Shift to Indexing

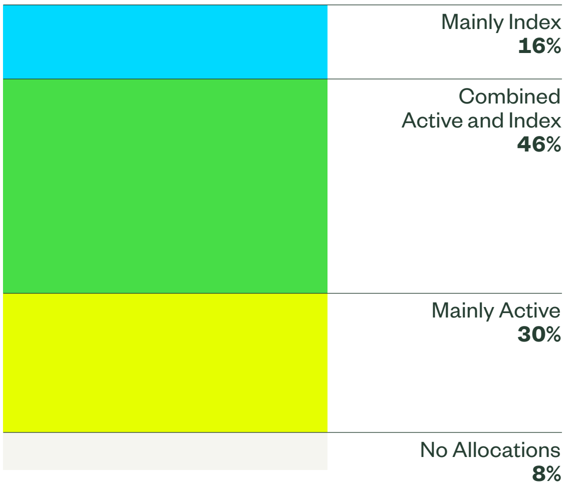
Emerging bond markets have been transformed in terms of market size, liquidity and security type. These developments have led to the rise of indexing in emerging market debt, giving investors new choices on how to access these markets. Furthermore, an analysis by State Street Global Advisors has shown that active managers have persistently fallen short of investor expectations, either in terms of delivering alpha or providing downside protection during periods of heightened market volatility.[2]

In our survey, we asked participants whether their actively managed strategies delivered the investment performance they were hoping for over the previous three years — for EMD strategies, just 46% responded that they had.

Historically, investors favoured an active approach on the basis that EM bond markets were difficult to access, often weren't particularly liquid, and the threat of default was not non-existent. The political and economic landscape was also typically more volatile than that of developed markets. But emerging economies are now on a much firmer footing, with significantly improved fundamentals, while the difficulty and cost of applying an indexed approach has eased substantially.

The survey also revealed that many investors take an approach that combines an active and indexed approach to emerging market debt.

Figure 2
What Type of Strategy Does Your Institution Use in the EMD Segment of its Fixed Income Portfolio?



Source: State Street Global Advisors. n=336.

Our Take

We do not find it surprising that investors are maintaining their interest in emerging market bonds, as it mirrors the flows we have been seeing to our indexed strategies in recent years.

As in other markets, the active/passive debate continues to rage. Our conversations with clients reflect the survey responses that some investors are switching to a fully indexed approach while others are combining both active and indexed — the two approaches can be complementary and not necessarily mutually exclusive.

2 Indexing on the Rise, October 2021, State Street Global Advisors. Please ask your State Street representative for a copy.

Why China and EM Bonds?

There are myriad reasons why investors are allocating to Chinese and emerging market debt and why indexing is an increasingly popular approach:

Yield Enhancement Potential	China's government and policy bank bonds and emerging market debt offer a relatively attractive yield pickup over developed market bonds.
Diversification Benefits	The low correlation and higher growth factor exposures provide potential diversification benefits for global bond and equity investors.
Market Liberalisation	Chinese bond markets are increasingly accessible following changes to open the onshore market to foreign investors, while market dynamics have also improved.
Structural Market Developments	Over the past decade, the emerging market universe has grown in variety, size, depth and liquidity, making this complex asset class more accessible for experienced and skilled index managers.
Delivery of Benchmark Returns	Index management prioritises tight tracking to benchmark returns, reducing performance variability and idiosyncratic risk, and increasing the impact of investor asset allocation decisions. With the right techniques and expertise, EMD is deliverable in indexed form in a reliable, cost-effective way.

The Takeaway

Not only has the EMD market grown in size and number of countries, but the types of securities on offer have also become much more diverse. The range of choices for investors is likely a key factor the market's ongoing growth. While the local currency corporate bond universe is still reserved primarily for local investors, hard currency EM corporate bonds have been gaining popularity with international investors.

Countries included in benchmark indices must meet exacting criteria, which helps bolster investor confidence in those assets. The inclusion of Chinese bonds in the FTSE WGBI is an important development — actual flows following previous index inclusions have exceeded levels explained by benchmark weights alone, indicating additional demand for bonds that 'prove' their investability by being included in benchmarks.

Accessibility, diversification, and yield pick-up opportunities are important for fixed income investors. Investment in emerging markets debt has grown significantly over recent years and the responses in our survey suggest this will continue, with the appetite for Chinese bonds similarly increasing. In terms of making allocations to these assets, the question has evolved in many cases from one of 'how', to one of 'how much'.

For the full survey, please visit ssga.com/insights/fixed-income-research.

Further Reading

Chinese Bonds: Enhancing a European Fixed Income Portfolio

https://ssga.com/insights/chinese-bonds-enhancing-a-european-fixed-income-portfolio

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- Start with rigour
- 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 $3.90 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 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.

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Marketing communication

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International Government bonds and corporate bonds generally have more moderate short term price fluctuations than stocks, but provide lower potential long-term returns.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

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