

Asian fixed income watch

- China index inclusion
- Latest from Asia credit and China property

October 2020



Cecilia Chan
*CIO, Fixed Income,
Asia Pacific*



Ming Leap
*Portfolio Manager,
Fixed Income*

Key takeaways:

- ◆ FTSE Russell has decided to include onshore RMB government bonds into its flagship index. The inclusion process is tentatively scheduled to begin in October 2021 and will be phased over a 12-month period. We could expect significant passive inflows of around USD140 billion to USD150 billion over the inclusion period
- ◆ Since the trough in March, the Asia credit market has rebounded and has already recovered. The market could be entering a phase of consolidation, where we could expect greater dispersion and where relative value opportunities will become more dominant
- ◆ Given Asia credit's attractive attributes, it may not be surprising that interest in the Asia credit market has been strong, as evidenced by the 3.6x growth in the AUM of Asia credit funds over the last seven years

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China onshore bonds

Index inclusion of China onshore bonds

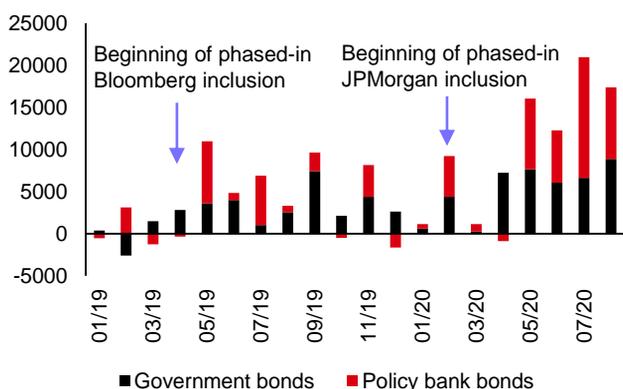
In its September 2020 annual review, FTSE Russell has decided to include onshore RMB government bonds into its flagship index, the FTSE World Government Bond Index (WGBI). The inclusion process is scheduled to begin in October 2021 and will be phased over a 12-month period; however this timeline is tentative and is subject to final affirmation in March 2021. China has been working to improve bond market accessibility for foreign investors. FTSE cited enhancements made to China's fixed income market since being placed on the watch list for reclassification (required to be included in the index), including in areas of secondary bond market liquidity, foreign exchange market structure, and global settlement and custody processes. Further, FTSE Russell stated that there are more reforms to come from the Chinese market. The index provider stated, though, that operations need to be tested given the changes in regulations before a final confirmation of the inclusion.

Assets tracking the WGBI are estimated to be around USD 2.5 trillion and the inclusion of Chinese bonds could drive significant passive inflows of around USD140 billion to USD150 billion over the inclusion period.

FTSE Russell is the latest of major index providers to announce China bond inclusion in the last two years. China's reform efforts were already recognized by Bloomberg as well as JP Morgan as both of these index providers are already in the phased-in process of including Chinese onshore bonds into their widely tracked global indices. The onshore China bond market is seeing strong demand from foreign investors this year and is witnessing a record amount of inflows: year-to-date, inflows into China government bonds and policy bank bonds have totaled more USD 85 billion.

Fig. 1: Strong demand from foreign investors in China onshore bond markets

Net monthly foreign inflows (USD million)



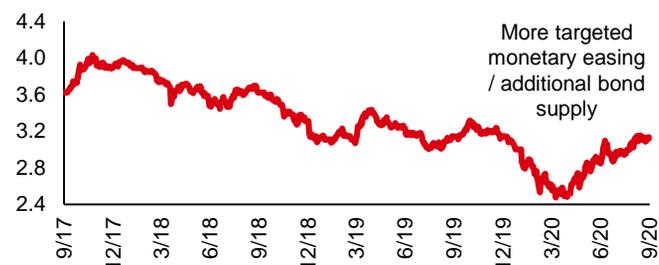
Source: CEIC as of August 2020

Benefits of China's diversified interest rate cycle

The yield on China's 10-year government bond has been climbing progressively from 2.5% at the end of April, to the current 3.1% (as of 29 September), but we see this as a sign of the Chinese economy recovering and the risk-on sentiment in China. Overall, this has been the effect of the decision to have more expansionary fiscal policy, which translated into increased government bond supply, while the central bank is waiting to see whether monetary policy will need adjustment. Bond supply has been well anticipated, and the supply overhang should cool down at the end of October. While the PBOC has paused on rate cuts, this does not mean that the central bank is not accommodative. Unlike in 2019 when food prices were driving inflation higher, price increases so far this year have been benign, allowing the PBOC more room to stay accommodative for longer.

Fig. 2: Monetary policy to remain accommodative

10-year China government bond yields (%)

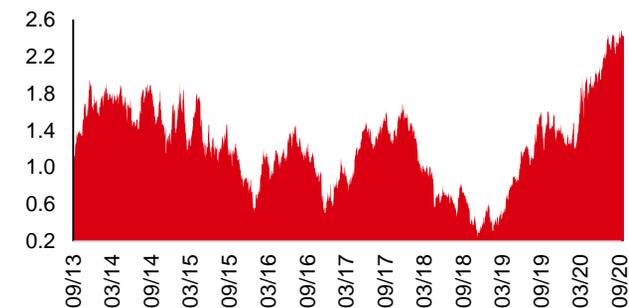


Source: Bloomberg as of September 2020

China's 10-year government bond yield is trading at a significant premium over other similarly rated markets. The current premium of China 10-year governments bonds over US 10-year government bonds is at a historical wide of 250bp. Investors hedging RMB China government bonds into domestic currencies may still enjoy a yield pick-up, while continuing to enjoy the benefits of China's diversified interest rate cycle.

Fig. 3: Yield differential between China and US government bonds is at a historical wide level

10-year CGB yield minus 10-year UST yield (%)



Source: Bloomberg as of September 2020

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Asia credit

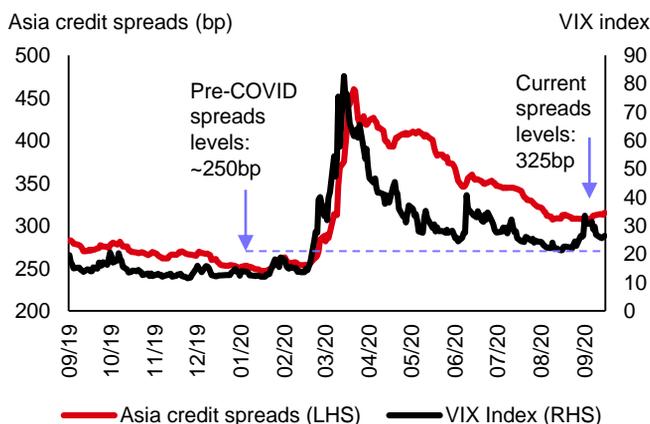
Market update

The Asia credit market stayed relatively resilient even during the height of the COVID-19 market panic in March. Asian investment grade corporate bonds, in particular, did well during the panic, falling by 7.1% during the downfall, versus US investment grade corporate bonds' fall of 15.1%. The Asia credit universe is largely made up of bonds issued by large, stable and often government related institutions, which has been beneficial during this period; many issuers also entered 2020 with better corporate fundamentals than in past years, indicating that they were better equipped to weather the uncertainties.

Asian bonds continue to be supported by Asia's solid macroeconomic backdrop. Asia ex Japan is one of the only regions in the world that is still expected to see positive GDP growth in 2020, and recovery is underway for a number of Asian economies. Helped by this and the Asia credit market's limited exposure to the oil sector, Asia's high yield default rate of 2.2% year-to-date has been lower than that of the US high yield market at 6.0% and emerging markets at 2.5%. On a full year basis, JP Morgan is forecasting a notably better picture for Asia (4.0%) versus other regions (US at 8.0%). It should be stressed that when investing in high yield markets, a strong credit selection process is crucial to avoid investments in securities with default potential.

Since the trough in March, the Asia credit market has rebounded and already recovered. The market could be entering a phase of consolidation, where we could expect greater dispersion and where relative value opportunities will become more dominant. The US Fed funds rate is projected to stay at its current levels until 2023, according to FOMC median projections, and we believe this has already been discounted by the market.

Fig. 4: Asia credit still spreads trading at wider levels versus pre-COVID period



Source: JP Morgan, Bloomberg, as of September 2020

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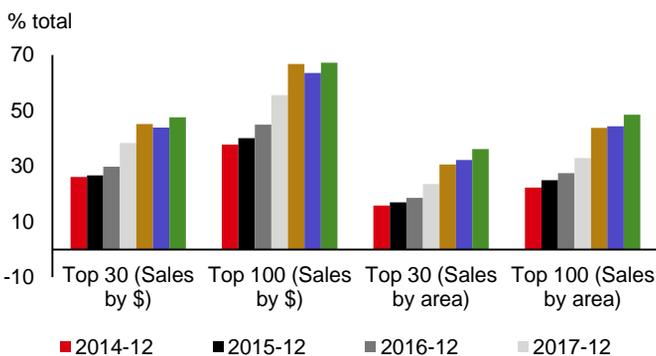
Update on China property

Chinese property developers in the offshore USD bond market have experienced a higher degree of volatility in recent days following recent news headlines. Despite this, we continue to favour the Chinese property sector, while remaining selective. We like developers with high-quality land banks, strong sales execution and diversified funding channels. We believe these types of developers can weather tightened policies on financing and should be able to take advantage of the accelerated industry consolidation. We are underweight highly leveraged developers who have limited funding channels, as they may face more difficulties obtaining refinancing and may therefore be relatively disadvantaged versus their peers; these companies would be more pressured by the recent "three red lines" window guidance. This policy sets limits on bank borrowings, which includes a 70% cap on developers' asset-liability ratio, 100% cap on net-debt ratio and a requirement that short term debt should not exceed cash.

We believe that the recent policy on tightening financing on developers aims to curb leverage growth of highly leveraged developers rather than reduce leverage of the sector overall, as was the case in 2017-2019. The purpose is to avoid over-heating the housing and land markets. In this situation, we believe refinancing should still be largely viable.

Over the short term, we may see greater credit differentiation in the market where highly leveraged property developers may underperform given the constraints on using debt as a means for growth. We may also see more developers try to take the opportunity to pre-emptively finance the offshore wall of 2021 maturity, which may potentially lead to more bond supply. Despite new policy measures, the overall sector remains well supported by strong investor demand, which we expect to continue given the strong search-for-yield globally and the attractive relative valuations of the property sector.

Fig. 5: China property: Industry consolidation expected to continue



Source: Wind, Bloomberg, HSBC Global Asset Management, data as of September 2020

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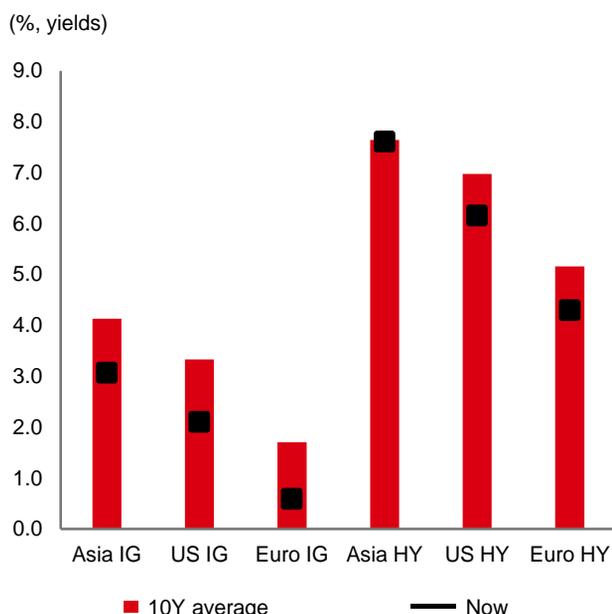
Asia credit

Attractive yields

Overall, the attractive yields on Asia credit continue to be appealing. For investment grade corporate bonds, Asia offers close to 100bp of yield premium over US bonds. For high yield corporate bonds, Asia's yield differential over US has reached 145bp.

Asia bonds are also bolstered by much lower levels of duration, which make them less volatile and sensitive to interest rates, and in the current environment this means that the asset class will be less vulnerable to rising treasury bond yields should there be a sustained recovery after the pandemic.

Fig. 6: Asian bonds offer higher yields vs global counterparts



Source: Bloomberg, data as of September 2020

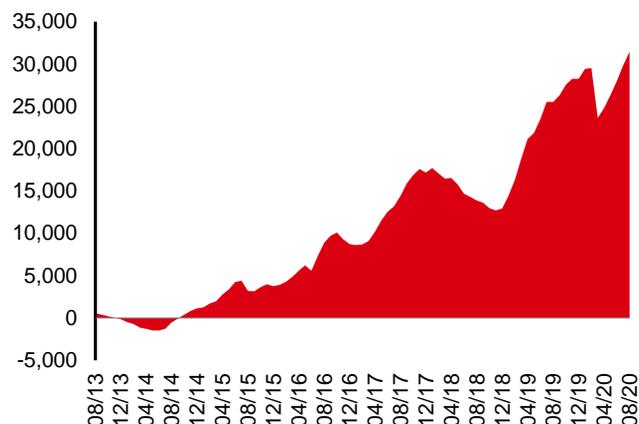
Strong demand

Given Asia credit's attractive attributes, it may not be surprising that interest in the asset class has been strong, as evidenced by the 3.6x growth in the AUM of Asia credit funds over the last seven years. Even after stripping out market gains, net inflows over the past seven years has totaled USD 31 billion (see Figure 7).

There has been increased interest in Asia credit from US and European fund managers, as shown by the origin of the inflows this year, which makes sense given the yield premium offered by Asia credit over US and Euro bonds.

Fig. 7: Asia credit funds' cumulative flows: USD 31 billion of net inflows over 7 years

Cumulative flows into Asia credit funds (USD million)



Source: Bloomberg, Morgan Stanley Research as of August 2020

Latest sector views

While there can be scenarios of technical corrections going forward, we believe possible market sell-offs could provide opportunities to pick up attractive investments.

In our Asia credit strategy, we continue to like China property, while we remain selective. Elsewhere in China, we like high quality state-owned enterprises, financials and construction. In Indonesia, we remain selective on property and utility. In India, we are overweight the utilities sector, favouring names with greater earnings visibility; we are exposed to India renewable and energy names for their stability. We are also looking at sectors and names that have been oversold but where fundamentals remain solid.

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