One-on-one interview

China fixed income: Investing in resilience

June 2020

Ming Leap

Portfolio Manager, Asian Fixed Income / Lead Manager, RMB Fixed Income

In this interview Ming Leap, Portfolio Manager, Asian Fixed Income / Lead Manager, RMB Fixed Income, shares his views on what will drive the China fixed income market in the post-pandemic environment whilst highlighting key investment opportunities in this asset class and detailing the outlook for the Chinese currency

In the National People's Congress (NPC) meeting concluded last month, the policymakers have signaled increasing targeted stimulus measures in a restrained manner in the coming months. How would an accommodative stance impact the Chinese bond market going into the second half of 2020?

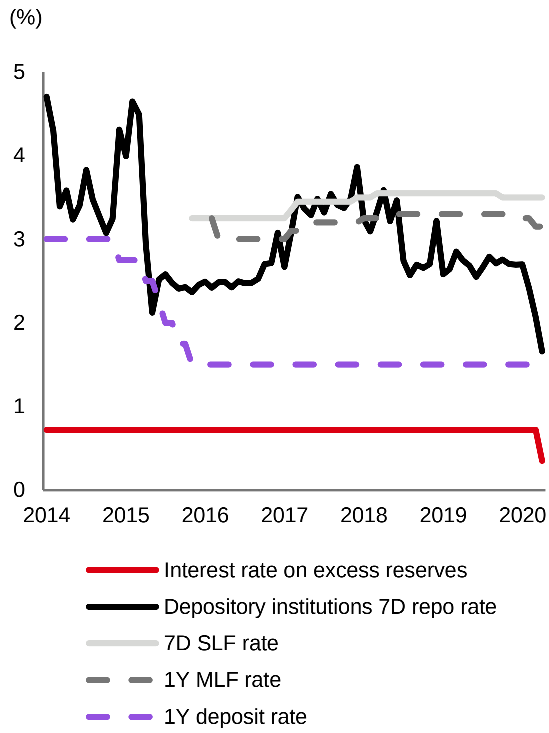
Ming: At the macro level, the NPC, which concluded on 28 May, has laid out China's plan to revive growth on both the supply and demand sides of the equation. For instance, the government has reduced taxes and fees for companies affected by the coronavirus outbreak, while around 30 mainland provinces have issued RMB19 billion worth of vouchers to boost household spending.

For fixed income investors, one of the key takeaways from the NPC is a different kind of credit expansion to the 2008 period, when we saw a surge in borrowing by the corporate sector and local government financing vehicles. This time around, we expect the increase in leverage to be largely driven by the public sector.

Premier Li Keqiang announced an increase in special purpose local government bond quota to RMB3.75 trillion, up from RMB2.15 trillion, and the local governments have issued over RMB2 trillion in special bonds in the first five months of this year, according to official data. On top of that, the government will issue RMB1 trillion in central government special bonds this year.

Local government bonds could be used to finance infrastructure projects, while central government bonds could be used to support businesses and regions hit by the virus outbreak. The central government has also set a fiscal deficit target at 3.6% of GDP or above, higher than the 2019 target of 2.8%.

Fig 1: Lowering the cost of money to support growth



Source: PBoC, HSBC Global Asset Management, data as of April 2020

(cont'd)

Broadly speaking, the country is returning to normal sooner than other parts of the world, barring any significant second or third waves of infection. However, the economic outlook remains challenging given a lackluster global backdrop.

We think the Chinese central bank has more policy leeway to support the economy than its developed market counterparts, potentially using more unorthodox tools at increasing scale. For instance, the central bank on June 1 announced a RMB400 billion credit loan purchase prgroamme to support small and medium enterprise (SME) lending, providing incremental liquidity that could potentially free up banks balance sheets to drive inclusive SME loan growth. Banks will still receive the interest payment on these SME loans, bear the credit default risk, and will need to pay it back to PBoC after one year.

Effectively the PBoC is making zero interest loans to small banks based on their new SME lending size. In return, SMEs that receive these loans should promise that they will keep their employment stable.

Going into the second half, we believe there will be more targeted easing to aid struggling companies in the country, while cheaper funding costs are expected to stay for a prolonged period – a key technical factor to allow companies to refinance their existing debt at friendly rates

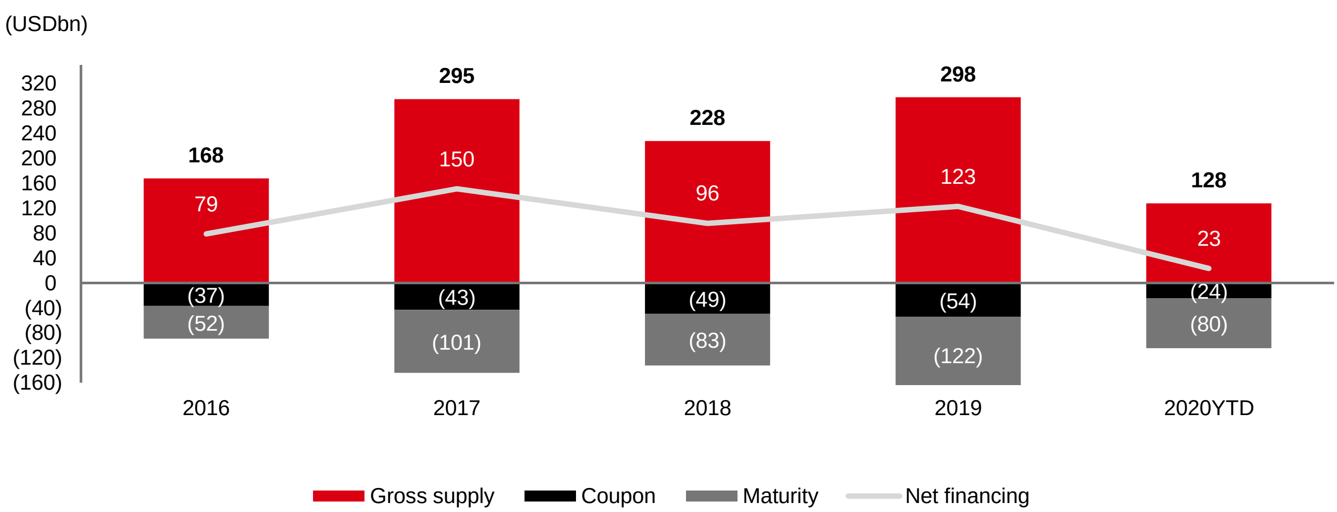
Given the sheer size of local government financing vehicles (LGFV) and property bonds, what's your assessment of the two closely-watched sectors?

Ming: Supportive policies from the central government are likely to partly offset the negative impact on LGFVs due to weakening trends in fiscal income and rising debt burdens on local government. Overall speaking, LGFVs – financing vehicles created by local governments – have benefited from the monetary policy, as evidenced by the surge in domestic LGFV bond issuance. We think the downward pressure is likely to persist on the sector and investors should pay attention to any shift in policy direction or business focus. According to data compiled by Wind, the net issuance of LGFV bonds picked up significantly to around RMB1.39 trillion for the first five months of the year, compared with RMB1.53 trillion for the full year of 2019. As a result of a strong fiscal spending, the issuance of LGFV bond is likely to surpass last year's level.

For the property sector, we saw narrower year-on-year decline in transaction volume across all region, with signs of a gradual recovery. The April property sales volume/value declined 2%/5% year on year, compared with 14%/15% in March 2020. The blended average selling price was down 3% year on year in April, but it was up 6% on a month on month basis. Spreads were generally tighter across much of the onshore and offshore property bonds, underscoring relatively resilient property prices across the country and an appetite for bonds.

With an accommodative onshore market, property developers are more likely to refinance their debt through onshore market than offshore USD channel. Overall, a reduction in the supply of USD bonds is likely to provide technical support for outstanding dollar bonds.

Fig 2: Net supply in the Asian credit market has declined



Source: JP Morgan as of May 2020

Investment involves risks. Past performance is not indicative of future performance
Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets. For illustrative purposes only.

(cont'd)

For global investors, what's the reason they should consider adding Chinese bonds into their portfolios?

Ming: First off, the attractive yield pick up over the US Treasury is something long-term global investors should be aware. The 10-year Chinese government paper is trading over 200 bps the US counterpart and the trend is likely to persist as the US Federal Reserve said it would keep interest rates close to zero until at least the end of 2022, citing concerns over the unemployment in the US and its willingness to fight against the economic shock triggered by the coronavirus.

Secondly, onshore Chinese bonds offer important diversification benefits, as it is still largely a domestically driven market. The China onshore and offshore RMB-denominated bonds have historically demonstrated a low correlation with US and Euro asset classes, with healthy risk-adjusted returns and low volatility.

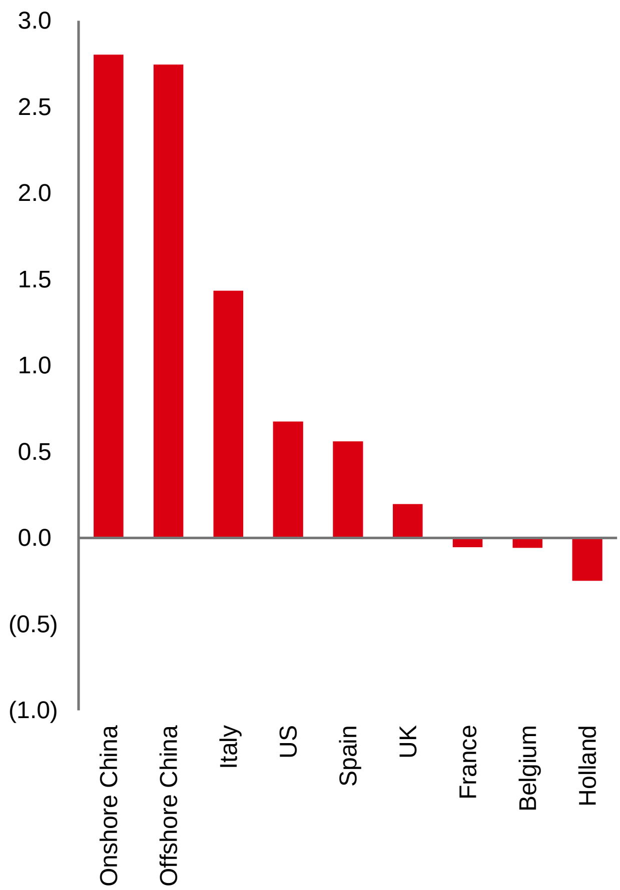
After the index inclusions by Bloomberg Barclays last year, and JP Morgan in February this year, we think it is only a matter of time before global fixed income investors own more Chinese assets especially in developed markets that offer very low yields in comparison.

Additionally, China government bonds are on a watch list for future inclusion into FTSE Russell's World Government bond Index, with the next review set to take place in third quarter of 2020.

According to HSBC Global Research's estimates, the index inclusion by Bloomberg would bring about USD150 billion of inflows into the onshore bond market, and add another USD150 billion and USD20 billion of inflows from the inclusions by WGBI and JP Morgan, respectively.

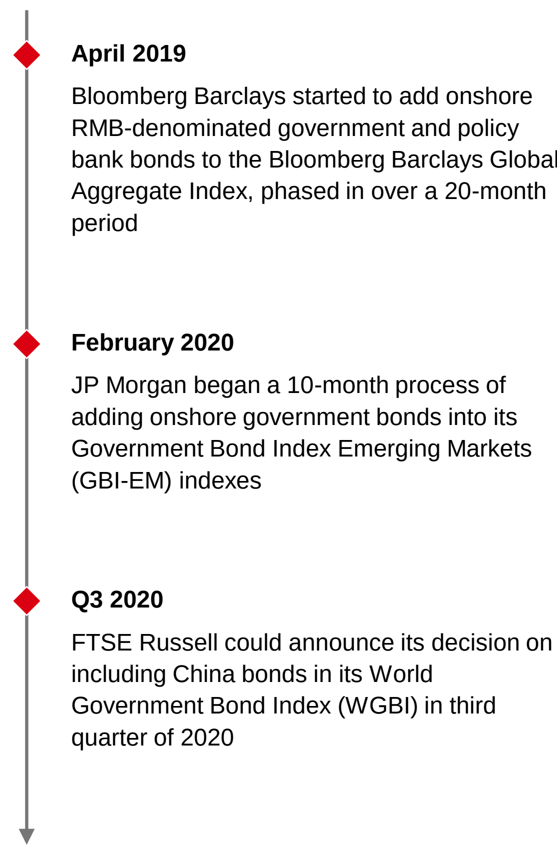
Fig 3: Attractive pick up over developed market peers

10-year gov't bond yield (%)



Source: Bloomberg, HSBC Global Asset Management as of June 2020

Fig 4: The inclusion of China into global bond indices



Source: FTSE, JP Morgan and Bloomberg as of June 2020

Investment involves risks. Past performance is not indicative of future performance

Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets. For illustrative purposes only.

(cont'd)

What's your view on the renminbi?

Ming: The renminbi has been relatively stable this year (CNY and CNH fell 1.6% and 1.5% against the USD this year) following signs of easing of tensions between the US and China, as well as the record high trade surplus of RMB62.9 billion in May and rising China market rates, especially at the short-end, as the central bank refrained from further broad-based easing amid a gradual domestic recovery.

Despite a challenging global outlook, the inflows into China's onshore market continue, as a desperate search for yield is prompting global investors to look beyond developed markets. According to the latest bond flow data from China Central Depository and Clearing Co (CCDC), foreign investors bought about RMB112 billion (USD16 billion) worth of Chinese bonds in May, of which USD7.7 billion flowed into the government bonds and another USD8.4 billion went into policy bank notes.

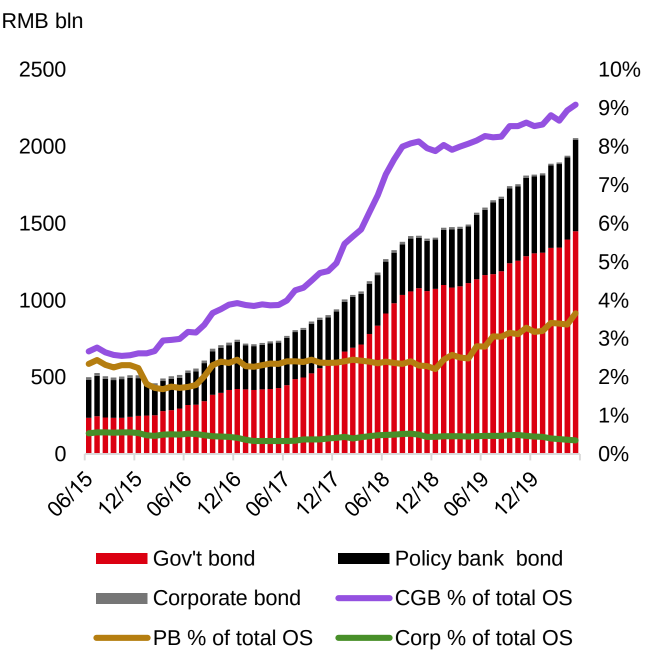
Not only is this largest monthly foreign bond inflow, helped by the ongoing bond inclusions into the Bloomberg Barclays Global Aggregate Index and the JP Morgan GBI-EM Index, but it is also largest foreign purchase of Chinese government bonds on record.

Besides the yield pickup over developed markets, we think the strong inflows were mainly due to expectations of further monetary easing in China to support growth. Looking ahead, we hold a constructive view on the Chinese currency from an asset class perspective.

On the flip side, offshore dividend payments by Hong Kong-listed Chinese companies are likely to weigh on the value of the renminbi in the short term. Chinese corporates listed in Hong Kong will pay roughly USD73 billion in dividends for FY2019 in June/July, according to Deutsche Bank's estimate. Traditionally, we expect to see 20% of the total dividends paid are remitted from China to Hong Kong. That said, we should see around USD15 billion worth of RMB selling in that period, which is one of the factors keeping the currency on a weaker footing. The other factor behind the RMB's weakness is that Chinese exporters continue to show a strong desire to keep their proceeds offshore for possible offshore investments and payments.

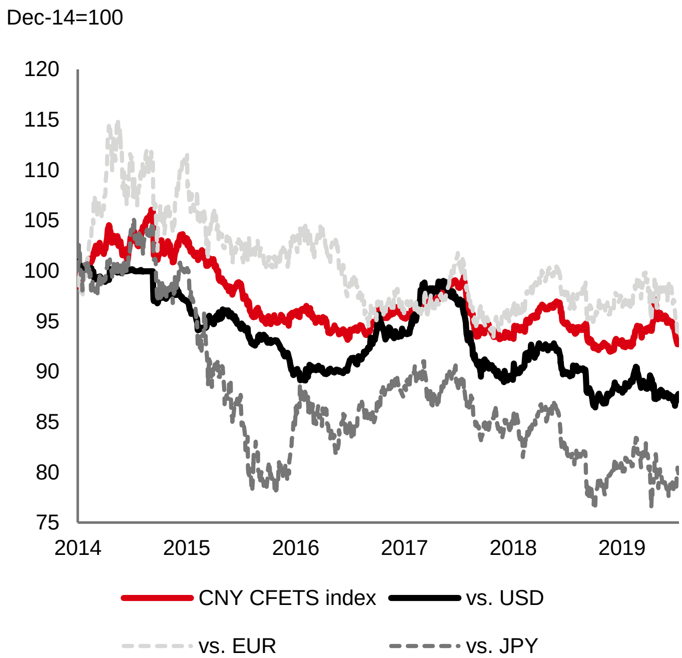
Looking ahead, the US dollar could become less attractive to investors with the Fed slashing interest rates to near zero and lower potential growth when compared with emerging markets. After reaching record highs in March, the dollar has softened against a basket of currencies. The dollar index broke through the 102 point barrier on March 20 for the first time since late 2016, but the index has moderated to 97 in mid-June as financial market jitters have eased.

Fig 5: Strong inflows into onshore bond market



Source: Wind, PBoC as of June 2020

Fig 6: RMB remains largely stable



Source: CFETS, Bloomberg, HSBC Global Asset Management as of June 2020

Investment involves risks. Past performance is not indicative of future performance
Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets. For illustrative purposes only.

(cont'd)

Any concluding thoughts?

Ming: China's bond market has become the second biggest in the world. With the authorities' focus on market liberalisation, the sheer size of the onshore market has provided an array of investment opportunities to foreign investors.

For China, the next step is to further open up its domestic financial market to offshore investors, raise its governance standards to an international level. We believe it will drive greater market access, hedging and liquidity, as well as product innovation, depending on the speed of libersation.

From an investment perspective, the value proposition is clear given its attractive real rates on offer. Besides government bonds, we see value in the credit market in both the onshore and offshore space.

Domestically, the consumer inflation dropped to a 14-month low in May because of easing food inflation. We expect inflation to creep up mildly in the near term, depending on the pace of a global recovery

In terms of default risk, we anticipate a mild pick up in default as the economy slows, and investors should be mindful about evaluating credit risk profile according to fundamentals and corporate structure.

We observed that the PBoC has recently allowed rise in funding cost as we believe it momentarily shifted its objective from supporting economic growth to reinforcing the stability of the exchange rate and financial system. With inflation easing we still expect monetary tools such as a reserve requirement ratio (RRR) cut, MLF reduction or 7-day reverse repo rate reduction to be used.

But rather than broad-based reductions, those measures will be targeted and well-timed to strike a better balance between the objectives of growth and financial stability.

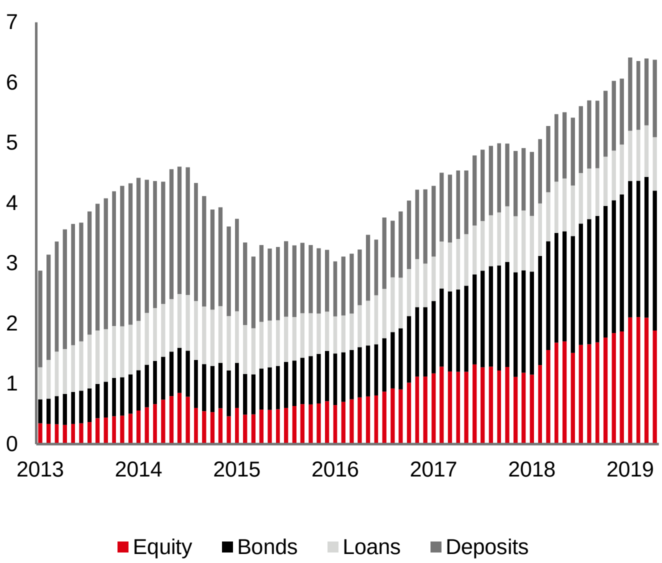
The RRR-reduction, for instance, is likely to focus on small and medium-sized banks.

While MLF rate cuts are still essential to efficiently guide the Loan prime rate (LPR) fixing for corporate funding, reverse repo rate reductions remains the most effective way to boost investor confidence and trigger demand for the bonds in this fiscal expansion cycle.

Looking ahead, we expected more capital movement in and out of China and steady pick up in Chinese bond holdings amongst global investors. According to official data, foreign investors bought more than RMB2 trillion of onshore bonds at the end of July, 2019, a milestone for the asset class.

Fig 8: Foreign investors' holdings of RMB assets largely stable

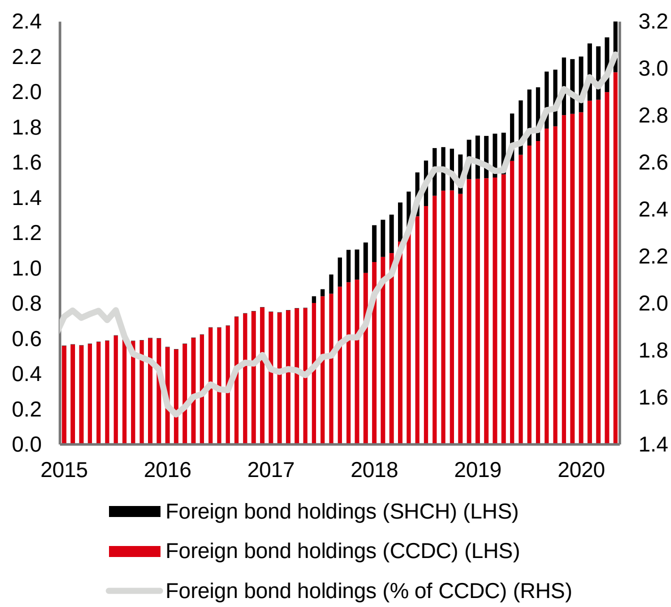
RMB trn



Source: CEIC, HSBC Global Asset Management as of June 2020

Fig 9: Relatively stable foreign holdings of Chinese onshore bonds

RMB trn



Source: CCDC, PBoC, HSBC Global Asset Management as of May 2020

Investment involves risks. Past performance is not indicative of future performance

Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets. For illustrative purposes only.

Important information

For Professional Clients and intermediaries within countries and territories set out below; and for Institutional Investors and Financial Advisors in Canada and the US. This document should not be distributed to or relied upon by Retail clients/investors.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance whilst any forecasts, projections and simulations contained herein should not be relied upon as an indication of future results. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. Investments in emerging markets are by their nature higher risk and potentially more volatile than those inherent in some established markets. Economies in Emerging Markets generally are heavily dependent upon international trade and, accordingly, have been and may continue to be affected adversely by trade barriers, exchange controls, managed adjustments in relative currency values and other protectionist measures imposed or negotiated by the countries and territories with which they trade. These economies also have been and may continue to be affected adversely by economic conditions in the countries and territories in which they trade. Mutual fund investments are subject to market risks, read all scheme related documents carefully.

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorised reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general information purposes only and does not constitute advice or a recommendation to buy or sell investments. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views and opinions expressed herein are those of HSBC Global Asset Management at the time of preparation, and are subject to change at any time. These views may not necessarily indicate current portfolios' composition. Individual portfolios managed by HSBC Global Asset Management primarily reflect individual clients' objectives, risk preferences, time horizon, and market liquidity. Foreign and emerging markets. Investments in foreign markets involve risks such as currency rate fluctuations, potential differences in accounting and taxation policies, as well as possible political, economic, and market risks. These risks are heightened for investments in emerging markets which are also subject to greater illiquidity and volatility than developed foreign markets. This commentary is for information purposes only. It is a marketing communication and does not constitute investment advice or a recommendation to any reader of this content to buy or sell investments nor should it be regarded as investment research. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination.

We accept no responsibility for the accuracy and/or completeness of any third party information obtained from sources we believe to be reliable but which have not been independently verified.

HSBC Global Asset Management is a group of companies in many countries and territories throughout the world that are engaged in investment advisory and fund management activities, which are ultimately owned by HSBC Holdings Plc (HSBC Group). HSBC Global Asset Management is the brand name for the asset management business of HSBC Group. The above communication is distributed by the following entities:

In Argentina by HSBC Global Asset Management Argentina S.A., Sociedad Gerente de Fondos Comunes de Inversión, Agente de administración de productos de inversión colectiva de FCI N°1,; In Australia, this document is issued by HSBC Bank Australia Limited ABN 48 006 434 162, AFSL 232595, for HSBC Global Asset Management (Hong Kong) Limited ARBN 132 834 149 and HSBC Global Asset Management (UK) Limited ARBN 633 929 718. This document is for institutional investors only, and is not available for distribution to retail clients (as defined under the Corporations Act). HSBC Global Asset Management (Hong Kong) Limited and HSBC Global Asset Management (UK) Limited are exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of the financial services they provide. HSBC Global Asset Management (Hong Kong) Limited is regulated by the Securities and Futures Commission of Hong Kong under the Hong Kong laws, which differ from Australian laws. HSBC Global Asset Management (UK) Limited is regulated by the Financial Conduct Authority of the United Kingdom and, for the avoidance of doubt, includes the Financial Services Authority of the United Kingdom as it was previously known before 1 April 2013, under the laws of the United Kingdom, which differ from Australian laws; in Austria by HSBC Global Asset Management (Österreich) GmbH which is regulated by the Financial Market Supervision in Austria (FMA); in Bermuda by HSBC Global Asset Management (Bermuda) Limited, of 37 Front Street, Hamilton, Bermuda which is licensed to conduct investment business by the Bermuda Monetary Authority; in Canada by HSBC Global Asset Management (Canada) Limited which provides its services as a dealer in all provinces of Canada except Prince Edward Island and also provides services in Northwest Territories. HSBC Global Asset Management (Canada) Limited provides its services as an advisor in all provinces of Canada except Prince Edward Island; in Chile, operations by HSBC's headquarters or other offices of this bank located abroad are not subject to Chilean inspections or regulations and are not covered by warranty of the Chilean state. Further information may be obtained about the state guarantee to deposits at your bank or on www.sbif.cl; in Colombia, HSBC Bank USA NA has an authorized representative by the Superintendencia Financiera de Colombia (SFC) whereby its activities conform to the General Legal Financial System. SFC has not reviewed the information provided to the investor. This document is for the exclusive use of institutional investors in Colombia and is not for public distribution; in Finland, Norway, Denmark and Sweden by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026) and through the Stockholm branch of HSBC Global Asset Management (France), regulated by the Swedish Financial Supervisory Authority (Finansinspektionen); in France, Belgium, Netherlands, Luxembourg, Portugal and Greece by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026); in Germany by HSBC Global Asset Management (Deutschland) GmbH which is regulated by BaFin; in Hong Kong by HSBC Global Asset Management (Hong Kong) Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission; in India by HSBC Asset Management (India) Pvt Ltd. which is regulated by the Securities and Exchange Board of India; in Israel, this document is only directed to qualified investors (under the Investment advice, Investment marketing and Investment portfolio management law-1995) of the Israeli Branch of HBEU for their own use only and is not intended for distribution; in Italy and Spain by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026) and through the Italian and Spanish branches of HSBC Global Asset Management (France), regulated respectively by Banca d'Italia and Commissione Nazionale per le Società e la Borsa (Consob) in Italy, and the Comisión Nacional del Mercado de Valores (CNMV) in Spain; in Mexico by HSBC Global Asset Management (Mexico), SA de CV, Sociedad Operadora de Fondos de Inversión, Grupo Financiero HSBC which is regulated by Comisión Nacional Bancaria y de Valores; in the United Arab Emirates, Qatar, Bahrain and Kuwait by HSBC Bank Middle East Limited which are regulated by relevant local Central Banks for the purpose of this promotion and lead regulated by the Dubai Financial Services Authority; in Oman by HSBC Bank Oman S.A.O.G regulated by Central Bank of Oman and Capital Market Authority of Oman; in Peru, HSBC Bank USA NA has an authorized representative by the Superintendencia de Banca y Seguros in Perú whereby its activities conform to the General Legal Financial System – Law No. 26702. Funds have not been registered before the Superintendencia del Mercado de Valores (SMV) and are being placed by means of a private offer. SMV has not reviewed the information provided to the investor. This document is for the exclusive use of institutional investors in Perú and is not for public distribution; in Singapore by HSBC Global Asset Management (Singapore) Limited, which is regulated by the Monetary Authority of Singapore; in Switzerland by HSBC Global Asset Management (Switzerland) AG whose activities are regulated in Switzerland and which activities are, where applicable, duly authorised by the Swiss Financial Market Supervisory Authority. Intended exclusively towards qualified investors in the meaning of Art. 10 para 3, 3bis and 3ter of the Federal Collective Investment Schemes Act (CISA); in Taiwan by HSBC Global Asset Management (Taiwan) Limited which is regulated by the Financial Supervisory Commission R.O.C. (Taiwan); in the UK by HSBC Global Asset Management (UK) Limited, which is authorised and regulated by the Financial Conduct Authority; and in the US by HSBC Global Asset Management (USA) Inc. which is an investment advisor registered with the US Securities and Exchange Commission.

INVESTMENT PRODUCTS:

Are not a deposit or other obligation of the bank or any of its affiliates;

Not FDIC insured or insured by any federal government agency of the United States;

Not guaranteed by the bank or any of its affiliates; and

Are subject to investment risk, including possible loss of principal invested.

Source: MSCI. The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided as an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively 'the MSCI Parties') expressly disclaims all warranties (including, without limitation, all warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com)