The case for Chinese Treasuries

What is in short supply at the moment for fixed income investors are high-yielding, lowly-correlated bonds with solid macro underpinnings: China ticks all of those boxes.

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It is 200 years since Napoleon coined his infamous aphorism about China – "Let her sleep; when she wakes she will shake the world" – and for much of the intervening period the country continued to slumber with few consequences for the global economy. That period is now definitively over, as the past 20 years have seen China rouse herself to become one of the largest economies in the world. The implications of that are of profound importance, not just to economists but also to politicians and diplomats.

Yet for investors, the story has been somewhat different. Despite the country's economic ascendancy, China's closed capital account and the difficulties of accessing its financial markets have constrained the inflows from foreign investors into the nation's bond and equity markets. No longer; 2021 is the year in which China becomes impossible to ignore from an investment standpoint.

The recent (and ongoing) financial liberalization process is now paying off, leading to rapidly increasing weights in the key benchmark indices and capital inflows. Those reforms have already facilitated the inclusion of China sovereign bonds into the Bloomberg Barclays Global Aggregate Index and the JPMorgan GBI-EM Global Diversified. Confirmation is expected this month that by end-2021 China will also be included in the FTSE World Government Bond Index (WGBI) with a weight, we estimate, of somewhere around 6% of the global index. This will represent a hugely significant reconfiguration of one of the world's major fixed income benchmarks. Deducing from the volume of assets benchmarked to this index, we calculate, the index inclusion will lead to around $100 billion of investments flowing into Chinese government bonds.

As a consequence of that index inclusion, from now onwards, not allocating to Chinese bonds is likely to result in a substantial underweight position. Whether or not a tracking error of that magnitude is tolerable depends on a multitude of factors; but whether it is desirable given the current attractiveness of Chinese bonds is highly doubtful. What is in short supply at the moment for fixed income investors are high-yielding, lowly-correlated bonds with solid macro underpinnings: China ticks all of those boxes.

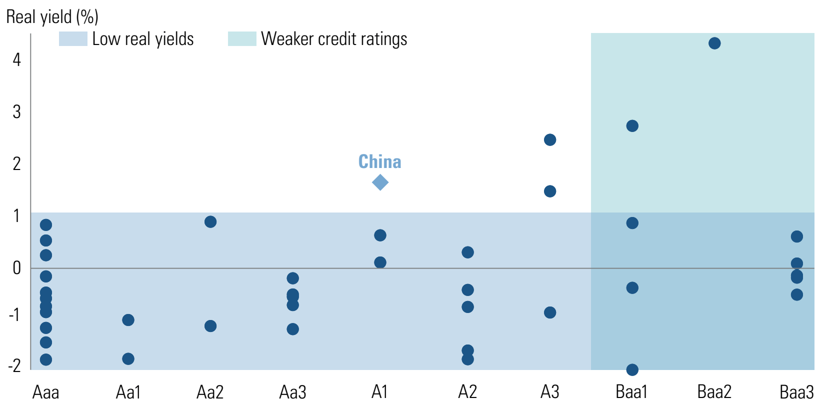
In nominal terms the China 10-year offers around 200bp of pick-up over Treasuries and closer to 350bp over Bunds. In real terms, the comparison is just as compelling as Figure A shows where China is a rare exception in offering a strongly positive real yield without the need to stretch on credit rating. Of course, FX exposure should always be factored-in to any investment decision, but China's current account surplus, manageable fiscal position, and solid growth outlook (of which, more below) all augur well, in our view, over a strategic investment horizon.

Exposure to Chinese bond returns is also not easily replicated indirectly via other major sovereign debt markets. China's bond market is lowly correlated with the moves in other markets, and the FTSE China Government Bond Index shows that returns are delivered with similar to lower volatility than the returns on US Treasuries or UK Gilts. So not only are the yields (currently) far superior, but they provided a lowly-correlated and low volatility source of returns.

Finally, the macro backdrop seems highly supportive. China is one of the few economies to have returned already to pre-COVID levels of output. Moreover, we think the consensus may be under-appreciating the forward from here. Whereas the Bloomberg consensus of market participants (as of 19 February) shows a market expectation for China 2021 growth of 8.4% (well in excess of expectations for the US or the euro area), Figure B shows that even very modest rates of quarterly expansion over the course of this year would lead to an annual expansion well in excess of that consensus.

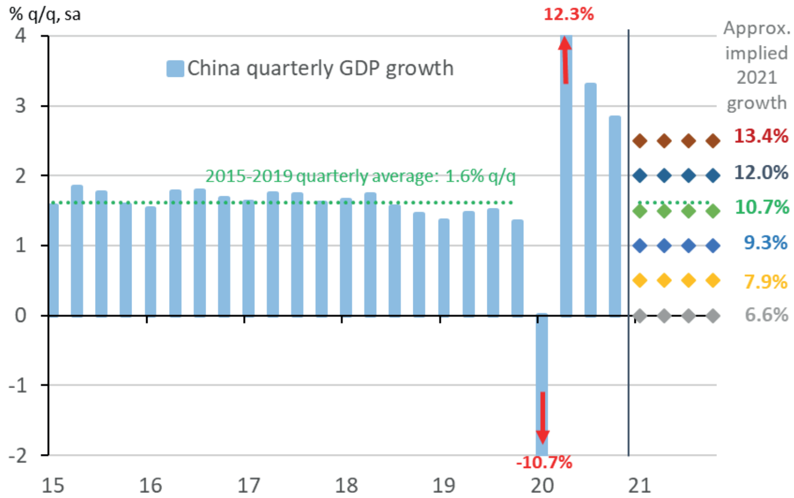
Chinese sovereign bonds have the potential to provide a high-yielding, low volatility, lowly-correlated source of returns. Those returns can be underpinned by both a cyclical component (the likelihood of stronger-than-expected growth in 2021) and a structural realignment (index inclusion and ever-increasing global macro relevance predicated on a more stable and sustainable growth model). China has awoken and just in time for the year of the Ox.

Figure A: Real* 10-year sovereign bond yields for IG issuers



Source: Bloomberg, Moody's, GSAM. As of 19 February, 2021. * Real yields are calculated as spot nominal rates (10y) minus consensus expectations for 2021 CPI inflation.

Figure B: China GDP growth in 2021 under a range of quarterly growth assumptions



	Assumed % quarterly growth rate (sa) throughout 2021					
	0.0	0.5	1.0	1.5	2.0	2.5
Approximate* implied 2021 growth:	6.6	7.9	9.3	10.7	12.0	13.4

Source: Bloomberg, Moody's, GSAM. As of 19 February, 2021. * Real yields are calculated as spot nominal rates (10y) minus consensus expectations for 2021 CPI inflation.

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