INCOME PARTNERS

MARCH 2020

THE BIRTH OF A NEW HAVEN ASSET AND CURRENCY: CHINESE RMB BOND

The coronavirus outbreak has triggered an unprecedented lockdown of global economy and the subsequent meltdown of financial markets has exceeded the severity witnessed during the 2008 global financial crisis. Amid this market turmoil, the Chinese domestic RMB government bond market has weathered the storm well and further proved to be uncorrelated to the broader global bond markets, looming as an alternative safe haven asset that will rival the US Treasury market. This is a landmark moment, both for China and for investors worldwide. The emergence of the Chinese government bond as a credible alternative to the US Treasury is just beginning.

CHINA WILL ARISE FROM THIS CALAMITY WITH STRONGER BALANCE SHEET AND GROWTH POTENTIAL

The US budget deficit reached 10% of GDP during the depth of 2008 global financial crisis. Similarly in the current crisis, the 2 trillion USD fiscal aid package CARES Act signed on 27 Mar is approximately 10% of 2019 US GDP. This will put further pressure on the public debt-to-GDP ratio (106.9% in 2019). In contrast, China's government debt-to-GDP is approximately 55.6% (2019) and its budget deficit ratio will likely go up to 7.5% this year (from 5.5% in 2019). The China government has ample fiscal ammunition to boost domestic economy.

The following table shows the impact on debt-to-GDP ratios for the two countries over the next three years.

		China	US
2019	Nominal GDP Growth	7.8%	4.1%
	Fiscal Deficit / GDP	-5.5%	-4.6%
	Gov't Debt / GDP	55.6%	106.9%
2020E	Nominal GDP Growth	4.0%	1.5%
	Fiscal Deficit / GDP	-7.5%	-16.4%
	Gov't Debt / GDP	**61.0%**	**121.7%**
2021E	Nominal GDP Growth	4.5%	2.0%
	Fiscal Deficit / GDP	-6.5%	-9.6%
	Gov't Debt / GDP	**64.8%**	**128.9%**
2022E	Nominal GDP Growth	5.0%	2.0%
	Fiscal Deficit / GDP	-5.5%	-5.0%
	Gov't Debt / GDP	**67.2%**	**131.4%**

Source: Wind, US Treasury Department, JP Morgan, and Income Partners

In addition to fiscal policy, China also has ample room in monetary easing, both in benchmark lending rates as well as in reserve requirement ratios. This compares favorably to the historical low US Fed Fund rates.

All in all, China's growth trajectory will continue to be more advantageous compares to US, and the rest of developed countries, when the dust settles.

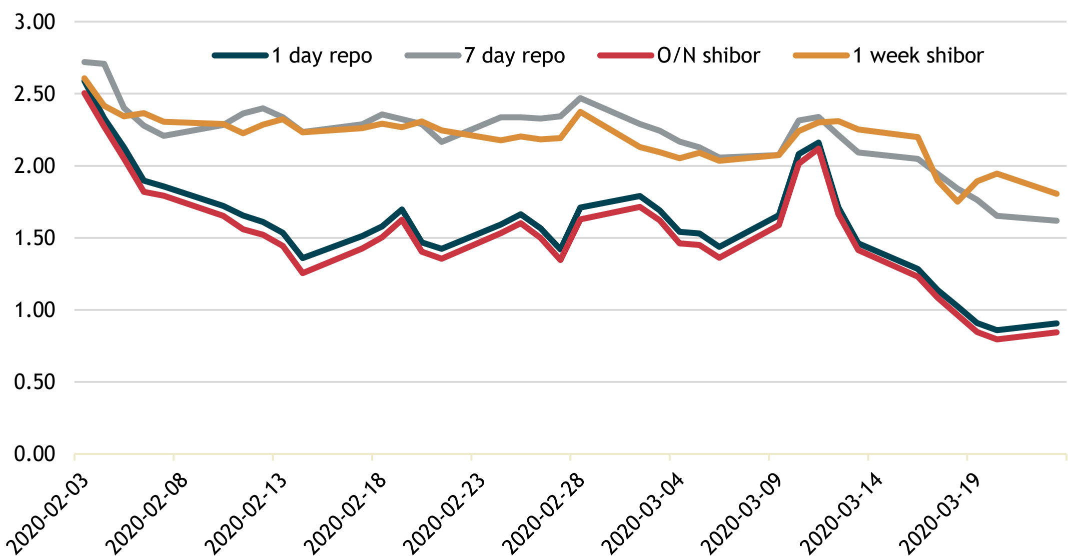
China Monetary Policy Stance: Accommodative at Measured Pace

Since the outbreak of coronavirus, China's central bank PBOC has maintained a measured, accommodative stance as against the massive easing seen in the US and other major economies.

We think the main reasons for this divergence could be the following:

1. China's domestic market did not experience the type of liquidity crunch seen in the US lately and thus does not require emergency easing. Onshore funding rate has remain largely stable since the epidemic started, even dropped moderately as the global spreading triggered massive volatility offshore.

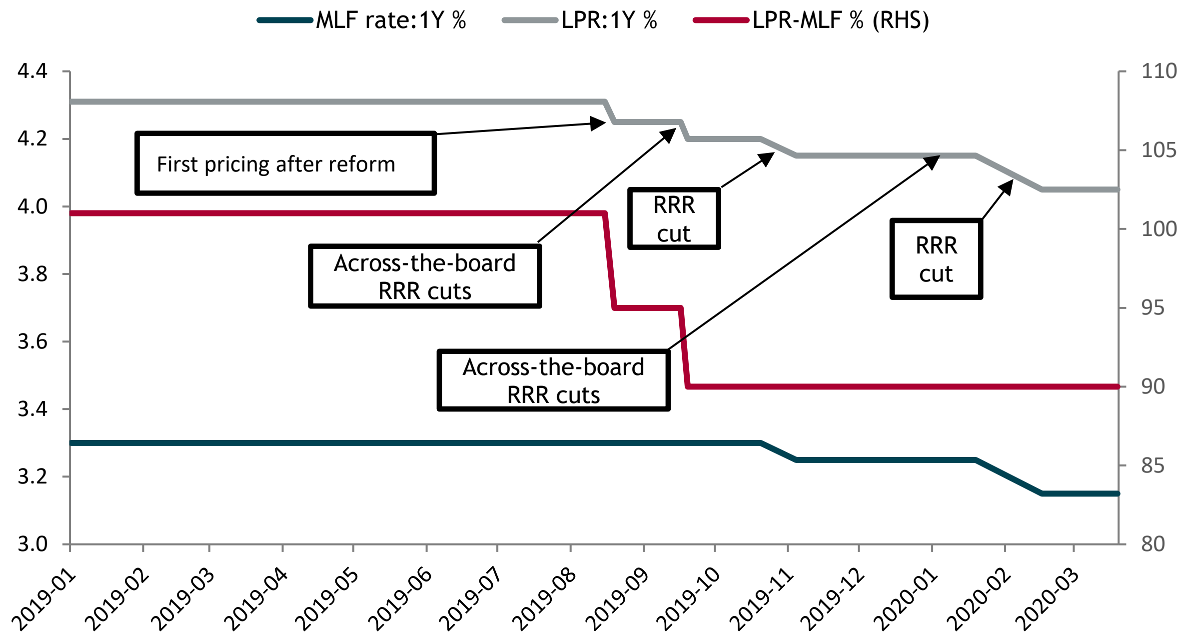
Chart 1. Chinese onshore funding rate has shown no panic among market participants



Source: Wind

2. To the Chinese Central Bank, reforming the transmission mechanism between policy rate (medium-term lending facility or MLF) and actual loan rate (by suppressing credit spreads to affect loan prime rate or LPR) is a bigger priority. This is to ensure that any easing efforts will eventually benefit the real economy rather than fueling asset bubbles. It is evident that LPR rate has been trending downwards many more times than MLF, closing the gap with MLF rate over the last two quarters. This shows the reform is already taking effect.

Chart 2. Evolvement of MLF rate, 1yr LPR rate and their difference since 2019



Source: Wind

3. While we think policy rate cut is quite likely in the following months in order to mitigate significant pressure on growth, timing may be quite fluid. We believe monetary easing will be in a supporting position to fiscal expansion. And even within monetary policy kit, other options such as RRR cuts or deposit benchmark rate cuts are also possible tools to be tapped.

Overall speaking, China's monetary policy has demonstrated high degree of independence to global shocks and is likely to be driven more by longer term domestic policy directives. Medium term growth headwind is arguably very strong, considering China's own 1Q economic standstill and subsequent global demand shock. However, compared to the US or DM central banks who have already been emptying their monetary tool kits and in crisis mode to calm the markets, PBoC is in a very robust position, combating the slowdown with planned reforms while easing in a controlled pace. Against this backdrop, China is likely to remain the most stable monetary environment among the big economies globally and one of few, if not the only one, in positive rates territory.

US Monetary Policy Outlook: Zero Interest Rate but Negative Real Yield

With the outbreak of the coronavirus in the US, the Fed has reacted quickly by cutting the Fed fund rate to 0-0.25% territory and announcing unlimited quantitative easing (QE) to support financial market and economy. Considering the potential recession in US and global economy, we expect the Fed to keep the Fed fund rate at current level in the medium term, but without moving further to negative interest rate policy as such move has shown limited simulative effect in the experiences of Japan and Eurozone. This zero interest rate policy in the US will have following implications:

- Room for further rally in US Treasuries will be limited, as policy rate has already arrived at the bottom;
- Any selloff in US Treasuries due to higher fiscal deficit in the US, on the other hand, could easily offset the thin positive carry;
- As the coronavirus could be inflationary at early stage of the economic slowdown, the real yield investors received from US Treasuries will stay negative for a period of time

CHINA GOVERNMENT BOND HAS OUTPERFORMED AND RMB HAS BEEN STABLE

China's government bond market has outperformed not only the EM aggregate bond index, but also the US aggregate bond index and the global aggregate bond index during the recent market turmoil.

Chart 3. China outperformed EM aggregate bond indices

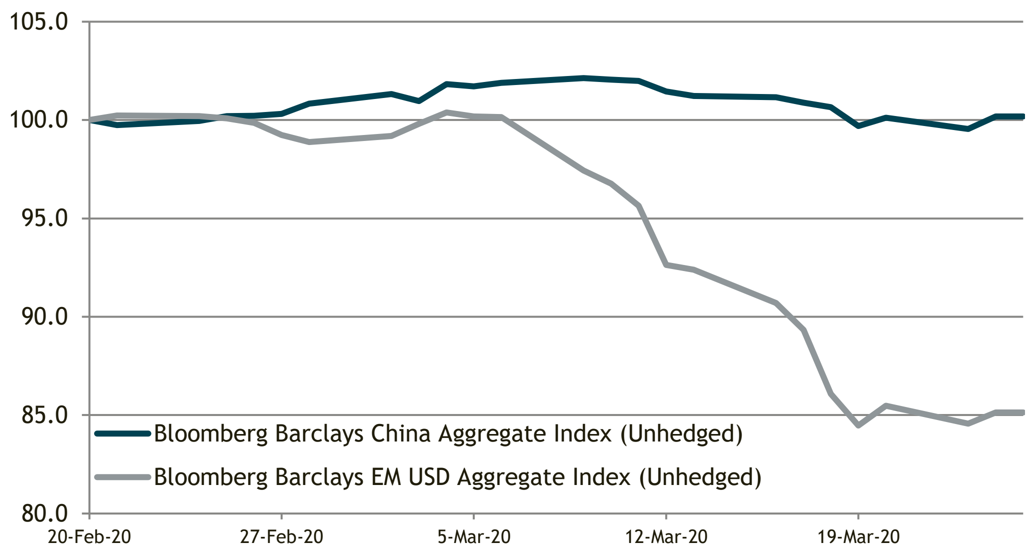
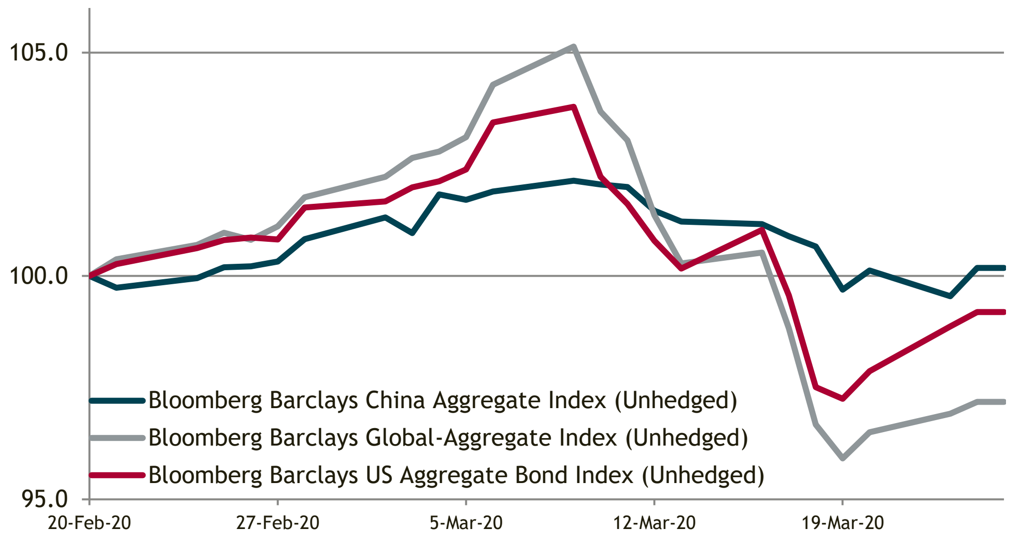


Chart 4. China Outperformed US and Global Aggregate Bond Indexes



At the same time, RMB has held steady within a narrow range, outperforming major EM currencies and less volatile than the dollar index.

Chart 5. RMB Outperformed MSCI Emerging Markets Currency Index

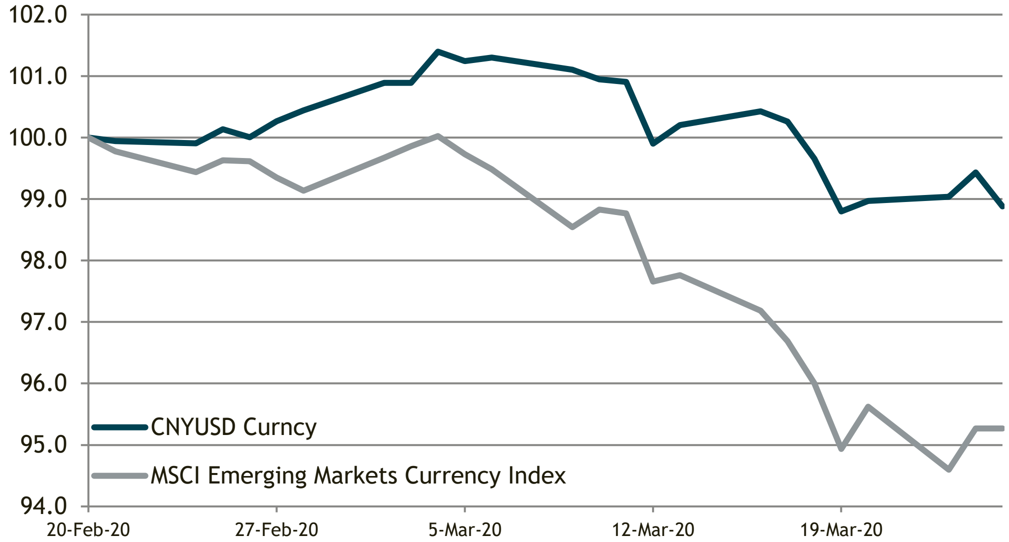
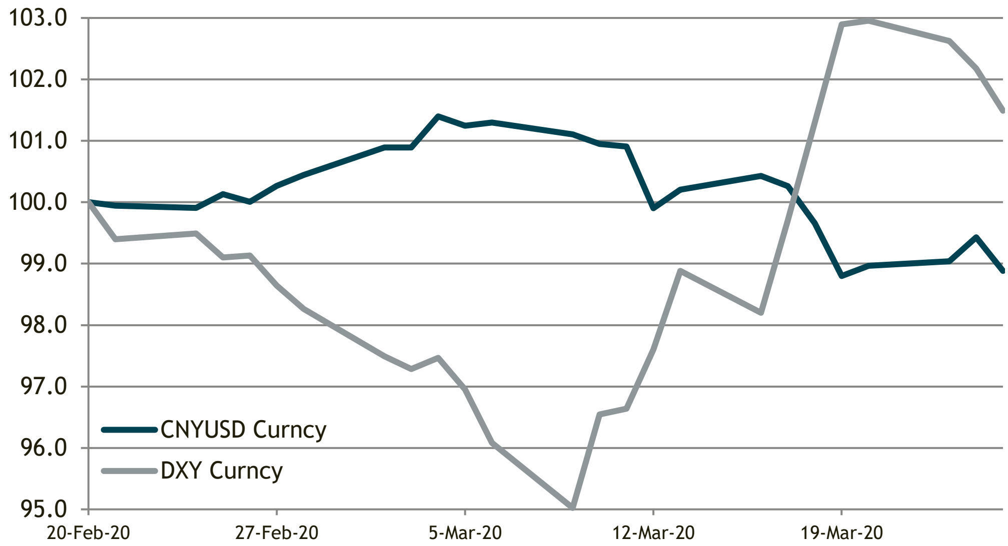


Chart 6. RMB Less volatile than the Dollar Index



More importantly, both the US Treasury and Dollar Index have seen volatility spiked up since mid-February, as charts below show, which is in sharp contrast to the relative stability of China CGB and RMB.

Chinese Treasury and Currency less Volatile than the US (20-day Volatility)

	20 February 2020	24 March 2020
Bloomberg Barclays US Treasury Total Return Index	4.3%	18.2%
Bloomberg Barclays China Treasury Total Return Index	4.8%	3.6%
Dollar (DXY) index	3.6%	15.3%
USDCNY	6.9%	6.7%

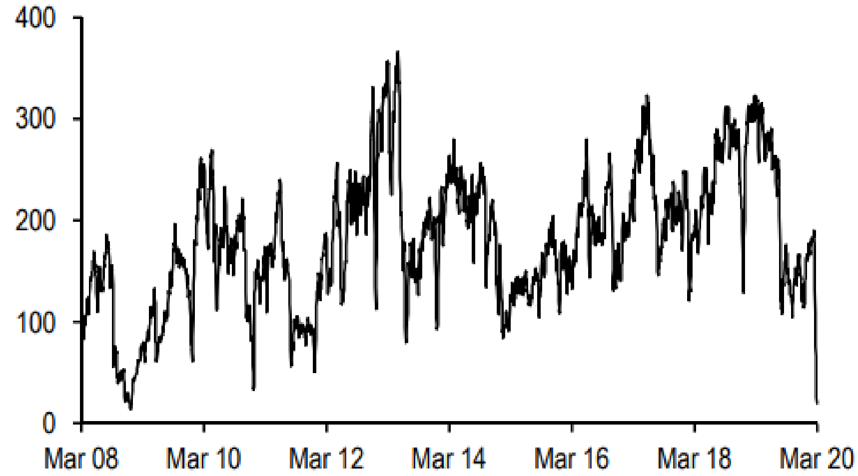
Source: Bloomberg

This begs the question- is the US Dollar dominance and the safe haven status of US Treasury sustainable?

AMPLE LIQUIDITY IN CHINA DOMESTIC MARKET COMPARED TO ILLIQUIDITY GLOBALLY

While global fixed income markets suffered from thin liquidity and tremendous volatility in the past few weeks, China onshore bond market has been relatively calm and functioning normally. As illustrated by the following chart from J.P. Morgan, even US treasury market experienced poor liquidity situation that was only last seen in 2008. On the other hand, liquidity in domestic Chinese government bonds and policy banks remained strong during the same period. The average bid-ask spread for China CGBs and Policy bank bonds, from what Income Partners observed during past three weeks, have been steady around 0.5bp to 1bp, with an daily trading volume of USD 28 billion and USD 65 billion equivalent respectively.

One-week average of 10-year Treasury market depth*; $mn

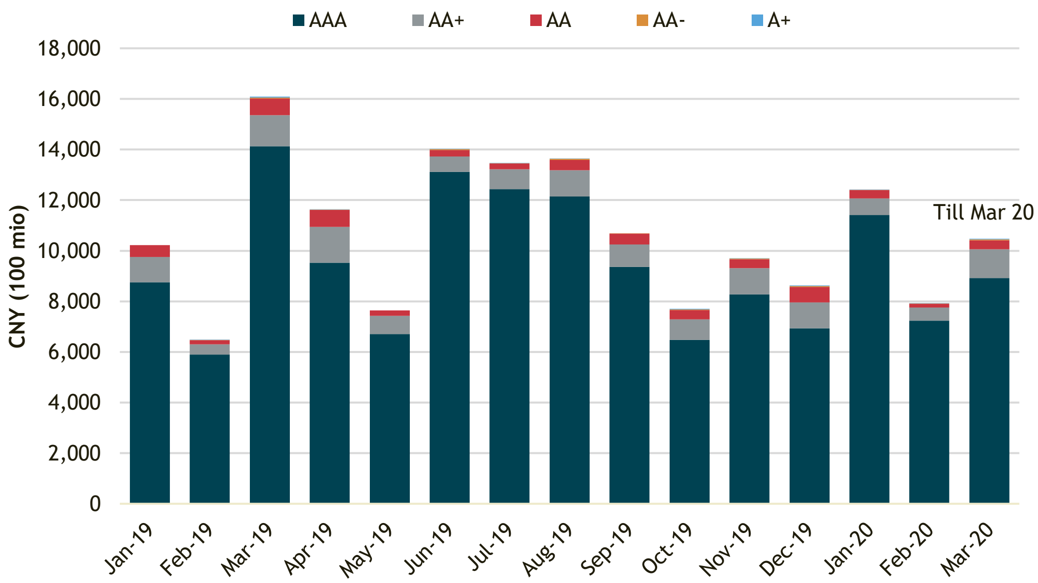


* Market depth is the sum of the three bids and offers by queue position, averaged between 8:30 and 10:30am daily

Source: J.P. Morgan, BrokerTec

Moreover, China's onshore credit conditions have been immune to external shocks. Onshore new issuance of credit bonds showed no sign of slowing in February and March on a year-over-year basis, as shown in the following chart.

Chart 7. Issuance Volume of China's Onshore Credit Bonds



Source: WIND. Ratings are based on domestic rating metrics.

CHINESE ONSHORE GOVERNMENT BONDS- A STRATEGIC INVESTMENT IN A GLOBAL PORTFOLIO

We have been advocating China onshore RMB bonds as an important asset class in a global portfolio based on the following considerations:

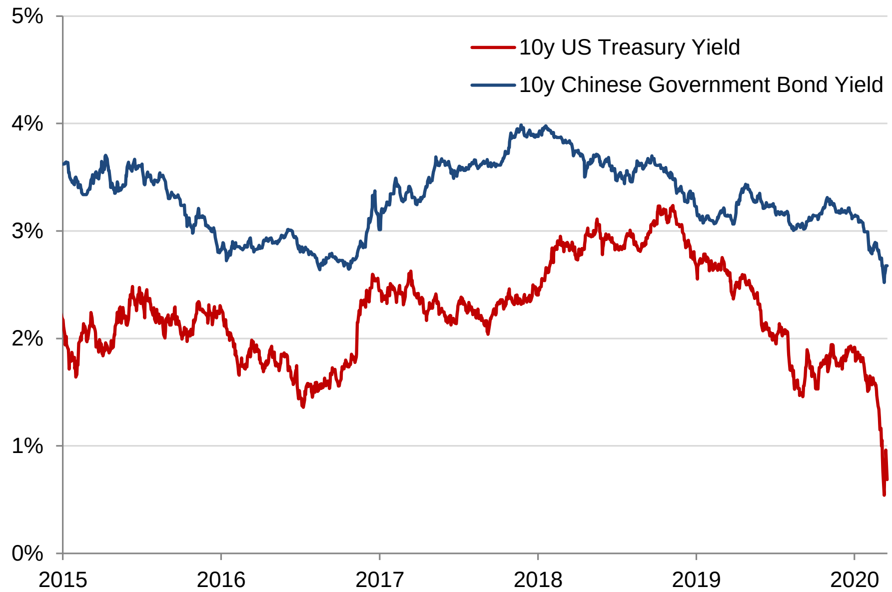
1. RMB becomes a genuinely global investment and reserve currency

Thanks to central bank purchases, the RMB is now the world's fifth largest reserve currency, making up just under 2 per cent of the total foreign exchange reserves. If that share were to double, it would amount to an additional RMB1.5 trillion of RMB bond investments, the IMF says. It won't be long before the RMB's share of international reserves is greater than that of the British pound[1].

2. Attractive valuation relative to developed market sovereigns

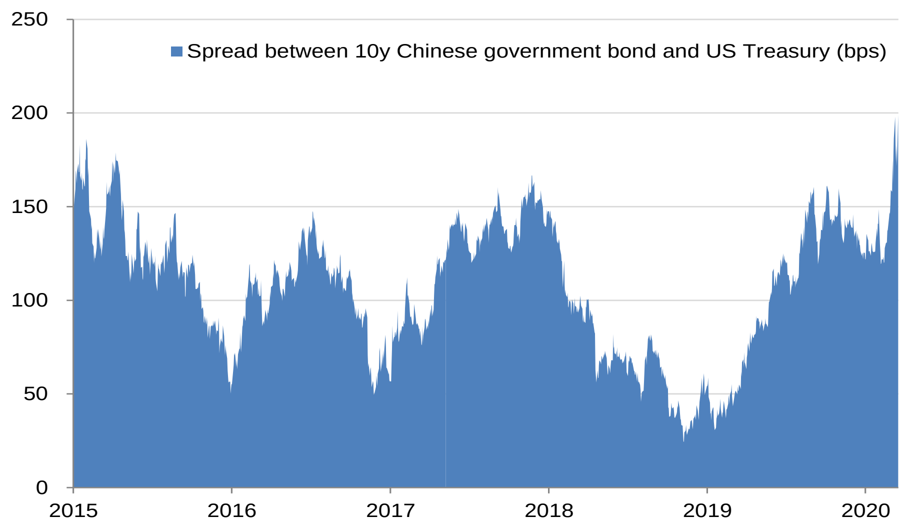
Since mid-February, with the strong rally of US Treasury yield, the yield difference between 10y Chinese government bond and US Treasury has widened to 190bps as of March 20th, at almost the widest level over the past 5 years. It makes China's onshore rates bonds more attractive than before.

Chart 8. 10 year Chinese Government Bond and US Treasury Yield



[1] IMF: The Future of China's Bond Market, March 2019

Chart 9. Spread between 10 year Chinese Government Bond and US Treasury



3. Low correlation to global fixed income markets offers diversification benefits

Due to different interest rate cycles, Chinese government bond has negligible correlation to major developed sovereign bonds, which makes it an attractive asset class for diversification in a global portfolio.

Chart 10. 10-Year Government Bond Correlation Matrix

	CGB	UST	Bund	JGB
CGB	-	0.362	0.191	0.199
UST	0.362	-	0.395	0.488
Bund	0.191	0.395	-	0.218
JGB	0.199	0.488	0.218	-

Source: Bloomberg, 30 March 2020; Period under consideration: 31 March 2015 to 30 March 2020. Period length for correlation analysis: 30 days

CONCLUSION: NOW IS THE TIME TO INVEST INTO CHINA ONSHORE BOND MARKET

Now is the time to gain exposure to the RMB bond market, especially for long term investors seeking return enhancement and diversification.

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