INCOME PARTNERS

JUNE 2021

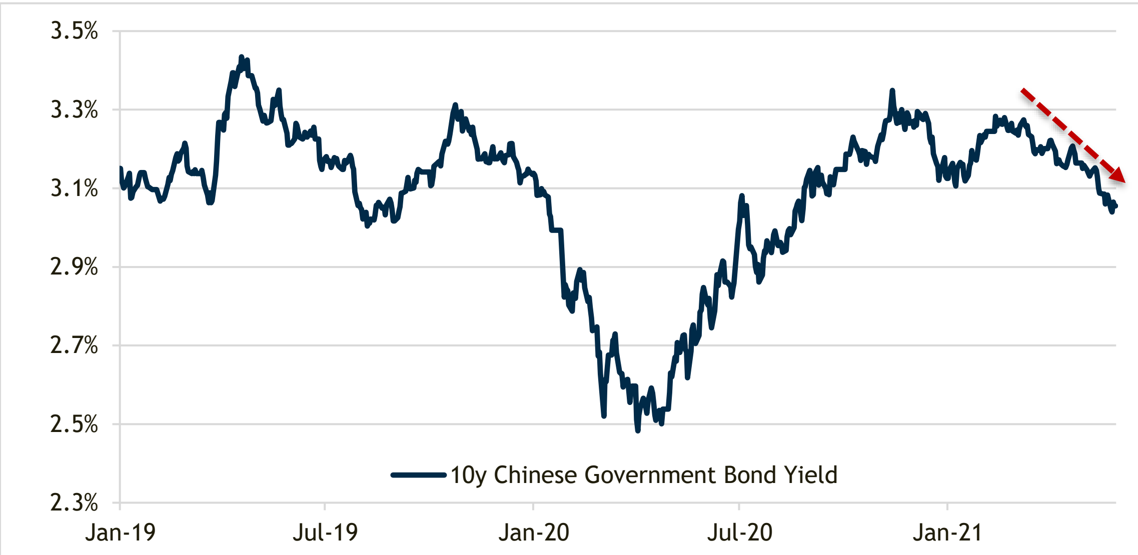
CHINA ONSHORE BOND MARKET QUARTERLY

Over the past three months, China's onshore rates market rallied steadily on the back of slower credit and economic growth momentum in China. We believe that the current rates rally is likely to extend into the second half, as China's credit growth rate converged further towards its nominal GDP growth rate as targeted by PBOC.

RATES RALLY LIKELY EXTENDING INTO 2H DUE TO FURTHER SLOWDOWN IN CREDIT GROWTH

As we expected, the onshore 10-year Chinese government bond (CGB) yield has been in a downward trend during March - May as more and more evidence from recent economic and credit data suggesting that the government planned slower credit growth in China has started to cool off the economy from its previous strong post-pandemic rebound.

10-Year CGB Yield Rallied since March

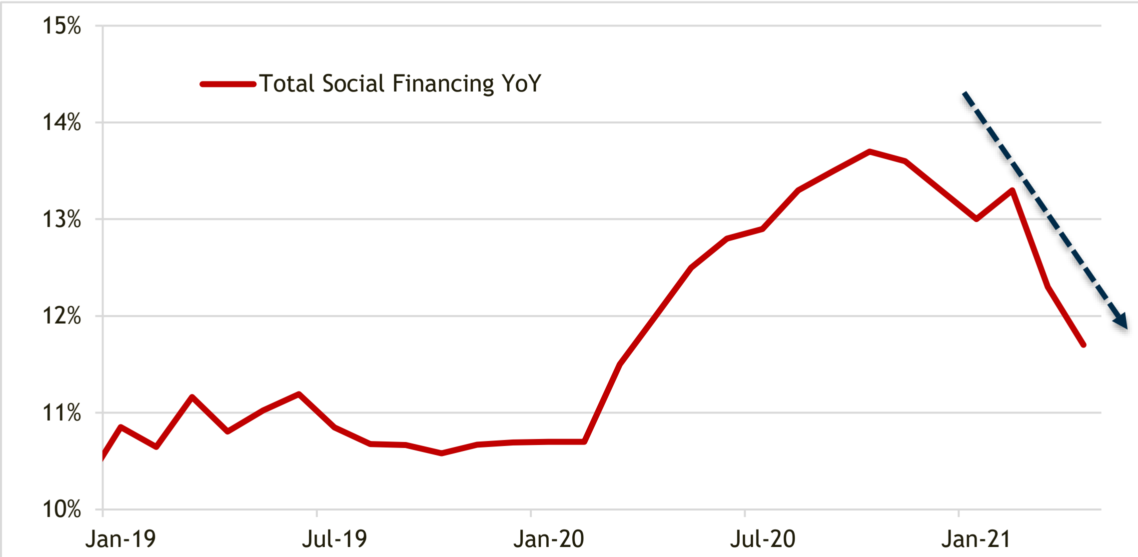


Source: Bloomberg, June 2021

Some notable trends to highlight here:

1) The YoY growth of China's Total Social Financing, an indicator of overall credit expansion, has slowed further to 11.7% in April from 13.3% in last December, and is expected to gradually slow down to pre-pandemic level of 11.5% by the end of 2021 as per PBOC's guidance. The major reason for PBOC to target a lower credit growth rate this year is to normalize the extraordinary monetary support launched in 2020 in order to control China's macro leverage (Debt/GDP ratio) from going higher. It implies a lower credit growth rate at around 11.5%, which is more in-line with China's nominal GDP growth rate. As credit growth in China typically leads the economy by 3-6 months based on past experience, we will see more lagging effect on the economy into the second half.

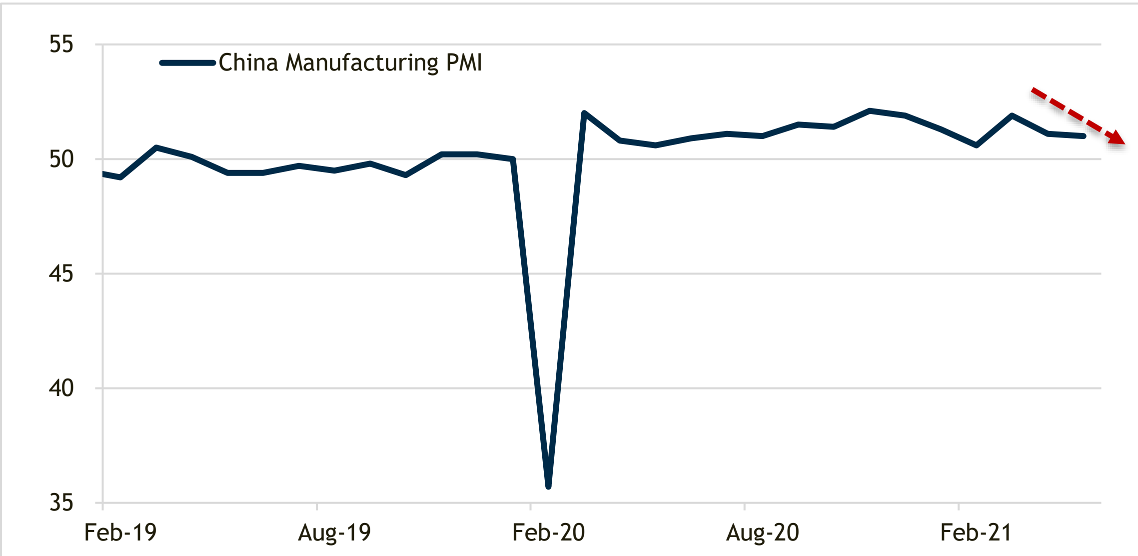
Total Social Financing on a Decelerating Trend



Source: Bloomberg, April 2021

2) The leading indicator, China's official Manufacturing PMI, peaked at 52.1 in November 2020 and has continued to weaken since April this year. As PMI is a relative indicator on sequential basis rather than on YoY basis, it is a better indicator in reflecting the progressive strengthening or weakening of the manufacturing sector.

China Manufacturing PMI Weakened since April



Source: Bloomberg, May 2021

3) The growth of China's Retail Sales is still well below pre-pandemic level, even decelerated in April, showing that, so far, the recovery of China's economy is not balanced and geared more toward investments than consumption. A better way to exclude the low base effect in 2020 is to compare Retail Sales between 2021 and 2019, or "2y-o-2y". On a 2y-o-2y basis, China's YTD

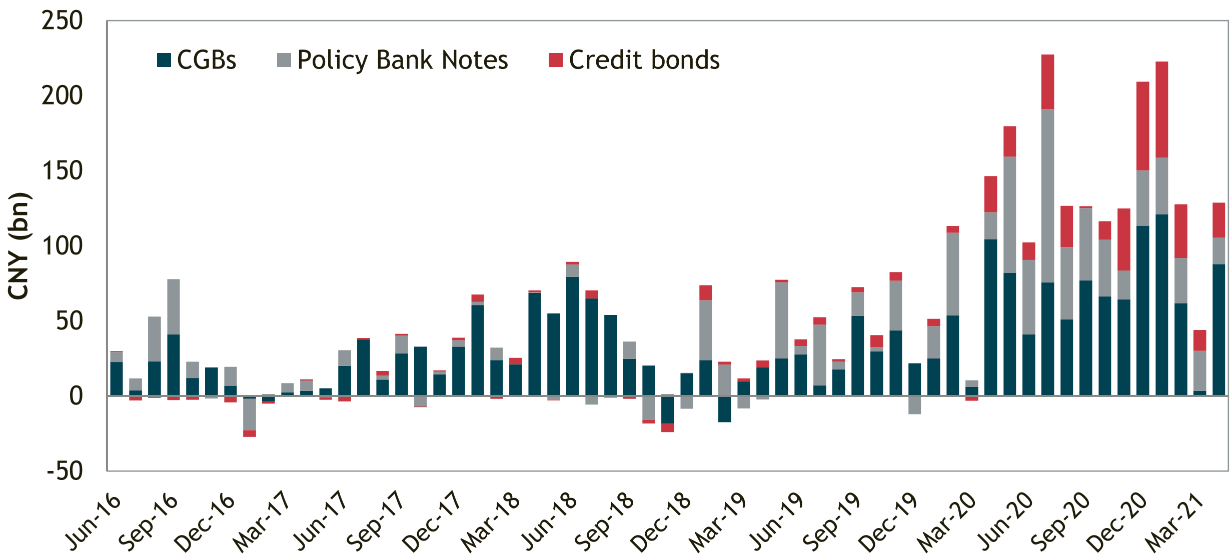
Retail Sales growth decelerated to 8.6% in April from 12.6% in March, or a growth of 4.3% in April on annualized basis, which is still well below the 8.0% YoY growth in 2019. If consumption remains weak going forward, there is a risk that overall growth will soften further as pandemic-related stimulus through government-led investment gradually fades.

Foreign Inflow to Continue on Additional Index Inclusion

Another notable development of China's onshore bond market is further index inclusion. In March 2021, FTSE Russell confirmed that it will include onshore Chinese Government Bonds (CGBs) into the WGBI index, starting in November 2021, with a target weighting of 5.25% in three years. This came after the inclusion by Bloomberg Barclays Global Agg Index in April 2019 and JPM GBI-EM index in February 2020. With tracking AUM of USD2.5 trillion, a simple calculation shows that the WGBI index could potentially trigger USD130 billion of inflows into CGBs (or USD4 billion per month) in the next three years.

The chart below shows that, on YTD basis, foreign inflows into China's onshore bond market remains strong at an average pace of over USD15 billion per month. The positive real yield of Chinese government bonds and its low correlation with developed market has continued to attract global asset allocation.

Monthly Incremental Foreign Inflow into China Onshore Bonds



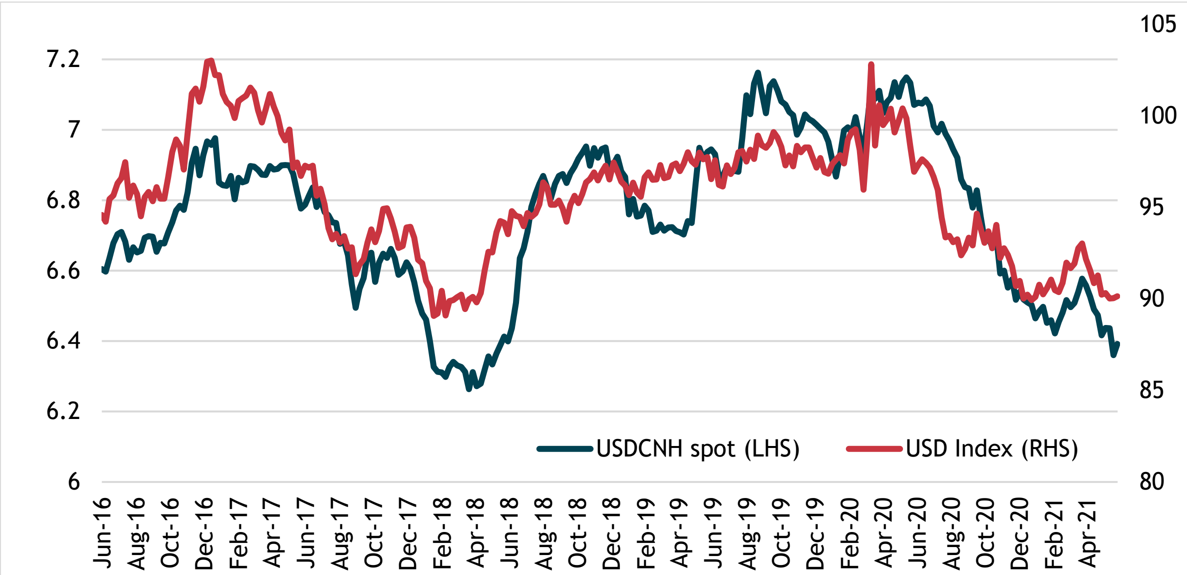
Source: WIND, Income Partners, 30 April 2021

Looking ahead, we believe that the current rates rally is likely to extend into the second half, not only supported by continuous foreign inflows but also due to potentially further slowdown of credit growth in China. From the experience in 2018-2019 cycle, a real turning point in rates will only appear when the overall credit growth stabilizes from decelerating further, which is more likely to happen later this year when China's credit growth rate converged to its nominal GDP growth rate as targeted by PBOC.

POSITIVE ON RMB OVER MEDIUM TO LONG TERM

Following the USD Index

The Chinese RMB has surged since April amid broad USD weakness. The appreciation accelerated in May after disappointing US employment numbers sent the USD index below 90. Till the end of May, RMB has outperformed USD index by approximately 1.5% YTD, and the CFETS RMB index (a gauge of RMB's performance against a basket of currencies) has rallied more than 3.1% in the same period.



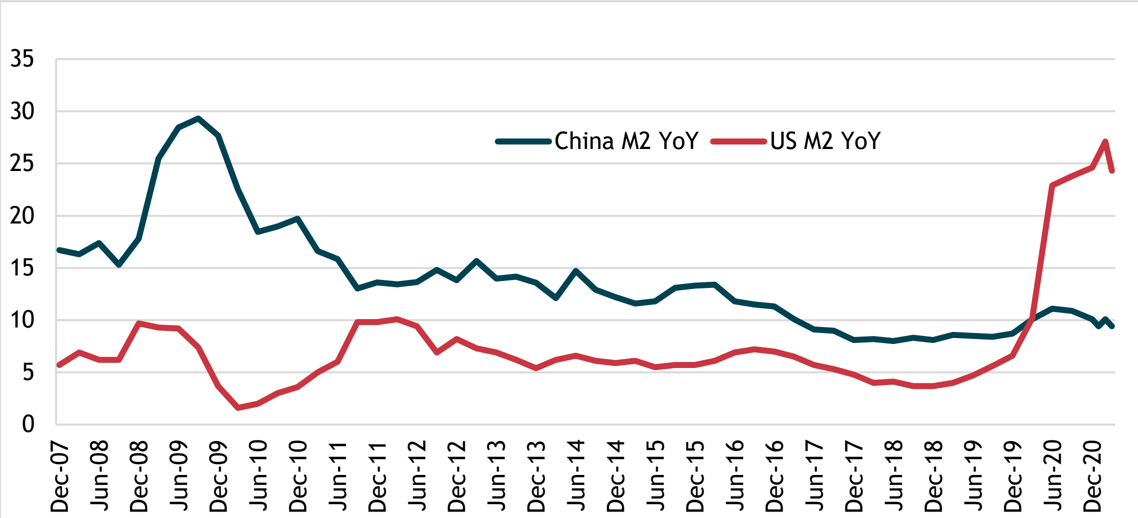
Source: Bloomberg, June 2021

The strong trend moderated so far in June as the central bank PBOC started to cool down the market. It raised onshore banks' required reserved ratio for their FX deposits, and further expanded QDII quota by USD10.3bn. While these measures are mild comparing with direct intervention, we think they did reverberate the central bank's stance to fend off any one-way speculation. As mentioned above, the recovery of Chinese economy has been softening, and a speculation-driven fast RMB appreciation with much volatility is certainly something Chinese government is trying to avoid. However, as we have been arguing in our previous quarterly comments, China is comfortable to let RMB follow the USD index movement, and we believe this is still the case.

Medium to Long-term Positive Trend Intact

We think there is more downside to the USD index in the medium term given that the US is running a Federal budget deficit equivalent to nearly 15% of GDP for both FY20 and 21, and the Fed's monthly purchase of USD120bn has kept US M2 growth at all-time high. On the other hand, China has refrained from massive monetary stimulus and instead focused more on long-term healthy growth. China's outperformance during recovery from the pandemic led to a widening growth differential between China and the US.

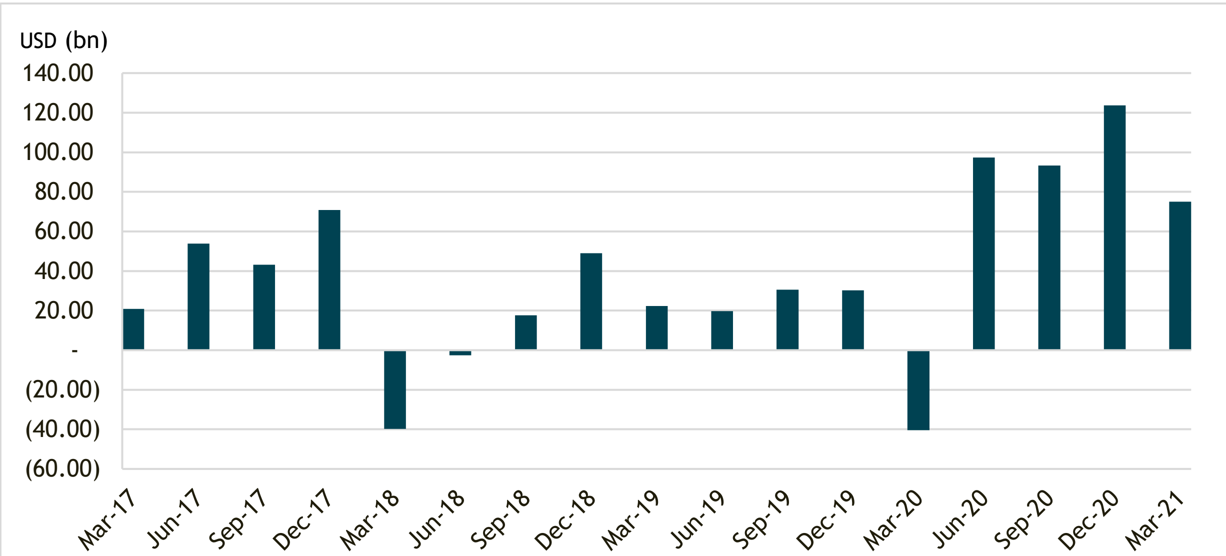
US and China M2 Growth (% YoY)



Source: Bloomberg, March 2021

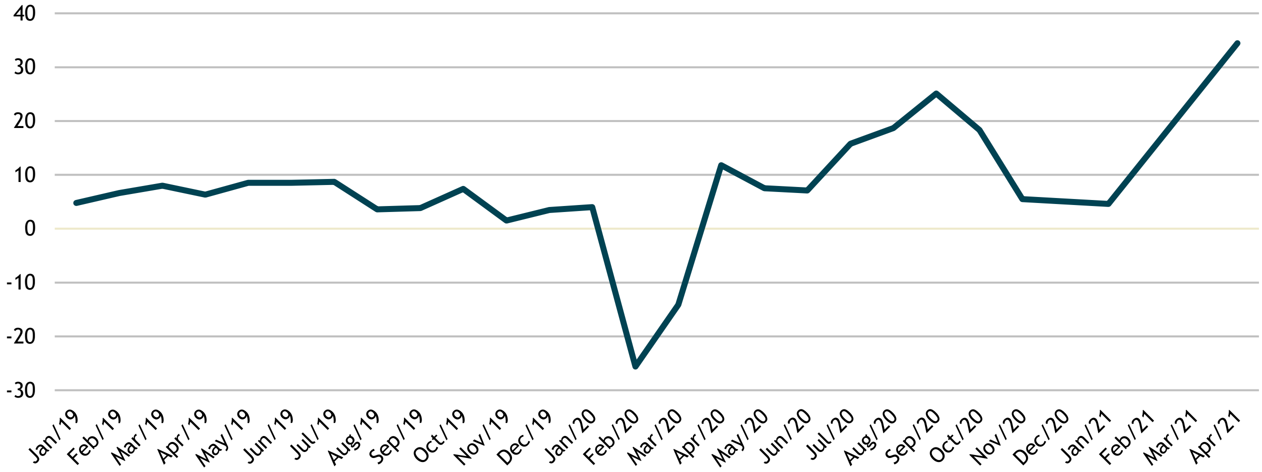
With global economies emerging from the lockdowns and consumer spending surging, China is playing an important role in filling the global output gap. This is evident in the strong exports numbers in recent months and healthy current account accumulation. The utilization of foreign direct investment (FDI) has also picked up despite the pandemic and trade tension. We think these trends will maintain good momentum into the second half of 2021.

China's Current Account Balance (Quarterly)



Source: Bloomberg, March 2021

China FDI Actually Utilized (YoY %)



Last but not least, we believe fundamental-driven asset allocation to RMB will continue to accelerate and provide support for the currency. The onshore bond market has been seeing positive and steady inflow from foreign institutional investors. Therefore, we remain constructive on RMB in the medium to long term.

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