INCOME PARTNERS

OCTOBER 2021

CHINA ONSHORE BOND MARKET QUARTERLY

Since early this year, we have been taking a view that the deceleration of credit growth in China will eventually feed back to the economy thus creates rates rally opportunity. Since March, as expected, onshore interest rate has been in a rallying trend which further accelerated in July. Looking forward, we believe the rates rallying trend is intact and will extend toward year end. As for RMB, the recent weak employment data and uncertainties on the US economy brought on by the Delta variant may hinder Fed intentions on applying tapering measures in the near term. We also observe easing tensions between the US and China, shifting away from a confrontational stance to opening mutual dialogue. Both developments are fundamentally supportive for RMB performance in the coming months.

FURTHER RATES RALLY OPPORTUNITY TOWARD YEAR END

During the third quarter, the onshore 10-year Chinese government bond (CGB) yield rallied strongly in July, and then consolidated in a tight range of 2.8-2.9% in August and September. The quick rally of rates in July was mainly due to the surprised bank reserve ratio (RRR) cut by the Chinese central bank PBOC. As explained by PBOC, the main purpose of RRR cut was to reduce financial cost for small-to-medium enterprises due to rising commodity prices, and to maintain stable liquidity in the banking system. It was interpreted by the market as positive for rates therefore the rally in July.

Looking forward, we believe that the slower credit growth, especially given policy tightening in the property market combined with the recent power shortage in China, will put more pressure on the economy, and cause further rates rally opportunity toward year end. There is potential for 10-year CGB yield to rally further to below 2.5% level.

10-Year CGB Yield Rallied since March

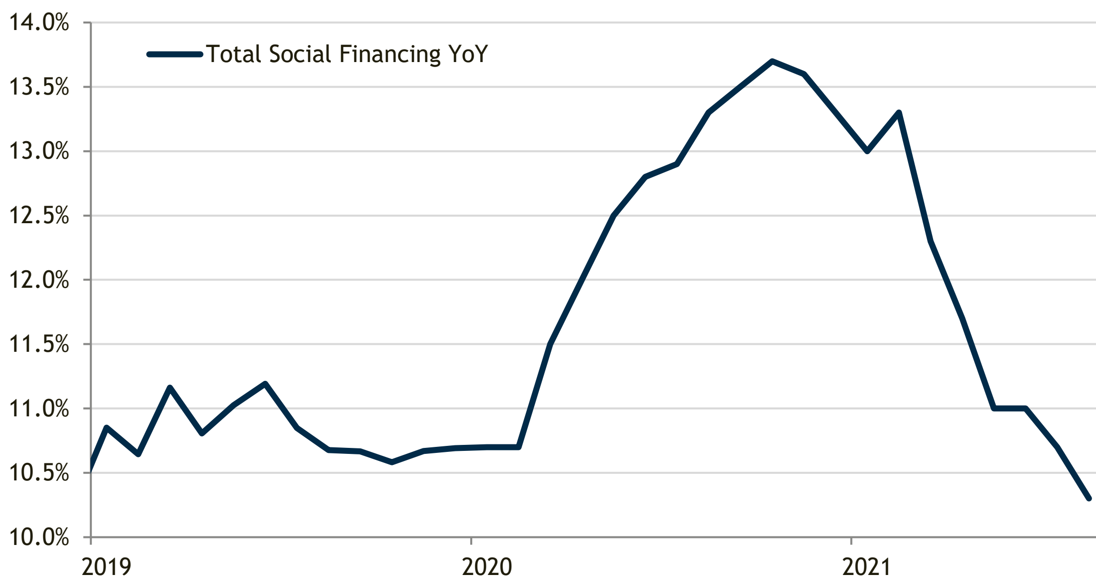
Source: Bloomberg, September 2021

Suites 3503 - 3504, 35/F, Cambridge House, Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong
香港鰂魚涌英皇道 979 號太古坊康橋大廈 35 樓 3503 至 3504 室
T 電話 (852) 2169 2100 F 傳真 (852) 2869 6991 www.incomepartners.com

There are several factors which could support further rates rally:

1) The YoY growth of China's Total Social Financing, an indicator of overall credit expansion, has slowed further to 10.3% in August from 13.3% in last December, and is now fully normalized to pre-pandemic level. As indicated by PBOC, the major reason for credit slowdown into this year is to control China's macro leverage (Debt/GDP ratio) from going higher by targeting a credit growth rate that is more in-line with China's nominal GDP growth rate. In our view, it's a positive development to control China's overall debt level for more sustainable growth. However, the side effect is that we will see more slowdown on the economy in the next few months as credit growth in China typically leads the economy by 3-6 months based on past experience.

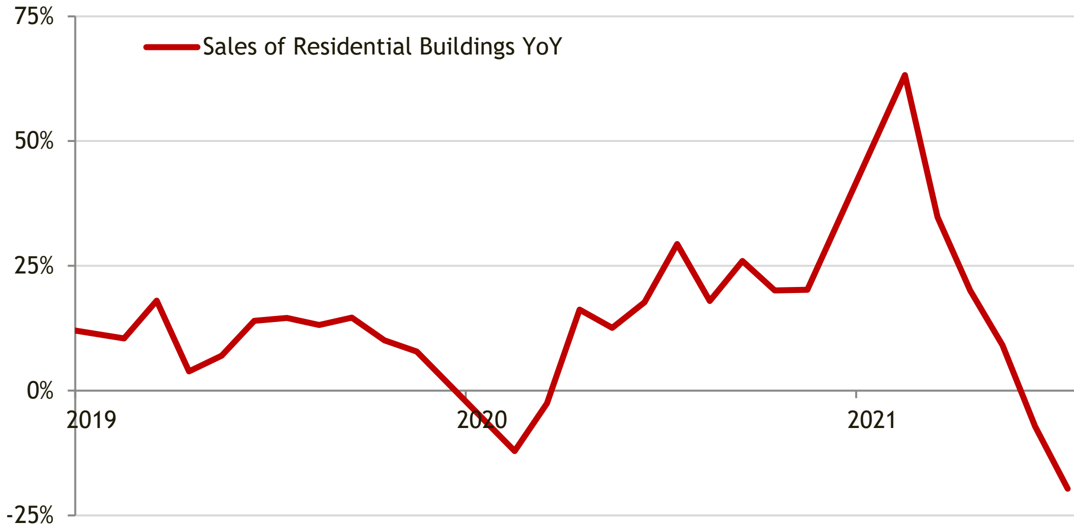
Total Social Financing on a Decelerating Trend



Source: PBOC, August 2021

2) As part of the credit policy, China has tightened policy in the property market since last year, including purchase control, caps on property and mortgage loans, as well as deleverage requirement on property developers. The major purposes are to control housing price from rallying too fast, and to push property developers to deleverage, for healthier growth of the property market in the long run. As a result, since middle of this year, housing prices have been cooling down, residential property sales growth has turned negative, and highly leverage Chinese property developers such as Evergrande have run into liquidity problem. Since real estate investment accounts for around one third of China's fixed asset investment, the slowdown of property market will also have negative impact on China's economy through the sector itself and related industries.

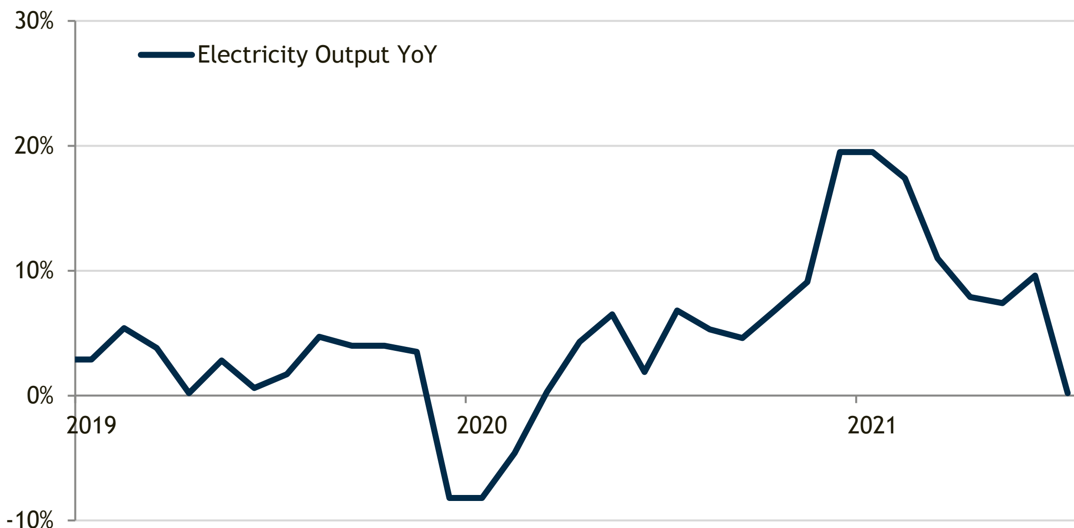
Residential Property Sales Growth Turned Negative since July



Source: Bloomberg, August 2021

3) Another new factor coming into play in September is the power shortage in China as a result of higher coal price. We believe that this is going to be temporary as China starts to release coal supply. In the near term, however, it will still lead to slower growth, especially production in the manufacturing sector.

Power Shortage in the Near Term



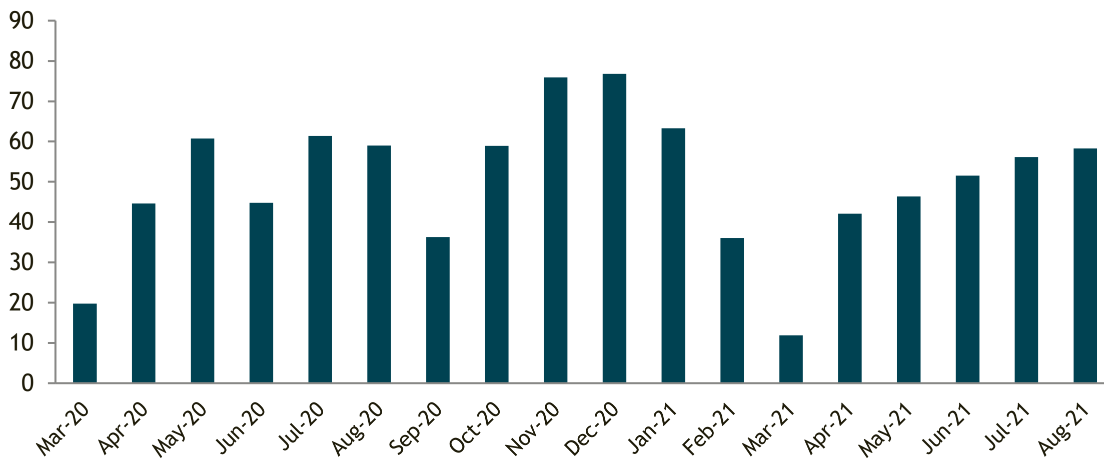
Source: Bloomberg, August 2021

In summary, we believe that the engineered credit slowdown and policy tightening in the property market in China, while positive for healthier growth in the medium term, will cause near term economic slowdown and as a result potentially further rates rally.

STAY POSITIVE ON RMB OVER MEDIUM TO LONG TERM

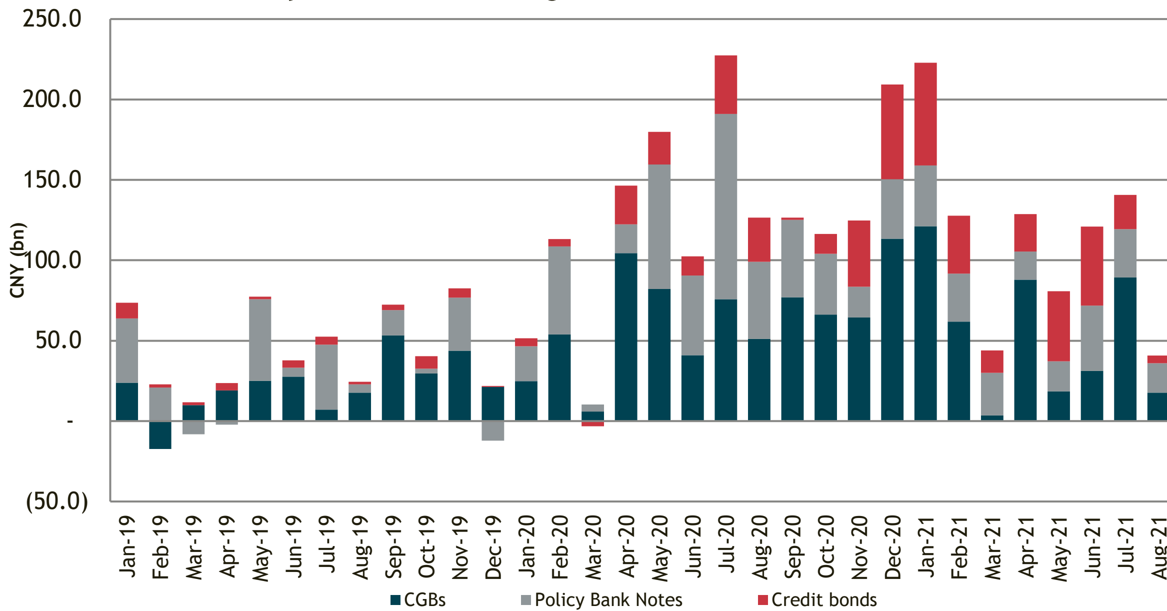
We remain constructive on RMB in the medium term as supportive factors such as strong export, robust Foreign direct investment (FDI), steady bond market inflow, and large yield differential stay intact.

China's trade surplus has surprised to the upside in recent months thanks to its integrated and resilient supply chain and solid global demand. As developed countries gradually overcome the delta variant-driven downturn and start to replenish their inventories for Christmas shopping season, we expect China's strong export growth to continue into the end of this year. On FDI front, China overtook the US as the top destination for overall foreign investment in 2020 and the trend continues this year. China Jan-Aug FDI jumped 22.3% y-o-y to USD113.8bn, with fastest growth from the Belt and Road countries (+37.6%) and the Association of Southeast Asian Nations (+368%), despite of the government's increasing scrutiny of various sectors in recent months.

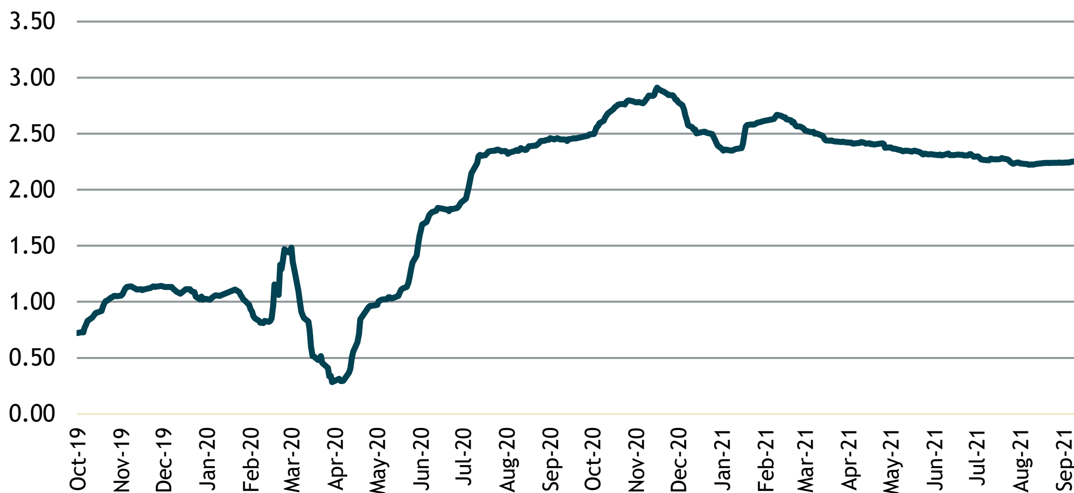


Source: WIND, August 2021

Foreign portfolio inflows, especially bonds, have been steady. With FTSE Russell WGBI index inclusion starting at end of October 2021, an estimated inflow of USD110-130bn may take place over the next 36 months. In addition, the yield differential, particularly in the front end, has remained elevated. This, together with factors such as low historical correlation with DM (developed market) rates and potential rally opportunity given headwind faced by domestic economy, have made China sovereign bonds attractive for foreign institutional investors and thus may propel more inflow, in our view.



Source: WIND, Income Partners, 31 August 2021



Source: Bloomberg, February 2021

On the other hand, the capital outflows such as tourism outflows have been restrained amid global COVID situations and China maintains border restrictions. The newly launched Wealth Management Connect and Southbound Bond Connect programs are signs of China's latest effort to further liberalize its capital accounts. We do not expect they will have material impact on RMB as both programs are capped by annual/daily quotas. Instead, we think RMB internationalization will promote more RMB settlement and foreign allocation in RMB assets.

DISCLAIMERS & IMPORTANT INFORMATION

This report is issued by Income Partners Asset Management (HK) Ltd. ("Income Partners") and has not been reviewed by any regulatory authority. It is not intended as an offer, solicitation, advice or recommendation to buy or sell any securities or any products. This report may not be received by and is not intended for any U.S. Person other than a U.S. Person who is an "accredited investor" as defined in Regulation D under the U.S. Securities Act of 1933, a "qualified purchaser" as defined in the Investment Company Act and the regulations thereunder, and "qualified eligible persons" as defined by the U.S. Commodity Futures Trading Commission ("CFTC") Rules and Regulations or the rules and regulations thereunder. This report is for distribution only under such circumstances as may be permitted by applicable law. Nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a recommendation. It is provided to you solely for information purposes only. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. We have prepared this report without consideration of the investment objectives, financial situation or particular needs of any investor. You should consider your own investment objectives, financial situation and particular needs before taking any action with respect to a financial product referred to in this presentation. In particular, we are not acting as your adviser or assuming any duty of care in this respect. To the extent permitted by applicable law, none of Income Partners, its affiliates, or any officer or employee of Income Partners, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents, including for negligence. Investments involve risk. Under some market conditions it may be impossible to liquidate a position. Losses incurred in trading can be substantial.

- Investment in the China market is subject to emerging market risk including political, economic, legal, regulatory and liquidity risks.
- Investment involves risk. Past performance is not a guarantee or a reliable indicator of future results and no guarantee is being made that similar returns will be achieved in the future.
- In making investment decisions, investors should not rely solely on the information in this document and should read relevant offering document for further details including the risk factors. This document does not constitute an offering document.
- Index or benchmark data are for reference purposes only and no comparability or relevance is warranted or implied. Care should be taken as the composition, volatility, duration, yield and other features may from time to time be materially different from the indices and the underliers of the indices. Indices may rebalance or change its composition and weighting of its underliers from time to time and no regard has been given to such changes in this document. The recipient should conduct its own research and be familiar with the characteristics and underliers of any indices.