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June 2020

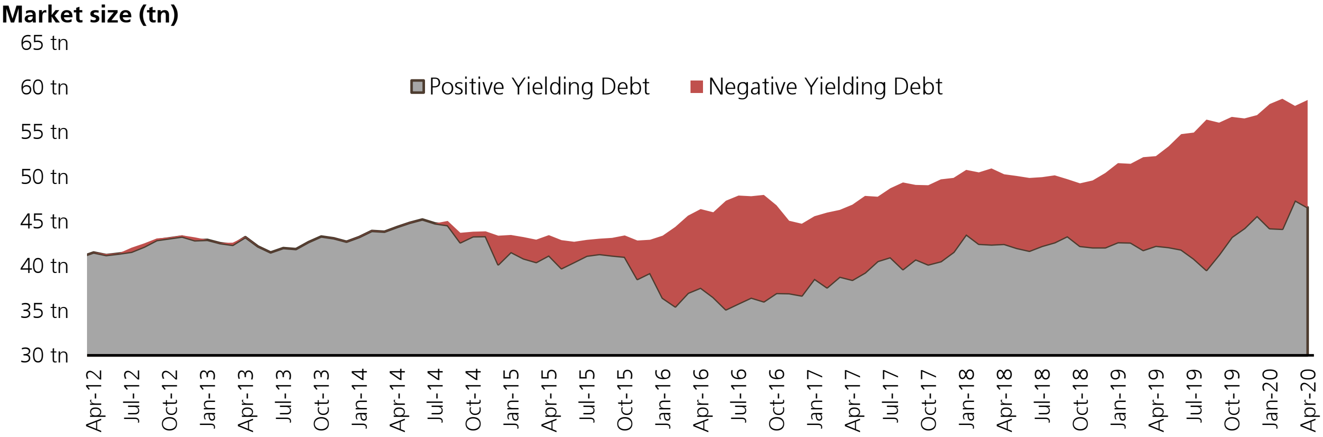
Investing in a new world

China Fixed Income

Fixed income investors are entering a new world

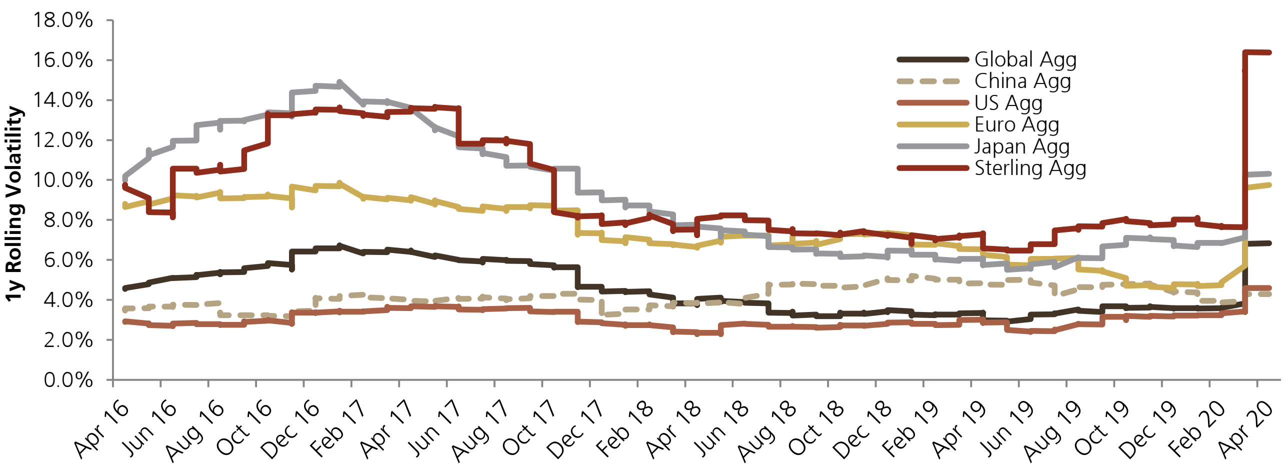
And it's a world of negative yields. Central banks' quantitative easing has driven a 36% average y-o-y increase in negative yielding debt over the past five years to reach USD 11 trillion at the end of March 2020.

Exhibit 1: Market cap of positive and negative yielding debt on global markets (USD billions), Feb 2012-Feb 2020



Source: Bloomberg, Bloomberg Barclays Global Aggregate Index MV USD. As of end February 2020

This new world is considerably more volatile - and correlated - than the past. Global economic uncertainty has pushed annualised volatility of some developed country bonds to double-digit levels.



Source: Bloomberg, Apr 30, 2020

But investors are also in a new world where China is much more influential. China's steady integration into the global financial system is seeing a new territory emerge for bond investors.

Given the challenges of negative yields and rising volatility, there's a strong investment case for China onshore fixed income - particularly in the government and policy bank sectors - because of the following five key factors:

- **Attractive yields**: China bonds offer superior yields against most global government bond benchmarks, and we expect this to continue to be the case given the differences in China's monetary policy regime;

- **Low volatility**: China's bond markets have been markedly less volatile than global markets: largely because the domestic market is dominated by domestic investors and the banking sector holds a large part of the bond market – two factors which are unlikely to change in the near-term;

- **Low correlation**: Offering diversification benefits against global asset benchmarks. China's economy and policy cycles are not directly influenced by Fed policies or volatility in the US banking sector, as in other western economies. After USD global currency status ascended since the 50's, so did its influence over other western financial markets. China's capital markets have largely been immune to US policy action as they're self-funded as one of the largest creditor nations in the world. Their domestic capital market has low foreign ownership, so correlation vs. global markets is also low, and will likely remain so;

- **Safe haven properties**: China government bonds have performed well during periods of volatility, which suggest they have potential to serve as a safe haven asset for global investors;

- **Historically low hedging costs**: The cost of hedging into CNY is at historical lows, so we believe now could be a good time for investors to take advantage.

But for all of China's progress, challenges still remain. Investors need to navigate the nuances of China's corporate structures, linkages to the state and liquidity in credit markets. As the credit markets will evolve rapidly we caution new investors to seek out solutions that offer interest rate sensitivity and take advantage of the defensive characteristics that are in short supply globally today.

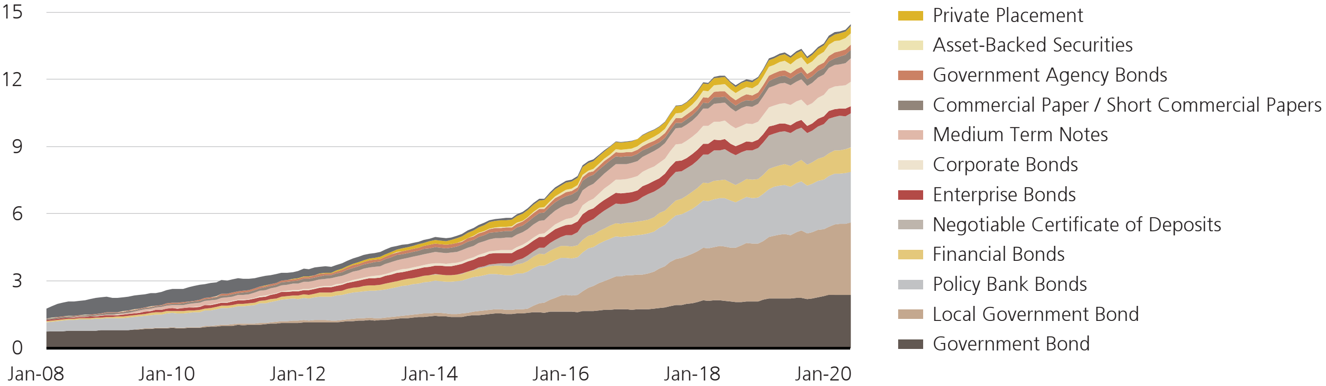
Challenges like this reinforce the value proposition of local expertise and deep networks across China's financial markets. We believe that an established China presence can help cut through the noise surrounding China and provide investors the best opportunities.

And we believe that's going to be valuable going forward. Yes, the current investment case is strong, but three megatrends described here - the rise of the RMB as a reserve currency, demographic change and the growth of China's pension industry, and China's rising status as one of the world's largest economies - will make positioning in China an essential part of global asset allocation strategy in the future

The new world in 8 pictures

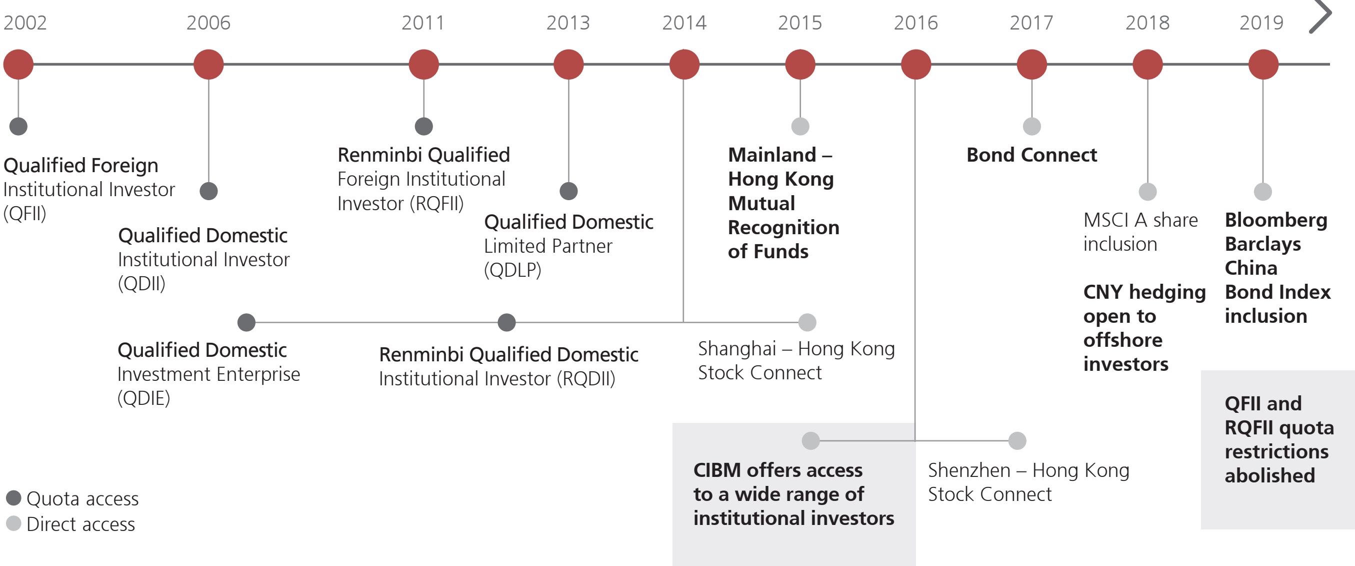
China's onshore bond markets are accelerating…

Bonds outstanding, USD trillions



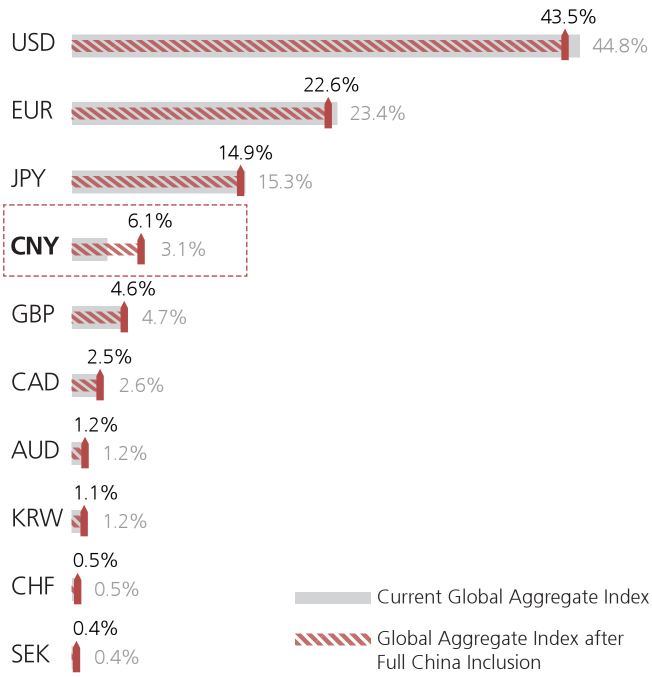
Source: Wind, March 2020.

As reforms take hold and barriers to foreign investors fall…



Source: UBS Asset Management. As of December 2019.

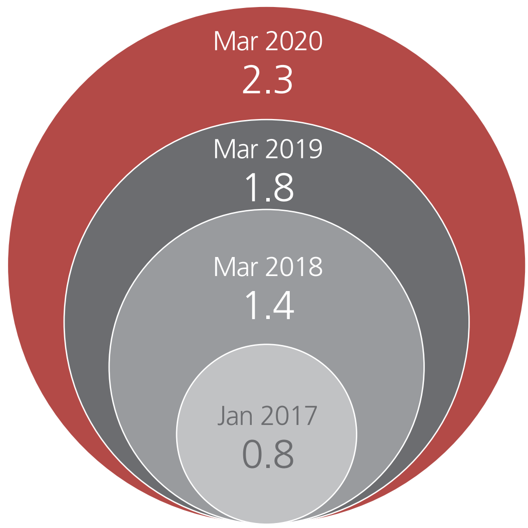
Which is driving index inclusion…



Source: Wind, March 2020.

And propelling a reallocation of global capital to China…

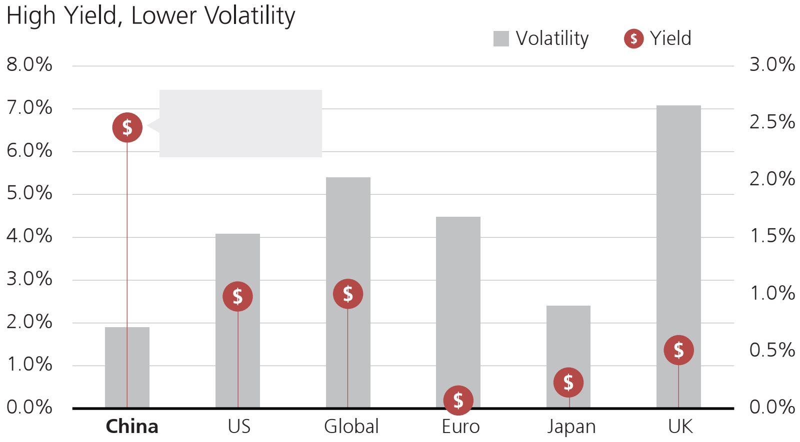
Overseas investors' holdings of China fixed income, Jan 2017-Mar 2020 (RMB trillions)



Source: PBoC, March 2020.

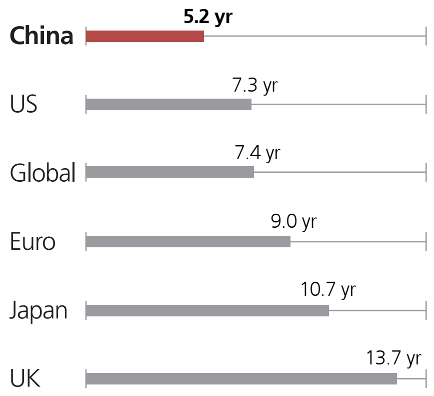
Because China fixed income offers…

High Yield, Lower Volatility



Source: Bloomberg, April 2020. Data is on a USD-unhedged basis. Countries and areas represented by Bloomberg Aggregates.

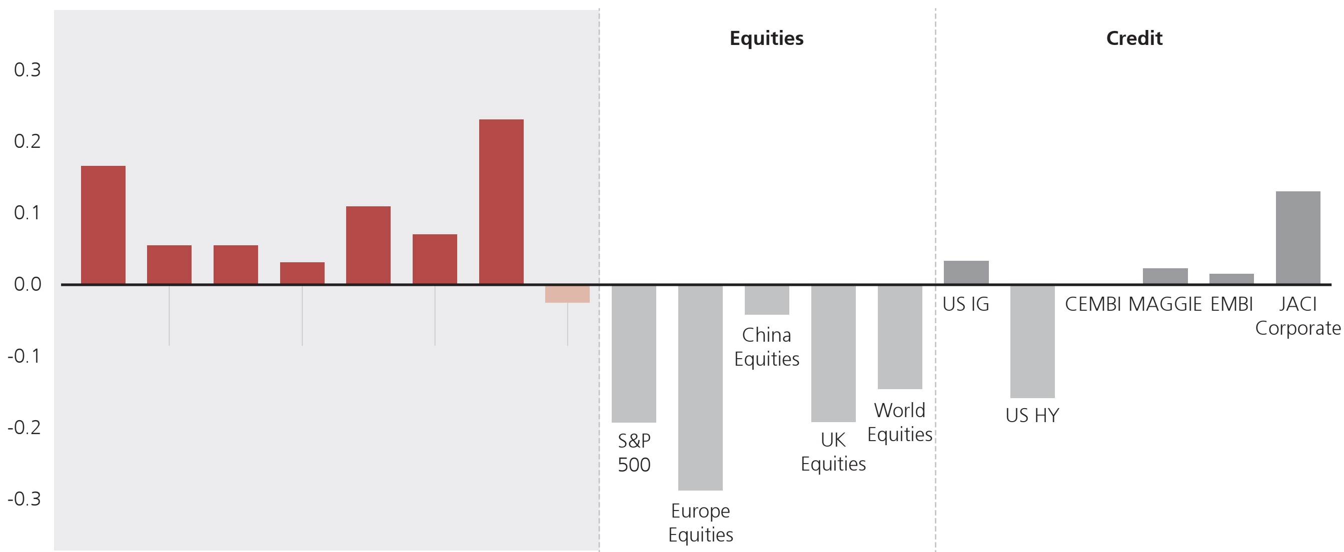
Shorter duration



Source: Bloomberg, April 2020. Data is on a USD-unhedged basis. Countries and areas represented by Bloomberg Aggregates.

Low (or negative) correlation to other global asset classes

Correlation to China Bonds



Source: UBS, Bloomberg, WIND, as of end March 2020.

Safe haven in times of crisis

Source: Bloomberg, April 2020.

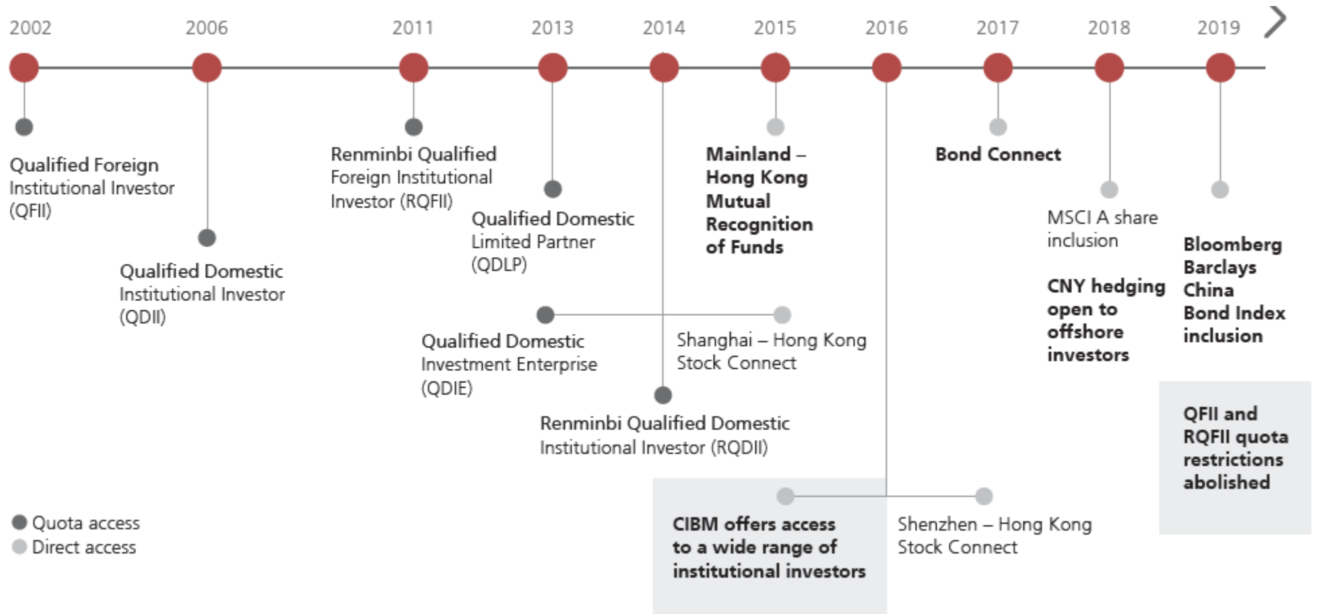
The investment case for China fixed income

- As China's onshore markets have grown in size, accessibility for global investors has improved. Programs like Bond Connect and CIBM Direct give direct access to onshore bonds;

- Government bonds offer attractive yields, low volatility and correlation vs global markets, and may serve as a safe haven asset during times of global market volatility;

- Hedging costs have been reducing recently making this a more attractive entry point for global investors;

- Including Chinese bonds into a global aggregate portfolio could reduce the risk of a global portfolio while also improving returns.



Source: UBS Asset Management. As of December 2019.

China - the world's second largest bond market
Onshore markets had grown to become the second largest in the world, overtaking Japan, and reaching USD 13.7 trillion at the end of March 2020.

Growth in China's onshore bond market comes from fundamental changes in China's financial system. China has passed a series of new budgetary laws to force local governments and companies to borrow from public bond markets rather than from banks, along with the government running a persistent fiscal deficit this has driven a sustained increase in the market during the past ten years.

Accessibility is no longer an issue
Additionally, China has opened up its onshore markets, making them fully accessible to overseas investors via programs like Bond Connect and CIBM Direct. China has also abolished investor quotas on QFII and RFQII programs and created onshore FX currency hedging capacity in 2019. This year legacy Qualified Foreign Institutional Investor (QFII) programs will be scrapped allowing legacy products full access and thus putting everyone on the same level of open access.

Global investors are underinvested
Despite the size of China's onshore bond markets, they remain under-represented in global bond indices.

Though index inclusion has begun, China's 2.4% weighting in the Bloomberg Barclays Global Aggregate understates the size of China's bond market and also China's weight in the global economy, measured at 19.3% of global GDP in 2019 in purchasing power parity (PPP) terms, according to data from the International Monetary Fund[1].

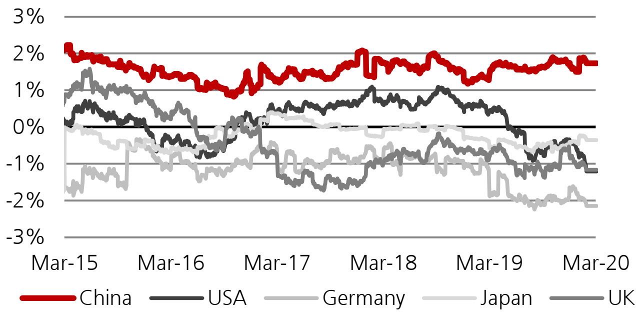
Despite global investors being under-allocated to China, we see a strong investment case for Chinese bonds, and particularly in the government and policy bank space.

Attractive nominal yields
China government bonds offer attractive nominal yields when we compare whats on offer in other developed market bond markets. In a world where safe income from the bond part of investors' portfolios is becoming harder to find we believe this will remain a standout opportunity.

Attractive real yields
If you're a multi asset investor one of the key things required in the bond part of your portfolio are positive real yields to protect real income returns. Chinese real yields on ten-year government bonds have been consistently higher than those in developed markets during the past five years, and the differential has opened up since mid-2019.

In part this represents differences in monetary policy, amid low growth and productivity, quantitative easing by central banks in US, UK, Japan and Europe has pushed their real yields steadily below zero. China's inflation has steadily declined over the last few decades, now looking more like other developed market countries inflation rates, making Chinese bonds a standout opportunity.

Real yields on China government 10-year bonds, Mar 2015-Mar 2020



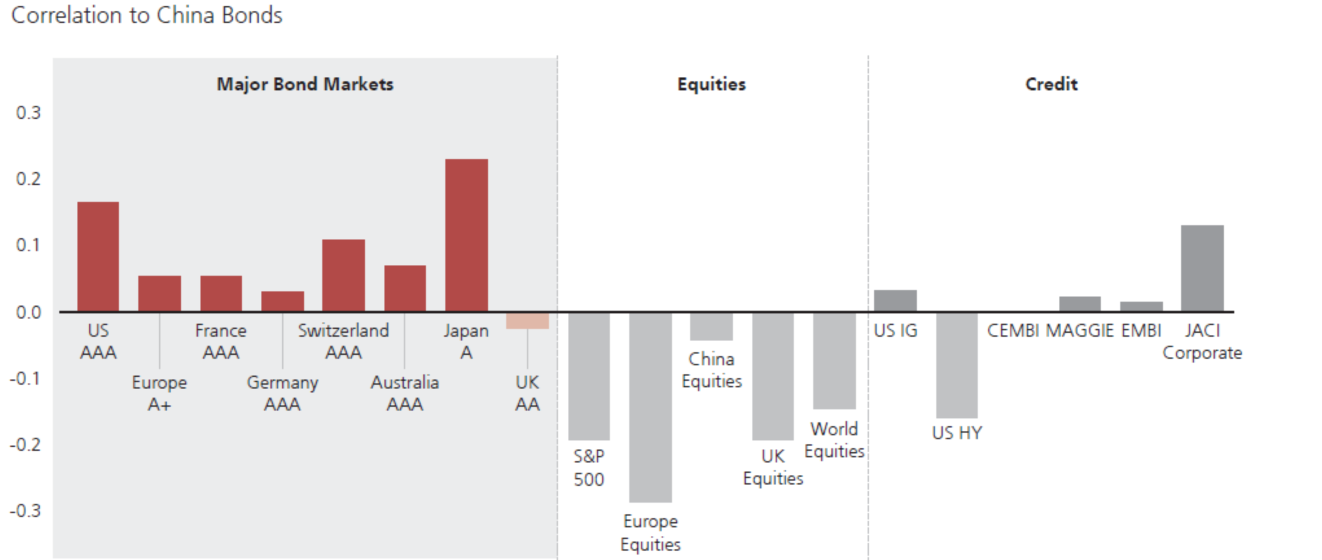
Source: Bloomberg, March 31, 2020

Low correlation and volatility
China bonds have low correlation to almost all global asset classes. To an extent, this is because China's monetary policy has been largely independent from other major economies around the world and that China's growth is more dependent on internal dynamics than other countries around the world.

This low correlation also reflects that China remains largely a self-sufficient capital market, China is one of the largest net creditor nations in the world. Domestic investors are the dominant group here, having the largest deposit base in the world around USD 40 trn and growing.

With few avenues to invest outside of China, correlation is thus very low compared to international markets. And that's different to other Asian bond markets where foreign ownership is much higher and thus more susceptible to global trends and investment flows.

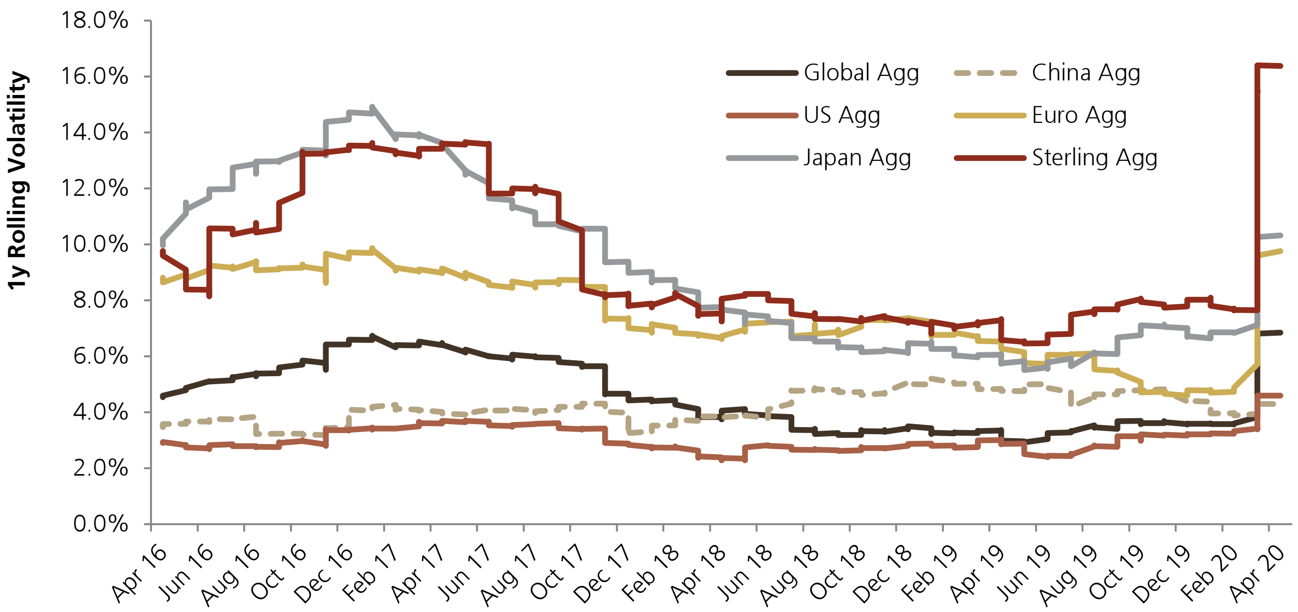
Global benchmarks and correlation to China bonds, Mar 2016-Mar 2020



Source: UBS, Bloomberg, WIND, as of end March 2020

[1] IMF, World Economic Outlook, October 2019

Global Bond Aggregates 1 yr rolling weekly volatility, Apr 2016-Apr 2020



Source: Bloomberg, as of end April 2020

Putting these factors together and comparing the main global China aggregate[1] to a range of different global aggregates, Chinese bonds offer superior yield with lower volatility compared with developed markets such as Japan, UK, and Europe.

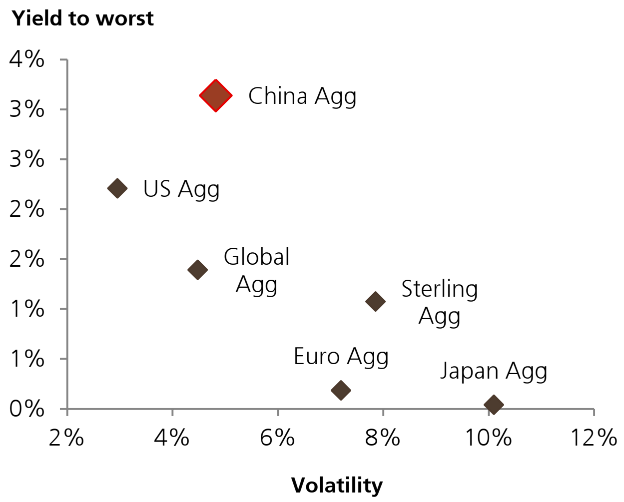
Safe haven properties

Looking at longer-term trends, China government bonds appear to behave as a safe haven asset. For example, during periods of high volatility in global markets, yields have tended to tighten.

This could be due because of China's status as a net creditor nation, but it also links back to the difference in yield available between Chinese government bonds and sovereign debt of other developed markets.

Performance so far in 2020, during periods of COVID-19-induced high volatility, offers some support for this thesis, as the Bloomberg China aggregate - which consists of government and policy bank bonds – has outperformed key global benchmarks both in March 2020 and YTD as of March 31, 2020.

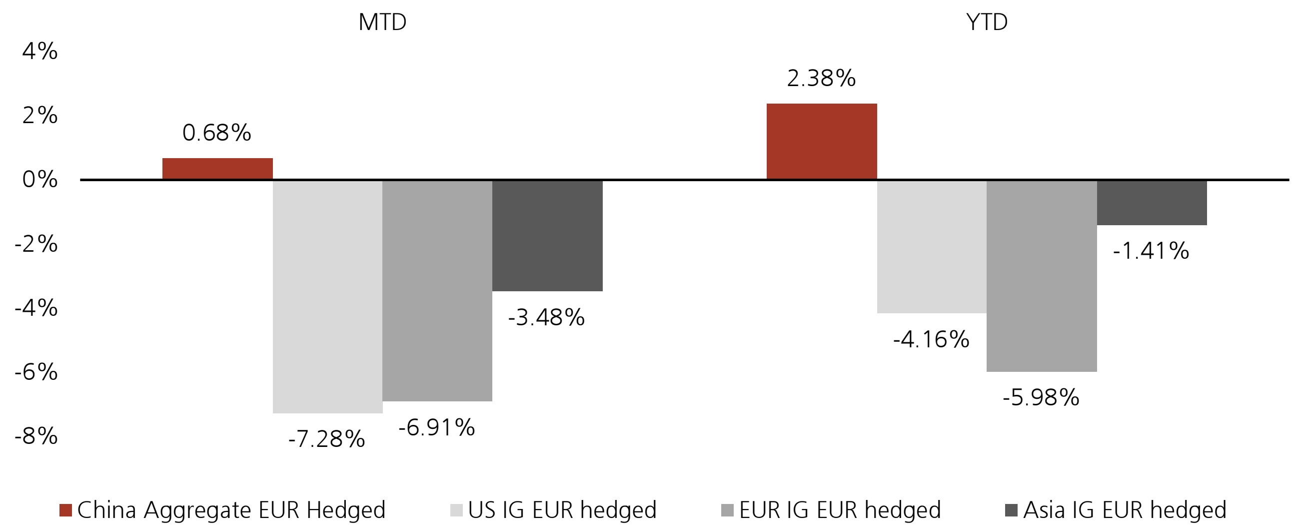
Bloomberg Bond Aggregates: Yield-to-Worst & Volatility (USD terms), Apr 7, 2019-Apr 7, 2020



Source: Bloomberg, April 2020

[1] The China Aggregate refers to the Bloomberg China Aggregate, which consists of a mix of central government bonds and policy bank bonds.

Global bond benchmarks: returns in March 2020 and YTD 2020 (%)



Source: Bloomberg, March 31, 2020

Hedging

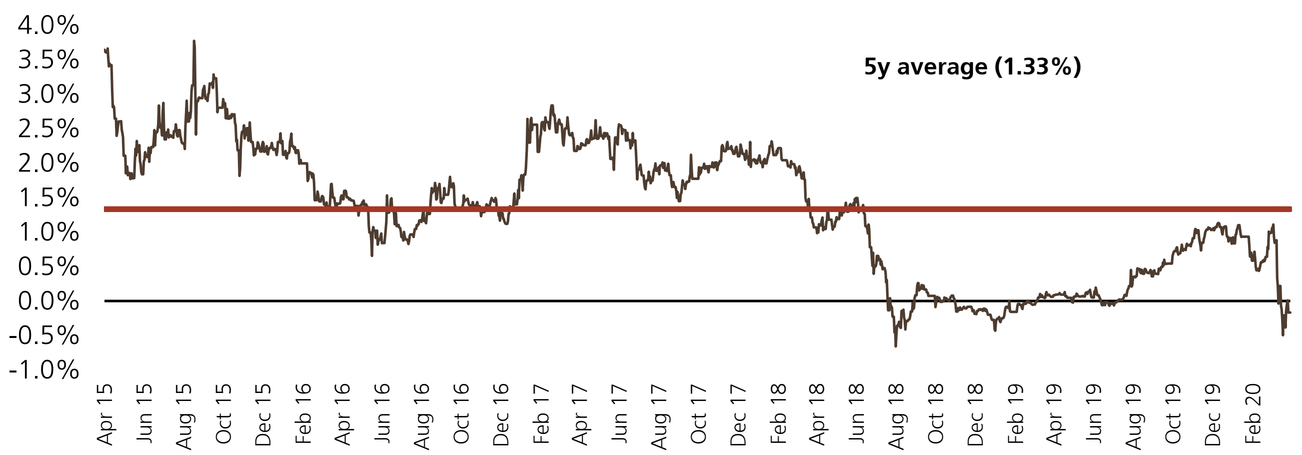
Prior to 2018, the only option for offshore investors to hedge their CNY exposure was via CNH deliverable forwards (CNH DF), or CNY non-deliverable forwards (CNY NDF).

In 2018, China announced that CNY deliverable forwards (CNY DF) would be made available to foreign investors as a hedging tool.

CNY DF hedging is now available to foreign investors accessing the market via both China InterBank Bond Market (CIBM) direct and Bond Connect schemes.

Hedging costs for CNY/USD have come down markedly to the extent that hedging costs at the end of March are now at -0.21%, and well below their historical average of 1.33% over the past five years.

CNY/USD Hedging Costs, Apr 2015-Mar 2020



Source: Bloomberg, March 31, 2020

What does China fixed income do for a portfolio?

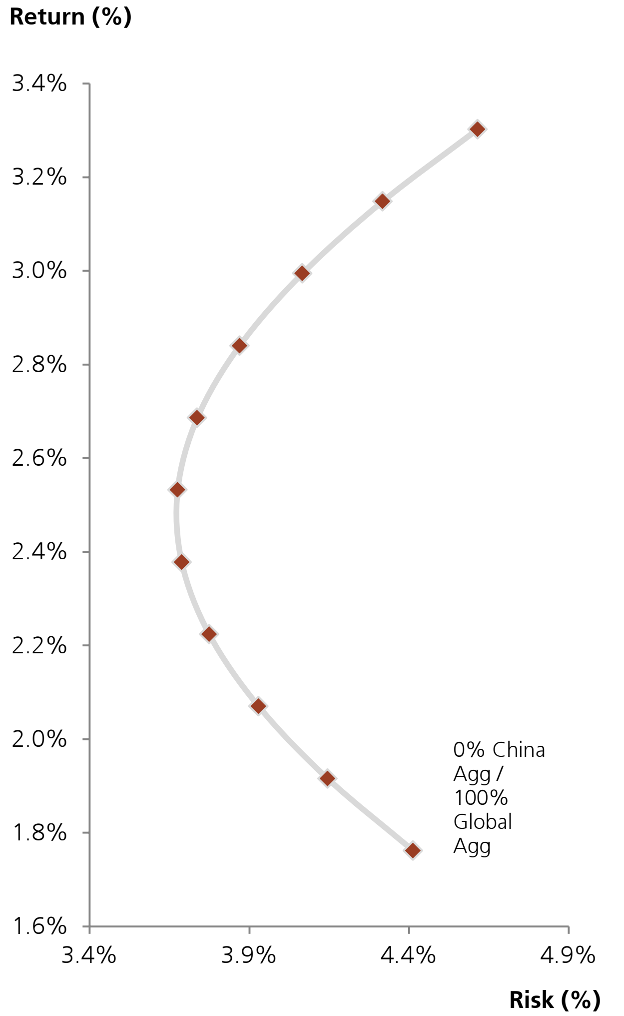
Adding further weight to our view on the benefits of adding Chinese bonds to a global portfolio, our range of combinations of Chinese and global aggregates[1] shows that including Chinese bonds into a global aggregate portfolio can reduce the risk of a global portfolio while also improving returns, according to historical data over a fifteen-year time horizon.

Risk & Returns combining China and Global Aggregates (USD Unhedged), July 30, 2004-April 30, 2020

	Return	Risk	Return/ Risk
Global Agg 100% / China Agg 0%	1.76%	4.41%	0.399
Global Agg 90% / China Agg 0%	1.92%	4.15%	0.462
Global Agg 80% / China Agg 20%	2.07%	3.93%	3.77%
Global Agg 70% / China Agg 30%	2.22%	3.77%	0.589
Global Agg 60% / China Agg 40%	2.38%	3.69%	0.645
Global Agg 50% / China Agg 50%	2.53%	3.68%	0.689
Global Agg 40% / China Agg 60%	2.69%	3.74%	0.719
Global Agg 30% / China Agg 70%	2.84%	3.87%	0.734
Global Agg 20% / China Agg 80%	2.99%	4.07%	0.736
Global Agg 10% / China Agg 90%	3.15%	4.32%	0.729
Global Agg 0% / China Agg 100%	3.30%	4.61%	0.716

Source: Bloomberg, April 30, 2020

All these factors amount to what we believe is a strong investment case for China fixed income, and particularly in the government and policy bank space. Offering attractive yields, low correlation and positive diversification benefits, there's an excellent case for allocating now, particularly while USD/CNY hedging costs are at historical lows.



Source: Bloomberg, April 30, 2020

[1] Bloomberg Barclays China Treasury and Policy Bank USD unhedged index; Global Aggregate (Glb Agg) = Bloomberg Barclays Global Aggregate USD unhedged index.

Three Main Investor Concerns

- Debt levels, market liquidity and onshore ratings are three main investor concerns when investing in China's onshore markets;

- China's debt pile has grown but China's external position is healthy and domestic debt remains concentrated in the state-owned sector;

- Market liquidity is improving, but uneven; investors will find the best liquidity conditions in the growing rates bond market, and particularly the government and policy bank sectors;

- China's onshore ratings system differs from other international markets. Foreign ratings companies are growing their onshore presence, but onshore expertise will remain key for the near future.

For all China's progress in recent years, the market can still be challenging, and investor concerns remain. Here we address three of the main concerns that investors have when considering investing in China fixed income.

China – debt issues
China's debt levels attract a lot of attention. Measured at 303% of GDP in 2019[1], China's debt-to-GDP ratio is one of the highest in the world. But investors must make some important distinctions.

Firstly, China's sovereign debt position remains healthy. China is one of the largest creditor nations in the world, and has a very different external position compared to other emerging and developed markets.

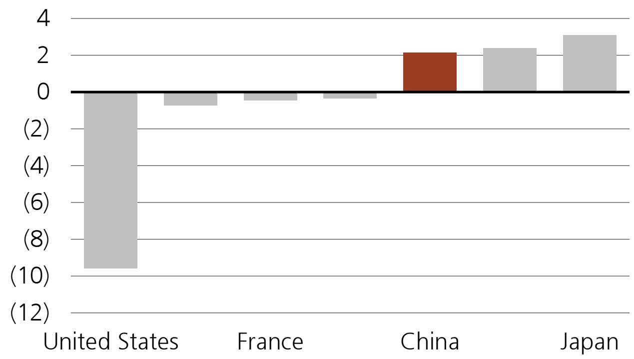
Secondly, China's debt pile is concentrated within distinct parts of the economy, specifically the local government and state-owned enterprise sector. As such, most of this debt is owed to the government, rather than to international institutions.

Additionally, China remains serious about deleveraging the financial sector. Since 2015, there have been a whole range of regulatory measures - such as more stringent rules on capital raising and closer supervision of bank lending practices - to more effectively manage the flow of credit in China's financial sector.

Finally, China still has a lot of growth potential, which means it can likely grow out of its debt situation. Though slowing compared to previous years, China is forecast to grow by 5%-6% between 2021 and 2025.

That's different to say the situation in Japan in the 1990s, and China still has a lot of productivity gains ahead of it. So while China's debt pile remains high, we believe it remains concentrated in China's state-owned sector and, crucially, owed to the government, rather than external investors.

Net International Investment Positions Compared (USD Trillions), Q4 2018

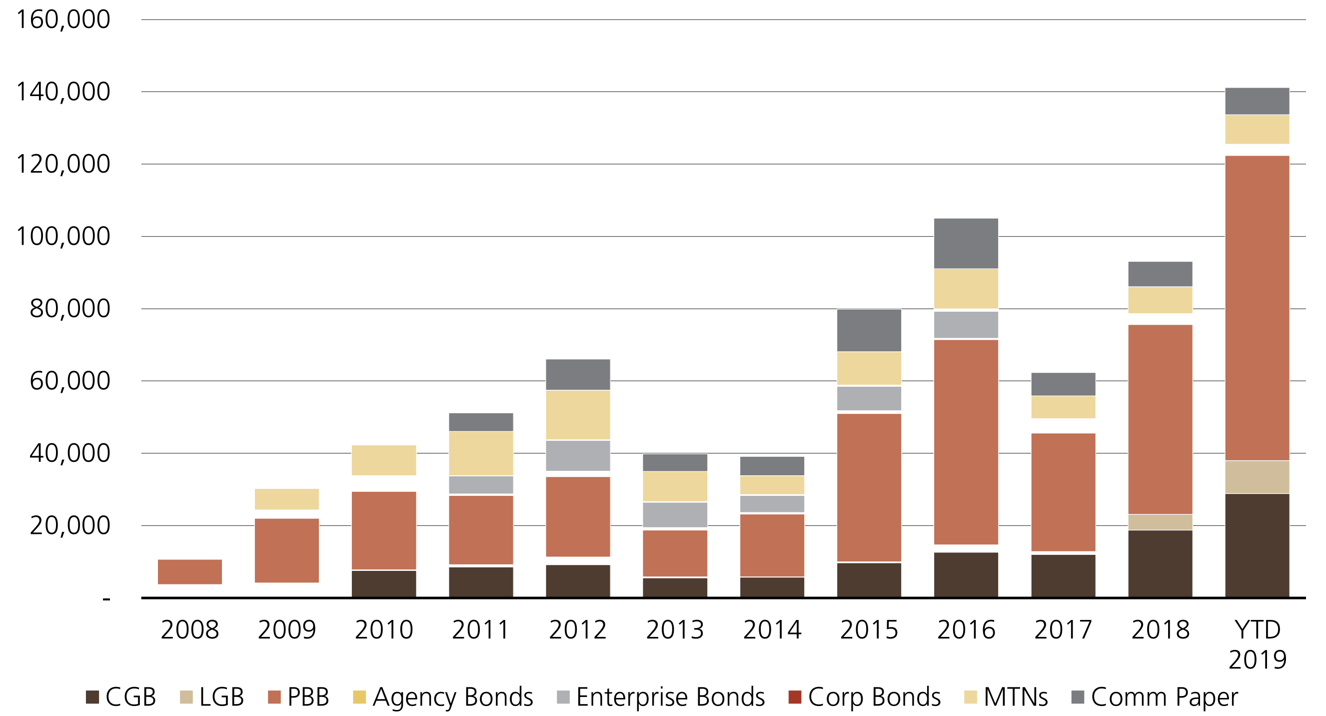


Source: IMF Data Mapper, April 2020

Market liquidity
As China's bond markets have grown, so has market liquidity, with total trading volume increasing almost seven times between 2009 and 2019 to reach RMB 140bn.

[1] Reuters: China's debt tops 300% of GDP, now 15% of global total: IIF

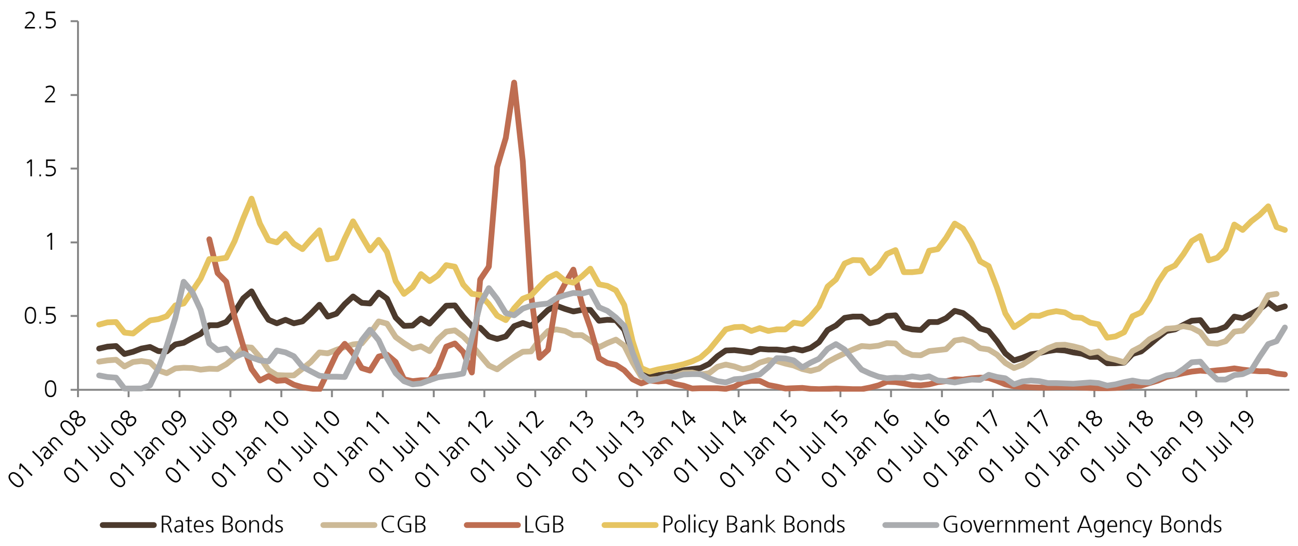
Trading volume broken down by product (RMB billions), 2008-2019



Source: Wind, January 2020

Turnover ratios for policy bank bonds (PBBs) and central government bonds (CGBs) are growing, most likely because they have entered into global benchmarks and are considered relatively risk-free.

Turnover ratios, Jan 2008-Sep 2019



Source: Wind, November 2019

Onshore ratings
China's onshore ratings system is a major differentiator to global fixed income markets.

The system is dominated by seven main agencies[1], some of which have government links. These create obvious conflicts of interest, particularly in the rating of state-owned enterprise debt.

More than that, bond ratings in China are highly skewed, reflecting both stringent issuance requirements and implicit guarantees. More than 95% of credit bonds are rated AA and above.

This partly reflects issuance requirements. For example, among corporate bonds, only bonds with AAA rating can be issued to all investors; for medium-term notes and commercial paper, only bonds with AA rating or above can be issued.

This backdrop explains why ratings in China differ markedly from international markets. For comparison, there is an obvious skew in ratings distribution between China and the United States.

Bringing in more foreign participation in the ratings industry could promote a better risk culture, improve the quality of bond ratings, and bring China's standards closer into line with international markets.

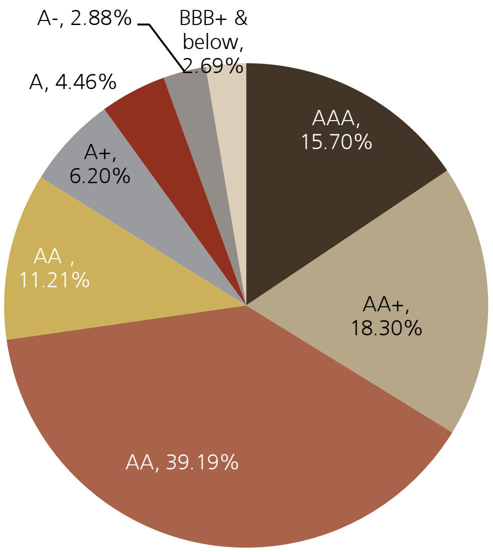
And China is making steps in this direction. Foreign ratings agencies were previously only allowed to operate in China as part of a joint venture with local ratings companies.

However, this has changed, and the Chinese government has recently allowed foreign agencies to set wholly-owned enterprises, the first being Standard & Poor's, which was given permission in January 2019 to independently rate bonds on the domestic market.

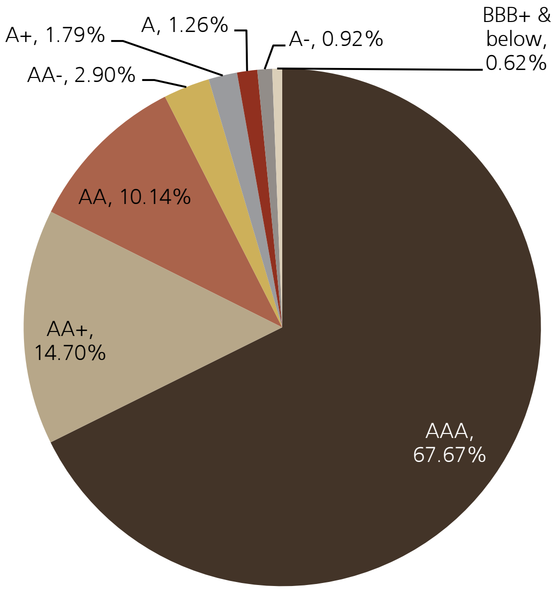
We see this as an important step toward bringing domestic ratings closer in line with international standards and we expect other major ratings agencies, like Moody's and Fitch, to receive similar status in the near future.

For the time being, on-the-ground expertise in China will likely continue to be a differentiator when assessing opportunities and risks within China's onshore bond market.

Onshore Bond Ratings by Issuance, September 2019



Ratings of Outstanding Onshore Bonds, September 2019



Source: Wind, October 2019

China fixed income: 2020 and beyond

- China will likely continue to loosen policy in 2020, so we expect yields to drift lower;

- Trends like the rise of the RMB as a reserve currency, demographic change and pension reform, and China's long-term positioning as a major global economic player, make a long-term strategic allocation to China essential.

2020: Policy easing likely
Looking into 2020, we are expecting a contraction in economic activity in China in the 1H2020 as consumption and manufacturing activities have all been significantly impacted. We therefore still expect easing, both monetary and fiscal from the Chinese government.

The People's Bank of China (PBoC) has been relatively more hesitant on pursuing an aggressive easing at the beginning of the COVID-19 crisis in China, but as COVID-19's impact became more global, we have since seen multiple cuts to reserve-requirement ratios and benchmark interest-rates.

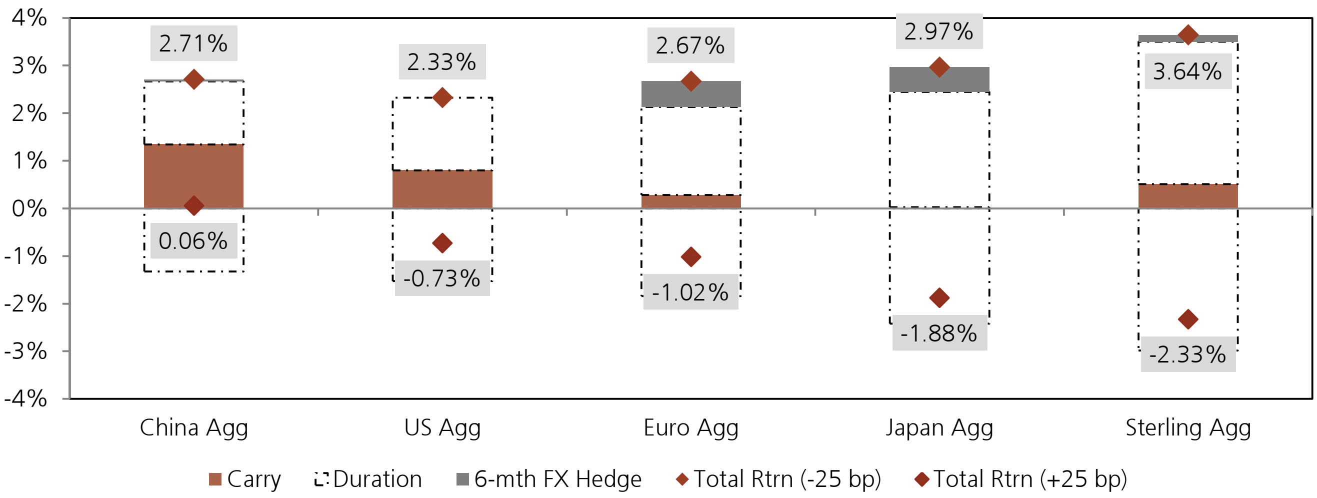
There is also stronger fiscal commitment to keep funding rates low via provision of cheap funding to banks/support via direct lending to SMEs. As such, we expect yields to drift lower this year. Unless we see a surprising game changer, such as the discovery of a vaccine, we see limited scope for upward movements in yields.

Carry will play a more important role in driving total returns going forward
As yield pick-up widens between developed markets. For illustration purposes, we ran simulations of potential total-returns of major bond markets over a 6-month horizon for 25 bps yield movements.

It can be seen from the charts below, that China, despite having a shorter duration (~ 5 years) can produce comparable total returns compared to major bond markets with longer duration (most global bond markets have 7-10 years of duration).

Conversely, due to higher carry and shorter duration, China has less downside risk if rates were to rise 25 bps. The upside/downside profile could be asymmetrical for major global bond markets given the same magnitude of interest-rate movements.

Breakdown of Forward Looking Total Return across Global Bond Aggregates (6 month horizon)



Source: UBS Asset Management, April 2020

Three Strategic Megatrends

China's progress to a reserve currency
The rise of the RMB as a reserve currency is a hot topic in the world of central banking. Indeed, in a 2019 UBS survey, 18% of participants ranked the inclusion of the RMB into the Special Drawing Rights (SDR) basket in 2015 as one of the key events for reserve managers over the last 25 years.

This inclusion raised expectations that the RMB could establish itself as a reserve currency relatively quickly. But the numbers indicate that the rise of the RMB as a reserve currency is a gradual rather than an accelerated process, Q1 2019 from Currency Composition of Official Foreign Exchange Reserves (COFER) show RMB has reached a share of almost 2% of all reserve currencies held at the time.

China's macroeconomic stability and market opening will determine the pace of the RMB's emergence as a reserve currency. For the latter, China is making progress and a 2019 UBS survey of reserve managers found target allocations to the RMB of around 4.2%, indicating the RMB is closing the gap with the Japanese yen and UK sterling and may become the third largest global reserve currency in the future.

While the RMB is unlikely to supplant the USD as the world's top reserve currency anytime soon, we do expect it's role to expand, and that's a trend which global investors, particularly in the sovereign space, need to prepare for.

China pension reform
'China has one of the largest and fastest growing aged populations in the world, with an estimated 172.3 million people aged 65+ in 2020, which is projected to grow to 246.9 million by 2030, according to United Nations data.

To meet this growth and support the need for pension income in the future, China is in the process of reforming its pension industry by bringing in foreign companies, promoting third pillar (personal) pensions, and approving pension annuities plans and mutual funds.

Deloitte estimates total public investible funds will grow to USD 3.3 trillion by 2023 compared to an estimated USD 1.9 trillion in 2018. These fundamentals support what we believe will be a much larger pension industry in China.

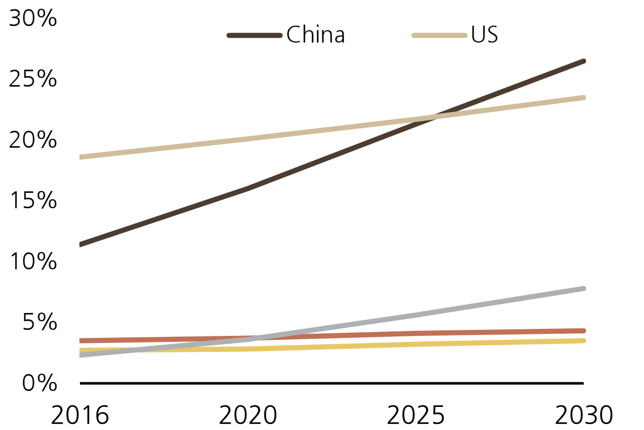
What does this mean for bond investors? As we have seen in many countries globally the two powerful dynamics of an aging society and rapidly growing pension scheme leads to increasing demand for bonds to meet income needs, plus regulation of pension schemes tends to compound this demand.

China's growing role in the world economy
China's rise from a relatively undeveloped country to one of the largest and most influential economies in the world has been one of the stories of the past thirty years.

Now China's influence is keenly felt around the world: it is now the largest retail market, a global manufacturing hub and, increasingly, a source of innovative technologies.

Given current trends - notwithstanding COVID-19 disruption - forecasts indicate that China will eventually overtake the United States in market exchange rate (MER)-terms as the world's largest economy by the end of the 2020s.

Share of Global GDP in MER, 2016-2030 (f)



Source: PWC: The World in 2050, Feb 2017

Asset allocators across the world will increasingly have to acknowledge China's size and the longer term prospects for the economy.

To an extent, this is already happening. Global equity and bond indices are moving to include onshore assets, and we are seeing a slow increase in overseas investment into Chinese assets.

But indices and global investors continue to underinvest in China compared to its weight.

We feel that given the long-run fundamentals underpinning China's rise and the prospects for China's economy, it makes sense for long-term investors to make a more weighty allocation and establish strategic positioning to reflect China's growing weight in the world economy.

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Americas

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