The future just happened

How China will drive global fixed income in the next 5 years

Hayden Briscoe's presentation at GCC on January 8th demonstrated how the inclusion of onshore China bonds will change the outlook for the global fixed income market; and the opportunities that are emerging.

Host
Hayden Briscoe
Head of Fixed Income, Asia Pacific

Panelists
William Tu
Bloomberg Asia Pacific Head of ETF and Index Sales Strategy

Ivan Chung
Associate Managing Director,
Moody's Asia Pacific

Brian Lou
China Fixed Income Portfolio Manager,
UBS Asset Management

"The future just happened in global fixed income," according to Hayden Briscoe's presentation at GCC.

That's because the inclusion of China onshore fixed income into the Bloomberg Barclays global fixed income benchmark is creating a shift of capital reorientation to China and making onshore markets much more influential.

Reforms have both made onshore China fixed income markets accessible to investors through programs like the Bond Connect and allowed offshore investors to directly hedge their CNY exposure.

And investors are responding, as overseas investors have added RMB 546bn (USD 807bn) of onshore holdings between January and September 2018, a 60.4% increase on the same period in 2017 [1].

As onshore China markets bring active managers, sovereign wealth funds, and central bankers into their orbit, Hayden estimated that USD 250bn will flow into China fixed income from the Bloomberg inclusion alone[2].

1 People's Bank of China, December 2018
2 UBS Securities Pte Ltd. As of April 2018

Index inclusion: the time is right

Moving onto the Q&A session, Briscoe asked the panelists about why index inclusion is happening, what benefits it will bring, and whether onshore markets are set up to handle the process.

William Tu explained that 'in 2016 we felt the pace of reforms in China meant the time was right to bring onshore bonds into our indices.'

Tu went on to say that, 'after consulting with clients and market participants, we presented our ideas and proposals to China's regulators and they responded by doing the groundwork for the inclusion process.'

As for the impact of index inclusion, Ivan Chung added 'index inclusion will bring positive changes because the authorities are working hard to adapt to their needs of international investors.'

He elaborated by saying that, 'the index inclusion process will bring more transparency to onshore markets by forcing issuers to meet the standards required by international investors.'

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As for whether domestic markets are set up to handle the inflows implied by index inclusion, Brian Lou explained, 'primary and secondary markets are already well-developed and can handle the flows that we anticipate. The credit market is quite different though, we still need to see some developments there but we have seen a concerted effort by the People's Bank of China since last year to push banks and securities to serve as liquidity providers.'

China in 2019 – the three Ls

> In China we will see a L-shaped recovery in 2019, longer business cycles, and longer-term quality growth.

Turning to the outlook for China and fixed income markets, Briscoe explained that 2019 looks quite different to previous years and that the outlook will be dominated by what he calls the 'three Ls':

1. An L-shaped recovery: growth is slowing in China as we move into 2019, but policy support will improve the macro outlook for the economy in H2 2019 and stabilize the growth rate. That's different to previous slowdowns, when massive stimulus drove a sharp rebound in growth.

2. Longer business cycles: historically, China's business cycles have been around three years and driven by big, cyclical changes in policy. However, because the authorities are taking a more measured policy approach, the business cycle will likely be longer and more stable.

3. Longer-term quality growth: on a related note to the business cycle, Hayden argued that deleveraging policies and new regulations imposed in 2017 and 2018 have imposed new discipline and forced poor-quality firms out of the market, and that has improved the longer-term outlook for China.

Looking in more detail at 2019, Chung added, 'deleveraging dominated markets in 2018 but growth has become the priority for the Chinese authorities in 2019. We expect to see targeted liquidity easing in China, with flows to the private sector and infrastructure being prioritized.'

Chung continued by saying that, 'not everyone will be able to get their bowl of rice and credit differentiation will be a key theme in 2019, with some sectors seeing a liquidity squeeze. Well-run companies will still be able to access credit but heavily-indebted companies will likely find it challenging.'

> 'We expect to see targeted liquidity easing in China (but) not everyone will be able to get their bowl of rice and credit differentiation will be a key theme

Echoing Chung's views, Lou added, 'looking at the markets now, it is clear that liquidity has improved. However, this won't support all players because there are strict controls to favor quality companies. We expect well-run private sector companies to be the main beneficiaries of credit support.'

Top picks for 2019: China High Yield

Bringing the presentation back to the asset class, Briscoe showed that onshore China fixed income has performed strongly during the past year, with the Bloomberg China aggregate benchmark offering a 8.9% total return in 2018 compared to a 3.2% loss on the US Investment Grade Corporate Bond index and a 6.6% loss on Global Equity benchmarks[3].

Moving to strategy, Briscoe made the case that Chinese government bonds continued to look attractive, 'these assets offer attractive yields compared to those currently available on developed markets, good diversification against global markets, and positive income prospects.'

Looking more closely, he pointed out that China high yield fixed income looks highly attractive because, 'yields have been rising through 2018 because of China's deleveraging policies and fears about a protracted slowdown. Now that policy and liquidity support is coming and will underpin growth in 2019, there's a strong outlook in the high yield space, with yields for some quality issuers currently running at 10%+.'

Now's the time to land on planet China bond

"Stars are aligning to bring investors onto 'planet China bond' because reforms have improved accessibility, index inclusion is forcing onshore markets to be more investor friendly, and because economic trends underpin a strong case for investors to allocate to onshore fixed income assets." Briscoe, summed up

Put together, these gathering trends, plus the steady reorientation of capital to China, mean that the future of global fixed income is happening in China's onshore markets, and that's a reality that all investors need to consider and prepare for as they build their strategies for the next five years.

[3] Source: UBS, Bloomberg. As of December 10, 2018

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