UBS

For marketing purposes
For professional / qualified /
Institutional clients and investors only

Finding opportunities in a negative yielding world.

Where do fixed income investors go as yields turn negative?
Time to take a look at China.

By Hayden Briscoe, Head of Fixed Income, Asia Pacific, UBS Asset Management

Where do investors go in a low-yield world?

With yields in most developed markets either negative or heading that way, there's probably no more pressing question in the investment world today, particularly as we move into 2020.

Luckily, there remains hope for bond investors and it lies with exploring the full opportunity set offered by what is a deep and diverse global bond universe.

China's onshore bond market has recently come to the fore with inclusion in major global bond indices. It offers a compelling opportunity to complement returns from traditional bond markets and help diversify investors' fixed income exposure. Here are some important reasons investors should take notice.

Yield

China government bonds offer positive nominal and real yields compared with developed markets, and that's been a standout feature for the past three-to-four years as well as an attractive one in the world economy as it is today.

Liquidity

China's bond markets overtook Japan as the world's second largest in late 2018 [1]. As China reforms its financial sector and continues to develop bond financing channels, the market is expected to continue growing in the coming years.

Correlation

China bonds have a low correlation to global bond markets so offers a strong diversification benefit. Taking Europe as an example, China has a 0.05 correlation, compared with 0.6 for the US and 0.55 for Japan, so exposure to China bonds can help diversify risk and return sources[2].

Downside protection

Given the higher relative yields and shorter duration profile of the China government bond universe, investors can expect to benefit from smaller drawdowns during periods of rising bond yields compared to other developed markets, adding further to the diversification characteristics of China bonds.

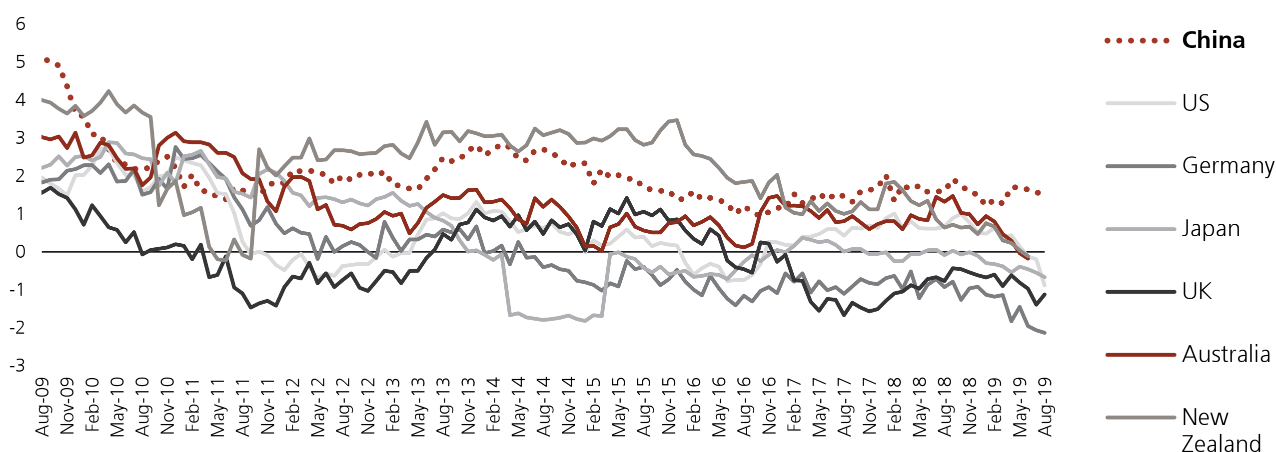
Safe haven

Chinese government bonds show all the traits you'd expect from safe haven assets and we have seen yields fall during recent bouts of broader market volatility[3] . Importantly, China remains a net creditor nation and has the world's largest FX reserves, so no one will be calling China on its debt.

But despite all these points, investing in China can be a leap for more traditional investors. In part, that's because China is always in the news cycle and much of the coverage is sensationalist.

Real yields (%)

Aug 2009 – Aug 2019



Source: Bloomberg. Real yields based on Core CPI. New Zealand based on Headline CPI.
As of end August 2019. Australia and New Zealand as of June 2019.

[1] UBS Asset Management, April 2019

[2] As of 27 September 2019, based on fortnightly returns since 3 October 2014. Source: JPMorgan

[3] UBS Asset Management, April 2019

The four biggest China investing concerns

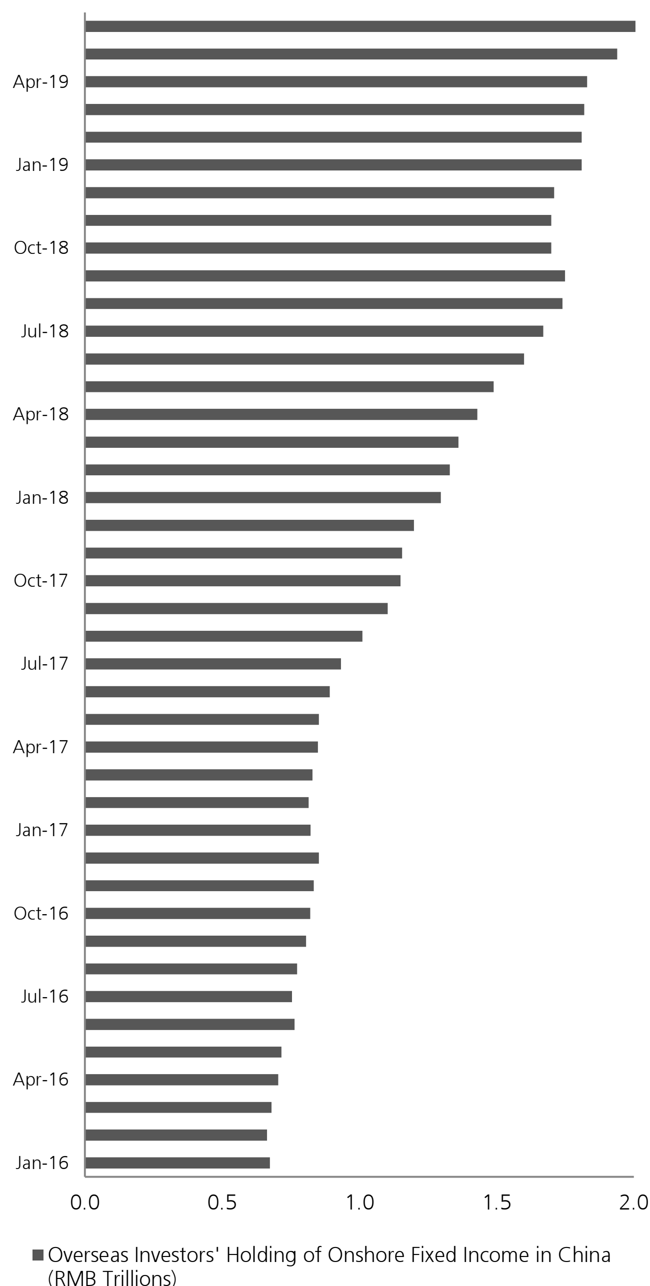
China's economy is slowing.
Yes, it is slowing – and that's a good thing. China's rapid growth of the past was fueled by unsustainable growth in debt and fixed asset investment. Now, China is committed to deleveraging and has shifted the economy toward the more sustainable growth drivers of consumer demand and services-led growth. This means slower but more sustainable growth for the long-term.

China has a debt problem.
Debt is certainly high, no doubt about it. However, we don't see it as a source of an impending crisis – and there are three main reasons for this. Firstly, China's debt is drawn from one of the world's largest savings pools, so it is domestically, rather than externally, financed, so there's little risk of a balance-of-payments crisis. Secondly, more than half of China's debt is concentrated within state-owned enterprises (SOEs), i.e. within the government and not the private sector. Finally, China still has a lot of growth potential. Unlike the Japan situation in the 1990s, China still has a lot of productivity gains ahead of it, so it has the room to grow its way out of the debt to some extent.

Investors can't get in or out of China's markets.
Not true. Recent index inclusion and the opening of the China Interbank Bond Market Direct and Bond Connect channels means full access to onshore China bond markets, with ready access to investment capital via these channels. We see it very unlikely that China will implement capital controls for foreign investors given its commitment to becoming one of the world's major developed bond markets and in integrating with the global financial system.

International investors just aren't convinced by China.
That, again, is wide off the mark. Official data shows sustained growth in international investors' holdings of onshore China fixed income. In fact, total holdings have tripled since January 2016, and recent trends have seen acceleration, discussed in more detail below.

Overseas investors' holdings of onshore China Fixed Income (RMB trillions)
Jan 2016 – Jun 2019



Source: People's Bank of China, August 2019

And that fundamental change is the shift in global capital to China as core components of China's onshore bond market are included into major global bond indices.

Bloomberg led the process with inclusion of China treasury and policy bank bonds in its global bond indices at the beginning of April 2019 – and this has now broadened with JP Morgan recently announcing index inclusion plans.

This impacts a wide range of global bond investors as passive (i.e. index) funds that follow these major indices must now invest in China bonds, and active managers must take a view given the major benchmarks will include parts of the China onshore bond market.

This shift is expected to lead to as much USD 500bn[1] of inflows into China's markets from Bloomberg bond index inclusion alone – and this has three important implications.

Firstly, it is happening because the world's biggest index providers have seen China's recent reform efforts and now deem China as 'safe-to-swim'.

Secondly, allocation to China is now going to become a mandatory, not optional, allocation for millions of investors worldwide.

Finally, the massive influx of global investor capital is going to put downward pressure on yields, and that means it is time for investors to take the opportunity and get exposure now, rather than after the chance has passed.

This phenomenon is occurring across more asset classes than just fixed income. MSCI began including China equities in its emerging markets index in 2018. FTSE Russell and S&P Dow Jones have since followed suit, a reflection of China's increased efforts to integrate its capital markets into the global financial system.

The compelling case for China fixed income is one of many opportunities uncovered by actively exploring the global fixed income opportunity set and why it pays to employ a truly global and diversified approach to investing, particularly as we face a world of lower – and increasingly more negative – bond yields.

[1] UBS Asset Management, April 2019

For marketing and information purposes by UBS. For professional clients / qualified / institutional investors only.

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund.

Americas
The views expressed are a general guide to the views of UBS Asset Management as of October 2019. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA
The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document.
Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient. The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG. This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK
Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC
This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction.
Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.
You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia
This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

Source for all data and charts (if not indicated otherwise): UBS Asset Management

The key symbol and UBS are among the registered and unregistered trademarks of UBS..

© UBS 2019. All rights reserved.
www.ubs.com/chinaforesight

For professional / qualified / institutional clients and investors only.

Follow UBS Asset Management on LinkedIn

UBS