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# Chinese local currency debt: what is Beijing really up to?

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# Q&A

*Fixed Income Monthly*
*September 2015*

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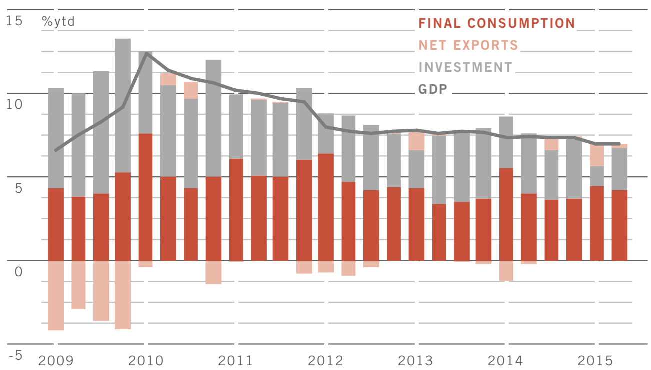
China has made waves in its domestic markets and beyond with some unexpected policy measures. In this Q&A, Cary Yeung sheds light on Beijing's motives and explains what recent moves may mean for investors in Chinese local currency bonds.

**How should we read Beijing's decision to devalue the renminbi? Is the move aimed at burnishing authorities' reform credentials or is it part of an aggressive policy to boost the country's flagging economy?**

**C.Y.** In our view, the August devaluation should be seen as a step forward for China's market reform efforts. The belief that the move was a competitive devaluation to boost the country's exports sits at odds with the facts. China's net exports currently account for about 0.3 percentage points of its total economic growth, which is currently running at about 7 per cent. That is dwarfed by the contribution made by either consumption (4.2 per cent) or investment (2.5 per cent) (Fig. 1).

**FIG. 1 – EXPORTS NOT A MAJOR ENGINE OF CHINESE GROWTH**

Contribution to GDP growth, percentage points




Source: CEIC, Pictet Asset Management

What is more, China will be well aware of the experiences of other countries in the region, which suggest that currency weakness no longer guarantees higher exports. Although Asian currencies are undervalued by historic standards against the US dollar, this has not translated into an export boost for the region's economies. Asian economies' prospects have dimmed for other reasons: their labour markets are less competitive and world trade is expanding at an ever slower rate.

So the theory that the People's Bank of China's decision was motivated by a desire to shore up exports strikes us as difficult to accept.

Rather, the change in policy has more to do with Chinese authorities' gradual embrace of the market economy. To us, the overhaul of the currency fixing mechanism brings the renminbi one step closer to being a fully convertible currency.

The PBoC's shift in stance is clearly intended to address the concerns raised by the International Monetary Fund (IMF), which in August announced it would delay its decision on whether to include the renminbi within its Special Drawing Rights basket. Inclusion would cement the currency's international standing. However, the IMF voiced misgivings over Beijing's currency fixing regime, which it said was unrepresentative of market forces.

Does this mean the renminbi cannot weaken further? Well, in the short run our view is that it will probably trade within a wider range, and exhibit higher volatility. It will also prove sensitive to changes in China's economic data. But we don't believe this is the start of long-term trend of renminbi depreciation. Indeed, over the long run, thanks to reforms aimed at opening up China's capital account, the renminbi will become a major investment, settlement and reserve currency, developments which should lead to an appreciation of the currency.

### Part of the appeal of local currency Chinese bonds is the potential for an appreciation of the renminbi over the long run. How important is it for the renminbi to be included in the IMF's SDR currency basket? What is the probability of that occurring this year?

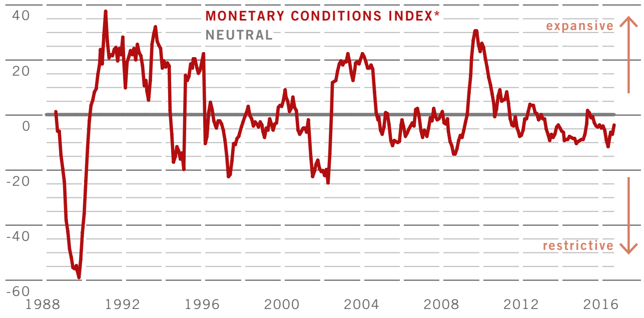
**C.Y.** While gaining SDR status alongside the likes of the US dollar, the euro and the Japanese yen will not necessarily directly result in a significant increase in usage of the renminbi as a reserve currency (note the Swiss franc is widely used as central bank reserve currency but is not in the SDR basket) this would nevertheless be an important milestone for China in terms of gaining recognition and wider international acceptance in the financial system. That said, it is hard to be certain on the outcome of the IMF's SDR decision later this year. It is possible that the IMF will announce a delay and postpone its verdict to next year. Still, the IMF has described the broadening of the exchange rate band as an "encouraging step" towards a freely floating currency, which it said China ought to achieve "within two to three years".

### What is the outlook for monetary policy in China over the next 6 to 12 months? And how will that affect bond market returns?

**C.Y.** Macroeconomic data are still on the weak side. Yet inflation is low and the real interest rate is high. What is more, as the Pictet Asset Management Strategy Unit's proprietary monetary conditions index shows, monetary policy remains tight (Fig. 2). This means the PBoC has plenty of scope to be even more aggressive when it comes to easing monetary policy. This may be deployed in the form of liquidity supply to the system – through the repo market, for instance – as well as cuts to banks' reserve requirement ratios. An increasingly accommodative stance from the central bank will continue to be beneficial for the Chinese onshore bond market.

**FIG 2 – PLENTY OF SCOPE FOR CHINA TO EASE MONETARY POLICY FURTHER**

Pictet AM China monetary conditions index




*MCI = f(real 1-year lending rate, real effective exchange rate and real stock of credit)

Source: Pictet Asset Management

### In what ways has Beijing's heavy-handed intervention in the Chinese stock market affected onshore renminbi bonds? Does the asset class acquire haven-like attributes during periods of broader market stress?

**C.Y.** When analysing the behaviour of Chinese bonds and equities, it is important to note that one of the key differences between the two markets is the composition of the investor base. Stocks are dominated by retail investors, which account for about 80 per cent of the market. Bonds, by contrast, are primarily the preserve of institutional investors, such as local banks and insurance companies. This helps explain why stocks are far more volatile than bonds.

In terms of investment flows in recent weeks, we have seen different trends unfold at different times. During the first phase of the equity market correction, from mid June to early July, 10-year government bond yields dropped from 3.62 per cent to 3.44 per cent.

We then saw a sell-off in government debt as investors hit by the stock sell-off disposed some of their bonds to cover their equity losses. This outflow was later reversed as investors switched from equities to bonds. (Interestingly, amid this reallocation, lower-grade bonds outperformed, probably because investors saw these securities as safer way of gaining equity-like returns.)

This volatility reminds us that, unlike benchmark bonds in the developed world, the Chinese onshore bond market has yet to achieve "haven" status during periods of turbulence.

### How sensitive might renminbi bonds be to a rise in US interest rates later this year? How favourable are valuations compared to developed government and corporate bond markets?

**C.Y.** Given that they are onshore instruments and that foreign investors have limited exposure to them, renminbi bonds are unlikely to be influenced directly by a rise in US interest rates. Still, the asset class could suffer a hit if the US Federal Reserve proves to be more hawkish than the market expects – either in terms of the timing or the magnitude of hikes – causing investors to indiscriminately sell risky assets. Also, if the Fed raises rates and the PBoC loosens monetary policy, this could narrow the yield differential between US and Chinese bonds and raise the prospect of continued strength in the US dollar. In turn, this could trigger additional capital outflows from China and negatively affect the liquidity of the onshore bond market. It would also push bond yields higher. However, we believe this risk is mitigated by the PBoC's capacity to replenish liquidity when outflows rise.

What the Chinese bond market has in its favour relative to developed market bonds is that it continues to offer more attractive yields than developed countries, whether it is in sovereign or corporate debt sectors. In addition, many corporations in China are state-owned enterprises which benefit from government support (to varying degrees).

## The RMB local currency bond market is at the early stages of its development into a mainstream asset class. What recent shifts can you point to that testify to the market's progression towards this goal?

**C.Y.** The authorities have taken significant steps to develop the onshore bond market. In particular, they have implemented several programmes which give foreign investors access to the onshore market via QFII and RQFII[1] schemes. Recently the Chinese government relaxed restrictions on access to the onshore bond market for central banks and sovereign wealth funds, who can now access it on a registration basis instead of an approval basis as before. In addition, these funds are permitted to trade onshore derivatives such as repos and interest rate swaps. We now expect China to open the market up in the same way to foreign institutional investors. However, we feel that the onshore bond market still lacks some transparency (with most financial documents only available in Chinese). What is more, many instruments still lack credit ratings from international agencies while broadly, we still do not see sufficient credit differentiation in the corporate bond market. It will take time for this to change.

[1] A Qualified Foreign Institutional Investor (QFII) is one that has been cleared to invest in a limited range of cross-border securities; A Renminbi Qualified Institutional Investor (RQFII) is one that has been cleared to invest in a limited range of renminbi denominated securities. A RQFII facilitates foreign investment in the Chinese mainland via offshore renminbi accounts

## How is your portfolio positioned and why?

**C.Y.** Our bias continues to be for high-quality, state-backed enterprise bonds in the onshore market, where we believe yields compensate investors better for the risks they take on. We have some exposure to higher-yielding bonds in the offshore market, where again we believe yields are attractive. We are positive on issuers that benefit from supportive government policies such as rail operators and utilities. We are also attracted to some large property developers with solid track records as well as diversified land banks.


### Cary Yeung, Head of Greater China Debt

Cary Yeung joined Pictet Asset Management last year as Head of Greater China Debt. Previously, Cary was working at Taikang Asset Management Hong Kong where he was Head of Fixed Income and the portfolio manager for a range of Asian fixed income products. Prior to Taikang Asset Management, he worked at UBS Global Asset Management Hong Kong and Prudential Asset Management Singapore as a senior portfolio manager for various Asian fixed income portfolios. Cary started his career with PwC before moving to KPMG, and subsequently to First State Investments where he took responsibility as Credit Analyst.

Cary graduated with a Bachelor of Business Administration (Finance and Accounting) from Simon Fraser University, Canada. He is a CFA Charterholder and a Certified Public Accountant. Cary is fluent in English, Mandarin and Cantonese.


### WHY PICTET-CHINESE LOCAL CURRENCY DEBT

Having a team based in Hong Kong gives us first-hand knowledge of the policy-driven Chinese market.

We also have the required language skills to conduct all research, trading and communication with brokers and issuers in Mandarin Chinese.

Most Chinese issuers are only rated by local agencies, whose standards are different from those of their international counterparts; our team includes a specialist credit analyst based in Hong Kong who has extensive experience in analysing the strength of Chinese issuers using internationally-accepted standards.


**Contact details**

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