October 2020

China Insights

China bonds: scoring a global inclusion hat trick

Summary

- FTSE Russell is set to add China bonds into its global benchmark starting October 2021, in a move that is likely to bring USD140-150 billion of flows into the world's second largest bond market
- The inclusion comes on the heels of widening rate differentials between China and US Treasury notes, with China bonds offering attractive yield pickup and diversification benefits to global investors
- Looking ahead, index allocation demand and RMB appreciation should further boost inflows into the onshore bond market amidst a weak dollar environment

China bonds: scoring a global inclusion hat trick

FTSE Russell has confirmed that Chinese government bonds will be added to its World Government Bond Index (WGBI) from October 2021, paving the way for billions of dollars of inflows into the world's second-largest bond market.

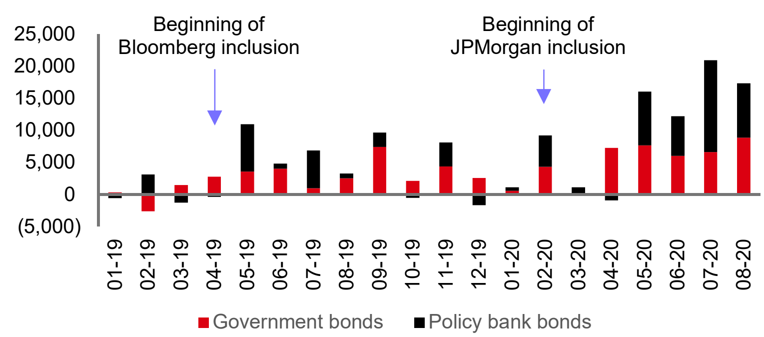
FTSE said the inclusion of the Chinese government bonds will be phased in over a 12-month period and subject to final affirmation in March 2021 that the recently announced reforms - simplified account opening process, the ability to transact FX with third parties, extended trading hours from 5pm to 8pm local time, as well as the changes to the settlement process to allow settlement beyond T+3 - have met the practical needs of investors.

We estimate assets tracking the WGBI to be around USD2.5 trillion and the inclusion of Chinese bonds could drive significant passive inflows of around USD140 billion to USD150 billion over the inclusion period, or USD12 or USD12.5 billion per month.

The WGBI inclusion represents the final step in China bond's global index inclusion journey, following similar action from Bloomberg Barclays Global Aggregate Index and JP Morgan GBI-EM Global Diversified, which will be completed by November and December this year, respectively.

Strong demand from foreign investors in China onshore bond markets

Net monthly foreign inflows (USD million)



Sources: CEIC, HSBC Global Asset Management, as of August 2020

HSBC

China bonds: scoring a global inclusion hat trick (cont'd)

> Foreign investors currently hold RMB1.6 trillion of China government bonds, or 9% of outstanding securities, from 2% in 2015

But that doesn't mean flows will stop after the inclusion period, given the widening rate differentials between China and US Treasury bonds and RMB appreciation. The 10-year government bonds in China are currently yielding 3.1%, which is more than quadruple that of the US (0.68%). At the same time, onshore Chinese bonds have shown relatively low correlation with other asset classes historically and are far less impacted by global risk sentiment, thus offering compelling diversification benefits.

Ongoing market reforms

The inclusion into all three major global bond benchmarks is a key milestone for China's financial market liberalization process, which aims to promote two-way capital flows and improve credit differentiation over the long run. One of the lingering problems in China's financial system is its heavy reliance on commercial banks, which tend to issue credit to large state-owned companies rather than small businesses in the private sector. By increasing foreign participation, policymakers hope to increase market liquidity and bank efficiency, while reducing systematic risk in the banking system.

In the short run, the WGBI inclusion means more passive and stable capital flows will be tracking China given 80% of the investors following the WGBI are passive. Comparatively, Bloomberg Barclays has a 80/20 mix between active and passive funds. More broadly, China bonds are being viewed as developed market assets since WGBI is predominantly a developed market gauge.

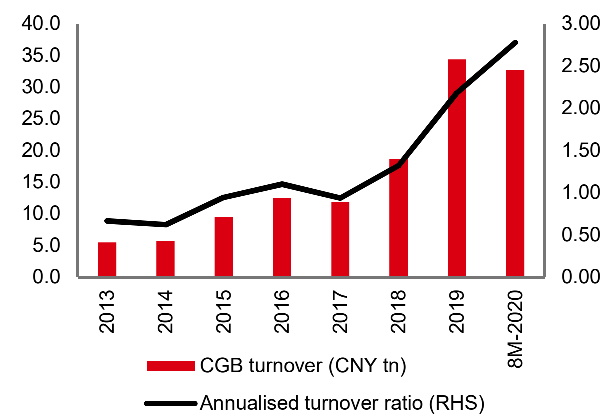
Meanwhile we estimate China's weight could be around 5.7% of WGBI based on the latest data, which will make it the sixth largest market in the index, following US (35.83%), Japan (17.69%), France (8.74%), Italy (7.77%) and Germany (6.37%). This will also put China on top of UK (5.46%) and Spain (5.04%), according to FTSE. At the same time, China's market yield will be the second highest in the WGBI after Mexico, based on current prices.

Road ahead

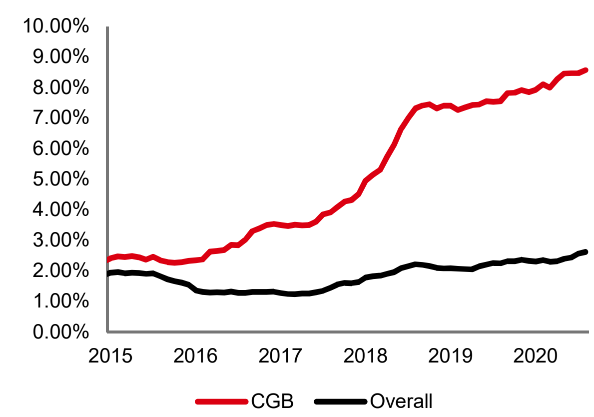
As of August 2020, foreign investors held RMB1.6 trillion of China government bonds, or 9% of outstanding securities, according to the People's Bank of China (PBoC).

As the market opens up, more investors (such as central banks, pension funds and insurers) are likely to buy into the asset class given its attractive yield pickup over other developed market peers. And once they have built their positions in government bonds, we expect them to navigate into policy banks and corporate credits.

Robust trading environment in the onshore market



Rising foreign ownership of China bonds



Source: CEIC, PBoC, HSBC Global Asset Management, data as of August 2020

In the following pages we will take a deeper look at how recent events and policy measures are impacting Chinese fixed income and equity markets:

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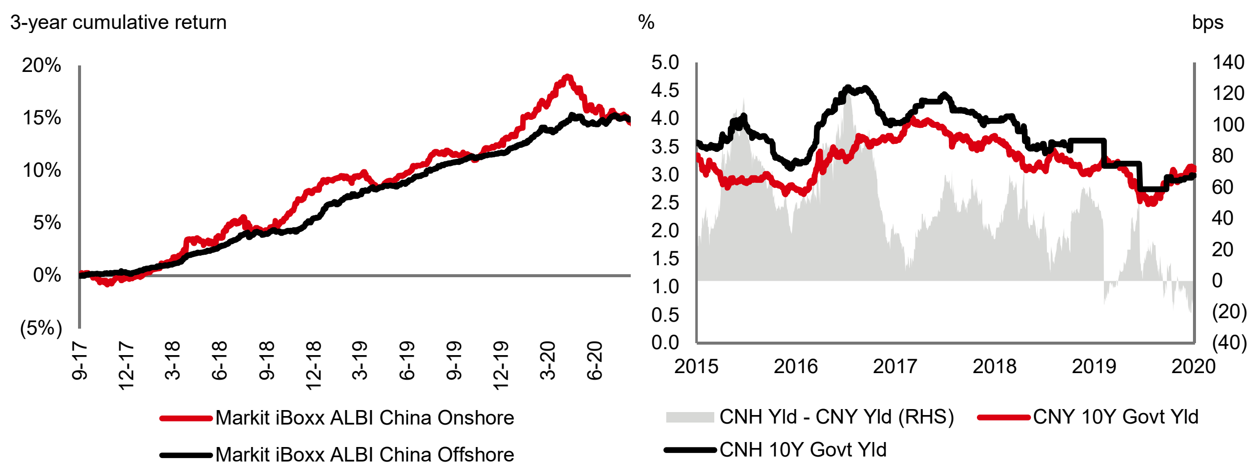
Fixed income

On a year-to-date basis, bond inflows have reached USD88 billion, pushing the foreign ownership of onshore bonds to USD405 billion, or 2.5% of the total bond market

- In September, the yield curve of Chinese government bonds was broadly unchanged following a recent sell-off that was led by the front and belly (3-year and 5-year in particular) of the curve. The relatively stable market condition in China's onshore bond market reflected widening rates differentials, RMB appreciation and a steady economic recovery from the Covid-19 pandemic
- The onshore RMB bonds, measured by iBoxx ALBI China Onshore Index, gained 0.2% in USD terms in the month ending 25 September, bringing the year-to-date gain to 3.4%. The monthly gain was largely due to dollar weakness, which slipped 0.4% against the RMB. On a spot basis, the RMB has strengthened about 2% against the greenback this year, underpinned by firm manufacturing activity. The country's factory PMI hit its best level in almost a decade
- On the other hand, the offshore gauge, the iBoxx ALBI China Offshore Index, rose 0.3 % in USD terms for the same period. Elsewhere, China dollar credit market, investors appeared to take profits after recent weeks of strong advances with high-yield bonds dropping 2.6% over the month after the dollar index bounced back from 92 in late August to 94 in September. The index reached its highest level of the year in March when global investors sought a safe haven in dollar assets
- In terms of fund flows, inflows into China's onshore market remained very strong at USD19 billion in August, the second highest monthly inflows in history and following the record high of USD24 billion in July. Government bonds specifically received net inflows of USD9 billion in August, up from USD7 billion in July, while policy bank notes moderated to USD8 billion from USD14 billion over the same period. On a year-to-date basis, bond inflows have reached USD88 billion, pushing the foreign ownership of onshore bonds to USD405 billion, or 2.5% of the total bond market. FTSE Russell's inclusion of China bonds could add another USD140 billion
- Looking ahead, index allocation demand and the RMB appreciation should further boost inflows into the onshore bond market amidst a weak dollar environment. With the onshore rates trading back at pre-Covid levels, and the US-China treasury spread at an elevated 240 basis points (bps), the onshore government bonds remain attractive for both onshore and international investors seeking long-term structural growth

Chinese bonds remain steady amidst new rounds of global easing



Sources: Bloomberg, Markit data as of 25 September 2020. Total return in local currency terms.
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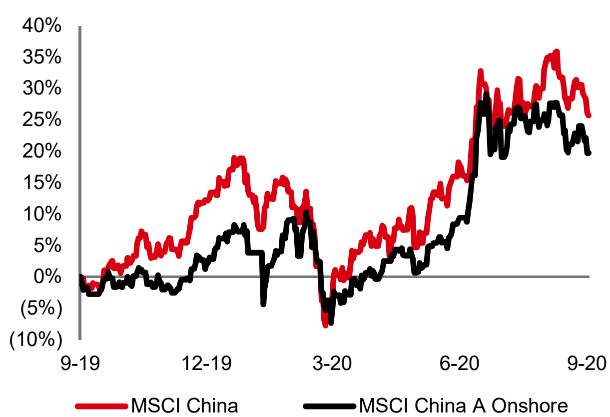
Equity market

Investors are likely to play defensive going into the last quarter of the year, amidst elevated valuations, fading hopes for further stimulus and poor corporate earnings

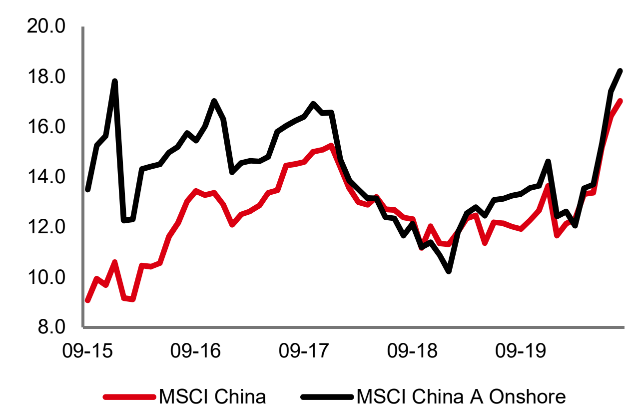
- Both onshore and offshore Chinese equities retreated in September, amidst global equity weakness after scaling new highs last month. On a month-to-date basis (25 September), MSCI China A Onshore and MSCI China both dropped 5.7% for the month. Locally the CSI 300 Index of the country's largest companies fell 4.7% in US dollar terms, while the Hang Seng Index shed 7.7%. MSCI AC World and S&P500 declined 5.1% and 5.8%, respectively
- Overall, a mixed bag of the uneven recovery in business activity, ongoing US-China tensions and rich valuations has prompted profit-taking given the 14.4% and 11.2% year-to-date gains for MSCI China A Onshore and MSCI China. MSCI AC World declined 1.8% and the S&P 500 advanced 2% during the same period
- Amidst renewed export curbs on chips and semiconductors to China, the ChiNext Index, the gauge of small-cap tech stocks in China, gave up 6.9% in September, while the American depository receipts (ADR) dropped 5% for the same period. However ChiNext and ADRs have still delivered a solid performance on a year-to-date basis, rising 41.3% and 30% after the recent pull back
- Given the US policy uncertainties and restrictions to purchase sensitive technology companies, more US-listed Chinese companies could mull a secondary listing in Hong Kong or mainland China. According to our estimate, a list of 37 ADRs could be eligible for a secondary listing in Hong Kong, with a total market cap of over USD477 billion
- In terms of fund flows (as of 25 September), the southbound trade through the Stock Connect has recorded USD60 billion of net buying so far this year, while the northbound trade has moderated to USD14 billion of net purchases for the same period after a net selling of USD 3.6 billion recorded in the week of 21 September – the largest single-week outflow since March
- Investors are likely to play defensive going into the last quarter of the year, amidst elevated valuations, fading hopes for further stimulus and poor corporate earnings. The 12-month forward price-to-earnings of MSCI China and CSI 300 are now trading at 14.3x and 13.9x, respectively, with a 2020 consensus earnings growth of -2% for the former and 4% for the latter

Chinese stocks pull back after recent surge

1-year cumulative return (%)



Forward price to earnings ratio (x)



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Sector[1]	Outlook	Comment
Consumer Discretionary	+	In particular, we like e-commerce platforms with faster adoption rates and expanding net margins along with better logistical systems. Amidst domestic consumption recovery, we prefer local brand names with strong online sales channels and low inventory levels, such as sportswear companies
Consumer Staples	+	Margin expansion capability of select strong staple brand names remains large with higher pricing power and ecommerce channels. Demand should recover quickly after Covid-19 outbreak, specially for alcoholic beverages. We like their defensiveness amid rising geopolitical risk and virus
Energy	-	Oil prices are still hovering around lower levels with slow recovery in demand due to prolonged travel bans during global Covid-19 outbreak, which we believe will take a long time to recover
Financials	-	We are underweight banks as lower rates may add pressure to their net interest margins. We prefer high quality insurance companies with long term growth opportunities at attractive valuations
Healthcare	+	We favour those with strong R&D capabilities in innovative drugs and service providers with high growth visibility and solid business models
Industrials	-	More infrastructure projects are on the cards and full resumption of construction works is underway, but focus will be on “New Infrastructure” instead
Information Technology	+	We are positive on the handset lens upgrade trend and we like names that can benefit from continuing tech upgrade as smartphone demand remains stable despite the Covid-19 outbreak and ahead of the upcoming new product launches by Apple
Materials	-	Demand for construction and industrial materials has been further impacted by heavy rainfall and flood. We prefer gold mining companies within the sector given the surge in gold prices amidst global uncertainty
Real Estate	O	We prefer property management companies from the longer term perspective as a defensive business with strong cash flow and ongoing market consolidation. Recent capital raising activities could reduce impact of market uncertainty
Communication Services	-	We selectively prefer gaming, social platform and cloud services companies as Covid-19 outbreak will speed up technology adoption. We underweight telecom names due to the lack of catalysts
Utilities	O	We are not positioned defensively in the current market

Note:
1. Sector views of HSBC Global Asset Management’s offshore Chinese equity team; “+” = positive, “–” = negative, “O” = neutral

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Source: Bloomberg, HSBC Global Asset Management, as of September 2020.

Data watch

Indicator	Date	Actual	Consensus	Prior	Analysis
Industrial production (IP) (yoy)	Aug	**+5.6%**	5.1%	4.8%	August activity indicators suggested that the economic recovery has become more broad-based, with services sector normalization catching up with the industrial sector and certain laggards expenditure-side components (e.g. offline, discretionary services consumption and manufacturing capex) showing further improvements. We have also seen signs of flood disruption starting to fade as well as recovery in domestic tourism and improving demand for entertainment sectors going into the National Day holiday week in early October. IP gains were led by activity in tech, medical, auto, machinery equipment as well as infrastructure and construction related sectors. Meanwhile, the service production index rose 4.0% yoy in August, up from 3.5% in July. Looking ahead, we expect a cyclical recovery to continue amid broadening of domestic demand recovery, thanks to improving consumer and business confidence with the pandemic situation remaining under control and ongoing (some lagged) impact of macro policy support. That said, the outlook faces uncertainties related to labour market pressures, corporate balance sheet risks, geopolitical tensions, and external demand uncertainty amid resurgence of Covid-19 infections and risk of renewed lockdown measures. The strength in recent economic and credit data may reduce the government's incentive to ramp up additional policy stimulus, but we expect policy stance to remain supportive of a sustained recovery with more focus on expanding and upgrading domestic demand.
Fixed Asset Investment (FAI) (ytd, yoy)	Aug	**(0.3%)**	(0.4%)	(1.6%)	Manufacturing FAI yoy growth turned positive for the first time in 2020, driven by a strong rebound in industrial profits, recovering domestic and external demand and a low base effect. Infrastructure FAI growth eased but stayed resilient amid policy support. Meanwhile, real estate FAI and property sales continued to show solid growth, though new housing starts and land purchases by property developers softened, probably to some extent due to the recent incremental policy tightening. Overall, while real estate and infrastructure FAI growth may be plateauing following the notable rebound in recent months, fiscal funding will likely remain supportive of infrastructure while we expect the government to continue its differentiated property policy stance, given the divergence across cities and markets.
Retail Sales (yoy)	Aug	**0.5%**	(0.0%)	(1.1%)	Retail sales printed the first positive reading since the Covid-19 outbreak. Auto sales growth moderated, probably reflecting the fading boost from post Covid-19 pent-up demand and replacement demand related to the full implementation of the 'National VI' emission standard on 1 July, the target of eliminating all National III-standard heavy diesel vehicles by end-2020. Sectors that had underperformed due to virus-related concerns have also improved, as spending in restaurants/ catering fell 7.0% yoy, a further narrowing of the yoy decline from -11.0% in July. Domestic air traffic/tourism and hotel occupancy are recovering fast. Meanwhile, the labour market continued to show a steady improvement. The surveyed unemployment rate edged lower to 5.6% in August from 5.7% in July. Generating adequate employment for new college graduates and migrant workers remains a top policy priority.

Exports (USD) (yoy)	Aug	**9.5%**	7.5%	7.2%	China's exports continued to benefit from economic re-opening and large (fiscal) policy stimulus of its key trading partners as well as filling of delayed goods delivery because of lockdowns in those virus-hit economies in previous months. External demand for medical and staying-at-home related products remained strong. China's "first in, first out" status in the post-pandemic recovery and resilient supply chains should see the country continue to gain global market shares in the near term, though production resumption elsewhere could eventually increase competition. Imports slowed on agricultural purchases and softer commodity demand, with the latter potentially reflecting flood disruptions to construction activities, whereas tech imports saw a strong growth. We expect China's exports to hold up and import growth to improve amid recovering external and domestic demand, despite uncertainties over global virus containments and US-China relations. While US-China tensions flare up in non-trade areas (e.g. technology, access to capital, and geopolitics, etc.), we think it is both countries' interests to continue to implement the phase one trade deal. China is set to miss the purchase target by a wide margin, but it has delivered most of the other commitments, including sector liberalization and IP rights protection, etc.
Imports (USD) (yoy)	Aug	**(2.1%)**	(0.2%)	(1.4%)	
Trade Balance (USD)	Aug	**58.93bn**	49.70bn	62.33bn	
CPI Inflation (yoy)	Aug	**2.4%**	2.4%	2.7%	Moderation in headline CPI inflation was driven by easing food inflation, with pork prices, the biggest swing factor, seeing mom, sequential price moderation in August as the impact of floods on cross-provincial pig transportation subsided. We expect pork inflation to ease further in the coming months as the supply continues to recover from the impact of the African swine fever. Both non-food and core CPI inflation remained low, at 0.1% yoy and 0.5%, respectively, indicative of a negative output gap in the economy. Meanwhile, PPI deflation eased amid improving investment and construction activity. Assuming a moderate pickup in core inflation amid an ongoing demand recovery, we still expect moderation in headline CPI inflation over the next few months partly reflecting the high base effect.
PPI Inflation (yoy)	Aug	**(2.0%)**	(1.9%)	(2.4%)	
Aggregate financing (AF) (RMB)	Aug	**3,580bn**	2,585bn	1,690bn	Growth of outstanding AF rose further to 13.3% yoy from 12.9% in July, driven by a notable increase in government bond issuance and a pickup in off-balance-sheet lending, while RMB loans and corporate bond issuance maintained solid growth. M2 growth slowed to 10.4% yoy in August from 10.7% in July. Strength in medium- to long-term loans to corporates and households may indicate increasing support to the real economy, though credit growth could be peaking off given a more neutral and targeted policy approach.
New yuan loans (RMB)	Aug	**1,280bn**	1,250bn	992.7bn	

Indicates improved data on month-on-month/quarter-on-quarter/year-on-year basis
Indicates worsened data on month-on-month/quarter-on-quarter/year-on-year basis
Indicates no change in data on month-on-month/quarter-on-quarter/year-on-year basis

Source: Bloomberg, HSBC Global Asset Management, as of September 2020

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