China Bonds Strategy
Nascent recovery amidst uncertainty

- Slow restart in China facing significant headwinds as the rest of the world locks down
- Monetary policy response anchors onshore short-end, while fiscal support elevates concern for supply surge necessary to fund the programmes
- Opening of onshore funding channels stabilizes liquidity for Chinese credits, but RV remains very unattractive; offshore Chinese credits remain more compelling despite recent recovery

Honyu Fung and Jim Veneau
Portfolio Managers, China Bonds

What's happening?

- China was in the process of restarting its economy in March as the rest of the world was being overwhelmed by the global pandemic. On the back of the ensuing global rates rally, onshore rates rallied heavily with government bond yields falling between 10 bps and 37 bps, the curve steepening considerably. Onshore rates significantly underperformed their U.S. counterparts, which saw the curve bull steepen slightly as yields fell 85 bps in the short-end and 48 bps in the 10-year part of the curve.
- US dollar liquidity crunch reached levels last seen during the Global Financial Crisis as the US Fed was forced to decisively inject liquidity into the financial system. While this stabilized domestic conditions, the offshore US liquidity was slower to respond. The US dollar appreciated significantly against many EM currencies, while the Euro was modestly weaker (-0.50%) and the Japanese yen was most unchanged (+0.10%). Both the onshore renminbi (CNY) and offshore renminbi (CNH) fell in March against the US dollar at -1.28% and -1.63%, respectively.
- Onshore rates rallied throughout March as market steadily priced-in the economic impact of the coronavirus outbreak. CGBs led PBBs having generated +1.17% to the latter sector's return of +1.09% returns. Concerns over corporate stress were a drag on the Onshore corporates at 0.68%, reflecting some impact from credit spread widening. Meanwhile, offshore China was more vulnerable to the global wave of selling as it endured a significant decline of -3.56% in March. As the offshore market froze, hard currency HY China was particularly hard hit at -9.19%. Although hard currency IG China fared much better, it still succumbed to risk aversion with -1.65%.

Monthly Returns:

Onshore China			JACI China	
+1.02%			-3.56%	
Central Government	**Policy Bank**	**Corporate**	**Investment Grade**	**HY**
+1.17%	+1.09%	+0.68%	-1.65%	-9.19%

Source: Bloomberg, BofAML, JP Morgan as of 31st March 2020. CGBs are Chinese government bonds and PBBs are policy bank bonds

Portfolio positioning and performance

	Onshore	Offshore (CNH and USD)	Performance
Asset Allocation	**Underweight weight 45%**	**Overweight weight 55%**	–
	More stable onshore markets contrasted sharply with the extreme volatility (negative) endured in the offshore markets. Re-allocation back to onshore proved difficult as overweight exposure was a key factor in negative monthly returns. As offshore markets stabilize, especially in hard currency Chinese credits, the recovery is expected to be relatively sharper. Rich onshore valuations limit returns, while offshore exposure was exposed to significant market volatility.		
Rates	• **Duration:** neutral rates view CGBs/PBBs	• **Duration**: neutral to negative USD duration view – stay short	–
	Short duration strategy benefitted less from the rates rally but will benefit from an eventual steepening of the yield curve.		
Credit	• **Credit**: Long Panda bonds	• **IG/HY**: Selective increase in HY exposure closer to max overweight exposure. • **Sector**: more cautious on USD LGFV and more constructive in China Properties, though this is a crowded trade	–
	Onshore credit spreads widened modestly yet remain extremely rich, while offshore credits, especially HY, saw spreads widen tremendously as the offshore markets froze. As markets recover from historically wide spread levels, look to add opportunistically to offshore IG and HY.		

Outlook

The resumption of China's economy has been gradual as its lockdown was broad and deep, the rest of the world also severely impacted with recovery still distant. As considerable fiscal and monetary support works its way into the Chinese economy, the onshore rates markets will be well supported. We see the short-end being well-anchored whilst the longer-end of the curve faces more pressure from the expected upswing in bond supply to fund spending. On the back of relaxed bond issuance procedures onshore, credit issuances are increasing while at the same time keeping onshore rates depressed. Meanwhile, the offshore market has quickly reacted to the improved funding conditions with Chinese property credits being among the favored. As tempting as the current valuation levels are, significant caution is warranted. The course of the virus remains unpredictable and the impact of government stimulus will take time to fully assess. While offshore Chinese credits may offer compelling yield levels and potential for sizeable capital gains as well as a great opportunity to generate performance against peers and benchmark, building conviction will require higher than typical diligence and patience.

No assurance can be given that the China Bonds Strategy will be successful. Investors can lose some or all of their capital invested. The China Bonds Strategy is subject to risks including Credit risk, Liquidity risk, Derivatives and leverage, Investments in specific countries or geographical zones, Sovereign debt, Emerging markets, High yield debt securities, Contingent convertible bonds.