China's promising bond market

The environment is ripe for greater foreign investor participation

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Setting the scene

The global race toward zero interest rates fogs the world's post-pandemic investment outlook. Demand for income continues to grow due in part to a steady rise of people entering retirement, yet it is increasingly hard to find bonds yielding 2% or more. Forty percent of those bonds are in China, and delving into the opportunities and risks this presents should not be optional.

China boasts the second-largest economy, bond and equity markets in the world, yet Chinese assets are still absent from many international investor portfolios or held in very small quantities via an aggregate emerging market (EM) exposure. Key reasons for this were limits on the ability of global investors to access onshore Chinese assets and lack of sophistication relative to developed markets, but the onshore market's rapid evolution and other factors warrant a closer look.

Better access – Barriers are coming down as Chinese markets increasingly reform, open up to foreign inventors and obtain inclusion in global indices.

Attractive yields – Most developed-market government bonds can't serve as portfolio ballast at current yields, and Chinese bonds can help fill the void.

Healthy diversification – On top of higher yields than other major bond markets, China's bond market has had low correlations to global fixed income.

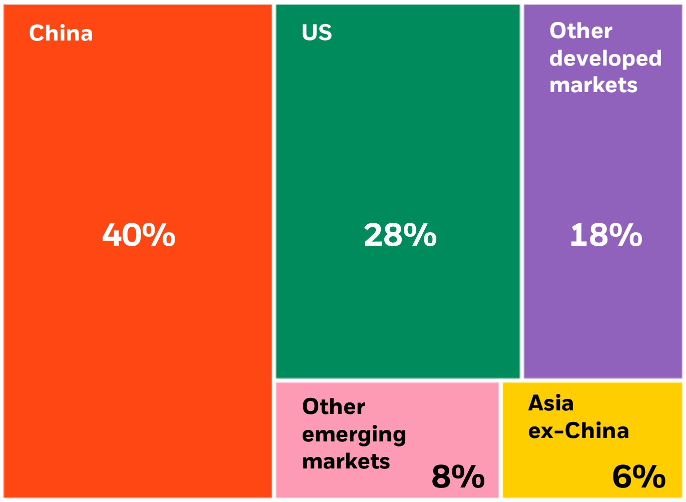
Positive fundamentals – Accommodative easing policies and increased differentiation of Chinese issuers afford opportunities for active credit selection.

Relative valuation – Diverging performance of the offshore USD versus onshore RMB credit enables alpha opportunities by allocating between the two markets.

Highlights

- **In a yield-starved world, Chinese bonds can offer attractive yields and diversification benefits.**
- **Index inclusion has triggered capital flows from abroad, yet much of the market remains untapped.**
- **Defaults have risen but from a low base, and low exposure to vulnerable sectors, such as energy, mitigate risks relative to other major markets.**
- **Heightened geopolitical tensions are likely to be a persistent risk; Chinese bonds were good portfolio ballasts amid risk-off episodes in 2018 and 2020.**

Global bonds yielding more than 2% by market



Source: BlackRock, Wind, May 2020. Based on the Bloomberg Barclays Multiverse and all eligible China onshore bonds - both rates and credit bonds (>1billion CNY size, >1 year maturity).

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Does index inclusion open up the full range of opportunity in Chinese bonds to foreign investors?

China has the world's second-largest bond and credit markets after the U.S. Inclusion in global indices has accelerated inbound flows, yet index representation leaves out a large portion of the investable universe where attractive opportunities lie.

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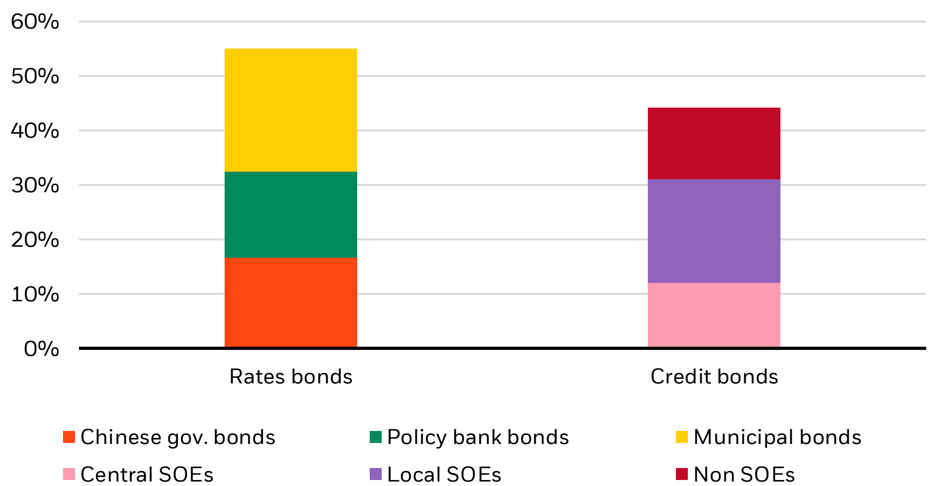
Index inclusion eases global inventors' access to China's bond market and begins to offer a fairer representation of the world's second-largest bond market. China's US$14 trillion total bond market of outstanding debt is topped only by the U.S.'s US$40 trillion bond market. In December 2019, Chinese bonds accounted for about 3% of the Bloomberg Barclays Multiverse Index, the broadest measure for global fixed income. That number should double to 6% by year-end 2020, yet credit, a significant part of the investable universe, remains out of scope for index inclusion. This matters because credit offers the highest potential for alpha generation, albeit it is no easy task.

The *Two bond types* chart shows the prevalence of state-owned enterprises (SOEs) in the onshore credit market. The SOEs significance to the central or local governments covers a broad spectrum, but it is unclear where they rank in importance. This fact and the standalone fundamentals of the credit affect an issuer's creditworthiness. The dominance of domestic credit rating agencies, which use different methodologies than their international counterparts, complicates the credits' analyses even more.

It would be very challenging to solve this puzzle without in-depth, on-the-ground research, and only investors who bring credit into the equation can take full advantage of the opportunities available in China's onshore bond market.

Two bond types

Composition of China's onshore bond market, May 2020



Source: Wind, May 2020. Policy bank bonds are owned by the central government and serve policy function; local government bonds are offered by the provinces.

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How may investors from other major bond markets benefit from diversifying into Chinese bonds?

Chinese bonds can offer portfolio ballast, attractive yield and two ways to achieve diversification based on the onshore and offshore nature of the market.

Drivers of uncorrelated returns

2017	Domestic deleveraging led to onshore market underperformance
2018	Monetary easing amid the U.S.-China trade tensions led to onshore market outperformance
2019	Global credit rally, attractive valuations post 2018 selloff led to offshore market outperformance
1Q 2020	The onshore market was resilient amid the global credit selloff

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In the post-Covid-19 world, China's bond market can help investors address their need for yield while offering dual paths of diversification: Low correlation between China and other major bond markets, and the onshore RMB and offshore USD Chinese credit markets. See historical data in the table and chart below.

Low correlation between China and other major bond markets:

- May benefit investors from other regions, regardless of home markets.
- Partially a result of low foreign participation in the Chinese bond market.

Diverging paths

China's bond market correlations with other major bond markets, May 2020

	China	US	UK	Japan	Germany
China	1				
US	0.14	1			
UK	0.12	0.71	1		
Japan	0.18	0.55	0.51	1	
Germany	0.17	0.65	0.66	0.58	1

Source: BlackRock, May 2020. Correlations shown reflect 3-year weekly correlations of 5-year government bonds across the world's top five bond markets.

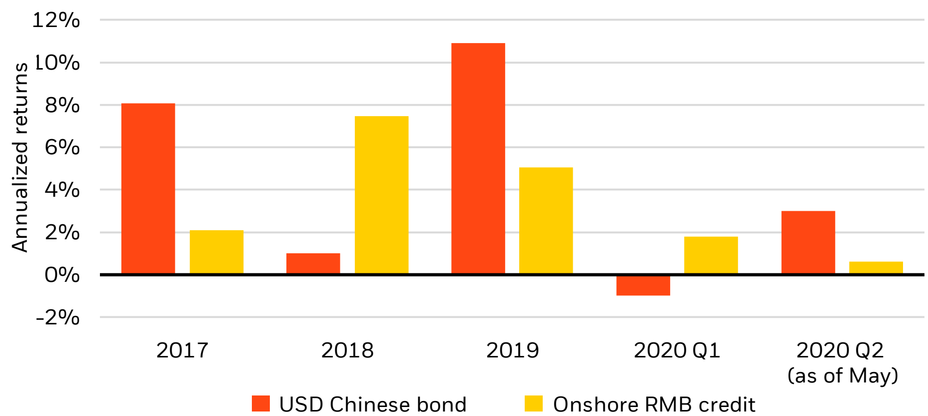
Low correlation between the onshore RMB and offshore USD Chinese credit:

The same issuer may offer different yields across markets, enabling managers to exploit yield differentials for alpha generation, while taking similar credit risks.

- Risk-free rates differ by market. Onshore credits are RMB-denominated and sensitive to Chinese monetary conditions and other onshore-market factors.
- Most offshore credits are U.S.-dollar denominated, subject to global risk factors.

Arbitrage opportunity

China's bond market annualized returns, 2017–2Q 2020



Source: BlackRock, May 2020. USD China Bond represented by the J.P. Morgan Asia Credit Index (China CNH hedged); Onshore Bond represented by the China Credit Bond Index.

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What about default risk, and how is this factored into portfolio construction?

Our in-depth understanding of an issuer's creditworthiness is the cornerstone of our return-seeking active approach. We do not believe default risks onshore present a systemic risk.

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The onshore renminbi market gained global credibility under extreme pressure from Covid-19. It was the only large bond market that avoided a liquidity crunch, and we believe the risk of a systemic credit crisis in China is very low. In our view, the current default outlook reflects the slower pace of credit expansion, which may support a more stable, less debt-intensive economy going forward.

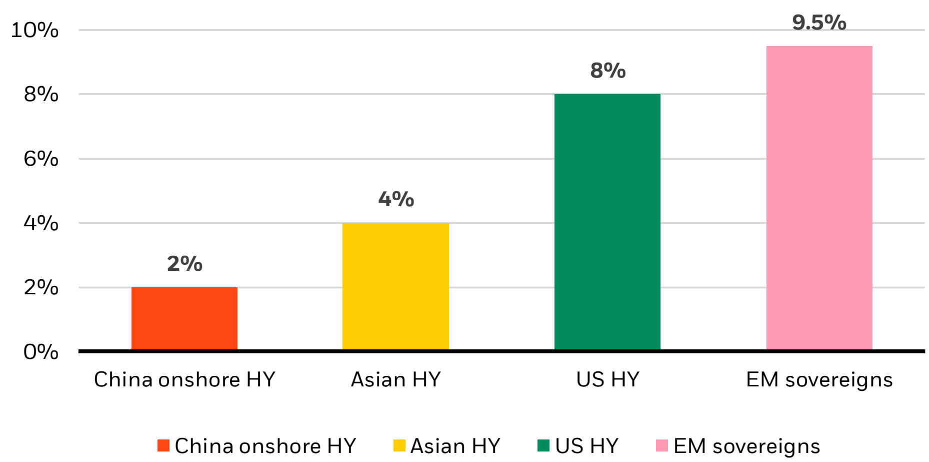
In early 2018, deleveraging removed the lowest quality credits in China before defaults headed below 1% in 2019. This year, the disruptions triggered by the coronavirus imply a possible tick up in defaults, but we believe a systemic event is unlikely. A few mitigants are the strong policy response – including the sizable injections of liquidity and targeted stimulus that protects areas of strategic importance – and the fact that Chinese credits have much lower exposure to sectors vulnerable to a global slowdown, such as oil and gas. The *Staying in business* chart shows the relatively benign forecast for Chinese onshore defaults compared to other asset classes.

The pattern of late 2019, when onshore high-yield defaults were below 2%, versus 2.5% in the U.S. bond market, may return on a larger scale. Unlike the U.S. credit market, where private corporates dominate, the onshore Chinese credit market is mainly about government-related credits, which partially explains the lower expected default rates in the onshore market. Other contributing factors are the lower exposures to cyclical sectors, such as energy, retail and hospitality.

As an active manager, we believe credit differentiation offers an opportunity to enhance returns, and apply our in-depth credit analyses of issuers to estimate risk and reward tradeoffs. We seek to deepen our understanding of company-specific fundamentals, and generally prefer those with strategic and social importance to the state. Assessing this importance as well as the fundamentals of municipalities is part of our day-to-day responsibilities.

Staying in business

Projected default rates for various asset classes, April 2020



All chart projections are for 2020, as of April. J.P. Morgan projects that EM sovereigns defaults may reach 19% by year-end 2021. Source: Data and projections are from J.P. Morgan except for China onshore HY (high yield), which is based on BlackRock calculations.

Looking ahead: China's bonds in a post pandemic environment

Relevant topic	Pre Covid-19 and during shock	Post pandemic world
Income needs	• In a world of few income sources and high demand, Chinese bonds stand out for their yield and stability • Breadth of opportunities in Chinese credit and low correlations to global credit creates an opportunity for investors to diversify their income sources	• Aging demographics = sustained demand for yield • With rates close to zero across most of the world, yield differentials become material considerations • 40% of global bonds yielding >2% come from China
Market structure	• Onshore renminbi market was effectively the sole large bond market that avoided a liquidity crunch in 1Q 2020, offering diversification for global portfolios • Deleveraging cycle pre-U.S.-China trade tensions in 2018 purged the system of low-quality credits • Zero correlation of onshore/offshore markets despite the same underlying fundamental risks	• Survival of higher-quality credits, flush liquidity and lower exposures to stressed sectors cap default risks • China's HY market has lower exposure to energy, commodities and hospitality, the most vulnerable areas to default risk due to Covid-19 • Preemptive policy action enabled a V-shaped recovery, underscoring China's potential as a global growth engine and enhancing global credibility
Risks	• Potentially devastating effect of the new coronavirus effectively mitigated by macro and social policies • Deleveraging cycle creating a wave of defaults, cut short by stimulus supporting the smaller enterprises	• Geopolitics disrupting globalization, breakdown of the current system + U.S. policies in an election year • Escalation of U.S.-China competition leading to barriers, restrictions on cross-border investments
Opportunities	• The race to the bottom in global government bond yields hasn't happened in China, and the V-shaped economic recovery may avoid it • Chinese government bonds offer one of the highest real yields, with tailwinds from index inclusion	• Index inclusion, opening up facilitates ownership by foreigners, now ~3% of the total onshore market • Diversification through the low correlation to global bonds and alpha opportunities with a low correlation of RMB/USD Chinese credit

Investment themes based on the overarching theme of divergence

The strategic versus the non-strategic credits	The credit haves versus the have nots	The domestic versus the international credit ratings
Government-related credits dominate the onshore credit market, but the significance of state-owned enterprises to the state varies. Uncovering this nuance entails rigorous research.	We see value in onshore bonds through the breadth of attractive yielding assets. But the market is complex, and we believe the alpha generation potential is vast through asset allocation and security selection.	Major rating agencies are increasing their presence in the onshore market, but lag domestic players, which incomparable ratings prevail. Onshore AAA ratings come close to an IG rating offshore.

How we seek to play these themes

Our boots-on-the-ground seek to assess the 1) standalone fundamentals of the credit, 2) quality of the state entity related to the credit, and 3) the quality of that state entity. Requirement: assessing the local political economy's interplay with markets.	An issuer's fundamental risks span across the onshore/offshore markets, but technicals can drive price differentials of the same credit. We hone in on these, seeking arbitrage opportunities among issuers and through assets allocation as technicals shift.	Our team in Singapore and Shanghai applies the same rigorous credit research, comparing like-for-like onshore/offshore credits. Our in-house ratings span all onshore credits we invest in, based on standards set by the major rating agencies.

We asked some senior BlackRock bond managers to describe the role Chinese bonds play in their respective strategies. Below is what they told us.

Rick Rieder — *Chief Investment Officer of Global Fixed Income, Head of the Global Allocation investment team in the Multi-Asset Strategies group*

"Our flagship multi-sector portfolios seek to diversify alpha sources and optimize portfolio construction to take advantage of favorable cross-correlation dynamics. The benefit to investors is a more stable alpha stream, able to navigate diverse market regimes.

China's sovereign bonds may offer attractive real-rates and portfolio diversification potential. Also, the growth and evolution of the market have increasingly aligned it more in trading and other characteristics with the developed bond markets than with other peers in emerging markets."

Michael Fredericks — *Head of Income Investing for the BlackRock Multi-Asset Strategies group and lead portfolio manager for a suite of income-oriented investment solutions*

"Our global multi-asset income portfolios seek to balance the tradeoffs between income and risk by tapping into a broad opportunity set across stocks, bonds and non-traditional income sources. The breadth of income opportunities in China and diversification benefits to global and regional multi-asset portfolios make the asset class an interesting building block for asset allocation.

We employ offshore U.S. dollar (USD) Chinese credit strategies in our global multi-asset income funds as a yield enhancer and diversifier. In our Asian multi-asset income strategy, we allocate to both the onshore renminbi bond market and the offshore USD Chinese credit market, given the lack of correlation between the two markets and diversification benefits this brings."

Jeffrey Cucunato — *Lead portfolio manager for the Multi-Strategy Credit platform within BlackRock's Global Credit group*

"The U.S. remains the core exposure in our flagship global credit portfolios, but we are increasingly allocating to Chinese credit with China now representing a significant part of our non-U.S. credit exposure. Fiscal and monetary policies in the developed markets are funnelling funds directly to the private sector. Valuations have shifted as a result, and Chinese credits attractive relative valuations to developed markets serve to enhance yield while providing diversification for global credit portfolios.

China is likely to remain the global growth engine in the post-Covid-19 world. We prefer exposure to sectors reliant on domestic demand, where fundamentals remain supportive, and the likelihood of default contained. We are cautious on cyclical sectors vulnerable to weak external demand, given current headwinds to global growth."

Artur Piasecki — *Portfolio manager for BlackRock's Asian fixed-income and credit funds and senior Asian Credit portfolio manager for global fixed-income, global credit and global multi-asset income portfolios*

"BlackRock has identified China fixed income and credit as a significant investment opportunity for our global portfolios and our clients. We are at the forefront of China investing. We launched one of the first renminbi/China fixed-income funds in 2011 and begun investing onshore in China soon after the opening up of capital markets.

We have developed a significant footprint and capabilities in China in tandem with increasing demand for China fixed income and credit from our global fixed income, credit and multi-asset portfolios. Clients increasingly recognize the breadth of income opportunities in China and value our experience to help them identify what we consider the best risk/reward opportunities in China's fixed income and credit markets."

Risks Warnings:

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

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