Fixed Income Weekly

FOR PROFESSIONAL INVESTORS

Fears are overdone on government bonds but beware of onshore corporates!

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Key takeaways

- As Chinese government bond yields approach 4%, we are still constructive on parts of the onshore bond market in the medium term
- We believe current fears are valid but overall there are more reasons to be constructive regarding onshore government bonds
- Running credit risk in China onshore corporate bonds is not healthy as we see much more price differentiation taking place in the near term

Full commentary

Much has been said about the 4% threshold in onshore Chinese bond markets. We are constructive on parts of the onshore bond market in the medium term despite the recent sell-off and we believe most current fears are overdone. This positive view on government bonds is coupled with a negative view on onshore corporates, however.

Four percent is not by any means a meaningful psychological threshold. Ten-year Chinese government bonds (CGBs) have broken through these levels several times already. For example, it happened in 2014, and we do not consider it a "fear" threshold (see Figure 1).

That said, the higher yields do reflect a few genuine concerns on the part of domestic investors:

1. Inflation fears have recently re-emerged after quarters of denial by market participants as the recent rebound in PPI (Production Price Index), which was originally seen as temporary, is now considered more sustainable. Over time, we do expect inflation to gradually pick up and the central bank's monetary stance might have to remain tight despite lower economic growth. It is, however, unclear to us whether the PBOC's preferred tool is rate hikes or more administrative measures.

2. The deleveraging process is real and could start to have a meaningful impact on the economy. On one hand, markets perhaps overreacted to fears of additional regulatory constraints on the banking sector. On the other hand, the latest communication from the PBOC as well as other regulatory bodies have been clear about the need for deleveraging given the alarming amount of debt in the system.

3. Investors are well aware that Fed tightening is likely to have ripple effects on all markets, including more idiosyncratic ones such as China. While it is unclear to us how potentially higher US Treasury yields ultimately translate into higher yields in China, there are nonetheless fears domestically in China that the country will not be immune to higher global rates. China is after all not an island.

All these fears are valid and there is some truth in all of them. For example, we agree that the economic slowdown will not trigger monetary loosening; it is too early to bet on this. Instead we could foresee having both slowing growth and still relatively tight monetary policy. Markets are nonetheless getting closer to a turning point, for several reasons:

1. First, we do not think that the macro story is tangibly improving and fears of inflation surprising on the upside are therefore actually misplaced. Hence we do not think the odds of "good" macro news translating into "bad" news on the inflation front are high.

2. Second, while we do believe that policy makers are serious about deleveraging, we think they are committed to striking a balance between 1) the need to deleverage and to inject some credit risk into the system through increased onshore default rates and 2) the necessity of avoiding the creation of systemic risk in the system. Gradualism will remain the key word, as always in China.

3. On the issuance side, we see little risk of a surprise increase in the issuance of government bonds. Just the opposite, in fact. While we are concerned about overall fiscal risks in the longer term, we see little supply risk in the short term and domestic demand should remain strong, especially if the A-share market enters into a consolidation phase after what has been a "one-way street" rally. We believe domestic institutional investors will remain buyers of their own market.

Last week's market developments

Monday, November 13

- No data to report

Tuesday, November 14

- Germany GDP increased to 0.8% q.o.q. s.a. for Q3
- Germany CPI remained at 0% m.o.m. for October
- UK CPI decreased to 0.1% m.o.m. for October
- UK Producer Price Index for manufactured products remained at 0.2% m.o.m. n.s.a. for October
- US Producer Price Final Demand Index remained at 0.4% m.o.m. for October
- Japan GDP decreased to 0.3% q.o.q. s.a. for Q3

Wednesday, November 15

- Markit UK Manufacturing PMI Index increased to
  UK ILO 3 month unemployment rate remained at 4.3% s.a.
- US CPI decreased to 0.1% m.o.m. for October
- US Empire Manufacturing Index decreased to 19.4 for November
- US retail sales advance decreased to 0.2% m.o.m. for October

Thursday, November 16

- Eurozone CPI decreased to 0.1% m.o.m. for October
- US industrial production growth increased to 0.9% m.o.m. for October
- US Philadelphia Fed Business Outlook Index decreased to 22.7 for November

Friday, November 17

- US housing starts increased to 1,290,000 for October

Source: Bloomberg, data as of November 20, 2017

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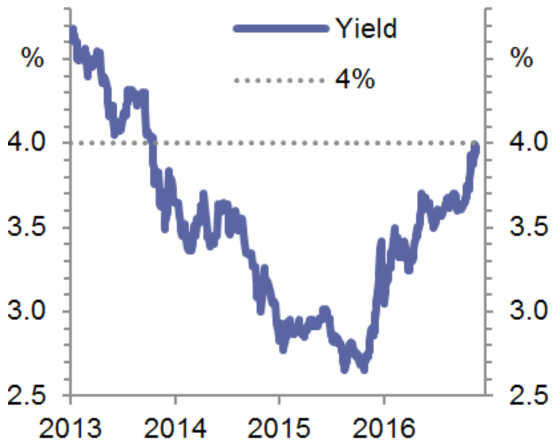
4. Importantly, we believe it is best to not fight foreign flows. Next year is likely to be a memorable one as we expect China will be included in both global and emerging markets fixed income indices. This inclusion could trigger significant inflows; by our own calculations, around USD 200 billion. China is the most under-owned market globally with the share of foreign ownership below 2% in contrast to Japan and Korea, where ownership is in excess of 10%. Other emerging market countries, such as Indonesia, have shares of foreign ownership around 40%. We do expect the percentage of foreign ownership in China to increase significantly over time as people become more comfortable with RMB risk and yields remain appealing compared to developed markets. Policy makers have recently made great efforts to streamline the regulatory environment, lifting all access constraints and alleviating settlement and tax concerns.

Consequently, despite all the negativity in the market, we are constructive on onshore bond markets. There are limits, however. We are positive just on government bonds as we still see some significant risks for corporate bonds. The price discovery mechanism is far from being optimal; credit risk is priced far too much from a “top-down” perspective (i.e., based on likelihood of a government bailout), rather than from a “bottom-up” perspective (i.e., based on standalone credit fundamentals). Onshore corporate default rates will pick up and, while this is healthy and good news in the longer term, the legal and regulatory environment has yet to be tested. So overall, after years of “lazy carry” (remember the “yield pick-up over the sovereign” story for adding a bit of credit risk), running credit risk in China onshore is not healthy in the short term. We see much more price differentiation taking place in future quarters. Hence we are cautious on corporates, but more constructive on government bonds.

The Fixed Income Weekly will not be produced on November 27, 2017 due to the Thanksgiving holiday in the US.

Chart of the Week

Figure 1: Chinese 10-year government bond yields



Data as at November 17, 2017. Sources: Bloomberg, BNP Paribas Asset Management.

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on December 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	June 14, 2017	1.00% - 1.25%	1.29%	December 13
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	December 14
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.07%	December 21
BoE	+25 basis points	November 2, 2017	0.50%	0.54%	December 14

Source: Bloomberg; data as of November 20, 2017

This week’s market developments

Monday, November 20

- Japan All Industry Activity Index is expected to decrease to -0.4% m.o.m. s.a. for September

Tuesday, November 21

- US existing home sales are expected to increase to 5,400,000 for October

Wednesday, November 22

- US durable goods orders are expected to decrease to 0.4% m.o.m. s.a. for October
- Europe Consumer Confidence indicator is expected to increase to -0.8% for November
- US University of Michigan Consumer Sentiment Index is expected to increase to 98.1 for November

Thursday, November 23

- Germany GDP is expected to remain at 0.8% q.o.q. s.a. for Q3
- Eurozone Markit Manufacturing PMI is expected to decrease to 58.2 s.a. for November
- UK GDP is expected to remain at 0.4% q.o.q. s.a. for Q3

Friday, November 24

- US Markit Manufacturing PMI is expected to increase to 55.0 s.a. for November

Source: Bloomberg, data as of November 20, 2017