Manulife Investment Management

2020 Outlook Series: China Fixed Income

Dec 2019

The outlook for the Chinese economy is expected to remain challenging in 2020, with further downside risks to growth. That said, our China Fixed Income team expects policymakers should continue to implement proactive fiscal policies while maintaining prudent monetary easing to provide support. In this 2020 outlook, the team also outlines the opportunities they see in the China fixed income market.

Macro environment review

In 2019, the Chinese economy faced several headwinds. In particular, the US-China trade war has had a negative impact on Chinese bond and currency markets. After reaching a temporary trade truce in December 2018, risk sentiment was positive in the first quarter of 2019. By May, however, there was a sharp deterioration in US-China relations when the Trump administration proposed hiking tariffs on US$200 billion of Chinese imports to 25% and launched sanctions on a leading Chinese telecommunications equipment maker.

Following the tentative truce reached at the Osaka G-20 meeting, trade tensions were reignited in August after the US threatened to impose tariffs on the remaining US$300 billion of Chinese goods. The renminbi (RMB) consequently depreciated by 2.85% against the US dollar during the month, with the People's Bank of China allowing the RMB to move above the psychologically important 7.0 level for the first time since 2008 [i]. As the RMB approached the 7.2 level in early September 2019[ii], we saw an easing in trade tensions as both sides agreed to work towards a Phase-One trade deal. Additional tariffs scheduled for October were also suspended.

We have seen gradual declines in China's GDP growth in 2019, with year-on-year GDP for Q3 falling to 6.0%. It had been 6.4% in Q1 and 6.2% in Q2. Meanwhile, GDP for 2019 as a whole is forecast to be around 6.1%[iii]. PMI indicators have remained below 50 for much of 2019, showing a contraction in economic activity before recovering slightly from August onwards. Despite weak macroeconomic conditions, the government has been careful to avoid over stimulus, and any monetary easing has been directed towards weaker small and medium-sized enterprises. The government has also adopted a more prudent approach to monetary easing and appears willing to absorb slower GDP growth in exchange for greater financial stability. At the same time, October's headline CPI inflation number accelerated to 3.8% (year on year), an increase that was primarily driven by pork prices breaching the official 3% ceiling for the first time since November 2013 [iv]. This development has naturally set a limit on how far monetary policy can be eased.

China bond outlook

The outlook for the Chinese economy is expected to remain challenging in 2020, with further downside risks to growth. That said, we expect policymakers should continue to implement proactive fiscal policies while maintaining prudent monetary easing to provide support.

On the fiscal front, the government could front-load the supply of special bonds in early 2020, allowing local governments to spur infrastructure investment growth. Monetary easing may be modest with further cuts to the reserve requirement ratio. There may also be measured reductions in the medium-term lending facility, the reverse repo rate and the loan prime rate that would all be implemented in a data-dependent fashion.

On the currency front, the path for the RMB may be somewhat binary in 2020, with room for further appreciation from current levels now that the Phase-One agreement appears to have been successfully concluded. On the other hand, the RMB could weaken if there is further disagreement on trade down the road. We believe that RMB will remain at or around current levels (perhaps slightly weaker) in 2020, as difficult US-China trade relations may persist, even if a Phase-One deal is successfully signed. Overall, we expect that returns for China bonds in 2020 will be well supported by their attractive yields relative to other similarly rated global bonds. They will also benefit from the softer economic conditions that will keep official rates low. This scenario should provide investors with the potential for capital gains.

Index inclusion puts China bonds in spotlight

Global investors will become increasingly attracted to the Chinese bond market over time, given its diversification benefits and the opening of channels such as Bond Connect that has helped improve access to the onshore Chinese market for foreign investors. This trend is also being promoted by the inclusion of Chinese bonds in global market indices. In September 2019, JP Morgan announced that it would include Chinese government bonds in its GBI-EM Global Diversified Index from February 2020. Such a move will lead to an approximate weighting of 10% in the index over 10 months[v] and estimated flows of around US$24 billion. Meanwhile, the widely followed FTSE Russell World Government Bond Index has postponed its inclusion of Chinese government bonds for now, but we believe this could still happen in 2020.

We believe that 2020 will present both opportunities and challenges while domestic growth continues to face downward pressure. Nevertheless, Chinese government bonds and high-quality corporate issues should be well-supported, even in such an environment, as they offer attractive and diversified risk-adjusted returns for global investors.

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[i] On 5 August, the Chinese renminbi notably depreciated against the US dollar, CNY breaching the psychologically important level of “7 per dollar” in response to a reescalation of Sino-US trade tensions. Bloomberg, 5 August 2019.
[ii] CNY hit 7.1847 per dollar on 3 September, Bloomberg,
iii Q1 to Q3 GDP figures: National Bureau of Statistics of China, as of 21 October 2019. IMF predicts in their latest report that China’s growth will be 6.1 % in 2019 and 5.8% in 2020, October 2019.
[iv] CPI further accelerated to 4.5% in November 2019, National Bureau Statistics of China, as of 10 December 2019.
[v] JP Morgan, September 2019.

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