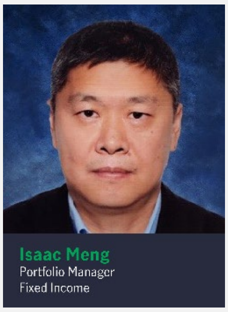
Manulife Investment Management

2024 Outlook Series: China Fixed Income

Jan 2024



In this 2024 outlook, Paula Chan, Senior Portfolio Manager, Fixed Income, and Isaac Meng, Portfolio Manager, Fixed Income, present their baseline views on the key macroeconomic themes that will likely impact China's bond market in 2024. They also explain why an active China fixed-income strategy should continue generating value for global investors.

Aggressive monetary and fiscal easing to fight debt-deflation[1] pressures

China Bond Market: 2023 Recap

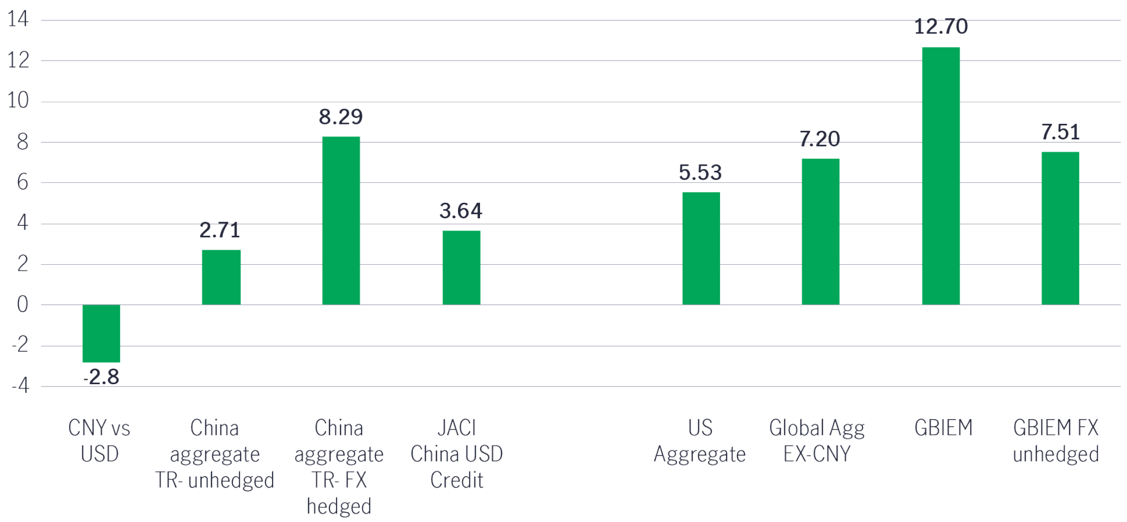
Global fixed income markets generally faced another highly volatile year in 2023. Investors maintained a relatively sanguine outlook and were constructive on mainland China assets at the beginning of the period. A view that was based on the country's reopening and economic recovery theme. Despite this early market optimism, China's fixed income markets then faced a series of headwinds throughout the year:

1. Despite a strong rebound at the start of the year, mainland China's recovery lost steam by the second quarter, with the economy dragged down by further weakness in the property sector, softer consumption amid depressed employment conditions, and deepening deflation. Mainland China's interest rates remained well-anchored even as global bonds sold off during the summer, while China's credit sold off and the renminbi (CNY) depreciated against the USD as global sentiment weakened.
2. US growth/inflation reaccelerated in the middle of 2023 despite the US regional banking crisis earlier in the year, prompting the US Federal Reserve (Fed) to hike rates by 100 basis points to 5.5%. The sell-off in global bonds intensified into the third quarter, as the 10-year US Treasury yield bear steepened by +170 basis points from the April low of 3.3% to eventually breach the 5% handle in October. In the final two months of 2023, the market rout dramatically reversed on cooling inflation and the Fed's dovish pivot after pausing on further hikes.
3. Rising geopolitical tensions: 2023 saw the Russia-Ukraine war enter its second year while the Israel-Gaza war broke out, adding further strains to the global system. On the other hand, the mainland China-US geopolitical rivalry appeared to stabilise with both Presidents meeting on the sidelines of the November Asia-Pacific Economic Cooperation (APEC) summit.

Anchored by monetary easing by the People's Bank of China (PBOC) and rising real yields, driven by low inflation and even deflation, Chinese government bonds (CGBs) enjoyed stable performance throughout 2023. The Bloomberg Aggregate China Total Return (TR) Bond Index gained +2.71% in USD terms over the calendar year 2023.

[1] Debt deflation is an economic theory attributed to economist Irving Fisher. The essence of debt deflation is that when prices and wages fall with the price level, but the nominal size of debts and interest payments are fixed, then borrowers face increasing pressure on the ability to repay. This leads to a leap in loan defaults, which in turn can cause bank insolvencies. The commonly assumed danger of debt deflation is that it can lead to a deflationary spiral, as defaulted debts lead to write-downs by banks and other creditors, which constitute a reduction in the overall volume of money and credit in the economy, which spurs further price and debt deflation in a vicious cycle. Investopedia.

Chart 1: 2023 market recap – returns in USD



Source: Manulife Investment Management, Bloomberg, as of 31 December 2023. It is not possible to invest directly in an index. Past performance does not guarantee future results. China aggregate TR-unhedged refers to Bloomberg Global Aggregate China TR Index Unhedged, China aggregate TR-FX hedged refers to Bloomberg Global Aggregate China TR Index Hedged, JACI China USD Credit refers to J.P. Morgan China Total Return, US Aggregate refers to Bloomberg US Aggregate Total Return Value Unhedged, Global Agg EX-CNY refers to Bloomberg Global Aggregate Ex-CNY, GBIEM refers to JPMorgan Government Bond Index-Emerging Markets, and GBIEM FX unhedged refers to JPMorgan Government Bond Index-Emerging Markets Unhedged.

Related market moves:

- The Bloomberg Global Aggregate China TR Index returned +2.71% in USD terms and +4.79% in local terms during the calendar year 2023.
- The CNY depreciated by approximately 2.8% to 7.1 against the USD over the year. On a foreign exchange (FX) hedged basis, China bond aggregate return was boosted to 8.29% due to a pick-up from hedging back to USD, given China onshore rates were lower than US rates.
- 10-year CGB yields declined by 28 basis points to 2.56% from 2.84% at the beginning of 2023.
- JACI China Credit Index returned 3.64% in USD terms over the year. After a strong rally at the beginning of 2023, credit spreads widened in the middle of the year. Economic data worsened before a strong rally, driven mainly by the Fed's rate pause, to finish in positive territory.
- US Treasury yields rallied to close the year at 3.88% after touching 5% in late October. The interest rate differential between 10-year CGBs and 10-year US Treasuries stood at -1.32% at the end of December from -1.03% at the beginning of the year.

2024 macro themes: further policy easing to address deflation and property woes

For 2024, we are monitoring key macro themes and their implications for our portfolio strategy.

1. **Deflation vs interest rates: a call to re-engage policy easing**

Mainland China's policymakers calibrated their 2024 economic planning at the annual Central Economic Work Conference (CEWC) in December 2023. While no major surprises were announced, the CEWC concluded that economic activity had bottomed and the principal of maintaining stability and promoting high-quality growth would be maintained in 2024. Macro policy will also retain an accommodative stance that was observed in 2H23.

Given the weakening recovery momentum of mainland China's economy, struggling property sector, and emerging signs of debt-deflation pressure across both local government finance and households, we believe there is a strong case for a more aggressive monetary and fiscal stimulus. We have already seen the Ministry of Finance announce a RMB1 trillion Special CGB issuance in the fourth quarter of 2023 to front-load fiscal support to boost growth while additional financing support and regulatory forbearance can be expected to backstop funding needs of leading property developers and local government financing vehicles (LGFVs) to prevent broader contagion across financial markets.

Despite pressure from the Fed's aggressive rate hikes and the ensuing impact on the CNY against the USD, the PBOC nevertheless cut its one-year medium-term lending facility (MLF) rates by 10 basis points in June and then by a further 15 basis points in August 2023. The cuts confirmed the PBOC's intention to ease monetary policy to address negative economic developments. Looking ahead, we expect the PBOC to cut policy rates (such as the reverse repo rate and the one-year MLF rate) by 50 basis points, as the window for more aggressive monetary easing will open in early 2024.

While the Fed is likely to begin cutting rates and end quantitative tightening (QT) as inflation approaches its 2% target in the second half of 2024. The market is currently pricing in five to six rate cuts (25 basis points each) in the second half of 2024. Clearly, with this backdrop, the PBOC will have greater freedom to intensify its monetary easing efforts to cushion the property downturn and counter emerging deflationary pressure. The potential re-coupling or convergence of the Fed and PBOC's respective monetary policies in the direction of further easing will be an important theme for all asset classes going forward. This will also directly impact the attractiveness of Chinese bond yields versus US bond yields and drive the direction of the CNY.

2. Property sector backstop

Despite a series of demand-side mortgage and property easing policies, as well as the "Three Arrows" policies to support financing for leading private property developers that have already been announced since 4Q22, the slump in the property market has continued to intensify. Property sales have fallen by around 40% vs pre-Covid levels, while the negative spillover to growth and employment has risen with rising systemic financial risks. The contraction of the property sector has also compounded the debt-deflation pressure on households, LGFV and corporate sectors via the wealth channel and physical land market. These risks are well recognized, and consensus is building within authorities to reduce contagion and tail risks. Discussion of "whitelists for property financing" and "quantitative financing targets for banks" are encouraging signals.

In the current environment, we remain cautious, focusing on selective national privately-owned enterprise (POE) developers with leading sales and state-owned enterprise (SOE) developers that potentially benefit from government ownership and explicit government support will likely to continue to be the main beneficiaries as the property sector continues to consolidate, led by this group of SOEs and POE survivors.

Risks to our baseline view

While the above macro themes constitute our constructive 2024 baseline views, the following potential events also need to be closely monitored and can present possible risks to our baseline views.

1. Policies are insufficient – monetary and fiscal policies and property sector policies are too passive and insufficient to counter debt-deflation pressure.

2. Spreading financial risks – policies fail to contain systemic risks, which spread to LGFV and lower-tier SOEs and banks.

3. Geopolitical events – post-Taiwan's election development in January 2024 and the US presidential election on 5 November 2024. Both events can potentially increase regional tensions and further damage the US-mainland China relationship.

4. US inflation re-acceleration – The Fed could be forced to resume hikes in this scenario, which would be negative for global fixed income.

Positive 2024 outlook for China bonds: Duration, currency, and credit

To summarise, we maintain a bullish outlook for China's bond markets in 2024.

We forecast that China's onshore bonds will provide mid-to-high single-digit returns for investors on a CNY basis, with the PBOC likely to intensify easing measures, including cutting repo rates by 50 basis points. At the same time, the government's fiscal stance will likely turn moderately expansionary.

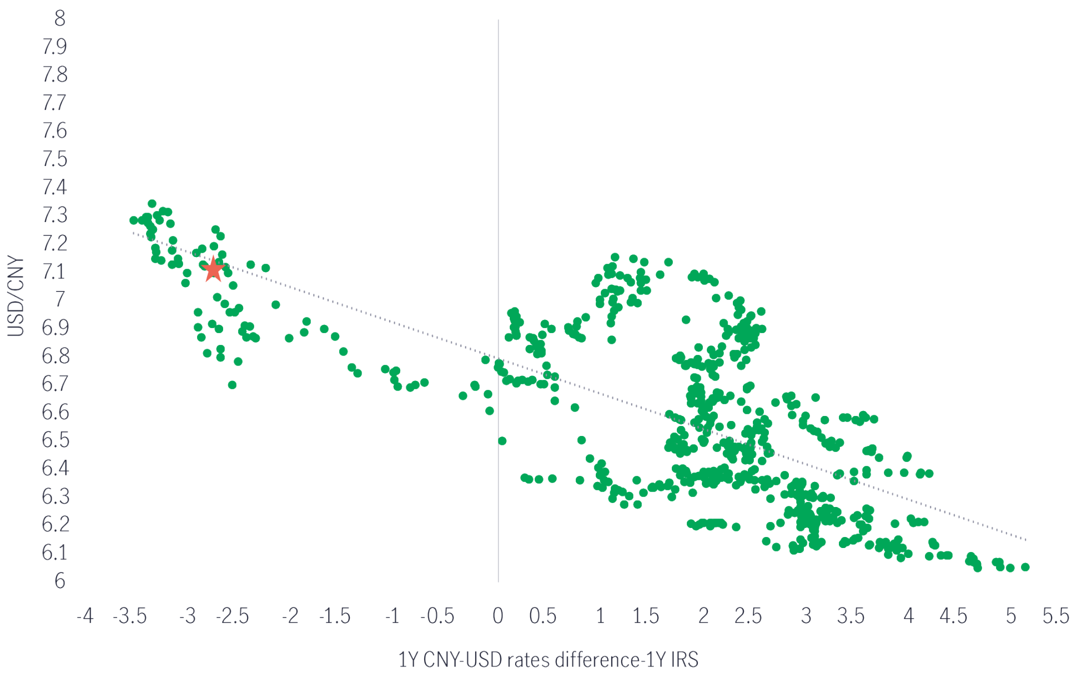
Neutral to moderate positive on CNY: the Fed is expected to ease by 75-150 basis points in 2024, and mainland China's more proactive stimulus should provide a constructive backdrop for CNY assets. Global investors' underweight positioning in CNY assets appears extreme, and we have already seen bond inflows resume in the fourth quarter of 2023. The CNY is expected to remain stable around 7.15 against the USD in early 2024, then moderately appreciate in the second half of 2024 as mainland China's stimulus gains traction and the Fed begins its easing cycle, leading to the USD index peaking.

For USD-based investors, 2024 looks promising as a year for tactical allocation to CNY bonds. An allocation to CNY bonds on a FX-hedged basis should add +200bp carry to result in a higher single-digit return. On the other hand, a more tactical FX unhedged CNY allocation could benefit from potential moderate CNY appreciation.

CGBs remain an attractive investment for global/emerging-market fixed-income portfolios. Mainland China's economic and policy cycles are divergent and often not synchronised with the US and other G3 (the US, Japan, and euro area) economies. Over the years, CGBs have shown low yield beta or often negative correlation to US/global rates. The deep liquidity of both government bonds and CNY FX makes China onshore bonds scalable and ideal for active allocations by global investors.

After another year of slumping property sales, falling prices and cascading POE developer defaults, policy consensus is forming that stabilisation of the property sector is necessary to achieve solid economic recovery and benign relations. The Politburo has highlighted a three-pillar approach to the housing recovery, including urban rehabilitation, public housing, and building strategic facilities. Potentially drawing a playbook of quantitative easing (QE) from G3 policymakers of past decades, mainland China has the resources (including its sovereign/central bank balance sheet) and tools (monetary and fiscal policies) to support the housing market and avoid cascading financial stress. PBOC's lending facilities, such as pledged supplementary lending (PSL) and local government special bond issuances, have already been engaged to extend trillions. With respect to onshore credit, we have seen little contagion to non-property and LGFV sectors following the volatility in the property sector. At the

Chart 2: CNY vs one-year mainland China-US rate difference



Source: Manulife Investment Management, Bloomberg, as of 31 December 2023. Star refers to the current and end-December data point.

same time, investor support for high-quality SOE names remains intact.

Portfolio positioning

From a positioning perspective, we believe investors can benefit from the following:

- Scaling in an overweight duration position. We see value in the belly of the yield curve to add duration both on an outright basis and relative to US/Asian local rates.
- CNY stable but with tactical upside: we typically manage CNY exposure on a hedged basis or with a tactical overlay. We will calibrate neutral or long CNY exposure depending on developments in monetary and fiscal policies and the extent of the divergence between the PBOC’s and the Fed’s monetary policies.
- For credit, we see attractive valuations for mainland China’s high-quality investment-grade companies. Particularly some rising star candidates in the tech and gaming sectors with improving credit profiles.

Conclusion

After experiencing extreme volatility in global rates, FX and credit in 2023, we believe China’s bond market should continue to offer moderate total returns but with lower volatility, buoyed by expected moderate policy easing, while mainland China’s divergent macro-policy cycle versus other major economies should continue to make China’s bond market attractive for diversification purposes.

Manulife Investment Management

Manulife Investment Management is the brand for the global wealth and asset management segment of Manulife Financial Corporation. Our mission is to make decisions easier and lives better by empowering investors for a better tomorrow. Serving more than 17 million individuals, institutions, and retirement plan members, we believe our global reach, complementary businesses, and the strength of our parent company position us to help investors capitalize on today's emerging global trends. We provide our clients access to public and private investment solutions across equities, fixed income, multi-asset, alternative, and sustainability-linked strategies, such as natural capital, to help them make more informed financial decisions and achieve their investment objectives. Not all offerings are available in all jurisdictions. For additional information, please visit manulifeim.com.

3327530