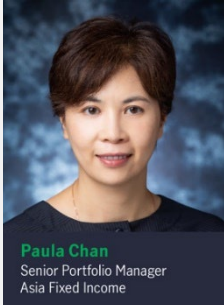


2022 saw fixed income managers' investment process tested to the extreme – probably unseen in the last 30 years. Yet, despite the unprecedented conditions, our risk management and portfolio construction processes served us well – particularly when the market experienced deep drawdowns. In this 2023 outlook piece, Paula Chan, Senior Portfolio Manager, Asia Fixed Income, and Isaac Meng, Portfolio Manager, Asia Fixed Income, explain why China's favourable policy climate coupled with attractive long-term fundamentals, could help onshore and offshore China fixed income harvest positive returns in the 12 months ahead.

China Fixed Income: sailing into a year of reopening and policy pivots

Against a volatile backdrop, onshore China bonds still managed to outperform most of their global peers in 2022 due to their liquidity buffer, lower correlation with other global fixed-income markets, and positive real yields. Indeed, "easing" has been the main tune for China's monetary easing policies in 2022 (see Appendix). Offshore China bonds, however, were being dictated by another set of dynamics: they were notably impacted by ongoing issues in the property sector, hence the sharp correction seen among high-yield names in this space.

Key highlight of market performance[1]:

- On a year-to-date basis, 10-year CGB yield closed marginally higher at 2.87% from 2.78%. Given the onshore market's abundant liquidity, yield levels stayed range-bound from 2.95% to 2.62%.
- Amidst a hawkish US Federal Reserve (Fed) and broad risk-aversion, the Chinese yuan (CNY) posted a full-year decline of 7.86% against the US dollar (USD). In the fourth quarter, the CNY passed the peak of foreign outflows, which saw the CNY recover to 6.90 against the USD from 7.12 at the beginning of the quarter.
- China USD credit posted -10.45% returns (JP Morgan China Total Return Index) during the year owing to higher US Treasury yields and wider credit spreads, though partially offset by positive carry. Uncertainty about selective developers' ability to service payments or refinance ahead of maturity continued to pressure Chinese property sector bonds.

Towards the fourth quarter of 2022, a major shift to ease COVID restrictions and property sector policies boosted market sentiment. In our view, these measures should help the sector find a bottom over the next 12 to 18 months. We'll detail our outlook for China's onshore and offshore bonds in the next section.

[1] Bloomberg, data as of 28 December 2022. USDCNY was as high as 7.3050 on 31 October 2022 and depreciated to 6.9501 as of 28 December 2022.

China's long-awaited reopening materialises – turning more offensive in 2023

Moving into 2023, our investment positioning could be viewed as more constructive compared to the defensive stance assumed during the previous year. Indeed, as soon as China announced a double pivot with a major shift in China's COVID and property sector policies, we started to reposition ourselves more offensively in the fourth quarter of 2022:

1. China's border re-opening and loosening of COVID-measures

2. Strong policy bazooka with an "all in" effort to boost economic growth

3. All-in type of property-sector support to sustain a recovery of the real-estate sector

4. US Fed to gradually slow down rate hikes or pause in 2023

We foresee our more offensive stance will continue to benefit from these macro and policy tailwinds operating throughout the fourth quarter of 2022 into the new year, as markets have not fully priced in the positive factors and the potential of underlying improvement of fundamentals. Moreover, the advanced reopening of some Asian economies continues to be a positive factor and one that is not fully priced in.

After announcing the zero-COVID fine-tuning ("20 measures") in November 2022, late December saw China abolish hotel quarantine and on-arrival PCR testing requirements for inbound travellers starting from 8 January 2023. On 27 December, the government further announced that it would resume issuing tourist and business visas for Chinese mainland residents visiting Hong Kong and begin reopening sea and land ports.

We believe that China's COVID U-turn paves the way for a shift to a strategy of living with the virus, which paves the way for resuming both inbound and outbound travels in the first half of 2023. Whether the return to normality will be gradual or abrupt is still subject to the surge of infections and the potential impact on supply chains. At the time of writing, the real growth rate of gross domestic product in China is forecast at 3.0% in 2022, followed by 4.8% in 2023 and 5.0% in 2024[2].

Our rate, currency, and credit outlook

As the market now expects improved economic growth in China that may lead to a moderate rebound in inflationary pressures and higher onshore rates, we could see the onshore yield curve steepen. At the same time, the CNY might strengthen in the foreign exchange market. Therefore, having an underweight exposure to duration in our onshore CNY bond portfolios should help buffer the impact of rising rates.

Turning to the foreign exchange space, the CNY will likely benefit from the domestic economic recovery, more substantial policy stimulus, and a USD that may be peaking in value. Higher rates would also attract portfolio flows to the onshore markets as the interest rate differential between the CNY and USD should narrow, providing support to the renminbi. Therefore, we believe that the outlook for the renminbi is more constructive, and investors could benefit from a reduction of CNY hedges against the USD.

Regarding different segments of China bonds in the onshore market, we maintain a relatively cautious view of corporate credit and bank capital bonds as valuations appear unattractive. We are more neutral on policy bank bonds and China government bonds. Simultaneously, as we seek to benefit from China's reopening theme, there is the potential to increase our offshore China USD high-yield exposure due to the latter's attractive valuations. From a sector perspective, we are looking to selectively add higher-quality property developers, especially SOE developers that benefit from greater state support. We have also added some exposure to internet and technology names that are well-positioned to gain from a domestic recovery.

[2] Based on Bloomberg consensus forecasts.

As a team, we always try to position the portfolio to reflect environmental, social, and governance (ESG) factors. Currently, the opportunity set for sustainable investing remains predominantly in the offshore USD market. However, once the onshore green-bond market develops further and becomes more scalable, it could offer multiple investment possibilities.

Potentially more targeted support for the real-estate

In the new year, we expect more supportive measures for the property sector following the financing support announced ("second arrow") in November 2022. Significantly, in early January, the People's Bank of China (PBOC) and the China Banking and Insurance Regulatory Commission (CBIRC) announced a bold new initiative to establish a new mortgage rate adjustment framework for first-time home buyers when housing prices drop. This will likely result in a material decline in these buyers' mortgage rates and will be supportive for the property sector. At the same time, market headlines suggest that China is considering relaxing its stringent "three red lines" property rules for some developers. If implemented, this would represent a significant policy shift and likely build investor confidence in the sector.

Indeed, the recovery story depends on how quickly developers can reinstate cash flow. But as the economy reopens, there may be an uptick in household incomes that, in turn, should result in increased property transactional activity. A headwind to note is the slowdown in the US and Europe could have a knock-on effect on China's export manufacturing sector, which may affect employment levels. Overall, the recovery should be quite meaningful in the second half of 2023 but possibly less robust (a U-shaped rebound) than the post-COVID upturn (a V-shaped rebound) in 2020.

Adopting a pragmatic approach with fiscal stimulus

The government and policymakers will be mindful of the aforementioned factors and likely observe how the reopening plays out before considering further fiscal stimulus. In terms of official benchmark interest rates, these should remain on hold, with no changes expected until late 2023, which could coincide with the US Federal Reserve (the Fed) reaching its terminal interest rate. Indeed, we may have already reached the maximum interest-rate policy differential between the PBOC and Fed. So, as China reopens and the Fed is in the latter stages of its tightening cycle, currency depreciation pressures have probably peaked. As we have detailed earlier, China bonds serve as a potentially resilient risk diversifier due to low correlation to other parts of the global fixed-income market, decent interest-rate carry (on a hedged basis) and abundant onshore liquidity.

Why risk and liquidity management processes matter

When we look back at the challenging market environment in 2022, one of the key takeaways we want to emphasise is the need to maintain a highly liquid portfolio – either with cash or equivalents, such as short-term Treasuries, during such periods of market turmoil. Our investment team's long track record and deep experience in China's onshore bond market[3] have helped the team navigate treacherous market conditions. By adopting a higher level of liquidity under such conditions, investors are able to methodically manage their way through a volatile market cycle. At the same time, maintaining a diversified portfolio can further reduce the downside impact.

In summary, we believe liquidity and diversification remain essential, as do perseverance and patience.

Lastly, we expect low-to-mid single-digit returns for CNY onshore bond investors in this space and reiterate the appeal of the China bond asset class to global investors.

[3] We established our Onshore China Bond performance track record in 2010.

Appendix: China's monetary easing in 2022

First quarter: the PBoC lowered its policy rates by 10 basis points, including the 7-day repo rate from 2.2% to 2.1% and the 1-year MLF interest rate from 2.95% to 2.85% on 17 January. This was followed by a reduction in the banks' loan prime rate (LPR) which was reduced by 10 basis points to 3.70% for the 1-year rate and by 5 basis points to 4.6% for the 5-year rate.

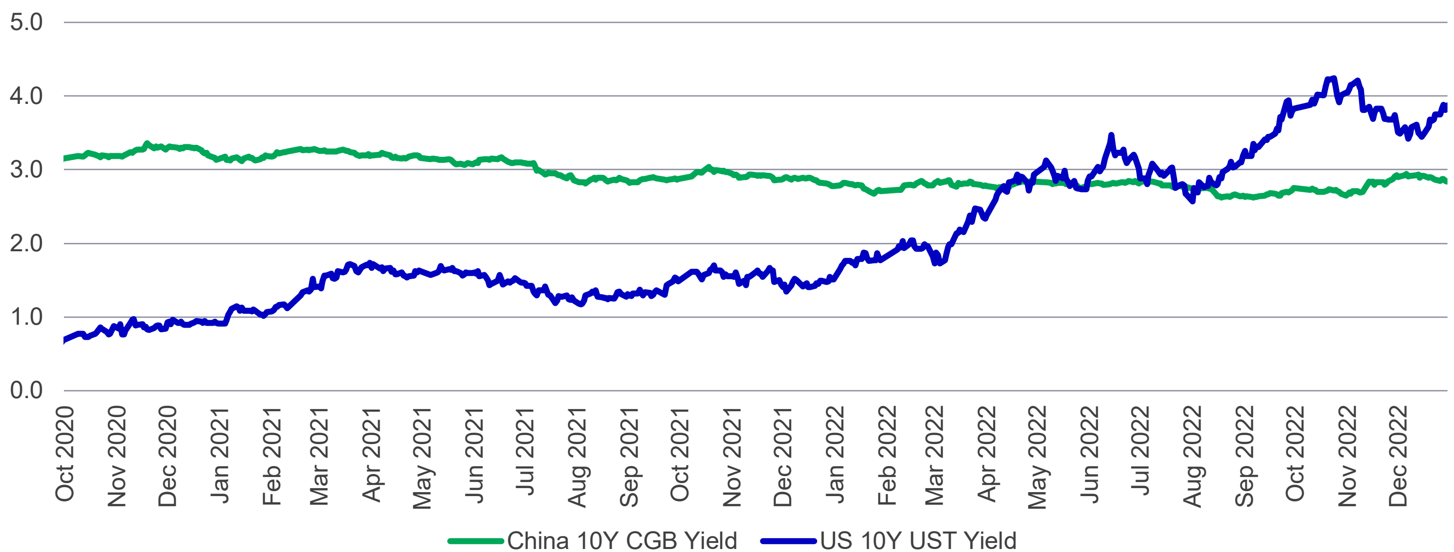
Second quarter: China reduced the RRR by 0.25% in April with the average RRR in the banking system falling to 8.1% from 8.4%. The PBoC also cut the 5-year LPR by 15 basis points to 4.45% to boost mortgage support while leaving the 1-year LPR unchanged at 3.70%.

Third quarter: The PBoC cut policy rates (1-year medium loan facilities (MLF) and 7-day reverse repo rate) by 10 bps to 2.75% and respectively in August. This was followed by asymmetric cuts in Loan Prime Rates with the 1Y LPR reduced by 5bp to 3.65% while the 5Y LPR was cut by 15bp to 4.3% to support the property market.

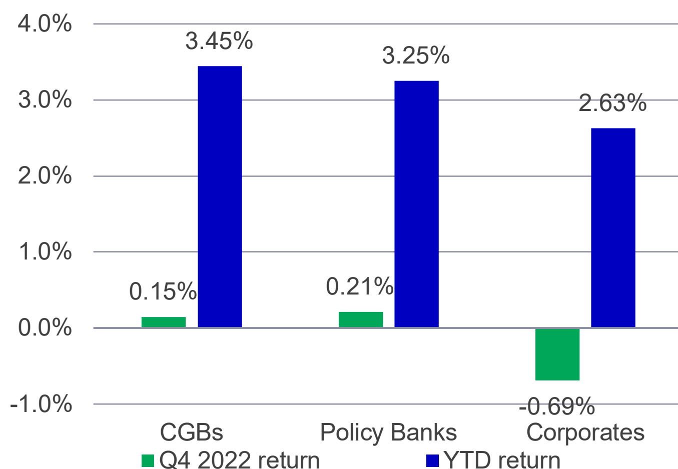
Fourth quarter: The PBoC announced a universal Reserve Requirement Ratio (RRR) cut on 25th November.

2022 Market review

China onshore rates (%)



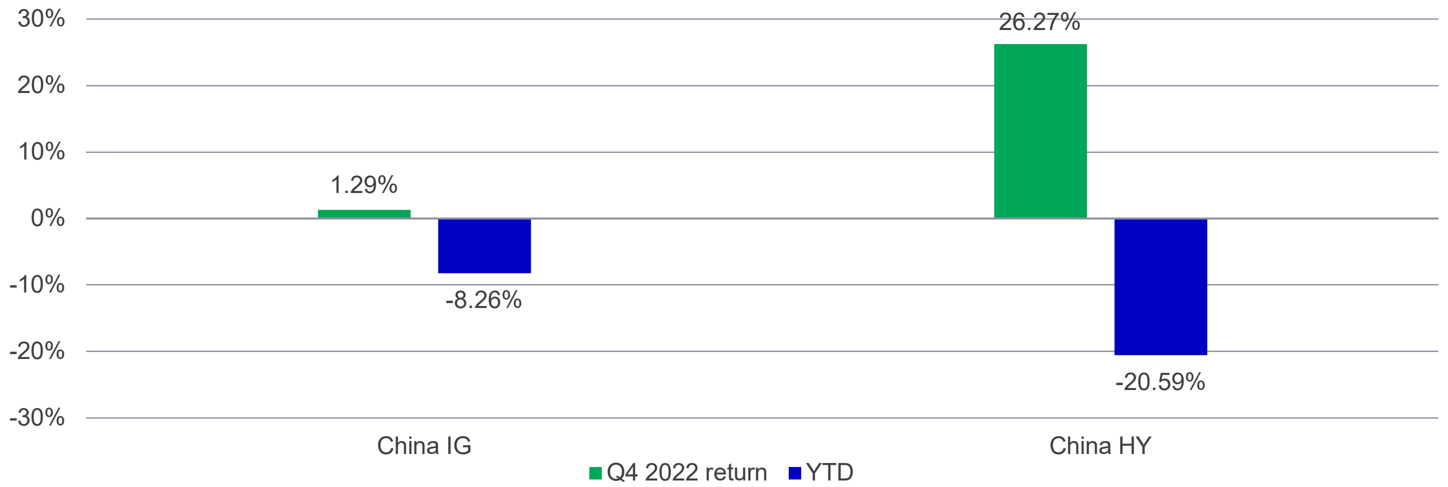
Credit



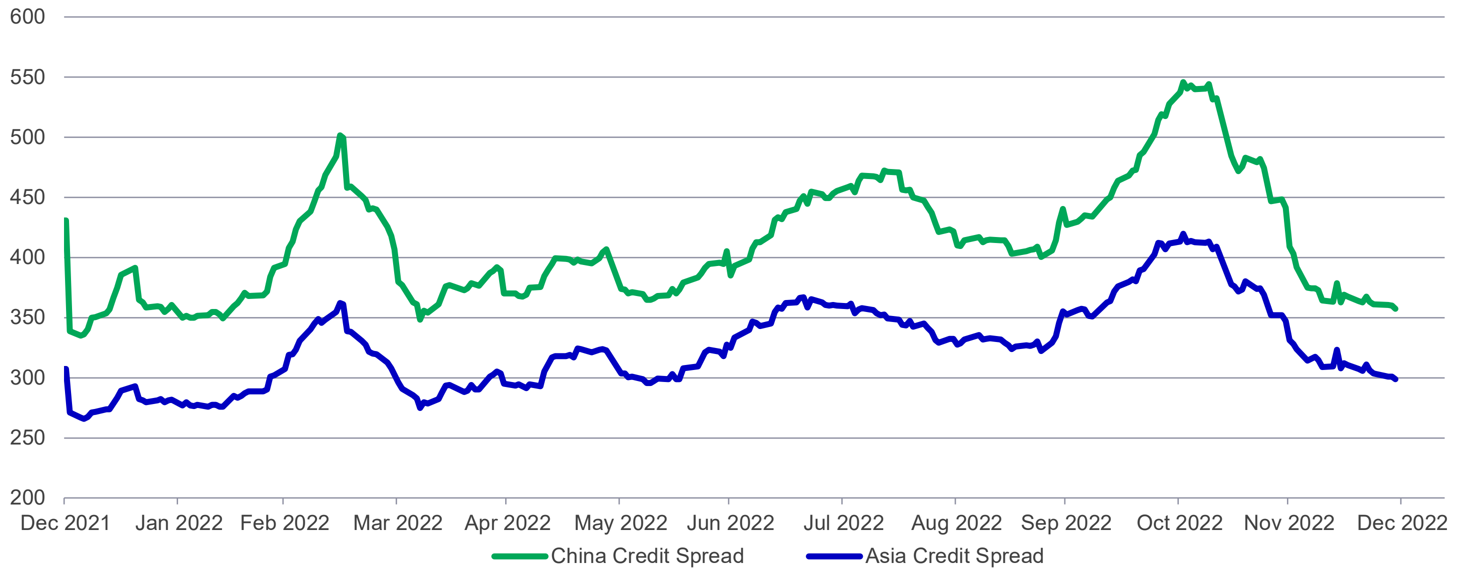
Renminbi

CNY vs	Q4 2022	YTD 2022
USD	3.15	-7.86
EUR	-5.55	-2.14
CHF	-3.38	-6.69
JPY	-6.56	4.98

China USD credit – returns (%)



China USD credit (spreads, basis points)



Source: Bloomberg, Manulife Investment Management, as of 30 December 2022. It is not possible to invest directly in an index. Past performance does not guarantee future results.

Important Information

A widespread health crisis such as a global pandemic could cause substantial market volatility, exchange-trading suspensions and closures, and affect portfolio performance. For example, the novel coronavirus disease (COVID-19) has resulted in significant disruptions to global business activity. The impact of a health crisis and other epidemics and pandemics that may arise in the future, could affect the global economy in ways that cannot necessarily be foreseen at the present time. A health crisis may exacerbate other pre-existing political, social and economic risks. Any such impact could adversely affect the portfolio's performance, resulting in losses to your investment

Investing involves risks, including the potential loss of principal. Financial markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. These risks are magnified for investments made in emerging markets. Currency risk is the risk that fluctuations in exchange rates may adversely affect the value of a portfolio's investments.

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