In this 2022 outlook, Paula Chan, Senior Portfolio Manager, Fixed Income, and Isaac Meng, Portfolio Manager, Fixed Income, outline why they believe China fixed income can continue to benefit from several key drivers.

From moderate policy tightening to easing: China bond market continues to provide opportunities

As we approach the end of 2021, our constructive view on the Chinese onshore bond market at the beginning of the year has played out, despite a generally challenging environment for global fixed income markets due to rising interest rates. Going forward, we believe that China bonds should continue to benefit from several key drivers, namely the call to re-engage policy easing, sustainable currency strength, and their diversification benefits for global investors.

China bonds (based on the Bloomberg Global Aggregate China TR Bond Index) have outperformed other major bond categories, gaining +6.99% over the year to date – as of 30 November 2021, in US dollar (USD) terms. (see Chart 1).

Related market moves:

- The Bloomberg Global Aggregate China TR Index has returned +4.2% in local terms (YTD to 30 November)
- The onshore renminbi (CNY) has appreciated by approximately +2.6% to 6.36 against the USD over the same period.
- Chinese government bond (CGB) 10-year yields declined by 28 basis points (bps) to 2.86% from the beginning of 2021 to the end of November 2021
- As US Treasury yields increased, the premium or yield pick-up in 10-year CGBs versus US Treasuries also narrowed by 81 bps to 1.42%.

China bond premium can attract yield-seeking investors

The strong absolute and relative performance of Chinese bonds in 2021 can be attributed to the Chinese government maintaining a tighter monetary and fiscal stance that has helped CGBs retain an attractive yield level relative to other global government bond yields. Since the pandemic began in the first half of 2020, the People's Bank of China (PBOC) has cut the 7-day reverse repo rate by only 30 bps to 2.2%. Unlike many global peers, the PBOC has refrained from implementing quantitative easing and has, therefore, preserved the capacity or policy room to ease monetary policy at a later stage. Accordingly, CGBs stand out with the bond curve offering a positive yield spread of between 150-200 bps above G7 sovereign bonds, given policy rates for G7 countries are negative or zero-bound with deeply negative real bond yields.

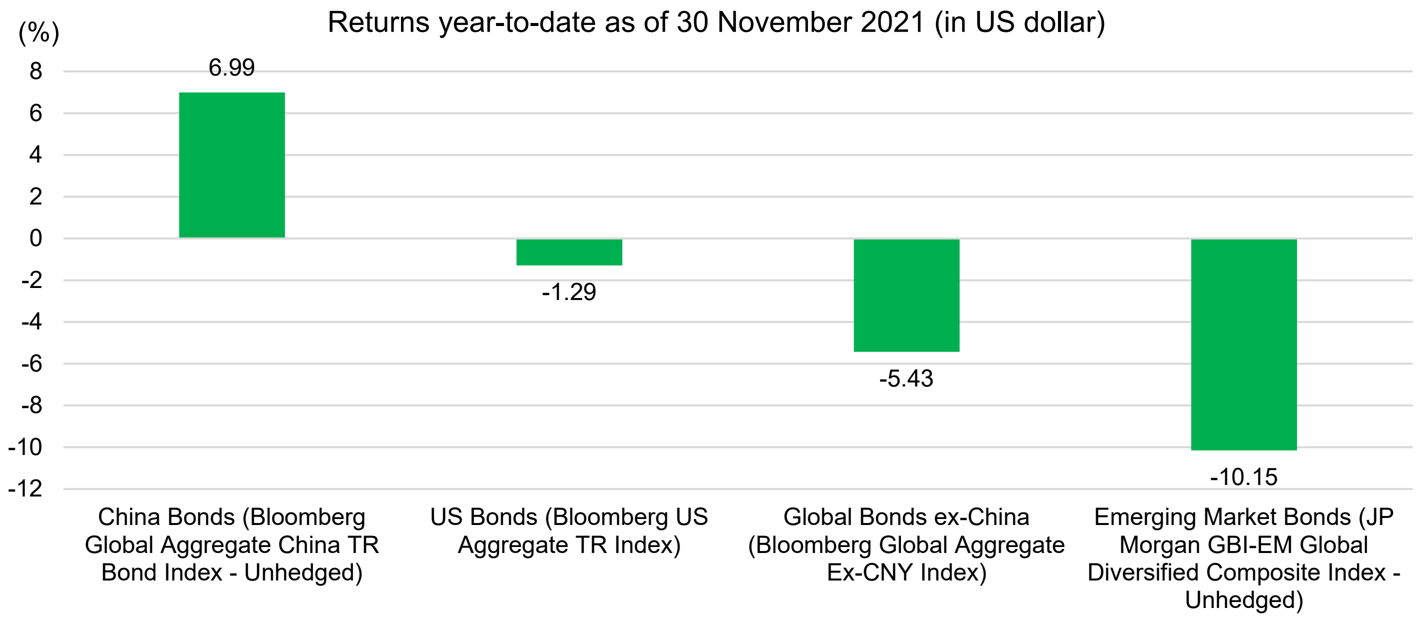
The changing shape of monetary and fiscal policies

In terms of fiscal policy, China is the only major economy in the G20[1] to meaningfully tighten in 2021. Over the year, China's fiscal impulse turned to -2.5% of GDP. The net issuance of government bonds (CGBs, local government financing, policy bank) declined by CNY 2.8 trillion over the first three quarters and is expected to be around CNY 2.4 trillion less than 2020 overall[2]. Moderate fiscal tightening has capped domestic demand and prices,

[1] Manulife Investment Management, as of December 2021.

[2] WIND, Manulife Investment Management, as of December 2021.

Chart 1: Major bond market returns in 2021



Source: Bloomberg, data as of 30 November 2021. Past performance does not guarantee future results. It is not possible to invest directly in an index.

while lower bond supplies have helped flatten the long end of the yield curve.

On the currency front, the CNY has appreciated by +2.6% against the USD and +8.3% against the CFETS currency basket, which measures CNY value against a trade-weighted basket of foreign currencies. The strength of the CNY has been underpinned by China's record trade surplus of over US$650 billion as China's economy benefitted from its resilient industrial supply chains, which have helped mitigate stagflation headwinds.

Overall, we think both China bonds and the CNY remain attractive given the above factors with ample risk-premium attached to China local bonds and the currency.

2022 macro themes: Policy easing, impact of COVID developments, and US rate normalisation

Looking ahead to 2022, we will closely watch the following three key macro themes and their implications.

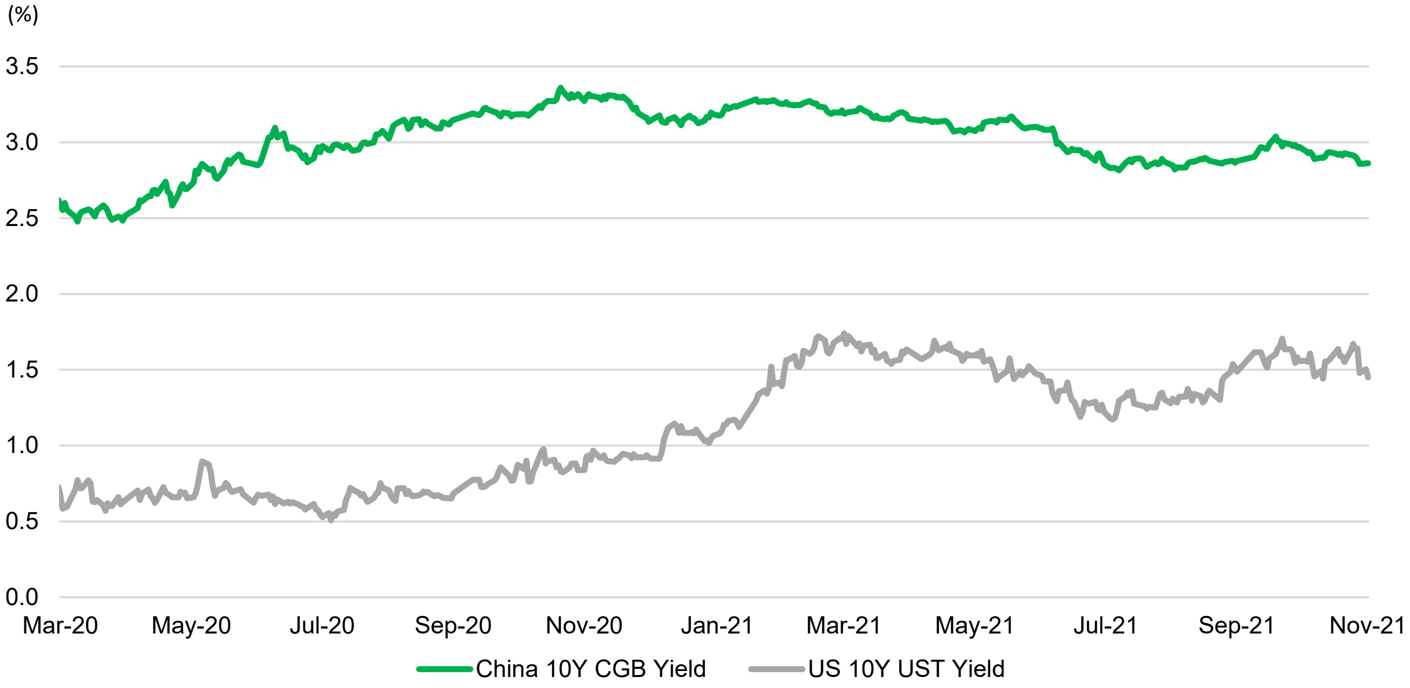
1. Weakening of Chinese domestic demand: A call to re-engage policy easing

Chinese policymakers calibrated the 2022 economic planning at the annual Central Economic Work Conference on 10th December, where GDP growth and inflation targets, monetary policy, and fiscal budget objectives were agreed upon. We believe that sustaining a benign macro environment with stable growth and financial stability will be paramount ahead of the 20th Party Congress due to be held in the second half of 2022. The Party Congress is held every five years and is responsible for formally approving the membership of the Central Committee, which comprises the top leaders of the Communist Party of China.

Given the weaker economic data experienced in the second half of 2021, we believe there is a strong case for some moderate loosening of China's monetary and fiscal stance, while additional credit and regulatory easing can be expected to provide relief to cushion the impact of the downturn in the property sector on the broader Chinese economy.

On 6th December, the PBOC made a broad-based 50 bps cut in the reserve requirement ratio (RRR) as widely expected by the market after the recent speech by Premier Li when he indicated that the RRR would be cut to support the real economy amid

Chart 2: China government bonds stands out with positive yield spread



Source: Bloomberg, data as of 30 November 2021. Past performance does not guarantee future results. It is not possible to invest directly in an index.

increasing signs of downside risk. According to the central bank, this will unlock CNY 1.2 trillion of long-term funding. We see the move as a clear sign of policy easing to address negative developments in the economy, while further monetary easing can still be expected in early 2022.

2. COVID developments: The Omicron variant and evolution of pandemic stagflation supply shocks

While we are close to two years into the pandemic, there are still no signs of a clear ending in sight. Recently, risk markets have been roiled by the discovery of the Omicron variant and the uncertainty surrounding its impact on global growth. Economic data for the Chinese economy remains lacklustre, and a deeper pandemic could result in further stagflation supply shocks that would have important consequences on investors' risk appetites and could drive their exposure to Chinese bonds in the short term.

3. Interest rate normalisation: An exit of pandemic stimulus, Fed tapering, and the path to higher rates

The Fed has proactively signalled its intention to increase the speed of tapering to exit its pandemic stimulus while the market is also currently pricing in two 25 bps rate hikes in the second half of 2022. Clearly, this will be an important theme for all asset classes and directly impact the attractiveness of Chinese bond yields versus US bond yields and determine the relative value of the CNY against the USD.

Our outlook for 2022: Duration, currency, and credit

To summarise, our baseline 2022 outlook for China bonds is as follows:

- We think China onshore bonds are projected to provide low- to mid-single-digit returns for investors, with the PBOC to take moderate easing measures, including cutting repo rates by 10-20 bps. At the same time, the government's fiscal stance will likely turn moderately expansionary.
- Due to the increasing divergence in global macro-policy cycles, we expect China onshore bonds to maintain their low correlation to other fixed income markets and continue to provide potential diversification benefits for global fixed income portfolios.
- CNY strength could continue into early 2022 due to China maintaining an elevated trade surplus, while foreign investor flows into onshore bonds remain strong. The strength of the CNY should

also help create a window for the PBOC to ease monetary policy even when the Fed is embarking on a gradual interest rate normalisation.

- Given the importance of the property sector as a key driver to China's GDP growth, we believe the government will be cautious to avoid triggering a macro hard landing while continuing to reform the sector. We think the government has enough tools to stimulate this sector and ensure the non-real-estate segment remains intact, such as tax cuts for SMEs, PBOC's lending facilities, and local government special bond issuances. With respect to onshore credit, we have seen very little contagion to non-property sectors following the volatility in the property sector while investor support for high quality SOE names remains in-tact.

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

- There is value in the intermediate and long-end of the yield curve to add duration both on an outright basis and relative to US rates.
- We expect the CNY to remain relatively stable against the USD in the near term, as the currency should be anchored by a strong balance of payment flows. For portfolios where the CNY exposure is actively managed, this will be calibrated depending on developments related to COVID and on the extent of the divergence between PBOC and Fed monetary policies.
- For credit, we see attractive valuations for high-quality names after the recent sell-off in September and October 2021 due to the volatility in the property sector.

To conclude, China bonds are expected to remain attractive in 2022, buoyed by potential moderate policy easing, China's divergent macro-policy cycle versus other major economies, as well as sustainable strength in the CNY which has been supported by China's elevated trade surplus and persistent investor inflows.

Manulife Investment Management

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