Manulife Investment Management

Investment Note

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Russia's invasion of Ukraine has driven a broad sell-off in risk assets. In this investment note, Paula Chan (Senior Portfolio Manager, Asia Fixed Income) and Isaac Meng (Portfolio Manager, Asia Fixed Income) outline their key observations and explain why they believe China onshore bonds and the Chinese renminbi (CNY) show resilient fundamentals in this current environment.

Pockets of resilience in China's bond markets amid uncertainty

With the invasion of Ukraine, we have seen a broad sell-off in risk assets and increased equity and credit market volatility.

Update on China's credit markets

In the China US-dollar-denominated (USD) credit market, benchmark investment-grade names saw spreads widen by 5 to 15 basis points (bps) while high-yield (HY) bonds sold off on weak macro sentiment and company-specific news. Some property issuances were also being marked lower by as much as 10 to 15 points.[1]

Onshore China bonds and CNY show resilience

Meanwhile, onshore China bonds remained stable compared to China USD bonds and continued to show relatively resilient performance. Similarly, the CNY maintained its strength against the USD, hovering at around USD/CNY 6.33 despite emerging-market (EM) currencies being generally weaker against the USD.[2] In contrast to other EM currencies, the CNY retained its strength amid market uncertainty due to relatively low inflation and positive real rates, which helped attract bond inflows.

A more defensive approach amid uncertainty

Amid heightened market uncertainty, we believe in taking a more defensive approach to portfolios with exposure to China USD credit. We have also been less positive on higher beta (risk-sensitive) names and more positive on higher-quality credits since the lead up to the current crisis. We are less positive on selected property names in the China USD credit space in recent weeks due to ongoing volatility in the sector.

Overall, we believe in taking a more cautious approach to the property sector for the time being, as government support has been relatively measured thus far, and it will take more time before we see a more concrete recovery in the sector. Meanwhile, sentiment toward the real estate sector remains weak, and its performance is expected to be volatile in the near term.

Diversification opportunities exist within the China bond space. In our view, we believe exposures to onshore China government bonds (CGBs) and China policy bank bonds can provide investors with diversification and may help manage portfolio risks and potentially benefit from lower onshore rates in the current environment.

Furthermore, we think China's onshore rates could head lower, as more monetary easing should support the Chinese economy while trade remains robust. In contrast to developed market (DM) economies that are hiking rates, China maintains a dovish monetary policy while the economy is expected to rebound in the second half of 2022. As a result, we expect the

[1] Manulife Investment Management data as of 24 February 2022.

[2] Bloomberg, as of 24 February 2022.

China bond asset class to be well supported and backed by positive flows from global investors.

The near-term outlook for China's bond market

Overall, negative market sentiment and heightened volatility are likely to persist in the short term amid geopolitical tensions, particularly in the China USD credit space. Investors remain side-lined, and investment flows are relatively muted. We will closely monitor any impact the crisis may have on China's economy, including the potential for higher inflation as commodity prices are expected to rise.

Due to the relative strength of the Chinese economy and its robust trade position, we maintain our view that the China fixed income asset class will continue to offer global investors diversification benefits and the potential to outperform other DM and EM bond segments this year.

Conclusion

While heightened market volatility and weaker sentiment may continue in the short term, we believe that taking a more defensive approach to China USD credit and the property sector can help manage risks. We see resilient fundamentals in onshore China bonds and the CNY. We expect a rebound in China's economy in the second half of 2022 and further monetary easing to attract inflows from global investors into the China bond market.

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Manulife Investment Management

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