# RMB bonds: An oasis of calm amid volatility

Despite sharp equity market correction in China since 12 June 2015, uncertainty over Greece's future in the EU and continued concern over the potential impact of a US Federal Reserve interest rate hike when it comes, Asian fixed income has remained relatively stable. In this note, Paula Chan, Senior Portfolio Manager in the HKD and RMB fixed income investment team with Manulife Asset Management, shares her outlook for RMB bonds from the perspective of interest rates, corporate credit and currency.

## Asian fixed income defensive amid uncertainty

After a month of nail biting, equity investors are heaving sighs of relief as China's A-share market closed 13 July with a third consecutive day of gains and the EU announced agreement on initial terms for a third bailout package for Greece. Investors in Asian Fixed income, on the other hand, continue to breathe relatively easy as bond markets in the region have remained generally calm. The JP Morgan Asia Credit Index (JACI) remained flat during 12 June to 13 July 2015[1] even as the A-share market shed 21.1% in the same period[2] on the back of panic selling and the fate of the European Union balanced on a razor's edge.

Indonesia is a case in point. While its sovereigns have shed 4.2% year-to-date[3], we believe this is more a result of anticipation of a US Federal Reserve (the "Fed") interest rate hike by end-2015 than to events in China or Greece. In fact, Indonesian sovereigns delivered total returns of +3.7% during the 12 June to 13 July period[3]. Indeed, in the mid to long term the direction of US interest rates likely has more implications for Asian fixed income than do China equity performance or Greece in particular, but we believe that even this has been largely priced into most bond markets in the region.

## RMB rates market holds steady

Renminbi (RMB) bonds – both on and offshore – showed their mettle over the past month. Equity market volatility initially led Chinese government bond (CGB) yields to rise, potentially because investors shifted cash to support margin positions in the A-share market. However, yields subsequently fell back and ended the period lower as the government poured liquidity into the economy via a 25 basis point (bp) one-year lending rate cut to 4.85% on 27 June 2015, a concurrent 50bp reserve ratio requirement (RRR) cut for select banks and direct liquidity injections to the equity market[4].

According to Paula Chan, Senior Portfolio Manager in the HKD and RMB fixed income investment team with Manulife Asset Management in Hong Kong, "Asian – and in particular Chinese – fixed income has been relatively defensive even as equity market volatility in China spread into Hong Kong and Taiwan and wobbled sentiment across the region. Whereas China's fixed income market has been quick to freeze during previous periods of uncertainty, investors were more measured in their response to recent unrest, suggesting a more sophisticated understanding of what is happening in the market."

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[1] The JACI declined 0.03% over the period 12 June to 13 July 2015, Bloomberg.
[2] Shanghai Shenzhen CSI 300 Index, Bloomberg, 12 June to 13 July 2015.
[3] In US dollar terms; HSBC Indonesia Local Currency Government Bond Total Return Index, Bloomberg, as at 13 July 2015.
[4] Bloomberg.

Looking ahead, Chan is constructive on the outlook for CGBs in particular, explaining, “At this point we are comfortable taking on long duration in the segment, as China remains in an easing cycle. The government has implemented four interest rate cuts since November 2014 and another cut is widely expected before end-2015 as part of continued efforts to support the nation’s economy.”

While some market watchers are forecasting aggressive interest rate movement by year end, Chan is more conservative in her outlook. She points out that Chinese equity markets have begun to stabilise and macro indicators have shown an uptick, suggesting that the next interest rate cut will be closer to a 25bp increment. After all, at this point maintaining stability in Chinese markets is about building and maintaining confidence and in this arena the signal of a rate cut is likely more important than the degree.

Meanwhile, market watchers around the world continue to anxiously wait to see what effect, if any, the US Fed rate hike has on global markets once implemented. Against this backdrop, it makes sense for central banks to save their monetary policy ammunition in case it becomes necessary.

## Careful selection to be rewarded in RMB credit

RMB credit remains another thing altogether, according to Chan. “While easy monetary policy and improving economic indicators are supportive of Chinese corporates and the credit sector is home to numerous attractive investment opportunities, it is also strewn with potential landmines. As a result, careful credit selection based on bottom-up analysis of standalone credit capability is the only way to be sure that the investment risk associated with any particular issuance lines up with the reward on offer. We believe that this involves more than just looking at disclosures, and often necessitates analysing the wider industry the issuer is involved in and actually visiting the company to talk with management and get a feel for operations.”

Diligent credit selection has always been important in the China market due to known unknowns such as still evolving regulatory and credit rating frameworks, the potential for shadow banking exposure and uncertainty surrounding the level of guarantees – government or third party – that corporate debt carries.

In the current context this is exacerbated by the potential for further equity market volatility as the currently high level of trading stoppages may be hindering the clearance of margin positions, which paradoxically could lead to liquidity flowing from fixed income to equities. In addition, the overhang of billions of dollars’ worth of shares bought up by non-financial institutions to support the market at the government’s behest could weigh on sentiment in the months to come.

## RMB on a moderate depreciation trend; outperforming regional peers

As China’s capital account continues to open and foreign investors gain increasing access to the nation’s fixed income market – most recently via the finalisation of a mutual recognition scheme for Hong Kong and Mainland China mutual funds – currency is also front of mind for many bond investors. While the RMB has been pretty stable so far in 2015, having shed a relatively modest 0.05% year-to-date despite a period of sharper depreciation in January-February, the trend over the past 18 months or so has been steadily downward[5].

Looking ahead, Chan expects the RMB to continue on its moderate depreciation trend throughout 2015, explaining, “This is likely to be the result of continued strengthening of the US dollar more than intrinsic weakness of the RMB itself. That being said, the RMB should continue to outperform other regional currencies on the strength of its growing prominence in international trade and its expected addition to the IMF’s special drawing rights (SDR) basket from November 2015. Inclusion in the SDR is widely viewed as a step toward the RMB’s emergence as a global reserve currency.”

[5] Bloomberg, as at 13 July 2015.