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DiversiChination

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Our regular readers would have read the word “diversification” countless times across our pieces, especially about it being “the only free lunch in finance”. Now, everyone loves a free meal but certainly you’re not going to eat it only because it’s free, am I right? It needs also to look, smell and taste good, and the various courses need to be well balanced. We have recently added a new course to our menu, with a certain eastern flavour, that should make that free meal a lot more palatable for our clients: Chinese government bonds.

Before we continue, it’s worth highlighting that a good diversifier is not necessarily also a defensive asset, despite defensive assets being often good diversifiers. Defensives are in fact those carrying little risk, typically offering lower return potential but outperforming riskier assets when things go badly, showing little to negative correlation with main risk assets like equities. Diversifiers are instead simply those having different, alternative return drivers than the rest of the portfolio.

Government bonds are very often part of a defensive allocation and are typically good diversifiers, but they don’t all share the same characteristics. Developed market bonds today offer low nominal yields, even lower real yields, and, given the inflationary outlook and the prospects for rate hikes, they don’t have a particularly rosy return outlook. Emerging market bonds offer higher yields, but that comes with significantly higher price volatility, currency and credit risk and a higher correlation with risk assets. Somewhere in between the two we find China, an emerging country on paper, but one of the two largest and most powerful economies in the world, offering a good compromise between the two.

We believe Chinese bonds offer an attractive combination of high income, good diversification benefits (low correlation with global equity and bond markets) and solid defensive characteristics, having held up really well during the pandemic and during most of the crises in the past 15 years.

At the time of writing, the yield on a 10-year Chinese government bond hovers around +2.7%[1], solidly above the latest year-on-year inflation print of +1.5%[1] and down from as much as +3.3%[1] in November 2020. For comparison, a 10-year US Treasury bond is yielding +1.8%[1] today, up from +0.9%[1] fourteen months ago, with the latest headline inflation number at +7.0%[1]. Chinese bonds have outperformed the US thanks to a higher starting yield and divergent monetary policy: while markets have been pricing in increases in interest rates across the Atlantic to fight soaring inflation, reduce the central bank’s balance sheet and withdraw some of the liquidity injected during the pandemic, they have instead been expecting quite the opposite for China.

The short term should be particularly beneficial. The People’s Bank of China is shifting its policy focus from deleveraging to growth, with increased expectation of some monetary easing ahead and thus rising bond prices. The country’s exports and trade balance continue to rise, making the external balance sheet stronger than ever. Chinese government bonds today are well positioned to outperform.

This investment doesn’t come risk free per se and there are a few things to be mindful of: the central bank is not independent from the government, the country’s facing slowing growth (though, still growing its GDP at an impressive +4% p.a.[1]) and a high level of corporate debt and its economic policy remains highly interventionist. However, we think we are being more than compensated for these risks, especially when placing these bonds in a multi-asset portfolio context.

1 Source: Bloomberg L.P. Finance

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