FUNDS

Are China's Bonds as Safe as Treasuries? Not Quite. But They're Closer Than You Think.

By Reshma Kapadia Oct. 22, 2020 5:30 am ET

Illustration by Michael Glenwood

In today's zero-rate world, investors have taken their search for yield and safety around the globe. Lately, that search has landed many of them in China.

"Chinese bonds are the ultimate anti-fragile building block in your portfolio," said Louis-Vince Gave, chief executive of money manager and fund research firm Gavekal Research, in a recent call with clients. He described them as assets that could hold up during periods of market shock.

It's a stretch to put Chinese bonds in the same bucket as U.S. Treasury bonds, but strong forces are driving fund managers to add a small allocation of them. Foreign flows into Chinese bonds have surged: $57 billion poured in through August this year, and the Institute of International Finance, which tracks the data, forecasts another $49 billion by year's end.

Market dynamics are driving some of those flows. China's stocks are still lumped in with emerging markets, but the country's creditworthiness—it has $3 trillion in reserves and its savings outstrip its investments—has earned it a spot among developed-market bonds. The Bloomberg Barclays Aggregate Global Bond Index began adding Chinese bonds in April 2019 and FTSE Russell World Government Bond Index said it would begin next year.

That means mutual and exchange-traded funds will need to have some allocation to the world's second-largest bond market, which will likely spur further investment. "Once it's part of the index, it will be a need-to-know [asset] and increasingly less misunderstood," says Teresa Kong, lead manager of the Matthews Asia Total Return Bond fund (ticker: MAINX), which has almost 9% in Chinese renminbi-denominated bonds.

Another selling point: It's the rare high-quality government bond that offers a positive yield after inflation. Chinese 10-year sovereign bonds yield 3.18% before inflation; U.S. 10-year bonds yield 0.81%.

The pandemic has made Chinese bonds even more attractive. While the U.S, Europe, and Japan have been on a money-printing binge and piling on more debt to support their economies, China has been much more restrained. The People's Bank of China's balance sheet is largely flat, while the Fed's has almost doubled. China also stands apart as the only major economy projected to grow this year, while the U.S. and Europe are still grappling with the virus. That's reflected in the differentials in interest rates.

Bond investors typically face two major risks: higher interest rates and currency fluctuations. China isn't likely to raise rates, and the renminbi will likely stay strong, says Exante Capital's Jens Nordvig. The tariff threat will diminish if Vice President Joe Biden wins the election, as polls suggest. And China's balance of payments is improving as the pandemic caused consumers worldwide to spend more on buying items than on going out to restaurants and events, contributing to a surge in China's exports. Chinese consumers are also spending more money closer to home.

What about concerns around transparency, government manipulation, and capital controls? Those are risks—but not the way some fear. "The idea they are Communists and are going to bring down the shutters and you can't get your money back is something of a trope," says Edmund Harriss, who has managed the Guinness Atkinson Renminbi and Yuan Bond fund (GARBX) for a decade. "China does about $3 trillion in trade in goods and services and is a major oil importer. It's not an economy that is suddenly going to retreat and say you can't have your money back."

China has also taken steps to liberalize the bond market and make it easier for foreign investors, such as allowing repatriation of dividends and making the settlement process conform more to international standards. China's debt continues to be an issue, but analysts put it in the slow burn category, especially after the country's deleveraging push a couple years ago. The opacity of corporate governance structures and weak accounting and auditing standards among Chinese companies are red flags, but "judicious investors who are willing to do their legwork should be able to find plenty of investment opportunities that offer good yields without unreasonable risks," says Eswar Prasad, senior fellow at the Brookings Institution and the former head of the International Monetary Fund's China division.

Xi Jinping's efforts to expand China's presence and bring more countries into its orbit also mitigate the risk in Chinese bonds. The renminbi is now tied to a basket of currencies, not just the U.S. dollar. China is also the largest trading partner for many countries, including Asian neighbors and Germany. Using the renminbi for some of those transactions would be a natural evolution.

The push to internationalize the renminbi becomes even more important as Beijing looks for ways to protect itself from sanctions that could result from U.S. trade tensions. "Their desire to build a reserve currency is essentially the protection as an international investor," Nordvig says, adding investors should consider China's bonds.

Few funds exclusively own Chinese bonds—and those that do are tiny, including Harriss' $3 million Guinness fund and the $26 million VanEck Vectors ChinaAMC China Bond ETF (CBON), which has a hefty 0.5% expense ratio. But as interest grows, more options are likely on their way. B

Chinese Bonds Are Coming to Your Portfolio

These funds are tiny but have been early in investing in Chinese bonds. More options are likely to follow.

Fund/Ticker	AUM ($mil)	1-YR Return	3-YR Return	Comment
Guinness Atkinson Renminbi Yuan & Bond Fund/GARBX	3.4	8.29	3.02	Tiny, but has been around for a decade. Uses long history investing in China to invest beyond just government debt
Matthews Asia Total Return Bond/MAINX	$109.80	3.86	3.59	Small, pricey fund, but run by Asia experts with long track record; Only 7% is invested in renminbi-denominated bonds
VanEck Vectors ChinaAMC China Bond ETF/CBON	25.6	10.72	4.42	Small and pricey with a 0.50% expense ratio but one of few ETF options for Chinese bond exposure

Source: Morningstar

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