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China’s Bond Market

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In this *iFlow Vision*, we explore how China’s bond market has performed and its future prospects.

To access the whitepaper **click here**.

China’s Bond Market

EMBRACING GROWING PAINS

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Risks, Reforms and Real Rates

Two-way flow to become more apparent as inclusion wins give way to maturity

After a difficult H1 dominated by domestic growth imbalances and volatility from regime shifts in global yields, China is now expecting more stable macro conditions for the second half of the year. If realized, a calmer market environment will allow authorities to continue long-term reforms designed to modernize China’s bond markets. Beijing will continue its efforts to improve foreign access to domestic markets, while the prospect of the opening of the Southbound Bond Connect also stands to improve two-way flow as Chinese investors will be able to better diversify holdings through increasing ownership of foreign bonds.

One of the biggest global investment themes in 2020 was the sharp rise in foreign purchases of Chinese government bonds (CGBs) – which the market now mostly considers a reserve asset. Even though index inclusion and better access channels were important technical drivers, international investors viewed the trajectory of China’s economy and bond yields as favorable, especially at a time when there was no clear way out of the pandemic for other markets. Initially, 2021 was expected to be another straightforward continuation of H2 2020 trends, where asset allocation tilted toward China and Asia-Pacific. However, the region’s weak performance in vaccinations relative to the US and Europe has severely challenged this narrative. Domestic economic needs have now necessitated more easing in China, and yield-seeking flow is now looking elsewhere.

In this piece, we take stock of how China’s bond markets have performed and its future prospects. Using the framework detailed in iFlow EM, we find that China suffered from strong outflows on the financial account in Q2. Policy and hedging needs will also remain sources of pressure on the renminbi. On the other hand, further index inclusion and the prospect of better growth in H2 will help stabilize flows, while we believe ESG is a major opportunity for Chinese bonds. On the risk front, corporate dollar debt exposure remains a bigger worry compared to asset allocation outflows upon the launch of Southbound Bond Connect.

1 China’sBond Market: Embracing Growing Pains

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