CHINA GOVERNMENT BONDS AND THE RENMINBI

SOME MORE PRESSURE ON THE CURRENCY, LESS ON BONDS

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SUMMARY

- The sharp rise in the 10-year US Treasury yield since the start of the year caused the rate differential between Chinese 10-year bonds and their US equivalents to turn negative in early May for the first time since 2010. Since then, fears regarding a potentially sharp economic slowdown in the US have pushed the US 10-year yield slightly below the Chinese one.
- Chinese bonds' total return performance in local currency has been vastly superior to the performance of US Treasuries year to date. But the renminbi's recent sharp depreciation against the US dollar means Chinese bonds' performance is negative once converted into US dollars (but still positive in euro).
- We expect the 10-year Chinese sovereign bond yield to rise slightly from 2.76% (on 27 May) to 3.2% by year's end as fiscal policy becomes more expansive in order to achieve the authorities' economic growth targets. Higher yields from increased government bond issuance could then attract foreign investors back to the Chinese market if the rate differential with US Treasuries turns significantly positive again.
- We have moved to neutral from overweight our stance on Chinese sovereign bonds, bringing it into line with our position on government bonds globally. Monetary policy divergence with the US is likely to weigh further on the renminbi in the coming months. This could limit monetary policy easing by the People's Bank of China, leaving fiscal policy to do the heavy lifting as China seeks to restore economic momentum.
- Our central scenario is for the USD/CNY rate to stabilise slightly below CNY7.00 in the coming months, in line with a US dollar that remains relatively stable at a high level and a renminbi trade-weighted index that continues to adjust lower. Further out, we see the renminbi rebounding towards CNY6.60 over the next 12 months as the dollar weakens.

No pressure on Chinese yields (just yet)

Chinese sovereign bonds stand out for having resisted the fast rise in yields seen elsewhere. The 10-year Chinese renminbi government bond yield stood at 2.76% on 27 May, being flat year-to-date compared to the 123 bps increase in its US equivalent, which stood at 2.74% (on 27 May, *see chart 1*). **After 10 years when the rate differential was always positive in Chinese bonds' favour, the sharp increase in the 10-year Treasury yield caused the differential to turn negative in May**. At the heart of this shift has been the monetary policy divergence between the US Federal Reserve (Fed) and the People's Bank of China (PBoC).

Faced with inflation that has accelerated well above its target since mid-2021, **the Fed has been hiking its policy rate and will start reducing its balance sheet from June onwards**, thus instigating what is called 'quantitative tightening'. But just as the Fed endeavours to

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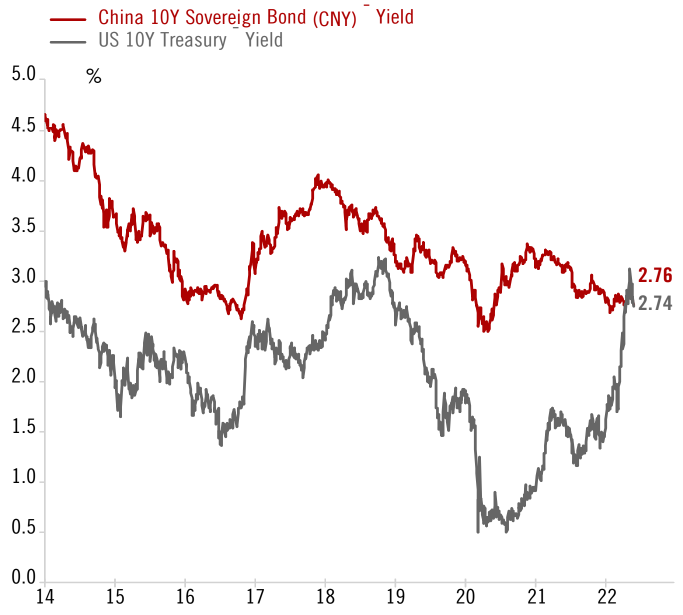
cool down the US economy to stem inflation, the PBoC is faced with a significant slowdown of the Chinese economy (mostly due to covid-19 related lockdowns and deep-seated problems in the property sector). Our economists now forecast Chinese GDP growth of only 4.0% in 2022, well below Chinese government's target of 5.5% (see Revising down our forecast for Chinese growth).

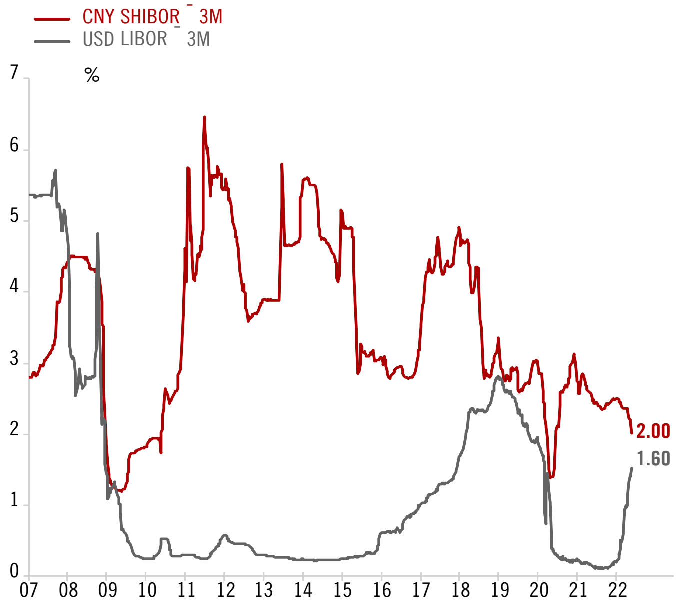
Since inflationary pressures are contained, **this means that the PBoC could continue to ease monetary policy in a bid to boost growth prospects to help the government reach its growth objectives.** In May, the PBoC introduced measures to support housing sales by cutting minimum mortgage rates for first-time homebuyers and lowering its five-year loan prime rate (LPR), which serves as the benchmark for mortgage loans. However, it has not cut its policy rate (the medium-term lending facility (MLF rate)) since January, suggesting reluctance to resort to more aggressive monetary stimulus—possibly due to concerns about renminbi depreciation and capital outflows. Nevertheless, having already cut it in April, we expect the PBoC to announce an additional 25 bps reduction in the required reserve ratio (RRR) for all commercial banks.

CHART 1: CHINA AND US 10-YEAR GOVERNMENT BOND YIELDS



Source: Pictet's wealth management division – Factset, 27.05.2022

CHART 2: CHINESE AND US SHORT-TERM RATES



Source: Pictet's wealth management division – Factset, 27.05.2022

Capital outflows have weighed on the renminbi

The divergence in monetary policy stance has led to a continued rise in US short-term rates while Chinese short-term rates have started to fall (*see chart 2*). This narrowing rate differential, along with increasing concerns about China's economic outlook and increasing geopolitical uncertainties, has triggered investor outflows from Chinese securities (in particular from Chinese bonds). At the same time, China's weakening export performance means the balance of payments has turned less supportive of the renminbi.

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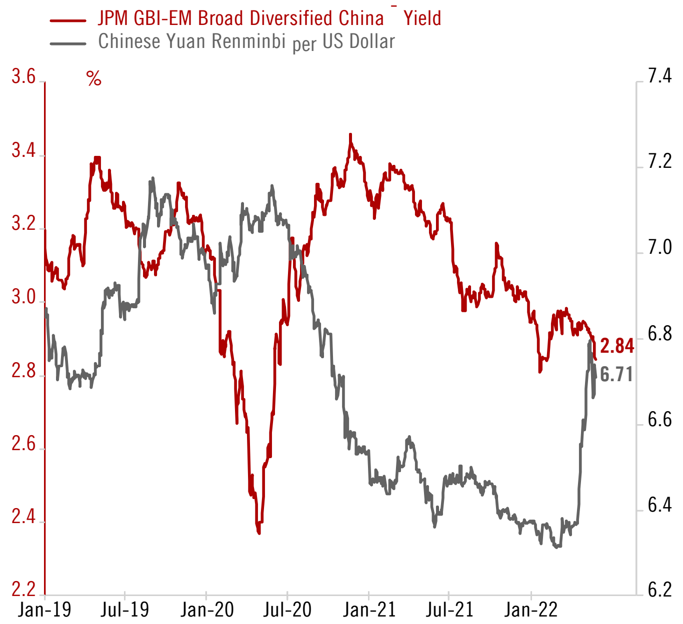
These factors have led to a depreciation of the renminbi against the US dollar, reaching a year-to-date low of CNY6.81 on 13 May (*see chart 3*). Currency weakness means that although Chinese 10-year bonds' total returns performance remain positive in both renminbi and in euro year to date (at 1.7% and 2.6%, respectively on 27 May), it is negative once converted into US dollars (at -3.4%).

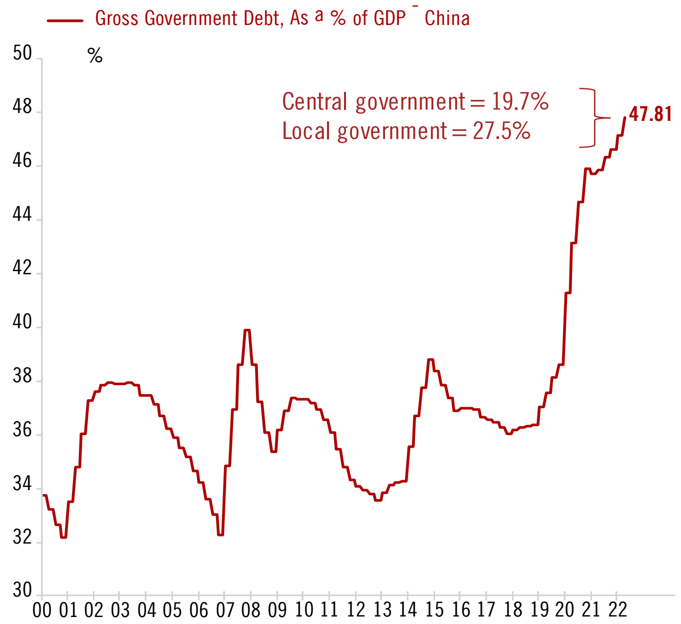
The renminbi's previous strength (it hit a seven-year high in March in trade-weighted terms) **was probably unwelcome to the Chinese authorities** given its impact on economic momentum and limited concerns about inflation. However, **the authorities are also aware that too weak a currency may worsen capital flows out of China and endanger financial stability**. Overall, we would not underestimate their willingness to keep the renminbi stable after its recent sharp adjustment.

CHART 3: CHINESE SOVEREIGN BOND YIELD AND USD/CNY RATE



Source: Pictet's wealth management division – Factset, 27.05.2022

CHART 4: CHINA GOVERNMENT DEBT IN % OF GDP



Source: Pictet's wealth management division - Factset, Q1 2022

CNY depreciation could be limited, but so could the attractiveness of Chinese bonds

Our contention that the maximum covid-related damage to the Chinese economy will occur in the current quarter could limit the downward pressure on the renminbi and Chinese sovereign bond yields further out. That said, as we see constraints on both fiscal and monetary policy, a slow rate of economic recovery in the remainder of this year may not provide a strong boost either to the currency or to government bonds.

But we admit that monetary policy divergence between China and the US could narrow as a slowing US economic growth may limit the Fed's ability to tighten policy as much as the market expects. Meanwhile, the front-loading of government bond issuance in China

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has clearly supported infrastructure investment year-to-date and could drive the country's economic recovery. Chinese central government debt-to-GDP ratio, which stood at a new high of 47.8% in Q1, is likely to rise further this year because of higher local-government bond issuance while their revenues from property sales has slumped (*see chart 4*).

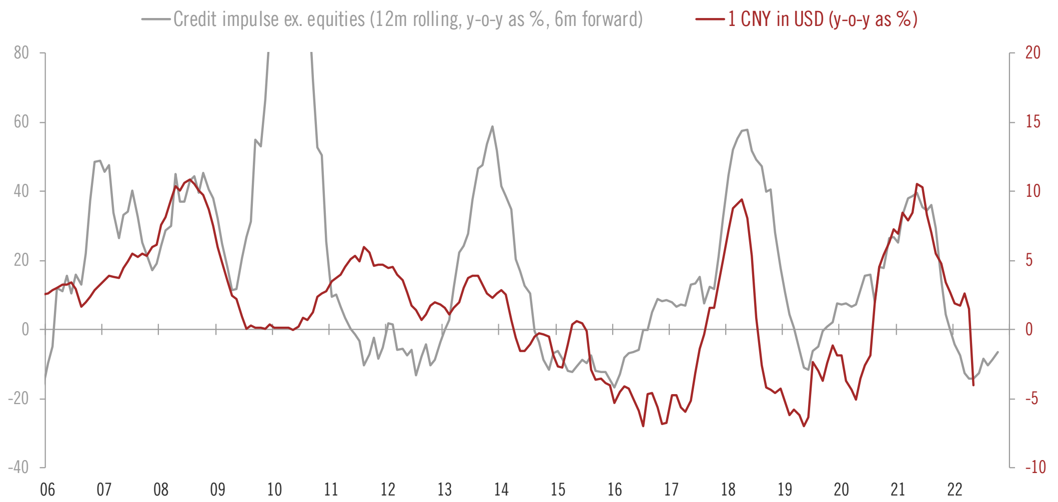
Increased bond supply coupled with lower foreign investors' demand could push Chinese long-term sovereign bond yields slightly higher in H2, especially if economic growth rebounds as we expect. We see the 10-year Chinese yield moving up from 2.76% (on 27 May) to 3.2% by the end of the year. Higher Chinese yields could then attract foreign investors back if the rate differential with US Treasuries is comfortably positive again and the outlook brightens for the renminbi.

However**, a change in the Chinese authorities' 'zero-covid' policy and/or more meaningful stimulus measures may be needed to significantly improve the outlook for the renminbi**, while heightened geopolitical tensions with the US (stemming from trade tariffs and China's strategic partnership with Russia) remain an issue.

Our central scenario is for the USD/CNY rate to stabilise at just under CNY7.00 in the course of the next few months. This would be consistent with the USD stabilising at a high level and a further slight downward adjustment in the renminbi trade-weighted index. **Over the next 12 months, we believe the CNY could rebound towards CNY6.60 as the dollar weakens.**

Given our less constructive view on the renminbi and our expectations for slightly higher yields, **Chinese government bonds look less attractive than before in the current climate. We have thus moved our stance on them from overweight to neutral, bringing it into line with our position on government bonds globally.**

CHART 5: CHINA'S CREDIT IMPULSE VS. USD/CNY



Source: Pictet's wealth management division – AA&MR, Refinitiv, 25.05.2022

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