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China bonds to offer diversification benefits to Hong Kong's MPF system

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In December 2021, the Hong Kong Financial Services and the Treasury Bureau and the Mandatory Provident Fund Schemes Authority announced plans to amend legislation governing MPF investments to include bonds issued by the Central People's Government (CPG) and Mainland policy banks. The much-welcomed move gives investment managers further flexibility to implement appropriate strategies that best meet the retirement investment objectives of MPF members. When the legislation becomes effective, potentially in mid-2022, China bonds could potentially enhance the stability of MPF portfolios amid increasingly volatile markets.

For the past few years, onshore Chinese government bonds have been particularly attractive for investors due to their yield advantage and low correlation with other assets, making the performances of Chinese government bonds and policy bank bonds relatively stable with low volatility. These bonds would have been able to provide diversification benefits to investors. With the potential new legislation in place, we believe the timing is appropriate for investors to consider gradually increasing their MPF portfolio exposure to China government bonds and policy bank bonds.

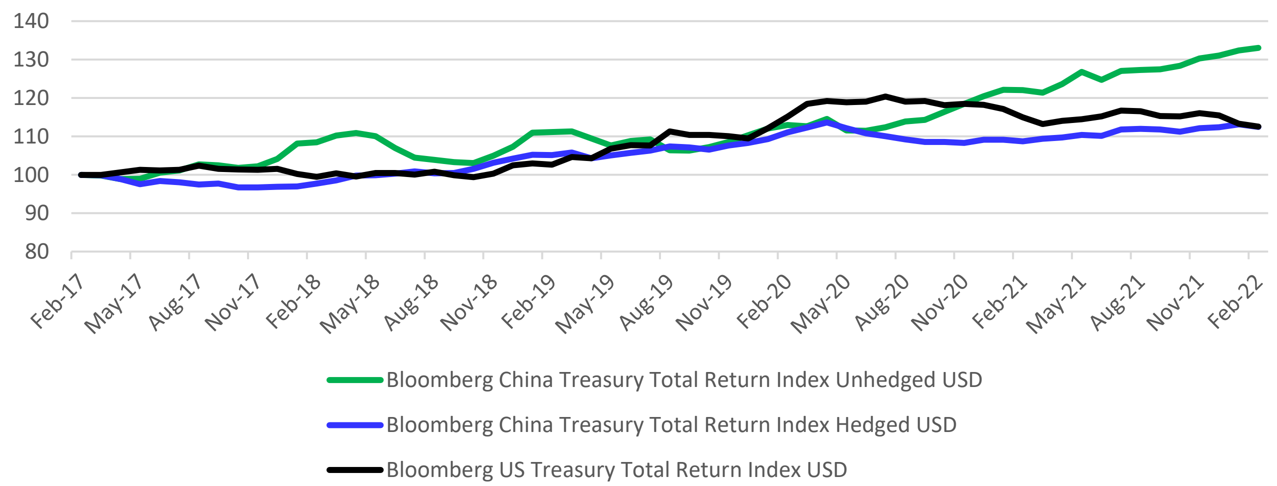
How will China Bonds drive MPF returns?

Given the generally weaker outlook for the Chinese economy in 2022, there is a strong case for China to pursue some moderate easing of both fiscal and monetary policies to support the economy. As interest rates in China are expected to remain low, this is a positive part of the interest rate cycle to invest in China bonds as lower interest rates will help drive positive performance in the asset class.

Higher Yield

The 10-year Chinese Government Bond yield is currently trading around 115 basis points (1.15%) higher than the equivalent Hong Kong government bond and 96 basis points (0.96%) higher than the equivalent US Treasury bond. On this basis, China bonds offer a yield pick-up or higher yield versus equivalent Hong Kong and US government bonds. Also, given that inflation rate in China has been lower than that of the US, Chinese bonds also offer attractive real yields for investors after taking into account the impact of inflation. We believe China government bonds and the Chinese renminbi (CNY) have the potential to act as hedges against US inflationary pressures. (see Chart 1).

Chart 1: China Treasuries (hedged to USD) have kept pace with US Treasuries and outperformed on an unhedged basis over last 5 years



Bloomberg, data as of 28 February 2022.

What are potential risks?

Bond defaults currently taking place are concentrated in the private sector and the property sector in particular. As Chinese government bonds and policy bank bonds are effectively issued by the Chinese government and policy banks that are closely associated with the Chinese government, the risk of default is considered extremely low. This contrasts with private sector bonds which do not have the backing of the Chinese government and are considered to have higher credit risks.

As we are seeing higher defaults in the corporate bond space and deleveraging is already taking place, we believe the Chinese government will likely pursue moderate policy easing to support the domestic economy. Expectations for lower interest rates will help support the performance for Chinese government bonds and policy bank bond which trade closely based on the direction of interest rates.

China Bond Market Outlooks – Implications for MPF Investors

The introduction of China bonds for MPF investors is a positive move and is likely to enhance risk-adjusted returns over the long term due to their attractive yields and enhanced diversification benefits.

Allowing an even larger range of bond issuers from the China local market will open up a large and fast-growing bond market for investors and expand the investment universe to offer the potential for even higher investment returns and diversification opportunities. This should be done gradually over time but ultimately expanding the investment universe to include state-owned enterprises (SOEs) and eventually private-owned enterprises (POEs) from other dynamic sectors and economic regions within mainland China would be appealing for MPF investors over the longer term.

As we have seen with the volatility in the onshore corporate bond market this year, MPF investors should partner with experienced investment managers that have the sufficient capabilities and resources dedicated to the broader China bond market to navigate this exciting and fast-developing part of the market.

Why is it crucial to start investing now?

It is never an easy task to manage a robust investment portfolio, in order to accumulate sufficient wealth for retirement. Substantially, members must understand which investments make the most sense for their age and financial situation. Investments with too much risk near retirement age can irreparably reduce an account balance once withdrawals begin, while investments that are too conservative can fail to generate enough retirement income for daily expenditures.

Given negative market sentiment and heightened volatility are likely to persist in the short term amid geopolitical tensions, it is important to make informed investment choices with the consultation of experts. It will be no surprise to see 2022 being a challenging environment for all, hence it is essential for investors to apply a long-term strategic perspective and take an active approach to retirement planning, this way investors will be one step closer to preparing sufficient capital to deal with unprecedented changes in the economy and domestic markets.

About HKRSA

The Hong Kong Retirement Schemes Association (HKRSA) was established in 1996 to promote the interests and best practices of retirement schemes in Hong Kong including provident and pooled retirement funds. The HKRSA is a not-for-profit, non-political association, which represents retirement schemes and their members, providing a forum for discussion of issues of current and topical interest.

About Manulife Investment Management

Manulife Investment Management is the global brand for the global wealth and asset management segment of Manulife Financial Corporation. We draw on more than a century of financial stewardship and the full resources of our parent company to serve individuals, institutions, and retirement plan members worldwide. Headquartered in Toronto, our leading capabilities in public and private markets are strengthened by an investment footprint that spans 18 geographies. We develop innovative global frameworks for sustainable investing and maintain a high standard of stewardship where we own and operate assets, and we believe in supporting financial well-being through our workplace retirement plans.