THE FUTURE OF FIXED INCOME

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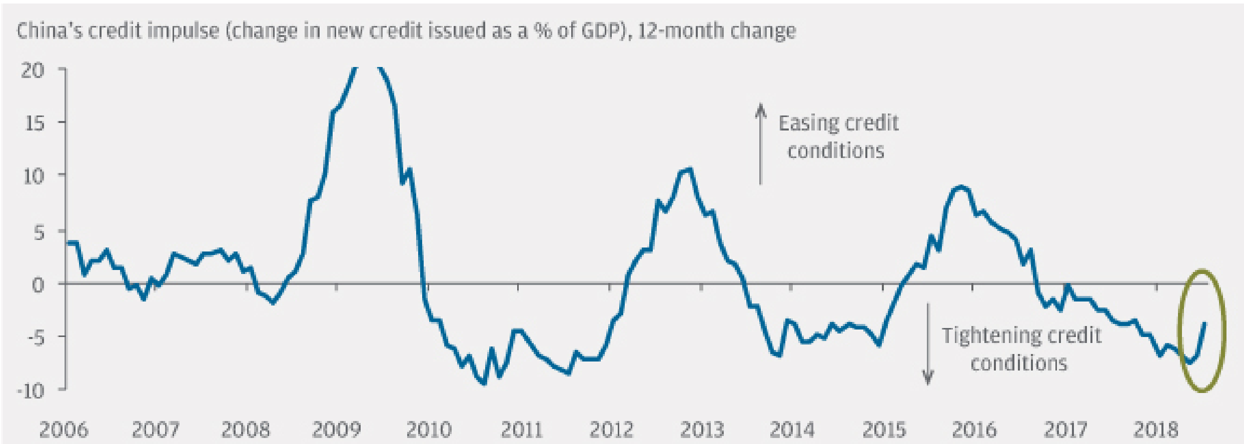
Beijing at the helm

China's monetary and fiscal efforts to manoeuvre a soft landing and cope with pressure from increased trade tensions are beginning to pay off. What are the broader implications?

Fundamentals:

China's credit impulse ticked up in January, suggesting that the four cuts to the required reserve ratio over the past year—designed to encourage banks to support the private sector—are transmitting through to the broader economy. Total social financing growth, which includes forms of financing outside the conventional bank lending system, also gained momentum. Meanwhile, Beijing has shown increased willingness to act on the fiscal front, implementing multiple tax cuts, with the potential for more. Here, too, the impulse is starting to feed through to the economy, with commodity imports moving meaningfully higher and fixed asset investment expected to pick up. While trade rhetoric has broadly improved and an extension to the 1 March tariff truce deadline looks likely, downside risk to upcoming data releases persists, given the overhang of uncertainty. The direction of Chinese data will be particularly important to monitor for Europe, which has arguably suffered the most from weakness in China given its export-oriented economy. In particular, watch for the longer-term trajectory of China exports, which rose in January but were likely impacted by front-loading, and therefore may experience a payback in February.

Tick up in China's credit impulse suggests transmission of monetary easing to the broader economy



Source: Bloomberg; data as of 31 January 2019.

Quantitative valuations:

The rally in risk assets has persisted, albeit with slower momentum: global high yield generated a total return of 0.4% and emerging market local bonds were up 0.3% in the week to 19 February. Much of the strong performance year to date has been driven by the dovish turn from central banks—and they are unlikely to get more dovish from here. However, it's possible that the risk rally could be further propelled by signs that China's easing efforts are succeeding in stimulating its economy. We are mindful of the speed of the recovery so far, though, and recognise that valuations are not as attractive as they were at year-end.

Technicals:

Technical factors also bear out the impact of China's easing measures: issuance of special bonds in the Chinese local government bond space totalled approximately RMB 400 billion in January, compared to less than RMB 200 billion in the previous three months combined. The increased issuance of these bonds, which specifically fund infrastructure projects and the like, further supports the view that fixed asset investment should continue to trend upward. The data also suggests the authorities have been successful thus far in following through on their intention to focus the transmission impact on corporations and infrastructure, rather than generically re-leveraging the broader domestic economy.

What does this mean for fixed income investors?

Easing measures in China have been incremental, but in aggregate they could have a meaningful impact on the trajectory of the domestic economy—and subsequently the global economy. However, we anticipate further downside risks to economic data releases over the next few months as tariffs imposed in 2018 continue to weigh on sentiment and consumer activity. With credit conditions showing some improvement recently, though, a sustained pickup in economic activity in the second half of 2019 is likely. Watch Europe as a potentially significant beneficiary.

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