The case for China fixed income: Better growth, fewer spillovers

The Chinese economy has at last broken free of pandemic restrictions and is now accelerating. This change has caught the attention of investors, who are now looking to participate. For those looking to access the opportunity via China's bond markets, we think some flexibility and nuance is required.

The opportunity is likely broader than just a play on Chinese reopening. Over the last three years, China has worked to address imbalances in its domestic economy, not always to the benefit of foreign investors. For example, the decision to reduce speculative activity in Chinese real estate may generate long-term stability in the sector, but has also played out negatively for bondholders to date. Moving forward to the present, however, we see an improving investment case for Chinese credit.

Greater economic diversification

Before the pandemic triggered lockdown, Chinese policymakers were focused on diversifying the country's economy away from excessive dependence on export-led growth. We see this trend continuing in a post lockdown world. In addition to services consumption, we think manufacturing and infrastructure investment are likely to support Chinese growth in 2023. The renewed interest of the Chinese authorities in both technological progress and next generation manufacturing should sustain investment spending as a source of growth in the current year. These themes should contribute positively to the case for both Chinese fixed income in general and credit specifically.

Economic rebound

Improving GDP growth is central to the quality of this opportunity. Our economists think Chinese economic growth should rapidly trend towards 5.0%, likely without creating a substantial inflationary impact. This resurgence has elevated market expectations around both growth and returns, with some more bullish voices calling for 6% GDP growth in 2023. In addition to improving activity levels and a recovery in consumption, we think Chinese growth is helped by more anchored energy prices and a normalised supply chain.

Recovery in manufacturing activity

While China's forecast growth recovery is eye catching, it is important to understand what stronger growth means within a regional and global context. China's well developed export sector is an important contributor to the global manufactured goods chain. A recovery in manufacturing activity should support developed market growth through lower inflation and greater availability of goods.

Increased demand for selected commodities

Domestic sources are driving Chinese consumption. Regionally, we see less than 3% of Chinese consumption coming from broader Asian value add. China uses coal power more intensively than comparable developed market economies: 55% of the country's power needs in 2022 were met through coal mining.[1] Hence, a recovery in activity may not directly contribute to inflation in oil prices. China's pickup in activity might increase demand for other industrial inputs, such as iron ore and copper, however.

Boost to global tourism

China's reopening has other impacts outside of China. We see regional trade partners and commodities exporters benefiting, while the tourism sector is likely to be boosted by the return of Chinese tourists. We think 2023's tourist arrival numbers will eventually reach around 90% of 2019's pre pandemic levels, with countries such as Thailand, Mexico, Turkey, and the Dominican Republic already reporting an improvement in tourist arrival data.

A stable monetary backdrop

Collectively, we see the Chinese recovery supporting a Chinese, Asian, and broader emerging market credit theme, boosted by a stable monetary policy backdrop. In our view, the absence of inflationary pressure in China should enable policymakers to maintain a neutral stance in the near term. We think it is possible that the People's Bank of China maintains its current funding rates, while accommodating government bond issuance. With the US dollar showing exceptional strength, relatively tight Chinese rates leave us less positive on China's local currency.

Opportunities in Chinese credit

While not explicitly positive for Chinese rates, the current environment may present an opportunity around Chinese credit. In general, we see spreads presently trading above their three-year average, which further supports our investment case. Recent policy changes around housing and property development may contribute to a recovery in selected real estate credits, though we caution that those in default are unlikely to recover, in our view. We think government policy priorities will continue to focus on small and medium sized enterprise, green development, and unfinished residential development.

[1] UN Emissions Gap Report, January 2022.

Regulatory reform provides a catalyst

We see opportunities in other sectors outside real estate, where valuations are relatively attractive. Regulatory reform acts as an additional catalyst and we think the technology space may present opportunities in the near term. We highlight that Chinese corporates provide positive exposure to real growth in the economy. With pent up demand and excess savings, the Chinese consumer economy may contribute positively to the country's growth story.