Matthews Asia

Matthews Asia Perspective
The Alpha Potential in Asia's Bond Market

Teresa Kong, CFA
Portfolio Manager
Matthews Asia

Wei Zhang
Portfolio Manager
Matthews Asia

Representing the equivalent of US$11.5 trillion in notional value outstanding, China's onshore renminbi (RMB) bond market is the largest in Asia, having overtaken Japan's market at the beginning of 2019. The size of China's market is now second only to the U.S. Notably, in our view China is one of the few places in the world where investors can still find attractive risk-adjusted returns among bonds.

The market also remains under-researched, meaning that an active approach to security selection has the potential to add significant value to investors over the long term. Yet some investors are not gaining access to this vibrant market, and if they do, it is via suboptimal index strategies. With local-currency Chinese bonds gaining greater inclusion in global benchmarks, now may be a good time for global investors to learn more about China's onshore bond market. By making deliberate, more-conscious decisions about how to access China's bond market, investors can better align their portfolios with their goals, objectives and time horizon.

Index Inclusion Captures Attention of Institutional Investors

The decision by J.P. Morgan's Government Bond Index-Emerging Markets (GBI-EM) Global Diversified Index to include China was an important development and serves as recognition of the opening up of China's capital markets. This marks the second major bond index to include China, after that of the Bloomberg Barclays Global Aggregate Bond Index (Global Agg), which started to include China in April of this year. Being included in widely tracked indexes such as the JPM GBI-EM Global Diversified Index and the Global Agg should help increase China's share in global institutional fixed income portfolios.

The inclusion into J.P. Morgan's widely tracked GBI-EM bond index will start Feb. 28, 2020, and will take place over a 10-month period. Inclusion into the index is estimated by J.P. Morgan to generate approximately US$250 to US$300 billion in inflows to China. Foreign investors have been underweight Chinese bonds. We believe Chinese bonds as an asset class offer unique advantages including attractive yield, low correlation with other major asset classes, and low currency volatility.

Bonds With Attractive Risk-Adjusted Returns

Chinese local-currency bonds offer an attractive solution in a world where approximately US$17 trillion bonds globally trade at a *negative* yield. (Bloomberg data as of August 31, 2019.)

Chinese bonds offer:

- 3% yield 10-year maturity A+ rated sovereign debt
  - — German and French government bonds yield below zero
  - — Japanese government bonds yield below zero
  - — U.S. 10-year Treasuries yield 1.76%
- Low correlation with other asset classes
- Currency with reduced volatility due to central bank management

For investors who are looking for additional return at reduced volatility, we believe Chinese bonds offer a great opportunity for diversification.

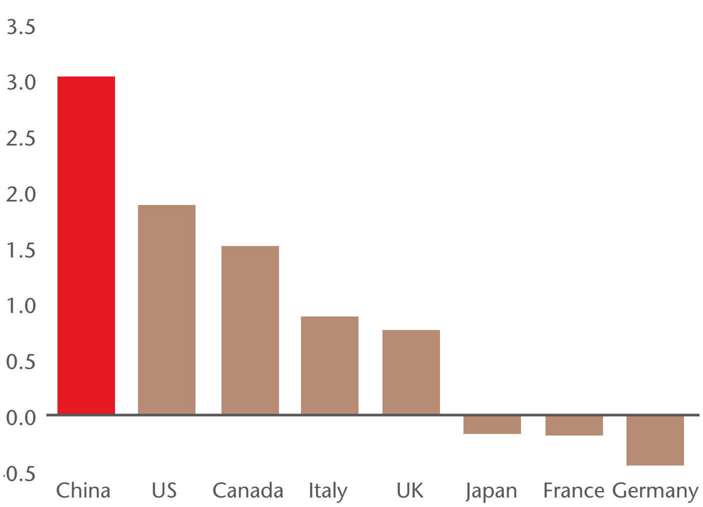
Foreign Investors Are Underinvested in China's Bond Market

Despite its attractive investment characteristics and large size, China's bond market remains underinvested by foreign investors. Foreign investors currently own about 2.5% of the China bond market. This can be attributed in part to:

- Limitation of indexes tracking China's bond market
- Investors' unfamiliarity with China's bond/financial system
- Other regulatory concerns

The inclusion into indexes such as the JPM GBI-EM Global Diversified Index goes a long way to solve the first hurdle. As investors become more familiar with China's system, their comfort level will gradually increase. Regulatory uncertainty remains a concern. Despite the perceived unpredictability of Chinese regulations, however, China has consistently liberalized policies regulating inbound capital flows. The recent significant measures include removing the quota for Qualified Foreign Institutional Investor (QFII) investors, allowing unlimited inflow of capital by current QFII investors. Other reforms bring operational standards more in-line with international standards, including delivery vs. payment (DVP) and the introduction of T+3 settlement cycle on the China Interbank Bond market where the vast majority of bonds trade.

FIGURE 1. ATTRACTIVE YIELDS



Source: Bloomberg, Data as of September 12, 2019

FIGURE 2. LOW CORRELATIONS TO OTHER ASSET CLASSES

Barclays China Aggregate

Global HY	-0.01
US HY	-0.01
CEEMEA Credit	0.05
LATAM HY	0.05
Asia High Yield	0.06
Asia Credit	0.08
Asia Investment Grade	0.08
US Credit	0.10
LatAm Credit**	0.10
Euro Bond	0.14
Emerging Market Bond	0.15
US Bond	0.18
US Treasury	0.20
Emerging Market Local Gov't Bond*	0.24
Global Bond	0.27
Asia Bond	0.33

Global · Emerging Market (EM) · Credit · High Yield

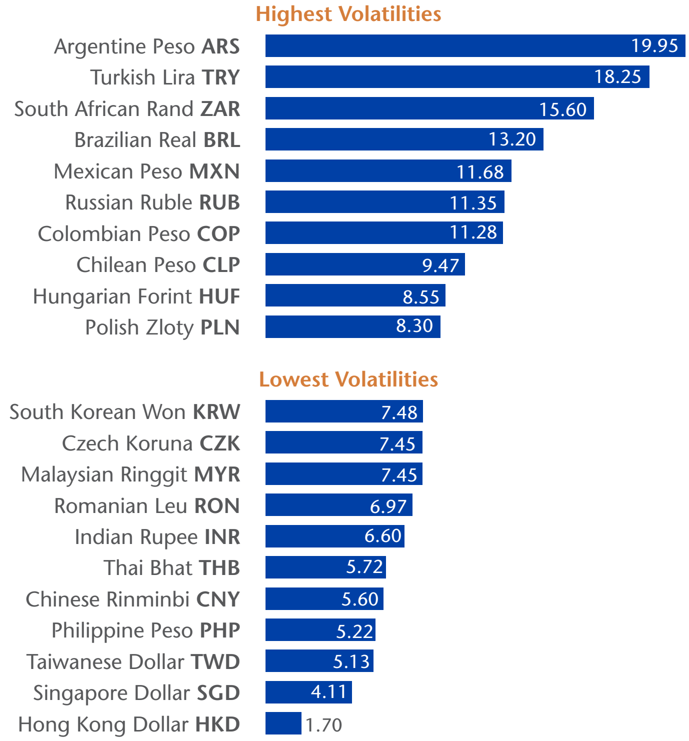
Asia Credit (J.P. Morgan Asia Credit Index–JACI), Asia High Yield (high yield portion of J.P. Morgan Asia Credit Index), U.S. High Yield (BofA Merrill Lynch High Yield Master II Index), LATAM High Yield (J.P. Morgan CEMBI Broad Latin American High Yield Index), Global High Yield (BofA Merrill Lynch Global High Yield Index), U.S. Investment Grade (BofA Merrill Lynch U.S. Corporate Master Index), CEEMEA Credit (J.P. Morgan Corporate Broad EMBI CEEMEA Index), Asia Bond (HSBC Asian Local Bond Index –ALBI), LATAM Credit (J.P. Morgan Corporate Broad EMBI Latin America Index), Emerging Markets (EM) Bond (JP Morgan Emerging Markets Bond Index Global), U.S. Bond (Barclays U.S. Aggregate Bond Index), Euro Bond (Barclays Euro Aggregate Bond Index), Global Bond (Barclays Global Aggregate Bond Index), Emerging Market Debt (J.P. Morgan EMBI Global) U.S. Equity (S&P 500 Index), Europe Equity (MSCI Europe Index) Asia ex Japan Equity (MSCI All Country Asia ex Japan Index), Asia Credit (Markit iBoxx Asian Local Bond Index), U.S. Credit (BofA Merrill Lynch US Corporate Index, Asia Investment Grade (Investment Grade portion of JACI Index) and U.S. Treasury (Bloomberg Barclays US Treasury Index)

Source: Bloomberg; data period Dec 1998 to June 2019; *Dec 2001 to June 2019, **2002 to June 2019, †2000 to June 2019; Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission. See Disclosures for full disclaimer.

The Role of Active Management

Investing in an unknown market is uncomfortable for any investor. This is especially the case when it comes to China, where the market is not fully liberalized, and due to the mixed capitalist and planned nature of its economy. In a complex market such as China, we believe active management and local expertise are two invaluable factors to generate alpha and minimize loss. Investing in China for more than 25 years, Matthews Asia has a deep understanding of the Chinese system and bond market.

FIGURE 3. LOW CURRENCY VOLATILITY



Source: Bloomberg, Data as of September 12, 2019

From a bottom-up perspective, we find some of the most interesting opportunities for generating alpha outside of the bonds that appear in global indexes, which are concentrated in central government and government-agency bonds. Rather, we currently find more attractive investment opportunities among corporate bonds, an area where we believe active management can add the most value. When generating investment ideas and evaluating the financial health of bond issuers, our bond managers have decades of experience investing in both emerging and developed markets, as well as the ability to draw on insights from our equity teams.

The opening of China's onshore bond markets is a welcome development for investors seeking to enhance the overall efficiency of their bond portfolios. We believe active strategies focused on domestic Chinese bonds can help investors add new sources of alpha within their broader portfolios. In our view, the depth and quality of China's universe, as well as the potential for generating attractive risk-adjusted returns, make Chinese local currency bonds an important source of diversification for investors around the globe.

In the United States, this document is issued by Matthews International Capital Management, LLC. **In Singapore**, issued by Matthews Global Investors (Singapore) Pte. Ltd. (Co. Reg. No. 201807631D). **In Hong Kong**, this document is issued by Matthews Global Investors (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission in Hong Kong (SFC). **In the UK**, this document is issued by Matthews Global Investors (UK) Limited, which is authorized and regulated by the FCA, FRN 667893. In the UK, this document is only made available to professional clients and eligible counterparties as defined by the Financial Conduct Authority ("FCA"). Under no circumstances should this document be forwarded to anyone in the UK who is not a professional client or eligible counterparty as defined by the FCA. This document has not been reviewed by any regulatory authorities.

*Source: Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission. BofAML permits use of the BofAML indices and related data on an "as is" basis, makes no warranties regarding same, does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the BofAML indices or any data included in, related to, or derived therefrom, assumes no liability in connection with the use of the foregoing, and does not sponsor, endorse, or recommend Matthews Asia, or any of its products or services.

The JP Morgan Asia Credit Index (JACI) tracks the total return performance of the Asia fixed-rate dollar bond market. JACI is a market cap-weighted index comprising sovereign, quasi-sovereign and corporate bonds and is partitioned by country, sector and credit rating. JACI includes bonds from the following countries: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Thailand and Singapore.

The Markit iBoxx Asian Local Bond Index tracks the total return performance of a bond portfolio consisting of local-currency denominated, high quality and liquid bonds in Asia ex-Japan. The Markit iBoxx Asian Local Bond Index includes bonds from the following countries: Korea, Hong Kong, India, Singapore, Taiwan, Malaysia, Thailand, Philippines, Indonesia and China.

The Barclays Capital U.S. Aggregate Bond Index is commonly used as a benchmark by both passive and active investors to measure portfolio performance relative to the U.S. dollar-denominated investment grade fixed-rate taxable bond market.

The Barclays Global Aggregate Index (GAI) provides a broad-based measure of the global investment grade fixed-rate debt markets. The GAI contains three major components: The U.S. Aggregate Index, the Pan-European Aggregate Index, and the Asian-Pacific Aggregate Index. In addition to securities from these three benchmarks (94% of the overall Global Aggregate market value as of December 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar, Euro-Yen, Canadian and Investment Grade 144A index-eligible securities not already in the three regional aggregate indices.

The Barclays Municipal Bond Index is a market-value-weighted index for the long-term tax-exempt bond market. To be included in the index, bonds must have a minimum credit rating of Baa. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date.

The Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The U.S. Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt. The U.S. Aggregate Index was created in 1986, with index history backfilled to January 1, 1976.

The Barclays U.S. Treasury Index is an unmanaged index of prices of U.S. Treasury bonds with maturities of one to 30 years.

The Bank of America Merrill Lynch Corporate Master Index is an unmanaged index comprised of approximately 4,256 corporate debt obligations rated BBB or better. These quality parameters are based on composites of ratings assigned by Standard and Poor's Ratings Group and Moody's Investors Service, Inc. Only bonds with minimum maturity of one year are included.

The Bank of America Merrill Lynch Mortgage Master Index tracks the performance of U.S. dollar-denominated fixed rate and hybrid residential mortgage pass-through securities issued by U.S. agencies in the U.S. domestic market having at least $5billion per generic coupon and $250 million outstanding generic production year.

The Bank of America Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Bank of America Merrill Lynch 5-Year U.S. Treasury Bond Index tracks the total return of current coupon 5-year U.S. Treasury bond.

The Bloomberg European 500 Index is a free float capitalization-weighted index of the 500 most highly capitalized European companies.

The Commodity Index (DJ-UBSCI) is composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The DJ-UBSCI is calculated on an excess return basis.

The Global Aggregate Index (GAI) provides a broad-based measure of the global investment grade fixed-rate debt markets. The GAI contains three major components: The U.S. Aggregate Index, the Pan-European Aggregate Index, and the Asian-Pacific Aggregate Index. In addition to securities from these three benchmarks (94% of the overall Global Aggregate market value as of December 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar, Euro-Yen, Canadian and Investment Grade 144A index-eligible securities not already in the three regional aggregate indices.

The J.P. Morgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets and includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. The EMBI Global defines emerging markets countries with a combination of World Bank-defined per capita income brackets and each country's debt-restructuring history.

The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The U.S. Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt. The U.S. Aggregate Index was created in 1986, with index history backfilled to January 1, 1976.

Indexes are unmanaged and it is not possible to invest directly in an index.

 BY516_0919