ALPHA SOURCES

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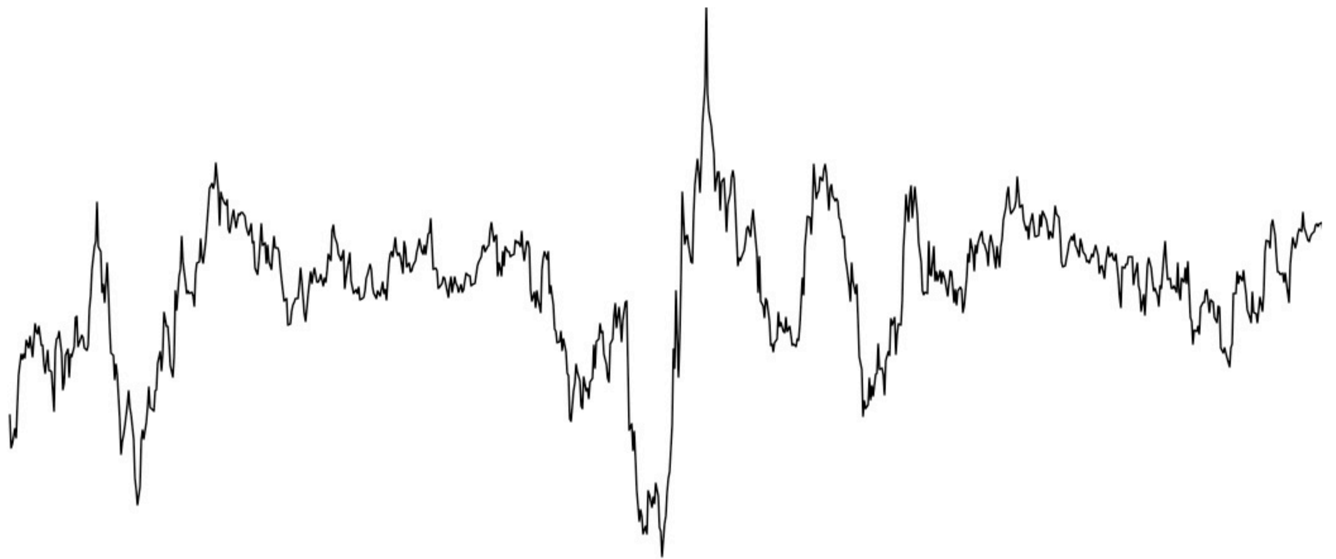

#YOLO - BUYING CARRY IN CHINA?

It's difficult to think of a more politically incorrect idea than recommending investors to allocate money to China's government bond market, ostensibly by selling a portion of their U.S. treasuries. Granted, this would actually be consistent with the rebalancing of the bilateral U.S.-Sino trade relationship that the most ardent critiques of China's economic model desperately want. Or perhaps what they really want is a strong dollar plus capital controls? It is difficult to tell sometimes. That said, it is fair to say that lending money to China's government to fund domestic investment, some of which invariably will go to defence, probably doesn't get you on the White House's Christmas list. Incidentally, and before I flesh out the trade, I should make one thing clear. I think the mismatch between the increasingly tense geopolitical relationship between China and the U.S., and the fact that capital and goods still flow more or less freely—with the exception of direct outflows from China's mainland—between them represent an enormous tail risk for mar-

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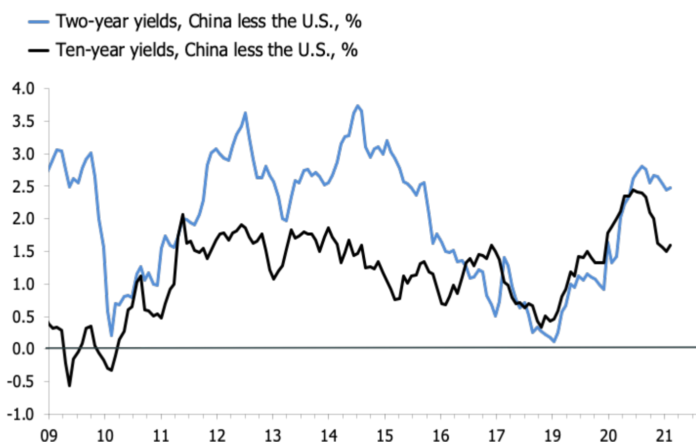
kets. More specifically, if the latter suddenly conforms to the former, risk assets would be in deep trouble, though I suspect both USTs and the dollar would do quite well. Heck, maybe even CNY-sovereigns would rally, depending on PBoC's actions, though I suspect the CNY would get flogged.

Leaving such nastiness aside, CLSA's Chris Wood argued the bull case for international investors in Chinese sovereign bonds last month in his weekly Greed and Fear column, a sentiment the mighty HSBC bond bull Steven Major has recently echoed. Let's start with the obvious, though not necessarily decisive, point. Chinese sovereigns offer investors significant more yield than their U.S. counterparts, both on the front-end and the long end, as the two chart below shows.

Professional fixed income investors will scoff at this for two reasons. Firstly, in emerging markets, a higher nominal rate often goes hand-in-hand with currency depreciation, or so at least the uncovered interest rate parity states. I have sympathy for that argument, though without going into too much details, it is fair to say that the UIP does not hold. Naked carry trades often pay off over significant periods of time, even if it is, as Buttonwood famously declared, like picking up dimes in front of a steamroller. Secondly, institutional investors can't swim naked, and often the cost of hedging overwhelms any nominal yield difference.

Leaving aside investors who have to hedge currency risk, it is plausible that China's currency regime is now uniquely favourable for investors seeking out higher returns in its govern-

fig. 01 / Plenty of unhedged carry in China - **fig. 02** / ...as long as CNY is stable



ment bond markets. In other words, China isn't your usual EM. China certainly doesn't want a currency that is too strong, but it is fair to say that the country's political leaders are now probably more open to such a trend—boosting domestic purchasing power and the global role of the CNY—than they have been in the past. By contrast, I am fairly confident that China wouldn't allow money to flow out too quickly, at least not initially in a process of liberalisation of its currency, and capital account. Put differently, while the CNY will certainly not be a one-way street as China contemplates engaging more freely with global capital markets, the path of least resistance is for a stronger currency, or less depreciation, at least insofar goes the assumption that the PBoC will continue to have a thumb on the scale.

Chris Wood sprinkles three more reasons on the argument for why investors should buy some sovereign bonds out east. First, unlike in U.S. treasuries the correlation between stocks and bonds is actually negative in China, indicating that sovereigns here offer more of a hedge against equity drawdowns. Second, foreign inflows into Chinese sovereign bonds are now picking up, but from a low level. The implication is that now is the time to get on the train. Thirdly, with the PBoC now stamping down hard on the riskier part of its domestic credit market—think highly levered local governments and SOE—domestic capital is also likely to flow into the relatively safe government securities, or quasi-publicly backed bonds.

In a nutshell the argument for allocating to Chinese sovereigns is a simple punt in the end. It is first a bet that the U.S.-China relationship doesn't deteriorate into a cold, if not lukewarm or hot, war. **Secondly, it is a bet on the early stages of japanification of China's government market; this is to say, falling bond yields, without the weaker currency, to begin with.** And for retail investors reading this and feeling left out, there is an ETF at hand; the iShares China CNY Bond UCITS ETF, or CNYB on the big board. As the kids say these days; YOLO.

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