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TRANSCRIPT

The Yield Hunters, Global Edition

Featuring: **Andy Sparks**, Managing Director, MSCI Research

Adam Bass (00:03):

This is MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host, Adam Bass and today is December 10th, 2020. This week, a journey through the world of global investing continues with a look at the increased global focus of fixed income investors. Next up, China with our tour guide and MSCI's head of portfolio management research, Andy Sparks. Andy, welcome back to the program.

Andy Sparks (00:34):

Thank you, Adam. Delighted to be back.

Adam Bass (00:36):

Last week, our guest was Raina Oberoi. She was on to talk about the idea of global investing. We spoke about equity investors and specifically the idea of looking at the world as your opportunity set, as opposed to, especially for us investors, having that so-called home bias. We wanted to have you on today to continue that conversation about global investing, but through the lens of fixed income, in particularly around Chinese bonds. And of course, we will get there, but before we do, let's just take a step back if we could. And I'd like to get a sense of fixed income investing from that global perspective.

Andy Sparks (01:21):

Yeah, it's traditionally fixed income more so than equities. Was very concentrated within specific countries where investors resided, but that's been changing over time. Bond investing in general has gone much more global. And I'd say particularly now in the current low yielding environment, there's a feeling in the market lower for longer rates are going to be lower for a longer period of time. I think a lot of fixed income investors who are looking for new tools to use, maybe take some existing tools out of the tool kits, tools that haven't been used for a while. And so I think there is quite a bit of interest in looking at opportunities in emerging markets in particular, but it extends to other parts of the bond sector as well.

Adam Bass (02:10):

So that's interesting, Andy. I'm curious, what do you think it is about fixed income that creates that even stronger home bias?

Andy Sparks (02:21):

So I think you need to look through to pension funds and liabilities. The pension funds, a lot of pension funds in the United States are paying pensions in U.S. dollars. And the way pensions are defined and the liability stream is defined it looks very much like a fixed income cashflow. If your liabilities are U.S. dollars and they're fixed income, the gravitational force on the fixed income assets side will also to invest in, in U.S. dollar fixed income. So I think that's one of the reasons why there is that natural home bias. And we did a study by the way several years ago, looking at benchmarks used by the top 20 defined benefit pension plans in the United States. And we found that the majority for fixed income were using U.S. dollar based benchmarks, but in equities, the majority were using global equity benchmarks. That underscores the home bias in fixed income, the traditional home bias, that's less appearance in equity. But I do think that home bias and fixed income... it is beginning to weakened as investors look for opportunities outside of home markets.

Adam Bass (03:39):

And one of those areas they've been looking for opportunity is Chinese bonds. And we're talking today about Chinese local currency sovereign bonds specifically. So can you help us define what those investments are? What does the market look like?

Andy Sparks (03:56):

It's a very large market. If you look at sovereign bond markets across the world, the two largest are the United States and Japan. The third is China and the local currency market has attracted increasingly foreign investment. This is partly driven by well-known index providers adding Chinese government bonds to flagship benchmarks. So it's estimated right now that somewhere between 9 to 10% of local currency, Chinese government bonds are held by foreigners. By the way, the comparable figure for the United States, it's approximately 35%. So the mere fact that the Chinese local currency market is large, that in itself attracts more investors because there's investment capacity. So if you're a large asset manager and you want to take a large position in a market, China has the depth to offer you significant flows.

Adam Bass (04:58):

Yeah, but what about debt issued by Chinese companies? Definitely seen a lot of stories lately talking about corporate debt in China in terms of the defaults that are happening and spin specifically from

what I've been able to see around what we call state owned enterprises, those SOEs to get the acronym in there. For non-Chinese investors, looking at this market terms of evaluating risk and also do I want to go toward the corporates or sovereign Chinese bonds? What are the important distinctions?

Andy Sparks (05:36):

Yeah. As you noted, Adam, the Chinese corporate bond market has been generating some headlines lately with some defaults among the several state owned enterprises, but the Chinese corporate bond market is very different from the central government bond market. And number one, it's attracted far less foreign investment. So it's estimated that only 1% of Chinese corporate bonds are held by foreigners. And I think a primary reason for that has to do with the lack of transparency of that market, the use of rating agencies, Chinese based rating agencies, that many foreign investors are not very familiar with. And so I think there's a general feeling that it's a much more opaque market in terms of looking at the underlying risks within the corporate bond sector in China than in the government bond sector. And I think that's a primary impediment. It also translates into diminished liquidity for Chinese corporate bonds versus Chinese government bonds.

Adam Bass (06:44):

So 1%. That's a startling number considering what you just said about the sovereign market.

Andy Sparks (06:48):

That's right. So I think as global investors increasingly look at China as in fixed income for investments they're probably most comfortable looking at the more transparent part of the market, which is the government bond market. And I think there is a lot of interest by the way, among foreign institutions in Chinese corporates, but they're going a lot slower about it for the reasons that I mentioned it. And frankly, some of these headlines around some of these defaults among state owned enterprises that reflects and reinforces some of the hesitation that foreign investors might have to invest in Chinese corporates.

Adam Bass (07:28):

So on the sovereign bonds, which are, as you say, proving more attractive to foreign investment, what about the other side? What about the yields? How do they compare, say to U.S. treasuries or even corporate bonds here?

Andy Sparks (07:43):

So the headline is for local currency, Chinese government bonds. The yields on the tenure in the tenure sector are approximately 250 basis points higher than yields on U.S. treasuries. Now, in a way that's comparing apples to oranges because one is in the local Chinese currency, the Yuan versus U.S. dollars. And I'll come back to that in a minute, but there is a much smaller part of the Chinese government bond market that's issued in foreign currency. And so for example, the government of China issued in U.S. dollars in October of this year. They also issued in Euro in November. And so for that Chinese debt that's issued, for example, and the U.S. dollar, we can directly compare those yields to yields on other U.S. fixed income assets.

Andy Sparks (08:36):

For the bonds that were issued in October, in USD, in the United States, they traded at roughly about 50 basis points over U.S. treasuries and that's very similar to where AA rated corporate bonds are trading. And so in terms of how the market is looking at the risk of Chinese government bonds, you could say approximately in terms of at least the yield spread, the market is thinking that it looks a little bit like a double A corporate, so that provides some information about how the market perceives the credit strengths of the Chinese government bond sector.

Andy Sparks (09:13):

But coming back to the local currency, part of the Chinese government bond sector, which is dramatically larger than the U.S. currency China bond sector, that 250 basis point difference in yield is partly going to reflect the market's view about future inflation. It's also going to reflect partly the market's view about foreign exchange, and it will partly reflect the market's view around liquidity within the respect of sectors.

Adam Bass (09:43):

And for context, the double A rating, how would you put that into focus for our listeners?

Andy Sparks (09:50):

So the risk of a foreign country when they're issuing in their own currency, there isn't really default risk in the classic sense. There's inflation risk. So if a country is falling behind in its payments for its debt in its own local currency, it can always resort to just printing money to pay off the debts. But when debt is issued in foreign currency, they can't do that. Comparing those U.S. denominated Chinese bonds to U.S. corporates, I think does provide some good information about how the market is viewing the credit strength and [inaudible 00:10:29] claims paying ability strength of the Chinese government.

Adam Bass (10:32):

Getting back to your analysis of that market and the basic question of course, is the attractiveness, the appeal of that higher yield you spoke about. Is that worth the risk? And does it provide global investors with the opportunity for diversification? You looked at the effect on risk of adding Chinese government bonds to an existing portfolio. How exactly did you go about that? What was your process?

Andy Sparks (11:05):

We assumed a benchmark of developed market government bonds. We utilized the MSCI fixed income risk factor model, and what we're doing, we calibrate the model looking at volatilities of yields and FX rates and not just volatilities, but correlations as well. And as an example, we added a weight of 10% to the portfolio, and we found that the risk actually went down by 7%. So that 10% overweight led to a 7% reduction in risk. And so that adds to the story that investing in China government bonds does offer potential diversification benefits. The investor ultimately has to balance the potential return upside versus the risk.

Adam Bass (11:59):

So let's go there. Let's break down these different types of risks that you mentioned. The first one you talked about was the effect of the fact that these are local currency, the FX, the foreign exchange risk. So what role does currency risk play in terms of China, let's say versus other markets?

Andy Sparks (12:21):

So, for a fixed income investor, investing in foreign bond markets, that FX risk is large. And the interesting thing about the co-relation of the U.S. dollar versus currencies is that that volatility of the exchange rate versus the Chinese currency is actually quite a bit lower than versus other currencies. And so for instance, versus the Euro, the dollar Euro exchange rate is significantly more volatile than the dollar Yuan exchange rate. And so when you're a U.S. based investor, and you're thinking about investing in government bonds outside of the U.S., that's a very important consideration because in terms of the return, it's going to be generated not just by what happens to yields within the country, but on a dollar basis, it's going to be impacted very significantly by the foreign exchange fluctuations. And so the lower the volatility of the, in this example, the Chinese currency versus the U.S. dollar, the lower the risk would be for a U.S. based investor on what we call it, a total risk on basis.

Adam Bass (13:40):

And of course the next logical step is to speak about the inflation risk. How does that factor in?

Andy Sparks (13:48):

Yeah, I think that's a really important issue. And if you look at the Chinese inflation rate compared to the U.S. inflation rate over the last few years, the Chinese inflation rate has been much more volatile than the U.S. rate. I think there are some economists that don't have as much transparency into the dynamics of inflation in China as they do in other countries. And so the Chinese authorities have not been as transparent about detailing in technical detail, exactly how their price indexes are computed. And so I think what gives some global investors pause about entering into the Chinese market is some uncertainty about the inflation rate and where the inflation rate is going to be going.

Andy Sparks (14:38):

Over the past two years the Chinese inflation rate on a year over year basis has ranged from 5%. The most recent reported number for China year over year inflation was 0.5%. So that 5% read from a year ago or so was much higher than measured inflation in the U.S. but the most recent number we got from China shows that it's now lower than the U.S. but it does underscores it's highly volatile and to investors considering that market, that's a key consideration.

Adam Bass (15:15):

The third risk that you mentioned was around liquidity. Certainly a word that we've heard a lot. Is the Chinese sovereign bond market, as liquid as say, the developed market bond portfolio that you noted in as part of your tests?

Andy Sparks (15:34):

So, it is not according to our models, but it could be getting better. Right now, according to our bond liquidity model, the MSCI bond liquidity model, the bid ask on most developed country bonds like U.S., Japan, U.K., Germany, it's roughly about four to five basis points. Whereas for the local currency on Chinese government bonds, it's more like 20 basis points. And so there is a liquidity difference there. Now one view of the world is that as more global investors invest in the Chinese government bond market, it may improve liquidity conditions and that will help out the sector too, from a total return basis. So I think another important consideration for a global investor is whether you think liquidity conditions will improve or not in the Chinese government bond sector.

Adam Bass (16:31):

What does that level of capacity mean for different types of institutional investors? Asset owners, for example. Why is that important?

Andy Sparks (16:41):

It's because asset owners... many asset owners are very large institutions, managing hundreds of billions of assets. And when they make a trade to really, to have an impact `on the actual portfolio, it may be a relatively small percent of the portfolio, but in terms of absolute volume of purchases, it's large. And a concern about investors is that if you buy a significant amount of bonds without very much volume, you could affect the price. This is called market impact. And so from a purchaser's perspective, you may say, a relatively small country offers a lot of opportunities, but if you want to buy a lot of that countries bonds, you may drive up the price. And so with China, just because it is the third largest government bond market, it does have the potential to offer depth. So I'm not saying that in the current market, it has the same amount of depth as other developed markets have, but just as it evolves and you get more foreign investors in there, which will generate more trading, market makers may be more willing to buy and sell that, which ultimately will help liquidity in the sector.

Andy Sparks (18:06):

And the mere fact that the size is large, I think will make it more attractive to large investors who are looking for alternative opportunities.

Adam Bass (18:16):

So given all of that and the low for long environment we spoke about at the top, what lessons can we draw? What are the insights to take from this in terms of whether the attractive yield is indeed worth the risk?

Andy Sparks (18:33):

You have to come back to fundamentals. I think for a long horizon investor, you always need to come back to fundamentals. And those fundamentals in fixed income, particularly for government bonds, the primary consideration is inflation. And so I think investors who are thinking about that market need to think carefully about what are longer term trends likely to be an inflation in China. And so in the developed world, particularly in the U.S. we have well-developed inflation linked markets. So U.S. tips offer information about what market expectations are about inflation. We don't have an inflation link market in China we can look to, so you can look at the behavior of the price index in the past. You can listen carefully to the monetary authority in China talking about their goals for inflation, their targets for inflation and so on. So I think that fundamental type of analysis is really going to be very crucial. On the FX side and FX is going to be very much related to inflation and future inflation is not completely driven by that, but FX is going to be very effected by inflation as well.

Adam Bass (19:50):

Well, Andy, thank you as always for joining us. Unfortunately, we do have to go now, but we could talk to you all day. So thanks again for being on the program and given the fact that we're looking toward the end of 2020, thank goodness, let me say Happy Holidays and Happy New Year as well.

Andy Sparks (20:13):

Yes. Thank you very much, Adam. The same to you.

Adam Bass (20:17):

That's all for this week. Our thanks to Andy and to all of you for joining us. Next week, we'll check in with Peter Zangari, MSCI's head of research and product development. We'll talk about where the world was just nine months ago, where we stand today and the insights that can help us continuing to manage through the crisis. Until next week, I'm your host, Adam Bass, and this is MSCI perspectives. Stay safe.

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