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Decoding China’s Rate Market Conundrum

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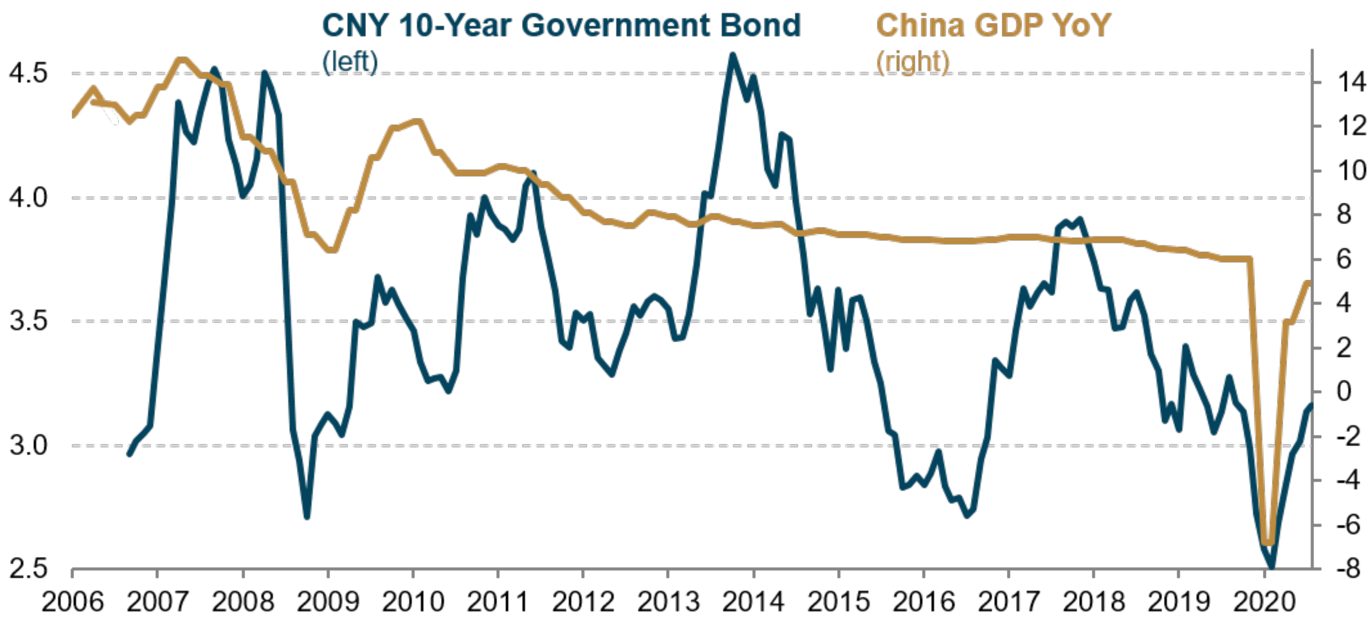
With China’s policymakers’ resolve to attract foreign capital to its onshore bond market and the country’s gradual inclusion in global bond indices, foreign investors are assessing the merits of investing in that market. Unfortunately, the market is sending mixed signals on whether monetary conditions are easing or beginning to tighten. China’s onshore rate market has been selling off since April, but at the same time credit growth has been expanding. Is the V-shaped recovery to blame for the selloff or are there are other factors at work? What is our expectation for China’s local rates going forward? Here, we assess the true indicators of the People’s Bank of China’s (PBOC) monetary stance, reasons for the market rate selloff, and whether China’s onshore bonds offer value.

The Weak Link between Bond Yields and GDP Growth

For most developed countries, government bond yields, due to their safe-haven nature and monetary transmission function, serve as a growth barometer. However, China’s government bond yield has not correlated with the country’s gross domestic product (GDP) growth. Instead, the 10-year government bond yield has hardly changed from its 2005 level even though China’s year-over-year GDP growth declined significantly to a low single-digit level from double-digit growth (see Chart 1). This anomaly indicates China’s bond market valuation is far from market-driven and suggests other policy levers are at play in transmitting to the real economy. The PBOC utilizes various levers to control the rate market, including quantitative methods, such as loan quotas and liquidity injections; open market operations, like controlling medium-term liquidity funding (MLF) or short-term liquidity funding (SLF); and regulation or administrative measures, such as directing bank lending to small- and medium-sized enterprises (SME), shadow banking crackdown, targeted easing, etc. We will discuss these tools below.

1 **China: GDP vs. 10-Year Government Bond Yield**

%, As 10/22/2020



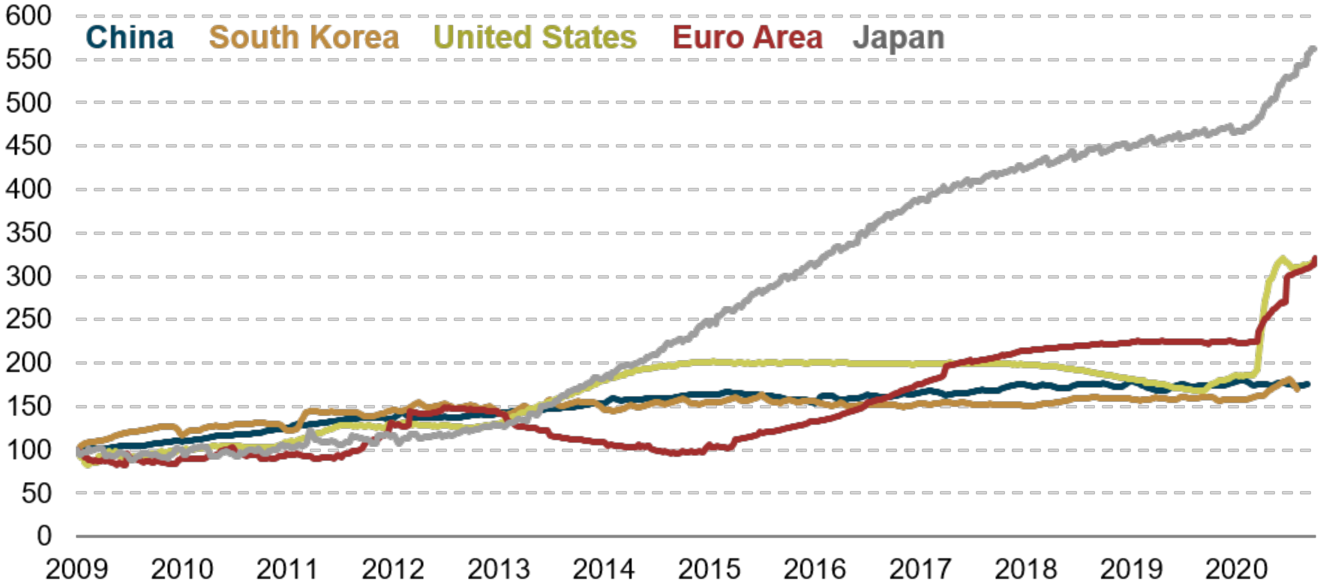
Source: Bloomberg (© 2020, Bloomberg Finance LP)

The Ambivalent Monetary Stance

China's monetary policy differentiates the PBOC from other major central banks. As other central banks gravitated to the zero lower bound and released the floodgate of quantitative easing to support economies post-COVID, the PBOC has eased more modestly this year and even assumed a more hawkish stance recently (see Chart 2). Market interest rates have risen since April and have remained high despite the government's repeated guidance on lower funding costs. At the same time, credit growth has continued to pick up. Has monetary policy started its tightening phase? Various market rates say "yes" and but the government's boost to the credit impulse says "no."

2 Central Bank Balance Sheets

December 2008 = 100, As of 8/2/2020



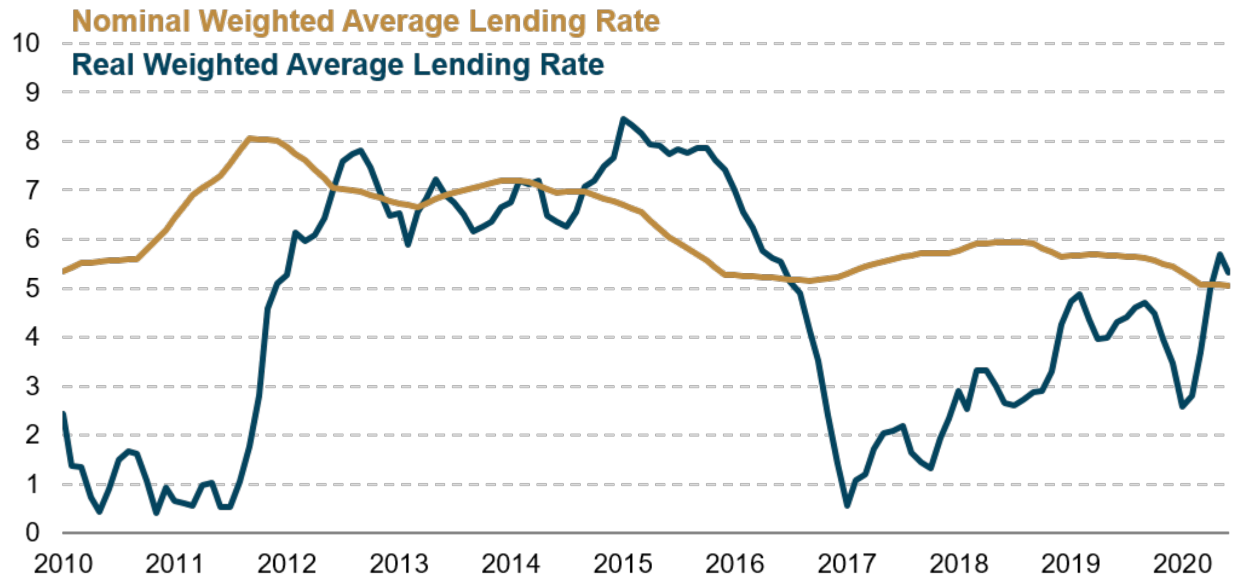
Source: Brandywine Global, Macrobond

Assessing Indicators of Monetary Stance against Historical Perspective

Amid the confusing signals, what is the most accurate way to gauge the PBOC's actual monetary policy stance? The PBOC's historical use of monetary tools over recent years should provide contexts and offer some clues:

- **Along with China's structural shift from an export-driven growth model to a more domestic consumption-driven one, foreign currency reserve inflows have not been an important driver of money supply since 2014. The PBOC's balance sheet expansion has been driven mainly by open market operations via instruments like MLF and SLF, i.e., collateralized lending to banks.**
- **China's deleveraging drive in 2017-2018 squeezed interest rates higher through the tightening of bank lending to non-bank financial institutions (NBFI). This campaign soaked up liquidity in the interbank market, which raised real interest rates (see Chart 3).**

3 **China: Nominal and Real Average Lending Rates**
%, As of 6/30/2020

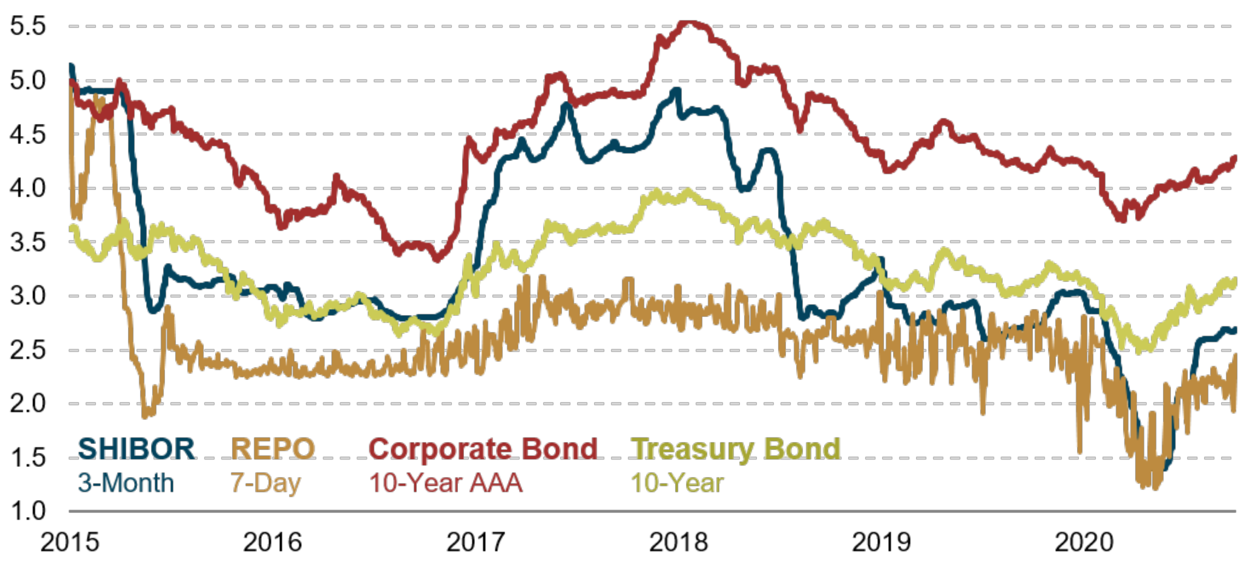


Source: Brandywine Global, Macrobond

* Real rates are deflated by the average of CPI and PPI

- **With the goal to offset the negative impact of the U.S.-China trade war, the PBOC started to ease monetary policy in 2018 by increasing liquidity injections. The easing efforts further strengthened in early 2020 to offset the shock of COVID-19 and led to the decline in market rates, like 7-day repo rates and bond yields (see Chart 4). However, rates have resumed their rise since April 2020.**

4 **China: Market Rates and Bond Yields**
%, As of 9/30/2020



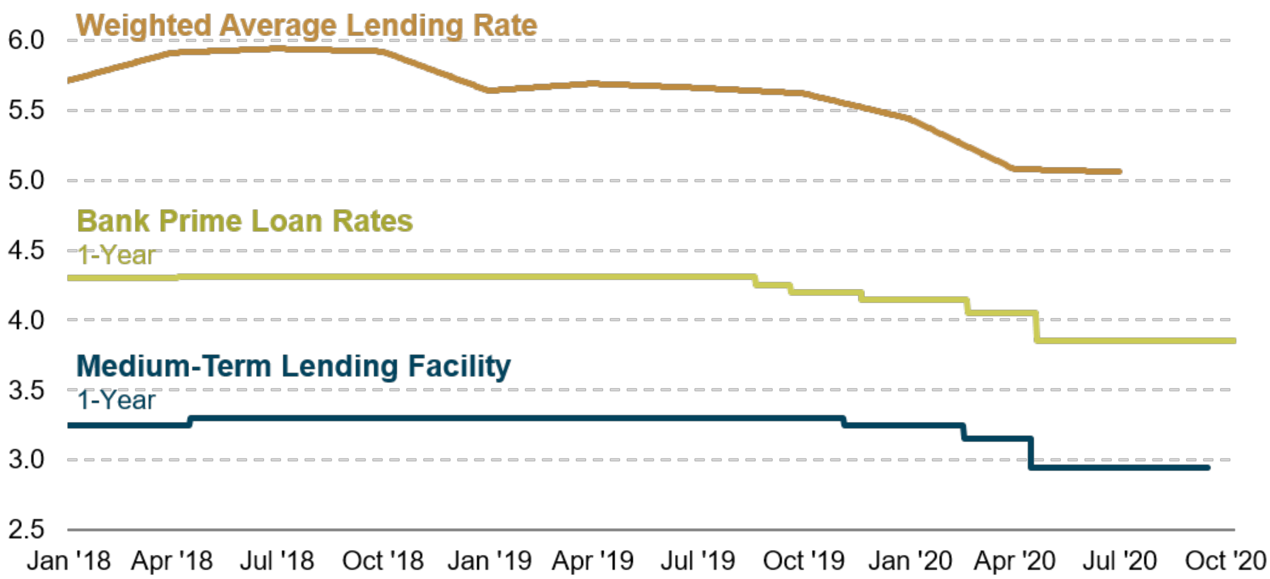
Source: Brandywine Global, Macrobond

- **Credit growth accelerated with average financing costs declining in 2019-2020. The loan prime rate (LPR)** was launched in late 2019 as the new benchmark lending rate to facilitate the transmission of monetary easing to the real economy, although this rate is based on MLF rates (see Chart 5). Despite the severe negative impact of COVID-19, the PBOC refrained from expanding its balance sheet like other central banks. Instead, its large liquidity injections in early 2020 were mostly withdrawn in later months, and its dry powder was retained to stimulate if needed in the future.

5

China: MLF, LPR, and Weighted Average Lending Cost

%, As of 10/8/2020



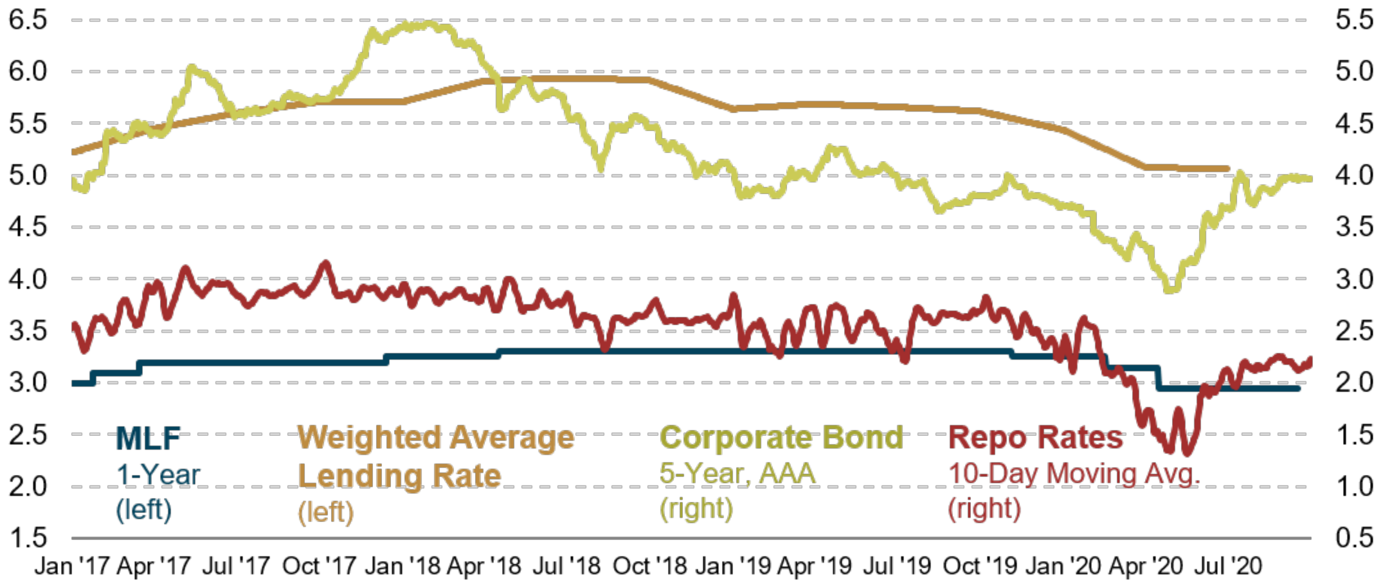
Source: Brandywine Global, Macrobond

The Divergence of Market Rates and Lending Rates

Now, here comes the conundrum of why market rates and benchmark lending rates are currently diverging. The former is rising while the latter is stabilizing at a lower level, sending confusing signals on China's monetary stance. This divergence also happened in 2018-2019 when the PBOC injected liquidity and cut the reserve requirement ratio (RRR), sending short-term rates lower while MLF rates stayed unchanged. This time around, although the government reiterated its focus on lowering funding costs to corporates with MLF unchanged, bond yields moved up significantly since April together with short-term repo rates (see Chart 6). More surprisingly, the PBOC refrained from injecting more liquidity to contain the sharp increase in short-term rates and bond yields. The market regards the PBOC's tolerance of higher market rates as a tightening signal of monetary conditions.

6 China: Market Rates and MLF Rate

%, As of September 2020

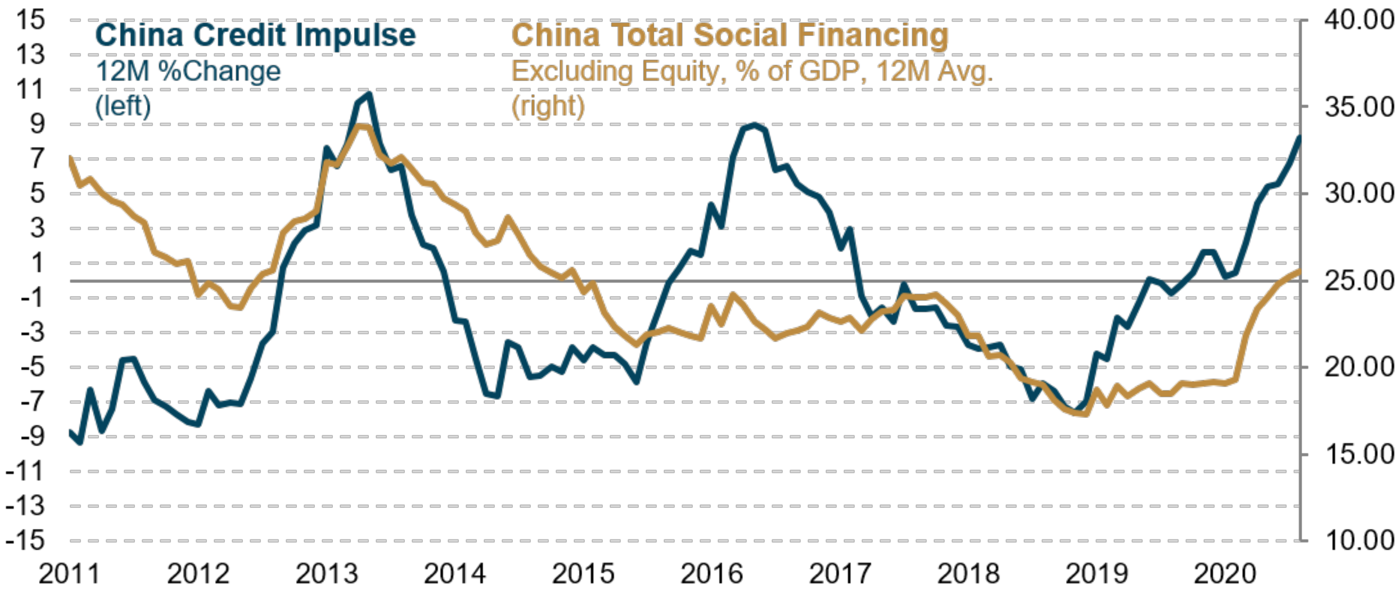


Source: Brandywine Global, Macrobond

The Best Indicator of Monetary Stance

China's monetary policy still relies more heavily on quantitative and administrative/regulatory instruments than merely just price tools. In addition to the liquidity operations and short-term and medium-term rates adjustments, the PBOC and other regulatory authorities also resort to regulatory measures and window guidance to influence credit quantity and channel direction. These may include credit controls or support to specific sectors, loan quotas, and easing or tightening of access to loans, the bond market, or shadow credit. As a result, the best indicator to gauge the monetary stance is through monitoring credit growth and credit impulse (see Chart 7). With liquidity easing starting in mid-2018, market interest rates dropped and credit growth along with credit impulse bottomed in late 2018. Both then rebounded sharply in 2020. In the same vein, while market rates have increased since April 2020, credit growth has continued to accelerate. Indeed, with China's growth gradually normalizing, the PBOC's focus seems to be shifting to containing a potential asset bubble and financial risks, demonstrated by its effort to rein in the leverage of the property market. We expect credit growth and credit impulse to peak in October or November of this year.

7 China: Credit Impulse and Credit Growth
%, As of 8/31/2020



Source: Macrobond

Relative Value of China's Government Bonds

As a result of the unique monetary policy intervention through a combination of tools, it is hard to build a valuation model to calibrate the fair value of China's government bonds. However, we can use the following metrics to assess their relative value to both developed and emerging market bonds (see Chart 8).

From a cross-market government bond valuation perspective, it really depends whether you prefer to compare China with developed markets or emerging markets (EM). For EM, there is a pattern where investors demand higher real yields for countries with higher twin deficits, e.g., Indonesia, Brazil, and South Africa. In this metric, China's real yield at slightly above zero is not particularly high (see Chart 8). However, if the comparable market is developed market bonds, then China is very attractive since virtually all these government bonds offer negative real yields today. Indeed, over the past three to four years, the significant portion of foreign inflows into Chinese government bonds are from reserve allocations into yuan-denominated assets from sovereign wealth funds and central banks.

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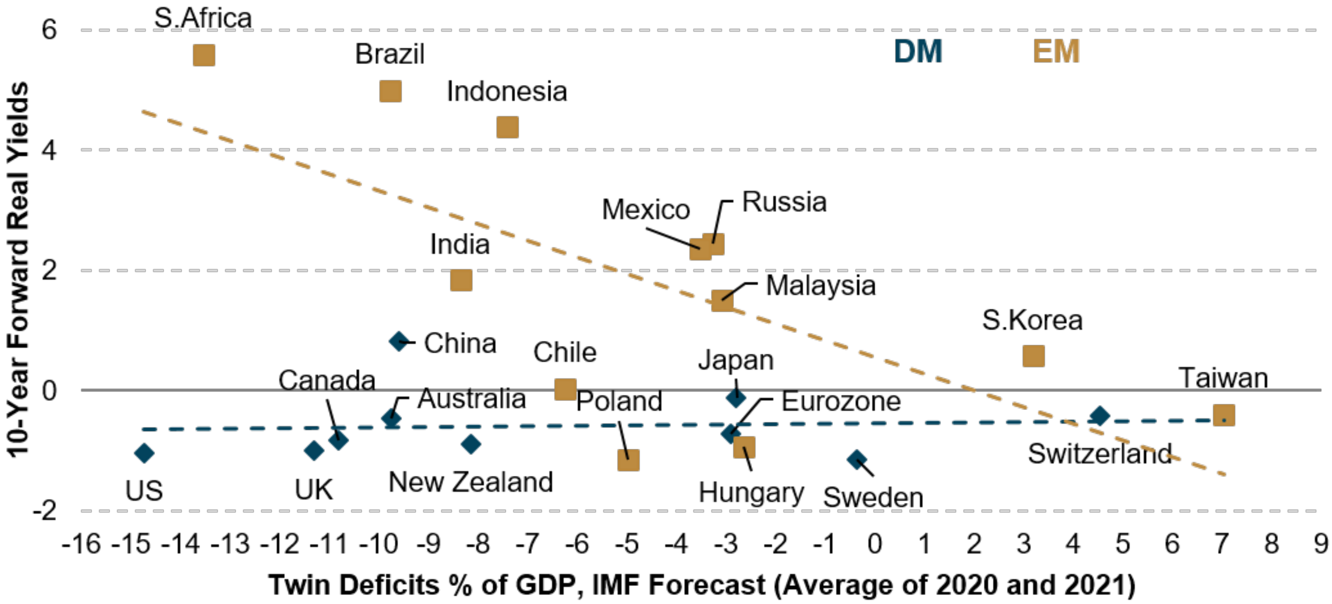
Global Real Yield on Government Bonds vs. Twin Deficits

%, As of 10/12/2020



Source: Macrobond

Conclusion

The PBOC utilizes multiple tools to control monetary policy. In addition to pricing control, quantitative and regulatory or administrative measures are important parts of its tool kit. To gauge the PBOC's monetary stance for China's real economy, we should focus more on credit growth and credit impulse rather than just looking at market rates. So far, the PBOC has been tolerating the divergence of market rates and benchmark rates. We do not expect the PBOC to inject liquidity to contain the rate rise as economic activities continue to recover. In addition, we believe caution around a potential asset price bubble and financial risk will restrain the PBOC from easing. Market rates should be range-bound or rise slightly until the end of 2020 as growth further picks up. However, rates should stabilize at a reasonably low level in 2021 given China's high debt level and slower structural growth.

We believe the current selloff in China's onshore sovereign bond market has limited further room to run, given its already higher rate differentials relative to the rate markets of developed market countries. Chinese bonds look cheaper than developed market bonds while offering stability and better fundamentals compared to other EM bonds.

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