

Duncan Tan

Strategist



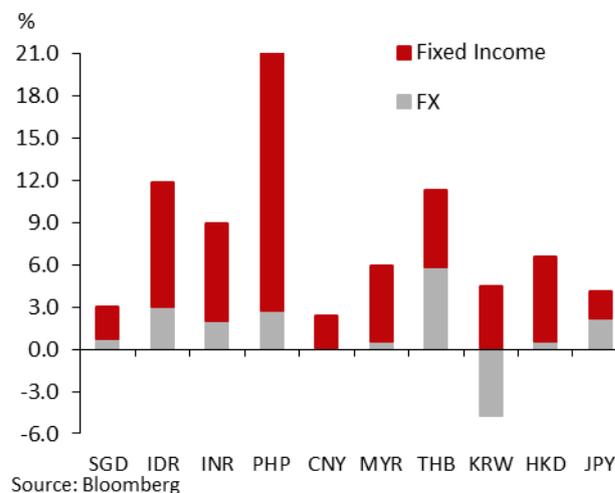
Please direct distribution queries to

Violet Lee +65 68785281 violetleeyh@db.com

- In 1H, expectations of CGB outperformance did not materialize.
- Some positive economic data and the takeover of Baoshang Bank were behind the poor showing.
- Having lagged in the global bond rally, CGBs now look quite cheap and offer decent roll down.
- PBOC turning more accommodative. Bank funding rates are coming down and could support CGBs.
- **Implication for investors** – stay bullish on CGB and expect better performance in 2H.

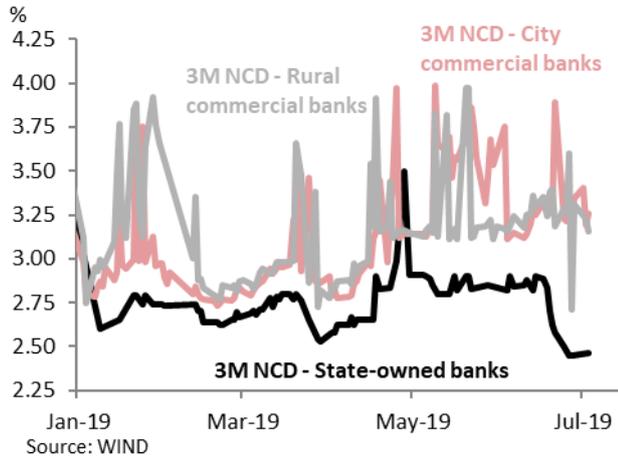
CGB performance was poor in 1H

The underperformance of China Government Bonds (CGB) in the first half of 2019 has caught investors by surprise (many had CGB as conviction ideas). Many held the view that the People's Bank of China (PBOC) has the will, the room, and the tools to ease to support economic activity. In addition, CGBs will enjoy a boost in foreign demand from inclusion into the Bloomberg Barclays Global Aggregate Index. But the CGB's underperformed.

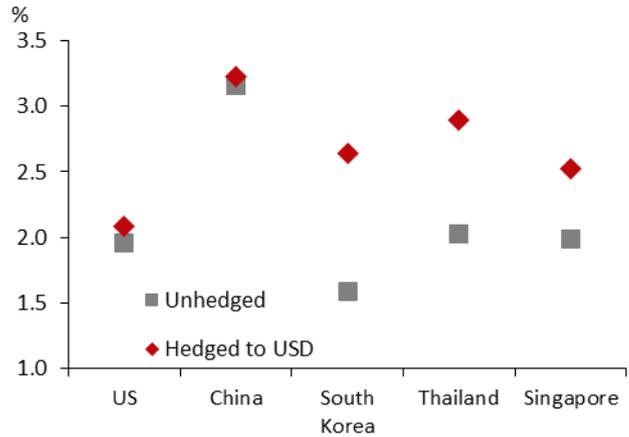
10Y Local Government Bond - YTD Total Return

When we compare movements in CGB vs US Treasury yields and look at the timeline of events, we think the underperformance was largely due to two time periods. In April, China's economic data was picking up, leading to greater confidence that the economy had bottomed. Stocks surged. PBOC officials subsequently gave signals that they were going to dial back on stimulus. Over the month of April, 10Y CGB yields jumped 34bps vs UST's 10bps. In late-May, PBOC and China Banking and Insurance Regulatory Commission assumed control of Inner-Mongolia-based Baoshang Bank, citing serious credit risks. The event spurned concerns over the credibility of smaller banks and non-bank financial institutions. Many of these smaller institutions were holders of CGBs and used CGBs as collateral to borrow. They had to sell when their funding markets contracted and borrowing costs surged. In the last week of May, 10Y CGB yields fell 2bps vs UST's 19bps.

NCD funding rates for city/rural commercial banks are still high. Rates for state-owned banks moving lower.



10Y CGB offers 130bps over US Treasury and 35-70bps over EM Asian peers.

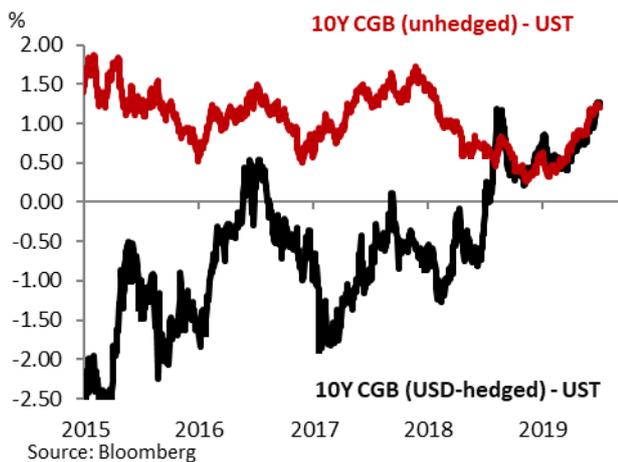


CGB are quite cheap now

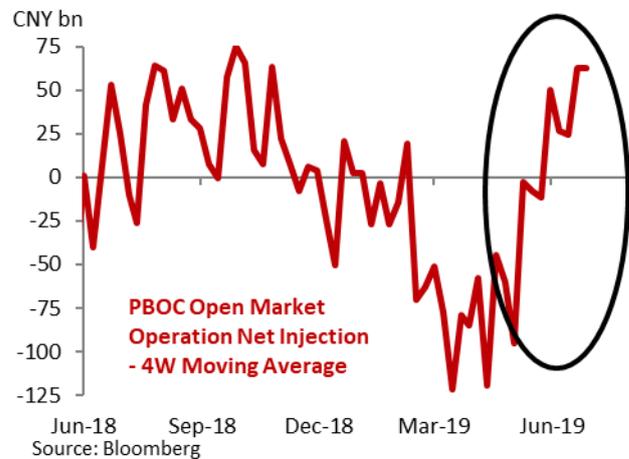
Ytd, we have seen a strong rally in global fixed income on the back of expectations that global interest rates would be lower for longer. Many sovereign bonds have gotten quite rich and are now pricing in substantial monetary easing and rather downbeat economic scenarios. For investors late to the rally, the bar for price appreciation has risen to quite high levels (markets would need to assume recession or sharp growth slowdown for bond prices to rally further). In contrast, CGB yields have lagged the rally (10Y tenor unchanged year-to-date), making it relatively cheap. 10Y CGBs now yield a massive 130bps over US Treasury and the CGB curve still offers decent roll down. In a world where positive yields and steep curves get increasingly scarce by the day, CGBs look compelling.

Interbank liquidity conditions are a key factor in the outlook for CGBs (ownership is dominated by domestic banks). Since April, PBOC's liquidity interventions in the banking system has clearly turned more accommodative. Consequently, bank funding rates are coming down and could drive CGB yields lower in the months ahead. Furthermore, with economic momentum still weak, PBOC could make further reductions to the required reserve ratios, freeing up funds that could go to purchasing CGBs.

CGB's yield spread over US Treasury is now quite wide.



PBOC has been injecting liquidity to cushion trade uncertainties; policy increasingly accommodative.



Group Research

Economics & Strategy

Taimur Baig, Ph.D.

Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow

Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.

Economist – Indonesia & Philippines
+62 21 2988-4003 masyita@dbs.com

Joanne Goh

Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Eugene Leow

Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung

Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying

Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao

Economist – Eurozone, India & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah

Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Duncan Tan

FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Samuel Tse

Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee

FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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