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China bonds in demand for mixed funds

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The rapper Eminem clearly does not think much of diversification – after all, in his song "Lose Yourself" he says: "You only get one shot, do not miss your chance to blow, this opportunity comes once in a lifetime".

Fund managers have a different view on diversification. You don't want to put all your eggs in one basket, because if the basket falls to the ground, all the eggs may break. But if you spread them across more baskets, while it may still hurt when an egg breaks, it does not mean that ALL eggs are lost.

Don't put all your eggs in one basket

This is why we do not only invest in one share, bond, or asset class for our funds, but instead we spread the risk across more investment vehicles. For a multi asset mandate that means among other things that we mix asset classes that go in different directions in the event of a crisis. In the past, this has been implemented by mixing risky asset classes (e.g. equities, high-yield bonds) and defensive investments (e.g. German or US government bonds).

In order to mitigate the economic impact of the corona crisis, the governments and central banks have resorted to ultra-expansive measures. Large fiscal aid packages have been passed across almost all countries of the developed world. In addition, the central banks have supported the real economy and the financial markets with bond purchase programmes and interest rate cuts. This has led to a status quo where the yields of traditional, conservative investments are either very low or even negative.

10Y yields of government bonds in the developed markets

Country	10Y yield of government bonds in %
Germany	-0.209
Switzerland	-0.195
Japan	0.070
France	0.162
Sweden	0.383
UK	0.804
Italy	0.907
USA	1.552

Source: Bloomberg, as of 9 June 2021

The low level of interest rates leads to accordingly low expected income from conservative government bonds and to the decline of the diversification potential of such instruments. Of course, in the event of a crisis, yields can still fall, but less significantly so than in the past.

China as third pole

This is why alternatives are needed that provide the aforementioned diversification potential and, in an ideal case, also higher returns. In addition to the two currency blocs in the USA and Europe, a third pole has emerged in the recent decade, i.e. China. Both equity and bond markets have grown substantially in China, but they are still underrepresented in the portfolios of many institutional investors. From our point of view, Chinese government bonds are particularly interesting. The following chart shows a comparison of the performance of government bonds in China, Europe, and the USA (allowing for currency effects).

Long-term performance comparison of the government bond markets in the USA, Germany, and China in euro

Source: Bank of America, Bloomberg

Much like government bonds from the USA and Europe, the Chinese market has offered a certain degree of diversification potential vis-à-vis riskier assets in the past. The correlation between global equities and Chinese government bonds in the past ten years has hovered around zero. This was also the case last year, at the beginning of the corona crisis.

Performance of Chinese government bonds and global equities in euro, 31 December 2019 to 29 May 2020 (equities: left scale; government bonds: right scale):

Quelle: Bank of America, Bloomberg

Also, the yield and thus the long-term return expectations of Chinese government bonds are clearly above those of the developed world. 10Y Chinese government bonds are currently traded at a yield of 3.1% (source: Bloomberg, 9 June 2021).

Chinese government bonds bring diversification and yield

In recent months, we have closely scrutinised Chinese government bonds as asset class, in terms of our return expectations and with regard to their diversification potential. In both cases we arrived at the conclusion that in the long run, adding these assets to our existing investment universe would bring advantages.

Therefore, we have added this asset class to our multi-asset funds and asset management mandates. We have allocated different bandwidths in accordance with the risk profile; Chinese government bonds are part of the emerging markets bonds allocation. This means that the maximum ratio of emerging markets bonds in local currency will not change.

This month, we will add Chinese government bonds to our funds and portfolios and will at the same time reduce our emerging markets bonds exposure.

Summary: our portfolios will become more efficient as a result of adding Chinese government bonds to our investment universe. The expected return of this asset class is above that of government bonds of the developed world, while the diversification potential improves.

ERSTE BOND CHINA: Chinese bonds in local currency

Investors who want to invest directly in Chinese government bonds can do so with our ERSTE BOND CHINA fund. The fund invests in local currency bonds that are issued and guaranteed by the People's Republic of China and traded on Mainland China. Please note: currency exchange rate fluctuations affect the fund performance.

ERSTE BOND CHINA performance

Quelle: Refinitiv Datastream, Note: Past performance is no reliable indicator for future performance.

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