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POLICY INSIGHTS

November 2017

The view from our global fixed income portfolio managers.

GLOBAL INVESTMENT TEAM


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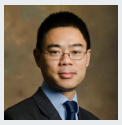

Ju Yen Tan


Steven Huber

Once a month, our fixed income portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This monthly article series examines one of the predominant themes highlighted during their discussions.

Revisiting the China Dream

In our latest round of investment policy meetings, we debated the outcomes of October's 19th Chinese Communist Party Congress and their potential medium-term impact on global fixed income markets. The biggest story of the Congress was the decision to approve an amendment to enshrine President Xi Jinping's name and signature slogans within the Party constitution. In his speech to Congress, Xi took the opportunity to lay the groundwork for scrapping China's focus on annual topline growth targets and adopting a broader "quality of life" economic objective from 2021, part of a bigger project nicknamed "China Dream."

In practice, however, this means China is still committed to doubling gross domestic product and per capita income by 2020 from 2010 levels, a target set in 2012. "The reinforcement of the China Dream project does not give the Chinese government much room to let growth targets fall before 2020," said Senior Fixed Income Portfolio Manager Ju Yen Tan. "It probably means they don't have the scope to let the growth rate fall below 6.3% from its current 6.8% level."

The overall policy bias of the ruling Communist Party has been toward gradual tightening for the past 12 months, leading to higher interest rates on local government bonds. For the time being, however, the People's Bank of China is likely to keep policy rates anchored close to current levels while using regulatory tools to deleverage by putting pressure on the broader financial system. "This has already begun with the inclusion of negotiable certificates of deposit in the calculation of financial institutions' interbank liability caps," said Tan.

> "South Korea, Thailand, and Hong Kong local bonds are likely to be impacted by stronger exports and creeping inflation."
>
> –Ju Yen Tan, senior fixed income portfolio manager

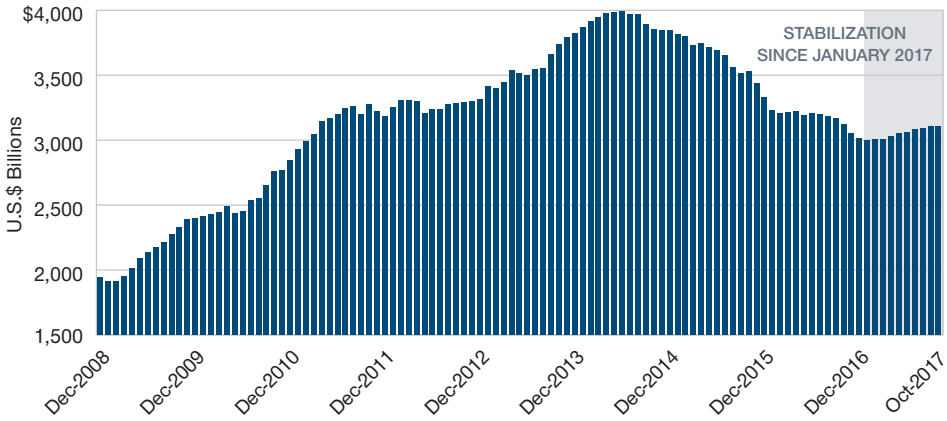
While China's consumer price index rose broadly in line with expectations in October, the producer price index accelerated more quickly than expected as the government's antipollution campaign has exerted upward pressure on prices. Inflation pressures are not limited to China, however, and have been rising in Asia more broadly, raising a question mark over the attractiveness of local Asian government bonds to international investors. "South Korea,

"The relative strength of the Chinese renminbi has added currency stability to the region and has helped the U.S. dollar to appreciate against major developed market currencies."

–Ju Yen Tan, Senior Fixed Income Portfolio Manager

FIGURE 1: China Foreign Exchange Reserves

As of October 31, 2017



Source: The People's Bank of China; data analysis by T. Rowe Price.

Thailand, and Hong Kong local bonds are likely to be impacted by stronger exports and creeping inflation," added Tan.

Stronger growth from China also influenced the currency market in 2017. "After a dip late last year, China's foreign exchange reserves have begun to rise again (albeit at a slowing rate), bolstering the renminbi and helping to keep capital outflows under control," said Tan. "The relative strength of the Chinese renminbi has added currency stability to the region and has helped the U.S. dollar to appreciate against major developed market currencies. This trend is likely to continue in the short term."

However, the impact on commodity prices from Chinese growth remains relatively unknown. The rebound in commodity prices has been supportive for the global economy via a rise in capital expenditure, yet many asset classes linked to higher oil prices have lagged recently. "The Russian ruble and, to a large extent, the U.S. Treasury market seemed to have completely ignored the latest rise in commodity prices," added Tan, who recommended taking profit on our short Russian ruble position.

Downside risks for China include a sharp slowdown in the economy on the back of the government's financial crackdown, Fed rate hikes leading to capital outflows, and a potential U.S.-China trade war. "On the upside, however, strong global growth would be supportive for Chinese exports, while the Chinese economy might be more resilient to deleveraging than people expect," concluded Tan.

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