

OUTLOOK FOR FIXED INCOME MARKETS  
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Marketing Material

## Why China's re-opening could be a blessing for emerging market bonds

The re-opening of the world's second largest economy shouldn't concern those worried about inflation.

The sudden re-opening of China's economy has caused fresh uncertainty among fixed income investors already worried about inflation and interest rate hikes.

But the country's unexpectedly rapid loosening of Covid restrictions will provide much-needed growth for the world economy. Its effect on global inflation is likely to be muted.

The upshot is that this should create a benign climate for fixed income markets, particularly emerging market bonds.

### Emerging markets: the beneficiaries

China's return to the global economic stage is a momentous event. The world's second largest economy is a significant source of output, consumption of goods, services and natural resources as well as liquidity.

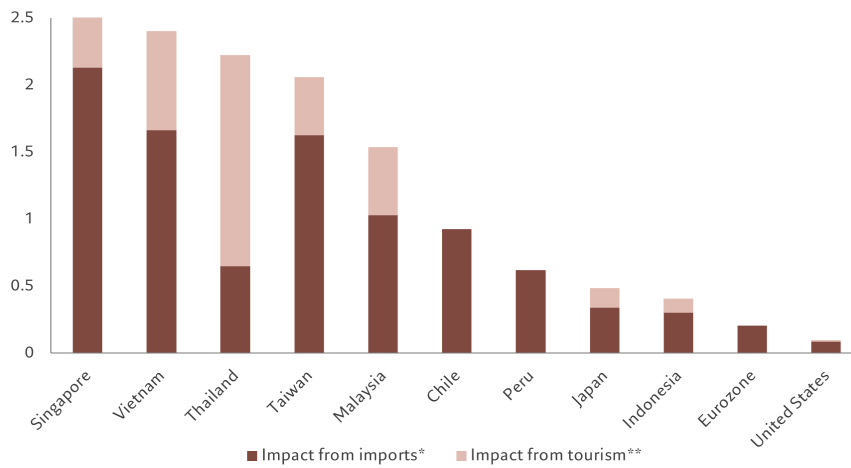
As such, its recovery will flow through to the rest of the world via trade, tourism and commodities. And, significantly, it will be other emerging market economies, rather than the developed world, that will receive the biggest boost.

Take imports. Chinese demand for goods made overseas is certain to surge as consumers loosen their purse strings after having spent nearly three years buying only food and other staples.

The scale of pent-up demand is considerable. Our analysis shows household excess savings – disposable income minus consumption – reached RMB5 trillion, more than twice the 2014 levels and equivalent of 4 per cent of GDP. According to our research, much of that spending will flow to other emerging nations – such as Singapore, Thailand and Chile.

Fig. 1 - Growth boost

Re-opening impact on GDP growth (%) from rising Chinese imports\* and tourism\*\*



\* Change in GDP growth from a 10 per cent increase in Chinese imports \*\* Change in GDP growth from a rise in tourism revenues from China, assuming tourism activity returns to half the 2019 level. Source: Pictet Asset Management, CEIC and Refinitiv. Data as of 31.01.2023

A pick-up in Chinese tourism should provide an additional economic boost to the emerging world. Thailand, for instance, expects as many as 5 million tourists from China this year and consumer spending to hit a three-year high.

Commodity exporters, especially those in Latin America, should also benefit from higher Chinese demand for their natural resources.

The developing world was already enjoying superior growth premium over their advanced peers. China's reopening will simply widen this growth gap further.

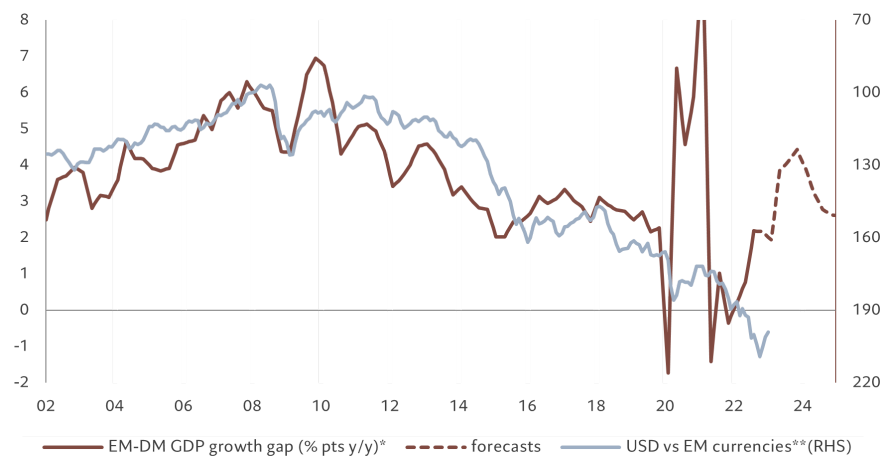
Taking all this into account, we expect emerging economies to grow over 4 per cent this year, outpacing developed peers, which will expand by just 0.5 per cent.<sup>1</sup>

## Stars aligned for emerging market bonds

This should translate into gains for emerging market currencies. As Fig. 2 shows, emerging market currencies tend to appreciate whenever the developing world's growth gap with advanced economies expands.

According to our model, emerging market currencies could appreciate by as much as 20 per cent against the US dollar. That, in turn, should provide a considerable source of return for emerging market local currency debt.

Fig. 2 - Superior growth in emerging world  
Growth gap and currency performance have strong correlation



\*Ex-Russia & Ukraine / \*\*Unweighted 17 EM exchange rates, rebased 100 to January 2008. Source: Pictet Asset Management, CEIC, Refinitiv, data covering period 01.01.2002 – 01.12.2024 (forecast)

The asset class was in any case cheap relative to its fundamentals.

Many emerging markets – especially in Asia and Latin America – already offer real yields on their local debt which are well above their five-year average and also higher than those in the US.<sup>2</sup>

Looking ahead, we expect emerging market sovereign and corporate bonds to be among the best performing fixed income asset classes in the next five years, with both local currency and dollar-based debt forecast to gain at least 7 per cent a year. We expect emerging corporate bonds to return 5.2 per cent.<sup>3</sup>

## International spillovers

But China's re-opening isn't free of risks.

Some investors fear its economic revival threatens to place a strain on already stretched global supply chains, pushing commodity prices higher and stoking inflation. This would then force central banks worldwide to tighten the monetary reins still further, risking a spike in developed market bond yields in a repeat of 2022 when US and European economies emerged from the lockdown.

The scenario is certainly plausible. China has already surpassed the US as the biggest consumer of energy and non-energy goods on a final demand basis.<sup>4</sup> Indeed, commodity prices such as copper and iron ore and copper have risen 20-40 per cent over the past three months.

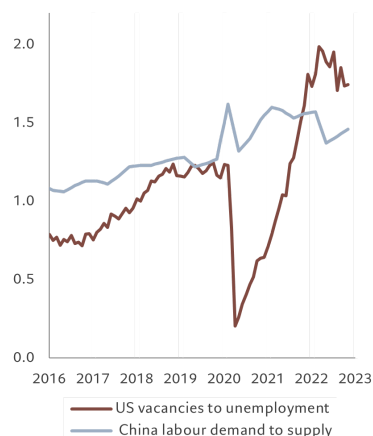
But we don't believe a pick-up in Chinese demand would radically change global inflation dynamics.

To begin with, much of the world economy is in a fragile state today. Many countries in the developed world are currently flirting with recession.

What is more, it is wrong to assume China's re-opening will play out in the same way as those of Europe and the US, when they removed Covid restrictions in early 2022. Then, wage inflation took hold primarily because of unusually tight labour markets.

At the time of the US's re-opening, for example, the number of job vacancies to the number of people unemployed had hit a record high of 2 to 1. So what began as higher prices for services quickly broadened out to all corners of the economy, triggering a wage-price spiral. Europe experienced similar problems. Yet China's employment market shows no such strains. It is far from excessively tight, with the job openings to unemployment ratio holding steady at around 1.5. This suggests it is unlikely to transmit price pressures to the rest of the world.

Figure 3 - Wanted: more staff  
US jobs demand outstripped supply in 2022



Source: Pictet Asset Management, CEIC, Refinitiv. Data covering period 01.01.2016 to 01.11.2022

This, in turn, means China's impact on global inflation is not powerful enough to trigger aggressive tightening from major central banks. Instead, they will soon reach the end of their rate hike campaigns. We expect the Fed to pause its rate hikes at around the 5 per cent mark.

Markets are already beginning to price in US interest rate cuts of as much as 171 basis points over the next three years, the most aggressive easing cycle ever seen while still hiking.

This should come as a relief to developed market bonds. We should expect no major sell-offs (which the asset class experienced last year), with yields likely to hover within narrow ranges.

China's abrupt opening is bound to cause upheaval throughout the world economy. But the benefits of its return to the global stage will outweigh the

risks, boosting the prospects of emerging debt without destabilising fixed income markets in the developed world.

[1] Pictet Asset Management, CEIC and Refinitiv

[2] Excluding Russia and Ukraine

[3] US 5-year real yield stands at 1.39 per cent, data as of 18.01.2022. Source: Pictet Asset Management, Bloomberg

[4] <https://am.pictet/en/uk/global-articles/2022/pictet-asset-management/secular-outlook#overview>

[5] OECD Trade in Value Added database, in 2015 final demand as a share of world value added

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