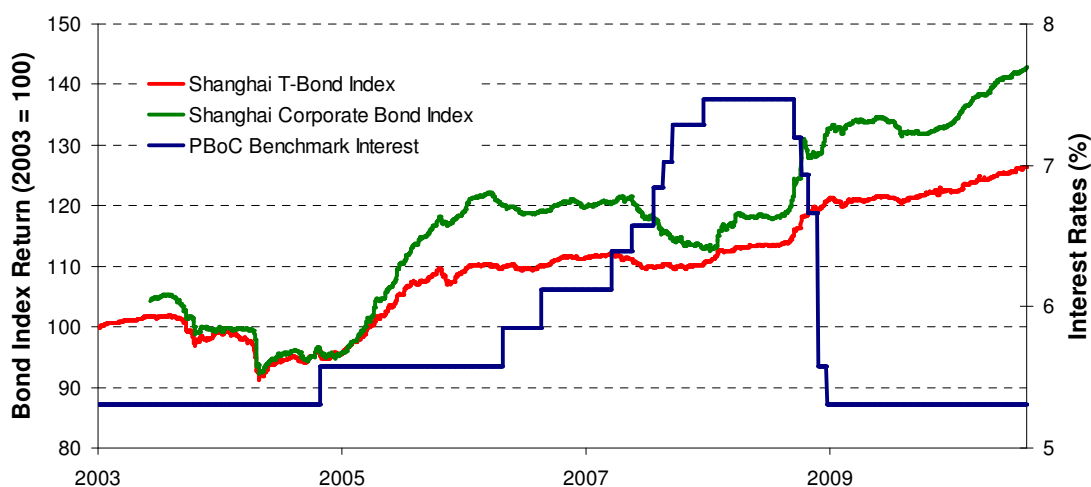


An interest rate outlook on China and impact on its bonds

Despite economic growth well underway (10.3% for 2Q2010), the People's Bank of China has resisted the temptation to hike the benchmark interest rate and has opted instead to cooling specific parts of the economy through other means e.g increasing the bank reserve requirement. Even so, it has done so with surgical precision, careful not to shake parts of the economy that are still need nurturing such as domestic consumption. However on the back of fresh inflation data, the People's Bank of China may look towards its first interest hike since 2008.

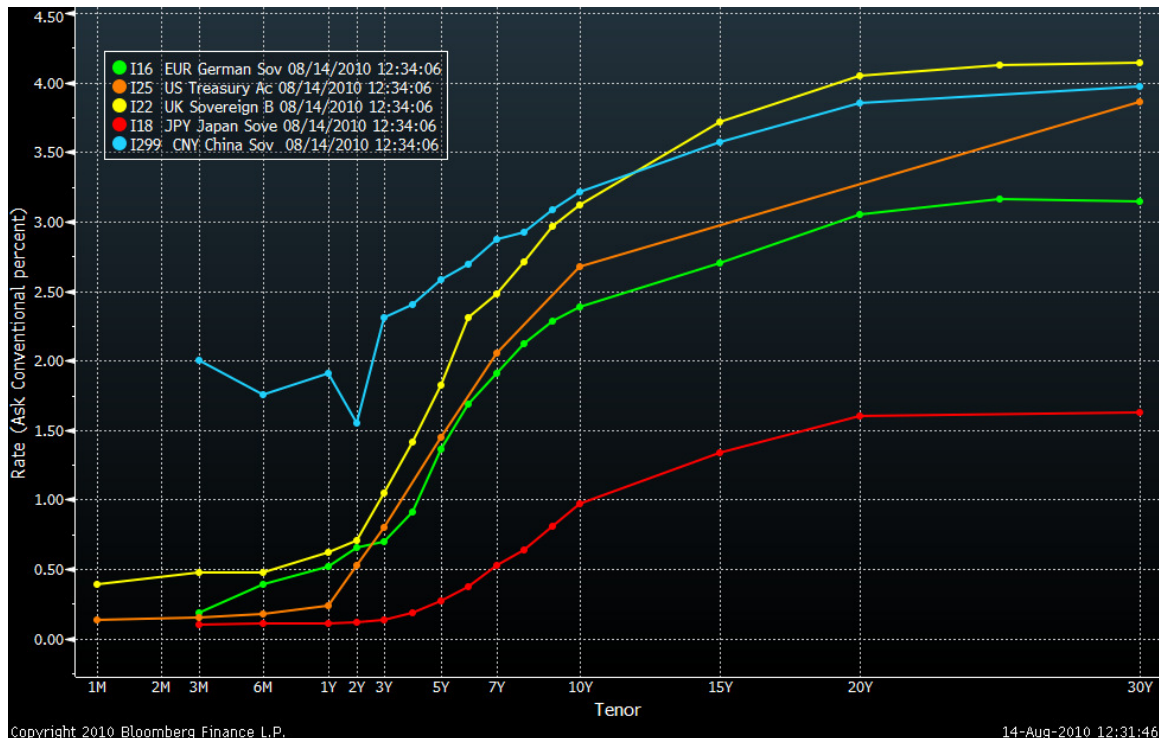
Investors should however not be overly concerned over a repeat of the steep interest rate hikes that took place during the 2004 - 2008. The last economic cycle which was characterized by credit fueled spending by the west is noticeably absent in this cycle as they continue to grapple with deleveraging pressures. More importantly, the key reason for resisting jumping on the interest rate hike bandwagon along with other Asia nations is so as not to choke off the budding growth of consumer spending growth, the 3rd engine of growth of the China economy. The takeaway here is that interest hikes are likely to come albeit at a more subdued pace that still favors fixed income investment.

China Central Bank Rate and Bond Indices Performance



The chart shows both government and corporate Renminbi bond delivering impressive returns through the last market cycle but underwent volatility during the peak of the interest rate hikes. It is therefore advisable for have a minimum 2 year holding period for such investments. It is also notable that despite market gyrations in the domestic share markets on the back of countercyclical measures being taken in 2010, both indices produced an respectable 3.3% and 7.0%.

Despite being backed by world leading foreign reserves of USD2.4 trillion, Chinese government bonds are trading at an attractive yield vis a vis their less financially sound counterparts such as United Kingdom, United States and Japan.



What we see here is elevated yield of the Chinese government debt especially at the short end of the curve. This provides cushion for spreads to tighten rather than widen and potential for price appreciation. The fact that the instrument is currently rated AA- (Fitch) also allows room for credit upgrades.

Despite the interest rate headwinds, we think the positives will triumph. Slight capital losses arising from increasing interest rates will be offset by the yields, credit improvements and possible currency appreciation and hence suitable for conservative investors with a minimum 2 year investment horizon or investors to hedge against equity risks in the China A share market.

Jack Chin, Manager, Investment Planning
iFAST Global Prestige

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