IMPERIUM CAPITAL

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DiversiChination

Global Matters Weekly

24 January 2022

– **Lorenzo La Posta, CFA**

Our regular readers would have read the word "diversification" countless times across our pieces, especially about it being "the only free lunch in finance". Now, everyone loves a free meal but certainly you're not going to eat it only because it's free, am I right? It needs also to look, smell and taste good, and the various courses need to be well balanced. We have recently added a new course to our menu, with a certain eastern flavour, that should make that free meal a lot more palatable for our clients: Chinese government bonds.

Before we continue, it's worth highlighting that a good diversifier is not necessarily also a defensive asset, despite defensive assets being often good diversifiers. Defensives are in fact those carrying little risk, typically offering lower return potential but outperforming riskier assets when things go badly, showing little to negative correlation with main risk assets like equities. Diversifiers are instead simply those having different, alternative return drivers than the rest of the portfolio.

Government bonds are very often part of a defensive allocation and are typically good diversifiers, but they don't all share the same characteristics. Developed market bonds today offer low nominal yields, even lower real yields, and, given the inflationary outlook and the prospects for rate hikes, they don't have a particularly rosy return outlook. Emerging market bonds offer higher yields, but that comes with significantly higher price volatility, currency and credit risk and a higher correlation with risk assets. Somewhere in between the two we find China, an emerging country on paper, but one of the two largest and most powerful economies in the world, offering a good compromise between the two.

We believe Chinese bonds offer an attractive combination of high income, good diversification benefits (low correlation with global equity and bond markets) and solid defensive characteristics, having held up really well during the pandemic and during most of the crises in the past 15 years.

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At the time of writing, the yield on a 10-year Chinese government bond hovers around +2.7% , solidly above the latest year-on-year inflation print of +1.5%[1] and down from as much as +3.3%[1] in November 2020. For comparison, a 10-year US Treasury bond is yielding +1.8%[1] today, up from +0.9%[1] fourteen months ago, with the latest headline inflation number at +7.0%[1]. Chinese bonds have outperformed the US thanks to a higher starting yield and divergent monetary policy: while markets have been pricing in increases in interest rates across the Atlantic to fight soaring inflation, reduce the central bank's balance sheet and withdraw some of the liquidity injected during the pandemic, they have instead been expecting quite the opposite for China.

The short term should be particularly beneficial. The People's Bank of China is shifting its policy focus from deleveraging to growth, with increased expectation of some monetary easing ahead and thus rising bond prices. The country's exports and trade balance continue to rise, making the external balance sheet stronger than ever. Chinese government bonds today are well positioned to outperform.

This investment doesn't come risk free per se and there are a few things to be mindful of: the central bank is not independent from the government, the country's facing slowing growth (though, still growing its GDP at an impressive +4%[1] p.a.) and a high level of corporate debt and its economic policy remains highly interventionist. However, we think we are being more than compensated for these risks, especially when placing these bonds in a multi-asset portfolio context.

[1] *Source: Bloomberg L.P. Finance*

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The **Marketplace**

- Global equities fell -4.7% last week
- Risk markets across the world saw declines amidst inflation and interest rate concerns
- Brent crude rose +2.1% to $87.9 a barrel
- Gold increased by +1% to $1835.4

Market **Focus**

US

- Benchmark US equities declined -5.7% last week on the back of interest rate and growth fears. The benchmark technology index fell by -7.5%, with Netflix notably falling by over 20%
- The Empire State manufacturing survey for January fell to -0.7 (vs. 25.0 expected), and the NAHB's housing market index fell to 83 (vs. 84 expected)
- US jobless claims rose unexpectedly to 286K, the most since mid-October
- Futures markets are currently pricing in a nearly two-thirds chance of official short-term rates increasing by at least +1% in 2022
- President Biden is considering deploying several thousand U.S. troops, as well as warships and aircraft, to NATO allies in the Baltics and Eastern Europe amid mounting fears of a Russian incursion into Ukraine.

UK

- U.K. equities fell -0.5% last week
- CPI inflation had another upside surprise in December at +5.4% (vs. +5.2% expected), the fastest pace since 1992. BoE Governor Andrew Bailey is concerned that elevated UK inflation might last longer than previously forecast, due to surging energy costs and increased wage demands
- UK consumer confidence fell in January to lows last seen during the early months of lockdown in 2021 at -19 (vs. -15 estimated) as the cost-of-living crisis took over from the pandemic as a primary concern.
- UK unemployment fell to a post-pandemic low of 4.1% in the three months ending in November (vs. 4.2% expected)
- The U.S. and UK planned to announce the start of talks to ease steel and aluminium tariffs that the Trump administration imposed on national-security grounds, aiming to remove a long-standing obstacle in their trade relationship.

Europe

- European equities fell -1.5% last week
- In Germany, the January ZEW survey saw expectations rise to a 6-month high of 51.7 (vs. 32.0 expected)
- The final reading of December's Euro Area inflation matched the initial estimate of +5.0%, the highest in the currency's history.
- Germany's PPI inflation accelerated to +24.2% year-on-year in December (vs. +19.3% expected), the highest level since 1949
- The prospect of PM Mario Draghi being selected as Italy's next president strengthened after former president Silvio Berlusconi pulled out of the running.

Asia/Rest of The World

- The benchmark Global Emerging Markets index fell -0.1% last week
- Japanese equities fell -2.6% last week
- Chinese equities rose by +1.5% as the government stepped up monetary easing measures and signalled additional support for the beleaguered property sector
- The Bank of Japan revised up its inflation forecast to +1.1% in fiscal 2022 from a +0.9% rise estimated earlier and sees inflation for fiscal 2023 reaching +1.1% from +1.0%
- Japan's headline inflation (+0.8% y/y) in December failed to surpass the market expectations of a +0.9% reading and may quell some of the recent policy normalisation stories
- Australia's, flash services PMI came in at 45.0 vs 55.1 previously and the manufacturing PMI came in at 55.3 vs 57.7 previously.

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Asset Class/Region	Currency	Currency returns			
		Week ending 21 Jan. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-5.7%	-7.7%	-7.7%	15.3%
United Kingdom	GBP	-0.5%	2.2%	2.2%	17.4%
Continental Europe	EUR	-1.5%	-3.5%	-3.5%	17.2%
Japan	JPY	-2.6%	-3.3%	-3.3%	5.8%
Asia Pacific (ex Japan)	USD	-1.3%	0.0%	0.0%	-11.2%
Australia	AUD	-2.9%	-3.6%	-3.6%	9.1%
Global	USD	-4.7%	-6.4%	-6.4%	10.9%
Emerging markets equities					
Emerging Europe	USD	-4.9%	-6.8%	-6.8%	2.8%
Emerging Asia	USD	-1.3%	0.4%	0.4%	-13.8%
Emerging Latin America	USD	1.2%	5.0%	5.0%	-2.3%
BRICs	USD	-0.1%	1.7%	1.7%	-17.2%
China	USD	1.5%	2.7%	2.7%	-28.2%
MENA countries	USD	1.4%	7.0%	7.0%	33.3%
South Africa	USD	1.6%	8.6%	8.6%	5.9%
India	USD	-3.7%	1.8%	1.8%	20.0%
Global emerging markets	USD	-1.0%	1.0%	1.0%	-9.6%
Bonds					
US Treasuries	USD	0.2%	-1.4%	-1.4%	-2.7%
US Treasuries (inflation protected)	USD	0.1%	-2.6%	-2.6%	3.0%
US Corporate (investment grade)	USD	-0.1%	-2.5%	-2.5%	-2.3%
US High Yield	USD	-0.7%	-1.5%	-1.5%	3.0%
UK Gilts	GBP	-0.5%	-2.2%	-2.2%	-5.6%
UK Corporate (investment grade)	GBP	-0.5%	-1.5%	-1.5%	-3.7%
Euro Government Bonds	EUR	0.0%	-0.4%	-0.4%	-3.2%
Euro Corporate (investment grade)	EUR	0.0%	-0.6%	-0.6%	-1.5%
Euro High Yield	EUR	-0.4%	-0.4%	-0.4%	2.2%
Japanese Government	JPY	0.1%	-0.3%	-0.3%	-0.4%
Australian Government	AUD	-0.4%	-1.2%	-1.2%	-4.2%
Global Government Bonds	USD	-0.1%	-0.8%	-0.8%	-6.2%
Global Bonds	USD	-0.3%	-1.2%	-1.2%	-5.7%
Global Convertible Bonds	USD	-2.2%	-3.6%	-3.6%	-9.0%
Emerging Market Bonds	USD	0.0%	-3.6%	-3.6%	-6.2%

Source: Bloomberg. Past performance is not indicative of future returns

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		Week ending 21 Jan. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-3.9%	-7.7%	-7.7%	29.9%
Australian Property Securities	AUD	-3.0%	-8.9%	-8.9%	14.0%
Asia Property Securities	USD	1.6%	2.4%	2.4%	-3.4%
Global Property Securities	USD	-2.5%	-5.0%	-5.0%	16.3%
Currencies					
Euro	USD	-0.5%	-0.4%	-0.4%	-6.6%
UK Pound Sterling	USD	-0.7%	0.2%	0.2%	-1.1%
Japanese Yen	USD	0.4%	1.2%	1.2%	-8.9%
Australian Dollar	USD	-0.2%	-1.2%	-1.2%	-7.2%
South African Rand	USD	2.3%	5.7%	5.7%	-0.6%
Swiss Franc	USD	0.3%	0.0%	0.0%	-2.8%
Chinese Yuan	USD	0.2%	0.3%	0.3%	1.9%
Commodities & Alternatives					
Commodities	USD	1.8%	6.8%	6.8%	44.1%
Agricultural Commodities	USD	2.0%	2.5%	2.5%	32.7%
Oil	USD	2.1%	13.0%	13.0%	56.7%
Gold	USD	1.0%	0.3%	0.3%	-1.6%
Hedge funds	USD	-0.6%	-1.3%	-1.3%	1.2%

Source: Bloomberg. Past performance is not indicative of future returns

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