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PENSION FUNDS LETTER

Building together smart solutions to face a challenging environment

Confidence must be earned

Amundi ASSET MANAGEMENT

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EXECUTIVE SUMMARY

The Red Dragon continues its ascent

In this latest edition of Amundi Pension Fund Letter we turn our gaze to China. The world's second largest economy since 2010, China is now emerging from the United States' shadow and may well become the world's leading economic power by 2030.

China's prospective position in the new international order has also been highlighted by the recent conflict in Ukraine. After an initial passive stance to the crisis, it has shifted to becoming strategically neutral. Its intervention is a game-changer and a role as a mediator would affirm its position as a global geopolitical power.

The search for Common Prosperity has seen many recent regulatory adjustments and crackdowns, which may have led some to be deterred from investing in the country. We explore these impacts and what this might mean for China's growth and economic prospects.

China's increasing global prominence across all spheres means it can no longer be overlooked by global investors, particularly as a diversifier given its low correlation to developed markets. But what is the best way for investors to gain exposure and take advantage of China's compelling domestic demand and growth story?

Aside from the investment rationale, consideration should also be given to how international institutional investors, such as pension funds, can access the Chinese financial markets. Whilst the percentage of foreign investment in domestic Chinese assets has grown in recent years, the overall exposure remains low and well below the relative share of China in the global economy. We look at how this has evolved and the different options available to pension funds wanting to gain access.

We then turn to the developments in China's own pension system, the world's largest, and the reforms it has put in place as it tries to address its challenges in inequality and demographics.

This edition wraps up with our regular focus on pension funding ratios. While funding ratios of European pension funds have continued improving since our last Pension Fund Letter in December 2021, the future developments in the current bear market remain to be seen.

In brief, this edition highlights that regardless of the standpoint, China's influence at a global level has grown significantly and it can no longer be regarded as a peripheral or emerging participant on the world stage.

Claire HUANG
Senior EM Macro Strategist

China: Plotting a course for Common Prosperity

In the past year, markets witnessed unprecedented regulatory resets in China. Tightening measures in housing, off-campus tutoring and e-commerce, coupled with fiscal austerity and slowing credit growth, has dragged Chinese economic growth into a low single digit trajectory. At the turn of the year, it became clear that the wide and deep structural adjustment was too painful for the economy. Beijing started to correct where it had previously overdone, carried out easing and accelerated fiscal spending to support infrastructure build-outs and manufacturing upgrade. That said, we still see hesitation to relax zero-tolerance Covid-19 policy, and reluctance to exit from the full-fledged housing tightening. Certain policy changes are more permanent than others.

In fact, we are just at the beginning of China's voyage towards a modern socialist country. In the initial stages, policy errors are inevitable, but we expect increasing clarity and coordination to assist the structural economic transition. Markets, however, have to adapt to new policy reaction functions and to reprice for Common Prosperity pursuits. Above all, Beijing's tolerance of slower growth has increased notably, and we expect China to be less reliant on policy stimulus in the longer run.

The 6th Plenum – Confirming continuity of power in 2022

To put things into perspective, 2021 was a critical year in Chinese politics. While markets were busy deciphering economic policies and regulatory trends, the 19th Communist Party of China (CPC) Central Committee concluded its Sixth Plenum in November and passed the *Resolution of the CCP Central Committee on the Major Achievements and Historical Experiences of the Party's Centennial Struggle*. It is only the third Historical Resolution since the birth of the CPC.

Mao's first Historical Resolution in April 1945 and Deng's second one in June 1981 both marked a departure from the past and rerouted China's development for the following decades. The third, however, is not meant to discern between right and wrong in the past, but to summarise the Party's centennial struggle and experience for a better future.

At the press conference, CPC Central Committee speakers stressed that the third Historical Resolution had confirmed Xi as the core of the Party and the importance of following *Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era*. This suggests a continuation of Xi's leadership after the 20th Party Congress in late 2022, which will be his third five-year term as CPC's General Secretary.

Destination: a land of modern socialism

Incorporating Xi's new development philosophy, this Third Historical Resolution pans out a long-term blueprint for China proposing a continuous pursuit of Common Prosperity, comprehensive opening-up and reforms, science and technology independence, and military modernisation.

In our view, **the success of Common Prosperity goes hand in hand with high quality growth**. First of all, doubling Chinese GDP by 2035 from its 2020 level is deemed achievable by Xi, implying a growth rate of above 4% for the coming decade. Future economic growth, however, will be less debt-laden and depends upon a continuous improvement of productivity.

Table 1: Three Pillars to achieving Common Prosperity

THREE PILLARS IN ACHIEVING COMMON PROSPERITY	
High-quality growth	**Double GDP in 2035 from 2021** • Minimum growth rates: 5% in 2022-25, 4.5% in 2026-30, 4% in 2031-35
	Domestic circulation: reform-driven growth; boost productivity • The L challenge: Population peak in 2026. Relax birth control, revive fertility, invest in human capital • The K challenge: Green Transition: carbon emission to peak in 2030, carbon neutrality in 2060; Credit efficiency: direct money away from housing/old infra (LGFV) to emerging sectors
	External circulation: balance opening-up with security • Build independent and secure supply chains • Financial market liberalisation to go along with Belt & Road, RMB internationalisation
Spread the wealth	**Raise the share of middle income** • Enhance income redistribution via tax (consumption, property, inheritance), social security and donation
	Transform the corporate sector • Fill in the regulatory blanks; Corporate Social Responsibility • Anti-monopoly, anti-unfair competition, anti-corruption
	Address rural-urban imbalance, regional imbalance • Increase rural household incomes, by raising the transferability of land use rights (Zhejiang pilot to go first)
DEFUSE FINANCIAL RISKS	

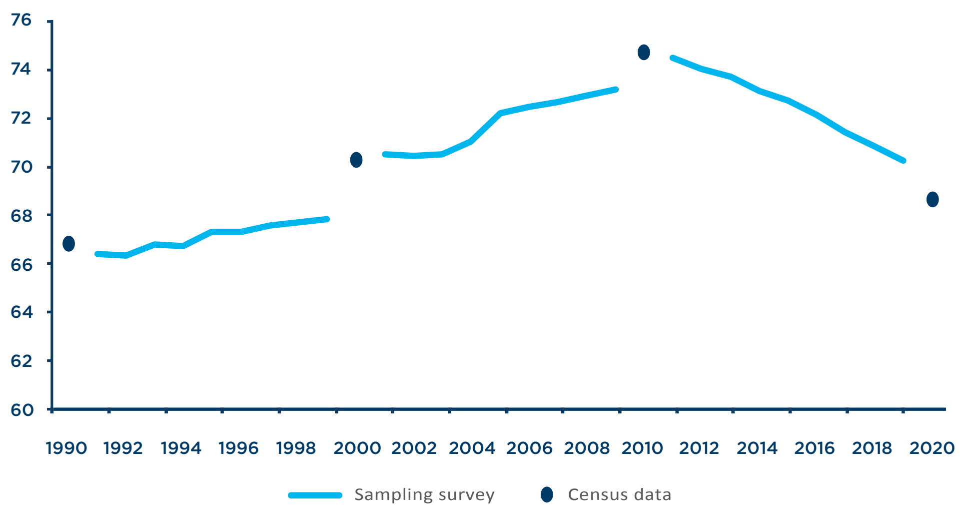
Source: CPC Constitution, Xinhua, Amundi Research.

As explained in the communiqué, Chinese leadership thinks the traditional growth model can no longer be sustained. While faced with strong demographic headwinds (Chart 1), making painful structural adjustments, and absorbing the effects of previous economic stimulus policies all at once, the GDP growth rate will not serve as the sole yardstick of success for development.

Rather, it was imperative to achieve **high-quality development** in which innovation is the primary driver, coordination is an endogenous trait, eco-friendly growth prevails, openness to the world is the only way, and shared growth is the ultimate goal, with a view to propelling transformative changes in the quality, efficiency, and impetus of economic development.

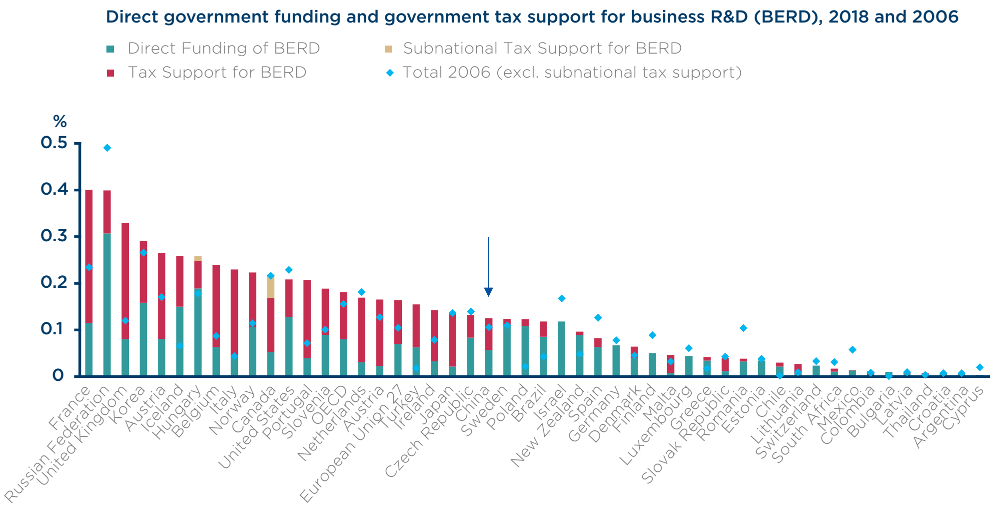
In Xi's own words, the advancing role of science and technology will play a bigger role in China's production function in the future, as the contributions from labour force growth and capital expansion diminish. In fact, the 14th Five-Year Plan promotes China's R&D spending to increase by more than 7% annually, and to account for a higher percentage of GDP than that during the 13th Five-Year Plan period. China's direct government support and spending for basic research is likely to climb in the following years.

Figure 1: China's working age population (age 15-64, % of total)



Source: NBS, Amundi Research

Figure 2: Direct government support in R&D



Source: OECD R&D Tax Incentives Database, http://oe.cd/rdtax, December 2020. For Argentina, Australia, Belgium, Brazil, China, France, New Zealand, Switzerland and Thailand, latest available figures of direct and tax support for business R&D refer to 2017 instead of 2018. For Romania, South Africa, and the United States, latest available figures of direct and tax support for business R&D refer to 2016 instead of 2017.

Short-term pain for long-term sustainability

The implications of the new development philosophy are profound. For one, we expect **China to be less reliant on policy stimulus**. Monetary policy will stay conventional as long as possible, and easing tools as targeted as possible, with the Carbon Emission Reduction Support Facility being the latest case in point. Meanwhile, for the most part, broad credit will be guided to expand at a similar pace as nominal GDP growth. Under national strategic planning, resources have been increasingly directed into the strategically important sectors that fulfil the green and innovative development theme. This also involves the financial sector's participation, which in the past had devoted too much into the housing sector. Hence, it is not a surprise when Beijing imposed caps on Chinese banking sector's exposure to the real estate sector, by restraining developer loan growth and mortgage growth.

The administration is also committed to supply-side structural reforms. Proposed by Xi back in 2015, the initial five priorities in promoting supply-side reform were cutting overcapacity, reducing excess inventory, deleveraging, reducing costs, and strengthening areas of weakness. In 2018, the leadership started to consolidate the gains of the five priority tasks, stressing improvement in the vitality of the private sector, upgrade value chains, and removing administrative bottlenecks in the economy.

Nevertheless, this also means the regulatory blanks will be filled. In 2021, to align the corporate sector with national development interests, we have seen the crackdown on monopolistic behaviour in the tech sector, not to mention the introduction of anti-monopoly, anti-trust and anti-unfair competition laws.

Against this backdrop, even though expanding the **domestic market will remain a strategic priority, it is not designed to be achieved by over-stimulating investment and consumption**, or reverting back to energy-intensive, high-emission projects. There is a structurally embedded preference for **reforms over seeking counter-cyclical stimulating measures**. There are clear signs that the latter will be adopted only when it is necessary to mitigate pains of a sharp economic slowdown, should such an event occur.

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The giant awakes. How China is shaking up the global investment landscape

Part I: The time is ripe for Chinese assets. Examining their role in a global portfolio

China has risen as a global economic superpower in recent decades, becoming the second largest economy in the world and its importance on the global stage is still expanding. Nowadays, a structural economic transition is underway to ease China towards high-quality growth, boosting competition, productivity and reducing systemic risks over a long-term horizon.

Looking ahead, China has a big role to play: its geopolitical relevance globally, its growing economic power and its emerging middle class are key opportunities for investors. In that respect, **global investors should look at making standalone allocations to Chinese markets**, to gain exposure to the country-specific story and domestic demand growth, coupled with China's limited correlation to developed markets. Chinese assets and currency are no longer emerging.

Chinese government bonds: a source of real positive yield

More than two years after the pandemic started, most Central Banks are starting to end their strategy of easy money. Global inflation is the main threat that a wide range of western and emerging markets central bankers are facing. While the US Federal Reserve (Fed) is preparing to raise interest rates at its upcoming Fed FOMC meeting (16 March 2022) and the market is pricing-in a rate hike at almost every meeting through to the end of 2022, the People's Bank of China (PBoC) is moving in the opposite direction and ramping up support for the Chinese economy.

Figures 1. and 2. PBoC vs. other CBs: orthodox vs. unorthodox, easing vs. tightening

Fig. 1.: Central banks balance sheets

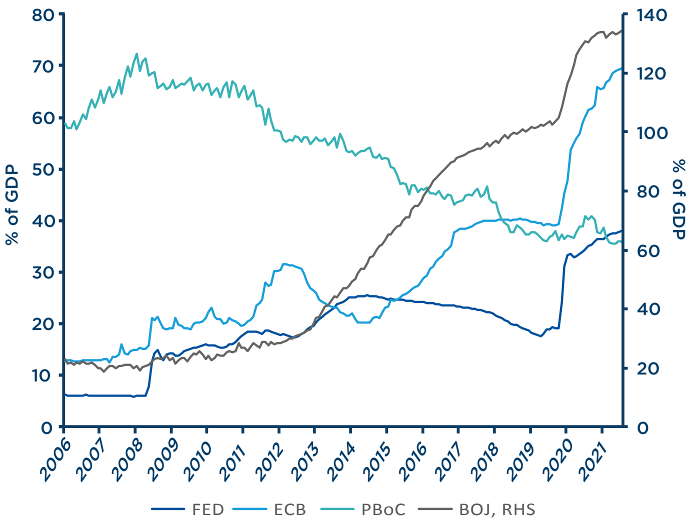
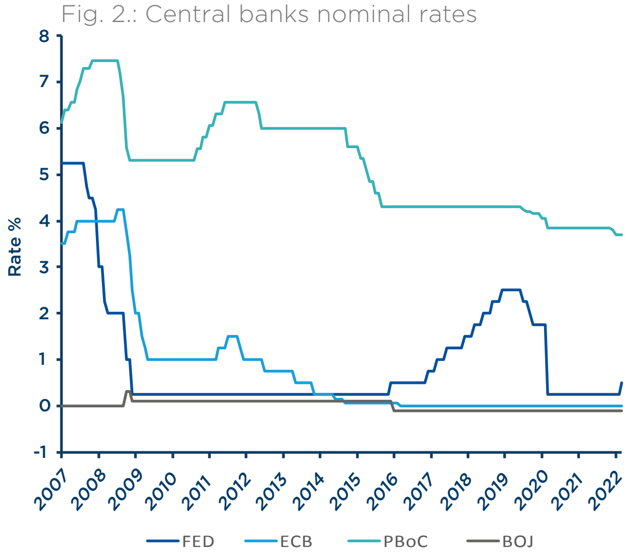


Fig. 2.: Central banks nominal rates



Source: Left chart. Amundi elaborations on Bloomberg and Refinitiv data. PBoC data are computed by Amundi Research. Data is as of December 2021. Right chart. Amundi on Bloomberg data as of 16 March 2022. Fed: Federal Reserve; ECB: European Central Bank; PBoC: People's Bank of China. BoJ: Bank of Japan. DM: developed markets.

This accommodative monetary policy stance, coupled with subdued inflation in China, are supportive for Chinese government bonds, which is **one of the main havens for positive real returns worldwide**. Chinese government debt outperformed US Treasuries and other global bonds in 2021 and we believe that this trend could continue, allowing investors to explore long-term opportunities in the asset class thanks to an attractive carry and there is still further room for bond yields to fall, amid tame inflation and a clear monetary easing trajectory.

Figure 3. Chinese sovereign debt outperforms

Source: Amundi on Bloomberg. Data is as of 24 February 2022. The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. The Bloomberg Global Agg Treasuries Total Return Index Value Unhedged USD Index includes treasuries, from both developed and emerging markets issuers. The Bloomberg China Aggregate Treasury Index tracks the performance of the Treasury component of the China Aggregate.

Investing in Chinese equities, a long-term opportunity

The Chinese equity market offers a significantly high potential return that investors should consider with a long-term view. There are structural forces at play that we believe will make the asset class **a core component of a diversified portfolio**, deserving an ad-hoc allocation in portfolios for various reasons:

1. it's one of the easiest ways to gain exposure to China's domestic demand and growth,
2. given its low correlation with developed markets, it could be considered as a true diversifier and
3. the greater autonomy of the Chinese cycle and better insulation from global economic, financial and geo-strategic considerations should provide higher desynchronised benefits and **an opportunity to gain exposure to areas of higher future growth**.

The Chinese onshore market is predominately composed of China A-shares (see Part II). Some technical points support the idea that foreign investors should look at this fast growing market. Its capitalisation size and the number of stocks are substantially larger for A-shares than the offshore market. Furthermore, it offers more balanced and diversified sector profiles and better reflects the real China and could, therefore, benefit from domestic demand dynamics, making a rather appealing investment proposition for global investors.

Figure 4. Ten-year correlation between China shares with other equity markets

	MSCI China	MSCI China A Onshore	MSCI EM	MSCI India	S&P 500 Index	MSCI Europe	MSCI World
MSCI China	1						
MSCI China A Onshore	0,64	1					
MSCI EM	0,86	0,49	1				
MSCI India	0,51	0,2	0,69	1			
S&P 500 Index	0,51	0,3	0,67	0,53	1		
MSCI Europe	0,52	0,28	0,68	0,57	0,77	1	
MSCI World	0,59	0,33	0,76	0,59	0,97	0,85	1

Source: Amundi on Bloomberg data. Calculations are based on weekly data for the past ten years. Data is as of 31 January 2022. The correlations are with local-currency indices. DM: developed markets. EM: emerging markets.

The Renminbi: its rise as a reference currency

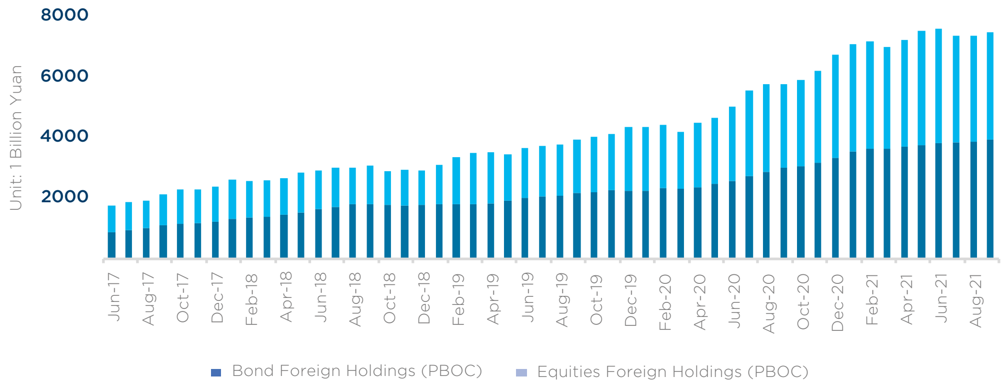
Global investors can also view the Chinese currency as a **store of value**. In light of the financial market opening in China, coupled with an increase of foreign investments into Chinese markets, the renminbi has strengthened as a reference currency for global investors as **a key currency for trade, capital, reserves and savings.** In the coming years the internationalisation of the renminbi should continue, allowing it to grow in international prominence, becoming an **alternative to the dollar** for Asian economies and attaining reserve currency status. As we mentioned for other Chinese assets, in our view, **China's currency should no longer be either emerging or peripheral in terms of portfolio construction.**

Part II: Opening the door to the Chinese domestic market. Access points for pension funds.

Over the last 20 years, the Chinese market has gradually matured and opened to international investors. Foreign investors can now virtually access 90% of the $35trn domestic market (balanced between Equities and Bonds). As shown in Figure 5, Chinese assets held by foreign investors have doubled in the last two years to reach CNY[1] 7.5trn at the end of 2021 (CNY 4trn in bonds and 3.5trn in equities). This appetite for Chinese assets is also shown by Global Foreign Direct investments data where China represented **15% of global flows in 2020**[2]. Whilst this trend has significantly accelerated in recent years, the market share of foreign investors still only represents about 3% of domestic Chinese assets (compared, for example, to more than 30% for US Treasuries[3], 15% for US MBS[4]and 13% for Japanese government bonds[5]). Additionally, allocation to Chinese assets by institutional investor portfolios is relatively low compared to the weight of the China in the global economy and the share of the renminbi in global trades. In a 2020 survey, Greenwich Associates found that the average exposure was only 4.6% of total assets (via direct investments, but mainly through global or emerging market strategies). Pension fund exposure was notably lower than the average at 3.3%[6].

1 The name of the Chinese currency is the Renminbi (RMB). The Yuan (¥) is the name given to one unit of renminbi. CNY and CNH are 2 types of RMB: CNY is controlled by the Chinese authorities and traded onshore exclusively, CNH is traded offshore (settled via HK, hence the "H" of CNH) and its price is freely determined by market forces. Even though CNH and CNY are both worth the same amount of RMN (1¥) and 1 CNH can be cleared for 1 CNY, they can trade at different levels vs foreign currencies, depending on capital flows and CNH/CNY convertibility conditions/restrictions (organized and controlled by Chinese Authorities).
2 See UNCTAD 2021 World Investment Report. https://unctad.org/system/files/official-document/wir2021_en.pdf
3 See https://ticdata.treasury.gov/Publish/mfh.txt
4 See https://www.ginniemae.gov/newsroom/publications/Documents/foreign_ownership_agency_mbs2021.pdf?csf=1&e=ulymVg#:-:text=For%20the%20second%20consecutive%20year,%2482%20billion%2C%20or%207.6%20percent.
5 See https://www.mof.go.jp/english/policy/jgbs/publication/debt_management_report/2021/esaimu2021.pdf
6 See Greenwich Associates Q2 2020 Crafting the Optimal China Allocation Strategy

Figure 5. Domestic RMB Financial Assets Held by Overseas Entities

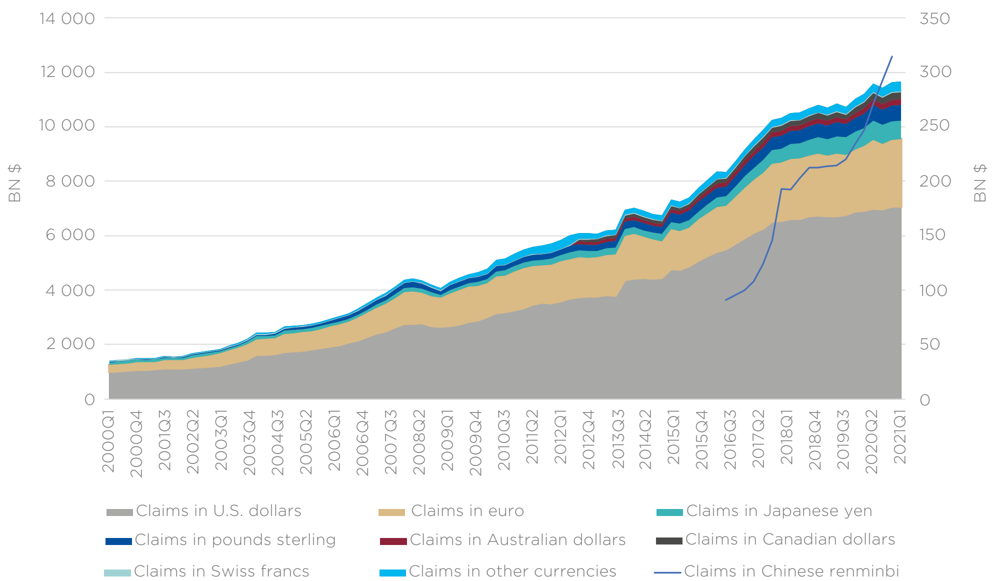


Source: PBOC

A gradual opening of the Chinese domestic market to international investors

The internationalisation of renminbi (RMB) has accelerated since the International Monetary Fund's (IMF) inclusion of the RMB in the basket of currencies in its Special Drawing Rights (SDR) on October 1st 2016[7]. This inclusion was a recognition of China's expanding role in global trade and the substantial increase in the international use and trading of the renminbi and it **reinforced the position of the Chinese economy in the global financial system.** As a result, the share of RMB in international reserves held by Central banks has sharply increased to represent more than $300bn today. Meanwhile, in its Second RAMP Survey on the Reserve Management Practices of Central Banks[8], the World Bank highlighted that among its 100 respondents, only 52% have the ability to hold CNY as part of their foreign exchange reserves and their allocation is still limited to 3.5% on average (vs a 11.5% weight in the SDR[9]).

Figure 6. World Currency Composition of Official Foreign Exchange Reserves

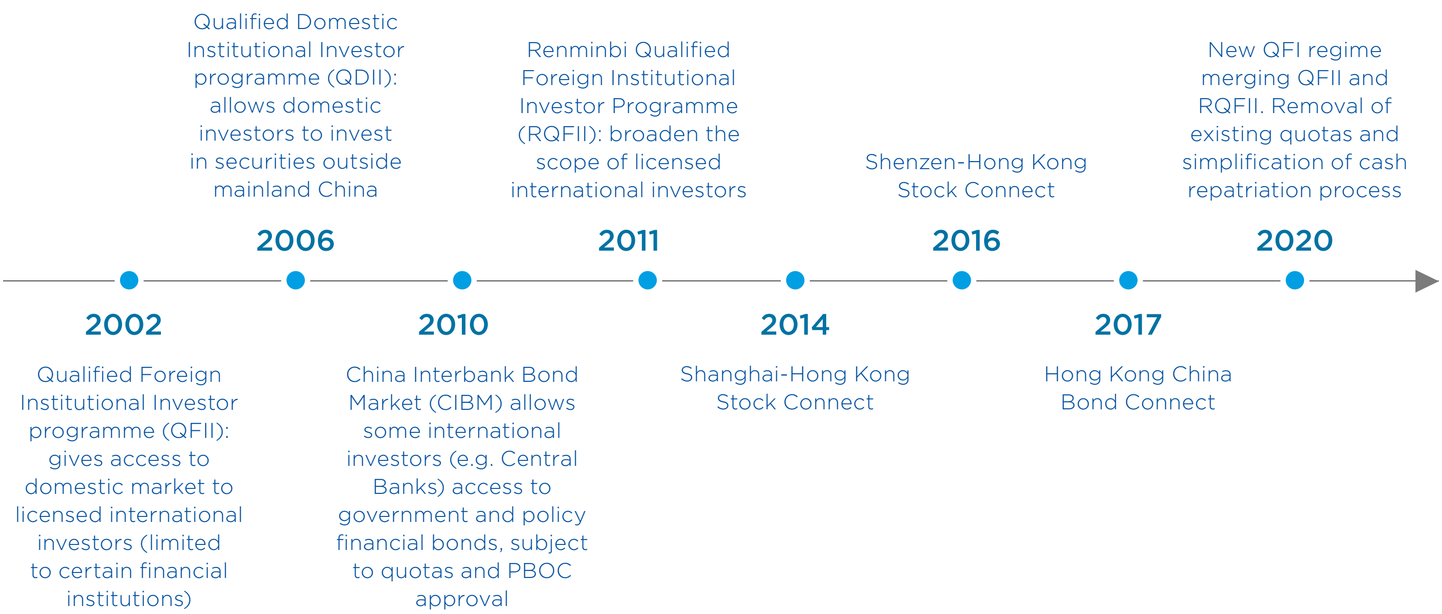


Source: IMF

7 See https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/14/51/Special-Drawing-Right-SDR
8 Central Bank Reserve Management Practices : Insights into Public Asset Management from the Second RAMP Survey https://openknowledge.worldbank.org/handle/10986/33657
9 See IMF SDR Valuation. https://www.imf.org/external/np/fin/data/rms_sdrv.aspx

There is still strict oversight from Chinese authorities and regulators on foreign investors (e.g. 2014/2015 decisive measures to restrict capital outflows). Meanwhile, in this overall capital control framework, specific channels, detailed in Box 1 and 2, have been created and improved over the past 20 years in order to facilitate access to the Chinese domestic market (Qualified Foreign Investor status, Stock Connect, Bond Connect and China Interbank Bond Market). In this process, Chinese authorities are targeting large and stable institutional investors, in particular pension funds (in addition to commercial banks, insurance companies, charities, endowments, international organisations and sovereign wealth funds).

Figure 7. Timeline of Chinese gradual opening to international investors



Meanwhile, renminbi exposure associated with investing in RMB denominated instruments can be a challenge for foreign investors, especially fixed income investors, as they might not wish to keep the FX risk.

Whilst hedging instruments on the CNH, the offshore renminbi market, have been available for some time, the basis risk with the on-shore market has seen significant deviation, like during the summer of 2015. As such, developing an efficient access to onshore RMB FX hedging instruments has been critical for Chinese authorities to promote its domestic bond market to international investors. Whilst the onshore FX derivatives market was initially restricted, on the whole, to Central Banks and large international organizations via the China Interbank Bond Market (CIBM), the access to FX hedging instruments has been greatly broadened and simplified since the inception of the Bond Connect framework that now allows hedging FX risk via both offshore or onshore RMB.

Pension funds allocation to the Chinese market is growing rapidly

Asset allocation to Chinese assets in international portfolios has been growing thanks to a mix of technical aspects (regulatory and infrastructure improvements), a maturing market (increased transparency), attractive risk premia and portfolio diversification, which we will cover later in this article. **Many pension funds, in particular, increased their allocation to Chinese assets in recent years**. Caisse des Dépôts du Quebec (CDPQ) Annual Report mentions a CAD 3.425bn investment in Chinese equities as of end 2020 (a still modest 1% of their AUM), up from CAD 2.187bn in 2019, while Reuters reports that according to German Bundesbank, German funds, including pension funds, invested a total of €2.5bn in Chinese bonds as of November 2020 (up 62% vs November 2019). In Sweden, AP2's strategic asset allocation includes 2.5% in Chinese A Shares and 1% Chinese government bonds[10]. According to De Nederlandsche Bank (DNB), Dutch pension funds reported an investment of €22.4bn in China as of Q3 2019, mainly in stocks, with only €300M in bonds[11].

Some investment challenges remain

Meanwhile some persistent challenges highlight the difference between the potential and the actual foreign investments on Chinese domestic markets. For example, Japan's Government Pension Investment Fund recently announced it has decided not to include RMB denominated government bonds in its portfolio despite their inclusion in the FTSE Russell global bond index, citing issues surrounding settlement, liquidity and stability. Successfully opening domestic markets to

10 https://ap2.se/en/asset-management/asset-management/strategic-asset-allocation/
11 https://www.reuters.com/article/us-global-bonds-china-insight-idUSKBN29P02P

international investors has required a gradual transition to standards required by these investors, in terms of market organization, regulation, corporate governance, engagement practices, reporting and accounting rules amongst others. Whilst clear progress has been made over the last few years, **some improvements are still needed to align Chinese local markets with the standards of international investors**. For example, many companies still have concentrated and controlling shareholders, with relatively opaque board management practices, while Chinese authorities still keep an upper hand on sectors or companies deemed strategic (which led to the regulatory pressures of summer 2021 that deeply impacted international investors, as detailed in Box 1). Aware of these challenges, Chinese Authorities have included "Transformation of the corporate sector" as an explicit part of its "Pillars to achieving Common Prosperity" (see Table 1 of article 1).

Box 1: Equity market

The Chinese equity market should not be considered as a single entity. It is split between the offshore market (HK and NYC) and the onshore markets of Shanghai and Shenzhen, with different classes of shares traded in several currencies (see Figure 8). Access to the domestic market for international investors is organized in the Stock Connect[12] framework, a cross-boundary investment channel that links the Hong Kong stock exchange with China's mainland markets in Shanghai (since 2014) and Shenzhen (since 2016). Stock Connect allows foreigners to buy China A-shares listed on the mainland, but also Chinese investors to purchase select Hong Kong and Chinese companies listed in Hong Kong.

Figure 8.

	Onshore		Offshore			
Share Type	A Shares	B Shares	H Shares	Red Chips	P Chips	N Shares
Description	Companies incorporated and listed in mainland China	Companies incorporated and listed in mainland China, denominated in foreign currency	Chinese companies incorporated in mainland China, listed in Hong-Kong	State-Controlled Chinese companies incorporated in Hong-Kong	Share of Chinese companies incorporated offshore controlled by mainland Chinese individuals	Chinese shares listed on international stock exchanges
Stock Exchange	Shanghai and Shenzhen	Shanghai and Shenzhen	Hong Kong	Hong Kong	Hong Kong	NYSE and NASDAQ
Investors	Chinese investors, international investors via Stock Connect	Chinese investors, international investors via Stock Connect	International investors, Chinese investors via Stock Connect	International investors, Chinese investors via Stock Connect	Iinternational investors, Chinese investors via Stock Connect	International investors, Chinese investors via Stock Connect
Currency	RMB	USD (Shanghai), HKD (Shenzhen)	HKD	HKD	HKD	USD
Market Cap (data as 31/12/2020)	12$tn	NA	1$tn	0.8$tn	3.5$tn	2$tn

Several indices of Chinese equities are available:

- **CSI 300:** replicates the performance of the 300 largest mainland stocks (A-shares) traded on the Shanghai and Shenzhen stock exchanges.
- **Hang Seng China Enterprises (HSCEI)**: made up of H-shares/Red Chips/P Chips traded in Hong Kong.
- **MSCI China:** the index represents a significant 32.08%[13] of the MSCI EM Index. It has a low inclusion factors on A-shares (only 20% currently). As such, it is very exposed to the performance of H-Shares even though mainland A-shares have a market cap almost 12 times higher[14].

Because of their distinct composition, these three Chinese equity markets do not follow the same performance trends. In 2021, whilst the mainland equity market (CSI 300) declined by a modest 0.9% (in USD), the MSCI China and HSCEI declined by 21.7% (in USD). This is mainly due to the sectoral bias of H shares market that has a large technology capitalization and has been greatly impacted by a series of regulatory measures on the private sector (video games/education) in the summer of 2021 and real estate difficulties following the Evergrande crisis (see also article 1).

12 https://www.hkex.com.hk/Mutual-Market/Stock-Connect?sc_lang=en - 13 https://www.msci.com/documents/10199/c0db0a48-01f2-4ba9-ad01-226fd5678111
14 See https://www.msci.com/msci-china-a-inclusion

Box 2: Fixed Income market

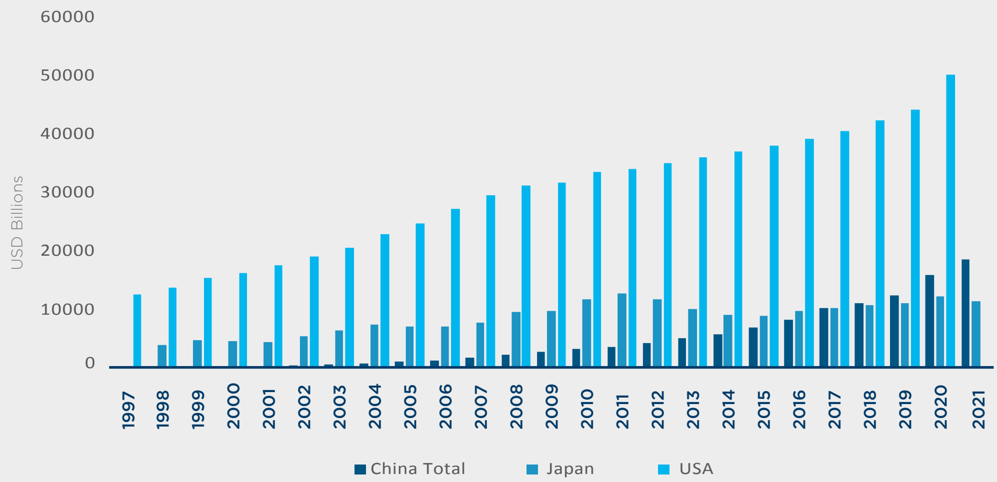
The fixed income version of Stock Connect, **Bond Connect**[15], started in July 2017.

It allows international investors to access all cash bonds in the China Interbank Bond Market (CIBM), via 56 onshore market makers and three global access platforms (Tradeweb, Bloomberg and MarketAxess). As shown on Figure 9, with a size of more than USD 18trn today, the local Chinese market is the second largest bond market in the world.

This includes not only Chinese government, local government and policy financial bonds, but also credit instruments (negotiable certificate of deposits, asset backed securities, panda bonds, financial bonds, corporate bonds, CPs, MTNs).

The entrance of offshore institutional investors into the China interbank bond market is governed under the Public Notice No. 3 in 2016 and Public Notice No. 220 in 2015 issued by PBOC[16].

Figure 9. Size of Bond market



Source: SIFMA, asianbondsonline.adb.org

Figure 10.

	Onshore	Offshore	
Description	Mainly bonds from governments and public banks	Mostly corporate issuers	Mostly corporate issuers
Currency	CNY	CNH	USD
Market Size (data as 31/12/2020)	15.5US$tn	17US$bn	608US$bn

As shown in Figure 10, international investments in Chinese bonds have doubled since 2019 to reach more than $500bn according to PBOC data. **The inclusion of Chinese debt in major benchmark indices has played a major role in this trend**. Since November 2021, China has been included in the FTSE Russell World Government Bond Index (China represents more than 5% and ranks 6th largest weight in the index). This is the first step in a process that is expected to last 36 months and will result in passive inflows into Chinese government bonds.

It is clear that the combination of an increasingly open market and the growing relevance of China as a global economic power mean that the opportunities for global investors today are significant and justify their inclusion as a core component of global portfolios.

15 https://www.chinabondconnect.com/en/index.html
16 See http://www.pbc.gov.cn/en/3688006/index.html

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Chinese pensions put to the demographics test

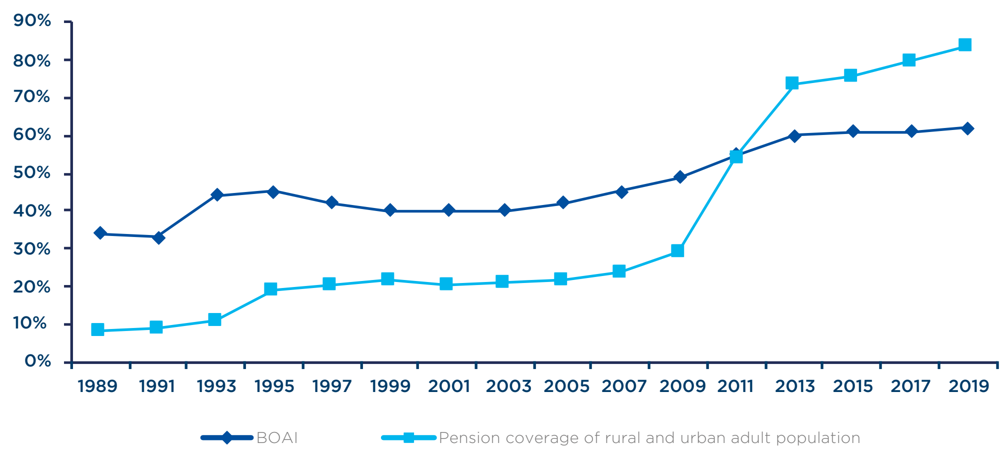
From small beginnings to the world's largest pension system

In recent decades, the Chinese pension system has undergone several reforms that have allowed it to reach coverage of nearly one billion adults, making it the **largest pension system in the world**. There were essentially two phases of reforms.

The first round of pension reforms took place following the opening up of the Chinese economy to the market: the broader objective was to improve the productivity of State-Owned Enterprises (SOEs). However, the rural population was excluded from these reforms and in 1989 only 7% of the population was covered by a public pension system. In 1997, the State Council enacted a mandatory two-tiered security system, and a third one on a voluntary basis. The two systems together were named "Basic Old Age Insurance" (BOAI) and were put under the management of the Ministry of Labor and Social Security.

The second round of reforms took place from 2000 onwards. China is moving towards a *"population ageing tsunami"*[17], with the share of the population aged over 65 expected to more than double between 2020 and 2050[18]. To put this figure in perspective, China's total population has grown by 7.7% between 2010 and 2020, while the people aged 65 and above has grown by 60%[19]. The coverage of the BOAI has been extended beyond the SOEs and urban collective enterprises and it now includes foreign-invested enterprises, private-owned enterprises and urban individual industries. However, this was still not sufficient. In 2006, the Government decided to pursue the ambitious objective of universal coverage, with a Social Security System covering both rural and urban areas by 2020 (Figure 1).

Figure 1. Coverage of China's pension system



17 OECD (2020), Wong, C and Yuan R., "Managing across levels of the government: The challenge of pension reform in China"
18 In 2020, the share of population aged over 65 was 12% and according to the World Bank forecast this share will achieve the 27% by 2050. Source: World Bank data, https://data.worldbank.org/indicator/SP.POP.65UP.TO.ZS?locations=CN, accessed 7 Mar. 2022
19 https://assets.ey.com/content/dam/ey-sites/ey-com/en_cn/topics/strategy/ey-parthenon-china-pension-report-2022-en.pdf

To this end, a series of plans and reforms has been put in place aiming essentially at equal treatment between urban and rural, and public and private employees[20].

Figure 2. Timeline of Chinese Pension Reforms

1997 — The Basic Old Age Insurance (BOAI), for urban employees, and the Public Employee Pension (PEP) are launched

2009 — New Rural Social Pension Scheme (NRSPS) is created to cover rural residents

2012 — Urban Resident Pension Scheme (URPS) is created to cover urban non-working residents

2014 — URPS and NRSPS merge to create the Urban and Rural Residents Pension Scheme

2015 — The PEP is included within the BOAI to achieve equal treatment for private and public employees

Source: Yang, L. (2021), Towards equity and sustainability? China's pension system moves center stage

The third pillar: The white knight rises

However, despite huge efforts, much remains to be done. The ageing trend is accelerating and this is resulting in a wider gap between increasing payouts and declining contributions, posing threats to the financial sustainability of the whole pension system.

The latest **Five-Year Plan** (2021-2025) launched by Beijing has set some ambitious targets that should be taken into account by participants in the Chinese pension market. The government has vowed to construct a **unified, equitable and sustainable pension system with full coverage**. Notably, the inequality-generating aspect of pensions presents a worrying situation, especially in elderly households. This is particularly the case in less developed regions of China with older populations[21]. To tackle these problems, the government has committed to increasing the supply of pension services, both public and private, by issuing more pension management by issuing more pension management licenses and by partially opening the pension market also to international providers.

As of last year, the **first pillar** is still the largest and is expected to remains so, with assets of more than RMB 4 trillion. The challenges ahead are several. In fact, the first pillar aims to expand its coverage, ensuring long-term sustainability and the development of a centralized management structure.

The **second pillar** experienced strong growth last year, recording an increase of +43% vs 2020 and with an aggregated size of RMB 3.5 trillion[22]. The Five-Year plan aims at encouraging the coverage of this pillar, by involving more and more employees from over 40 million Chinese enterprises.

Lastly, the **third pillar** holds great promises. The two main products offered, tax-deferred pension insurances and pension target funds, had assets on aggregate of RMB 76 billion in 2020. While demand remained limited over 2021, the third pillar is expected to be the fastest growing pension pillar in the next years, thanks to a combination of financial education, enhanced tax incentives for eligible mutual funds and wealth management products as well as expanded product selection.

Overall, the government is planning to make **the third pillar the real pension growth engine in China**, as the plan to launch a National Pension Insurance Company shows[23].

Pension Pillar Definition

- **First pillar:** publicly managed pension schemes with defined benefits and pay-as-you-go finance, usually based on a payroll tax.
- **Second pillar:** privately managed pension schemes which are provided as part of an employment contract.
- **Third pillar:** personal pension plans in the form of saving and annuity schemes. Source: OECD (2002)

20 The first one was the New Rural Social Pension Scheme (NRSPS), which was created in 2009 to give a coverage to rural residents. The Urban Residents Pension Scheme (URPS), created in 2012 to cover urban residents without work, was merged with the NRSPS to create the new Urban and Rural Residents Pension Scheme (URRPS). Lastly, in 2015, the PEP was included within the BOAI, achieving equal treatment for private and public employees.
21 https://www.macaubusiness.com/how-china-secures-pension-payment-through-reform-state-asset-supplement/
22 EY Parthenon (2022), How can we make saving for the future feel like a good investment now?
23 https://www.caixinglobal.com/2021-08-20/china-plans-172-billion-national-pension-company-101757511.html

Jean-Xavier BOURRE
Senior OCIO Advisor

Pension funding ratios: Riding out the storm

	31/12/2018	31/12/2019	31/12/2020	30/06/2021	30/09/2021	31/10/2021	30/11/2021	31/12/2021	31/01/2022	28/02/2022
Netherlands	103.60%	104.30%	100.20%	109.40%	110.3%	110.5%	109.6%	114.3%	111.6%	
UK	95.70%	99.20%	95.50%	105.80%	106.4%	105.9%	105.9%	107.7%	109.1%	108.4%
US	86.10%	86.80%	87.90%	92.40%	91.7%	93.5%	92.5%	93.4%	92.1%	92.00%
German CTA	67.30%	67.90%	69.10%	73.90%			74.1%	77.0%		

Sources:
- UK data: Purple Book, PPF S179 funded status
- Netherlands data: Dnb
- German CTA data: FactSet, based on average pension exposure of German corporates of EUROSTOXX 600 for 31/12/18 until 30/12/20. Amundi estimate from 30/06/21.
- US data: Aon Pension Risk Tracker

Early 2022 has seen **agitated market conditions**, notably on the fixed income market, as the biggest theme was the hawkish pivot by multiple central banks in response to continued and persistent inflation. The Fed in particular has been at the forefront of this, and investors moved to price in a much more aggressive pace of hikes relative to their expectations at the end of 2021. With the prospect of tighter monetary policy much earlier than anticipated, risk assets struggled in January (global equities seeing their worst monthly performance since March 2020), at the height of the initial wave of the Covid-19 pandemic.

Growing geopolitical risk played a role in supporting commodities prices and, overall, the Bloomberg Commodity Index returned +8.8% in January. But with mixed results: after its impressive gains in 2021, oil held onto its position as the top-performing major asset in January, while the hawkish pivots by central banks helped to undermine the position of precious metals as a hedge against inflation, with both gold (-1.8%) and silver (-3.6%) declining over the month. Risk assets suffered significantly as central banks adopted a more hawkish tone, bringing into question the sustainability of current valuations (MSCI World fell -5.3% whilst the MSCI Emerging Markets Equity Index only depreciated -1.9%). Interestingly, the UK's FTSE 100 generated a positive return of +1.1%, whilst the Banking sector benefited from a strong growth-value rotation, supported by higher yields. As with credit, sovereign bonds lost ground across the board, and US Treasuries (-1.9%) underperformed their European counterparts such as bunds (-1.1%) and OATs (-1.2%). Indeed, it was the worst monthly performance for US Treasuries since February 2021.

This mood continued into the first half of February, but then in the second half, we saw a **massive risk-off move** prompted by warnings and then the reality of Russia's invasion of Ukraine, which in turn triggered severe sanctions on Russia. By far the biggest moves over the last month have been in Russia itself (Russia's MOEX equity index has shed -30.0% in local currency terms while the Russian ruble has weakened by -26.3% in February).

The conflict's implications go far beyond Russian assets however, with numerous commodities surging in February, which will have significant inflationary consequences for the world more broadly (WTI crude up +8.6% in February, European natural gas +16.4%, wheat +21.9% and aluminium +11.5%).

These inflationary concerns led to markets racing to forecast an ever-greater amount of rate hikes in 2022, and this impacted on sovereign bond markets, which despite a strong risk-off environment, didn't manage to recover the losses they made earlier in 2022. Geopolitical turmoil and the prospect of more aggressive central bank hikes proved bad news for risky assets, with equities continuing to lose ground, pretty much across the board. Credit markets also continued suffer, with US credit out-performing, but still generated negative absolute returns in February. In this context, liquidity on interdealer market dried up, widening the swap spread significantly, in Europe in particular (driven by a general risk-off sentiment, and concerns regarding the banking sector, in a flattening curve environment and a perceived exposure to Eastern Europe risk).

In this environment, **funding ratios in European jurisdictions have continued to improve** since the last pension fund letter and marginally decreased in the US. The move on European pension funds was due, on the one hand, to steady performance for risky assets and credit at the end of 2021 that were only partially offset by market sell off in early 2022 (US assets being more affected than European ones). At the same time, the valuation of liabilities was impacted by:

1. the persistent tensions on bond markets since mid-December, following inflation data and Central Bank hawkish tones and
2. the historical widening of swap spread mentioned above.

One noticeable exception was Dutch pension funds that saw their funding ratio decrease on average from 114.30% in December 2021 to 111.60% in January 2022 (the 12-month moving average Policy Funding Ratio, continued to improve to 109%). If the market sell off in January undoubtedly affected asset valuation, the correction in funding ratio was mainly technical. As described in the Pension Fund Letter #11 published in May 2021, the long tenors of the discount curve for Dutch pension funds are based on the so-called ultimate forward rate (UFR) framework[24]. A reform of the UFR methodology, which aims to gradually reconnect the liabilities discount curve with market rates for long tenors, was approved by DNB in 2020. The main changes are a shift in the last liquid point (LLP) from 20y to 30y and a reduction of the speed of convergence to the UFR. Consequently, tenors up to 40y will be very close to the actual swap curve (vs. an UFR currently well above). In order to avoid a shock to the Dutch PF market, it has been decided to smooth the impact of over a four-year period (Jan 2021 to Jan 2024). The current discount curve is equal to a 50/50 weighting between the old and new methodologies. In 2023, the weights will be 25/75, for full implementation in 2024.

The above mentioned tensions on the European swap curve in February should have offset this technical move and Dutch pension funds funding ratios are expected to have recovered some of this decrease during the month of February (data to be published by DnB end of March).

24 Ultimate forward rate (UFR): Methodology used to extrapolate the liability discount curve beyond the tenor that is considered liquid enough to be representative (referred to as the last liquid point, or LLP). The method is similar to the one used by EIPOA for the solvency requirements of European insurance companies. It assumes forward rates will regularly converge to a long-term equilibrium rate, the ultimate forward rate, and reconstructs the yield curve for long tenors based on this trajectory For more detail on the EIPOA UFR methodology, see Amundi Research Paper, Solvency II - A change to the Ultimate Forward Rate in June 2017? (2016)

CROSS ASSET Investment Strategy

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We amend the narrative of our scenario to take into account the consequences of the war in Ukraine. We increase the probability of our downside scenario to 30% (from 15%) to reflect the rising risk of stagflation. The probability of our central scenario is moving down to 60% (from 70%) while the probability of the upside scenario is reduced to 10% (from 15%).

We expect a repricing of risk premia across the asset classes in this new geopolitical and economic context.

DOWNSIDE SCENARIO 30%

Renewed slump toward stagflagtion

Analysis

- Long lasting war in Ukraine is hurting confidence and activity, and pushes commodities and energy price higher for longer, and disrupting supply.
- **Covid-19** Omicron resurgence leads to renewed mobility restrictions and bottlenecks.
- Both triggers lead to an **economic downturn** while **inflation** remains elevated and uncontrolled.
- **Renewed monetary and fiscal accommodation**, possibly a further step in financial repression.
- Inflation amid slower growth, forces some **Central Banks** and the ECB in particular, to **deviate** from their guidance and potentially lose credibility.
- Policies and investments designed to fight **climate change** are postponed and/or countries policies are disorderly implemented.

Market implications

- Favour cash, USD and US Treasuries
- Play minimum-volatility strategies
- Gold
- Commodities and energy

CENTRAL SCENARIO 60%

Bumpy road, regional divergences

Analysis

- The **war in Ukraine** is hitting confidence and pushes commodities and energy price temporarily higher.
- **Covid-19** becomes an endemic disease, with random contagion waves.
- **Global activity** to hold better than previous waves, but supply chain bottlenecks will remain until end-2022.
- **Growth** progressively abate to trend in 2022. Opening 2023's to downside risk. Soft patch in H1 2022 due to China's slowdown, negative impact of Omicron and accelerating inflation.
- Persistent **inflation** pressures throughout 2022 due to high energy and commodity prices, supply-side bottlenecks, rising wage pressures; and abating in 2023. Inflation is a psychological and political issue.
- **Monetary policy asynchrony:** Fed in fast move from tapering to a light QT and initiating a hiking cycle; BoE in a soft hiking cycle, ECB recalibrate QE and potentially hiking rates; and PBoC on an easing bias. Rates to move higher but to stay low for longer.
- **Fiscal policy:** withdrawal of some support, but public funding and subsidies are used to smooth the impact of the energy transition on households in the short term.
- **Climate change** bites into growth and pushes commodity and energy prices higher, adding to stagflationary trends.

Market implications

- Lower risk-adjusted expected returns real
- Contained steepening of US Treasuries yield curve as well as EZ and EM
- Inflation hedge via gold, linkers and equities
- EM: Short-term caution, long-term real income and growth story intact

UPSIDE SCENARIO 10%

Inclusive and sustainable growth

Analysis

- The **war in Ukraine** ends quickly with limited disruption of the energy and commodities market.
- **Endemic recedes** more quickly than anticipated, despite variants.
- Extra savings and wage rises fuel **consumption** with low erosion of corporate margins.
- **Productivity gains** thanks to digital and energy transition and structural reforms.
- **Inflation** remains under control.
- **Higher interest rates**, due to stronger investment and less savings.
- **Central banks'** policy normalisation is well received by financial markets.
- **Debt is sustainable** thanks to strong growth and a gradual shift towards fiscal discipline.
- **Inclusive growth** and effective fight against inequality.

Possible triggers include structural reforms, effective drugs and vaccine campaigns, and inclusive decentralised finance.

Market implications

- US Treasuries curves bear steepen
- Favour risky assets with cyclical and value exposure
- Favour linkers as an inflation hedge

Geopolitic | *Growth and inflation expectations* | *Recovery plans or financial conditions* | *Economic or financial regime*
Covid-19 related topics | *Monetary and fiscal policy* | *Solvency of private and public issuers* | *Social or climate related topics*

CROSS ASSET Investment Strategy

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		Recent weeks have been characterised by higher market volatility, led by the more hawkish tone from the Fed and rising geopolitical risks. In a rising real yield environment with inflation risks, equity is a place to look at, but selection is key.
EQUITY PLATFORM	US value	+	▼	The rotation favouring value is a medium-term trend supported by rising real rates, and we believe this will continue as economic growth remains solid and the valuation discount of value is still attractive. We explore high-quality value names.
EQUITY PLATFORM	US growth	-	▲	Overall, growth remains overvalued, and if real rates increase, it may weaken further. Yet, we acknowledge thatselective tech growth names are becoming attractive after the recent volatility.
EQUITY PLATFORM	Europe	=	▼	Visibility on European equities is decreasing amid the escalating Russia-Ukraine conflict and increasing energy prices. While the economic reopening still bodes well for the area, we take a neutral stance in order to reassess the evolution of the conflict and its economic implications for the area.
EQUITY PLATFORM	Japan	=		Accommodative monetary and fiscal policies, along with improving earnings momentum, should be supportive for the country's markets. We are watching the evolution of the pandemic and the resultant pressures, if any.
EQUITY PLATFORM	China	=/+		Better policy visibility emerging from a clear easing stance, coupled with a more balanced growth approach that should help clear out systemic risks, is supportive of Chinese equities. However, there are near-term uncertainties in the form of zero tolerance of Covid-19. All this requires a watchful and a selective approach in navigating the country's equities.
EQUITY PLATFORM	Emerging markets	=		EM present a fragmented universe where investors should focus on important factors to avoid using a uniform approach – commodity exports, strong internal demand ('the help yourself' countries), countries with a value tilt, and those with limited external vulnerability. Overall, country-specific factors and bottom-up selection remain important.
FIXED INCOME PLATFORM	US govies	-		While we believe the Fed will raise rates multiple times this year (four), we stay cautious and agile on duration and believe the Fed will not tighten financial conditions so much that it stalls the economic recovery. Flexibility in FI is the name of the game when policy uncertainty and geopolitical risks are high. TIPS show signs of high valuations.
FIXED INCOME PLATFORM	US IG corporate	=		Credit markets have been affected by the tightening stance shown by the Fed even as financial conditions remain accommodative. We believe current valuations reflect the positive fundamentals, but there is uncertainty with respect to future CB policy. Thus, we aim to minimise our duration exposure and look for income in securitised markets.
FIXED INCOME PLATFORM	US HY corporate	=		While HY spreads have widened amid the Fed's tightening stance, we think this is more due to liquidity risks and less due to fundamental concerns over credit quality. Nonetheless, we are monitoring the effects of future monetary policy on this asset class, and are staying clear of names that could destroy value through increasing leverage.
FIXED INCOME PLATFORM	European govies	-/=		A relatively hawkish ECB supports our cautious stance on duration amid our belief in upward yield trajectory, but we are flexible across geographies and curves to benefit from tactical movements driven by risk sentiment. The policy path for the ECB will not be straightforward and becomes increasingly uncertain amid rising risks from the Russia-Ukraine crisis.
FIXED INCOME PLATFORM	Euro IG corporate	=/+	▼	Recent ECB communications indicate near-term volatility for the asset class due to receding support from the regulator's purchase programme, increases in core yields, and higher liquidity premiums. However, corporate fundamentals (balance sheet strength, earnings) are strong. We look for relative value opportunities in IG and favour shorter-maturity assets.
FIXED INCOME PLATFORM	Euro HY corporate	=		HY provides carry at reasonable risk, but we remain vigilant in light of liquidity concerns and pressures from upward movements in core yields. While default rates remain low and we prefer spread compression opportunities in BB (rising stars), we aim to balance the potential for extra yield with liquidity and quality through our bottomup selection approach.
FIXED INCOME PLATFORM	China govies	=/+		We see relatively stable appetite for Chinese debt amid clear monetary easing, attractive carry, and expectations of foreign inflows. We remain neutral/positive and are closely monitoring the policy environment.
FIXED INCOME PLATFORM	EM bonds HC	=/+		HC bonds provide attractive yields, but inflation and policy tightening in DM are important considerations for us. We believe EM spreads may tighten in absolute and relative terms vs DM over the medium term, but we maintain a bias towards HY vs IG. We are defensive on duration, but slightly less so now due to uncertainty due to Russia's actions.
FIXED INCOME PLATFORM	EM bonds LC	=		We prefer countries where monetary tightening cycles are maturing or are close to peak, and where real rates are back in positive territory, i.e., China (monetary easing mode compared to 2021). However, we are cautious on EM FX. Country-wise, we are getting defensive on Russian bonds and FX near term, and are closely monitoring the situation.
OTHER	Commodities			Inflationary regime and still-robust macro backdrop allow us to be constructive on base metals. Geopolitical risks may provide near-term support to gold.
OTHER	Currencies			We keep our 12M EUR/USD target unchanged at 1.14 as the upside potential in the single bloc currency is capped by a relatively dovish ECB (vs the Fed). Higher interest rate expectations in Europe already seem to be priced into the EUR.

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Negative view | Neutral | Positive view

▼ Downgrade vs previous mont

▲ Upgraded vs previous month

Source: Amundi, as of 24 February 2022, views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current past or future asset allocation or portfolio of any Amundi product.

IG = investment grade corporate bonds, HY = high yield corporate, EM bonds HC/LC = EM bonds hard currency/local currency, WTI = West Texas Intermediate, QE = quantitative easing.

To go further: The Amundi Research Center

Research Center

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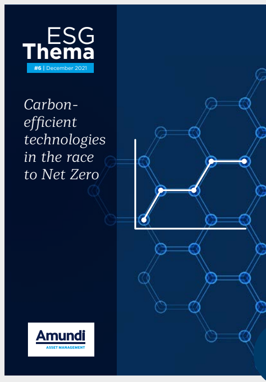
research-center.amundi.com

ESG Thema



Investment Talks – Special Focus Ukraine-Russia

Thematic Papers