Equity

Paradigm Shift

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Paradigm Shift

When multiple risk factors occur simultaneously, investors should gradually increase their holdings of defensive, high-dividend and value stocks

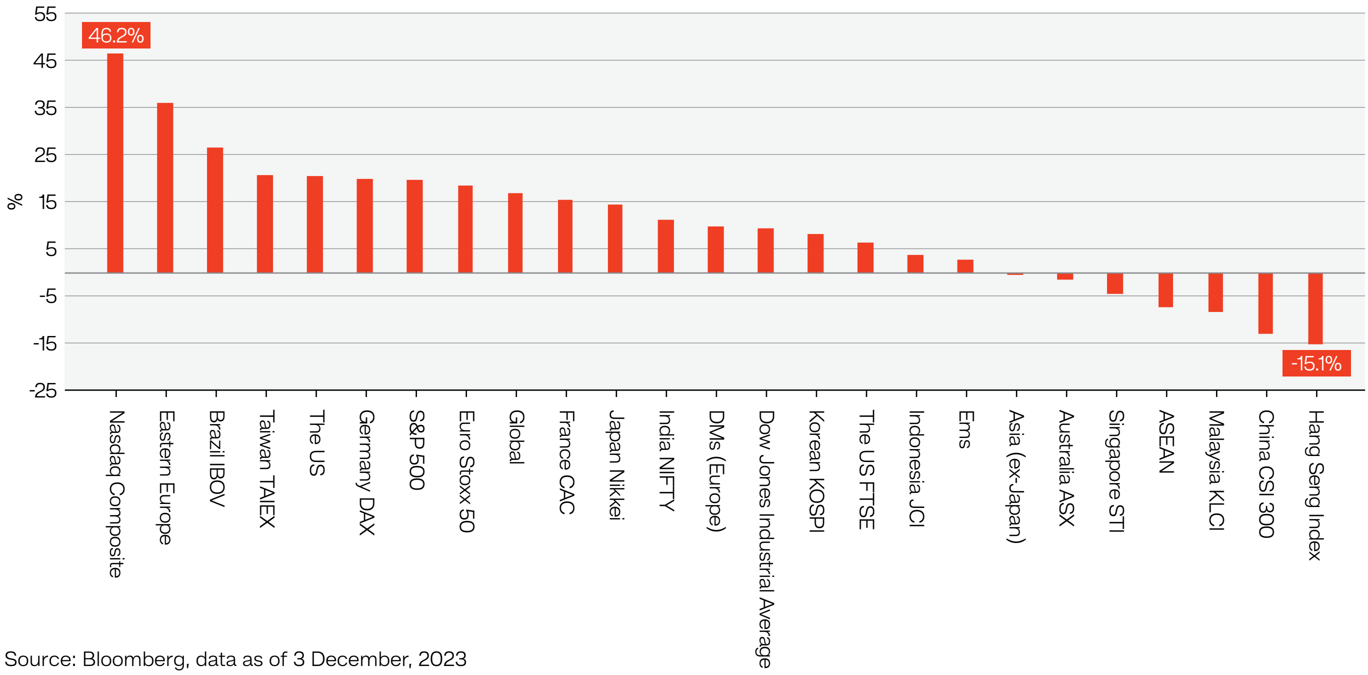
The title of the "Equity" section of BEA Wise of the Q4 2023 was "The Inflection Point". The US economy and interest rates are poised to pivot in the near term. With changing fundamentals exerting pressure on US equities, which have consistently reached new highs, increased volatility is expected. In particular, we expect technology equities to take the lead. However, the equity market will be particularly vulnerable if the "Magnificent Seven Index"[1] continues to dominate market growth. Through extensive lateral analysis of the derivatives market and investor sentiment in the fourth quarter of 2023, we anticipate a correction in the US stock markets. Nevertheless, adopting a strategy of keeping all money on the sidelines may not the most desirable approach. Instead, investors should seize market opportunities to adjust their positions. Historically, defensive and value stocks have proven to outperform amidst economic downturns, interest rate peaks and the initial interest rate cut. Both valuation analysis and trend analysis point towards similar conclusions. At the same time, it is worth noting that growth stocks, which spearheaded the sharp growth throughout the year, may still reach new heights, bolstered by investors who remain bullish on the prosperity of the US economy. Our past projections are broadly in line with the current outcomes.

The title of the "Equity" section in the first quarter of 2024 is "Paradigm Shift ", a term which encapsulates the concept of pivotal shifts occurring as Yin and Yang energy reach extremes. Such dynamic is manifested in the emergence of anomalies within stock markets, propelled by the current reshuffling of international interests. One of the core reasons is that the government and the public have divergent forecasts of the economic outlook. The resurgence of capital flows and bond volatility will influence stock market movements and continue to impact market dynamics. Based on data, defensive and high-dividend stocks find support when valuation and interest rates hit inflection points. As such, it is anticipated that bank stocks and technology stocks will exhibit contrasting trajectories going forward. The major investment risk factors of the stock market, including the US presidential election year, the interest rate inflection point and the economic downturn, are likely to pose concurrent challenges. In light of these circumstances, investors should increase their exposure to defensive, high-dividend and value stocks in an orderly manner to hedge against the risk of a drastic decline in the performance of technology stocks.

Fundamental Analysis: Economic Growth in Doubt

As of 3 December 2023, among the major global stock indices, the best performing index is the NASDAQ Composite Index, while the worst performing index is the Hang Seng Index, with a positive return of 46.2% and a negative return of 15.1% respectively. This represents a staggering difference of 61.3 percentage points between the two indices. Following a series of mutual sanctions and financial conflicts between China and the US, there is a stark contrast in the performance of the stock markets of the two countries, providing a beacon for institutional and individual investors to align with the prevailing tides.

Returns of regional and MSCI's stock indices in 2023



Source: Bloomberg, data as of 3 December, 2023

[1] See Bloomberg website, https://www.bloomberg.com/quote/BM7T:IND

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Building upon the insights from the "Macro Strategy" section, there's a maxim saying "if the water is clear, no fish could be caught", denoting the situation that the more chaotic the market, the more investment opportunities there are. The key is for investors to discern the market's trajectory and underlying trends. Fundamental analyses are indispensable in this increasingly chaotic situation.

Investment anomalies flood the market

The Global Risks Report, published at the World Economic Forum in 2023, refers to the concept of "Polycrisis", a term denoting the intertwined nature of multiple global crises and their compound effects on the economy[2]. The report also highlights risks such as extreme weather, geopolitical conflicts, epidemics, economic downturns, and political polarisation among countries are posing threats to the world. The number of risks identified is unprecedented in modern times. From an investment perspective, the world is currently experiencing extreme negativity, with compound effects increasing tail risk. Similar to extreme weather, investment markets are seeing all sorts of anomalies in what is statistically known as "Fat Tail" conditions:

1. Under normal circumstances, a decline in gross domestic product (GDP) combined with an environment of interest rate hikes should push equity indices downwards. However, looking at the 200 quarterly changes over the past 50 years, only 21 of which have seen the S&P 500 Index rise despite the interest rate hikes and GDP declines in US, accounting for only 10.5% of the total. This reflects a very rare situation. Notably, between the fourth quarter of 2022 and the second quarter of 2023, GDP fell while interest rates rose, while the S&P 500 Index went up for three consecutive quarters, a trend not seen in the past 50 years. During this period, the S&P 500 Index reported an average return rate of about 7.5%, higher than the average return rate of 4.9% in similar conditions in the past. This further illustrates the rarity of the current trend in the US stock market. When applying this framework to the Eurozone, which has only been in existence since 1999, and using the Euro Stoxx 50 as a proxy for the European stock market, there were only five quarters where GDP fell and interest rates rose. However, during those quarters, the stock index rose by a mere 5.1%, which is also very rare.

The relevant figures for the US are as follows:

Quarterly	Quarter by quarter (%)		
	S&P 500 Index	GDP by quarter	Federal interest rate
1976 Q2	1.5	-6.3	0.75
1978 Q3	7.3	-12.3	1.00
1979 Q2	1.3	-0.3	0.25
1984 Q3	8.4	-3.2	1.25
1986 Q4	4.7	-1.7	0.12
1987 Q3	5.9	-0.9	0.50
1989 Q1	6.2	-1.3	1.00
1994 Q3	4.1	-3.1	0.50
1995 Q1	9.0	-3.3	0.50
1997 Q1	2.2	-1.6	0.25
1999 Q2	6.7	-0.4	0.25
2000 Q1	2.0	-5.2	0.50
2005 Q2	0.9	-2.5	0.50
2005 Q4	1.6	-1.0	0.50
2015 Q4	6.5	-0.9	0.25
2016 Q4	3.3	-0.7	0.25
2017 Q1	5.5	-0.2	0.25
2018 Q2	2.9	-1.2	0.25
2022 Q4	7.1	-0.1	1.25
2023 Q1	7.0	-0.4	0.50
2023 Q2	8.3	-0.1	0.25
Average	4.9	-2.2	0.52

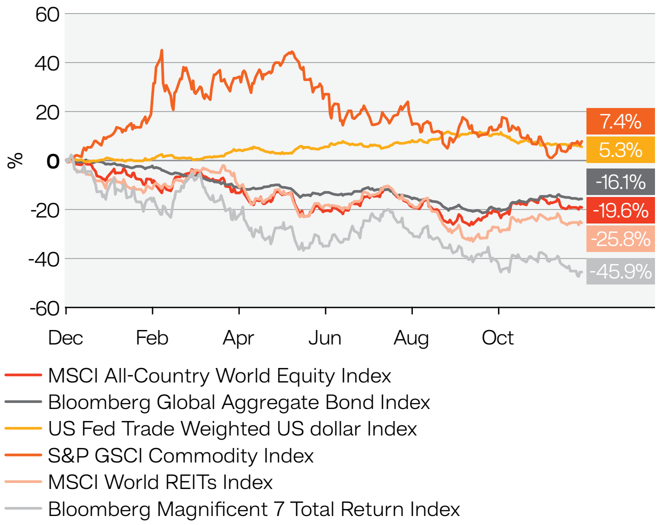
Source: Bloomberg, data as of 30 November 2023

2. When examining the performance of major global asset indices, such as, MSCI All-Country World Equity Index, Bloomberg Global Aggregate Bond Index, US Fed Trade Weighted US dollar Index, S&P GSCI Commodity Index, MSCI World REITs Index, and the technology stocks in the currently hottest "Magnificent Seven" Index, it is observed that only the US dollar and commodities rose by 5.3% and 7.4% in 2022 respectively. All other assets posted double-digit declines, with technology stocks such as the "Magnificent Seven" Index falling by almost 45%. However, in 2023, technology stocks, including the "Magnificent Seven" Index, have made a remarkable comeback. As of 14 December 2023, the annual average return of technology stocks, such as the "Magnificent Seven" Index, is 102%, contributing to a stunning 16% rally in global equity indices. Other assets have seen single-digit declines, with the commodity composite index being the worst performer, with a decrease of 8.5%. The performance of 2022 and 2023 suggests that in an extreme environment where global capital tends to concentrate and flow rapidly into individual assets,

[2] See World Economic Forum website, https://www.weforum.org/publications/global-risks-report-2023/digest/

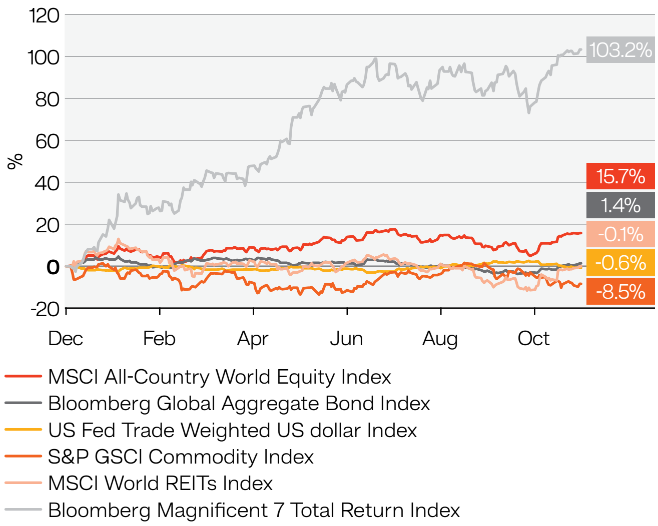
going all-in could yield outsized returns. However, one careless move could result in losing the whole game. This manoeuvre makes it harder to diversify risk.

Performance of asset indices in 2022



Source: Bloomberg, data as of 30 November, 2023

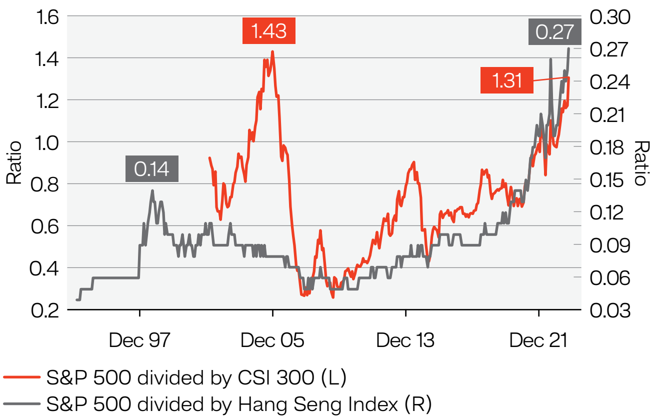
The performance of asset indices in 2023



Source: Bloomberg, data as of 30 November, 2023

3. The ratio of indices reflects the divergence between the performance of the US and Chinese Mainland and Hong Kong stock markets. As of 30 November 2023, the ratio of the S&P 500 Index to the Hang Seng Index has reached a 30-year high. It is nearly double that of the 1997 Asian financial crisis. This reflects the fact that Hong Kong equities have been hit by a combination of unfavourable factors, including the US-China power play, elevated interest rates in Hong Kong, and the political and economic challenges faced by Hong Kong. This is an unprecedented situation in the past 30 years. The Hong Kong stock market with shrinking turnover is dwarfed by the crowded US stock market. The CSI 300 Index is also struggling.

Ratio of the US Stock Indices to China and Hong Kong Stock Indices



Source: Bloomberg, Data as of 30 November 2023

Ultimately, the macro environment is uncertain, and the divergence in asset performance is being exacerbated by the polarised forecasts of the US economy by both the public and the government. The Federal Reserve Bank of Philadelphia has warned that the economies of one-third of US states had contracted between July and October 2023[3]. Despite the emergence of these headwinds, government officials continue to use official rhetoric such as 'soft landing' and 'better than expected' to manage the expectation of a downturn[4]. However, despite the reported 4.9% quarter-on-quarter economic growth in the third quarter of 2023, public expectations and a number of economic data do not support the growth (for more details, please refer to the "Macro Strategy" section). The Wall Street's promotion of the 'Goldilocks economy' has fuelled the market polarisation.

The divergent economic outlooks between the public and the government steer capital to flow into divergent paths under the tug-of-war between the two sides, creating a state of fear among investors. This extreme phenomenon in the investment market is not only solely rooted in divergent economic outlooks but is also exacerbated by conflicting forecasts regarding interest rates. For more details, please refer to the "Bond" section.

[3] See Business Insider website, https://www.businessinsider.com/recession-outlook-economy-states-contracting-gdp-growth-philadelphia-fed-texas-2023-11

[4] See Reuters website, https://www.reuters.com/world/us/yellen-says-us-economy-does-not-need-drastic-tightening-soft-landing-track-2023-11-30/

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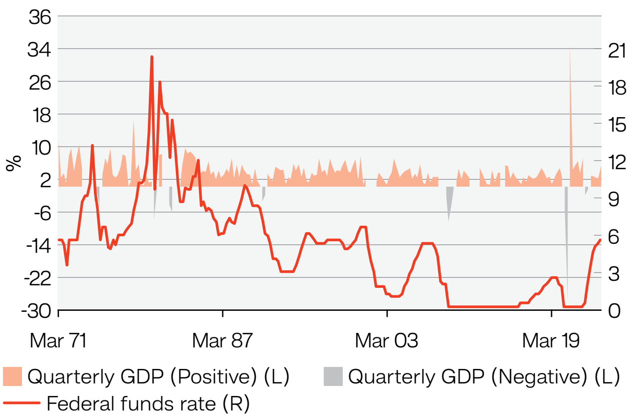
Core Risks: Economic Growth Forecast

In summary, economic growth and interest rate movements were identified as the primary sources of market risk in 2024 according to public opinion and market participants.

The "Bond" section discusses interest rate forecasts, which will not be covered here. However, it is a well-established practice to project recession period using interest rate hiking cycles. From 1973 to the third quarter of 2023, the US economy has invariably experienced a recession at the end of a rate hiking cycle. A recession is indicated by negative GDP for more than two consecutive quarters. If we also define a recession as negative GDP seen in the first and last quarters of three consecutive quarters, the US economy has experienced nine such recessions in the past 50 years following an interest rate hiking cycle. On average, these recessions occur 3.8 quarters after the end of a rate hiking cycle. Based on this pattern, it is likely that a recession will occur in the US during the second quarter of 2024, following the current rate hiking cycle, which has ended in July 2023.

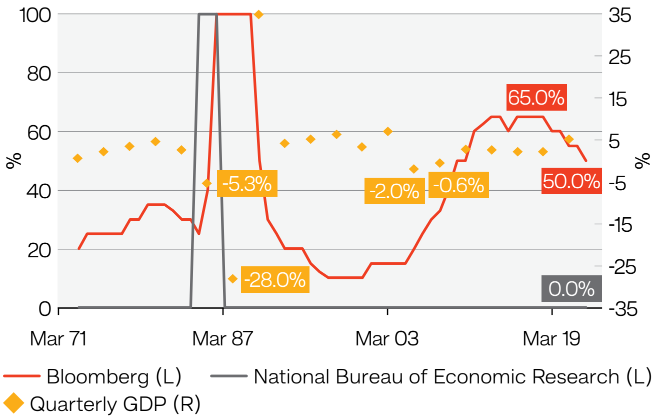
The US Quarterly GDP and the Federal Reserve's Interest Rates



Source: Bloomberg, Data as of 30 November 2023

Furthermore, according to forecasts by Bloomberg, which represents private institutions, and the National Bureau of Economic Research (NBER), which represents official institutions, the likelihood of a US economic recession in the next 12 months is 50% and 0%, respectively. Based on the predictive track record from both organisations over the past five years, when the probability of Bloomberg's forecast model ascends past the 40% threshold, the US quarterly GDP recorded negative values. The Bloomberg's data is more indicative as NBER deploys a binary forecast model with absolute outcomes of 0% and 100%. Unlike NBER, Bloomberg's forecast model provides a nuanced spectrum of probabilities to show the gradual changes in probability. According to Bloomberg's data, the probability decreases from 65% to 50% since July 2023, not fulfilling the criteria for an ascending likelihood of recession. However, it is worth noting that the probability of a recession still exceeds 40%, which serves as a cautionary signal to investors against complacency. Conversely, the NBER maintains a forecast of 0%, which aligns with the US official line. This highlights a significant disparity in economic outlook between the government and the public.

Institutions' projected probability of a recession in the US in the next year



Source: Bloomberg, Data as of 30 November 2023

Below is an excerpt of Bloomberg's comprehensive private market forecasts for future U.S. economic data:

Indicator	2023 (forecast)	2024 (forecast)			
	Q4	Q1	Q2	Q3	Q4
Real GDP growth (quarterly,%)	1.1	0.4	0.2	1.0	1.6
Personal consumption expenditures (by quarter,%)	1.5	0.7	0.7	1.1	1.5
Government expenditures (quarterly,%)	1.6	1.0	1.0	0.9	1.0
Private investment (quarterly,%)	-0.2	-0.4	0.4	1.1	2.4
Export (by quarter,%)	2.2	1.5	0.7	2.0	2.7
Import (by quarter,%)	1.0	1.0	1.5	2.0	2.5
Unemployment rate (year-on-year,%)	3.9	4.1	4.2	4.4	4.4
Financial budget as a share of GDP (quarterly,%)	-6.1	-5.7	-4.9	-5.6	-5.7

Source: Bloomberg, data as of 30 November 2023

Notably, the projected quarterly GDP growth in the fourth quarter of 2023 is a mere 1.1%, representing an astonishing difference of almost 80% from the GDP growth of 4.9% in the third quarter of 2023. This precipitous drop is mainly due to the anticipated sharp contraction in personal consumption expenditure, which is anticipated to fall from 3.6% growth in the third quarter of 2023 to 1.5% growth in the fourth quarter of 2023, a contraction of over 50%. It is expected that the personal consumption expenditure will plummet further by almost 50% to 0.7% in the first quarter and the second quarter of 2024. Another significant factor dragging down GDP is private investment, which is forecasted to experience a dramatic reversal from a growth of 10.5% in the third quarter of 2023 to a contraction of 0.2% in the fourth quarter, which will remain negative until the first quarter of 2024. Furthermore, the unemployment rate is forecasted to increase quarter-on-quarter, in line with the overall pessimistic outlook. The absence of a meaningful improvement in the projected fiscal deficit suggests that the US governments' heavily criticised fiscal discipline remains unchanged. This scenario is expected to necessitate further issuance of Treasury bonds, which will bolster Treasury yields and strain the performance of both the US stock market and bond market. (For further details, please refer to the "Macro Strategy" and "Bond" sections) The contrast between the public forecast and the official statistics is noteworthy. Is the public excessively pessimistic, or is the official stance overly optimistic?

FactSet, a data firm, provides a unique take on economic growth predictions[5] by analysing the frequency of the word "recession" mentioned in all S&P 500 companies' earnings announcements between 15 September and 16 November 2023. This provides insight into the business sector's outlook on the future direction of the economy. The results indicate that 53 companies referred to a "recession", a 13% decrease from the second quarter of 2023 and a 78% decrease from the second quarter of 2022. This is the lowest number since the fourth quarter of 2021 and is below both the 5-year average (84 companies) and the 10-year average (60 companies). In terms of sector, the financial sector mentioned "recession" the most frequently (14 times), while the real estate sector had the highest percentage of (30%) for mentioning "recession".

On the whole, official narratives remain optimistic, yet the possibility of an economic recession still looms in historical data, public forecasts, and from the perspective of business owners. Investors and business owners are always vigilant amidst prosperity, which starkly contrasts with the short-term electioneering of politicians. We expect that developed markets will remain mired in recession. However, our equity strategy does not advocate for a whole retreat from equities. Rather, we advise a strategic reallocation of capital towards defensive or value stocks.

Market Analysis: Lifting the Gloom

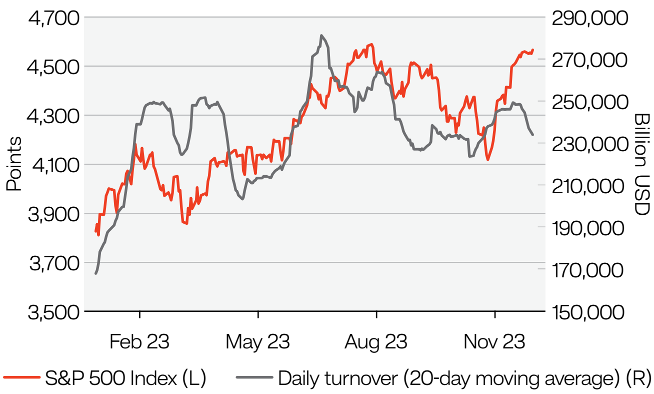
The primary risk at present is the future trajectory of the economy and interest rates, spawning volatility across a spectrum of variables. The substantial amount of disorganised and contradictory data is just like the "muddy water", confusing investors. Market analysis is there to discern the underlying patterns.

Capital Flows: A Resurgent Tide

The "Equity" section for the fourth quarter of 2023 is titled as "Inflection Point". The results of lateral analysis show that the investment market was experiencing a capital outflow, which negatively impacted the performance of the US equities at that time. The subsequent results are largely consistent with the predictions.

The following analysis refers to the daily turnover of the S&P 500 Index, which is expressed by a 20-day moving average. The data indicates that from late June through late October 2023, the S&P 500 Index saw a declining trend in its turnover. This coincided with soaring US Treasury yields and a slowdown in economic data. Nevertheless, the situation reversed after the Federal Reserve's meeting in November of the same year. The Federal Reserve's Chairman Jerome Powell announced that interest rates would remain unchanged. However, in a surprising move during the press conference, he expressed doubt about the reliability of the Federal Reserve's dot plot[6], ostensibly contradicting his prior assertions. This unexpected pivot fuelled market speculation that the Federal Reserve might be setting the stage for future interest rate cuts, despite its talk of potential interest rate hikes. US Treasury yields plunged sharply, and the capital flowed back into the US equities, propelling the S&P 500 Index to a new high of the year. This reflects the fact that authorities can manipulate asset movements with just a few words, amidst extreme market sentiment.

S&P 500 Index and its daily turnover (20-day moving average)



Source: Bloomberg, Data as of 30 November 2023

[5] See FactSet website, https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_111723A.pdf?hsCtaTracking=31d0f488-5c02-4193-b93b-f1708067f4fa%7Cb994622e-6b82-4c98-ad34-76c848088314

[6] See Barron website, https://www.barrons.com/articles/fed-meeting-rate-hikes-pause-6251ded0

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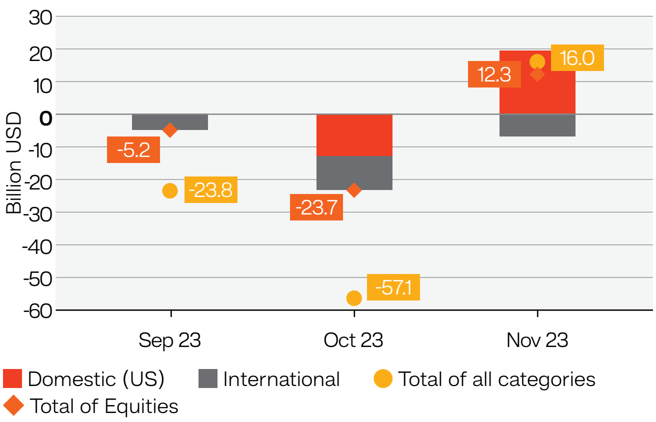
This is also applicable at the investment funds. According to the fund flow data of the Investment Company Institute, equity funds saw net outflows in September and October 2023, with net outflows amounting to US$5.2 billion and US$25.7 billion respectively. All types of funds, also had an aggregate net outflow of US$23.8 billion and US$57.1 billion during the same period. The data reflects that non-equity funds, particularly bond funds, have been severely hit by the soaring US 10-year Treasury yield (for more details, please refer to the "Bond" section). Domestically, the US equity funds saw significant changes, with net outflows rose sharply to US$13.3bn in October, following a slight net outflow of US$0.4bn in September. However, a net inflow of US$19.5bn was recorded in November. Such pronounced fluctuation signals volatile capital movement and investor hesitancy. The international equity funds saw consistent net outflows of US$4.8 billion, US$10.4 billion and US$7.2 billion in September, October and November, respectively. This suggests that the US stock market is in the "eye of the storm".

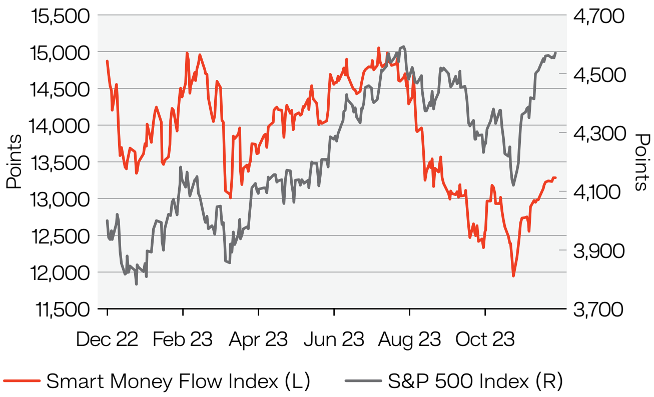
Capital Flow Data of the Investment Company Institute



Source: Bloomberg, Data as of 8 December 2023

Where does the capital come from? It is believed to be relevant to individual investors. The Smart Money Flow Index, which tracks the capital activity of institutional investors, exhibits a similar trend to that of the S&P 500 Index. The Smart Money Index orderly rebounded from its yearly low in early November 2023, but did not rise as much as the S&P 500 Index. This suggests that "smart money" investors are waiting for further data before making investment decisions, or harbouring reservations regarding official comments on the economy and interest rates. Despite the unprecedented heights by the US equities, there is a disparity between institutional and individual investors in terms of investment mindset, risk management and timing of market entry.

S&P 500 Index and Smart Money Flow Index



Source: Bloomberg, Data as of 30 November 2023

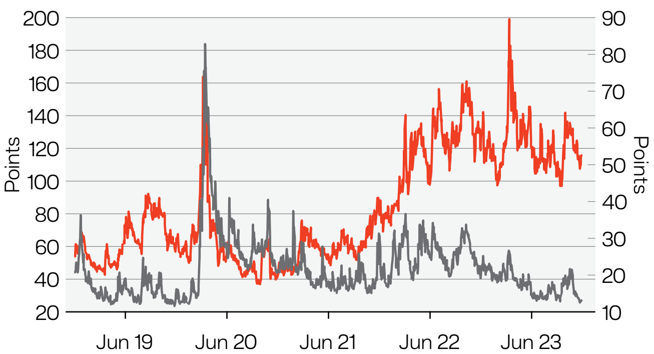
The rebound from bottom in capital and turnover is a positive sign, albeit lacking the robust momentum as demonstrated by the trends of indices. Undoubtedly, capital flows will continue to be the dominant factor for index trends. In line with the aforementioned forecast of a US economic downturn, investors should manage their position sizing. Moreover, portfolio construction should incline towards defensive or value stocks to hedge against the risk of potential decrease in turnover in the future.

Volatility: Be Prepared for Danger when in Peace

In the investment market, there is a degree of correlation between the returns across diverse assets, with risk profiles following suit. The Volatility Index (VIX) of Chicago Board Options Exchange (CBOE) represents the volatility of the S&P 500 Index, and the ICE BofA MOVE Index (MOVE) represents the volatility of the bond market. The data over the past five years shows a correlation between the two volatility indices prior to the commencement of the 2022 interest rate hiking cycle. However, subsequent to the initiation of the latest rate hiking cycle, the VIX index drifted lower while the MOVE index continued to rise, mirroring the prevailing high inflation and the Federal Reserve's persistence to interest rate hikes, leading to the onset of the bond market turmoil. On the other hand, in respect to stock markets, US technological innovation, alongside the US sanctions on China for chips and artificial intelligence have catalysed a massive diversion of funds into the US growth stocks. This shift, coupled with the buoyant consumer spending figures supported by high fiscal deficits, has bolstered the climb of the S&P 500 Index, bringing the VIX Index to a new low in the past five years.

Nevertheless, will the risk profile of the US economy continue to decline in tandem with the VIX Index in the future? The technology and consumer sectors have rallied on upward-revised earnings forecasts. Yet, after years of exponential and double-digit growth, can earnings continue to grow at such a rapid pace? If the rate hiking cycle is over, regardless of whether interest rates are cut or not, will unlimited funds still flood the stock markets rather than into the bond market which is likely to bottom out? Once these doubts take root in the minds of investors, scepticism will likely drive a rebound in the VIX index. A narrowing disparity between the two volatility indices could be detrimental to US equities, in particular to a market uptick that is driven solely by growth stocks.

US Treasury Yield Volatility Index and VIX Volatility Index



the ICE BofA MOVE Index (MOVE)(L)
The Volatility Indexof Chicago Board Options Exchange (VIX) (R)

Source: Bloomberg, Data as of 30 November 2023

Equities and bonds are not a zero-sum game. As analysed above, there are signs that capital is flowing back to US equities in an orderly way. However, the allocation across various sectors remains to be seen.

Valuation: Value stocks are more attractive

While US equities appear robust, it is predominantly driven by the technology sector, especially the gains from the 'Magnificent Seven' Index, signifying a remarkably narrow market breadth. Global funds rushing into just a few stocks is rare, mirroring the situation of the dot-com bubble during the millennium. Upon examining the trends in the technology and utility sectors of the S&P 500 sectors indices, the values as of 30 November 2023 reflects the fact that the technology sector's outperformance has exceeded levels observed during the millennium, reaching a 30-year new high and highlighting the current speculative frenzy. The same concept applies to US growth stocks and value stocks, which, though not at the 30-year high reached during the pandemic, are only a short step away from revisiting those peaks.

Sector Indices and Ratio of Growth and Value Indices

S&P Sectors: Technology Index divided by Utilities Index (L)
MSCI USA: Growth Index divided by Value Index (R)

Source: Bloomberg, Data as of 30 November 2023

Further reference is made to the forward price-to-earnings (P/E) ratios for the MSCI USA Growth and MSCI USA Value Indices over the past 10 years, as detailed below:

Forward P/E (times)	MSCI USA	
	Growth Index	Value Index
Present value	32.5	15.8
Average value	25.7	15.8
The highest value	46.5	20.9
The lowest value	18.1	12.5

Source: Bloomberg, data as of 3 December 2023

The MSCI USA Growth Index data shows that while the current value remains 43.1% below its peak, it is trading at a premium of approximately 26.5% above its ten-year average. The MSCI USA Value Index is down only 32.3% from its peak and is at its average value. The Value Index is relatively more attractive when benchmarking against their respective lows.

Taken together, it is not surprising that today we are in the midst of a 30-year extreme, making the prospect of mean reversion a possibility. The MSCI USA Value Index presents higher risk-reward ratios when considering valuation differences.

Interest Rate Inflection Point: High-Dividend Stock Reverses

Regardless of the Federal Reserve's final decision, the market has long held that the rate hiking cycle has ended, which will be favourable to US equities. However, is the conventional notion of being a contrarian valid? By analysing the correlation coefficients between the US Federal interest rates and the S&P 500 Index over the past 50 years, and by generating their 20-quarter moving averages to mitigate the impact of outliers, we found a marked difference in the data before and after 2000. With negative correlations of 60.4% before and 13.5% after 2000, the historical likelihood of interest rate cuts in tandem with equity rallies was nearly 60% before 2000, but subsequently dropped to less than 15%. Therefore, investors expect that even if there are interest rate cuts in the future, it may not provide support to the stock markets. Instead, they are concerned about whether there are greater underlying risks of abrupt interest rate cuts.

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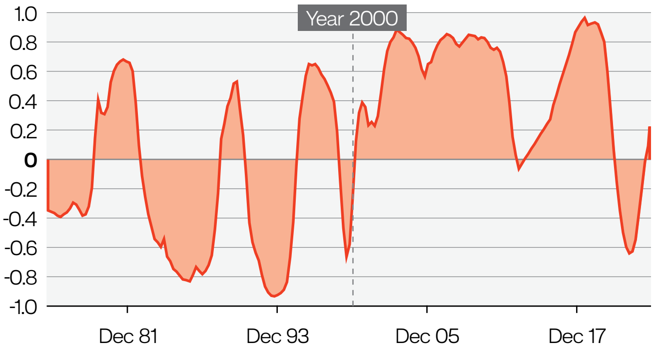
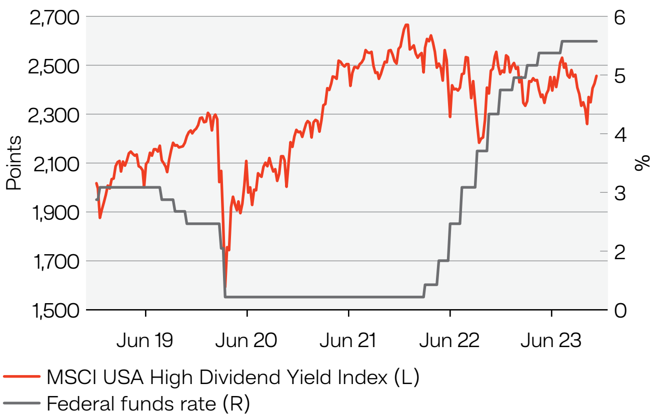
Correlation Coefficients – US Federal funds rate and S&P 500 Index



Source: Bloomberg, Data as of 30 November 2023

From a microeconomic perspective, it is not difficult to understand that high-dividend stocks are under pressure during interest rate hikes, and vice versa. This concept is vividly illustrated when examining by the interplay between the MSCI USA High Dividend Yield Index and Federal funds rate over the past five years. Although the index is still on a downward trajectory, the Federal Reserve's adherence to a "Higher for longer" interest rate policy suggests that a rally in high-dividend stocks upon the peak of interest rates. In November 2023, the MSCI USA High Dividend Yield Index posted a return of over 8.5%, which is comparable to the S&P 500 Index's 8.9% return, bolstered by a surge in technology stocks. However, high-dividend stocks are more attractive when risk and valuation are taken into considerations.

MSCI US Dividend Index and Federal funds rate



Source: Bloomberg, Data as of 1 December 2023

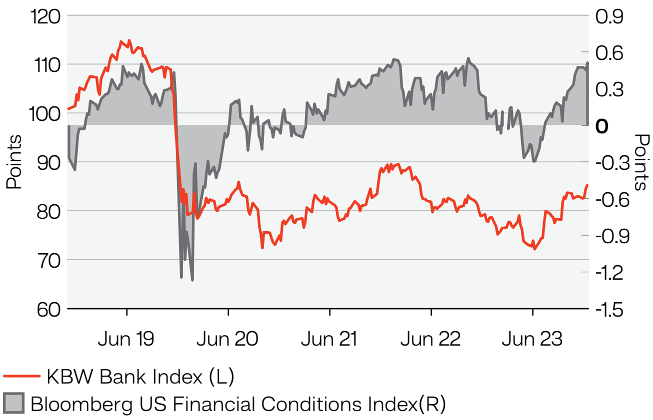
The MSCI USA High Dividend Yield Index's factsheet in October 2023[7] suggests that dividend yields should be of priority in formulating investment strategies, followed by low volatility and attractive valuations. It also advises a reduction in holdings of low market capitalisation equities and those driven by momentum. In other words, the recommended investment strategy should focus on defensive equities, including consumer staples, healthcare and industrial sectors.

Banking Sector: After The Bitter Ends

Since 2022, the US Federal Reserve's has been committed to interest rate hikes and monthly balance sheet contraction, with the ECB following suit, resulting in a significant tightening of liquidity in the financial systems of Europe and the US. This indirectly led to the regional bank runs in the US in March 2023[8] and the mergers and acquisitions among major European banks[9]. Despite swift policy reversals by authorities to mitigate the fallout, investors' confidence in the banking and credit markets was shaken. Referring to the KBW Bank Index, which tracks the performance of the 24 leading saving institutions, regional banks or national monetary centres in the US, plunged nearly 37.5% from its peak in February, only stabilised in May following governments' intervention.

In addition, the Bloomberg US Financial Conditions Index, which reflects the state of financial liquidity in the US, signaled a severe financial liquidity shortage at that time (where positive values indicate 'expansion' and negative values 'contraction'). In response, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) provided liquidity and facilitated mergers and acquisitions within the market[10]. Such measures were instrumental in preventing a broader systemic crisis. However, the banking stocks remained depressed.

KBW Bank Index and Bloomberg US Financial Conditions Index



Source: Bloomberg, Data as of 30 November 2023

[7] See MSCI website, https://www.msci.com/documents/10199/fee511ac-bb6e-48df-bd21-fa399b9bd1eb
[8] See CNBC website, https://www.cnbc.com/2023/03/15/credit-suisse-chairman-says-silicon-valley-bank-crisis-looks-contained.html
[9] See Reuters website, https://www.reuters.com/markets/europe/ubs-completes-swiss-mega-merger-gains-clout-global-wealth-player-2023-06-12/
[10] See Reuters website, https://www.reuters.com/markets/us/speed-us-bank-failures-play-starring-role-fed-fdic-post-mortems-2023-04-27/

The US Federal Reserve has kept interest rates unchanged since the second half of 2023. This policy stance was reflected in the Bloomberg US Financial Conditions Index, which remained in expansionary territory, even surpassing its pre-regional bank crisis level in November. As of 30 November 2023, the KBW Bank Index surged nearly 22% from the year's bottom, riding on the back of high correlation coefficients. However, it still represents around 30% of a potential upside from its pre-crisis peak.

Although Moody's[11] and S&P Global[12] downgraded the credit ratings of dozens of US banks, it is believed that the KBW Bank Index, which has borne the brunt of the interest rate hikes, is poised to potentially benefit from the forthcoming interest rate cuts.

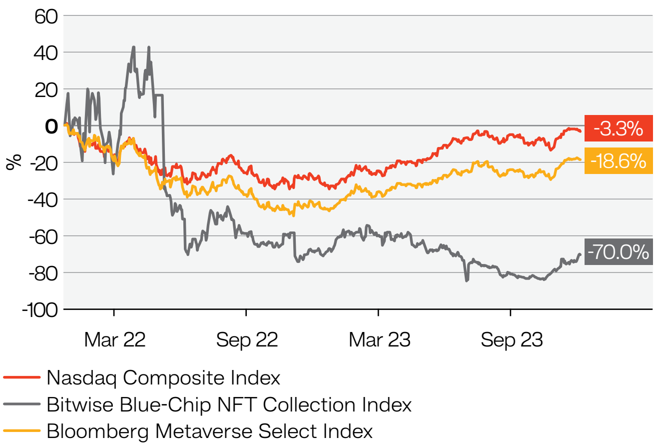
Tech Stocks: A Trial by Fire

Do you remember the investment boom of non-fungible tokens (NFT)? It's a blockchain technology that turns real art, collectibles, games and images into unique digital assets. With the support of internationally renowned auction houses, NFTs were traded globally for tens of billions of US dollars in 2021[13]. However, the subsequent price collapse of some celebrity-endorsed NFTs prompted investors to file a class action lawsuit in August 2023 against the auction houses, as well as a group of NFT creators and stakeholders, alleging misleading promotion, collusion and price inflation[14].

What about the metaverse? It is a virtual world that claims to be disruptive to human work and life[15]. The Harvard Business Review even published a research report in 2022 stating[16] that despite its nascent stage, the virtual universe has burgeoned into lucrative business and has led tech and gaming giants to invest substantial resources into the creation of their proprietary virtual universes. Utilising an array of technologies including virtual reality (VR) platforms, machine learning, blockchain, 3D graphics, digital currency, sensors and VR-enabled devices, these entities are constructing their own virtual universes. Despite the billions of dollar losses booked as of 2023, these tech titans maintain an unwavering conviction in the metaverse as the future of businesses[17].

Looking at the performance of Bitwise Blue-Chip NFT Collection Index from 2022 to early December 2023, the index, which demonstrates extreme volatility, surged more than 40% over the period, only to subsequently plummet, registering a cumulative decline approaching 70%. The Bloomberg Metaverse Select Index depreciated nearly 19% during the same period, reflecting the fact that pioneering innovations bring widespread benefits to humankind at the expense of investors. Compared to the performance of the Nasdaq Composite Index over the same period, the index declined by nearly 33% in 2022, and made a robust recovery buoyed by the boom of artificial intelligence advancements in 2023. The index rebounded by nearly 44% as of 6 December 2023, with a combined decline of only 3.3% over the two-year period.

Performance of Nasdaq, NFT and Metaverse Underlying Indices



Source: Bloomberg, Data as of 6 December 2023

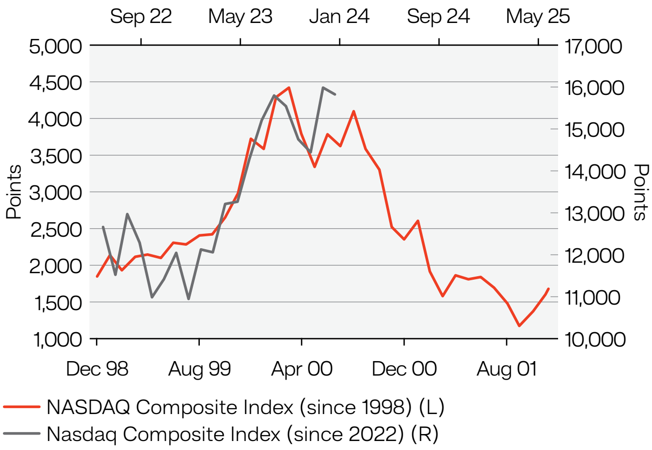
The trend of the Nasdaq Composite Index recently has been steered by thematic speculation, as evidenced by the rally based upon NFTs in 2021, the metaverse in 2022, and artificial intelligence throughout 2023, which propelled the index to surpass all major global indices, most notably within the US stock markets and particularly among technology stocks, including those comprising the "Magnificent Seven" Index. Can the above technological themes ultimately benefit mankind? It appears this question is not the central concern for the speculative capital.

Referring back to the millennium, the boundlessness Internet technology has shortened the distance between people into inches away. Now, more than two decades later, the Internet's contribution to global disruption is well recognised, and there is reason to believe that artificial intelligence can change the future. However, a comparison of the monthly performance of the Nasdaq Composite Index between then and recent years is chilling.

[11] See Reuters website, https://www.reuters.com/markets/us/moodys-downgrades-10-us-banks-warns-possible-cuts-others-2023-08-08/
[12] See CNN website, https://edition.cnn.com/2023/08/21/business/sp-us-bank-downgrades/index.html
[13] See Reuters website, https://www.reuters.com/markets/europe/nft-sales-hit-25-billion-2021-growth-shows-signs-slowing-2022-01-10/
[14] See CNN website, https://edition.cnn.com/style/article/bored-apes-sothebys-lawsuit/index.html
[15] See The Wall Street Journal website, https://www.wsj.com/story/why-the-metaverse-will-change-the-way-you-work-95f15faa
[16] See The Harvard Business Review website, https://hbr.org/2022/04/how-the-metaverse-could-change-work
[17] See CNBC website, https://www.cnbc.com/2023/02/01/meta-lost-13point7-billion-on-reality-labs-in-2022-after-metaverse-pivot.html

Equity

3-year charts of Nasdaq from 1998 and 2022



Source: Bloomberg, Data as of 6 December 2023

From the second half of 2023 onwards, the market has been particularly concerned about the divergence between the US Treasury yields and the "Magnificent Seven" Index. The divergent is interpreted as partially attributable to increasing borrowing costs for technology stocks due to heightened Treasury yields, which in turn constrains the scale of funding for research and development, among other things. The proportion of negative correlation coefficient between Bloomberg Magnificent Seven Index and the US 10-year Treasury yields just below 43% on average between 2015 and 2021. However, this figure jumped to nearly 80% and 68% in 2022 and 2023 respectively. Details are as follows:

Year	The proportion of negative correlation coefficient (%)
2015	34.3
2016	37.3
2017	63.7
2018	34.9
2019	24.2
2020	49.8
2021	53.3
2022	79.5
2023	68.2

Source: Bloomberg, data as of 30 November 2023

The decoupling between US Treasury yields and the "Magnificent Seven" Index has been apparent for only the recent two years. There is insufficient data to analyse the trend of US tech giants through Treasury yields. If the forecast of future trends is solely relied on quantitative data, there may be still room for a potential uptick in the US Treasury yield curve in the short term (for details, please refer to the "Bond" section). This suggests that technology stocks, such as the "Magnificent Seven" Index, may experience volatility in the future.

On an economic level, proponents argue that artificial intelligence can replace human effort in a various monotonous and repetitive tasks, freeing up time for innovation and creating more wealth at the same time. However, historically, technological advancement led to economic imbalances and conflicts of interest among classes. Reflecting on the millennium, the development of the Internet has catalysed the creation of numerous new jobs, and has also spawned numerous billionaires, more and faster than during the recent Industrial Revolution. Nonetheless, it has also exacerbated the disparity between the rich and the poor. Historically, technological innovation has helped reduce operating costs, but not invariably translated into lower consumer prices. Profit polarisation has accelerated the elimination of the weak and the retention of the strong in various industries. However, this may not necessarily improve people's livelihoods. Therefore, it is important to prioritise fairness as a global issue for AI development, rather than preying on grandiose illusion.

Investment strategy: orderly increasing exposure to defensive, high-dividend and value stocks

In 2024, three major factors impacted the stock market: the US presidential election, the inflection point of interest rates, and the economic downturn. The interaction of these factors will change over time. Combined with human influences such as political conflicts, it is anticipated that global stock markets will become more volatile in 2024. This will necessitate investors to review their portfolios more frequently and adjust their positions more flexibly.

US Presidential Election Year: The US Equities Win

This is the most recognised factor in strategy deployment.

Based on data from the past 10 US presidential elections, which covers a total of 40 years since 1984, this analysis harnesses seven major US and international stock indices to represent the performance of regional stock markets. These benchmarks encompass the S&P 500 Index, the Nasdaq 100 Index, the Russell 2000 Index, the MSCI European Index, the MSCI Emerging Markets Index, the MSCI Asia ex-Japan Index and the MSCI ASEAN Index. The ratings are based on the following four criteria:

1. The ratio of average return to standard deviation is used to reflect the advantage of higher returns than volatility. This is calculated by dividing the average return by the standard deviation, and ranking the resulting ratio of indices. The top 3 indices receive a score of one point;

2. The ratio of the maximum to minimum absolute return is used to reflect the greater advantage of rising over falling. Absolute value is used to eliminate calculation misunderstandings. After dividing the maximum by the minimum absolute return, the indices' ratio greater than 1 will be awarded one point;

3. The difference between the number of positive and negative returns reflects the advantage of value bets. The indices are ranked based on this difference, calculated by subtracting the number of negative returns from the number of positive returns. The top 3 receive one point;

4. The difference between the total number of times the best and worst quarterly performance occur is used to reflect the time advantage. Each quarter, we rank the seven indices to identify the top two and bottom two performs. We then calculate the total number of times the best and worst quarterly performances occur across all quarters and find the difference. Finally, we rank the indices based on this difference, assigning one point to the top three. Please note that this criterion only applies to data from 2008 onwards due to differences in data availability.

Based on the above conditions, the results of the analysis are as follows:

Criterion		US equity indices			MSCI equity indices			
		S&P 500	NASDAQ 100	RUSSELL 2000	Europe	Emerging markets	Asia ex-Japan	ASEAN
1	Average return (%)	0.9	1.6	2.0	-1.6	0.4	0.1	-2.4
	Average volatility (%)	7.8	12.9	11.1	9.3	12.7	11.3	14.5
	Ratio	0.1	0.1	0.2	-0.2	0.0	0.0	-0.2
2	Maximum return (%)	20.0	30.0	31.0	11.7	20.6	18.3	20.4
	Minimum return (%)	-22.6	-34.4	-30.9	-23.1	-27.9	-23.9	-31.0
	Ratio	0.9	0.9	1.0	0.5	0.7	0.8	0.7
3	Number of positive return	25	18	24	12	20	20	7
	Number of negative return	15	18	16	12	16	16	9
	Difference	10	0	8	0	4	4	-2
4	Number of ranking top 2	4	6	7	2	3	6	4
	Number of ranking bottom 2	5	3	3	7	3	5	6
	Difference	-1	3	4	-5	0	1	-2
Total score		**2**	**2**	**4**	**0**	**1**	**2**	**0**

Source: Bloomberg, data as of 6 December 2023

In summary, the Russell 2000 Index has the highest total score, followed by the S&P 500 Index, the Nasdaq 100 Index and the MSCI Asia ex-Japan Index. From a regional perspective, the total score for US equities (8 scores) is higher than the total score of Europe, Asia and Emerging Markets (3 scores), reflecting the dominance of US equities during the US presidential election year. From a risk perspective, the MSCI Europe Index and the MSCI ASEAN Index score 0, reflecting the high-risk profile of both markets.

To better reflect changes over time, the above analyses have been repeated on a half-yearly basis and the results are as follows:

Criterion		US equity indices			MSCI equity indices			
		S&P 500	NASDAQ 100	RUSSELL 2000	Europe	Emerging markets	Asia ex-Japan	ASEAN
1	Average return (%)	1.7	3.2	3.8	-3.1	1.0	0.6	-5.0
	Average volatility (%)	10.8	18.2	14.4	13.4	19.2	18.4	19.3
	Ratio	0.2	0.2	0.3	-0.2	0.1	0.0	-0.3
2	Maximum return (%)	21.2	26.9	37.0	11.0	33.7	29.9	14.4
	Minimum return (%)	-29.4	-37.8	-27.6	-31.4	-47.8	-40.5	-41.4
	Ratio	0.7	0.7	1.3	0.3	0.7	0.7	0.3
3	Number of positive return	13	12	13	7	11	10	4
	Number of negative return	7	6	7	5	7	8	4
	Difference	6	6	6	2	4	2	0
4	Number of ranking top 2	3	4	4	0	2	2	1
	Number of ranking bottom 2	1	2	0	5	2	2	4
	Difference	2	2	4	-5	0	0	-3
Total score		**3**	**3**	**4**	**0**	**0**	**0**	**0**

Source: Bloomberg, data as of 6 December 2023

Equity

Based on the above analysis, the Russell 2000 Index achieved the highest score, followed by the S&P 500 Index and the Nasdaq 100 Index, where both scored the same. All other indices score 0. Once again, US equities outperformed non-US equities. The table below displays the final combined quarterly and half-yearly results:

Total score	S&P 500	NASDAQ 100	RUSSELL 2000	Europe	Emerging markets	Asia ex-Japan	ASEAN
By quarter	2	2	4	0	1	2	0
Semi-annual	3	3	4	0	0	0	0
Total	5	5	8	0	1	2	0

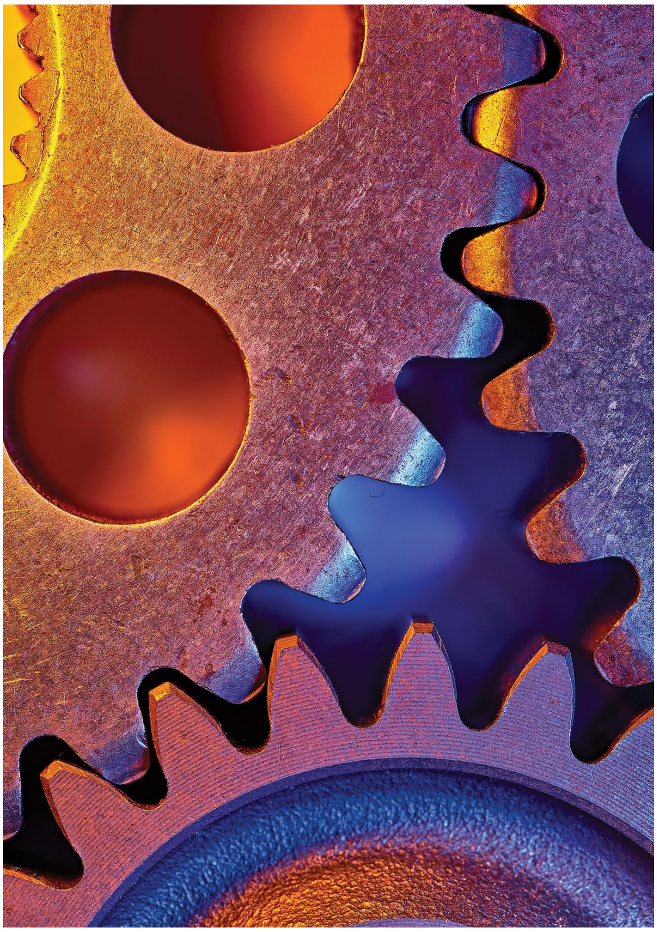
Source: Bloomberg, data as of 6 December 2023

Excluding the effects of investment timing, the results indicate an overwhelming victory of US equities and a significant divergence in global equity market performance during the US presidential election year. The Russell 2000 Index, which represents small capitalization companies, outperformed, while the S&P 500 Index and the Nasdaq 100 Index had comparable performance. Among non-US stock markets, Asia ex-Japan performed better, with Europe and ASEAN posing risks.

When the frequency of trades is reduced to lower investment risk and the data is split biannually, the aggregated score results are as follows:

Overall score	S&P 500	NASDAQ 100	Russell 2000	Europe	Emerging Markets	Asia ex-Japan	ASEAN
First half of the year	1	4	4	0	3	2	0
Second half of the year	3	3	4	0	2	1	0

Source: Bloomberg, data as of 6 December 2023



These results demonstrate a more sophisticated investment strategy, with US equities remaining the top investment choice. The Russell 2000 Index and the Nasdaq 100 Index demonstrated unwavering stability in their performance. However, the S&P 500 Index significantly lagged in the first half of the year, even worse than some non-US stock markets, only to stage a robust recovery in the second half of the year. Emerging markets outside the US performed well throughout both halves of the year, presenting a viable strategy to hedge against the risk concentration in US equities. The performance of Europe and ASEAN stock markets were disappointing, scoring 0 out of 10 when analysed from different timeframes and perspectives. The risks and disparity in performance relative to other regions are self-evident.

Interest Rate Inflection Point: Defensive and High-dividend Equities Prevail

The global interest rate forecasts are detailed in the "Bond" section and will not be repeated here.

To clarify, this analysis assumes that the US Federal Reserve's interest rate has reached its peak and will either be reduced or maintained unchanged. Upon examining the past 10 US presidential election years, only the years 1992, 2000 and 2008 align with these criteria.

The analysis indicates that US equities are a favourable option for investors during presidential election years. By narrowing our investment strategy to use the S&P 500 Index to represent US equities, and extracting quarterly performance data of each of the 11 S&P sector indices over a three-year period, we can use the scoring methodology based on the four criteria mentioned above to obtain the final aggregate scores as follows:

Indices	Total score	Indices	Total score
S&P 500	0	Financials	4
Technology	0	Consumer Staples	4
Energy	1	Industrials	0
Utilities	3	Communication Services	0
Consumer Discretionary	0	Real Estate	2
Healthcare	1	Materials	0

Source: Bloomberg, data as of 6 December 2023

The three sectors with the highest overall score are Utilities, Financials and Consumer Staples. According to the analysis conducted in the fourth quarter of 2023, Utilities, Healthcare and Consumer Staples were the top three best-performing sectors during the period between the peak of interest rates and the first interest rate cut (for details, please refer to the "Equity" section of BEA Wise of the fourth quarter of 2023). High-dividend equities and Financials equities, as analysed above, were also among the top performers at an interest rate inflection point. The analysis indicates that during a US presidential election year, Utilities, Financials, Consumer Staples and Healthcare sectors, characterized by defensive and high-dividend equities, will outperform when the interest rate inflection point occurs.

To conclude, when considering the three qualifying years that satisfy the interest rate criteria, the data in 2000 is most relevant to the current market due to the same dominance of tech boom in US equities trend. The sector-by-sector quarterly performance of the S&P 500 Index in 2000 is as follows:

2000	Index Performance (%)										
	S&P 500	Technology	Energy	Utilities	Consumer Discretionary	Healthcare	Financials	Consumer Staples	Industrials	Communication Services	Real Estate	Materials
Q1	2.0	13.5	1.8	-0.2	-3.9	1.8	6.4	-17.5	-1.5	-1.7	Not applicable	-12.7
Q2	-2.9	-9.3	2.4	23.1	-8.8	-3.4	4.8	13.1	-1.4	-14.3	Not applicable	-15.4
Q3	-1.2	-14.0	8.0	-0.5	-5.3	23.3	31.9	1.7	8.5	-11.2	Not applicable	-8.3
Q4	-8.1	-33.4	0.5	10.8	-4.5	1.7	3.2	20.7	-0.8	-19.4	Not applicable	21.6
Criteria analysis												
Number of positive values	1	1	4	2	0	3	4	3	1	0	Not applicable	1
Number of negative values	3	3	0	2	4	1	0	1	3	4	Not applicable	3
Difference	-2	-2	4	0	-4	2	4	2	-2	-4	Not applicable	-2
Number of top 3	1	1	0	2	0	1	3	2	1	0	Not applicable	1
Number of bottom 3	1	3	0	0	1	0	0	1	0	3	Not applicable	3
Difference	0	-2	0	2	-1	1	3	1	1	-3	Not applicable	-2
Total scores	0	0	1	1	0	2	2	2	1	0	Not applicable	0

Source: Bloomberg, data as of 6 December 2023

In view of the relatively small amount of data, the average value and the maximum to minimum ratio criteria were excluded, and the two frequency-based criteria were retained for scoring. The results show that the top 3 sectors in terms of overall score are Healthcare, Financials and Consumer Staples. Among them, technology stocks scored 0, reflecting not only their high risk profile, but also their quarterly performance which was almost 90% opposite to the top 3. As mentioned in the above analysis, when comparing today's AI boom to the dot-com boom in 2000, the monthly trend of the Nasdaq 100 Index is very similar to that of today, it is likely that the index has seen the peak and will retreat in the near term.

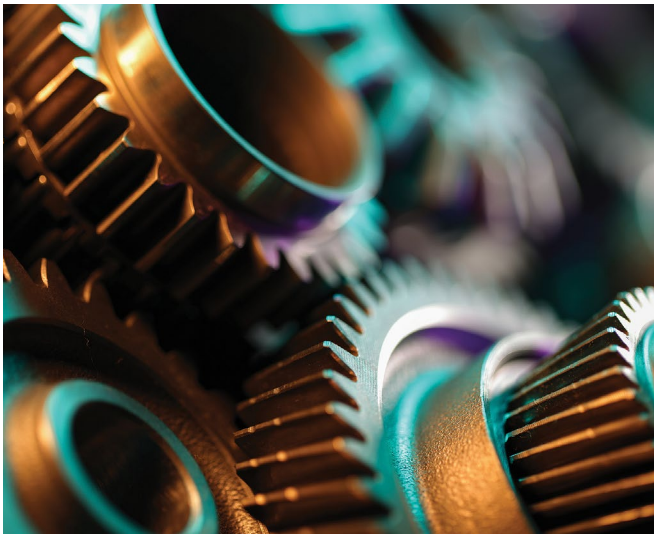
In conclusion, due to the impact of the US presidential election year and the risk of interest rate inflection, investors should consider increasing their positions of defensive and high-dividend equities at a gradual pace, including utilities, financials, consumer staples and healthcare equities, to hedge against the risk of a sharp fall of technology equities.

Equity

Economic Downturn: Defensive Stocks Benefit from Approaching the Edge of Boom-Bust Line

Among the three major risk factors, predicting the direction of the economy is the most challenging due to the volatility of the data, which creates extreme optimism and pessimism in the market.

The US economy expanded 4.9% in the third quarter of 2023, which is more than double the 2.1% growth in the second quarter. This revision shocked the market when the market was still unsettled for the rapid economic growth rate. The fear at these elevated levels is twofold: it reflects a quest for the underlying truths of these figures, and a concern for the potential precipitous descent from these economic heights. None of the economic data can explain the vigorous growth across the economy. Some analysts explain that the recent surge in economic growth may be attributed to the concert tours of international superstars[18], which have stimulated a jump in domestic demand for services such as airlines, hotels, and food and beverages, overshadowing the unfavourable factors for the economy. In addition to exceeding the expectations of bearish analysts and driving the rally in European and the US stock markets to record highs, there are rational analyses suggesting that the economic surge may be short-lived[19]. Without commenting on the reliability and scope of these analyses, should the assertions hold true, they could considerably undermine the capability of central banks and the fiscal authority officials which are determined to improve the economy by hook or by crook, as their efforts are no match for the economic stimulus brought by international superstars.



Given the economic downturn and the risk factors of a US presidential election year and an interest rate inflection point, how will the US equities perform?

The MSCI USA Value Index and the MSCI USA Growth Index are used to represent the two major economic cycle equities. The US quarterly GDP figures and their quarterly changes during presidential election years are extracted and compared with the full 40-year dataset. The results are as follows:

Indicators	GDP figures (%)	Quarterly changes (%)		
		GDP	The MSCI USA Value Index	The MSCI USA Growth Index
The average in the US presidential election years	2.7	-0.5	1.6	0.9
The 40-year average	2.9	0.0	2.6	3.2
The standard deviation in the US presidential election years	7.8	12.2	7.7	9.4
The 40-year standard deviation	4.3	6.4	7.8	9.3

Source: Bloomberg, data as of 6 December 2023

The averages indicate a marginal softening in economic growth during US presidential election years, with a minor downward trend that renders the findings less meaningful. Nonetheless, the standard deviation indicates substantially increased volatility, characterized by significant quarter-to-quarter changes, suggesting that the political conflicts between the ruling and opposition parties often leads to large fluctuations in the economy during presidential election years.

From the trends of indices, the standard deviations of both the MSCI USA Value Index and the MSCI USA Growth Index are of similar level to the 40-year figures. However, the average returns of both indices are lower than their 40-year averages, while the difference is particularly pronounced in the MSCI USA Growth Index. This reflects the heightened sensitivity of the MSCI USA Growth Index to the significant volatility in the economy.

[18] See FOX Business website, https://www.foxbusiness.com/economy/3q-gdp-economic-growth-a-head-fake
[19] See Business Insider website, https://www.businessinsider.com/taylor-swift-beyonce-wont-prop-up-us-economy-much-longer-2023-11

For analysts who deem the phrase 'significant fluctuation' as excessively broad, a more granular approach is proposed. The data can be meticulously disaggregated into 1% intervals, providing a refined view of economic volatility. The detailed breakdown is presented in the following table:

Distribution	Percentage of quarterly GDP (%)	Percentage of quarterly changes (%)
-Under 3%	7.5	27.5
-3 to -2%	2.5	5.0
-2 to -1%	2.5	7.5
-1 to 0%	0.0	20.0
0 to 1%	7.5	15.0
1 to 2%	7.5	5.0
2 to 3%	20.0	0.0
3 to 4%	17.5	7.5
4 to 5%	15.0	2.5
Over 5%	20.0	10.0

Source: Bloomberg, data as of 6 December 2023

The distribution of quarterly changes indicates that negative values accounted for approximately 60% of the distribution, signifying a general GDP downturn during U.S. presidential election years. Unfortunately, the proportion of GDP decline exceeding 3% approaches 28%, the highest in the dataset. The proportion of GDP decline ranging from 0 to 3% accounts for nearly 33%, suggesting a one-in-three likelihood of a moderate economic downturn. According to Bloomberg's aggregated projections as of 9 December 2023, the US's quarterly GDP growth is expected to plummet from 4.9% in the third quarter of 2023 to approximately 1.1% and 0.4% in the fourth quarter of 2023 and the first quarter of 2024 respectively. These figures align with the analysis of the past 40 years, which included 10 US presidential election years.

According to Bloomberg's projections, the US GDP growth in 2024 is anticipated to hover between 0.4% and 1.6% on a quarterly basis, which is on the boom-bust line. However, historical data shows that such growth levels during U.S. presidential election years have only been recorded approximately 15% of the analysis period. This reflects the rarity of such economic growth expectations from the market, and the divergence between optimistic and pessimistic outlooks within the market. Below is Bloomberg's aggregated forecast for the US's quarterly GDP growth is detailed below:

Quarter	Quarterly growth (%)
2023 Q4	1.1
2024 Q1	0.4
2024 Q2	0.4
2024 Q3	1.0
2024 Q4	1.6

Source: Bloomberg, data as of 6 December 2023

After sampling data of 1992, 2000 and 2008 from the 10 presidential elections year, and analysing the two indices, the results show the impact of the economic downturn and interest rate inflection factor:

Quarter	GDP (%)	Quarterly changes (%)		
		GDP	The MSCI USA Value Index	The MSCI USA Growth Index
1992 Q1	4.9	3.5	-0.7	-4.4
1992 Q2	4.4	-0.5	4.7	-1.7
1992 Q3	4.0	-0.4	1.5	3.8
1992 Q4	4.2	0.2	3.2	6.5
2000 Q1	1.5	-5.2	-0.1	2.8
2000 Q2	7.5	6.0	-2.1	-5.2
2000 Q3	0.4	-7.1	5.3	-9.5
2000 Q4	2.4	2.0	-0.7	-17.4
2008 Q1	-1.7	-4.2	-9.1	-9.8
2008 Q2	2.4	4.1	-6.8	2.2
2008 Q3	-2.1	-4.5	-5.7	-12.3
2008 Q4	-8.5	-6.4	-20.0	-24.8
Statistical Analysis (%)				
Average	1.6	-1.0	-2.5	-5.8
The average in the US presidential election years	2.7	-0.5	1.6	0.9
Standard deviation	4.2	4.4	7.1	9.4
The Standard deviation in US presidential election years	7.8	12.2	7.7	9.4
Proportion (%)				
Negative values	25	58	67	67
US presidential election years with negative values	13	60	33	38
Positive values	75	42	33	33
US presidential election years with positive values	88	40	68	63

Source: Bloomberg, data as of 6 December 2023

The results indicate that the average values of GDP are lower than the overall GDP during the US presidential election years, with a higher volatility for quarterly changes. The standard deviation is lower than the overall figure, which reflects the fact that interest rate cuts contribute to economic stability but not expansion.

In terms of the proportion of positive and negative values, both GDP measures tilted towards positive values, with minimal disparity in their quarterly changes. This suggests

Equity

that interest rate cuts can sustain economic expansion, albeit at a slower pace. However, the timing of interest rate cuts during a US presidential election year when the economy is already weak appears to be ineffective.

The returns of the two major cyclical indices were negative on average, lagging the overall performance during US presidential election years, with the MSCI USA Value Index exhibiting a slight less decline. The proportion of positive and negative returns is vastly different, with negative returns constituting approximately 67% for both indices, indicative of a high-risk profile. Overall, the results indicate that during US presidential election years featured with interest rate inflection points and economic decline, a cyclical stock-picking strategy would be ineffective, regardless of actual performance or odds ratio.

Finally, by incorporating the factor of the technology boom and focusing on analysing the data of the year 2000, the result shows that all GDP values are positive, but there is marked volatility on a quarterly basis. The sharp fluctuations within the first three quarters, only to stabilize in the fourth quarter. Despite the high volatility, the performance of two major cyclical indices warrants a differentiated interpretation. Despite both indices recording declines in three of the four quarters, the MSCI USA Value Index still managed to return approximately 2% for the full year, while the MSCI USA Growth Index fell by about 27%, highlighting a considerable disparity. This reflects the resilience of the MSCI USA Value Index amidst the simultaneous emergence of four predominant risks: the burst of the tech boom bubble, the US presidential election, an inflection point in interest rates, and an economic downturn, which overshadow the performance of the MSCI USA Growth Index.

Upon comprehensive analysis of all strategies, the result projects a pronounced contraction in the economic performance of the US for the year 2024, characterized by sluggish growth and a potential boom-bust situation. In terms of stock markets, the defensive and value stocks may benefit from such a macro environment.

Chapter Summary:

- There are a number of anomalies in global equity markets in 2023, with one of the key risks going forward being a stalled economic downturn
- Market analysis suggests that value stocks and high-dividend stocks will perform well, while banking and technology stocks will have polarised trends
- The three main risk factors for the stock market in 2024 are the US presidential election year, the interest rate inflection point and the economic downturn
- In the US presidential election year, US stocks will outperform non-US stocks, while the interest rate inflection and the economic downturn will be favourable to defensive stocks
- Taking into account of technology boom, investors should add their value stock holdings in an orderly manner to hedge against the risk of growth stocks faltering at any time

Investment Strategist, Wealth Management Division,
The Bank of East Asia **Jason Chan**

Outlook on Hong Kong and China stock markets: Striving Ahead

In a timid market, investment decisions should be made with a long-term perspective, rather than being swayed by the short-term market sentiment

The Hang Seng Index and CSI 300 Index hit their lows in Q4 2023 amid market fluctuations

Hong Kong equities and China A-shares in the first six weeks of the fourth quarter of 2023 were in a broad tug-of-war pattern. With the Hang Seng Index fluctuated narrowly between 16,800 and 18,200, and the CSI 300 Index swung between 3,450 and 3,700, the tug-of-war between the bulls and the bears embodied exactly the title "Nip and tuck" of this section in 2023. During the period, the spike in US 10-year Treasury yield, which briefly exceeded 5%, coupled with the sudden outbreak of conflict in the Middle East, provided ample cause for the market's bearishness. On the other hand, the economic data released by China during that period was quite solid, with heavyweight Chinese stocks outperforming expectations. Additionally, the Central Huijin Investment Ltd. announced that it had increased its holdings of A-shares of the four largest domestic banks and state-owned enterprise-related ETFs, signalling the injection of state-backed capital into the market to offer the support. Furthermore, the Central Ministry of Finance (MOF) announced in late October of the same year that it intended to issue an additional RMB1 trillion of bonds and significantly revised the annual deficit target upward to 3.8% to support local water conservation infrastructures, which could be considered as the most unexpected stimulus measures during the quarter, propelling the Hang Seng Index to close at 18,175 points.

Regrettably, the respite in the property sector was short-lived. China's property market failed to pick up during the traditionally robust "Golden September and Silver October" period. The stagnation in sales was compounded by stalled debt restructuring negotiations among private developers, leaving the market with lingering concerns over the sector's debt issues. During this period, the downgrade of China's credit rating by Moody's to "negative" was a further blow. Despite calls from various Chinese decision-marking authorities urging financial institutions to extend financing support to private developers, and there were even rumours of formulating a 'white list' offering unsecured loans to eligible enterprises, the lack of detailed information has left the market's risk appetite languishing. A number of Chinese economic data releases in November 2023 reflect the rekindled economic headwinds and deflationary pressures in China. As a result, Hong Kong equities and A-shares have been losing ground since mid-to-late November. The Hang Seng Index tumbled nearly 12% in 4 weeks, sinking to a new trough in 2023 at 15,972. The CSI 300 Index also plunged 8% during the same period, hitting a new low of 3,346 of the year.

The Chinese authorities convened the Central Economic Work Conference in mid-December 2023, which explicitly stated that the fiscal policy for 2024 should be "strengthened and more effective". On the monetary policy front, the policy direction of "aligning with the expected price level targets" was added. Significantly, the conference elevated the development of the science and technology innovation sectors, positioning it at the forefront of their work plan, thereby reviving the market's expectation of "stable growth". Yet, it was the Federal Reserve's unexpectedly pivot to dovish stance that emerged as a key market driver. Following its meeting in December, the Federal Reserve markedly lowered its core inflation forecast for 2024, with the dot plot hinting three potential interest rate cuts within the year. With the anticipation of an interest rate-cutting cycle, the US 10-year Treasury yield tumbled below 4%, which offers a timely relief for Hong Kong stocks.

Concluding the fourth quarter of 2023, as of 27 December, the Hang Seng Index and the CSI 300 Index accumulated losses of 6.7% and 9.6% respectively during the quarter. Sector-wise, utilities, conglomerates, industrials, telecommunications and financials all outperformed the market, with the former two even registering gains during the quarter. Conversely, the consumer discretionary, information technology, consumer staples, and real estate & construction sectors lagged.

The first quarter of 2024 is expected to be a rocky one for the stock market

The title of this section in the first quarter of 2024 is "Striving Ahead", which means that the short-term outlook for both A-shares and Hong Kong equities may remain rugged. Yet, in the fragile market, investors are advised to maintain composure and cautious, while investment decisions should not be swayed by short-term market sentiment. In line with the adage, "Every trough is followed by a peak", could Hong Kong stocks, which have been falling for four years and at extremely low valuations, witness a rebound in the first quarter of 2024? Which sectors are poised to outpace the broad indices? Our forthcoming analysis will analyse the investment opportunities and risks of both A-shares and Hong Kong stock markets in the first quarter of 2024 in terms of China's economic policies, external interest rates and capital flows.

Equity

China's economy and policies analysis: Choosing the Best

Traditionally, China's fiscal and industrial policies have been a pivotal force driving the movements of A-shares and Hong Kong stocks, often eclipsing the impact of economic data and corporate earnings performance. Whenever a major economic stimulus measure is announced by a major decision-making bodies such as the People's Bank of China, the State Council or the National Development and Reform Commission, there would be an influx of capital into the market, which leads to the recovery in Chinese stock valuations ahead of an earnings recovery cycle. However, the reliability of this investment formula is being put to the test. Despite a number of policy easing and growth stabilization measures—ranging from multiple interest rate cuts and reserve requirement reductions, to the relaxation of property market controls on purchases and sales, lowering down payment ratios and mortgage interest rates for second homes mortgages, bolstering financing support for property developers, the Ministry of Finance's increment of the deficit budget by an additional RMB 1 trillion, and the People's Bank of China's rumoured injection of trillions of funding to support urban village renovations through Pledged Supplementary Lending(PSL), the stock market's reaction has been tepid. The indices have only shown short-lived rallies with no significant reversal of the downward trend in valuations. This indicates that the fervour for speculating on policy-driven market plays is no longer as strong as it was in the past.

The three current major obstacles to market confidence are the excess inventory in China's property market, the debt repayment burden of Chinese property developers and the deleveraging pressure on local government financing vehicles. As mentioned at the Central Economic Work Conference in December 2023, the focus should be on "co-ordinating the resolution of risks in real estate, local government debt, and small and medium-sized financial institutions". However, these long-standing structural problems cannot be resolved by simply introducing a few governmental measures, while the efficacy of which would be questioned by investors. For instance, even if the Ministry of Finance were to increase bond issuance by an additional RMB 1 trillion, dedicated entirely to local transfer payments, there are concerns whether this amount would sufficiently offset the impact of the deleveraging process of local financing platforms on infrastructural investment, especially regarding infrastructure investment and the broader economic momentum of provinces and cities. Secondly, if the Chinese authorities mandatorily require financial institutions bond issuance or provide unsecured loans to financially distressed property developers, apart from giving rise to moral hazards, will this lead to even more severe challenges to the banking sector's asset quality, profitability and capital adequacy ratios? However, if the central government turns a blind eye and continues to allow property enterprises defaults, it casts doubts on how to boost new housing sales amid public concern over potential delays in property delivery and quality guarantees? In essence, the central government's ability to strike a balance between supporting economic growth, stabilising the property market and alleviating local debt pressures is a focal point of global investors, as well as a crucial deciding factor to a significant recovery of valuation of Hong Kong equities and A-shares.

The National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC), collectively known as the "Two Sessions," typically convene in March. One of the key issues this year is whether the policymakers of China will uphold an annual economic growth target of "around 5%". According to Bloomberg data, the current market expectation for China's economic growth in 2024 is only 4.5%. A clear reaffirmation by the central government of an "around 5%" growth target would strengthen market confidence, potentially averting another sell-off wave. The Central Economic Work Conference (CEWC) emphasised that "Proactive fiscal policies should be appropriately strengthened and their effectiveness improved", and the Standing Committee of the National People's Congress (NPCSC) approved the issuance of an additional RMB1 trillion in sovereign bond issuance in October, raising the national deficit ratio for 2023 to an unprecedented 3.8%. With China's departure from the conventional 3% deficit threshold, it is expected that the deficit rate set by the 2024 Two Sessions will remain at a higher level. The central government's proactive measures to amplify leverage and fiscal spending, complemented by the central bank's appropriate interest rate cuts and reduction in reserve requirement ratios and reactivation of policy financial tools such as Pledged Supplementary Lending (PSL), and the acceleration of projects such as water conservancy and energy, urban village transformation, social housing construction, and dual-use infrastructure, are expected to mitigate the drag on economic growth caused by local government's efforts in resolving its hidden debt burdens. On the other hand, the two sessions may focus on the development of high-end emerging industries, science and technology innovation is expected to break out in the cloud of many industries. Potential beneficiary sectors include: artificial intelligence themes, such as chips, cloud computing and data centres, large language model development, AI mobile phones and computers; concepts of domestic substitution, such as smartphones and related supply chain and application software; and automated driving related theme, such as new energy vehicle outsourcing manufacturing (OEM), parts and components and related equipment.

External Interest Rate: Be Vigilant in Peacetime

The surge in US interest rates has proven challenging for Hong Kong equities over the past two years. Weakening economic data of the US on labour, consumer spending and manufacturing sectors in the fourth quarter of 2023, coupled with stubbornly high inflation indicator that appears to be losing steam, has prompted the Federal Reserve to soften its previously strong hawkish stance at its interest rate meeting in December. The Federal Reserve markedly revised its core Personal Consumption Expenditures (PCE) inflation forecasts downward to 3.2% and 2.4% respectively for the following two years, a decrease from its forecast of 3.7% and 2.6% in September 2023 respectivelyy. Furthermore, the latest Federal Reserve's dot plot suggests potential three interest rate cuts totaling 75 basis points in 2024. US interest rate cuts seems inevitable in 2024. This shift indicates a potential easing of one of the major overhangs on Hong Kong and A-share markets seen in 2023. A downward shift in the US Treasury yield curve, an RMB exchange rate that is shaking off weakness and a decline in Hong Kong Interbank Offered Rates (HIBOR) are poised to be catalysts for a revaluation in both stock markets. Historically, over the past 30 years, the Hang Seng Index has seen an average growth of up to 25.2% during periods following the peak of the US Federal Funds Rate (FFR) and the early stages of an interest rate-cutting cycle (prior to the second interest rate cut). After the presumed final interest rate hike of this cycle in July 2023, the Hang Seng Index experienced a cumulative drop of 14% by late December 2023. If the market's predictions hold, the Federal Reserve's second interest rate cut in mid-2024 could indicate a potential catch-up rally for Hong Kong equities in the first half of 2024, potentially reaching into the mid-double digits. However, the market has been speculating about a Federal Reserve's interest rate cut for some time now. According to the interest rate futures market as of 21 December 2023, the market is currently betting on a US interest rate cut of up to 140bps in 2024, far exceeding the Federal Reserve's own projections as shown in its dot plot. If the Federal Reserve's easing pace is not as aggressive as the market expects, a potential rebound in the US dollar and US bond yields could emerge, which is a potential concern for Hong Kong stocks.

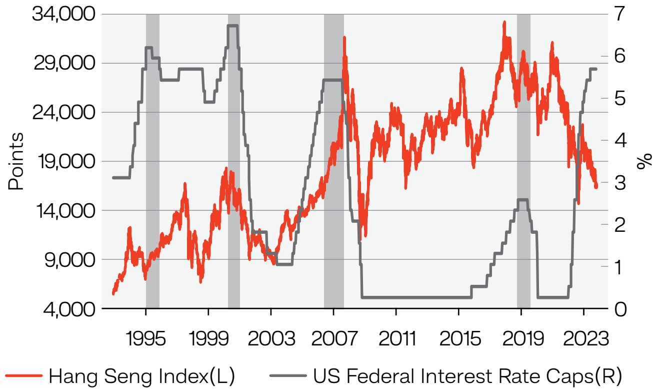
Investors looking to speculate on the forthcoming US interest rate-cutting cycle in both Hong Kong and A-share markets are advised to pay attentions to the following three thematic sectors:

(i) High-yield value equities: these stocks stand to benefit from the decline in risk-free interest rates. As the spread between corporate dividend yields and risk-free interest rates widens, investors are likely to redirect capital from low-risk assets, such as time deposits and government bonds, back into these equities. This investment theme includes local utility equities, local and Chinese telecommunication equities and local Real Estate Investment Trusts (REITs).

(ii) Equities with significant US dollar or Hong Kong dollar denominated debts in terms of total amount and percentage: such companies stand to benefit from lowered Hong Kong dollar and US dollar borrowing rates and bond issuance rates, translating to reduced interest expenses and enhanced net interest margins. This investment theme includes local property equities, local utility equities, local conglomerates, Macau gaming equities and airline operations and leasing equities.

(iii) Gold-related equities: As US dollar interest rates decline, the opportunity cost of holding gold reduces, which drive international gold prices upward. This investment theme includes gold mining equities and gold-related Exchange-traded funds (ETFs).

Trend of Hang Seng Index and US Federal Funds Rate over the past 30 years



Source: Bloomberg, data as of 27 December 2023

Trend of Hang Seng High Dividend Yield Index and US 10Y Treasury yield over the past 3 years

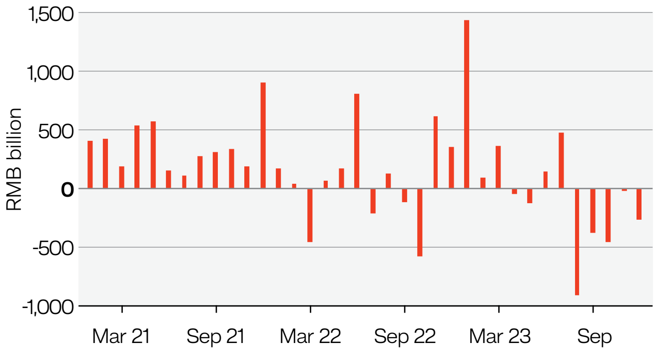
Source: Bloomberg, data as of 27 December 2023

Equity

Cash flows outlook: A Steady Advance

As mentioned in the "Nip and tuck " section of the fourth quarter of 2023, the possibility for a turnaround in the Hong Kong stock market and A-share markets largely depends on foreign investors' risk appetite for Chinese equities. According to the northbound capital flow data from the "Shanghai-Shenzhen-Hong Kong Stock Connect," following the huge net outflows in the third quarter of 2023, the situation of the fourth quarter in 2023 remained unchanged, with a net outflow of RMB 44.8 billion, RMB 1.8 billion and RMB 25.9 billion in October, November and December (as of December 27th) respectively. Upon closer examination, the foreign divestment from A-shares and Chinese Hong Kong equities in recent months is attributed to several factors, including a spike in US bond yields, heightened expectations of RMB depreciation, persistent concerns over China's debt issues and the extension of US unilateral investment restrictions targeting China. As we look to 2024, these core factors influencing foreign capital flows are anticipated to change to varying extents. Notably, the pressure of high external interest rates and the RMB's depreciation are expected to be the first to ease. With the central government proactively rolling out debt resolution schemes for the property sector and local financing platforms, challenges remain, yet the mere avoidance of systemic "blow-ups" should suffice to stabilise global investor confidence. The implications of the US-China game on capital flows requires cautious consideration, especially as we approach the US presidential elections in November 2024. It is expected that both Republicans and Democrats will further leverage the 'China threat' narrative to secure a competitive edge in their campaigns. Under these circumstances, it may be overly optimistic to anticipate any loosening of US restrictions on investments in Chinese firms or on the supply of high-tech products. Hence, in the short term, the vigilance of US funds towards Chinese equities is unlikely to dissipate. In sum, while the selling pressure on northbound funds is projected to gradually abate in the coming months, potentially leading to instances of net inflows, the scale and sustainability of foreign capital inflows are still subject to major uncertainties.

Monthly net turnover of the Stock Connect Northbound Trading over the past 3 years



Source: Bloomberg, data as of 27 December 2023

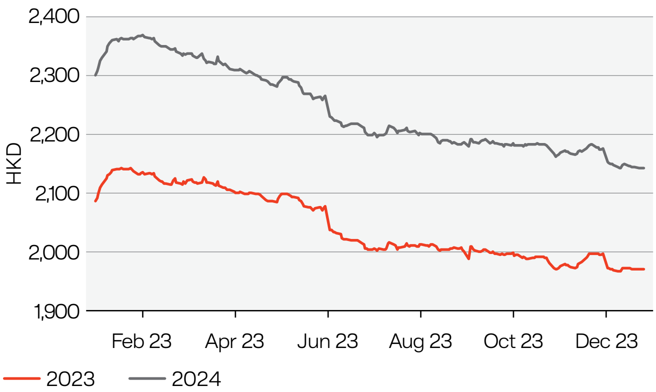
With Western capital cooling off on Chinese equities, the significance of domestic funds has grown increasingly prominent. Following the meeting of the Political Bureau of the Central Committee of the Communist Party of China in July 2023, the Central Financial Work Conference, convened in late October, reiterated the imperative of vitalizing the capital market. In recent months, policymakers have implemented a number of measures to boost market liquidity, reducing the stamp duty on stock transactions by 50%, regulating corporate refinancing and controlling shareholders' shareholding reduction. In addition, no effort has been spared in enhancing capital supply, including the announcement by the Central Huijin Investment to increase its holdings of A-shares of four major state-owned banks and related state-owned enterprise ETFs, the announcement by China Reform Holdings Corporation Ltd. to buy technology innovation and central enterprises-related ETFs, as well as the revision of investment restrictions on the National Social Security Fund (NSSF), which guides an increase in its stock and equity fund allocations. The purpose of the above measures is clear, such measures aim to increase the medium-to long-term capital allocation to equity assets. After all, the proportion of domestic medium- and long-term funds in equity holdings is currently less than 6%, which is far below the level of more than 20%

standard in mature overseas markets, implying considerable room to increase equity holdings. We anticipate the central government authorities to roll out further stimulative "policy combination" in 2024, such as adjusting the accounting treatment of equity investments by insurance funds, enhanced tax incentives to broaden the scope of commercial pensions, the introduction of a broader array of central enterprise-related ETF products, and the easing of share buyback conditions for listed companies. While long-term conservative funds typically adopt a strategy of phased accumulation at low prices, providing a foundational support for stock markets, they are not the primary force shifting a bear market to a bull market. Furthermore, the investment preference of long-term funds often prioritizes state-owned enterprises, rendering sectors such as banking, telecommunications, power, and energy to be more defensive relatively.

Hong Kong equities poised for a valuation recovery, with Hang Seng Index target set at 19,500 points

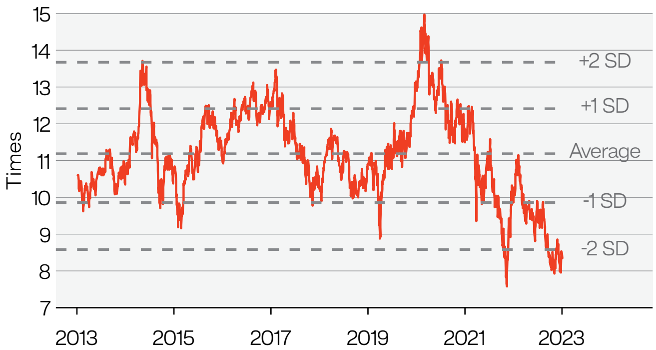
Despite China's economy grappling with short-term challenges such as deflationary pressures, regional deleveraging and sluggish property sales, the possibility of central policymakers introducing more aggressive economic stimulus and more comprehensive debt alleviation measures during the "Two Sessions" should not be overlooked. Additionally, the earnings release peak in March will be another test, with sectors like Chinese financials, consumer discretionary, raw materials and property expected to face significant downward revisions in earnings forecasts. Fortunately, we believe these sectors are approaching the end of their downward earnings revision phase. On the whole, we anticipate a 10% year-on-year increase in the Hang Seng Index's earnings per share, reaching HK$2,170 in 2024 (the current Bloomberg Consensus is approximately HK$2,140). Valuation-wise, the Hang Seng Index is currently trading at a forward price-to-earnings (P/E) ratio of around 7.7 times, marking two standard deviations below the 10-year average. With US long-term treasury yields exhibiting a downward trajectory, a catalyst for the revaluation of Hong Kong equities appears imminent. We have set a 2024 forward P/E target multiple of 9.0 times for the Hang Seng Index, with a 12-month target level of 19,500 points.

Trend of Hang Seng Index Earnings Forecasts



Source: Bloomberg, data as of 27 December 2023

Forecast P/E Ratio of Hang Seng Index



Source: Bloomberg, data as of 27 December 2023

Equity

Key Sectors to Watch in 1st Quarter 2024

Sectors/Thematic sectors	Key investment rationale	Bullishness#
Technology (Supply chain of new energy vehicles and smartphones)	1. Many leading automobile companies have successfully launched the highway-navigated autonomous driving (NOA) function and are expediting the research and development of more advanced (without high-precision map) urban-navigated autonomous driving capabilities. It is anticipated that the shipment volumes of high-end intelligent driving new energy vehicles will surge in 2024, benefiting suppliers of smart cockpits, vehicle-mounted sensing cameras and intelligent electronic control systems. 2. National smartphone shipments have seen a marked improvement since September 2023. The market share of high-end products from leading domestic brands has soared, now equipped with self-developed operating systems. It is expected that, with policy support, the momentum for domestic substitution in the smartphone market will gather pace in 2024, offering potential advantages for suppliers of relevant chips, components and software. 3. Benefiting from the growing popularity of Generative Artificial Intelligence (AI), it is expected that more new smartphones and computers new models will incorporate features related to large AI models, potentially sparking a new wave of device upgrades and replacement.	****
Chinese Telecommunication	1. Propelled by an acceleration of China's digital transformation and the broadening scope of AI big model training and applications, revenues from emerging business segments like cloud computing and data centers in the telecommunication sector have climbed to 21% in 2023, and are projected to continue their rapid growth into 2024. 2. The Ministry of Industry and Information Technology (MIIT) has indicated that 2024 will focus on deepening 5G applications, advancing 6G – pre research, and expediting the development of intelligent computing infrastructure, marking it as one of the key industries receiving policy support. 3. Benefiting from the peaked 5G capital expenditure and strong operating cash flow, the leading telecommunication operators have significantly increased their dividend payout ratios over the past 3 years, with current forecast dividend yields as high as 7.4-8.0%, positioning them a resilient option in volatile market conditions.	****
Local high-dividend equities (Utilities, telecommunications, transportation, conglomerates, REITs)	1. The Federal Reserve's latest interest rate meeting signals a potential for three interest rate cuts in 2024. The intermediate-term downtrend in the US 10-year Treasury yield is solidifying, rendering the dividend yields of certain local utilities, telecommunication and conglomerates equities – ranging from 5.2% to 7% – increasingly attractive. 2. A number of Hong Kong corporations have a high proportion of Hong Kong dollar or US dollar debts. As US Treasury yields fall and Hong Kong Interbank Offered Rate (HIBOR) is anticipated to gradually decrease post-year-end, corporate refinancing costs are expected to be lower in 2024. 3. Hong Kong companies generally have more robust balance sheets and stronger cash flows compared to their Chinese peers, aiding in upholding high dividend payout ratios, increasing share buybacks or providing potential overseas M&A opportunities.	****
Macau Gaming	1. Several US-owned gaming companies have high debt ratios, with a considerable portion of their debt denominated in US dollars or Hong Kong dollars. With US interest rates trending downward, there is possibility for further reduction in refinancing costs, which may enable these companies to resume dividend payments sooner than anticipated. 2. In recent months, the industry's mass market gaming revenue has returned to the pre-epidemic level. Coupled with the strengthening Renminbi and the drop in hotel room rates, it is expected that the strong growth in China's visitor arrivals to Macau during the Lunar New Year will lead to a growth in gaming revenue. 3. For 2024, the Macau gaming sector's projected EV/EBITDA average stands at just 9 times, which is over one standard deviation below the historical average. Should earnings reports surpass expectations, there appears to be considerable room for valuation uplift.	***

The degree of bullishness is denoted by the number of asterisks, with 5 being the highest level of bullishness and 1* being the lowest. The rankings of 5/4/3/2/1 asterisks represent views of very bullish/bullish/cautiously optimistic/neutral/bearish, respectively.

Chapter Summary:

- As the US enters an interest rate-cutting cycle, high-yield value equities, equities with substantial amount and proportions of US dollar and Hong Kong dollar-denominated debts, and gold-related equities are expected to benefit from interest rate cuts
- With cooling interest from U.S. and European funds in Chinese equities, Chinese capital becomes more important. The conservative, long-term investment approach of Chinese official funds contributes to market resilience, but it is not the main catalyst to turn the stock market from a bear to a bull
- Declining US Treasury yields may prompt a revaluation of Hong Kong equities, with the Hang Seng Index's 12-month forward target price set at 19,500 points
- For the first quarter of 2024, investors may want to focus on sectors such as the supply chains for new energy vehicles and smartphones, Macau gaming, Chinese telecommunications and high-dividend equities including those Hong Kong's utilities, telecommunications, transportation and conglomerate sectors, and REITs

BEA Union Investment – Investment Teams

Outlook on Chinese Mainland and Asian equities – bullish on South Korean and Taiwanese technology sectors, with focus on Chinese Mainland's economy and Japan's monetary policy

Despite ongoing volatility, capital markets are poised for improvement and new investment opportunities in 2024

US fiscal spending and personal savings are on a downward trend, coupled with the US service sector's Purchasing Managers' Index (PMI) hovering near 50, a noticeable decline from the previous norm of 55. Should these trends persist without a reversal, the BEA Union Investment does not rule out the possibility of the US economy experiencing a less than smooth soft landing, contrary to market expectations. Currently, the market is anticipating an earlier conclusion to the Federal Reserve's interest rate-hiking cycle, with potential interest rate cuts of a larger extent than previously projected. We maintain the view that the Federal Reserve is likely to consider stimulating the economy through interest rate cuts only by mid-2024. With the cessation of the high-interest-rate environment, a resultant dip in bank time deposits is anticipated. We predict that an interest rate cut will lead to weakening US dollar, thereby boosting non-US dollar-denominated assets, including Asian equities, particularly Indonesia and India markets which benefit from structural growth, and the South Korean and Taiwanese technology sectors are poised for a cyclical uplift. Investors are also advised to monitor the markets closely in China and Japan. Our focus sharpens on Japan's exit from inflation and its potential shifts in its monetary policy, in addition to the recovery pace of China's economy and property market, as well as the likelihood of further market-supportive measures.

Cyclical recovery of electronic goods is favourable to semiconductor equities in South Korea and Taiwan

Amidst expectations for a cyclical recovery in demand for smartphones and personal computers, our investment team is bullish on South Korean and Taiwanese equities, particularly in the semiconductor sector. The economic slowdown in 2023 has tempered consumer sentiment, leading to an overhang of unsold inventories among suppliers. Nevertheless, recent corporate earnings reports suggest signs of improvement. The investment team anticipates the industry cycle to have bottomed out and is expected to rebound, with the consumer electronics replacement cycle about to begin and the launch of Windows 11 driving the upgrades of both personal and corporate computer equipment replacement. We are particularly positive on semiconductor manufacturers or upstream businesses specializing in semiconductor equipment – sectors recognised for structural growth and strategic investment value.

India and Indonesia's economic tailwinds bolster investor sentiment, potential rating upgrades for Japanese enterprises

In the quarter ended September 2023, India's economic growth exceeded market expectations, posting a robust 7.6% year-over-year increase, fuelled predominantly by a vigorous manufacturing sector and a rebound in consumer spending. As the government stepped up investment ahead of the 2024 elections, India's major indices, the Sensex and Nifty 50, consistently set new records. Indonesia's economic fundamentals remain solid with a commendable growth of 4.94% in the third quarter to September 2023, despite emerging signs of slowdown as influenced mainly by declining commodity prices and export slowdowns. Market sentiment is buoyed by expectations of increased welfare spending and an uptick in government expenditure as the 2024 general elections approach – factors likely to invigorate the local economy and boost the investment climate.

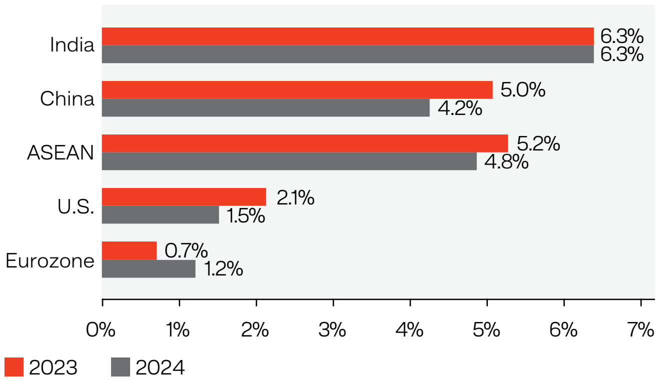
Equity

By the end of November 2023, the Nikkei 225 Index had surged by over 25%. Our investment team expect the Japan's capital markets will remain in the spotlight. Japan's pay rises have continued, with inflation reaching 3.3% in October, surpassing the Bank of Japan's target. This indicates that Japan may finally be poised to exit the shadows of persistent deflation. Consequently, we anticipate that Japan will be in a position to adjust its yield curve control in 2024, initiating a gradual exit from its ultra-loose monetary policy. While the yen and Japanese equities might face volatility as a result, the upside of moderate inflation is anticipated to help improve corporate performance and gross margins. Moreover, Japan has rolled out corporate governance reforms at the beginning of 2023, compelling companies trading below book value to demonstrate strategies for enhancing capital efficiency and improving return on equity (ROE). Currently, about half of Japanese companies are priced below their book value, successful implementation of these reforms could lead to a potential upgrade in ratings of Japanese enterprises, creating a favourable investment environment.

China's value stocks present attractive valuations

We expect China's market will continue to be of interest to investors. Our team believes in 2024, China's economy will need to be catalysed by robust measures, while maintaining the balance between the economy, livelihoods and politics. The possibility of indiscriminate fiscal stimulus is deemed unlikely. We believe that China's economy and property sector are navigating through a period of structural transition, a process that is gradual and protracted, necessitating patience from investors. For now, our team highlights the Chinese value stocks to be included in the watch-list. For example, the valuation of some state-owned enterprises (SOEs) has been adjusted to a very attractive price-to-earnings (P/E) ratio after the market correction in 2023, such as the oil, banking and telecommunication sectors trading at single-digit P/E ratios.

Real gross domestic product (GDP) growth forecasts for major global economies



Source: International Monetary Fund, World Economic Outlook, as of October 2023

After the tumultuous year of 2023, we have witnessed improvements in key macroeconomic factors, with inflation seemingly reined in. Looking ahead to mid-2024, we foresee a potential fall in interest rates, setting the stage for a rebound in risk assets. Despite the anticipation of ongoing volatility, the capital markets are poised for improvement and are likely to present a broader spectrum of investment opportunities that should command investor attention.

Chapter Summary:

- With the cyclical recovery in smartphones and personal computers, we are bullish on semiconductor manufacturers or semiconductor equipment producers in South Korea and Taiwan
- Robust economic fundamentals in India and Indonesia foster conducive local investment environment
- Approximately half of the Japanese enterprises are currently trading below their book value. If initiatives to enhance capital efficiency and equity returns gain traction, they may enjoy rating upgrades
- Attractive valuations for Chinese value stocks, particularly within state-owned enterprises in the oil, banking and telecommunications sectors

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