Macroeconomics

Steady Progression

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Economic Outlook for the Second Quarter of 2024

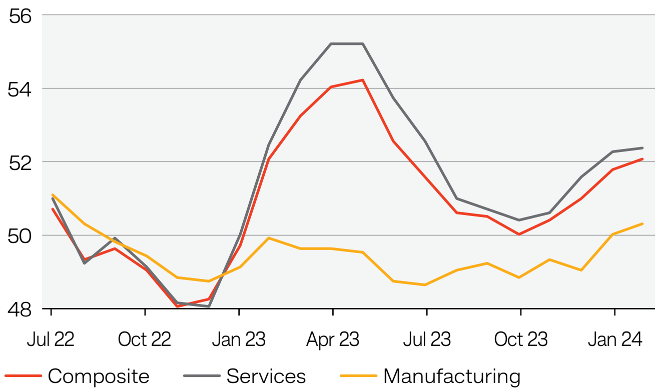
Advanced and Emerging Economies to Exhibit Dual-Track Recovery Trend This Year

Global Economic Outlook

Global Economy Shows Resilience, Inflation Trending Downward

Global economic growth momentum is gradually balancing. In the first quarter of this year, all sectors of the global economy exhibited positive developments. Firstly, the Global Manufacturing PMI indicated a rebound in industrial activity, ending a 16-month contraction trend. This reflects a gradual recovery and stabilisation of global demand following a destocking phase. Additionally, the booming development of AI has driven the production, exports and investments of AI-related supply chains. Secondly, the global services PMI showed sustained rapid growth in service sector activities, primarily driven by further expansion in tourism industry. Of particular note is the acceleration in outbound travel by Chinese Mainland tourists, as well as the steady private consumption in advanced economies, which provide essential support for service sector growth. Thirdly, financial conditions have slightly eased due to expectations for the peak of interest rate-hiking cycle, alleviating the constraints posed by high interest rates on consumption and investment.

Global PMI



Source : Bloomberg, data as of 22 March 2024
>50 Represents expansion

Inflation is generally maintaining a downward trend. As major economies have implemented tightening monetary policies, the balance between market supply and demand is gradually restored. Corporations, too, exhibit cautious pricing strategies, contributing to an overall cooling of inflationary pressures worldwide. In the early months of this year, US inflation exhibited minor fluctuations. However, inflation expectations remain anchored. Moreover, the slowdown in housing inflation, including property prices and rents, from high levels in 2023 is expected to gradually lead to an alleviation in overall inflationary pressures. Europe's elevated inflation concerns are gradually easing, attributable to factors such as stable energy supply and subdued economic growth. Across Asia, inflation remains generally moderate. Currently, the global economy has been at the pivotal juncture in the battle against inflation. The path ahead is uncertain, particularly for inflation in Europe and the US which may hover above their respective central bank's policy targets. Geopolitical tensions continue to pose inflation risks. For instance, the ongoing Red Sea incident has significantly escalated international shipping costs.

Central banks across the world are poised to recalibrate their monetary policies. Since 2022, the current global monetary tightening cycle has lasted for approximately two years and witnessed the most aggressive pace of interest rate hikes in decades. Notably, as inflation progressively recedes, the imperative for prolonged tight monetary policies has waned, as most major central banks now find their interest rates significantly surpassing inflation levels. Our outlook anticipates that major central banks in the US and Europe will embark on interest rate cuts around the midpoint of this year, with a cautious and orderly approach. This will also create room for interest rate cuts by Asian central banks. As the BOJ is in the transition from an era of ultra-loose monetary policy towards normalization, it is expected to proceed with a slow pace of monetary tightening. This diverges markedly from the easing stance adopted by other major central banks.

Underpinned by a resurgence in external trade, heightened service sector activities and a strong labor market, the global economy is poised for a more balanced recovery. Furthermore, with the majority of major central banks expected to initiate interest rate cuts around the middle of this year, the global tight monetary environment is likely to be eased, fostering renewed confidence among consumers and investors. Overall, we anticipate a dual-track recovery for advanced and emerging economies this year, with the US economic growth slightly moderating to around 2%. Overcoming stagnation, Europe is poised for a return to low growth. Chinese Mainland and Hong Kong, as well as other Asian economies are expected to maintain steady growth.

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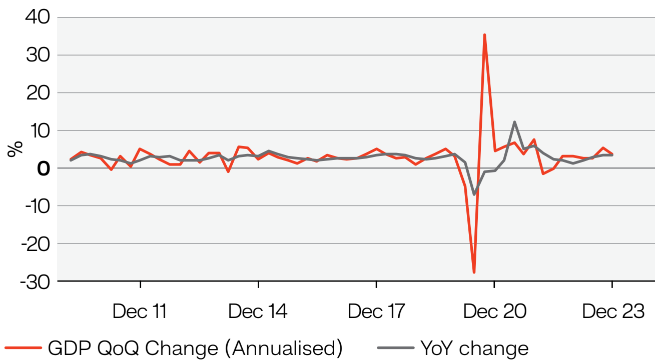
US Economic Outlook

Fed Maintains Median Forecast of 3 Rate Cuts, Core Inflation Remains Sticky

The US economy demonstrated sound performance in 2023, with expectations of a mild slowdown this year. Compared to 2022, the US economy saw accelerated growth in 2023, culminating in approximately 3% growth in the fourth quarter on a quarterly basis. This underscores the US economy's ability to withstand rapid monetary tightening, supported by resilient labor market conditions which in turn drive consumption and household spending, along with the positive contributions from sustained investments and government spending. While monthly data may exhibit fluctuations, key leading economic indicators, such as the University of Michigan Consumer Sentiment Index, the Institute for Supply Management, and the S&P Global Purchasing Managers' Index, consistently indicate steady growth in general. However, the persistent high-interest rate environment is likely to temper US economic performance, particularly impacting business investment. Additionally, private consumption may be influenced by cooling labor market dynamics and the normalisation of previously accommodative fiscal policies. In summary, we anticipate a measured deceleration in US economic growth this year.

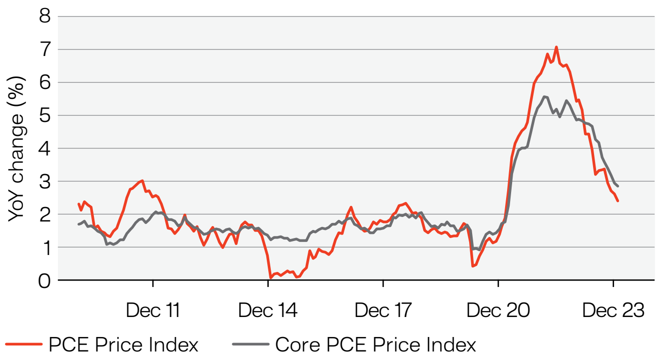
US GDP Growth Rate



Source: Bloomberg, data as of 22 March 2024

The last mile of inflation retreating to the policy target remains a challenge. US inflation has been on a downward trend since peaking in the first half of 2022, which subsequently experienced a faster decline in the second half of 2023, fueled by high base effects, supply chain normalisation and demand resurgence. However, recent months have seen a deceleration in the pace of inflation decline, particularly affecting inflation (particularly core inflation), measured by the Personal Consumption Expenditures (PCE) price index and its core index. Such inflation has retreated from 2022's elevated levels of 7.1% and 5.6% to 2.6% and 2.8% by the end of 2023, respectively. Yet, the pace of decline in both indicators has markedly eased in the initial two months of this year. Among the components of inflation, core service prices (excluding rents) remain sticky, which may relate to the resilience in the labour market. Despite a drop in various employment indicators from post-pandemic highs, low unemployment rates, steady additions of non-farm payrolls, and average hourly wages remaining elevated above levels consistent with the inflation target may continue to exert pressure on inflation, especially core inflation, to return to the policy target.

US PCE Price Index



Source: Bloomberg, data as of 22 March 2024

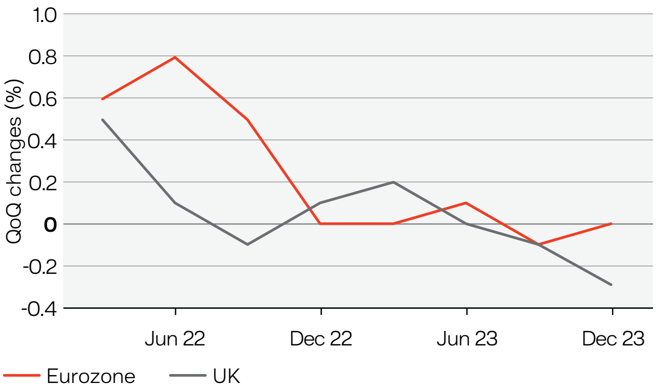
The Federal Reserve has once again maintained its interest rates unchanged, with the dot plot reaffirming a median projection of three interest rate cuts for this year. During its March meeting, the Federal Open Market Committee (FOMC) opted to keep interest rates unchanged. Its dot plot reflected upward adjustment of median forecasts for economic growth and the core PCE price index from this year through 2026. Notably, the FOMC retained its projection of three interest rate cuts totaling 75 basis points for this year, while revising down the median forecast for 2025 from four to three interest rate cuts. Currently, the Fed emphasises the need for greater confidence that inflation will persistently recede toward the 2% target before considering rate reductions. Chairman Jerome Powell has indicated that this confidence is within reach, despite the higher-than-expected inflation in January and February, which are fluctuations during the process. These variations are unlikely to significantly impact the Fed's assessment of inflation and interest rate trends. Our outlook anticipates that the US will commence interest rate cuts around mid-year, with subsequent reductions likely at a pace of 25 basis points per quarter. Additionally, Chairman Powell has signaled an imminent slowdown in balance sheet tapering to mitigate potential pressures on the currency market arising from liquidity constraints.

European Economic Outlook

European Economy Shows Slight Improvement from Last Autumn-Winter's Gloomy Prospects

The European economy continues to stagnate. Hindered by persistently high interest rates, weakened fiscal stimulus efforts and escalating geopolitical tensions, the Eurozone's economic momentum remained subdued in the latter half of 2023. Following a contraction of 0.1% quarter-on-quarter in real GDP in the third quarter of last year, performance remained flat in the fourth quarter. Although the Eurozone economy saw marginal growth of 0.4% for the full year of 2023, performance across major member states varied. Germany's economy contracted by 0.1% for the year, weighed down by weakness in manufacturing sector, while France and Italy saw moderate growth of 0.9% and 1.0% respectively. Spain, benefiting from robust performance in service industries such as tourism, recorded a growth of 2.5% for the year. Conversely, the UK witnessed deteriorating net exports in the fourth quarter of 2023, coupled with lackluster household and government spending, resulting in two consecutive quarters of contraction and technical recession in the latter half of 2023, with only marginal economic growth of 0.1% for the full year of 2023. However, in early 2024, indicators have shown a simultaneous rebound in the Eurozone and UK composite purchasing managers' indices (PMIs), indicating that the economies in these regions are gradually recovering from the sluggish levels experienced in the last autumn. Furthermore, Southern European economies such as Spain and Italy, which heavily rely on the service sector, have demonstrated resilience in their performance.

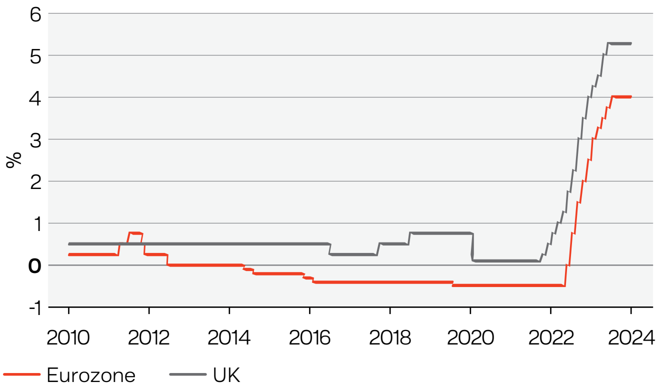
Economic Growth in Eurozone and UK



Source : Bloomberg, data as of 22 March 2024

European inflation is expected to gradually ease back towards policy targets as central banks maintain cautious monetary policy stances. Inflation in the Eurozone and the UK continues to slowdown, primarily driven by sustained declines in energy prices and subdued commodity prices. Amid a tight labour market and rapid wage growth, along with persistent service inflation pressure, it is evident that both Eurozone and the UK are facing challenges in achieving the 2% inflation policy target. The European Central Bank (ECB) and the Bank of England (BoE), having kept interest rates unchanged since October 2023, acknowledge an easing in inflationary pressures. However, they emphasise the need for further evidence regarding labor market conditions, wage growth and service sector prices before committing to a sustained return to their policy objectives. We expect the ECB will have room for policy rate reduction by mid-2024. Given the relatively high inflation level in the UK, the BOE may delay interest rate cuts.

Policy Rates of Eurozone and the UK



Source : Bloomberg, data as of 22 March 2024

Looking ahead, the slight improvement in the European economy from the sluggishness experienced in the autumn and winter of the previous year could potentially support the region in combating the stagnation and achieving mild growth. Decreasing inflation and rapid wage growth should improve household real incomes, thereby bolstering consumption. Moreover, with heightened expectations of interest rate cuts and shift in the monetary environment from tight to neutral, business investment sentiment is expected to receive a boost. However, the tense geopolitical situation may impact the stability of global supply chains and hinder the progress of trade recovery.

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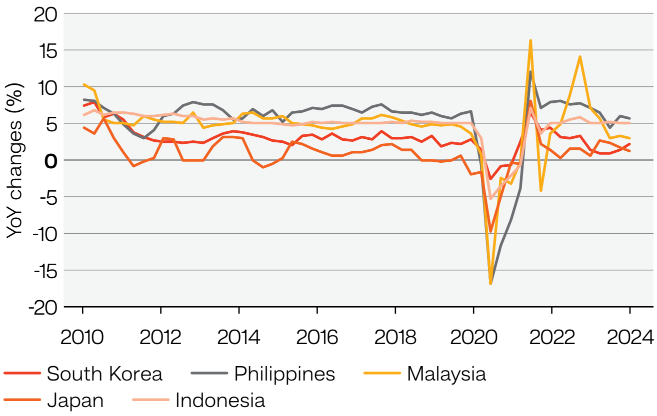
Asian Economic Outlook

Rebounding Exports Solidify the Recovery Momentum of Asian Economies

Amid persistently high interest rates, diminishing global commodity demand in 2023 and ongoing adjustments in the electronics cycle, several export-oriented Asian economies faced pressure. Among the generally sluggish Asian economies in 2023, Japan's economy bucked the trend with acceleration due to a weakening currency, declining commodity prices, and stimulus from automotive exports. Since the fourth quarter of 2023, global trade activity has shown signs of stabilisation, particularly with the dramatic recovery in the semiconductor industry driven by the surge in demand for artificial intelligence, along with increased regional tourism. This gentle upward trajectory of exports now plays a pivotal role in Asia's stable economic growth.

GDP of Selected Asian Eonomies



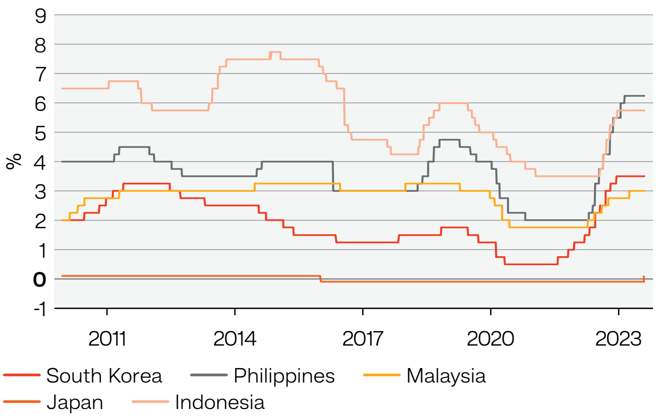
Source : Bloomberg, data as of 22 March 2024

In the first quarter of this year, Asian exports continued to rebound. Most economies within the region recorded year-on-year increases in merchandise exports, reflecting sustained external demand improvement. Additionally, visa-free policies and the resumed international flights have fueled rapid outbound tourism demand from China, injecting new momentum into the Asian economic recovery, particularly in many Asian cities popular among Chinese tourists. The Asian labour market remains resilient, with relatively low unemployment rates. Overall, we anticipate steady growth in the Asian economies.

Asian inflation continues its steady easing, inching closer to target levels. Drawing strength from the low base effect of commodities and falling food prices, inflationary pressures in the region further improved in the first quarter of 2024, with consumer price inflation in most Asian economies easing to around 2-3%, aligning closely with central banks' inflation targets. Notably, Asia has avoided the economic overheating witnessed in Western markets. Combined with generally stable exchange rates, the region's underlying inflationary pressures remain relatively flat. Overall, we anticipate that inflation in Asia will remain controlled, falling within the target ranges set by various Asian central banks.

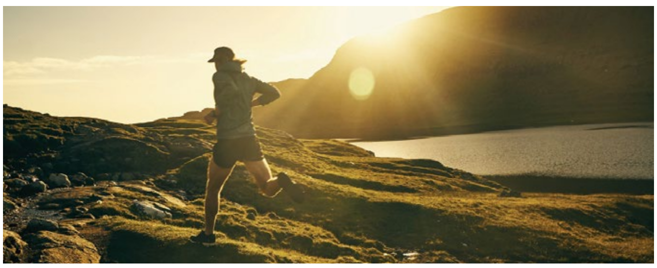
With the exception of the Bank of Japan (BOJ), other Asian central banks are poised to loosen their monetary policies. Despite a significant retreat in inflation during the first quarter of 2024, most Asian central banks have maintained interest rates unchanged. This cautious approach primarily stems from the fact that major central banks, such as the Federal Reserve and the ECB, have yet to embark on easing measures. The foreign exchange market, in particular, remains susceptible to substantial volatility due to potential shifts in monetary policy. As we approach the second half of 2024, both the Federal Reserve and the ECB are likely to initiate a rate-cutting cycle. Consequently, most Asian central banks will have room to follow suit and ease their monetary policies. On the other hand, the BOJ announced the end of its interest rate policy in March this year, raising the benchmark interest rate to a range of 0 to 0.1%, and ending its yield curve control & purchasing of exchange-traded funds and real estate trust funds at the same time. Despite the BoJ's exit of its negative interest rate policy, any further tightening measures in the future are expected to be implemented with caution and order. The overall financial conditions in Japan are anticipated to remain accommodative.

Policy Rates of Selected Asian Economies



Source: Bloomberg, data as of 22 March 2024

As exports rebound and internal demand solidifies, coupled with anticipated interest rate cuts by the Federal Reserve and the ECB in mid-2024, cross-border investment activities are expected to be stimulated. Asia's economic trajectory remains positive. The region is poised to maintain steady growth, with internal economic momentum gradually strengthening and accelerating in the latter half of the year. Overall, we expect Asia's economic growth rate in 2024 to surpass that of 2023.

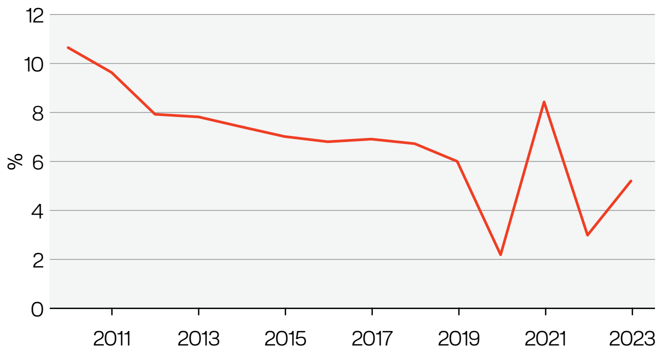


Chinese Mainland Economic Outlook

Chinese Mainland Economic Outlook: Steady Start in 2024

The Chinese Mainland economy showed steady recovery in 2023. With the orderly resumption of economic and social activities post-pandemic, Chinese Mainland's real GDP grew by 5.2% in 2023, surpassing the government's target of around 5%. Final consumer spending emerged as the primary catalyst for economic expansion during the year, followed by gross capital formation, offsetting the drag from net exports.

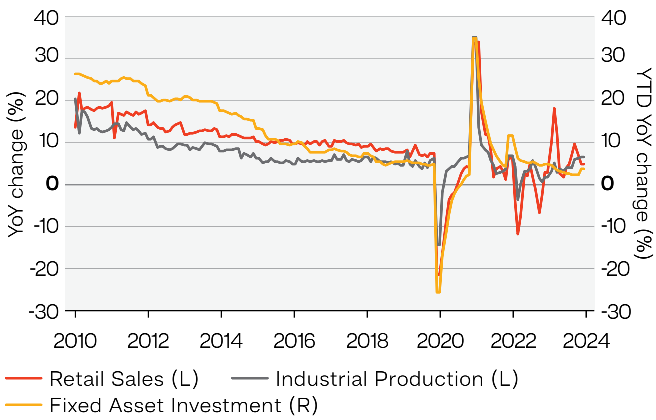
Chinese Mainland's Annual Economic Growth



Source: Bloomberg, data as of 22 March 2024

The economy has started the year on a steady note, continuing its upward trajectory. Building upon the orderly resumption of economic activities and increased macroeconomic policy support from Chinese Mainland authorities, key economic indicators for the first two months of this year have generally outperformed expectations. Benefiting from the festive atmosphere during the Chinese New Year holiday, sectors such as dining, accommodation and transportation recorded significant growth. Service sector's retail sales for January and February surged by 12.3% year-on-year. Retail sales remained vigorious, with total retail sales of consumer goods growing by 5.5% year-on-year in the first two months of the year. Industrial production continued its upward trend, registering a 7.0% year-on-year growth in the same period, higher than the 6.8% growth in December 2023. This was mainly supported by improved exports from high-tech manufacturing sectors (such as electronics and communication equipment manufacturing), consumer-related manufacturing sectors and industrial sectors. Furthermore, there are signs of improvement in fixed asset investment, with the year-on-year growth rate accelerating from 3.0% for the full year 2023 to 4.2% in the first two months of this year. Private investment reversed its downward trend, recording a 0.4% year-on-year increase in the first two months. In terms of sector, investment growth in manufacturing and infrastructure sectors reached 9.4% and 6.3%, respectively, offsetting the weakness in real estate investment. It is worth noting that the data mentioned above does not reflect the impact of the "Action Plan to Promote Large-scale Equipment Renewals and Trade-ins of Consumer Goods (《推動大規模設備更新和消費品以舊換新行動方案》)", which was released by the State Council in mid-March this year. This plan is expected to drive consumption and investment demand for upgraded goods (such as automobiles and smart appliances) and advanced equipment.

Chinese Mainland's Retail Sales, Industrial Production & Fixed Asset Investment



Source: Bloomberg, data as of 22 March 2024

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Real estate market remains in a phase of consolidation at a low level. In the first two months of this year, sales of commercial residential properties, new housing construction areas and funds in place for real estate developers decreased year-on-year by 32.7%, 29.7% and 24.1% respectively, reflecting market's overall state of consolidation at lower levels. However, there are slight signs of stabilisation in certain indicators. For instance, in first-tier cities, the monthly decline in second-hand property prices has narrowed, and retail sales related to housing have shown some improvement. In fact, since 2023, Chinese Mainland authorities have consistently strengthened their support for the real estate market. Their objectives include ensuring timely delivery of property, boosting buyer confidence, providing a stable funding environment for high-quality real estate developers, and enhancing the development of affordable housing, all of which serve as maneuvers to facilitate a stable and healthy development of the real estate industry. Specific measures have been implemented, including lowering the 5-year loan prime rate, reducing various mortgage loan rates, restarting pledged supplementary lending, and establishing a "white list" for real estate projects to provide financing support.

Furthermore, consistent macroeconomic policy direction aims to consolidate and strengthen the positive momentum of economic recovery. The government's work report for this year sets the economic growth target at around 5.0%, taking into consideration the need to promote employment and income growth, prevent and mitigate risks, and aligns with the goals of the "14th Five-Year Plan" and basic modernization objectives. It also takes into account economic growth potential and supporting conditions. The Chinese Mainland authorities will continue to implement proactive fiscal policies and prudent monetary policies, while strengthening policy tool innovation and coordination. In terms of fiscal policy, the budget deficit ratio for 2024 is set at 3%; the target for local governments' special-purpose bonds issuance has been raised by RMB 100 billion to RMB 3.9 trillion. Additionally, another RMB 1 trillion of ultra long-term special government bonds will be issued to support major national strategic development projects. In terms of monetary policy, liquidity will be maintained reasonably ample. The scale of social financing and monetary supply will be in line with the targets for economic growth and price levels, thereby stabilising and lowering the overall financing costs. Efforts will be made to vigorously develop technology finance, green finance, inclusive finance, pension finance and digital finance. Consequently, there is room for further reductions in reserve requirement ratio and policy interest rates this year. Overall, we anticipate that Chinese Mainland's economic dynamics will become more balanced this year, with a focus on fostering new high-quality productivity and promoting high-quality development.

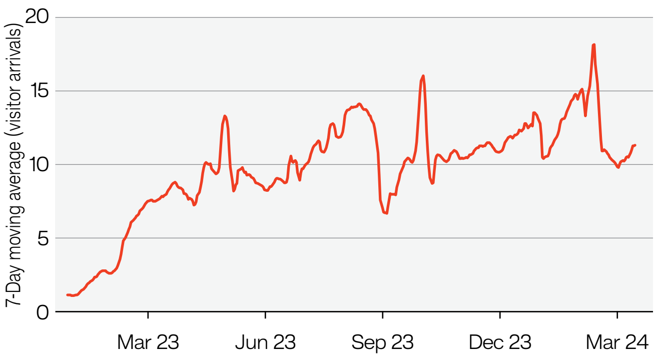
Hong Kong Economic Outlook

Hong Kong Economy Set to Move Toward a More Balanced Recovery

Supported by the resurgence in private consumption and inbound tourism, the Hong Kong economy recorded a vigorous growth of 3.2% in 2023. This year, the recovery is expected to shift toward a more balanced trajectory. As we step into 2024, private consumption and the tourism industry will continue to be the primary drivers of Hong Kong's economic revival. The labor market remains stable, and the Hong Kong Special Administrative Region (SAR) government's initiatives to attract talent and stimulate the economy have proven effective in bolstering private consumption. Furthermore, market expectations indicate that major central banks will begin cutting interest rates around mid-2024. "The 2024-25 Budget" has introduced favourable measures for the recovery of the economy, stock markets and real estate sector. Large-scale infrastructure projects are also set to gain momentum. Moreover, Chinese Mainland's economy continues its upward trend, and external trade performance has shown signs of improvement. All these factors will further contribute to Hong Kong's overall economic resilience and a more balanced recovery. The latest forecasts from the HKSAR government predict an annual economic growth rate ranging from 2.5% to 3.5% in 2024.

Number of Visitors Arrivals of Hong Kong

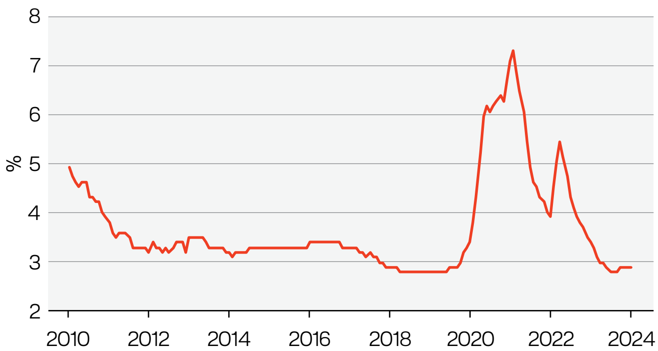
Daily visitor arrivals



Source: Bloomberg, data as of 22 March 2024

Hong Kong's tourism industry is expected to further recover. In January and February 2024, the total number of visitor arrivals of Hong Kong reached approximately 7.8 million, surpassing 70% of the levels seen during the same period in 2018. Starting from March, Individual Visit Scheme will be expanded to cover Xi'an and Qingdao. Additionally, HK SAR government's initiatives to promote mega event economies and diverse tourism activities are poised to further stimulate the recovery of inbound tourism.

Unemployment Rate of Hong Kong



Source: Hong Kong Census and Statistics Department, data as of 22 March 2024

A stable job market supports local consumption. In early 2024, Hong Kong's unemployment rate has consistently remained around 3%, closely aligned with full employment levels, while the underemployment rate stayed at around 1.0%. To meet the long-term talent needs for economic development, the HKSAR government has launched several talent schemes, with significant success. Approximately 90,000 talents arrived in Hong Kong throughout 2023, exceeding the annual target of 35,000. Among them, around 36,000 talents entered Hong Kong through the Top Talent Pass Scheme. The influx of talents from both Chinese Mainland and oversea is expected to generate new demand for local consumption, partially offsetting the recent trend of Hong Kong residents' cross-boundary travel for consumption.

Anticipated declines in interest rates and the implementation of policy measures are expected to promote a more balanced economic development. Currently, it's widely expected in the market that major central banks will begin a gradual easing of interest rates around mid-2024. This adjustment is expected to lead to a peak and subsequent decline in HIBOR, gradually loosening the monetary environment of Hong Kong. This development is likely to contribute to asset market stabilisation, encourage business investment and restore consumer confidence. Furthermore, "The 2024-25 Budget" has introduced various support measures for families and businesses, along with policies related to the finance, innovation and technology, and the development of the Greater Bay Area as well as significant infrastructure projects, which will create substantial business opportunities and employment prospects for Hong Kong's economy.

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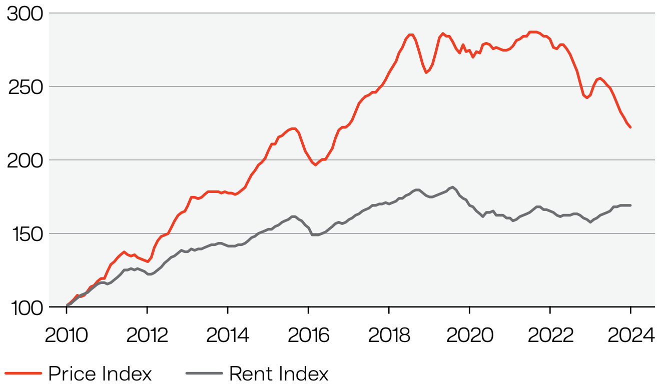
Housing Price & Rent Indices of Hong Kong
Base figure is 100 as of January 2010



Source: Rating and Valuation Department, data as of 22 March 2024

The relaxation of policy measures is expected to facilitate a rebound in residential property transactions. Amidst a rapid tightening of monetary policy, Hong Kong's residential property market experienced two years of orderly consolidation. The residential property price index declined by 15% and 7% in 2022 and 2023, respectively, with a further 1.6% month-on-month decrease recorded in January 2024. This led to a record low in terms of the number of residential property transactions in 2023, prompting some prospective buyers to adopt a wait-and-see approach. "The 2024-25 Budget" has revoked all demand-side management measures for residential properties, followed by adjustments by the Hong Kong Monetary Authority regarding the countercyclical macroprudential measures for property mortgage loans and related regulatory policies. Within weeks after the measures being implemented, there have been clear signs of a significant rally in residential property transactions, which may help to alleviate downward pressure on the property market. With the anticipated onset of interest rate cuts by the Federal Reserve around mid-2024, Hong Kong's residential property prices are expected to gradually stabilise, trending towards stability after an initial decline.

Chapter Summary:

- The momentum of global economic recovery is becoming more balanced. Inflation continues its downward trend. Major central banks are expected to begin adjusting monetary policies around mid-year
- Forecasts indicate a moderate slowdown in US economic growth. Inflation retreating toward policy target remains a challenge. The Fed keeps a median projection of three interest rate cuts this year
- Chinese Mainland's economy has started the year on a steady note. Authorities are reinforcing consistent macroeconomic policy direction, sustaining the positive trajectory of economic recovery
- Hong Kong's economy is poised for a more balanced recovery. Residential property prices are expected to stabilise after an initial decline

Equity

After the Party

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Equity

Chief Investment Strategist, Wealth Management Division, The Bank of East Asia **Frank Lee**

After the Party

Mindset adjustment is important than relying on calculated technical analysis

Last quarter's title was "Paradigm Shift". Various anomalies emerged in global stock markets, with capital predominantly flowing into mature markets, particularly growth sectors related to technology. However, historical data indicates that multiple interest rate hike in mature markets often followed by an economic downturn. The divergence between economic performance and stock market trends remains one of the key investment risks at present, yet it creates a conducive environment for defensive stocks on the other hand. Despite rumors of interest rate cuts, elevated interest rates continue to suppress capital flows, providing space for a rally in high-yield and value stocks. Financial stocks, following the gradual dissipation of last year's concerns surrounding the community banks' liquidity stress in US, are expected to stand out as a contrarian investment. For this quarter's equity strategy, it is advisable to maintain allocation towards strong technology stocks, while further diversifying US stocks allocation. Historically, US stocks outperformed other major stock markets during presidential election years, with defensive and value stocks being standout performers. Historical data aligns with current analysis. Previous forecasts have generally been in line with the present outcomes.

The title of this quarter is "After the Party". Today, the prevailing "Fear of Missing Out (FOMO)" mentality has created a fervent and exuberant atmosphere as global investors delving into three major investment themes: US stocks, Japanese stocks, and technology stocks.

US stocks have registered a record high, with capital flows indicating a continued influx of retail investors, while institutional investors and international funds have already begun shifting their focus to Asian stock markets. Short-term dynamics suggest that the upward momentum of US stocks is waning, fortunately, current valuations remain reasonable. The rotation of sectors outside of the technology sector is the true centerpiece for the US market. Similarly, Japanese stocks also have achieved unprecedented milestones, with various dynamic indicators reflecting their unwavering momentum. However, valuations have significantly deviated from fundamentals, and technical indicators suggest a potential slowdown in the upward trend. Additionally, earnings forecasts for Japanese stocks are mixed, with only a few industries providing real support for the current uptrend. Political and economic factors may pose challenges to Japanese stocks.

Amid the global tech frenzy, disruptive innovations have fortified certain tech stocks with moat of monopolistic advantages. Notably, the artificial intelligence (AI) and semiconductor industries stand unassailable. The prevailing "There is No Alternative" (TINA) mindset compels capital inflows into tech equities worldwide. As history attests, the evolution of innovative industry chains drives profitability for companies within the sector. During tech stocks' repeated peaks, mindset adjustment is increasingly important than relying on the cool precision of technical analysis for investors.

In the grand party of US stocks, Japanese stocks and the tech stocks, emotions run high. However, when the music suddenly halts, revelers who find themselves reluctantly to exit and cling to the fading warmth of the party will be played for a fool. Any sudden disruptions during the party could lead bloodbath in the market. The warning that excessive joy leads to sorrow is always a bitter pill to swallow.

US Stocks Soar to New Heights: Stumbling at the Summit

As of 12 March this year, the S&P 500 index closed at 5,175 points, reaching a new peak since its establishment on 4 March 1957. The market is expecting further highs in the future. Reflecting on the milestones of this index, it took approximately 11 years to surpass the significant 100-point mark. It took nearly 30 years to achieve the breakthrough of the 1,000-point threshold in 1998. Subsequently, the US economy boomed, and multiple rounds of quantitative easing by the central bank propelled the index to climb higher. It took only 17 and 5 years, respectively, to surpass the 2,000-point and 3,000-point milestones. Remarkably, the S&P 500 index became a "beneficiary" of the global pandemic. At that time, central banks worldwide united in significantly increasing liquidity to rescue economies severely impacted by the pandemic. Consequently, capital flooded into US stock market, and it took merely about two years to break through the 4,000-point mark, with each subsequent breakthrough occurring in shorter timeframes. Coinciding with the recent boom of AI, the S&P 500 index crossed the 4,000-point mark in just three years and successfully surpassed the 5,000-point threshold on 9 February this year.

The AI revolution is reshaping the world. Driven by the FOMO mentality, global capital are enticed to pour into US tech stocks, a scene so familiar to the dot-com bubble of the 2000s. However, the lessons from the burst of the dot-com bubble in 2000 remain vivid, causing investors to question when the relentless upward trajectory of tech stocks will reverse.

Historical Data of the S&P 500 Index:

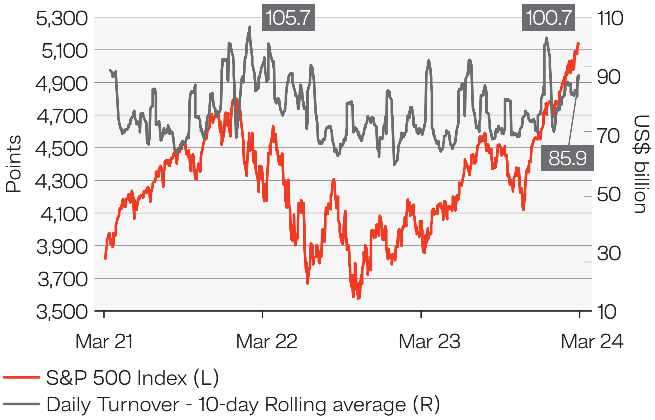
Dates	Points	Years from the last crossing of milestones
4 March 1957	44.1	N.A.
4 June 1968	100.4	11.3
2 February 1998	1,001.3	29.7
26 August 2014	2,000.0	16.6
12 July 2019	3,013.8	4.9
1 April 2021	4,019.9	1.7
9 February 2024	5,026.6	2.9

Source: Bloomberg, data as of 4 March 2024

Capital Flows: Expected Slowdown in US Stocks Momentum

The surge in the S&P 500 Index can be largely attributed to the FOMO mentality among investors, which drives global capital towards US stocks. By referencing the daily trading volume of the S&P 500 Index, the 10-day rolling average for the year stands at approximately $76.6 billion (USD, same below), surpassing the 3-year average of $71.2 billion by approximately 7.6%. As of 4 March this year, the S&P 500 Index has also recorded a year-to-date increase of around 7.6%, aligning with the upward trend in trading volume. Furthermore, on 4 March, the rolling average of trading volume reported $85.9 billion, holding a 17% potential upside compared to the previous peak of $100.7 billion, and 23% away from the 3-year peak of $105.7 billion. This indicates that trading activities continue to create strong momentum to propel the index to new highs.

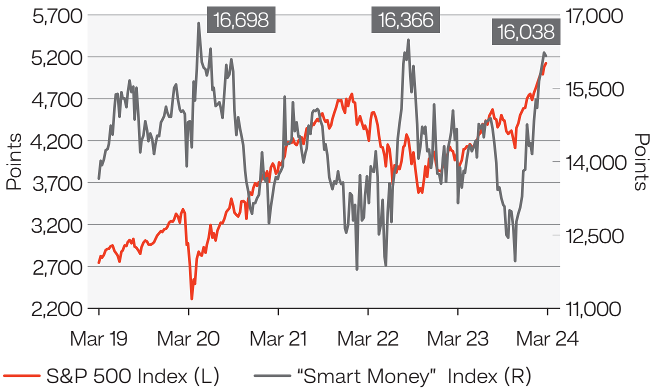
S&P 500 Index and Daily Turnover (10-day rolling average)



Source: Bloomberg, data as of 4 March 2024

Looking at the "Smart Money" Index, which primarily consists of institutional investors, starkly contrasting results have been observed. Over the past three years, the index has moved inversely to the S&P 500, indicating that the "Smart Money" has been accumulating stocks whenever the S&P 500 entered correction territory. Such capital flows acted as a catalyst for the stock market's transition from weakness to strength. When the "Smart Money" became aware of an approaching market peak, it often coincided with individual investors entering the market to sustain the upward momentum. At that point, the "Smart Money" started to lessen trading activities or even exit the market for profit-taking. Typically, when trading activities by individual investors stagnates, the stock market tends to slide. As of 1 March this year, the "Smart Money" index is only approximately 2% away from its last peak and 4% off its three-year peak, reflecting that investors are on their guard as the uptrend in stock market continues but loses steam, with subtly rising risks.

"Smart Money" Index and S&P 500 Index

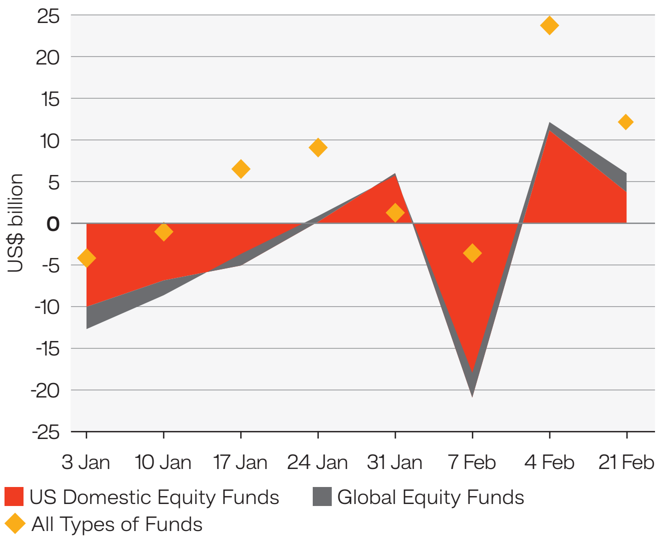


Source: Bloomberg, data as of 3 March 2024

In addition to spot trading data analysis, the capital flow data of long-term mutual funds and exchange-traded funds (ETFs) registered in the US, provided by the Investment Company Institute (ICI), also holds valuable insights. Over the course of the year, the total fund flows of long-term mutual funds and ETFs (including equities, bonds, hybrids and commodities) recorded a net inflow of $54.9 billion (USD, same below). However, equity funds witnessed a total outflow of $18.2 billion, indicating a general sense of caution among fund investors towards equity funds. In particular, US domestic equity funds experienced a significant outflow of $22 billion, whereas global equity funds saw a net inflow of approximately $3.8 billion. This suggests that the fund sector has harbored doubts about the upward momentum of the US stock markets, which aligns with the aforementioned "Smart Money" fund flow analysis. Looking at the data of the first eight weeks of the year, the weekly fund flows of equity funds consistently lagged behind the total fund flows of long-term mutual funds and ETFs, indicating that the weakness in equity fund flows was not solely caused by individual investors' impulsive behavior. US domestic equity funds has consistently recorded capital outflows for almost half of the year, with a notable weekly outflow of $20.9 billion occurring on the week of 7 February, when the market was speculating on a rebound in inflation and the expected interest rate hikes, rather than cut. Consequently, the 10-year US Treasury yield jumped to a yearly high of 4.31%, reflecting the significant impact of interest rate forecasts on the trajectory of US stock markets (further analysis will be provided below).

Equity

ICI's Capital Flow Data of US-registered Funds



Source: Investment Company Institute (ICI), data as of 4 March 2024

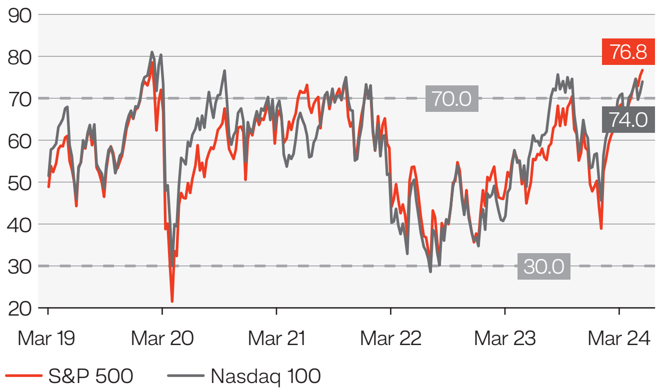
The data released by another research institution presents a very different picture. According to a report by EPFR (Emerging Portfolio Fund Research) in February this year[1], over $65 billion of capital has flooded into international equity funds during the year, surpassing the amount of inflows in the same period last year by more than five times. Among them, China, Japan and India recorded the largest continuous inflows into equity funds.

Summarising the findings from both institutions, it is evident that capital invested in equity funds is shifting towards non-US markets. Most of the long-term and passive investors hold the view that the current uptrend of US stocks is unlikely to be sustained, especially with the possibility of a weakening US economy, prompting a redirection of funds to Asian stock markets, which are perceived to have sustained growth potential or attractive opportunities.

Short-term Dynamics: Deceleration in an Orderly Manner

In addition to analysing investors' current FOMO investment sentiment by studying trading volume and fund flows data, the Relative Strength Index (RSI) provides useful insights into the market dynamics. The RSI serves as a heat indicator for short-term capital inflows or outflows, with values above 70 indicating overbought and values below 30 indicating oversold. As of 4 March this year, out of 261 weeks of data over the past five years, both the S&P 500 and the Nasdaq 100 indices had RSI above 70 for only 22 weeks, accounting for approximately 8.4% of the total. The instances where both indices remained above 70 for more than one consecutive week were concentrated in the periods of December 2019 to January 2020, July to September 2021, and January to March 2024, with durations of 6, 7 and 5 weeks respectively. These data reflect the recent unusually heated market conditions, which are likely to cool off in the short term. The RSI analysis suggests that the upward momentum of both indices may slow down, aligning with the findings of the aforementioned capital flow analysis.

RSI – S&P 500 and Nasdaq 100 Indices

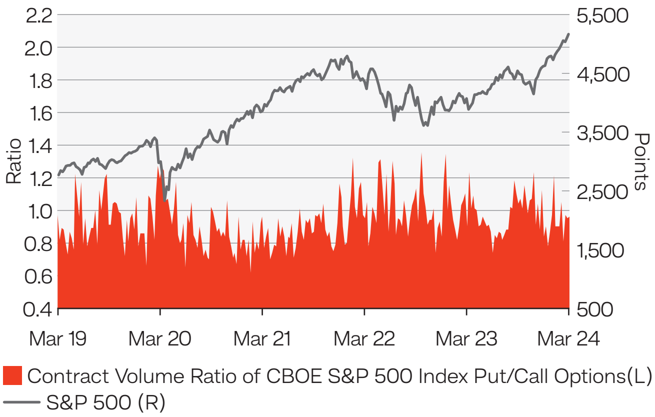


Source: Bloomberg, data as of 4 March 2024

The short-term trend of the indices can also be assessed by the ratio of put options to call options on the S&P 500 index. Taking 1 as a reference level, a ratio above 1 indicates a bearish bias and a greater presence of bearish capital, while a ratio below 1 suggests the opposite. Over the past 5 years as of 1 March this year, the ratio has moved inversely to the S&P 500 Index, meaning that when the ratio rises due to bearishness, the S&P 500 Index is more likely to fall in the next 3 months. When the S&P 500 index hit record highs repeatedly throughout the year, the ratio hovered at the level of 1, with an average value of about 0.96, reflecting that both bullish and bearish funds are still in a struggle, without obvious revelation on the direction of index. This may be related to the mixed results of the inflation-sensitive economic data in the year. Markets are awaiting the Fed's interest rate meetings and updated dot plot forecasts, as the outcome of expected interest rate changes will be crucial for future market direction. Investors should also keep a close eye on the changes in the options ratio in assessing the market's future trajectory.

[1] See EPFR website, https://epfr.com/insights/global-navigator/for-equity-investors-plenty-of-sunlit-uplands-equity-fund-flows-bond-flows-money-market-fund-flows-esg-fund-flows-investor-sentiment-financial-markets-data/

Contract Volume Ratio of CBOE S&P 500 Index Put/Call Options and The S&P 500 Index



Source: Bloomberg, data as of 3 March 2024

The Fear & Greed Index[2], provided by CNN, is a widely referenced indicator in the financial market. The index value, ranging from 0 to 100, is an equal-weighted average of seven stock market indicators. A lower value implies fearful market sentiment, and conversely, a higher value signals a greedy market. Based on the inverse theory, when the market is extremely greedy, investors should consider cashing out and exiting, and vice versa.

As of 5 March this year, the index attained a score of 79, meaning that the market was in "extreme greed" state. The "extreme greed" market state has persisted not only on that day but also in the previous week and month. Investors may start to take profits and exit the market, suggesting an increased risk of a market correction. Looking at the movement of the index over the past year, it has been in a state of "extreme greed" since December last year, and a similar situation occurred between June and July last year.

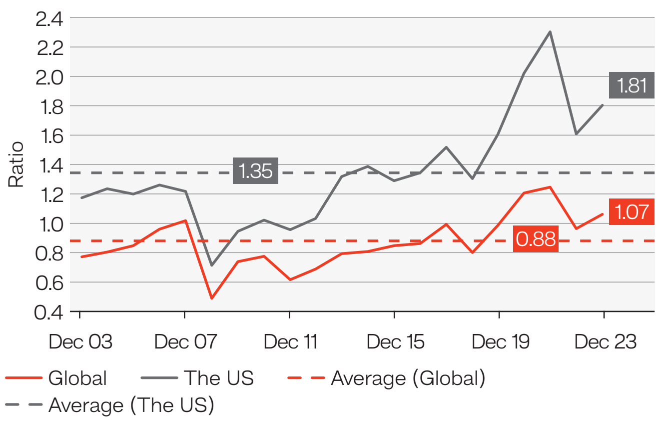
Among the seven different market indicators in the index, five are currently in the "extreme greed" territory, including the S&P 500 Index and its 125-day moving average, the ratio of new 52-week highs to new lows on the NYSE, the 5-day average ratio of put options to call options, the performance gap between US stocks and bonds over the past 20 days, and the credit spreads between high-rating and high-yield bonds. All these indicators reflect the exuberance in the stock market. Given that the McClellan Summation Index, an indicator measuring the levels of overbought and oversold markets, is only "greedy", while the S&P 500 Volatility Index (VIX) and its 50-day moving average are only rated as "neutral," both of these indicators suggest that the stock market may not see an immediate downturn in the short term. However, they also indicate that an inflection point for a market reversal is approaching and should not be overlooked.

Market Capitalisation and Valuation: Economic Outlook vs. Earnings Forecasts

Last quarter, we observed an unusual phenomenon where the US economy and the US stock market indices moved in opposite directions, a rare occurrence in the past 50 years. The US quarterly GDP fell from 4.9% to 3.2% in the third and fourth quarters of last year, and further contraction is anticipated in the first quarter of this year. However, astonishingly, from the second half of last year until 4 March this year, the Dow Jones Industrial Average, the S&P 500 and the Nasdaq 100 indices jumped by 16.6%, 26.7% and 48.2% respectively, deviating significantly from the economic trend.

The Buffett Indicator, also known as the ratio of the total market capitalization of a country's stock market divided by its GDP, is used to gauge whether a country's stock market valuation is supported by its real economy. With reference to the Buffett Indicator data for the past 20 years in both the global and US stock markets, we find that the US indicator has been consistently higher than the global indicator. This can be attributed to the size and dominant global economic role of the US. However, recent data from 2023 reveals that the US indicator differs from the global indicator by nearly 70%, which is approximately 50% higher than the 20-year average difference between the two. Furthermore, while the current global indicator is approximately 22% higher than its 20-year average, the US indicator exceeds its 20-year average by almost 34%. These figures imply that the overall market capitalization of the US stock market has deviated from the real economy, aligning with the analysis of last quarter. If the US economic recession occurred in an orderly manner as expected, the US stock market could potentially face a downward adjustment of 15% to 20% to return to a relatively reasonable level.

The Buffett Indicator – Global and US Stock Markets



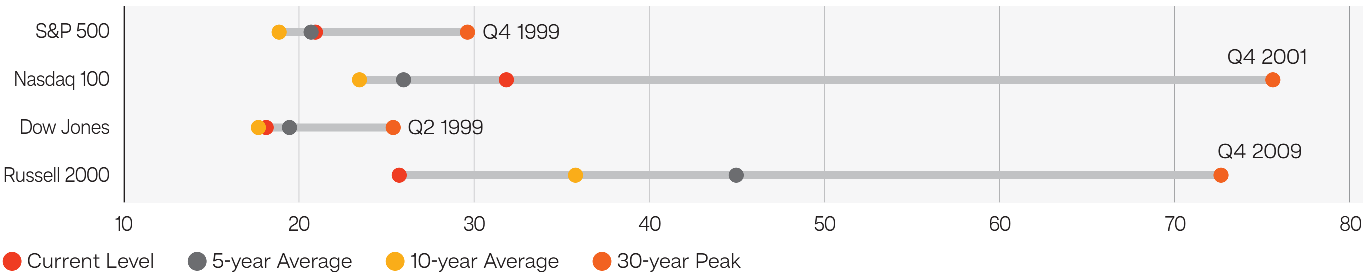
Source: Bloomberg, data as of 4 March 2024

2 See CNN Business website, https://edition.cnn.com/markets/fear-and-greed

Equity

Additionally, the market often employs the projected price-to-earnings ratio (P/E ratio) as an indicator to assess the reasonableness of stock market valuations. Drawing from data over the past 30 years and considering the four major indices of US stock markets, namely the S&P 500, the Nasdaq 100, the Dow and the Russell 2000 Indices, the analysis is as below:

The Forward 12-month P/E ratio (times)



Indicators	S&P 500	Nasdaq 100	Dow	Russell 2000
Difference from the current level (%)				
Compared with the average of the past 5 years	1.0	22.3	-4.4	-41.7
Compared with the average of the past 10 years	9.5	38.4	3.2	-27.8
Compared to the peak of the last 30 years	-28.6	-56.7	-25.0	-63.9

Source: Bloomberg, data as at 6 March 2024
*2020 data excluded above

High and low are relative concepts. Excluding the extreme figures resulting from non-economic factors during the 2020 pandemic, as of 6 March this year, the Nasdaq 100 Index, with its high potential for earnings growth, has the highest projected P/E ratio, while the Dow, which is heavily weighted towards traditional sectors, has the lowest.

Focusing on the Nasdaq 100, its current projected P/E ratio stands at 32.9x, which is approximately 22% and 38% higher than its 5-year and 10-year averages, respectively. Such high valuation often becomes a target for the short sellers. If we consider the AI factor of the so-called "Industrial Revolution 4.0", a more appropriate time zone for valuation comparison would be the last technological breakthrough, i.e., the popularisation of the Internet amongst the millennials. The 30-year peaks of the S&P 500, Nasdaq 100 and Dow indices all occurred in this period, and the current P/E ratios of the these indices are approximately 29%, 57% and 25% below their respective peaks, suggesting that the current valuations of US stocks are not overstated. The reason behind is that technological breakthroughs have considerably boosted the profitability of many companies. Today's AI surpasses the impact of the internet's popularisation during the millennial era, as its applications provide investors with more tangible benefits (further analysis will be provided below).

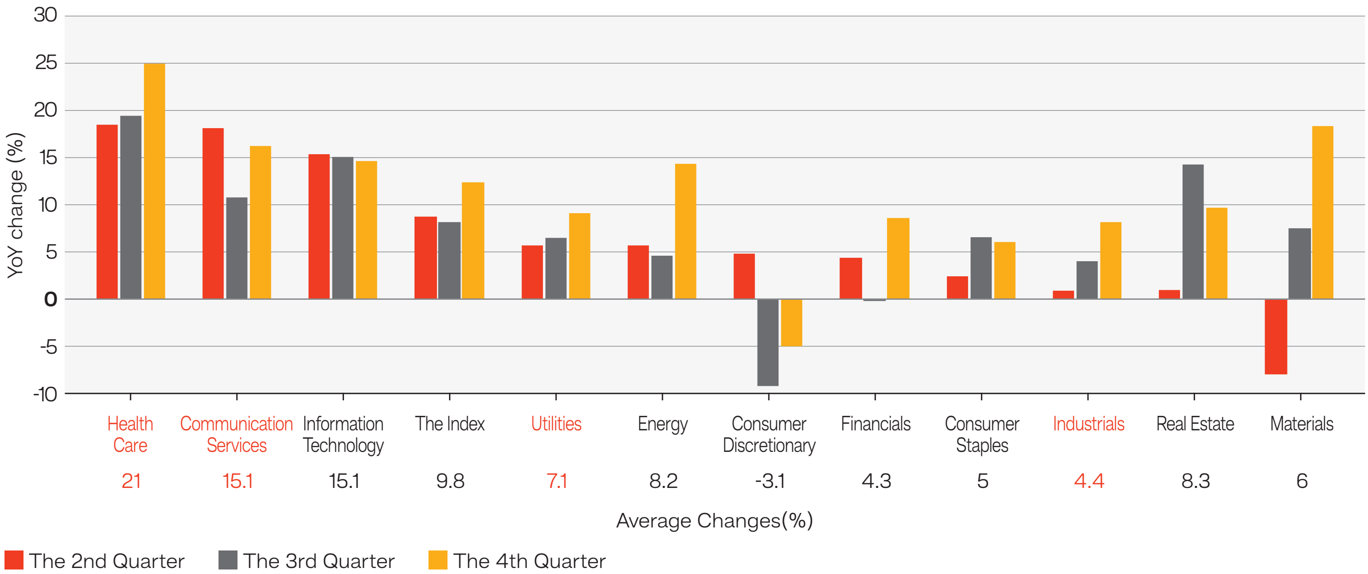
It is evident that numerous industries related to AI are poised to benefit from the ongoing AI frenzy, including software development and application hardware replacement. While the components of the S&P 500 and the Dow include such companies, contributing to the overall index performance and valuations, the impact is not as pronounced as in the Nasdaq 100. Additionally, the Russell 2000 Index reached its peak in 2009, during the financial tsunami. This reflects that it would be difficult for small-cap stocks to immediately benefit from large-scale economic reforms. Instead, the small cap stocks tend to be sought by investors in times of fervent financial speculation financial techniques. It is worth noting that the Russell 2000 Index exhibits the highest volatility and sensitivity to market fluctuations among the indices mentioned above, which required higher attention from investors.

Earnings Projections: Opportunities Beyond Tech Stocks

The roaring rally in tech stocks has been thrusted by robust earnings growth. As of 6 March this year, the year-on-year earnings growth forecasts for the tech sector for the 2nd to 4th quarters this year, with reference to the eleven sectors of the S&P 500 and industry indices, stand at 15.4%, 15.1% and 14.7% respectively. These projections indicate that the pace of earnings growth in the tech sector is expected to remain relatively steady in the coming quarters, suggesting a potential slowdown in the upward trajectory of stock prices driven by earnings growth.

However, impressive earnings forecasts are not exclusive to the technology sector, as investors can find hidden gems elsewhere. There are three sectors that have consistently seen an upward trend in earnings growth forecasts and positive returns for quarters, namely Health Care, Consumer Staples and Real Estate. Additionally, there are three sectors that exhibit double-digit year-on-year growth projections that outperforming the composite index for all next three quarters, namely Health Care, Communication Services and Information Technology. When considering the average growth in earnings forecasts for the next three quarters, the top three sectors, in order, are Health Care, Communication Services and Information Technology.

Year-on-Year Earnings Growth Forecasts for The S&P 500 And Its Eleven Sectors Are as Follows:



Source: Bloomberg, data as of 11 March 2024

The performance of the S&P 500 and its eleven sectors throughout the year has broadly aligned with the aforementioned earnings forecasts. As of 6 March this year, the Information Technology sector has been the standout performer, closely followed by Communications Services, Healthcare and Financials, demonstrating head-to head performance with the index.

Performance of the S&P 500 and its eleven sectors during the year:

Indices or sectors	Performance during the year (%)
Information Technology	11.1
Communication Services	10.6
Financials	7.6
The Index	7.4
Health Care	7.1
Industrials	7.0
Consumer Staples	4.4
Energy	4.4
Materials	4.1
Consumer Discretionary	2.4
Real Estate	0.0
Utilities	-0.2

Source: Bloomberg, data as of 11 March 2024

As analysed in the last quarter, US stocks have demonstrated superior performance compared to other stock markets during presidential election years. Furthermore, the orderly economic downturn of the US economy throughout the year, coupled with the anticipation of the first interest rate cut by the Fed, will favour high-yield, value and defensive stocks within the US market. From a sectoral perspective, the Financials, Consumer Staples and Health Care sectors are expected to outperform. These findings align with our earlier predictions.

In the "Macro Strategy" section of this quarter, it is highlighted that if the US economy undergoes a managed adjustment in the future, defensive value stocks will be benefited, thereby favorably impacting the performance of related sector indices. The above analyses reflect that there are numerous sector indices within the US stock market that investors can choose from, beyond the technology sector.

Amidst the unstoppable tide of the technology frenzy, the insiders have already made alternative arrangements. Let it be clear: this is not about abandoning tech stocks altogether. Rather, when investing in US stocks, a prudent approach involves emphasising risk-return balance. Allocating more positions across diverse sectors becomes crucial. By allocating position beyond tech stocks, we mitigate the potential risks associated of pullbacks in tech stocks. Time is of the essence; action is imperative.

Equity

Japanese stocks reach new highs: Triumph on shifting sands

On 4 March this year, Nikkei 225 Index closed at 40,109 points, soaring past the 40,000-point mark for the first time in nearly 34 years, since its reach of the previous high of 38,915 points on 29 December 1989. This achievement marked a historical milestone. After all the ups and downs of over the past three decades, the glory of reaching the summit is indeed hard-earned.

Following its peak in the late 1980s, the Japanese stock market fell into the "Lost 30 Years" predicament. The Nikkei 225 Index even plummeted to a low of 7,055 points on 10 March 2009. It was only after a number of prime ministers' economic reforms and the global economy's gradual recovery from the financial tsunami that Japanese stocks rebounded. Since the low in 2009, it took approximately five months for the Nikkei 225 Index to reclaim the 10,000-point threshold. However, it took nearly 6 and 8 years to break through the 20,000 and 30,000 marks respectively, as the economy struggled to regain its footing. It took a total of around 14 years for the economy turnaround.

The current ascent of the Japanese stock market, rising above the 40,000-point mark in less than a year, raises doubts about the sustainability of the uptrend, particularly after taking into account the lack of dramatic economic improvement as compared to the past three decades. The real economy does not have sufficient fundamentals to support such a skyrocketed uptrend in the stock market.

Historical data of the Nikkei 225 Index:

Dates	Closing price (points)	Number of years from the last significant milestone
10 March 2009	7,055	N.A.
27 July 2009	10,089	0.4
19 May 2015	20,026	5.8
17 May 2023	30,094	8.0
4 March 2024	40,109	0.8

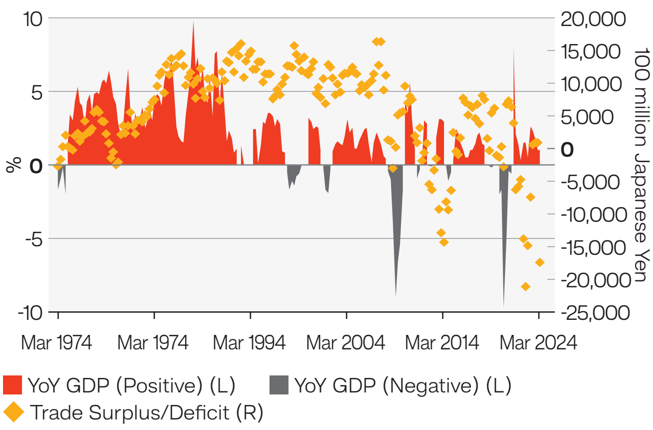
Source: Bloomberg, data as of 4 March 2024

Despite Economic Headwinds, Japanese Stocks Boom

The Plaza Accord is widely regarded as the culprit of Japan's economic downturn. During the 1980s, Japan's strong exports of innovative industries, including electronics, automobiles, optics and pharmaceuticals, acted as the thrust to boost the country's economy to unprecedented heights. It was not until 22 September 1985 that the financial representatives of five countries, namely the US, Japan, the United Kingdom, France and Germany, signed an agreement at the Plaza Hotel in New York, USA, agreeing to jointly intervene in the foreign exchange market to bring about an orderly appreciation of the Japanese yen against the US Dollar and the then German Mark, in order to address the massive trade deficits of the US and the associated global impact. This move dealt a severe blow to Japan's export-dependent economy.

In the fourth quarter of the same year the Plaza Accord was signed, Japan's GDP still managed to achieve a remarkable 7.2% growth, even exceeding the growth rate of 7.7% witnessed in the third quarter of 1990. However, over the following decade, the US dollar fell sharply against the Japanese yen from nearly 252 to 85, a drop of nearly 66%. The long-term soaring of the Japanese yen severely dampened Japan's export capabilities, which ultimately erode the core economic fundamentals, leading to the collapse of the domestic property market and the economy. Subsequent factors such as the Asian financial crisis, the bursting of the technology bubble and the emergence of China as an economic power further hindered Japan's ability to rebound. The trade deficit issue became increasingly prominent. Since the 1990s, Japan's trade surplus has repeatedly dropped, especially after 2008 when central banks worldwide introduced quantitative easing policies, which indirectly diminished the efficacy of the Bank of Japan (BOJ)'s pioneering easing measures. Despite the implementation of negative interest rate policies adopted by BOJ in September 2016, Japan has struggled to reverse its fortunes. During the pandemic, the trade deficit expanded vastly, reaching a modern-day high. As of 4 March this year, the trade deficit surged dramatically to reach 1.8 trillion Japanese yen, serving as a juxtaposition of extreme to the trade surplus peak of 1.8 trillion Japanese yen in the 1980s. Gazing upon the once mighty and vibrant past, the frailty of the present evokes a sense of lamentation.

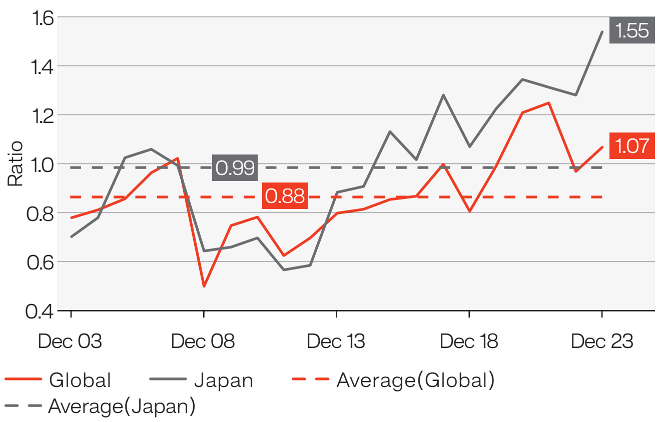
Japan's YoY GDP Changes and Trade Surplus



Source: Bloomberg, data as of 4 March 2024

This year, the Nikkei 225 index eclipsed record high once again. Nevertheless, concerns have emerged regarding the underlying strength of the Japanese economy over the past three decades. Evaluating this through the Buffett Indicator, which compares the total market capitalisation of Japan's stock market to the size of the local economy, the value of Japanese stocks reached 1.55 at the end of 2023. Not only does this figure represent the highest value recorded in the past two decades, but it also highlights a substantial difference of nearly 45% from the Buffet indicator of global stock market. Comparing this to the modest 13% difference observed between the respective 20-year averages of the Buffet indicators of the global stock market and the Japanese stock market, it becomes evident that the valuation of Japanese stocks is disproportionately elevated. Furthermore, while the current global stock market indicator stands 22% above its 20-year average, Japanese stocks have skyrocketed 57% higher. This discrepancy underscores a broad divergence in the overall market capitalisation of Japanese stocks from the underlying real economy. In the event that Japan's economic growth fails to meet expectations, projections indicate that a downward adjustment of approximately 30% may be required for Japanese stocks to return to a relatively reasonable level of valuation.

Buffett Indicator – Global and Japanese Stock Markets

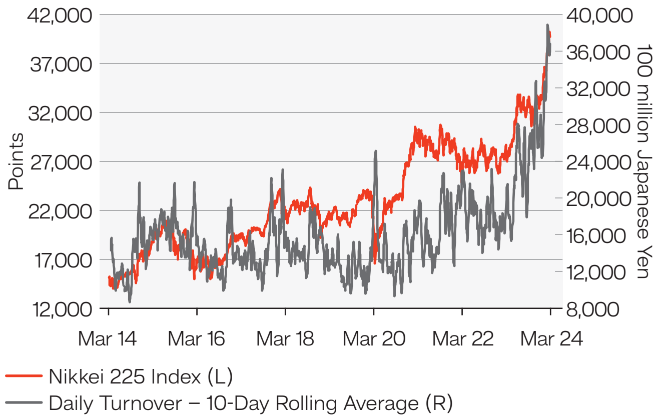


Source: Bloomberg, data as of 4 March 2024

Short-term Dynamic Analysis: Seizing Opportunities Amidst Global FOMO Sentiment

Japanese stocks have been riding on the prevailing FOMO sentiment that has swept through the global market. Analysis of the above global capital flows reveals a progressive shift of funds out of US equities and into Asian markets, with Japan ranking among the top three countries receiving substantial net inflows. Looking at the 10-day rolling average of daily turnover of the Nikkei 225 Index over the past decade, the trend was relatively flat until 2020. However, since then, daily turnover has exhibited a steady upward trajectory, reaching unprecedented levels last year, pushing the index to new heights. Between 2014 and 2023, the average daily turnover of the Nikkei 225 Index stood at approximately 1.5 trillion Japanese yen. However, from 2023 to 7 March this year, it rose dramatically to around 2.4 trillion Japanese yen, reflecting a notable increase of 60%. This upsurge in turnover reflects investors' redirection of capital towards Japanese stocks induced by the FOMO mentality.

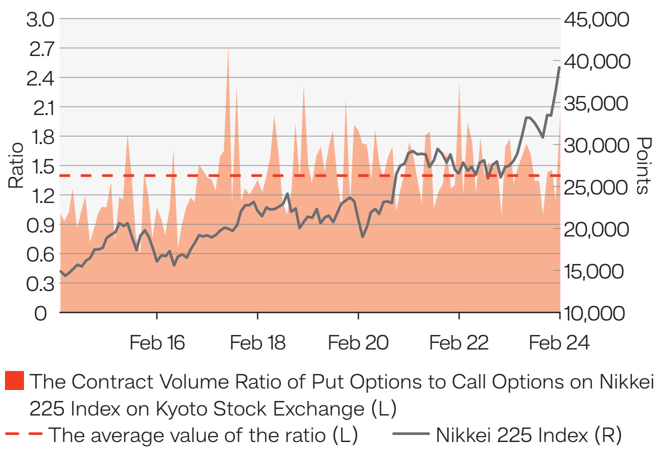
Trend of Nikkei 225 Index and 10-Day Rolling Average of Daily Turnover



Source: Bloomberg, data as of 7 March 2024

The contract volume ratio of put options to call options on Nikkei 225 Index on the Kyoto Stock Exchange has remained above 1 since 2017, signifying the stronger prevailing bearish sentiment towards Japanese stocks. Interestingly, despite this sentiment, the Nikkei 225 index has repeatedly broke previous highs during the same period, prompting position holders to heavily allocate funds into put warrants for hedging. Over the past decade, the average ratio has stood at 1.39. However, as of 29 February this year, it soared to 2.04, marking an impressive spike of nearly 47% above the average. Although unusual, the ratio still falls short of the five-year peak of 2.73 recorded in July 2017 and the 2.35 peak witnessed in February 2022. Investors remain fervent towards Japanese stocks, throwing caution to the wind.

Contract Volume Ratio of Kyoto Stock Exchange Nikkei 225 Index Put/Call Options and Nikkei 225

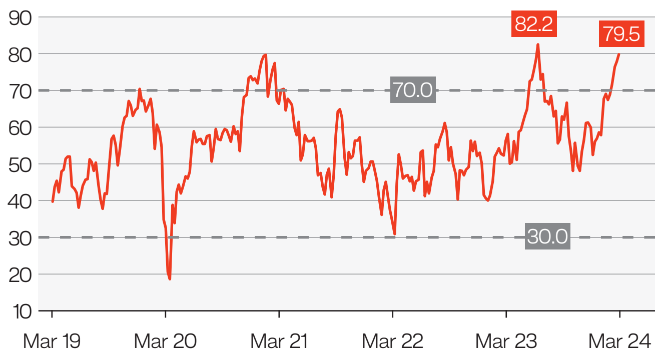


Source: Bloomberg, data as of 29 February 2024

Equity

The RSI reflects similar outcomes. The recent reading of 79.5 recorded as of 1 March this year was the second highest in the past five years, trailing closely behind the peak of 82.2 in June last year. The proximity of these figures highlights the persistent bullish sentiment in the market. Furthermore, over the last five years, instances where the RSI surpassed the overbought level of 70 have been relatively rare, accounting for a mere 9.6% of occurrences. Therefore, a RSI that came within a whisker of 80 mark indicates a severely overbought market condition. Despite these warning signals, market sentiment remains exuberant, driving investors to readily pour into the already overbought Japanese stocks. However, it is crucial to recognise that any misstep in Japan's economic trajectory or interest rate trends could trigger a harrowing scenario, resulting in a plummet in Japanese stocks and potentially impelling a chaotic sell-off (for more detailed analysis of interest rates, please refer to the "FX" section).

RSI – Nikkei 225 Index



Source: Bloomberg, data as of 1 March 2024

Technical Analysis: Pointing Towards a Deceleration

In addition to short-term momentum indicators, the fundamental factors of the Nikkei 225 index also underpin the strong performance of the index. Referring to Bloomberg's forecast data, the following is observed:

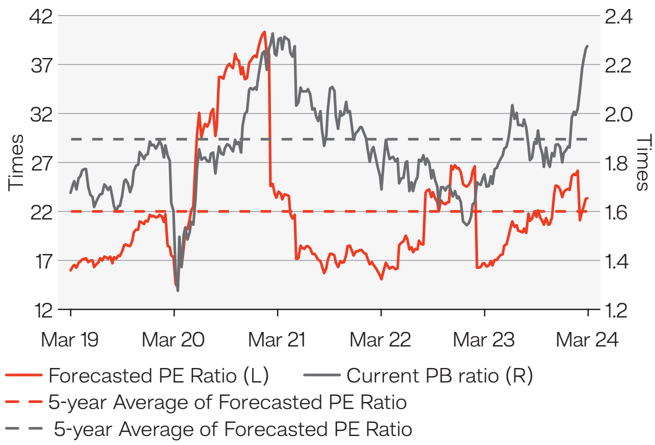
Fundamentals Indicators	Forecast for the next 12 months	Forecast for the next 24 months
EPS Growth (%)	17.6	11.7
PE Ratio (Times)	23.4	21.0
PB Ratio (Times)	2.2	2.1
Dividend Yield (%)	1.6	1.9

Source: Bloomberg, data as of 7 March 2024

The most prominent fundamental indicator is earnings per share (EPS) growth forecast. The projected growth for the next 12 months reaches 17.6%, surpassing the current 16.1% increase seen in the sought-after the Nasdaq 100 Index and outperforming the 9.0% growth of the S&P 500 Index. It also extensively outpaces the negative 1% EPS growth forecast of the Euro Stoxx 50 index. The favorable fundamental outlook is one of the reasons attracting international capital inflows towards Japanese stocks.

With robust earnings growth forecast, the Nikkei 225 Index's 12-month forecasted P/E ratio stands at around 23x, not far from its 10-year average of 22x. However, there is still a considerable distance from the 5-year peak of nearly 40x. This suggests that current valuations remain reasonable to hold up the current upward trend. On the other hand, the current price-to-book (P/B) ratio of approximately 2.3 times is about 20% higher than the 10-year average of 1.9 times. This shows that the asset appreciation of the Nikkei 225 Index's components has not kept pace with the gains in share prices, potentially creating greater pressure for share price adjustments, particularly for capital-intensive companies. Regarding dividend yield, the current level of approximately 1.6% aligns with the forecast for the next 12 months. However, the dividend yield forecast for the subsequent 24 months is expected to climb to 1.9%, representing an increase of around 19% compared to the current level. This provides additional pillar for the ongoing upward momentum in Japanese stocks.

Projected P/E and P/B of Nikkei 225 Index



Source: Bloomberg, data as of 7 March 2024

Based on Bloomberg's classification index, the Tokyo Stock Price Index (TOPIX) is categorised into 11 industry indices, and the projected earnings changes for each industry from the 2nd to 4th quarters this year are as follows:

Industry Indices	Projected Earnings Changes (%)		
	The 2nd quarter	The 3rd quarter	The 4th quarter
Utilities	148.8	115.3	159.8
Consumer Discretionary	41.5	22.8	1.6
Materials	27.9	13.7	-3.5
Industrials	23.3	-2.2	27.8
The Index	**21.9**	**-6.7**	**10.3**
Energy	21.9	16.6	-7.5
Financials	20.7	10.9	17.8
Real Estate	17.4	1.3	-4.7
Consumer Staples	10.9	6.1	8.9
Information Technology	6.7	-0.5	-12.8
Health Care	3.8	-10.3	-10.5
Communication Services	-43.7	-99.2	35.8

Source: Bloomberg, data as of 7 March 2024

The above data indicates that forecasted earnings changes in various industry are highly varied and subject to marked quarterly fluctuations. Additionally, out of the 36 forecasts provided, 11 of them are negative, reflecting a potential earnings decline in nearly 30% of the industry indices. This could weigh on the current upward momentum of the index. Furthermore, market expectations suggest that no industry will be able to achieve three consecutive quarters of earnings growth, which starkly contrasts with the index' robust performance. This may foreshadow a deceleration in the rise of the Japanese stock market. Among the Q2 earnings forecasts, four sectors, being Utilities, Consumer Discretionary, Materials and Industrials, are expected to beat the composite index in terms of earnings growth. Looking ahead, four sectors, being Utilities, Consumer Discretionary, Financials and Consumer Staples, have the potential to achieve earnings growth over the next three quarters. It is evident that the Utilities and Consumer Discretionary sectors, bolstered by positive earnings forecasts, may outrun other sectors.

Political and Economic Factors: Returning to Fundamentals

Japan's economy was at the zenith in the 1980s, but it was subsequently dragged into a downward spiral due to various internal and external challenges. Today, Japan's stock market is not only "resurrected", but blasted, as propelled by heated investment sentiment. However, investors' enthusiasm will cool off one day. The fundamental analysis covering political, economic and interest rate factors highlight that Japanese stocks are in a rather passive position:

- On the political front, the rebound of Japan's stock market began in late 2009, owing to the vigorous implementation of the "East Asian Community" by then-Prime Minister Yukio Hatoyama[3]. This strategic concept was groundbreaking and transcended traditional frameworks of thinking. The "East Asian Community" advocates for an integrated approach with the principle of "economy first, politics second". Its objective is for Japan to assume a balanced role between the dominant forces of China and the US, maintaining an equidistant triangular relationship. However, there are risks involved. Any tilt by Japan towards either China or the US could lead to interference from the dominant force or strain relationship between China and Japan. The "East Asian Community" is a double-edged sword, as it holds the potential for Japan to regain its political stature, but it also presents challenges and dilemmas. Yukio Hatoyama's visionary approach seemingly foreshadowed the current dynamics between China, the US and Japan.

- On the economic front, in Japan, employers and employees engage in discussions every spring to determine the wage increase for the upcoming year, known as the "Shunto". Japan's large companies agreed to raise wages by an average of 5.28% this year, the heftiest pay hikes since 1991. Over the past 30 years, Japan's real average monthly wage growth and the Nikkei 225 Index have moved in a similar trend, albeit with a lag of a few months. This indicates that the impact of wage changes will be reflected in the performance of Japanese stocks several months later. Japan's wage fluctuation has improved from a recent low of -2.9% to -0.6% at the beginning of March this year, but it has not yet turned positive. Moreover, over the past three decades, a significant proportion, as high as 61%, of employees have experienced negative wage growth, highlighting the long-term contraction of employee incomes, which directly impacts the domestically-driven Japanese economy. Another contributing factor is the recent inflation in Japan, attributable to the rising import prices and the depreciation of Japanese yen, indirectly hampering real economic growth. The current upward momentum in Japanese stocks has already deviated from wage rise. The outcome of this year's "Shunto" is expected to boost Japan's domestic demand growth and bolster the Japanese economy, based on which investors' fervor towards Japanese stocks will continue in the short term.

[3] See Straits Review Monthly (海峽評論) website, https://haixia-info.com/articles/5520.html

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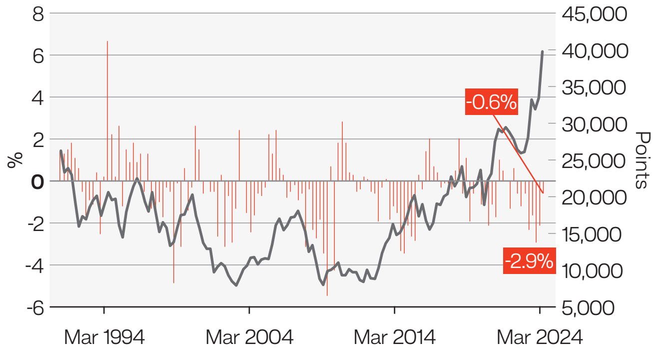
Japan's Average Monthly Real Wage Growth and Nikkei 225 Index

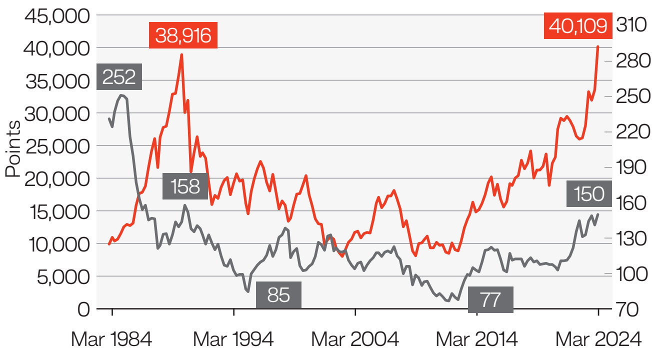


Average Monthly Real Wage Growth in Japan (L)
Nikkei 225 Index (R)

Source: Bloomberg, data as of 7 March 2024

- On the interest rate front, the late former Japanese Prime Minister Shinzo Abe's "Abenomics" strategy initially relied on the implementation of an aggressive monetary policy to inject an enormous amount of liquidity into the economy. The most notable measure was the introduction of a negative interest rate policy by the BOJ in September 2016. This was accompanied by proactive fiscal policies and efforts to stimulate private investment, which helped stabilise the economy and maintain the steady uptick of the Japanese stock market. However, the situation changed when the US Fed began to halt its interest rate hikes last year. Japan's interest rate advantage gradually diminished, and the strategy of relying on a weakened Japanese yen to boost the economy became less effective. Furthermore, central banks in mature markets, such as Europe and the US, have expressed intentions to initiate interest rate cuts this year. In contrast, the BOJ has abandoned its long-standing negative interest rate policy amid high inflation. As a result, the likelihood of a Japanese yen rebound has increased, which poses challenges to the future performance of the Japanese stock market.

Trends of Nikkei 225 Index Trend USD/JPY



Nikkei 225 Index (L) USD/JPY (R)

Source: Bloomberg, data as of 4 March 2024

Considering the aforementioned political, economic and interest rate risk factors, along with a review of the Nikkei 225 Index, USD/JPY exchange rate, and Japanese economic data over the past 40 years, a comparison can be drawn between the current situation and the previous peak of the Japanese stock market:

Dates	Nikkei 225 Index (points)	GDP YoY Growth (%)	Trade surplus (100 million Japanese yen)	USD/JPY
29 December 1989	38,915	6	8,950	144
4 March 2024	40,109	1	-17,600	150

Source: Bloomberg, data as at 4 March 2024

Japan's GDP growth rate is noticeably lower. However, amidst the ongoing China-US rivalry, the US intentionally put stranglehold[4] on China's technological advancements, and encouraged technology companies from other countries to establish manufacturing facilities in Japan. For instance, during the G7 summit held in Hiroshima, Japan in May last year, major global chip companies expressed their interest in setting up factories in Japan[5]. Japanese Prime Minister Fumio Kishida promptly responded by pledging policy and financial support[6]. The recent joint military exercises between the US and Japan have further stirred tensions with China[7]. As mentioned by Yukio Hatoyama, striking a delicate balance between China and the US is an artful test rather than a scientific one. Japan finds itself treading on thin ice in international relations, as any misstep could directly impact the trajectory of the Japanese stock market.

4 See Reuters website, https://www.reuters.com/technology/ahead-g7-summit-japan-pm-says-he-expects-more-investment-global-chipmakers-2023-05-18/
5 See Nikkei Asia website, https://asia.nikkei.com/Business/Tech/Semiconductors/Chips-at-center-of-G-7-discussion-of-how-to-counter-China-s-rise
6 See The Economic Times website, https://economictimes.indiatimes.com/tech/technology/japan-pm-fumio-kishida-expects-more-investment-from-global-chipmakers/articleshow/100318934.cms?from=mdr
7 See Japan Maritime Self-Defense Force website, https://www.mod.go.jp/msdf/en/release/

Interest rate spreads among various currencies are interdependent. Given that the decision-making power over international interest rates has long been held by central banks in the US and Europe, their choices will inevitably impact the BOJ's interest rate policy. The size of Japan's economy has already been surpassed by Germany and is closely followed by India[8]. Japan has been grappling with economic stagnation for the past 30 years. Reversing the interest rate policy abruptly would risk undoing the hard-fought achievements of previous prime ministers. Moreover, over the past few decades, a substantial amount of global capital has been engaged in carry trades using the Japanese yen, and the implications of transitioning from negative to zero interest rates on global assets should not be underestimated.

Referencing to the previous peak of Japanese stocks, the USD/JPY exchange rate has traded softer from 144 to 150 today. There is a strong correlation between Japanese stocks and the Japanese yen's exchange rate. In late 2022, when the exchange rate approached the 150 level, the BOJ announced a limited adjustment to its yield curve control policy[9]. This move caused the USD/JPY to decline, indicating that the market perceived it as the BOJ's acceptable upper limit. Now that the exchange rate has reached the 150 level again, the question arises whether the new BOJ Governor, Kazuo Ueda, will follow a similar course. With the exchange rate teetering on the 158 level, reminiscent of the peak in the 1980s, will the BOJ allow the exchange rate to surge with any constrains? Furthermore, how will they balance the exchange risk for overseas funds investing in Japanese assets and the impact of reverse carry trades? The potential backlash from exchange rate movements poses a substantial risk to investments in Japanese stocks.

Leaving aside all financial analyses, if the prevailing political, economic and interest rate uncertainties fail to dissipate, the record-breaking highs of the Japanese stock market will be akin to triumph on shifting sands, susceptible to sudden collapse overnight.

Take-off in Technology Stocks: Cultivating the Right Investment Mindset

Similar to celestial black holes, US-listed technology stocks draw an immense gravitational force induced by FOMO and the TINA mentality, which devours global capital, irrespective of the source of active or passive funds, leaving investors with no option but to follow the trend and pour their funds into technology stocks. As technology stocks continue to soar, as of 7 March this year, three out of the four colossal enterprises with a combined market capitalisation exceeding 2 trillion (USD, same below) are within the technology sector[10]. The significance of 2 trillion is profound, as it equates to the 11th largest economy among the world's major economic powerhouses, surpassing Mexico, Russia, South Korea and Australia. Should the market capitalisation of these three technology behemoths further expand to 3 trillion, they would ascend to the 8th position among the world's major economies, trailing only behind France. Their wealth is comparable to that of a country[11].

Adopting a trend-following or contrarian investment strategy is a perennial debate among investors. Warren Buffett, widely known as the "Oracle of Omaha," provides an insightful perspective through his evolving views on the technology sector over the past three decades. According to a 2018 CNBC report[12], Buffett expressed a preference for industries with stability in 1996 and admitted limited understanding of the technology industry. It was not until 2011 that he began investing in computer companies, and in 2016, he made his initial investment in a smartphone company. In the midst of this red-hot era, where shareholders' opinions are a mix of praise and criticism, Warren Buffett stands out for his prudent and balanced approach to stock trading, and his resistance to the allure of stock price hike. This exemplifies the true essence of "high difficulty" trading. His esteemed late partner, Charlie Munger, who often referred to the Lollapalooza Effect in his book " Poor Charlie's Almanack: The Essential Wit and Wisdom of Charles T. Munger" to caution against the magnified effect of compounded biases. Investors should be wary of one-sided bias in the market.

Learning from History: The Risks of Thematic Investments

In the technology world, abbreviations are commonly used to represent concepts, such as B2B (business-to-business) and IoT (Internet of Things). Similarly, the investment world often assigns catchy acronyms to the tech industry. For instance, in 2017, the acronym "FAANG" was coined to describe the five most popular and best-performing tech companies listed in the US stock market at that time. Inspired by the 1960s classic film "The Magnificent Seven", the term "M7" was used to refer to the top US-listed tech stocks in the past year, particularly those related to AI. Additionally, the term "AI-5" has been used to collectively refer to the five leading global chip manufacturers and developers[13].

8 See Politico website, https://www.politico.eu/article/germany-now-world-third-largest-economy-japan-recession/
9 See Bank of Japan website, https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2022/rel221220h.pdf
10 See CompaniesMarketcap website, https://companiesmarketcap.com/#google_vignette
11 See Forbes website, https://www.forbesindia.com/article/explainers/top-10-largest-economies-in-the-world/86159/1
12 See CNBC website, https://buffett.cnbc.com/2018/04/02/over-time-buffett-softens-stance-on-tech-stocks.html
13 See Nasdaq website, https://www.nasdaq.com/articles/spotlight-on-the-ai-5:-microsoft-tsmc-broadcom-nvidia-and-amd

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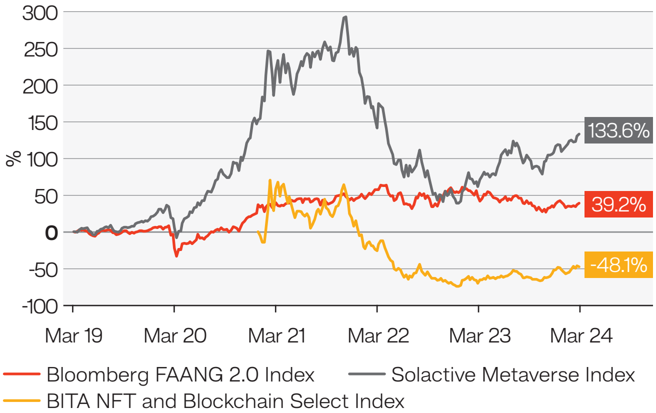
The recent tech hype in the investment market gained momentum since the global pandemic in 2020. The widespread adoption of remote work and reduced physical interactions resulted in a surge in demand for internet-based services such as video, streaming and gaming. This, in turn, triggered a wave of upgrades and replacements of mobile phones and computers. Moreover, central banks worldwide injected substantial liquidity to mitigate the economic downturn. However, an unintended consequence was the speculative frenzy surrounding tech stocks that registered explosive profit growth during the pandemic. As of 7 March this year, the performance of the thematic technology sector indices over the past five years is as follows:

The Performance of the Thematic Technology Sector Indices



Source: Bloomberg, data as of 7 March 2024

Indices	Introduction Year	Number of weeks from introduction to peak
Bloomberg FAANG 2.0 Index	2019	163
Solactive Metaverse Index	2019	142
BITA NFT and Blockchain Select Index	2021	7

Source: Bloomberg, data as of 4 March 2024

Investors are well acquainted with FAANG, the metaverse, and non-fungible tokens (NFTs) or blockchain. Regardless of their previous popularity, FAANG and metaverse-related indices launched by index companies typically reach their peak approximately 153 weeks after their introduction, followed by an unsustainable trend. The most extreme case is the NFT themed index, which lacks profitability support and witness a slump only 7 weeks after its launch. As of 7 March this year, the NFT themed index has reported a negative return of 48%. On the other hand, the M7 and AI-5 trends continue to maintain a formidable upward trajectory. The AI concept, in particular, has been gaining momentum since last year and has sustained for 62 weeks, accounting for approximately half of the analysed period.

It is worth noting that one of the purposes of naming speculative stocks is to facilitate understanding and recollection for investors, especially individual investors who tend to be more responsive to name-based investments compared to institutional investors. As individual investors flock to the market in response to high-profile media coverage, the market becomes saturated with highly leveraged derivative products, often signaling the end of the music. Traditional wisdom cautions that the enticing cheese right in front of us often blinds us to the iron traps above our heads. The "naming" seems to have become a curse in the investment world.

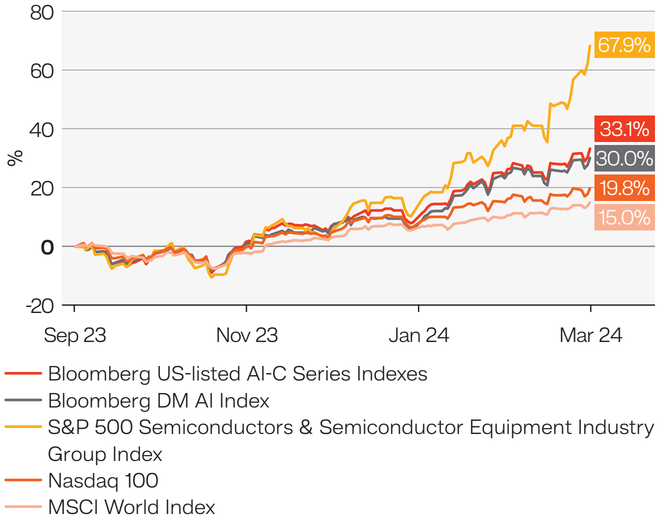
The Profit Myths: Identifying Beneficiaries in Different Stage

Investing in the tech is often driven by anticipation and belief, leveraging the potential for disruptive advancements that can transform lives. However, it is crucial to recognise that the realisation of these visions, such as the far-reaching internet revolution of the millennial era, often takes years to materialise into revenue and profitability. Understanding the evolution of profitability in the tech industry and identifying beneficiaries at each stage is essential.

In the context of AI, the core component is chips, functioning as the hardware equivalent of the human brain. High-end processes like deep learning rely on chips to generate artificial intelligence. During the initial stages of AI industry development, a few manufacturers monopolise chip technology, raking in massive profits from selling those chips to program developers. As development progresses, related high-end and costly products are introduced to the market, enabling developers to generate profits. Finally, the end-user devices, such as smartphones and tablets, benefit the general public, with the end-user producers and service providers reaping the rewards. This cycle of innovation breakthrough and product replacement completes the profit chain within the industry. The best recent example is the first generation of smartphones announced by a cell phone manufacturer in 2007, followed by a smartphone boom lasting for more than 10 years, attaining brilliant results of the related industrial chain.

Recent earning reports from US tech companies reveal that chips are expensive in the early stages of the AI industry. Chip manufacturers monopolising the technology reaping enormous returns. However, downstream companies representing the AI industry chain face elevated costs. As a result, the share prices of two prominent mobile phone and electric car manufacturers of the M7 have experienced double-digit declines since the beginning of the year. Institutional investors increasingly prioritise the profitability of tech stocks, with long positions in tech stocks with growing profits, in parallel to short positions in low-profit or loss-making tech stocks. This long-short strategy not only dampened the stock prices of certain technology companies whose profitability lacked conviction, but also impacted other stocks that merely claim AI association or involved in deceptive practices and fraudulent activities [14].

Tech and AI related Indices and MSCI World Index



Source: Bloomberg, data as of 7 March 2024

Studying the performance of the AI-related stock indices over the past six months, the overall trend resembled that of the end of last year. However, starting from this year, semiconductor and industrial equipment stocks have notably outrun other sectors, followed by program developers, and then the composite AI index. As of 7 March this year, the semiconductor index has outperformed the latter by more than double, and has even surpassed the Nasdaq 100 and the MSCI World Index by over three times. The technology industry's "winner takes all" feature remains as long as the moat is built upon technology monopolies. It is believed that the share prices of chip giants are unlikely to dip, as emerging higher-end chips continue to bring irresistible high-profit growth for investors.

Lastly, upon careful analysis, it becomes apparent that in addition to the prevailing dominance of AI, communication services are also indispensable in today's market, particularly in the highly contested domain of 6G. Even the most advanced and costly AI equipment would be rendered futile if it cannot access the internet or if internet speed is inadequate. As AI becomes more ubiquitous, communication service providers eagerly await their opportunity to capitalise on this demand. As of 7 March this year, the technology sector leads the S&P 500 sector indices with a 13.2% increase, followed by the communications sector with approximately a 10.6% growth. The "Smart Money" has already seized this advantage before the market "names" the communication concept.

Technical Analysis: The Debate of Perspectives and Angles

In addition to establishing the right investment mindset through qualitative and historical analysis, it is crucial to discern the similarities and differences when analysing data. Data is relative, depending on the objects being compared. The recent parabolic rise in tech stocks brings back memories of the dot-com bubble in the millennium, with lingering reminders of the pain caused by irrational exuberance. Let's compare various technical analyses with the bubble:

- Today, AI reigns supreme in the market with chip manufacturers emerging as the frontrunner of the industry. However, amid the FOMO sentiment that devours global capital and the narrow market breadth, it is crucial to remain cautious. Reflecting on the dot-com era, the internet frenzy swept across the globe, attracting capital inflows into software and network operators. By comparing the market capitalisation data of the top 5 constituents of the S&P 500 Information Technology sector index as a percentage of the total market capitalisation on 11 March 2024 and 2000, the result is as follows:

Indicators	11 March 2000	11 March 2024
Total market capitalization of the top 5 constituents (USD trillion)	1.8	8.8
Total market capitalization of the sector index (USD trillion)	4.1	13.2
Percentage of the total market capitalization of the sector index	44.2	66.5

Source: Bloomberg, data as off 4 March 2024

[14] See Investing.com website, https://www.investing.com/analysis/hedge-funds-continue-betting-against-big-us-tech-stocks-200644968

Equity

Data shows that the market capitalisation of the top 5 technology stocks today accounts for nearly 67% of the total market capitalisation of the sector index, indicating a higher level concentration of capital compared to the past. This suggests that the future performance of the sector index and the overall market will be mainly subject to the performance of these 5 stocks, representing a narrow and unhealthy market breadth. The market capitalisation of the technology sector index today is approximately 3.2 times that of the past, indicating the exponential growth of the sector, while other sectors are lagging behind. The high concentration of individual sectors poses greater potential volatility risks to the overall market;

- In addition to market capitalisation, other sector indices were left far behind by the information technology and communication services sector indices, distorting the performance of the composite index. As of 8 March this year, the rapid ascent in the US stock market has continued for over five consecutive quarters since 2023. The S&P 500 (excluding the information technology and communication services sector indices) representing traditional sectors, compares with the Nasdaq 100 as a benchmark for measuring market breadth. The comparison is based on the 5-quarter performance before the peak of the millennium. Historical data shows a performance gap of approximately 137% between the two indices during the relevant period, indicating a high concentration of capital and a significant divergence between the Nasdaq index and traditional sector indices. As of 8 March this year, the performance gap stands at around 47%, showing a narrower market breadth but still far from that observed during the millennium. Furthermore, it's worth noting that after reaching its peak, the Nasdaq 100 witnessed a sharp downturn with a performance gap of around -68% in the subsequent five quarters. In contrast, traditional sectors continued to register positive returns, highlighting the turbulent performance of the Nasdaq Index's rapid surge and subsequent plunge during that time.

Performance and performance gap between the then and current indices:

Period	Changes in indices' performance		
	S&P 500 index (excluding the information technology and communication services sector indices)	Nasdaq 100 Index	Performance gap
5 quarters prior to 31 March 2000	2.9%	139.5%	136.7 percentage points
5 quarters after 31 March 2000	9.6%	-58.4%	-68.0 percentage points
From 2023 to 8 March 2024	17.4%	64.7%	47.3 percentage points

Source: Bloomberg, data as of 8 March 2024

- Some analysts argue that the current technology fervor is not comparable to the millennium bubble, as the key difference lies in the fact that the speculation back then revolved around technology concepts lacking profitability prospects. In contrast, today's technology stocks boast robust earnings data, particularly chip manufacturers, which justifies the current valuations of technology stocks as being at a reasonable level. A comparison of projected P/E ratios is provided below:

Time/Period	Nasdaq 100 Index	S&P 500 Information Technology sector index	S&P 500 Communication Services sector index
Projected P/E for the next 12 months (times)			
Peak of Millennium Bubble	75.9	69.4	33.9
11 March 2024	26.7	37.6	18.8
Performance gap	184.3%	84.6%	80.3%
Average of projected P/E for the next 12 months of the previous year			
Peak of Millennium Bubble	62.0	56.2	32.7
11 March 2024	34.9	32.7	18.7
Performance gap	77.7%	71.9%	74.9%

Source: Bloomberg, data as of 11 March 2024

The above data underscores the mania surrounding speculative trading in technology concepts during that period. The current level of 20 to 30 times of the projected P/E of the Nasdaq 100 and the S&P Information Technology sector index is merely a drop in the bucket as compared to approximately 70 times during the Millennium Bubble. The Nasdaq 100 was valued at even 1.8 times its current value. The communications service sector followed suit, with its previous valuation exceeding the current level by approximately 80%. Even when comparing the one-year averages, the average projected P/E of the three major indices at that time exceeded the current level by roughly 70%. However, it is worth to note that the above analysis has certain limitations, such as the unknown peak status of today's data, which prevents a direct "peak-to-peak" comparison.

- What attracts investors to the technology sector is its potential for exponential growth. Comparing the average EPS growth of the constituents of the S&P 500 Information Technology sector index on 11 March, 2000 and in 2024, we observe the growth rates of 134% and 105% respectively. These figures aptly capture the explosive and disruptive nature of the industry, fueled by groundbreaking technologies that transcend the present state of affairs. However, when focusing on the top five companies with the highest market capitalisation, their average EPS growth stands at approximately 4.4% and 951% respectively. This indicates that current industry growth is highly concentrated among a few key players, signifying a notable shift from the previously diversified landscape witnessed in the past. It seems that the "winner takes all" phenomenon is even more pronounced today than before, resulting in heightened risks.

EPS growth and performance gap between the then and current S&P 500 Information Technology sector index:

Period	EPS growth		
	Overall average	Average of the top 5 constituents	Performance gap
11 March 2000	134.0%	4.4%	129.6 percentage points
11 March 2024	104.7%	950.9%	-846.2 percentage points

Source: Bloomberg, data as of 8 March 2024

The above analyses reflect that the investment market today and back then both has its own merits. Behind the vigour of the speculation in technology stocks, there is also a certain degree of risk, only that the risk exposure is different. In short, technical analysis shows that the valuation of technology companies is in a bubble, but not out of control. Given the current optimistic earnings forecast stimulating market investment sentiment, while there is no default of highly leveraged investment products as in the past when the bubble burst, the possibility of a collapse of tech stocks is faint, yet a major adjustment is imminent.

With tech stocks repeatedly making new highs, investors are lusting for adding more positions. We shall remain neutral in our emotions and adjust our mentality instead of losing ourselves in data.

Chapter Summary:

- Capital flows and short-term dynamic analyses suggest an imminent correction after US stocks hitting new peak, while earnings growth and economic optimism support the current outlook
- Japanese stocks are at record highs. However, financial analysis aside, if the political and economic clouds do not dissipate, the triumph of Japanese stocks is like building on shifting sand
- Tech stocks have been a source of fascination for investors, yet emotions control and adjustment are the key to keep awake from the data

Equity

Investment Strategist, Wealth Management Division,
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Hong Kong and Chinese Mainland Stock Market Outlook: Flickering Warmth Amidst Lingering Chills

As investors bask in the warmth of market recovery, they must also adhere to strict position sizing control, risk diversification and prioritise stock selection to get well-prepared

The theme of last quarter was "Striving Ahead", signifying that despite the challenging short-term market conditions, investors who remained calm and seized the bottoming out moments after market panic sell-offs reaped substantial returns. Looking back, the outcomes were in line with expectations.

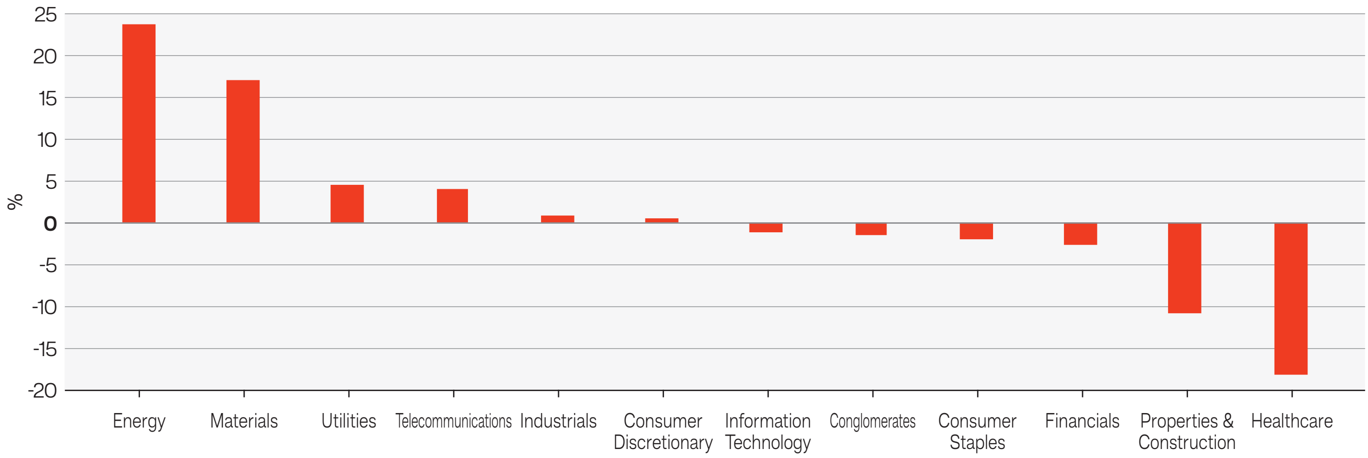
The first quarter witnessed a roller-coaster ride in the Hong Kong stock market and Chinese Mainland's A-share markets, starting with a sluggish January driven by Chinese Mainland's sluggish economy and subdued inflation data. Additionally, the drastic downward revision of expected US Fed's interest rate cuts triggered substantial foreign selling of Chinese stocks. The Hang Seng Index (HSI) and the Shanghai-Shenzhen 300 Index (CSI 300 Index) plummeted by 12.2% and 9.4%, respectively, hitting lows of 14,794 points and 3,108 points. These trends diverged significantly from global stock markets.

In response to market clamor, the central government gradually shifted its policy direction to a more favorable stance. Various government authorities intensified growth-stabilising measures. These included an unexpected 50-basis-point reserve requirement ratio cut, a 25-basis-point reduction in the 5-year loan prime rate (LPR), the resumption of pledged supplementary lending (PSL) to support the "Three Major Projects", the establishment of a financing whitelist for real estate projects, and relaxation of property purchase restrictions in first-tier cities. In addition, in an effort to alleviate the heavy burdens on the equity market, a series of policies to boost the capital market have also been introduced. For instance, the State-owned Assets Supervision and Administration Commission (SASAC) has announced that it will launch a market capitalisation assessment for state-owned enterprises (SOEs), market expects that Chinese central State-owned enterprises and SOEs will further heighten the dividend payouts ratio and enlarge the scale of shares buyback. Furthermore, the "national team" comprising medium- and long-term funds including the Central Huijin, social security funds and insurance capital, have actively participated in and supported the market. Led by the surge of high-dividend value stocks under "Valuation System with Chinese Characteristics", A-share and Hong Kong stock markets staged a remarkable comeback. By the end of February, HSI and the CSI 300 Index rebounded by up to 14% and 13.1% respectively.

In early March, the successful convening of the "Two Sessions" (being NPC and CPPCC sessions) in the Chinese Mainland unveiled economic policy targets and directions that broadly aligned with market expectations. Key highlights included an annual economic growth target of 5% and an inflation target of around 3%, the issuance of RMB 1 trillion worth of special treasury bonds and RMB 3.9 trillion worth of local government's special purpose bonds, loosening monetary policies, and measures to support the development of new quality productive forces. Although these developments did not bring about extraordinary surprises to the investors, they sustained the upward momentum of stock indices. The HSI and CSI 300 Indices reached their intra-quarter highs of 17,214 and 3,605, respectively. Market capital also shifted from value sectors to growth and cyclical sectors such as technology, consumer goods and non-ferrous metals.

As of 21 March, the first quarter saw a 1.1% decline in the HSI and a 4.4% rise in the CSI 300 Index. In terms of sector performance of Hong Kong equities, sectors including energy, materials, utilities, telecommunications, industrial, and consumer discretionary outperformed the broader market, with the energy and materials sectors posting impressive gains of 24% and 17% respectively. Conversely, the healthcare and real estate & construction sectors experienced declines of 18% and 11% respectively. Regarding the "overweighed" sectors in the previous quarter including Chinese telecommunications and the local high-dividend stocks, as well as Macau gaming stocks rated as "cautiously optimistic," performed well.

Performance of the Hang Seng Composite Industry Indices for Q1 2024



Source: Bloomberg, data as of 21 March 2024

Outlook for A-shares and Hong Kong Stocks Remains Uncertain, Subject to Central Economic Policies and Capital Flows

The title of this quarter is "Flickering Warmth Amidst Lingering Chills", symbolising the end of the harsh winter for Chinese Mainland's A-shares and Hong Kong stocks. However, the anticipated trajectory remains as unpredictable as early spring weather – sometimes chilly, sometimes mild. As investors bask in the warmth of market recovery, they must also adhere to strict position sizing control, risk diversification and prioritise stock selection to get well-prepared.

During the recent Two Sessions, Premier Li Qiang's government work report outlined the main direction of stable economic growth. However, certain areas still remain shrouded in uncertainty for investors. The timing and scale of future economic stimulus policies will continue to shape capital flows and market trends. Let's delve into the specifics below.

1. Industry Regulatory Policies Expected to Ease, Bolstering Valuation Recovery

The government's work report emphasises the "consistent assessment of macro policies". This signifies that before implementing any economic or industrial policy, authorities must conduct comprehensive and holistic evaluations to ensure policy transparency and minimise adverse effects on economic stability and market expectations. We believe that policymakers in Chinese Mainland will prioritise stability in their short-term policy decisions. While there may not be significant relaxation in the previous strict regulatory measures that have worried international investors in recent years, further tightening measures are unlikely to be put in place at this stage. This will help reduce the additional risk premium associated with policy uncertainty and support valuation recovery. Several sectors such as internet, game streaming, education, healthcare and food and beverage may stand to benefit the most from reduced regulatory and policy risks.

2. Central Budget Deficit Cautiously Restrained; Focus On Fiscal Fund Allocation.

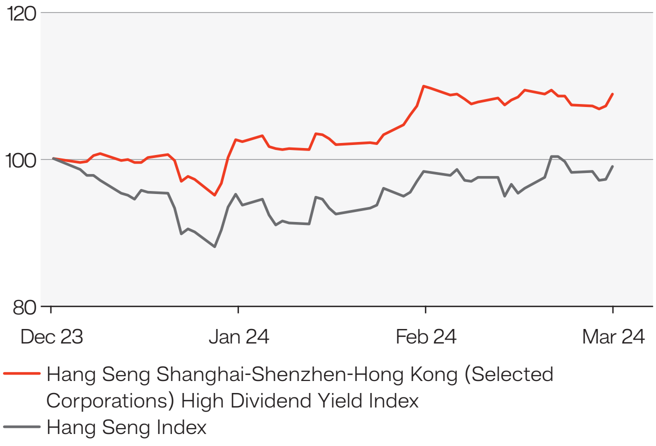
Regarding fiscal policy, Chinese Mainland's budget deficit ratio for this year is set at 3%. While this figure is lower than the 3.8% adjusted at the end of 2023 or the market's general expectation of 3.3% to 3.5%, it reflects the relatively restrained approach of the central government in expanding fiscal expenditures. In parallel, authorities announced plans to issue RMB3.9 trillion worth of local government bonds and an unprecedented RMB1 trillion worth of ultra-long-term special treasury bonds. The funds raised will be used for major strategic industries and construction projects. The intended issuance of these long-term special treasury bonds in the coming several years signals a sustained expansion of broader fiscal policy. The current low-interest-rate environment in Chinese Mainland provides an excellent opportunity for the central government to increase leverage moderately to stabilise economic growth. This is expected to provide support to Chinese Mainland and Hong Kong stock markets. However, it is important to consider the challenges faced by local governments stemming from reduced land sale proceeds and the deleveraging pressure on financing platforms. The marginal benefits of the central government's leverage expansion on stimulating the real economy may be diluted to some extent given these constraints. In summary, investors should keep a close eye on the actual progress of the issuance of long-term treasury bonds and the targeted aspects where such funds are parked to make comprehensive and precise investment decisions.

Equity

3. Low-Interest-Rate Environment Favors High-Yield SOEs; Inflation Resurgence Boosts Risk Appetite

Regarding monetary policy, the narrative in the government's work report remains largely unchanged from 2023, with phrases such as "flexible and appropriate, precise and effective" and "the social financing scale should align with the economic growth and price levels expectations". During the Two Sessions, People's Bank of China (PBoC) Governor Pan Gongsheng made statements at a press conference that imply potential actions, which include "promoting the recovery in price levels as an important consideration for monetary policy" and "current deposit reserve requirement ratio for banks averages 7%, and there is still room for subsequent reserve requirement ratio cuts", in response to increasing deflationary risks in Chinese Mainland. This suggests that the PBoC will act swiftly by implementing additional reserve requirement ratio cuts, interest rate reductions and increased net input of PSL should the deflationary risks escalate. In the short term, as monetary policy remains accommodative, it is anticipated that interest rates in Chinese Mainland market will hover at lower levels. The recent dip in the 10-year government bond yield to a historic low of 2.3% diminishes the allure of conservative fixed-income assets. The fall in yields may accelerate the redeployment of medium-to long-term funds from government bonds and investment-grade corporate bonds to higher-yielding value stocks, particularly large central enterprises and SOEs with stable cash flows, low net debt ratios or healthy net cash positions and high dividend payout ratios. These enterprises predominantly operate in sectors such as banking, energy, telecommunications, utilities and infrastructure. Notably, as China's 10-year government bond yield declined from 2.6% at the end of 2023 to 2.3%, the Hang Seng Shanghai-Shenzhen-Hong Kong (Selected Corporations) High Dividend Yield Index has surged 8.7% year-to-date, outperforming Hang Seng Index. Despite a retreat in the former's current dividend yield to approximately 8%, it remains significantly higher than the Chinese Mainland's risk-free interest rate. Therefore, it is expected that as stock prices experience minor adjustments, the related stocks are poised to continue attracting medium- to long-term capital in Chinese Mainland. Additionally, investors should closely monitor Chinese Mainland's inflation data over the next two quarters. As the effects of the PBoC's recent liquidity easing measures become more pronounced and the year-on-year base effect diminishes, we anticipate the bottoming-out in both the Consumer Price Index (CPI) and the Producer Price Index (PPI) in this quarter. The former, in particular, is expected to show signs of a turnaround. Should the market confirm the dissipation of Chinese Mainland's deflation concerns, risk appetite will be boosted, with the consumer and materials sectors poised to emerge as the primary beneficiaries.

Trend of Hang Seng Shanghai-Shenzhen-Hong Kong (Selected Corporations) High Dividend Yield Index and HSI for Q1 2024

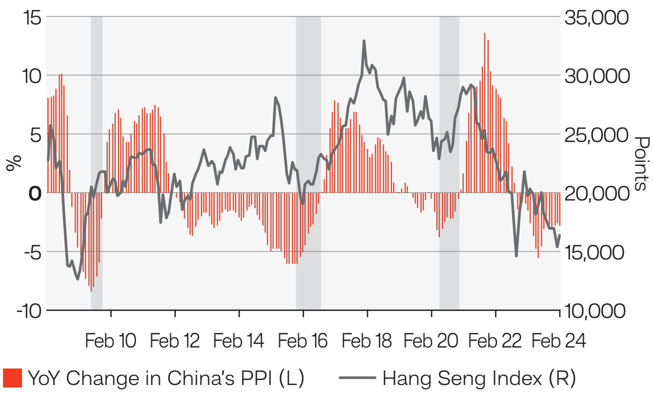


Source: Bloomberg, data as of 21 March 2024
Note: The base on 29 December 2023 is 100

Trend of Hang Seng Shanghai-Shenzhen-Hong Kong (Selected Corporations) High Dividend Yield Index & China Government Bond Yield

Source: Bloomberg, data as of 21 March 2024

Trend of China's PPI and Hang Seng Index since 2008



Source: Bloomberg, data as of 21 March 2024

4. Emerging Tech Industry Faces Risks and Opportunities; Wary of US Sanction Risk

In terms of industrial policy, the development of new productivitive forces has emerged as a key focus of this year's Two Sessions. Specifically, it can be divided into three major areas:

i) Optimisation and upgrading of the industrial and supply chains, aiming to propel conventional industries toward high-end, intelligent and energy-efficient transformations;

ii) Active cultivation of emerging and future industries, encompassing intelligent internet-connected new energy vehicles, hydrogen energy, bio-pharmaceuticals, high-end equipment and commercial aerospace;

iii) Advancing digital economy innovation and development with the "AI+" initiative gaining momentum, which benefits segments such as semiconductor equipment, data centers, cloud computing, the development of generative AI models and AI intelligent hardware equipment.

While state support is a significant advantage, we cannot overlook the multiple challenges faced by these innovative industries, which causes slump in prices of relevant stocks. The most formidable hurdle lies in the frequent US government and congressional sanctions targeting Chinese tech firms. Following the restrictions on the supply of manufacturing equipment to Chinese semiconductor companies in 2023 to suppress the development of AI technology in China, the recent passage of the Biosecurity Act further restricts business interactions between Chinese biotech companies and US pharmaceutical firms. As we approach the US presidential election in November, the greatest short-term risk to the investment market lies in whether Washington will impose further sanctions to restrict the development of high-tech industries in China, including smart electric vehicles, commercial computers, smartphone devices and 6G telecoms equipment.

5. Effectiveness of Trade-In Programs Depends on Subsidy Details; Consumer and Industrial Stocks Selectively Chosen

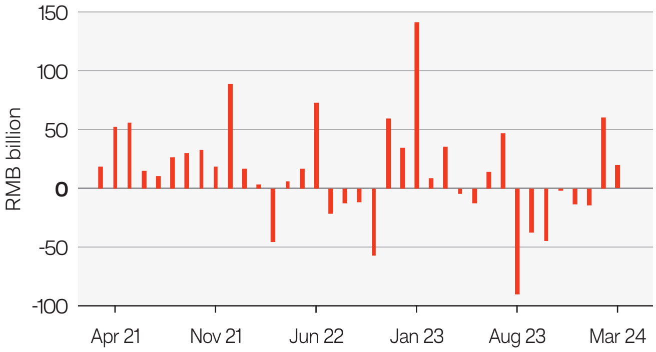
This year's government work report has placed significant emphasis on stimulating consumption and expanding investment. Among them, the action plan to promote trade-ins of consumer goods and mass replacement equipment renewals and is the highlight. As in the past, the primary targets of consumer goods replacement are household appliances and new energy vehicles. However, the report does not provide specific information regarding the government's subsidy amount. Upon reviewing subsequent action plans issued by the State Council, it appears that the measures focus on encouraging automakers to conduct promotional activities, optimising vehicle purchase restrictions and providing tax and credit support. However, the stimulus measures appear to be relatively modest. Some cities, particularly Shanghai have recently released a new round of car trade-in and smart home appliance consumption subsidy policies, with the maximum single subsidy amount being RMB10,000 and RMB1,000 respectively. More first- and second-tier cities may follow suit with similar substantial subsidy programs, so it is advisable to remain vigilant and selectively consider consumer discretionary stocks. Regarding the upgrading of production equipment, the government's focus lies in industries such as manufacturing, construction, transportation, agriculture and healthcare. By guiding enterprises to upgrade and replace their equipment, the goal is to achieve a 25% increase in equipment investment within four years. While the authorities have set ambitious targets, the actual pace of corporate investment will hinge upon the specific scope and scale of the subsidies. Should the finalised package surprise the market, it is anticipated to boost sectors such as liquefied natural gas (LNG) heavy-duty truck equipment, railway locomotive equipment, construction machinery, power equipment and shipbuilding.

Capital Markets: Foreign Selling Pressure Eases, National Team Achieves Success and Withdraws?

After 6 consecutive months of foreign capital outflow from China's stock market since August 2023, the market finally turned around in February this year. Referring to the northbound capital flow data from the Shanghai-Shenzhen-Hong Kong Stock Connect, there were net inflows of RMB60.7 billion and RMB19.7 billion in February and March this year respectively (as of March 21). The net increase in A-share positions in February even hit a 13-month high. It is worth considering that some of the northbound funds may have been contributed by offshore "national team" funds, as European and US funds remain relatively cautious about A-shares and Hong Kong stocks. Nevertheless, there has been a reversal in the pattern of aggressive selling and extreme underweighting of Chinese stocks observed in the past six months. Looking ahead, whether foreign investors will further increase their holdings of Chinese stocks depends on factors such as the price level recovery in Chinese Mainland, the strength of growth-supportive policies and developments in China-US relations. Overall, significant headwinds persist. Additionally, the strong performance of stock markets in the Asia-Pacific region and emerging markets has attracted continued inflows from overseas long position funds, which has diluted the proportion of capital allocated to Chinese equities.

Equity

Monthly Net Turnover of the Northbound Stock Connect Over the Past 3 Years



The data of March as of 21 March 2024
Source: Bloomberg, data as of 21 March 2024

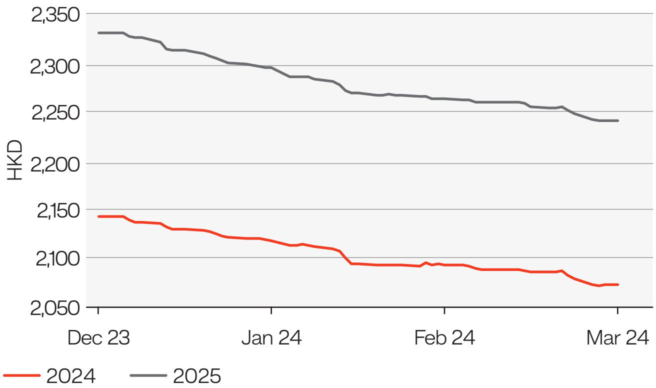
On the other hand, the bottoming out of A-shares and Hong Kong stocks in January this year was largely attributable to the "national team" funds. As anticipated in last quarter's "Striving Ahead" section, the Central Government will adopt a multi-pronged approach to increase the proportion of medium- to long-term capital allocation to equity assets, which has been realised in various ways over the past three months, including: i) Central Huijin has indicated that it will expand the scope and scale of its holdings of ETFs; ii) the China Securities Regulatory Commission (CSRC) has announced that it will steer active various types of institutional investors, such as public equity funds, private equity funds, securities firms, social security funds and insurance institutions, into the market for active participation; iii) the SASAC has announced that it will launch a market capitalisation assessment for SOEs, encouraging them to optimise the return on medium- to long-term capital investments through higher dividend payouts or share buyback ratio. The "national team" has played a pivotal role in safeguarding market stability. Their strategic accumulation of A-share index ETFs has resulted in record net capital inflows into these ETFs in recent months. According to Bloomberg's data as of March 22, the ETF products tracking the CSI 300 Index and the CSI Smallcap 500 Index have recorded net inflows of USD36 billion and USD6 billion respectively for the year. These amounts represent approximately 60% and 76% of their net inflows over the past year, reflecting the heightened involvement of the "national team" in the first quarter of 2024 as compared to that observed in 2023. However, historical patterns suggest that "national team" interventions occur primarily during periods of extreme market weakness or panic selling, aiming to acquire shares at lower levels rather than providing sustained upward momentum. Consequently, as market sentiment stabilises, we may witness a retreat of the "national team" funds. Whether the market can move up again or not, the participation of other types of capital is still crucial.

Adjusted Earnings Forecasts and Valuations for Hong Kong Stocks: HSI Target at 18,500 Points

Despite headwinds from a sluggish real estate market, persistent default risks among property developers and deleveraging efforts among local governments, which result into prolonged recovery period for corporate earnings, there are promising signs on the policy front in monetary, sectoral and capital markets. Additionally, the unwavering commitment of the "national team" funds to safeguard market stability has helped mitigate downward pressure on valuations.

In light of these dynamics, we have adjusted our earnings per share (EPS) forecast for the HSI this year from HK$2,170 of last quarter to HK$2,100, albeit slightly higher than the current Bloomberg market consensus of approximately HK$2,060. Turning to valuations, the HSI's forward price-to-earnings (P/E) ratio of approximately 8 times now, sits below the 10-year historical average by two standard deviations. However, we believe that certain catalysts could trigger a revaluation of Hong Kong stocks: i) interest rate cuts by US in mid-year; ii) strengthened stimulus by Chinese Mainland; and iii) improved China-US relations. Given these factors, we set a target forward P/E ratio of 8.8 times for HSI this year. Consequently, we adjust the HSI's 12-month target level from last quarter's projection of 19,500 points to 18,500 points.

YTD Trend of Hang Seng Index Earnings Forecasts



Source: Bloomberg, data as of 21 March 2024

Key Sectors to watch in the 2nd Quarter 2024:

Sectors/Thematic sectors	Key investment rationale	Bullishness#
Chinese Telecommunications	1. Benefiting from the accelerated digitalisation, AI large model training and expanded application scope in Chinese Mainland, the telecommunications industry, including emerging enterprise businesses such as cloud computing and data centres, recorded a 19% year-on-year growth in revenue in 2023, raising its revenue share to 21%. This upward trajectory is poised to continue, sustaining a higher growth rate this year. 2. China's Ministry of Industry and Information Technology (MIIT) said that this year, it will deepen the application of 5.5G technology, push forward 6G pre-research and accelerate the deployment of intelligent computing infrastructure. This sector is one of the key industries receiving policy support. 3. Capitalising on the peak of 5G capital expenditures and substantial operating cash flows, leading telecom operators are well-positioned to increase their dividend payout ratios to the range between 55% and 71% in 2023, with incremental increases anticipated over the next two years. Currently, related stocks offer forecasted dividend yields ranging from 6.2% to 8.0%. In a volatile market, they represent a prudent defensive choice.	****
Local High-dividend Equities (Utilities, Telecommunications, Transportation and Conglomerates)	1. The Fed's anticipated interest rate cuts, likely to commence this quarter, coincide with a well-established downward trajectory in US 10-year bond yields. Against this backdrop, local companies in utilities, telecommunications and conglomerates sectors offer compelling dividend yields ranging from 5% to 9%. 2. The results of the relevant companies are more visible. Most of the overseas utilities, such as electricity, water and gas supply, are protected by profit control agreements, with revenues linked to the inflation rate. Moreover, these firms boast robust balance sheets, positioning them to augment dividend distributions. Importantly, their ample room for leverage provides flexibility for potential future acquisitions. 3. Hong Kong's fiscal budget prioritises stimulating the local tourism industry through a series of high-profile events. Additionally, the inclusion of more Chinese Mainland cities in the Individual Visit Scheme is anticipated to bolster air and rail passenger traffic.	****
Industrial Equipment (Railway Equipment, LNG Heavy Trucks, machinery, power and Hydrogen equipment)	1. A wave of production equipment replacement driven by state policies, potential financial credit facilities or tax subsidies in the future and introduction of more stringent environmental requirements on energy consumption and emissions may stimulate sales of new-generation equipment for construction, transportation, industrial and energy 2. The National Energy Administration (NEA) released the "Guiding Opinions on Energy Work in 2024", aiming to increase the share of non-fossil energy power generation to 55% within this year. This directive aligns with broader efforts to advance the development of hydrogen energy industry. As a result, orders for relevant energy equipment are poised for growth. 3. Most of the leading enterprises in the industry have a state-owned enterprise background. Their balance sheets exhibit resilience, and they remain attractive to Chinese Mainland's long-term capital. Consequently, there exists ample room for upward valuation adjustments.	***
Online Gaming	1. In January of this year, the National Press and Publication Administration removed the draft Measures for the Administration of Online Games from its website. In addition, between October 2023 and February this year, the authorities granted an average of 115 new game licenses per month, surpassing the monthly average in 2021 (before the suspension of new licenses). This surge reflects a normalisation of the approval process, effectively mitigating policy risks. 2. The significant mobile game releases are expected in the second and third quarters this year. Notable titles include "Condor Heroes", "Where Winds Meet World", "NARAKA: BLADEPOINT", "Mobile DnF" and "Need for Speed". These games are expected to boost the recurring revenues of the leading companies and become the main driving force for earnings growth in the second half of the year. 3. Leading companies in the sector currently trade at an average P/E ratio of 14 to 16 times, well below the historical average. However, if the market responds favorably to the new game releases, there exists significant room for upward valuation adjustments.	***

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:

- The chilly season for A-shares and Hong Kong stocks has thawed, yet the path ahead remains capricious. Investors must exercise prudence on position sizing and risk diversification and prioritise stock selection
- The timely intervention of "national team" funds has resuscitated A-share and Hong Kong stocks. However, the trajectory hinges on the continued participation of overseas capital
- Our forecasted EPS for HSI this year is HK$2,100, with a projected P/E ratio of 8.8x, and the corresponding index target for the next 12 months is 18,500 points
- Sectors to watch this quarter include industrial equipment, online gaming, China telecommunications and local high-dividend concepts

Equity

BEA Union Investment – Investment Teams

Stay Invested: Asian Equities Offer Prospects for Growth and Profits

Given Asia's manageable inflation levels and sound economic fundamentals, opportunities abound in sectors with structural growth and development potential

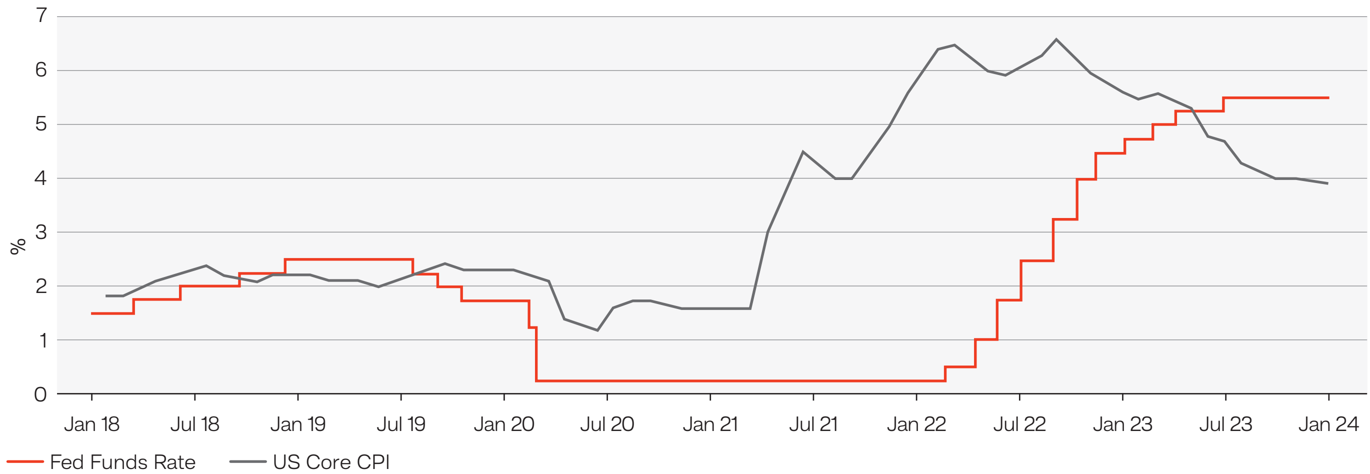
Market opinions on the timing of an interest rate cut by the Federal Reserve remain divided. The prevailing high-interest-rate environment is expected to persist until mid-year. While the US economy may experience a slowdown, its underlying resilience, coupled with steadily declining inflation, suggests an inevitable downward trajectory for interest rates. However, the pace of rate cuts remains elusive.

BEA Union Investment maintains its view that the high-interest-rate environment will continue until mid-year. We anticipate a robust GDP growth of 2.7% in the US and the positive economic fundamentals across Asia, which favor risk assets. Investors are advised to stay invested and maintain a balanced portfolio of both equities and bonds (for detailed bond analysis, please refer to our "Bond" section). Prudent allocation strategies can mitigate the erosion of portfolio value and enhance wealth appreciation.

While the timing of interest rate cuts remains uncertain, Asian assets, in particular, warrant close attention. The impact of interest rate-cutting cycle, along with the twin deficits (a fiscal deficit and a current account deficit) is expected to weaken the US dollar, favoring Asian markets. BEA Union Investment hold a bullish outlook for India and Indonesia. Sectors benefited from demographics structure, such as healthcare, infrastructure, consumer goods, banking and industrials, are overweighed. Additionally, we remain optimistic about technology stocks in Japan, Taiwan and South Korea. These sectors stand to benefit from the structural growth trends in artificial intelligence and cyclical recovery within the technology sector.

Tech Sector Thrives in Asia; Opportunities Re-emerged in South Korean and Taiwanese Tech Stocks

The tech industry is poised for massive growth potential, bolstered by both structural and cyclical growth dynamics. BEA Union Investment holds a bullish outlook for tech stocks across Japan, Taiwan, South Korea and the US, with a particular focus on Taiwan. The semiconductor recovery has commenced, with historical data suggesting growth could last six to eight quarters. Post-cyclical businesses, including ABF substrates, raw wafers and foundry space of the later recovery cycle are in focus. With the prospect of the bottoming out of stocks in this sector, data centres, memory chips, semiconductors and AI are set to propel the developments of personal computers and mobile phones. AI emerges as a multi-year thematic narrative, buoyed by mounting demand for AI-related semiconductors from tech giants and intensifying global competitions. Companies and nations already leading in this sector are poised for exponential growth in the coming years.



Source: BEA Union Investment, Bloomberg, data as of 31 January 2024

India and Indonesia: Structural Growth Potential with Favorable Prospects in Consumer, Banking, and Industrial Sectors

India and Indonesia are riding the wave of structural growth. Heavy infrastructure investments, coupled with a burgeoning labor force, bode well for local consumer and service industries, ranging from food and beverages to automobiles, hotels and healthcare. Additionally, banking, personal finance, and insurance stocks are poised for growth, as fueled by lending activities related to automobiles, housing and infrastructure.

Indian Prime Minister Modi's economic reforms, including corporate tax reductions and increased investments in infrastructure such as roads, renewable energy capacities and railways, signal optimism for industrial and raw material stocks in India.

Indonesia's metal and material stocks are likely to gain investor favour. Indonesia possesses the world's largest nickel reserves, a crucial material used in the production of electric vehicle batteries. The government's ban on nickel exports in 2019 has led foreign battery manufacturers to establish production facilities in Indonesia, resulting in substantial foreign investments and driving industry growth.

Both India and Indonesia will hold major elections this year. Currently, Prime Minister Modi's ruling party in India holds a leading position, contributing to a sustained optimistic investment sentiment. In Indonesia, the presidential election took place in mid-February. Prabowo Subianto, the current Defense Minister, won the presidential election, while the eldest son of incumbent President Joko Widodo will become the Vice President. Market anticipates continuity in Indonesia's favorable economic policies.

China's Structural Transformation Takes Time; Consumption, Value Stocks Eyed

The recently concluded "Two Sessions" saw the Chinese government setting targets for 2024 economic growth and deficit rates that are similar to those of the previous year. As a result, the market anticipates the need for more vigorous measures by the authorities to achieve these economic goals. China's recent bailout efforts have been in the spotlight, including the "national team" entering the market to stabilise investor confidence, and the People's Bank of China's drastic lowering of 0.25% for the 5-year Loan Prime Rate, far exceeding the market's expectation of 0.1%. Currently, China's economy is still undergoing structural adjustments, and the authorities are adopting a gradual policy approach to control the risks of economic downturn. However, economic recovery is expected to take time. Despite the uncertain economic outlook of China, which has affected consumer sentiment, certain leading consumer stocks have shown increased investment value in an environment of downgraded consumption. Moreover, China's value stocks with high dividend yields, such as energy and utilities, have gained favor from the BEA Union Investment team due to their solid fundamentals. Energy stocks, in particular, can serve as a hedge against geopolitical risks.

While the market faces uncertainties such as the timing of interest rate cuts, the pace of China's economic recovery and changes in the geopolitical landscape, risk assets will continue to gain ground as inflation eases. The prospects of a weaker greenback could act as an additional catalyst for Asian assets. As such, investors should stay invested ahead of the well-expected rate-cutting cycle. Given Asia's manageable inflation levels and sound economic fundamentals, opportunities abound in sectors with structural growth and development potential, especially in the tech space.

Chapter Summary:

- US's interest rate cut timeline remains uncertain, investors should stay invested. Asian assets to benefit from USD weakness expectations
- Favour equities, particularly Taiwanese and South Korean tech stocks
- Structural growth to boost India's and Indonesia's consumer, financial and industrial stocks

Bond

Spring Chill

Chief Investment Strategist, Wealth Management Division, The Bank of East Asia | **Frank Lee**
BEA Union Investment – Investment Teams

Bond

Chief Investment Strategist, Wealth Management Division,
The Bank of East Asia **Frank Lee**

Spring Chill

Orderly Extend Portfolio Duration and Highly-rated Corporate Bonds Exposure Amid Policy Uncertainty

Last quarter's title was "Waiting for the Dawn", subtly hinted at the Federal Reserve (Fed)'s eventual abandonment of interest rate hikes and its intension for interest rate cuts. Investors have long anticipated the arrival of this dawn, yet the fundamentals for interest rate cuts remain insufficient, particularly the economic growth of US remains strong. Following last year's bond market extremes, capital has positioned for an impending interest rate reversal. Once again, we successfully predicted the US 10-year Treasury yield's volatility range last quarter, along with the yield curve normalisation which occurs in the final phase of "Bear Steepening". Financial conditions and volatility in stocks and bonds signal that investors should begin reduce government bonds holdings and increasing exposure to corporate bonds. However, the risks associated with high-yield corporate bonds remain substantial, suitable only for investors with a higher risk tolerance. Lastly, regional analysis of bond market performance in Europe and the US is more reliable when rate cuts are being anticipated. Overall, our forecasts align closely with today's outcomes.

This quarter's title, "Spring Chills," captures the imminent inflection point in interest rates, akin to the unusual cold early spring day. Investors must remain cautious for sudden changes. Both bond issuers and investors have already become astute to the Fed's policy maneuvers and have devised their own strategies accordingly. While economic conditions and risk aversion signal an impending interest rate cut, it's essential to temper excessive optimism. The expected interest rate reduction is likely to be mild, diverging from some overly bullish expectations. Turbulence is expected on the path to interest rate cuts. Although the projected volatility range for US Treasury yields has slightly narrowed compared to last quarter, the downward trend is unlikely to reverse. It is advisable to seize the opportunity to lock in higher yield of bonds as early as possible. As yield spreads gradually narrows, investors should consider increasing their exposure to corporate bonds while employing a barbell strategy to balance and orderly extend the duration of their bond portfolios. The landscape after interest rate cuts remains uncertain, but that's another story for another day.

Market Dynamics: Policy Volatility Spurs Preemptive Capital Moves

When will the Fed announce its first interest rate cut? This is the pressing question on the minds of global investors. Today, there's no definitive answer, not even from Fed Chair Powell. Since July of last year, the federal funds rate has remained at 5.5%, while major central banks worldwide have followed suit, gradually tightening liquidity. Consequently, concerns about tight global liquidity are gradually coming to the fore. From the pressure on local banks in Europe and the US to the faltering commercial real estate market, and from the signs of weakening consumer discretionary sector to the polarisation of the investment market, major central banks are compelled to consider the necessity of maintaining high interest rates. Among them, Powell has restated that it would be appropriate to start rate cut at some point this year, and the European Central Bank (ECB) has indicated a high likelihood of its first rate cut in June[1], while Bank of England Governor Bailey expresses confidence in an interest rate cut within the year[2]. Although a minority of Fed members and market participants advocate for maintaining the current interest rate or even considering further interest rate hikes, these recommendations remain inconclusive.

Recently, the People's Bank of China (PBOC) lowered the 5-year and above Loan Prime Rate (LPR) by 25 basis points, the largest reduction ever. On the other side, the Bank of Japan (BoJ) contemplates ending its negative interest rate policy implemented since September 2016. However, this initiative is rooted in Japan's own context, so details will not be discussed here. The following discussion is focused on the context of interest rate cuts and the perspective from the global macro-economy, not just the US economy.

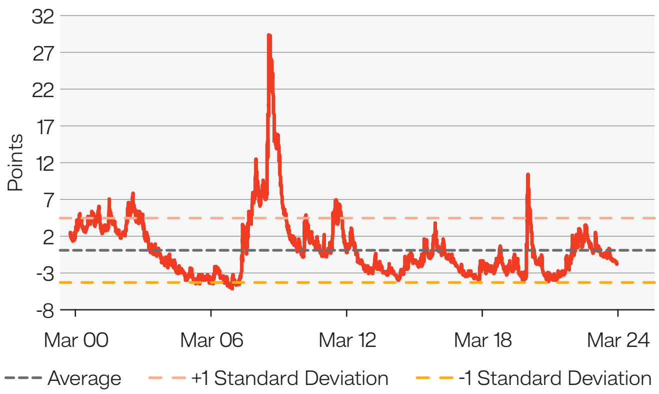
1 See CNBC website, https://www.cnbc.com/2024/03/07/european-central-bank-holds-interest-rates-cuts-inflation-and-growth-forecasts.html
2 See Reuters website, https://www.reuters.com/world/uk/bank-englands-bailey-sees-signs-uk-economy-upturn-2024-02-20/

Liquidity Data Reflects Lack of Urgency for Interest Rate Cuts

Is market liquidity excessively tight? According to a February poll by the National Association for Business Economics[3], 21% of respondents believe the Fed's current monetary policy is "too restrictive". This figure has surpassed the 14% recorded in March and August last year, marking a new high since 2011. In addition to the financial difficulties faced by US regional banks in recent months, liquidity concerns have also begun to impact Europe and Japan. Europe has witnessed a wave of bankruptcy announcements from major corporations in sectors such as real estate development, retail, shopping centers and department stores. Meanwhile, Japan has seen a rise in the number of corporate insolvencies for two consecutive years, reaching a 31-year high. Last year's increase in bankruptcies surpassed 30% compared to the previous year[5].

Interestingly, while public sentiment leans pessimistic about the economic outlook, macro data shows a contrasting picture. The US Office of Financial Research (OFR), established under the Dodd-Frank Act, aims to enhance the US government's crisis response capabilities through data analytics. It has also established an alert system to identify systemic risks promptly. The Financial Stress Index (FSI) is a daily measure of financial market stress levels, derived from the variables such as yield spreads, valuation indicators and interest rates in 33 global financial markets. A value below 0 indicates low stress, conversely, a higher value suggests increased stress. As of 7 March this year, the FSI stood at -1.821, significantly lower than the average of approximately +0.160 since 2000. While the index has not reached a level that is negative one standard deviation, which is approximately -4.108, this suggests the liquidity-induced systemic risk remains remarkably subdued. This is not the most reassuring level seen over the years, but it reflects central banks' lack of urgency to reverse liquidity tightening.

Financial Stress Index

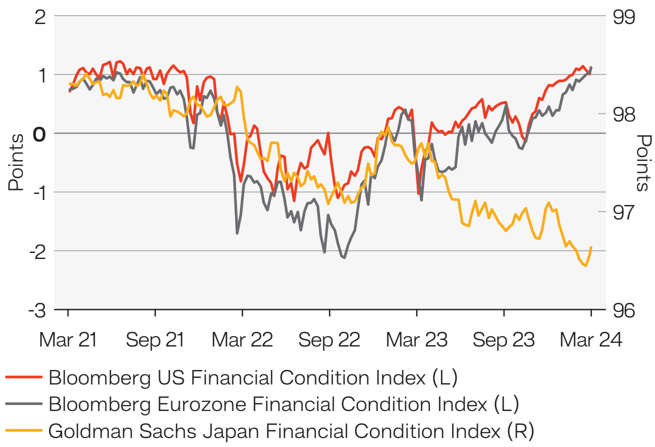


Source : The US Office of Financial Research, data as of 7 March 2024

Looking at the Financial Conditions Index, a gauge of financial stability across various regions, a reading of 0 (Bloomberg Index) or 100 (Goldman Sachs Index) above signifies ample liquidity, and vice versa. Data for the past three years ending 13 March this year show that the Financial Conditions Index for the US and the Eurozone have nearly returned to the levels observed during the 2021 pandemic, indicating a notable improvement from the low point witnessed in 2022. These indices reflect a consideration of extreme risks, suggesting that there is no urgency for central banks in the US and Europe to ease liquidity. Instead, they should channel capital flows to businesses orderly, rather than keeping capital locked within their respective banking systems, which stifles capital growth.

However, the financial situation in Japan raises concerns as its respective Financial Conditions Index has been declining for three consecutive years. This persistent decline underscores the fact that, despite the implementation of quantitative easing and negative interest rate policies over the years, the local liquidity problem remains unresolved. One of the primary reason to this issue is the negative interest rate policy, which has compelled private market funds to exit the local financial system. The substantial interest rate arbitrage have created difficulties for local enterprises in obtaining loans, contradicting the initial intent of the policy. In response to these challenges, the BOJ has expressed its intention to exit the negative interest rate policy. While this move is deemed necessary from the perspective of local liquidity, it will undoubtedly impact beneficiaries of interest rate arbitrage.

Financial Condition Indices – US, Eurozone, Japan



Source: Bloomberg, data as of 13 March 2024

3 See Business Insider website, https://www.businessinsider.com/federal-reserve-interest-rates-cut-outlook-recession-risks-us-economy-2024-2
4 See Reuters website, https://www.reuters.com/business/retail-consumer/german-retail-giant-insolvent-wake-signa-collapse-property-crunch-2024-01- 09/
5 See Japan Times website, https://www.japantimes.co.jp/business/2024/01/15/business-failures-high/

Bond

Both Bond Buyers and Sellers Position for Rate Cuts

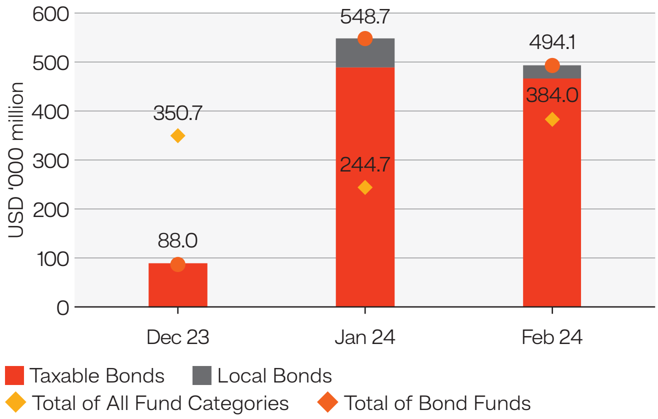
Although interest rate cuts have only been heard of, market participants have already started to get well-positioned for the interest rate cuts. As market sentiment becomes more optimistic, companies are seizing the opportunity to issue a substantial amount of debt. Data from the US Securities Industry and Financial Markets Association (SIFMA)[6] as of February this year reveals that corporate bond issuances in the first two months for the year reached $454.7 billion (USD, same below), marking a 31.1% year-on-year increase. In February alone, issuances amounted to nearly $230 billion, the highest level in almost a year, with investment-grade bonds accounting for over 85% of the total. The daily trading volume in the US corporate bond market has reached $53.6 billion, showing a year-on-year increase of 13.6%. Furthermore, the outstanding amount of corporate bonds (as of the fourth quarter of last year) stands at nearly $10.8 trillion, reflecting a 3.0% year-on-year increase.

These findings align with the estimates provided by the rating agency Fitch. According to Fitch's February report[7], approximately $759 billion (14%) of the nearly $5.6 trillion of US investment-grade bonds will mature within this year and the next, with around $332.0 billion maturing this year and approximately $427.0 billion next year. Despite the uncertainty surrounding the Fed's interest rate policy, it is anticipated that a significant portion of these corporate bonds will be refinanced, thereby providing substantial supply to the investment-grade bond market throughout the year.

Significant supply must also be met with robust demand

Fund investors are driven by the pursuit of returns. Referring to the fund flow data of US registered long-term funds and exchange-traded funds (ETFs) provided by the Investment Company Institute, as of 12 March this year, bond funds have consistently recorded net inflows in the past three months, with January and February outpacing the cumulative inflows across all fund categories. This indicates a shift of long-term and passive funds to the bond market when US equities were on a positive trend. The total inflow into bond funds over the past three months stands at approximately $113.1 billion (USD, same below), a staggering 16% higher than the combined inflow across all fund categories, approximately $97.9 billion. Among bond funds, the vast majority of inflows were into taxable bonds, mainly corporate bonds, which accounted for nearly 92% of the total inflows over the same period. Most notably, in February, net inflows into taxable bond funds were nearly 17 times higher than those into local bond funds, reflecting the pursuit of reliable and higher-yielding assets, driven by expectations of future interest rate cuts.

Monthly Fund Flows of US-registered Long-term Funds and ETFs



Source: Investment Company Institute, data as of 12 March 2024

EPFR, a US-based company specializing in providing data on fund flows of investment funds and asset allocations of financial institutions worldwide, has released its February report[8]. The report highlights a continuous influx of funds into the bond funds tracked by EPFR, with over USD 10 billion flowing in for four consecutive weeks. Among which, US bond funds attracted the highest fund inflows. Global and European bond funds recorded 16 and 17 consecutive weeks of net inflows respectively. Asia-Pacific bond funds recorded the largest weekly inflows since early October last year, while Canadian bond funds saw a 12-week high in fund inflows. However, emerging market bond funds recorded net outflows for the seventh time this year, marking the third consecutive net outflow for global emerging market bond funds.

By bond category, both high-yield bond funds and municipal bond funds posted net inflows for the eighth consecutive week, while convertible bond funds recorded outflows for the eighth consecutive week, reflecting that investors are reducing their equity-related positions. In addition, it is worth noting that European corporate bond funds recorded the largest one-week outflow since the fourth quarter of last year.

Overall, there is a significant influx of funds into bond funds, with highly-rated bonds of mature countries being more sought after.

Interest Rate Forecasts: Caution Against Over-Aggression

For details on forecasting the Fed's future interest rate policy based on economic data forecast, please refer to the "Macroeconomics" section. The following is an analysis from the perspective of the investment market. Traditionally,

[6] See US Securities Industry and Financial Markets Association website, https://www.sifma.org/resources/research/us-corporate-bonds-statistics/
[7] See Fitch Ratings website, https://www.fitchratings.com/research/corporate-finance/us-investment-grade-bond-market-monitorsemi-annual-update-16-02- 2024
[8] See EPFR website, https://epfr.com/insights/global-navigator/what-price-peace-and-interest-rate-cuts-bond-fund-flows-equity-fund-flows-money -market-fund-flows-esg-fund-flows-investor-sentiment-financial-markets-data/

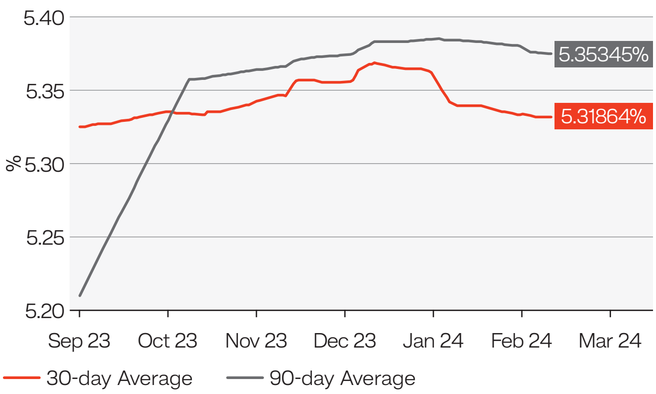
interest rate cut is favorable for the bond market. However, factors such as the timing, magnitude and trend changes associated with the first interest rate cut can affect investment strategies, particularly the portfolio allocation of medium and long-term funds. The following is a detailed analysis of these factors.

Timing Forecast for the First Rate Cut: Imminent

The market typically relies on gross domestic product (GDP) or consumer price index (CPI) to forecast the timing of the first interest rate cut. Last quarter, the historical inflection points from interest rate hike to interest rate cut was analysed, which were mostly related to economic downturn, rather than the inflation concerns emphasised by the Fed Reserve members today. For detailed analysis, please refer to the "Bond" section of last quarter. In this quarter, we will analyze the treasury market and historical data to estimate the timing of the first interest rate cut.

Changes in the treasury market are a more sensitive indicator of interest rate trends. Referring to the Secured Overnight Financing Rate (SOFR) that has been very sensitive to interest rate trends in the past six months, we analyse the 30-day and 90-day averages and compared their trends to minimise the impact of daily fluctuations. The results show that the 90-day average peaked at 5.36146 on 29 January this year, followed by a pullback, reflecting a shift in the treasury market's medium-term view of maintaining high interest rates, while the 30-day average peaked at 5.34835 on 4 January, followed by a slump, suggesting that short-term funds believe that interest rate cut is no longer in doubt. The two data reached their peaks at a time difference of about 25 days, reflecting that funds have only recently changed their views on maintaining high interest rates. Furthermore, both data peaks occurred before the Fed's interest rate meeting on 31 January, suggesting that the market's anticipation of an interest rate cut this year was established prior to the interest rate meeting. This implies that neither the comments made by Fed committee members nor the economic data had any impact on the treasury market's speculation for nitiating an interest rate cut within this year.

Average USD SOFR – 30 & 90 days



Source: Bloomberg, data as of 12 March 2024

In addition to the current interest rate changes, we can also make reference to the Fed's interest rate policies over the years. Excluding the data of 2023, there have been 11 cases in the past 50 years where there were three consecutive interest rates cuts after interest rates peaked. The number of months between the peak and the first interest rate cut are as follows:

Year	Number of months	Year	Number of months
1974	4	1991	3
1980	0	1998	17
1982	0	2001	7
1984	1	2007	14
1985	0	2019	6
1990	2		

Source: Bloomberg, data as of 14 March 2024

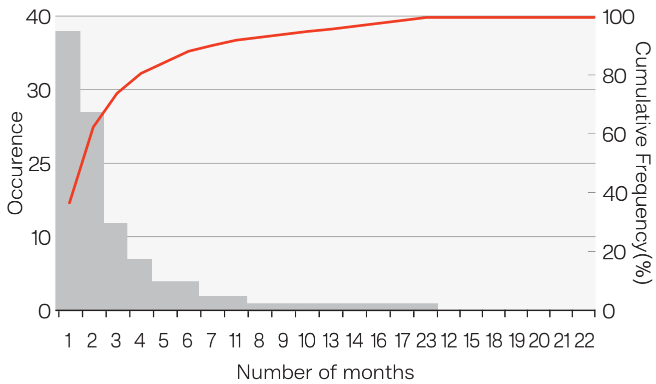
The average duration between the interest rate peak and the first interest rate cut is 4.6 months. The instances where the interest rates remained unchanged for more than a year were in 1998 and 2007, both preceding global financial crises. As of 13 March this year, interest rates have remained unchanged for about 8 months, significantly surpassing the historical average. This extended waiting time for an interest rate cut is the third longest in years, potentially signaling a forthcoming financial crisis.

If we simply count the number of months when the interest rate is kept unchanged and then express it with cumulative frequency, it was found that in the past 50 years, the total number of months when the interest rate was kept unchanged was 105 months, with an average value of 4.16 months. The majority of cases (62%) saw interest rates unchanged for only 1 or 2 months, with 38 and 27 occurrences respectively. The number of occurrence for other duration when interest rates remained unchanged is significantly lower. Instances of interest rates remaining unchanged for more than 8 months is rare, with only one occurrence observed. The longest duration of unchanged rates was recorded in 2009, lasting for 83 months, followed by 23 months in 2020. Excluding the influence of extreme values, the more informative figure is the cumulative median, at around 1.4 months.

When considering the duration of the interest rate cycle, the average number or cumulative median of months with unchanged interest rates, the practice of maintaining interest rate unchanged for 8 months today is rare. Given such rarity, it would not be surprising to see the first rate cut in the near future.

Bond

Title: Number of Months with Unchanged Interest Rate and Frequency of Occurrence*



Source: Bloomberg, data as of 12 March 2024
*Excluding the extreme value of 2009

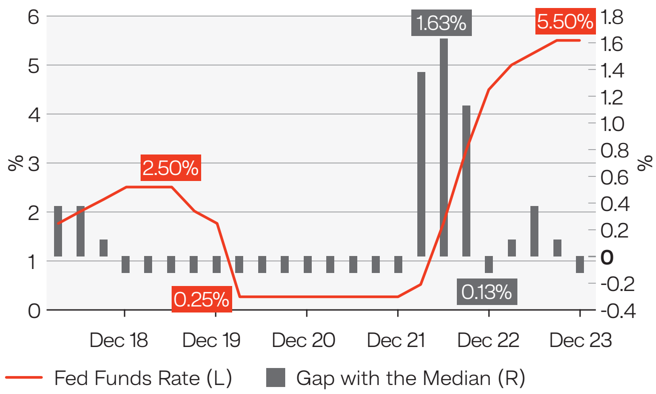
Forecasting Magnitudes: The Paradox of the Dot Plot

The interest rate dot plot is based on the annual target interest rate voted by Fed's committee member, and median is used to express their expectation for the annual interest rate of that year. The Fed held a new round of interest rate meetings on 20 March this year, and the market focus was on the quarterly revised interest rate dot plot. The dot plot is based on the votes of all Fed members on the annual target interest rate, with the median reflecting their collective outlook of the interest rate of the year. The dot plot in March this year showed that the median interest rate this year is 4.625%, compared to the Fed Funds Rate ceiling of 5.5% as of 22 March, a difference of 0.875%, suggesting that the Fed will start cutting interest rates this year. Market consensus suggests that there may be three rate cuts totaling 75 basis points throughout the year, assuming a 25-basis-point cut each time.

However, the Fed has often been criticised for the substantial disparity between the interest rate level indicated by the dot plot and the actual interest rate changes over the course of the year. Not only does this increase the investment risk in the market, but it also creates uncertainty for businesses, homeowners and consumers in the private market.

Just how inaccurate are the interest rates indicated by the dot plot? We have extracted the median of the dot plot for each quarter since the current Fed Chairman Powell took office in 2018 to the fourth quarter of last year, and have compared such data with the Fed Funds Rate at that time. The results show that there is a gap in all 24 quarters, reflecting that the median has not accurately reflected the actual interest rate level once. The average value and standard deviation are 0.16 and 0.51% respectively, and the difference between the two is nearly three times, reflecting high volatility. Looking at the trend, during periods of interest rate hikes, the difference between the median and the actual interest rate is more pronounced, peaking at 1.63%. On the contrary, during the period of interest rate cut of unchanged interest rate, the difference generally ranges from -0.13% to -0.15%, indicating that when the interest rate is cut, the actual magnitude of interest rate cuts tends to exceed the median's predictions. On this basis, if the final March dot plot remains unchanged, the rate cut could be in the range of 75 to 100 basis points for the year.

Fed Funds Rate and the Difference Between the Median of Dot Plot and Real Interest Rate



Source: Bloomberg, data as of 14 March 2024

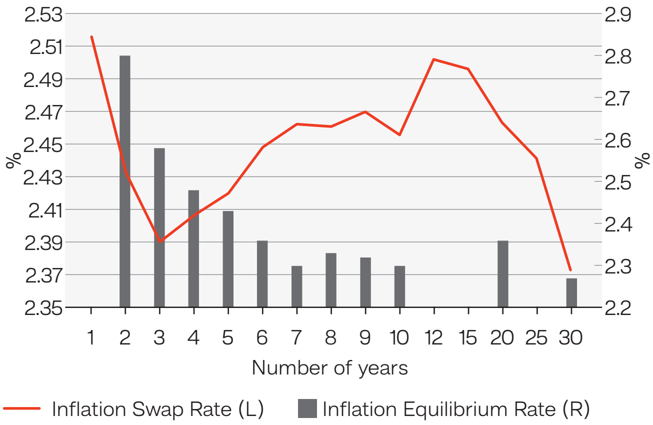
Trend Prediction: A Bumpy Downtrend

In addition to using short-term interest rate changes to predict the timing of the first interest rate cut, medium- and long-term interest rate fluctuations can offer insights into the future trajectory of interest rates under the influence of inflation. As of 14 March this year, referring to the trend of the US dollar inflation swap rate, which reflects a medium-term funds bias, it shows that the market expects inflation will fall gradually from about 2.52% to 2.39% over the next three years. While the projected decrease of 13 basis points may seem modest, it indicates that the treasury market is already preparing for a potential interest rate cut of at least 25 basis points. Moreover, the fluctuating trend of interest rates across different durations, with periods of ascent (for instance, 3-15-year interest rates) followed by declines (after 15-year uptrend), suggests that inflation is not likely to linger at low levels for a long period of time. While it may not rebound to previous highs, the market anticipates fluctuations will keep inflation from reaching the Fed's 2% inflation target.

Examining the changes in inflation equilibrium rate over difference years, which focuses on long-term funds bias with one-month average to mitigate daily fluctuations, the initial trend of inflation equilibrium rate supports the expectation of a decline in inflation from 2.8% to 2.3%, followed by erratic movements ranging between 2.27% and 2.36%. This reflects the expectation of long-term funds for cooling inflation, despite a smaller decline of approximately 50 basis points which will still fall short of Fed's target.

It is important to note that interest rate changes can reverse overnight. However, before the Fed's interest rate meeting and the revision of dot plot by the end of March, the treasury market still holds the view that interest rate cuts are imminent, albeit potentially not as prolonged and aggressive as the mainstream market speculated.

Inflation Swap Rate and Inflation Equilibrium Rate (1-month Average)



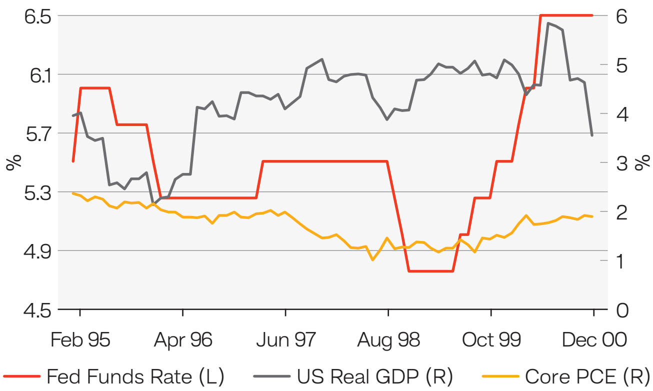
Source: Bloomberg, data as of 14 March 2024

In addition to treasury market analysis, a comprehensive understanding of fundamental economic data are indispensable. Last quarter's analysis showed that the trend of interest rates after interest rate cuts is largely affected by the economic situation. After all, maintaining GDP and CPI at manageable levels is the primary task of the Federal Reserve.

As of 12 March this year, Bloomberg's forecasts for the real GDP growth of the US for the four quarters of this year are 2.9%, 2.6%, 1.7% and 1.3% respectively, with an annual high-low difference of about 1.6%. While the economy is not expected to enter a recession, these figures suggest an upcoming "soft landing" scenario. The Core PCE is forecasted to rise by 2.6%, 2.3%, 2.3% and 2.3% respectively over the same period, indicating a gradual decline in inflation throughout the year but falling short of the Federal Reserve's 2% target. Based on the current US Fed Funds Rate ceiling of 5.5%, the real interest rates (calculated by subtracting inflation from nominal interest rates) is estimated to hover between 2.9% and 3.2%. Historically, real interest rates need to align with the real economy to support long-term economic growth. Extremely high or low rates can have adverse effects. Simply put, if the US economy avoids a "hard landing," the Fed will not have sufficient justification for a significant interest rate reduction. Unless unexpected events occur, the Fed will likely proceed with caution when considering interest rate cuts.

A comparable period to the current situation is the period between 1995 and 2000, when core personal consumption expenditure (PCE) decreased from 2.4% to 1.0%, and real GDP declined from 3.9% to 2.1% before rebounding to 4.2% within two years. During that time, interest rates experienced both decreases and increases, with a fluctuation of only 50 basis points. It was not until the Asian financial crisis in 1998 that US interest rates sharply dropped by 70 basis points and remained at that level for less than a year. Subsequently, in line with the steady growth of the US economy and the rebound in core PCE, interest rates began to rise consistently.

US Fed Funds Rate, Core PCE and Real GDP – 1995 to 2000



Source: Bloomberg, data as of 12 March 2024

In summary, it is highly likely that the Fed will initiate interest rate cuts in the coming months, although the magnitude may not be as aggressive as expected by the market. From historical patterns to treasury market predictions, interest rate trend is often influenced by economic fluctuations. While a slight interest rate hike cannot be ruled out, it is not expected to reverse the overall trend of interest rate cuts. Barring unforeseen events, inflation is projected to decline in an orderly manner, but it is unlikely to reach the Fed's target level of 2%.

Bond

Investment Strategy: Prioritising Investment-Grade Corporate Bonds

After analysing the trend of interest rates, the next step is to forecast various yields, including the projected volatility range, trends and the corresponding weighted duration and rating within the bond portfolio. Each of these factors will be analysed below.

Projected Volatility Range of Yields: Slightly Lower than Last Quarter

Last quarter, the US 10-year Treasury yield was forecasted to fluctuate between 3.76% and 4.46% from different perspectives. As of 14 March this year, the actual quarterly range was between 3.88% and 4.32%, with a difference of only 0.12 and 0.14 percentage points from the upper and lower ends of the predicted range, indicating a fairly accurate forecast. For this quarter, a similar analytical framework will be employed with minor adjustments (for detailed analysis, please refer to last quarter's "Bond" section).

Firstly, let's consider real interest rates. The real rates of Fed Funds Rate and the US 10-year Treasury yield can be calculated by subtracting the core PCE, which the Fed uses as an inflation indicator. Currently, the Fed Funds Rate ceiling is set at 5.5%. Subtracting the anticipated 75 basis points interest rate cut indicated by the dot plot for this year and then subtracting Bloomberg's forecasted core PCE of 2.3% for the next three quarters, the resulted real Fed Funds Rate would be 2.45%. Based on the average difference of 1.24% between the real Fed Funds Rate and the real US 10-year Treasury yield over the past 30 years data, the real US 10-year Treasury yield is extrapolated to be 1.21%. Adding the forecasted PCE to this value, we arrive at a projected nominal US 10-year Treasury yield of 3.51%. Comparing this projected value with the nominal US 10-year Treasury yield of 4.24% as of 14 March, it implies a decrease of approximately 73 basis points in the US 10-year Treasury yield over the year, aligning closely with the previously mentioned expectations for interest rate cuts.

Over the past 30 years, the average difference between the real Fed Funds Rate and the real US 2-year Treasury yield has been -0.26%. Consequently, the nominal US 2-year Treasury yield is extrapolated to be 5.01%. Compared this projected value with the nominal US 2-year Treasury yield of 4.66% as of 14 March, it implies a decrease of approximately 35 basis points in the US 2-year Treasury yield over the year. This magnitude of interest rate cut is lower than that of the US 10-year Treasury yield, indicating that the yield curve inversion is unlikely to be resolved in the short term.

Furthermore, referring to the analysis from the last quarter, it has been observed that in the interest rate cycle of past 50 years, both the US 10-year and US 2-year Treasury yields generally fell before the first interest rate cut, with a decrease of approximately 43% and 52% more than the final interest rate cut in Fed Fund Rate. Excluding the extreme data of 1976, the ratio is approximately 47% and 51%. Based on the analysis mentioned earlier, with the US 10-year and US 2-year Treasury yields of 4.24% and 4.66% reported respectively on 14 March and the anticipation of a 75 basis points interest rate cut during the year, the US 10-year and US 2-year Treasury yields are extrapolated be around 3.92% and 4.27% respectively. If we exclude the data of 1976, the extrapolated yields would be approximately 3.89% and 4.28%.

Secondly, also referencing the analysis from the last quarter, historical data suggests that irrespective of the eventual outcome of interest rate cuts, the average declines in US 10-year and 2-year Treasury yields before the first interest rate cut have been 1.20% and 2.10% respectively. Based on the US 10-year and US 2-year Treasury yields of 4.24% and 4.66% reported respectively on 14 March, the reasonable yields are extrapolated to be 3.04% and 2.56% respectively. Excluding the extreme data of 1976, the average declines would be 1.00% and 1.40% respectively, based on which, the reasonable US 10-year and US 2-year Treasury yields are extrapolated to be 3.24% and 3.26% respectively.

Finally, a polynomial linear regression model is utilised to project the theoretical levels of the two yields. Using quarterly data from the past 50 years as base, as of 14 March this year, and taking into account the risk factors, we utilize the Fed Fund Rate, YoY CPI and YoY GDP (being independent variables) and the US 10-year Treasury yield (being a dependent variable) to derive the comprehensive forecast via a three-dimensional matrix encompassing the following dimensions:

- Starting with the Fed Funds Rate of 5.5%, the variable is reduced to 3.75% by a 25-basis point magnitude per each reduction;
- Starting with a YoY CPI of 3.0%, the variable is reduced to 1.5% by a 25-basis point magnitude per each reduction;
- Starting with a YoY GDP of 2.5%, the variable is reduced to 1.0% by a 50-basis point magnitude per each reduction;

Projected Matrix of 10-Year US Treasury Yield

		Year-over-Year CPI (%)								Year-over-Year CPI (%)						
	GDP=2.5%	3.00	2.75	2.50	2.25	2.00	1.75	1.50	GDP=2.0%	3.00	2.75	2.50	2.25	2.00	1.75	1.50
Fed Funds Rate (%)	5.50	4.90	4.92	4.94	4.95	4.97	4.99	5.01	5.50	4.87	4.89	4.91	4.92	4.94	4.96	4.98
	5.25	4.75	4.77	4.79	4.80	4.82	4.84	4.86	5.25	4.72	4.74	4.76	4.77	4.79	4.81	4.83
	5.00	4.60	4.62	4.64	4.65	4.67	4.69	4.71	5.00	4.57	4.59	4.61	4.62	4.64	4.66	4.68
	4.75	4.45	4.47	4.49	4.50	4.52	4.54	4.56	4.75	4.42	4.44	4.46	4.47	4.49	4.51	4.53
	4.50	4.30	4.32	4.33	4.35	4.37	4.39	4.41	4.50	4.27	4.29	4.31	4.32	4.34	4.36	4.38
	4.25	4.15	4.17	4.18	4.20	4.22	4.24	4.25	4.25	4.12	4.14	4.16	4.17	4.19	4.21	4.23
	4.00	4.00	4.02	4.03	4.05	4.07	4.09	4.10	4.00	3.97	3.99	4.00	4.02	4.04	4.06	4.08
	3.75	3.85	3.87	3.88	3.90	3.92	3.94	3.95	3.75	3.82	3.84	3.85	3.87	3.89	3.91	3.92
	GDP=1.5%	3.00	2.75	2.50	2.25	2.00	1.75	1.50	GDP=1.0%	3.00	2.75	2.50	2.25	2.00	1.75	1.50
Fedl Funds Rate (%)	5.50	4.84	4.86	4.88	4.90	4.91	4.93	4.95	5.50	4.81	4.83	4.85	4.87	4.88	4.90	4.92
	5.25	4.69	4.71	4.73	4.75	4.76	4.78	4.80	5.25	4.66	4.68	4.70	4.72	4.73	4.75	4.77
	5.00	4.54	4.56	4.58	4.59	4.61	4.63	4.65	5.00	4.51	4.53	4.55	4.57	4.58	4.60	4.62
	4.75	4.39	4.41	4.43	4.44	4.46	4.48	4.50	4.75	4.36	4.38	4.40	4.42	4.43	4.45	4.47
	4.50	4.24	4.26	4.28	4.29	4.31	4.33	4.35	4.50	4.21	4.23	4.25	4.26	4.28	4.30	4.32
	4.25	4.09	4.11	4.13	4.14	4.16	4.18	4.20	4.25	4.06	4.08	4.10	4.11	4.13	4.15	4.17
	4.00	3.94	3.96	3.98	3.99	4.01	4.03	4.05	4.00	3.91	3.93	3.95	3.96	3.98	4.00	4.02
	3.75	3.79	3.81	3.83	3.84	3.86	3.88	3.90	3.75	3.76	3.78	3.80	3.81	3.83	3.85	3.87

Source: Bloomberg, data as of 14 March 2024

Projected Matrix of 2-Year US Treasury Yield

		Year-over-Year CPI (%)								Year-over-Year CPI (%)						
	GDP=2.5%	3.00	2.75	2.50	2.25	2.00	1.75	1.50	GDP=2.0%	3.00	2.75	2.50	2.25	2.00	1.75	1.50
Fedl Funds Rate (%)	5.50	4.33	4.34	4.36	4.37	4.39	4.40	4.42	5.50	4.29	4.31	4.32	4.34	4.35	4.37	4.38
	5.25	4.15	4.16	4.18	4.19	4.21	4.22	4.24	5.25	4.11	4.13	4.14	4.16	4.17	4.19	4.20
	5.00	3.97	3.98	4.00	4.01	4.03	4.04	4.06	5.00	3.93	3.95	3.96	3.98	3.99	4.01	4.02
	4.75	3.79	3.80	3.82	3.83	3.85	3.87	3.88	4.75	3.76	3.77	3.79	3.80	3.82	3.83	3.85
	4.50	3.61	3.63	3.64	3.66	3.67	3.69	3.70	4.50	3.58	3.59	3.61	3.62	3.64	3.65	3.67
	4.25	3.43	3.45	3.46	3.48	3.49	3.51	3.52	4.25	3.40	3.41	3.43	3.44	3.46	3.47	3.49
	4.00	3.25	3.27	3.28	3.30	3.31	3.33	3.34	4.00	3.22	3.23	3.25	3.26	3.28	3.29	3.31
	3.75	3.07	3.09	3.10	3.12	3.13	3.15	3.16	3.75	3.04	3.05	3.07	3.08	3.10	3.11	3.13
	GDP=1.5%	3.00	2.75	2.50	2.25	2.00	1.75	1.50	GDP=1.0%	3.00	2.75	2.50	2.25	2.00	1.75	1.50
Fedl Funds Rate (%)	5.50	4.26	4.27	4.29	4.30	4.32	4.33	4.35	5.50	4.22	4.24	4.25	4.27	4.28	4.30	4.31
	5.25	4.08	4.09	4.11	4.12	4.14	4.15	4.17	5.25	4.04	4.06	4.08	4.09	4.11	4.12	4.14
	5.00	3.90	3.92	3.93	3.95	3.96	3.98	3.99	5.00	3.87	3.88	3.90	3.91	3.93	3.94	3.96
	4.75	3.72	3.74	3.75	3.77	3.78	3.80	3.81	4.75	3.69	3.70	3.72	3.73	3.75	3.76	3.78
	4.50	3.54	3.56	3.57	3.59	3.60	3.62	3.63	4.50	3.51	3.52	3.54	3.55	3.57	3.58	3.60
	4.25	3.36	3.38	3.39	3.41	3.42	3.44	3.45	4.25	3.33	3.34	3.36	3.37	3.39	3.40	3.42
	4.00	3.18	3.20	3.21	3.23	3.24	3.26	3.27	4.00	3.15	3.16	3.18	3.19	3.21	3.22	3.24
	3.75	3.00	3.02	3.03	3.05	3.06	3.08	3.09	3.75	2.97	2.99	3.00	3.02	3.03	3.05	3.06

Source: Bloomberg, data as of 14 March 2024

Bond

The Confidence Interval of the above matrix is 95% and the Coefficient of Determination (R^2) is as high as 83% and 94% respectively, reflecting a high degree of confidence in the results unless the three economic data exceeds the pre-determined analysis range in the future. Based on the average and standard deviation derived from the matrix, the composite analysis for the US 10-year Treasury yield and the US 2-year Treasury yield are presented below:

GDP	Matrix (10-year)		Matrix (2-year)	
	Average	Standard deviation	Average	Standard deviation
2.5	4.43	0.35	3.75	0.42
2.0	4.37	0.35	3.68	0.42
1.5	4.40	0.35	3.71	0.42
1.0	4.34	0.35	3.64	0.42
Average	4.38	0.35	3.69	0.42

Source: Bloomberg, data as of 14 March 2024

Summarising the results of all the above analyses, the extrapolation of various scenario and the projected final value of the US 10-year and 2-year Treasury yields are set out as follows:

Analytical Indicators	US Treasury yields (%)	
	10-year	2-year
Real interest rate	3.51	5.01
Projected final value with anticipated rate reductions for the full period (full period)	3.92	4.27
Projected final value with anticipated rate reductions for the follow period (excluding the data of 1976)	3.89	4.28
Projected final value from the interest rate peak to the 1st interest rate cut (full period)	3.04	2.56
Projected final value from the interest rate peak to the 1st interest rate cut (excluding the data of 1976)	3.24	3.26
Regression analysis results (average)	4.38	3.69
Total average	3.66	3.85

Source: Bloomberg, data as of 14 March 2024

Unless economic data ultimately exceeds the predefined analysis range, the reasonable levels for the US 10-year and 2-year Treasury yields are extrapolated to be around 3.66% and 3.85% respectively. Additionally, within a fluctuation range of plus or minus one standard deviation, the US 10-year Treasury yield is projected to fluctuate between 3.31% and 4.01%, while the US 2-year Treasury yield is projected to fluctuate between 3.43% and 4.27%.

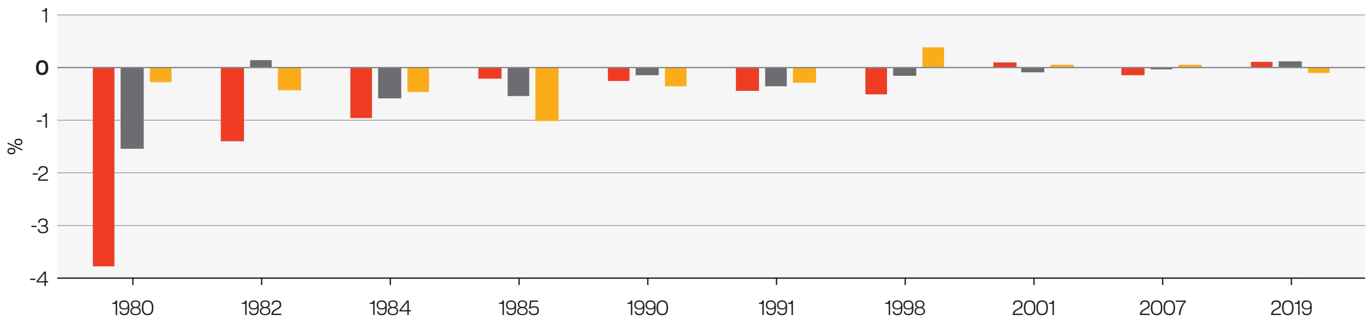
The overall results, both in terms of the average values and the fluctuation range, are slightly lower than those of the previous quarter. Revisions will only be necessary if there are significant fluctuations in the economy in the future, or if the Fed further elaborates its roadmap for interest rate cuts.

Yield Trend Forecast: The Early Bird Gets the Worm

It is a well-established understanding that interest rate cuts are favourable for the bond market, and being ahead of the curve is often the key to investment returns. Citing the scenario of 3 consecutive interest rate cuts, we will analyse the changes in the US 2-year and 10-year Treasury yields after these interest rate cuts. Examining the US 2-year Treasury yield data, we observe that the overall probability of recording decline in yields reaches nearly 77%, providing evidence in support of the theory that interest rate cuts generally favour the bond market. In terms of distribution per interest rate cut, the probability of recording decline in yields for the first two interest rate cuts is 80%, while that of the third interest rate cut is 70%. This indicates the significance of early investment, as the earlier one deploy investments, the higher the probability of receiving positive returns. In terms of distribution per period, before 1998, the overall probability of recording decline in yields is nearly 94%, while on the contrary, only 50% is recorded in 1998 or after. This indicates that interest rate cuts in modern times do not necessarily benefit the bond market. Additionally, the decline in yields has been less pronounced compared to the periods before 1998. The possible reason may be the persistent low interest rates and the diversification of financial products, which undermine the attractiveness of bonds.

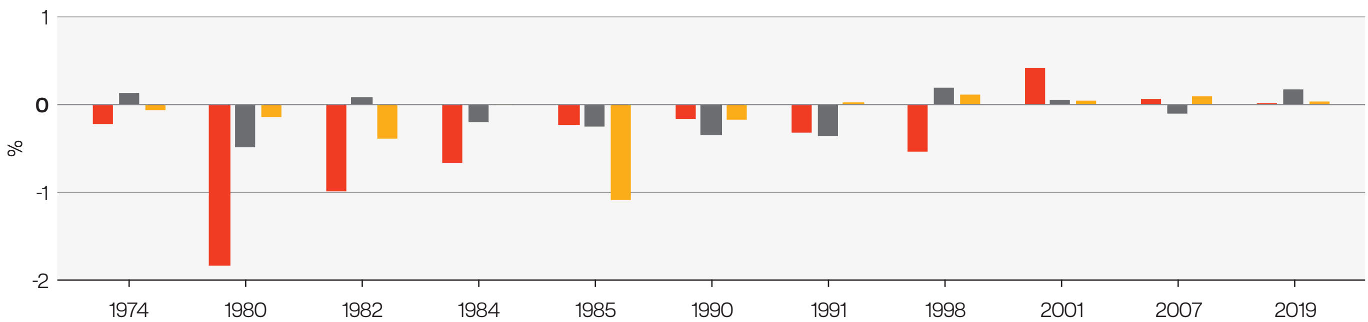
Applying the same analysis framework to the US 10-year Treasury yield data, the overall probability of recording decline in yields is only 61%, reflecting that the first three rate cuts may not be favourable to long-term treasuries. In terms of distribution per interest rate cut, the probability of recording decline in yields for the first interest rate cut is 73%, while that of the second and the third interest rate cuts is 55%. This reinforces the notion that early investment yields higher chances of positive returns. In terms of distribution per period, taking 1998 as the watershed year, the overall probability of recording decline in yields is nearly 86%, while on the contrary, only 17% is recorded after in 1998 or after. Such a substantial divergence alerts investors that initial interest rate cuts in modern times may not favor long-term bonds. It is worth noting that the traditional approach of extending the duration of bond portfolios during interest rate cuts should be exercised with caution in the initial stage of interest rate cuts to avoid unintended consequences.

Changes in US 10-year Treasury Yields Between the First and Third Interest Rate Cuts After the Peak of Interest Rates



Source: Bloomberg, data as of 14 March 2024

Changes in US 10-year Treasury Yields Between the First and Third Interest Rate Cuts After the Peak of Interest Rates

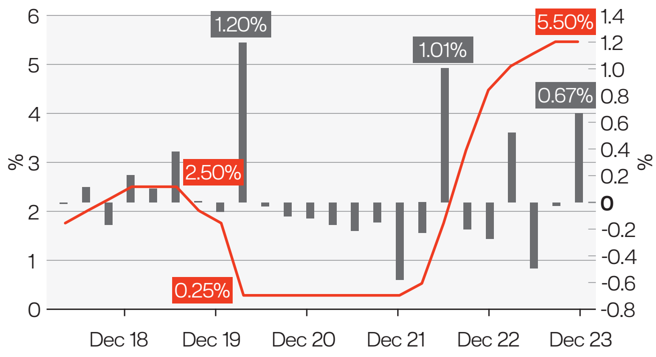


Source: Bloomberg, data as of 14 March 2024

Separately, we examine the notable differences between the actual interest rates and the median of the dot plot during current Fed Chairman Powell's tenure, which began in 2018. In this analysis, the question arises: will the inconsistent remarks of the current Fed's members disrupt investors' strategies? We refer to the differences between the Fed Funds Rate and the median of the dot plot from 2018 to 2023, which serve as indicators of the risk interest rate forecast, and subtract the quarterly changes in the US 2-year Treasury yield on US bonds to gain insights into the potential impact. A value of zero indicates that the market is entirely influenced by the remarks of the Fed's members, whereas negative values suggest that market sentiment and reactions are significantly affected by interest rate discrepancies, and vice versa.

The results reveal an overall negative ratio of 63%, indicating that the Fed has a dominant influence on investor sentiment. This can be attributed to Chairman Powell's skilled rhetoric in his post-meeting statements and the subsequent contradictory remarks made by the Fed's committee members, leaving investors uncertain about the appropriate course of action. Despite the Fed's challenge of well-established understanding and its overthrowing of its own previous stands, investors ultimately find themselves following the guidance of the Fed, highlighting the Fed's success in managing market expectations. The data also suggests that the market becomes increasingly sensitive to actual interest rate changes, particularly in 2020 and 2022 when interest rates rise and fall sharply, which induce strong reactions from investors. In recent months, the market has once again anticipated the Fed's initiation of the first interest rate cut. The pent-up anticipation accumulated over the past six months has made investors highly responsive to every piece of news, implying that as the inflection points of interest rates draws near, market volatility is bound to escalate. These findings align with our previous analysis, emphasising the need for investors to focus on risk management in the short term.

Relative Changes in Fed Funds Rate and 2-Year Yields



Source: Bloomberg, data as of 14 March 2024

Bond

Duration Deployment: The Barbell Strategy is Preferable

Anticipating a slight decrease in interest rates, it is crucial to strategically structure the duration of a bond portfolio, considering the significant variations in yield changes across different durations. What are the insights on the preparation for the upcoming interest rate cut?

Drawing on 30-year data of interest rate changes, combined with the performance of bond portfolios with different maturities in the Bloomberg US Aggregate Bond Index, we divide the data into five groups: 1 to 3 years, 3 to 5 years, 5 to 7 years, 7 to 10 years and 10 years and above. As only mild interest rate cuts are expected, the market consensus suggests three rate cuts totaling 75 basis points for the year. Consequently, our analysis focuses on the performance of each bond index during the first three interest rate cuts, evaluating their performance at 3 and 6 months after the initial interest rate cut, as well as 6 months after the cessation of the current interest rate cut. The results are presented in the table below:

3 months after the 1st interest rate cut	Magnitude of rates cuts (%)	Bloomberg US Aggregate Bond Index Performance (%)				
Year		1 to 3 years	3 to 5 years	5 to 7 years	7 to 10 years	More than 10 years
1998	-0.75	0.8	0.5	0.2	0.0	-0.2
2001	-4.75	1.9	1.6	1.4	0.9	**-1.0**
2007	-3.25	2.1	2.8	3.0	3.4	3.8
2019	-0.75	1.1	1.5	1.7	3.0	5.7
2020	-1.50	0.9	1.8	3.7	5.7	**6.2**
6 months after the 1st interest rate cut	**Magnitude of rates cuts (%)**	**Bloomberg US Aggregate Bond Index Performance (%)**				
Year		1 to 3 years	3 to 5 years	5 to 7 years	7 to 10 years	More than 10 years
1998	-0.75	1.6	1.2	0.2	-0.8	**-3.6**
2001	-4.75	4.2	4.5	4.3	4.2	3.9
2007	-3.25	4.6	5.2	5.5	5.4	4.6
2019	-0.75	1.9	2.8	3.1	5.4	**10.1**
2020	-1.50	1.0	2.1	4.5	7.1	7.5
6 months after cessation of interest rate cuts	**Magnitude of rates cuts (%)**	**Bloomberg US Aggregate Bond Index Performance (%)**				
Year		1 to 3 years	3 to 5 years	5 to 7 years	7 to 10 years	More than 10 years
1998	-0.75	1.5	0.8	0.1	-1.2	-4.9
2001	-4.75	2.6	3.9	4.2	4.5	3.1
2007	-3.25	0.2	-1.9	-3.3	-4.9	**-10.1**
2019	-0.75	2.6	4.0	4.7	4.6	**9.8**
2020	-1.50	1.0	2.1	4.5	7.1	7.5

Source: Bloomberg, data as of 15 March 2024

Firstly, the magnitude of the final interest rate cut does not significantly affect the performance of the five bond indices categorized by duration in terms of timing. This implies that even if the forecasted interest rate changes are not entirely accurate, it will have minimal impact on the future duration arrangements for bonds.

Secondly, among the three interest rate cuts, the performance of the five bond indices categorised by maturity reveals that both the highest and lowest returns are concentrated in the bond index with maturity of more than 10 years, regardless of the maturity after interest rate cuts. This reflects the conventional wisdom that longer-term bonds exhibit higher sensitivity to interest rate changes. Examining the interest rate cut magnitudes, smaller rate cuts correspond to higher returns, while larger rate cuts have a less impact on returns. This asymmetric performance suggests that investors harbor economic concerns regarding aggressive interest rate cuts, leading to conservative investment decisions. Consequently, a mild rate cut in the future is expected to benefit the performance of long-term bonds.

Thirdly, we ranked the performance of the five bond indices categorised by maturity for the five instances where there were three consecutive interest rate cuts over the past 30 years in descending order, calculating the number of times each bond index ranked the top. The results are as follows:

Point of Time	Number of times performance ranked as the top				
	1 to 3 years	3 to 5 years	5 to 7 years	7 to 10 years	More than 10 years
3 months after the 1st interest rate cut	2	0	0	0	3
6 months after the 1st interest rate cut	1	1	1	0	2
6 months after cessation of interest rate cuts	2	0	0	1	2
Total number of times	5	1	1	1	7

Source: Bloomberg, data as of 15 March 2024

The results clearly indicate that, regardless of whether interest rates were cut or ceased to be cut, the best performers in the short term were bonds with a maturity of 10 years or longer. However, the bond index with a maturity of 1 to 3 years also performed strongly, while the bond index with a maturity of 3 to 10 years lagged behind. This analysis confirms that longer-duration in bond portfolio are more advantageous for returns during the initial stages of interest rate cuts. However, in practical deployment, it is not advisable to directly invest in bonds with maturity of 3 to 10 years. Instead, taking a barbell strategy, by which a higher proportion of bonds with maturity between 1 to 3 years and 10 years or more are purchased, thereby shifting the weighted duration towards the middle range of the yield curve. This approach also addresses the significant volatility observed in the performance of the US 2- and 10-year bonds prior to interest rate cuts.

Bond Types: Narrowing Spreads Benefit Corporate Bonds

From the 2nd to 4th quarter of last year, we predicted that the US Treasury yield curve will show a "bear steepening" pattern, with the negative 10-year minus 2-year spread, the inverted yield curve expected to gradually normalize over time. When US interest rates peaked in July last year, this spread went from a maximum of about -108 basis points to a positive value, although it once again expanded after seeing a low level of -20 basis points, as of March 15 this year, the spread still hovered at the -40 basis point level. The performance is similar to last year's overall prediction.

In the future, when the first interest rate cut occurs, it is expected that the spread will orderly narrow until it disappears, completing the final stage of curve normalisation. Referring to the same data above, and focusing on the period of 3 and 6 months after the first interest rate cut, we examine the performance of Bloomberg US Treasury Bond Index and Bloomberg US Corporate Bond Index. Firstly, we analyze the movement of spreads, and the results are as follows:

Year	Magnitude of rates cuts (%)	The US 10-year minus 2-year Treasury yield difference (%)		
		3 months after the 1st interest rate cut	6 months after the 1st interest rate cut	Difference between the first 3 and 6 months after the 1st interest rate cut
1998	-0.75	-17.7	-3.3	14.4
2001	-4.75	55.2	68.2	13.0
2007	-3.25	39.0	123.6	84.7
2019	-0.75	2.3	4.7	2.5
2020	-1.50	8.4	13.3	4.9

Source: Bloomberg, data as of 15 March 2024

Bond

Based on the available data, excluding the year 1998, spreads have consistently increased in all other years, supporting the prediction that negative spreads will gradually narrow after this year's interest rate cut. The magnitude of the interest rate cut correlates with the magnitude of the rise in spreads. In contrast, the forecasted interest rate cut for this year is relatively mild, resulting in a more moderate increase in spreads. Importantly, in all five instances, spreads have risen in the 3 to 6 months following interest rate cuts. This indicates that while spreads may exhibit some volatility in the initial stages of interest rate cut, they tend to rise significantly after 3 months, implying a higher likelihood of the disappearance of inversion approximately 6 months after the first interest rate cut. This suggests that the completion of yield curve normalisation takes time.

Furthermore, last year's analysis recommended overweighting treasury bonds in bond portfolios due to the interest rate risks caused by the spreads and volatility from the yield curve, which subsequently affects the bond market. Increased instability will result in higher credit spreads for corporate bonds, with varying degrees of negative impact depending on their ratings. As investors seek hedging opportunities, funds tend to flow into treasury bonds. Therefore, increasing the allocation to treasury bonds was a preferred strategy.

However, as the yield curve normalisation enters its final stage, corporate bonds are expected to perform well, particularly investment-grade bonds outperforming higher-yield bonds. Drawing from the above analysis of narrowing spreads and historical periods, a comparison of the performance of US treasuries and corporate bonds across years, represented by the Bloomberg US Treasury Bond Index and Bloomberg US Corporate Bond Index respectively, are as follows:

Based on the available data, in four out of the five instances over the past 30 years when interest rates reached an inflection point, corporate bonds have outperformed both in the first three to six months after the interest rate cuts and after the three and six months. Only in 2007 did Treasuries outperform, which is likely related to the reason for the interest rate cut at that time. It is worth noting that these five inflection points occurred following significant global economic shocks, including the Asian financial crisis in 1998, the dot-com bubble in 2001, the financial tsunami in 2007, the Fed's consecutive interest rate hikes in 2019, and the global pandemic in 2020. Based on the analysis of the current financial conditions in the US and insights from "Macroeconomics" section, the likelihood of a financial tsunami similar to the one experienced in 2007 has been ruled out. Therefore, regardless of the future reasons that may prompt the Fed to cut interest rates, it is advisable for investors to increase their allocation to corporate bonds in their bond portfolios before the narrowing of interest rate spreads.

Year	Magnitude of rates cuts (%)	3 months after the 1st interest rate cut (%)		6 months after the 1st interest rate cut (%)		Difference between the first 3 and 6 months after the 1st interest rate cut (%)	
		Treasuries	Corporate bonds	Treasuries	Corporate bonds	Treasuries	Corporate bonds
1998	-0.75	-0.1	0.6	-1.8	-0.1	-2.1	-1.5
2001	-4.75	0.3	1.1	3.6	5.3	3.6	2.3
2007	-3.25	4.0	2.0	8.6	1.8	1.8	-15.1
2019	-0.75	2.6	3.1	4.2	6.1	8.0	2.0
2020	-1.50	0.5	9.0	0.6	10.7	0.6	10.7

Source: Bloomberg, data as of 15 March 2024

Finally, comparing each investment-grade rating (based on Moody's ratings) to the Bloomberg US Corporate High Yield Bond Index, with 1 indicating outperformance, the following analysis are as follows:

Year	Magnitude of rates cuts (%)	Performance by rating for the 3 months after the 1st interest rate cut (%)				Performance by rating for the 6 months after the 1st interest rate cut (%)				Difference between the first 3 and 6 months after the 1st interest rate cut (%)			
		Aaa	Aa	A	Baa	Aaa	Aa	A	Baa	Aaa	Aa	A	Baa
1998	-0.75	0	0	0	0	0	0	0	0	0	0	0	0
2001	-4.75	1	1	1	1	1	1	1	1	1	1	1	1
2007	-3.25	1	1	1	1	1	1	1	1	1	1	1	1
2019	-0.75	1	1	1	1	1	1	1	1	1	1	1	1
2020	-1.50	0	0	0	1	0	0	0	0	0	0	0	0

Source: Bloomberg, data as of 15 March 2024

Investment grade bonds have mostly outperformed the Bloomberg US Corporate High Yield Bond Index (around 62%), but not 100%, particularly in 1998 and 2020. The advantageous periods, especially at the inflection points of interest rates, were all related to the US market, including the dot-com bubble in 2001, the financial crisis in 2007 and the Fed's rate hike in 2019. The main risk factors in the future are AI frenzy and the consequences of last year's continuous rate hikes. In summary, investors should increase the proportion of investment-grade corporate bonds before the first interest rate cut.

Chapter Summary:

- While there is no urgency for interest rate cuts, the supply and demand sides of the bond market have already made their own deployment
- Undoubtedly, interest rate cuts will soon be initiated, but the magnitude is expected to be mild and the trend will be volatile
- The projected range for the US 10-year Treasury yield is between 3.31% and 4.01%.
- Portfolios should be adjusted by gradually extending the duration and early allocation to investment-grade corporate bonds

Bond

BEA Union Investment – Investment Teams

Asia's High-Yield Bonds Offer Investment Attractiveness, with India and Indonesia in the Spotlight

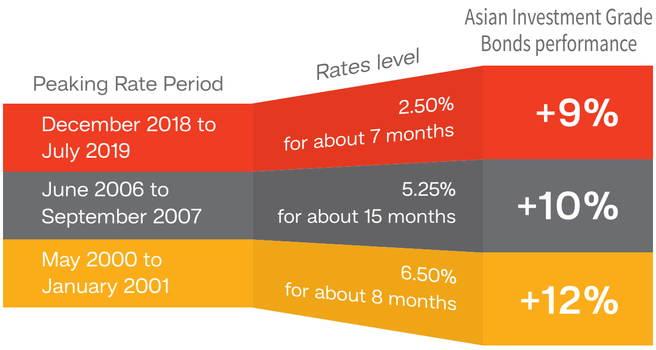
Investors should stay invested, maintain agility and seize opportunities arising from interest rate changes

Asia's investment-grade and high-yield bonds stand out as a resilient asset class with fundamental strength and enticing yields. Particularly in the context of controlled inflation across the Asian region and low financing costs for businesses, the relatively lower default risk for high-yield bonds provides support to the sector. BEA Union Investment holds a positive outlook for Asian high-yield bonds this year, which are deemed to create complementary benefits with investment-grade bonds. From a diversified asset allocation perspective, the team currently maintains a cautious stance on cash holdings.

Asia's Investment-Grade Bonds Offer High Yields, with China, South Korea and Indonesia in Favor.

Asian investment-grade bonds offer attractive yields, with an effective yield of 5.2%, compared to 4.5% for US investment-grade bonds. In terms of duration, Asian investment-grade bonds have a relatively shorter duration of 5.1 years, shorter than the duration of 6.5 years of US counterparts. Within the Asian region, investment-grade bonds from China, South Korea and Indonesia present numerous opportunities. These bonds not only offer appealing yields but also exhibit solid fundamentals.

Asian Investment Grade bonds started to rise amidst a period of interet rate plateau



Source: Bloomberg. Respective peaking rates data from 16 May 2000 to 2 January 2001; 29 June 2006 to 17 September 2007; and from 19 December 2018 to 30 July 2019 respectively. "Asian Investment Grade Bonds" is referred to ICE BofA Asian Dollar IG Corporate Index. The performance is not indicative of BEA Union Investment Asia Pacific Multi Income Fund.

China's technology, media, and telecommunications (TMT) sector investment-grade bonds are viewed favorably by BEA Union Investment due to reduced regulatory risks and relatively attractive valuations. Notably, the yield spread between A-rated and BBB-rated bonds is enticing. The team also sees potential for narrowing yield spreads between those bonds. The creditworthiness of state-owned enterprises with high yields and high beta has improved, making them worthwhile investments. We particularly favor 30-year long-term bonds due to their limited supply and strong market demand. Chinese investment-grade bonds denominated in US dollars are sought after by Asian and Chinese investors due to their limited supply and higher yields compared to onshore bonds. We believe this trend will continue to support the Chinese investment-grade bond market.

BEA Union Investment maintains a preference for South Korean investment-grade bonds, with a particular focus on the financial sector, including securities, insurance subordinated bonds and banks' additional tier 1 (AT1) bonds. These bonds are valued higher than similarly rated bonds due to their attractive valuations. The well-regulated securities industry in South Korea, backed by government support such as commitment in liquidity injection, further bolsters our confidence in South Korean securities firms. Overall, the industry exhibits sound liquidity management and access to domestic financing channels, within which major securities firms boast significant assets and employment, and stable business operations.

Indonesia's quasi-sovereign bonds, including government-backed entities in power and commodities sectors, offer another compelling investment-grade bond market. Indonesia have robust macroeconomic conditions with projected economic growth of 5.05% in 2023, controlled inflation and a positive and stable interest rate outlook. The country's healthy demographic structure and potential for structural economic growth contribute to optimistic corporate valuations. Indonesia's quasi-sovereign bonds also demonstrate positive technical factors. Comparing with sovereign bonds, the yield spreads for quasi-sovereign bonds could be narrowed, providing long-term investment potential. Our team favors Indonesian quasi-sovereign over sovereign bonds, particularly the 30-year ultra-long bond due to the limited supply.

Asian high-yield bonds exhibit robust quality, with a particular emphasis on India and Indonesia.

These bonds offer attractive yields alongside short durations. Additionally, Asia's relatively low inflation compared to Europe and the US contributes to low domestic borrowing costs. Corporates can efficiently raise funds domestically to repay offshore US dollar-denominated bonds, resulting in a reduced risk of default. Conversely, US companies issuing high-yield bonds face elevated interest rates, making financing costly and increasing default risk. Consequently, our team finds Asian high-yield bonds more appealing than their US counterparts, with India and Indonesia standing out.

Indian high-yield bonds offer diverse investment prospects across various sectors, including airports, steel and renewable energy. Passenger growth at two major Indian airports, along with completed capital expenditure cycles, supports the expected improvement of gearing ratios. Furthermore, airport operators are set to reduce their revenue splits with the government from April this year, which should drive performance. The team remains bullish on Indian renewable energy high-yield bonds. Domestic financing accessibility for Indian renewable energy companies, coupled with strong government support, ensures resilience within the industry. Many Indonesian companies effectively utilise domestic funding and cash on hand to prepay their US dollar-denominated bonds, which enhance debt management effectively. The team is particularly optimistic about Indonesian high-yield real estate bonds due to factors including ample access to financing, attractive valuations and government incentives. The Indonesian government's recent full exemption of property prices below 2 billion Indonesian Rupiah from the 11% VAT until June 2024, coupled with a 50% VAT reduction which remain effective after the deadline of the VAT exemption, further stimulates the domestic economy.

In respect of China's real estate high-yield bonds, despite the lingering weakness in China's domestic property market this February, there have been positive signs as private real estate developers have successfully divested assets or secured loan facilities from banks by collateralising commercial investment projects. BEA Union Investment will seek investment opportunities and strategically allocate resources to private developers with low short-term default risks. Additionally, attuned to the strong domestic travel demand and new financing sources, our team will increase allocations to travel-related high-yield bonds. In parallel, logistics bonds with solid refinancing capacity and strong asset sales are also part of our increased allocation strategy.

Conclusion

Asian countries have already ended their interest rate hiking cycles. Compared to the US, Asian corporates enjoy lower financing costs and solid fundamentals, making their high-yield bonds alluring. We anticipate a favorable performance for Asian high-yield bonds this year, complementing investment-grade bonds. Investors should stay invested, maintain agility, adapt their allocations and seize opportunities arising from yield fluctuations.

Chapter Summary:

- Asia's high-yield bonds outshine US counterparts
- China's ongoing structural adjustments warrant attention, particularly in the technology, media and telecommunications investment-grade bond

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