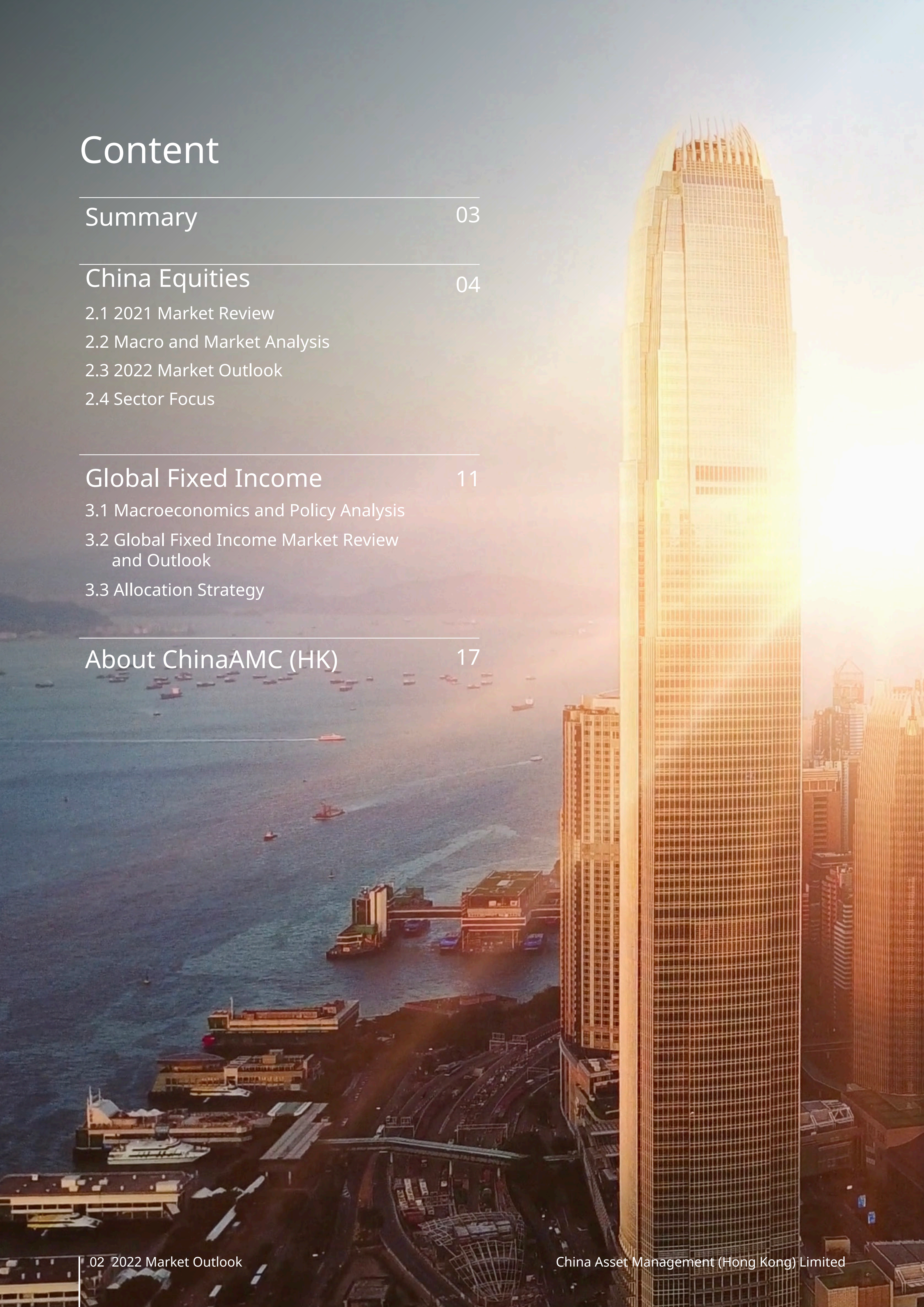
2022
Market Outlook

華夏基金(香港)
ChinaAMC (HK)



Content

Tian GAN

Chief Executive Officer

Despite the lingering pandemic, the global economy recovered strongly in 2021. While COVID-19 outbreaks might occur intermittently as new variants emerge, it's clear that the virus won't be paralysing global economic activities again as we near the end of the pandemic.

In 2021, the Chinese stock market lagged significantly behind major global markets as deteriorating Sino-US relations, the lingering COVID pandemic, the enactment of anti-monopoly laws targeting the tech sector and the real estate sector's credit risk pulled Chinese stocks downward. The green sectors proved a bright spot in an otherwise difficult year and we have been increasing our exposure to investment opportunities associated with carbon neutrality. Meanwhile, the AUM of our Hong Kong mutual funds recorded an upsurge in the volatile market while the performance in 2021 of our New Horizon China A-share Fund ranked first among peers.

The global bond market faced a tough year in 2021 as the loose monetary policies aimed at stimulating the economy during the epidemic fuelled inflation pressures and triggered a steady rise in US treasury rates. Still, amongst the world's major USD bonds, only US credit bonds performed satisfactorily as increased risk appetite resulted in narrower credit spreads. Meanwhile, Chinese high-yield bonds declined sharply as the credit problems of the real estate sector spooked investors. Despite this challenging environment, our fixed income team succeeded in maintaining our industry-leading investment performance achieved through prudent risk management and judicious portfolio adjustments. The performance of our Asia Bond Fund and Global Investment Grade Bond Fund both ranked in the top tier versus competing products in 2021.

As we bid farewell to 2021 and look ahead to 2022, the United States appears to be entering an era of rising interest rates while China's macro policy – reflecting purely domestic priorities – aims at delivering steady growth. The strains in Sino-US relations appears to be easing just as COVID's economic disruption lessens and the credit risk overhang of the real estate sector is gradually resolved.

We remain confident that both China's stock market and our equity funds will perform well in 2022. Meanwhile, although the bond market is expected to remain under pressure due to rising US interest rates, we expect our fixed-income funds to continue delivering industry-beating returns as our team unearths attractive investment opportunities while managing risk conservatively.

In the coming year, we also plan to enhance our efforts in ESG (Environmental, Social and Governance) investments by launching ESG-related equity and fixed-income funds dedicated to fostering the sustainable development of businesses and society.

Let us move forward together and create a wondrous 2022!

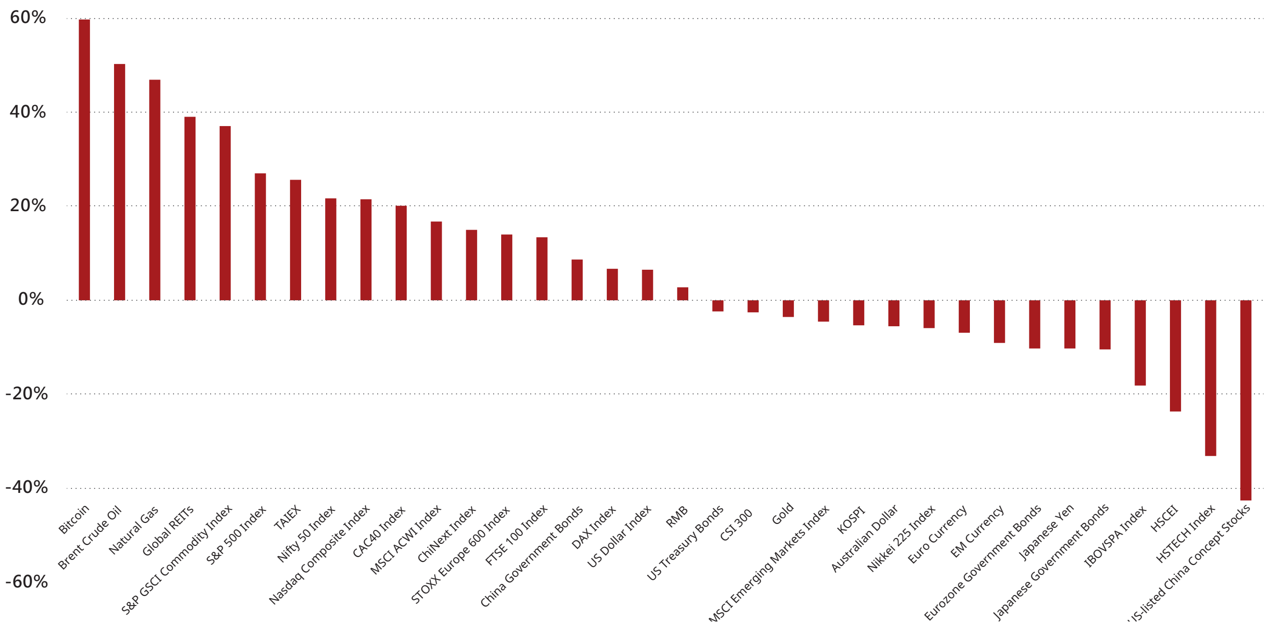
China Equities

Raymond JING
Portfolio Manager

Jun ZHANG
Head of Research

2021 Market Review

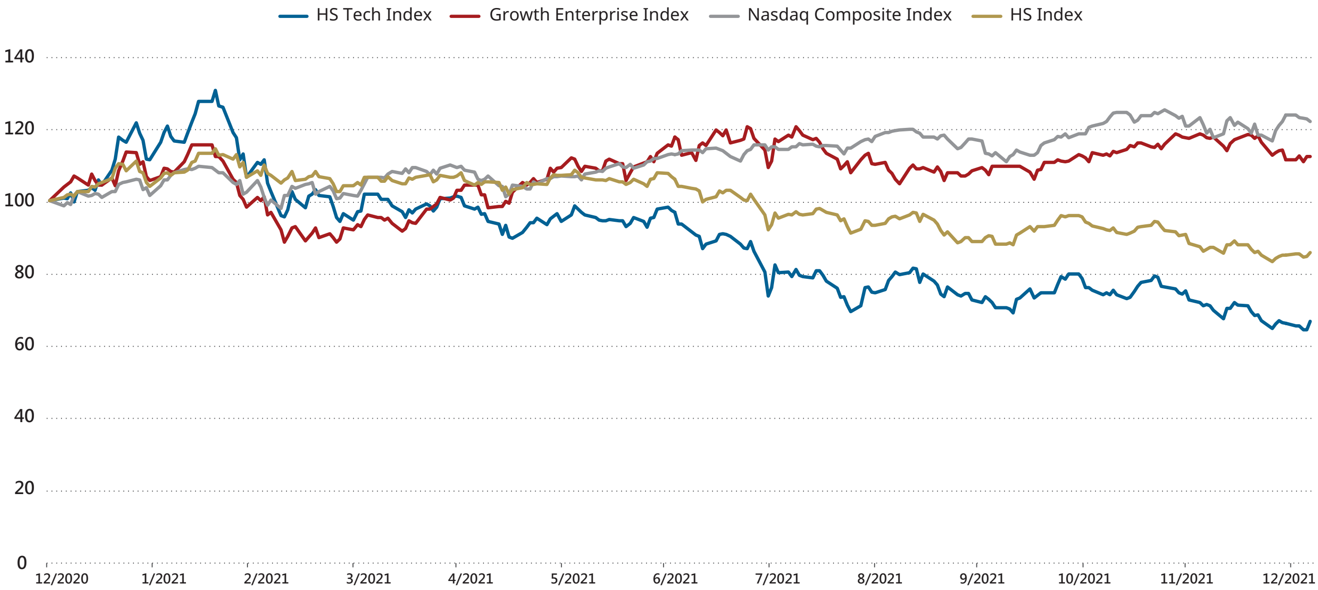
Chart 1: Global market performance in 2021



Source: CICC, as at 5 Nov 2021

Hong Kong stock market underperformed

Chart 2: Hong Kong stock and US stock index performance



Source: Bloomberg, as at end of Dec 2021

Hong Kong stocks significantly underperformed other major global markets in 2021. Despite substantial fund inflows to Hong Kong stock market via the southbound leg of the Hong Kong Shanghai-Shenzhen Stock Connect scheme early in the year, China's subsequent introduction of laws curbing the activities of Internet giants and private education operators had a dampening effect on the Hong Kong market. As the growth momentum weakened, the Hang Seng TECH Index – a proxy for the tech sector – fell sharply, a decline that continued throughout the year. The credit risk that engulfed some of China's largest real estate companies also triggered concerns about systemic risk and market contagion. The ensuing flight to safety impacted the shares of firms involved not only in real estate and property management services, but in related sectors such as financial services, further eroding market sentiment.

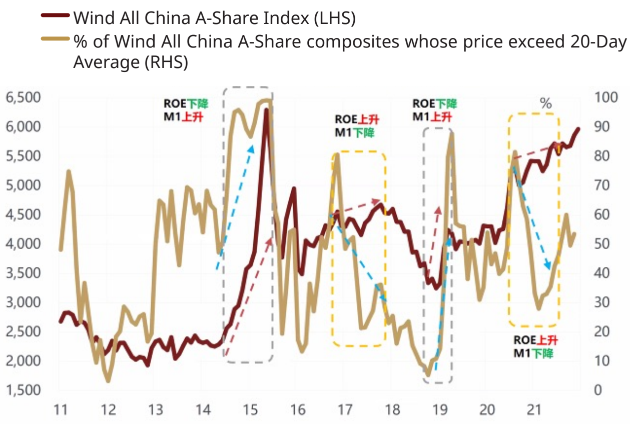
Overall, the value stocks outperformed the growth stocks in 2021. While global supply chain imbalances caused by the pandemicpushed shipping prices to record highs, loose monetary and fiscal policies implemented by governmentsfuelled overall demand in 2021, triggering sharp price increases in major commodities.

Transition to sustainable energy was a popular theme throughout 2021. The rapid adoption of electric vehicles ("EV") drove growth across the EV supply chain, pushing up the prices of non-ferrous metals and chemicals used in their production. Given China's transitioning to sustainability, many traditional energy companies – including some active in thermal power and coal – allocated substantial resources to renewables in order to secure their mid to long-term growth prospects.

A-Share market presents structural opportunities

The A-share market was flat yet volatile in 2021. Small cap stocks significantly outperformed the large cap stocks, with investors rotating between traditional sectors and emerging sectors. Benefitting from sharp rises in the prices of their products, firms involved in upstream industries saw their profitability and stock prices rose in tandem. Meanwhile, companies active in emerging industries – including EV, lithium batteries, new materials, photovoltaics, environmental protection and related equipment – saw their profitability and stock prices rise as the world's transition to carbon neutrality and renewable energy accelerates.

Chart 3: A-share market performance



Source: Wind, as at end of Dec 2021

In contrast, traditional blue-chip stocks in sectors like consumer, healthcare, financial services and real estate were laggards. Facing slowing demand and rising costs, the consumer sector experienced lower growth and tighter margins. Meanwhile, the price cuts in centralized procurement and the pandemic affected both the short-term earnings and long-term growth prospects of pharmaceutical firms, leading to a significant drop in the sector's valuation. Tightening policies introduced to solve the credit risk of the real estate sector affected not only property developers, but also sank the valuation and liquidity of firms in related sectors such as financial services, home appliances and furniture.

Macro and Market Analysis

China's Total Social Financing ("TSF") growth rebounds as policy shifts towards stabilization

TSF's year-on-year growth rate stabilized in October 2021 before picking up again in November, a momentum that we expect will carry forward over the next few quarters. A leading indicator of asset prices, the bottoming out of TSF's growth tends to be followed by a rise in the stock market.

Chart 4: TSF growth is a leading indicator for China's stock market

Source: Bloomberg, as at 7 Jan 2022

Chart 5: China market performance in 3 months after TSF growth bottomed out

Start Date	End Date	SSEC	CSI 300	CSI 500	SSE 60	SZSME
10/6/2005	8/9/2005	7.8	6.8	7.0	7.9	23.1
10/11/2008	8/2/2009	16.3	24.2	48.8	14.9	48.3
10/6/2012	8/9/2012	-6.7	-8.2	-6.4	-6.9	-1.6
10/7/2015	8/10/2015	-18.9	-19.7	-12.0	-24.4	-11.0
11/12/2018	11/3/2019	16.7	18.0	24.1	12.1	23.9
Average Return		3.0	4.2	12.3	0.7	16.5
Median Return		7.8	6.8	7.0	7.9	23.1

Source: Wind

We saw signs of policy easing and steady growth beginning in Q4 2021:

- On November 19, the People's Bank of China proposed a self-centred monetary policy orientation, signalling a moderate easing.
- On November 24, Premier Li Keqiang chaired an executive meeting of the State Council to improve the management of local government special bonds and fasten the issuance of the remaining quota of the special bonds.
- On December 6, the People's Bank of China ("PBOC") announced it would cut the reserve requirement ratio (RRR) of financial institutions by 0.5% on December 15 to support the development of the real economy and stabilise financing costs.
- On December 15, the PBOC also launched a RMB 500 billion MLF operation giving financial institutions access to RMB 250 billion additional long-term funding.
- In early December, meetings held at the Politburo and the annual Central Economic Work Conference sent a clear signal that returning to "steady growth" would be the priority.

- On December 20, the PBOC announced a reduction in its one-year LPR from 3.85% to 3.80% – the first cut of this key rate since April 2020 yet another easing measure introduced following the Central Economic Work Conference;
- On January 1, the PBOC released its 2022 outlook, stating that it will pursue a prudent and flexible monetary policy aimed at better supporting the real economy.
- At the beginning of January, policies related to the real estate industry also showed signs of being relaxed. For example, Shanghai's mortgage lending cycle was shortened to less than a month while banks relented on some standards such as exempting loans made to some leading real estate firms from being included in the "three red lines" indicators.

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2022 Will be a 'stabilization' year

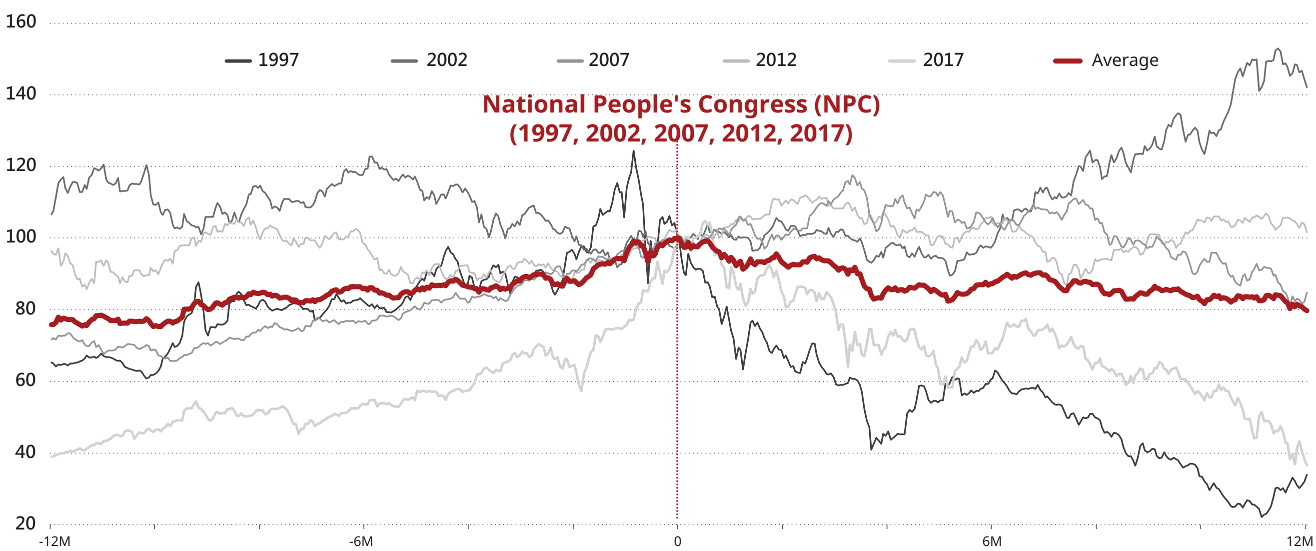
There will be several major events and conferences in 2022, including 1) February: Beijing Winter Olympics; 2) March: the election of Hong Kong's Chief Executive Election; 3) July: 25th Anniversary of Hong Kong's Return to China; 4) 4Q: 20th National People's Congress ("NPC"). From a macro perspective, 2022 will be a 'stabilization' year.

Historical data shows that the market tends to trend upwards in the 12 months preceding a NPC of the Communist Party of China, with an average increase of about 30%.

Rmb remains strong

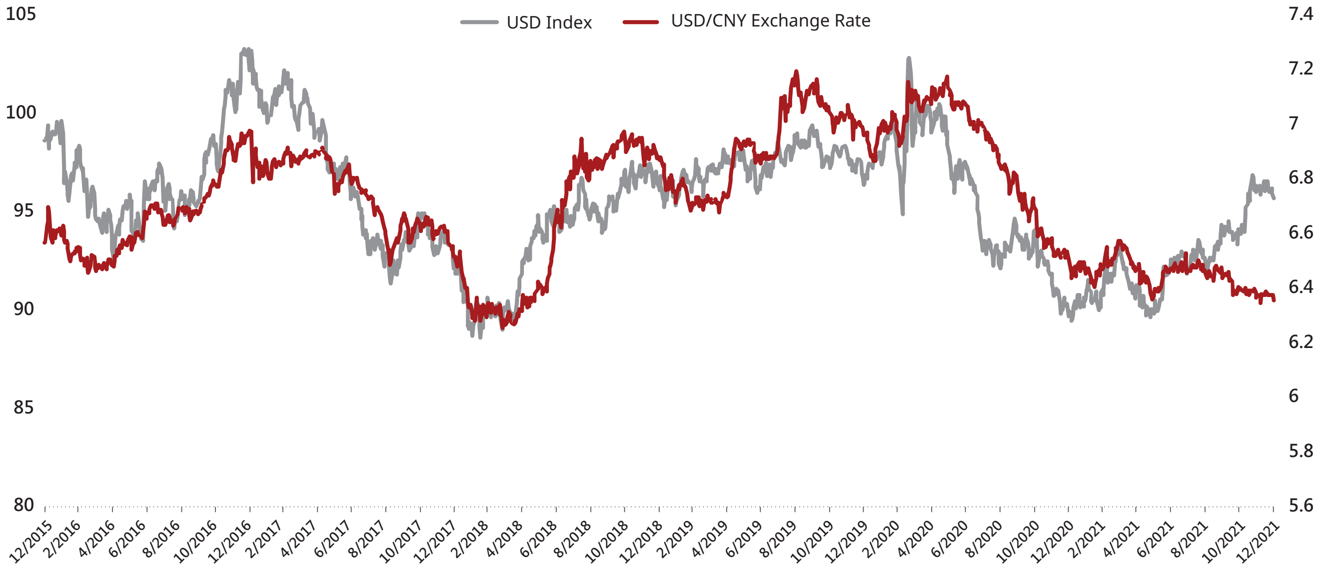
Although Hong Kong stocks performed poorly in 2021, the RMB continued to appreciate against the USD, reaching a three-year high in December 2021. This indicates that investors' confidence in – and risk appetite for – RMB assets continued to rise. Even the PBOC's announcement that it was cutting the RRR on December 6, 2021 had little impact on the RMB. The rapid appreciation of RMB even prompted the PBOC to announce another increase in the reserve requirement for foreign exchange deposits again on December 9, but with little impact. The strong performance of the RMB reflects both the stability of China's economy and the country's enduring export competitiveness throughout the pandemic. We expect these trends to support the performance of China stock market this year.

Chart 6: Chinese stock market performance before and after the CCP meeting



Source: Bloomberg

Chart 7: USD Index and USD/CNY Exchange Rate



Source: Bloomberg, as at end of Dec 2021

The potential correction of US equity market is the main risk to Chinese equities in 2022

The main risks facing China's stock market this year are the volatility of the US equity market and the risk of capital outflows from emerging markets as a result of potential interest rate hikes by the Fed.

As the US has entered a tightening cycle and given that US stock indices have reached record highs = both in absolute terms and in valuation levels, a sharp correction of the US market could trigger a drop of China's market. Current valuation metrics show that US stocks are priced even higher than that during the 2000 Internet bubble, the ratio of gold and silver prices to the S&P 500 hit a new low. Many indicators now suggest that the US stock market may be overvalued and that a correction is imminent.

Pressured by high inflation – the statement that "inflation is temporary" has been erased from the statement of the Fed's meeting on December 15 – the Fed officially stated it was contemplating to accelerate monetary tightening. Then, in early 2022, the Fed stated that it will start raising interest rates as early as March and might begin shrinking its balance sheet, both strong hawkish signals. The news sent U.S. bond yields soaring to a nearly two-year high at 1.8% in early January.

In response to these trends, global investors dumped growth stocks in favour of value stocks as the US technology shares dropped from their recent highs. Further tightening by the Fed will continue to put pressure on US stocks for the foreseeable future and will also impact the Chinese market. However, this will be partly mitigated by the fact that China just entered a new round of policy easing centred on delivering steady growth. We intend to adjust our positions flexibly to reflect the possibility of potential decline in US stocks.

As inflation surged globally and with the Fed's rate hike providing support for the US Dollar, some emerging markets currencies weakened sharply as investors pull funds from emerging markets. While China's market may be impacted, China's macroeconomic fundamentals are significantly stronger than other emerging economies. The strong performance of RMB and China's pro-growth policy may thus make the risk of capital outflow manageable.

2022 Market Outlook

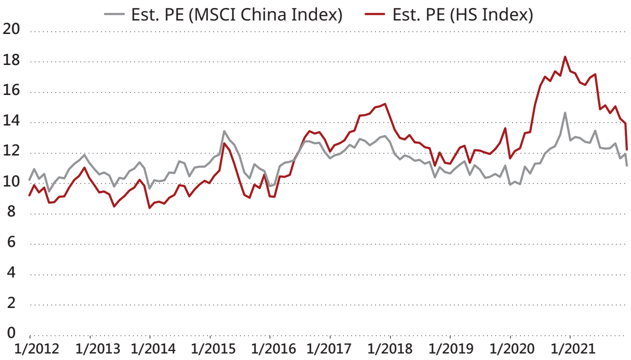
The calm after storm forHong Kong market

Affected by the economic downturn, the credit risk of the real estate sector and policies as the Internet anti-monopoly law, Hong Kong equity market performed poorly versus global peers. Already at a historical low, there seems to be limited room for the P/E ratio of the MSCI China Index to drop further, especially given the easing policy cycle in China.

In recent years, Hong Kong's financial market has become increasingly correlated with China, effectively decoupling from the movements in US markets. Historically, the data shows that Hong Kong M2 growth is highly correlated with the Hong Kong stock market. As China enters a new easing cycle, the year-on-year growth rate of Hong Kong's M2 turned positive in November which is good news for Hong Kong stock market.

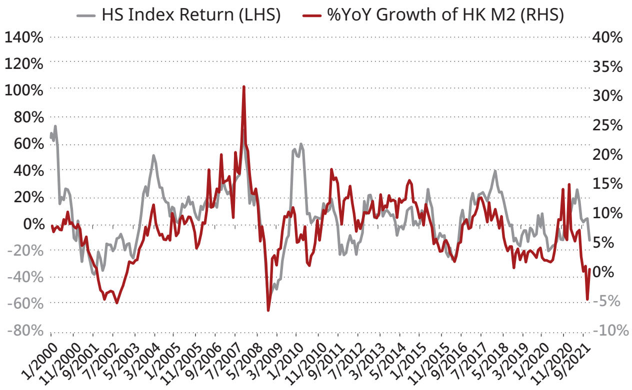
While investor's sentiment remains mired in extreme pessimism, we believe the earnings cut for Hong Kong listed companies is near the end. The extremely low valuations and stock prices fully reflect the earning pressure and policy risks, as does the historically high equity risk premium. Some regulatory risks still exist but they are unlikely to have much impact on the market. Meanwhile, as the economy and corporate earnings improved in the aftermath of growth-stabilizing policies, market expectations will eventually turn positive. We thus expect Hong Kong stock market to offer attractive investment opportunities in 2022.

Chart 8: Chinese equity market valuation



Source: Bloomberg, as at 10 Jan 2022

Chart 9: Hang Seng Index and Hong Kong M2 Growth



Source: Haver, as at end of Dec 2021

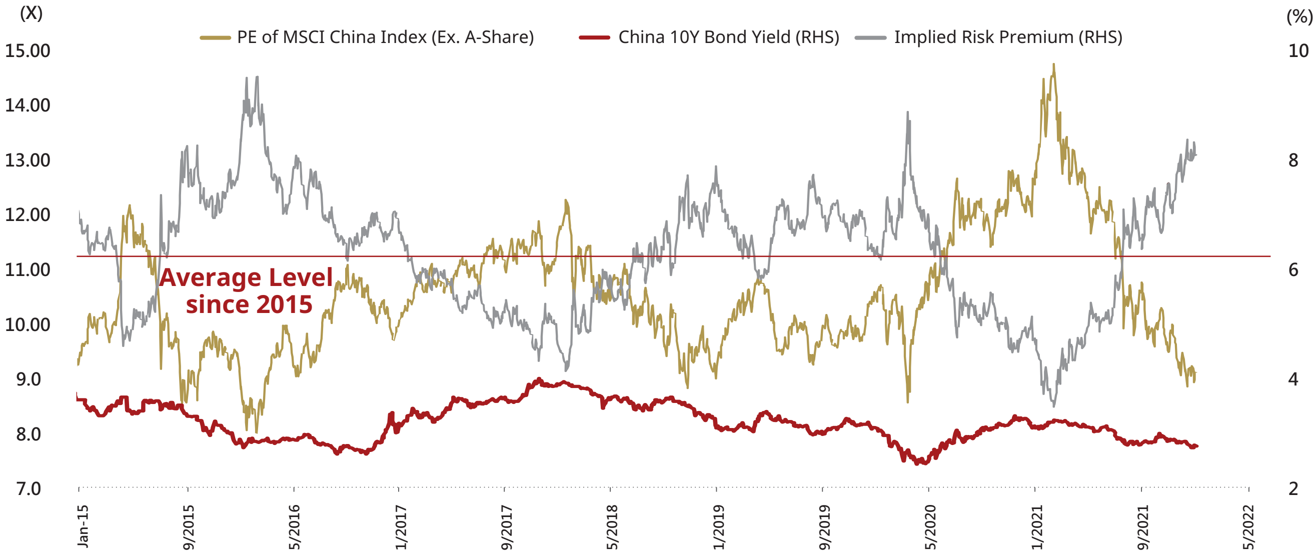
A-Share market will benefit from industry and growth-stabilizing policies

We expect the amount of incremental inflows to China A-shares to be slightly lower in 2022. Domestically , the new fund issuance of both mutual funds and secondary market private equity funds should slow down. Meanwhile, the scale of trusts and securities' asset management business should stabilize once they fully absorbs the impact of new regulations while the inflows from the wealth management products of banks will continue. Besides, as the weighting of A-shares in major international indices is unlikely to be raised for the time being, we expect overseas inflows to shift from passive allocation to active management. While rate hikes by the Fed may play a role in foreign capital flows, we believe that China's own policies and economic conditions will mostly set the tone for foreign investors.

In contrast to Hong Kong stock market, China A-share market remains more dominated by manufacturing and hard-tech companies with minimal internet firms, a pattern more in line with the current direction of China's industrial policy. Moreover, the correlation between A shares and Chinese policies is more pronounced than that of Hong Kong market. We thus expect investors' confidence in China A-share market to rise in synch with the mainland's gradual strengthening of growth-stabilizing policies.

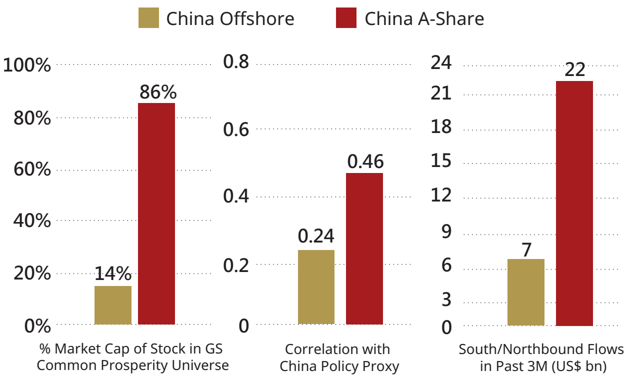
From an earnings perspective, we expect the earnings growth rate of firms traded on the A-share market to fall back to a normal level after the high growth recorded in 2021. However, such a slowdown in earnings growth might not trigger a decline for the market as we have often seen the A-share market rose despite lower corporate earnings growth. Since we expect China's pro-growth policy and abundant liquidity to drive A-share market in 2022, the performance differences between various sectors should narrow.

Chart 10: Equity Risk Premium and MSCI China Index (Except A Shares) Valuation



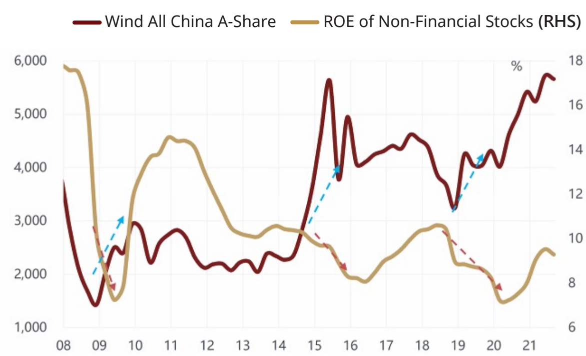
Source: CICC, as at 11 Jan 2022

Chart 11: China A Share and the Offshore China Market



Source: Goldman Sachs, as at end of Dec 2021

Chart 12: Earnings growth of A-share listed companies



Source: Wind, as at end of Dec 2021

Sector Focus

Sectors benefiting from pro-growth policy with high dividend yields

The return of wealth management products issued by banks continued to decline in line with the decrease in the yield of long-term government bonds. By contrast, the pay-out ratio and dividend yield of China listed companies continued to increase, both in absolute and relative terms. Given China's changing demographic profile and real estate cycle, we expect the downward trend in the yield of government bonds to continue in the foreseeable future. Consequently, the funds currently in the wealth management products will account for a large portion of incremental equity market inflows and we expect such funds to focus on stocks with high dividend yields.

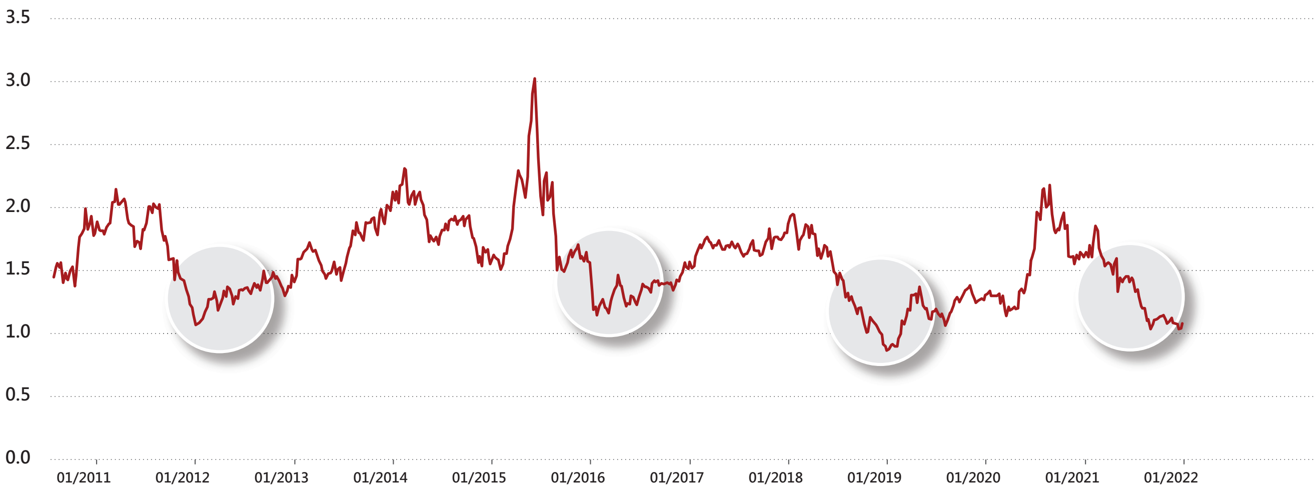
Companies offering high dividend yields tend to be concentrated in sectors such as financials, energy, infrastructure, steel, and home appliances, etc. Highly correlated with economic growth, these more cyclical sectors have been neglected as investors focused more on firms in growth industries. Given their low valuations, marginal institutional holdings and relative immunity to movements in US interest rates, these high-yielding companies represent a safe haven from the turbulent global market environment. Since they are also likely to be the main beneficiaries of China's easing policies, both their earnings outlook and share prices should improve.

Healthcare sector

Inhibited by intermittent COVID outbreaks and the price cuts from centralized procurement, the stock prices of pharmaceutical companies dropped sharply as valuations tested new lows in 2021. While rumours such as possible US sanctions on some CXOs and biopharmaceutical companies have further depressed investors' sentiment, some leading companies have been attractive from long-term perspective, especially the nature of the industry's global supply chain make it highly unlikely that the US can fully decouple from China. Consequently, China's healthcare sector represents a compelling long-term buying opportunity at current low valuation.

Key indicators, such as the healthcare sector P/E ratio * risk-free rate (long-term bond yield) have historically signalled a turning point for the healthcare sector, as bottoms reached in early 2012, early 2016 and early 2019 were all followed by large-scale sector stock price increases last 2-3 years. Given that the sector is trading at another historical low, we believe that the shares of some leading pharma, biotech and medical device companies offer good long-term investment opportunities.

Chart 13: Healthcare Sector Index (P/E * R)



Source: Wind, as at end of Dec 2021

Hard-tech sector

Although the value-added of China's manufacturing industry has been ranking first in the world for 11 consecutive years, China's transformation from a manufacturer of quantity to one of quality is still at an early stage. It's apparent that sectors in harmony with China's national and industrial policies – including semiconductor, advanced manufacturing, renewable energy, electric vehicles, and power transmission and distribution – may offer interesting investment opportunities.

Considering the current relatively high stock prices and valuations of the companies in related sectors, waiting for a better entry point may be a good strategy in the short run. However, we are very positive on the long-term investment opportunities from the process of emergence of Chinese world-leading companies in the hard-tech fields.

Global Fixed Income

Serene CAI
Portfolio Manager

Ziyun WANG
Portfolio Manager

Macroeconomics and Policy

Overseas economy and policy

The large-scale fiscal and monetary policy stimulus packages introduced in major economies in 2021 have ushered a rapid economic recovery that helped many emerging markets outside of China resume growth. However, the recurrence of COVID outbreaks will continue to disrupt the economy, wreaking havoc with supply chains while exposing structural issues in the labour market and subduing demand for services.

From a fundamental perspective, the U.S.'s labor market recovered quickly as GDP grew nearly 5.5% in 2021. However, inflation also returned with the U.S. composite consumer price index rising by 6.8% yera-on-year in November, its highest increase in 30 years. In general, inflationary pressures are no longer associated with the economy's reopening but are triggered by price increases that are passed from commodities downstream to consumers. There is also little chance that inflation will subside in the service sector in the first half of 2022. The freight rate, a leading indicator, has dropped significantly while we don't expect commodities to rise as much in 2022 as port congestion improves.

On the policy front, Biden successively launched major economic relief and employment support programs in his first year in office. However, "Build Back Better" – a core part of his agenda – was derailed by legislative bottlenecks. The 2022 U.S. mid-term elections may complicate matters further should a change in congressional control.

Meanwhile, as the U.S. employment indicators suggest that the economy nears full employment, we expect that monetary policy will shift from promoting employment to policy normalisation. This hawkish approach looks set to last following the re-election of the Fed chairman and the rotation of some officials. Market expectation are the Fed will raise interest rates three to four times in 2022 with the first hike to occur in March at the latest. This change is already fully reflected in the short-end interest rate market, and we expect that rising interest rates and tightening liquidity will eventually trigger an increase in real interest rates too, a risk that needs to be taken into account when assessing risky assets globally.

The lack of a unified fiscal stimulus policy has dampened the economic recovery of the euro area, which lags behind that of the United States. While unemployment remains higher, inflationary pressure is relatively light. Still, the ECB is expected to end its bond purchase programme and begin raising interest rates 1-2 quarters after the Fed does. Meanwhile, the Bank of Japan is expected to maintain supportive policies as Japan's economic growth remains sluggish due to the pandemic and continuing shortages across the auto industry's supply chain.

Chinese economy and policy

Since the first COVID outbreak, the economic activities of most countries have been interrupted while China's economy thrived as it became the sole major economy in to post positive economic growth in 2020. Despite the lingering pandemic, floods and energy shortages, it is expected that the economy still achieved a relatively high growth of about 8% in 2021.

Held in early December 2021, the Central Economic Work Conference casted a more cautious judgment on the country's economic prospects, conveying instead a clear signal that policy will shift towards delivering change "stable growth", an objective set to underpins China's fiscal, monetary and real estate policies.

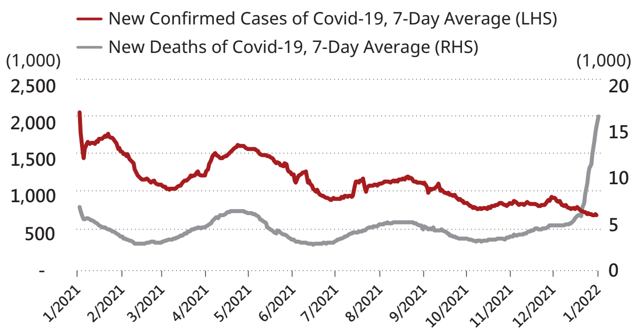
Already, China has implemented some easing measures to cope with the economic downturn. After such quantitative easing, the market expects credit easing may also be introduced. Should the economy grow less than expected, it cannot be excluded that the government may intervene more forcefully, and perhaps in a more flexible, diversified and structured manner.

Virus variant brings unknown to the pandemic

The high transmissibility of the Omicron variant has led to a massive surge in the number of COVID cases around the world. In the US, the number of new cases reached a new high, with new daily cases even exceeded one million. However, the relatively low fatality rate of Omicron has not led to complete lockdowns although it remains vital to enhance prevention measures to reduce the speed of transmission.

On the other hand, the vaccination rate in many emerging markets remains below 50%. If a new outbreak were to occur, it could push local health systems to the breaking point and causes another shock to global supply chains, especially if Southeast Asian countries were forced to into lockdown. In early 2022, a new variant dubbed "IHU" was discovered but it remains too early to assess its transmissibility, potency and resistance to vaccines. We will continue to pay close attention to COVID.

Chart 14: Global Pandemic Figures



Bloomberg, as at 7 Jan 2022

Global Fixed Income Market Review and Outlook

Review of key fixed income assets

As market expectations for economic recovery and inflation grew in early 2021, US long-term interest rates have been rising at a torrid pace, causing a real drag on the performance of U.S. dollar bonds. The upward trend of long-term interest rates receded as the supply for U.S. Treasury bonds improved in the second quarter. As inflation exceeded expectations in May, the Federal Reserve has sought to promote the flattening of interest rates, and the US 10-year Treasury bond rate fell to around 1.2% in June. Then the Fed officially announced in September that it would consider reducing bond purchases and focus on dampening inflation. In response U.S. Treasury bond yields – especially for short-term instruments – began oscillating in an upward trend. Meanwhile, U.S. dollar index strengthened.

Commodities and equities continued their bullish run in 2021, an upward trend that had started in the second half of 2020. Crude oil and euro zone stocks reversed their decline to recover their lost ground while both the S&P 500 and Nasdaq hit new highs. Investors' risk appetite has led to tighter credit spreads across major U.S. dollar fixed-income instruments. For example, the credit spreads between US high-yield instruments and investment-grade corporate bonds narrowed from 393bps and 103bps to 309bps and 98bps respectively, which were very close to their historical lows.

However, rising interest rates have offset a large portion of these narrowing spreads. Among major overseas bond indices, only the US high-yield index and emerging market local currency bonds delivered positive returns in 2021. Core instruments such as U.S. Treasury bonds, U.S. investment-grade bonds, and China U.S. dollar investment-grade bonds all posted negative returns. Dragged down by the real estate sector, the China US dollar high-yield index recorded its second worst annual performance ever.

Developed market credit

In 2021, the global credit market of developed countries – whether investment grade or high yield – as represented by the United States was supported by multiple factors:

- **Funding:** The Fed' s accommodative monetary policy, which maintained maintained large-scale bond purchases until November and abundant liquidity helped curb the volatility of US fixed-income instruments.

- **Supply and demand:** Compared with 2020, the financing needs of mega enterprises decreased sharply in 2021 as did new issues, resulting in more funds flowing into the secondary market;
- **Sentiment:** Stock market indices set multiple new highs while commodities and crude oil prices remained elevated, which induced narrowing interest rate spreads in related sectors.

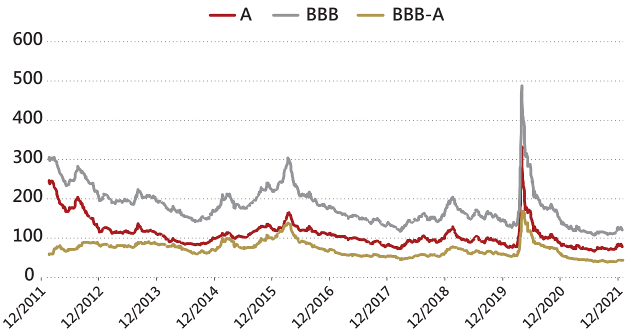
In the U.S. investment-grade bond market, the spread between different ratings significantly tightened, leading to a synchronized movement with the overall investment-grade benchmark. The BBB-A spread was less than 10bps from its narrowest level in history. Credit spreads among different sectors were more divided however, as we witnessed a re-rating of sectors like technology and healthcare, while the spreads remained wider in the consumer discretionary sector which was greatly affected by the pandemic. Spread tightening was most noticeable in the energy sector.

Chart 15: Performance of overseas fixed income assets in 2021

Index	1Q 2021	2Q 2021	3Q 2021	4Q 2021	2021
US Treasury	-4.6%	-2.0%	-0.0%	0.3%	-2.4%
Developed Market Sovereign Debt	-5.8%	-1.0%	-1.1%	-1.0%	-6.9%
US Investment Grade Corporate Bond	-4.5%	-3.6%	-0.1%	0.2%	-1.0%
US High Yield Bond	-0.9%	-2.8%	-0.9%	0.7%	5.4%
European High Yield Bond	-1.4%	-2.5%	-1.0%	-1.7%	-1.6%
Emerging Market Corporate Bond	-1.8%	-1.9%	-0.7%	-1.3%	-1.9%
Emerging Market Local Currency Bond	-0.1%	-1.6%	1.4%	1.2%	4.2%
Asian High Yield Bond	-0.1%	-0.2%	-8.4%	-10.1%	-17.5%
Asian Dollar Bond	-1.6%	-1.2%	-1.3%	-1.6%	-3.1%
Emerging Market Sovereign Bond	-5.4%	-3.8%	-1.2%	-0.6%	-3.6%
Chinese US Dollar Investment Grade Bond	-1.1%	-0.5%	-0.9%	-0.4%	-0.2%
Chinese US Dollar High Yield Bond	-1.6%	-1.5%	-15.0%	-18.9%	-33.3%

Source: Wind, as at end of Dec 2021

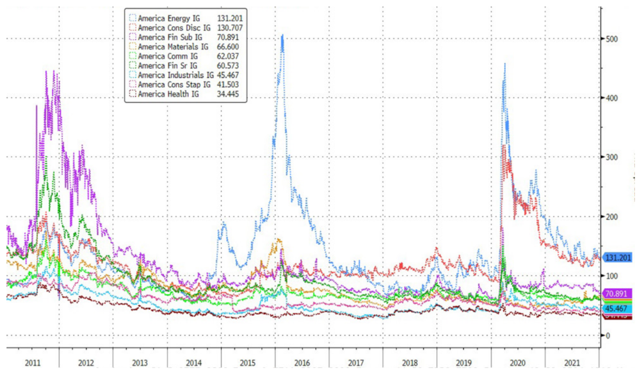
Chart 16: U.S. investment grade bond spread



Source: Wind, as at end of Dec 2021

Looking ahead to 2022, funding, supply/demand, and sentiment in the fixed income market may not replicate their strength as observed last year. Although the economies of developed countries should remain relatively stable in 2022 and the credit fundamentals of many sectors and companies could probably improve further, the momentum that drive the narrowing of interest rate spreads has weakened significantly. The official kick-off of the Fed's tightening cycle and potential interest rate hikes are subduing market sentiment. We believe the U.S. investment-grade bonds will struggle to repeat their 2021 performance and spreads might widen by about 30-50bps.

Chart 17: U.S. investment grade credit spreads by sector



Source: Wind, as at end of Dec 2021

Tactically, we believe overweighting the healthcare sector is appropriate while the pro-cyclical financial and energy sectors may offer opportunities in a rising interest rate environment. Investors should look opportunistically take profit if the energy sector runs ahead of commodity prices. We prefer bond issuers with improving leverage ratio or potential ratings upgrade to those aggressive issuers which pursue M&A opportunities.

Chinese dollar bond

2021 proved a difficult year for China U.S. dollar bonds. Early in the year, the China U.S. dollar bond market was hit hard by the rapid steepening of the U.S. Treasury bond yield curve. Subsequently, real estate bonds with longer durations fell sharply after China Fortune Land Development and Languang defaulted on their debt while ending a goldilocks era of high yields and low volatility. While U.S. Treasury bond yield stabilized in the second quarter, the China U.S. dollar bond market continued to fluctuate. In April, Huarong's decision to postpone the release of its annual report triggered a sharp decline in their bond prices. The sell-off quickly spilled over to other peers and had a huge impact on investment-grade bonds until Huarong secured investments from a group of credible strategic investors. China investment-grade bond market was generally stable in the second half of the year, although bonds issued by real estate firms and some internet, technology and education enterprises remained under pressure.

In the high-yield bond space, declines in lower rated bonds issued by Chinese property developers exacerbated after Evergrande's bonds dropped in the aftermath of negative news and credit downgrades. As declining sales and regulatory interventions were sending investors fleeing from September 2021 onwards, the Fantasia default in early October further damaged market confidence. Bond yields in the sector skyrocketed to levels last seen during the 2008 financial crisis.

Looking ahead, we expect China investment-grade bond credit spreads to return to their pre-pandemic levels, which seems fair given the yield of U.S. investment-grade bonds. Whether this momentum will endure remains to be seen as interest rate hikes are bound to motivate investors to seek perpetual bonds supported by strong underlying rights and favourable coupon reset clauses.

Among investment-grade bonds, fixed-income instruments issued by weaker Local Government Financing Vehicle (LGFV) present unsolved long-term credit risks. Bonds issued by state-owned enterprises and leading private enterprises with clear business plans and sound financial status will remain in favour and we intend to devote our research and allocations to these instruments.

With regards to the real estate sector, the market generally expects that its earnings and growth are entering a downward cycle. Although China is showing signs of loosening credit policy, the central government attaches great importance to containing financial systemic risks and financial institutions will remain cautious when assessing real estate companies. A flight to quality is expected as the industry's practice of guaranteeing projects and delivery prompt investors to differentiate operators based on their credit risk. We expect investors to look for state-owned enterprises and private enterprises with better reputation to acquire projects in a timely manner whereas weaker firms will face the dual blow of sinking sales and debt repayment.

In 2022, the repayment schedule of U.S. dollar property bonds will put pressure on many developers. Until refinancing improves, we expect to see more developers defaulting or seeking to restructure debts. The pattern of credit differentiation and price volatility will continue. From a fundamental point of view, we will prudently select bond issues by leading firms which are on sound footing i.e. developers with few off-balance-sheet liabilities and high-quality land bank, and those that rely on domestic sources (especially banks) for their financing. It makes sense to allocate more to safer names when opportunities of overshooting arise. Looking ahead, we will closely monitor policy changes, construction and sales statistics, and changes in regulations on pre-sales financing in order to seize opportunities when fundamentals and technicals improve.

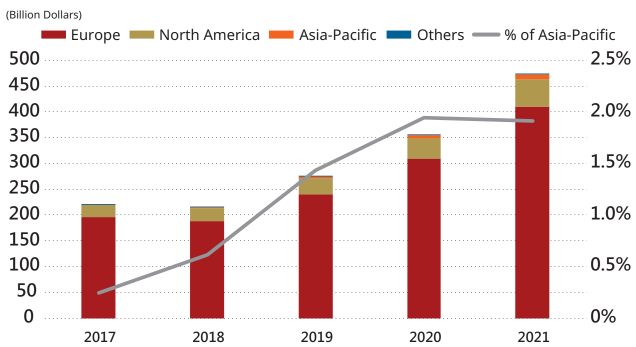
Asian ESG bond market

Since the first green bond was issued in Asia in 2013, total issuance of ESG U.S. dollar bonds have exceeded US$210 billion in the region and the sector experienced tremendous growth in 2021. The second half of the year was particularly strong, with annualised issuance exceeding US$70 billion, of which the circulation alone from July to December accounts for about 50% of total issuance. Investment-grade instruments accounted for 72% of the amount issued, compared with 23% for high-yield instruments. According to national statistics, China accounted for nearly 40% of the total issuances in the region while South Korea and Japan also underwent fast growth over the past two years.

The risk-adjusted return of the MSCI EM Asia ESG-Weighted Index significantly outperformed the benchmark. The premium (a.k.a. the greenium) of Asian ESG bonds relative to developed markets is not yet apparent but the potential is huge. Many funds are in the hunt for more ESG-themed fixed-income funds after AUM grew strongly over the last three years,. However, fixed-income ESG funds based in Asia account for a mere 2% of the world's total so there is plenty of room to grow.

We are very optimistic about investment opportunities in this segment in 2022, both in terms of issuance volume and secondary market trading. This will help drive the rapid development of Asia's ESG bond market.

Chart 18: ESG bond fund size (US$ billion)



Source: Wind, as at end of Dec 2021

Other emerging markets

The issuance volume in emerging markets was healthy in 2021. Although global risk appetite slightly diminished late in the year, 2021 performance was relatively stable thanks in part to commodity-related issuers. In terms of macro fundamentals, most economies are expected to maintain growth in 2022 albeit at a slower pace than in 2021. However, the tightening dollar funding environment and the strength of U.S. dollar may trigger capital outflows from emerging markets, which will be a challenge for those emerging market currencies with weaker current accounts. The local currency bond markets of certain emerging markets might also come under pressure. In 2022, Brazil, Colombia and other major emerging market countries will be holding elections. The rise of populism and related policy changes remain in investors' focus.

2022 Outlook for major emerging markets

India

Growth exceeded expectations to reach 20.1% in Q2-2021 and 8.4% in Q3-2021. Market worries about the contradiction between India's fiscal deficit and growth policy under the pandemic gradually eased, which led to a significant narrowing of India's quasi-sovereign credit spread in the past two months. We maintain a market weight as the opportunity for excess returns seems relatively limited. India's economy recovery is positive for a range of industries and will benefit issuers with improving operations and upward earnings cycle, or those which may have ratings upgrade. Sector-wise, we are optimistic about renewables such as wind and solar energy, ports, communications, and consumer industry.

Indonesia

As the country introduced stringent measures to fight COVID in the second half of the year, it is expected that Indonesia's GDP grew less than 4% in 2021, a relatively weak performance compared to other ASEAN countries. Low vaccination rates and unstable power supply bring further uncertainty to Indonesia's economic recovery. Given the tight valuations currently prevailing, we recommend to be underweight Indonesian sovereign and quasi-sovereign bonds.

Malaysia

With vaccination rates increasing and lower base effect, we believe Malaysia's economic growth will accelerate in 2022. The country will also maintain a current account surplus. However, we recommend maintaining a market weight on Malaysia's sovereign bonds due to high valuation.

Brazil

In order to fight surging inflation, the Central Bank of Brazil has been adopting a series of tightening measures. As factors such as disruption in supply puts pressure on the Brazilian economy in 2022, we expect GDP growth to decline. Political uncertainty is increasing as polls suggest Brazilian voters are moving away from centrists while investors remember how the virulent political tone of previous elections impacted its financial market and its currency. Until the country's current account improves significantly, foreign exchange and sovereign credit spreads are expected to remain volatile in the first three quarters of 2022 as investors wait for the election results, and for inflation and interest rates to peak before looking at new opportunities.

Allocation Strategy

Economic Scenario	Analysis	Allocation Strategy
Optimistic	Economic activity is recovering rapidly while inflation remains high due to strong demand. U.S. Treasury bond yields widen by more than 50bps. As expectations are met, the interest rate curve steepens at first before flattening. The spread of investment-grade bonds in developed countries, emerging markets and high-yield bonds all narrow slightly.	**Appropriately overweight in emerging markets and high-yield strategies.**
Neutral	Economic activities will be generally maintained, inflation easing, and US Treasury bond rates widen by more than 25 bps. Investment-grade bonds, emerging market and high-yield bond markets also widen slightly in response to changes in liquidity and valuations	**Neutral allocation to maintain a certain level of coupon rate. Adopt a stable and balanced strategy.**
Pessimistic	The worsening of the epidemic leads to a massive economic shutdown. Due to its robust epidemic control capabilities, China is epected to suffer less. Emerging markets – where sanitation and vaccination rates lag behind – will be hit harder than developed countries. We expect that US Treasury bond yields to potentially narrow by 30bps while investment-grade bond spreads in developed countries widen by 25bps and emerging market bond spreads with high liquidity by 30-50bps with high-yield bond prices falling by 2-5pt. U.S. Treasuries outperform other U.S. dollar assets, and China outperforms other markets in emerging markets substantially.	**Adopt a credit allocation strategy featuring longer durations and higher security.**
Stagflation	Severe stagflation as the virus drags the economy down while creating bottlenecks across supply chains. In this scenario, neither equity assets nor fixed-income assets can compensate investors for risks.	**Focus on cash allocation.**

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Benchmark Fund of The Year Awards 2021

Outstanding Manager - Asia Fixed Income
- CAI Jing

Best-in-Class - Physical ETF
- CSI 300 Index ETF

Benchmark Fund of The Year Awards 2020

Outstanding Achiever - China Equity
- New Horizon China A-Share Fund

4th Overseas Golden Bull Fund Awards

Overseas Golden Bull China Fixed Income Fund (1 Year)
- Select Asia Bond Fund

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