MARCHING TOWARDS 15th YEAR

華夏基金(香港)
ChinaAMC (HK)

2023
Investment Outlook

Contents

Tian GAN
Chief Executive Officer
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Dear Valued Investors,

2022 turned out to be an extremely challenging year for both equity and bond investors. Heightened volatility in economic activities and the financial markets, combining with geopolitical conflicts, inflationary pressures, monetary policy tightening, and the COVID pandemic, have cast a shadow over the global markets throughout the year. Nevertheless, while the spectre of a global recession is still looming, we believe that the most difficult phase is now behind us.

The return of China's equity market in 2022 fell short of most investors' expectations. The COVID pandemic and its related prevention and control measures have dealt a major blow to the economy, significantly undermining the effectiveness of stabilization policies. Investors continued to lower expectations for China's economic growth and corporate earnings. In the meantime, concerns over geopolitical risks, including the Russia-Ukraine conflict, the situation in the Taiwan Strait, and US-China relations, lingered for most of the year. Rapid interest rate hikes in the United States and other European developed economies to tame high inflation placed further pressure on Chinese Yuan and China's equity market.

Despite the challenges, through diligence and by leveraging its rich professional investment experience, the equity investment team at China Asset Management (Hong Kong) have successfully navigated the turbulent market and continued to deliver steady performance in 2022. The return of our key products has been among the best in the industry, helping us win several key mandates from long funds.

Against the backdrop of a global tightening, bond markets around the world recorded their worst performance in the 21st century. Geopolitical conflicts and supply-side structural issues in the labor market have made global inflation far more severe and lasting than market expectations. The Federal Reserve (Fed) has raised interest rates by as much as 425bp in 2022, pushing the US bond yield curve up sharply. The overall global credit spread of credit bonds has dropped to a relatively reasonable level from its historical high at the beginning of the year. For Chinese-issued USD bonds, investment-grade offered a modest upside supported by strong technicals, while high-yield plunged further as the real estate sector remains subdued.

Our fixed income investment team strived to reduce and diversify credit risks by managing the key macro challenges while navigating the volatile market in 2022, consistently creating alpha for investors.

Looking ahead, the rate hike cycle in developed economies is nearing its end, with the risk of a global recession now appearing greater. On the upside, China will fully reopen as it scrapes COVID-related prevention and control measures. The key internal and external fundamentals bode well for China's equity market. The country's economic growth is expected to lead major economies in the world in 2023. We expect less impact of interest rate hikes in developed economies and geopolitical risks on China's equity market and believe that earnings, valuations and risk appetites all support a recovery in China's equity market in 2023.

We see a high possibility of the U.S. economy moving into a mild recession in the coming year, while the Fed may restart interest rate cuts by the end of 2023. As rate hikes peak, U.S. Treasury rates are expected to fall, leading to an inversion of the yield curve. At the same time, we need to be wary of the risk of a phased widening of credit spreads against the backdrop of an economic downturn or liquidity tightening in 2023. We prefer investment grade medium- and long-term bonds as a safe haven in the global bond market and recommend a combination of short-term trading and long-term allocation strategies.

More importantly, we've made great strides in ESG investing in 2022. We have put into place a set of ESG investing practices, integrating ESG factors into our daily investment research process and raising employee ESG awareness throughout the company. Our first ESG product, HSI ESG ETF, was successfully listed on the Hong Kong Stock Exchange on November 10, 2022. It soon became the largest ESG-index fund in the Hong Kong market. We continue to see great potential in ESG investing and are committed to becoming a practitioner and advocator of sustainable investment in the asset management industry. We are well-positioned to launch more ESG-themed equity and fixed income funds in 2023.

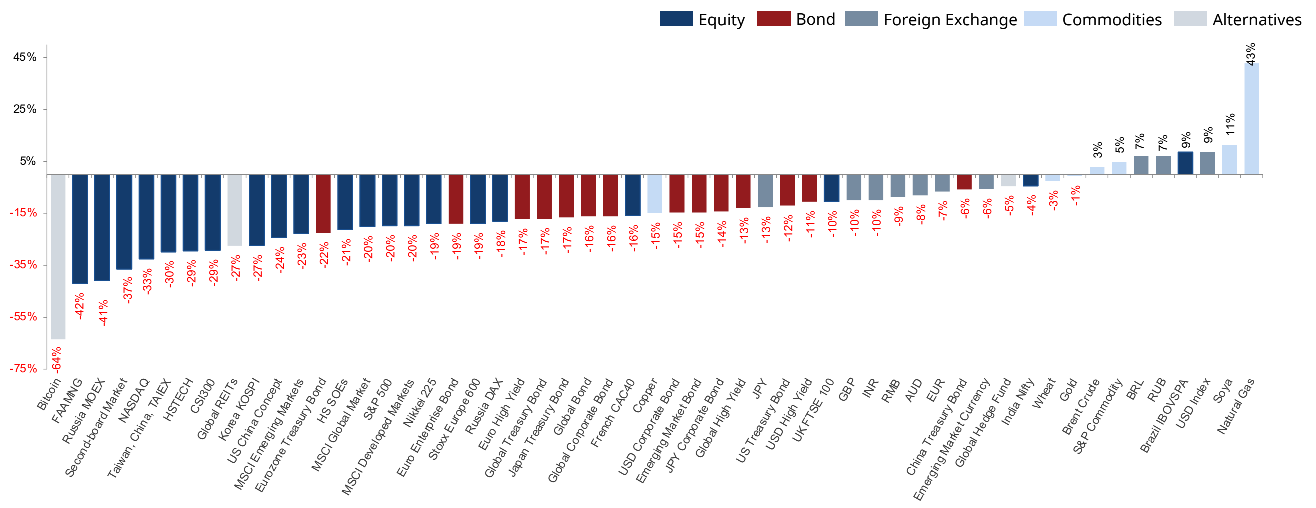
Thank you for your continuous trust and support!

China Equity Market

2022 Market Review

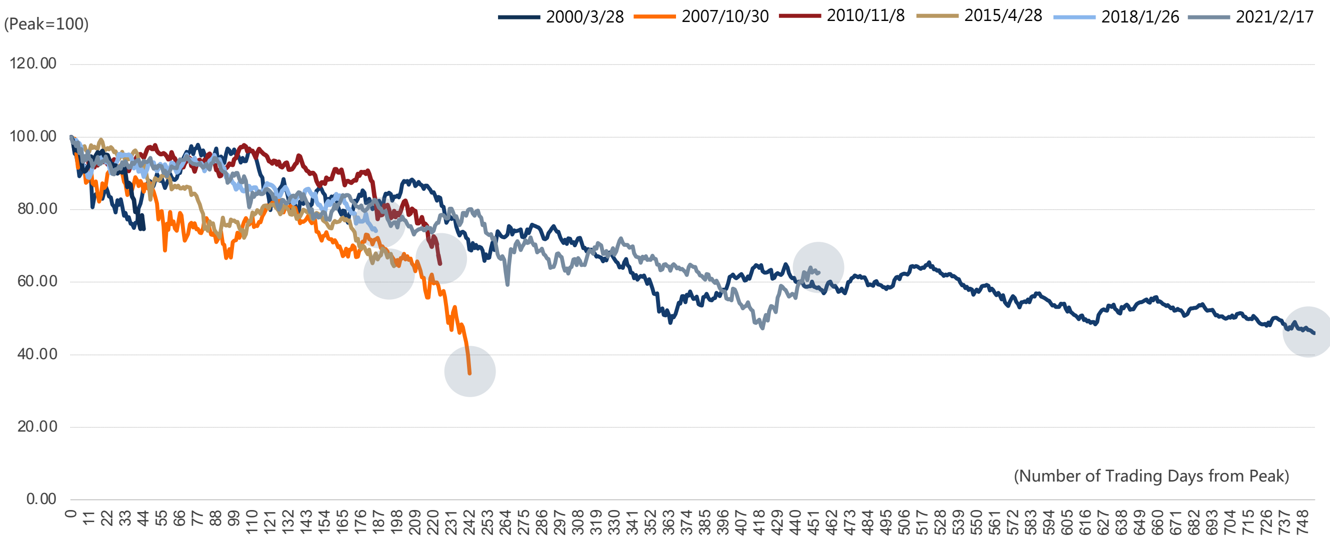
China equity market had its ups and downs in 2022 under a mix of internal and external factors. Its overall performance has failed to meet the expectations most investors had at the beginning of the year, and has also lagged behind other major equity markets for the second consecutive year. The rally in the past two months was preceded by a decline that lasted for about 20 months, a rare scenario both in terms of length and magnitude. At this point, with the reopening of China's economy and the introduction of more stabilization policies, China's economic growth is expected to accelerate, with corporate earnings gaining support, and market uncertainties likely to diminish. Meanwhile, investors' higher risk appetite and reduced impact of external adverse factors are all pointing to improved return prospects in 2023. dramatically. The rising trend continued in the following weeks, as tensions eased between Russia and Ukraine, coupled with positive progress in talks over U.S.-listed Chinese stocks.

Chart 1: Performance of Major Assets in 2022



Source: Bloomberg, data as of Dec 20, 2022

Chart 2: Retreat Range of HSI and Time Needed to Hit the Bottom



Source: Bloomberg, FactSet, CICC, data as of Dec 20, 2022

Internal factors

Strict COVID prevention and control measures applied by the government amid sporadic outbreaks in mainland China has disrupted the pace of economic recovery. In the meantime, concerns over regulations on the platform economy and real estate sector lingered, constraining both earnings and valuation of Chinese equities. Although the country has entered a new easing cycle since the fourth quarter of 2021, financing demand remained weak due to COVID. Not even a loose monetary policy and abundant liquidity are able to drive a continuous recovery of social financing demand.

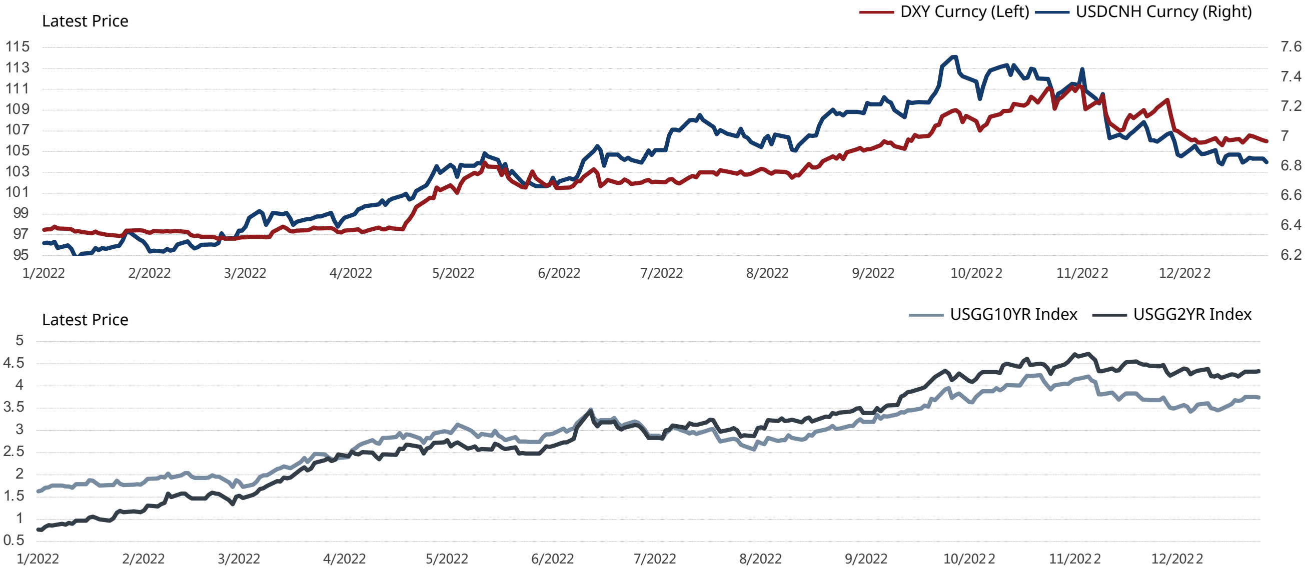
The high transmissibility of the new coronavirus variant has significantly increased the difficulty and economic cost of the “dynamic zero” policy. Economic growth and corporate earnings both missed expectations, while most sectors and individual stocks faced continued downward pressure on earnings forecasts during the year. Uncertainties around COVID-related restrictions also dampened investors’ risk appetite. However, since November 2022, with the release of the “20 measures” and “10 new measures”, the focus of the Chinese government has shifted from infection prevention and control to medical treatment. We expect the impact of the pandemic prevention and control measures on economic activities to reduce drastically in the coming transitional months. More importantly, Beijing’s supportive stance towards the platform economy and real estate sector will help rebuild investors’ confidence in the growth prospect of the Chinese economy and corporate earnings.

External factors

Since the beginning of 2022, the developed economies in the U.S. and Europe have raised interest rates rapidly and sharply due to high and sustained inflationary pressure. The stickiness of inflation and the pace of interest rate hikes have significantly exceeded market expectations. The strong US dollar index and rising bond yields in Europe and the US have dealt a blow to risk assets worldwide. The Russia-Ukraine conflict has pushed up the prices of energy, food and other commodities, further aggravating inflationary pressures. The strict sanctions imposed on Russia have also triggered concerns over potential spillover risks to China. This had led to a slowdown in foreign capital inflows and reduced exposure to China by overseas active funds. Interest rate hikes in overseas developed economies and geopolitical risks have aggravated the existing short-term fundamental challenges of the pandemic.

Since the fourth quarter of 2022, however, there have been clearer indications of sluggish growth in the US and Europe. Investors have fully priced in expectations of inflationary pressures and interest rate hikes. The dollar index and US bond yields have both fallen from the year’s highs, and the impact of rate hikes on the Yuan and China’s equity market has weakened. At the same time, as China reopens its economy, shows a more positive stance towards the platform economy and the real estate sector, collaborates with the US regulators to effectively reduce the delisting risk of US-listed Chinese companies, and strikes constructive dialogues with a number of countries, investors’ risk appetites for RMB assets have improved significantly. We expect plenty of upsides for China’s equity market as investors shake off their previously extreme-pessimistic expectations and begin to increase their positions.

Chart 3: Performance of USD, Offshore RMB, and U.S. Bond Yield in 2022

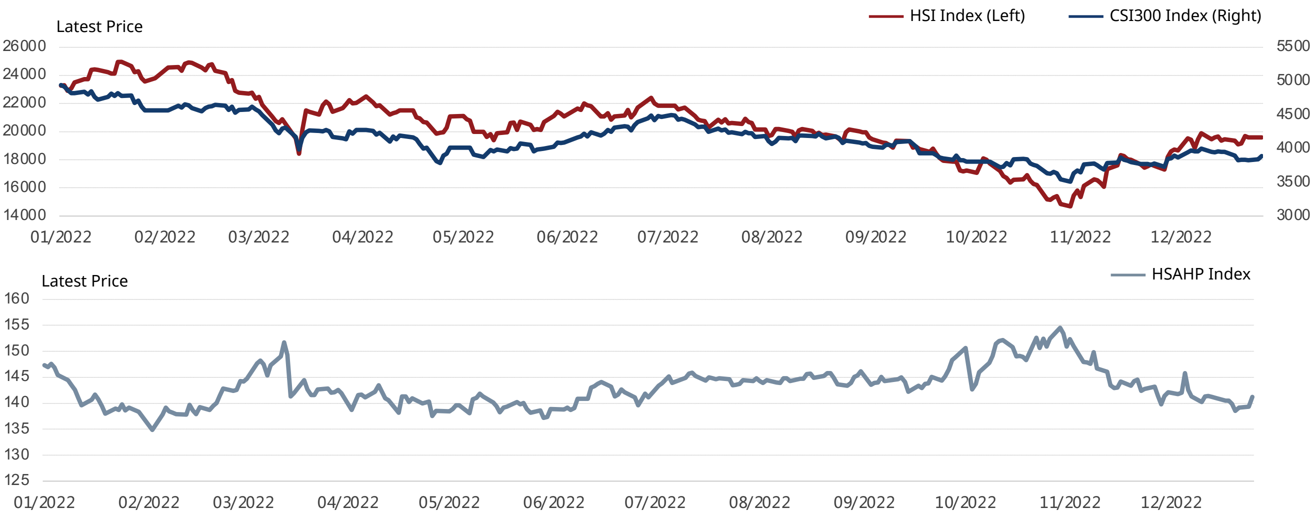


Source: Bloomberg, data as of Dec 27, 2022

Compared with the A-share market, offshore China equity market has been even more volatile in 2022, with the A-H premium index reaching extreme levels multiple times as the market inches downward. The main reason is that offshore China equities are prone to external factors, while consumer and TMT names are assigned higher weighting. As such, disruptive events such as the Russia-Ukraine conflict, the heightened delisting risk of US-listed China ADRs, the COVID outbreaks in Shanghai and other provinces, the escalated situation in the Taiwan Strait, and faster-than-expected monetary tightening, tend to have farther-reaching impacts on offshore China equities compared with A-shares during the same period. On the other side, the rebound of offshore China equities tends to be stronger than that of the A-shares when supportive events appear. For example, the market snapped back during the latter half of the second quarter when the pandemic eased and recovery expectations strengthened, and again in November when external and internal factors improved significantly.

Historically, offshore China equities generally outperformed when the US dollar index moved downward, and China's economic growth improved. The impact of external factors, improvement in the expectations of China's growth, liquidity, earnings expectations and risk appetite all lend more support to offshore China equities than to A-shares. Although the A-H premium index has fallen from the extremely high level amid the market rally since November 2022, subsequent fundamentals are likely to support further valuation recovery of offshore China equities.

Chart 4: Performance of CSI 300 Index, Hang Seng Index, and HSAHP Index in 2022



Source: Bloomberg, data as of Dec 27, 2022

Chart 5: Performance of HSAHP Index in the Past 10 Years

Source: Bloomberg, data as of Dec 27, 2022

Reopening Accelerates and Economic Recovery in 2023

The reopening marks an important turning point in the trajectory of asset prices and prospects for economic growth in China. Although investors' expectations of the reopening have been delayed multiple times during the year, the timing and pace of China's reopening since November 2022 have significantly exceeded market expectations. We believe the most challenging period for the economy and equity market is finally behind us.

The outbreaks of COVID and prevention and control measures are key variables affecting China's economy during the year. The pressure on economic growth created by the pandemic has exceeded market expectations at the beginning of the year. The economy was under enormous external and internal pressures, and as a result, has missed the country's full-year growth target. Earnings forecasts of most listed companies continued to be revised downward, constraining the return of China's equity market. The high transmissibility of the new coronavirus variant poses a challenge to the effectiveness and economic cost of China's "dynamic zero" policy, and the brief outbreak in Shanghai in the first half of the year undermined investors' confidence in China's economic growth. Investors were concerned about the uncertain timing of the reopening and the pace of recovery, putting China equities that are already at a historical low level under even greater pressure.

However, since November 2022, with the direction of the reopening becoming much clearer, investors' confidence in China's mid-to-long-term economic growth has been restored. Noticeably, overseas investors' risk appetite for Chinese assets has returned. As such, we believe the market had likely bottomed out for the medium to long term.

Changes in China's COVID prevention and control measures since November 2022	
Nov 10	The Standing Committee of the Politburo of the Chinese Communist Party's Central Committee met. While doubling down on the "dynamic zero" policy and maintaining the tone of "effectively coordinating pandemic prevention and control with economic and social development", the meeting emphasized "rectifying superfluous measures and minimizing the pandemic's impact on economic and social development", marking the first marginal change in China's pandemic prevention and control policies.
Nov 11	The Comprehensive Group of the Joint Prevention and Control Mechanism of the State Council released the "20 measures" to optimize pandemic response from various aspects, ranging from the definition of close contacts and risk areas, to measures related to inbound flights and travelers. These steps markedly reduced the economic impact of the pandemic and boosted market expectations on economic activity.
Dec 6	The Politburo of the Chinese Communist Party convened a meeting, in which it vowed to achieve an "overall improvement" of the economy in 2023 "characterized by higher quality and reasonable growth", highlighting the strategy of "further expanding domestic demand" and "giving full play to the fundamental role of consumption".
Dec 7	The Comprehensive Group of the Joint Prevention and Control Mechanism of the State Council announced the "10 new measures" to further optimize the pandemic response, easing restrictions on travel and service consumptions, narrowing down the scope of high-risk areas, and allowing close contacts, asymptomatic cases, and mild cases to be quarantined at home. These changes clearly showed that minimizing economic impact is now the priority of pandemic responses. Investors gradually reached the consensus that China will undoubtedly reopen, and positive expectations and confidence were further boosted.
Dec 26	The Comprehensive Group of the Joint Prevention and Control Mechanism of the State Council announced that China will downgrade the management of COVID from Class A to Class B, starting from Jan 8, 2023. The latest changes scrapped quarantine requirements for confirmed cases and stopped identifying close contacts and designating risk areas. In addition, disease control measures targeting inbound travelers and imported cargo will also be lifted. Up to this moment, almost all COVID-related prevention and control measures have been radically reversed. China's reopening has further accelerated.

With the adjustment in prevention and control measures, China has now moved into a new phase of pandemic control that emphasized more on medical treatment. The optimization of the pandemic response will inevitably lead to a nationwide infection peak in the short term and a transition period of several months before a full reopening.

In other countries, the first peak in infections typically occurs within 2-3 months after the initial easing of pandemic restrictions. Taking into account of the strong transmissibility of the current variant, the radical lifting of COVID restrictions, and the upcoming Chinese New Year, we expect infection to peak sooner in most parts of China, while the impact on the economy should wane after the Chinese New Year.

A direct impact of the peaking of infection is the surging demand for medical resources. Based on statistics from provinces that have gone through the first peak, such as Beijing and the Hebei provinces, the pressure caused by rapidly rising infection is generally controllable. Data shows that while many large cities in China have reached the infection peak, microeconomic activity indicators in some cities have begun to rebound. As more regions reached infection peaks, the economic and social order will be restored at an accelerated pace, while economic growth will be back on track sooner.

The short-term impact of the increase in infections has been reflected in the economic data for November, with sharp declines in key indicators of production, investment and consumption. The negative impact is expected to lessen significantly over the following 1-2 months. as more regions brace for infection peaks around the Chinese New Year. An early reopening will facilitate the recovery of economic growth in 2023.

We expect China's economy to grow at around 2-2.5% in the fourth quarter of 2022, with a full-year target of around 3%. As the government emphasises "high-quality development" and "balancing between current work and future development", we expect China's GDP growth to reach 5% or higher in 2023 after taking into consideration the accelerated reopening, China's potential growth capacity and employment pressure.

We expect China's economy to enter its strongest recovery phase after the Chinese New Year, which will last through the end of the second quarter of 2023. On one hand, the pandemic will largely come under control after the Chinese New Year, with little to no influence on economic activities while accelerating the pace of recovery. On the other hand, more stabilization policies are expected to be introduced as the new leadership team takes over following the "Two Sessions". We expect to see more stimulus policies for consumption and investment during the second quarter, creating a unique window of opportunity for a quick recovery.

Although a subsequent wave of infections after the initial peak or in later 2023 can't be completely ruled out, the shock to medical resources and economic activity is expected to be milder than that of the initial wave. The impact on the equity market is also likely to be softer.

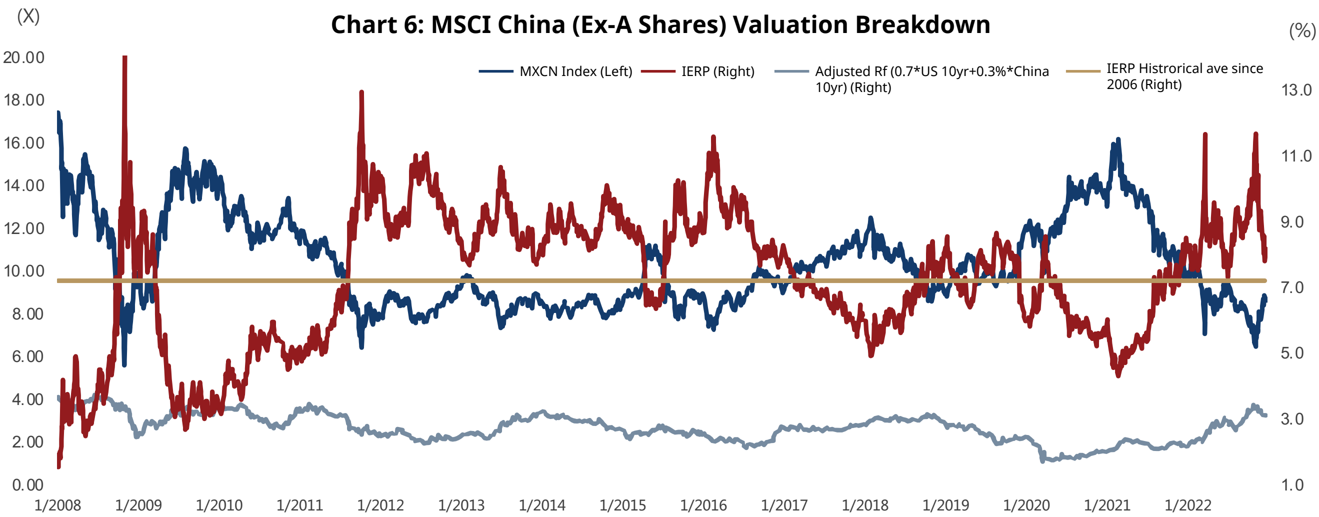
Sector Allocation and Investment Themes in 2023

In terms of the valuation and catalysts, we believe offshore Chinese equities may outperform A-shares in 2023. In the past two years, the valuation of offshore Chinese equities has gone through more drastic corrections, thanks to a mix of internal and external factors. As the US dollar index drops and China's economy rallies, the real estate sector and platform economy will benefit more from China's policy support and economic recovery. As a result, we see more upside potential in offshore Chinese equities than in A-shares.

In terms of capital, offshore Chinese equities are expected to draw more funds from overseas investors as the growth prospect and external environment improve.

Overseas institutional investors have underweighted Chinese equities over the past few months, and offshore Chinese equities are much more important for them than A-shares. Despite the extreme volatility in 2022, mainland investors kept pumping money into the Hong Kong equity market through the connect program. We expect the trend to be reinforced in 2023 as regulators continue to expand the Stock Connect Program, add more eligible stocks, introduce RMB-denominated stocks, as well as launching the RMB trading counter. Furthermore, listing rule reform in Hong Kong will also create a more diversified offshore Chinese equity market. In the past, a lack of cutting-edge technology companies (innovative information technology, advanced hardware and materials, new energy etc.) has been a pain point for offshore China equity market investors. With the listing of more cutting-edge technology companies, the investment options available to investors will be expanded, which will in turn draw more overseas investors to the offshore China equity market.

Chart 6: MSCI China (Ex-A Shares) Valuation Breakdown



Source: Bloomberg, Wind, FactSet, CICC, data as of Dec 20, 2022

In terms of investment themes, we will focus on opportunities that can benefit from these trends in 2023: 1) China's economic recovery, 2) industrial upgrading and domestic substitution in the high-prosperity technology manufacturing industries, and 3) investment opportunities presented by high-quality state-owned enterprises (SOEs) under the "valuation system with Chinese characteristics".

1. The leading macroeconomic factor in 2023 will be China's economic recovery, and the relevant sectors that stand to gain from this are consumption, transportation, real estate, financials, medical devices and services. The valuation of the majority of the companies in the aforementioned sectors has rebounded somewhat since the November rally, but overall valuation remains at a reasonable level given the short-term impact of an increase in infections brought on by the removal of COVID restrictions. The pace of recovery remains a critical factor in China's equity market in 2023. As the impact of the pandemic dies down, investors should pay close attention to indicators like residents' income expectations, their willingness to consume, the pace of real estate sales recovery and the stabilization of housing prices, as well as additional stimulus packages in consumption and investment. Nevertheless, as the economy grows, especially following consolidations triggered by the pandemic over the previous years, we believe that there will be enormous investment opportunities in the aforementioned sectors, and leading companies will outperform peers and generate higher returns for investors.

2. The high-prosperity technology manufacturing industry will benefit from industrial upgrading and domestic substitution in 2023. The sector is expected to receive long-term support from the government as it is in line with the needs of China's "high-quality development". In the report from the 20th National Congress, the words "security" and "stability" appeared multiple times. Additionally, the Central Economic Work Conference has determined to "roll out an array of national-level major science and technology projects and enhance the government-led incentive system". As a result, we expect to see more supportive measures in the advanced technology manufacturing sector in 2023. In recent years, many Chinese science and technology manufacturing companies have experienced tremendous growth. Breakthroughs have been made in sectors such as semiconductors, national defence, advanced instruments and materials, and a few domestic companies have taken the lead globally in the new energy and electric vehicle-related industries. All these developments offer a wealth of investment opportunities in small and medium-cap growth stocks to investors. Although the rate of growth may somewhat slowdown in 2023, we expect the new energy and electric vehicle industries to continue to grow rapidly. Investors may keep an eye on companies that have a competitive edge and stand to gain from new technological revolutions. Domestic substitution (medium and long-term trends) and prosperity (short-term trends) are two primary investment themes in the semiconductor industry. We prefer to invest in those that benefit from long-term trends (domestic substitution) but trade at low valuations in the short term (low prosperity), as these companies have bigger potential upside once the short-term disruptions are addressed. The national defence sector, though susceptible to market sentiment, has strong growth potential in 2023. We prefer individual stocks with solid fundamentals and reasonable valuations.

3. With the introduction of the "valuation system with Chinese characteristics", valuations of high-quality listed SOEs are expected to increase. On November 21, Yi Huiman, chairman of the China Securities Regulatory Commission, stated that the regulator intended to "explore ways to build a valuation system with Chinese characteristics so that the market plays a better role in resource allocation". Listed SOEs have traditionally been trading at low valuation multiples, with many SOEs' stock prices (in sectors of financials, energy, telecommunications, infrastructure, transportation etc.) trading below their book values. Despite stable profitability, the vast majority of listed SOEs trade at massive discounts. We expect the valuation of high-quality listed SOEs to increase substantially amid an economic recovery in 2023 as listed SOEs strengthen investor relations, enhance incentive mechanisms, increase dividend payout ratios, and broaden the scope of investments. Listed SOEs typically offer higher downside protection but less upside potential. They will also be able to offer stable cash flow returns when the market goes through periods of high uncertainty and volatility in 2023. We see ample investment opportunities in listed SOEs with strong earnings stability.

Global Fixed-income Market

2022 Global Fixed-income Markets Review

Looking back on 2022, the combination of geographical conflicts and tightening global liquidity has brought the greatest pressure to risk assets since the financial crisis. Safe-haven assets such as the U.S. dollar and commodities have outperformed financial assets, while equity, especially emerging markets and growth stocks lagged behind. Global fixed-income assets also recorded their worst performance in 20 years.

Chart 7: Performance of Major Assets

Index	2020	2021	1st Quarter 2022	2nd Quarter 2022	3rd Quarter 2022	4th Quarter 2022	2022
Agricultural Product	14.9%	24.7%	22.0%	-8.0%	1.4%	-1.4%	12.1%
USD Index	-6.7%	6.4%	2.8%	6.5%	7.1%	-7.7%	8.2%
WTI crude oil	-20.5%	55.0%	33.3%	5.5%	-24.8%	1.0%	6.7%
Gold	25.1%	-3.6%	5.9%	-6.7%	-8.1%	9.8%	-0.3%
Nikkei Index	16.0%	0.5%	0.9%	-5.1%	-1.7%	0.6%	-5.3%
Industrial Metal	14.8%	29.6%	17.7%	-25.3%	-7.5%	13.6%	-7.6%
Eurozone Stock Index	-5.1%	21.0%	-9.2%	-11.5%	-4.0%	14.3%	-11.7%
Total Return of Global High Yield Bond	7.0%	1.0%	-5.7%	-11.9%	-2.7%	8.0%	-12.7%
Total Return of Global Investment Grade Bond	-3.4%	-14.1%	-6.0%	-0.6%	-21.2%	14.9%	-15.5%
HSI Index	9.2%	-4.7%	-6.2%	-8.3%	-6.9%	4.5%	-16.2%
US S&P Stock	18.4%	28.7%	-4.6%	-16.1%	-4.9%	7.6%	-18.1%
Russel Index	18.4%	13.7%	-7.8%	-17.5%	-2.5%	5.8%	-21.6%
CSI 300 Index	27.2%	-5.2%	-14.5%	6.2%	-15.2%	1.8%	-21.6%
EM Stocks	15.8%	-4.6%	-7.3%	-12.4%	-12.5%	9.2%	-22.4%
NASDAQ	43.6%	21.4%	-9.1%	-22.4%	-4.1%	-1.0%	-33.1%

Source: Bloomberg, data as of Dec 22, 2022

If the Russian-Ukraine conflict is seen as a black swan event of the first-half of the year, then persistently high inflation, especially the stickiness of inflation in the service sectors, has cast a shadow over the market in the full year far exceeded investors' expectation. The primary reasons for runaway inflation are large-scale liquidity loosening ahead of the pandemic, and supply-side structural problems brought about by the pandemic. These gave the Fed no choice but to take its most drastic rate hike path in 40 years. For the full year of 2022, it has lifted rates seven times by a total of 425 basis points. This was far higher than the 75 basis points predicted by the market at the end of 2021. At the same time, the U.K. and European central banks and most emerging markets have adopted similar rate hike paces, thereby dampening the overall risk appetite of the market.

Chart 8: Performance of Fixed Income Assets

Index	2020	2021	1st Quarter 2022	2nd Quarter 2022	3rd Quarter 2022	4th Quarter 2022	2022
US National Bond	8.2%	-2.4%	-5.6%	-3.8%	-4.7%	0.7%	-12.9%
Developed Market Sovereign Bond	9.3%	-6.9%	-6.5%	-8.9%	-7.7%	4.3%	-18.0%
US Investment Grade Company Bond	9.8%	-1.0%	-7.7%	-6.7%	-5.1%	3.5%	-15.4%
US High Yield Bond	6.2%	5.4%	-4.5%	-10.0%	-0.7%	4.0%	-11.2%
Europe Investment Grade Bond	2.8%	-0.8%	-5.9%	-7.5%	-5.0%	1.1%	-16.4%
Europe High Yield Bond	9.5%	-1.6%	-9.2%	-14.7%	-5.8%	11.9%	-18.3%
EM Company Bond	7.8%	-1.9%	-9.6%	-6.7%	-3.8%	5.0%	-14.8%
Asia High Yield Bond	6.2%	-17.5%	-13.8%	-13.3%	-8.3%	14.1%	-21.8%
Asia USD Bond	7.1%	-3.1%	-7.0%	-5.3%	-4.0%	3.4%	-12.6%
EM Sovereign Bond	6.9%	-3.6%	-10.0%	-12.5%	-5.4%	9.0%	-18.8%
China USD Investment Grade	6.6%	-0.2%	-5.7%	-2.9%	-3.2%	1.8%	-9.9%
China USD High Yield	9.4%	-33.3%	-25.2%	-16.9%	-15.5%	27.1%	-33.3%

Source: Bloomberg, data as of Dec 22, 2022

However, a global recession that could be triggered by rapid interest rate hikes and a slowdown in the pacing of rate hikes are gradually being priced in by the market. Following a short-term rebound in July, since November the U.S. treasury yield has taken another dive, once again driving up the performance of risk assets.

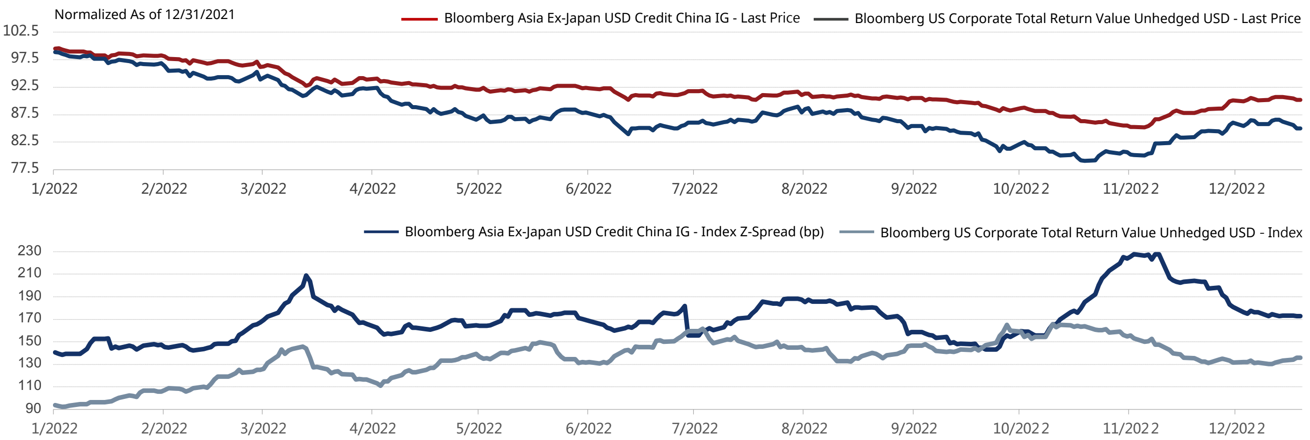
There is little doubt that rapid tightening has had an enormous impact on the global bond markets. The Bloomberg Global Bond Index has fallen over 15% in 2022, wiping out the entire gain it has accumulated over the past five years. Among them, the rise in the U.S. bond interest rate has contributed over 70% to the "negative returns." The two-year and 10-year U.S. treasury rates rose 3.5% and over 2%, respectively. The inversion of the U.S. yield curve came earlier and deeper than the previous rounds of rate hike cycles. Other than China and Japan, the sovereign debt interest rates of all other countries have risen, though by varying degrees.

For credits, rising financing costs have led to an over 30% decrease in the supply of corporate bonds compared with 2020 and 2021. On the demand side, there has also been a significant outflow from bond funds. The full-year credit spread has gone through a correction from the relatively high level at the end of 2021. To break it down by phases, the overall credit spread widened in the first half, before fluctuating wildly in the second half.

For investment-grade bonds, the performance of Chinese-issued U.S. dollar bonds was relatively independent of other factors, benefiting from the technical support brought by the interest rate spread between the U.S. and China. Shorter-term Chinese-issued U.S. dollar bonds outperformed developed markets in Europe and the U.S.

For high-yield bonds, the U.S. is still leading the pack, while China and Europe have been underperforming due to the depressed real estate market and the Russia-Ukraine conflict respectively.

Chart 9: China Investment Grade Bond VS U.S. Investment Grade Bond



Source: Bloomberg, data as of Dec 22, 2022

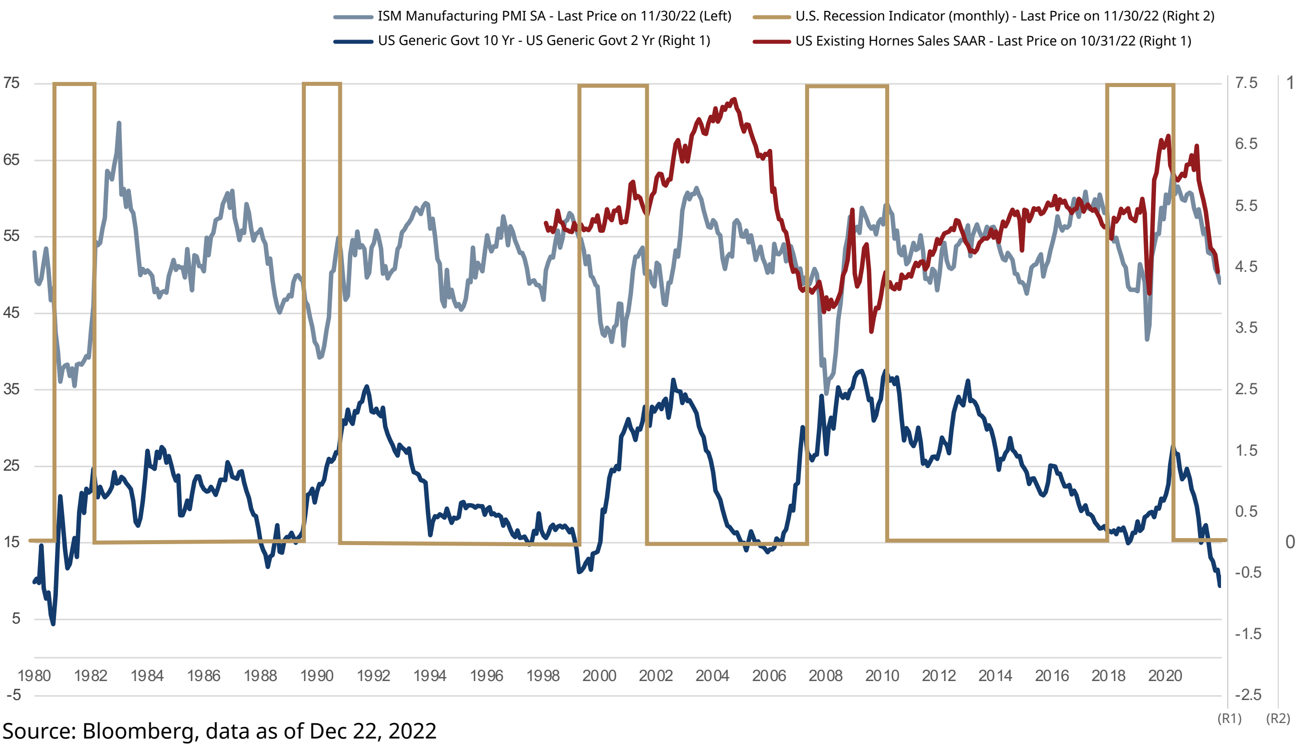
“Soft Landing” of the U.S. Economy and Central Bank Monetary Policies

The U.S. Economy

Going into 2023, the focus of the market will gradually shift from inflation and the Fed’s interest rate hikes to a recession in the U.S. Based on past experience and the uniqueness of the current cycle, we tend to believe that under the base scenario, the U.S. economy will achieve a relatively soft landing after going through a mild recession.

After recording negative growth for two straight quarters, U.S. GDP was back in positive territory in the third quarter. Yet most leading indicators in past economic cycles (economic data such as PMI and home sales, financial indicators such as 2- to 10-year credit spreads) all pointed to a higher possibility of the U.S. going into recession by the second quarter of 2023. As the 9 rate hikes over the past 50 years showed, recession seemed almost inevitable in the face of high inflation.

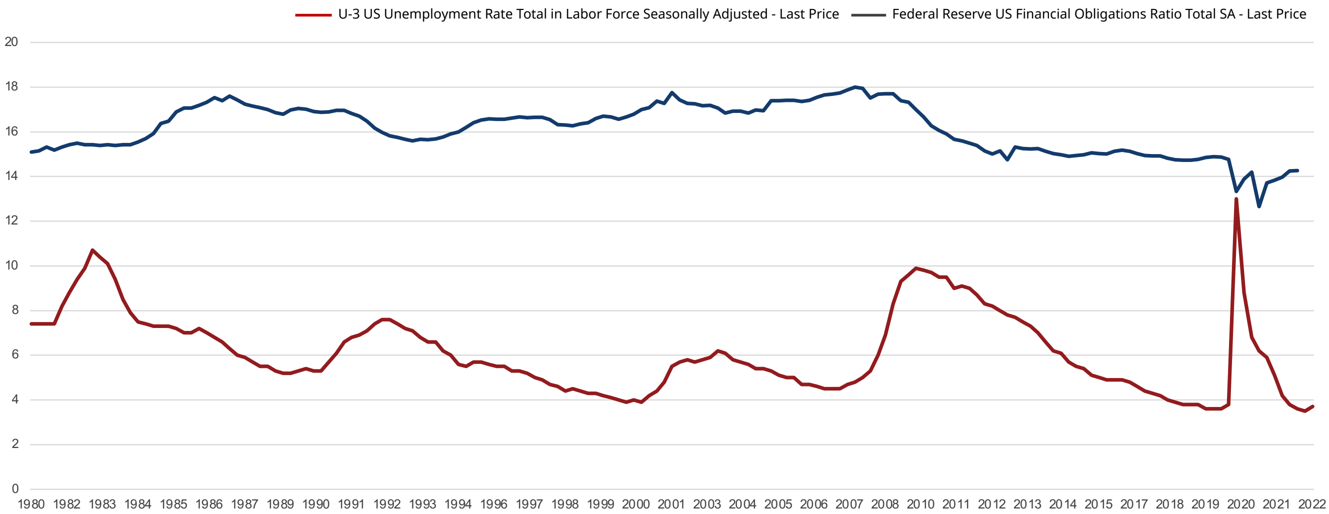
Chart 10: Multiple Indexes Show a Relatively Large Pressure of Recession



Source: Bloomberg, data as of Dec 22, 2022

Having said that, the current scenario is quite different from most rate hike cycles in history. On the one hand, structural problems in the job market have not been resolved and the unemployment rate remains low. On the other hand, even as home sales and prices have retreated significantly, the debt to asset ratio and the percentage of fixed-rate mortgages remain at healthy levels. As such, we believe the probability of a deep recession or economic crisis is relatively low.

Chart 11: Relatively Healthy Employment Rate and Household Financial Liabilities



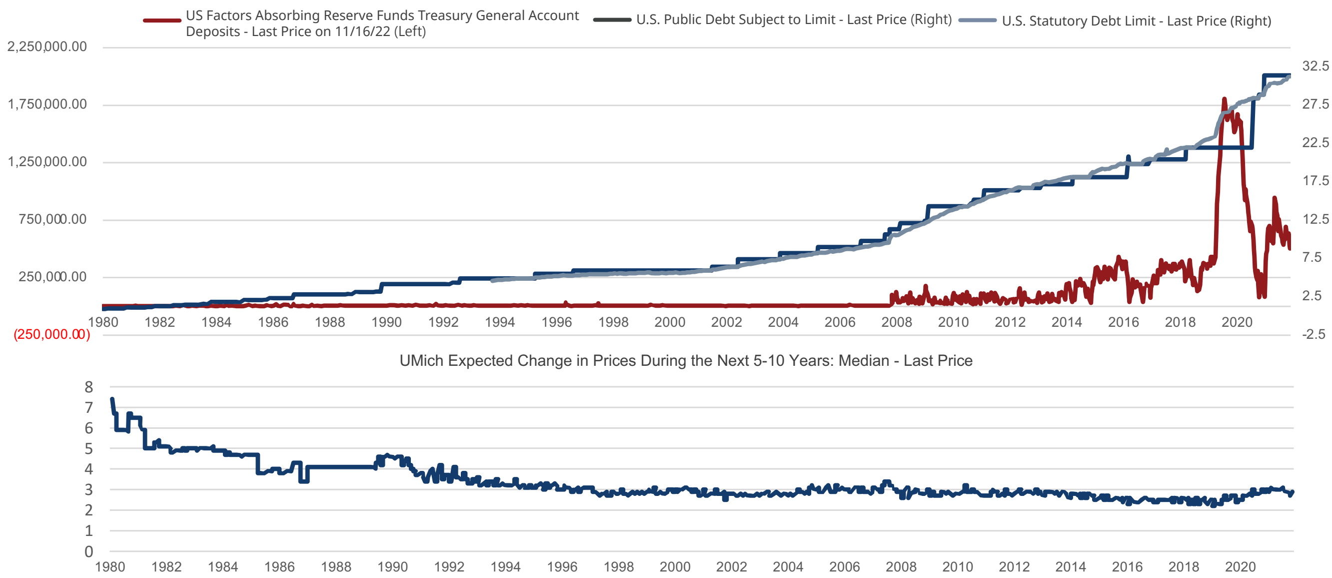
Source: Bloomberg, data as of Dec 22, 2022

The Fed's Monetary Policy and Rate Hike Path

To decide the next step of its monetary policy, the Fed must balance economic recession with inflation.

Inflation in the U.S. has probably peaked. On the one hand, housing rent is a lagging indicator, and it's only a matter of time before it comes down. On the other hand, the bottleneck in the supply chain has been significantly alleviated. Whether job vacancies and the pace of wage increases can be eased will be the core focus of next year. In contrast to the Volcker era, the Fed nowadays needs to consider more factors while formulating its policies. The liquidity and stability of the financial markets, and the questions surrounding the debt ceiling can potentially constrain future rate hikes. At the same time, the current long-term inflation rates remain at healthy levels.

Chart 12: Problem of Debt Limit Still Exists while Long-term Inflation Expectation Remains Stable



Source: Bloomberg, data as of Dec 22, 2022

We believe that in the short term, the probability of a major reversal in the Fed's views is not high. But at the same time, we don't think the current round of interest rate hikes has been sufficient. As such, the Fed may raise rates two to three more times in 2023 (not more than 75 bps) before calling an end to the current rate hike cycle. Afterwards, it may maintain the rate at its peak for a short period (about 6 months) before bringing it down gradually. Of course, we can't rule out the possibility that the Fed may, under stagflationary pressure, provide more maneuvering room for its monetary policy by adjusting its inflation target.

In the short run, the U.S. treasury yield will still maintain upward momentum in the first quarter of 2023. The 2-year U.S. treasury yield is expected to approach 4.5%, with the 10-year yield returning to around 4%.

In the medium term, with rates having peaked, the expectation for a rate decrease will rise while the U.S. treasury yield will gradually decline. If rates begin to come down at the end of 2023, the 2-year bond yield may drop to around 3.5% to 4%, with the yield curve gradually steepening.

For other economies, China and most developed countries have grown at a slower than expected pace in 2022, while most countries in emerging markets have grown faster than expected. Going into 2023, the International Monetary Fund (IMF) predicts that most major economies, other than China, will be constrained by liquidity tightening, weakening demand and high base, among other factors, leading to a further slowdown in growth. The Euro zone energy and debt issues, along with the adjustment of Japan's monetary policy framework, will become the keys to whether regional economies will fall into recession in 2023.

In terms of monetary policy, futures market expectations indicate that most economies will finish raising rates in the second quarter, with the base rate either plateauing or falling. China and Japan, on the other hand, will run counter to the global cycle and face tightening pressure.

Chart 13: Global Expectation of GDP Growth Rate and Implied Interest Rate

	2022 GDP Estimation	2023 GDP Estimation	Current Benchmark Interest Rate	Six months Implicit Interest Rate	One Year Implicit Interest Rate
US	1.6	1	4.38	4.93	4.5
Canada	3.3	1.5	4.25	5.17	3.69
Eurozone	3.1	0.5	2	3.79	3.82
UK	3.6	0.1	3.5	4.61	4.74
Japan	1.7	1.6	-0.1	0.1	0.28
China	3.2	4.4	2	2.16	2.41
India	6.8	6.1	6.25	6.35	6.03
Brazil	2.8	1	13.75	14.04	13.21
South Africa	2.1	1.1	7	7.45	7.56

Source: Bloomberg, IMF, data as of Dec 22, 2022

Opportunities and Challenges in the Fixed Income Markets in the Face of Global Recession

After a dismal performance in 2022, the overall yield of global fixed-income markets (using the Bloomberg Global Composite Total Return Index as an example) has reached a 10-year high. In the long run, it has attractive value in relative and absolute allocation. In addition, with the peaking of the Fed rate hike, there will be better trading opportunities for good-quality long-term bonds. However, considering that the valuation of the credit spread in most sectors is not cheap, if the economy goes into recession, they may face the risk of a widening credit spread. As such, we maintain a cautiously optimistic view of the overall bond market for 2023.

Looking at the valuations of different sectors globally, most sectors' credit spreads are now in the 50th to 70th percentile, following November's rebound (the peak in 2022 was in the 70th to 90th percentile of the past 5 years). On the other hand, the credit spreads of large banks' credit default swaps (CDS) are still some way from the peak during the financial crisis (2008 financial crisis, 2012 Euro debt crisis, 2020 liquidity crisis). Even though we believe the probability of a financial or economic crisis in 2023 is extremely low, the market should remain vigilant about the risk of periodic widening of the credit spread in 2023.

US Investment-Grade Bond

Valuation: From a vertical perspective, the credit spread of US investment-grade bonds is now at the 65th percentile of the past 10 years. Laterally, even though the spread of U.S. high-yield and emerging market U.S.-dollar debts has risen from historical lows compared with U.S. investment-grade bonds, it is still at its historical average level from a long-term perspective and remains somewhat attractive.

01

Fundamentals: The overall credit situation is still very healthy. Though a downturn in 2023 is more or less a certainty, most issuers have already taken advantage of the low-rate environment in 2020 and 2021 and completed the early financing of a great number of long-term debts.

02

Past economic cycles show that the credit spread of US investment-grade bonds will neither widen nor narrow significantly following the peaking of interest rates. That said, we expect it to widen considerably following the first rate cut.

03

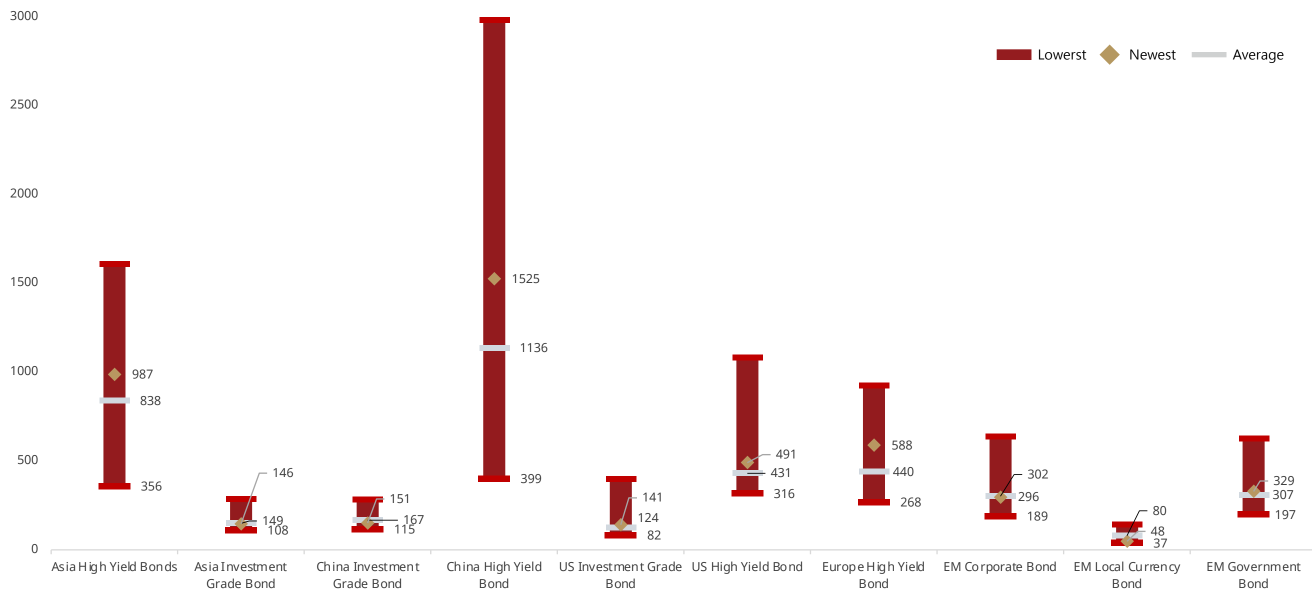
Allocation Recommendation

U.S. investment-grade bonds have better long-term allocation and stage trading opportunities when interest rates peak or if the recession is controllable.	
Rating	Our top pick is long duration, A rating (or above) bonds to reduce the risk of widening credit spreads
Industries	Overweight sectors with stable profitability and healthy liquidity, such as healthcare, communications and public utilities Relatively overweight the banking industry, with its attractive valuation and expected slowdown in supply growth Relatively underweight the pandemic recovery and energy sectors, last year's outperformers Underweight on cyclical industries

Chinese-issued U.S. Dollar Bonds

As infection peaked in China following the relaxation of pandemic prevention measures, the country's economy is expected to recover robustly. The key influencing factors are consumption and real estate. Fiscal policies rely more on the central bank's targeted and precise delivery. It is worth noting that Chinese-issued U.S.-dollar bonds have rebounded sharply since November. Over the same period, onshore corporate bonds have been repriced as a result of a large number of redemptions of domestic wealth management products. At the moment, the premium of Chinese-issued U.S. dollar bonds relative to onshore bonds has already significantly narrowed or even reversed. At the same time, investors should remain vigilant about the accelerator effect of the rise in the cost of leverage during a market downturn in the context of liquidity tightening in the U.S.

Chart 14: Global Credit Spread Valuation in Past 5 Years



Source: Bloomberg, data as of Dec 31, 2022

China USD Bond Allocation Advice under Standard Context

	Chinese Banks	Chinese Non-bank Financial Institutions	Chinese State-owned Enterprises (SOE)	Chinese City Investment Enterprises (non-core SOE)	Chinese TMT (Private-owned Enterprises)	Chinese Real Estate
Performance Review of 2022	Chinese banks had leading performance. High-class bonds had been at a historically high level and subordinated bonds had been far ahead of other regions	AMC had lagging performance due to influence from macro factors. Other sectors had relatively strong performance	Most names largely outperformed thanks to support from technical side and fundamentals	Had a relatively large issued volume with an increasing percentage of SBLC. Had strong performance in the first three seasons but relatively large division in performance recently	Had a relatively larget fluctuation with equity asset within the year. valuation return to relatively appropriate level recently	A large number of enterprises continue to default. With a really bad market mood, the index has once fallen by over 50%. But there was a rebound recently
Current Valuation	**Highly**	**Neutral (low for AMC)**	**Relatively high**	**Neutral**	**Relatively low**	**Low**
Enterprise Fundamentals Outlook	Influenced by real estate, NPL might experience a small rise, but generally bad debt and liquidity risks are controllable	Recovery of economic fundamentals creates relative support to leasing and insurance. AMC is still estimated to suffer a relatively large loss	Funtamentals are still expected to remain strong under the support of policies. Pay attention to China-US relations	Lagging performance of real estates and spending on pandemic cause rather large pressure to local public finance	Internet software companies are expected to recover as the market digests bad news. Hardware companies take the pressure from global economic recession	Policy supports are expected. But the falling trend of the industry in the long term stays unchanged and there will still be some real estate enterprise crises
Technical Side Outlook	Expected to be lots of TLAC bond supply, but can be well digested due to a lack of asset	Refinancing is expected to be the main source of supply. There is still expected to be relatively high fluctuation of high beta. Can seize the opportunity under belief in state-owned enterprises	Expected to be a lack of supply and constantly negative net financing. Expected to be relatively high demand still under the domestic low-interest environment	Refinancing is expected to be the main source of supply. Percentage of the issued guarantee might rise. Currenly BBB still had a 50bp difference of interest compared to domestic city investment debt, but the domestic valuation is still relatively high	Mainly about refinancing. Paying attention to whether international investors will re-enter	Normal financing window in the first half-year period next year is still quite hard to open. Market mood is still hard to recover completely. There are relatively large fluctuation as well as gaming opportunities
Holding Advice	**Relatively low**	**Seek the opportunity**	**Neutral**	**Low**	**Neutral**	**Seek the opportunity**

Allocation Advice for Different Regions Globally under Standard Context

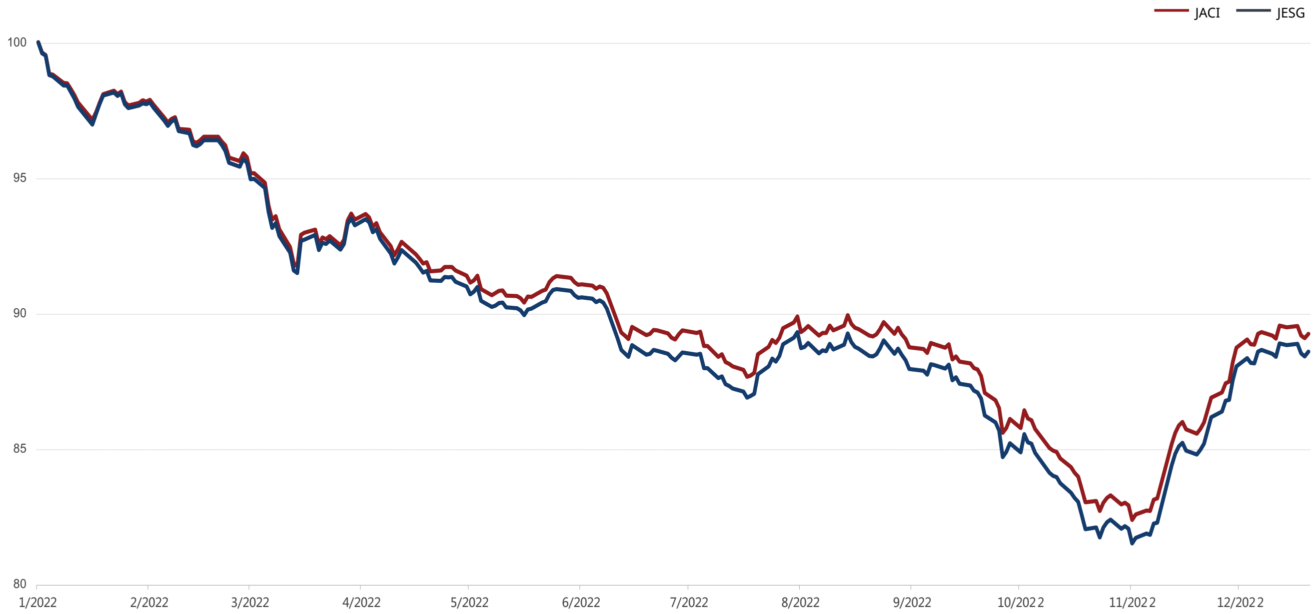
	Horizontal relative valuation	Risk	Rebound sequence	Advice on short-term holding	Advice on middle to long-term holding		
					Pessimistic	Neutral	Optimistic
China	Middle	Middle	Relatively independent	Neutral	High	Neutral	Neutral
Asia (except China)	Relatively expensive	Middle	Relatively in the middle	Neutral	Neutral	High	High
America	Middle	Relatively small	Relatively forward	Neutral	High	High	Neutral
Europe	Relatively cheap	Relatively large	Relatively in the middle	Low	Low	Low	High
Other newborn markets	Relatively expensive	Relatively large	Relatively backforward	Low	Low	Neutral	High
Cash (money market instrument)	Cheap	Very small	counter-cyclical	High	High	Low	Low

Investment Themes

ESG fixed-income investment is expected to regain momentum in 2023. The concept of ESG, which has become a controversial topic because of the energy crisis in 2022, was the reason behind the underperformance of the Asia ESG Bond Index compared with traditional indices. Nevertheless, the proportion of ESG bond issuance has continued to rise throughout the year, while ESG funds have also attracted net inflows against the trend. We see attractive opportunities in ESG fixed-income investments.

With the continual improvement of regulation and disclosure, the shift in market preferences, and the continuous inflow of funds brought about by long-term investment trends, ESG bonds and bonds issued by corporates with higher or consistently-improving ESG scores will become some of the most sought-after investment opportunities in 2023.

Chart 15: Performance Comparison Between Asia Bond ESG Index and Traditional Index



Source: J.P. Morgan, data as of Dec 22, 2022

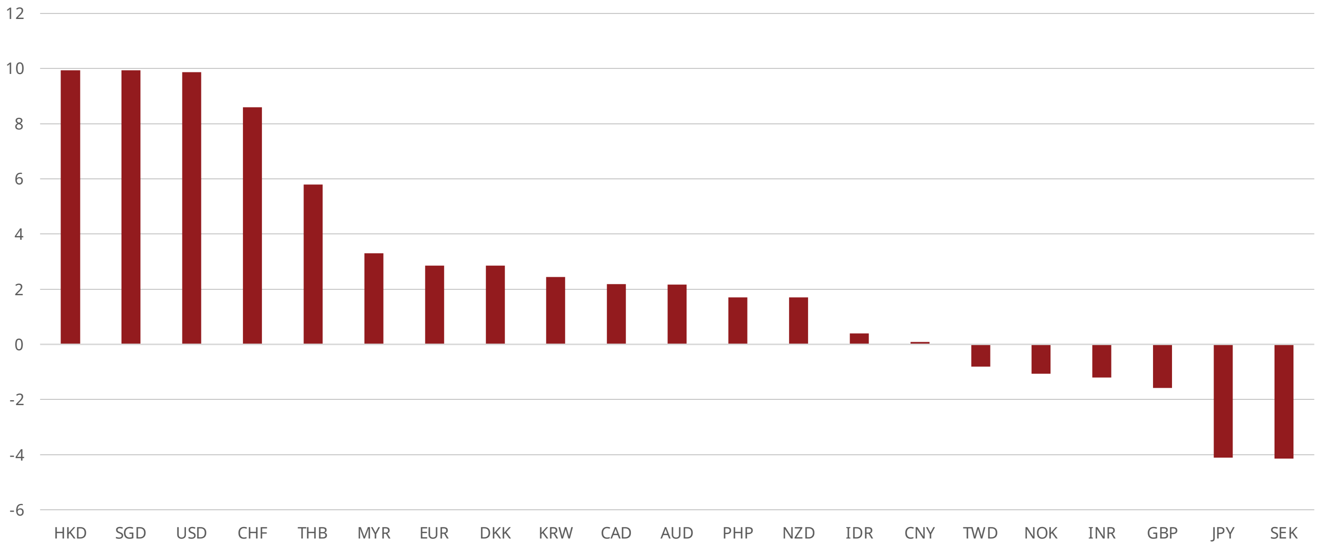
Overall, we believe that as interest rates peak, there will be solid opportunities in the global bond market in the midst of economic and policy uncertainties in 2023. The US market will stabilize if its economy achieves a soft landing. We expect to see a gradual and fluctuating rise, rather than a rapid and robust V-shaped rebound similar to what we witnessed in the aftermath of the liquidity crisis in 2020.

We recommend investors take measures to manage and diversify credit and country risks in the short term, maintain good liquidity to cope with potential crises, and reserve "bullets" for dip buying. When the opportunity arises, investors are recommended to start with investment-grade bonds, including US Treasuries, sovereign bonds, semi-sovereign bonds and other investment-grade credit bonds.

RMB Assets Set to Rise Against the Trend

Looking back on 2022, the Yuan has depreciated about 9% against the US dollar and 3.5% against the CFETS basket currency index, even as China's trade surplus reached a historic high. The key contributing factors include frequent geopolitical events, the Fed's aggressive interest rate hikes, the pandemic, and the worsening risks associated with China's real estate sector. However, the Yuan remained strong against other currencies, including the pound and the Japanese yen.

Chart 16: Performance of Major Currencies in 2022 Compared to RMB



Source: Bloomberg, data as of Dec 22, 2022

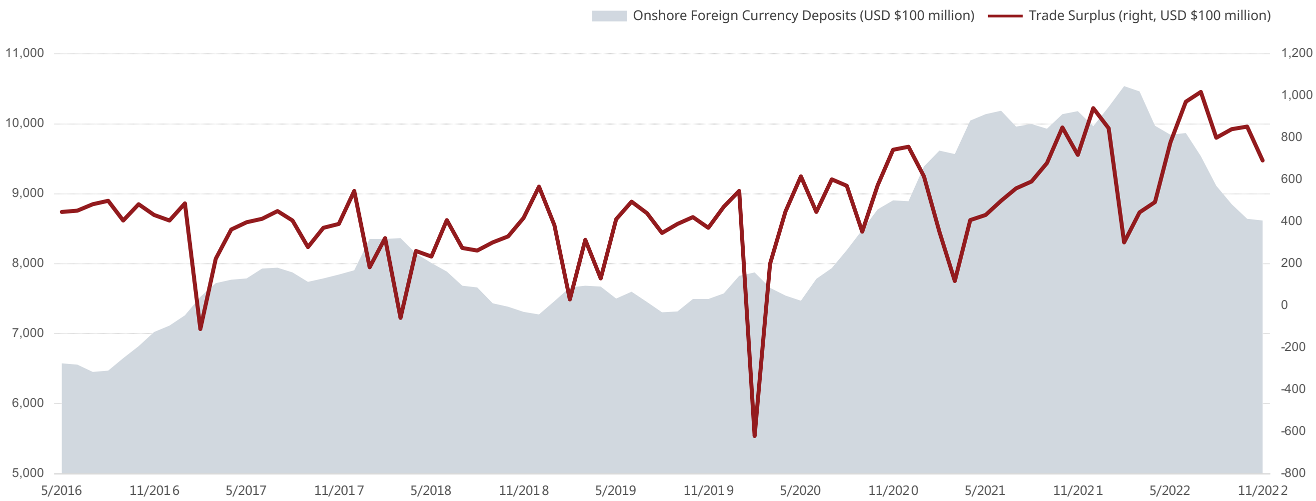
Nevertheless, the most aggressive phase of the Fed's rate hike has passed. The dollar index has peaked and started to slide, while the USD/CNY exchange rate has dropped to below 7.0 from its highest since the 2005 CNY exchange rate reform. We believe that the dollar will remain weak in 2023, though there are still uncertainties in the Fed's tightening path, the dollar index may not trend down immediately. Under the pressure of rising interest rates and the high base effect, the US economy will find it difficult to maintain its strong momentum. In fact, a series of US economic indicators have begun to contract recently. After the midterm elections, the US will face a divided government. The chances of major legislation being delayed in the next two years will increase, which can lead to contracted fiscal policies and slow down the U.S. economy. At the end of the tightening cycle, the dollar index tends to fall before that of US Treasury yields. As such, we expect a tailwind for the Yuan in 2023.

Meanwhile, the main growth obstacles are gradually being removed in China. The government eased pandemic prevention and control measures in the fourth quarter of 2022, ramped up supportive measures for the real estate sector, and re-prioritized stable growth. We expect China's economy to pick up significantly in 2023, lending extra support to the exchange rate.

China's export growth is likely to slow down, and the trade surplus is expected to drop from its all-time high in 2023 due to shrinking overseas demand and the high base effect. Still, the total balance of US dollars held abroad by Chinese exporters remains at a high level, excluding the trade surplus settled in CNY and positions hedged through derivatives (options, forwards, etc.). As of November 2022, the amount of foreign exchange settlement and sales by banks accounts for only about 30% of the total trade surplus. With the fall of the US dollar index in 2023 and the recovery of China's economy, foreign exchange settlement is also expected to recover as the Yuan strengthens. This will offset the negative impact of a shrinking trade surplus to some extent. We expect the median exchange rate to remain within the range of 6.6 to 6.9 in 2023.

Specifically, consumption and real estate investment are the two major burdens on China's GDP economy in 2022.

Chart 17: China Onshore Foreign Currency Deposits and Trade Surplus



Source: Bloomberg, data as of Dec 22, 2022

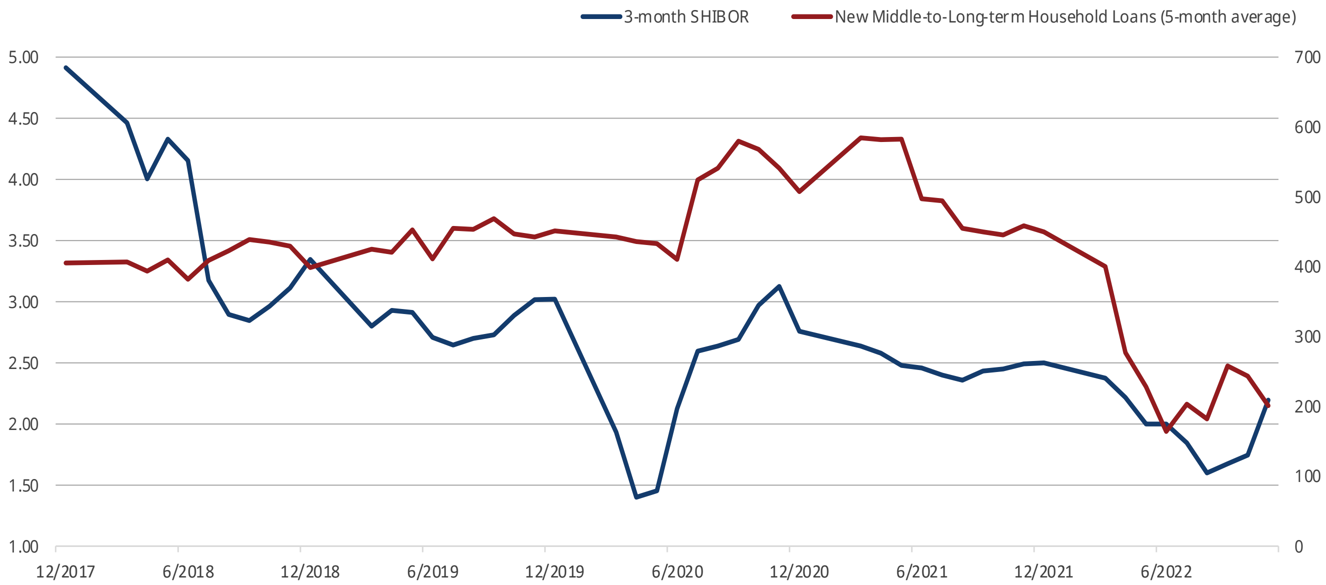
	Consumption	Real estate investment
2022 YTD growth rate	0.1%	**-9.8%**
Average growth rate over the past five years	7.2%	**7.6%**
As a percentage of GDP	50%	**10%**

With the introduction of supportive policies for the real estate sector in November, such as the "Three Arrows" and "16 Financial Measures", developers' credit profiles and property sales are expected to improve. As the likelihood of a property sales recovery this year increases, real estate investment will stabilize, and thus enabling credit expansion.

The disrupting effect of the pandemic will be much reduced after the central government adjusted the relevant restrictions. The service sector, which employs the greatest number of workers, is expected to be back on track, resulting in higher income expectations. Household consumption is also expected to rebound to the average level of the previous few years from a low base, thanks to a slew of stimulus measures. Traditionally, the service sector plays an important role in job creation, and credit expansion in the real estate sector has a multiplier effect. The recovery of the two sectors will provide strong fundamental support to China's economy and corporate credit profiles.

The demand for medium- and long-term residential loans has historically shown a strong correlation with RMB money market interest rates. With the plunge in property sales, demand for residential loans contracted sharply, with the 3-month SHIBOR hitting its lowest point since the subprime crisis and the COVID outbreak in 2020. We expect the median of money market interest rates to rise in 2023 as property sales and residential loans bottom out. The recent turmoil in wealth management product redemptions has rapidly pushed up risk-free interest rates and drastically widened credit spreads, creating ample investment opportunities for short-term investment-grade credit bonds. The aggregate yield of some RMB-denominated bonds has surpassed that of USD-denominated bonds when taking into account foreign exchange hedging.

Chart 18: New Middle-to-Long-Term Loans and Money Market Rates



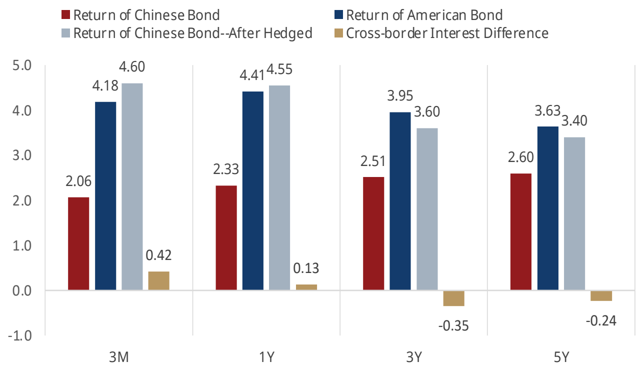
Source: Bloomberg, data as of Dec 22, 2022

Chart 19: Historical Percentile of Credit Spread

	1 Year	3 Year	5 Year
AAA+	31%	77%	72%
AAA	50%	80%	74%
AA+	55%	78%	68%
AA	60%	73%	50%
AA-	98%	98%	97%

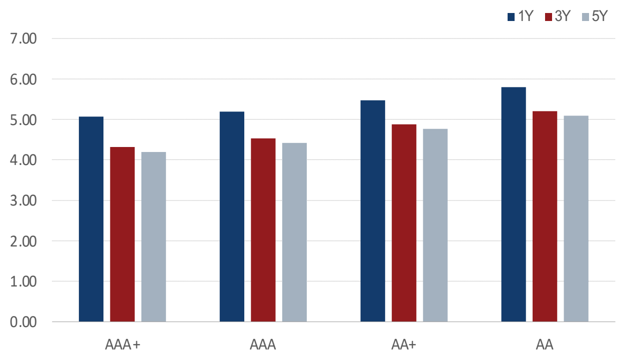
Source: ChinaBond, Shanghai Clearing House, ChinaAMC(HK), data as of Dec 22, 2022

Chart 20: China-US Cross Border Interest Difference (The Hedged Bond Spread)



Source: Bloomberg, ChinaBond, data as of Dec 22, 2022

Chart 21: Credit Bond Yield (FX Hedged vs. USD)

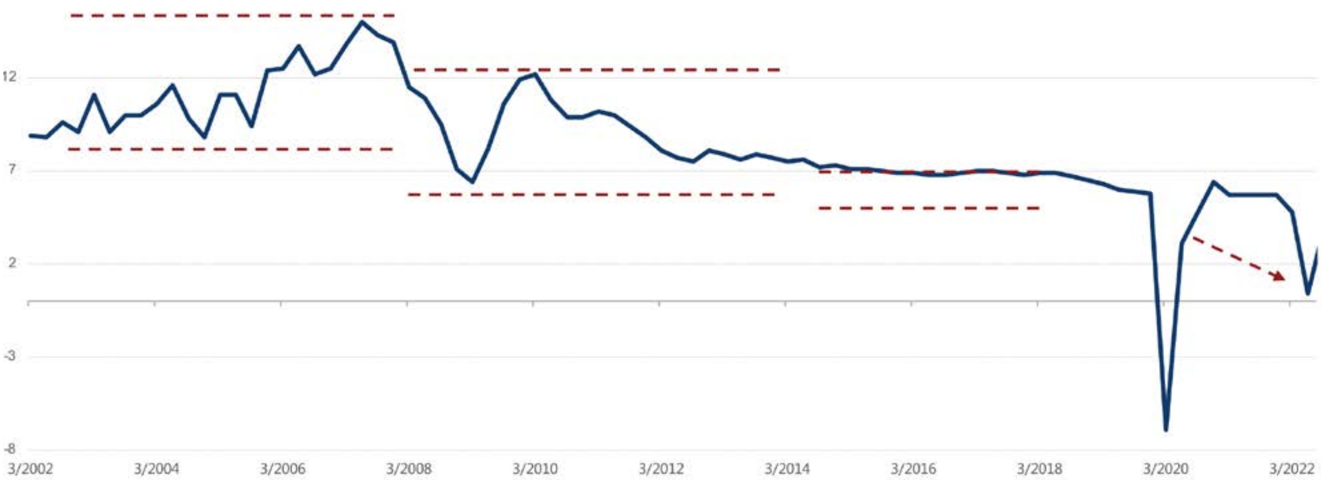


Source: Bloomberg, ChinaBond, data as of Dec 22, 2022

The median risk-free interest rate may climb if the economy recovers and demand for private financing picks up as expected in 2023. The rise in the yield of medium- and long-term government bonds since the easing of pandemic restrictions and real estate policies in November, however, has partially reflected investors' expectations for economic recovery. In the longer term, the return on capital also tends to decline in the same way China's potential growth rate does. This trend is also reflected by how, over the three rate cycles in the past 10 years, the peak yield on 10-year government bonds has consistently fallen below its level in the previous cycle.

Considering that property sales have peaked in 2021, there will be sizable residential loan repayment obligations going forward. Assuming that property sales will stabilize or increase, we expect no significant expansion in medium- and long-term residential loans in 2023, while any uptick in credit demand is likely to be modest. As a result, we expect the yield on medium- and long-term government bonds won't rise sharply from its current level in 2023, and the overall yield on 10-year government bonds will stay in the range of 2.8%-3.1%. On the contrary, any excessive yield rise will create premium allocation and trading opportunities.

Chart 22: Quarterly Annualized Real Growth Rate of China GDP



Source: Bloomberg, NBS, data as of Dec 22, 2022

Chart 23: Long-term Movement of China's Interest Rate

Source: Bloomberg, ChinaBond, data as of Dec 22, 2022

RISKS

- Liquidity tightened more than expected
- Inflation is stickier than expected
- Geopolitical conflicts and the pandemic worsen again

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- China A-Share Fund

Insights & Mandate

Performance Awards

- China A-share Equity (3 Years)
  China A Share Fund

- Asian Bond (3 Years)
  Asia Bond Fund

Market Awards

Best Fund Launch (ETF) - Hong Kong

- Hang Seng Hong Kong Biotech Index ETF

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Regional Bond - Platinum

- Asia Bond Fund

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