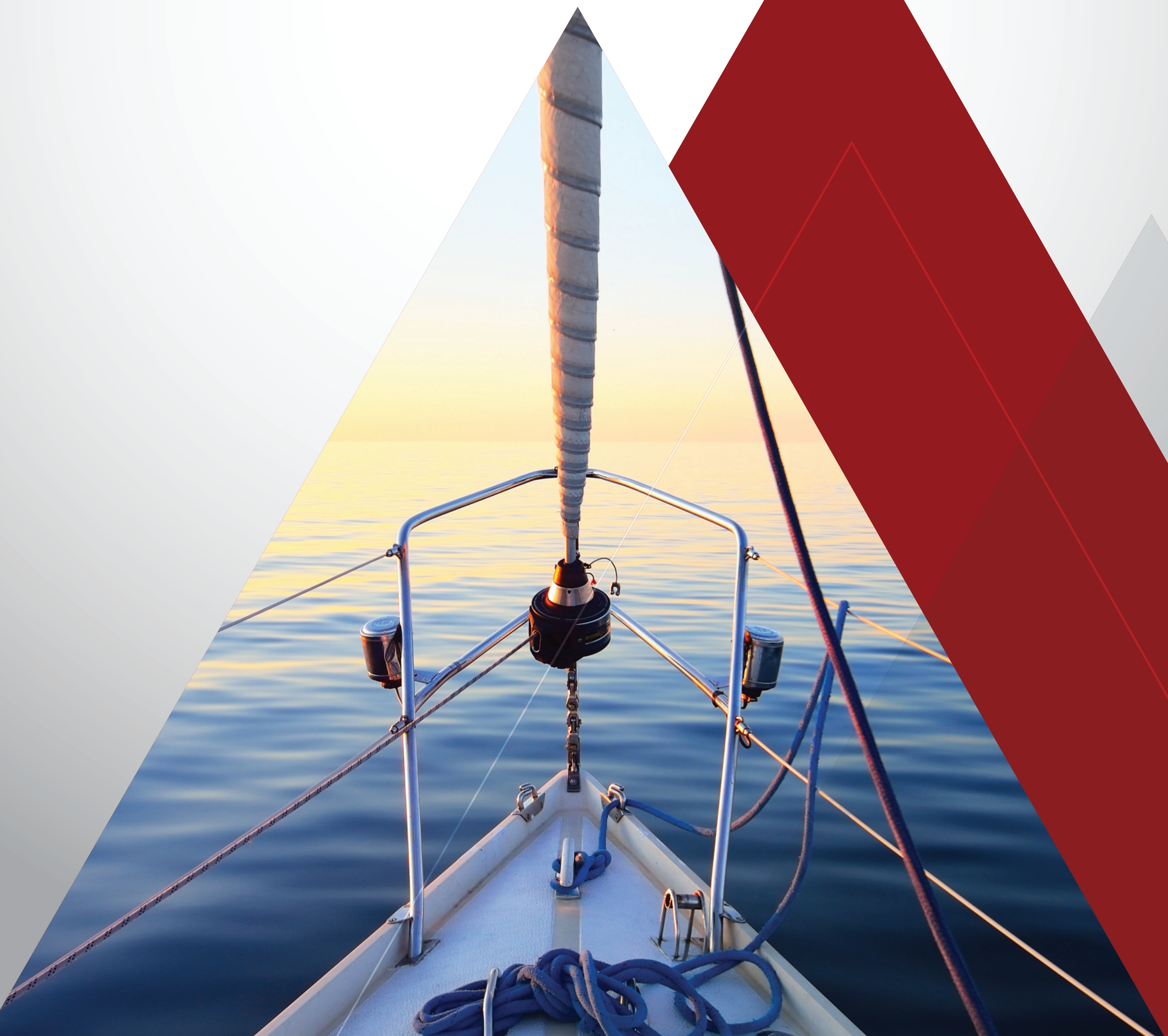
ChinaAMC(HK)

MARCHING TOWARDS 15th YEAR

2023

Mid-year Investment Outlook



Contents

China Equity Market

2023 Mid-year Market Review

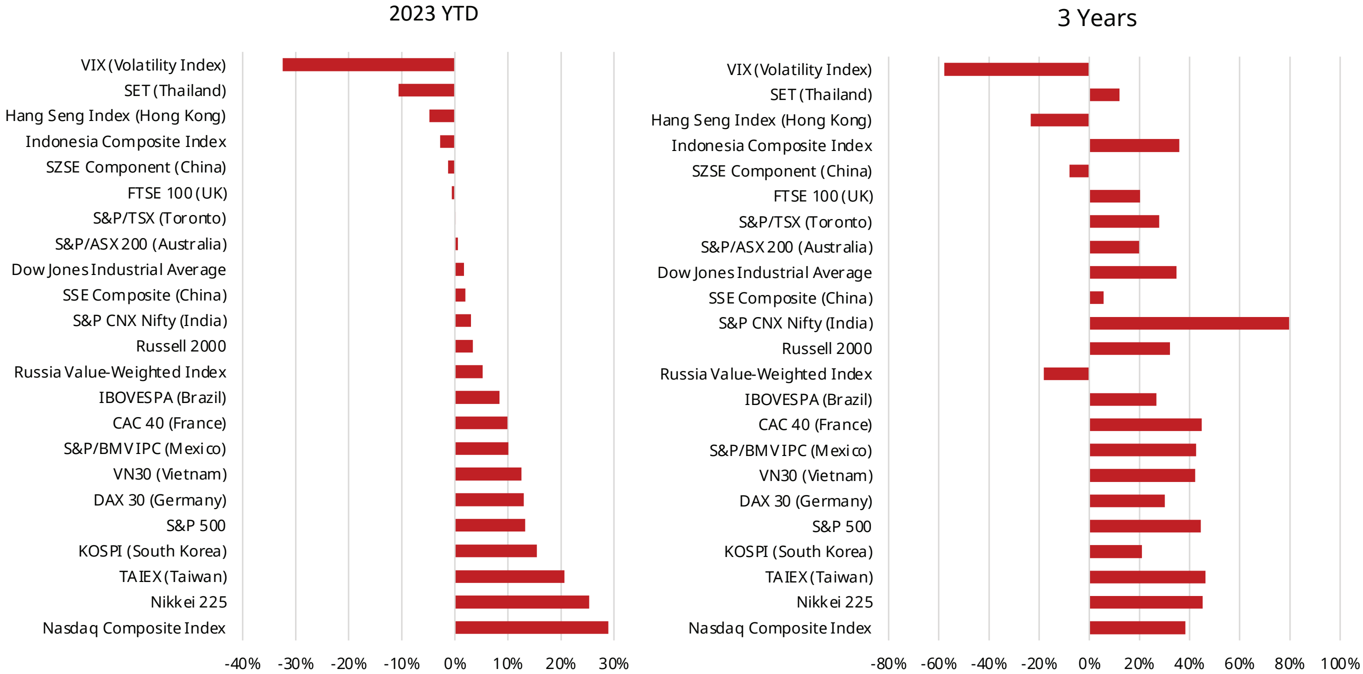
China's stock market has been relatively disappointing since the start of 2023, with its performance lagging behind major global benchmarks.

Overall, the A-share market rose by approximately 1.48% in the first half of the year, as represented by the Wind All A Index. In contrast, the Hong Kong stock market, represented by the Hang Seng Composite Index, declined by around 4.19% during the same period. Both markets were choppy, but the Hong Kong market showing even greater volatility. After a brief rally in January, the Hang Seng Composite Index went on a roller coaster ride in February and began trending lower until mid-April. From then until May, the market was in a correction period before rebounding briefly in early June. Yet in recent weeks, it has entered another correction period. The main factors causing these volatilities included the pace of China's economic recovery, geopolitical tensions, the U.S. and European banking crisis, and interest rate hikes in major overseas markets.

In the A-share market, the media, communications and computer sectors were the outperformers, while consumer services, property, materials, consumer goods and healthcare underperformed. In the Hong Kong stock market, the energy and telecommunications services sectors have been the top performers, while healthcare, consumption, property and internet were the laggards. Overall, technology stocks benefiting from generative AI and high-dividend stocks benefiting from the revaluation of state-owned enterprises (SOEs) have been the best performers in the A-shares market. The situation in Hong Kong was similar, with high dividend-paying SOEs in the energy and communications sectors remaining resilient. Nevertheless, excluding the digital economy sector and high dividend-paying SOEs (benefiting from sector revaluation), the overall performance of the market has been relatively weak.

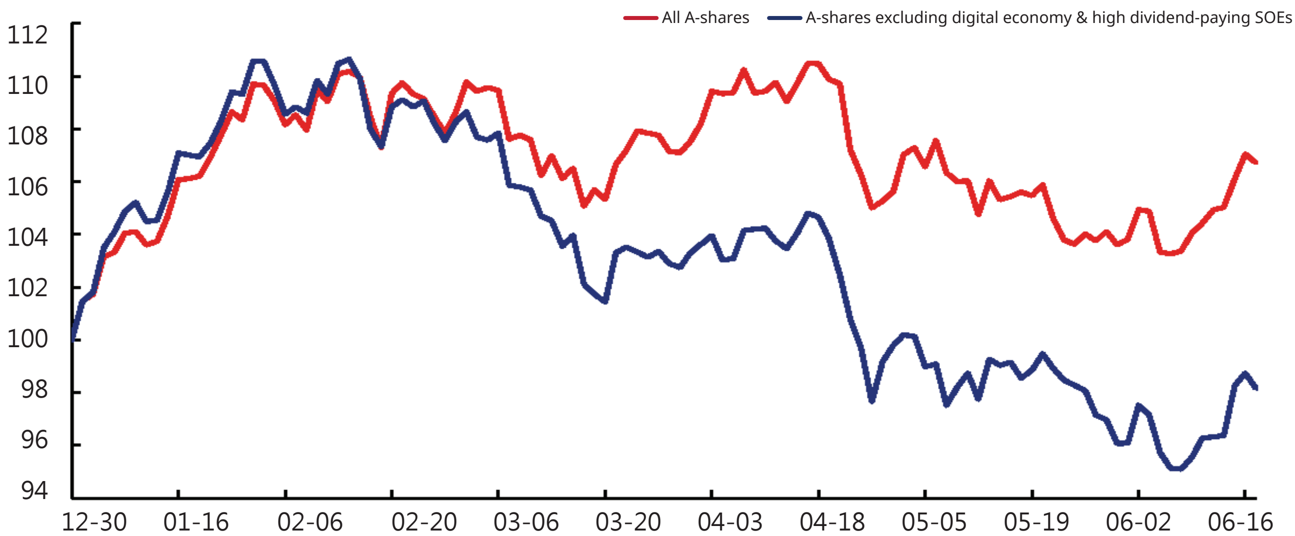
Another noteworthy development was that sector rotation or investment theme rotation in both the A-share market and the Hong Kong stock market has intensified over the past year. According to a China Securities Co., Ltd. (CSC) research report, the market has undergone seven sector rotations in the past year, with an average interval of less than two months. In comparison, the average interval for the prior three to four years had been close to four months. The escalation of the quest for returns in the limited pool of available funds could be one of the factors driving such shifts, given uncertainties in domestic economic structural adjustments, risk digesting, external geopolitical concerns and liquidity conditions.

Chart1: Global Major Indices Performance



Source: China Asset Management (Hong Kong), as of 23 June 2023.

Chart 2: China A-Share Market Performance



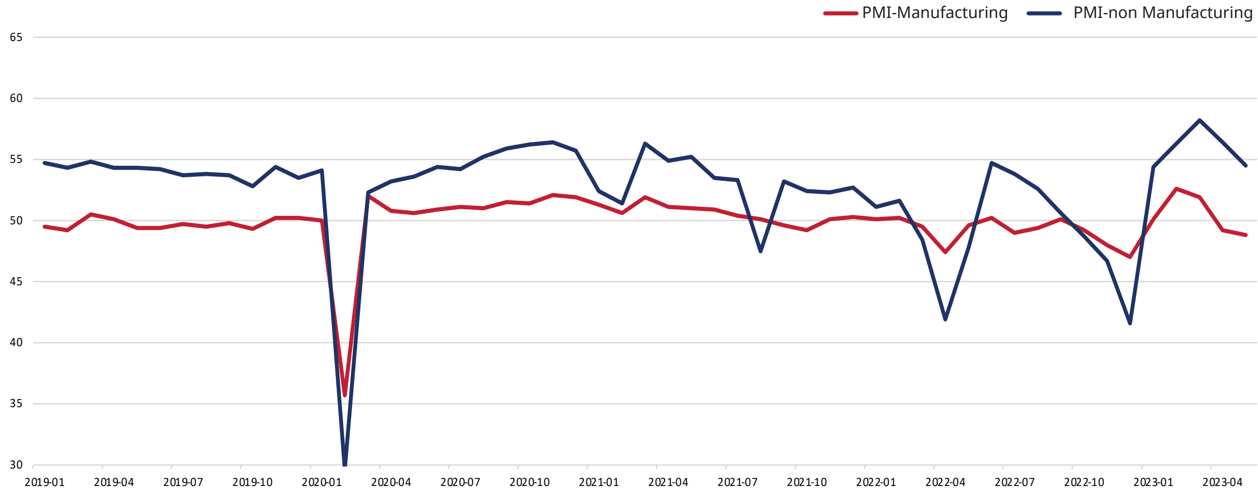
Source: Industrial Securities, as of 25 June 2023.

China's Economic Fundamentals

With the government lifting all COVID prevention and control measures, China's economy was poised to recover in the first half of 2023. Although GDP in the first quarter beat market expectations, high-frequency economic data indicated a weaker-than-expected rebound in the second quarter. Overall, China's economy recovered more slowler than expected in the first half of 2023. Concerns about global political situations, local government debt, and the property industry undermined consumer and business confidence, leading to weak investment in the manufacturing and property sectors, as well as a reluctance to leverage and consume in the private sector. All these factors played a part in hampering the effectiveness of monetary easing.

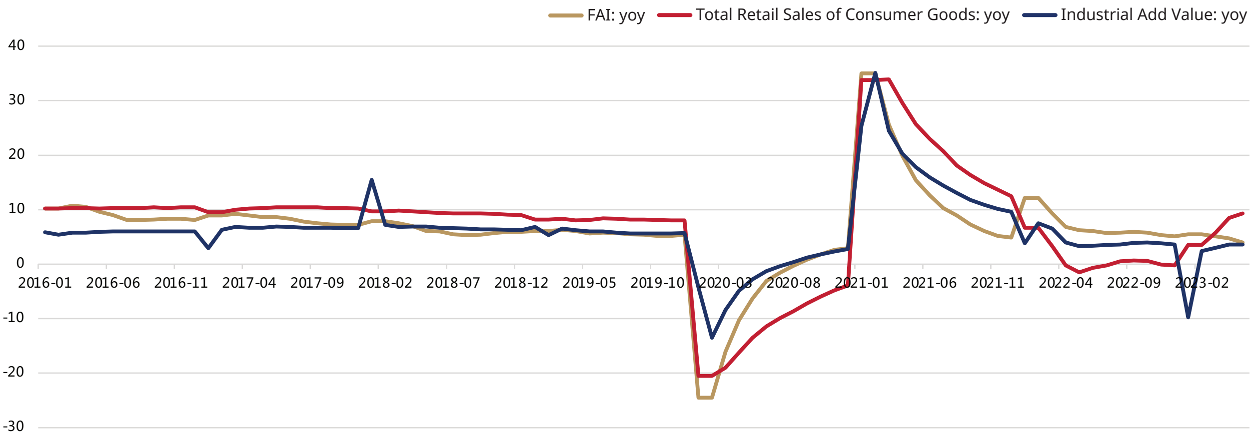
China's H1 Economic Recovery Fell Short

Chart 3: China PMI Data



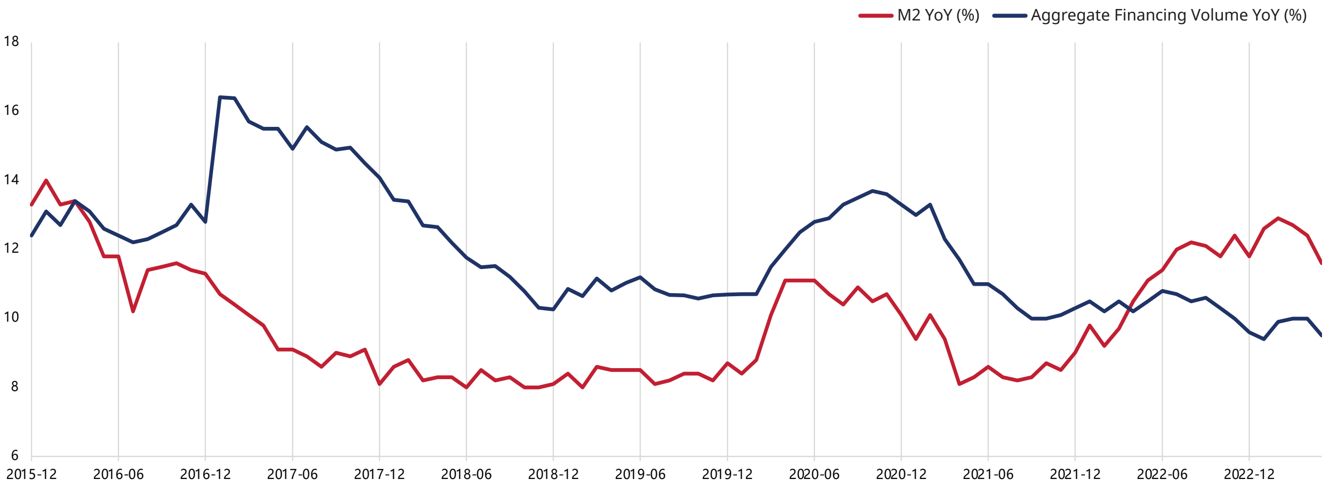
Source: China Asset Management (Hong Kong), as of 23 June 2023.

Chart 4: China Economy Activities



Source: China Asset Management (Hong Kong), as of 23 June 2023.

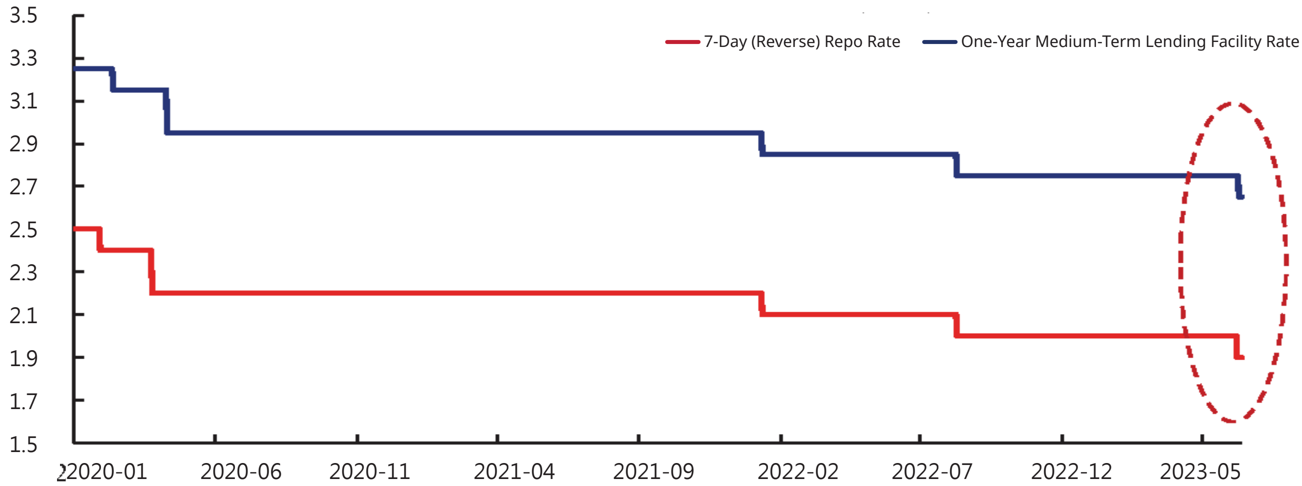
Chart 5: China Monetary Volume



Source: China Asset Management (Hong Kong), as of 23 June 2023.

Against this backdrop, the government's introduction of growth-stabilizing policies aimed at bolstering consumer and business confidence and support endogenous growth became more critical. Since June, the Chinese government has expressed the intention of introducing more policies, including additional supportive measures and interest rate reductions. At the moment, investors are awaiting the unveiling of more details about the stabilizing measures in the future.

Chart 6: China Lowered Short-to-Medium Term Interest Rates



Source: Industrial Securities, as of 25 June 2023.

China's growth stabilization policies package in June

- On June 16, during the State Council executive meeting, it was emphasized that in response to the evolving economic landscape, more powerful measures must be taken to enhance development momentum, improve the economic structure and promote a robust recovery. Policies proposed at the meeting centered on four areas, namely intensifying macro management, expanding effective demand, strengthening and optimizing the real economy, and preventing and defusing risks in key sectors. The meeting also emphasized that ready-to-implement policies or measures should be rolled out without further delay. Meanwhile, the government should ramp up policy tools to maximize the overall impact of policies.

- On June 20, the People's Bank of China cut two key lending rates by 10 basis points for the first time in nearly 10 months, signaling policy support for stable growth. The one-year Loan Prime Rate (LPR) and the over-five-year LPR were lowered. The cut to the one-year LPR was deeper than expected, despite the adjustment of the over-five-year LPR fell short of market expectations. The one-year rate cut will help stimulate consumption by lowering borrowing costs on consumer loans and other short-term loans. More diversified mortgage interest rates policies are also expected to be announced in the future.

- On June 27, Premier Li Qiang attended and addressed the opening plenary of the 2023 Summer Davos Forum. He stressed that China will continue to provide strong momentum to global recovery and economic growth, creating win-win opportunities for worldwide investors in the long run. China is willing to work closely with entrepreneurs to actively promote economic globalization, uphold the market economy, support free trade and steer the global economy toward a more inclusive, resilient and sustainable future.

We believe that the key to an effective short-term boost to the economy lies in finding solutions and regulatory adjustment for local government and property debt issues, as well as an increase in the central government's leverage ratio. If future policies prioritize mitigating long-term risks and structural transformation while aiming to provide minimal support instead of stimulus to the recovery, China's economy may continue to fluctuate cyclically, with the endogenous momentum bottoming out around the fourth quarter.

Global Liquidity and Geopolitical Relations

As we enter 2023, the interest rate hike cycles in major developed economies, led by the U.S., are nearing their end. Nevertheless, bond yields have consistently remained at a high level in Europe and the U.S. due to strong inflation stickiness and the resilience of their economies. The combination of such market conditions with external recession concerns and the banking crisis in Europe and the U.S. have weighed on the Hong Kong stock market. In May, the U.S. CPI and PPI both fell short of expectations. The Federal Reserve's (Fed) June Federal Open Market Committee (FOMC) meeting ended with a rate hike pause, but the dot plot indicates a rise of median rate to 5.6% at the end of 2023, suggesting two more 25-basis points rate hikes within the year. Fed Chairman Jerome Powell further underscored the central bank's goal to achieve the inflation target, though he was less hawkish than the dot plot readings. With the Fed's rate hike cycle nearing its end, we believe the marginal impact of rate hikes on the Chinese financial market has plateaued, despite two more hikes coming in the second half of 2023.

Chart 7: US Interest Rate Hike Dot Plot

Meeting Probabilities													
Meeting Date	275-300	300-325	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550	550-575	575-600
2023/7/26					0%	0%	0%	0%	0%	23.1%	76.9%	0.0%	0.0%
2023/0/20	0%	0%	0%	0%	0%	0%	0%	0%	0%	19.0%	67.2%	13.8%	0.0%
2023/11/1	0%	0%	0%	0%	0%	0%	0%	0%	0%	17.6%	63.7%	17.7%	1.0%
2023/12/13	0%	0%	0%	0%	0%	0%	0%	0%	3.8%	27.5%	53.8%	14.1%	0.8%
2024/1/31	0%	0%	0%	0%	0%	0%	0%	2.0%	16.1%	41.1%	33.3%	7.2%	0.4%
2024/3/20	0%	0%	0%	0%	0%	0%	1.1%	10.1%	30.6%	36.6%	18.2%	3.2%	0.2%
2024/5/1	0%	0%	0%	0%	0%	1.0%	9.3%	28.8%	36.0%	19.8%	4.6%	0.4%	0.0%
2024/6/19	0%	0%	0%	0%	0.6%	5.8%	20.4%	32.9%	26.8%	11.1%	2.2%	0.2%	0.0%
2024/7/31	0%	0%	0%	0%	4.9%	18.1%	30.9%	27.8%	13.6%	3.7%	0.5%	0.0%	0.0%
2024/9/25	0%	0%	0%	0%	16.1%	29.0%	28.2%	15.8%	5.2%	1.0%	0.1%	0.0%	0.0%
2024/11/6	0%	0%	0%	0%	28.9%	27.0%	14.7%	4.7%	0.9%	0.1%	0.0%	0.0%	0.0%
2024/12/18	0.5%	3.8%	13.1%	24.7%	27.7%	19.1%	8.3%	2.3%	0.4%	0.0%	0.0%	0.0%	0.0%

Source: CME, as of 25 June 2023.

Geopolitical risk has been a key factor influencing investors' risk appetite. In spite of the uncertainties that continue to overhang China-US relationship in the mid to long term, there are some encouraging signs in the near term.

- On June 18, U.S. Secretary of State Antony Blinken paid an official visit to China. The two sides had constructive discussions with regard to resolving conflicts, underscoring bottom lines, and promoting open communications and exchanges.
- On June 19, President Xi Jinping met with U.S. Secretary Antony Blinken in Beijing, where he pointed out China's intention to maintain a sound and stable relationship with the U.S. and is confident that the two sides can overcome difficulties and find a way forward based on mutual respect, peaceful coexistence and win-win cooperation.
- On June 27, Bloomberg reported that U.S. Treasury Secretary Janet Yellen is planning an early-July visit to Beijing to hold top-level economic talks with Chinese officials. If the trip materializes, she will be another U.S. cabinet official to visit Beijing since the relationship between the world's two largest economies began souring earlier this year.

China is also actively pushing forward diplomatic efforts in Europe and among the Belt and Road Initiative (BRI) member countries. Premier Li Qiang paid official visits to Germany and France from June 18 to 23, during which he co-chaired the seventh round of Sino-German government consultations and attended the Summit for a New Global Financing Pact. Just a few days earlier, the 10th China-Arab States Cooperation Forum Entrepreneurs Conference was held in Riyadh, Saudi Arabia on June 11 and 12. The deepening cooperation between China and Europe and BRI members will contribute to a more stable external environment in the midst of the ongoing China-U.S. rivalry in the mid to long term.

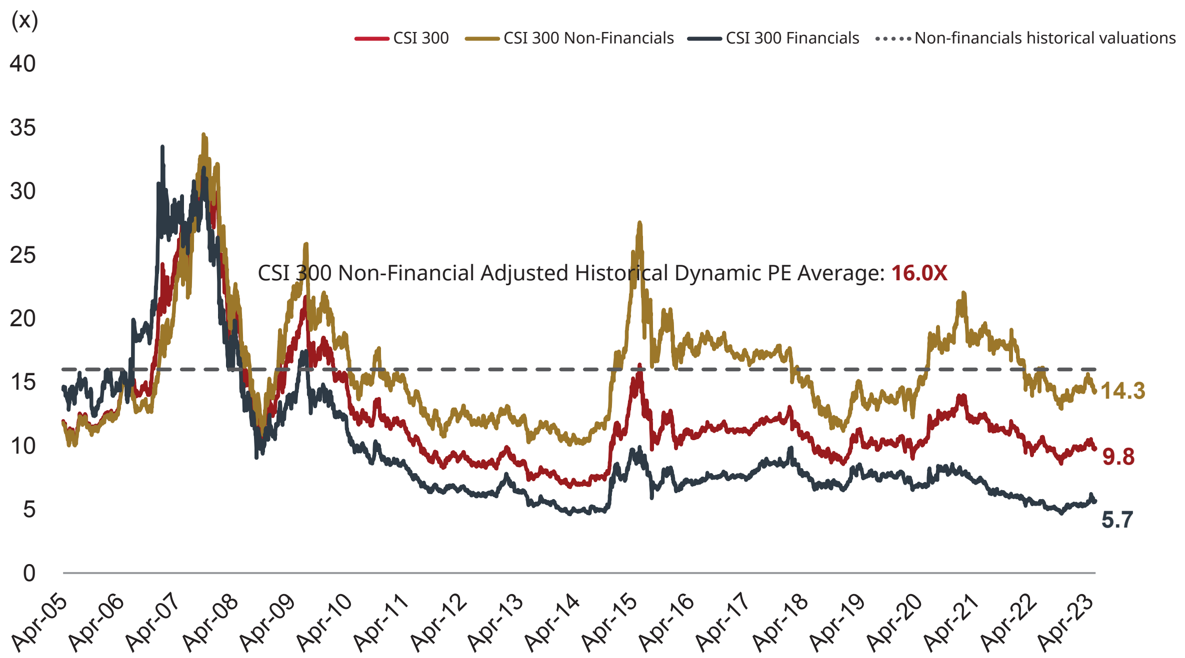
In general, we expect China and the U.S. will most likely continue to compete in the areas of trade and technology over the mid to long term, albeit at varying intensity. While China may face more uncertainties brought by the U.S. election and other geopolitical events, we believe the overall risk is manageable and unlikely to evolve into substantial risks in the second half of 2023.

China's 2023 Mid-Year Stock Market Outlook

Overall, the valuations of A-shares and Hong Kong stocks have been at historical lows, fully reflecting concerns about the endogenous driving forces of China's economy, long-term risks, and external uncertainties. We are optimistic that the current valuation of Chinese shares will offer more attractive opportunities in the long run. Valuations of A-shares and Hong Kong stocks are already at historic lows.

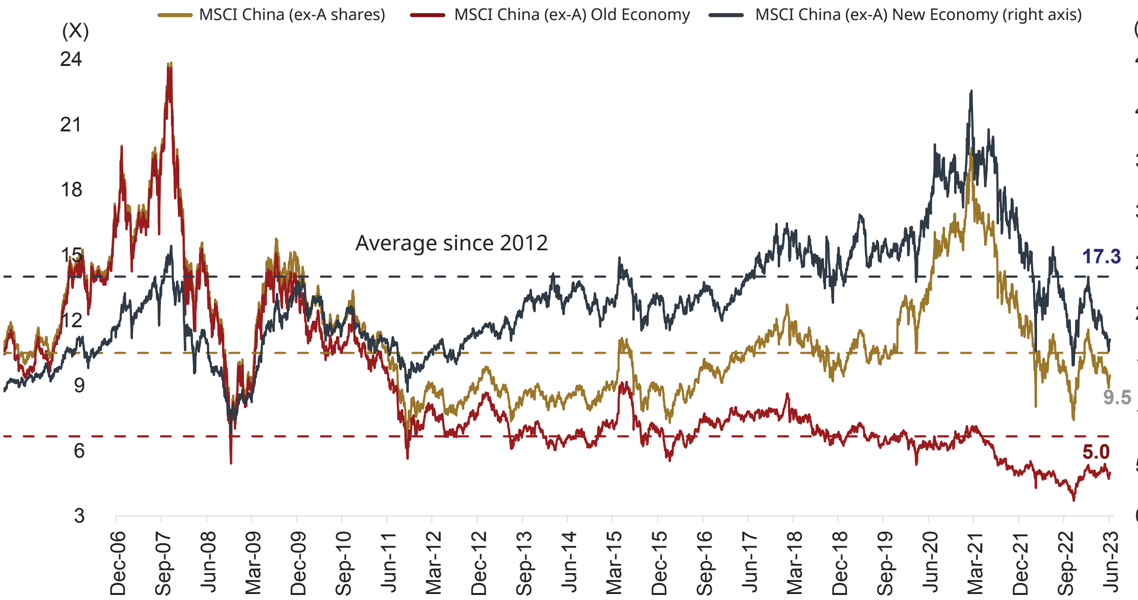
A-Shares and HK Stocks at Historic Valuation Lows

Chart 8: CSI 300 Index forward P/E



Source: CICC, as of 13 June 2023.

Chart 9: MSCI China (ex. A-shares) Historical Valuation



Source: CICC, as of 13 June 2023.

In the second half of 2023, major internal and external factors influencing the A-share and Hong Kong stock markets are likely to abate. In consideration of the low current valuation, investors' expectations and investment positions, we expect an uptick in the A-share and Hong Kong stock markets in the second half of this year.

Economic recovery is likely to pick up if the Chinese government steps up support in the coming six months. This, in turn, will generate attractive opportunities in the stock market as current market expectations for pro-cyclical industries, including pan-consumption and property, are low. In addition, a slowdown of inflation or a decline in economic resilience in overseas economies could increase the chances of interest rate cuts, driving up valuations of growth stocks such as healthcare and internet companies in the Hong Kong stock market. Specifically, we expect artificial intelligence and the revaluation of SOEs to be the top two investment themes for the second half of 2023. Investors should pay close attention to changes at the company and industry levels for AI-related stocks, and potential mergers and acquisitions for SOEs that might act as a catalyst for higher valuation.

Frequent sector rotation may continue if future policies provide only minimal support and prioritize mitigating long-term risks and structural transformation. In this case, investors should focus on thematic opportunities in the stock market. Pro-cyclical industries such as pan-consumption and property may rebound when the endogenous momentum of China's economy reaches the bottom.

Global Fixed Income and FX Market

2023 Mid-year Market Review

In the first half of 2023, global financial markets remain volatile amid a flurry of headwinds, including banking crisis in the U.S. and Europe, the U.S. debt ceiling deadlock and geopolitical conflicts. U.S. Treasury yield returned to the level seen at year-end 2022 whiles equity assets ended the first half with an overall gain as market expect hiking cycle toward the end.

As interest rate hikes almost peak, the market gradually digests the risk, and the economy rebounds in the short term, most of asset classes have generated reasonable returns. In general, equity assets outperformed bonds and commodities, while developed markets outpaced emerging markets.

Following a dismal 2022, most fixed-income securities posted positive returns in the first six months. Within USD dominated bond, duration outperform as yield curve inverted deepening, credit outperform rates, US HY outperform US IG, China HY still lagging.

Chart 10: Global Major Assets Performance

Index	2020	2021	2022	Q1 2023	February 2023	Since Q2 2023	YTD 2023
Agricultural Products	14.9%	24.7%	12.1%	-0.4%	-3.2%	5.5%	5.0%
US Dollar Index	-6.7%	6.4%	8.2%	-1.0%	2.3%	0.4%	-0.6%
WTI Crude Oil	-20.5%	55.0%	6.7%	-5.7%	1.8%	-8.6%	-13.8%
Gold	25.1%	-3.6%	-0.3%	8.0%	-7.2%	-2.4%	5.3%
Nikkei Index	16.0%	0.5%	-5.3%	7.5%	-2.1%	16.9%	25.6%
Industrial Metals	14.8%	29.6%	-7.6%	0.7%	-0.3%	-8.1%	-7.4%
Eurozone Stock Index	-5.1%	21.0%	-11.7%	13.7%	-1.8%	-1.0%	12.6%
Global High Yield Bond Total Return	7.0%	1.0%	-12.7%	3.1%	-0.9%	1.4%	4.6%
Hang Seng Index (Hong Kong)	-3.4%	-14.1%	-15.5%	3.1%	-3.0%	-7.4%	-4.5%
Global Investment Grade Bond Total Return	9.2%	-4.7%	-16.2%	3.0%	-3.1%	-1.3%	1.7%
S&P US Equities	18.4%	28.7%	-18.1%	7.5%	-3.5%	6.2%	14.2%
Russell Index	18.4%	13.7%	-21.6%	2.3%	5.2%	1.1%	3.4%
CSI 300 (China)	27.2%	-5.2%	-21.6%	4.6%	0.5%	-4.6%	-0.2%
Emerging Market Equities	15.8%	-4.6%	-22.4%	3.5%	-2.7%	0.2%	3.7%
Nasdaq	43.6%	21.4%	-33.1%	16.8%	-6.3%	10.4%	28.9%

Source: Bloomberg, China Asset Management (Hong Kong), as of 23 June 2023.

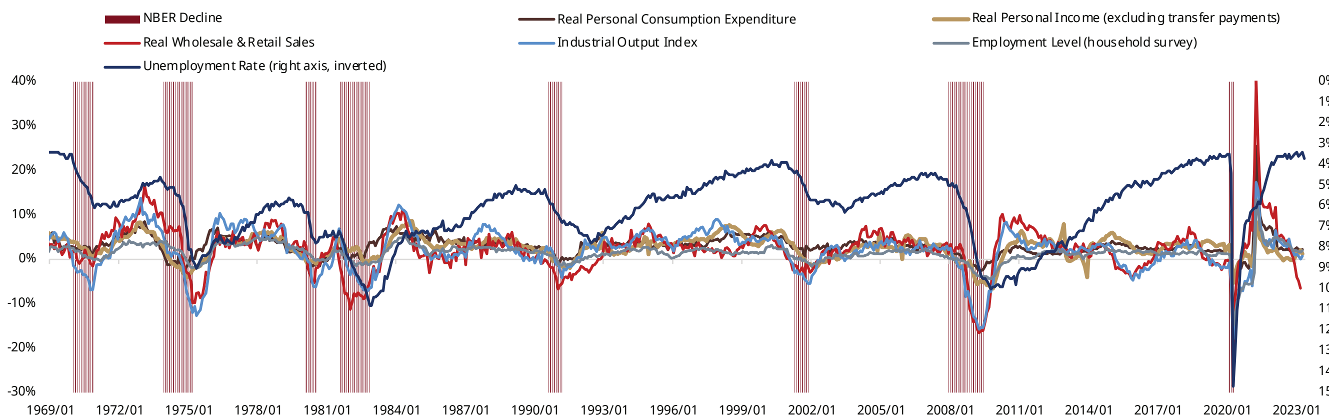
Macro Economy and Monetary Policy

U.S. Recession Risk Persists

Currently, market expectations of a soft landing in the U.S. are on the rise, as key economic data all point to a relatively sound and healthy economy and financial system. Broadly speaking, GDP and consumption data are stronger than expected, and the housing market is showing signs of stabilization. Personal consumption expenditures (PCE) and core Consumer Price Index (CPI) in the U.S. have both declined slightly, yet they demonstrate high resilience.

The labour market faces lingering structural challenges, yet the unemployment rate has only increased modestly. Moreover, despite with the rate hikes in the first half of 2023, the financial conditions index (FCI) remains strong, which shows that the U.S. economy and financial market has built resilience during the previous cycle of ultra-low interest rates and large-scale fiscal stimulus.

Chart 11: The U.S. economy and financial sectors are robust



資料來源：彭博、華夏基金(香港)，截至2023年6月23日。

We concur that the U.S. economy is much more resilient in a high-interest-rate environment, due to the uniqueness of the current cycle. Yet, this does not change our view that the US economy will eventually slide into a recession. Our reasons are threefold:

As the effect of the reopening boom wears off, with interest rates rising and inflation cooling, bank and corporate earnings are unlikely to sustain their better-than-expected results in the first quarter;

01

As banks tighten credit in the rate hike cycle, the rise in borrowing costs will eventually burden consumption, the housing market, and small and medium-sized businesses in the U.S.;

02

Most recession indicators, such as persistently high inflation, inverted yield curves and a weakening housing market, still point to a looming outlook.

03

As a result, we anticipate the U.S. economy will inevitably fall into a recession during the current cycle as shrinking manufacturing productivity spills over to the services sector — a scenario likely to occur in the first half of 2024.

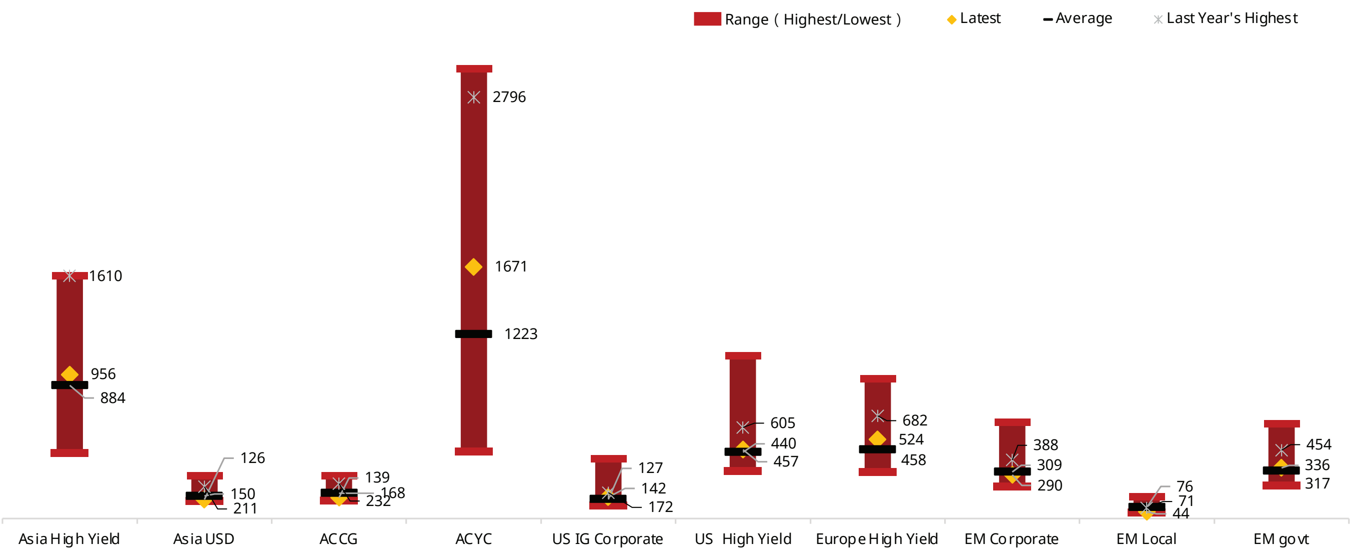
Divergence in Global Monetary Policies

Monetary policies in emerging markets have generally diverged from those in developed markets. In most emerging economies, inflation has been brought under control as commodity prices drop, allowing central banks to wrap up the tightening cycle. In contrast, core inflation in developed economies has stayed far above targets. While the Fed paused on further rate hikes in June, we expect the committee to decide the path of rates based on data in the coming months. The latest hawkish comments indicate possible hikes as long as no extreme risk event occurs in the short term. and we believe the Fed may be attempting to manage rate cut expectations as priority. Meanwhile, we expect the first rate cut to come around the mid year of 2024, given the high resilience of the U.S. economy and high-flying inflation in major developed economies at the moment. Based on our forecast of a inevitable recession, we expect faster-than-consensus rate cuts in the early stage of the upcoming easing cycle.

Allocation Strategy

We are cautiously optimistic about the global fixed-income market in the coming six months. We are relatively optimistic for interest rates as the growth in the supply of short-term bonds has a limited impact on the rise of medium- and long-term interest rates. History suggests that overall U.S. bond interest rate will begin to fluctuate downward before or after the final rate hike, causing the inverted yield curve to gradually normalize. We expect the yield on 2-year bonds to spike to as high as 5% before stabilizing at 4.5% when the tightening cycle ends, while the yield on 10-year bonds will bounce between 3.5%-3.8% most of the time. We are relatively cautious about credit spread. Credit spread has largely reversed the widening that occurred in early to mid-March, sending it back to levels seen at year-end 2022. Valuations of most sectors to 60% of their five-year averages as the banking crisis subsided and the debt ceiling standoff ended. However, considering a possible recession and a worsening risk sentiment, current valuations appear rich, especially given relatively negligible net inflows into credit bond funds and a higher-than-expected bond supply. Therefore, we believe there's a higher likelihood of widening rather than further narrowing.

Chart 12: Fixed Income Assets Valuation



Source: Bloomberg, China Asset Management (Hong Kong), as of 23 June 2023.

Our forecasts for different sectors of global USD bond markets are as follows:

China: We expect more stimulus measures to kick in. At the moment, the continuing inversion of China-US interest rate spreads, along with a shortage of supply, provides strong technical support for Chinese-issued USD bonds. Yet, the valuations of these bonds vary due to potential credit risks associated with LGFV and property bonds. We prefer bonds issued by SOEs and corporates with strong fundamentals, while remaining cautious towards property and LGFV.

Japan: Japan's economy and inflation have reached a relatively niche stage since the twentieth century. We prefer bonds issued by large financial institutions and recommend keeping a close eye on changes to Japan's monetary policy and the yen.

Korea: Korea's economy has been in a downturn over the past two years. We expect economic pressure to ease this year as China lifted all COVID restrictions and reopened to the world at the end of 2022. The proportion of Korean-issued USD bonds relative to total Asian-issued USD bonds grew in the first half of 2023, amounting to continuous supply pressure. We prefer quasi-sovereign bonds.

Asia emerging markets: Market expectations on the overall endogenous economic momentum remain strong, with inflation, domestic demand, foreign reserves and government debts all at relatively stable levels. Investors should pay attention to the spillover effect of risk sentiments in developed markets. We prefer quasi-sovereign bonds and will look for opportunities in commodities and chean energy.

United States: The rate hike cycle is nearing its end. At present, the U.S. economy remains robust and inflation stays at a relatively high level. Historical data and leading indicators still point to a possible recession. We expect the first interest rate cut to come at the end of this year, and corporate bonds will have higher valuations than utility bonds and financial bonds and prefer high-grade bonds (A and above) issued by large banks and corporates in defensive sectors.

Europe: The economy may resume its downward trend after a brief rebound. High inflation may constrain monetary policy, with corporate bonds expected to be impacted directly when the central bank reduces its balance sheet. We prefer financial bonds as bank fundamentals are relatively strong.

We prefer high-grade medium and long-duration bonds in developed markets. Historical data shows that the decline of interest rates can effectively offset the widening of credit spreads on A or higher rated bonds in weakening risk sentiment during the late stage of a high-interest rate cycle. However, we do not plan to overweight long-duration bonds immediately. Considering an inverted yield curve, we will also hold some short-duration bonds for stable and high yields and look for opportunities when the overall all-in yield rises as the market condition changes.

Besides, we will continue to seek investment opportunities in ESG themed fixed income investment. We will keep closely monitoring for headwinds, including stickier-than-expected inflation, worse-than-anticipated economic shock from rate hikes, and increasing geopolitical tensions.

The Outlook of Renminbi

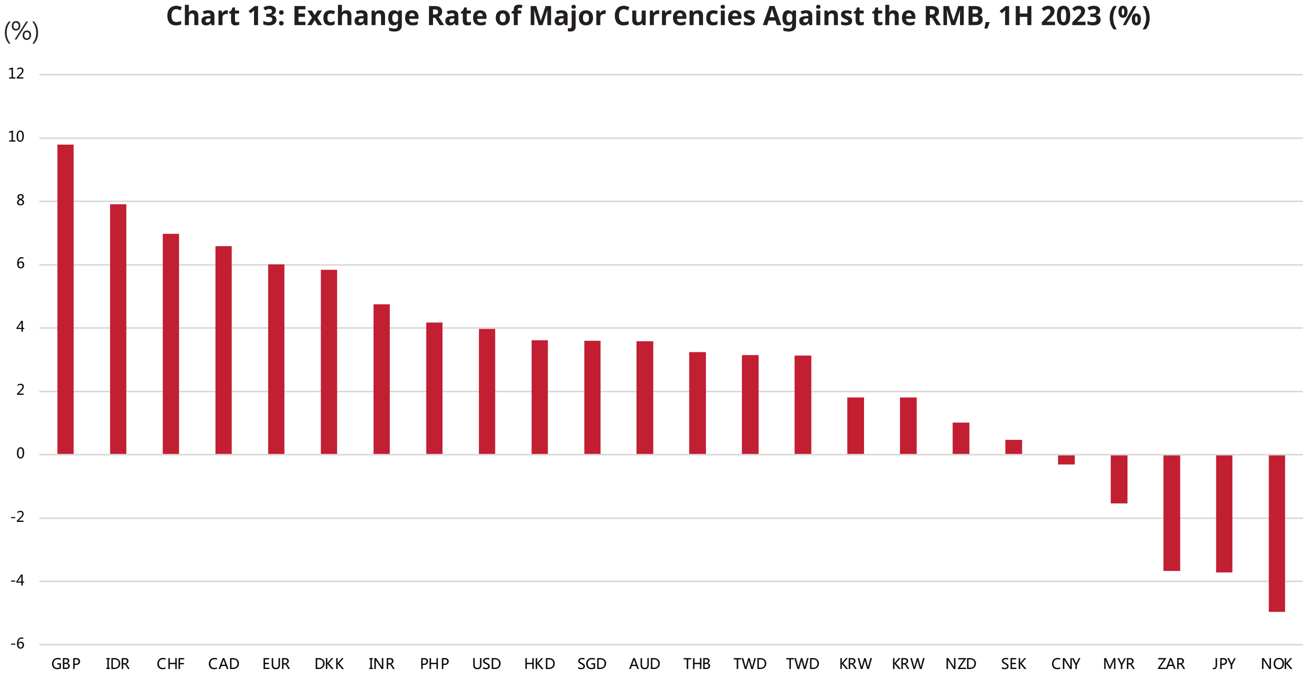
The Trajectory of the Renminbi

Market expectations for the fundamentals of China's economic have greatly improved, driven by the lifting of COVID control measures and the introduction of a series of growth stabilisation policies such as property support. These factors combined to drive a sharp rebound of the yuan since the fourth quarter of 2022. Between early November last year and Chinese New Year, the yuan appreciated by about 9%.

As the effect of "reopening trade" wore off, the yuan pared back some of its gains after the Chinese New Year and fluctuated in line with risk assets. The RMB exchange rate index remained stable, and volatility eased significantly during this period. This pattern suggested that the U.S. dollar index's rebound was the primary driver of the depreciation and there was no deterioration in market expectations for RMB exchange rates.

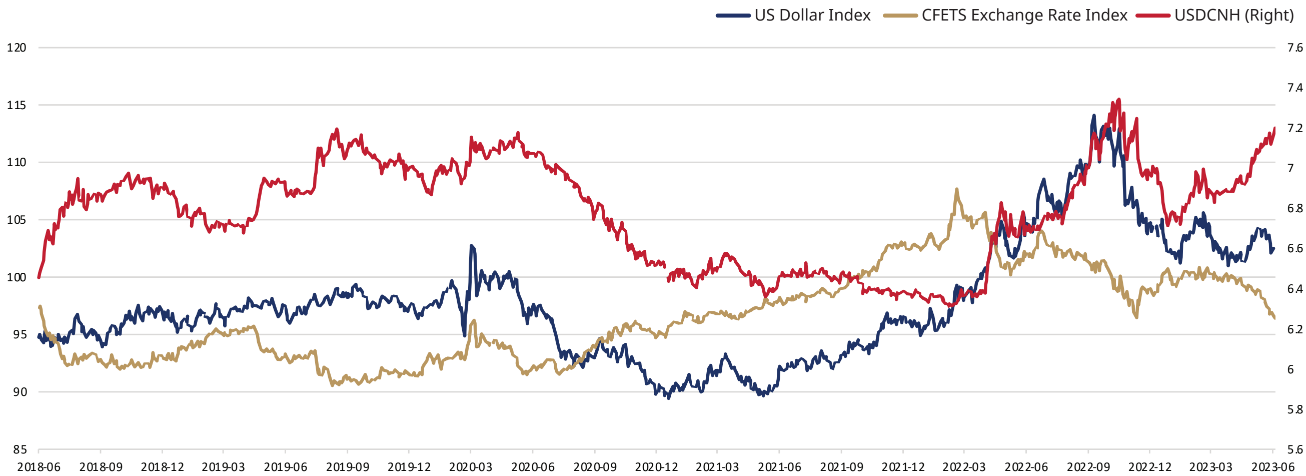
The yuan entered another depreciation phase at the end of April, dipping nearly 5% in two months. During the same period, the RMB exchange rate index fell nearly 4% while the U.S. dollar index rebounded 1%. The depreciation was triggered by a pullback in economic data. Risk appetite fell sharply due to the economic recovery failing short of expectations and a faster-than-anticipated drop in exports. The yuan drifted down in tandem with risk assets, and the RMB exchange rate index went below its 2022 lows. In the year-to-date period, the only currencies that the yuan outperformed were the yen and those of a few oil-exporting nations.

Chart 13: Exchange Rate of Major Currencies Against the RMB, 1H 2023 (%)



Source: Bloomberg, China Asset Management (Hong Kong), as of 23 June 2023.

Chart 14: RMB Index Trend



Source: Bloomberg, China Asset Management (Hong Kong), as of 23 June 2023.

Drivers of RMB Depreciation

The recent weakness in the yuan can be attributed mainly to the following reasons:

1. Weakening domestic and foreign demand: The weakness in foreign demand is reflected in softer exports, while the domestic demand is reflected in the decline of domestic economic data, including the PMI.

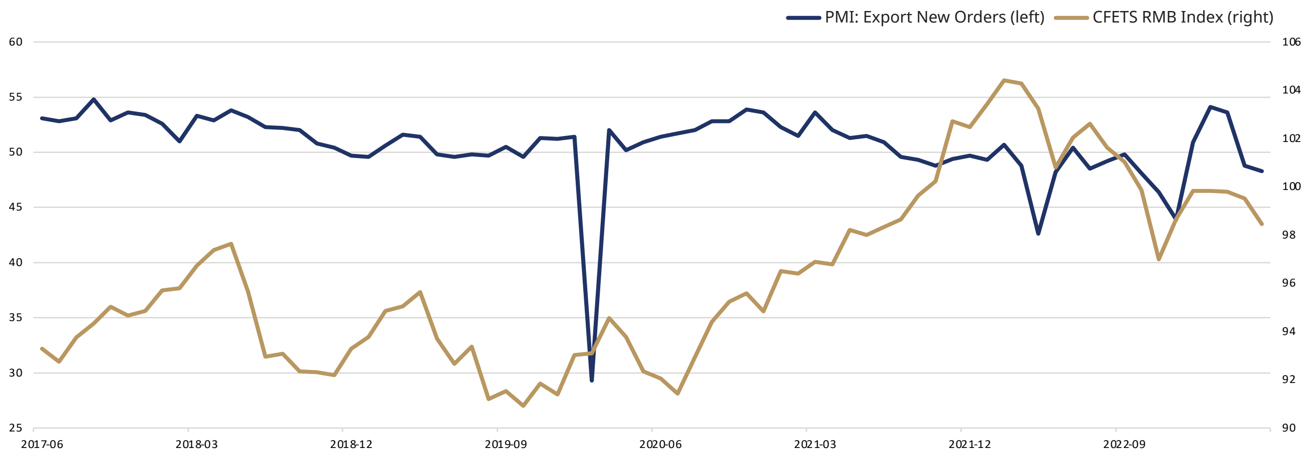
2. Decreasing risk appetite: The market sentiment has become pessimistic regarding China's economic recovery and the RMB exchange rate.

3. The continuing expansion of China-US interest rate spreads: On one hand, the Fed maintains a relatively hawkish rate hike pace. On the other hand, domestically, there's a return to easing, with the expansion of short-term interest rate spreads leading to a weaker yuan exchange rate.

These factors will continue to drive the performance of the yuan in the second half of the year.

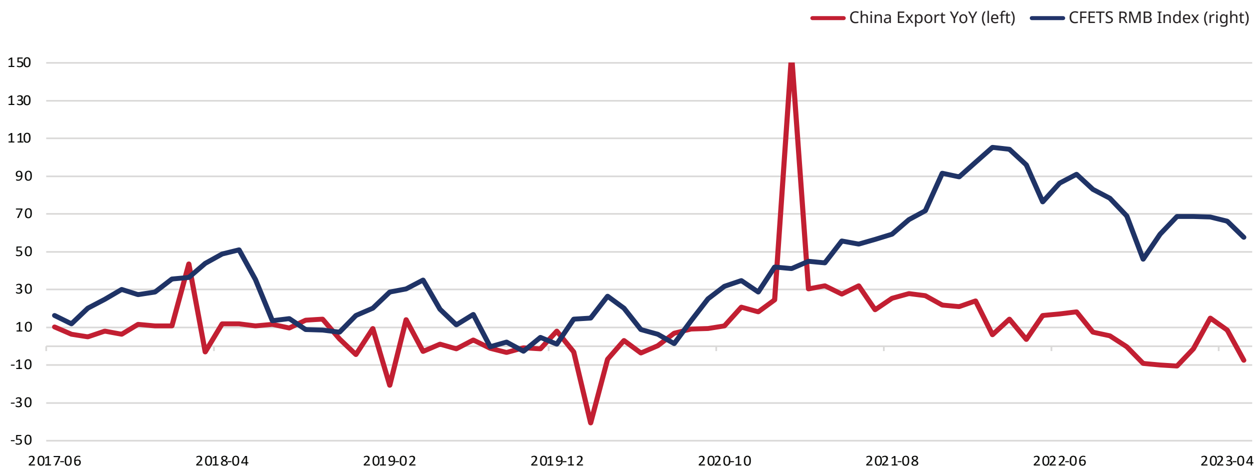
(1) Demand. With export data turning negative again in May, and the manufacturing PMI and new export orders sub-index falling below the boom-bust line, the downward trend in exports is reestablished. If we use the RMB exchange rate index to measure the relative strength of the yuan against a basket of currencies, history shows a high correlation between the exchange rate index and the sub-index of export orders and year-on-year export growth rates, which are respectively leading and coincident indicators reflecting export conditions. Since the PMI returned to the contraction zone, and the growth rate of exports turned negative again, the exchange rate index began to weaken significantly, recently falling below the low of last November. The current RMB exchange rate index is still about 1% - 2% above the average before the pandemic, and there is further room for decline before the downward trend in exports ends. At present, the consumption of goods in major demand countries such as Europe and the United States is declining, and domestic manufacturing is in the proactive de-stocking phase, which, according to historical experience, may last until the end of the third quarter or the fourth quarter. The reversal of the exchange rate index trend will have to wait until the year-on-year trend of PMI export orders and export growth rate turn positive again.

Chart 15: China PMI Export New Orders vs. RMB Index



Source: Bloomberg, China Asset Management (Hong Kong), as of 23 June 2023.

Chart 16: China Import and Export YoY and RMB Index

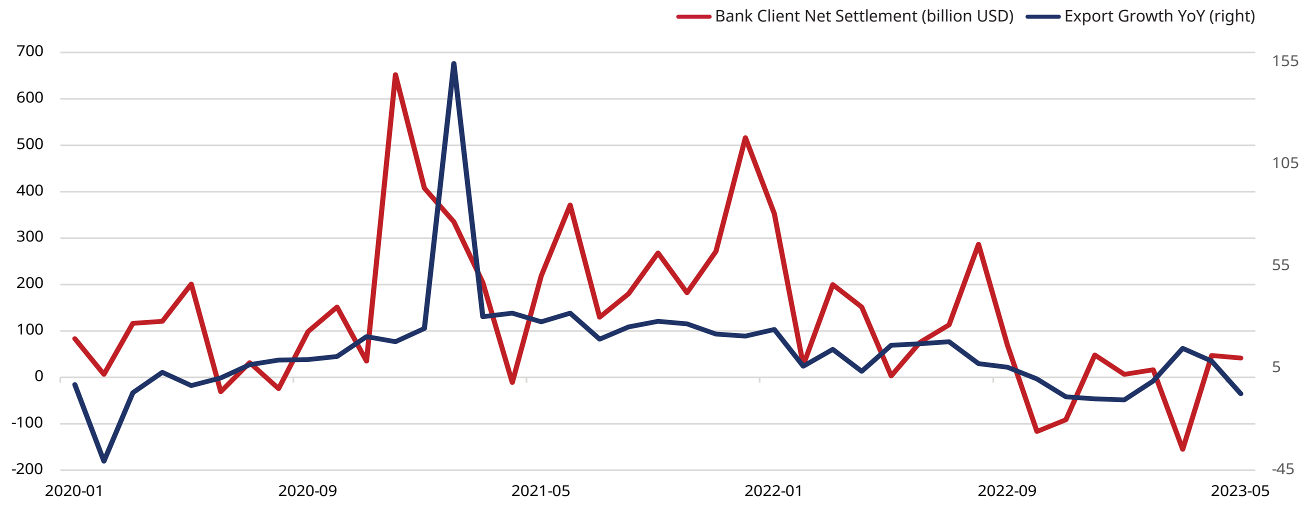


Source: Bloomberg, China Asset Management (Hong Kong), as of 23 June 2023.

(2) Risk appetite. As the momentum of economic recovery weakens, the market is repricing the prospects of China's economy. Economic fundamentals, which were a key factor supporting the yuan exchange rate from the end of last year to the first quarter of this year, have been significantly shaken, thereby encouraging the market to short the yuan. With the continuous depreciation of the yuan, the enterprise settlement rate is low, and the net settlement of foreign exchange on behalf of clients has also returned to a deficit state, indicating that enterprises have relatively weak expectations for the yuan. Of course, these data are also affected by seasonal factors such as foreign exchange purchases for Hong Kong stock dividends. However, unlike previous yuan depreciation cycles, the recent yuan weakness has not been accompanied by a significant rise in option volatility. On the contrary, risk reversal options reflecting market expectations continue to fall, indicating that the market has not engaged in panic buying of foreign exchange, but market participants holding dollar positions are constantly selling dollars at high levels through option combinations.

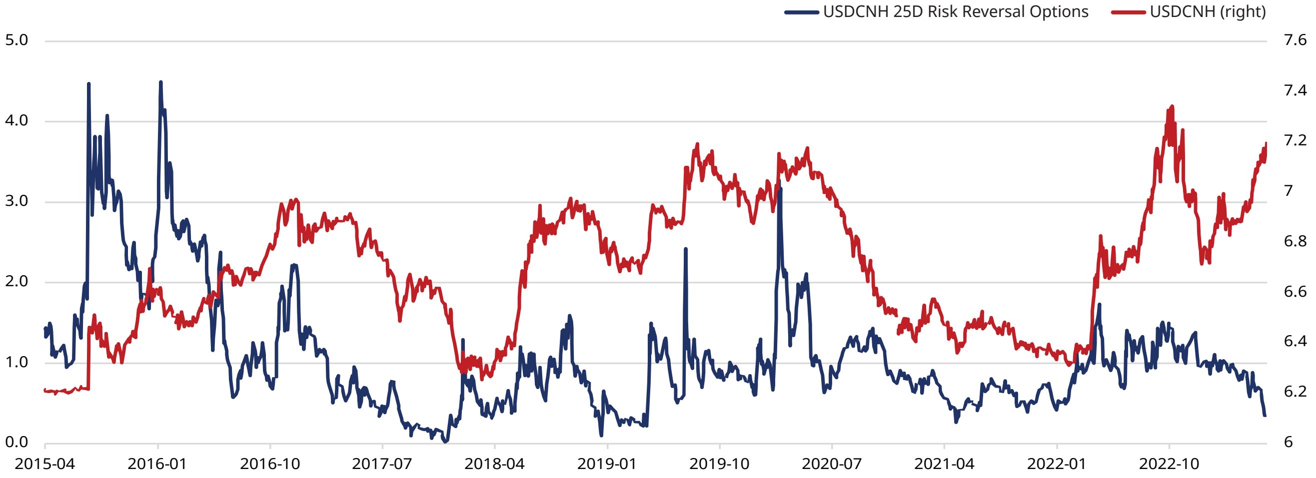
Therefore, although this round of yuan depreciation is not insignificant, the overall trend is flat. Considering that the current enterprise settlement rate is already low, and the market sentiment is stable, even if the yuan continues to maintain weakness, the risk of rapid depreciation is relatively small. Moreover, dividends from Hong Kong-listed companies will end in mid-August this year, and the rebalancing of the net settlement of foreign exchange at that time is expected to provide some support for the performance of the yuan.

Chart 17: China Bank Client Settlement and Sales



Source: Bloomberg, China Asset Management (Hong Kong), as of 23 June 2023.

Chart 18: USD/CNY 25-Day Risk Reversal Options



Source: Bloomberg, China Asset Management (Hong Kong), as of 23 June 2023.

(3) Interest rate spreads. The opportunity cost of keeping the yuan has increased for businesses as interest rates rose in the U.S. market but fell in China, lowering their willingness to sell dollars. The Fed's relatively hawkish stance has kept interest rates high in the U.S. market, while interest rates in China have begun to fall since the end of the first quarter, particularly in the money market interest. Three-month SHIBOR has fallen around 40 basis points, reflecting the private sector's reduced risk appetite.

Investments in the manufacturing and real estate sectors, which are more closely associated with private sector demand and risk appetite, have fallen short of expectations this year. This discrepancy is further evidenced by the downward trend of medium and long-term household loans observed in the second quarter, pointing to sluggish endogenous demand. Historically, demand for medium- and long-term household loans were strongly correlated with RMB money market interest rates. In the context of less-than-satisfactory recovery in real estate sales and investment, the demand for household credit continues to bottom out, leading to a easing in the RMB interest rates. Expectations for the property market and household income will need some time to restore. We expect interest rate spreads to hover at low levels, with a rebound likely not visible until after the end of the third quarter. Furthermore, the current U.S. economic data remains robust, and even if the Federal Reserve cuts interest rates within the year, it is highly likely to occur in the fourth quarter. By then, the negative impact of interest rate spreads on the yuan will gradually weaken.

Chart19: China's GDP Growth by Component in Q1 2023

Category	Expected growth rate at the beginning of the year	Q1 Growth Rate (Annualized)
Consumption (household + government)	7-9%	8%
Infrastructure investment	7-9%	10%
Manufacturing investment	7-10%	6.10%
Property investment	-2%	-6.20%
Net exports	-10%	-4%

Source: Bloomberg and China Asset Management (Hong Kong), as of 21 June 2023.

To sum it up, the yuan is anticipated to maintain a relatively softer stance until the fourth quarter. During this period, we expect a gradual accumulation of positive factors, both fundamentally and technically. Moreover, the current position of the US dollar against the yuan is less than 2% away from its peak in the previous year. Assuming no strong resurgence in the US dollar index, the 7.37 mark is poised to represent a formidable resistance level that could be challenging to surpass.

About ChinaAMC (HK)

Established in 2008, China Asset Management (Hong Kong) Limited is a leading Chinese asset manager in Hong Kong. We are a wholly-owned subsidiary of China Asset Management Co. Limited, which reigns one of the top asset managers in Mainland China and manages over USD 260 billion in assets as of December 31, 2022.

Rooted in Hong Kong with a specialised expertise in China, we take a global perspective in building a multi-solution platform to provide asset management and investment advisory services for institutional and retail investors in the region and globally with our vision of **"Beyond China Expert"**.

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ETF		
Greater China Equity	**Asia Equity**	**Global Equity**
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Fixed Income	**Leveraged & Inverse Product**	
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