Value Partners
Investing through discipline

2022 Mid-Year Market Outlook

Identifying silver linings amidst the volatility

July 2022

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Market Views

Inflation at the forefront of investor worries

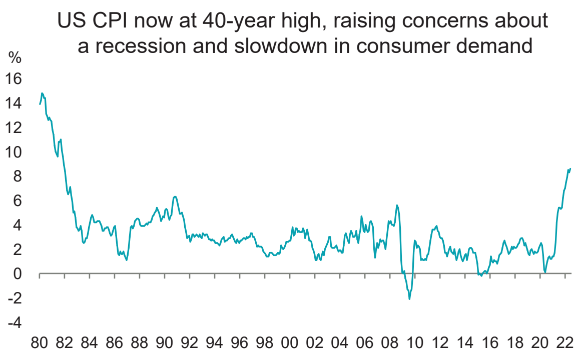
Volatility was carried into 2022, with Asian markets broadly under pressure in the year's first half. Various risks loomed on the horizon, including unexpected rising geopolitical events, particularly the Russia-Ukraine tensions and the surging commodity prices that drastically changed the world's inflation expectations. At the beginning of the year, we expected macro concerns over inflation to be one of the key risk factors in 2022, and we have become more concerned about the heightened inflation expectations to drive further global weakness.

To combat inflation, the US Fed and other central banks have started hiking interest rates at a faster-than-expected pace. Central banks have found themselves way behind the curve, especially after CPI numbers continued to rise higher among developed markets. Investors have gradually shifted their attention from the beginning of an aggressive rate hike cycle and quantitative tightening to recession and stagflation risks.

The market now expects a total of 350 bps hike from the Fed and 175 bps from the European Central Bank (ECB) by December.

With elevated inflation, a more aggressive rate hike is warranted. We view that it is better for central banks to be more hawkish now and should act before inflation is out of control. The heightened inflation numbers in the US (Figure 1) have already eroded the purchasing power of Americans, inviting greater worries about consumer demand for various goods, including electronic products and staples.

Figure 1: Heightened inflation numbers in the US



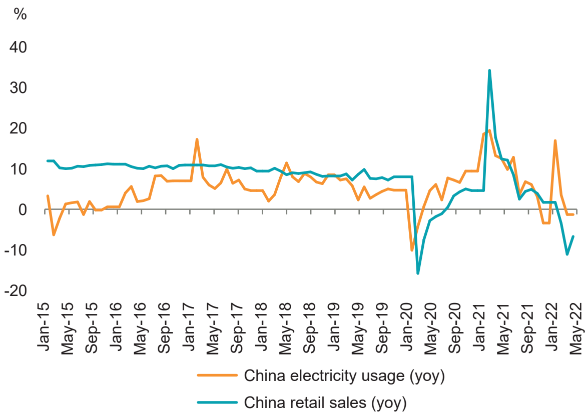
Source: Bloomberg, as of 31 May 2022

Key concerns in Asia

Elsewhere, the sudden resurgence of Covid cases in China, notably in Shanghai and Beijing, took investors by surprise, as the subsequent lockdowns further weighed on the economic activities and led to supply chain disruptions, with the latter raising further concerns over inflationary pressures (Figure 2).

Overall, the MSCI Asia ex-Japan index was down by 17% in the first six months of 2022, with mixed performances across the region. Like China, North Asia markets, such as Taiwan and Korea, dragged amid concerns over end-demand weakness in the technology sector. On the other hand, commodity-driven countries, especially Indonesia, performed well as they benefitted from the elevated commodity prices.

Figure 2: China's economic activities weakened sharply amid Covid resurgence (yoy)



Source: Bloomberg, as of 31 May 2022

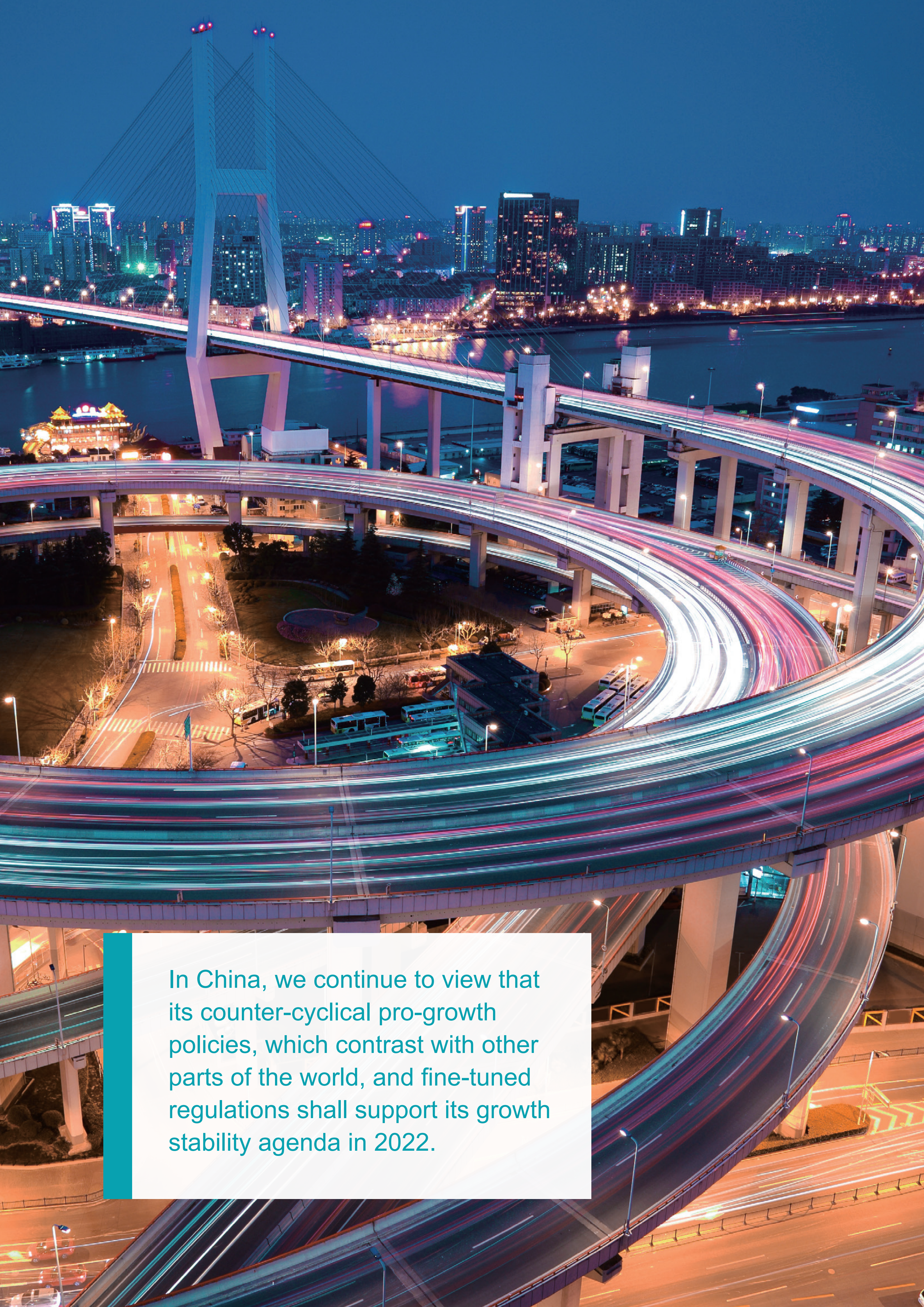
Silver linings in the cloud

Despite a weak macro backdrop, we believe there are some silver linings. In China, we continue to view that its counter-cyclical pro-growth policies, which contrast with other parts of the world, and fine-tuned regulations shall support its growth stability agenda in 2022:

- The government will provide additional stimulus to the economy. In a national assembly meeting held in May, Premier Li Keqiang has urged provincial governments to step up the policy execution, announcing a package of measures to stabilize the economy.

- Fine-tuned regulations are expected, especially in the internet and property sectors, which were heavily beaten last year. In May, top policymakers in China met with dozens of executives and industry experts, pledging to support the healthy developments of the technology sector.

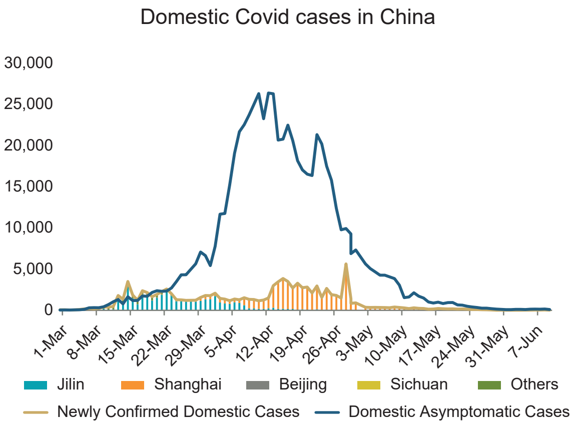
- Although we remain cautious and closely monitor China's zero-Covid strategy, newly reported Covid cases have been falling in China (Figure 3). At the same time, more measures are being taken to ensure the logistic flows and production resumptions. For one thing, Shanghai has lifted the white-list system for resumed production from the beginning of June.



In China, we continue to view that its counter-cyclical pro-growth policies, which contrast with other parts of the world, and fine-tuned regulations shall support its growth stability agenda in 2022.

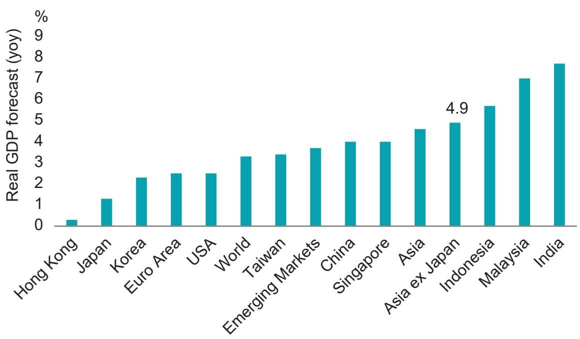
A solid performance of China will not only support its domestic markets but also potentially benefit other Asian markets, given China's large scale and relevance in this region. For one thing, China is a key trading partner and a key source of Foreign Direct Investment (FDI) to many ASEAN countries.

Figure 3: The pandemic situation in China is improving



Source: NHC, as of 7 June 2022

Figure 4: 2022E GDP growth forecast



Source: FactSet, I/B/E/S, MSCI, Goldman Sachs Global Investment Research, as of 3 June 2022

Figure 5: 2022/2023 EPS growth forecast

Source: FactSet, I/B/E/S, MSCI, Goldman Sachs Global Investment Research, as of 3 June 2022

In Asia, inflation shall continue to drive diverging developments within the region. Nevertheless, the easing disruptions in the supply chain and the reduced geographical tensions may help lower inflation pressures and lift investor sentiment.

In a nutshell, we are cautiously optimistic about the China and Asia markets, although we believe market volatility to remain as more rate hikes are in the cards of the US Fed and quantitative tightening starts to gather its pace.

While we expect downward adjustments in GDP and earnings to continue (Figures 4 and 5), we believe having a selective and bottom-up focus on quality fundamentals could be rewarding for long-term investors as some valuations offer compelling investment opportunities, which we will further illustrate in this report.

Sub-asset Class and Asset Allocation Views for 2H 2022

Figure 6: Asset allocation views for the next 12 months

Equities		Bonds		Alternatives	
US	↓	US Treasury	↓	Real Estate	↓
Europe	↓	Other developed markets government	↓	Gold	→
Japan	→	US/European investment grade	↓	Base Metals	↓
North Asia (ex-Japan)	↑	Asian investment grade	→	Oil	↑
South Asia	→	US/European high yield	↓	Cash	→
Other emerging markets	↓	Asian high yield	↑		
		Emerging markets bond	→		

↑ Add exposure → Remain the same ↓ Reduce exposure

Source: Value Partners, as of 7 June 2022

As we expect volatility to be elevated, we remain defensively positioned in the near term. However, we believe Asia is in a better position than the west as inflation is better controlled in the region and more supportive policies are in place. Moreover, valuations in Asia have already reached attractive levels. In contrast, more earnings downgrades and devaluations in the west are still needed as equity risk premium remains below average.

Developed market equities

United States

Although the US equity market has already reached a bear market after correcting by more than 20% year-to-date from the peak, the correction so far has only adjusted for the higher bond yields. We believe there will be more downside to the market as the equity risk premium remains low. Earnings for the rest of the year would need to be revised down, as a recession is still not the base case for most earnings estimates. The outlook on consumer spending also remains muted, as consumer sentiment has reached a record low level while rent, food, and energy prices remain elevated. We view that US equities have material downside risks, and volatility could spike further in the third quarter.

Europe

In Europe, stagflation is slowly materializing. The skyrocketing gas prices are having a significant impact on the region's economy. Bank of England (BOE) has already forecasted inflation to reach 10% by the fourth quarter with negative GDP growth in 2023. After having negative interest rates for so long, the ECB move to increase rates to positive in the second half has created more economic uncertainty. In addition, Europe needs additional financing to fund its increasing defense spending and renewable energy push as geopolitical risks have significantly increased since the onset of the Russia-Ukraine tensions.

Japan

Japan is sensitive to global trades, and as recession risk looms, Japanese equities will be affected. However, we believe it will outperform the US as easing remains in Japan, and the country's weak currency supports its export sector. However, as Japan's inflation finally hit above the 2% target, there are concerns that the Bank of Japan (BOJ) may shift its policy stance on yield curve control soon as the Japanese yen continues to break the 20-year low. Also, with long-end yields continuing to go up, the magnitude and the pace of Japanese government bonds (JGBs) purchases by BOJ is becoming unsustainable. However, the gradual reopening of Japan and its fiscal stimulus package should support consumption growth.

Asia (ex-Japan) equities

China

China has been ahead of the economic cycle since the onset of Covid and will maintain highly counter-cyclical economic policies versus the west. CPI is well under control in China, with expectations of it hitting 2-2.5% in 2022. Therefore, China has room to implement more aggressive fiscal policies to offset the impact of its zero-Covid policy and revive the economy. Starting from May, the government has pledged to implement more easing policies, including tax cuts, consumption stimuli, increasing credit supply, renewable energy push, and others, with more expected to come in the second half.

In addition, despite the lockdowns in April and May, economic data for those months came out better than initially feared. Investor sentiment towards the internet sector also improved. First-quarter earnings for internet companies beat expectations, and China's government has released supportive signals to the internet sector and is downplaying regulatory issues to stabilize growth.

Meanwhile, China is the only major market that has already undergone both earnings and multiple reductions. As a result, we expect Chinese equities to gradually recover from their bottoms, and given their attractive valuations, further re-rating and inflows should continue.

We believe that China A-shares will benefit more from the country's economic recovery and are less impacted by global markets. Also, the RMB has stabilized, and we don't expect much more depreciation, even as the US dollar strengthened against most other currencies. For offshore-listed Chinese equities, we view that they will be supported given their attractive valuations.

Hong Kong

Hong Kong's economy has been gradually improving, although the pace will depend on the timing of the reopening of its border. The valuations of domestic sectors are attractive and will likely benefit from the SAR's gradual reopening. We believe that we have seen the worst, as investor sentiment has bottomed on the back of the supportive measures from China. However, we expect volatility to likely remain as Hong Kong is more affected by weakening external demand and the US rate hikes.

Taiwan

Although exports and new orders growth had been slower compared to 2021, the upstream technology hardware segment continues to see strong demand. As there are some signs of supply bottleneck easing in the semiconductor space, we expect that the aggressive price hikes in the last two years will likely end. However, with recession risks looming globally, the slowdown in demand next year is still highly unpredictable at the moment. That said, valuations are below the average level, and given the high dividend yields of companies, we are neutral on Taiwanese equities.

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Korea

Given inflation concerns, Korea has continued with its aggressive rate hike cycle following the US. As external demand slows down, we expect earnings growth to remain moderate. In addition, the uncertainty in the memory cycle adds to the negative sentiment. Its currency will also likely suffer from the strong US dollar.

Southeast Asia

After their reopening, Southeast Asia markets have continued their economic recovery, with economic activities exceeding pre-pandemic levels. However, their currencies will likely suffer from the strong US dollar, while the tighter global liquidity and inflation have started to hurt some countries. Within Southeast Asia, Indonesia will continue to outperform as it enjoys the high commodity prices in its exports and has enough resources to supply its own. In Singapore, given its sensitivity to global trades and high interest rates, we expect its market correction to continue.

India

India has continued to enjoy its long-term secular bull market, supported by the expansion of new economy sectors and the country's ongoing upward profit cycle. However, valuations are at extreme levels relative to the rest of Asia. India also suffers from high food and energy inflation, causing consumer spending to slow down.

Other emerging markets

The strong US dollar and global recession risks do not bode well for emerging market equities. Elevated food prices have become a problem in some emerging markets, with social instability becoming a major concern. While recession risk has caused industrial commodities to correct, oil has become the only commodity that is seeing its price go up, given the tight supply and decreasing inventory. As a result, selective oil-producing emerging markets are still well-supported.

Fixed income and alternatives

Developed market bonds

The US and Europe will likely struggle with persistently high inflation, with risks of a possible recession. Their yield curves will continue to shift upward as the market now expects a total of 350 bps hike from the Fed and a 175 bps rate hike from the ECB by December to combat inflation. Bear flattening will remain as growth concerns will keep longer-term real yields low. We expect volatility in government bonds to remain. Meanwhile, the risk in Japanese government bonds (JGBs) is rising significantly as the cost of yield curve control by the Bank of Japan (BOJ) is getting higher. If BOJ gives up on yield curve control, global liquidity will further tighten. Credit spreads in both investment grade and high yield bonds are still tight, which will likely widen as recessions risk looms and earnings downgrade intensifies.

Asia investment grade bonds

With a more positive outlook on China, credit spreads of China investment grade bonds have stabilized. Some quality Asia investment grade bonds have also become attractive, yielding around 5-6%. However, as interest rate risks are likely to remain elevated, a shorter duration stance will be warranted.

Asia high yield bonds

The valuations of Chinese high yield bonds are at very attractive levels versus the rest of Asia. With sentiment in China improving, there are opportunities in select high yield bonds. However, as some Chinese property bonds continue to face downgrades and negative outlooks, the China property sector remains weak. That said, with the property sector's outlook improving on the back of more supportive policies, we view that we may have seen the worst. Meanwhile, in India, due to concerns over high inflation and rate hikes, credit spreads in the country will likely continue to widen.

Alternatives

Cyclical commodity prices except oil are expected to decrease as demand softens and supply increases. On the other hand, oil prices will be supported as OPEC+ has a strong incentive to maintain it at a high level with tight production. In addition, a strong pick-up in supply will be challenging given the low capital spending on oil extraction in the past few years. As a result, oil will remain in deficit for 2022. For gold, although higher interest rates will cap its performance, the asset class remains a good hedge against geopolitical uncertainties and stagflation.

Equity Sector Focus

Asia tech leaders – beneficiaries of the long-term digitalization trend

Despite the recent setback from end-demand concerns in the broader technology space, the longer-term outlook of Asia technology leaders continues to be solid as technology consumption demand trends up with technology advancement. Asia technology leaders continue to see a promising outlook underpinned by the long-term digitalization trend and their edge in the industry.

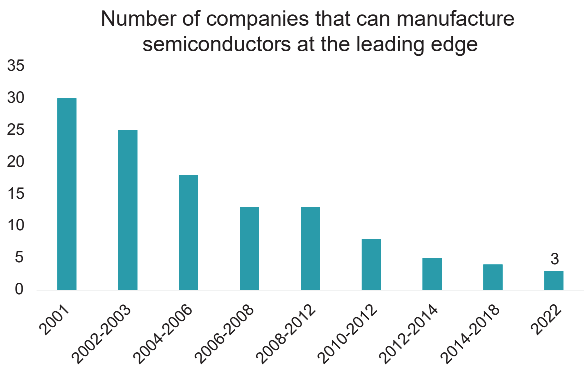
Lower latency and more powerful computing capacity have created more technology-enabled options, especially AR/VR, AI, and cloud computing, stimulating the need for more powerful technology solutions and IT infrastructure, including hardware and software components. The AI semiconductor market alone is estimated to reach US$86bn by 2026[1] from US$35bn in 2021, a 20% compounded pace, while cloud spending is expected to grow 13% per annum in 2021-2026E[2] as adoption continues.

[1] Gartner, as of 31 December 2021

[2] IDC, as of 31 December 2021

With technological advancement, Asia leaders are expected to maintain their upward momentum of market share gain with their technological edge. For instance, Asian foundry leaders, with their superior manufacturing process technology, are gaining more market share over the years (Figure 7). Their leading-edge process technology is expected to enable them to capture most of the market share in advanced nodes. Similar trends are also observed in the supply chains of other new generation technology devices.

Figure 7: The number of companies with leading edge semiconductor manufacturing capability has dropped to just three in 2022



Source: SIA, Intel, as of 31 May 2022

Figure 8: China's technology localization addressable market size

Technology area	Market size (RMB billion)	Import substitution rate	Market for substitution (RMB bilion)
CPU (2021)	187.5	2%	183.5
Server (2021)	25.1	74%	6.5
Operating system (2021)	35.4	5%	33.5
Storage (2020)	31.7	73%	10.5
Office suite (2020)	11.8	28%	8.5
Database (2021)	30.9	4%	29.9
Middleware (2020)	15	8%	13.7
Enterprise resource planning (ERP, 2020)	34.6	71%	9.9
Total	**372.0**		**296.0**

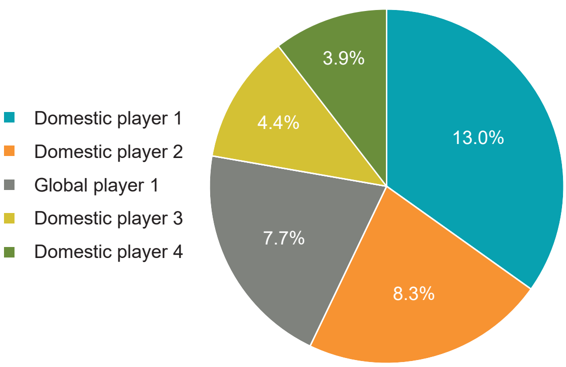
Source: Wind, IDC, Urtrust ThinkTank, Company websites, Huaon, CAICT, Soochow Securities, as of 30 April 2022

Meanwhile, in China, the nation is working towards increasing self-sufficiency amid heightened geopolitical tensions, ramping up its hardware and software technology and capacity. Currently, the country relies heavily on other countries – over 90% of its advanced chips and operating systems come from US companies. Given the rising geopolitical risks, China is reinforcing technology localization, which comes to a considerable market size of RMB 296bn If all areas adopt locally-developed products (Figure 8).

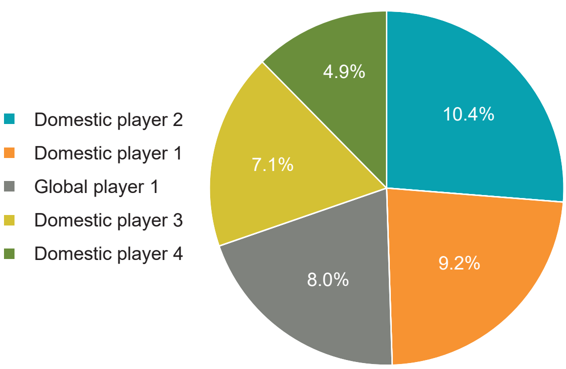
At present, technology disadvantages and performance issues are the biggest concerns for companies when considering switching to domestic vendors. That said, the vendors' continuous investment in R&D in recent years to narrow the performance gap is boosting confidence in import substitution. China's commitment to achieving self-sufficiency is also reiterated in its 14th Five Year Plan and its aggressive patent applications in computer technology and digital communication. Its patent filings on 5G, blockchain, and AI have ranked top[3], proving China's attempt to close the gap in IT innovation with other countries, supporting the growth of leading domestic companies that can provide innovative solutions in various IT areas.

Figure 9: China enterprise resource planning (ERP) vendors have gained market share

2016 top five vendors in the ERP market



2021 top five vendors in the ERP market



Source: IDC, as of 31 December 2021

The need for more advanced technologies bodes well for the Asia tech leaders, as they are well-positioned to gain more share in the market. In particular, China's tech leaders are also beneficiaries of the country's acceleration in tech localization, which presents a massive market for import substitution and room for growth.

[3] WIPO, as of 31 December 2021

To most people, consumption upgrade is about quality consumer products at higher prices. In our view, it also represents a broad spectrum of consumption behaviors supported by the solid and sustained income growth in China.

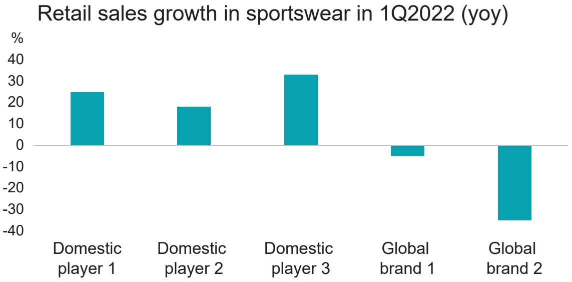
Consumption upgrade theme not being derailed

Consumption in China was dented by the Covid-induced lockdowns and softened macro conditions, with retail sales registering three consecutive yoy monthly declines from March to May 2022. This drag in consumption was markedly different from other Asian economies, which benefited from the reopening of their economies and the relatively low base effects.

Despite the near-term hiccups affecting consumption demand in China, we believe the consumption upgrade theme remains a structural and secular trend. To most people, consumption upgrade is about quality consumer products at higher prices. However, we would like to stress that, in our view, it also represents a broad spectrum of consumption behaviors supported by the solid and sustained income growth in China, especially among the younger generation (i.e., Gen-Z) and the growing affluent middle-class.

For example, the rise of "Guochao"（國潮）has led Chinese consumers to prefer more Chinese products with deeper cultural roots. This is best represented by a landscape change in China's sportswear sector. During the first quarter of 2022, key domestic sportswear brands still registered positive sales growth, which compares with major global or foreign brands whose sales continued to retreat amid the more cautious consumption environment (Figure 10).

Figure 10: Domestic sportswear brands continue to register positive sales growth

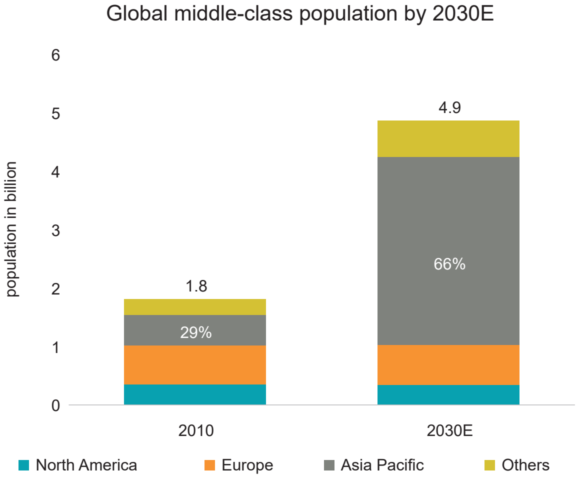


Source: Company data, UBS, as of 31 March 2022

It is also worth noting that growing consumption is not only limited to China but also across Asia, particularly in the ASEAN markets. This should not be a surprise given the continuous income growth across the region, driven mainly by the large and growing middle-income population (Figure 11). Overall, we believe consumption upgrade represents a structural growth story, and investors should look beyond near-term consumption weakness.

That said, we still need to watch the potential downside risks closely, especially from the high food and energy prices and the impact of a possible recession in the US. In our view, a recession in the US may affect the export-oriented markets more. It is also vital to know that consumption trends may evolve quickly and, despite a rosy long-term outlook, many players could phase out rapidly. One example is the quick boom-and-bust of certain fads, such as some "new tea drink"（新茶飲）brands in China in the last few years. In view of this, we believe a bottom-up analytical approach to stock selection should be adopted to tap this theme. Closely monitoring these players is critical to be cognizant of any short-term changes in a certain industry.

Figure 11: A bulk of the global middle-class population will come from Asia Pacific



Source: OECD-FAO, PWC Analysis, Value Partners, as of 30 November 2019

E-commerce: penetration still rising with new drivers

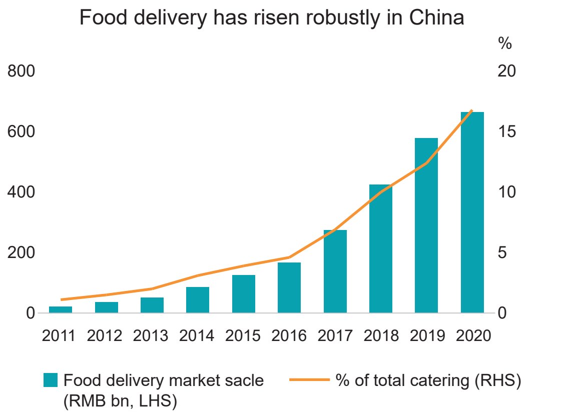
Closely related to the consumption theme is e-commerce. E-commerce businesses in China were also hit by the weak macro backdrop, with the combined online retail sales growth down to just 3% in the first five months of 2022 (Figure 12). It also seems inevitable for the e-commerce business growth to slow down, given the penetration in China has already reached a decent level of about 30%.

Figure 12: China's online sales growth has also substantially slowed down

Source: Bloomberg, as of 31 May 2022

Nevertheless, we believe online consumption could still stage a recovery trend ahead, especially given the government's dedicated efforts to bolster consumption, such as in the form of the consumption coupons distributed by the local governments. It is also noteworthy that new business forms or models, such as food delivery and the Community Group Buying (CGB) business, have gained popularity (Figure 13). Food delivery businesses have become a key part of the catering business in China. Meanwhile, while CGB has also gained popularity during Covid-related lockdowns, it has now increasingly become a habit of many consumers in top-tier cities. With increased scale, improved unit economics, and a more consolidated market, CGB is becoming a more viable long-term business, providing potential new drivers to the e-commerce players. We also believe these new business models in China could be replicated in other Asian markets, once successfully applied.

Figure 13: Food delivery businesses are becoming a key part of the catering sector in China



Source: China Hospitality Association, Ele.me, as of 31 December 2020

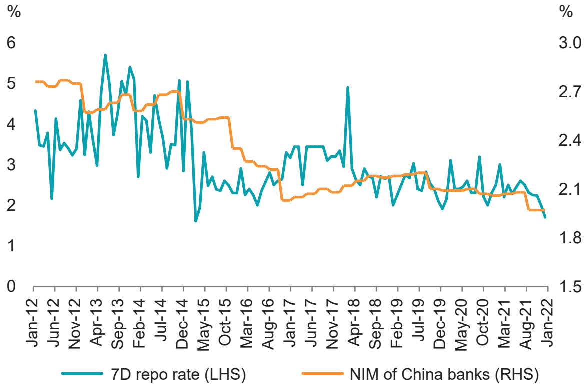
Financials – riding the growth of wealth management

We believe the accommodative monetary conditions in China could prove to be a double-edged sword for Chinese financials, especially banks, which we underweight. While lower rates and ample liquidity may help support economic recovery, the banks' net interest margins (NIMs) tend to narrow amid these conditions, especially if large liquidity fails to turn into effective lending assets (Figure 14).

In some parts of Asia, where interest rates tend to track the Fed fund rate direction (such as Singapore), the banks' NIM may be bolstered. That said, we still need to closely monitor the credit quality trend, particularly the potential impacts of a possible recession in the US to Asian economies.

Despite the short-term macro pressures that may adversely affect China banks, we believe the secular growth of wealth management businesses remains intact. In the long run, the growing household wealth – driven mainly by rising middle-income affluence – provides solid and growing demand for wealth management products. It is estimated that Chinese households' total investable financial assets will grow more than 60% from US$31trn in 2020 to US$50trn by 2025e, or at a CAGR of 10%[4] (Figure 15).

Figure 14: China banks' NIM could narrow amid a declining rate environment



Source: Bloomberg, as of 31 May 2022

Figure 15: Growing household wealth in China to grow demand for wealth management products

Source: Goldman Sachs, KPMG, as of 30 April 2022

[4] "The Future Wealth Management" 2022, KPMG, May 2022

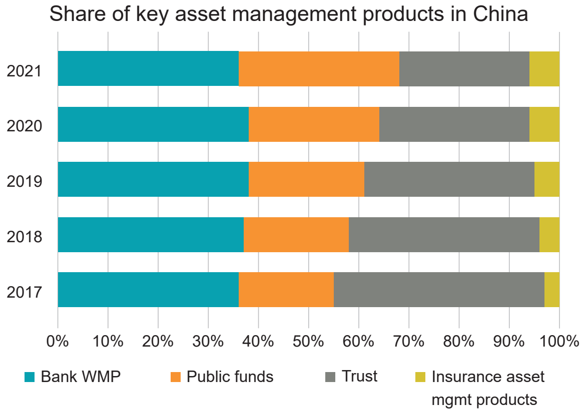
Moreover, in the near term, we continue to view the three key trends reinforcing wealth management business growth:

- **The declining interest rate in China may drive more investors to reallocate financial assets from deposits to other wealth management products.**
- **The weakened property market has accelerated the trend to diversify from property investments into financial assets.**
- **The encouragement of the common prosperity agenda may help more balanced income growth and hence broader demand for wealth management services.**

In addition, the shore-up of the irregular financing channels, such as the P2P, micro-lending, and local financial asset exchanges, could help drive the demand toward more proper or stable platforms from established brands. We believe leading financial intermediaries – especially banks, asset management companies, and wealth management distribution platforms – remain well positioned to capture this growth. The traction of products offered by these players is already gaining momentum, partly reflected in the increased percentage share of the banks' wealth management products (WMP) and public funds, which now jointly account for nearly 70% of the industry's total (Figure 16).

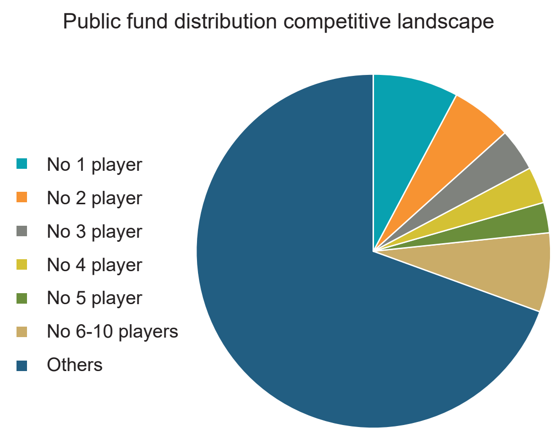
It is also worth noting that some players have already established strong leading positions. Take public fund distribution as an example; the top five players now account for 23% of the total market share, while the top ten have jointly taken 31% of the pie (Figure 17). We believe the market share of the top players should progress further, leading to greater scale and higher profitability, presenting good, long-term investment opportunities for some relevant players.

Figure 16: The share of WMPs and public funds has increased over the years



Source: Banking Wealth Management Registration and Custody Center (% share of outstanding value), as of 31 March 2022

Figure 17: Top players in fund distribution dominate the industry in 1Q2022



Source: Asset Management Association of China, as of 31 March 2022

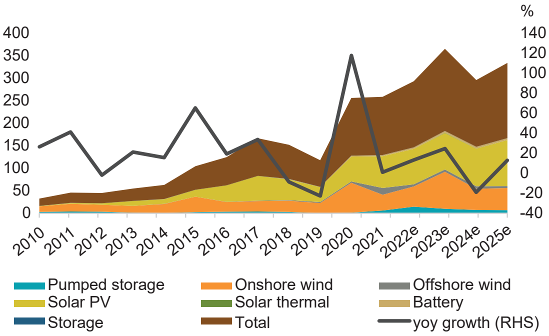
The new energy sector is a long-term beneficiary of China's structural transition toward renewable energy and the cohesive global efforts to achieve carbon neutrality, with a highly visible outlook.

New energy – solid long-term outlook with a healthier ecosystem

We view the new energy sector as a long-term beneficiary of China's structural transition toward renewable energy and the cohesive global efforts to achieve carbon neutrality, with a highly visible outlook.

Despite some end demand disruptions, capacity expansion of renewable energy remains firmly on track. In China, the installed capacity of wind power and solar farms has jumped 17.7% and 23.6% yoy in the first four months of 2022, respectively[5], and is expected to increase further on the back of policy support (Figure 18). In May, China's National Development and Reform Commission (NDRC) further promulgated measures to promote renewable energy, with the national energy administration estimating that 108GW of solar projects will be installed in 2022 – above consensus estimates – doubling the level in 2021.

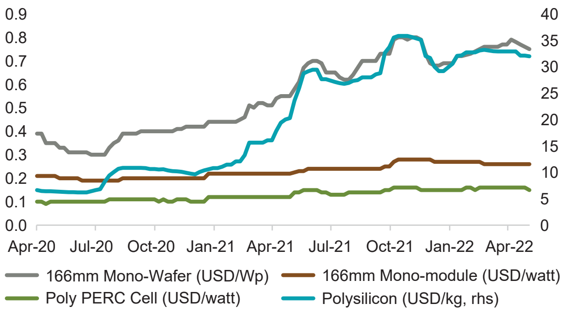
Figure 18: New renewable energy installation capacity is likely to sustain solid growth in the coming years



Source: HSBC, Rystad Energy estimates, as of 31 May 2022

In Europe, the escalated geopolitical risks and the resulting heightened concerns over energy security will likely accelerate the capacity expansion of renewable energy. As a result, the region is likely to boost the imports of Chinese solar products, further solidifying the country's strong, global leading position. We also expect further upside in the market. In June, the US recently confirmed the exemption of solar panels imported from Thailand, Malaysia, Cambodia, and Vietnam from the potential tariffs for 24 months. While this benefits relevant suppliers in these ASEAN markets, it could also indirectly benefit China. China has already become a key source of FDI in these markets in recent years, and some Chinese producers have established a physical manufacturing presence there.

Figure 19: Sharp rise in raw material price has driven up the prices of solar components



Source: Bloomberg, HSBC, PVinfolink, PVinsights, as of 11 May 2022

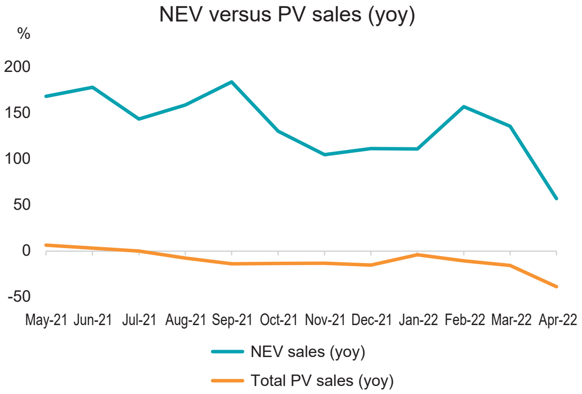
However, we note that the new energy sector has a long and sophisticated value chain, which means business benefits may be distributed unevenly at different times. For example, since the beginning of last year, the price of polysilicon has spiked on tight supply, leading to upward cost pressures on various components

[5] Xinhua News Agency report, 18 May 2022

and squeezing some producers' margins (Figure 19). A similar story has also taken place in the new energy vehicles (NEV) battery market. In light of this, we view that large, integrated producers are in a better position to defend their margins. Furthermore, over the longer term, we believe the dynamics of raw material suppliers and component manufacturers should improve with better demand-supply dynamics, leading to a healthier ecosystem and supporting the sustainable growth of the new energy sector.

We are also optimistic about the long-term outlook of the NEV space. Led by the increased awareness of the general welfare of society, sales of NEVs have significantly bucked the general auto market weakness in recent years (Figure 20).

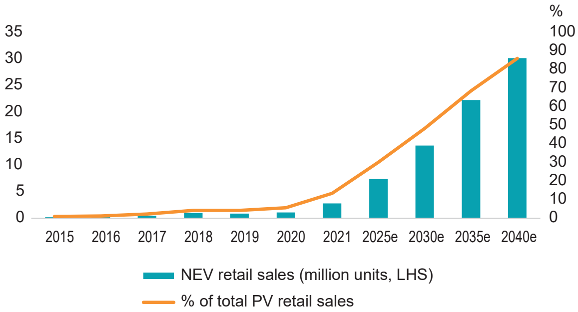
Figure 20: Growth of NEV sales has significantly outpaced Passenger Vehicle (PV)



Source: CPCA, as of 30 April 2022

Although sales growth was recently affected by the supply chain disruption caused by the pandemic and subsequent lockdowns, we expect industry sales to recover quickly amid economic resumption. Longer-term, the NEV market remains firmly on track to achieve higher penetration rates in China. Bloomberg Intelligence forecasts that the retail sales volume of NEVs is likely to increase from less than 3 million units in 2021 to 13.7 million units in 2030, with the penetration ratio (of new passenger vehicle retail sales) rising from 15% to around 50% during the same period (Figure 21). This creates enormous growth opportunities for some players.

Figure 21: New energy vehicle: a burgeoning market in China



Source: Bloomberg Intelligence, as of 30 April 2020

Overall, despite some short-term volatility in the new energy sector, we believe that the long-term outlook of the new energy sector remains intact. We view that looking through the short-term volatility and identifying long-term winners is key to capturing opportunities in this space.

Fixed Income Views

Inflation overshoots and fed hawkishness are drivers of market volatility

The first half of 2022 was marked by heightened market volatility due to the military tensions between Ukraine and Russia and expectations of a faster pace in US policy normalization on inflation overshoots. We believe the Fed will maintain a hawkish tone to curb inflation. During the first half, the 10-year US Treasury yield was up 150 basis points, landing at about 3%. Some consolidation cannot be ruled out as we may not be too far off from peak Fed hawkishness and if the narrative of slower growth gradually becomes dominant. With quantitative tightening underway and the Fed's ongoing hawkish response, we expect market volatility to stay high.

Downward shift in China's GDP growth prompts more timely policy easing

In March, the National People's Congress (NPC) meeting set a GDP growth target of around 5.5% for 2022, with front-loaded infrastructure spending, higher tax cuts, monetary, and property easing. More monetary easing, including policy rate cuts or Reserve Requirement Ratio (RRR) cuts, should be employed to ensure abundant liquidity and support credit growth. While the reopening of Shanghai at the beginning of June provides a short-term respite, the growth recovery outlook and market sentiment will hinge on the country's dedication to its "zero-Covid policy".

We are watchful of a potential moderation on this policy after the Party Congress Meeting to be held in October or November. In addition, higher oil prices, geopolitical conflicts, and easing global demand could narrow China's trade surplus contribution to GDP. Overall, there is some chance that growth will rebound in the second half on recovery in consumption and property sales, following the contraction seen in the first half. We believe the property sector to stabilize in the coming quarters, given signs of coordinated policy relaxation and bottoming out of credit contraction.

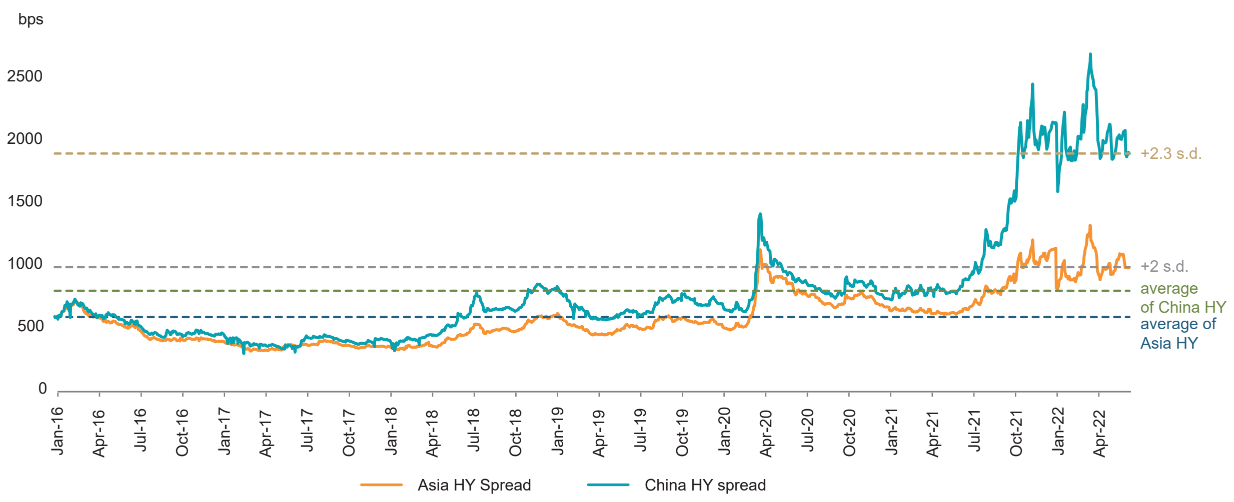
Credit strategy

With a significant correction seen in Asia High Yield (HY) bonds during the past few quarters, we should not be too far off from the bottom of the credit and property cycle in China. The supportive tone from regulators and government officials in mid-March on curbing risks for the property sector (which accounts for around 16% of the JACI HY Index as of end-May) are encouraging signs that should stabilize the sector outlook. We look for further signs of improvement in China's physical property market, which is likely to emerge in the latter half of the year following the lockdown disruptions in the first half. More fine-tuning measures, such as the relaxation of mortgages and home purchase restrictions in selective cities, shall continue to forge ahead. We emphasize diversification and credit quality in our bottom-up bond selection, as credit polarization will likely stay.

So far this year, the higher US Treasury yield had been a drag on bond performance for Asia Investment Grade (IG) bonds. Shorter duration is preferred, and tight credit spreads provide less cushion to offset rate risks. We look to capture opportunities in Asian credits exhibiting higher credit spreads, as they offer a better cushion against rate risks. We also expect less regulatory overhang on the government's directives to support the healthy development of Chinese technology platform companies.

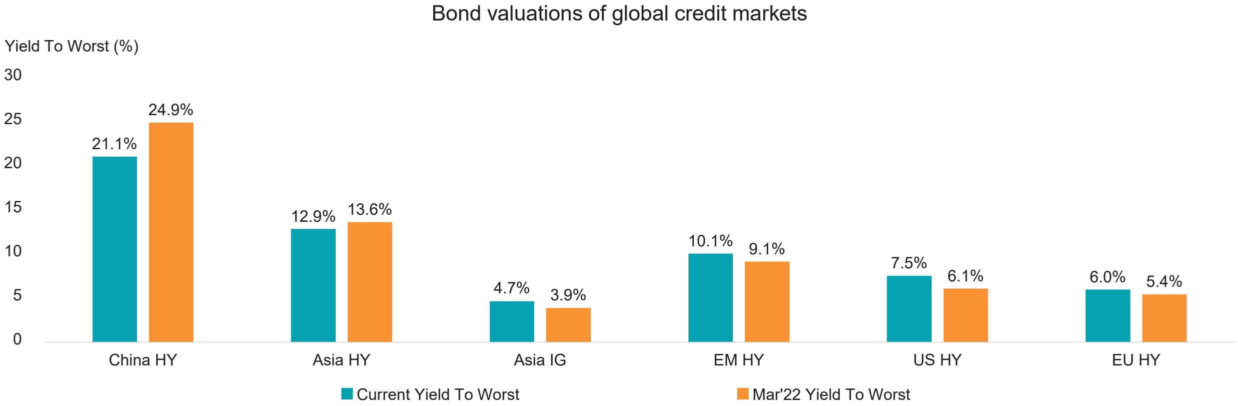
Overall, credit spreads for Asia IG bonds should remain resilient amid low fallen angel risks. Specifically, China High Yield (HY) spreads have already priced in the property cycle and sector consolidation (Figures 22 & 23). We prefer credit names with access to funding and manageable near-term maturities as we remain cautious about idiosyncratic risks.

Figure 22: China HY credit spreads have priced in the bottoming of credit and property cycle



Source: Bloomberg; as of 9 June 2022

Figure 23: Value dislocation in China HY bonds



Source: Bloomberg; as of 9 March 2022

Year-to-date, both credit spreads of Asia IG and HY bonds widened from 18 bps and 144 bps to 193 bps and 838 bps, respectively. The Asia IG Index generated losses of 8%, which was mainly attributed to the higher US Treasury yield. The universe was also impacted by geopolitical tensions and the regulatory crackdown on China's technology sector. A risk-off mode was also seen in the Asia HY Index, which recorded losses of 13.6% amid defaults within the China property sector and fund outflows.

Sector views

Onshore China

The 10-year China Government Bond (CGB) yield was largely flat at 2.8% with a mixed movement. The yield peaked at 2.85% in early March and late April due to further policy easing in the property sector and strong credit data. It subsequently declined amid the pandemic-induced lockdowns and sluggish new loan growth. We view that the current level has already priced in some expectations of policy rate cuts or RRR cuts.

With the pandemic disruptions, we believe China will proactively pursue an accommodative monetary policy to reduce downward pressure on growth. We believe growth will recover from the third quarter onwards, with credit contraction bottoming and additional policy stimulus. We reiterate our view that the CGB yield should march higher towards the year-end. Risks to this view could be that growth stabilization is harder to accomplish amid Covid disruptions and regulatory changes.

The 10-year US-China yield differential was mostly flat, versus 127 bps at the start of 2022. The huge compression reflected the tightening path the US is embarking on, which contrasts with the expectation of more easing in China. With the US Treasury yield pricing in the Fed's rapid rate hikes and may consolidate, there is a lower likelihood that the US-China yield differential to compress further. Foreign inflows into the onshore bond market may decelerate faster if the yield differential is inverted or the RMB depreciates sharply. This, however, is not our base case scenario. Most onshore rate bonds are owned by long-term investors, including foreign central banks and funds that track global bond indices. We believe they will keep their CNY bond allocations with the ongoing development of the RMB internationalization process.

Asia investment grade

Asia IG credit spreads widened year-to-date amid the regulatory crackdown in the technology sector and concerns over an economic slowdown. The heightened geopolitical tensions between Ukraine and Russia have a little direct impact on Asian credits, but second-order effects, such as the drags on growth, a slowdown in global trade, and higher commodity prices, have dampened the overall sentiment towards the sub-asset class. While the increasing pressures on China's economic growth will require more aggressive policy support, the fundamental profile of high grade credits should remain resilient.

Meanwhile, India's sovereign rating is kept at a stable outlook, reflecting the country's growth rebound, despite inflationary pressures and the country's widening current account deficit. Against this backdrop, there is a high likelihood that the Reserve Bank of India to raise rates further. In Indonesia, the strong commodity prices and benign local currency movement should also support Indonesian credits.

We have kept our underweight direction call for the earlier part of 2022. We believe much of the US Treasury impacts are front-loaded and may wane towards the year-end as growth slows. This should present opportunities given our expectation of some consolidation in US rates and China's improving domestic macro backdrop later this year. We look for spread widening in China IG as an opportunity to offset the US Treasury yield move. The fundamentals of most Asian IG corporates should remain solid, and there should be fewer policy shocks in China compared to 2021.

China property

During the first half, China property sales were sluggish and declined by 40-50% yoy due to weak home buyers' sentiment, limited project launches, and Covid restrictions. That said, we expect some improvement in sales in the latter part of the year due to a low base yoy (weak 2H21) and the ongoing fine-tuning of policy measures.

The NPC meeting in March maintained a similar tone to the Politburo in December last year on policy continuity. The policy focuses on fulfilling reasonable housing demand with city-specific measures and more emphasis on rental housing. More cities, such as Zhengzhou, Fuzhou, and others, have started to fine-tune their home purchase restrictions and are seeing more favorable mortgage costs or down-payment terms. We reiterate our view that while the government would not aggressively relax the sector, more supportive measures should be unveiled given the Covid-led downside risk on growth.

For the second half, besides physical market recovery, we also closely monitor the potential relaxation of restricted funds under escrow presale accounts. This, however, is not our near-term base case assumption as timely project delivery remains a top priority. On the financing front, some developers were able to raise funds from onshore (medium-term notes, bonds backed by credit default swaps/credit risk mitigation warrants) and offshore markets (convertible bonds, Stand-by Letter of Credit (SBLC) bonds). We believe credit differentiation remains the key trend.

Refinancing pressure remains heavy for the rest of 2022. To maintain ample cash liquidity to survive through the cycle is pivotal. We analyzed developers in our universe based on their "three red lines" compliance and noted that the coverage of cash to short-term debt ratio has declined. This is in line with market expectations, given a decline in sales and rigid debt repayment. Therefore, we prefer developers with lower near-term refinancing needs, a decent buffer in the cash-to-short-term debt ratio, and a relatively better landbank life as land acquisitions tend to slow in coming quarters.

Macau gaming

The sector was affected by the lockdowns in China, dimming the recovery outlook for Gross Gaming Revenue (GGR) and contributing to the broad weakness across China high yield bonds. Macau's GGR was at 20% of the 2019 pre-Covid level, owing to the delay in border opening. While we believe most operators have maintained sufficient liquidity runway even in a zero GGR scenario, the travel demand to Macau may take time to recover, given the restrictive border measures.

We believe opening Macau's borders will remain the key catalyst for gaming bonds, as the risk of concession non-renewal is considered low. The border situation is critical for operators' earnings recovery and maintaining their current credit rating. The sector remains a diversification and "re-opening" play within the China high yield sector. Risks to this will be prolonged restrictions on border crossing and increasing government intervention.

Commodities

The metal and mining sector outperformed within the Asia high yield space, spanning across the China, Indonesia, and India markets. We continue to prefer this sector as it offers diversification and benefits from robust commodity prices. Given ongoing geopolitical tensions, we see that a huge loosening of supply/demand imbalance is unlikely to happen in the near term. The risk to this will be a more prolonged than expected slowdown in China.

About Value Partners

Established in 1993, Value Partners is one of Asia's largest independent asset management firms offering world-class investment services and products for institutional and individual clients globally. In addition to the Hong Kong headquarters, we operate in Shanghai, Shenzhen, Kuala Lumpur, Singapore and London, and maintain a representative office in Beijing. Value Partners is the first asset management firm listed on the Main Board of the Hong Kong Stock Exchange (stock code: 806 HK) after it went public in 2007. We offer a diversified asset management portfolio for both institutional and individual clients in Asia Pacific, Europe and North America. It includes equities, fixed income, alternatives, multi-asset and quantitative investment solutions. For more information, please visit www.valuepartners-group.com.

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