2021 Mid-Year Market Outlook

Navigating through uncertainty in the midst of normalization

August 2021

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Preface: the year of normalization

The global COVID-19 vaccine rollout has led some economies to gradually recover during the first half. While some semblance of normalcy returned this year, a changing economic environment also comes with new risks that could affect investors' appetite for the rest of the year.

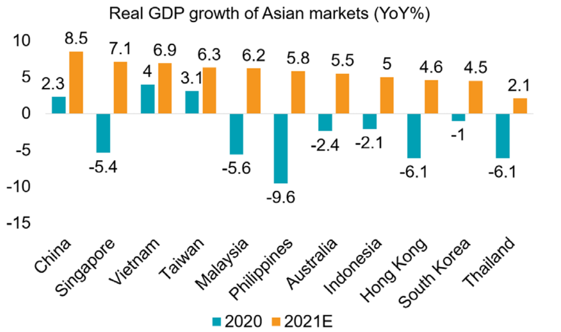
A broader recovery during the first half

The global stage was set to restart in 2021. In December, we said that the eventual vaccine rollout should unlock a gradual recovery process this year. Indeed, we have seen improvements in the economy during the first half.

The macroeconomic outlook in Asia has become encouraging, with economic growth expected to be more broad-based across all markets throughout the rest of the year (Figure 1).

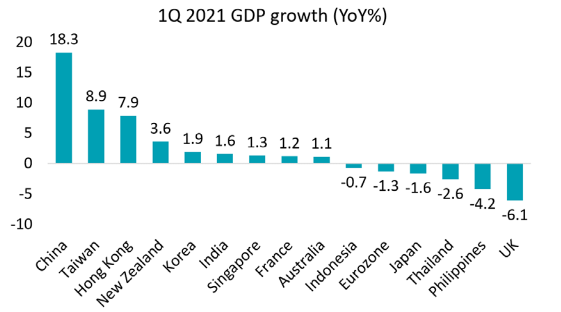
During the first quarter, North Asia led the economic recovery in the region (Figure 2), as they were more successful in containing the pandemic relative to their Asia counterparts.

Figure 1: growth is expected to normalize in Asia this year



Source: Bloomberg, June 2021

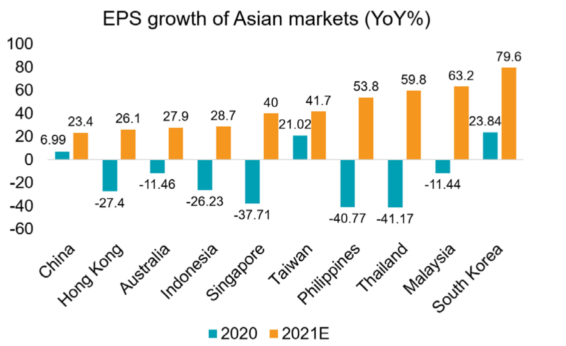
Figure 2: Growth in the beginning of the year was led by markets that were less challenged by containing the pandemic



Source: Official numbers released by respective market bureaus

In addition, earnings per share growth in Asia also saw a broad-based and more balanced recovery across all markets this year from last year, indicating that earnings normalization is also on track (Figure 3).

Figure 3: EPS growth in Asia became more balanced this year



Source: FactSet, I/B/E/S, MSCI, Goldman Sachs Research, 16 July 2021

Pandemic risks continue

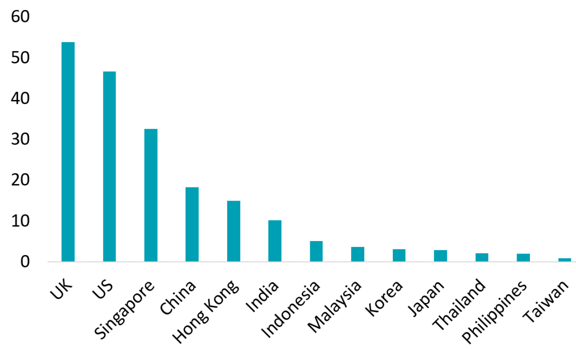
COVID-19 remains a risk in the financial markets. We continue to monitor developments of the pandemic, especially since new variants of the virus, particularly the highly contagious Delta variant, are putting a halt in recovery in several parts of the world.

In Asia, several markets saw the resurgence of the pandemic, such as in Taiwan in May, which caused its financial market to be volatile. During that month, the MSCI Taiwan Index first dipped 11.5% in the middle of May, and then recovered to close at only 1.2% lower at the end of the month[1], despite the market's overall fundamentals being solid.

Pandemic risks also continue to loom in Southeast Asia, with some markets recording an increasing number of infections during the first half.

Vaccination rates also remain low in Asia relative to the UK and the US, making the region vulnerable to new infections (Figure 4).

Figure 4: COVID vaccination rates based on at least one dose of vaccine per 100



Source: Worldometer, Bloomberg, Morgan Stanley Research Data, as of 15 May 2021

We view that the willingness to get vaccinated, the supply and availability of vaccines and their effectiveness to the new variants all contribute to the recovery. Stamping out the epidemic still requires precautionary measures, border controls and active testing.

1 Source: MSCI, 01 June 2021

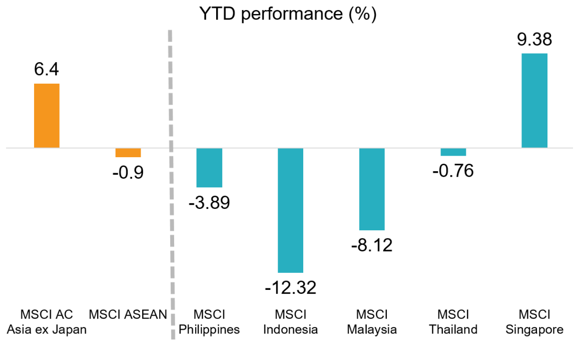
The macroeconomic outlook in Asia has become encouraging, with economic growth expected to be more broad-based across all markets throughout the rest of the year.

Review of markets

ASEAN continues to lag peers

The Association of Southeast Asian Nations ("ASEAN") market continues to lag its Asian and global peers, especially for emerging countries, as most of them continue to grapple with containing the pandemic (Figure 5).

Figure 5: Only the Singapore market has recorded positive returns year-to-date ("YTD") in the ASEAN



Source: MSCI, 30 June 2021

However, vaccination is picking up across the region, surpassing initial expectations, with the main bulk of vaccine deliveries to take place in June and July. We expect that this should improve the economies by the third or fourth quarter this year.

Despite our underweight positions in ASEAN markets, we continue to monitor the market for select opportunities, particularly in recovery plays. For example, we may find opportunities in the emerging ASEAN markets over the more developed countries, such as Singapore, which has outperformed earlier this year. We also continue to like new economy names in the region, such as e-commerce and some of the digital banks, which both benefit from structural under penetration.

China: Moderating growth and regulatory direction take the center stage

<u>Moderating growth indicators</u>

While recovery was robust in China post-pandemic, we expect that economic growth in the country will continue but moderate in the second half of the year.

Several indicators have pointed to this normalization. China's GDP, for example, has started to slow down during the second quarter (Figure 6).

Figure 6: China's GDP has normalized

Source: National Bureau of Statistics of China

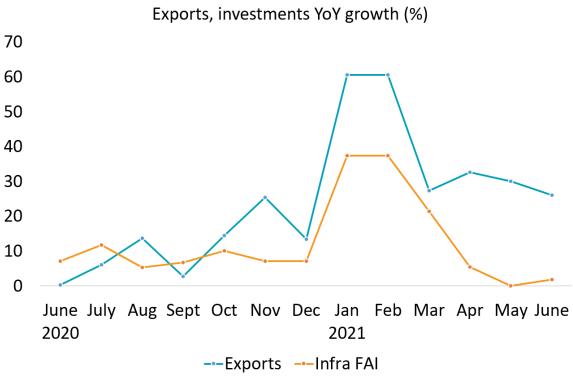
We are also seeing normalization in other growth indicators. Purchasing Managers' Index ("PMI"), exports and investments, for example, have trended down (Figure 7a and 7b).

On the credit growth side, indicators have also pointed towards moderating growth. China's credit impulse has peaked in 2020 and has started to slow down in recent months (Figure 8). We are also seeing a similar trend in the country's Total Social Financing ("TSF") growth, which is an indicator of the country's liquidity levels. This downtrend is not surprising, as the

Figure 7a: China's manufacturing PMI (seasonally adjusted)

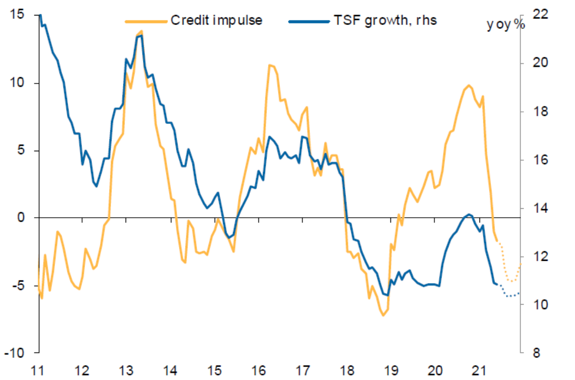
Source: National Bureau of Statistics of China

Figure 7b: Exports and fixed asset investments (YoY %)



Source: Wind, NBS, CEIC, Bloomberg, Goldman Sachs Global Investment Research, July 2021

Figure 8: Credit impulse and TSF have trended down in recent months

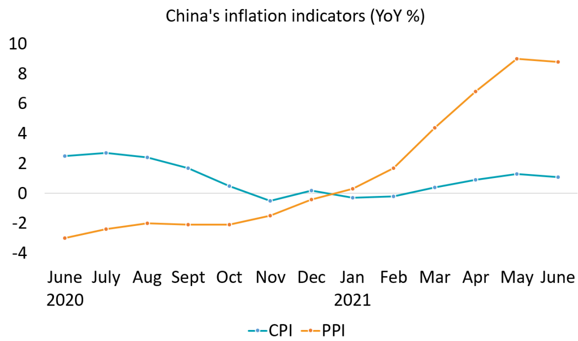


Source: NBS, PBOC, Wind, Macquarie Macro Strategy, July 2021

government has already mentioned that it will be limiting credit growth this year to prevent the economy from overheating. We expect that both credit impulse and TSF growth to slow down during the second half.

Adding to moderating growth concerns is the pick-up of inflation that has led to fears about earlier-than-expected tightening, which may hinder growth (Figure 9).

Figure 9: China's inflation indicators have been on an upward trend since the start of the year



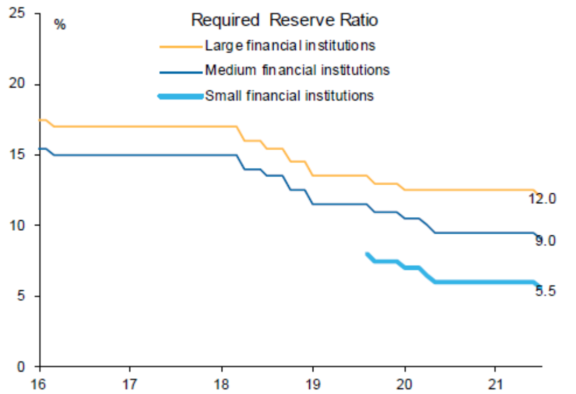
Source: Wind, NBS, CEIC, Bloomberg, Goldman Sachs Global Investment Research, July 2021

Policies: accommodative, but targeted

That said, we view that policies will remain accommodative, but targeted, as maintaining economic stability continues to be a key item on China's agenda. The People's Bank of China ("PBOC") reiterated that it will properly manage the timing, intensity and effectiveness of monetary policy to keep liquidity at a reasonable level and TSF generally in line with GDP growth. The government has also set a GDP growth target of just "over 6%" to focus on quality development.

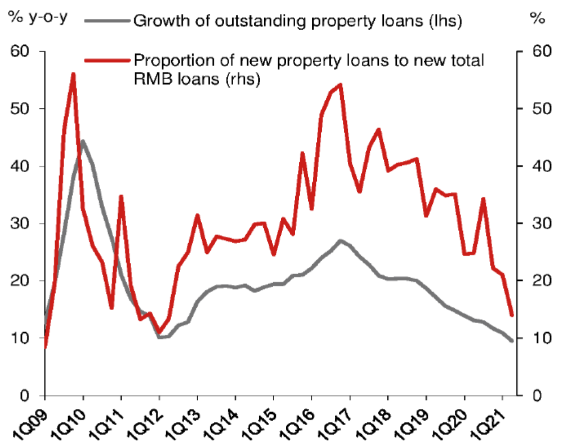
Recent moves from Chinese authorities have indicated an accommodative and targeted policy, in a move to achieve this quality growth agenda. For example, inflation in the country has been under control as the government was able to curtail the rise of commodity prices with the release of state metal reserves. Meanwhile, PBOC's reserve requirement ratio ("RRR") cut in July indicates its intention to support liquidity and preserve lower funding costs to support the continuing economic recovery (Figure 10). On the other hand, regulatory measures on the property sector with the "three red lines" remain tight, as the

Figure 10: China lowered RRR in July



Source: PBOC, MOF, Wind, Macquarie Macro Strategy, July 2021

Figure 11: New property loans are on a downward trend



Source: Wind and Nomura Global Economics, July 2021

growth of outstanding property loans and the proportion of new property loans to new total loans have trended down (Figure 11). This should be in line with the quality growth agenda to prevent overheating in the property market.

Although we do not expect economic growth in China during the second half to be as exciting as the first half this year, we believe that policies should help China's economy to be on track with its recovery.

Alongside global recovery, investors are also concerned about inflation, especially in the US, which may have implications for global markets. Hence, we are not ruling out the potential risks brought about by inflation and policy tightening.

In the US, the Federal Reserve has already acknowledged inflationary concerns as it raised its inflation projections for this year (Figure 12). It also expects rate hikes could come as soon as 2023, after saying in March that it may not increase rates until 2024. A sharp turn in the Fed's monetary tone could derail market sentiment globally.

Figure 12: Fed board members are projecting higher inflation this year (in %)

	Median		
Variable	2021	2022	2023
PCE inflation	3.4	2.1	2.2
March projection	2.4	2	2.1
Core PCE inflation	3	2.1	2.1
March projection	2.2	2	2.1

Source: US Federal Reserve. Economic projections of Federal Reserve board members and Federal Reserve bank presidents, under their individual assumptions of projected appropriate monetary policy, June 2021

While regulatory changes have made the market more volatile in recent months, we view that these reforms are in line with the government's goal of achieving quality growth, shaping the country's long-term development.

Regulatory direction: Will regulation and policy reforms derail the markets?

In addition to tightening fears, a series of regulatory changes in China targeted at various sectors, including internet and e-commerce, healthcare, property and education, have made investors concerned about the extent of the sector's profitability.

Investors now perceive that these sectors, which were among the beneficiaries of the lockdowns last year, no longer have the same long-term prospects they presented before. For example, with the anti-trust and monopoly laws in the e-commerce space, competition should be fiercer, with new players expected to come in and gaining market share from the current large players. Meanwhile, within the healthcare space, reform has consolidated the pharmaceutical industry to a smaller number of players.

While regulatory changes have made the market more volatile in recent months, we view that these reforms are in line with the government's goal of achieving quality growth, shaping the country's long-term development. Unlike the more developed markets, China's new economy sectors are still in their early stages, having a lax regulatory environment. Developed markets have gone and even continue to go through these regulatory challenges. In the US, for example, internet companies were and still are being scrutinized for privacy issues.

The reforms also underscore China's move towards its "common prosperity" policy, which focuses on social welfare and social equality, and thus, sectors that are facing reforms include healthcare, education and housing.

We expect that the China markets will continue to see volatility amid policy headwinds. At the same time, we view that the potential earlier-than-expected tightening driven by the change in inflation expectations could pose risks on the equities markets, while growth moderation may entail a lackluster environment for equities.

Nevertheless, we remain cautiously optimistic on China equities. While we continue to favor companies that are riding on the structural growth cycle, we believe that it is critical to be aware of how policy changes can impact individual names. At the same time, it is crucial to be selective in our bottom-up approach and choose quality names, including those that have strong balance sheets and good governance and compliance practices, that will be rewarded in the current macro environment.

Rosy fundamentals in South Korea, Taiwan

<u>South Korea</u>

The South Korean equities market was among the best performers globally in 2020 (Figure 13). Its tech-heavy market – an area that was hugely favored during the pandemic – contributed hugely to the market's outperformance.

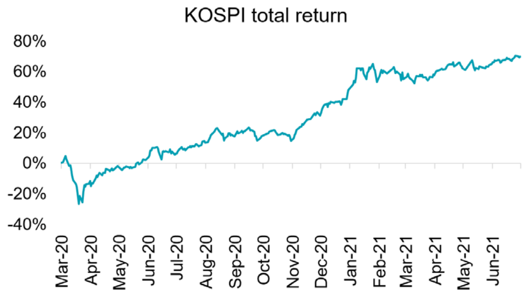
For 2021, the macroeconomic outlook is also positive, as exports and investments remain strong driven by the global economic recovery, as well as improving domestic consumption[2].

In addition, most companies are seeing strong growth earnings this year. During the first quarter, around 63% of companies beat and 19% were in-line consensus estimates[3].

While prospects are rosy in South Korea's market, we view that investors have already priced in late last year strong recovery and earnings growth for 2021 on the back of vaccine development and the expectation that most people will be inoculated by this year. This does not bode well for the market as the country continues to have a low vaccination rate, and a resurgence of the virus during the second half may dampen market sentiment.

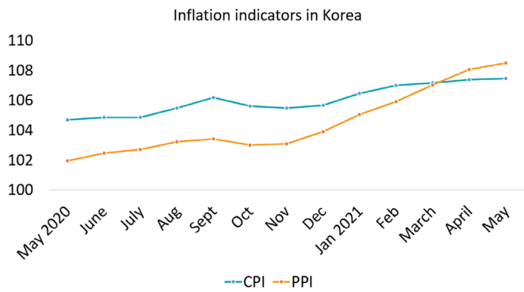
An earlier-than-expected monetary tightening in South Korea could also be a downside risk in the market, given its improving economy and rising inflation. In May, Bank of Korea upgraded its GDP growth outlook to 4% for 2021 from the projected 3% in February. The central bank also raised consumer inflation this year to 1.8%, up from the earlier 1.3% projection (Figure 14).

Figure 13: Market performance since selloff in March 2020



Source: Bloomberg, June 2021

Figure 14: Korea's rising inflation



Source: Bank of Korea. Rebased on 2015 prices (2015 = 100)

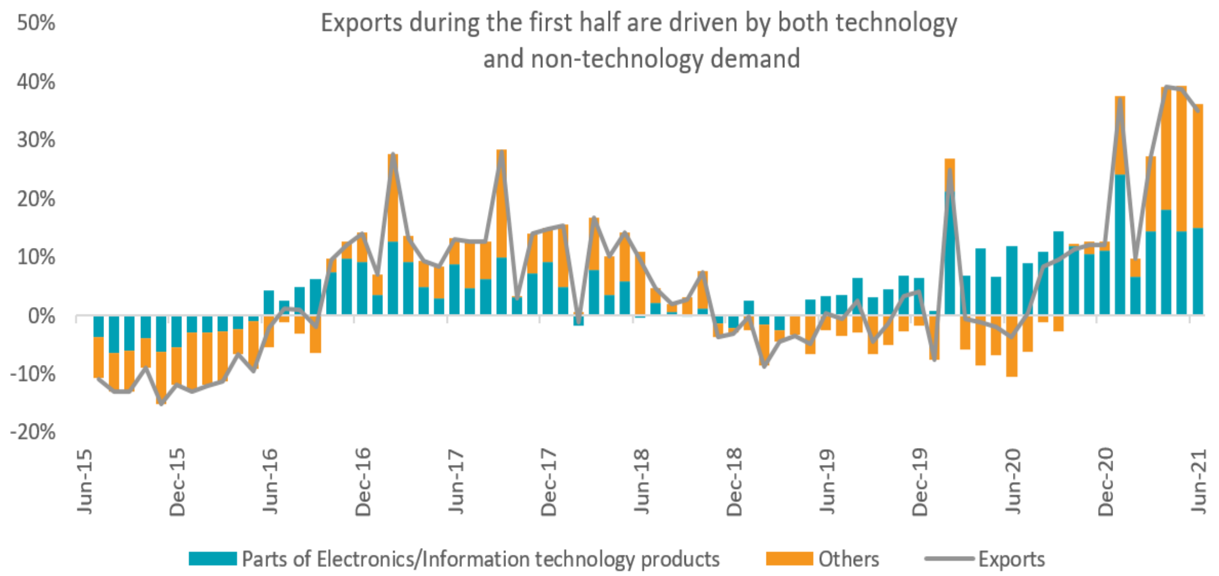
Despite these potential risks, we continue to see selective opportunities in the market, particularly in the technology hardware space, including semiconductors and electronic components, on the back of sustained global demand.

<u>Taiwan</u>

Taiwan's equities market continues to outperform its Asia peers, with the MSCI Taiwan Index returning 18.8% during the first six months.

2 Source: Bank of Korea, 27 May 2021
3 Source: Bloomberg, CLSA Research, as of May 2021

Figure 15: Taiwan's exports continue to be strong



Source: Ministry of Finance, R.O.C. (Taiwan)

As mentioned earlier, the resurgence of the pandemic in May caused volatility in the market during the month. Taiwan's government has responded aggressively, setting up more testing stations, as well as accelerating the procurement of vaccines. It has also topped up the total stimulus budget by TWD 420 billion (US$15.2 billion) to subsidize impacted individuals and businesses in the form of one-time cash subsidies, bank loans and tax reductions.

Nevertheless, Taiwan's overall fundamentals remain unchanged and decent, supported by robust export-related growth (Figure 15).

Despite the resurgence of the pandemic, Taiwan authorities expect that overall production to stay normal for manufacturing companies. They have also reiterated their optimistic view on the reopening of the global economy and the ongoing digitalization trend.

The government expects that Taiwan's GDP to grow by 5.5% in 2021, which is 0.8 percentage points higher than the previous forecast in February, on the back of strong export demand as well as ongoing capacity expansions inside the market[4]. Exports are projected to grow by 15.4%.

Similar to South Korea, we continue to favor the market, particularly in the technology-hardware space, on the back of the semiconductor super-cycle.

4 Source: Directorate-General of Budget, Accounting and Statistics, Taiwan, 04 June 2021

Value Partners asset allocation views

The global economic recovery from the COVID-19 trough has peaked in the second quarter of 2021 ("2Q21"), as data has shown that while the global economy continues to recover, it is growing at a more moderated pace. The concern of investors has shifted from high and prolonged inflation to growth slowdown, as suggested from the flattening yield curve globally.

As a result, we are more cautious about risk assets for the next 12 months (Figure 16).

Within the US equities space, we expect that the asset class is likely to be range-bounded, as markets are awaiting the message and tapering cue from the Fed. Since economic data have suggested growth has started to moderate, the Fed may delay its decision of tapering to next year. With supportive monetary and fiscal policies, the asset class will be supported. However, the upside is capped as valuations are expensive, especially under a moderating growth environment.

For European equities, economic recovery in the region is a little behind the US but is also expected to peak in July. The European Central Bank ("ECB") has extended its supportive measures further, which should continue to support the equities market. However, all positives have been largely priced in.

In Japan, economic recovery should pick up in 4Q21 as the vaccination rate has accelerated since June. However, as the

Figure 16: Asset allocation views for the next 12 months

Equities		Bonds		Alternatives	
US	→	US Treasury	↓	Real Estate	↑
Europe	→	Other developed markets Treasury	↓	Precious Metal	→
Japan	→	US/ European investment grade	↓	Cyclical Commodities	→
North Asia (ex-Japan)	↑	Asian investment grade	→	Gold	↑
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, July 2021

country continues to record more COVID cases, and with most cities still under the emergence alert, investor sentiment in Japan equities would be capped. Foreign capital continues to flow out since the announcement of a closed Olympics. Sentiment should improve after the Olympics as the worst has passed.

We are most positive about North Asia within Asia's equities market, particularly Taiwan. Taiwan has gradually moved out from COVID pressures and most of its sectors have not been affected by the pandemic. The earnings momentum in the technology hardware sector is the strongest, with high earnings visibility until next year. Demand in tech hardware remains very strong, with not much improvement in the supply shortage in sight. For China, we are selective in sectors that would benefit from the potential supportive measures towards Q4 given the slowdown in growth. We continue to favor the consumer sector with its pricing power as the policy's priority is to improve personal household income and the empowerment of the working class.

For South and emerging markets equities, we expect that a strong US dollar would hurt the markets in general. The currency will remain strong on the back of the dampened sentiment as investors have become concerned about growth moderating. In addition, with the extended pandemic situation in these markets, as well as lagging vaccination progress, we expect that the recovery road would be difficult in these regions.

On the fixed income front, although market concerns have shifted to the slowdown in growth from high inflation and tapering, the flattening of the yield curve has moved faster than expected. With the global economy still expanding, particularly the developed markets, the long-end yields should be higher than the current levels. As a result, we remain negative on government bonds and long-duration bonds. The yield spreads in Asian bonds remain attractive compared to developed market bonds. As the search for yield continues, demand will continue to support Asian investment grade and high yield bonds.

Within the alternatives space, we expect that real estate investments, such as real estate investment trusts ("REIT"), will be in demand on the back of the flattening yield curve. For gold, while the asset class has been underperforming on a YTD basis, we expect that capital will flow back from cyclical commodities. The asset class continues to be a hedge against the slowdown in growth, as well as political uncertainties, as tensions between the US and China remain.

Equity themes: focusing on quality and structural growth

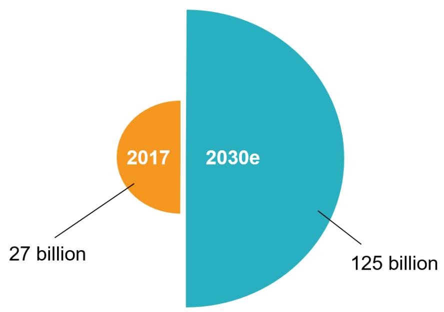
1. Regional technology hardware

We continue to favor regional technology hardware, especially in the semiconductor space, given the long-term opportunities the sector presents.

The semiconductor sector is driven by the growth of connected internet of things ("IoT") devices globally, with the number of IoT devices expected to grow five times by 2030 (Figure 17).

Figure 17

Number of connected IoT devices globally

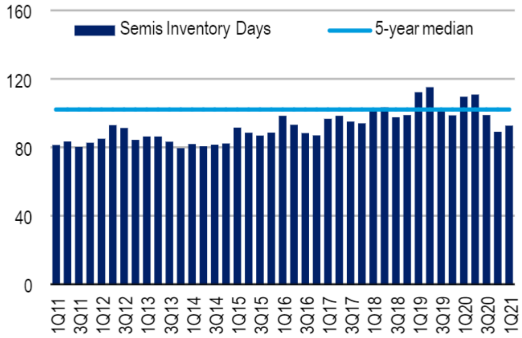


Source: Markit

We view that the IoT-driven era opens huge growth avenues, which translates to sustainable earnings headroom for companies across the value-chain of the industry. IoT comprises individual, corporate, and industrial applications. Compatible software, accessories, and systems are necessary to enable gadgets, which, in turn, lead to value-added content such as new forms of entertainment, consumption, transportation, smart city infrastructure and finance. The application of IoT devices also unlocks a new era of manufacturing, such as industrial automation, which allows a wider range of customization and smarter production processes.

While semiconductors are to benefit from the IoT trend, there have been concerns in the market during the first half about the semiconductor industry being nearly at the peak of the cycle. However, inventory levels continue to be at a multi-year low, and there is still a long way to go to be at a comfortable inventory level post-COVID (Figure 18).

Figure 18: semiconductors inventory days compared to 5-year median

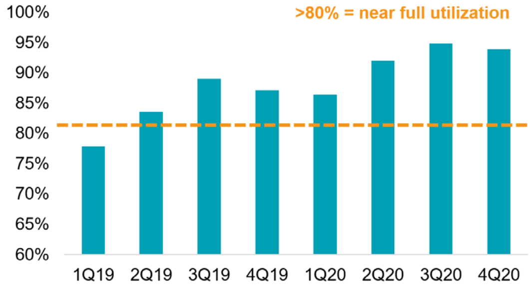


Source: BofA Global Research estimates, FactSet

Although semiconductor manufacturers have announced that they will be expanding capacity, expansion takes time, making it difficult to catch up with the demand. It is estimated that manufacturing a finished chip can take over six months, given the complexity of the processes involved in semiconductors[5] (Figure 19a). With manufacturers running at nearly full capacity, average selling prices of semiconductors have increased, benefitting these manufacturers (Figure 19b). We expect the cycle to last until 2022 or longer.

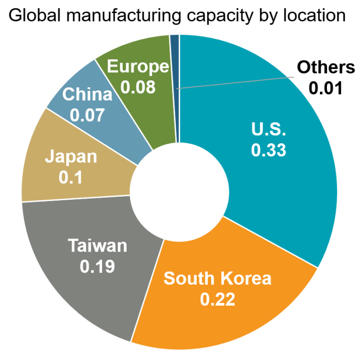
Semiconductor manufacturers benefiting from this global demand include regional players in Asia, which are taking nearly 60% of the global manufacturing capacity (Figure 20).

Figure 19b: Quarterly fab utilization



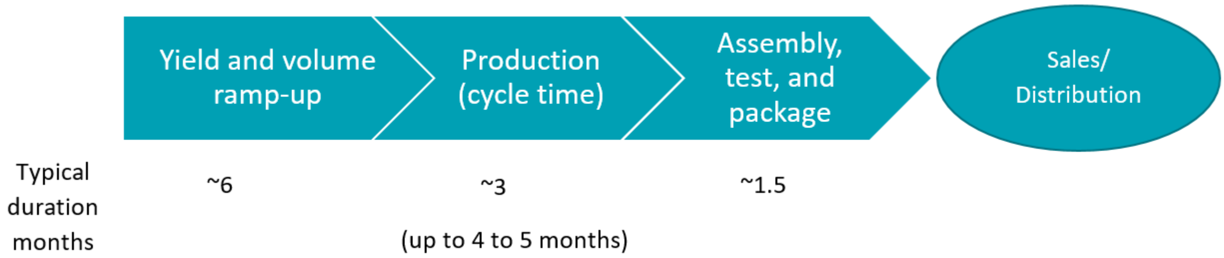
Source: VLSI Research

Figure 20: Asia accounts for more than half of global manufacturing capacity of semiconductors



Source: BofA Global Research

Figure 19a: Semiconductor fab production timescales



Source: SIA, February 2021

5 Source: www.semiconductors.org

2. China's consumption upgrade

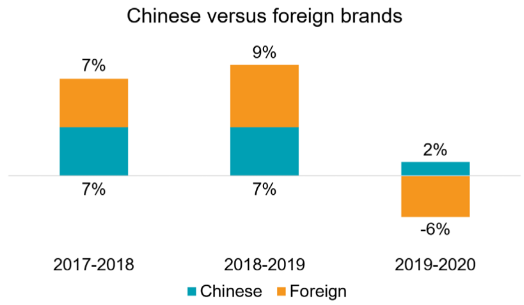
We continue to be positive about China's consumption upgrade story. Even last year, the impact of the pandemic did not interrupt the structural trends of consumption upgrade, with more consumers willing to spend more on lifestyle upgrades. The drivers of consumption – the rising middle-class population, surging household income, and urbanization – remain intact and continue to spur on domestic consumption in the future.

The room for growth in the consumption space is huge. Currently, consumption only accounts for a smaller proportion of China's GDP than that of Japan and the US. This is expected to accelerate, especially on the back of China's dual circulation policy to achieve a more sustainable economy. The agenda is supported by the rising purchasing power of the middle-class, which accounts for 600 million citizens[6], roughly double of the US population.

But perhaps the huge driver now for China's consumption upgrade story is the rise of "Guochao", which incorporates traditional cultural elements in fashion. As the concept is also tied to nationalism, Guochao has driven the preference for domestic over foreign brands. Indeed, the popularity of foreign brands has sunken in recent years (Figure 21).

Mostly driving the Guochao phenomenon are younger consumers, including the Gen-Z and millennials, who are also the main drivers for consumption upgrade.

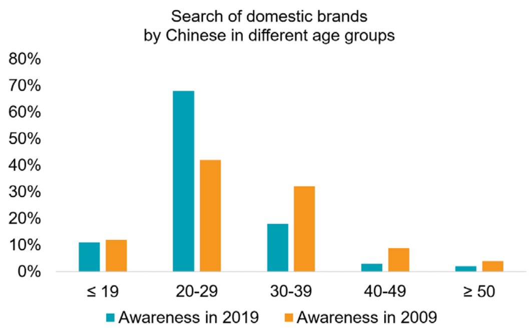
Figure 21: Domestic brands in the Fast Moving Consumer Goods ("FMCG") sectors show better growth overall than foreign brands. YoY growth in market share



Source: Bain & Company, Kantar Worldpanel. Based on fast-moving consumer goods categories

China's younger generation grew up in an environment where national pride was more appreciated as the country was becoming a global powerhouse, unlike the older generation who often perceive that foreign brands translated into better quality (Figure 22).

Figure 22: Younger consumers lead the Guochao trend



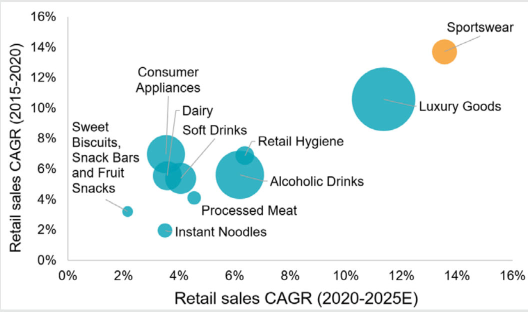
Source: Baidu index

Case study: Sportswear

The sportswear category has become one of the fastest-growing consumer categories over the past five years and will continue to be for the coming five years (Figure 23). We view that the

6 Source: Citi estimates

Figure 23: Sportswear is one of the fastest growing category in China

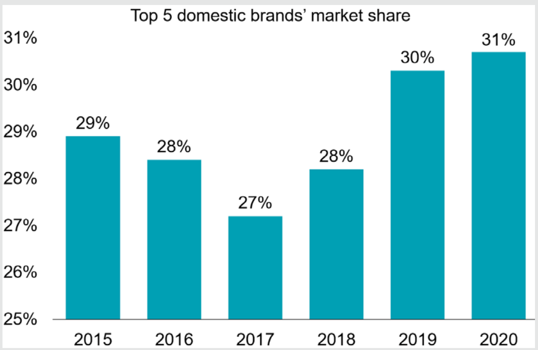


Source: Euromonitor

sportswear segment is in a sweet spot now, as it is propelled by multiple drivers, including the rise of national pride and premiumization.

Domestic sports manufacturers started integrating the Guochao fashion trend into athleisure in the past few years, making them more appealing to the younger generation. Indeed, domestic brand names have further gained recognition and popularity, enabling them to gain more market share in the past few years (Figure 24).

Figure 24: Domestic sports brand names are gaining market share



Source: BofA Global Research, Euromonitor

Other than the sentimentality of nationalism, these manufacturers have premiumized their brands, improving their quality and giving a sense of exclusivity, which has aroused shoppers to pay a premium for a better experience.

3. Healthcare

Demographics transition, regulatory revamp and sector consolidation, and global competitiveness remain to be positive drivers for China's healthcare sector.

China's ageing population is rapidly rising. It is projected that people over 65 years of age will reach 366 million by 2050 – exceeding the combined numbers of the US, Japan, and Europe[7]. The incremental demand from the ageing population would require a more robust healthcare system and improved access to affordable yet quality drugs. Despite the growing needs, medical expenditure in China still lags other markets, making up only 6.6% of total GDP compared to 17% in the US and 12% in Japan and Germany[8]. While this calls for the need to ramp up investment in healthcare, it also implies the massive potential growth of the industry in the country (Figure 25).

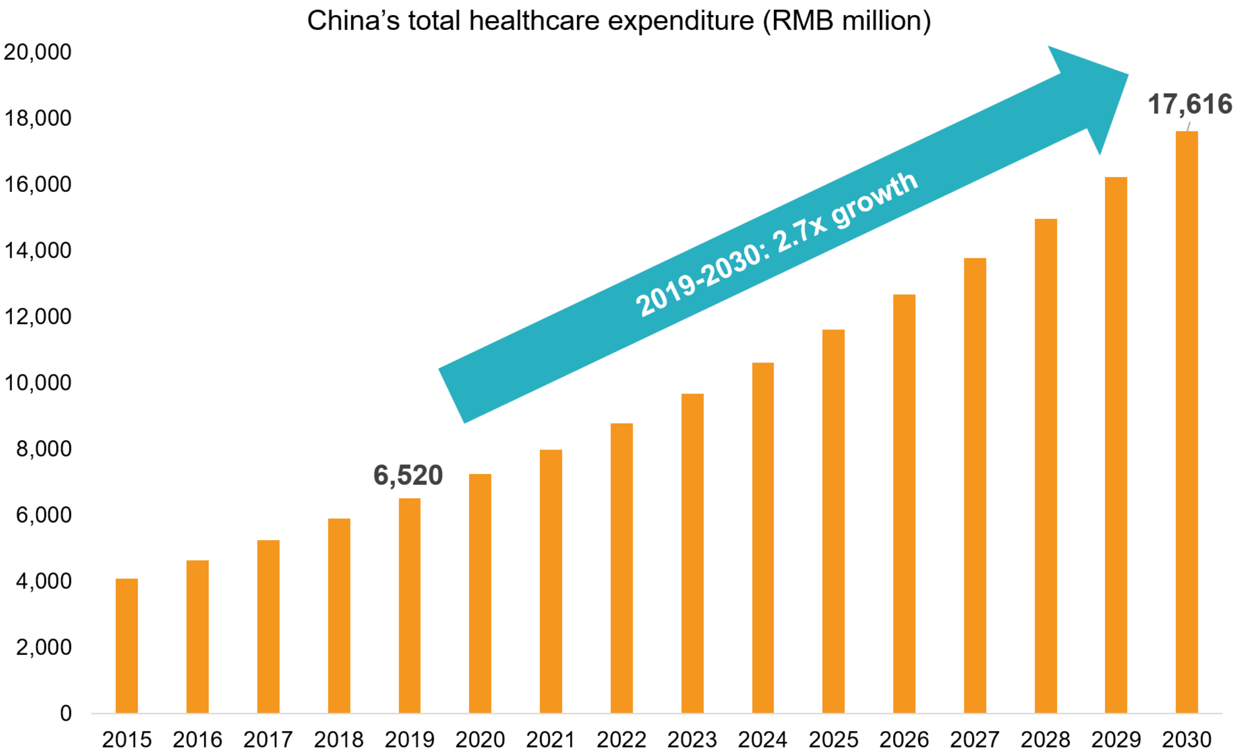
The growing needs in the industry have called for reforms. In 2018, Chinese authorities launched a centralized bulk procurement program, known as the Group Purchasing Organization ("GPO"), to consolidate bargaining power, obtain the best prices for selected generic drugs and equipment, and eliminate poor quality manufacturers.

The initiative was proven effective. For example, the latest (fifth) round of the GPO involved 62 products, which saw an average of 56% price cut (Figure 26).

However, as prices went down significantly, profit margins of lower value-added generic drugs have been squeezed, resulting to

7 Source: Population Pyramid, Statistics bureau of respective countries
8 Sources: Statista, OECD, as at 31 December 2019

Figure 25: China's total healthcare expenditure is expected to more than double by 2030 from 2021

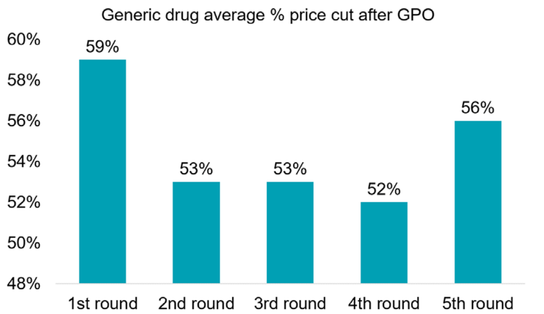


Source: Frost & Sullivan, 2020-30 are estimates, Goldman Sachs Research, November 2020

share price volatility among mass generic makers.

That said, the initiative has consolidated the industry to a fewer number of companies, presenting investment opportunities. They include leading pharmaceuticals, which are in a better financial position to absorb the drop in margins. They are expected to continue to gain market share, as several of these leading companies won most of the bids. It is expected that the top four generic drug manufacturers to account for 30% of the generics market by 2025 from just 8% in 2017[9].

Figure 26: The GPO has cut generic drug prices by 50-60%



Source: Sunshine Medical Procurement All-In-One, BOCI Research, 8 June 2021

9 Source: Citi Research, January 2021

Demographics transition, regulatory revamp and sector consolidation, and global competitiveness remain to be positive drivers for China's healthcare sector.

Meanwhile, research and development costs also support Chinese innovative drugmakers, representing only one-tenth that of the top US pharmaceutical companies (Figure 27). This paves the way for them to compete against global peers. For example, two leading Chinese biotech companies had one-billion-dollar deals to out-license their drugs to global pharmaceutical companies. More domestic biotech companies are also doing multi-country clinical trials, aiming to gain more global market share.

Figure 27: Domestic players benefiting from cheap labor and research & development costs

	China Top 10 Drugmakers	USA Top 10 Drugmakers
Average staff costs per year (RMB)	300,000	1,500,000
R&D costs per drug (RMB mn)	700	7,000
Number of approved innovation drugs in 2019	48	47
R&D % of revenue	15%	18%
R&D spending (USD bn)	3	82

Source: VP channel check, as of January 2021

We are also seeing growing opportunities in leading Chinese drug distributors, as they are set to take more market share due to better hospital connections, logistics, warehousing, and financing support. We expect that the top Chinese drug distributors will deliver 10-15% revenue-to-earnings growth in the medium term, which compares with the 8-9% growth in the broader healthcare industry.

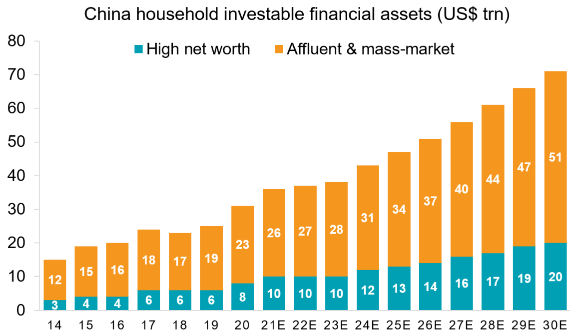
They also have attractive valuations on a historical basis. Currently, they are trading at around 6-7x on a price-to-earnings basis, versus the historical average of about 16x.

4. Financials

While financials were among those that recovered at the beginning of the year, we view that the sector provides long-term investment opportunities, particularly in the wealth management space in China.

We expect that firms providing wealth management services should benefit from the growing demand for wealth management products from retail investors. The opportunity is massive, as investable assets from the retail segment (affluent and mass affluent) are expected to grow to more than double to US$51 trillion by 2030 from 2020 (Figure 28).

Figure 28: Massive addressable market in China's wealth management sector (excluding property and luxury assets)[10]



Source: BCG, PBOC, CBIRC, Wind, Goldman Sachs Global Investment Research, Gao Hua Securities Research.

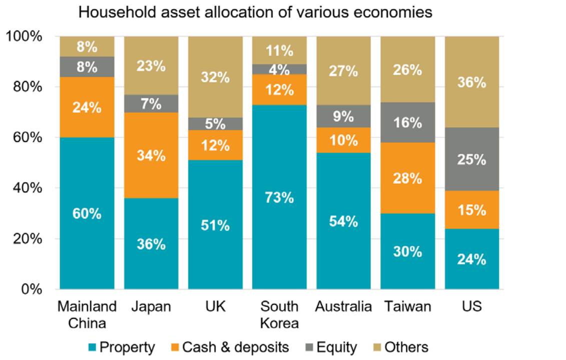
In addition, Chinese investors continue to be under-allocated in wealth management products. A bulk of their financial assets are invested in property, followed by cash (Figure 29).

Research conducted at Tsinghua University has also pointed to the need for retail investors to get hold of professional services to manage their investments. Findings show that although retail investors

10 Note: Individual investable financial assets include deposits, securities, mutual funds, bank wealth management products, and other financial assets held by Chinese households, but excludes non-financial assets such as real estate and luxury goods

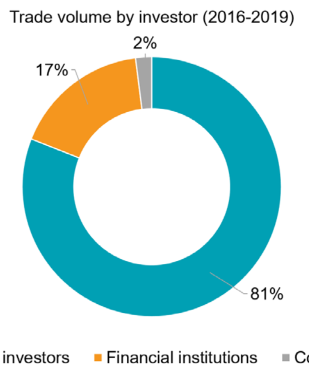
accounted for 80% of trading volume on China's stock exchanges between 2016-2019, they only held 21% of outstanding shares. This indicates that retail investors in the country are frequent traders and not long-term holders (Figures 30a and 30b).

Figure 29: Mainland investors prefer property investments over wealth management products



Source: NFID, CEIC, Wind, Goldman Sachs Global Investment Research, Gau Hua Securities Research. Data as of 2019.

Figure 30a

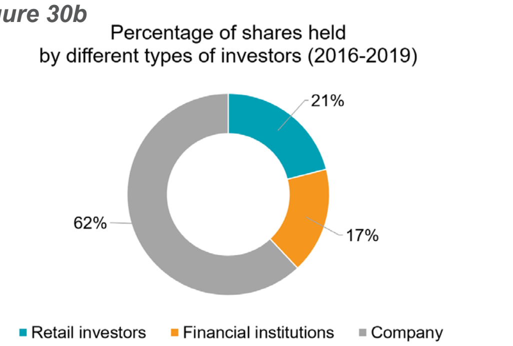


Source: Tsinghua University, World Economic Forum and Oliver Wyman, July 2020

Data also shows that most profits generated from the stock market were made by institutions and corporates (Figures 31a and 31b). This presents an opportunity for wealth management companies to step in and provide professional advice to investors.

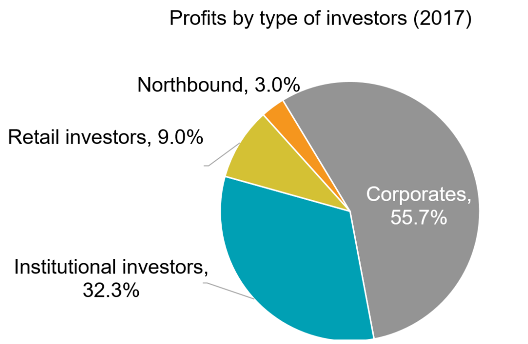
Within this space, we favor leaders in the industry. China's wealth management industry has high entry barriers and investors usually invest in companies that have a good reputation and have an established brand.

Figure 30b



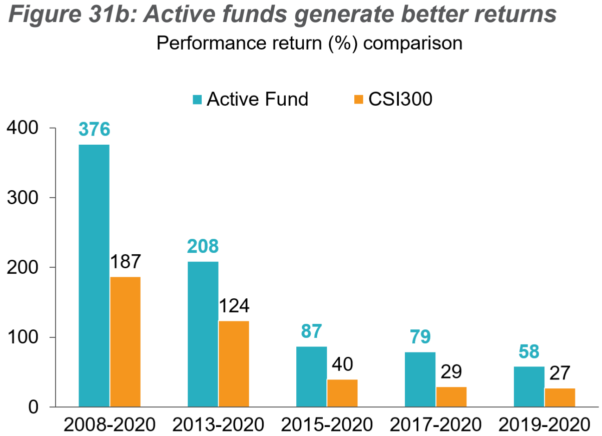
Source: Tsinghua University, World Economic Forum and Oliver Wyman, July 2020

Figure 31a: Profits by type of investors (2017)



Source: Shanghai Stock Exchange

Figure 31b: Active funds generate better returns



Source: CLSA, Wind, 2020 data as of 31 December 2020

Asia credits: weathering the policy tightening cycle

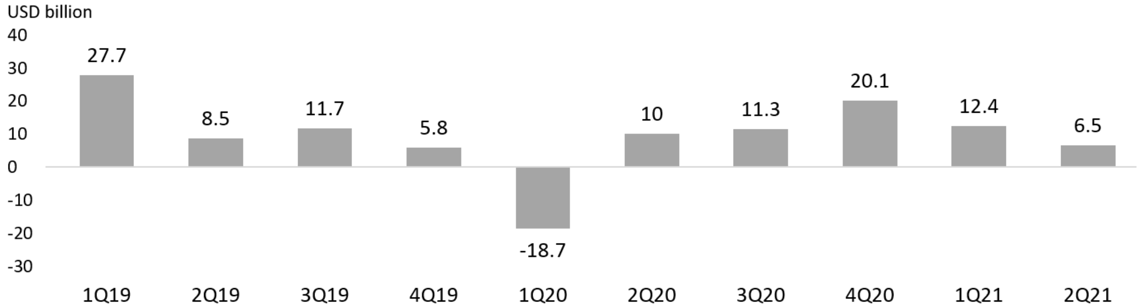
The vaccination rollout and easing of mobility restrictions should reset global growth higher. However, the growth pace in the near term could be derailed by the Delta variant and fading low base effect, but we view that the uptrend in growth should be maintained. With global credit spreads being priced for growth recovery and benign default rates, in the coming quarters, we are cautious about any shift in the Fed's tone on policy normalization in the US and taper timetable and any change in China's onshore financing environment that has been kept in a tightening mode for most of this year as growth slowly dissipates.

We expect that the possibility of a US rate hike remains low in the near term, as the recent inflation increase in the US is due to pent-up demand and supply chain bottlenecks, while the US labor market is yet to normalize. That said, we view that a sharp turn in the Fed's dovish tone could derail market sentiment in the fixed income markets. We will continue to stay cautious on possible US tapering timetables. After the consolidation in 10-year US Treasury yield in 2Q21, we believe there are scopes to trend higher towards end-2021 despite the growth normalization. The possibility of a US rate hike remains low in the near term. The market is now pricing in one or two hikes by 2023.

In China, the recent RRR cut action underscores PBOC's intention to support liquidity and preserve lower funding costs. Falling credit impulse would linger to keep financial risks under control. This and slower growth momentum should keep onshore government bond yields at a lower level (c.3% currently) after tightening 11bps YTD.

In addition, the ongoing demand/supply imbalance behind the upcycle in commodities may turn in the second half of 2021 ("2H21"). Nonetheless, we think it is a bit early to expect a material correction in commodity prices when growth is still expanding, albeit at a moderating pace. This, together with a benign US dollar, matters for maintaining a supportive tone for emerging market ("EM") credit markets and fund flows (Figure 32).

Figure 32: EM hard currency bond funds had steady inflows YTD

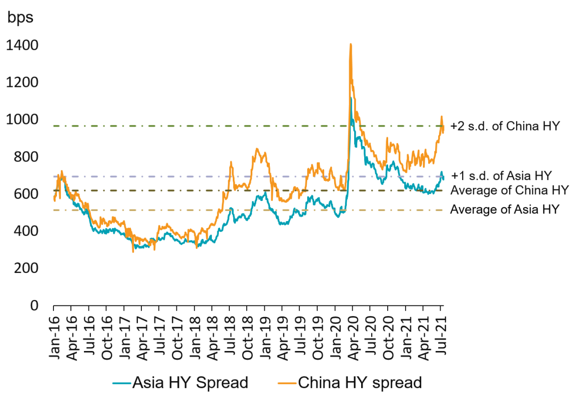


Source: EPFR data as of 20 July 2021

The prospects for growth recovery in Asia and manageable default rates should bode well for the region's dollar bond market. Moreover, the ample level of global liquidity looking for yield enhancement should lure demand for Asian high yield dollar bonds, which has scope to mean reverse as China's tightening cycle is being priced in.

Overall, we view that Asia high yield ("Asia HY") continues to provide attractive value over Asia investment grade ("Asia IG") and US high yield (Figure 33 and 34). During the first half, credit spreads of the JP Morgan Asia Credit Index Investment Grade ("JACI IG") tightened 22bps, while that of

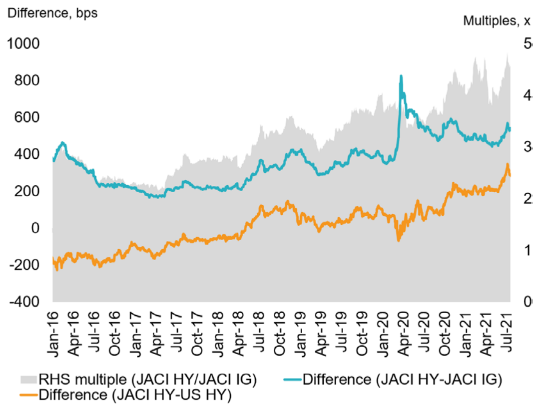
Figure 33: China HY credit spreads at 2 s.d. cheap over the last 5 years



Source: JACI Asia HY Index, Barclays China HY Index

JP Morgan Asia Credit Index High yield ("JACI HY") widened 42bps. The Asia HY index fared better at 1.3% during the same period, mainly driven by carry, versus the muted returns of Asia IG (-0.5%), driven by the falling 10-year US Treasury yields in the second quarter. Segment-wise, consumer and sovereigns continued to outperform against real estate being affected by onshore tightening.

Figure 34: Asia HY index offers attractive value over Asia IG index and US HY index



Source: Bloomberg as of 20 July 2021

Watch out for idiosyncratic events

Besides policy changes, idiosyncratic events should be the market's focus in the second half. We stick to our bottom-up approach on bond selection and move up the credit quality spectrum as we expect markets would likely stay jittery. The events that we will continue to monitor include:

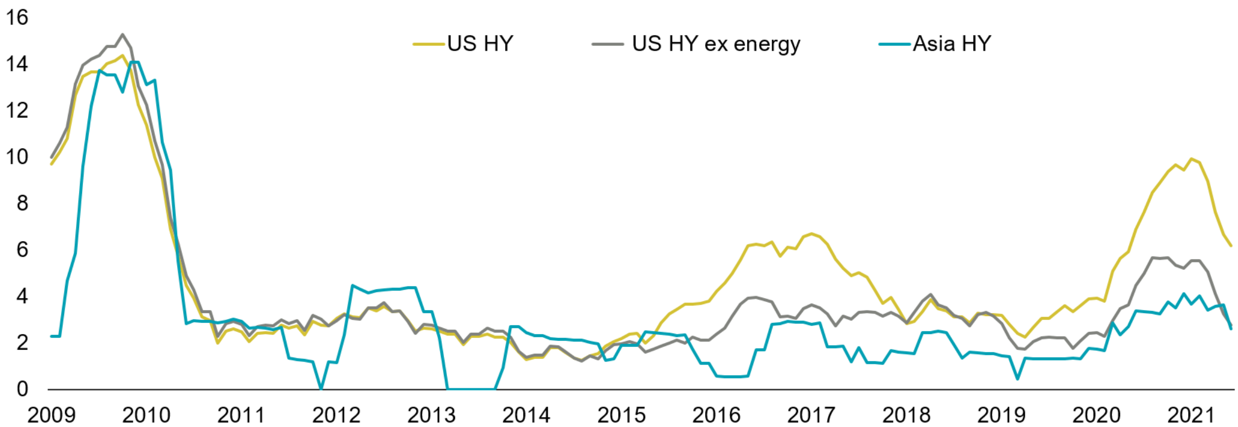
1) Whether Huarong will publish its upcoming fiscal year 2020 ("FY20") results by the due date at the end of August 2021 to avoid an event of default, if the government will bail out these state-owned enterprises ("SOE") to keep reputational risks under control, and if there is a concrete plan on addressing its offshore bond maturity

2) Whether Evergrande's sizable payable issue will drag on and if there will be any form of debt restructuring.

Contagion risks have been under control as better names with decent fundamentals could still issue bonds. That said, market volatility will not abate until there is a clearer picture of those events. While spillover effects could occur, these events should not result in an acceleration of systemic defaults in the offshore bond market (Figure 35). From an index weight perspective, Huarong accounts for 1% of the JACI composite, while Evergrande accounts for 3.9% of the JACI HY (0.9% in the JACI composite). Hence, any impact should be manageable given bond valuations have also moved. Fallen angel risks in Asia IG bonds are also low. Strong property YTD presales, cashflow preservation and the decelerating Chinese property's offshore bond refinancing needs in the second half (US$17 billion, US$23 billion in the first half) should keep their credit profiles in check.

In our view, China's policy target to balance growth and risk controls should provide a healthier credit landscape in the longer run. To neutralize risk exposure in Chinese property, we diversify into commodities- and consumption-related credits as defensive plays.

Figure 35: Steady default rate of Asia high yield bonds



Source: BMAL research, as of 30 June, 2021; Default rate = LTM count of defaulted issuers/total number of issuers at period start

Besides policy changes, idiosyncratic events should be the market's focus in the second half. We stick to our bottom-up approach on bond selection and move up the credit quality spectrum as we expect markets would likely stay jittery.

Sector views

Onshore China

China onshore yield was kept over 3.1% for most of the year, except recently when the curve flattened to 2.9% post-RRR cut on 9 July. The RRR cut reiterated PBoC's prudent monetary policy to boost long-term funding for banks, not the overall liquidity. Aggressive fiscal stimulus is unlikely in the short term on expanding GDP growth. Another RRR cut cannot be ruled out for the rest of the year, together with rising uncertainty on exports and slower investment. The rising expectations of more accommodative policy and more normalized economic growth should continue to flatten the onshore yield curve in 2021.

For the onshore credit market, the default amount remains fairly high but the number of defaulters is trending downwards. In particular, the amount of SOEs defaults accelerated, but that of private-owned enterprises ("POE") reduced. This trend will likely persist as China has been shifting towards capital efficiency from growth and has become more tolerant of defaults. That said, we envisage that government support will remain in place for the majority of to avoid widespread defaults. We seek investment opportunities on those names affected by market sentiment but with better fundamentals, and avoid more commercialized local government financing vehicles ("LGFV") owned by weaker governments due to higher refinancing risks.

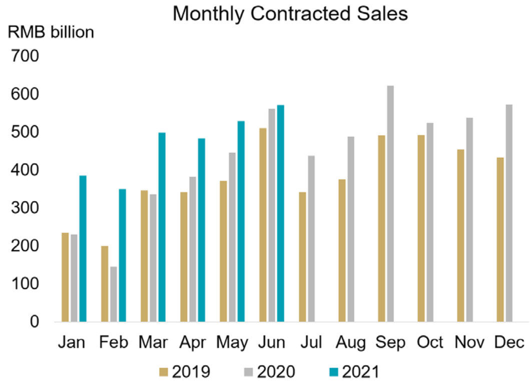
Asia investment grade

The segment underperformed in 1Q21 and recovered in 2Q21 on the US rates move. In total, the asset class returned -0.5% during the first half. Credit spreads were overall tight, reflecting low fallen angel risks, despite the ongoing overhang of China's anti-competition issue and ongoing US-China tensions. The rising COVID cases and low vaccination rate in Indonesia will pose downside risks on growth recovery, and put on hold fiscal consolidation along with pushing policy normalization to 2022. There is some pressure on EM currencies from moderating global trade growth and Fed tightening concerns.

The Indonesian rupiah could be on the back foot into year-end, which usually keeps Bank Indonesia from cutting rates. A cut in policy rates is therefore unlikely. Moody's and Fitch have kept their negative outlook on India sovereigns since June last year. Subdued growth and downside risks to the financial system are key drivers for a downgrade. We believe agencies will be patient as lockdowns eased, but growth uncertainty will likely force the Reserve Bank of India to remain dovish even if inflation is uncomfortably high.

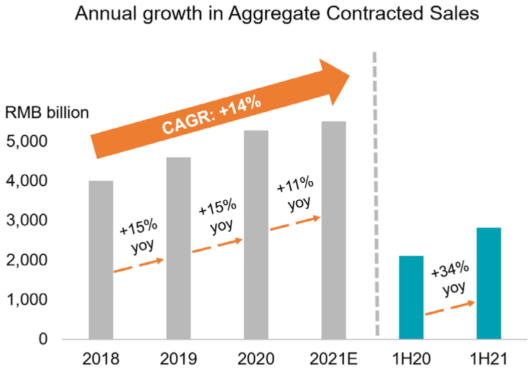
In this space, pre-refinancing may bring the supply pipeline forward on expectations of higher US Treasury yields in the second half and onwards. Overall, we see little room for spread compression and stay underweight the segment on a potential rise of the US Treasury yield.

Figure 36: YTD contracted sales on track with target



Source: Company data from 28 listed Chinese developers, as of June 2021

Figure 37: 1H21 contracted sales noted decent YoY growth

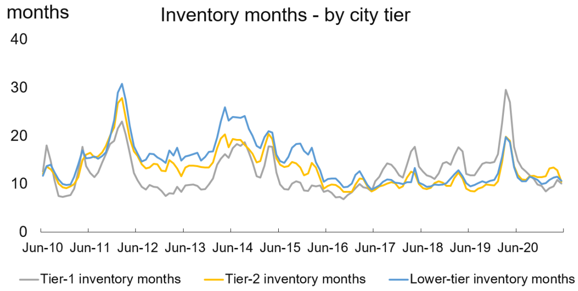


Source: Company data from 28 listed Chinese developers, as of June 2021

China Property

Among the 28 listed Chinese developers that we track, contracted sales growth in the first half was maintained at a healthy level of 34% year-over-year ("YoY") (73% YoY in 1Q21 due to a low base). Overall inventory months were kept at a healthy level when compared to the last downturn (Figure 38). Developers generally met 50% of the FY21 full-year presales target, and this is key in cashflow generation. The trend of slower revenue growth and compression in profit margins, however, will persist in 2021. This is attributable to higher land

Figure 38: Property inventory level was kept at a stable level



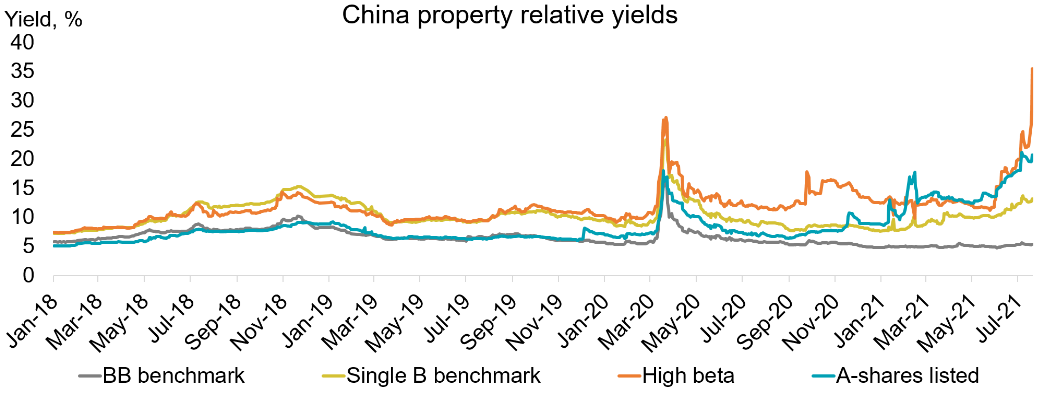
Source: CREIS; Sales to inventory ratio = current inventory/ average sales in the past six months. Up to June 2021

prices and slower land acquisitions – a result of concentrated land sale policy and overall tight financing under "three red lines" policies – as well as the increasing amount of non-consolidated joint venture/ associates' projects. Those developers with a competitive edge on Greater Bay Area and urban redevelopment projects are better protected on margin.

We take some comfort that 1) presales target was on track this year and cash collection rate would be maintained at around 70-80%; 2) developers exhibited an overall disciplined land banking strategy in the first half to preserve liquidity (land acquisition costs accounted for 40% of presales), and this trend should prevail in the second half due to a tighter funding environment; and 3) developers' bond refinancing needs to decelerate in 2H21 versus 1H21 (offshore at US$17 billion in 2H21 versus a total of US$40 billion in FY21, onshore at US$20 billion in 2H21 versus a total of US$50 billion in FY21). Developers might resort to asset disposal if the onshore bond channel is shut for refinancing purposes.

The sector returned -2.3% in 1H21 given

Figure 39: Bond valuations



its close ties with policy tightening in China. Yields of single B and BB widened 6-7% since June 2021, from 3% at year start. Sentiment also waned after the defaults of China Fortune Land and Sichuan Languang, as well as Yuzhou's surprised earnings miss.

We see value in selective B and high beta B credits on their compelling valuations (Figure 39). Although China's growth will normalize and a tightening tone bias on the property sector remains, developers with decent landbank quality and prudent financial management shall survive in this cycle. We believe yield compression could come from the muddling through of the Evergrande saga without a major restructuring event and an improvement in China's onshore financing environment.

We are more focused on assessing developers' landbank quality given their falling profitability and are mindful of issuers who have low contracted liabilities to revenue coverage. We favor developers that maintain their access to onshore funding channels, prioritize financial discipline and liquidity management over growth, have the ability to execute sales and maintain healthy cash collection rate, and are less exposed to heavy off-balance sheet liabilities.

China industrials

The sector performed in line with the index in the first half. Bond technicals were strong on diversification needs from the property sector, leading to tight valuations. Most credits have already captured the market window to issue bonds for refinancing purposes and led to an upward adjustment on credit ratings. Fundamentally, corporates should continue to benefit from earnings recovery and a favorable commodity price trend. We are overweight on some consumption-related and commodity names to take advantage of the ongoing recovery of the economy.

Macau

Gaming bonds outperformed in the first half and returned 2.2%. The sector benefited from partial relaxation of cross-border travel restrictions from Mainland China to Macau. More importantly, casino bond issuers exhibited some liquidity cushion against cash burn and have taken steps to lengthen bond maturity extension.

In the coming quarters, the more widespread vaccination rollout in Mainland China, Macau and Hong Kong could increase chances for further border relaxation to boost up the sector's gross gaming revenue at some point in the second half. Another key event to watch out for is the gaming concession renewal as all operators' licenses expire in June 2022. The Macau government has not yet even announced the public consultation timetable nor any renewal plan. Hence, we expect the entire renewal process, commencing from consultation, law revision to bidding, may take one-two years. Temporary license extension could be an interim resolution.

Commodities

The metal & mining sector had a decent return of 7.2% during the first half. The upcycle has been supported by demand recovery and capital underinvestment, and inflation hedging. We shall watch for signs of correction if the supply/demand imbalance were to loosen in 2H21. Possible tailwinds include much slower demand from China in terms of infrastructure and property activities. Elevated commodity prices should facilitate improvement in earnings and deleveraging for issuers. Similar to Chinese industrials, we prefer to stay invested in this space, which offers diversity in risk exposure.

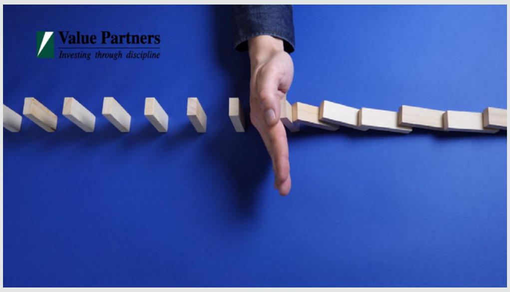
Sovereign high yield

The sector outperformed with a 10% return in 1H21, mainly driven by Sri Lanka sovereigns. The country managed to get US$792 million of Special Draw Rights ("SDR") allocation from the IMF and various swap facilities from PBOC, Reserve Bank of India ("RBI") and Bangladesh. Looking ahead, we believe the credit story remains binary and will be monitoring the sovereign's ability to manage their short-term debt over the next 18 months, which they have US$2.5 billion of dollar bond maturities falling due and any intention to turn to IMF for financing support.

Additional media

Videos

2021 2H Market Outlook
https://bit.ly/3rOV03L



Seizing opportunities in China's healthcare
https://bit.ly/3xivBkd

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Value Partners
Investing through discipline

Value Partners Hong Kong Limited

43rd Floor, The Center,
99 Queen's Road Central, Hong Kong

T +852 2143 0688
F +852 2564 8487
E investservices@vp.com.hk

Value Partners Asset Management Singapore Pte. Ltd.

9 Raffles Place, #13-04,
Republic Plaza,
Singapore 048619

Value Partners Asset Management Malaysia Sdn Bhd

Level 28, Integra Tower The Intermark,
348 Jalan Tun Razak,
50400 Kuala Lumpur,
Malaysia

Value Partners Fund Management (Shanghai) Limited

701, Citigroup Tower,
33 Hua Yuan Shi Qiao Road,
Pudong New District, Shanghai
200120, China

Value Partners Investment Management (Shanghai) Limited

702, Citigroup Tower,
33 Hua Yuan Shi Qiao Road,
Pudong New District, Shanghai
200120, China

Value Partners (UK) Limited

16 Berkeley Street,
London W1J 8DZ,
United Kingdom