INVESTMENT INSIGHT OCT 2022

Investment Services Department

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RECESSION MAY COME, ARE INVESTMENT OPPORTUNITIES STILL HERE?

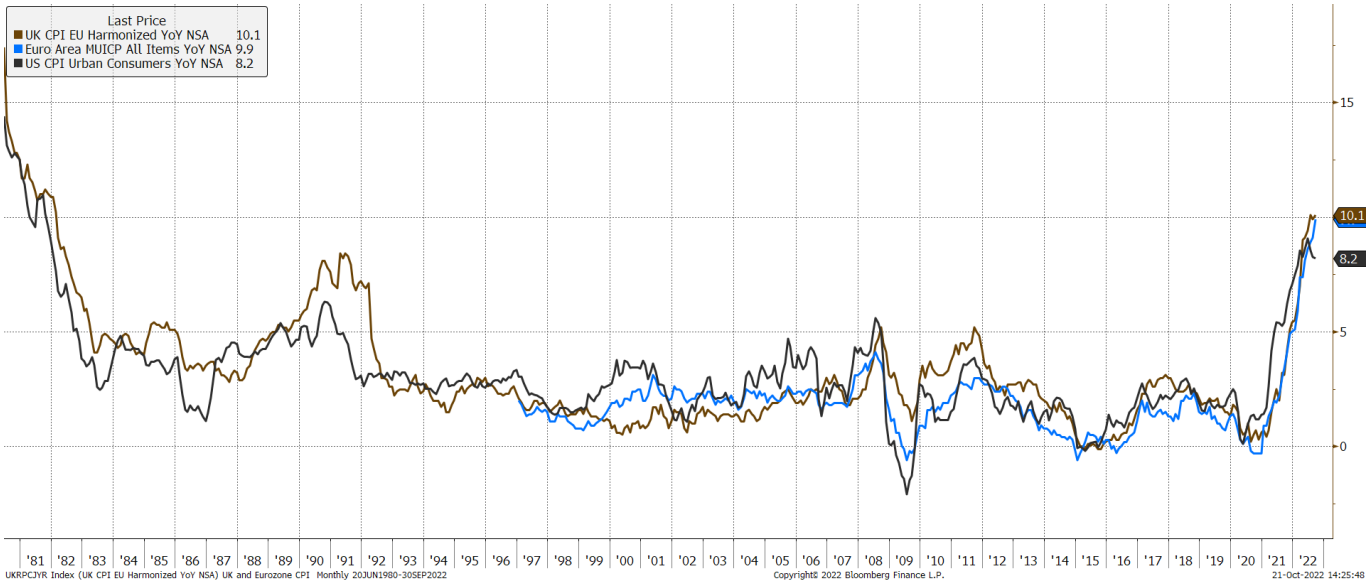
2022 Q3 MARKET HIGHLIGHTS

- *Most of the major central banks in the world tightened monetary policy aggressively in order to tackle the fastest pace of inflation in decades.*
- *Repeated Covid lockdowns in China disturbed the country's economic activities.*
- *The Russia-Ukraine war showed no sign of easing and the Russian gas supplies to Europe dropped massively.*
- *Global major equities markets continued the downward trend and the Hong Kong Heng Seng Index plummeted more than 20% in the past 3 months.*

Since the beginning of 2022, the global economy and investment markets have been under the threat of worldwide heightening inflation, the Russian invasion of Ukraine and slowdown of the Chinese economy.

The above problems showed no sign of easing in the past three months and were even getting worse. The inflation rate in the western world now is at 40-year high. Although central banks have already risen interest rate aggressively in order to tame the demand, the war in Ukraine and repeated Covid lockdowns in China have caused continuous supply chain disruptions and accelerating price level.

EXHIBIT 1: Skyrocketing inflation in the U.S., U.K. and Eurozone

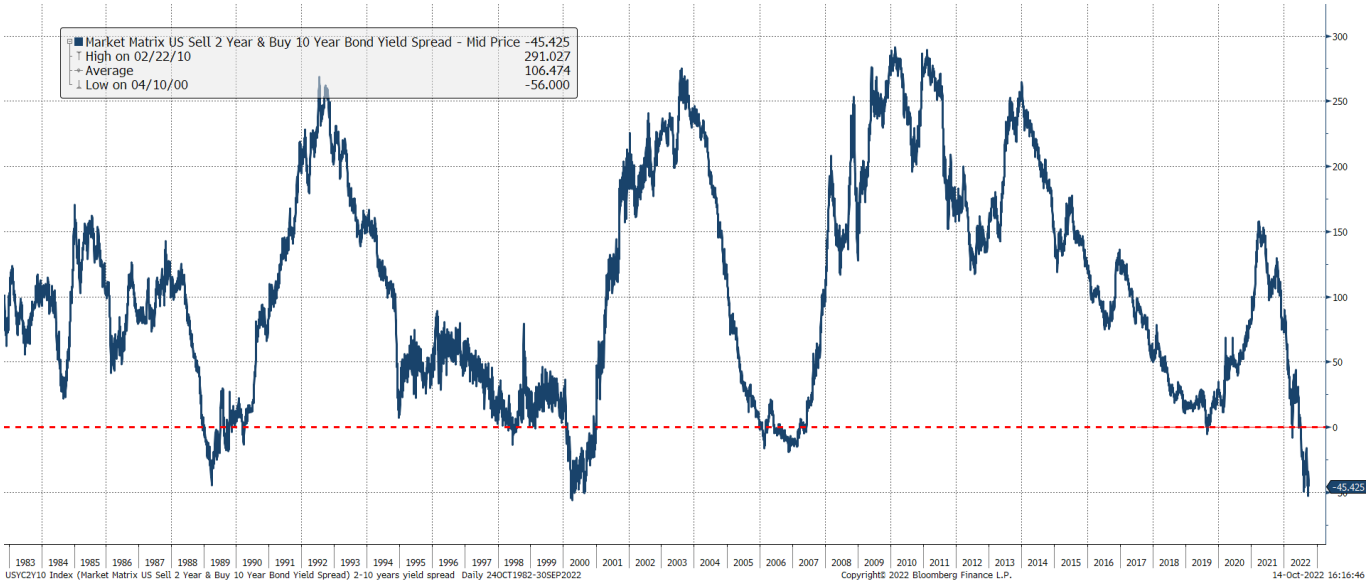


Source: Bloomberg (as at 30/09/2022)

While the global central banks aggressively tighten their monetary policies, their economies enter a downturn at the same time. As described by the International Monetary Fund "IMF", the outlook of global economy is "darkening", it is shifted to a world with more fragility, greater uncertainty, higher economic volatility, geopolitical confrontations, and more frequent and devastating natural disasters. Three of the world largest economies, the U.S., China and Europe, are slowing down and the risk of recession is increasing. Among them, it is believed that the European economy would be the most vulnerable. Most of the European countries are relying on the energy supply from Russia. The massive cut of Russian energy supply has already boosted up the energy price and if the winter in Europe becomes more extreme this year, more economic loss would be unavoidable.

In the U.S., the consumer spending which accounts for about 70% of the U.S. GDP is still strong. However, the accelerating inflation has already cooled down the housing markets and the consumer confidence continues to deteriorate. Although the employment market remains robust, there are more and more companies, like Tesla, Netflix, Oracle, etc, have already announced or planned to cut headcounts. In addition, if we look at the yields of the 2- and 10-year U.S. Treasury, the yield inversion is almost the deepest in 30 years which shows that long-term interest rates are much less than short-term interest rates. It seems that the increasing evidences are signaling that the market is becoming more pessimistic about the economic prospect in the near future. Recession is likely to come, and the question is how deep and how long it would be.

EXHIBIT 2: The yield inversion is almost the deepest in 30 years



Source: Bloomberg (as at 30/09/2022)

The Chinese economy still maintains growth, however, the pace has slowed down which is due to both cyclical and structural factors. The Covid zero policy and the property crash have hammered the country's economic activities. At the same time, as the economy becomes more mature and the base is much larger than before, it is expected that lower economic growth will become the "new normal" and the growth will rely less on export and fixed investment. Instead, it will be driven more by private consumption, services and technology innovation.

The slowdown of Chinese economy is not only the matter of China but the whole world. In the past decades, China was the engine of global economic growth. When some countries faced economic slowdown, they could still rely on the consumption from the Chinese people and companies to boost up the growth. At the same time, China also supplied abundant of cheap products and the cost of living could be kept at a lower level. As the Chinese economy may transit to a lower growth mode, it will be a big challenge to the rest of the world which has already been under immense economic downside pressure.

TABLE 1: Global Stock Markets Performance (% In local currency)

Indexes	2022 Q3	2022 YTD	2021
S&P 500	-4.89	-23.88	28.68
Nasdaq Composite	-3.91	-31.99	22.21
STOXX Europe 600	-4.24	-18.05	25.82
DAX	-5.24	-23.74	15.79
CAC 40	-2.50	-17.12	31.88
Nikkei 225	-0.94	-8.19	6.66
Hong Kong Hang Seng	-20.13	-23.98	-11.84
Hang Seng China Enterprises	-21.53	-25.63	-21.25
Shanghai Stock Exchange Composite	-9.66	-14.79	7.05
Shanghai Shenzhen CSI 300	-14.29	-21.40	-3.51
Singapore Straits Times	2.37	3.78	13.55
Korea KOSPI	-7.59	-27.27	5.56
Taiwan TWSE	-7.04	-23.05	26.92
India SENSEX	8.63	-0.34	23.23
Indonesia JCI	2.10	9.48	12.53
Thailand SET	2.33	-1.60	17.70
Russia RTS	-20.48	-32.06	21.73
Brazil IBOV	11.66	4.97	-11.93
S&P Pan Arab Composite	-0.43	-0.02	32.66
MSCI World	-6.07	-25.12	22.38

Source: Bloomberg (as at 30/09/2022)

TABLE 2: Major Currencies Performance (In terms of USD)

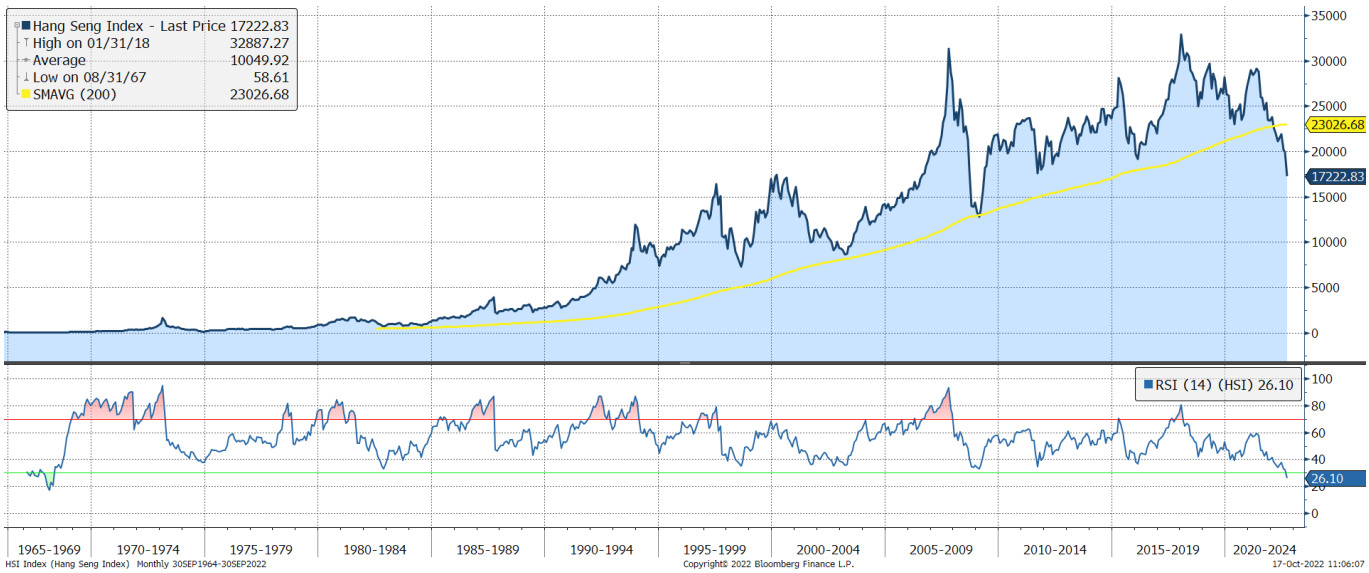
Currency	% Change in 2022 Q3	% Change in 2022
Euro	-6.51	-13.79
British Pound	-8.28	-17.45
Japanese Yen	-6.23	-20.49
Hong Kong Dollar	-0.04	-0.68
Chinese Renminbi (CNY)	-5.86	-10.68
Australian Dollar	-7.29	-11.88
New Zealand Dollar	-10.31	-17.96
Singapore Dollar	-3.12	-6.01
South Korean Won	-9.25	-16.93
Taiwanese Dollar	-6.45	-12.87
Indian Rupee	-2.92	-8.62
Indonesian Rupiah	-2.17	-6.4
Thai Baht	-6.3	-11.46
Russian Ruble	-9.92	25.01
Brazilian Real	-2.93	2.96

Source: Bloomberg (as at 30/09/2022)

THE STOCK MARKET

The Hong Kong stock market, once again, was the market focus in the last quarter. The Heng Sang Index tumbled over 20%, which was the worst quarterly performance in the previous 2 decades. Currently, it is at the lowest level in more than 10 years and it seems that it has been extremely oversold. On fundamental side, the Price-to-Earning and Price-to-Book value of the Heng Seng Index are about 6 and 0.67 times respectively which are very rare to see at that low level in the past. On technical side, the 14-month Relative Strength Index was at 26.1 at the end of September 2022, the lowest since 1967.

EXHIBIT 3: The 14-month RSI of the Heng Seng Index is at lowest since 1967



Source: Bloomberg (as at 30/09/2022)

Global inflation and the war between Russia and Ukraine may partly explain the poor performance of Hong Kong stocks. However, it is believed that China's Covid policy and the deteriorating relationship between U.S. and China are the main causes of the weakness. Although the Dynamic Zero Covid policy is unlikely to change in China in the near term, it is believed that it is just a question of time to shift the policy. On the other hand, the structural conflict between China and the U.S. is accelerating which is extremely hard to change. In the past few months, we have witnessed the heightening tension in Taiwan Strait, the launch of the Chips and Science Act in the U.S., it seems that the pace of decoupling between the two largest economies is moving faster and faster now.

The "new normal" of the U.S.-China relationship would add uncertainties and volatilities to the Hong Kong markets as over 65% of the weightings of the Heng Seng index are Mainland China related companies. The valuation of the Hong Kong stock market is cheap, market rebound may be seen, however, a concrete and consistence market turnaround may still not likely to happen.

Technology stocks also suffered significantly, the Nasdaq Composite index has lost over 30% this year. Most of the major central banks in the world have tightened monetary policies, global money supply is largely reduced and triggers the rise of government bond yields. As at the end of September, the U.S. 2-year treasury yield has risen to about 4.28% from 0.73% at the end of 2021. When bond yields rise, the attractiveness of risky asset is decreasing, and those expensively priced technology stocks are dropped by investors.

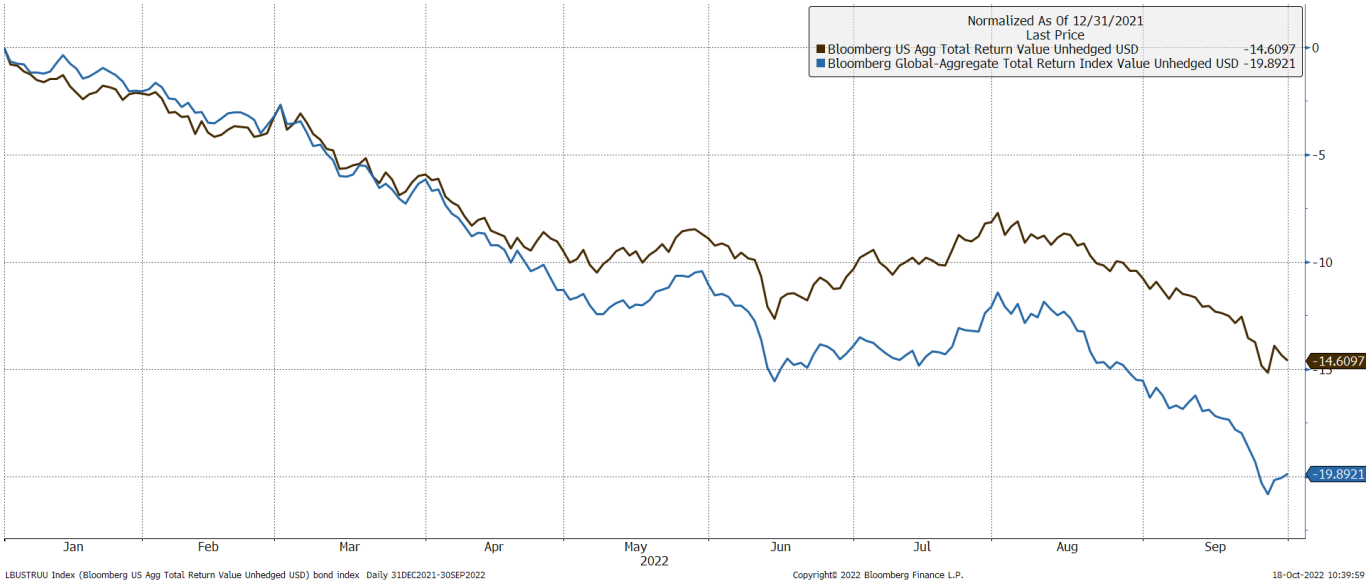
As at the end of September 2022, the Brazilian, Singaporean and Indonesian stock indexes are few of the stock indexes that still delivered positive return this year. The Brazilian economy has benefited from the rise of commodity prices. Unlike the rest of the world, the inflation of the county is slowing down in recent months and the Brazilian Real appreciated about 3% against the U.S. Dollar which is the strongest currency this year.

Almost all Asean countries have already dropped Covid restrictions and most of the economic activities have resumed normal. Like Singapore, about 302,000 people attended the 3-day Formula 1 Grand Prix in early October which set a new record for the highest race attendance in the 13-year history. In addition, countries like Malaysia and Indonesia also benefited from the rise of commodities prices. The Asean stock markets outperformed so far this year and its investment outlook remains positive.

FIXED INCOME

Due to the rise of interest rate, bond prices have dropped significantly this year which we have never seen before. Year-to-date, the Bloomberg U.S. Aggregate Bond Index which has never declined more than 3% in a year since 1976, has fallen 14.61% while the Bloomberg Global Aggregate Bond Index has dropped 19.89% versus its prior record annual decline of 5.17% in 1999.

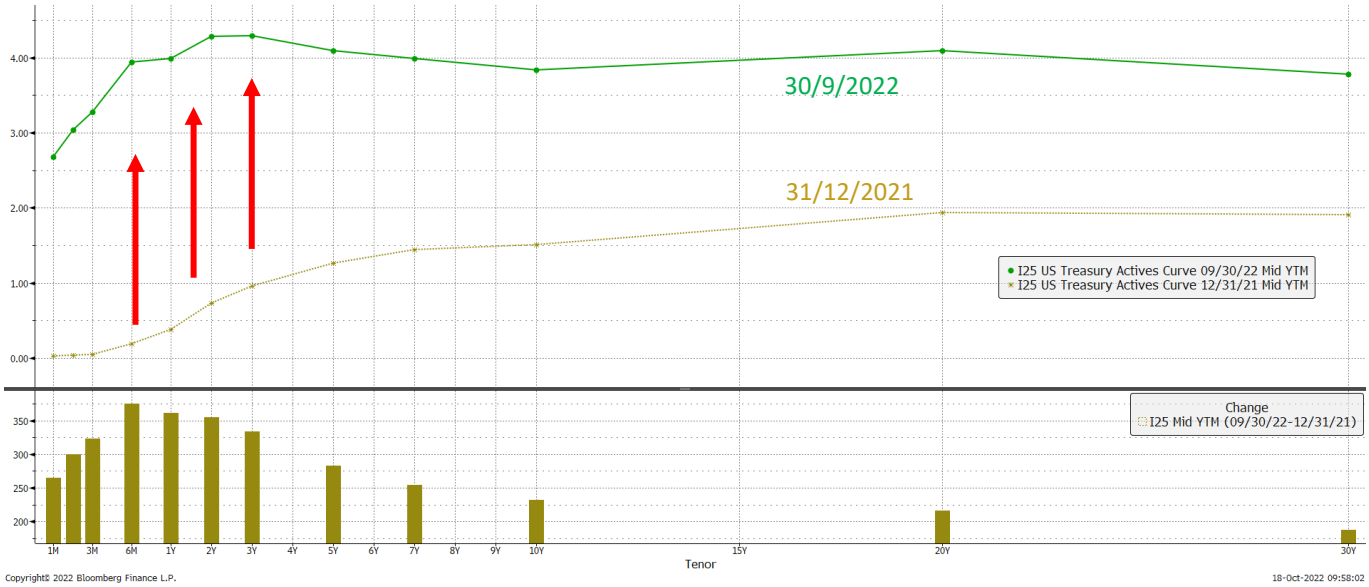
EXHIBIT 4: Historical slump of bond price



Source: Bloomberg (as at 30/09/2022)

The hawkish stance of the U.S. Federal Reserve has driven the treasury yield curve shifting up this year. Since the market is pessimistic towards the near-term economic prospect, the short-term treasury yields have risen much more than the long-term. Among all, the increase of the 6-month treasury yield was the biggest, it rocketed from 0.183% at the end of 2021 to 3.808% as at 30 September 2022 and such phenomenon is very exceptional.

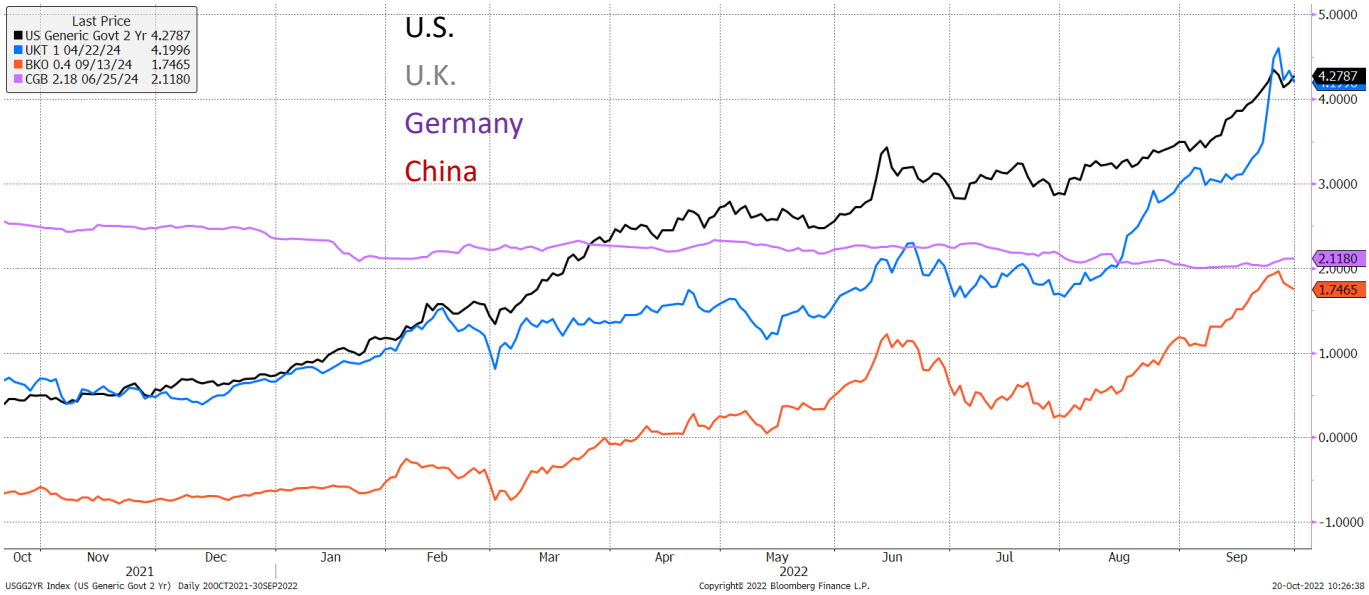
EXHIBIT 5: Upward shift of U.S. treasury yield curve



Source: Bloomberg (as at 30/09/2022)

Among all major global economies, the U.S. government treasury now provides the highest yield even though the default risk of holding it is the least. The yield spread also explains why the U.S. Dollar Index appreciates more than 17% this year which is at its strongest since the early 2000s.

EXHIBIT 6: The 2-Year government bond yield of global major countries



Source: Bloomberg (as at 30/09/2022)

CONCLUSION AND RECOMMENDATION

In the past decade, we were in a global low interest rate environment with abundant liquidity due to the quantitative easing monetary policies imposed by major central banks in the world. This year, the situation is on the opposite side. Interest rate is moving up aggressively and market liquidity is dried up. As a result, almost all asset classes, except commodities, recorded significant loss this year. Pessimistic sentiment is around us and the outlook of global economic growth looks gloomy. Looking ahead, the downturn pressure would still be high, and it is expected that the investment markets will also be full of volatility.

Market correction and volatility seem to be a threat to investors; however, it may also be an opportunity. To a certain extent, the market sell-off this year is indiscriminate. No matter it is a growth stock without any concrete earning or value stock with steady cash flow, investors tend to sell their stock holdings in the market. After the recent market correction, some good quality blue chip stocks are currently traded at a deep valuation discount and it is believed that they may have a good medium-to-long term investment potential.

Opportunity may also be found in the bond market. Although the U.S. Federal Reserve is likely to have more rate hikes in the near future, the valuation of investment grade bonds has come to an attractive level after the historical slump of bond price. The current 1, 2 and 3-year of U.S. treasury yield are all over 4.6%. Since the U.S. treasury is always regarded as a risk-free investment with high market liquidity, it now provides a tempting yield to conservative investors who are looking for fixed return.

Opportunity may also be available from market volatility. Under volatile market condition, investors may consider starting a regular investment. Through fixed investment amount with regular intervals, investors take the advantage of cost dollar averaging which can avoid the mistakes of timing the market and accumulate more investment positions when market corrections happen. In the long run, investment markets always have cycles and that simple investment strategy may bring a remarkable return to investors.