

Principal Hong Kong

2023

Economic and Asset Allocation Outlook

Principal Q&As – Light at the end of the tunnel



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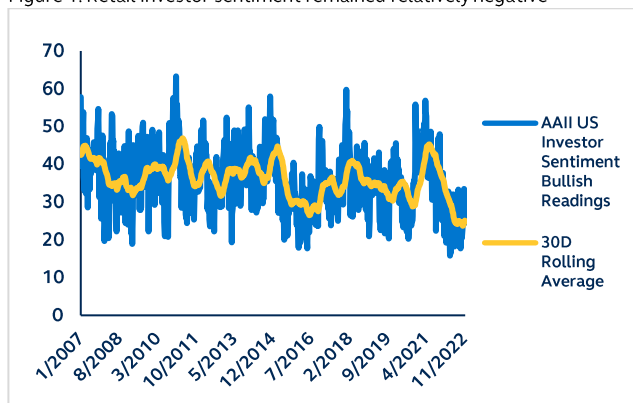
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Will global stock markets rebound?

Risk assets may weaken before trending higher; Stay focused on U.S. inflation and Fed policies

Figure 1: Retail investor sentiment remained relatively negative

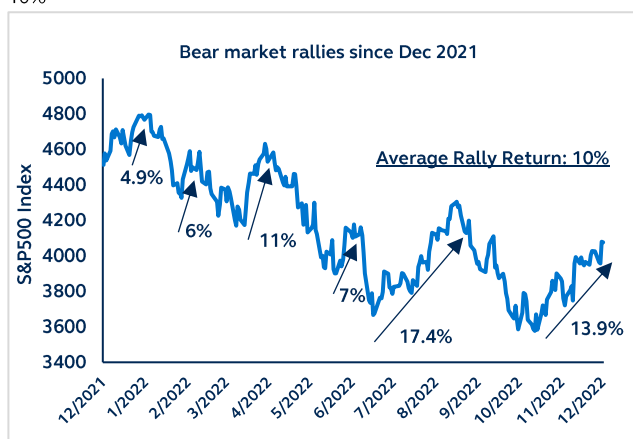


Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 12/1/2022)

Boosted by a slowdown in U.S. inflation and softened expectations for rate hikes by the U.S. Federal Reserve (Fed), global equities saw a rebound led by developed markets in the fourth quarter. Stock markets worldwide had fallen more than 16% in 2022, as of the end of November.

The bear market in 2022, which was initially triggered by inflation concerns, has resulted in valuation compression. In addition to bond yields shooting up, market fears rapidly intensified (Figure 1) as a result of aggressive policy tightening by central banks. In the second half of the year, global stock markets continued to decline with the troughs heading lower (Figure 2).

Figure 2: Return of bear market rallies over the past year averaged about 10%

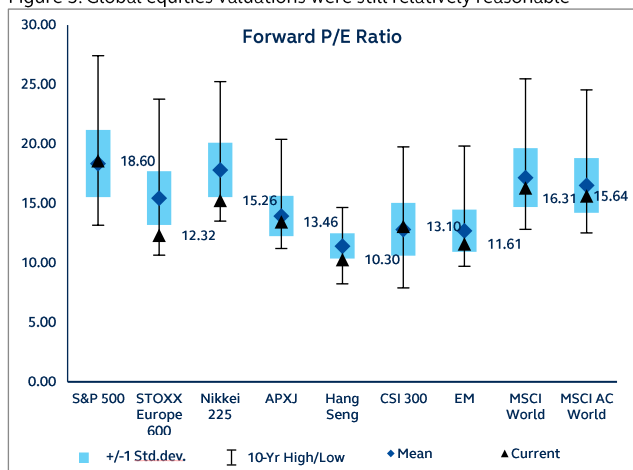


Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 12/1/2022)

In 2023, global economic growth may stall further, and the trend of corporate earnings downgrades is likely to continue. However, equities valuations are comparatively fair (Figure 3) and investors' risk positions are light. Investors may consider gradually increasing their risk allocations in the first half of next year as inflation growth slows and the cycle of global interest rate hikes comes closer to an end. Stock markets may recover before earnings bottoming out, as global financial conditions and investment market sentiment are likely to improve.

Indeed, risk factors such as the pandemic and the conflict between Ukraine and Russia that have impacted the world economy and financial markets over the past two years are still present. In 2023, these problems are probably going to keep weighing on the world economy. As the effects of tightening monetary policies by global central banks kick in, many developed markets are likely to enter a recession. These are the uncertainties we are facing.

Figure 3: Global equities valuations were still relatively reasonable



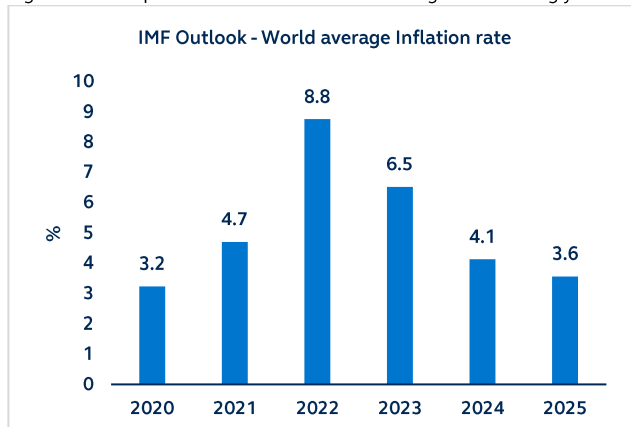
Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 11/30/2022)

As a result, investors should stay focused on factors that will influence asset performance in the near future, such as the U.S. inflation trend, the Fed policy rates, the pandemic and Covid policies in China, as well as global economic indicators and geopolitical situations. Overall, the first half of 2023 is likely to see more volatility in investment markets, despite there could be light at the end of the tunnel.

Has global inflation peaked?

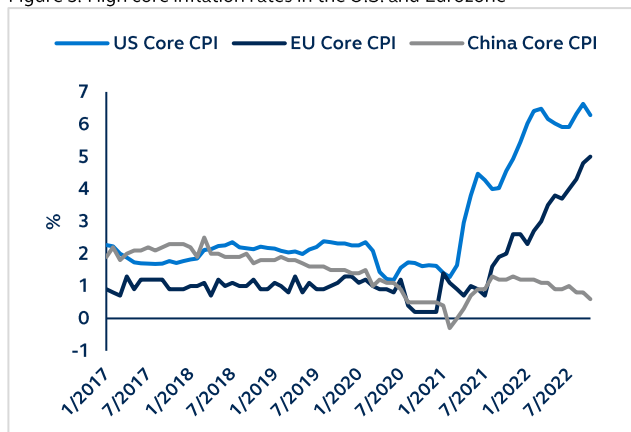
Global inflation is peaking; A meaningful decline may take time

Figure 4: IMF expected inflation to continue falling in the coming years



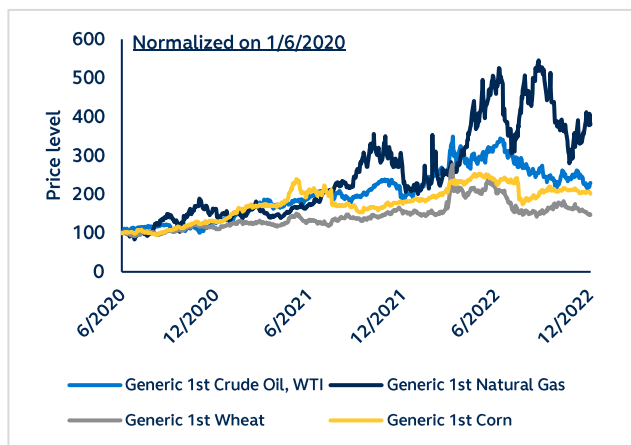
Source: International Monetary Fund, world economic outlook report, October 2022

Figure 5: High core inflation rates in the U.S. and Eurozone



Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 10/31/2022)

Figure 6: Energy and food prices remain relatively high



Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 12/1/2022)

Global inflation has possibly approached its peak thanks to the collective efforts of global central banks to fight inflation. In October, the International Monetary Fund forecasted that the global inflation rate could peak at 8.8% in 2022, and then steadily decline to 6.5% in 2023 and fall further to 4.1% in 2024 (Figure 4). We believe that the overall trend of inflation will be towards the downside in 2023, although the situations in different countries are not necessarily the same.

U.S. inflation figures of October surprised the market, with headline and core CPI unexpectedly decreasing to 7.7% and 6.3% respectively (Figure 5). Core inflation for goods and services both decelerated month over month. Rental growth has started to slow down thanks to a drop in home prices, and this trend may continue. The CPI data in October does not fundamentally alter the status quo of inflation, but it does appear to support the notion that it has peaked and begun to decline in the U.S.. The core CPI in the U.S. is anticipated to continue to move lower in 2023 and fall back to below 3% at the end of the year, as demand weakens and the unemployment rate rises.

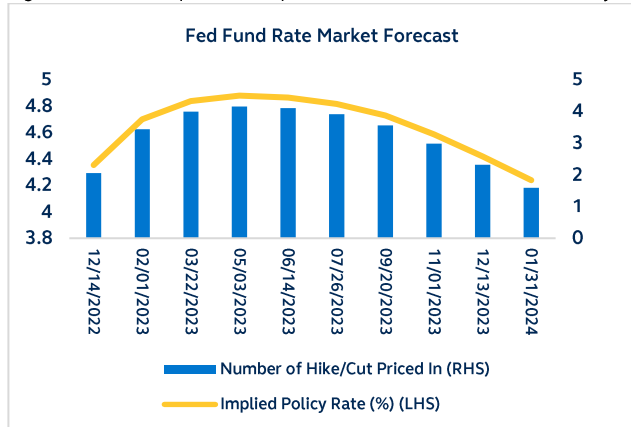
In contrast, inflationary pressures in the Eurozone are still fairly strong, with both the overall inflation rate and core inflation rate hovering at high levels historically. Prices may continue to remain elevated in the short term under the threat of further rises in retail gas and food prices (Figure 6). Stepping into 2023, even though energy and agricultural product inflation may decline due to the high base effect, the pace of price decline may be slower than that of the U.S., given the relatively tight labour market and pressure on rising wages. A significant decline in inflation may not happen until the middle of next year and core inflation may remain at a relatively elevated level throughout 2023.

In Asia, core inflation trends are relatively contained. Even with economic reopening, the risk of inflation is only more notable in a range of Asian nations, particularly those that are more dependent on imported oil and food. Overall inflationary pressure in China was comparatively moderate due to a softening in domestic demand. In October, consumer prices dropped significantly to well below the annual target of 3% set by the government. Looking ahead to 2023, local and regional inflation is likely to rise if China relaxes its zero-covid policy and the economy swiftly recovers. Due to the comparatively pessimistic economic trends in developed markets, the impact on global inflation may be relatively limited.

Can the Fed pause rate hikes?

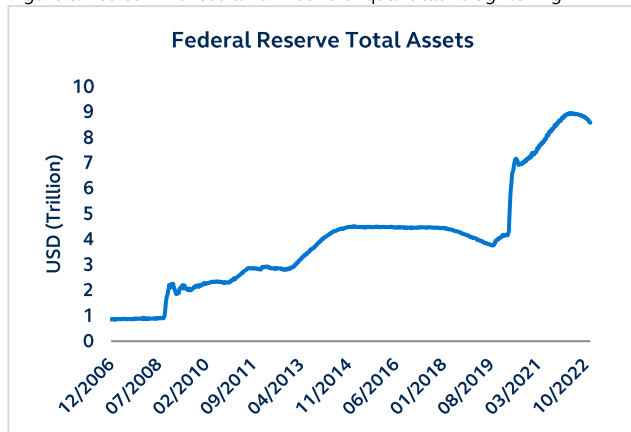
Rate hike cycle may peak in 1H23; rate cuts are possible in early 2024

Figure 7: Markets expect Fed to pause rate hikes in the middle of next year



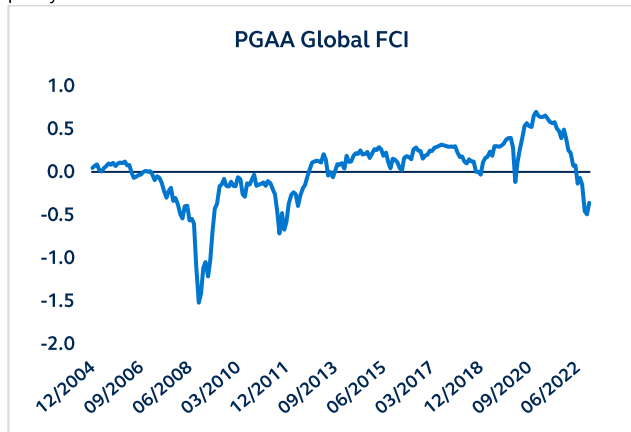
Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 12/1/2022)

Figure 8: Fed commenced a new round of quantitative tightening



Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 11/30/2022)

Figure 9: Global financial conditions have tightened significantly over the past year



Source: Principal Global Asset Allocation, Principal Asset Management Company (Asia) Limited (As of 11/30/2022)

The Fed unanimously opted to raise interest rates by 75 basis points at the FOMC meeting in November, bringing the upper bound of the Federal funds benchmark rate to 4%. Considering the current picture of inflation and the labour market in the U.S., the Fed may be inclined to raise the policy rate by 50 basis points in the December meeting. The Federal funds rate may hit as high as 5.25% at its peak in the first or second quarter of 2023. With that said, the future trajectory of U.S. monetary policy is still uncertain.

In fact, the Fed has never paused raising interest rates when the benchmark rate is lower than the annualised core PCE inflation rate. Over the past three months, the average monthly core PCE inflation rate in the U.S. has ranged between 0.3% and 0.4%, which was comparable to the average rate throughout the post-pandemic period. Unless the core PCE inflation declines prominently over the next three months, the Fed is unlikely to deviate from our current projections. The Fed may need to raise the upper bound of the policy rate to above 5% to bring the rate above core PCE inflation and only by then can the Fed consider a pause of rate hikes.

From our perspective, it is still premature for a rate cut in the second half of 2023 as expected by the market (Figure 7). Even if the Fed stops raising interest rates, the rate is likely to stay in the restrictive zone for a longer period of time, given the inflation trajectory and a relatively resilient economy in the U.S.. We may need to wait until 2024 for the Fed to start cutting rates. Since inflation remains the focus of policies, the Fed may not be able to cut interest rates early. They may not cut rates significantly by 500 basis points as in previous recessionary cycles, or push the benchmark interest rate down to a level close to zero.

In addition to the adjustment of interest rates, the Fed stepped up quantitative tightening in September by doubling monthly bond sales to \$95 billion. After peaking at \$9 trillion in April, Fed’s balance sheet started to decline. As of November, it had decreased by more than \$340 billion (Figure 8) and may contract by nearly \$1 trillion in the coming year if the current pace of bond sales is maintained, which would be the equivalent of a rate hike of 0.25%. Such bond sales could cease by the end of 2023 with the Fed’s balance sheet dropping to around \$7.5 trillion at the time.

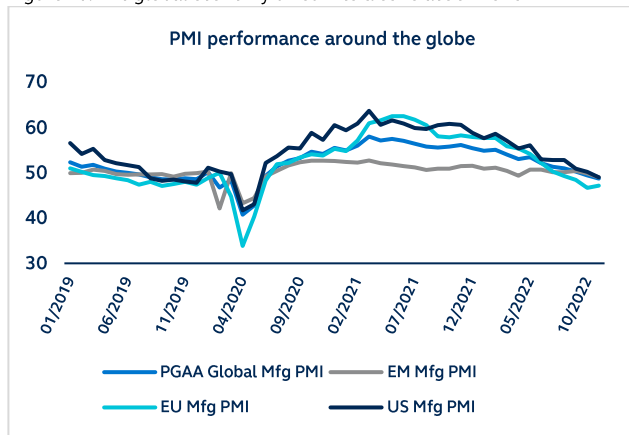
Financial conditions in the U.S. have tightened significantly over the past year and reached the lowest level since the 2009 financial crisis thanks to rate hikes, monetary tightening and the prominent appreciation of the U.S. dollar. Global financial conditions in November remained close to the tightest territory since the 2011 European debt crisis, with the magnitude of contraction in developed markets outstripping emerging markets in the past year. The simultaneous rate hikes by global

central banks mean that the world's financial conditions are likely to remain relatively tight (Figure 9) before there are clear signs of slowing inflation. This may be unfavourable to some of the economic activities.

Will developed markets enter recession simultaneously?

U.S. and Europe could face weaker growth momentum; recession may be relatively shallow

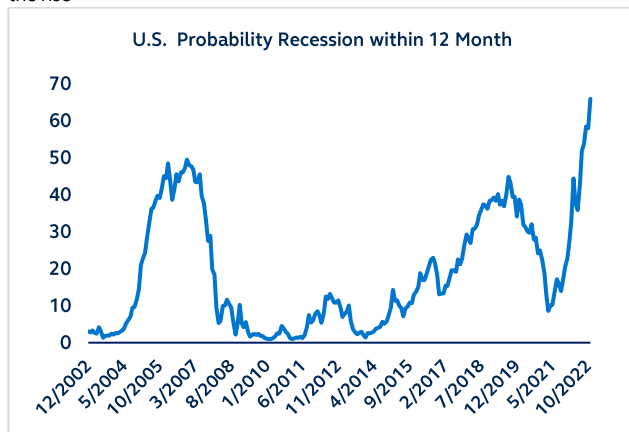
Figure 10: The global economy dived into a contraction zone



Source: Principal Global Asset Allocation, Principal Asset Management Company (Asia) Limited (As of 11/30/2022)

As the world economy continues to weaken, the Principal Global Manufacturing PMI Index has dipped below 50 and entered the contraction zone. The PMI indexes for developed and emerging markets were both relatively weak (Figure 10). The repercussions of monetary tightening over the last nine months may be seen in 2023. Real consumer spending will continue to be impacted by high inflation, particularly for low-income groups. Indeed, financial conditions stay tight and real estate activity is losing momentum, the global economy may continue to deteriorate. The prospects for economic growth in the developed markets may be less favourable than that of the emerging and developing markets.

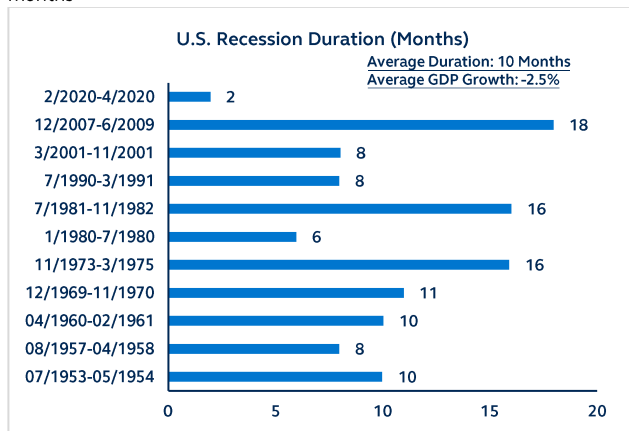
Figure 11: Risk of U.S. entering recession within 12 months has been on the rise



Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 11/30/2022)

In the U.S., for instance, over the next year, the risk of a recession may rise significantly as monetary tightening takes effect (Figure 11), even though its economy appears to be still relatively resilient at the moment, as evidenced by hard data such as retail sales and durable goods orders. The economy may fall into a recession in the third quarter of 2023, where we expect a negative growth of about 1% for its GDP quarter over quarter and the recession to last for three quarters. Previous economic downturns in the U.S., after 1950s, have had an average duration of 10 months and average negative GDP growth of 2.5%. (Figure 12). Therefore, even if the U.S. economy enters a recession in 2023, the slowdown is likely to be considerably less severe than the average of previous cycles, the global financial crisis of 2008 or the pandemic-induced recession in 2020.

Figure 12: Duration of the last 11 recession cycles averages around 10 months



Source: Bloomberg, National Bureau of Economic Research, Principal Asset Management Company (Asia) Limited

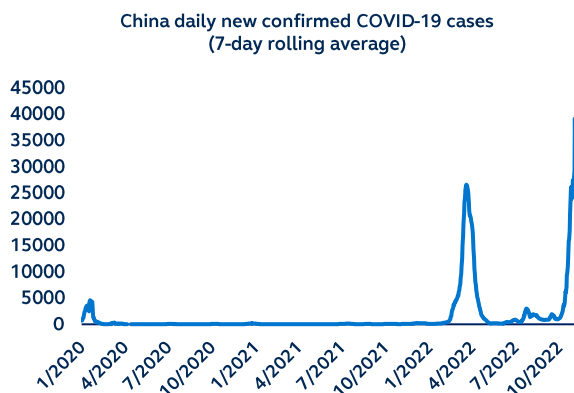
The outlook for the Eurozone is expected to be gloomier. The European Central Bank may need to substantially tighten policies in the face of high energy costs, persistent and elevated inflation, as well as the ongoing Russia-Ukraine War. Dragged by weakening external demand and other factors, the Eurozone PMI has been in the contraction zone for five consecutive months. The economy in the region may shrink in the fourth quarter of 2022, and the weakening trend may be extended to the first and second quarters of next year.

Will China ease the zero-covid policy?

Easing of restrictions depends on the vaccination rate of the elderly;

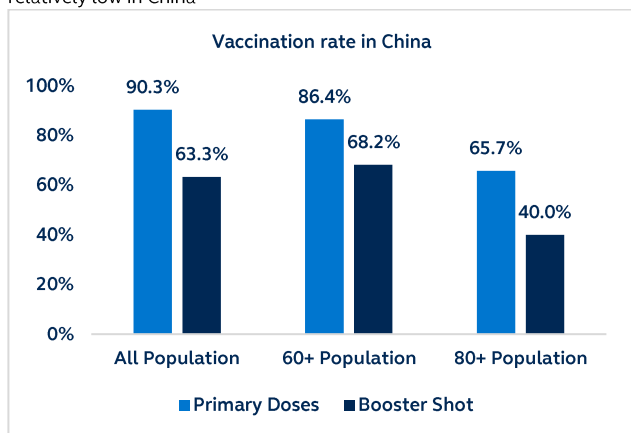
The outlook for economic growth in China remains uncertain

Figure 13: Daily new confirmed cases soared after China eased Covid restrictions



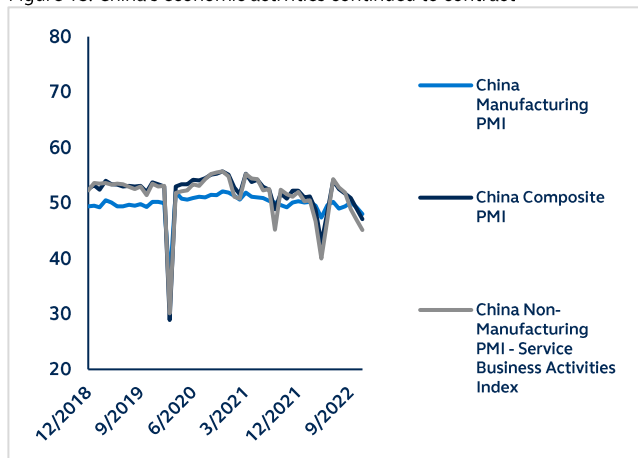
Source: Our World In Data, Principal Asset Management Company (Asia) Limited (As of 11/30/2022)

Figure 14: The share of population who have received booster shots were relatively low in China



Source: National Health Commission of the People's Republic of China, Principal Asset Management Company (Asia) Limited (As of 11/11/2022)

Figure 15: China's economic activities continued to contract



Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 11/30/2022)

China's economic outlook for next year is still highly uncertain, with the pandemic and corresponding policies being the most important factors among a series of uncertainties. The pandemic situation in Mainland China remained unstable as of the end of November. Although China's daily new confirmed cases were comparatively low by international standards, there were around 40,000 new cases per day (Figure 13) which exceeded the peak level in April when Shanghai was under lockdown. This round of the pandemic has spread to more than 100 cities, which was the most extensive since the initial outbreak in 2020. These areas account for more than half of China's GDP and 90% of its exports.

In China, the percentages of people aged 60 and over 80 who have not received booster shots were about 32% and 60%, respectively (Figure 14). As a response to the escalation of the pandemic, the Chinese government announced a plan to increase the vaccination rate of the elderly. The greatest obstacle to easing Covid restriction measures will be the incremental burden on medical systems once the pandemic rapidly worsens. Given the low level of confirmed cases, a sudden relaxation may pose a greater threat to the economy of China. Therefore, if the vaccination rate of the elderly increases significantly in the next three months, China may gradually relax its zero-Covid policy as early as the first half of 2023.

Due to the resurgence of the pandemic and the corresponding preventative measures, economic activities in China have weakened further, especially in the service sector with the official Purchasing Managers' Index (PMI) for the sector falling to 45.1 in November (Figure 15). Downside risks to the Chinese economy have increased towards the end of the year. Retail sales may wane further, and the real estate sector (both property sales and property prices) will probably remain relatively sluggish until the pandemic is under control. As external demand continues to weaken, industrial production will be dragged, and exports could decline persistently. Therefore, the economic outlook for China is dimmed in the short term, with full year economic growth anticipated at around 3% under the current economic backdrop.

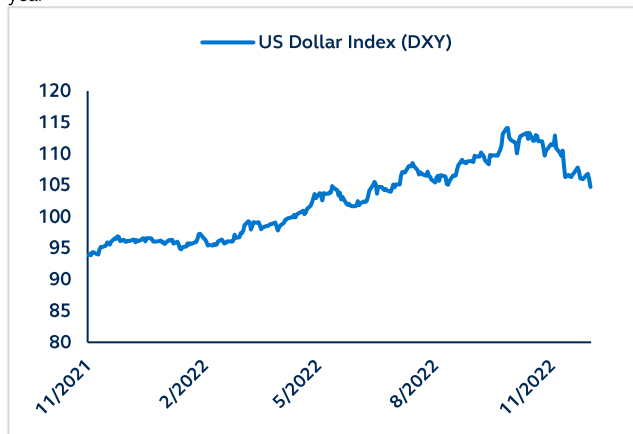
Looking ahead to 2023, the prospect of the Chinese economy will depend on the pandemic, outlook of the property market and global demand. With the government continuing to focus on maintaining growth, the new budget to be released in March may provide a larger scale of fiscal support. Under the backdrop of the

relatively controlled inflation, the People's Bank of China may have more room to implement relatively accommodative monetary policies. The overall economic growth rate in 2023 may be slightly better than in 2022, ranging from 4% to 5%.

Will the dollar reverse its trend?

The U.S. yield spread advantage diminishes; DXY could fall to below 100 in 2023

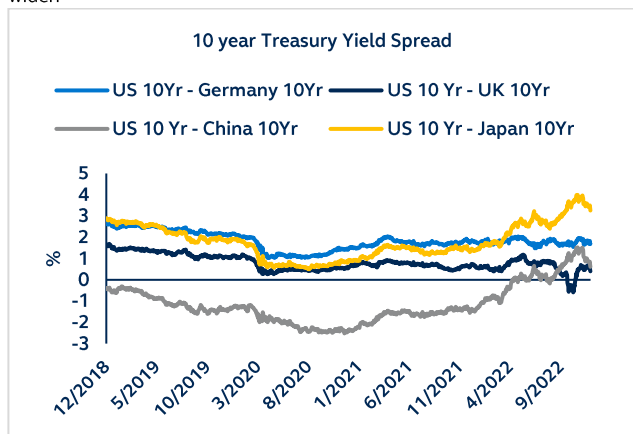
Figure 16: The U.S. dollar index strengthened significantly over the past year



Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 12/1/2022)

The uptrend of U.S. dollar index lasted from the middle of 2021 to September 2022, where it rose from below 90 to 114, by as much as 27%. The index has started dropping from its peak since late September, and fell to below 106, representing a 7% correction compared to the peak (Figure 16). Other currencies appreciated against the U.S. dollar. Euro recovered by more than 6% in the fourth quarter, exceeding parity with the dollar. The Japanese yen also bounced back to 140 against the dollar. We believe that the dollar may remain rangebound in the short term before ushering in a further correction in the second quarter of 2023.

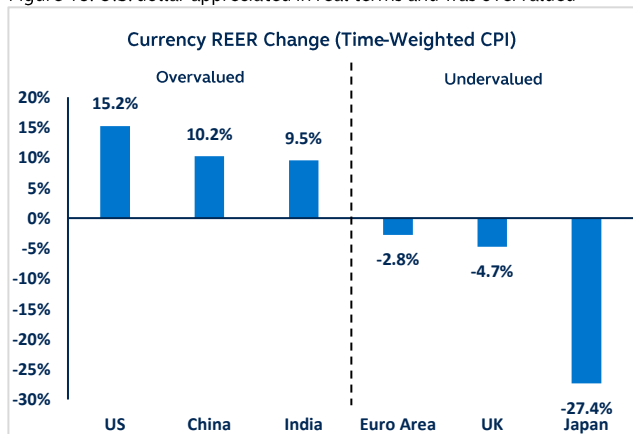
Figure 17: Treasury spreads of U.S. against China and Japan continued to widen



Source: Bloomberg, Principal Asset Management Company (Asia) Limited (As of 12/1/2022)

The performance of U.S. dollar is typically driven by three major factors - global economic trends, U.S. spread advantage and risk appetite. In fact, the dollar typically outperforms during global economic slowdowns. Despite higher risks of recession for many countries in 2023, global central banks may continue their tightening policies if inflation picks up again. This may lead to rising concerns about recession and once again push the dollar higher. However, such expectation has been largely priced in and several leading indicators suggest that global economic downturns started to decelerate, which may trigger a correction of the U.S. dollar in 2023.

Figure 18: U.S. dollar appreciated in real terms and was overvalued



Source: Principal Global Asset Allocation, Principal Asset Management Company (Asia) Limited (As of 11/2022)

Besides, we should pay attention to the Fed's policy. Fed has been hiking rates aggressively in 2022, with the level of hikes prominently exceeding other major central banks in the developed markets, not to mention countries maintaining loose monetary policies. The interest rate advantage in the U.S. provides major support to the strength of the dollar (Figure 17), with its short-term interest rates being particularly attractive under highly uncertain global economic conditions. In 2023, as U.S. inflation could continue to retreat after reaching its peak and the Fed's rate hike cycle draws to a close, the spread advantage will probably abate, and interest rate volatility may decrease.

Therefore, risk-off sentiment may improve if Fed pauses hiking rates, which will result in weaker demand for the U.S. dollar as a safe haven. While being relatively overvalued (Figure 18), the dollar may adjust alongside a significantly weakened U.S. economy. The abovementioned factors could all contribute to a further retreat of the dollar in 2023. The uncertain time

frame for the infection point of these factors remains the major concern at present. In the short term, the trend of U.S. dollar may be determined by the difference between the path of the Fed's policy and market expectations. In view of the resiliency of the U.S. economy and the strength of its labour market, the U.S.

dollar index may rebound from its current level, but is likely to pick up the downward trend and fell to below 100 in the second half of 2023.

How should investors allocate assets?

May consider reducing cash holdings, while increasing allocation to bonds and alternative assets

Q1 Outlook	Underweight	Slightly Underweight	Neutral	Slightly Overweight	Overweight
Equities	○	●	●	○	○
- U.S.	○	○	●	○	○
- Eurozone	○	●	○	○	○
- Asia ex-Japan	○	○	●	●	○
- Japan	○	○	●	○	○
- HK	○	○	●	○	○
- China	○	○	●	○	○
Fixed Income	○	○	●	●	○
- Sovereign	○	○	○	●	○
- Investment Grade	○	○	●	○	○
- High Yield	○	●	●	○	○
- Preferred Securities	○	○	○	●	○
Alternative	○	○	○	●	○



indicates a change in preference from the previous quarter

Looking ahead to 2023, investment markets may remain volatile. Investors should continue to focus on the economy, inflation, global financial conditions, market fundamentals and technicals when making asset allocation decisions.

Economy and inflation

Global economic growth will continue to slow, especially in the developed markets. High inflation is likely to continue to drag real consumption. With tightening policies starting to take effect, the European and U.S. economies may contract next year. The economic prospects of the Asian region are relatively solid. If China doubles down on the relaxation of covid controls, it could provide a stimulus for a better economic recovery within the region.

Central bank policy and financial condition

Global financial conditions are close to their tightest levels in more than a decade and likely to stay so in the near future. However, when inflation peaks and starts falling, the central banks of developed markets may

slow the pace of policy tightening and even call a halt to rate hikes around the middle of next year, which may help ease the tight liquidity in markets and improve financial conditions.

Market valuation and corporate earnings

Stock valuations rose from low levels as markets rebounded in the fourth quarter, with some markets returning to reasonable ranges. The forward price-to-earnings ratio of the S&P 500 index returned to its ten-year average, while valuations in Europe, Japan and Hong Kong were still one standard deviation below their ten-year averages. Corporate earnings growth will continue to adjust lower following rising expectations of economic recession. The earnings of S&P 500 index corporates are expected to post negative growth next year

In the first quarter of 2023, in terms of asset allocation, investors may consider reducing the overweight in cash, at the same time, reducing the underweight in equities,

and increasing allocation to bonds and alternatives, which may help diversify risks in investment portfolios.

Bonds

With the Fed's policy rate likely to remain in a restrictive zone for an extended period of time, coupled with economic slowdown, default risks may rise moderately, and credit spreads may widen from current levels. Therefore, we are neutral on investment-grade and high-yield corporate bonds. However, real interest rates and inflation expectations may have peaked, and the upside of longer-term U.S. Treasury yields is relatively limited. Given the possibility that the investment market will remain volatile, bond investors may allocate part of their assets to sovereign bonds in developed markets. In addition, investors may consider the type of bonds with spread advantages, such as preferred securities which are also investment-grade or low-duration high-yield bonds with comparatively lower risks and higher asset quality.

Equities

On equity allocation, many developed economies are more vulnerable to economic downturns. On the other hand, Asia has benefited from economic reopening and a relatively controlled inflation environment. If the strength of the U.S. dollar reverses, it may benefit the equity markets in the region. Therefore, from a geographical standpoint, we are slightly underweight

Europe, neutral on the U.S., Japan, China and Hong Kong equities, and maintain a slightly bullish view on Asia ex-Japan. With respect to sector allocation, apart from energy, we favour more defensive sectors such as healthcare, consumer goods and utilities. The performance of these sectors is less correlated with economic cycles and backed by a comparatively stable demand in times of economic downturns. Before the market trend turnovers, value stocks may continue to outperform growth stocks, particularly for the more financially resilient companies and those with a proven track record in paying dividends.

Alternatives

In terms of alternative assets, real assets, such as global REITs or infrastructure investments, may be used as inflation hedging tools to diversify the investment risks of equities whilst generating better dividends compared to global stocks. For instance, in the past year as of November, globally listed infrastructure companies outperformed global stock markets by nearly 16%, backed by the low correlation of infrastructure investments with economic cycles and the fact that it typically outperforms during times of high inflation. Whilst REITs underperformed year to date, a recovery of the asset class is possible following the peaking of interest rates and considering its sizable discount to the underlying net asset value.

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(Written on 1st December 2022)