2023 Asian Investment Outlook:

Treading a careful path back to stability and growth

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Executive Summary – Treading a careful path back to stability and growth

By Ecaterina Bigos

The key dynamic in markets this year has been the relentless tightening in financial conditions, with Central Banks globally ongoing challenge of bringing inflation lower - with exception of China and Japan – leading to elevated volatility, and negative returns across majority of asset classes. Moderation of demand growth, improvements in supply chains, high inventories and tighter monetary policy are likely sufficient to bring inflation back towards central banks' targets over the next two years. We forecast inflation to moderate rapidly, averaging 5% in 2023 and back to 2% target in 2024.

For the remainder of this year and into 2023 the focus is increasingly shifting to calibrating the impact of tighter financial conditions on global growth. We expect it to display resilience heading into next year, based on the support of a healthy private sector due to excess savings, the unwinding of adverse supply shocks, signs of a slowdown in inflation and the lags in the monetary transmission mechanism. We forecast global growth levels of 3.1% in 2022, 2.2% in 2023 and 2.7% in 2024.

The degree of this years' global synchronization and pace of interest rate hikes is one of the greatest on record. With the financial system adjusted to a low-rate environment, a period of higher real and nominal rates is bound to place stress on the system. Amid this backdrop, our central case is that US economy enters a mild recession in 2023, with the Eurozone in recessionary mode by the end of 2022. The dynamics in emerging markets (EM) are more complex and EM vulnerabilities are rising unevenly, differentiated by region and country. Across most of Asia, for example, the re-opening impulse is fading as we enter 2023, and subsequently economic growth is likely to moderate.

China may prove to be counter-cyclical to the global growth slowdown; its ongoing easing of monetary policy and mild inflation offers the potential for growth – from an expected 3% in 2022 to 5% in 2023, assuming the reopening impulse materializes. Investor concerns about the housing market downturn, de-globalization, technology restrictions, private-sector policy and aging population will keep China's potential growth in focus beyond the long-awaited reopening excitement.

Looking at the investment landscape more broadly, the result of global investors fleeing almost every asset class this year is a decade-high amount of cash sitting on the side-lines. This might result in support for risk assets in 2023. Yet until the timing of further growth weakness is clearer, a trading environment is likely to be more prevalent than trending one. However, until the timings of further growth weakness are clear, investment environment may stay more of a trading one than a trending one, with slower growth, still elevated inflation and higher yields favouring bonds.

Any additional adverse shocks could cause protracted and deeper domestic recessions. Persistent inflationary pressures bring risks of policy miscalculation and overtightening of financial conditions. Further, financial markets stability is susceptible to fiscal policy acting in cross-purpose with monetary. Bank of Japan possible removal of the 10yr yield target, puts markets at risk of a rapid rise in global term premia. Politically, escalation of the war in Ukraine, with potential increased tensions in the European energy market are skewing risk towards a more severe downturn in Europe. China's zero Covid policy management and its economic recovery remain a key headwind, for growth in Asia, and globally.

China – A bumpy path to reopening

By Aidan Yao

Key points

- China's economic outlook continues to hinge on the path of the pandemic and Beijing's response
- We expect the authorities to pave the way for a reopening, but that path will be bumpy and uncertain
- Falling exports – partially offset by a less bad property market – call for continued policy accommodation

COVID-19 response fails to keep up with virus

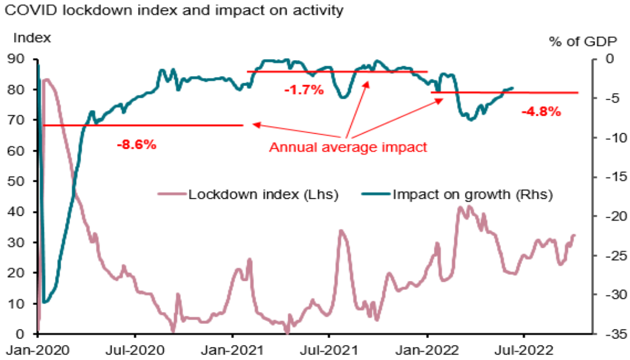
Three years into the COVID-19 pandemic, while most countries have exited emergency responses, China remains wedded to a rigid containment strategy. 2022 was a particularly difficult year for the Chinese economy, with the impact of rolling lockdowns exacerbated by a collapsing housing market and stiffening external headwinds – manifested in rising food and energy prices, escalating geopolitical tensions, and tightening global financial conditions. Beijing has tried to mitigate these shocks by easing counter-cyclical policies and finetuning its COVID-19 response after the Shanghai debacle. But those moves have failed to prevent a steep decline of economic growth. With annual GDP gains expected to more than halve to about 3% from 8.1% in 2021, Beijing is set to miss its growth target for the second time in three years.

The outlook for the economy will continue to hinge on the evolution of the pandemic and Beijing's response. Continuing with draconian controls against repeated COVID-19 flare-ups will likely prolong the economic stress, creating permanent scarring in the economy and society. The housing market remains a wild card, as it struggles to find a bottom against depleting home-buyers' confidence and acute financial stress among property developers. Exports – once a strong engine of growth – have also started to sputter and will likely lose further steam as developed economies fall into recession. These challenges will complicate Beijing's counter-cyclical policies and make next year's outlook more uncertain than usual. Below, we explain in detail these four drivers of the economy and the risks to our assessment.

Changing tack to reprioritise the economy

Starting with the pandemic, developments over the past year have likely brought two revelations to Beijing. First, the virus is unlikely to disappear any time soon, and could continue to mutate turning the pandemic to endemic, which may already be the case outside China. Second, and related, the medical response has to adapt for a long fight against a constantly changing enemy. The brutal lockdown in Shanghai, which brought China's largest city to a standstill, was a painful lesson that achieving zero infections against a highly transmissible virus will inflict tremendous economic and social costs. Calls for an exit from the Zero COVID Policy (ZCP) have since grown as China becomes isolated from the rest of the world.

Exhibit 1: Economy at the mercy of the pandemic



Source: CEIC, Goldman Sachs and AXA IM Research, 16 November 2022

Beijing's reluctance to change is likely a result of three considerations. Medically, China is not ready to exit the ZCP with a low immunity rate among its vast population and limited medical resources, which could prove insufficient to deal with increased severe cases upon reopening. Economically, the ZCP had been seen as a success not long ago for contributing to China's growth outperformance and gains of export market share before this year. Finally, altering a policy, extolled as an emblem of China's superior governing system ahead of a once-in-a-decade leadership reshuffle, was seen as unwise politically.

These arguments, however, have been weakened by recent events. The economic calculation has clearly shifted, reflected by the higher costs of tackling Omicron compared to the Alpha or Delta variants. Meanwhile, the conclusion of the 20th Party Congress has helped remove a major political uncertainty and refocus the party's attention on its core objective of delivering growth and prosperity. The remaining hurdle is weak medical defences. Hence, moves to build such a defence should be seen as preparation for an exit from the ZCP.

Our baseline view for 2023 rests crucially on the assumption that the ZCP will be adjusted for an eventual reopening of the economy. We see this proceeding in three phases. Phase one focuses on getting the public medically and mentally ready for a change. This involves raising the vaccination rate (particularly for the elderly), introducing antiviral drugs, constructing more field hospitals, and reshaping public consensus to ease people's fears of the virus. These changes are already underway and the latest announcement from Beijing of 20 measures to fine-tune the COVID-19 strategy suggests more is to come. Phase two puts the emphasis on reopening the domestic economy by easing social and mobility restrictions, reducing mass testing, and abandoning the frequent use of 'static management'. A broad liberalisation within China is assumed to be reached by the middle of next year. The final step is to open the border with the rest of the world through successive reductions of quarantine restrictions for visitors.

It is important to reiterate our long-held view that no official announcement on ending the ZCP will be given until, perhaps, full liberalisation is achieved. But under the ZCP banner, we see the emphasis shifting from achieving zero infections at all costs to 'dynamically adjusting' the strategy to reprioritise economic normalisation. Investors therefore need to pay more attention to what Beijing does than what it says.

There is however considerable uncertainty around this baseline view. It is entirely possible that the fear of exposing China's vast unvaccinated population to a virulent virus continues to hold Beijing back from reopening. And even if the ZCP is adjusted, the path could be bumpier than hoped. Too slow a change will do little to save the economy, while too fast an exit could lead to surging infections and hospitalisations that overwhelm the public health system. The ensuing social backlash could set back the reopening and economic recovery. We have built a cautious forecast – including a negative quarter of growth followed by only a partial recovery – to account for potential hiccups in this transition, but the actual path ahead could be bumpier still.

Property and exports switch sides

Besides the pandemic, the ongoing property market turmoil has also rattled the economy and financial markets. Fears of contagion to the household sector and banking system – following the mortgage boycott instance – prompted the authorities to ease property policies. But this was barely enough to slow the deterioration of conditions. The good news is that the policy wind has shifted further with Beijing now taking more substantial steps to ease developers' funding stress. The bad news is that there are no easy fixes to the structural imbalances, with an overhang of housing supply in lower-tier cities and excess leverage at many private-sector developers. After abruptly pricking the bubble, Beijing now must manage its fallout. We expect further policy support to stabilise the market next year, helped by easing COVID-19 controls. But there will unlikely be a vigorous rebound of activities until structural challenges are tackled.

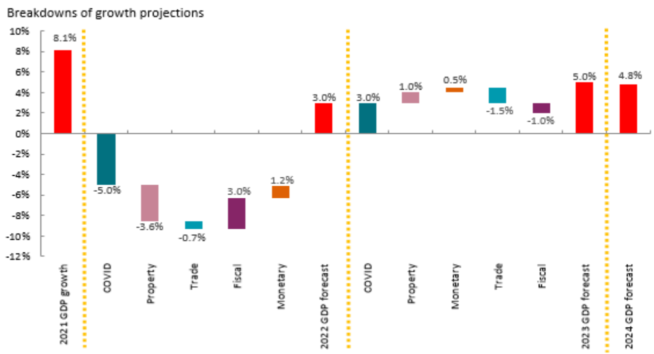
The external sector is set to become less supportive of the economy next year. After acting as a solid engine of growth since 2020, export activity has faltered lately and is expected to contract as developed economies slide into recession. In addition, rising geopolitical tensions between China and the US – notably in the area of advanced technology – could further impact an already soured trade relationship. The loss of this export growth contribution could add to the urgency for Beijing to ease COVID-19 controls to revive domestic demand.

Better transmission improves policy efficacy

The multitude of economic headwinds call for continued accommodation from China's counter-cyclical policies. Compared to this year, policy efficacy may improve in 2023 if easing COVID-19 controls and stabilising property market can help to unclog policy transmission channels. On the monetary side, the room for aggressive easing is limited by concerns about currency depreciation and capital outflows, while tightening is unlikely given the uncertain path of the economy. Incremental policy exit is possible later in the year only if economic reopening proceeds smoothly. Fiscal policy will likely stay supportive too, but Beijing may struggle to repeat some ad-hoc, frontloaded, stimulus implemented this year given the already stretched fiscal balance sheets of local governments. With reduced potential for conventional stimulus, there are few options left to bolster growth other than freeing the economy from the grip of the pandemic.

Exhibit 2 shows how our above-consensus 5% growth forecast for 2023 is derived. This is followed by a slight moderation to 4.8% in 2024 as the economy reverts to trend. The biggest swing factor in our forecast is the ZCP, which offers a two-sided risk. However, we consider the chances of inaction or delayed action from the authorities as greater than proactive action. In an adverse scenario of China continuing its current pandemic response for another year, we think the economy would suffer from deeper economic scarring and further reduced space for counter-cyclical policy. Annual growth could fall to 3.5% or lower in that scenario even with the help of a low base.

Exhibit 2: Dissecting our growth forecast for 2023-2024



Source: CEIC and AXA IM Research, 16 November 2022

Emerging Asia – A soft landing despite growing external headwinds

By Shirley Shen

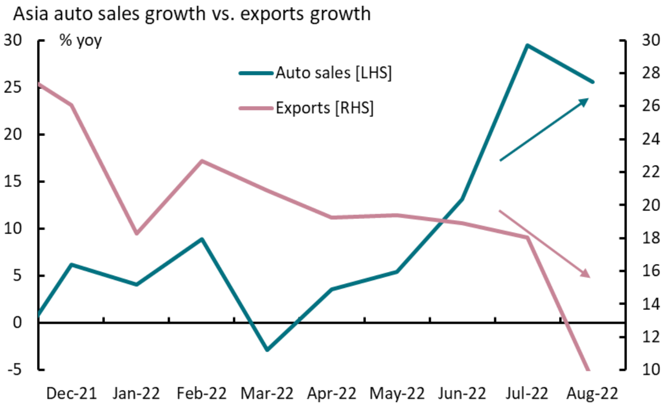
Key points

- Growth expected to soften on weakening exports and heightened external headwinds
- Most central banks to pause tightening from March next year due to falling inflation and weaker growth
- Escalation of geopolitical tensions remains a risk, exacerbating already vulnerable external positions

A weakening growth outlook

Slowdown in developed market (DM) economies and China, coupled with tightening global monetary conditions, have created headwinds for the economic recovery in Asia in 2022. Meanwhile, domestic consumption and services recovered strongly throughout the year following the easing of COVID-19-related restrictions and border reopening (Exhibit 1). Export momentum is set to weaken further in 2023 as reduced DM demand is expected to be only partially offset by a modest recovery from China. This will pressure the export-dependent economies of the region, including South Korea, Taiwan and Singapore. However, commodity exporters such as Indonesia and Malaysia should still benefit from elevated energy and raw material prices. In contrast, domestic-oriented economies may prove more resilient, thanks to a further recovery in consumption and services activity. Overall, we forecast economic growth for Asia ex. China to moderate to 4.5% from 5.2% this year before edging up to 4.8% in 2024.

Exhibit 1: Growth anchor has shifted away from exports



Source: CEIC and AXA IM Research, 18 November 2022

We expect domestic activity to drive the region's growth in 2023. Recent data has pointed to a strong growth rebound in private consumption, which we think will continue, albeit more gradually. Unemployment rates have fallen from the peak and border reopening has brought tourists back to the region. Despite the continued absence of Chinese visitors, exports of services should provide a growing tailwind for economies that rely on tourism.

Goods exports have softened this year, but by less than feared, thanks to strong demand for lower-end chips and commodity exports from a few resource-producing nations. However, export growth will come under further pressure as developed economies enter recession. In addition, external positions have deteriorated for some, with a widening of current account deficits in India, Philippines and Thailand. Currencies have also depreciated sharply against the dollar, prompting central banks to intervene to defend their exchange rates, which ends up eroding currency reserve buffers. These external vulnerabilities, if prolonged, could affect the operation of domestic policies, complicating the growth and inflation outlook.

Monetary tightening approaching an end

Price pressure is also rising. This has prompted concerns and talks about potential disruptive monetary policy tightening across Asia. While we believe there are plenty of upside risks to inflation in the near term, most central banks are unlikely to react aggressively.

From a policy standpoint, a gradual easing of inflation and slowing economic growth should limit the extent of further monetary policy tightening. In our base-case scenario, most Asian central banks are expected to press pause from March 2023, barring a major surprise from the Federal Reserve (Fed). Meanwhile, fiscal consolidation is expected to proceed cautiously, as authorities exit from the generous policy support provided during the pandemic. Such gradualism is warranted as economies slow and growth risks bias to the downside.

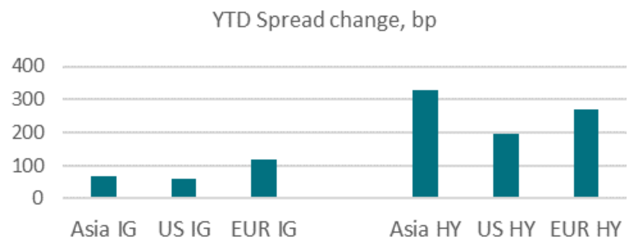
Thailand and India face general and state elections respectively in 2023. In general, we expect policy continuity with the governments continuing to pursue economic re-opening to recoup the losses from the pandemic. However, a further escalation of geopolitical tensions globally could lead to higher commodity prices and risk aversion, posing a risk to Asia's already fraying external position.

Asian Credit – 2023, time to think positively?

By James Veneau, Christy Lee, Honyu Fung, Celine Fong

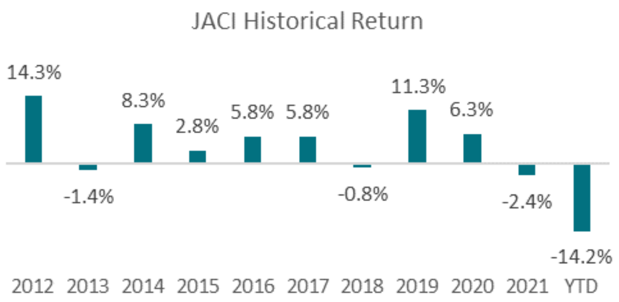
Key points

- Inflation may be peaking, and while market uncertainty and fundamental challenges abound, the case for a market recovery is improving
- China may be preparing to reopen
- China property developers may have reached bottom
- With performance expectations turning positive, alpha focus begin to turn from defense back to offense



Source: AXA IM, Morgan Stanley, as of November 2022.

After keeping interest rates anchored near zero since the beginning of COVID, the world entered a hiking cycle in 2022. Given persistent inflation and geopolitical dynamics, as well as the slowdown in China, Asian credit had a challenging year. Year-to-date (YTD) (as of Nov 21), the JP Morgan Asia Credit Index (JACI) dropped 14.2%, mainly impacted by higher US treasury yields (-9.3%). Asian high yield (HY) (-24.60%) significantly underperformed Asian investment grade (IG) (-11.98%) due to China property distress and volatility in HY sovereigns.



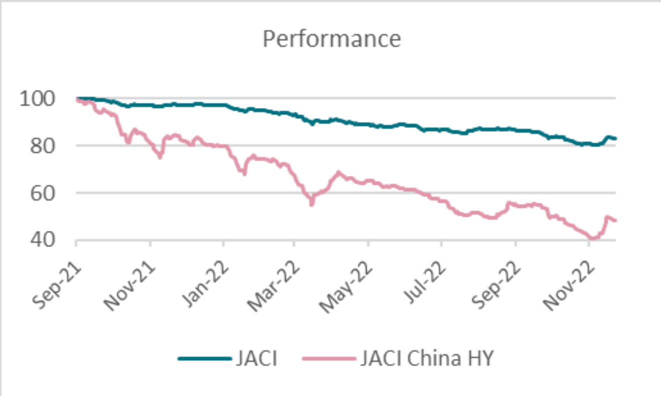
Source: AXA IM, Bloomberg, as of Nov 21, 2022.

Despite these challenges, Asian IG is still quite resilient compared with its global peers – its spread widening of 66bp YTD is only slightly higher than US IG. By contrast, Asian HY is one of the worst-performing markets.

Sustainable recovery in sight – or at least a more stable bottom

China announced a broad-based relaxation of COVID measures in early November – taken as possible indications of an easing in its zero-COVID policy. The challenge continues to be dealing with the inevitable consequence of escalating infections as administrative controls are relaxed. While the markets may look to an eventual reopening in 2023, we think the path to recovery may be slow and subject to setbacks. For now, local COVID measures are still tight given quarantines and PCR testing requirements, while case numbers are surging. Recent sharp market rallies will now be tested by closer scrutiny of policy adjustments and the rapidly evolving macro and geopolitical environments.

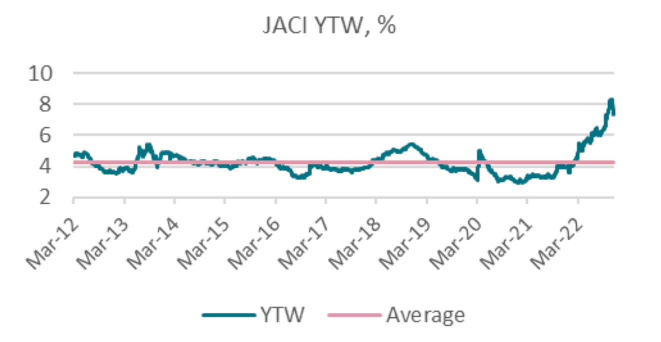
The percentage of China property in our universe (JACI) was 12% as of the end of 2020, and 8.7% when we wrote our outlook in November 2021.Today, it has dropped to 3.4%. Over the year we have seen several rounds of market rallies right after various leadership forward-guided the market with "vows" of policy support. Some of the rallies have been sentiment driven, some more technically led. Eventually, we believe the market will return to a fundamental focus. On 13 November, China issued a package of 16 measures intending to provide financial support to stabilize the property sector. Despite these seemingly extensive measures, some uncertainties remain. Firstly, will the economy recover under the latest, looser zero-COVID policy? Secondly, will sales recover sustainably (so far China has yet to find a more reliable solution to reboot housing demand)? And lastly, public bond funding channels remain closed for POE developers, which need access on a consistent basis – we therefore remain cautious and will further monitor the execution of the policies.



Source: AXA IM, Bloomberg, as of Nov 21, 2022.

Attractive entry points for safe carry

The market has already priced in a 4-5% peak in the Fed Funds rate for the end of 1Q2023. There are also signs that inflation is starting to trend lower. In our view, a stable US rates environment is key for Asian credits to perform consistently. Our strongest conviction is on short duration positioning given the currently inverted yield curve. Short-term US treasury yields reflect the expected peak in central bank rates, while the long end can remain volatile depending on upcoming data releases in the US. JACI spreads have widened over 120bps since the start of the year (as of Nov 14), taking all-in yields to over 7.7%. We believe this offers an attractive entry point for Asian credits.



Source: AXA IM, Bloomberg, as of Nov 21, 2022.

Despite such supportive metrics, we are cognizant of the fact that inflation is still high and growth is slowing. The cost of high inflation may continue to negatively impact the macro environment, and the length of time that the Fed will keep rates at their peak is likely to remain data dependent. Hence, investor sentiment and companies' cashflows could remain under pressure in 2023. As such, we are not changing our cautious stance on HY going into next year, favouring IG instead. **Within IG, we prefer Singapore SOEs (state-owned enterprises)/ banks, Indonesian sovereign & quasi and China central SOEs.** Our caution extends to mid-tier Hong Kong banks (due to their exposure to China's property sector), Korean corporates (due to the recent liquidity crunch in the onshore bond market) and China POEs (private-owned enterprises, due to the domestic economic slowdown coupled with a potential for inflation concerns from pent-up reopening demand).

For HY, we expect there may be better entry levels in 2023 as a mild recession in the US could potentially result in the Fed cutting rates. Prior to that, Asian HY issuers could be exposed to high funding costs and the tight global liquidity conditions. As such, we prefer solid BB credits in the region with decent liquidity buffers and strong banking relationships to mitigate any near-term refinancing risk. In terms of sectors, we prefer Indian renewables, bank capital and Indonesian property bonds. By contrast, we remain cautious on China property and industrials (due to weak end-demand and falling contracted sales), as well as frontier sovereigns (given their deteriorating external positions). On Macau gaming, we will monitor the COVID situation and progress on the eventual opening in China, and await further details on the license renewal result before repositioning in the sector.

China onshore rates likely to head higher

We expect liquidity conditions for China SOEs to remain loose amid the domestic slowdown. In line with this, we remain constructive on solid China SOEs following the sell-off in US Treasuries and spreads. The onshore and offshore markets continued to diverge; the onshore market was kept depressed by the ample liquidity supplied by the PBOC in response to the property meltdown that threatened onshore stability on top of the already strict zero-COVID measures; and the offshore market surged on the back of central banks hiking interest rates to combat surging inflation. As a result, the large rate differentials that favoured the Chinese local onshore market over the developed markets before 2022 swung in favour of developed markets. With foreign investors unwinding their onshore bond positions, this helped weaken the renminbi as much as 15% by early November.

The onshore market is currently relatively unattractive as onshore rates are among the lowest globally and credit spreads continue to trade at very tight levels. Meanwhile, hard currency credit spread widening since April now offers better relative value compared with their onshore peers on both a currency unhedged as well as hedged basis. Looking to 2023, the forecast for onshore rates may be biased towards a rise despite a weak macroeconomic situation that would typically trigger monetary policy support.

We consider the government's recent actions to introduce flexibility on COVID controls and measures to support the property market as the beginning of policy adjustments to stabilize a weakening domestic economy. We expect further announcements of more substantial support in the coming months. Normally, monetary policy easing would be the most likely policy deployed, anchoring onshore rates near currently low levels. With the PBOC warning that inflationary pressures may rapidly emerge when the domestic economy reopens, this instead hints at the central bank's reluctance to maintain a dovish monetary policy. The market is therefore vulnerable to miscalculating the PBOCs policy intentions. Highlighting this risk, significant positions have built-up in onshore rates securities, while strong SOE credit bonds (often with considerable leverage) recently faced a liquidity squeeze as the "reopening" trade saw considerable repositioning out of bonds and into risk assets. This resulted in a quick intervention by the PBOC to inject liquidity to stabilize rates, but we are wary of the PBOC's priorities in light of competing (and difficult) market conditions. If a reopening-driven recovery does ensue in 2023, onshore rates make may steadily rise during the year, resulting in lower bond prices, mark to market losses for investors and the narrowing of interest rate differentials with developed market rates.

Note:

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Asian Equities – A re-emerging growth story

By Simon Weston, William Chuang, Natalia Mu

Key points

- Optimism slowly returning in Asian ex Japan equities amid emerging signs of policy support in China for growth and reopening
- Mixed reional prospects demand a selective approach by investors
- Despite a volatile outlook, risk appetite is likely to return, and momentum quickly build, as global headwinds recede

Source: Bloomberg, Refinitiv Eikon, JP Morgan Research, AXA IM

China policy shift sparks optimism

Asia ex Japan equity markets have been on a downward trajectory for two years, with macro challenges in China, in particular, the main drag over the past 12 months. A rising rate environment globally and strong US dollar – the other key headwinds – look likely to persist in 2023.

However, there are early signs of positive developments in China around both COVID policy and property sector support, though further policy shifts will be necessary for growth outlook and confidence to improve in China equities. However, any rebound in confidence in China will also be a positive driver for the rest of the region.

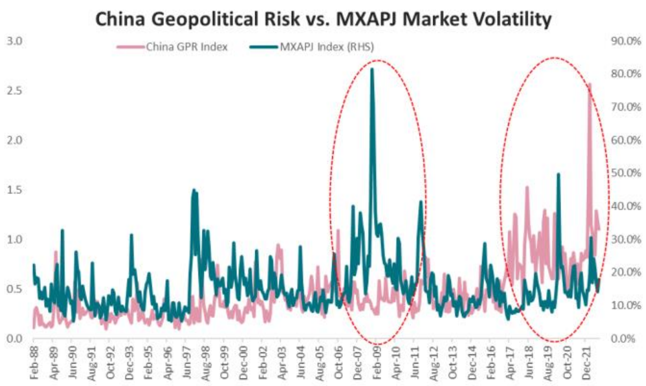
Source: Bloomberg, AXA IM

Ready for a boost in China

Chinese and Hong Kong equities have reached record low valuations (even beyond Asian financial crisis levels) and whilst there may be further volatility ahead, a lot of the negative news seems to be already in the price. China's strict zero-COVID policy and lockdowns have been a key issue, and many investors were waiting for re-opening policies following the 20th Party Congress. However, we had limited expectations that the Congress would be the definitive turning point in terms of zero-COVID policy as vaccination rates for the elderly population remain low. That said, it was encouraging to see China's National Health Commission release 20 measures aiming to fine-tune current zero-COVID policy shortly after the first meeting of the new Politburo Standing Committee. This is a clear signal that the top decision makers in Beijing can be flexible. Hence, we expect to see easing in a gradual manner from next year.

More broadly, whilst foreign investors viewed the political outcomes and lack of re-opening from the Party Congress in a negative light, it's important to note that the Chinese government has been vocal in supporting growth and topics such as more stringent regulation or anti-monopoly were not brought up. Following the Party Congress, the government announced comprehensive support measures aimed at stabilizing the property sector, which is a key pillar of the economy and a sector that has struggled over the past year. Furthermore, with the Congress completed and key government roles in place, we expect more meaningful policy tunings to come in 2023.

US-China relations is an area where investors have been cautious about since 2018. Whilst there has been no real change from the policy direction since the Trump government, presidents Biden and Xi appear to have adopted a more conciliatory stance given recent remarks. The easing of US-China political tensions could provide an added boost to Chinese equities in 2023, led by a rebound in the technology sector.



Source: Bloomberg, Caldara, Dario and Matteo Iacoviello, AXA IM

Regional divide: South trumps North

Elsewhere in Asia, the export driven economies such as Taiwan and Korea have underperformed due to the expected global slowdown, whilst geopolitical risk has further dampened sentiment in Taiwan. Export growth is likely to continue to decelerate for next year on weaker demand given the softer global backdrop. Due to the importance of the Tech sector, Taiwan has been particularly impacted by slowdown in demand. However, industry heavyweight TSMC has continued to report strong sales even whilst the share price appears near trough levels.

India and ASEAN markets have been the stronger performers within the region due to their tilt towards domestic driven demand. India has been a beneficiary of the flow out of China even as the underlying fundamentals are not so robust given slowing economic growth, twin deficits, and potential for currency pressure. Whilst India has always been an expensive market, MSCI India's valuation premium to the MSCI Emerging Markets index has reached a historical high (over 2 standard deviations for 12M fwd PE) and we expect the upside could be limited in the medium term.

Equity returns finally on the horizon again

As we head into 2023, we believe Asian equity markets will likely see continued volatility in the near term as inflation remains elevated and the US Federal Reserve (Fed) is expected to tighten further into early 2023.

However, Asian equity returns may shift towards growth once the market believes the Fed has stopped hiking. The other important indicator will be any clearer signals that China is moving away from its zero-COVID policy. Given that the current vaccination rate amongst the elderly population remains low and with domestic mRNA vaccines still under development, we expect meaningful progress towards re-opening will likely not happen before 2H 2023. However, given the extent of decline and the de-risking in Chinese/Hong Kong equities, any indication of improving momentum could trigger a healthy rebound in the market.

Lastly, whilst foreign investors have been de-risking in Asia, retail investors have been buyers of equities. Foreign risk appetite could return as the global macro backdrop gradually improves next year. China's reopening could drive net foreign inflows into the region, given the currently large underweight positioning in the market.

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