The Way We See It

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INSIDE THIS ISSUE

Economic and Investment 2023 Outlook : Selective Opportunities in a Continuing Uncertain Macroeconomic Backdrop

Executive Summary

The year 2022 marked a reversal of many positive and market-friendly trends in the global economy and financial markets which prevailed in the two preceding years. Inflation and interest rates rose sharply, putting pressure on corporate earnings and all risky assets. Starting with an exuberant sentiment and a fully-invested positioning in risky assets in December 2021, investors are now underweighted. Fear and uncertainty dominate investors' sentiment as we approach the end of 2022.

In the year ahead, the big question in investors' mind is whether the US and G7 economies will fall in a recession (and how deep), and whether inflation will rise at a noticeably lower rate to motivate the US Fed to pivot from tightening to pausing, and possibly cutting interest rates late in the second half. The second key issue is whether China will truly relax its Zero-Covid policy and implement expansionary policies to grow its economy. The third issue revolves around the more difficult-to-predict geopolitical tensions between Russia and Ukraine, and how this could continue to impact on global energy and food prices.

What does this mean for financial markets? From a low sentiment and positioning in risky assets, will the above backdrop lead to a more solid performance in equities and bonds next year ? Or will the above potential positive and negative factors keep markets volatile, resulting in a wide trading range ?

Lastly, how will the above backdrop translate into investment strategy? In our Outlook 2022 document published at the end of of 2021, GOJI recommended to take profits in overvalued Technology and equity markets, and overweight defensive assets. Our investment strategy in 2023 is to adopt a more opportunistic approach to gradually raise exposure to risky assets, but to be mindful of the entry price levels.

GOJI: Turning from a defensive stance to a cautiously opportunistic approach.

Review of 2022

- Global Economy

There are two contrasting trends in the world economy in 2022 : a) following a strong post-lockdown 2021 year, economic growth (a coincident indicator) slowed noticeably in 2022; b) inflation (a lagging indicator), on the other hand, continued to rise. This forced the US Fed and many other central banks to raise short-term interest rates aggressively and quickly. Among major economies, only China did not, as they already tightened early in 2021, and that their economic growth slowed visibly in 2022 (zero-Covid restrictions, long lockdowns, property sector's woes).

The inflation trend (both headline and core) in the US and other economies in the OECD bloc was particularly high because they were affected by both structural and cyclical factors. Cyclical factors include the high pent-up demand for goods and services, post the lockdown period, which suffer from supply bottlenecks and shortages. Structural ones include firstly the continuing war and geopolitical tensions between Russia and Ukraine which pushed up energy and food prices; secondly the unwillingness of low-skilled workers in the OECD bloc to immediately return to their old jobs (after receiving massive subsidies from their respective governments), as well as the slowness of immigrant workers to go back to their previous host nations (after being ordered to go home). The end result is that not only energy and food prices rose substantially, wages in the OECD bloc also gained to partially compensate for workers' higher cost of living. At the time of writing, while oil and a few other goods' prices have eased off somewhat, the underlying inflation trend remained too high to enable central banks to pause or cut rates.

On currencies, boosted by the aggressive tightening of the US Fed and investors' preference for a defensive investment strategy, the US dollar was very strong against all other currencies.

Looking back through the tumultuous year, we were pleasantly surprised that, despite a significant jump in global interest rates, a slump in the value of risky assets and a strong US dollar, there have not been more countries falling in a recession, more debt crises in the Emerging universe, or more financial crises in the US and elsewhere in the OECD bloc. Thus the question whether these potential problems will show up in 2023?

- Global Markets

With the exception of USD cash, all risky asset classes fell over the year to November 2022. Long-dated government bonds were not spared, as inflation concerns and the aggressive Fed tightening (rate

as at 30/11/2022

Asset Class	US Equities	Global Equities	GEM Equities
Index	MSCI USA	MSCI World	MSCI EM
1 month	5.44%	7.00%	14.85%
3 months	3.26%	4.10%	-1.70%
YTD	-14.43%	-14.12%	-18.64%

Asset Class	US Corporate	US Treasury	US Aggregate
Index	Bloomberg US Corporate	Bloomberg US Treasury	Bloomberg US Agg
1 month	5.18%	2.68%	3.68%
3 months	-1.38%	-2.25%	-2.09%
YTD	-15.39%	-12.01%	-12.62%

Asset Class	Global Govt Bonds	Global Aggregate	Global Commodities
Index	Bloomberg Global TSY	Bloomberg Global Agg	CBR
1 month	4.79%	4.71%	2.05%
3 months	-1.37%	-1.36%	-3.67%
YTD	-18.06%	-16.70%	2.05%

Asset Class	Asia ex Japan Equities	China Offshore	China A
Index	MSCI AC AxJ	MSCI China	MSCI China A Onshore
1 month	18.82%	29.72%	10.97%
3 months	-2.62%	-7.78%	-7.89%
YTD	-19.24%	-25.67%	-28.38%

Source: GOJI, MSCI, Bloomberg

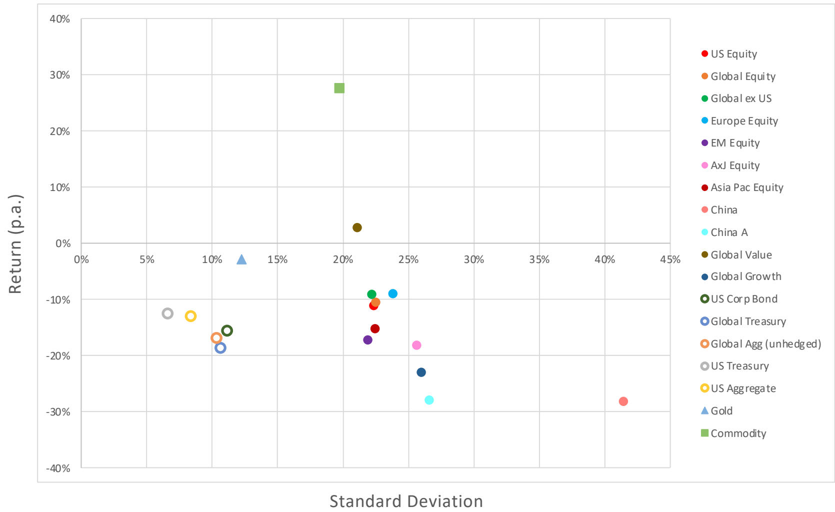
All asset classes fell YTD, except USD cash (and Commodities).

hikes plus quantitative tightening) impacted adversely on the value of this (normally-safest) asset class.

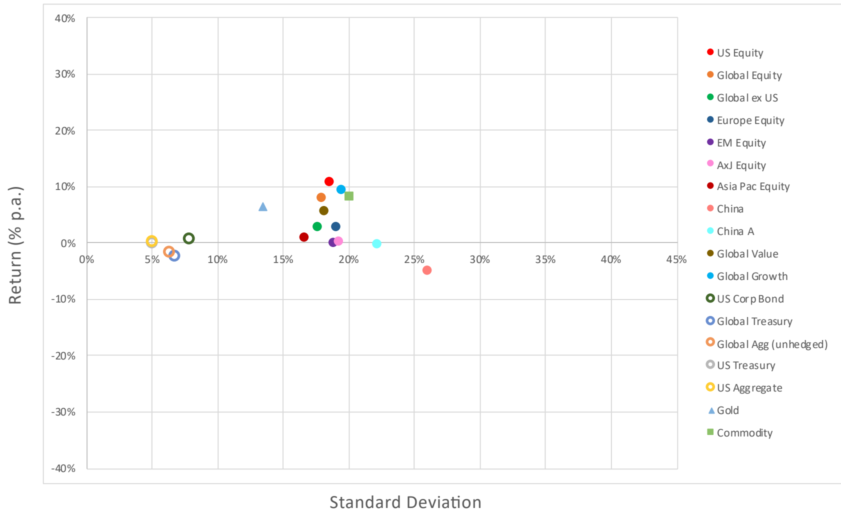
In addition, the volatility of risky asset returns was high in 2022. Shocked investors (fundamental or quant-driven) had to scramble to liquidate some or all the exposure of bonds and equities, all at the same time. Below, for comparison purposes, we show the short- and medium-term risk-return quadrants of key asset classes.

Short-term volatility of most asset classes spiked up from their medium-term average.

1-year Risk-and-Return



5-year Risk-and-Return



Source: GOJI, MSCI, Bloomberg; data as of 30/11/2022

In brief, unless an investor can move into USD cash or place bets as a macro hedge fund investor (shorting bonds and equities, and going long energy), 2022 has been a very challenging year for all. As a result, the latest surveys of investors' sentiment and equity positioning point to a rather prudent or outright bearish stance adopted by the average US and global investor.

Please refer to the "Outlook for 2023 - Global Markets" section for selective charts which show investors' current positioning.

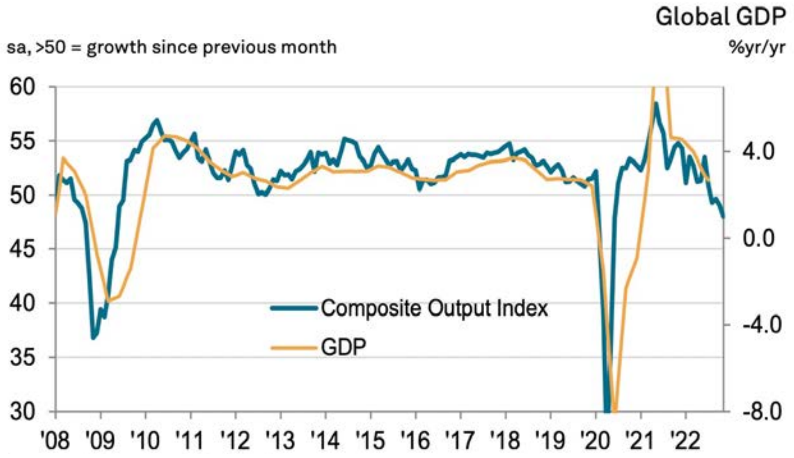
Outlook for 2023

- Global Economy

First, let us look at economic growth. There is little doubt that major economies are either going to grow rather sluggishly in coming months (US, China and other Asia Pacific nations); or are not expected to grow at all; or, worse, that they already entered a mild recession (Europe, U.K., and other heavily indebted and non-energy-producing Emerging nations). Understandably, this is the consequence of high energy and food prices, negative real wages growth, un-coordinated reopening (West vs China/Japan), declining trade flows, rising interest rates, hesitant consumers and businesses, and long periods of lockdown across China.

Sluggish or no growth ahead; mild recession for some countries.

J.P.Morgan Global Composite Output Index



Source: J.P.Morgan, S&P Global

We include a summary table of key macroeconomic indicators on the next page.

Morgan Stanley forecast vs Consensus

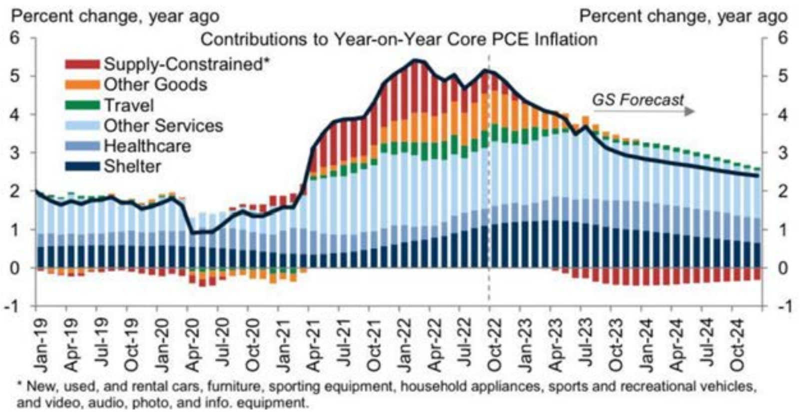
GDP (%Y)	2022	2023E MS	2023E Cons	2024E MS	2024E Cons
Global	**3.0**	**2.2**	**2.4**	**2.7**	**3.0**
G10	**2.6**	**0.3**	**0.3**	**1.1**	**1.5**
US	1.9	0.5	0.2	0.9	1.5
Euro Area	3.3	-0.2	-0.1	0.9	1.6
Japan	1.5	1.2	1.3	1.6	1.1
UK	4.4	-1.5	-0.8	0.5	0.9
EM	**3.3**	**3.7**	**3.9**	**3.9**	**4.1**
China	3.2	5.0	4.9	4.4	4.8
India	6.8	6.2	7.0	6.4	5.9
Brazil	2.8	1.2	0.6	1.5	1.7
CPI (%Y)					
Global*	**8.1**	**5.4**	**5.9**	**3.8**	**3.2**
G10	**7.6**	**4.5**	**4.4**	**2.1**	**2.1**
US	8.1	3.3	3.9	2.1	2.3
Euro Area	8.6	6.3	5.6	2.2	2.0
Japan	2.3	1.0	1.9	1.6	1.3
UK	9.0	8.3	6.9	2.1	2.3
EM*	**8.5**	**6.2**	**7.0**	**5.1**	**4.0**
China	2.1	2.1	2.4	1.7	2.2
India	6.7	5.4	6.2	5.0	5.1
Brazil	9.3	3.9	5.0	3.7	3.4
Policy Rates (eop)					
G4					
US	4.375	4.375	4.25	2.375	4.25
Euro Area	2.00	2.50	2.35	2.00	2.35
Japan	-0.10	-0.10	0.00	-0.10	0.00
UK	3.50	4.00	3.88	2.50	3.88
BRIC					
China	2.00	2.00	n/a	2.00	n/a
India	6.25	6.25	6.29	6.00	6.29
Brazil	13.75	11.00	10.63	8.50	10.63

Source: Morgan Stanley

In brief, it is quite plausible that the world economy will continue to show little real growth or a mild recession in the first half of 2023. In addition, the global growth picture could be complicated by potential financial crises caused by the fast rising U.S. Fed Fund rate and the very strong US Dollar: financial difficulties could emanate either from the indebted parts of the Emerging world, or other leveraged sectors in the US and/or other OECD countries. Lastly, on the positive side of the global economic ledger, assuming that China will continue to loosen their restrictive Covid measures and focus on their domestic economy, it is likely to boost trade flows with other Asian/Emerging and all other trading partners.

Second, let us address the inflation and interest rates concerns. Needless to say, the recent fall in energy and other goods prices (including used cars, houses, bulk carrier transport costs, etc.) is good news for inflation watchers. This has helped to slow down the rate of rise of headline inflation in the OECD bloc. At the core level (excluding energy and food), however, the good news are not yet visible. Wages and housing rentals, key lagging core inflation indicators, remain sticky and high. The latter are only expected to show a deceleration in their growth towards the end of 2023 and into 2024.

Core PCE Inflation Will Likely Decline to 2.9% by End-2023on Goods Disinflation and Slower Shelter Inflation in H2



Source: Goldman Sachs Global Investment Research

In brief, next year, we can expect a deceleration of the rate of increase in both headline and core inflation data in the US and other OECD countries. However both are likely to remain on the high side, compared to the average inflation rate of the past decade.

Expect headline and core inflation data to decelerate but remain high in 2023.

This therefore means that one can expect more rate hikes in the US and elsewhere amongst other OECD countries in H1 '23, or more precisely, Q1. It would only be around the middle part of the year that one can expect a pause in the Fed's monetary policy. Currently, as we do not predict a deep recession or a massive financial crisis to develop in the US or Europe, it is our belief that one should not expect the Fed or other OECD central banks to cut rates in 2023. It's more a late 2023 or 2024 story.

Third, let us discuss the direction of the US Dollar versus global currencies. It is clear that the acceleration of the rise of the USD is over, as the Fed has announced that they are close to achieving their restrictive monetary stance by around mid-year next year. Thus, instead of +75bps hikes, +50 or +25 bps moves are more likely, going forward. In addition, the USD is well owned by almost everybody. A very crowded position makes the USD very expensive. Lastly, led by China, as Asian and Emerging countries are expected to stage a solid recovery from the middle of next year onwards, this would be positive for their currencies.

Solid recovery of Asian and EM economies in H2 ‘23 and supportive of their currencies.

The chart below shows how cheap the Yen has become relative to the US Dollar. The same can be said about the valuation status of many EM and other OECD currencies vs the USD.

The Yen Is Very Cheap on PPP

Source: Credit Suisse

In summary, as far as the global economy is concerned, we believe that growth will not be very exciting next year. Inflation will remain an issue, but is expected to decelerate, which will allow G7 central banks to pause from around mid-year onwards. The USD is likely to lose some of its lustre when the Fed pauses, particularly at a time when China and other countries are likely to show a stronger relative growth trend.

- Global Markets

The base case of GOJI's global economic outlook emphasises sub-par moderate economic growth, high but decelerating inflation, higher cash rates in H1 and then a pause, and a mild decline in the USD in H2.

GOJI's base case 2023:
- sub-par growth
- decelerating inflation
- pause in rate hikes
- mild decline in USD

(i) Equities

The above macro backdrop suggests to us that the base case of global equity markets is likely to see continuing volatility, with stocks trading in a fairly wide range. At the time of writing (@14th December), we predict that the leading global equity index, the S&P 500, is not likely to make new highs, nor will it fall too much. In numerical terms, it will likely trade between 3,200 and 4,500. To illustrate, the table below shows the implied valuations of the S&P 500, based on the current price of 3,934, with varying EPS growth and P/E ratios assumptions.

Equities to remain volatile and trade in wider range.

S&P 500 Price Sensitivity to EPS and P/E Valuation

Forward P/E			2023 EPS scenarios: Consensus	GS baseline	GS recession
	Growth vs. 2022		*$231* *(+4%)*	*$224* *(+0%)*	*$200* *(-11%)*
		19x	4400	4250	3800
	Current	**18x**	4150	4050	3600
		17x	3950	3800	3400
		16x	3700	3600	3200
		15x	3450	3350	3000
		14x	3250	3150	2800
	Mar. '20	**13x**	3000	2900	2600
		12x	2800	2700	2400

Source: Goldman Sachs

Based on the consensus IBES analysts' earnings forecast of +4% in 2023, the S&P 500 currently trades at a P/E of 17X. Should this prove to be too optimistic and that earnings were to decline by around 11% as a result of a mild US / OECD recession, then, at 17X P/E, the S&P 500 would trade at 3,400. As things change quickly in the US and around the world, we will update our clients if and when we change our mind on our investment base case. In addition, should there be an unexpected and significant financial crisis in the US which requires the Fed's intervention, then the S&P 500 can fall lower towards 3,200. Conversely, should the Fed decide to cut rates significantly to prevent the US economy falling in a deep recession, the S&P 500 can rally towards 4,500.

Another analysis of the US market's performance around a recession event may be of interest to our clients.

US Stock Market Returns Before/During/After Recessions (1950-2022)

Recession Start	Recession End	Length of Recession (months)	Market Bottom During The Recession?	US Stock Returns				
				12 Months BEFORE	6 months BEFORE	DURING Recession	6 Months AFTER	12 Months AFTER
Aug 1953	May 1954	10	Yes	-3%	-6%	18%	17%	30%
Sep 1957	Apr 1958	8	Yes	-5%	5%	-4%	18%	33%
May 1960	Feb 1961	10	Yes	-6%	-5%	17%	7%	10%
Jan 1970	Nov 1970	11	Yes	-11%	-6%	-5%	14%	8%
Dec 1973	Mar 1975	16	Yes	-18%	-9%	-13%	1%	23%
Feb 1980	Jul 1980	6	Yes	14%	10%	7%	6%	8%
Aug 1981	Nov 1982	16	Yes	8%	1%	6%	-19%	20%
Aug 1990	Mar 1991	8	Yes	3%	8%	5%	3%	8%
Apr 2001	Nov 2001	8	No	-23%	-19%	-2%	-6%	-18%
Jan 2008	Jun 2009	18	Yes	4%	-2%	-37%	21%	12%
Mar 2020	Apr 2020	2	Yes	6%	1%	-1%	12%	44%
Average		**10**		**-3%**	**-2%**	**-1%**	**7%**	**16%**

Source: SAXO Markets

The above clearly shows that the market performance around each recession is quite different. Having said that, assuming that a mild classical recession amongst the G7 nations could occur next year, one observes that equities has tended to bottom half-way through the recession, and then bounced strongly subsequently (as their central banks will cut rates and inject liquidity in the system).

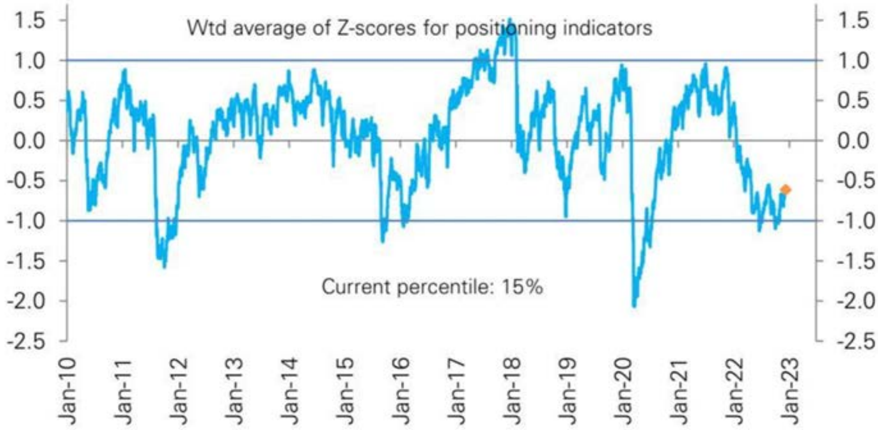
How are investors currently positioned in equities? The brief answer is: underweight and bearish (refer to the four charts in the following pages). Both fundamental (discretionary) and quant-driven (systematics) appear to remain very underweight, even after both have modestly added over the past few weeks. What this means is that when our set of key investment factors turns positive, there could be a massive pent-up demand for equities from both types of investors.

Discretionary vs Systematic Strategies Divide

*Wtd average of Z-scores for positioning indicators, weights based on explanatory power in regression of equity performance on indicators

Source: CFTC, Bloomberg Finance LP, Haver, Deutsche Bank Asset Allocation

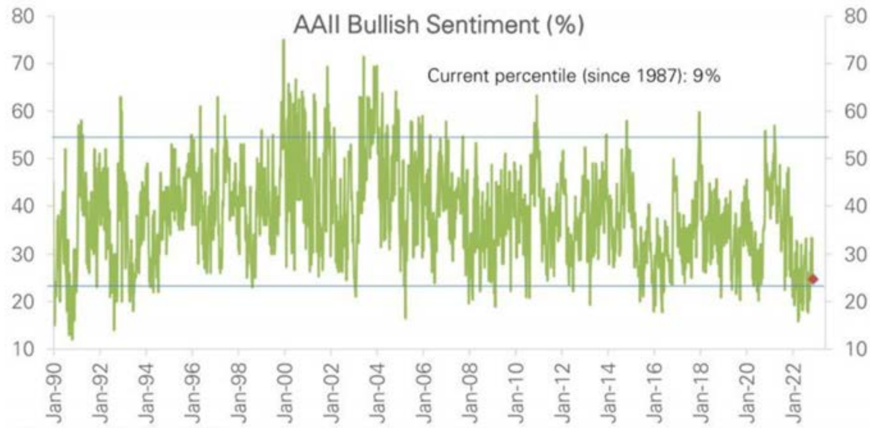
Consolidated Equity Positioning



*Weights based on explanatory power in regression of equity performance on indicators

Source: CFTC, Bloomberg Finance LP, Haver, Deutsche Bank Asset Allocation

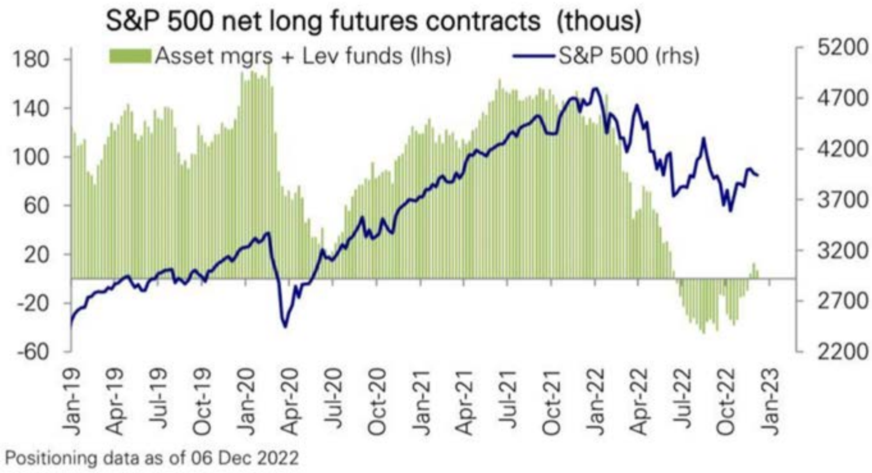
Investor Bullish Sentiment



Data as of 07-Dec-2022

Source: Deutsche Bank Asset Allocation, Barron's, Haver

S&P 500 Futures Positioning



Source: Deutsche Bank Asset Allocation, CFTC, Haver

As far as GOJI's view on whether the US market will continue to lead next year, we think not. We believe that the probability of the Chinese government boosting their domestic economy in 2023 is high: there is little doubt that they will gradually reopen and relax their monetary and fiscal policies a little in order to kick-start their domestic economy. Consequently, one can expect more corporate earnings upgrades in HK and China than anywhere else. Combined with a relatively low current valuation, Chinese equities is likely to outperform next year.

(ii) Bonds

Based on our macroeconomic base case, we believe that government and investment grade corporate bonds are likely to have a less volatile and a modestly positive return year in 2023. The risks to this scenario include an unexpected burst of existing or new inflation sources, or a much more solid US domestic economy than we predicted, which thus may force the Fed to tighten further. Conversely, should there be a significant financial crisis which requires intervention by the Fed, then the safe-haven status of Treasuries will come into play.

Govies and IG Corp to yield modest return.

From an investor's positioning viewpoint, it appears that investors are still underweight long-dated bonds.

10Y Bond Futures vs 10Y Yield

Source: Deutsche Bank Asset Allocation, CFTC, Haver

We estimate the expected trading range of the US 10-year Treasury bond yield, at the time of writing, will likely be 2.75% to 4% pa.

In terms of which sub-asset class within the fixed income sector will outperform in 2023, on a risk-adjusted basis, we believe that the potential returns of investment grade corporate bonds will be superior to those of their high-yield counterparts. The latter is correlated with equities, which we expect to continue to trade within a wide range.

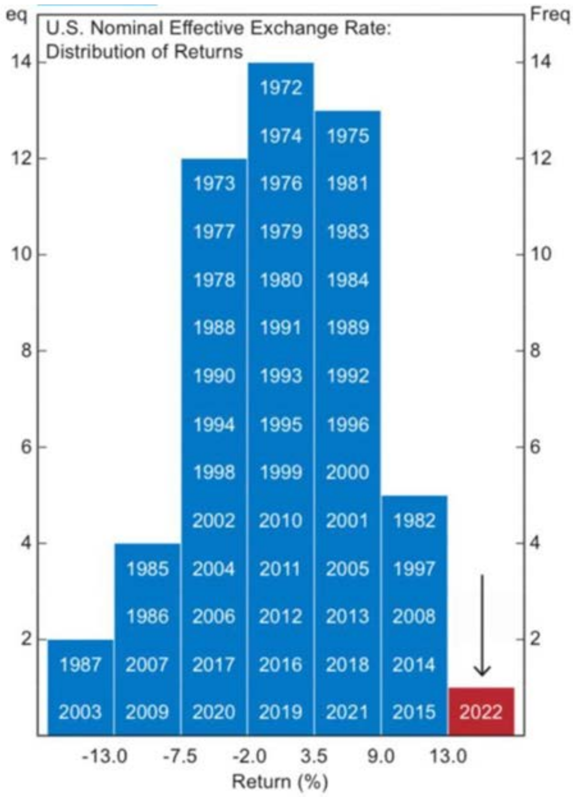
(iii) USD vs Other Currencies

2023 is unlikely to see the USD remaining the strongest currency in the world. At the same time, neither are we predicting its collapse. The most likely scenario is for the USD to trade within a range, with a downward bias later in the year. One notes its extraordinary outperformance and overvaluation over the past 18 months. In addition, it remains an overweight in most investors' portfolios.

Strong USD to plateau with a downward bias in late 2023.

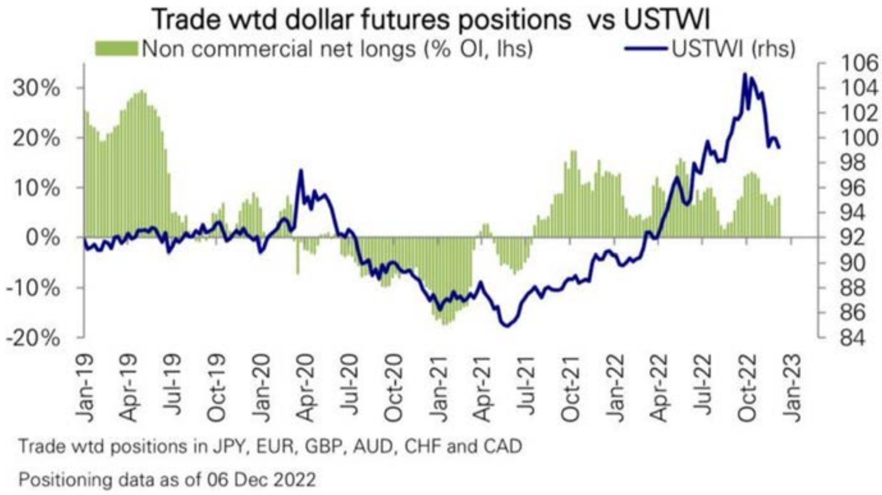
The charts on the next page illustrates this point.

2022 Is One For The Record Book



Source: Alpine Macro, Deutsche Bank

US Trade Weighted Dollar Positioning



Source: Deutsche Bank Asset Allocation, CFTC, Haver

While we would not discount the possibility of the USD returning to its 2022 high, we expect it to underperform the RMB and other Emerging and commodities-linked currencies in the second half, particularly when the Fed announce a pause.

As far as over OECD currencies are concerned, since we do not forecast any strong revival in their economies, we think that they will trade within a fairly narrow range vs the USD. The Fed pause, when it comes, could give the former a modest upward boost.

(iv) Commodities

This asset class will be influenced principally by the direction of the USD, China's return to a solid growth path (or not), and (difficult-to-forecast) geopolitical tensions in Russia, China and Taiwan. Based on our macroeconomic base case, since global growth is not expected to surprise on the upside, it appears that commodity prices will be subject to the other two above-mentioned factors, together with their own dynamic supply-demand characteristics.

Commodities to be influenced by direction of USD and geopolitical tensions.

Indicatively, we prefer base metals, coal and iron ore, and gold to energy.

The Way We See It

Investment Strategy

Based on our macroeconomic base case and our projected outlook of key global asset classes, we would suggest that clients should continue to adopt a relatively prudent strategy (which we recommended since November 2021), particularly in the first half of next year.

GOJI: prudent strategy remains, particularly in H1 2023.

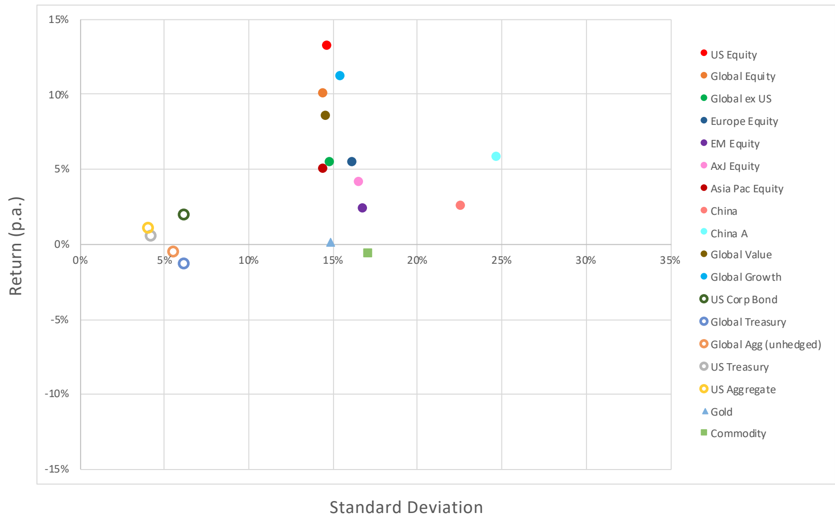
Quality, Low Beta and Defensive Yield should continue to outperform in the near future, until the Fed is perceived to be satisfied with their rate hike programme, and decide to pause. If this were to coincide with a visible and sustainable stronger growth trend in China, then the investment strategy should switch from the above platform to one which emphasises Cyclicality, Growth and High Beta.

From a geographical perspective, depending on their risk tolerance / budget and their current positioning vs benchmark, clients should be thinking of adding to HK/China and other Emerging Markets' exposure (via equities or local debt).

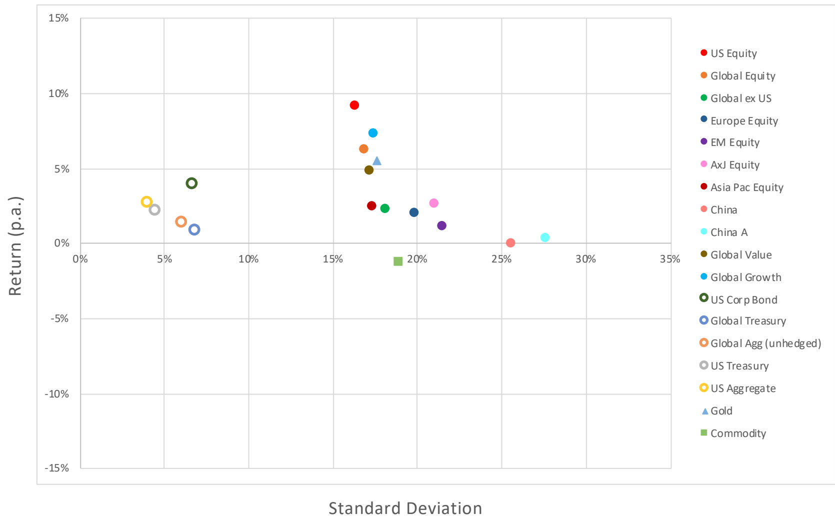
Opportunistic allocation subject to risk budget.

Before we finish the Outlook report, we think that it may be of some use to our long-term investor clients to look back at the long-term risk / return profile of key asset classes summarised in the charts below. Please note that these returns were achieved in the "artificial" 13-year period which was blessed by the ZIRP[1]/ QE "monetary experiment".

10-year Risk-and-Return



15-year Risk-and-Return



Source: GOJI, MSCI, Bloomberg; data as of 30/11/2022

In coming months, we will endeavour to publish and share with you GOJI's long-term forecasts of returns of equities and bonds. We forewarn that our own forecast will not be as optimistic as those recently published by number of large global investment banks.

GOJI's economic and investment rationale over the long term is simple: no ZIRP / QE anytime soon, ageing demographics, geopolitical tensions (US vs China, Russia vs others, China vs Taiwan, etc.), a higher underlying inflation rate, and a quality-, not quantity-driven GDP growth pattern in China and elsewhere in the world (climate control and ESG constraints to growth).

[1] ZIRP – Zero Interest Rate Policy

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