HEALTHIER, LONGER, BETTER LIVES

AIA Investments

“A Pivotal Year”

—— 2024 Global Market Outlook

EXECUTIVE SUMMARY

> **INVESTMENT OUTLOOK MAY START TO LOOK MORE POSITIVE AS THERE IS A HIGHER CHANCE THAT CENTRAL BANKS WILL GO INTO AN EASING DIRECTION IN 2024**
>
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2023 will end on a unique note – The Federal Reserve (Fed) has wrapped up the year with a significant shift in policy: from curbing inflation to balancing growth. We expect more central banks to follow suit. Higher-for-longer interest rate policy will no longer be the norm as policymakers become more cautious about the adverse effects of higher rates. It is now clear that Central Banks are weighing on to assess the appropriate time to start easing policy.

Price stability remains the top goal of the Fed, with a long-term inflation target of 2%. Post-COVID, inflationary pressure due to pent-up demand and energy disruption became the catalyst forcing major central banks to kickstart a series of aggressive monetary policy tightening. The Fed brought benchmark rates from nearly zero at the beginning of 2022 to an incredibly 17-year high at 5.5% by the second half of 2023. Surprisingly, the US economy managed to handle the eleven rate hikes without falling into a recession. The resilience provides the Fed more policy flexibility to fine-tuning interest rates to tame inflation, which dropped from its 42-year peak of 9.1% while balancing growth.

Source: AIA Investments

The ongoing market speculation about how long the economy can outperform expectations in a high-rate environment has persisted for a year. As we step into 2024, the economic scene is changing gears - shifting from battling inflation to protecting growth. On December 13, Federal Reserve Chairman Jerome Powell indicated that the tightening cycle is coming to an end (an acknowledgement that inflation is under control). Moving forward, investors will focus on the timing and pace of rate cut by the Fed. In a soft-landing scenario (our base case), any cut by the Fed is welcome and will be positive for equity. As of printing, futures market is pricing in the first cut by the Fed in 1Q24, with a total of 6 cuts throughout the year. We reckon the timing is relatively aggressive to our base line, but the easing direction is confirmed. By around the middle of the year, Fed should be looking at easing of policy (rate cut) which can be a boost for risk assets following the mild slowdown in economic activities.

In Europe, regional inflation kept going down close to the long-term targeted goal, which is enough to convince policymakers that the focus point should move away from defending price swelling. Eurozone registered a negative growth in the third quarter of 2023, coupled with decline in economic activities sentiment. Under the signs of impending weakness unfolding, the European Central Bank (ECB) faces an even tougher scenario to have to be one of the first central bankers to turn the policy stance (i.e cutting interest rates).

Over in Asia, Bank of Japan (BOJ) and People Bank of China (PBOC) will print quite different trajectories given the different economic momentums. BOJ will likely introduce a tightening direction with an end of negative rate in the coming year. While China needs to rebuild market confidence not only by conducting more easing monetary policies by PBOC, but also injecting massive and multisectoral fiscal stimulus – which continues to disappoint economists and investors.

Looking ahead, investment outlook may start to look more positive as there is a higher chance that central banks will go into an easing direction which will lower funding costs and increase asset prices.

Diversification into the different asset classes and deployment of idle cash will help to capture opportunities ahead. Within equities, Developed Market (DM) is expected to experience a more favourable outlook once the rate-cut roadmap becomes clear. Investment in global bond markets, typically treasury notes, will hold a fruitful year in 2024. Credits will benefit from improving funding conditions and strong fundamentals. Moreover, the weakening dollar will pave the way for ASEAN region to perform again but the overall Asia ex Japan region depends on the outlook of China to a larger extent.

Source: AIA Investments

GLOBAL MACRO – A DILEMMA OF CENTRAL BANKS

At the beginning of 2023, to defeat the rampant inflation without trapping economy into recession, central banks found themselves walking on a tightrope, trying to balance the conflicting demands of inflation control and economic growth.

Looking into 2024, a dilemma may lay ahead of us. As inflation readings ease off its peak, but still above targets from central banks, and that the last mile is usually harder and slower (sticky inflation), major central banks around the world will face a difficult situation in deciding their next move. Will they choose to continue the rate hike cycle and risk stifling economic growth, or will they continue to pause and risk inflation spiking back up?

Our view is that the Fed will begin to cut Fed fund rate starting from around the middle of 2024. We believe policymakers will not wait until a recession before stepping in to safeguard economic activities' growth. Recent economic data readings which indicate lower inflation, resilient employment have prompted the Fed to hold rates unchanged for the third straight time and pivot towards easing of policy in its December Federal Open Market Committee (FOMC) meeting.

Therefore, the Fed will not be in a hurry to start the easing (rate cut) cycle in the first half of 2024, as inflation will hold for a while. For example, price of services, which is a major component of the consumer price index, is unlikely to adjust significantly in the short term, and may affect the pace of decline in inflation. The introduction of clean and renewable energy helped to soften price pressure due to the global energy disruption.

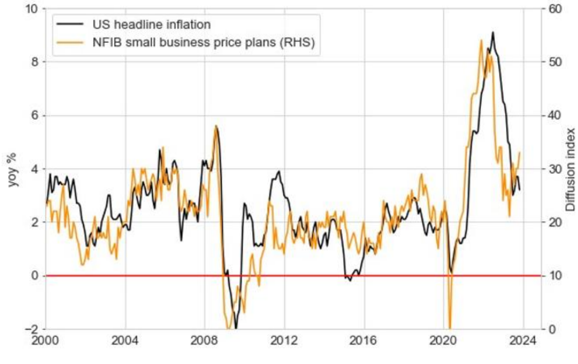
Going forward, we do not expect any rate cut at least till the summer of 2024. We believe a soft landing (and not a recession) is the more likely scenario. Current market pricing of first cut in 1Q24 is therefore too aggressive in our view.

Source: AIA Investments

Slower disinflation in the near term, amid sticky service prices

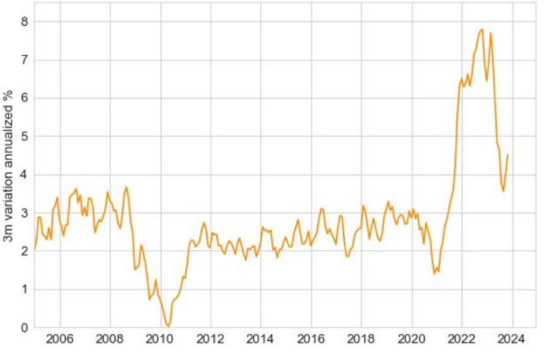
The Fed should maintain a restrictive bias until summer 2024

US inflation and small business price plans



Source: Bloomberg, AIA

US median CPI inflation



Source: Bloomberg, AIA

Meanwhile, the latest inflation rate in the eurozone declined faster than expected, which saw a 2.4% year-on-year drop in November. This is the lowest level in over two years, mainly contributed by the fast falling of Germany's inflation. This slowdown in inflation brings the European Central Bank (ECB)'s 2% inflation target back into clear focus for the first time since the summer of 2021, paving the way for a potential shift in its monetary policy stance.

Looking forward, the ECB may be one of the first central banks to cut their benchmark rate in 2024. The disinflationary trend will probably overlap with a slowdown in economic activity. Market has been pricing in the assumption that the ECB will consider a rate cut around 100 basis points (bps) and the first cut will be likely in the first quarter of 2024.

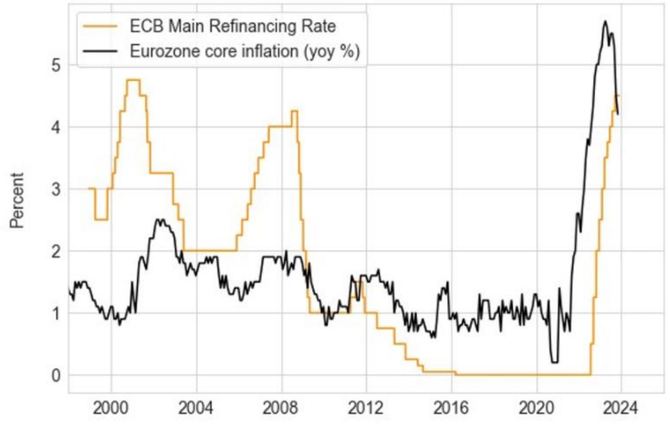
At the same time, the impending disinflation is a possible start demonstrating higher unemployment rate and lower corporate earnings. Therefore, any rate cut, which is taken as a counter measure by central banks to defend economy depression, would indicate that a recession or economic downturn is on its way, hurting corporate profitability via shrinking economic activities.

Source: AIA Investments

The Eurozone is at a standstill, if not already in recession

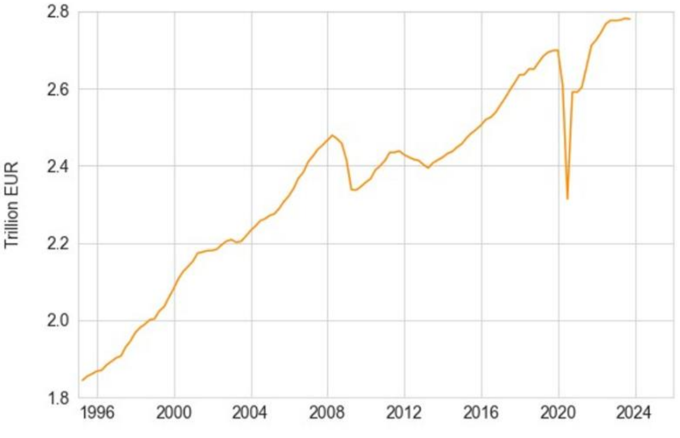
The ECB could be one of the first central banks to cut policy rates in 2024

Eurozone policy rate and inflation



Source: Bloomberg, AIA

Eurozone GDP



Source: Bloomberg, AIA

CHINA – BET ON FISCAL STIMULUS VS. ASEAN – AN IMBALANCED RECOVERY

How much we and market held our hopes on China strong rebound is the same as how much disappointment we felt on the economic difficulties after the easing of its Zero Covid policy in early 2023. Signs of weakened demand and sluggish credit growth have cast a shadow on market confidence. How China rebuilds consumer confidence and reignite private sector investment sentiment become crucial to lead the way out of the wood.

The pandemic resulted in service supply reduction, at the same time property market deleveraging has led to delayed construction and delivery of new houses that has led to decreased spending on durable goods like household appliances and furniture. Challenges such as a fragile job market and diminishing profits in the private sector underscore the uncertainty surrounding the economic rebound. To address these hurdles, a comprehensive approach involving not only monetary but also fiscal policies will be needed to bolster economic growth – some of these have been mentioned in the latest Central Economic Work Conference (CEWC) held in December, which was viewed as more "pro-growth" by China observers, but no signals on any immediate stimulus are released in the statement The road of China economy recovery is expected to be uneven. There are still hopes waiting ahead to revive the market as the Chinese authorities have always focus more attention on economic and financial development.

EXCEPTIONAL FISCAL STIMULUS TO SPUR THE ECONOMY GROWTH INTO THE RIGHT TRACK

Looking ahead to 2024, we expect that massive fiscal stimulus will become the main policy driver complemented by monetary policy support. Although China's Gross Domestic Production (GDP) in the first three quarters of 2023 satisfied market expectation, signs of slower economic activities, dip in Purchasing Managers' Index (PMI) readings, negative export growth, and slack consumption, are clear signs of near-term obstacles. Two rounds of benchmark rate cut, and progressive fiscal policy proved to be less effective to revive the economic vitality after the reopening post pandemic. The expansion on infrastructure spending, previously seen as an effective stimulus, may have uncertain effects on driving economic growth this time due to the diminishing multiplier effect.

Furthermore, more fiscal stimulus presents a double-edged sword. While investors prioritize additional fiscal policies to steer the economy, the rising funding will exacerbate the prevailing debt burden. In October, China issued an unprecedented sovereign bond of about one trillion yuan to alleviate local governments' financial pressure through transfer payments. This special treasury bond raised the deficit-to-GDP ratio from 3% to a record high of 3.8%, contributing to concerns about mounting debt pressures. Combined with the dampened property sector, Moody's changed China's long-term outlook from stable to negative.

Eventually, the effectiveness of the chosen stimulus policies will be crucial in solving the challenges posed by lingering uncertainties in the property sector, weakened domestic demand, subdued export demand, accumulated debt issues, and geopolitical tension.

Source: AIA Investments

CHINA'S PROPERTY SECTOR CHALLENGES PERSIST AMID POLICY EFFORTS AND MARKET CONFIDENCE STRUGGLES

In 2024, we anticipate China's property challenges will continue to be the foremost hurdle for economic growth. The decline in property prices and the struggles of builders have eroded consumer confidence, failing to reignite housing demand, especially given that Chinese consumers consider property a primary family investment.

The real estate sector's woes not only impede its own performance but also pose a threat to prospective economic growth through stagnant demand from both upstream and downstream industries. Additionally, financial intermediaries face spill-over risks from home builders' funding drainages, which was seen from rising default cases in bond market and missing instalments from home buyers. Recently, the trust companies with more exposure to cash-flow crunched developers, became another victim after failing to repay the investment principals and interests.

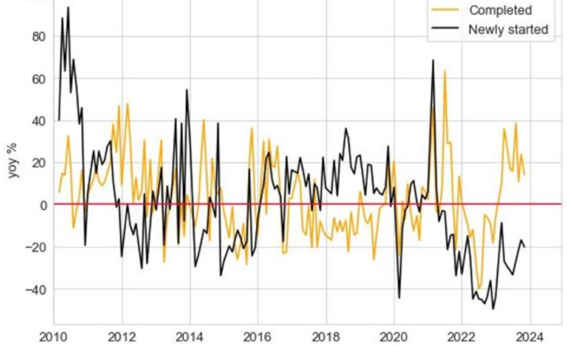
In response to these challenges, Chinese policymakers have intensified their focus on credit support for developers in 2023. Regulatory authorities lowered loan interest rates for first and second homes, along with reducing the down payment ratio for mortgage loans in late August, several megacities later lifted restrictions on mortgage lending for second home purchases. However, the effectiveness of these policies seems inadequate to restore market confidence and drive demand.

Besides, the central bank and financial regulators in China pledged to facilitate the reasonable financing needs of home builders to prevent calling back the outstanding loans or scaling down the credit facilities by banks. Financial authorities are urging financial institutions to increase funding for property developers to reduce the risk of additional defaults and ensure unfinished housing projects get completed and delivered to buyers to boost market confidence.

"China property remains by far the biggest headwind

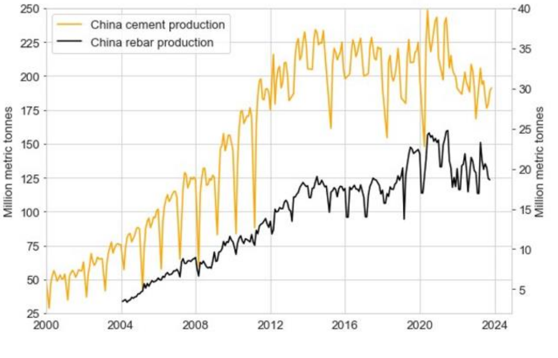
Restoring confidence implies completing existing projects, more than credit easing"

China residential buildings (Floor space)



Source: Bloomberg, AIA

China cement and rebar production



Source: Bloomberg, AIA

Source: AIA Investments

ASEAN ECONOMIES EMBRACE AN IMBALANCED RECOVERY AMID WEAKER GLOBAL DEMAND

Looking into 2024, Southeast Asia economies will improve at a mild pace in an imbalanced approach. Facing the headwind from global uncertainty in a high inflation environment, ASEAN becomes the bright spot and attracts more investment among the emerging markets. Besides, the resilience on domestic demand and continuous recovery of tourism will support ASEAN robust economic growth.

However, we expect a bumpy growth among the ASEAN economies, typically Singapore, Malaysia, Thailand, Indonesia, Philippines and Vietnam, which are seen as the export dominated countries. The trend of shaky export will continue to influence the regional growth due to the weaker global demand. It will be reflected in sluggish export growth rate directly linked with the lowering consumption sentiment and contracted manufacturing in China, the murky outlook of Europe and shrinking demand in US in the coming year.

Meanwhile, the elevated living cost will become another concern on boosting the region recovery. The inflated energy and food prices, together with ripple effect from geopolitical tensions from Russia-Ukraine and Hamas-Israel wars, and more importantly, China and US, limit the upside of the region's growth.

Source: AIA Investments

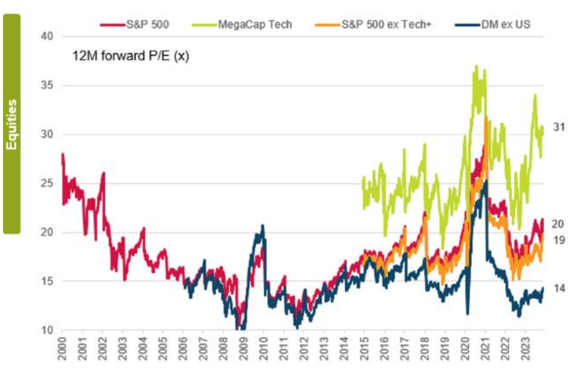
KEY INVESTMENT VIEWS

In 2023, equity valuations remain stretched, amplified mainly by the "Magnificent Seven" AI-related stocks. Those stocks are Meta Platforms (META), Apple (AAPL), Amazon (AMZN), Alphabet (GOOG), Microsoft (MSFT), Nvidia (NVDA), and Tesla (TSLA), which have contributed the bulk of S&P 500 returns despite only accounting for around 29% market capitalization of the S&P 500. We believe, should DM equities continue the uptrend, the rest of the market will catch up with the Magnificent Seven's performance.

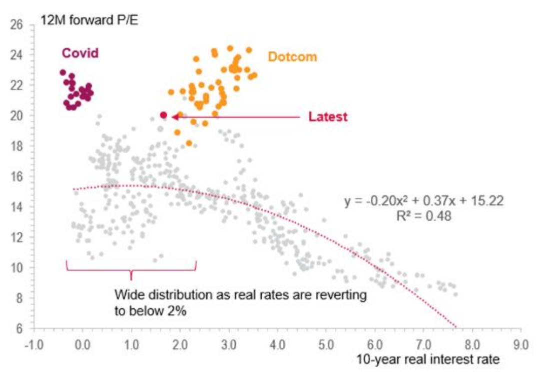
The expectation of central banks to start easing monetary policy may boost stock market sentiments and provide niche opportunities, especially from small and mid-cap companies with healthier financial statements and sustainable business growth.

Valuations: Stretched, driven by the Tech 7. As real rates are coming back down, this becomes less of a problem but should still limit upside potential

US inflation and small business price plans



US median CPI inflation



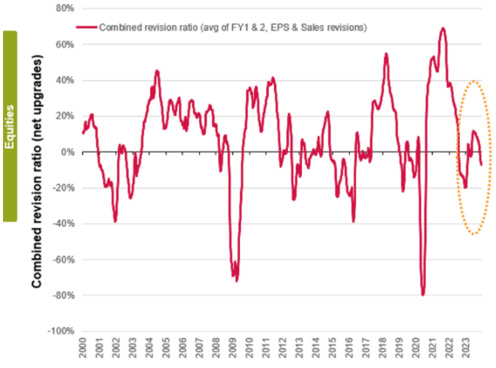
Source: Bloomberg, JPM, GS. Data as of 18 Dec

The mixture of stretched valuation and ambivalent macro scenarios reminds us to keep vigilant eyes on upcoming market movement in equities. But our cautious viewpoint should not be understood as a pessimistic posture directly. We expect Earnings Per Shares (EPS) to decline by 5% in 2024 due to the incoming macro slowdown, which represents a negative net change from current 10% growth forecast. Fortunately, from the historical experience, equities can handle such disappointment well as long as the expected decline of EPS is within the single digit in percentage.

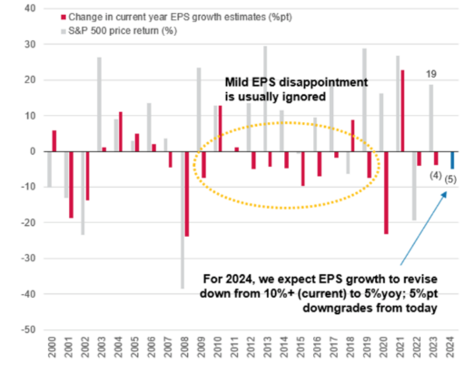
Source: AIA Investments

Fundamentals: Analysts are downgrading into 2024. Our base case is another 5% down to EPS growth, but historically equities can often live with disappointment of that magnitude.

Analysts are downgrading into 2024 to position for the consensus slowdown



...but equities usually ignore mild EPS disappointment. It takes big EPS downside for equities to take notice

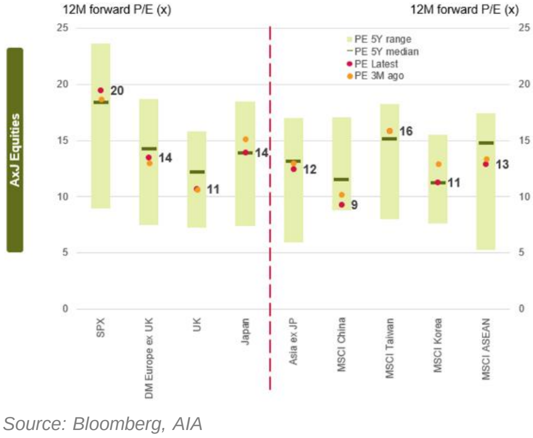


Source: Factset

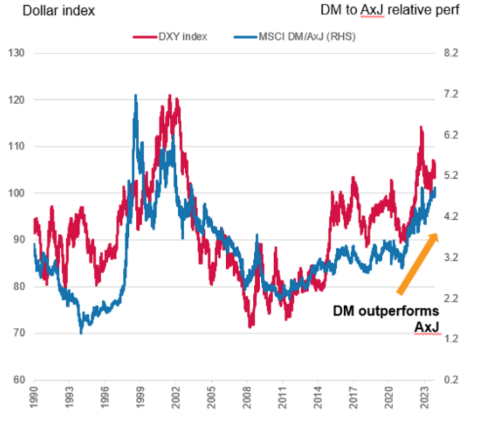
We maintain our neutral views towards Asia Ex-Japan equities given its less demanding valuation as compared to developed market equities. The stabilization or weakening of the greenback may become a tailwind for Asia Ex-Japan equities down the road, in particular for the ASEAN markets. To sustain outperformance in the long run, catalyst from Chinese stock market is necessary. Any disappointment from the second largest economic will lead to set back for the region as a whole.

Asia Ex-Japan (AxJ): Undemanding valuations and weakening dollar (reinforced by the Fed) are setting the stage for AxJ performance, but China's reversal is still uncertain

AxJ valuations are not demanding compared to history & S&P500, weighted mostly by China and ASEAN



As we expect the dollar to stabilize then weaken in 2024, it could set the stage for AxJ to outperform DM



Source: Bloomberg, AIA

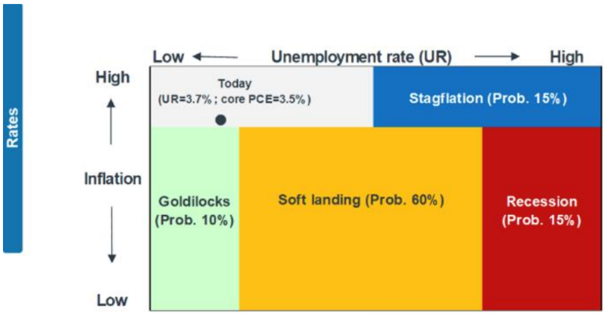
Source: AIA Investments

Despite the unclear outlook for equity market, we expect US Treasuries (UST) to perform well in the coming year. After experiencing a stressed year driven by rate hike cycle, the benchmark 10 years yield topped 5%, its highest level since 2007. The less hawkish tone expressed by the Fed governors coupled with the optimistic market sentiment is evident in the rally of bond prices. Global bonds experienced their best month since the 2008 financial crisis in November 2023.

Although the yield curve is still abnormally inverted, which means the short-term yield (2 years note) is higher than the longer-term rate (10 years or 30 years bond), the upcoming improvement in sentiments will help revert the inverted yield curve situation. We believe the yield decline of the short-end will be faster than the long-end in 2024. By the end of 2024, we expect 30-year yield will reach 4.0%. Indeed, in 3 out of our 4 scenarios for 2024, we see UST yield curve bull-steepen, with levels lower and shape steepen.

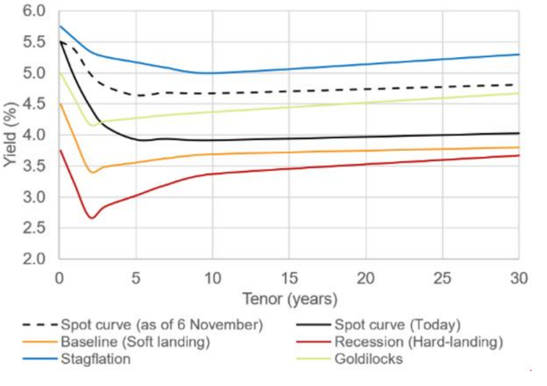
For 2024, UST bull-steepening is the projected outcome in 3 out of 4 scenarios, based on Fed's reaction function

Stylized economic conditions for 4 scenarios in 2024



Source: Bloomberg, AIA

UST Yield Curve: 4 Scenarios (by year-end 2024)



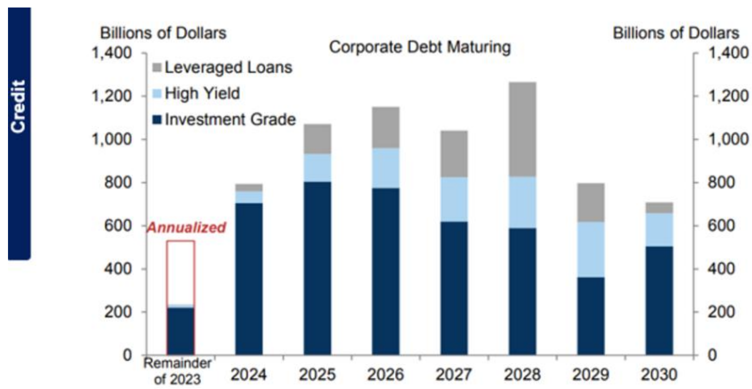
Source: Bloomberg, AIA

We hold a neutral view on US and Asia investment grade (IG) debts. The still-strong corporate fundamentals and lower refinancing risk should improve corporate bonds performance, normally resulting in a narrower credit spread - a measurement of the difference between risk-free yield and corporate borrowing rate. However, spreads should also widen during economic slowdown theoretically, consumer and company spending should come down and hurting the weaker end of corporate spectrum. From the balance sheets perspective, the higher cash reserves held by nonfinancial corporations can provides the buffer to counter higher interest expense in the following years. Besides, corporate debts matured in next two years are also at its lowest in the past 15 years, indicating lower financing demand. In addition, central banks monetary policy easing can be a plus for corporates as interest coverage ratio improves on the back of low borrowing cost. So overall, we remain neutral for the asset class as a whole.

Source: AIA Investments

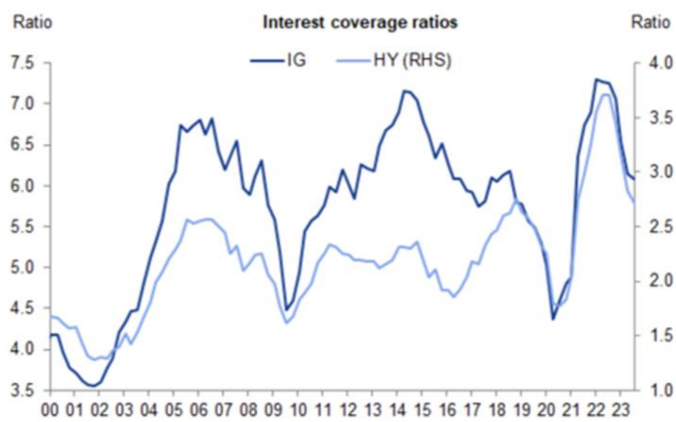
Corporate fundamentals remain strong and looming refinancing risk not a concern, at least in the near term. Fed's pivot should put an end to the gradual decline in interest coverage ratios

Maturity wall not a concern: share of corporate debt maturing within next 2 years is the lowest in 15 years (16% today vs 26% in 2007)



Source: Bloomberg, Goldman Sachs Global Investment Research

The sharp decline in interest coverage ratio should be mostly behind us given the Fed's end to current hiking cycle



Source: Bloomberg, Goldman Sachs Global Investment Research

Source: AIA Investments

ASSET CLASS PREFERENCES

We are more positive on the macro backdrop in 2024 compared to 2023. Even though uncertainty remains as we go into early 2024, especially around the timing and severity of US slowdown, the recovery that follows and the rate cut expectations should pave way for a more friendly environment to risk assets. On the rates side, after a volatile 2023, as yields come off from high levels, we do see some more room throughout 2024 for bonds to perform, reinforced by the rates cutting cycle. Therefore, for the full year as a whole, we do prefer both bonds and DM equities – likely during different episodes of the year. Timing and sequencing of asset class allocation is key, but cash should no longer be the preferred asset and rather be deployed to capture opportunities in other major asset classes.

KEY TAKEAWAYS - LOOKING INTO 2024

Growth

Significantly slower, but no recession

US economy looks set to slow significantly, and macro risks remain. Timing and extent of slowdown are uncertain, but it unlikely to result in outright recession.

Inflation

Continuing to grind lower

Inflation has slowed a lot, and this should continue. However, the last mile if disinflation may be slow, and the Fed could stay on hold until mid-year.

Rates

Lower, steeper

Yield curve highly likely to continue steepening but may not end 2024 outright steep. Yield levels can still move lower, but the recent overshoot has largely corrected.

Credit

Spreads look tight

Credit spreads are tight, especially in IG. This suggests risk of underperformance vs rates, but given limited re-financing needs it's hard to see a real blow-up near-term.

DM Equities

Uncertainty, then opportunity

Full valuations, positioning and macro uncertainty suggest short-term caution. But Fed cuts are coming into view and, absent recession, this is a bullish signal.

AxJ Equities

A little help from USD & China?

A rally in China and/or a substantially weaker USD could drive a recovery in Asian equities. Both look likely over the course of 2024, but not necessarily imminent.

Source: AIA Investments

TACTICAL ASSET ALLOCATION (TAA) PREFERENCES

Asset Classes	TAA 6-month Preference	Key Thesis
US Treasury	OW+	Lower, steeper curves with growth slowing and inflation grinding lower
US IG Credit	N	Very tight spreads; strong fundamentals; low but rising defaults
Asia IG Credit	N	Very tight spreads; strong fundamentals; buffered by higher yields today
Global DM Equities	N	Near-term overbought, but Fed cuts soon points to improving outlook into 2024
AxJ Equities	N	Undemanding valuations, weaker dollar should be a tailwind; China still uncertain
USD Cash	UW-	Funding the overweight in bonds and equities given the rally in both

- OW+ = Overweight
- N = Neutral
- UW- = Underweight

Source: AIA Investments

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