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Spotlight Equities

FSA Equity Competence Center
31 July 2024

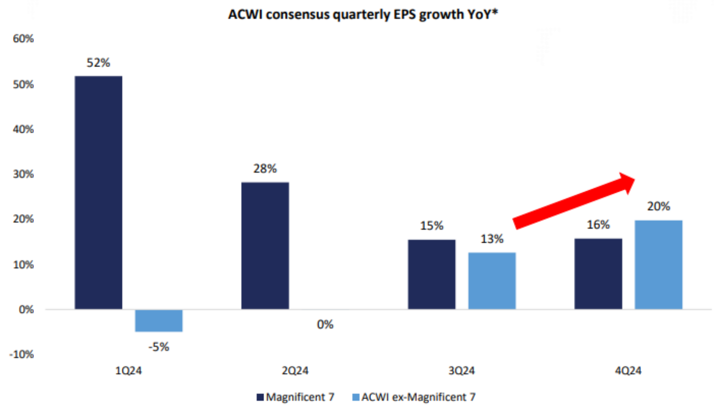
2024 Mid-Year Outlook

Bullish 'til the Bill Comes Due.

US
We have recently seen signs of a gathering storm beneath the surface, but we do not think this is anything more than a short term consolidation/profit taking/broadening exercise. It's worth noting that markets have been on a historic run since last October, so we need to put this decline into some context. The S&P 500 is up for 28 of the last 39 weeks, which is something that hasn't been exceeded since 1989. But given we've had that relentless run of gains, in many respects that leaves markets more vulnerable, as historically it's unusual to see such a prolonged run of gains maintained for much longer. On top of that, equity positioning was elevated by historic standards and we're about to enter the toughest part of the year on a seasonal basis, with markets often struggling in the late-summer period. But, if growth continues to run above trend as the Fed elects a series of adjustment cuts, this should provide a good foundation for risky assets in the near/medium term. At the same time, we are a bit wary of both valuation and positioning, as well as the astronomical deficits and exploding debt by the US government longer term.

We think, the micro follows the macro and because of that, it's likely both growth and inflation will continue to cool going forward. Corporate America is performing well on EPS (thanks to impressive margin/operational management), however the demand landscape has taken a turn for the worse, something many retailers are acknowledging. The shift is hardly catastrophic, but it will influence corporate behavior when it comes to hiring and pricing, this will eventually show up in the formal economic statistics. Overall, we want to stick with our highest conviction trades, trim lower conviction ideas and take advantage of cheap optionality. Our favorites themes/sectors; Energy Transition, quality small/mid-caps, commodities, AI, financials, Equal weighted S&P & NDX.

The broader global market is projected to outpace Mag 7 by end of year



Source: Bloomberg, 31 July 2024

Earnings
Investors will be looking closely at 2Q earnings to determine whether the market will continue its upward momentum or take a breather to consolidate its gains. Expectations for 2Q earnings and revenue growth now stand at +9.6% y/y and 4.5% respectively. Earnings call transcripts are likely to be scrutinized to answer the following questions: 1) is the enthusiasm for investments in artificial intelligence still robust? 2) how deep are the cracks forming for consumer spending, especially at the low-end? 3) how likely is it that companies can continue to grow profit margins? and, 4) are the changing prospects for the election resulting in changes in business strategy? is the election changing?

So far, the banks were a mixed bag with major dispersion across the big names. A handful of non-Magnificent Seven, yet high profile tech companies; ASML, TSM and NFLX -- were generally pushed around. Expectations are quite elevated for tech, so we think it will be challenging for them to outperform in the near term. One year ago, consensus was calling for an earnings decline of 9%, while this year the expectation is for growth of 9% -- and that has proven to be a challenge so far. As we head into a stretch that will be heavily dominated by the mega cap tech names, NDX is off 4% from the local highs, yet still 21% above the Q1 lows. The bar is high, and now the onus shifts to the best companies on the planet to deliver.

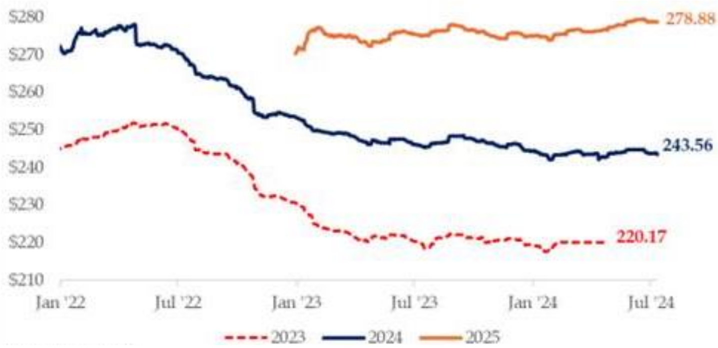
The S&P 500 2nd Quarter Earnings Scorecard

	Sales Growth (Y/Y%)			Earnings Growth (Y/Y%)			# Reported
	Jan. 1	Apr. 1	Today	Jan. 1	Apr. 1	Today	
S&P 500	4.9%	4.5%	4.5%	11.4%	10.4%	11.1%	70/500
Discretionary	5.3%	4.7%	4.1%	6.2%	6.2%	8.9%	8/52
Staples	2.5%	2.2%	2.0%	5.1%	2.8%	0.8%	7/38
Energy	7.8%	3.5%	5.6%	16.4%	10.0%	-1.0%	3/22
Financials	0.7%	1.1%	4.1%	7.3%	7.2%	17.0%	26/71
Health Care	5.7%	6.4%	6.5%	25.0%	22.0%	19.5%	5/63
Industrials	4.1%	3.8%	-0.7%	4.2%	2.2%	-2.9%	10/78
Materials	1.4%	-0.7%	-2.3%	-1.1%	-6.4%	-9.7%	2/28
Real Estate	7.3%	7.2%	6.6%	-1.6%	-1.2%	-2.7%	2/31
Technology	9.5%	8.8%	9.7%	15.0%	15.4%	17.2%	5/67
Communications	5.9%	6.3%	6.0%	16.5%	18.8%	21.8%	2/19
Utilities	7.5%	3.9%	5.0%	7.9%	6.8%	6.0%	0/31

Source: Bloomberg, 31 July 2024

EPS figures for both 2024 and 2025 have stalled at roughly ~$243.50 and ~$279, respectively. On a positive note, the growth rates for each year remain 11% and 14% which are still well ahead of the long term CAGR for EPS growth of roughly 6-7%.

2023 & 2024 & 2025 S&P 500 EPS Progression



Source: FactSet, 31 July 2024

Politics

We are ~100 days away from the US election and we have received four black swan events in the past seven weeks. It would not be surprising if another is coming before the winner is declared. President Biden formally announced he will not seek reelection and endorsed Vice President Harris for Democratic nominee. While Biden's delegates are not bound to support Harris, betting markets consider her strong favorite to win nomination and appears that she has garnered enough support to have already wrapped up the nomination.

The ability of Harris to inherit the existing Biden campaign operation makes it very challenging for anyone other than her to be the nominee at this late stage. It's not clear who will be VP, but current front runners are; Sen. Mark Kelly (AZ), Gov. Andy Beshear (KY), Gov. Josh Shapiro (PA) and Gov. Roy Cooper (NC) as the most likely people (Newsom and Whitmer don't want the VP job).

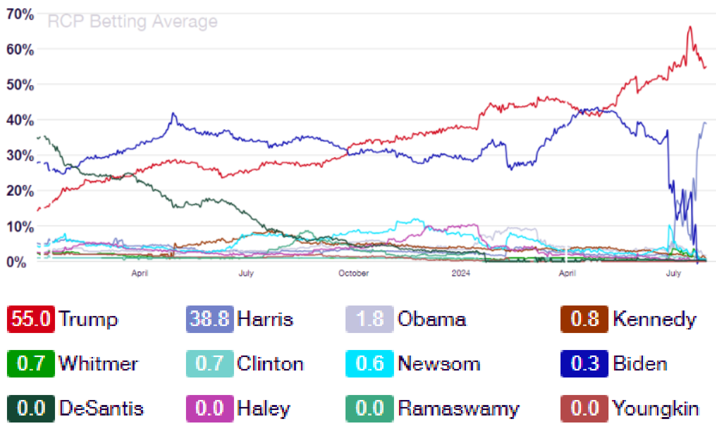
Biden's presence had become such a drag on generic Dem polling numbers that simply removing his name from the equation has caused things to tighten dramatically (remember, no one wanted Biden to stay in the race more than the Trump campaign). That said, while Dems are seeing a bounce in the polls, Republicans have enormous political momentum at their backs, and the odds will continue to favor a full GOP sweep.

There Is Not Much Difference Between Biden and Harris On Policy, but Health Care & Cannabis May Be Two Areas That Differ, with Harris being more aggressive on Medicare for All and on cannabis legalization. We expect Harris to put out some new policy proposals to distance herself a bit from Biden.

The assassination attempt will make it a lot less socially awkward to support Trump. In 2016, few people openly endorsed Trump. This time around, high-profile business leaders such as Elon Musk and Bill Ackman have openly pledged their support. And the man on the street is also no longer shy of showing his allegiance.

As monumental as recent political events have been (the debate, Trump's assassination attempt, the RNC, etc.), Washington hasn't been nearly as important to the market as larger economic forces, specifically the "Goldilocks" nature of June economic data (jobs, inflation, and retail sales) and the dovish pivot in Fed rhetoric.

2024 US President Betting Average

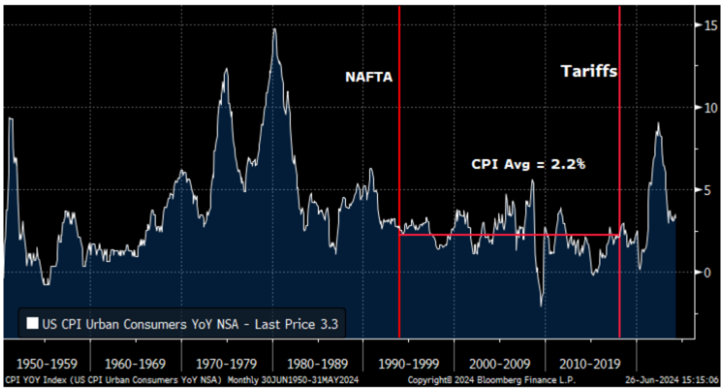


Source: RealClearPolitics, 31 July 2024

Inflation

The trajectory of US inflation remains the single most important global economic indicator, as shown by the dramatic market reaction to the unexpectedly soft CPI report for June. With the reversal of the upside inflation surprises earlier in 2024, the door is now open for the Federal Reserve to do what it clearly wants to and cut policy interest rates. That in turn eases market worries that the Fed will crush the ongoing US and global economic expansion, a risk that was rising given how the US housing market is now clearly being dragged down by high interest rates. Lower rates and continued US growth could enable a rotation out of US mega-cap growth stocks, and a weakening of the structurally strong US dollar. Still, the medium- and long-term risks to inflation have not gone away. The Fed's asymmetric inflation target means that even if it achieves its policy goals, inflation will end up averaging more than 2%. And deglobalization, the green transition, demographics and other factors mean that the Fed may well fail to get inflation back to target.

Globalization & Increased Competition led to Secular 2% Inflation



Source: Bloomberg, 31 July 2024

Central Banks

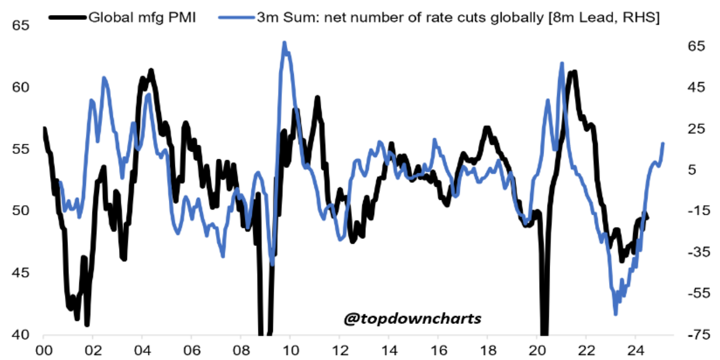
The backdrop feels different after the recent June US CPI print. We are getting close to mission accomplished territory for the Fed and this will give them a lot of conviction to deliver the long hoped for easing the market has been looking for. Currently, it looks like inflation is dropping faster than activity is slowing. The current outlook for rate cuts looks more like a mid-cycle adjustment vs. the panic of a recession. With numerous central banks having cut rates and others likely close, there are already some green shoots developing in global demand. There's evidence even small rate cuts and the anticipation of such policy when it comes to the Fed can matter. In fact, they may be desirable (eg, Fed policy in 1995).

Despite history's suggestion that rate cuts are better feared than hoped for, capital flows appear to have disregarded this analogue and continue to be directed at whichever monetary region seems intent on (relative) policy accommodation. The ECB cut in July, and may act more aggressively (3-4 cuts by year end) than the Fed (Sept., 1-2 cuts). As more and more central banks move into rate cut mode, monetary policy is going from headwind to tailwind — and that has key implications for the global growth outlook in the second half of 2024. Reacceleration Risk, after a clear and significant slowdown in global trade and manufacturing, things could begin to reaccelerate. We've seen no new incremental monetary headwinds, outright shifts to rate cuts (e.g. ECB, SNB, BOC), and a general easing of financial conditions. The other elements supporting the case are the inventory cycle (firms ran down inventories during the rates/inflation shock and recession scare, now need to order more), generally resilient services, recovering real incomes (fading cost pressures), and improving economic confidence.

The ephemeral animal spirits aspect could be a key driver to this macro-risk scenario and an important determinant as to whether it is just a rebound vs more fulsome reacceleration that results in growth re-heating.

Substantive reacceleration in growth and re-heating of the economy will likely see upward pressure on bond yields; tailwinds for old cyclicals (energy, materials, industrials, financials) and potentially trigger a rotation from tech to some of the previous out-of-favor and relative value standouts that would benefit from this theme: e.g. value vs growth, small vs large, global vs US. On the face of it, an improvement in growth would be good, but the impact on markets would likely be mixed — rising volatility, and rampant rotation.

Global Monetary Policy Stimulus



Source: TopdownCharts, 31 July 2024

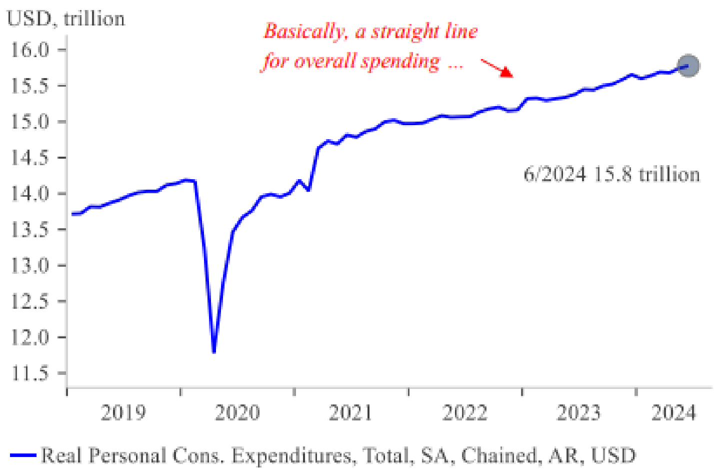
Small caps typically outperform in the 6-12 months after the first rate cut

Source: Fama French data library, Haver Analytics, 31 July 2024

The Consumer

There has been evidence of strain on some U.S. consumers, eg, rising credit card borrowing, increasing auto delinquencies. However, overall real (inflation-adjusted) consumer spending continues to advance, rising m/m in both of the past two months. It appears premature to fade the U.S. consumer in aggregate, with the labor market still solid, home prices rising, and risk assets performing decently. This setup also makes the current outlook for Fed rate cuts look more like a mid-cycle adjustment vs. the panic of a recession.

US Real Consumer Spending

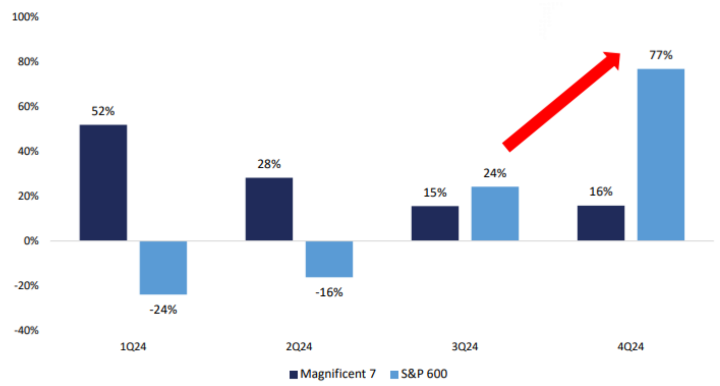


Source: Strategas, 31 July 2024

Small Caps / Equal Weight S&P

The combination of two powerful forces in a short period of time; a CPI-induced shift in Fed expectations and a turn in the election outlook, lit a fire under the unpopular parts of the market. The Russell 2000 has broken out and stands to benefit from a friendly growth/inflation interplay, but we want to be careful here, because if the growth backdrop deteriorates meaningful, we do not want to be owing small/midcaps into a meaningful slowdown/rate cutting environment. For, the rotation to persist, results and forecasts from individual companies will need to reinforce the view that smaller and more cyclical businesses are poised to perform. Compared with the achingly high valuations of the country's biggest companies, the miniatures look like a rare and ever-more attractive bargain.

Small Caps projected to have significant growth by end of year (S&P 600 consensus quarterly EPS growth YoY)



Source: Bloomberg, 31 July 2024

Small Caps remain historically cheap vs large caps (Relative forward P/E Russel 2000 vs Russell 1000)

Source: BofA, 31 July 2024

Artificial Intelligence

The artificial intelligence arms race is a marathon and not a sprint by any means and we are still in very ear days. With AI adoption still in its infancy, many companies still exploring AI use cases. Companies are looking to implement Gen AI in customer service & support functions as well as helping to boost developer productivity. While Gen AI hype is massive, it has become apparent that companies have learned their lessons from the shift to Cloud, and are proceeding cautiously as they consider putting Gen AI products into production, they can be very expensive to run. Hence, companies are proceeding gradually with Gen AI deployments ensuring they can deploy them in a cost-efficient manner. Companies are indicating that customer concerns over data governance are causing them to "drag their feet" in adopting Gen AI solutions.

We remain focused on the picks and shovel names (hardware, Data centers, energy generation, hyperscalers, handsets) while slowly looking to expand into the consumer related names (software, discretionary, healthcare, etc). We think the AI Smartphone Era will kick off in 2H24 thanks to Apple Intelligence's official launch. Smartphone shipments and ASP will both increase, which will boost the industry TAM. Both smartphone OEMs and supply chain companies with spec upgrades will benefit. The smartphone industry market cap is likely to be boosted from US$4.9tn to US$5.8tn within 12 months. Over time, AI will be the biggest technological shift we see in our lifetimes. It's bigger than the shift from desktop computing to mobile, and it may be bigger than the internet itself.

Energy Transition

Following the recent first US presidential debate, the clean tech sector took a hit, as a Republican Sweep in November might threaten parts of Biden's Inflation Reduction Act (IRA) win. Despite concerns and uncertainties, we believe the energy transition is well underway and renewable energy equities should perform strongly in the coming decades. Stock picking remains key to focus on leading players with value added, product differentiation, pricing power, attractive growth prospect and solid margins and fundamentals overall.

Technology

We think what's happening in tech is mostly technical in nature as the group had simply become too crowded and overbought at a time when the macro narrative is pivoting away from a Fed perpetually on hold to a scenario characterized by monetary easing and disinflation, the type of landscape that tends to favor cyclical/value stocks. The starting point for this pivot occurred with the June CPI.

The fact the tech rotation happened isn't shocking – the group has seen periodic moments of volatility in the past before quickly rebounding. However, the duration of this move is catching many people by surprise, as most assumed the tech slump would be ephemeral, lasting no more than a few days. With the tech rout nearing the two-week mark, all sorts of technical alarm bells are being tripped, and the selling is feeding on itself as people follow the price action to avoid further "performance pain".

Tech fundamentals are mostly fine on an absolute basis and should stay that way. However, relative to expectations, it's likely this is a rocky earnings season, simply because the bar is so elevated (and because these names remain crowded). ASML showed how investors will treat a "beat-and-reiterate" report. It's hard to imagine the hyperscalers accelerating their capital spending even further and a plateauing in this metric (which feeds so much of the AI optimism/enthusiasm) could dent sentiment (for Microsoft specifically, the Street is modeling Y/Y capex growth slowing from +65% in CQ1 to +48% in CQ2, w/the number flatlining in the ~$13B range for the next several quarters). Meanwhile, there does seem to have been a small deterioration in enterprise tech purchasing trends (something the Apr-end reports revealed back in May and June, including CRM, WDAY, VEEV, and others).

SOX Index – Average Monthly Performance since 1994

Source: Bloomberg, 31 July 2024

Technology was the relative loser as the Fed eased policy in summer '95, enduring a rough 6-month run of underwhelming relative performance. It likely takes on some added significance today given how overbought / extended the notable names are. Pay attention to what has not been on the new high list over recent weeks ahead of a weaker seasonal stretch, semiconductor names (NVDA, AVGO, QCOM, MU).

Europe

European equity markets are navigating a complex landscape characterized by divergent performance and shifting macroeconomic conditions. A good opportunity might present itself in 2H to buy Eurozone. For this to have traction, Growth style needs to stop leading, French politics needs to demonstrate stability and USD and tariffs should not become the headwinds.

The ECB has started easing and may decide to be more aggressive than the Fed. Better China performance helps Eurozone and its valuations relative to the US are as cheap currently as at the extremes of TMT sell-off, GFC and Euro peripheral crises, among other.

Europe's stock level dispersion and equities market breadth are just starting to recover from lows amid recent investor focus on elections, economic growth and the direction of policy rates. However, history suggests both dispersion and breadth should rise from here as we head into earning season, pass peak European/UK election uncertainty, cycle through economic growth concerns and approach 2H rate cuts, both in Europe and the US, on the back of softening inflation. This set up makes today the optimal time for bottom-up stock picking. In Europe, Real Estate, Medtech, Construction & Materials (Overweight), Utilities, and Div Fins are currently more rate sensitive than the overall European equities market.

A rising probability of a Trump presidency will raise doubts about the US commitment to NATO. These doubts will press European countries to further increase their defense spending—several major economies are still short of Nato's 2% of GDP target—reinforcing the bull market in local defense plays.

However, longer term, Europe's problem is that it no longer generates the economic growth within its economic model, which is heavily reliant on manufacturing industries, and on welfare systems that changed from providing insurance to guaranteeing minimum incomes. The EU looks to us as a place that has stayed behind in the 20th century. When confronted with disruptive 21st century technologies like crypto currencies or artificial intelligence, the EU's first reflex is to protect, not to participate. It is challenging to identify any political parties, in government or in opposition, focused on this. Ursula von der Leyen, and the political majority in the European Parliament, clearly are not. Europe's leaders fret more about who is going to be the next US president than about how to restore productivity growth.

Risks

The key risks we see in the near/medium term 1) August/September typically sees weak equity seasonality and liquidity, 2) a major rotation in equity markets is possible with a near historic valuation dispersion between growth and value, 3) extreme positioning, 4) A fed that moves too slow to rebalance rates, while being too concerned with inflation and not enough focus on growth.

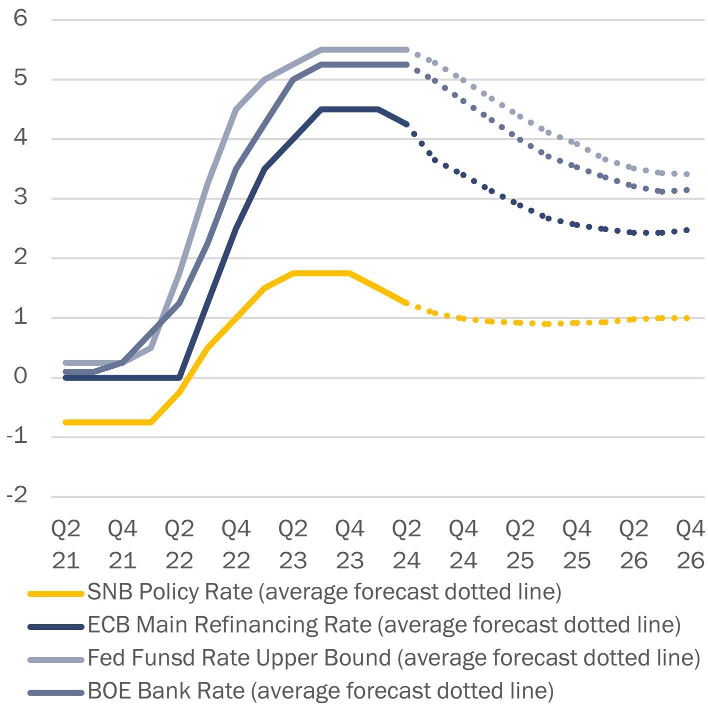
Switzerland

SNB – The first major central bank to reduce rate

Following a second consecutive cut at its monetary policy assessment in June, the Swiss National Bank (SNB) policy rate appears now closer to its terminal value. The SNB lowered its policy rates again, from 1.5% to 1.25%. The central bank justified the move with the decrease in underlying inflationary pressure compared to spring numbers and the swiss franc's recent strength against the euro and the US dollar. Inflation decreased to 1.3% in June, within the SNB's target range of 0-2%.

The CHF strong appreciation was driven by political uncertainty following French President Macron's announcement of new elections in France at the end of June, changes in the US presidential elections landscape and ongoing geopolitical conflicts globally. Nonetheless, data recently published show that there was no SNB intervention in the Forex market since December 2023, but the central bank remains willing to intervene if needed. Looking forward, market expectations already reflect an SNB policy interest rate of 1.0% by the end of the year, a level considered to be broadly neutral. This implies the SNB is expected to reduce rate at least one more time either in September or in December. Meanwhile, the SNB expects inflation to continue to move lower in the coming years.

Major Central banks expected to lower rates in the near term



Source: Bloomberg, 31 July 2024

Swiss economy – A rebound expected in 2025

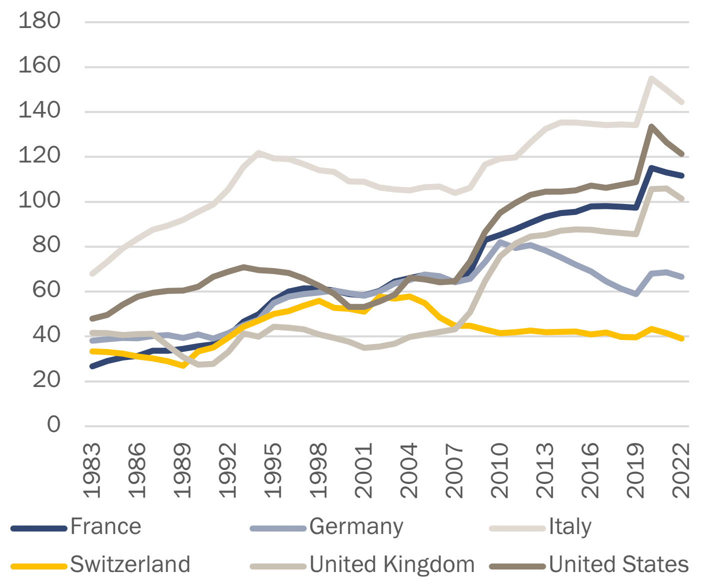
Economic growth in Switzerland, particularly in the manufacturing sector, should remain subdued through the rest of the year, similarly to the economic growth in the Eurozone. Switzerland's economy has expanded only slightly by 0.3% in the first quarter of 2024, following the moderate economic growth of the previous quarter. The services sector grew again and private consumption increased solidly. However, industrial output stagnated.

Going forward and based on June forecasts, the Swiss government continues to expect Switzerland's economic growth in 2024 (at 1.2%) to come in well below average. As the global economy gradually recovers, growth is likely to normalise to 1.7% in 2025. Expected Eurozone economic growth strengthening in 2025 should provide help to the Swiss economy to return to trend growth.

While solid domestic consumption and a resilient labour market are likely to support the Swiss economy this year, investments and manufacturing should play a more important role in growth in 2025. Long term labour shortages in Switzerland should keep unemployment from rising significantly, but higher health insurance costs are expected to weight somewhat on household consumption. On the other hand, Swiss manufacturing which is currently depressed from weak foreign demand (especially from the Eurozone) should gradually recover in conjunction with a strengthening of the Eurozone economy. This would also lead to a rebound in Swiss equipment investments next year.

Moreover, Switzerland remains well positioned in terms of fiscal policy. The debt-to-GDP ratio declined from 52% in 2000 to 39% in 2022, while the ratio for the US more than doubled over the same period. Despite existing challenges including net-zero target for greenhouse gas emissions, rising geopolitical tensions leading to higher national defense spending, and demographic changes with a growing number of pensioners relative to the working population, Switzerland's relatively low public debt might suggest the government could use the fiscal latitude to increase productivity growth if needed.

Stable Swiss Fiscal policy in the 21st century (General Government Debt as % of GDP)



Source: IMF, 31 July 2024

Positioning – Favour defensive but diversification is key

Swiss Performance Index returned over 9% in the first half of 2024, lagging behind the global index year to date. The difference is more significant over the past year and a half, a period that has been characterized by above-average performance in the technology sector (only poorly represented in the Swiss market). Additionally, the two main sectors in Switzerland, namely healthcare and consumer staples, have performed poorly.

Nestlé in particular has underperformed in 2023 and the first half of 2024 relative to the overall market. Roche was also a laggard until the beginning of May 2024, when the company bounced back strongly driven by positive news. Therefore, we argue that a well-diversified investment approach in terms of sectors helps to lower value fluctuations and prevents extreme movements performance wise.

On a more positive note, going forward, lower rates should reverse headwinds that hurt Swiss equities last year. In terms of positioning, we continue to prefer the traditional defensive sectors in the near term until manufacturing activity starts to picking up. A more levered sector, like utilities should benefit from lower rates while sales are defensive.

We also favour quality dividend-paying companies with healthy businesses generating robust cash-flows that firms share with their shareholders and invest in growth. We particularly appreciate characteristics such as strong pricing power, enabling companies to offer strong margins, robust balance sheet and high profitability that should secure stable dividend payments in the future, even in a more sluggish growth environment.

Headwinds and risks include forex, political risks, slower growth in Europe, and geopolitical tensions globally. While the SNB cut its rate as a result of domestic inflation rates moderating significantly, the Swiss franc, considered a safe-haven currency, has regained strength recently. This is expected to weight on Swiss corporate profits (reported in CHF), of which 90% are generated in foreign currencies. Meanwhile, in addition to the impact on safe-haven currencies appreciating against the euro, political uncertainty in France could weigh on the recovery process of the Eurozone economy.

China

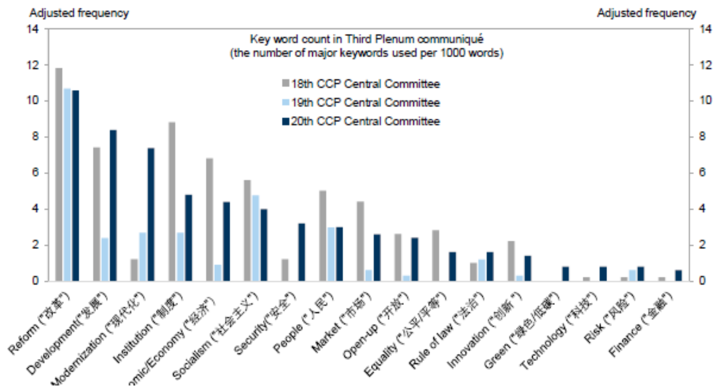
The Third Plenum of the 20th Chinese Communist Party Central Committee (CCPCC) concluded on 18 July, where China policy makers laid out its economic policy and path of reforms for the next five years. Slowing economic growth, coupled with growing conflicts with the West, have moved policy makers to recalibrate their reform initiatives to be more efficient than before. There are three key items from the Third Plenum that we discuss below including; the government's shifting focus from absolute GDP growth to productivity, how to unwind the structural risks behind the path of achieving its growth target and how China is managing the risk arising from the China Plus One strategy from the US. For the remainder of 2024, we remain skeptical on Chinese internet stocks and private developers and continue to suggest investors to reduce exposure on rebounds. We see selective opportunities in defensive high yield SOE sector leaders and hardware technology stocks.

We summarize the reforms from the Third Plenum, in five key areas:

- Fueling new growth through technology – large emphasis was placed on innovation and the cultivation of science and technology. The emphasis was on 'science, education and talent'. We may see further government measures to promote R&D expenditures, support for education and vocational studies as well as support for the integration of new technologies and digitalization of existing industries. Green development was also highlighted as an area were progress is needed to move towards China's carbon reduction goals, which can in turn fuel green-related investment and promote more energy efficiency.

- Fiscal and tax reforms –Ongoing fiscal reforms should be better aligned with revenues and costs, with the focus on facilitating more expansion of productivity enhancing projects in area such as; infrastructure and social services.
- Resolving risk for the real estate sector - As the property market continues to remain under pressure, the mention of 'managing risk in the property sector' likely means more support may come through as we move towards a new housing development model. We think the government has the space to provide more policy support to help stabilize the industry.
- Improving people's livelihoods - Policies to expand social safety nets and grow the middle-income class are also in focus with calls to improve the income distribution system, employment, social security system, and medical system.
- Capital market reform and further opening up - This could entail further easing of market access, encouragement of foreign investment into China, and development of China's capital markets to encourage more 'patient capital'. In terms of global relations, mainland China reiterated the development of the Belt and Road Initiative, further encouragement of investment flows as well as integration with Hong Kong and Macau.

Key theme comparison table: 20th vs 18th CCPCC 3rd Plenum communiqué

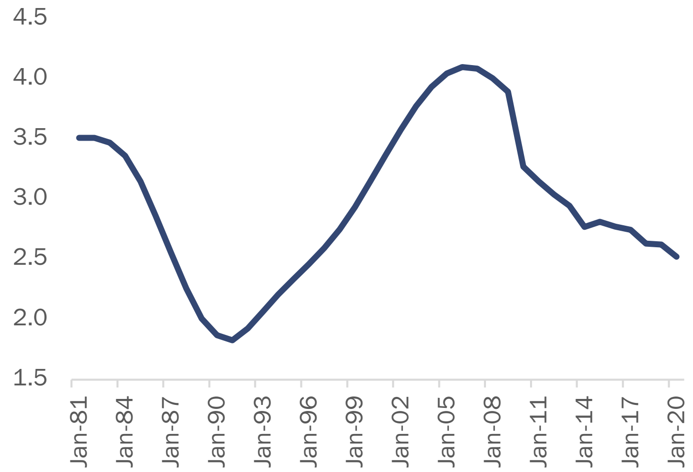


Source: GS Research, State Council communiqué, 18 July 2024

How to interpret "quality of growth"
We believe what Chinese President Xi Jinping meant by quality of growth is the boosting of total factor productivity (TFP). TFP is a measure of the output of an industry or economy relative to the size of all of its primary factor inputs. Simply put, it is the output that is produced in excess of the contributions made by increased employment and investment. That said, TFP reflects the incremental value add of innovation, technological change, the emergence of new industries versus what can be generated simply by increasing the factors of production (land, labour and capital). TFP is an important indicator of growth for China in recent times due to its aging population. When an economy is experiencing a declining population among its working age cohort, increasing productivity garners real economic growth. According to Bloomberg, China's TFP was 3.7% on average during 2000-2010, which was spectacular. From 2011 to 2019 (pre-Covid) however, TFP decline 0.9pt to 2.8% on average.

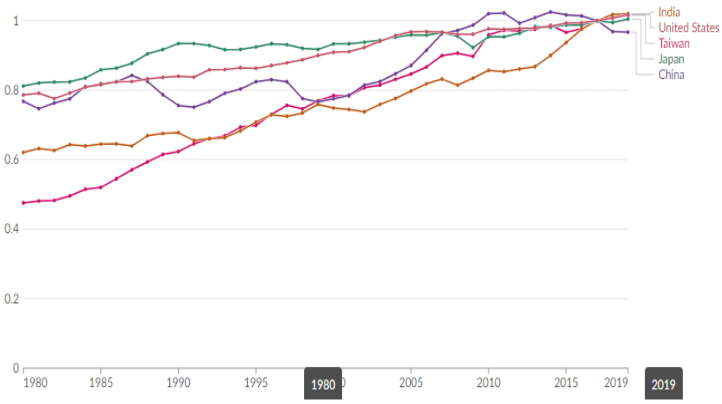
Boosting private household consumption
TFP without consumption growth alignment is a recipe for unbalanced growth, which has proven to be unsustainable in China. This is because China has been an investment-driven economy (property and infrastructure construction). This is in stark contrast to the service-led economy in the US. In addition to technology/ innovation-led growth drivers, China is attempting to transition more towards a service and consumer-driven economy. This explains why regulators have been emphasizing the building of a social safety net in the past years. A social safety net is of utmost importance as China pushes forward on its urbanization plan (Hukou reform). Currently, there are ~300 mn migrant workers lacking benefits in the cities they are working in. This has resulted in excess household savings, which in turn reflects the fear of an uncertain future and insufficient health protection.

China TFP 2000-2024



Source: Bloomberg, 25 July 2024

Total factor productivity, 1980 to 2019



Source: Feenstra et al. (2015), Penn World Table (2021)

Rebalancing technology innovation and common prosperity
Even before the Third Plenum, China has been investing heavily on upgrading manufacturing automation during the COVID-pandemic period. The country's factories are now no longer hiring tens of thousands of workers for production because these have turned into "lights-out" factories with only a few skilled operators on the floor. As a result, the Third Plenum has highly emphasized the importance of vocational education. In the coming few years, the Chinese government may also need to reallocate resources on enhancing new industry training to address the gap created by the increasing adaptation of automation. Robotaxis (enterprise) can be a classic example of capitalist reaping the rewards to the detriment of taxi drivers (labour). We all understand that it would be difficult for a 50-year-old taxi driver to beef up his skill set to become a software engineer. As a result, in order to maintain Beijing's common prosperity agenda, policymakers must determine whether

sufficient preparations have been made to rebalance the employment disruptions that could be generated by innovative technology.

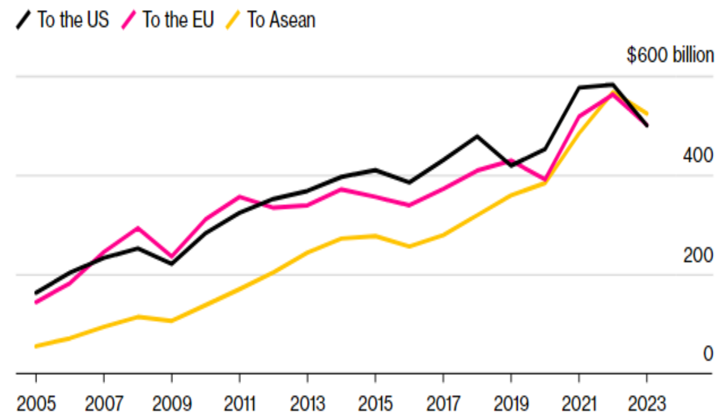
Addressing the local government debt issue

The Central Committee has pledged that the central government would take a greater burden of fiscal expenditure, aiming to alleviate the financial strain on local governments. The objective is to help local governments make their fiscal positions sustainable by adding more revenue sources and reallocating some of the expenditure to be handled by the State Council. Measures in the pipeline include increasing the general transfer payments from the Central government to local authorities, handing over consumption tax collection to local government and improving the central-local split for shared tax revenue (e.g. value-added tax).

Shall we worry about the rising US-China conflict?

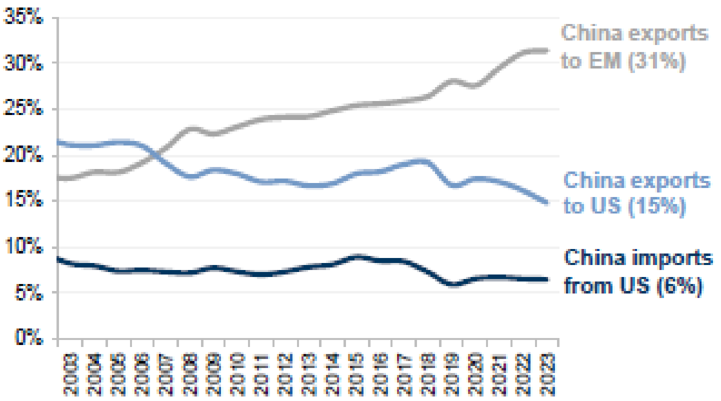
We evaluate the US-China conflict in three key perspectives: trade, technology and national security. For trade conflict, if Donald Trump wins the 2024 US Presidential Election, the economic confrontation between the two countries could possibly increase in 2025 in our view. Still, China could mitigate the US tariff impact through shifting its exports to non-US countries. For the first time last year, China has exported more goods to Southeast Asia than the US, which may suggest trade has been realigned to mitigate the direct impact of US trade restrictions. According to Bloomberg, the ten nations in Asean bought USD524 bn of goods in 2023, higher than the USD500 bn worth sold to the US or the value of shipments to the European Union. Direct Chinese exports to the US have fallen, but some of the trades might have been replaced by re-export trades via Emerging Markets.

Asean is now China's biggest export region



Source: China's General Administration of Custom, 15 January 2024

Imports/Exports value of China



Source: Haver, MSCI, GS Research, 20 July 2024

What is most worrisome is not trade but technology development. In the next five years (2024-2029), the gap between China and the US in artificial intelligence (AI) and chip research and manufacturing is set to grow. These are two areas which would have a great impact on the future digital economy, something that the world is increasingly dependent on. Another factor is that in the coming years, foreign and Chinese private investment in China could be smaller than that in the US. As a result, the investment item of the GDP equation will widen the gap of the US-China macro-economic growth.

With regards to national security, we don't believe the risk of a US-China direct conflict is higher under Trump's leadership, than that of the current Biden administration period. One thing we noticed during Trump's administration in 2016-2019 is that he always claimed that he was the only US president since the Cold War who had not been involved in a new war. Thus we believe Trump may be more cautious in preventing a war across the strait as he could leverage the situation and take advantage from it both financially and strategically.

Investment implications

We are overweight quality growth companies and high dividend SOEs. China's localization efforts stand out as a main catalyst of equipment market growth. In line with the third plenum agenda, our stock selection will be focusing on Beijing's quality growth driver such as technology hardware. Policy-support on property demand revival may hand SOE developers the first-mover advantage. AI equipment and advanced packaging companies may ride on Beijing's new growth drivers for the economy. We continue to accumulate banks, energy and telcos for their solid track records of dividend yield.

Investment risks

Heavy indebtedness of the government remains a key investment concern. The macro leverage ratio, which measures total outstanding nonfinancial debt-to-nominal GDP ratio, rose to 287.8% in 2023, an increase of 13.5pt yoy. Another concern is leaking foreign direct investments (FDI) due to decoupling from the West. China attracted RMB498.9 bn in FDI in 1H24, down more than 29% yoy. Last but not least, the property crisis is still far from an end. The total value of unsold homes, unfinished projects and unused land in China is about RMB30 tn. We are still in a wait-and-see stage for any effective demand-side measures, if there is any, to reboot the animal spirits of private homebuyers

Japan

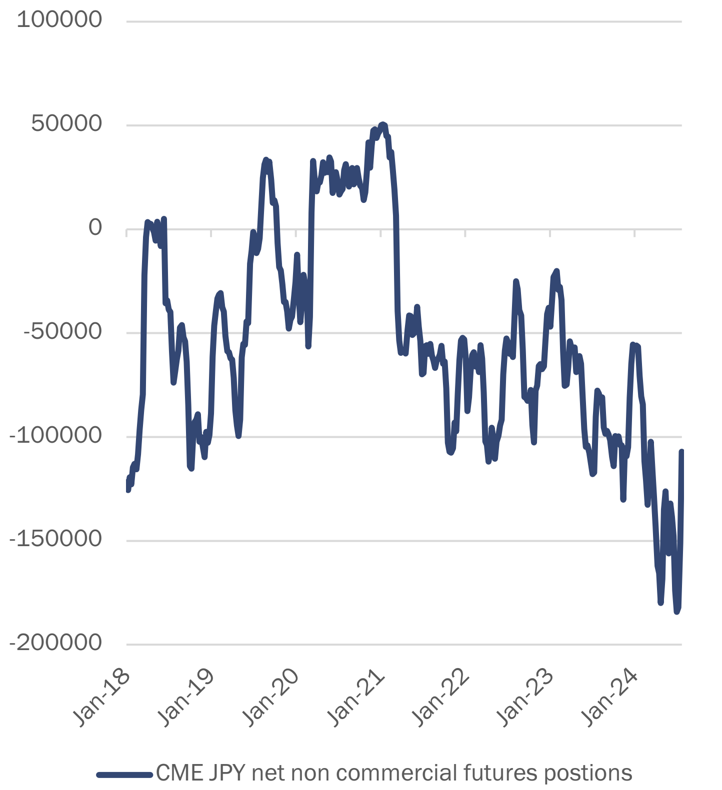
Will JPY volatility derail the Japanese equity bull market?

Japanese equities did well in the first half of the year, on optimism of the country emerging out of its deflationary spiral for the first time in over three decades, and as the Bank of Japan successfully engineered a path of monetary policy normalization for the country. The JPY continued to weaken considerably in the first half, falling -12% against the USD to trade above 160, making it one of the worst performing major currencies in 1H24.

However, there are signs of change with regards to the prospects of the JPY in 2H. The Ministry of Finance has adopted a more pro-active and acute interventionist approach towards outsize JPY moves. An increasingly crowded trade, the JPY has also saw significant volatility in July on forced unwinding of carry positions. Besides positioning, there are other reasons the JPY can strengthen in the near term. Interest rate differentials may start to converge as recent soft data out of the US may finally allow the US Federal Reserve to embark on an interest rate cut cycle just as the BOJ may hike rates for the second time this year. The possibility of a Donald Trump presidency also introduces the prospects of geopolitical uncertainty for the JPY, as he is likely to focus on the export competitiveness of the US and any perceived trade advantage Japan has gained through its currency depreciation.

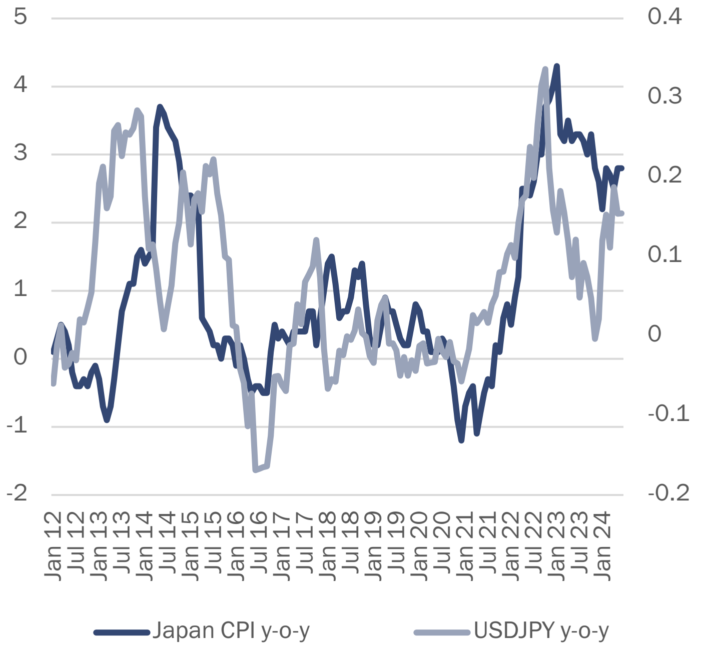
The near term unwind of crowded short JPY positions has also resulted in a selloff in Japanese equities in July. It however does not alter our longer-term optimism on Japanese equities. Position unwinds tend to be short lived, and the global trade cycle remains well intact. Japanese exporters have spent the last three decades fighting the strength of the JPY, and many have been able to carve a competitive niche for themselves through product innovation, manufacturing efficiency and a laser like focus on precision and product quality. Even if this marks the end of the JPY's weakness, we believe the right Japanese companies can continue to maintain their growth trajectories as they have done so in the last three decades.

A significant portion of short JPY futures positioning may have been de-risked according to CME data



Source: Bloomberg, 31 July 2024

A greater uncertainty of the JPY's possible reversal is its impact on reflationary momentum in Japan. Prices and wages have risen in the last two years in response to imported inflation. Whether inflation can continue in a virtuous cycle without the help of a weakening JPY is an unknown at this juncture. Japan's demographic profile still looks unattractive, although we believe there is positive change at the margin in terms of a more flexible attitude towards foreign imported labour. Thus overall while we believe the JPY at above 150 perhaps is too weak for the Japanese government's liking at this juncture even with the recent bounce, longer term the bigger risk to policy makers is the structural strength for the JPY, given the country's historical current account surplus. As such, we believe it would perhaps be wise for BOJ to proceed



on any interest rate hikes in a prudent manner,

A stronger JPY may derail the fragile reflation momentum that is currently building in Japan (Japan CPI vs USDJPY appreciation)

Source: Bloomberg, 31 July 2024

How to Position in Japanese Assets

In terms of sectors, the JPY strength in the near term may favor domestic consumption companies. The JPY's strength helps to mitigate the high level of imported inflation in the country, raising disposal income for higher discretionary spending. Financials such as banks and insurance companies may also start to benefit from a gradual increase in interest rates in Japan. Exporters such as tech, autos, machinery may take a breather amidst JPY strength, but most corporates have USDJPY assumptions of ~150 to 152, and as such we believe unless the JPY significantly strengthens beyond that level, the pace of earnings downgrades may be manageable.

North Asia Tech – Life beyond AI

Tech heavy North Asian markets of Korea and Taiwan regained investor focus in the first half of 2024 on the back of surging enthusiasm for AI related shares. However, unlike the last two years, it was no longer the case of a rising tide lifting all ships. Divergence was high in North Asia Tech – companies which were able to immediately ride on the surging AI demand for processing chips were rewarded with stock price appreciations on the back of earnings improvement. Conversely, those which faced execution issues, or did not demonstrate their ability to monetize their AI ambitions, saw their respective stocks left behind during the rally.

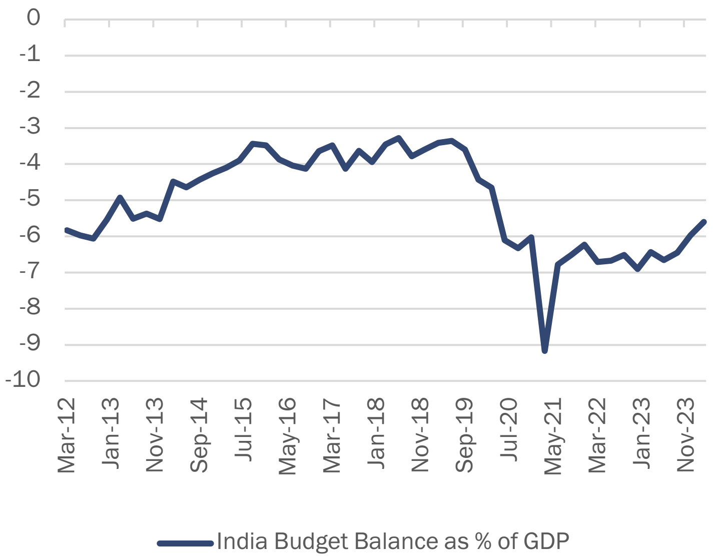
North Asia Tech companies started 2H24 on uneasy footing, as global technology shares came under concerted selling pressure. While some of the factors could be attributable to macro themes such as the rising possibility of a Trump presidency and its implication for US-Asia diplomatic relations and a possible rotation towards more cyclically oriented stocks as the Fed embarks on its interest rate cutting cycle, there are also industry specific developments to be mindful of. The surge in AI spending so far has been funded by hyperscalers who have yet to show significant ROI (return on investments) for their huge capital expenditure outlays. The biggest risk for AI, and tech, in our opinion is the pivot in hyperscalers AI spending as their deprecation expenses start to weigh in. That is the bear case which may be presumptuous for us to assume just yet. 2H tech spending on AI looks resilient with demand still outstripping supply. Also, it may be a scenario where hyperscalers are all still forced to spend on AI to defend their market shares, leading to a period of structurally lower margins for hyperscalers but continued demand for AI suppliers.

Given the strong 1H rally, Asia tech thus may consolidate in 2H as the strength of 2024's AI ramp is increasingly priced in. As such, investors may look towards 2025 AI spending trends in valuing of Asia Tech stocks. What is not yet priced in, which could be a potential incremental surprise for Asia Tech in 2H, is a potential recovery in other non-AI segments. Smartphones, Flash (NAND) memory, analog trends are still sluggish and any signs of a recovery could be interesting stock picking opportunities in 2H.

In summary, we believe 2H would be a period of active stock selection for Asia Tech. Much of the easy money on tech has been made in the last 15 months, and with AI now being a consensus theme, investors need to be prudent in stock selection.

Rest of Asia
India has done well in the first half of 2024 and is still one of the most compelling, macro agnostic trades. A less than desired election outcome, which saw the ruling BJP party needing its coalition party members to form the government, did not derail equity sentiment in the country. The BJP's subsequent appointment of technocrats in the new cabinet, and the Union budget which steered clear of incremental populist measures, should come as a relief to investors who fear the BJP may need to seek a compromise with its coalition partners.

Regardless of election outcome, India remains on a path of economic growth driven by fiscal investment



Source: Bloomberg, 31 July 2024

Singapore is a market dominated by Banks, which have done well in the first half. As the Fed embarks on its interest rate cut cycle in 2H, we believe Singapore interest rates are likely to be stickier on the way down given the wide relative gap in US-Singapore rates, A higher for longer interest rate environment is also positive for Singapore, where its banks through an oligopolistic market structure, are likely to benefit from continued low funding costs. Besides Banks, we also see selected opportunities in turnaround stories within the telecommunications and industrials sectors.

Southeast Asian markets of Indonesia and Philippines may provide interesting tactical macro opportunities in 2H as the Fed embarks on its interest rate cutting cycle. Historically, these markets benefit from a weaker USD given their persistent fiscal and current account deficits. Much however, would depend on USD liquidity. While policy rates are likely to come down, the Fed is still reducing its balance sheet, and it remains unclear the net impact on USD liquidity for these EM countries who need the dollars to fund their deficits and government spending.

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Where shares in the Fund are subscribed or purchased under Section 305 by a relevant person which is:

(a) a corporation (which is not an accredited investor (as defined in Section 4A of the SFA)) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or

(b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary of the trust is an individual who is an accredited investor, securities (as defined in Section 239(1) of the SFA) of that corporation or the beneficiaries' rights and interest (howsoever described) in that trust shall not be transferred within six months after that corporation or that trust has acquired the shares in the Fund pursuant to an offer made under Section 305 except:

(1) to an institutional investor or to a relevant person defined in Section 305(5) of the SFA, or to any person pursuant to an offer referred to in Section 275(1A) of the SFA;

(2) where no consideration is or will be given for the transfer; or

(3) where the transfer is by operation of law.

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