



Macroeconomic overview **BCC Invest**

Investment Outlook 2023: China Market

US Review: Macroeconomic Outlook

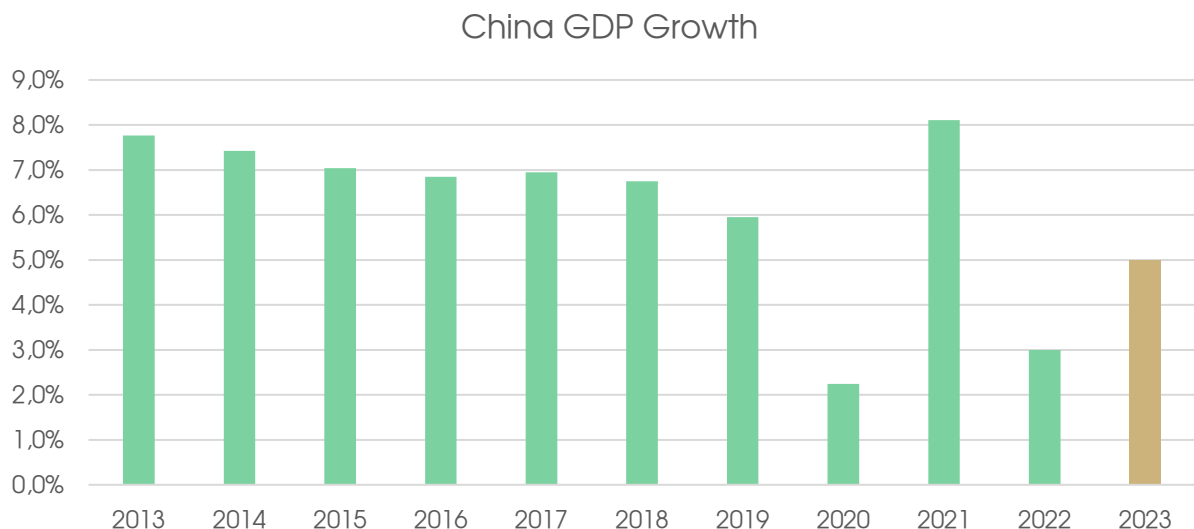
May, 2023

Investment Outlook 2023: China Market

1. Economic growth and business activity

In 2022, China's GDP growth was 3.0%, which was the second lowest value in the last 10 years (after the pandemic 2020). The main reason for this slowdown in economic activity was the policy of zero tolerance for Covid-19, which kept consumer demand, inflation and employment at low levels. The most severe restrictions were in April-May 2022, when the spread of Covid-19 led to a complete lockdown in Shanghai, after which Q2 GDP growth was -2.3% q/q. The transition of the central banks of developed countries to restrictive monetary policy and the slowdown in the real estate market in China put additional pressure on economic growth.

Chart 1. China's GDP Growth Is Expected to Accelerate in 2023 as Covid-19 Restrictions Are Lifted



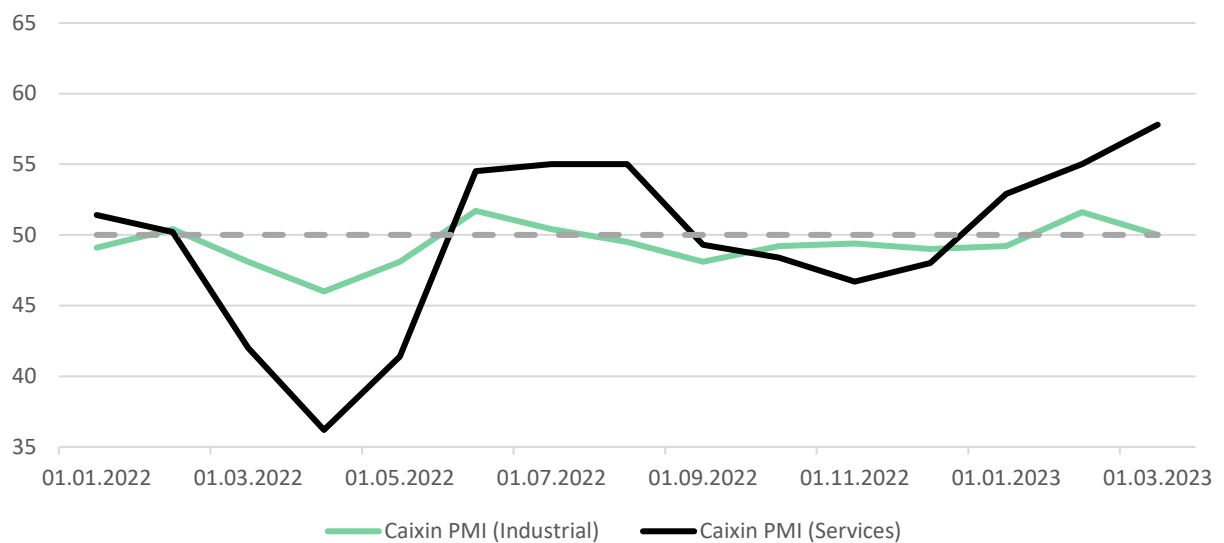
Source: China National Bureau of Statistics

Note: 2023 value is Chinese government GDP growth target

The situation began to change in November 2022, when the Chinese Communist Party, amid protests from the population, decided to lift covid restrictions and resume economic activity. In this regard, analysts' forecasts for economic growth in China for 2023 were optimistic. For example, the IMF forecast for China's GDP growth in 2023 and 2024 is 5.2% and 4.5%, respectively, while the Chinese government has set a goal of achieving 5% GDP growth in 2023.

In the first quarter of 2023, positive dynamics are already observed: GDP growth was 4.5% y / y, and business activity indexes for the first time since August exceeded 50, indicating economic expansion. Following the publication of the data, analysts revised their forecasts for China's GDP growth upwards: currently, the range of economic growth estimates is from 5% to 6.5%. However, some indicators raise concerns about the prospects for economic growth in the short term.

Chart 2. China PMI shows positive trend in Q1 2023



Source: Caixin Global

The full recovery of the economy is likely to take time, and growth in the second half of the year is expected to be higher than in the first. This is due to the increase in the number of infections, which was observed in December-January. A similar situation was observed in 2022 in South Korea and Taiwan, where, after the removal of covid restrictions, the spread of the omicron strain led to a sharp increase in diseases and, as a result, a decrease in population activity for some time.

Despite an increase in infections in early 2023, consumer demand in China has begun to pick up. In March, retail sales grew by 10.6% y/y, which was a record pace for the last year. This increase is likely due to the effect of pent-up demand, which was also observed in other countries after the lifting of restrictions. However, its impact on inflation and unemployment may occur with some time lag.

Chart 3. Consumer demand in China is on the rise

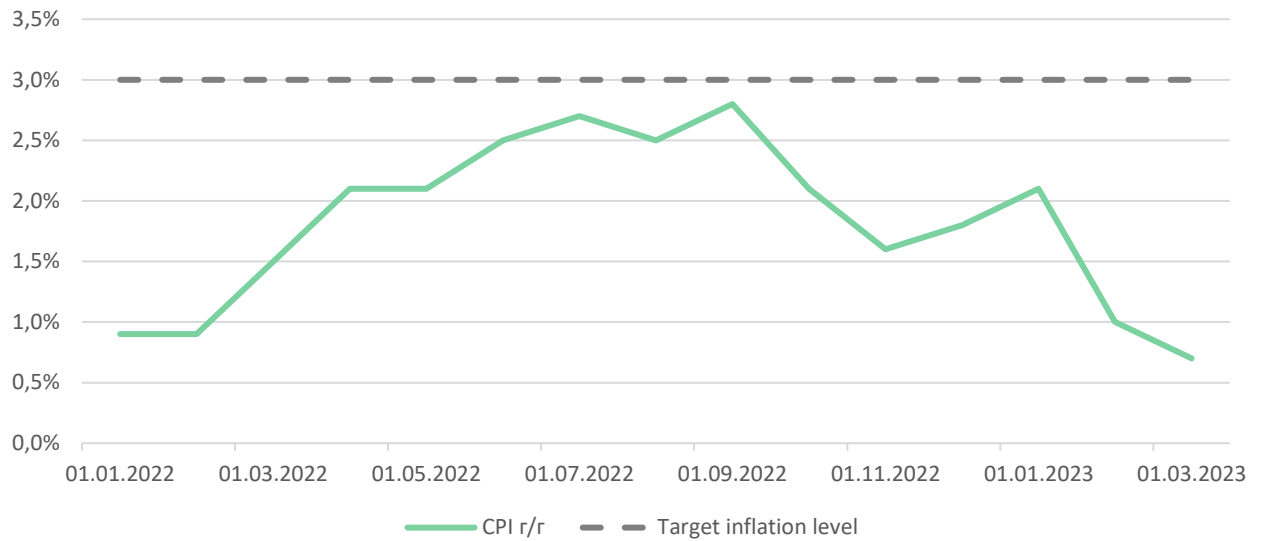


Source: China National Bureau of Statistics

2. Inflation

As of March 2023, inflation in China is 0.7% y / y - the lowest in the world. A recovery in economic activity and stronger consumer demand are likely to drive up inflation in the second half of the year. At the same time, the sustained rise in inflation that has been observed in developed countries since the lifting of covid restrictions is unlikely: the global supply chain crisis has eased, and the global recession may slow down demand for Chinese exports.

China's inflation target is 3% per annum, well above the current level. The increase in consumer spending in the first quarter has not yet begun to be reflected in prices. Loose monetary policy in China is likely to lead to higher inflation in the second half of 2023, but if the recovery in consumer demand is slow, annual inflation may again fall below the target.

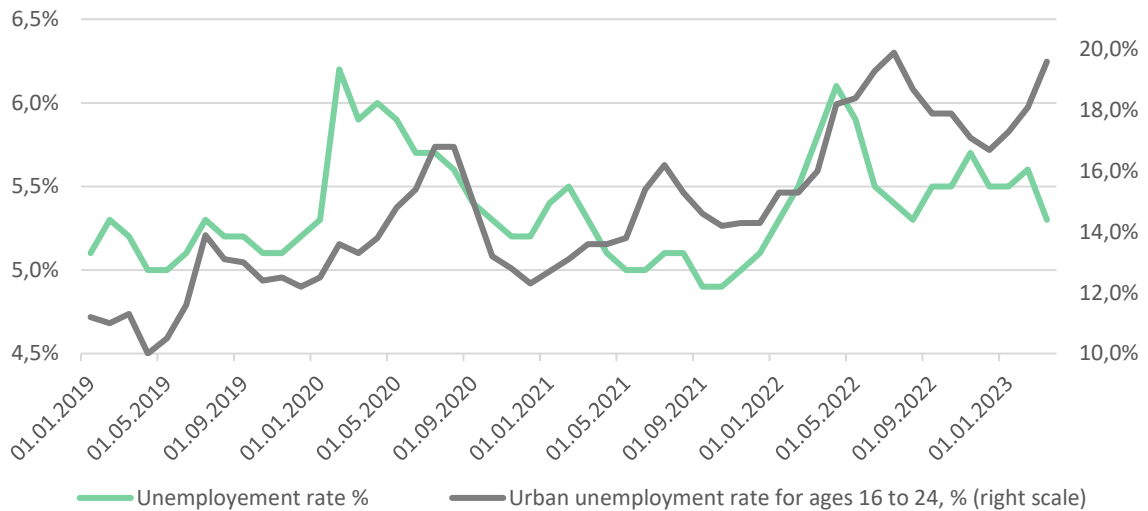
Chart 4. Low inflation in China indicates slow growth in consumer spending

Source: China National Bureau of Statistics

3. Labor market

At the moment, the labor market and wage growth have not yet returned to pre-pandemic levels. Despite some decline in the overall unemployment rate in the 1st quarter of 2023, youth employment in China remains low. This trend in the medium term may slow down the recovery of the labor market, however, as consumer demand recovers, it is highly likely that unemployment will continue to decline.

Graph 5. Economic growth has not yet fully reflected in the labor market



Source: China National Bureau of Statistics

In Q1 2023, incomes of urban residents grew by 2.7% y/y, which is higher than in the second half of 2022, but still significantly lower than before the start of the pandemic. With these dynamics, growth in consumer demand is likely to be limited in the short term.

Chart 6: Wage growth falls short of pre-pandemic pace



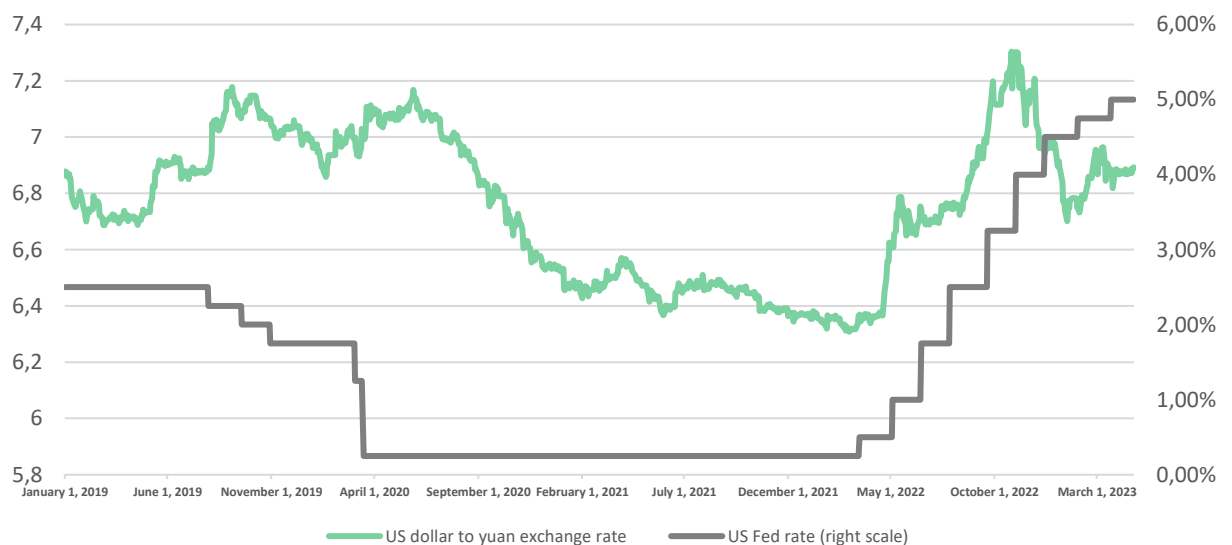
Source: China National Bureau of Statistics

4. Fiscal and monetary policy

Unlike most countries, the main objective of monetary policy in China is not to target inflation, but to maintain the competitiveness of the yuan exchange rate.

Against the backdrop of a rate hike by the US Federal Reserve, the yuan exchange rate against the US dollar weakened by 15% over 10 months of 2022, but strengthening followed at the end of the year. In 2023, due to slowing inflation and lower economic growth in the US, the Fed rate increase may stop. This will help reduce capital outflows and moderately strengthen the yuan.

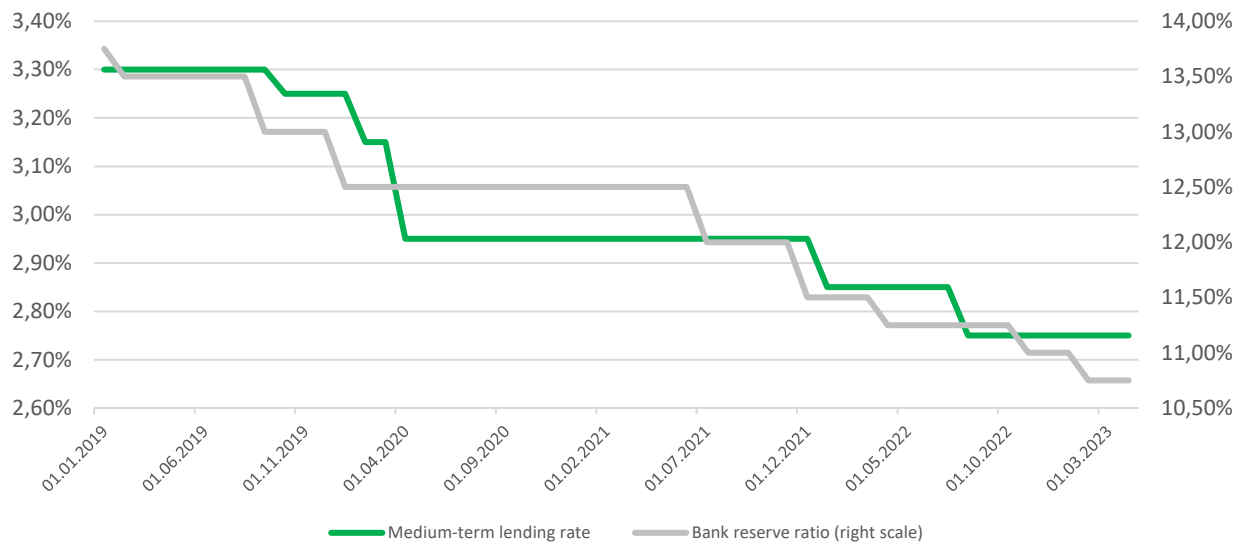
Chart 7. The yuan is strengthening on the back of expectations for the stabilization of the US Fed rate



Source: US Federal Reserve, Yahoo Finance

At the same time, the current monetary policy is aimed at supporting economic growth. In March 2023, in order to support the economic recovery, the People's Bank of China lowered the bank reserve ratio to 10.75%, which is the lowest rate since 2007. The medium-term lending rate (MLF) also continues to systematically decrease, which increases the availability of credit. It is worth noting that the rate cut began back in 2022, but due to covid restrictions, this did not have a significant effect on the economy.

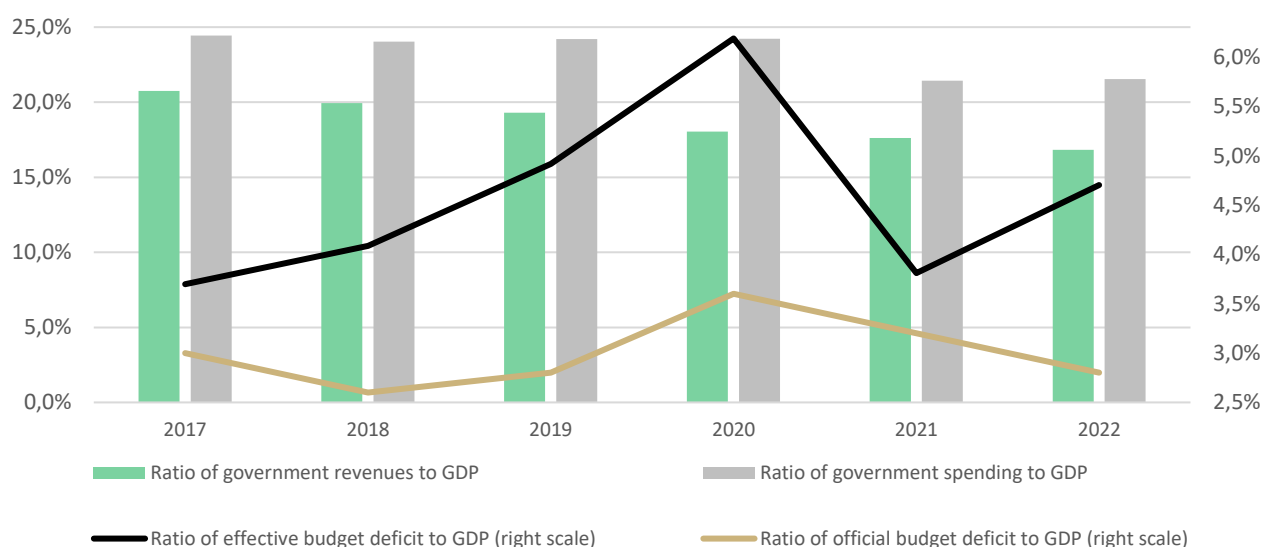
Chart 8. Monetary policy in China continues to ease



Source: People's Bank of China

Fiscal support in China is targeted. According to China's Fourteenth Five Year Plan, the government should provide support to areas such as science, education, culture, health and agriculture. With the spread of COVID-19, the budget deficit-to-GDP ratio has risen: counter-cyclical regulation implies increased spending during times of crisis. In 2023, during the period of economic recovery, it is expected that fiscal support from the government will continue and the ratio of the official budget deficit to GDP will exceed 3%.

Chart 9. Fiscal support expected to continue in 2023 for economic recovery

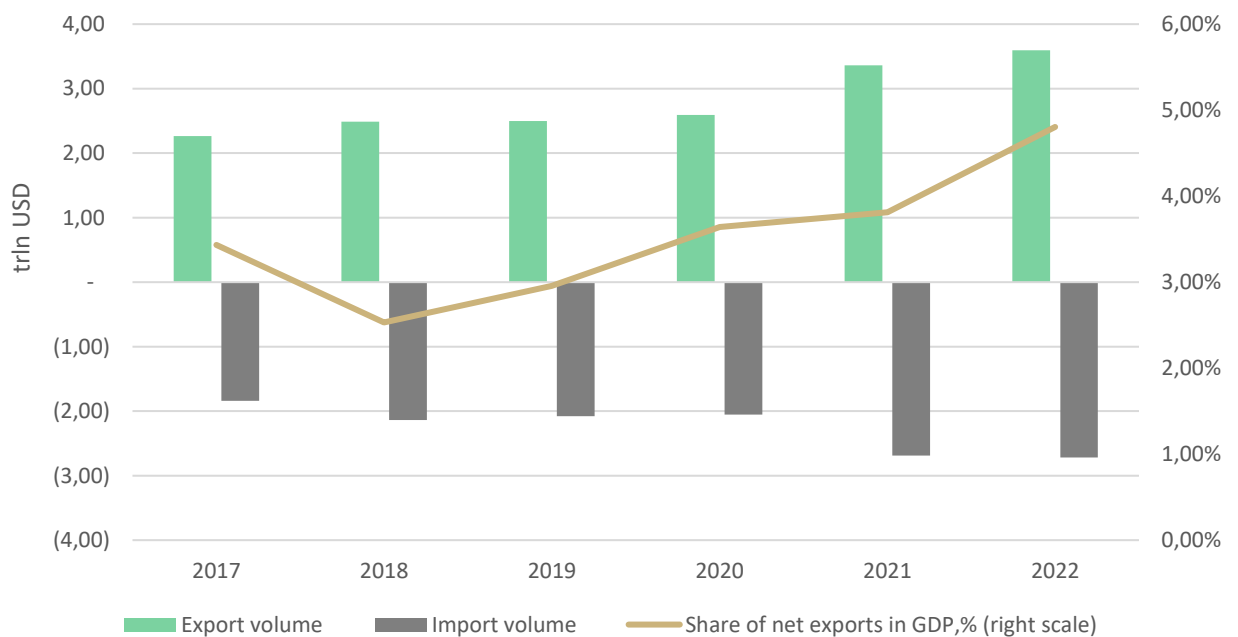


Source: China National Bureau of Statistics

5. Trade balance and foreign exchange reserves

China is generally a net exporter: in order to keep Chinese products competitive on the international market, the country has a managed exchange rate regime. At the same time, the volume of export earnings may depend on the state of the global economy. A global economic slowdown is expected in 2023 amid high rates, which is likely to negatively affect the share of net exports in GDP. In addition, economic expansion and the strengthening of the local currency against the US dollar may lead to an increase in imports.

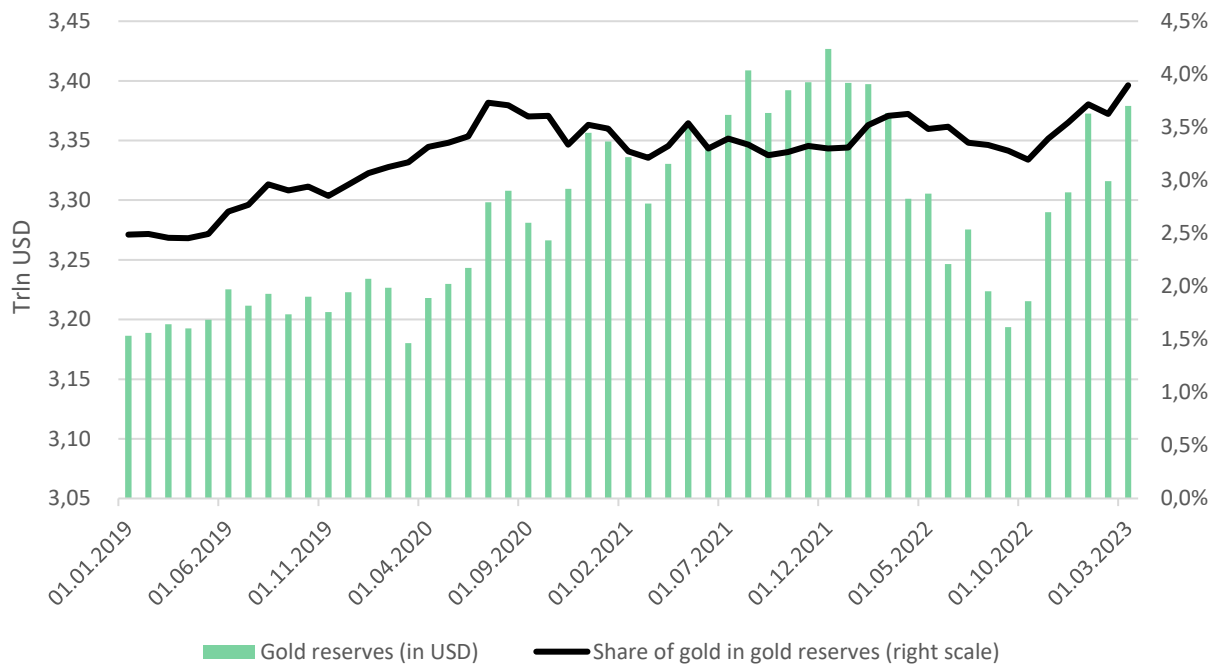
Chart 10: China's net exports have been growing in recent years, but may decline in 2023



Source: China National Bureau of Statistics, BCC Invest calculations

The weakening of the yuan in the first 3 quarters of 2022 was accompanied by a reduction in China's gold and foreign exchange reserves. The increase in reserves resumed in October. It is worth noting that the share of gold in the structure of international reserves began to grow against the backdrop of China's desire to diversify. However, at the moment it does not exceed 4%.

Chart 11. The share of gold in China's international reserves is increasing



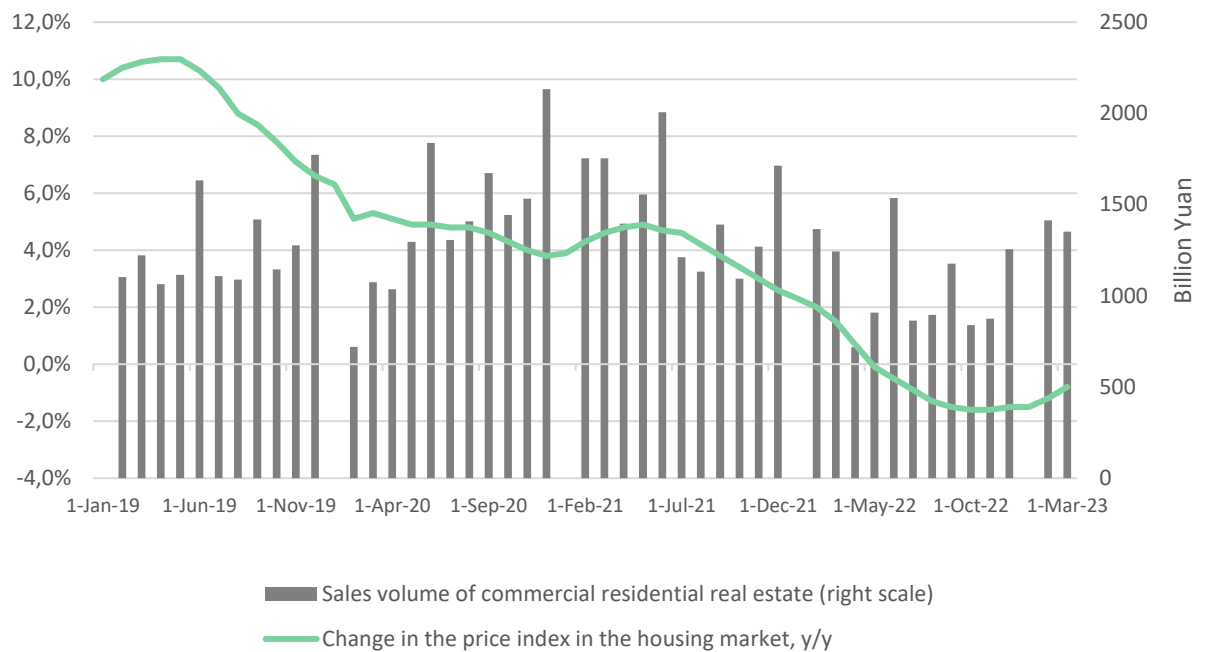
Source: State Monetary Administration of China, BCC Invest calculations

6. Real estate market

In 2020, the Chinese government passed the so-called “three red lines” law, according to which developers who did not meet the debt load limits were prohibited from increasing the amount of debt obligations. This significantly increased the risk of default for Chinese construction companies. In the summer of 2021, rating agencies downgraded the credit ratings of Evergrande Group, the largest residential real estate operator in China, and in December the developer went into technical default. The decline in the investment attractiveness of buying real estate caused a decline in sales in the housing market, which continued throughout 2022.

While the real estate market is still deflated, sales in Q1 2023 have started to pick up. This happened against the background of increased government support for the industry, which began in the second half of 2022. The market is expected to stabilize in 2023.

Chart 12. The real estate market shows signs of recovery after the crisis, but deflation is not over yet



Source: China National Bureau of Statistics

Note: The National Bureau of Statistics of China does not provide real estate sales data separately for January of each year, they are included in the February figures.

A similar trend is taking place in real estate investment. Despite announced developer financing measures, real estate investment and housing under construction are still declining in Q1 compared to the same period in 2022. Insufficiently high rates of recovery of the housing market may be a negative signal for investors.

Chart 13. Investment in real estate continues to decline



Source: China National Bureau of Statistics, BCC Invest calculations

7. Stock and bond market

At the beginning of 2021, the MSCI China stock index, which reflects the dynamics of stocks of Chinese companies of large and mid-cap, reached its maximum, after which the Chinese stock market began a long drawdown. So, in October 2022, the maximum drawdown from the peak was 63.4%.

Chart 14. The Chinese stock market has shown negative dynamics over the past two years



Source: Yahoo Finance

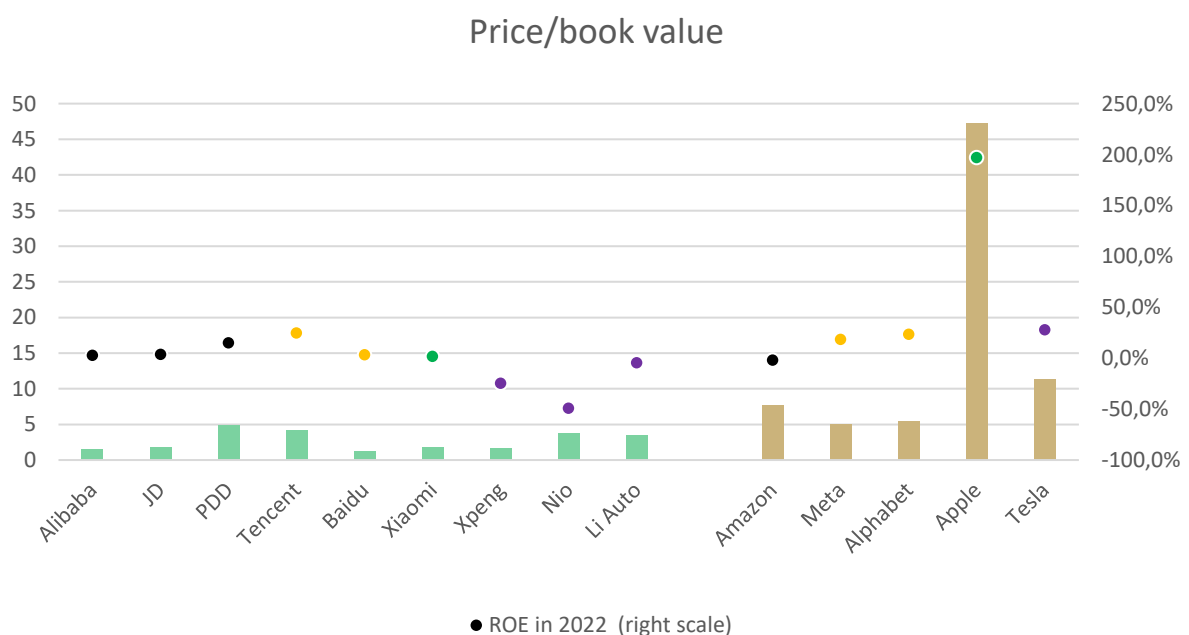
This fall occurred against the backdrop of negative news related to the regulatory policy of the PRC, covid restrictions, the real estate crisis, geopolitical tensions in the region, and the threat of delisting the shares of Chinese companies in the

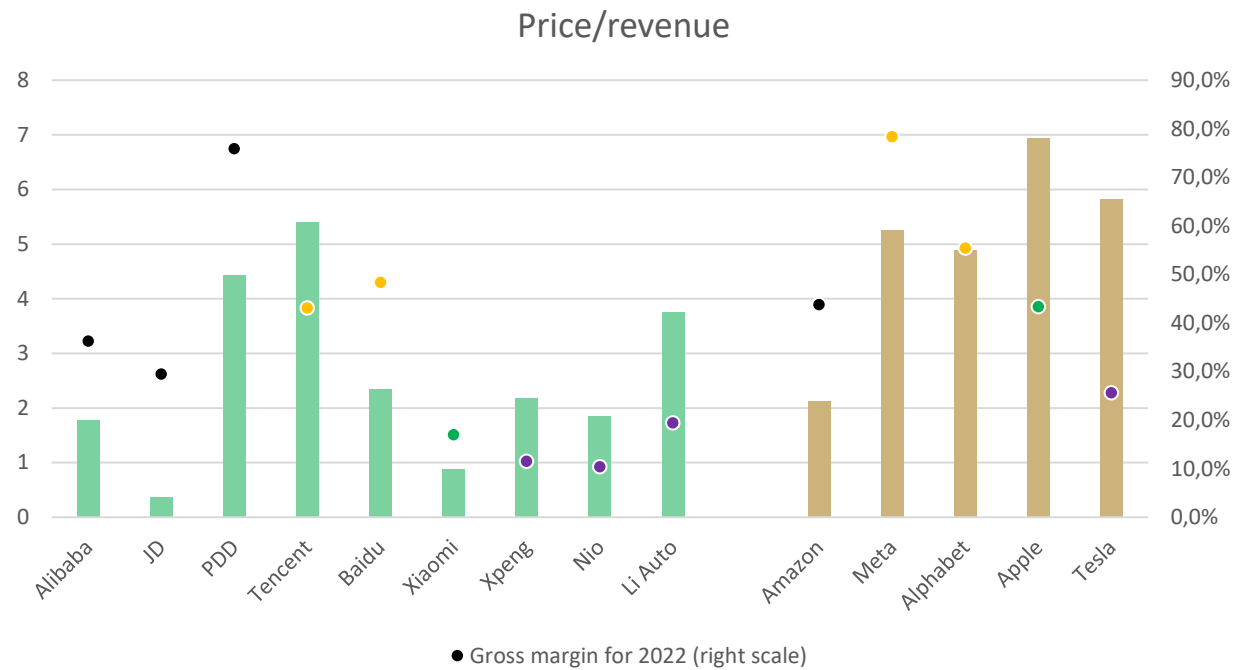
United States. Regulatory measures included fines for antitrust and disclosure violations, IPO cancellations, and targeted domestic sanctions. The most telling example is government pressure on the Alibaba Group. The threat of a military conflict in Taiwan and tense relations between China and the United States also created an unfavorable news background for investors.

However, against the background of the economic slowdown and the dissatisfaction of the population in the country with covid restrictions, the first priority of the Communist Party was to restore the economy. In October 2022, at the 20th Party Congress, Xi Jinping announced the need to support the domestic sectors of information technology, artificial intelligence and new energy. The initial market reaction to the outcome of the congress was negative: investors were unhappy with Xi Jinping's re-election for a third term and statements about maintaining a zero-tolerance policy for COVID-19. However, at the end of November, after the protests, covid restrictions began to be eased, which had a positive impact on the quotes of Chinese companies. The Chinese government has embarked on a full-scale recovery of economic activity.

At the same time, the fundamental and technical indicators of many Chinese stocks indicate their market undervaluation. The negative news background over the past two years has undermined investor confidence, but at the same time, profitability indicators remain normal.

Chart 15. Price multiples of Chinese companies are on average lower than those of similar American companies with comparable profitability indicators





Source: company reporting, finviz.com, Yahoo Finance

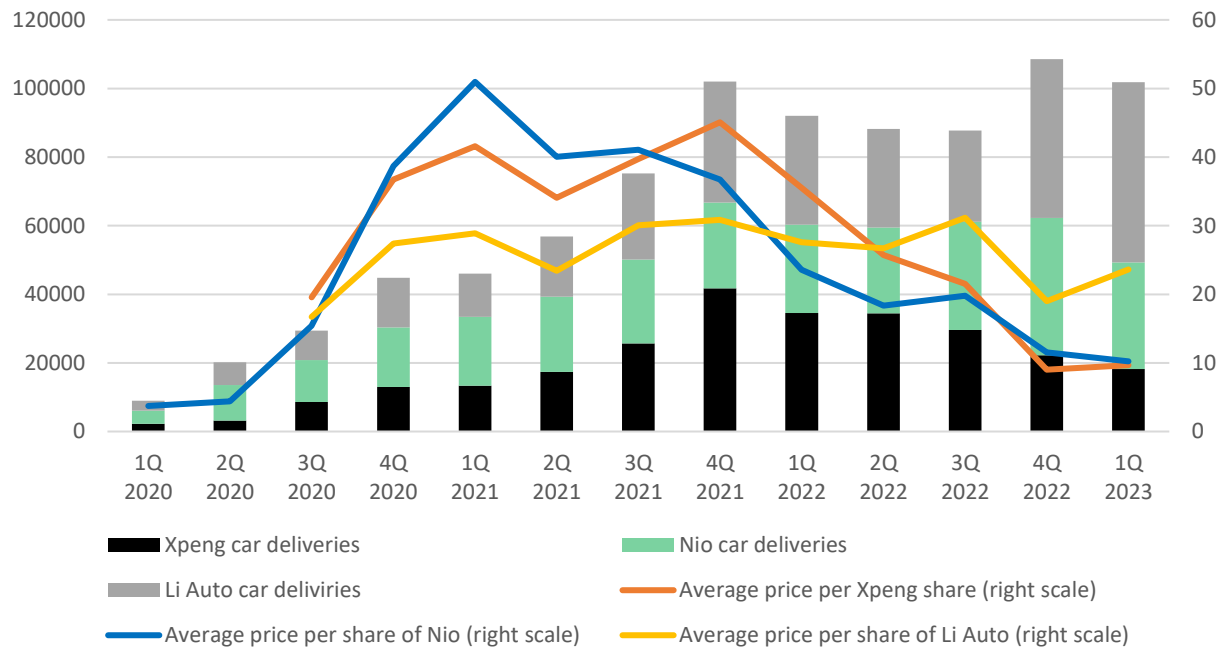
Note: data on price multipliers are taken as of 04/27/2023

Box 1. Electric vehicle market in China

China is the world's leading country in sales of electric vehicles. The 3 Chinese companies with the largest market capitalization are Li Auto, Nio, Xpeng. Despite the fact that at the moment all companies are unprofitable, deliveries of electric vehicles have increased significantly over the past 3 years. At the same time, companies are striving to optimize production costs. The shortage of semiconductors observed in 2020-2022 led to a slowdown in car production worldwide. Companies are making moves to produce their own chips, including for the introduction of autonomous driving technology.

Starting from the second half of 2021, shares have been declining in price, which was associated with negative investor expectations regarding a slowdown in production, covid restrictions and a general drawdown in the market. The triple-digit year-on-year growth in shipments seen in 2021 has indeed slowed down, but the demand for electric vehicles is still there. Companies are moving into a more mature growth stage.

Chart 16. Electric vehicle deliveries in China continue to improve



Source: company reporting, Yahoo Finance

Unlike the US, where an inverted yield curve is a sign of an impending recession, in China, the spread between long and short bond yields is positive, indicating positive expectations for economic growth. The credit rating of government bonds remains at investment grade:

	Standard & Poor's	Moody's	Fitch
Credit rating	A+	A1	A+

Chart 17. The spread between the yields of 10-year and 2-year bonds remains consistently positive, the yield curve has an upward slope



Source: Bloomberg

8. Risks

The prolonged drawdown of Chinese stocks reflected the most critical risks inherent in doing business in China. As a rule, they are not related to the internal problems of companies, but rather have an exogenous character. Among the main such risks at the moment, the following can be distinguished:

- **Regulatory policy of China.** In 2020-2021, government pressure on some large companies has caused a decrease in the investment attractiveness of the Chinese stock market as a whole. Despite the fact that authorities later announced their willingness to support technology companies, the narrative from the regulators can change dramatically depending on the interests of the Communist Party. A new turn of regulatory policy may again cause a negative reaction from investors.
- **Geopolitical Tensions.** Concerns about a possible conflict in Taiwan are one of the reasons for the current stagnation of Chinese stocks. In the event of the outbreak of hostilities, China could be subjected to large-scale sanctions pressure, as happened with Russia in 2022. At the same time, it is worth noting that the unleashing of the conflict runs counter to the current economic and political agenda in China, aimed at restoring business activity. In this regard, we believe that the risk of military conflict in the medium term is moderate.
- **Slow economic recovery after the lifting of restrictions.** At the moment, there is some positive dynamics of macroeconomic indicators, but it also points

to insufficiently high rates of recovery. Among these indicators: low inflation, slow wage growth, continued deflation in the real estate market. The publication of macro data below expectations is often accompanied by the sale of Chinese shares in the market. Nevertheless, one can expect that the provided fiscal support, coupled with loose monetary policy, will have the necessary positive impact on aggregate demand. This risk is rather short-term.

- **The impact of the recession on Chinese exports.** Against the backdrop of a high interest rate regime supported by the world's central banks, a global economic slowdown is expected in 2023. This could reduce external demand for Chinese goods and services, which is likely to put pressure on China's net export component. The risk of a recession affecting China's economic recovery is likely, but its effect is rather limited.
- **Resumption of covid restrictions.** Over the past year, thanks to vaccination and the acquisition of herd immunity, the death rate from COVID-19 has dropped significantly. The omicron strain, which appeared at the end of 2021, had a much higher spread rate than the previous ones, but at the same time, a lower severity of the disease. In this regard, large-scale covid restrictions around the world no longer seemed necessary. However, new strains of coronavirus continue to emerge. The "kraken" and "arcturus" strains caused an increase in diseases, but were much less dangerous than the previous ones. The zero-tolerance policy for COVID-19 was relaxed in November 2022, but if new strains become widespread in China, restrictions could be reintroduced. This will lead to a greater slowdown in the economic recovery and likely adversely affect stock prices. The introduction of new restrictions may carry political risks for the CPC, while new strains are likely not to pose much of a threat. We believe that this decision would be inappropriate and therefore unlikely.

9. Conclusion

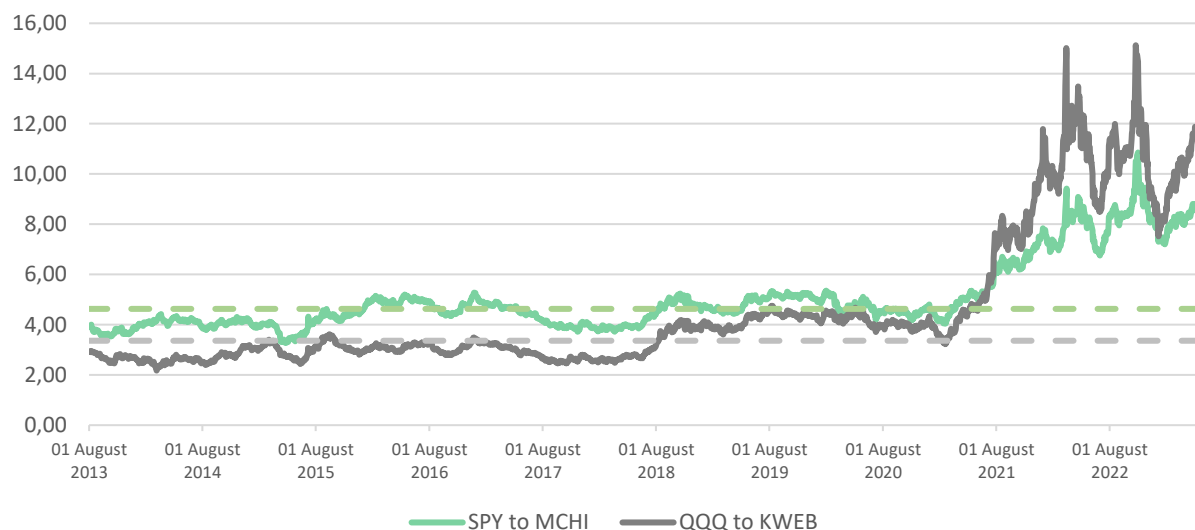
The full-scale opening of the Chinese economy is one of the main investment topics of 2023. The acceleration of economic activity, coupled with a positive news background, can give a strong impetus to the growth of Chinese securities. The forecast range for China's GDP growth in 2023 is between 5% and 6.5%, well above the 2022 level of 3%. This recovery will take time: it is expected that high growth rates will be observed only in the second half of 2023. At the moment, macroeconomic indicators show some positive dynamics, but some data indicating a slow pace of recovery continues to cause investors to be wary. At the same time, external risks associated with the regulatory policy and actions of China in the political arena remain.

After a long drawdown in the Chinese stock market, observed since the beginning of 2021, fundamental and technical indicators indicate that Chinese shares are oversold. Despite the persistence of some negative factors, in the medium and long term, recovery of quotations is likely. We highlight several economic conditions under which the growth of the Chinese stock market seems most likely:

- Moderate rise in inflation;
- Bringing annual wage growth closer to pre-pandemic levels;
- Maintaining current levels of fiscal support and loose monetary policy;
- Growth in sales and investment in the real estate market.

The chart below illustrates how Chinese stocks are oversold relative to US stocks. The ratio of US stock indices to Chinese since the second half of 2021 is significantly higher than the historical median. Regulatory policy, which largely influenced this change, is currently being eased, and the expected growth of the Chinese economy is much higher than in the United States. If the above conditions are realized, the return of investor optimism towards China could lead to a significant increase in Chinese securities. For a long-term investor, attractiveness can be rated at 9 on a 10-point scale.

Chart 18. The current ratio of American stock indices to Chinese ones is significantly higher than the median historical



Source: Yahoo Finance, BCC Invest calculations

US overview: **Macroeconomic Outlook**

US Review: Macroeconomic Outlook

The investment environment is inevitably fraught with risks, but it is uncertainty that becomes the source of new opportunities. We are tackling periods of volatility as markets grapple with headwinds such as higher inflation, monetary tightening and recession risks. Despite this, investment portfolios have shown solid growth this year, helping to offset some of the 2022 losses. American stock markets successfully completed the 1st quarter, and the technology sector, with its growth, was able to even out the weak performance of the banking sector. Despite ongoing uncertainty, and that the road to recovery in the near future may be difficult, we are convinced that

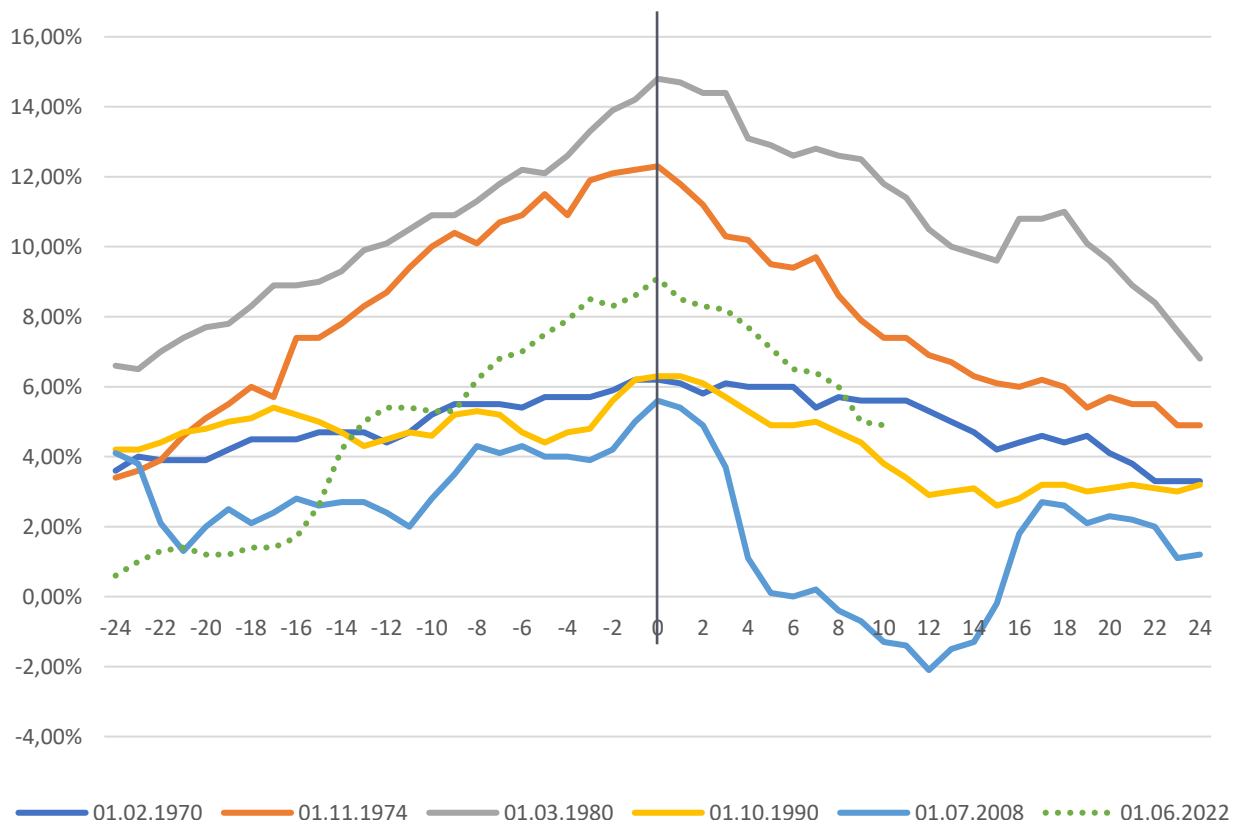
1. The disinflationary trend continues.

Inflation data has been a source of concern among investors for much of the past 18 months. CPI, having peaked in June 2022, shows a downward trend. The latest release of consumer prices in the US for April exceeded expectations. Headline inflation stood at 4.9% y/y, declining for the 10th straight month since CPI peaked at 9.1%. Inflation remained under control thanks to lower prices for fuel, energy services and new cars, while the cost of used cars and gasoline showed an increase. The situation in the latter categories may stabilize in the coming months, especially as gasoline futures are beginning to reverse their downward trend. As in previous months, the cost of housing also made a significant contribution to inflation. However, based on historical data on the delay between the decline in inflation and new leases, and its reflection in official statistics, we assume that housing inflation will start to cool in the summer. The most encouraging moment in the latest inflation report was that the indicator that the Fed focused on core inflation of services, excluding housing (depending heavily on the state of the labor market) has improved significantly, showing the lowest growth rate in the last nine months. The increase in jobless claims to an annual high in April indicates that labor market tensions are starting to cool, which in turn should help slow wage growth. as well as its reflection in official statistics, we assume that housing inflation will start to cool down in the summer. The most encouraging moment in the latest inflation report was that the indicator that the Fed focused on core inflation of services, excluding housing (depending heavily on the state of the labor market) has improved significantly, showing the lowest growth rate in the last nine months. The increase

in jobless claims to an annual high in April indicates that labor market tensions are starting to cool, which in turn should help slow wage growth. which the Fed has been focusing on, core inflation in non-housing services (which depends heavily on the state of the labor market) has improved significantly, showing the lowest growth rate in the last nine months. The increase in jobless claims to an annual high in April indicates that labor market tensions are starting to cool, which in turn should help slow wage growth. which the Fed has been focusing on, core inflation in non-housing services (which depends heavily on the state of the labor market) has improved significantly, showing the lowest growth rate in the last nine months. The increase in jobless claims to an annual high in April indicates that labor market tensions are starting to cool, which in turn should help slow wage growth.

Conclusion. We forecast that consumer inflation will continue its downward path. Historically, inflationary fluctuations have been symmetrical, meaning that the pace and duration of the decline after the peak of inflation has largely matched the pace and duration of the preceding rise. This pattern continued even during the high inflation periods of the 1970s and 1980s. We assume that by the end of the year the inflation rate may fall to 3%, which will be a significant success, given the magnitude of the peak reached.

Chart 1. Dynamics of inflation in different years. The graph shows the dynamics of inflation for two years before and after the main peaks. For now, this year's decline is consistent with historical symmetry in inflation, which typically declines at about the same rate as it rises.

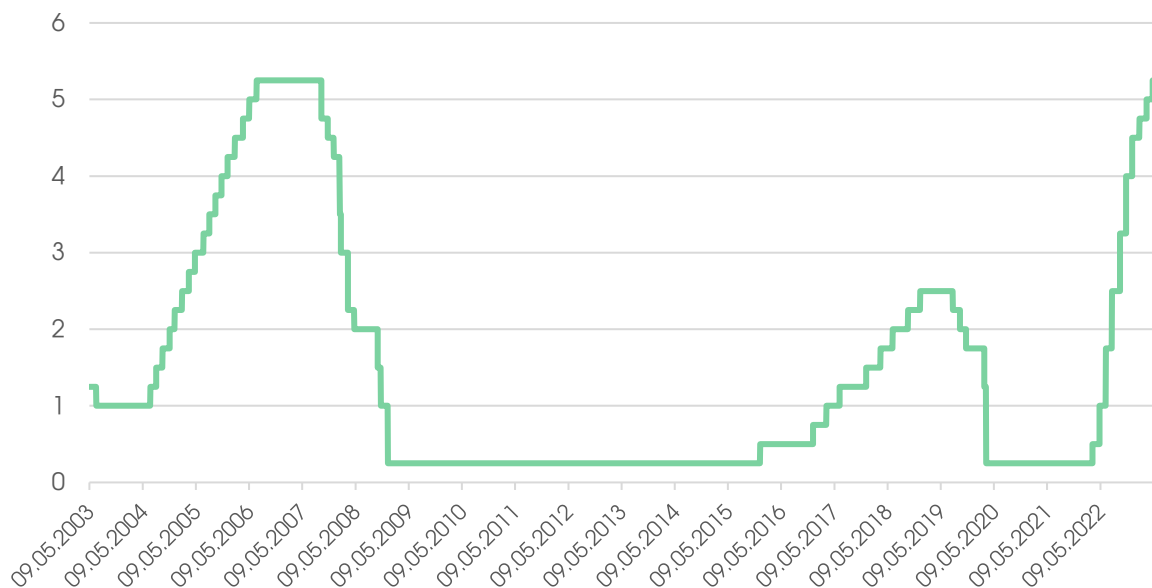


Source: US Bureau of Labor Statistics

2. Pause in monetary tightening.

The slowdown in both consumer and producer prices takes some of the pressure off the Fed to raise rates, reinforcing expectations of a possible pause. The Federal Reserve raised interest rates twice in the first quarter of 2023. In May, the Fed raised rates by another 0.25%, the 10th consecutive increase since March 2022, bringing the rate to 5.0-5.25%.

Chart 2. Dynamics of changes in interest rates



Source: Bloomberg

While the Fed is considering pausing the rate hike cycle, Jerome Powell dismissed the possibility of a cut soon. He stressed that "it would be inappropriate to cut rates" given that inflation is still at a high level and it will take time to return to the target level of 2.0%. However, markets expect the Fed to cut rates at the September meeting. We believe that the strong April labor market report reduces the likelihood that the Fed will cut rates, and most likely lead to a long pause in rate changes.

Table 1. Fed Rate Change Probability Based on 30-Day Federal Funds Futures Price Data

Likely rate:	Next Fed meeting date:				
	06/14/2023	07/26/2023	20.09.2023	11/01/2023	13.12.2023
4.00 - 4.25					15.20%
4.25 - 4.50				16.00%	45.20%
4.50 - 4.75			24.30%	46.80%	31.40%
4.75 - 5.00		27.60%	58.40%	30.60%	7.50%
5.00 - 5.25	85.60%	62.60%	16.10%	6.30%	0.70%
5.25 - 5.50	14.40%	9.80%	1.20%	0.40%	

Source: Bloomberg

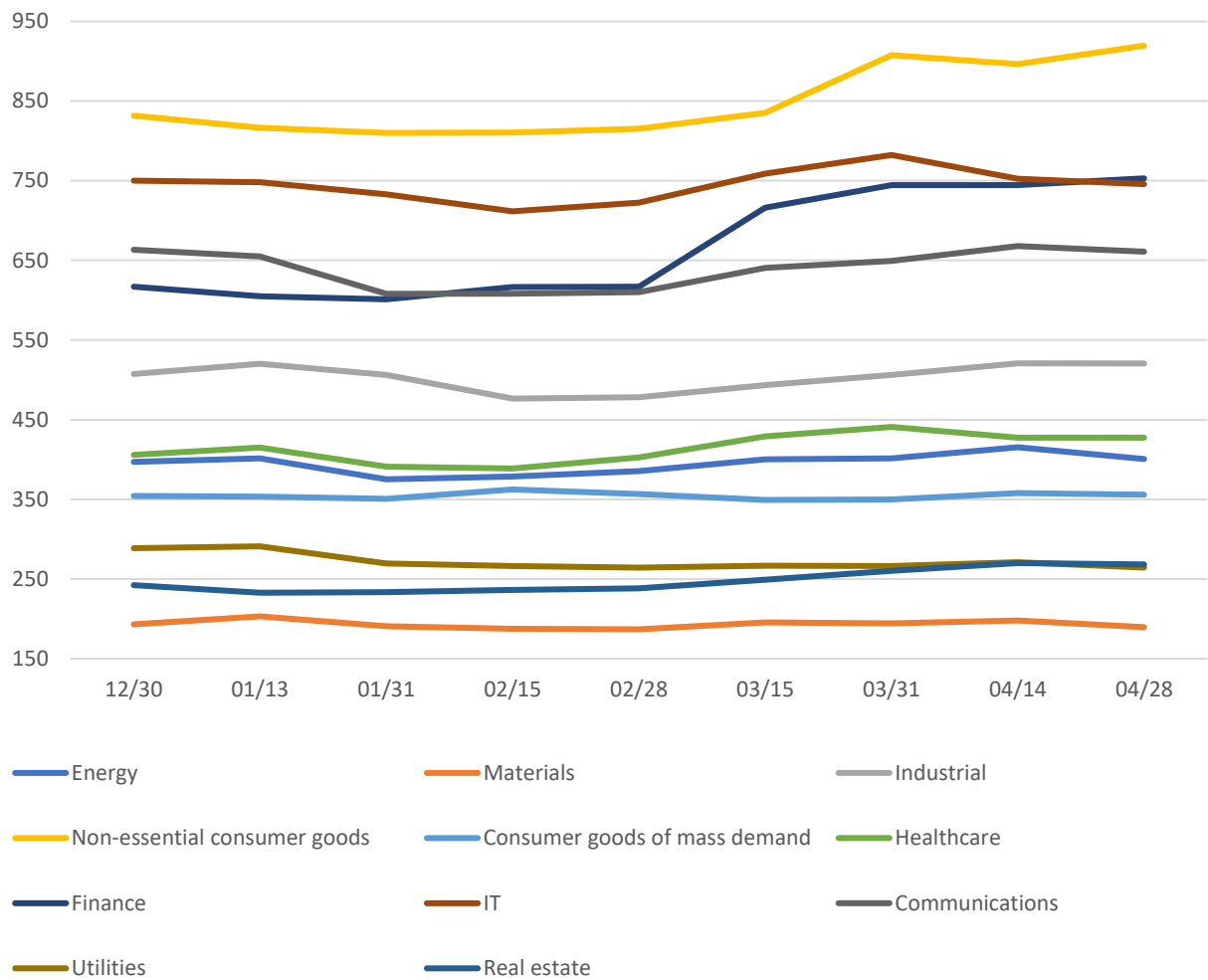
Note: calculated by adding the probabilities of all target rate levels above (or below) the current target level

3. Stock market.

The expected completion of the US Fed rate hike cycle is gradually beginning to have a positive effect on the mood of stock market participants. At the same time, certain risks still remain. We forecast that economic growth will continue to decline, as it did in the first quarter, although we do not expect a deep or long-term downturn.

During periods of instability, markets may fluctuate in a certain range, or there may be a change of leaders among sectors. We have already seen some manifestations of this in recent months, when market leadership has shifted between different segments, while interest rates have fluctuated and monetary policy expectations have been volatile. Lower volatility could signal a wait-and-see attitude as markets watch to see if inflation reaches the Fed's targets without further tightening of monetary policy, a significant slowdown in the economy, or a significant blow to corporate earnings forecasts.

Chart 3. Short selling volumes in the S&P500 sectors indicate the wait-and-see attitude of investors - short volumes are basically at the same levels as at the beginning of the year.



Source: Bloomberg

Over the past year, a relationship has formed in the following sequence: inflation determines Fed policy → policy Fed defines interest rates → interest rates affect on consumer expenses → consumer expenses govern economy → economy will form corporate income, and corporate earnings will determine market performance. As we see signs of lower inflation and Fed funds futures point to a pause in monetary policy tightening, positive market conditions are emerging. Over the past 40 years, between the final Fed rate hike in the tightening cycle and the first rate cut in the next easing cycle, stock market returns have averaged 11%, while bond returns have averaged nearly 7%.

Table 2: Average Market and Bond Returns During Fed Easing

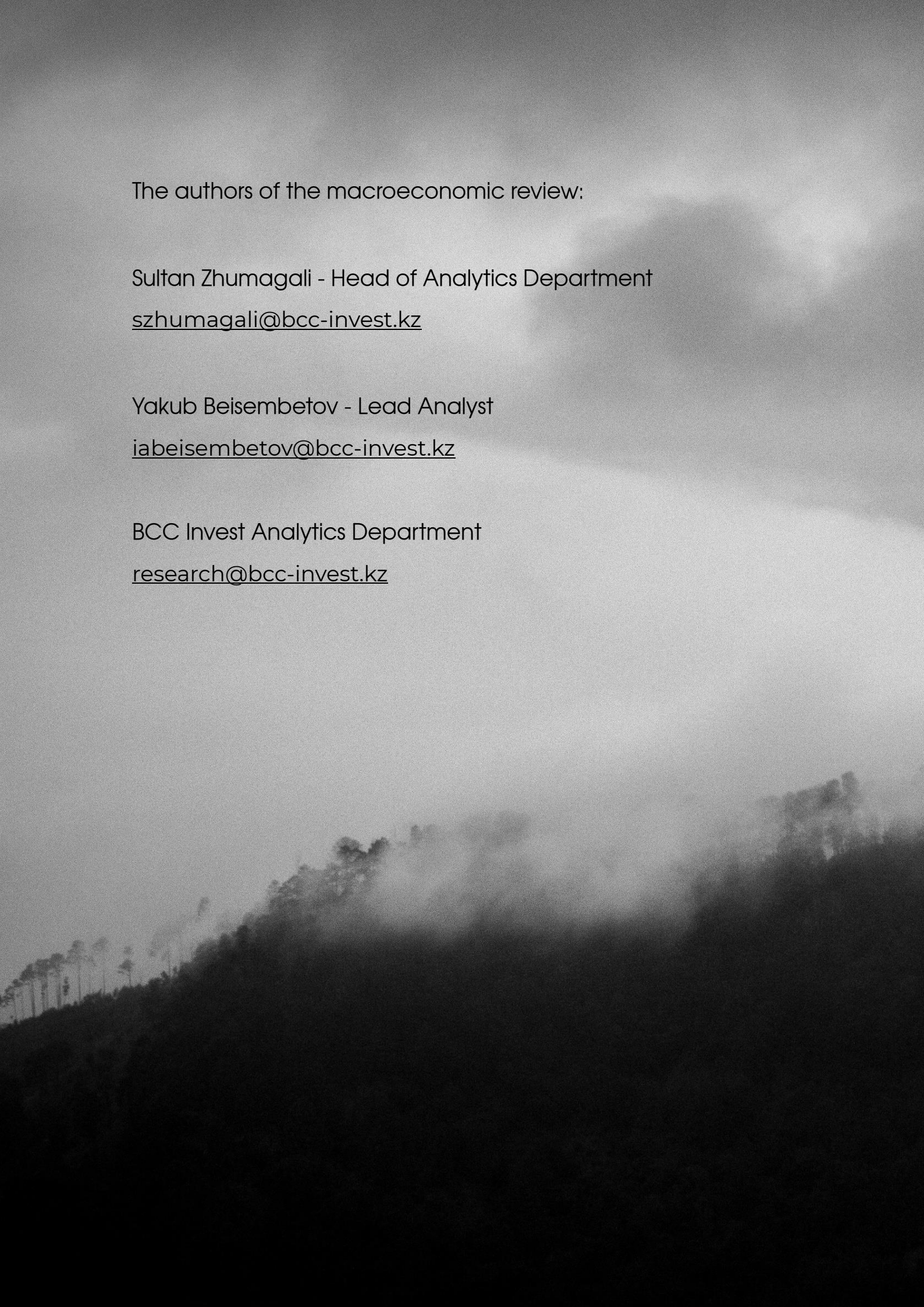
Last rate increase	First rate cut	Number of months	S&P 500 returns	US bond yield with investment grade
August 1984	October 1984	1.4	11%	4%
September 1987	October 1987	1.5	-2%	-2%
February 1989	June 1989	3.3	11%	7%
February 1995	July 1995	5.1	19%	10%
May 2000	January 2001	7.6	-7%	11%
June 2006	September 2007	14.6	25%	10%
December 2018	July 2019	7.3	18%	7%
Average		5.8	11%	7%

Source: Bloomberg

4. Conclusion

The review of the macroeconomic situation in the US market highlights moderate optimism for the rest of 2023. The current economic situation in the US, despite some challenges, reflects a certain stability and suggests positive prospects for the nearest investment horizon. A moderate slowdown in inflation, together with an expected stabilization period in monetary policy, is expected to contribute to a steady increase in assets in the stock market.

Economic and financial markets have different cycles, and as a rule, financial markets act ahead of the real sector of the economy. We are probably in the final stages of a bear market, which provides an opportunity for investors to find favorable entry points or to average out current positions.



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