

2024 Market Outlook

January 2024

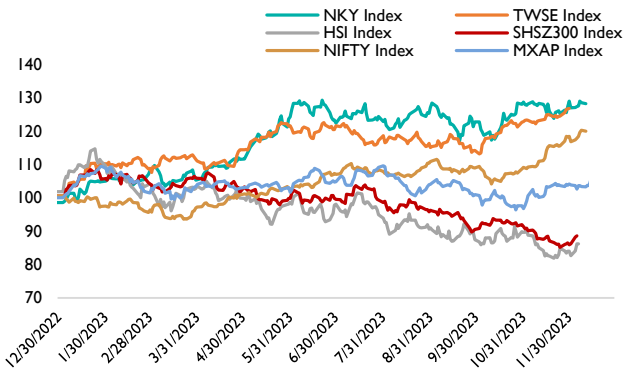
2023 has been a year full of surprises and volatility. In terms of US Equities, as represented by the S&P Global, it has already exceeded most of the optimistic targets set by sell-side analysts a year ago (Chart 1). Thanks to the surprisingly resilient consumer and employment sectors, confidence in the US economy achieving a “soft-landing” is being bolstered. As inflationary pressures start to ease, the key narrative on Wall Street is shifting from “Higher-for-Longer” outlook to when and how low interest rates will go, although this transition is occurring gradually and is met with some ceremonial pushback by the Fed. Closer to home in Asia, the rally in Japanese equities has caught everyone by surprise (Chart 2). India and Taiwan extended their streak on the back of structural growth opportunities. On the other hand, sentiment towards China assets remains low due to lackluster macroeconomic fundamentals. Geopolitical tensions around the world are expected to persist, leading to a continued trend of reducing risk exposure and seeking alternative locations for business operations. Consequently, the risk premium associated with Chinese assets is likely to remain high.

Chart 1: US 2023 stock market actual performance vs sell-side forecast in 2022 (S&P Index (“SPX”) current price level: 4,644)

Name of Institution	2023 Target Price	Hit / Miss	Deviation
Fundstrat	4,750	Hit	2%
Deutsche Bank	4,500	Miss	-3%
Oppenheimer	4,400	Miss	-5%
BMO	4,300	Miss	-7%
Jefferies / JP Morgan	4,200	Miss	-10%
Credit Suisse / HSBC / Goldman Sachs	4,000	Miss	-14%
Morgan Stanley / UBS	3,900	Miss	-16%
Barclays	3,725	Miss	-20%
Societe Generale	3,650	Miss	-21%
BNP Paribas	3,400	Miss	-27%

Source: Streetinsider

Chart 2: Japan 2023 year-to-date stock market performance vs Asian peers



Source: Bloomberg, as of 13 Dec 2023

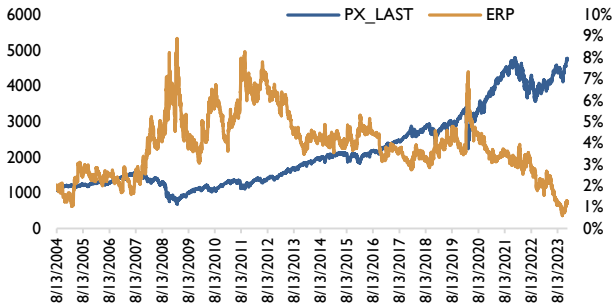
Macroeconomic and Asset Class Update

US Equities

In 2024, we maintain a neutral stance on US equities due to stretched valuations (Charts 3, 4). While the market is driven by optimism of a potential shift in Fed policy in 2024, we caution that any such pivot would likely be a response to visible economic slowdown rather than a full-blown recession. Meanwhile, US leading indicators (Chart 5) paint an economic outlook that is in contrast with optimism seen in the stock market. Nevertheless, there may be opportunities to enter the market for structural or thematic investments within the US, such as Big Tech or AI names, should a significant market correction occur.

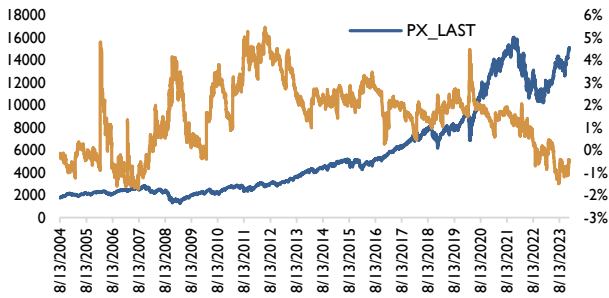
Besides, both QUALITY names with visible earnings growth and strong moat and VALUE names with low valuation and resilient fundamentals should feature in the portfolio. Despite the allure of cyclical stocks due to anticipated lower interest rates and a declining US dollar, we differ in opinion and are not enthusiastic buyers of such stocks. One exception may be gold, which can serve as a hedge against volatility as lower interest rates are often a result of slow economic growth and weak demand.

Chart 3: SPX earnings premium 2004 to 2023



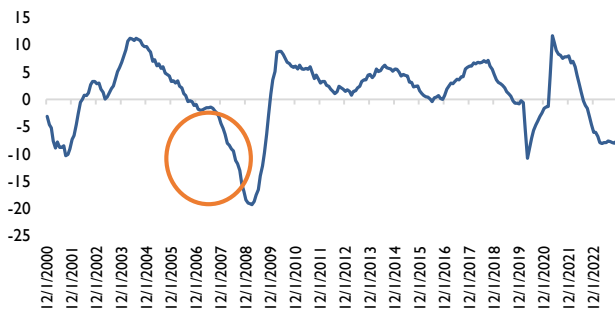
Source: Bloomberg, as of 13 Dec 2023

Chart 4: Nasdaq earnings risk premium 2004 to 2023



Source: Bloomberg, as of 29 Dec 2023

Chart 5: US leading economic indicator not painting a rosy economic outlook



Source: Bloomberg, as of 13 Dec 2023

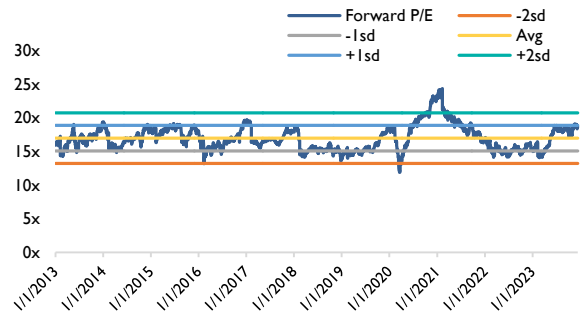
Asian Equities

In 2023, the performance of Asian equities was mixed, with Japan and Taiwan experiencing rallies while China lagged behind. This divergence in performance contrasted with the expectations of many strategists at the beginning of the year, who were eager to invest in Chinese equities after the country lifted COVID-19 restrictions. Looking ahead to 2024, the Asian region as a whole still presents structural opportunities, and our views on selected markets within the region are as follows:

Japan

Following a strong 2023, we believe Japan still has upside in 2024. From a top-down or macro perspective, Japan has just come out of its 30-year long deflationary cycle and is on track to reflate its economy. In terms of PE valuations, Japan is now trading around its historical average (Chart 6). Despite the 2023 rally, Japan is still slightly underweighted in a global fund context. The corporate governance reforms implemented in recent years were expected to yield positive results in upcoming corporate earnings reports, which could drive further market revaluation.

Chart 6: MSCI Japan 10-year forward valuation band



Source: Bloomberg, as of 13 Dec 2023

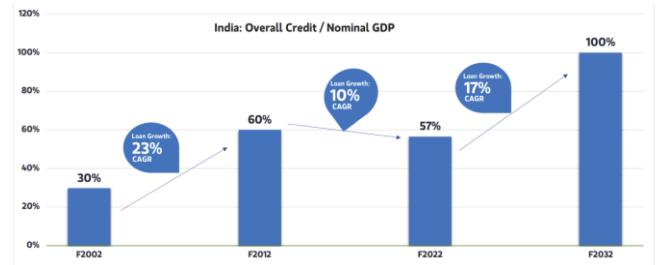
Taiwan

Taiwan is likely to continue to benefit from the trend of de-risking, deglobalization, or friend-shoring, in the near-to medium-term. Investors are particularly drawn to the semiconductor or tech hardware story. However, caution is advised in the short-term due to stretched valuations. Looking ahead, the success of Taiwan's economy will depend on the Tech or IT sector to stimulate domestic investment and consumption.

India

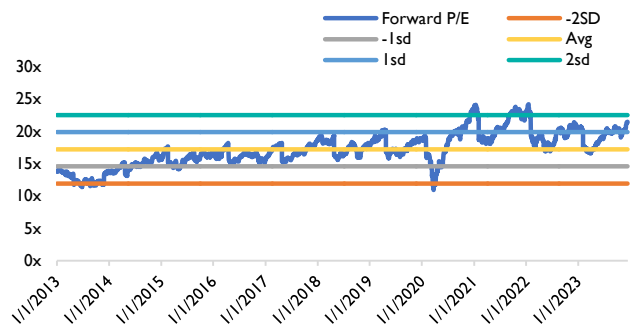
India shares similarities with China in the 1990s, benefiting from demographic dividends (Chart 7), increased penetration rates in various industries (e.g. e-commerce, Chart 8), and undergoing a capital expenditure cycle (Chart 9). Although valuations appear stretched (Chart 10), this can be justified by strong earnings revisions and robust ROE (Chart 11). More importantly, India had undergone successful policy reforms, for instance, cutting corporate taxes and introducing production-linked incentive schemes which enabled them to crystallize their potential into economic and earnings growth. India's contribution to global GDP growth is expected to go up from 11% in 2019 to 18% in 2024E (Chart 12). We remain positive on Indian equities, especially with continuous portfolio inflows.

Chart 9: India's capex cycle



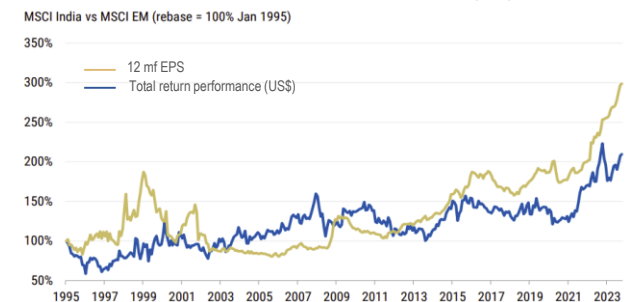
Source: RBI, Morgan Stanley Research estimates

Chart 10: MSCI India forward valuation band (2013 to 2023)



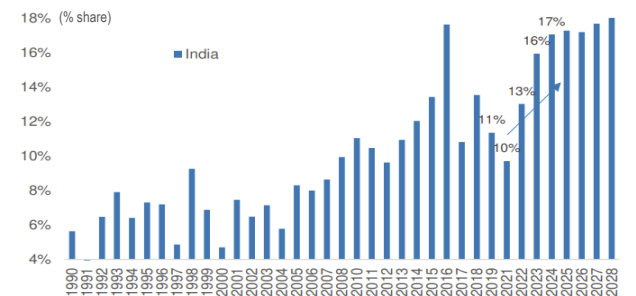
Source: Bloomberg, as of 13 Dec 2023

Chart 11: India delivering consistent EPS growth



Source: MSCI, IBES, Datastream, Morgan Stanley Research. Data as of 31 Oct 2023

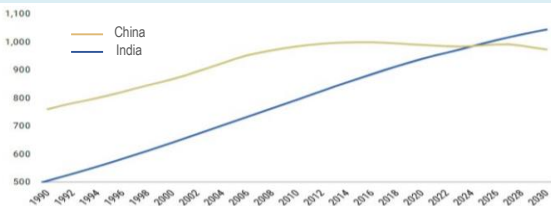
Chart 12: India's increased contribution to global GDP growth



Source: CEIC, Haver, Morgan Stanley Asia Economics Research (E) estimates

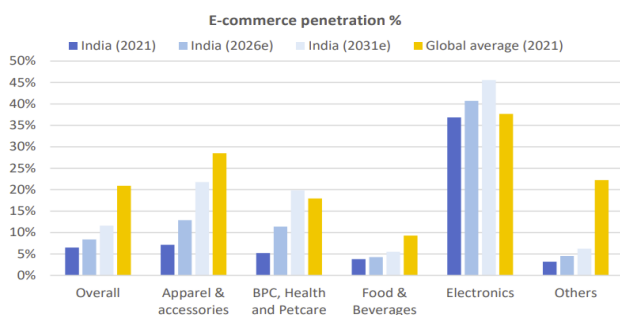
Chart 7: India demographic dividends

Working age population in India and China (age 15 to 64, millions) – India is seeing a favorable demographic trend, while China has seen a decline in its working age population since the early part of the last decade



Source: UN Population Database, Morgan Stanley Research; Note: Data for 2023 and onwards is a forecast by the UN

Chart 8: India's e-Commerce penetration trends



Source: Euromonitor, National Data Sources, Morgan Stanley Research estimates

China

China clearly has been a concern for many investors who have a strong preference for domestic investments throughout the year. Aside from the geopolitical tensions, the domestic economic challenges and corporate troubles have been evident in the public market. As we enter 2024, it has become clear that both onshore and offshore equity market investors are seeking more substantial actions beyond what has appeared to be temporary measures in the past. While a US Fed pivot and cheap market valuations may help a tactical rebound in the near-term, for investors to believe that the China market can escape the downward spiral that has beleaguered Japan over the past 30 years, China needs to produce a second paradigm shift. This could involve accelerating corporate development and reforms, among others.

However, despite the challenging environment, a good number of Chinese corporates and entrepreneurs continue to persevere with creativity and endurance. Those operating in sectors where China still maintains a competitive advantage and where the central government is committed to providing support present compelling investment opportunities for long-term investors employing a private equity approach. For more information on these types of opportunities in China, please refer to the analysis by our Private Equity Team accompanying this commentary.

Credit

Within the overall credit space, we will be selective in public credit. Given signs of global economic slowdown, we continue to prefer Investment Grade names for better risk reward, especially those in the US, where corporate fundamentals appear to be more resilient. On the other hand, the high-yield market will face increasing maturity wall pressure in 2024, which could negatively impact select names and create temporary trading difficulties for the overall high-yield space.

The private credit sector has experienced significant growth in 2023, with the industry accumulating over USD 400 billion in dry powder globally¹. 2024 should continue to be a good year for private credit as global financial conditions are still somewhat tight, especially in Europe.

Capable private credit managers can negotiate with borrowers and often structure deals to mitigate adverse impacts from possible deterioration in credit fundamentals, providing downside protection through collateral or covenants. This makes private credit a more attractive option when compared to publicly traded high-yield investments. Therefore, it is crucial for private credit managers to have a solid track record, strong downside protection and ample resources.

Other Alternatives

Hedge Funds

Given the anticipated volatility, within Hedge Funds, we prefer strategies that can generate healthy risk-adjusted returns with low correlation to major assets. As such, multi-strategies funds and event driven funds are sensible choices. On the other hand, we are also interested in strategies that can navigate and benefit from volatility, including systematic trading funds and relative value strategies funds. In addition, as more price dispersion may occur amid a strained economic environment, in particular in developed markets such as Europe, “market-neutralish” special situation funds there may be utilized in order to capture those dispersion opportunities. Among the “traditional” equity related hedge fund managers we will advocate those with average or low net exposure and who have truly demonstrated robust downside protection process.

Real Estate

In general, we are lukewarm towards Real Estate given sluggish global growth. Having said that, investors are still well advised to accumulate selected quality real assets with secure cash yield as hedges just in case the “soft-landing” scenario is pushed back by either stubbornly high rates or by black swan – like, geopolitics-induced shocks.

Source:

1. 'Global Credit Outlook 2024 – New Risks, New Playbook', S&P Global Rating, Dec 2023

Sector Highlights

Healthcare

Looking back in 2023

Private equity investments in the healthcare industry continued to face a period of adjustment:

Capital markets remained sluggish, IPO opportunities were scarce, and companies struggled to secure capital. China's healthcare sector raised approximately RMB 8.6 billion in the first three quarters of 2023, a 43% decrease year-on-year¹ (YoY), and RMB funds with local government affiliations were relatively more active. While the overseas market experienced a slighter slowdown, the overall sector also saw fewer transactions, lower valuations, smaller deal sizes, and longer decision-making processes. One contributing factor to this slowdown was the multiple interest rate hikes by the US government. As interest rates peak and the market anticipates rate cuts, the global investment environment, especially for biopharmaceuticals, may improve next year.

Significant increase in high-profile out-licensing:

Chinese biotechs have engaged in more out-licensing activities with overseas entities, accounting for half of the top 10 global licensing transactions for innovative drugs in 2023 (based on upfront payment amounts)². Antibody-drug conjugates ("ADC") was the most popular modality. For example, in a recent transaction, Sichuan Biokin Pharmaceutical granted global rights for a dual-antibody ADC to Bristol Myers Squibb, with an upfront payment of USD 800 million and potential transaction size of USD 8.4 billion, setting a new record for a single-drug licensing by a Chinese innovative drug company expanding overseas.

Industry consolidation and cost control were the predominant policy themes:

An anti-corruption campaign in the third quarter of 2023 had a significant impact on the industry. Since its launch, the CSI 300 Healthcare Index and Hang Seng Healthcare Index declined by 8% and 15%³, respectively, adding to the correction in first half of 2023. As volume-based procurement and China's public health insurance negotiations continued, drug price reductions stabilized, success rates inclusion improved, and renewal rules enhanced.

Outlook for 2024

Anti-corruption and cost control on public medical insurance will be the new normal. China's healthcare sector is expected to undergo further transformations in 2024, with two key trends prevailing: (i) intensified effort to battle corruption, and (ii) cost control measures on public medical insurance. The anti-corruption program aims to promote real innovation of clinically valuable products, encourage high-quality academic activities, and foster a healthier ecosystem in the industry. In terms of medical insurance, negotiations will focus more on domestically produced innovative drugs, with the government considering factors beyond pricing when making procurement decisions. While this has led to significant profit reductions for distributors, the extent of these price reductions is stabilizing. There is also a growing trend of import substitution with domestic alternatives in cases where domestic market shares are low. Furthermore, companies offering innovative drugs and high quality medical devices can still compete through non-VBP procurement processes. This favors market leaders with a strong focus on innovation, diverse product offerings, and strong commercialization capabilities.

Outbound licensing by Chinese companies has become an important source of revenue and a measure of their credibility. China has emerged as the world's second largest hub for innovative drug research⁴, with the number of new drug developments ranking just behind the US⁵. This has allowed Chinese companies to surpass their overseas counterparts in terms of new drug registration applications. Chinese innovations are gaining recognition in the global medical industry, making these companies a desirable partner for multinational pharmaceutical companies. In the current challenging fundraising environment, Chinese companies are increasingly looking to license their high quality assets to secure funding and improve their commercialization efforts. This strategy has become an important criterion for investors when evaluating potential investment targets.

Sources:

- (1) 动脉网
- (2) From public sources
- (3) Capital IQ
- (4) 医药魔方
- (5) McKinsey

Overseas expansion has become crucial for Chinese pharmaceutical companies.

China's pool of engineers offers advantages on a global scale, and the country has an established and robust pharmaceutical supply chain. Chinese companies with high quality contract outsourcing services are highly sought after as partners in the international medical industry. China has already seen success in terms of active pharmaceutical ingredients going overseas, and there has been significant progress in outbound licensing for intellectual property. The next focus will be on expanding the availability of cost effective drugs and medical devices that cater to the mid-range market. However, overseas expansion involves complexities such as registration, commercialization, compliance, and regulations with various stakeholders.

Companies should place greater emphasis on management, strategy, and leverage their ecosystem.

With profit margins being squeezed due to medical insurance policies, healthcare companies are concentrating on improving operational efficiency by optimizing pipelines, reducing costs, and improving overall efficiency to navigate through challenging times and maintain cash flow. In order to secure further fundraising, companies are adopting a more rational approach to valuation expectations. Furthermore, these companies are relying more on their own ecosystems and leveraging their investors. By sharing resources and engaging in business collaborations, they may be able to overcome the current challenging environment and sustain their growth.

One major opportunity lies in the rising needs of an aging population and evolving lifestyle.

China's population is experiencing a trend of aging, and in the coming decade, there will be a significant increase in the elderly population who grew up during the era of China's economic reform and opening. This group has a greater awareness of health and is more willing and able to pay for quality healthcare. In addition, new lifestyle trends have created a new set of healthcare demands. There is a growing demand for innovative drugs in fields such as neurodegenerative diseases, cardiovascular and cerebrovascular diseases, eye diseases, glucose reduction, weight loss, muscle building, and anti-aging. This demand will drive the development of new modalities of drugs, medical devices, as well as the supply chain, tools, and services that support these categories. To capitalize on these opportunities, companies need to prioritize innovation and quality in order to meet the demands of an increasingly sophisticated market.

Opportunities in 2024

Despite challenges stemming from anti-corruption policies in public medical insurance, valuation correction, a weakened capital market, and a tightened IPO market, we maintain a positive outlook on the long-term prospects of China's healthcare industry. Our optimism is based on strong demand from China's aging population, the country's domestic innovation capabilities, and overseas expansion opportunities.

In light of the current challenging environment, future investments in the healthcare industry will prioritize value and fundamentals. It will be crucial for investors to leverage various ecosystems and focus on diversified exit strategies beyond IPOs, such as M&A or licensing agreements.

The reduction in market funding will expedite the industry's natural selection, leading to lower competition for investments. Over time, this will create a more favorable investment environment, benefiting investors with industry expertise and strong ecosystems.



Consumer

Looking back at 2023

Consumer spending after the pandemic fell short of the market's expectations for recovery. In fact, the momentum weakened in the second quarter of 2023. Discretionary consumption experienced lower growth and greater demand fluctuations compared to consumer staples. This is mainly due to weakened consumer demand, as evidenced by weak YoY and month-on-month (MoM) growth rates in the Consumer Price Index throughout the year, which fell below expectations.

Insufficient demand can be attributed to two main factors:

- **The short-term yet difficult-to-reverse impact of the pandemic on consumer habits:** individual consumers and business' income generation was effected by the pandemic, which affected disposable income and the willingness to spend. Even after the end of the pandemic, it will take time to recover from its "traumas".
- **Economic downturn as a new challenge following the pandemic:** China was already experiencing an economic downturn before the pandemic. The real estate boom, previously fueled by urbanization trends and favorable sector policies, reached its peak. As a result, housing prices declined across the board in 2023, despite the low-interest-rate environment and the gradual relaxation of home purchase and loan restrictions. Additionally, China's stock market performance was disappointing, as the prices of financial assets declined along with economic growth. This inevitably affected consumers' net asset levels, leading to sluggish demand and reduced willingness to spend.

Outlook for 2024

In the long run, changes in China consumer industry's underlying supply or demand will continue to generate investment opportunities. These opportunities include diversification and segmentation of consumption needs, as well as innovation and efficiency improvements on the supply side.

Based on the current economic backdrop and short-term trend analysis, we believe 2024 may present the following opportunities:

- **Discounted retailing:** Slowing disposable income will inevitably increase consumers' demand for cost-effective products, creating opportunities for discounted retailers to expand. Discount models, such as restructuring distribution channels or profiting from selling clearance goods, have proven successful and have ample vitality and market space in developed countries. Based on observations in 2023, we believe China will start to see the emergence of high-quality discount retailer that can effectively integrate different discount models and become more competitive.
- **Brands going global:** Although domestic demand is weak, developed countries such as the US have shown resilience and enthusiasm in 2023 (according to Adobe Analytics, online consumer spending on "Black Friday" in the US increased by 7.5% YoY, surpassing expectations). This creates a significant window of opportunity for high quality Chinese products. Although cross-border e-Commerce traffic may not be as strong as in previous years, we believe that, based on the exponential growth logic of brand value, Chinese brands going global are expected to reach new heights in overall quality and reputation in 2024.
- **Changing landscape:** The significant impact of new consumer brands within their respective sub-segments, seen from 2018 to 2021, weakened as capital markets cooled off in 2022 and 2023. We anticipate that the theme of "survival of the fittest" will continue for these new consumer brands in 2024. When economic and capital market conditions have not significantly improved, many brands lacking competitiveness will disappear, and brands with some value but reaching a bottleneck in their development may be acquired. At the same time, we are optimistic that well-established new brands with sound business models may rise to challenge traditional industry giants with unstable foundations.

Evaluating risks in 2024

Although weak domestic demand may bring opportunities such as "consumption downgrade," this could have detrimental effects on China's economic cycle in the long run and increase the risk of a recession. In 2023, China maintained loose monetary policy while increasing fiscal efforts. The most notable measure was the issuance of one trillion yuan in government bonds, aimed at boosting infrastructure investment and accelerating GDP growth to stimulate consumption recovery. However, the direct impact of these stimulus measures on consumption is relatively small. The effectiveness of these measures in different economic environments remains uncertain and require further and continued observation.



Technology

Looking back at 2023

The tech sector has returned to its roots of hard tech, with more investments drawn to projects in the overall manufacturing category, autos, and healthcare. In the past 12 months, the manufacturing sector (including semiconductors, advanced manufacturing, and industrial production), autos (vehicle manufacturing and supply chain), and healthcare have garnered the most attention, with total fundraising of RMB 126 billion, RMB 91.5 billion, and RMB 74.3 billion, respectively. The AI industry has garnered substantial interest but falls short on actual commitments, with a total fundraising of RMB 32.2 billion. The energy and corporate services businesses have experienced a decrease in popularity, with fundraising of RMB 26 billion and RMB 25.8 billion, respectively.

The EV business segment has shown significant recovery recently. According to the third quarter of 2023 data, the total equity investments in integrated circuits, autos, and biopharmaceuticals all exceeded RMB 10 billion.

In particular, the EV industry saw a remarkable growth of 28.6 times (quarter-on-quarter/QoQ) in equity investments. Autonomous driving businesses raised RMB 3.9 billion, representing a 48% increase (QoQ), while medical devices raised RMB 5.3 billion, representing a growth of 115% (QoQ).

Outlook for 2024

State-owned assets, hard tech and manufacturing, AI large models and applications. SOE-background funds will be in the spotlight and will undertake the national mission of investing in the tech industry. These capital funds will continue to focus on areas such as new generation AI, quantum information, and the integrated circuit industry, as outlined in the "14th Five-Year Plan" and the long-term goals for 2035. However, this may result in sustained high valuations in related industries.

Investment focus will continue to be placed on hard tech and advanced manufacturing. AI large models may continue to evolve at a faster rate and applications will gradually emerge. Digitization aimed at improving operational efficiency will be valued more rationally, and customers will see improved return on investment from select companies. The US will further restrict China's development in AI and semiconductor industries, which will strengthen the concept of domestic substitution.

IPOs for loss-making companies will face more restrictions, as capital markets will increase their requirements for a company's profitability. It is expected that companies will be more cautious in R&D expenses, recruitment, and business investments. The market will demand higher levels of corporate governance as well.

Opportunities in 2024

- Businesses with clear advantages and domestic demand will be able to accelerate their international expansion plans. Chinese companies' growth can be replicated globally, such as solar and wind power businesses. There are two specific categories: (i) going global with domestic customers, such as tier-one suppliers to domestic automakers (advanced driver assistance systems, wire control chassis, etc.); (ii) technology going global by leveraging the domestic supply chain and rising global demand, such as consumer electronics (mobile phone accessories, headphones, small home appliances), smart vehicles (e-bikes, EVs), and high-voltage fast charging and energy storage.

- The impact of semiconductor bans is affecting even Chinese companies outside of this industry. Many are considering supply chain security and hoping to support domestic suppliers to reduce risks. These domestic suppliers are becoming more technologically advanced and cost efficient, and there is an expectation of more domestic substitution for core components, such as high-end computer numerical control (CNC) machine tools, motors, sensor, reducers, and others. Under the US AI chip ban, domestic AI chip companies will accelerate market entry while exploring new technological routes, such as integrated storage and computation, reconfigurable computing, neuromorphic chips, etc.
- EV penetration continues to grow with rising consumer demand for intelligent vehicles. The domestic market for assisted intelligent driving (L2, L2+) will experience a surge in installed units, which represents a good window of opportunity for domestic Tier I suppliers. The main benefits are: (i) providing decoupled and cost-effective solutions, (ii) China's leading position in autonomous driving algorithm, and (iii) domestic automakers' demand for localized services and supply.
- AI large models are starting to roll out various applications, and it is expected that a large number of B2B startups will integrate AI application with traditional industries to provide new solutions for customers. However, the growth prospects for such startups remain uncertain: (i) updates in underlying technologies often lead to significant product changes, yet these underlying technologies are often controlled by leading players, and (ii) there is relatively low customer loyalty and switching costs in the consumer market.

Industry risks

In 2024, industry risks are more likely to exist at the macro level.

Internal: starting in the second quarter of 2023, consumer and market sentiment, as well as corporate development, have all been affected to varying degrees. Rebuilding this confidence requires top-level wisdom and macroeconomic recovery, which is not easily achievable.

External: The global trade market has undergone significant changes compared to a decade ago. Currently, China is facing global trade protectionism and tensions with the US. If external pressure lessens slower than expected, this will further intensify internal competition in domestic industries.

Conclusion

In summary, 2024 is likely a year of slow economic growth, a moderate decrease in inflation or deflation, and slightly more favorable borrowing conditions. However, the outlook for corporate earnings remains modest, and there is a possibility of a weaker US Dollar. Nevertheless, ongoing geopolitical tensions and the upcoming elections in approximately 40 countries and regions, including Taiwan, India, and the US, as highlighted by several top Wall Street research teams, may introduce significant market volatility. In light of these circumstances, we will maintain a cautious approach in 2024, prioritizing liquidity and closely monitoring risks.

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