REPORT ON GLOBAL ASSET ALLOCATION STRATEGY BY PRIVATE BANKING BANK OF CHINA

2024

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Executive Summary

Review: In 2023, the world experienced centennial changes and accelerated evolution. The inflation in the US and Eurozone peaked before declines, and the inflection point of the cycle of the USD interest rate hikes is on the horizon, leading to the silver lining of global assets. Global stock markets rose in general, but the A-share market experienced declines. The US bond market was at the end of its bearish trend, and the rise in China's bond market converged to some extent. The crude oil market fluctuated within a wide range and closed down, and the gold market experienced a unilateral rally. The USD weakened from a strong position, and non-USD currencies experienced divergent performance, whereas the RMB slightly depreciated. The BOC Investment Strategy Research Center made a proactive response. Over the past five years, the performance of our strategic asset allocation was quite satisfactory, and the tactical timing was optimal. The alpha value of our strategic asset allocation and tactical timing was well manifested.

Global economy: In 2024, the Fed is expected to end its cycle of interest rate hikes, and is likely to start the cycle of interest rate reductions. The inflection point of global liquidity is on the horizon. Moreover, the global economy is likely to recover slowly, and the recovery of varying economies may resonate with each other in 2H, 2024. China is promoting stability through progress and facilitating a mild recovery. The CPI is expected to rise slightly, and the PPI is likely to bottom out and turn positive. The monetary policy is expected to remain flexible, moderate, precise and effective, and the fiscal policy is likely to be moderately strengthened with improved quality and efficiency. The US economy is gradually cooling down and returning to the "potential growth rate", and is likely to enter into a shallow recession, and the European economy may enter into a recession.

Stock market: In 2024, China's economy is expected to experience a moderate recovery. Corporate earnings are likely to be enhanced, and stock market fundamentals will improve. The development of a strong financial sector will lead to the adaptive calibration of the position of the stock market, thus bolstering the confidence of investors. The capital market is expected to be activated, and the undervalued A-shares are likely to usher in brighter prospects. Positive factors both at home and abroad will resonate with each other and build up growth momentum, and the Hong Kong stock market is expected to usher in a historical turnaround. Hence, it is justified to overweight (recommended) the Chinese stock markets (including both A-shares and Hong Kong stocks). Investors are engaged in trading ahead of the start of the cycle of USD interest rate reductions. Given that the US stock market has fully priced in the economic "soft landing", the market may experience downward adjustments after the start of interest rate reductions. Hence, it is recommended to give an underweight to US stocks first, and then shift to a neutral view after the US stocks bottom out. Due to the sluggish economic growth in the Eurozone and the UK, the rebound of stock markets can hardly be sustained. Hence, it is recommended to give an underweight to the stock markets in the Eurozone and the UK. Japan's economy is likely to escape from deflation, and Japan's stock market is expected to experience a moderate rally due to the sustained economic recovery. Hence, it is recommended to give an appropriate overweight (recommended) to Japanese stocks. Subsequent to the alleviation of global liquidity pressure, stock markets in the emerging economies are likely to usher in rather optimal performance. Hence, it is recommended to moderately invest in markets that are driven by domestic demands, experience faster growth and benefit from the restructuring of global industrial chain and supply chain.

Bond market: The US inflation continued to decline, and the Fed has started the cycle of interest rate reductions, leading to the possibility of a shallow recession in the US economy. As such, the optimal stage of investing in US bonds is likely to come, and the opportunities of rises are assured. Along with the downward movements of US bond yields, Chinese USD bonds are likely to usher in the golden period of asset allocation. China's economy is recovering moderately, but the foundation of recovery is not solid. The liquidity situation is rather loose, and there is still room to lower reserve requirement ratios and interest rates. The benchmark interest rate is expected to constantly move downward, and the 10-year treasury yield is likely to oscillate in the range between 2.45% and 2.75%.

Foreign exchange: Driven by the start of the cycle of USD interest rate reductions, there is a high chance that the US economy will encounter a soft landing. Performance of the economies other than the US varies to some extent. Hence, the performance of non-USD currencies may continue to diverge. The US economy is expected to be stronger than the Eurozone economy mired in recession, and the market may have traded in advance of the reductions of USD interest rates. Hence, it is recommended to maintain the underweight (conservative) for the USD as in Q3, 2023, and then transition into a neutral view afterwards. The European economy is likely to enter into a recession, and it is recommended to given an underweight (conservative) to the EUR. Moreover, it is recommended to adopt a neutral view for the GBP before shifting to an underweight (conservative). Driven by the economic recovery

Executive Summary

in Japan, the inflation has mildly risen, and the US and Japan treasury spreads have narrowed. Hence, it is recommended to give an overweight to the JPY (recommended). Given that the economic fundamentals are optimal in Australia with strong monetary policies, it is recommended to given an overweight to the AUD (recommended). Moreover, investors may adopt a neutral view for the CAD. Driven by the gradual end of external tightening and restoration of the domestic economy, the RMB is likely to maintain a neutral performance amid strengthening, and it is recommended to adopt a neutral view.

Commodities: Due to the features of save-haven assets and the role of currency credit yardstick, gold has revealed its value of long-term asset allocation. In addition, since the rally is likely to reappear upon the Fed's policy shift, it is recommended to maintain the overweight for gold as in 2023. Global economic recovery remained slow, and the growth of demands for commodities was rather limited. The crude oil market is likely to maintain the pattern of tight balance between supply and demands, and the oversupply of copper is expected to ease, and thus it is recommended to give an underweight before shifting to a neutral view. The shortage of aluminum is expected to exist in stages, and it is recommended to adopt a neutral view.

Asset Allocation: Against the backdrop of the macro-theme that "global assets are ushering in the dawn as the USD starts the cycle of interest rate reductions", we believe the allocation among major asset categories should be in the following order: stocks, gold, commodities and bonds. With respect to stocks, the infection point is emerging due to the start of the cycle of USD interest rate reductions, and emerging markets are likely to become more resilient. Judging from the optimal cost performance in the world, the Chinese stock market shall be given priority in the allocation of global assets, and overweight shall be given to China's A-shares (recommended) and China's Hong Kong stocks (recommended). Judging from the market trading ahead of the start of the cycle of interest rate reductions, the US stock market has already fully priced in the economic "soft landing". Hence, it is recommended to adopt a neutral view on US stocks first. After the first USD interest rate cut is initiated, investors may shift to an underweight, and then increase allocation to a standard position after sufficient declines. The European economy continued to be sluggish, and the rebound can hardly be sustained. Hence, it is recommended to given an underweight to the EUR. Japan's economy is likely to escape from deflation and continue to recover, and the Japanese stock market is likely to experience a moderate rally. Hence, it is recommended to given an overweight (recommended) to the JPY. With respect to the bond market, investors are in the optimal stage of investing in US bonds, and it is recommended to maintain the overweight (recommended) in Q4, 2023. Moreover, it is recommended to maintain the overweight (recommended) in Chinese USD bonds as in Q4, 2023. China's economy is recovering moderately, but the foundation of recovery is not solid. The liquidity situation is rather loose, and there is still room to lower reserve requirement ratios and interest rates. The benchmark interest rate is expected to constantly move downward, and the 10-year treasury yield is likely to oscillate in the range between 2.45% and 2.75%. Hence, it is recommended to adopt a neutral view. With respect to the foreign exchange, the USD is expected to fluctuate within a wide range and fall into the neutral range, and the performance of non-USD currencies will continue to diverge. The US economy is expected to be stronger than the Eurozone economy mired in recession, and it is recommended to maintain the underweight (conservative) for the USD as in 2023, and then transition into a neutral view afterwards. It is recommended to given an underweight (conservative) to the EUR, and it is recommended to adopt a neutral view for the GBP before shifting to an underweight (conservative). Driven by the economic recovery in Japan, the inflation has mildly risen, and the US and Japan treasury spreads have narrowed. Hence, it is recommended to give an overweight to the JPY (recommended). Given that the economic fundamentals are optimal in Australia with strong monetary policies, it is recommended to given an overweight to the AUD (recommended). Moreover, investors may adopt a neutral view for the CAD. Driven by the gradual end of external tightening and restoration of the domestic economy, the RMB is likely to maintain a neutral performance amid strengthening, and it is recommended to adopt a neutral view. Due to the features of save-haven assets and the role of currency credit yardstick, gold has revealed its value of long-term asset allocation. In addition, since the rally is likely to reappear upon the Fed's policy shift, it is recommended to maintain the overweight for gold as in 2023. The crude oil market is likely to maintain the pattern of tight balance between supply and demands, and it is recommended to give an underweight before shifting to a neutral view. Moreover, it is recommended to give an underweight before shifting to a neutral view for copper as well. The oversupply of aluminum is expected to ease with enhanced demands, and it is recommended to adopt a neutral view.

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Review

USD is Approaching the End of Its Strength, and Assets are Seeing a Silver Lining

In 2023, the world experienced centennial changes and accelerated evolution. The inflation in the US and Eurozone peaked before declines, and the inflection point of the cycle of the USD interest rate hikes is on the horizon, leading to the silver lining of global assets. Global stock markets rose in general, but the A-share market experienced declines. The US bond market was at the end of its bearish trend, and the rise in China's bond market converged to some extent. The crude oil market fluctuated within a wide range and closed down, and the gold market experienced a unilateral rally. The USD weakened from a strong position, and non-USD currencies experienced divergent performance, whereas the RMB slightly depreciated. The BOC Investment Strategy Research Center made a proactive response. Over the past five years, the performance of our strategic asset allocation was quite satisfactory, and the tactical timing was optimal. The alpha value of our strategic asset allocation and tactical timing was well manifested.

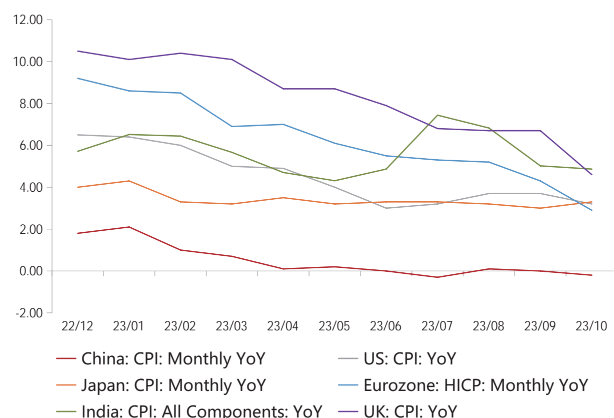
1.1 Global Economy: Inflation was Resilient in the US and Europe, and China's Recovery Experienced Twists and Turns

1.1.1 Inflation was on a downward path in the US and Europe, and the US economy remained resilient as opposed to the gradual entrance into recession in Europe

In 2023, the highlights of the global economic growth were rather unique. Globally, the growth was driven by the inflation in the US and the Eurozone as well as the Fed's interest rate hike process. In China, much attention was drawn to the progress of economic recovery and measures of policy stimulus. The inflation peaked in mid-2022 overseas, and trended downward in 2023. In particular, the downward trend of the inflation was evident in the US, whereas the European (EU and UK) inflation was moving downward at a slower pace.

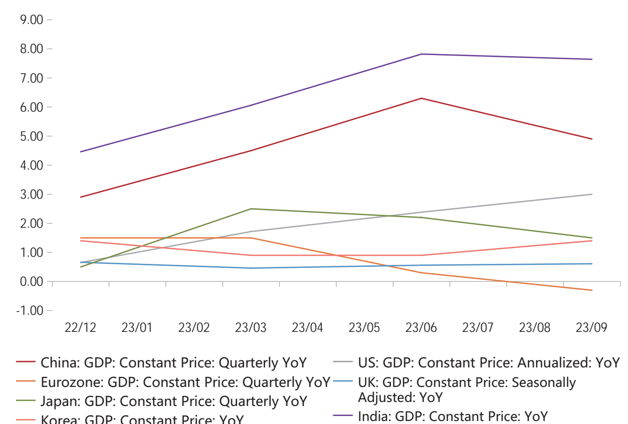
The US CPI declined from 6.5% in early 2023 to 3.2% in November 2023. As shown by the CPI movements, the inflation rate trended downward and was already in a low range. Throughout the year 2023, the CPI declined slowly in Q1, and started to decline rapidly in Q2. The CPI reached 3.0% in June, hitting a record low since March 2021. Subsequently, the CPI oscillated at lows in Q3 and Q4. The CPI fell from 9.2% and 10.5% in early 2023 to 2% and 4.6% in October 2023 in the EU and the UK respectively, leading to greater resilience of the European inflation compared to the inflation in the US. Accordingly, the US economy has shown greater resilience compared to the EU and the UK. Since the beginning of 2023, the US economy maintained a rather rapid growth. In particular, the annualized QoQ growth reached 2.2% and 2.1% in Q1 and Q2, and rose to 4.9% in Q3, significantly exceeding the potential growth rate. The resilience of the US economy was attributable to the support of fiscal spending to the economy. In 2023FY, although the fiscal spending and deficit declined in the US compared with previous years, it was maintained at a relatively high level. The relatively high level of the US fiscal spending contributed to the optimization of the balance sheet structure of both enterprises and households. The US employment situation reached the optimal state in history, and the unemployment rate was at a historically low level. In addition, the growth of wages was relatively fast. Driven by excess savings and stock market rally, the residential consumption remained at a strong level, and the US economy was full of resilience. The European economy was gradually entering into a recession. The Eurozone manufacturing PMI fell from 48.80 in early 2023 to 44.2 in November, and the German manufacturing PMI even dropped from 47.30 in early 2023 to 42.60. In the Eurozone, the GDP growth reached 1.5%, 0.3% and -0.3% in Q1, Q2 and Q3, respectively. As such, the Eurozone economy has already entered into a technical recession.

Figure 01. Trend of Inflation Rate in Major Global Economies in 2023 (As of October 2023, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 02. Trend of GDP Growth in Major Global Economies in 2023 (As of Q3, 2023, %)



Data sources: Wind and BOC Investment Strategy Research Center

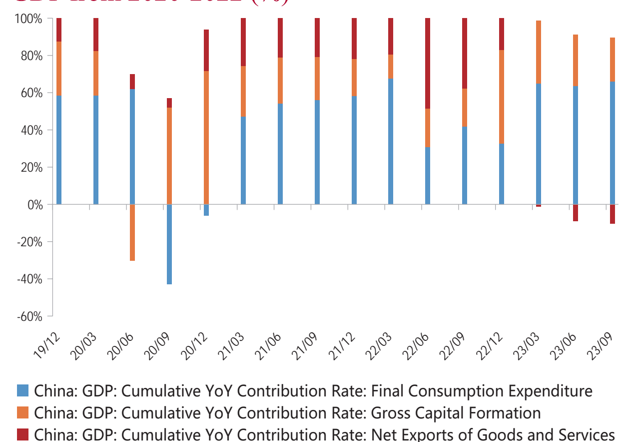
1.1.2 Investment and exports were sluggish, and China's economic recovery experienced twists and turns

Different from the resilience of the US economy and the recession in Europe, China's economy started a new round of

recovery at the end of 2022, and experienced post-pandemic recovery in 2023. China's economy withstood external challenges including the interest rate hikes by the Fed, and alleviated pressure of "decoupling" overseas and adjustments in the real estate sector domestically. Subsequent to the twists and turns, China's economy finally experienced a rebound for the better. In particular, the GDP growth reached 5.2% in the first three quarters of 2023. Consumer spending contributed 83.2% to economic growth, driving GDP growth by roughly 4.4%, and became the decisive force supporting the economic growth. The gross capital formation contributed 29.8% to economic growth, driving GDP growth by about 1.6%. The net exports of goods and services contributed -13.0% to economic growth, driving down GDP growth by approximately 0.7%. In 2023, China's economy gradually developed a unique pattern of composition. In 2019, the consumption contributed about 60% to GDP growth, whereas investment as well as import and export contributed about 40%. In 2023, China's economy was "driven primarily by consumption, assisted by investment, and dragged down by import and export". Such changes have highlighted the need to stabilize both investment and exports. Judging from the quarterly growth, China's GDP grew by 4.5% in Q1, 6.3% in Q2, and 4.9% in Q3. China's economy is expected to achieve a growth of about 5.2% for the entire year of 2023, thus fulfilling the target set for the year.

Both the CPI and the PPI showed a unilateral downward trend. Due to the utilization of residential savings over the recent years, the declines in real estate prices, and the decrease in property income from stocks, deposits and wealth management products, etc., the consumption capacity of the society has weakened overall. Residents have increased their willingness to accumulate excess savings. Coupled with a slow economic recovery, which has led to a gloomy employment situation and a decline in income expectations, the consumer confidence has weakened in general. Overall, the recovery momentum for consumption in 2023 was relatively weak. In particular, the CPI dropped from 2.1% in January to -0.5% in November, and the PPI growth was negative throughout the year, falling from -0.8% in early 2023 to -5.4% in June, and increased month-over-month since then. The PPI rebounded and reached -3% in November, slightly showing the features of "deflation". Judging from the GDP growth as well as both CPI and PPI indicators, China's economic recovery underwent twists and turns, and the foundation for consistent recovery remained unstable. At present, China's economy is undergoing a structural recovery rather than a comprehensive recovery, and the recovery has been mainly driven by the service industry and high-end manufacturing. However, the real estate, finance, and Internet platform economy were subject to significant impact, and endogenous growth momentum remained insufficient. Consumption and manufacturing investment were still experiencing negative growth. Coupled with unfavorable factors such as falling external demand and damage to the balance sheets of residents, aggregate social demands remained insufficient.

Figure 03. Cumulative YoY Contribution to China's GDP from 2020-2022 (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 04. Trend of China's CPI and PPI in 2023 (%)

Data sources: Wind and BOC Investment Strategy Research Center

1.2 Global Assets: Hike of USD Interest Rate is Approaching the End, and Trading of Global Assets is Seeing Declining Interest Rates

In 2023, the trend of global assets (including equities in risky assets and US bond yields in risk-free assets) was affected by the evolution of inflation in Europe and the US, as well as the market's perceptions of the Fed's rate hike progress based on the inflation data. The market has been engaged in early trading of expectations for the end of USD interest rate hikes. Among global assets, except for US bonds and Chinese stock markets, which recorded negative returns, other major asset categories achieved positive returns. Nevertheless, compared with the global "downturns in both stocks and bonds" in 2022, the investment experience has been improved to some extent. China's stock market fluctuated and experienced declines. In particular, the SSE Composite Index fell below 3,000 points several times in 2023, which became a hot-spot issue in the investment community. At the same time, active management products of equity public funds have largely underperformed compared with broad-based indexes, and the general loss of alpha value of active management products has led to a heavy blow to investor confidence. Invigorating the capital market and bolstering investor confidence have become top priorities for the recovery of China's stock market.

1.2.1 Global stock markets

1.2.1.1 Overseas stock markets: The USD interest rate hike is almost over, and the dawn of overseas stock markets is emerging on the horizon

The US inflation trended downward in 2023. Except for the Fed's rate hikes by 25 bps at each of the FOMC meetings in February, March, May and July, the Fed kept interest rates unchanged at the rest of the FOMC meetings. In September, the Fed's hawkish stance of "maintaining higher interest rates for a longer period of time" has imposed a huge impact on global stock markets and US bond yields. Generally speaking, the market has gained the upper hand in trading expectations for the end of the Fed's interest rate hikes, and overseas stock markets have risen across the board. The US Dow Jones Industrial Index, Nasdaq Index and S&P 500 Index rose by 12.54%, 22.91% and 41.54% respectively. The UK FTSE 100 Index, the French CAC40 Index and the German DAX Index rose by 1.67%, 17.35% and 20.31% respectively. Thanks to the impact imposed by the ChatGPT's phenomenal technological innovation, US tech stocks have staged a bull run. In particular, the Nasdaq Index became the most bullish stock index around the world, driving a bull run of tech sectors of global stock markets. Asian stock markets also experienced a general rally. The Nikkei 225 Index, the KOSPI Index, and the Indian SENSEX 30 Index rose by 26.35, 14.63%, and 26.35% respectively. The Japanese stock market even hit a record high over the past 33 years. The above market trends have all benefited from the expected impact of USD interest rate reductions and improved liquidity, thus fully verifying the prediction in our strategy report in 2023 that "the hike of USD interest rates is coming to an end, and global stock markets are seeing a silver lining". Looking back, we may even describe the trend of overseas stock markets as the "the silver lining of global assets has emerged due to the imminent end of USD interest rate hikes" at the end of 2023.

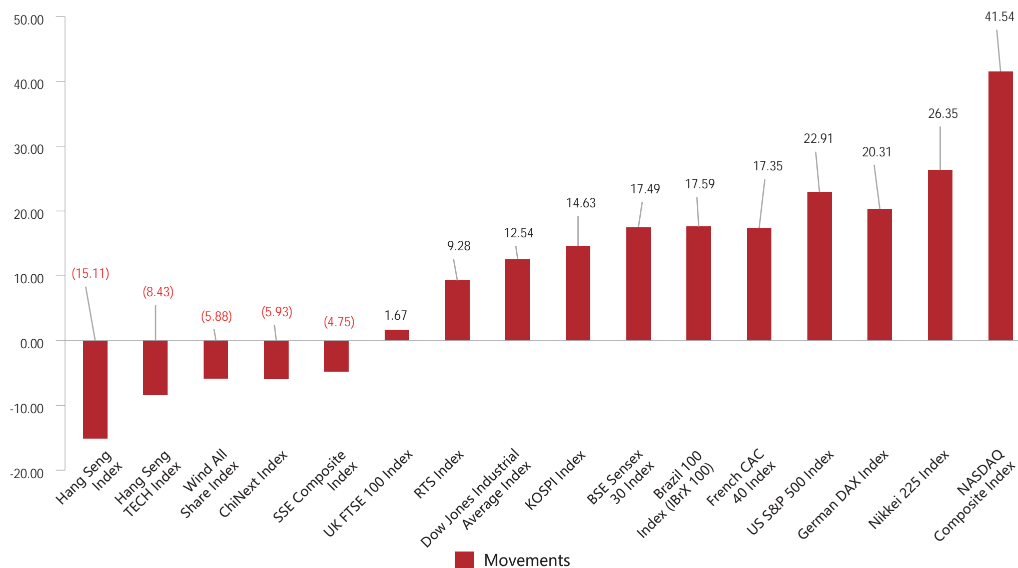
In terms of market movements, overseas stock markets showed an N-shaped trend throughout the year. The markets rose in 1H 2023, pulled back in Q3, and rose again in Q4. Such movements reflected the pace of the Fed's rate hikes and the repeated shift of "hawkish" and "dovish" statements that led to investors trading in expectations of interest rate reductions. In 1H 2023, the market generated high expectations for a rapid decline in the US inflation and a speedy end to interest rate hikes by the Fed, and global stock markets experienced a rally across the board. The US Nasdaq and Japanese stock markets were among the top performers, rising 31.73% and 27.19% respectively. The Nikkei 225 Index hit a record high in more than three decades. European stock markets, except for the UK, saw lower gains. In particular, the French CAC40 Index, the German DAX Index, and the Stoxx Europe 600 Index rose by 14.31%, 15.98%, and 8.72% respectively. In Asia, the stock indexes of South Korea and Vietnam also experienced double-digit gains, ranking in the second echelon together with European stock markets. China A-shares (Wind All Share), Hong Kong stocks, British stocks and the US Dow Jones Industrial Average that represented traditional US industries grew by 3.06%, -4.37%, 1.07%

and 3.8% respectively, ranking in the third echelon. Although global stock markets have shown different growth rates due to divergent fundamentals and external economic environments, the general rise in the stock market at the end of the USD interest rate hike implied that “the silver lining is beginning to emerge”.

In Q3, the US CPI dropped to 3%, and then bottomed out and rebounded to 3.7% in August, showing that the US inflation was quite resilient. However, the FOMC meeting in September released a hawkish signal of “maintaining higher interest rates for a longer period of time”, which exceeded the market’s expectations. The Fed signaled that it might raise interest rates once more in 2023, and the dot plots also reduced the room for interest rate cuts in the next two years. The frequency of rate reductions was reduced to 2 times from 4 times. The above policy statements have led the market to expect the federal funds rate to fall to 5.1% in 2024 and to 3.9% by the end of 2025, respectively 50 bps higher than the forecast made in June 2023. The long-term federal funds rate is expected to reach 2.9%, which is also higher than the expected rate of 2.5% in June 2023. The rise in risk-free interest rates will undoubtedly impose greater pressure on the US and global stock markets, and there will be pressure of reducing profits gained previously. In Q3, the US Nasdaq, S&P 500 and Dow Jones Industrial Average Indexes fell by 4.12%, 3.65% and 2.62% respectively. The French CAC40, German DAX, and Stoxx Europe 600 Indexes fell by 3.58%, 4.71%, and 2.54% respectively in Q3. The Japanese stock market also fell by 4.01% in Q3.

In Q4, the market trading about the Fed’s “maintaining higher interest rates for a longer period of time” continued until the end of October. As the inflation data continued to fall and the unemployment rate rose, the Fed stayed on hold at its FOMC meeting in November. The dot plots indicated that the Fed’s cycle of interest rate hikes had already ended and that interest rates might be cut four times in 2024, totaling 100 bps. The market reacted immediately to such perception, and overseas stock markets once again showed a rebound trend. As of December 15, 2023, the US Dow Jones Industrial Average Index, Nasdaq Index and S&P 500 Index rose by 11.33%, 12.06% and 10.05% respectively, once again reaching new highs for the year. The UK FTSE 100 Index, French CAC40 Index, and German DAX Index grew by -0.42%, 6.47%, and 8.87% respectively. The Nikkei 225 Index rose again by 3.49% in Q4, hitting a record high over the past 33 years, and became a global hot-spot issue in the financial sector, thus greatly stimulating global enthusiasm for investing in Japan. The statements of “getting out of the three lost decades” became popular.

Figure 05. Stock Market Performance of Major Global Economies in 2023 (%)



Data sources: Wind and BOC Investment Strategy Research Center

1.2.1.2 Chinese stock market: The progress of recovery was not as good as expected, and growth stocks outperformed amid the gaming of existing funds

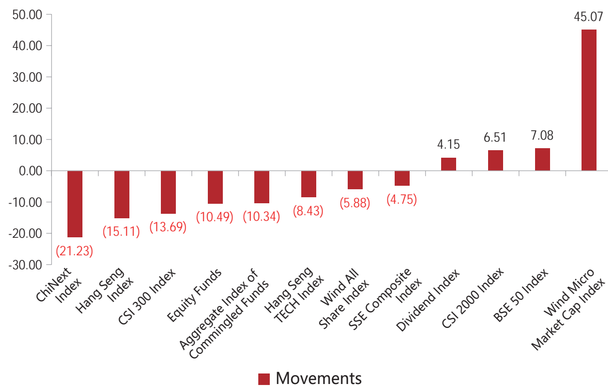
Economic cycles started to diverge between China and the US in 2020. As a result, China's fiscal and monetary policies were out of sync with those of overseas economies. In 2023, China's economy was in the early stages of recovery after adjustments to pandemic prevention policies, and consumption has become the decisive force contributing to the economic recovery for the first time. However, structural issues such as real estate risks and local debt risks have undermined national expectations and confidence, leading to twists and turns in the economic recovery. Overall, China's stock market showed a general downward trend in 2023. Wind All Share, which represented the overall movements of the stock market, dropped by 5.88%. The major broad-based indexes and component indexes showed divergent features. In particular, the Wind Micro Market Cap Index recorded the largest increase, up by 48.93%, whereas the CSI 2000, BSE 50 and Dividend Index rose by 6.51%, 7.08% and 4.15% respectively. All other major sub-indexes experienced declines. The SSE Composite Index, CSI 300 Index, STAR 50 Index, ChiNext Index, and SZEXT 50 Index fell by 4.75%, 13.69%, 21.23% and 20.81% respectively. It shall be noted that the SSE Index fell below 3,000 points again in Q4. The index has fallen below 3,000 points 55 times in history, which was seen as a sign of low investor confidence. In particular, the stock markets showed the following features in 2023:

First, against the backdrop of the gaming of existing funds, hot money has become the decisive force in activating the market. Growth stocks have outperformed compared with other stocks. Thematic investment has become popular, and investment into stocks with "valuation with Chinese characteristics" started to take shape. In 2023, the overall funds in the A-share market revealed an outflow trend. The limited funds were insufficient to activate the entire market. Hot money focused on small-cap and micro-cap stocks to start a round of gaming. Throughout the year, the Wind Micro-cap Stock, CSI 2000, and BSE 50 indexes have performed well while other indexes experienced declines, thus showing the typical features of a "weak market market". At the same time, the stocks that feature "valuation with Chinese characteristics" promoted by the regulatory authorities performed relatively well throughout the year. In particular, the Dividend Index rose by 4.15%. During the overall market declines, it reflected the attraction of high-dividend sectors to long-term funds, and the value of stocks that feature "valuation with Chinese characteristics" was on the horizon.

Second, the "alpha value" of actively managed equity products by public funds was lost. Accordingly, passively managed investments have become more popular, and ETF funds have become the new favorite of institutional investors. The general stock fund index and partial stock hybrid fund index fell by 10.64% and 12.56% respectively. It has been nearly three years since active management products underperformed broad-based indexes. As can be seen, the myth of "alpha" equity funds has been shattered, and the sales of equity-focused actively managed fund products were mired in trouble. As of the end of November 2023, there were only 277.3 billion shares of newly established partial stock funds (hybrid funds and equity funds), accounting for 63.03% of the new issuance in 2022 and merely 13.39% of the new issuance in 2021. In contrast, varying ETF funds have received large subscriptions. Since 2023, the cumulative net subscription of non-monetary ETF products has reached 583.528 billion units. In particular, the total scale of non-monetary ETF products reached 1.7544 trillion units, an increase of 49.84% from RMB 1.1714 trillion in 2022. The lack of market enthusiasm for newly launched equity funds and the surge in ETF shares reflected that investors were increasingly paying attention to product costs in the absence of money-making effects in the market overall, and also revealed the investors' desire for the linkage of product management fees with investment returns. Moreover, it revealed the increased recognition of the value of index investment by certain professional investors, and there have been signs of greater purchase volume as prices fall. This is particularly shown in the movements of the ChiNext 50 ETF, which experienced a large decline in 2023 and was net subscribed for more than 50 billion units. The largest volume CSI 300 ETF was net subscribed for more than 10 billion units in Q3, and its latest scale exceeded RMB 120 billion.

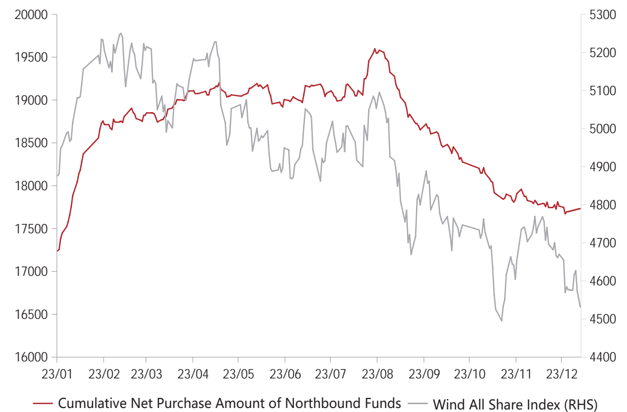
Third, the direction of northbound capital flow has been labeled, and has become a benchmark for certain investors to analyze the short-term movements of the market. Judging from the trend of changes in the market value of northbound stock holdings in 2023, when the market value of northbound stock holdings continued to decrease (net outflow from the north), the Wind All Share Index would fall, reflecting a high level of correlation. As can be seen, when the market sentiment is filled with confusion, there is a lack of first-class investment institutions in China capable of leading the investment direction and playing the role of "backbone" in the Chinese stock market. The market movements have also shown the distortion of the investment values of certain market participants. Since early 2023, the cumulative inflow of northbound funds reached RMB 42.586 billion. The above market movements mainly took place in the stage of the market's "strong expectations" in Q1. The outflows of funds primarily occurred in the stage of "weakening status-quo" in 2H, 2023. After China introduced a series of economic stimulus policies in July 2023, northbound funds still flowed out to a significant extent for many days in a row. The abnormal outflow of funds drew much attention from the market.

Figure 06. Performance of Major Broad-based Indexes in China's Stock markets in 2023 (%)



Data sources: Wind and BOC Investment Strategy Research CenterStrategy Research Center

Figure 07. Comparison of Changes in the Cumulative Net Inflow of Northbound Funds in 2023 and the Trend of Wind All Share Index (RMB 100 million, bps)



Data sources: Wind and BOC Investment Strategy Research Center

1.2.2 Global bond markets: Growth of the economy and cycle of inflation were asynchronous, and the bull run of China's bond market was accompanied by the bearish trend of the US bond market

In 2023, there was a bull run for China's bond market and a bearish trend for the US bond market. The trading logic of US bonds was influenced by the rate of decline in inflation and the end of monetary tightening (interest rate hikes), whereas the trading logic in China's bond market was the twists and turns in China's economic recovery as well as the progress and intensity of monetary policy easing. With respect to the overall performance of the global bond markets, in Q1, the US showed strong performance but China showed a trend of moderately weakening. In Q2, China's bond market strengthened in stages, and the rebound of US bonds encountered headwinds. In Q3, China and the US bond markets weakened simultaneously. China's bond market experienced corrections, and the US bond market to continued to weaken. In Q4, the US bonds showed stronger performance than China's bonds. The annual declines of US bonds has narrowed to some extent, and the yields of varying types of bonds have accelerated their downward movements at the end of the year. The above market performance was mainly attributable to the fact that the Chinese and US economies were in different cycles, and the corresponding policy cycles were also out of sync. China's economy was in the early stages of recovery from recession, which was conducive to a stronger bond market, while the US economy was in the transition stage from overheating with high inflation to a state of equilibrium, which imposed a negative impact on a stronger bond market. However, there were strong expectations that the USD interest rate hikes would come to an end and the cycle of interest rate reductions begin at the end of 2023, causing the US 10-year treasury yield to fall sharply. Throughout the year 2023, the overall performance of the bond market was slightly different from our expectations in the strategy report in 2023. In particular, China's bond market was stronger than expected, and the US bond was weaker than expected.

With respect to China's bonds, the market experienced a slight bull run in 2023, and the downward trend in yields was limited. The range of fluctuations of the 10-year treasury yields was less than 40 bps throughout the year. The funding rates of varying maturities have been mixed compared with the beginning of the year: 1-year treasury yields rose by 21.07 bps to close at 2.31%, and the 10-year treasury yield fell by 21.26 bps and closed at 2.62%. The short-term funding costs fell by an even greater extent, with SHIBOR overnight falling 36.3 bps to 1.59%.

In Q1, the market expected China's economy to recover strongly. Therefore, the 10-year treasury yield rose and then fell back, and once hit a high of 2.93% at the end of January. The 1-year treasury yield continued to rise, and the spread between long-term and short-term treasury yields continued to narrow. On the one hand, it was hard to confirm the progress of economic recovery during the vacuum period of credit expansion and macroeconomic data, leading to more cautious market sentiment. On the other hand, rising interest rates attracted greater forces of asset allocation to enter into the market, but the overall amplitude was small after accounting for the offsets between long and short positions.

In Q2, the domestic economic recovery fell short of expectations, and loose monetary policy was initiated. Driven by rather ample liquidity and the market behaviors of asset allocation, the bond market became bullish again in Q2. In China, new demands remained insufficient, as shown by the PMI data in April and May that were consistently below the boom-bust line. Moreover, investment, consumption, industrial production and other data were significantly weaker than expected, and inflation data fell sharply. At the same time, the PBOC maintained reasonably sufficient funds, and the market's expectations for interest rate cuts continued to increase, and finally ushered in the reduction of LPR in June, which became a direct contributing factor for the bond market to strengthen in Q2. As of the end of Q2, the 1-year treasury yield dropped by 22.46 bps to close at 1.87%, and the 10-year treasury yield dropped by 20.02 bps to close at 2.64%. The costs of short-term funds fell by an even greater extent, as shown by SHIBOR overnight falling by 47.3 bps to 1.48 %.

In Q3, the economic recovery was still less than expected, but policies were clearly effective. Under the positive tone set by the crucial meeting held in July, varying government departments have successively implemented easing policies. For example, the National Development and Reform Commission (NDRC) established the Private Economy Development Bureau to boost the confidence of the private economy. Municipal governments in first-tier cities began to implement the policy of "treating mortgages on second homes in the same way as a first mortgage, as long as the buyer has paid off the first loan", and lowered the interest rates of existing mortgages, among other measures in the real estate sector. The treasury department reduced stamp taxes on the stock market and increased special additional deductions for personal income tax, among other measures. Affected by the above policy stimulus, economic data has improved to some extent. Specifically, the PMI rebounded for three consecutive months, and the inflation data turned from falling to rising. Local governments have stepped up efforts in issuing bonds to promote new social financing. The PBOC has lowered the reserve requirement ratio by 25 bps in September, exceeding the market's expectations. The above policies all showed China's firm determination to facilitate the economic recover. Therefore, the superior performance of the bond market in the first two quarters has been severely tested in Q3. Especially since mid-August, the yield rose significantly, and the 10-year treasury yield rose back to 2.68% after dropping to 2.55% (the lowest level in recent years). The short-term bonds even gave up the gains since early 2023. The 1-year treasury yield experienced the largest intraday increase of more than 29.54 bps in Q3, closing at 2.17%.

In Q4, as economic data weakened again, policies of stabilizing growth were issued in package. Moreover, local government special refinancing bonds and one trillion special treasury bonds were issued intensively. The supply of bonds increased, but there was no significant change in treasury yields. The 1-year treasury yield increased by 13.99 bps to close at 2.31%, and the 10-year treasury yield decreased by 5.24 bps to close at 2.62%. The cost of short-term funds dropped significantly, with SHIBOR overnight falling 56.1 bps to 1.59%.

With respect to US bonds, the inflation continued to decline, with CPI data falling to 3.2% in October and core PCE also falling to 3.5%, but it still exceeded the target level of 2%. In addition, the unemployment rate in the US job market remained at low levels. After the Fed sent a hawkish signal of "maintaining higher interest rates for a longer period of time" to the market in September to curb inflation, the 10-year treasury yield hit a new high in 2023. After the suspension of interest rate hikes in November, the market was clearly affected by expectations of interest rate cuts, and there were accelerated declines in US bond yields. Throughout the year 2023, the 2-year US treasury yield rose by 3 bps to 4.44%, and the 10-year US treasury yield rose by 3 bps to 3.91%. Overall, the US bond market still experienced a bearish trend. At the same time, the constant inversion of long-term and short-term treasury yields also implied the market's expectations of an economic recession in the US.

In Q1, the market expected that the Fed would continue to raise interest rates by 100 bps in 2023, and long-term and short-term US bond yields rose simultaneously. However, the ensuing unexpected event of the Silicon Valley Bank triggered market concerns about the stability of the financial sector, and arouse expectations for a reversal of the Fed's monetary policy. Accordingly, the US bond yields fell rapidly again. The yields on 2-year and 10-year US treasuries fell by 35 bps and 40 bps respectively in Q1. The inversion in the 10-year treasury yields between China and the US continued, and the yields on short-term and long-term treasuries in the United States remained inverted, reflecting the heightened risks of a recession in the US.

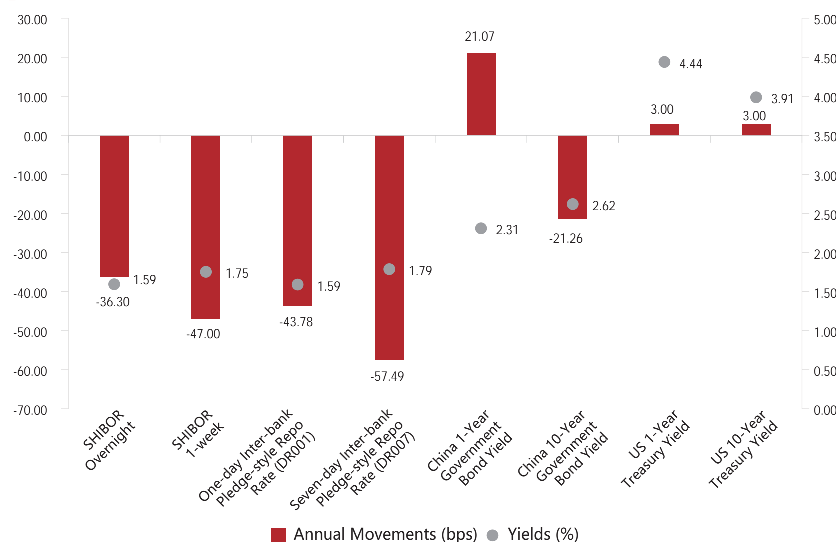
In Q2, the US inflation remained resilient. The core CPI in May reached 5.3% year-over-year, and the declines in core inflation remained at a slow pace. Although the Fed chose to suspend raising interest rates in June, it also raised the dot plots of rate hike by 50 bps to express its determination to curb inflation. The market perceived the end of the USD interest rate hikes to be slower than expected at the beginning of the year, and the rebound of the US bond market was hindered in Q2. The yields on US 2-year and 10-year treasuries went up by 81 bps and 33 bps respectively from Q1. In Q1, 2023, the US 2-year treasury yield rose by 46 bps to 4.87%, while the US 10-year treasury yield fell by 7 bps to 3.81%. The contrast

between long-term and short-term US Treasury yields indicated that the market expected the probability of the Fed to cut interest rates in the short term was low. Nevertheless, in the long run, interest rate reductions are inevitable.

In Q3, US economic data unexpectedly strengthened. The US services PMI rose to the level of 54.5 in August, reaching a new high since February 2023. Crude oil prices rose by more than 20% in Q3, and the US inflation rate picked up once again. Moreover, the core CPI was still above 4%, significantly higher than the target inflation rate of 2%. The market's expectations for the Fed to end the current round of interest rate hikes were delayed. The FOMC meeting in September released a hawkish signal that exceeded the market's expectations, and the strong USD made a comeback. US treasury yields evidently rose under pressure. In particular, the movements of long-term treasury yields were even greater. The 10-year US treasury yield rose to 4.59% in Q3, a quarterly increase of 78 bps.

At the beginning of Q4, the market continued to rise under the expectations of "maintaining higher interest rates for a longer period of time". The 10-year treasury yield once hit a high of 5.1%. Corresponding to the falling inflation and rising unemployment, the Fed suspended interest rate hikes in November, and the market continued to revise the timing of the end of the Fed's rate hikes and the start of the cycle of interest rate reductions. Accordingly, the US 2-year and 10-year treasury yields fell rapidly. In Q4, the yields fell by 59 bps and 68 bps respectively, closing at 4.44% and 3.91% respectively. The interest rate gap between China and the US 10-year treasury yields also narrowed from about 240 bps to around 130 bps. Expectations of interest rate reductions have dominated the ambience of market trading at the end of the year.

Figure 08. Trend in China's Capital Market, and the Movements of Interest Rates and Yields of China and US Treasuries in 2023 (bps, %)



Data sources: Wind and BOC Investment Strategy Research Center

1.2.3 Gold and crude oil markets: Investments into safe-haven assets contributed to the rise of gold price, and the price of crude oil experienced wide-range fluctuations amid the game of supply and demand

In 2023, USD gold (London gold) and RMB gold rose by 10.79% and 16.14% respectively. RMB gold rose for five consecutive quarters with the smoothest path of rally. Gold was the best-performing major asset category among RMB assets over the past two years. The trend of USD gold experienced slight twists and turns. In mid-October, the difference between the movements of RMB gold and USD gold were more than 10%. The reason was that RMB gold hedged against the depreciation of the RMB exchange rate. The major contributing factor to the rally of gold prices was that its status as a credit benchmark was well manifested, and its hedging function played a role in the wave of "de-dollarization", triggering a boom of gold purchases by certain central banks around the globe. Geopolitical factors including the tension between Russia and Ukraine and the Palestinian-Israeli war have also contributed to the rise in demands for safe-haven assets. Hence, the traditional factor that affects the price of gold, namely, the real yield of the USD, only imposed a limited impact in 2023. Especially in 1H 2023, the real USD yield did not become a major factor restricting the rise of gold prices. Nevertheless, at the end of the year, the

market was engaged in trading about the end of USD interest rate hikes, and the expectations for interest rate reductions were formed, thus bolstering gold prices. The path of gold price movements in 2023 were as follows:

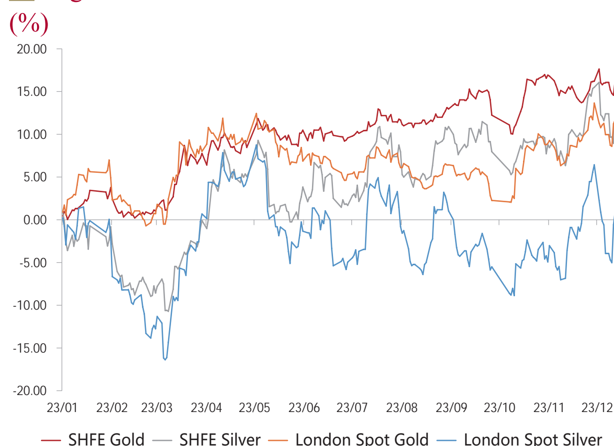
In Q1, from January to February, the trend of gold prices was affected by the expectations of the Fed's policy stance. In particular, the hawkish statements made by the Fed's chairman Jerome Powell undermined the market's previously optimistic perception about the monetary policy shift, causing the price of precious metals to fall. However, under the impact of the Silicon Valley Bank and Credit Suisse events in March, the risk aversion sentiment quickly escalated in the market. Expectations for the Fed to cut interest rates started to brew, and the safe-haven nature of gold prices was highlighted, leading to rapid increases of gold prices. In Q1, London gold (spot gold) and Shanghai gold rose by 8.0% and 7.77% respectively, with London gold prices exceeding USD 2,000 per ounce. The trend of gold prices reflected the credit damage caused by the excessive issuance of the USD, as well as the complex and diverse changes in geopolitical factors as well as economic and trade relations across the globe.

In Q2, the US economy continued to grow, and the inflation entered into a stage of downward movements, but at a slower pace than expected. Moreover, the Fed's policy of interest rate hikes entered into a stage of observation while coming to an end. At this stage, monetary policies in Europe and the US remained tight, and the US treasury yields remained high. The real interest rate in the US turned positive and is expected to rise further in the short term. The economic fundamentals supporting the rise of gold prices encountered both positive and negative factors, and gold prices experienced oscillations at highs. The movements of London gold prices reached 9.1% in Q2, with an overall decline of 2.5%. Due to the appreciation of the USD, the movements of RMB gold reached 5.1%, and it rose particularly in Q2 with an increase of 2.03%.

In Q3, the Fed's hawkish policy stance exceeded the market's expectations, allowing the USD to resume its strength. The expansion of real interest rates has become the dominant factor in determining the price of USD gold at this stage, while expectations of USD interest rate cuts and the gold's substitution of the USD became a secondary factor. The USD gold fell by 3.69% in Q3. Due to exchange rate adjustments, RMB gold rose for three consecutive quarters, and went up by 2.59% in Q3.

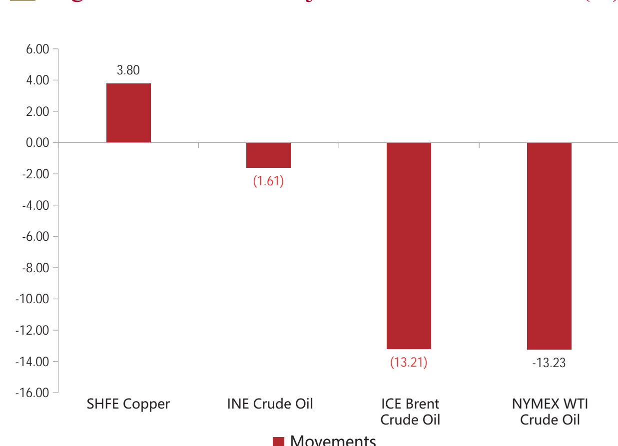
In Q4, gold prices continued to rise due to the Fed's statement of "maintaining higher interest rates for a longer period of time" as well as the impact imposed by the Palestinian-Israeli war. The USD gold rose by 9% in early October. After a brief pause of rally, the Fed suspended interest rate hikes in November, leading to the market trading of expectations for the cycle of interest rate reductions, and gold prices gained momentum of rises. London gold and RMB gold rose by 9.25% and 3.15% respectively in Q4.

Figure 09. Trends of Gold and Silver Prices in 2023 (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 10. Trends of Major Commodities in 2023 (%)



Data sources: Wind and BOC Investment Strategy Research Center

In 2023, the trend of crude oil prices fluctuated widely. In particular, NYMEX crude oil, ICE Brent oil and Shanghai crude oil prices slumped by 10.55%, 10.43% and 1.61% respectively throughout the year. In 1H 2023, crude oil prices fell by 12.22%, 12.48% and 1.21% respectively. Due to the changes in the RMB exchange rate, Shanghai crude oil price fell significantly lower than NYMEX and Brent crude oil prices. The movements of crude oil prices were mainly attributable to the gaming between supply and demand. The OPEC+ alliance proactively adjusted production and played a vital role in determining crude oil prices. The movements of crude oil prices throughout the year were as follows:

In Q1, NYMEX crude oil, ICE Brent oil and Shanghai crude oil prices fell by 5.68%, 6.96% and 4.59% respectively. There were rising expectations of a global economic recession due to the surging global inflation, heightened concerns of investors about rising interest rates, and the impact imposed by the banking crisis in Europe and the US. Although China's demand recovered, it remained hard to offset the market's concerns about declining demands for crude oil.

In Q2, NYMEX crude oil and ICE Brent oil dropped by 6.90% and 5.88% respectively. Due to changes in the RMB exchange rate, Shanghai crude oil price rose by 3.74%. At the macro level, the risks of Credit Suisse and Silicon Valley Bank were defused, and the market's concerns about the banking crisis were eased. At the supply and demand level, crude oil exports from the Kurdistan region of Iraq were blocked, and the OPEC+ alliance unexpectedly cut oil production. In late April, after the impact of production cuts subsided, the market's concerns about economic recession were rekindled, and oil prices fell back from their highs once again. The center of the oil price oscillations shifted downward in May. Due to concerns about the recession, the US debt ceiling crisis, and the market's risk aversion sentiment, crude oil prices were under greater pressure. The spot supply and demand of crude oil did not improve after the production cuts initiated by the OPEC+ alliance, causing oil prices to fall further.

In Q3, the OPEC+ alliance stepped up oil production cuts, and both Saudi Arabia and Russia remarked that they would extend production cuts until the end of the year, exceeding the market's expectations. The reduced supply became the crucial factor leading to the sharp rebound of crude oil prices. China introduced a number of economic stimulus policies, and the economy rebounded further. The market generally expected that China's crude oil demands would experience a rebound. NYMEX crude oil, ICE Brent oil and INE (Shanghai) crude oil prices surged by 28.5%, 22.15% and 31.61% respectively.

In Q4, the market's expectations for a soft landing of the US economy and a recession in Europe became stronger. Coupled with China's PMI falling below the boom-bust line in October, concerns about weakening demands were intensified. Disturbed by rumors that Saudi Arabia would give up production cuts and reach a political deal with the US, and the profit-taking transactions after rally of crude oil prices in Q3, NYMEX crude oil, ICE Brent oil and Shanghai crude oil prices slumped by 20.91%, 16.54% and 23.73% respectively.

1.2.4 Global foreign exchange market: The strength of the USD no longer exists, and non-USD currencies experienced divergent performance with alternative rises and falls

In 2022, the USDX fluctuated within a wide range of 21.0%, and it appreciated by 7.84%. In 2023, under the guidance of expectations by the Fed, the USDX volatility converged to 7.54% for the entire year of 2023, with an overall slight decline of 0.87%. Non-USD currencies experienced divergent performance with mixed gains and losses. The JPY was the currency that depreciated the most. The depreciation totaled 6.01% throughout the year, and the highest depreciation during the year amounted to 151.91 USD/JPY, which was only one step away from the nearly 33-year high (159.60) set in October 2022. The JPY depreciated by more than 10% for three consecutive years, with a cumulative depreciation of 42% over the past three years. The RMB and the AUD depreciated by 3.19% and 1.69% respectively against the USD. The GBP, the EUR, the CAD appreciated by 4.86%, 1.7%, and 1.28% respectively against the USD.

With respect to the USD, the USDX fell by 0.11% in 1H 2023, and non-USD currencies showed evidently divergent performance. The GBP, the EUR, and the CAD continued to appreciate against the USD in Q1, which was attributable to the higher inflation and stronger expectations of interest rate hikes in the above-mentioned countries. The JPY depreciated by 10.05%, including the depreciation of 8.65% in Q2 alone, which was due to the relative strength of economic growth and monetary policies between Japan and the US. In Q3, as US inflation remained resilient and the economy grew strongly, the Fed tightened the monetary policy more than expected by the market. Subsequent to the FOMC meeting in September, the market accepted the Fed's expectations of "maintaining higher interest rates for a longer period of time", and the risk sentiment declined. Moreover, risk-free interest rates continued to rise, thus forming support for the strong USD. The US 10-year treasury yield continued to rise in Q3, driving the USDX to strengthen again to a high level of above 106. Affected by the strong USD, the overall performance of non-USD currencies remained weak. At the beginning of Q4, the USDX continued to surge. Nevertheless, due to falling inflation and softening economic data, the market was convinced about the arrival of the turning point for interest rate hikes. Since then, the USDX dropped rapidly and once again fell below the level reached in early 2023.

With respect to the RMB, it went out of an "N"-shaped trend throughout the year and fell by 1.26%. In particular, the RMB rose by 1.4% in Q1, fell by 3.87% in Q2, and went up by 1.26% and 0.25% respectively in Q3 and Q4. The above changes were mainly caused by the depreciation of the RMB/USD. The RMB depreciated against the USD by 5.02% in the first three

quarters, reaching a maximum of 7.3682. In particular, the RMB/USD appreciated by 1.15% in Q1, depreciated by 5.69% in Q2, and appreciated by 0.53% in Q3. Although it was inevitable for non-USD currencies to depreciate against a strong USD, the depreciation of the RMB was rather attributable to the differences in monetary policies between China and Europe as well as the US. It is the result of the discretionary decision-making of central banks in varying countries based on economic fundamentals.

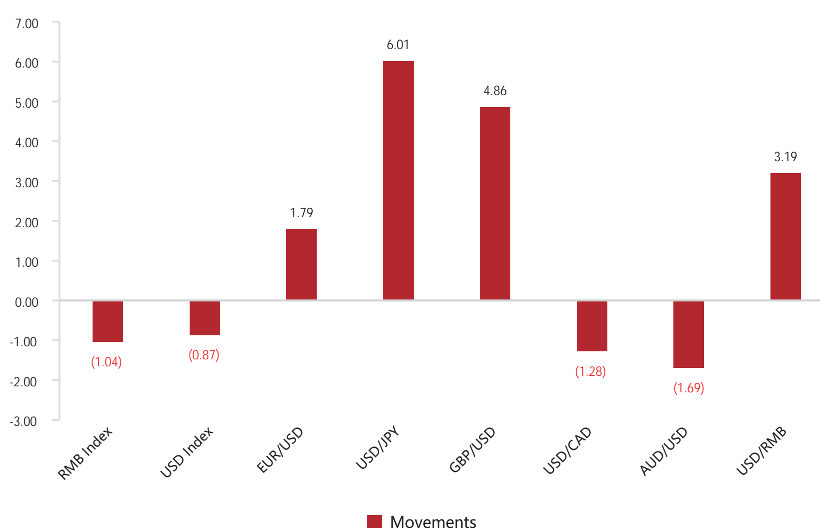
With respect to the operating rhythm, under the expectation of economic recovery in Q1, China's economy recovered ahead of the major economies around the globe. Even against the backdrop of the central bank's reduction of reserve requirements, recurrent shift of policy stance about interest rate hikes by the Fed, and the outbreak of banking crises in the US and Europe, the RMB exchange rate revealed the features as a safe-haven currency. The USD/RMB once reached the level of 6.7 in Q1, and the RMB index rose by 1.4%, whereas the RMB appreciated by 1.15% against the USD.

In Q2, the overall recovery of domestic demands was rather sluggish, and major economic data such as consumption, investment, and the aggregate financing to the real economy (AFRE) were lower than expected. The "strong expectations" of economic recovery were met with "weak reality". Although there were bright spots in the structure of import and export data, it is hard to make up for the weakening pattern of total volume. Exports (denominated in USD) showed negative year-over-year growth in May. In Q2, the RMB Index fell by 3.87%, and the exchange rate of RMB/USD depreciated by 5.69%.

In Q3, driven by the evidently intensified macroeconomic control and the consistent efforts of monetary and fiscal policies, data including the AFRE, PPI, PMI, and total retail sales of social consumer goods all showed a certain degree of marginal improvement. The declines in exports also slowed down. At the special meeting on the self-regulatory mechanism of the foreign exchange market held in September, the PBOC stated that "financial authorities have the ability, confidence, and conditions to maintain basic stability of the RMB exchange rate", demonstrating its resolution of stabilizing the exchange rate. In Q3, the RMB exchange rate index returned to the range of appreciation, rising by 1.26%, and also appreciated slightly against the USD by 0.53%.

In Q4, the USDX remained at a high of 106-107 in October, thus imposing depreciation pressure on the RMB. However, as the market quickly turned to the trading of USD interest rate reductions in November, short positions of RMB were quickly made up, and the exchange rate movements ushered in a turning point. In Q4, the RMB/USD appreciated by 2.76%. Although the RMB depreciated against a basket of currencies, thanks to its appreciation against the USD, the RMB Index still rose by 0.25% in Q4, and the annual movements were similar to those of the USDX. Since 2020, the RMB Index has risen by 2.29% and has appreciated by 11.84% against the USD, thus revealing the features of a global stable currency at a preliminary stage.

Figure 11. Exchange Rate Movements of Major Currencies in 2023 (%)



Data sources: Wind and BOC Investment Strategy Research Center

1.3 Strategy Review: Right Direction of Strategic Allocation and Optimal Selection of Tactical Timing

1.3.1 Review of strategies over the past years: We have oriented our strategic allocation towards the right direction, and opted for the opportune tactical timing

1.3.1.1 Changes in the proportion of strategic assets revealed the prediction on the direction of market operation

Bank of China started to release reports on global asset allocation strategies in 2018, and it is our sixth edition in a row. Over the past five years, we have shared our insights through these strategy reports to guide our clients on strategic asset allocation, especially the asset allocation ratio between equities and bonds. Taking the asset class (equity) allocation ratio that is the decisive factor in portfolio income for customers with risk appetite C4 as an example, we held that A-shares experienced “a year of turn” in 2019. We were optimistic about the opportunities available in the stock market and set the equity asset allocation ratio to be up to 65%. In 2020, we held that A-shares would experience a “transition from turn to recovery”, and continued to increase the equity asset allocation ratio to a maximum of 69%. In 2021, we held that A-shares would move “from recovery to resurgence”, thus breaking the “curse of stock market would only rise for not longer than three years, and the bearish trend lasted longer than the bull run”. Nevertheless, the market beta might not be large enough, thus we recommended that the market would gradually reduce the equity asset allocation ratio to 60% when stock prices reached a high of the year, thus cashing in the gains from the high allocation ratio of equity in the previous three years. In 2022, we held that A-shares were at the “start of resurgence to lay a solid foundation”, and A-shares might rise or fall slightly. During the declines in February, the equity asset allocation of varying portfolios was promptly reduced by 1%-5%, and the equity asset allocation of the portfolio of customers with risk appetite C4 was lowered to 55%. In 2023, we believed that “USD interest rate hikes are approaching the end, and the silver lining of global equities is emerging”, and we once again increased the equity asset allocation ratio by 5% to 60%. Looking back on the past five years, except for 2023, A-shares rose sharply in every year when we increased the equity asset allocation ratio, especially in years when we significantly increased the ratio. In years when we lowered the equity asset allocation ratio, A-shares rose merely slightly or even fell. This fully demonstrated that the adjustment direction of our strategic asset allocation was consistent with the direction of market operation in the specific year, and verified the ability of our strategy in predicting the general direction of the market, namely, the existence of “alpha value of Bank of China Investment Strategy”. We improved portfolio returns by increasing the equity asset allocation ratio in years when the market trend was rosy, and lowering the equity asset allocation ratio in years when the market trend was relatively gloomy to reduce portfolio volatility.

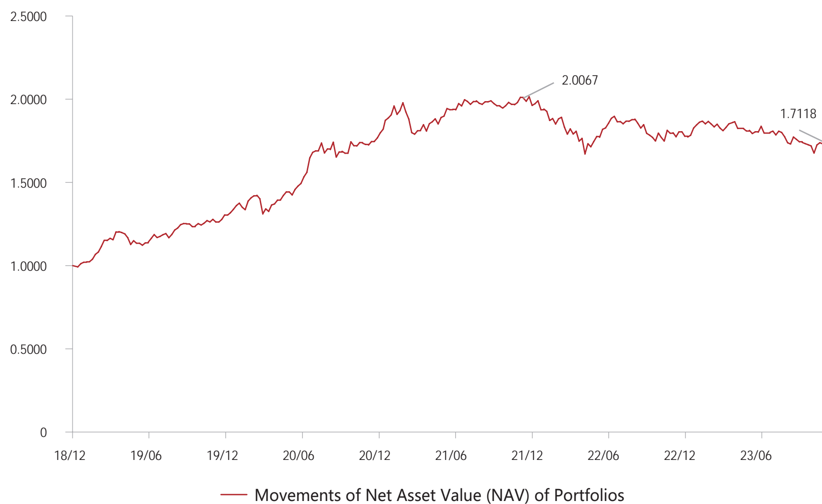
Figure 12. Ratio of Equity Assets and Portfolio Returns for Customers with Risk Appetite C4 from 2019 to 2023

Ratio of Equity Assets and Portfolio Returns for Customers with Risk Appetite C4 from 2019 to 2023			
Year	Ratio of Allocation into Equity Assets	Movements of Equity Funds in the Same Period	Movements of Our Simulated Portfolios in the Same Period
2019	65.00%	38.15%	38.15% (No portfolio established during the year)
2020	69.00%	38.63%	40.13%
2021	60.00%	8.00%	9.36%
2022	55.00%	-17.74%	-11.00%
2023	60.00%	-10.64%	

Data source: BOC Investment Strategy Research Center

In 2023, we increased the equity asset allocation ratio. Nevertheless, the index has yet to rise, but we still firmly believed that this would be the bottom area in the next few years. It is the year when we need to increase equity asset allocation at the bottom, so that we can enjoy the benefits of allocation of strategic assets when the index rises in 2024. It shall be noted that over the past two years, we accurately grasped the timing of asset allocation into gold, an alternative of strategic assets. According to the tradition of asset allocation, the proportion of gold as an alternative asset is not too high in the portfolio. Our purpose was only to smooth the fluctuations of the portfolio and to indirectly improve the portfolio returns. Starting from July 2022 (strategy for Q3, 2022), we increased the asset allocation into gold from an underweight to a standard position. In the strategy report in 2023, we continued to increase asset allocation into gold to an overweight. In addition, in each of the risk appetite simulation portfolios, the gold allocation ratio was doubled, and the gold allocation ratio of customers with risk appetite C4 and above was increased to 10%. In our strategy for Q3, 2023, the poor profit-making effects of equity investment were taken into account. Moreover, based on the benefits of currency hedging, geopolitical hedging, and the start of the cycle of USD interest rate reductions, the value of gold was highlighted. We recommended that positioning of gold be upgraded in a phased manner (tentatively within 2 years) from an allocation-type asset (alternative asset) to a strategic asset category as crucial as stocks and bonds. In other words, we may use gold as an income-generating asset instead of merely for the purposes of asset allocation and hedging. In addition, we recommended that customers could use gold to replace equity investments in stages, and viewed gold consumption (gold jewelry) as "hedging investment, saving and value preservation while generating pleasure". The moves proved to be bold but utterly justified. Subsequent to the adjustments, Shanghai gold rose by 8% while the CSI 300 Index fell by 8.87% during the same period. This could also be regarded as the alpha value of our strategic asset allocation.

Figure 13. Trend of Yield Movements of BOC Investment Strategy Allocation Portfolios from 2019 to 2023



Data source: BOC Investment Strategy Research Center

1.3.1.2 During the selection of timing for tactical asset allocation, precise reminders were given at critical moments

Over the past five years, we have created the alpha value of strategic asset allocation by adjusting the allocation of varying strategic assets. From January 2019 to April 2020, the equity ratio was maintained at 65%. In April, the equity ratio was increased to 69%. In early 2021, we encouraged profit-taking and reduced the equity asset allocation ratio to 60%. In Q1, 2022, the ratio was reduced to 55% again. Cashing in equity returns at high levels helped avoid the declines in the stock market, and switching to gold or bonds further increased portfolio returns. In particular, increasing the asset allocation into gold since 2022 has increased earnings by at least 1.5%. The result manifested the alpha value of Bank of China's strategic asset allocation adjustments. Figure 13 showed the trend of cumulative returns of the strategic asset allocation of our weekly strategies for customers with risk appetite C4 from 2019 to 2023 (each major category of assets was replaced by the corresponding fund index). As shown by the figure, since 2019, if investors strictly followed the recommendations given in our strategy for strategic asset allocation by purchasing the corresponding ETFs, the

cumulative return could reach 71.18% over the past five years, with an average annualized rate of 14.23%. This was the joint contribution of our strategic asset allocation income and the alpha value of our strategic asset allocation adjustments. On the other hand, we created alpha value through the timing of tactical asset allocation (this part of the returns was not factored into the simulated portfolio). Taking the "Bank of China Investment Strategy Weekly Report" as an example, we opted for the best timing to arrange asset allocation into volatile equity assets based on market fluctuations, and we managed to reduce costs of portfolio construction, and accumulated more excess returns in the long term. In Figure 12, we made a statistical analysis. Since 2019, the "Bank of China Investment Strategy Weekly Report" has strongly recommended the allocation into equity assets for 13 times. If we use the movements of WIND stock funds as the standard of assessing returns of our recommended portfolios, then the average time needed to reach the investment goals of 10% and 15% would be 40 and 70 trading days respectively. In addition, our weekly strategy report gave staged bearish (cashing out gains) recommendations at several key high points over the past five years. Although it was not as strong as a buy recommendation, this is the style of our strategy to adapt to the current environment. For example, according to the weekly report on the high point of the index for the year 2023 released on July 13, 2020, we suggested that the "rapid rise is nearing the end, and the index is likely to return to the normalcy of consolidation amid oscillations". According to the weekly report on the high point of the index released on July 4, 2022, we suggested that the "rebound was close to the short-term range of equilibrium, and the structural market trend was driven by interim report". According to the weekly strategy report released on January 30, 2023, we suggested that "market sentiment is released in the near term, and the upward slope may become flatter", so as to express our judgment on the tail end of the rapid rally in spring, and the market would subsequently start to fluctuate within a range, etc. Overall, we abide by the concept of asset allocation and long-term investment. Nevertheless, at the juncture when we think is the high point in stages, we still hope that investors can realize certain short-term gains on the one hand. On the other hand, we attempt to avoid asset allocation into remaining equity assets during the period when stock prices are at highs", and we would postpone the timing of asset allocation until the period of low levels in stages. To sum up, although according to traditional concepts of asset allocation, it is impossible to create alpha value through timing, through our practice over the past few years, we have grasped the timing of tactical asset allocation of varying assets and provided accurate and timely reminders for investors. Creating greater excess returns revealed the alpha value of Bank of China's tactical timing.

Figure 14. Statistical Table of 13 Clear Recommendations for Buying Made by BOC Investment Strategy Research Center from 2019 to 2023 and the Time Required for Reaching the Profit Targets

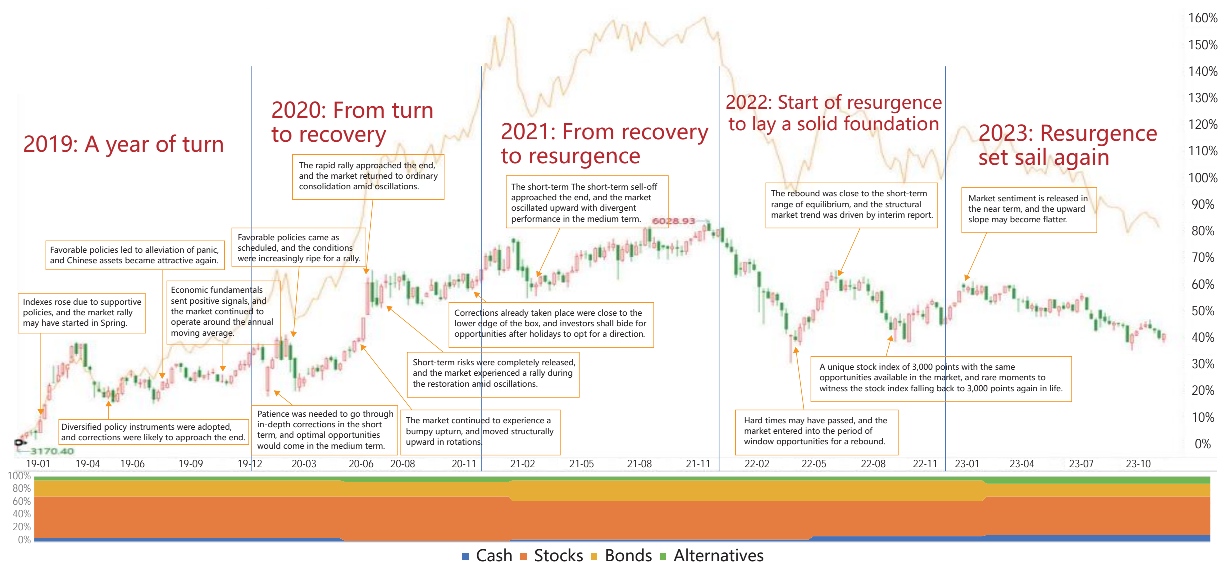
Date	Clear recommendations for buying made by BOC Investment Strategy Research Center	Number of trading days of taking profits at 10%	Number of trading days of taking profits at 15%	Annualized rate of return of taking profits at 10%	Annualized rate of return of taking profits at 15%
2019/01/21	Indexes rose due to supportive policies, and the market rally may have started in Spring.	21	26	119.00%	144.20%
2019/06/10	Diversified policy instruments were adopted, and corrections were likely to approach the end.	51	63	49.00%	59.50%
2019/08/12	Favorable policies led to alleviation of panic, and Chinese assets became attractive again.	55	96	45.50%	39.10%
2019/12/02	Economic fundamentals sent positive signals, and the market continued to operate around the annual moving average.	28	49	89.30%	76.50%
2020/02/03	Patience was needed to go through in-depth corrections in the short term, and optimal opportunities would come in the medium term.	8	15	312.50%	250.00%
2020/04/07	Favorable policies came as scheduled, and the conditions were increasingly ripe for a rally.	43	52	58.10%	72.10%
2020/06/22	The market continued to experience a bumpy upturn, and moved structurally upward in rotations.	10	14	250.00%	267.90%
2020/07/20	Short-term risks were completely released, and the market experienced a rally during the restoration amid oscillations.	103	113	24.30%	33.20%

Date	Clear recommendations for buying made by BOC Investment Strategy Research Center	Number of trading days of taking profits at 10%	Number of trading days of taking profits at 15%	Annualized rate of return of taking profits at 10%	Annualized rate of return of taking profits at 15%
202/09/28	Corrections already taken place were close to the lower edge of the box, and investors shall bide for opportunities after holidays to opt for a direction.	53	63	47.20%	59.50%
2020/12/14	The market stepped back and gained crucial support, and would return to the rising channel.	16	29	156.30%	129.30%
2021/03/29	The short-term sell-off approached the end, and the market oscillated upward with divergent performance in the medium term.	43	79	58.10%	47.50%
2022/05/09	Hard times may have passed, and the market entered into the period of window opportunities for a rebound.	19	33	141.60%	125.10%
2022/10/26	A unique stock index of 3,000 points with the same opportunities available in the market, and rare moments to witness the stock index falling back to 3,000 points again in life.	65	276	46.15%	0.00%
	Average	40	70	107.47%	100.30%
	Maximum	103	113	312.50%	267.90%
	Minimum	8	14	24.30%	33.20%

Note: For the recommendation made on October 26, 2022, the target of taking profits at 15% has yet to be achieved. Hence, the duration until the date of data extraction is temporarily used as the proxy of the number of trading days to take profits, and the annualized returns of taking profits is temporarily replaced by 0%.

Data source: BOC Investment Strategy Research Center

Figure 15. Fitting between Bank of China's Annual Strategies on Asset Allocation and Previous Precise Recommendations from 2019 to 2023 as Well as the Weekly Trend of Wind All Share Index



Data source: BOC Investment Strategy Research Center

1.3.2 Review of strategic allocation in 2023: Our views on global stocks (excluding China) are precise, and our recommendations for asset allocation into gold hit the nail on the head

As mentioned in our strategy report in 2023, we believed that in the macro-theme of “end of a strong USD and silver lining of global equities”, we believed the allocation among major asset categories in the year should be in the following order: stocks, gold, commodities and bonds. China’s economy is expected to lead the recovery with progress made in stability, and the sparks of fire of the internationalization of RMB will contribute to the trend of global favor of Chinese assets. As to which country’s stocks to buy, the priority should still be given to Chinese stocks, particularly an overweight on China’s A-shares (recommended) and Hong Kong stocks (recommended). Moreover, Hong Kong stocks are likely to be more resilient after bottoming out. The US economy may enter into a recession. As such, we recommend to underweight US stocks first, and to resume the neutral view at an opportune moment. Due to the high resilience of the European economy, and coupled with the slowdowns of rate hikes, it is recommended to hold a neutral view on the European stocks. Japan’s economy is likely to experience a moderate recovery, and the stock market features reasonable valuation. As such, it is recommended to hold a neutral view on the Japanese stocks, but attention shall be paid to the risk of policy shift away from its loose monetary policy. With respect to the bond market, attention shall be paid to the US inflation that is expected to reach the peak before falling back. Moreover, the Fed is likely to end its cycle of rate hikes, and the US bond market is expected to usher in historic investment opportunities. It is recommended to hold a neutral view first, and investors may shift to an overweight (recommended) on US bonds at an opportune moment. The same logic holds true for Chinese USD bonds. Due to the economic recovery, the cost performance of equity has improved, and thus Chinese bonds are under pressure. As such, it is recommended to underweight (conservative) first, and then transition to a neutral view after reaching the upper limit of the range of yields. With respect to precious metals, at the end of a strong USD amid the potential dusk of empire, gold will play the role of credit yardstick, revealing its value of long-term allocation, and thus investors are recommended to hold a neutral view first, and shift to an overweight (recommended) on precious metals at an opportune moment. With respect to the crude oil market, due to the strong capability of the supply side in regulating production capacity, and coupled with the weakening of USD, it is recommended to hold a neutral view on crude oil. With respect to foreign exchange, the US economy is gradually entering into a recession with the end of the cycle of interest rate hikes, and it is recommended to hold a neutral view on USD first, and underweight (conservative) may be given at an opportune moment. In the UK, the economic environment will experience consistent worsening, and thus it is recommended underweight (conservative) GBP. In Japan, the trade deficit is expected to narrow further, so does the interest rate gap between the US and Japan’s government bonds, and the risk aversion features of JPY are expected to resume. As such, it is recommended to overweight (recommended) JPY. Moreover, it is recommended to hold a neutral view on EUR, AUD and CAD. China’s economy is expected to recover, whereas the weakening of foreign demands may lead to weaker exports. RMB tends to be rather strong amid neutrality, and it is recommended to hold a neutral view.

While taking into account the overall market conditions, we made proper revisions to our strategic asset allocation recommendations in our quarterly strategy reports. We closely tracked the pace of US inflation and interest rate hikes. Based on the preset conditions, prior to the emergence of the inflection point of the Fed’s interest rate hike trend (i.e., the inflection point of the market trading about the Fed’s interest rate hikes), we promptly increased the asset allocation into gold to an overweight at the beginning of Q2. Hence, it is recommended that at the end of the Q2, investors opt for an opportune moment to raise the position of US bonds from a neutral view to an overweight, and lower the position of the USD from a neutral view to a conservative position in Q3. In addition, we raised the position of the GBP from a conservative position to a neutral view, and lowered the position of the JPY from an overweight to a neutral view. Our views on other asset categories remained unchanged.

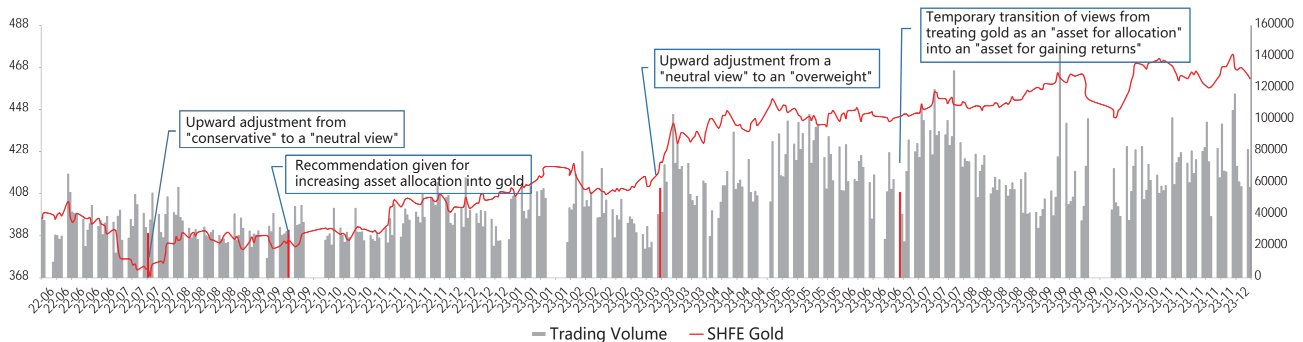
As can be seen from our previous review, the order of movements in global major asset categories in 2023 was as follows: US Nasdaq Index > Japanese stock market > European stock markets > RMB gold > USD gold > Chinese bonds > INE crude oil > Crude oil (US crude oil) > Chinese stock markets > US bonds. From a global perspective, stocks and gold remained the top two performing assets in 2023, with increases of more than 10%. Although commodities recorded negative returns, they performed better than US bonds, which fully verified our analysis in the strategy report on major asset categories. Nevertheless, if we reviewed the trend in China and observed only from the perspective of RMB assets, the order of performance of major asset categories was as follows: RMB gold > bonds > INE crude oil > Wind All Share > Hang Seng Index. In addition to gold and bonds that achieved positive returns, stocks and commodities all recorded negative returns. Gold was the best-performing asset, whereas stocks were the worst-performing assets. The performance of the stock market deviated to a significant extent from the views specified in our strategy report. Although our views

on domestic stock markets deviated greatly from the market trend, the bearish trading logic cannot be self-consistent. Our logic of being optimistic about the Chinese stock markets would eventually be verified by the bull run.

Unlike the deviations from our analysis of China's stock markets, our perceptions on the trend of gold prices were pertinent. In Q3, 2022, the strategic investment opportunities of gold were particularly highlighted. In addition, in the strategy communication meeting of Q3 held on July 13, 2022, we reminded investors of the opportunities to build a position at the bottom of gold prices. As mentioned in the annual strategy report in 2023, we recommended to increase asset allocation into gold to an overweight, and doubled the gold allocation proportion in each of the simulation portfolios of varying risk appetites (increased the gold allocation proportion of gold for customers with risk appetite C4 and above to 10%). In Q3, 2023, we further upgraded our view for gold from an allocation-type asset (alternative asset) to an income-generating asset. As such, we recommended that investors further increase the proportion of gold allocation so as to generate greater income. Since our first recommendation to increase positions, gold has risen by 27.42% (annualized growth of 20.57%). In the two months after the recent recommendation to increase the gold allocation ratio, gold has risen by 4.48% (annualized growth of 27%). Since 2022, we firmly believed that the logic of the negative correlation between the real yield of the USD and gold was not the core factor that determined the trend of gold prices. Instead, core factors related to the gold pricing included the currency hedging function of gold against the USD, the gold purchases by central banks due to the gold's role as credit yardstick, and hedging against geopolitical conflicts, and our perceptions proved to be pertinent about the timing of asset allocation into gold.

Overall, our views on global strategic asset allocation were precise in 2023, and our perceptions about the pace of increasing asset allocation into gold were classic. Nevertheless, our views on domestic stocks deviated to a significant extent, which is worthy of reflection. The reason behind our mistaken view about stocks is that we followed the logic of past policy research to predict the general trend, but underestimated the declines in investor confidence, and overestimated the positive correlation and elasticity coefficient between policy and investor confidence. The market movements have shown the short-term failure of the policy transmission mechanism and the pricing mechanism, which could be the biggest challenge facing our future strategy analysis. The problem facing China's stock markets was not valuation or funding, but lack of investor confidence, which highlighted the necessity and importance of "activating the capital market and bolstering the investor confidence".

Figure 16. Recommendations for the Timing of Asset Allocation into Gold since 2022



Data sources: Wind and BOC Investment Strategy Research Center

Figure 17. Recommendations for Asset Allocation after Quarterly Revisions in 2023

Stocks	Underweight			Overweight	
	Bearish	Conservative	Neutral	Cautiously Recommended	Bullish
US (S&P 500)		●	● (gray)		
Europe (DAX, CAC)			●		
UK (FTSE 100)			●		
Japan (Nikkel 225)			●		
China A-shares (CSI 300)				●	
China Hong Kong Stocks (Hang Seng Index)				●	
Bonds	**Bearish**	**Conservative**	**Neutral**	**Cautiously Recommended**	**Bullish**
US Treasuries	Bullish			● (red)	
Chinese Dollar Debt				● (red)	
China: Money Market			●		
China: Rate Securities		●	● (gray)		
China: Credit Debt		●	● (gray)		
China: Convertible Bonds		●	● (gray)		
Commodities	**Bearish**	**Conservative**	**Neutral**	**Cautiously Recommended**	**Bullish**
Gold				● (red)	
Silver				● (red)	
Crude Oil			●		
Foreign currencies	**Bearish**	**Conservative**	**Neutral**	**Cautiously Recommended**	**Bullish**
USD		● (green)			
EUR			●		
GBP			● (green)		
CAD			●		
AUD			●		
JPY			● (green)		
CNY			●		

Notes: The gray dot represents the direction of adjustment based on preset conditions. The red dot represents the revised opinion made for Q2. The green dot represents the revised opinion made for Q3. The black dot represents the unchanged annual view.

Data source: BOC Investment Strategy Research Center. The gray dot represents the direction of adjustment based on preset conditions. The red dot represents the revised opinion made for Q2. The green dot represents the revised opinion made for Q3. The black dot represents the unchanged annual view.

1.3.3 Review of tactical timing for asset allocation in 2023: Despite the lack of highlights in the timing of stock market trading, the timing of tactical allocation into gold and bond markets are rather suboptimal

Under circumstances when strategic asset allocation failed to avoid systemic risks of the market, we attempted to minimize the impact of systemic risks as much as possible through the timing of tactical asset allocation. Bank of China transmitted views of tactical asset allocation through strategic quarterly reports and weekly reports, and provided relatively accurate and timely operational recommendations at critical moments.

Since our analysis on the trend of the stock market deviated from the market's perceptions, we issued reminders on the tactical timing for the bottom of the stock market in 2023 too early. In addition, we sent bullish signals too often while giving insufficient reminders on the bearish trend. The average position (index points) for the selection of tactical timing is about the same as the index median of the entire year, with not much alpha value to be generated. With respect to the tactical timing selection, we specified in the last edition of our weekly report in 2022 (issued on December 26, 2022) that "short-term adjustments are in place, and the rebound amid oscillations is likely to end", thereby reminding investors of the start of the market trend across years. In the first issue of the weekly strategy report in 2023 (issued on January 1, 2023), we specified that "the hikes of USD interest rates is approaching the end, and stock markets are seeing a silver lining", thus reminding investors of the start of the Spring market trend in 2023. In the fourth issue of the weekly strategy report (issued on January 30, 2023), we specified that "market sentiment is released in the near term, and the upward slope may become flatter" to express our view on the tail end of the rapid rally in Spring. Looking back, the opinions given in the aforementioned weekly reports were rather pertinent. In Q2, our selection of tactical timing was not satisfactory. The overall tone of our recommendations was still optimistic about the stock market, and did not give reminders of the possible adjustment risks at relatively high levels. Nevertheless, when the market fell to the level of 4,900 points of Wind All Share (3,200 points on the SSE), we remained firmly bullish. For instance, in the 20th issue of the weekly strategy report (issued on May 29, 2023), we specified that "the market is close to a proven bottom, and closer attention shall be paid to opportunities of deployment against the market trend". In addition, we recommended using broad-based indexes and index-enhanced products as targets of deployment at lows, so as to overcome the loss of alpha value of active management products in 2023, and to address the shortcomings of the incapacity of these products to outperform broad-based indexes. In Q3, based on our high confidence and expectations for policy stimulus measures, we firmly resisted the shorting views about China's economy and China's stock market with practical actions. From our perspective, the policy bottom already arrived, and the market bottom was gradually being consolidated during the economic recovery. In the 37th issue of weekly strategy report (issued on September 25, 2023), we specified that the "market reached the bottom for a second time, and oscillations at the bottom were approaching the end", and we once again called on investors to pay closer attention to the investment opportunities at the bottom of the market. Now in hindsight, we indeed underestimated the pressure of northbound capital outflows. At the same time, our expectations for the effects of policy transmission were too high. In Q4, we shared our view that "activating the market to boost confidence has a long way to go, and China's stock market will eventually fulfill its crucial mission", thereby reiterating our firm confidence in the China's stock market. In the 40th issue of the weekly strategy report (issued on October 23, 2023), we stated that the "market has fallen to a critical point, and the market bottom may be close at hand", and we emphasized that a rebound is imminent. Accordingly, we recommended to actively arrange asset allocation when stock index fell below the threshold of 3,000 points of the SSE (4,400 points of Wind All Share). Since then, the market did rebound by about 6% and then fell back, but this position was still the lowest position of the index in 2023. From this perspective, given that we were brave enough to persist in bullish views and actions in the face of extreme market panic, we manifested the rationality, objectivity, courage and knowledge that a professional institution ought to have. If the stock index could rise by 10% from this position in subsequent stages, our recommendations will undoubtedly become another classic operation of tactical asset allocation.

The highlights of our tactical asset allocation in 2023 were still gold and bonds, especially the asset allocation into gold. Our perception about the orientation of strategic asset allocation into gold has been justified. Nevertheless, holding a bullish view does not necessarily mean buying without thinking in every period. Instead, we still recommended not to buy gold at excessively high prices during the product scheduling meetings held in May, July and September 2023. We recommended asset allocation into gold subsequent to potential pullbacks. After these several reminders, opportunities of deployment were available at the levels of 3-5% lower from high points. We spare no efforts to refine the timing of tactical asset allocation, and in particular, our tactical timing for allocation into gold proved to be superior in 2023. With respect to bonds, we raised concerns about the adjustment of the domestic bond market in our third quarterly strategy report. In early September, the 10-year government bond yield rose by 25 bps in a single month after touching the threshold of 2.55%, thus triggering an adjustment in the net value of bond products. These were some of the useful attempts and examples of the alpha value of our tactical timing.

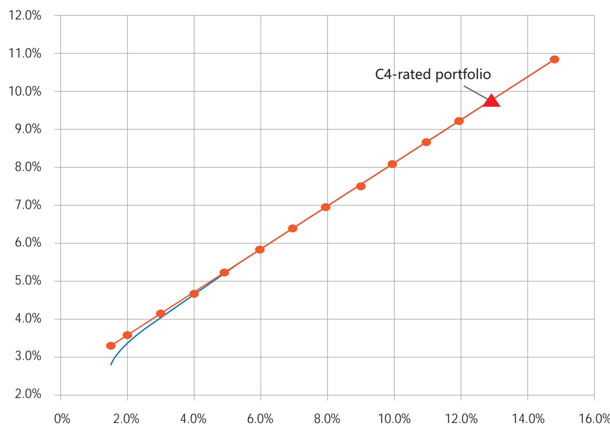
Figure 18. Fitting between Investment Strategies and Trend of Wind All Share Index in 2023

Data sources: Wind and BOC Investment Strategy Research Center

1.3.4 Performance of simulated portfolios: Dragged down by the declines in equity assets, the performance of simulated portfolios outperformed the benchmark but still experienced losses

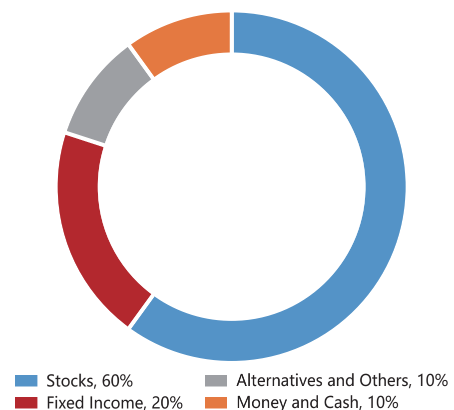
The timing of our strategic and tactical asset allocations have created rather large "excess returns of BOC Investment Strategy" over the past four years, which is regarded as the "alpha value of BOC Investment Strategy". Nevertheless, as a strategic asset allocation for ETF fitting, annual simulated portfolios can hardly reflect these excess returns. Based on the allocation ratios of major asset categories for customers with different risk appetites in the strategy report in 2023, we use major asset class indexes and industry ETF combinations to simulate the trends of returns for several customer groups, as illustrated below:

Figure 19. Performance of the Asset Allocation Portfolio for Customers with Risk Appetite C4 or Higher Levels in 2023 (%)



Data source: BOC Investment Strategy Research Center

Figure 20. Ratio of Strategic Asset Allocation for Customers with Risk Appetite C4 or Higher Levels (%)



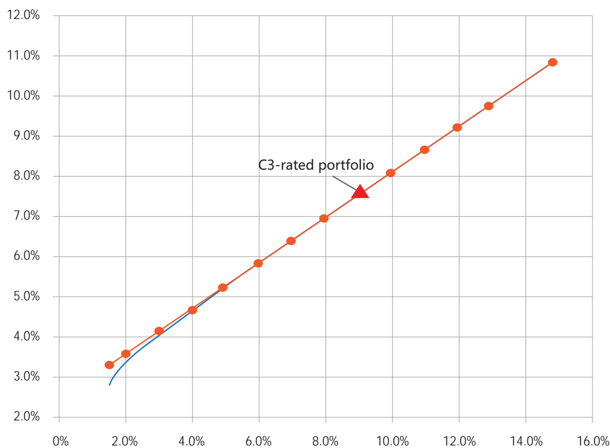
Data source: BOC Investment Strategy Research Center

Figure 21. Tactical Asset Allocation for Customers with Risk Appetite C4 or Higher Levels in 2023

Data source: BOC Investment Strategy Research Center

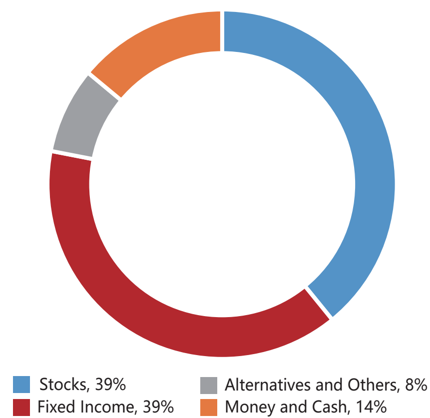
In 2023, the absolute return of our simulated portfolio for customers with risk appetite C4 or higher levels reached -9.42%, whereas the benchmark fell by 12.51% during the same period, and our simulated portfolio outperformed the benchmark by 3.09%.

Figure 22. Performance of the Asset Allocation Portfolio for Customers with Risk Appetite C3 or Higher Levels in 2023 (%)



Data source: BOC Investment Strategy Research Center

Figure 23. Ratio of Strategic Asset Allocation for Customers with Risk Appetite C3 or Higher Levels (%)



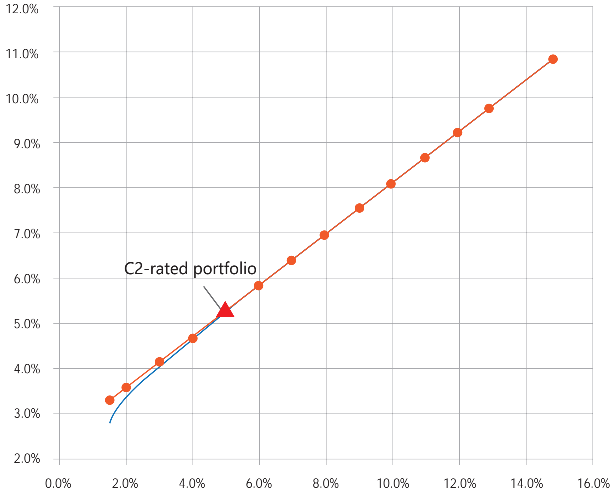
Data source: BOC Investment Strategy Research Center

Figure 24. Tactical Asset Allocation for Customers with Risk Appetite C3 or Higher Levels in 2023

Data source: BOC Investment Strategy Research Center

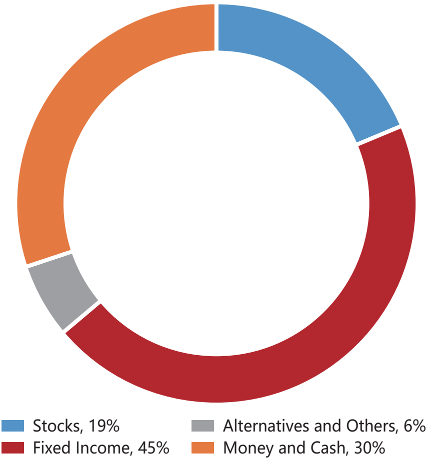
In 2023, the absolute return of our simulated portfolio for customers with risk appetite C3 reached -5.04%, whereas the benchmark fell by 7.37% during the same period, and our simulated portfolio outperformed the benchmark by 2.33%.

Figure 25. Performance of the Asset Allocation Portfolio for Customers with Risk Appetite C2 or Higher Levels in 2023 (%)



Data source: BOC Investment Strategy Research Center

Figure 26. Ratio of Strategic Asset Allocation for Customers with Risk Appetite C2 or Higher Levels (%)



Data source: BOC Investment Strategy Research Center

Tactical Asset Allocation for Customers with Risk Appetite C2 or Higher Levels in 2023

Data source: BOC Investment Strategy Research Center

In 2023, the absolute return of our simulated portfolio for customers with risk appetite C2 reached -0.69%, whereas the benchmark fell by 1.15% during the same period, and our simulated portfolio outperformed the benchmark by 0.46%.

In addition to the aforementioned demonstration portfolios, we responded to regulatory calls and established the Bank of China portfolio of "valuation with Chinese characteristics" in 2023. The portfolio return reached 2.49%, as opposed to the decline of 11.49% of the benchmark during the same period, making it the only portfolio that achieved positive returns.

Figure 28. Rate of Return of Bank of China's Portfolio under the Valuation System with Chinese Characteristic

Data source: BOC Investment Strategy Research Center

Overall, all three simulated portfolios in 2023 significantly outperformed the comparison benchmark. Unfortunately, these portfolios failed to achieve positive returns. The C4 and C3 portfolios have recorded negative returns for two consecutive years, giving up most of the returns since 2020. However, the returns accumulated in 2019 still exist, and it is indeed challenging to properly arrange asset allocation. In the absence of long-term and stable money-making effects in China's stock markets, the challenges posed to asset allocation are even greater. This may be the reason why it is intricate to bolster investor confidence in 2023. Nevertheless, as a major state-owned bank, we still recommend using asset allocation concepts and long-term investment philosophy to guide the wealth management of investors. If we persist in long-term investment, the annualized return of our simulated portfolio so far in 2019 would reach approximately 14.13%, and the average return in five years would still exceed that of deposits. The only bright spot in 2023 is our portfolio of "valuation with Chinese characteristics". When most products in the stock markets suffered losses and more than half of the stocks suffered significant losses, the portfolio of "valuation with Chinese characteristics" still recorded a positive return of 2.49%. This has demonstrated the benefits of actively responding to regulatory calls as well as the long-term investment value of China's core assets, which served as pillar of China's high-quality assets when the market lacked money-making effects overall.

Recovery Remains Slow, and China is Promoting Stability through Progress

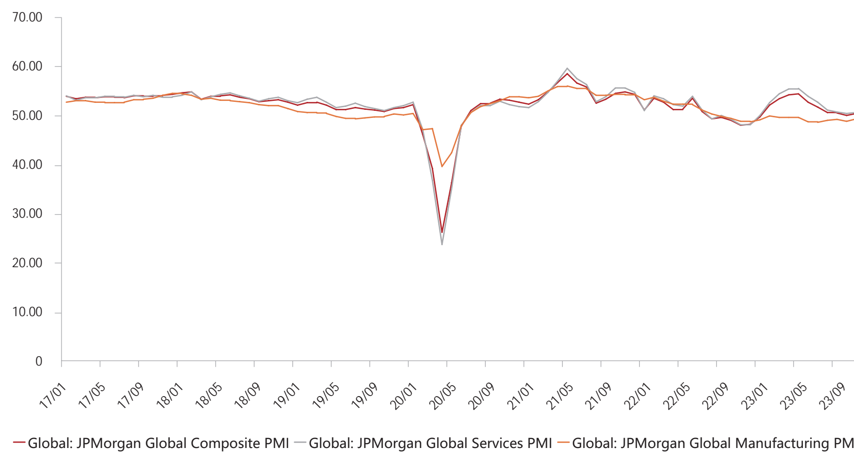
In 2024, the Fed is expected to end its hike of interest rates and start the cycle of interest rate reductions. The infection point of global liquidity is likely to arrive, and the global economic recovery will be slow, whereas there is the chance of resonance of economic growth in 2H, 2023. China is promoting stability through progress, and will experience a moderate rally. The CPI is rising slightly, and the PPI may bottom out or turn positive. The monetary policy remains flexible, moderate, precise and effective, and the fiscal policy is moderately strengthened with improved quality and efficiency. The US economy is gradually cooling down and returning to the "potential growth" with the possibility of a slight recession, and the European economy is likely to enter into a recession.

2.1 Global Pattern: The Global Economy is Experiencing a Moderate Recovery, and is Likely to Usher in the Liquidity Inflection Point

2.1.1 Global economy: Recovery remains slow, but growth is likely resonate with each other

In 2023, the global economic recovery will still be relatively slow. After the global manufacturing PMI of JPMorgan Chase fell below the boom-bust line in September 2022, it remained below the threshold as of the time of writing. The global service sector was rather prosperous. In November 2023, the global services PMI of JPMorgan Chase reached 50.6, but it did show a downward trend since May, 2023.

Figure 29. Global Manufacturing PMI Remained below the Boom-bust Line (%)



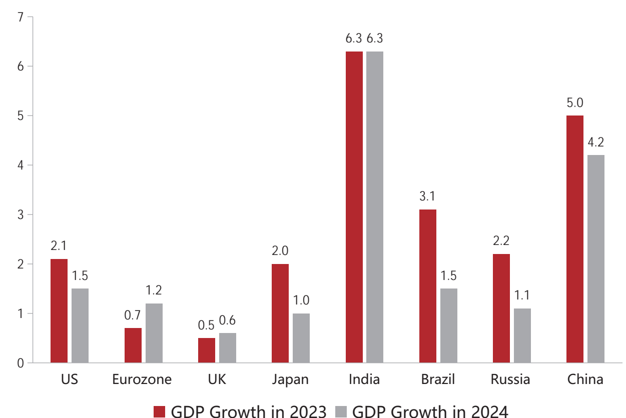
Data sources: Wind and BOC Investment Strategy Research Center

According to the IMF's forecast in the World Economic Outlook for 2024, the global economic growth is estimated to reach 2.9%, which remains rather weak. Since 2010, global economy grew at a rate below 3% only in 2019 and 2020. The IMF pointed out that the slow recovery of the global economy is attributable to several factors, including the geopolitical crisis, long-term impact of anti-globalization, lagging effects of monetary and fiscal policies caused by the surging inflation, and cyclical factors such as extreme weather. Although the global economy has a low chance to encounter a "hard landing", it is still faced with downside risks.

Figure 30. Based on the IMF's Forecast, Global Economic Growth is Expected to Slow Down in 2024 (%)

Data sources: IMF and BOC Investment Strategy Research Center

Figure 31. Based on the IMF's Forecast, the Growth Rate of Most Major Economies in 2024 are Expected to be Lower than That in 2023 (%)

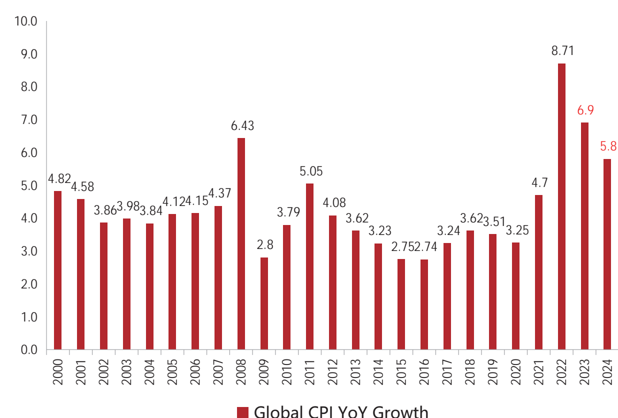


Data sources: IMF and BOC Investment Strategy Research Center

According to the forecast of the IMF, the GDP of developed economies will grow by 1.4% in 2024, and that of developing economies will grow by 4.0%. The economic growth rates of most major economies are likely to decrease compared with 2023, with the exception of India, the Eurozone, and the UK. The economic growth rate of the US is expected to drop to 1.5%; Japan is to drop to 1.0%; Brazil is to drop to 1.5%; and Russia is to drop to 1.1%. Indian economic growth will remain at 6.3% in both 2023 and 2024, and the Eurozone economic growth will rise to 1.2% in 2024, whereas the British economic growth will rise to 0.6%.

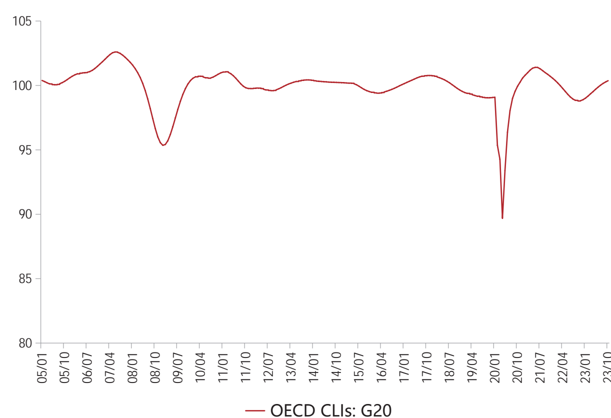
While global economic growth is slowing down, inflation has gradually come down from its previous highs, but the absolute level is still not low. According to the forecast of the IMF, YoY growth of global CPI will fall to 6.9% in 2023 from 8.7% in 2022, and will further decrease to 5.8% in 2024. The gradual declines in inflation means that the global tightening of monetary policies is likely to come to an end, and the liquidity inflection point is expected to emerge in 2024.

Figure 32. Based on the IMF's Forecast, Global Inflation is Expected to Experience Consistent Declines in 2024, though Remaining at Rather Levels (%)



Data sources: IMF and BOC Investment Strategy Research Center

Figure 33. OECD Composite Leading Indicators (CLIs) Already Started to Rise (%)



Data sources: OECD and BOC Investment Strategy Research Center

Although global economic growth remained relatively weak, the OECD CLIs for the G20 countries returned to the level above 100 in July 2023, and continued to rise since then, indicating that the global economy is still going through the trend of recovery. Inflation has gradually come down, and under circumstances of the shift of monetary policy in 2024, the economic cycle of major economies may resonate with each other once again in 2H 2024, which could potentially drive a new round of economic growth.

2.1.2 Global policy: The hike of interest rates is approaching the end, and the liquidity infection point is on the horizon

In 2023, global inflation gradually declined, but remained at a high level. Global central banks represented by the Fed continued to raise interest rates in 1H, 2023. The Fed raised interest rates by 100 bps in total through four rate hikes in February, March, May and July 2023, increasing the federal funds target rate from 4.25-4.5% to 5.25-5.5%. The ECB raised interest rates six times in February, March, May, June, August and September, increasing the main refinancing rate from 2.5% to 4.5%.

After consistent and rapid rate hikes, the Fed paused raising interest rates in September and November as inflation slowed down. The ECB also suspended interest rate hikes from October. Starting in September, the Fed emphasized that it would take a holistic view on the lagging policy effects of monetary tightening as well as economic and financial conditions to determine the room for further tightening of subsequent monetary policies. The Fed's chairman Jerome Powell stated that subsequent actions would depend on economic data. Although the Fed maintained the possibility of subsequent interest rate hikes, given that the labor market and inflation have both shown signs of slowing over the recent period, the Fed's interest rate hikes may

have already ended.

In a nutshell, although both the US and European central banks remained open to whether to continue their rate hikes in the future, their policy stance would depend on the trend of inflation data. However, as inflation slowed down significantly in both the US and Europe, the current round of interest rate hikes that started in 2022 is most likely coming to an end. The Fed is likely to cut interest rates in mid-2024. In addition to the BoJ, other major central banks around the globe are expected to follow the Fed and start cutting interest rates. Accordingly, the global liquidity infection point is emerging on the horizon, and is expected to drive global economic growth.

2.2 China's Economy: Promoting Stability Through Progress amid a Moderate Recovery

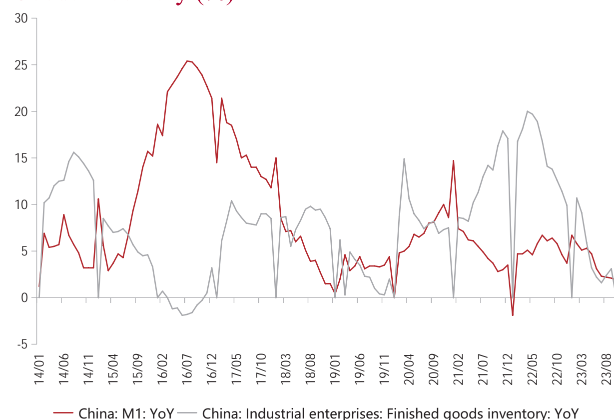
In 2023, China's economy continued to recover with gradually stabilizing growth rate. The service consumption basically returned to the level of 2019, and endogenous growth momentum continued to increase. Nevertheless, the foundation for economic growth remained unstable. Interest rates were rising amid surging global inflation, and the balance sheets of domestic economic entities were under pressure. Market entities became less willing to invest amid weakening expectations, leading to insufficient aggregate demands. Although the market expected GDP growth to return to the level around 5.2% in 2023, the average growth rate from 2022 to 2023 reached only about 4.1%, still lower than the potential growth rate. Further policy efforts need to be made so as to stabilize growth.

Looking forward to 2024, market confidence will continue to be restored, but the cycle of adjustments in the real estate sector has not yet to bottom out, and bottlenecks still exist in the domestic economic cycle, whereas the external environment remains intricate and highly uncertain. Overall, China is faced with arduous tasks of maintaining steady growth, adjusting the economic structure, and promoting high-quality economic development. On October 24, 2023, China's central government confirmed that it would issue an additional RMB 1 trillion worth of special treasury bonds, sending signals that fiscal policies will be moderately stepped up to improve quality and efficiency, and proactive fiscal policy efforts are expected to return in full. The Fed's cycle of interest rate hikes has come to an end, thus providing greater room for further easing the monetary policy and maintaining reasonably ample liquidity in China. China's economy is expected to maintain a growth rate of 4.5-5% in 2024, converging towards the potential growth rate, and the upward momentum of the CPI will be further accumulated.

2.2.1 Macroeconomic fundamentals

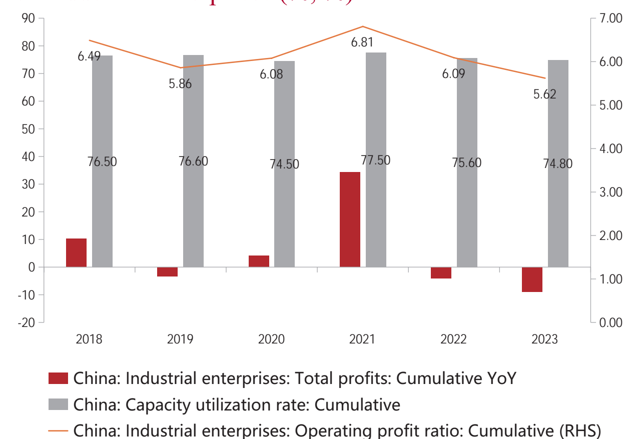
Since 2023, the real economy sector was still in the stage of restoring the balance sheet. Affected by factors such as the declines in external demands and the in-depth adjustments taken place in the real estate sector, economic entities have seen diminishing earnings. The operating profit ratio of industrial enterprises above designated size dropped from 6.49% in 2018 to 5.62% in September 2023, and the profits of industrial enterprises dropped from 10.3% to -9%, whereas the industrial capacity utilization rate dropped from 76.5% to 74.8%. The willingness of enterprises to invest has declined, and the growth

Figure 34. YoY Growth of M1 and Corporate Finished Goods Inventory (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 35. Growth of Profit and Capacity Utilization of Industrial Enterprises (%, %)

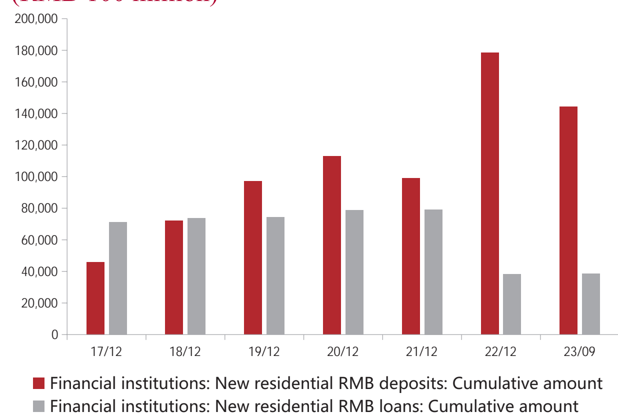


Data sources: Wind and BOC Investment Strategy Research Center

of M1 continued to decline, indicating that the production activity of enterprises was at a low level. Inventories declined year-over-year, and were found in a passive destocking stage. Weakening expectations and declining returns on investment have disincentivized enterprises from raising funds.

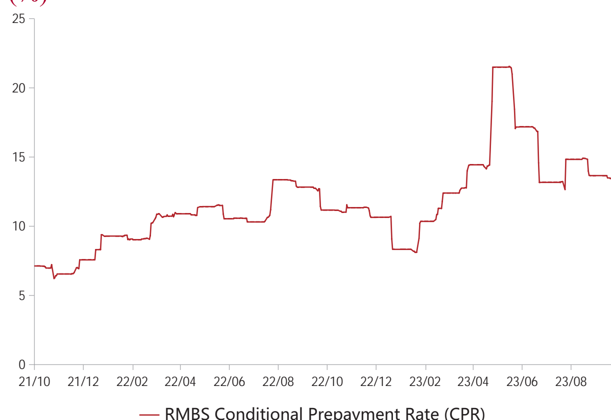
Residential sectors have lowered their expectations for future income, and tend to increase savings and repay loans early. Although bank deposit interest rates continued to fall in 2023, residential deposits still went up by RMB 14.4 trillion in the first three quarters, and the proportion of stocks, wealth management, and real estate investments in the balance sheets of residents experienced declines. Since 2021, the balance of new loans to residents has dropped significantly. In particular, short-term loans have decreased due to income expectations, while mid-to long-term loans have been mainly affected by adjustments to the real estate market. In addition, the willingness of residents to increase leverage has weakened. As the return on investment declined, interest rates on existing mortgages remained at relatively high levels, leading to an evident trend of early repayment. In June, 2023, the RMBS prepayment rate index once rose to more than 20%. Subsequently, with the adjustment of mortgage interest rates, the loan prepayment eased to some extent, but remained higher than the average level of previous years.

Figure 36. New Residential Deposits and Loans (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

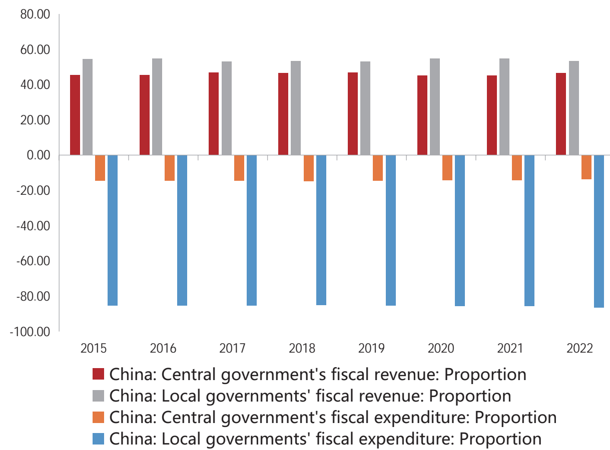
Figure 37. Movements of RMBS Prepayment Rates (%)



Data sources: Wind and BOC Investment Strategy Research Center

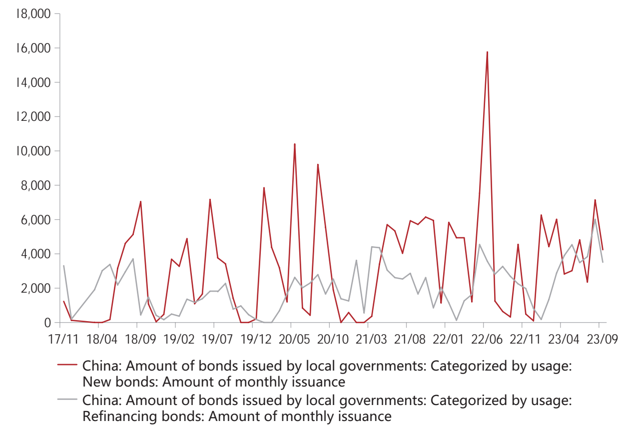
Over the recent years, local governments have assumed greater responsibilities of implementing counter-cyclical and macro-control measures due to factors of comprehensive performance evaluation. In 2000, the proportions of fiscal expenditure by central and local governments reached 34.70% and 65.30% respectively. In 2022, the proportions of fiscal expenditure by central and local governments reached 13.65% and 86.35% respectively. The scale of local government debt has risen rapidly. As of the end of 2022, the balance of local government bonds amounted to RMB 35 trillion, and the interest-bearing liabilities of urban investments totaled RMB 61.9 trillion (including the balance of urban investment bonds of RMB 15.4 trillion, borrowings of RMB 41.6 trillion, and non-standard debts and other products of RMB 4.9 trillion). Moreover, the balance of national debt amounted to RMB 25.87 trillion. As the real estate sector saw diminishing prosperity, the land auction market also witnessed a cooling trend, thus imposing pressure on the revenue from land transfer. According to statistics, from January to September 2023, the budget revenue of government-managed funds reached RMB 3.8683 billion, a year-over-year decrease of 15.7%. In particular, the budget revenue of central government-managed funds amounted to RMB 304.8 billion, a year-over-year decrease of 7.9%, and the budget revenue of local government-managed funds amounted to RMB 3.5635 billion, a year-over-year decrease of 16.3%. Moreover, the revenue from the transfer of state-owned land use rights reached RMB 3,087.5 billion, a year-over-year decrease of 19.8%. Among the newly issued local government bonds, the proportion of refinancing bonds continued to rise, revealing the debt pressure.

Figure 38. Proportion of Central and Local Governments' Fiscal Revenue and Expenditure (%)



Data sources: Wind and BOC Investment Strategy Research Center

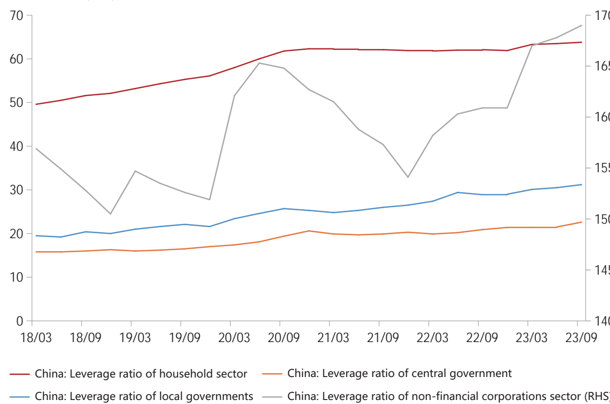
Figure 39. Composition of New Bonds Issued by Local Governments (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

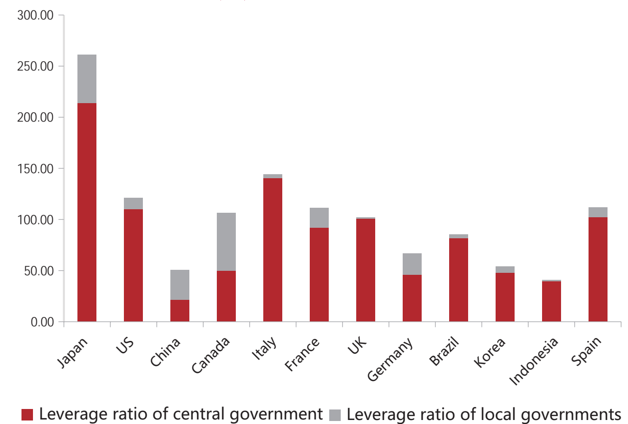
In China, the fiscal deficit ratio is basically kept within the soft constraint of 3%, and the leverage ratio is lower than that of major developed countries. As of the end of 2022, China's leverage ratio reached 50.40%. In particular, the central government debt accounted for 42%, and local government debt accounted for 58%. If the interest-bearing liabilities of urban investment were included in the local government debt, the proportion of central government debt in total government debt would be even lower. According to the Global Debt Database (GDD) of the IMF, the average proportion of central government debt to total government debt in the world reached 89% in 2022, and the median was 96%. Over the recent years, China's economy has been faced with the challenges of insufficient aggregate demand, weakening willingness of residents and enterprises to increase leverage, and piled up debts of local governments. In fact, the central government has the ability to increase leverage and implement countercyclical measures to fine-tune the economy. Since October 2023, the issuance of an additional RMB 1 trillion worth of treasuries, the issuance of special refinancing bonds, and the Central Financial Work Conference have all sent signals of "increasing leverage". The deficit ratio is expected to continue to break through the soft constraint of 3% in 2024, whereas proactive fiscal policies are expected to bring economic growth back to the levels of potential growth.

Figure 40. Leverage Ratio of the Real Economy Sector (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 41. Leverage Ratio of Governments around the World in 2022 (%)



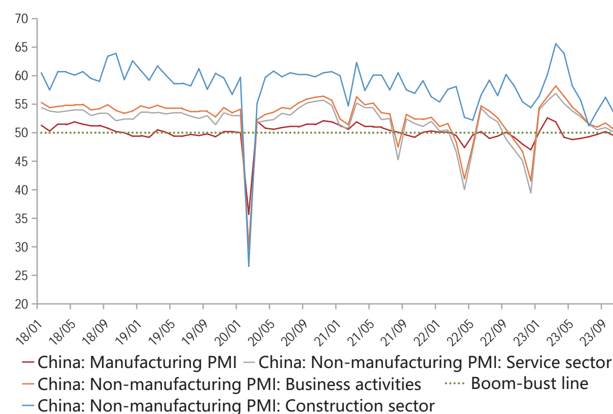
Data sources: Wind and BOC Investment Strategy Research Center

Judging from the movements of PMI as an indicator measuring economic prosperity, the non-manufacturing industry performed better than the manufacturing industry in 2023. The manufacturing PMI rose above the boom-bust line of 50 for three consecutive months in Q1, and then basically fell into the range of contraction. Affected by the consistent inflationary pressure in major economies and geopolitical conflicts that have plagued the global economic recovery, China's exports experienced declines. Judging from the PMI sub-indexes, orders on hand, new export orders and production indexes were all lower than the average in October 2023, indicating that the demands were still insufficient in the manufacturing sector, and the foundation of economic recovery still needs to be further consolidated. From the aspect of expectations of enterprises, the sub-index for production and operation activity expectations of manufacturing enterprises amounted to 55.6%. Over the recent period, industrial production has shown a steady and rising trend. The profits of industrial enterprises above designated size have increased year-over-year, and enterprises have increased their willingness for production activities.

2.2.1.1 Investment continued to play a key role in underpinning the economic growth

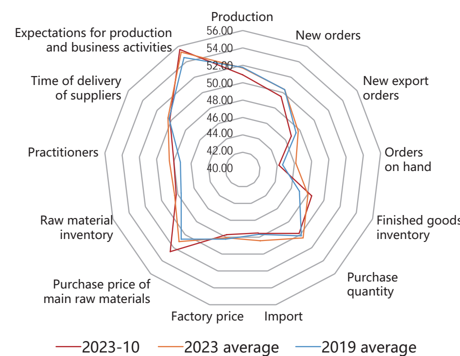
From Q1 to Q3, 2023, final consumption expenditure contributed 83.2% to economic growth, driving GDP growth by about 4.4%. Gross capital formation contributed 29.8% to economic growth, driving GDP growth by about 1.6%. Net exports of

Figure 42. PMI Index (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 43. Manufacturing PMI Sub-indexes (%)

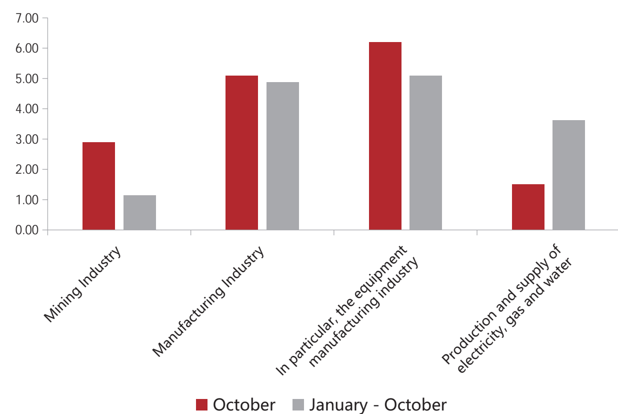


Data sources: Wind and BOC Investment Strategy Research Center

Figure 44. Profits of Industries above Designated Size (%)

Data sources: Wind and BOC Investment Strategy Research Center

Figure 45. Value-added of Industries above Designated Size by Industry (%)



Data sources: Wind and BOC Investment Strategy Research Center

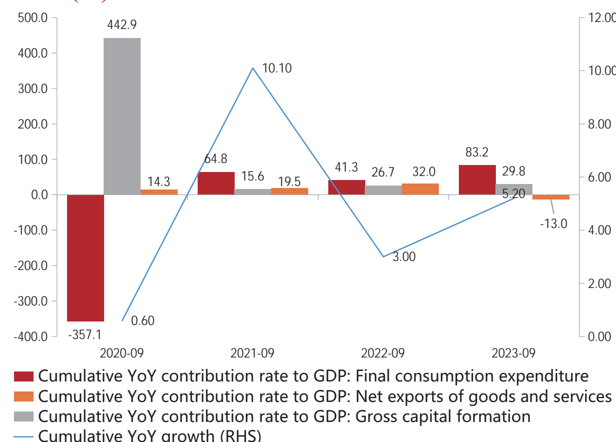
goods and services contributed -13.0% to the economic growth, dragging GDP growth down about 0.7%. Against the current backdrop of global economic slowdown and increasingly complex geopolitical situation, China mainly relies on the growth of domestic demands to offset the impact of weakening external demands on the economy. In 2024, investment is expected to constantly play a key role in underpinning the economic growth. Moreover, only by expanding domestic demands can the real economic growth be firmly consolidated.

Greater efforts were made to enhance infrastructure investment so as to maintain steady growth. The current cycle of real estate adjustment has yet to come to an end. In addition, it is expected that infrastructure investment will serve as a policy instrument to hedge against the downward pressure on real estate investment, thus playing the role of countercyclical adjustment and hedging. In Q4, 2023, RMB 1 trillion worth off treasuries were issued and transferred to local governments through transfer payments, mainly used for the restoration and enhancement of major projects including local flood control and drainage infrastructure. In addition, it is expected that the local government special debt limit will be set at RMB 3.8 trillion in 2024 (slightly higher than the limit of RMB 3.65 trillion in 2023). If 60% of the quota is issued in advance, it will contribute significantly to infrastructure investment and aggregate demands in 2024. At the same time, since 2022, the introduction of policy-based financial instruments has become a crucial source of support for major projects such as infrastructure construction. By tapping into the role of government investment leverage, China is expected to effectively encourage social investment and bolster infrastructure investment. However, certain provincial urban investment platforms have entered into the period resolving local government debts, and their investment expansion will be under constraints, which will impose an inhibitory effect on infrastructure investment. Infrastructure investment is expected to maintain a medium-to-high growth rate in 2024, roughly close to the level of 8.3% from January to October in 2023.

Manufacturing investment is expected to achieve a high growth rate. Manufacturing investment went up by 6.2% year-over-year from January to October, 2023. Investment in high-tech manufacturing rose by 11.3%, laying a solid foundation for the growth of new growth engines. In recent years, China has intensively introduced numerous policies and supporting measures in revitalizing the equipment manufacturing sector, developing high-end manufacturing sector, and facilitating the growth of strategic emerging industries. In the 14th Five-Year Plan, China stated its national strategy to improve the innovation capacity of the manufacturing sector, promote the integration of informatization and industrialization, and focus on intelligent manufacturing. China aims to better coordinate development and security, and has placed the strengths of the industrial and supply chain as well as the renovation of the industrial base on top of the agenda for driving manufacturing investment. Bolstered by rising foreign demands and favorable domestic policies, the manufacturing sector has maintained a relatively high growth rate over the past three years. At present, financial institutions provide key support to the manufacturing sector in terms of financial services including loan access, credit, innovation in guarantees and repayment methods, and preferential interest rates. Manufacturing investment is expected to maintain a relatively high growth rate in 2024.

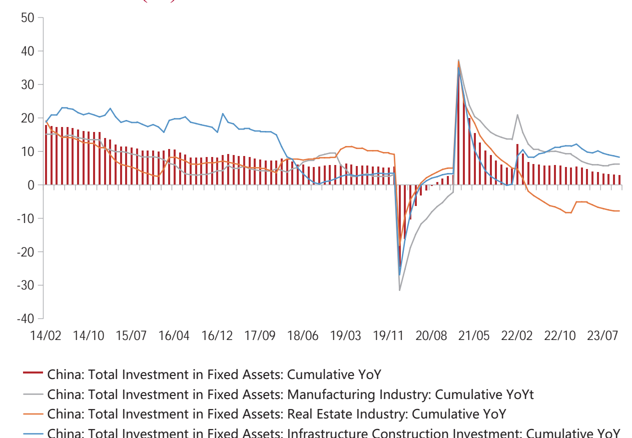
The cycle of adjustment in the real estate sector has yet to come to an end. At present, China's real estate industry is experiencing cyclical adjustments. According to the data released by the National Bureau of Statistics on November 15,

Figure 46. Cumulative YoY Contribution Rate to GDP (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 47. Cumulative YoY Growth of Fixed-asset Investment (%)



Data sources: Wind and BOC Investment Strategy Research Center

2023, national investments into real estate development dropped by 9.3% year-over-year from January to October, and the declines continued to expand by 0.2% from January to September. The sales area of commercial housing fell by 7.8%, and the sales volume of commercial housing dropped by 4.9%. Currently, the relationship between real estate supply and demand has undergone major changes, and the real estate industry has become the biggest headwind restricting the economic growth in China. Although real estate-related policies were consistently eased, the market has formed expectations for decreasing housing prices, and the willingness to buy houses has declined. From January to October in 2021, 2022, and 2023, the sales area of commercial housing reached 1.79 billion, 1.36 billion and 930 million square meters respectively. Sales fell off a cliff, and real estate enterprises reduced the housing starts to a significant extent. From January to October in 2021, 2022, and 2023, the new area of real estate construction reached 1.989 billion, 1.21 billion, and 791 million square meters respectively, indicating that real estate investment could still decline sharply in 2024.

To address the issues in real estate development, efforts shall be mad to build a new model of real estate development. According

Figure 48. Package of Loosening Mortgage Policies in August 2023

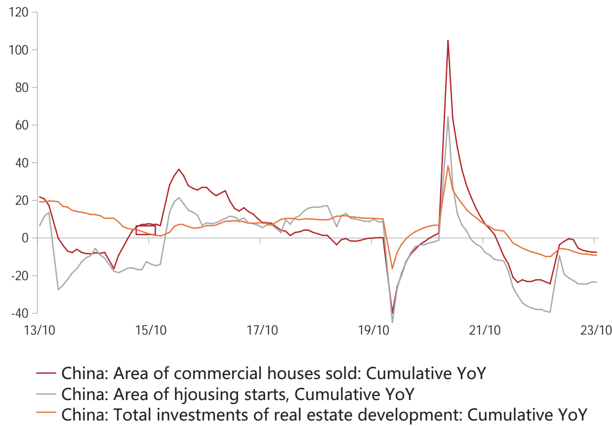
<table>
<tr><th rowspan="2">Time</th><th rowspan="2">Standards for recognizing house ownership and credit registry</th><th colspan="4">Down payment ratio</th><th rowspan="2">Lower limit of the mortgage interest rate for the first house at the national level</th><th rowspan="2">Lower limit of the mortgage interest rate for the second house at the national level</th><th rowspan="2">LPR</th></tr>
<tr><th>First house (Restricted purchase)</th><th>First house (Non-restricted purchase</th><th>Second house (Restricted purchase)</th><th>Second house (Non-restricted purchase)</th></tr>
<tr><td>Before August, 2023</td><td>Loan issuance based on the review of both house ownership and credit registry</td><td>30%</td><td>20%</td><td>40%</td><td>30%</td><td>LPR minus 20 bps (In case that the sales price of newly-built commercial houses declines for three consecutive months both on MoM and YoY basis, then the lower limit of the first home loan interest rate can be maintained, lowered or cancelled in stages in the specific region).</td><td>LPR plus 60 bps</td><td>1 year LPR: 3.65%
5-year LPR: 4.3%</td></tr>
<tr><td rowspan="2">After August, 2023</td><td rowspan="2">Mortgages on second homes to be treated in the same way as a first mortgage, as long as the buyer has paid off the first loan</td><td colspan="2">20%</td><td colspan="2">30%</td><td>LPR minus 20 bps (existing mortgage loans can be replaced with mortgage interest rates not lower than the lower limit of the original loans)</td><td>LPR plus 20 bps</td><td>1 year LPR: 3.45%
5-year LPR: 4.2%</td></tr>
<tr><td colspan="6">(Each city shall independently determine the minimum down payment ratio and the lower interest rate limit of the commercial personal housing loans under circumstances when the buyers purchase their first or second homes.)</td><td></td></tr>
<tr><td colspan="9">Notes: For the commercial individual housing loans, interest rates are determined through the “three-tier pricing mechanism”. First, at the national level, the PBOC and the NAFR (formerly known as the CBIRC) shall determine the lower limit of the loan interest rate.</td></tr>
<tr><td colspan="9">Second, based on the lower limit of the loan interest rate at the national level, each municipal government shall determine the lower limit of the local interest rate of commercial personal housing loans according to “city-specific” policy measures.</td></tr>
<tr><td colspan="9">Third, commercial banks shall adopt a holistic approach while considering factors such as capital costs and credit risks, and negotiate with borrowers to determine the specific level of loan interest rates.</td></tr>
<tr><td colspan="9">The loan interest rate of individual housing provident funds shall be determined and announced by the PBOC.</td></tr>
</table>

Data sources: PBOC and BOC Investment Strategy Research Center

to the Central Financial Work Conference held at the end of October 2023, China shall speed up the development of “three major projects”, including affordable housing, urban village renovation, and flat emergency dual-use infrastructure. These projects are likely to become a crucial starting point for the new real estate development model. In case that the central bank leverages policy tools such as pledged supplementary lending (PSL) and provides mid-to long-term low-cost funds through policy banks in stages, so as to support the development of the “three major projects”, it will not only generate new demands for investment and housing

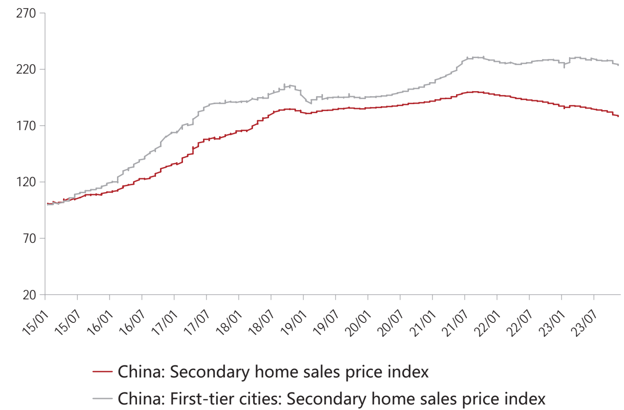
consumption, but also provide great support to related industries in the upstream and downstream, as well as cultural tourism, healthcare, wellness, and other industrial investment and consumption sectors.

Figure 49. Data on the Real Estate Investment, Housing Starts and Sales (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 50. Second-hand Housing Price Index (January 4, 2015=100)



Data sources: Wind and BOC Investment Strategy Research Center

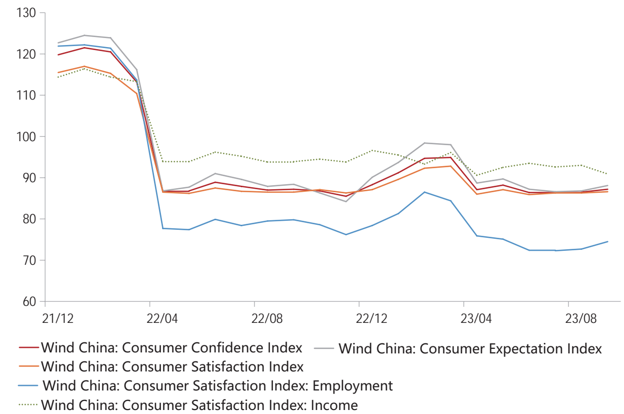
2.2.1.2 Consumption recovery holds the key to economic recovery

As per capita disposable income of residents bottomed out, total retail sales of social consumer goods reached RMB 38,544 billion from January to October 2023, a year-over-year increase of 6.9%. However, the compound growth rate for four consecutive years from October 2019 to October 2023 amounted to only 3.6%, and there is still room for consumption growth to unleash its potential. From January to October 2023, residential consumption expenditure on grain, oil and food increased from 10.62% in the same period in 2019 to 11.58% in 2023, and the expenditure on daily necessities went up from 4.36% in the same period to 4.61% in 2023. The proportion of expenditure on construction and decoration materials dropped from 1.47% in the period from January to October 2019 to 0.95% in the same period in 2023. The consumer confidence index, expectation index and satisfaction index have rebounded from low levels for three consecutive months since July 2023, but remain at a

Figure 51. Total Retail Sales of Social Consumer Goods and Income Growth (%)

Data sources: Wind and BOC Investment Strategy Research Center

Figure 52. Consumer Confidence Index (%)



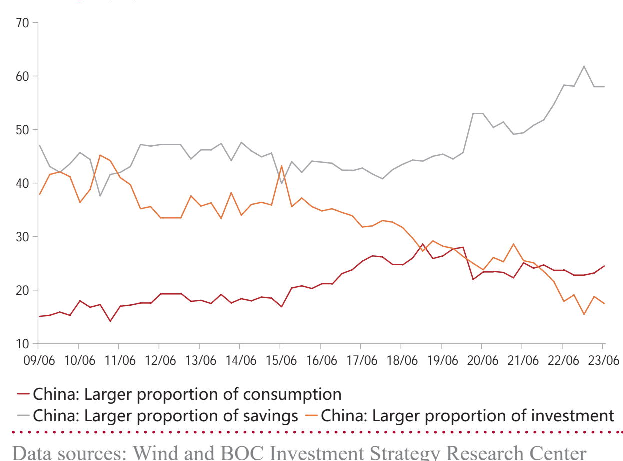
Data sources: Wind and BOC Investment Strategy Research Center

low level.

The growth of household consumption depends on expectations for future income and security levels. The momentum for consumption recovery in 2023 was relatively weak, mainly due to lower income levels that weakened overall consumer confidence, unsatisfactory employment situation, and unstable expectations for future wage growth. Coupled with falling real estate prices, poor stock market performance, diminishing bank deposit interest rates and wealth management product yields, the property income of residents has decreased, and the precautionary savings rate continued to rise. Against the backdrop of slower economic growth, aging population and declining birthrate, the decrease in consumption momentum is even more prominent.

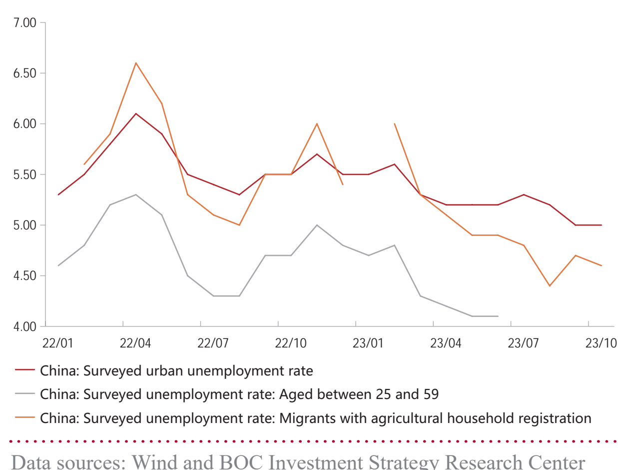
To increase the capacity and willing of residents to consume, China has placed employment as a priority in socioeconomic development. The authority has proactively taken measures to stabilize employment, protect the income levels of low- and middle-income groups, and secure the basic livelihood of people. Moreover, efforts were made to support small and micro enterprises as well as the private economy, and implementation of the rural revitalization strategy. These measures will help increase the income of low- and middle-income groups, and will bring about marginal growth in consumption. As proactive fiscal policies underpin the growth of the economy, labor demands have increased, and the employment rate has rebounded. As such, residential income is expected to gradually recover, and residents' tendency to consume will improve, whereas consumer demands are expected to be further released.

Figure 53. Constantly Rising Levels of Precautionary Savings (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 54. Declines of the Unemployment Rate (%)



Data sources: Wind and BOC Investment Strategy Research Center

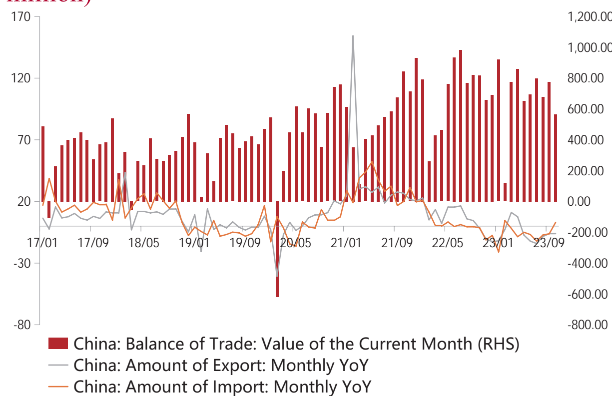
2.2.1.3 Contribution of net exports to the economy is expected to decline

From January to October 2023, the contribution of net exports of goods and services to economic growth amounted to -13.0%, mainly due to the following factors. First, the global economy is slowing down, and the manufacturing PMI has been in the contraction range for 14 consecutive months, whereas overall external demands continued to be weak. Second, import and export prices have decreased. In June 2023, China's import price index reached 91.5, compared with 114.30 in the same period in 2022, and the export price index reached 93.3, compared with 115.70 in the same period in 2022. Third, the US continued to pursue the strategies of "de-Sinicization" and "small yard, high fence", which have imposed a negative impact on China's export demands. From the aspect of export structure, the amount of China's exports to traditional trading partners such as ASEAN, the EU, and the US has declined sharply year-over-year. Trading partners represented by Russia and Africa have provided strong support to China's export demands.

As to whether export demands can be stabilized in 2024, it will depend mainly on the changes in the share of China's imports from the US and the EU. In 2024, the active destocking of the US economy is coming to an end, and it is expected to start a cycle of active replenishment of inventories. The recent easing of Sino-US relations has sent a positive signal. As US demands gradually pick up, the share of China's imports from the US are expected to stabilize. China is constantly strengthening communication with the EU to jointly manage differences and competition in China-EU economic and trade relations. It is expected that the share of China's imports from the EU will maintain a slowly decreasing trend in 2024. In addition, closer

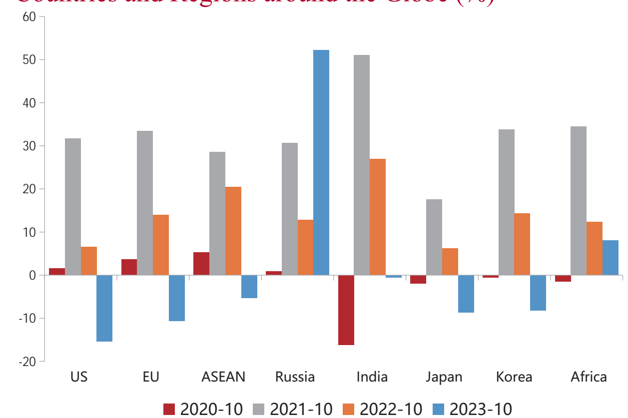
attention needs to be paid to the support brought by emerging markets to China's exports, especially the ASEAN region. The economies of the above-mentioned countries are in a stage of rapid development. From the aspect of industrial development and actual demand, their dependence on products "made in China" is increasing, which will bolster China's exports. Overall, it is expected that the contribution of net exports to economic growth will decline in 2024, and economic growth will still rely on domestic demands.

Figure 55. Data on Imports and Exports (%, USD 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 56. Cumulative YoY of Exports to Major Countries and Regions around the Globe (%)



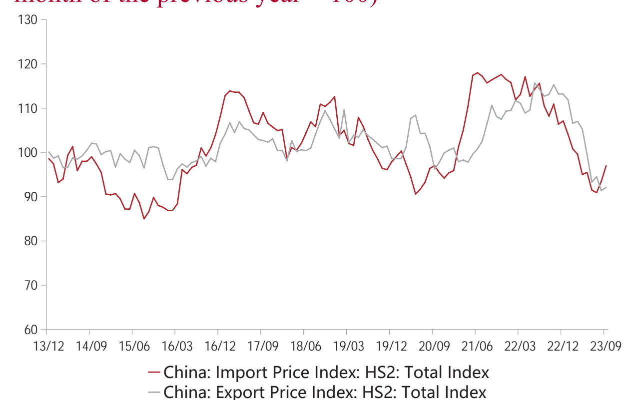
Data sources: Wind and BOC Investment Strategy Research Center

Figure 57. IMF's Forecast of GDP of Major Economies (%)

Real GDP	2022	2023E	2024E
Global	3.5	3.0	2.9
China	3	5.4	4.6
US	2.1	2.1	1.5
Eurozone	3.3	0.7	1.2
Japan	1	2	-1
Other Developed Economies	2.6	1.8	2.2
Emerging Markets and Developing Economies in Asia	4.5	5.2	4.8
India	7.2	6.3	6.3
Russia	-2.1	2.2	1.1
Sub-Saharan Africa	4	3.3	4.0

Data sources: Wind and BOC Investment Strategy Research Center

Figure 58. Trend of Import and Export Prices (Same month of the previous year = 100)

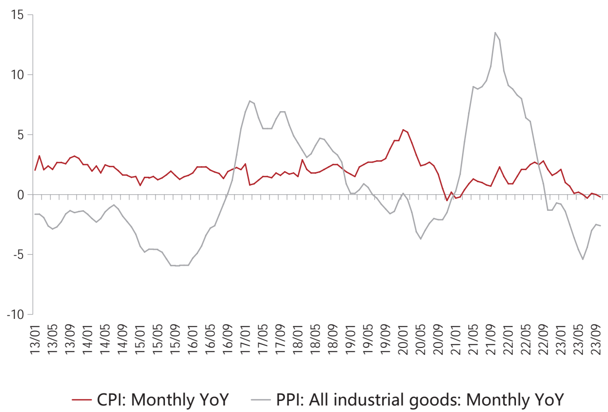


Data sources: Wind and BOC Investment Strategy Research Center

2.2.2 Prices remained low in 2023, and are expected to rise moderately in 2024

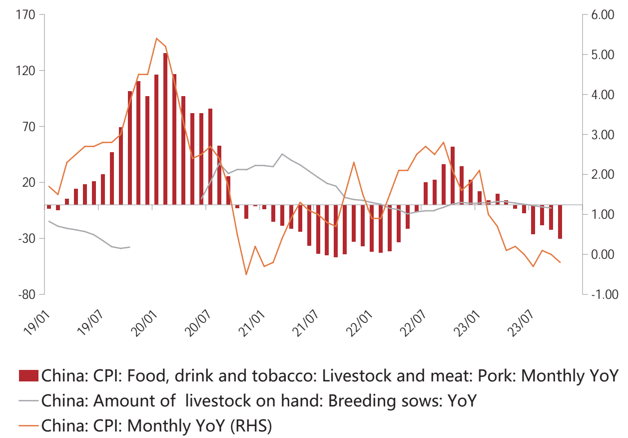
In 2023, price levels remained at lows in China. As of October 2023, the cumulative year-over-year increase of price levels reached 0.4%, and the full-year CPI could remain around the level of 0.3%. It is expected that China's CPI will remain in a moderate range in 2024. From the aspect of food items, with respect to pork, the number of live pigs and reproductive sows remained at low levels since January 2023, and pig prices are expected to bottom out in 2024. With respect to fresh vegetables and fruits, their prices were greatly affected by seasonal factors, and thus undergoing certain fluctuations. From the aspect of non-food items, service prices maintained steady growth with the recovery of the economy. With respect to industrial consumer goods, due to the start of cycle of replenishing inventories with China and the US, commodity prices in the upstream industry may bottom out. Driven by the stabilization and improvement of the economy, the release of consumer demands and the low base effect, the CPI is experiencing a rebound overall, and the year-over-year CPI growth is expected to reach approximately 1-1.5% n 2024.

Figure 59. Trend of CPI and PPI (%)



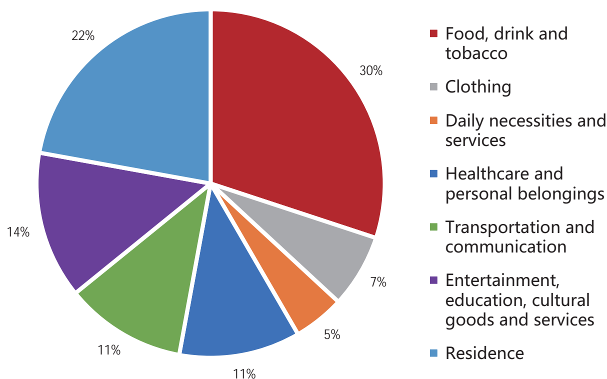
Data sources: Wind and BOC Investment Strategy Research Center

Figure 60. Pork Price and CPI (%)



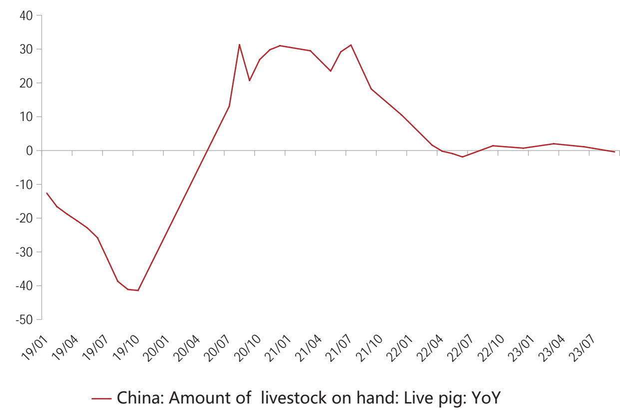
Data sources: Wind and BOC Investment Strategy Research Center

Figure 61. Composition of CPI (%)



Data sources: Wind and BOC Investment Strategy Research Center

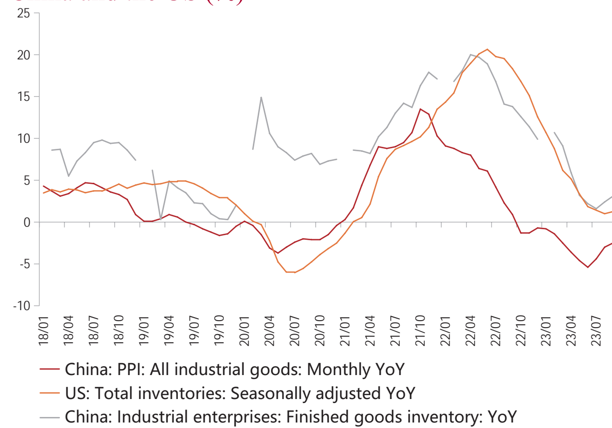
Figure 62. Number of Live Pigs on Hand (%)



Data sources: Wind and BOC Investment Strategy Research Center

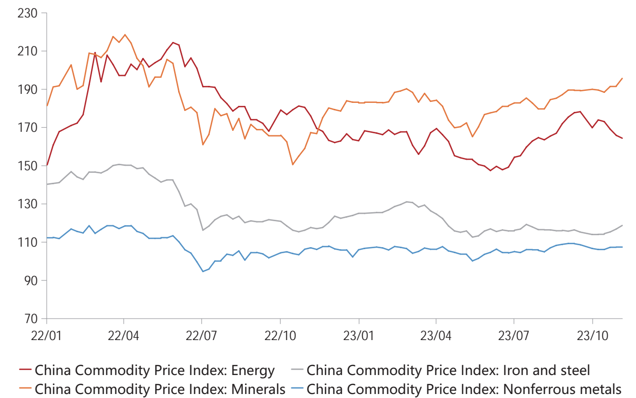
PPI experienced declines from its high level in 2023, with a cumulative year-over-year decrease of 4.0% as of October 2023, and could decrease by about 3% throughout the year 2023. Judging from the month-over-month PPI growth in October, upstream prices continued to rise, and midstream prices diverged, whereas downstream prices went up to a smaller extent than expected. In 2024, due to factors including the potential start of a new round of inventory replenishment cycle by the US, China's fiscal expansion to stimulate domestic infrastructure investment demands, and the increase in downstream consumer demands, China's PPI is expected to bottom out. Due to tail-raising factors, the PPI may first decline before rises. The growth of the PPI is likely to be negative in 1H 2024, and will gradually rebound after hitting a low level in Q2, whereas the annual growth of the PPI is expected to reach 0-0.5%.

Figure 63. Inventory Cycles and Trends of PPI in China and the US (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 64. Trend of Commodities Prices in China (%)

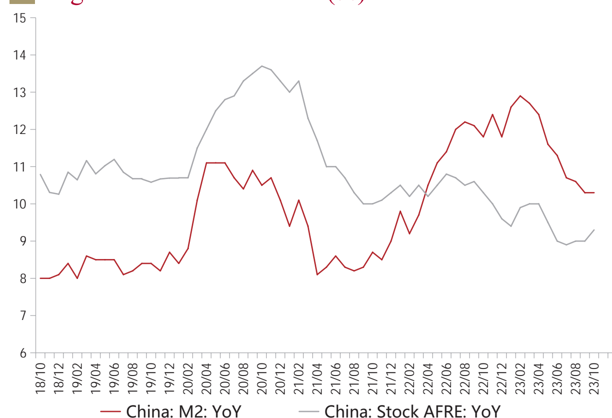


Data sources: Wind and BOC Investment Strategy Research Center

2.2.3 Prudent monetary policy remains flexible, moderate, precise and effective

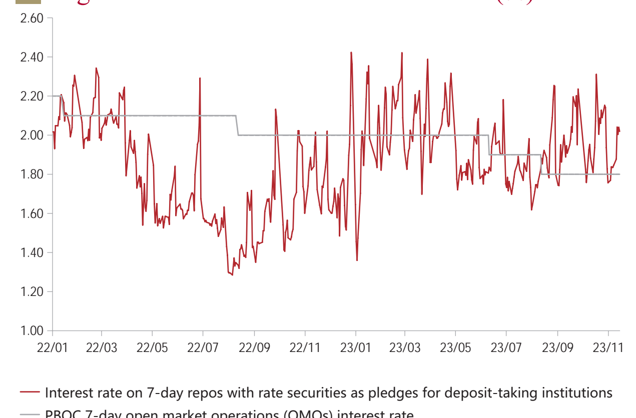
In 2023, prudent monetary policy remained precise and effective. The authority has provided greater financial support for the real economy through aggregate, price-based and structural monetary policy instruments, and promoted the downward trend of financing costs in the real economy. From the aspect of aggregate policy instruments, the PBOC lowered the reserve requirement ratio twice in 2023, and was engaged in open market operations to provide sufficient liquidity for the real economy. In particular, the broad money (M2) and the stock of the aggregate financing to the real economy (AFRE) grew by 10.3% and 9.3% year-over-year at the end of October 2023, respectively. From the aspect of price-based policy instruments, the PBOC cut the medium-term lending facility (MLF) interest rate, open market repurchase rate and LPR twice, and the weighted average interest rate of newly issued corporate loans and that of individual housing loans reached 3.82% and 4.02% respectively in September 2023, 0.18% and 0.32% lower than the same period in 2022, hitting historically low levels.The average interest rate for DR007 in the interbank market reached 1.94% during the period from January 1 to November 17, and the average interest rate for DR007 reached 1.94%, which was at a record low level. From January 1 to November 17, the average DR007 rate in the interbank market reached 1.94%, and experienced upward and downward oscillations around the PBOC's 7-day repo policy rate in the open market. From the aspect of structural policy instruments, the PBOC increased the amount of agricultural and small-scale refinancing loans in 2023. By fulling leveraging the structural monetary policy instruments, the authority supported the development of key economic sectors and weak links by means of policy guidance and loan issuance before refinancing. In particular, the growth of credit in the areas of inclusive finance, green development and sci-tech innovation remained above 20% for several years in a row. The authority has also bolstered the real estate sector through the implementation of policies such as "treating mortgages on second homes in the same way as a first mortgage, as long as the buyer has paid off the first loan" and optimizing the "differentiated housing credit policy".

Figure 65. AFRE and M2 (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 66. Trend of DR007 Interest Rate (%)



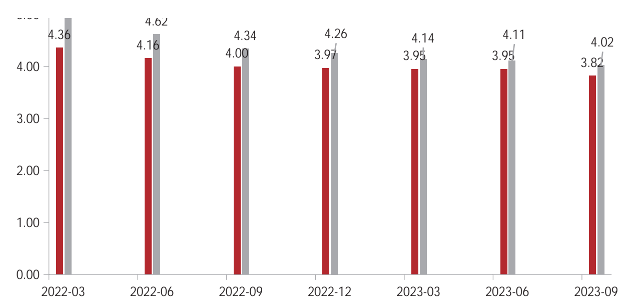
Data sources: Wind and BOC Investment Strategy Research Center

Figure 67. Monetary Policy Instruments Adopted by the PBOC

Monetary Policy Instruments Adopted by the PBOC	Related Measures (as of November 17, 2023)
Quantity-based Instruments	The PBOC announced a cut in the reserve requirement ratio (RRR) of 25 bps on March 27, 2023.
	The PBOC announced a cut in the reserve requirement ratio (RRR) of 25 bps on September 15, 2023.
Price-based Instruments	The medium-term lending facility (MLF) and open-market reverse repo rates (7-day) were cut by 10 bps on June 13, 2023.
	The medium-term lending facility (MLF) and open-market reverse repo rates (7-day) were cut by 10 bps on August 15, 2023.
	The 1-year LPR and 5-year LPR were cut by 10 bps on June 20, 2023.
	The 1-year LPR was cut by 10 bps on August 21, 2023.
	As of June 30, 2023, among all 343 cities (prefecture-level and above), 100 cities had lowered or abolished the mortgage rate floor for first-time home buyers. In particular, 87 cities reduced the mortgage rate floor for first-time home buyers, and the reductions were 10 to 40 bps lower than the national mortgage rate floor. In addition, 13 cities removed the lower limit for mortgage rates for first-time home buyers.
Structural Instruments	See the Table on Structural Monetary Policy Instruments for details.

Data sources: Wind and BOC Investment Strategy Research Center

Figure 68. Weighted Average Interest Rate of New Loans (%)



Data sources: Wind and BOC Investment Strategy Research Center

In 2024, the PBOC is expected to consistently lower policy interest rates, thereby guiding deposit and loan interest rates downward. From the aspect of domestic demands, judging from the negative PPI growth at present, the real interest rate is still at a relatively high level. To address the issue of high financing costs in the real economy that may suppress corporate investment needs, and to collaborate with the expansion of fiscal policy by lowering fiscal interest payment pressure, the PBOC is likely to consistently lower the LPR and deposit reserve ratio for two times each. The authority is also expected to strengthen counter-cyclical and cross-cyclical adjustments, and consolidate the trend of economic recovery. From the aspect of external constraints, the Fed is expected to start cutting interest rates in 2024, which will also help increase the room for the PBOC to implement monetary policies.

In 2024, the authority is expected to constantly make full use of structural policy instruments to provide low-interest financial support to manufacturing, technology, small and micro enterprises, green development, flat emergency dual-use public infrastructure and real estate sectors, among other fields. The authority is also expected to improve the efficiency of counter-cyclical and cross-cyclical measures. Driven by the transmission of loose money to loose credit, the money supply and the AFRE are expected to reach 10% and 9.5% year-over-year.

2.2.4 Proactive fiscal policy is moderately strengthened with improved quality and efficiency

In the government work report in 2023, China set the target of fiscal deficit ratio at 3%, and slightly increased the limit of special bond issuance. Overall, proactive fiscal policy is moderately strengthened with improved quality and efficiency. In October, the central government announced that it would issue an additional RMB 1 trillion worth of special treasuries in Q4, and adjusted the deficit ratio to 3.8%. In addition, the authority centered around measures to support post-disaster restoration and reconstruction, so as to make up for the shortfalls in disaster prevention, mitigation and relief (RMB 500 billion to be arranged for use in 2023, and RMB 500 billion to be carried forward for use in 2024). From January to October, China's new tax and fee reductions, tax refunds and fee deferrals amounted to more than RMB 1.66 trillion, thus further improving the quality and efficiency of the fiscal system. China's general public budget revenue amounted to RMB 18,749.4 billion, a year-over-year increase of 8.1%. China's general public budget expenditure amounted to RMB 21,573.4 billion, a year-over-year

Figure 69. Table on Structural Monetary Policy Instruments

Name of Instruments (As of the end of Q3, 2023)		Targeted Areas	Status	Limit (RMB 100 million)	Balance (RMB 100 million)
Long-term Instruments	Agricultural refinancing	Agriculture-related areas	Effective	8100	5991
	Refinancing for micro and small enterprises) MSEs	MSEs and private enterprises	Effective	17850	15655
	Poverty reduction refinancing	Poverty-stricken areas	Effective	/	1304
	Rediscounting	Agriculture-related, MSEs and private enterprises	Effective	7400	5289
Instruments Adopted in Stages	Loan-extension supporting instrument for inclusive MSEs	Inclusive MSEs	Effective	800	498
	Supplemental mortgage loans	Shantytown renovation and water conservancy projects, etc.	Effective	/	29022
	Instruments for reducing carbon emissions	Technologies supporting the development of clean energy, energy saving and emission reduction, and carbon emission reduction	Effective	8000	5098
	Special refinancing loan for clean and efficient utilization of coal	Clean and efficient utilization of coal, coal development, utilization and reserves	Effective	3000	2624
	Special refinancing loan for universal elderly care	Pilot programs of universal pension launched in Zhejiang, Jiangsu, Henan, Hebei, Jiangxi Provinces	Effective	400	16
	Instruments supporting the financing of bonds of private enterprises	Private enterprises	Effective	500	0
	Loan support schemes of ensuring the delivery of housing projects	Schemes to ensure that overdue housing projects are completed and delivered	Effective	2000	56
	Special refinancing loan for distressed real estate enterprises	M&A projects in the real estate sector	Effective	800	0
	Loan support schemes of rental housing projects	Acquisition of existing houses in pilot cities	Effective	1000	0
	Refinancing loan for technological innovation	Technological innovation enterprises	Expired	4000	3456
	Special refinancing loan for transportation and logistics	Road freight transport operators and small, medium and micro enterprises in the logistics and warehousing sector	Expired	1000	451
	Special refinancing loan for equipment renewal and renovation	Manufacturing, social services, small, medium and micro enterprises, and individual industrial and commercial households	Expired	2000	1672
	Instrument supporting the reduction interest rates for inclusive MSE lending	Inclusive MSEs	Expired	/	269
	Loan support instrument for toll road operators	Toll road operators	Expired	/	83
Total					71484

Data sources: PBOC and BOC Investment Strategy Research Center

increase of 4.6%. Expenditure of the national general public budget amounted to RMB 21,573.4 billion, up 4.6% year-over-year. China constantly optimized the structure of fiscal expenditure, and provided solid support to expenditure in key areas such as people's livelihood, rural revitalization, major regional strategies, education, and scientific and technological research. From January to October, the revenue of government-managed funds nationwide amounted to RMB 4,379.5 billion, a year-over-year decrease of 16%, whereas the expenditure of government-managed funds nationwide amounted to RMB 7,289.9 billion, a year-over-year decrease of 15.1%. Amid the overall cooling of land finance, the authority stepped up efforts in increasing fiscal spending by accelerating the issuance of local government bonds. The Ministry of Finance issued a quota for part of the new local government bonds for 2024 in advance, and made greater efforts in issuing special refinancing bonds. Fiscal policy was moderately strengthened, so as to play a counter-cyclical and cross-cyclical adjustment role and facilitate the economic recovery.

Looking forward to 2024, against the backdrop of resolving local government debts, the central government will increase its leverage ratio to offset the impact of non-increase in implicit debt in certain provinces and municipalities. China is expected to strengthen coordination between fiscal and monetary policies, and continue to step up efforts in stimulating aggregate demands. The final fiscal deficit ratio is expected to be no less than 3.5% (including the RMB 500 billion worth of special treasuries in 2023 for use in 2024), and the issuance of local government special bonds will not be less than the newly added limit in 2023. The all-round return of proactive fiscal policies will help enhance the confidence of market entities, and encourage the establishment of expectations about a stabler economic growth. In 2024, funds raised through local government special bonds will be used to address shortcomings of economic development, and fiscal funds are expected to be invested in three major projects including infrastructure, urban village and affordable housing. By leveraging social funds, China will consistently make efforts to stabilize both investment and economic growth.

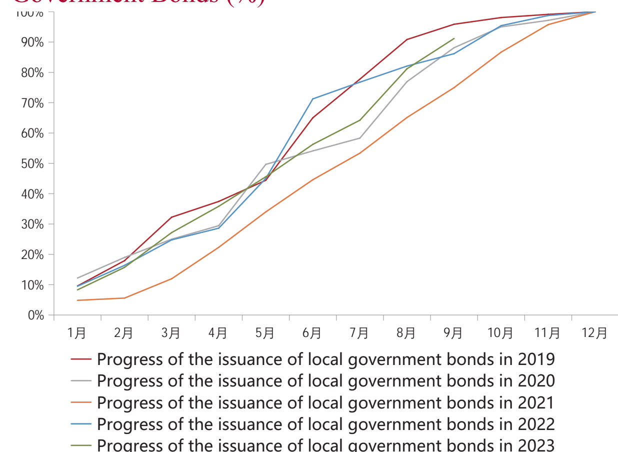
Figure 70. Limits for Central and Local Government Debt Issuance

Indicators (Unit: RMB 100 million)		2019	2020	2021	2022	2023	2024E
Annual Limit	Central government deficit	18300	27800	27500	26500	41600	41600
	Local government deficit	9300	9800	8200	7200	7200	7200
	Budget deficit ratio	2.80%	3.60%	3.20%	2.80%	3.80%	3.50%
	Special treasury bonds	/	10000	/	/	/	/
	Increment of local special bonds	21500	37500	36500	36500	38000	38000
	Inventory balance of special bonds for revitalizing stock assets	/	/	/	5000	/	/

Data sources: MOF and BOC Investment Strategy Research Center

Measures will be taken to effectively resolve local government debt risks. The central government proposed to effectively prevent and defuse local government debt risks. It has formulated and implemented a package of debt reduction plans, clarified the framework of local government “debt reduction + debt management”, and prioritized the establishment of “a long-term mechanism to prevent and resolve local government debt risks” and “a government debt management mechanism compatible with high-quality development”. In this way, the authority intends to eliminate risks of implicit debt, and give full play to the positive role of local government debt. As of November 10, 2023, a total of 26 provinces and municipalities across China and two cities under separate state planning have disclosed plans to issue special refinancing bonds. The amount of special refinancing bonds issued and to be issued totaled RMB 1,356.5 billion, so as to alleviate the pressure of provinces with greater debt repayment burden in terms of regional repayment of arrears, and non-standard and urban investment bonds included in implicit debt. In addition, the additional issuance of RMB 1 trillion worth of special treasuries will all be arranged to local governments through transfer payments, thereby alleviating the pressure on local fiscal expenditures.

Figure 71. Progress of the Issuance of Local Government Bonds (%)

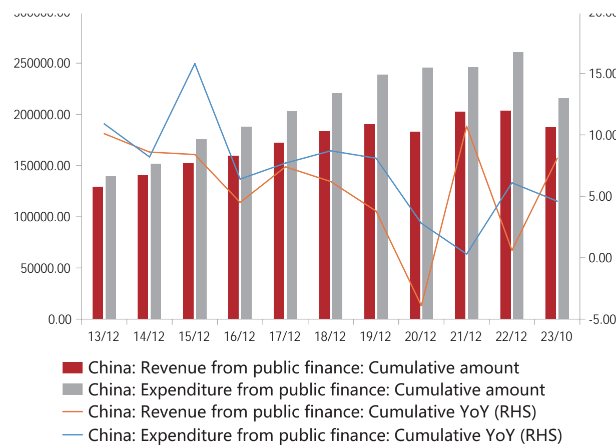


Data sources: Wind and BOC Investment Strategy Research Center

Figure 72. Deficit Ratio (%)

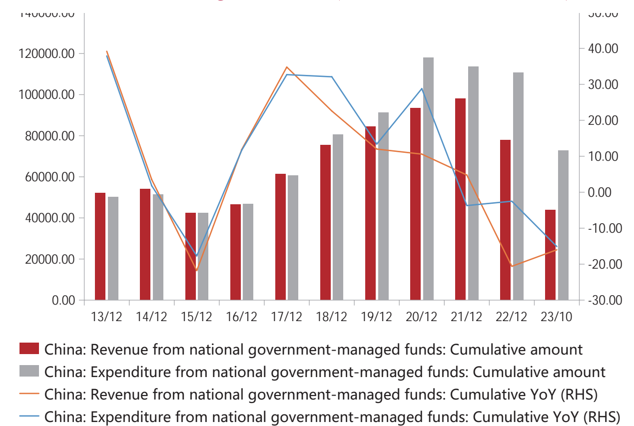
Data sources: Wind and BOC Investment Strategy Research Center

Figure 73. General Public Budget Revenue and Expenditure (RMB 100 million, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 74. Annual Revenue and Expenditure from Government-managed Funds (RMB 100 million, %)



Data sources: Wind and BOC Investment Strategy Research Center

According to China's fiscal measures, the authority intends to "open the front door, block the back door, curb the increment and resolve the existing debt", which serves the purpose of making implicit debt explicit. These measures have shown the central government's attitudes and solutions on debt risks of local government financing vehicles (LGFVs). The issuance of special refinancing bonds is the first step towards resolution of local government debt, which is conducive to the restoration of refinancing functions of local governments, and will place implicit debt and explicit debt under the same regulatory system. Policies to be rolled out include: reinvigorating existing assets, raising resources, and repaying debts; encouraging financial institutions to support debt resolution through credit extensions, interest rate reductions, etc.; setting up special purpose vehicle (SPV) at the central bank level; and improving the supervision and accountability mechanisms. While resolving existing debts in an effective and orderly manner, China will also take strict measures of controlling increment of hidden local government debts to ensure fiscal security. In the long term, institutional changes are needed to resolve local government debt risks. In addition, efforts need to be made to optimize the allocation of financial power between the central and local governments. Local government obligations of expenditure shall be appropriately transferred to central government in such areas as education, healthcare and elderly care, so as to alleviate the rigid expenditure pressure of local governments. On the other hand, the central government shall properly decentralize its financial power, increase transfer payments and issuance of treasuries, and alleviate the rigid expenditure pressure on local governments through the transmission of central financial resources. Measures shall be taken to clarify the relationship between the government and the market, promote the classified transformation and development of LGFVs, encourage the professional restructuring and integration of financing platforms, and gradually divest their government financing functions; clarify the boundaries of responsibilities between the government and enterprises; and further strengthen the constraints of budget.

Figure 75. Scale of the Current Round of Special Refinancing Bonds Already Issued and to Be Issued (RMB 100 million)

Province	General Bonds	Special Bonds	Total	Province	General Bonds	Special Bonds	Total
Guizhou	1490.7814	658.0462	2148.8276	Hebei	123.8	153.2	277
Tianjin	681.67	604.66	1286.33	Jiangsu	116.7	144.3	261
Yunnan	1156.5	99.5	1256	Henan	130.8374	125.1507	255.9881
Hunan	501.6	620.3976	1121.9976	Gansu	186.3	33.7	220
Inner Mongolia	892.8	174.2	1067	Jiangxi	69.7	86.3	156
Jilin	537	355	892	Dalian	89.58	46	135.58
Liaoning	729.42	141	870.42	Shaanxi	55.3	44.7	100

Province	General Bonds	Special Bonds	Total	Province	General Bonds	Special Bonds	Total
Chongqing	588.83	137.17	726	Qinghai	54	42	96
Guangxi	349.8	273.2	623	Hubei	41.1	50.9	92
Anhui	277.2	342.8	620	Ningxia	80	0	80
Heilongjiang	232.8	70.2	303	Xinjiang	25	31	56
Shandong	126.1	155.9	282	Shanxi	12.5	15.5	28
Fujian	126.1	155.9	282	Ningbo	11.2	13.8	25
Sichuan	125.2	154.8	280	Hainan	10.7	13.3	24
				Total	8822.5188	4742.6245	13565.1433

Data sources: PBOC and BOC Investment Strategy Research Center

2.2.5 Grasping the connotation of high-quality development in the financial sector

The Central Financial Work Conference in 2023 was held at the critical juncture of global economic slowdown and high-quality transformation of the national economy. In the conference, China has made directional arrangements for providing better financial services to the real economy and achieving high-quality development in the financial sector in the new era.

Providing better financial services to the real economy

To enhance financial services so as to better serve the real economy, the authority aims to improve the quality and efficiency of financial services. First, the financial sector should provide high-quality services for economic and social development. Over the recent years, China has seen rapid progress in facilitating scientific and technological innovation, green industrial development and other areas, and made evident breakthroughs in basic research and strategic high technology. New growth engines are formed at an accelerated pace, which requires the financial sector to increase support for relevant industries, and facilitate the high-quality development of the economy. As pointed out in the conference, China will "strengthen financial support for new technologies, new tracks and new markets, and speed up the development of new growth engines and new advantages". Moreover, China aims to "optimize the structure of capital supply, allocate more resources to promote scientific and technological innovation, advanced manufacturing, green development and small and medium-sized enterprises, and provide greater support to the implementation of the strategies of innovation-driven development, regional coordinated development, and the strategy of ensuring the national development strategy". It also strongly supports the implementation of the innovation-driven development strategy, regional coordinated development strategy, and national food and energy security. Second, China will adopt measures to reduce financing costs, revitalize inefficiently occupied financial resources, and improve the efficiency of capital use.

Over the recent years, the overall cost of financing for the real economy has been on the decline, but the structure remains unbalanced. On the one hand, the lending rates of champion enterprises, especially the pioneering state-owned enterprises, are significantly lower than the average lending rate of the entire market, and there has even been an inversion of deposit and loan interest rates. The low interest rate may lead to outflow of capital from the real economy. As a result, it will be hard to expand aggregate demand, and may even lead to the expansion of inefficient and ineffective production capacity. On the other hand, the overall financing cost of private enterprises is still maintained at the level of 5-6%, and such high cost of financing will intimidate private enterprises from investment. Considering that the net interest margin of commercial banks has reached a record low, the operating pressure becomes even higher. Commercial banks are able to provide low-interest loans to private enterprises by expanding the source of low-cost refinancing funds. In this way, the counter-cyclical adjustment mechanism of monetary policy can be smoothly transmitted to the real economy.

High-quality development in the financial sector

According to the Central Financial Work Conference, "finance is the lifeblood of the national economy and an important part of the country's core competitiveness, and efforts shall be made to accelerate the development of a strong financial sector". This is the first time that the central government put forward the goal of building a strong financial sector. To strengthen the development science and technology as well as manufacturing sector, a strong financial sector is indispensable. Otherwise,

it is impossible to develop modern science and technology as well as modern industry. In this sense, finance is a vital part of a country's core competitiveness. In addition, the meeting urged greater efforts to "comprehensively step up financial supervision, prevent and resolve risks, and promote high-quality development of China's financial sector".

High-quality development of the financial sector, risk prevention and control will always be on top of the agenda of financial work. The meeting proposed to focus on regulations of key risk areas such as local government debts, real estate market, and small and medium-sized financial institutions. In recent years, due to lack of sound corporate governance and professional competence, the anti-risk capacity of certain small and medium-sized financial institutions is weak, leading to greater risk exposure. Hence, there is a need for "enforcing strict admission standards and regulatory requirements for small and medium-sized financial institutions". In addition, the authority intends to encourage small and medium-sized financial institutions to make use of local resource endowments to "conduct localized operations" so as to form differentiated competitive advantages. With regard to local government debt, the meeting focused on addressing the root causes of local government debt risks in the long term and establishing an institutional framework for local government debt risk resolution. The authority proposed to "establish a long-term mechanism to guard against and defuse local debt risks, set up a government debt management system that is compatible with China's pursuit of high-quality development, and optimize central and local government debt structures". With respect to the real estate sector, the real estate market has entered into a stage of in-depth adjustment due to profound changes in supply and demand. The meeting proposed to "promote a virtuous cycle between finance and real estate, which includes a better regulatory system for real estate enterprises and fund management, and macro-prudential management of real estate finance". First, measures shall be taken to ensure equal treatment for different types of real estate enterprises in meeting their reasonable financing needs. Second, city-specific targeted policies should be adopted to better support both rigid housing demands and demands for improved housing. Third, quicker steps should be taken on the "three major projects", including affordable housing, so as to alleviate the downward pressure on real estate investment. Fourth, efforts shall be made to build a new development model for the real estate sector, and facilitate the transition of real estate sector from the pattern of "high debt, high leverage and high turnover" into the model of asset-light and asset-heavy development with holding of real estate properties. The earnings model shall be transformed from generating profits through incremental development into enhanced development, renewal of existing properties, development of affordable housing, and all-round profit generation in asset-light business in both upstream and downstream industries. In addition, the financing model shall be transformed from high debt into a diversified mode, whereas the target set by real estate enterprises shall not be based solely on scale and speed of development, but shall focus on the improvement of brand image and product quality.

2.3 US Economy: Monetary Policy is Expected to Gradually Ease under the Hysteresis Effect and Return to Normalcy

2.3.1 Economic growth: Actual growth is gradually slowing down and returning to the "potential growth rate"

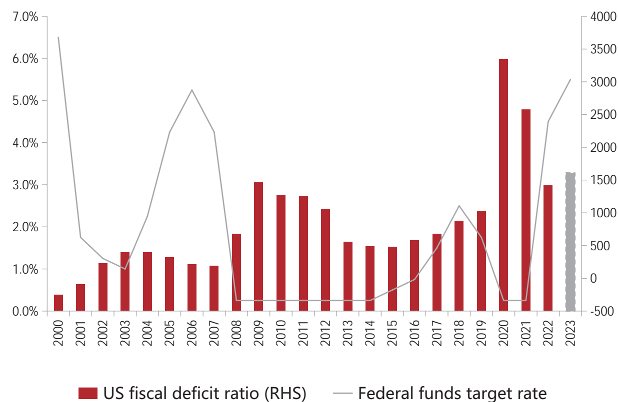
Since March 2022, the Fed has raised the federal funds rate to 5.25-5.5% after 11 consecutive interest rate hikes. Nevertheless, enterprises and residents have locked in interest rates in advance under the low interest rate environment, and liquidity in the USD market remains relatively abundant. Coupled with utterly loose fiscal policies that exceeded the market's expectations, the effects of monetary tightening have been greatly reduced. The US economy achieved better growth than 2022. In addition, the economy was encountered with high inflation and low unemployment rate. From the aspect of the economic cycle, the US economy was in the stage of "overheating". The US PCE reached 3.44% year-over-year in September, above the inflation target of 2%, and the unemployment rate reached 3.9% in October, below the potential natural unemployment rate of 4.4%. As of September 2023, nominal GDP amounted to 6.27% in Q3 year-over-year, higher than the potential nominal GDP growth rate of 5.02%, and real GDP reached 2.93% year-over-year, higher than the potential real GDP growth rate of 1.77%.

Looking forward to 2024, the core challenge faced by the US economy is "to what extent the lag effect of monetary policy will be reflected". At present, mortgage interest rate, consumer loan interest rate, US 10-year treasury yield and AAA corporate bond yield are all at new highs over the past decade. Against the backdrop of high interest rates, the endogenous growth

momentum of the US economy is likely to gradually weaken, and the supply and demand of the labor market will gradually achieve an equilibrium. Moreover, the core inflation will continue to ease. In case that there is no evident external shock or unexpectedly increased fiscal policy efforts, the US economy will gradually transition from the overheated demands at present to the balance between supply and demand, thus resuming the normalcy.

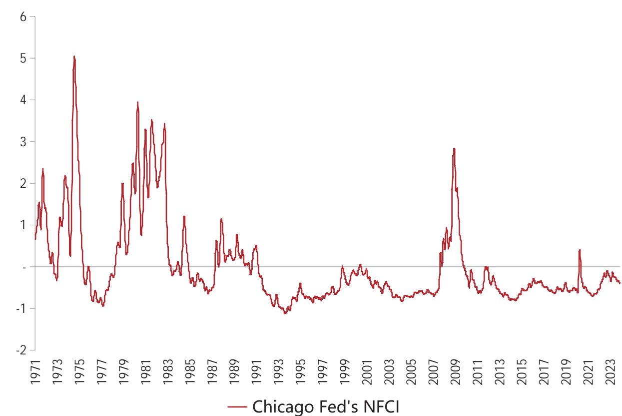
From the aspect of pace of development, the slowdown of the US economy in 1H 2024 may be faster than the market's expectations ate present. In case that interest rate cuts are started, the slowdown is expected to gradually stabilize, and the US economy is still able to achieve a "soft landing". Based on the comprehensive analysis of consumption, investment and finance, the real GDP growth rate of the US is expected to return to the potential growth rate in 2024.

Figure 76. Rising US Interest Rate and Easing Fiscal Policy (%, USD 1 billion)



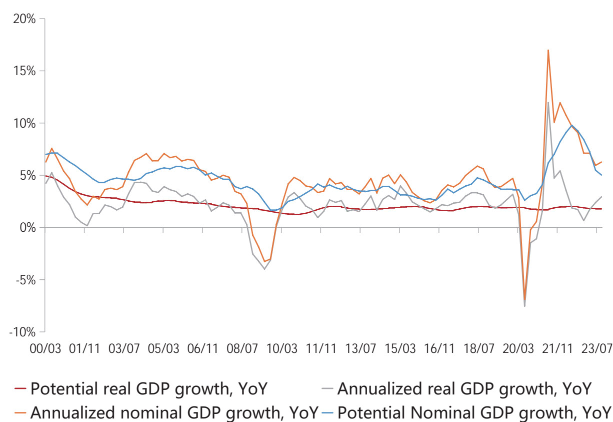
Data sources: Wind and BOC Investment Strategy Research Center

Figure 77. US Chicago Fed's National Financial Conditions Index (NFCI)



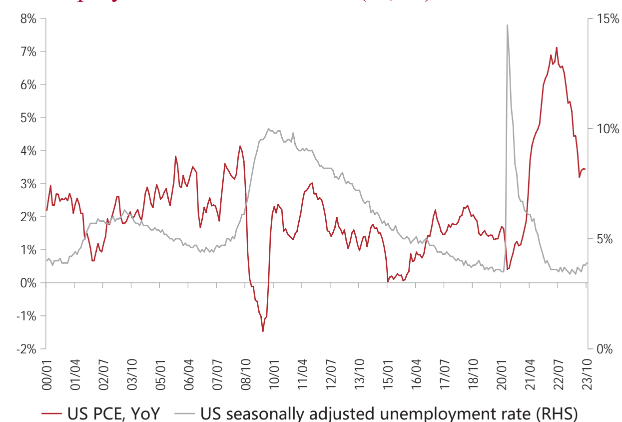
Data sources: St. Louis Fed and BOC Investment Strategy Research Center

Figure 78. YoY Growth of GDP in the US (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 79. Coexistence of High Inflation and Low Unemployment Rates in the US (%, %)



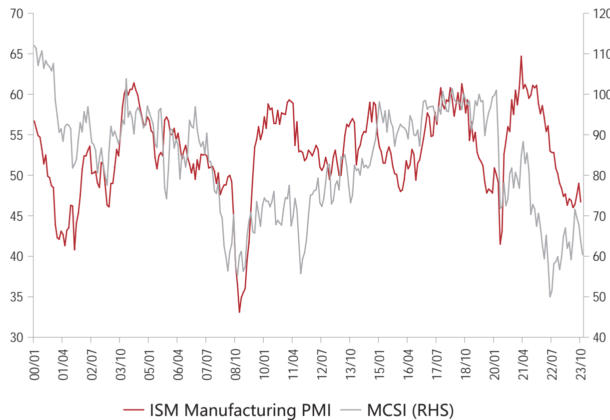
Data sources: Wind and BOC Investment Strategy Research Center

2.3.1.1 Growth of aggregate demands is expected to slow down as leading indicators experienced evident declines

The US ISM manufacturing PMI has been below the boom-bust line of 50 for 12 consecutive months, and the Michigan Consumer Sentiment Index also hovered at a 20-year low, both pointing to a slowdown in US economic growth. According to the forecast on the economic recession from the New York Fed, the chance of a US economic recession is estimated to be 46%

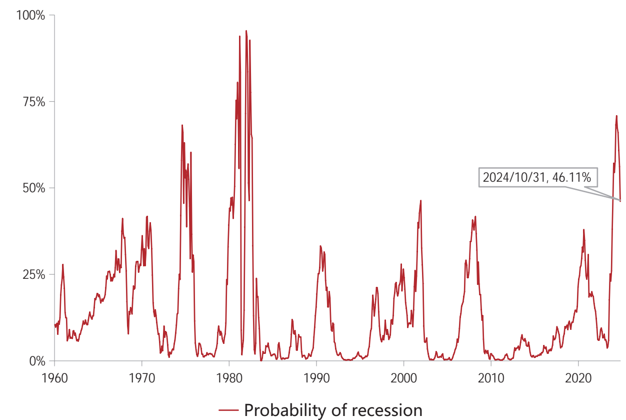
in the next 12 months. Given that the balance sheets of US residents are relatively healthy, capital market liquidity remains supported under the hegemonic system of USD, and the US economy is relatively resilient. If the Fed makes adaptive easing policy arrangements, the US economy will have the resilience to “take off as soon upon policy easing”. It is expected that the US economy will most likely achieve a “soft landing” in 2024 without a cliff recession.

Figure 80. US PMI and Michigan Consumer Sentiment Index (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 81. Forecast on the Recession by the New York Fed (%)

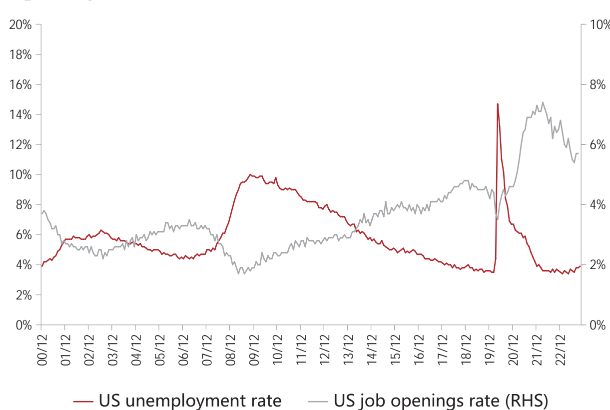


Data sources: New York Fed and BOC Investment Strategy Research Center

2.3.1.2 Unemployment rate gradually cross the inflection point, and there could be a phase of rapid upward movement

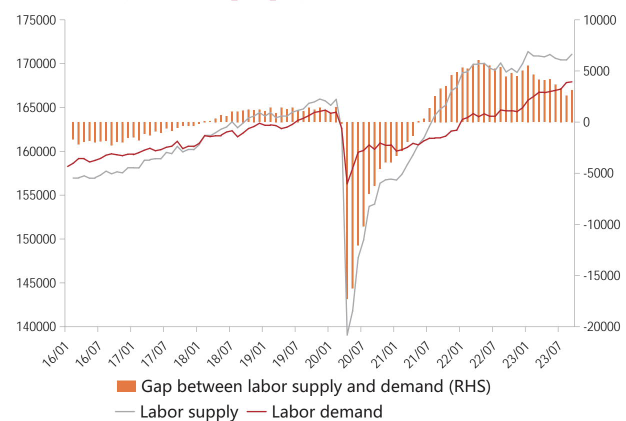
In 2023, the US labor market was in a state of oversupply, but the gap between supply and demand continued to narrow. The unemployment rate also rose from 3.4% in early 2023 to 3.9% in October. The job openings rate dropped from 6.4% in early 2023 to 5.7% in September. As can be seen, the job market remained tight, but continued to cool down. Looking forward to 2024, it is expected that the unemployment rate will cross the infection point, and there could be a trend of rapid rally in stages. The employment market is likely to achieve a balance between supply and demand in mid-2024, and gradually approach the potential unemployment rate of 4.4%, while approaching the level of 5% by the end of the year.

Figure 82. US Unemployment Rate and Job Openings Rate (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 83. Gap between Labor Supply and Demand in the US (thousand people)

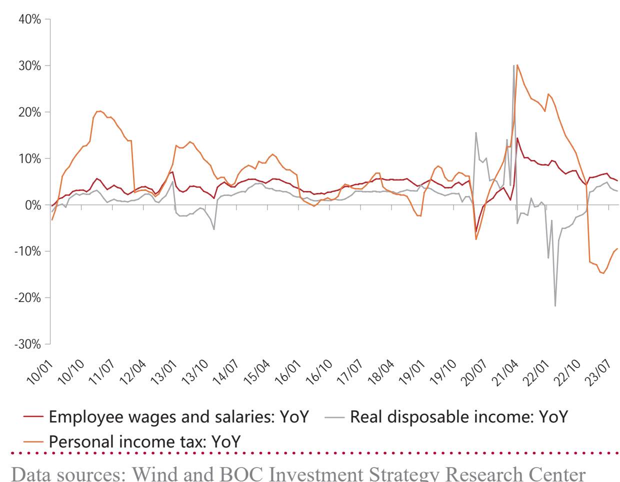


Data sources: Wind and BOC Investment Strategy Research Center

2.3.1.3 Consumption gradually suffered from a negative impact as real income growth slowed down

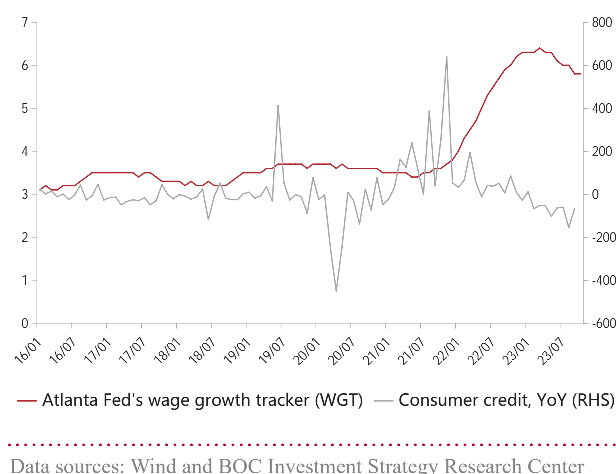
In 2023, the US consumption showed optimal resilience, mainly due to the significant rebound in the growth of real disposable income of US residents driven by excess savings and personal tax cuts under the inflation-protected payroll system. Looking ahead to 2024, the excess savings will be nearly exhausted, and the labor market will tend to reach an equilibrium of supply and demand. Moreover, the nominal growth of wages will tend to slow down, and the real estate market may face a more significant impact under the high interest rate environment. In addition, adjustments in the stock market will lead to a marginal weakening of the wealth effect. In a nutshell, real income of residents will gradually suffer from a negative impact. Coupled with the inhibitory effects imposed by high interest rates on consumer credit, the real growth rate of consumer spending will gradually slow down.

Figure 84. US Residents Benefited from Effective "Tax Cuts" in 2023 (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 85. Decelerated Growth of Consumer Credit and Wages (Times, %)



Data sources: Wind and BOC Investment Strategy Research Center

2.3.1.4 High interest rates imposed an inhibitory impact on investment

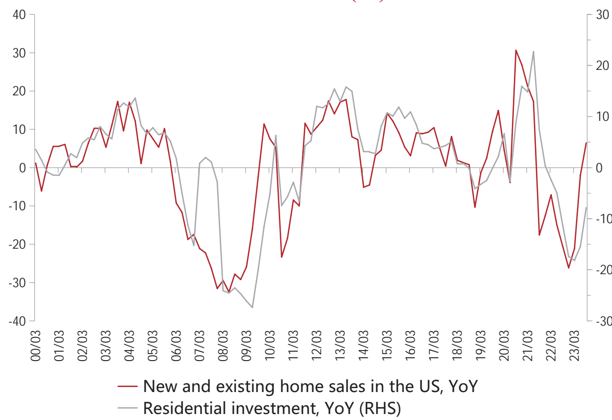
Another crucial factor that made the US economy exceed the market's expectations in 2023 was the structural bottoming out of the investments, which experienced in-depth corrections during the cycle of interest rate hikes. Looking forward to 2024, interest rates are expected to remain at a high level for a long time, and there is limited room for a rebound in cyclical investments. In particular:

With respect to the residential investment, although sales and investment data have bottomed out, the 30-year mortgage interest rate has risen to the level around 7.5% at present, and the job market has gradually returned to an equilibrium, whereas the residential income growth is expected to slow down. Moreover, given that home ownership rate returned to the historical average level of 66%, it is expected that the expansion of real estate demands will be suppressed to a significant extent. The confidence index of real estate developers continue to decline over the recent period, and the rebound is likely to be encountered with a bottleneck.

With respect to non-residential investment, the US policy of reindustrialization has promoted the return of manufacturing investment to the country, leading to the surge of construction investment since 2H, 2022 and driving equipment investment. However, the investments were mainly concentrated in the construction sector, which was most directly related to the industrial policy. The distribution of investments was obviously directed to the areas supported by the US policy, and the policy support was not clearly reflected at the employment. Hence, corporate investment may hardly achieve cycle reversal.

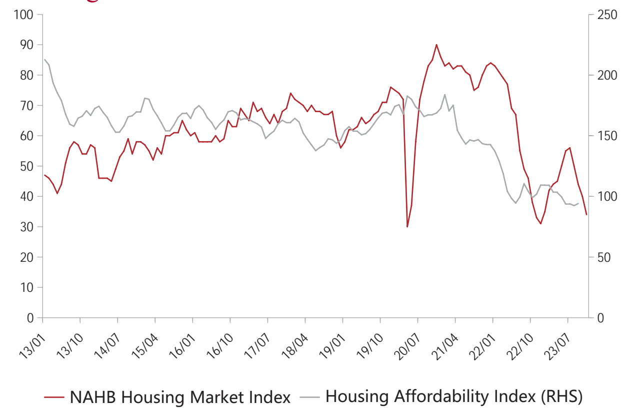
With respect to inventory investment, the destocking cycle sped up in the US in 2023, and the growth rate of inventory investment continued to decline. In 2024, closer attention needs to be paid to whether the US may enter into a replenishment cycle. Sales data are the leading indicator of inventory replenishment. When interest rates remain at high levels, the start of the inventory replenishment cycle could encounter a headwind.

Figure 86. YoY Growth of Residential Investment and Real Estate Sales in the US (%)



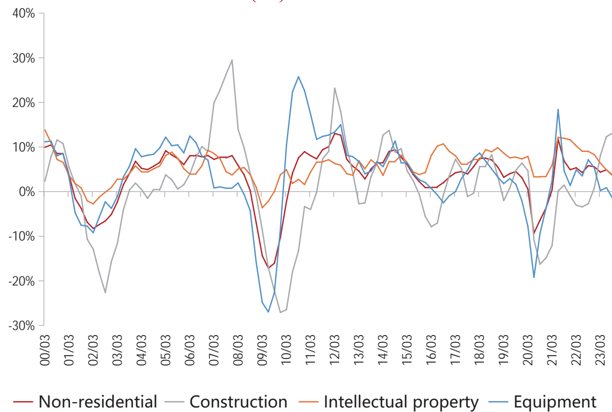
Data sources: Wind and BOC Investment Strategy Research Center

Figure 87. Housing Affordability Index and NAHB Housing Market Index



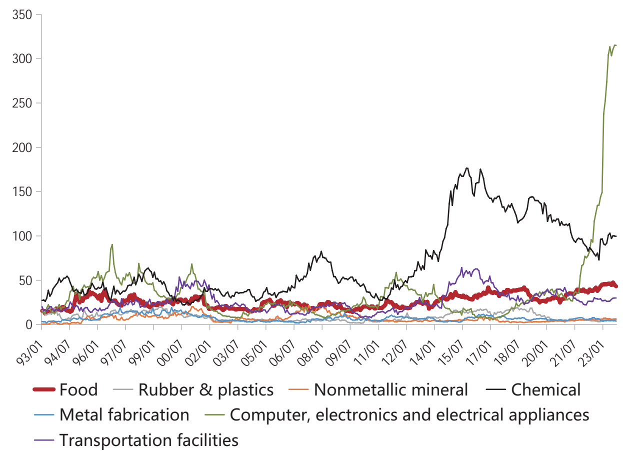
Data sources: Wind, NAHB and BOC Investment Strategy Research Center

Figure 88. YoY Growth of Non-residential, Construction, Equipment and Intellectual Property Investments in the US (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 89. High Correlation of Construction Growth with Industrial Policies (USD 100 million)

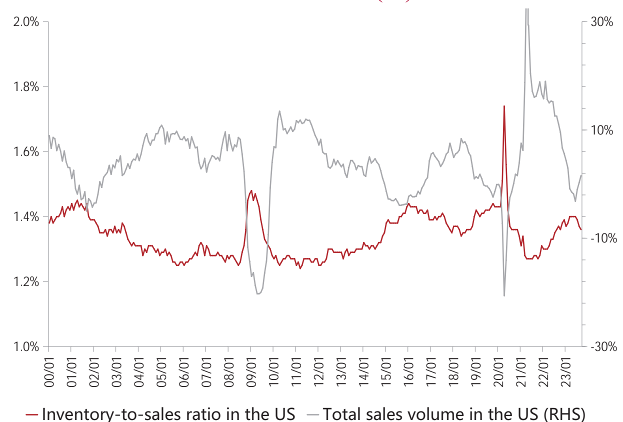


Data sources: Wind, US Census and BOC Investment Strategy Research Center

Figure 90. YoY Growth of US Inventory and ISM Manufacturing PMI (%)

Data sources: Wind and BOC Investment Strategy Research Center

Figure 91. YoY Growth of Inventory-to-sales Ratio and Total Sales Volume in the US (%)

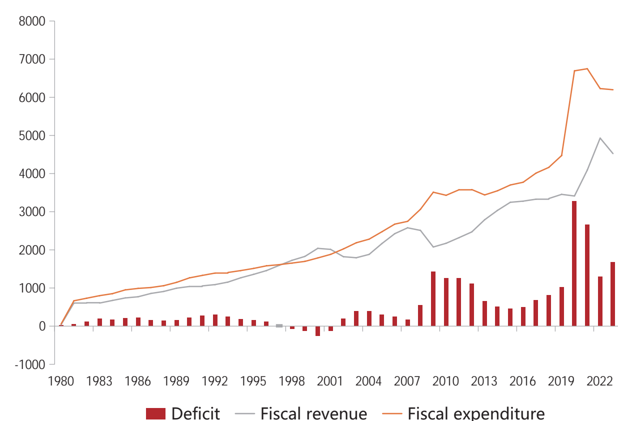


Data sources: Wind and BOC Investment Strategy Research Center

2.3.1.5 Fiscal efforts are likely to subside

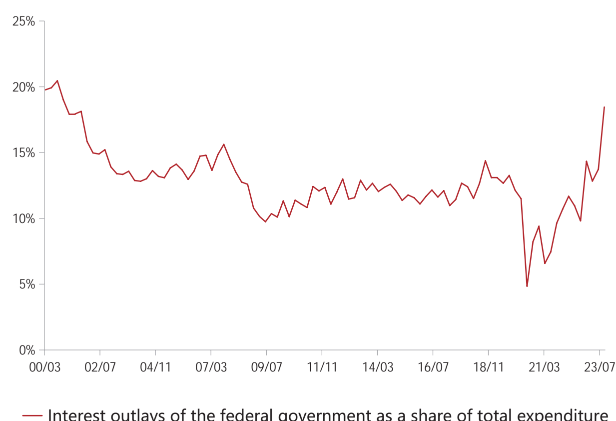
In 2023FY, the US federal government deficit reached USD1.7 trillion, an increase of 23% from 2022FY. The deficit ratio expanded to 6.3% from 5.5% in 2022, hitting a record high over the past four decades. Looking forward to 2024, it is expected that both the scale and ratio of fiscal deficit may decline in the US. The fiscal deficit failed to play the role of automatic fiscal stabilizer in 2023. The main reason was that the increase in inflation-adjusted deductions passively lowered fiscal revenue, and expanded social security expenditures. As inflation slowed down, it could help reduce the scale of the deficit in 2024. On the other hand, as the Fed would maintain higher interest rates for a longer period of time, the pressure on interest expenditures has been heightened to a significant extent. From Q1 to Q3, 2023, the proportion of federal government interest expenditures in total expenditures rose to 18%, and the proportion of interest in GDP was approximately 2.5%. Given that the year 2024 is an election year, fiscal policies may hardly achieve much progress under the rivalry between the two parties. According to the US CBO, OMB and primary dealers, the US fiscal deficit is expected to reach around USD 1.5 trillion to USD 1.8 trillion in 2024FY, and is likely to be slightly lower than the amount of USD 1.7 trillion in 2023FY. The incremental contribution to the economy will be weaker than in 2024.

Figure 92. US Fiscal Spending, Revenue and Deficit (USD 1 billion)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 93. US Federal Fiscal Interest Outlays as a Share of Total Expenditure (%)

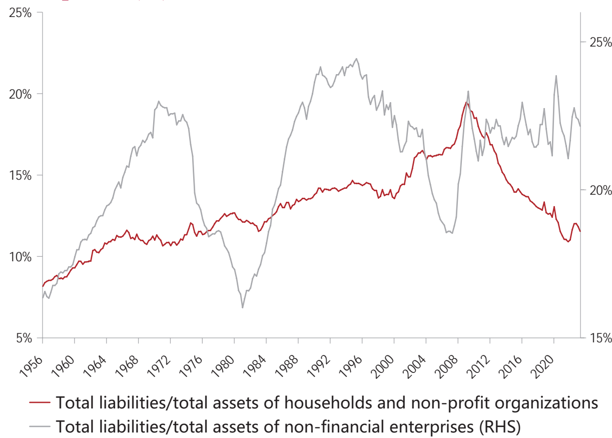


Data sources: Wind and BOC Investment Strategy Research Center

2.3.1.6 Certain enterprises may experience a liquidity crisis, but it is unlikely to trigger systemic risks

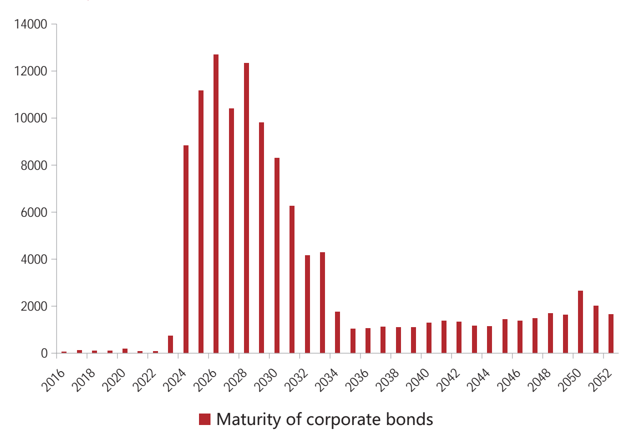
Since the 2008 global financial crisis, the leverage ratio of US enterprises has increased, and the maturities of corporate bonds are concentrated in the years between 2024 and 2028. As liquidity continued to tighten, localized default or bankruptcy risks could take place. Overall, the current corporate credit risk remained at a relatively controllable level. The capital adequacy ratio of the US financial sector is rather sufficient. The balance sheets of residents are relatively healthy. Moreover, the leverage ratio experienced declines instead of a rally during the stage of economic overheating. In Q2, 2023, the asset-liability ratio of households amounted to only 11.5%, hitting a historical low level. Judging from the experience of local financial risk events such as Silicon Valley Bank incident, the Fed may still provide emergency liquidity support. As such, localized shocks to the corporate sector are unlikely to impose a comprehensive impact or even evolve into a systemic risk.

Figure 94. Asset-liability Ratio of US Residents and Enterprises (%)



Data sources: Wind, St. Louis Fed and BOC Investment Strategy Research Center

Figure 95. Maturity of Corporate Bonds (USD 100 million)



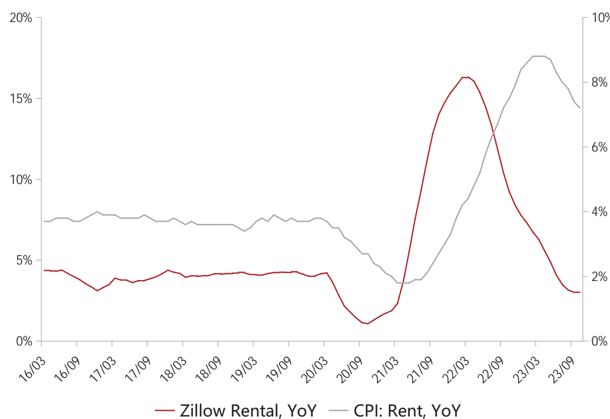
Data sources: Bloomberg and BOC Investment Strategy Research Center

2.3.2 Inflation: Core inflation has steadily declined, and nominal inflation is likely to experience ups and downs

Since June 2023, the slight rebound in CPI has been mainly derived from the inflation in energy and food items. In particular, prices of energy items entered into the low-base range in 2H, 2023, and coupled with the upward chain reaction in oil prices, they have formed a larger contribution to the inflation. Looking ahead to 2024, in case that geopolitical conflicts do not worsen and oil prices remain stable, PCE is expected to gradually move closer to the inflation target of 2% year-over-year in 2024 amid a sustained fall in aggregate demands.

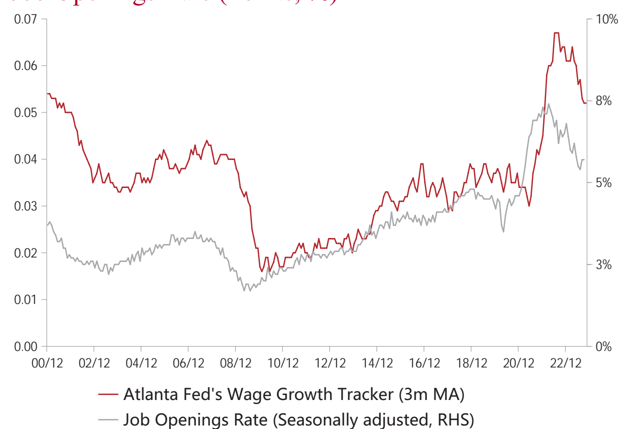
With respect to the core inflation, the movements of "rental" and "wages" basically pointed to a trend of stabilization in 2024. First, rental accounted for nearly 1/3 of the CPI, and Zillow rental peaked in March 2022 and continued to fall. Second, wage leading indicators saw sequential declines after the labor market cooled to some extent. With respect to nominal inflation, there is a risk of an upside rebound under circumstances when commodity prices, such as oil and food, rise sharply as a result of force majeure events like geopolitical conflicts.

Figure 96. US Zillow Rentals and Rent Inflation (%)



Data sources: Wind, Zillow and BOC Investment Strategy Research Center

Figure 97. Atlanta Fed's Wage Growth Tracker and Job Openings Rate (Points, %)



Data sources: Wind and BOC Investment Strategy Research Center

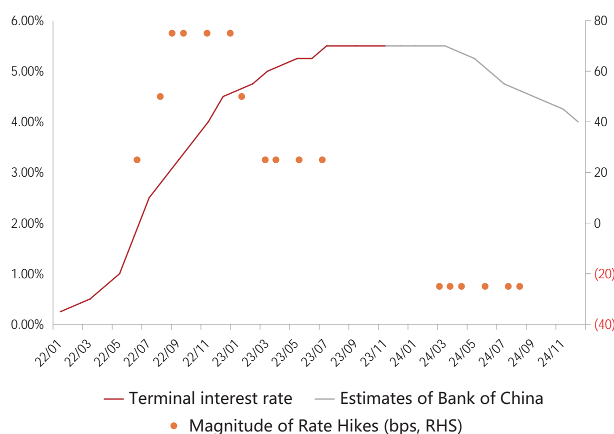
2.3.3 Monetary policy: The cycle of interest rate hikes will most likely approach the end, and attention shall be paid to the start of interest rate reductions

As the market liquidity remained relatively abundant, the transmission efficiency of monetary policies were greatly affected. At present, mortgage interest rates, consumer loan interest rates, US 10-year treasury yields and AAA corporate bond yields have all hit 10-year highs, indicating that the transmission at the interest rate level is nearly complete. Nevertheless, there is still a "time lag" from high interest rates to the tightening in the real economy, and the unemployment rate is still lower than the potential natural unemployment rate. In addition, the current inflation rate is still higher than the inflation target. Therefore, from the aspect of "time lag" in monetary policy, the amplitude of rate hikes may already be sufficient, but high interest rates will still need to be maintained for a certain period of time. According to historical statistics, the time lag could last for "3-6 months". With respect to the Fed's monetary policy in 2024, we expect that high interest rates would remain unchanged in Q1, 2024. In addition, interest rates may be lowered as soon as May 2024, when the job market is expected to gradually approach the balance between supply and demand. At the same time, the core inflation will fall steadily, and the policy interest rate of 6% will be significantly higher than the neutral interest rate consistent with US economic growth. Based on our analysis on the US inflation and neutral interest rates, it is expected that the magnitude of interest rate cuts could range between 100 and 150 bps in 2024.

The pace of the shrinking of balance sheet at present has been much faster than the previous round. As of the end of October 2023, the amount of overnight reverse repurchases in the Fed's balance sheet had experienced evident declines, but the balance still remained at the level of USD 1.4 trillion. Moreover, the Chicago Fed's National Financial Conditions Index (NFCI) remains at a relatively low level, indicating that the liquidity in the US market remains quite abundant. From our perspective, the shrinking of the balance sheet will continue in an orderly manner in 1H, 2024 at the current pace, and there is still the chance of periodic interest rate cuts accompanied by balance sheet shrinking at the same time in 2H, 2024.

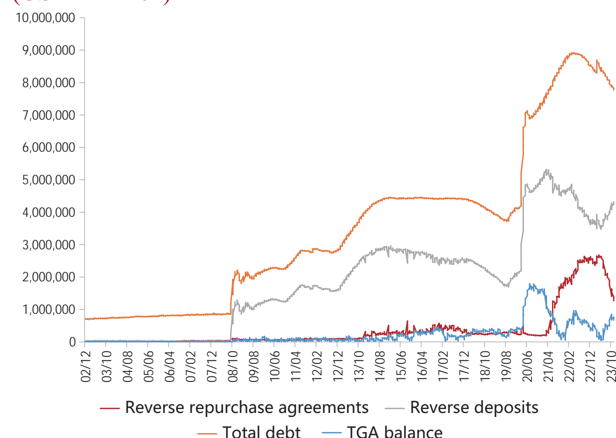
The aforementioned analysis is based on baseline assumptions. In case that unexpected geopolitical events take place, including the escalation of the Russia-Ukraine tension and the Palestine-Israel conflict, or that the recovery of the US labor supply is hindered becomes further tightened while wage growth rises, the trend of consistent disinflation could be altered. Under such circumstances, the period when interest rates remain high could be prolonged, and there may still be the chance of monetary tightening measures such as further interest rate hikes. In case that the excessive monetary tightening by the Fed triggers a localized liquidity crisis that leads to widespread exposure to financial risks, sharp declines in asset prices, shrinking economic demands, and a sudden drop in inflationary pressure, the Fed is likely to cut interest rates even earlier, and liquidity could be further eased.

Figure 98. Path of the Fed's Subsequent Rate Hikes (%, bps)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 99. Reverse Repos, TGA and Reserve Deposits (USD 1 million)



Data sources: Wind and BOC Investment Strategy Research Center

2.4 European Economy

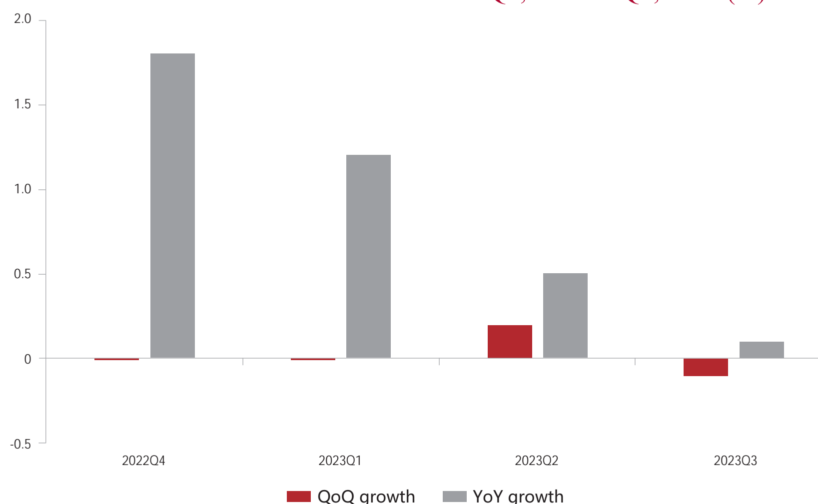
2.4.1 Eurozone: Against the backdrop of imminent recession, interest rate reductions are likely to take place

The Eurozone economy showed a trend of weak recovery in 2023, achieving high growth before declines. Global energy prices fell sharply, injecting momentum into the Eurozone economy in 1H, 2023. Nevertheless, high interest rates, strong service sector and wage inflation dragged down economic growth in 2H, 2023, hindering the momentum of further recovery. in the first three quarters of 2023, the economic growth rates reached 0%, 0.2% and -0.1% respectively, and the downward trend in year-over-year GDP growth was even more significant. In September 2023, the total industrial production of the Eurozone dropped by 6.9% year-over-year. In particular, the two items that experienced the most significant declines were capital goods (-9.5%) and durable goods consumption (-8.1%). According to country statistics, the industrial production of Ireland slumped by 27.2%, and that of major economies such as Germany, Italy and Spain fell by 4.4%, 2% and 1% respectively. Moreover, the industrial production growth was flat in France, thus narrowing from the decline of 0.3% in August. With respect to the service sector, as of the end of August 2023, the overall service industry output level was 14% higher than in February 2020 in the Eurozone, and different industries experienced varying extents of recovery. In particular, aviation, accommodation and catering services have experienced the most significant rebound.

With respect to the monetary policy, the ECB clearly ended its cycle of interest rate hikes, and the debt ratio in the Eurozone has eased to a slight extent. The Governing Council maintained the three key ECB interest rates unchanged in October 2023, after raising interest rates ten times in a row previously. According to the ECB's policy stance, the current interest rate has already reached a restrictive level, but it needs to be maintained for a longer period of time. With the gradual withdrawal of fiscal measures related to energy subsidies, the financial conditions of major economies in the Eurozone and Southern European economies with high debt risks have recovered to some extent. As of the end of Q2, 2023, the debt ratio averaged 90.3% among Eurozone countries, lower than the 90.7% at the end of Q1. The deficit ratio reached -3.3%, a slight increase of 0.1% from the end of Q1. Debt interest expenditures accounted for 1.7% of the total economy.

From the aspect of economy, the Eurozone economy could further weaken in Q4, 2023 and a technical recession is more likely to happen. In general, two consecutive quarters of negative economic growth are defined as a technical recession. Industrial output in the Eurozone weakened in Q3, and the growth of service sector output slowed down. In addition, due to the impact of high interest rates, demands for fixed-asset investment weakened to some extent. Coupled with the sluggish growth in the real estate market and the lack of consumer confidence, credit demands have diminished. Eurozone banks further tightened credit standards to prevent liquidity risks as well as the risks of asset quality deterioration. Overall, the Eurozone economy is more likely to weaken further in Q4, and could hardly avoid a technical recession in 2023. Moreover, there is still the chance that the ECB may advance its interest rate reductions to June 2024.

Figure 100. QoQ and YoY Growth of the Eurozone GDP from Q4, 2022 to Q3, 2023 (%)



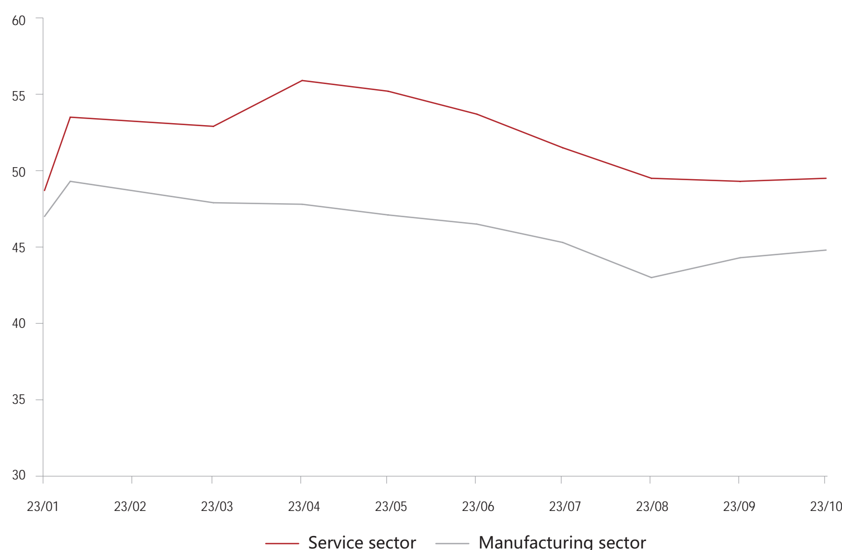
Data sources: Eurostat and BOC Investment Strategy Research Center

2.4.2 UK: Inflation has experienced evident declines, and interest rates are cut to a significant extent to cope with the economic headwinds

In the UK, the economic growth in 2023 was better than the market's expectations. The CPI fell to 3.9% in November 2023 from double-digit at the start of the year, mainly attributable to the restoration of global supply chain and constantly restrictive monetary policies. Similar to the situation in the Eurozone, the British economy also experienced growth before declines in 2023. In the first three quarters, the British economic growth reached 0.3%, 0.2% and 0% respectively, but the overall economic growth for the year 2023 in the UK would be weaker than that in the Eurozone. Since April, both service and manufacturing sectors have weakened simultaneously in the UK. Since August, the services PMI has remained in the contraction range below the level of 50, and the manufacturing PMI has been in the contraction range throughout the year. Nevertheless, the British economy has shown certain resilience, exceeding the estimates by major institutions that the British economy might enter into a recession. According to the forecast of the IMF in early 2023, the British economy would decline by 0.6% in 2023, and its forecast in October was revised to positive growth of 0.5%. Low unemployment rate and high consumption resilience are the major driving forces behind the economic growth.

Judging from the headwinds faced by the British economy, the interest rate cuts may be brought forward to mid-2024 with greater efforts in the UK. As the real estate market weakened, and mortgage interest rates remained at high levels, household consumption and corporate investment would be subject to significant negative impact. There is still the chance that the British economy could decline further in Q4, and the quarter-over-quarter growth rate could turn negative. In addition, the banking industry in the UK weakened its credit support for the real economy, which could accelerate the risks of economic recession in 2024. Taking the British banking industry represented by the five major banks headquartered in London (HSBC Holdings, Barclays Bank, Lloyds Banking Group, NatWest Banking Group and Standard Chartered Bank) as examples, the average level of year-over-year credit growth experienced declines of 10% in the above five banks, which was inferior to the credit expansion of 8.5% in the same period in 2022. As of November 17, the overnight swap rate model predicted that the BoE might cut interest rates as early as June 2024, which is basically consistent with the timing of the Fed's interest rate reductions. Since 2020, the changes in the UK and US economic and monetary policies have been rather synchronized. Accordingly, the Fed's monetary policy measures may also be one of the key factors to analyze the BoE's interest rate cut. Nevertheless, the inflation situation in the UK seems to be more severe, and the BoE has already adopted hawkish guidance to prevent inflationary expectations from strengthening. Still, according to the market's perceptions, once the BoE cuts interest rates, the rate cuts may be adopted with greater efforts at a faster pace. Unlike the resilient US economy and the precautionary interest rate cuts by the Fed, the UK has limited control over the inflation. Despite downward movements of the external inflation, the structural issues are prominent in the UK's domestic job market. Due to labor shortages, wage growth remains at a high level, and a recession-style interest rate cut is emerging on the horizon.

Figure 101. UK Manufacturing and Services Purchasing Managers Index (PMI) (%)



Data sources: Wind and BOC Investment Strategy Research Center

Stock Market

Driven by the Start of the Cycle of USD Interest Rate Reductions, Global Stock Markets are Likely to See the Silver Lining

In 2024, China's economy is expected to experience a moderate recovery. Corporate earnings are likely to be enhanced, and stock market fundamentals will improve. The development of a strong financial sector will lead to the adaptive calibration of the position of the stock market, thus bolstering the confidence of investors. The capital market is expected to be activated, and the undervalued A-shares are likely to usher in brighter prospects. Positive factors both at home and abroad will resonate with each other and build up growth momentum, and the Hong Kong stock market is expected to usher in a historical turnaround. Investors are engaged in trading ahead of the start of the cycle of USD interest rate reductions. Given that the US stock market has fully priced in the economic "soft landing", the market may experience downward adjustments after the start of interest rate reductions. Due to the sluggish economic growth in Europe, the rebound of stock markets can hardly be sustained. Japan's economy is likely to escape from deflation, and Japan's stock market is expected to experience a moderate rally due to the sustained economic recovery. Subsequent to the alleviation of global liquidity pressure, stock markets in the emerging economies are likely to usher in rather optimal performance.

3.1 China's Stock Market: Positioning of the A-share Market is Moderately Calibrated, and the Market's Confidence is Bolstered Due to Bright Prospects

Starting from the "year of turn" in our strategy report in 2019, we are convinced that the Chinese stock markets will usher in a great era of equity investment, and embark on a long-term rally compatible with the national destiny. In 2020, we believe that A-shares will experience a transition "from turn to recovery". In 2021, we believe that A-shares would move "from recovery to resurgence", thus breaking the "curse of stock market would only rise for not longer than three years, and the bearish trend would last longer than the bull run", and we have technically confirmed the long-term upward trend. The views of the strategy reports from 2019 to 2021 have all been verified. However, from 2022 to 2023, the trend of A-shares deviated from the established upward trend. Especially in 2023, although the global stock markets experienced a bull run, verifying our perception that "the hike of USD interest rates is approaching the end, and stock markets are seeing a silver lining", A-shares slumped abnormally and unexpectedly. Unlike the adjustments taken place in the A-share market in previous years, the vast majority of mainstream institutional investors, namely public funds, have underperformed the stock indexes, whereas insurance funds also suffered substantial losses. Funds and wealth management products delivered no money-making effects. The confidence of ordinary investors who indirectly participate in the stock markets through professional institutions has suffered from a severe impact, and the market sentiment has been extremely depressed. The background for all of these developments is that China has become the second largest economy, and country's economic growth is ahead of the global major economies. Moreover, China's economic fundamentals have comparative advantages. China's multi-tiered capital market has been established, and the registration system has been fully promoted and integrated with the mature capital markets. The majority of investors believe that China's capital market have been "maturely established at the thirtieth anniversary", and are ready to share the dividends of economic growth and reform. Investors are increasingly pondering over the developments of China's stock markets over the past three decades, and as they raise more questions, they also have greater expectations. China's stock markets are rooted in the Chinese society, and are related to numerous aspects such as socio-economic development, financial security, scientific and technological progress, corporate growth, residential wealth accumulation, and people's sense of gain. Externally, the development of China's stock markets could impose an impact on the country's long-term economic growth prospects as well as foreign investors' confidence in investing in China. Internally, the development of a sound capital market connects with the national strategy, is also closely linked with people's wallets. It is not only related to bolstering national confidence, but also relevant for the common prosperity of all walks of life. As a window of services for hundreds of millions of customers, Bank of China thinks from the perspective of investors: How do we view the future of China's capital market? How shall we view the status-quo of A-shares? How to manage the wealth of individual clients? We also attempt to review the past, base ourselves on the present, and look forward to the future. By sharing our observations, we hope to rebuild investor confidence and promote the development of a strong financial sector so as to facilitate the high-quality development.

3.1.1 Looking back: Market thinking from the aspect of investors

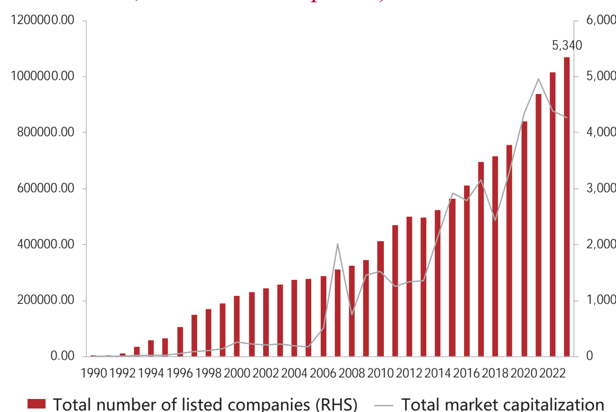
After more than three decades of development, China has initially established a multi-tiered capital market. China is dedicated to fulfilling the goal of building a standardized, transparent, open, dynamic and resilient capital market with the basic principles of "systems establishment, non-interference and zero-tolerance". Despite the remarkable achievements, the development of China's capital market is also worthy of further reflection and improvement.

3.1.1.1 Remarkable achievements in the A-share market over the past three decades

First, China has established a multi-tiered capital market with the number of listed companies and market value ranking second in the world. In 1990, two exchanges were established in Shanghai and Shenzhen respectively, with a total of 9 listed companies in the market. As of December 21, 2023, there are three stock exchanges in Shanghai, Shenzhen and Beijing, as well as the National Equities Exchange and Quotations (NEEQ, commonly known as the "New Third Board"). In addition, China has established four major futures exchanges, namely, the Shanghai Futures Exchange, China Financial Futures Exchange, Dalian Commodity Exchange, and the Zhengzhou Commodity Exchange. Securities transactions are conducted in five major trading venues of listed stocks, including the Main Board of the Shanghai Stock Exchange, the Main Board of the Shenzhen Stock Exchange, the ChiNext Market, the STAR Market, and the A-shares listed in Beijing Stock Exchange, in

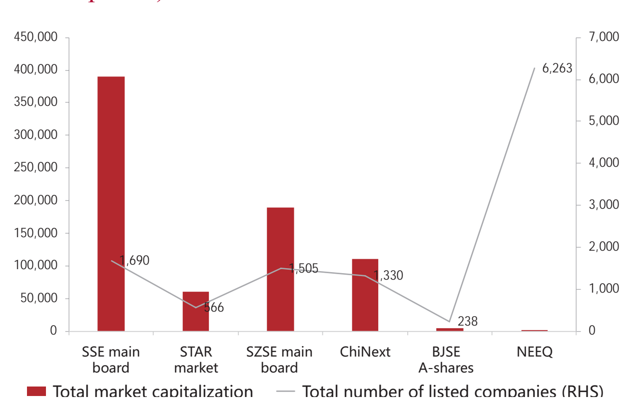
addition to the NEEQ (New Third Board). There are 5,340 listed companies with a total market value of approximately RMB 76 trillion. In particular, in the Main Board of the Shanghai Stock Exchange, the Main Board of the Shenzhen Stock Exchange, the ChiNext Market, the STAR Market and the Beijing Stock Exchange, there are 1,690, 1,505, 1,330, 566, and 238 listed companies respectively, with market values of RMB 39 trillion yuan, RMB 19 trillion yuan, RMB 11 trillion, RMB 6 trillion and RMB 0.44 trillion, respectively. There are 6,263 companies listed on the NEEQ, with a total equity capital of RMB 267.2 billion. In particular, 1,883 companies are listed at the innovation level, and 4,380 companies are listed at the basic level, with equity capital reaching RMB 98.7 billion and RMB 168.5 billion, respectively. As such, China has already established a multi-tiered capital market, ranking second in the world in terms of both the number of listed companies and the market value. It's fair to say that China has made world-renowned achievements in the development of its capital market.

Figure 102. Total Number and Market Capitalization of Listed Companies in China throughout the Years (RMB 100 million, number of companies)



Data sources: Wind and BOC Investment Strategy Research Center

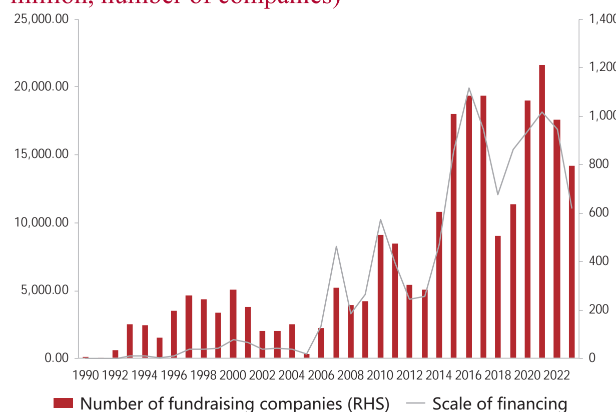
Figure 103. Number and Scale of Listed Companies by Major Stock Exchanges (RMB 100 million, number of companies)



Data sources: Wind and BOC Investment Strategy Research Center

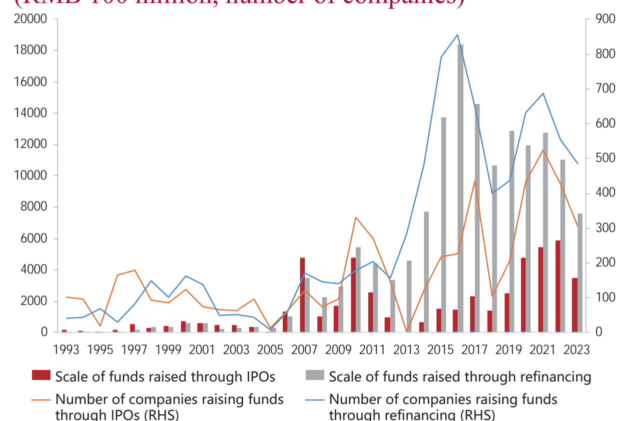
From a financing perspective, China's IPO system has evolved from the original review-based system and the approval-based system into the establishment of the STAR market on the Shanghai Stock Exchange in 2018 as well as the pilot implementation of the registration-based system, before transitioning into the full implementation of the registration-based system in 2023. China's stock markets have provided financing for 5,329 IPOs (initial public offerings) of listed companies, raising a total of RMB 5.1209 trillion. These markets provided channels of refinancing for 8,284 times for the listed companies, raising a total of RMB 15.2412 trillion. In a nutshell, China's capital market has financed a total of RMB 20.3621

Figure 104. Number of Fundraising Companies and Scale of Financing throughout the Years (RMB 100 million, number of companies)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 105. Number of Fundraising Companies and Scale of IPOs and Refinancing throughout the Years (RMB 100 million, number of companies)



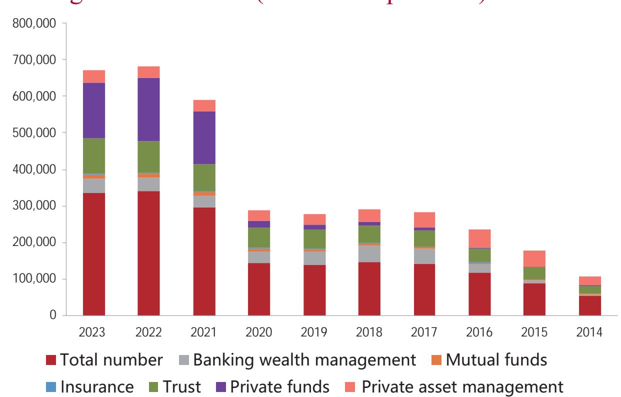
Data sources: Wind and BOC Investment Strategy Research Center

trillion for listed companies, making it a financing champion at a global scale during the same period. During the five years since the pilot registration-based IPO system was launched, the number of A-share listed companies has increased from more than 3,500 to the current number of more than 5,300. On average, about 1.6 companies are listed on each trading day. The rapid development of China's capital market is unprecedented around the world.

For more than three decades, the capital market has served national strategic goals in different historical periods, including but not limited to: providing relief to state-owned enterprises (SOEs); promoting the reform of SOEs; enhancing the scientific and technological security; and facilitating breakthroughs in stranglehold projects, among other national strategies. Moreover, the capital market has managed to guide factor resources to gather in key areas, accelerate the transformation of scientific and technological achievements, and promote the development of enterprises. As a result, numerous world-leading industrial champion enterprises and little giants in domestic subdivided industries have been established. Taking the STAR market as an example. 562 companies have been listed in the STAR market over the five years since its launch, and the total amount of IPO financing has exceeded RMB 1 trillion yuan, with the total market value exceeding RMB 6 trillion. A market ecosystem that supports technological innovation has been initially set up. In just over three decades, China's capital market has gone through a journey that took a century for Western developed countries, and has become the base of China's economy and the pioneer in industrial upgrading. In developing the capital market, China has made world-renowned achievements with the Chinese speed.

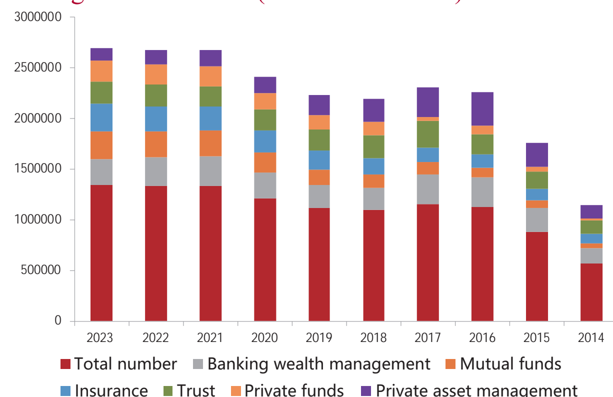
Second, the wealth management market has grown and thrived from scratch, and the number and scale of investment products has increased. The growth of China's stock markets has provided the capital market with a wide variety of high-quality assets. Accordingly, there have been an increasing number of asset management institutions, investment products and investors. The wealth management market has been established with gradually enhanced ecosystem and world-leading development potential.

Figure 106. Number of Varying Sorts of Asset Management Products (Number of products)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 107. Scale of Varying Sorts of Asset Management Products (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

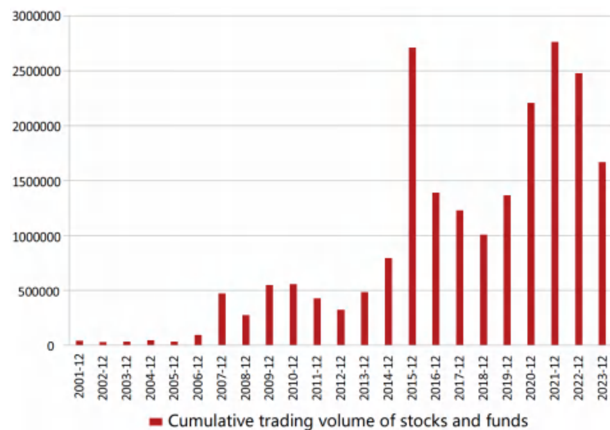
Notes: The data on the scale of mutual funds is as of December 21, 2023. The data on the scale of banking wealth management products is based on the statistics of the Wealth Management Market Report released in the ChinaWealth Website, and the data is as of December 30, 2023. The data on the scale of insurance is based on the fund usage balance shown in the Statistical Table on the Insurance Industry Operation released by the NAFR, and the data is as of October 31, 2023. The data on the scale of trust products is based on statistics released by the China Trustee Association, and the data is as of June 30, 2023. The data on the scale of private funds and private asset management is based on the statistics released by the Asset Management Association of China, and the data is as of October 31, 2023.

At present, China has established six major asset management sectors, namely, banking wealth management, public funds, insurance, trusts, private equity funds and private equity management. The total number of asset management products has reached 334,900, and the total volume of assets under management (AUM) has reached RMB 149 trillion. Over the past decade, the total number of asset management products and the AUM increased by 6.22 times and 2.36 times annually. In particular, the private equity funds has grown at the fastest pace, and the number of products and the volume of AUM surged by 143.84 times and 13.78 times respectively. The speed of development is unprecedented. As such, China is undoubtedly the second largest market of wealth management around the world.

The penetration rate of asset management products has been increasing year by year. There is a vast number of investors, and the wealth management market is closely related to the common prosperity of people from all walks of life. As of June

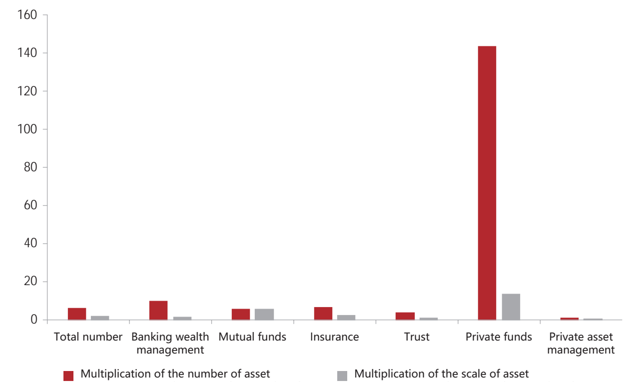
2023, there were about 220 million stock accounts and 104 million financial product customers nationwide. According to the Asset Management Association of China, the number of fund accounts as of the end of 2020 reached 3.872 billion (number of non-fund investors). At present, we are able to get a glimpse of the number of investors in the three main types of asset management products. Nevertheless, if we take into account the indirect participation in the capital market through social security funds and personal pensions, investors in the wealth management market would cover almost all households and the vast majority of citizens. Hence, the performance of the capital market is closely related to the property income of the public, and the people's nature of the capital market has been evidently shown.

Figure 108. Total Trading Volume throughout the Years (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 109. Multiplication of the Number and Scale of Asset Management Products over the Past Decade (Times)



Data sources: Wind and BOC Investment Strategy Research Center

Third, the trading system and products have evolved ahead of schedule, and were linked with developed markets in advance. From the trading side, the Shanghai Stock Exchange and the Shenzhen Stock Exchange are ranked the fourth and sixth largest stock exchanges around the world by market capitalization respectively, with a total trading volume of RMB 2,095 trillion yuan over the past three decades. These exchanges have provided investors with a wide variety of investment targets, and offered ample liquidity support to asset management products. Moreover, they have created huge income for the asset management industry, and generated a large amount of tax revenue for the country. During the period from the year 2001 for which data is available, to August 2023, the amount of stamp tax withheld from transactions reached RMB 2.24 trillion in less than 23 years, bolstering China's economic development to a significant extent.

With respect to trading products, the market trading products have evolved rapidly. Securities trading, commodity trading and derivatives exchanges are all available to investors. The major asset categories available in the stock exchanges cover stocks, bonds, convertible bonds, and REITs. Stocks include A-shares, B-shares and H-shares. Derivatives include stock index futures, options and individual stock options. As can be seen, China's capital market has been fully integrated with the international capital market in terms of stock index futures, options, margin trading and quantitative trading, etc., and the trading system has evolved ahead of schedule.

3.1.1.2 Thoughts on the A-share market over the past three decades

Although the market has made world-renowned progress on the financing, investment and trading, it is faced with the challenge of being big but not strong. In addition, certain structural issues that have caused the stock market index to "struggle at the bottom" for many years (for instance, the SSE Composite Index exceeded 3,000 points for the first time in 2006, and is still fluctuating at 3,000 points seventeen years later). Consequently, the market lacks a wealth effect, and investors have a weak sense of gain. As such, the ecosystem of China's stock markets is not healthy enough, and there are still areas awaiting further improvement.

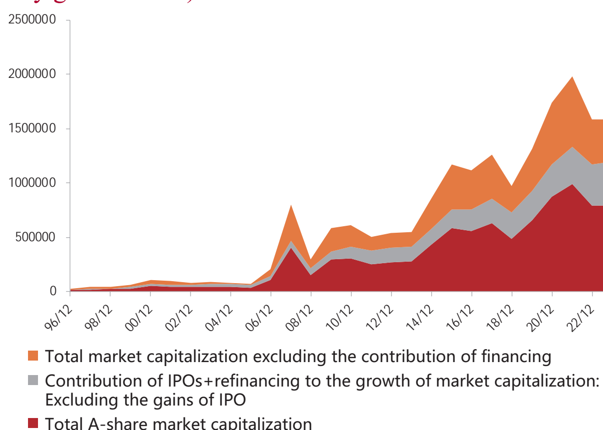
First, the stock market has deviated from economic fundamentals for a long time, and is not regarded as an economic barometer. We collected data on the movements of A-shares and GDP growth over the past three decades, and conducted the correlation analysis. As a result, we found that the correlation coefficient between economic growth and the stock price

movements reached only 0.28. This finding did not support our hypothesis that the stock market could serve as an economic barometer. From the perspective of total GDP and total stock market value, after more than three decades of development, the growth slope of total GDP growth and the total market value of stocks are relatively consistent at first glance. However, in the total market capitalization of stocks, the market value growth directly contributed by financing funds over the years accounted for a fairly high proportion, with an average of 39.7%. On the other hand, the contribution from the increase in market value over the years amounted to only 60.30% on average.

Figure 110. China's Total GDP and Total Stock Market Capitalization (RMB 100 million)

Data sources: Wind and BOC Investment Strategy Research Center

Figure 111. China's Total Stock Market Capitalization and Contribution of Financing to the Market Capitalization (RMB 100 million) (Excluding the first-day gains in IPO)



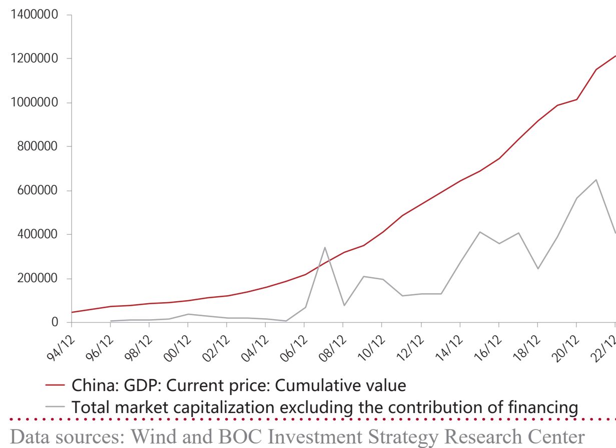
Data sources: Wind and BOC Investment Strategy Research Center

Over the past three decades, the cumulative financing amount of stock market IPO and refinancing has reached RMB 20.36 trillion. In particular, the IPO financing has reached RMB 5.12 trillion. Given that IPO accounts for 20% of the total equity on average (large IPOs account for less than 20%), it is estimated that IPO alone can contribute RMB 25.6 trillion to total equity even on a conservative basis (calculated based on IPO issue price). Based on the weighted average increase of 91% on the first day of IPO over the years, the market value contributed by IPO over the years has reached nearly RMB 48.9 trillion. If the refinancing amount of RMB 15.24 trillion is added, then IPOs + refinancing contributed a market value of more than RMB 64 trillion. According to the above calculation, the market value growth brought about by the rise of the stock market would less than RMB 15 trillion over the past three decades. If the retained profits of listed companies of about RMB 29.02 trillion are included, the actual market value growth brought about by the stock market rise by the end of 2022 would be around RMB -10 trillion yuan, whereas the added value of GDP during this period exceeded RMB 110 trillion. As can be seen, the market capitalization growth rate of the stock market was far lower than the GDP growth rate, and the stock market did not fully reflect the ups and downs of the economic growth. For the sake of caution, in Figure 112 we only use (IPO financing amount * 5 + refinancing amount) to measure the market value brought by financing. After deducting the market value brought by financing, the total market value (market value derived from three decades of stock market rises) already had a high slope deviation from the trend of GDP growth.

In Figure 113, we calculate the market capitalization growth derived from the rise in the stock market after deducting (IPO financing amount * 5 * 191% + refinancing amount + retained profits of listed companies over the years), and found that there have been ten years including 2023 when annual stock market rose but the market capitalization contribution remained negative. By rough estimate, the negative contribution to market capitalization reached more than RMB 10 trillion in 2023. From this perspective, we may also conclude that economic growth has a low correlation with the growth of market capitalization, which is worthy of reflections.

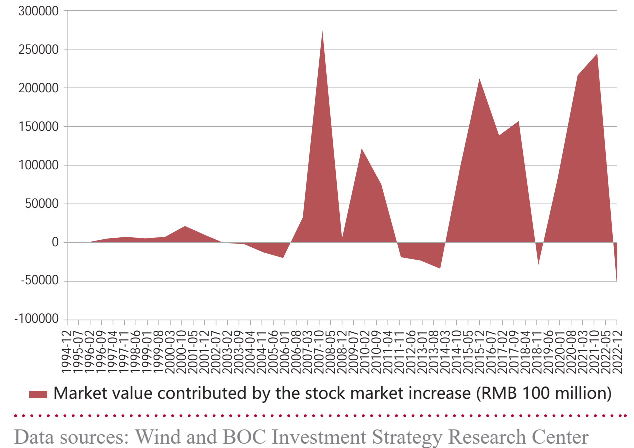
Second, the focus of the capital market is placed on financing instead of investor returns, and the positive interaction between investment and financing has yet to be formed. With respect to the returns on investment in China's stock markets, they are partly reflected in the dividends paid by listed companies, and partly reflected in the capital gains brought by the rise in the stock market.

Figure 112. China's Total GDP and Total Market Capitalization Excluding the Contribution of Financing (RMB 100 million) (Excluding the first-day gains in IPO)



Data sources: Wind and BOC Investment Strategy Research Center

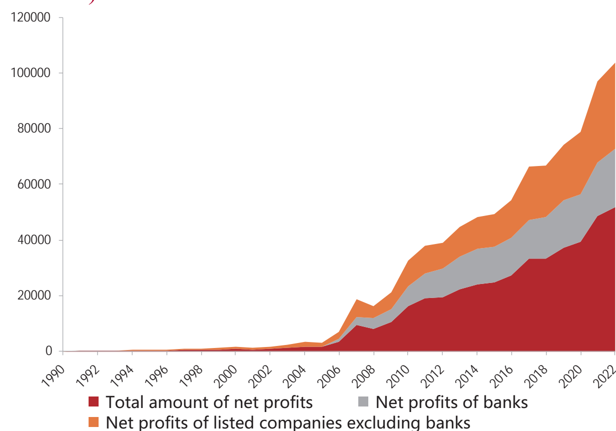
Figure 113. Contribution of Stock Market Rally to the Market Capitalization throughout the Years (RMB 100 million) (Including the first-day gains in IPO and undistributed profits over the years)



Data sources: Wind and BOC Investment Strategy Research Center

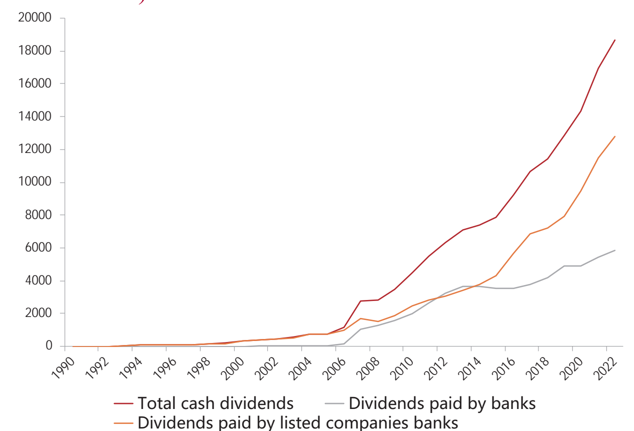
Looking at the dividends alone, the total amount of dividends paid by listed companies in the stock markets depends on three factors, namely, 1) The proportion of companies participating in cash dividends among all listed companies; 2) The dividend-paying capacity of listed companies engaged in cash dividend payments, or the total net profits; 3) The proportion of dividend payments, or the weighted average proportion of dividend amount to the net profits of listed companies. Over the past three decades, the total net profits of listed companies in China's stock markets have reached RMB 43.7 trillion. In particular, the total cash dividends have reached RMB 14.68 trillion. The total cash dividends accounted for an average of 33.59% of the total net profits. Since 2017, against the backdrop of regulatory calls for cash dividend payments, the proportion of cash dividends paid by listed companies in their total net profits has exceeded the historical average, and has been increasing year by year, reaching a level of 36.05% in 2022. Since 2000, the average proportion of companies engaged in cash dividend payments among Wind All Share companies has reached 62.49%, and the average dividend payout ratio has reached 1.78% (total cash dividends for the year / total market value at the end of the year). Over the past five years, the average proportion of companies engaged in cash dividend payments has increased to 68.73%, with an average dividend payout ratio of 2.17%. Nevertheless, there is still room for improvement in terms of the proportion of China's listed companies engaged in cash dividend payments and the proportion of cash dividends in net profits. There is still a long way to go for investors to achieve stable cash returns through cash dividends.

Figure 114. Total Amount and Structure of Net Profits of Listed Companies throughout the Years (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

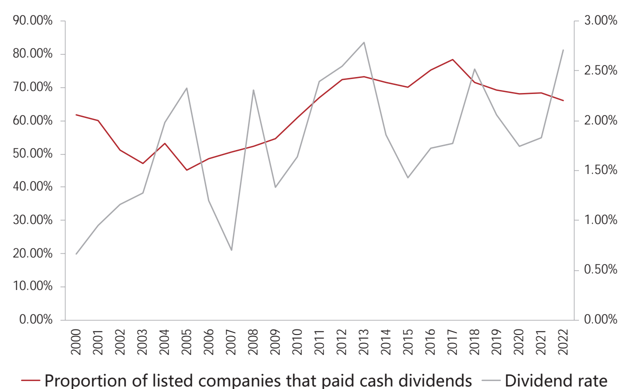
Figure 115. Total Amount and Structure of Dividends Paid by Listed Companies throughout the Years (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

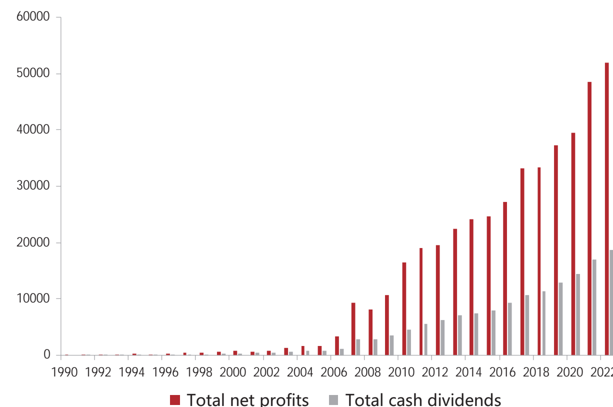
Looking at the capital gains brought about by the stock market rally alone, the capital gains in the Chinese stock markets have been relatively small over the past three decades, and their contribution to the total market capitalization is likely to be less than 30%. The main reason is the pressure to reduce holdings caused by the large scale of stock supply, and the severe imbalance between supply and demand. In China's stock markets, large-scale shareholding reductions all took place during the full circulation era subsequent to the split-share structure reform in 2007. Over the past 17 years, major shareholders have reduced their holdings by a total of RMB 4.46 trillion, with an average annual reduction of RMB 262 billion. If the amount of shareholding reduction by small and medium-sized shareholders is also added into calculation, then the total amount of shareholding reduction is expected to more than double. Especially during the period from 2020 to 2021, the average amount of important shareholder reductions reached as high as RMB 602.5 billion. Cases of shareholding reductions through divorce and other events led to market disturbance, and given that the lifeblood is drawn from the market, the stock market and investor confidence have suffered from a huge negative impact. On the contrary, with respect to the share repurchase by listed repurchases, there have been only 14 years since 2000 when there have been announcements of share repurchases, with a cumulative amount of repurchase reaching RMB 572.2 billion (without excluding repurchase plans that were eventually uncompleted). The average repurchase amount reached only RMB 40.9 billion, and the average repurchase amount over the past five years reached RMB 101.5 billion. Compared with the huge reduction in holdings during the same period, the amount of buybacks is a drop in the bucket, which is another reason contributing to the lack of market confidence over the recent years.

Figure 116. Proportion of Listed Companies That Paid Cash Dividends and Total Market Dividend Rate since 2000 (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

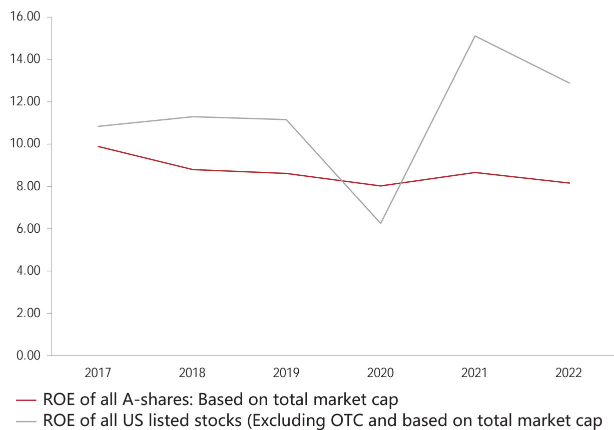
Figure 117. Total Net Profits Versus Total Cash Dividends of Listed Companies throughout the Years (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

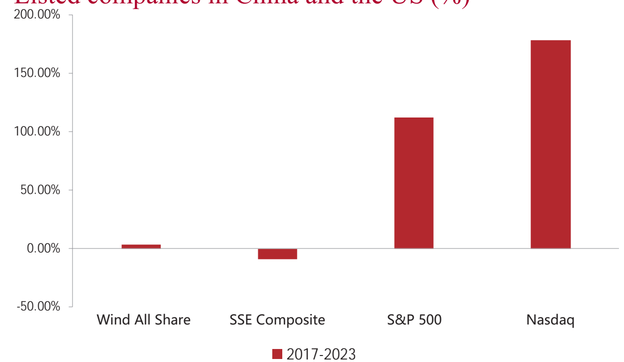
Third, the quality of the development of listed companies is not high, and the exit mechanism is not well established. The incomplete exit mechanism for listed companies allows a large number of low-quality listed companies to stay in the market, thus lowering the overall profitability of the market and undermining the growth of the stock index. To analyze the factors contributing to the divergence of trends between the Chinese and US stock markets over the recent years, the ROE of listed companies can be seen as a good explanatory indicator. Since 2017, the ROE of Chinese listed companies has been evidently lower than that of US listed companies (except for 2020). During this period, the Wind All Share and SSE Composite Index grew by 3.30% and -9.04% respectively, whereas the US S&P 500 Index and the Nasdaq Index rose by 112.37% and 178.50% respectively. The profitability of listed companies is the cornerstone of rising stock indexes. Hence, improving the quality of listed companies is a method of facilitating the "high-quality development" to increase the total market value of the stock market. In contrast, promoting the increase in total market value through expansion alone often leads to short-term prosperity of the market with speed of growth instead of quality.

Figure 118. Comparison of ROE between Listed Companies in China and the US (%)



Data sources: Wind and BOC Investment Strategy Research Center

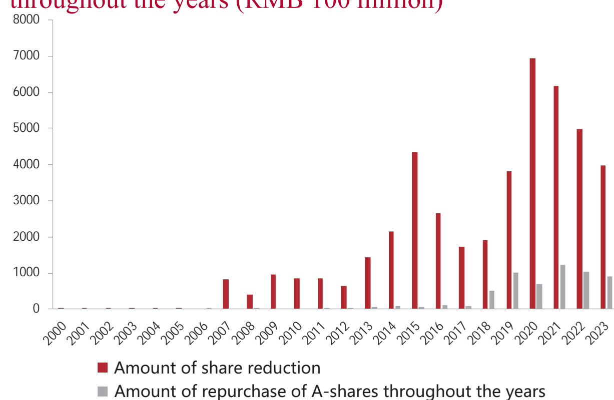
Figure 119. Stock Index Movements Corresponding to the Strengthening and Weakening Stages of ROE of Listed companies in China and the US (%)



Data sources: Wind and BOC Investment Strategy Research Center

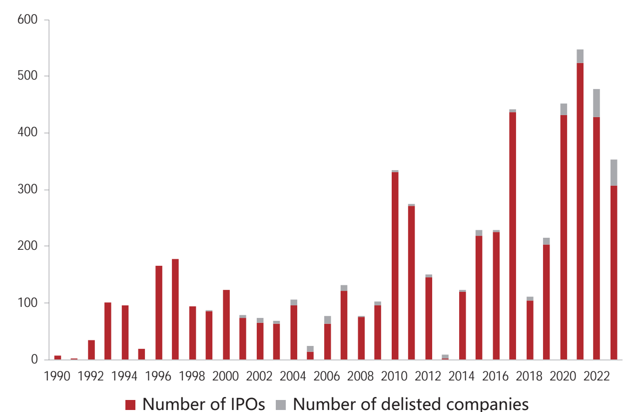
The low ROE level of listed companies is closely linked with unsmooth procedures of delisting. Over the past three decades, a total of 5,329 companies have been listed through IPO, but the cumulative number of delisted companies is only 267, with a delisting rate of merely 5%. In the initial decade subsequent to the start of China's stock markets, there were 784 listed companies and only one delisted company. In the second decade, there were 795 listed companies and 70 delisted companies. In the third decade, there were 2,059 listed companies and 56 delisted companies. Judging from data, over the recent years, the number of delisted companies has increased due to their poor performance as well as violations of laws and regulations. However, investor protection during delisting was not well guaranteed. As a result, major shareholders just simply exited from the market (with low cost), whereas minority shareholders were collectively punished to foot the bill for major shareholders. In addition, the quality of information disclosure by listed companies is unsatisfactory. From time to time, the market suffered from a negative impact of illegal and even criminal acts including insider trading, false information, illegal reduction of shares, misappropriation of funds by major shareholders and collusion to manipulate the market. Supervision and punishment for such acts are not stringent enough. Due to low costs of misbehavior, similar acts repeatedly take place.

Figure 120. Amount of Share Reduction and Repurchase of Vital Shareholders of Listed Companies throughout the years (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 121. Number of IPOs and Delisted Companies throughout the Years (Number of companies)

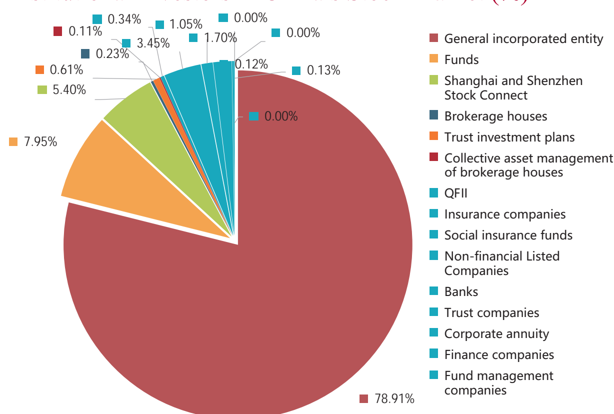


Data sources: Wind and BOC Investment Strategy Research Center

Fourth, there is a lack of consciousness for long-term and value-based investment, nor are stable funds in place to guide the market's expectations. Compared with the consistent and large-scale growth in the number of listed companies and financing scale, the market value of the stock market reached RMB 89 trillion (as of June 2022). The market value held by institutional investors reached RMB 39.44 trillion, accounting for 44.31%. Moreover, the vast majority of these stocks were held by general legal persons (due to the need for control), with a market value of RMB 31.11 trillion, accounting for 34.96%. In addition to general legal persons, the total stock market value held by other institutional investors reached RMB 8.32 trillion, accounting for 10.3% of the total market value. Among institutional investors, the top institutions holding A-shares in terms of market capitalization are public funds, Shanghai and Shenzhen Stock Connect (foreign capital), insurance, non-financial listed companies and social security funds, with shareholding amounts of RMB 3.14 trillion, RMB 2.13 trillion, RMB 1.36 trillion, RMB 0.67 trillion yuan and RMB 0.41 trillion, respectively. The scale of public funds and foreign capital are subject to the impact of customer subscription and redemption, and the stability of funds is rather worse in the near term. Nevertheless, the scale of patient funds and smart funds recognized in mature capital markets, such as social security, corporate annuities, and insurance funds, remains at a relatively small scale. Given that the proportion of long-term funds is lower than that in the US, the market funds are less capable of stabilizing and leading the market's expectations.

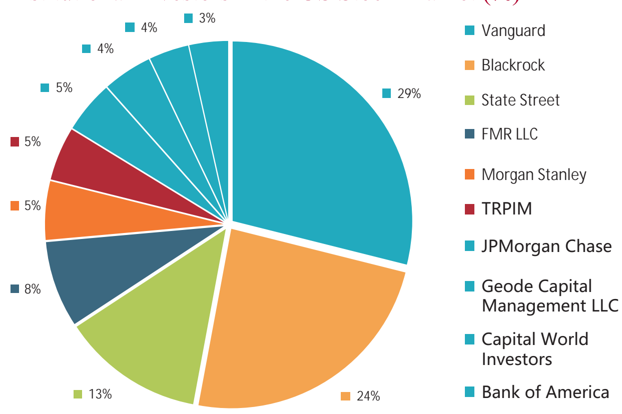
In the US stock market, the market value of institutional investors reached USD 33.46 trillion, accounting for 52.48% of the total market value (USD 63.75 trillion). In particular, the top ten institutions hold shares with a market value of USD 135,100, and the concentration of institutional shareholdings reach a level as high as 40.37%. These institutions are all asset management institutions and banks, and the primary sources of funds are long-term funds including social security and pension insurance.

Figure 122. Proportion of the Value of Stocks Held by Institutional Investors in China's Stock Market (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 123. Proportion of the Value of Stocks Held by Institutional Investors in the US Stock Market (%)



Data sources: Wind and BOC Investment Strategy Research Center

3.1.2 Looking forward: Undertaking the mission and responsibility of improving capital markets while building a strong financial sector

3.1.2.1 The new positioning of China's capital market

According to the Central Financial Work Conference, finance is the lifeblood of the national economy and an important part of the country's core competitiveness. The meeting called for accelerating efforts to build up China's financial strength, strengthen financial regulation, improve the financial system, optimize financial services, and forestall and resolve risks. In addition, China will remain committed to the path of financial development with Chinese characteristics and boost the high-quality development of the financial sector, so as to provide strong support for enhancing China's strength and advancing the great rejuvenation of the Chinese nation through a Chinese path to modernization.

According to the meeting, promoting high-quality development is the primary task of building a modern socialist country in all respects. In this regard, finance should provide high-quality services for economic and social development. China aims to create a sound monetary and financial environment, while stepping up quality financial services for major strategies, key areas and weak links. It will also maintain a prudent monetary policy, and pay closer attention to cross-cyclical and counter-cyclical adjustments, and enrich the toolbox of monetary policy. Moreover, efforts will be made to optimize the structure of fund supply, channel more financial resources into promoting technological innovation, advanced manufacturing and

green development. China is also committed to supporting small, medium-sized, and micro enterprises, facilitating the implementation of the innovation-driven development strategy, and coordinated regional development strategy, and ensuring national food and energy security. It is essential to activate financial resources that are inefficiently utilized and improve the efficiency of fund utilization. China will also make significant efforts in the areas of technology finance, green finance, inclusive finance, pension finance, and digital finance. It is essential to build modern financial institutions and a modern market system, and clear up channels for funds to enter the real economy. It is equally important to optimize the financing structure, give full play to the pivotal role of the capital market, advance the registration-based IPO system, develop diversified equity financing, significantly improve the quality of listed companies, and cultivate first-class investment banks and institutions. We should promote the high-quality development of the bond market. It is essential to improve institutional positioning, support large state-owned financial institutions in becoming stronger and better, playing a major role in serving the real economy, and being a cornerstone for financial stability. Strict admission standards and regulatory requirements for small and medium-sized financial institutions must be enforced, and their operation should be based locally with their own distinctions. The functional positioning of policy-based financial institutions should be strengthened, and the insurance industry as an economic shock absorber and stabilizer for social harmony should be given full play. China is also dedicated to promoting the high-quality development of the bond market.

As can be seen, better playing the pivotal role of the capital market is the new positioning specified by the central government in the new era.

3.1.2.2 China's capital market has huge potential for building the financial strength

First, China's capitalization rate still has great room for improvement. Compared with international financial powers, China's capitalization rate still has ample room for further progress. There are more than 5,300 listed companies in China with a market value of nearly RMB 80 trillion, but China's capitalization rate has merely reached 70%, a huge gap from the capitalization rate of 247% of traditional financial powers like the US. Compared with other domestic financial sectors, the proportion of direct financing in China's stock market also has room for improvement. At present, China's financial market is still dominated by indirect financing from banks. From 2020 to 2022, the loan balance amounted to RMB 172.75 trillion, RMB 192.69 trillion and RMB 213.99 trillion respectively. The three-year average of newly-issued loans amounted to RMB 20.10 trillion, which was 11.62 times of the financing amount of "IPO+ refinancing" in the stock market that reached RMB 1.73 trillion during the same period. From this perspective, although the scale of stock market financing has been utterly high relative to the returns given to investors by the market, it is still low compared with the scale of bank loans. In case that investment and financing are able to achieve coordinated development, then direct financing including stock financing will still have large room for improvement. In China, the proportion of financial assets in the asset allocation of Chinese households is too low, and the capital market has considerable potential funds. China's residential savings rate is generally higher than that of traditional financial powers like the US. In 2022, the RMB deposits of resident increased by RMB 17.84 trillion in 2022, and rose by another RMB 14.42 in the first three quarters of 2023. This is attributable to several factors, including: the willingness of residents to increase precautionary savings after 2020; the reduction in fund demands for the purposes of home purchases after the proposal that "housing is for living in, not for speculation"; the impact of poor stock market performance; and the inflow of deposits after funds lack the money-making effects in wealth management. According to the experience of traditional financial powers, 16% of the disposable income of residents originate from property income, but China's current level of 4% remains low. As interest rates continue to fall and interest income decreases, it is necessary to strengthen investor protection and enhance the returns of the capital market through the development of reasonable systems and mechanisms, so as to guide savings to flow into the capital market and ultimately build a strong financial sector.

Next, the capital market is expected to play an indispensable role in economic transformation and high-quality development. The Central Financial Work Conference proposed that high-quality development is the primary task of building a modern socialist country in all respects. To build a strong financial sector, China must propel the development of technology finance, green finance, inclusive finance, pension finance and digital finance. The capital market has unique advantages in fulfilling the aforementioned goals. First, the capital market is highly transparent, and has sensitive price signals, providing crucial channels for policy transmission and resource allocation. Second, the capital market has the characteristics of sharing both risks and benefits, which can promote the improvement of corporate governance and effectively stimulate social innovation, creativity and entrepreneurship. Third, the capital market is endowed with the function of optimizing the financing structure, which will help stabilize the macro-leverage ratio. Fourth, the capital market covers a wide variety of investment and financing products

available in the markets or over the counter, including stocks, bonds and futures, so as to meet the diversified financial needs of the real economy and investors.

Last but not least, by improving the system of investment, financing and trading, China is able to restore the function of the stock market as a barometer for the economy. Over the past three decades or so, numerous factors have deprived the capital market of the capacity to fully reflect the prosperity of the economy, including but not limited to: unbalanced investment and financing structure that "focuses on financing and neglects investment just like killing the goose that lays the golden eggs"; insufficient investor protection and "cyclical rug-pull"; certain listed companies are accustomed to capital operations while making inadequate efforts to build up their strength; the quality of information disclosure by listed companies is unsatisfactory; asset management agencies may violate their fiduciary obligations; and the design of the trading system is unfair. Numerous factors in the financing, investment and trading aspects need to be improved, which could explain why China's stock market is still not mature enough in its thirtieth anniversary. Nevertheless, it shall be noted that the aforementioned situation is undergoing changes. Moving forward, China will gradually improve the system of investment, financing and trading, and restore the function of the stock market as a barometer for the economy.

3.1.3 Based on the status-quo: Positioning of the A-share market is recalibrated to bolster confidence for the stock market to rise again

3.1.3.1 Strategic positioning: Positioning of the A-share market has been recalibrated, and measures of activating the market are expected to bolster confidence

Based on the insights on the development of China's stock market over the past three decades, the Chinese society has conducted numerous useful discussions on the positioning of the capital market, and relevant authorities have also organized varying symposiums to consult the opinions of people. The Central Financial Work Conference held in November emphasized the need to speed up the development of a strong financial sector, and better play the role of pivot of the capital market, which is the new positioning given by the central government in the new era. Faced with the current issues of weak investor expectations and lack of confidence, the Politburo meeting held on July 24, 2023 proposed to "activate the capital market and boost the investor confidence", which is a new goal of development based on the new positioning of the capital market.

Against the backdrop of the new positioning of the capital market, the Political Bureau has put forward sincere expectations for "activating the capital market and boosting investor confidence", which is in line with the expectations of the majority of investors (people from all walks of life) for the stock market. It is also a new historical mission for the Chinese stock market in the new era. It is gratifying that the authority is taking action around the new positioning and goals. The CSRC put forward specific work plans in conveying the spirit of the Central Financial Work Conference: First, promoting the in-depth and practical implementation of the registration-based IPO system. It is recommended to adhere to the concept of information disclosure as the core, uphold the basic structure of the registration-based system, and increase support for key areas such as high-level sci-tech self-reliance and modernization of industrial systems. Greater efforts will be made to promote investment-side reforms, attract an increasing inflow of mid-to long-term funds into the market, and optimize institutional arrangements such as IPO pricing, refinancing, and shareholding reduction, so as to facilitate the dynamic balance of investment and financing. Second, improving the system of multi-tiered capital market. Efforts will be made to proactively develop a diversified mechanism of equity financing; abide by the positioning of each exchanges, support the building of Shanghai and Shenzhen Stock Exchanges into world-class stock exchanges; improve the quality development of the Beijing Stock Exchange; encourage the innovation of the New Third Board and regional equity markets; better leverage the role of private equity and venture capital funds; further enhance the multi-tiered capital market structure. In addition, China intends to promote the high-quality development of the bond market and facilitate the expansion and quality improvement of the real estate investment trust funds (REITs) sector. It is also necessary to develop futures and derivatives markets in a prudent and orderly manner so as to help increase the influence of commodity prices. Third, measures will be taken to improve the quality of listed companies. The function of"barometer" function of the capital market is mainly reflected through listed companies. In 2023, more than 5,000 listed companies achieved an added value of over RMB 18.23 trillion, accounting for 15.1% of GDP, and their R&D investment accounted for 50% of the national R&D expenditure. China will promote the implementation of a new three-year action plan to improve the quality of listed companies, and speed up the improvement of corporate governance with Chinese characteristics. Efforts will be made to optimize mergers and acquisitions, equity incentives, dividends and other institutional arrangements; improve the normalized delisting mechanism; supervise listed companies to improve governance

and operate with integrity; support more listed companies to grow and thrive; and facilitate collaboration among upstream and downstream industrial and supply chains, as well as small, medium and large-sized enterprises, so as to lay a solid foundation for the high-quality economic development. Fourth, the authority aims to promote high-level institutional opening up of the capital market. Efforts will be made to coordinate opening and security; steadily promote the all-round opening of markets, institutions, and businesses; deepen and expand interconnection; facilitate cross-border investment and financing; and strengthen the development of regulatory capabilities during the opening-up.

Figure 124. Recent Policies and Measures on the Financing, Investment and Trading in the Capital Market

Types of Measures	No.	Date	Authority	Specific Measures
Investment	1	August 27, 2023	CSRC	Easing the registration conditions for index funds, enhancing the efficiency of index fund development, and encouraging fund managers to increase innovation of product development.
	2	August 27, 2023	CSRC	Guiding pioneering mutual fund companies to increase the proportion of equity funds issued, and promoting the enhancement of total amount and optimization of structure of mutual funds.
	3	August 27, 2023	CSRC	Promoting the full implementation of mutual fund fee rate reform and reducing management fee rate.
	4	August 27, 2023	CSRC	Guiding mutual fund managers to increase self-purchase of their respective equity funds.
	5	August 27, 2023	CSRC	Establishing an incentive and constraint mechanism for mutual fund managers to reduce pro-cyclical resonance.
	6	August 27, 2023	CSRC	Broadening the scope of investment and strategies of public funds, and easing the investment restrictions on mutual funds investing in stock index options, stock index futures, treasury bond futures and other varieties.
	7	August 15, 2023	PBOC	Lowering the interest rates on deposits.
	8	August 28, 2023	PBOC	Lowering the personal income tax.
	9	August 31, 2023	PBOC	Lowering the interest rates for both existing and new mortgages
	10	September 14, 2023	PBOC	Cutting reserve requirement by 0.25% to 7.4%
	11	October 11, 2023	Central Huijin	Increasing the investment in the shares of four major state-owned commercial banks
	12	October 23, 2023	Central Huijin	Increasing the investment in the ETFs

Types of Measures	No.	Date	Authority	Specific Measures
Trading	13	August 27, 2023	CSRC	Reducing the stamp duty rate for securities trading from a unilateral levy on sellers based on 1‰ of the amount of stock trading to a levy of 0.5‰
	14	August 27, 2023	CSRC	Reducing the handling fee for securities trading and lowering the commission rates for securities companies at the same time
	15	August 27, 2023	CSRC	Expanding the scope of margin trading and securities lending targets, reducing margin trading and securities lending rates, and including the ETFs as refinancing targets
	16	August 27, 2023	CSRC	Improving the share reduction system, strengthening supervision of share reductions that are illegal or in disguise, and imposing severe punishments on illegal share reductions
	17	August 27, 2023	CSRC	Optimizing the supervision on trading, enhancing the convenience and smoothness of trading, and improving the transparency of trading supervision; launching a programmatic transaction reporting system in a timely manner
	18	August 27, 2023	CSRC	Pondering over ways to properly extend the trading hours of the A-share market and the exchange bond market to better meet investment and trading needs
	19	November 17, 2023	CSRC	Cracking down on the avoidance of regulatory oversight through derivatives
Financing / Quality of Listed Companies	20	August 27, 2023	CSRC	Listed real estate companies are exempt from restrictions of refinancing under circumstances where the stock of a listed company trades below the offering price or book value of the stock, or that the listed company encounters losses
	21	August 27, 2023	CSRC	Formulating and implementing an action plan for improving capital market services to facilitate sci-tech self-reliance and self-strengthening at higher levels; establishing and improving the "green channels" for listing, financing, bond issuance, mergers and acquisitions as well as reorganization of technology-based companies that have made breakthroughs in core technologies
	22	August 27, 2023	CSRC	Strengthening the orientation of dividend payments and promoting the improvement of the stability, sustainable growth and predictability of dividends of listed companies, especially large-capitalization companies; elaborating on ways to improve the systematic long-term dividend restriction mechanism; guiding listed companies with stable operating cash flows to pay dividends in the medium term and strengthening information disclosure constraints on low-dividend-paying companies, so as to enable investors to share the dividends of listed companies to a greater extent and at an earlier time
	23	August 27, 2023	CSRC	Revising the rules of the share repurchase system, easing relevant repurchase conditions, and supporting listed companies in carrying out share repurchases
	24	August 27, 2023	CSRC	Deepening the market-oriented reform of mergers, acquisitions and reorganizations of listed companies; optimizing the mechanism of quick review of small-sized mergers and acquisitions, and properly increasing the inclusiveness of valuations for the restructuring of asset-light technology companies, and enriching the restructuring payment and financing instruments

Types of Measures	No.	Date	Authority	Specific Measures
Financing / Quality of Listed Companies	25	August 27, 2023	CSRC	Promoting the development of a valuation system with Chinese characteristics; supporting those superior companies while limiting those inferior ones, and elaborating on ways to restrict the financing activities of listed companies whose stocks trade below the offering price or book value of the stocks, and require these companies to propose plans to improve their market value
	26	August 27, 2023	CSRC	Coordinating the balance of primary and secondary markets; properly managing the pace of IPOs and refinancing, and improving the countercyclical adjustments in the primary and secondary markets; introducing pragmatic measures to support the high-quality development of the Beijing Stock Exchange, publicizing the "green light" approval cases for overseas listing of enterprises, and promoting the regular issuance of REITs
Activation of the vitality of market entities	27	August 27, 2023	CSRC	Abiding by the intensive, differentiated, functional and international development concept while building a high-quality investment bank; optimizing the computational standards for risk control indicators of securities companies, easing capital constraints on high-quality securities companies, and improving the efficiency of capital use
	28	August 27, 2023	CSRC	Implementing countercyclical adjustments for margin trading and securities lending, and elaborating on ways to reduce the margin ratio for on-site financing business on the premise that leverage risks are generally controllable
	29	August 28, 2023	CSRC	Raising the margin ratio for securities lending, and tightening the regulations on share lending for strategic investment and allotment in stages
	30	August 27, 2023	CSRC	Exploring ways to launch a series of financial futures options such as Shenzhen Stock Exchange 100 Stock Index futures options and CSI 1000 ETF options to better meet the risk management needs of investors; allowing more investment institutions both at home and abroad to use derivatives to manage risks on a prudent basis
	31	August 27, 2023	CSRC	Implementing differentiated regulatory policies, simplifying the registration and filing of high-quality PE venture capital funds, and promoting the pilot program of physical distribution of stocks by PE venture capital funds
	32	August 27, 2023	CSRC	Developing the stock index system and indexed investment with Chinese characteristics, and encouraging all types of funds to enter the market through indexed investment
	33	November 3, 2023	CSRC	Supporting brokerage houses to grow and thrive
Support of the development of the Hong Kong market	34	August 27, 2023	CSRC	Introducing a block trading mechanism into the Shanghai-Shenzhen-Hong Kong Stock Connect program
	35	August 27, 2023	CSRC	Optimizing the interconnection mechanism, expanding the scope of eligible entities for interconnection, and adding RMB stock trading counters to southbound trading
	36	August 27, 2023	CSRC	Introducing treasury bond futures and related A-share index options in Hong Kong
	37	August 27, 2023	CSRC	Supporting the dual listing of Chinese concept shares already listed in the US to be listed in Hong Kong

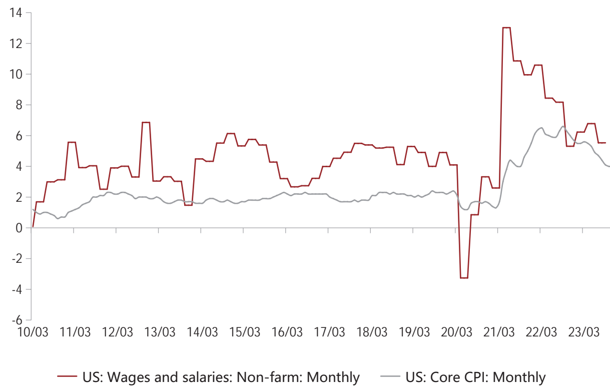
Types of Measures	No.	Date	Authority	Specific Measures
Others	38	August 27, 2023	CSRC	Promoting the optimization of capital market-related tax arrangements such as the timing of personal income tax payments for equity incentives of listed companies
	39	September 10, 2023	CSRC	Promoting the establishment and improvement of a long-term assessment mechanism for equity investments such as insurance funds, lowering the risk factors of insurance funds, and encouraging these funds to increase equity investments
	40	August 27, 2023	CSRC	Guiding and supporting the banking wealth management funds to engage in the stock market
	41	August 27, 2023	CSRC	Supporting more investors such as banking institutions to fully participate in the exchange bond market, among other measures
	42	2H, 2023	CPC Central Commission for Discipline Inspection	Stepping up anti-graft efforts in state-owned enterprises and the financial sector
	43	October 31, 2023	Central government	The financial work conference once again sent signals of activating the capital market
	44	November 3, 2023	Ministry of State Security	Warning is issued at the national security level against those who “hold shorting views”, “speak shorting voices” and “conduct shorting activities”
	45	October 24, 2023	State Council	Additional issuance of RMB 1 trillion of special treasury bonds

Data sources: Wind and BOC Investment Strategy Research Center

3.1.3.2 External environment: Hike of the cycle of USD interest rates is coming to an end, and global assets are ushering in greater opportunities

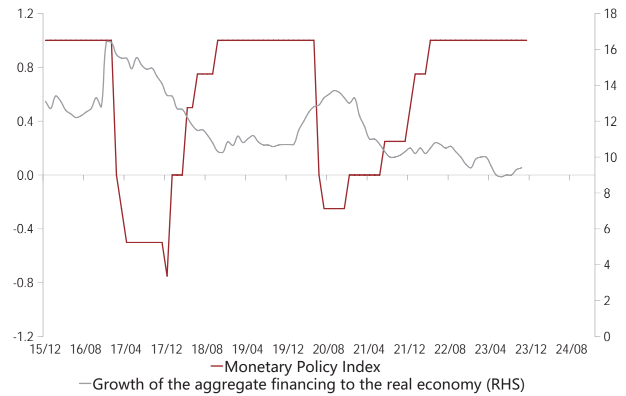
In 2024, the Fed’s cycle of monetary tightening is coming to an end, and the cycle of USD interest rate reductions is emerging on the horizon. As a result, global risk assets have ushered in a silver lining. China’s domestic monetary policy will remain relatively loose, and both internal and external liquidity environments of A-shares will improve. In 2023, the Fed’s policies of monetary tightening lasted longer than the market’s expectations, and will be the most crucial factor affecting the performance of global assets. In 2024, on the one hand, the Fed’s cycle of interest rate hikes is basically over, and major indicators such as the core CPI have shown evident signs of weakening. After the Fed suspended interest rate hikes for the third consecutive time in December 2023, it also conveyed a more dovish stance on future monetary policies. Although the market is still divided on when the Fed will start to cut interest rates in 2024, it is a rather certain event that the Fed’s cycle of rate hikes will end in 2024. The marginal easing of overseas monetary policies is expected to become the most crucial factor affecting the trend of major global asset categories in 2024. On the other hand, the endogenous growth momentum of domestic demand is still relatively insufficient. The downside risks in the real estate sector have yet to be completely defused, and China is still expected to maintain a rather loose monetary policy stance. At the same time, enhancing the fiscal strength will be the major tone in 2024, and easing monetary policy is expected to coordinate with the fiscal measures. Therefore, we believe that China’s monetary policy will be precise and effective in 2024, and there will be a policy package of “stable monetary policy with easing fiscal policy”.

Figure 125. Infection Points for the Wage Growth and Core Inflation Already Occurred (%, %)



Data sources: iFind and BOC Investment Strategy Research

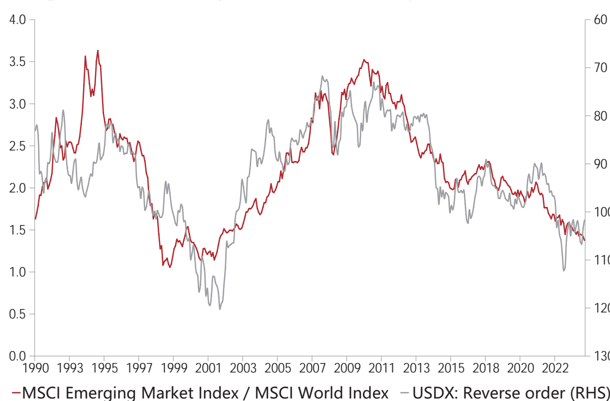
Figure 126. China is Likely to Integrate Easing Credit with Stable Monetary Policy in 2024 (%)



Data sources: iFind and BOC Investment Strategy Research

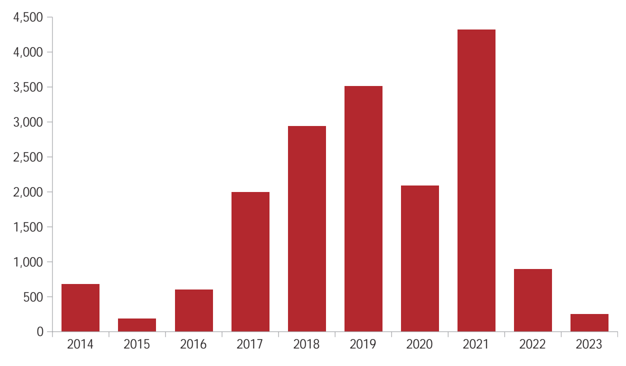
Overseas pressure has eased to some extent, and the A-share market is expected to bottom out in 2024. In 2023, the consistent cycle of overseas monetary tightening exceeded the market's expectations, and the fluctuations of earnings expectations at bottom in China are the two major factors affecting the performance of major asset categories. The overall performance of assets is specified as follows: The equity assets of developed economies led by US stocks have achieved the best performance. China's domestic bonds have performed better than stocks. Moreover, the performance of commodities has been divergent. Crude oil prices have risen higher than expected, and gold prices have strengthened as expected,. In addition, the prices of procyclical conventional industrial products have weakened. In 2024, the above factors are likely to be reversed. On the one hand, the suppressive effects imposed by overseas tightening are likely to subside to improve liquidity, and the declines in US treasury yields from highs are expected to become a key factor affecting the allocation of major global asset categories in 2024. Since 2023, the stronger-than-expected trend of the USD has imposed pressure on the RMB exchange rate, resulting in a substantial net outflow of northbound trading fund. This trend has also dragged down the performance of A-shares to a certain extent. In 2024, the weakening of the USD is expected to bolster the performance of emerging market equity assets, and the net outflow of northbound trading capital, which dragged down the performance A-shares in 2023, is also likely to be marginally repaired. On the other hand, driven by the policy efforts in 2024 and the bottoming-out of the market's expectations, domestic demands are expected to recover gradually, and the market's expectations for earnings are also likely to pick up. Therefore, the A-share market is expected to gradually bottom out and usher in a silver lining of recovery based on their original odds advantage.

Figure 127. Risk Assets of Emerging Markets Outperformed during the Downward Cycle of the USD



Data sources: iFind and BOC Investment Strategy Research

Figure 128. Net Capital Inflow from Northbound Trading Reached a Record Low in 2023 over the Recent Years (RMB 100 million)



Data sources: iFind and BOC Investment Strategy Research

With respect to the improvement of valuation, the Fed's suspension of interest rate hikes is expected to bolster A-share valuation. From a historical perspective, after the end of the Fed's cycle of monetary tightening, the marginal slowdown in overseas tightening of liquidity will most likely have impose a positive impact on the A-share market. We have summarized the performance of major asset categories from three months to one year after the Fed's rate hikes, and our major findings are as follows: 1) For US stocks, within three months after the Fed's end of rate hikes, the US stock market experienced declines more often than a rally. As time went by, the US stock market evidently priced in the negative expectations of economic downturn and the supportive effects of monetary easing on the economy, and the gains and chance of rally for US stocks will increase over time; 2) Through the horizontal comparison with US stocks in the same period, subsequent to the Fed's halt of rate hikes, the A-share market has a higher chance of a rally in the near term. As time went by, the absolute returns of A-shares would become more significant. During the early stages of the peaking before declines of US treasury yields, the effects of enhanced valuation were most evident in the A-share market, which was attributable to several factors: The suppressive effects imposed by overseas monetary tightening had eased, and global funds of allocation had returned, whereas the infection point of domestic cycle usually came ahead of the overseas situation. Moreover, driven by the improvement of risk appetites, the valuation of A-shares is likely to be boosted to a significant extent.

Figure 129. Performance of Major Asset Categories Subsequent to the Fed's Halt of Interest Rate Hikes

T+3		S&P 500	SSE Composite	CRB Commodity	LME Copper	Brent Oil	Gold	China Bond
April 1974	July 1974	8.5%	-	2.6%	-	-	-16.6%	-
May 1981	August 1981	1.4%	-	0.9%	-	-	-15.9%	-
February 1989	May 1989	4.1%	-	-1.4%	-	-	-4.2%	-
March 2000	June 2000	4.0%	10.5%	6.1%	2.7%	-1.3%	-7.3%	-
May 2006	August 2006	-2.6%	12.0%	3.3%	12.5%	4.9%	-1.8%	-0.6%
September 2018	December 2018	-4.9%	-5.0%	1.2%	3.6%	-10.9%	1.3%	2.2%
Average performance during the three months after the end of interest rate hikes		-1.6%	5.8%	1.2%	6.3%	-2.4%	-7.4%	0.8%
T+6		S&P 500	SSE Composite	CRB Commodity	LME Copper	Brent Oil	Gold	China Bond
April 1974	October 1974	-32.4%	-	-1.5%	-	-	-12.6%	-
May 1981	November 1981	-8.2%	-	-6.6%	-	-	-11.5%	-
February 1989	August 1989	16.3%	-	-3.3%	-	-	-6.5%	-
March 2000	September 2000	11.1%	17.9%	-0.4%	11.7%	6.2%	-5.7%	-
May 2006	November 2006	5.1%	27.6%	7.7%	3.4%	-17.1%	-6.3%	1.3%
September 2018	March 2019	-4.0%	7.9%	0.3%	8.6%	-12.3%	9.7%	3.9%
Average performance during the six months after the end of interest rate hikes		-2.0%	17.8%	-0.6%	7.9%	-7.7%	-5.5%	2.6%
T+12		S&P 500	SSE Composite	CRB Commodity	LME Copper	Brent Oil	Gold	China Bond
April 1974	April 1975	-11.3%	-	-13.8%	-	-	2.5%	-
May 1981	May 1982	-12.3%	-	-9.8%	-	-	-25.2%	-
February 1989	February 1990	10.6%	-	-9.2%	-	-	5.3%	-

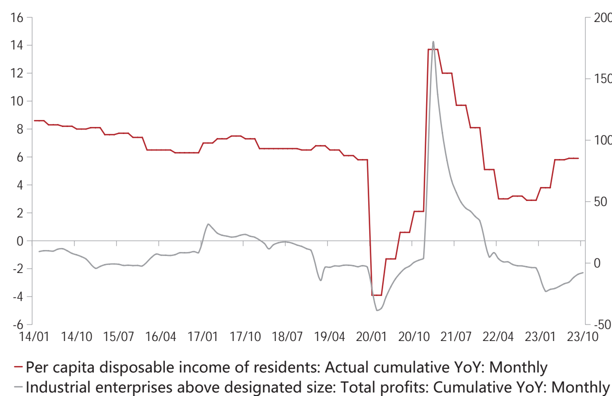
T+12		S&P 500	SSE Composite	CRB Commodity	LME Copper	Brent Oil	Gold	China Bond
March 2000	March 2001	-9.3%	14.3%	2.1%	3.6%	-1.0%	-9.2%	-
May 2006	May 2007	13.1%	166.7%	21.2%	9.7%	-4.3%	5.1%	1.7%
September 2018	September 2019	0.9%	5.9%	-5.9%	-5.7%	-19.0%	27.1%	6.2%
Average performance during the twelve months after the end of interest rate hikes		-1.4%	62.3%	-2.6%	2.5%	-8.1%	0.9%	3.9%

Data sources: iFind and BOC Investment Strategy Research Center

3.1.3.3 Economic fundamentals: Driven by the long-term transformation and short-term recovery, the A-share market is likely to be supported by a good economic foundation

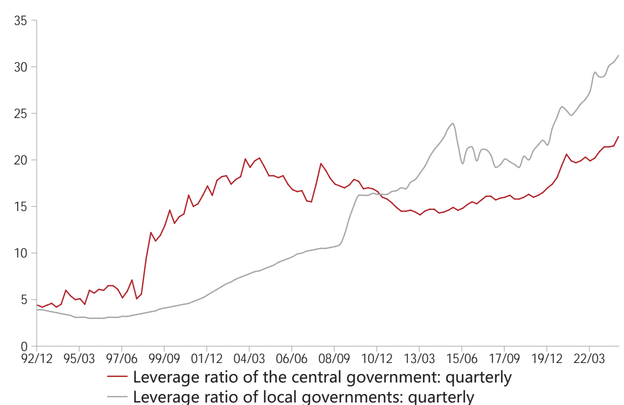
With respect to domestic demands in 2024, policies of stabilizing growth will be implemented with greater efforts, while fluctuations are inevitable during the transition of growth momentum. In 2023, the factor contributing to lower domestic demands was the weakening of real estate sector that lasted longer than expected, and the timing and intensity of efforts to stabilize growth (especially the fiscal measures) were weaker than expected. Both of these aspects are likely to be alleviated or restored in 2024. On the one hand, due to the enhanced support to the three major projects of urban village renovation, affordable housing, and public infrastructure for both emergency and emergency use, as well as the accelerated release of easing policies on the real estate sales in the early stage, the negative impact of real estate investment on the economy is likely to be alleviated. On the other hand, China has introduced a series of policies such as increasing the issuance of special treasuries and resolving local debt risks, showing the positive policy stance towards enhancing fiscal measures in 2024. Against the backdrop of the calls of the Central Economic Work Conference to "establish the new before abolishing the old, and to promote stability through progress", fiscal measures will become the core of ensuring GDP growth in 2024. In addition, as financing costs drop and the declines in corporate profits narrow, it will inject impetus into the growth of residential income and the recovery of consumption. We expect manufacturing investment to maintain moderate growth in 2H, 2024 as overseas demand stabilizes. It should be pointed out that China's economy is still going through structural adjustments and transition of old industrial momentum into the new one. Although demands are expected to recover in the near term, the complexity of the transitional period will bring greater fluctuations to the expectations of the capital market.

Figure 130. Corporate Profits Drove the Growth of Residential Income and Sent Signals of a Rebound in Consumption (%, %)



Data sources: iFind and BOC Investment Strategy Research

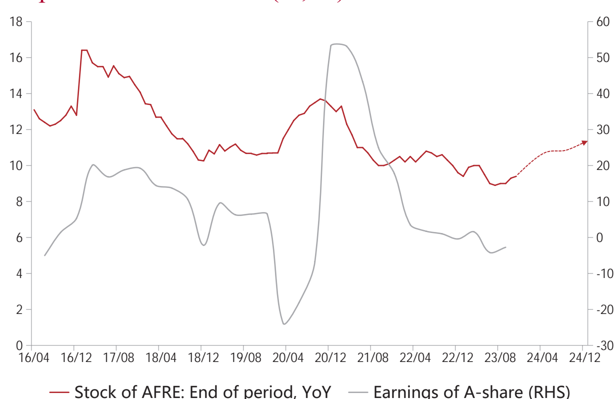
Figure 131. Room for Improvement in the Central Government's Leverage Ratio (%)



Data sources: iFind and BOC Investment Strategy Research

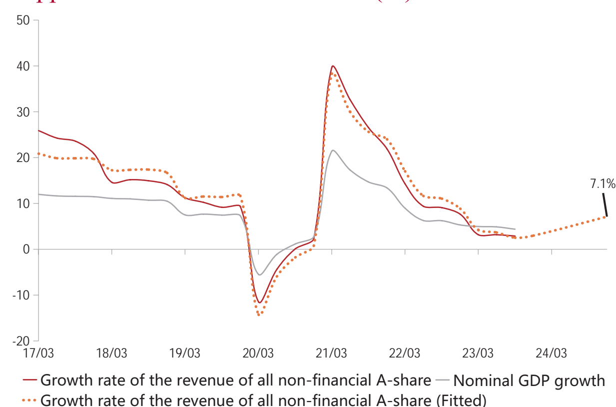
With respect to the profitability, it is expected to bottom out and recover. In 2024, China's domestic credit environment is expected to recover, the growth of the aggregate financing to the real economy (AFRE) will bottom out and rebound. Moreover, the earnings of A-shares will also bottom out before a rally. Based on the status-quo, the growth rate of existing AFRE is still fluctuating at the bottom. The total amount of newly added AFRE since Q4, 2023 was in line with expectations, but the structure still needs to be improved. It is expected that with the enhanced fiscal efforts, the growth rate of the AFRE will bottom out in early 2024. The earnings of the A-shares are also expected to bottom out in tandem. According to the third quarterly reports of listed companies in 2023, the earnings growth of A-shares in the non-financial industry showed certain signs of ending declines and picking up, but the endogenous growth momentum remained weak, and credit policies still need to be relaxed. Based on the forecast of major economic indicators in 2024 in our analysis for global economy, the real GDP is likely to achieve growth of 4.9%; the CPI is to grow by 1.2%, and the PPI is to grow by 0.2%; under such circumstances, the nominal GDP growth is expected to reach 5.9%, whereas income growth of non-financial enterprises in the Wind All Share is expected to reach 7.1%. Under the assumptions that net profit margins will recover slightly following price factors, the earnings growth of the non-financial sector in the Wind All Share may reach the level around 6.1% in 2024.

Figure 132. Growth Rate of the AFRE Experienced Oscillations at the Bottom, and Earnings of A-share are Expected to Bottom out (%, %)



Data sources: iFind and BOC Investment Strategy Research

Figure 133. Growth Rate of the Revenue of All Non-financial A-share is expected to be Restored under the Support of Price and Base Effects (%)

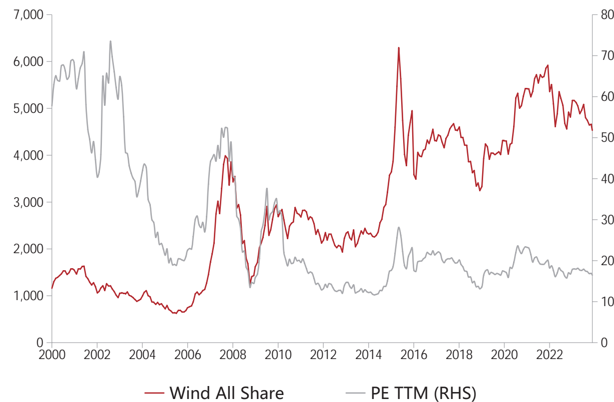


Data sources: iFind and BOC Investment Strategy Research

3.1.3.4 Stock valuation: Released of risks leads to cost-effective valuation, and A-shares have comparative advantages

From the aspect of valuation, risks have been fully released, and the valuation of China's A-shares is cost-effective. In 2023, A-shares moved against the global trend and experienced declines, thus undermining the market confidence. However, it could also be a blessing in disguise. The declines in 2023 could also be regarded as a full release of risks and an improvement in cost performance. Compared with global stocks, from the aspect of static valuation, A-shares have the lowest valuation among the world's major economies. The PE of Wind All Share is 16.17 times, which is lower than the valuation of other economic component indexes, whereas the PE of the dividend index that has the lowest valuation is only 5.46 times. In addition, the dividend payout ratios in 2022 and 2023 were 7.24% and 6.63% respectively. From a historical perspective, PB that reflects the absolute valuation level of A-shares is only 1.43 times, which is the second lowest level in history and is only slightly higher than 1.42 times in 2018. The lows of PB over the past decade took place in 2013 and 2018 respectively, showing a regular pattern of lows every five years. It is expected that the year 2023 would become the low in the next five years. Compared with other major asset categories, the cost performance of the ERP is outstanding. Looking forward to a longer period of time, the core driving force for the stock market's rally still originates from the improvement in the profitability of listed companies, as well as their ability and willingness to provide better returns for shareholders. On the one hand, the ROE of A-shares has stabilized and rebounded, and is expected to continue the upward movement, while the European and US stock markets are showing just the opposite trend. On the other hand, driven by the support of regulatory policies that encourage listed companies to distribute cash dividends to return shareholders, the dividend payout ratio of listed companies has steadily increased in recent years. In 2022, the market-wide dividend payout ratio reached a historical high of 2.7%. In 2023, due to the market declines as well as the increase in the proportion and dividend payout ratio of companies that paid cash dividends, it is expected that the dividend ratio will further increase.

Figure 134. A-share Valuation is Significantly Driven by the Fed's Halt of Interest Rate Hikes

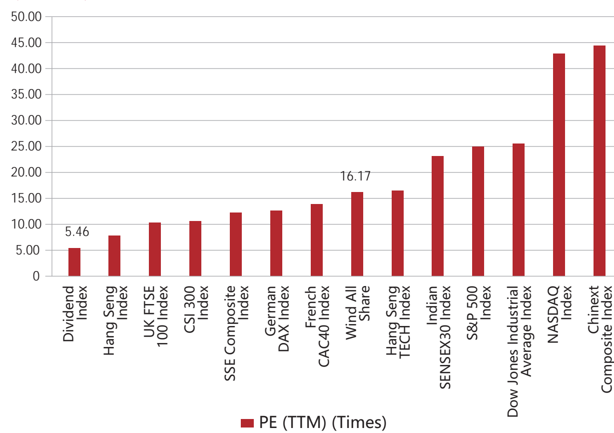


Data sources: Wind and BOC Investment Strategy Research Center

Figure 135. Prominent Cost-effectiveness as Shown by the Current Equity Risk Premium (ERP) of A-shares

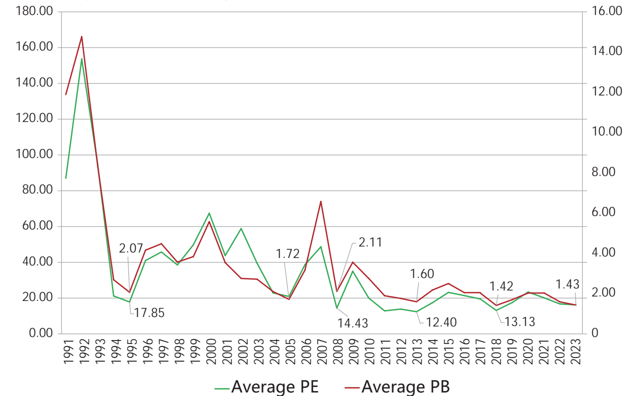
Data sources: iFind and BOC Investment Strategy Research

Figure 136. Valuation of Major Global Stock Markets (Times)



Data sources: Wind and BOC Investment Strategy Research Center

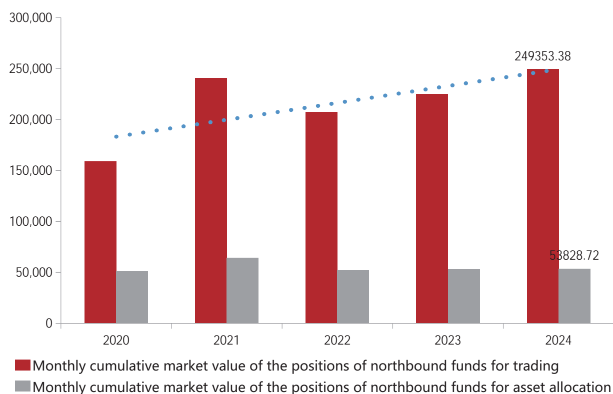
Figure 137. PE and PB of A-shares throughout the Years (Times, times)



Data sources: Wind and BOC Investment Strategy Research Center

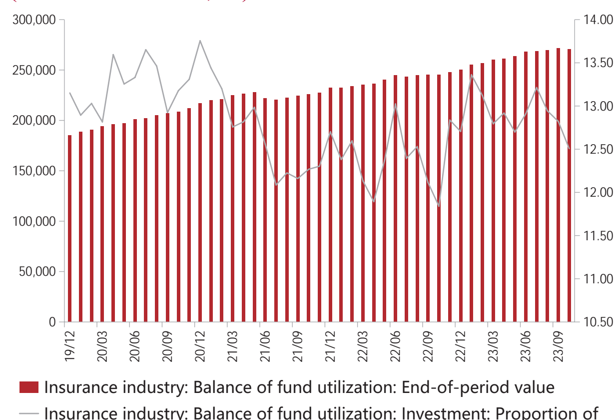
From the aspect of capital, the situation of net capital outflows from the northbound trading will be significantly alleviated, and allocable funds including social security and insurance are expected to evidently increase. Due to tight liquidity of the USD and weak expectations for domestic recovery, there has been a substantial net outflow of northbound trading funds, and the liquidity pressure on the stock market has increased sharply at the micro level. Despite the consistent inflow of equity ETF funds, it is still unable to fully hedge against the impact of the outflows of northbound capital on the liquidity of the stock market. In addition, shares with heavy foreign capital shareholding were reduced, thus exerting a significant drag on the index. In 2024, the Fed's monetary tightening is likely to come to an end, and the expectations for domestic recovery are likely to be marginally restored, whereas the major factors dragging down the funding of A-shares are expected to be alleviated. Judging from other sources of funds, the maximum proportion of investment for social security funds in stocks and equity assets has been further clarified. The proportion of insurance funds invested in stocks and securities investments (12.8%) is far below the upper limit (45%). In addition, a new insurance investment trend has taken place in the market, such as the venture private securities investment fund jointly established by Xinhua and China Life. The allocation trends of social security and insurance are worthy of special attention.

Figure 138. Changes in the Monthly Cumulative Market Value of the Positions of Northbound Funds for Trading and Asset Allocation (RMB 100 million)



Data sources: iFind and BOC Investment Strategy Research

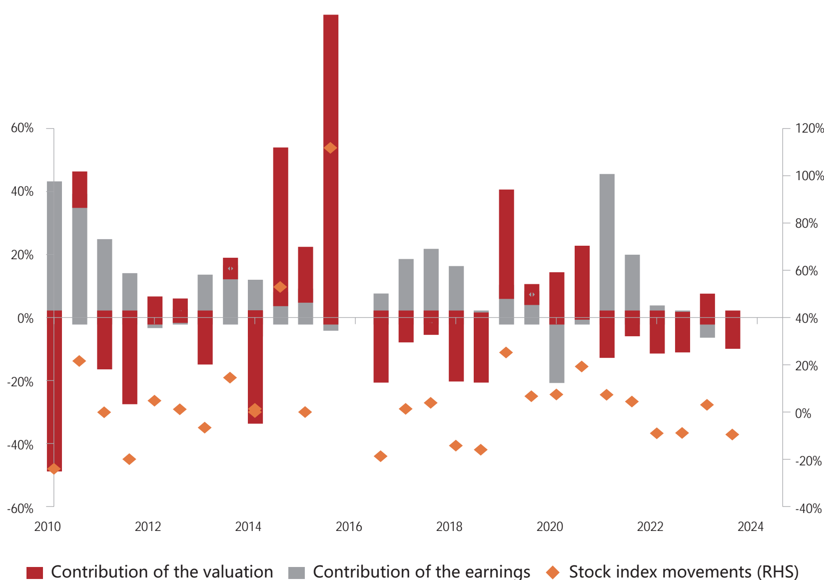
Figure 139. Proportion of the Balance of Insurance Industry Fund Utilization and Securities Investment (RMB 100 million, %)



Data sources: iFind and BOC Investment Strategy Research

The A-share market is expected to usher in a new pattern of high-quality development. In 2024, the macroeconomic environment is expected to feature a combination of "loose credit + stable money supply + strong earnings growth". Under such circumstances, the A-share market will usher in a new pattern of high-quality development due to above growth momentum. The macroeconomic cycle is basically similar to the period between 2012 and 2013, but the liquidity environment will be significantly better. Positive earnings contribution will dominate the A-share market in 2024. In case that the liquidity environment does not tighten beyond expectations, then valuation will not be dragged down under the support of both expectations and liquidity, and the A-share market will resume a bull run led by earnings growth. Investors are likely to pay closer attention to the growth of financial results, which will once again become the focus of market investment.

Figure 140. Contribution of Earnings and Valuation to the A-share Market and Related Forecast (%, %)



Data sources: iFind and BOC Investment Strategy Research

3.1.3.5 Focus on industries: Supporting industries with new productive forces

Forecast on the prosperity for the A-share market in 2024: Focus shall be placed on the maintenance of prosperity and the reversal of dilemma of industries. Based on the static earnings expectations of analysts at present, we may understand the current market's views on the future performance of the first-tier industries, which can still be divided into four categories: 1) Maintenance of prosperity. The industries whose absolute level of prosperity is rather high in both 2023 and 2024, which are mainly in the midstream advanced manufacturing categories (machinery and military industry), medicine, technology, media, and telecom (TMT) and travel chain (consumer services and transportation); 2) Reversal of dilemma. Industries that are expected to reverse the dilemma of earnings in 2024, which are mainly concentrated in electronics, agriculture, forestry, animal husbandry and fishery, basic chemicals, building materials, as well as the non-ferrous metals and steel industries that have seen diminishing losses; 3) Persistence of dilemma: Industries that experienced sluggish economic performance in 2023 and expected to remain weak in 2024, which are mainly concentrated in upstream resources and the financial chain of the real estate sector; 4) Relative declines prosperity. These industries are mainly concentrated in food and beverages, electric power utilities, commerce and textile clothing.

Figure 141. Forecast on the Prosperity of Primary Industries in 2024

Name of industries	Stock index movements from January to December 2023	Sample earnings growth, 2022A	Actual earnings growth by industries, 2022A	Actual earnings growth by industries, 2022A	Actual earnings growth by industries, 2023Q3	Sample earnings growth, 2023E	Ranking of sample earnings growth by industries, 2023E	Sample earnings growth, 2024E	Ranking of sample earnings growth by industries, 2024E
Agriculture, forestry, animal husbandry and fisheries	-13%	482%	142%	-160%	-420%	-44%	-14	298%	14
Electronics	5%	-21%	-35%	-25%	-33%	5%	-6	47%	13
Transportation	-13%	-50%	-47%	56%	55%	155%	13	40%	12
Basic chemical engineering	-14%	13%	2%	-36%	-48%	-19%	-13	36%	11
Consumer services	-40%	-41%	-68%	77%	171%	120%	12	36%	10
Computer	13%	-17%	-37%	0%	17%	45%	10	33%	9
Machinery	-3%	-4%	-10%	11%	7%	28%	6	32%	8
Medicine	-7%	4%	-5%	8%	-14%	21%	3	29%	7
Defense and military	-11%	19%	-8%	5%	-4%	28%	5	30%	6
Light manufacturing	-6%	-18%	-29%	-1%	-15%	40%	8	28%	5
Building materials	-21%	-45%	-49%	-28%	-32%	-5%	-10	26%	4
Automobiles	6%	26%	0%	30%	30%	38%	7	27%	3
Electronic equipment and new energy	-29%	66%	74%	13%	9%	18%	1	23%	2
Media	35%	-71%	-83%	26%	27%	174%	14	25%	1
Non-banking finance	1%	-21%	-26%	-11%	3%	11%	-3	23%	-1
Commerce and trade retail business	-7%	-17%	63%	15%	7%	41%	9	21%	-2
Non-ferrous metals	-10%	73%	63%	-28%	-27%	-12%	-11	20%	-3
Steel	-6%	-34%	-72%	-13%	-34%	0%	-9	19%	-4
Food and beverage	-16%	15%	12%	16%	16%	19%	2	21%	-5
Electricity and public utilities	1%	46%	55%	46%	49%	100%	11	18%	-6
Textile and apparel	5%	-9%	-31%	17%	22%	21%	4	15%	-7
Real estate	-21%	-32%	-341%	-11%	-6%	14%	-4	14%	-8
Construction	-3%	14%	11%	3%	2%	14%	-2	14%	-9
Home appliances	6%	10%	8%	15%	13%	16%	-1	13%	-10
Communicationz	25%	12%	84%	7%	7%	11%	-5	12%	-11
Petro-chemical	5%	32%	7%	-4%	-4%	7%	-7	10%	-12
Coal	13%	54%	49%	-28%	-27%	-18%	-12	6%	-13
Banking	-4%	8%	8%	3%	3%	4%	-8	6%	-14

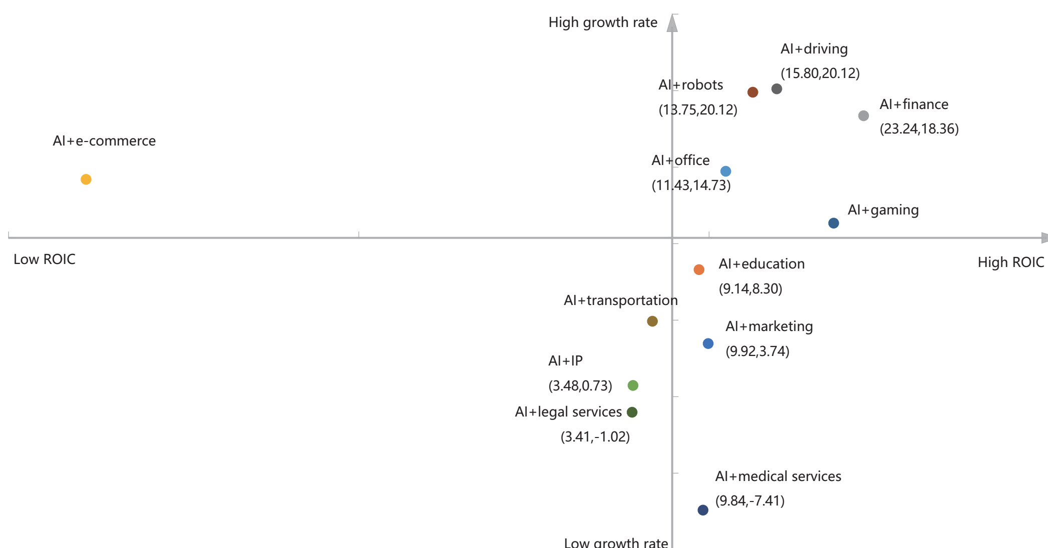
Data sources: iFind and BOC Investment Strategy Research

With respect to the allocation into specific industries, we believe that: New tracks (TMT and high-end manufacturing) > Core assets (Medicine) > Old tracks (New energy, national defense and military industries) > Financial and cyclical sectors.

The new track is mainly focused on the TMT and high-end manufacturing industries. According to the Central Economic Work Conference in 2023, the authority will prioritize the work of "leading the development of a modern industrial system with scientific and technological innovation" in 2024, with special emphasis placed on "promoting new industrialization, developing the digital economy, and accelerating the development of artificial intelligence; fostering bio-manufacturing, commercial aerospace, low-altitude economy and other strategic emerging industries". At present, China is at a critical

juncture of replacing old growth drivers to new ones. Technology and high-end manufacturing are the pillars of the new economy. These industries have received the most sufficient and assured policy support, and they also correspond with the trend of global emerging industries. Moreover, the current trend of upward movements in the second inventory cycle has been basically confirmed. Compared with the “increase in both volume and price” in the first inventory cycle that started with capital expenditure, the trend of upward price movements in the second inventory cycle has been weaker, and the structure of valuation distribution has prominent features, whereas the midstream manufacturing industry is also most likely to benefit from the trend. Therefore, from our perspective, the TMT and high-end manufacturing are the sectors that are most worthy of attention for asset allocation in 2024. In particular, the TMT and high-end manufacturing sectors are influenced by three major factors: 1) The trend of the AI industry has been established, and the industry is going through the stage of accelerated penetration; 2) The requirements for technological independence and self-control have been strengthened, and there are urgent needs for “replacement with domestic technologies”; 3) Certain Chinese technology industries have strong competitiveness, and the process of going global is accelerating. Focus shall be placed on the following areas: AI industry chain (computing infrastructure at the hardware side and “AI+ applications” at the software side); technological independence and self-control (including semiconductor equipment and materials, information technology application innovation industry, satellite communications and robots); technologies products going global (including semiconductor packaging and testing, consumer electronics, gaming and optical modules).

Figure 142. Analysis on the ROIC-g Business Model of AI Application

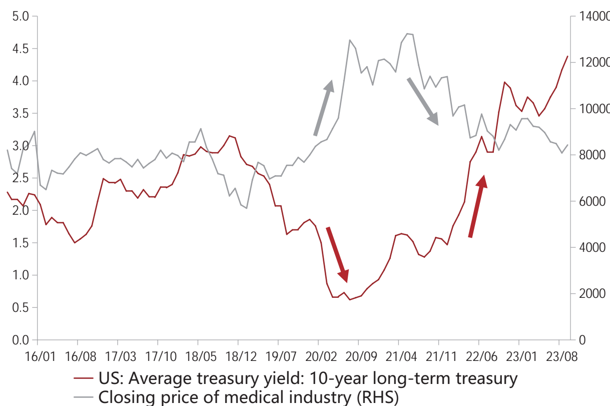


Data sources: iFind and BOC Investment Strategy Research

ong other core assets, the pharmaceutical industry has shown signs of reversing dilemma. The industrial uncertainties caused by the early anti-corruption in the pharmaceutical industry and medical insurance negotiations have dissipated, and the industry is likely to usher in prosperity. At the industry level, the focus is placed on innovative drugs and medical devices. For old tracks that have performed well from 2020 to 2021, such as new energy and military industry, the current industry sentiment is faced with certain negative factors, and it is necessary to opt for high-quality niche tracks or wait for the opportune moment to invest. After experiencing the expansion of production capacity from 2020 to 2022, the major sectors of new energy, such as new energy vehicles, photovoltaics, energy storage and several other industrial chains, will be encountered with the overcapacity issues in 2023, and the issues are likely to persist in 2024. The lithium carbonate prices are expected to stabilize in early 2024, which will lead to a recovery in the industrial chain to a certain extent, especially the performance of material factories. Nevertheless, under the vast oversupply cycle, it is hard to usher in an inflection point of industrial supply and demand, and the market may not experience a major reversal of momentum. In the new energy sector, opportunities may arise for asset allocation amid a rebound when the industrial performance recovers. In addition, better choices of asset allocation may be available in areas such as offshore wind power sector where supply and demand are balanced, or demands have yet to be fully released. In 2023, due to personnel adjustments and other reasons, the mid-terms orders of military defense in the “14th Five-Year Plan” fell short of expectations. However, as personnel changes have been put in place, orders that

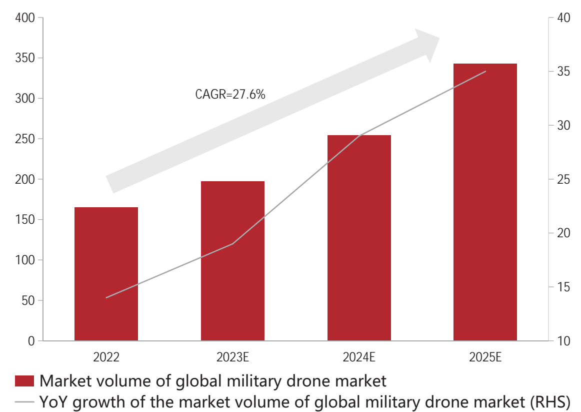
were delayed in the early stage are expected to be fulfilled in 2024, as evidenced by the recovery of new orders from varying manufacturers since mid-October 2023. The current valuation of the military industry is at a historical low. In case that the demands for orders are realized in 2024, the industrial performance is expected to be restored, and focus shall be placed on the military aircraft, drones and large aircraft industry chain.

Figure 143. Closing Price of Pharmaceuticals is Negatively Correlated with the US 10-year Treasury Yield (%)



Data sources: iFind and BOC Investment Strategy Research

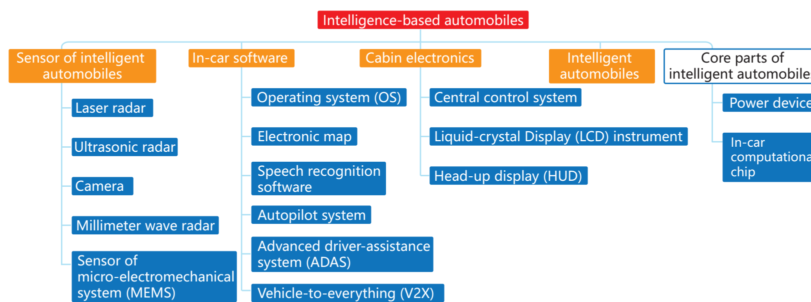
Figure 144. Global Military Drone Market is Expected to Expand Rapidly (USD 100 million, %)



Data sources: TrendForce and BOC Investment Strategy Research Center

Focus shall be placed on the intelligent driving, which is expected to usher in a moment of singularity in 2024. As the demands of users for intelligent experience continue to increase, related policies continue to evolve, and the industry participants attach greater importance to intelligent driving technology, intelligent driving has experienced rapid development, and the trend of progress is expected to continue in 2024. At present, the popularity of the function of intelligent driving remain at a rather low level in China. Driven by the progress made in technologies, declines of product prices, and the pursuit of users for intelligent experience, the intelligent driving function is gradually expanding from high-end luxury cars to mid-to low-end cars, and its penetration rate is climbing up. In 2024, the intelligent driving is expected to usher in a moment of singularity with large-scale mass production of L3 intelligent driving.

Figure 145. Hierarchical Graph on the Industrial Chain of Intelligent Automobile Investment



Data sources: iFind and BOC Investment Strategy Research Center

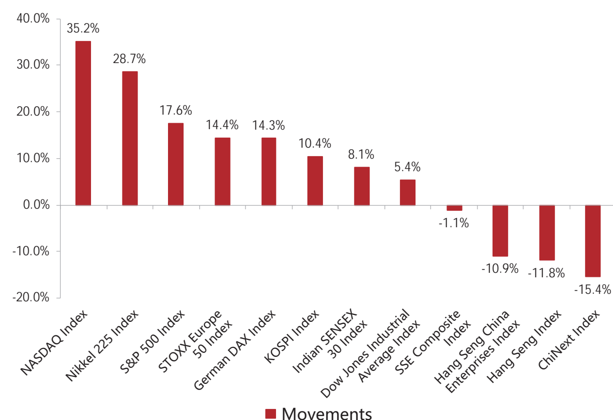
Looking forward to 2024, the cycle of USD interest rate hikes has come to an end. Driven by the easing of external pressure, global assets are likely to usher in greater opportunities. The valuation of A-shares is expected to increase due to the outflow of USD. The long-term mechanisms for mitigating risks incurred by the real estate sector and local government debts will be set up, thus gradually addressing the challenges that hinder the improvement of expectations for the long-term economic growth in China. The economy is transitioning into high-quality development, and will continue to recover in the near term, laying a solid foundation for the A-share market. Subsequent to two consecutive years of declines, the risks of A-shares are fully released. Judging from the results of horizontal comparison at a global scale, vertical comparison with its own history,

and cost-performance analysis between stocks and bonds, the valuation of A-shares is at cyclical and historically low levels. As such, the A-share market is worthy of closer attention for global asset allocation. It is recommended to pay attention to investment opportunities available in the industries related to new productive forces. In the year of Loong of 2024, the positioning of the A-share market will be recalibrated amid a buoyant ambience, and the confidence will be boosted for the stock market to set sail again.

3.1.4 Hong Kong stocks: Strengthening domestic fundamentals and alleviation of overseas pressure are building momentum, and the Hong Kong stock market is likely to usher in a historical turning point

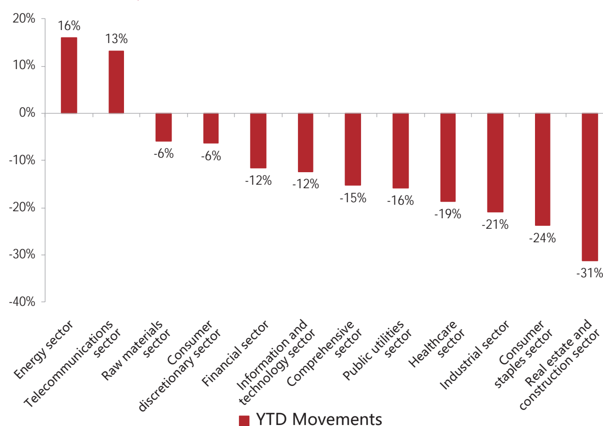
After experiencing two years of unilateral declines in 2021 and 2022, the Hong Kong stock market experienced a sharp rebound periodically from the end of 2022 to January 2023. Since then, there have been unilateral declines amid oscillations throughout the year 2023, and the market is accumulating momentum for future rebounds. The downturn in Hong Kong stocks is derived from varying factors at home and abroad. First, the US economy remained resilient, and the consistent cycle of interest rate hikes exceeded the market's expectations, causing the Fed to adopt rate hikes and maintain high interest rates for longer than expected. As a result, liquidity in Hong Kong stocks continued to be tight. Second, China's recovery was not as good as expected. China's economic fundamentals remained under pressure, and the actual performance was far different from the optimistic expectations in early 2023. As a result, the market was subject to the effects of repricing. Third, the risks of intensifying competition between China and the US have spilled over to the Hong Kong stock market, and Sino-US relations did not evidently improve before October 2023. Certain foreign investors invested in Chinese assets based on value bias, and asset allocation into Hong Kong stock was the first to bear the brunt, showing a periodic decline. Among the major industries, the energy and telecommunications industries recorded gains, while all other industries experienced declines. In particular, the real estate and construction, consumer staples and industrial sectors experienced the largest declines. The information technology and the healthcare sectors narrowed their declines compared with the previous year.

Figure 146. Movements of Major Global Stock Indexes in 2023 (as of November 17, 2023, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 147. Movements of Varying Sectors in the Hong Kong Stock Market since 2023 (as of November 17, 2023, %)

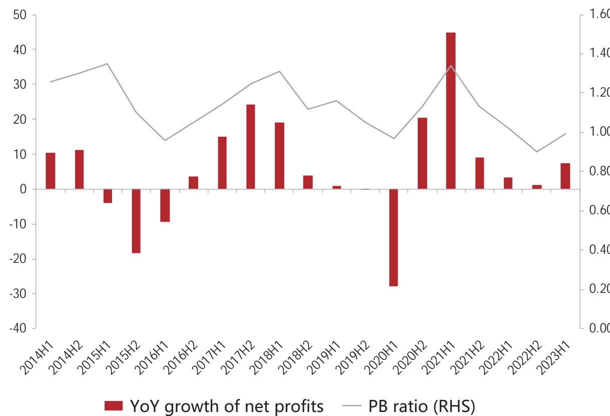


Data sources: Wind and BOC Investment Strategy Research Center

3.1.4.1 Further discussion on the features of the Hong Kong stock market: Economic fundamentals lay the foundation, and monetary policy determines the orientation

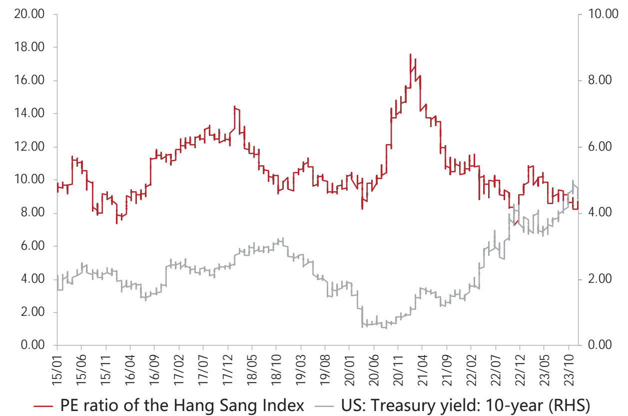
Over the past three years, there have been bearish views such as "the Hong Kong stock market is an abandoned market", "Hong Kong stocks have exhausted their liquidity" and "Hong Kong stocks do not reflect fundamentals", and yet despite all these pessimistic views, we still firmly believe that China will continue to support the development of Hong Kong as an international financial center, and the city's international status has not fundamentally changed. The future trend of Hong Kong stocks will be determined by economic fundamentals. As a typical offshore market, the US monetary policy may impose a crucial impact on the liquidity of the Hong Kong stock market.

Figure 148. Net Profit Growth Versus Valuation of the Hang Seng Index (%, times)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 149. Hong Kong Stock Valuation Versus US 10-year Treasury Yields (Times, %)



Data sources: Wind and BOC Investment Strategy Research Center

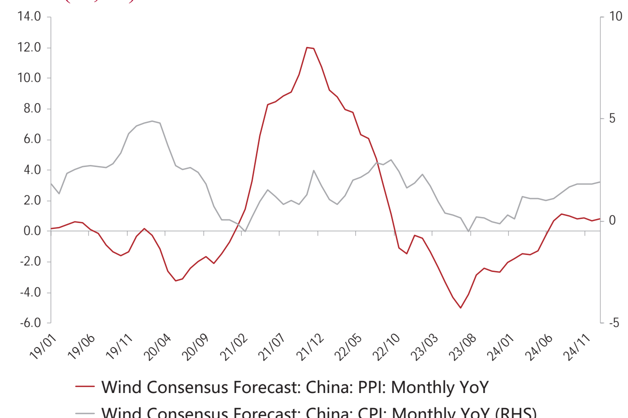
3.1.4.2 Fundamentals: China's economy is expected to bottom out amid a rebound, laying a solid foundation for Hong Kong stocks

From the aspect of fiscal policy, the foundation for China's economic recovery is not yet solid at present. Affected by the expectations of an economic recession in the US, exports are likely to make limited contributions to economic development in 2024. Although consumption is gradually coming out of the trough, its positive impact is likely to emerge slowly on economic development. Therefore, greater fiscal policy efforts are likely to be implemented in a consistent manner so as to support the economy, as evidenced by the higher-than-expected fiscal expenditure plan of RMB 1 trillion in Q4, 2023. From the aspect of monetary policy, as China's macro-economy is still under pressure at present as mentioned above, monetary policy will continue to be loose in the general direction. Subsequent to the Fed's start of the cycle of interest rate reductions, it will also provide greater room for the RMB's operation. Judging from recent economic data, China's macro-economy experienced twists and turns in 2023, but has shown a trend of rebound and recovery since August 2023. A trend of bottoming out and rebound has been shown in the total retail sales, e-commerce sales index, PPI, CPI and other major monthly indicators with high-frequency as well as corresponding market expectations. In general, China will make concerted efforts to achieve the long-term vision of "doubling" the GDP in 2035, and to ensure optimal employment and enhanced international status in the short term. Greater policy efforts will be made to constantly support the high-quality development of the Chinese economy, thus laying a solid foundation for Hong Kong stocks.

Figure 150. Total Retail Sales of Social Consumer Goods in China (%, %)

Data sources: Wind and BOC Investment Strategy Research Center

Figure 151. Monthly Movements of China's PPI and CPI (%, %)

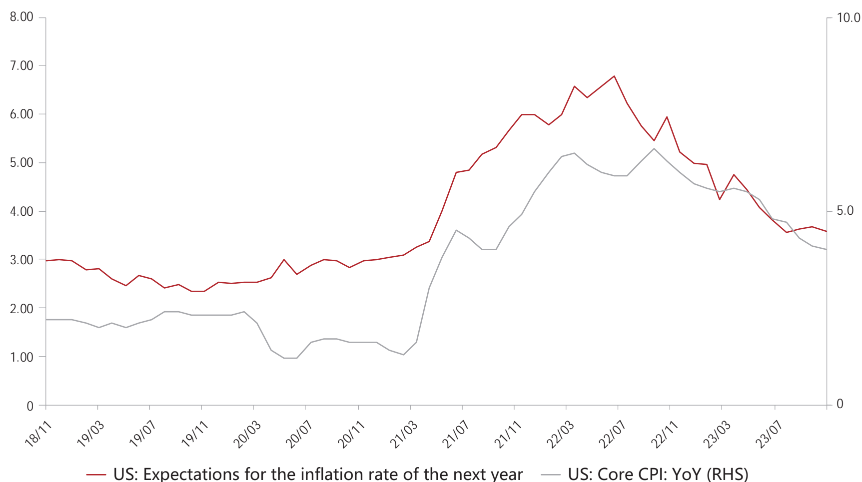


Data sources: Wind and BOC Investment Strategy Research Center

3.1.4.3 Liquidity: Cycle of the Fed's hike of interest rates is coming to an end, and the liquidity infection point is emerging on the horizon

The US inflation has passed its high point and is moving along a downward path. According to the FedWatch Tool, the market generally expects the cycle of USD interest rate hikes to come to an end. Starting from the end of Q2, 2024, the chance of the start of USD interest rate cuts will be higher than 50%. The USD is expected to enter a downward channel from then on, thus providing ample liquidity for Hong Kong stocks.

Figure 152. Trend of the US Inflation (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 153. FedWatch Tool (as of November 17, 2023)

Name of indicator (Probability, %)	US : FedWatch tool : Probability of changes in target rate at the FOMC meeting : Decrease	US : FedWatch tool : Probability of changes in target rate at the FOMC meeting : Unchanged	US : FedWatch tool : Probability of changes in target rate at the FOMC meeting : Increase
2023/9/20	0.00	99.00	1.00
2023/11/1	0.00	98.09	1.91
2023/12/13	0.00	100.00	0.00
2024/1/31	0.00	100.00	0.00
2024/3/20	30.00	70.00	0.00
2024/5/1	61.85	38.15	0.00
2024/6/12	83.84	16.16	0.00
2024/7/31	93.19	6.81	0.00
2024/9/18	97.48	2.52	0.00
2024/11/7	100.00	0.00	0.00
2024/12/18	100.00	0.00	0.00

Data sources: Wind and BOC Investment Strategy Research Center

3.1.4.4 Policy: Measures are taken to activate the capital market, and Hong Kong is also on the move

Due to three years of market downturn, the Hong Kong government is also aware of the lack of liquidity in the stock market. To further enhance the market competitiveness of the Hong Kong Stock Exchange, the Hong Kong government and the HKEX have successively introduced (or are considering to introduce) a series of policies, including the reduction of stamp duty, increase of market activity and gradual improvement of the market ecosystem.

Figure 154. Overview of the Policy Measures of Activating the Capital Market in Hong Kong

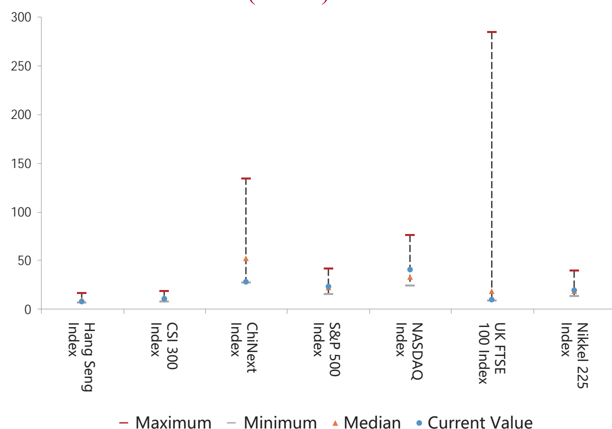
No.	Policy Measures of Activating the Capital Market in the Hong Kong (Including the measures under discussion)
1	Lowering the stamp duty on shares from 0.13% to 0.1%; subsequent to the reduction, the stamp duty rate will return to the level prior to the increase in 2021.
2	Setting up funds to invest in projects related to the Greater Bay Area; promoting the listing of overseas issuers; facilitating share buyback by listed companies; promoting RMB-denominated trading of Hong Kong stocks; reviewing the spread between buying and selling of stocks; and exploring the trading mechanism of Hong Kong stocks during inclement weather.
3	Reviewing stock trading spreads and lowering market information costs.
4	Further connecting domestic and overseas markets and investors; creating a more innovative and diversified financial market; and expanding interconnection with the financial market of the Chinese mainland. Measures include strengthening the offshore RMB business; setting up a new platform to expand fund sales; and promoting the development of green and sustainable finance in Hong Kong.
5	Proactively building Hong Kong into a “world-leading family office hub”; re-launching the Capital Investment Entrant Scheme (CIES), and announcing the details of the CIES, commonly known as “investment migrants”. In 2024, the investment threshold will be substantially raised from HKD 10 million in 2015 to HKD 30 million. The investments can be made in stocks, funds and bonds, among other assets, but not the real estate sector.

Data sources: Wind and BOC Investment Strategy Research Center

3.1.4.5 Valuation: Level of valuation is at an absolute low, and the market is expected to usher in the return of strength

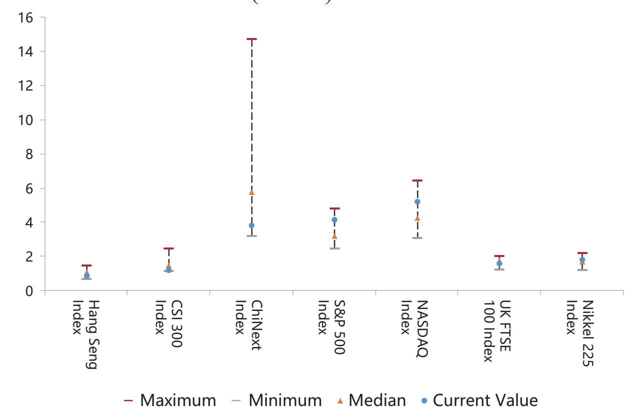
From the aspect of valuation, as of November 17, the PE valuation of the Hang Seng Index reached only 8.29 times, and the PB valuation reached only 0.86 times. Through horizontal comparison with the world’s major stock markets, the valuation of the Hang Send Index is the lowest. Through vertical and historical comparison, the PE and PB ratios of the index are at 3.26% and 1.73% of the historical percentile, both at extremely low levels in history with outstanding cost-performance. From a horizontal aspect, low valuations will inevitably become the target of available funds when part of the value investment of international capital subsides and resume the profit-seeking nature. From a vertical aspect, cyclical laws and the power of mean reversion will inevitably come into play to improve low valuations. As such, stocks with low valuations will eventually bottom out, and investors will eventually be attracted by the return on investment brought by high dividends and high growth. Hence, we firmly believe in the power of growth and the return of value.

Figure 155. Comparison of PE Valuation of Major Global Stock Indexes (Times)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 156. Comparison of PB Valuation of Major Global Stock Indexes (Times)



Data sources: Wind and BOC Investment Strategy Research Center

The premium of AH shares is a window for observing the cost-performance of Hong Kong stocks relative to A-shares. During the simultaneous declines of A-shares and Hong Kong stocks, the premium of A-shares relative to H-shares continued to reach new highs due to the larger relative declines of Hong Kong stocks. The latest AH premium index reached 153.26, which was at the highest range over the past five years, and it has been above one standard deviation for over 4 months. Considering that A-shares are also at a low level of valuations, the advantages of Hong Kong stocks in terms of cost-performance are even more prominent.t

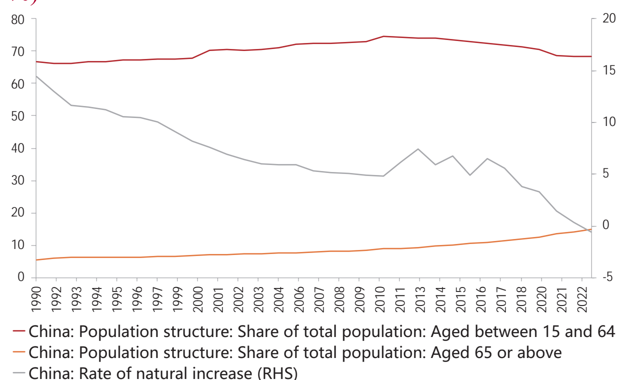
Figure 157. AH Share Premium of the Hang Seng Shanghai-Shenzhen-Hong Kong Stock Connect (Points)

Data sources: Wind and BOC Investment Strategy Research Center

3.1.4.6 Thoughts on asset allocation into specific industries: Growth of pharmaceutical and technology sectors

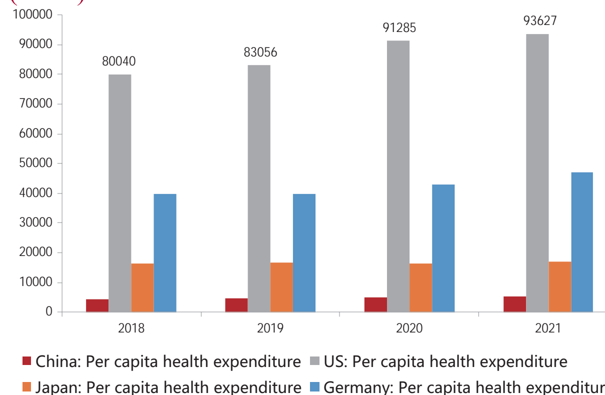
With respect to the pharmaceutical sector, the aging of population is a certain trend in China. According to internationally accepted standards, the proportion of the population aged over 65 in China already reached more than 14% in 2021, which is in line with the standards of deep aging. Worse still, this trend is irreversible and the proportion will continue to increase. China's largest wave of baby boomers (368 million people born between 1962 and 1975) will drive a huge wave of retirement. These people who have benefited from the results of China's reform and opening up for four decades. They have more wealth, and will have greater demands for medical products and services in the future. At the same time, compared with developed economies, China's per capita health expenses are only 1/3 of Japan, 1/9 of Germany, and 1/17 of the US. As China's per capita GDP continues to increase, per capita medical expenses will consistently rise in the long run. To narrow the gap with the above-mentioned developed economies, there is huge room for improvement.

Figure 158. Trend of the Population in Population (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

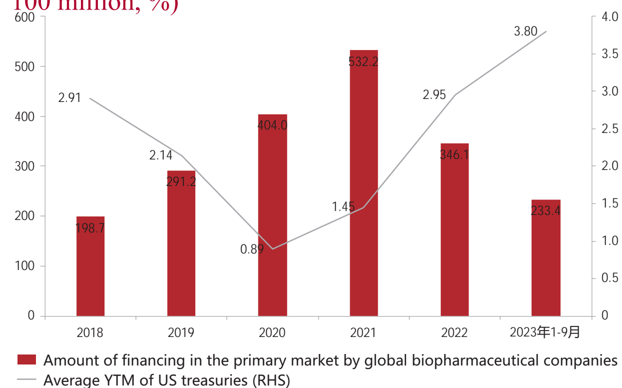
Figure 159. Per capita Health Expenditure by Country (RMB)



Data sources: Wind and BOC Investment Strategy Research Center

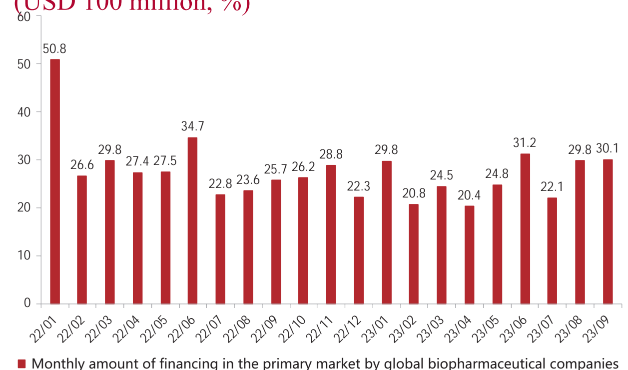
From the aspect of industrial prosperity, the amount of financing in the primary market by global biopharmaceutical companies is a leading indicator of the development of the global innovative medicine industry and the source of industrial prosperity. If the amount of financing is high, then the research and development of innovative medicine will be more active, thus benefiting related sub-sectors such as innovative medicine and CXO. In general, the USD interest rate may impose a significant impact on the indicator. When the USD interest rate is high, the cost of funds is expensive, leading to the declines in the amount of financing. Over the past two years, due to the unprecedented interest rate hikes by the Fed, the amount of financing in the primary market by global biopharmaceutical companies has dropped significantly. However, judging from monthly high-frequency data, there will be a trend of gradual recovery in 2H, 2023, leading to the recovery of the prosperity of the pharmaceutical industry.

Figure 160. Amount of Financing in the Primary Market by Global Biopharmaceutical Companies (USD 100 million, %)



Data sources: Market Information and BOC Investment Strategy Research Center

Figure 161. Monthly Amount of Financing in the Primary Market by Global Biopharmaceutical Companies (USD 100 million, %)



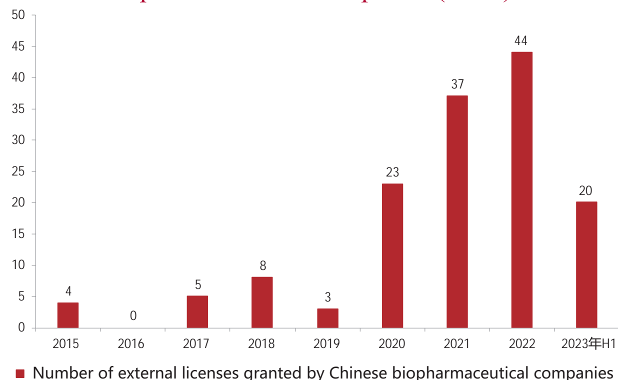
Data sources: Market Information and BOC Investment Strategy Research Center

From the aspect of the competitiveness of China's innovative medicine companies at the micro level, despite the macroeconomic downturn and drastic changes in centralized procurement and other industries over the past three years, the stock prices of China's innovative medicine enterprises have generally fallen sharply. Nevertheless, from another perspective, regulatory authorities still intend to encourage and protect the development of the innovative medicine sector. After this sector experienced the stages of fierce competition and chaotic rivalry, it has now been cleared with optimized pattern, and the companies with truly competitive products will usher in a better environment of development.

Since the reform of China's pharmaceutical review system in 2015, funds have poured in from all channels, and the industry has flourished accordingly. As can be seen from the figures below, since 2020, the number of external licensing projects of China's biopharmaceutical companies has increased to a significant extent, and continue to increase amid the pressure over the past two years. To some extent, the rapid development has shown the relative improvement in competitiveness of the innovative medicine sector in China. At the same time, this sector has made breakthroughs in terms of the approval by the US FDA. Since the end of October 2023, three domestic innovative medicines from three domestic listed pharmaceutical companies, including Junshi Biologics, Chi-Med and Yifan Pharmaceuticals, have been approved in the US market. As a result, there have been five Chinese innovative medicines approved by the FDA so far.

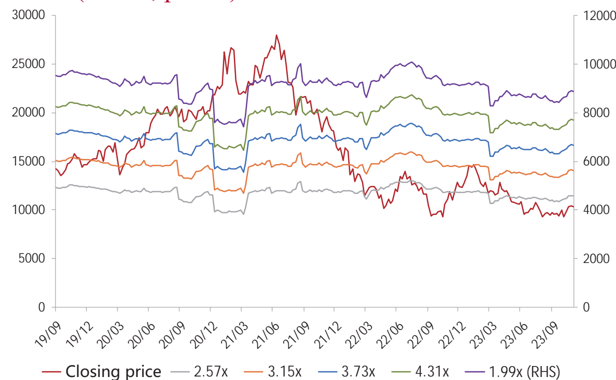
The positive trend in the aforementioned aspects will jointly lead to the bottoming-out and recovery of the pharmaceutical industry in 2024.

Figure 162. Number of External Licenses Granted by Chinese Biopharmaceutical Companies (Units)



Data sources: Market Information and BOC Investment Strategy Research Center

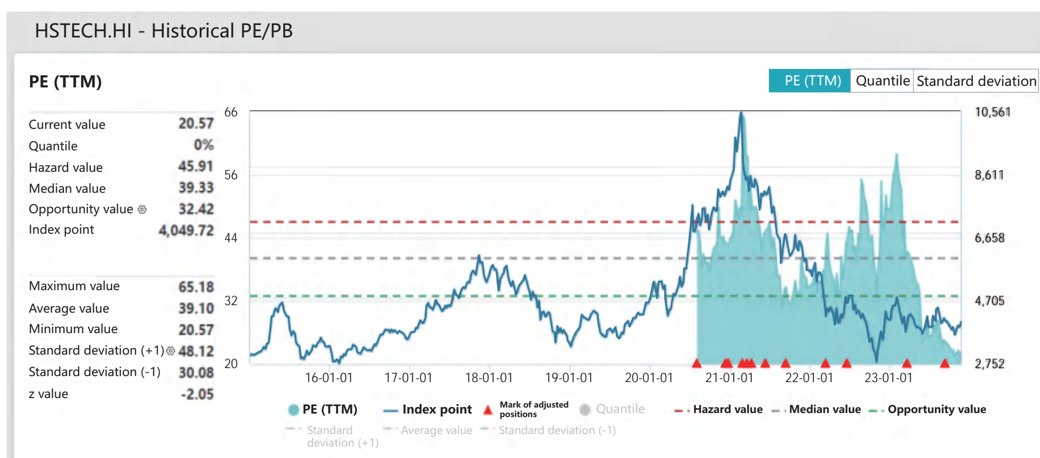
Figure 163. Valuation of the Hang Seng Healthcare Index (Points, points)



Data sources: Wind and BOC Investment Strategy Research Center

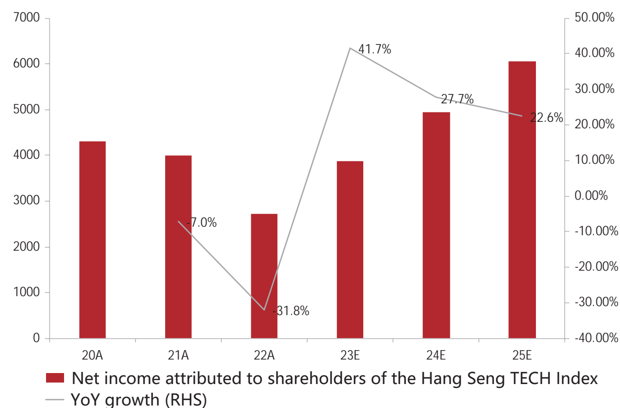
With respect to the technology sectors, taking the Hang Seng TECH Index as an example, there have been a number of leading tech companies listed in the Hong Kong stock market, which can represent the future of China's economy. Over the past three years, despite the tightening of the USD monetary policy, China's macroeconomic downturn, and tightening of industrial regulatory policies, these companies have encountered headwinds during their operations, and their stock prices have experienced sharp declines. However, at the current juncture, the business model of these tech companies is still reliable, and their market competitiveness remains solid. As a result, the market has resumed the growth expectations for the operating performance of these tech companies in the next three years. Coupled with the historically underestimated valuation at present, these stocks are expected to provide highly resilient returns in the future.

Figure 164. Valuation of the Hang Seng TECH Index (Points)



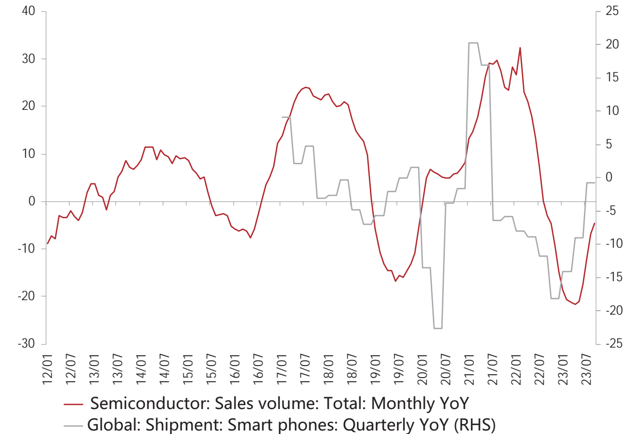
Data sources: Wind and BOC Investment Strategy Research Center

Figure 165. Forecast on the Performance and Profits of the Hang Seng TECH Index (RMB 10,000, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 166. Global Sales in the Semiconductor and Mobile Phone Sectors (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

With respect to the industry segments, the Internet stocks of Chinese concept shares represented by Tencent and Alibaba are still supported by solid fundamentals. Over the past two quarters, revenue has returned to the range of low-to-medium growth of about 10%. Moreover, due to the adoption of a more efficient development model, net profit margins have generally improved. The policy measures and macroeconomic environment have also shown signs of marginal easing, and the industry is coming out of the trough. In terms of consumer electronics, subsequent to two years of global cyclical industrial downturn, destocking is coming to an end based on past experience. However, popular concepts such as AI, autonomous driving, and Huawei are emerging in succession, which is expected to drive the industry out of the trough and usher in a new cycle of boom. The aforementioned industries are all supported by the restoration of valuation and resumption of the growth of performance.

In a nutshell, after nearly three years of adjustments, the valuation of Hong Kong stocks is at an absolute low at present with further consolidation at bottom. Looking forward to 2024, driven by the end of the cycle of USD interest rate hikes and the start of the cycle of interest rate reductions, the external liquidity environment is expected to be greatly improved. In addition, China's fiscal policy is moderately strengthened with improved quality and efficiency, and monetary policy remains flexible, moderate, precise and effective. Moving forward, China's economy is expected to experience a moderate recovery in 2024 with further consolidation of economic fundamentals. On the one hand, the unfavorable factors restricting the performance of Hong Kong stocks at the macroeconomic level are improving. On the other hand, the low absolute valuation of large financial sector can support the bottom at the micro level, whereas the pharmaceutical and technology industries are able to lead the rebound of growth. Subsequent to the longest declines in the Hong Kong stock market in history, the market is likely to usher in a positive impact of both a strengthening domestic economy and easing overseas liquidity. A historic turnaround is likely to take place in the Hong Kong market, which could be more resilient than A-shares.

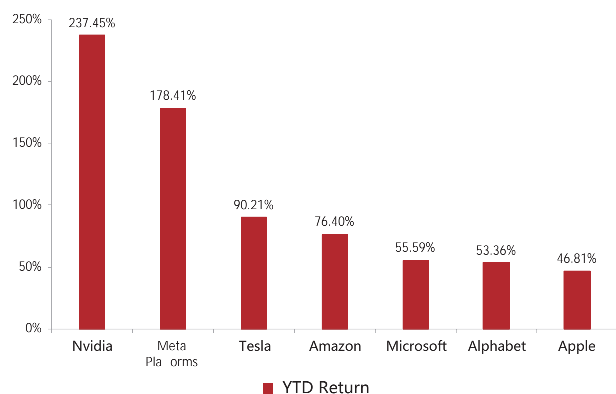
3.2 US Stock Market: Fully Priced for "Soft Landing", and Asset Allocation is to be Increased Subsequent to the Release of Risks

3.2.1 "Magnificent Seven" tech stocks bolstered the stock index, whereas the rest of the stocks experienced mediocre performance

After a dismal year of 2022, the major US stock indexes withstood multiple challenges such as the the Fed's consistent monetary tightening, a bank run crisis, and further rises in long-term US treasury yields in 2023, thus revealing surprising strength. Driven by factors including the boom of the concepts of AI and diet pills, the resilience of employment and consumption, fiscal stimulus measures exceeding expectations, and the unmet expectations about the economic recession, the

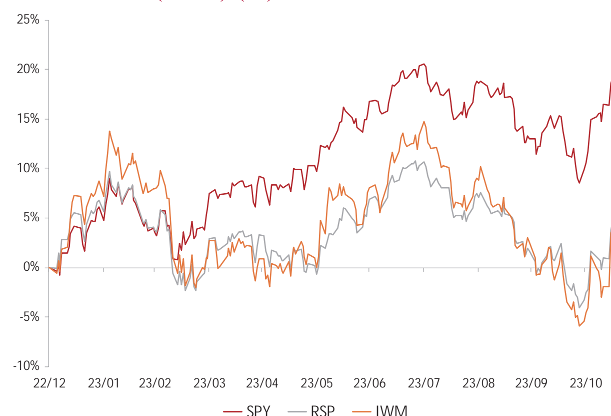
YTD of S&P 500 ETF (SPY) and the Nasdaq 100 ETF (Invesco QQQ) rose respectively by 19.18% and 45.61%. However, the divergence among US stocks is severe, and the real market situation is concealed by the bright performance of the index. In fact, most of the gains in the stock index are contributed by the highly weighted tech giants, including Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and META, which are collectively known as the "Magnificent Seven". The weighted increase of these stocks has exceeded 70%, and the total weight has reached 30% of the S&P 500 Index and more than 40% of the Nasdaq 100 Index. After eliminating the high weighted effect of the "Magnificent Seven", it will be a different picture. Both the S&P 500 Equal Weight ETF (RSP) and the Russell 2000 ETF (IWM) experienced mediocre performance, rising by only 4.42% and 3.4%, respectively.

Figure 167. Ranking of the YTD Return of the "Magnificent Seven" US Stocks (%)



Data sources: Bloomberg and BOC Investment Strategy Research Center

Figure 168. Comparison of YTD Return between S&P 500 (SPY), S&P 500 Equal Weight ETF (RSP) and Russell 2000 (IWM) (%)



Data sources: Bloomberg and BOC Investment Strategy Research Center

Despite the rosy picture in the "Magnificent Seven" of the US stock market, it has shown features of light-headedness and lacks breadth of gains, which is attributable to several factors. First, artificial intelligence is very popular, and investors center around the pursuit of growth stories of tech giants in AI applications. Second, large-cap stocks have strong balance sheets. During the period of low interest rates, these stocks have locked in low-cost financing with a longer term, and are thus more capable of withstanding the impact of high interest rates, whereas small-cap stocks are faced with the challenges of the tightening of bank credit and debt rollover. Third, at the end of the cycle of prosperity, numerous stocks that are sensitive to economic cycles continued to weaken, and funds tend to be increasingly attracted by tech giants that have high certainty of long-term earnings growth. Fourth, the US market is dominated by institutional investors, and more investment is made through index ETFs. This will cause heavyweight stocks to attract more buying funds than other constituent stocks. As a result, a cycle of positive feedback is established with rising market value, greater weight, and increased buying of funds.

3.2.2 End of the cycle of rate hikes has kindled hopes of a market rally despite weak performance of the ERP

After raising interest rates seven times by 425 bps in 2022, the Fed hiked interest rates four times by 100 bps in 2023. As a result, the interest rates are kept within the range between 5.25% and 5.5%. Moreover, the Fed maintained the hawkish guidance of monetary tightening policy subsequent to the suspension of rate hikes. The yields of US treasuries with a maturity of less than two years reached the level of above 5%, and the yields of long-term US treasuries with a maturity of ten years or more once rose above 5%. In a nutshell, the entire yield curve has risen sharply from the end of 2021 and reached a record high since 2006. The nominal interest rates have risen, whereas the expectations for ten-year average CPI inflation rate (based on the break-even inflation rate of ten-year inflation-protected treasuries) have dropped from 2.56% to 2.28%, making the inflation-adjusted real interest rate rise by an even greater margin. Real interest rates jumped from a record low of -1.04% to a high of 2.12% since 2008.

Figure 169. Changes in the US Treasury Yields by Maturity

Date	6 months	1 year	2 years	5 years	10 years	20 years	30 years
2021/12/31	0.19	0.39	0.73	1.26	1.52	1.94	1.9
2023/11/17	5.39	5.24	4.88	4.45	4.44	4.8	4.59
Changes of bps	520	485	415	319	292	286	269

Data sources: US Treasury Department and BOC Investment Strategy Research Center

The sharp increase in capital costs since 2022 led to a rolling recession in numerous industries, including the real estate, information technology, and manufacturing sectors in the US. Normally, the stock market should face downward pressure on both valuation and profitability, but after experiencing a decline in 2022, the S&P 500 Index experienced a strong rebound in 2023, only about 2% from the highs at the end of 2021. According to information released by FactSet, although the one-year forward EPS expectation of the S&P 500 Index dropped from 260 at the end of 2021 to the current level of 245, the PE ratio has hardly been affected by the rise in US treasury yields known as the "anchor of global asset pricing". The US treasury yields remain at a level of around 18.5, and thus the slight decline in the S&P 500 Index from its historical high has only reflected the decline in EPS so far.

At present, the forward PE ratio of 18.4 corresponds to an earnings yield of 5.4%. Although it is only slightly lower than the average of 5.7% over the past decade, the risk-free interest rate during the past decade has been an average of 200 bps lower than now. Prior to the current round of rising US interest rates, the TINA ("There is no alternative", namely, bond yields are too low and there is no choice but to invest in stocks to generate desirable returns) phenomenon has supported the high valuation of US stocks. Now that the current investment-grade bonds generally have yields of 6% or even 7%, the TINA effect no longer exists. In fact, the stock valuations have reached the most expensive level relative to bond valuations over the past two decades, and the equity risk premium (ERP)once fell into negative territory. If mean reversion is still effective, then there is a high chance that US stocks could perform worse than US bonds in the future.

Figure 170. Risk Premium of the S&P 500 Index: S&P 500 PE Ratio Versus US 10-year Treasury Yield (%)

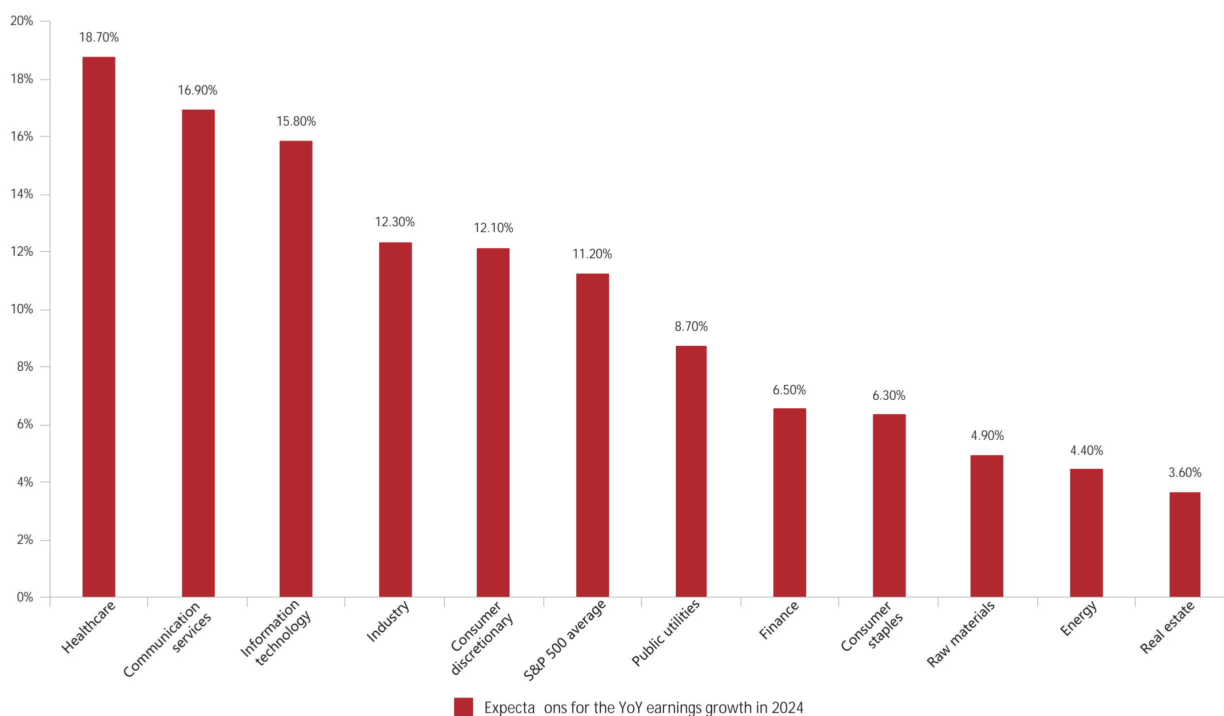
Data sources: Bloomberg and BOC Investment Strategy Research Center

Although stocks are inferior to bonds from a valuation perspective, the relationship between the stocks and bonds may not immediately return to the benchmark. Due to the sharp slowdown in the US inflation over the recent period, the end of the Fed's expectations to raise interest rates has stimulated optimism in the stock market to a significant extent. The trading logic has entered into the stage when "bad news is regarded as good news" and "good news is even more so", which has repeatedly taken place many times in the bull run of the US stock market over the past decade. Under such circumstances, upon release of negative economic data, the weakening of earnings prospects is ignored, and attention is paid to the improvement in valuations caused by falling interest rates. Upon release of positive economic data, the suppressive effects of rising interest rates on valuations are downplayed, whereas the expectations of a "soft landing" for the economy are strengthened. Driven by the improvement in the market sentiment due to enhanced risk appetites, unless economic fundamentals deteriorate to an extreme extent, investors are unlikely to "abandon stock portfolios in favor of bond investments". Instead, "stocks and bonds may experience a joint rally".

3.2.3 Driven by the market's expectations of a recovery in both revenue and profits in 2024, the market has fully priced in the "soft landing" of the US economy

The current 1-year forward P/E ratio for the S&P 500 Index is 18.4. This estimate is based on the analysts' expectations for the growth of operating income per share of 5.4% and the growth of EPS of 11.2% in the S&P 500 Index. With respect to industries, healthcare (18.7%), communication services (16.9%), and information technology (15.8%) sectors have led the growth of expected earnings. Raw materials (4.9%), energy (4.4%), and real estate (3.6%) sectors have ranked rather lower, but none of the industries are expected to experience shrinking earnings. It shall be noted that these data are compiled through the bottom-up approach by various corporate analysts, and may naturally have a optimistic tendency. For the entire year of 2023, the nominal GDP growth in the US reached 6.2% year-over-year, whereas the revenue and EPS of the S&P 500 Index grew by merely 0.6% and 2.3% respectively. Looking forward to 2024, the nominal GDP growth may drop to 3.5% in the US. Nevertheless, analysts predict that the growth rates of both revenue and EPS will still reach high levels of 5.4% and 11.2%, respectively. Such expectations may be utterly intricate to fulfilled against the backdrop of high interest rates. As the financial reports will be released soon, these forecasts could be faced with downward revisions.

Figure 171. Expectations for the YoY Earnings Growth of Varying Sectors of the S&P 500 Index in 2024 (%)



Data sources: Factset and BOC Investment Strategy Research Center

Figure 172. Expectations for the Revenue and EPS of the S&P 500 Index in 2024 May be Too High

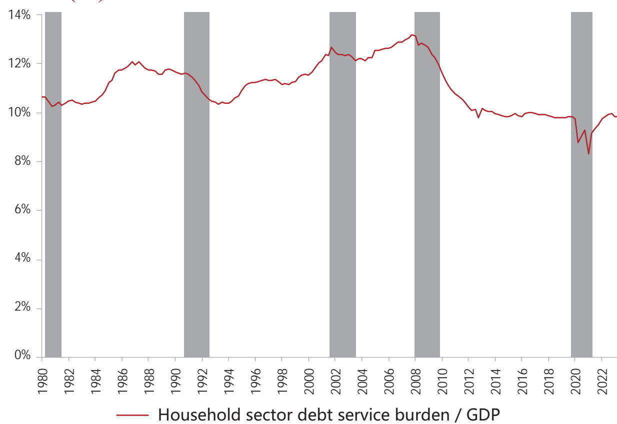
Year	Nominal GDP	Revenue	EPS
2023	6.20%	0.60%	2.30%
2024	3.50%	5.4%?	11.2%?

Data sources: Factset and BOC Investment Strategy Research Center

Judging from the above analysis from numerous aspects, the valuation of US stocks is not low at present, and the optimistic scenarios have been fully priced or even overpriced in the market. The expectations implicit in current pricing include: moderate economic growth, declining inflation, lower interest rates and strong corporate earnings. The core logic of such market pricing is specified as follows:

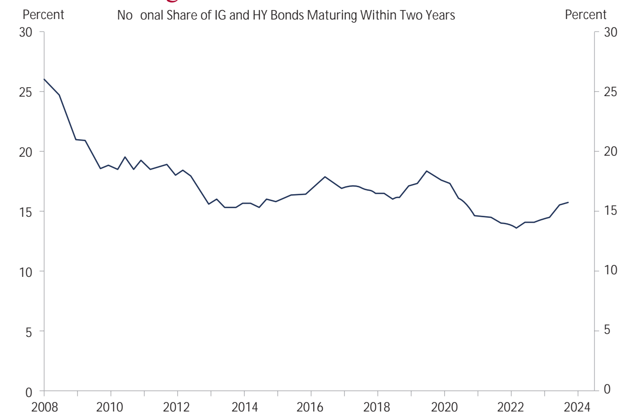
First, policy efforts of “Bidenomics” through fiscal deficit. “Bidenomics” is the major source of the US economic resilience at present, which exceeds the market’s expectations. Government expenditure provides the income of the private sector, and the huge fiscal deficit fills the “wallets” of residents, which is converted into corporate earnings and leads to stronger consumption and employment. The industrial policies adopted under the Inflation Reduction Act (IRA) of the Biden administration have supported the growth of the high-tech industries of computers, electronics, and power equipment through subsidies and other methods, driving investment growth in these industries against the trend of rising interest rates of financing. Second, given that the financial conditions of the private sector are strong, the impact imposed by the hikes of interest rates will be limited for the time being. Thanks to the deleveraging of residents after 2008, the debt-to-GDP ratio of the US household sector has structurally declined, reaching a low of 73.6% over the past two decades. Although the marginal financing interest rate has soared in the US, given that a large number of existing mortgage loans were refinanced between 2020 and 2021, an ultra-low fixed mortgage interest rate of about 3% for 30 years has been locked. The new mortgage interest rate of more than 7% at present basically has no impact on existing mortgage loans. Hence, the debt service expenditure in the household sector as a proportion of personal disposable income has merely returned to pre-pandemic levels, and remained at historical lows. Similarly, given that companies issued large amounts of low-interest debt in 2020 and 2021, refinancing demands remain at a record low level since 2008. According to the estimates of the Goldman Sachs, refinancing mature debts will only increase corporate interest expenses by 2% in 2024 and only 5.5% in 2025. In addition, as the stock market and housing prices experienced a rally, and the value of businesses and household wealth increased, the financial conditions also strengthened in the private sector. Third, the normalization of the supply chain contributed to the downward movements in inflation and interest rates. From 2020 to 2022, the US CPI soared from 0.1% to 9.1%. However, starting from June 2022, it took only one year for the CPI to fall from 9.1% to 3%, and it is expected to return to the level of 2% in 2024, which is the central level prior to the pandemic. This trend has shown that long-term structural factors such as anti-globalization, transition into green development, and aging of population are not the primary factors contributing to the ups and downs of the current round of inflation. Instead, short-term factors such as the mismatch in global supply chains and unprecedented fiscal stimulus measures are the major driving forces. At present, the Global Supply Chain Pressure Index of the New York Fed has completely fallen back to pre-pandemic levels from the abnormally high levels during the pandemic. In the near term, the supply chain will at lease not cause disturbance to the downward trend of inflation. As inflation continues to approach the policy target set by the Fed, interest rates should also return to a neutral level from the current restrictive level. Under such circumstances, the suppressive effects of high interest rates will also subside on US stocks.

Figure 173. Household Sector Debt Service Burden/GDP (%)



Data sources: St. Louis Fed and BOC Investment Strategy Research Center

Figure 174. Investment-grade and High-yield Corporate Bonds Maturing within Two Years



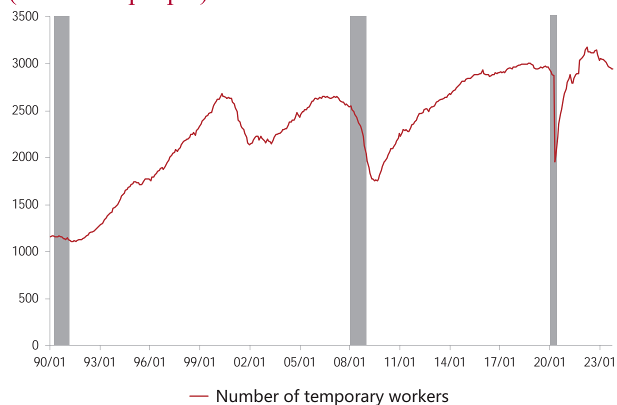
Data sources: Bloomberg and Goldman Sachs Global Investment Research

3.2.4 Closer attention shall be paid to the risks such as the accelerated rise of the unemployment rate, underperformance of the banks' balance sheets and corporate earnings falling short of expectations

Although there are several factors to support the current high valuation of US stocks, and the consistent rise in the next few months is in line with historical experience, its downside risk still cannot be underestimated. In particular, after the Fed's initial interest rate cut in 2024, the focus of market trading may shift to economic recession and declining earnings. Closer attention shall be paid to the following risk factors:

First, the labor market has shown signs of softening, and the unemployment rate may rise at an accelerated pace. In recent years, there has indeed been a structural shortage of blue-collar and contact jobs in the US, and the actual prosperity of the job market is not as strong as the unemployment rate suggests. Inflation-adjusted real wages have not departed from the trends of the past two decades. The number of temporary workers continued to decline since peaking in March 2022. When the labor demands of enterprises decrease, temporary workers will be the first to be laid off. From a historical aspect, the declines in temporary workers have also been one of the leading signals of economic recession. According to the Sahm Rule (which has a 100% track record predicting recessions), if the three-month moving average of the unemployment rate increases by 0.5% above the 12-month unemployment low, a recession is not only likely but has probably started already. Since hitting a 50-year low of 3.4% in April 2023, the unemployment rate rose to 3.9% in October, and the three-month moving average also reached 3.83%. Although the unemployment rate unexpectedly fell back to 3.7% in November, if it reached 3.9% for two consecutive months starting from December 2023 or January 2024, an alarm will be triggered. Once an economic recession gains momentum, the unemployment rate will usually accelerate, which will impose a significant impact on the US stock market currently filled with expectations of a soft landing.

Figure 175. Number of Temporary Workers (Thousand people)



Data sources: St. Louis Fed and BOC Investment Strategy Research Center

Figure 176. Sahm Rule Recession Indicator

Data sources: St. Louis Fed and BOC Investment Strategy Research Center

Second, the risks of the balance sheets of banks have been heightened, and there is the chance of another banking incident. The rate of commercial real estate loans that are delinquent for more than 30 days is on the rise. In particular, the delinquency rates of three types of commercial real estate loans, including industrial, apartment, and office buildings, have increased to a significant extent since August 2023. The recent bankruptcy of WeWork Inc is likely to exacerbate rising delinquency and default rates of commercial real estate loans in 2024, as the company is the largest lessor in the US with approximately 20 million square feet of office space. WeWork is terminating leases, causing related landlords to lose income from rental cash flow. Regional banks assume 70% of total commercial real estate loans in the US, and retain 30% of these loans on their own balance sheets. In 1H, 2023, the US regional banking system has experienced the second, third, and fourth largest bank failures in US history. Evidently, the dilemma in the commercial real estate sector will further increase the pressure on the balance sheets of regional banks, causing these banks to tighten credit to the regional economy and increasing the chance of an economic recession. Overall interest rates are still rising in 2023, and thus the market value of mid-to long-term fixed-income securities has fallen again after plummeting in 2022. In addition, the floating losses of banks holding these assets have expanded to some extent. The balance of Bank Term Funding Program (BTFP) borrowings launched by the Fed in response to bank runs in 1H, 2023 is still on an upward trend, reaching USD 120 billion at the end of October. The problem is that the maximum borrowing term of the program is only one year, and will expire as early as March 2024. By then, the Fed's renewal policy could be uncertain. Therefore, although the US financial system seems to be stable at present, the factors that may lead to financial instability constantly exist, and have yet to be fundamentally addressed.

Figure 177. Delinquency Rate of Commercial Real Estate Loans Overdue by More Than 30 days

Type of commercial real estate	All	Industrial	Hotel	Apartment	Office	Retail
August, 2023	4.25%	0.33%	5.31%	1.84%	5.07%	6.87%
September, 2023	4.39%	0.30%	5.27%	1.85%	5.58%	6.92%
October, 2023	4.63%	2.56%	4.76%	2.64%	5.75%	6.55%

Data sources: Trepp and BOC Investment Strategy Research Center

Third, there are risks that corporate earnings may fall short of expectations. Even excluding the factor of a recession, the forecast of the S&P 500 earnings of 11.2% by analysts through a bottom-up approach seems overly optimistic compared with the expected nominal GDP growth of 3.5% in 2024. Moreover, according to calculations by the San Francisco Fed, the excess savings accumulated by US residents during the pandemic have been basically exhausted. Coupled with the cooling of the job market, consumption momentum may weaken to a significant extent, leading to a headwind for corporate earnings growth. In addition, the European economy is already in the early stages of recession, and the economic recovery has also weakened again in China, making it more difficult for the S&P 500 companies to achieve growth in their overseas revenue (accounting for 40% of total revenue) and profits. Last but not least, the strong fiscal support in 2023 can hardly be replicated. On the one hand, the issue of fiscal sustainability in the US has aroused great concern from society, and any further deficits may encounter stronger opposition from conservatives. On the other hand, according to statistics from China International Capital Corporation (CICC) on the US fiscal budge during election years since 1960, when the Congress is divided, and the House of Representatives and the president belong to different parties, the fiscal contraction during the election year is generally the largest. This is also exactly the status-quo. A divided Congress often means that the degree of competition between the two parties intensifies, and the deficit ratio will shrink significantly. For instance, in 2012, fiscal expenditures shrank by 1.4% of GDP, and the EPS of the S&P 500 Index only went up by 0.39% in the same period.

3.2.5 Pattern of short-term bearish trend and long bull run remains unchanged for the US stock market, and investors are recommended to patiently wait for opportunities to increase asset allocation

Over the past century, the US stock market has led the global markets in returns, which is attributable to numerous factors including but not limited to: the high degree of market-oriented and rule-based development; the cultural heritage that focuses on corporate governance and shareholder returns; the mature investor group; the stock index compilation of survival of the fittest; the advantages of attractive global innovative talents; and the status of the USD as the world's reserve currency. Given that these factors have yet to change much at present, the long-term bullish view is still justified for the US stock market. The

US stock market has an apparent and unchanging feature, namely, the rapid and large fluctuations in the bear market are able to quickly clear out market risks, while during the long bull run, the market only has small fluctuations. As a result, investors are convinced that the US stock market will rise steadily in the long term. According to statistics over the past century, the proportion of the rising years of the S&P 500 Index has been as high as 75%, and the average annualized return (dividend reinvestment) has fallen within the range of around 10% without a large standard deviation over the past 10, 20, 30, 50 and 100 years. The factors that contribute to the increase in the S&P 500 Index are mainly the growth of EPS and dividends. Despite the expansion and contraction of the P/E ratio, there is a boundary to the movements. Hence, for long-term investors into the S&P 500 Index, timing is less important. Nevertheless, for investors with shorter investment horizons and more balanced requirements for asset allocation, the US stock market could become more volatile in 2024, and closer attention shall be paid to the adding or reduction of positions at the opportune moment.

Figure 178. Historical Returns of the S&P 500 Index

Past X Years	10	20	30	50	100	Standard deviation
Compound average annualized return of dividend reinvestment	12.08%	9.66%	9.86%	10.76%	10.53%	0.96%

Data sources: Bloomberg and BOC Investment Strategy Research Center

Looking forward to 2024, optimistic expectations for a “soft landing” in the US economy and the shift of the Fed’s stance from a hawkish policy to a dovish one may push the S&P 500 Index to reach new highs in the coming months. Accordingly, the bearish views and short-selling operations are likely to be postponed. However, when investors think that they have withstood all the negative impact and become excited, the cyclical top of the bull run is usually formed, thus paving the way for the “black swan” event in the market prospects. At present, the prospect of interest rate cuts have kindled the enthusiasm of investors, but when the cycle of interest rate reductions truly begins, it often corresponds to an economic recession and heightened stock market volatility, which is a signal to reduce shares on highs. During the past six cycles of the Fed’s interest rate reductions, it took an average of 322 days from the first rate cut to the low of the stock market during the rate cut cycle, with the average decline of a level as high as 22%.

Figure 179. Performance of the S&P 500 Index Subsequent to the First Rate Cut

Timing of the first rate cut	1984/10/2	1989/6/5	1995/7/6	2001/1/3	2007/9/18	2019/8/1	Average	2024/?/?
Interval for the S&P 500 Index dropping to a low (days)	7	493	13	644	538	235	322	?
Magnitude of the declines of the S&P 500 Index	-1.20%	-8.30%	-0.50%	-42.40%	-55.50%	-24.20%	-22.02%	?

Data sources: Bloomberg and BOC Investment Strategy Research Center

From our perspective, the US stock market is likely to experience a rally before declines in 2024. The highest point may be reached around the time of the first interest rate cut, and may continue to fall thereafter. In terms of the asset allocation, it is recommended to start with a neutral view on the S&P 500 Index. After the first rate cut, investors may reduce holdings on highs and switch to lower levels of asset allocation. After sufficient declines, investors may increase holdings and return to a neutral view.

3.3 European Stock Markets: Economy Remained Sluggish, and the Rebound is Unsustainable

3.3.1 Review of European stock market performance: Inflation peaked before declines, following the rally of US stocks

Since 2023, European stock markets have shown a V-shaped trend characterized by highs at first, lows in the mid-term and recovery at the tail. As of November 15, the UK FTSE 100 Index was down 0.61% in 2023, the French CAC40 was up 9.60%, the German DAX index rose by 11.78%, wheres the STOXX Europe 600 Index went up by 6.28%.

In Q1, European stock markets achieved strong performed. At the beginning of 2023, the European and US economies performed better than the market's expectations, and major European stock indexes experienced a rally. Rising energy prices drove the UK FTSE 100 Index higher. In mid-February, the FTSE 100 Index rose above the level of 8,000 points. The European and US banking crisis that broke out in early March fueled the market panic, and European stock markets experienced a cliff-like slump. Subsequently, European and US central banks quickly provided liquidity support, thus curbing the contagion of market panic. During Q1, 2023, the UK FTSE 100 Index rose by 2.42%; the French CAC40 Index surged by 13.11%; the German DAX index increased by 12.25%; and the STOXX Europe 600 Index went up by 7.75%.

In Q2, European stock markets weakened in general. European stock markets entered into a phase of consolidation after a rebound. At the same time, the negative impact imposed by the sharp interest rate hikes as well as hawkish guidance of major Western central banks on the economy have been gradually reflected in stock prices. In Q2, 2023, the UK FTSE 100 Index fell by 1.31%; the French CAC40 Index picked up by 1.06%; the German DAX Index rose by 3.32%; and the STOXX Europe 600 Index went up by 0.89%.

In Q3, European stock markets continued to weaken. The US inflation rebounded in August, and there were higher market expectations for the Fed to further raise interest rates. Moreover, funds flooded back to the US at an accelerated pace. On the other hand, the European economy was weak, with manufacturing PMI in major euro zone economies such as Germany and France falling below 50. In addition, the market concerns about a European economic recession are rising. In Q3, 2023, the UK FTSE 100 Index rose by 1.02%; the French CAC40 Index fell by 3.58%; the German DAX Index dropped by 4.71%; and the STOXX Europe 600 Index slid by 2.54%.

Given that major central banks in Europe and the US already start to release signals that interest rate hikes are coming to an end, the market have gradually priced in the effects of interest rate cuts. European stock markets are expected to have a "breathing moment" in Q4. From October 1 to November 15, the UK FTSE 100 Index fell by 0.04%; the French CAC40 Index rose by 2.26%; the German DAX Index went up by 3.14%; and the STOXX Europe 600 Index rose by 2.31%. With the exception of the UK FTSE 100 Index, major European stock markets outperformed the movements in Q3 overall.

In a nutshell, the primary factors affecting European stocks in 2023 included inflationary expectations and tightening monetary policy. The UK's stock index showed a certain synchronicity with the major stock indexes in continental Europe. European stocks, which are dominated by value stocks, have underperformed compared with US stocks, which are dominated by growth stocks. Among the major European stock markets, the German stock market achieved the best performance, whereas the British stock market experienced the worst performance.

3.3.2 Outlook on the European stock market performance

3.3.2.1 Expectations of an economic recession are bearish signals for the stock market, and the trend of rebound is unlikely to be sustainable

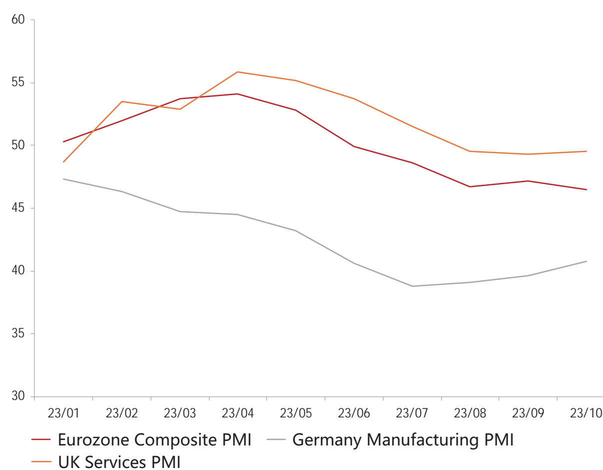
In 2024, there is a high chance that the inflation in Europe (including the Eurozone and the UK) will continue to decline, and the economic growth may rise slightly. According to the IMF's forecast in October, in 2023 and 2024, the Eurozone economic growth is estimated to reach 0.7% and 1.2%; the German economic growth is estimated to reach -0.5% and 0.9%; and British economic growth is estimated to reach 0.5% and 0.6%, respectively. Due to the easing of inflationary pressure in major European and US economies, the production activities and investment confidence are likely to be restored, which is expected to constantly bolster the performance of European stocks in Q1, 2024. However, there is a high chance that major Western central banks will enter into the cycle of interest rate reductions in 2H, 2024. Therefore, in Q2, 2024, the focus of market trading will shift from inflation to recession. Before and during the early stages of the interest rate reductions, the market

ambience is still expected to be buoyant. However, driven by the progress of interest rate reductions, the market will enter into the period of adjustments and enhanced volatility. In 2023, the bad news for the economy could be interpreted as good news for the stock market, but the bad news for the economy in 2024 would eventually be understood as bad news for the stock market, and the trading of stock market will return to economic fundamentals.

Figure 180. Forecast on the European Economic Growth in 2023 and 2024 (%)

Data sources: IMF and BOC Investment Strategy Research Center

Figure 181. PMI of Major European Economies in 2023 (%)

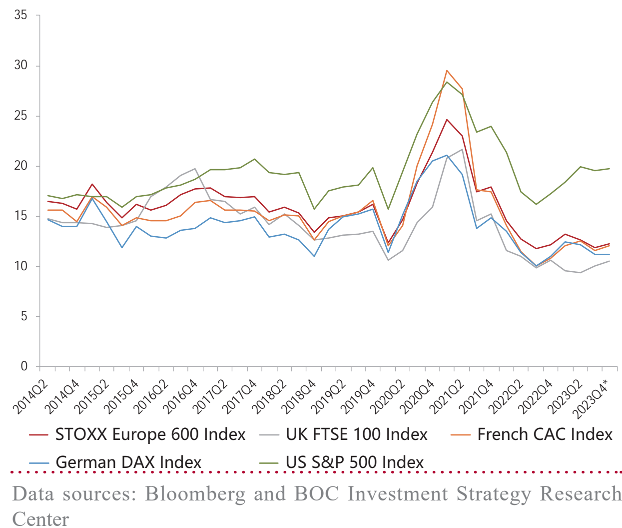


Data sources: SP Global and Goldman Sachs Global Investment Research

3.3.2.2 Advantages of valuation may hardly be released with prominent structural issues

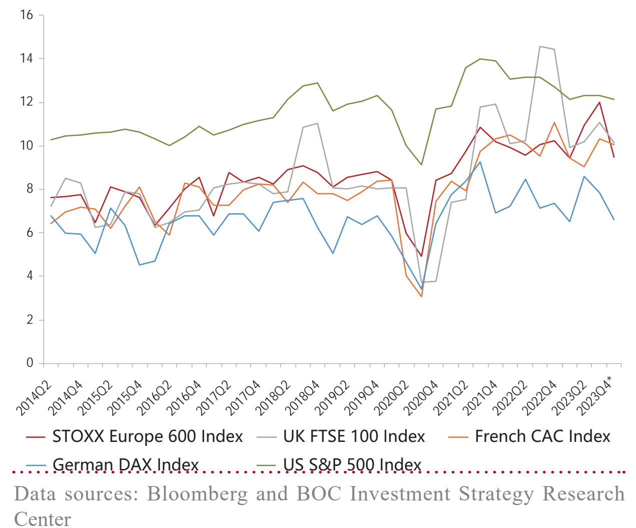
The valuations of the Eurozone and the UK's stock indexes have been lower than the valuation of US stocks for a long time, and such structural issues may hardly be reversed in the near term. In Q3, 2023, the rolling PE ratio (PE TTM) of the STOXX Europe 600 Index reached about 12, and the UK FTSE 100 Index was 10, which was lower than the US S&P 500 Index (which reached 19.5). The STOXX Europe 600 Index and UK FTSE 100 Index both had rolling P/E ratios below their averages over the past five years (which reached 15.7 and 13.1 respectively). Low-valuation stocks are generally more attractive, but the overall profit margins of European enterprises were lower than those of the US S&P 500 Index. Due to market fragmentation, investors tend to pay less attention to European stocks than bond markets, thus offsetting the advantages of low valuations in European stock markets. In addition, the low valuations of European stocks have reflected their own structural issues. First, among European stocks, the proportion of growth stocks is rather small, and the number of large tech companies is also small. Moreover, the boom in emerging technologies such as AI failed to drive the stock market up, and falling US treasury yields have also imposed limited impact on the stock market rally. Second, international trade situation remained sluggish. There are numerous traders among European companies, and the sluggish growth of international trade imposed a negative impact on the stock market movements. Third, the stalling growth of major economies represented by Germany suppressed the performance of the stock market. The German government did not adopt effective response measures to the changes such as decarbonisation, digitalisation, demographic (3D), and the reform of the industrial system is "imminent".

Figure 182. 12-month PE Ratio of Major European Stock Indexes on a Rolling Basis (Times)



Data sources: Bloomberg and BOC Investment Strategy Research Center

Figure 183. Profit Margin of European Enterprises (%)

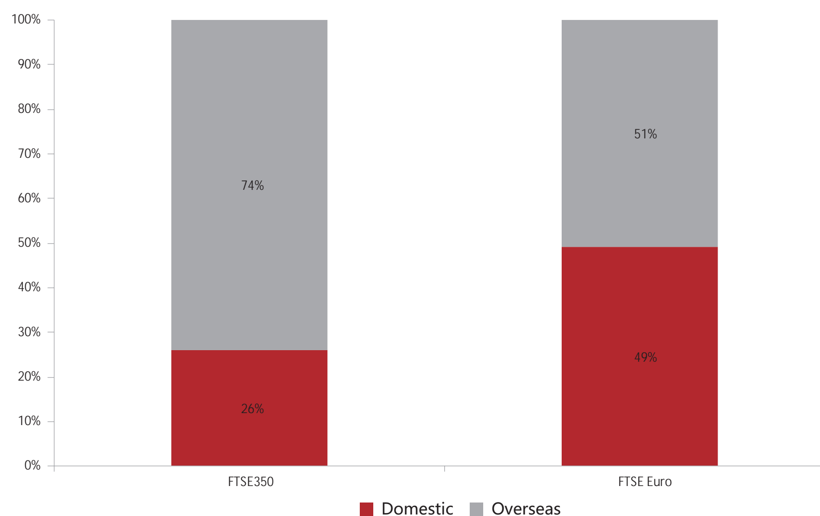


Data sources: Bloomberg and BOC Investment Strategy Research Center

3.3.3 View on asset allocation: It is recommended to given an underweight on European stocks, and focus shall be paid to structural opportunities

In 2024, the European economy may continue to be sluggish and remain weaker than the US economy. The BoE and the ECB are expected to cut interest rates earlier to prevent the risks of economic recession. Economic fundamentals have imposed pressure on European stock markets. At the same time, more than half of the revenue of major European listed companies originates from overseas markets. Economic recession or weak recovery of major European and US economies will make it harder to provide support to the performance of stock markets, which will also send bearish signals to the European stock markets. In addition, structural issues may hardly be reversed in the near term, and low valuations may hardly be converted into actual investment returns in the short term. This will be no good news for European stocks to attract long-term investors. Moreover, non-tradable sectors such as public utilities and real estate sectors are more sensitive to economic downward pressure.

Figure 184. Proportion of Domestic and Overseas Revenue of Enterprises Included in the FTSE Europe and FTSE 350 Indexes (%)



Data sources: HSBC Holdings and BOC Investment Strategy Research Center

Compared with expectations of unsatisfactory performance in European stock markets overall, certain industries may be encountered with structural issues. First, the falling energy prices will drive part of the profits from upstream industries to be transferred to midstream and downstream industries. Second, low unemployment and strong wage growth are likely to bolster consumption. Opportunities exist for companies with relatively stable assets and liabilities in the consumer discretionary, consumer staples and medical industries. Third, tech stocks are likely to benefit from the rebound in valuations brought about by the declines in US treasury yields. Based on the aforementioned analysis, it is advocated to remain cautious about European stock markets in 2024. We recommend an underweight for European stocks, and closer attention shall be paid to structural opportunities in industries with prosperity.

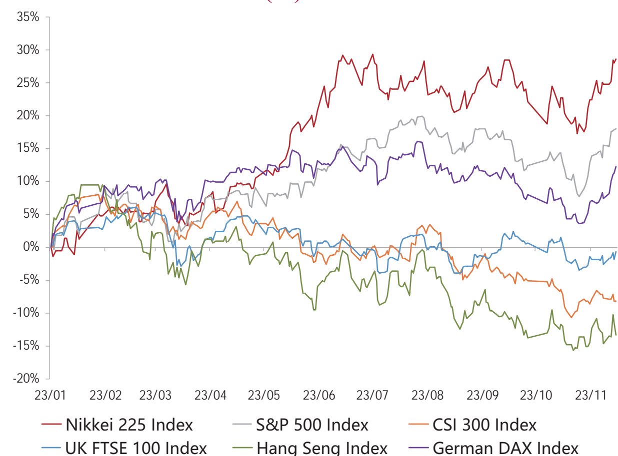
3.4 Japan's Stock Market: Recovery Continued with a Moderate Rally

3.4.1 Economy continued to recovery, leading to a rebound of the stock market

As of November 17, the Nikkei 225 Index had increased by 28.71% for the year 2023, far exceeding the increase in major developed markets around the world, and its performance was regarded as outstanding. The Japanese stock market continued to experience a rally since early 2023, which is attributable to numerous factors including the ultra-loose monetary policy and improved economic prospects, the celebrity effect of Warren Buffett's increased holdings, and accelerated foreign capital inflows. The Nikkei 225 Index rose by 7.46% and 18.36% in Q1 and Q2, 2023 respectively. Starting from July, the BoJ adjusted the Yield Curve Control (YCC) range, and the market optimism gradually weakened. Moreover, foreign capital inflows slowed down, and the Nikkei 225 Index dropped by 4.01% in Q3. With the pause of rate hiked by the Fed again in November, the Nikkei 225 Index recovered its losses in Q3.

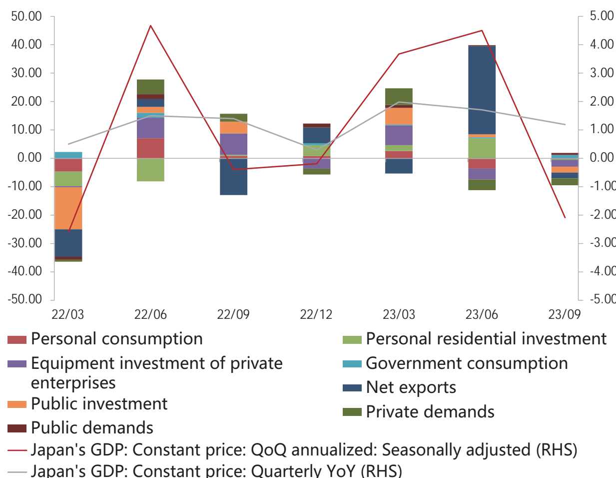
Japan's stock market has benefited from the economic recovery in the country. In 1H, 2023, the Japanese economy maintained a relatively strong momentum of recovery. The annualized rate of GDP growth reached 3.7% in Q1 and 4.5% in Q2, achieving positive growth in a consistent manner. However, in 2H, 2023, dragged down by household consumption and corporate spending, Japan's GDP fell by 2.1% in Q3 at an annualized rate, which also reflected to a certain extent that Japan's post-pandemic economic recovery remained relatively fragile.

Figure 185. Performance of Nikkei 225 and Major Market Indexes in 2023 (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 186. Performance of Japan's Economy (%, %)



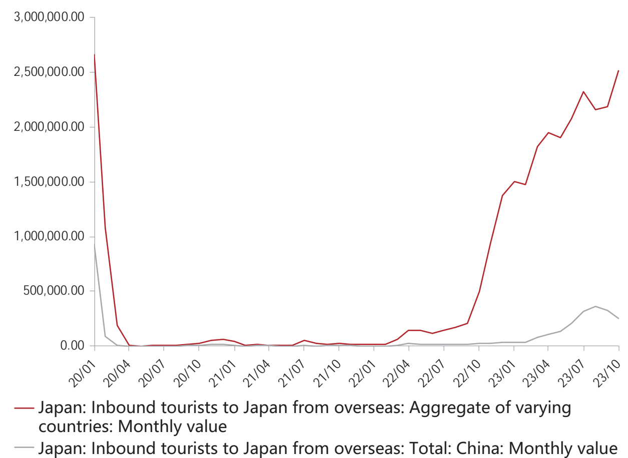
Data sources: Wind and BOC Investment Strategy Research Center

Domestic demands have boosted the post-pandemic economic recovery in Japan. Under the combined effect of the government's implementation of fiscal transfer policies, the release of forced savings, and the growth of wages, consumer spending has increased to some extent. At the same time, enterprises have a relatively stronger willingness to invest after the pandemic. External demands have become the most vital factor supporting the rapid economic recovery in Japan in 1H, 2023. The consistent depreciation of the JPY has promoted the improvement of exports and the growth of corporate earnings. The relaxation of travel restrictions has led to a rebound in the number of inbound tourists. The influx of foreign investment has boosted the economy and pushed up the Japanese stock market.

Figure 187. Employee Remuneration and Household Consumption Expenditure in Japan (JPY 1 billion, JPY)

Data sources: Wind and BOC Investment Strategy Research Center

Figure 188. Number of Inbound Tourists to Japan (People)



Data sources: Wind and BOC Investment Strategy Research Center

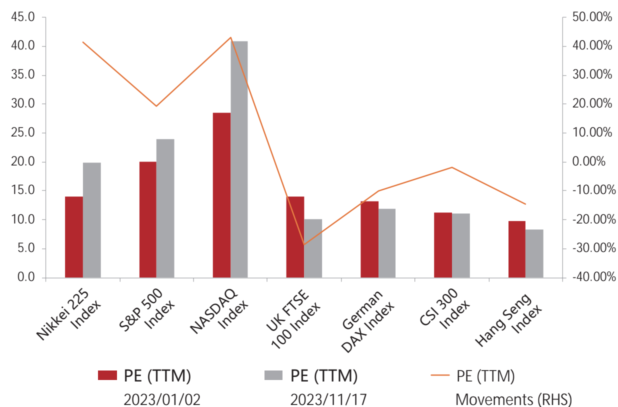
3.4.2 Valuation remained reasonable and profit-driven

Japan's stock market has long been regarded as a market of deep value. Compared with the stock markets in Europe, the US and emerging economies, Japan's stock market is less volatile with a lower level of valuation. The PB ratio of a large number of listed companies has been lower than one time for a long period time. Over the recent years, the corporate governance efforts made in Japan to call for listed companies to return to shareholders have produced positive results. For instance, the Tokyo Stock Exchange proposed a guidance plan on the PB of Japanese listed companies on March 31, 2023. In particular, the regulator required enterprises with a PB ratio lower than one time for a long time to formulate plans of improving valuations through buybacks, additional issuances and other means. At the shareholders' meeting of Berkshire Hathaway in early May, Warren Buffett proactively mentioned his plan to increase his positions in Japanese stocks. He stated that investing in large Japanese commercial companies was due to their low valuations, stable dividends, and optimal cash flow. This statement has reflected the recognition of international institutional investors for the measures taken by Japan's securities regulatory authority. At the same time, the move to repurchase shares directly has enhanced the attractiveness of listed companies in Japan.

After the Nikkei 225 Index experienced a sharp rally in 2023, its valuation has expanded. The PE (TTM) has increased from 14.06 times in early 2023 to 19.88 times on November 17, but it is still at the level around average and median of the past decade. Though the ratio is higher than the developed European markets such as the UK, Germany, and France, but it is lower than the US market. Furthermore, the PB ratio (LF) has increased from 1.45 times at the beginning of the year to 1.81 times. At present, it is slightly higher than the historical average as well as the European markets, but it is still low compared with US stocks. From a valuation perspective, the valuation of Japanese stocks is still within a reasonable range at present.

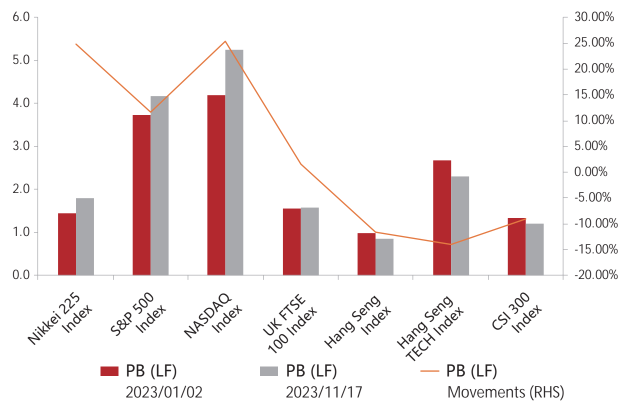
Driven by the recovery of economic activities and the depreciation of the JPY, the performance of the export-oriented listed companies in Japan has been bolstered. In particular, the enterprises engaged in manufacturing, international trade, transportation, finance and other industries have achieved remarkable earnings growth. According to statistics, the net profits of the manufacturing industry reached JPY 11.6425 trillion from April to September 2023, an increase of 12% over the same period in 2022, and exceeded the non-manufacturing industry (which reached RMB 11.5652 trillion, an increase of 8%). Production recovery and price increases brought about by the improvements in the supply chain have become vital factors supporting the growth of profitability, and will become a crucial factor driving the market rally in 2024.

Figure 189. Horizontal Comparison of PE (Times, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 190. Horizontal Comparison of PB (Times, %)



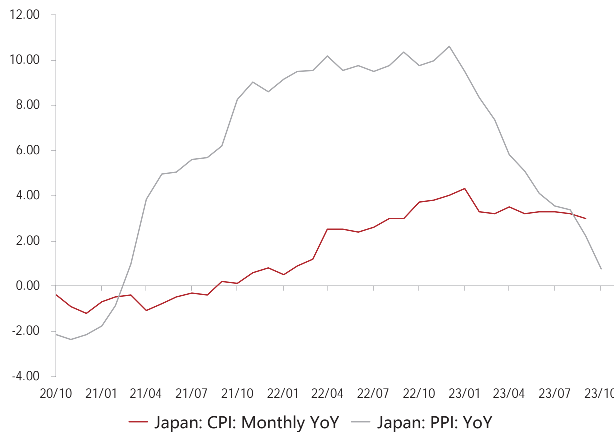
Data sources: Wind and BOC Investment Strategy Research Center

3.4.3 Japan escaped from deflation and maintained the policy of monetary easing

Japan has been in a state of deflation for a long time over the past few decades. Nevertheless, driven by the restructuring of industrial and supply chains, the unbalance between supply and demand has led to surging global inflation. Japan has experienced the start of a new round of inflation cycle and price increases since September 2021. Japan's CPI reached 4.3% year-over-year in January 2023, hitting a record high over the past four decades. At present, Japan's inflation has undergone certain positive changes. Prices have increased, and the costs of living have increased, whereas workers started to require companies to increase wages. During the Spring Fight in 2023, many labor unions put forward requirements for higher salary increase than in previous years. In the end, most of the demands were met. The average wage growth of employees reached 3.99% in large enterprises, which was a significant increase of wages. Regarding the Spring Fight in 2024, certain large companies have announced salary increase plans for the year 2024, increasing employee wages by more than 5% of the annual salary. Furthermore, the Japanese government is expected to provide greater tax cuts and benefits to companies that increase wages, which will also stimulate companies to increase wages. It is expected that the moderate inflation in Japan will persist in 2024, and is expected to form a virtuous cycle when prices and wages rise in a healthy and balanced manner, driving the growth of consumption in Japan.

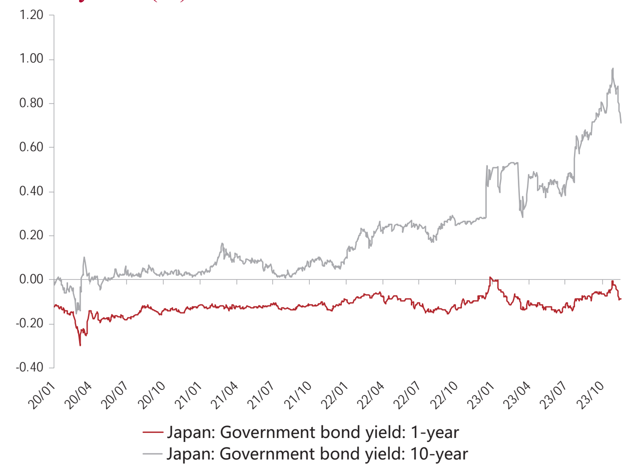
At present, Japan's inflation rate has gradually dropped to the level around 3%. Its GDP fell by 2.1% at an annualized rate in Q3, lower than the market's expectations. Previously, the BoJ was planning to withdraw from decades of ultra-loose monetary policy, but the slowdown in economic growth has brought uncertainty to the outlook for the BoJ's monetary policy. If the central bank withdraws from the policy of negative interest rates too early, it could intensify the pressure of economic downturn. Therefore, from our perspective, the BoJ is likely to maintain an ultra-loose monetary policy in the near term, and will exit at an appropriate time after wages, prices, and economic growth continue to form a virtuous cycle. Moving forward, the ultra-loose monetary policy is still likely to support the stock market.

Figure 191. Monthly YoY of CPI and PPI in Japan (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 192. Japan 1-year and 10-year Government Bond yields (%)



Data sources: Wind and BOC Investment Strategy Research Center

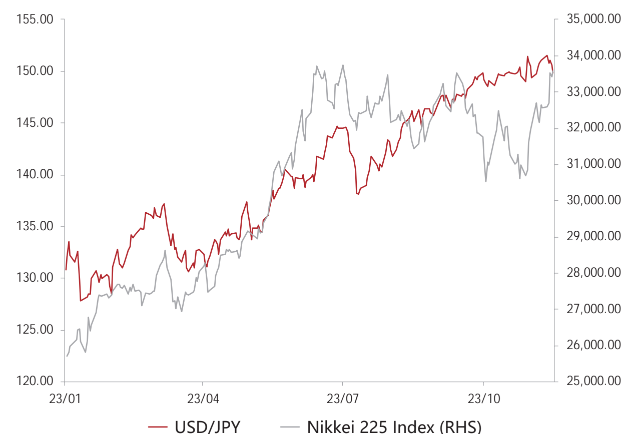
3.4.4 Policy adjustments may become headwinds

In the short term, we believe that the BoJ may continue to maintain an ultra-loose monetary policy. Nevertheless, if Japan's economy is able to constantly achieve optimal growth in subsequent stages, leading to wage growth and the inflation rate above the target level for a long time, then Japan may usher in a window of opportunities to withdraw from the policy of negative interest rates. In case that the BoJ shifts its monetary policy, and that the Japanese interest rates rise to narrow the interest rate gap with Europe and the US, it could impose pressure of appreciation on the JPY. For a long time, the performance of the Japanese stock market has been negatively correlated with the trend of the JPY. Hence, once the JPY appreciates significantly, Japanese stocks may be subject to greater pressure.

Figure 193. Japan Manufacturing PMI and Services PMI (%)

Data sources: Wind and BOC Investment Strategy Research Center

Figure 194. JPY and Nikkei 225 Index



Data sources: Wind and BOC Investment Strategy Research Center

3.4.5 Conclusion: Japanese stock market is expected to maintain the trend of moderate rally

Overall, Japan's economy is likely to maintain its pattern of recovery in 2024, but with a marginal slowdown. The Japanese stock market used to be underweighted by international funds due to long-term sluggish economic growth and deflation.

However, over the recent years, Japan's economy has seen more positive changes. Driven by the rising inflation, recovery of consumption, and benefits brought to industries due to restructuring of the global supply chain, the Japanese stock market has attracted greater attention from an increasing number of global investors. In 2024, Japan's stock market is expected to maintain a moderate rally, and it is recommended to give an overweight to Japanese stocks.

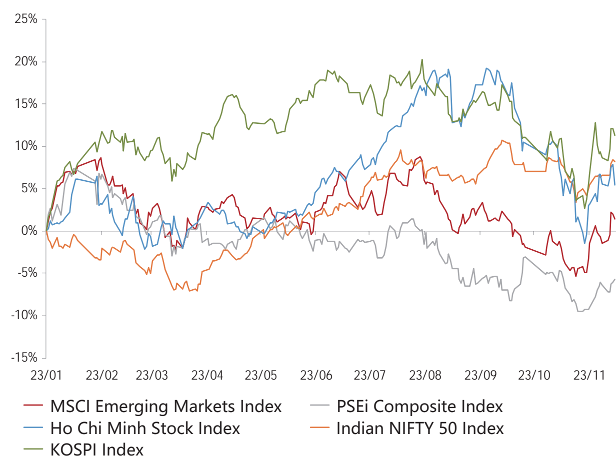
3.5 Emerging Markets: A Silver Lining is Emerging at the Infection Point of Monetary Tightening, and Market Performance Becomes Divergent Due to Structural Differences

3.5.1 Interest rate spreads remained high and the pressure continued to exist

In 2023, emerging markets evidently underperformed compared with developed markets. As of November 17, the MSCI Emerging Markets Index rose slightly by 2.1%, whereas the MSCI Developed Markets Index rose by 14.69% in 2023. This is primarily attributable to the rising US treasury yields and China's economic recovery that was inferior to the market's expectations. The performance of emerging markets was also divergent in 2023. In particular, the KOSPI Index rose by 10.43%; the Ho Chi Minh Stock Index went up by 9.34%; the Indian NIFTY 50 Index increased by 8.98%; the PSEi Index fell by 5.39%; and the FTSE Bursa Malaysia KLCI Index dropped by 1.30%.

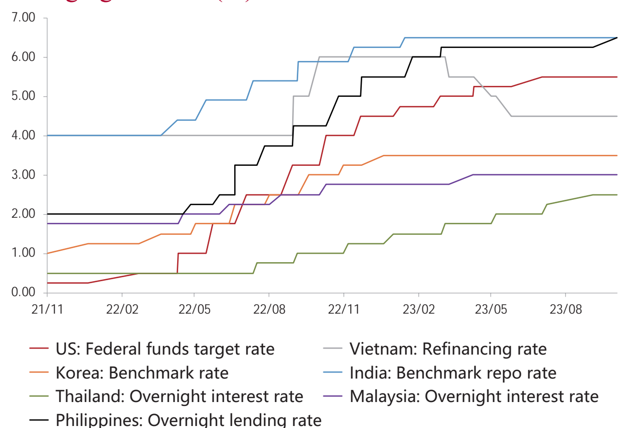
Since early 2023, the frequency of interest rate hikes by central banks has gradually decreased in emerging markets, and the overall magnitude of interest rate hikes has dropped significantly. Certain emerging markets, such as Vietnam and Brazil, have taken the lead in lowering interest rates. Although the Fed's hike of interest rates is coming to an end, interest rates may stay high for a longer period of time. If the timing of interest rate cuts is postponed, then interest rate spreads will remain high for some time, which will exert certain pressure on the market. Looking forward, after the Fed's shift of its monetary policy, external pressure is likely to ease, and the market will also achieve better performance against the backdrop of loosening liquidity.

Figure 195. Emerging Market Performance (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 196. Interest Rate Movements in the US and Emerging Markets (%)



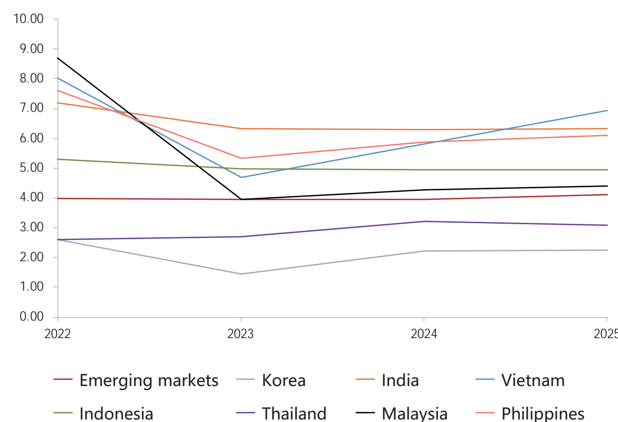
Data sources: Wind and BOC Investment Strategy Research Center

3.5.2 Economy slowed down, and exports remained under pressure

Driven by the rising global interest rates, economic growth is expected to slow down. According to the latest World Economic Outlook report released by the IMF on October 10, 2023, global economic growth would slow down from 3.5% in 2022 to 3.0% in 2023 and 2.9% in 2024. The growth rate is lower than the historical average level of 3.8% (from 2000 to 2019). In

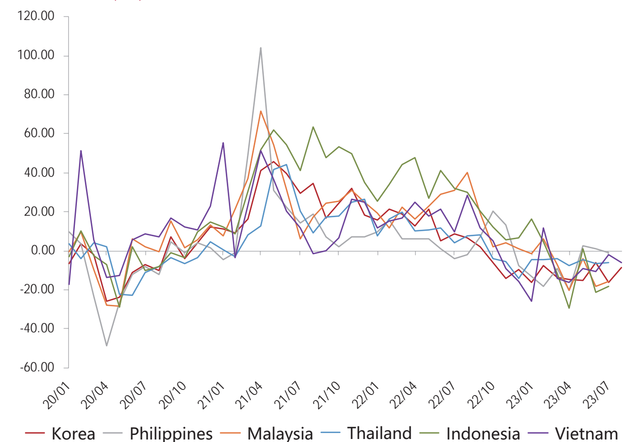
particular, the growth rate in 2024 is lowered by 0.1 percentage points from the forecast value in July 2023. The slowdown in global economic growth will also impose a greater impact on emerging economies that focus on foreign trade. The export growth rates in Southeast Asia, South Korea, Mexico and other countries have experienced evident declines. According to the latest data released by the WTO, the export value of South Korea slumped by 16.17% year-over-year, and that of Malaysia fell by 15.81% year-on-year, whereas that of Indonesia went down by 18.39% year-over-year. Countries with a large proportion of manufacturing exports are expected to face challenges in their economic growth and corporate earnings, which will restrict the performance of emerging markets to a certain extent.

Figure 197. IMF's Forecast on the GDP of Emerging Markets (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 198. YoY Growth of Exports from Emerging Markets (%)



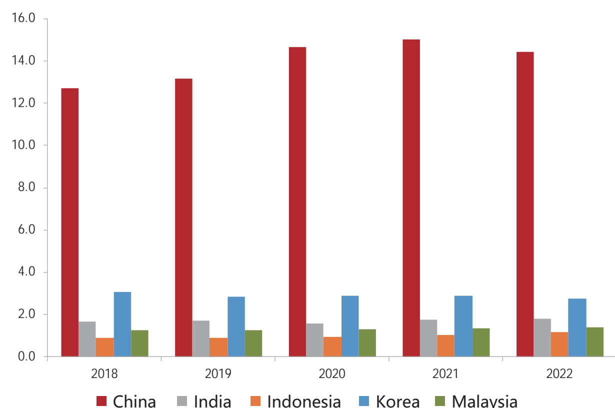
Data sources: Wind and BOC Investment Strategy Research Center

3.5.3 Market performance becomes divergent due to structural differences

Due to discrepancy in the economic structure of different countries, certain emerging economies will continue to maintain high resilience. Against the backdrop of slowing global growth and weakening external demands, markets with a higher proportion of domestic demands or faster growth, controllable inflation, and greater room for monetary and fiscal policies will usher in greater opportunities. In addition, as Chinese companies accelerate their overseas expansion, they are expected to increase investment in emerging markets to cope with rising domestic labor costs. Labor-intensive links and certain parts of the industrial chain have been relocated, and part of the production and export capacity has been transferred to other economies. Countries such as Vietnam and Malaysia have benefited to a greater extent. The share of global commodity exports in certain emerging markets has increased, and these markets are the beneficiaries of the restructuring of the global industrial chain and supply chain. As such, the investment value is available in the mid-to long-term in the above markets.

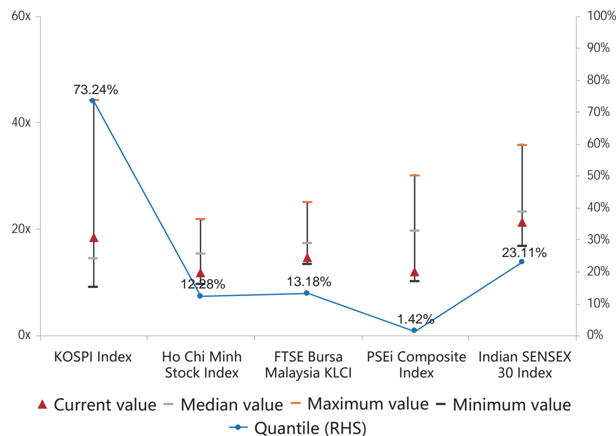
From a valuation perspective, the valuations of the majority of emerging markets are at historically lows at present. The Ho Chi Minh Stock Index is at the 12.28% quantile level of the past decade, and the Indian SENSEX 30 Index is at the 23.11% quantile level of the past ten decade. Overall, emerging markets are faced with rather limited pressure in terms of valuation, and their resilience is mainly derived from economic fundamentals.

Figure 199. Global Share of Exports of Goods (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 200. Valuation of Emerging Markets (Times)



Data sources: Wind and BOC Investment Strategy Research Center

3.5.4 Conclusion

Looking forward to 2024, external pressure is likely to be alleviated in emerging markets with the occurrence of global liquidity infection point. Nevertheless, the stock market performance may continue to diverge. The slowdown in global economic growth may lead to weaker growth in export-oriented economies. A rather bullish trend is likely to take place in countries that are driven by domestic demands, achieve faster growth, and benefit from the restructuring of global industrial and supply chains, including South Korea, India and Vietnam, among other economies.

Bond Market

US Bond Market Ushered in an Opportune Moment, and China's Bonds Remained Relatively Stable Without Significant Fluctuations

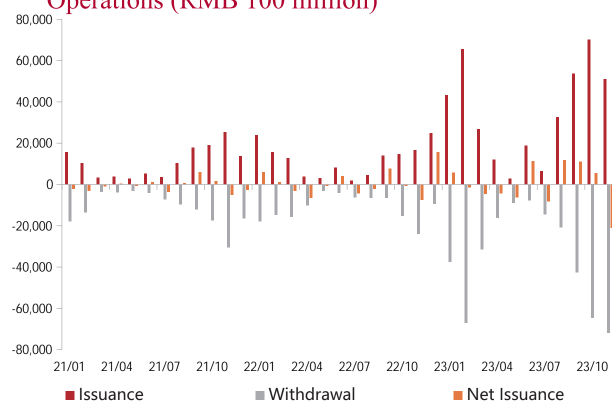
The US inflation continued to decline, and the Fed has started the cycle of interest rate reductions, leading to the possibility of a shallow recession in the US economy. As such, the optimal stage of investing in US bonds is likely to come, and the opportunities of rises are assured. Along with the downward movements of US bond yields, Chinese USD bonds are likely to usher in the golden period of asset allocation. China's economy is recovering moderately, but the foundation of recovery is not solid. The liquidity situation is rather loose, and there is still room to lower reserve requirement ratios and interest rates. The benchmark interest rate is expected to constantly move downward, and the 10-year treasury yield is likely to oscillate in the range between 2.45% and 2.75%.

4.1 China's Money Market

4.1.1 Review of the Year 2023: The PBOC implemented an unexpected reserve requirement cut and interest rate reduction, leading to an "N"-shaped fluctuation in funding rates in the domestic money market

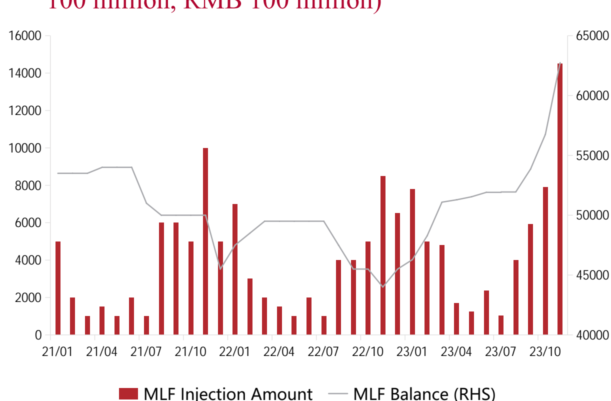
In 2023, the PBOC effectively employed the dual functions of both quantity and structure in monetary policy tools to implement counter-cyclical and cross-cyclical adjustments. These measures aimed to facilitate a stable reduction in the costs of corporate financing and residential credit. Moreover, the PBOC consistently increased its support for crucial sectors and vulnerable aspects of the national economy, including inclusive finance, green development, scientific and technological innovation, and infrastructure construction. Throughout the year, two rounds of reserve requirement and interest rate cuts were implemented. Serving as anchors for short- and long-term funding rates, the 7-day reverse repo and MLF rates were lowered by 20 bps and 25 bps, respectively. This strategic move guided the central point of the money market funding rate downward, resulting in an "N-shaped" trend in real interest rates. In early and late 2023, interest rates experienced an upward trajectory and increased volatility due to the influences of credit expansion, bond supply, and seasonal demand. The PBOC's open market operations became more precise, with a significant increase in both the scale and balance of these operations. The volume of reverse repurchase transactions surpassed RMB 8 trillion, and as of the end of November, the MLF balance exceeded RMB 6 trillion, marking a three-year high.

Figure 201. Increase in the Scale of Open Market Operations (RMB 100 million)



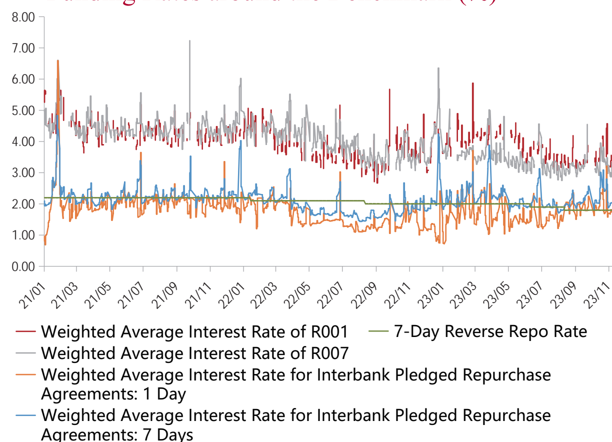
Data sources: Wind and BOC Investment Strategy Research Center

Figure 202 MLF Balance Hit Three-Year High (RMB 100 million, RMB 100 million)



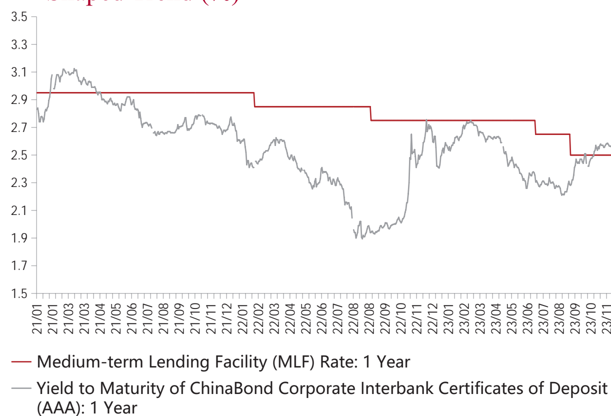
Data sources: Wind and BOC Investment Strategy Research Center

Figure 203. Heightened Volatility of Short-Term Funding Rates around the Benchmark (%)



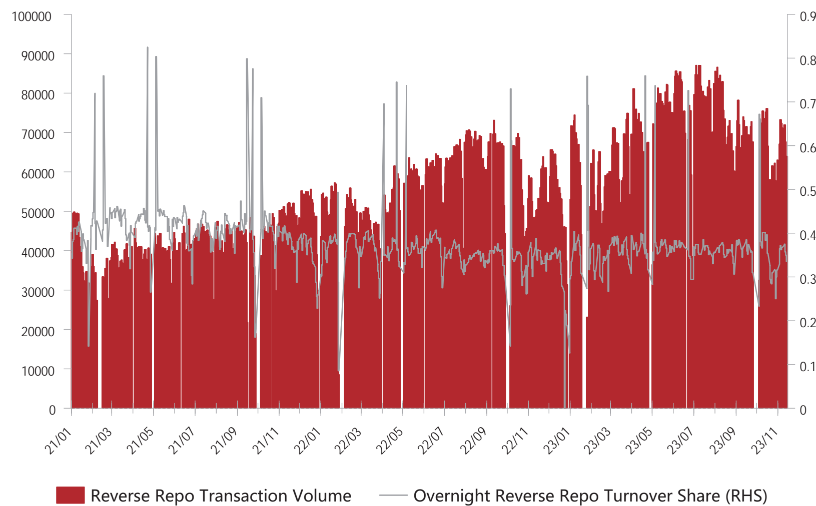
Data sources: Wind and BOC Investment Strategy Research Center

Figure 204. Long-term Fund Rates Exhibit a "V"-Shaped Trend (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 205. Reverse Repo Transaction Volume Surpassed RMB 8 Trillion (RMB 100 million, %)



Data sources: Wind and BOC Investment Strategy Research Center

4.1.2 Outlook on the Year 2024: Counter-cyclical policies are indispensable, and capital volatility may rise

In 2024, against the backdrop of the recovery of economic fundamentals with a fragile foundation, coupled with the challenges of real estate risks and local debt resolution pressure, China is expected to step up efforts in making coordinated efforts of monetary, fiscal, and industrial policies. Monetary policy will continue to play a pivotal role as a significant component of the counter-cyclical and cross-cyclical adjustment policies. This aims to facilitate the issuance of tools for local debt refinancing, sustain prudent credit growth, and cultivate a conducive monetary and financial environment to enhance economic vitality.

Compared with the situation in 2023, the potential withdrawal of tight policies in overseas economies, and possibly the implementation of loose policies, could alleviate constraints on further loosening of China's monetary policy. While taking into account both domestic and international environments, we anticipate that the PBOC will continue to pay attention to the funding conditions. It is highly likely that the overall liquidity will remain mildly loose, with room still available for interest rate reductions. The center of interest rates is expected to continue its downward movements. However, in the context of comprehensive efforts in aggregate and structural policies, the interest rates may become increasingly volatile in the market.

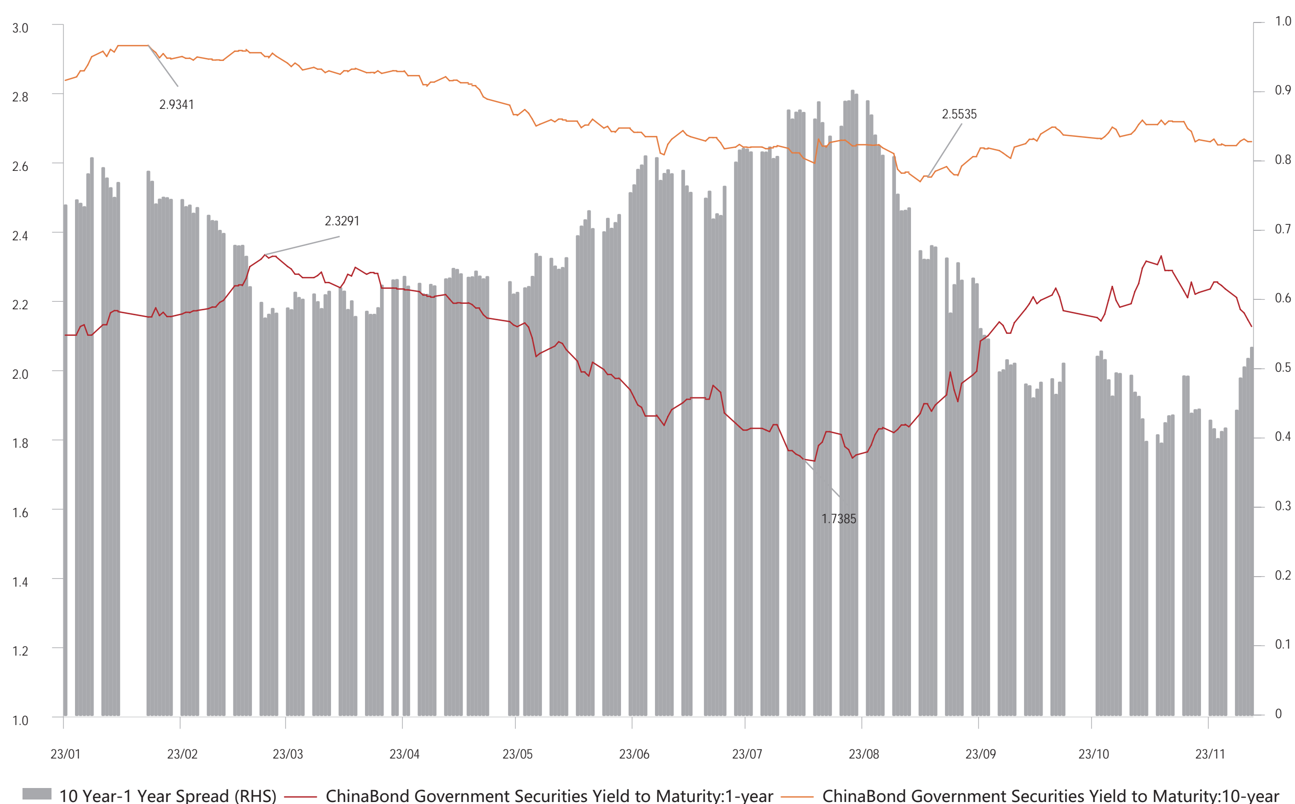
4.2 China's Bond Market: Structure of Supply and Demand Experienced Changes, and the Center of Bond Yields Moved Downward

4.2.1 Interest rate securities: Limited interest rate risks with narrower oscillation range

In 2023, the interest rate securities oscillated within a narrow range overall, with a noticeable narrowing of term spreads. From an operational perspective, the movements of interest rate securities can be broadly divided into three stages: During the first stage from January to early March, the market witnessed a strengthening outlook for economic growth. There was a significant credit expansion, and despite experiencing the negative feedback effects at the end of 2022, bond yields continued

to edge slightly higher. The upward movement was more pronounced in the short-term interest rates, and the peak in yields for the entire year occurred during this period. During the second stage from mid to late March to August, the market was subject to the impact of weakening economic fundamentals coupled with two interest rate cuts that slightly exceeded the market's expectations, resulting in an overall decline in bond yields. During this period, the short-term securities outperformed the long-term ones, leading to an expansion of term spreads to the largest range within the year. During the third stage from September to the year-end, the market saw a diminishing expectation for further monetary policy easing after the interest rate cut adopted in August. The surge in bond supply also triggered a short-term tightening in funding conditions, causing yields to briefly turn upward. The 10-year government bond yield oscillated within a narrow range of 2.65%-2.70%, with even greater volatility in the near term. Subsequently, with major banks initiating another round of deposit rate cuts, bond yields reverted downward, bringing the 10-year government bond yield back below 2.6%.

Figure 206. Interest Rate Securities in 2023: Range-bound Oscillation and Narrowing Spreads (%, %)



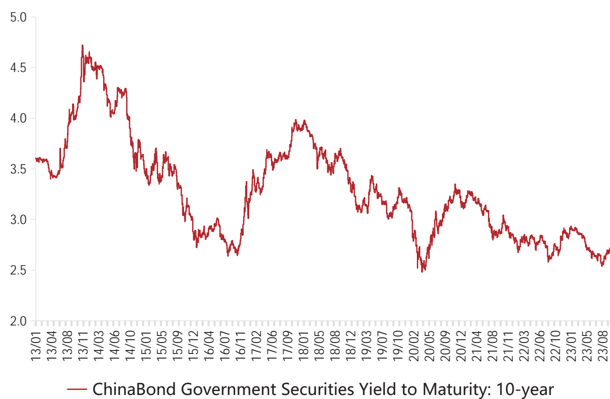
Data sources: Wind and BOC Investment Strategy Research Center

Looking forward to 2024, with the weak recovery of China's macroeconomic fundamentals and to resolve the real estate and local debt risks, monetary policy is expected to remain stable with a slight easing. The risk of bond yields trending upward is not significant. However, considering the market's position in a relatively lower range, absent unexpected factors such as a notable deterioration in macroeconomic fundamentals or a favorable impact from a reduction in money market interest rates, the potential for downward movement is also relatively limited. Therefore, we anticipate a higher likelihood of bond yields oscillating near the bottom, with the expected range for 10-year government securities yields being 2.45% to 2.75%. In terms of timing, disruptions in the bond market due to increased supply and fundamental factors may be more pronounced in the first half of the year. Given the seasonal characteristics of bond allocation, the upward movement may be relatively restrained, providing opportunities for allocation during peaks.

4.2.1.1 Downward shift in benchmark interest rate with narrowing oscillation range

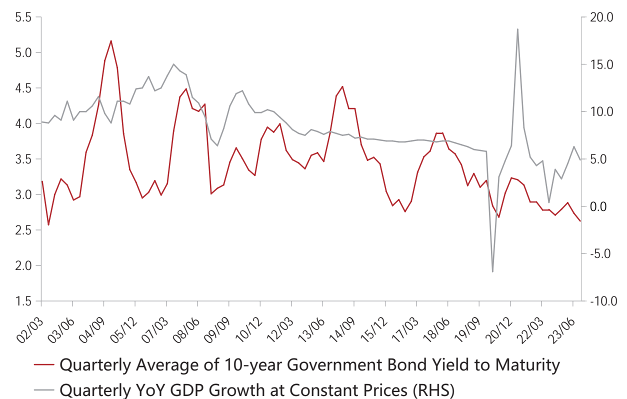
Examining the bond yield curve, the top and pivotal positions of the 10-year government bond yield have shown a consistent downward trend over the past decade, with the top of each round of interest rates approaching the pivot position of the previous rate cycle. Starting from 2020, the yield pivot has further broken through the 3%-5% interest rate level, descending below 3%. Simultaneously, the fluctuation amplitude has gradually reduced from the peak of 100 bps to around 30 bps, indicating a noticeable narrowing of the range. Considering the relationship between the funds rate and the economy, the interest rate level, as the cost of economic and social liabilities, is primarily determined by the levels of economic growth and inflation. In practice, changes in the 10-year government bond interest rates are highly positively correlated with the trend in nominal GDP. As China's economic development transitions from a high-growth phase to high-quality growth, the potential economic growth rate is shifting downward, leading to a corresponding downward shift in the long-term funds rate pivot. In 2024, with the domestic economy experiencing a moderate recovery, it is not very likely that there will be a significant upward movement in long-term fund rates.

Figure 207. Downward Shift in Tops and Benchmarks of Long-term Interest Rates (%)



Data sources: Wind and BOC Investment Strategy Research Center

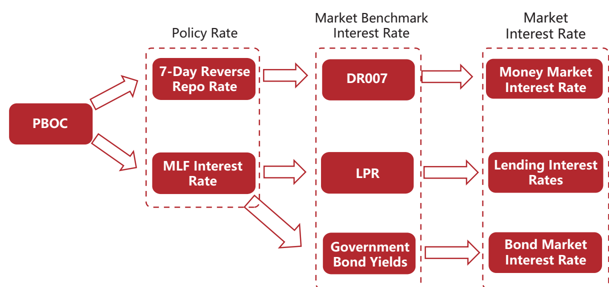
Figure 208. High Correlation between Long-term Interest Rate Movements and Nominal Economic Growth (%)



Data sources: Wind and BOC Investment Strategy Research Center

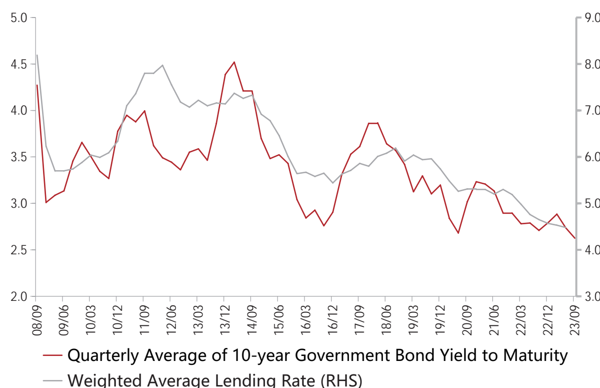
The PBOC continues to guide the optimization of pricing for deposit and loan interest rates. Currently, the transmission mechanism for lending rates follows the path of "market interest rate + central bank's guidance → LPR → lending rate", while the transmission mechanism for deposit rates involves "bond yield represented by the 10-Year Government Bond Yields + loan market interest rate represented by 1-Year LPR → deposit rate". The trend in the market benchmark interest rate, represented by the Government Bond Yields, closely correlates with changes in deposit and loan interest rates. In terms of the transmission mechanism, the MLF serves as an anchor for long-term interest rates in the money market and exerts a direct impact on deposits, loans, and bond yields. With policies prioritizing stable economic growth and reducing debt costs, and to boost financing needs, it is necessary to continue to decline interest rates, not only to reduce the interest expenses but also to increase the availability of funds. Guiding the downward movement of loan interest rates has been the primary operational strategy in recent years to drive down financing costs. In most cases, the reduction in lending rates influences a corresponding decrease in deposit rates. The trend of a benchmark downward shift in deposit and loan rates appears relatively clear, with bond yields as a factor influencing these rates, combined with the decline in money market interest rates.

Figure 209. China's Interest Rate System and Transmission Channels



Data sources: Wind and BOC Investment Strategy Research Center

Figure 210. 10-Year Government Bond Yields Aligned with the Trend in Lending Rates (%)

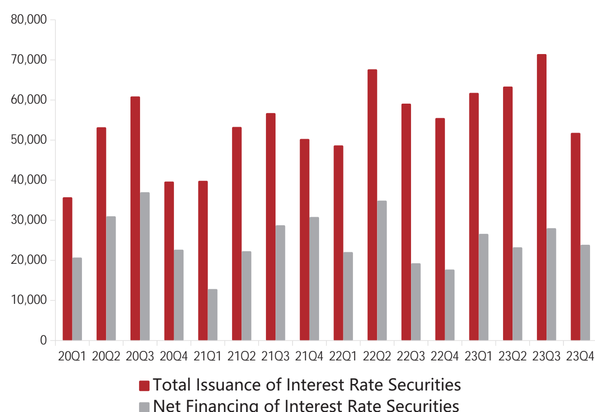


Data sources: Wind and BOC Investment Strategy Research Center

4.2.1.2 Interest rate securities: Policy support was given for the supply side, and ample liquidity was ensured for the demand side

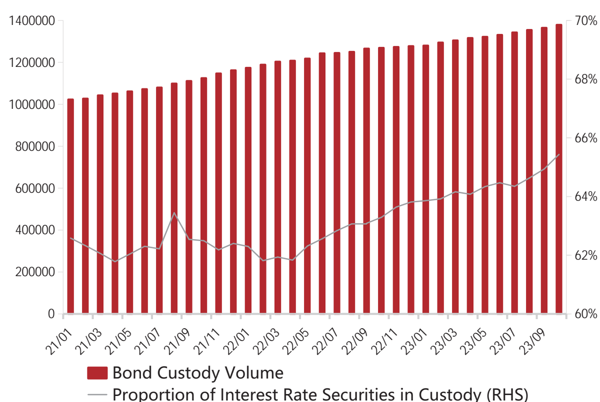
In 2023, the overall supply and demand of interest rate securities remains balanced. In terms of issuance pace, the early period was relatively slow, but after the third quarter, the issuance of special-purpose bonds accelerated, coupled with the issuance of special refinancing bonds, reaching the highest scale in nearly three years. As of November 20,2023, the net financing amount of interest rate securities has surpassed the entire year of 2022. In addition, to support post-disaster recovery, reconstruction, and projects aimed at enhancing disaster prevention, mitigation, and relief capabilities, and to implement important measures for shoring up weaknesses and benefiting people's livelihoods, a planned additional issuance of RMB 1 trillion worth of government bonds has been proposed. Among these, RMB 500 billion will be utilized within the year 2023, and RMB 500 billion will be carried forward to 2024. Regarding the supply structure, the proportion of interest rate securities in the bond custody balance has consistently increased in recent years. This is primarily attributable to the decrease in net financing and restrictions on non-market-oriented bond issuance. The limited space for market credit sinking, coupled with risk appetite and asset scarcity, is driving demand for subscription to interest rate bonds.

Figure 211. Supply and Net Financing of Interest Rate Securities in 2023 (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

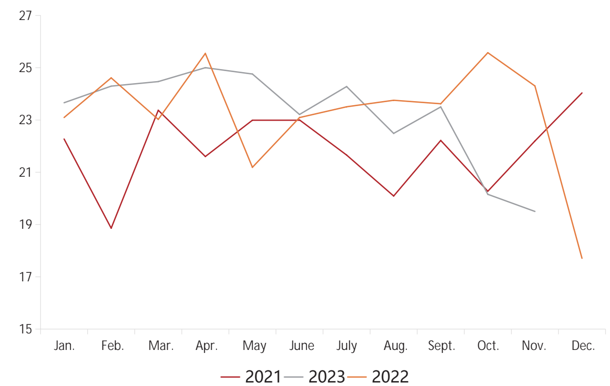
Figure 212. Bond Supply Structure Inclined Towards Interest Rate Securities



Data sources: Wind and BOC Investment Strategy Research Center

On the supply side, fiscal policy is set to play a crucial role in supporting stable economic growth in 2024. In 2023, an unexpected increase in the deficit rate to 3.8% is very likely to break the historical norm of maintaining the deficit rate below 3%, with expectations of reaching approximately 3.5%. In addition, with the commencement of a new round of local government debt issuance, it is anticipated that government bond issuance will remain active. In line with recent practices, the Ministry of Finance (MOF) of the People's Republic of China is expected to proactively allocate the new quota for local bonds in 2024. To expedite the commencement of tangible projects, it is highly likely that the allocation will approach the upper limit of 60%, significantly influencing the accelerated pace of interest rate security issuance. This proactive approach is expected to result in a notable surge in the issuance of interest rate securities. The market will potentially witness a peak in issuance activity in 1H, 2024, particularly in Q1, 2024.

Figure 213. Local Bond Subscription Sentiment was Generally Positive in 2023 (Times)



Data sources: Wind and BOC Investment Strategy Research Center

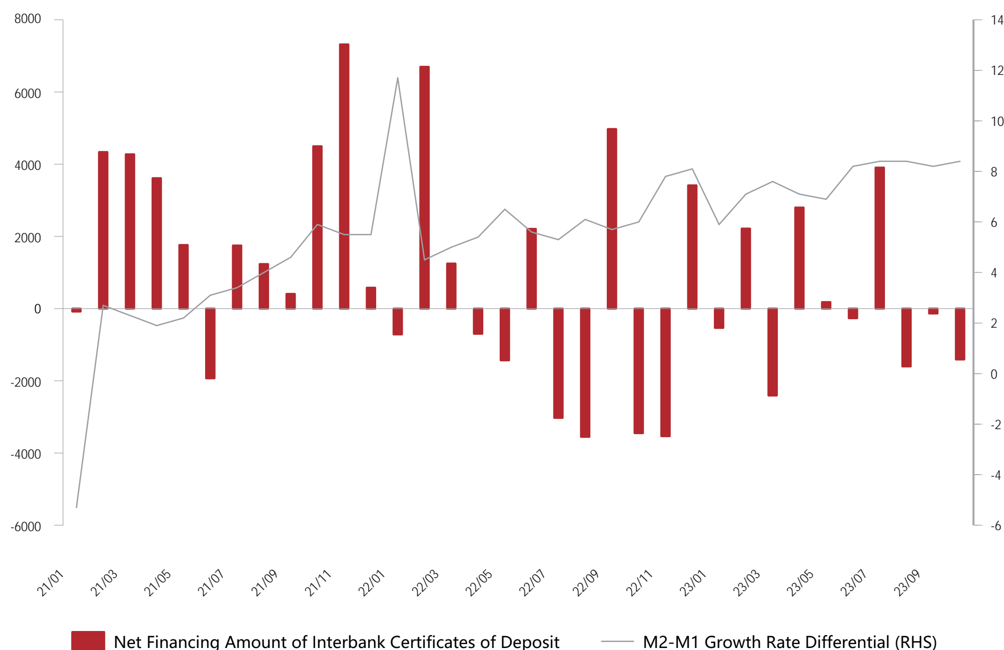
Figure 214. Allocation Status of Annual Early Tranche Quota for Local Bonds (RMB 1 trillion, %)

Tranche	Issuance Date	Special Bonds Quota	Issued Quota as Percentage of Previous Year's	General Bonds Quota	Issued Quota as Percentage of Previous Year's
Early Tranche in 2019	December, 2018	0.81	60.00%	0.58	69.00%
Early Tranche in 2020	November, 2019	1.29	60.00%	0.558	60.00%
Early Tranche in 2021	March, 2021	1.77	47.20%	0.588	60.00%
Early Tranche in 2022	December, 2021	1.46	40.00%	0.328	40.00%
Early Tranche in 2023	November, 2022	2.19	60.00%	0.432	60.00%

Data sources: Wind and BOC Investment Strategy Research Center

On the demand side, the fluctuations in interest rate securities demand are significantly influenced by commercial banks, being the largest purchasers and holders of such bonds. The downward movement of interest rate securities yields in in 2023 is not only attributable to loose liquidity and weaker-than-expected economic fundamentals, but is also crucially tied to the favorable dynamics in the supply and demand relationship. The stability observed in the liabilities of commercial banks plays a pivotal role in providing substantial support to the demand for bonds.

Figure 215. Stability in the Liability Side of Banks (RMB 100 million,%)

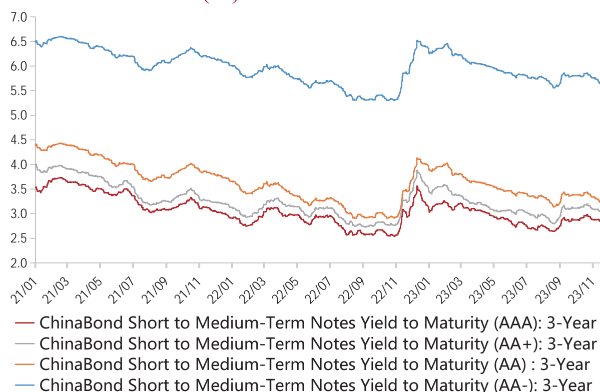


Data sources: Wind and BOC Investment Strategy Research Center

4.2.2 Credit bonds: Structural adjustments took place in supply and demand, and performance diverged among different types of bonds

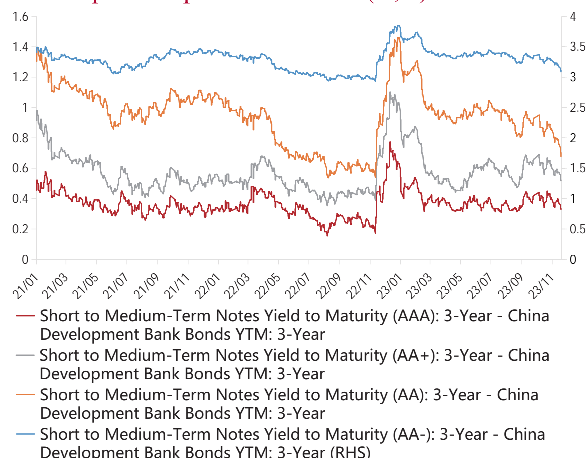
Reflecting on 2023, the overall trend of credit bonds mirrored that of interest rate securities, but their performance outpaced interest rate securities under the trading dynamics of asset scarcity and the issuance of bonds by local governments. Specifically, the trend in 2023 can be broadly divided into three stages: During the first stage from January to early February, the consistent impact of the redemption wave of financial funds at the end of 2022, combined with a stronger-than-expected economic recovery, led to a slight increase in yields of credit bonds. During the second stage from early February to late August, the market witnessed a relief in the redemption pressure of financial funds. This helped stabilize the scale and a return of funds and bolster the demand for credit bonds. Subsequently, under the supply-demand mismatch, asset scarcity persisted, resulting in a significant compression of credit spreads from high-grade to medium and low-grade varieties. This period also saw an unexpected interest rate cut, seasonal rebound of wealth management funds adding to allocation pressure, and the alternating impact of debt programs, all contributing to a downward trend in credit bonds yields. During the third stage from late August to the end of the year, the market experienced a phase of fund redemption as growth-stabilizing policies, especially those related to real estate, were introduced, leading to increased liquidity volatility. During this period, credit bond yields initially rose, followed by a period of high-range oscillation. In mid to late December, influenced by expectations of interest rate cuts, yields rapidly declined once again. Additionally, in 2023, credit bonds also merit attention for the mitigation of credit risk. The size and number of defaulted bonds in 2023 continued to decrease, reaching a nearly three-year low. The number and size of newly defaulted bonds decreased synchronously, approximately half of the figures observed in 2022. Notably, about half of the new defaults were still concentrated in the real estate industry.

Figure 216. Significant Declines in Credit Bond Yields in 2023 (%)



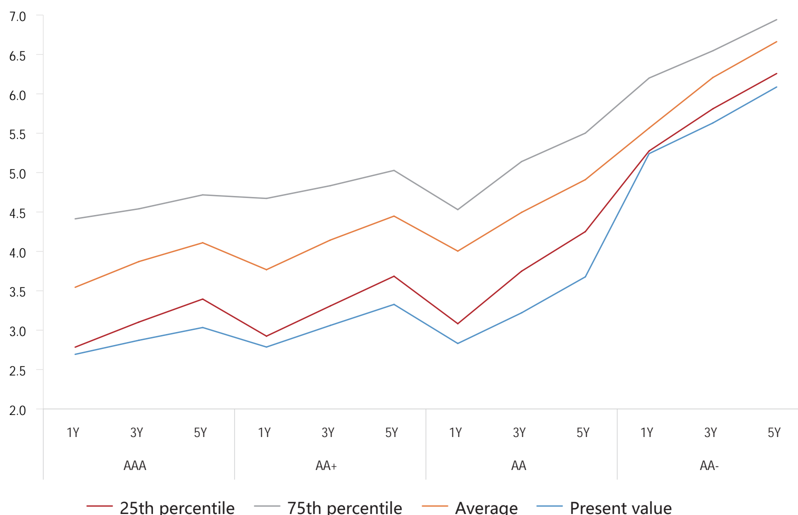
Data sources: Wind and BOC Investment Strategy Research Center

Figure 217. Significant Widening of Credit Spreads and Subsequent Sharp Declines in 2023 (%,%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 218. Credit Bond Yields at Historical Lows (%)



Data sources: Wind and BOC Investment Strategy Research Center

Looking ahead to 2024, the implementation of local government bonds and new capital regulations is expected to significantly impact the supply and demand dynamics of credit bonds. Considering the discrepancy between the reduction in high-yield assets and the relatively abundant demand for funds, the possibility of an ongoing asset scarcity exists, and there remains potential for further compression of credit spreads. Furthermore, as risky entities such as state-owned enterprises with lower creditworthiness and private enterprises in the real estate sector have gradually exited the market due to the exposure of default risks in recent years, coupled with the sustained economic recovery and robust credit support, the risk of credit bond defaults is anticipated to continue decreasing in 2024.

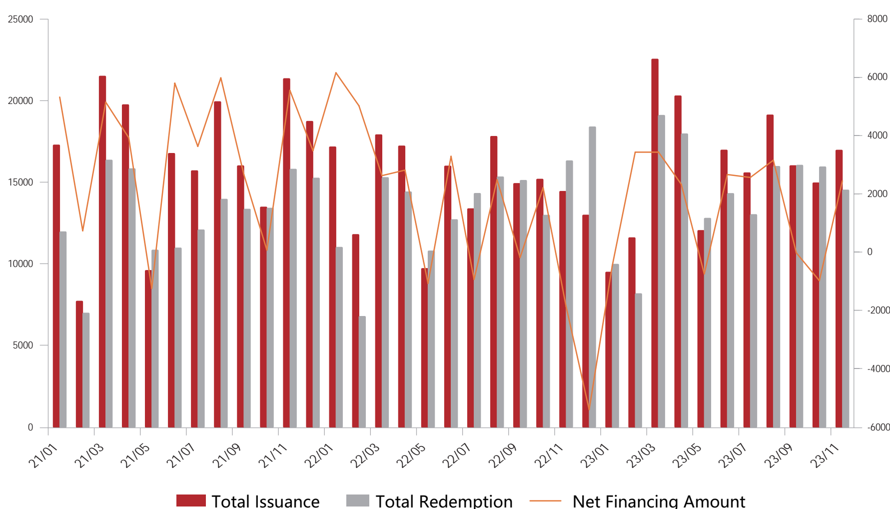
4.2.2.1 Structural differences existed in supply and demand, and spreads may continue to compress

In 2023, the issuance and net financing of credit bonds are expected to remain relatively stable compared to 2022, but there is a notable structural difference. Urban investment and financial bonds account for approximately half of the total issuance of

credit bonds, yet their net financing scale contributes 1.43 times to the total net financing of credit bonds. Apart from urban investment and financial varieties, the net financing scale of most other industries or industrial bonds has turned negative. With this issuance and financing structure, on the supply side, it is anticipated that credit bond issuance and net financing in 2024 will face challenges in experiencing a significant increase. Moreover, the financing structure is likely to become greatly different, and the trading logic of an asset scarcity is expected to persist.

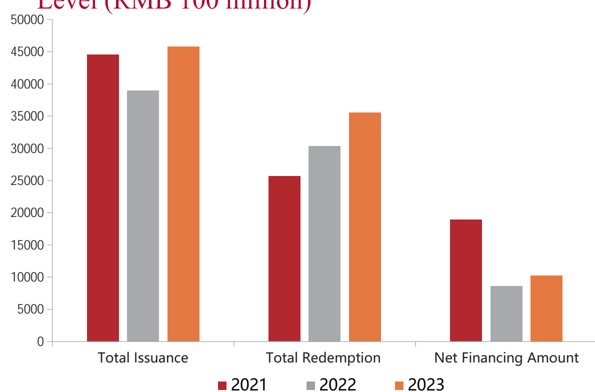
On the demand side, commercial banks and wealth management funds serve as the primary drivers of credit bond demand, consistently expanding their position sizes in recent years. Notably, wealth management and bond funds have rebounded from the adverse effects of the market's negative feedback at the end of 2022, showing signs of recovery. As of the end of October 2023, the bond fund's position size increased by RMB 480 billion, approaching the level of the same period in the previous year. Market projections suggest that the scale of wealth management products is poised to recover to RMB 28 trillion by the year-end. With a moderate domestic economic recovery and ongoing resolution of real estate risks, there is an expectation for an improvement in investors' risk appetite in 2024. However, guiding investors to shift toward other assets or investment varieties may prove challenging. In terms of overall volume, the scale of wealth management products is projected to maintain stable growth, providing support for the demand for credit bonds. Structurally, the short-term investment behavior of individual investors may exacerbate the imbalance between supply and demand for short-term varieties of credit bonds, further compressing the spread space of certain credit bond varieties.

Figure 219. Issuance and Maturity Situation of Credit Bonds in 2023 (RMB 100 million, RMB 100 million)



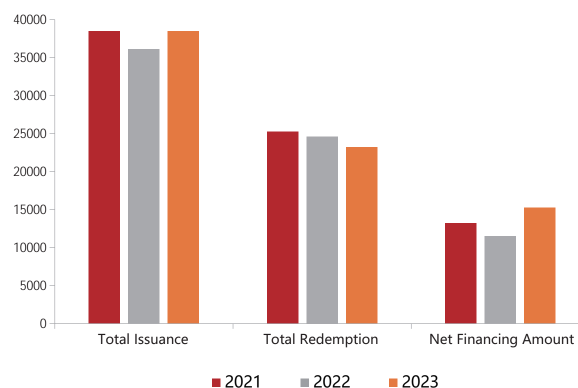
Data sources: Wind and BOC Investment Strategy Research Center

Figure 220. Net Financing Amount of Urban Investment Bonds Maintained a Relatively Low Level (RMB 100 million)



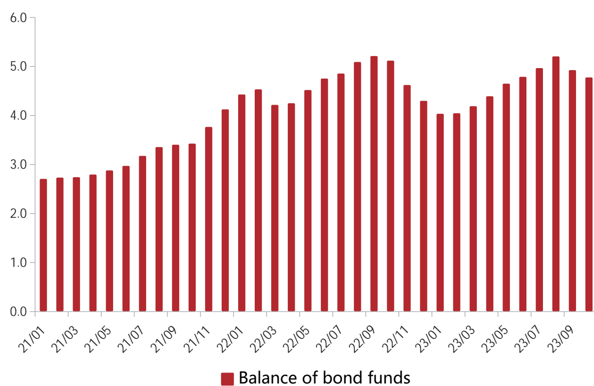
Data sources: Wind and BOC Investment Strategy Research Center

Figure 221. Increase in Both Issuance and Supply of Financial Bonds (RMB 100 million)



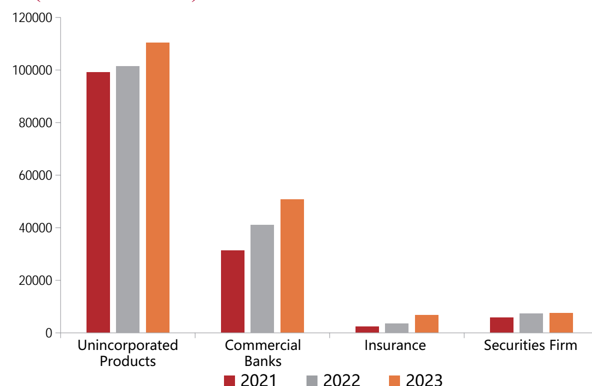
Data sources: Wind and BOC Investment Strategy Research Center

Figure 222. Scale of Bond Products Showed a Gradual Recovery (RMB 1 trillion)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 223. Wealth Management Institutions and Commercial Banks Dominated Credit Bond Holdings (RMB 1 trillion)



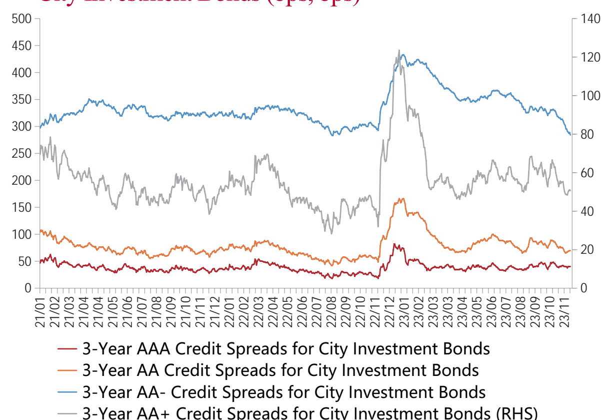
Data sources: Wind and BOC Investment Strategy Research Center

4.2.2.2 Advancement in debt restructuring as city investment bonds experienced high-level fluctuations

In July 2023, a new phase of resolving local hidden debt was initiated. The State Council issued a directive in 2018 to define and mandate the resolution of hidden debt by local governments within 5-10 years. Since then, efforts of regulating local government debt have been consistently centered around the principle of "resolving existing hidden debts and containing new ones". Despite stringent control measures implemented in recent years and a continued tightening of policies for the refinancing of city investment bonds, the fundamental challenge of rapid local debt growth remains unresolved.

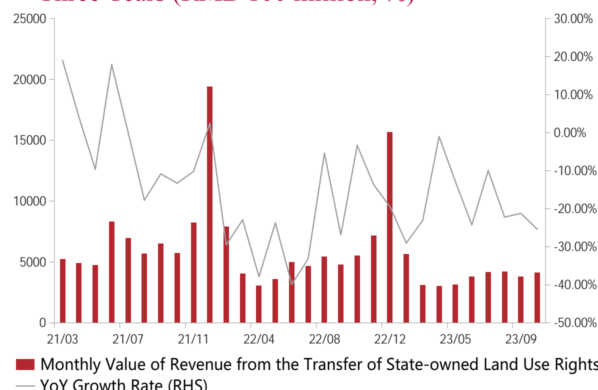
Based on the disclosed information, the current round of debt resolution will proceed in three directions. First, it involves consolidating the responsibilities of local governments, which is a fundamental prerequisite for this debt resolution effort. Under the fundamental principle that "provincial-level governments shall assume overall responsibility, local governments at all levels shall undertake their respective responsibilities, and the central government shall provide proper support when necessary", local governments are tasked with effective resource coordination and cost-saving measures within their jurisdictions. Second, financial institutions will extend support through options such as extending maturity periods or reducing interest rates. During the Politburo meeting held in July 2023, China highlighted the need for the first time to "prevent and resolve local government debt risks", and the policy stance was reiterated in the Central Financial Work Conference. This indicates a comprehensive management approach to local government debt, with various operational debts of local urban investment platforms being included in the current round of local debt resolution. Third, the central government will extend support, including allowing the issuance of special refinancing bonds. The PBOC will establish Special Purpose Vehicles (SPVs) to provide liquidity support for commercial banks involved in supporting local debt. As of November 10, 2023, 26 provinces, municipalities directly under the central government, and two cities specifically designated in the state plan have issued over RMB 1.35 trillion worth of special refinancing bonds to repay existing debts, thereby alleviating the pressure in regions facing significant repayment challenges in the near term.

Figure 224. Significant Contraction in Credit Spreads for City Investment Bonds (bps, bps)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 225. Land Auction Situation over the Past Three Years (RMB 100 million, %)



Data sources: Wind and BOC Investment Strategy Research Center

n 2024, the resolution of local government debt is expected to constantly make progress. In the short term, the recent round of debt resolution has mitigated credit risks for urban investment bonds, particularly in the case weaker regional issuers. The robust subscription in the issuance market and the compression of credit spreads for lower-rated city investment bonds indicate the market's acknowledgment of favorable policy conditions. The scarcity of high-yield assets and the low-cost substitution through debt resolution also provide strong support for maintaining elevated valuations of city investment bonds in 2024. From the perspective of the mid-to long-term, the fundamental strategy behind debt resolution remains a trade-off between time and space. After the short-term alleviation of pressure, it is expected to be on top of the policy agenda to establish a long-term mechanism for local debt management and to clarify the functional roles of government platforms while resolving local government debt issues. Along with the heightened sentiment brought about by debt resolution, urban investment bonds may experience divergent performance, and return to the trend of development of local economic fundamentals.

Figure 226. Partial List of Policy Statements on Local Debt Resolution in 2023

Date	Department	Conference/Policy	Related Statements
March 5th 2023	State Council	Government Work Report	Prevent and resolve the risks of local government debt, optimize the debt maturity structure, reduce interest burdens, control increments, and resolve outstanding debts.
March 9th 2023	Financial and Economic Affairs Committee of the National People's Congress (NPC)	*Report on the Execution of the Central and Local Budgets in 2022 and the Review Results of the Draft Central and Local Budgets for 2023*	Enhance the accounting and management of funds for the repayment of principal and interest in special bonds, and explore the establishment of a mechanism for the repayment of principal in special bonds. Solidify the resolution of hidden debts of local governments, regulate the disposal of hidden debt risks through market-oriented and legal mechanisms.
June 26th 2023	National Audit Office	*The Audit Report on the Execution of the Central Budget and Other Financial Revenues and Expenditures for the Year 2022*	Forty-nine regions unlawfully incurred an additional hidden debt of RMB 41.516 billion through commitments to complete buybacks and the advance financing for construction by state-owned enterprises. It is recommended to urge grassroots entities to gradually reduce the level of debt risk in a prudent manner, ensuring the cautious resolution of the stock of hidden debt. Additionally, there is a suggestion to gradually divest local government platform companies of their financing functions and promote a categorized transformation and development. July 24th 2023 CPC Central Committee Political Bureau Work Conference To effectively prevent and resolve local debt risks, formulate and implement a comprehensive debt resolution plan.

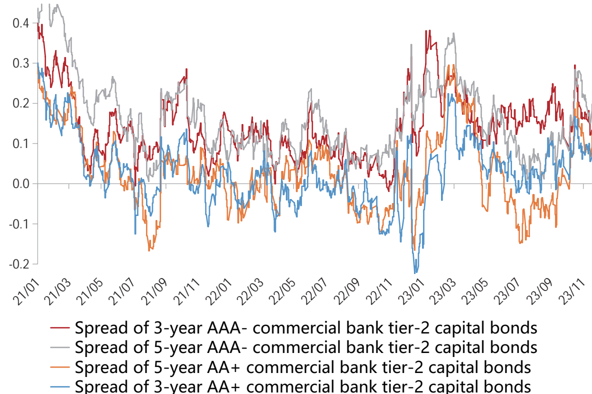
Date	Department	Conference/Policy	Related Statements
July 24th 2023	-	CPC Central Committee Political Bureau Work Conference	To effectively prevent and resolve local debt risks, formulate and implement a comprehensive debt resolution plan.
August 1st 2023	the Central Bank, State Administration of Foreign Exchange	Work Conference for the Second Half of 2023	Coordinate and oversee financial support for the resolution of local debt risks.
August 18th 2023	China Securities Regulatory Commission (CSRC)	Responses from Relevant Officials of the China Securities Regulatory Commission (CSRC) to Questions from Journalists	Enhance the monitoring and early warning of risks associated with city investment bonds, prioritizing the prevention of market explosions in both publicly traded bonds and non-standard debts. Devote full efforts to safeguarding the stable operation of the bond market.
August 18th 2023	Central Bank, National Financial Regulatory Administration, China Securities Regulatory Commission	Television Conference on Financial Support for the Real Economy and Prevention and Resolution of Risks	The financial sector must earnestly implement the spirit of the Central Committee of CPC and the State Council in preventing and resolving risks in key areas. It should coordinate and oversee financial support for the resolution of local debt risks, enrich tools and means for preventing and resolving debt risks, strengthen risk monitoring, assessment, and prevention and control mechanisms, promote risk disposal in key regions, and firmly guard against the occurrence of systemic risks.
August 28th 2023 August 30th 2023	State Council, Ministry of Finance	The State Council's Report on the Execution of the Budget Since 2023, Report on the Implementation of China's Fiscal Policies in the First Half of 2023	The State Council's Report on the Execution of the Budget Since 2023 Report on the Implementation of China's Fiscal Policies in the First Half of 2023
October 30th-31st 2023	-	The Central Financial Work Conference	Establish a long-term mechanism to prevent and resolve local debt risks, develop a government debt management mechanism in line with high-quality development, and optimize the debt structure of central and local governments.

Data sources: News and BOC Investment Strategy Research Center

4.2.2.3 Financial bonds are worthy of attention with the implementation of new capital regulations

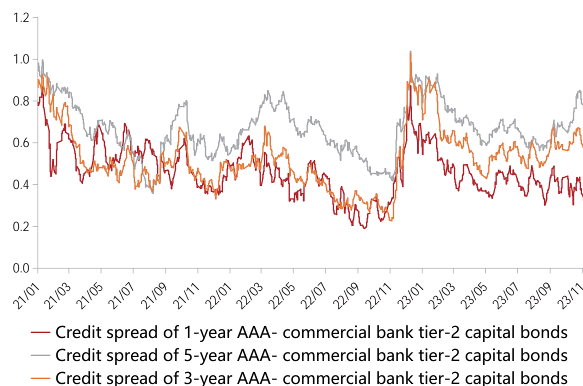
Tier-2 capital bonds and perpetual bonds issued by commercial banks are the most typical types of financial bonds, possessing both trading and allocation attributes. Market institutions are active participants, with funds and insurance institutions being the primary participants alongside commercial banks. From the end of 2022 to the beginning of 2023, influenced by a redemption wave of wealth management products and the non-redemption of tier-2 capital bonds issued by city commercial banks, the yields of tier-2 capital bonds and perpetual bonds experienced a noticeable increase. Though their yields followed the general trend of decline observed in other ordinary credit bonds, the extent of the decrease was not as significant as that of other credit bonds of the same rating. From an allocation perspective, their valuation seems to have a relative advantage. Due to the limited supply of high-yield bonds, and given that long-term tier-2 capital bonds and perpetual bonds of medium to high-grade have manageable credit risks as well as a higher yield spread percentile than other bonds of the same rating, they may potentially help alleviate the issue of insufficient choices of asset allocation for long-term funds such as insurance funds.

Figure 227. Advantages Existed in Tier-2 Capital Bonds from Allocation Perspective (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 228. Advantages Existed in Tier-2 Capital Bonds from Allocation Perspective (%)



Data sources: Wind and BOC Investment Strategy Research Center

Apart from valuation, the implementation of new capital regulations may bring new changes to the supply and demand of financial bonds. Relevant management measures previously released require that the risk-weighted ratio of the total external loss-absorbing capacity of global systemically important banks should reach 18% by 2025. According to the latest announcement, there are currently 5 commercial banks in China that are global systemically important banks. In addition to the four major banks, namely, Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China (BOC) and China Construction Bank (CCB), which remain on the list, Bank of Communications has been included into the list for the first time. Basel III requires additional capital requirements of 1% and 1.5% respectively for Group 1 and Group 2 banks. In order to meet the above standards, before launching the issuance of TLAC non-capital bonds, the above five institutions can supplement their capital by issuing tier-2 perpetual bonds. The issuance of tier-2 perpetual bonds may be accelerated. Meanwhile, the requirement of the new capital regulations to increase the risk weight of subordinated bonds and TLAC debt instruments of commercial banks and other financial institutions from 1.0 to 1.5 will affect the demand of commercial banks. This could change the pattern where commercial banks used to hold tier-2 capital bonds through asset management products among each other.

Figure 229. Comparison of the Latest Update of New Capital Rules Compared with the Current Standards

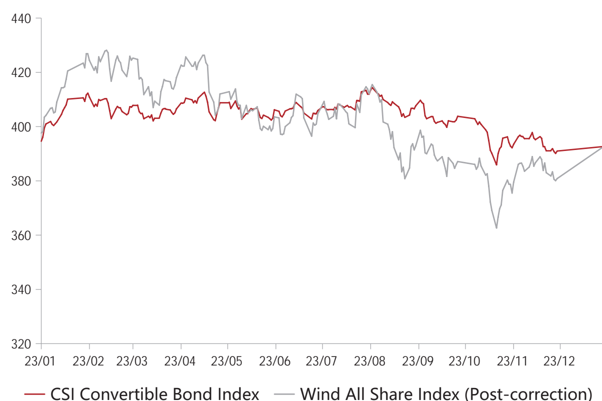
Risk Exposure	Category		Weight	
			New Standards	Existing Standards
To China's public sectors	People's governments at the provincial level (autonomous regions, municipalities directly under the Central Government) and cities with independent planning status	General bonds	0.10	0.20
		Special bonds	0.20	0.20
To public sector entities registered in other countries or regions	AA- rating and above		0.20	0.25
To multilateral development banks	AA- rating and above		0.20	1.00
	Below AA- rating, A- rating and above		0.30	
	Below A- rating, BBB- rating and above		0.50	
	Below B- rating		1.50	
	Unrated		0.50	
To domestic and overseas financial institutions (excluding subordinated debts)	Risk exposure to commercial banks rated A+	Risk exposure with original length within three months (inclusive), or with original length within six months (inclusive) due to cross-border trade in goods	0.20	0.20
		Others	0.30	0.25
	Risk exposure to commercial banks rated A	Risk exposure with original length within three months (inclusive), or with original length within six months (inclusive) due to cross-border trade in goods	0.20	0.20
		Others	0.40	0.25
	Risk exposure to commercial banks rated B	Risk exposure with original length within three months (inclusive), or with original length within six months (inclusive) due to cross-border trade in goods	0.50	0.20
		Others	0.75	0.25
	Risk exposure to commercial banks rated C		1.50	0.20 or 0.25
	Risk exposure to other investment-grade financial institutions		0.75	1.00
To companies	Risk exposure to general companies	Risk exposure to investment-grade companies	0.75	1.00
		Risk exposure to SMEs	0.85	1.00
To subordinated debts (undeducted part)	Subordinated debts by China's development-type financial institutions and policy banks		1.00	1.00
	Subordinated debts by China's commercial banks		1.50	
	Subordinated debts by China's other financial institutions		1.50	
	TLAC issued by global systemically important banks		1.50	

Data sources: NAFR and BOC Investment Strategy Research Center

4.2.3 Convertible bonds: Valuation adjustment is expected to be restored, and closer attention shall be paid to structural opportunities

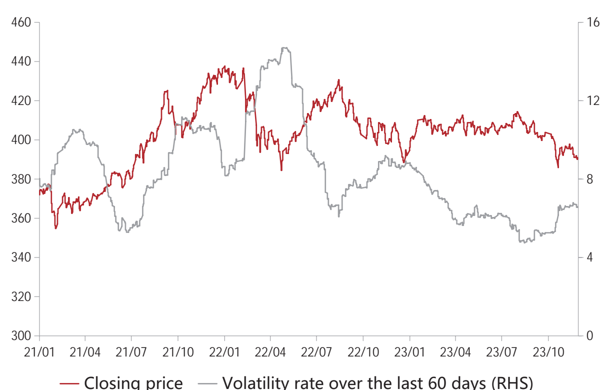
In 2023, the valuation of convertible bonds continued to oscillate at highs, featuring a trend of "upturn, bumpy downturn and rebound". In an environment of loose liquidity and relatively strong pure bonds, the downside risk was controllable. The trend of convertible bonds was highly correlated with their underlying stocks and the macro environment remains the principal influence factor, therefore market trading confidence was affected by the expectation of domestic economic recovery. At the beginning of 2023, convertible bonds rebounded in tandem with the stock market, delivering better parity-driven performance than valuation-driven performance; the CSI Convertible Bond Index rose from 394.6 points to 412.34 points, an increase of 4.50%, and the valuation stayed at highs and continued to rise. Since February, convertible bonds entered a phase of oscillation, but supported by pure bond value, convertible bonds continued the oscillation and delivered better performance than their underlying stocks, showing higher resilience than the stock market. The valuation was affected by the delisting of convertible bonds issued by poor credit rating entities, which led to greater volatility. Since August, affected by the quick selling into stock market corrections, the CSI Convertible Bond Index fell sharply by 6.87%, and the valuation of the convertible bond market significantly declined to a new low since 2021. From the end of October, the CSI Convertible Bond Index rebounded from the low, and the valuation of convertible bonds rebounded accordingly.

Figure 230. Convertible Bonds Showed Relatively Solid Resilience in 2023 (Points)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 231. Center of Volatility Rate of Convertible Bonds Moved Downward in 2023 (Points, %)



Data sources: Wind and BOC Investment Strategy Research Center

At the beginning of 2023, the implementation of the comprehensive registration system also simplified and moderately relaxed the approval of convertible bonds. In the long run, the issuance of convertible bonds will benefit from the relaxation of requirements and accelerated administrative approval. In particular, applicable rules for the issuance of convertible bonds by companies listed on the main board have been significantly optimized, including but not limited to the relaxation of refinancing restrictions, the clarification and shortening of the review period and approval period. It should be noted that due to the impact of the new regulations on share reductions by major investors, the approval speed of convertible bonds has slowed down to a certain extent since August 2023, but in the long term, the supply of the convertible bond market remains promising.

Figure 232. Streamlined Requirements for Convertible Bond Issuance under the Comprehensive Registration System

Prior to the Implementation of the Comprehensive Registration-based IPO System		After the Implementation of the Comprehensive Registration-based IPO System		
	Main board of Shanghai and Shenzhen Stock Exchanges, STAR market, ChiNext market, Beijing Stock Exchange, National Equities Exchange and Quotations (NEEQ)	Main board	ChiNext market	STAR market
Profitability	Companies listed on the main board issuing convertible bonds to non-specific investors shall make positive net profits in the last 3 fiscal years	Continuous positive net profit in the last 3 fiscal years	Positive net profit in the last 2 years	Nil
Return on equity	Companies listed on the main board issuing convertible bonds to non-specific investors shall have the weighted average return on equity of no less than 6% on average in the last 3 fiscal years	The weighted average return on equity shall be no less than 6% on average in the last 3 fiscal years	Nil	Nil
Leverage	The cumulative balance of corporate bonds after this issuance shall not exceed 50% of net assets of the latest period	The cumulative balance of corporate bonds after this issuance shall not exceed 40% of net assets of the latest accounting period	Nil	Have a reasonable asset-liability structure and normal cash flow
Interest coverage ratio	The average profits distributable to shareholders for the last three years shall be enough to pay the company's one-year interest on corporate bonds	The average profits distributable to shareholders for the last three fiscal years shall be no less than the company's one-year interest on corporate bonds	Nil	The average profits distributable to shareholders for the last three years shall be enough to pay the company's one-year interest on corporate bonds
Guarantee	Nil	Companies shall provide guarantee for public issuances, except for those whose latest audited net assets are not less than RMB 1.5 billion.	Nil	Nil

Data sources: CSRC and BOC Investment Strategy Research Center

4.2.3.1 Both internal and external environments are expected to improve, and an active stock market is favorable for convertible bonds

Positive factors in the domestic economic recovery should not be overlooked, with industrial enterprises maintaining positive profit growth for two consecutive months. In terms of structure, profit margins of midstream and downstream industries have improved, while that of upstream industries have decreased. In terms of inventory, the month-over-month decrease and the year-on-year improvement in finished goods inventory of industrial enterprises suggest that an inventory restocking cycle is approaching. The faster-than-expected GDP growth in Q3 and front-load policies to stabilize growth in Q4 indicated a strong demand for a stable economy in 2024. Coupled with a proactive fiscal policy and the implementation of policies like building public infrastructure for both emergency and emergency use, urban village renovation, and affordable housing construction, the market's expectation regarding the slope of economic recovery has improved, which will become a crucial factor in boosting market sentiment. With the continuous rollout of countercyclical adjustment policies and policies starting to play their role gradually, China's economy will continue to recover. In fact, signs of fundamental economic recovery have already emerged. As the stock market becomes more active, convertible bonds will also usher in periodic opportunities.

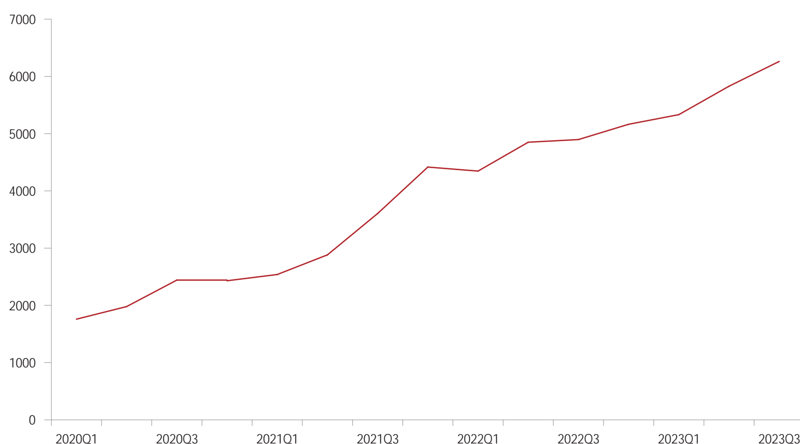
4.2.3.2 Countercyclical policies are precise and effective, providing protection for pure bond value

The concern regarding the bond market lies in the impact of countercyclical policies. It is recommended to focus on the intensity of the implementation of credit easing policies in 2024 and whether the policies could provide a safety net for the drag of real estate investment and the slowdown in infrastructure investment momentum. The current fiscal expansion is not solely aimed at pushing up investment growth rates but by focusing investments on key areas and weak links and maintaining precise and effective investment guidance to accelerate improvement of weak areas and supporting new infrastructure, new urbanization, and major projects in transportation and water conservancy. Therefore, the adjustments in the bond market are relatively limited. In the meantime, as the fluctuation range narrows, the margin effect of the bond market on the convertible bond market becomes weaker.

4.2.3.3 Net supply of convertible bonds is expected to decrease, whereas demands are expected to remain relatively stable

On the supply side of convertible bonds, the requirements have been relaxed to some extent in terms of the issuance of convertible bonds under the comprehensive registration-based IPO system. Nevertheless, considering the slowdown in the issuance process, the shortage of supply by large-scale issuers in 1H, 2024, the restrictions of the new refinancing regulations, and the upcoming maturity of certain convertible bonds, the net supply of convertible bonds is expected to consistently decline in 2024. The demand of convertible bonds continues to come from institutional investors, with public funds, annuities, insurance companies and proprietary trading of securities firms being the four major types of institutions with the highest holding. Given that these institutions have relatively stable demand for convertible bonds, the foundation of convertible bond demands remains robust. With respect to the changes of asset allocation into convertible bonds by "fixed income +" funds that have drawn much attention from the market, we may get a clear picture from the perspectives of total fund shares and holding positions. With the expectation of a more active equity market in 2024, the shares of "fixed income +" funds are expected to stabilize and rebound. At the same time, against the backdrop of a downward pure bond yield, the demand for convertible bonds from "fixed income +" products is expected to persist. Therefore, the positions of "fixed income +" funds in convertible bonds is expected to remain stable in 2024. Based on the perception of fund share rebound and stable positions, the market is expected to witness a net growth in demand for convertible bonds from "fixed income +" funds in 2024.

Figure 233. Changes in the Scale of Convertible Bonds Held by "Fixed Income+" Funds (RMB 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

4.2.3.4 Valuation of convertible bonds remains high, and it is recommended to focus on structural opportunities

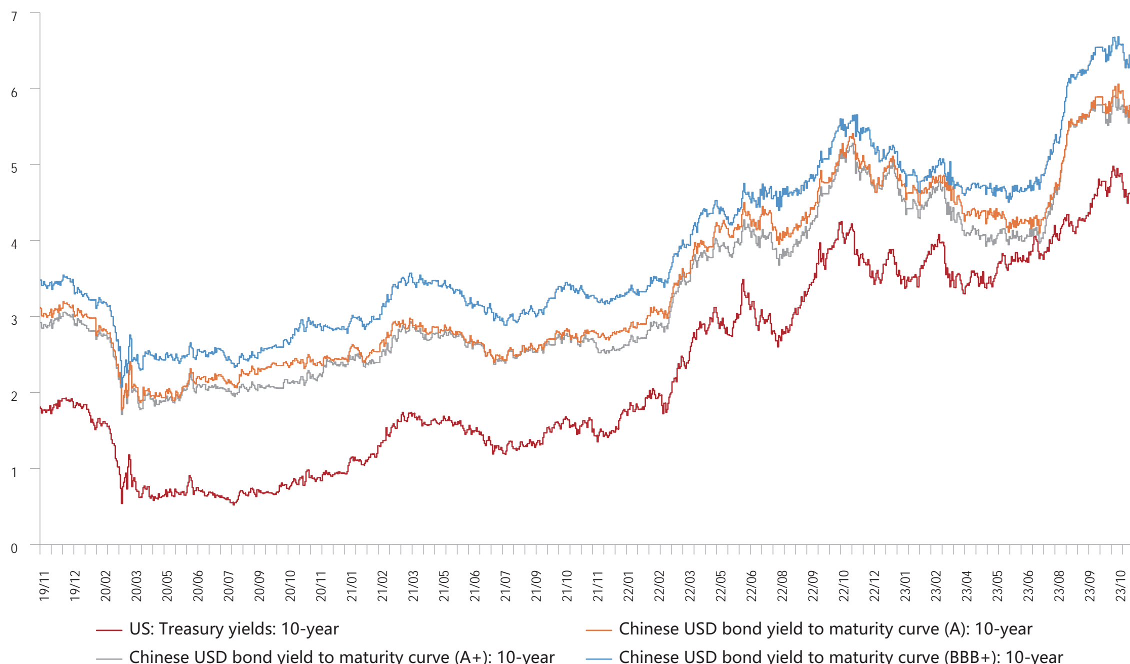
The valuations of equities such as PE shows that the overall valuation level of the current A-share market is at a relatively low point in history. The valuations of the underlying stocks of convertible bonds have also been adjusted to historical lows, both close to the historical 10th percentile. However, looking at the convertible bond market, the current valuations are still relatively high. Given the relatively sluggish momentum of economic recovery and a relatively flat recovery slope, monetary policy is not yet in a position to shift. In particular, in the pursuit of high-quality development, liquidity may continue to remain stable to facilitate economic recovery, with the PBOC cutting reserve requirements in September to protect cross-seasonal liquidity. On August 27, the CSRC released new refinancing regulations, significantly slowing the progress of convertible bond plans. Subsequently, the slowdown in the issuance pace of new bonds continued with no signs of improvement, which may provide certain support to the valuation of the convertible bond market. Against the backdrop of the ongoing recovery of the endogenous economic growth and the constant strengthening of domestic macroeconomic policies, the current valuations and sentiment indicators of the equity market are at relatively low levels. After significant compression, convertible bond valuations have fallen below the central level since 2022, but remain within an investable range in general. Hence, it is recommended to focus on periodic and structural opportunities in the convertible bond market.

4.3 Chinese and Other Emerging Markets USD Bonds

2023, Chinese and other emerging market USD bonds experienced initial gains followed by a decline, featuring fluctuations and divisions. From Q4, 2022 to the Q1, 2023, amidst rising concerns about the US economic recession, banking crisis in the US and Europe, market expectations for the Fed to stop interest rate hikes and the commencement of pricing in interest rate cut expectations, US treasury yields suffered from a rapid decline, thus boosting the overall rise of various USD bond assets, including Chinese and other emerging market USD bonds. Nevertheless, subsequent data confirmed the resilience of inflation and economy in the US. The Fed continued to tighten its policies by implementing four rate hikes to raise the benchmark interest rate to the range between 5.25% and 5.50%, which suppressed the rebound of Chinese and other emerging market USD bonds and created a clear division of performances across regions and industries since Q2, 2023. For instance, government bonds of various maturities from emerging markets like Sri Lanka, Colombia, and Ukraine have recorded yields of over 50% since 2023, while USD bonds from Russia and Turkey have plummeted due to global capital divestment. Among Chinese USD bonds, investment-grade bonds recorded relatively stable performance with a yield increase of over 4% in 2023, but high-yield bonds have seen significant continuous declines due to the persistent sluggish performance of the domestic real estate sector and frequent defaults, with the Chinese USD Bond Real Estate Bond Index falling nearly 30% throughout the year.

Looking ahead to 2024, as the core inflation continues to drop in 2024, the market's focus will shift to when the Fed will start the reductions of interest rates. Hence, the market is likely to experience a downward trend in the USD and US treasury yields in 2024. There may be a golden opportunity to arrange asset allocation into Chinese and other emerging market USD bonds, which are expected to rebound amid oscillations. Despite constantly divergent performance due to the global and regional economic disparities, capital inflows may improve, which could drive up the overall investment value of emerging markets USD bonds. Investment-grade Chinese USD bonds with high interest rate differentials between home and abroad and lower credit risks, such as urban investment bonds, financial bonds, and bonds of non-financial sectors, have attractive valuations. Hence, it is recommended to increase allocation when appropriate. However, the real estate sector is still under a slow recovery with strong uncertainties. Even though there are short-term speculative opportunities under easing policies such as the expansion of the whitelist of property developers eligible for financing, it is recommended to remain prudent and only focus on bonds of high-quality central and local state-owned enterprises with more accessible financing channels and more solid sales.

Figure 234. Yield Performance of High-grade Chinese USD Bonds and US Treasury Bonds over the Same Period (%)

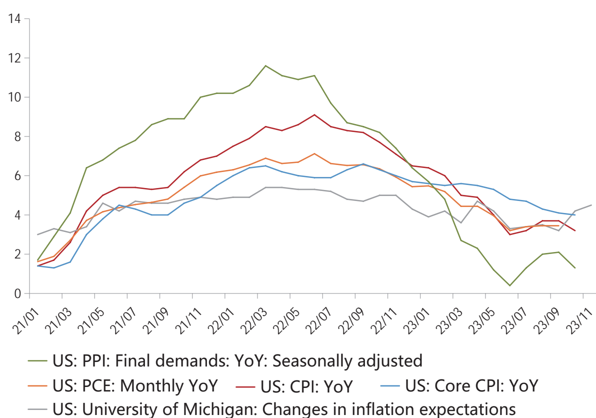


Data sources: Wind and BOC Investment Strategy Research Center

4.3.1 End of interest rate hikes is expected to push USD bonds to emerge from the shadow

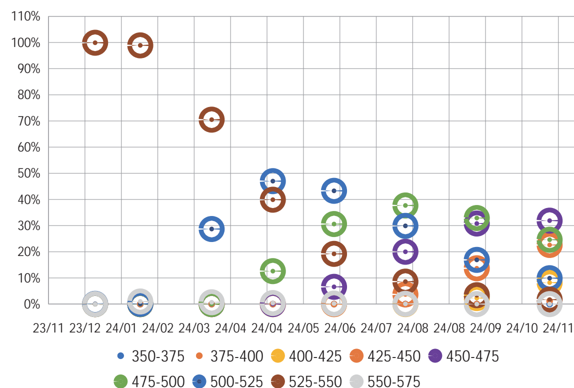
The yield trend of Chinese and other emerging market USD bonds is usually influenced by benchmark interest rates, exchange rates, and credit spreads, while both benchmark interest rates and exchange rates are largely determined by the Fed's monetary policy. Based on historical performance, the Federal funds target rate is as a crucial price indicator of the Fed's monetary policy, and is regarded as a key factor affecting the benchmark interest rate, namely, the yield of US 10-year treasuries, as well as the USDX. As such, the Federal funds target rate can play a significant role in pricing Chinese and emerging market USD bonds, especially investment-grade ones. For example, the correlation between the investment-grade Chinese USD bonds and US Treasury yields has been high of above 0.98 over the past two years.

Figure 235. US Inflation Gradually Cooled down (%)



Data sources: Wind and BOC Investment Strategy Research Center

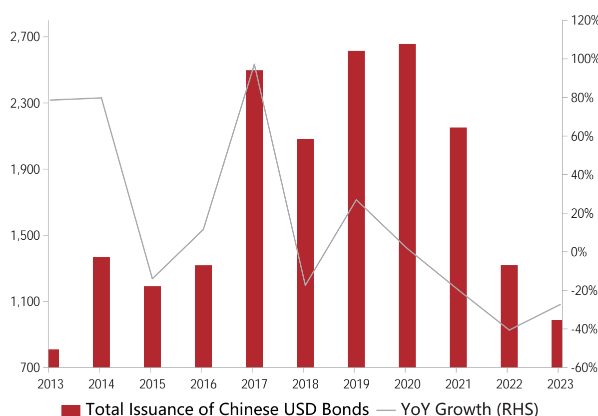
Figure 236. Universal Market Expectations that the Fed Would Halt Interest Rate Hikes (%)



Data sources: CME and BOC Investment Strategy Research Center

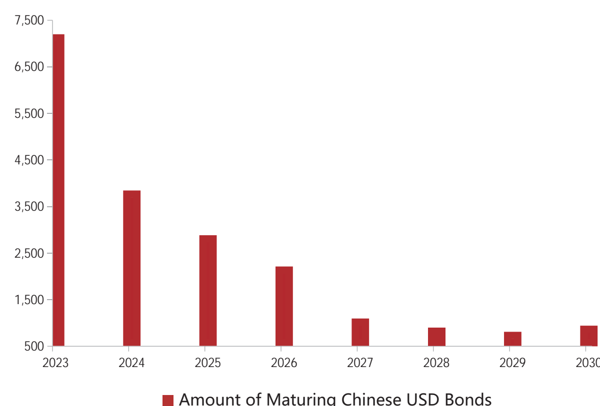
With the end of the US interest rate hikes, the US treasury yields may have peaked. In October, the US CPI grew by 3.2% year-over-year, lower than the previous 3.7% and the market consensus of 3.3%. At the same time, influenced by declining energy prices, the PPI in October reached only 1.3% year-over-year, significantly below the previous 2.2% and the expectation of 1.7%. Retail data also showed a trend of decelerating, with the month-over-month growth rate turning negative in October after seven months, indicating a clear cooldown in the US consumer market. In 2024, there is a relatively strong certainty of a decline from high levels in US treasury yields and the USDX, and Chinese and other emerging market USD bonds will emerge from the shadows, pushing down bond yields in tandem with US treasury yields.

Figure 237. Issuance Scale of Chinese USD Bonds from 2013 to October, 2023 (USD 100 million, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 238. Maturity of Chinese USD Bonds from 2013 to 2023 (USD 100 million)



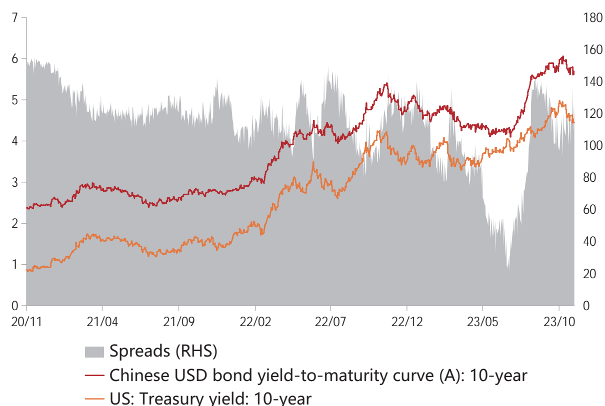
Data sources: Wind and BOC Investment Strategy Research Center

The downward trend in the supply of Chinese USD bonds is expected to slow down in 2024 as the interest rate hikes end. Over the past two years, affected by stricter offshore financing regulations, credit risk events in Chinese real estate enterprises, and aggressive interest rate hikes by the Fed, the net financing scale of Chinese USD bonds has significantly contracted. As of October 2023, the issuance scale of Chinese USD bonds had dropped by approximately 27% compared with the same period of 2022, a new low since 2015. The sharp increase in financing costs caused by the Fed's interest rate hike constituted a crucial disincentive. Considering that around USD 360 billion worth of Chinese USD bonds will mature in 2024, which is significantly lower than the amount of more than USD 700 worth of bonds in 2023, there will be lower pressure of refinancing in 2024. In addition, the primary issuance market of Chinese USD bonds may pick up, and the net financing scale may further rebound.

4.3.2 Investment-grade bonds outperformed against the backdrop of narrowing spreads

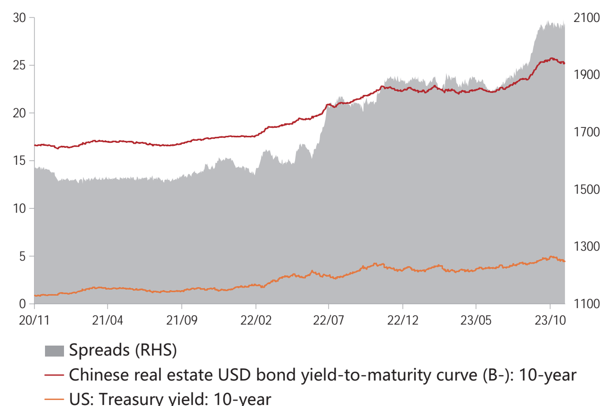
The impact imposed by credit spreads on Chinese and other emerging markets USD bonds often reflect different macroeconomic environments and the fundamentals of issuing entities, as well as risk premiums due to market segmentation and information asymmetry between domestic and international markets. The trends of Russian, Turkish, and high-yield Chinese property USD bonds in 2023 are typical events indicating widening credit spreads driven by geopolitical risks, currency devaluations and credit default risks. In 2023, China and other emerging market countries have started economic recoveries with production returning to normal and demand gradually recovering. The macroeconomic environment and the fundamentals of bond issuers have significantly improved compared to previous years, which has stabilized USD bonds in most regions, especially investment-grade bond index, and credit spreads have narrowed from historical highs. However, as US treasury yields rose rapidly, credit spreads of Chinese USD bonds reached new highs, with high-yield bonds represented by real estate bonds exceeding a spread of 2,000 bps, reaching a new high.

Figure 239. Yields and Spreads of Investment-grade Chinese USD bonds (%, bps)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 240. Yields and Spreads of High-yield Chinese USD Bonds (%, bps)



Data sources: Wind and BOC Investment Strategy Research Center

Considering that the global interest rate hikes are coming to an end in 2024, the fall in US treasury yields will push credit spreads for Chinese and other emerging market USD bonds to narrow further. At the same time, fiscal and monetary policies in emerging countries, particularly China, are becoming more relaxed in order to support economic recovery. Under such circumstances, investment-grade USD bonds with smaller credit risk, such as urban investment bonds, financial and non-financial bonds, boast better investment value. As the yields of investment-grade dollar bonds are at historical highs, their valuation is attractive and thus it is recommended to increase allocations in 2024 and appropriately extend durations to capture capital gain opportunities. For high-yield bonds of the property sector, without clear signs of substantial improvement prior to an upturn in commodity housing sales, there may be short-term speculative opportunities for bonds of whitelisted enterprises supported by credit policies. It is recommended to pay closer attention to high-quality central and local state-owned enterprises with more accessible financing channels and more stable sales. However, the overall demand for real estate is expected to remain weak in 2024. Although the spreads for high-yield Chinese USD bonds are tempting, aggressive asset allocation into these is not recommended.

4.3.3 Capital inflows revitalized emerging markets

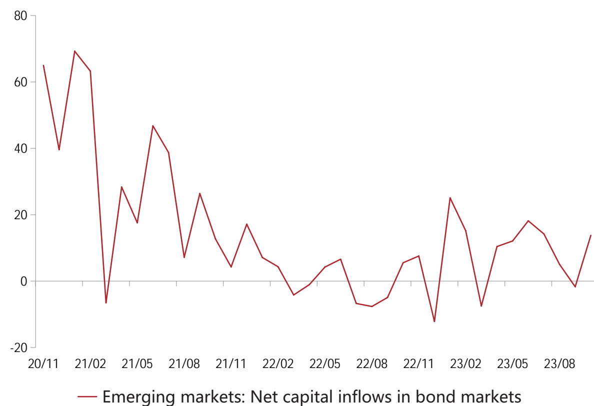
Since the start of the current interest rate hike cycle in March 2022 in the US, the rise of the USDX has tightened the financing environment, placing some emerging market countries under dual pressures of increased debt burdens and capital outflows. Sri Lanka became the first emerging country to default on its sovereign debt during this cycle in 2022, and countries with relatively high credit risks, such as Turkey, faced significant setbacks in 2023. The interest rate hike cycle indeed became the greatest pressure on emerging market USD bonds. Performances in this cycle differentiated from the past. Currency performances of emerging countries like Mexico and Brazil in Latin America, which are primarily resource-exporting countries, benefited from increasing exports due to high commodity prices pushed up by the economic expansion of developed economies. In 2023, yield performance of some of the lowest-rated sovereign bonds led the global bond markets, with countries like Zambia and Sri Lanka, which in 2022 suffered from low ratings, lack of financing, and persistently weak economic fundamentals, gaining market attention again due to debt restructuring and IMF support. Countries like Argentina and Nigeria also attracted global investors with their extensive reforms.

Looking ahead to the trend of emerging market USD bonds in 2024, although performance differences will continue due to the global economic environment and regional economic disparities, the overall investment opportunities and interest are expected to increase. On the one hand, the USDX is unlikely to remain strong, the environment for currencies of various countries is expected to improve significantly, and capital inflows will become more active. The overall inflation in emerging markets has significantly declined, and the balance of fundamentals will help stabilize exchange rates. The return of capitals and stability of exchange rates will boost the emerging bond market, and the credit rating of emerging market USD bonds is more likely to rise than fall. On the other hand, emerging market USD bonds currently deliver extremely attractive overall yields. The

valuation of the Emerging Market Dollar Bond Index is low, and the space for profit is considerable. As of October 2023, the Emerging Market Dollar Bond Index had fallen by nearly 18% from the highs before the start of this round of rate hikes, currently at the 27th percentile of the past five years. It is recommended to pay more attention to emerging market USD bonds.

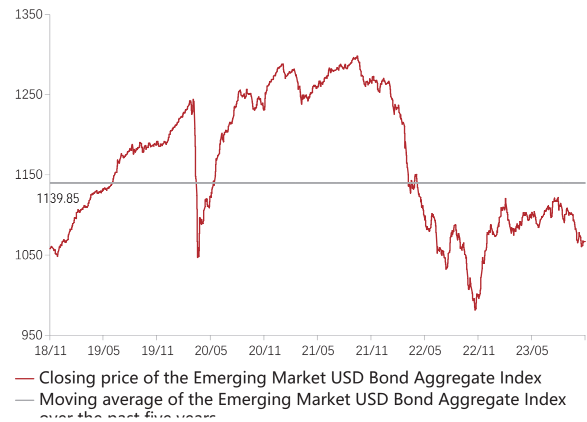
Regionally, some Asian emerging market bonds, already high in valuation and subject to exchange rate controls, may not quickly benefit from rate cuts and may perform weaker than many Latin American emerging economies who are implementing monetary easing. According to the governance results of 2023 Emerging Markets Index, from June 28th, 2024, JP Morgan will include Indian government bonds in its Government Bond Index-Emerging Markets indices, with an expected weight of up to 10%. This may bring in USD 30 billion worth of fixed-income funds, which will help stabilize the bond yields in India.

Figure 241. Net Capital Inflows in Emerging Bond Markets (USD 1 billion)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 242. Emerging Market USD Bond Aggregate Index



Data sources: Bloomberg and BOC Investment Strategy Research Center

4.4 US Bonds: Pricing Logic Returned to Fundamentals and the Yields Continued to Fluctuate Downward

In terms of US treasuries, the US economy grew beyond expectations and the labor market remained generally stable in 2023, leading the market to revise its earlier expectations of a recession in the US. Instead, the market began pricing in a soft landing for the US economy, hence the market anticipated that high interest rates could persist for a longer time. Meanwhile, even though the US inflation continued to trend downward, CPI data rebounded after falling to 3.0% in June, with core inflation remaining significantly above the 2% target level. Moreover, the US labor market's unemployment rate continued to stay at low levels. The Fed's Chairman Jerome Powell conveyed to the market the determination to maintain interest rates at highs for a longer period to control inflation, causing US treasury yields to reach new highs for the year.

In Q1, 2023, the market at one point expected the Fed to continue raising interest rates by 100 bps in 2023, and thus both short and long-term treasury yields rose in tandem. However, the unexpected collapse of Silicon Valley Bank aroused concerns about financial stability and sparked market expectations for a reversal in Fed's monetary policy, leading to a rapid decline in Treasury yields once again, with the US 2-year and 10-year treasury yields falling by 35 bps and 40 bps respectively in Q1. The US 10-year treasuries and China 10-year government bond spreads remained inverted for nearly 11 months, and the US short-term and long-term treasury yields continued to remain inverted, indicating an increasing likelihood of recession in the US.

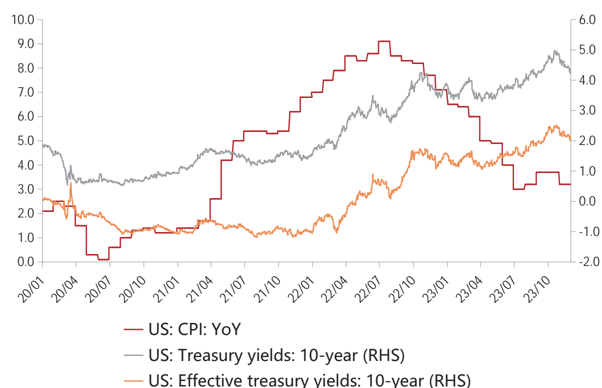
In Q2, the US inflation remained resilient, with the core CPI standing at 5.3% year-over-year in May, and the pace of decline in core inflation remained slow. Although the Fed chose to pause interest rate hikes in June, it simultaneously raised the dot

plot by 50 bps to express its determination to curb inflation. Market expectations for an end to USD interest rate hikes were lower than at the start of the year, leading to a failed rebound in the US bond market in Q2, with the US 2-year and 10-year treasury yields rising by 81 bps and 33 bps respectively from Q1. However, looking at the half-year period, the US 2-year treasury yield rose by 46 bps to 4.87%, while the US 10-year treasury yield dropped by 7 bps to 3.81%, showing that the market expected less likeliness of rate cuts by the Fed in the short term, but that the cuts were inevitable in the long run.

In Q3, the US economic data unexpectedly went strong in a consistent manner. Although the services PMI dropped slightly to 53.6 in September from the previous month, the US services PMI had reached 54.5 in August, hitting a new high since February 2023. Coupled with a more than 20% increase in crude oil prices in Q3, the US inflation data experienced a rebound, with the core CPI remaining above 4%. This was well above the 2% target, leading to the market's expectations for a delay to end the current round of interest rate hikes by the Fed. Moreover, at the FOMC meeting in September, the Fed conveyed hawkish signals that exceeded the market's expectations, leading to a strong return of USD and obvious upward pressure on US treasury yields, especially long-term treasuries. The US 10-year treasury yield recorded a new high at 4.59% in Q3 for the current adjustment cycle, rising by 78 bps quarter-over-quarter.

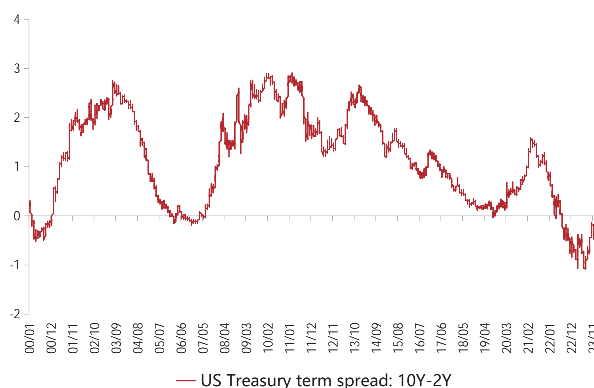
In Q4, the data of CPI and PPI in October unexpectedly slowed down, and inflation continued to decelerate. The number of US unemployment insurance claims exceeded expectations, and the US labor market cooled down in tandem. There have been rising market expectations for the Fed to end its most aggressive rate hike cycle over the past few decades, causing the benchmark yields to fall from the highest levels in over a decade. The US 10-year treasury yield dropped by 53.3 bps from a 16-year high of 5.02% on October 23 to 4.49%.

Figure 243. Elevated Center of Effective Yields Pushed up US Treasury Yields (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 244. US Treasury Term Spreads Remained Inverted (%)



Data sources: Wind and BOC Investment Strategy Research Center

Looking ahead to 2024, the key factors affecting the trend of US treasury yields are still the US economic growth and inflation issues as well as the orientation of the Fed's monetary policy. Starting from the end of Q4, 2023, the US economic growth is expected to slow marginally, primarily because the support from excess savings in US households for private consumption is weakening. Household excess savings are expected to be exhausted by the Q2, 2024, but the negative impact on consumption expectations should be evident in 1H, 2024. Combined with the continuously emerging effects of interest rate hikes, the US economic growth is expected to slow at the end of Q4. Additionally, an economic cooldown is expected to lead to a further cooling of the labor market, and the influx of new immigrants should help relieve supply and demand pressure on the US labor market, further easing the core inflation pressures. We expect that the turning point for US treasury yields may have already occurred, and the Fed is likely to start cutting rates in 2H, 2024. However, considering that the market may price this in advance under repeated expectation reversals, short-term US treasury rates may maintain wide-range oscillation, waiting for clearer signals of rate cuts before a downward trend.

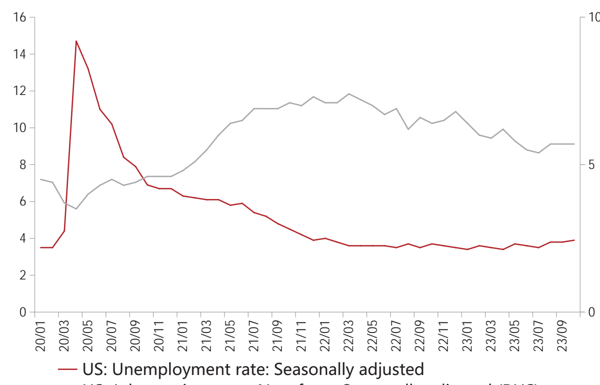
4.4.1 Consumption and investment remained resilient while the Consumer Confidence Index showed weakness

Consumption accounts for nearly 70% of the US GDP, and the trend of US treasuries is closely related to consumption resilience, thus consumption plays a significant guiding role in assessing the outlook of the US economy. Driven by fiscal support and a strong labor market, private sector consumption in the US showed resilience in 2023, supporting a six-quarter high in personal consumption in Q3. The strength of private sector spending can be explained by real income indicators. In constant prices, the disposable income in the US was negative in 2022 (due to high inflation), but the situation improved significantly in 2023. Currently, the actual growth rate of the US disposable income is around 3.5%, completely offsetting inflationary pressure, which holds the key to improving the expectations of a soft landing for the US economy.

Figure 245. US Economic Surprise Index Oscillated Upward in 2023

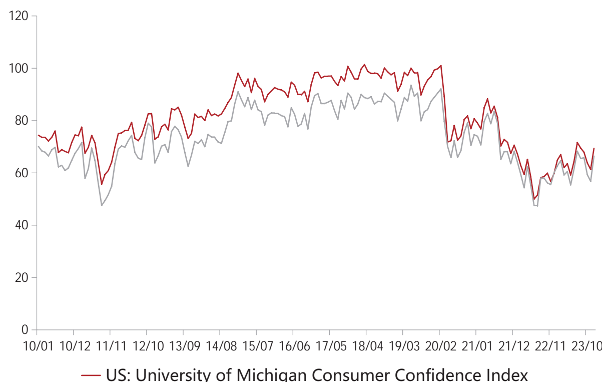
Data sources: Wind and BOC Investment Strategy Research Center

Figure 246. US Labor Market Showed Strong Performance in 2023 (%, %)



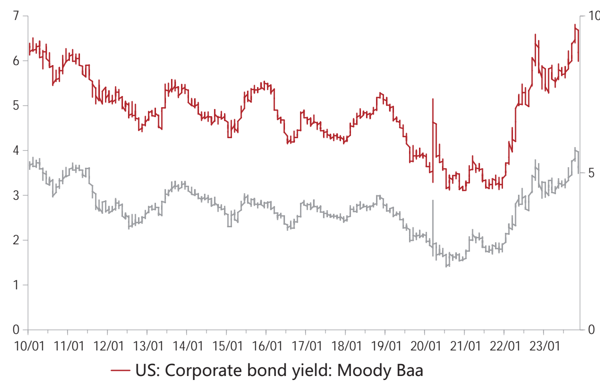
Data sources: Wind and BOC Investment Strategy Research Center

Figure 247. US Consumption Market Remained Resilient in 2023



Data sources: Wind and BOC Investment Strategy Research Center

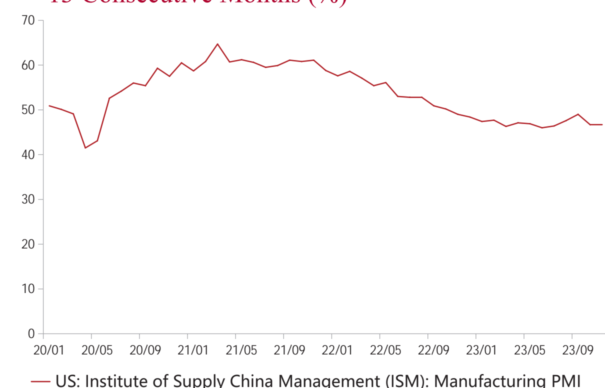
Figure 248. Constantly Rising Costs of US Corporate Bond Yields in 2023



Data sources: Wind and BOC Investment Strategy Research Center

In 2024, the support from excess savings is likely to weaken, and both work hours and wage growth rates are expected to trend downward. As of April 2023, the excess savings of US households accumulated over the recent years had already been exhausted. Even if the trend line is estimated as a horizontal line, excess savings were already exhausted by September, 2023. Excess savings will be hard-pressed to continue supporting the resilience of the US economy in 2024. While consumer data remains strong, the US consumer confidence has declined sharply. The US Consumer Sentiment Index accelerated its decline to 63.0% in October, falling for three consecutive months. All these reflect uncertainties in the consumption outlook. High interest rates will significantly increase their impact on the US private sector in 2024. First, the US corporate debt repayment will peak in 2024. Second, consumer credit growth is likely to slow as banks tighten lending standards. The financing cost for small and medium-sized enterprises has risen significantly. After the long period of maintaining interest rates high, the negative effects will continue to transmit, which will lead to a decline in the overall financing demand of the society. In addition, the high interest rate of the US treasuries, and the US 10-year and 2-year treasury yields have remained inverted for nearly a year and a half, the longest inversion record, indicating that pressure of a recession is looming large.

Figure 249. US Manufacturing Sector Declined for 13 Consecutive Months (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 250. US Banking Crisis in March 2023 Intensified Pressure in the Financial Sector

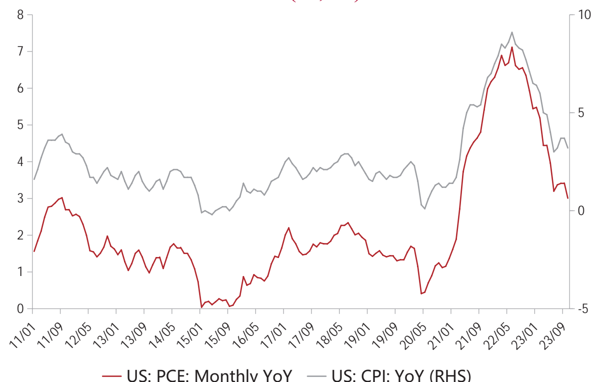
Data sources: Wind and BOC Investment Strategy Research Center

4.4.2 Center of inflation continued to drop, and energy prices were encountered with disturbing factors

In 2023, the core PCE significantly decreased from the range between 5% and 5.25% in 2022 to 3.7% in September 2023. This decline stems mainly from three factors: First, contractionary policies reduced the overall demand, and the Fed successfully controlled inflation by curbing aggregate demand. Interest-sensitive industries such as real estate and the automotive industry were the first to contract. For example, the rates for 15-year and 30-year mortgages in the US continued to rise, with the average rate for 30-year loans reaching 7.79% on October 26, 2023, the highest since November 2000. Second, rent increases have fallen. Housing rent accounts for about 35% of the US CPI, and the US House Price Index goes ahead the CPI rent by about one year. This index has significantly decreased over the past year, and the US rent CPI is expected to decline later in 2024, potentially driving the core PCE down from around 4% to around 3%. Third, the US labor market has weakened. As the Fed's contractionary policies take effect, the tightness of the labor market will ease, with the employment gap reducing from 6 million to about 2.5 million. Wage growth has already fallen by more than 1.5 percentage points, reaching an annualized rate of 4.2%, and leading indicators suggest a further decline. As core inflation for goods and housing falls quickly and service inflation marginally recedes, given the resilience of the economy, it will take some time for core inflation to return to 2%. Therefore, the Fed has taken no action regarding the monetary policy moves.

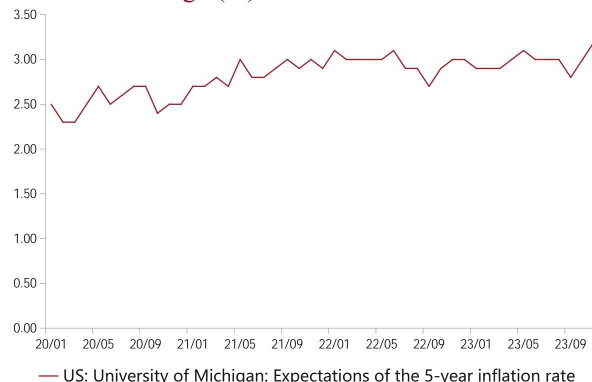
Whether inflation will continue its downward trend in 2024 will be key for the Fed to determine if it will quickly start a cycle of interest rate cuts. Although the inflation has started a downward trend, uncertainties will prevail in the process of decline: First, housing rent accounts for over 30% of the CPI basket, and the slowdown of the CPI housing index is lagging, this will affect the CPI decline. Second, wage growth remains sticky, and it is an important factor affecting changes in CPI in 2023, apart from housing rent. Early retirements in recent years have caused a systemic decline in the US labor supply, and even as the labor market tightness eases at some stage, wages remain sticky and will act as a restraint on the downward trend of inflation. Third, geopolitical conflicts disturb energy prices, thus the occurrence of geopolitical conflicts in 2024 that trigger a rise in oil prices will bring new uncertainties to changes in US inflation.

Figure 251. US Inflation Dropped from the High Level Reached in 2022 (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 252. Expectations of the 5-year Inflation Rate Remained High (%)

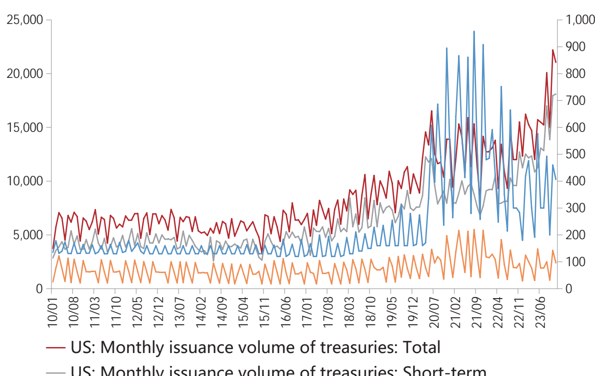


Data sources: Wind and BOC Investment Strategy Research Center

4.4.3 Fiscal expansion slowed down and supply pressure eased in the near term

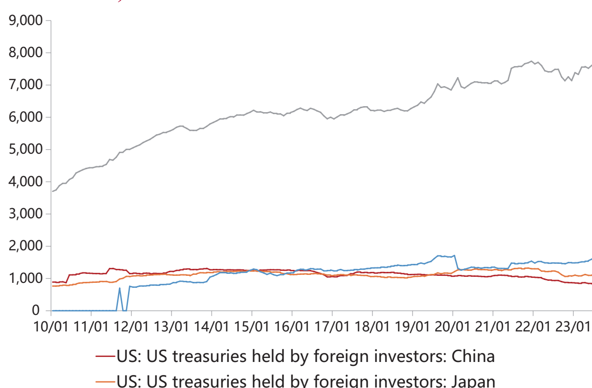
Currently, the expansion pace of US government debt and the level of interest rate increases far exceed inflation, leading to intensified interest payment pressures. In 2023, the US federal government's net interest expenditure accounted for 2.45% of GDP, and the weighted average interest rate of outstanding debt was 2.97%, significantly higher than the rate of 2.07% in the previous year. Overall, the significant fiscal deficit in the US since 2023 is unsustainable, and there may be a relative easing in the supply-demand contradiction of US treasuries in 2024.

Figure 253. Issuance of US Treasuries Continued to Rise in 2023 (USD 100 million, USD 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 254. Total Volume of US Treasuries Held by Foreign Investors Remained Stable (USD 100 million)



Data sources: Wind and BOC Investment Strategy Research Center

From the perspective the net issuance scale, the plan for issuing mid-to long-term US treasuries is relatively certain. According to TBAC data, although the planned issuance volume of mid-to long-term US treasuries in Q4, 2023 was slightly higher than the same period in 2022, it has already fallen back to the overall level before 2020. There is a slight increase in the planned issuance in Q1, 2024, but the proportion of mid-to long-term debt has decreased from 40.7% to 28.2%, which could alleviate concerns about the supply of mid-to long-term US treasuries. It is evident that the US Treasury Department is taking into consideration the rapid rise in the term premium of US treasury yields, and has reduced the pace of issuance of mid-to long-term bonds. In addition, the high level of long-term US treasury yields put a strain on the structure of new government bonds. Therefore, supply pressure is likely to adjust spontaneously according to market changes and is unlikely to affect the trajectory

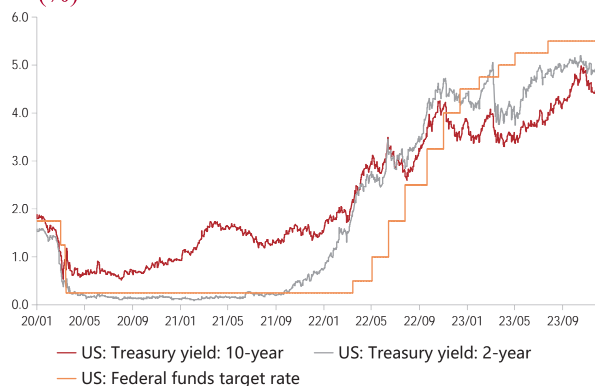
of US treasury yields in the mid-to long-term. Hence, without the pressure of forced issuance of bonds, it is highly unlikely to cause significant disturbances to the existing supply-demand balance of the treasury market. In 2024, the pricing logic for US treasuries will depend more on fundamental contradictions, and supply pressure may bring short-term, phase-specific disturbances.

Regarding the demand for US treasuries, as a major buyer, the Fed has provided support for the issuance of US treasuries. Despite the downgrade of the US sovereign debt rating, foreign investors, other than the Chinese central bank, continue to increase their holdings of US treasuries. Regarding fiscal deficit, the pressure of US government interest payments remains the major issue, and the market is currently more concerned with the issuance of treasuries, triggering significant short-term volatility in US treasuries through rather pessimistic trading sentiment, which could signal the bottom for US treasuries.

4.4.4 Fiscal expansion slowed down and supply pressure eased in the near term

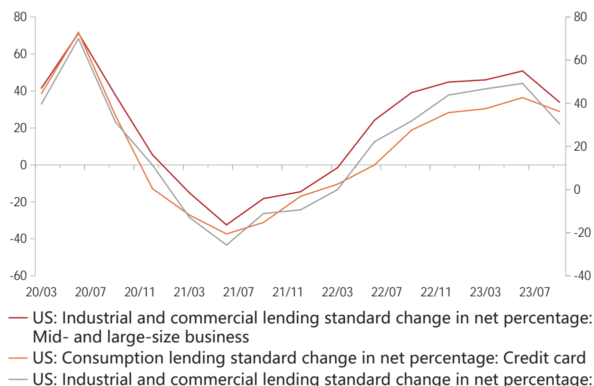
In 2023, the Fed primarily adopted a hawkish stance to influence market expectations, attempting to minimize the cost of rate hikes. Although the Fed claims inflation is still too high, monetary policy remains tight, and further tightening is possible if necessary, it is also paying more attention to the balance between excessive and insufficient tightening. The focus has gradually shifted from the speed of rate hikes to the extent and duration of high interest rates. The Fed temporarily stopped raising rates after July 2023, mainly because the US inflation had dropped successfully, with the PCE inflation rate dropping from 5.5% in January 2023 to 3.2% in June. Second, to offset concerns over excessive US treasury supply amid larger-than-expected fiscal financing, the Fed chose to pause rate hikes again at the FOMC meeting in November to balance the impact of the rapidly rising treasury yields. At the end of November, the Fed's hawkish governor Christopher Waller made dovish remarks, suggesting that if inflation continued to cool for several months, and that the Fed's officials were confident they were moving in the right direction, then the Fed might lower policy rates due to lower inflation. This sparked market trading ahead of rate cuts and led to a rapid decline in US treasury yields.

Figure 255. Consistent Rate Hikes by the Fed Led to the Oscillations of US Treasury Yields at Highs (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 256. US banks Remained Cautious about Lending in 2023 (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

According to the minutes of the FOMC meeting in November, FOMC members expect economic activities and the labor market to cool marginally in the near future, but there is no solid evidence that inflation will return to the 2% policy target. Changes in core US economic data related to labor and inflation remain the key factors influencing the Fed's monetary policy decisions. FOMC members mentioned the rapid rise in long-term US treasury yields over the past period, which led to a rapid tightening of financial conditions and increased borrowing costs for residents and businesses. After the market considered the end of rate hikes as a foregone conclusion, the Fed finally officially stated about stopping rate hikes.

Looking ahead to 2024, the extent and timing of rate cuts will be the focus of market attention. The FOMC meeting in December predicted a decline in the terminal rate to 4.6% in 2024 from 5.4% at the end of 2023, with the latest dot plot implying three rate cuts. Although this number is lower than the five rate cuts implied by the CME interest rate futures market, both the statements made by Jerome Powell and the dot plot changes are increasingly converging with market predictions rather than challenging them. Overall, we expect the Fed to cut rates by 100 bps in 2024.

The timing of the rate cuts may require some significant changes in fundamentals. The market currently focuses on economic growth, unemployment rates, and inflation data, such as the US non-farm payrolls for November, which were much higher than expected, causing market rates to fluctuate at high levels. Looking at the transition in the Fed's path of monetary policy, it will need to complete the adjustment of the dot plot, end the shrinking of the balance sheet, and hint at rate cuts. Based on the experience of the previous cycle of rate cut, it took the Fed six months from hinting at the end of rate hikes to the first rate cut. Therefore, the timing of rate cuts might come sooner than originally expected, but fundamentals do not support rate cuts in the near term. Hence, it is recommended to closely monitor if key data such as unemployment rates or inflation could encounter certain breakthroughs.

The USD Declined into the Neutral Zone, and Non-USD Currencies Experienced Divergent Performance, Whereas the JPY and the AUD Were Rather Strengthened

Driven by the start of the cycle of USD interest rate reductions, there is a high chance that the US economy will encounter a soft landing. Performance of the economies other than the US varies to some extent. Hence, the performance of non-USD currencies may continue to diverge. The US economy is expected to be stronger than the Eurozone economy mired in recession, and the market may have traded in advance of the reductions of USD interest rates. Hence, it is recommended to maintain the underweight (conservative) for the USD as in Q3, 2023, and then transition into a neutral view afterwards. The European economy is likely to enter into a recession, and it is recommended to given an underweight (conservative) to the EUR. Moreover, it is recommended to adopt a neutral view for the GBP before shifting to an underweight (conservative). Driven by the economic recovery in Japan, the inflation has mildly risen, and the US and Japan treasury spreads have narrowed. Hence, it is recommended to give an overweight to the JPY (recommended). Given that the economic fundamentals are optimal in Australia with strong monetary policies, it is recommended to given an overweight to the AUD (recommended). Moreover, investors may adopt a neutral view for the CAD. Driven by the gradual end of external tightening and restoration of the domestic economy, the RMB is likely to maintain a neutral performance amid strengthening, and it is recommended to adopt a neutral view.

5.1 Renminbi: RMB Experienced Oscillation within a Wide Range, and Cautious Optimism is Recommended

5.1.1 RMB exchange rate saw twists and turns in 2023

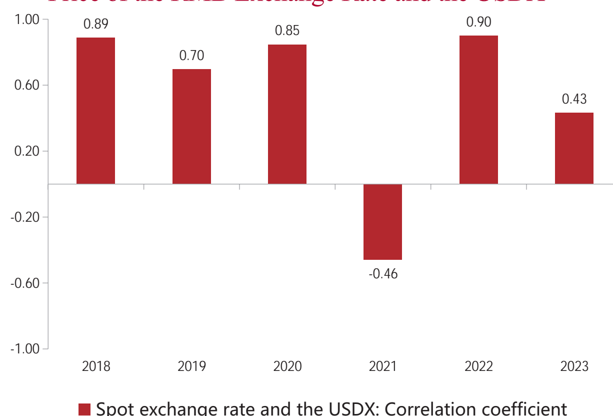
In January 2023, the RMB exchange rate (referring to the bilateral exchange rate against the USD) continued the rebound from the end of the previous year, delivering "weak reality against strong expectation" and resonating with the stock market. After February 2023, as expectations were met, the RMB exchange rate surged and then dropped from 6.7 to around 7.0 before fluctuating narrowly around 6.9. In mid-April, economic data for Q1, 2023 released by the National Bureau of Statistics indicated a good start of the domestic economy but with underlying concerns. The partial fulfillment of economic recovery expectations caused fluctuations in the Renminbi exchange rate. By mid-May, the RMB exchange rate fell below 7.0 again after more than five months. In mid-June, the PBOC unexpectedly cut interest rates, and the RMB spot exchange rate fell to 7.30 at the end of June. In July, the Politburo meeting released a package of positive signals to stabilize growth, and related departments introduced policies to stabilize foreign exchanges, combined with a pullback in the USDX, the RMB exchange rate stabilized and rebounded. After August, as the domestic economy continued its bumpy recovery and the USD strengthened again, coupled with another unexpected rate cut by the central bank, the RMB exchange rate fell below 7.30 at the end of August and dropped to the lowest point of the year in September. Since then, the RMB exchange rate has remained stable, with the central parity rate around 7.17 to 7.18, and the spot exchange rate fluctuating narrowly around 7.30 (see Figure 257).

From the beginning of November to 17 November, benefited by the easing of expectations of the Fed's tightening and a pullback in the USDX caused by the unexpected drop in US CPI in October, the RMB spot exchange rate rose back within 7.30. During the period, the USDX fell from around 107 to below 104, a total decline of 2.7%, and the onshore RMB spot exchange rate increased by 1.0%. From the early 2023 to November 17, the correlation coefficient between the onshore RMB spot exchange rate and the USDX dropped to 0.43 (the full-year correlation coefficient for 2022 was 0.90), indicating that internal factors had more impact on the RMB exchange rate trend in 2023 than external factors (see Figures 257-258).

Figure 257. Trend of the Central Parity and Closing Price of the USD/RMB Exchange Rate

Data sources: Wind and BOC Investment Strategy Research Center
Notes: Spot exchange rate refers to the closing price on the interbank foreign exchange market at 4:30 p.m.

Figure 258. Correlation Coefficient between the Closing Price of the RMB Exchange Rate and the USDX



Data sources: Wind and BOC Investment Strategy Research Center

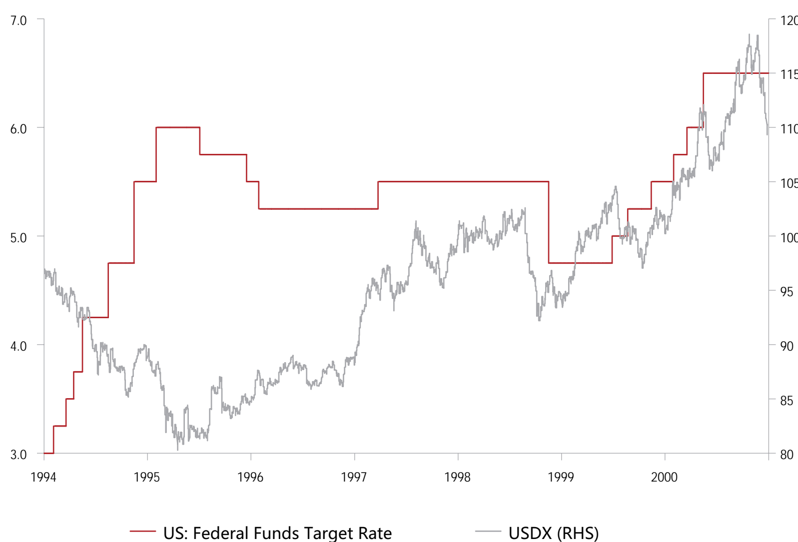
5.1.2 Three Scenarios for the RMB Exchange Rate Movements in 2024

The trend of the RMB exchange rate in 2024 is expected to be mainly influenced by three factors: domestic economic recovery, orientation of overseas monetary policies, and regulation of foreign exchange policy.

Judging from the trend of the RMB exchange rate in 2023, the key to stabilizing the exchange rate lies in stabilizing the

economy, and the role of foreign exchange policy is to gain time for domestic economy adjustment. In 2024, uncertainties continue to prevail in the domestic economic recovery. There are three favorable factors supporting economic recovery: First, the continuation of a proactive fiscal policy. After the additional issuance of RMB 1 trillion worth of special treasuries, positive signs have been shown in the fiscal policy efforts. The Central Financial Work Conference stressed the need to "optimize the debt structure of central and local governments", and it is expected that there is still room for the central government to increase leverage. Second, there is still room of operation for monetary policy. The Central Financial Work Conference emphasized the need to "create a sound monetary and financial environment", and advocated that "focus shall be placed on cross-cyclical and counter-cyclical adjustments as well as measures of enriching the monetary policy toolbox". In 2024, there is likely to be an adequate supply of monetary policy instruments. At the same time, overseas policy of monetary tightening is coming to an end, which also means a reduction in external constraints. Third, the drag of real estate on the economy may tend to ease. Regulatory authorities have recently released positive signals for the financing of property developers. The Central Financial Work Conference proposed to "promote the virtuous cycle between finance and real estate" and "to treat real estate enterprises with different ownership systems equally to meet their reasonable financing needs". Judging from the housing enterprise forum held by the Ministry of Housing and Urban-Rural Development and the financial regulatory authorities on November 7, and the financial institution forum held by the financial regulatory authorities on November 17, which proposed the "three no less than" policy (on the basis of effectively increasing the loan increment, efforts should be made to achieve the growth rate of small and micro enterprise loans not lower than the average growth rate of various loans; the number of small and micro enterprise loans is not lower than that of the same period of the previous year; small and micro enterprises' loan acquisition rate is not lower than the same period of the previous year),it is expected that the financing pressure on housing enterprises will be relieved, and growth rate of real estate investments with the support of policies may improve. However, since market expectations remain weak, there may be fluctuations in the economic recovery during the transition of new and old economic drivers, coupled with the possible exposure of the tail effects of overseas monetary tightening, all of which will affect the stability of foundation for the domestic economic recovery.

Figure 259. Federal Funds Target Rate and the USDX (%, March, 1973 = 100)



Data sources: Wind and BOC Investment Strategy Research Center

In 2024, there are three possible scenarios for the Fed's monetary policy and the trend of the USD. The first scenario is a "soft landing" of the US economy, where the US economic growth slows slightly and the unemployment rate rises modestly, accompanied by a continuous decline in US inflation. At that time, the Fed may not raise interest rates or may cut rates slightly, and the USD may experience a trend similar to that from 1995 to 1996. Back then, the Fed, unable to withstand pressure from the White House, briefly cut interest rates but maintained a tight stance, the so-called "hawkish rate cut". Initially, the market felt the "warmth" of the policy and drove the USD to depreciate slightly, but as the election approached, concerns grew that the Fed had not turned around, and ultimately in early 1997, the market "surrendered" completely under the pressure of

only a small rate hike by the Fed, and the USD strengthened again. The second scenario is that the US economy "does not land", meaning the US economic growth rate continues to maintain a positive output gap, the unemployment rate remains at historically low levels, and inflation stays high or even rises again. At that time, the Fed may not raise rates or may raise rates again, and the strong USD policy package relying on tight monetary policy and loose fiscal stimulus to boost the economy may continue. The third scenario is a "hard landing" of the US economy, where the US economy suddenly decelerates or even falls into recession, the unemployment rate rises sharply, and inflation drops quickly to deflation. In this case, it is expected that the Fed will quickly switch to crisis management mode, suspend quantitative tightening to increase the liquidity of US bonds, and simultaneously cut rates quickly. Although the short-term trend of the USD will benefit from safe-haven demand, over a longer period, once safe-haven sentiment and credit tightening alarms are lifted, the USD will go exceptionally weak.

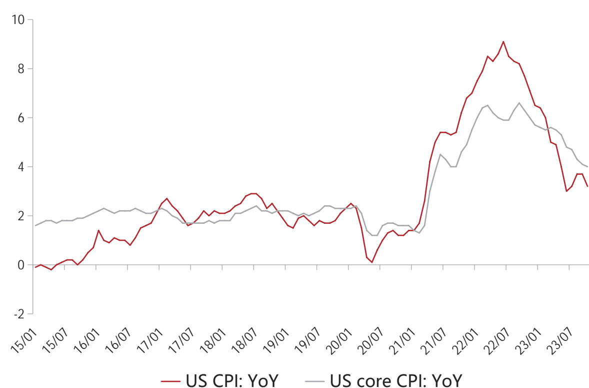
In 2024, the RMB exchange rate trend faces three scenarios. The neutral scenario is, if the Chinese economy recovers well and the Fed continues its tightening stance, the RMB/USD may show a trend of rising and falling, with wide-range fluctuations. The optimistic scenario is, if the Chinese economy continues to rebound, while the US economy goes downward and shifts its monetary policy, the expansion of China's economic lead over the US may support the RMB to rally against the USD. The pessimistic scenario is, if the US economy does not slide into recession and China's economic recovery continues to face downward pressure, then the RMB exchange rate may remain under pressure. We tend to hold the neutral scenario to be more likely, while not ruling out surprises in the optimistic scenario, and the pessimistic scenario to be less likely. After all, China's economic risks have been fully exposed, the worst-case situation has emerged, and policies have been taken to mitigate and resolve risks, while the situation in the US may be the opposite. Based on the observation of the relative strength of the Chinese and US economies, there may be a period of respective strength and weakness in 2024, so the RMB is most likely to fluctuate within a wide range, but the "golden cross" moment of the "fall of the West and the rise of the East" between the Chinese and US economies may appear during the year, and the relative strength of the RMB should be inevitable. What needs to be pointed out is that as uncertainties and destabilizing factors prevail at home and abroad, it is necessary to avoid linear unilateral thinking in determining the exchange rate movements.

5.2 US Dollar: US Dollar: USD's Infection Point is Emerging, and is Expected to Neutrally Fluctuate within a Wide Range

5.2.1 Shift of the Fed's policy from tightening to easing

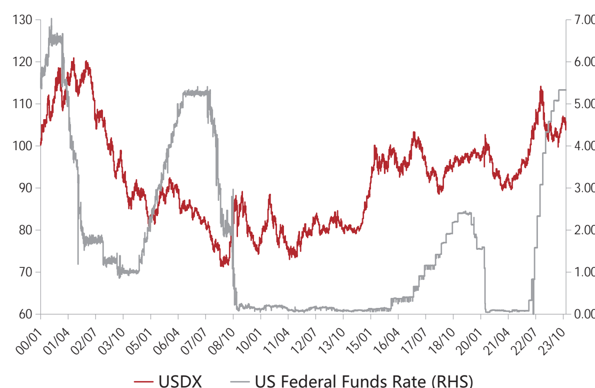
Although the US inflation has experienced consistent year-over-year declines since 2023, there is still some distance from the target level set by the Fed. Curbing inflation remained a core task for the Fed in 2023. Therefore, the monetary policy of the Fed in 2023 remained relatively tight, with the federal funds rate target increasing by 100 bps over the year, and the US 10-year treasury yields briefly rose above 5%. Currently, the Fed maintains a tightening stance, and it is expected that the core US inflation will further decline in 2024. In December 2023, the year-over-year growth in the US CPI in November was announced to be 3.1%, and the core CPI increased by 4%, falling within a low range seen over the past two years. Another key economic indicator that the Fed closely monitors, the US employment data, has also shown signs of declines. In December 2023, the US unemployment rate for November was announced to be 3.7%, and there was an increase of 199,000 non-farm payroll jobs in November. With inflation entering a reasonable range and an increase in unemployment rate, the Fed is expected to stop raising interest rates in 2024, and may gradually shift from observation to initiating a cycle of rate cuts.

Figure 260. YoY Growth of the US CPI and Core CPI (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 261. USDX and Federal Funds Rate (March, 1973 = 100, %)



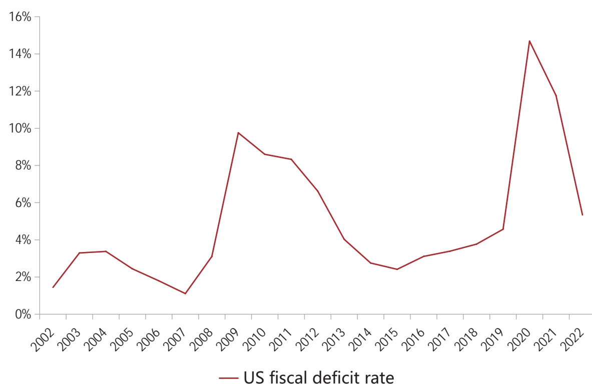
Data sources: Wind and BOC Investment Strategy Research Center

5.2.2 Fiscal policies are expected to weaken marginally, and excess savings are likely to decline

In terms of the total size, the US fiscal deficit expanded in 2023 to a level just below that of the previous two years. In 2023FY, the US federal government's fiscal deficit reached USD 1.7 trillion, with a deficit rate increasing from 5.5% in 2022 to 6.3%. Apart from the years of 2020 and 2021, such deficit volume was the highest in nearly four decades. Fiscal expansion supported the relatively strong performance of the US economy in 2023 to some extent, and it is expected that the total fiscal deficit in the US will slightly contract in 2024. According to forecasts from CBO, OMB, and primary dealers, the fiscal deficit size for the 2024 fiscal year is estimated to be around USD 1.5 trillion to USD 1.8 trillion, slightly lower than the amount of USD 1.7 trillion in the 2023FY. Referring to the CBO's estimate, the proportion of fiscal revenue to GDP is expected to decrease slightly in 2024, with a slowdown in the income tax revenue mainly due to a slowdown in the growth of income tax deductions caused by decreasing inflation growth, and the deficit rate is expected to decrease from 6.3% in 2023 to 5.8% in 2024. In addition, the year 2024 is an election year in the US, and the Republican Party demanded, among others, substantial cuts in the government deficit ratio in the new fiscal budget. Given the historical pattern in election years, there is a high chance that the intensity of fiscal policy will fall short of expectations, thus it is expected that the overall intensity of US fiscal policy in 2024 will remain strong, but it may weaken marginally.

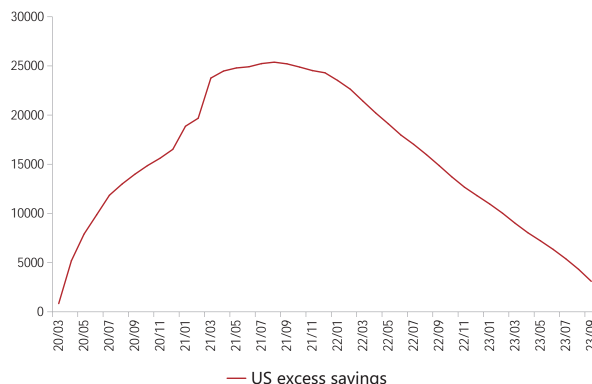
Regarding excess savings, thanks to the fiscal subsidies from the US government in the past two years, US residents accumulated a significant amount of excess savings in 2020 and 2021. Consumption growth derived from these savings has played a crucial role in driving economic growth in the US over the past three years. However, with the end of these subsidies, household excess savings had been rapidly diminishing. As of September 2023, excess savings were estimated to be only about USD 300 billion (calculated based on a hypothetical compound growth rate of approximately 13% in US residents' savings deposits from 2013 to 2019). It is expected that excess savings will be largely used out by 2024, and the support to consumption will weaken accordingly.

Figure 262. US Fiscal Deficit Rate (%)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 263. US Excess Savings (USD 100 million)

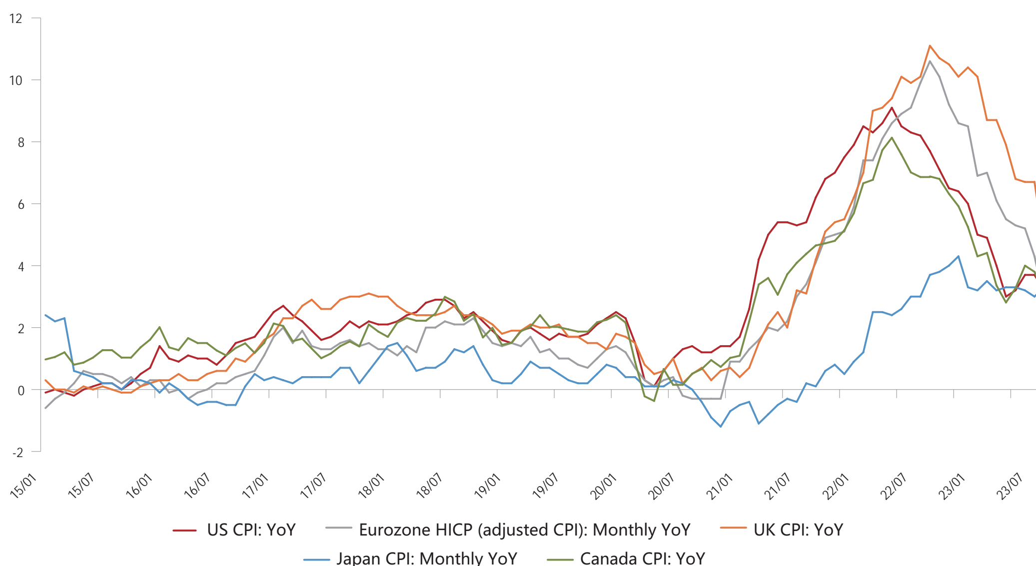


Data sources: Wind and BOC Investment Strategy Research Center

5.2.3 Attention shall be paid to the impact of non-US monetary tightening and easing, and potential risk events on the USD

The exchange rate measures the relative strength and weakness of two currencies. In addition to factors within the US, the strength and weakness of the USD are also influenced significantly by the relative strength and weakness of non-US countries against economic and monetary policies of the US. In a situation of free capital flow, nominal interest rates have a greater short-term impact on exchange rates. Starting from Q3, 2023, not only the Fed but also central banks of other major developed economies have gradually ceased raising interest rates. Given that the EUR constitutes the largest weight in the USDX, the Eurozone is especially facing a hardly optimistic economic outlook in the coming period. In Q3, 2023, the Eurozone GDP declined by 0.1% compared with Q2. The manufacturing PMI remained below the boom-bust line since June 2023, and the CPI in November increased by 2.4% year-over-year. Compared to the US, the Eurozone economic fundamentals have been weakened, and the ECB is expected to initiate a loose monetary policy cycle ahead of the Fed in 2024.

Figure 264. CPI in the US, Japan, Eurozone, UK and Canada (%)



Data sources: Wind and BOC Investment Strategy Research Center

Another factor worthy of attention is the potential financial risks posed by vulnerabilities of sectors with high leverages amidst high interest rates and financial tightening. Due to the rapid increase in benchmark interest rates by the Fed over the past two years, some commercial banks in the US have recorded unrealized losses on the asset side of their balance sheet. Crisis could arise should there be a liquidity run, as was the case with Silicon Valley Bank's bankruptcy in 2023. Should similar events occur in 2024, it would also have a significant impact on the Fed's monetary policy and, consequently, the foreign exchange market.

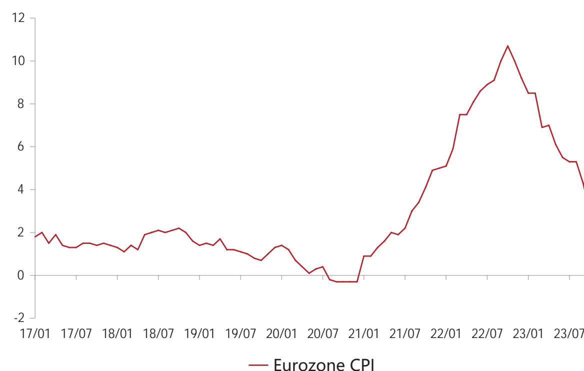
In 2024, as the US inflation returns to a reasonable range, the labor market continues to normalize, and fiscal stimulus weakens, it would difficult for the US economy to maintain its resilience of 2023. The Fed's monetary policy is likely to transition from tightening to observation before interest rate cuts. However, considering the comparative advantage of the US economy against the Eurozone, and relatively weaker comparative advantage compared to emerging economies like China, our baseline scenario for the USD trend in 2024 suggests a low probability of a sustained one-sided strengthening or weakening of the USD. There is a high chance of a neutral trend with wide-range oscillation, and the full year fluctuations are expected to narrow. By the end of 2023, if the Fed continues to put a pause on interest rate hikes, the moment when the market starts to price in the turning point of the rate hikes and rate cut expectations could be a turning point for the USD which had remain strong in the past two years. Such moment may have already occurred at the end of 2023. Also, it is recommended to keep an eye on two lower-probability scenarios: The first scenario is an optimistic scenario, where the USD strengthens against the basket, triggered by consistent inflation in the US, a substantial economic downturn in the Eurozone, or major risk events in regions outside the US. The other scenario is where the USD weakens against the basket, triggered by a rapid decline in the US inflation, interest rate cuts by the Fed that exceed the market's expectations, or a crisis in highly leveraged sectors in the US.

5.3 Euro: EUR Continued to Find Itself at a Turning Point of Rebound

5.3.1 Interest rate hikes have gradually taken effect, and the economic downturn is weighing on the EUR

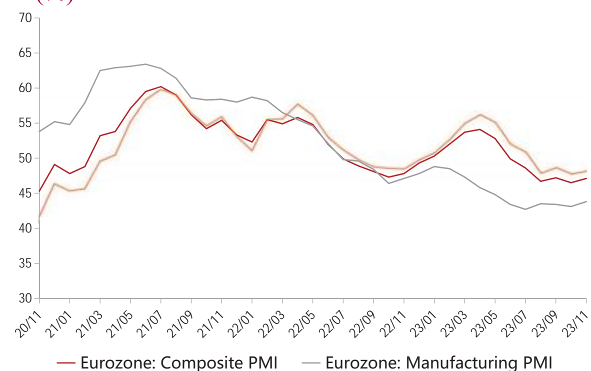
The EUR/USD fluctuated between 1.05 and 1.12 throughout the year 2023. The primary drivers of the earlier market trends were high inflation in the Eurozone, which stepped up expectations of interest rate hikes, supporting the EUR to rise and reaching at highs in July. Subsequently, interest rate hikes started to hamper the economy, leading the market to anticipate an end to the interest rate hike cycle, causing the EUR to briefly drop below 1.05. Until the end of 2023, the market further expected that the Fed had concluded its current interest rate cycle. This optimism boosted the EUR to close to 1.10. Nevertheless, without economic growth support, this positive sentiment can hardly sustain. The 450-bp rate hikes by the ECB noticeably negatively impacted the economy, with both manufacturing and service sectors in PMI turning from expansion to contraction, despite occasional rebounds. Additionally, the EU has, for multiple times, lowered its 2024 economic growth forecasts, implying an increasing probability of a recession in Europe, which would adversely affect the performance of the EUR.

Figure 265. Eurozone CPI (%)



Data sources: Bloomberg and BOC Investment Strategy Research Center

Figure 266. PMI of Major Counties in the Eurozone (%)

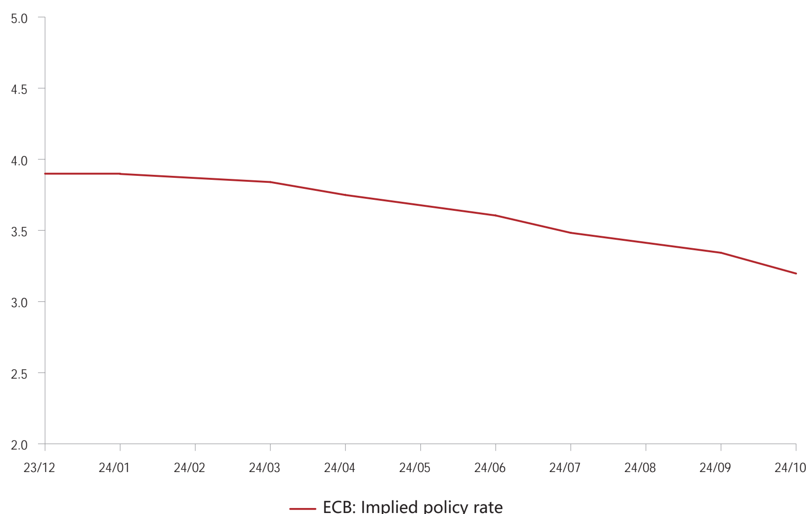


Data sources: Bloomberg and BOC Investment Strategy Research Center

5.3.2 ECB is expected to first cut interest rates so as to stabilize the economy, and EUR is likely to reverse its weakness subsequent to the Fed's rate cuts

midst the weak economy caused by tightening policies and falling oil prices, inflation moderation may become the major trend in 2024. Global central banks are easing their tight policies, with their focus shifting to the timing of interest rate cuts. According to interest rate futures contracts, the market currently expects the ECB to start cutting rates before March 2024, with rate cuts comparable to that in the US throughout the year 2024. With the widening interest rate differential, it will be difficult for the EUR to appreciate. However, once the Fed begins to cut rates as expected in 2H, 2024, the Eurozone economy is likely to recover before the US implements loose policies, potentially reversing the weakening trend of the EUR.

Figure 267. Implied Policy Rate of the ECB (%)



Data sources: Bloomberg and BOC Investment Strategy Research Center

5.3.3 Potential benefit from China's economic recovery is likely to lay ground for the EUR's rebound

From the Russia-Ukraine conflict to the Israel-Palestine conflict, rising oil prices have a prominent negative impact on the European economy. Geopolitical instability and increased winter energy demand are expected to limit the downward movement of oil prices. Although geopolitical factors are difficult to predict, seasonal changes in energy demand follow a certain pattern. Furthermore, wages in the Eurozone increased in 2023, combined with the falling inflation, disposable income in Europe is expected to increase, subsequently affecting consumption in a positive manner. Besides the impact on consumption, considering the close economic ties between China and Europe, a stable economy in China is expected to drive European economic growth, laying the groundwork for EUR's rebound and gradually shifting its weakness.

In summary, after the EUR's rebound at the end of 2023, we believe that in 2024, due to the weaker economic fundamental in the Eurozone than that in the US, coupled with the possibility of earlier but same range of interest rate cuts against the US, and no comparative advantage in the currency policy, we expect the EUR to remain subdued with occasional rebounds during the alternate interest rate cuts between the EUR and the USD, until a turning point in economic stability occurs.

5.4 British Pound: GBP is Unlikely to Reverse its Persistent Weakness Due to Insufficient Economic Momentum

5.4.1 Effects of interest rate hikes pose warnings on the economy, establishing a weak tone for the GBP

In 2023, the GBP was one of the best-performing G10 currencies, reaching around 1.31 against the USD. This was primarily due to a highest inflation in 31 years and a robust job market, leading the Bank of England to adopt the most hawkish stances among major central banks. However, this move failed to bring inflation down to target levels and had negative repercussions on the economy. Unemployment rates rose, and job vacancies continued to decline, indicating a weak job market. High-interest rates have lagged impacts on debt repayment, keeping real consumption in the UK constrained, still not fully recovering to pre-2020 levels. Furthermore, based on the Sahm Rule's definition, the UK has warned an economic recession ahead of other

G10 countries. The economic downturn weighed on the British Pound in the second half of the year, resultingly the currency failed to surpass its highs of the year. Additionally, the Bank of England has lowered its economic growth expectations for the UK in 2024 to 0.7%, anticipating continued economic weakness, which will contribute to a weak tone of the British Pound.

Figure 268. As Inflation Failed to Drop to the Target Level, the Unemployment Rate Experienced a Rebound, Sending Signals for an Economic Recession (%, %)

Data sources: Bloomberg and BOC Investment Strategy Research Center

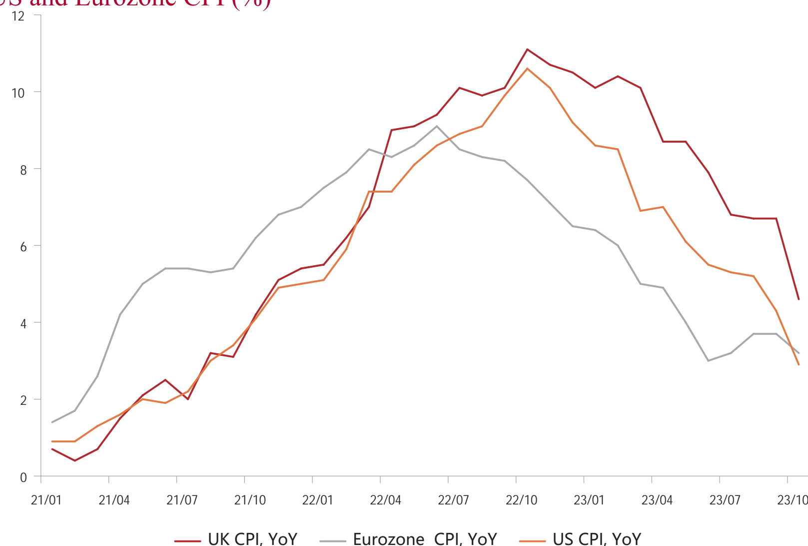
Figure 269. Consumption in the UK Remained Subdued (%)

Data sources: Bloomberg and BOC Investment Strategy Research Center

5.4.2 Real estate sector posed challenges to the economy, and signals were sent on early rate cuts

After the BOE's rate hikes of 515 bps, UK CPI fell to 3.9% in November 2023. Despite relatively high inflation compared to Europe and the US, the BOE took similar moves as other central banks in Europe and the US and ceased interest rate hikes in response to the risk of an economic recession. From the perspective of inflation levels, the BOE's stance on future rate hikes is more dovish than that of European and US central banks, weakening the interest rate advantage of the GBP. Real estate has been the cornerstone supporting the strength of the GBP, but recent data showed a significant decrease in mortgage growth, with the number of newly approved mortgages lingering around levels during the financial crisis. Given the relatively short duration of mortgages in the UK, as more fixed-rate mortgages expire and are reset, this will have a more significant impact on borrowers, further exacerbating the UK's economic predicament. If the UK's economy continues to weaken, it will strengthen market expectations of an earlier rate cuts by the BOE.

Figure 270. UK, US and Eurozone CPI (%)



Data sources: Bloomberg and BOC Investment Strategy Research Center

5.4.3 Political disturbances from general elections could lead to greater volatility of the GBP

In addition to economic pressures, domestic political dynamics in the UK may also affect the GBP. The date for the UK parliamentary election has not yet been set, with the Prime Minister previously suggesting that the election may be held earlier in autumn 2024. While both parties have yet to provide detailed quantitative information behind their policies, it is expected that they have learned lessons from the budget crisis in 2023 to potentially limit fiscal support. If the proposed plans fall short of market expectations, it will not only fail to boost the GBP, but also increase its volatility.

In summary, based on the cumulative effects of interest rate hikes, signs of an economic recession in the UK reflected in real estate mortgage growth data have laid a weak tone for the GBP. Strong currency policy is no longer in place, and the added disruption from early elections and other political factors weakens support of a strong GBP. It is expected that in 2024, the GBP will likely go weak, with its strength unsustainable based solely on hawkish currency policy and nominal interest rate differentials, ultimately returning to the relative strength determined by economic fundamentals.

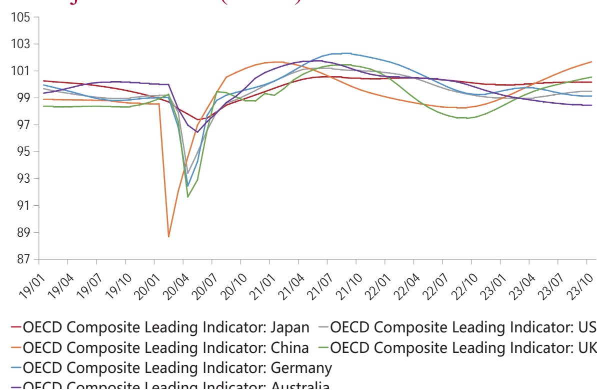
5.5 Japanese Yen: JPY is Likely to Return to Mean Reversion in the Wake of a Sharp Decline

5.5.1 Consistent economic growth and mild inflation

Benefiting from a series of economic stimulus policies by the Japanese government and continued loose monetary policy, the overall Japanese economy has maintained moderate growth over the past two years. Although the real GDP in the third quarter of 2023 decreased by a seasonally adjusted decrease of 2.1% quarter-on-quarter, the real GDP growth rate year-on-year remains positive, and 2023 is expected to end with positive growth. According to the OECD Global Composite Leading Indicator, the Japanese economy has taken the led since the quarter of 2022. According to forecasts of IMF as well as the Japanese government, the Japanese economy is expected to continue its moderate growth in 2024.

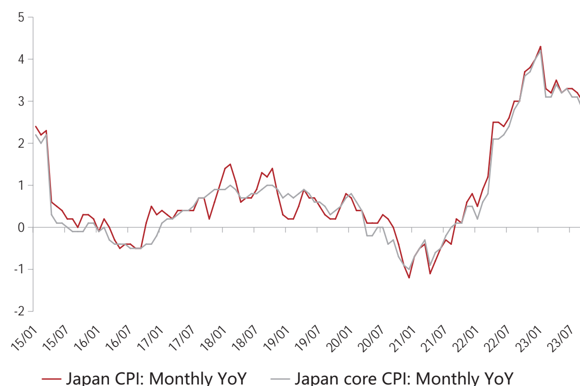
Regarding inflation, the core CPI (excluding fresh food) data released in December 2023 showed a 2.5% increase compared to the same period in 2022. Considering factors such as loose monetary policy, wage growth, and post-pandemic tourism recovery, domestic inflation in Japan in 2024 is expected to continue its mild trend upward.

Figure 271. OECD Composite Leading Indicator of Major Countries (Points)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 272. Japan CPI and Core CPI (%)



Data sources: Wind and BOC Investment Strategy Research Center

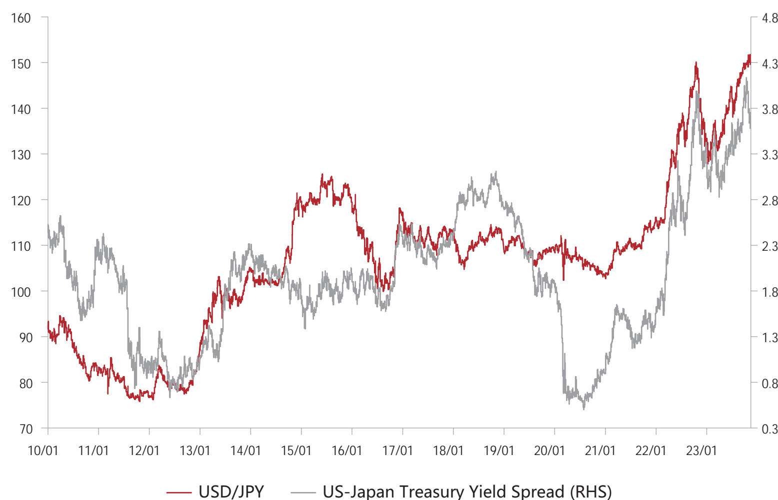
5.5.2 Efforts of monetary easing weakened, and spreads between US and Japan treasury yields narrowed

From Q1 to Q3, 2023, the JPY recorded weak performance overall. The main reason was the divergence in monetary policies between the BoJ and major central banks in Europe and the US. With a widening interest rate differential, arbitrage trading continued to drive the JPY's depreciation. In 2024, as the Japanese economy will continue to recover, and the core inflation will remain above the policy target of the BoJ. As such, the BoJ may start to diminish its efforts of monetary easing. In fact, the BoJ has gradually adjusted its Yield Curve Control (YCC) policy since the end of 2022, raising the upper limit from 0.25% to 0.5% at 2022 year-end meeting and further the limit to 1% in July 2023, before removing the description of an absolute upper limit in the October 2023 meeting. However, compared to the rapid rate hikes and balance sheet reductions by European and US central banks, the BoJ's adjustments have been relatively mild in terms of range and intensity. Looking ahead to 2024, it is expected that the BoJ's monetary policy will maintain a loose stance but gradually shift toward tightening, while European and US central banks are likely to transition from rate hikes to rate cuts. This narrowing of the interest rate differential between the JPY and the USD is expected to drive the JPY's mean reversion in 2024.

Figure 273. Time and Range of YCC Adjustments

Time	2022/12/1	2023/7/1	2023/10/1
Upper limit of Japan 10-year treasury yield	0.25% to 0.5%	0. 5% to 1%	Remove descriptions of an absolute upper limit

Figure 274. JPY/USD and US-Japan Treasury Yield Spread (USD/JPY, %)



Data sources: Wind and BOC Investment Strategy Research Center

5.5.3 Weakening US economy could drive potentials for safe-haven demands

As mentioned in our previous strategy report, the JPY has long been considered a safe-haven currency by the market. However, over the past two years, due to the rapid rise in US interest rates while the BOJ has maintained a 0% rate, the USD/JPY was mainly supported by the interest rate differential, and the JPY's safe-haven attributes have not been prominent. Historical data since 1990 shows that during each US economic recession, the JPY appreciated to some extent against the USD, indicating some safe-haven attributes. In 2024, if the US economy experiences a recession or a soft landing, the US-Japan interest rate differential will narrow, and the JPY's safe-haven attributes are expected to reemerge.

Figure 275. USD/JPY Performance during US Economic Recessions (USD/JPY)

Data sources: Wind and BOC Investment Strategy Research Center

In summary, the continued economic growth and mild inflation rise in Japan are the fundamental factors supporting the yen. The weakening in monetary easing and adjustments to YCC have led to a narrowing of the US-Japan bond yield spread. Additionally, the trend of a weakening US economy is expected to stimulate renewed safe-haven trading of the yen. After experiencing a significant depreciation over the past three years since 2021, it is expected that the yen will undergo mean reversion in 2024, with a high probability of appreciating.

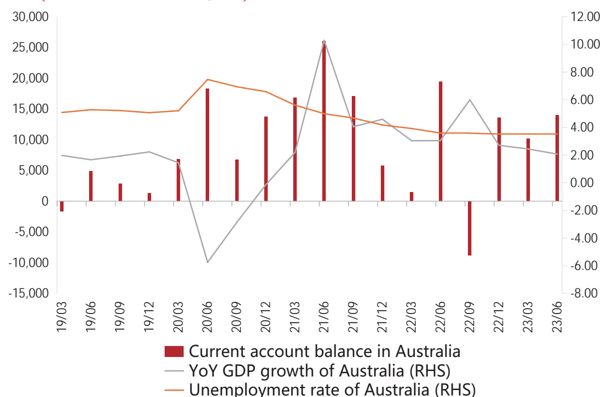
5.6 Australian Dollar: AUD is Likely to Strengthen as Driven by Brighter Economic Outlook and Hawkish Policy Stance

Looking back at 2023, the AUD remained weak throughout the year, with a decline of 4.43% against the USD as of November 17. This is because, on the one hand, the magnitude of interest rate hikes and absolute interest rates in Australia were lower than in other developed economies, and the monetary policy was less hawkish than in Europe and the US, which did not support the strength of the AUD. On the other hand, geopolitical issues have suppressed the economic outlook for Australia. Looking ahead to 2024, we believe that the AUD has the potential for a strong trend.

5.6.1 Strong fundamentals of the Australian economy

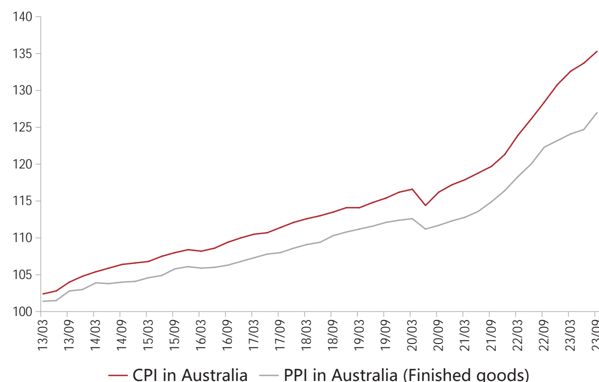
Although in the short term, the Australian economy may continue to slow down under the constraints of a high-interest-rate environment and weak external demand, in the medium to long term, as inflation returns to the target range and the rate hike cycle ends, coupled with the rebound in immigration and improving regional economic and trade relations, the market expects the Australian economy to steadily recover to a normal growth rate of over 2%. Data shows that Australia's year-over-year growth in Q2 was 2.07%, with an unemployment rate at 3.4%. As an export-oriented country, the steady improvement in the current account balance supports the view of a soft landing for the Australian economy.

Figure 276. Fundamentals of the Australian Economy (AUD 1 million, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 277. Australian Inflation (2011 to 2012 = 100)



Data sources: Wind and BOC Investment Strategy Research Center

5.6.2 Hawkish policies by the RBA may support a stronger AUD

The inflation growth in Australia has increased. The inflation rate is higher than market expectations and it is rising on a quarterly basis, the inflation level is still lagging behind the 2% target. According to the latest minutes from the RBA meeting, the RBA is attempting to reducing inflation without pushing up the unemployment rate. They continue to view inflation levels and employment data as key factors for interest rate adjustments. With CPI and PPI showing moderate strength, we have reason to believe that there is still room for the RBA to raise interest rates, which would provide interest rate differential support to the AUD.

5.6.3 Improved relations with China bring more positive factors to the Australian economy

As a resource-based economy, Australia boasts rich natural resources, a highly developed mining industry, it is one of the world's largest iron ore and coal exporters. About 30% of Australia's export trade comes from China, and trade with China supports around a quarter of Australia's jobs. The easing of tensions in Sino-Australian relations, coupled with the potential for economic recovery in China, will provide stronger support to the Australian economy and the AUD.

In conclusion, considering that the AUD against the USD was at historically low levels in 2023, based on favorable economic fundamentals in Australia, improving regional economic and trade relations, and the potential for the RBA's monetary policy to continue interest rate hikes, it is anticipated that the AUD has the potential to go strong in 2024.

5.7 Canadian Dollar: CAD is Likely to Transition into Oscillations with Increased Volatility

Looking back at the year 2023, the CAD rose first before going down. As of November 17, the CAD/USD fell 1.27%. In 1H, 2023, the Bank of Canada followed the Fed's pace of interest rate hikes, and superimposed the support of oil prices, making the performance of the CAD very eye-catching among the G10 currencies. In 2H, 2023, the Fed raised interest rate aggressively, the US and Canadian interest rate spreads widened, the USD/USD went up gradually, and therefore the CAD went from strong to weak. Looking ahead to the year 2024, we believe that the CAD may enter a state of oscillation.

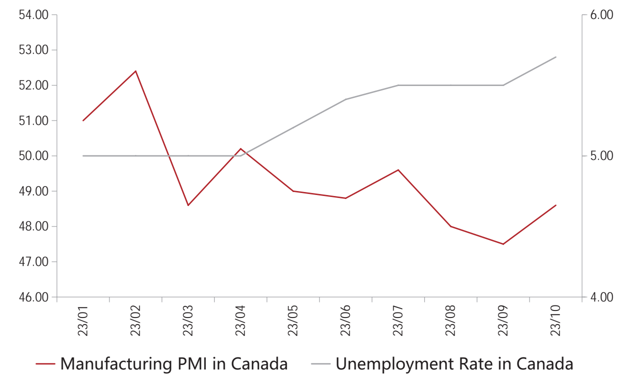
5.7.1 Economic fundamentals weakened as high interest rates weighed on the economy

The negative impact of the gradual rise in the neutral rate of interest on the Canadian economy has gradually emerged. The growth rate of the Canadian economy slowed down significantly in 2023 as the Bank of Canada's interest rate hike process accelerated since 2H, 2022. The Canadian manufacturing PMI, which is a leading indicator of the economy, has been below the threshold for a long period since May 2023 to date, and the labor market has made the outlook for the Canadian economy even more difficult with the rise in the unemployment rate.

Figure 278. Canadian Economy and Interest Rate Levels (%)

Data sources: Wind and BOC Investment Strategy Research Center

Figure 279. Economic Prosperity in Canada (%)

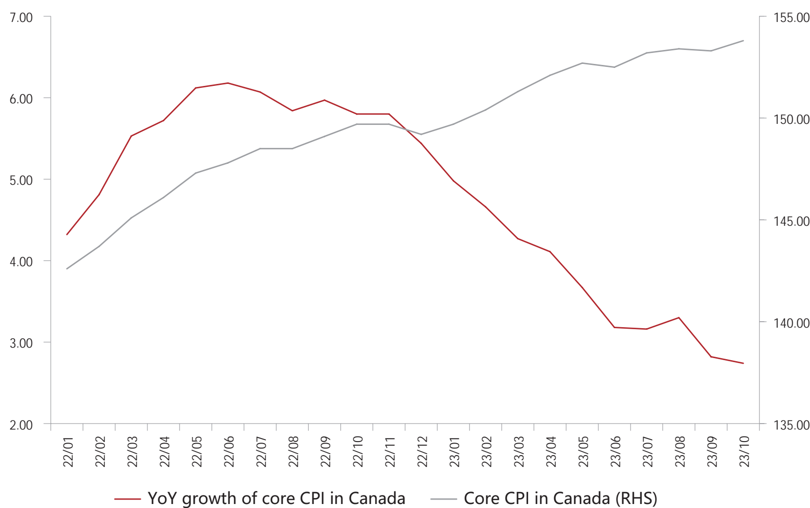


Data sources: Wind and BOC Investment Strategy Research Center

5.7.2 Inflation data have come down and a shift in monetary policy is imminent

Canada's core CPI, while remaining at historically high levels, showed a clear inflection point from the previous situation. Canada's Consumer Price Index (CPI) rose 3.1% in November from a year earlier, which was unchanged from October and the slowest rate of growth since June 2022. This is a reassuring sign for Bank of Canada policymakers, suggesting that current interest rate levels are sufficient to significantly reduce inflationary pressures. With the Canadian economy already showing signs of stagnation and inflation expected to slow further, the market generally expects that this rate hiking cycle may be over.

Figure 280. CPI and Core CPI in Canada (%, 2002 = 100)



Data sources: Wind and BOC Investment Strategy Research Center

5.7.3 Price of crude oil is likely to be increasingly volatile, and can hardly support the CAD

Our neutral assumption for oil prices is that, from the demand side, the European and American economies are in a soft landing. The global demand for crude oil in major economies is slowly decreasing, so oil prices may continue to oscillate and weaken. On the supply side, oil inventories are still at a low level, so any major supply disruptions or OPEC+ production cuts that exceed expectations could trigger oil prices to rise. In the supply and demand gaming, oil price volatility may intensify. It is difficult to form a unilateral upward market to support the CAD.

Overall, in the context of slowing economic growth, the possible synchronization of the turn of monetary policy and the Fed, and the uncertainty of oil price support, we believe that the CAD's strength may hardly maintain its strength seen in 2023. It may turn into a state of oscillation and increased volatility.

Commodities

Value of Asset Allocation into Gold Increased, and Commodities Prices May Oscillate at Highs

Due to the features of save-haven assets and the role of currency credit yardstick, gold has revealed its value of long-term asset allocation. In addition, since the rally is likely to reappear upon the Fed's policy shift, it is recommended to maintain the overweight for gold as in 2023. Global economic recovery remained slow, and the growth of demands for commodities was rather limited. The crude oil market is likely to maintain the pattern of tight balance between supply and demands, and the oversupply of copper is expected to ease, and thus it is recommended to give an underweight before shifting to a neutral view. The shortage of aluminum is expected to exist in stages, and it is recommended to adopt a neutral view.

6.1 Upward Trend is Certain for Gold Prices, and Timing Will Determine the Amount of Excess Returns

As predicted in our strategy report in 2023, gold gave full play to the role of credit yardstick, aligning with the major trading logic that the cycle of interest rate hikes is coming to an end in Europe and the US. Looking forward to 2024, the main logic of gold trading is shifting to when the time of interest rate cuts will come, during which there is a window of opportunities for precious metal allocation. However, against the backdrop of the Fed's "wait and see" approach in implementing the monetary policy, and the Fed's speculation and verification of the timing of interest rate cuts, the annual trend of gold is expected to be strong overall with oscillations. Therefore, prudential pursuit of a rally and asset allocation at lows should still be the main approach of gold allocation in 2024. Tips of investment are as follows: First, it is recommended to remain optimistic about the allocation value of gold, and uphold the primarily bullish view. Second, closer attention shall be paid to gold allocation opportunities amid oscillations, namely, to establish the confidence of making decisions in the changing situations.

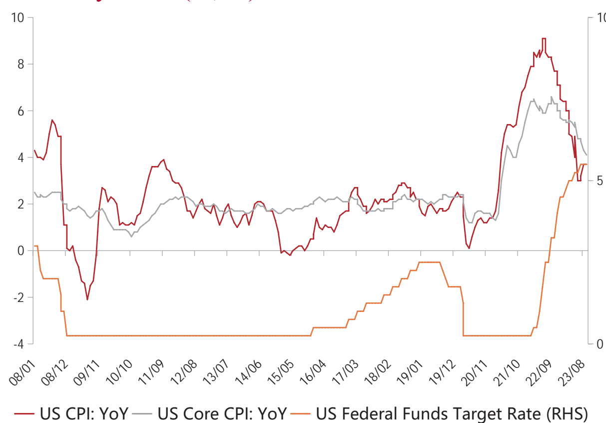
6.1.1 Great certainty for gold prices to move upward

Allocation certainty mainly comes from four aspects. First, Europe and the US tightening cycle is in the final stage, coupled with market calls for interest rate cuts. Second, the US bond yields topped, and the USDX is weakening, thus sending positive signals. Third, demand by the unleveraged funds on the allocation of precious metals is strengthened.. Fourth, in the major change unseen over the past century, the function of the credit yardstick stands out.

6.1.1.1 End of the rate hike cycle and the beginning of the rate cut cycle in Europe and the US are expected to bring maximum benefits for the gold market

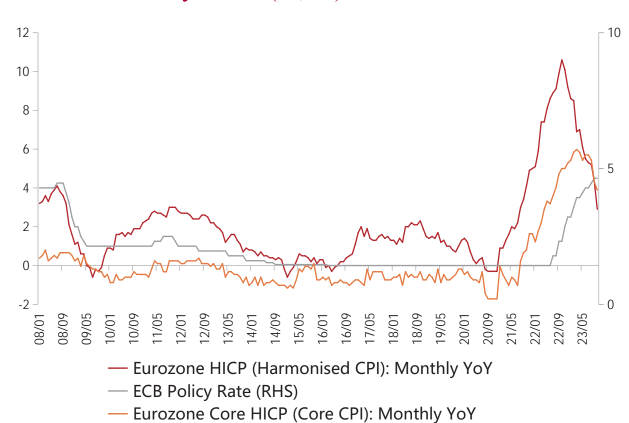
The trend of gold in 2023 is closely related to the direction of monetary policy in Europe and the US, especially the Fed's monetary policy. After a rapid and substantial rate hike process in 2023, the downward trend of inflation data in Europe and the US and other countries has been relatively solid. Although some officials in Europe and the US have repeatedly voiced to the market, emphasizing that the absolute level of inflation had still not reached the target, the need to continue to raise rates has been significantly reduced in comparison. The FOMC meeting in December 2023 again unanimously passed a resolution to keep the benchmark interest rate unchanged, and the Fed's Chairman Jerome Powell remarked after the meeting that interest rate cuts had inevitably become a theme, indicating that the inflection point of monetary policy in Europe and the US is getting increasingly imminent.

Figure 281. US Monthly CPI Rates and the Fed's Policy Rates (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 282. Eurozone CPI Monthly Rates and the ECB's Policy Rates (%, %)



Data sources: Wind and BOC Investment Strategy Research Center

If the downward trend in inflation validates the non-essentiality of continued tightening policy, then the economic downturn illustrates the inadequacy of continuing tightening policy. Unemployment rate gradually passing over the inflection point, the growth of real income of residents slowing down, consumption impacted negatively, high interest rates environment suppressing investment, fiscal spending very likely to retreat, the corporate sector may having a local liquidity crisis, influenced by the above factors, the US economy is expected to shift gradually from the current overheated status to supply and demand balance, returning to the “normal” state.

Under the expectation of lower inflation and economic downturn, the certainty of monetary policy turn in Europe and the US in 2024 is stronger. From the historical performance of the gold price, the marginal shift in monetary policy will bring about an inflection point in the price of precious metals, so the end of the interest rate hike cycle and the start of the interest rate cut cycle is one of the most crucial positive signal for gold price movements in 2024.

6.1.1.2 Gold prices were supported by lower US treasury yields and a weaker USDX

US treasury yields, as the opportunity cost of holding gold, are generally negatively correlated with gold price movements. At the current point in time, US treasury yields are expected to move downward under the expectation of US economic downturn and the start of the interest rate reduction cycle. In addition, from the perspective of fiscal policy, the US Treasury Department issued Quarterly Refunding Statement, showing that the Treasury plans to increase the amount of subsequent bond auctions. However, the upward scale of the long end of the US bond supply scale was lower than the market. Although this would not impose a substantial impact on the US bond supply and demand, it could guide changes in market sentiment. This effect was particularly evident in the volatility of the US 10-year US treasury yield, which fell with the announcement of the refunding statement. Considering the higher likelihood that subsequent demand for US debt may continue to weaken, the probability of future debt issuance significantly exceeding expectations is expected to be low, and the downward trend in US treasury yields is clearer.

The USD is regarded as a strong substitute of financial asset for gold, and the USDX tends to be negatively correlated with the price of gold. Intuitively, under the economic downward pressure, the Fed is expected to start the interest rate hike in 2024, which will suppress the USDX. Driven by the corresponding reduction of the real interest rates, gold prices are likely to be bolstered.

Figure 283. US 10-year Treasury Yields Versus USDX (%, March, 1973 = 100)

Data sources: Wind and BOC Investment Strategy Research Center

6.1.1.3 Asset allocation into gold by ETF Funds and purchases by central banks have bolstered gold prices

When funds invested in gold are categorized and ranked by investment timeframe, futures (non-commercial positions) and derivatives, ETF funds and central bank gold purchases have increasing investment timeframes in that order. Of these, ETF funds and central bank gold purchases are unleveraged funds in the usual sense, which is more reflective of investor confidence and logic. We believe that the increased demand for gold from unleveraged funds will support gold prices in 2024 .

ETF funds are expected to increase their gold allocation in a lower interest rate environment. According to data published by the World Gold Council, the size of gold ETF positions has been decreasing in a high interest rate environment as ETF funds have a stronger expectation of yield. However, on the other hand, funds that have left the market due to interest rate levels will choose to reallocate to gold for the same reason. Therefore, in a declining interest rate environment, ETF fund allocations to gold are price-elastic, which is favorable to gold in the medium to long term. The data released by the World Gold Council shows that the demand for gold purchased by central banks has increased recently. Considering the impact of the global currency credit, the global central banks have turned to purchasing gold to maintain the stability of the national currency credit system and to safeguard the soundness of their assets. Similarly, the PBOC has again increased its gold reserves since Q4, 2022, rising to 71.58 million ounces as of December 2023 after thirteen consecutive months of increases. Global central banks continue to increase their gold holding, which also highlights to a certain extent the bullishness on future gold prices.

Figure 284. Global Gold Supply and Demand (Tonnes)

	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2	2022Q3	2022Q4	2023Q1	2023Q2	2023Q3
Gold Production	832.1	875	929.4	939.9	839.4	889.7	949.1	946.7	860.2	912.7	971.1
Producer Net Hedging	4.8	-16.2	-11.8	17.8	25.7	1.6	-26.8	-13.6	37.1	-19.5	7.2
Recovered Gold	269.7	278.6	292.9	295.1	295.9	285.2	268.3	290.7	312	322.9	288.8
Total Supply	1106.6	1137.4	1210.5	1252.8	1161.0	1176.5	1190.6	1223.8	1209.3	1216.1	1267.1
Gold Jewelry Manufacturing	539.0	456.6	515.2	719.5	517.4	493.5	582.6	601.9	512.4	492.8	578.2
Technology	81.0	79.8	83.4	85.9	81.1	78.3	77.3	72.1	70.1	70.4	75.3
Investment	174.9	285.8	229.2	300.6	555.9	209.3	100.5	247.4	274.3	255.7	156.9
Of which: Total demand of gold bars and coins	352	245.1	259	324.1	284.1	257.6	344.2	336.6	303	276.8	296.2
Of which: Gold ETFs and similar products	-177.1	40.7	-29.8	-23.6	271.8	-48.3	-243.7	-89.2	-28.6	-21.2	-139.3
Central Banks and Other Institutions	115.6	209.6	90.6	34.3	82.4	158.6	458.8	382.1	287.7	174.8	337.1
Total Demand	910.5	1031.8	918.4	1140.3	1236.8	939.7	1219.2	1303.5	1144.5	993.7	1147.5

Data sources: World Gold Council

Figure 285. PBOC Official Gold Reserves and SPDR Gold ETF Fund Positions (10,000 ounces, tonnes)

Data sources: Wind and BOC Investment Strategy Research Center

6.1.1.4 Asset allocation into Gold played an unprecedented role as a credit yardstick

Finally, the role of gold as a credit yardstick, which is least affected by individual's will, is more prominent in the major change unseen over the past century. Under the current system of international monetary settlement, the value of gold and the credit currency value of the USD are deeply bound. During the emergence of unfavorable changes in the national credit of the US and the global wave of de-dollarization, the role of gold as global credit yardstick has strengthened. Coupled with the frequent geopolitical risks around the globe, it could provide stronger support for the price of gold due to the premium related to its safe-haven attributes.

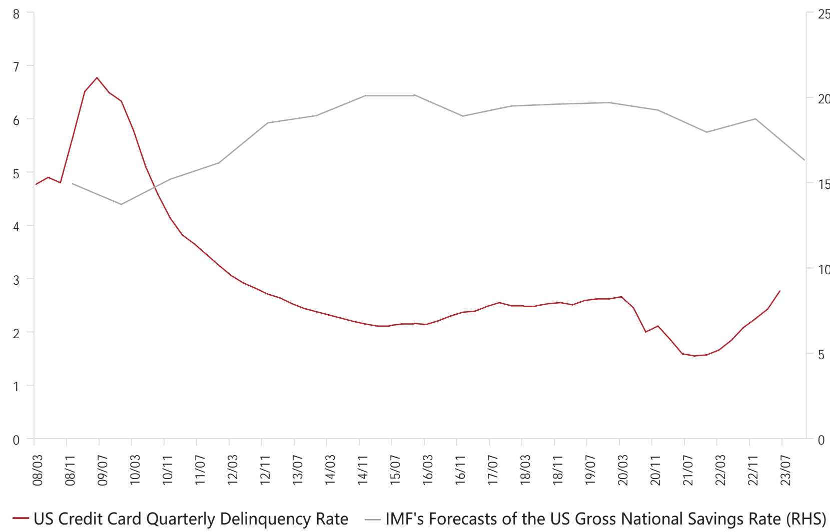
6.1.2 Oscillations remain in the upward channel

While the logical certainty of gold allocation is strong, the excess return on investment in 2024 depends on timing. Currently the market is more fully priced in certainty. The interest rate market reflects higher expectations of the USD rate cut, where there is the possibility of a phased repair. This kind of repair brings both short-term investment risks of blindly chasing the high buy, but also will bring better opportunities for asset allocation. Therefore, the current market expectations of the repair process is the window period of gold asset allocation, the timing when the market is disappointed by the interest cuts of Europe and the US is the time to buy gold.

6.1.2.1 Market expectations of maintaining high interest rates in Europe and the US are not solid enough

After Q3, 2023, the central banks in Europe and the US are clearly guiding the market with the intention that market participants' expectations for the policy rate will gradually change from "higher" to "higher for longer", and eventually to "longer". Current market expectations are that monetary policy in Europe and the US will be significantly looser in 2024, and that there are some precursors of a US recession, such as consumption and savings. However, there are many scholars who believe that the strength of the US economy will support the current level of interest rates for a longer period of time. In any case, one thing that should not be overlooked is that 2024 is a US presidential election year, and significant policy adjustments should be prudent unless policymakers are absolutely certain. As a precious metal investor with a medium- to long-term view, more attention should be paid to the fact that interest rate cuts in Europe and the US "will happen sooner or later", and they should try to find time window of certainty in uncertain situations.

Figure 286. US Federal Funds Target Rate and Likelihood of Changes (%, %)

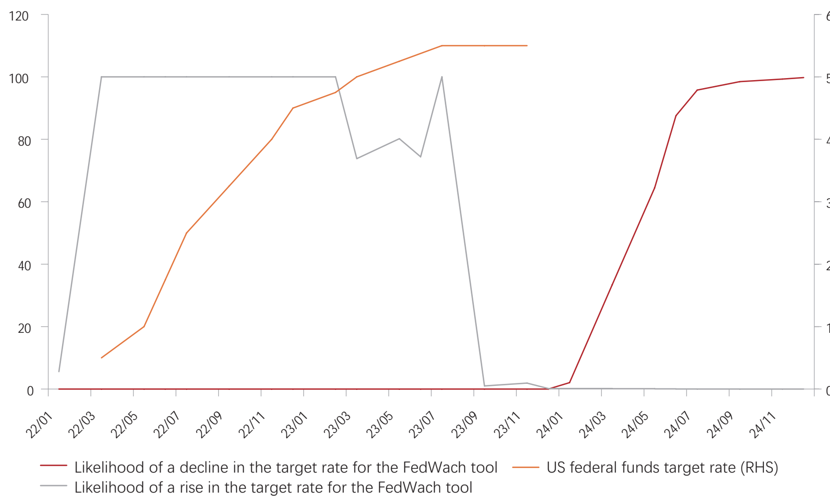


Data sources: Wind and BOC Investment Strategy Research Center

6.1.2.2 Pace of the Fed's rate cuts is likely to remain choppy in 2024

Currently, rate pricing reflected through futures suggests that the Fed will cut rates by 100 bps in 2024, with the US federal funds rate priced near 4.5% by the end of 2024. This implies that perhaps every Fed rate meeting in the second half of 2024 will see a rate cut. Phased repair is more likely to appear under circumstances of higher expectations. For example, the market's expectations are likely to be restored due to the Fed officials' hawkish statements, rising crude oil prices, rebound of the US CPI data and US employment data exceeding expectations, among other factors. It is a more reasonable choice to buy gold during the phase of market expectation repair rather than when there is high expectations for interest rate cuts.

Figure 287. US Federal Funds Target Rate and Likelihood of Changes (%, %)



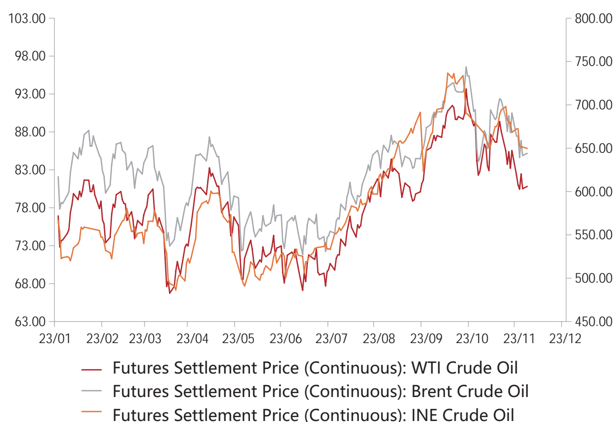
Data sources: Wind and BOC Investment Strategy Research Center

6.2 Energy Market

Looking back to 2023, the supply and demand of the global crude oil fundamentals was generally stabilized. Amid the intertwined factors at the macroeconomic level as well as both supply and demand sides, the crude oil price went lower before a rally, whose center price shifted downward compared with 2022, and ICE Brent oil in the position of 70 USD/bbl received strong support. In 1H, 2023, against the backdrop of global high inflation, the impact of the banking crisis in Europe and the US, and the warming of global recession expectations, oil prices experienced declines. In Q3, due to factors including the increasing production cuts by the OPEC+ alliance, voluntary extension of production cuts by Saudi Arabia and Russia beyond market expectations, and cooling expectations of US interest rate hikes, oil prices began to rebound. In Q4, against the backdrop of the outbreak of the Israeli-Palestinian conflict, international oil prices surged again, and then retreated from the high level at the end of the year, whereas the trading logic once again returned to the fundamentals of supply and demand.

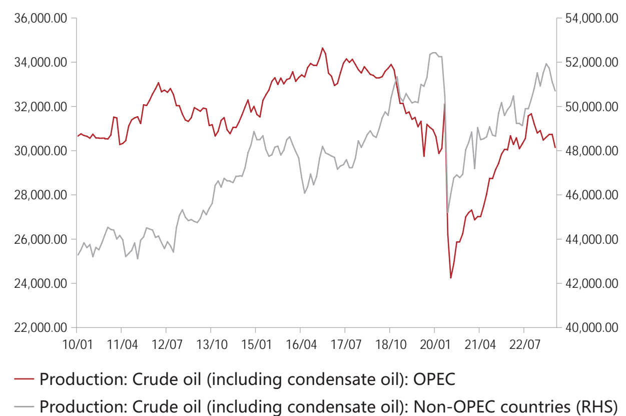
Looking ahead to 2024, oil prices may show a trend of “falling down before going up”. With the soft landing of the US economy, expectations of weak recovery in domestic and emerging markets in Asia-Pacific become stronger, and the demand side may grow moderately. The intentions by the oil-producing countries represented by OPEC+ alliance to support price hike by cutting production is obvious, and there is strong uncertainty on the supply side. The oil price central pivot range is expected to rise compared to 2023, and to maintain a high level of oscillation, where ICE Brent oil benchmark operates between 75-100 USD/bbl. The lower limit of the oil price may be near the supply cost below, and more flexible above. It should be alerted to geopolitical conflicts and supply-demand relationship of the phased imbalance.

Figure 288. Crude Oil Price Movements in 2023 (USD/Bbl, RMB/Bbl)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 289. OPEC’s Consistent Production Cuts (Thousand bbl/d, thousand bbl/d)



Data sources: Wind and BOC Investment Strategy Research Center

6.2.1 Crude oil supply side: Supportive downwards, more flexible upwards

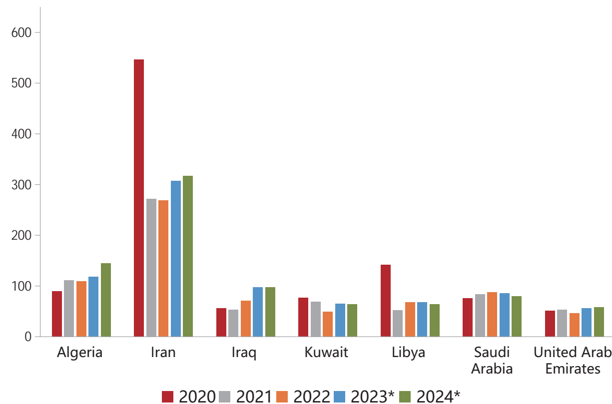
In 2024, supply-side uncertainty will remain one of the main factors affecting the resilience of international oil prices. The pattern of tight balance between supply and demand is likely persist due to the demands of the OPEC+ alliance for high oil prices, slow recovery of US shale oil production, and the impact of geopolitical.

6.2.1.1 OPEC+: Evident demands for high oil prices, strong willingness to control production and stabilize prices

Energy major powers represented by OPEC+ countries will extend the oil supply reduction program in the aim of supporting oil price by controlling production. After several rounds of internal consultations, the 26th Ministerial Meeting of OPEC+ reached an agreement on November 30. According to the announcement, in the first quarter of 2024, relevant member countries will voluntarily cut total amount of oil products by 2.193 million bbl/d in addition to the framework agreement of the organization, of which the total

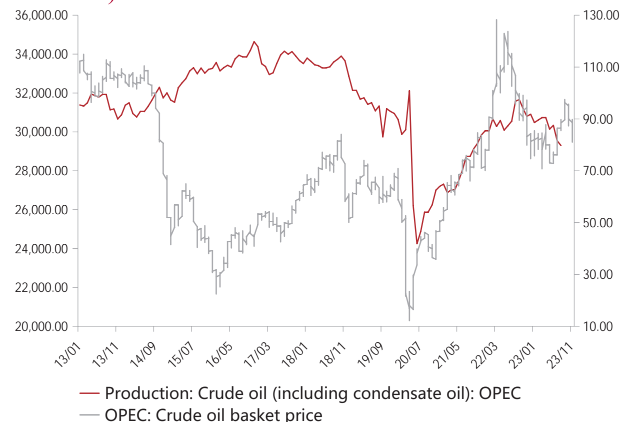
amount of crude oil supply cuts will be about 1.993 million bbl/d. Judging from the financial balance and market supply and demand fundamentals, OPEC+ will continue to play the role of market stabilizer under the demand of maintaining high oil prices, and the production policy may continue to be tight, playing a core support role for the global crude oil market. In view of the fiscal balance of the main OPEC member countries, oil prices are concentrated around 75 USD/bbl, and it is expected that the bottom price of crude oil in 2024 will be 75-80 USD/bbl with strong support.

Figure 290. Fiscal Equilibrium Oil Prices of Main OPEC Member Countries Fall in the Range of 75-80 USD/bbl (USD/bbl)



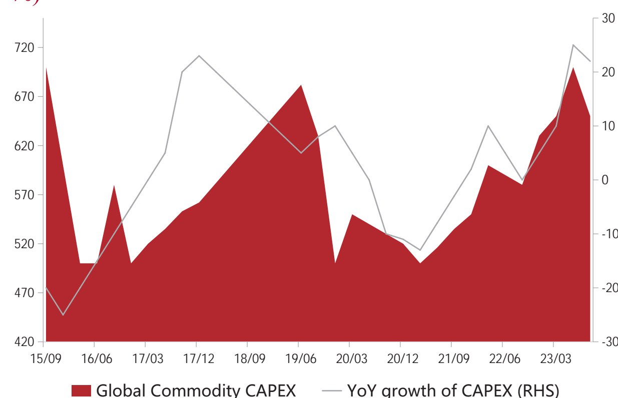
Data sources: IMF and BOC Investment Strategy Research Center
Note*: Data for the years 2023 and 2024 originate from the IMF's forecasts

Figure 291. OPEC's Crude Oil Supply Strategy Imposed an Impact on Global Oil Prices (Thousand bbl/d, USD/bbl)



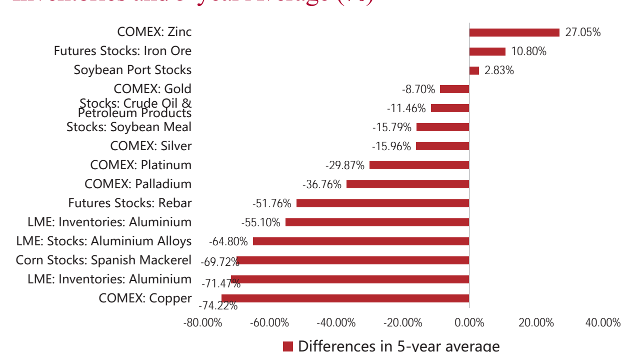
Data sources: Wind and BOC Investment Strategy Research Center

Figure 292. Global Commodity CAPEX (USD 1 billion, %)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 293. Difference between Current Commodity Inventories and 5-year Average (%)

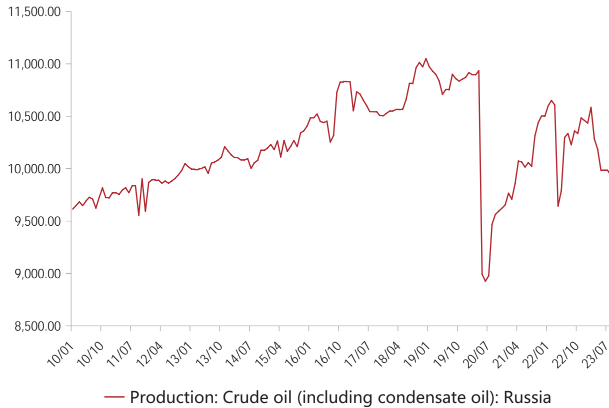


Data sources: Wind and BOC Investment Strategy Research Center

6.2.1.2 Russia: Active production cuts contributed to stabler oil prices and consistent patter of oil shortage

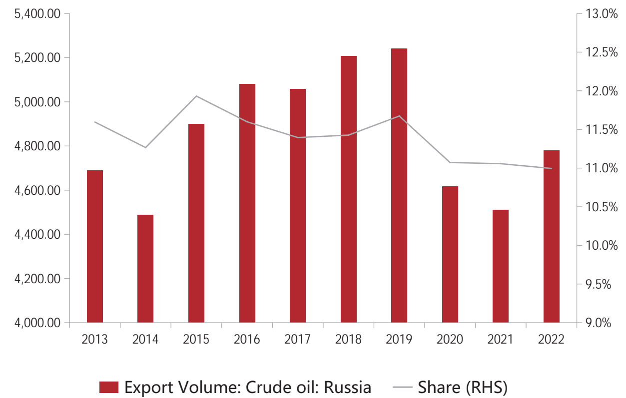
At present, Saudi Arabia and Russia are more determined to reduce production in the aim of maintaining prices, and Russian crude oil production is at the bottom of history. On the one hand, Russia's attitude towards voluntary production cuts and export cuts is resolute. On the other hand, as Russian crude oil prices continue to break through the G7 sanctioned prices, part of the European fleet may not be able to provide transport for the export of Russian oil, which also indirectly amplify the tightness of the external supply of Russian oil. According to the latest agreement at the OPEC+ meeting on November 30, Russia will voluntarily cut its oil product exports by 500,000 bbl/d in Q1, 2024, outside the framework agreement. Moving forward, closer attention needs to be paid to whether Saudi Arabia and Russia will launch a new production cut plan or expand the scale of production cuts, which will further push up oil prices.

Figure 294. Russian Oil Production at Historically Low Levels (Thousand bbl/d)



Data sources: EIA, Wind and BOC Investment Strategy Research Center

Figure 295. Russia Exports Account for More Than 11% of the World's Crude Oil Production by Volume (Thousand bbl/d, %)



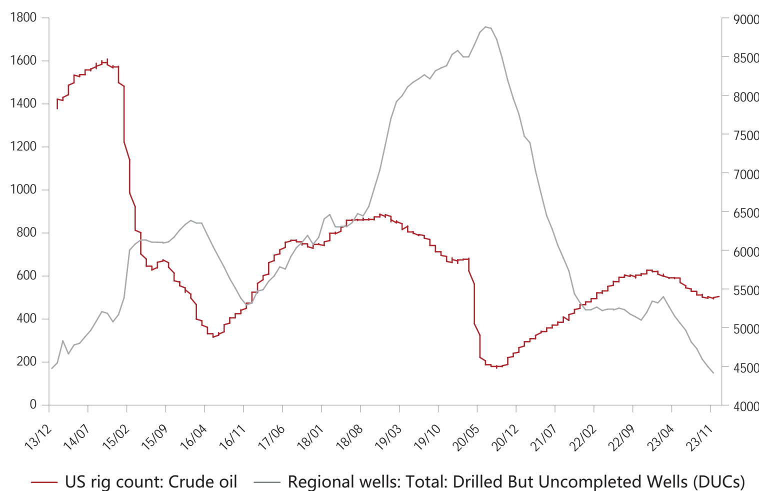
Data sources: OPEC, Wind and BOC Investment Strategy Research Center

6.2.1.3 US: Growth of shale oil production is expected to be low, and strategic inventories are at historic lows

Under the constraints of cost pressure, clean energy policies and other constraints, shale oil capital expenditure remains low in the US. Starting from 2014, the number of wells drilled in the major shale oil gas producing regions in the US gradually declined, and the number of drilled but uncompleted wells (DUCs) put into use slowed down. Shale oil CAPEX remains cautious and is currently at a low level. Inflationary pressures on upstream raw material and fuel costs have been increasing, crowding out the real capital expenditures of enterprises in the face of high cost inflation, weakening the effective transmission of capital expenditures to production and limiting crude oil production growth.

The growth rate of shale oil is expected to remain limited in 2024, given that the current number of drilling wells and DUCs in the US is approaching a lower level since 2017, and the high cost of a significant increase in drilling rigs in the current economic environment is more difficult for most energy providers to accept. The absolute value of US commercial and strategic crude oil inventories are at historically low levels, and its elasticity to the supply side of crude oil will decline.

Figure 296. US Rig Count and DUCs (Units, Units)

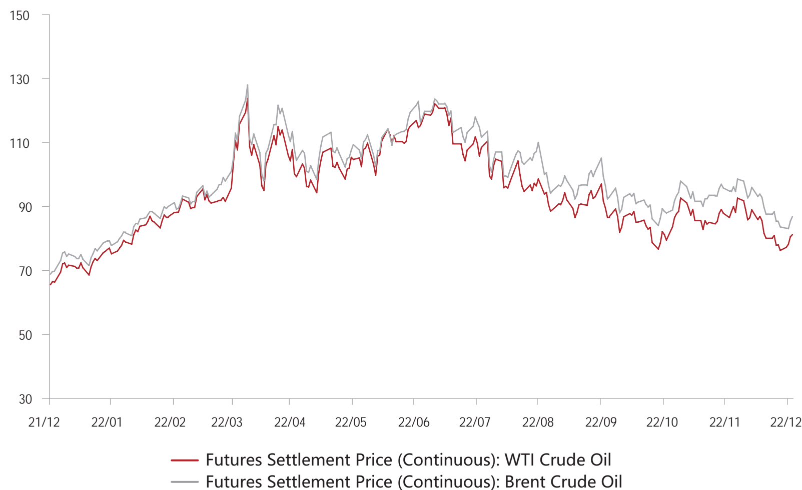


Data sources: EIA, Wind and BOC Investment Strategy Research Center

6.2.1.4 Crude oil market is encountered with a mix of bullish and bearish factors in the geopolitical game

The heating up or easing of the game in many hot spots around the world will intensify the volatility of crude oil prices. In terms of upside risks, such as the Israeli-Palestinian conflict spread to other major oil-producing countries in the Middle East, global geopolitical disputes, it's possible Brent oil stages a breakthrough above the level of 100 USD/bbl. In terms of downside risk, with the easing of situations in the Russian-Ukrainian region and the Palestinian-Israeli region, the tight pattern on the supply side may be reversed. In extreme cases, in case that the US still determines to maintain high interest rates, and there is a "hard landing" of European and the US economy, then the crude oil prices are expected to face greater downward pressure, whereas the Brent oil may fall below the level of 60 USD/barrel.

Figure 297. Russia-Ukraine Conflict Pushed up Oil Prices (USD/bbl)



Data sources: IMF, Wind and BOC Investment Strategy Research Center

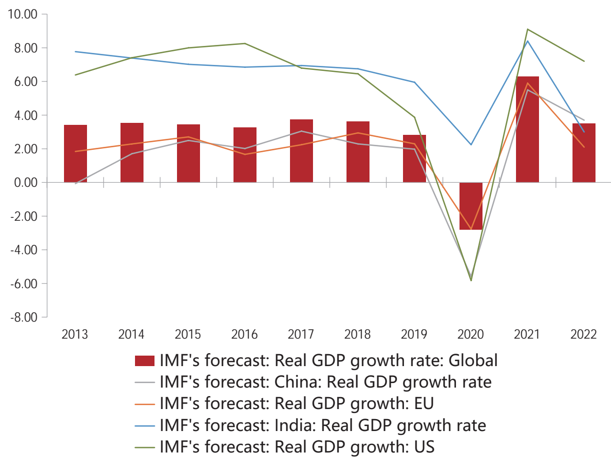
6.2.2 Crude oil demands: Global economic prosperity experienced divergent performance, and oil demands are likely to show moderate restoration

From the demand side, the global economy is expected to improve, but the downward pressure on the economy may compress the upward range of oil prices. Looking ahead to 2024, oil demand growth in Europe and the US is expected to remain under pressure, while the growth rate of oil consumption in non-OECD countries such as China and India is expected to increase.

6.2.2.1 European and US markets: Economic growth in Europe and the US slowed down, and the increase in demands for crude oil is Limited

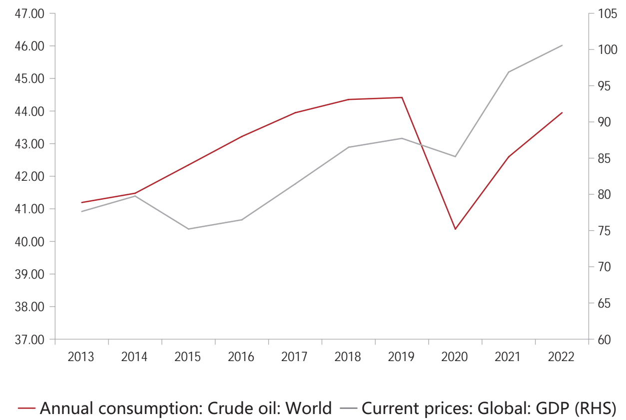
The slowdown in economic growth in the US and the heightened risk of recession in Europe and other developed economies pose challenges to the momentum of global economic growth. According to the latest World Economic Outlook report of the IMF, the global economic growth rate is estimated to slow down from 3.5% in 2022 to 3% in 2023 and 2.9% in 2024, of which the forecasted economic growth rate of the US and the Eurozone in 2024 is 1.5% and 1.2% respectively. In case that the economy of Europe or the US subsequently exceeds expectations and enters into a recession, the market demand for crude oil will shrink further.

Figure 298. IMF's Forecasts on Real GDP Growth by Country (%)



Data sources: IMF, Wind and BOC Investment Strategy Research Center

Figure 299. Strong Correlation between Global Oil Consumption and GDP Trends (1 billion tonnes, USD 1 trillion)

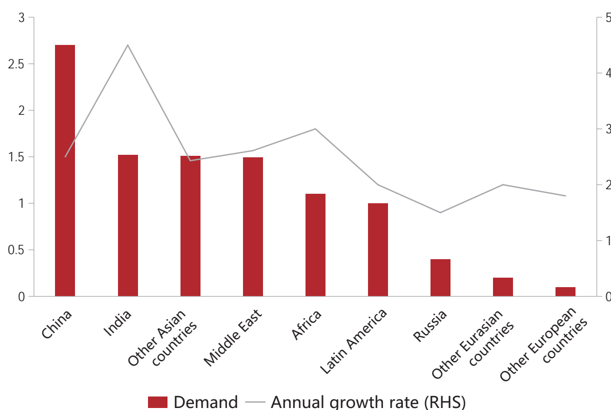


Data sources: BP, IMF, Wind and BOC Investment Strategy Research Center

6.2.2.2 Asian markets: Crude oil demands gradually recovered on slightly stronger economic growth in Asia

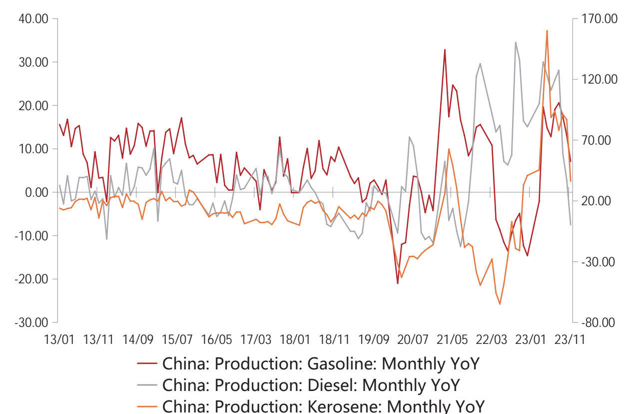
In 2023, a large portion of global crude oil demand growth will come from developing countries in Asia and the Middle East. The 2023 World Oil Outlook report by OPEC indicates that as global economic growth becomes more robust, economic improvement in China and non-OECD regions is expected to further boost oil consumption in 2024. It is expected that global oil demand will increase by 2.25 million bbl/d in 2024, and the global total oil demand is expected to average 104.31 million bbl/d, with a year-over-year increase of 2.20%. The growth rate of crude oil demand in non-OECD countries will be 3.54%, with the growth rate of China and India being 3.61% and 4.10% respectively. In terms of the structure of demands, non-OECD countries are likely to maintain their role of pillar to crude oil demand growth in 2024 just like in 2023.

Figure 300. Crude Oil Demands of Non-OECD Countries and Growth Forecasts (Million bbl/d, %)



Data sources: OPEC, Wind and BOC Investment Strategy Research Center

Figure 301. Growth Rate of China's Refined Oil Production (%, %)



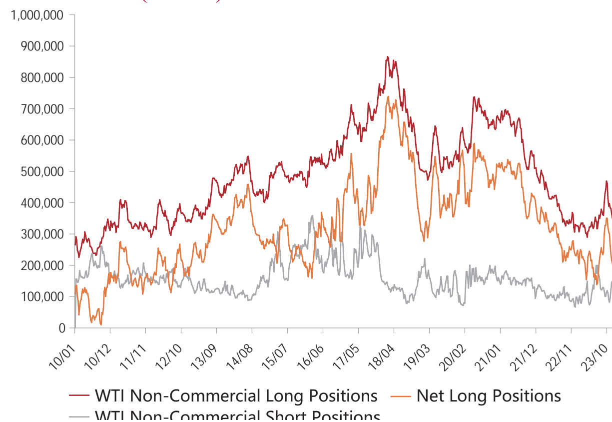
Data sources: OPEC, Wind and BOC Investment Strategy Research Center

6.2.2.3 CFTC positions: Insufficient institutional confidence led to low levels of long positions

The number of non-commercial net long positions in the crude oil futures market continued to decrease, CFTC net long crude oil futures position dropped to a low in recent years, and institutional position confidence is insufficient.

In 2023, crude oil spread structure continued to contract, and the overall pattern of tight supply played a certain supportive role for the structure of the monthly spread of crude oil futures. Since 2023, the monthly spread of ICE Brent oil futures maintained the structure of slight backwardation, and oil prices remained rather stable in 1H, 2023. Subsequently, monthly spreads expanded to the year's peak under the pattern of strong expectations for macroeconomic as well as supply and demand fundamentals in Q3. Under short-term pressure on the demand for oil prices, the monthly spreads gradually adjusted back to near the par in Q4. Over the recent period, the monthly spread of WTI crude oil futures oscillate around the par, which is attributable to the influence of multiple factors such as the risks of US macro-economy and its financial system and the Fed's monetary policy. In Q1, 2023, the monthly spread was dominated by a slight structure of contango. In Q2, it hovered around par. In Q3, it was affected by the strong macroeconomic expectations and the consistent de-stocking of crude oil in the Cushing area, among other factors. In Q4, with the pullback of the international oil price and the pricing-in of the market sentiment towards low inventories, the WTI monthly spread returned to a slight structure of contango.

Figure 302. WTI Institutional Positions with Low Confidence (Pieces)



Data sources: CFTC, Wind and BOC Investment Strategy Research Center

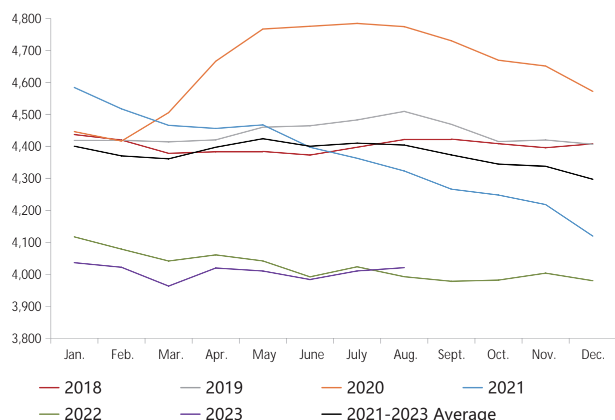
Figure 303. Structure of Crude Oil Futures Spreads (USD/Bbl)

Data sources: Wind and BOC Investment Strategy Research Center

6.2.3 Crude oil inventories: Global inventories stayed low, and demands for replenishment bolstered oil prices

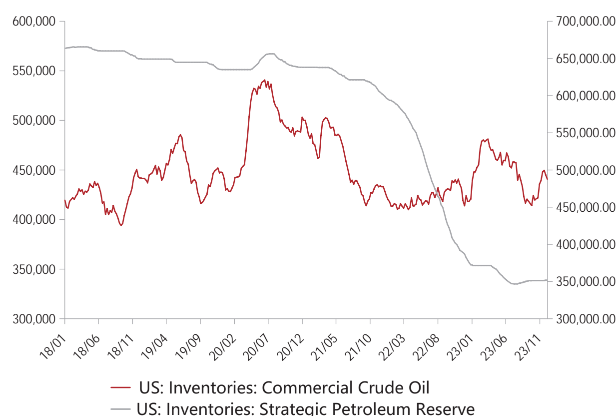
The current background of low global crude oil inventories remains unchanged. US commercial crude oil stockpiles are running low, and strategic petroleum reserve stockpiles continue to decline. As of mid-December, 2023, both the amount of 441 million bbl of US commercial crude oil inventories and the amount of 352 million bbl of strategic crude oil reserves are in a historically low range. The US gasoline stocks in the lower range still continue the downward trend. According to OPEC's report released in November, commercial crude oil inventories in OECD countries are slightly lower than the same period in 2022, and are at the bottom of the inventory range over the past five years. From a comprehensive point of view, the absolute value of global inventories in 2024 is to maintain a low level of operation. While the overall weakness of inventories will support oil prices, it also means that under such tight balance of supply and demand, emergency events will lead to greater volatility of oil prices.

Figure 304. OECD Inventories (Million bbl)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 305. US Commercial Crude Oil and Strategic Petroleum Reserves (Thousand bbl, thousand bbl)



Data sources: EIA, Wind and BOC Investment Strategy Research Center

6.2.4 Conclusion: Pattern of tight supply and demand is expected to persist, and oil prices may oscillate within a range at highs

Figure 306. OPEC Calibre Global Crude Oil Supply/Demand Balance Sheet (Million bbl/d)

Year	2020	2021	2022	2023E	2024E
Global supply	94.00	95.52	100.07	101.03	102.37
In particular, OPEC production	25.72	26.34	28.86	28.00	27.90
OPEC NGL + unconventional oil	5.17	5.28	5.39	5.44	5.51
Non-OPEC liquid oil production	63.11	63.90	65.81	67.59	68.96
Global demands	91.22	97.23	99.66	102.11	104.36
OECD aggregate	42.06	44.85	45.75	45.82	46.08
Non-OECD aggregate	49.16	52.38	53.90	56.29	58.28
Gap between supply and demand	2.78	-1.71	0.41	-1.08	-1.99

Data sources: *OPEC, Zheshang Securities Research Institute and BOC Investment Strategy Research Center*
(Note: Non-OPEC calibre forecasts in blue are taken from the rolling average of the previous four quarters)

From a comprehensive point of view, we believe that in 2024 the global crude oil price is to maintain a high range oscillation. The price central pivot range shifted upward compared with 2023. The lower limit may be supply costs, and the upper limit is dependent on the degree of demand recovery. Moreover, the market is to return to the supply and demand-led fundamentals. It will continue the overall tight balance of supply and demand pattern. In the latest forecast by four major institutions OPEC, IEA, EIA and OIES, the oil demand growth rate of 2024 will be 0.93-2.25 million bbl/d with supply growth rate of 0.57-1.6 million bbl/d. On the supply side, the major oil-producing countries have obvious appeal for high oil prices. The bottom price of crude oil may be an equilibrium price by Middle East oil-producing countries considering the fiscal balance, that is, around 75-80 USD/bbl. On the demand side, the global economy is expected to improve, but the pattern of differentiation continues. The downward pressure on the European and the US economies may compress the upward range of oil prices, and the incremental demand will depend on the development of the national economies, and the non-OECD countries may be the main force of demand. It is expected that the ICE Brent oil benchmark will operate in the range of 75-100 USD/bbl, and geopolitical conflicts may have a short-term impact on oil prices, briefly deviating from the equilibrium price determined by the fundamentals of supply and demand.

6.3 Base Metals

In 2023, base metal prices moved downward, approaching the cost line, and were in the stage of oscillating around the bottom line. In 2024, global industrial production still faces further downward pressure. There will be a weak recovery for China's demand. Short-term completion demand will be improved, but the medium-term pressure on the investment side is still large. The overall demand side of industrial metals is expected to be weak. However, taking into account the inventory has been at a low level and stable growth policy support and other factors, base metal prices are expected to rise periodically, where the rising timing and driving factors will be differentiated. Among them, copper, aluminium and other industrial metal prices may have a phased performance after the oscillation around the bottom line. Metal prices will show a pattern of "domestic strength coupled with overseas weakness" more frequently.

In the long run, there are certain structural changes in the supply and demand of base metal market. First, compared with the expansion of smelting capacity and end demand, metal mining capital expenditure is still insufficient. Second, new energy substitution factors are gradually emerging, and China's new energy industry has a high market share. In the future, key industrial metals such as copper and aluminium will face supply gaps after the downward pressure on global demand is cleared and the green industry's share of usage is systematically increased. Therefore, there are crucial opportunities for strategic allocation, and it is possible that they will enter another "super cycle".

6.3.1 Copper: Priced continued to stay around the bottom with possibility of moving upward

In 2023, the supply and demand of the copper metal market was tightly balanced, and the copper price basically maintained a weak oscillation trend with limited fluctuation. Influenced by the exchange rate trend and the difference between domestic and foreign supply and demand, the price performance was "internally strong and externally weak". Annual Shanghai copper oscillate at high levels with core operating range of RMB 65,000-70,000 per tonne, and it had briefly probed the year low of RMB 62,000 per tonne at the end of May. LME copper oscillated at relatively weak levels. At the end of the year, it moved up slightly for repair after the low consolidation. The main operating range of LME copper is USD 8,000-9300 per tonne. As of the end of 2023, domestic cathode copper premiums and discount was maintained at about RMB 100 per tonne. The current spot premium and discounts are maintained at the average level of the past five years, and the difference between domestic and overseas premium and discount is obvious, and the supply and demand environments are very different.

Figure 307. Trend of SHFE Copper/LME Copper Prices (RMB/tonne, USD/tonne)

Data sources: Wind and BOC Investment Strategy Research Center

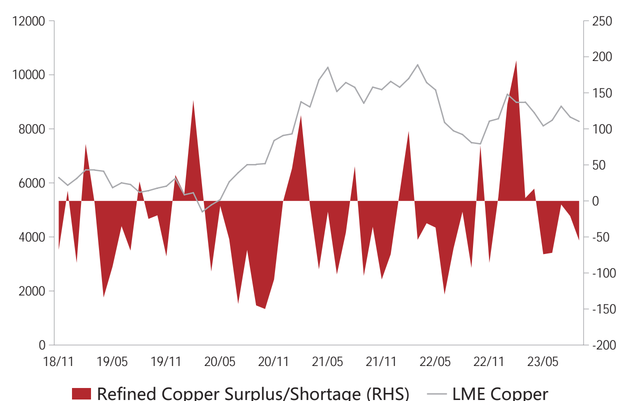
Figure 308. Domestic and International Copper Basis Difference (RMB/tonne, USD/tonne)

Data sources: Wind and BOC Investment Strategy Research Center

6.3.1.1 Balance of supply and demands: Equilibrium reached at a high level

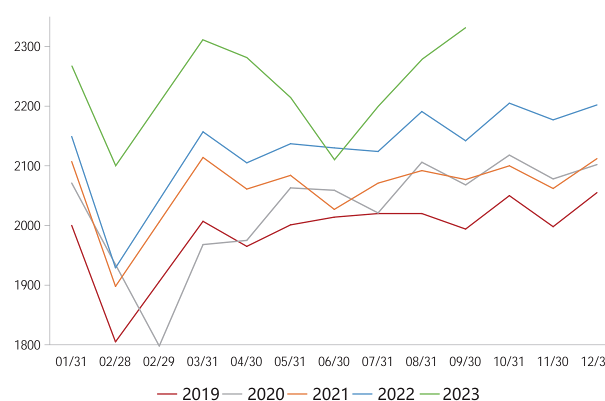
The current willingness of major global copper enterprises to increase capital expenditure is low, and has remained low for many years since it peaked in 2013. In the cycle of rising copper prices from 2019 to 2022, there is no significant increase in the capital expenditure of major copper mines, and it is expected that expansionary capital expenditure may still trend downward after 2023. The supply of refined copper is expected to peak in 2024 and fall back in 2025, with the supply gap gradually emerging, showing a pattern of staying stable with a slight decline. On the demand side, the traditional infrastructure and manufacturing copper consumption is still strong, and the growth rate of copper consumption in emerging industries has increased. The market expectation for domestic policy is to turn optimistic. If there is a resonance of demand in the US and China, it will drive copper prices upward. From seasonal analysis, the current supply-demand balance compared to the level of the last five years is in a higher position, where the production and consumption is also at a higher level.

Figure 309. ICSG Global Refined Copper Supply/ Demand Balance (USD/tonne, kt)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 310. ICSG Global Refined Copper Shortfall Seasonality (kt)



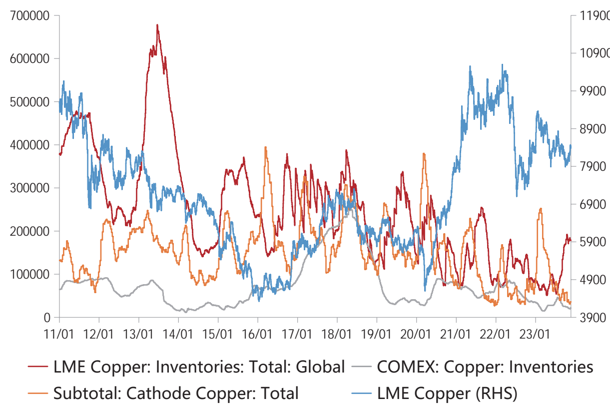
Data sources: Wind and BOC Investment Strategy Research Center

6.3.1.2 Inventory analysis: Stronger demands for inventory replenishment

At the end of 2023, the overall inventories of the three major exchanges had risen compared to mid-2023, but were still at a historically low position, with a strong demand for inventory replenishment in the future, and domestic hidden inventories were also at a low level. Over the past two decades, LME copper price and inventory cycle trend have been synchronized generally, especially after 2008, the bottom of the inventory cycle usually means that copper prices are at the bottom. From a seasonal perspective, current inventories are also at low levels compared to the last five years.

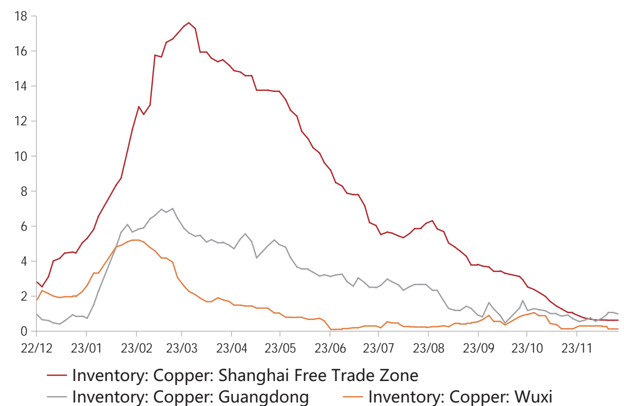
From the perspective of manufacturing inventories, China and the US manufacturing inventory cycle is at the bottom, replenishment cycle may pull demand expansion. Manufacturing industry is one of the important base metal demand industry. China and the US manufacturing inventory cycle and base metal price cycle overlap to a high extent. In early 2022, China and the US manufacturing industry has entered the de-stocking cycle, the base metal prices have also fallen from the peak. The current China and the US manufacturing inventory growth rate are at the bottom, the negative suppression by the de-stocking cycle on metal prices gradually slows down. Shifting to replenishment cycle is expected to lead the demand cyclical rebound.

Figure 311. Copper Inventories and LME Copper Prices on the Three Exchanges (tonnes, USD/tonne)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 312. Domestic Hidden Inventories (10,000 tonnes)

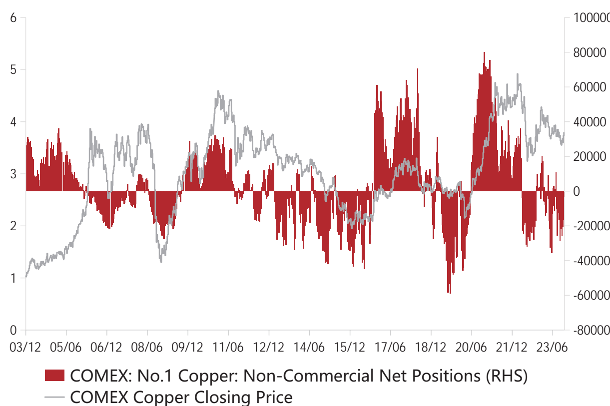


Data sources: Wind and BOC Investment Strategy Research Center

6.3.1.3 Position analysis: Convergence of short positions

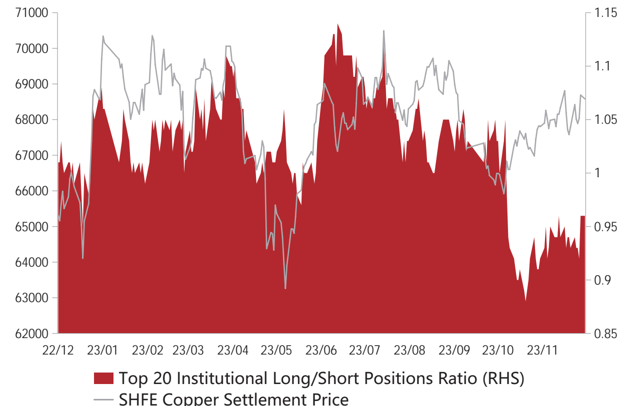
2023 CFTC non-commercial net positions remained mostly net short, reaching a maximum of 36,000 at mid-year. However, the short-dominated trend began to converge in the second half of the year, with net shorts shrinking to less than 0.2 million by year-end. The long/short ratio of the top 20 institutional positions in Shanghai copper averaged above the level of 1 during the year, and then declined towards the end of the year, but gradually converged to near parity.

Figure 313. CFTC Net Non-Commercial Positions and COMEX Copper Price (Pieces, USD/pound)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 314. SHFE Copper Long/Short Positions Ratio and Price Movements (RMB/tonne)



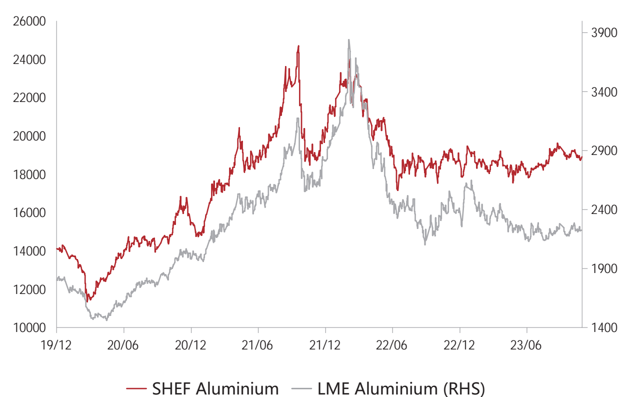
Data sources: Wind and BOC Investment Strategy Research Center

Conclusion: Looking forward to 2024, the global copper oversupply situation is expected to improve; supply and demand is to maintain a tight balance. The continued strength of domestic macro-control policies, the slowdown in tightening expectations of overseas central banks and the gradual opening of the space for interest rate cuts will pull the center of copper prices upward. In addition, the USD interest rate cuts are expected to enhance and ultimately land, which will highlight the financial attributes of copper. The downward USDX will contribute to the rise of the copper price center. Copper prices are expected to maintain a wide range of oscillation in the first half of the year. It will see phased opportunities in the second half. Shanghai copper's main operating range will be RMB 63,000-73,000 / tonne, and the main operating range of LME Copper will be USD 7,800-9,500 per tonne.

6.3.2 Aluminium: Expected replenishment of inventories with possibility of breakthroughs

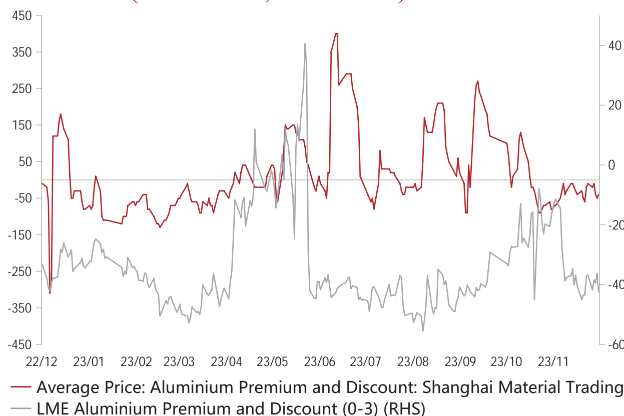
In 2023, Shanghai aluminium price oscillated in the overall range. The Fed was in the interest rate hike cycle, whereas the domestic macroeconomic situation failed to meet the market's expectations. The drag of real estate sector imposed a negative impact throughout the year. Nevertheless, the inventory decline obviously supported aluminium prices. Furthermore, pulled by demand in the new energy, the overall supply and demand were still in tight balance, where the price followed the inventory fluctuations. In 2023, LME aluminium was weaker as a whole. There has been an evident pattern of "domestic strength coupled with overseas weakness". In terms of basis difference, Shanghai aluminium encountered four large backwardation, but the durations were short. Moreover, the basis difference of LME aluminium mostly maintained a state of discount.

Figure 315. SHFE/LME Aluminium Price Movements (RMB/tonne, USD/tonne)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 316. Domestic and Foreign Aluminium Basis Difference (RMB/tonne, USD/tonne)

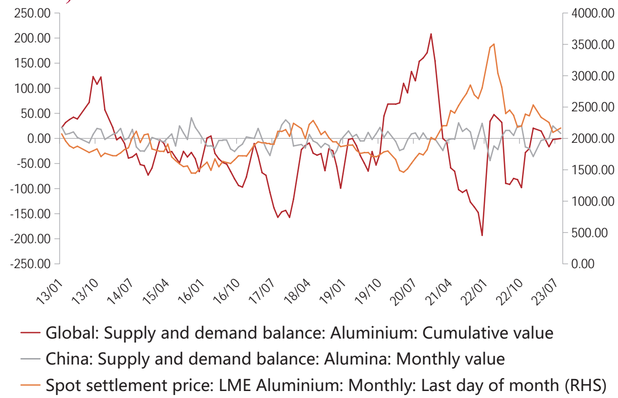


Data sources: Wind and BOC Investment Strategy Research Center

6.3.2.1 Balance of supply and demands: Maintaining a Tight Balance

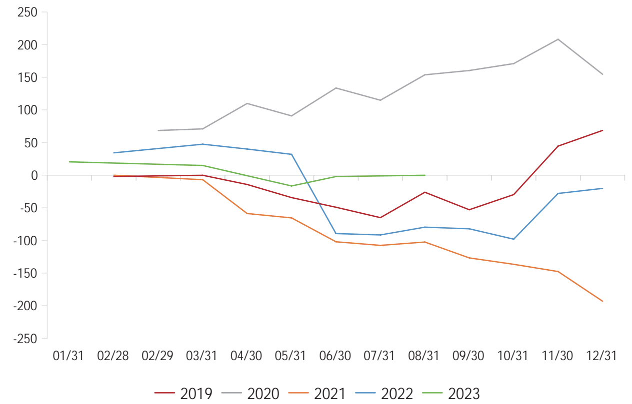
Under the guidance of the carbon peak and carbon neutrality strategy, the bottleneck of new electrolytic aluminium production capacity is gradually highlighted, and the ceiling of supply is relatively clear. In 2024, the aluminium market is still in a tight supply and demand balance, and the domestic production will have some growth. Nevertheless, the imports will fall back, and the growth rate of supply will go down. The risk point of supply-demand imbalance is the uncertainty of aluminium production reduction in Yunnan and the demand decline brought by the completion of real estate in 2H, 2024. Supply will be disturbed by the dry and wet period in Yunnan, and aluminium prices are expected to oscillate upward during the dry period. On the consumption side, it will expand moderately overseas and the domestic traditional consumption momentum is weak. Nevertheless, with the gradual repair of demands in the real estate, photovoltaic and new energy sectors, consumption is expected to maintain positive growth. The overall pattern of aluminium supply and demand will not be weak. In the full year of 2024, aluminium prices will oscillate at rather optimal levels. In the long run, aluminium prices are likely to remain strong.

Figure 317. Analysis on the Balance of Global Aluminium Supply and Demands (10,000 tonnes, USD/tonne)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 318. Seasonality Analysis on the Balance of Global Aluminium Supply and Demands (10,000 tonnes)

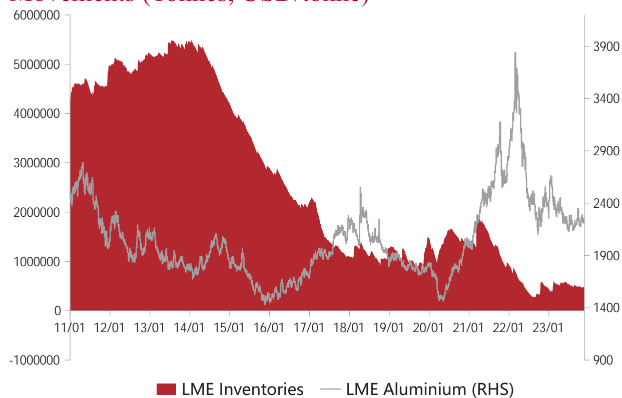


Data sources: Wind and BOC Investment Strategy Research Center

6.3.2.2 Inventory analysis: Low inventories are expected to improve

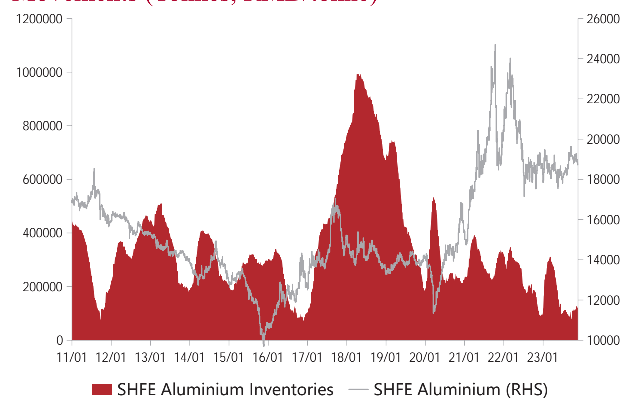
Aluminium stocks fluctuated in 2023, but were still at a low level in recent years. As of the end of 2023, the Shanghai Futures Exchange electrolytic aluminium inventory was 120,300 tonnes, falling back by 61% compared with the high point of 311,400 tonnes by the end of Q1, 2023, which was a low point of nearly five years. The LME aluminium inventory reached 493,800 tonnes, falling back by nearly 10% compared with the situation in Q1, 2023. Judging from a seasonal perspective, current inventories remain at a low level compared to the last five years. Based on similar logic of the above-mentioned copper market, low inventory of aluminium is expected to improve with short cycle of economic recovery.

Figure 319. LME Aluminium Inventories and Price Movements (Tonnes, USD/tonne)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 320. SHFE Aluminium Inventories and Price Movements (Tonnes, RMB/tonne)

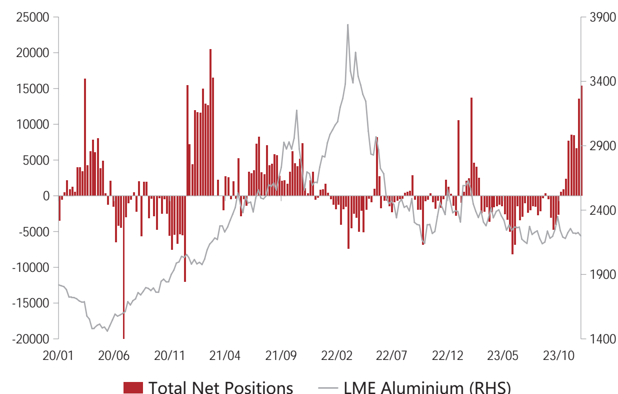


Data sources: Wind and BOC Investment Strategy Research Center

6.3.2.3 Position analysis: Positive trend

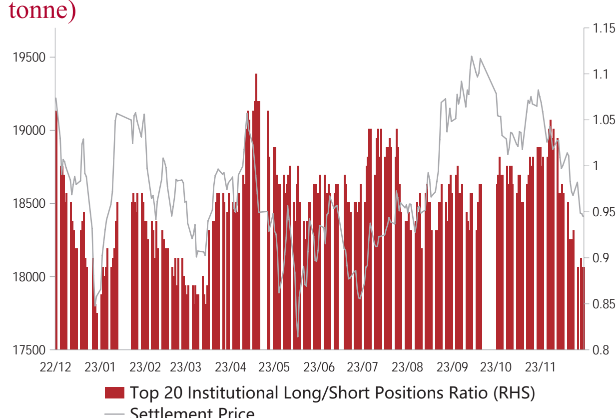
By the end of 2023, Shanghai aluminium top twenty institutional positions long-short ratio is short biased, of which the average value was 0.96. The long-short ratio fell to 0.89 to the end of the year, close to the low in Q1, 2023. LME aluminium net position reached 15,400 lots, hitting a new high in recent years.

Figure 321. LME Aluminium Positions and Price Movements (Lots, USD/tonne)



Data sources: Wind and BOC Investment Strategy Research Center

Figure 322. Institutional Net Long/Short Positions Ratio and Settlement Price of SHFE Aluminium (RMB/tonne)



Data sources: Wind and BOC Investment Strategy Research Center

Conclusion: In 2024, from the supply side, it remains difficult for aluminium production to grow significantly. From the demand side, real estate policy continues to be optimize. Urban village and old city renovation as well as other projects will support the construction demands. In addition, photovoltaic and automotive industry demands for aluminium can be expected. In the case of demand support and difficulty in significant growth of supply, aluminium prices are expected to oscillate amid strengthening in 2024, with the possibility of breakthrough in the near term. The main operating range of Shanghai aluminium is at RMB 18,000-20,000 per tonne, and that of LME aluminium is at USD 2,000-2,400 per tonne.

Asset Allocation

Global Asset Allocation Strategy and Bank of China Solutions 2024

Against the backdrop of the macro-theme that "global assets are ushering in the dawn as the USD starts the cycle of interest rate reductions", we believe the allocation among major asset categories should be in the following order: stocks, gold, commodities and bonds. The infection point is emerging due to the start of the cycle of USD interest rate reductions, and stock markets in emerging economies are likely to become more resilient. The Chinese stock market shall be given priority in the allocation of global assets, and overweight shall be given to China's A-shares (recommended) and China's Hong Kong stocks (recommended). In the cycle of USD interest rate reductions, US bonds and Chinese USD bonds are expected to usher in the optimal investment stage. The logic of long and short positions continue to provide support, and gold is in an upward trend. It is recommended to maintain the overweight (recommended) in 2023 for gold. We are committed to exploring opportunities of annual strategic allocation and tactical timing options through professional research, so as to create greater alpha value of bank of China. We are dedicated to promoting the development of asset allocation through the "Five Investment Strategy Reports", and to sustain companionship throughout the whole process. "With a century-old history, Bank of China is to navigate continuously for your wealth!"

7.1 Macroeconomic Theme: Global Assets are Likely to See a Silver Lining amid the Start of the Cycle of USD Interest Rate Cuts

In 2023, the world underwent a pivotal transformation, the most significant in over a century, validating the predictions of the "end of a strong USD and silver lining of the world". Amid this context, inflation in the US and Europe peaked before receding, with Europe inching towards a recession while the US economy remains resilient. The end of the Fed's unusual interest rate hikes has heralded new prospects for global assets. Concurrently, China's economy navigates a winding path to recovery, with a focus on enhancing its development quality. Its stock market is increasingly prioritizing the elevation of listed company quality, alongside a reform of investment, finance, and trade, a move poised to fortify market fundamentals. In 2024, the global economy is poised for a moderate revival. The US economy is expected for a soft landing, while Europe grapples with the looming threat of a recession. The cycle of USD interest rate cuts begins, accompanied by an impending shift in liquidity. Amid these changes, China's economy is exhibiting signs of a gradual upturn, steadfast in its pursuit of high-quality developmental goals. The USD, entering a phase of rate reduction, adopts a relatively weak position compared to the strengthening of other currencies, though this trend exhibits divergence. This economic environment ushers in new prospects for global risk assets, notably in emerging markets.

7.2 Recommendations for Global Asset Allocation

Against the backdrop of the macro-theme that "global assets are ushering in the dawn as the USD starts the cycle of interest rate reductions", we have examined global assets through various lenses, including geopolitical structures, macroeconomic policies, growth rates, valuation levels, and liquidity levels. We aim to predict the potential trajectory of major asset categories for the forthcoming year. From our perspective, given the backdrop of "slow global economic revival and the Fed's start of a cycle rate cuts" in 2024, the allocation among major asset categories should be in the following order: stocks, gold, commodities and bonds.

Regarding stocks, China's economy is steadily advancing towards stability and recovery, underpinned by its commitment to high-quality development new productive forces. In conjunction with the RMB's robust performance, Chinese assets are emerging as the most globally compelling. The Chinese stock market is readjusting its focus, steadfastly engaging in reforms across investment, finance, and trade, aiming to elevate the standards of listed companies and bolster investor protection and rewards. Such moves are poised to enhance investor confidence. The development of a distinct Chinese valuation system and investment philosophy is gradually taking shape, indicating a bright future for the Chinese stock market. Our stance promotes an investment view centered on generating and investing wealth in China, suggesting a primary focus on Chinese equities in global asset portfolios. It is recommended to overweight China A-shares (recommended) and Hong Kong stocks (recommended). Considering the Fed's trio of halted interest rate hikes, markets have anticipated the start of a rate-cutting phase. US equities have completely factored in the economy's soft landing, advising an initial standard investment in US stocks, scaling down at peak values following the initial rate reduction, and later augmenting investments post a substantial decline. With the ongoing downturn in the European economy and a durable recovery seeming improbable, it is recommended to maintain a minimal investment in European assets. The Japanese economy is likely to overcome deflation, sustaining its recovery phase, with prospects for a gentle rise in its stock market. Standard allocation is advised. Benefiting from the relaxation of global liquidity constraints, emerging markets present investment opportunities, especially in nations gaining from global supply and industrial chain reorganization.

In the bond market, as the US inflation declines and the Fed begins lowering rates, a shallow recession is conceivable. US treasuries are in an ideal investment stage, recommending a continuation of the overweight allocation from late 2023 (recommended). As US treasury yields trend downwards, it presents a prime opportunity for investing in Chinese USD bonds. It is advised to prolong the overweight allocation from Q4, 2023 (recommended). China's economy is showing signs of a modest recovery, though the foundation remains uncertain. With increased liquidity and the possibility of additional cuts in reserve requirements and interest rates, a further reduction in the interest rate benchmark is expected. The yield on the 10-year government bond is likely to fluctuate between 2.45% and 2.75%, suggesting that a standard allocation would be advisable.

In terms of precious metals and commodities, the sustained importance of geopolitical hedging and monetary hedging (as a credit yardstick) reinforces gold's long-term strategic value, surpassing earlier projections. Taking into account the trend of rising gold prices from the cessation of US interest rate hikes to the commencement of the rate-cutting cycle, which suggests a decline in real US interest rates, it is advisable to maintain an overweight allocation (recommended) in gold starting from the fourth quarter of 2023. Given the persistently tight balance between supply and demand in the crude oil market, it is advised to adopt a conservative strategy, before transitioning later to a standard allocation. The strategy report in 2024 includes industrial metals for the first time. For copper, it is recommended to take a conservative approach first, followed by a shift to a neutral view. For aluminum, with improved oversupply situation and likely increased demand, a standard allocation is recommended.

Regarding currencies, with the hike of USD interest rates concluding and the US economy edging into recession, it is recommended to maintain an underweight (conservative) during the phase of market trading around expectations of policy easing, then adjust to a neutral view at an opportune moment. Given the ongoing adverse economic conditions in the UK, which offer little support for the currency, it is recommended to maintain the neutral view for the GBP from 2023 and opportunistically move to an underweight (conservative). As Japan's trade deficit shrinks and the interest rate gap with US bonds lessens, potentially reaffirming the JPY as a safe-haven currency, it is advised to increase the JPY's allocation from a neutral view in 2023 to an overweight (recommended). The Eurozone economic fundamentals lag behind the US, and with the potential for earlier and comparable rate cuts to the US, its comparative monetary policy advantage is diminishing. A downgrade from a neutral view in 2023 to an underweight (conservative) is advised. The Australian economy shows positive fundamentals, and its monetary policy maintains an edge. Considering the historically low position of the AUD/USD in 2023 and its rebound potential, it is recommended to revise the opinion of the AUD from a neutral view to an overweight (recommended). Moreover, it is advised to maintain a neutral view for the CAD. China's economy is expected to recover, but closer attention shall be paid to the weakening external demands that could lead to declines in exports. The RMB is neutrally strong, and a neutral view is recommended.

Figure 323. Global Asset Allocation Views on Year 2024

Stock	Underweight		Neutral	Overweight		Investment Logic
	Bearish	Conservative	Equal Weight	Recommended	Bullish	
US (S&P 500)		●	•			Interest rate cut expectations first elevate valuations, but the realization of rate cuts poses profit risks.
Europe (DAX, CAC)		●				As the economy enters a recession, a downturn is expected following the rate cuts. This decline is likely similar to, yet less severe than, that experienced by the US stock market.
UK (FTSE 100)		●				With a clear trend towards economic weakness, interest rate cuts could occur faster than in the US. The market is trading with recession expectations.
Japan (Nikkel 225)				●		The economy is recovering and moving out of deflation, due to the restructuring of supply chains.
China A-shares (CSI 300)				●		In the wake of economic recovery and efforts to establish financial strength, the stock market needs adaptive readjustment to boost investor confidence. The capital market is poised for heightened activity, offering bright prospects for undervalued A-shares.
China Hong Kong Stocks (Hang Seng Index)				●		Fundamentals are expected to marginally improve, and a liquidity turning point is imminent. Valuations are at extremely low levels.
Bonds	**Bearish**	**Conservative**	**Equal Weight**	**Recommended**	**Bullish**	**Investment Logic**
US Treasuries				●		With the Fed initiating a rate-cutting cycle, a historic investment opportunity arises for 10-year U.S. Treasuries.
Chinese USD Bonds				●		As US treasury yields trend downward, Chinese USD bonds enter a prime period of allocation.
China: Money Market			●			The coordinated implementation of both aggregate and structural monetary policies may lead to heightened volatility in interest rates.
China: Interest Rate Securities			●			Limited room for yield fluctuation. Allocation at higher yield points recommended.
China: Credit Bonds			●			The scarcity of assets contributes to the narrowing of credit spreads, highlighting opportunities in certain sectors.
China: Convertible Bonds			●			Convertible bond valuations have significantly contracted, indicating the importance of focusing on both cyclical and structural investment opportunities.
Commodities	**Bearish**	**Conservative**	**Equal Weight**	**Recommended**	**Bullish**	**Investment Logic**
Gold				●		The long-term rationale behind shifting geopolitics and currency hedging (as a credit yardstick) aligns with the transition from the end of US interest rate hikes to the start of rate-cutting cycles, both contributing to the logic of gold price increases.
Silver				●		Consistent with the logic of gold.
Crude Oil		●	•			The tight supply-demand balance in oil is likely to continue. The lower price limit is influenced by production costs, while the upper boundary is determined by the degree of demand recovery.
Copper		●	•			Global copper oversupply is expected to improve, driven by rising domestic demand and the US dollar. Broad fluctuations in the first half of the year is anticipated, followed by periodic opportunities in the latter half.
Aluminum			●			While domestic production is increasing, a decrease in imports is contributing to a constrained increase in supply, resulting in a declining growth rate. On the demand side, the "three major projects" and growing demand for new energy are expected to offer periodic opportunities.

Foreign Exchange	Bear-ish	Conser-vative	Equal Weight	Recom-mended	Bullish	Investment Logic
USD		●	●			The Fed's monetary policy shifts from tight to loose. This shift, coupled with intertwined rate cuts in both the US dollar and other global currencies, is resulting in a series of strategic financial maneuvers.
EUR		●				As the ECB begins a cycle of rate cuts, the EUR's interest rate position holds no comparative edge. It is advisable to wait for economic stabilization and a clear turning point in growth.
GBP		●	●			With economic downturn indicators surfacing, the benefits of a hawkish monetary policy and nominal interest rate spreads are likely unsustainable.
CAD			●			Deceleration in economic growth, a pivot in monetary policy, and the uncertainty in oil price support.
AUD				●		Positive trends in economic fundamentals, enhanced regional economic and trade relations, with continued potential for interest rate hikes in monetary policy.
JPY				●		Japan's economy is recovering, with a slight increase in inflation. The US-Japan bond yield spread is narrowing. After three years of consistent depreciation, a mean reversion in the currency's value is anticipated.
CNY			●			Gradual end to external tightening measures, coupled with the restoration of the domestic economy.

Perspectives on Major Asset Categories:

7.2.1 Global stock markets

China A-shares: The contrast between China's "strong economy, weak stock market" and the overseas "weak economy, strong stock market" in 2023 has sparked a reflection on the thirty-year trajectory of the Chinese stock market as well as a discussion on its strategic positioning. Looking back: Over the past three decades, the Chinese stock market has mirrored a century-long journey of Western developed markets, emerging as the world's largest financing market, the second-largest securities market, a major wealth management market, and home to an enormous investor base. A multi-tiered capital market structure is now established, with the thorough implementation of a registration system, marks substantial progress in its institutional and regulatory framework. However, a detailed analysis indicates that the Chinese stock market still falls short in effectively serving as an "economic barometer", with limited contributions to appreciating market value. There is substantial room for improvement in the cash dividend payouts and dividend yields of listed companies. The market is characterized by an emphasis on extensive financing at the expense of investor returns, and a noticeable absence of constructive interplay between investment and financing activities. Additionally, the quality of listed companies remains subpar, and there is a noticeable scarcity of stable, leading-edge, patient and intelligent capital. Looking forward: The Central Financial Work Conference emphasized the need to accelerate the building of a strong financial sector. In the new journey of this era, the central government has redefined the role of the capital market, emphasizing its "pivotal function". There remains considerable scope to boost the capitalization rate of China's capital market, a critical element for driving high-quality economic transformation. Refining the "investment, financing, and trading" system and reshaping the stock market's role as an "economic barometer" are key measures of a financially robust nation. These efforts are expected to contribute to the expansion and strengthening of the Chinese stock market. Starting from the present situation: The Central Government's directive to build a financially strong country redefines the role of the capital market as a pivotal hub. "Energizing the capital market and boosting investor confidence" is an urgent task based on this new positioning. Reforms of the financing, investment, and trading systems are being enhanced, with gradual reforms of the capital market well underway. The strategic positioning of the A-shares market is undergoing adaptive adjustment. Looking forward to 2024, with the end of the cycle of USD interest rate hikes, external pressure is easing, presenting opportunities for global assets. The A-share market, benefiting from the outflow of US dollars, is expected to see an increase in valuation. With the mitigation of real estate risks and the establishment of a

long-term mechanism for resolving local debt, coupled with high-quality economic transformation, the short-term economic recovery continues, providing a strong economic foundation for the A-share market to strengthen. After two consecutive years of decline, risks in the A-share market have been fully released. Whether from a horizontal, historical, or stock-bond cost-effectiveness comparison, A-share valuations are at a cyclically and historically absolute low, making it a worthwhile allocation for global investment. In 2024, with a moderate recalibration of the positioning of A-share and a bright outlook for boosting confidence, it is advised to give an overweight (recommended) to A-shares.

China Hong Kong stocks: After nearly three years of adjustment, the current valuation of Hong Kong stocks is at an absolute low. For the year 2024, a moderate recovery of the Chinese economy is anticipated, which should bolster its fundamental strengths. Besides, the beginning of the cycle of USD interest rate cuts is expected to substantially enhance the external liquidity environment. Given both the domestic and international favorable conditions, Hong Kong stocks are poised for a significant rebound. An overweight (recommended) is advised.

US stocks: Despite insufficient risk premiums and lofty valuations, the market's optimism persists rooted in linear extrapolation. This optimism, coupled with the power of trend trading, is likely to drive the S&P 500 index to new highs. However, excessive enthusiasm is often a key characteristic of a cyclical peak. After the interest rate hike cycle ends, risks such as rising unemployment, deteriorating credit quality, and corporate earnings falling short of expectations become apparent. When the rate-cut cycle truly begins, it often coincides with an economic recession and increased stock market volatility, making selling at highs the mainstream strategy. We anticipate that in 2024, US stocks may initially surge due to momentum, experiencing highs before lows. The peak might occur around the time of the first rate cut, followed by a continuous decline. Investors are advised to maintain a standard allocation during this cross-year cycle. It is advised to sell at higher prices and shift to an underweight allocation around the time of the initial rate cut. Following a substantial decline, investors should then increase their holdings, returning to a standard allocation.

European stocks: Since 2023, the European stock market has exhibited a "V-shaped" pattern with high initial levels, a mid-period decline, and a tail-end recovery. The stock markets of major Eurozone economies have a strong correlation with the UK stock market, but overall, they have performed slightly better than the UK. The decline in crude oil prices is unfavorable for the UK FTSE 100 Index, which has a large proportion of traditional oil and gas companies. Looking ahead to 2024, easing inflationary pressures and low economic growth are reinforcing market expectations for rate cuts. The European stock market is expected to initially surge in the first half of the year, with subsequent trends still highly correlated with the US stock market. Compared to the US stock market, European stocks typically do not feature highly dynamic or popular themes. Given their long-standing trend towards lower valuations, a systemic issue that is expected to persist, it seems prudent to recommend an underweight allocation in European stocks.

Japanese stocks: The Japanese economy is expected to continue its recovery pattern in 2024, but with a marginal slowdown in growth rate. Due to its long-term economic stagnation and deflation, the Japanese market has historically been underweighted by international investors. In recent years, the Japanese economy has shown positive changes, with rising inflation, consumer recovery, and industrial benefits from the restructuring of the global supply chain. This has led to increasing attention from global investors towards the Japanese market. It is expected that in 2024, the Japanese stock market will maintain a moderate upward trajectory. A neutral allocation is recommended, and investors should adapt their strategies according to their individual circumstances.

Emerging markets: Looking ahead to 2024, emerging markets as a whole are likely to benefit from the easing of global external liquidity pressures. However, there will be variations in the extent of benefits derived from the restructuring of global industrial and supply chains. Stock market performances are expected to continue diverging. Moderate attention should be given to countries that benefit from both aspects, such as South Korea, India and Vietnam, among other countries.

7.2.2 Global bond markets

China's money and cash market: In 2024, the coordination of monetary policy with fiscal and industrial policies will be a key focus. The withdrawal of contractionary policies by overseas economies (or even the initiation of expansionary policies) may widen the scope for domestic monetary policy. There is a high probability that overall liquidity will remain moderately loose. There is still room for cuts in reserve requirements and interest rates, and the interest rate pivot is expected to continue to decline. The coordinated implementation of both aggregate and structural monetary policies may lead to heightened volatility in the market's interest rates.

China's interest rate securities: In 2024, the domestic macroeconomic fundamentals are expected to continue a weak recovery. Under the dual influence of a stable and somewhat loose monetary policy environment and bond yields in the lower range, the space for yield fluctuation is limited. Narrow fluctuations in the lower range are likely. In terms of timing, disturbances are relatively greater in the first half of the year. It is advisable to allocate at higher yield points. The 10-year government bond yield is expected to oscillate between 2.45% and 2.75%, thus standard allocation is suggested.

China credit bonds: In 2024, the efforts of local government to mitigate debt risks and the launch of new capital regulations are expected to significantly impact the supply-demand pattern of credit bonds. Considering the mismatch between the reduction in high-yield assets and the relatively abundant funds, the scarcity of assets may persist. There is still room for credit spread compression, and the risk of default is expected to continue to decrease. Regarding types of investments, investors should focus on urban investment bonds as well as tier-2 and perpetual bonds issued by banks. A neutral allocation is recommended.

China's convertible bonds: Currently, equity market valuations and sentiment indicators are at absolute lows. Convertible bond valuations, significantly compressed, are now below the central level since 2022, still within an investable range. Attention should be paid to phased and structural opportunities in the convertible bond market, with a standard allocation recommended.

Chinese and other emerging market USD bonds: In 2024, a window for a downward trend in the US dollar and US bond interest rates has opened, possibly signaling a prime period for allocation in Chinese and other emerging market dollar bonds. Chinese USD bonds, with high domestic and international interest rate differentials and low credit risk in investment-grade categories, remain attractive in valuation. Opportunistic increases in allocation are advisable, but attention must be paid to credit issues in high-risk sectors. Emerging market dollar bonds, besides their valuation advantage, will also benefit from the capital inflows following a weakening of the USD. An overweight allocation (recommended) is advised.

US bonds: In 2024, the most crucial factors influencing US treasury yield trends remain the US economy, inflation issues, and the Fed's monetary policy. Although there is a high expectation for a "soft landing" of the US economy, a mild recession cannot be ruled out. The downward trend in inflation and the commencement of the Fed's cycle of interest rate reductions are certain. The only uncertainties are the timing and magnitude of the first rate cut. We anticipate that the turning point for US treasury yields may have already occurred, with an established downward trend. The US bonds remain in a high-value investment range, thus an overweight allocation (recommended) is advised.

7.2.3 Global exchange rate

RMB: In 2024, the RMB exchange rate trend will mainly be influenced by domestic economic recovery, the process of withdrawal from overseas monetary tightening, the timing of the start of the US dollar rate cut cycle, and foreign exchange policy regulation. The RMB's strength will hinge on whether the benefits of China's domestic economic rebound can effectively counterbalance the adverse effects of ongoing overseas monetary tightening and the lingering tail effects of the persistently high level of the USDX. Under a neutral scenario, the RMB exchange rate is expected to fluctuate widely with a bias towards strength. It is advised to maintain the standard allocation as in 2023.

USD: The baseline scenario for the USD trend in 2024 is that the likelihood of the USDX continuously moving in one direction, either strong or weak, is low. A broader probability is for wide fluctuations throughout the year with a neutral trend, and the annual fluctuation range is expected to converge. At the end of 2023, the market started trading on the turning point of the US dollar interest rate hike, partially reflecting related expectations. After the official start of the cycle of USD interest rate cuts in 2024, or during the process of alternating rate cuts between the USD and the EUR, there is a higher probability of strength and weakness alternating, with frequent low-level fluctuations. It is recommended that investors continue the conservative allocation strategy adopted since the third quarter of 2023, and opportunistically increase to a standard allocation in 2024.

EUR: After a rebound of the EUR at the end of 2023, the Eurozone economic fundamentals lag behind the US in 2024. With the potential for earlier and comparable rate cuts to the US, its comparative monetary policy advantage is diminishing. A downgrade from the standard allocation in 2023 to an underweight (conservative) is advised.

GBP: Reflecting the cumulative effect of interest rate hikes and the increase in real estate loans, signs of recession in the UK economy have been established, setting a weak tone for the GBP. With the diminishing comparative advantage in monetary policy, compounded by political factors, the strong supporting forces for the GBP are weakened. In 2024, there is a high probability of the GBP's weak consolidation. The strength brought about solely by hawkish monetary policy and nominal interest rate differentials is unsustainable. Ultimately, the exchange rate will definitely return to being determined by the

relative strengths of economic fundamentals. It is recommended that investors continue the standard allocation strategy adopted since 2023, and opportunistically lower to a underweight allocation.

JPY: The continuous growth of the Japanese economy and the moderate uptrend in inflation form the basis for supporting the JPY. The reduced intensity of monetary easing and the adjustment of Yield Curve Control (YCC), combined with the narrowing of US-Japan government bond yield spreads and the transition of the US economy from overheating to a mild recession (or soft landing), will all stimulate a resurgence in JPY-based safe-haven trades. After experiencing significant depreciation for three consecutive years since 2021, the yen is expected to revert to its mean in 2024, with a high probability of appreciating. Investors are advised to increase their allocation from a standard level in 2023 to an overweight position (recommended).

AUD: In 2023, the AUD/USD is at a historical low. Based on positive Australian economic fundamentals, improved regional economic and trade relations, room for further interest rate hikes by the RBA, and the impact of the shift in the Fed's monetary policy, we predict that the AUD has the potential to strengthen in 2024. Investors are advised to increase their allocation from a standard level in 2023 to an overweight position (recommended).

CAD: With economic growth slowing, monetary policy potentially aligning with the Fed's shift, and uncertain support from oil prices, the CAD's strength in 2023 is unlikely to continue. It may enter a more volatile, fluctuating state. Investors are advised to maintain a neutral view.

7.2.4 Commodities and industrial metals

Gold: In 2024, gold continues to play its role in the century's geopolitical shift and as a hedge against currency volatility (as a credit yardstick), with central banks' gold purchases emerging as a new growth driver. This opens up possibilities for gold to exceed its historical performance, underscoring its long-term strategic value. During the transition from the end of US interest rate hikes to the beginning of the rate-cutting cycle, the regular pattern of gold price increases (anticipated decline in real US interest rates) re-emerges. This may be the key driver for the rise in gold prices in the first half of the year. We continue the recommendation of overweighting gold since Q2, 2023, executing the strategy proposed in Q3 to elevate gold from an allocation asset to an income-generating asset and to give an overweight. We reinforce the concept of gold consumption as a "hedging investment, savings-oriented consumption, and value-preserving personal satisfaction", suggesting an overweight allocation (recommended).

Crude Oil: In 2024, the global oil supply and demand will continue to be tightly balanced, with prices fluctuating within a high range. The price pivot is expected to shift slightly upwards compared to 2023, with the lower limit potentially being the total supply cost and the upper limit dependent on the extent of demand recovery. The market returns to equilibrium prices determined by supply and demand. Geopolitical conflicts may temporarily impact oil prices, but they do not alter the trend towards equilibrium pricing. On the supply side, major oil-producing countries have a clear demand for high oil prices. The baseline price for crude oil could be the supply cost after considering fiscal balance in the primary oil-producing countries of the Middle East. On the demand side, the global economic recovery is slow and continues to be uneven. Downward economic pressures in Europe and America could constrain the upward space for oil prices. The increase in demand depends on the recovery status of each country's economy, with non-OECD countries potentially being a source of increased demand. It is anticipated that the ICE Brent crude benchmark will operate within a range of 75-100 USD/bbl. The recommendation is to start with a conservative approach and then move to a neutral view.

Copper: In 2024, the global oversupply of copper is expected to improve, with supply and demand likely maintaining a tight balance. Domestic stimulus policies continue to be effective, sustaining economic recovery. The commencement of the cycle of USD interest rate cuts will also enhance the financial attributes of copper, jointly driving an upward shift in copper prices. We expect copper prices to fluctuate widely in 1H, 2024 with opportunities for periodic increases 2H, 2024. The main operating range for Shanghai copper is projected to be between RMB 63,000 and RMB 73,000 RMB per tonne, and for London copper, it is expected to be between USD 7,800 and USD 9,500 USD per tonne. The recommendation is to start with a conservative approach and then move to a neutral view.

Aluminum: In 2024, from a supply perspective, domestic production is expected to increase slightly, but with a decline in imports, overall output is unlikely to grow significantly, leading to a downward trend in supply growth. Affected by the dry and wet seasons in Yunnan, aluminum prices are expected to fluctuate and rise during the dry season. On the demand side, driven by the increasingly supportive policies in the real estate sector, the release of demands related to "three major projects"

that involve urban village and old town renovation, infrastructure demands will be bolstered. In additional, incremental demands are likely to arise in the photovoltaic and automotive sectors. In 2024, aluminum prices are expected to fluctuate with a strong bias, and there is the chance of periodic strengthening. The main operating range for Shanghai aluminum is estimated to be between RMB 18,000 and RMB 20,000 per tonne, and for London aluminum between USD 2,000 and USD 2,400 per tonne. It is recommended to adopt a neutral view.

7.3 Solutions Provided by the Bank of China

7.3.1 Our investment strategy and service philosophy

The Bank of China is committed to building an investment portfolio that maximizes returns based on "understanding the customers" through professional market research and judgment, a strong resource integration platform, a rich sequence of high-quality products, and a scientific asset allocation system. At the same time, we guide clients to set reasonable expectations and achieve their goals through long-term investment, to establish scientific wealth management concepts, to stay away from various illegal investment (collection) traps, in the aim of strengthening national financial education, and advocating wealth management activities through professional financial institutions. Under the national policy of common prosperity, we are committed to increasing residents' property income through multiple professional channels. We advocate wealth for good, supporting the first rich to help the second rich, helping our clients to achieve common prosperity in material and spiritual wealth, unifying personal and social values, and jointly fulfilling social responsibilities.

We encourage investors to use the asset allocation concept to achieve their wealth management goals through long-term investment. Our allocation of clients' major asset categories (strategic assets) remains stable in principle over time. If we judge that there is no trend reversal in the major asset categories, we usually do not adjust the strategic asset allocation ratio. We suggest that investors do not need to pay too much attention to short-term market fluctuations and adjust their strategic asset allocation frequently, but they can refer to our weekly strategy recommendations to keep the strategic asset allocation relatively stable while adjusting the structure of tactical asset allocation and the rhythm of product purchases in conjunction with market fluctuations (i.e., switching or re-examining and optimizing products with the same risk attributes), which is where our advantage lies. In order to better serve the asset allocation of BOC's clients, based on the "Five Investment Strategy Reports[1]", we have built the comprehensive service system "BOC Investment Strategy[2]" with the aim to provide guidance and accompaniment for clients' asset allocation from the perspectives of long-term strategic asset allocation, medium-term tactical asset allocation, and optimal timing of short-term products respectively.

7.3.2 Our asset allocation methodology

Bank of China Private Banking adopts the "1+1+1" housekeeping financial service model, which means an exclusive private banker + an exclusive private banking investment consultant (IC) + a specialized global financial service platform. The process of Bank of China's personal financial global asset allocation service is divided into four steps: understanding needs,

1 Global Asset Allocation Strategy by Private Banking Bank of China (issued on an annual basis in English and Chinese), Quarterly Report on Asset Allocation Strategy by Private Banking Bank of China, Bank of China Private Banking Global Investment Strategy Report (issued on a monthly basis in English and Chinese), Bank of China Asset Allocation Strategy Weekly Report and Bank of China Asset Allocation Daily Report.

2 BOC Investment Strategy Comprehensive Service System: This system encompasses a wide spectrum of time frequencies, covering daily, weekly, monthly, quarterly, and yearly analyses, and spans across all asset classes, including stocks, bonds, currencies, commodities, and real estate. It provides investment consulting information services aimed at preserving and increasing the value of total financial assets throughout their entire lifecycle for clients at all levels. Leveraging the diversified financial services resources of the entire Bank of China group, it enables clients to allocate assets globally. The system offers a complete product shelf, provides asset portfolios suited for all risk preferences, and ensures comprehensive accompaniment for clients.

planning solutions, step-by-step implementation and re-examination and optimization. We start asset allocation for our clients from the core parameters of individual client's risk appetite and asset allocation target and take advantage of Bank of China's professional advantages of "Five Investment Strategy Reports", unique advantages of global product and service platform, and advantages of artificial intelligence and big data system. Based on the view of global major asset allocation in the coming year, the Bank of China scientifically allocates clients' assets among currency and cash, fixed income, equity and alternative asset classes according to certain rules, and constructs a strategy-tracking portfolio (strategy β portfolio) for different types of clients, and dynamically adjusts it according to market changes in the future weekly and quarterly reports of Bank of China Asset Allocation to guide clients to implement them step by step and ultimately achieve their wealth management goals.

7.3.3 Our asset allocation solution in 2024

Bank of China classifies individual clients' risk appetite into five risk levels from C1 to C5, corresponding to five client categories with risk appetite of low risk, medium-low risk, medium risk, medium-high risk and high risk respectively. This series of asset allocation plan divides the major asset categories into currency & cash, fixed income, equity and alternative asset classes. Specifically at the product level, there are five risk classes, R1-R5, which correspond to low risk, medium-low risk, medium risk, medium-high risk, and high risk respectively. We will build a strategy-tracking portfolio (strategy β portfolio) by focusing on the most upbeat assets and broad-based indices in accordance with the assessment of global asset trends in 2024 provided in this strategy report, and will also rely on Bank of China's strong product and service platform to help clients build investment portfolios (portfolio) by selecting advantageous products in each asset area and strive to earn more excess returns for clients (alpha α). Through the perfect combination of investment strategies and products, we aim to achieve clients' asset allocation goals.

Based on the analysis of the investment strategy research center on the expected performance of various assets, we use inverse optimization and Black-Litterman model to construct an effective portfolio under different risk levels, including the equity market subdivided into different sectors and themes of the A-share market, as well as domestic and overseas broad-based indices. According to the different risk levels, we set the corresponding portfolio risk budget, and then determine the effective portfolio with the highest expected return under different risk levels. Finally, we calculate the standard error of the return forecast model for each market segment and give the expected annualized volatility of the portfolio, as well as the expected return range (90% confidence level). After the release of the following allocations, the Bank of China Investment Strategy Research Center may make occasional adjustments at the tactical level according to market trends, and will continuously monitor the portfolio returns and related risk indicators, periodically review them, and optimize them when appropriate to strive for the best results.

7.3.3.1 Asset allocation solution for clients with risk appetite of C4 and above

This asset allocation plan represents our recommended major asset category allocation and sector-specific portfolios for clients with risk appetite of C4, according to the strategy report in 2024. Based on the high risk appetite of our clients and the 11% annualized volatility risk budget, we have increased the allocation to equity assets to 65% in 2024. We have also reduced the allocation to fixed income assets, moderately invested in cash management assets, and further increased the allocation to gold to 12% to hedge against the potential depreciation of the US dollar. In terms of equity assets, our focus is on domestic core broad-based indices. We also moderately allocate to overseas broad-based indices and domestic sector indices. This includes a small allocation to indices in the tech and pharmaceutical sectors, aiming for higher returns within our carefully defined risk budget. We estimate that the expected return range for C4 clients in 2024 is -5.6% to 30.6% (90% confidence level).

Figure 324. Asset allocation solution for clients with risk appetite of C4 and above

Equities 65% Alternatives and Others 12%
Fixed Income 22% Money and Cash 1%

C4-rated Portfolio
0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%
Cash
CSI 500 Index
CSI A50 Index
CSI Dividend Low Volatility Index
ChiNext Index
Healthcare
Securities and Insurance
S&P 500 Index
Nikkei 225 Index
US 7-10 year Treasury Yields
CSI Aggregate Bond Index
SHFE Gold

Range of Portfolio Yields
C4-rated Portfolio
-5.6%
30.6%
-10.0% -5.0% 0.0% 5.0% 10.0% 15.0% 20.0% 25.0% 30.0% 35.0%

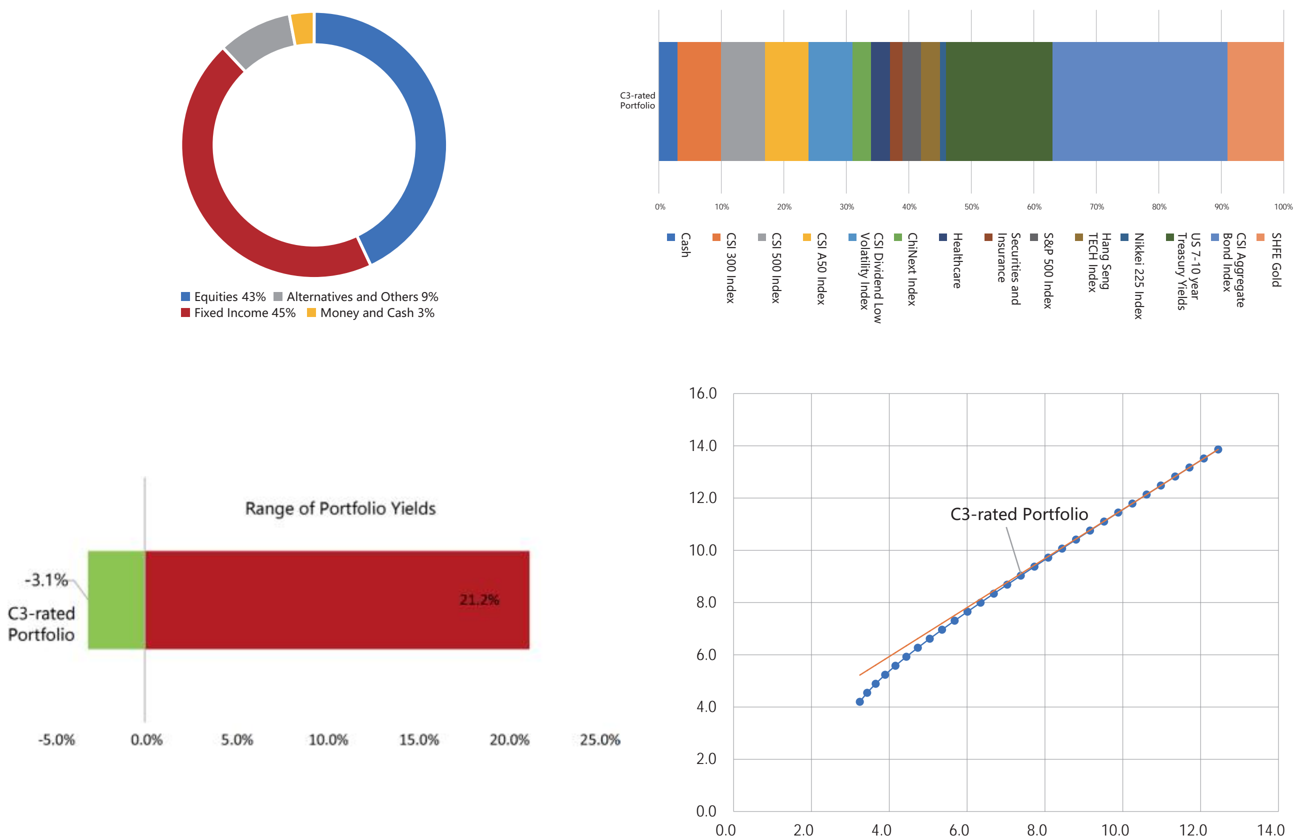
C4-rated Portfolio
6.0 4.0 2.0 0.0 8.0 6.0 4.0 2.0 0.0
0.0 2.0 4.0 6.0 8.0 10.0 12.0 14.0

Data sources: Wind and BOC Investment Strategy Research Center

7.3.3.2 Asset allocation solution for clients with risk appetite of C3

This asset allocation plan represents our recommended major asset category allocation and sector-specific portfolios for clients with risk appetite of C3, according to the strategy report in 2024. Based on the moderate risk appetite of our clients and the 7.4% risk budget, we have increased the allocation to equity assets to 43% in 2024. We have reduced the allocation of fixed income assets, moderately invested in cash management assets, and increased the allocation to gold to 9% to hedge against the potential depreciation of the US dollar, aiming for balanced returns within a moderate risk budget. We estimate that the expected return range for C3 clients in 2024 is -3.1% to 21.2% (90% confidence level).

Figure 325. Asset allocation solution for clients with risk appetite of C3

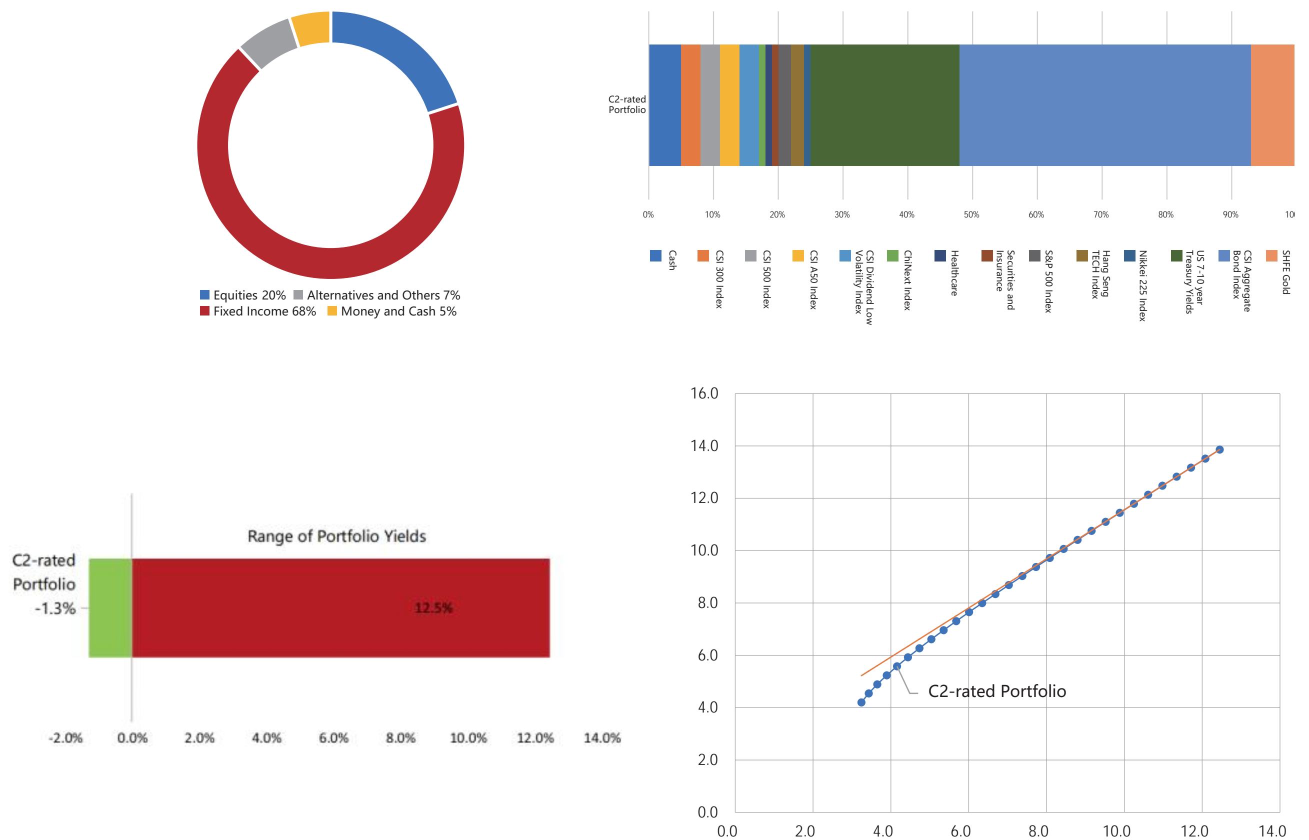


Data sources: Wind and BOC Investment Strategy Research Center

7.3.3.3 Asset allocation solution for clients with risk appetite of C2

This asset allocation plan represents our recommended major asset category allocation and sector-specific portfolios for clients with risk appetite of C2, according to the strategy report in 2024. Based on the low to medium risk appetite of our clients and the 4.2% annualized volatility risk budget, we have slightly increased the allocation to equity assets to 20% in 2024. We have reduced the allocation to fixed income assets, moderately invested in cash management assets, and increased the allocation to gold to 7% to hedge against the potential depreciation of the US dollar, aiming for balanced returns within a moderate risk budget. We estimate that the expected return range for C2 clients in 2024 is -1.3% to 12.5% (90% confidence level).

Figure 326. Asset allocation solution for clients with risk appetite of C2



Data sources: Wind and BOC Investment Strategy Research Center

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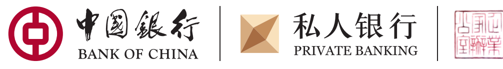
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