NUS INVESTMENT SOCIETY

Global Macro Department –North Asia, China (OVERWEIGHT)

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Analysts

Pan Yumo
Lead Global Macro Analyst
e0772905@u.nus.edu

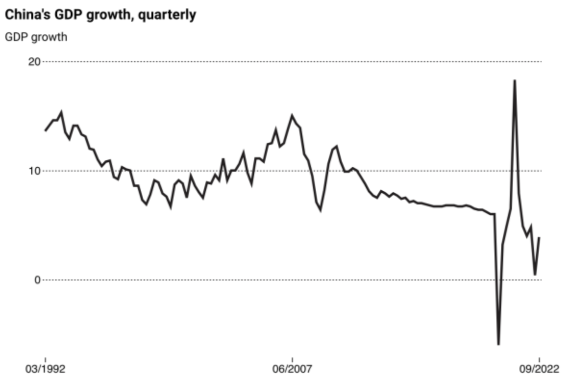
Chelsea Queck Shu Hui
Global Macro Analyst
e0775203@u.nus.edu

Basic Information

Real GDP (US$)	17.73T
M2 (US$)	261.29T
CPI	101.6
PPI	98.7
Stock Index	SSE Composite
Currency	CNH

Chart info

Figure 1: China Quarterly GDP Growth



Source: SCMP

Figure 2: China's Trade Balance

Source: Reuters, Refinitiv Datastream

China: 2H2022 Overview

Waning Economy

China narrowly avoided contracting in the second quarter this year due to strict nationwide COVID-19 lockdowns. Beijing's goal of a full-year growth target of 5.5% seems increasingly out of reach, where we expect a GDP growth of around 3.0% this year. China's top leaders have hinted at flexibility on the official target, reiterating the focus on employment and stable prices.

GDP in H12022 grew only 2.5% YoY, owing to several headwinds: uncertainty over recurring COVID lockdowns, the beleaguered property sector, and global demand slowdown due to recessionary fears. China's zero-tolerance COVID-19 approach has been a major drag on its economy, with frequent lockdowns and regular testing causing consumers to cut back on spending. China retail sales declined by 0.5% YoY in October 2022, missing forecasts where it was the first drop in 5 months, due to rising COVID infections and lockdowns. As businesses faced persistent supply disruptions due to factory closures, China Caixin Manufacturing Purchasing Managers' Index (PMI) remained in contractionary territories for most of 2022, ending at 49.40 in November 2022.

China unexpectedly delayed the release of key economic data without explanation amid the Party Congress, including 3Q GDP and quarterly retail sales, industrial production and monthly unemployment rates. The delayed economic data published afterwards disappointed as GDP grew only 3.9% YoY in third quarter (Fig. 1), far from the government target growth of 5.5% albeit beating estimates. Additionally, retail sales and industrial production both missed expectations.

The worsening trade balance (Fig. 2) has been undermining China's economy over the last two years. The unanticipated fall in China's October exports marked the first year-on-year fall since May 2020 and indicates faltering global demand. Meanwhile, declining imports imply weak domestic demand.

Turning Points

The 20th National Congress of the Chinese Communist Party reemphasised "common prosperity" and a firm position on zero-Covid policy. The Congress also witnessed how Xi Jinping cemented his power as he moved into a historic third term with strong loyal allies.

Relaxation of COVID-19 restrictions following protests has hinted at a plausible earlier exit from the zero-COVID policy. 20 guidelines were introduced in November followed by 10 new guidelines in December, to ease COVID-19 control protocols. China stocks rallied on reopening hopes with a major shift away from zero-COVID policy. China's CSI 300 index, which tracks the largest mainland-listed stocks, rose almost 2% after release of 10 new easing guidelines.

COVID-19: The Bumpy Road to Reopening

Impacts due to zero-COVID Policy

Dozens of cities across China went into lockdown due to zero-Covid policies, including two-month long lockdown in Shanghai earlier in April and May 2022.

China's manufacturing activity has contracted severely due to lockdowns. The Producer Price Index (PPI) fell 1.3% in November 2022 from a year earlier. China's obstinate insistence on the zero-Covid policy with imposition of lockdowns has shuttered malls and public spaces across the nation alongside movement curbs. The economy has been battered due to supply disruptions, domestic demand cutback and international trade slowdown.

Protests (A4 Revolution)

Public outcry was ignited over deadly fire in Urumqi, capital of the remote region of Xinjiang on 24 Nov 2022, which killed 10 people and injured 9. Claims of apartment doors being locked due to strict covid-19 policies that impeded fire escape has sparked domestic upheaval and fuelled nationwide protests. Aggravated by the Urumqi fire, the zero-tolerance COVID-19 approach has triggered demonstrations in more than 20 cities including Beijing, Shanghai, Chengdu. The protests called for loosening of COVID-19 restrictions and stepdown of Xi. Protestors used A4 white paper as a symbol for discontent against censorship, which has seen social media posts and articles wiped from the Internet.

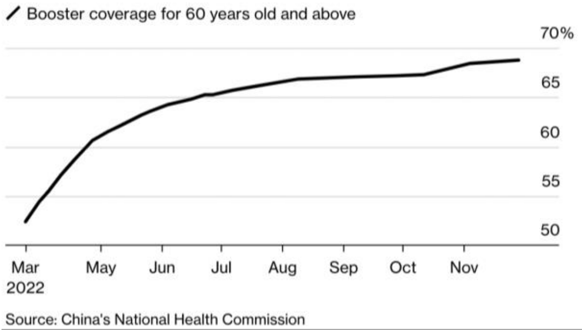
Such rare nationwide movement has not been seen since 1989. Thus, these multi-city protests has forced the CCP to cave to public pressure by recalibrating its COVID-19 approach. This marks a significant milestone, signalling a possible end to zero-COVID policy after 3 years.

Loosening COVID-19 Restrictions

China's announced 20 guidelines in November 2022 and 10 new measures in December 2022, shifting away from its zero-tolerance stance. Key changes include allowing those infected with COVID-19 to isolate at home instead of going to centralised government facilities, removing forced quarantines for people with no symptoms or with mild cases, removing need for proof of green health code or negative COVID-19 tests in indoor venues, reducing mass PCR testing, shortening the mandatory quarantine time for inbound travellers, and so on. China's stocks have begun recovery after withdrawal of restrictions.

The low vaccination rate amongst elderly (Fig. 3) has long been seen as a main obstacle impeding reopening. China is accelerating the vaccination of elderly after spike in daily case numbers due to relaxation of COVID-19 restrictions.

Figure 3: Low Elderly Vaccination Rate



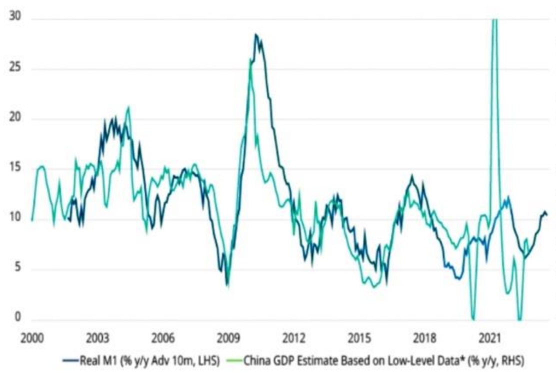
Source: Bloomberg, China's National Health Commission

The Omicron variants currently are still highly infectious, but are milder than earlier iterations. An inevitable wave of COVID cases is expected and concerns loom over the readiness of China in battling this surge. For the past 3 years, China has been fixated on lockdowns instead of focusing on vaccinations.

Moving Forward:

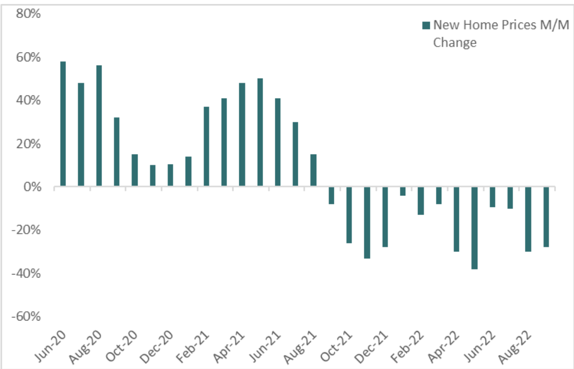
We expect full reopening of China to take place after the "Two Sessions" in March 2023 (Fig. 4). The worse will come before visible recovery. We expect a sharp infection curve in the near-term

Figure 4: GDP Recovery Expected in 2023



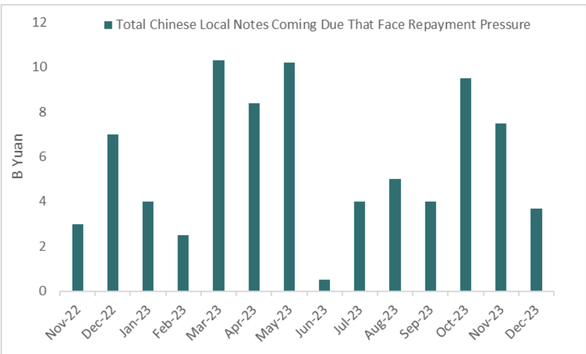
Source: Schroders, Refinitiv Datastream

Figure 5: Depressed Home Prices After 2 Years



Source: Bloomberg

Figure 6: Property Bond Default Risks



Source: Bloomberg

immediately after full re-opening. The initial stage of China's reopening will negatively affect growth with surging COVID-19 cases, similar to the trajectories of other East Asian economies.

China's reopening will be the pivot for economic outlook. We expect higher equity prices and commodities' demand, alongside a stronger RMB currency with China's reopening.

China's Housing Slump: Is Recovery on the Horizon?

Property Crisis

The property sector, including related industries, account for about a quarter of China's GDP. Nevertheless, the real estate industry has shrunk significantly after China's Three Red Lines Policy to crack down on developers' overreliance on leverage. China home price slump drags on as investors' fears linger (Fig. 5). Ultimately, China is trying to get through a key message: houses are for living in, not speculation. Governor of the People's Bank of China, Yi Gang, hopes to engineer a "soft landing" for its property market.

China Property Bonds

Chinese junk dollar bond prices have plunged to record lows, with some trading below 10 cents on the dollar. Support policies by the government have been insufficient and been blanketed in Covid lockdowns as developers remain embroiled in liquidity traps. As refinancing costs surge in global debt markets, China's real estate sector has at least $292 billion of onshore and offshore borrowings due at the end of 2023. Default risks remain high (Fig. 6).

The pessimistic trajectory of higher quality developers defaulting has crushed markets' last hopes in China's offshore bonds. Default by CIFI Holdings Group Co sent further shock waves through the troubled property market. CIFI was recognised to have a relatively healthy balance sheet and was even under a state-guarantee program for a small group of developers. Amid uncertainties, investors are adopting a "sell first, think later" mentality toward higher-yielding developers. The property crisis is ultimately hinged on the restoration of homebuyers' confidence, which is expected to take years to recover.

Rental Housing

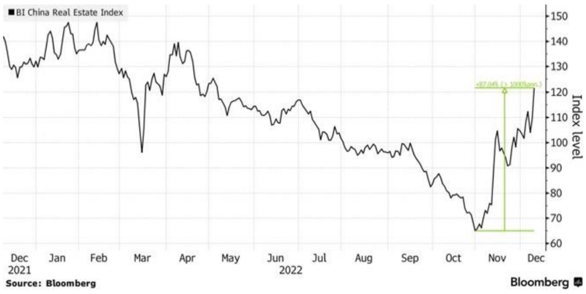
To support property developers unable to complete the construction projects and to promote "common prosperity", there has been a rise in state-led conversion of unfinished homes to rental housing. China is developing more rental properties to make housing more affordable for many young people and migrant workers in big cities, after years of high property prices due to speculation. Across China, city governments have asked local state-owned entities to buy properties in bulk and convert them to rental homes.

16-point Playbook

A long-awaited rescue package for the beleaguered real estate sector i.e. the 16-point plan was announced in November 2022, causing market to rally (Fig. 7). Previously, support measures have been piecemeal and this package is an optimistic sign reflecting the government' shifting attitude towards salvaging its real estate market.

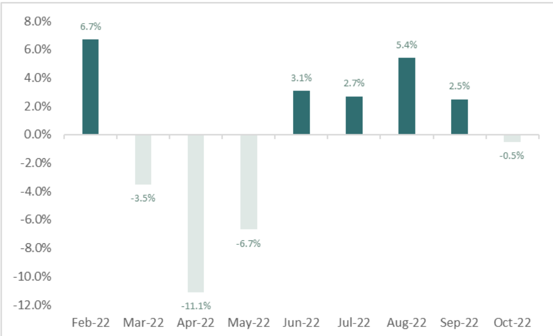
Main points include equal treatment of state and privately-owned developers in terms of providing loans, optimising home-buying requirements by setting down-payment thresholds and mortgage rate in a city-specific approach, extension on developers' outstanding

Figure 7: China Property Stocks Rally After 16-point Package Announced



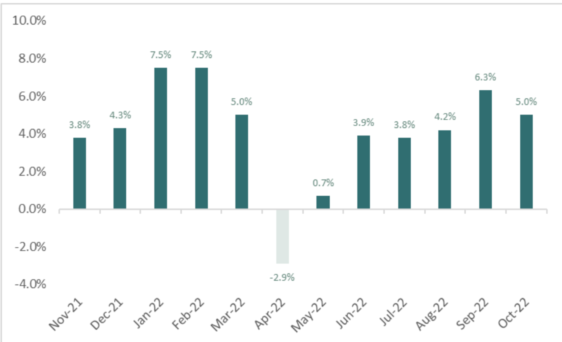
Source: Bloomberg

Figure 8: China Retail Sales Growth YoY



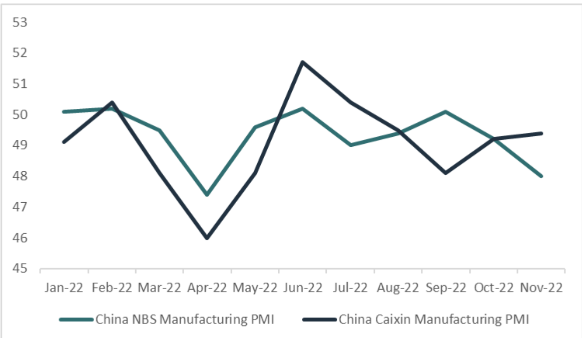
Source: Trading Economics

Figure 9: China Industrial Production Growth YoY



Source: Trading Economics

Figure 10: China NBS Manufacturing PMI & China Caixin Manufacturing PMI



Source: Trading Economics; Investing.com

borrowings. Major Chinese banks subsequently announced financing aid for developers. Chinese real estate stocks such as Country Garden surged after news of the rescue package was announced, signalling optimism ahead. Nonetheless, it remains too early to determine if current measures are sufficient to drive the property market's recovery trajectory.

Strong headwinds remain in place: net population outflows in lower-tier cities, uncertainty brought about by COVID on future income, weak homebuyer confidence due to current backlog of undelivered apartments. In addition, bond yields remain extremely high at above 20%, which will not prove sustainable in the medium term for companies that raise debt through offshore funding, that have bene used to yields of below 10% for the past decade.

The Waning Economy

The insistence on zero-Covid policy and the dragged-out property crisis have been the headwinds holding back China's economy in 2H22. After a slight rebound in June, the July economic data came as a disappointing shock: the retail sales growth (2.7% YoY actual vs 5.0% YoY consensus) and industrial output growth (3.8% YoY actual vs 4.6% YoY consensus) missed consensus by large.

<u>PBoC's Response</u>

Amidst fiscal stimuli from the government, PBoC entered a phase of ultra-accommodative approach, with two rounds of unexpected rate cuts in August. On 15th August, PBoC cut Medium-Term Lending Facility Rate (MLF rate) by 10bps to 2.75% and the seven-day reverse repo by 10bps to 2.0%. This was followed by another round of rate cuts on 22nd August.

<u>The Dominating Covid Factor</u>

However, the overall effect of the August rate cuts on demand revival was overshadowed by the Covid factor. Despite an initial improvement in both retail sales growth and industrial production growth in August, the economy was soon struck by rounds of spikes in Omicron cases, dragging down major indicators from September onwards (Fig.8, Fig.9, Fig.10).

Notably, although September NBS PMI was back above 50 (Fig.10) and beat the consensus of 49.6, the main driver was a rebound in production while demand weakness persisted. Similarly, rebound for the credit demand side was also short-lived. Total Social Financing (TSF) growth delivered positive surprise in September before missing the October consensus by RMB692.1Bn (Fig.11). Similar trend was observed for the M2-M1 gap, which indicates marginal sentiment improvement when narrows.

To further the support, PBoC launched a 25bps universal Required Reserve Ratio (RRR) cut on 25th November, effectively reducing the average RRR to 7.8% starting from 5th December. This round of RRR cut is expected to effectively release RMB500Bn in long-term liquidity, boosting credit demand.

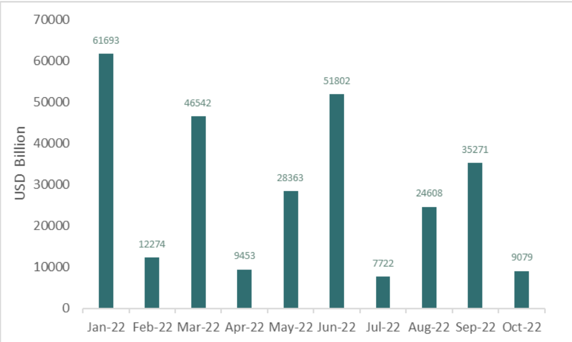
<u>Moving Forward</u>

Interestingly, the NBS PMI and Caixin PMI (Fig.10) has shown a rare divergence from August onwards, with the latter sending a much more optimistic trend. This difference mainly stems from Caixin's higher export-related metrics likely due to differing regional coverage and

Figure 11: China Total Social Financing

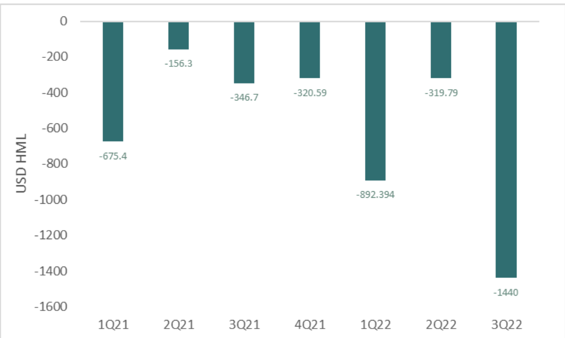
Source: Trading Economics

Figure 12: China Exports



Source: Trading Economics

Figure 13: China Capital Flows



Source: Trading Economics

timeline. Comparing with the actual export data (Fig.12), it is worth noting that the less optimistic NBS PMI has been a more accurate leading indicator in recent months. Therefore, we expect a longer and deeper export weakness throughout the next quarter.

Overall, pivoting on China's recent relaxation on Covid control, we expect to see a distinct "two halves" for China's economy in 2023. With increasing reopening rhetoric, China will inevitably see surging Covid cases and even a temporarily paralysed economy in 1H2023. In line with the newly outlined 2023 priority on stabilising growth from the December Politburo meeting, continued monetary and fiscal stimulus will remain relevant in the initial stage of reopening. We expect at least another round of rate cut by 10bps next spring and possible utilisation of a diversified set of liquidity instruments to tide through the transitionary pain in 1H2023. Entering the second half of the year, we expect the economy to experience a U-shape rebound as consumption and production resume with improving vaccination rate and flattening infection curve. We thus expect cyclical policies to normalise in 2H2023. Notably, the growth will likely to be consumption-driven as the imminent recession for China's trading partners will continue to drag China's export.

Yuan Weakness

As elaborated previously, PBoC has launched a series of monetary policies to stimulate the waning demand. PBoC's ultra-dovish stance amidst global tightening has thus triggered rounds of CNY/CNH depreciation in 2H2022. Coupled with an unprecedentedly low investor confidence in China's capital markets, massive capital outflow has pushed both the onshore and offshore Yuan to their 14-year-low by the end of October, with USDCNY breaking 7.3 (Fig.13).

<u>PBoC's Response</u>

Although onshore Yuan is tightly regulated, offshore Yuan is also influenced by PBoC. PBoC practices daily 'Yuan Fixing' by setting a mid-band reference rate each day for CNY. Thereafter, the CNY will only be allowed to fluctuate against the USD within a 2% band. In September alone, the off-market Yuan purchase burned USD 0.26Bn from Foreign Reserve, depleting the Reserve to its 5-year low (Fig.14). Yet, due to the sheer amount of capital outflow (Fig.13), the CNY still depreciated to 7.21 by the end of September, the weakest since 2008.

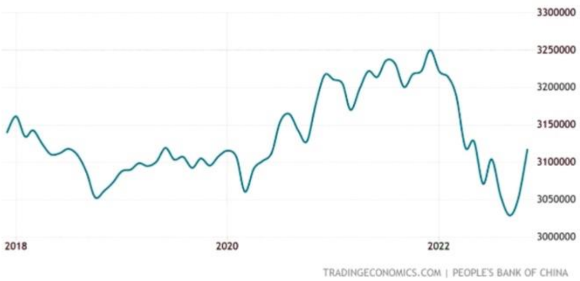
In response to the drastic depreciation, additional tools were activated to further support the Yuan. On 5th September, PBoC lowered the FX Risk Reserve Ratio (RRR) from 8% to 6%. This effectively increased the amount of foreign currency that can be traded from 15th September onwards. With USDCNY breaking the 7.2 level towards the end of September, PBoC raised the RRR for FX forward trading from 0% to 20% on 28th Sept. This increased the cost for purchasing dollar forwards and helped limit the Yuan weakness. Both measures artificially popped up the Yuan, as seen from a fleeting appreciation of Yuan against USD in October (Fig.14).

However, in late October, PBoC set the fixing to above 7.2, the first time since 2008. The weakened Yuan support despite replenished foreign reserve (Fig.15) signalled that PBoC is finally willing to loosen the grip, sending both USDCNY and USDCNH above 7.3.

Figure 14: USDCNY

Source: Trading View

Figure 15: China Foreign Reserve



Source: Trading Economics

Moving Forward

With improved sentiments from the reopening rhetoric, both onshore and offshore Yuan have strengthened drastically against USD to below the 7.0 line. Our Yuan outlook will be further elaborated upon in the Trade Idea section.

The Equity Market: Trading on Sentiments

In 2H2022, China's equity market has traded like a macro-market. Equities across the board have been extremely volatile and sensitive to top-down macro risks.

The 20th National Congress (16th – 22nd Oct)

Xi echoed the push for "common prosperity", having set precedents with crackdowns on big tech, education and real estate sectors. The new concept of "frugality" fuelled by social media movement, was also brought up as Xi called for cultivation of new trends and customs. National security, technology and energy transition were key goals highlighted in Xi's opening speech. Focus on technological innovation was evident as the US announced efforts to cut China off from cutting-edge chip capabilities.

President Xi Jinping solidified his grip on power with a precedent-breaking third term as he packed key posts in the Politburo Standing Committee (PSC) with loyalists. 4 members of the PSC, a group of 7 top-ranking party officials, were replaced. Li Qiang, a close ally of Xi, was anointed as the second-ranking PSC member. He is also poised to become China's next premier after Li Keqiang steps down. Unlike his predecessors, Li is the first premier since 1976 with neither experience as vice premier nor regional administration such as leading an impoverished province. Li was most notably known for handling Shanghai's two-month Covid lockdown that incurred public wrath. Therefore, Li's appointment utters a key takeaway: Xi places loyalty above all else.

A historic sell-off was initiated as investors feared Xi's adherence to zero-Covid strategy and big tech crackdown. CSI 300, the Index that tracks China's top 300 blue-chip firms, has committed to a firm down trend since July this year due to concerns over China's economic recovery. While investors previously pivoted the 20th National Congress as the turning point for ZCP, Xi's reaffirmation on sticking to zero-Covid policy in his opening speech disappointed the market, leading to a crashing CSI 300 Index (Fig.16, Red Box). Xi's successful third-term and a new party hierarchy consisting of Xi's close allies paved the way for an unprecedented power consolidation in the second largest economy of the world. Investor confidence dropped to the lowest point and sell-off intensified. The CSI 300 closed down 2.93% in a single day, eroding all profits from the 2021 recovery (Fig.16, red box).

V-Shape Rebound on Reopening

As mentioned in the 'Covid' section, there were two rounds of policy changes regarding Covid control. The faster than expected reopening progress cheered up investors, as seen from the 14% rebound in CSI 300 and almost 19% rebound in MSCI China Index in just a month.

Moving Forward

While a spike in Covid cases will pose near-term growth pressure, the momentum for a sentiment-driven rebound will likely stay strong moving into 2023 with the Chinese stocks currently trading at 2-year low.

Figure 16: CSI 300 Index

Source: Trading View

Geopolitics: China and the World

<u>Taiwan</u>

China vehemently deems Taiwan as its territory and has repeatedly reiterated its determination for reunification. Xi Jinping hopes to pursue a "One Country, Two Systems" approach. Beijing has demonstrated its resolve and commitment in various forms in the recent months through: strong verbal warnings by senior officials, as well as military, economic, and diplomatic measures.

Although the deadline for reunification has been set for 2049, cross-strait tensions has escalated significantly after US House Speaker Nancy Pelosi's trip to Taiwan in August. The unannounced congressional delegation to the democratic island was seen by Beijing as a de-facto endorsement of Taiwan's independence.

In response to the visit, a white paper titled "The Taiwan Question and China's Reunification in the New Era" was released by China in August, emphasising that Beijing reserves the option of using force to reunify should it be necessary.

In addition, China's ruling Communist Party's military arm, the People's Liberation Army launched military exercises around Taiwan to demonstrate its capability and readiness in resolutely defending national sovereignty and territorial integrity. It also acts as a signal of China's attempt to establish a new normal of military operations around Taiwan. The military drills around Taiwan have raised significant fears of events playing out like the Russia-Ukraine war i.e. China staging a blockade or invasion of the island. Economically, following Pelosi's visit, China suspended natural sand exports crucial for construction to Taiwan and imposed bans on a range of Taiwan food imports. Globally, firms are ramping up their contingency plans and moving out of China as they re-examine business risks within the country on the back of escalating tensions.

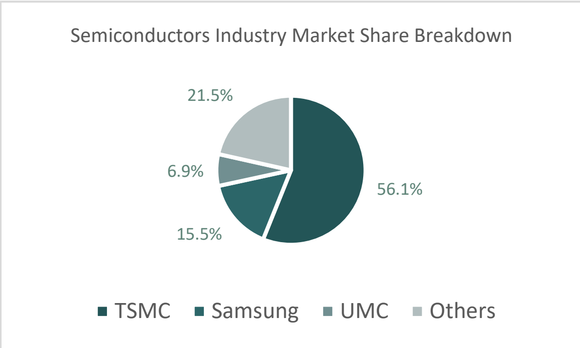
Drawing parallels to Russia-Ukraine war, should a war play out, China is likely to face international sanctions and boycotts of goods and services. The extent of the impact may be limited as China doubles up on its self-sufficiency efforts. Beijing has been aligning itself with its "Dual Circulation" framework and gravitating towards self-reliance. The end goal would be bolstering growth within the domestic market and synergising that with the global economy.

The crux of why Taiwan is so important to both China, US, and the world is due to the island's flagship semiconductor industry, what President Tsai Ing-wen has dubbed its "Silicon Shield". Taiwan Semiconductor Manufacturing Company (TSMC) is indispensable in the global supply chain due to its leading-edge technologies in producing advanced chips and is almost unrivalled (Fig. 17). In the case of TSMC shutdown should war erupt, American tech giants including Apple, Google, Tesla, major European auto makers and Chinese companies would have to put a hold on production.

<u>US Ban on Semiconductors Exports to China</u>

In October 2022, US imposed bans on the transfer of advanced US semiconductor technology to China. The sweeping regulations imply that not only US firms, but any company whose products contain US

Figure 17: Market Dominance of TSMC



Source: Trendforce

Figure 18: Semiconductor Stocks Plunge After Ban Announced

Source: Bloomberg

semiconductor technology, must apply for a license should they wish to produce specific high-end chips for sale to China. Foreign enterprises such as Samsung, SK Hynix, and Taiwan Semiconductor Manufacturing Company (TSMC) have been impacted as they have offices located in China and they utilise US technology and equipment (Fig. 18).

The ban on advanced chips used in supercomputing and artificial intelligence has been seen as an attempt to impede China's advancement towards technological parity with the US. In terms of national security, the ban impedes China's self-sufficiency in terms of developing its military weapons and surveillance technology, providing lag time for US to pull ahead of China. Furthermore, Chinese enterprises ranging from electronic vehicles, advanced robotics, aircrafts and drones have been impacted. This includes output losses in not only the semiconductor industry itself, but also downstream sectors that use advanced chips in the medium-term. Asian chip stocks were hit severely after the US announced tighter controls over chip exports to China.

In face of US efforts to hinder its growth, China has redoubled on its efforts to attain self-sufficiency in semiconductors. Semiconductor Manufacturing International Corp (SMIC) has been seen as China's national champion in the drive to establish self-sufficiency in semiconductors amid the US-China tech war.

Nonetheless, existing problems further hamper self-sufficiency. The state-backed China National Integrated Circuit Industry Investment Fund ("Big Fund"), a fund that has been instrument in nurturing China's domestic chipmakers including SMIC, now faces a corruption probe and is under scrutiny. Moreover, China is only able to rely on domestic supply for basic chips as technology for higher-end chips remain out of reach. External reliance on other countries is still required for advanced chips production.

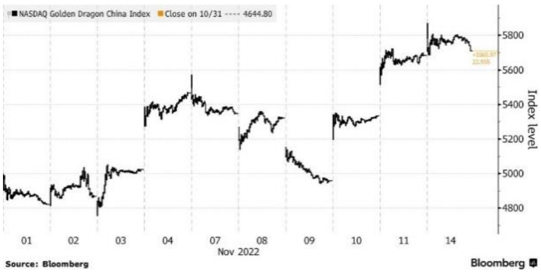
Biden-Xi Meeting

November 2022 marked the first face-to-face meeting of the two leaders since Biden took over as president. This was hailed as an optimistic signs amid escalating tensions between China and US where markets reacted positively. The Hang Seng Tech index jumped by more than 7% while China shares rose more than 10% in Asia following the talks.

Both sides pledged to work on underscored areas of potential cooperation such as global macroeconomic stability including debt relief, health and food security. Both countries have agreed that China-US relations need not be a zero-sum game where both can prosper together. There was consensus on increased communication, especially after cancellations of dialogues following Pelosi's visit to Taiwan. Open communication between US and China regulators is critical to reducing risk of China ADRs delisting (Fig. 19).

Moving forward, strategic competition between the US and China is likely to be inevitable but we should expect more open lines of communication.

Figure 19: Lower Risk of China ADRs Delisting Boost Investors' Confidence



Source: Bloomberg

Writing off African Loans

Persistent claims of debt-trap diplomacy have led China to forgive 23 interest-free loans for 17 African countries in August, debunking the narrative.

Debt-trap diplomacy was coined to refer to how China ensnares smaller countries in unsustainable debt, in order to seize strategic assets or exercise control over their governments.

China has reaffirmed its commitment towards cooperation with Africa at the China-Africa cooperation forum, in terms of major infrastructure in Africa through financing, investment and assistance.

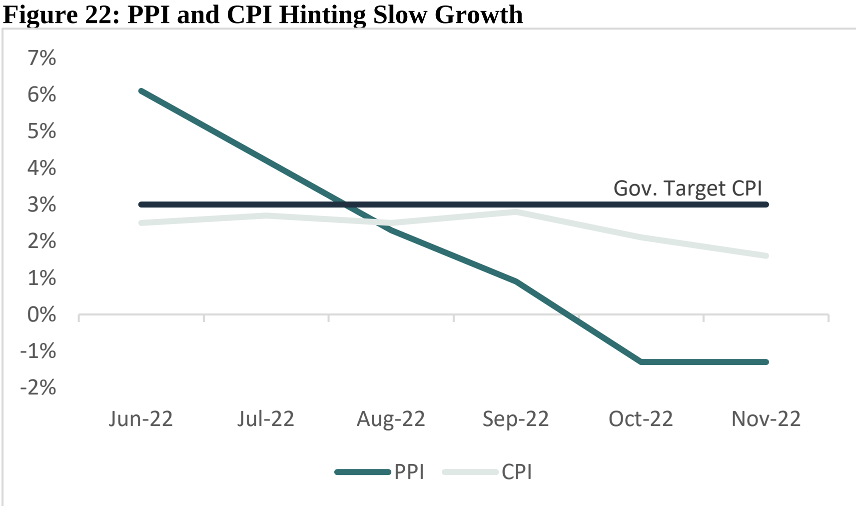
Figure 20: USDCNH Daily Chart

Source: Trading View

Figure 21: USDCNH & US China 2-year yield spread

Source: Trading View

Figure 22: PPI and CPI Hinting Slow Growth



Source: Reuters, Refinitiv Datastream

Trade Idea: Long USDCNH

Following our analysis under section 'Yuan Weakness', we would like to pitch a long USDCNH trade with a 3-month timeframe. We have based our analysis on the following pivots: 1) anticipation for a widening interest rate differential, 2) the overlooked service deficit issue and 3) the transitionary pain on the Chinese economy in 1Q2023. Near-term catalyst and risk are identified to monitor any turnings in the market. We have also performed technical analysis to support our pitch and determine critical levels.

Pivots

1) As mentioned under section 'Yuan Weakness', PBoC's ultra-dovish stance in contrast to the hawkish Fed has led to a widening US-China 2-year yield spread in 2H2022 (Fig.21). This widening differential has been the main driver for Yuan's weakness this year, and we anticipate the yield to continue widening for the next quarter for the following reasons. First, our outlook for a weak Chinese economy in 1Q23 (section 'Waning Economy') due to the transitionary pain in the slightly rushed reopening will likely lead to another round of rate cut in 1Q23. China's well-below-target PPI and CPI in November (Fig. 22) also leaves more room for dovish monetary policies. On the US side, although the November CPI missed estimate, showing a potentially easing inflationary pressure, the PPI growth beat by 10bps and 20bps for MoM and YoY growth estimates respectively. We therefore expect the Fed to stick to the 50bps rate hike in December until a clearer signal is observed. As seen from the strong correlation between US China 2-year yield spread and USDCNH, a widening spread in the next quarter will further weaken the Yuan against USD.
2) While speculators are excited to long the Yuan amidst faster than expected reopening, the impact of reopening on China's service deficit is grossly overlooked. According to the State Council Information Office of China, the country has been running on a service deficit this year. Although the deficit improved slightly in October, a massive reopening will lead to a spike in service import in the next quarter as overseas travelling resumes. Therefore, we think

the market has been over-reacting to reopening news recently and will cool down as a worsening service deficit weigh on Yuan's intrinsic value.

3) Anticipating a distinct "two halves" next year (section 'Waning Economy'), we expect the Chinese economy to perform poorly in 1Q23. We believe this upside risk on USDCNH has not been fully priced in as seen from prices being ultra-responsive to reopening news. Hence, we expect the bullish Yuan sentiment to cool down moving into 1Q23.

Catalysts

The sentiment-driven Yuan appreciation for November and possibly the rest of December will create a decent entry point for our long USDCNH trade.

Risks

1) Dovish than expected Fed moves.
2) Historically, the year-end conversion of FX receipts into Yuan as Chinese people prepare for the Chinese New Year holiday contributes to Yuan strength. However, due to the low scale of impact, this will likely be a tail-risk.

Technicals (Fig.20)

MACD and the actual price forms a bullish divergence, signalling possible near-term reversal (red trend line). The overly bullish market sentiment in the past one month has also been reflected by a low RSI. Given a likely continuation in market excitement till the end of December, we determined a lower-than-current entry point using the previous low. The take profit and stop loss levels are determined based on the high-volume support and resistance zone we identified (Zone A and one B respectively).

Entry: 6.94318
Take Profit: 7.04107
Stop Loss: 6.89221
Risk Reward Ratio: 1.93

Disclaimer

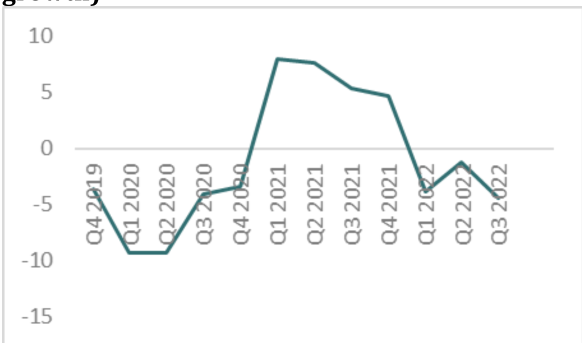
Analyst
Vivienne Tsui
Global Macro Analyst
e1095626@u.nus.edu

Basic Information

GDP	USD 365bn
GDP Growth Rate	-4.5%
USDHKD	7.7854
HKMA Rates	4.75%
3 Month Interbank Rate	5.35%
Inflation Rate	1.8%
Manufacturing PMI	48.7
Unemployment Rate	3.8%
Foreign Reserves	USD 417.2bn

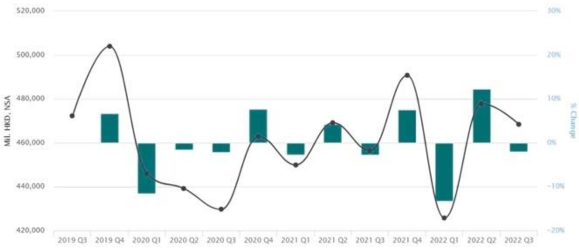
Chart info

Figure 1: Hong Kong's quarterly GDP (% growth)



Source: Tradingeconomics

Figure 2: Private consumption expenditure



Source: Moody's Analytics, Census and Statistics Department, Hong Kong

Overview of Hong Kong

Ranked as the 6th largest exports region in 2021, Hong Kong operates a trade-dominant economy, with the value of its total exports in goods and services accounting for 203.9% of its GDP. Hong Kong is also a tertiary sector-based economy, with its services sector accounting to up to 93.6% of 2021's GDP. It specializes in financial and insurance, public administration, social and personal services, as well as wholesale and retail trades.

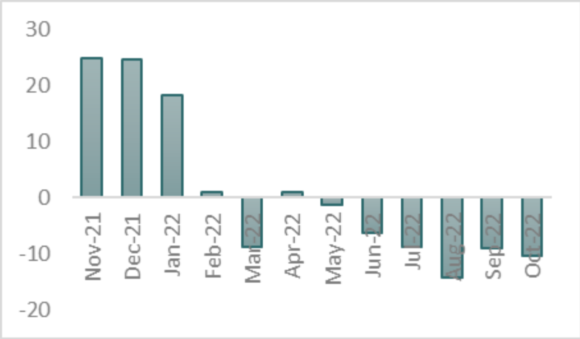
The export-dominant nature of its economy as well as its unique political standing have, however, made Hong Kong particularly susceptible to changes in the external environment. The pessimistic global macroeconomic climate and the heightening geopolitical tensions have both caused strains on its export activities.

With the steady roll-out of the National Security Law in the past year and the commencement of Chief Executive John Lee's new term this July, Hong Kong's economy is expected to be increasingly intertwined with the Chinese market, enhancing its integration into the Greater Bay Area.

Summary of events in the past 6 months

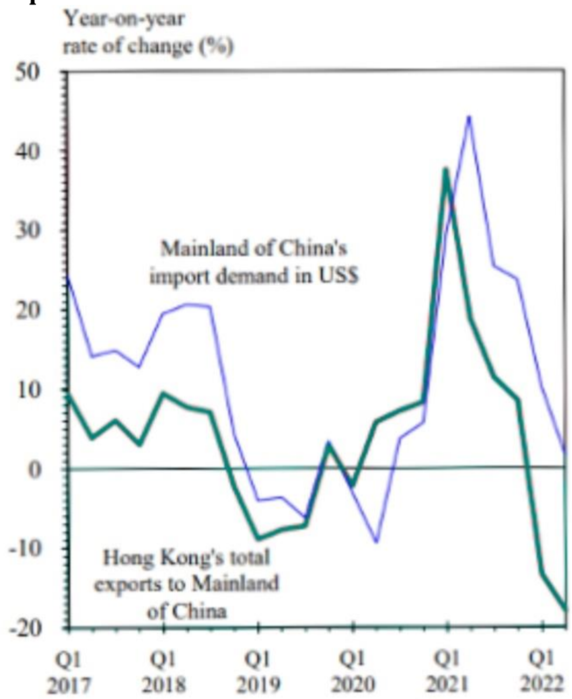
- In tandem with the Fed, the HKMA has increased the base rate for 4 times in the second half of 2022 (75 basis points in July, September, and November respectively, 50 basis points in December). The current basis rate is at 4.75%.
- The property market suffered a hard hit in the second half of 2022, with property transaction volume and price plunging to historical lows.
- On 1/7, John Lee Ka Chiu was elected as the Chief Executive for Hong Kong, serving a 5-year term after the previous Chief Executive Carrie Lam.
- The Hong Kong government has gradually scrapped its Covid-19 policies, no longer requiring visitors to quarantine in hotels upon arrival. The most recent relaxation in pandemic policy was on 14/12, where 3-day medical surveillance for inbound personnel and recording visiting history with the medical tracing app Leave Home Safe were no longer required.
- The Hong Kong stock market continued to experience serious slumps, with a slight recovery in November.

Figure 3: Total exports (year-on-year %)



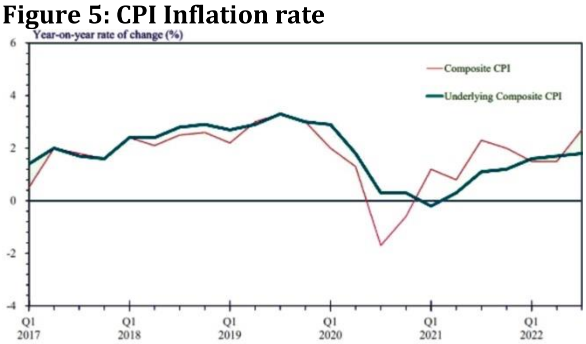
Source: Tradingeconomics, Census and Statistics Department, Hong Kong

Figure 4: Hong Kong's exports to China, China import demand



Source: Census and Statistics Department, Hong Kong

Figure 5: CPI Inflation rate



Source: Census and Statistics Department, Hong Kong

Recession: softening domestic consumption and trade

The quarterly real GDP in Hong Kong has recorded negative growth so far in 2022, with the respective growth rates (year-on-year) being -3.9% in Q1, -1.9% in Q2 and -4.5% in Q3 (Figure 1). On the overall, the real GDP from Q1 to Q3 fell by 3.3%. As a result of subpar Q3 economic data release, the Hong Kong government downgraded the projections for whole year GDP growth to -3.2%. It is the only recessionary Asian economy in 2022, contracting by 3.5% against pre-pandemic levels.

Weakening domestic consumption

Referring to Figure 2, domestic consumption has weakened this year. Despite the government implementing a series of fiscal stimulus packages, in particular multiple rounds of consumption voucher schemes, it appears that their expansionary effects are diminishing. Retail sales in the first 9 months declined 1.3% year-on-year. The consumption stimulus caused by the gradually stable pandemic situation, consumption voucher scheme and improved employment situation is generally offset by the tightened financial condition locally and globally. On top of that, upon the loosening of quarantine measures, more citizens are travelling abroad and hence affecting the local retail scene. Consumption is expected to gradually recover in the coming year, with the gradual recovery of the global macroeconomic scene and consumer confidence.

Slow-down in export growth

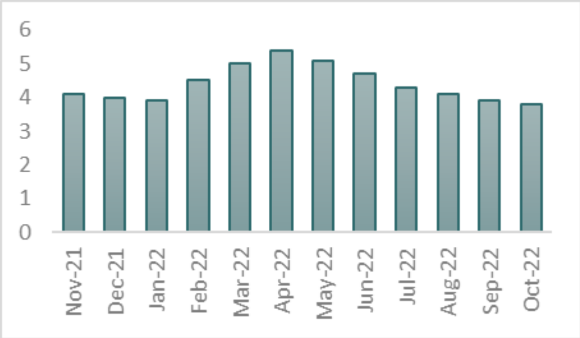
The growth rate of its total exports experienced a drastic slow-down from February onwards, and the volume declined significantly in Q3. October's export volume fell by 10.4% (year-on-year), making it the sixth month with slumping exports (Figure 3). Exports to China, the US and the EU recorded double-digit decline in October as well. Except for January, the trade balance was negative and further deteriorated in Q2 and Q3. This can be attributed to the weak external demand from its major trading partner (China: 56.5% of total exports, the EU: 6.9%, the US: 6.6%) due to the widespread pessimistic sentiment for economic growth. In fact, exports to China fell by almost 20% in Q1 2022, as seen from Figure 4. Also, due to strict pandemic control measures, the continuous disruptions in cross-boundary land cargo flows between China and Hong Kong have caused significant strains on both re-exports of Mainland from other parts of the world as well as exports to Mainland. Yet, with a quicker-than-expected schedule of relaxing Covid-19 policies in both Hong Kong and China, the border control problem is anticipated to ease and bring relief to Hong Kong's exports.

Mild inflation

On the other hand, inflation in Hong Kong has been rather mild, averaging at around 2% year-on-year apart from 4.4% in September (Figure 5). The underlying and headline CPI inflation rates for Q3 are 1.8% and 2.7% respectively – the low base of comparison for underlying CPI inflation is due to the rent waiver for tenants provided by the Hong Kong Housing Authority this September. Increase in food prices averaged at 4% in the first 3 quarters, which is rather moderate because of the steady supply of fresh food from China. Prices of energy-related goods (electricity, gas and water) had a 12.5% increase in Q3, greater than the 6.5% and 10.7% increases in Q1 and Q2 respectively, Price pressures are constrained by the fall in prices of private property. Commercial rentals remained soft, with the 8-month moving-average of office rentals and shop rentals falling by 3.5% and 1% in Q3.

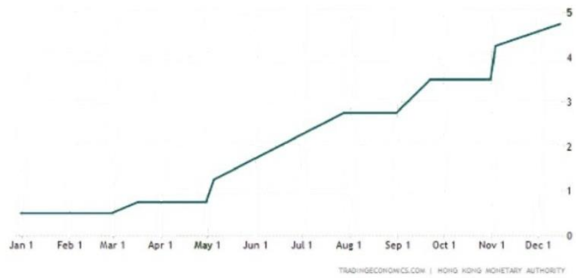
Domestic cost pressures remained mild while import price pressures were much intensive, even when the appreciation of the Hong Kong dollar against other major currencies has already provided some offset to external inflationary pressures. Merchandise imports prices rose by 8.1% year-on-year in Q3. Notably, energy imports saw a 56.8% increase in prices, as contributed by the recent elevation in worldwide energy prices amid the Russian-Ukraine war.

Figure 6: Unemployment rate



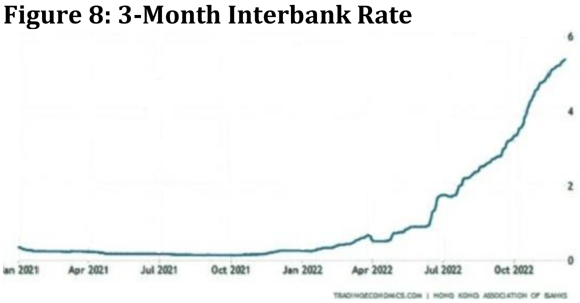
Source: Tradingeconomics, Census and Statistics Department, Hong Kong

Figure 7: Benchmark Interest Rate



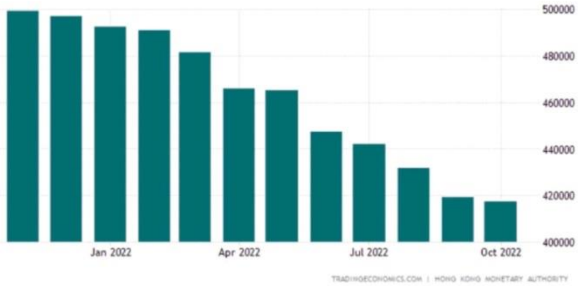
Sources: Tradingeconomics, HKMA

Figure 8: 3-Month Interbank Rate



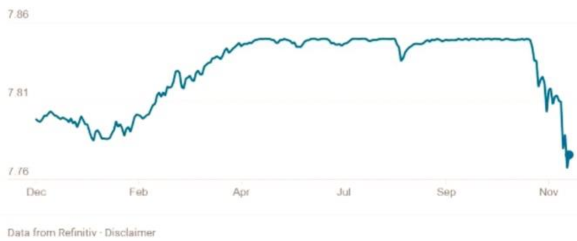
Sources: Tradingeconomics, Hong Kong Association of Banks

Figure 9: HKMA Foreign Reserve



Source: Tradingeconomics, HKMA

Figure 10: USDHKD



Source: Refinitiv

Energy cost pressures are expected to intensify due to the ongoing conflict between Russia and Ukraine, yet increases in price of other items in the price level basket are likely to be less intense and can serve to neutralize the impact of energy on inflation in the coming year.

Improving labour market

The labour market has been improving in the second half of 2022. Unemployment rate peaked at 5.4% in April and gradually fell to around 4% in later months (Figure 6). The seasonally adjusted unemployment rate in Q3 was 3.9%, while the underemployment rate was 1.8%. The recovery in the employment scene is mainly due to the resumption of domestic economic activities upon the steadying of the local pandemic situation, as well as the implementation of various support schemes for small-to-medium enterprise owners and job seekers. The improvement in labour market is likely to sustain in the coming year because of the gradual economic recovery brought by reopening of borders and scrapping of Covid-19 measures in 2023. Labour demand for sectors like tourism and retail will also witness a rebound because of an improvement in economic activities in these sectors upon an anticipated border reopening in the first half of next year.

HKMA rate hikes and interventions

Aggressive rate hikes

The Hong Kong Monetary Authority (HKMA) has raised the benchmark interest rate for 7 times this year, by 425 basis points (Figure 7). The most recent rate rise was from 4.25% to 4.75% on Dec 15, reaching a 14-year high. HKMA's action is in tandem with the US Federal Reserve's (Fed) hawkish decision to embark on rate hikes to curb inflation. The interbank rate (HIBOR) also climbed in accordance with the benchmark interest rate, as seen from Figure 8. Expecting a 50 basis point rate increase by the Fed in January 2023, HKMA is likely to embark on a 50 basis point rate hike as well next month.

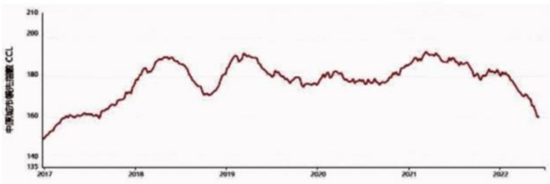
Frequent HKMA interventions

To support the currency's peg to the US Dollar, HKMA has bought HKD 241.2 billion in 40 currency market interventions this year due to the increase in frequency for USDHKD to hit the weak-side convertibility rating (USDHKD = 7.85). This is the most aggressive stance that HKMA has taken out of all past rate-hike cycles. HKMA's foreign reserves are around 1.7 times of Hong Kong's monetary base, which is still ample for backing the Hong Kong Dollar. Despite the strains created on the foreign reserve balance as demonstrated in Figure 9, such interventions were necessary to reduce capital outflows, as well as short selling of local stocks and carry trades of US dollar assets.

Due to the linked exchange rate, HKD remains strong against other major currencies like the USD. However, USD showed signs of gradual weakening in October and November, possibly due to expectations for a less hawkish stance from the Fed as well as the release of US midterm election results. Hence, HKD also weakened during this period. From Figure 10, HKD appreciated against USD as well from November onwards, after triggering the weak-side convertibility rating multiple times between April and October.

As a result of the interventions, the aggregate balance fell by the same amount to HKD 96.977 billion, the first time falling below HKD 100 billion since June 2020. With a decline of around 71% since the first intervention, this nudges commercial banks to further increase their prime rate to regain liquidity, yet at the same time hurting borrowers of personal, commercial and mortgage loans. 5 of Hong Kong's major banks increased the prime rate for the first time since 2018, by 12.5 basis points to a range between 5.125% and 5.375%.

Figure 11: Centa-City Leading (CLL) Index



Source: Centaline Property Agency

Figure 12: Profitability of retail banks

Source: HKMA

Future for linked exchange rate

Led by founder of Pershing Square Capital Management Bill Ackman, worries about the potential discontinuation of the peg due to the lack of reserves and the political decoupling of US and China recently surfaced. Yet, this is not bound to happen in the short to medium term, because a lack of substitutes for the greenback (in comparison with the Yuan with restrictive capital controls).

Hard hit on property market

The high-rate environment, coupled with the uncertainty in the economic outlook, disincentivises property purchases, leading to a softening of the property market. For instance, property sales plummeted to a 27-year low and are likely to hit 65000 this year. The transaction volume is similarly expected to decline by 15% in 2022. The overall transaction volume in November fell for the third month (16.7% month-on-month fall), reaching the lowest since December 2018. From Figure 11, the Centa-City Leading (CLL) index, which is a basket of secondary private residential property prices compiled by Centaline Property Agency, has already fallen by 16.5% compared to its peak in early August. Analysts from Goldman Sachs and JP Morgan predict a fall in housing prices by 30% and 20% respectively by the end of 2023.

The price-to-income ratio of Hong Kong property in 2017 was 18.1, showcasing the unaffordability of local property. Thus, the government has been implementing a series of cooling measures like stamp duties and taxes for non-local and speculative purchases in hopes of curbing the rise in housing prices since 2010. However, such measures were mildly effective in controlling prices and instead restricted the transaction volume. If such measures were relaxed, it could steady prices, minimize the chance for homeowners to experience negative equity and remove their distortions on the transaction volume. The government's decision entails striking a balance between maintaining property affordability and the interests of property developers and homeowners.

On the other hand, the rate hike has also created heavier debt burdens for property developers, lowering their aggression in bidding for land and potentially slowing the process of housing shortage alleviation. This also created pressure for them to sell non-core assets for liquidity used for loan repayment. However, the case in Hong Kong is unlikely to evolve into a housing crisis like the situation in China because Hong Kong developers have around 40% - 50% of profits as rental income, which is significantly higher than 10% among Chinese developers.

Prospects in 2023

China's Covid-19 policy decision is a crucial factor affecting Hong Kong's property market. With further easing of its pandemic measures and a gradual reopening of borders, Chinese investors can travel to Hong Kong for property purchases. Appetite and purchase confidence from the Chinese will also increase in accordance with improvement in its domestic economy in 2023.

Resilient banking sector despite declining profitability

The aggregate pre-tax operating profits of retail banks fell by 19.5% year-on-year in the first half of 2022 (Figure 12). This is due to a reduction in non-interest income and an increase in loan-impairment charges, which more than offset the effect of an increase in interest rate.

Loans for use in Hong Kong fell slightly by 0.8% from end-June to end-September. Trade finance declined by 7% due to the weak external macroeconomic environment, and loans to stockbrokers plunged by 12% due to the marked local stock market correction. Loans for use outside Hong Kong declined by 3%, implying dampened loan demand attributable to geopolitical uncertainties and global stagflation risks.

Despite declining profitability, the capital and liquidity positions of Incorporated Authorized Institutions (AIs) remain healthy. The total capital adequacy ratio stood at 19.8% at end-June, and the asset quality of the local banking sector was sound. The ratios of classified loans to total loans for all AIs were 0.98% at end-March and 1.1% at end-June, deteriorating slightly yet still considered low by historical standards. The delinquency ratios for credit card lending were 0.26% at end-March and 0.25% at end-June, while the delinquency ratios for residential mortgage loans were 0.05% at end-June and 0.04% at end-September. These robust financial figures all showcase resilience of the banking sector.

However, should worldwide geopolitical conflicts escalate, or more aggressive rate hikes take place in the US, a rapid rise in domestic interest rate that follows suit may lead to increased decline in loans and asset quality, ultimately posing challenges to banks' credit risk management for loan portfolios and further harming profitability.

Bearish equity and IPO markets

The local equity market underwent marked correction this year. Along with the decline of global equity markets, the slump in Hong Kong market was mainly due to pessimistic sentiments and weaker risk appetites from investors in the recessionary macroeconomic environment.

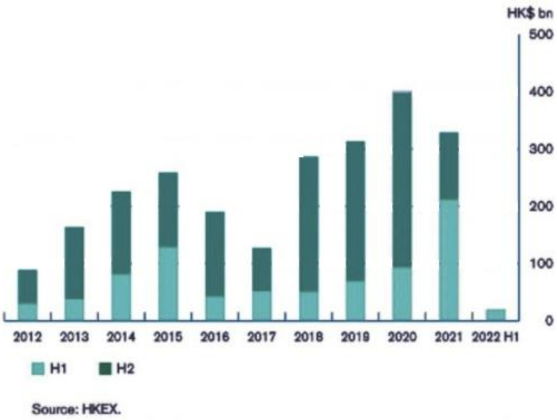
Figure 13: Equity market fund flows into Hong Kong

Source: HKMA, EPFR Global

As of November, the benchmark stock index, Hang Seng Index, has witnessed a year-on-year fall of around 35%, making it one of the world's worst performers. It dropped to its 13-year low in October (14687.2), yet it has recently regained momentum since late November, neutralizing the overall year-on-year decline at 18%. Such a situation is due to the relaxation of Chinese quarantine policies and expectations of a less hawkish stance from the Fed from December onwards. It is also attributable to the strong comeback of the property, casino and technology companies included in the index.

There was also a slowdown in the net inflows through the equity market funds after a period of recovery starting in Aug 2022 (Figure 13). The figure started declining since February, even recording a negative figure in May. On the other hand, while external uncertainties have greatly slowed down primary market activities, the IPO market in Hong Kong was also greatly hit. In the first half of the year, the amount raised through IPO plunged by 90.1% compared to the same period last year (Figure 14). This phenomenon reflects both the base effect due to strong IPO activities in the first half of 2021 and the weakening business demand worldwide amidst the global recession. Nevertheless, the demand for listing is recovering, hopefully leading to a rebound in IPO performance in 2023.

Figure 14: Initial Public Offering market in Hong Kong



Source: HKMA, HKEX

Looking ahead: Policy address

Shortly after John Lee Ka Chiu stepped up as the new Chief Executive after Carrie Lam Cheng Yuet Ngor, he delivered his policy address and revealed a wide plethora of ambitious policy plans for the coming year.

Talent acquisition is one policy area that was strongly emphasised in his plan. The talent outflow problem is yet another crucial issue impeding Hong Kong's economic development potential in the recent 2 years. There was a net outflow of almost 157000 residents in the beginning of 2022, making it the most serious brain-drain problem after the transfer in sovereignty in 1997. This can be attributed to recent changes in the political environment: the ongoing Anti-Extradition Law Amendment Bill protests in 2019 demonstrate increasing political instability and the implementation of the National Security Law in 2021 shows the increasing political influence from China. Besides, the stringent Covid policies since 2020 also acted as a deterrent to cross-border trade and flow of workers, prompting heads of corporates to migrate headquarters to other competitive economies.

In response, the government expressed its determination to attract foreign talents, including granting graduates from top 100 universities a 2-year visa and refunding extra stamp duty to foreigners-turned-permanent residents. At the same time, it seeks to attract foreign enterprises as well – Hong Kong Stock Exchange (HKEX) and the government both reached out to significant firms and sovereign fund leaders in the Middle East for listing and investment opportunities in Hong Kong. This helps re-establish investors' confidence in Hong Kong's status as an international financial centre by showing that the government is acting in an efficient and well-targeted manner to improve on the status quo. However, the retainment of talents remains the crucial fundamental problem to address to reduce turnover rate of both local and foreign talents.

As for pandemic control measures, Lee stressed on a gradual, step-by-step schedule for scrapping quarantine policies and opening borders. With no firm timetable on the policy decision for Covid-19, the ambiguity in the government's attitude may act as a dissuasive factor that sways investors' confidence. Yet, with increasing interlinks between Hong Kong and China, it is expected that the relaxations of pandemic measures of both regions are likely to be in tandem with each other.

Another key policy area is strengthening Hong Kong's integration with China. Enhancing Hong Kong's role as an international I&T and financial centre in the Greater Bay Area is crucial, which is achieved through constructing the Northern Metropolis as an innovation test bed for Mainland tech enterprises as well as establishing more stock connect schemes with Chinese stocks.

Hong Kong and the world

Interconnections between China and Hong Kong

Under the leadership of Lee, it is anticipated that the economic, political, and technological cooperation between Hong Kong and China will be significantly enhanced in the coming years. In terms of financial market integration, there have been multiple stock connect schemes between both markets launched, for example, the inaugural Stock Connect scheme, southbound Bond Connect that enables offshore yuan-denominated debt (dim-sum bonds) and the Wealth Management Connect scheme that allows Hong Kong banks to sell Hong Kong investment fund products to Greater Bay Area citizens.

Figure 15: Net buying through southbound Stock Connect

Source: HKMA, CEIC

Hong Kong serves as an important gateway for international investors and multinational firms to invest in Chinese business, in addition to major trading centres like New York. It also greatly facilitates trade exchanges between the two regions, and this phenomenon is increasingly evident in 2022. For instance, the offshore Renminbi (RMB) business experienced solid growth, especially in Q3. RMB trade settlement transactions handled by local banks increased by 28.6% compared to last year to RMB2413.3 billion. Total RMB deposits also increased by 11.3% from end-June to end-September. Despite an overall fall in net inflow of funds into the local equity market, funds from the southbound Stock Connects remained relatively stable, with the cumulative net capital inflow being HKD 2.6 trillion since its launch in 2014 (Figure 15). As of November 30, Hong Kong and international investors held RMB 2.2 trillion in A-shares listed on the Shanghai and Shenzhen exchanges, compared with only RMB 86.5 at the end of 2014. Mainland investors held HKD 2 trillion Hong Kong-listed shares by November 30, significantly greater than HKD 13.1 at the end of 2014.

However, Hong Kong's unique political standing and its close ties with China at the same time makes it especially vulnerable to any recessionary headwinds in Mainland. With the previous occurrence of the property crisis, crackdown on the private sector, and most recently the ongoing protests on the relaxation of Covid-19 measures, negative sentiments for the Chinese economy similarly impact the Hong Kong markets in the same way. Weak import demand from China also creates a hit on Hong Kong's export volume, due to Hong Kong's primary reliance on China for re-exports.

With China's easing of pandemic measures, a U-shaped economic recovery is expected – a hit on its economy due to increases in infection rates across regions, then gradually an economic rebound after the pandemic situation reaches its steady stage. Thus, the improvement of Hong Kong's economy due to Chinese recovery will not be witnessed immediately.

Changing order: Hong Kong's role on the world stage

According to the Global Financial Centres Index (GFCI), Singapore was ranked 3rd and Hong Kong was ranked 4th this year, making Singapore the top financial hub in Asia and overtaking Hong Kong's past dominant status. This is due to the uncertainties in Covid-19 measures and political uncertainty in Hong Kong, creating stark contrast with the rather rapid reopening of borders and economic recovery and stable political environment in Singapore. This gives Singapore an edge over Hong Kong for now. Spotlights are currently on Singapore and Hong Kong being engaged in neck-to-neck competition for talents and foreign investment.

Yet, it is worth noting that both regions are ultimately not direct competitors but complements in the foreseeable future. Due to differences in their strategic economic positions, Hong Kong is expected to act as a connecting bridge for firms that wish to access the large market in Mainland, while Singapore mainly targets the rest of Asia. As for the financial market, Hong Kong has an advantage in investment banking over Singapore not only because of its connections with the emerging, high development potential financial markets in China, but also because of its historical widespread presence of multinational banks, brokerages, and other financial institutions. On the contrary, Singapore is more suitable as a hub for venture capital and entrepreneurship because of its use of English as the first language, a more welcoming attitude towards start-ups by the government, and a slight advantage in its transparency and stability in the legal and political environment over Hong Kong.

Role of Hong Kong amidst US-China tensions

The US continues to advocate for fundamental freedoms and human rights in Hong Kong, showing opposition for the city's National Security Law arrangements. China is however very firm on its "One Country Two Systems" rule, and has increased its political presence in Hong Kong especially since the Anti-Extradition Law Amendment Bill protests in 2019. The new Chief Executive John Lee has also promised enhanced interconnections between Hong Kong and the Mainland in the upcoming years. Thus, unlike Taiwan, there is less political ambiguity about Hong Kong's stance amidst US-China tensions.

Figure 16: HSI Daily Chart

Figure 17: HSI MACD chart

Source: Tradingview

Long Hang Seng Index (HSI)

Pivots

1. With the gradual easing of Chinese Covid-19 policies being expected, the re-opening of its economy facilitates cross-border trade activities. This is beneficial to Hong Kong's economy, especially its exports. Further reopening or even complete reopening is anticipated next March after China's "Two sessions", thus a continuous upward momentum for the HIS is expected.
2. The Chinese central government has recently implemented a series of pro-growth policies, particularly schemes targeting the recovery of the property industry.
3. It is anticipated that the Fed will be more dovish and opt for more mild rate increases in the coming months, which serves to alleviate the negative impacts on growth amidst inflation taming.
4. The rebound in the index is expected to sustain due to the market adjustment mechanism that takes place because of the common perception of Hong Kong stocks being significantly undervalued – the HSI was trading at a 14-year low in October.

Risks

The Hang Seng Index mainly consists of Chinese stocks. Upon relaxing of Chinese quarantine measures, a steep infection curve is expected in the initial stage. Thus, economic rebound may not be immediate, such that the HSI may suffer a dip due to subpar performance of Chinese businesses.

Technical analysis (Figure 17)

From the MACD chart, the signal line crossed the MACD line from below at around 14833, indicating a buy signal. We are looking to enter a long position at 18814 and take profit at 20170, the resistance level in late August.

Entry: 18814
Take Profit: 20170
Stop Loss: 17270
Risk Reward Ratio: 1.14

Disclaimer

NUS INVESTMENT SOCIETY

Global Macro Department – Taiwan (Neutral)

Date: 15th December 2022

Analyst

Vivienne Tsui

Global Macro Analyst

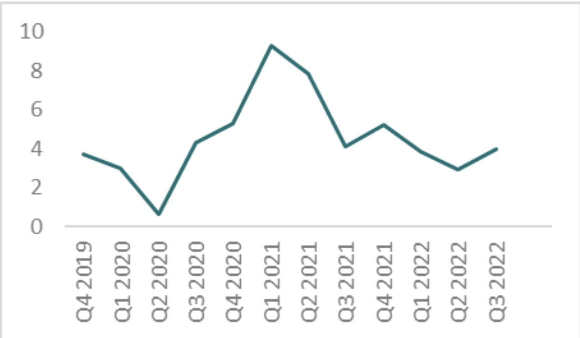
e1095626@u.nus.edu

Basic Information

GDP	USD 745bn
GDP Growth Rate	3.06%
USDTWD	30.7070
CBC (TW) Rates	1.625%
3 Month Interbank Rate	1.23%
Inflation Rate	2.94%
Manufacturing PMI	41.6
Unemployment Rate	3.64%
Foreign Reserves	USD 552.2bn

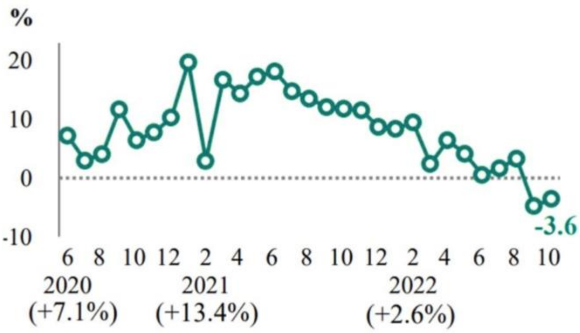
Chart info

Figure 1: Taiwan's quarterly GDP (% growth)



Source: National Development Council

Figure 2: Retail sales growth rate



Source: National Development Council

Overview of Taiwan

Taiwan is the 21st largest economy in the world, with its manufacturing sector accounting for 32% of its GDP, followed by 15.38% by the wholesale and retail sector and 8.21% by residential services. Known for its world-leading semiconductor industry, activities in this sector account for up to 15% of its GDP. Taiwan is highly engaged in foreign trade – its foreign trade value was USD 830 billion in 2021, greater than its GDP of USD 773 billion. This, however, makes Taiwan's economy extremely susceptible to economic blockade and geopolitical tension.

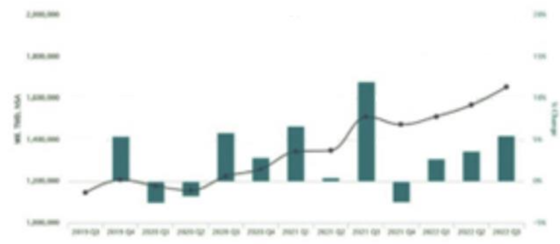
Summary of events in the past 6 months

- Exports growth has drastically slowed in the second half of 2022 and started recording negative growth since September.
- The Central Bank of the Republic of China (CBC) implemented the third rate hike of the year in September, raising rates by 12.5 basis points to 1.625%.
- US House Speaker Nancy Pelosi visited Taipei on 2/8, making her the first US House Speaker to visit Taiwan in 25 years. This shows US's support for Taiwan despite threats of economic and military retaliation from China.
- The US imposed a new round of semiconductor bans on China this October, restricting semiconductor companies, including Taiwan's flagship TSMC, from selling semiconductor equipment to Chinese companies.
- Local elections were hosted on 26/11, resulting in a defeat for the Democratic Progressive Party and a victory for the pro-China Kuo Min Dang. Another round of elections is to be held on 18/12 to elect magistrates and mayors.
- Following UK lawmakers' visit to Taiwan in late November and US's approval of military equipment sales to Taiwan in mid-December, China sent a record 18 nuclear-capable bombers into Taiwan's air defense identification zone.
- The Taiwan Stock Market Exchange suffered a hard hit this year and has recently experienced a brief recovery since October.

Figure 3: Private consumption growth rate

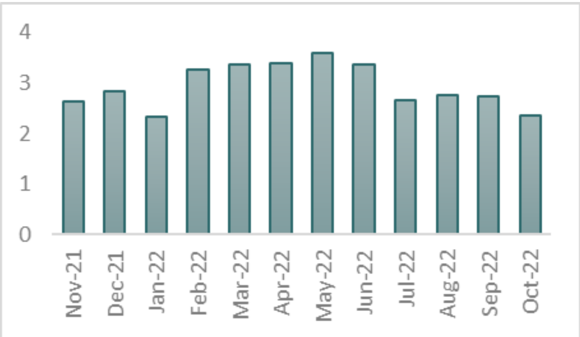
Source: National Development Council, Directorate General of Budget, Accounting and Statistics

Figure 4: Nominal fixed investment



Source: Moody's Analytics, Directorate General of Budget, Accounting and Statistics

Figure 5: CPI Inflation rate



Source: Tradingeconomics, Directorate General of Budget, Accounting and Statistics

Steady recovery supported by domestic economic activities

Taiwan's real GDP has been growing steadily in 2022. As seen from Figure 1, real GDP grew at 3.87%, 2.95% and 4.01% year-on-year respectively in Q1, Q2 and Q3, which is considered relatively strong recovery compared to neighbouring regions. Its yearly real GDP growth was downgraded from 3.28% in October to 3.04% in December upon reviewing the impacts of heightening recessionary headwinds and inflationary pressures worldwide on its exports. This marks a slowdown after experiencing marked growth of 6.45% in 2021. Considering heightening headwinds faced by Taiwanese exports, economic growth in 2023 is predicted at a moderate rate of 2.72%.

Strong private consumption and fixed investment expenditure

For this year, economic stimulus from strong domestic consumption and fixed investment combined more than offsets the contractionary effects of declining exports volume. Retail sales in Taiwan have increased for the 14th consecutive month, predicting an overall 7.9% growth in 2022 (Figure 2). Real private consumption is expected to grow by 3.03% this year after experiencing a rebound in Q2 (Figure 3). This is attributable to the diminishing austerity sentiments brought by the pandemic after easing of Covid-19 restrictions, as well as the implementation of the domestic travel subsidy program which encourages domestic tourism and stimulates consumption like retail, dining out, recreation and transportation.

The annual growth rate of nominal fixed investment this year is expected at 6.14%, as seen from Figure 4. In Q2, private enterprise and public enterprise fixed investments grew rapidly at 11% and 35.94% respectively. Being one of the key growth drivers, such increase is partly due to the reshoring of Taiwan's overseas companies to dodge business operation uncertainties because of political conflicts between the US and China. Other reasons behind the investment growth include the strategic acceleration in investment in the semiconductor industry for strengthening Taiwan's national power as well as the roll-out of the government's sustainability plans through investments in green energy and relevant firms' equipment and production technology. The trend of strong public investment growth is expected to sustain in the coming year, due to the high priority for the government to invest in sectors of strategic interest, particularly the semiconductor industry, to provide Taiwan with more bargaining power in navigating through the escalating geopolitical tension scene. The trend private investment growth remains uncertain. Instead of reshoring back to Taiwan, there is an increasing number of domestic firms considering India due to its emerging market and Vietnam due to its low cost as viable options for manufacturing outsourcing.

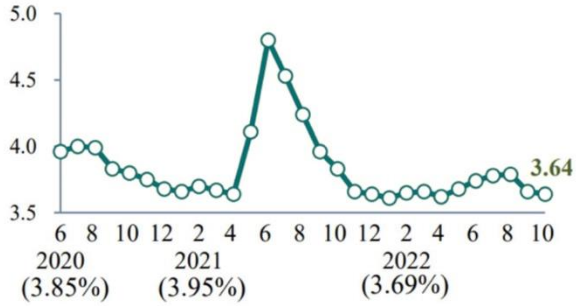
Mild inflation

From Figure 5, inflation remains mild, averaging at around 2% to 3% for its monthly inflation figures this year. November inflation rate was 2.35%, and the CPI for the first 11 months in 2022 increased by 2.97% compared to the same period last year. The recent inflation is mainly driven by the increase in prices of food items like fruits, vegetables, meat, and eggs – vegetable prices surged in September due to Typhoon Hinnamnor, and the price index for eggs rose by 34.53% in October. The rise in egg and meat prices is attributed to the growing costs of feeding and raising cattle. The rise in electricity rates due to Russian-Ukrainian conflicts contributed to inflation mainly in Q2.

The Taiwan Dollar's depreciation against the greenback increases import costs of local manufacturers, and constant supply chain disruptions from strict Chinese cross-border controls as well as the war are all factors contributing to the increase in the Wholesale Price Index this year. Inflation for water, electricity and gas supply remains at around 29% in Q3, while the figure for quarrying and mining products inflation is between 41% to 45%. Recording double digit year-on-year growth every month in 2022, its growth peaked in Q2 between 15% to 16% and steadied in Q3 at around 10%.

With the ongoing conflicts between Russia and Ukraine as well as a further depreciation in the Taiwan Dollar against the US dollar in the coming year, constant supply chain disruptions in oil and gas will continue to increase pressures on the Wholesale Price Index, while escalating energy and food cost pressures will be partly neutralized by moderate price growth of other domestic products, resulting in a forecasted mild CPI inflation in 2023.

Figure 6: Unemployment rate

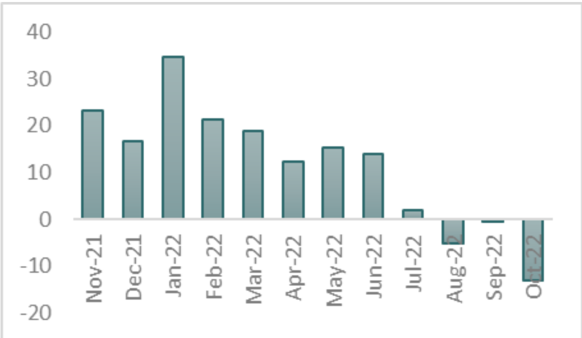


Source: National Development Council

Stable labour market situation

Labour market remains stable in 2022, after recovery in the second half of 2021 upon peaking its unemployment rate in June 2021 at 4.15% (Figure 6). The monthly statistics of unemployment rate this year is around the level of 3.6%, with the most recent rate in November being 3.64%. Due to the easing of the local pandemic situation, businesses of firms have witnessed gradual rebounds, hence causing fewer job losses because of business downsizing and closures, especially in the domestically oriented services sector. Such momentum in the labour market is expected to sustain, with the derived demand for labour growing moderately upon the expectation of continued rebound of the domestic economy next year. One minor downside factor that potentially impacts the labour market situation could be the disincentive brought by a worsening domestic political situation and intensifying conflicts between Taiwan, China, and the US.

Figure 7: Total exports (year-on-year)

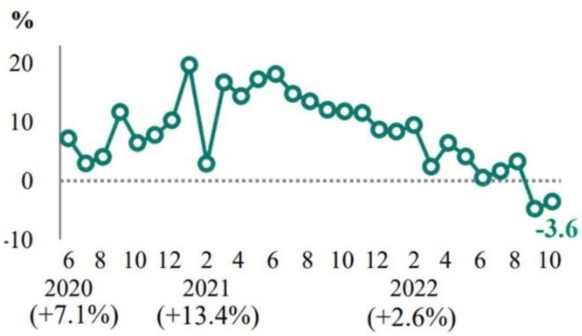


Source: Tradingeconomics, Ministry of Finance, R.O.C.

Slowed export growth

Taiwan's overall growth in exports of goods and services is estimated at 8.73%, down from its 13.51% prediction earlier this year, as referenced from Figure 7. Export growth is mainly fuelled by a strong demand for semiconductors and digital gadgets, due to enterprise digitalization and a global digital economy transformation that drives the development of innovative technologies like Artificial Intelligence, 5G technology and Cloud systems.

Figure 8: Industrial production index



Source: National Development Council

However, export growth has witnessed a marked slowdown in the second half of 2022. The total exports in November recorded a year-on-year -12.1% growth, making it the third consecutive month with negative export growth. Industrial Output Index has also recorded a fall since September, making it the first fall in 2.5 years (Figure 8). This indicates consumer hesitation from major markets for Taiwanese exports. The previous steadily growing demand for electronic gadgets weakened starting November, with chip exports falling by 3.4%, electronic components falling by 4.9% and optical devices (flat panels and camera lenses) plunging by 31.9%.

Factors behind slowed export growth: China's influence and supply chain adjustments

The fall in exports to China contributed 66% to the overall decline in exports in November; orders of made-in-Taiwan exports from Hong Kong and China fell by a considerable 26.7% (year-on-year) in October. Involved in over 40% of Taiwan's overall trade, cross-border trade activities to Hong Kong and China are largely hindered due to the stringent pandemic measures in place. China is also facing growth slow-down due to the property crisis as well as its "Dynamic-Zero" Covid-19 policy, ultimately dampening import demand from Chinese citizens and firms. On top of that, China has imposed multiple bans on Taiwanese exports as a political strategy for pressurizing Taiwan to maintain an appropriate diplomatic distance with the US. Exports of natural sand, citrus fruits, frozen mackerel, and chilled white scallops to Mainland were suspended after US house speaker Nancy Pelosi's visit to Taipei. Regulations restricting around 100 Taiwanese seafood exporters were imposed recently as well, causing the amount of fish shipped to China from Taiwan plunging from 18470 tonnes in September 2021 to merely 912 tonnes this September.

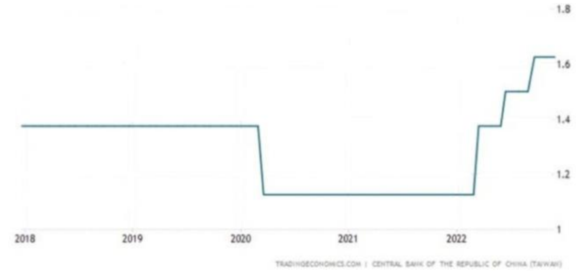
Meanwhile, the heightening inflationary pressures worldwide, rate-hike cycles and the Russian-Ukraine war all contribute to dampening global demand for Taiwanese exports. Exports to the US and Europe similarly fell by 11.3% and 19% respectively in November.

Another factor contributing to the impediment of export growth is the adjustment of supply chains. During the pandemic, many firms tend to pile up stocks of inputs in inventories to hedge against uncertainties in the global value chain amidst changes in pandemic control measures. In particular, producers of digital gadgets tend to overorder factor inputs like semiconductors. Upon the general recovery of the worldwide pandemic situation, most firms are currently using up their piled-up inventory stocks, resulting in falling orders for electronic parts. Similarly, demand for electronic devices dipped this year after purchases for laptops and tablets for work from home were generally made previously already when the pandemic struck.

Prospects for Taiwan's exports

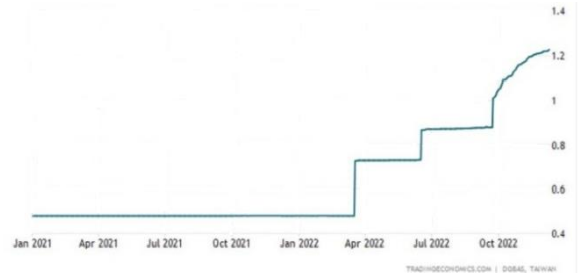
The prospects for exports in the first half of 2023 remain gloomy, with the expectation that global inflation being persistent and the geopolitical scene (China-US-Taiwan, Russia-Ukraine) remaining uncertain. It is however worth noting that the quickened scrapping of Chinese Covid-19 policies can provide some relief to the falling export growth situation. Besides, with the mainland-friendly Kuo Min Dang winning the recent local elections, it is probable for economic ties with China to be further strengthened and the partial lifting of export bans to China. However, this at the same time highlights the need for Taiwan to diversify trade and the risk for China and Hong Kong being its dominant trade partners – any recessionary headwinds in these regions or heightening political decoupling between China and the US would impose great costs on Taiwan's trade balance. For instance, in light of the Chinese seafood ban, many seafood exporters are focussing on untapped markets such as Thailand, but export diversification provide limited relief due to the long time required to fully open up new markets.

Figure 9: CBC benchmark interest rate



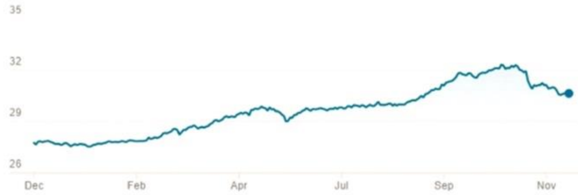
Source: Tradingeconomics, Central Bank of the Republic of China

Figure 10: 3-Month interbank rate



Source: Tradingeconomics, Directorate General of Budget, Accounting and Statistics

Figure 11: USDTWD



Source: Refinitiv

Figure 12: TAIEX performance

Source: Tradingview

Figure 13: TSM performance

Source: Tradingview

"Silicon Shield": Semiconductor industry

Taiwan's semiconductor industry currently worth USD 127 billion and accounts for 15% of its GDP. Semiconductors are crucial factor inputs for developing advanced technologies and has at the same time become tokens for strategic national interest because any restrictions on access to advanced semiconductors would hinder innovation progress in digital technologies. Because of Taiwan Semiconductor Manufacturing Company's (TSMC) advancement in semiconductor production technology and dominance in the global market, the semiconductor industry is also known as Taiwan's silicon shield that gives the nation bargaining power to navigate through the political scene. The industry grew by 26.7% in 2021 due to strong demand for electronic gadgets for remote work during the pandemic; its growth is expected to moderate at 15.6% and 6.1% in 2022 and 2023 respectively, attributing to the constantly growing demand for new technology despite the pessimistic global economic outlook and the roll-out of US-China trade sanctions. TSMC's business growth remains solid, with its profits increasing by 80% in Q3 and beating market expectations. This demonstrates the strategic importance of TSMC's advanced technologies (5nm and 7nm semiconductors) in placing it front and centre of any country's artificial intelligence and economic digitalization strategy.

Provided that the governments' demands for advanced chips for implementing their digital transformation strategies are relatively less cyclical, and that TSMC's manufacturing technology leadership in nanoscale semiconductors will hardly be surpassed by other foundries in the short to medium term, the semiconductor industry will continue to experience solid growth in the coming year unless semiconductor trade bans between US and China increase drastically in terms of the coverage of banned trade products.

In October, the US has just implemented a new round of semiconductor bans on China, prohibiting Taiwan from selling semiconductor manufacturing equipment and advanced chips to Chinese companies. On the other hand, TSMC has recently constructed fabrication plants in Arizona, US. With plans for TSMC to expand the construction of plants in Japan and Europe, there are increasing concerns of losing employment opportunities in Taiwan and causing Taiwan's sole strategic competitive edge to diminish upon exporting its advanced technologies to other countries.

Mild rate hikes

Compared with the US and other major economies, Taiwan's rate of monetary policy tightening has been relatively mild. The Central Bank of the Republic of China (CBC) has raised its benchmark interest rate three times this year, with the most recent increase being 12.5 basis points from 1.5% to 1.625% this September (Figure 9). A mild 12.5 basis point rate increase is expected this December. The benchmark rate has been stable at 1.125% during the pandemic, making this is the first rate hike after 2010.

The reserve requirement ratio similarly increased twice this year, from 4% to 4.25% in July and to 4.5% in October. From Figure 10, 3-month interbank rate also underwent multiple increases, more than doubling the rate in July as of December, to 1.23%. The huge rate differential between the US and Taiwan results in a year-on-year

10.4% depreciation of the Taiwan Dollar against the Dollar (Figure 11), serving as an upside factor for its exports.

Taiwan's external debt increased from Jan 2021 onwards, and recently dipped slightly to USD 226.4 billion. Its foreign reserves are currently at USD 552.2 billion, which is ample to service its external debt.

Overall slumping equity market with recent recovery

The Taiwan Stock Market Exchange's (TSME) benchmark index, TAIEX, has tumbled by 32% from its high at 18598 in January to 12666 in October, in tandem with the slump in the US stock market (Figure 12). In light of the continuous slide of Taiwanese stock performance, the Financial Security Commission (FSC) tightened bans on the short selling of selected stocks on the TSME for multiple times in order to stabilize the markets, including raising the minimum securities financing deposits.

The TAIEX has then been rebounding since early November. The recovery is due to the waning of recessionary fears with a less hawkish stance by the Federal Reserve board (Fed) – a 75 basis point rate increase in November contrary to the expectation of 100 basis point hike. With a slight weakening of the US Dollar, concerns about capital flight out of Taiwan have also subsided. Additionally, with TSMC being one of the dominant stocks with high composition in TAIEX, the recent pickup in TSMC's stock performance has also contributed to the rebound in TAIEX. Improvement in TSMC's stock performance in November (Figure 13) is largely due to its better-than-expected business performance amidst the weak recessionary global macroeconomic outlook. TSMC's October sales growth rate was at 56%, and its Q3 profit growth is at a remarkable rate of 80%.

As inflation worldwide is anticipated to moderate next year, the less intense rate hikes adopted by major central banks, i.e. the Fed, could facilitate a gradual recovery of main stock markets. This creates a spillover effect on TSME, providing relief to slumps in major stocks listed on TSME.

Diplomatic relations

<u>Caught in between China and US</u>

China has always been firm on its stance that Taiwan is an inseparable part of China, and that possibilities of China regaining its sovereignty over Taiwan with military action are not impossible. On the other hand, the US has been walking a diplomatic tightrope with its Taiwan policy. Some recent political measures implemented by the US include US House Speaker Nancy Pelosi's visit to Taiwan in early August, US's semiconductor ban on China, TSMC's construction of fabrication plant in Arizona, and most recently US's approval of military sales to Taiwan. China has responded in dissatisfaction and retaliates by not only taking action on American officials but also on Taiwan, including imposing export bans on Taiwanese products and sending nuclear-capable bombers to the Taiwan territory. This results in an especially tricky situation for Taiwan where it is not strategically favourable to explicitly pick sides. However, with Kuomindang's recent victory in local elections, Taiwanese policies may be slightly more inclined towards the pro-China side.

Tech diplomacy

The rising geopolitical tensions worldwide and the Covid-19 pandemic have showcased how uncertainties act on supply chains, hence creating wake-up calls for governments and enterprises to upgrade their supply chains. This in turn creates new trade and diplomatic opportunities for Taiwan. For instance, Taiwan has already started investing in relationships with Eastern and Central Europe and signed trade agreements with Baltic states like Lithuania. Foxconn is also entering a collaboration with Indian companies to build India's first semiconductor fabrication plant.

Figure 14: USDTWD Daily Chart

Source: Tradingview

Figure 15: USDTWD MACD chart

Source: Tradingview

Long USDTWD

Pivots

Inflation in the US peaked at 9.1% in June and slowed down to 7.7% in October. Despite an expectation of slowed interest rate growth of 50 basis points by the Fed in January, the Fed Funds rate is nonetheless expected to peak at 5% in 2023 to tame inflation. On the other hand, inflation in Taiwan is relatively mild, ranging from 2% to 3% every month in 2022. The benchmark rate hikes in Taiwan have therefore been mild this year, with the CBC rate projecting to peak at 2% in the first half of 2022. The large interest rate differential between the two countries is the key driver behind the continuous overall depreciation trend of the Taiwan dollar against the US dollar.

Risks

1. Monthly release of lower-than-expected CPI or PPI in the US could cause the USD to temporarily weaken amidst the appreciation trend.
2. Loss of investor confidence in the US economy in case of a subpar US economic performance, weakening the USD.

Technical analysis (Figure 15)

From the MACD chart, the signal line is about to cross the MACD line from below at 30.707, indicating a buy signal. We are looking to enter a long position at 30.707 and take profit at 32.386, the resistance level in late October. The stop loss level is at 29.86, which is the next support level (August) after the first support at 30.477 (December).

Entry: 30.707
Take Profit: 32.386
Stop Loss: 29.86
Risk Reward Ratio: 1.98

Disclaimer

NUS INVESTMENT SOCIETY

Global Macro Department – Japan (UNDERWEIGHT)

Date: 15th December 2022

Analysts

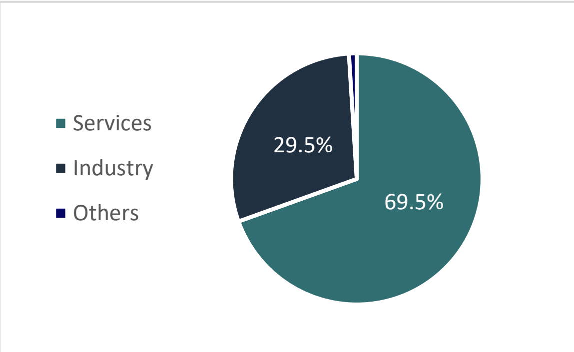
Fang Xinzhe
Global Macro Analyst
fang.xinzhe@u.nus.edu

Basic Information

Real GDP Growth Rate Q3 YoY	1.5%
October Inflation Rate YoY	3.7%
October Trade Balance	-15.4b USD
USD/JPY	137.1
November Con. Confidence	28.6
Nikkei 225	27901

Chart info

Figure 1: Breakdown of GDP by Sector



Source: Cabinet Office, Japan

Overview of Japan's Economy

The Comatose Giant

As the pioneer of Asian economic miracles, Japan boasts a highly developed and complex, service-based economy that is the 3rd largest in the world. Consumption drives the main bulk of growth in Japan, accounting for upwards of 50%. The biggest contributors to GDP are the services and industry sector, coming in at 69.5% and 29.5% respectively. However, while developed, Japan's economy has been in a state of stagnation for a while now, even after an unprecedented amount of stimulus.

Unexpected Inflation

Surprisingly, inflation has befallen Japan, given the deflationary mindset that characterized Japanese society and its economy in the past few decades. As a result of soaring energy prices and supply chain disruptions, bottom lines have fallen and businesses have finally decided to pass on some cost increases to consumers. Despite this, the Bank of Japan has elected to maintain its monetary easing in the form of yield curve control, placing bets on the fact that inflation is transitory.

Summary of events in the past 6 months

- Between March and October this year, USDJPY plummeted from a stable 112-116 range all the way to a 30 year low of 151, prompting the Bank of Japan (BoJ) to intervene multiple times in order to halt its descent. Following a better-than-expected US inflation report in November, the Yen recovered back to the 140 range, where it currently hovers.

- On 28/10, Kishida unveiled a fiscal package worth 440b USD that aimed to subsidize household electricity costs by up to 20%, alongside a host of other benefits. The package is slated to run up to September 2023.

- Kishida's popularity has progressively gotten worse, reaching unprecedented lows of 27.4% in October. This is due to public perception that Kishida's policies are hurting the economy, as well as his personal connection to the controversial Unification church.

- Japan's October inflation rate of 3.7% is the highest in 30 years, stemming from high energy costs due to both geopolitical reasons as well as the weak Yen raising overall costs for imports.

- Apart from its participation in sanctions over Russia over the Ukraine war, Japan is also increasingly being swept into the US-China conflict over the semiconductor industry, all the while under the pervasive concern of the missiles North Korea keeps lobbing flying astray.

- The BoJ's strict adherence to their yield curve control (YCC) policy has also resulted in an immensely distorted bond market, where upwards of 70% of long-term Japanese government bonds (JGBs) are being held by the BoJ. Bond market illiquidity is at an all-time high. While BoJ governor Haruhiko Kuroda has said that an eventual pivot was inevitable, it would not be undertaken before a satisfactory level of economic growth had been achieved.

- Japan's tourism industry experiences a hopeful resurgence as international borders fully open and Covid management measures are eased even further.

- Japan continues to navigate choppy waters as the de-facto chair of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership regarding membership of China and Taiwan, amidst heightening tensions across the Taiwan Strait.

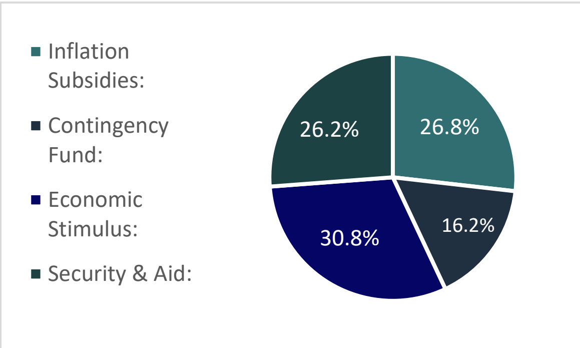
Kishida's Cabinet - A Dovish Peek into the Future

Kishida's ascent to prime minister promised improved levels of wealth distribution so as to expand the middle class, which he has attempted to deliver through policies such as higher capital tax gains and tax incentives for companies that delivered consistent wage increases. However, his main focus remains to pull Japan's economy out of its current sluggish state, which has been exacerbated first by the Covid pandemic, then by the geopolitical instability brought by the Ukraine war.

While Kishida has publicly denounced 'Abenomics', he has remained consistent in his message that he wants to improve growth by ensuring a 'virtuous cycle' of wage growth and thus increased spending. It is certainly a contrarian move in a slowly global economy, where advanced countries are cutting back on spending to rein in inflation. Yet, in the case of Japan, a detraction from stimulus could prove to be more problematic than inflationary pressures. Japan's chronic deflationary mindset entails a dangerous risk- that any contractionary policy could kickstart a second lost decade.

Thus, Kishida is forced to choose the lesser of two evils. In any case, a sudden backtrack would also not bode well for his political standing and most likely push an already record low approval rating of 27.4% further down into the gutter.

Figure 2: November 2022 Extra Budget



Source: Ministry of Finance, Japan

To that end, Kishida has delivered multiple extra budgets, the first in November 2021 to stimulate the economy in response to the recession brought about by Covid and two more in May and November 2022 to cushion the blow dealt by imported inflation stemming from the weak yen. The budgets are valued at 257b USD, 20b USD and 207b respectively. We can expect Kishida to continue with his expansionary fiscal policy into 2023 as the Japanese government rides on hopes that inflation proves to be transitory and the dirge of stagflation does not ring true. While the budget for fiscal year 2023 is likely to be smaller than that of 2022 in view of the return to post-pandemic normalcy and the ballooning government debt, we can expect it to still be sizable enough to deliver growth, particularly in the area of domestic consumption.

Bank of Japan and the Yield Curve Control

For all intents and purposes, yield curve control in Japan is here to stay, at least until there is stable, consistent economic growth accompanied by wage increases. Ever since the lost decade, the BoJ has been obsessed with using yield curve control as its stimulus tool, characterized by negative interest rates and large volumes of direct asset purchases from the Japanese government. Even as the world economy begins to slow and other major economies begin to tighten up to fight inflation, Japan has maintained its ultra-loose monetary policy in stark contrast against the world. This divergence has led to capital outflows from Japan as investors saw better returns elsewhere, ultimately leading to the Yen's collapse.

Figure 3: 10-Year JGB Yields, %

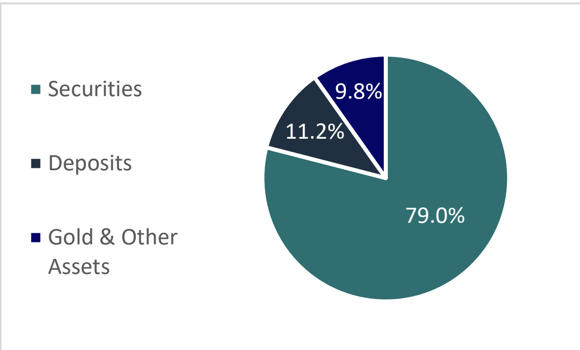
Source: TradingView

With the world economy looking to stagnate in fiscal year 2023 as the full weight of interest hikes all across the globe catches up, it is extremely unlikely that we will see a pivot in BoJ policy, especially since the Japanese economy itself is extremely vulnerable to global headwinds, with exports consisting of a significant portion of their GDP, as well as their large reliance on energy imports. While there have been policy adjustments to improve nuclear energy output, it is far from allowing Japan to become self-sufficient, which will ultimately lead to a slowdown in the manufacturing sector. With such a context in mind, it is hard to see a world where the BoJ can achieve its economic goals without flooding the economy with cheap capital.

Figure 4: USD/JPY

Source: TradingView

Figure 5: Japan's Foreign Reserves, November



Source, Ministry of Finance, Japan

<u>The slumping Yen:</u>

While this policy maintenance is sure to bring about a weakness in the Yen, with the USDJPY having collapsed to a 30 year low recently after the divergence between the BoJ and Federal Reserve's monetary policy caused a sharp outflow of capital from Japan, we believe the worst has already come to past. This is because the US' expected pivot towards dovishness, coupled with the beginnings of a global recession, will raise the overall demand for the Yen, driving up its price. While the US dollar and Swiss franc are also considered safe haven currencies, the potential upside for both of them are much less compared to the Yen, which should cause the Yen to be the preferable option for investors.

The BoJ's clear hard-line policy regarding the Yen's strength should also restrict the Yen from falling back down to its previous lows, as investors price in potential interventions. While the BoJ is not necessarily overly concerned about a weak Yen, it has also stated that any depreciation not in line with Japan's economic fundamentals will be dealt with. The BoJ has intervened multiple times in the past 4 months, both publicly and stealthily, expending over 200b USD to do so. It still wields over a 1.2 trillion USD in foreign reserves that it could use to prop up the Yen as it sees fit, which, while not inexhaustible, should be more than sufficient to tide them over into a world of monetary easing.

<u>Into the Future:</u>

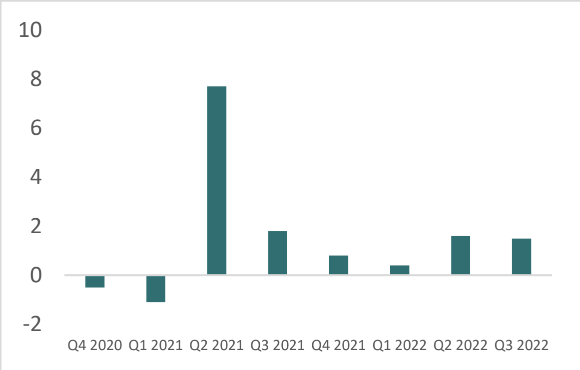
As such, we believe that the BoJ will maintain its current policy of capping bond yields at 0.25% and interest rates at -0.1%. While this can stimulate domestic economic growth, it leaves Japan extremely vulnerable to external conditions, especially as central banks worldwide continue their rate hikes. It is entirely possible that any gains accrued by the loose policy at home will be offset by crippling energy and heightened commodity prices abroad, a grave concern to an economy primarily driven by domestic consumption and exports.

However, this is not to say that yield curve control is here to stay forever. The BoJ has stated that they have been examining ways that they can exit the policy without overly straining the economy. Nevertheless, we do not foresee this event happening before fiscal year 2024, due to the global climate and the immense difficulty of executing such a drastic policy shift. The BoJ's historical dovish bias towards monetary policy will undoubtedly exacerbate the backlash towards this comparatively hawkish pivot, leading to inevitable pains that will require delicate handling.

Japan's Economy - Weathering the Storm

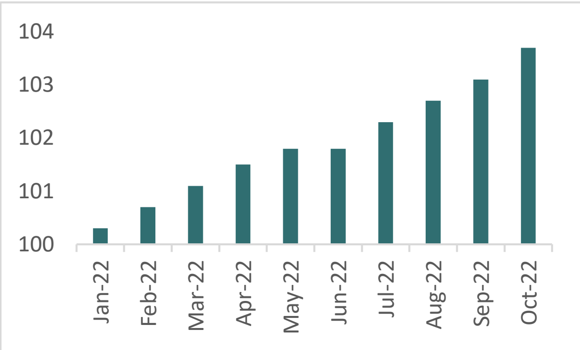
Japan's current economic condition is best described as beleaguered, as it continues to endure external blows and stave off internal predicaments. Even as its economy faces weak growth, with real GDP growth in Q3 being reported at 1.5%, it also suffers from unprecedented levels of inflation unseen since 2015 at 3.7% in October. While a low figure by global standards, it is alarming for Japan due to the deflationary inclination of the economy and population. The economy also runs the real risk of stagflation, where prices rise while

Figure 6: Japan's GDP Growth Rate, %



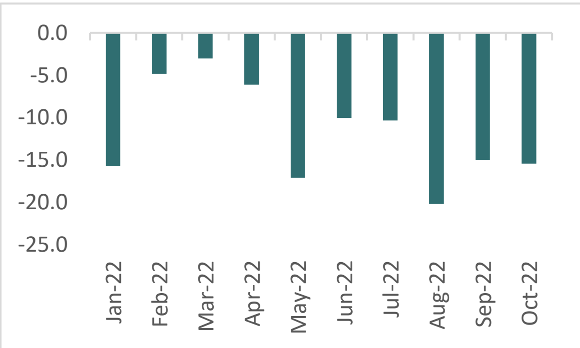
Source: TradingEconomics

Figure 7: Japan's CPI



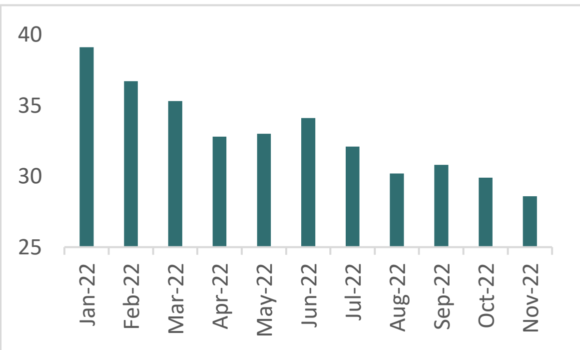
Source: TradingEconomics

Figure 8: Japan's Trade Balance, Billions USD



Source: TradingEconomics

Figure 9: Japan's Consumer Confidence



Source: TradingEconomics

growth stagnates, if imported inflation persists while consumers balk at high prices and cut spending.

The main source of inflation comes from a rise in energy prices, stemming from elevated crude oil prices due to the economic sanctions that were imposed on Russia over its initiation of the Ukraine war. As a major oil importer, Japan imports over 90% of its required crude and relies heavily on crude oil for its energy source for both household and manufacturing consumption. The sanctions delivered near-immediate shocks to Japan's economy as the inflation rate doubled from 1.2% in March to 2.5% in April. The weak Yen during this period due to a divergence of monetary policy from the world worsened the situation by further raising costs of crude oil and other imported goods such as minerals and integrated circuits. With the BoJ's strict adherence to the yield curve control, there are also no measures in place to limit actual inflation. Rather, the government is providing subsidies to consumers to assist them in weathering out the storm.

Japanese exports are also much weaker in the face of slowing global demand, contributing to a trade deficit of 15.4b USD in October. As interest rates increase, consumers are turning away from big ticket items such as automobiles, which Japan is a large exporter of. The shift in global sentiment to environment conservation also plays a part in shifting demand from gasoline-run vehicles to their electric counterparts, an industry which Japan is not a major player in. While the weakening Yen does serve to boost exports, Japan's manufacturers import large quantities of intermediate components such as integrated circuits and plastic articles to be used in manufacturing processes, thus driving up cost of final products and reducing effect of the weak Yen.

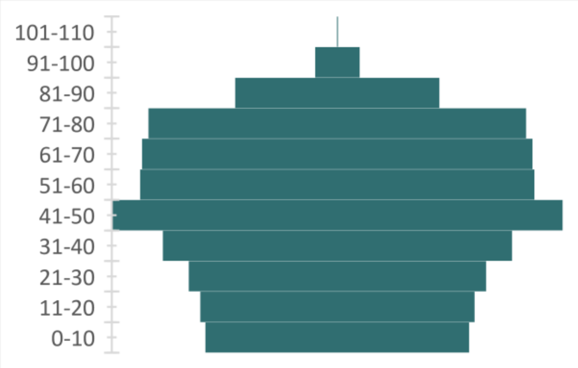
Japan's Population Woes:

While weak to negative growth is to be expected in economies with contractionary monetary policies, it is rather surprising in Japan's case given how aggressively expansionary the BoJ's policy is. With the yield curve control, the access to practically free loans should spur domestic consumption and investment, but yet there has been no manifestation of tangible results. This is primarily due to the nature of Japan's consumers, which drive a heavy portion of growth. Japan's shrinking population leans heavily towards the conservative side, with persistently low consumer confidence as well as unmatched fiscal prudence that culminate in a situation where even when they have the ability to spend, they prefer to save up for a possible rainy day. This can be seen from the 12-month low consumer confidence of 28.6 in November and the high household savings rate of 29.5% in October.

Additionally, the Japanese companies' preference for the status quo also worsens matters. While they are inclined to shy away from raising product prices, they also don't tend to raise wages, as seen from the consistent fall in inflation adjusted wages over the past few months, with the most recent fall of 2.6% in October. This brings about an adverse cycle to the economy, whereby persistently low wage growth erodes consumer willingness to spend, preventing significant growth, which in turn circles back to poor financial performances and hence low wage growth.

The severely aging Japanese population also serves as a prominent obstacle to growth. Japan's median age of 48.6 is the second oldest in the world and they have a ridiculously low birth rate of roughly 7.1 births per thousand people. This entails a gradually shrinking labour

Figure 10: Japan's Population Pyramid



Source: Statistical Bureau of Japan

force which eats away at both actual and potential economic growth, with less people working to produce growth and little spare manpower available for expansion even when desired. This is most evident in Japan's agricultural industry, where there is a succession crisis for aging farmers as the younger generation is either absent or unwilling. As the Japanese government scrambles to increase food security in the face of supply chain uncertainties, they face a challenge in increasing food production even with the application of advanced machinery and robotics simply because there is a lack of people willing to enter the industry.

<u>The Liquidity Trap:</u>
All indicators point towards the fact that Japan is embroiled in a liquidity trap situation, where monetary policy is ineffective and further liquidity injections have no effect. The population's stubbornly conservative mindset borne from Japan's lost decade, while having improved in the early 2010s, immediately regressed following the Covid pandemic. Yet, we believe that this current situation in Japan is temporary, and is merely due to the rather unfortunate combination of a pandemic and a global slowdown, rather than a return to Japan's old ways.

<u>Into the Future:</u>
We are of the opinion that there are ample growth opportunities for Japan moving forwards into fiscal year 2023. The BoJ and Japanese governments' loose monetary and fiscal policy ensures that there is easy access to capital for businesses seeking to expand and consumers seeking to purchase, with government cash handouts being a significant portion of Kishida's fiscal packages. As the world shakes off the dredges of Covid, tourism should also rebound in response to the pent-up demand of travellers worldwide. Japan, being a premier tourist destination, is well poised to respond to this demand, with foreign borders having opened up and most restrictions eased in October. Additionally, China's loosening Covid policies of shortened quarantines upon arrival bodes well for Japan as it could increase the number of Chinese tourists, historically a large portion of tourists visiting Japan.

In line with BoJ governor Kuroda's opinion that inflation is transitory, we similarly believe that inflationary pressures should begin to subside in fiscal year 2023 as the Yen begins its path to appreciation. Forex markets should account for the slowing pace of interest rates rises worldwide, which should lead to a weakening of respective currencies as the market corrects expectations. Additionally, the restructuring of supply chains should be nearing completion as new agreements regarding crude oil between Russia and non-sanctioning countries are hammered out, leading to the resumption of original levels of crude oil supply, driving prices down. The slowing global economy should also reduce the demand for crude oil, with the clearest example being China, where disruptions due to stringent Covid policies and generally negative sentiments have resulted in diminished crude consumption. With Japan poised to be the only major economy aiming for significant growth in fiscal year 2023, we believe it has significant ability to take advantage of this incoming opportunity for cheap crude and deliver a double whammy in terms of both curbing inflation as well as stimulating growth.

Hostility Overseas

Japan's Conundrum:

The unspoken position of Japan as the de-facto leader of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) continues. The CPTPP is one of the largest free trade areas by GDP size, accounting for roughly 13.4% of global GDP at 13.5 trillion USD, and is composed of eleven signatories, with highly developed economies such as Australia, Canada and Singapore. The contentious matter with the CPTPP comes with the near simultaneous applications by China and Taiwan- China's on 16th September 2021 and Taiwan's just 6 days later.

While the addition of new members will require all eleven current signatories to accede, Japan undoubtedly has very large sway and the final say over new members. Internationally, very few countries recognize Taiwan as a sovereign entity, despite it functionally being one. This murky status quo has served the world well for the past few decades- China being content to "officially" own Taiwan and Taiwan enjoying its own democratic autonomy. However, in recent times, China's stance has turned increasingly belligerent in response to Taiwan's foreign policy, such as the hosting of US House speaker Nancy Pelosi despite strong objection from China. Japan thus has to make a difficult choice- accepting Taiwan into the CPTPP, which entails recognizing Taiwan's sovereignty and facing China's wrath, or rejecting Taiwan and lose out on large economic benefits that free trade with Taiwan would bring, given their status as the world's largest producer of semiconductors.

It is implicitly agreed upon that the application from China wouldn't be accepted, given their penchant for protectionist policies and poor industrial environmental and labour standards. It is unlikely that Australia, nor Mexico, would agree to China's application in either case due to existing trade disputes between the countries. Thus, the question ultimately comes down to whether Taiwan's bid will materialize.

Our analysis of Japan's current geopolitical situation indicates that it is highly unlikely that Japan will permit Taiwan's entry into the CPTPP. While Japan is closely allied to the US, which has recently exhibited signs of hawkishness over Taiwan, Kishida's cabinet is ultimately dovish in terms of foreign policy and has eyed rehabilitation of relations with China even as the dispute over the Senkaku Islands persists. Acceptance of Taiwan into the CPTPP is rather serious provocation, something that will be very uncharacteristic of Kishida's cabinet, given that they were unwilling to even use the word 'threat' to describe China's military actions in their economic zone. Additionally, Japan is also dependent on China for its growth, with China consuming a significant portion of their exports, as well as comprising a large portion of Japan's tourist makeup. With Kishida's focus on economic recovery, it is highly unlikely that he will shoot himself in the foot by provoking China and guaranteeing retaliation.

Figure 11: USDJPY Daily Chart

Source: TradingView

Trade Idea – Short USDJPY

We would like to propose a tactical short on the currency pair USD/JPY following the US' positive CPI report in November that sent the dollar tumbling. While we are of the opinion that the Yen is currently at a rather appropriate level given current economic conditions, we also believe that there is a temporary dollar weakness that we can exploit. Since the Yen is overly cheap as compared to its intrinsic value as a safe haven currency, backed by one of the strongest foreign reserves in the world, we see the Yen as the prime target for forex strategies relating to the dollar.

Given the US' expected slower pace of rate raises going forwards, it is likely that we will see a short-term fall in the price of the dollar as the market prices in expectations of a full halt and an eventual reversal. We aim to exit from the trade near the end of the first quarter, before the final decision over how long rates will be maintained begins its influence on the dollar strength

The Yen also has the ability to strengthen further, especially as investors weigh in the expectations of a new BoJ governor after Kuroda's second five-year term comes to an end in April 2023. Since Kuroda has publicly said he has no intention to be re-elected for a third term, sentiment surrounding a pivot of BoJ policy with the election of a new governor have grown stronger. However, we are reasonably certain that the status quo of monetary easing will be maintained as ultimately, Kishida has the power to nominate the next governor. As such, we aim to exit from the trade before market corrections from dying expectations push the Yen back down.

Given that the USD/JPY pair is on a downtrend, the overbought territory of the relative strength index will be lower than the typical 70. As such, even as the indicator hovers near the oversold territory, we believe that the currency pair has potential to fall further. However, in the extremely short term, it is likely that the currency pair has a tendency to strengthen in line with a dead cat bounce. As such, we shall enter the trade only when the currency pair hits its recent high of 139. Our stop loss will be above the upper resistance level at 141 and our take profit will be the support level at 133. The trade has a risk reward ratio of 3.

Entry: 139
Take Profit: 133
Stop Loss: 141
Risk Reward Ratio: 3

Disclaimer

NUS INVESTMENT SOCIETY

Global Macro Department – South Korea (UNDERWEIGHT)

Date: 15th December 2022

Analysts

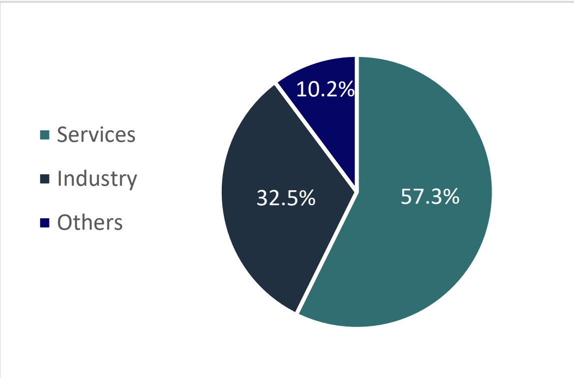
Fang Xinzhe
Global Macro Analyst
fang.xinzhe@u.nus.edu

Basic Information

Real GDP Growth Rate Q3 YoY	3.1%
November Inflation Rate YoY	5%
November Trade Balance	-7b USD
USD/KRW	1303.8
November Con. Confidence	86.5
KOSPI	2389

Chart info

Figure 1: Breakdown of GDP by Sector:



Source: World Bank

Overview of South Korea's Economy

The Miracle on the Han River

As one of the four Asian Tigers, South Korea's transformation from a rural, agrarian economy to one characterized by industrial efficiency and advanced technology is nothing short of a miracle. Consumption drives the main bulk of South Korea's economic growth, accounting for upwards of 60%. South Korea's GDP is predominantly composed of the services and industry sectors at 57.3% and 32.5%, while exports of electronics and semiconductors chip in another significant amount. It ranks overall as the 12th largest economy in the world.

Expected Inflation

Like most advanced economies, South Korea currently suffers from inflation borne from the reopening from Covid and the effects of the stimulus that has been pumped into the economy. The Bank of Korea and Yoon's government have taken steps in tandem to mitigate this problem by raising base rates and reining in the fiscal budget. Yet, it remains to be seen whether the measures are adequate in a world where the global economy is similarly battered.

Summary of events in the past 6 months

- Between March and October this year, USDKRW plummeted from the 1220 range all the way to a 13 year low of 1440. While this fall has not prompted direct action from the Bank of Korea (BoK), it increased the frequency of verbal interventions by officials in forex markets as they attempted to suppress what they saw as an unjustified depreciation of the Won.

- The BoK has been raising interest rates consistently over the past year, up to the current rate of 3.25%. Its latest raise was for 25 basis points in November. Further rate hikes are expected to follow as South Korea continues to grapple with rather high inflation.

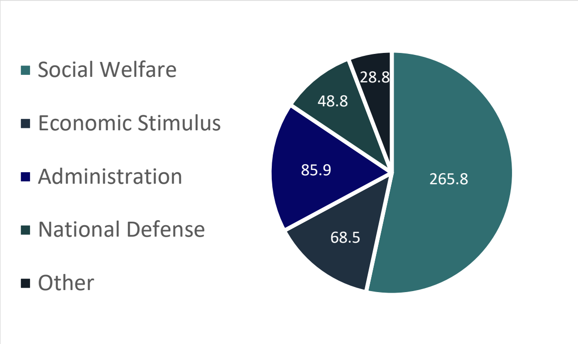
- President Yoon's popularity is at an all-time low as a personal lack of charisma coupled with a series of international gaffs weighed on his approval back at home. His government's response to Itaewon's Halloween tragedy further exacerbated this disapproval, with unsatisfactory police response being a key factor.

- A concerning default by a Legoland theme park operator over a bond payment backed by the local government strikes fear into bond markets, threatening instability and wider contagion.

- South Korea is directly drawn into the intensifying competition over the semiconductor industry between China and the US, which threatens their country's growth as their own semiconductor industry is caught in the crossfire.

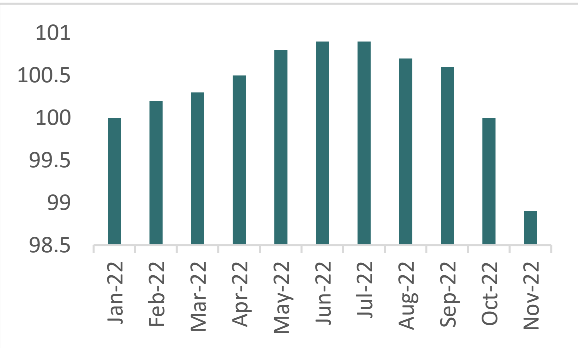
- South Korea's trade has been at a deficit for 8 months now, the longest since the Asian Financial Crisis. This is primarily due to a weaker Won and expensive imported energy.

Figure 2: 2023 Budget Proposal, Billions USD



Source: Ministry of Economy and Finance, S. Korea

Figure 3: S. Korea's Housing Index



Source: TradingEconomics

Yoon's Cabinet - A Hawkish Peek into the Future

In view of rising inflation and the wake of the Covid crisis, South Korea's government has decided to rein in its budget for fiscal year 2023, cutting spending by 6% compared to fiscal year 2022. It seeks to achieve this by shifting some projects into the public sector, as well as trimming the fat off the salaries of top-ranking bureaucratic officials. The main focus of the budget is to ensure the population is shielded from soaring energy prices and protect vulnerable industries from adverse international conditions.

One of those is the shipping industry. The government plans to invest 2.3b USD into the shipping industry to protect it from the slump brought about by recessionary headwinds. The funds would be utilized to digitalize the industry as well as improve the environmental impact it brings, with expected gains of more than 6b USD by 2027. Since South Korea is rather dependent on trade as a driver for its economic growth, with exports totalling to 42% of their GDP, the investment will prove timely in shoring up cost weaknesses to maintain profit margins in a slowing global economy.

The government has also expanded investment into technology start-ups, emphasizing its perceived importance of forging South Korea into a leading, tech-based economy. The 1.4b USD package distributed to roughly 1000 start-ups is the largest in recent years, partly in response to the eroding competitiveness South Korea once enjoyed as other countries such as China and the US caught up.

Credit Struggles:

South Korea's housing market is a stark reflection of the wider economic conditions within the country. Due to higher interest rates, expenditure on housing has fallen considerably, causing the housing market to abruptly shift from red-hot to floundering. Floating mortgage rates have soared, leaving consumers strapped for cash. As consumers are battered twinfold from rising energy prices and mortgages, the likelihood of defaults increases. This could lead to a financial crisis if unchecked since South Korea's household debt is a staggering 105% of its GDP. A string of defaults could lead to banks being less willing to lend, leading to a credit crunch that could sink South Korea into a recession.

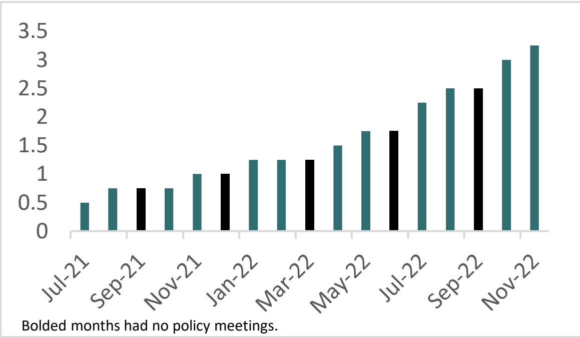
South Korea's credit market also faces significant challenges in the current economic landscape, as seen by how the default of a USD150m bond payment in September by a Legoland theme park operator immediately sent shockwaves through the bond market. This situation was exacerbated by the Gangwon government, the province the park is located in, who suggested it would renege on its guarantee over the bond payment by taking the park operator into court receivership, essentially leaving the operator to independently gather funds to repay the bond payment itself. The credit rating for the Gangwon government was downgraded from 'A1' to 'D' overnight by various credit rating agencies, even after the government retracted its words and promised to repay the debt. This event cast doubts on other similarly rated bonds such as bonds issued by state-owned companies and offshore bonds, causing yields for top-rated 5-year corporate debt to jump by as much as 157 basis points in the three months through October.

The South Korean government's timely response in tandem with the BoK ensured that the tremors didn't trigger a full collapse of the credit market. They unveiled a 35b USD aid package to inject liquidity into the market and expanded the range of bonds commercial banks can use as collateral for loans. However, the rate raises being undertaken by the BoK ensures that while a financial crisis may be avoided, a slowdown of the economy is inevitable as investments dry up from a lack of credit.

Bank of Korea – In Tandem with the World

In line with the US and other major economies, the BoK has been raising rates to fight inflation back at home precipitated by a surge in consumption and investments following the post-Covid economic reopening and slew of stimulus checks. It has consistently raised its base rate for the past year, starting from August in 2021, with the latest raise being in November by 25 basis points. The base rate currently sits at 3.25% and is slated to further increase as inflation remains considerably hot.

Figure 4: Bank of Korea's Base Rate



Source: Bank of Korea

The BoK has forecast a slowdown of South Korea's economic growth, down from 4% in 2021 to 2.6% and 1.7% in 2022 and 2023 respectively. The acceptance of this slowing growth demonstrates the BoK's commitment to curbing inflation as its' number one priority, which should result in a fairly consistent monetary policy going into fiscal year 2023, where heightened rates will be maintained until inflation falls below the target of 2%. Additionally, BoK governor Rhee Chang Yong's recent election to the position ensures that there will be no abrupt policy shift due to differing ideologies in the upcoming year, further ensuring a consistent forward guidance.

While the raised rates are in line with the actions of the US' Federal Reserve, the Won has nevertheless slid to a 13 year low against the dollar, with the USDKRW peaking at 1440. This is mainly due to the moderate rate at which the BoK raised rates as compared to the aggressive rate raises conducted by the Federal Reserve. Additionally, weakening global demand for South Korean imports have also reduced the demand for the Won, leading to further depreciation. While the BoK has not directly intervened in forex markets, it has stepped up checks on forex traders and conducted verbal intervention to dissuade large short positions against the Won. There also remains the option of renewing a currency swap option with the US at a fixed USDKRW which would bolster the strength of the Won should there be a need to.

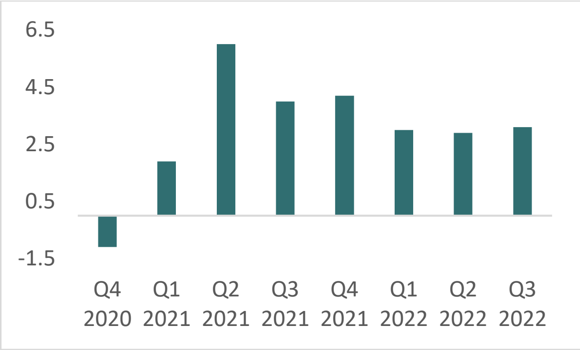
Figure 5: USD/KRW Daily Chart

Source: TradingView

Decent Growth, Indecent Inflation

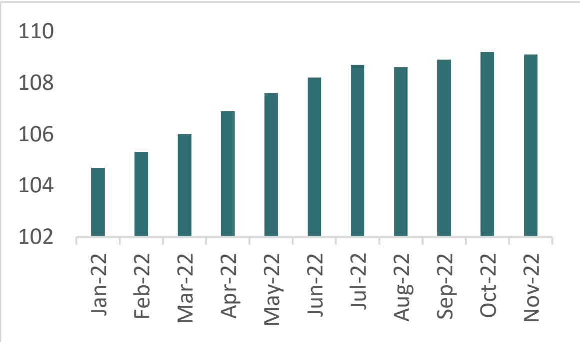
South Korea's 3.1 real GDP growth in the 3rd quarter, while decent in a vacuum, is tarnished by the high inflation that comes accompanied with it. The latest November inflation reading of 5% year-on-year is far beyond acceptable range and affects all sectors, ranging from food and utilities to transportation and services. The most prominent increase comes from energy, which rose 7.3 year-on-year due to the elevated crude oil prices that occurred as a result of the Ukraine war. South Korea imports roughly 95% of the crude oil it consumes and derives 43% of its energy from crude, demonstrating the extent of the impact that expensive crude has on inflation. Additionally, overheated demand due to Covid stimulus mixed with choked supply chains undoubtedly contributed to the rise in prices of food and household items.

Figure 6: S. Korea's GDP Growth Rate, %



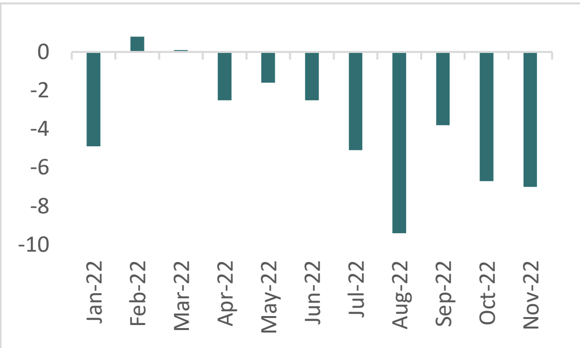
Source: TradingEconomics

Figure 7: S. Korea's CPI



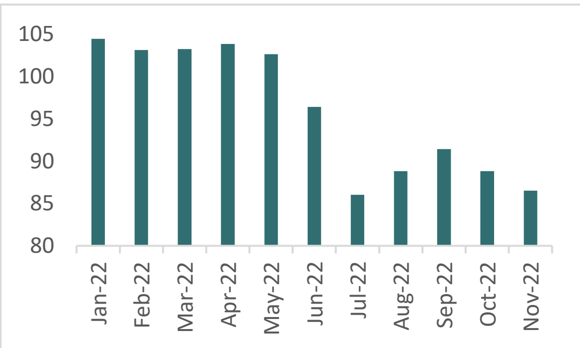
Source: TradingEconomics

Figure 8: S. Korea's Trade Balance



Source: TradingEconomics

Figure 9: S. Korea's Consumer Confidence



Source: TradingEconomics

Nevertheless, we do not expect inflation to remain persistently high. The BoK's commitment to curbing inflation through base rates will directly reduce demand-pull inflation, while the ironing out of global supply chains, particularly that of Russian crude, will reduce cost-push inflation. While numerous countries, including South Korea, have sanctioned Russian crude, major importers such as China and India have opted not to do so, and are instead purchasing Russian crude at massive discounts. As such, the overall global supply of crude has not decreased significantly, which should cause a fall in crude prices once new supply agreements are hammered into place. With these factors in mind, it is rather plausible that inflation will fall back to the acceptable level of 2%.

South Korea's economic growth in the 3rd quarter is mainly bolstered by strong demand for consumer goods, as well as a strong entertainment and services sector that benefited greatly from the post-Covid reopening. The growth in the two areas is 1.5b USD and 2.3b USD respectively. However, we foresee the growth to falter due to slowing demand overall, particularly internationally, where consumers from large importers such as the US and China cut back on spending. The smaller fiscal budget for 2023 and heightened base rates will cause capital to become tighter, reducing the amount being borrowed for investments and consumption of big-ticket items. Domestic consumption for general goods and services are also expected to slow as stimulus packages dry up. The overall negative sentiment surrounding the economy should also have an effect on expenditure as consumers tighten up over expectations of worsening financial conditions. This can be seen from the composite consumer sentiment index generated in November of 86.5, which is a 4-month low.

Interestingly, while South Korea has run a trade deficit for 8 months now, the longest streak in more than 20 years, it is not due to export weaknesses, but rather soaring import costs mainly attributed to crude, which increased by 34% in November. South Korea's exports grew 7.8% in the past eleven months compared to 2021, while imports grew remaining particularly competitive in the automobile and petroleum products sectors, which increased by 31% and 26% respectively in November. These sectors are core components of industrial exports, accounting for roughly 20% of total exports. Tighter economic conditions have shifted consumers' preference of automobiles towards those that have more value-for-dollar, which South Korea specializes in. Additionally, the 'Green Wave' of environmental consciousness has greatly benefited their exports of fuel-efficient petrol, hybrid and full electric vehicles.

While we foresee South Korea's trade deficit to further worsen in the coming months as global demand slows and their semiconductor industry weakens further amidst stiffer competition and a supply glut, we expect their trade to eventually rebound once global outlook improves, most likely in the 3rd quarter of 2023. South Korea, assuming maintenance of its identity as an exporter of quality goods, coupled with refinements made to their shipping industry, should be very competitive going ahead. Particularly, China's reopening and return to economic strength should bode well for South Korea's exports as China accounts for more than 20% of South Korean exports. Based on the current timeline, it is likely that this will occur in the 2nd or 3rd quarter in 2023.

Semiconductor Wars

South Korea, as one of the leading semiconductor, or 'chip' manufacturers in the world, has recently been drawn directly into the brewing conflict between the US and China regarding chip production. The US aims to curb China's rising military power by limiting their access to advanced chips needed for military systems and artificial technology, and has initiated a series of measures that restricted US technology from being utilized in operations located in China. With major South Korean chip producers such as Samsung Electronics and SK Hynix both using US technology in their production processes while maintaining extensive operations in China, the pressure is mounting for the entire semiconductor industry in South Korea as they scramble to relocate while maintaining their current profitability.

Additionally, the US is also granting subsidies to companies willing to set up operations on US soil, which could cause an outflow of manufacturing processes from South Korea, resulting in a fall in domestic exports and thus hurting economic growth. In response, the South Korean government has expanded tax breaks and provided funding for key infrastructure such as power and water supply and has drafted two bills, known as the 'K-Chip Acts', that aim to provide greater backing for the industry as a whole.

While in the short term, South Korea's chip production is unlikely to stutter due to the US providing temporary exceptions to their measures, it still faces enormous problems in the long term unless a successful pivot can be engineered, or US foreign policy becomes more accommodating. Samsung Electronics has already begun the process, with negotiations to build two factories in the US already underway. However, the US' higher labour costs and stronger labour unions will undoubtedly eat into Samsung's profits. In culmination with the falling global demand for chips in general due to the slowing global economy, we expect South Korea's chip industry to contract barring abrupt shifts in global headwinds.

Figure 10: KOSPI Daily Chart

Source: TradingView

Trade Idea: Short KOSPI

We would like to propose a tactical short on the KOSPI due to three main factors- weaknesses of index heavyweights that will only worsen in the coming fiscal year, the continued base rate hikes and a negative economic outlook. We aim to exit from this trade by the 2nd quarter of 2023, before BoK policy normalization raises investor confidence.

Firstly, the top 50 companies by market capitalization listed on the KOSPI predominantly operate in the technology sector, specifically the telecommunications, battery, automobile and semiconductor industries. Apart from telecommunication firms, the other industries are all expected to experience declines going into 2023 as the economy slows and exports decrease. Specifically, apart from Samsung Biologics, the other 4 companies in the top 5 constituents of the KOSPI, which account for nearly 30% of total capitalization, have all been exhibiting signs of weaknesses in recent months.

Secondly, the BoK has forecasted rate hikes into 2023 until inflation is quelled to the ideal 2% and has emphasized their commitment towards this process. This spells bad news for the KOSPI as investors would be more inclined to pledge capital in fixed deposits rather than the stock market, given the volatility of the latter. This preference can be seen from the gradual, 20% decline of the KOSPI year to date. The more expensive Won that comes with higher rates will also deter foreign investors from investing in the KOSPI.

Finally, the general pessimism surrounding the economy will result in households being tighter on expenditure as they try to hedge against unexpected crises. While a deflationary spiral is unlikely, households would be more inclined to save now and spend later if they have the expectation that prices will fall. This self-reinforcing prophecy for falling prices can similarly apply to the KOSPI, where investors' assumption that equities will be cheaper in the future plays into their declining value in the present.

It can be seen that the KOSPI is on a fall from the recent high of 2482 and is exhibiting price weaknesses, as seen by the incoming convergence of the 15-day moving average and the 50-day moving average. The relative strength index corroborates this fact, with it also being unlikely that there is an imminent trend reversal. Thus, an entry at the current level of 2389 gives us ample room to generate positive returns. We will cap our stop loss at the recent high of 2482 and our take profit at the recent low of 2152, for a trade with a risk-reward ratio of 2.55.

Entry: 2482
Take Profit: 2152
Stop Loss: 2465
Risk Reward Ratio: 2.55

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