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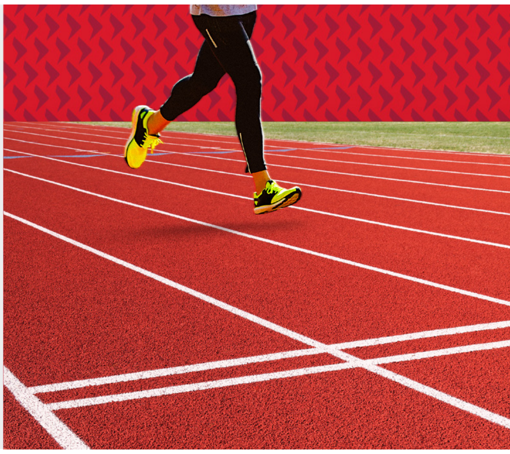
A Prudential plc company

2023 Mid-Year Outlook

Positioning for the end of the rate hiking cycle



At the start of 2023, we wrote that we will be approaching peak Fed hawkishness and peak inflation in the second half of the year. The slowdown that we are currently seeing in the global economy suggests that we are close to the end of the rate hiking cycle in most economies.

It is inevitable that the sharp rise in interest rates, following more than a decade of easy money, would result in hidden issues rising to the surface across the global economy. Although this will drive short-term market volatility, the process of cleansing the system of companies and business models built on the foundation of cheap, plentiful money is a long-term positive. Well diversified and low volatility portfolios should fare better during periods of market downturns while the ensuing market volatility should present rewarding opportunities for active managers over the longer term.

- The odds of a US recession are rising. China's economic recovery contrasts with the slowdown in the developed economies.
- Rising recession risks plus disinflationary trends globally may provide a more constructive backdrop for high-quality bonds and duration.
- Within Emerging Market (EM)/Asia equities, bouts of market volatility may present opportunities for investors to get exposure to the region's longer-term supply chain rebalancing and carbon transition themes.
- Within EM/Asia bonds, the risk return dynamics continue to favour higher grade bonds where all-in yields remain elevated and reasonably attractive.
- The deteriorating global growth outlook remains a key risk for investors. In terms of geopolitical risks, the Taiwan straits crisis remains a low probability but high impact event in our view.

INVESTMENT IMPLICATIONS

Theme	Rationale	Solutions
Peaking rates	Easing inflationary pressures and global growth slowdown.	High quality fixed income Long duration
Higher volatility	Geopolitics, higher borrowing costs expose vulnerabilities in corporates and business models.	Multi asset portfolios Low volatility portfolios
Contrasting growth	Less aggressive Asian central banks and a recovering China help to support growth in Asia, in contrast to the slowdown in the developed economies.	Asian investment grade bonds Asian equities
Carbon transition (long term)	Increasing investments in infrastructure as a result of the carbon transition will support commodity-rich emerging markets.	Global emerging market equities
Supply chain rebalancing (long term)	Geopolitical tensions and COVID-era lockdowns in China have led companies to enhance supply chain resilience.	Global emerging market equities Asean equities

Source: Eastspring Investments. June 2023.

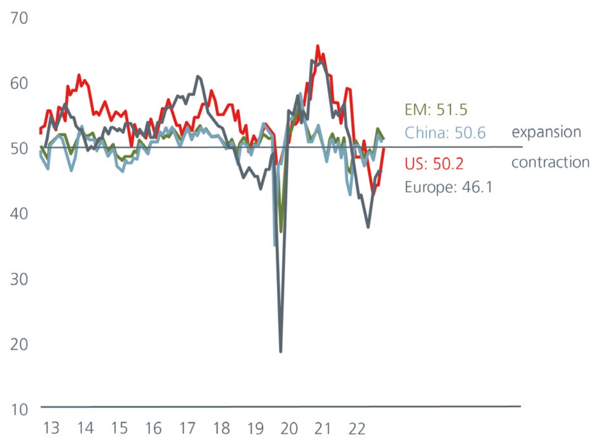
MACRO: THE ODDS OF A US RECESSION ARE RISING

Having peaked in the second quarter of 2021, growth continues to decelerate in the G10 economies. Fig. 1. The leading variables that we monitor point to a US recession potentially in the next six to twelve months, as the US economy absorbs the full impact of the US Fed's tightening. The tightening of financial conditions in the US has been further exacerbated by the recent volatility in the US banking system. That said, any recession is likely to be shallow as household and non-financial corporations' balance sheets remain relatively healthy. Despite the recent troubles faced by the regional banks in the US, we continue to believe that this does not pose any systemic risk to the US banking system.

While core PCE inflation, the Fed's preferred gauge of price pressures, remains elevated in May at 4.7%, inflation should decline in the second half of the year due to high base effects among other factors. As such, we believe that we are close to the end of the Fed's tightening cycle. Nevertheless, we continue to monitor the US labour market closely for inflation risks. Fig. 2.

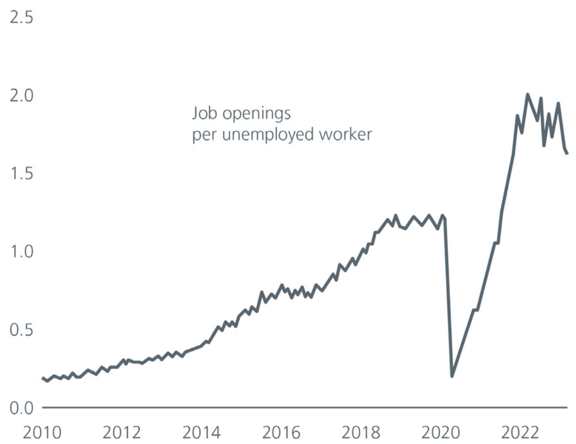
> Leading variables point to a potential US recession in 6 to 12 months.

Fig 1: Developed and Emerging Market PMIs diverge



Source: Refinitiv Datastream. May 2023.

Fig 2: US labour market still resilient

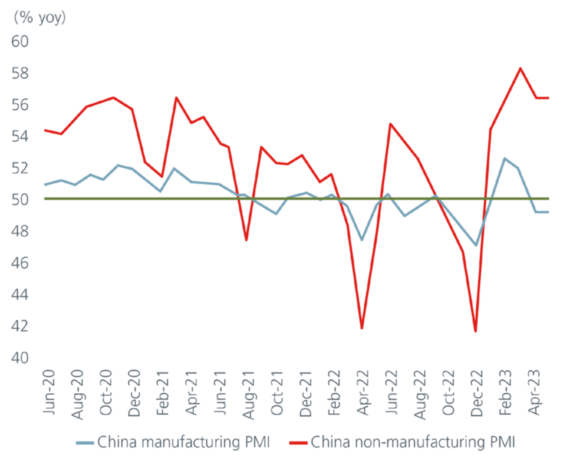


Source: Bloomberg. May 2023

China's economic recovery contrasts with the slowdown in the Developed Markets (DMs). That said, investor optimism surrounding China's re-opening has been tempered as the rebound momentum appears to be easing. With export demand expected to remain subdued, domestic spending, especially on services, continues to be key in driving China's recovery. Fig. 3. The government seems unlikely to roll out significant policy stimulus as the focus is on the "quality" of growth. The People's Bank of China is widely expected to keep monetary policy accomodative as inflation remains subdued.

China's consumption-led recovery will have limited positive spillovers for the rest of Asia although Thailand and Singapore

Fig 3: China's 2-speed recovery



Source: Bloomberg. May 2023.

should benefit from the higher tourist spend. Weak exports would weigh on South Korea and Taiwan, although supply-chain rebalancing should continue to benefit ASEAN and India. Fig. 4. Inflationary pressures have been more benign in Asia, helped by slower gains in goods and energy prices. Barring unforeseen shocks, the end of Asia's rate hiking cycle seems in sight.

ASSET ALLOCATION AND CURRENCIES: A MORE CONSTRUCTIVE BACKDROP FOR BONDS AND THE USD

Global equities may still benefit from a decent growth environment in the near term, but downwards earnings revisions could be a risk. Rising recession risks in the US and some parts of the developed economies plus disinflationary trends globally may provide a more constructive backdrop for high-quality bonds and duration in the second half of the year. Fig. 5.

Fig 4: China's consumption-led recovery not benefiting Asia

Source: Bloomberg. May 2023.

Fig 5: Asset allocation views

	3-month view Underweight	3-month view Neutral	3-month view Overweight	12-month view Underweight	12-month view Neutral	12-month view Overweight	Rationale
Equities			●	●			Slowing growth and an economic recession likely to drive equities lower over the medium-term, but may remain supported in the next three months due to supportive technicals.
10Y Government Bonds	●					●	As the economy slows, the market will begin to price in rate cuts driving a bull steepening of the yield curve.
Corporate bonds			●	●			In line with the medium-term outlook for equities, we expect corporate bond yields to head higher. particularly in high-yield space.
Cash		●				●	Positioning for risk-off assets over a 12-month time horizon keeps us overweight cash over the medium term.
Equities							
US		●		●			Underweight US equities over the medium term, driven by slowing growth and as the impact of tighter monetary policy kicks in.
Europe			●	●			European equities may hold up in the near term as earnings growth sustain, but are likely to trend lower over the next year in line with recessionary trends.
Emerging Markets	●				●		EM equities remain the bright spot over the medium term as global recession is driven by the developed markets (DM).
Asia Pacific ex-Japan			●		●		Asian equities may trade rangebound over the medium term as global headwinds are offset by improving fundamentals in China.
Government Bonds							
US	●					●	As the economy slows, the market will begin to price in rate cuts driving a bull steepening of the yield curve.
Europe	●				●		The ECB may keep rates higher for longer than the Fed which may continue to cause yields to trend higher before stabilising in the second half of the year.
Singapore		●				●	Singapore's inflation and growth are easing on the margin, causing the Monetary of Singapore to pause its tightening policy.
Corporate bonds							
US High Yield			●	●			Slowing economic growth and earnings present a weak picture for US High Yield bonds and we expect spreads to widen, albeit not reach all-time highs as corporate balance sheets look healthy.
US Investment Grade	●				●		Investment Grade credit may trade sideways as higher spreads are offset by lower base rates.
Emerging Markets			●		●		EM central banks have remained relatively dovish, supporting overall spreads.
Asian Credit			●		●		As growth slows but not as much as in DM economies, corporate bond yields in Asia may remain under control.
FX							
USD	●					●	The recessionary environment will lead investors to favour safe-haven currencies like the USD.
EUR			●	●			As the European economy slows, the strong rally in EUR/USD may reverse.
SGD		●			●		Trend to be flat as Singapore's economic data looks mixed and SGD looks to be fairly valued.

Source: Eastspring Investments. Multi Asset Portfolio Solutions team. Asset class views are as of the team's most recent monthly meeting in June, and should not be taken as a recommendation. The information provided herein is subject to change at the discretion of the Investment Manager without prior notice.

Higher yielding local currency EM sovereigns also look attractive if the interest rate cycle peaks, although investors will need to be selective. Within EMs, bouts of market volatility may present opportunities for investors to get exposure to the region's longer-term supply chain rebalancing and carbon transition themes. The recessionary environment will drive investors to safe-haven currencies such as the US dollar.

EMERGING MARKET/ASIA EQUITIES: POCKETS OF OPPORTUNITIES ACROSS MARKETS

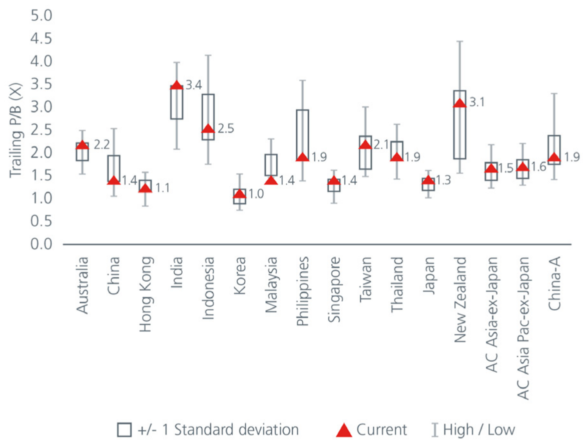
Year-to-date, Asia ex Japan equities have underperformed other regions, dragged by China. Individually, however, Korea and Taiwan equities outperformed on tech optimism while Indonesian shares rose on strong economic data. Still the region[1] continues to be a bright spot; growth is expected to increase this year to 4.6 percent, from 3.8 percent in 2022. Generally healthy macroeconomic fundamentals and medium-term earnings drivers such as supply chain rebalancing, a pickup in capex in real economy sectors, and increased decarbonisation and infrastructure spending bode well for the region.

That said, many Asia ex Japan markets are still trading below their 5-year averages and remain underrepresented in global indices. Fig 6. Valuation dispersion also suggests there is still a huge opportunity to exploit for bottom-up value managers.

Japan equities hit a 33-year high in May, underpinned by strong corporate earnings and renewed interest from foreign investors encouraged by growing expectations for accelerated corporate reforms. Tailwinds from the domestic re-opening post COVID, the normalisation of the Chinese economy and supply chains, and the recent price increases have boosted profits. Ongoing corporate restructuring continues to enhance shareholder value. The long-term upward trajectory for earnings and margins remains intact. Fig. 7. We see many opportunities on a bottom-up basis in this market that still trades at very attractive valuations versus global peers.

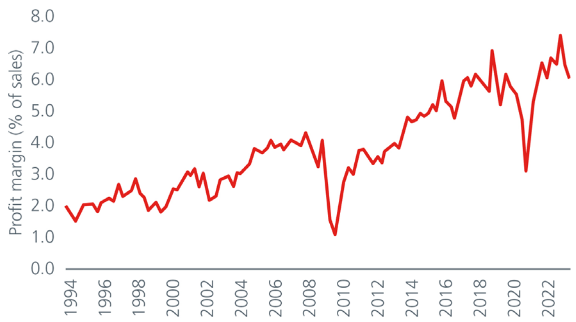
Potential earnings upside and further investor inflows should be supportive of the Chinese equity market. The China A-share market is flat[2] for the year and valuations are currently not expensive. Fig. 8. We continue to be optimistic about the opportunities in China's high-end manufacturing industry including medical equipment and semiconductors, which are in line with the government's goal of achieving

Fig 6: Several Asian markets continue to be cheap



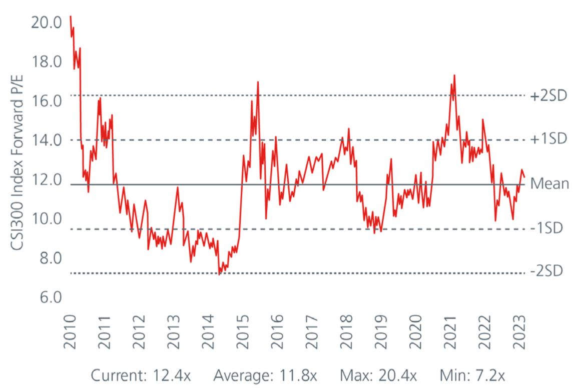
Source: Factset, MSCI, GS Global ECS Research as of 30 April 2023.

Fig 7: Corporate profit margins are improving in Japan



Source: Refinitiv Datastream and MOF as of 31 March 2023 Current profits in JPY of all Japanese incorporated enterprises' industries (except finance and insurance)

Fig 8: China A-share market is not expensive



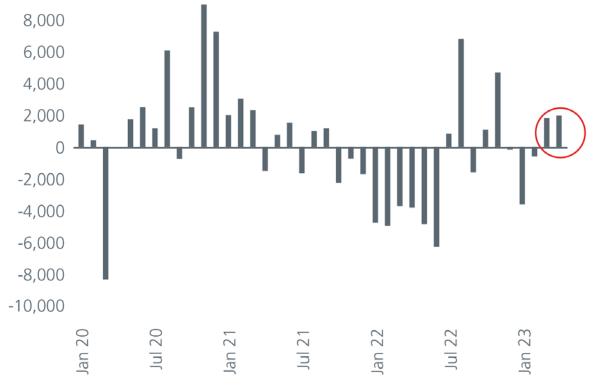
Source: Factset, MSCI, GS Global ECS Research as of 30 April 2023.

Source: [1]Asia and Pacific from IMF report May 2023. [2]Bloomberg. CSI300 and Sensex Index as at 22 May 2023.

technological self-independence. We are also positive on the new economy sectors including new energy, energy storage and information security.

India is on track to be the fastest growing major economy this year. India's manufacturing purchasing managers' index hit a 31-month high in May as factory orders surged. A prudent fiscal stance and lower commodity prices should help keep inflation contained. The rupee is expected to stay steady given the positive trend in the balance of payments data. As the market remains expensive relative to its peers, stock picking is key in identifying the market's most attractive opportunities. The Indian equity market is up 1.7% in USD terms for the year[2] and has been enjoying rising portfolio inflows in recent months. Fig. 9.

Fig 9: India equity market sees rising portfolio inflows

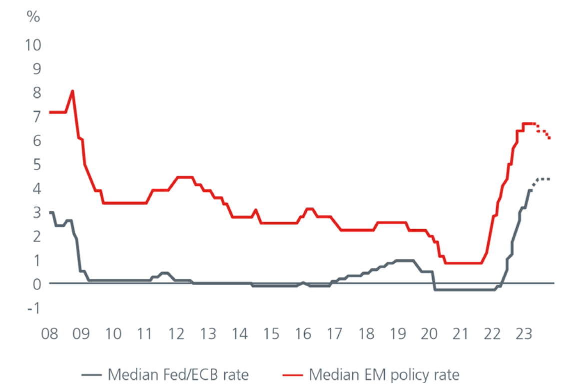


Source: Refinitiv Datastream and MOF as of 31 March 2023 Current profits in JPY of all Japanese incorporated enterprises' industries (except finance and insurance)

EMERGING MARKET/ASIA BONDS: RISK REWARD DYNAMICS FAVOUR HIGH QUALITY DURATION

2023 is shaping up to be a better year for fixed income. Much of the improved performance is due to moderating inflation, ongoing recession fears and major central banks nearing the tail end of their hiking cycles. The US Fed has signalled a potential pause in rates if inflation continues to ease. In Asia, the monetary cycle seems to be topping out as inflation has undershot expectations in many markets. Fig. 10.

Fig 10: Asia's monetary cycle is topping out

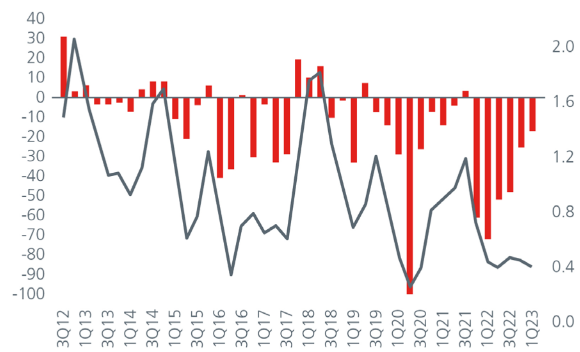


Source: Deutsche Bank, Haver Analytics, Bloomberg Finance LP, May 2023.

For now, there seems to be little in terms of domestic cyclical pressures to compel Asian central banks to rush into easing cycles. While the US Fed policy has a large impact on Asian central bank behaviour, we expect some to start easing should the balance of risks tilt from inflation to recession.

Against this backdrop, Asian fixed income performance has been mixed; investment grade bonds (IGs) delivered positive returns of 3.4%[3] year-to-date, and IGs' credit ratings have stabilised in 1Q23 back to pre-COVID levels. On the other hand, high yield bonds (HYs) posted more muted returns and continue to be pulled down by poor China real estate sentiment. The recovery in China's property sector still has some way to go both in terms of physical demand and developers gaining access to sufficient financing. HYs continue to see a deterioration in credit ratings. Fig. 11. On a positive note, HY default rates have eased from 2022 levels and are expected to decline further.

Fig 11: IGs' rating stable but HYs still deteriorating



Source: Moodys, S&P and Fitch ratings, March 2023

Valuations for Asian bonds vary across the rating curve with the AA and A names looking cheap compared to AAAs and BBBs/BBs. We see the most value in Asian financials and

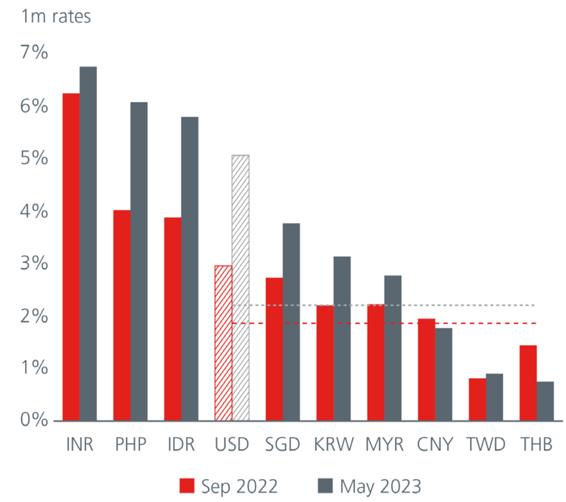
Source: [2]Bloomberg. CSI300 and Sensex Index as at 22 May 2023. [3]JPM JACI Investment Grade from Refinitiv Datastream as of 18 May 2023 selective HY names. Asian banking systems have been resilient in the face of the US regional banking stresses. Meanwhile the valuations of Asian local bonds are improving amid moderating inflation and peaking rates. In particular, we find Singapore government bonds attractive for a AAA-rated sovereign. We also like SGD credits for their relatively low volatility and stable credit fundamentals.

On Asian currencies, the high USD yields post a hurdle for investors to hold long Asia foreign exchange positions. Only the Indian rupee, Philippine peso, and Indonesian rupiah have slightly higher yields. Fig. 12. Asian currencies are also unlikely to be immune to the deteriorating global growth outlook in which case the high yielding Indonesian rupiah and Indian rupee are likely to fare better than the low yielding currencies such as the Taiwan dollar and Thai baht.

We expect Asia and Gulf Cooperation Council countries to dominate the EM bond recovery and broadly prefer sovereigns over corporates. Moreover the 2023/2024 GDP growth forecasts[4] for EMs, including Asia, surpass those in the DMs. This would encourage more inflows to EMs vis-à-vis DMs and help to keep default rates modest in EMs in the next few years. Equally, Asia's stable economic and policy fundamentals as well as tailwinds from China's re-opening and recovery, albeit an uneven one, will continue to underpin the demand for Asian bonds. Technicals too are positive given that the net supply of new Asian USD issuances will likely be flat or negative in 2023.

The risk return dynamics continue to favour higher grade bonds where all-in yields remain elevated and reasonably attractive. Fig 13. High yield names with strong fundamentals and those that have sufficient liquidity and financing are potential alpha sources.

Fig 12: Only INR, PHP, and IDR have slightly higher yields vs USD



Source: Bloomberg, HSBC, May 2023.

Fig 13: Asian IGs offer attractive yields

Source: Bloomberg and Barclays Research as of 13 April 2023. YTW = Yield to worst

Source: [4]IMF April 2023.

RISKS: THE DETERIORATING GLOBAL GROWTH OUTLOOK IS A KEY RISK FOR INVESTORS

	Likelihood	Negative Impact
Financial & economic		
Inflation persisting at levels higher than what is being priced in the markets.	Low	High
China growth slowdown exacerbated with US-China chip war looming under nationalistic policy backdrop.	Low	Medium
Energy crisis as new sustainable investment not able to make up for under investment in old dirty energy.	Low	Medium
Global recession as the impact of the concerted global central bank monetary tightening is felt.	High	High
Geopolitical		
Middle East instability as Iran threatens Saudi or Iraqi oil infrastructure to distract from domestic instability.	Medium	Medium
Taiwan straits crisis with increasing China nationalistic rhetoric in order to distract attention from China's growth weakness.	Low	High
Cyberattacks.	Medium	Medium

Source: Eastspring Investments Multi Asset Portfolio Solutions. May 2023.

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