Quarterly Strategy

Hamon Investment

3Q 2023

After the robust rally in the first half of 2023, the third quarter saw a pullback in performance, mainly led by the change in market expectations on the US interest rate, following the September FOMC meeting. It was previously expected that there would be no further rate hikes this year, followed by up to four rate cuts in 2024 of 25bps each. However, according to the latest Fed "dot plot", Federal officials expect one more 25 bps interest rate hike this year, followed by two 25 bps rate cuts next year. This shift in expectations, alongside strong US treasury issuance, triggered a global selloff in both the bond and global equity markets. Our view is that it is unlikely that the Fed would raise rates again this year, due to the damage it may do to bonds and the weakness in the commercial property sector.

The Japanese market saw profit taking in Q3, after strong performance in the first half of the year, with the Nikkei 225 index down 7.28% in USD terms over the quarter. The Bank of Japan (BoJ) unexpectedly tweaked their policy on its yield curve control (YCC) from remaining at the 0%-0.5% yield for their 10-year bond, to raising its cap to 1%. However, it did not put a stop to the weakening currency and the yen fell for another 3.39%. With the possibility of exiting the YCC and rising interest rates in 2024, we believe financial stocks, such as one of our top holdings Mizuho Financial, will be re-rated amid improving earnings outlook. Japanese corporates are showing very strong profitability in Q2 2023, the highest in six decades. With improving companies' profitability, good economic growth, weak currency, and improving inbound tourists post Covid-19, we believe the market will continue to outperform, and remain one of our top picks for the region.

While the MSCI China and HSI Index were down 1.94% and 5.78% over the quarter, we are beginning to see better macro data that points to signs of economic stabilization in China. September Manufacturing PMI in China was at 50.2, in expansionary territory after five consecutive negative months. Retail sales numbers, industrial production figures, and exports were better than expected, alongside improving CPI figures. This was amid further policy easing on the property market, lowering the one year loan prime rate, and the cutting of banks' reserve ratio by 25bps. To support the A share capital market, the government also planned to cut the stamp duty on stock trading, tighten the pace of IPOs, and prohibit the dilution of smaller shareholders unless certain share price and dividend requirements are fulfilled.

As the economic recovery continues and these measures take effect, we remain positive towards the HK/China market and believe the central government will further roll out easing policies to stimulate the economy. Our top picks in internet-related companies, such as Alibaba, Tencent, and Baidu, should outperform the market and benefit the most from the recovery, especially after China Premier Li Qiang's vocal support for a "platform economy". The Hang Sang Index is currently trading at only 8x FY24 P/E, which we believe is good value.

We maintain our view that global semiconductors and hardware tech will benefit from increasing adoption of AI. Aside from DRAM memory as one of our areas of focus, which we discussed in our Q2 quarterly strategy, we also like server manufacturing companies, such as Super Micro Computer. We believe they will also benefit from the explosive growth of AI server deployments in datacenters and will see a significant increase in blended average sales prices due to increasing revenue contribution from AI servers.

Strong US employment numbers, high inflation, and a strong oil price may provide support for further rate hikes in the US. The idea of "higher for longer" interest rates has triggered repricing for global bond yields, and led to volatility in the equity markets.

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Quarterly Strategy (cont'd.)

HAMON INVESTMENT

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As borrowing costs have been increasing sharply in the past two years, with no signs that it will fall back materially in a short period of time, our strategy will have two main areas of focus:

1. Companies with strong balance sheets, especially those that are net cash, with high dividend yield or low valuations, such as Alibaba, CNOOC, and Mizuho; and
2. Companies with strong balance sheets that relate to the secular trend, such as AI-related companies Super Micro Computer and Samsung Electronics

We believe that focusing on these areas would lead to outperformance during such a volatile market. We also continue to like the HK/China and the Japanese market, and remain conservative towards the US market, only selectively adding stocks.

We also like the US bond market as yields reach 5%. US bond yields rose during Q3 after the change in interest rate expectations, alongside the strong issuance of US Treasury bonds and weak demand for longer dated ones. The US 10-year Treasury bond yield rose from 3.84% to 4.57%, the highest level since 2007. The Japanese 10-year government rose from 0.39% to 0.76% after the YCC was adjusted. While we believe the 10-year bond at greater than 4.5% yield is not sustainable for the long term, we prefer shorter duration bonds, and monitor timing to gradually add longer dated bonds, given there is still high uncertainty on the global economy and how much longer the high inflation environment may continue.

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