HSBC Asset Management

Asia Insights

Meaningful transitions

January 2024

For professional investors only

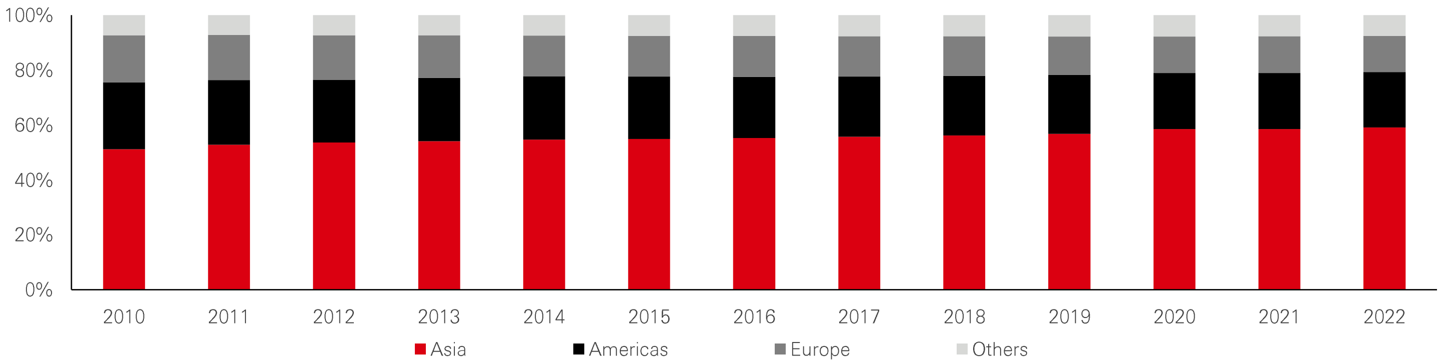
In a nutshell:

- As the fastest growing economic region, Asia faces the dual challenge of balancing significant development needs while decarbonising
- China and India, the world's most populous countries, now account for roughly 40% of global greenhouse gas emissions from fuel combustion
- The scale of transformation needed for Asia's net-zero transition means substantial opportunity for job creation, innovation and investment, but also poses regulatory and competitive risks for some companies

Last year was the world's hottest on record, by a wide margin. We are now increasingly experiencing economic impacts from higher temperatures and the broader impacts of climate change. For instance, drought-induced restrictions on the volume of ships passing through the Panama Canal will result in as little as half of full freight capacity by next month. Demonstrating the interconnected and widespread nature of climate change impacts, this is not only a problem for the Americas. The ripple effects of this disruption are being seen on the global food supply chain, with US grain carriers headed to Asia having to detour East, through the Suez Canal or around southern Africa, posing a threat of elevated food prices for Asian consumers.

Asia itself must play a primary role in reducing future climate change impacts. Rapid industrialisation, urbanisation, and population growth have propelled an increase in the region's contribution to global greenhouse gas emissions from half in 2010 to 60% just over a decade later. At existing emission rates, by 2040, Asia alone would deplete the world's remaining carbon budget aligned to limiting global warming to 1.5 °C.[1]

Regional contribution to global greenhouse gas emissions (%)



Source: HSBC AM, OECD Air Emission Accounts; UNFCCC; EDGAR; IMF staff calculations. As of December 2023.

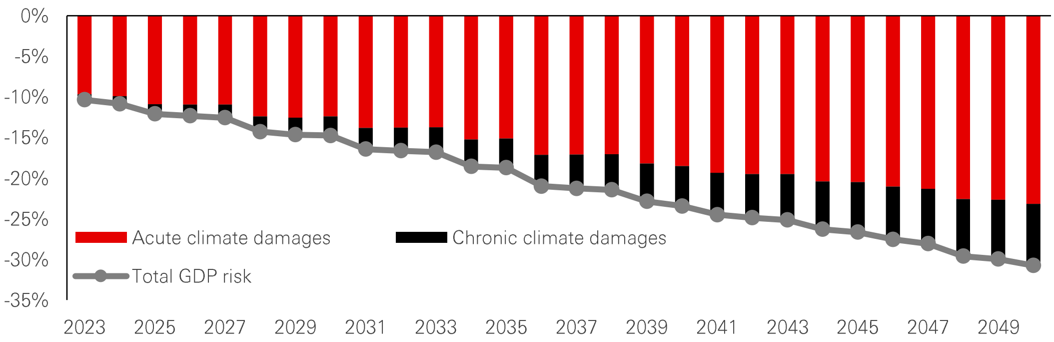
[1] Asian Development Bank, May 2023

Costs of climate change should motivate net-zero progress

Last year's average temperature was already just shy of the 1.5 °C warming threshold targeted to avoid more catastrophic impacts from climate change. For Asia, motivation to decarbonise is as much self-serving as it is to the benefit of the rest of the world. Due to its geography and the make-up of its economies, Asia is highly vulnerable to both enduring impacts of long-term climate shifts and the immediate consequences of extreme weather events. For instance, agriculture accounts for roughly one-fifth of South Asia's economic output. Higher temperatures along with more frequent and extreme weather events such as droughts or flooding are now putting pressure on crop yields.

More broadly across the region, climate change will increasingly contribute to resource scarcity, weakened supply chains which hinder production capacity, damage to fixed assets and rising insurance premiums, amongst many other financial consequences. Below is a projection of potential GDP impacts across developing Asia. In contrast, pursuing a net-zero economy by 2050 incurs mitigation costs over time but offers significant benefits, halving the projected GDP losses according to IMF estimates.

Asia's estimated GDP loss in a 'business as usual' scenario (%)



Source: HSBC AM, NiGEM model and IMF staff calculations. As of December 2023.
Note: The baseline is a hypothetical scenario with no transition nor physical risk.

Much of Asia has now committed to climate goals and submitting nationally determined contributions (NDCs) under the Paris Agreement. Notably, 19 economies, representing around 80% of the region's emissions, have pledged to achieve net-zero emissions. China, the world's top emitter, aims for carbon neutrality by 2060, while India, another major contributor, targets net-zero emissions by 2070. Today, both countries rely on coal for the majority of their energy production and account for roughly 40% of global greenhouse gas emissions from fuel combustion.[2]

However, embarking on the decarbonization journey must navigate the challenges of relatively low-income levels and significant developmental needs. According to the Asia Development Bank, developing countries in Asia require annual investment of $1.7 trillion until 2030 to sustain growth, address poverty, and effectively respond to climate change.

> Pursuing a net-zero economy by 2050 halves projected GDP losses in Asia from climate impacts.

Given the substantial investment needed for balanced growth, the region's current NDC targets set for 2030 deviate from the emission reduction trajectories outlined by the Intergovernmental Panel on Climate Change (IPCC) to limit global warming to the 1.5 °C threshold. Projected greenhouse gas emissions indicate only an 11.8% reduction compared to the business-as-usual scenario by 2030.[3]

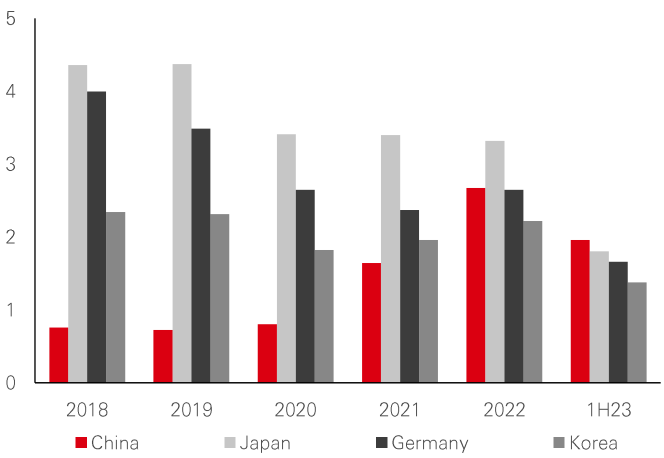
While this paints an unimpressive picture for Asia, it is important to acknowledge that developed nations outsourced carbon-intensive industries over decades, significantly contributing to the current situation. The anticipated growth in Asia's developing economies further complicates emission reduction efforts, given the need to power rapid economic growth doesn't always align to the imperative to decarbonize.

[2] HSBC Research, IEA data, December 2023
[3] IMF Research, December 2023

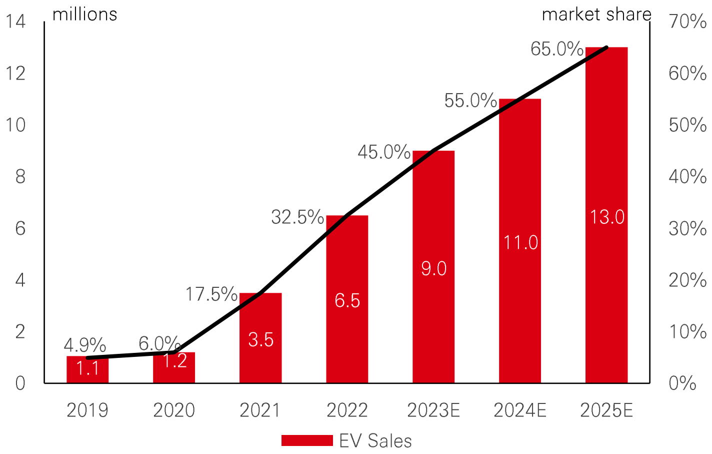
Facilitating growth through the energy transition

Nonetheless, the global shift to decarbonisation can be a growth driver with the right investment that leverages opportunities. China last year became the biggest global exporter of passenger cars, overtaking neighbouring Japan, as a result of the relatively rapid shift to electric vehicles. And per the below, the shift to EVs is not expected to lose momentum any time soon. While the Chinese economy has clearly struggled of late, growth in exports of electric vehicles, solar cells and lithium batteries have become the new leaders of its export engine.

Passenger car export volumes (millions)



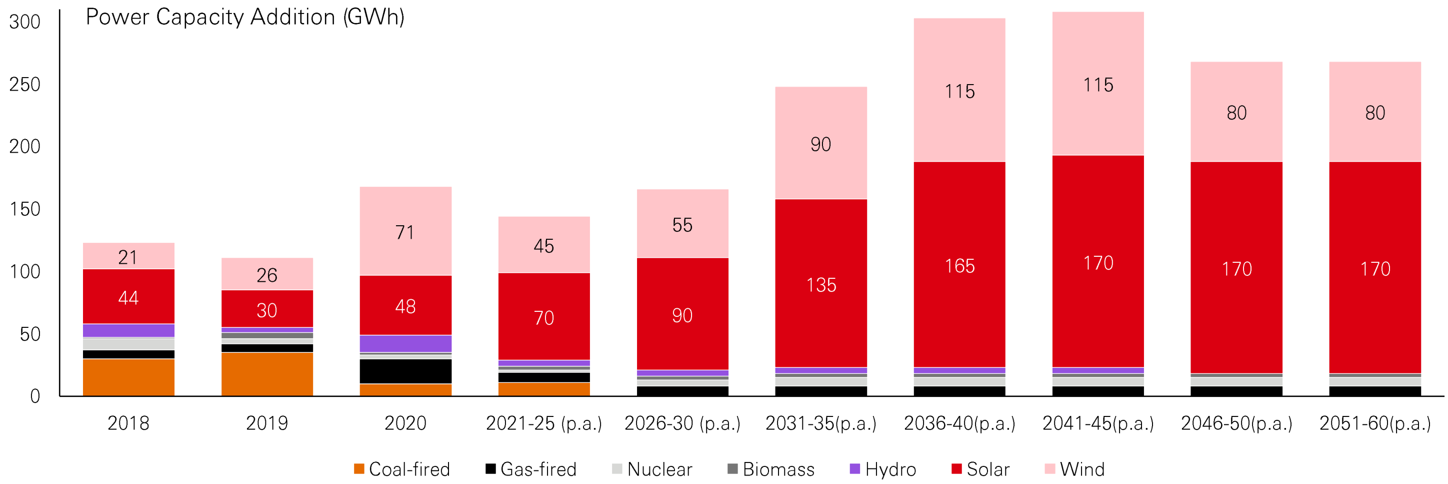
Acceleration of electric vehicle sales



Source: HSBC AM, HSBC Research, September 2023. For illustrative purposes only. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC Asset Management Limited accepts no liability for any failure to meet such forecasts, projections or targets.

In a similar vein, Asia's energy mix must undergo a massive shift to deliver decarbonisation targets and drastically diversify away from today's roughly 80% reliance on fossil fuels. The chart below provides perspective on the scale of renewable installations to come over the coming years.

China needs to install on average 85GW-100GW per annum of wind and solar combined under its latest 5-year plan



Source: HSBC AM, as of July 2023.

Early steps supporting this shift are underway. During COP28 last month, China announced plans to release new NDCs by 2025. Simultaneously, the Asia Development Bank solidified an agreement with the sovereign wealth fund of Indonesia to decommission the country's largest coal-fired power station. And collaboration between India and Japan, the hosts of this year's G20 summit and PRI in Person, respectively, highlighted strategies for energy transition, emphasizing a departure from fossil fuels and exploration of emission reduction measures.

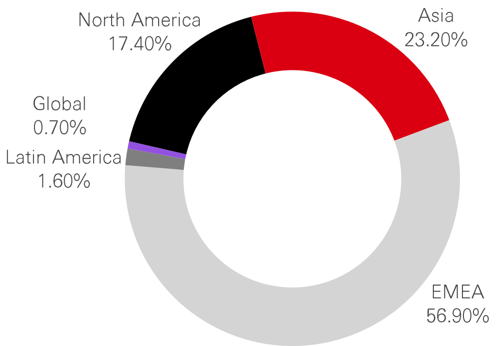
Asian countries are increasingly embracing renewable energy not only for environmental sustainability, but also as part of efforts to support economic growth. Steps such as the European Union's carbon border adjustment mechanism are helping to incentivise this, given added cost considerations for exporters into the bloc with high carbon emissions. A growing shift in Asia is evident in multiple facets, including significant investment in sustainable projects that have supported job creation and technological innovation. Globally, there were 13.7 million jobs in the renewable energy sector in 2022, up from 12.7 million in 2021. Two-thirds of those jobs were in Asia. India, aiming for 500 gigawatts from non-fossil fuel energy sources by 2030, envisions creating 3.4 million new job opportunities.[4]

As of 2022, two-thirds of jobs in the renewable energy sector were in Asia.

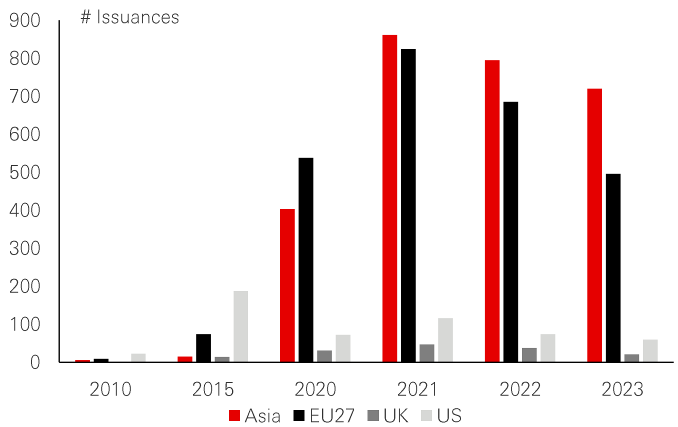
The Paris Agreement's commitment of annual financing of $100 billion to assist developing countries in their climate mitigation and adaptation efforts can support the transition ahead. To fulfil this commitment, 31 countries have pledged $12.8 billion through the Green Climate Fund, announcing the second replenishment at COP28.

Considering the substantial funding required for Asia's ambitious transition to a net-zero economy, estimated at around $30 trillion by 2050, the Global Financial Markets Association predicts that more than half of global investment in climate solutions will be needed in Asia. The region's ascendancy in the green bond market reflects the growing scale of investment proceeding.

Regional breakdown of green bond market



Source: HSBC Global Research, Bloomberg, November 2023.



Source: HSBC AM, Refinitiv, November 2023.

Private capital will play a significant role in both economic development and the region's energy transition. Importantly, enhanced governance and disclosure practices are needed to deliver transparency in climate risk reporting and facilitate a clear taxonomy for defining "green" investments. Such steps have typically been rewarded. Companies in Asia aligned with the EU taxonomy have shown that improved governance and enhanced disclosure practices can lead to sector-relative price premiums, which have expanded to 55% versus earnings in 2022, surpassing the global average of 37%.[5]

Public spending on energy research and development around the world is continuing at pace. Growth was 10% in 2022, with 80% dedicated to clean energy. Given its contribution to current emissions, it is positive that China's spending led the pack, allocating a substantial $14.9 billion budget for innovation in the energy sector, focusing on energy efficiency, low-cost renewable energy, and energy storage solutions.[6]

Large spending figures present context for the scale of change set to take place amidst the net-zero transition. Accordingly, it presents a compelling opportunity set for investors over the long term. Asia should be a priority consideration, given both the scale of opportunity and potential for maximising impact. In addition to positive earnings growth potential for some companies, investors should consider risks to competitive positions for others lagging in the transition.

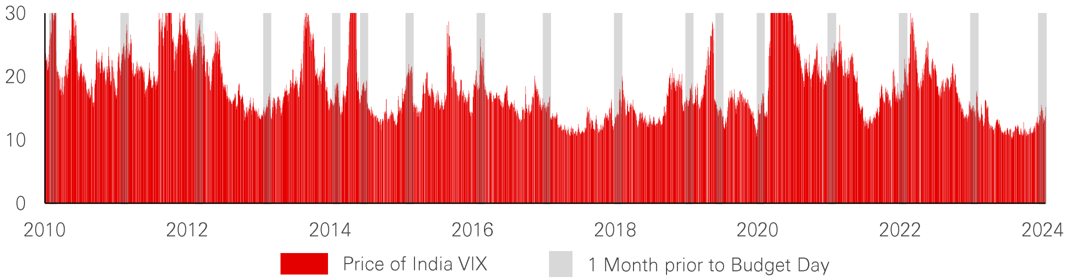
[4] International Renewable Energy Agency (IRENA), International Labour Organisation (ILO), September 2023
[5] Goldman Sachs Global Investment Research, February 2022
[6] International Energy Agency (IEA), June 2023

Asia equities: Heightened dispersion

Asian markets experienced volatility throughout last year, swaying between China's policy outlook, macroeconomic data points, and US rate actions. Significant dispersion emerged both across and within markets. Notably, India, Taiwan, South Korea, and Japan closed 2023 with robust double-digit equity gains, while Hong Kong and China faced challenges, struggling to gain momentum amid high hopes for a post-Covid reopening boom.

The impressive 19.2% rise in the MSCI India index reflected the country's compelling growth trajectory, despite stretched valuations in some areas. Forecasts for earnings growth remain strong. Yet, the country's upcoming interim budget and subsequent election add an element of heightened volatility to Indian stocks – something we have seen historically around Budget Day.

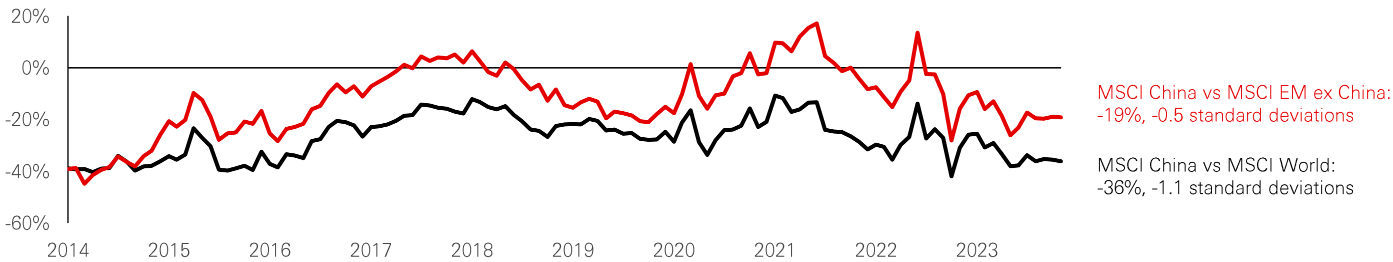
India equity volatility tends to spike around government Budget Day (volatility measured by India VIX index)



Source: HSBC AM, Refinitiv, January 2024.

China witnessed a dramatic de-rating of its stocks last year, marked by MSCI China trading at historical lows – 36% below MSCI World and 19% below Emerging Markets ex-China, relative to earnings. Persistent net outflows resulted in the deepest underweight and largest cumulative outflows for China and Hong Kong since 2018. Although near-term volatility is expected, the MSCI China Index's 9.6-times forward P/E suggests that growth concerns and the geopolitical outlook are largely factored in. Opportunities may arise in well-valued stocks benefiting from favourable policies and potential corporate reforms.

P/E premium or discount for MSCI China (%)



Past performance does not predict future returns.

Source: MSCI, FactSet, Goldman Sachs Global Investment Research, November 2023.

Elsewhere in the region, the outlook for earnings in Taiwan and Korea improved as chip demand rebounded. In Japan, foreign investment flows and a drive for investor-friendly corporate reforms contributed to impressive returns of nearly 30% for the Nikkei index – leading developed markets and outpacing even the big tech-led US rally last year.

A cloudy global economic outlook, geopolitical events, and currently tight external financial conditions could have negative impacts ahead for Asia. While these uncertainties must be considered, valuations are generally below long-term averages and earnings are stabilising. With expectations for double-digit earnings growth in 2024, realised earnings recovery will be a key driver of returns. This is especially the case for Asian equities, whose performance has closely matched profit growth over the last decade. Increased valuation dispersion across and within markets suggests that being selective can offer benefits, supporting an active investment approach.

Increased valuation dispersion across and within markets supports an active investment approach.

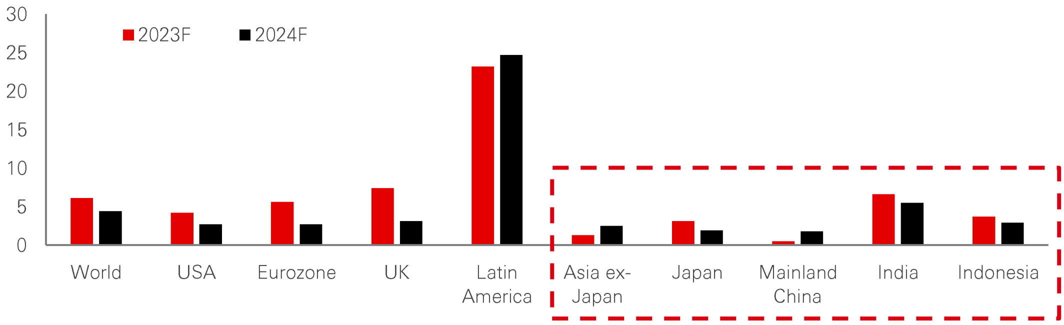
Asia fixed income: Overcoming challenges

Credit markets face their own transition in the years ahead. This includes the maturities of credit funding secured during and post pandemic, which was a prudent strategy, but has given rise to a concerning 'maturity wall' from 2024 to 2026. It could potentially lead to refinancing challenges in the current environment of elevated rates, or necessitate deleveraging. In Asia, over a third of the $840 billion investment-grade market is expected to mature by 2025, escalating to 43% for high-yield markets—higher than in the US and Europe. However, access to lower cost onshore debt, especially in China and India where financing costs are lower and the market is deep, alleviate concerns.

Access to lower cost onshore debt will be helpful in mitigating risks arising from the 'Covid maturity wall'.

Overall, we think prospects for Asia fixed income are promising. This outlook is collectively supported by the culmination of global rates reaching their peak, robust performance in Asian economies, and China poised to benefit from enhanced policy support. Notably, Asia stands apart from US and European economies, boasting superior growth prospects without succumbing to inflation and interest rate shocks. This will limit potential credit defaults and downgrades, while affording governments and central banks the flexibility to be supportive with both fiscal and monetary policy.

Lower expected inflation for Asian economies versus the West (Inflation %)

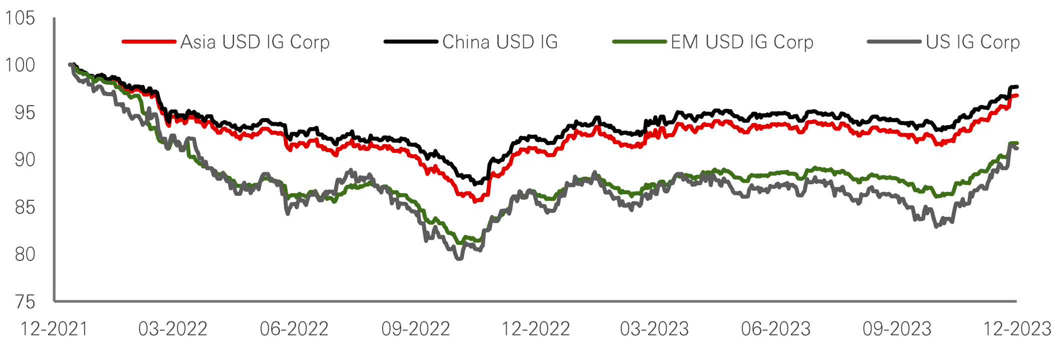


Source: HSBC AM, Bloomberg. Data as of 23 October 2023.

A shift to dovish monetary policy in the West should certainly add tailwinds, and we expect the first rate cut by the Federal Reserve in the second quarter of the year. This should contribute to credit spread tightening for Asia investment grade bonds and the overall credit market. The dovish shift should also mean US dollar strength dissipates, benefitting Asian local bonds.

Despite the persistent dominance of the China real estate market in headlines, the broader credit landscape in Asia retains its relatively high quality. This is particularly the case in the investment grade segment, while offering premiums compared to western markets. As the negative impact of the China real estate funding crisis diminishes, we think it may be an opportune time to reassess the case for Asia credit in global asset allocations.

Investment grade performance comparison (31/12/2021 = 100)



Past performance does not predict future returns.

Source: HSBC AM, Bloomberg, JP Morgan, ICE Data Indices. Data as of 31 December 2023.

Data watch (as of December 2023)

Country	Economic Indicator	Data as of	Last data	Consensus	Previous data	Analysis
Japan	**GDP growth** % yoy	Q3 2023	1.5	-	2.2	Japan Q3 GDP contracted, with widespread weakness. Consumer spending fell with non-residential investment declining for the second consecutive quarter. Rising global headwinds pose a downside growth risk.
	% qoq		-0.7	-0.1	1.1	
	CPI Inflation Headline, % yoy	Nov	2.8	2.8	3.3	Core inflation fell in November. Goods dis-inflation is evident, but service inflation is rising gradually. The outlook depends on the trajectory in wages in the coming months.
	Core*, % yoy		3.8	3.8	4.0	
	Policy rate	Dec	-0.1	-0.1	-0.1	The Bank of Japan maintained its ultra-loose interest rate policy as expected, until more evidence of a virtuous cycle in prices and wages. The central bank also upheld its dovish policy guidance. BoJ Governor Ueda said that while conditions remain uncertain, price and wages appeared to be moving in the right direction.
China	**GDP growth** % yoy	Q3 2023	4.9	4.5	6.3	The economy shows signs of cyclical growth stabilisation and looks on track to achieve the "about 5%" growth target. More policy support is still needed amid a prolonged downturn in property sectors.
	% qoq		1.3	0.9	0.5	
	CPI Inflation Headline, % yoy	Nov	-0.5	-0.2	-0.2	Weaker food prices and subdued goods demand continue to weigh on headline inflation prints, with core inflation remaining modest.
	Core*, % yoy		0.6	-	0.6	
	Policy rate**	Dec	3.45	3.45	3.45	The PBoC maintained its policy rate unchanged for four consecutive months. More proactive fiscal policy and liquidity support remain likely ahead.
India	**GDP growth**, - % yoy	Q3 2023	7.6	6.8	7.8	India's strong Q3 GDP was driven by robust manufacturing and construction. Increased government spending was also supportive.
	CPI Inflation Headline, - % yoy	Nov	5.55	5.8	4.87	Headline CPI inflation rose in November as base effects and higher food prices offset a further moderation in core inflation and a fall in fuel prices.
	Policy rate	Dec	6.50	6.50	6.50	The RBI kept policy rates and its tightening bias unchanged, with an upgrade to its FY2024 growth forecast.

Improved or better-than-expected
Worsened or below-expectations
Unchanged or in line with expectations

* Japan Core CPI is CPI excluding fresh food and energy. China core CPI is CPI excluding food and energy.
** China policy rate is the one-year loan prime rate.
Sources: Bloomberg, Refinitiv, HSBC Asset Management.

F: Final A: Advanced P: Preliminary estimate

Asset class positioning

Asset class	House view	Comments
Asia local government bonds	▲	Asia's more resilient growth should be supportive. As core inflation in the region moderates further, most central banks may have room for rate cuts in H2 2024 following a potential Fed policy easing. Global macro uncertainties and geopolitical developments remain the key risks.
RMB bonds	↔	More proactive liquidity support is likely, in addition to the already accommodative monetary backdrop. Although long-term diversification benefits remain intact, strong primary supply could limit the upside in the medium term.
Asia ex-Japan equities	▲	Macro uncertainties, earnings downgrades and geopolitics remain key risks, but potentially more fiscal policy measures in China and slimmer odds of further tightening by Asian central banks ahead may offer some support. Dispersion in regional markets remains likely.
China equities	▲	Although risks to the outlook still linger from a prolonged property market downturn and softening external demand, more proactive policy support may help stabilize the economic momentum outside the property sector and revive investor confidence as equity valuations stay appealing.
India equities	▲	While rich valuations are a concern, Indian equities show solid earnings growth potential with a strong structural story and a resilient macro backdrop. Policy rates should have peaked, but the RBI will likely hold tightening bias for a while before the potential Fed rate cuts in 2024.
ASEAN equities	▲	ASEAN's resilient macro backdrop, their space to ease monetary policy following peak Fed hawkishness and supply-chain relocations in the region are positives. Defensive qualities are attractive, but lingering global and Chinese macro worries are still the headwinds.
Hong Kong equities	▲	Prevailing global and Chinese macro uncertainties, and the faltering domestic property market still drag the earnings outlook. But their compelling valuations and the loosening financial conditions amid growing hopes of Fed rate cuts ahead should help partially offset some headwinds.
Japan Equities	▲	A robust earnings outlook and attractive valuations are positives for Japanese equities. Moves by the BoJ to ease its Yield Curve Control and Negative Interest Rate policies could put pressure on valuations.
Asia FX	▲	Potential USD weakness remains a medium-term benefit, and a stabilizing RMB and lower Treasury yields could also lift sentiment. The overall macro backdrop supports the outlook, but dispersion in currency pairs may extend with their divergent economic performance and fiscal status.

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