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Playing the Yield

Mid Year Global Investment Outlook

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HSBC Asset Management

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Foreword

Foreword from our Chief Investment Officer

Welcome to our Global Investment Outlook, reflecting the main findings of our quarterly Strategic Forum. I am pleased to share our view on the global economy and investment markets for the months ahead.

The first half of 2024 has been characterised by significant shifts, particularly influenced by evolving interest rate expectations. We have witnessed a divergence in central banks' policy priorities alongside diverging economies. Notably, interest rate cuts in Europe and Latin America contrast with the Federal Reserve's cautious approach in maintaining a 'higher-for-longer' policy amidst resilient US growth.

While western central banks have recalibrated their strategies as services sector inflation proved sticky, the global economy continues to be navigating towards a 'soft-ish landing'. This resilience has been supported by robust labour markets and favourable fiscal policies. Our outlook posits a gradual moderation in inflation, anchored by cooling labour markets and subdued goods' prices. This trajectory, however, hinges on navigating a landscape increasingly shaped by a more hostile geopolitical climate amidst a multi-polar world.

The economic power shift towards Asia and emerging markets is becoming more pronounced and the supply side of the economy is facing more challenges compared to the past 30 years, which could result in higher inflation and lower potential output. As protectionist measures rise and economic statecraft becomes commonplace, investors must recalibrate their strategies to account for heightened volatility and divergent country dynamics.

In this context, we maintain a 'defensive growth' stance, with a bias towards quality and selectivity in stocks and credits. At the core of our approach is the 'playing the yield' strategy of capitalising on attractive yields in US Treasuries and UK Gilts. Equally compelling are opportunities in global credit markets, although narrow spreads should concentrate the search for income to investment grade and quality high yield bonds. This also applies to securitised credit that can also bring diversification benefits amidst rate volatility.

Separately, the growth outlook in emerging markets is a relative bright spot in a global context. Equity market valuations remain relatively undemanding while currencies can benefit from a Fed pivot. Idiosyncratic trends within emerging markets imply scope for portfolio diversification too. More specifically, we still emphasise Asia. Chinese policy support has helped stabilise growth, while countries such as India and Indonesia offer attractive structural and cyclical growth opportunities.

In the long-term, as a result of mega trends (demographics, green transition, geopolitics, etc.) inflationary pressures may persist and lead to more volatile bond-equity correlations. Diversification and return enhancement should be found through geographical granularity, within emerging countries notably as divergent country dynamics are increasingly at play. Investors must also be prepared to adapt their strategies in response to the evolving multi-polar world and find intelligent diversification while maintaining growth exposures, such as in alternatives like real assets and natural capital assets.

"The increasing influence of geopolitical factors on markets signals a shift to a new era with more volatile inflation and lower potential growth."

Xavier Baraton
Chief Investment Officer

Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Macro outlook and market implications

Macro outlook and market implications

As the global economy approaches a 'soft landing’, resilient growth alongside potentially tighter-for-longer policy creates an uncertain longer-term outlook.

Strong labour markets and supportive fiscal policies have helped the soft landing narrative withstand restrictive interest rates. However, an unusual trend of differing economic conditions across regions has emerged, causing some divergence in central banks’ policy priorities.

Regions such as the US, India, parts of industrial Asia, and emerging markets have experienced resilient economic growth, while European economies have endured lacklustre real growth.

Consequently, European and Latin American central banks have cut rates ahead of the Federal Reserve, while countries like Brazil and Mexico are adjusting their strategies in response to the Fed.

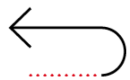
On the inflation front, early 2024 saw an unwelcome revival of price pressures in some economies, indicating that the disinflation process might be slower and more uneven than anticipated. However, more recent data suggest inflation is ‘sticky, but not stuck’ and we expect further improvement through the second half of the year.

While Western economies have seen inflation spikes in Q1, Japan has been a contrast with unexpectedly low readings. Emerging markets are also seeing inflation move lower, with China gradually emerging from deflation. We think currency weakness against the dollar poses risks for EMs but doesn’t outweigh strengths.

As divergent country dynamics offer unique return drivers, granular geographic considerations become more important. We take a cautious view on western risk assets as valuations look stretched in places. Maintaining ‘defensive growth’ positioning, we emphasise the benefits of real assets and opportunity from ‘all-in yields’, i.e. total returns rather than just rates in fixed income. There are opportunities in high yield and investment grade bonds, especially in emerging and frontier markets.

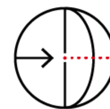
Emerging markets have shown remarkable resilience to the prolonged high interest rate environment, China’s growth challenges, and a stronger dollar in 2024. The EM growth premium, which should be supported by proactive Chinese policies, contributes to our positive outlook for EM assets, with long awaited Fed cuts and a weaker dollar as potential catalysts.

Figure 1: Playing the yield – Investment themes



The return of fixed income

- Interest rate expectations reset in the first half of the year
- High carry and ‘all-in’ yields point to better fixed income returns in the second half, amid rate cuts and disinflation
- Duration could boost returns under any adverse growth scenario, or more aggressive policy pivot



Emerging market leadership

- Valuation discounts and broadening global growth create an opportunity for emerging markets to lead
- Key issues are the direction of the US dollar and the extent of the Fed pivot. But EMs are becoming less US-centric
- In a multi-polar world, emerging and frontier market trends are more idiosyncratic

Real role for real assets

- Economic shifts create a more volatile inflation environment in the medium term
- This has profound implications for stock/bond correlations
- Current pricing offers an attractive entry point for many real assets

Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Scenarios

A 'soft-ish landing' remains our baseline scenario, envisioning a moderate economic slowdown that avoids a severe recession. This means that inflation, which has been sticky, unsticks itself.

There are plenty of positives, including growth broadening out, evidence that inflation is reverting to an improving trend, profits news is good, and policy makers are pivoting. Equally, there are risks. These stem from multiple areas including geopolitics and elections, the effects of higher-for-longer rates and a possible policy error, and the potential for economies to cool down faster than we expect.

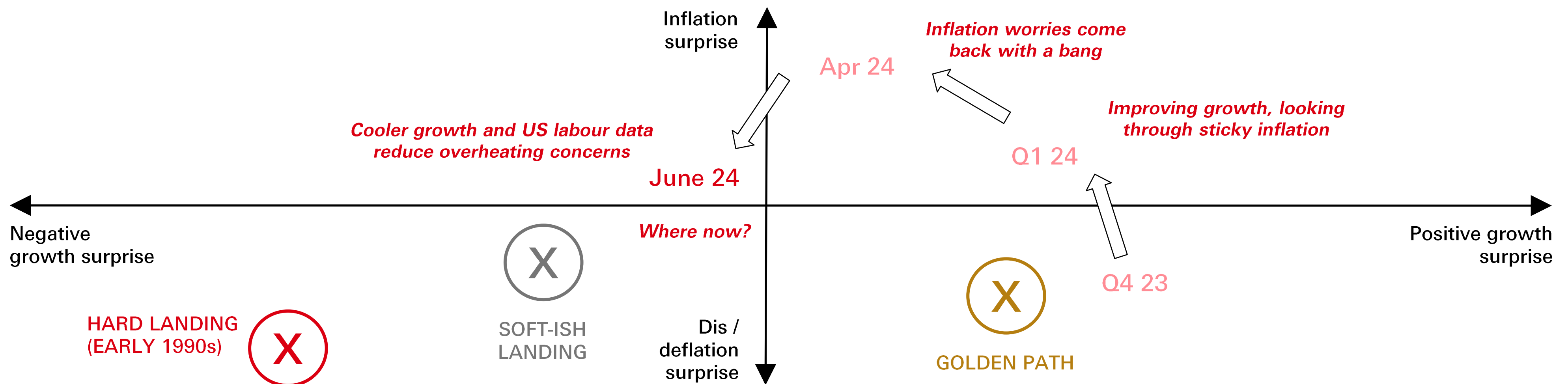
Our scenario expects a gradual weakening of the labour market with a limited rise in the unemployment rate. This is enough to dampen services inflation, while goods inflation remains well-behaved. Together it means that inflation can fall back toward target and central banks can cut rates. Our central scenario is for two Fed cuts this year. Importantly, with different growth and inflation dynamics across regions, policy divergence could emerge, creating idiosyncratic returns across geographies.

We remain cautiously optimistic overall but think 'playing the yield' is the right strategy now. A combination of cooling demand, weaker profits, modest rate cuts, and higher term premia could be a tricky situation for risk markets to navigate. It would give us, at best, a choppy market outlook.

The downside scenario, which we assign a low probability to at this point, is that the economy cools too quickly, perhaps due to rates remaining too high for too long. This could create a mild recession and some financial stress.

Conversely, the upside scenario, which we call 'the golden path', aligns with current market pricing. This is a 'soft landing – plus' outcome, and relies on factors like AI boosting productivity, or immigration and improved healthcare/childcare increasing the labour supply to balance against elevated demand – of particular importance over the longer term as societies age. That would allow the economy to grow faster and deliver more profits, thereby supporting higher-for-longer interest rates. While we have a constructive economic scenario in mind, it is not quite as optimistic as that priced in by parts of the market.

Figure 2: Where have we been, where are we heading? Our macro scenarios in context



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Market implications

Exuberance in markets reflects expectations of a soft-landing under ideal conditions. Hence, we maintain our preference for a ‘defensive growth’ stance and see opportunities in fixed income, including in emerging markets.

With various potential difficulties on the horizon for risk markets to navigate, we opt for bonds over equities in multi-asset portfolios, with a focus on positioning.

The resetting of Fed rate expectations in the first half of the year has led to volatility in core fixed income markets. However, the reset has created attractive entry points to ‘play the yield’.

Our view is to put cash to work with selective exposures. We like income opportunities in global investment grade, Asia high-yield, and private credit. Spreads are tight, but all-in yields must be considered.

The trend of central banks pivoting to rate cuts will continue, with the European Central Bank and Bank of Canada having already moved ahead of the Fed. This should be a clear tailwind for bond markets in the second half of the year.

We expect emerging market central banks in Latin America and Europe to continue leading the global easing cycle, but at a slower pace to avoid currency volatility amid a strong US dollar. This supports our positive view on emerging market bonds, although the divergence in central bank policies means assessment of currency risks and rate differentials is necessary.

Overall, the EM growth premium, catalysed by new policy proactivity in China, supports the outlook. Realisation of Fed cuts and a weaker dollar are obvious catalysts, but the argument for strong medium-term performance is backed up by solid fundamentals, as well as cheap valuations. We favour EM and frontier equities over developed markets for similar reasons. Furthermore, differing economic backdrops create diversification benefits.

Over the longer term, geopolitical factors should increasingly influence market dynamics, signalling a shift to a new era with more volatile inflation, lower potential growth, and altering stock/bond correlations. Diversification should be prioritised, with alternative sources of portfolio resilience becoming a must. Real assets, for instance, such as infrastructure and natural capital, can offer defensive qualities and stable returns amid fluctuating bond yields.

Figure 3: Views per asset class (▲ Positive / ↔ Neutral / ▼ Negative bias)

Equities

Asset Class	House view
Global	↔/▼
US	↔/▼
UK	↔/▼
Eurozone	↔/▼
Japan	↔/▲
Emerging markets (EM)	▲
Latam	▼
Frontier	▲

Government bonds

Asset Class	House view
Global	↔/▲
US10yr	▲
UK10yr	▲
German 10yr	↔
Euro Periphery	▼
Japan	▼
Inflation-linked	↔
EM (local currency)	▲▲

Corporate bonds

Asset Class	House view
Global investment grade	↔/▲
USD IG	↔/▲
EUR & GBP IG	▲
Asia IG	↔/▲
Global high-yield	↔/▼
US high-yield	▼
Europe high-yield	▼
Asia high-yield	↔/▲
Securitised credit	▲▲

Commodities, alternatives and FX

Asset Class	House view
Gold	↔/▲
Oil	↔
Listed Real estate	▲▲
Infrastructure	▲▲
Hedge funds	▲▲
Private equity	↔
Direct lending	▲▲
Natural Capital	▲▲
US dollar	↔/▼

Asian assets

Asset Class	House view
Pan-Asia government bonds	▲
Asia ex-Japan equities	▲
China A	▲
India	↔/▲
ASEAN	↔
Hong Kong	↔/▲
Asia FX	▲

Source: HSBC AM, June 2024. House view represents a >12-month investment view across major asset classes in our portfolios. Views reflect our long-term expected return forecasts, our portfolio optimisation process and actual portfolio positions. These views are for general information purposes only and does not constitute advice or a recommendation to buy or sell investments. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

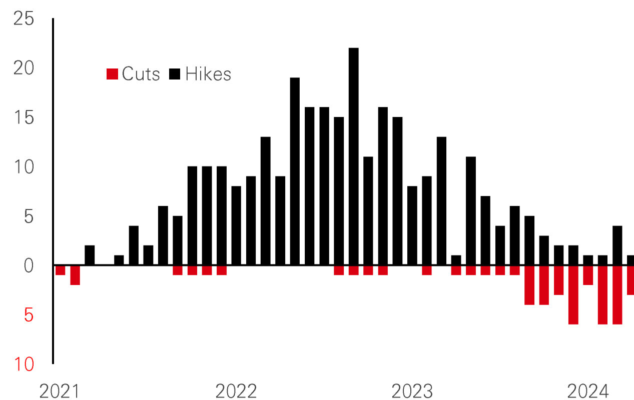
The return of fixed income

Aggressive rate hikes to curb inflation have led to the highest yields in over 15 years, accompanied by an inverted yield curve for the last two years.

This presents a rare opportunity for investors to capitalise on attractive yields, whilst minimising duration risk. Although the rate cutting path through to the end of the year is uncertain – and will be much more modest than markets were pricing at the start of the year – the procession of rate cuts that has already started in several markets will gain steam, with the red bars below set to expand. Combining the high yields on offer with capital appreciation as rates move lower presents a compelling option for putting cash to work, while maintaining some protection should economies and risk assets stumble.

Figure 4: Policy cuts – everywhere all at once

Number of central banks changing policy rate



Source: Bloomberg, HSBC AM, April 2024.

US treasuries and UK gilts look appealing, and should growth deteriorate and result in a more aggressive pivot by central banks, impressive returns could be realised.

Attractive all-in yields underlie opportunities in credit, in both investment grade and high-yield bonds. Resilient macro trends and solid fundamentals are keeping default projections contained. This leaves potential returns looking high. Nevertheless, spreads are at multi-year tights, so we emphasise a focus on quality and defensive parts of the market.

In EM bonds, our positive stance has been reinforced by their resilience in the face of the higher-for-longer interest rate environment, China growth challenges, and a stronger dollar. Solid fundamentals are key to this story, with strong growth and buffers against external pressures, along with improved policy credibility. We would highlight India, Indonesia and Mexico as particularly appealing parts of the EM bond universe.

Meanwhile, Asian high yield credit has been on the back foot in recent years amid China's property market downturn. Yet, Chinese policy support has contributed to a turnaround in performance this year. Ongoing policy activism in China and relatively strong regional growth prospects mean we remain positive on this segment.

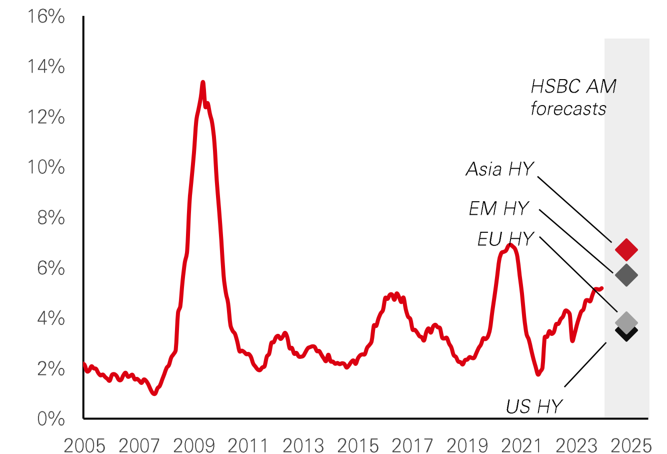
Private credit is another area that we favour, and typically consisting of floating rate debt, has delivered better returns than traditional fixed income amidst the higher rate environment. Going forward, the role of private credit in much needed infrastructure development supports steady cash flow generation and credit quality, which is ultimately key across fixed income.

Figure 5: Estimated 12m total return under different US treasury yield changes

	300bps	100bps	50bps	-50bps	-100bps	-300bps
2yr	-0.3%	3.1%	4.0%	5.8%	6.7%	10.4%
5yr	-7.3%	0.3%	2.4%	6.6%	8.8%	18.3%
10yr	-15.5%	-3.0%	0.6%	8.3%	12.4%	30.9%
20yr	-23.3%	-6.9%	-1.5%	11.1%	18.2%	52.2%
30yr	-25.6%	-9.4%	-2.9%	12.8%	22.1%	68.9%

Source: Bloomberg, HSBC AM, data as of May 2024.

Figure 6: 12m trailing global high yield default rate



Source: Bloomberg, HSBC AM, April 2024.

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Top of mind

Top of mind

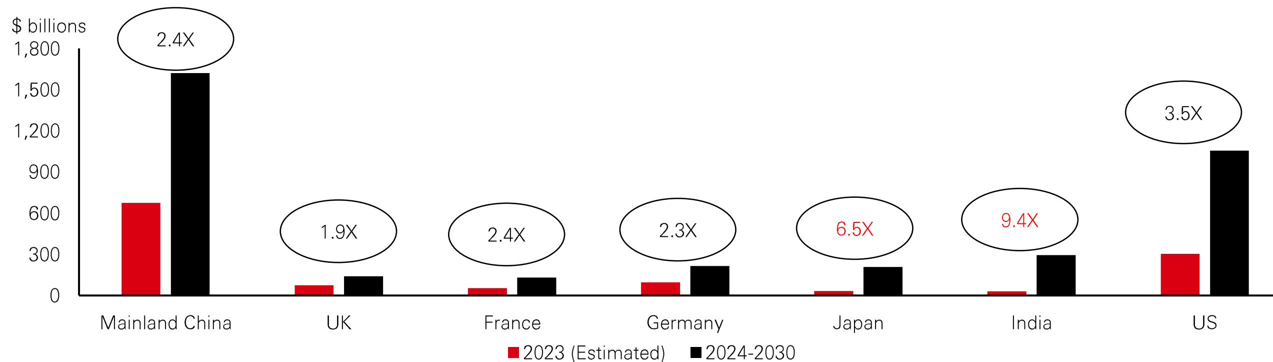
Where else can infrastructure development benefit portfolios?

We are broadly positive on assets tied to infrastructure, with growing development needs and steady cash flows aligned with our defensive growth positioning. We see particular opportunity in Asia, where solid growth and a comparatively benign inflation outlook mean that many Asian markets are in a sound position to fund future investment in infrastructure. Much of this investment is focused on renewable energy generation, with governments across Asia being proactive in supporting renewable energy through incentives, subsidies, and favourable policies to meet growing demand sustainably.

Within Asia, countries are at different stages in their infrastructure investment and development. China already spends more than any other country on energy investment to transition away from fossil fuels, but still needs to more than double that investment to hit net zero targets. Japan and India on the other hand, need to massively increase their investment to achieve targets.

The scale of investment needed in renewables for the region is large and spread across many countries, several of which have a long-term track record of infrastructure delivery with private sector participation. Focusing on the mid-market in Asia offers additional benefits from quicker decision-making processes and the ability to adapt more rapidly to market changes compared to the often slower-moving large-scale projects in the West. This agility can lead to faster deployment of renewable infrastructure.

Figure 1: 2023 energy transition investment versus required annualised levels, and multiple of current investment required, via New Energy Outlook 2022 net zero scenario



Source: HSBC AM, BNEF, data as of January 2024

While, in our view, the market opportunity across Asia stands out, within the region there are specific countries that offer significant potential, such as Japan. As one of the world's industrial powerhouses, the country is playing catch-up when it comes to the move away from traditional sources of energy and towards renewables.

Meanwhile, the Japanese tech sector is also growing, with a focus on data centres and digital infrastructure. These are power intensive and require significant up-front investment, with the volume of data being created growing, and intensive applications such as artificial intelligence only adding to the processing (and electrical) power needed. There is of course increasing focus among data centre operators on the sources of their power, given net zero targets and corresponding regulatory pressures. This includes in Japan, where renewable energy is in demand either as a primary source of power, or as a back-up to provide resilience in the event of power disruptions.

The Japanese government is also investing to provide the groundwork for further power production and grid expansion, having announced plans to invest between $50bn and $60bn over the next decade to enhance transmission lines, for example.[1]

[1] Together for Action: Japan's Initiatives for Achieving the Common Goal of Net Zero by 2050 | The Government of Japan – JapanGov. Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

What are some longer-term implications of climate change for portfolios?

We recently conducted research into this, published in the Journal of Portfolio Management, and first note that analysing historical relationships between climate change and asset prices offers little insight; the cumulative effects of climate change and potential tipping points ahead mean future impacts will be more consequential than what we experienced in the past.

Accordingly, we focus on long run relationships between asset price risks and key macro variables such as GDP growth and inflation, before considering how climate change may influence those variables in the future, relying on scenarios developed by the Network for Greening the Financial System (NGFS).

Our study concentrates on the three major components of risk to a typical multi-asset portfolio – equity volatility, bond volatility and equity-bond correlation.

We relate these to the macro variables by a series of regressions, finding that a rise in inflation increases asset price risk for both bonds and equities, whilst the same is true of declining growth rates. An increase in temperature has historically had a small but positive link to risk, which we might reasonably expect to increase going forward.

Equity-bond correlation demonstrates a positive link to inflation and growth, with the former relationship having strong academic support and being visible in the post-covid market experience.

Having established relationships between macro and portfolio variables, we use forward-looking, ‘climate aware’ projections for macro variables to see what impact these have on risk estimates, leveraging outputs from the National Institute Global Econometric Model (NiGEM) and temperature scenarios from the International Panel on Climate Change (IPCC).

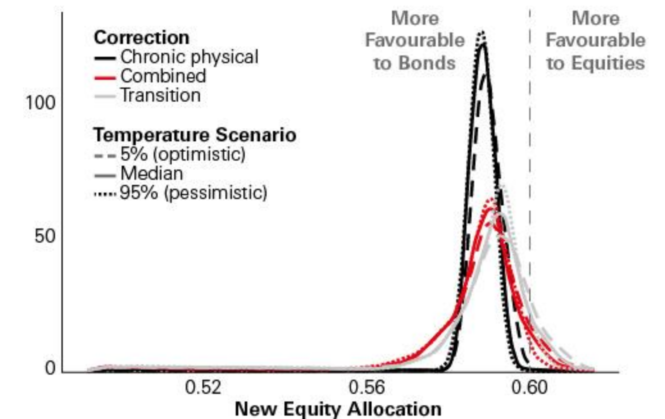
One important takeaway is that both bonds and equities see a very similar pattern in the shift of their risk; a minority of scenarios predict lower volatility, whilst the majority of them indicate marginally larger risks. A very small proportion of cases imply much larger risks.

We also model the distribution of predicted volatility, but conditional on the severity of climate scenarios. As the severity of climate scenarios increases from baseline to combined physical and transition risk, the distribution slowly shifts and with it the average risk increases, as one would expect.

One of our main objectives is to examine the impact of these climate aware variables on portfolio asset allocations. To do this, we start from a baseline 60% equity, 40% bond portfolio and examine how the portfolio allocation shifts in light of this new climate awareness.

We can see that given updates to a portfolio’s risk model, the asset allocations shift to a more ‘defensive’ stance, with bonds favoured over equities - due to the increase in risk anticipated by climate concerns. Finally, we extend the framework to introduce returns which are impacted by climate and compare the Sharpe ratios of portfolios before and after adjustment.

Figure 2: Climate-based adjustment to the 60/40 allocation, without long-term returns



Source: HSBC AM, February 2024.

This reveals a clear deterioration in portfolio properties once the capital market assumptions embed a degree of climate awareness, highlighting the prospective challenge for asset allocators. In efficient frontier terms, most portfolios are likely to see a shift down (lower returns) and to the right (higher risk) in the face of climate concerns.

For further analysis:

See our latest Multi-Asset Insights

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Is the AI rally losing steam?

Generative AI has developed very quickly in the US since the beginning of last year, and the Magnificent 7 performed well. It is difficult to deny the AI theme has scope to provide further strong momentum to the US stock market. Similar to the internet, AI is a long-term transformative technology. Tech results have been broadly positive in the Q1 earnings season, helping to buoy overall S&P 500 performance. We expect the increased rollout of AI technologies will continue to support not only revenues for tech companies, but also labour-intensive firms which should benefit from automated processes.

Nevertheless, we also recognise there are some valuation challenges. Today, the Magnificent 7's 12-month forward price-earnings ratio is 32x versus 18x for the rest of the S&P. Tech earnings growth expectations remain high (at around 20% for 2024 and 2025) and along with communication services make up over half of the expected overall index EPS growth. Therefore, at these valuations, investors remain vulnerable to a scenario where earnings in these sectors disappoint.

Investors can also be exposed to above-average volatility, as illustrated by Nvidia, who's market capitalisation grew from $2 trillion to over $3 trillion in just a matter of weeks, but also suffered a record three-day value loss (over $400 billion) in this journey.

We think the opportunity today looks to be more in other international stocks. There is evidence that profits growth is broadening out from the technology areas to rest of the economy, and from the US and India, to the rest of the world.

Within developed markets, we continue to like the low valuations, macro recovery story, and long-run corporate reform theme in some Japanese stocks, for example, which can also be longer-term beneficiaries of AI.

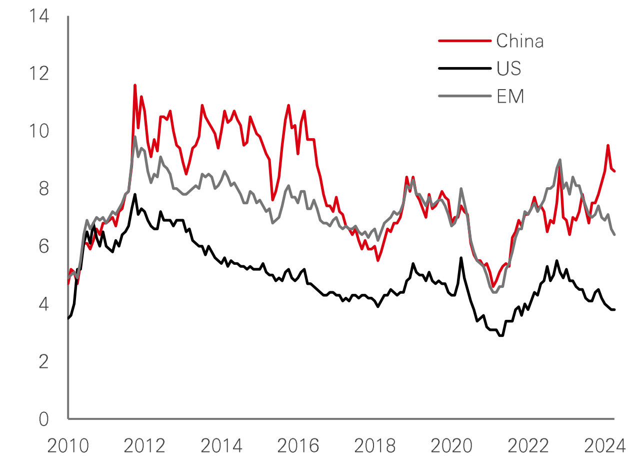
Will the China stock rally last?

After a significant decline since mid-2021, the Hong Kong stock market has finally rebounded, more than 20% since late April. The market's recent strong run has come amid a package of Chinese government support, including targeted backing for key sectors, guidelines for promoting high-quality development of capital markets, and measures to reinforce Hong Kong's financial hub status.

Sentiment has also been boosted by signs of a cyclical stabilisation in China coming from exports, advanced manufacturing, and infrastructure. There has also been evidence of increasing investor-friendly corporate actions in China and Hong Kong (e.g. more buybacks and raising dividend pay-outs).

The valuations of Hong Kong stocks are still compelling and well below the long-term average (8.9x for the HSI on a 12-month forward PE basis) and offers a significant discount to global peers.

Figure 3: 12-month forward earnings yield (%)



Past performance is not an indicator of future returns.
Source: HSBC AM, Bloomberg, June 2024.

Similarly, valuations of Chinese equities remain relatively attractive, showing a material discount to US or other emerging market peers, as illustrated by a 12-month forward earnings yield over twice that of their US peers.

Overall, we think further re-ratings are possible should the news flow around earnings, policy measures (from China), and corporate actions remain positive. However, we also recognise there are headwinds to performance. Macro challenges in China and Hong Kong remain, and growth is unbalanced across sectors. Investor concerns include deflationary pressures in China, a prolonged property market overhang (in mainland China/HK), soft consumer sentiment, and ongoing geopolitical tensions.

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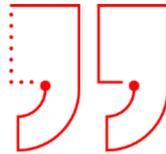
Tracking energy issuers' net zero transition

Tracking energy issuers' net zero transition

"Energy companies need to finance new green technologies to reduce their scope 3 emissions (80-95% of total[1]), but in the short term, they prioritise scope 1 & 2, where technologies are more mature."



Oil demand is expected to keep growing this year. After rising by more than two million barrels per day in 2022/23, it is expected to increase by a further 1.2 million barrels per day in 2024, with China remaining the key source of demand growth.

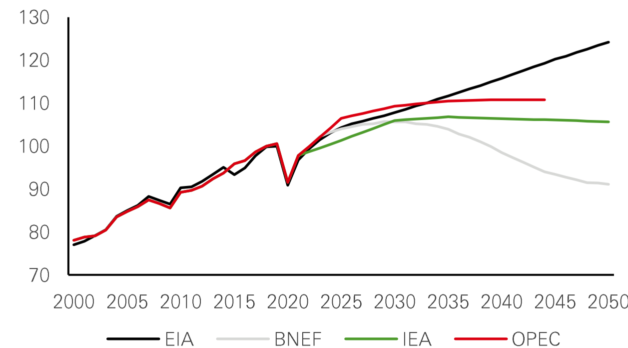
Many agencies make long term forecasts for oil demand, but all of them fall well short of net zero emissions targets which would require demand falling to around 24 million barrels per day[2] in 2050, around a quarter of 2023's figure. Projections for future oil demand are heavily dependent on assumptions for electric vehicle adoption, but in other sectors demand is broadly tracking the expansions of economies and populations, meaning that peak oil consumption by 2030 is an ambitious target.

Energy transition may well be a multi-decade process, with past experience showing that new energy sources such as oil and natural gas took perhaps four decades to move from proof of concept to meaningful scale. Emerging clean technologies like wind and solar currently only account for 2-3% each of the global primary energy mix[2].

The so called 'Energy Trilemma', which highlights the potential three-way conflict between energy security, affordability and sustainability, is a further complicating factor which could put the brake on progress towards net zero. Governments need to consider the politics of high energy prices, while the vulnerability of global supply chains has been brought into sharp relief by the conflict in Ukraine and the general geopolitical zeitgeist. This means that the need to secure and maintain sufficient energy supplies can turn policy away from environmentalism and promote the use of domestically sourced dirty assets such as coal, as has occurred in India and China[3].

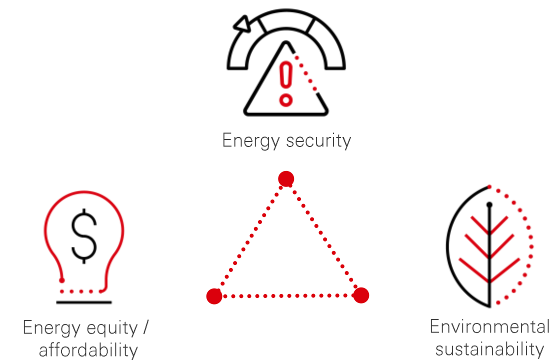
Investments into clean energies have grown significantly in the last 10 years (+24% CAGR), but a tectonic shift is still required to reach targets embedded into the IEA Announced Pledges Scenario (APS) and the net zero emissions pathway, which would require a respective 138% and 300%+ further increase in investment to achieve[4].

Figure 1: Updated oil demand outlook from Agencies (million barrel per day)



Source: IEA, BNEF, OPEC, M Stanley and UBS estimates, May 2024.

Figure 2: The energy trilemma



Source: IEA, HSBC AM, May 2024.

[1] Source: Wood Mackensie / [2] Source: IEA / [3] Source: Climate Action Tracker / [4] Source: IEA. Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Oil and gas companies need to be part of the transition and lowering of their emissions requires various technologies depending on their scope.

Most of the investment required to transition to clean energy comes from private sources, mobilised by public policies which create incentives within an appropriate regulatory and tax framework. However, direct government financing is also needed to boost the development of new infrastructure projects and to accelerate innovation of technologies in development. Most assumptions for reduction in CO2 emissions embedded into the IEA net zero pathway[5] come from technologies readily available today, and would mean that the share of renewable energy in the primary energy mix would have to rise to 57% by 2040. After 2030, 35% of assumed reductions come from technologies under development, including advanced batteries, hydrogen electrolysis and direct air capture and storage, the latter playing a key role in hard to abate sectors.

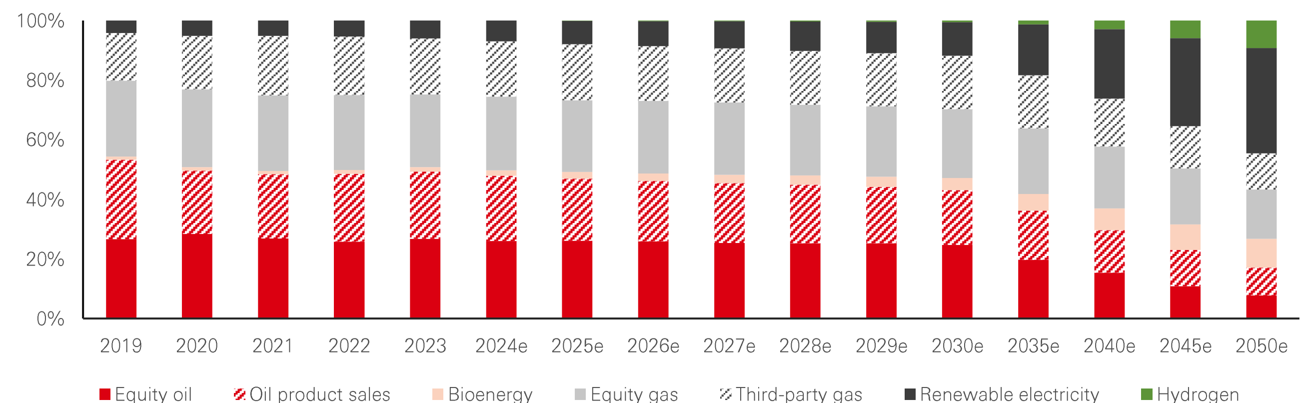
In terms of oil and gas companies' priorities in cutting different types of emissions. For scope 1 & 2, tackling methane leaks, reducing flaring and carbon capture have the potential to make the most positive difference and much progress has been made in these respects in recent years. But cutting scope 3 emissions (those created by the actual burning of the fossil fuels extracted and refined), which make up by far the largest share overall, is more about reducing carbon intensity of energy produced and requires more radical solutions, such as lowering hydrocarbon production and divesting upstream assets.

Transitioning to gas from oil will reduce intensity, but the move to renewables, biogas, renewable liquid fuels and hydrogen will have more of an impact. The difficulty for investors and regulators is that scope 3 carbon emissions are not disclosed in an homogenous way across the world and targets vary per region, making peer comparison challenging.

European energy companies remain very much at the forefront of energy transition, with all disclosing their scope 3 emissions with more explicit targets, while US companies have no legislated national policy to define categories and obligations. Asian companies typically don't specify if net zero targets include scope 3, while other emerging market issuers also lag in terms of commitments.

In Europe, all large oil companies have set an ambition to be net zero (scope 1, 2 & 3) by 2050, even if only two of them have set intermediate goals for scope 3. A likely decrease of 10% in carbon intensity by 2025 and 19% by 2030 should come from a rising share of low carbon activities. Even so, European big oil is still not aligned with IEA Net Zero, although more consistent with APS. Different pathways and business models are emerging for each company, with varying degrees of balance in capital expenditure (capex) between oil and gas and low carbon assets. In aggregate we expect European majors' upstream oil and gas volumes to decline substantially, with capex to low-carbon assets[6] likely to rise from the current 15-20% to 30-40% by 2030. As a result, European oil and gas majors have provided support to their credit profiles by demonstrating that their business models and capital returns are becoming more resilient to energy-transition risks.

Figure 3: European oil majors – indicative mix of energy sales to 2050 (% of total production)



Source: UBS Research, HSBC AM, May 2024.

[5] Source: IEA / [6] Source: Forecasts from EIA research reports. Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

"Only some of the largest United States energy companies have net zero targets and they typically do not include scope 3."

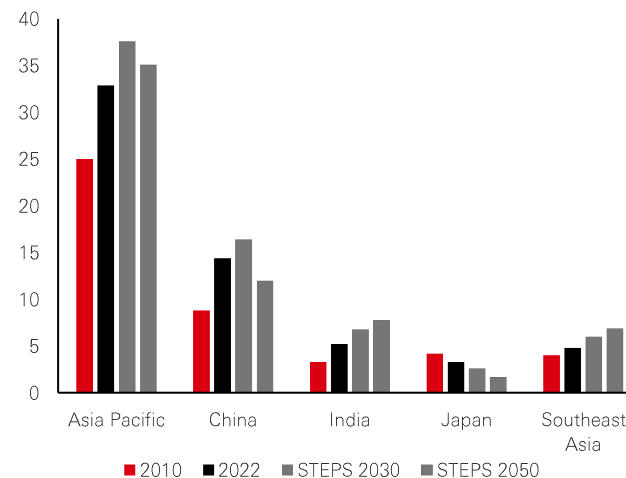
US oil and gas companies are prioritising transition technologies which fit within their existing infrastructure. Carbon capture is the most targeted technology given the ability to repurpose existing assets and the 45Q tax credit, which provides subsidy for carbon dioxide which is geologically stored permanently, through enhanced oil recovery or via other utilisation. Renewable natural gas and liquid fuels (also called 'biofuels') production can also be scaled to existing processes in some companies. Its superior destination flexibility and optimisation qualities makes liquefied natural gas a critical enabler of accelerating the switch from coal which could have a profound effect on emissions, with US companies set to take around a 36% share[6] of a fast-growing global market by 2030. Only a few upstream/mainstream companies are experimenting with hydrogen, but with one notable exception, a company building a plant which will be six times larger than any other hydrogen facility currently in existence.

The current trend is for sub-scale high yield companies to be absorbed by investment grade rated peers, while many of the largest high yield energy index constituents are candidates for credit upgrade.

In Asia, oil and gas majors aim to transform into integrated energy companies but have been underspending their capex targets for energy transition in recent years. Fast economic growth and a preoccupation with energy security mean that Asia oil demand is rising and there remains a high proportion of fossil fuels in the energy mix.

Although China's oil demand is expected to peak by 2030, India and Southeast Asia's demand is likely to keep increasing beyond that point. Although countries and companies have set net zero targets, they are vague and don't specify whether they also cover scope 3 emissions, which makes it difficult to scrutinise the targets and compare them with global peers.

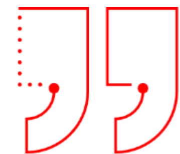
Figure 4: Asia oil demand expectation (million barrel per day)



STEPS: Stated Policies Scenario.
Source: Forecasts from EIA research reports, March 2024.

Amongst other emerging markets, a few companies stand out as best in class in relation to the transition, being the only ones with credible commitments to net zero, even if these do not include scope 3. Low emission fuels could create significant value to producer economies in the emerging markets, but they are unlikely to replace more than a small part of today's fiscal and export revenues from fossil fuel activities. Meanwhile, none of the producer economies are visibly shifting towards a low-carbon energy system, even if each has distinctive national circumstances and a track record in environmentalism.

"Less than 20% of current oil and gas production comes from companies that plan to diversify into clean energy[7]."

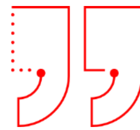


[7] Source: IEA. Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

A frontier worth exploring

A frontier worth exploring

"Frontier markets, often overshadowed by their emerging markets counterparts, offer unique growth and diversification opportunities."



Frontier markets have proven to be a useful compliment to equity portfolios, having been less correlated with developed markets than their emerging markets peers, while delivering lower volatility than both emerging and developed markets. A primary reason is that frontier countries exhibit distinct internal dynamics and domestic drivers, enabling them to develop somewhat independently from the wider global economy. This leaves intra-country correlations low, meaning reduced overall volatility at an asset class level that can enhance risk-adjusted returns within portfolios.

Frontier markets are characterised by their nascent financial infrastructures and evolving regulatory landscapes, but these markets boast young and growing working-age populations, offering a significant 'demographic dividend'.

Furthermore, increases in the middle class are fuelling consumer expenditure, as disposable incomes increase.

This is in contrast with the general slowdown of population growth across developed markets, an issue that is also beginning to impact some emerging markets countries, such as China. Despite housing some of the world's most populous and fastest-growing economies, frontier markets are still relatively under-researched, undervalued and under-owned.

Frontier markets economies have experienced a boost in recent years from the adoption of the China plus one strategy by western corporations aiming to diversify their supply chains. With frontier markets having undergone significant reforms and providing an abundant supply of low-cost labour, they have become preferred markets for such expansion. Apple's selection of Vietnam for MacBook production offers an example, enabling the company to benefit from labour costs which are less than half of those in China, where much of its current products are made.

Figure 1: Correlation amongst frontier markets and against emerging markets (5-year, weekly returns)

	Emerging	Frontier	Colombia	Nigeria	Kuwait	Pakistan	Kazakhstan	Oman	Kenya	Argentina	Vietnam	Lebanon	Croatia
Colombia	0.64	0.56	1.00										
Nigeria	0.02	0.18	0.01	1.00									
Kuwait	0.39	0.64	0.44	0.09	1.00								
Pakistan	0.33	0.34	0.25	0.09	0.13	1.00							
Kazakhstan	0.39	0.52	0.39	0.00	0.24	0.22	1.00						
Oman	0.26	0.41	0.34	0.05	0.36	0.06	0.30	1.00					
Kenya	0.14	0.29	0.17	0.04	0.13	0.26	0.11	0.08	1.00				
Argentina	0.45	0.42	0.46	0.02	0.35	0.18	0.27	0.14	0.16	1.00			
Vietnam	0.41	0.58	0.27	0.05	0.05	0.24	0.20	0.17	0.10	0.14	1.00		
Lebanon	-0.01	0.01	0.05	-0.01	-0.06	-0.14	0.03	-0.03	-0.09	-0.04	0.03	1.00	
Croatia	0.60	0.64	0.56	0.03	0.45	0.21	0.31	0.31	0.11	0.39	0.25	0.04	1.00

Past performance does not predict future returns. Source: Bloomberg, weekly data (Wednesday to Wednesday) from 27 March 2019 to 27 March 2024. Frontier Markets: MSCI Frontier Markets Daily TR Net USD; Emerging Markets: MSCI Emerging Markets Daily TR Net USD.

Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

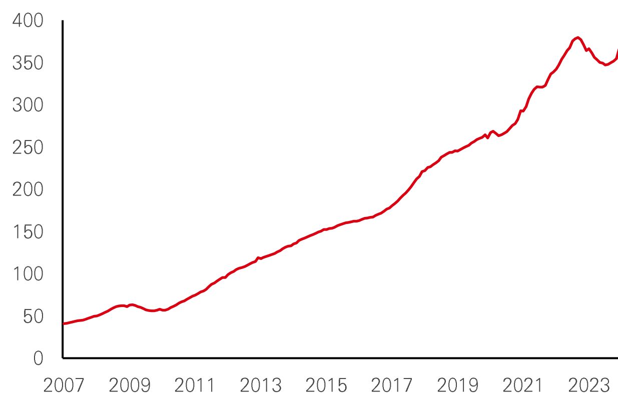
Evolution of frontier markets

Frontier markets are increasingly becoming more business-friendly, attracting foreign investment through legislative reforms and reduced barriers to entry. According to the World Bank's Ease of Doing Business survey, factors such as starting a business, obtaining electricity, paying taxes, and accessing credit have improved, indicating an improving regulatory environment. This shift has supported the movement of manufacturing hubs to these countries, where improved infrastructure reinforces the benefit of low labour costs.

Supply chain diversification

When the pandemic highlighted the vulnerability of global supply chains being concentrated in East Asia, supply chain diversification and nearshoring emerged as a significant theme across frontier markets.

Figure 2: Vietnam's exports ($ billion)



Source: HSBC AM, Bloomberg, data as of April 2024.

By moving various production stages in neighbouring economies, companies could leverage lower costs, economies of scale and higher productivity. Countries like Vietnam, Bangladesh and Kenya exemplify this trend with their low wage costs, competitive productivity and substantial working-age populations.

Morocco's automotive sector has become a nearshoring success story, attracting international brands to set up manufacturing bases and leverage proximity to Europe for efficient market access. Similarly, Eastern European countries such as Slovenia and Romania are progressing toward becoming key manufacturing hubs for the EU, delivering export growth and positioning themselves as local leaders in the nearshoring trend. This geographic diversification enables companies to be closer to end-customers, while boosting the local economy.

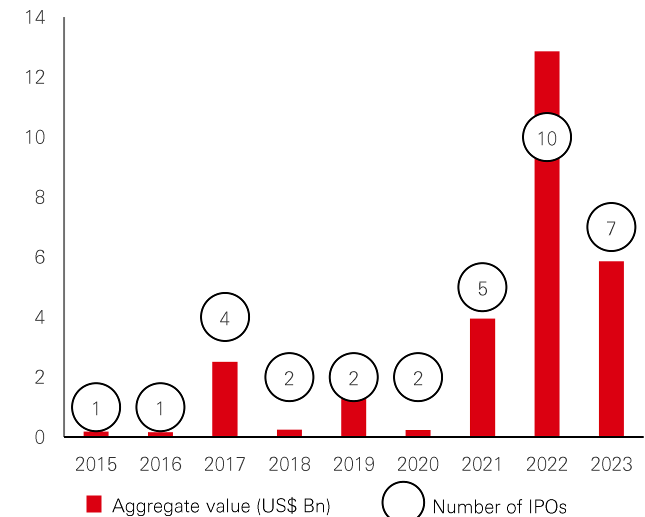
Liberalisation

Liberalisation efforts have been a cornerstone of the economic reforms in enhancing the attractiveness of doing business in frontier countries. Vietnam's market liberalisation in 2009, for instance, to increase foreign ownership limits in publicly listed companies from 30% to 49%, has helped improve market efficiency and attracted significant foreign investment, particularly in high-cost manufacturing sectors such as electronics. Other examples can be seen in the Gulf Cooperation Council members, especially the UAE and Qatar, which have also made moves to bolster industrial growth and the start-up ecosystem. Saudi Arabia is also taking significant steps toward market liberalisation, creating diverse opportunities for businesses.

Digitisation and increased capital markets activity

Digitisation and increased capital markets activity are also acting as transformative forces. As cash circulation decreases globally, the sizable informal economies of these markets are integrating into the broader economy, enhancing financial inclusion, reducing leakage and improving efficiency. Separately, growth in initial public offerings and the universe of listed equities has supported investment opportunities, with new companies showing confidence in tapping public funding in countries like Romania, the UAE and the wider MENA region. This trend furthermore promises corporate growth, improved governance, heightened competition and job creation.

Figure 3: IPO activity in UAE since 2015



Source: HSBC AM, Bloomberg, data as of March 2024. Terminated/withdrawn IPOs have been excluded from the sample.

Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

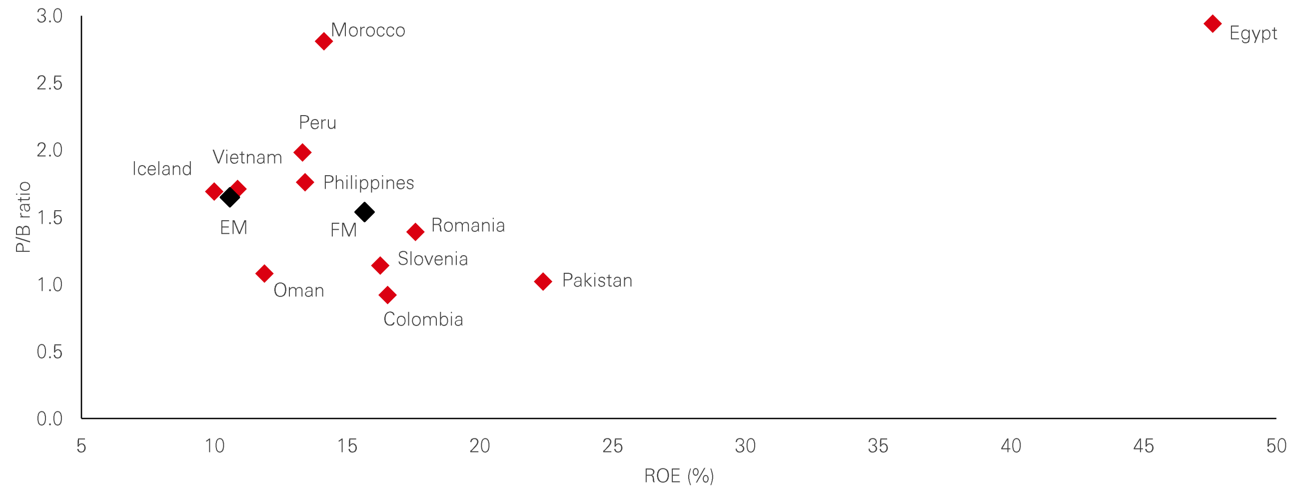
An illustrative example

The United Arab Emirates (UAE), a key member of the Gulf Cooperation Council (GCC), exemplifies rapid economic transformation in frontier markets. Leveraging oil export revenues, the UAE government has successfully diversified its economy through extensive infrastructure development and urbanisation. A notable trend in the UAE and the wider GCC region is the implementation of comprehensive economic and social reforms. These reforms aim to enhance regional leadership, attract foreign investment and drive economic growth through increased liberalisation.

The UAE has achieved supported growth through significant policy changes. For example, the Foreign Ownership Liberalisation (2021) abolished the requirement for local commercial companies to maintain majority Emirati ownership, allowing full foreign ownership. Additionally, social liberalisation efforts, such as the Golden Visa (2019), attract and retain talent by offering long-term residency and pathways to Emirati citizenship.

Strategically located at the crossroads of trade routes between the West, Asia and Africa, the UAE benefits from its prime location and world-class infrastructure. This strategic positioning attracts businesses looking to establish a presence and leverage market access. The government's strong fiscal position, net asset strength and high GDP per capita further enhance its investment appeal. Investor interest in new IPOs has been strong, underscoring the favourable business environment.

Figure 4: Frontier markets price/book ratio versus return on equity



Past performance is not a reliable indicator of future performance.
Source: HSBC Asset Management, data as of 31 May 2024. Index used: MSCI Select Frontier + EM Capped index.

Evaluating the investment opportunity

Frontier markets are generally smaller, less developed and more volatile, but they exhibit idiosyncratic behaviour with low intra-country correlations. Limited foreign investor presence (<20%) and local investor-driven pricing also helps reduce correlations across these markets.

Hence, pooling investments across multiple frontier market countries can together change the risk profile. For instance, by investing in Vietnam and Kuwait, which have a near-zero correlation, investors achieve effective diversification given these markets do not move in tandem.

Moreover, frontier markets offer strong earnings growth at attractive valuation levels, within economies less indebted than their emerging and developed counterparts. Currently trading at a forward price-to-earnings ratio of under 11x, these markets trade at a greater-than-usual discount of 45% to developed markets and 20% to emerging markets. And for almost the same price-to-book ratio, frontier markets are offering a better return on equity compared to their emerging market counterparts.

One challenge of less developed capital markets in these countries is constrained liquidity. This is where active management plays a crucial role in effectively managing liquidity across a portfolio.

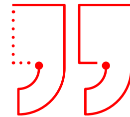
Source: HSBC AM, June 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Are emerging markets primed for the spotlight?

Foreword
Macro
Top of mind
Fixed income deep dive
Equity deep dive
Multi-asset deep dive

Are emerging markets primed for the spotlight?

"Emerging markets are proving resilient in the face of 'slowbalisation' and a mix of headwinds."



Our tactical developed versus emerging markets equities signal, based on macro factors alongside relative valuation, profitability and momentum, began reversing its decline for emerging markets (EM) since the end of January, once China stabilised, and has been steadily improving since. Even before the stabilisation of the Chinese market, many emerging market economies have shown more resilience to a strong dollar and higher core rates than past history.

The fundamental reasons behind this resilience include:

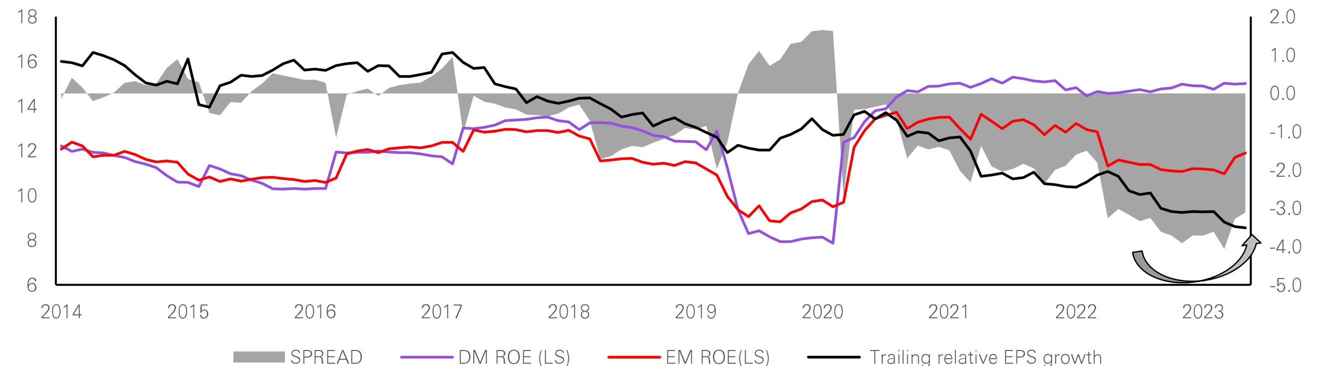
- Improvements in national accounts
- Counter cyclical measures taken by central banks to contain inflation
- Better current account management
- Increasing share of trade within emerging market countries diversifying export markets

Furthermore, we are now seeing positive momentum for various EM countries in GDP growth and EPS Trends.

The negative factor contributions for emerging markets remaining in our signal are headwinds from US dollar strength and depressed profitability compared to developed markets. Per the below chart, earnings growth has increasingly trailed developed markets post covid.

However, this year's reversal in the delta may indicate the bottom of this trend and coincides with a recent uptick in expected returns, particularly in parts of Asia such as India, Taiwan and Indonesia. Expected returns on equity are now above the 10-year average in many markets, including non-Asian EMs such as Turkey, Brazil and Mexico. Expected ROE for China remains below its 10-year average but is also showing some improvement.

Figure 1: Post-covid profitability divergence bottoming?



Source: HSBC AM, Bloomberg data, May 2024

Of course, there are levers which can be pulled to improve profitability and shareholder returns. While growing sales and margins will obviously help, there are also shareholder friendly actions such as share buybacks or increasing payouts that can certainly be pursued.

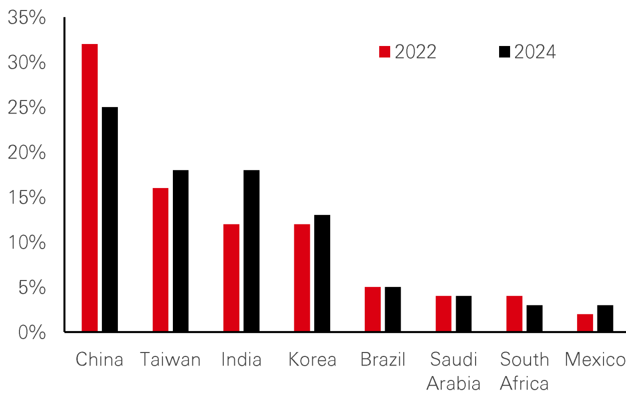
A lot of attention has been placed on such steps by Asian policy makers, with developed market (DM) peer, Japan, having successfully started the ball rolling on these efforts. Korea is now emulating the value up programme from Japan, while a new nine-point guideline issued in China is similarly aiming to strengthen capital markets and shareholder interests. Both markets have high cash-to-market-cap and low payout ratios, providing significant scope for change.

[1] as of 23 October 2023. **The performance figures displayed relate to the past and should not be seen as an indication of future returns.** Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Newfound resilience to external shocks

Index composition for emerging markets equity is very Asia-centric, at roughly 80%. While the overwhelming Asia presence has remained relatively stable over the past years, there have been material changes within the individual Asian markets. Notably, China's weighting has decreased from roughly a third, to now a quarter of the index, while Taiwan and India have seen their weights increase to 18% – reflecting a significant 6% jump for India.

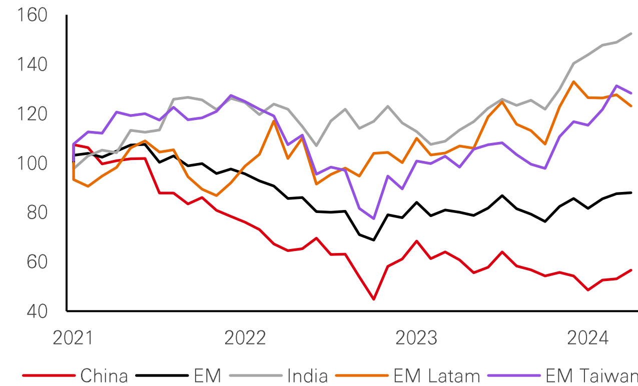
Figure 2: MSCI EM largest country exposures



Source: HSBC AM, MSCI, RIMES, March 2024

As a result, recent EM equity performance has been less driven by China. Highlighting the diversification, its negative performance has been offset by strong performance elsewhere, particularly in India and Taiwan recently. Of course, China's strong rebound in the second quarter means it is once again contributing positively to the index returns, to the extent that the EM index has outperformed EM ex China year-to-date, after lagging in recent years.

Figure 3: Performance of MSCI Indexes since January 2021



Source: HSBC AM, Bloomberg, June 2024.

It is important to note that amid the higher rate environment and strong dollar over the past year, many EM countries have delivered positive returns, demonstrating resilience which has not typically been the case in the past.

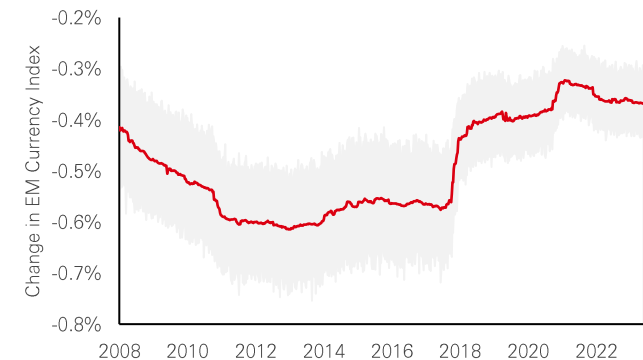
To examine the context of this resilience, we've studied EM sensitivity to the US dollar. Historically, we have seen on a relatively consistent basis that a stronger US dollar leads to weaker EM currencies. However, the recent strengthening in the US dollar has had minimal impact on EM FX.

We ran a sensitivity analysis of EM FX versus the dollar (DXY index) to determine the historical response to a positive one standard deviation shock to the dollar (figure 4). The result shows a 0.36% depreciation looking back over data since the turn of the century. However, that sensitivity has materially decreased over the past 15 years, particularly since 2018. This is partially due to the roll-off of GFC data within the 10-year rolling lookback applied. Nonetheless, the trend has continued into the more recent years.

Using the same vector autogression (VAR)-based impulse response simulation, we examined EM equity sensitivity to the US dollar, with the result showing a 0.25% initial drawdown in EM stocks, given a one standard deviation shock to the US dollar. However, in the second week following the currency shock, a small rebound of roughly 0.1% was experienced, resulting in a less significant overall decline.

Repeating the trend demonstrated in EM currencies, we also see decreasing sensitivity for EM equities to US dollar gains, as reflected by recent performance in the face of a stronger US dollar. This aligns with a recent IMF study, which found that the economies of EM countries with more anchored inflation expectations or more flexible exchange rates fared better in response to a US dollar shock. And what we've seen over the years is emerging market countries shifting to more flexible exchange rate policies, and similarly having more anchored inflation expectations in conjunction with key economic reforms.

Figure 4: Response from USD shock, looking one week ahead



Source: HSBC AM, April 2024

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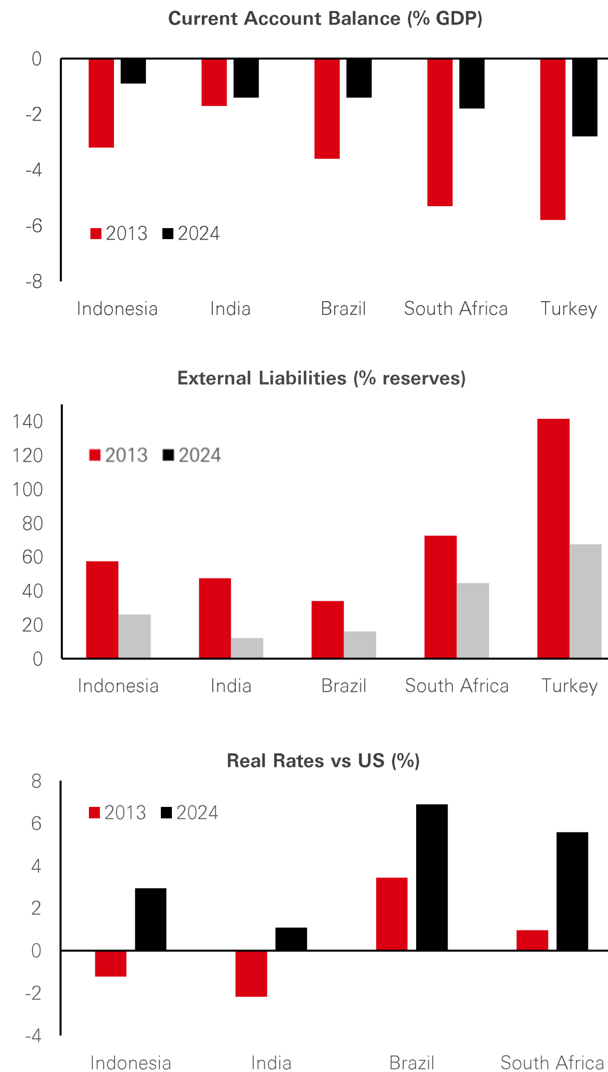
Accordingly, this increased resilience is clearly a result of EM country reforms carried out to tackle their vulnerability to global economic shifts and reduce reliance on foreign investment. The 'fragile five' of 2013 offer a prime example of the change. At that point in time, Turkey, South Africa, Brazil, India, and Indonesia found themselves most vulnerable to global risks due to their heavy reliance on foreign investments to drive growth. They ran significant current account deficits, and four out of the five countries had greater than 50% external liabilities as a percentage of their reserves. Furthermore, they boasted very low real rates, even lower than the low rates of the US at that time, causing their bonds to be unappealing to investors.

Since 2013, they have carried out a number of key reforms to improve their fundamentals and resilience to global economic developments. For example, in Brazil they increased domestic savings rates and developed local capital markets to finance long-term Investments, while also diversifying their economy to reduce vulnerability to external shocks. Separately, India implemented policies to attract more stable forms of foreign investment while encouraging domestic entrepreneurship.

All of these countries have now reduced their current account deficits and decreased external liabilities as a percentage of reserves. Furthermore, they are now running real rates above the U.S, making their debts more appealing to investors. Ultimately, these reforms played a vital role in solidifying the economies to deliver the resilience seen in the face of the post-covid inflation spike. Inflation has been kept under control in most emerging markets, delivering lower headline levels than those experienced in the US.

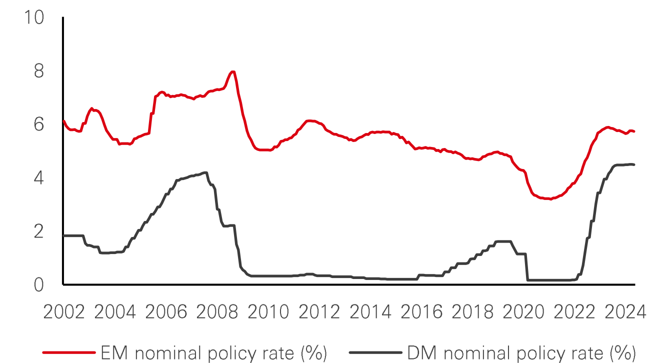
Figure 5: Contrasting 2013's 'fragile five' versus today



Source: Bloomberg, IMF, HSBC AM, May 2024.

Inflation progress can be credited to prudent monetary policies by EM central banks, whereby they tightened ahead of DM central banks. Enacting monetary policies more independently than in the past, they were able to deliver more successful outcomes compared to 2018, for instance. As a result, real rates are positive, and even higher than those in developed markets, despite a sharp increase of over 500 basis points by the Fed. This furthermore provides scope for EM central banks to adjust policy if needed.

Figure 6: EM vs DM policy rates



Source: HSBC Global Research, Refinitiv, June 2024

Improving balance of payments has not been limited to yesteryear's fragile five, and coincides with EM foreign currency denominated debt having nearly halved from just under 12% in 2010. Alongside this, foreign reserve buffers having been built up across the EM cohort, but particularly in key markets of India, Taiwan and Thailand.

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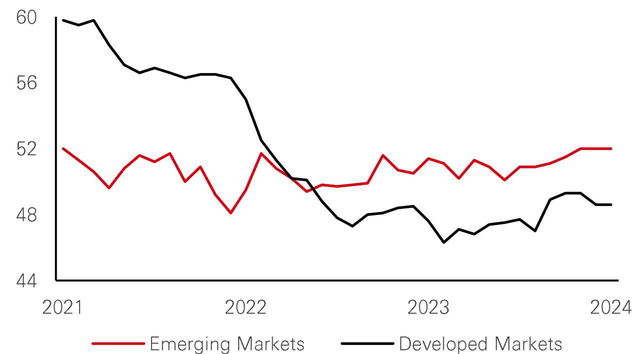
Economies outperforming

Emerging economies appear well-positioned going forward, delivering stronger growth than developed markets, with a recovery in the global manufacturing cycle boding well for exports. Global manufacturing new orders have ticked up, along with the EM manufacturer PMI.

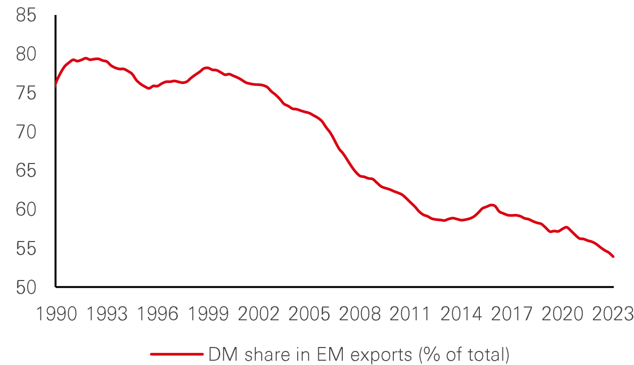
Figure 7: Manufacturing PMI



Source: HSBC AM, CPB, CEIC, Morgan Stanley Research, June 2024

A pickup is already evident for Asian exports, including tech exports which are rebounding following a sharp adjustment from 2022. Importantly for this, trade within emerging markets is growing to an extent that there is now much less reliance on developed markets. Given a stronger outlook for emerging markets growth, which is projected to be around double that of developed markets over the next couple of years, this again bodes well for earnings growth.

Figure 8: EM exports increasingly to other EM countries



Source: HSBC Global Research, 2024.

China, of course, accounts for a large share of trade within emerging markets, with EM overall exposure to China more than tripling since the country joined the World Trade Organisation over 20 years ago. Given a stabilising outlook for China, this also bodes well for EM export growth ahead. Recent activity surprises to the upside and upward growth revisions for the region contribute to our positive outlook.

Granular country considerations

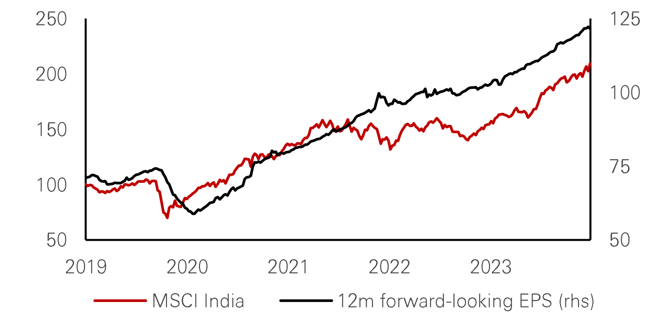
Taiwan stands out as offering particular opportunity on a tactical basis, while we feel India continues to offer potential on a longer-term, strategic basis. Taiwan equities have recently recorded a strong rally led by the tech sector, outperforming broader emerging markets and the region this year.

We see room for further upside considering:

1. A positive semiconductor outlook with continued strong earnings growth within the AI supply chain
2. Tech upcycle broadening out
3. Improving macro with leading GDP growth, steady domestic demand and disinflation trends.

Separately, we overweight Indian equity on a cyclical horizon on the back of the country's long-term structural growth outlook as the fastest growing major economy, macroeconomic resilience, strong domestic inflows, as well as pro-reforms policy and political continuity post-election. We expect the decent growth fundamentals to revive foreign inflows and continue to support a valuation premium in Indian equities. Negative correlation to sentiment in China equity and record trading activities post-election are additional benefits.

Figure 9: Indian equity market led by strong earnings growth



Source: HSBC AM, Bloomberg data, June 2024.

Finally, we are tactically overweight Turkish equities on the back of further confirmation of policy normalisation from the central bank which is directly supportive of Turkish assets.

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