HSBC Asset Management

Asia Insights

Emerging and diverging

June 2024

For professional investors only

In a nutshell:

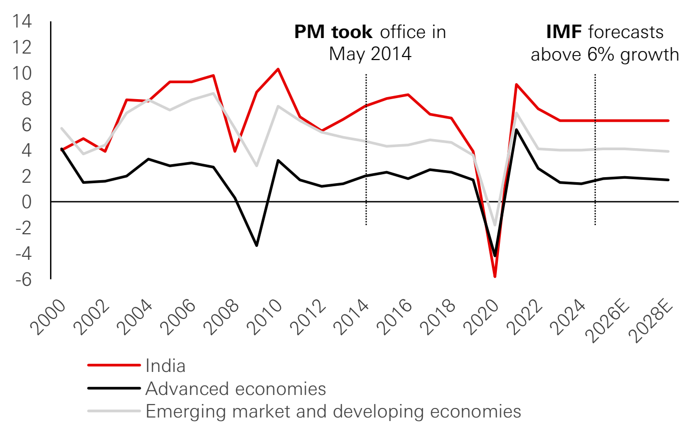
- Economic transformation combined with demographic advantages are propelling India's ascent and equity market outperformance, but investors remain under-allocated
- Well-publicised challenges and uncertainty for China's economy led to what may have been peak negativity in China equities, which continue to boast a large valuation discount even after this quarter's sharp rally
- Indian equities exhibit strong earnings and consistent growth, while Chinese equities trade at significant discount relative to rest of the world and their own history, presenting very different investment considerations

Emerging and diverging

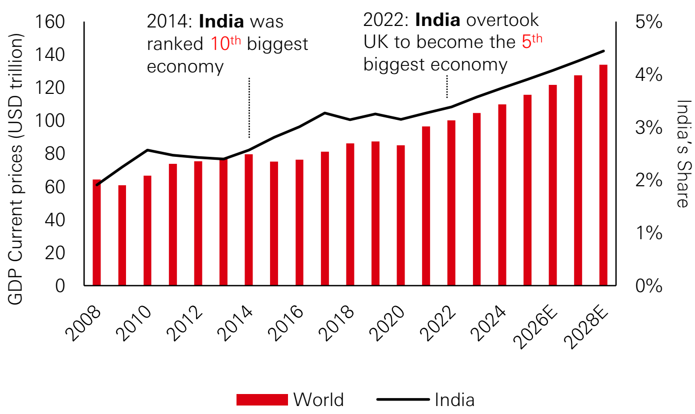
The economies of India and China continue climbing towards the top of global GDP rankings, but slowing growth and negative sentiment towards opportunities in China contrast with India's growth leadership and equity market gains. We will examine why both equity markets present different, but compelling investment prospects.

Strong equity market returns for India have come in conjunction with the economy demonstrating resilience through global challenges. The economic ascent has been supported by strategic reforms and demographic advantages. India's economy grew by 8.4% year-on-year in the last quarter of 2023, with expectations of sustained annual growth around 7% for the upcoming fiscal years. Continuing this growth trajectory can make India the third-largest economy in the world by 2027, surpassing Germany and Japan. With prudent fiscal policies leading to a decrease in deficits and a declining debt-to-GDP ratio, the responsible nature of this growth has helped in bolstering investor confidence.

Year-on-year real GDP growth (%)



India's contribution to world GDP (%)



Source: HSBC AM, IMF, data as of October 2023

Despite a very recent positive turn, Chinese equities have had the opposite trajectory over the last few years as concerns mounted over the stability of the Chinese economy. Various factors have contributed to challenges for China's economy, from the knock-on effects of the property market downturn to geopolitical tensions. However, a deeper analysis reveals potential indicators for recovery and increased investor confidence.

Government steps to drive physical and digital infrastructure development in India are key growth drivers.

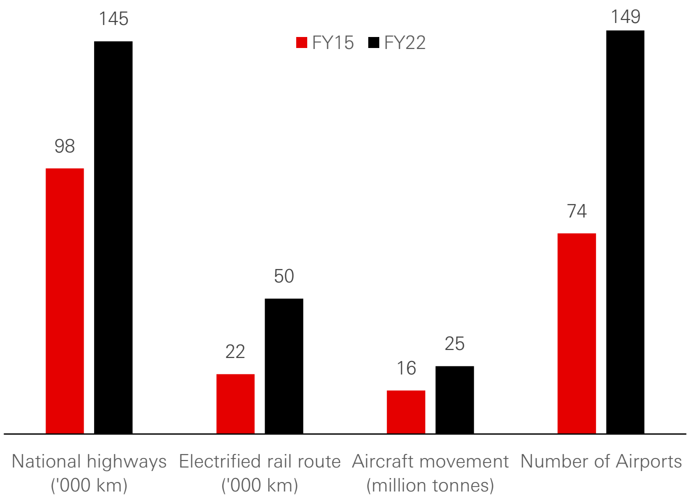
Policy measures shaping the economic landscape

The Indian government's concerted efforts to liberalise the economy, streamline regulatory frameworks, and foster an investor-friendly ecosystem through initiatives like "Make in India" and the implementation of a Goods and Services Tax - which increased supply chain efficiencies alongside government revenues - have bolstered investor confidence and propelled growth. A conducive business environment has spurred interest in long-term growth sectors supporting the economy’s transformation, such as technology, healthcare, and renewable energy.

The momentum has been further encouraged by the Production Linked Incentive scheme for large-scale electronics manufacturing, launched in 2020. This initiative allocated $34 billion, or roughly 1% of India’s GDP, in production-linked incentives to stimulate domestic manufacturing of mobile phones and specified electronic components. Growing investment in the country by global leaders in technology and semiconductors, for instance, demonstrates the progress and ongoing trend.

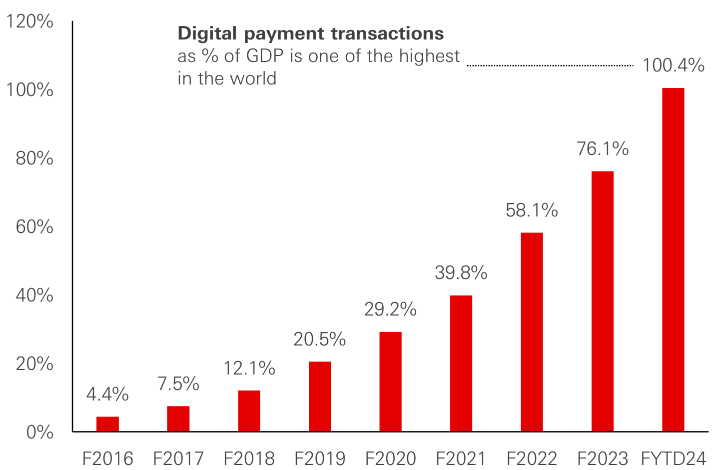
Infrastructure development has been a critical factor in supporting economic transformation. Significant strides have been made in expanding transportation networks, including doubling the number of airports and expanding metro systems across urban centres. This has enhanced connectivity, further improved business efficiencies, and generated employment opportunities to drive the growth engine. Additionally, there has been a notable shift towards renewable energy sources, with the 14th National Electricity Plan (NEP14) targeting half of power generation through renewable energy by 2030. Achieving the targets would result in a quadrupling of solar capacity and more than double wind power capacity. This emphasis on sustainable infrastructure development bodes well for long-term economic growth prospects.

Improvement in physical infrastructure for India



Source: HSBC AM, India Budget 23-24, CMIE, Jefferies, JP Morgan, CRISIL

Total value of digital transactions as % of GDP



Source: HSBC AM, RBI, Morgan Stanley forecasts, data as of October 2023.
Note: Transactions include IMPS, UPI, PPI and Credit and Debit card POS

India’s forward-looking approach to economic development is also supported by digital innovation. This has been catalysed by the implementation of the digital infrastructure initiative, India Stack. The comprehensive framework encompasses three key elements to revolutionise financial inclusion and digital payments in the country.

The first element aimed at bringing the population into the formal financial system, which was vital given that prior to 2014, nearly three-quarters of the country was outside of it. Government actions that year sparked a major shift which resulted in 520 million bank accounts being opened in just four months. This laid the groundwork for delivering the benefits of formal banking systems to the broader population, such as enabling the seamless transfer of government benefits to rural communities - releasing them from dependence on usurious money lenders.

The second element, Aadhaar, was aimed at addressing the challenge of identification faced by four-fifths of the population which did not have documentation to identify themselves until 2010. Aadhaar provided a unique biometric identity to 1.4 billion people. Combined with newfound access to bank accounts, Aadhaar enabled seamless transactions and much broader access to government assistance schemes. Additionally, the widespread adoption of mobile networks – over 870 million users and 1.37 billion SIMs makes India's mobile network the second largest after China – has facilitated easy and secure real-time digital payments through mobile phones across the country. This unified payment infrastructure, being the third element, not only streamlined financial transactions but also paved the way for efficient delivery of public goods and services. The success of India Stack has garnered international attention, with several developed nations considering its implementation.

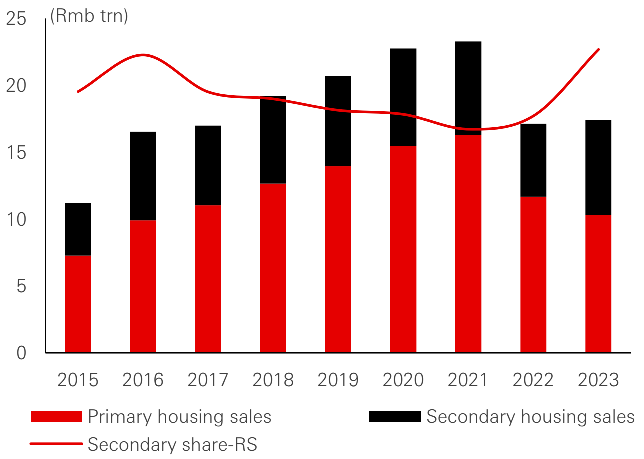
India Stack remains a cornerstone in India's inclusive growth strategy. With successive governments prioritising economic reforms and infrastructure development, there exists a consensus on key policy objectives, transcending political affiliations. The ongoing elections, while contributing to noise and speculation, are unlikely to derail economic progress given overarching commitment to growth-oriented policies.

On the opposite end of the spectrum, China's still relatively strong economic growth also presents clear opportunities but interwoven with pressing challenges that have generated apprehension among investors. Of course, the most severe of these has been the slowdown of the property market, with credit tightening measures on property developers having led to liquidity issues for some private-owned property developers and a halving of housing transactions in recent years. Despite the severity of this slowdown, it is important to note that it didn't crater the broader economy and result in a financial crisis akin to those witnessed in the US in 2008 or Japan in the 1990s - indicating a degree of resilience within the system.

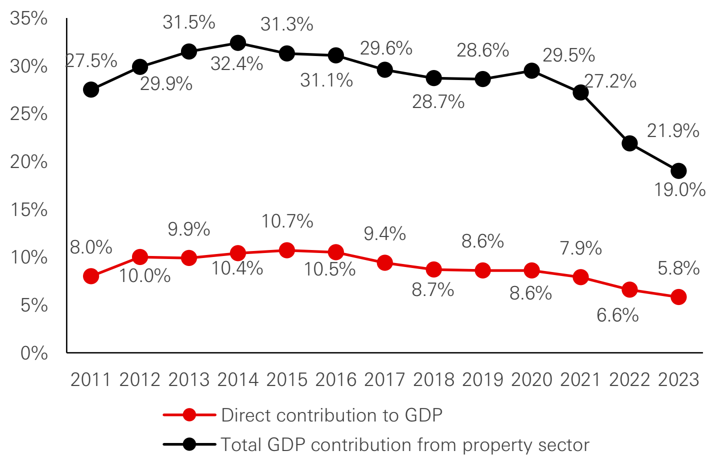
Speculative demand has been washed out, but genuine demand for housing has shifted away from low-quality developers who traditionally collected the full purchase price for homes two-to-three years in advance of completion. Instead, most buyers are now turning to the secondary market, leading to an uptick in its transactions by 25% year-on-year and suggesting an underlying resilience in China's housing sector.

> Apprehension amongst investors has been justified, but China's growth has been resilient in the face of significant challenges, including those of the maligned property market.

Secondary homes "squeeze" the primary market



GDP contribution from China property sector

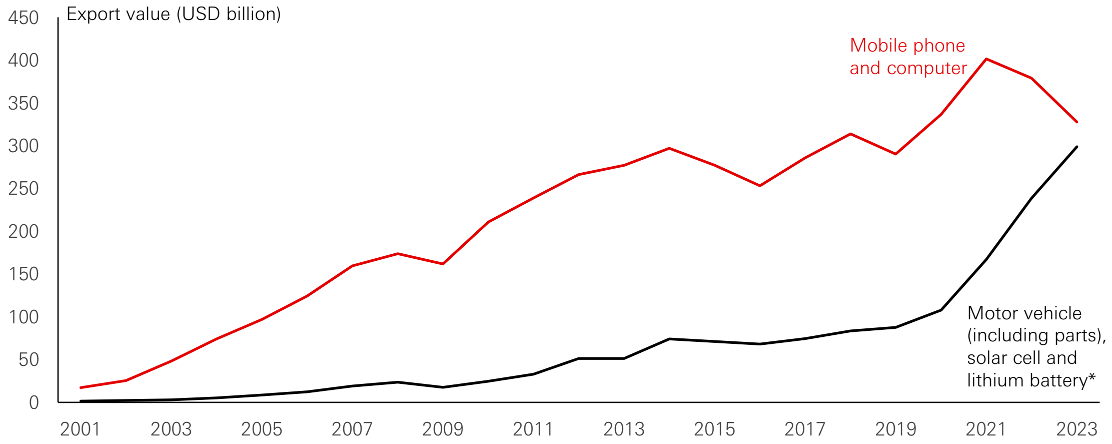


Source: HSBC AM, PBOC, Citi Research estimates, February 2024.

However, the repercussions of the property market slowdown extend beyond the real estate sector, exerting a significant drag on China's output. Historically, property-related investments, including construction materials and home appliances, contributed substantially to GDP growth. Output has faced obvious pressure but remained solidly positive throughout the challenging periods of recent years, including an extended period of Covid restrictions. Nonetheless, with property's contribution to GDP diminished, there remains a pressing need for alternative growth drivers.

In support of new growth drivers, the Chinese government has made strategic shifts towards higher-end manufacturing and technological advancement. This entails a redirection of resources and policies, steering away from virtualized sectors like internet-based industries. Investments in areas such as mobile phones, new energy vehicles, and renewable energy sources have shown promising and rapid growth. These sectors accounted for a marginal proportion of GDP as recently as five years ago, but are now approaching the total contribution of the property sector.

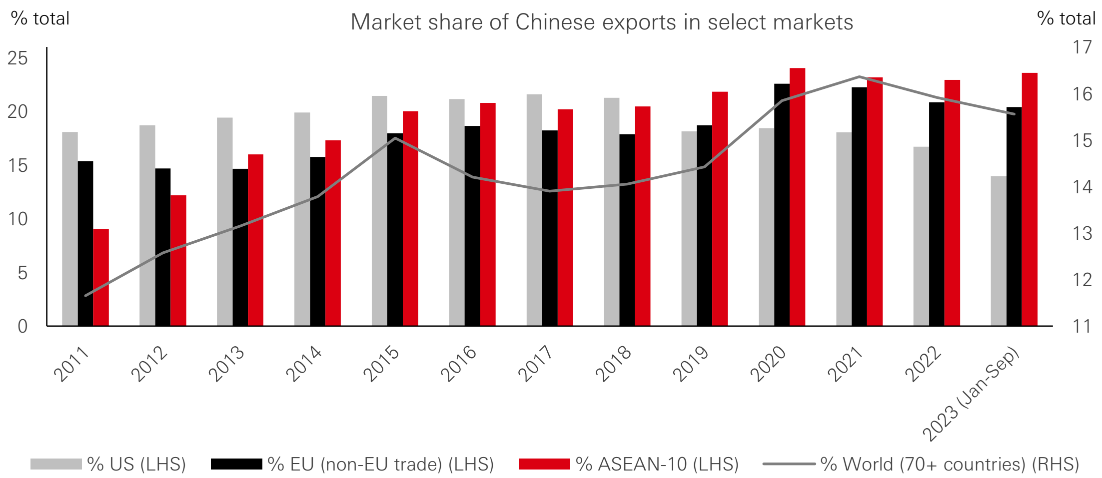
EV and solar now exceed electronics in export value



*Solar cell data is not available before 2012, while lithium battery data is not available before 2020.
Source: HSBC AM, China Customs, CEIC, Haver, IMF, Morgan Stanley Research, February 2024.

Yet, the outlook for the Chinese economy remains intricately linked to global economic cycles. Furthermore, concerns over trade tensions and geopolitical uncertainties persist. China's export resilience, leveraging competitive pricing, technological advancements and diversified supply chains have mitigated some of these challenges. And its export prowess has extended beyond traditional markets like the US and Europe, with increasing penetration into other emerging markets.

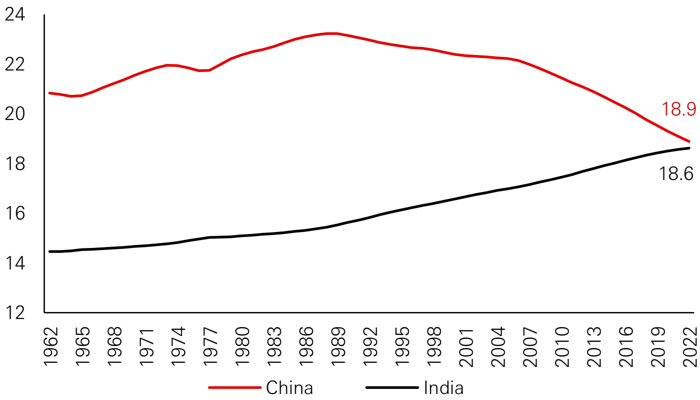
China pushes deeper into non-US markets, especially EM/ASEAN



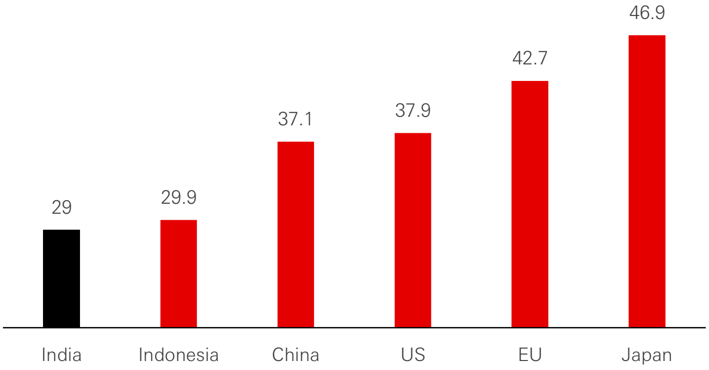
Source: WTO, CEIC, HSBC Asset Management, February 2024.

The demographic impact and changing consumption patterns

Working age population as % of global working age population



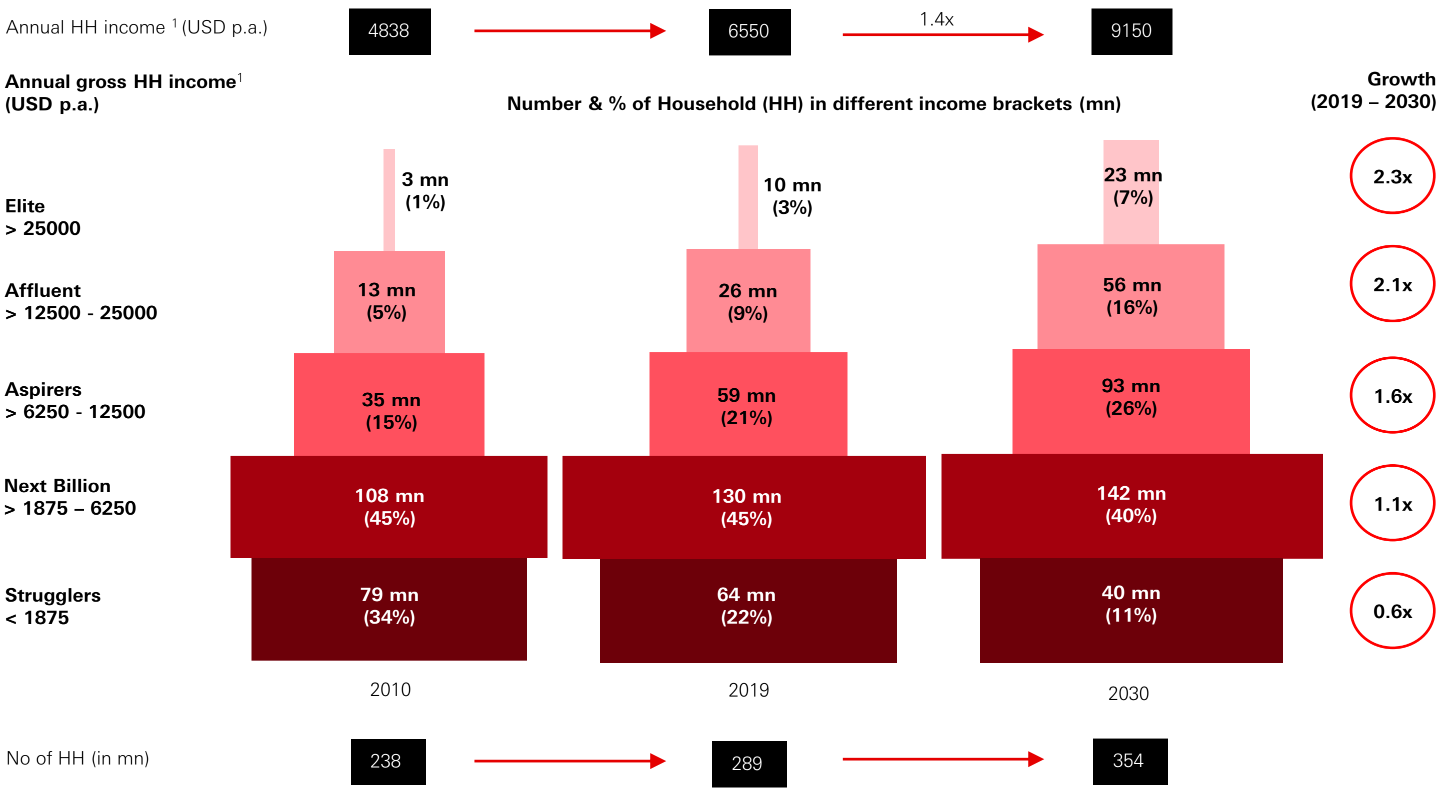
Median age of working population



Source: World Bank, IMF, Spark Research, data as of May 2023.

One of the key drivers underpinning India's growth story is its demographics, with India's young and growing population presenting a significant advantage over other large economies with ageing populations. With a median age of 29 years, India boasts a growing workforce and middle class that are substantial contributors to production and consumption growth. This demographic dividend, coupled with rising per capita income, sets the stage for sustained growth in consumer spending, particularly in aspirational and discretionary goods and services. This shift is already being seen in higher income regions today.

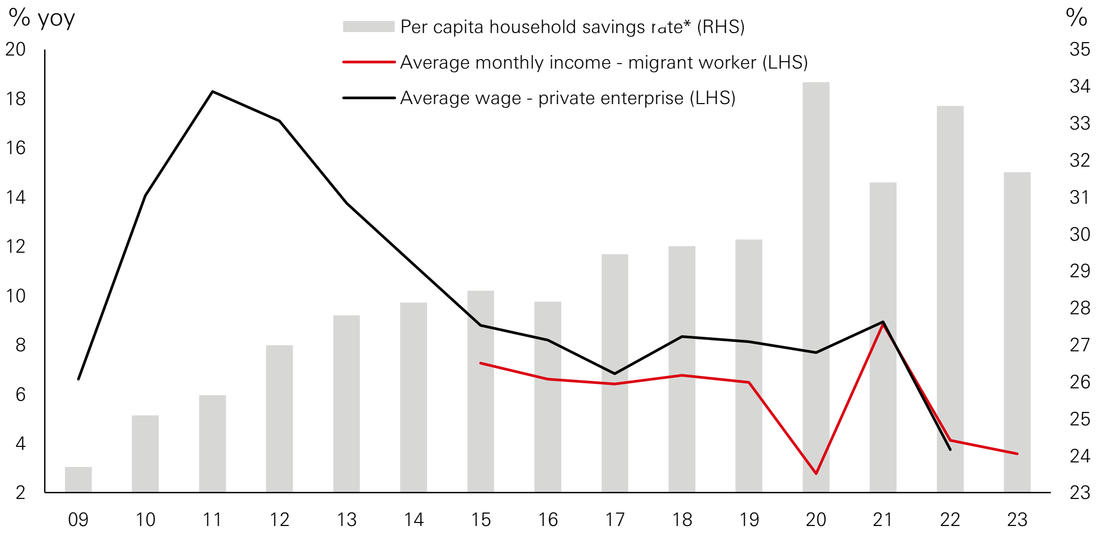
India's household consumption story



Source: BCG X Rai 2022. 1 - Annual HH gross income based on 2019 prices, Bloomberg. For illustration purpose only.

Conversely, China's newfound challenge of a shrinking population deprives it of the demographic advantages of India and much of the rest of developing Asia in supporting consumption growth and broader expansion. China is, of course, further ahead in its economic transformation to higher incomes jobs and greater consumption as a proportion of GDP. Yet today, this higher reliance on consumer demand is being hindered by economic uncertainties. While overall consumer savings remain high, consumption has been relatively weak and reflects lower confidence and job security.

Jobs/income concerns and negative wealth effects weigh on confidence



Source: CEIC, Bloomberg, HSBC Asset Management, February 2024.

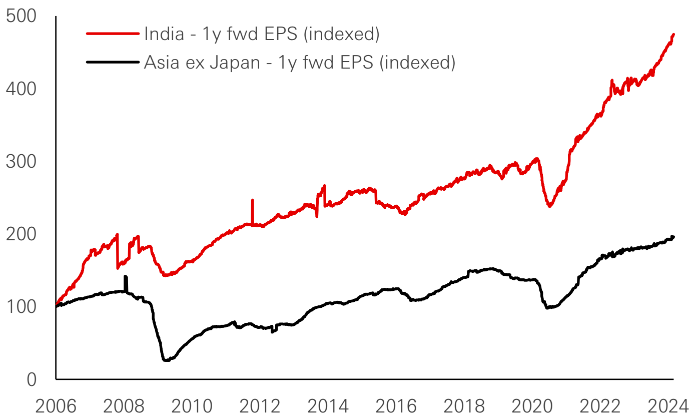
Amidst this environment, the Chinese government is maintaining a cautious approach to fiscal stimulus. Recent moves such as confirmation of a new CNY1 trillion ($140 billion) ultra-long government bond issuance are encouraging for mitigating key drags on growth. Early details suggest the central government will allocate half of the proceeds to local governments to ease financial constraints and deleveraging pressures at the local level. Even if efforts to stimulate local consumption are successful, China's manufacturing accounts for around 30% of global capacity. And important growth segments such as solar cells are less connected to local consumption. At some point, there is a need for a global demand upswing to absorb manufacturing capacities fully.

Implications for two contrasting equity markets

Indian equities boast P/E multiples higher than their 10-year average and are relatively expensive compared to peers. However, India's market performance is being primarily driven by higher returns on equity compared to its peers – having improved to over 16%, well above its 10-year average of 13.7%. A sustained corporate earnings growth trend is likewise outpacing the region. Driven primarily by domestic factors, the EPS for the Nifty index is expected to more than double between 2020 and 2025, with an impressive CAGR of around 19%.

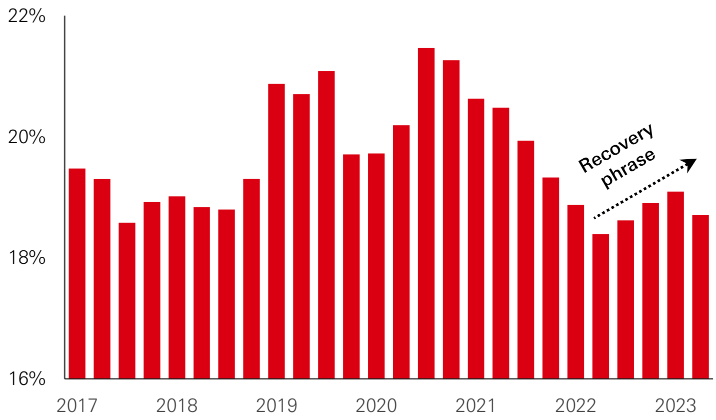
Despite the outperformance, allocations to India remain underweight relative to global benchmarks. However, per increasing investor confidence in the country, foreign institutional investor ownership of NSE 500 companies has been on an upward trend after bottoming out in September 2022. An additional benefit that has been attracting investors since the global market volatility of 2022 is the diversification benefit, given India's low correlation to global and regional markets.

1-year forward EPS of India v/s Asia ex-Japan (indexed)



Source: HSBC AM, Bloomberg, data as of February 2024; India: MXIN Index, Asia ex-Japan: MXAP Index

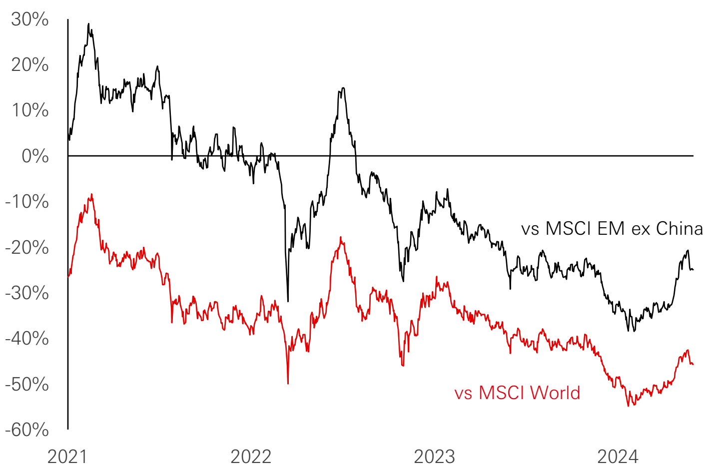
FII Ownership of NSE 500 (%)



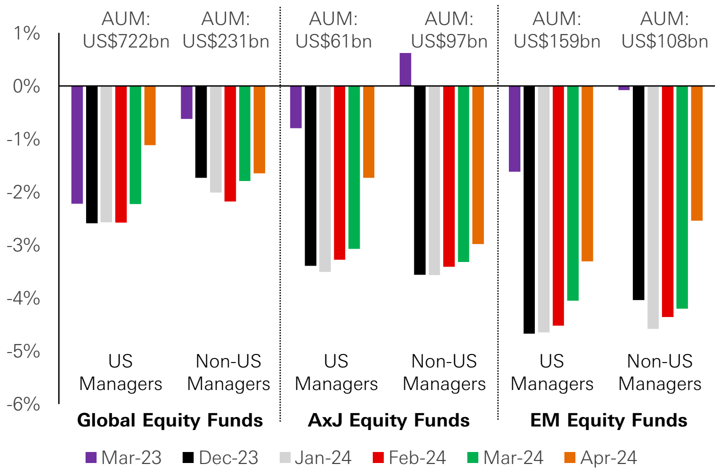
Source: HSBC AM, BofA, data as of September 2023

Pessimism surrounding Chinese equities has created a contrasting opportunity for investors. Foreign participation in China's onshore market has dropped to late-2019 levels, before the 20% inclusion in the MSCI emerging markets index. As global funds have cut allocations to China, the valuation gap to other Asian markets has expanded dramatically. Even amidst this quarter's rebound that has seen underweight allocations begin to shift, Chinese equities trade at less than 10x earnings, dropping from 12x at the start of last year - far below its 10-year average and at the lowest levels in Asia.

MSCI China's relative valuations (12M Fwd P/E)



Active weights of China/HK equities



Past performance does not predict future returns.
Source: HSBC AM, Bloomberg, EPFR, Wind, Goldman Sachs Prime Services, MSCI, FactSet, Morgan Stanley, May 2024.

China's economy remains in transition, moving away from a reliance on manufacturing and exports towards domestic consumption and services. While regulation over certain sectors may concern some investors, government policies are aligned with long-term economic stability and growth. With a transitioning economy and undervalued assets, we think potential for material upside over the long-term balances risks from geopolitical uncertainties and structural challenges in the economy.

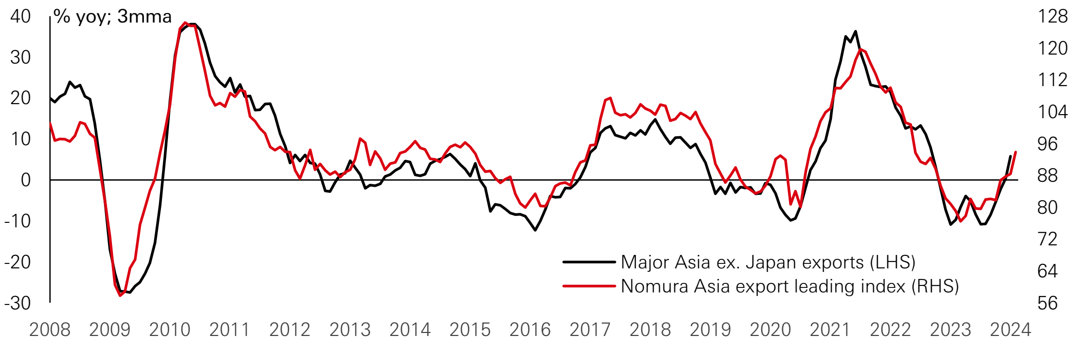
Overall, the Indian and Chinese equity markets offer distinct investment prospects. This supports our stance that exposure to both can benefit portfolios, with the low correlation between each market providing useful diversification. Individually, China is trading as a significant discount across metrics relative to its own history and other markets. A rebound of nearly 30% since the January low signifies the potential for a longer-term turnaround on positive economic developments and as investor confidence rebuilds. Indian equities on the other hand, come at a steeper price, but one which we believe is warranted based on strong earnings and consistent growth fuelling returns.

Asia equity markets may not reflect growth prospects

In contrast to the recessionary risks looming over developed markets, Asia stands at a different juncture in its economic cycle, propelled by higher growth relative to developed peers and solid macro fundamentals. The region continues to benefit from technology upgrades, especially in artificial intelligence. Optimism over tech developments and an upswing in the semiconductor cycle has been particularly favourable for export-oriented economies, like Taiwan and Korea. In Korea, as in Japan, stocks with low price-to-book ratios have recently outperformed.

Asian equities stand out as offering relatively inexpensive valuations amidst promising earnings growth potential.

An ongoing tech-led export recovery



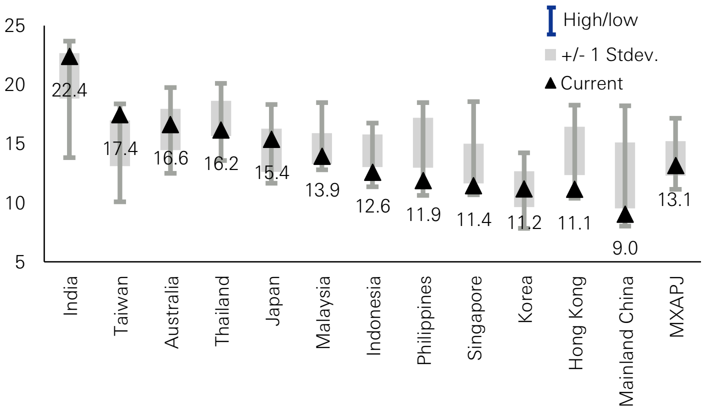
Source: OECD TiVA, CEIC, Bloomberg, HSBC Asset Management, March 2024.

Japan's overall outperformance reflects investor optimism over corporate governance reforms. The reform push by the Tokyo Stock Exchange has led to many companies adopting shareholder-friendly measures, improving disclosures, and increasing dividends. Firms have also announced plans to boost capital efficiency through crossholding wind-ups and share buy-backs. The valuation boost is already evident, with 60% of TOPIX companies now trading above book value, up from 50% last year. Japan equities still trade at a discount to their developed market peers, while boasting an improving earnings outlook along with multi-year tailwinds.

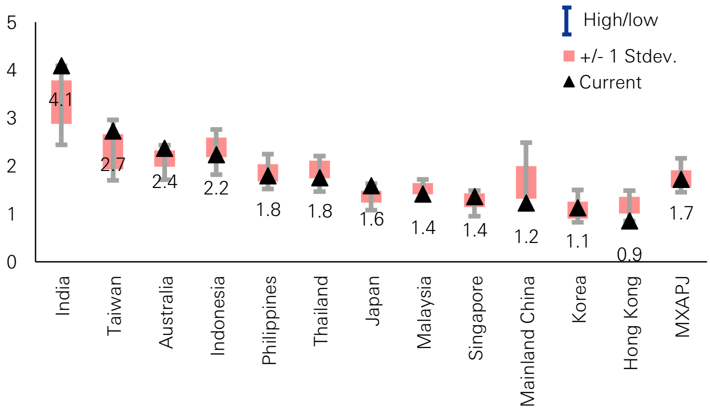
Elsewhere in Asia, China plus one supply chain strategies and a resilient macro backdrop present opportunities in ASEAN equities. Emerging Asia as a whole continues to offer compelling valuations, with the opportunity supported by a strong medium-term growth story and inflation easing back towards central bank targets in most markets.

The region continues to trade below or at historical averages for both price-to-book and and forward P/E. Following stubborn inflation data in the US, renewed concerns around higher-for-longer rates has shifted the focus to quality stocks, with earnings growth becoming the key performance driver in Asia. Hence, our emphasis remains on companies with resilient earnings and business models fortified by strong competitive positioning and healthy balance sheets, prioritising resilience amid an evolving macro environment.

1-year forward P/E (x)



1-year trailing P/B (x)



Past performance does not predict future returns.

Source: Goldman Sachs, MSCI, HSBC Asset Management, as of April 2024. Note: High/low range and +/- 1 stdev. is the 10-year average.

Diversification and carry in Asia bonds

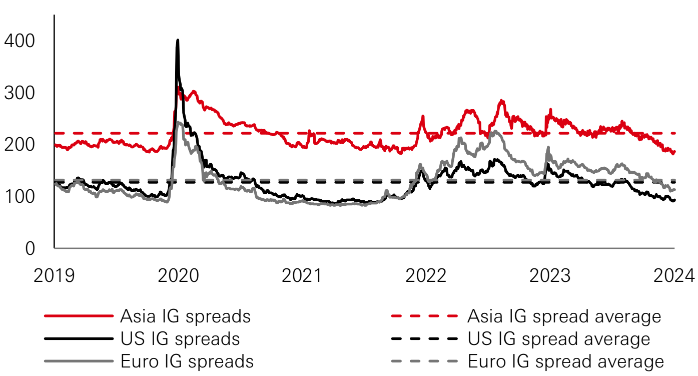
Asia's fixed income market remains a useful option for asset allocations, offering relatively attractive yields compared to other regions and maintaining a stable credit outlook in the near term.

With the Federal Reserve's 'wait and see' approach following a stall in inflation progress, the expectation is that of a more modest easing cycle considering the resilience of the US economy, with markets remaining acutely sensitive to incoming economic data. Under such circumstances, Asia's investment grade bonds are poised for lower volatility than their global counterparts, given their shorter duration and lower correlation with US treasuries.

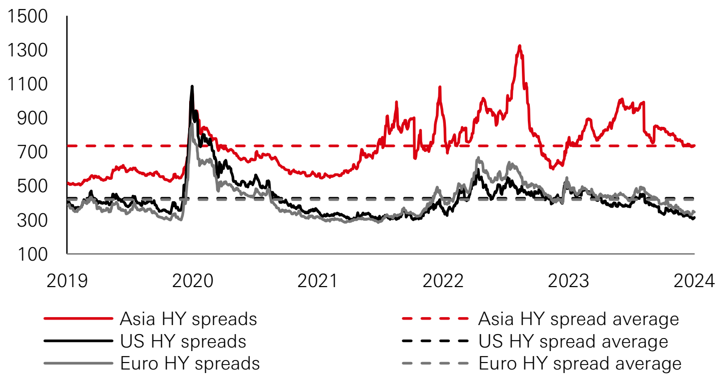
Fundamentally, Asia's investment grade issuers, primarily consisting of national champions and government related entities, exhibit consistency in credit quality, leading to the stability of spreads demonstrated. The macro tailwind in Asia, including strong economic growth, low inflation pressure and pre-emptive monetary policy, will also support corporates' credit position and limit fallen angel risk. Overall, Asia investment grade provides opportunities for carry strategies and is anticipated to deliver strong risk-adjusted performance over the course of this year. High yield spreads have tightened to a greater extent from their highs, but likewise continue to offer relatively attractive yields.

Asia's investment grade bonds offer stability and strong risk-adjusted performance amidst global economic uncertainties.

Asia investment grade credit spreads (bps)



Asia high yield credit spreads (bps)

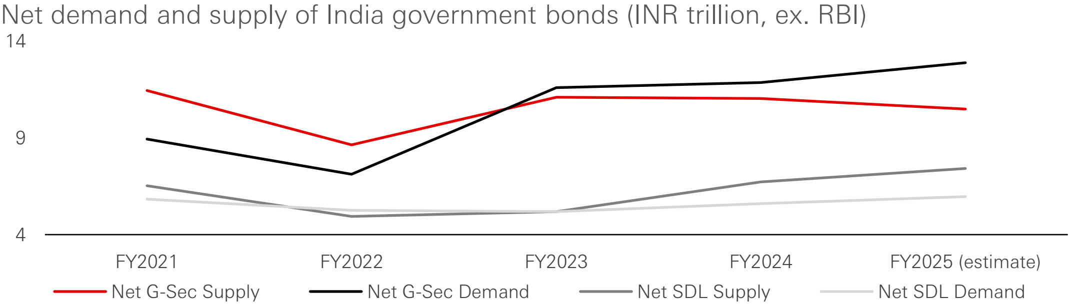


Source: Bloomberg; BAML, HSBC Asset Management as of 25 March 2024. Note: spread average shown is the 5-year average.

The diversification qualities of Asian local currency bonds present an especially strong argument for inclusion in strategic asset allocations. Key markets such as China, India and Indonesia tend to follow domestic interest rate cycles and local supply and demand conditions, while having enough critical mass to be less driven by the global risk cycle. They also have relatively low volatility, on a hedged and unhedged basis.

Supply and demand conditions in the India bond market are particularly auspicious today, given that the inclusion of Indian sovereign bonds in the JPMorgan GBI-EM index should drive around $25 billion of flows over the ten months from June 2024. Further index inclusion announcements are likely over the course of the year, while on the supply side, India's fiscal consolidation driven by strong growth and prudent policy should also ensure continued downward pressure on yields.

Net demand and supply of India government bonds (INR trillion, ex. RBI)



Note: G-Secs (Government securities) are issued by the central government and State Development Loans (SDL) are issued by the state government of India.
Source: reserve Bank of India, February 2024. FY 2025 is HSBC Estimate, Bloomberg, March 2024.

Data watch (as of May 2024)

Country	Economic Indicator	Data as of	Last data	Consensus	Previous data	Analysis
Japan	**GDP growth**					
	% yoy	Q1 2024	-0.2	-	1.2	GDP saw a renewed fall in early 2024, driven by a fourth consecutive quarterly decline in consumer spending. Capital investment weakened, with net exports acting as a drag on growth
	% qoq		-0.5	-0.3	0.0	
	CPI Inflation					
	Headline, % yoy	Mar	2.7	2.7	2.8	Japan's core-core CPI (which excludes fresh food and energy) was slightly below market consensus. It rose 2.9% yoy in March on moderating service prices growth after climbing 3.2% yoy in February. Higher wage growth should boost service sector inflation in coming months, keeping core-core inflation above 2% yoy in H2 24
	Core*, % yoy		2.9	3.0	3.2	
	Policy rate	Apr	0.0 - 0.1	0.0 - 0.1	0.0 - 0.1	The BoJ kept policy on hold in April. The FY24 inflation forecast was upgraded to 2.8%, but FY25 and FY26 inflation projections were slightly below the BoJ's 2% target
China	**GDP growth**					
	% yoy	Q1 2024	5.3	4.8	5.2	China's Q1 2024 real GDP growth beat market expectations following the pick-up in investments, but Q1/March macro data showed a mixed trend, with ongoing property activity weakness, muted inflation on lingering demand-supply imbalances, and cautious consumer confidence remaining concerns.
	% qoq		1.6	1.5	1.2	
	CPI Inflation					
	Headline, % yoy	Apr	0.3	0.2	0.1	China's headline inflation edged higher in April. Services inflation remained modest, while flat-lined goods prices reflected subdued domestic demand.
	Core*, % yoy		0.7	-	0.6	
	Policy rate**	May	3.45	3.45	3.45	The PBOC kept the 1- and 5-year LPR unchanged, after leaving the MLF Rate unchanged earlier in the month
India	**GDP growth**,					
	- % yoy	Q4 2023	8.4	6.6	8.1	India's Q4 GDP beat expectations by expanding 8.4% yoy, confirming that the economy remains resilient. The widened gap between GDP & GVA data may have reflected the impact from indirect taxes
	CPI Inflation					
	Headline, - % yoy	Apr	4.8	4.8	4.9	India's headline CPI inflation edged down to 4.8% yoy in April from 4.9% yoy in March, broadly in line with expectations. Food inflation, which is closely watched by the RBI, increased modestly
	Policy rate	Apr	6.50	6.50	6.50	The RBI kept policy rates and its tightening bias on hold, with the growth and inflation forecast kept unchanged

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

F: Final A: Advanced P: Preliminary estimate

* 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.

Asset class positioning

Asset class	House view	Comments
Asia local government bonds	▲	The medium-term outlook is stable, supported by a solid macro backdrop in the region, with some markets benefiting from high carry. However, a potential delay in monetary policy easing amid fading optimism over US rate cuts may trigger some volatility in the short term.
RMB bonds	↔	More proactive liquidity and targeted credit support are likely, and mild rate cuts cannot be ruled out 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	▲	Overall valuations remain fair, and Chinese policy activism is rebuilding investor confidence in the market. India's fundamentals are supportive, with strong EPS growth despite elevated valuations. Korea and Taiwan continue to benefit from the upswing in the semiconductor cycle.
China equities	▲	Equity valuations are appealing, with strong earnings performance remaining possible should ongoing policy measures continue to filter through. Downside risks still linger from a prolonged property market downturn, softening domestic demand and weak consumer sentiment.
India equities	▲	Rich valuations remain a concern (particularly in small and mid-cap stocks), but firms are benefiting from solid earnings growth potential, a strong structural story, and a resilient macro backdrop. The RBI maintains a tightening bias, but rates should have peaked as disinflation continues.
ASEAN equities	↔	The region continues to see mixed performance, with relatively muted overall earnings growth. Heightened FX volatility is a concern in the short-term but the resilient macro backdrop and supply-chain relocations to the region should be supportive, with defensive qualities staying attractive.
Hong Kong equities	▲	External headwinds and faltering domestic economic momentum are concerns. Appealing valuations and policy support to reinforce Hong Kong's financial hub status are positive, with the pace of recovery in the local property market still in focus after the removal of home-buying curbs.
Japan Equities	▲	The outlook for Japanese stocks remains supported by a robust earnings outlook and attractive valuations. Corporate governance reforms have boosted sentiment, but cyclical exposure could be sensitive to a global growth slowdown.
Asia FX	▲	Cooling Fed rate cut expectations could heighten FX volatility in the short run, but the overall macro backdrop stays supportive, with potential USD weakness still a medium-term benefit. Dispersion in currency pairs may extend depending on economic performance and fiscal status.

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