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Spinning Around

2025 Global Investment Outlook

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HSBC Asset Management | Opening up a world of opportunity

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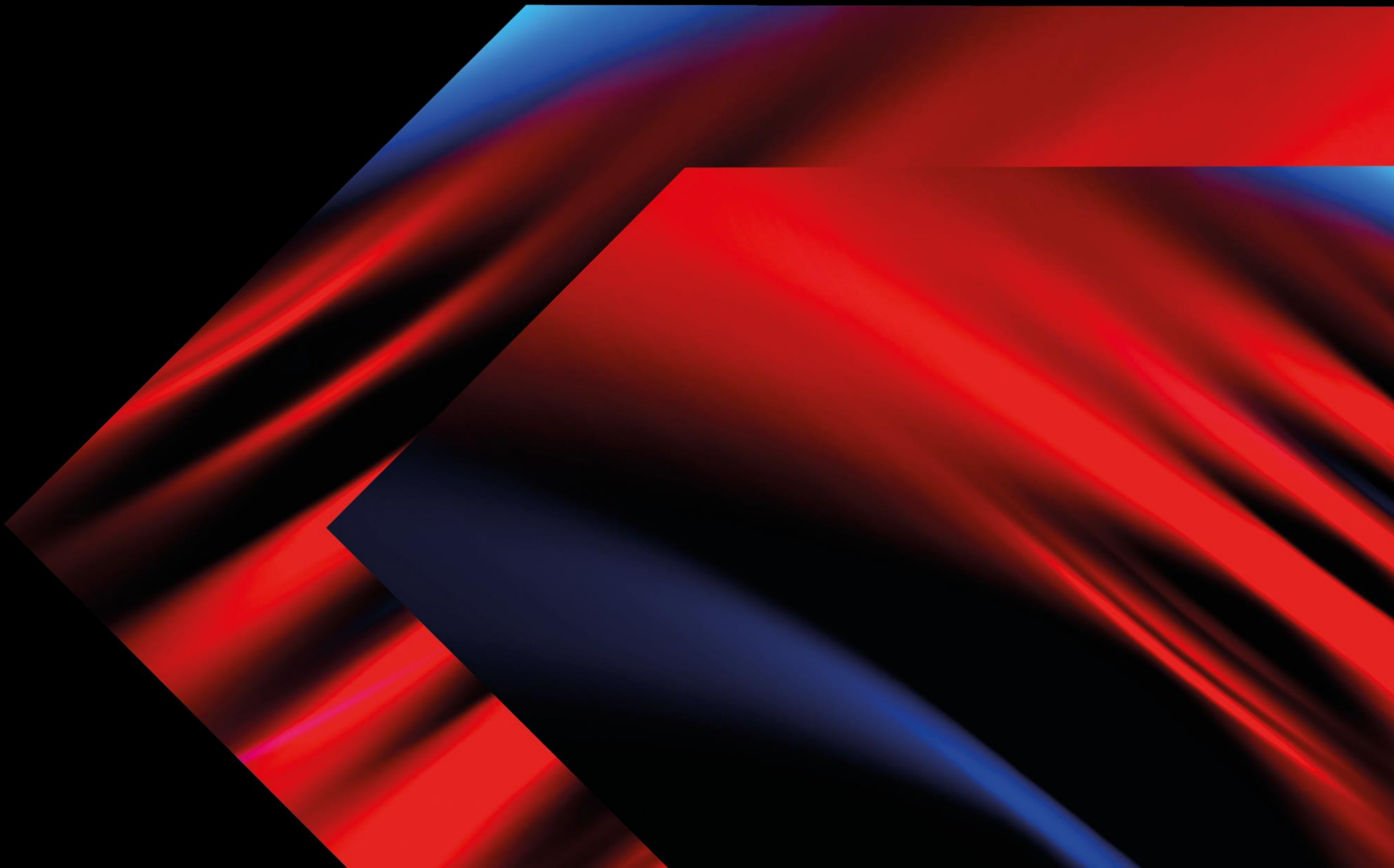


Foreword from our Chief Investment Officer

Welcome to our 2025 Global Investment Outlook, titled ‘Spinning Around’. This reflects the dynamic and evolving nature of the global economy and markets, and our expectation for continued rotations in market drivers ahead.

The year 2024 has largely been characterised by positive developments – disinflation, resilient growth and improving corporate profits. These factors have enabled central banks to pivot their policies, initiating a global cutting cycle in the latter half of the year. However, as we look ahead, concerns about inflation are likely to linger and we do not foresee a return to the low inflation environment of the 2010s. Instead, we anticipate inflation settling in the 2-3% range for most major economies, with interest rate cutting cycles expected to be shallow in both the US and Europe.

In advanced economies, we expect growth to converge. While the US economy shows some signs of cooling, the period of US exceptionalism that has characterised the post-pandemic economy may begin to fade. Europe is on a recovery path, but growth remains subdued. In contrast, Asia and frontier economies are projected to experience premium growth rates, with China benefiting from policy support and India maintaining its status as the fastest-growing large economy.

From an investment standpoint, next year is likely to be marked by heightened volatility and policy uncertainty. In our view, tail risks shouldn’t be ignored. Currently, markets seem to prefer an optimistic outlook, focusing on assumptions around tax cuts, deregulation and their expected impact on future profits. What market valuations may not yet capture is a scenario of higher long-term rates and declining global trade, which could ultimately weigh on company fundamentals.

In terms of asset allocation, assets currently priced for perfection could be the most exposed, paving the way for a significant shift in market leadership. Previously overlooked sectors such as value stocks, small caps and emerging market assets are likely to gain traction. This 'great rotation' underscores the need to focus on local fundamentals and be nimble in our approach.

Emerging markets, in particular, present compelling opportunities for diversification. Many of these markets remain undervalued and under-owned by international investors, meaning that any positive developments can lead to strong market reactions. However, we must remain selective, as risks associated with a stronger US dollar, rising interest rates and geopolitical uncertainties could impact market sentiment. In this context, alternative asset classes, such as private credit, offer valuable options to provide diversification and resilience to a global allocation.

In this publication, we expand on these views and delve into the key themes that will define 2025, including the nuances of small-cap investing, impacts of growing materials demand and the sectoral implications of China's economic policies. We also explore recent developments in Japan, India and broader emerging markets.

I trust that this outlook will provide valuable insights as you embark on your investment journey in 2025.

“While a soft landing appears likely, our scenario also accounts for the potential tail risks that could materialise.”

Xavier Baraton
Chief Investment Officer

Source: HSBC Asset Management, November 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 we approach 2025, rising policy uncertainty, protectionism, and geopolitical tensions signal a more volatile and fragmented global economy.

This is the backdrop of a ‘multi-polar world’ with competing trade blocs. The most significant consequence for investors is a higher and more unpredictable inflation regime. Supply chains are being rerouted, shifting production to potentially higher cost locations. Separately, less international security cooperation will compel governments to spend more on defence, adding to the pressure on public finances. And geopolitical tensions can easily spill over into commodity markets.

Structurally higher inflation poses challenges, including for central banks who will be constrained in their easing cycle. This could weigh on growth and profits.

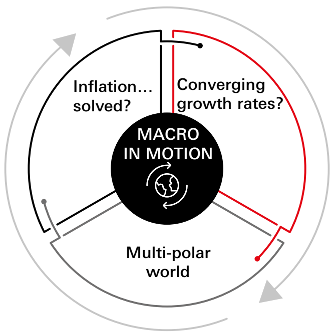
Globally, growth patterns are shifting too. US growth is now moderating and expected to cool further in 2025, signalling a potential end to its post-pandemic ‘exceptionalism’. While risks of an economic downturn in the next 12 months have receded of late, recent optimism — underlined by the anticipation of tax cuts and deregulation under new leadership — coexists with concerns around stretched valuations.

Meanwhile, low levels of productivity growth and a weak manufacturing sector are hobbling Europe’s rebound, where economies largely remain ‘in the slow lane’.

Emerging and frontier markets paint a different picture, evolving beyond their historical dependence on the US economy and monetary policy. Importantly, the emerging markets (EM) growth premium is expected to grow, which usually drives outperformance in EM assets. Valuation discounts support the opportunity, but acknowledged risks include a stronger dollar and dependence on China stimulus.

With geopolitics potentially disrupting assumptions on the growth, profits, and inflation outlook, market volatility could easily pick up — leaving the most expensive parts of the market vulnerable. We think alternatives present a crucial source of diversification. And with correlations between country performance breaking down, an active approach to geographic allocations can be an opportunity as we navigate expected rotations.

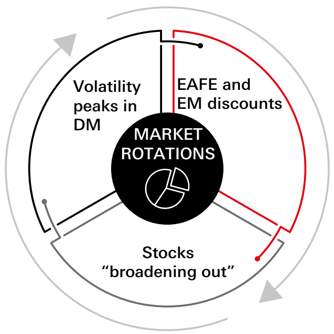
Figure 1: Spinning around



The US is likely to secure a soft landing amid rate cuts and ongoing disinflation

As US growth cools, it will look less exceptional versus the rest of the world

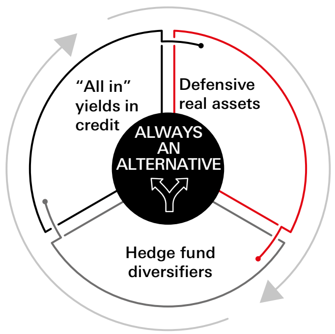
But policy uncertainty is rising. And the world is becoming more ‘multi-polar’



Policy uncertainty means that investors need to be prepared for market volatility

But markets are primed to rotate – stock laggards can become leaders, and yield curves can steepen

Emerging and frontier markets trade at a discount, and have potential to deliver bumper returns



A shallow rate cutting cycle creates yield opportunities in private credits

Real asset equity strategies provide a defensive route into the market

Hedge funds can be a proxy allocation for bonds in this new market regime

Source: HSBC Asset Management, November 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 Asset Management accepts no liability for any failure to meet such forecast, projection or target. This shouldn’t be considered as a recommendation to invest in the markets provided.

Scenarios

Multiple macro scenarios emerge based on varying degrees of fiscal and trade policy implementation.

Our baseline scenario assumes moderate global growth with lingering inflation concerns translating to subdued rate cuts from central banks. This would coincide with modest trade policy changes and geopolitical disruption. In the US, this could mean selective tariff application coupled with tax cuts by the new government.

In this case, markets might maintain stability, with steady growth across emerging and developed markets (DM). US equities could see continued strength, albeit limited by valuation concerns and interest rate sensitivity.

As growth stabilises and inflation remains under control, we expect to see high-quality equities outperforming. This scenario is already reflected in the current market sentiment.

Further support comes from moderating wage growth, which has helped corporate profit margins. Companies have been managing labour costs by reducing hours rather than laying off employees, allowing them to maintain profitability despite tight labour conditions. This resilience has helped sustain corporate profits and market optimism, supporting a 'soft landing' economic scenario.

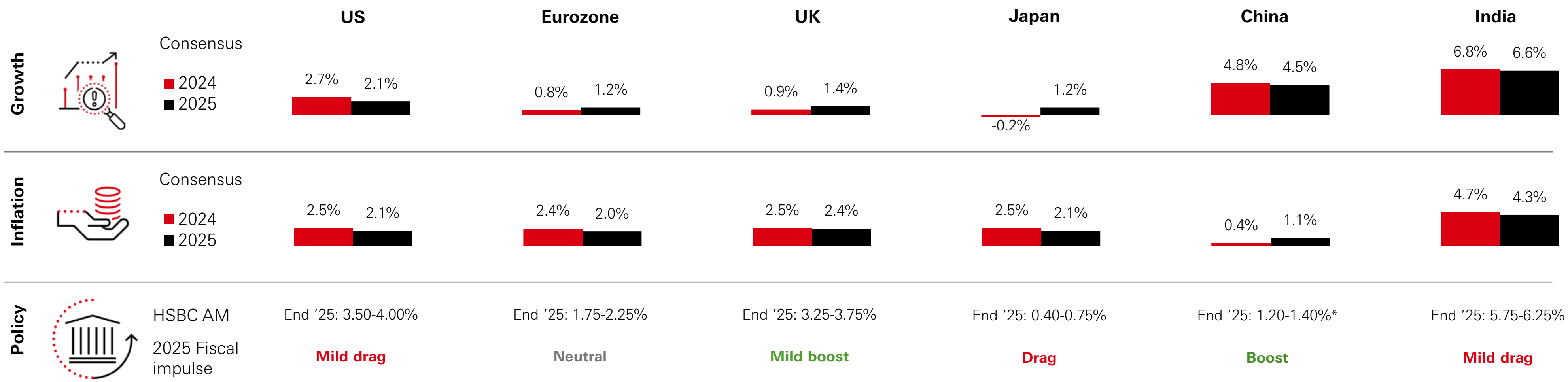
We expect GDP and profit growth to converge in advanced economies, suggesting that investment markets outside of the US have room to perform. Neglected parts of global stock markets — such as value stocks — have an opportunity to catch up.

In EM, where growth will be stronger — especially for those less reliant on US exports — we could see outperformance on the back of favourable valuations.

An alternative scenario is more aggressive fiscal and trade policy, with wider geopolitical disruption. This scenario could boost US growth in the short term due to fiscal stimulus, but also introduce inflationary pressures, potentially necessitating tighter monetary policy. EM and export-oriented economies would face challenges as global trade tensions escalate, with greater effects on those highly exposed to US demand, such as Mexico, Canada and select Asian economies.

In this high-inflation, high-tariff scenario, investors might seek shelter in commodities and inflation-linked assets, while riskier assets may suffer due to escalating trade policy risks.

Figure 2: Economic scenarios



*7-day reverse repo rate. Source: HSBC Asset Management, Bloomberg, November 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 Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Market implications

A shallow rate-cutting cycle and converging growth could set up a rotation in markets.

With US valuations stretched, broadening profits growth could see a rotation within US equities towards neglected or defensive sectors that stand to benefit from policy actions, such as financials and industrials. Financials in particular would benefit from potential deregulation and increased M&A, while some industrials may benefit from tariffs, even with higher input costs. Additionally, less globally exposed companies may be shielded from trade policy impacts, which could continue to support recent resilience in small-cap stocks.

We also know from history that value stocks can outperform growth in a backdrop of higher inflation, and continued growth driving nominal profits. With growth more evenly distributed across the globe, a strong valuation case remains for EM and non-US DM.

The world's premium economic growth rates will be in Asia and frontier economies, with India maintaining its position as the fastest growing major economy. Beyond India, the 'multi-polar world' presents opportunities for many Asian economies to exploit a restructuring of global trade patterns as production is 'friend-shored'. Although EM should not be treated as one bloc amidst vastly different situations, the US dollar outlook will play a role across EM. Should US dollar strength at least moderate, this supports potential for emerging assets.

With the yield curve set to structurally steepen, fixed-income returns will increasingly hinge on income components rather than capital appreciation — although less inflation risk and more pronounced growth risks in Europe support the case for duration assets there.

We think shorter duration credits, like asset-backed securities, look interesting. They benefit from a higher-for-longer scenario given their floating rate nature. Securitised credits have high starting income levels and exhibit low correlations to traditional fixed income – making them a useful diversifier for portfolios. There are favourable opportunities from high all-in yields elsewhere in credits, with fundaments solid, but many segments are 'priced for perfection'. This leaves little buffer against any downturn in credit quality.

A higher-for-longer rate environment also challenges traditional 60/40 portfolio constructs, with government bonds losing some of their hedge appeal. This adds to the benefits of alternatives like private credit and real assets, alongside the uncorrelated returns of hedge funds.

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	▲
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	↔
Private credit	▲▲
Real assets	▲
Hedge funds	▲▲
Private equity	↔
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 Asset Management, November 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 do 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 Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Top of mind

Top of mind

Has private credit reached its peak?

In recent months, there have been many headlines written about private credit – particularly around risks. Potential defaults are frequently cited, alongside the asset class expansion, as a source of risk. This argument suggests that credit quality has deteriorated as the asset class expanded – with pressure on managers to deploy rising volumes of committed capital. However, data suggests that defaults have remained relatively consistent since interest rates began to increase, averaging 2.5% each quarter since the beginning of 2022, taking into account non-accruals and interest modifications[1]. While concerns over private credit defaults are legitimate, and we remain vigilant, evidence suggests these fears have been somewhat overstated.

A further concern centres around potential reductions in demand while interest rates fall. One explanation for still solid demand and activity is that, while rates are on their way down, it is unlikely they will get close to the very low levels experienced during the 2010s. Should interest rates begin to normalise around the 2.5% to 3.5% level, that leaves significant room for private credit assets to deliver attractive all-in yield to investors. Premium spreads inherent in private credit investments provide a buffer as yields decline, while floating-rate structures enhance the diversification appeal as inflationary pressures persist.

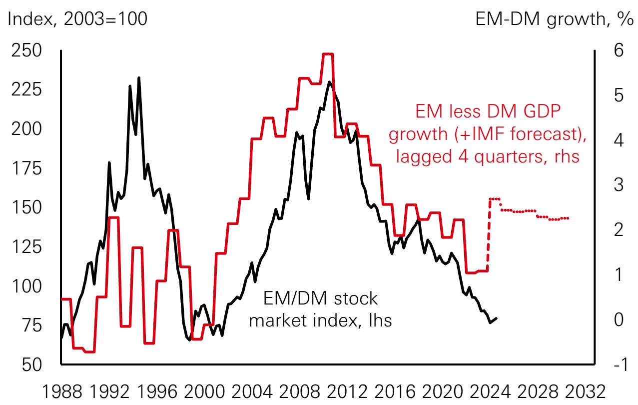
Despite experiencing a significant increase, just 6% of US corporate lending is private credit. In our view, given its characteristics, there remains considerable upside for future growth – particularly when considering that the US is arguably the most mature private credit market and penetration is still low. This means there are a wide range of options available to private credit managers, supporting opportunities in the asset class.

What are key considerations for emerging markets (EM) in 2025?

Fed cuts and China stimulus, alongside a starting point of hefty valuation discounts, has meant a good year for a broad range of EM asset classes. This backdrop hasn't changed much as we head into 2025. And importantly, the EM growth premium is expected to increase, which usually drives outperformance in EM assets. Still, they remain unloved and under-owned by international investors, reflected in low price-to-earnings (PE) ratios and high real yields.

There are several key risks contributing to investor hesitancy. Firstly, there is the potential for higher-for-longer US interest rates, which could diminish the appeal of higher-yielding international assets and exert upward pressure on the dollar. A stronger dollar could lead to capital outflows from EM, particularly if US economic growth outpaces expectations.

Figure 1: EM-DM relative growth and stock market performance



Source: Macrobond, HSBC Asset Management, November 2024.

Additionally, there is risk of Chinese authorities under-delivering on promised policy stimulus, or a ramp-up of protectionist policies hurting global trade. Simply the uncertainty around policy from both the US and China could weigh on confidence.

Investors must do their homework when allocating to EM, given regions are performing so differently and are facing different challenges. The multi-polar world presents risks but also opportunities for countries as the global economy is rewired. ASEAN, for example – an already fast-growing region – is a potential major beneficiary of higher US-China tensions as production is 'friendshored'.

Source: HSBC Asset Management, November 2024. Past performance does not predict 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 Asset Management accepts no liability for any failure to meet such forecast, projection or target. 1 - Private Debt: Few Facts Behind the Fears | Neuberger Berman (nb.com)

What does the recent volatility in India's equity markets mean for its outlook?

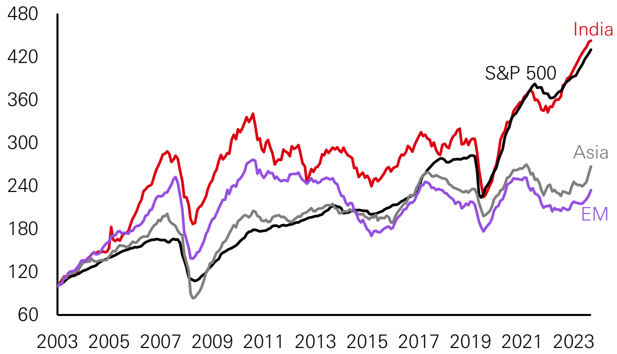
In recent months, Indian equity markets have experienced notable volatility, primarily driven by a shift in foreign investor sentiment. After a period of robust inflows, foreign investors have turned net sellers of Indian equities, a trend that can be partially attributed to a renewed focus on China.

Since China implemented a series of stimulus measures in September, it has recaptured the attention of global investors while experiencing its own period of pronounced market swings. A moderation in short-term economic indicators and expectations of a softer earnings season in India have also contributed to the reversal of prior tactical inflows into equities, leading to an increasing divergence in capital flows.

Exceptionally strong net domestic inflows, totalling $56 billion thus far in 2024, have effectively more than compensated for the $1.9 billion of foreign outflows. The result has been a rise in domestic ownership that has surpassed foreign ownership over the last few years.

Despite the short-term turbulence, the MSCI India index in USD terms has appreciated by double digits as of November, underscoring the resilience and strength of domestic investor sentiment in the face of external volatility. Optimism is supported by superior earnings growth potential and high corporate profitability.

Figure 2: Next twelve-month EPS (indexed to 100)



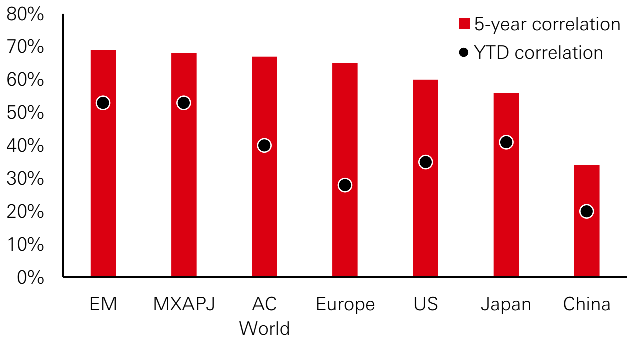
Source: Goldman Sachs, as of August 2024.

The IT and banking sectors, in particular, have emerged as key growth drivers, underpinned by strong earnings and digital transformation. Additionally, small and mid-caps, buoyed by structural reforms and innovation, continue to garner attention despite higher valuation risks.

The Indian economy, too, has shown resilience despite global challenges. The economy benefits from targeted government investment, expanding infrastructure and a burgeoning middle class. These factors, combined with its domestic demand-orientation and minimal reliance on US exports, position India as one of the least exposed major economies to any global trade disruptions.

Notably, there has been a gradual decoupling of India's economic and financial markets from major global markets, including the US, Europe and Japan. This has been demonstrated by a lower correlation of MSCI India with these major markets compared to the past five years, presenting appealing diversification benefits.

Figure 3: MSCI India correlation with respective markets



Correlation is based on weekly price returns in USD terms. MXAPJ refers to MSCI Asia ex Japan Index. AC World refers to MSCI All Country World. Source: MSCI, HSBC Asset Management, as of 16 September 2024.

The Indian equity market has now become the 4th largest in the world, with its market capitalisation tripling to roughly $5 trillion over the last decade.[2] Yet, a stronger global standing may not prevent a continuation of short-term volatility due to foreign capital flows influenced by a variety of factors, including additional stimulus measures from China, key policy announcements from the new US administration, relative market valuations and the outlook for the Indian Rupee.

Over the long term, it is anticipated that foreign flows will align more closely with the trajectory of corporate earnings growth in India. The Reserve Bank of India's calibrated monetary stance, and the government's emphasis on fiscal prudence, will also be instrumental in mitigating some of the headwinds. Thus, Indian equities should continue to offer a blend of diversification benefits and growth potential for portfolios with a long-term investment horizon.

Past performance does not predict 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 Asset Management accepts no liability for any failure to meet such forecast, projection or target. 2- Refinitiv/LSEG data, November 2024.

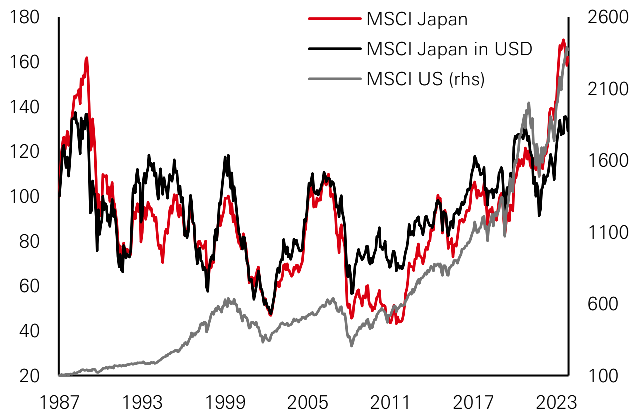
What is behind the revival of Japanese equities?

Japanese equities are garnering renewed interest, propelled by structural reforms, attractive valuations and macroeconomic shifts. Recent data shows the MSCI Japan Index revisiting levels unseen since 1989, highlighting a potential turning point. However, it is necessary to closely examine the economic policies, market positioning and external factors for understanding the dynamics at play.

Japan's economic revival owes much to reforms initiated during the Abenomics era and extended through the Value-Up Program. These initiatives have spurred meaningful changes in corporate governance which in turn have led to capital allocation efficiency, heightened shareholder returns and improved return on equity (ROE). Additionally, policies incentivising retail participation in equities, including tax-advantaged Nippon Individual Savings Accounts (NISA), have been aimed at mobilising the massive $9 trillion held in household savings.

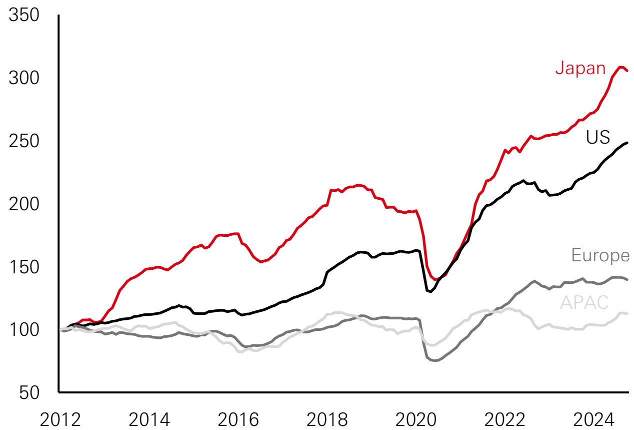
Valuation metrics further reinforce the case for Japanese equities. Despite outperforming most developed markets in earnings-per-share (EPS) growth over the past decade, Japanese stocks trade at a significant discount relative to both US equities and global peers. Importantly, earnings growth remains a primary driver of returns, reflecting the structural improvements within Japanese companies. This means that the undervaluation, coupled with a lack of multiple expansion, presents not just an attractive entry point but signals the potential for re-rating.

Figure 4: MSCI Japan performance



Past performance does not predict future returns.
Source: Bloomberg, HSBC Asset Management. Data as of October 2024. Index values rebased to 100 as of December 1987.

Figure 5: 12-month forward earnings growth index



Past performance does not predict future returns.
Source: Bloomberg, HSBC Asset Management, October 2024. Values rebased to 100 as of December 2012.

Japan has historically been synonymous with export-oriented giants. Today, its semiconductor and auto industries are being bolstered by a weaker yen and geopolitical realignments, including 'friendshoring'. The resurgence of the 'made in Japan' trend has led to reshoring of high-value-add manufacturing, revitalising its semiconductor ecosystem. Amid an acceleration of momentum in AI, the Japanese government has been facilitating investments to support the opportunity. For instance, the government has allocated over $3 billion for the development of new chip-making facilities. Meanwhile, domestically-oriented sectors such as financials and utilities are also gaining traction, showing strong earnings momentum.

Yet, challenges persist. Japan's equity market remains heavily influenced by external factors, notably the dollar-yen exchange rate and trade dynamics with the US and China. While a weaker yen has traditionally supported exporters, recent data suggests diminishing sensitivity. Additionally, competition for foreign capital inflows between Japan and China underscores the complexity of sustaining equity performance. Lastly, the sustainability of its reflation regime will remain a key criteria in Japan's bull thesis.

Overall, Japanese equities present a compelling investment case rooted in inexpensive valuations and a reflating economy, supported by improving governance standards aligned with shareholder interests. However, this summer's turbulence around the unwinding of the Yen carry trade shows us that navigating this market demands vigilance towards external developments.

Source: HSBC Asset Management, November 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 Asset Management accepts no liability for any failure to meet such forecast, projection or target. This information shouldn't be considered as a recommendation to invest in the sectors or companies provided.

Sectoral implications of China's policies

Sectoral implications of China's policies

"Recent policies emphasising local government financing, stabilisation of the property sector and resilience of the banking system underscore their interconnections."

In recent months, China has continued to face a combination of economic challenges characterised by a sluggish property market, heavily indebted local governments (LG), and a banking sector under scrutiny. This scenario has led to the more urgent implementation of various policies designed to ease immediate financial pressures on these three sectors, and a few others.

The announcements made at the end of September aim, most importantly, to address the fiscal stress faced by local governments. A pivotal measure in this regard is the 10 trillion RMB debt swap over the next three to five years, which allows local governments to issue special-purpose bonds to repay local government financing vehicles (LGFVs) debts.

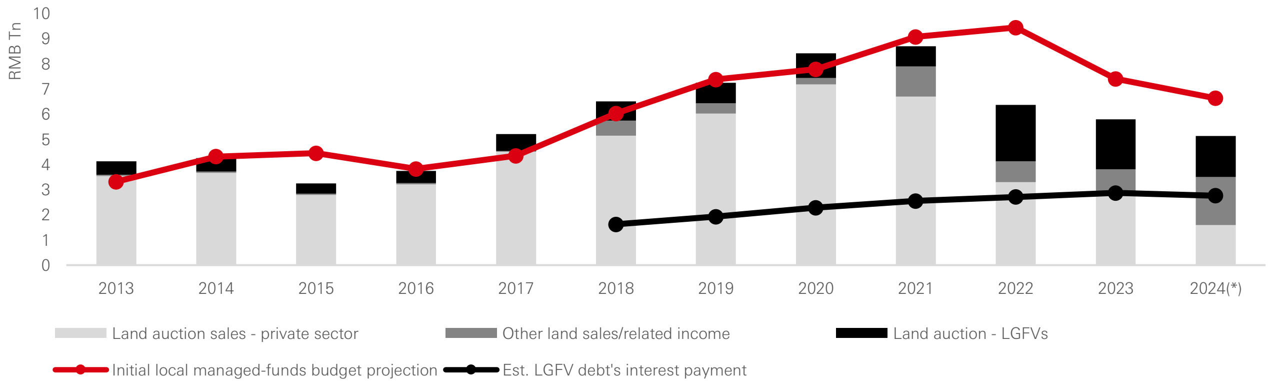
This program effectively transfers some of the off-balance-sheet LGFV debts onto the balance sheets of local and central governments.

The decline of the property market has severely impacted land sales, which are local governments' main source of revenue, exposing their fragile fiscal position with a budget shortfall of approximately RMB 3 trillion, or 2.5% of GDP per year vs. 2019-20 levels. Authorities have been grappling with rising LGFV debt levels, which have reached over RMB 60 trillion — a significant portion of China's total debt — estimated to be around RMB 300 trillion.

This debt swap is particularly important as it aims to convert short-term debt into long-term LG bonds, thereby easing the immediate repayment pressures on local governments and lowering interest costs. Additionally, this initiative is expected to significantly reduce potential defaults, thereby stabilising LG/LGFVs that have been under significant strain.

The second focal point for policymakers is indeed the property sector. A significant concern is the substantial unsold inventory in the market which poses a barrier to a robust recovery.

Figure 1: Collapsed property market led to significant and persistent fiscal gap



Source: National Bureau of Statistics, MOF, WIND, Huaxi Securities (* Annualised from September 2024 data).

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According to market data, the average inventory level in key cities stands at 33 months, compared to a long-term average of around 15 months. This overhang poses a substantial barrier to a robust recovery in the property market, and further targeted policies will likely be necessary to address these challenges effectively over the long term.

Additionally, tax reforms could provide a short-term boost, particularly benefiting state-owned enterprises (SOEs) focused on first and second-tier cities. However, a genuine recovery may take at least two years, with developers holding idle land likely to be the first batch to benefit. The Chinese government has also signalled its intent to stabilise the property market, emphasising the need to halt the decline and stabilise prices. This strong signal has prompted various departments to launch supportive policies. However, execution risks remain high, as past rounds of policy easing have shown that local governments often struggle to implement measures effectively. Unless these measures are clearly tied to key performance indicators for local governments, the desired outcomes may not materialise.

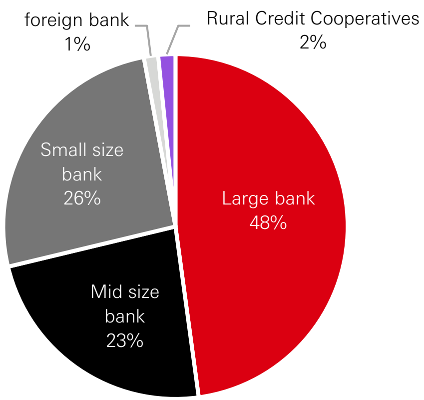
Impact on the banking sector

The property sector's struggles are compounded by the fact that approximately 30% of the total loan book of Chinese banks is tied to real estate[1], including mortgages and developer loans. This exposure raises concerns about the overall health of the banking sector.

Stress tests conducted on various risks, including those associated with commercial real estate (CRE), LG/LGFVs, and small and medium-sized enterprises (SMEs), indicate that banks are most sensitive to LG/LGFVs risks. The average non-performing loan (NPL) ratio for LG/LGFVs exposures is currently low, ranging from 0.5% to 1%, while the average NPL ratio in the first half of 2024 is projected to be around 1.2 with specific sectors, such as CRE, exhibiting higher ratios[2]. However, this may not fully reflect the underlying risks due to recent debt relief programs and asset quality relaxation policies.

One of the key policy measures announced by the Chinese government is the planned recapitalisation of the six major SOE banks, which is expected to amount to approximately RMB 1 trillion. This figure represents about 0.95% of the risk-weighted assets of these banks.

Figure 2: Bank industry by total asset size

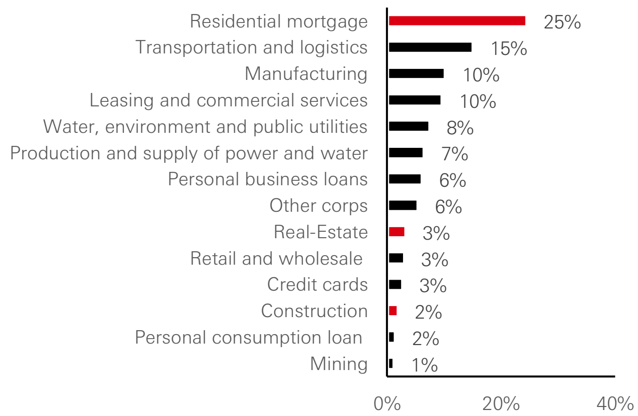


Source: China Financial Stability Report 2023

While this recapitalisation is viewed as credit positive in the near term, its long-term benefits depend on the size and utilisation of the funds. The overarching goal of the new policies is to stabilise the banking system and stimulate domestic demand. This includes support for LG/LGFVs and SMEs, with an intended move to support the execution of property policies. The banking sector's health is indeed vital for overall economic stability, and this capitalisation is seen as a necessary step to ensure that banks can absorb potential losses while continuing to lend. Importantly, the Chinese regulators perform annual stress tests on the banking system, for early identification of key credit risks and weak links in the system.

Despite these measures, numerous structural issues remain, and the execution of current policies is likely to be a multi-year process.

Figure 3: Typical loan book of a large bank



Source: HSBC Asset Management, June 2024.

Source: HSBC Asset Management, November 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. [1]Industrial & Commercial Bank of China as proxy. [2] Seven major SOE banks.

> "While the outlook remains uncertain, these proactive measures provide a framework for potential recovery."

Internet and technology

The Chinese government's recent stimulus measures are expected to yield positive short-term earnings for Internet companies. A notable initiative is the introduction of a trade-in subsidy program, which allocates approximately RMB 150 billion ($21 billion) from August to December. This program aims to boost consumer spending on electronics and home appliances, with sales in these categories reportedly increasing by nearly 40% year-on-year in October, up from 20% in September. E-commerce platforms are also poised to be the primary beneficiaries of this consumption recovery. For instance, online retail sales of goods grew by 11.3% year-on-year in October, compared to 6.4% in September.

In contrast to these sectors, the hardware technology segment has yet to experience the same level of positive impact from consumption initiatives. Recent data indicates that smartphone shipments in China remained flat year-on-year in the third quarter, while PC shipments declined by 10%.

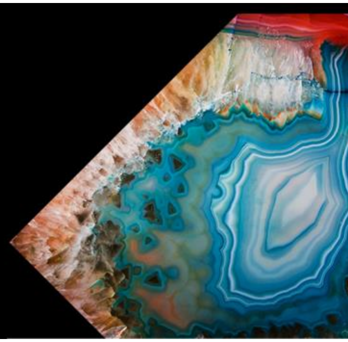
This suggests that the replacement cycle for these devices is driven more by technological upgrades than by trade-in programs.

Potential geopolitical tensions, particularly with the United States, looms large over the hardware tech sector. Any increase in tariffs on electronics could disproportionately affect companies that have significant exposure to the US market. Additionally, the possible rollback of the CHIPS Act could hinder semiconductor companies, impacting their ability to secure funding for US investments.

While further sanctions and trade restrictions from US remain tail risks, potential delisting risks from US should be manageable given most dollar issuers are now dual-listed in both the US and Hong Kong. However, the potential for a sector-wide sell-off, similar to 2018, remains a concern if tensions escalate beyond market expectations.

Other sectors

Macroeconomic headwinds and geopolitical tensions have altered consumer behaviour, leading to a "consumption downgrade" that may not be easily reversed. The government's commitment to fiscally support consumption in the coming years may revive sentiment, with the market expecting fiscal support ranging from 0.5 to 1 trillion in 2025. Despite these challenges, selected sectors like domestic travel and EVs thrive under current policy.



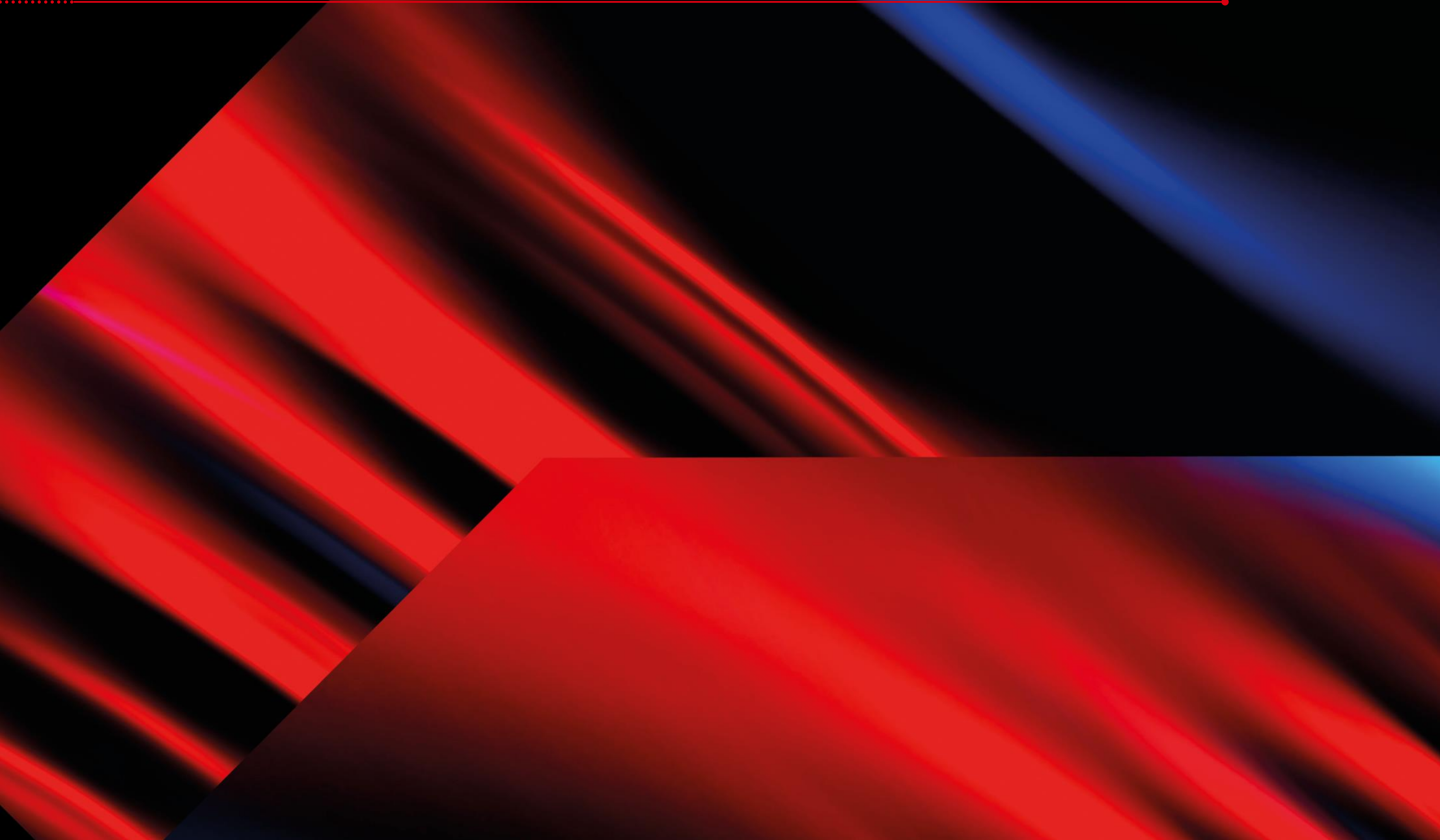
Looking ahead

Overall, while there are positive signs emerging from China's technology and consumer sectors, the landscape remains complex and fraught with challenges. For investors, a selective approach should prevail, particularly in the hardware tech sector, where geopolitical risks could significantly impact performance.

> " As we move into 2025, the focus will shift to how these policies unfold and their impact on domestic markets."

Source: HSBC Asset Management, November 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. This information shouldn't be considered as a recommendation to invest in the sector shown.

Materials supply a prerequisite for decarbonisation



Materials supply a prerequisite for decarbonisation

> "Materials demand is projected to grow exponentially, fuelled by the decarbonisation investment cycle and shifts in how we live."

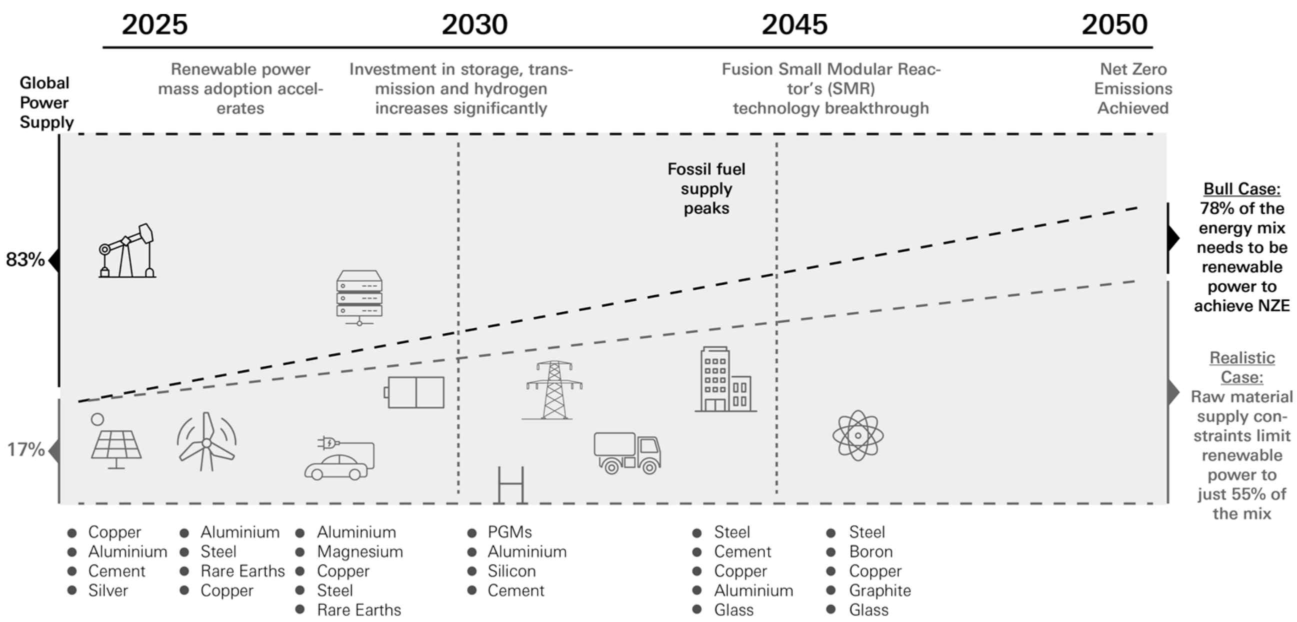
After spending 100 years developing a world powered by fossil fuels, in the next 25 years we are going to develop an integrated power system that relies on renewables. This is very complex, given that it means creating a power system that relies on many forms of power, after building a global system based on one. And, importantly to this analysis, the new power sources are material-intensive.

Currently, renewable energy sources account for less than a fifth of global power generation, with fossil fuels still dominating the energy landscape. To achieve net-zero emissions by 2050, this ratio must be inverted. This necessitates a comprehensive rethinking of how we consume, generate, store and utilise power. Accordingly, decarbonisation remains a compelling long-term theme for investors and presents a broad, often overlooked, opportunity set for materials companies.

Decarbonisation also overlaps with other long-term themes such as the digital transformation and urbanisation, with the materials sector playing a vital role across them.

Decarbonisation itself can be categorised into two primary streams: mitigation and adaptation. Mitigation encompasses clean energy, the electrification of transport and the corresponding infrastructure – which drives demand in a number of materials, beyond the more obvious ones such as copper. Adaptation ties into how we build and live in communities, how we use data to gain efficiencies (e.g. AI), and much more. Again, this involves a broad range of materials needs.

Figure 1: A structural shift in demand for natural resources as the decarbonisation journey strains supply



Source: HSBC Asset Management, IEA, September 2024. Based on a Safety4Sea diagram. For illustrative purposes only.

Mitigation a big consumer of materials

Examining the components of clean energy technologies can help us comprehend the materials required for a successful transition. For instance, a wind turbine requires a diverse array of commodities including concrete, steel, aluminium, rare earth elements and even plastics. Notably, offshore wind farms require six times more steel per megawatt of power generated than traditional thermal coal plants. Such needs highlight the complexity of the energy transition and the vast quantities of materials that will be required to make it a reality.

Even clean energy technologies are not entirely free from fossil fuel dependence. Sticking with our look at wind turbines, they require synthetic lubricants derived from oil to operate efficiently. These lubricants can be created from bio-based products, but would then be taking away food supply. The finite nature of these resources underscores the challenges which must be addressed.

Urbanisation contributes to demand

Projections indicate that 9 billion people will reside in cities by 2050 – roughly double that of today.[1] As urbanisation accelerates, the demand for materials will only intensify. Urbanisation is not merely about population growth; it is about rethinking how we sustainably design and inhabit our cities, including the concept of smart cities which is gaining traction. This rethink of how we live in cities also involves how people move between cities, through high-speed rail networks and other means. The evolution will require new materials, including rare earths, vanadium, titanium and hydrogen to support the infrastructure of the future.

The materials we consume in urban environments will also need to adapt to changing climate patterns. As we confront the realities of extreme weather events and shifting environmental conditions, our approach to urban planning and construction must evolve. This presents clear challenges, but also opportunities for the materials sector.

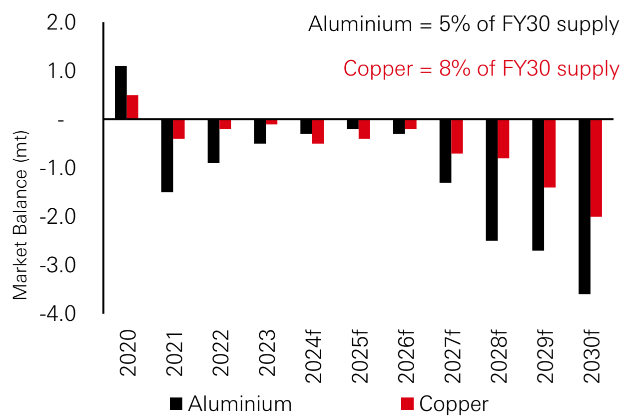
Mining companies starting from a deficit

The International Energy Agency estimates that to achieve net-zero emissions by 2050, the world will need to triple its renewable energy capacity by 2030. Yet, we are already behind the proverbial eight ball in scaling up supply of key materials to facilitate this alongside broader demand growth.

In response to past boom and bust cycles in demand, mining companies have more recently become much more disciplined in their capital allocation approach, avoiding investment in mines that would produce an oversupply from their output. This has meant healthy balance sheets amidst a renewed focus on shareholder returns – producing dividend yields of 5-10% alongside stock buybacks. However, the need for new mines is intensifying. The scale of the deficit is such that 27 new copper mines at 300 kilotons per mine would need to be built by 2030, to fill the gap for projected demand of one of the most important transition metals, given its outsized role in electrical wiring and energy grids.

As it stands today, the industry is now grappling with aging mines and declining grades. For instance, the average copper grade in mines has halved since the early 1990s,[2] and many mines are now operating at depths that pose significant technical challenges.

Figure 2: Supply imbalance continues to grow



Source: HSBC forecasts, Morgan Stanley historic data, November 2024.

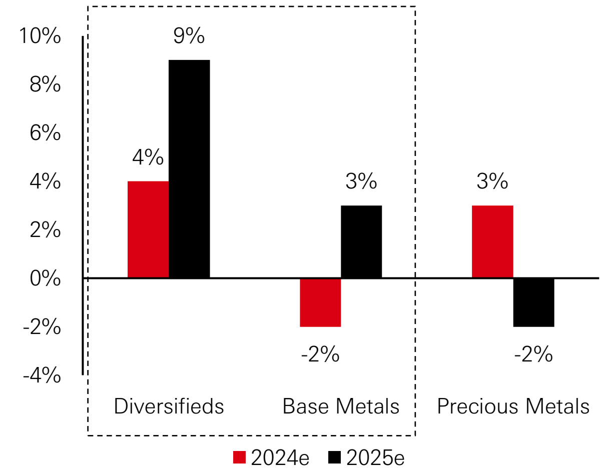
Valuations may underappreciate the long-term opportunity

Europe has the highest percentage of materials and mining companies that are exposed to this theme. As a group today, their price-to-book ratio sits a full standard deviation below its historical average relative to the STOXX Europe 600. Sagging valuations of late have been in part due to shorter-term issues such as growth concerns in China and questions over the size and effectiveness of stimulus there, as a major consumer of metals and materials. The unknown implications of a new US administration on global trade and growth has been another recent factor. However, we see a longer-term, enduring demand thesis that largely overrides these shorter-term challenges and is strongly connected to decarbonisation and the materials needed to achieve net-zero targets and broader societal shifts.

1 – World Bank, April 2023. 2 – S&P Global Market Intelligence, Wood Mackenzie, 2024.

As a key enabler of much of the technological and societal change currently in early stages, we view the opportunity in materials as structural in the years ahead – not a cyclical play as they have been treated in the past. However, even looking more near-term offers a positive view, with earnings upgrades starting to come through.

Figure 3: Consensus mining EBITDA upgrades/downgrades



Source: Morgan Stanley, October 2024.

The above reflects a shift away from defence – in the form of precious metals companies benefitting from shorter-term safety demand – with a move more onto the front foot as a sector. Positive momentum in the form of earnings upgrades starting to come through comes alongside the underlying thematic demand drivers and inexpensive valuations. Accordingly, we think there are particular opportunities which make this area of the market more relevant to investors than has been the case in years past.

Mining and AI

While not two topics you would typically discuss together, materials and AI do increasingly need to be considered alongside each other given corresponding impacts. Coming back to copper as a key component of power grids, huge amounts of it will be needed as more data centres consuming more power to drive AI advancements are built out across the globe. We estimate around 300,000 tons of copper is needed to supply new data centre demand alone over the next 10 years – that would require a new mine built in the US every year to support this demand growth.

Another element of the power need for data centres is that it is consistent. Clearly, one of the problems with relying on renewables such as wind and solar is that they're intermittent. Battery storage can't address the problem by itself. This is where nuclear power appears to be coming into play as a more prominent consideration for clean energy. Recent deals by data centre hyperscalers – such as Microsoft, Google and Amazon – to secure access to nuclear power highlight this trend, built out of a necessity to address growing power needs amidst net-zero commitments and limitations of existing power grids or renewable energy supply elsewhere.

As the tech industry increasingly engages with the nuclear sector, the demand for a broad set of raw materials such as boron, graphite, and glass will accelerate. Again, growing need for such materials is typically overlooked or underappreciated as a side effect of the growth in AI. This supports opportunities not yet priced into markets

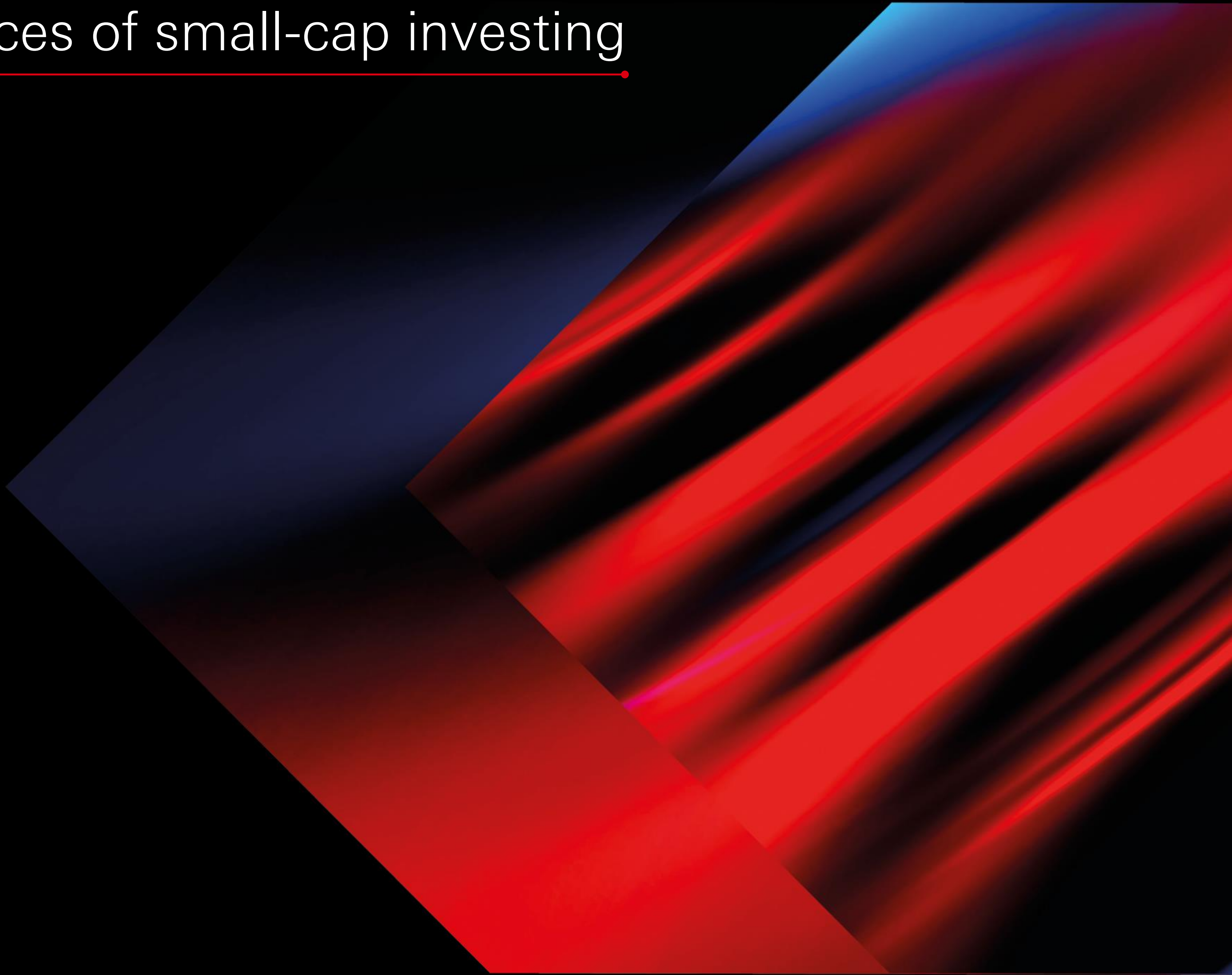
> "For every gigawatt of power in the US that goes into data centres, about 65,000 tons of copper is needed."

Unique opportunity in equity markets

The imperative for transition resources in a decarbonising world is clear, driven by both mitigation and adaptation needs. We will consume vast amounts more of commodities that are in structural deficit today, than we have done in the past 50 years. That will mean prices need to move higher to incentivise miners to build more mines and produce more of those critical raw materials. While higher commodities prices would certainly be unhelpful for inflation paths and potential returns elsewhere in equity markets, it would support better earnings and returns for mining and materials companies – a useful component to consider within broader equity portfolios.

Further tailwinds can be found in the form of AI's heavy power consumption and the ongoing buildout of data centres globally. Long-term thematic considerations alongside inexpensive valuations present materials companies as a unique story in global equity markets. We think these deep cyclical sectors will become more structural investments going forward, presenting an opportune time to pursue opportunities ahead of that shift gaining steam.

The nuances of small-cap investing



The nuances of small-cap investing

> "Understanding the nuances can help deliver benefits within portfolios."

Small-cap stocks have long been viewed as a promising avenue for investors seeking growth and higher potential returns. Consisting of many earlier-stage companies, small caps often exhibit higher growth potential compared to their larger counterparts. However, small-cap investing is complex and multifaceted, influenced by regional and structural factors that must be considered as part of portfolio construction.

Capturing the desired benefits

The effectiveness of 'size' as a factor is often debated. Studies have often emphasised that small caps exhibit characteristics closely tied to beta exposure, with limited standalone strength as a factor. The research broadly finds that small-cap stocks often fail to outperform without the influence of other factors, such as value or momentum.

The findings point to small caps catalysing other factors, highlighting the importance of integrating small-cap investing into broader, multifactor strategies rather than relying on them in isolation.

Moreover, small-caps are known for their higher skewness in returns. The data below reflect the more frequent occurrences of exceptionally high individual stock returns. However, this 'lottery effect' seldom translates effectively at the index level. Only 3% of US small caps transition to large caps annually, highlighting the difficulty in capturing widescale gains at the index level. Hence, a nuanced approach is needed to achieve the desired portfolio objectives.

Figure 1: S&P 500 stock return distribution (%)

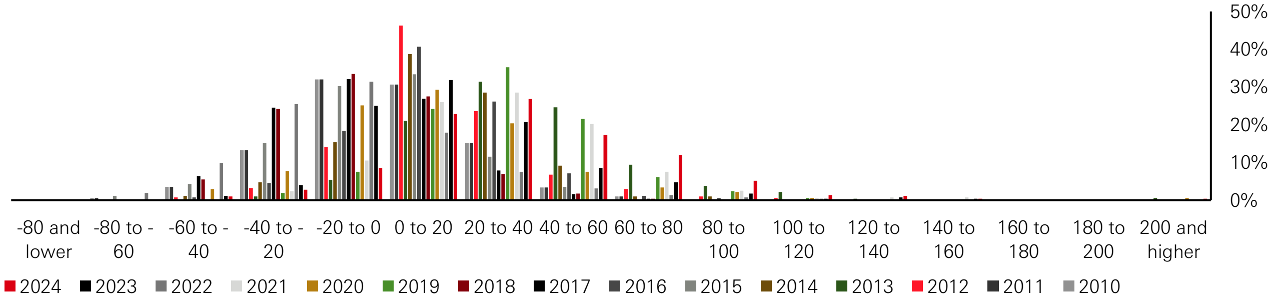
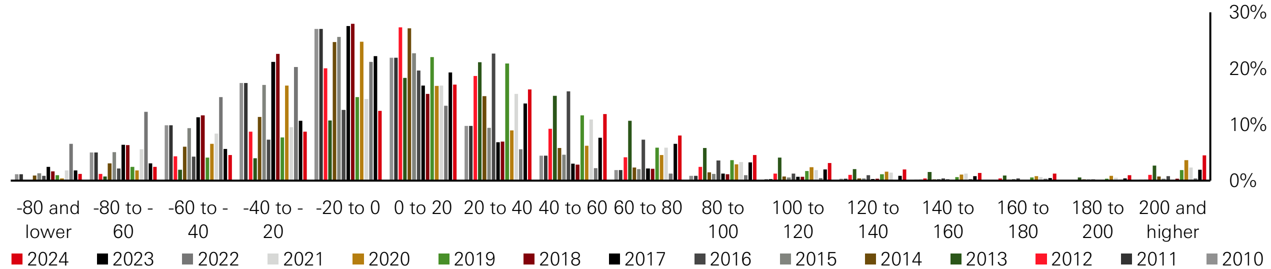


Figure 2: Russell 2000 stock return distribution (%)



Source: HSBC Asset Management, Bloomberg, November 2024.

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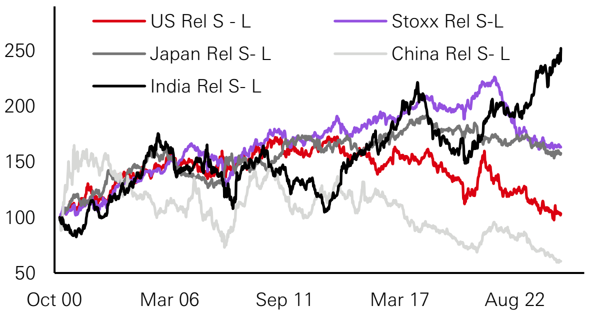
Regional trends

A review of differences in the regional performance of small caps vs large caps over the last two decades demonstrates that a one-size-fits-all approach is not appropriate, with local factors clearly at play.

Figure 3: Small vs large cap returns per region



Source: HSBC Asset Management, Bloomberg, November 2024.

For instance, the stark contrast between China and India reflect differences in local economic momentum. And, contrary to the common assumption of small caps being high-beta plays, US small caps have shown muted beta levels. This has translated into US small caps massively underperforming in recent years – the Russell 2000's cumulative return of roughly 50% from 2009 to 2021 pales in comparison to the S&P 500's 300% return.

Unlike the US, European small caps have exhibited a classic high-beta characteristic, with performance closely tied to macroeconomic cycles and activity. This cyclicality can also be linked to their higher operating leverage and sector distribution, resulting in more volatility but also opportunities during economic recoveries.

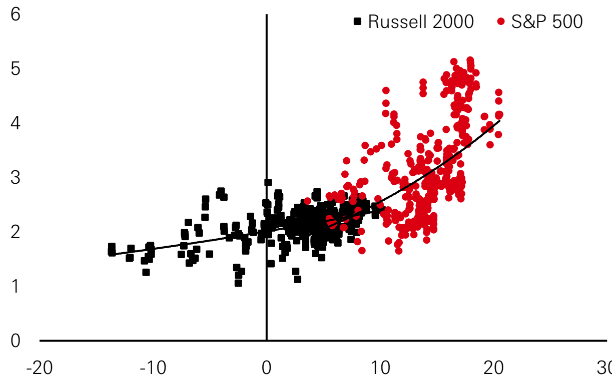
Yet, periods of economic stress expose vulnerability to external shocks. The onset of the Covid-19 pandemic was one, which revealed weaknesses across the board for small caps that has continued to date. Indian small caps have been an exception, benefitting from world-leading economic growth and domestic fund inflows. Over the past three years, the Nifty SmallCap 100 Index has outperformed the Nifty 50 Index by approximately 20%.

In Europe, small caps historically outperformed large caps until the onset of the pandemic, and now trade below their long-term average P/E, having given up their prior valuation premium versus large caps. This may signal a compelling entry point, particularly if uncertainties around inflation, interest rates and trade policies diminish – uncertainties to which European small caps have been particularly sensitive to historically, given their cyclicality.

In the US, divergence between large-cap and small-cap valuations has reached historical extremes. The current price-to-book ratio for large caps stands at around 5, compared to approximately 2 for small caps. This gap – a ratio of 2.5 – is about the highest it has ever been. Return on equity (ROE) is an important contributing factor, with a 15% spread in ROE having opened up in favour of large caps in recent years.

As it should in functioning financial markets, ROE trends help tell the story of what has played out. Similarly, when we examine the contrast of China and India small cap performance over the last 15 years, ROEs moving in opposite directions in each market coincide with the performance dispersion.

Figure 4: Price-to-book vs return on equity %

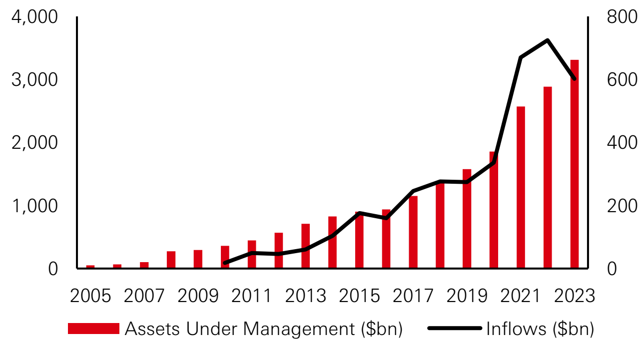


Source: HSBC Asset Management, Bloomberg, November 2024.

Challenges and strategic considerations

The number of initial public offerings (PO) peaked in the 1990s, while the value of IPOs is now materially higher. This trend points to fewer smaller companies entering the public markets, limiting the opportunities available to small-cap investors. Contributing to this has been the absorption of smaller companies by private equity firms.

Figure 5: Private equity AUM and inflows



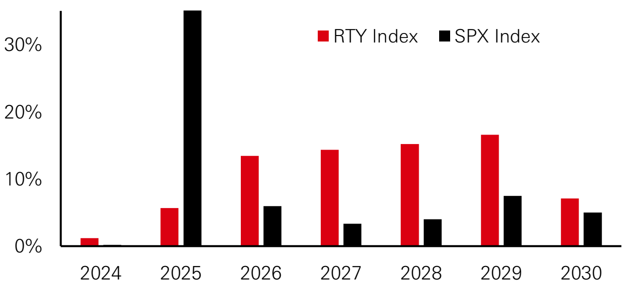
Source: HSBC Asset Management, Bloomberg, November 2024.

Implications are evident in the US. The earnings and cash flows of US small caps has deteriorated over the last few decades, while the opposite has occurred for the S&P 500. Of course, profitable small firms are better candidates for removal from the market by private equity. We now see a concentration of wealth within a small number of large companies – the largest 320 stocks in the Russell 2000 account for 50% of the index's market capitalisation.

Again, this situation is not replicated across markets. Less concentration in Europe means small-cap investors there benefit from a significantly reduced concentration risk compared to large cap indices. These differences and nuances are key to why small caps can be useful for playing tactical themes within a portfolio - not necessarily from a global perspective, but on region-by-region basis.

Small caps today can certainly present compelling opportunities due to significant valuation resets. While higher-for-longer rates contributing to higher ongoing financing costs are a clear concern for small caps – which have much more variable-rate debt – there is not a massive refinancing wall ahead for 2025 to pose additional obstacles.

Figure 6: Russell 2000 vs S&P 500 refinancing risk

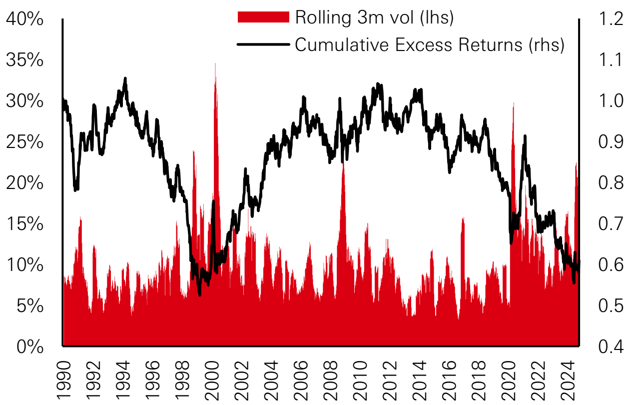


Source: HSBC Asset Management, Bloomberg, November 2024.

Potential catalysts for a rebound

Structural challenges must be considered for small caps, but several potential catalysts could drive a rebound. One is the aftermath of the US elections. Both previous turnarounds in small-cap performance occurred during periods of heightened volatility – in the late 1990s and the initial pandemic recovery. The recent spike in three-month rolling volatility, which surpassed 20% in August and September, may indicate that we could be on the cusp of another significant shift.

Figure 7: Russell 2000 vs S&P 500 volatility and excess returns



Source: HSBC Asset Management, Bloomberg, November 2024.

The recent outperformance by the index similarly follows a historical trend that has seen the Russel 2000 outperform the S&P 500 by nearly 4% historically during election weeks – placing it in the 98th percentile of weekly performance since 1990. Favourable policy changes under the new US administration could support a longer-lasting reversal for the US small caps.

Other catalysts could include a reduction in global economic uncertainty and favourable shifts in trade dynamics that benefit smaller companies. Improved policy coordination in markets like China can restore investor confidence in downtrodden small caps there.

Portfolio implications and outlook

Small-cap stocks offer distinct diversification benefits, with lower concentration risks compared to large-caps. This characteristic is particularly evident in Europe, where small caps provide a broader sector spread. However, this advantage comes with trade-offs we have outlined.

Importantly, the path for small caps appears to remain regionally divergent. While there are potential entry points for European and Chinese small-cap equities that could get support from a rebound in growth and removal of uncertainty, US and Indian small caps face profitability challenges and stretched valuations, respectively. Overall, small-cap investing is not a one-size-fits-all. The new US government, sector compositions, and the debt landscape will necessitate a tactical approach for blending small caps in well-diversified portfolios.

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