Fixed Income Insights

Macro factors behind US resilience

Energy issuers' journey to net zero

Q3 2024

For professional investors only

HSBC Asset Management

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Foreword

The US economy has demonstrated more resilient growth and more persistent inflation than most investors had expected, despite the Fed's restrictive monetary policy. We expect some of the factors underlying that to dissipate in the coming months, with below-trend growth contributing to further disinflation which should allow the Fed to begin to dial back monetary restraint.

Michael Cross
Global CIO, Fixed Income
HSBC Asset Management

Welcome to the latest edition of our Fixed Income Insights series, where we present the findings of our quarterly Strategic Forum.

We publish this edition as the Bank of Canada and the ECB became the first major central banks to begin their monetary easing cycles. They need to balance the risks of continuing above target inflation with that of the risks to growth of maintaining a restrictive monetary stance, and we expect them to take a cautious and data-dependent approach to further cuts. It is the first time since its formation that the ECB has cut rates before the FOMC.

In the US, where the economy has been remarkably robust and accompanied by more persistent inflation, the FOMC faces the same growth and inflation balancing act but has signalled that it will have to wait a little bit longer to begin cutting rates. We dedicate the first section of this publication to the reasons behind the surprising strength of the US economy. Specifically, we examine how fiscal policy played a significant role in the build-up of savings during the pandemic era, and how the running down of those savings contributed to stimulate growth since the economy reopened from Covid 19. We expect the run-down of those savings and the current low level of the savings rate, together with fiscal stimulus becoming a slight fiscal drag, to contribute to a slowing of growth now. While aggregate demand in the United States has been stronger than expected, so too has the growth rate of aggregate supply. As the United States is experiencing a surge in immigration, we also discuss how additional supply of labour could make a soft landing likely (by allowing wage growth to moderate while maintaining robust employment growth).

Separately, this quarter's section dedicated to credit research investigates the progress made by energy issuers in adapting to the net zero transition. We think this topic merits consideration as the demand for oil is not expected to plateau until at least 2030, causing a gap between demand and net zero targets. Currently, energy companies focus on reducing their scope 1 & 2 emission, where technologies are more mature. However, their long-term challenge is to reduce scope 3 emissions, which represent the vast majority of their emissions. This will require them to finance and develop new green technologies.

I trust you will find our analysis and takeaways interesting and a useful resource.

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In a nutshell

Has US fiscal policy been more stimulative than expected, and how will it impact the economic outlook?

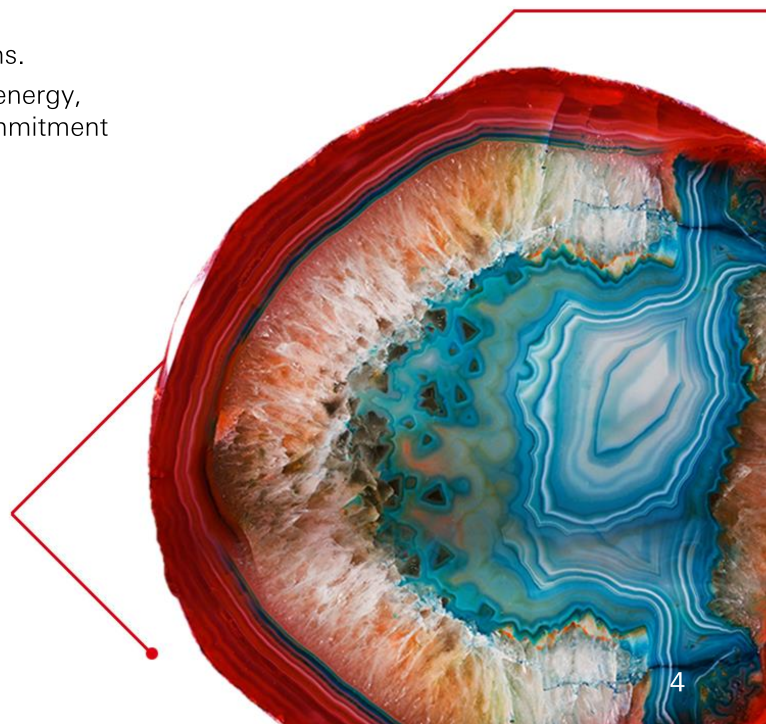
- Fiscal policy has provided a boost to consumption and investment in the post-Covid period, but is likely to act as a modest drag on the economy in the coming quarters, adding a downside risk to growth.
- The US Federal deficit is now back to its pre-Covid trend of gradual deterioration, with net interest payments making up more than half of the overall deficit, but most of these remain in the US.
- The impact of policies such as the CHIPS and Science Act on investment is likely to remain a slight net positive, but their impact may diminish over time, while the drawdown of excess savings is unlikely to create a strong stimulus to consumption in the future.

What impact has the growth of the US labour force had on the US economy and outlook?

- The US population is experiencing a surge due to an increase in immigration, particularly from non-legal or pending status migrants crossing the southern border, resulting in about 10 million more people living in the US than previously expected by January 2027.
- This surge in population has made it easier for the Federal Reserve to moderate the interest rate cycle with less pressure on wages, and has helped absorb the surge in labor demand as the economy opened up after the pandemic, moderating wage inflation.
- With the immigration surge consisting of mainly low-wage immigrants, it has helped contain wage growth in the tightest areas of the labour market, but since many migrants have low levels of education and are likely to be employed in lower productivity sectors, it may cap the rise in potential growth.

What progress has been made by energy issuers in terms of adapting to the net zero transition?

- Demand for oil is expected to plateau around 2030, causing a gap between demand and net zero targets.
- Energy companies currently focus on reducing their scope 1 & 2 emission, where technologies are more mature, but they also need to finance new green technologies to reduce their scope 3 emissions that represent the vast majority of their emissions.
- Companies in Europe are leading the transition to cleaner energy, while US and Asian companies have different levels of commitment to net zero targets and emissions reduction.



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Has US fiscal policy been more stimulative than expected, and how will it impact the economic outlook?

Fiscal policy played a significant role in the build-up of savings during the pandemic, but these excess savings have been largely exhausted and fiscal policy is set to become modestly restrictive, implying some downside risks to growth.

Dominic James Bryant
Director of Macro Strategy

Nick Stamenkovic
Economic Analyst

Fiscal policy has provided a boost to consumption and investment in the post-Covid period, with excess savings built up during the pandemic subsequently spent freely and run down, while incentives for reshoring and manufacturing investment have positively contributed to growth. In contrast, fiscal policy is likely to act as a modest drag on the economy in the coming quarters, adding a downside risk to growth.

The US Federal deficit is now back on its pre-Covid trend of gradual deterioration but with net interest payments now accounting for over one percentage point of GDP more than prior to the pandemic.

The deficit widened in the third quarter of 2023 but narrowed in Q4 and at the start of 2024 and is now lower as a percent of GDP than it was in H1 2023. More than half of the federal deficit consists of net interest payments, which are at their highest since 1999. Excluding net interest, the federal deficit is slightly narrower than prior to the pandemic. Although not technically a fiscal stimulus, around three quarters of federal government interest payments are flowing to US persons and businesses, thus providing an income boost for the private sector.

Figure 1: Net Interest payments account for over half Federal deficit

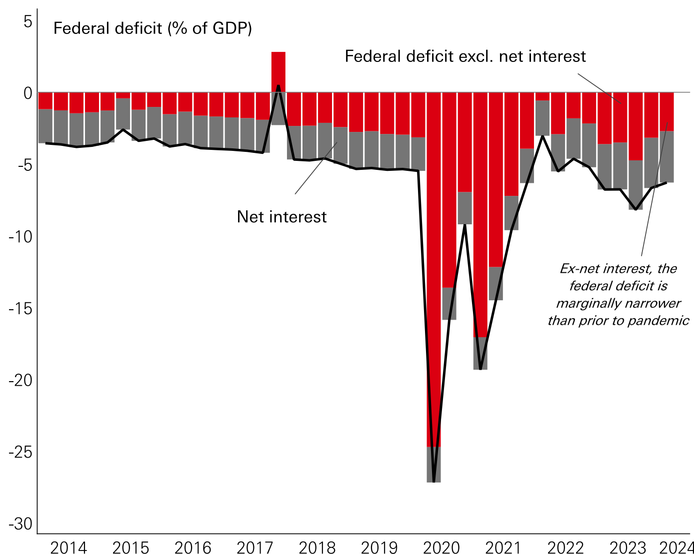
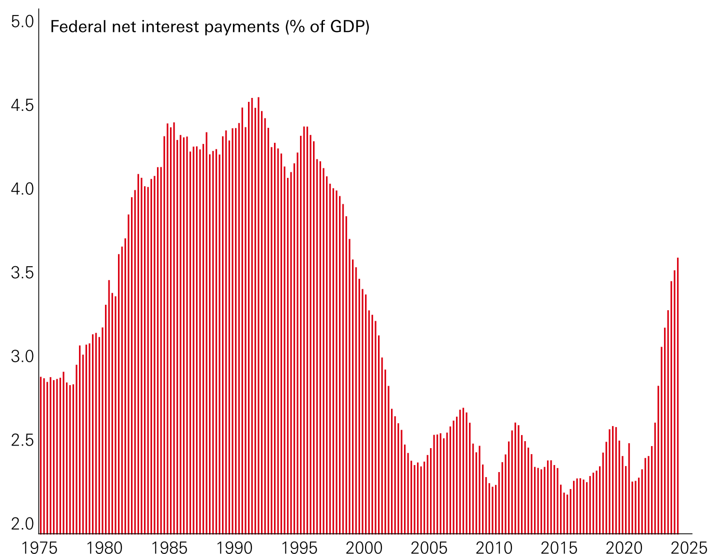


Figure 2: Net Interest payments up by over 1% of GDP since early 2020



Source: HSBC AM, Macrobond, May 2024.

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More widely, fiscal policy is likely to turn from a modest boost in 2023 to a modest drag in 2024. Although we would not seek to exaggerate the risks this poses to the economy, it is likely to come at a point at which the US is beginning to slow under the influence of restrictive monetary policy, thereby potentially exacerbating downside risks to growth. The Hutchins Center forecasts[1] a fiscal impact reduction in real annualized GDP growth of around 0.3-0.4% on average for each quarter in 2024, with a somewhat more significant headwind in 2025.

The reshoring and policy-driven investment boom is fading following an outsized contribution in H1 2023, while the strength of consumption is unlikely to be maintained in the context of an unusually low savings rate.

Fiscal policies can be seen to have supported the US economy to a significant degree in 2023. Private fixed investment was a key contributor to first half growth as the CHIPS and Science Act and other incentives led to increased investment, particularly in manufacturing structures. However, the impact of this, while likely to remain a slight net positive, will diminish over the coming quarters, especially as it is a relatively small part of the economy. Meanwhile, the remarkable build-up of savings during the pandemic, 80% of which could be directly attributed to fiscal policy, has been drawn down very significantly and therefore highly unlikely to create such a strong stimulus to consumption in the future. Overall, it should not be underestimated how large the fiscal stimulus was during the pandemic – three times that seen during the Global Financial Crisis. As its impact fades, the US economy should experience a period of below trend growth.

Figure 3: Consumer driving growth

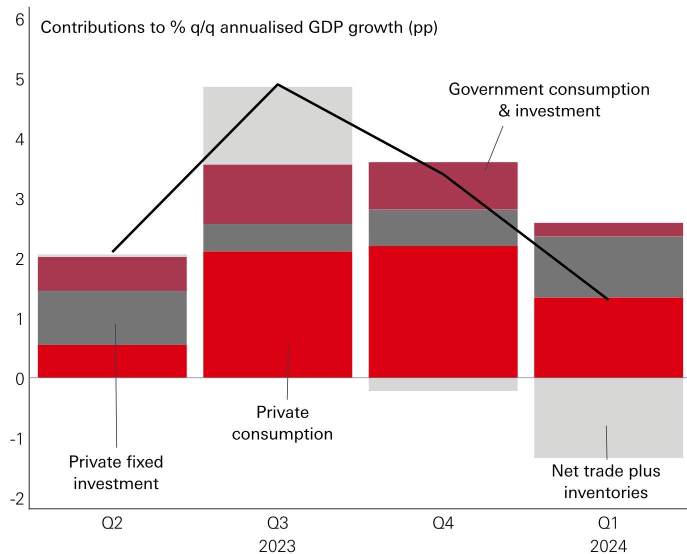
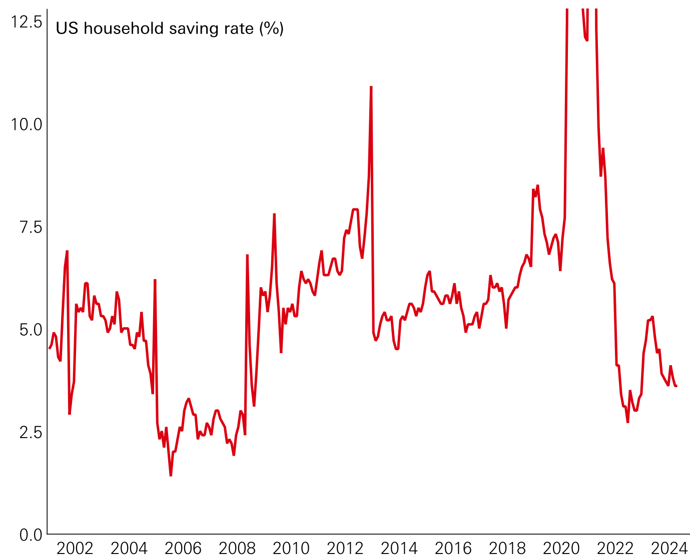


Figure 4: Saving rate slumped since mid-2023



Source: HSBC AM, Macrobond, May 2024.

[1] **Source:** Hutchins Center forecasts

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What impact has the growth of the US labour force had on the US economy and outlook?

The US is experiencing a surge in immigration which is estimated will add around 10 million more people to the population than previously expected by January 2027. The additional supply of labour makes a soft landing more likely by allowing wage growth to moderate while maintaining robust employment growth.

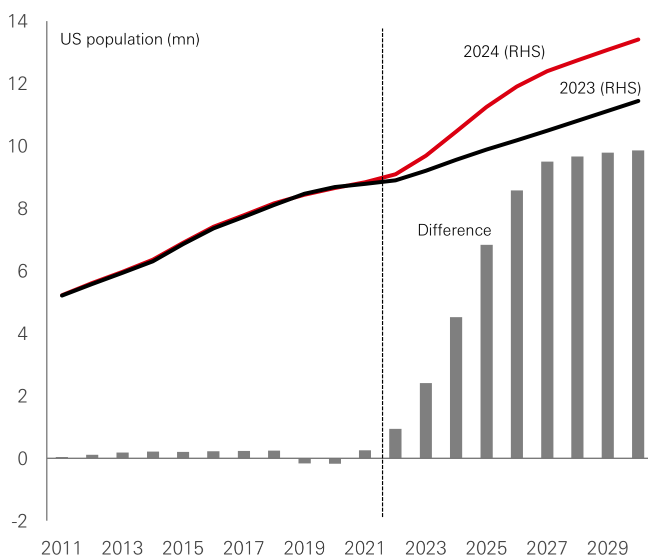
Dominic James Bryant
Director of Macro Strategy

Nick Stamenkovic
Economic Analyst

The Congressional Budget Office (CBO) has significantly revised up its estimate of population growth in its 2024 assessment[1] mainly due to a surge in immigration, much of which is coming through the southern border in the form of non-legal or pending status migrants.

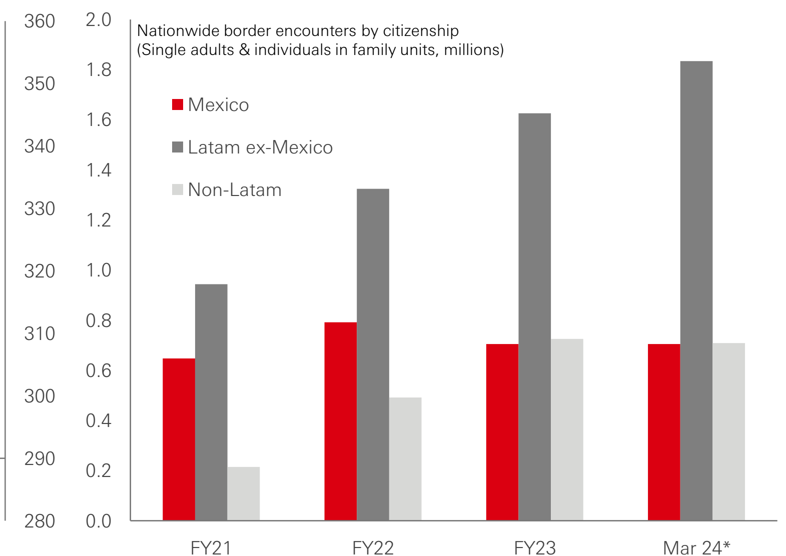
Following a period of weaker population growth during the pandemic, the CBO expects a 20-25 million increase during 2022-2027, around 10 million more than expected at the beginning of 2023. Much of the immigration is from outside official channels, with the south-west border being by far the main entry point. The encounters at this border account for around 75% of the total, with a significant share of those seeking entry into the US now coming from parts of LatAm affected by social and political unrest, such as Venezuela and Haiti, rather than from Mexico itself, which is making up a lower proportion of overall migrants.

Figure 1: Six years of significant population increases



Source: HSBC AM, Macrobond, May 2024.

Figure 2: Mexican immigration flattening off, other LatAm still rising



*12 months to March 2024. Source: HSBC AM, Macrobond, May 2024.

[1] **Source:** Congressional Budget Office

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The nature of this immigration will cap a rise in potential growth as many migrants have lower levels of education and are likely to be employed in lower productivity sectors. Nevertheless, the CBO estimates potential growth to be its highest since 2006.

Although the proportion of immigrants having a Bachelor's degree or higher is roughly the same as for native born Americans, the share of those with less than a high school diploma is much higher, while the types of jobs available to immigrants from outside official channels tend to be those in lower productivity sectors, such as farming, building maintenance and catering. Therefore, assumptions on productivity are key to assessing any increase in potential growth rates which have accrued due to population growth. The CBO forecasts that potential GDP will continue its modestly rising trend, which has been in place approximately since 2010, to reach 2.25% around 2027, but with a period of labour productivity in the near term.

Figure 3: Boost to labour force but lower productivity

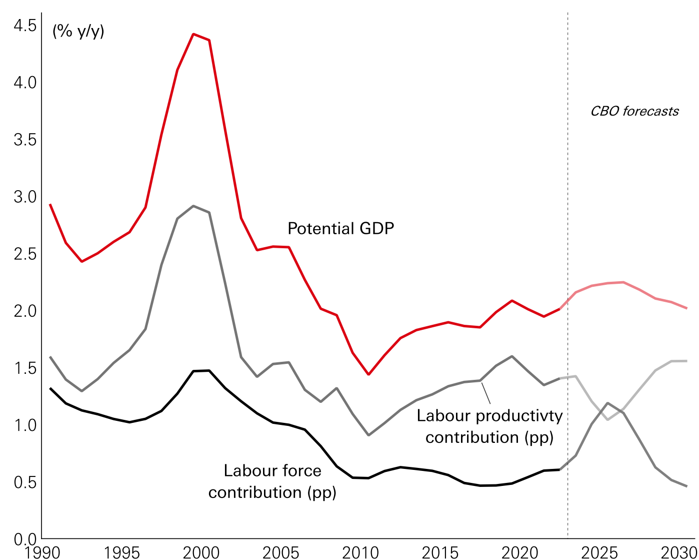
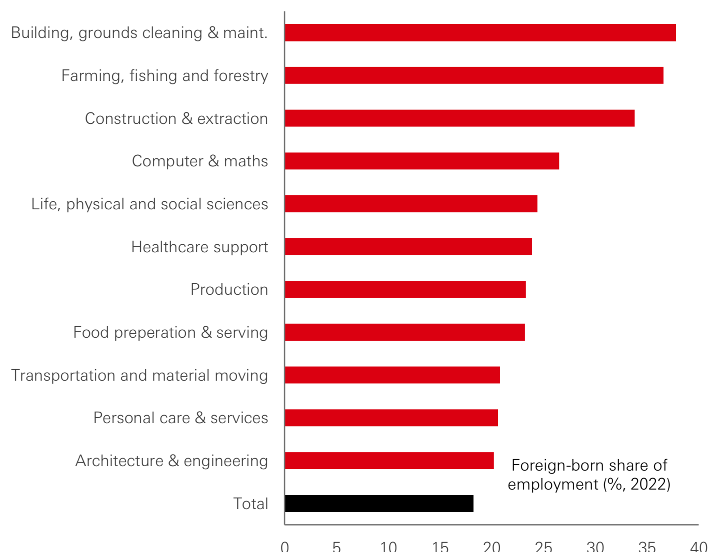


Figure 4: Foreign born employment by sector



Source: HSBC AM, CBO, Oxford Economics, Macrobond, May 2024.

The Brookings Institution[2] estimates that immigration has significantly raised sustainable employment growth, while the surge in labour demand as the economy opened up after the pandemic is being absorbed by immigration and has been an important factor in moderating wage inflation.

The resilience of the US economy in terms of household spending, the labour market and GDP growth can be partly attributed to net immigration, with the Brookings Institution estimating that employment can grow sustainably at nearly double the rate assumed before the pandemic in 2024, due to the increase in labour supply. It forecasts that immigration will add around 0.1% to GDP growth in the years 2022-2024, lifted by rising equipment investment, higher government spending and increased demand for rental housing. In terms of the impact on wages and inflation, an influx of mainly low- wage immigrants has helped to contain wage growth in the tightest areas of the labour market in the post-Covid era. Although rents have increased in the short- term as more people seek housing, these pressures should moderate as housing supply increases.

[2] **Source:** Brookings Institution

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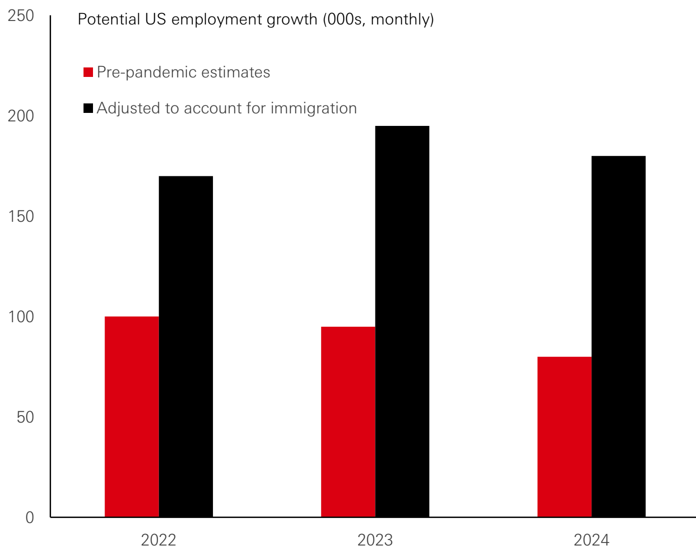
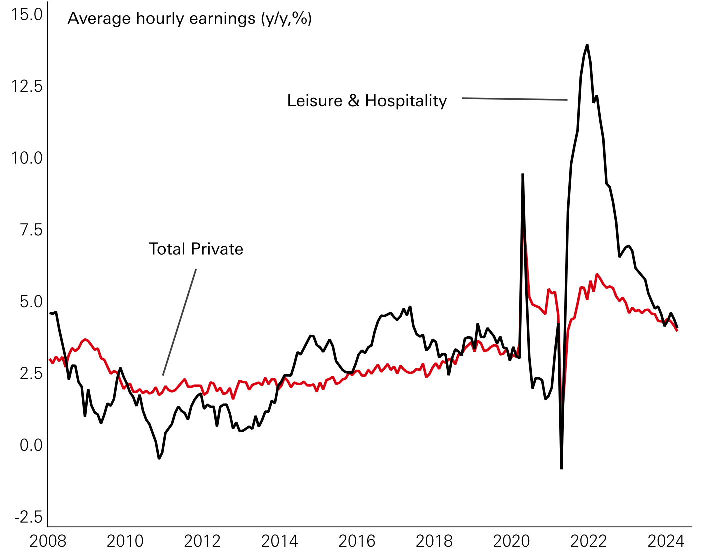
Figure 5: Immigration estimated to have raised sustainable employment growth



Source: Brookings Institute, HSBC AM, May 2024.

Figure 6: Wage growth (total versus leisure and hospitality)



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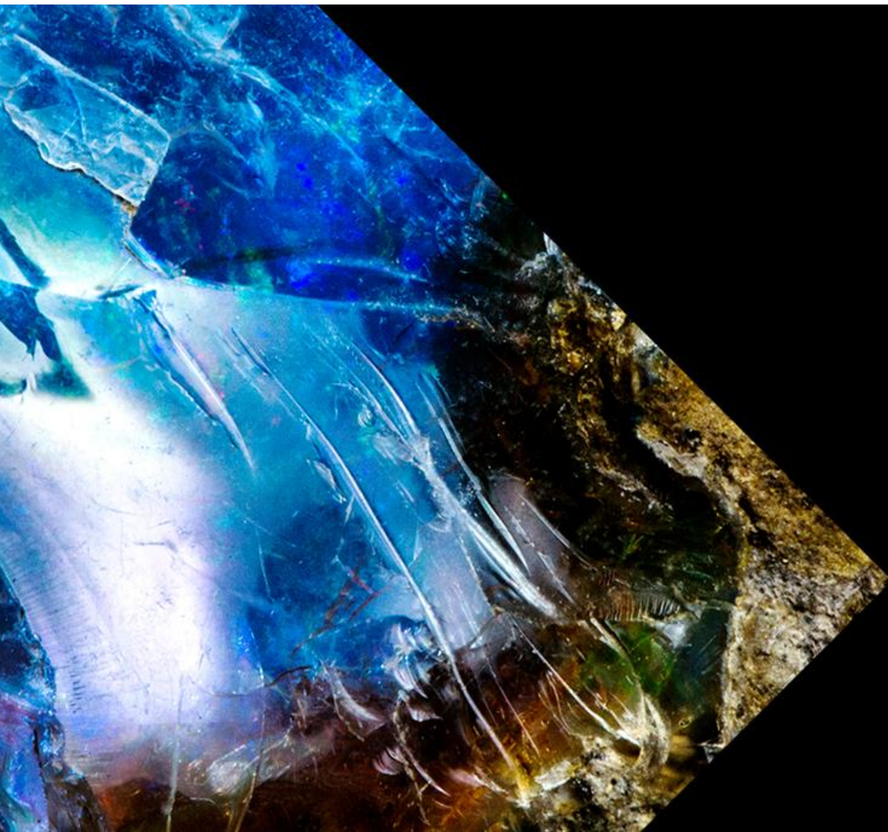

What progress has been made by energy issuers in terms of adapting to the net zero transition?

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 prioritize scope 1 & 2 emission, where technologies are more mature. Methane, which accounts for half of these emissions, is a priority due to its impact on global warming.

John Leblanc
Credit Analyst (US)

Kelvin Yeung
Credit Analyst (Asia)

Oil demand remains robust, especially post Covid, so that upstream investment will remain crucial to meeting existing demand. Energy security and affordability have come under increased scrutiny since the start of the Russia-Ukraine conflict, sometimes pushing environmental considerations down the priority list.

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 remains 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[1].

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].

[1] **Source:** Wood Mackensie

[2] **Source:** IEA

[3] **Source:** Climate Action Tracker

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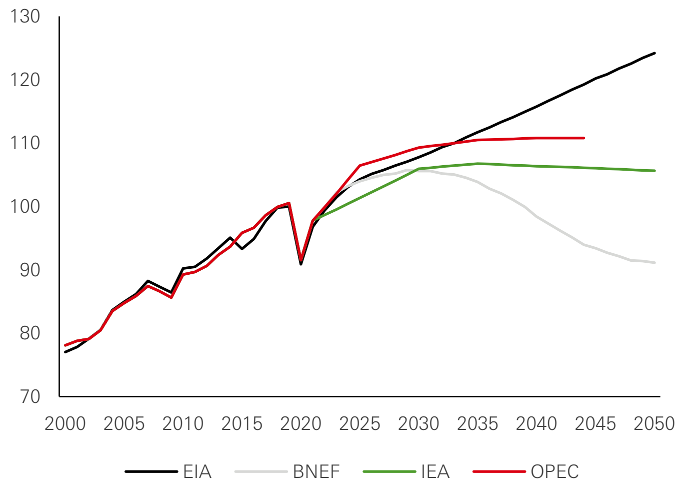
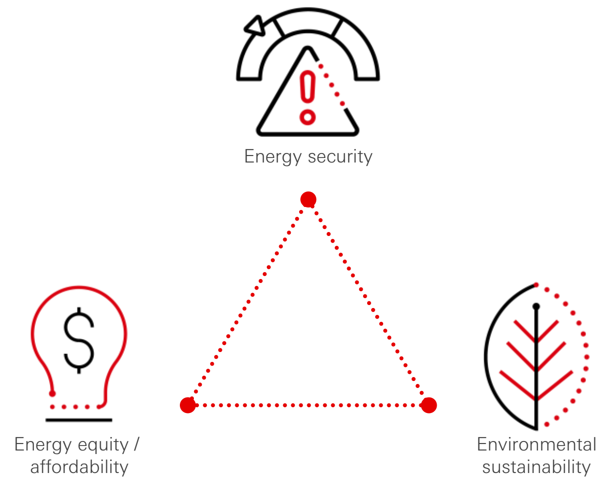
Figure 1: Updated oil demand outlook from Agencies (million barrel per day)



Source: IEA,; BNEF; EIA; OPEC; Morgan Stanley and UBS estimates

Figure 2: The energy trilemma



Source: IEA, HSBC AM, May 2024.

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]. 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, mobilized 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 CO_2 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 (those emitted during the extraction, processing and transportation of carbons, plus from the use of external energy sources from third parties), 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.

[4] **Source:** IEA

[5] **Source:** IEA

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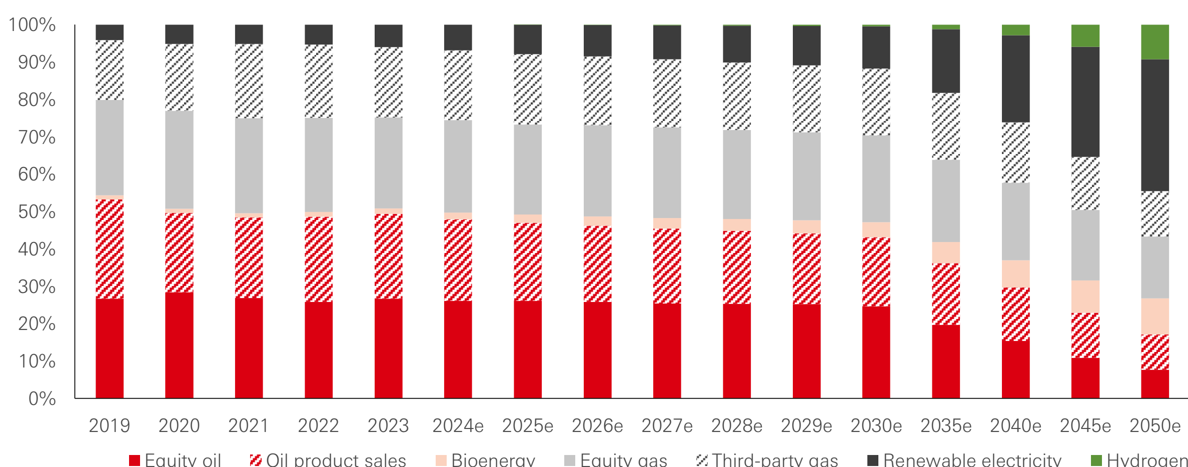
European energy companies remain very much at the forefront of energy transition, with all disclosing their scope 3 emissions with more explicit targets, while US companies have no legislated national policy to define categories and obligations. Asian companies typically don't specify if net zero targets 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 Announced Pledges Scenario (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[5] likely to rise from the current 15-20% to 30-40% by 2030. As a result, European Oil & 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.

Only some of the largest **United States** energy companies have net zero targets and they typically do not include scope 3. Companies are prioritizing 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, stored through enhanced oil recovery or via other ultilisation. 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 optimization 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.

[5] **Source: Largest oil companies communications**

[6] **Source: Forecasts from EIA research reports**

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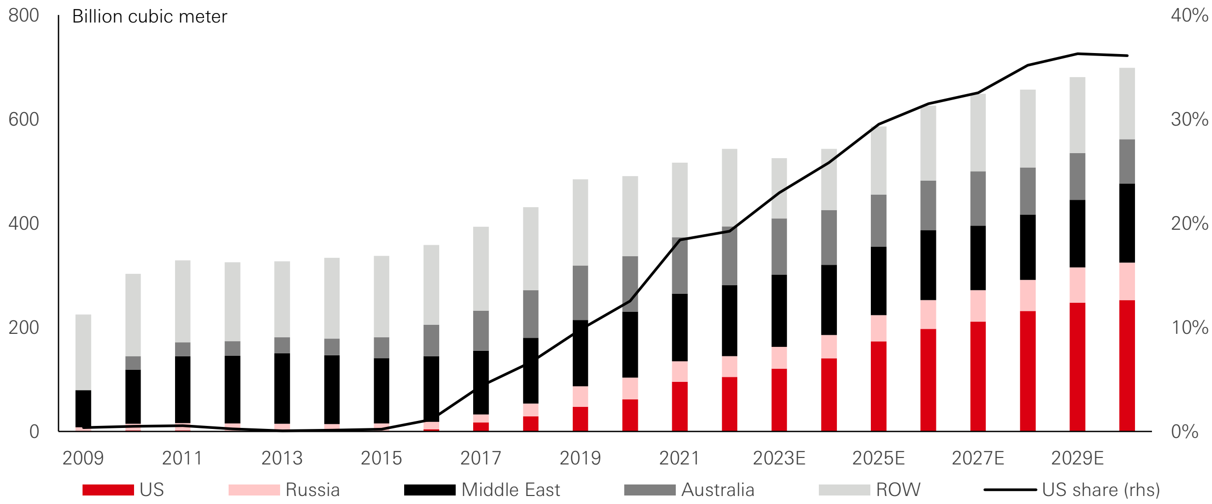
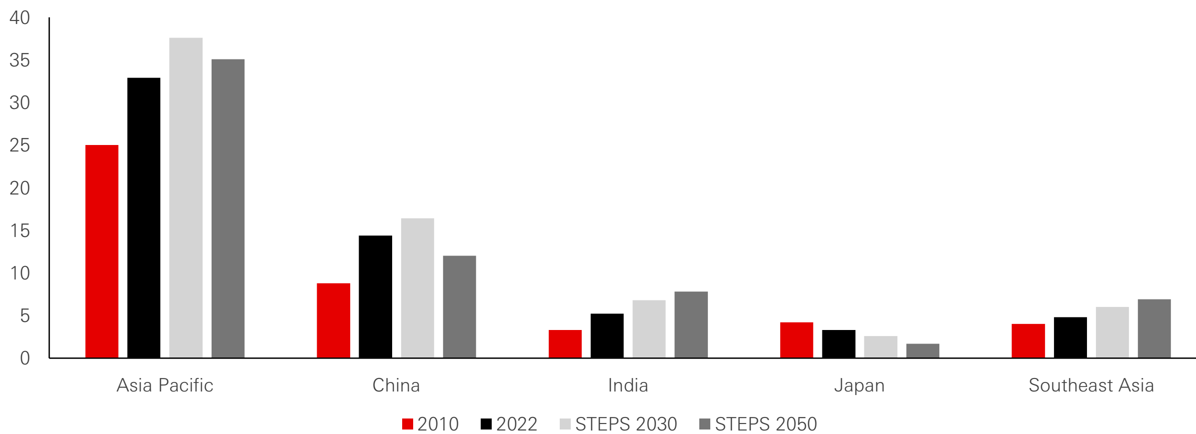
Figure 4: US LNG to have ~36% market share by 2030YE



Source: Forecasts from EIA research reports, JPM, Wood Mackenzie, May 2024.

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 scrutinize the targets and compare them with global peers.

Figure 5: 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.

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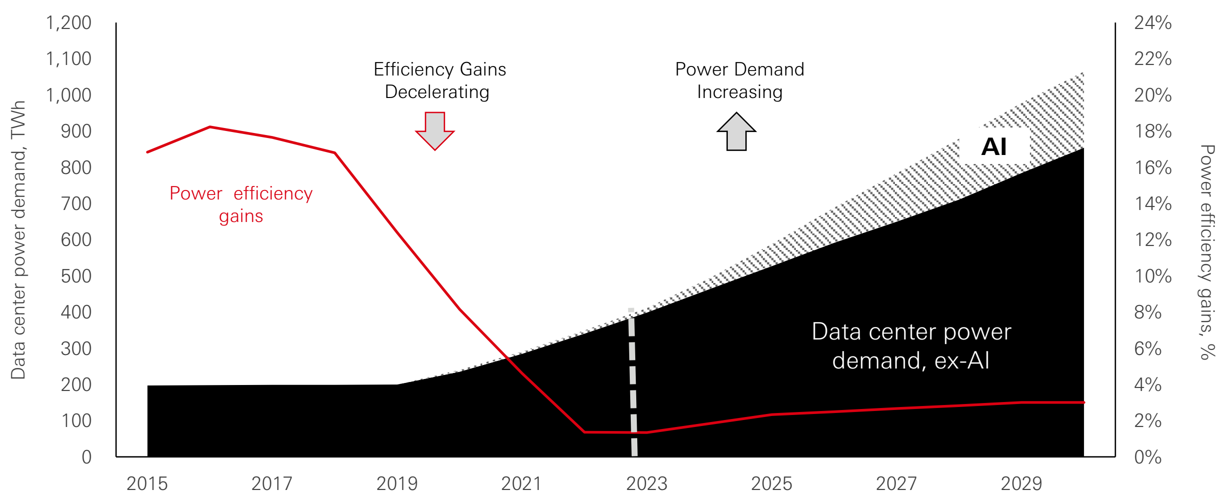
Spotlight on artificial intelligence: An emerging source of large-scale energy demand

Data centre power demand (excluding crypto) is set to rise 160% by the end of the decade from 1-2% of global demand to 3-4% by 2030[7]. The step change in data centre requirements will be driven by Generative AI utilising large language models built by the hyperscalers Alphabet, Amazon, Apple, Meta and Microsoft. AI data centres run on high performance chips and consume around seven times the energy compared to traditional data centres.

Due to the intermittent nature of renewable power, the additional demand for power supply that runs constantly with no downtime cannot be met solely with renewables, particularly during peak times, and this will inevitably have an impact on the production of other traditional energy sources.

Figure 6: AI will incrementally ramp while overall Data Centre power demand will surge to +1,000TWh/yr



Source: JPM Research; Goldman Sachs Research, May 2024.

[7] **Source:** Goldman Sachs

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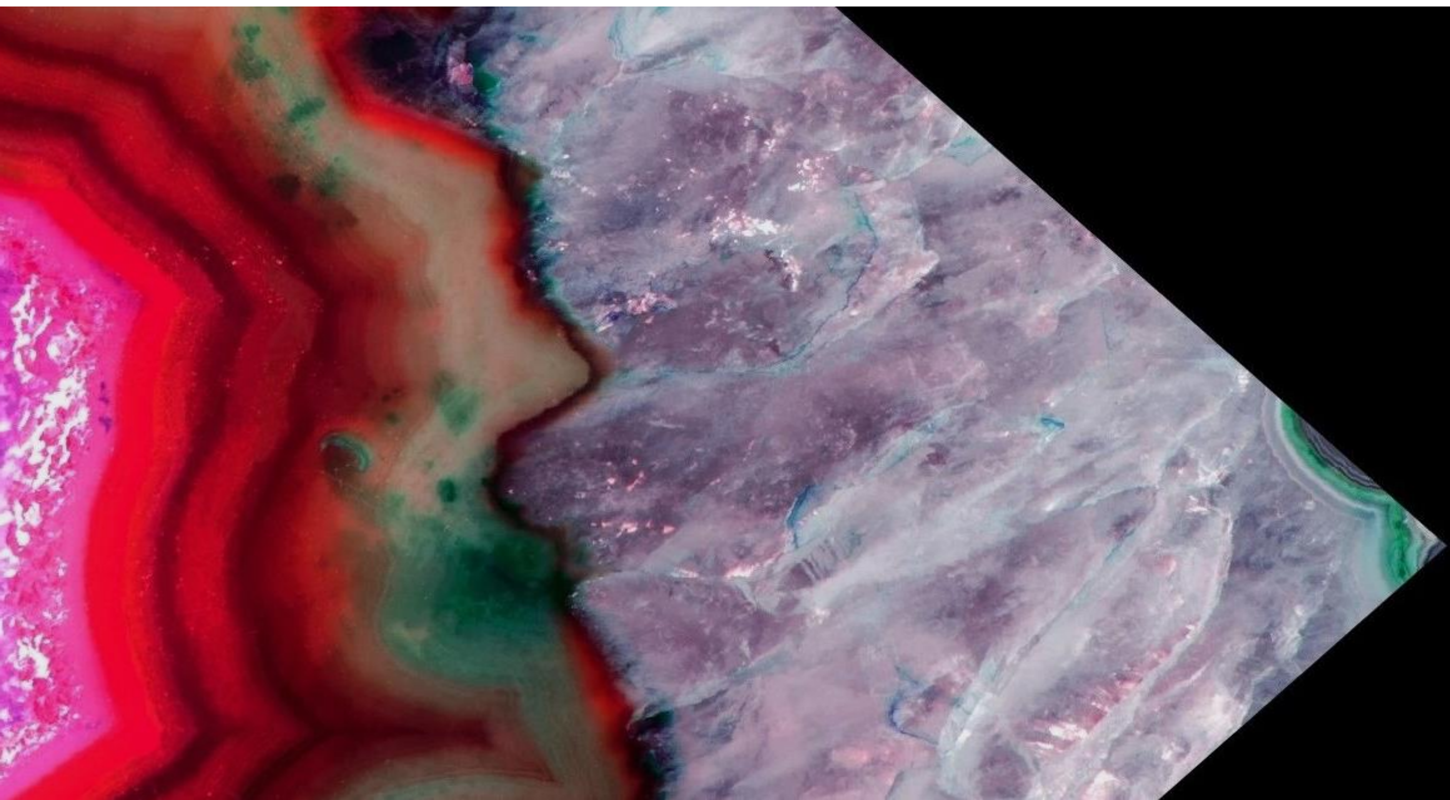

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