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TAKEAWAYS FROM OUR INVESTMENT SUMMIT IN HONG KONG

Conviction in a time of uncertainty

As part of our regular investment dialogues, we convened our senior investment and distribution professionals to discuss the coming opportunities for investors. Topics ranged from the prospects for China – and for Asia more broadly – to the implications of increased geopolitical tensions and the future of sustainability. How investors can navigate today's elevated uncertainty around growth, inflation and monetary policy – with conviction – was a recurrent theme. We are pleased to share the major conclusions from our panels.

Summary

- Investors should prepare for “**back to the future**”: higher nominal rates, alongside structurally elevated inflation and continued volatility.
- Fixed income set to outperform cash in major **bond reset**: extended pause by central banks expected, market focus may be on a long duration position in US Treasuries; avoid writing off high yield.
- Emergence of competing trade ecosystems and supply chain de-risking will prolong **inflationary pressures**.
- Explore **diversification** within and between asset classes as the traditional 60:40 portfolio comes under pressure.
- **China** will continue to evolve and create a domestic tech ecosystem, and its digital solutions are likely to be adopted by friendly trading partners.
- Strong structural dynamics, such as their rising middle class, make **Asian economies** attractive long-term investments, with expected decoupling from US in due course.
- Clearer regulation and standardised methodologies needed to facilitate even wider adoption of **sustainable** products, including for the fast-evolving transition theme.



Geopolitics: Trade regionalisation to become more pronounced

From 1989, the world economy experienced two decades of globalisation, strong growth and a reduction in capital barriers. Since the Great Financial Crisis (GFC), however, the world has started to fragment again, ushering in a new era of regionalisation, creeping protectionism and competing trade ecosystems.

Regionalisation and geopolitical tension: spurring inflation, but also innovation

- While most investors would consider global growth to be the major casualty of reduced globalisation, an overlooked aspect is the impact on inflation and inflation volatility.
- Another major fallout of the regionalisation of trade and elevated geopolitical uncertainty is corporates “de-risking” their supply chains. This potentially results in higher production costs and less-than-optimal capital allocation.

The key fault line of regionalisation lies in US-China trade, but headline figures are misleading. While China’s trade surplus with the US has shrunk since 2018, it has widened with other Asian countries and with Mexico, as supply chains were reconfigured.

US-China rivalry is sharpest in the tech space, a rivalry that also spills over into their trade relationships with other countries. The development of new technologies has captured the interest of investors so far, but the determining factor will be the adoption of these technologies. Standards will play a key role in ensuring faster adoption rates, but may diverge as the US and China establish competing ecosystems and spread their standards via foreign policy projects like China’s Belt and Road Initiative. Economies and investors need to navigate this new dual trade ecosystem.

There is still room for collaboration, however, as the US and China have shown in adopting updated World Trade Organization trade rules in 2021 with regards to services.¹

These new trade patterns also have an impact on currencies:

- While the USD is still dominant, and expected to remain so for the foreseeable future, investors and central banks are diversifying to the CNY, to smaller reserve currencies (AUD, CAD) and/or to gold. Indeed, central banks bought over 1,100 tons of gold in 2022, the highest annual amount on record.²
- For the time being, however, the CNY cannot replace the USD as the world’s main means of exchange, given in particular its lack of liquidity.

The US trade sanctions on China are only the most prominent example of the creeping protectionism we have become accustomed to in recent political debate. Differing attitudes to sustainability, and indeed to carbon pricing, add further grit into the system. Western countries will have to find a balance between defending their value systems and ensuring their economic prosperity when trading with other countries.

This balancing act will be put to the test by the latest bout of conflict in the Middle East. This should not mask the fact, however, that the world is slowly decarbonising and moving away from oil. While oil and gas still play an important role in today’s geopolitics, tomorrow’s race for commodities will centre around the rare earths crucial for renewable energy generation or, indeed, for uranium, as countries like China look to nuclear power to manage their climate transition.



Rates: Cost of money favours quality selection across asset classes

We think the macroeconomic environment is going “back to the future” – to a world where real rates are positive, inflation is structurally elevated, and monetary policy stays higher for longer. Without ruling out a soft landing, our base case is recession in Europe and the US in 2024 caused by an overtightening of financial conditions and a natural cyclical slowdown in the post-Covid recovery. Central banks will know only in hindsight that they have done enough.

Implications: opportunities but also volatility

- Years of cost-free money imply significant misallocations of capital that need to be rebalanced. Key players

like banks and insurers can usually keep loss-making bonds on their balance sheets unless forced to sell by either market participants or events. This is integral to predicting episodes of financial stress.

- Potential risk of policy desynchronisation across the major central banks (US, Europe, UK and Japan). The European Central Bank could do more than what the market is pricing vs. the US Federal Reserve.
- While the Bank of Japan remains dovish, an unexpected policy shift could destabilise financial markets as Japan is the largest holder of US Treasuries. With signs

¹ WTO | Joint Initiative on Services Domestic Regulation, December 2021

² Central Banks | Gold Demand Trends Full Year 2022 | [World Gold Council](#), January 2023

Rates cont'd.

of a change in the inflation regime in Japan after 30 years of deflation, investors may take a fresh look at opportunities there.

We think the scene is set for bonds to outperform cash in a major bond reset:

- With markets priced for an extended pause by central banks, market focus may be on a long duration position in US Treasuries and a basket of US, Europe and UK curve steepeners.
- Avoid writing off high yield (HY): HY rated B and above tends to have a lot of cushion against defaults.
- We also like the theme of short credit duration and layering in a rates overlay – rather than long duration credit.
- Asia fixed income could be a possible diversifier as Asia ex-Japan begins to desynchronise from the US cycle and is driven more by local dynamics.

With money having a cost again, so-called zombie companies will struggle and the focus should be on quality companies with pricing power in a higher-inflation environment:

- Small caps tend to be more vulnerable to a rising cost of capital, while for large companies the refinancing wall tends to be a few years away.
- In a world of digital Darwinism, the winners will likely be distinguished by the ability to improve productivity

through investment: which companies truly have the resources and management skill to leverage AI?

Traditional multi-asset mandates are set to re-emerge as an attractive proposition, with decorrelation returning across the major asset classes in 2023. Investors could explore diversification across the entire investment universe and beyond the traditional 60:40 allocation, including private markets and commodities.

Infrastructure assets may provide protection against a higher rate environment as they are often inflation-linked and return expectations are resetting. Think about infrastructure opportunities across the capital structure: megatrends such as energy transition have accelerated despite higher interest rates.



Asia: A region of increasing diversification opportunities

With China grappling with an economic slowdown, and negative news continuing to emerge around the problems of its property sector and its trade tussles with the US, investors are keen to understand the prospects of China's pivot to an innovation-driven economy. Their attention is also turning towards the rest of Asia and the opportunities offered by countries including India, in particular given that Asia is expected to comprise two-thirds of the global middle class by 2030.³

China's pivot to innovation – how will China tackle the emerging fields of AI and climate tech:

- While artificial intelligence (AI) presents opportunities for China over the medium to long run, it is the sector most clearly stymied by the US trade sanctions.
- The availability of AI hardware and its established supply chains in the US, Taiwan or Japan make these countries more attractive over the short term.
- Over the longer term, China does have advantages.

Its domestic market is huge, and with its prowess in manufacturing, it may first focus on niche applications of AI like industrial automation. And China has shown in other areas that while it may not always be a technology leader, it is very adept at being a "fast follower".

- In the area of climate tech, for instance, China has now established a commanding position in areas like solar panels (more than 80% share of global manufacturing capacity⁴), wind turbines (nearly 60% of installed capacity⁵) or lithium batteries (up to an 80% market share⁶).

With regards to supply chains more broadly, "China +1" strategies are becoming more widely adopted, with India and South East Asia touted as promising "+1"s:

- While relocations are clearly happening, many ignore the active role Chinese companies are playing in reshaping their own supply chains, and the close ties they have built across South East Asia.

³ Brookings Institute – [The unprecedented expansion of the global middle class](#) | Brookings, February 2017

Asia cont'd.



- While India has notable advantages to becoming a service and manufacturing hub over the longer term, industrialisation is still in its infancy overall. Despite some progress, reforms are needed for India to reach its potential.
- The one sweet spot for investors in India is its bond market: its central bank no longer needs to focus on

possible balance-of-payment issues, and the credit cycle is in a strong position.

A structural shift in central bank policy can be observed in other Asian countries as well:

- In the short term, South East Asian central banks will likely continue to follow the lead of the US business cycle. But as their economies pivot away from the US and orient themselves more on China and on intra-Asian trade, we should see a shift, where long rates start converging towards China's and decouple from the US.
- Over longer time horizons, this could lead to rising currencies, rising consumption and rising asset prices in South East Asia economies.

Sustainability: Transition finance needs to be fully addressed

Discussion included the evolution of sustainable investing, particularly in the wake of the Russia-Ukraine war that shone a spotlight on energy dependency. Pragmatic approaches are required that combine financial returns and real-world impact. In addition, to facilitate even wider adoption of sustainable products, clearer regulation and standardised methodologies are essential. At AllianzGI, we think we have a role to play in shaping these.

An increasing area of focus for sustainable investors is transition, which involves a pathway – preferably ambitious – towards a specific goal of achieving a more resilient economy. Transition is a way of reorienting the conversation on sustainability from climate change to energy security. It is relevant across asset classes, from impact investments in private markets to equity products linked to a clear sustainable objective.

- Transition focuses on supporting – not censuring – those companies that are making or facilitating the means to a lower-carbon economy.
- Building a credible and scalable transition finance market will be essential, particularly for economies reliant on carbon-intensive sectors.
- This approach could represent an opportunity to engage those investors less comfortable with exclusion-led approaches.

- The importance of measurement is reflected in regulation, which is driving a higher need for climate-focused benchmarks (eg, stringent net-zero KPIs).

A net-zero transition also represents a significant opportunity from a sovereign perspective, where climate transition risk factors already affect borrowing costs. An Investor Group on Climate Change (IGCC) project is developing a transition methodology for sovereign bonds.

Transition is a theme that should span asset classes:

- There is an opportunity to link climate to the growing thematic topic of biodiversity.
- With its drive, ambition and new net-zero transition plan, our parent company Allianz is supporting our first-mover status in areas such as green infrastructure and hydrogen.
- We see an opportunity to align with retail investor thinking on sustainability, including significant demand for Article 9 equity products with a clearly defined sustainable investment objective.
- Transition-focused debt is a small but evolving subset of labelled debt, including in China and more broadly in Asia. Guidance around standards and incentives is needed to facilitate growth.

⁴ IEA – [Executive summary – Solar PV Global Supply Chains – Analysis - IEA](#), August 2022

⁵ Global Wind Energy Council – [Global Wind Report 2023](#), March 2023

⁶ BloombergNEF estimates – [The World Can't Wean Itself Off Chinese Lithium | WIRED UK](#), 30 June, 2022

Looking ahead

Looking ahead, we think investors are set for a “back to the future” world where some aspects will look eerily reminiscent of the past – positive bond returns, a world divided into different ecosystems, geopolitical tensions. Other aspects will seem completely different, with South East Asia and India emerging as new investment opportunities within Asia, and climate transition taking centre stage.



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