eastspring investments

A member of Prudential plc (UK)

2022 Market Outlook

ESG accelerated

Investors have gone beyond the "why" of responsible investing and are increasingly focusing on the "how". As the sense of urgency rises on the back of intensifying climate concerns, there are opportunities for investors to get better at doing good.

The COP26 agreement in Glasgow had set common timeframes and put procedures in place to help keep the global temperature increase to 1.5 degrees Celsius by 2030. However, the gap in reducing carbon emission levels remains considerable.

FACILITATING A COAL TRANSITION

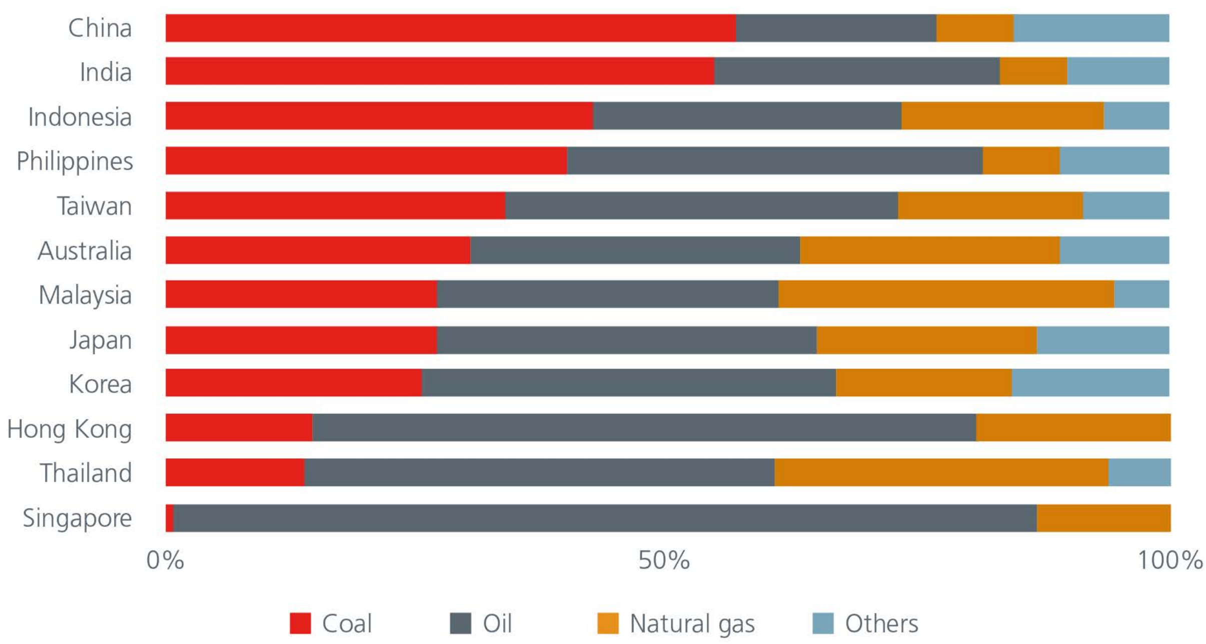
An 80% reduction in coal energy globally is required to meet the Paris climate goal. In Asia and the Emerging Markets (EMs), a large existing stock of coal plants and mines continue to be a key source of energy and jobs.

A holistic approach is needed to help the emerging economies transition away from coal. Governments need to develop transformation strategies and minimise the impact of the transition on people and communities. This may require upskilling and reskilling of people. Significant resources are also needed to build new green infrastructure or repurpose existing ones. EM governments and companies will need substantial financing to achieve the COP26 goals and timelines.

As an Asian and EM investment specialist, we feel a great sense of responsibility to support the EM economies in their transition out of coal. In our equity and fixed income investments, we support companies that show a willingness and are earnest in their desire to lower their carbon emissions. We believe that investors can make a positive impact by actively engaging companies and helping them in the coal to clean transition.

> **"We support companies that show a willingness and are earnest in their desire to lower their carbon emissions."**

Coal and fossil fuels are key energy sources for Asia (Primary fuel type as % of total in 2020)



Note: Others refer to nuclear energy, hydro electricity and renewables.

Source: BP Statista Review of World Energy 2021, Morgan Stanley Research.

ACHIEVING LOW CARBON FOOTPRINTS

Some Asian economies are making headways in building a more carbon-neutral, climate resilient world. In October 2021, South Korea proposed a 40% cut to its greenhouse gas emissions by 2030 compared with 2018 levels, up from an earlier target of 26%. Hydrogen will play a big role in achieving this outcome.

South Korea plans to expand its hydrogen consumption from the current 220,000 tons to 3.9 million tons in 2030 and 27 million tons in 2050. The revised 2030 hydrogen consumption goal is double the original target that was proposed in Korea's "Hydrogen Economy Revitalisation Roadmap" in 2019.

Many South Korean companies have announced plans to invest and integrate into the hydrogen economy, as market valuations are increasingly impacted by rising environmental costs. Adapting businesses to a low-carbon structure can help support valuations, as well as provide new growth opportunities for investors. Companies have announced more than KRW 43 trillion worth of investments by 2030 to produce clean hydrogen, produce and distribute liquefied hydrogen, expand the supply of hydrogen fuel cells and manufacture hydrogen mobility vehicles.

While South Korea aims to reduce its carbon footprint by becoming a hydrogen-based economy, other Asian economies will forge their own paths to decarbonise the environment. This may include developing new clean energy sectors, such as electric vehicles (EV) in China, EV batteries in Indonesia and renewable energy in Malaysia.

LEVERAGING QUANT FOR ESG

Data is often seen as one of the biggest obstacles in integrating environmental, social and governance (ESG) considerations into an investment process. Some of the most cited concerns include inconsistencies among rating agencies, lack of clarity around standards and metrics as well as insufficient data to make informed decisions.

We believe the ESG data landscape has dramatically improved as more comprehensive, reliable and comparable datasets have become available, though many challenges still remain. With the exponential increase in ESG data in terms of both volume and categories, a quantitative approach offers an attractive method for integrating ESG considerations into the investment process.

The "E" component takes centre stage for many investors as the climate impact is forecast to hit most regions the hardest. As such, we think integrating carbon metrics into the investment decision-making process and striving for an improvement in a portfolio's weighted average carbon intensity ("WACI") score is a good starting point for investors wishing to invest with a sustainability angle.

A portfolio with superior WACI characteristics, that is not significantly skewed in any industry, country or stock, can be quantitatively constructed by using the carbon emissions data provided by MSCI. A quant approach also offers greater flexibility. By mapping out an efficient frontier of optimised portfolios for various levels of WACI, the trade-offs between reducing the carbon intensity of the portfolio, reducing expected volatility, and enhancing expected returns become apparent.

INVESTMENT IMPLICATIONS

Equities – Investment opportunities will emerge as companies strive to make their business models more sustainable. South Korea's automotive industry for example is generating new income streams by producing hydrogen-powered trams, cleaning trucks and forklifts. Korean shipbuilders are also benefiting from an increased demand for hydrogen carriers & storage facilities. Over in Japan, many companies have begun to set specific carbon reduction targets, which would ultimately boost their global competitiveness in the long term. We are also finding investment opportunities in EV companies and upstream suppliers (e.g. the separators in lithium ion batteries) in the EV supply chain within Asia.

Bonds – 48% of the energy consumed in Asia is generated by coal. To reduce carbon emissions meaningfully, Asia needs to transition towards renewable sources of energy. In the last two to three years, we have seen the first wave of renewable energy bond issuers from India. Going forward, we expect the next wave of renewable issuers to emerge from China as the decarbonisation and energy transition theme gains momentum. In addition, China's net carbon neutrality goal by 2060 is likely to see the government's ambitious target being cascaded down and shaping companies' medium to long-term business strategies. As companies seek funding for such efforts, we expect to see a highly diverse mix of green bond issuances from China going forward.

Quant – A quantitative approach potentially offers a more informed and flexible way to integrate ESG considerations into the investment process. Quantitative strategies can leverage carbon emissions data to construct portfolios with superior WACI characteristics. The key is having clear, aligned metrics for the sustainability goals that investors are trying to achieve. Once that goal is met, quantitative tools and techniques lend themselves well to building bespoke ESG investment solutions.

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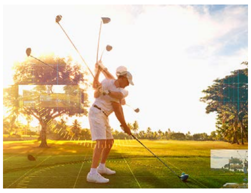

Normalisation in motion

Underappreciated Asia

China redefined

Continuous disruption

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