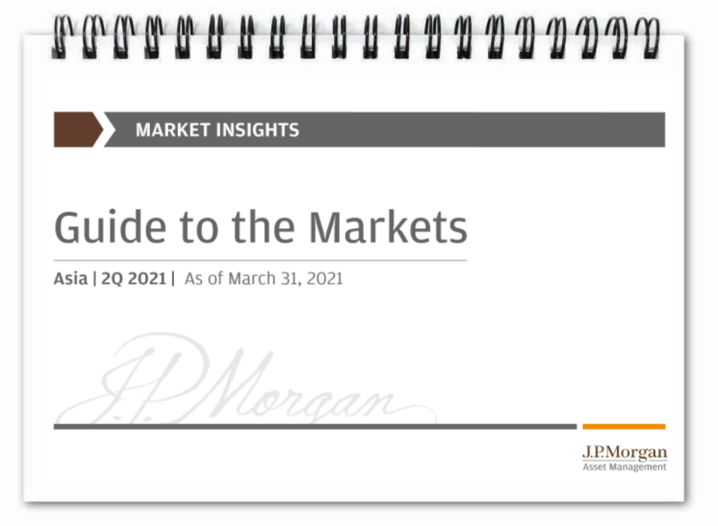
Quarterly Perspectives

Asia | 2Q 2021

J.P. Morgan Asset Management is pleased to present the latest edition of ***Quarterly Perspectives***. This piece explores key themes from our ***Guide to the Markets***, providing timely economic and investment insights.

THIS QUARTER'S THEMES

1. Building resilience against higher bond yields and inflation worries
2. Let a thousand equity flowers blossom
3. Fixed income: Managing inflation risk
4. Integrating ESG in portfolio construction



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Building resilience against higher bond yields and inflation worries

Global fixed income: Inflation expectations - GTMA slide 55

Asset class returns in rising inflation environments - GTMA slide 67

Global equities: Profit margins - GTMA slide 34

OVERVIEW

- Investors are bracing for higher inflation as the global economy recovers from the COVID-19 pandemic, alongside sizeable fiscal stimulus in the U.S. Central banks are also likely to keep their monetary easing measures to further support the economic recovery.
- We expect U.S. Treasury (UST) yields to gradually normalize in the next 12-24 months. This will be driven by both a rise in real yields consistent with economic recovery, and inflation consistent with the Federal Reserve's (Fed) target.
- Rising yields coincide with stronger growth at this phase of the economic cycle, and this should be constructive for equities. Fixed income investing could become more challenging with the potential price decline from duration risk.

INVESTMENT IMPLICATIONS

- Equities have historically delivered positive return to investors when yields are rising from a low level. Despite potential volatility in the months ahead, market corrections are opportunities for investors to build equity allocation in portfolios.
- For fixed income, given tight credit spreads, coupons will likely be a key buffer against the price risk from rising yields. Developed market (DM) government bonds and investment-grade (IG) corporate debt, with their low yields, could still face headwinds in the months ahead.
- Short-duration high yield (HY) corporate debt and emerging market (EM) fixed income can still serve the purpose of providing some diversification benefits to a portfolio. Investors can also consider alternative assets (real estate, infrastructure, transportation) to look for income opportunities and lower correlation with equities and risk assets.

Let a thousand equity flowers blossom

United States: Interest rates and equity performance - GTMA slide 49

Global equities: Valuations - GTMA slide 35

APAC ex-Japan equities: Earnings expectations by market and sector - GTMA slide 38

OVERVIEW

- The equity market's recovery over the past year has been concentrated in select markets or sectors, such as the U.S. and Northeast Asia, alongside technology and health care.
- The rising yield environment and a more comprehensive economic rebound from the COVID-19 pandemic should help to broaden earnings recovery. The 2020 laggards could enjoy a period of catch-up.
- Long-term structural growth themes, such as rising EM consumer spending, tech upgrades in China and greater emphasis on the reduction of carbon emissions, should be the foundation of a strategic equity allocation.

INVESTMENT IMPLICATIONS

- A number of cyclical sectors, including financials and banks, materials, industrials and energy, would traditionally outperform the benchmark in a rising yield environment. These sectors are also primed to benefit from the recovering global economy.
- Because of index composition, the rebound of cyclical sectors could benefit regions that have underperformed in 2020, including Europe, the Association of Southeast Asian Nations (ASEAN) and EM ex-Asia.
- While China, the U.S. and tech are generally long-term strategic equity allocations, investors should look to diversify, by both sector and region, in the next 12 months to better tap into the global economic recovery.

Fixed income: Managing inflation risk

Global fixed income: Yields and duration - GTMA slide 51

Global fixed income: Valuations - GTMA slide 53

Global fixed income: Yields and risks - GTMA slide 58

OVERVIEW

- The effectiveness of monetary and fiscal policy in responding to COVID-19 has created a credible risk that bond investors have not faced for many years—higher inflation.
- The rise in core government bond yields from a low starting point limits the appeal of owning these assets in the near term, but they remain a key source of diversification within portfolios. Credit and EM debt can still offer an income solution.
- Investors may wish to consider a dynamic allocation to fixed income markets so as to remain nimble to traverse the uncertainties of the bond market.

INVESTMENT IMPLICATIONS

- Rising inflation is traditionally the enemy of the bond investor, and rising yields certainly limit the appeal of longer duration fixed income assets in the near term.
- With uncertainty over how persistent the inflation threat will be, or how fast and high core government bond yields may go, investors should take a dynamic approach to bond markets, allowing for a shifting fixed income allocation across fixed income segments.
- Positioning in shorter duration assets limits the impact of the inflation risk and allows for re-investment amid better valuations as yields rise.
- The rise in yields will likely come in waves, but eventually bond yields will reach a level where they are once again appealing for both portfolio income and diversification.

Integrating ESG in portfolio construction

Sustainable investment strategies - GTMA slide 77

Sustainable investment performance and market size - GTMA slide 78

Emissions targets and global energy mix - GTMA slide 79

OVERVIEW

- A growing number of investors are incorporating environmental, social and governance (ESG) factors in their portfolio construction process. This includes sustainability issues, such as climate change, and social inequality, which is gaining prominence politically and economically.
- The number of economies committing to net-zero emissions by or near the middle of this century equates to 77% of Asia's 2019 GDP and 46% of the population in 2019, according to World Bank data. This is a powerful market shift that will shape the investment landscape in the region. Still, Europe remains the uncontested leader in ESG investing. However, momentum is building in Asia, with net inflows into sustainable funds of close to USD 8billion in 2020, approximately 10 times that of 2019.

INVESTMENT IMPLICATIONS

- Focusing on companies that take ESG seriously typically means investing in higher-quality businesses that take a long-term view on executing investment decisions that are good for the environment and society, while incorporating corporate governance considerations.
- Although sustainable investing is gaining traction, the level of adoption varies among investors amid evolving policies and preferences. Having a better understanding of ESG objectives is key to providing the right solutions.
- ESG investing is likely to become an even more prominent driver in the coming years as the value of assets under management (AUM) increases. We expect ESG metrics will be increasingly integrated in asset managers' investment processes, not only as a risk measure but also when considering the return metrics across investments. We believe there is still some mispricing in capital markets, and hence room for alpha remains for long-term investors.

Building resilience against higher bond yields and inflation worries

OVERVIEW

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INVESTMENT IMPLICATIONS

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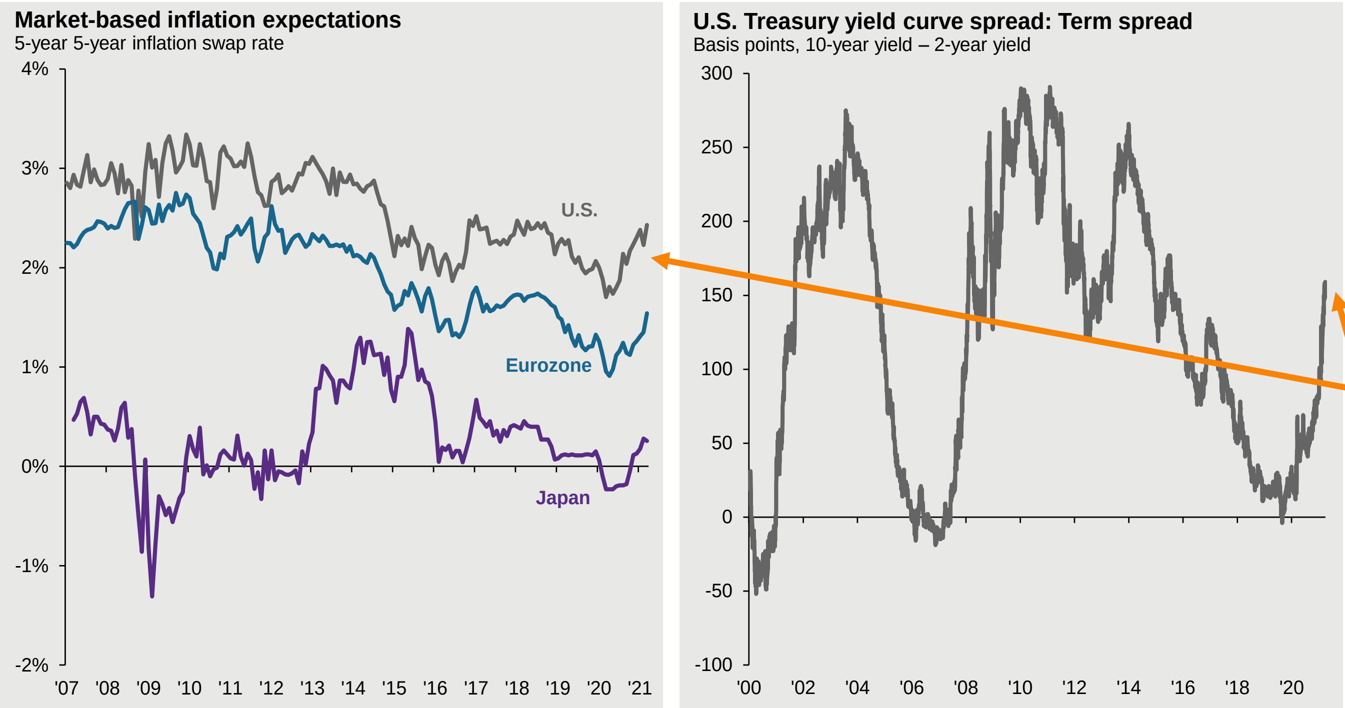
- Short-duration high yield (HY) corporate debt and emerging market (EM) fixed income can still serve the purpose of providing some diversification benefits to a portfolio. Investors can also consider alternative assets (real estate, infrastructure, transportation) to look for income opportunities and lower correlation with equities and risk assets.

Global fixed income: Inflation expectations



Source: J.P. Morgan Asset Management; (Left) Bloomberg Finance L.P.; (Right) FactSet, U.S. Federal Reserve.
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Fixed income

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- The left chart shows the market expectation of long-term inflation in the U.S., eurozone and Japan.
- The right chart shows the difference between 2-year and 10-year UST yields. A wider spread, or steeper yield curve, indicates market expectations for stronger growth or higher inflation in the long run. Currently, the Fed's commitment to low interest rates is also underpinning the short end of the yield curve close to zero.

Better growth prompts higher inflation expectations

The economic outlook of the U.S. is improving because of vaccination progress and supportive fiscal measures.

- The U.S. is on track to vaccinate about half of its population by this summer. This should provide impetus for the economy, especially the services sector, to reopen and deliver more growth. The USD 1.9trillion fiscal package will also fuel this recovery.
- The combination of these factors is prompting investors to focus more on the possibility of higher inflation. Despite the Fed's ongoing commitment to keep its monetary easing policy, growing skepticism is pushing UST yields higher, forcing the yield curve to steepen.
- Even though the global economic outlook is improving, delays in vaccination progress in some regions could lead to the U.S. and China becoming the outperformers in gross domestic production (GDP) growth in 2021.

Asset class returns in rising inflation environments

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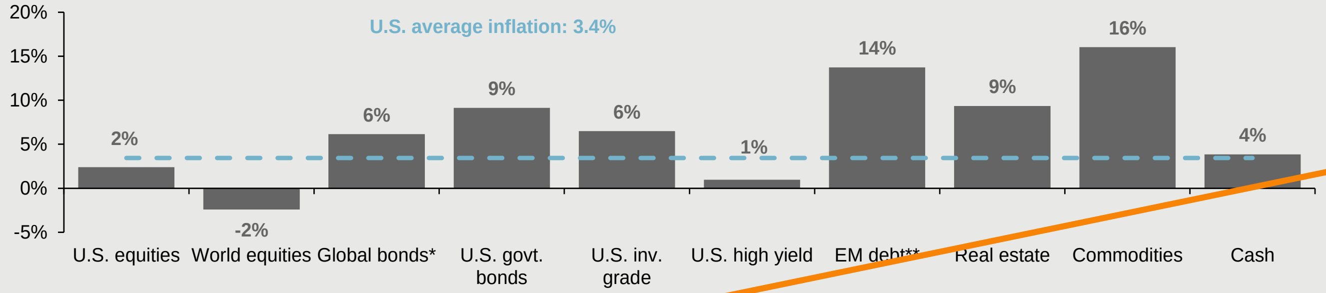
Other asset classes

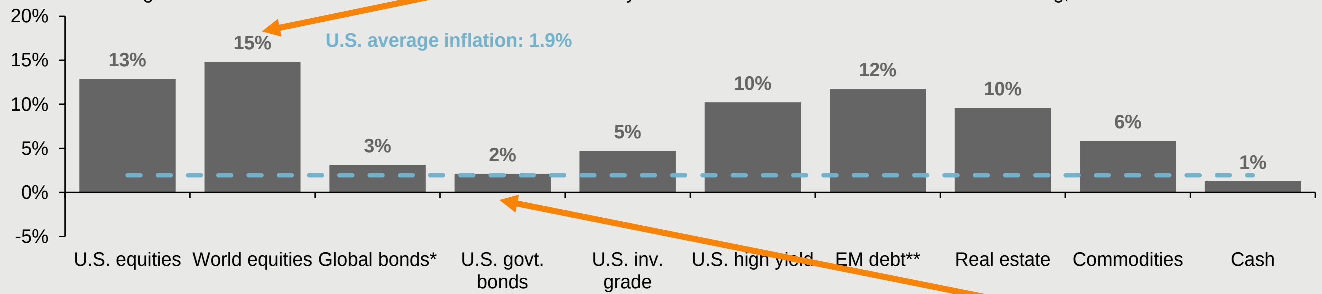
High and rising U.S. inflation

Arithmetic average of nominal annual returns of different asset classes for years in which inflation was above median and rising, 1989 to 2020



Low and rising U.S. inflation

Arithmetic average of nominal annual returns of different asset classes for years in which inflation was below median and rising, 1989 to 2020



Source: Barclays, Bloomberg, Dow Jones, FactSet, Federal Reserve, J.P. Morgan, MSCI Global, NCREIF, Strategas/Ibbotson, J.P. Morgan Asset Management. Median inflation was 2.51% in measured period. Rising or falling inflation distinction is relative to the previous year. High and rising inflation occurred in 8 of the 32 measured years. Low and rising inflation occurred in 7 of the 32 measured years. *Global bonds based on the period 1991-2020. **EM debt based on the period 1994-2020. Based on Shiller S&P 500 Composite total return index (*U.S. equities*), MSCI AC World Index (*World equities*), Bloomberg Barclays Global Aggregate (*Global bonds*), Bloomberg Barclays Aggregate U.S. Treasury Index (*U.S. govt. bonds*), Bloomberg Barclays Aggregate U.S. Corporate Investment Grade Index (*U.S. inv. grade*), Bloomberg Barclays U.S. Corporate High Yield Index (*U.S. high yield*), J.P. Morgan EMBI Global (*EM debt*), NCREIF Property Index (*Real estate*) and S&P GSCI (*Commodities*). Past performance is not a reliable indicator of current and future results.
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- This page shows the performance of financial assets under different inflation scenarios.
- Inflation rising from a low level usually takes place when the economy is recovering from a recession. This scenario is positive for risk assets, such as equities, corporate credit and EM fixed income.
- Once inflation is more established at a higher level, this could force central banks to switch to monetary tightening, and companies would find it more challenging to control costs. The performance of these risk assets could thus deteriorate.

Inflation rising from a low level should benefit risk assets

Some investors are spot-on to question the outlook for inflation. However, historical data has shown risk assets can still outperform when inflation is rising from a low level.

- Risk assets, such as equities, higher-yielding corporate bonds and EM fixed income, could deliver positive returns with higher yields and inflation rising from a low level. The positive earnings growth associated with this environment should have a stronger influence than the withdrawal of liquidity from higher yields.
- Admittedly, investors should also take into account the prevailing valuations of these risk assets since some segments, such as technology (tech) and corporate credit, started this recovery with expensive valuations.
- The outlook for DM government bonds and high-quality corporate credit is challenging. Their low yields would struggle to provide an adequate buffer against price declines as UST yields rise.

Equities

Global equities: Profit margins

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Source: FactSet, J.P. Morgan Asset Management; (Left) Federal Reserve Bank of Dallas, MSCI; (Right) U.S. Bureau of Economic Analysis, U.S. Department of Labor.
*PPI is producer price index, world excluding U.S. **Wage growth is the year-over-year change in the average hourly earnings of production and non-supervisory workers.
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- The chart on the left shows the relationship between global corporate earnings growth and producer price inflation. Some pick-up in inflation should help improve the pricing power of businesses.

In fact, some inflation could help boost earnings

Moderate inflation could help to enhance corporate earnings and improve profit margins.

- With valuation re-rating driving much of the equity rally over the past year, corporate earnings will need to do more of the heavy lifting to deliver returns to investors. Globally, earnings reports have been encouraging.
- With profit margins at a low point, expanding profitability will be an important driver of earnings growth, as stronger economic activities should boost revenue.
- A modest pick-up in inflation should help improve businesses' pricing power, especially for downstream retailers. However, too much sustained inflation could pose a challenge in controlling costs, undermining earnings. Active management is needed to understand which sectors or companies are in a strong position to control costs when this happens.

Let a thousand equity flowers blossom

OVERVIEW

- The equity market's recovery over the past year has been concentrated in select markets or sectors, such as the U.S. and Northeast Asia, alongside technology and health care.
- The rising yield environment and a more comprehensive economic rebound from the COVID-19 pandemic should help to broaden earnings recovery. The 2020 laggards could enjoy a period of catch-up.
- Long-term structural growth themes, such as rising EM consumer spending, tech upgrades in China and greater emphasis on the reduction of carbon emissions, should be the foundation of a strategic equity allocation.

INVESTMENT IMPLICATIONS

- A number of cyclical sectors, including financials and banks, materials, industrials and energy, would traditionally outperform the benchmark in a rising yield environment. These sectors are also primed to benefit from the recovering global economy.
- Because of index composition, the rebound of cyclical sectors could benefit regions that have underperformed in 2020, including Europe, the Association of Southeast Asian Nations (ASEAN) and EM ex-Asia.
- While China, the U.S. and tech are generally long-term strategic equity allocations, investors should look to diversify, by both sector and region, in the next 12 months to better tap into the global economic recovery.

United States: Interest rates and equity performance

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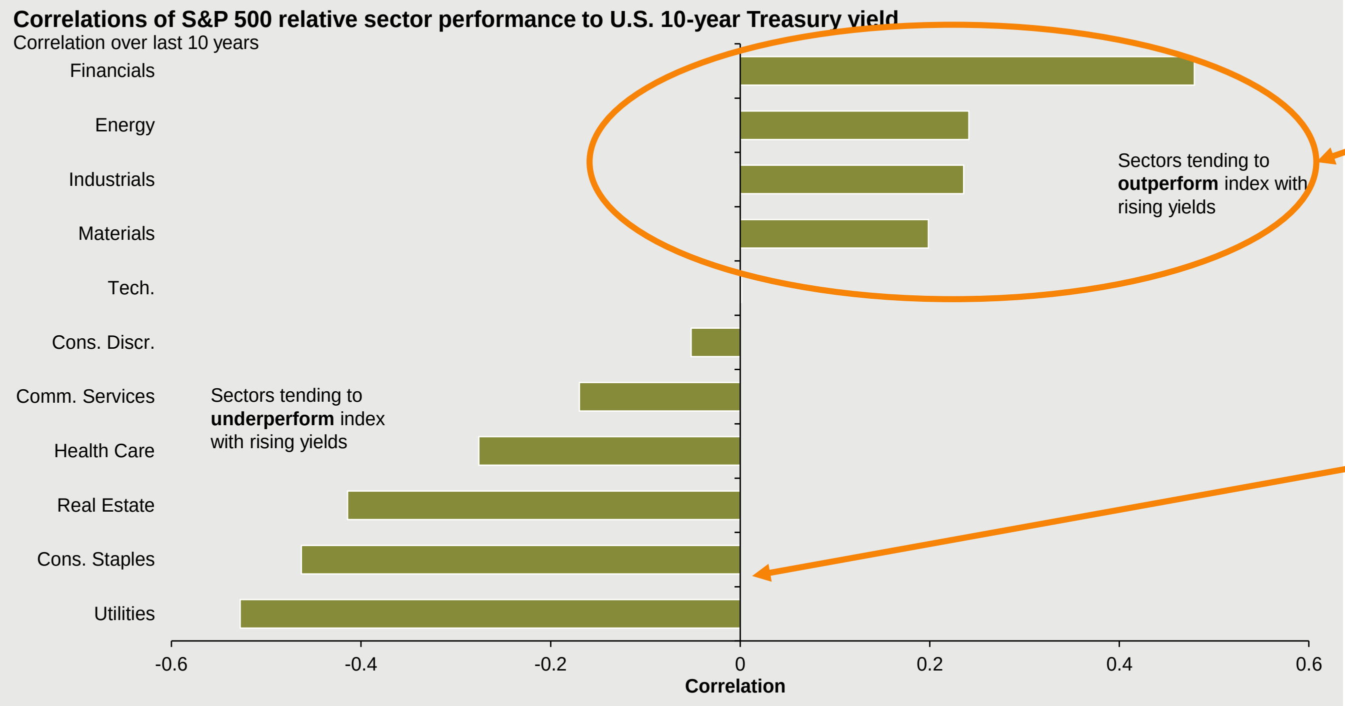
Equities



Source: FactSet, U.S. Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Past performance is not a reliable indicator of current and future results.
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A rising yield environment could broaden the market rally

Historically, rising UST yields benefit sectors that thrive in an economic upturn.

- Financials and banks typically enjoy a higher volume of business activities. A steeper yield curve also implies improvement in net interest margins on their lending. Materials, energy and industrials typically also outperform the benchmark when UST yields are rising.
- In contrast, consumer staples, health care, and utilities would underperform the S&P 500 when yields rise.
- Investors should diversify their sector allocations to better capture the benefit of the economic recovery in the U.S., and globally.

- This shows sector performance relative to the S&P 500 Index in a rising yield environment. Cyclical sectors, such as financials, materials and industrials, tend to outperform, while consumer staples and utilities generally underperform.

Global equities: Valuations

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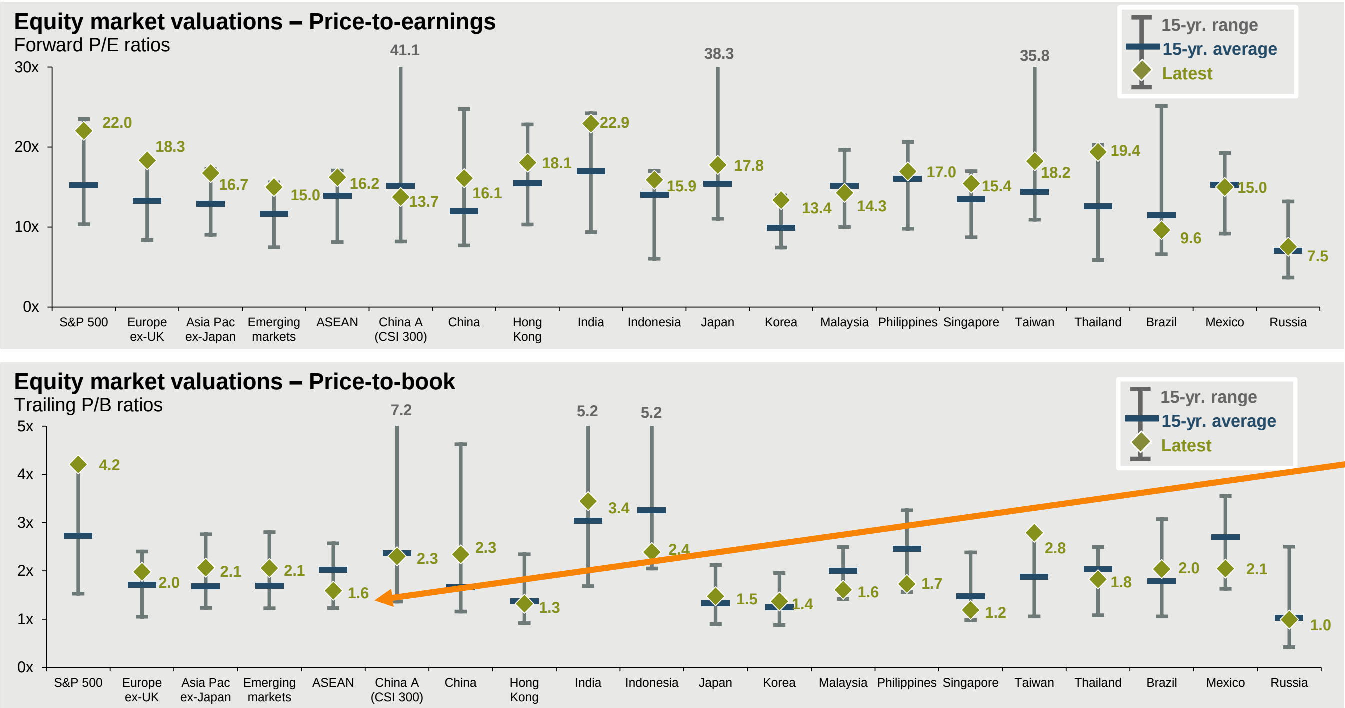
Equities



Source: Bloomberg Finance L.P., China Securities Index, FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Price-to-earnings (P/E) and price-to-book (P/B) ratios are in local currency terms. 15-year range for P/E and P/B ratios are cut off to maintain a more reasonable scale for some indices. Past performance is not a reliable indicator of current and future results.
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Taking into account medium-term growth prospects when considering valuations

Some investors are concerned about the rich valuations in equities. Still, not all markets or sectors face the same challenge.

- While the P/E ratios across the world seem high relative to the long-term average, they should gradually return to a more normal level with the earnings outlook (the denominator) improving.
- Looking at the P/B ratio, a number of 2020 laggards, such as Hong Kong and ASEAN, are still reasonably priced.
- Additionally, consider the earnings prospects over the next three to five years when gauging the medium- to long-term investment value of equities. A number of structural themes, such as a growing middle class in Asia, increased tech investment in China and the reduction of carbon emissions across Asia, could sustain strong earnings growth over a number of years.

- This page shows the price-to-earnings (P/E) and price-to-book (P/B) ratios of major markets around the world. The current level is compared with the 15-year average as well as the 15-year maximum and minimum levels.

Equities

APAC ex-Japan equities: Earnings expectations by market and sector

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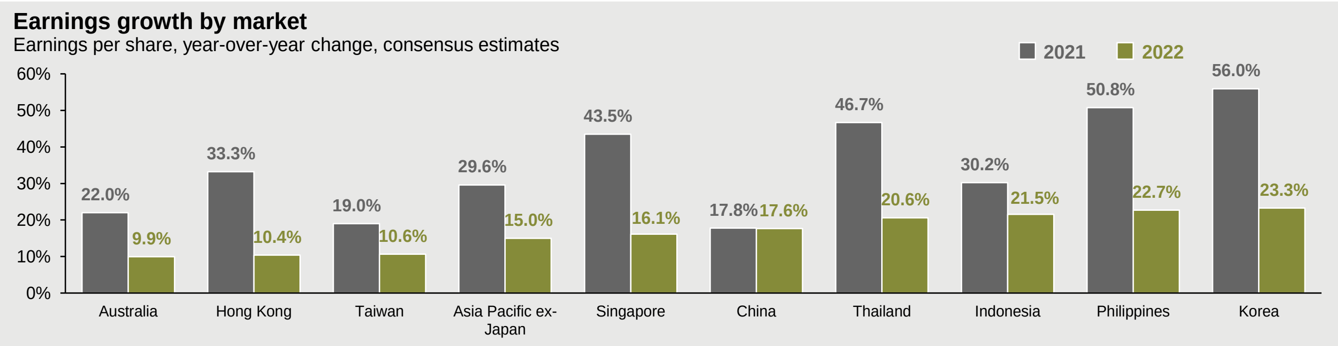

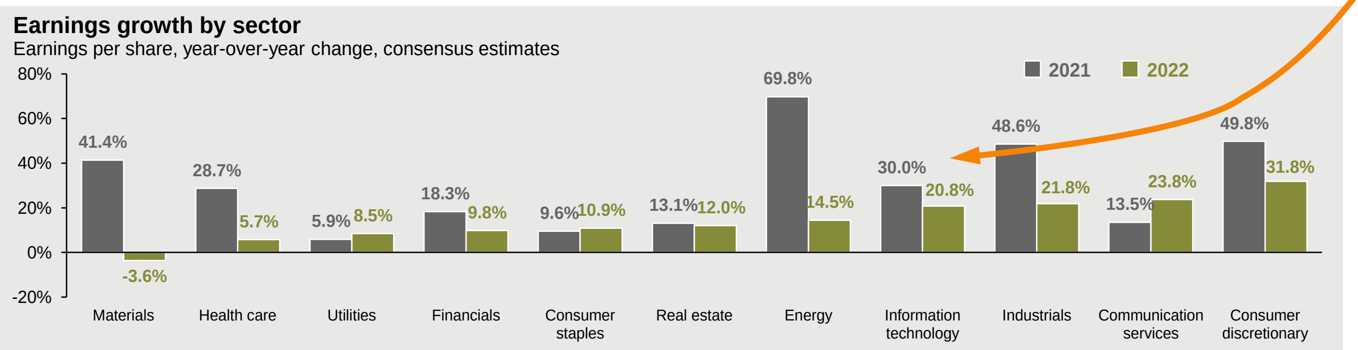

Source: MSCI, J.P. Morgan Asset Management. (Top) IBES. Equity indices used are the respective MSCI indices. Consensus estimates used are calendar year estimates from IBES. (Bottom) FactSet. Sector indices used are from the MSCI AC Asia Pacific ex-Japan Index. Consensus estimates used are calendar year estimates from FactSet. Past performance is not a reliable indicator of current and future results.
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- The top and bottom charts show the earnings expectations for 2021 by market and sector, respectively.
- The COVID-19 pandemic has hit cyclical sectors hard in 2020, but they are expected to rebound in 2021 as the global economy gradually normalizes. Tech, health care and defensive sectors have been more resilient and outperformed in 2020.

A broad set of opportunities across Asia

Asian tech and health care should produce consistent earnings performance, but the cyclicals could bounce back strongly.

- The tech, health care and defensive sectors weathered the pandemic well with positive earnings in 2020 and are expected to keep growing in 2021. This could bode well for China, South Korea and Taiwan, which are the leading markets in Asia for these sectors.
- In contrast, cyclicals, such as materials, consumer discretionary and financials, struggled in 2020, and this weighed on markets like Hong Kong and ASEAN. Better earnings prospects could facilitate a rebound of these 2020 laggards.
- This rebound would be partly determined by the pace of the vaccine rollouts across Asia. An acceleration in vaccination progress could speed up reopening of the domestic economy and borders. The reopening could bode well for the tourism and business travel sectors, which would in turn boost domestic demand via the labor market.

Fixed income: Managing inflation risk

OVERVIEW

- The effectiveness of monetary and fiscal policy in responding to COVID-19 has created a credible risk that bond investors have not faced for many years—higher inflation.
- The rise in core government bond yields from a low starting point limits the appeal of owning these assets in the near term, but they remain a key source of diversification within portfolios. Credit and EM debt can still offer an income solution.
- Investors may wish to consider a dynamic allocation to fixed income markets so as to remain nimble to traverse the uncertainties of the bond market.

INVESTMENT IMPLICATIONS

- Rising inflation is traditionally the enemy of the bond investor, and rising yields certainly limit the appeal of longer duration fixed income assets in the near term.
- With uncertainty over how persistent the inflation threat will be, or how fast and high core government bond yields may go, investors should take a dynamic approach to bond markets, allowing for a shifting fixed income allocation across fixed income segments.
- Positioning in shorter duration assets limits the impact of the inflation risk and allows for re-investment amid better valuations as yields rise.
- The rise in yields will likely come in waves, but eventually bond yields will reach a level where they are once again appealing for both portfolio income and diversification.

Global fixed income: Yields and duration

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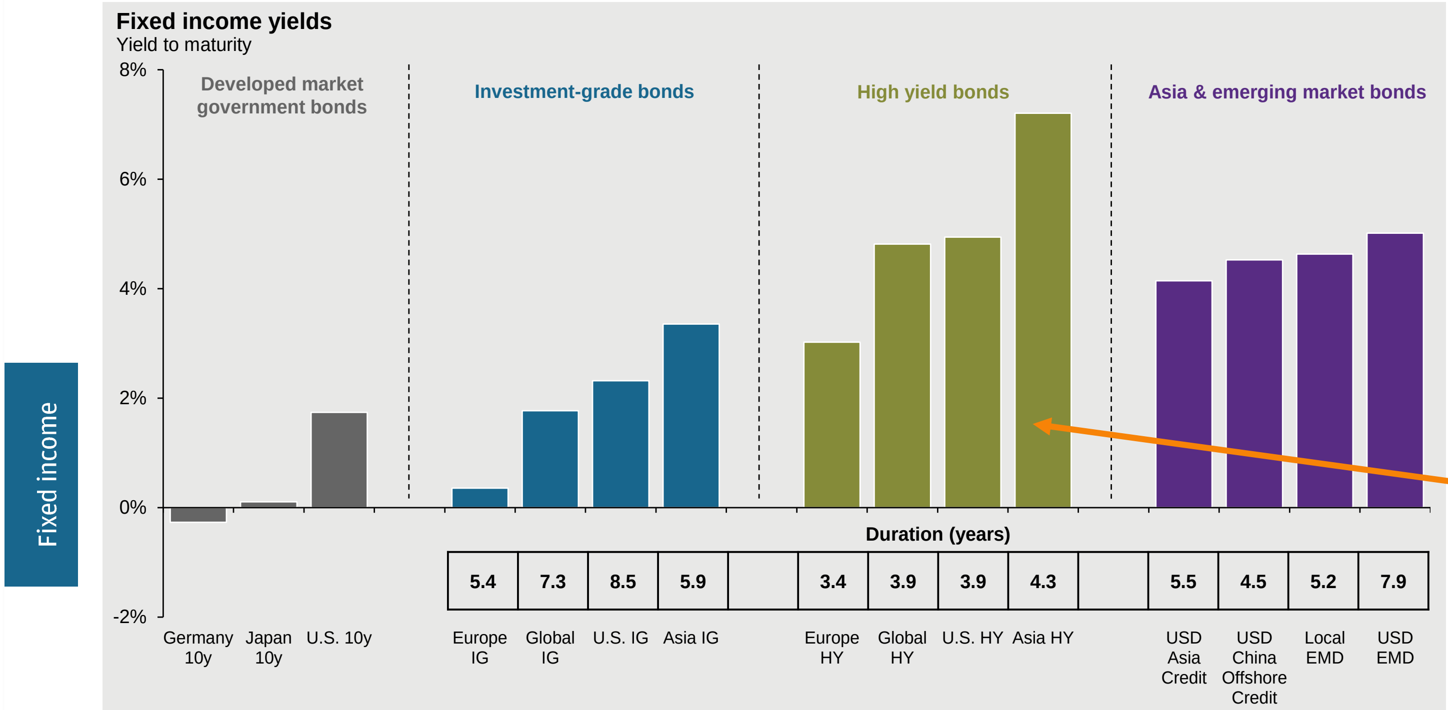

Source: Barclays, Bloomberg Finance L.P., FactSet, ICE BofA Merrill Lynch, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Based on Bloomberg Barclays U.S. Aggregate Credit – Corporate Investment Grade Index (*U.S. IG*), Bloomberg Barclays Euro Aggregate Credit – Corporate (*Europe IG*), J.P. Morgan Asia Credit Investment Grade Index (*Asia IG*), Bloomberg Barclays Global Aggregate – Corporate (*Global IG*), Bloomberg Barclays U.S. Aggregate Credit – Corporate High Yield Index (*U.S. HY*), Bloomberg Barclays Pan European High Yield (*Europe HY*), J.P. Morgan Asia Credit High Yield Index (*Asia HY*), ICE BofA Global High Yield (*Global HY*), J.P. Morgan GBI-EM (*Local EMD*), J.P. Morgan EMBI Global (*USD EMD*), J.P. Morgan Asia Credit Index (JACI) (*USD Asia Credit*), J.P. Morgan Asia Credit China Index (*USD China Offshore Credit*). Duration is a measure of the sensitivity of the price (the value of the principal) of a fixed income investment to a change in interest rates and is expressed as number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. Positive yield does not imply positive return. Past performance is not a reliable indicator of current and future results.
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- The chart shows the yields available across the fixed income spectrum. Yields on DM government bonds have started to rise from an exceptionally low level, while the search for income has kept yields low in other sectors.
- Investors will have to look across the higher yielding end of EM bonds for income. However, they will need to remain mindful of the risk of inflation and higher UST yields and work to manage that risk.

Don't fear inflation

The effectiveness of the 2020 policy response to the COVID-19 pandemic has created an inflation risk that bond investors have not faced for many years.

- In the years after the global financial crisis, the extraordinary policies of central banks failed to create inflation, but helped to avoid persistent deflation.
- Now, the combined effect of coordinated monetary and fiscal policies changes the narrative, with higher inflation being a real risk.
- A risk does not need to be feared, but does need to be managed. Being short duration rather than long means bond holders can re-invest at higher yields. Tilting towards credit over government debt also means investors can use the positive inflation environment to their advantage as corporate fundamentals improve and credit risk declines.

Global fixed income: Valuations

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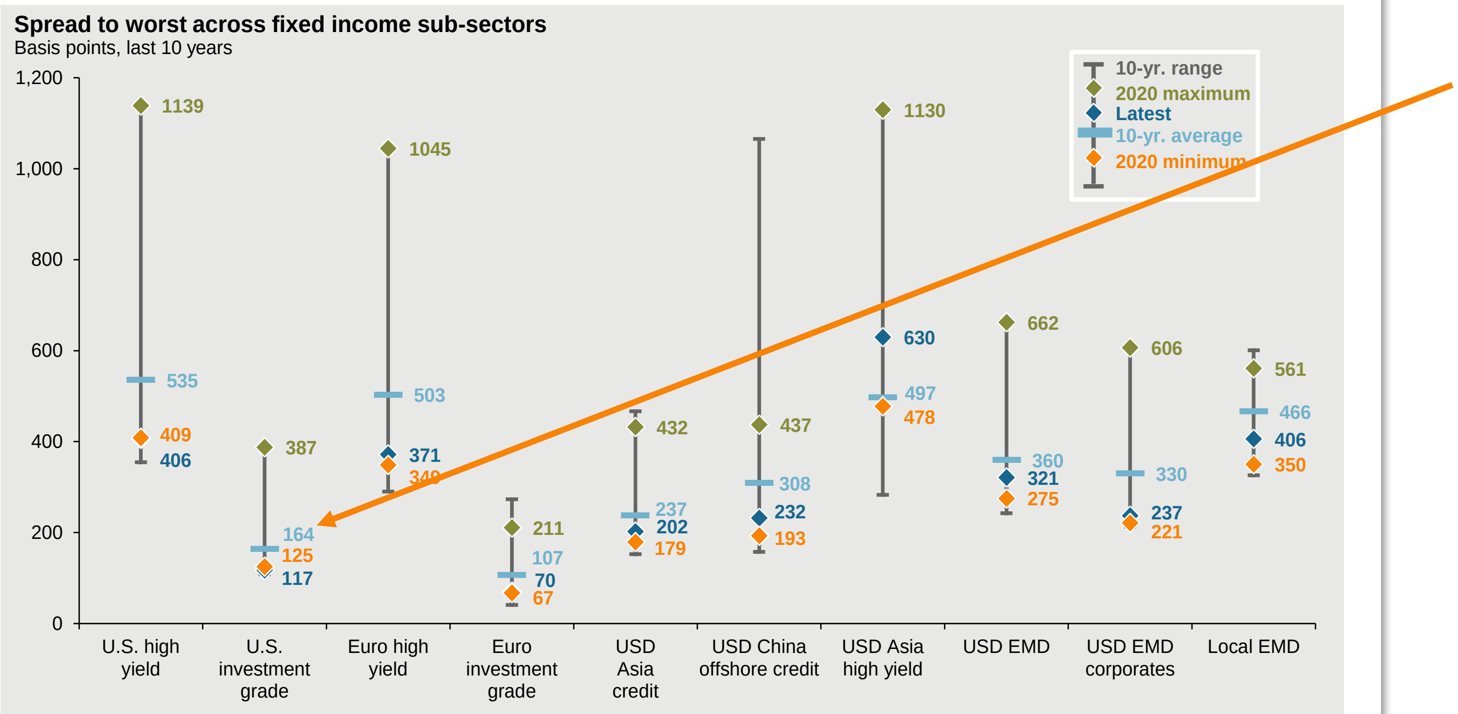

Source: iBoxx, ICE BofA Merrill Lynch, J.P. Morgan Economics Research, J.P. Morgan Asset Management.
Based on J.P. Morgan Domestic High Yield Index (*U.S. high yield*), J.P. Morgan U.S. Liquid Index (JULI) (*U.S. investment grade*), J.P. Morgan Euro High Yield Index (*Euro high yield*), iBoxx EUR corporates (*Euro investment grade)*, J.P. Morgan Asia Credit Index (JACI) (*USD Asia credit*), J.P. Morgan Asia Credit China Index (*USD China offshore credit*), J.P. Morgan Asia Credit High Yield Index (*USD Asia high yield*), J.P. Morgan EMBI Global (*USD EMD*), J.P. Morgan Corporate Emerging Markets Bond Index – CEMBI (*USD EMD corporates*), J.P. Morgan GBI-EM Global (*Local EMD*). Positive yield does not imply positive return. Past performance is not a reliable indicator of current and future results.
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Fixed income

- This chart shows the spread-to-worst across DM credit markets and EM bonds. The lower the spread, the more expensive the market.
- Across the credit spectrum, spreads have fallen back toward their lows prior to the pandemic.

Credit tights

The support of both the government and the Fed led to a sharp retracing in spreads, with U.S. IG credit spreads back at their pre-COVID-19 levels by January 2021. Many other segments of the credit market experienced a similar, but less dramatic, market movement.

- Further narrowing in credit spreads is unlikely and, as such, coupons will make up a greater proportion of returns. This suggests allocating to the segments of the market with the highest yield, namely EM debt and the higher beta parts of the HY bond market.
- Improving corporate health and earnings recovery is supportive of credit markets in the same way it supports equities, minimizing the potential for significant spread widening.
- Investors will have to be mindful of the impact of rising UST yields and may opt for a more dynamic approach to fixed income markets as yields rise.

Global fixed income: Yields and risks

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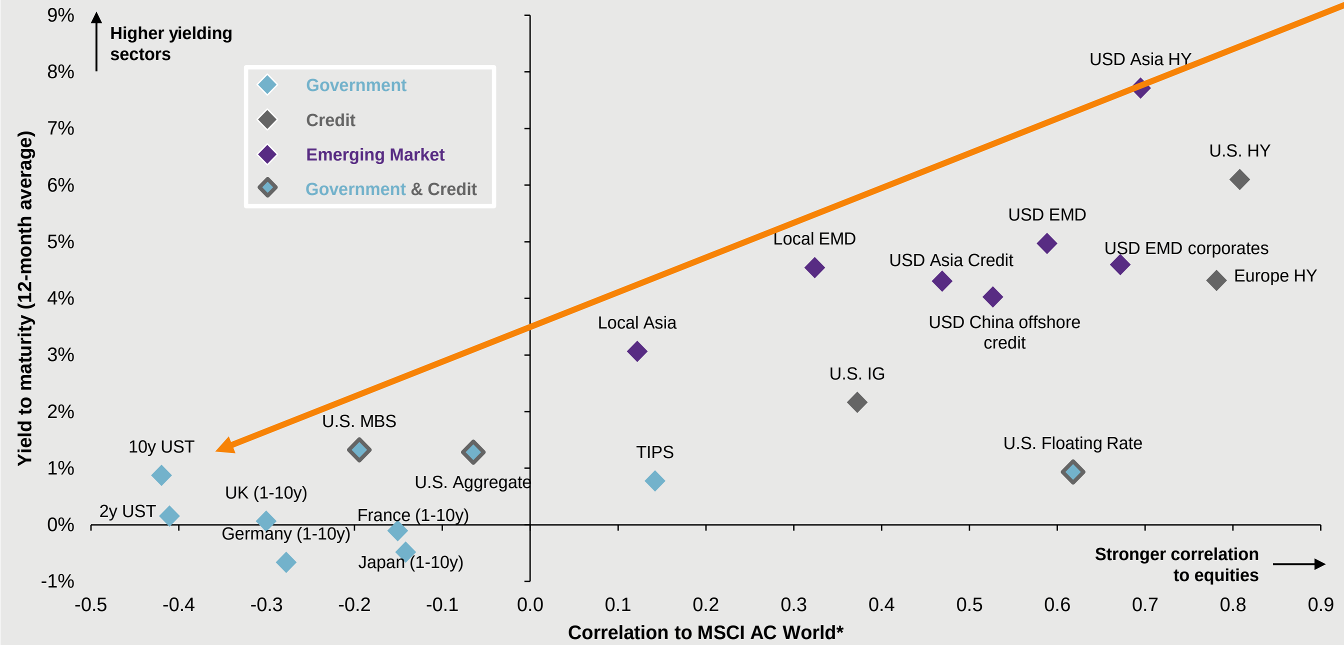
Fixed income

Yields and correlations of fixed income returns to equities

Yield, 10-year correlation between monthly total returns



Source: Barclays, Bloomberg Finance L.P., FactSet, ICE BofA Merrill Lynch, J.P. Morgan Economics Research, MSCI, J.P. Morgan Asset Management. Based on Bloomberg Barclays U.S. Treasury (UST) Bellwether 2y & 10y (*2y & 10y UST*), Bloomberg Barclays Treasury Inflation-Protected Securities (*TIPS*), ICE BofAML Country Government (1-10y) (*France, Germany, Japan & UK (1-10y)*), Bloomberg Barclays U.S. Aggregate, Credit – Investment Grade & High Yield (*U.S. Aggregate, IG & HY*), Bloomberg Barclays U.S. Floating Rate (*U.S. Floating Rate*), Bloomberg Barclays U.S. Aggregate Securitized – Mortgage-Backed Securities (*U.S. MBS*), Bloomberg Barclays Pan-European High Yield (*Europe HY*), J.P. Morgan GBI-EM Global (*Local EMD*), J.P. Morgan EMBI Global (*USD EMD*), J.P. Morgan Asia Credit (JACI) (*USD Asia Credit*), J.P. Morgan Asia Credit (JACI) – High Yield (*USD Asia HY*), J.P. Morgan Asia Credit China Index (*USD China offshore credit*), J.P. Morgan CEMBI (*USD EMD corporates*), J.P. Morgan Asia Diversified (JADE) (*Local Asia*). *Correlations are based on 10-years of monthly returns. *Guide to the Markets – Asia.* Data reflect most recently available as of 31/03/21.

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Finding balance

Owning government bonds has been relatively unappealing with the low level of income and high valuations. But rising yields may change this dynamic.

- The early stages of the rise in bond yields imply large capital losses when yields are low. But as yields rise, investors may start to rotate back into government bonds.
- The relative valuations argument to equities and other risk assets could start to narrow, and investors who have benefited from rising equities over the last year may wish to rebalance their portfolios.
- This rebalancing may actually cap, or at least stem, some of the rise in bond yields, limiting the potential for losses. However, the rotation may not gain momentum until there is more clarity on the strength of the rebound and central banks' responses.

- The chart illustrates the relationship between bond yields and the correlation to equity markets.
- The trade-off of moving up the risk spectrum in fixed income markets is a lower level of diversification against equity markets and increasing correlation to equities.
- Core government bonds still have a role as a diversifier in a portfolio, albeit a more costly one.

Integrating ESG in portfolio construction

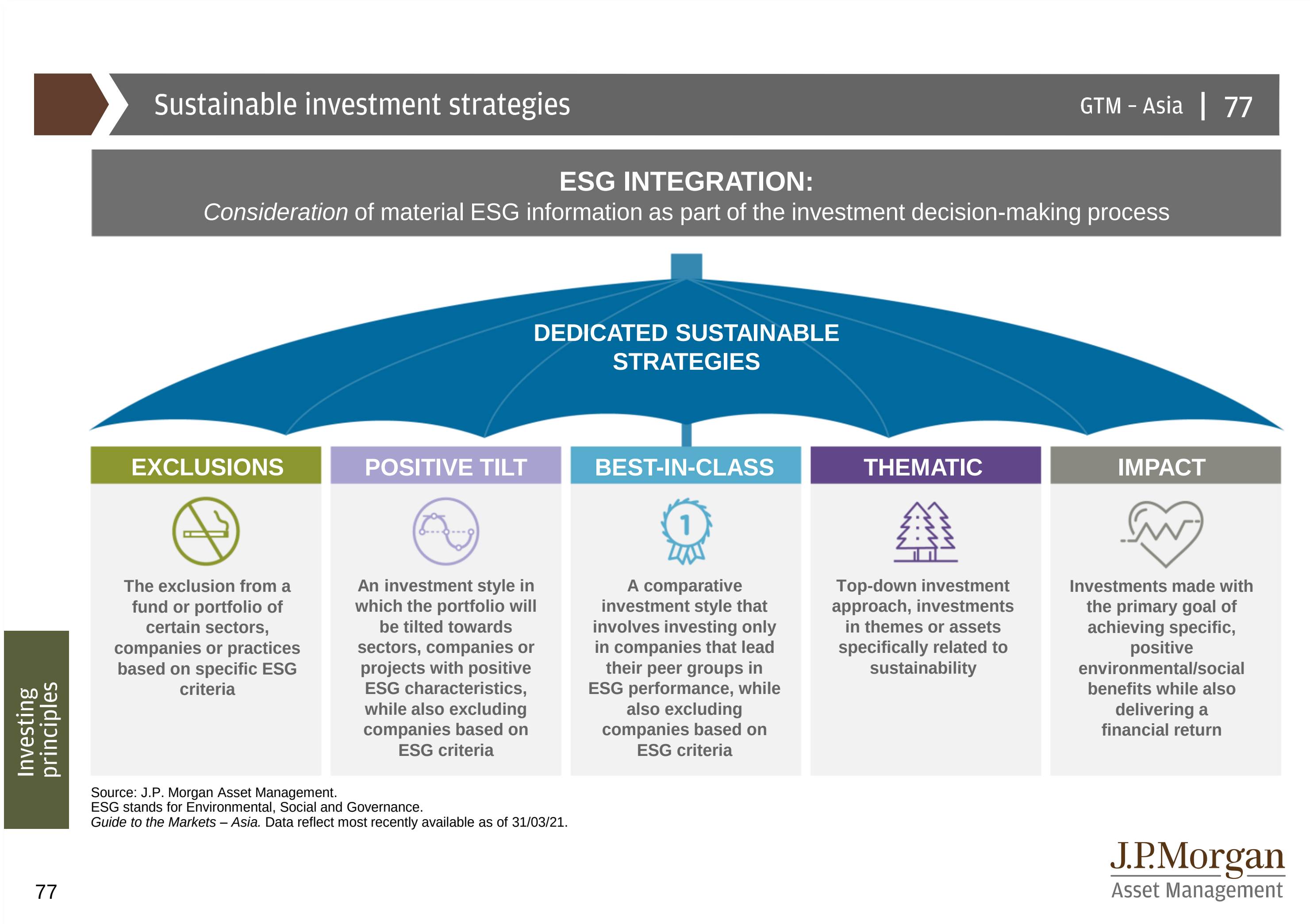
OVERVIEW

- A growing number of investors are incorporating environmental, social and governance (ESG) factors in their portfolio construction process. This includes sustainability issues, such as climate change, and social inequality, which is gaining prominence politically and economically.
- The number of economies committing to net-zero emissions by or near the middle of this century equates to 77% of Asia's 2019 GDP and 46% of the population in 2019, according to World Bank data. This is a powerful market shift that will shape the investment landscape in the region. Still, Europe remains the uncontested leader in ESG investing. However, momentum is building in Asia, with net inflows into sustainable funds of close to USD 8billion in 2020, approximately 10 times that of 2019.

INVESTMENT IMPLICATIONS

- Focusing on companies that take ESG seriously typically means investing in higher-quality businesses that take a long-term view on executing investment decisions that are good for the environment and society, while incorporating corporate governance considerations.
- Although sustainable investing is gaining traction, the level of adoption varies among investors amid evolving policies and preferences. Having a better understanding of ESG objectives is key to providing the right solutions.
- ESG investing is likely to become an even more prominent driver in the coming years as the value of assets under management (AUM) increases. We expect ESG metrics will be increasingly integrated in asset managers' investment processes, not only as a risk measure but also when considering the return metrics across investments. We believe there is still some mispricing in capital markets, and hence room for alpha remains for long-term investors.

MARKET INSIGHTS



How can ESG factors be incorporated into strategies?

- Most ESG funds are “positive-tilt” or “best-in-class” strategies. Positive-tilt strategies not only exclude certain industries but also award a larger allocation within a portfolio to equities with higher ESG scores. These scores may be defined in-house by investment teams or sourced from third-party ESG research providers.
- “Best-in-class” strategies build on the exclusion processes by ranking the investible companies within their sectors and then selecting the most sustainable companies within a given sector. This process strives to reward ESG leaders in an industry, while also avoiding large portfolio skews toward sectors more associated with strong ESG practices or better disclosure.
- Thematic and impact strategies are built according to specific forward-looking sustainability goals.

- There are different ways in which ESG factors can be considered or screened when investors are making decisions.
- ESG integration is the broadest category, while the five dedicated ESG strategies are investment processes that are more rules-based and may invest in themes specifically related to sustainability.
- Exclusion strategies apply restrictions on the ability of an asset manager to buy assets related to industries such as weapons, tobacco, alcohol and adult entertainment. Alternatively, asset managers may be able to invest only in businesses that have signed up to the United Nations Global Compact initiative on sustainable and socially responsible policies.

Sustainable investment performance and market size

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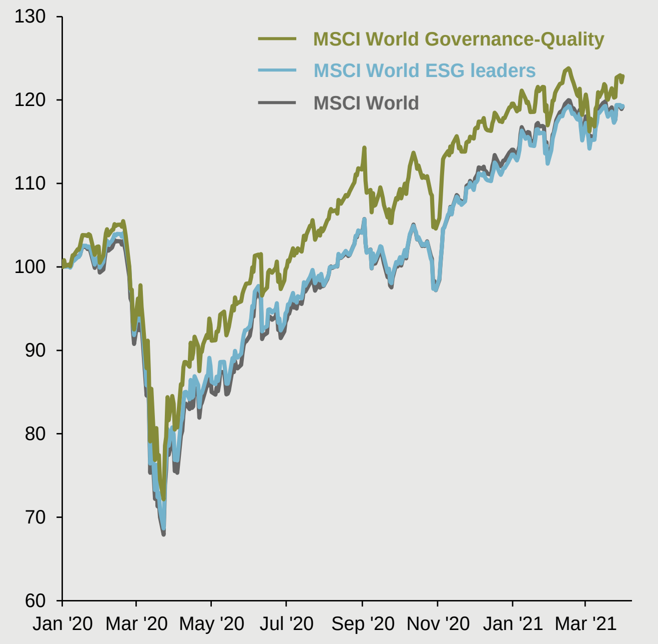
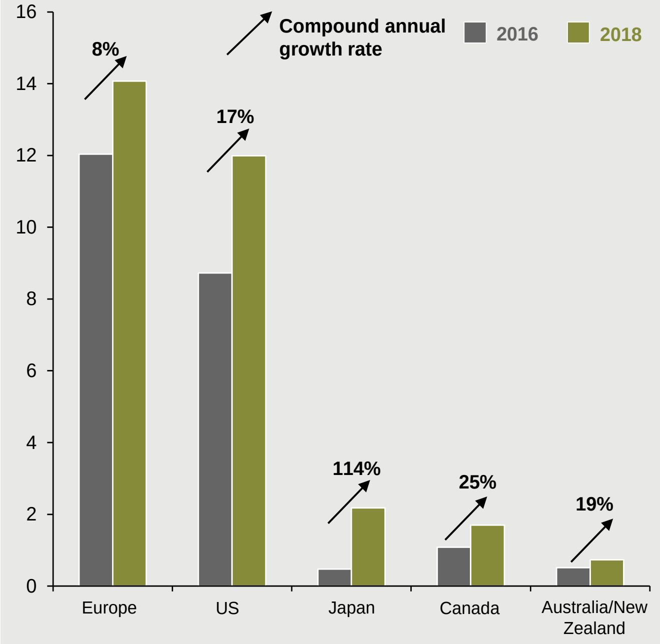
MSCI World ESG performance
Index level in USD, rebased to 100 at Jan. 2020



Sustainable investment assets under management
USD trillions



Source: J.P. Morgan Asset Management; (Left) MSCI, Refinitiv Datastream; (Right) Global Sustainable Investment Alliance (GSIA). The MSCI World ESG Leaders Index is a capitalization-weighted index that provides exposure to companies with high Environmental, Social and Governance (ESG) performance relative to their sector peers. The MSCI World Governance-Quality Index aims to reflect the performance of a strategy that is seeking to capture both the financial and corporate governance aspects of Quality investing. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – Asia. Data reflect most recently available as of 31/03/21.

Investing principles

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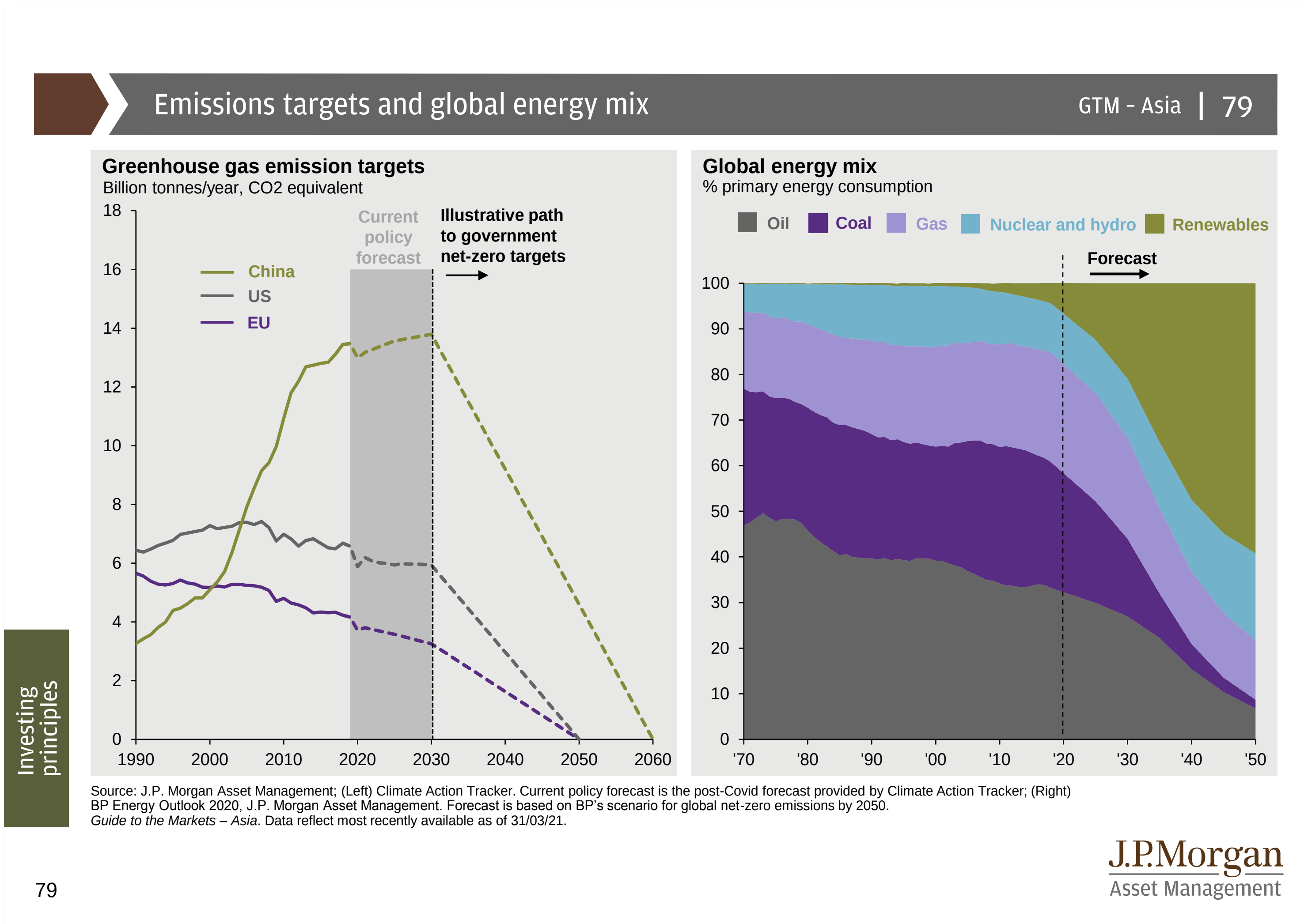
J.P.Morgan
Asset Management

ESG in Asia is gathering pace

- The past few years have seen a steady increase in assets in sustainable funds globally. Assets remain dominated by Europe, accounting for about 81% of the global sustainable fund universe, largely because of its long history of responsible investing and favorable regulatory environment.
- In terms of fund flows, Europe also remains the leader in ESG investing. However, Asia is gradually gaining momentum.
- Other than fund flows toward ESG, another key driver in Asia is the increasing number of ESG investment regulations being adopted or discussed in various economies. The ongoing industry and regulatory development should help create a sound infrastructure for sustainable investment, thereby boosting the momentum of ESG investing within Asia.

- The left-hand chart compares the performance of three indices: 1) the broad index; 2) the MSCI World ESG leaders: an index that tilts toward ESG leaders in each sector; and 3) the MSCI World Governance-Quality Index, which aims to reflect the performance of a strategy that is seeking to capture both the financial and corporate governance aspects of quality investing.
- The two ESG indices have mostly matched or outperformed the broader world index, demonstrating that investing sustainably does not compromise returns.
- The right chart shows the rise in sustainable investment AUM over recent years.



- The left-hand chart shows the target dates set by different governments to achieve net-zero emissions.
- Major Asian economies—China, Japan and South Korea—announced net-zero/carbon neutral targets. China's carbon dioxide (CO2) emissions will peak sometime before 2030, with the goal of achieving carbon neutrality, or net-zero emissions, by 2060.
- In the U.S., President Joe Biden has committed to a net-zero target by 2050. Similarly, the European Union aims to be climate neutral by 2050.
- The right-hand chart shows how the mix of energy sources has evolved over time.

Overhauling the energy mix to achieve net-zero emissions

- The production of energy from coal is one of the largest contributions to CO2 emissions. Responsible for 28% of current energy consumption, this will have to be slashed to 2% in the coming decades. This will need to be offset by a five-fold increase in energy consumption sourced from renewables and other non-fossil fuels, from 15% to 78%[1].
- The global energy system has historically been dominated by a single energy source. The ongoing energy transition suggests the global energy mix is going to be far more diversified in the future, with increasing demands for integration across different and more environmentally friendly fuels and energy services.
- Carbon emissions reduction could also profoundly impact heavy and energy-intensive industries such as steel and cement production. These industries will need to innovate or face rising costs of production.

[1] Source: BP Energy Outlook 2020

Quarterly Perspectives

Asia | 2Q 2021

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