Asset Management

# Multi-Asset Insights

Q3 2023

For professional investors only

HSBC | Opening up a world of opportunity

# Table of contents


Foreword 3

In a nutshell 4

Enhancing portfolio resilience 5

China and India: Shifting sentiments 11

Important information 17



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## Foreword

As valuations continue to reflect an optimistic scenario, we anticipate that we may soon enter a more challenging macroeconomic context that could result in choppy waters for the markets. In the coming months, we expect the resilience of our asset allocations to be put to the test.

**Jean Charles Bertrand**
Global CIO, Multi-Asset
HSBC Asset Management

Welcome to the latest edition of our quarterly Multi-Asset Insights series, where we present asset allocators with the findings of our Strategic Forum. Our goal is to provide valuable insights on the latest market and macroeconomic developments, as well as share significant discoveries from our Multi-Asset Research team. This includes advancements in how we build portfolios and our attempts to discover new alpha drivers.

As the market continues to price in a soft landing, the consensus assumption is one of 'immaculate disinflation'. However, we present a somewhat less optimistic central scenario. While resilient profits and excess savings have supported economic activity, we believe that markets have yet to fully capture the fact that a potential recession may have been delayed but not avoided. Besides, the Fed is likely to keep an asymmetric approach and be in no rush to ease. This is why we are recommending a cautious investment approach for the next few months. In a context of defensive portfolio positioning being appropriate, we dedicate the first section to potential options for enhancing asset allocation resilience as bonds' ability to systematically diversify equity risk in portfolios might have come to an end. However, there are opportunities to enhance asset allocations through a combination of strategies with explicit downside protection and uncorrelated sources of return.

Accordingly, we believe that emerging markets are relatively cheap and could be more attractive after having delivered lacklustre returns. Recent news has focused on Asia, with India becoming a more positive story and China receiving more negative attention. Here again, our own perspective is a little bit more nuanced. We detail it in the second section of this edition.

I trust you will find this publication an interesting and useful resource.

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# In a nutshell

### Enhancing portfolio resilience

- Bonds have traditionally been a reliable source of positive returns and diversification in multi-asset portfolios, but they posted large negative returns in 2022 while equities experienced a bear market, highlighting the need for diversification beyond bonds.
- Simple correlation analysis may not adequately capture an asset's defensiveness, and investors should also consider metrics such as defensive return and defensive consistency.
- Strategies that exhibit desirable defensive properties, such as put options, gold and low volatility equity factors, can be combined to build strategic defensive allocations that balance reduced drawdowns with limited cost-of-carry during normal times.
- Accordingly, government bonds should not be the only option for diversification; their ability to systematically diversify equity risk in portfolios – as they did during the last 20 years – having most likely come to an end.

### China and India: Shifting sentiments

- India has achieved several milestones recently, including surpassing China as the world's most populous country, and overtaking the UK as the world's fifth-largest economy. It didn’t go unnoticed, with financial publications stressing India's young and growing workforce, as well as its potential to grow its role in industries at the forefront of technology, providing tailwinds for continued growth.
- Conversely, China has been experiencing a deceleration in its economic growth, primarily attributed to the cautious approach taken by Chinese authorities towards increasing support for the economy.
- From a market perspective, Indian Government Bonds have consistently outperformed both Chinese Government Bonds and US Treasuries in their respective local currencies over the past two decades, providing a basis for the prevailing positive sentiment towards India.
- In addition, India's recent inclusion in JP Morgan’s emerging markets government bond indices is expected to attract a substantial influx of foreign capital into India's considerable government debt market, building the investment case for global investors.
- On the equity side, India's growth trajectory has been seen in its representation in the MSCI Emerging Markets index, ticking up from single digits to 15 per cent in recent years, and potentially approaching China's weighting in the years ahead. The question is now about how justified current valuations are.
- For asset allocators, taking exposure to both India and China, as well as other Asian countries with compelling growth narratives, is a valid option, assuming they have the necessary research resources to tap into the diverse growth potential offered by these economies.

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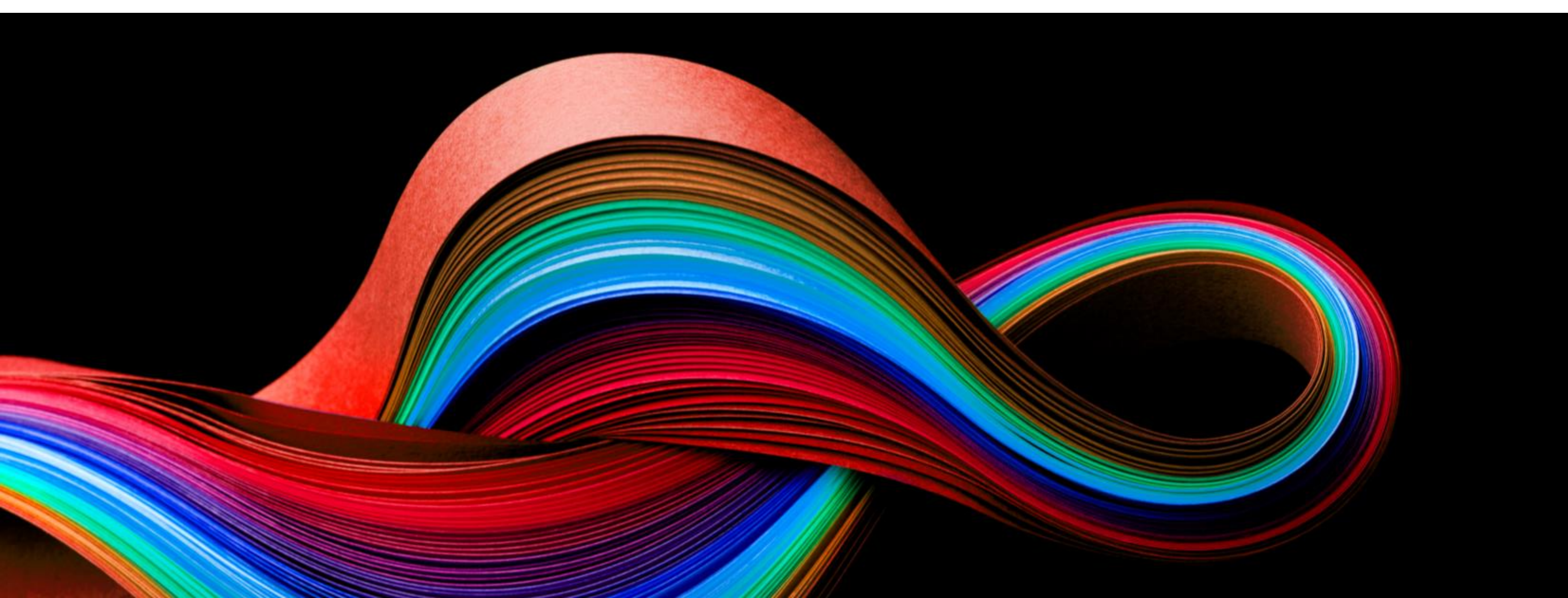

# Enhancing portfolio resilience

Bonds' ability to systematically diversify equity risk in portfolios might have come to an end. But there are opportunities to enhance asset allocations through a combination of strategies with explicit downside protection and uncorrelated sources of return.

**Nicholas McLoughlin**
Global Head of multi-asset Research

**Mathieu Guillemet**
Head of Multi-Asset, France

Having bonds in any multi-asset portfolio has been a no-brainer over the last two decades, thanks to their persistent ability to produce both steady positive returns and diversify equity risk in portfolios. But 2022 was the year that those two long standing pillars of portfolio construction met their first challenge in recent decades: bonds posted large negative returns whilst equities had a bear market.

Although bond markets were slightly down in 2021, investors have to go back to 1994 to find the previous calendar year decline, whilst equity-bond correlation has sat below or close to 0 for over two decades before moving into strongly positive territory last year.

Figure 1: 3y rolling equity-bond correlation

Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

Thanks to bonds' long-standing ability to be a reliable performance driver and an efficient defensive asset, taking strategic exposures to other potentially more sophisticated defensive assets or strategies was usually not seen as necessary. This was partly a consequence of the extraordinary measures implemented by central banks in the wake of the financial crisis, which were reinforced by a muted inflation backdrop and predictable policy response to equity market weakness or growth concerns.

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Although a backdrop of disinflation has seen normal service resume for 2023, asset allocators should take forward some lessons from the 2022 experience. Bonds still have plenty to offer investors, especially in terms of returns following the spectacular rise in yields, but should not be relied upon as the only source of protection in the face of equity drawdowns. Persisting uncertainties about the end of QE, the change in inflation regime and the impact of de-globalisation promote the idea of "diversifying our diversifiers".

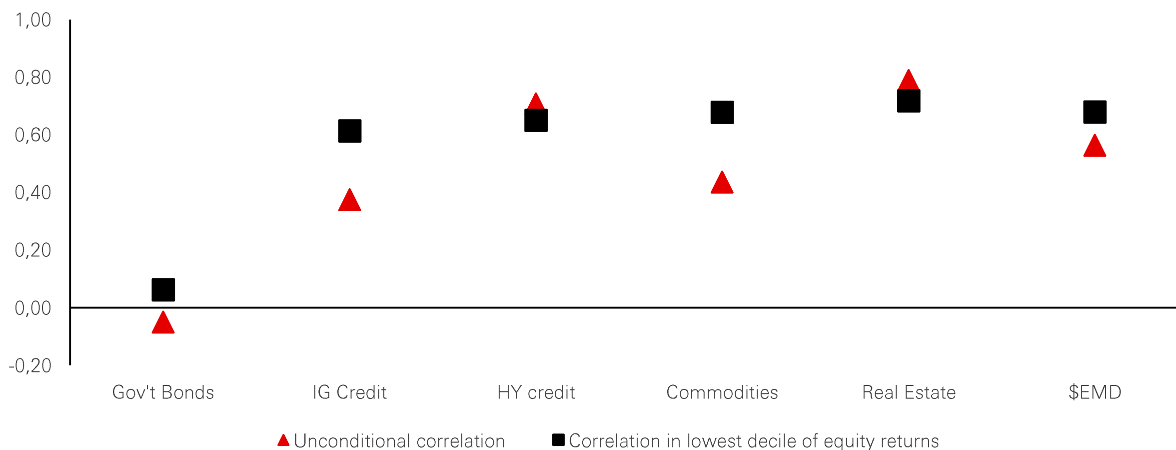
## Going beyond correlation?

Simple correlation analysis such as the previous chart hides an important nuance of diversification: low or negative correlation is not particularly valuable to investors when considered in isolation. Whilst it helps keep overall portfolio risk low during normal times, and by doing so helps to improve risk-adjusted returns, many investors really only need diversification when their main performance engine (typically equities) enters difficult times. Having below average returns when equities outperform is a drag on portfolio returns – what is key is that when equities disappoint, we have assets that can come to the rescue.

We can capture this behaviour in a few ways, but a simple starting point is to consider a downside correlation measure: $\tilde{\rho} = corr(r_2, r_1 | r_1 < x)$.

Here we look at the correlation between two assets when the return of the first asset is below a given threshold $x$. The chart below shows what happens when we set this threshold to cover the worst ten per cent of equity returns measured on a monthly basis since December 1993 (-5% monthly returns or worse). We see that when equity markets disappoint, traditional asset classes do not necessarily come to the rescue, and in fact we see correlations increase on average[1].

Figure 2: Correlation of selected asset classes with equities during their worst months




Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

## Defensiveness

This feature of correlations rising during times of crisis means we need to think differently about how we measure portfolio diversification. We suggest two alternative metrics that better describe an asset's defensiveness:

*Defensive Return*: What is the return of the asset when equity markets fall?

*Defensive Consistency*: How reliable is that return?

1, Page and Panariello (2018). "When Diversification Fails", Financial Analysts Journal, 74:3, 19-32

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To see how these metrics might be useful from a portfolio construction standpoint, we introduce a range of strategies that are well-known for bearing defensive properties, and see how they score on these metrics:

1. Put Options – *systematic long exposures to put options*
2. Gold
3. Equity Volatility Strategies – *long exposures to US equity volatility futures contracts (VIX) when the term structure is inverted (no position otherwise)*
4. Interest Rate Volatility Strategies – *long exposures to long-term rates volatility*
5. Defensive FX Strategies – *long exposures to counter-cyclical ("safe-haven") currencies and short exposures to more pro-cyclical ("high equity-beta") currencies*
6. Cross Asset Trend Following Strategy – *long (resp. short) exposures to assets that have delivered positive (resp. negative) returns over the last 12 months, on average*
7. Global Government Bonds
8. Quality and Low Volatility Equity Factors – *Quality factor takes long exposures to stocks with higher and more stable profitability characteristics; low volatility factor takes long exposures to stocks with lower volatility and lower sensitivity (beta) to equity market (factor returns are shown in excess of market cap equity index returns)*

To measure defensive returns, we look at the Conditional Sharpe Ratio when equity markets have their worst ten per cent of returns (measured on a weekly basis from October 2007 to July 2023), whilst we monitor the defensive consistency by considering how often the strategy has a positive return in those periods:

Figure 3: Defensive properties of selected strategies when equities experienced their worst weeks

| | Equity market | Put options | Gold | Equity volatility | Interest rate volatility | Defensive FX | Trend following | Government bonds | Quality equity | Low volatility equity |
|---|---|---|---|---|---|---|---|---|---|---|
| **Defensive return** | -1.82 | 0.57 | 0.05 | 0.58 | 0.5 | 0.89 | -0.02 | 0.44 | 0.54 | 1.82 |
| **Defensive consistency** | | 97.60% | 53.70% | 76.80% | 76.80% | 86.60% | 57.30% | 78.00% | 73.20% | 97.60% |

Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

Our selected set of defensive strategies show some diversity in terms of defensive metrics: some strategies exhibit higher conditional Sharpe ratios whilst consistency is above 50 per cent across the board.

An important compliment to these two metrics is how a candidate strategy performs in normal times. One of the issues with defensive strategies is their tendency to become a drag on portfolio returns during good times (a "cost-of-carry"), such that investors tend to abandon them right at the point they are needed.

Plotting the full sample Sharpe Ratios of each strategy against their respective level of defensiveness[2], we see an intuitive trade-off emerging: the more defensive the strategy, the lower the risk-adjusted return, on average. It is worth noting here that, although based on more than 15 years of data, the estimated relationship / analysis remains attached to a period that saw equity markets deliver average returns well above historical reference levels and bond yields exhibit an almost uninterrupted downward trend. This may help better understand the historical behaviour of Put Options – and their structural negative equity beta – and Quality Equity – and their structural positive duration beta.

2, We measure defensiveness as the average cross-sectional rank of the defensive return and the defensive consistency

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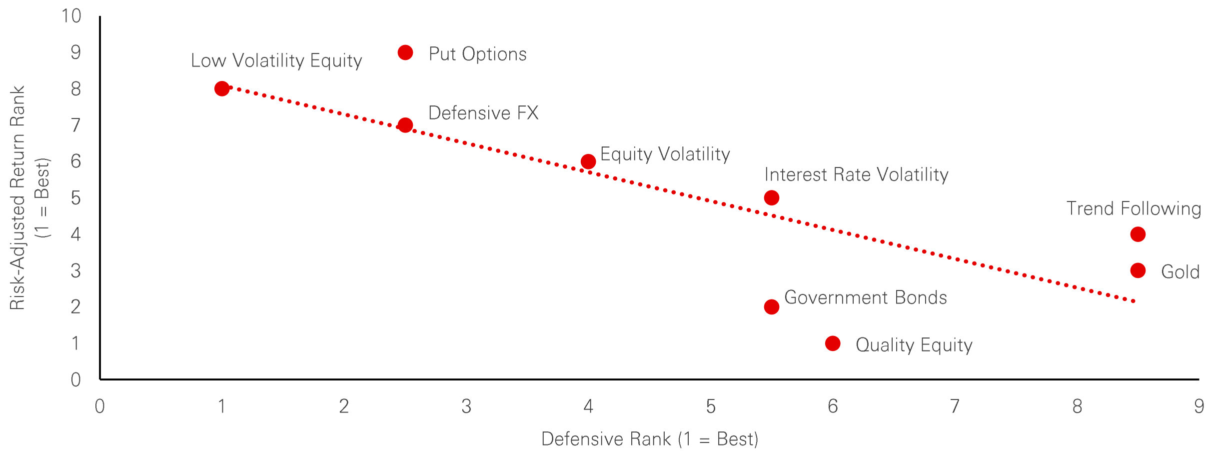
Figure 4: Risk-adjusted return and defensive properties of selected strategies




Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

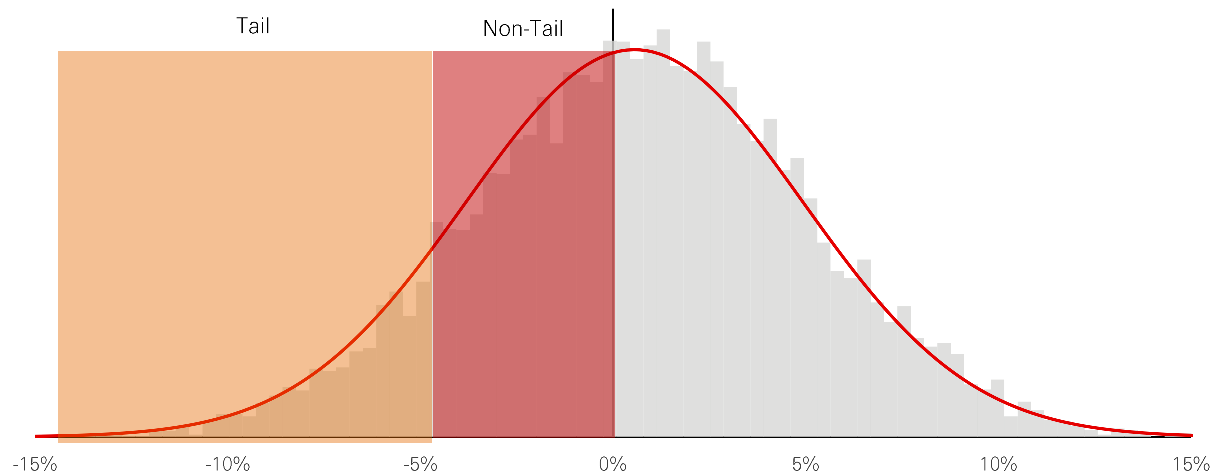
We therefore have to find the right balance between protection in market sell-offs and the cost-of-carry during normal times.

## Defensive portfolio construction

While all selected strategies exhibit desirable defensive properties, they show some variation when considering their defensive metrics and cost of carry individually. Such variation gives the opportunity to build “strategic defensive allocations” based on considerations such as the combination of defensive properties (the balance between defensive return and defensive consistency), or the average cost-of-carry not exceeding a certain level.

To do so, it can be helpful to consider further distinctions between candidate strategies by looking at performance during tail (i.e. large equity drawdown) and non-tail (mild equity correction) events and comparing these to ‘normal’ times. We define tail events as those occurring during the worst decile of equity market returns, whilst non-tail events are those when equity returns are below zero but above the bottom decile of returns.

Figure 5: Tail and non-tail equity drawdowns




Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

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Figure 6: Risk-adjusted returns

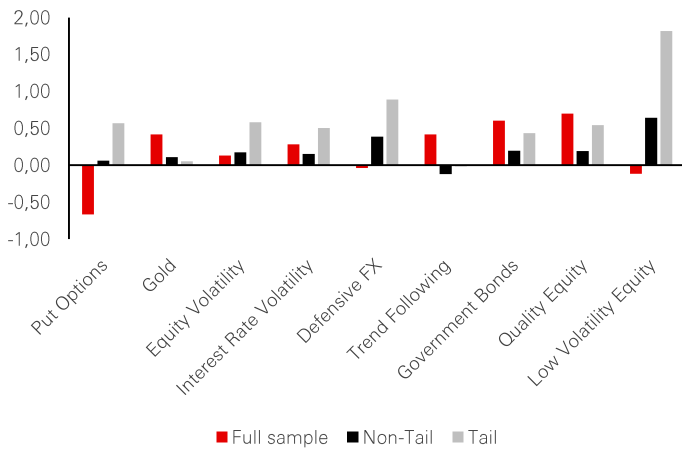
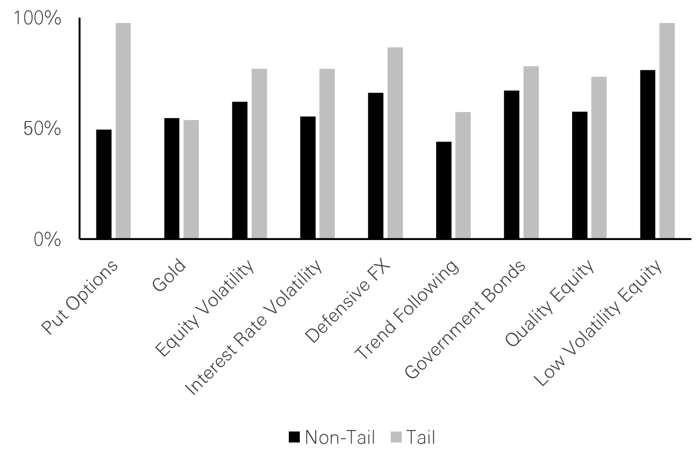



Figure 7: Defensive consistency




Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

Using the above analysis, and considering more qualitative inputs related to the nature/rationale of the strategies, we can further subdivide the strategies into 'explicit defensive' strategies and 'diversifiers'.

Explicit defensive strategies such as Put Options, Defensive FX and Low Volatility Equity perform poorly during normal market conditions and have consistently negative equity beta. Most other strategies fit the description of diversifiers; their defensive returns are not consistently stronger than during normal times and are less reliable than strategies with explicit defensiveness. They also produce positive returns in normal markets, meaning the cost-of-carry is lower.

We next build two separate portfolios comprised of 'explicit defensive' and 'diversifier' strategies, allocating the same risk budget to each constituent.

Figure 8: Explicit defensive strategy

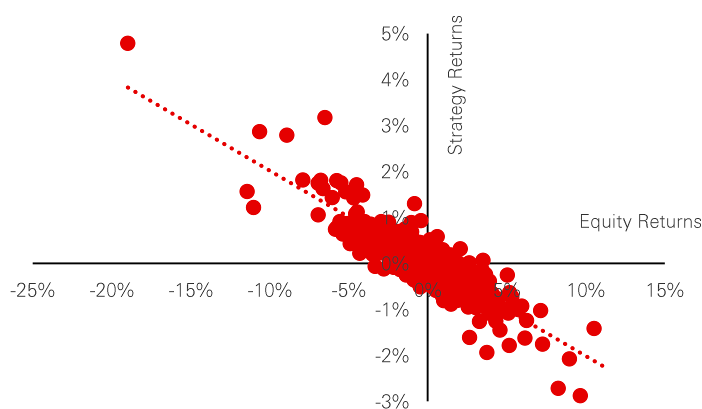
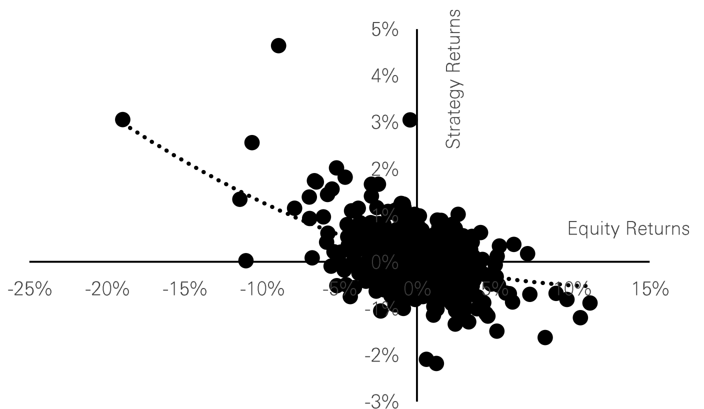



Figure 9: Diversifier strategy




Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

There is an element of convexity to the diversifier portfolio; an attractive feature when trying to mitigate significant drawdowns whilst accepting the risk of losses when equity markets have smaller sell-offs. The insurance premium is visible in the explicit defensive portfolio; having strong reliability and consistency of protection comes at a cost in normal times.

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In reality, most investors will seek to use a combination of the two when building defensive allocations. A 'combination' strategy using an equal weighted blend of the explicit defensive and diversifier portfolios has the following outcomes:

Figure 10: Combining defensive and diversifying strategies

| | | Combination |
|---|---|---|
| **Non-tail** | Defensive return | 0.43% |
| | Defensive consistency | 66.3% |
| **Tail** | Defensive return | 0.97% |
| | Defensive consistency | 93.9% |
| **Full sample** | Risk-adjusted performance | 0.23 |

Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

Of course, investors may wish to tailor the weighting scheme between diversifiers and explicit defensive strategies to suit specific needs when considering the patterns exhibited in figures 8 and 9.

## Concluding remarks

Government bonds remain a critical component of multi-asset portfolio construction, delivering low correlation to equities whilst providing a low-risk, steady-return stream in a liquid and easily accessible asset class. They should not however be the only option for diversification; their ability to systematically diversify equity risk in portfolios – as they did during the last 20 years – having most likely come to an end. For investors with an appetite for alternative investment strategies, there are opportunities to enhance portfolios through a combination of strategies with explicit downside protection and uncorrelated sources of return which can enhance portfolio diversification at the points when it is needed the most.

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## China and India: Shifting sentiments

In recent years, the discourse surrounding the economic growth of both India and China has experienced a significant shift. India has emerged as a more important economic player on the Asian stage, driven by its growth trajectory.

**Philippe Declerck**
Multi-Asset Fund Manager and Head of multi-asset research (Paris)

This positive momentum has been punctuated by several recent achievements and milestones. One such milestone was the successful lunar exploration program, which has resulted in India becoming only the fourth nation to land a spacecraft on the moon, and the first to successfully land on the unexplored south pole of the moon. The feat provides a symbol of India's ascent on the world stage, and remarkably was achieved through a modest budget of approximately $74 million. That is significantly less than Russia's $200 million south-pole lander and NASA's estimated $430 million budget for its planned VIPER rover mission to the lunar south pole.

Other recent milestones include India surpassing China to become the world's most populous country, and overtaking the United Kingdom to claim the position of the world's fifth-largest economy. Keeping in line with the narrative of an ascending India was its hosting of the latest G20 summit, which saw Western leaders actively seeking to build partnerships with the country to support economic and geopolitical ambitions.

Economic growth in India is forecast to be six per cent this year, standing out in contrast to sputtering growth in the West and elsewhere. Tailwinds for continued growth include major multinationals choosing to relocate manufacturing to India as part of efforts to diversify supply chains away from an overreliance on China. Accordingly, India's young and growing workforce offers a compelling option and sufficient scale. Just this month, the CEO of the leading chipmaker behind AI data processing (Nvidia) spent a week touring India and meeting with leaders in support of his interest in building a hub there and leveraging local engineering talent. Such developments, alongside India's ranking as the third-largest hub globally for unicorns, highlight the country's potential to grow its role in industries at the forefront of technology.

Conversely, China has been experiencing a deceleration in its economic growth, primarily attributed to the cautious approach taken by Chinese authorities towards increasing support for the economy. Instead, they have favoured a measured approach to stimulus, which has not fully instilled confidence among investors.

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In our latest Asia Insights

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To return to stronger growth, China can't rely on growing exports exponentially, particularly with other governments and firms seeking to diversify supply chains. Mexico, for instance, has now become the top trade partner for the US. And the more poignant challenge may be the approximately 70 per cent of Chinese household wealth tied up in the real estate sector. Accordingly, declining property values has had a ripple effect across the economy, extending far beyond the financial difficulties being faced by the country's property developers.

China also grapples with other concerning trends, including a shrinking population, rising youth unemployment, and an escalating old-age dependency ratio. These factors collectively contribute to the complexities and uncertainties surrounding China's economic landscape.

Nonetheless, it is imperative to embark on a comprehensive analysis of the prevailing narrative that assigns a diminished weight to China relative to India. Such a holistic assessment is critical to formulating a well-informed perspective on the current economic landscape of both nations. This entails a deep exploration of the underlying expectations reflected in both the bond and equity markets, as well as a thorough examination of various macroeconomic factors and rationales that have steered these evolving trends.

## Government bond markets

When we assess the performance of Indian Government bonds (IGBs), Chinese Government bonds (CGBs), and US Treasuries in their respective local currencies over the past two decades, a notable trend emerges. IGBs have consistently outperformed both CGBs and Treasuries, providing a basis for the prevailing positive sentiment towards India. Still, choosing CGBs over Treasuries has been an obvious choice for the past three years, with Treasuries exhibiting similar returns until 2020 but demonstrating higher volatility.

This analysis requires nuance, however. When we shift our perspective to evaluate the same performance in US dollar terms, a contrasting picture emerges - China becomes the consistent top performer in over the last two decades.

Figure 1: Despite outperforming China over the last decade in local currency terms…

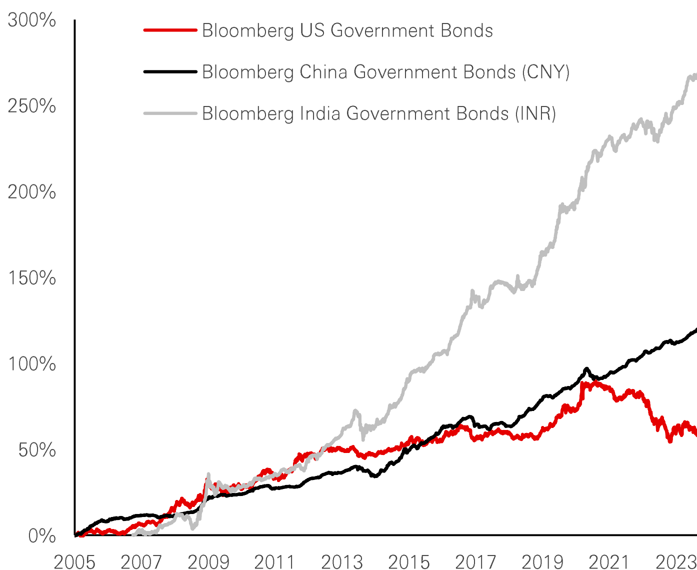
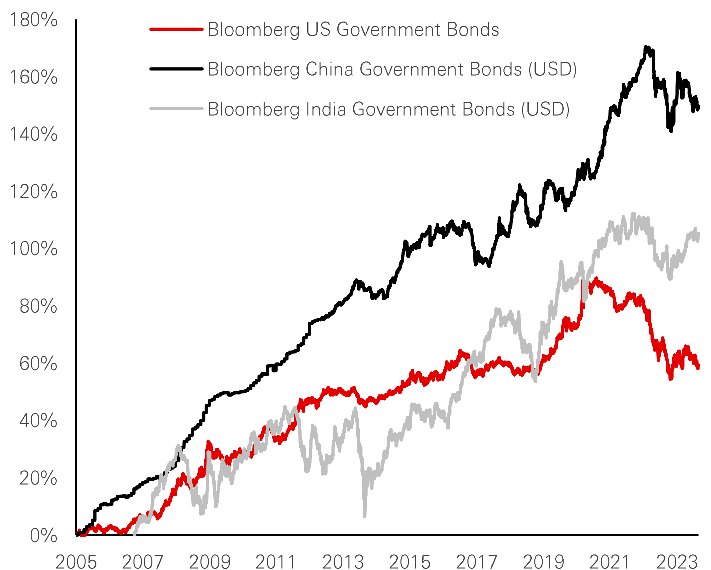



Figure 2: …The IGBs were more volatile and weaker in performance than CGBs




Source: HSBC AM, Bloomberg data, September 2023. **Past performance is no guarantee of future returns.**

While this long track record should at least alleviate concerns of instability as they pertain to Chinese government bonds, investor confidence in the Indian bond markets is certainly on the rise. The recent announcement that India will be included in JP Morgan's benchmark emerging markets government bond indices is expected to attract a substantial influx of foreign capital, estimated at around $25 billion into India's considerable $1 trillion government debt market.

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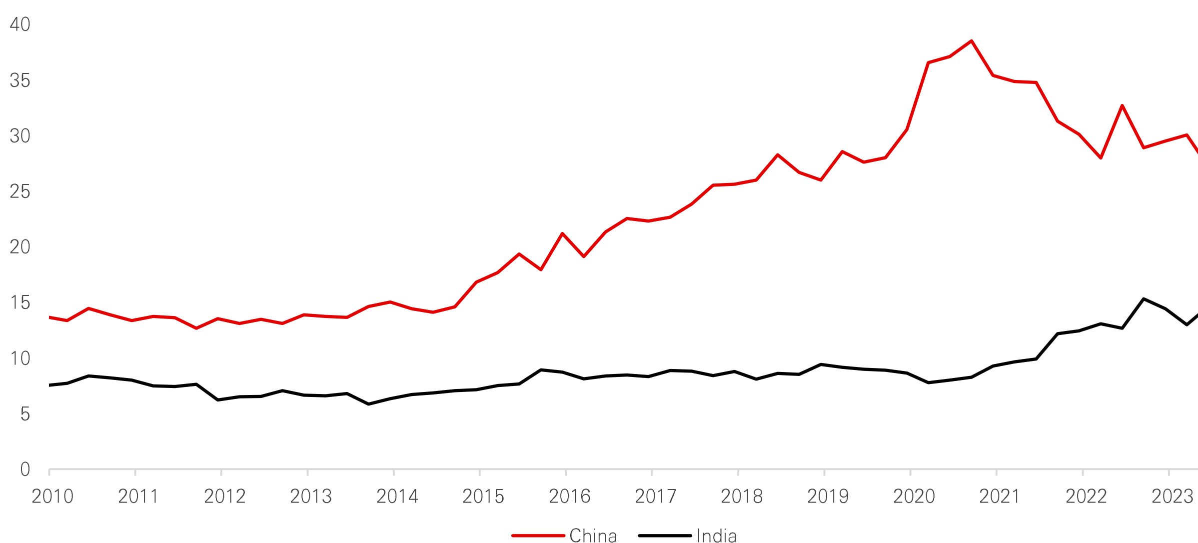
India's weight in these indices is projected to reach the maximum threshold of 10 per cent in the GBI-EM Global Diversified index and just under 9 per cent in the GBI-EM Global index. This development occurs at a pivotal juncture, with investors seeking diversification in their portfolios due to Russia's removal from these indices and the decelerating growth in China.

The inclusion of India in these benchmark indices is expected to pave the way for substantial growth in the Indian bond markets, making it even more appealing to international investors.

## Equity markets

Volatility in China's equity market has been reflected in its weight in the MSCI Emerging Markets index (figure 3). After years of impressive economic growth, China's weighting grew to over a third of the index at its peak. Retracing since 2021 has left its representation at 25 per cent of the index. India's growth trajectory has seen its representation in the index tick up from single digits to 15 per cent in recent years. That growth trajectory means its weighting in the index could begin to approach that of China in the years ahead. Such developments would mark another positive milestone for India, but also offer a potential positive impact for investors in the form of a more diversified index.

Figure 3: China and India share in MSCI Emerging Markets Index




Source: HSBC AM, Bloomberg data, September 2023. **Past performance is no guarantee of future returns.**

Of course, with all of the positive sentiment around future growth, comes more expensive valuations. The gap in valuation between the Indian stock market and other emerging markets mirrors the divergence between the United States and the rest of the world. Indeed, India's stocks are the most expensive among the developing world, trading at around 20-times expected earnings. This aligns with valuations in the US and is twice the earnings multiple of the out-of-favour Chinese stock market.

While Indian stocks are expected to deliver strong double-digit earnings growth this year and next, that pace will be difficult to maintain. Accordingly, forecasts are for earnings growth to slow from there. Even if the long-term growth opportunity is clear, in the near term, any disappointment in earnings growth could challenge price levels.

Those price levels come on the back of strong performance recently in Indian equities. Yet, and in parallel to what we saw when comparing historical government bond performance, local currency and USD returns paint different pictures in relative performance for the India and China equity markets up to now.

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Clearly, local currency returns delivered in China have been less impressive relative to India's Nifty 50 index. Chinese stocks have exhibited considerable volatility, experiencing a decline from their peak levels, particularly in the aftermath of the Covid-19 pandemic. However, in USD terms, that decline has only allowed Indian equities to catch up from underperformance across over a decade.

Figure 4: Equity market returns for China and India in local currency

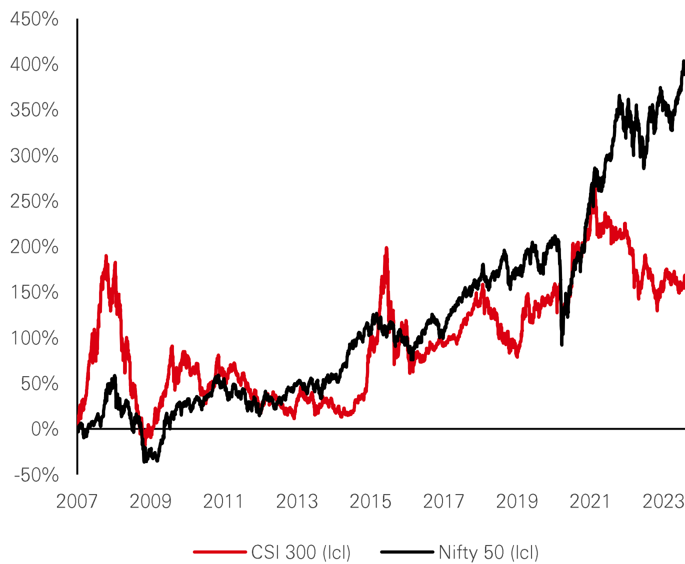
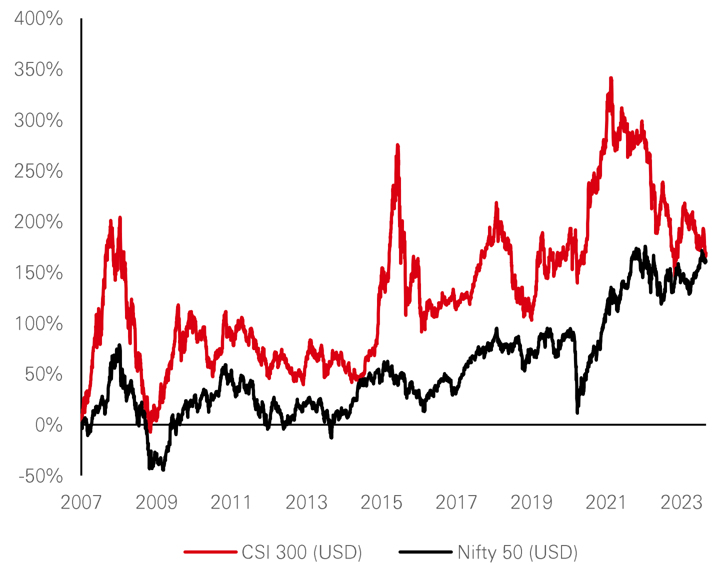



Figure 5: Equity market returns for China and India in USD currency




Source: HSBC AM, Bloomberg data, September 2023. **Past performance is no guarantee of future returns.**

The recent disparity in returns between the two markets could mark a significant shift in growth dynamics from China to India. However, it is important to acknowledge the possibility that this could represent a temporary shift in sentiment, and the gap between the two markets may narrow in the future.

## FX Movements

Foreign exchange rates have clearly been a crucial factor in performance differentials between China and India. It is somewhat surprising that in USD terms, India continues to trail, which can be predominantly attributed to the Indian Rupee (INR) being a one-directional currency over the past 15 years.

The INR's depreciation against the USD has come to a halt and has even stabilised recently. One contributor to this stabilisation appears to be the benefits of lower cost Russian oil, with India being the largest importer of the discounted supply after the EU, US and some Asian countries sanctioned Russian oil imports due to the Ukraine conflict. Indian refiners, responsible for converting crude oil into finished products like gasoline and diesel, became the largest purchasers of Russian oil after surpassing Chinese imports due to demand challenges alongside increased electrification of vehicles in the country. India's ability to avoid importing energy inflation certainly hasn't been the determining factor of the INR exchange rate, but should have helped avoid further weakening. On the other hand, the Chinese Yuan (CNY) experienced a substantial uptrend in the pre- and post-Global Financial Crisis (GFC) period, but since 2014, has displayed considerable volatility and weakened in comparison to the USD.

When comparing the performance of INR and CNY, it is noteworthy that while the INR has appreciated against the CNY on a year-to-date basis, this comes after a significant 25 per cent depreciation since 2017. This disparity makes it somewhat challenging to reconcile the narrative that Foreign Direct Investment has significantly shifted from China to India.

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## Macroeconomic Factors

Looking beyond the capital markets and taking a broader view of macroeconomic factors, it is evident that both China and India have witnessed robust real GDP growth over the past two decades. However, India's GDP per capita significantly lags behind China due to various factors, including China's early lead in infrastructure development.

Figure 6: Real GDP growth

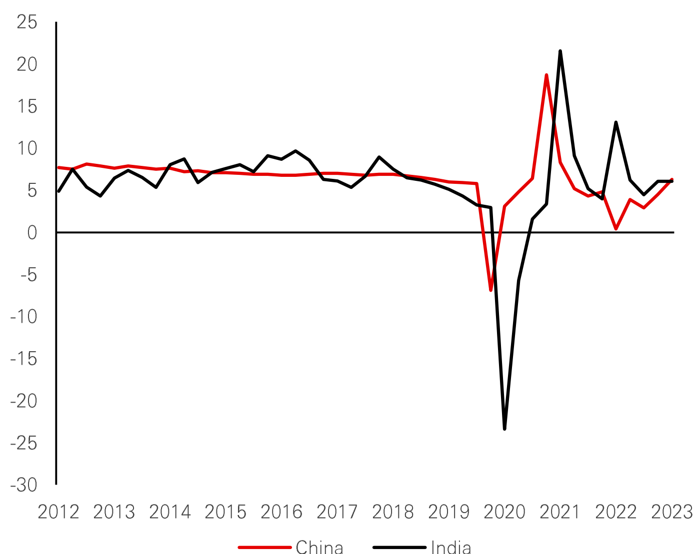
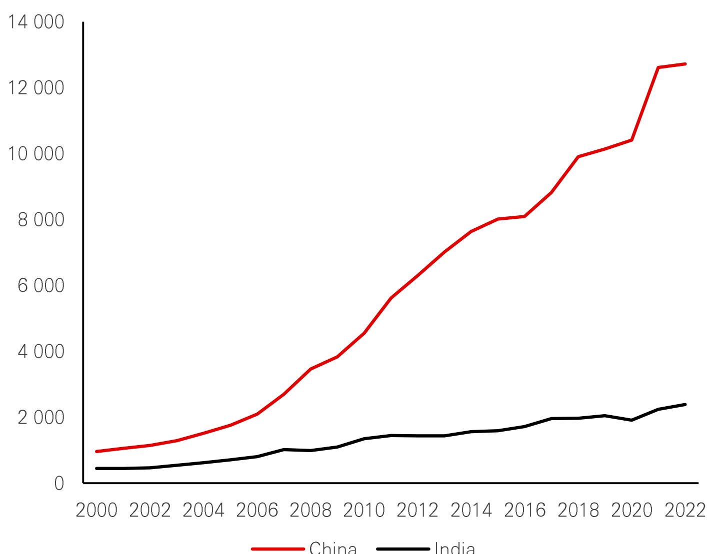



Figure 7: GDP per capita




Source: HSBC AM, Bloomberg data, September 2023. **Past performance is no guarantee of future returns.**

China's accelerated growth on a per capita basis can be attributed to its shift away from a heavy reliance on the agricultural sector and towards a structural transformation driven by high growth in infrastructure investments, manufacturing and exports.

India, on the other hand, is at an earlier stage of its economic transformation. Down from nearly a third of the economy thirty years ago, now less than one-fifth of India's output comes from agriculture – still a sizeable amount, but the majority of output comes from manufacturing and services. The transformation is further supported by the burgeoning startup ecosystem in India, which has benefited from encouraging startup policies in more than 26 states across the country.

Highlighting the early stages of India's transformation, more than half of the population currently depends on the agriculture sector for their livelihoods. Efficiencies can clearly be gained, but for now, disruptions in India's monsoon patterns that are occurring have posed challenges to crop yields. These challenges have had a ripple effect on the Food and Beverage Consumer Price Index, which reached an all-time high of 10.6 per cent in July 2023.

Separately, growing pains are occurring in the startup ecosystem, with a fundraising slowdown over the past 15 months resulting in significant valuation markdowns and legal and financial challenges for startups. Without being addressed, these factors could potentially impede India's growth trajectory.

Nevertheless, India continues to hold promise, driven by its demographic dividend and economic reforms. Policymakers have already taken significant steps in the manufacturing sector through initiatives like 'Make in India,' leading to a 57 per cent increase in FDI inflows in the manufacturing sector from 2014 to 2022, compared to the previous 8-year period. The realization of its potential now largely hinges on the country's infrastructure development, particularly planned enhancements through an estimated $1.4 trillion allocated for the National Infrastructure Pipeline.

China's near-term growth trajectory appears to depend on the possibility of substantial fiscal stimulus, which policymakers seem reluctant to enact. As evidenced by returns and investment flows, it appears that investors may no longer be willing to wait patiently for fiscal commitments to materialize in China.

[1]Urals is the most common export grade of crude oil from Russia and an important benchmark for the medium sour crude market in Europe.

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**Conclusion**

India and China present unique growth stories and challenges. While India's positive narrative warrants attention, being selective to pursue the most attractively priced opportunities may be wise. Separately, the less favourable sentiment surrounding China may be overstated. There are distinct investment prospects in each market.

A prudent investment strategy should encompass a diversified portfolio that includes exposure to both India and China. An active approach will allow for shifting weights as markets change.

Exposure to other emerging markets where intriguing growth narratives are likewise unfolding is also important. Elsewhere in Asia, for instance, Indonesia is actively looking to establish itself as an electric vehicle manufacturing hub, positioning to benefit from the global shift towards electric mobility. With over half of the world's nickel resources - a crucial component in the production of lithium-ion batteries - Indonesia has a strategic advantage to capitalise on the automotive sector's green transition.

There are many promising opportunities in Asian and broader emerging markets. Investment success can hinge on diligent research and a comprehensive understanding of the various factors at play.

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