Federated Hermes Sustainable Global Equity

Quarterly Report
Q1 2023

Federated Hermes
Limited

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Introduction

Welcome to our Sustainable Global Equity Quarterly Update

In this issue we focus on China's 'Great Reopening' and consider its likely impact both locally and globally. After nearly three years of sticking rigidly to its zero-Covid policy, China's sudden relaxation of its approach is as welcome as it was unexpected.

As we explain, the move has major implications – both for China itself and for the many countries whose economic wellbeing is affected by the health of the Chinese economy. In the short term, the relaxation of rules should see an easing of supply-chain pressures and a surge in foreign travel that will be a welcome boost to international tourism. Meanwhile, evidence of a new approach to driving economic growth is promising from an investment standpoint.

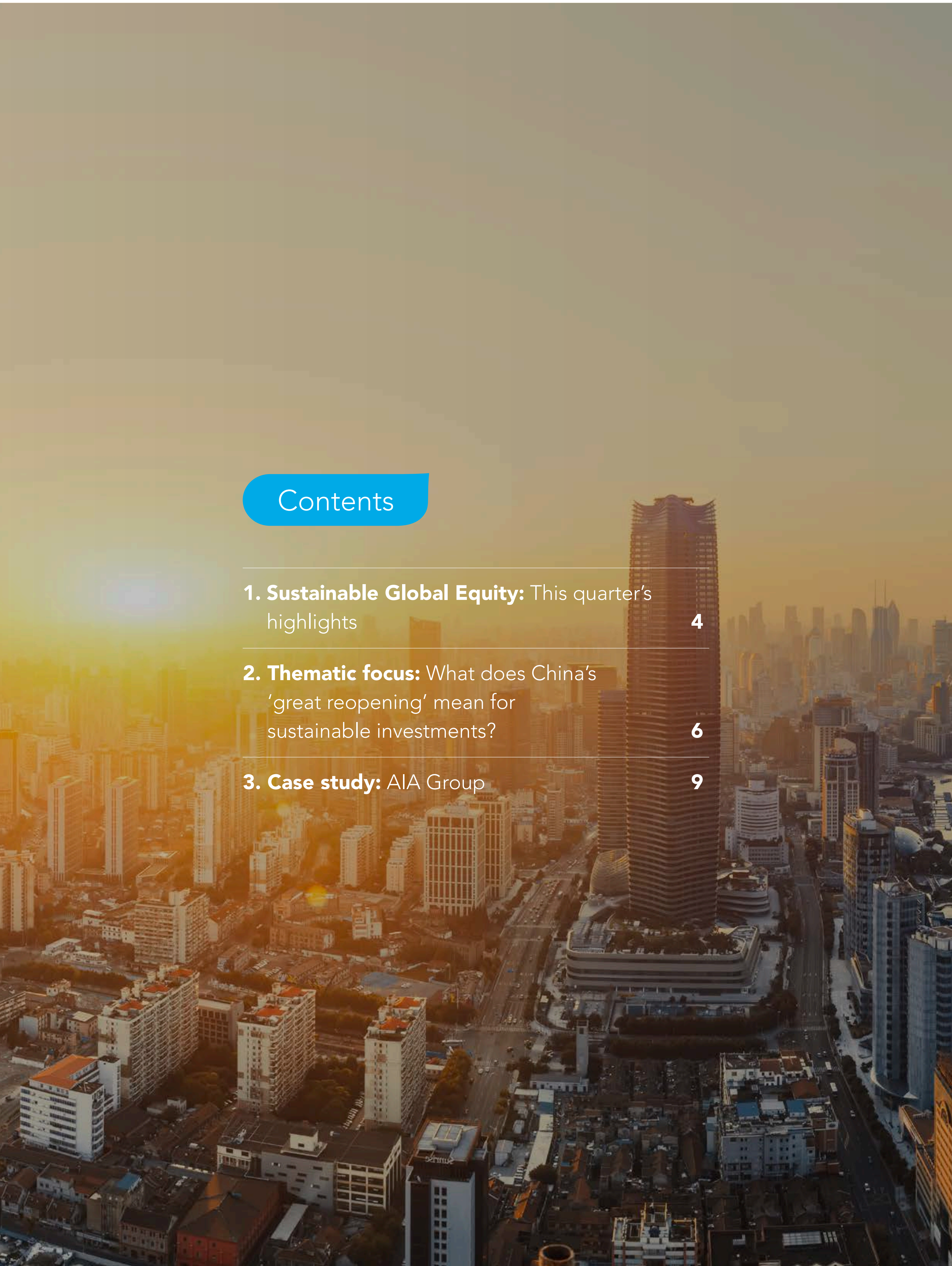
Of course, there are risks – political, corporate and demographic. We unpack the key issues in our Thematic Focus section.

As always, we begin the update with an overview of the strategy's latest environmental and engagement data.

Meanwhile, to close this issue, we highlight our Hong Kong-listed portfolio holding AIA Group. This regionally dominant life insurance company should benefit both from increased freedom of movement in the short term and from the ongoing expansion of China's middle class in the longer term. Read our case study to find out more.

Our vision for sustainable long-term investing in global equities

Federated Hermes Sustainable Global Equity is a high conviction, fundamental strategy targeting sustainable companies: profitable businesses whose products, operations and activities help create a more sustainable future. Our ability to identify these investment opportunities – and engage companies to sustain and strengthen their positive actions – is reinforced by best-in-class ESG and stewardship integration. Through this approach, we seek long-term transformative change and financial outperformance.



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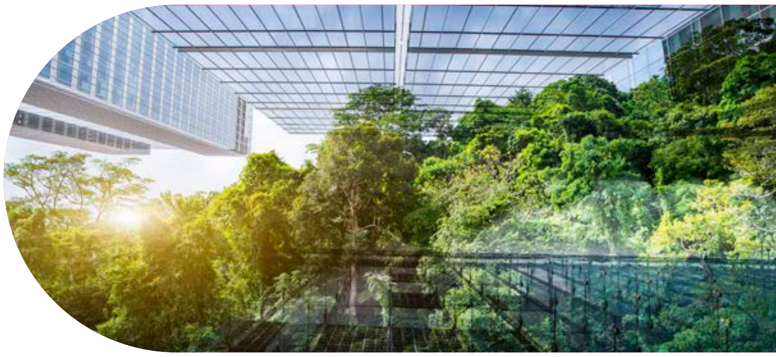
SECTION 1: SUSTAINABLE GLOBAL EQUITY

This quarter's highlights

Exposure to sustainability themes

All portfolio holdings fit into one or more of our four investible themes, each of which consists of several sub-themes.

As at 31 December 2022, exposure to these themes was as follows:



Environmental preservation

Sub themes include:
- Energy transition
- Biodiversity
- Future mobility
- Decarbonisation
- Electrification

Portfolio weighting: **21%**

Health and wellbeing

Sub themes include:
- Life sciences
- Pharmaceutical innovation
- Healthy and active lifestyles
- Medical equipment

Portfolio weighting: **21%**

Efficient production and resource usage

Sub themes include:
- Circular economy
- Better and faster decision-making
- Water preservation
- Supply chain efficiency
- Green materials

Portfolio weighting: **28%**

Social inclusion

Sub themes include:
- Democratising access to goods and services
- Financial inclusion
- Access to education
- Digitalisation

Portfolio weighting: **26%**

Source: Federated Hermes, as at 31 December 2022. The sub-themes listed above are not an exhaustive list. The portfolio weightings are subject to change.

Environmental footprint

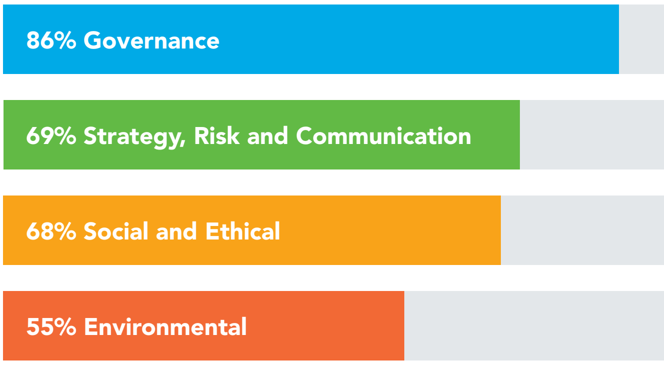
The strategy aims to have a smaller environmental footprint than the benchmark, the MSCI All-Country World Index. As at 31 December 2022, the portfolio's carbon, waste and water footprints measured as follows: :

	Portfolio (tonnes per US$m invested)	Benchmark (tonnes per US$m invested)
CO_2 footprint (scope 1, 2 & 3)	115.4	213.9
Waste footprint	3.2	11.1
	Portfolio (m^3 per US$m invested)	Benchmark (m^3 per US$m invested)
Water footprint	10k	21.2k

Source: TruCost, Federated Hermes, as at 31 December 2022.

Engagement themes

The team's engagement efforts over the last 12 months covered 93% of the strategy's AUM. The breakdown by theme was as follows:



Source: Federated Hermes, as at 31 December 2022.

The team's engagement efforts over the last 12 months covered **93%** of the strategy's AUM.

Portfolio positioning

As at 31 December 2022, the portfolio's top 10 active positions were as follows:

Holding	Portfolio active weight (%)*
Microsoft	3.6
Mastercard	3.4
Thermo Fisher	3.4
Novo-Nordisk	3.2
Wex	3.0
RELX	2.9
Costco Wholesale	2.9
Adobe	2.8
AIA Group	2.8
PTC Inc	2.7

Source: Federated Hermes, as at 31 December 2022.

*The portfolio active weight is calculated as the strategy weight minus the benchmark weight.

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The above does not represent all of the securities held in the portfolio and it should not be assumed that the above securities were or will be profitable.

SECTION 2: THEMATIC FOCUS

What does China's 'great reopening' mean for sustainable investments?

China's new direction should act as a catalyst for emerging markets in particular (and global growth in general), while retaining a focus on common prosperity and decarbonisation, says **Martin Todd, Portfolio Manager of the Federated Hermes Sustainable Global Equity strategy**.

Fast reading:

- The abandoning of China's strict zero-Covid policy and the announcement of a range of stimulus measures should drive a resurgence in outbound travel, an easing of global supply-chain pressures, and an increase in growth both domestically and more widely.
- While there are potential pitfalls, the change of approach demonstrates that Xi Jinping is not inflexible, and that the Chinese leadership recognises that its goal of common prosperity is difficult to achieve unless the country's economy is growing.

What may prove to have been one of the most significant events of 2022 happened in the final weeks of the year, as China quietly – but no less unexpectedly – consigned its 'zero-Covid' policy to history. Around the same time, at the central economic work conference in December, the country's leadership signalled a shift to a more pragmatic, pro-growth economic policy, supported by a series of stimulus measures designed to kickstart the Chinese economy after a moribund 2022.

The country's commitment to what is rapidly becoming known as the 'great reopening' ends almost three years of strict lockdowns and significant resultant disruption both to China's domestic economy and to global supply chains. In this report, we provide our view on what this change of approach means for global markets in general, and for sustainable investing in particular.

A return to health – Covid allowing

While China's aggressive anti-Covid measures appear to have been successful in containing the spread of the virus (at least for a time), the side-effects have been acute. Lockdowns have severely hampered the Chinese economy, with estimated GDP growth in 2022 only around 3%, against an official target of 5.5%. This represented a dramatic fall from the 2021 figure of 8.1%, which was slightly below China's long-term average of over 9%.[1]

As well as damaging inbound tourism and decimating China's foreign student population, more importantly, curbs on movement hit business travel domestically and internationally. This hampered the efficiency of Chinese firms and impacted the ability of Chinese suppliers to maintain effective relationships with overseas clients.

The easing of restrictions should improve the situation, while the country's leadership hopes the use of both fiscal and monetary policy to increase domestic demand and boost consumption will ensure its key economic targets for 2023 are achieved.

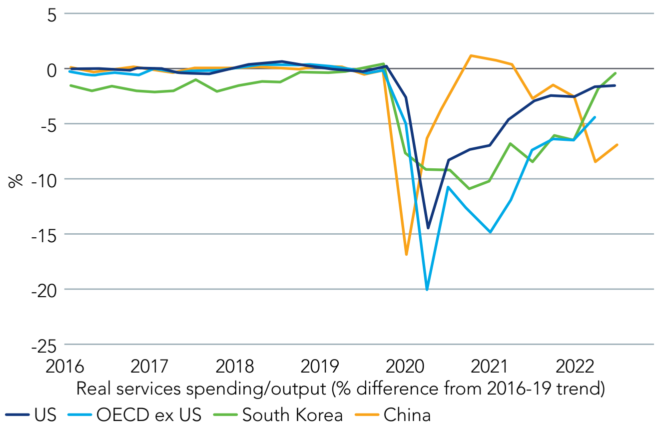
The likelihood of a Covid wave in the wake of reopening could potentially drag on the economy in the first quarter. Certainly, data from November showed a weakening of activity, with industrial production, retail sales and fixed asset investment all falling and failing to match already-low expectations. However, evidence from Hong Kong and Taiwan's experience suggests that new cases may peak before January is out. What's more, having enjoyed little in the way of Western-style stimulus to help them through lockdowns, Chinese citizens – and businesses – will be keen to get back to work.

The country's commitment to what is rapidly becoming known as the 'great reopening' ends almost three years of strict lockdowns and significant resultant disruption both to China's domestic economy and to global supply chains.

[1] 'The World Bank in China'. Published on the World Bank website. Accessed 17 January 2023. .

Again, past evidence, this time in terms of China's rapid recovery from its first Covid outbreak in 2020, indicates that services output at least will bounce back quickly, as figure 1 below illustrates.

Figure 1: Real services output recovered quickly following initial Covid outbreak in China in 2020



Source: Haver Analytics, Goldman Sachs Global Investment Research, as at 16 December 2022.

Assuming overall economic activity rebounds and that the economy gets back into its stride, the implications will be not just local but global. We expect the great reopening to have three key consequences: a resurgence of outbound (and inbound) travel, an easing of supply-chain pressures, and increased growth – domestically and globally.

The great wall comes down: Outbound and inbound travel

Chinese borders reopened for outgoing travel on 8 January, easing severe restrictions in place since May 2022. These rules had forbidden citizens from going overseas for 'non-essential' reasons, turning already dwindling levels of movement since 2020 into a de facto international travel ban.

According to the China Tourism Academy, 155 million Chinese travelled abroad in 2019, representing around one fifth of all international travellers.[2] While numbers are unlikely to reach pre-pandemic levels this year, experts believe they could be back to around 50% of 2019 figures by the summer.

A wave of infections, along with restrictions on Chinese citizens entering other countries due to the perceived risk they present, may have a dampening effect initially. However, once outbound travel resumes in earnest, international businesses in relevant sectors including hotels, airlines and visitor attractions should experience a noticeable uplift.

Inbound travel rules were also updated, removing the need for quarantine and reintroducing the visa-free policy for eligible visitors, including foreign workers (although tourist visas have yet to be reinstated).[3] As inbound travel into China becomes easier, expect business travel into the country to pick up rapidly. This should improve relationships with international customers, increasing dealmaking and new projects. At the same time, the return of China's international workforce should also facilitate business and boost productivity.

Easing the pressure: Supply chains

Given that a significant proportion of global production is based in China, reinvigorated industrial activity and improved communication with the rest of the world should ease supply-chain issues worldwide. What's more, this should happen quite rapidly; evidence from the Global Manufacturing PMI Suppliers' Delivery Times Index, as seen below, shows that supply-chain disruptions in China were short-lived after both the national lockdown in early 2020 and after the Shanghai lockdown in 2022.[4]

[2] 'China reports growth in outbound tourists in 2019', *Xinhuanet*, as at 11 November 2020.
[3] 'Foreign travel advice: China'. Published on the GOV.UK website, accessed 17 January 2023.
[4] Global Manufacturing PMI Suppliers' Delivery Times Index, Goldman Sachs research, as at December 2022.

Figure 2: Supply-chain disruptions were short-lived during pandemic

Source: S&P Global PMI Index, Bloomberg, as at January 2022.

Assuming pressure eases, this should help to put a lid on the supply-chain inflation that has been a major issue for many sectors since the start of the pandemic, as well as ending the long delays for products ranging from cars to consumer electronics.

Admittedly, for China, this may not mean a complete return to its role as supplier to the world. Geopolitical concerns had already led to some reshoring and 'friendshoring' – relying on suppliers in countries with shared value – of supply chains from China before Covid hit. The country's long semi-closure has exacerbated this trend, and for both political and logistical reasons some of this impact may not be reversed.

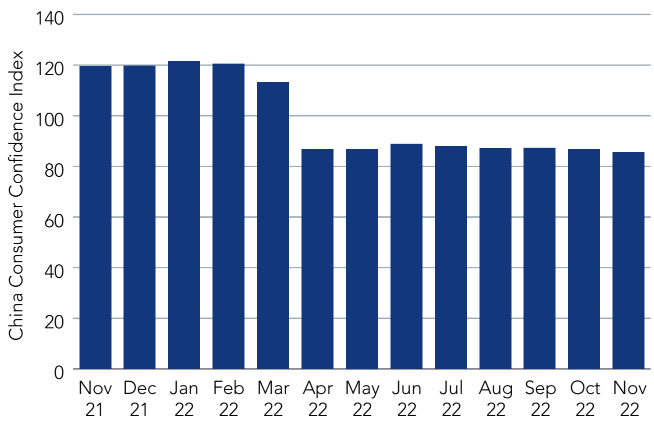
Restarting the engine: Global growth

Thanks to its size and rapid development, China had been a major driver of global growth for 20 years before the pandemic hit. Although that trend had slowed somewhat as the country's economy matured, Chinese GDP growth was still close to +6% in 2019 – well above the global average.

Given the constraints China's economy will still be operating under, GDP growth is unlikely to surpass mid-single digits; Goldman Sachs estimates a 200bps boost from reopening, putting its new 2023 growth forecast at +5.5%.[5] Even so, that represents a significant jump on its 2022 forecast of +2.2% and would be enough to provide a major boost to demand generally – and, by extension, to equities.

The great reopening should unleash three years of pent-up domestic demand for goods and services in China. Until recently, consumer confidence in China had been on the wane as a result of the zero-Covid policy and its damaging impact on the economy. The consumer confidence index experienced a sharp drop in April following the Shanghai Covid outbreak and has remained in similar territory even amid another outbreak in November 2022, reaching a record low of 85.50 points as shown below.

Figure 3: China consumer confidence lingers in lukewarm territory at end of 2022



In China, the consumer confidence index is based on a survey of 700 individuals over 15 years old from 20 cities all over the country. This composite index covers the consumer expectation and consumer satisfaction index, thus measures the consumers' degree of satisfaction about the current economic situation and expectation on the future economic trend. The Index measures consumer confidence on a scale of 0 to 200, where 200 indicate extreme optimism, 0 extreme pessimism and 100 neutrality.
Source: Trading economics, National Bureau of Statistics China, as at November 2022, and Our World in Data, as at November 2022.

[5] Goldman Sachs research, as at December 2022.

Assuming the great reopening does encourage a surge in domestic demand, the impact will be positive for companies globally as well as locally. For example, many luxury goods companies popular in China are based in Europe, while consumer brands and companies including KFC, McDonalds, Coca-Cola, Procter & Gamble and Carrefour derive a significant proportion of their business from their Chinese operations. In fact, Goldman Sachs estimates that 25% of European sales are to Asia, half of which are to China.[6] With one-eighth of their performance directly driven by China, the positive implications of a successful Chinese reopening for European corporates are obvious.

A new landscape: China beyond the reopening

With a lot of risk already priced in and plenty of potential upside from reopening, Chinese stocks were still looking relatively cheap as the new year arrived. The MSCI China index lagged the developed market index by 26% in the first ten months of 2022, and although it jumped 29% in November as markets perceived a zero-Covid U-turn, that still left Chinese stocks undervalued.[7]

However, aside from attractive prices and beyond the great reopening story, the main reason to invest in China is that the country's economic landscape has changed forever. Xi Jinping has made clear there will be no return to the historical debt-fuelled growth model seen during the global financial crisis.

China should now continue its rapid transformation away from a command economy built on heavy industry, and towards a more open, consumer-focused economic model. Instead of an overreliance on real estate and infrastructure to drive growth, it is likely to focus more on the digital economy, especially the previously lagging analogue-to-digital shift for traditional enterprises. A move towards greater efficiency and automation in these sectors is likely to accelerate, as this plays well to government policy.

At the same time, China seems ready to look outwards to bring this transformation to fruition: "Foreign investments are welcome in China, and the door to China will only open up further," announced the country's Vice-Premier, Liu He, at the World Economic Forum annual meeting in Davos on 17 January.[8]

China's sustainable future

One thing that hasn't changed is China's commitment to the policy of common prosperity. This is a social project within which property, education and healthcare for all are prominent elements.

Decarbonisation also remains a key goal, reflected not only in policy and regulation but in China's position as a global leader in transition technologies for renewable energy and the green economy.

The heatmap below, which uses 2018 data and shows the provinces with the highest carbon emissions, illustrates how crucial this goal is and, perhaps, how far the country has yet to go in their pledge to reach carbon neutrality by 2060[9].

Figure 4: China's CO_2 emissions by province

Source: CLSA Investment Group, Wind, as at 2018.

[6] Goldman Sachs research, as at December 2022.

[7] MSCI China Index, as at November 2022.

[8] 'Davos 2023: China reopens its doors with investment pitch to global elite', *Reuters*, as at 17 January 2023.

[9] The United Nations, UN News, as at 21 September 2021.

Meanwhile, with the property bubble having burst, China's ever-growing middle class will be looking elsewhere for a place to put their household savings. As a result, the focus for personal investment will move from property to financial products.

The key element to watch will be whether there will be a renewed trajectory and pace to the economic reforms started a few years ago, which subsequently took a backseat as Covid took hold. These include changes to the way state-owned enterprises (SOEs) are owned, organised and regulated, as well as land reform. Globally, countries rarely cross the US$10,000 per capita income mark without these kinds of major institutional reforms. While ¬China has already passed this economic milestone, as drivers like the demographic dividend, property speculation and excessive leverage unwind, it will need new, more sustainable drivers to continue to prosper. These will only be made possible by staying committed to fundamental changes to its economic model.

Avoiding the pitfalls

While China's new direction is promising for markets, investors need to be aware of several potential potholes and roadblocks to navigate the road ahead.

Geopolitics: Political sensitivity and tensions with other powers, particularly over Taiwan, continue to be an issue. This in turn has brought about the prioritisation of a secure semiconductor supply chain by the US and other Western countries.

Domestic politics: Xi Jinping has tightened his grip on control by appointing allies to key positions. The regime continues to favour SOEs, creating a challenging environment for private firms. However, the loss of traditional drivers including the demographic dividend enforces the need for more pro-business policies and less command and control, to avoid stagnation.

Corporate: Engagement with some Chinese companies remains difficult, as they continue to be something of a closed book. Some cyclical companies are clearly highly leveraged, often delivering returns below the cost of capital.

Property sector: China's property sector shrank by 5.1% in 2022, making it one of the biggest drags on the Chinese economy.[10] Its performance affects the global price of materials including copper, steel and iron ore. However, a 16-point rescue plan was announced in November, with access eased to financing.[11] As a result, the drag on GDP from the housing market should progressively reduce.

Demographics: China's birth rate has long been in decline, but 2022 saw a significant milestone as the country's population fell for the first time in 60 years.[12] This is being seen by many as a symbolic end to the so-called 'demographic dividend' – the economic growth potential derived from a large working-age population. With the fading out of this advantage, China will need to ensure other drivers take its place.

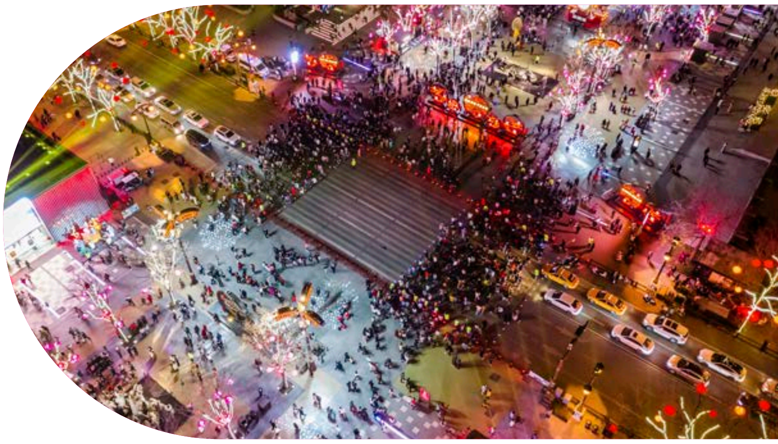
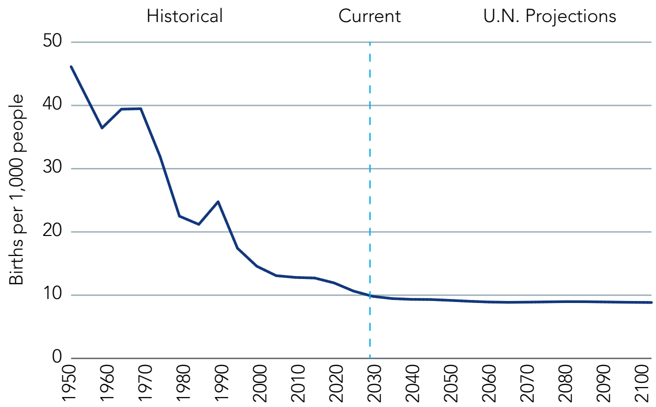


Figure 5: China's falling birth rate sees population growth stall, removing demographic dividend



Source: United Nations World Population Prospects, as at 2022.

Investment implications

China's reopening demonstrates that despite Xi Jinping's iron grip on power, the Chinese leadership can change its mind and adapt to new circumstances when necessary. The government's new approach goes further than simply accepting the failure of its zero-Covid policy, recognising that common prosperity is difficult to achieve if the economy isn't growing. This makes us cautiously optimistic for China's future investment potential.

China's reopening demonstrates that despite Xi Jinping's iron grip on power, the Chinese leadership can change its mind and adapt to new circumstances when necessary.

Ultimately, the Chinese reopening is a catalyst for emerging markets more broadly (as well as for overall global growth). Most global equity funds are underweight emerging markets: Given the boost China should provide, we believe that is a missed opportunity.

[10] 'China's property sector shrinks 5.1% in 2022 – NBS', *Reuters*, as at 18 January 2023.
[11] 'China's 16-Point Plan to Rescue Its Ailing Property Sector', *Bloomberg*, as at 13 November 2022.
[12] 'China's population falls in historic shift', *Financial Times*, as at 17 January 2023.

CASE STUDY

AIA Group

A Hong Kong-listed American insurer focused on the Asian market

Investible theme and sub-theme: Social, Financial inclusion

Within developing economies, access to financial services such as life insurance and investments can be a key driver of prosperity and wellbeing. AIA is the largest publicly-listed life insurance and securities group in Asia, and, as such, we believe it's well positioned to benefit from the increasing demand for financial products from the region's growing middle class.

By 2030, over

70%

of China's population could be middle class which could create a potential addressable market of nearly

760M people.

Aiding Asia's prosperity

AIA has been present in China since 1992. It now fully owns its Chinese business and is ready to pursue the vast opportunity offered by the liberalisation of the country's financial markets. Despite China's stalling population, the country's increasing prosperity will see its middle class continue to grow significantly over the next decade. In fact, according to the World Bank, by 2030, over 70% of China's population could be middle class.[13] That would create a potential addressable market of nearly 760 million people for AIA in China alone.

The company is also present in 17 other markets in Asia, and is in either first or second position in its sector in them all. Not least of these is India, whose own middle class could surpass China's in size in the next decade.[14]

A clear competitive advantage

Founded over a hundred years ago in Shanghai as American Asiatic Underwriters, AIA boasts strong brand recognition within the APAC region and has a proven track record in pricing risk. As well as life insurance, it offers retirement planning, wealth management and investments through a strong network of exclusive agents. More than half of the firm's business is processed digitally, reducing fraud, improving alignment with regulation, and enabling remote training of agents.

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The ESG case

- **Social:** Financial inclusion is central to AIA's business model, as the firm provides access to life insurance policies with healthcare cover to a customer base that previously wouldn't have had this safety net. It is recognised as a good employer, offering competitive packages to agents and over-indexing on female employees versus its peers.
- **Governance:** Overall governance metrics are strong, and the company has an open and accessible leadership team who are readily engaged on issues. AIA is in the top quartile for disclosure in its sector and has robust anti-bribery and corruption and data privacy policies in place.

How China's reopening will impact the business

Reopening should benefit AIA twofold:

- Many policies sold by AIA in Hong Kong were previously targeted at mainland Chinese, who must be physically present for purchase. The return of greater freedom of movement from mainland China to Hong Kong should therefore be positive for the company.
- The Chinese government's new approach and stimulus measures should drive renewed growth. This in turn should drive the ongoing expansion of China's middle class, who are a key target market for AIA's products and services.

[13] 'World Reimagined: The Rise of the Global Middle Class', *Nasdaq*, as at 9 July 2021.
[14] United Nations, as at July 2022.

The above does not represent all of the securities held in the portfolio and it should not be assumed that the above securities were or will be profitable.

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The fund has environmental and/or social characteristics and so may perform differently to other funds, as its exposures reflect its sustainability criteria.

Investments in emerging markets tend to be more volatile than those in mature markets and the value of an investment can move sharply down or up.

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