



Investment Outlook

Year-end review and 2018 outlook

December 2017

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HSBC 
Global Asset Management

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Message from the Global CIO

Chris Cheetham

Global CIO, HSBC Global Asset Management

Welcome to our 2018 investment outlook.

It's been another good year for investors with strong returns having been delivered across a broad range of asset classes and investment strategies during 2017. Some commentators will no doubt have been surprised by this positive outcome. At the start of the year many economists feared that a combination of political instability with ongoing economic uncertainty would lead to financial market volatility and disappointing investment returns, but the year has not worked out this way. Before addressing the outlook for 2018 it is important to understand how and why we have arrived at this point. So what has been behind the continuing bull market in risk assets?

While some investors have been climbing a 'wall of worry', in our view market performance reflects what might be termed rational exuberance. Given the fundamentals, markets have justifiably performed well. First, we have been enjoying a genuinely 'Goldilocks' economic environment with the world economy experiencing strong and synchronised growth across the developed and emerging world. In addition, and to the surprise of investors and policy makers alike, cyclical inflation pressures have been remarkably subdued so that inflation expectations have been driven out of market pricing. As in the tale of Goldilocks and the Three Bears, the economy has been "not too hot and not too cold". Perhaps not surprisingly given this combination, corporate profitability has been strong.

Second, reflecting the lack of inflation pressures, economic policy has remained very supportive. Or, put another way, the long-awaited mean reversion in interest rates is still long-awaited. Third, as we noted this time last year, the valuations of risk assets at the beginning the year were relatively attractive; when adjusted for current and prospective real interest rates, risk premia were at normal or even above normal levels.

As we head into 2018, the key question for investors now, of course, is whether this market-friendly economic environment can continue? It's hard to know, as ever, but as things stand today the economic data remains fairly encouraging. However, our sense is that the environment could get somewhat more difficult from here, principally as inflation pressures gradually build in what should remain a fairly healthy environment.

An even more important question for investors to reflect on is how much of the good news on the economy is already discounted in market pricing. Some observers might argue that after a year of such strong market performance, it is reasonable to assume that "everything is overvalued", but we don't think this is quite right. On the basis of our proprietary, cross-asset valuation framework, the risk premium in both global and emerging markets continues to look attractive.

However, as we have discussed in previous outlooks, today's financial markets are best described as being in a "fragile equilibrium". Market pricing is not as generous as it was. The key risk comes from a meaningful pick-up in cyclical inflation that forces policy makers to tighten more aggressively, in particular in the US, than is currently discounted. Given that current market risk premia leave little margin for error, a major 'rate surprise' might require a significant market adjustment to restore 'pricing equilibrium'. It follows that it will be important to remain vigilant for evidence that this scenario is materialising, even if, for the time being, the carry opportunity in global equities and emerging markets continues to look good.

As always, we believe that an active, structured and disciplined approach to investment strategy will serve our clients well.

In this Investment Outlook, Joe Little (Chief Global Strategist), Xavier Baraton (Global CIO Fixed Income, CIO HAIL), Bill Maldonado (Global CIO Equities) and Jonathan Curry (Global CIO Liquidity), explain how the outlook for 2018 is shaping our key investment conclusions. I hope you enjoy our report.

Chris Cheetham

Global CIO



Macro and multi-asset outlook

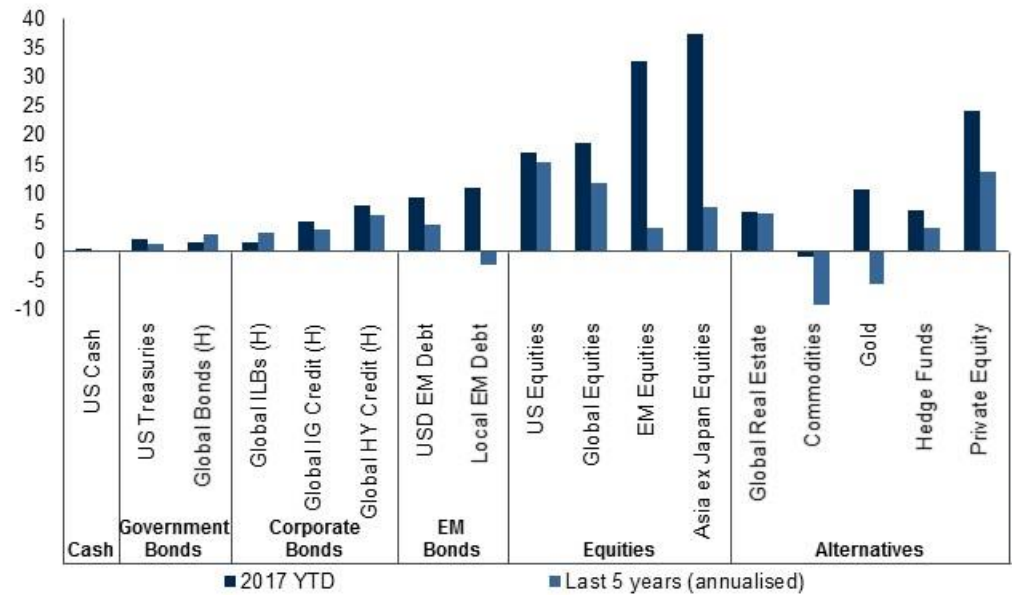
Q&A with Joe Little
Global Chief Strategist

How have major asset classes performed in 2017?

2017 has been a year of bumper returns for investors. Total returns have been surprisingly strong across a whole variety of asset classes (see figure 1). In ‘safety’ asset classes, like global government bonds, we have seen positive single-digit returns and in riskier parts of fixed income, total returns have been just under 10%. Further out on the risk spectrum, total returns are even higher. Global equities have delivered over 15% and emerging markets above 30% in US dollar terms.

These are impressive annual returns and, with hindsight, it has been a great phase to be an asset allocator! What’s more, when we look back over the last few years, cumulative returns look pretty strong in selected parts of the opportunity set. Global equities, for example, have returned an annualised 10%+ over the last five years.

Figure 1: Asset-class performance
%, USD Total Returns



Source: Bloomberg, HSBC Global Asset Management. Data as of end October 2017.

Past performance is not a guarantee of future performance.

What is behind this phase of strong total returns?

A key question for investors is: what has driven this phase of strong returns? Understanding the drivers of market performance will help us assess the sustainability of recent trends. We believe there are three elements at work.

First, investors have been surprised by lower-than-expected interest rates. Since the financial crisis, economists have repeatedly been confused by the low level of inflation rates across the global economy. This means that the rate profile that has actually been delivered is much more dovish than virtually everyone assumed. We have been living in a regime of “lower for longer” interest rates. This is key because a low inflation/low rates mix has anchored total returns in government bonds and been the foundation for strong returns across risk assets.

Second, we have been climbing the “wall of worry” in risk markets. It has been a long and gradual economic expansion and bull market but, despite the persistent outcome of ultra-low market volatility across asset classes, investors have found themselves worrying about a whole host of factors. At the start of 2017, for example, investment strategists were paralysed by the “unusual uncertainties” in the economic and political outlook. Ultimately, growth worries or political fears proved to be “risks that weren’t”. Either the feared outcome didn’t materialise (French and Dutch elections) or it did (Federal Reserve balance-sheet tapering) but the market implications were a lot more benign than many perceived. It has been a financial bull market built on anxiety.

Third, at least over the last 18 months, macro-economic fundamentals have been “Goldilocks”. The growth data has been good, but not hot enough to warrant a more aggressive move from policymakers. The environment has been one of synchronised growth, low inflation, and booming corporate profits (up 15% this year). All this means is that the strong investment returns in 2017 are largely a consequence of Goldilocks and other supportive factors being delivered. Figure 2 shows global equity returns split by key components. We think that over 90% of global equity performance in 2017 can be explained by better corporate fundamentals. The percentage is lower in emerging market (EM) equities, but it is still the main driver of returns.

Contrary to the worry of many analysts that recent performance has pushed all risk assets into overvaluation territory, we disagree. Our analysis suggests that much of 2017 performance and what has happened over the last five years in many asset classes can be directly linked to fundamentals and the policy environment. It has not been a phase of “irrational exuberance”, but more of “rational exuberance”.

Figure 2: Global equity return decomposition 2013-2017 YTD



Source: MSCI, HSBC Global Asset Management. Data as of end October 2017.

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How should we think about what comes next?

Looking forward, investors face two key questions. First, can this Goldilocks economic regime sustain itself? And, second, perhaps even more importantly, how much Goldilocks is currently being incorporated into market psychology?

So, what is the outlook for the global economy now?

As we have said, the global economy has been in a “Goldilocks” environment in 2017. We have had a phase of surprisingly good global growth, low inflation, supportive policy, and strong corporate profits. But now that Goldilocks has become the consensus macro theme, can it persist?

Our conclusion is that the forces that have driven Goldilocks economics are now beginning to wane, and the scope for a much better than expected economic environment in 2018 (as it was in 2017) seems more limited. We call this new economic environment “less than Goldilocks”.

Globally, growth continues to be relatively strong and synchronised across the advanced and emerging economies. Our Nowcast model (which is a “big data” approach to tracking the economic cycle) is tracking global growth at a pace of just over 4% today. This is the strongest rate of economic expansion since the early 2010s. And while it may appear modest by historical standards, the breadth and scope of global growth is impressive.

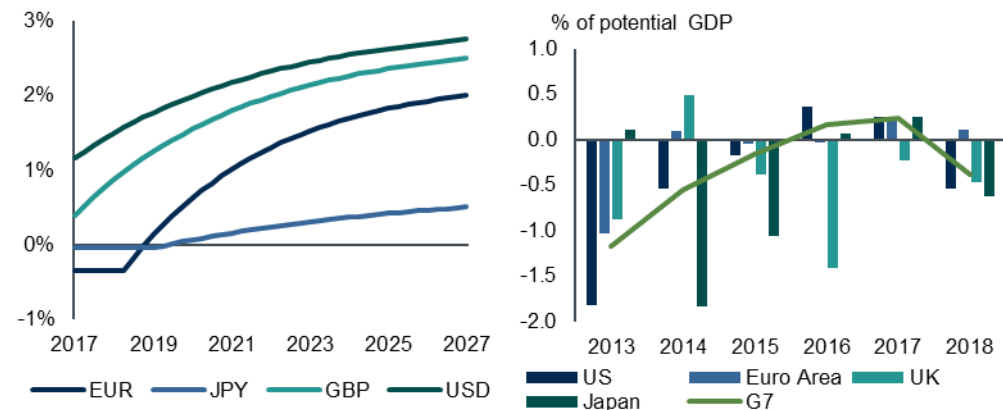
What’s more, there is essentially zero risk of an imminent recession based on current leading indicators. In fact, we can argue that there are possible upside scenarios for global growth (e.g. via growth momentum in EM economies or the US tax reform). However, better growth momentum in 2017 has been matched by an improvement in growth expectations, as economists have revised their forecasts upwards. This means that the hurdle for an upside growth surprise is higher than it was at the start of 2017.

For the time being, inflation remains “low and below”, but upside risks are building. In 2017, inflation has been “low” relative to growth trends and labour market activity, and “below” central bank targets. This has confused economists, and central bankers have attributed the inflation undershoot to a series of one-off factors. At the Federal Reserve (Fed), Mrs Yellen has even termed low inflation “a mystery”. In spite of all this, we think that cyclical inflation pressures are now beginning to build, especially in the US. This acceleration in inflation is most apparent in a key new indicator from the Fed, the “underlying inflation gauge”. This is now reading just under 3%, the fastest rate at any time since the crisis.

And what does this mean for policy?

We think the policy mix is becoming less supportive for risk assets. The world of ultra-accommodative monetary policy is coming to an end, and fiscal policy could be a small drag on growth in 2018.

Figure 3: Policy rates are expected to normalise at a gradual pace & Figure 4: Fiscal boost*



* Fiscal boost calculated as the change in the cyclically-adjusted primary deficit.
Source: HSBC Global Asset Management. Data as of end October 2017.

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On the monetary policy side, many analysts fear that the Fed balance sheet unwind (“Quantitative Tightening”) could have a negative impact on the outlook. But we think these concerns are overdone. The balance sheet run-down has been well-signalled by the Fed, and global liquidity conditions should remain expansionary right through 2018, given the continuation of the European Central Bank and Bank of Japan’s asset-buying programmes. The greatest impact is likely to be on the yield-curve shape, rather than the real economy.

Yet it does look like the interest-rate cycle will accelerate from here. We still think interest rates will end up at a much lower level than they have in the past but, as inflation risks build in an already tight labour market, the scope for a cyclical pick-up in inflation and a faster trajectory for rates (in the US) looks like a key issue for 2018.

On the fiscal side, it remains difficult to gauge what will actually be implemented and how quickly, but it does look like fiscal policy could be a small drag on G7 growth in 2018. This is highly uncertain and we don’t really know. Policymakers remain anxious about high levels of gross debt, but fiscal austerity is very clearly no longer in fashion.

And what about the emerging market economies?

Broadly speaking, there are reasons to be confident about the outlook for emerging market economies.

Over the course of the year, the baton of growth momentum has been passed from the advanced economies to EMs, and global trade continues to grow very strongly, which creates a supportive backdrop for emerging markets. Our Nowcast model (our “big data” approach to tracking the economic cycle) indicates a strong pace of expansion in China and India, and an impressive growth recovery in Brazil. Meanwhile, inflation trends continue to look quite subdued (apart from in Mexico and Turkey).

A central worry has been the build-up of leverage, especially dollar debts, in many emerging economies. This remains a key vulnerability and a critical issue to track. For the time being, decent growth trends imply that the outlook remains reasonable, but the build-up in total economy leverage over the last ten years in many EMs (especially markets like China, Brazil, Turkey, Mexico, and Russia) is an important economic risk factor that investors need to watch. Any deterioration in global conditions, or the realisation of a much more aggressive Fed tightening cycle, could trigger some adverse dynamics – even if, in most instances, we still believe that policymakers have sufficient tools (monetary, fiscal, exchange rate) to manage against shocks.

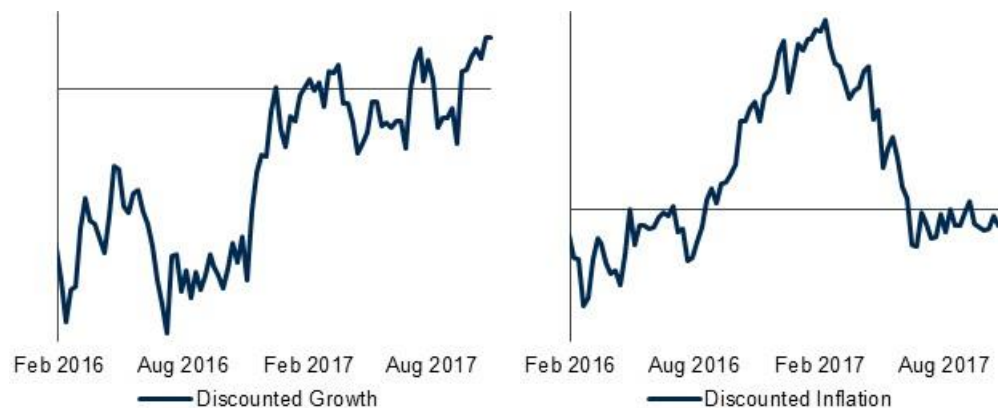
In a slightly tougher, “less than Goldilocks” economic environment, being selective in emerging markets looks like it will be key.

What does this economic outlook mean for investors and asset allocators? What are your key investment strategy views now?

We have reflected above on why we think the economic environment going forward looks set to remain decent, even if a little tougher than what we have seen in 2017. We have described this as “less than Goldilocks”. But the really important question is not so much about how we feel the economic outlook is set to unfold, and is more connected to what economic scenario is embedded in current market prices. That is to say, what do investors assume for the growth/inflation mix now?

Figures 5 and 6 show our measures of the growth and inflation scenarios that are discounted by investors today. We measure this by seeing the relative behaviour of growth-sensitive and inflation-sensitive asset classes. The implication of this work is fascinating: investors have grown increasingly confident in terms of the outlook for global growth, but appear to believe that low inflation will be a persistent feature of the global economy.

Figures 5 & 6: Market-implied “discounted growth” and “discounted inflation” indicators



Source: Bloomberg, HSBC Global Asset Management. Data as of end October 2017.

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In global bonds, our measure of the term premium (the relative reward versus cash) is still very negative. Sustainable bond returns are low and investors are unconvinced of a meaningful return of inflation pressures. We feel that this creates an opportunity for contrarians. The market is offering us good odds to bet on a “mild reflation” – something that seems to be reasonable based on our macro analysis above. We believe a combination of being underweight global government bonds and being long of break-even inflation in the US makes sense today.

The outlook for global credits is trickier. Fundamentally, a regime of good growth and relatively low inflation points to a benign credit outlook. It's likely that credit defaults and downgrades will remain low for now. Yet a lot of this good news is already priced in. To us, the pay-off and potential reward for taking credit risk seems limited. Based on current pricing, even a slight deterioration in the data, or an impulse of mild inflation, could induce an abrupt re-pricing.

We believe the best rewards for bearing risk are still in global equities and emerging market assets. Relative valuations look better here, which means that we have a "margin of safety" should a less favourable macro backdrop emerge. In global equities, we measure an implied risk premium that is broadly in line with historical averages. This looks good given the profit delivery we continue to see and against the rest of the opportunity set. We would tend to focus more on "late cycle" equity markets (such as Japan). In the emerging markets space, we see selective opportunities in parts of local-currency debt and EM equities (mainly in Asia and parts of Europe).

And what do you think about currencies?

Short-term currency forecasting is incredibly hard. For the major currencies, we don't observe particularly extreme tactical signals at present.

The recent weak performance of the US dollar, coupled with mild reflationary forces and Fed tightening, support the idea of dollar strength over the short term. On balance, we think we will see a relatively mild Fed rate cycle continue to be delivered in 2018 and 2019. However, if the pace of policy tightening were to accelerate faster than we expect, the dollar would be likely to strengthen at a time when other asset classes could suffer. This means that being long of dollars, versus major currencies, is an attractive strategy from a portfolio construction perspective.

Despite strong performance in emerging market currencies this year, many of these currencies continue to look attractively valued for the medium term. EM growth trends remain generally good and, if we are right that the environment is still broadly favourable for risk assets, then EM should continue to do well. What's more, after recent volatility, there are a number of highly idiosyncratic opportunities in parts of the EM universe.

What could go wrong with this outlook?

A popular view among economists today is that, after a historically long economic expansion, we are "due a recession". But economic cycles don't run on clocks and we don't think this is quite right. Growth trends are still synchronised across the advanced economies and emerging markets – and recession risk is effectively zero for now. The typical factors that drive recessions (i.e. significant monetary tightening, economic imbalances, and external shocks) are not present today, and there is no evidence in the global leading economic indicators of an imminent downturn.

A second worry is that we are going to see a "policy error" as central bankers increasingly focus on financial stability issues and perceived overvaluations in parts of asset markets. The idea here is that, even if inflation remains low, central banks like the Fed will still pursue rate hikes. In turn, this strategy could flatten the yield curve and induce recession. It is clearly a possible scenario for 2018, but we would put a relatively low probability on it materialising.

The major concern for us is that we see a more decisive increase in inflation pressures (particularly in the US). Faster inflation would force the hand of policymakers to hike interest rates more aggressively than we and others in the market expect. Given the way some asset classes are priced today, this would imply a significant adjustment in market prices. And there may not be that many places for investors to hide.

Based on these risks, we believe that monitoring the developing trends in growth and inflation will remain critical in 2018. The balance of risks seems much more skewed to an emergence of faster-than-expected inflation in our view, but we remain open to multiple economic scenarios developing.

As always, it will be critical to take an active and opportunistic approach to asset allocation.



Global fixed income outlook

Q&A with Xavier Baraton

Global CIO Fixed Income, CIO HAIL, CIO North America

After a year of positive returns across segments, the fixed income outlook for 2018 is not as clear-cut as 2017.

Government bonds will be largely dependent on central bank policy. We see value in the eurozone periphery, while we believe credit will warrant adopting a more cautious stance. We maintain a positive medium-term view on emerging market debt, with Asian bonds and local debt our preferred segments.

We think the key risks to our scenario revolve around monetary decisions, which could put pressure on valuations and shift the global economic balance.

How has the environment impacted fixed income assets in 2017?

Appetite for fixed income assets has not abated, and is largely unchanged from 2016. This year, the asset class benefited from the 'Goldilocks' scenario of robust economic growth, muted inflationary pressures, and dissipating geopolitical risks, which had been significant sources of concern in 2016.

Meanwhile, central banks were particularly slow to normalise monetary policy, though the US Federal Reserve (Fed) and the European Central Bank (ECB) communicated a more explicit path for normalisation. The Fed confirmed its balance-sheet contraction in October, and the ECB announced further tapering in November. Thanks to this, liquidity remained ample, with investors keen to find allocation opportunities. This supported the asset class, translating into spread compression across fixed income assets, as investors reduced their cash buffers against volatility or market shocks.

In 2017, all segments posted positive returns, from 2-3% for government bonds to 3-5% for investment-grade (IG) corporate bonds, and 7-10% for high-yield (HY) and emerging market debt (EMD).

Corporate spreads have compressed this year, benefitting from the supportive liquidity conditions and a visible improvement in credit quality. The 2015-2016 energy crisis led corporate managers to adopt more cautious balance-sheet management, which yielded results in 2017. Moreover, shareholder-friendly activity – in the form of buybacks and dividend payments – has now abated, upgrade/downgrade ratios have been more favourable, and default rates have continued to decline.

On the currency front, relative improvements in economic growth and political risks benefited the euro and emerging market currencies whilst penalising the US dollar and sterling. For the US dollar, this changed somewhat in June, when the Fed began showing a greater determination to raise rates, thereby supporting the currency. Similarly, sterling began to stabilise once the UK government adopted a more pragmatic stance on Brexit negotiations.

Lastly, emerging markets (EM) were supported by a positive economic environment, as the structural adjustments undertaken over the last three years began to bear fruit. Latin America and Eastern Europe also benefitted from the recovery of commodity prices, including oil and metals. Asian debt was supported by steady economic growth, modest inflationary pressures, and the visible acceleration in global trade. Finally, China made visible progress this year in addressing its imbalances. Leverage began to stabilise or even curb, the authorities managed to control the opening of financial markets whilst maintaining their FX reserves, and they addressed the lingering issue of State-Owned Enterprise overleveraging.

Looking to 2018, what is your outlook on government bonds (rates)?

With oil prices likely to increase slowly, inflationary pressures should remain steady. We therefore expect rates to be impacted primarily by central bank policy normalisation. We will pay particular attention to the Fed's rate rises and balance-sheet reduction, though these have been well communicated so far. We anticipate that inflation break-even rates will continue creeping up next year, leading US Treasury 10-year nominal rates to range between 2.5% and 3% by year-end. We don't have a strong view on the curve, foreseeing some further flattening, albeit at a slower pace than in 2017.

In Europe, the ECB remains moderately dovish and will not raise rates before 2019. Long-term German bund rates should therefore remain well-behaved. However, the sensitivity of the demand-and-supply balance in the region leads us to believe German bund 10-year rates will continue rising, with an objective of reaching 0.75% to 1% by the end of 2018.

We continue to see value in the eurozone periphery for next year. Economic growth, stabilising above 2%, should help the region address its idiosyncratic risks. Spread compression in countries like Ireland and Portugal has been spectacular in 2016 and 2017, and we believe that the strong economic uptick in the eurozone will support further compression while the ECB maintains its extended asset purchasing programme.

Figure 7: Major developed market bond yields (%)



Source: Bloomberg, as at 24 November 2017.

Past performance is not a guarantee of future performance.

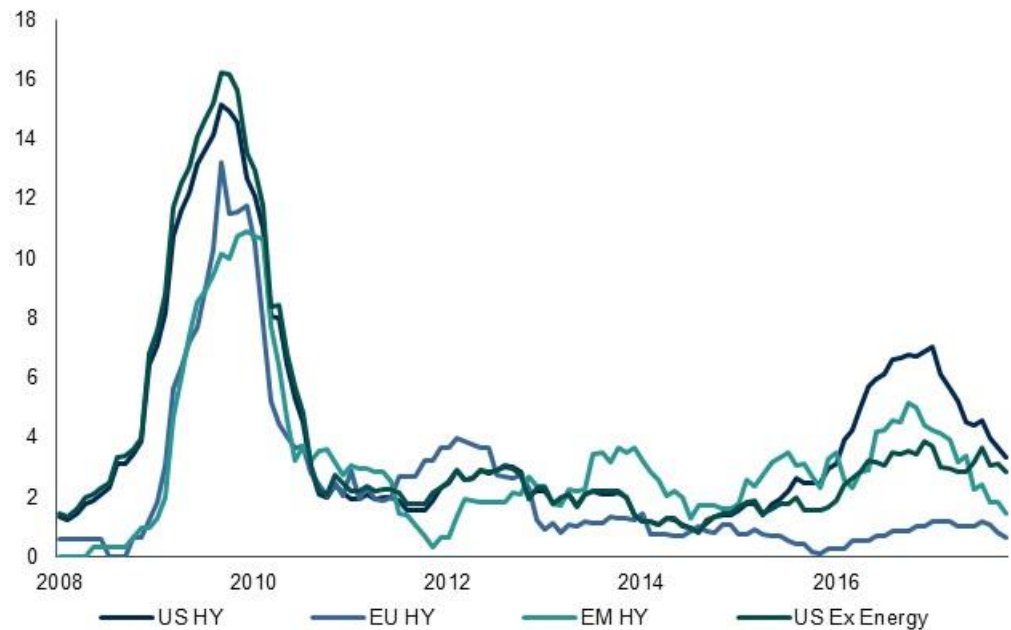
What are your views on corporate bonds (credit)?

We will certainly adopt a more cautious stance on credit in 2018. 2017 saw substantial spread compression, particularly in Europe, fuelled by improving upgrade/downgrade ratios, and default rates returning close to their historical lows after a short spike in late 2016. This makes for an asymmetric investment case: there is little room for further appreciation, whilst credit is more vulnerable in an environment of rising rates and gradually decreasing liquidity.

We expect that some sectors will perform better than others. Being selective will be essential, particularly in HY credit, where we aim for betas slightly below 1 and focus on quality, preferring BB-B names.

In Europe, current yields and spreads are extremely low, and offer little value compared to historical default rates, in our view, although technicals remain supportive. However, spreads could widen by contagion if there were a volatility spike in the US.

Figure 8: HY default rates (%)



Source: BofAML, as at 31 October 2017.

Past performance is not a guarantee of future performance.

And on emerging market debt?

On emerging markets, we anticipate stable-to-improving economic growth, and very modest inflationary pressures across regions – except in countries that have faced substantial currency depreciation, such as Turkey.

We therefore maintain a positive medium-term view.

The credit-rating trend is neutral, although a few countries – Turkey or South Africa – remain exposed to possible downgrades, largely because of external vulnerabilities. Elsewhere, a solid macroeconomic and policy mix remains positive for Latin America, Asia and Eastern Europe, based on improving commodity prices and global trade. We do not expect commodity prices to accelerate much further but, at current levels, this mix of supportive conditions may pave the way for some upgrades, such as the one we recently saw in India.

On hard-currency debt, we have seen more extensive spread compression. Spreads are close to their historical lows of the past 10 years, which we think justifies a beta slightly below 1. We are waiting for more favourable entry points. From a relative standpoint, we see more value in Asian bonds, which remain relatively unscathed compared to other hard-currency EM debt: spreads have not compressed as strongly as in other regions, and Asia continues to enjoy macroeconomic resilience, with China gradually addressing imbalances.

Local debt remains our preferred asset class. Many EM currencies rose until October before losing about a third of their gains year-to-date, and we believe they could begin rising modestly again in early 2018. This recent easing of currencies, combined with attractive relative yields – just below historical averages versus developed markets – build a compelling story for local debt, in our view. We think the asset class could post mid-to-high single-digit returns again in 2018.

And what are the key risks to this outlook?

Leaving aside specific and localised geopolitical risks, we believe the main risks revolve around monetary decisions. The current strength in fixed income valuations undoubtedly stems from global economic growth, but it is also largely dependent on the ample liquidity provided by monetary conditions. This liquidity will be pulled out of the market over the next two years as central banks normalise their balance sheets, so any surprises in the speed of this process could create shocks.

This may occur if central banks decide to increase the pace of normalisation based on falling unemployment rates or rising wage inflation, even if consumer-price inflation does not accelerate. The risk of faster tightening would be even greater if labour-market conditions did eventually translate into consumer-price inflation.

Such an acceleration in the rate cycle would be most detrimental for US HY (where leverage is at cycle peaks) and could translate into unsustainable balance sheets for the weaker issuers. It would also likely put pressure on valuations generally. Eventually, such an acceleration in rate tightening might drag the global economy back to its long-term equilibrium, with growth held in sway by the secular stagnation forces of demographics and deleveraging (in both corporate and public sectors).

Global equities outlook

Q&A with Bill Maldonado

Global CIO Equities, CIO Asia Pacific



Can you give us an overview of global equity markets in 2017?

Even after a year of exceptional returns, equities remain in the spotlight as the biggest potential beneficiaries of the ongoing improvement in the global economic climate.

While expected returns for global equities look rather subdued relative to historic levels, they still manage to stand out when compared with other major asset classes. Though it may be difficult to replicate the level of outperformance we experienced through 2017, we still remain positive towards equities in general and emerging market equities in particular.

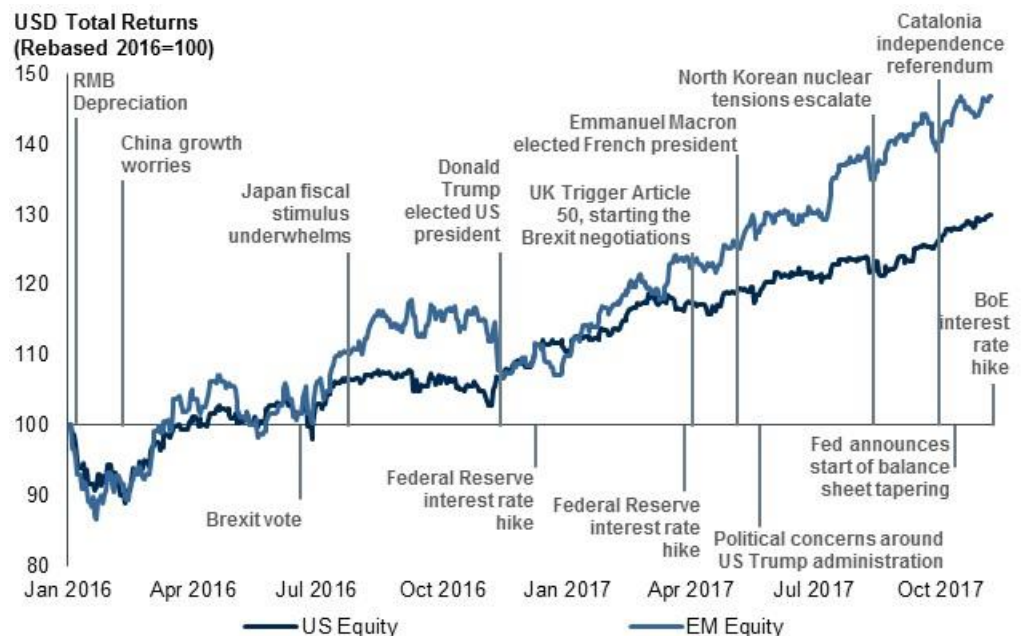
Global equity markets have performed very strongly in 2017. Developed market equities have delivered returns of around 15% in US dollar terms, and emerging market equities have returned more than double that, coming in at over 30% in US dollar terms.

Throughout the year, valuations have been supported by 'uber-gradual' policy normalisation, waning geopolitical risks, and the advent of a 'Goldilocks' environment of good growth, low inflation and low rates. But undoubtedly, earnings growth has been the main driver of equity markets in 2017. Global corporate earnings have increased by around 15% in 2017, thus emerging as the biggest driver of returns during the year. The combination of an improved economic environment and stronger corporate fundamentals has allowed investors to shrug off disruptive market events and geopolitical risks to a large extent.

We have seen a notably stronger rally in emerging market equities, with robust corporate profits supporting rising valuations. Asia ex Japan equities, for example, have recorded 13 consecutive months of positive earnings revisions since September 2016. This contrasts with the sharp cuts to earnings revisions in early 2016, which were in part driven by concerns on China. Earnings of Chinese companies have been in recovery mode through 2017, particularly in non-financial sectors which have experienced their best earnings growth since 2010.

However the fact that we have seen virtually no multiple expansion in the equity market in 2017 implies that investors are still not confident about the sustainability of the current rally.

Figure 9: Strong rally despite a noisy macro backdrop



Source: HSBC Global Asset Management, November 2017.

Past performance is not a guarantee of future performance.

What is the outlook for equities for next year, and what are some of the key opportunities you see?

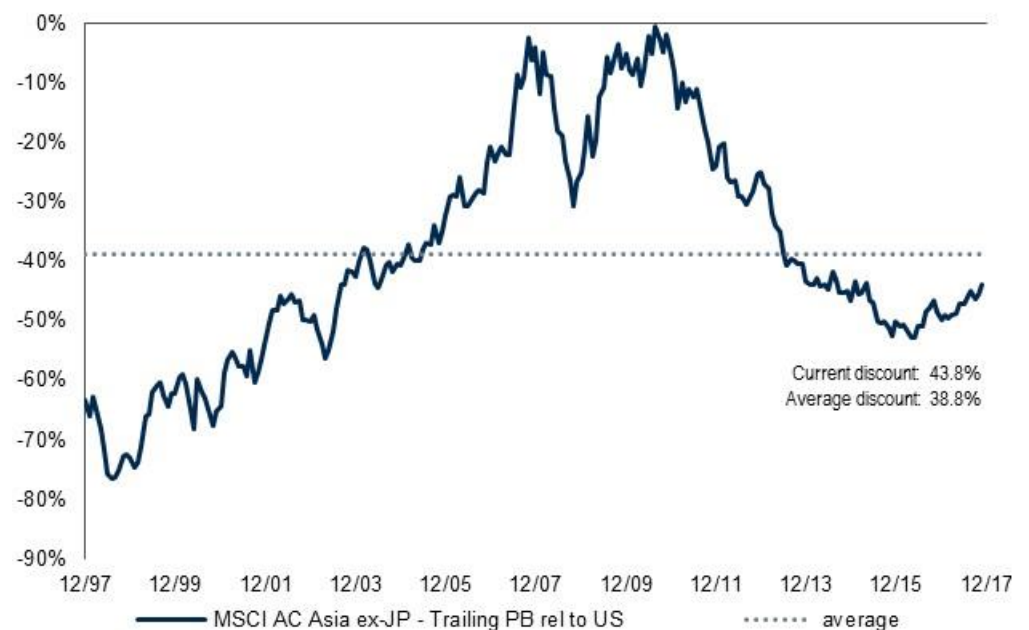
We expect equities to continue delivering positive performance next year, particularly in emerging markets (EM), where valuations remain less demanding when compared with their developed market (DM) peers. However, it's important to note that, even at this stage, DM equities have not moved into overvalued territory. In our view, equities across the board continue to offer better risk premia relative to cash and government bonds.

Investors have been particularly worried about the US market being overvalued since the start of the year as some popular valuation indicators hovered around historical peaks. Based on our valuation work we would consider the US market to be fair value and not yet expensive. While it's reasonable to expect the market to pause for breath and consolidate a bit after a long, uninterrupted rally, it's worth noting that the US equity market has been resilient in the face of a hawkish Federal Reserve (Fed), ongoing geopolitical risks and historically low volatility all through 2017. We also believe concerns around Fed policy normalisation impacting equity growth have been overdone at this point. Similarly in Europe, there still appears to be more room to grow despite the strong rally in 2017, but it would be difficult to foresee the same level of outperformance as valuations are no longer as inexpensive as they were a year ago.

We believe 2018 will continue to offer many opportunities in equities, as a number of themes, predominantly that of continued synchronised global growth, play out. Asia is particularly geared to benefit from this environment, not just from recovering commodity prices, global capex upcycle and strong international trade flows, but also from the pickup in local economies. Domestic growth in the region has been on a recovery, benefitting from several years of structural reforms including increased infrastructure spending and opening up of Asian markets to foreign investments. The region is also set to gain as key large economies continue to work towards achieving more balanced and sustainable growth models.

We also find Asia ex-Japan equities particularly attractive as valuations remain reasonable on a relative basis and with return on equity (ROE) picking up after a multi-year decline. When compared with the US market in particular, Asia ex Japan equities still trade at a significant discount with a current price-to-book (P/B) discount of over 40%, and this presents some interesting opportunities. For example – if we look at the price-to-earnings ratio (P/E) of two of the world's largest smartphone makers – one listed in the US and the other in Korea – we observe that the US-listed stock trades at 18x P/E, while the Korea-listed stock trades at 9x P/E. While the Korean stock-market has rallied year-to-date, there is still a valuation gap favouring the Korean name over its American peer. Moreover, Asia is not a crowded trade as it is still under-owned by global investors and asset allocators. In our opinion, Asian equities offer some of the best risk/return trade-offs amongst all asset classes.

Figure 10: Asia ex Japan equities still trading at attractive discount vs. US stocks



Source: MSCI, data as of November 2017.

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Our preference for Asian equities also extends to Japan, where above-average growth, low inflation and robust earnings growth will likely continue supporting the equity market. Elsewhere, we see selective valuation opportunities in emerging Europe, namely Russia, Poland, Turkey and Hungary.

While we remain optimistic about investment opportunities in various equity markets, we do not try to predict market movements. We believe in adding value over the long term through our focus on stock selection, underpinned by our fundamental focus, and concentrating our overweight positions in profitable companies at below-average valuations. In our experience this approach is most likely to be effective across a range of market conditions.

Figure 11: Emerging markets in the spotlight

Expected returns for key equity markets (Emerging markets are highlighted)		
	Local	USD Return
AC World	5.7%	5.7%
Developed Markets	5.5%	5.3%
Emerging Markets	7.6%	8.5%
United States	5.5%	5.5%
United Kingdom	5.1%	5.3%
Europe ex UK	5.3%	4.6%
Japan	5.5%	5.9%
Asia ex Japan	7.0%	8.6%
HK	6.7%	6.7%
China (USD)	7.2%	7.2%
South Korea	7.1%	9.1%
Taiwan	6.2%	13.1%
India	7.7%	8.3%
Indonesia	8.4%	5.8%
Brazil	8.6%	2.8%
Mexico	8.3%	8.8%
South Africa	8.7%	8.3%
Russia	12.1%	14.9%
Turkey	12.7%	14.1%

Source: HSBC Global Asset Management, Global Investment Strategy.

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What are the key risks to your central scenario?

The key risks to our scenario revolve around the global growth and inflation outlook, led by events in the United States but affecting all geographies.

The very positive performance of equities in 2017 has been partly due to the Goldilocks scenario of decent, globally coordinated economic growth coupled with very subdued inflationary pressures. If inflation begins to pick up, or if growth remains strongly above trend – and above sustainable long-term rates – central banks around the world, including the Fed, may begin tightening policy more aggressively, which could lead to market volatility and weigh on valuations.

We do not expect this to materialise in 2018, but it is the central risk we see to an otherwise positive scenario for equities around the world.



Global liquidity outlook

Q&A with Jonathan Curry

Global CIO Liquidity, CIO USA

Can you give us an overview of liquidity markets in 2017?

2017 was a fascinating year for liquidity markets, as they aimed to balance the impacts of rising interest rates in the US and UK, the continued tightening of credit spreads, Money Market Fund reform in Europe and China and the long-awaited stabilisation of asset supply.

Whilst we expect similar themes to play out again in 2018, the key questions will revolve around inflation levels, notably in developed markets, and the potential impact of the Federal Reserve's (Fed) balance-sheet normalisation, on money markets and the broader economy.

2017 has been an interesting year in the liquidity markets. Rising interest rates have been a key area of focus, particularly in the US, where we saw three 25-bp rate hikes over the year, and more recently in the UK, which increased rates in November, also by 25 bps. After many years of ultra-low yields across developed market economies, this was a significant change. In both the US and the UK the market was late to respond to the heightened probability of a rise in official interest rates. In the US, voting members of the Federal Open Market Committee (FOMC) had clearly articulated their intention to raise interest rates by 0.25% on three occasions during 2017. The market did not heed this advice and had to rapidly re-price in the run-up to the interest-rate rise in March and the expected interest-rate rise in December. In the UK, the market also had to rapidly re-price after Monetary Policy Committee members began to articulate that they expected to vote to raise the Base Rate in November.

The second notable element for money markets this year was the continued tightening of credit spreads. The example of the 3-month LIBOR OIS spread in USD is particularly striking, having contracted by around 75% over the last 12 months. This has been driven by continued improvement in credit fundamentals, particularly in the banking sector, in developed markets. It follows the trend of credit-spread compression across the credit spectrum and across maturities.

Money Market Fund (MMF) Reform also remained a key area of focus in 2017, notably with European regulation eventually finalised this summer, and further regulation of MMFs being passed in China. Money Market Fund reform in Europe was finally passed after an almost seven-year gestation. The good news for investors in Constant Net Asset Value ('CNAV') MMFs is that we believe the new Low Volatility Net Asset Value ('LVNAV') is a very credible alternative. Feedback from investors suggests the LVNAV MMFs that will be created will be the MMF of choice for the vast majority of investors in European Prime CNAV MMFs today.

Supply of assets, which had been contracting more or less continuously since the financial crisis, has fortunately begun to stabilise at last. It is certainly not yet expanding, and supply conditions remain very tight, but at least we are no longer seeing contraction in supply to end-investors in the money markets.

What is your outlook for money markets in 2018?

Looking forward to 2018, we see similar themes continuing to develop. The market expects interest rates to continue to rise in the US, and is currently pricing in two further 25-bp hikes by the FOMC. In parallel, the UK is expected to raise rates on at least one more occasion in 2018.

The outlier in the major developed economies is the eurozone, where we expect official rates to remain on hold throughout 2018. We also think the region's economy will continue to be supported by the high levels of monetary easing which the ECB confirmed they would maintain until at least September next year.

2018 is going to be a potentially challenging year for credit-spread markets. Credit spreads are at tight levels, particularly in the money markets, which are our area of focus. The key question for us is whether we will see any reversion of the spread-tightening that took place after the US MMF Reform was fully implemented in 2016. This is certainly an area we will be monitoring very closely next year.

And what are the key risks to this outlook?

Looking forward to next year, there are two key risks that we would highlight for money market investors.

Firstly, inflation in the major developed market economies remains at very low levels. Given the current levels of employment, in the US or UK for example, based on historic comparisons we would expect inflation to be higher. The key question for investors is whether next year will see a “mean-reversion” of inflation to these expected higher levels. It would be a significant shock to the market, and would likely lead to a rapid response from central banks in the US, the UK and the eurozone. This possibility is not currently priced in, and we see this as a major, though low probability, risk to the market.

The second key risk to our outlook for next year is the potential impact of the Fed’s unwinding of quantitative easing in the US. It is challenging to predict what the balance-sheet normalisation will bring for markets, and the broader impact it may have on the US economy. Going this far into quantitative easing was an experiment to begin with, and managing its unwinding is also, to a degree, an experiment, which the Fed will undoubtedly be managing very closely. Reassuringly, the Fed has the ability to change the magnitude of its unwinding, to reduce or indeed increase it as the situation requires.

Can you give us an update on reforms likely to impact liquidity markets in 2018?

In terms of Money Market Fund Reform, we finally saw the new MMF regulation being agreed in Europe in the summer of this year, and 2018 will very much be a year spent implementing those reforms across the region. All existing MMFs in Europe will have to be compliant with the new regulation by January 2019, meaning there is a lot of work to do, for us as providers of MMFs of course, but also for suppliers to the industry, and indeed for investors themselves.

We are well into our implementation process, having been working with the many teams involved internally, and with our suppliers, to ensure they are delivering the necessary changes. Most importantly, we have been working closely with our clients who are invested in MMFs in Europe, to help them navigate these changes and to decide on how they can best respond to the regulation. Working with our clients to support them and help them navigate through these changes will be a key focus for us in 2018.

Reform therefore continues as a key theme for next year, but we will eventually come out on the other side of all these changes. Fortunately, we believe that the reforms, whilst delivering what the regulators want, will not be disruptive to the end investor.





Global alternatives outlook

Q&A with Xavier Baraton

Global CIO Fixed Income, CIO HAIL, CIO North America

Alternatives have performed extremely well this year, for the same reasons that have supported equity and bond markets: strong economic growth, low inflation, and the ample liquidity offered by central banks, who were quite slow to normalise. In this context, valuations look more stretched, and we will be both more cautious and more selective as we go into 2018, particularly when it comes to more directional strategies.

HEDGE FUNDS OUTLOOK

What have been some of the key performance drivers within hedge fund portfolios this year?

In the hedge fund space this year, within multi-strategy portfolios, equity long/short and event driven allocations were key drivers of performance.

In 2017 there was a reduction in intra-stock correlation and increased dispersion within equity markets, both of which helped create a good stock-picking environment on the long and short sides. We saw standout returns from some Asia specialist managers, reflecting the continued contribution to global earnings growth from Asia and Emerging Markets. Following 2016 and the year of 'FANG' (Facebook, Amazon, Netflix and Google), technology was another area of strong performance for many managers.

Returns within event-driven strategies were supported by sustained corporate activity. There continues to be shareholder pressure on management to deploy cash-rich balance sheets, enhance shareholder returns and to spur growth through acquisitions.

What are some of the key opportunities you see for 2018?

In the current market environment, multi-strategy and equity long/short are our highest conviction strategies.

Global earnings-per-share growth forecasts remain generally positive, supported by continued business and consumer optimism, strong PMIs and muted inflation. Country and sector correlations also continue to weaken, and the increased dispersion within equity markets creates a more conducive environment for managers to identify winners and losers. As a result, we believe there is strong potential for alpha through security selection on both long and short books in 2018.

In the current low yield environment, we expect investors to continue being more thoughtful and nuanced in their credit allocations. Increased regulatory pressures have resulted in reduced bank lending, which in turn has resulted in greater interest in private credit for investors willing to exchange liquidity for potentially higher returns. For this asset class, we retain a preference for senior secured exposure, which offers priority in the capital structure, and floating rather than fixed exposure, to protect allocations against a backdrop of rising rates.

In 2017 we continued to see an increased interest in multi-advised/multi-manager structures across the industry, and this is something we think will persist. Such vehicles can offer similar diversification to traditional fund of funds allocations, but allow greater flexibility in implementation and can also make bespoke portfolio combinations easier to achieve.

And what are the key risks to your outlook?

Managers remain vigilant due to several risks, including a shift from monetary policy to fiscal policy and geopolitical tensions. For this reason, we think it will be crucial for hedge fund managers next year to be able to alter their net and gross exposure nimbly in response to market activity and newsflow.

The Global alternatives Outlook was produced in collaboration with William Benjamin, Head of Hedge Funds, HSBC Alternative Investments, Mark Tucker, Head of Private Equity, HSBC Alternative Investments, Guy Morrell, Head of Real Estate, HSBC Global Asset Management and Ingrid Edmund, Infrastructure Debt Senior Product Specialist, HSBC Global Asset Management.

PRIVATE EQUITY OUTLOOK

What is your analysis of the environment in 2017?

In 2017, strong economic fundamentals have supported the growth of private-equity-backed businesses, driving performance that continued to exceed public-market equivalents. Five-year returns currently stand at an average of 15.4% per year¹.

Exits this year were a focus for many firms, to take advantage of high public equity valuations and maximise returns on investments. The long-term fund structure of the asset class allows managers to time entry and exits points in this way, which they did in 2017, leading to record distributions. Overall in 2017, distributions are likely to exceed USD500 billion for the first time, which is roughly equal to the dividends paid by the S&P 500 over the same period².

In terms of new investments, the high equity-valuation environment has led managers to take a disciplined approach.

Although capital deployment remains consistent with previous years, standing at around USD400 billion a year³, managers are focusing on sustainable businesses with identifiable operational improvement plans to drive returns. Whilst new deal valuations have risen to a peak of 10x-EBITDA this year, public market valuations remain significantly higher, which confirms the opportunities in this asset class, in our view.

The continued strength of long-term performance in private equity, which was maintained even during the Global Financial Crisis, has led to increased investor appetite for the asset class, with 2017 fundraising likely to reach record levels, surpassing the 2016 total of USD700 billion.

What are the main opportunities you see for 2018?

We expect several long-term themes to drive deal flows in 2018 and beyond, in areas where private equity has been an instigator and funding partner of change. We think key opportunities remain in technology as it continues to drive innovation across developed economies, often towards online platforms backed by private equity. In China, the technology opportunity is compounded by the growth of the middle-income population – the largest in the world – driving the rise of a myriad private-equity-backed online retail firms to meet Chinese consumer needs.

The secondary market has grown rapidly, particularly as a tool to provide liquidity for older private equity funds, also generating opportunities as record levels of mature portfolios go on sale.

What's more, the energy and infrastructure industries have large financing needs (currently estimated at USD6 trillion a year⁴) to fund the development and expansion of critical assets. Public funding is decreasing steadily in favour of private equity, creating opportunities in this area as well.

What are the key challenges for 2018?

Although private equity valuations remain at a material discount to listed equity valuations, they have significantly increased in recent years, making it much more difficult to find opportunities that can deliver positive valuation expansion over a five-year holding period. It will be more important than ever to focus on conviction-led strategies and firms with robust operational plans that can generate returns throughout the stages of a market cycle.

REAL ESTATE OUTLOOK

How have global property markets performed in recent years?

In recent years, unlisted (direct) global property markets have benefitted from the broader trends in asset price growth supported by ultra-low yields.

More recently, performance has been mixed despite the global economic upswing. A slowing economy, occupier uncertainty and significant new supply in some markets have dampened UK performance, though the investment market has remained surprisingly resilient since the Brexit vote. Hong Kong and Singapore have been struggling with demand weakness. In the US, the real estate cycle has run its course and, as a consequence, returns have been more moderate.

Similarly, publicly listed property, such as Real Estate Investment Trusts, benefitted from the strong performance of underlying physical markets in recent years. Total returns averaged 9.4% a year globally over the five years to the end of September 2017, according to the FTSE EPRA/NAREIT Developed Index in local currency terms. Yet in recent months performance has also weakened. In the US in particular, concerns over the impact of online retailing and store closures have been a drag on retail-focused REIT performance.

1. Source: Preqin All Private Equity five year horizon IRR 2. Source: Hamilton Lane 3. Source: Hamilton Lane 4. Source: McKinsey & Co.

What is our outlook for global property markets?

We expect significant variations in performance between cities and sectors globally.

Europe's economy is growing strongly, while new developments remain limited, building pressure on rental growth. Given the extended period of loose monetary policy in the region, further yield compression is likely in property incomes.

Aside from Singapore and Hong Kong, which suffer from stretched pricing and poor prospects for rental growth, we expect other markets in Asia Pacific to outperform. Here, we highlight offices in some Australian cities. Rental growth should benefit from positive demand (due to economic growth and strong demographics), limited new developments, and the repurposing of offices for alternative uses.

In the current environment, we expect the UK to underperform, largely because of the likely impact of Brexit and associated uncertainty on central London office rents, combined with a high level of development completions.

Federal Reserve tightening is putting upward pressure on capitalisation rates, weighing on the US market, which is already further along than most in the supply cycle. This effect is significant in some cities like New York, while overall the rise of online retailing is fuelling demand for industrial property but buffeting retail assets. That said, we believe that better quality, regionally dominant centres are likely to outperform as retailers consolidate their requirements and choose to pay for better locations.

Overall, we expect listed real-estate equities to deliver stronger long-run returns than physical property, with a number of key markets and sectors currently trading at a significant discount to underlying net asset values. That said, listed real-estate equity prices tend to exhibit higher volatility than physical property valuations, especially over shorter periods.

What are the main risks to this outlook?

There are two key areas of risk which have the potential to impact property returns over the coming years: (i) political risk and (ii) central bank policy. The rise of populism has created uncertainty around policy direction – particularly globalisation – and it does not yet seem to have run its course. An acceleration of populist policies could hit global trade and weaken prospective returns.

Although tightening is likely to be extremely gradual, and is already largely priced in, we think rising short and long-term rates will weigh on the attractiveness of real estate relative to other income-generating assets. Our central view assumes that rates will gradually rise in response to more buoyant economic conditions.

INFRASTRUCTURE DEBT OUTLOOK

What is your analysis of the environment in 2017?

The Goldilocks environment and ultra-loose monetary conditions were beneficial for real assets in 2017 as investors looked to enhance returns and diversify their portfolios. Long seen as an opportunistic investment, infrastructure debt came into its own this year as a strategic extension to traditional liquid fixed income allocations, thanks to its sustainability, volatility control and diversification benefits. For the first time, institutional bond issuance outweighed that of bank loans in the third quarter and, over the year, the total financing volume in the asset class reached more than USD300 billion.

Inflows were driven notably by European insurance companies, who were able to use Qualifying Infrastructure Investments to optimise their regulatory capital under Solvency II. In addition, with infrastructure equity valuations at high levels, expected risk-adjusted returns started to converge between infrastructure debt and infrastructure equity, the former attracting assets traditionally allocated to the latter.

The volume of investments improved liquidity in the asset class and increased the competition for underlying assets. However, significant spread compression in corporate bonds allowed infrastructure debt to deliver illiquidity/complexity premia of 30-150 bps over credit.

The best-performing segments in 2017 were transportation and energy – particularly renewable energy. Geographically, the US offered higher yields and a much deeper market of opportunities than Europe.

What are the main opportunities you see for 2018?

Despite its increasing attractiveness, infrastructure debt remains one of the largest investment-grade floating-rate investment opportunities, and we expect it to continue to deliver good performance next year.

As investors gain a better understanding of the asset class, more are investing in high-yield/junior debt to achieve higher returns. This space remains less crowded than core segments, offering opportunities for yield. However, we remain cautious, foreseeing yield compression in 2018 as inflows increase into core-plus and value-add segments.

We also think opportunities lie in ESG investments as an overlay, as companies and governments increasingly invest in sustainable projects under the joint pressure of regulation and investor demand. Geographically, we also see interesting opportunities in Europe, particularly in the mid-market core and HY core-plus segments.

Yet, in our view, the key opportunities for next year lie in the core space in the US and Asia. Although the two regions are at entirely different stages of development, they both present infrastructure spending requirements in the order of several trillion dollars. We see significant opportunities from refinancing and acquisition activity, but also in Greenfield (i.e. new developments) in core sectors like transportation, utilities and renewable energy. We particularly like current developments in Asia, where we see opportunities both in USD and local currencies at attractive yields. Australia has also developed a good pipeline of Greenfield transportation and renewable energy projects, which may offer interesting risk-adjusted returns on a selective basis.

What are key challenges for 2018?

Infrastructure is generally seen as a stable, predictable, defensive asset class. Yet the unprecedented level of liquidity and the resulting pressures on deployment and yield premia are stretching the definition. Late in the credit cycle, and on the backdrop of high equity valuations, there is little room for bad news.

In such an environment, investment discipline remains key to deliver the performance expected of an infrastructure debt portfolio. Before moving down in the capital structure, investors looking for higher returns should exercise particular caution, and consider whether the additional risks are appropriately structured and rewarded.

Contributors



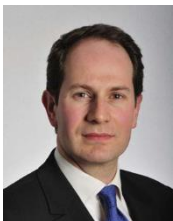
Chris Cheetham,
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Chris Cheetham joined HSBC Global Asset Management in 2003 as Global Chief Investment Officer and has worked in the industry since 1978. Prior to joining HSBC, Chris was Global Chief Investment Officer of AXA Investment Managers, where he also held the position of CEO AXA Sun Life Asset Management. Chris began his career with Prudential Portfolio Managers (now M&G), where he worked in a variety of investment management roles, ultimately as Director of Investment Strategy and Research. He holds a First Class honours degree (BSc) in Economics from Hull University (UK) and a Masters in International Economics from Warwick University (UK).



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Jonathan Curry,
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Joe Little,
Global Chief Strategist

Joseph Little joined HSBC's Asset Management business in 2007. He is currently Chief Global Strategist, responsible for leading our work on macroeconomic and multi-asset research, and for developing the house investment strategy view. He was previously Chief Strategist for Strategic Asset Allocation and a Portfolio Manager on HSBC's absolute return Global Macro fund, working on Tactical Asset Allocation. Prior to joining HSBC, he worked as a Global Economist for JP Morgan Cazenove. Joseph holds an MSc in Economics from Warwick University and is a CFA charterholder.

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