Investment Outlook

December 2014

To 2015 and beyond...

HSBC
Global Asset Management

Contents

Message from the Global CIO

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It is natural, as we come towards the end of the year, to look ahead to next year and try to forecast what it will bring. Although such exercises can be fraught with peril, they are still useful, though our preference is to take a long-term view of the outlook for asset markets and the economy, grounding our views in long-term drivers of asset class returns such as valuation, and the secular forces driving global growth and interest rates, whilst also recognising the need to be flexible and adapt to short-term opportunities and risks. Indeed, given that it is the main driver of long-term returns, we believe valuation provides an important anchor to our framework for analysing the outlook for asset markets and stops us from being overly focused on the 'day-to-day' noise of financial markets and macroeconomic data flow.

2014 saw most major asset classes, other than commodities, post positive returns as ultra-loose monetary policy and subsiding fears about the sustainability of the global recovery boosted asset prices. 2014 was also the year in which the policy stances of the major central banks started to diverge for the first time in around seven years. Although the US Federal Reserve ended its asset-purchase programme, the European Central Bank and the Bank of Japan both announced plans to increase the size of their balance sheets. Consequently, at a global level central bank liquidity is likely to continue to support growth and asset prices in 2015 and beyond, though tightening by the Fed will lead to volatility in asset markets from time to time in our view. Global growth should also benefit from the 30% fall in the oil price seen since late June.

However, the divergent outlook for monetary policy has already resulted in a rise in foreign exchange market volatility and may well trigger spikes in foreign exchange and equity and bond market volatility in the year ahead. October saw a spike in volatility, as markets became increasingly concerned about the eurozone outlook, highlighting the benefits of holding a multi asset portfolio diversified across asset classes and regions. Although divergent monetary policy is likely to be a new force shaping the economic landscape and asset class returns in 2015, a number of major secular forces will continue to play out including deleveraging, population ageing and a related adjustment to lower potential growth rates. Overall, though there are risks, we think the 'fragile equilibrium' of modest but continued global growth, supportive liquidity conditions notwithstanding Fed tightening and attractive valuations for risk assets compared to perceived safe haven assets will be maintained.

Macro and asset strategy outlook

Q&A with Julien Seetharamdoo,
Chief Investment Strategist

The global economy has become increasingly reliant on the US, with China slowing down and Japan and the eurozone stagnating. Looking ahead to 2015, there are some glimmers of hope for a slightly faster pace of global growth given lower oil prices and generally accommodative monetary policy, which is likely to be supportive for risk assets.

However, secular headwinds to growth remain, particularly as developed markets continue to deleverage and their populations age. There are also a number of risks to the outlook for global growth and financial markets, including deflation risk in the eurozone. The combination of monetary policy divergence and an inflection point in US policy rates is also likely to cause spikes in financial market volatility from time to time.

Q. Could you summarise the performance of the main asset markets and the drivers over the past year?

A. In 2014, equity markets have been mixed and quite varied, though at a global level equity markets have still seen positive performance (Figure 1). Global equities as measured by the MSCI All Country World Index are up 4.0% in USD terms as of 21 November. Including dividends, ie in total return (TR) terms, they have returned 6.6%. Across the main developed equity markets, the US has seen the strongest performance so far this year, with the S&P 500 index up around 11% year-to-date (13.7% TR). The Japanese market, as measured by the Nikkei 225 index, is up 6.1% (8.2% TR) and in Europe, the Euro STOXX 50 index is up 2.5% (5.4% TR). Note that more than half of all returns from Europe so far this year were from dividends. (All data as of 21 November 2014.)

In Emerging Markets (EM), performance has been particularly varied, highlighting the importance of diversification. Some markets such as India, China, the Philippines and Indonesia are up sharply with year-to-date price gains in an 18 to 33% range, whilst other markets such as Malaysia and Hong Kong are down year-to-date. Overall, the MSCI EM Index is up 3.5% in local currency terms (7.4% TR), but down 1.3% in USD terms (although up 2.8% TR).

In foreign exchange (FX) markets, the USD has strengthened pretty much across the board against other developed as well as emerging market currencies this year. The US Federal Reserve (the Fed) has ended its Quantitative Easing (QE) programme, and the economic data has continued to demonstrate the resilience and dynamism of the US economy compared to the rest of the world, suggesting modest rate hikes are likely in 2015.

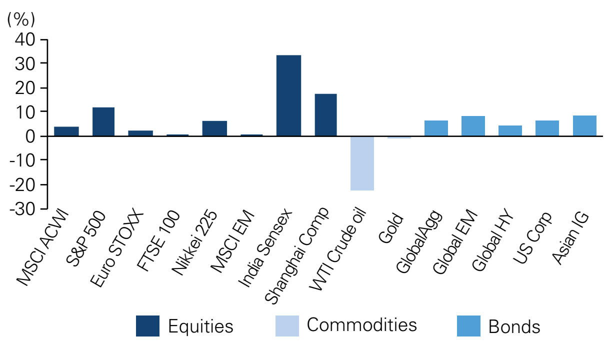
2014 has so far been a relatively positive year for most fixed income asset classes, in contrast to 2013 which was a difficult year for fixed income outside of the safe haven government bond markets and some credit markets.

Developed market government bond yields have generally fallen further with a further loosening of monetary policy from both the Bank of Japan (BoJ) and the European Central Bank (ECB) helping to keep yields down and support bond prices, despite the US Federal Reserve ending its QE programme and preparing the ground for eventual rate rises. The traditionally more risky assets within the fixed income universe such as Emerging Market bonds and High Yield credit have also seen positive performance so far this year overall, albeit modest and accompanied by bouts of volatility, for example with a sharp sell-off in high yield credit over the summer months.

Commodity prices have collapsed this year, on soft global growth and an increase in supply. For example, crude oil is down around 25% since the beginning of the year (Figure 2).

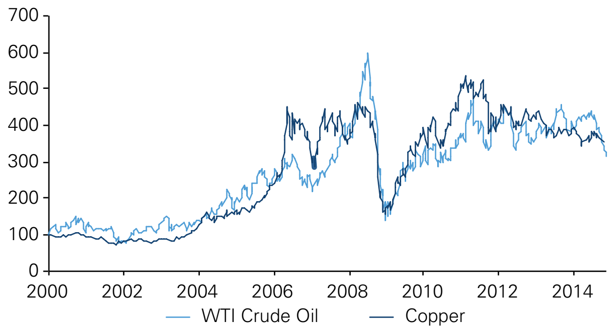
More generally, the positive returns in key fixed income and equity markets have not been achieved without volatility and

Figure 1: 2014 YTD Asset class performance



Source: Bloomberg and HSBC Global Asset Management, data as at 21 November 2014. For illustrative purposes only and does not constitute any investment recommendation. Past performance is not indicative of future performance. Returns are expressed in price terms

Figure 2: Commodity prices have fallen sharply this year (rebased Jan 2000 = 100)



Source: Bloomberg, data as at November 2014. For illustrative purposes only and does not constitute any investment recommendation. Past performance is not indicative of future performance.

some market turbulence. In October in particular, global equity markets fell with many down year-to-date in price terms at the time, on global growth concerns emanating from weak data in the eurozone and China. Investor risk appetite rebounded quickly however, as these concerns were deemed to be overdone on the back of some better than expected macro data and supportive comments from central banks, and further QE action from the Bank of Japan which added to global central bank liquidity.

Q. What's your view of the long-term or so-called 'secular' drivers of the global economy?

A. In our view, Developed Markets (DM) are still dealing with the heavy household and government debt burdens built up before the 2008/09 Great Financial Crisis (GFC), and this will continue to be a headwind for growth in these economies. However, some countries and sectors have been more successful than others in deleveraging (ie reducing debt levels). For example, the process of deleveraging looks to have run its course for US households. Indeed, in the nearer term, the US consumer looks to be one of the more dependable sources of demand given strong labour markets, a boost to real income from lower gasoline prices, and the potential for re-leveraging. However, in Europe, the deleveraging of household and government balance sheets is still very much an ongoing process and will continue to weigh on growth. This is one of the reasons why we expect the US to grow more quickly on average than Europe over the next few years.

Another long-term headwind to developed market growth is rapidly ageing populations (Figure 3), reducing the size of the working age population in both relative and sometimes absolute terms. Around a quarter of Japan's population is over 65, and this will increase to almost 30% by 2020. The eurozone is also seeing a rapidly ageing population, and the US too, though its demographic trends are not as unfavourable as either Japan's or Europe's. The result of slow growth in the working age population is a slower average growth rate in the developed world, especially when combined with ongoing deleveraging.

However, the silver lining to this relatively soft growth outlook is that DM central bank interest rates are likely to be kept extremely low by historical standards, and further QE-type policies are likely in some parts of the developed world, which should generally be supportive of financial markets.

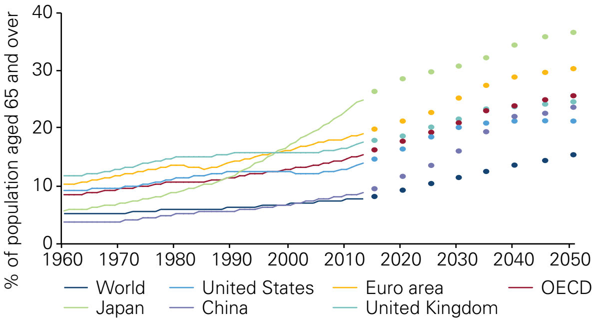
Another secular theme in our view that is having, and will continue to have, important implications for some emerging and developed markets is the end of the so-called 'commodity supercycle'. China had been an important driver of commodity price demand in the early 2000s but this is now diminishing as China alters the pace and composition of its growth. The result is that economies that had relied on strong commodity demand such as many of the Latin America (LATAM) economies as well as large DM commodity exporters such as Australia face an additional secular headwind unless they can reform and restructure their economies quickly.

Q. How about the nearer-term cyclical drivers for these economies?

A. If we use the Global Purchasing Managers' Index (PMI) surveys to take a snapshot of the current pace of economic growth and business confidence across the world, at a global level we are still seeing a decent pace of growth for 2014 and the early start of 2015 of around 3% plus (Figure 4). However, the global recovery has become increasingly reliant on the US, with China slowing down and Japan and the eurozone stagnating.

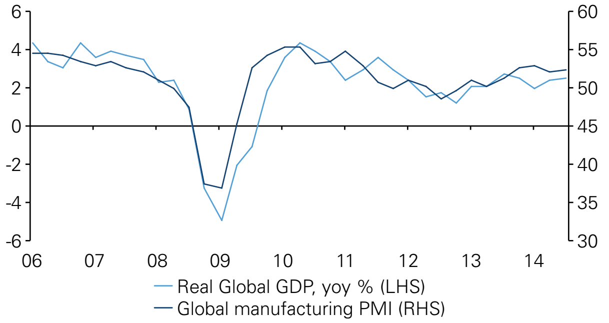
Looking ahead to 2015, there are some glimmers of hope for a slightly faster pace of world growth. The fall in oil prices effectively acts as a tax cut for developed market consumers as well as helping the emerging markets which are big consumers of oil (though not the producers). Lower oil prices

Figure 3: The global population is ageing



Source: World Bank Databank, data as at October 2014. For illustrative purposes only.

Figure 4: Global PMI surveys indicate robust economic growth



Source: Bloomberg, data as at November 2014. For illustrative purposes only. Past performance is not indicative of future performance tend to boost global growth because they transfer income from oil producers to oil consumers, who have a higher propensity to spend.

On the fiscal side, the emphasis on austerity has changed, and we are likely to see only a small negative impact, if any, on developed market growth from fiscal consolidation. This is in stark contrast to earlier this decade (for example, 2013) when austerity in the US and eurozone weighed down substantially on growth in the short term. Overall growth should be as good in 2015 as in 2014, if not slightly better, with US consumers likely to be one of the more dependable sources of demand in 2015, but China probably slowing further.

The ECB is committed to increasing the size of its balance sheet in order to try to stop disinflation becoming outright deflation. It may finally prove that it is willing to do 'whatever it takes' to save the euro by buying government bonds. We expect growth in the eurozone to remain soft, but a weaker euro should help exporters.

In EM, the cyclical outlook varies a lot by country, but overall the latest PMI indicators also suggest growth has stabilised, albeit at low levels. Hikes in central bank rates have helped contain inflation, though it remains above target in some countries. Elections in many EM countries are now out of the way. Therefore, as well as the stance of monetary and fiscal policy and oil prices, the outlook for growth will hinge on reform, and whether countries can follow the example of India and re-engage with the reform process.

Q. So how do you view the short- and long-term prospects for asset markets?

A. The combination of monetary policy divergence and an inflection point in US policy rates is likely to cause spikes in financial market volatility from time to time. This has been the case in the FX market and will probably continue.

Nevertheless, with the ECB and the Bank of Japan (BoJ) aiming to increase the size of their balance sheets and the Fed intending not to allow it to shrink, the net injection of central bank liquidity into the global economy in 2015 could actually be larger than it was in 2014 (Figure 5). This will help to boost growth and should support asset prices. The Fed has also said that it intends to raise rates gradually.

We construct long-run asset return forecasts for each of our key strategic assets. These are monitored regularly and formally updated quarterly. In essence, we build up asset class return expectations from: (i) starting valuations, (ii) economic fundamentals, and (iii) mean-reversion of risk premia.

History is an important guide to what we might expect going forward, especially when we have a very long time series of data. But history does not always repeat itself, so we need to be cautious about simply extrapolating past trends, rather, we should use valuation as our long-term anchor of expected performance.

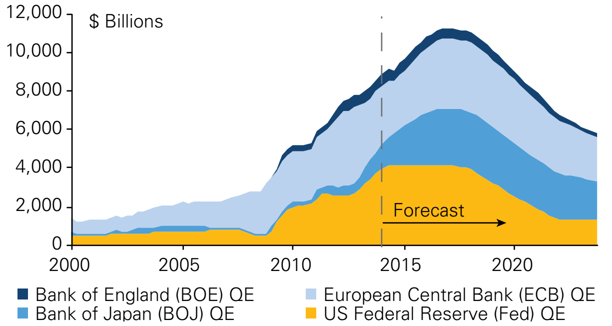
Indeed, the good news is that the distribution of asset returns and risk premia is not random, but has an element of predictability and mean reversion over the long term, if we focus on valuations and the economic environment. However, it is important to bear in mind that valuation is a long-term driver of asset market performance rather than a short-term driver.

Q. So from a multi asset perspective, what does all this mean for your allocations in multi asset portfolios?

A. The positioning of our multi asset portfolios reflects our preference for corporate assets, like equities and corporate bonds, overdeveloped market government bonds based upon our long-term expected return forecasts, and our view that the nearer-term cyclical and liquidity outlook is generally still supportive for risk assets, though not without risk. We believe that the global economy is gradually healing and that monetary policy remains biased towards supporting growth and asset prices. Equity valuations are not yet stretched but government bonds appear richly valued, and we expect yields to gradually rise as the market becomes more confident that the recovery is sustainable and that the Fed is in the process of shifting its monetary policy stance.

Within the fixed income universe, we prefer credit and emerging market debt relative to safe haven developed market debt, though we recognise that these asset classes will be more volatile and good credit selection is key.

Figure 5: Global liquidity is likely to continue rising next year



Source: Bloomberg and HSBC Global Asset Management, data as at November 2014. For illustrative purposes only. Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets.

The fall experienced by equity markets in October highlights the need in our view to have a long time horizon when investing in equities and to be comfortable holding onto positions during the regular periods of market volatility that come with owning risk assets. Even though our expected-return work suggests that equities should outperform perceived 'safe haven' developed market government bonds over the long term, we still hold government bonds in most multi asset portfolios due to the diversification benefits that they can bring in risk-off phases like the one seen in October.

In summary, this is an environment when we may have to learn to live with volatility above the historic lows of recent years and take comfort from the superior yield that equities offer relative to the historically low yields offered by developed market government bonds.

Q. What are some of the key risks and challenges to the outlook you see going forward?

A. There are a number of risks to the outlook for global growth and financial markets.

With headline inflation in the eurozone just above zero, there is a risk that the region could slip into deflationary territory should the ECB not act aggressively enough. In China, there is a danger that what currently is a policy-engineered slowdown in the Chinese housing market gets significantly worse and negatively impacts the banking system. This represents a risk to our macroeconomic outlook and also will need to be monitored closely. Geopolitical risk seems more elevated than it has done for a number of years.

For example, the situation in the Middle East is a key risk. But so far, the fighting has been away from major oil-producing areas. There is also uncertainty over both the pace and scale of US monetary policy tightening that will take place in 2015 and its likely impact on asset prices. The process of asset prices adjusting to tighter policy after six years of near-zero interest rates is likely to result in market volatility and concerns over whether the US economy can sustain higher interest rates, though in the event we think this will be possible. Nevertheless, the process of the US Fed tightening monetary policy while other major central banks are loosening could result in volatility in FX markets in particular, leading to a process of competitive depreciations by exporter economies and leading to volatility.

Finally, it is always nice to end on a bright point and a source of upside surprise could be an improvement in productivity, possibly linked to the ongoing changes in information technology.

Multi asset outlook

Q&A with Guillaume Rabault,
Global CIO Multi Asset

We believe that in 2015 investors may see more volatility than in the past few years. The main factor for this expected shift is that the cycle is maturing in the US and, as a result, monetary policy will be less supportive. Markets will likely be confronted with more risk coming from contradictory forces: economic expansion on one side and tighter monetary conditions on the other. The net effect, however, should remain positive for risk assets. We therefore continue to favour equities, though think EM equities in particular could see volatility. Finally, we continue to maintain a significant allocation to credit and a cautious stance towards government bond exposure.

Q. What are your key takeaways in 2014 and what is your outlook for 2015 and beyond?

A. The US equity market reached new highs in 2014 thanks to steady economic recovery and strong corporate profit growth. Throughout the year, US growth picked up in pace, with US GDP stabilising well above the pre-crisis peak of 2007.

Although authorities have not rushed to announce rate hikes, it seems probable that the first rate hike will take place in 2015. This contrasts with the euro area where the situation led the ECB to take interest rates into negative territory and to announce its asset-purchase programme. In 2014, the BoJ embarked on a spectacular new round of quantitative easing in support of the economy, affected by a Value-Added Tax (VAT) hike.

In this context, the yield of German 10-year bonds fell below 0.80%, approaching Japanese Government Bond levels.

We expect this situation of diverging monetary policy prospects to continue in 2015, where news coming from the US will likely be reassuring, whereas other parts of the world may be confronted with lacklustre conditions. In this context, financial markets will find less support from previous ultra-loose and coordinated monetary policies, unless accompanied by an improvement in economic conditions.

Q. How will US monetary policy tightening impact market volatility in 2015?

A. We believe that the prospect of monetary policy tightening in the US should lead to a rise in volatility. As liquidity is withdrawn in the largest global economy, equity markets around the world will lose some support and will have to rely on positive trends in corporate profits and the economy. US bonds will likely fall in price (higher yields) and over time, until eventually becoming more attractive, and then potentially putting pressure on other asset classes. Cross border portfolio flows will likely continue to favour the US, leading to continued USD appreciation.

This changing landscape could unsettle investors who have become accustomed to seeing many asset classes rise in tandem. In 2015 we may see more volatile equity markets and potentially less stability in the upward trend established over the past few years.

Q. What is the relationship between leverage and volatility? What is your view for 2015?

A. The liquidity cycle has important consequences for financial markets. Rising liquidity tends to encourage the search for yield in peripheral asset classes. For USD-based investors, this implies investing in non-USD asset classes (emerging markets, for example) as well as in non-core USD asset classes (such as high yield, small caps).

A long period of ample liquidity can encourage investors to take on more risk. When the liquidity cycle reverses and liquidity gets withdrawn from the markets, money tends to flow out of asset classes more or less brutally depending on how investors are positioned.

Going forward, we expect the market environment to remain broadly positive for risk assets. However, in 2015, market corrections may make investors feel less confident.

Overall, although the economic growth outlook in Europe and Japan continues to remain a concern, the depreciation of currencies relative to the USD should keep deflation risk under control and prevent debt burdens from spiralling out of control.

Q. What is your outlook for emerging markets?

A. Emerging markets have generally seen slower economic growth since the summer of 2013. A number of factors explain this situation:

- Things have changed significantly in China, where for years the country benefited from strong investment, which encouraged the commodity boom. However, this phenomenon has come to a halt and China is now dealing with excess leverage and excess capacity. As a result, commodities have lost support.
- Many emerging markets are commodity exporters. The backdrop in China has created a headwind for the commodities markets.

- In addition, the prospects of reduced US liquidity has a significant impact on capital inflows into emerging economies. In the summer of 2013, when the Fed announced it would phase out its asset purchase programmes, emerging markets were hit by capital outflows leading to currency depreciation, interest rate hikes and generally tighter credit conditions.

Emerging markets will likely continue to be affected by interest rate tightening in the US and less monetary support as the economy continues to grow; although we see long-term value in the asset class, in the short term we expect them to be volatile.

Q. What is your view of fixed income markets? The yield curve and credit markets?

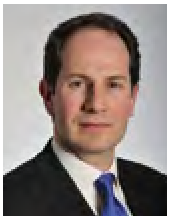
A. Over the last few years, bond yields have fallen to extraordinarily low levels. They have thus prolonged a trend which started in the eighties and has only been temporarily interrupted a few times in this long period. The main reason behind this trend is the continuous decline in inflation since the early eighties. Nominal bond yields are anchored around inflation. Why has inflation continued to fall over this very long period? The most reasonable explanation is that monetary policy has been too tight. This implies that over long periods of time, inflation is a monetary phenomenon.

The credit crisis has slowed demand growth and has reinforced the need for monetary expansion. However, monetary expansion has failed to revive credit demand due to debt overhang in the banking sector. Monetary expansion has been extraordinary, but deflation risks are still dominant. Only in the US do we see signs of a potential rebound in inflation.

Given the tendency of markets to overreact, we believe some economic improvement should bring higher government bond yields. We do not, however, expect this move to be brutal as slack is still present overall and inflation is likely to remain dangerously low.

Yields have also fallen because credit spreads have compressed from the levels seen in the financial crisis. Corporates' balance sheets are healthy, however. We think that credit risk remains low and therefore believe that credit spreads should remain around the current levels, providing returns for investors.

We thus favour credit over government bonds and prefer a short duration position in government bonds.



Global fixed income outlook

Q&A with Xavier Baraton,
Global CIO Fixed Income

As we approach 2015, there are many questions that are yet to be answered: are we returning to a 'normal cycle' in the US after several years of deleveraging? Is the paradigm of low real yields in Europe (impacted by balance sheet repair) still valid? What should we expect in those Emerging Markets facing elevated geopolitical risk and several headwinds, after two decades of supportive global trends? Such questions make the equation increasingly challenging for fixed income in 2015. These conditions are likely to encourage fundamental-oriented investment once more, as opposed to the 'risk-on or risk-off' approach that we have seen in recent years. We consider it to be a real opportunity for those investors with the appropriate resources to benefit from this shift.

Q. What is your analysis of the current macro environment?

A. Economic growth in the US clearly showed positive signs in 2014. In contrast, the eurozone has experienced not only low growth, but progressively slowing growth, while peripheral countries (including Spain and Ireland) provide a notable exception: as they continue to recover at a reasonably steady pace, they contribute significantly less to the overall Gross Domestic Product (GDP) numbers in the eurozone.

Geopolitical risks certainly appear to have elevated in comparison to those in recent years, or perhaps our perception of them was skewed by factors such as the financial crisis and systemic risk. The situation in the Middle East is a key risk, even if, at this time, the fighting has not impacted oil-producing areas. The conditions in Ukraine, and the 'stand-off' between Russia, the European Union (EU) and the US is, of course, an area for concern. Although while the increase of sanctions will affect Europe, it should have limited impact on overall global growth.

With regards to medium-term fundamentals, the ongoing deleveraging process, which is likely to continue to exert downward pressure on inflation and slow down potential GDP growth, could be cause for concern in 2015 and beyond. Also, the appetite for 'income' investments due to an ageing population and growth of capitalisation pension schemes will weigh on consumption, through being a support for bond assets.

Q. What is the impact on interest rates?

A. Varying macro environments translate into diverging trajectories for the corresponding monetary policies. As the Bank of England and the Federal Reserve add to a relatively steep forward curve, it reflects the acceleration of their respective economies, while the European Central Bank is committed to keeping short-term rates low for a longer period of time.

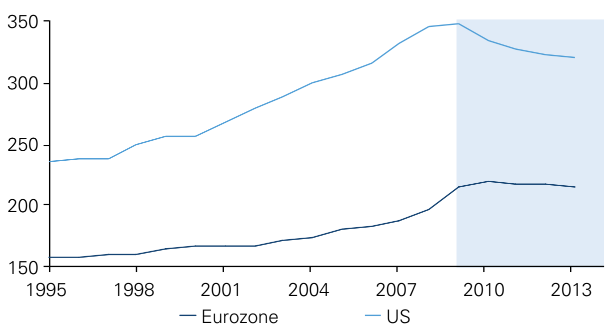
We believe that the robustness of the US economy will probably continue to push the slope of the forward curve further.

Fed Chair Janet Yellen has indicated a cautious move towards increasing rates in Q2 2015. We believe this is likely to push long-term rates higher as we head into year-end 2015 but don't see this priced in by markets yet. Market expectations are currently up to 50 basis point (bp) of rate hikes by the end of next year, which is relatively low and not particularly consistent with how the Fed reacted in past rate hike cycles, even though the challenging global context, the secular deleveraging and ageing trends are factored in.

The average of the last three rate hikes led to a relatively pronounced movement, with a magnitude of 100 basis points for 10-year Treasury yields. That translates into relatively flat returns for indices which had started to post positive returns after 12 months. This is a relatively digestible movement for long-term investors, as the carry and roll down would offset part of the capital losses due to the increase in rates.

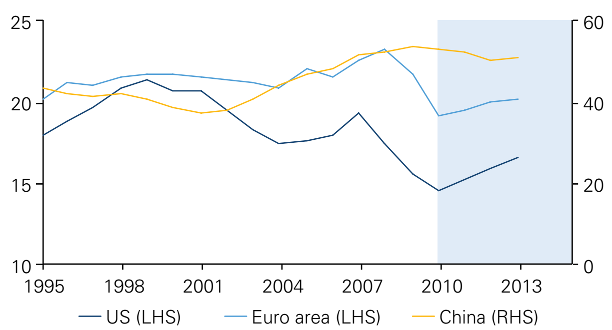
The ECB has a completely different challenge. Inflation expectations are below the 2% target. This is a concern for

Figure 6: US and eurozone total debt (% of GDP)



Source: Moody's and HSBC Global Asset Management, data as at 30 June 2014. For illustrative purposes only.

Figure 7: Gross savings (% of GDP)



Source: Moody's and HSBC Global Asset Management, data as at 30 June 2014. For illustrative purposes only.

the ECB, as it is also happening in core European countries. It has been the main driver behind the decision to start quantitative easing much more proactively with an asset-purchase programme. We expect the programme to be relatively meaningful, but not necessarily game-changing.

It will also enable the ECB to achieve two of its objectives: keeping the euro at a more competitive level and fuelling lending activity, particularly in the periphery. We are relatively confident that, over the next six months, this should help growth improve in the region. It should also help bond yields find a floor, probably where we are at the moment, and we also expect further compression in the periphery, albeit more slowly. Some additional factors will help growth in the eurozone. The first is the demand for loans, which is improving, so bank balance sheets are growing again. We expect the demand for loans to accelerate, as bond yields are falling quite quickly, particularly in the periphery.

It's positive for the financing costs of countries but it also eliminates a few options for banks and investors, and forces banks to lend to the real economy much more actively. It also encourages investors to leave the eurozone, sell euro and buy other currencies and assets, which are yielding more. This contributes to the carry trades and puts pressure on the euro, which is now down to 1.25 (versus the USD), which means a 9% depreciation year-to-date. We expect this process to continue with the change in policy by the Federal Reserve.

Q. ... and emerging markets?

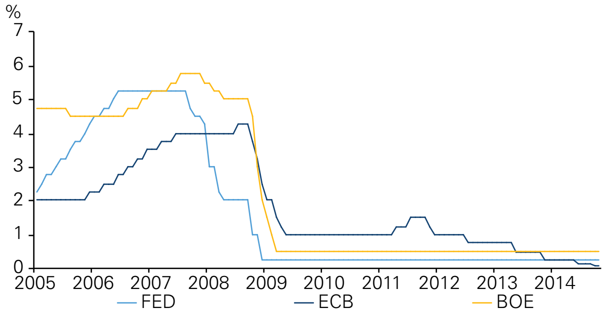
A. Emerging countries are still in a slowdown as they face structural adjustments without the benefit of the previously supportive trends: commodity prices, industrial globalisation and credit expansion. China is facing and engineering the rebalancing of its economy in favour of consumption. It is a relatively slow process, especially as China has two particular headwinds to cope with. The first is the total outstanding amount of credit resulting from rapid lending activity over these past few years. It reduces the room for manoeuvre in terms of further supporting growth by more credit and more lending. The second is the property market, which we expect will continue to slow gradually in terms of prices and activity, even if we don't anticipate a hard landing. This will weigh on economic growth in China, but we expect continued economic growth. In India, we closely monitor the wave of reforms after the election of Modi. The country could accelerate similarly to countries such as Mexico for instance, which had also engaged in a significant wave of reforms earlier this year.

Over the past 12 months, currencies in emerging countries have been the most volatile segment; they depreciated on average by 20% since the tapering tantrum about 8 months ago, so relative value could look attractive but we are relatively cautious in the short term. Countries have continued to be confronted with a deterioration in their current accounts. The currency depreciation has not reversed the trend. In a context where US dollar liquidity will be less ample, we believe that this will possibly put further pressure on the currencies in the short term. It is also reflected by the terms of trade, which bounced back in Q3 2013 after the first wave of currency depreciation, but have since started to deteriorate again. While not all countries are in exactly the same situation, on average they are relatively exposed to an acceleration in the tightening cycle in the US.

Q. What are your views on credit?

A. In our opinion, it is not the end of the credit cycle yet, but it is time to be more selective on quality. Liquidity remains ample in Europe and also in the US. The end of QE is largely compensated by rapidly growing bank balance sheets, in addition to the BoJ and ECB adding more. Of course, US interest rates are likely to increase, but companies benefit from a high level of liquidity and good market access.

Figure 8: Central banks' rates (%)



Source: Bloomberg, data as at September 2014. For illustrative purposes only.

Figure 9: Demand for loans in eurozone (ECB bank lending survey index)

Source: Bloomberg, data as at September 2014. For illustrative purposes only.

Profitability is still very positive when looking at the US, with a less rosy picture in Europe. Leverage has increased in the US, but is still around the average of the past few cycles. Nevertheless, we will probably observe a credit discrepancy arising from the change in the monetary cycle.

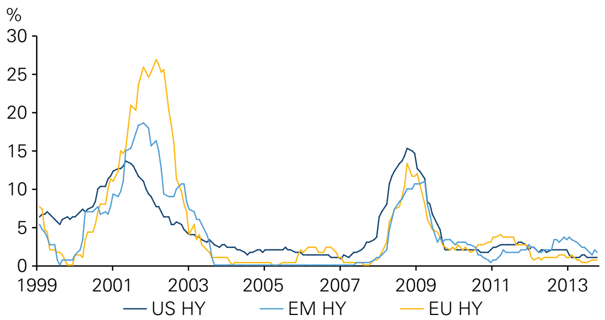
Increasing rates will be much more detrimental for the most leveraged CCC-rated companies. For now, default rates are relatively flat in Europe and in the US, and a little bit higher for emerging countries. From here, we anticipate another couple of years after the first rate hike before seeing the new monetary and economic conditions bite into corporate balance sheets and lead to a much sharper rise in defaults in Europe and in the US. We are less confident with high yield issuers in emerging countries. Slower growth overall, combined with some form of credit tightening due to their high leverage and US dollar liquidity, could lead to higher default rates. Over the region, higher quality is recommended. We also have a preference for Asia over other EM regions.

Regarding government bond yields, we have seen the divergence between the eurozone and the US reach 150 basis points on the 10-year maturity. We think it could go slightly beyond that, even though it looks like the extreme end of the variations, but we think that there is a very different cycle and diverging trends between the two regions that will last for a little while before economic growth in Europe picks up.

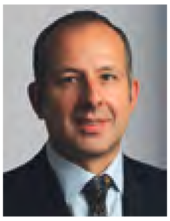
In high yield segments, we have seen a reaction to a change in the monetary cycle, and in a context of relatively low market liquidity, we have seen US high yields reacting in a relatively negative fashion since June. But we continue to believe that the fundamentals are sound for companies, providing some selective carry opportunities.

Overall, 2015 promises to be more about carry, selectivity in country and issuer selection, and the same challenging regime of sudden spikes in volatility, exacerbated by a lack of market liquidity.

Figure 10: High Yield (HY) issuer default rates (%)



Source: BofA-ML High Yield Default Rates, data as at 30 September 2014. For illustrative purposes only.



Global equities outlook

Q&A with Bill Maldonado,
Global CIO Equities, CIO Asia-Pacific

The global equity market rally over the past two years has been unusually smooth with only a few notable sell-offs. However, volatility has returned to the markets in recent months, with the US federal funds rate hikes on the horizon and stark divergences in the policy trajectory of major central banks amid a mixed outlook for economic growth.

Q. What can we expect from global equity markets in 2015 as the normalisation of US monetary policy takes effect?

A. We are currently in an environment that can be described as a fragile equilibrium, where markets are vacillating between two very different and opposing views of the future. One view is the deflationary one, where the assumption is that the steps taken by central banks, particularly in the US, eurozone, and Japan, are not enough to get these economies back on track. The other view is that we are entering a period of normalisation. We broadly subscribe to the latter view. We believe that we are not going to fall back into a period of recession as we see the US very clearly on the growth path. The forthcoming US interest rate increases will likely occur alongside an improving US economy, due to the data-dependent nature of the Fed's monetary policy.

Considering how low rates currently are and looking at where they are headed, equities remain the highest expected return asset class. However, as multi asset investors, we have to get used to the idea that returns across all asset classes will be rather muted over the coming years. Given that corporate balance sheets are in comparatively good shape, we expect mid-single-digit annualised real returns from equities on average over the long term as the global economy heals and US monetary policy continues to normalise.

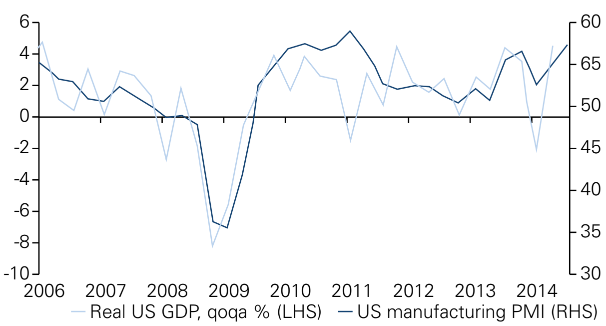
There remains considerable uncertainty over both the timing and magnitude of the US monetary policy tightening that will take place in 2015 and its likely impact on asset prices. The transitional nature of the policy normalisation will likely continue to trigger temporary bouts of volatility. We expect this normalisation to play out over an extended period of time, so investors may have to learn to live with higher volatility and lower returns than they have become accustomed to in recent years.

Q. As the economic divergence between the US, eurozone and emerging markets becomes increasingly stark, how does it impact your investment strategy in these key markets?

A. The net injection of central bank liquidity into the global economy in 2015 could actually be larger than it was in 2014, which would help boost growth and support asset prices. However, while liquidity may not be a major source of concern, living in a globally connected world does mean that developments in one economic bloc could have a significant bearing on others. The same applies to companies. Companies listed in Europe and the US are increasingly earning more of their revenue offshore, particularly in the emerging markets, and there are a large number of companies in the emerging world that export principally to western markets. So we can't look at markets or companies in isolation or only in relation to their home economies.

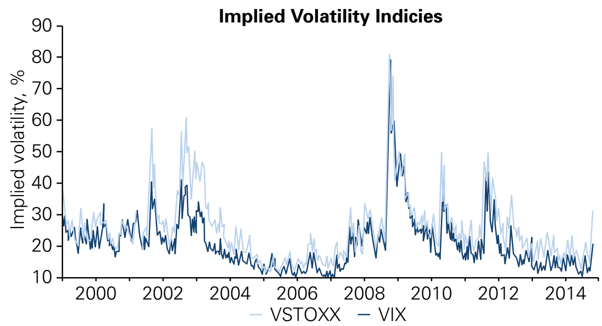
What our investment process seeks to do is look for companies that are outliers by being inexpensive for the level of profitability they generate. In the current environment, as at any other period of time, our investment team is focused on understanding what the changes in the economic scenario mean for specific companies and their profitability at a granular level. This level of research presents us with a more mixed picture and prevents us from painting all European or US or Chinese companies with the same brush simply based on the state of their economies.

Figure 11: US data points to solid growth in H2 2014



Source: HSBC Global Asset Management, data as at October 2014. For illustrative purposes only. Past performance is not indicative of future performance.

Figure 12: Implied volatility still around 2005-06 lows



Source: DataStream, data as at October 2014. For illustrative purposes only. Past performance is not indicative of future performance.

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It is during times like these that we need to have a clear philosophy and discipline so we can stay focused and make the right decisions within our investment framework. If we have the conviction that the companies that we are invested in will continue to deliver on their profitability, then when the market has one of its wobbles, we will have the courage to view that as a buying opportunity. But we also need to stay vigilant and recognise when the fundamentals have changed and make decisions accordingly.

Q. 2014 was a year of big changes in the political landscape of various countries. Looking into 2015, do you expect the reform agendas of these new governments to continue to drive the markets?

A. We've seen a number of game-changing elections in the emerging world in 2014 and the results of these elections have been largely positive for markets. However, a few of these key elections have not yielded a result that would, at the moment, appear as a positive outcome for investors.

To illustrate this, we can put Brazil and India at the opposite ends of the spectrum as far as market desirability of election results is concerned. In Brazil we saw no change as Dilma Rousseff was re-elected to a second four-year mandate. Over the last four years Brazil has disappointed expectations, as GDP grew only 1.6% and inflation was at 6.2%, leading to a sharp deterioration in confidence towards the economy.

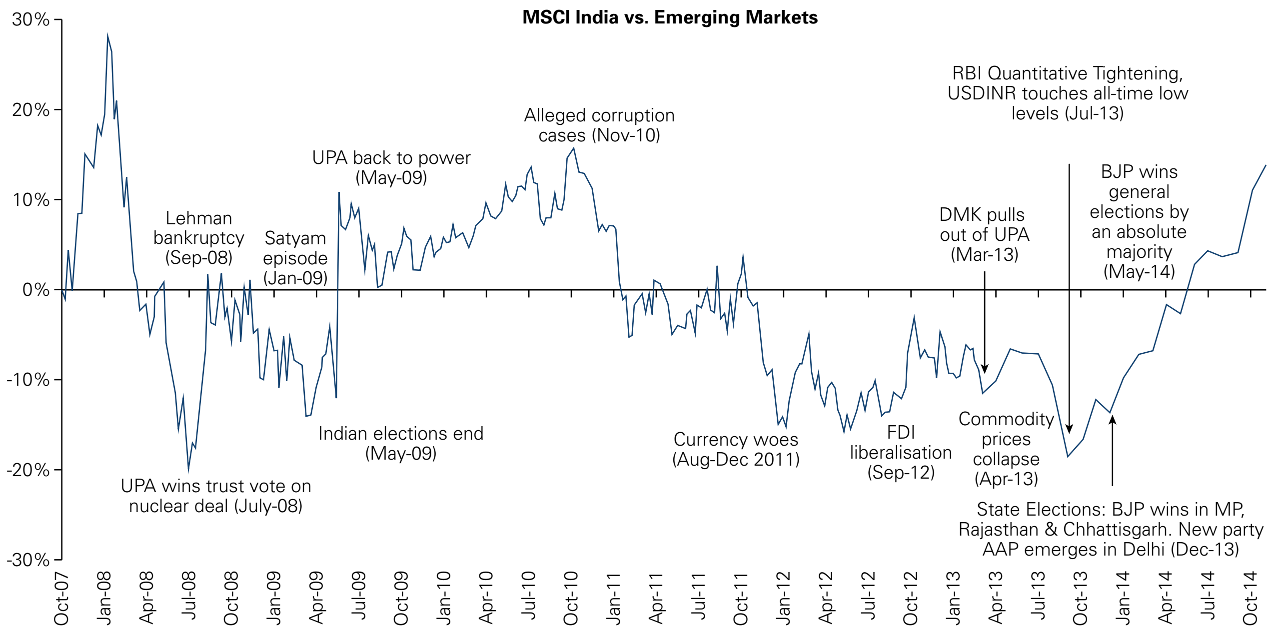
Rousseff's government had rolled out a number of antiquated and anti-market policies in its previous term, so we will now have to watch closely to see how that changes in her current term. However, we take comfort in the fact that at least we have a definite outcome and we can start factoring it into our investment decisions concerning this market. We are now waiting to see the policies that will be rolled out by Rousseff, so we can gauge their impact on Brazilian companies.

On the other hand, in India, the Narendra Modi-led Bharatiya Janata Party (BJP) swept to power with an historic mandate and our portfolios benefited significantly from that landslide victory. We remain positive about this government's ability to get things done and we see some important and interesting investment consequences from the reforms that are being introduced in the energy, coal, electricity generation and infrastructure sectors. But we are also objective about the current state of affairs in India and we are being very careful about not getting carried away by the wave of post-election euphoria.

In China, while there were no elections, we saw a relatively new leadership rolling out key structural reforms with the aim of rebalancing the country's economy for long-term sustainable growth.

In 2013 we were living in an environment that was dominated by macro concerns, not just those related to global growth and impending tightening measures from the US Federal Reserve, but also those due to the slowdown in various key

Figure 13: Re-rating of Indian stocks to be led by decisive government



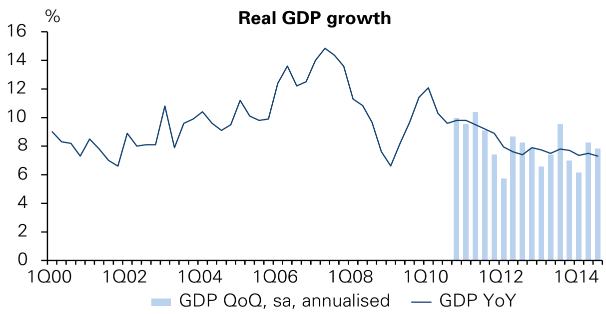
Source: RIMES, MSCI and Morgan Stanley Research, data as at 31 October 2014. For illustrative purposes only. Past performance is not indicative of future performance emerging markets and to whether policymakers in these countries would do enough to put their economies back on track. As we near the end of 2014, it appears that investors have regained some of that lost confidence in these economies and the reform agendas of their governments. We believe that effective implementation of reforms could lead to a sustainable improvement in economic fundamentals and the growth prospects of emerging market countries, prompting a reform-led re-rating of stocks listed in these markets in the longer term.

Q. As China's economic growth continues to normalise and the economy rebalances, how do you see it impacting global equity markets in 2015?

A. China has been weighing on investors' minds for a couple of years now and, given the slew of negative headlines, it has been difficult to analyse in certain key aspects. There is a notable difference in the way Chinese policy is formed and communicated which makes it challenging, particularly for western investors, to evaluate. Reforms in China tend to be small, frequent and incremental, unlike in the western world where we are used to big bang reforms and policy changes. So, when examining the reform process in China, we need to keep close tabs on the series of seemingly small announcements from the government which then add up to important and meaningful changes. The current leadership in China has emerged as a very powerful one, even this early in its lifecycle, and it is not afraid to make bold moves in carrying out its reform agenda. We expect these reforms to have a positive impact on the economy and markets in the medium to long term.

The other concept that has been difficult for investors to grapple with is that of a slowing China, which has also fed into the 'fragile equilibrium' position that we find ourselves in today. China has lived on a credit-fuelled infrastructure boom for the past two to three decades and that helped the country maintain a fantastic rate of growth for that period of time. But China has now grown too big, relative to its trading partners, to be able to sustain the same pace of investment and growth.

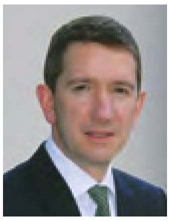
Figure 14: Soft landing of the Chinese economy so far



Source: CEIC and HSBC Global Asset Management, data as at October 2014. For illustrative purposes only

While data has shown signs of softening in the past few quarters, we expect the government to look past short-term economic fluctuations and desist from rolling out big stimulus measures to boost the economy. Instead, it will continue to use targeted policy measures and push forward structural reforms to ensure growth within a reasonable range and sufficient job creation. The government may set a lower growth target of 'about 7%' or specify a range of '7 to 7.5%' for 2015. Or, the government could replace an explicit growth target with a growth forecast, which is less binding.

Policymakers in China are cognisant of the challenges involved in rebalancing that economy towards a more domestic consumption-driven one and we think they are making many right moves in that direction. But this will certainly be a long and, at times, painful process. In the meantime, we will be paying very careful attention to the developments on that front as China undergoes its period of transition. The performance of Chinese stock markets will likely be driven by the outlook on policy, growth and reform in the short to medium term. Current valuations are low and have likely priced in much of the macro risks. We believe stock selection based on corporate profitability and fundamentals remains the key to outperformance.



Liquidity outlook

Q&A with Jonathan Curry,
Global CIO Liquidity

2014 has seen a number of themes affecting money market and liquidity funds. This article will review the events of this year, and then take a look at how these events will continue to dominate many agendas in 2015, as well as give a view of what else the coming year could have in store.

Q. How have money market funds fared in 2014?

A. Looking back, my first observation of 2014 is, despite turbulent financial markets, how much money market funds have continued to provide a valuable tool for short-term cash during the year. For example, the institutional AAA-rated funds industry in Europe (IMMFA members) has grown 14% year-to-date to the end of October, and the US domestic industry has also grown in recent months. The rise in importance of emerging market currencies during the year is also worth noting, with money market funds being used more and more by local investors in markets such as China, India, and Latin America. HSBC has a particular role to play around the globe as trade increasingly expands, helping investors in local markets as well as in the traditional international centres.

Q. What impact did the low interest rate environment have?

A. Unsurprisingly, the low interest rate environment in the developed markets of Europe and the US has been the second theme for 2014. The low returns available in the money markets clearly continue, but we also have started to see a divergence in outlook as the economic well-being of a number of countries has improved whilst others have deteriorated or stagnated. In our opinion, for US dollar and sterling funds the outlook is positive, but for euro funds the situation is less than rosy. In June 2014, the European Central Bank took the widely expected step of reducing rates, including taking the Deposit Rate (DR) (paid on banks' excess reserves) into negative territory for the first time in the history of the euro. At the same time, the ECB announced a number of other measures to inject liquidity. This had an obvious knock-on effect on market yields. However, the ECB went even further a few months later (this time taking many by surprise) and reduced rates again. The DR with effect from 10 September 2014 stands at minus 20bps.

Q. What part has money market fund regulatory reform played?

A. In the US, the Securities and Exchange Commission (SEC) finally announced its package of reform for money market funds (MMF) in July. The most significant change is that funds will now be required to be based on Variable Net Asset Value (VNAV) for prime and municipal MMFs held by institutional investors, and the other major change is the requirement for the same funds to have the ability to apply discretionary redemption gates and liquidity fees, designed to protect investors. The SEC has proposed a two-year period for implementation. In Europe, the new European Parliament began its deliberations in October on the MMF reform proposals of the European Commission. Whilst we are at an early stage in the process and the EU Parliament is likely to propose changes to some of the Commission's proposals, some form of conversion to VNAV is likely to remain. The European Parliament is targeting March 2015 to complete its deliberations. The European Council has also begun its deliberations. Many compromise proposals have been discussed but no clear direction exists at this time. As it stands, there is one major similarity between the announced US and proposed European changes; a move towards VNAV (though different criteria apply). There are also significant differences: Europe currently makes no provision for redemption gates and liquidity fees, whereas the US has no prohibition on fund providers paying for external ratings; the US also allows for a two-year implementation period recognising the complexity for providers, investors and support services whereas Europe, at least as currently proposed, only factors in a six-month period which we consider insufficient. At HSBC we are continuing to engage with regulators to work for prudent reforms, and we continue to work with clients to educate them.

Q. Although Basel III hasn't yet been fully implemented, what kind of impact is it already having?

A. Due to Basel III, banks are reviewing how they treat various client deposits, potentially with implications for their appetite (and rates paid) for certain balances (based not just on the type or duration of cash, but also on the type of client that is placing it). Investors are now evaluating the values of their deposits under the new regulations, and deciding how best they can allocate their investments across deposits, MMFs, and other asset classes, including direct securities.

The regulatory environment is also opening up more markets from a business point of view; witness, for example, the rapid expansion of the cash management and working capital framework to support doing business in and with China, and the RMB currency, both onshore and offshore.

Q. How do you see these themes evolving in 2015?

A. Looking forward to 2015, the themes we have already touched on will clearly persist. Regulatory reform for MMFs will continue to evolve – in the case of the US the concrete steps to implementation of the new regime will begin; in the case of Europe we would expect to see the regulatory debate concluded and the industry prepare itself for change (potentially at a faster pace than in the US). Even though Basel III is not to be fully implemented until 2019, many US and European banks and local regulators are already moving towards early compliance, and we expect to see changes in banks' balance sheet priorities driving new deposit and investment requirements in 2015. This means we also expect to see a potential for increased demand for off balance sheet options, including MMFs.

Q. How about short-term interest rates in 2015?

A. On interest rates, we would expect to see the first moves by policy makers to raise rates in USD and GBP potentially as early as Q2. US consumers are likely to be one of the more dependable sources of demand in 2015, due to rising employment, the boost to real incomes from lower gasoline prices, faster nominal wage growth, and the scope for households to take on more debt given that they have deleveraged and debt service costs are at record lows. These are some of the factors that have led the Federal Reserve to stop new Quantitative Easing (QE) purchases being a precursor to raising interest rates. In parallel, expectations for the first interest rate rise in the UK have been pushed forward into the middle of next year. This change has been driven by the change in expectations for global growth and the impact this is likely to have on UK growth and inflation expectations. The latter remain well under control, despite the UK's growth profile and falling unemployment.

The outlook for the eurozone economies remains tough however, and we expect rates to stay low or negative for the foreseeable future. While the ECB may finally prove that it is willing to do 'whatever it takes' to save the euro by buying government bonds, there is clearly a danger that it may do too little too late to avoid slipping into outright deflation, given that its policy making is complicated by politics and a consensus-based decision-making structure.

Q. Whilst the themes discussed will dominate many agendas in 2015, what else do you see in store?

A. We foresee an increase in demand for investment solutions that are more integrated with operating services, such as banks' cash management or custody capabilities. This is in part driven by changes in bank balance sheet needs, and in part driven by the continuing goals of investors for greater diversification and choice in their daily cash allocations. The use of technology to support this integration will be critical – whether that is the use of automated sweeps from the underlying bank accounts or the use of investment portals to direct investments to money market funds. We also expect cash investment products to become more embedded with collateral arrangements, whether through the simple pledging of a money market fund account to support a credit transaction, or the use (and subsequent investment) of cash collateral to support areas such as securities' lending arrangements.

We also foresee the continued growth in relative importance of emerging market currencies to investment policies, and the need for investors to achieve consistency in the quality of how investments are managed, irrespective of currency or location.

We expect investors in emerging markets, both local and global, to continue to embrace money market funds and other outsourced cash investment solutions. Regulatory focus on money market funds is not just a US and European phenomenon, but is more global, with regulators in many jurisdictions reviewing their regulation for money market funds. Ultimately, if the reforms implemented make money market funds even more robust whilst maintaining the value of the asset class for both investors and providers, this is clearly a positive outcome for all.

In conclusion, it's been a busy and exciting year for the liquidity business, and 2015 will be no different as many changes take shape. We expect that the value money market funds and other cash investment solutions deliver will continue to be at the centre of investors' needs, and will evolve with them.

Contributors

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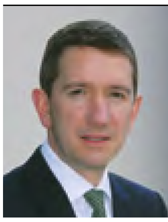
Chris was appointed Global Chief Investment Officer in 2010. He was previously CEO of Halbis, HSBC's active investment specialist, and joined HSBC's asset management business in May 2003 as Global Chief Investment Officer. Chris was previously Global CIO of AXA Investment Managers and also held the position 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.



Jonathan Curry,
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Jonathan is Global CIO for the Liquidity business and has been working in the industry since 1989. Prior to joining HSBC in 2010, Jonathan worked as Head of European Cash Management at Barclays Global Investors. Jonathan is Chairman of the Institutional Money Market Fund Association and a Board member since 2006 of the industry association for AAA rated money market funds. He is also a member of the Bank of England's Money Market Liaison Group and a member of the European Banking Federation's STEP Committee.

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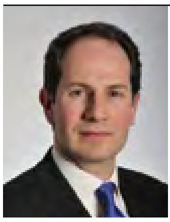
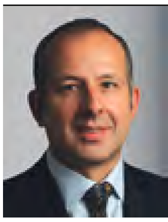


Xavier Baraton,
Global CIO Fixed Income

Xavier Baraton joined HSBC in September 2002 to head the Paris-based Credit Research team and became Global Head of Credit Research in January 2004. From 2006, Xavier managed euro credit strategies before being appointed as Head of European Fixed Income in 2008 and as Global CIO, Fixed Income in 2010. Prior to joining HSBC, Xavier spent six years at Credit Agricole Indosuez, including five years as Head of Credit Research. Xavier began his career in 1994 in the CCF Group. Xavier graduated from the "Ecole Centrale Paris" as an engineer with a degree in Economics and Finance in 1993 and gained a postgraduate degree in Money, Finance and Banking from the Université Paris I – Panthéon Sorbonne (France) in 1994.



Bill Maldonado,
Global CIO Equities,
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Bill is the CIO, Asia-Pacific and Strategy CIO for Equities and has been working in the industry since joining HSBC in 1993. Based in Hong Kong, Bill oversees the investment strategies in the region. Over the past 18 years, Bill has headed up a number of investment functions, such as non-traditional investments (including passive indexation mandates, fund-of-funds, structured products and hedge funds) and Alternative Investments teams. He then became Strategy CIO, Equities and CIO for the UK in 2010. He holds a Bachelor of Science degree in Physics from Sussex and Uppsala Universities, a D. Phil degree in Laser Physics from Oxford University and an MBA from the Cranfield School of Management.

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