

Investment Intelligence



Don't lose sight of the opportunities in 2012

- ▶ Volatility may continue but deep value is emerging across asset classes
- ▶ Within the bond universe, value is likely to be found in specific areas
- ▶ Having sold off, equities are now trading at very attractive valuations
- ▶ Emerging markets offer a range of opportunities for discerning investors

As we move into 2012, concerns that plagued markets the year before are likely to continue. While the magnitude of problems in Europe has the ability to further roil market sentiment, deep value is beginning to emerge in specific parts of the investment world. More importantly, there are signs that we may be turning the corner.

Eurozone debt crisis would remain an overhang in the near term

European policymakers will need to enforce credible plans across the Eurozone to repay debt, balance budgets and ensure that individual member countries do not overspend. In the meantime, central banks have been proactively providing liquidity through coordinated easing policies and bond buying programmes. This has been instrumental in providing near term support, and buying time for European policymakers to hammer out credible solutions.

Deep value emerging across asset classes

Riskier assets are now pricing in very low growth, in some cases, a potential recession. While the risk of this scenario exists, it is not the expected outcome. Should markets show definite signs of a recovery, assets that have been sold off sharply but retain good fundamentals have strong chance of upside.

▶ Equity

Global equities are now trading at a very low valuation relative to long term history. Meanwhile, corporate earnings remain in good shape as companies have tightly controlled costs following the previous crisis. This sets the stage for a potential re-rating in equity markets if companies start to beat bearish earnings estimates.

Chart 1: Valuations for global and emerging market equities

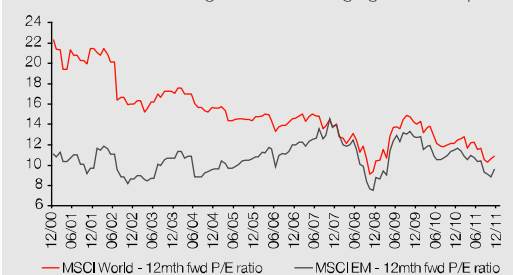


Chart 1 Source ¹

▶ Bond

As volatility is likely to continue in the near term, bonds as an asset class are likely to remain popular with investors in 2012. We continue to see very good value in fixed income but in specific areas of this universe.

US and European government bonds have become expensive and are supported by weak fundamentals. However, corporate bonds remain very good value. Companies have benefited from strong profit growth and low borrowing costs as interest rates fall. In addition, default rates are falling, and this is a key indicator of health in the corporate bond sector.

There are significant opportunities in high income quality credits. These credits may have suffered recently during the downturn but as a result, offer exceptional value. When compared to extremely risky debt (e.g. rated CCC), they offer similar or higher yield for much lower levels of risk. In addition, corporate bonds offer some downside cushion amid the volatility, and are likely to benefit as markets recognise fundamentals.

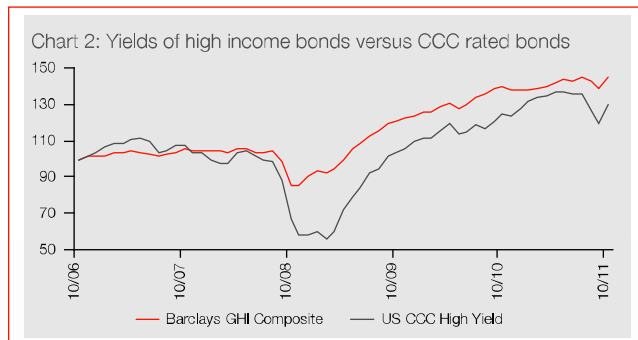


Chart 2 Source ²

Seek growth opportunities in emerging markets

Emerging markets are likely to be prime beneficiaries coming out of this crisis. Fundamentals remain strong relative to developed markets, but valuations have cheapened considerably as risky assets sold off. As sentiment stabilises and the recovery begins, investors are likely to search for higher growth and income markets.

In this regard, emerging market or Asian bonds, offer investors solid growth and income potential. Asian bonds have continued to deliver resilient performance despite a very challenging global environment. The HSBC Asian Bond Index returned 4.7% year to date and 54.5% in the past 3 years⁴. Going forward, Asian bonds are well-placed to outperform, given their strong fundamentals, ample liquidity and relatively benign interest rate environment. Investors with slightly higher risk appetite could opt for Asian high yield bonds which have a slightly higher risk return profile.

Another reason to invest in emerging markets is the exposure to rising domestic consumption. Emerging economies such as Brazil, Russia, India and China are among the fastest growing economies today, and by 2050 will be among the six largest in the world⁵. These economies are increasingly driven by domestic demand as exports as percentage of GDP falls. For example, in China, the world's fastest growing economy, domestic consumption will likely account for 41.7% of GDP by 2015 while exports' contribution will drop to 20.2%⁶. This development will be supported by favourable government policies. As such, exposure to the activities of Chinese consumers could be one way in which investors could play the dynamic emerging market consumption theme.

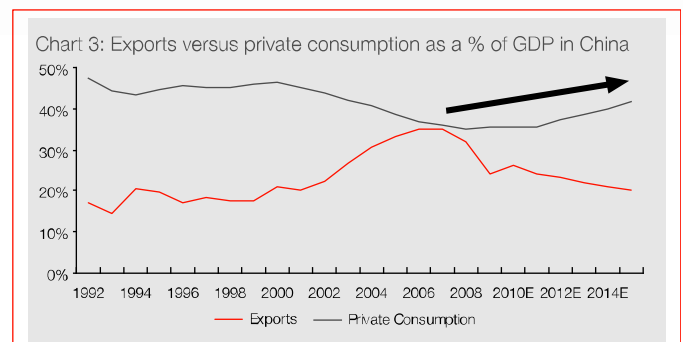


Chart 3 Source ⁷

In the near term, markets are likely to remain volatile, and all asset classes are likely to be affected to varying degrees. This has created an uncertain environment that is nonetheless rich with opportunities. However, identifying these investment opportunities can be difficult and active management can help investors uncover hidden gems while mitigating risks.

Commodities

The correction in 2011 has taken off the speculative edge in commodity prices, which had been increasing prior to Eurozone crisis. As a result, prices are well-positioned to rise in the longer term on the back of continued demand from emerging markets. As commodity prices can be highly volatile, it is worth considering exposure to markets that are likely to benefit from strong prices such as Brazil or Russian equities.

Key risks in 2012

The resolution of the Eurozone crisis is likely to be a prolonged process, even if it moves in a constructive direction. Thus the possibility of market falls, as a result of political wrangling and stalemate, is potentially high during the course of the year.

In addition, there are a number of elections in 2012 that pose both political and economic risks. For example, the US faces parliamentary and presidential elections at the end of 2012, and progress on deficit reduction is likely to be slow as both Republican and Democratic parties seek to avoid unpopular policies. Without sufficient commitment to cut spending, the US could suffer further credit rating downgrades.

Table1: Political calendar 2012

Date	Country	Election
01/12	Taiwan	Presidential
03/12	Russia	Presidential
04/12	South Korea	Parliamentary
04/12	France	Presidential (1 st round)
06/12	France	Legislative
07/12	Mexico	Presidential and legislative
07/12	India	Presidential
11/12	US	Parliamentary
12/12	US	Presidential
2012	Turkey	Presidential
2H 2012	China	18 th National Congress of the CCP

Table 1 Source ³

Outlook⁸

United States



The outlook for the US economy remains tough, particularly as unemployment remains stubbornly high at about 9%, with consumer spending a key driver of economic growth. However, the US economy does appear to be seeing stronger growth than other developed economies, which may provide some support to 2012 corporate earnings, particularly if economic stimulus measures are extended into 2012. Political deadlock has been a severe impediment to the US dealing with its budgetary problems with the US standing alone amongst major economies in not enacting fiscal austerity.

Europe

Prospects for continental European equities remain dominated by the economic impact of the Eurozone debt crisis and the ability of the Eurozone's politicians to arrive at a permanent resolution to the problem. European equities trade on a low multiple of 8.8x forward earnings, implying that the asset class offers significant value should a solution to the European debt crisis be found. However, the sovereign debt crisis is already having an impact on the European economy with PMI manufacturing and services indices moving more firmly into contraction territory in October.



Bonds

Countries with high debt and/or budget deficit ratios witnessed their funding cost surging to all-time highs since the euro was launched, with Italian and Spanish yields causing particular concern, pushing firmly through 7% and 6% respectively. Even core economies saw their government bond yields rising well above corresponding German benchmark yields. In the US, the positive surprise seen in economic data can continue. Should the Eurozone reach an agreement on a lasting solution to its sovereign debt crisis, the safe haven premium currently embedded in US Treasury prices may start to evaporate, forcing yields to rise to levels more reflective of the current economic and fiscal backdrop.



Asia ex-Japan



The slowdown seen in global economic activity has had an impact on Asia ex Japan economies, given their relatively high levels of exports to developed economies. However, we still view the economic backdrop of the region favourably, with the region's economies offering stronger growth than the developed world. Inflation is showing signs of moderation and we could see loosening fiscal policies in 2012, which we would regard as positive catalyst for the region's economies and equity markets. Within Asia ex Japan, we favour Chinese equities where valuations are low, with the market trading on about 7.8x 2012 expected earnings.

Japan



The Japanese equity market has frequently traded in a rather disconnected manner from other markets in 2011. Like other equity markets, valuations remain attractive, particularly if Japanese companies can boost their levels of return on equity, although this is likely to be longer-term development. For 2012, Japanese equities are likely to be affected by the slowdown in global growth, whilst the appreciation seen in the Japanese yen is also likely to dampen corporate performance.

Currencies

Many currency markets have been driven by similar factors as those driving equity and bond markets, for example, the Swiss franc which has seen significant appreciation. We would see a resolution of the Eurozone sovereign debt crisis being positive for the euro and negative for the Swiss franc, and possibly the US dollar and Japanese yen, should such a resolution be accompanied by a wider increase in risk appetite. Longer term we see the emerging market currencies are well placed to appreciate, reflecting their long term structural advantages, albeit policy actions may be used to prevent currencies appreciating.

Footnotes

1. Source of Chart 1: HSBC Global Asset Management, I.B.E.S., data as at 2 December 2011. "MSCI World" consists of 24 developed market country indices, "MSCI Emerging Markets" consists of 21 emerging market country indices. Performance information above refers to the past and should not be seen as a guide to the future.
2. Source of Chart 2: HSBC Global Asset Management, data as at 31 October 2011.
3. Source of Table 1: HSBC Global Asset Management, as at 30 November 2011.
4. Source: Bloomberg, data as at 30 November 2011.
5. Source: Goldman Sachs, BRICs 10 years on – Halfway through the global transformation, Global Economics Paper No.208.
6. Source: Credit Suisse, data as at 31 January 2011.
7. Source of Chart 3: Credit Suisse, data as at 31 January 2011.
8. Source of macroeconomic data: Bloomberg as at 30 November 2011.

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