IM
Investment Monthly

30 September 2015

Fed stays on hold amid global growth concerns

Key takeaways

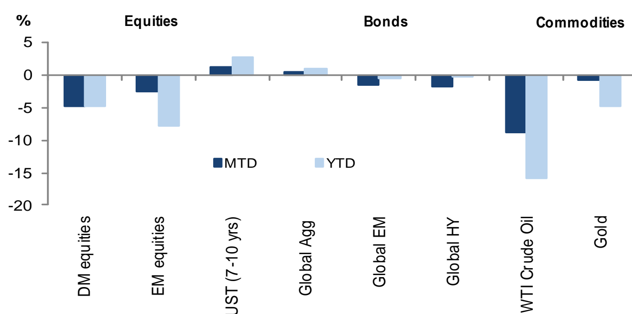
- Lingering global growth fears and continued US monetary policy uncertainty saw global equities fall in September
- Developed Market (DM) government bond yields fell as risk aversion remained elevated
- The Fed kept interest rates on hold at its September meeting, but signalled a rate hike is likely later this year
- The European Central Bank (ECB) indicated it could expand and extend its quantitative easing programme if deflation risks rise
- Brazil's sovereign credit rating was downgraded to junk status with the BRL hitting a record low against the USD
- Chinese data continued to disappoint, as the slowdown in the manufacturing sector intensifies

Our base case remains that the global economy is in a "fragile equilibrium" whereby there is just enough demand relative to supply, maintaining low growth and inflation. This supports an assumption of a "slow-and-low" interest rate cycle and relatively low asset class returns.

From time to time, shocks may cause financial markets to price in a higher probability of either a "secular stagnation" scenario characterised by very weak demand growth and negative real interest rates or a "stronger demand recovery" scenario exerting pressure on central banks to raise interest rates more aggressively than the current tepid expectations.

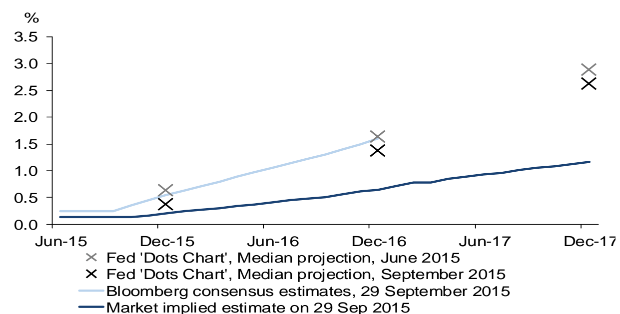
Volatility will therefore likely remain high, but overall we continue to prefer risk assets such as equities, high yield credit and Emerging Market (EM) debt over developed market government bonds over the long-term within the context of well diversified multi asset portfolios.

Asset class performance: September 2015



Note: UST= US Treasury; Agg= Aggregate; HY= High Yield; WTI= West Texas Intermediate.
All performance data is calculated in total return terms (capital and income), gross of fees. Equity returns are expressed in local currency. Bond and commodity returns are expressed in USD. Source: Bloomberg, data as at 29 September 2015. For illustrative purposes only and does not constitute any investment recommendation in the above-mentioned asset classes. Past performance is not indicative of future performance.

Chart of the month: The US Federal Reserve signalled a more gradual pace of tightening in their latest projections



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HSBC
Global Asset Management

Long term Asset class positioning (>12 months)

Asset class	View	Rationale
Equities		
Global	Neutral	We expect to be better rewarded over the long term for holding equities rather than developed market cash or government bonds. However, valuations are less attractive now than they were a year or two ago even despite the most recent sell off. Overall, we remain neutral for this asset class. We continue to believe that the global economic recovery is on track and global equity markets will post positive returns over the long term. Continued support from global Quantitative Easing (QE) will, in the medium and longer term, likely outweigh headwinds created by slower Chinese growth and tighter US monetary policy. These risks could flare-up from time to time leading to sudden spikes in volatility ahead such as that observed in August 2015.
US	Neutral	A durable US economic recovery and a growth focused central bank are both supportive for US equities, in our view. However the strong post crisis equity market performance, supported by 'ultra-loose' monetary policy, has lowered our estimate of prospective returns and we remain in a neutral position. US equity valuations remain attractive relative to government bonds.
UK	Neutral	Similarly, UK valuations have also become less attractive over time and we retain a neutral positioning in portfolios. An upcoming referendum on membership of the EU, in addition to potential rising interest rates, could inject market volatility in 2015-17.
Eurozone	Neutral	Eurozone equities should see support from the European Central Bank's (ECB) substantial quantitative easing programme, particularly given the potential expansion of the current program, and the ongoing economic recovery. Eurozone equities remain attractive relative to government bonds. However, our estimate of long-term prospective returns has also fallen given the growth outlook and we maintain a neutral position.
Japan	Neutral	Japanese stocks remain supported by stronger corporate governance and increased net profit margins. In the near to medium term, earnings per share could expand and the Bank of Japan's extremely loose monetary policy may help the yen to depreciate, which in our view should improve the earnings outlook. However, the rally over the last couple of years leaves our long-term expected returns signal tilted towards a neutral position.
Global Emerging Market (GEM)	Overweight	In EM equities are attractive for western currency based investors (USD, GBP or euro based) in our view. Within EM, Asia is our preferred region, as the prospective returns look higher, supported by potential long term currency upside, though there could be some near term volatility as worries remains around Fed tightening and a slowdown in China.
Central and Eastern Europe (CEE) & Latin America (LatAm)	Neutral	In the long term, we anticipate positive growth differentials compared with Developed Markets to be maintained. As with Asia, however, these markets are vulnerable to investor concerns about reduced global liquidity. The recent fall in commodity prices will also continue to be a severe headwind for commodity dependent producers. In addition, geopolitical tensions remain high and unpredictable.
Government bonds		
Global	Underweight	At an aggregate level, global government bond yields (of which the majority are core developed market) are still too low in our view. Our expectations for long-term returns from this asset class are therefore still low, though yields have moved up since April, meaning they have become less expensive. Government bonds still provide an important role when seeking diversification benefits and reducing volatility within multi-asset portfolios.
US	Underweight	We believe US treasuries are pricing in an overly pessimistic outlook for the US economy. With yields still low we prefer to be underweight and instead still have a preference for risk assets such as equities, high yield credit and EM debt. However, the size of the valuation gap between DM bonds and risk assets has narrowed over the past few years.
UK	Underweight	We believe UK gilt yields are also too low relative to their long-term averages and are pricing in an overly pessimistic macroeconomic outlook. Hence, on a relative basis we generally prefer risk assets to perceived 'safe-haven' government bonds.
Eurozone	Underweight	Similarly core European bonds are overvalued in our view, but with European QE continuing this may not correct soon. Despite a backup since April, yields are still extremely low suggesting overall price upside is still limited and so we prefer to be underweight government bonds and overweight risk assets.
Emerging markets	Overweight	The yield pick-up on USD denominated EM sovereign debt makes them attractive relative to Developed Market (DM) government debt in our view. However, in the short-term, spreads in the EM debt universe are at risk of widening when tighter US policy arrives. Bonds from commodity-dependent currencies and with significant external financing needs are particularly at risk. Local currency bonds have lost ground with a stronger USD in recent months, though we expect stronger local currencies longer term.

Asset class	View	Change	Comment
Corporate bonds			
Global investment grade	Neutral		Corporate balance sheets remain in good shape and default rates low but we retain a neutral positioning for this asset class. Tighter US monetary policy also remains a risk for the asset class in the nearer term.
- USD investment grade	Neutral		There is a wide spread between USD and EUR-denominated investment grade corporate bonds, but improved relative valuations for USD-denominated credit is offset nearer term by the risk of a more aggressive pace of Fed tightening, in our view.
- EUR and GBP investment grade	Neutral		Euro-denominated investment grade corporate bonds continue to be supported by QE, while the latest survey data suggests a gradual improvement in credit conditions and default rates remain low. However, valuations are still around neutral levels in our view.
Global high yield	Overweight		The widening of developed market high yield credit spreads since mid-2014 has improved valuations and with it our estimate of the expected return for this asset class. Defaults remain reasonably low and the search for yield continues. However, there are risks. As with Investment Growth (IG), as the market starts to anticipate tighter US monetary policy, high yield credit could be volatile in the short term.
Gold	Underweight		Gold is likely to disappoint in a context of low inflation, especially as oil prices remain weak, and with the relatively strong USD. Large QE programmes in the Eurozone and Japan have failed to buoy the precious metal. However, fear of further depreciation of the CNY could support gold. Nevertheless, overall, we believe gold offers limited value in portfolios except as a diversification hedge.
Other commodities	Neutral		Other commodities, more exposed to the global economic cycle, have resumed their downward trend since June, falling to their lowest level in six years. Crude oil prices are now below our estimate of long term fair value, but the supply glut increased after the Iran nuclear deal conclusion in July, limiting potential upside. We remain neutral for commodities overall.
Real estate	Overweight		Given our outlook for rental values in key developed markets, listed property equities offer reasonably attractive long run prospective returns relative to core Developed Market government bonds in our view.
Asian assets			
EM Asian Fixed Income	Underweight		From a long term perspective, return signals are still positive, backed by sound economic fundamentals, stable inflation and credit quality. However, on a nearer term perspective, this asset class is sensitive to US monetary policy and its impact on global interest rates and liquidity. Moreover, Asian bond spreads look tighter (264bp for the EMBI Global Asia as at 28 September) than in other regions of the EM space (644bp for the EMBI Global Latin America for example), which reduces their relative attractiveness in the near to medium term.
Asia ex Japan Equity	Overweight		The trajectory of US interest rates, the Chinese and global economic outlook and currency volatility remain key near-term risks to Asian equities. Amid such headwinds, Asian equity markets will likely remain volatile in the near-term. However, supportive macro policies, the lagged growth impulse from lower energy costs, and a continued focus on structural reforms should help a moderate recovery in economic growth and earnings/ profit prospects. We continue to believe that Asia overall is well positioned to manage market volatility, while valuations metrics are attractive.
- China	Overweight		Chinese stocks (MSCI China universe) continued to show weakness and experience high volatility, amid weak China macro data, A-shares correction, concerns over reform prospects, and global de-risking. FX also adds another layer of complexity for Chinese stocks. Despite headwinds to economic and corporate top-line growth, we expect macro policies to remain supportive of economic growth and the market in the near term. While market volatility will likely stay high in the near term, valuations remain attractive on a price-to-book vs. profitability basis. Economic rebalancing, accelerated capital market liberalisation and progress on reforms are medium-term catalysts
- India	Overweight		Low earnings trajectory, relatively high valuations and the uncertainty over the fate of some key reform legislations could be near-term concerns as Fed rate hike looms. However, there are nascent signs of earnings recovering, and India is better placed amid external headwinds within Asia, particularly against China growth/currency risks. The plan to revamp public-sector banks and improved inflation outlook are positives. The government remains committed to reforms, while a gradual economic and capex recovery, supported by lower interest rates, should help revive earnings ahead
- Hong Kong	Neutral		Hong Kong stocks (MSCI Hong Kong universe) should benefit from monetary easing in China and China's ongoing capital market liberalisation. However, the Hong Kong economy and asset markets face the risk of tightening monetary conditions from Fed liftoff and weakness in China growth. Regional FX depreciation is negative for tourist shopping in Hong Kong. Valuations based on price-to-book vs. profitability look neutral
- Singapore	Underweight		The country's transition from a labour-driven economic model to a productivity-driven one remains challenging and incurs short-term pain on GDP/earnings/employment growth. The defensive nature of the Singapore market during periods of high volatility is a positive, but Singapore faces the challenge from higher US interest rates or USD strength and the domestic property market continues to show weakness.
- South Korea	Neutral	▼	Our bottom-up stock selection approach led to a change in our positioning in Korea to neutral from overweight, mainly as we took advantage of an earlier rebound in some auto shares to trim our exposure. On the macro front, data have been mixed. Weaker demand in China/EM poses downside risks to Korea's growth outlook. Accommodative monetary and fiscal policies and a housing market recovery should support a gradual improvement of domestic demand and earnings prospects, but currency impacts on earnings remain risks. The policy to boost dividend payout is a positive

-	Taiwan	Underweight	In response to the recent growth disappointment, the authorities unveiled an economic stimulus package, eased housing market measures and interest rates. Valuations are attractive and the relatively high dividend yield is a positive, However, convincing signs of an upturn in tech demand are still lacking, and Taiwan faces the risk of soft Chinese demand, a weaker CNY and loss of export competitiveness. Policy and political risks could increase heading into the January 2016 elections

Basis of Views and Definitions of 'Long term Asset class positioning' table

Views are based on the HSBC Global Asset Management Multi Asset Strategy Update meetings held between 22 and 25 September 2015, HSBC Global Asset Management's long-term expected return forecasts which were generated as at 31 August 2015, our portfolio optimisation process and actual portfolio positions.

Icons: ▲ View on this asset class has been upgraded. ▼ View on this asset class has been downgraded

Underweight, overweight and neutral classifications are the high-level asset allocations tilts applied in diversified, typically multi-asset portfolios, which reflect a combination of our long-term valuation signals, our shorter-term cyclical views and actual positioning in portfolios. The views are expressed with reference to global portfolios. However, individual portfolio positions may vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions.

"**Overweight**" implies that, within the context of a well-diversified typically multi-asset portfolio, and relative to relevant internal or external benchmarks, AMG has (or would have) a positive tilt towards the asset class.

"**Underweight**" implies that, within the context of a well-diversified typically multi-asset portfolio, and relative to relevant internal or external benchmarks, AMG has (or would have) have a negative tilt towards the asset class.

"**Neutral**" implies that, within the context of a well-diversified typically multi-asset portfolio, and relative to relevant internal or external benchmarks AMG has (or would have) neither a particularly negative or positive tilt towards the asset class

For global investment grade corporate bonds, the underweight, overweight and neutral categories for the asset class at the aggregate level are also based on high level asset allocation considerations applied in diversified, typically multi-asset portfolios. However, USD, EUR and GBP investment grade corporate bonds are determined relative to the global investment grade corporate bond universe.

For Asia ex Japan equities, the underweight, overweight and neutral categories for the region at the aggregate level are also based on high level asset allocation considerations applied in diversified, typically multi-asset portfolios. However, individual country views are determined relative to the Asia ex Japan equities universe as of 29 September 2015.

Similarly, for EM government bonds, the underweight, overweight and neutral categories for the asset class at the aggregate level are also based on high level asset allocation considerations applied in diversified, typically multi-asset portfolios. However, EM Asian Fixed income views are determined relative to the EM government bonds (hard currency) universe.

Fed stays on hold amid global growth concerns

Global equities remained focused on the Fed as global growth concerns continued to dominate sentiment

Global equities fell in September, with investor sentiment focused on the US Federal Reserve (Fed) policy meeting on 16-17 September and the continuing concerns about the pace of global economic growth, especially in China. The MSCI AC World index fell 4.7%. The S&P 500 index was 4.4% lower on mixed US economic data with markets responding negatively to global growth concerns highlighted by the Fed. In Europe, stocks were buoyed by dovish comments from the European Central Bank (ECB) as well as generally positive macro data. Nevertheless, Fed uncertainty, China-related growth concerns and a large drop in auto stocks pushed the MSCI Europe 5.6% lower. Japanese stocks underperformed this month, with the MSCI Japan falling by 5.9%, dragged down by generally weak economic data as Bank of Japan left monetary policy unchanged, although support came from a government pledge to cut the corporate tax rate next year. After recent sharp declines, Emerging Market (EM) stocks fell further this month, with the MSCI EM index losing 1.9%, although Chinese equities were comparatively stable, with the MSCI China losing 0.8%. However, Fed policy uncertainty and poor macro data pushed the MSCI Brazil and Russia down by 5.9% and 6.9% respectively. (All data as of close of 28th September in local currency, total return terms).

US 10-year Treasury yields fell slightly in September, falling by 12bp to around 2.09%. Yields rose ahead of the Fed meeting on positive retail sales data which boosted rate hike expectations, although retreated after the Fed decided to keep policy unchanged. Meanwhile, German 10-year Bund yields fell more sharply, down 21bp to 0.59%, with demand supported by speculation of further monetary stimulus from the ECB and general risk aversion. Elsewhere, oil prices continued their lurch downwards in September after rallying at the end of last month, brought lower by continuing oversupply concerns.

Fed stays on hold in September, but a rate rise later in 2015 is still expected

The Fed kept interest rates on hold at its September policy meeting, broadly in line with financial market expectations. The Fed cited a protracted slowdown in EM growth, in addition to the recent volatility in financial markets, as the main reasons for maintaining their dovish stance. Compared to its June projections, the Fed raised its growth forecast for 2015 on the back of a strong second quarter and an upward revision to Q1 data, but lowered its Gross Domestic Product (GDP) forecast for 2016 (see Figure 1). Projections for inflation were also revised lower amid sliding commodity prices and softer global economic growth. Fed Chair Yellen's lack of conviction that inflation will return to its 2% target over time prompted the Fed to also signal a more gradual pace of monetary tightening. The median estimate of the Fed's interest rate projections now points to only one rate hike of 25 basis point (bp) in 2015 and a lower terminal policy rate of 3.50%.

Figure 1: The Federal Open Market Committee (FOMC) lowered its inflation and interest rate forecasts for both 2015 and 2016

FOMC Median Projections	Jun 2015 (%)	Sep 2015 forecast (%)
2015 GDP growth	1.9	2.1
2016 GDP growth	2.5	2.3
2015 PCE inflation	0.7	0.4
2016 PCE inflation	1.8	1.7
End of 2015 Fed Funds Rate	0.625	0.375
End of 2016 Fed Funds Rate	1.625	1.375

Note: PCE= Personal Consumption Expenditure.

Source: US Federal Reserve, as at September 2015. 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 dovish rhetoric in the FOMC statement came despite recent positive economic data. According to consensus forecasts, US growth is tracking around 2.5% quarter-on-quarter (qoq) annualised in the third quarter, supported by private consumption and an improving housing market, though the manufacturing sector remains soft. Within the labour market, the change in nonfarm payrolls came in at 173K in August, while the unemployment rate fell to a cyclical low of 5.1% and job openings surged, suggesting that spare capacity continues to diminish. However, there is little evidence yet of a sustained upward pressure in wages, August saw average hourly earnings grow 2.2% year-on-year (yoy).

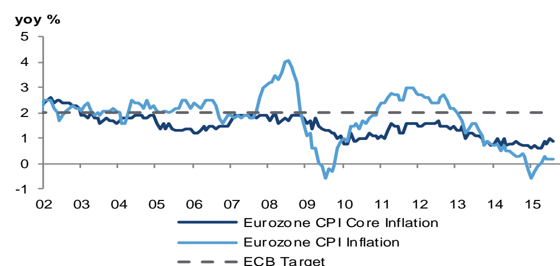
In our view, the Fed is still on track to begin normalising monetary policy later in 2015; a view has supported in recent speeches by Yellen and other Federal Open Market Committee (FOMC) members Williams and Lockhart. However, it appears that the balance of risks needs to shift in order for the majority of FOMC members to be comfortable raising rates. This would most likely be in the form of a stabilisation in Chinese (and EM) activity data, as well as a further improvement in the US labour market – in terms of both employment and wage growth. Given this, we believe there is insufficient data before the 28 October meeting to make a reasonable judgement on this and view a December lift-off as more probable. US Fed fund futures are currently pricing in only a 43% probability of a rate rise in 2015 (as at 29 September) and in our view, there remains a risk that financial markets may be caught off guard.

In Europe, the ECB signalled further monetary stimulus, whilst Syriza performed well in Greece's elections

The outlook for European monetary policy was also scrutinised at the ECB's September 3 meeting. As widely expected, interest rates were kept unchanged, but the ECB extended the pool of eligible bonds for its asset purchase programme and raised the issue limit to 33% from 25%, meaning that they may now buy up to 33% of the outstanding amount of a particular issue. The dovish move signalled the ECB would make full use of their tools

in order to bring inflation back to target, which remains well below the ECB's 2% target (Figure 2).

Figure 2: Inflation remaining below-target in the Eurozone has raised the prospect of further monetary easing by the ECB



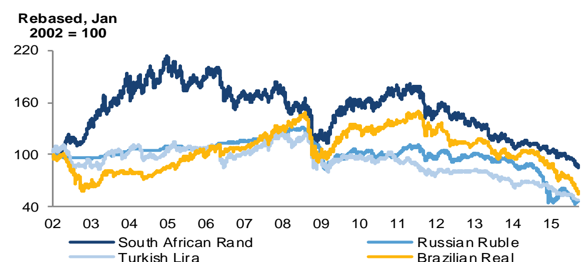
Note: CPI= Consumer Price Index.
Source: Bloomberg, as at 29 September 2015. For illustrative purposes only and does not constitute any investment recommendation.

The ECB also downgraded their outlook for growth and inflation, given recent weakness in commodity prices and the EM slowdown, particularly in China. As a result ECB president, Mario Draghi, also signalled that the current QE programme, due to expire in September 2016, could run until then "or beyond, if necessary". Elsewhere in Europe, Greece's election on September 20 resulted in a resounding victory for the Syriza party who announced they would revive their coalition with the Independent Greeks party (Anel). Overall the new coalition is likely to be more stable; however implementation risks remain given the tough package of reforms required.

EM economies are still struggling, with weak Chinese manufacturing data in the spotlight

September was another poor month for EMs. Brazil's sovereign credit rating was downgraded by S&P to junk status (BB+), with a negative outlook, as the fiscal outlook deteriorates and political challenges mount. Along with other EM currencies, the Brazilian real reached a new all-time low against the USD (Figure 3), What's more, August manufacturing Purchasing Managers' Index (PMI) numbers continued to show a declining trend in almost all EM economies, with the BRICs underperforming. We expect EM growth to remain under pressure this year as commodity prices remain soft and global trade growth stagnates, although a full blown EM crisis is unlikely.

Figure 3: Many EM currencies dropped to fresh record lows against the USD in September



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Investors have also paid close attention to incoming Chinese data which generally continues to disappoint. The Caixin manufacturing PMI dipped to 47.0 in September, from 47.3 last month, the lowest level since March 2009, and export growth remains in negative territory (-5.5% yoy in August) with imports also dropping sharply. More positively, infrastructure Fixed Asset Investment (FAI) has accelerated as the government has stepped up fiscal spending and looser monetary policy has supported property sales. Overall, we expect fiscal and monetary policy support to help stabilise the economy to allow it to meet its official target of "about 7%" for this year, although downside risks to the growth outlook remain.

Figure 4: Chinese industrial sector growth is declining with September's Caixin manufacturing PMI hitting a 6 ½ year low

Source: Bloomberg, as at 29 September 2015. For illustrative purposes only.

Prospective returns for risk assets have improved following recent market volatility

EM equities remain attractive within our long-term valuation-based framework, though near-term economic and profitability risks persist and volatility is to be expected. Prospective returns for DM equities have improved to a lesser extent due to softness in US and Canadian profitability.

Within high yield credit, the relative valuation signals for both US and European high yield corporate bonds have improved, though the oil and gas sector remains in distress. The default cycle continues to appear benign in our view, with only a modest rise in default rates expected over the next 12 months. We maintain our neutral positioning for global investment grade corporate bonds as the increased compensation for investing in credit is offset by falling interest rates.

In our view, DM government bonds remain unattractive relative to other asset classes from a long-term valuation perspective and we maintain our underweight positioning. DM government bond yields were relatively stable despite the recent market volatility. Our estimates show the compensation for taking additional interest rate risk remains negative and we generally prefer to hold shorter duration government bonds and cash in multi-asset portfolios.

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