IQ

Investment Quarterly

Q3 2014

The power of diversification

HSBC Global Asset Management

Contents

IQ is part of a suite of investment communications produced by the Macro and Investment Strategy Unit of HSBC Global Asset Management. The views expressed herein are as of the end of June 2014 and subject to change as the macroeconomic environment evolves. Other short-term thematic publications, such as New World Insights and events-based communications are also available. To be included in the distribution list for these communications, please contact your HSBC Global Asset Management Relationship Manager.

Overview

Asset class performance so far in 2014 contrasts with performance in 2013 and helps illustrate the importance of diversification for investors. Those markets which did very well last year, such as developed market (DM) equities, have not done as well this year, whereas most of the markets that were 'beaten up' last year, such as emerging market (EM) equities and bonds, have often rebounded this year. These contrasting trends highlight the importance of diversification for investors. Simply following last year's winners or putting all of your 'eggs in one basket' could be problematic.

Indeed, the power of diversification is that assets with a positive expected return, but that are not perfectly correlated, can be combined to allow investors to target a higher level of return for a certain level of acceptable risk. The process of identifying the optimal portfolio weights to capture these diversification benefits is called mean-variance optimisation (MVO). However, there are limitations to the benefits of MVO and diversification. Even with a diversified portfolio of risk assets and perceived 'safe-haven' assets, periods of extreme volatility and significant drawdowns can take place from time to time.

Indeed, even a diversified portfolio can experience significant drawdowns, such as during times of extreme market stress when correlations 'move to one'. Correlations will not typically stay at these very high levels for an extended period of time because fundamentals will eventually reassert themselves. However, this phenomenon does illustrate that investors need to take a long-term approach in order to benefit from diversification. Other limitations of diversification are typically more technical and to do with the practical problems of using an 'optimiser' (a mathematical algorithm) to apply MVO to construct a multi-asset portfolio.

There are some methods we can use to eliminate or reduce these problems, which we explain.

Market focus: Asia ex Japan

We expect a modest cyclical recovery in Asia in H2 2014 and into 2015 as external demand improves and several economies boost investment. Risks to such a benign outlook include further bouts of volatility from external shocks, such as the US Federal Reserve normalising monetary policy, and risks from within the region, eg a sharp Chinese economic slowdown and geopolitical tensions. However, economic fundamentals in the region are generally solid and Asian policymakers are, on balance, moving in the right direction to address macro risks. Asia is well positioned to remain the most dynamic region of the global economy with positive long-term growth prospects, despite facing some structural headwinds. Whether emerging Asia meets the challenges ahead and continues growing strongly depends crucially on structural reforms. We identify several long-term macro trends that are likely to shape investment themes in Asian markets. These include: economic policy reforms; economic re-balancing; regional cooperation/integration and a growing financial sector, amongst others.

Ask the expert

The European equity market has rallied strongly over the last two years. The main drivers of the rally have been a decline in the market's perceived risk of a eurozone break-up, and a return to modest growth in the region. The rally has pushed the price-to-earnings ratio to around 20% above its 10-year average. Consequently, one risk to the European equity market is that companies fail to deliver earnings growth in the short term. Nevertheless, given the improving macroeconomic backdrop and the likelihood that eurozone monetary policy will remain stimulative, we believe that the equity market looks attractive on a medium-to-long-term basis.

What's more, during the global financial crisis and the eurozone sovereign debt crisis that followed, equity performance was increasingly driven by broad macroeconomic factors as investors became concerned about systemic risks. However, since the peak of the eurozone crisis in late 2011, intra-stock correlations have fallen back again. Consequently, the equity market has once again become a rich environment for fundamental stock pickers.

Navigating markets

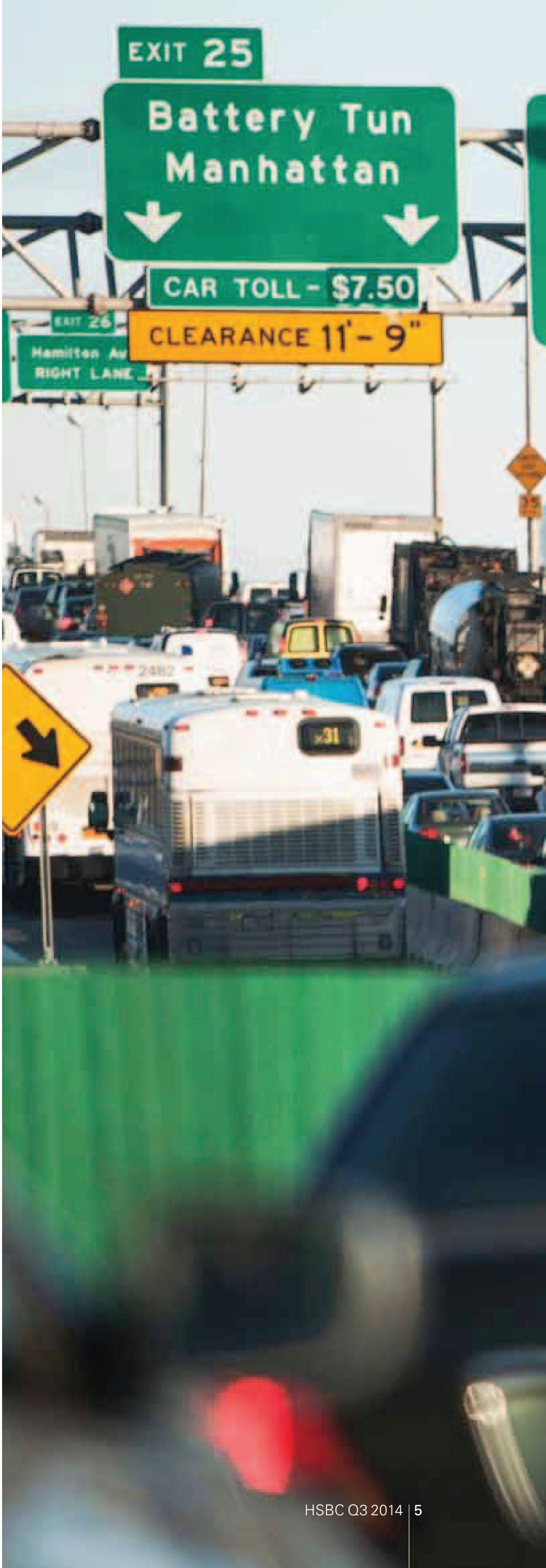
The second quarter of 2014 has seen risk assets remain resilient, despite geopolitical tensions between Ukraine and Russia and, more recently, in the form of fighting in Iraq. Both DM and EM equities have advanced this quarter with EM equities outperforming their DM counterparts. Bonds and key commodities have also advanced this quarter. Global macroeconomic data and corporate earnings results were generally favourable, while dovish comments from the US Federal Reserve (Fed), and the European Central Bank's (ECB) monetary stimulus package, further boosted investor sentiment. Looking ahead, we expect risk assets to remain supported by an improving global economy and accommodative monetary policy. Nevertheless, there are some risks for the second half of the year given the high level of investor bullishness and the potential for an increase in geopolitical risk, particularly in the Middle East.

Global data watch

In the global data watch section we review how economic data releases have been coming out and how consensus economic forecasts have changed from the previous quarter.

Economic growth in the developed world generally accelerated in Q1 2014, with the exception of the US, which was affected by the adverse winter weather. Most of the BRIC economies also saw their economies grow at a slower pace. During Q1, inflation in the US remained stable, although the most recent monthly data for Q2 suggests a pick-up in wage growth and inflation, while the eurozone experienced disinflation due to the strength of the euro and spare capacity in the economy, leading the ECB to respond by loosening monetary policy in June.

The consensus global growth forecast for 2014 has been revised down since we published our last IQ, with the most notable revisions over the past three months coming from the US, India and Russia. This mainly reflects weaker-than-anticipated activity in Q1, with growth expected to pick up modestly during the rest of the year as the global economic recovery gathers momentum.



The benefits and limitations of diversification

Julien Seetharamdoo, *Chief Investment Strategist*

Asset class performance so far in 2014 contrasts with performance in 2013 and also helps illustrate the importance of diversification for investors. Those markets which did very well last year, such as developed market (DM) equities, have not done as well this year, whereas most of the markets that were 'beaten up' last year, such as emerging market (EM) equities, have often rebounded this year. As a result, while traditionally very high, the correlation between DM and EM equity markets has fallen back recently. Should investors be pleased about this, or worried? The answer is, it depends how you invest.

In 2013, DM equities did exceptionally well, while most bond markets apart from DM high yield struggled and performance across EM equity markets was mixed. So far in 2014, DM equities have shown only modest, though still positive, returns while bond markets have done well pretty much across the board. EM equity markets have been mixed, but overall have performed much better than in 2013, especially when compared with DM equity markets.

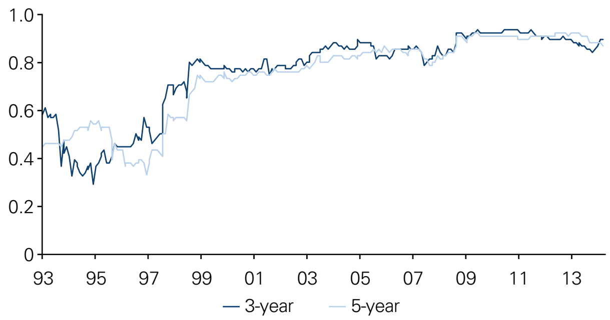
These contrasting trends highlight the importance of diversification for investors. Simply following last year's winners or putting all of your 'eggs in one basket' could be problematic. To illustrate the power and importance of diversification, let's begin by taking as an example just two broad equity market indices, the MSCI World Total Return Index (a measure of DM equity market performance) and the MSCI EM Total Return Index (a measure of EM equity market performance). Historically, the MSCI EM has been the more volatile of the two indices but has delivered higher returns. The correlation between these two markets has often been high and has risen since the early 2000s, but it is still less than one and it has fallen back a little recently, as noted above.

This suggests that an investor could potentially obtain equity market-like returns with lower risk by combining developed and emerging market equities together. The chart below shows the performance of an equally-weighted portfolio of EM and DM equities (total return, MSCI indices), rebalanced at the end of each year (ie back to a 50/50 portfolio).

It is clear that a more diversified portfolio has given a higher return per unit of volatility; with the equally weighted portfolio of EM and DM equities providing an average return per unit of volatility of 0.57, compared to 0.48 for a portfolio invested entirely in EM equities and 0.50 for a portfolio invested entirely in DM equities (between 1988 and mid-2014). This works because EM and DM markets are not perfectly correlated. Diversification benefits are available not just within asset classes, such as equities, but across asset classes as well. In fact, they are likely to be greater across different asset classes because asset classes are generally less correlated than individual securities or different geographical markets within an overall asset class.

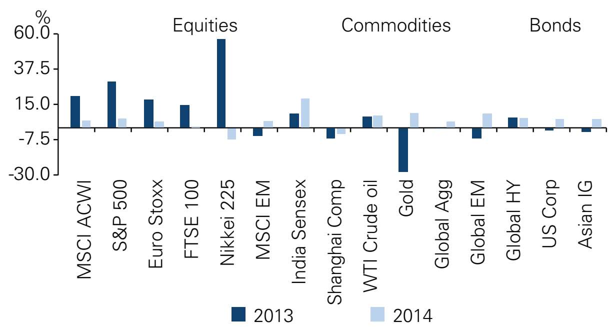
The benefits of adding a different asset class to a portfolio can be illustrated by adding US government bonds to our portfolio of DM and EM equities. Because the correlation between the assets is lower the potential benefits from diversification should be higher.

Figure 1: DM and EM equities rolling correlation (three and five years)



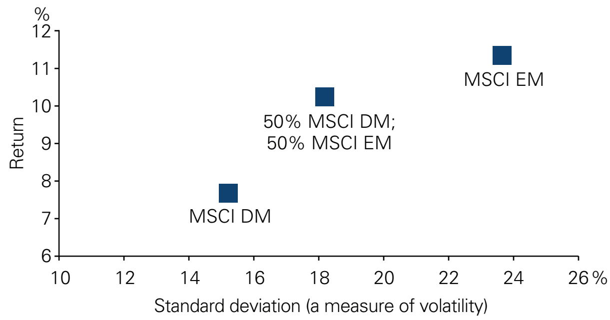
Source: Bloomberg, HSBC Global Asset Management, as of June 2014

Figure 2: Asset Market Performance (Price Index) in 2013 and 2014 Year-to-Date (YTD)



Source: Bloomberg, as of June 2014
Data shown is for illustrative purposes only and does not constitute any investment recommendation in the above-mentioned asset classes.
Past performance is not indicative of future returns.

Figure 3: MSCI World (DM), MSCI EM and 50/50 portfolio (1988-2014)



Source: Bloomberg, HSBC Global Asset Management, as of June 2014

Indeed, as Figure 5 shows, a portfolio weighted one third developed market equities, one third EM equities and one third US government bonds, rebalanced at the end of each year, has delivered even higher returns per unit of risk (0.86). In fact, historically it has delivered higher returns and a lower standard deviation, than a portfolio of just DM equities.

Why should we choose to weight our portfolio one third each? There may be a better way to weight the assets to capture these diversification benefits, given an investor's tolerance for risk and required return. The process of identifying the optimal portfolio weights to capture these diversification benefits is called mean-variance optimisation (MVO). For a given expected portfolio return, we can search for the weights associated with the portfolio offering the lowest overall variance. This portfolio is known as the minimum-variance portfolio (MVP), which we can use to plot the so called 'efficient frontier'.

The above is a very simple illustration of modern portfolio theory developed by economics Nobel Prize winner Harry Markowitz in 1952 and subsequently refined by various other academics. The power of diversification is that assets with a positive expected return, that are not perfectly correlated, can be combined to allow investors to reduce risk for a required level of return or achieve a higher level of return for a certain level of acceptable risk.

The limitations of diversification

However, there are limitations to the benefits of MVO and diversification. Indeed, even with a diversified portfolio of risk assets and perceived 'safe-haven' assets, periods of extreme volatility and significant drawdowns can take place from time to time. For example, during the 2008 credit crisis, even our hypothetical diversified portfolio of a third DM equities, a third EM equities and a third US government bonds would have experienced a loss of 34% between May 2008 and February 2009. However, this is less than the loss that would have been experienced by a hypothetical portfolio made up solely of risk assets. For example, the 50/50 EM/DM equity market portfolio would have fallen 54% during the same time period. The key point is that diversification can help reduce certain types of investment risk but it does not eliminate investment risk altogether.

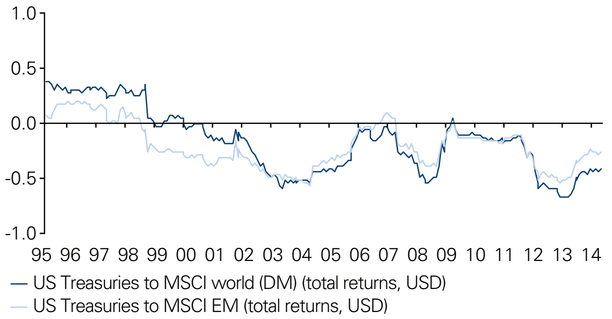
Therefore, even a diversified portfolio can experience significant drawdowns (ie losses), especially during times of extreme market stress when correlations 'move to one'. Correlations will not typically stay at these very high levels for an extended period of time because fundamentals will eventually reassert themselves. However, this phenomenon does illustrate that investors need to take a long-term approach in order to benefit from diversification.

Other limitations of diversification are typically more technical and to do with the practical problems of using an 'optimiser' (a mathematical algorithm) with estimates of expected returns, volatilities and correlations to apply MVO to construct a multi-asset portfolio. There are some methods we can use to eliminate or reduce these problems, which are explained below.

Overcoming the practical problems of applying mean-variance optimisation

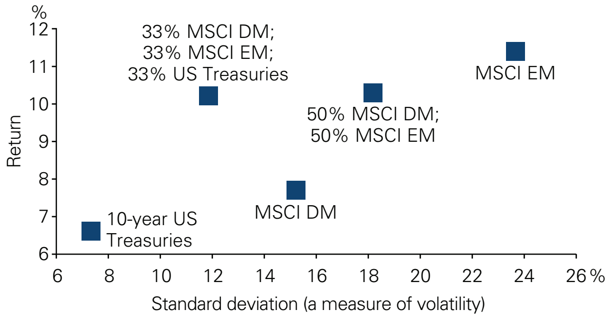
The MVO process seeks to achieve the maximum return subject to not exceeding the investor's risk tolerance. Markowitz's framework provides the optimal portfolio allocation assuming we have perfect forecasts for the three inputs required: the expected returns, the volatilities, and the correlations of the assets to be included in the portfolio. If we have accurate forecasts for the three inputs then mean-variance optimisation should be straightforward.

Figure 4: Three-year rolling correlation of US Treasuries against DM and EM equities



Source: Bloomberg, as of June 2014

Figure 5: MSCI World (DM), MSCI EM, US Treasuries and equally-weighted portfolios (1988-2014)



Source: Bloomberg, HSBC Global Asset Management, as of June 2014

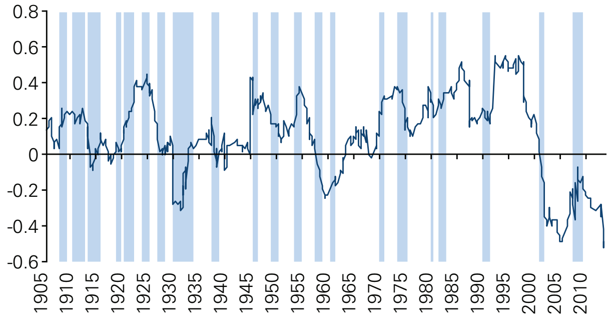
However, we cannot know today with certainty what returns, volatilities and correlations will be in the future. Asset returns vary over time with bull and bear markets, volatilities are dependent on market conditions and subject to security mispricing and idiosyncratic risks, and correlations between assets alter over time as the economic environment changes.

All attempts to accurately predict their values will contain some degree of estimation error, regardless of how sophisticated or complex the methodology used to forecast them. Unfortunately, mean-variance optimisation is very sensitive to changes in each of its main inputs. Whilst mean-variance optimisation is a powerful tool when input estimates are accurate, minor changes to these inputs can lead to wildly different portfolio allocations. An example of this can be seen in Figure 7, which shows portfolio allocations over time using four assets and a simple mean-variance optimisation procedure.

This simulation exercise shows that, at times, portfolio optimisation using a mean-variance approach would involve reallocating 100% of the portfolio from one asset to another, only to have to switch back again within one year. This is clearly not a practically feasible approach to investing due to the high trading costs that would be incurred and the concentration risks of investing so heavily in a single asset.

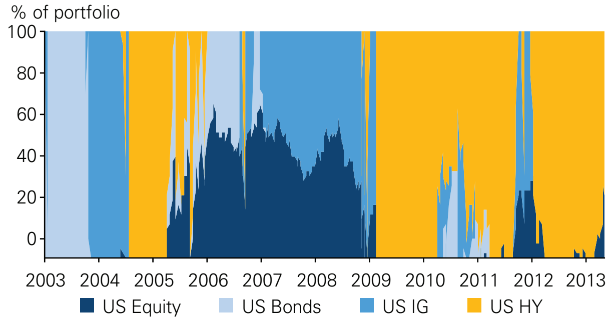
The challenge is to achieve the diversification benefits of mean-variance investing while minimising the drawbacks.

Figure 6: Rolling five-year US bond-equity correlation (with NBER recession periods in light blue)



Source: Global Financial Database, National Bureau of Economic Research, as of June 2014

Figure 7: Stylised mean-variance allocation for US assets



Source: Bloomberg, HSBC Global Asset Management, as of June 2014
Note: IG – Investment Grade; HY – High Yield

Fortunately, there are numerous techniques we can use to overcome the problems mentioned above.

The simplest of these is to place constraints on the proportion of the portfolio held in individual assets. By constraining the optimiser from investing more than a certain percentage of the portfolio into a single asset class, we can prevent large swings in allocations.

A better and more robust technique than using weight constraints to overcome the problems with mean-variance investing is to consider making adjustments to the 'covariance matrix', which is the collection of asset class volatilities and correlations arranged in matrix format. This involves a process known as 'regularisation', which essentially makes sure extreme estimates contained within the covariance matrix are dampened down to more reasonable values. Extreme values are likely to be values which suffer from the highest estimation error. Unfortunately, these are the values which mean-variance optimisation will rely most heavily on if left to its own devices. It can be shown mathematically that this regularisation technique is equivalent to adding weight constraints in the manner we discussed above. However, we are more likely to have stable allocations under this second approach.

As mentioned earlier, there are three inputs required for mean-variance investing: returns, correlations and volatilities. Regularising the covariance matrix should make asset correlations more stable through time. In addition, we can also make adjustments to the asset class return and volatility forecasts to prevent errors in these forecasts becoming dominant in the optimisation process.

For asset returns, anchoring the output from expected return models to long-run equilibrium returns will help to reduce any potential instability or short-termism present in the models. For volatilities, long-run historic estimates can be used but these can be adjusted to account for large 'tail' events, as experienced during the 2008-2009 financial crisis, when investors suffer large losses that are not accurately reflected in an asset's volatility level.

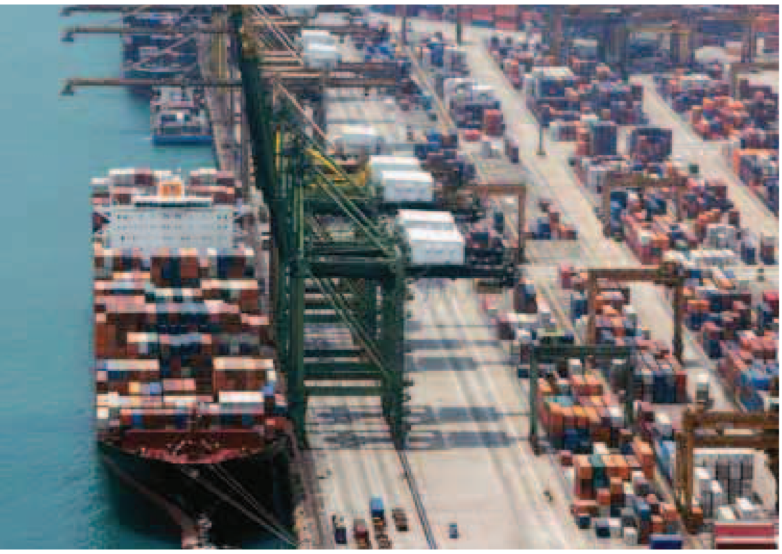
Making these adjustments allows us to generate portfolios which maximise expected return for a given level of risk but do not encounter the issues of high turnover and portfolio instability that the classic approach generates.

Conclusion

Overall, it is clear that there are substantial benefits to investors from holding a diversified portfolio of assets. While not a panacea, it can help reduce certain types of risks. There are some statistical techniques that can also be applied to enhance the mean-variance optimisation process to make it more stable and deal with some of the practical issues. Diversification is especially useful if investors rebalance and also take a long-term view. We use these principles when managing multi-asset portfolios on behalf of our clients.

Market Focus: Has Asia the resilience necessary to face the challenges ahead?

Renee Chen, *Macro and Investment Strategist*



We expect a modest cyclical recovery in Asia in H2 2014 and into 2015 as external demand improves and several economies boost investment. The region has strengthened its resilience to external shocks, such as the US Federal Reserve (Fed) normalising monetary policy and the tightening of global financial conditions that will come with it, but the risk of further bouts of volatility remains. As well as the danger of external shocks, Asia also faces risks from within the region, for example a sharper-than-expected slowdown of the Chinese economy and geopolitical tensions. However, economic fundamentals in the region are generally solid and Asian policymakers are, on balance, moving in the right direction to address macro risks.

Asia is well positioned to remain the most dynamic region of the global economy, with positive long-term growth prospects, although the region also faces some structural headwinds. There has been a structural downshift in the growth rates of many Asian economies, due to the exhaustion of previous engines of growth, slowing productivity gains, unfavourable demographic trends, domestic financial constraints, and country-specific vulnerabilities. Whether emerging Asia meets the challenges ahead and continues growing strongly depends crucially on structural reforms. We identify several long-term macro trends that are likely to shape investment themes in Asian markets. These include: economic policy reforms, economic rebalancing, regional cooperation/integration and a deeper financial sector.

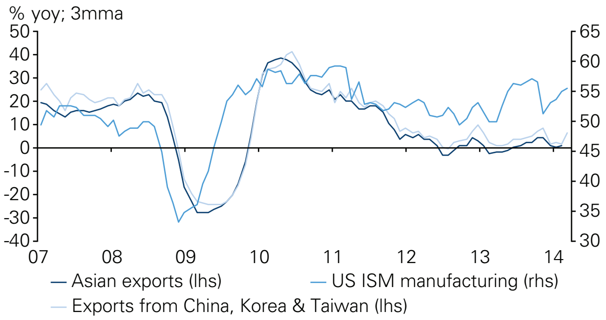
Macroeconomic outlook

Cyclical recovery amid risks

Recent economic data across the region is generally consistent with a slowly improving or stabilising cyclical trend. Asia's export growth, although subdued by historical standards, continues to recover but domestic demand dynamics diverge between countries. Both consumer and investment demand in India may get a post-election boost after slowing over the past two years. There are already some signs of a recovery of domestic demand in Korea and Taiwan alongside the export recovery. The prolonged political and policy uncertainty has taken a heavy toll on domestic activity in Thailand. However, given reduced political instability following the military coup and the unlocking of fiscal spending, Thailand's near-term domestic economic outlook has improved.

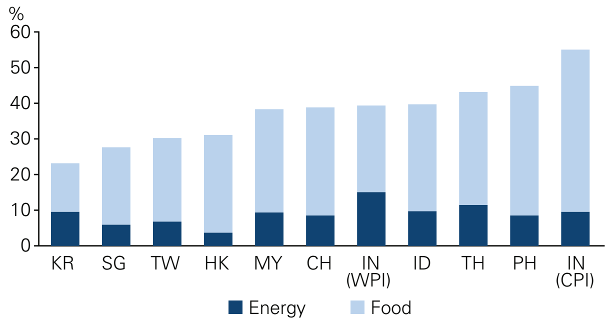
The external environment should improve in H2 2014 and into 2015, given that the US, eurozone and Japanese recoveries are gaining traction even as growth in China moderates. The impact of improved developed market (DM) demand should be felt broadly across emerging Asia, particularly by the economies most leveraged to a pick-up in developed market imports. As export growth recovers and the government's pro-growth policy measures start to take effect, we expect China's growth momentum to improve

Figure 1: Asian exports



Source: CEIC, HSBC Global Asset Management, as of May 2014
Note: yoy - year-on-year, 3mma - 3 month moving average

Figure 2: Asian CPI weights



Source: CEIC, HSBC Global Asset Management, as of May 2014
Note: KR- Korea, SG- Singapore, TW- Taiwan, HK- Hong Kong, MY- Malaysia, CH- China, IN- India, ID- Indonesia, TH- Thailand, PH- Philippines, WPI- Wholesale Price Index, CPI- Consumer Price Index

over the coming months. Most countries in emerging Asia are likely to see a marginal increase in growth in 2014-15 relative to 2013, as better exports support domestic production and capital spending, and several economies boost investment.

Inflation pressures are manageable in most countries in the region. Although headline inflation rates have been pushed up by rising food prices, core inflation across the region has generally been benign. The path of food and energy prices, and the ability of governments to use subsidies to offset any rises, will be a key determinant of the inflation outlook, although the second-round effects will depend on the strength of domestic demand and subsidies will add to fiscal burdens. Any El Niño-driven food price spikes will push up headline inflation the most in countries where food is a large share of the consumer spending basket, for example India and the Philippines. In response to the recent rise in food prices, and anticipation of below-normal monsoon rainfalls, the Indian government has introduced a series of measures to improve domestic food supply to curb future food price increases. Given the proactive measures taken by the government and the credible anti-inflationary stance of the RBI, we think any food supply shock due to a bad monsoon should be manageable. Higher oil prices, if they persist, would raise energy bills and drive up inflation.

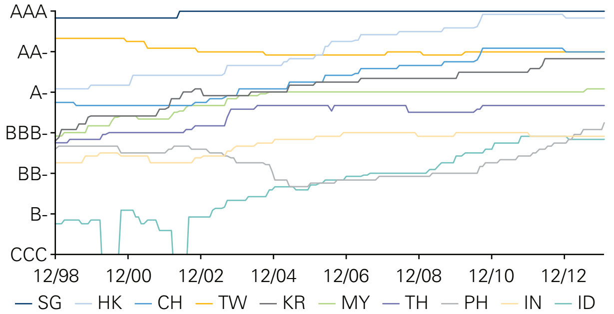
Financial stability risks are likely to have a large bearing on monetary policy across Asia, given the build-up of leverage post the 2007-08 global financial crisis (GFC). The Malaysian central bank has warned of a broad build-up in economic and financial imbalances, especially the risks associated with household debt. The Philippines central bank has also raised the reserve requirement ratio and hiked the Special Deposit Account (SDA) rate in response to rapid liquidity and credit growth, with the aim of containing inflation risks. In China, monetary conditions have eased recently following the targeted policy easing by the People's Bank of China (PBoC). Benign inflationary pressure in the near term gives the PBoC some leeway to loosen monetary policy further, if necessary. However, the need to prevent a further increase in financial vulnerability limits the PBoC's room for manoeuvre. Most other central banks in the region will probably remain on hold throughout this year but some could start gradual policy normalisation in 2015, as domestic economies gradually recover and inflation rises, especially if the Fed moves to raise interest rates.

Major downside risks to Asia's H2 2014 and 2015 macro outlook include: (1) a sharp rise in US Treasury yields in anticipation of Fed rate hikes causing tightening of financial conditions across the region, which will likely result in increased volatility in capital flows and asset prices; (2) a sharper-than-expected slowdown of the Chinese economy, which could be triggered by a significant correction of the property sector and/or financial sector vulnerabilities; (3) an economic shock or reversal in the US, eurozone or Japan that could cause the global recovery to falter and (4) geopolitical tensions escalating, for example tension between Russia and Ukraine, fighting in Iraq spreading to oil-producing areas of the country or beyond its borders, China's increasingly assertive maritime claims in the South and East China Seas and its relationship with Japan.

Solid fundamentals with structural challenges

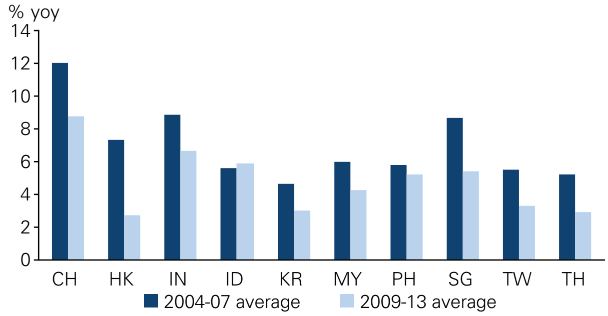
Asia is one of the fastest-growing regions in the world with strong long-term growth prospects that are expected to remain sound. Emerging Asia (including Hong Kong, Korea, Singapore and Taiwan) represented approximately 30% of global GDP, measured by purchasing power parity (PPP), in 2013, according to the International Monetary Fund (IMF), and is expected to grow to nearly 35% of global GDP by 2019. Asia weathered the GFC and its aftermath well thanks to the resilience it steadily built over the previous decade. Emerging Asian economies pursued prudent fiscal policies, improved their external debt positions, built FX reserves, and reformed their banking sectors after

Figure 3: Ratings history of selected Asian economies (average of S&P and Moody ratings)



Source: Citi Research, Bloomberg, HSBC Global Asset Management, as of May 2014
Note: KR- Korea, SG- Singapore, TW- Taiwan, HK- Hong Kong, MY- Malaysia, CH- China, IN- India, ID- Indonesia, TH- Thailand, PH- Philippines

Figure 4: GDP growth of selected Asian countries



Source: CEIC, HSBC Global Asset Management, as of May 2014
Note: KR- Korea, SG- Singapore, TW- Taiwan, HK- Hong Kong, MY- Malaysia, CH- China, IN- India, ID- Indonesia, TH- Thailand, PH- Philippines

the 1997-98 Asian financial crisis. As a result, we have seen a series of sovereign credit rating upgrades among emerging Asian countries over the past decade.

Despite its solid fundamentals, emerging Asia faces some structural headwinds. China and India have been on a declining growth trajectory since the GFC. In other major emerging Asian economies, growth rates in the past few years have also been significantly lower than in the period prior to the GFC, with the notable exceptions of Indonesia, Malaysia and the Philippines, where growth rates have been resilient. Asia's generally lower post-GFC growth reflects not only cyclical headwinds but a structural downshift in growth rates due to the exhaustion of previous engines of growth, slowing productivity gains, unfavourable demographic trends in some economies, domestic financial constraints in many countries and country-specific vulnerabilities.

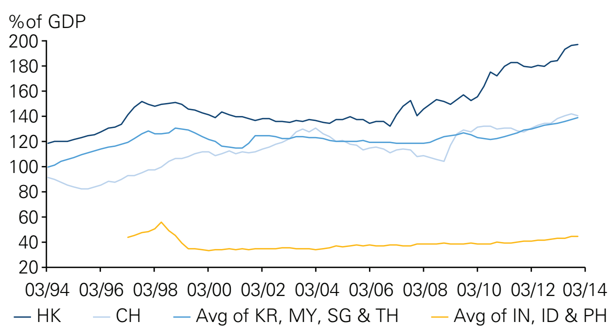
Asia has witnessed a sharp rise in both corporate and household leverage over the last few years. The rapid rise in corporate leverage is a concern in China, Hong Kong and India, while the high level of household debt is a risk in Korea, Malaysia, Taiwan and Thailand. In addition, the north-east Asian economies, Singapore and Thailand suffer from unfavourable demographics, in the form of ageing populations and declining fertility rates, which could exaggerate their financial vulnerabilities. Demographic trends will become an increasing burden on government finances and weigh on future economic growth rates. Higher-income north-east Asian economies also face potential growth challenges from slowing total factor productivity gains given that they may already be at or close to the technology frontier.
Whether emerging Asia can continue growing strongly will depend crucially on structural reforms to raise productivity.

Macro investment themes

Economic policy reform prospects
India and Indonesia both have national elections this year.
In India, Prime Minister Narendra Modi swept to power with the most resounding election victory for 30 years. His strong mandate could result in more decisive policy making and accelerated execution of economic reforms, leading to a sustainable improvement in India's economic fundamentals and private-sector confidence. Fighting inflation, especially food price inflation, is among the new government's top priorities. In addition to temporary supply-side measures, the government is likely to push through fundamental reforms of minimum support prices and procurement practices and supply chains. Unlocking investments and pushing through projects that have stalled due to bureaucracy, environmental issues or financing problems is another policy priority.
The government plans to liberalise foreign direct investment (FDI) in industries such as railways, defence, e-commerce and insurance. Broad reforms to boost productivity and reduce supply-side bottlenecks are crucial to reviving the investment cycle and key to India's medium-to-long-term growth outlook and macro stability. A more credible and sustainable path for fiscal consolidation is also a priority.

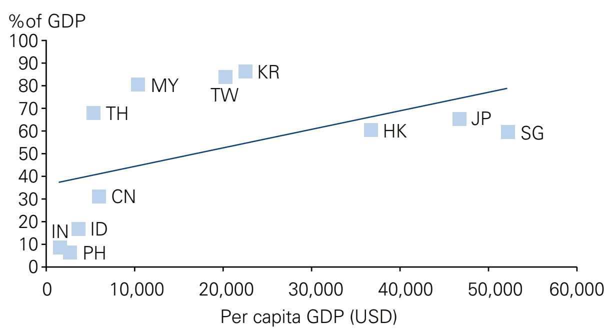
We do not expect any broad changes to Indonesian economic policies under a new presidency. The manifestos of the two main candidates both have protectionist undertones, particularly where natural resources are concerned.
However, we believe that the risk of Indonesia actually moving towards a more protectionist style of policymaking is low.
Doing so would probably harm FDI, links with key trading partners and adversely impact the capital inflows that the country needs to fund its current account deficit.
Both candidates have pledged to revamp education, accelerate infrastructure spending, reduce fuel subsidies, improve tax collection and support agriculture and rural development.

Figure 5: Asian non-financial corporate credit to GDP ratios



Source: Citi Research, BIS, CEIC, HSBC Global Asset Management, as of May 2014
Note: KR- Korea, SG- Singapore, TW- Taiwan, HK- Hong Kong, MY- Malaysia, CH- China, IN- India, ID- Indonesia, TH- Thailand, PH- Philippines

Figure 6: Asian household debt



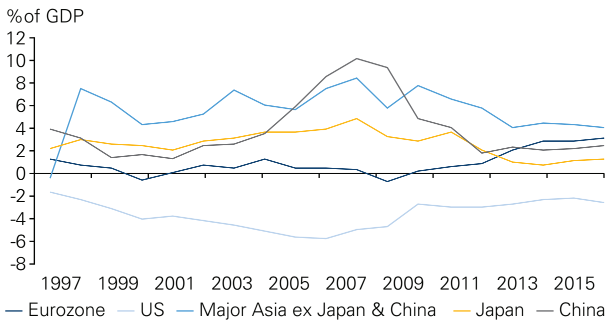
Source: BIS, CEIC, HSBC Global Asset Management, as of May 2014
Note: KR- Korea, SG- Singapore, TW- Taiwan, HK- Hong Kong, MY- Malaysia, CH- China, IN- India, ID- Indonesia, TH- Thailand, PH- Philippines, JP- Japan

The reform pace is likely to be gradual, given the consensus building required in Indonesian politics.

China announced a comprehensive reform agenda after the third plenum in November 2013. The reform roadmap allows the market to play a decisive role in the allocation of resources and levels the playing field between state-owned enterprises (SOEs) and non-SOEs. The government is determined to rebalance the economy towards consumption-driven growth and to increase the quality and sustainability of growth. There are strategies targeted at increasing rural household incomes and addressing urban-rural income inequality as well as improving the social security system and standards of environment protection. The government aims to implement these reforms by 2020. Implementing them is key to unleashing China's growth potential, through productivity gains, and putting the economy on a more balanced, inclusive and sustainable longer-term path.

Korean President Park Geun-Hye, who took office last February, has unveiled a three-year economic innovation plan, including rebalancing an export-reliant economy, deregulation to improve investment, increasing employment among women and young people, developing creative industries and raising R&D spending to 5% of GDP. Following the military coup in May 2014, the earliest that general elections are expected to be held in Thailand is 2015. There is still uncertainty over the long-term outlook for a stable government and its economic policy, particularly on structural reforms. In the Philippines, the strong showing of the Liberal Party and its alliance in the mid-term elections in May 2013 has given the current President Benigno Aquino III's administration a strong mandate for the second half of his presidency. The mid-term election outcome was an expression of the voters' desire for reforms that fight corruption and poverty. There is a high expectation that the ongoing reforms, on a broad range of structural, administrative, institutional and governance issues, will endure beyond the term of the current administration, after the 2016 presidential election.

Figure 7: Current account balance by major regions/countries



Source: IMF (World Economic Outlook April 2014), HSBC Global Asset Management, as of May 2014
Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets.
Note: 2014 and 2015 figures are IMF forecasts

Economic rebalancing across the region

The aggregate current account surplus of the major Asian emerging economies has declined since the GFC as global trade has weakened. Some of this weakness is likely to be cyclical, as global business investment, which typically has a high trade content, has been soft in recent years. However, some structural factors could also underlie slow global trade growth, including a stalling of the progress in global trade liberalisation and slower integration of global supply chains. While a cyclical recovery in advanced economies, and with it their import demand, could give a tailwind to Asian exports, Asia needs to strengthen its domestic demand to sustain strong growth and reduce economic vulnerability.

This rebalancing process will vary across countries in the region, and may also include internal rebalancing. Some countries, in particular China, will need to boost consumption, while several other EM Asian economies, such as India and south-east Asian countries like Indonesia, the Philippines and Thailand will have to increase investment, especially much

needed investment in infrastructure. Some countries, such as China, need reforms to boost service sector growth and others, such as India and Indonesia, need reforms to revitalise manufacturing sector growth. While growth of small open economies like Korea and Taiwan will likely remain export led, promoting domestic demand and the development of the services sector will, nevertheless, be important.

Effective rebalancing will require a combination of policy measures that boost domestic demand and bolster domestic and regional capacity to meet such demand. Structural reforms to adjust both the demand and supply sides of the economy need to be implemented. Strengthening domestic consumption requires policies that transfer more corporate savings to households (eg via policies that encourage companies to pay out higher wages and dividends). More government spending on health, education and housing, as well as greater public provision of social services and social safety nets, will reduce households' precautionary motive for saving and encourage household consumption. Governments should give priority to enhancing the investment climate and financial developments to help effectively translate domestic savings into domestic productive investment.

China's rebalancing towards a more sustainable growth path should generally be positive for its Asian trading partners in the long term. China's reorientation of growth from investment to consumption, from resources-intensive to technology-intensive industries and from low-end manufacturing to the service sector could have negative effects on China's supply-chain trading partners specialising in the production and export of raw materials and intermediate goods to China and Asian commodity exporters, such as Indonesia. However, these negative effects are likely to be at least partly offset by demand for capital goods tied to industrial upgrading and service sector capital spending, as well as commodity demand linked to continued urbanisation. Trading partners can also benefit from China's rebalancing if they are able to successfully expand their direct and indirect access to Chinese consumers. Lower-cost manufacturing countries, eg Indonesia, Vietnam and India, could benefit if FDI shifts away from China as its wages rise.

Regional cooperation and integration

Asia's intra-regional trade remains strong, accounting for more than 50% of Asia's total trade. There has also been a significant increase in Intra-Asian FDI, especially from east Asia to the Association of South-east Asian Nations (ASEAN). Countries in the region have signed or are negotiating bilateral and multilateral free trade agreements (FTA) or economic partnership agreements to facilitate the expansion of regional trade and investment. The Regional Comprehensive Economic Partnership (RCEP) is a proposed FTA between the ten member states of the ASEAN and the six states with which ASEAN has existing FTAs (China, Japan, Korea, India, Australia and New Zealand). RCEP negotiations were formally launched in November 2012 and are scheduled to conclude by end-2015. RCEP covers about half of the world's population, a quarter of world GDP and about 40% of world trade.

Regional integration could play a significant role in bringing firms and consumers in the region together, an important step given Asia's burgeoning middle classes. Cross-border infrastructure investment could also help boost productivity and connect demand and supply within the region. Further growth in intra-regional economic activity will hinge on improvements in infrastructure connectivity. Regional connectivity needs an integrated transport system linking land, maritime and air routes within Asia. One approach to achieve effective regional connectivity is the creation of cross-border economic corridors, with quality logistics, ports, industry clusters and economic zones. An example is the Mekong-India economic corridor, which will be a network of land and sea infrastructures connecting Indian industrial corridors with production networks in Myanmar, Thailand, Cambodia and Vietnam. To succeed, these economic corridors also need


人民
10
圆

the 'soft' aspects of connectivity, eg government policies, procedures, institutions and business practices, to be modernised and simplified. There will also be enhanced regional cooperation to improve the Information and Communications Technology (ICT) networks, especially the internet and mobile-communication connectivity.

Other long-term investment themes include: a deeper financial sector; the rise of the middle class, resulting in increasing discretionary consumer spending; urbanisation, bringing with it the need for infrastructure investment; and demographic trends. There is an ageing population in China, north-east Asia and Thailand at a time when India and other south-east Asian countries continue to enjoy a demographic dividend that boosts the size of their working age populations.

Conclusion and investment implications

Asia is well positioned to remain the most dynamic region of the global economy with positive long-term growth prospects. Economic fundamentals are generally solid, with policymakers overall moving to address macro risks and limit structural headwinds. A wide diversity of investment opportunities exists across sectors and industries.
Asian equities enjoy some structural advantages over their peers in other emerging markets, including Asia's relatively higher value-added sectoral composition and smaller direct exposure to commodity and mining/resources industries.
The growing number of high net worth individuals in Asia brings with it greater local ownership of financial assets and a source of structural support for Asian equities. Asian bond markets are liquid, diverse and growing quickly.

Asian equities
A more supportive global economic outlook and manageable inflation provide a positive macro backdrop for medium-term earnings growth in Asia. Nevertheless, the external and domestic risk events discussed in the macro outlook section could cause bouts of volatility in financial markets.
We continue to see opportunities for investors in sectors that could potentially benefit from the long-term macro themes outlined above. In particular, effective implementation of reforms could lead to a sustainable improvement in economic fundamentals and the growth prospects of China and India, prompting a reform-led re-rating of Chinese and Indian stocks in the longer term. In India we expect the industrial, energy and materials sectors to benefit from government policies to unlock investment and address supply-side bottlenecks.
In China, clean energy should benefit from the government's focus on tackling pollution and the subsequent implementation of environmental reform measures.

Korea's technology sector should remain supported by the government's economic innovation reform. Economic rebalancing in China toward consumption could benefit sectors such as discretionary consumer goods and services, technology and logistics companies that serve the booming Chinese e-commerce market. Increased infrastructure investment and steps to improve regional connectivity could lend support to the industrial, transportation, technology and property sectors.

Asian credit
Asian credit markets put in a decent performance in H1, boosted by the continued search for yield, as US Treasury yields fell, and US rate volatility declined, providing a supportive backdrop for carry trades. Investor appetite for emerging Asian bonds was also supported by the measures that governments have taken to address their external and macro vulnerabilities, and sentiment toward India was boosted by the new government's strong mandate and reform prospects. However, valuations could become a constraint, with limited room for further spread compression, in some sectors/markets.

Fed policy and movements in US interest rates are likely to create volatility in Asian fixed income markets, especially going into 2015, although the impact should not be as disruptive as it was last summer, barring any sharp moves in Treasury yields and/or material changes in Fed policy guidance. Currency volatility may also cause pressures on some corporate fundamentals and credit metrics. Market differentiation and credit selection remain key themes. However, Asian credits still offer sufficient yield premium over comparable US and European credits, especially in the high-yield space and at the lower end of the investment-grade credit spectrum. Some of this premium is justified by additional legal and market liquidity risks and macro uncertainty. Nevertheless, on a risk-adjusted basis (default and recovery), Asian credits still offer an attractive relative value opportunity. The still-low default rates – in line with global developed market peers but lower than most emerging market peers – and overall healthy level of leverage as measured by net debt to Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) among Asian companies provide a solid base for Asian fixed-income markets in the medium to long term.

CNH bonds have developed into an interesting credit market, with attractive yield, short duration, and diversified and relatively high-quality issuers. Demand is high in this market as investors seek exposure to this fast-developing market and hope to capture a medium-term CNY appreciation trend.

Ask the expert: European equity market outlook

macroeconomic backdrop and the likelihood that eurozone monetary policy will remain stimulative for some time to come, we believe the European equity market looks attractive on a medium-term basis, especially as, on balance, we expect earnings growth to pick up.

During the global financial crisis and the eurozone sovereign debt crisis that followed, equity performance became less driven by company-specific factors and more driven by broader macroeconomic factors as investors became increasingly concerned about systemic risks, such as bank failures and the eurozone breaking up. However, since the peak of the eurozone crisis in late 2011, intra-stock correlations have fallen back again. Consequently, the European equity market has once again become a rich environment for fundamental stock pickers.

Overview

The eurozone economy is slowly but steadily recovering after an 18-month recession and the European Central Bank (ECB) has recently taken additional action to underpin that recovery. Nevertheless, the recovery remains fragile, and geopolitical risks have recently risen in the form of tensions over the future of Ukraine and fighting in Iraq that could, if it spreads, push up the oil price markedly.

The European equity market has rallied strongly over the last two years in anticipation of improved earnings, with the MSCI Europe up 46% in local currency terms. The main driver of the rally has been a decline in the market's perceived risk of the eurozone breaking up, following ECB President Mario Draghi's summer 2012 speech committing to do whatever it takes to save the eurozone. The rise in equity prices has pushed the forward price-to-earnings ratio to around 20% above its 10-year average. Consequently, one risk to the equity market rally is that companies fail to deliver earnings growth in the short term. Nevertheless, given the improving

The eurozone economy is slowly but steadily recovering

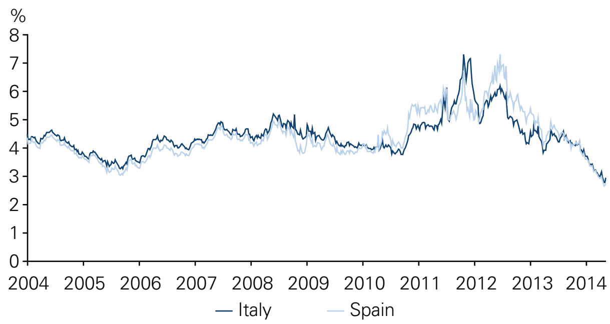
Since the height of the eurozone debt crisis in late 2011, sovereign risks have fallen. This has been reflected in a large decline in peripheral sovereign bond yields with, for example, Italian 10-year government bond yields falling from a peak of 7.3% in November 2011 to 2.9% and Spanish yields falling from 7.3% in July 2012 to 2.7%, at the time of writing. In a sign of how much the situation has improved, Greece, once the poster boy for the eurozone crisis, successfully issued its first sovereign bond since 2010 in April. Reforms need to continue but the Greek government has delivered both a primary surplus (the budget balance excluding interest payments) and a current account surplus, something many feared they would be unable to do. In addition, Greek banks have been restructured and re-capitalised.

After contracting for a year and a half, the eurozone economy has expanded in each of the last four quarters with growth totalling 0.9% over the past year. Encouragingly, the

Figure 1: MSCI Europe

Source: Bloomberg, as of June 2014

Figure 2: Sovereign 10-year bond yields



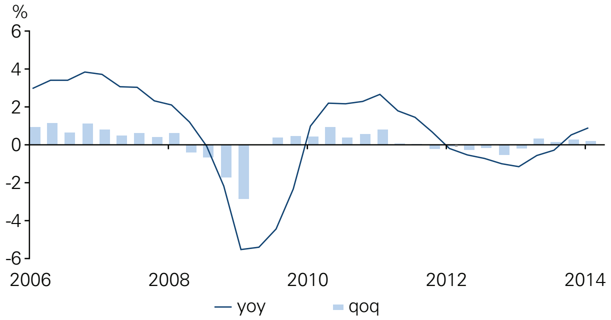
Source: Bloomberg, as of June 2014

eurozone composite purchasing managers' survey is tracking at a higher level so far in Q2 than it did in Q1 and consumer confidence is at its highest level since late 2007. This suggests that growth should, at the very least, exceed Q1's 0.2% qoq pace in the quarters ahead. Corporate results also suggest that the eurozone economy is in the early stages of a recovery. First quarter company results show positive year-on-year sales growth for early-cyclical goods, such as chemicals, steel, cement, concrete and asphalt.

The European Central Bank has taken action to keep recovery on track

To help ensure the embryonic economic recovery continues, and that the eurozone crisis does not break out again, the ECB cut its refinancing rate from 0.25% to 0.15% in June. In addition, it took the historic step of moving the interest rate it pays to banks that have reserves on deposit with it into negative territory, with a cut in the deposit rate from 0% to -0.1%. At the same time, the ECB paved the way for quantitative easing, should the falling inflation the eurozone has experienced over the last 18 months show signs of becoming outright deflation, by accelerating the preparatory work it is doing to facilitate the purchase of asset-backed securities and announcing it will no longer sterilise the purchase of bonds under its Securities Markets Programme. Although the ECB's recent actions were triggered by weak activity and inflation data, we believe its actions should be supportive of the corporate environment and that it is likely to maintain stimulative conditions even once the Fed starts to tighten monetary policy.

Figure 3: Eurozone GDP growth



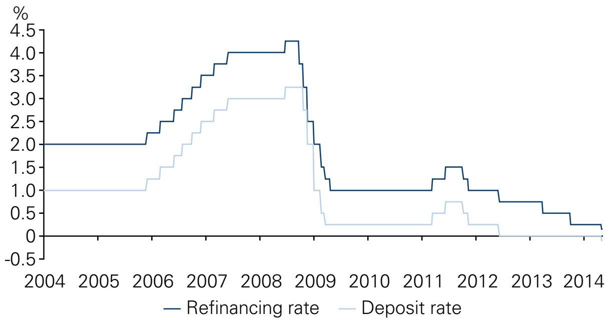
Source: Bloomberg, as of June 2014
Note: yoy - year-on-year, qoq - quarter-on-quarter

Politics and geopolitical risks could come to the fore

Although fighting in the north of Iraq could push up the price of oil and constrain the pace of global growth, the situation in Ukraine is probably the most acute geopolitical risk faced by Europe. Although the Ukrainian economy is tiny, equivalent to just 0.9% of eurozone GDP, tensions over its future between Russia and the US and Europe have the potential to negatively impact on the eurozone economy because Russia supplies about 30% of Europe's gas. For this reason Europe is likely to be much more cautious about imposing any additional sanctions on Russia, should it be seen to be interfering in the future of Ukraine, than the US. Any Russian threats to cut off Europe's oil supply are more credible now that Russia has signed a 30-year gas supply deal with China, ensuring a much-needed revenue stream.

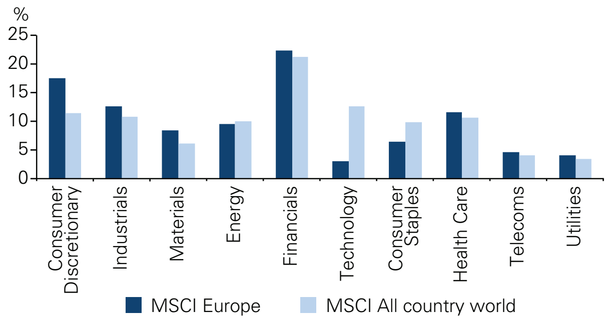
Turning from geopolitics to domestic politics, the recent European parliamentary elections saw a notable rise in the number of seats won by 'far-right' parties. Though any short-term impact may be small, this development is worth monitoring because the dissatisfaction expressed by voters could influence the future direction of European Union policymaking. In particular, it could reduce the pressure on peripheral governments to reform their economies and improve their fiscal situations. This, in turn, could even trigger another bout of the eurozone crisis.

Figure 4: ECB interest rates



Source: Bloomberg, as of June 2014

Figure 5: MSCI equity sector weights



Source: Bloomberg, as of June 2014
Data shown is for illustrative purposes only and does not constitute any investment recommendation in the above-mentioned sectors

European companies are geared into the global economy

The MSCI Europe index has a relatively high weighting of consumer discretionary stocks, industrials and materials, and relatively low weighting of technology stocks and consumer staples. Consequently, the European equity market is more cyclical than the overall global equity market, as measured by the MSCI All Country World Index, which is made up of both developed and emerging markets.

Encouragingly for the European earnings outlook, leading indicators, such as the purchasing managers' surveys, suggest that domestic demand growth is set to accelerate over the next couple of quarters. In addition, as European companies derive more than 50% of their sales from outside Europe, they should enjoy a tailwind from the global economy as it continues to recover over the coming year. The US economy is growing again, after contracting in the first quarter due to unseasonably cold weather, while the growth rate of the Chinese economy seems to be stabilising thanks to targeted stimulus measures and the Japanese economy has taken April's sales tax hike in its stride.

Can the European equity market make further headway?

We expect investors to continue to become more confident that the eurozone will endure and that the European economy is on the path to recovery. Nevertheless, we would be surprised if market volatility remains at multi-year lows. We think this is for two reasons: firstly, as the US recovery gains momentum, news flow and data points are unlikely to be uniformly positive, creating bouts of optimism and pessimism in the equity market. Secondly, given that the equity market rally has been driven mainly by multiple expansion, any failure to deliver the anticipated improvement in earnings growth will be punished by markets. Although it is possible for multiples to rise further, it seems likely that companies will need to actually deliver the anticipated earnings for the equity market to reach higher levels.

Given the improving macroeconomic backdrop and the likelihood that eurozone monetary policy will remain stimulative for some time to come, we believe the European equity market looks attractive on a medium-to-long-term basis. However, in the short term, it is worth noting that equity prices have run ahead of earnings, as is often the case

in a cyclical recovery. As a result, the European forward price-to-earnings ratio is about 20% above its 10-year average. The price-to-book ratio has also risen, despite a decline in return on equity. One risk to the equity market rally, therefore, is that companies fail to deliver earnings growth in the short term.

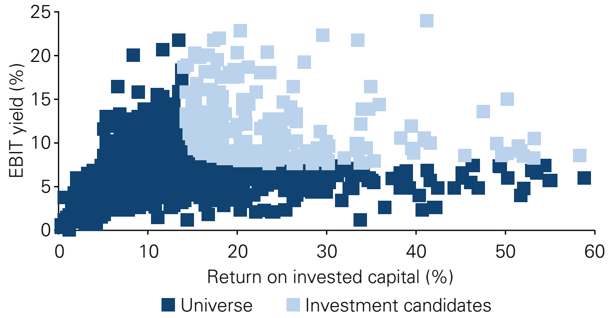
Overall, we prefer European equities to both the perceived 'safe-haven' of core European sovereign bonds and cash. We expect the return from equities to exceed that from bonds and cash over the next decade. One indication of the relative attractiveness of European equities is the fact the dividend yield on the EURO STOXX 50 is 3.6%, over two percentage points above the 1.2% yield offered by 10-year German government bonds.

Active management

At the core of our approach to active equity fund management is a focus on quality companies that offer an attractive combination of profitability and value. Although in the long run there is a well-established relationship between a company's profitability and the valuation the market places on its equities, in the short term market volatility can result in deviations from this relationship. These deviations create potential investment opportunities that can be confirmed using fundamental research. We believe these deviations away from fundamentals are temporary and will correct over time. Consequently, we can profit from them if we are disciplined and patient with a long-term investment horizon.

The first stage in our disciplined stock selection process is to rank stocks based on their combination of profitability and valuation to highlight those companies that are relatively more attractive. The result of this stage of the process is an opportunity set of European companies within the global equity universe that are potential investment candidates. The second step of our process is to carry out proprietary fundamental research to identify which of these companies have the competitive advantage, business model, balance sheet and management necessary to sustain or grow their profitability.

Figure 6: Stock selection process focuses on profitability and valuation



Source: HSBC Global Asset Management, as of June 2014.

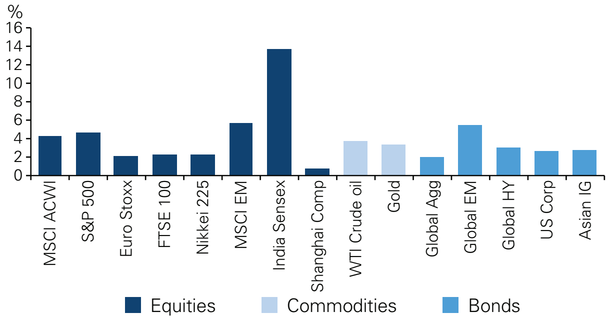
Conclusion

We are cautiously optimistic about the outlook for the European equity market, though there are risks. Investors' focus has already shifted from sovereign risks to economic activity and is now likely to shift to whether companies deliver on the anticipated improvement in earnings that has driven the market higher over the last two years and pushed the price-to-earnings ratio about 20% above its 10-year average. At the individual stock level we are seeing attractive investment opportunities. We believe that a 'bottom-up' approach to stock picking that focuses on quality companies that have the competitive advantage, business model, balance sheet and management necessary to sustain or grow their profitability will serve us well in a market environment that is once again becoming increasingly driven by stock-specific factors.

Navigating markets

Paras Patel, *Associate, Macro and Investment Strategy*

Figure 1: Q2 asset class performance (price indices)



Primary equity indices in local currency, all other indices in USD
Source: Bloomberg, 31 March 2014 to 30 June 2014
Data shown is for illustrative purposes only and does not constitute any investment recommendation in the above-mentioned asset classes.

The second quarter of 2014 has seen risk assets remain resilient, despite geopolitical tensions between Ukraine and Russia and, more recently, in the form of fighting in Iraq, with the MSCI All-Country World Index up 4.1% in USD terms. EM equities have outperformed their DM counterparts this quarter, with the MSCI EM (USD) index rallying 5.6%. Among the emerging markets, the Indian Sensex was the best performing major equity market, advancing 12%, while the Chinese Shanghai Composite was the main underperformer. Bonds and key commodities have also advanced in Q2. Global macroeconomic data and corporate earnings results were generally favourable, while dovish comments from the US Federal Reserve (Fed) and the European Central Bank's (ECB) monetary stimulus package further boosted investor sentiment. Looking ahead, we expect risk assets to remain supported by an improving global economy and accommodative monetary policy. Nevertheless, there are some risks for the second half of the year given the high level of investor bullishness and the potential for an increase in geopolitical risk, particularly in the Middle East.

Macroeconomic data on balance suggest the global economic recovery is gaining momentum

Macroeconomic activity data releases have generally come in ahead of consensus expectations this quarter. In the US, data in April was stronger than expected and supported our view that the weakness in some of the data around the start of the year was transitory and the result of extreme winter weather. The US macro releases continued to surprise on the upside in May and June, particularly the labour market data. Corporate earnings data for the first quarter released in April also generally came in better than expected, further supporting risk assets.

European data releases were more mixed during the quarter. Business confidence data in April showed improvement and are consistent with continued growth. However, in May, eurozone data disappointed somewhat, in particular CPI inflation, which remained well below the ECB's target. Chinese economic data remained soft though there have been indications of a potential stabilisation in growth. The Chinese government also announced some modest stimulus measures in March.

Developed market central bank policies diverge

During Q2 2014, risk assets were supported by accommodative monetary policy in the eurozone and the US, despite hawkish comments from Bank of England (BoE) Governor Mark Carney. ECB president Mario Draghi announced a package of monetary stimulus measures aimed at preventing deflation on 5 June. These measures included reducing both the refinancing rate and the deposit rate by 10 basis point (bp), to 0.15% and -0.10% respectively, and stopping the 'sterilisation' of purchases made under the Securities Markets Programme (SMP). In addition, the ECB attempted to improve the functioning of the monetary transmission mechanism by offering 'targeted' cheap four-year loans to banks. The ECB still has the option to use QE in the medium term if inflation expectations decline significantly further.

In the US, Fed comments remained dovish, helping US equities hit fresh record highs. In mid-April, Fed Chair Janet Yellen signalled, in her speech at the Economic Club of New York, that there was still sufficient slack in the US labour market to justify keeping interest rates at their current low level for a 'considerable time'. This dovish sentiment continued into June as the Fed's forecasts for inflation remained broadly unchanged, despite a pick-up in some measures of inflation in recent months. The Fed's latest economic growth forecasts suggest that it anticipates stronger growth for the remainder of the year after the weather-induced contraction in Q1.

In stark contrast to the continued dovish tone of comments from the ECB and the Fed, BoE Governor Mark Carney signalled for the first time that an interest rate increase could come as early as this year, in his speech at the Mansion House on 12 June. His hawkish comments reflect the recent strength of the UK economy, particularly the housing market.

The effects of escalating global geopolitical tensions have so far been contained

Although geopolitical risks have been at the forefront of news headlines, their impact on financial markets has been limited to date. The US and EU imposed fresh sanctions on Russia in April, in response to the escalating tensions in Ukraine, accusing Russia of breaching the Geneva agreement signed on 17 April to defuse the crisis. However, the sanctions, which included visa bans and asset freezes on key Russian individuals and companies, were limited in scope and did not significantly dampen global risk appetite. Since May, tensions have lessened following a shift in rhetoric from Russian President Vladimir Putin and the successful election of the new Ukrainian President Petro Poroshenko.

The recent territorial gains made by rebels in Iraq have also weighed on investor sentiment, particularly the potential for an economic growth-reducing rise in oil prices. Crude oil prices in both the US and Europe rose modestly in June, as a result of fears over potential supply disruptions. However, so far, the immediate risk to the global oil supply from the unrest in northern Iraq has been limited as the majority of Iraq's oil output comes from the south of the country. The situations in both Iraq and Ukraine remain fluid and investors are likely to continue to monitor developments closely over the coming weeks and months.

Looking ahead, we envisage a strengthening recovery and continued loose monetary policy

Looking ahead, we expect risk assets to be buoyed by improving macro data as the global economy continues to recover. However, there is a possibility of higher volatility in the short run if geopolitical risks spill over into markets. In the US, wage and unemployment data will be monitored closely to assess the extent of slack in the labour market and, by implication, the outlook for monetary policy and expectations for the future path of interest rates. Further monetary easing in the eurozone is also anticipated, as the ECB attempts to combat the threat of deflation and boost economic growth.

However, risks still lie ahead

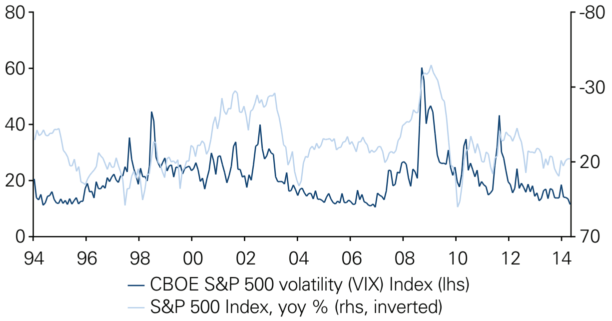
Geopolitical risks are likely to remain a concern in the short term, particularly relating to Iraq and Ukraine. So far, the impact has been localised. However, there is a risk that markets could be more widely affected should developments escalate and investor confidence subsequently deteriorate. World oil prices may also rise should the unrest in Iraq spread to the south of the country, where the majority of Iraqi oil production capacity is located.

A faster-than-expected acceleration in wage growth in the US over the coming months may prompt the Fed to revise up its inflation forecasts and raise interest rates more quickly, which would probably trigger asset price volatility.

Lastly, the recent rally in risk assets has made valuations appear more stretched. For example, even though PE ratios for key equity markets have not reached all-time highs, PE ratios for these key markets have all reached a post-2008 financial crisis high. Moreover, bond yields, particularly in the eurozone, have or are approaching all-time lows. It is also interesting to note that markets are experiencing a period of extremely low volatility, as illustrated by the Chicago Board Options Exchange (CBOE's) Volatility Index (VIX) falling to its lowest level since 2007 in June. Indeed, there may be a risk investors have become too complacent in the short term.

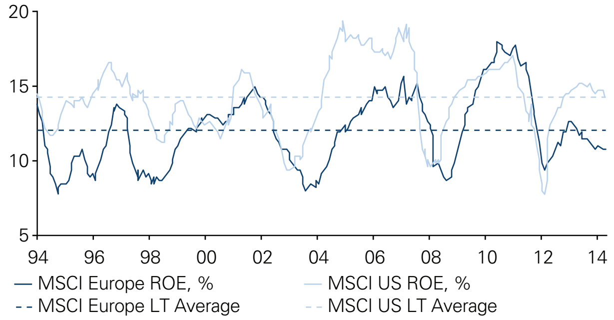
Overall, in the context of our long-term outlook for asset prices, we continue to favour corporate assets on a relative return basis, ie equities and corporate bonds over core government bonds, though the second half of the year could see choppier markets and a pick up in volatility from its current low levels.

Figure 2: The current low levels of implied volatility (VIX) could be a sign of investor complacency



Source: Bloomberg, as of June 2014

Figure 3: The latest earnings season was stable in the US and slightly disappointing in Europe



Source: Thomson Reuters Datastream, as of June 2014

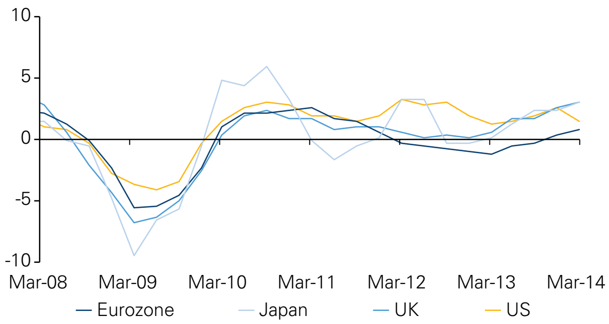
Global data watch

Shaan Raithatha, *Junior Investment Strategist*

Key highlights

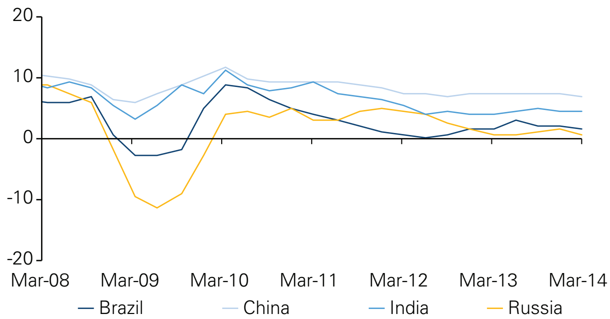
- **Growth:** With the exception of the US, economic growth in the developed world generally accelerated in Q1 2014. On a year-on-year basis, the pace of US growth slowed primarily as a result of the adverse winter weather. Most of the BRIC economies also saw their economies grow at a slower pace.
- **Inflation:** Inflation in the US remained stable in Q1 2014, although recent data suggests an acceleration. The eurozone continued to experience disinflation, while inflation trends in the BRIC economies were more mixed. Russian inflation spiked as a consequence of escalating geopolitical tensions in Ukraine.
- **Industrial production:** Industrial production (IP) growth amongst the advanced economies accelerated modestly, although the eurozone is still lagging behind. The emerging world paints a more mixed picture, with Brazilian and Indian IP slightly contracting, and Chinese IP growth slowing.
- **Labour market:** With the exception of the eurozone, labour markets in the developed world significantly improved in the first quarter of the year with the US, the UK and Japan all recording marked falls in unemployment.

Annual real GDP growth – developed markets (DM) (% yoy)



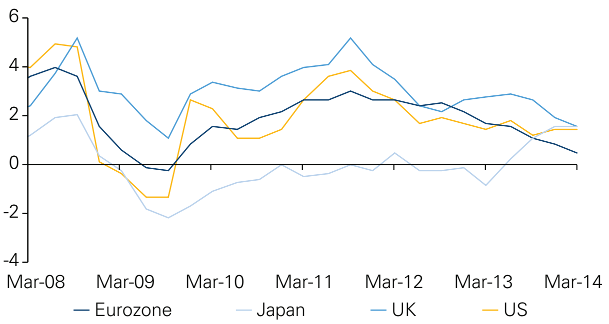
With the exception of the US, GDP growth in the developed world picked up on a year-on-year (yoy) basis in the first quarter of 2014. The pace of growth in the US slowed to a rate of 1.5% yoy in Q1 2014 from 2.6% yoy in the previous quarter as the harsh winter weather took its toll.

Annual real GDP growth – BRIC markets (% yoy)



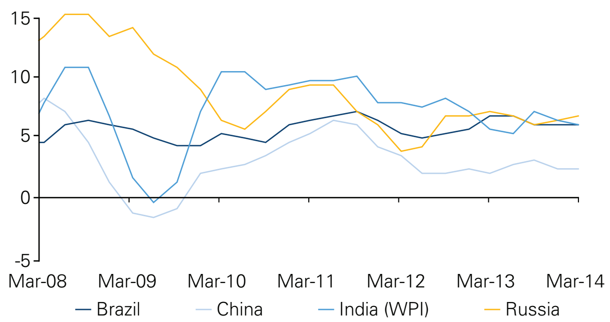
In contrast, most of the BRIC countries saw their economies grow at a slower pace in Q1. Russia's growth rate fell markedly to 0.9% yoy in Q1 from 2% in the previous quarter as a consequence of the Ukraine crisis. Economic growth in China and Brazil also slipped, while India's real GDP growth remained flat.

Headline inflation – developed markets (DM) (% yoy)



Inflation in the US and Japan remained little changed in Q1 2014 compared to the previous quarter, although the most recent data points suggest a pick-up in inflation in the US. Eurozone inflation dropped to just 0.5% in March 2014 and recent data are not showing signs of an imminent recovery yet.

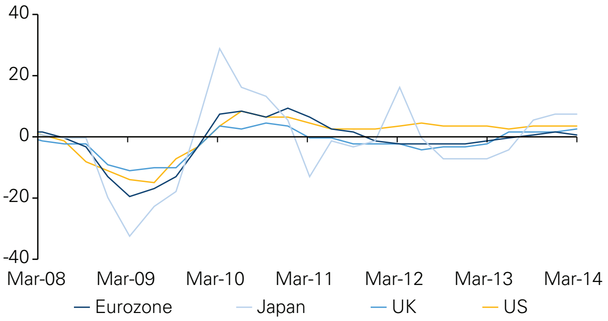
Headline inflation – BRIC markets (% yoy)



Inflation within the BRIC economies was mixed in Q1 2014. Russian inflation spiked to 6.9% yoy in March and recent data has shown a further acceleration in prices as a result of the escalating tensions in Ukraine. Indian WPI inflation has slowed while inflation in China and Brazil has remained fairly stable.

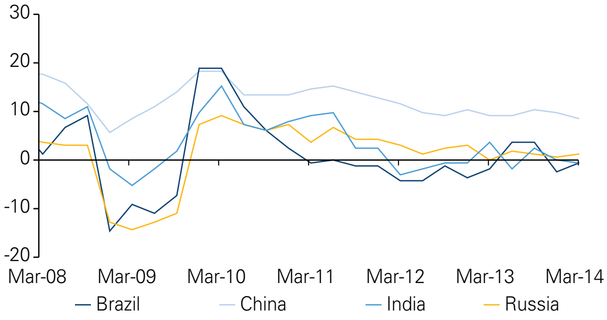
Sources: MSCI, Thomson Reuters Datastream and Bloomberg, as of March 2014.

Industrial production – developed markets (DM) (% yoy)



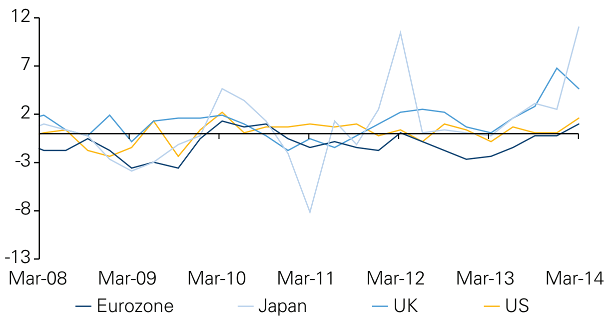
Across the majority of advanced economies, growth in industrial production (IP) accelerated modestly as the global economic recovery gathered momentum. In the UK, IP growth jumped to 2.5% yoy in Q1 2014 from 1.7% yoy in Q4 2013. However, IP growth in the eurozone lagged behind the rest of the developed world, falling to just 0.2% in Q1 2014 from 1.4% in the previous quarter.

Industrial production – BRIC markets (% yoy)



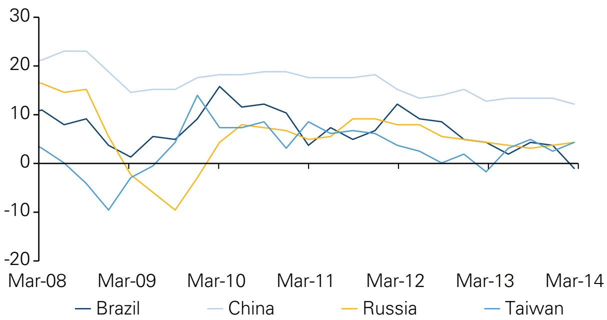
In both Brazil and India, IP contracted in the first quarter of the year. Chinese IP grew at a slower rate of 8.8% yoy in Q1, down from 9.7% yoy in the previous quarter, as China attempted to shift towards a more consumption-driven economy. Russian IP growth accelerated slightly in Q1 2014.

Retail sales – developed markets (DM) (% yoy)



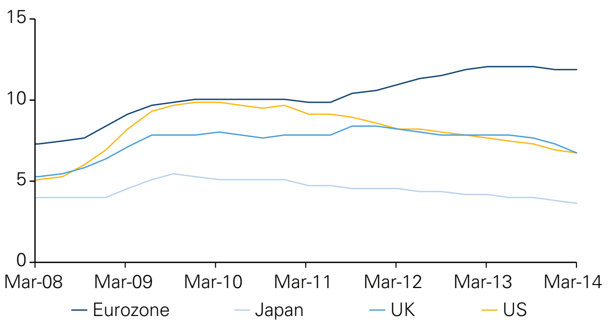
In Japan, retail sales growth surged at the end of Q1 2014 to 11% as consumers rushed to make purchases before the sales tax hike on April 1. Retail sales have subsequently dropped as the effect of the tax rise took hold. Retail sales in the US and eurozone grew modestly in the first quarter of the year, while growth dipped in the UK, albeit remaining at a high level.

Retail sales – emerging markets (EM) (% yoy)



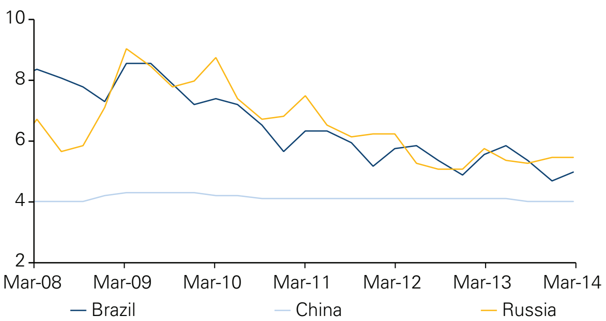
Consumer spending patterns in EM countries were mixed in Q1 2014 with Russia and Taiwan experiencing accelerating retail sales growth, while China and Brazil experienced a slowdown. Indeed, Brazilian retail sales growth entered negative territory in March 2014, although recent monthly data suggest a rebound.

Unemployment rates – developed markets (DM) (%)



Unemployment in most developed markets declined in Q1 2014, reflecting a strengthening global economic recovery. In the US, the unemployment rate fell to 6.7% in Q1 2014 from 7.0% in Q4 2013, although some of this improvement is a result of a declining labour force participation rate. The outlier is the eurozone, which did not see a significant decline in unemployment over the quarter.

Unemployment rates – emerging markets (EM) (%)



Within emerging markets, both China and Russia's unemployment rates remained little changed over the quarter. However, Brazilian unemployment increased slightly in Q1.

Sources: MSCI, Thomson Reuters Datastream and Bloomberg, as of March 2014.

Economic forecasts for 2014 and 2015

Growth: The Consensus global growth forecasts for both 2014 and 2015 have been revised down since we published our last IQ, from 3% to 2.8% for 2014 and from 3.3% to 3.2% in 2015. The most notable downward revisions over the past three months have come in the US, India and Russia.

Inflation: The Consensus 2014 global inflation forecast has remained relatively unchanged since March. The most notable changes are for the UK and the eurozone, where 2014 inflation forecasts has been revised down to 1.8% and 0.7% respectively.

Consensus Economics' growth forecasts (% yoy)

	March 2014 Consensus		June 2014 Consensus	
	2014F	**2015F**	**2014F**	**2015F**
Developed markets				
United States	2.8	3.1	2.2	3.1
Canada	2.2	2.5	2.2	2.5
Japan	1.4	1.3	1.5	1.2
UK	2.7	2.5	3.0	2.6
Eurozone	1.1	1.4	1.1	1.5
France	0.8	1.2	0.8	1.3
Germany	1.8	2.0	2.0	2.0
Spain	0.9	1.5	1.1	1.6
Italy	0.5	1.0	0.4	1.2
Emerging markets				
Brazil	1.8	2.1	1.5	1.8
China	7.4	7.3	7.3	7.1
India	5.4	6.8	5.4	6.2
Mexico	3.0	4.0	2.6	3.9
Russia	1.3	2.1	0.2	1.6
South Africa	2.6	3.3	1.9	3.1
South Korea	3.5	3.7	3.6	3.7
Turkey	2.2	3.8	2.7	3.6
World	**3.0**	**3.3**	**2.8**	**3.2**

Source: Consensus Economics, as of June 2014.
Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets.

Consensus Economics' inflation forecasts (% yoy)

	March 2014 Consensus		June 2014 Consensus	
	2014F	**2015F**	**2014F**	**2015F**
Developed markets				
United States	1.7	2.0	1.8	1.9
Canada	1.5	1.9	1.8	2.0
Japan	2.6	1.7	2.6	1.8
UK	2.0	2.2	1.8	2.1
Eurozone	0.9	1.3	0.7	1.2
France	1.1	1.4	0.8	1.1
Germany	1.5	1.9	1.2	1.8
Spain	0.5	1.1	0.3	0.9
Italy	0.9	1.2	0.6	1.0
Emerging markets				
Brazil	6.0	5.6	6.4	6.0
China	2.9	3.2	2.5	2.9
India	8.0	7.0	7.8	7.0
Mexico	4.1	3.5	3.9	3.5
Russia	5.8	5.1	6.5	5.3
South Africa	2.6	3.3	6.2	5.8
South Korea	2.1	2.6	1.8	2.5
Turkey	8.1	6.8	8.5	6.8
World	**3.0**	**3.1**	**3.1**	**3.1**

Source: Consensus Economics, as of June 2014.
Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets.

Policy rates

- **Monetary policy:** Consensus forecasts for interest rates in the US, the eurozone and Japan indicate that policy rates are likely to be on hold at least for the next 12 months while, in the UK, rates are expected to move up within 12 months and possibly as early as this year. However, market implied policy rates suggest further rate hikes in Brazil and now possibly in South Africa and Mexico over the coming 12 months.

Market implied policy rates

	Current (%)	3 months (%)	12 months (%)
Developed markets			
United States (FED)	0-0.25	0-0.25	0-0.25
Eurozone (ECB)	0.15	0.15	0.15
United Kingdom (BOE)	0.50	0.50	0.75
Japan (BOJ)	0-0.1	0-0.1	0-0.1
Emerging markets			
Brazil	11.00	11.00	12.00
India	8.00	8.00	8.00/7.75
Korea	2.50	2.50	2.75/3
Mexico	3.00	3.00	3.00/3.25
South Africa	5.50	6.00	6.25/6.5
Taiwan	1.88	1.75/2	2.00
Turkey	12.00	11/11.25	11.25

Sources : Merrill Lynch, JP Morgan, Barclays, Deutsche Bank, Danske, Westpac, HSBC, Nomura, Credit Agricole, Société Générale, UBS, Citigroup, Commonwealth Bank, HSBC Global Asset Management, as of June 2014.

Central bank interest rate setting meetings

Date	Country	Event
10 July 2014	UK	BoE MPC monetary policy decision
15 July 2014	Japan	BoJ monetary policy decision
30 July 2014	US	FOMC monetary policy decision
07 August 2014	Eurozone	ECB monetary policy decision
07 August 2014	Japan	BoJ monetary policy decision
08 August 2014	UK	BoE MPC monetary policy decision
04 September 2014	Eurozone	ECB monetary policy decision
04 September 2014	UK	BoE MPC monetary policy decision
04 September 2014	Japan	BoJ monetary policy decision
17 September 2014	US	FOMC monetary policy decision

Source: HSBC Global Asset Management and Bloomberg, as of June 2014.

Currency expectations (quoted versus USD)

	Spot	3 months ago	6 months ago	12 months ago	2 months forward	6 months forward	9 months forward	12 months forward
Developed world								
Eurozone (EUR)	1.36	1.38	1.37	1.31	1.36	1.36	1.36	1.37
UK (GBP)	1.70	1.65	1.64	1.54	1.70	1.70	1.70	1.69
Japan (JPY)	101.9	102.3	104.3	97.7	101.9	101.8	101.7	101.6
Sweden (SEK)	6.71	6.40	6.57	6.77	6.71	6.72	6.72	6.73
Norway (NOK)	6.11	6.02	6.16	6.14	6.12	6.15	6.17	6.18
Switzerland (CHF)	0.89	0.88	0.90	0.93	0.89	0.89	0.89	0.89
Australia (AUD)	0.94	0.91	0.89	0.93	0.94	0.93	0.92	0.92
Canada (CAD)	1.07	1.12	1.06	1.05	1.07	1.08	1.08	1.08
New Zealand (NZD)	0.87	0.86	0.82	0.78	0.87	0.86	0.85	0.84
Asia								
China (CNY)	6.23	6.20	6.07	6.15	6.25	6.28	6.30	6.31
Hong Kong (HKD)	7.75	7.76	7.76	7.76	7.75	7.75	7.75	7.75
India (INR)	60.1	60.7	61.9	59.8	60.7	62.0	63.1	64.1
Indonesia (IDR)	11989	11385	12176	9955	12082	12344	12585	12774
Malaysia (MYR)	3.21	3.30	3.30	3.21	3.22	3.25	3.26	3.28
Philippines (PHP)	43.8	45.1	44.4	44.0	43.9	44.0	44.0	44.1
Singapore (SGD)	1.25	1.27	1.27	1.28	1.25	1.25	1.25	1.25
South Korea (KRW)	1018	1079	1062	1162	1021	1026	1029	1033
Thailand (THB)	32.4	32.5	32.7	31.1	32.5	32.7	32.8	33.0
EEMEA								
Czech Republic (CZK)	20.1	19.8	20.1	19.7	20.1	20.1	20.1	20.1
Hungary (HUF)	224.4	226.4	217.1	227.8	225.0	226.0	226.7	227.4
Poland (PLN)	3.05	3.04	3.03	3.31	3.07	3.09	3.10	3.11
Russia (RUB)	34.00	36.14	32.63	32.76	34.48	35.40	36.08	36.75
Turkey (TRY)	2.13	2.24	2.08	1.95	2.16	2.22	2.26	2.30
South Africa (ZAR)	10.57	10.83	10.34	10.07	10.67	10.90	11.07	11.26
Latam								
Argentina (ARS)	8.1	–	–	5.4	8.6	9.5	10.3	11.1
Brazil (BRL)	2.22	2.32	2.36	2.23	2.26	2.33	2.38	2.44
Mexico (MXN)	13.03	13.18	13.05	13.30	13.08	13.19	13.27	13.35

Source: Forward currency rates sourced from Bloomberg, as of June 2014.
Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets.

Global equity market performance (MSCI indices)

Total return (% in USD terms) – MSCI indices	-1M	-1Q	-1Y	YTD
Developed World	**3.0**	**6.6**	**26.0**	**6.6**
Emerging World	**0.4**	**11.4**	**18.8**	**5.4**
North America	**3.5**	**5.9**	**26.3**	**7.4**
Europe	**1.3**	**6.4**	**31.5**	**6.6**
Eurozone	**2.1**	**5.9**	**36.6**	**6.5**
Europe ex UK	**1.5**	**5.6**	**33.7**	**7.1**
Asia Pacific ex Japan	0.5	7.3	20.2	7.2
Australia	1.2	6.8	23.1	9.6
Austria	3.9	2.9	16.4	-2.0
Belgium	2.0	7.5	33.5	8.1
Brazil	2.8	19.1	19.3	12.1
Canada	4.2	10.3	26.3	10.6
Chile	-1.6	9.1	-4.4	0.6
China	1.3	8.0	16.9	-2.6
Colombia	4.7	16.7	14.7	14.2
Czech Republic	4.8	5.8	29.5	11.7
Denmark	3.5	6.1	50.1	19.5
Egypt	-6.4	-4.3	52.9	13.1
Finland	3.0	11.7	48.9	8.6
France	0.8	5.0	32.2	6.6
Germany	1.4	4.8	31.9	2.2
Greece	9.0	-7.0	76.3	10.2
Hong Kong	-0.7	7.7	16.7	1.9
Hungary	-2.9	17.2	-6.2	-1.1
India	-0.9	16.6	28.9	19.6
Indonesia	-6.3	1.0	-4.6	19.9
Ireland	-2.7	-4.8	42.3	6.5
Israel	3.3	5.4	32.1	22.1
Italy	6.0	6.0	55.6	17.6
Japan	7.1	12.0	11.5	0.8
Korea	-2.0	9.4	26.9	2.1
Malaysia	0.2	6.6	8.2	2.8
Mexico	1.6	9.1	18.4	1.3
Netherlands	1.7	4.0	28.4	1.7
New Zealand	-1.9	0.1	31.1	13.9
Norway	3.2	16.2	32.5	16.1
Peru	0.6	15.5	11.7	13.2
Philippines	-1.6	11.0	15.1	18.9
Poland	0.5	6.2	28.6	4.5

Source: MSCI, Thomson Reuters Datastream and HSBC Global Research, as of June 2014.
Past performance is not an indication of future returns.

Total return (% in USD terms) – MSCI indices

	-1M	-1Q	-1Y	YTD
Portugal	5.1	5.0	26.3	12.6
Russia	-7.0	8.0	34.1	20.1
Singapore	-0.3	10.2	12.0	4.5
South Africa	-1.6	12.6	32.7	10.1
Spain	5.2	12.2	58.9	13.8
Sweden	-0.7	1.8	25.5	3.7
Switzerland	-0.4	4.7	25.7	7.8
Taiwan	2.9	12.0	23.0	8.8
Thailand	5.0	8.4	2.7	14.4
Turkey	-0.5	31.8	2.5	21.3
UK	1.0	8.2	27.2	5.5
US	3.4	5.6	26.3	7.2

Source: MSCI, Thomson Reuters Datastream and HSBC Global Research, as of June 2014.
Past performance is not an indication of future returns.
Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets.

GEMs equity valuations

	End year PE (x)			End year EPSg (%)			PEG
	2012	2013	2014e	2012	2013	2014e	2014e
China	8.4	7.5	7.5	8.9%	11.7%	-0.3%	-22.9
India	14.3	12.5	9.5	17.3%	14.5%	32.2%	0.3
Indonesia	14.7	13.0	11.4	9.5%	13.1%	13.5%	0.8
Korea	9.0	8.1	7.3	25.1%	11.7%	10.6%	0.7
Malaysia	15.8	14.4	13.6	5.2%	10.0%	6.1%	2.2
Philippines	18.9	16.5	15.6	7.9%	14.8%	5.8%	2.7
Taiwan	14.6	13.2	9.9	8.6%	10.7%	34.2%	0.3
Thailand	12.0	10.7	9.9	13.5%	11.4%	8.9%	1.1
Czech Rep	11.9	12.7	12.9	-10.1%	-6.2%	-1.4%	-9.0
Hungary	9.2	7.8	7.0	-12.6%	17.9%	12.4%	0.6
Poland	13.4	12.0	11.1	-1.5%	11.8%	8.2%	1.4
Egypt	10.8	9.8	6.2	57.2%	10.4%	58.3%	0.1
Russia	4.2	4.3	3.7	-1.4%	-1.7%	13.8%	0.3
South Africa	14.5	13.2	11.9	13.7%	10.4%	10.3%	1.2
Turkey	9.5	7.9	7.0	-4.7%	20.4%	11.6%	0.6
Argentina	6.4	6.2	5.9	-4.7%	2.9%	5.3%	1.1
Brazil	9.0	8.1	7.3	14.2%	11.1%	11.4%	0.6
Chile	14.8	12.3	11.4	36.1%	20.3%	7.6%	1.5
Colombia	14.8	13.5	11.7	16.4%	9.7%	15.4%	0.8
Mexico	17.4	15.3	13.0	12.8%	13.9%	17.5%	0.7
Peru	12.2	10.5	8.5	75.5%	16.3%	23.3%	0.4
GEMs	10.3	9.3	7.9	11.0%	10.6%	17.4%	0.5

Source: IBES estimates, MSCI, Thomson Reuters Datastream and HSBC Global Research, as of June 2014.
PE = price earnings; EPSg = earnings per share growth; PEG = price/earnings to growth ratio. Data is for end year.

Contributors

Julien Seetharamdoo,
Chief Investment Strategist

Julien Seetharamdoo is Chief Investment Strategist within HSBC Global Asset Management's Macro and Asset Strategy team where he provides analysis and research on the key issues facing the global economy and asset markets. Prior to joining HSBC, Julien has worked for Coutts & Co., RBS and Capital Economics. He holds a first class degree in Economics from Cambridge University and a PhD in Economics from the Management School, Lancaster University focusing on the implications of the European Monetary Union.

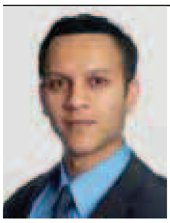
Stephen Tong,
Director, Senior Equity Product Specialist

Stephen joined HSBC in 2014 as a Senior Equity Product Specialist supporting global, European, UK and thematic equities. Previously he worked on sustainable solutions as Head of Emerging Markets Portfolio Management at Bank Vontobel. Before this, he was at AllianceBernstein for 12 years in Singapore, Tokyo and London.

Stephen started his career as a strategy consultant at Bain & Company. He holds an MBA from Stanford University, an MSc Food Science from the University of California at Davis, and a BSc Mechanical Engineering and Nuclear Engineering with High Honors from the University of California at Berkeley. Stephen is a CFA charterholder.

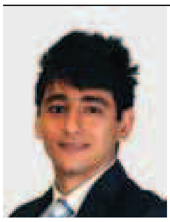
Renee Chen,
Macro and Investment Strategist

Renee Chen joined HSBC Global Asset Management as Macro and Investment Strategist in April 2012. Prior to this role, she held Economist roles at Macquarie Capital Securities, Nomura and Citigroup and has over 14 years' experience in economic and policy research. Renee holds a master's degree in International Affairs and Economic Policy Management from Columbia University, New York and an MBA in Finance and Investment from George Washington University, Washington DC.



Paras Patel,
Associate, Macro and Investment Strategy

Paras Patel is an Associate Macro and Investment Strategist within HSBC Global Asset Management. Prior to joining HSBC Asset Management, Paras worked on the sell side with HSBC Global Research as an Associate in the Global Emerging Markets team. He holds a first class degree in Engineering from the University of Warwick and a master's degree in Finance from Warwick Business School.



Shaan Raithatha,
Junior Investment Strategist

Shaan Raithatha is a Junior Investment Strategist within HSBC Global Asset Management's Macro and Asset Strategy team. Prior to this role, he spent 18 months on the HSBC Global Asset Management Graduate Programme working as an Analyst on both the Global Emerging Markets Equity and Equity Quantitative Research teams. Shaan holds a BA degree in Economics from the University of Cambridge.

Source: HSBC Global Asset Management, data as at 30 June 2014.

Disclaimer

This document is prepared for general information purposes only and the opinions expressed are subject to change without notice. The opinions expressed herein should not be considered to be a recommendation by HSBC Global Asset Management (Singapore) Limited to any reader of this material to buy or sell securities, commodities, currencies or other investments referred to herein. It is published for information only and does not have any regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this document. This document does not constitute an offering document. Investors should not invest in the Fund solely based on the information provided in this document and should read the offering document of the Fund for details. Investors may wish to seek advice from a financial adviser before purchasing units in the fund. In the event that the investor chooses not to seek advice from a financial adviser, he should consider whether the fund in question is suitable for him.

Investment involves risk. The past performance of any fund and the manager and any economic and market trends/forecasts are not necessarily indicative of the future or likely performance of the fund. The value of investments and units may go down as well as up, and the investor may not get back the original sum invested. Investors and potential investors should read the Singapore prospectus (including the risk warnings) which is available at HSBC Global Asset Management (Singapore) Limited or its authorised distributors, before investing. Changes in rates of currency exchange may affect significantly the value of the investment.

HSBC Holdings plc, its subsidiaries and other associated companies which are its subsidiaries, and including without limitation Global Asset Management (Singapore) Limited (collectively, the "HSBC Group"), affiliates and clients of the HSBC Group, and directors and/or staff of any of the foregoing may, at any time, have a position in the markets referred to herein, and may buy or sell securities, currencies, or any other financial instruments in such markets.

HSBC Global Asset Management (Singapore) Limited has based this document on information obtained from sources it believes to be reliable but which it has not independently verified. Care has been taken to ensure the accuracy and completeness of this presentation but HSBC Global Asset Management (Singapore) Limited and HSBC Group accept no responsibility or liability for any errors or omissions contained therein.

HSBC Global Asset Management (Singapore) Limited
21 Collyer Quay #06-01 HSBC Building Singapore 049320
Telephone: (65) 6658 2900 Facsimile: (65) 6225 4324
Website: www.assetmanagement.hsbc.com/sg
Company Registration No. 198602036R