HSBC Global Asset Management

News Release

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EMERGING MARKETS "STILL THE SWEET SPOT" ACCORDING TO HSBC GLOBAL ASSET MANAGEMENT

- *After near universal growth throughout 2017, divergence has returned*
- *Outlook good for US*
- *Less positive for Europe and Japan*
- *Emerging Markets – especially Asia – look to remain strong*

We entered 2018 with a combination of synchronized global growth, low inflation, and low financial market volatility. It was a true sweet spot for investment markets, and we saw very strong returns across risk asset classes. In January many asset classes were up c.5% – the kinds of returns we would expect over a whole year.

But since February, stronger US inflation, trade and political concerns, the re-emergence of economic divergence and US dollar strength have dampened financial market performance and generated volatility. Total returns – capital plus any gains - When we look at global equities, they now look flat over the year, and most fixed income asset classes have posted low or negative total returns. Commodities, especially oil, is the outlier after delivering strong returns in 2018.

Importantly, where we had broad growth in 2017, we are now seeing a degree of cyclical variation. In the US, growth remains good and looks balanced, while the outlook has slipped in Europe and Japan. For the time being, emerging market growth has appeared resilient. Crucially, Chinese growth has held up well despite ongoing deleveraging efforts.

"Yet global growth still looks relatively robust, and there are no signs of an imminent recession," tempers Joseph Little, Chief Global Strategist at HSBC Global Asset Management. "For investors, this means that we continue to see strong corporate fundamentals. Global profits growth is running above 7%, and global default rates are still falling – from 5% at the end of 2016 to 3% now."

Inflation trends are even more globally divergent than growth, which is impacting the monetary policy outlook. Faster inflation in the US keeps the Fed on track to raise rates gradually, whereas in Europe and Japan inflation doesn't warrant a reversal of monetary easing yet. We are seeing policy divergence in emerging economies too. In China, the focus is on reducing leverage while supporting domestic demand, while limited inflation pressures mean that many – but not all – other emerging economies are free to keep interest rates at current levels.

The outlook for bonds

In many government bond markets, the reward (risk premium) for taking duration risk remains heavily negative. "Even without a smoking gun for an imminent inflation shock in Europe or Japan, asset classes like Bunds, Gilts or Government Bonds seem unattractive" adds Little. "This part of the market still looks priced for recession, deflation, and indefinitely continued monetary easing – not for today's economic situation."

Yet US Treasury bonds are in a somewhat different place. After a large re-pricing of interest rate expectations over the last nine months, the risk premium in US Treasuries is now positive. For the first time in ten years, the short end of the curve yields more than the dividend yield on US equities.

In corporate credit, the outlook for global default rates is impressively low. "Credit spreads have widened a bit since the beginning of the year, which has made asset classes like global high yield slightly more attractive in valuation terms, although still not enough to take significant exposure, in our view," comments Little.

Despite the current US dollar strength, emerging economies' fundamentals remain solid, uncovering opportunities in both hard-currency and local-currency debt. Yet it will be crucial to remain selective in both segments, given the economic divergence we are seeing across these regions.

The outlook for equities

Despite flat performance over the first five months of 2018, the good news is that the other catalysts for equity markets are still in place. Valuations remain relatively attractive for emerging market equities and some late-cycle markets such as Japan and Europe (on a currency-hedged basis for the latter two).

Emerging Market equities

Looking at emerging markets – such as Brazil, Mexico, Russia or South Africa – a number of particular risks need to be considered. However, it is worth noting that growth trends remain robust in most of these countries, whilst macroeconomic fundamentals have significantly improved in recent years, which has reinforced the ability of EMs to weather external shocks. "It's worth emphasising here that the term 'emerging markets' in fact covers a huge diversity of markets and economies," explains Little. "And we particularly like emerging markets in Asia.

Our constructive view on Asia's macro environment is reinforced by healthy fundamentals, adequate FX reserves, policy firepower and positive reform prospects in many countries in the region". These factors also create a supportive environment for Asian equities vis-à-vis their peers in other emerging markets, in addition to their relatively more attractive valuations and higher potential earnings growth.

Key risks to our investment outlook

"Faster inflation is something that we have worried about as a key risk, and which has now materialised in H1 2018," according to Little. Is a further US inflation and rate shock possible?

HSBC Global Asset Management believes it is, given the risk of overheating in the US. Such a shock would require a further re-pricing of risk across asset classes, with emerging markets vulnerable to capital market outflows. But Little adds that "large-scale revisions to the market's view of inflation aren't everyday events. And the combination of a significant re-pricing of US rates having just occurred, plus the sustained and low inflation in Europe and Japan, mitigates this risk somewhat – at least for now."

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