Switching Gears: 
Emerging Markets Debt 2019 Outlook

December 2018

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Switching Gears: Emerging Markets Debt 2019 Outlook

Introduction

Emerging markets (EM) toiled throughout 2018 as a wave of economic pressures, trade disruptions and geopolitical factors culminated in a more volatile environment for investors. Much of the disruption originated in the US where rising Treasury yields and dollar strength prompted a reversal in investor flows while, at the same time, the Trump Administration’s tariff agenda accelerated a flight to safer havens. For EM countries with greater fiscal and external imbalances, the cocktail of outflows, together with currency weakening and higher oil prices, proved to be a heavy burden to bear.

Still, many EM countries were able to weather the storm by taking the necessary fiscal and monetary adjustments to absorb these types of external pressures. While the consequences have ranged from higher inflation, currency depreciation, monetary tightening and in some cases IMF support, EM economic fundamentals have stood up to the test. Naturally, growth forecasts have been clipped, but growth rates remain healthy.

Global growth has also shifted gears. While 2016-2017 was typified by synchronized growth, 2018 heralded a cyclical divergence with the US steaming ahead of other developed markets (DM). So what should investors expect in 2019?

Here are our baseline expectations:

◆ Global growth will moderate as US growth will revert to a more normalized pace, narrowing the differential to the rest of the world
◆ The US dollar appears overvalued and its strength will likely wane as US growth moderates
◆ The US Federal Reserve (Fed) will stick to its tightening schedule, with inflationary pressures unlikely to disrupt the current path
◆ US-China trade tensions will continue into the foreseeable future, although the recent pause to negotiate is a small positive development
◆ Chinese growth will temper, however authorities will continue to lend support through fiscal and monetary policy stimulus
◆ European and Japanese growth will continue to be uninspiring without any significant growth catalyst on the horizon
◆ EM will move sideways, no longer accelerating but certainly ticking over.

What do these expectations mean for emerging markets debt (EMD)? While lower global growth, trade tensions and rising idiosyncratic risk factors will pose challenges for investors, we’re entering a period which could be supportive for EMD. The “re-pricing effect” which has seen EMD valuations cheapen over the course of 2018 has resulted in a more attractive entry point for investors, while the yield differential to DM assets is still a compelling draw. With global trade activity showing resilience and other leading indicators of global business confidence still in positive territory, we remain cautiously optimistic in our outlook for EM. In what is likely to be a fluctuating environment, we believe a back-to-basics approach is required, focusing on selectivity and being opportunistic when spells of volatility occur.
US factors keep tipping the growth scales

There is no two ways of looking at it—strong growth in the US has not had a positive spillover effect on the global economy in the last year. Indeed, the associated increase in US rates and the US dollar have weighed on global risk assets and prompted much volatility in global markets. As we look to 2019, there are three main issues influencing our EMD strategy.

◆ Inflation

Inflation expectations were central to market volatility in 2018. A combination of strong economic data, tight labor markets and real wage growth fueled expectations that the Fed would hike rates, pushing US 10-Year Treasury yields above 3% and triggering sell-offs in the stock market. In reality, however, inflation has been contained. Rising salaries have coincided with increased productivity growth, limiting the cost impact on employers. At the same time, consumer inflation expectations have remained low, keeping a lid on wage demands.

Looking at short-term risks, in the event that inflation does overshoot the Fed’s 2% target threshold, we do not believe there will be a deviation from the current rate hike trajectory. The FOMC has expressed that fund rates are “close to neutral” and markets are now pricing in a much shallower rate hike trajectory with two more hikes expected in the next year.

A medium-term risk is a sustained upside surprise in inflation. Should wage growth continue to rise as GDP growth slows, it will push up unit labor costs and, therefore, core inflation toward the end of 2019 and 2020. In this instance, we could see an extension of the Fed rate hike agenda, but not to the point where we would see a rapid increase in USD strength. However, this is not our base case and we continue to monitor developments.

◆ US growth

Much of the acceleration in US growth can be attributed to the Trump Administration’s fiscal stimulus package in December 2017, which reduced both individual and corporate tax rates, boosting an economy already at full employment. Our base case scenario going into 2019 calls for the fiscal stimulus effect to fade away significantly, while simultaneously the lagged effects of tighter monetary conditions will come to the forefront, pulling some steam out of a buzzing US economy. We do not foresee a recession as there is no evidence of that dramatic of a slowdown. However, growth will revert to a more trend-like pace of 2% to 2.5%.

◆ US dollar strength

As global growth is set to converge in 2019 (Figure 1), so too will US dollar strength relative to other major global currencies. Having strengthened by ~5% in 2018, its current value looks unsustainable, especially when we consider that a shallower rate hike agenda will keep US Treasury yields contained. We believe US 10-Year Treasury yields are unlikely to exceed the 3.50% target from its current levels of ~2.78% as of 27th December 2018.

Figure 1. Global growth will converge to a more trend-like pace.

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The China Factor

Trade dilemma

We cannot discuss US growth potential without talking about trade as the US-China tariffs remain the biggest headline risk for 2019. Prior to November’s G20 meeting, the market consensus was that the US would increase tariffs from 10% to 25% on $200 billion (bn) of imports. While the announcement of a 90-day postponement has at least opened up the possibility that a more conciliatory environment could prevail and provide a modest upside risk for global growth, a positive overall outcome is still hard to gauge.

Recently, both sides have cut back on the rhetoric but that could reflect broader concerns around stock market volatility and global growth. But, US-China tensions go beyond just trade, involving a complicated mass of issues over technology transfer, intellectual property, business practices and market access, all sticking points that neither country wants to cede. Our belief is that a more hardline stance will negatively impact global trade, growth in China and EM growth, especially for countries that are heavily integrated into global value chains such as South Korea and Taiwan.

For now, we expect tariffs will eventually be raised to 25%, as was initially planned on January 1st, but trade tensions will not escalate further.

Slowing growth

Recent Chinese economic data, Purchasing Managers Index (PMI) readings and the China Activity Proxy (CAP) suggest that trade disputes are beginning to take a toll on the country’s economy. But this slowdown is not solely a product of trade tensions—the country has been battling weaker economic data, such as falling retail sales and lower industrial profits, for some time.

Chinese authorities have been quick to respond to this softening by injecting stimulus into the economy (Figure 2). Measures have included reducing reserve requirements for small- and medium-sized institutions to infuse liquidity back into the system. Officials have cut liquidity rates (SHIBOR), loosening monetary policy and making interbank lending cheaper. Infrastructure development has also expanded, bringing local government bond issuance and enterprise financing with it.

While policy stimulus should provide some short-term stabilization in growth, authorities are treading a fine line. Having spent the last four years reinining in credit growth, particularly in the shadow banking sector, adding to already high levels of debt will limit the upside potential of such measures.

But a longer-term positive outlook can be drawn based on the headway made on its structural economic transition. Over the past 15 years, China has made concerted efforts to move away from resource-intensive industries or heavy industrial manufacturing (i.e., “old economies”) to more technologically-based or service sector-focused industries where industrial productivity has grown. This is just further evidence of China’s longer-term ambitions to move from higher rates of growth to higher quality, more sustainable growth.

Figure 2. Chinese authorities have injected stimulus into the system in the last year.

The rest of the world lies in wait

Europe and Japan face more of the same

European growth expectations were buoyed in early 2018 by growing global trade activity and lower oil prices while European Central Bank (ECB) support continued in the form of large-scale net asset purchasing (quantitative easing (QE)). However, as the year progressed, these supportive factors dissipated in the face of brewing headwinds, most notably US tariffs on imported steel and aluminum, scaled back QE and a general concern that globalization could reverse.

Meanwhile, Japan has struggled to overcome the pressure of rising oil and slowing global trade activity. An increase in trade tensions weighed on business confidence given its levels of integration into both US and China’s global value chains. But these near-term issues pale in comparison to the longer-term challenges facing the country with significant demographic hurdles (i.e., ageing population, shrinking workforce) which has weighed on growth for some time.

We expect 2019 to be equally as challenging as there is nothing to suggest that growth will pick up from current levels. For Europe, the scaling back of large-scale asset purchasing has had the effect of reducing money growth, a key indicator of domestic demand, and service sector growth. Core inflation remains below ECB target levels of 2% and, although signs of burgeoning wage growth are welcome, they must be tempered by the broader slack in labor markets across the Eurozone. The downside risk to remain watchful of is that weakening domestic activity could be a game changer for Italy, whose delicate financing needs and optimistic growth projections could be significantly impacted by a downturn in demand.

EM growth re-adjusts

The rise in US dollar strength and the reversal in investor flows has seen EM currencies weaken on average by ~11% (JPM EMCI Fixing Index) and in economies with twin deficits, fiscal and external, the impact has been even more pronounced. As a corollary to a weakening in domestic currency, inflationary pressures have increased, albeit from historically low levels. The degree to which inflation has increased has by no means been uniform either. Pass-through rates have varied by country depending on how open the economy is to trade, levels of FX reserves and the extent to which companies and/or governments pass on these changes to broader market prices. Monetary policy response has also had a heavy influence.

In Indonesia, for example, the effects of pass-through inflation have been mitigated by preemptive policy tightening, propping up the domestic currency through higher policy rates (see also Figure 9) or selling US dollar reserves and buying local currency.

But while some EM have boldly adopted counter-cyclical rate hikes, most others appear likely to continue hiking through 2019 as suggested by 1-year implied rates (Figure 3).

Figure 3. The broad depreciation in EM currencies (red) has altered market expectations with implied yields (black) pricing in rate increases over the next 12 months.

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The rest of the world lies in wait

Tightening in some countries has led to a reduction in growth forecasts. Argentina, for example, sunk into recession after the central bank increased rates to an eye-watering 60% to stem the deterioration in the peso. In trade-oriented Asian economies and commodity-exporting countries, a less sanguine global trade environment has also weighed on next year’s outlook.

Yet, there is evidence of a robust underlying fundamental story here. Although, GDP growth forecasts have moved down a notch, EM growth is not in contractionary territory. EM is better prepared to absorb external shocks today than during past challenges such as the Asian financial crisis, the taper tantrum and the commodity collapse. The structural monetary and fiscal adjustments made in light of these episodes, including the implementation of floating exchange rates and the acquisition of foreign FX reserves, has helped mitigate some of the wider negative effects of local currency depreciation.

Figure 4. 2019 EM growth forecasts have been subject to some revision, with twin deficit countries more adversely affected.

Commodities in focus: 2019 Outlook

China’s demand for raw materials has only deepened over the last few years. While EM countries have tried to wean themselves off their dependence on commodity exports, there remains a heavy indirect consequence from China’s economic future. In this regard, China’s policy stimulus and, more specifically, infrastructure planning, such as the Belt and Road Initiative, should provide some support for EM commodity exporters, at least in the near term.

Looking more specifically at oil (Figure 5), 2018’s increase was largely a result of increasing geopolitical tensions in the Middle East as well as the imposition of US sanctions in Iran, Venezuela and, to a lesser extent, Russia. The disruption to supply saw oil prices rally, straining EM oil importers such as India, Turkey and Indonesia. We believe oil prices should remain range-bound in 2019 and, following recent price movement, $50-$70 per barrel will be more palatable for both EM oil exporters and importers.
Do EMD valuations reflect the risks?

Although 2019 is likely to be a more challenging growth environment, there are reasons to be cautiously optimistic for EM. While global trade activity has slowed, it is not showing signs of reversal. Rather, it is merely converging on a lower growth trajectory following a period of rapid expansion between 2016 and 2017 (Figure 6). Furthermore, global PMI data is still in positive territory, despite the anti-trade rhetoric for most of 2018, with measures for US, Europe and EM all above 50. Moreover, real GDP growth forecasts in emerging economies remain elevated compared to those of DM, even with the fiscal challenges and structural adjustments over the last year.

The difference for investors today is that following the sell-off in EMD assets in 2018, the risk premia appears more attractive. In hard currency, a combination of a heavy supply calendar at the beginning of the year and the broader risk-off sentiment, which prompted outflows from the asset class, created a negative supply/demand dynamic. Consequently, spread levels widened significantly.

However, we believe spreads may have overstretched, particularly when we look at previous periods of significant turmoil (Figure 7). Firstly, today’s risk compensation is attractive when we compare valuations to their post-global financial crisis averages. Secondly, spread levels are attractive relative to previous market sell-offs, including the taper tantrum and the commodity collapse, where broadly underlying EM fundamentals were weaker (e.g., large current account deficits and lower levels of FX reserves).

We therefore believe that at current levels, spreads offer an attractive entry point for investors.

Figure 6. Global trade activity has slowed, but not reversed.

Past performance is no guarantee of future results. Source: CBS Netherlands Global Trade Monitor, as of 30 Nov 2018.

Figure 7. Hard currency spread valuations have widened significantly and are now at their widest levels since the recovery from the commodity collapse of 2014/2015.

JP Morgan EMBI Global Index – ex Venezuela spread to worst

Past performance is no guarantee of future results. Source: JP Morgan, as of 27 Dec 2018.
Do EMD valuations reflect the risks?

We do, however, need to keep an eye on the technicals. We anticipate a more positive supply dynamic in 2019, as net issuance is likely to temper (from $102.8bn in 2018 to $53.5bn in 2019\(^1\)), a result of many countries bringing borrowing forward into 2018 due to tightening fiscal conditions. However, flows data is harder to predict and we need to be aware that risks could emanate from unlikely scenarios, such as a surprise rate hike by the ECB towards the end of 2019.

EM local rates continue to look attractive relative to their DM counterparts. Although inflation ticked upward in the latter part of 2018, it has not unwound the real yield compensation available in EM local debt. Furthermore, with average real yields at about 1.5%, there is a significant pick up to DM where real yields continue to be negative, except in the US (Figure 8).

However, one must exercise caution within this space. While inflation has not gotten out of control, the rate hike agendas adopted across many EMs has seen yields rise to compensate investors. We are therefore highly selective, targeting countries with high real yield compensation and steeper yield curves. A good example is Mexico where real yields are ~4.5% (Figure 9). Inflation looks to have peaked and there is room for the central bank to ease monetary policy.

Figure 8. Real yield compensation in EM local rates outstrips its DM counterparts.

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Figure 9. EM real yield historic ranges since 2011. We currently hold overweights in Indonesia, Mexico and Russia as real yield compensation is attractive and appears high against their historical averages. Conversely, we are underweight in Poland, Czech Republic and Thailand as real yields are negative.

Source: HSBC Global Asset Management, Bloomberg, as of 26 Dec 2018.

\(^1\)JP Morgan, December 18, 2018.

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Do EMD valuations reflect the risks?

In local FX, 2018’s correction has seen currency valuations fall below their longer-term averages (Figure 10). Our expectations that US growth will diminish and US fiscal tightening will pass at a slower rate support the view that EM currencies will be appealing in 2019. Moreover, while EM central banks have been raising rates in line with or ahead of the Fed, the carry trade has improved, offering a compelling risk-adjusted return.

Still, attractive valuations alone do not mean we should load up on risk. We believe that 2019 will see a continuation of volatility from both macro risks and trade related news as well as idiosyncratic factors from electoral surprises in Argentina or South Africa to geopolitical challenges in the Middle East. In what is likely to be a fluctuating environment, we expect significant divergence between EMD constituents, making country and region selection crucial to driving alpha.

What is the carry trade?

The carry trade is a common currency trading technique where an investor can use a low-yielding currency to fund a position in a high-yielding currency. The difference between the two amounts is known as the “carry.” For example, rates on 1-month US dollar LIBOR is 2.50% while the implied yield on a 1-month forward in the South African rand is 7.29%, providing a positive carry of 4.79%. Equally, there are currencies which will offer negative carry. For example, the implied yield on a 1-month forward in the Thai Baht is 1.61%, giving a negative carry of -0.89%. In this instance, it would make more sense to hold US dollars in cash.

Source: Bloomberg, as of 26 Dec 2018.

Figure 10. EM REER deviation from its 5-year average. Currency valuations have fallen below their longer-term average following 2018’s sell-off.

Past performance is no guarantee of future results. Source: JP Morgan, as of 30 Nov 2018.
Where do we find value?

Central America and the Caribbean

This region is closely correlated to the US as it is the region’s largest export market as well as providing much of the tourism to these destinations. Furthermore, remittances from US-based foreign nationals are also an important source of income and recent US dollar strength has been beneficial. In the last few years, the region has experienced an uplift in growth given the strength of the US economy and flows of foreign investment, which has provided scope for infrastructure development and economic diversification. Consequently, we have seen gradual improvements in both fiscal and current account deficits and, although US growth will moderate, economic forecasts for the region are solid. However, we will need to exercise caution with some high-yield issuers as levels of external debt used to fund development are elevated.

Within this space, we are **overweight** Costa Rica hard currency bonds where spread levels have de-coupled from its regional peers. Spreads had widened as the government struggled to pass fiscal reform through Congress and the Courts. However, a ruling in early December finally approved the motion and should be a catalyst for more sustainable long-term growth. In contrast, El Salvador has experienced similar price movement given the uncertainty around upcoming elections in February 2019, with polls showing business-friendly party ARENA lagging behind. As a result, markets are becoming jittery and we are therefore exercising caution, positioning our portfolios closer to **market weight**.

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**Figure 11. Growth and inflation forecasts are encouraging.**

<table>
<thead>
<tr>
<th></th>
<th>Costa Rica</th>
<th>El Salvador</th>
<th>Dominican Republic</th>
<th>Jamaica</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP</strong></td>
<td>4.6</td>
<td>3.2</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td>1.6</td>
<td>2.4</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td><strong>GDP</strong></td>
<td>2.3</td>
<td>2.4</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td>1.0</td>
<td>1.2</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td><strong>GDP</strong></td>
<td>4.6</td>
<td>5.5</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td>3.3</td>
<td>3.9</td>
<td>4.1</td>
<td>4.0</td>
</tr>
<tr>
<td><strong>GDP</strong></td>
<td>0.7</td>
<td>1.5</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td>4.4</td>
<td>4.2</td>
<td>4.5</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Source: Bloomberg, IMF, as of 30 Nov 2018. Forecasts, projections or targets are indicative only and are not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets.

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**Figure 12. Central American and Caribbean economies are integrated with the US to various degrees.**

**Figure 13. Spreads in Costa Rica and El Salvador de-coupled from its regional peers.**


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Where do we find value?

**Eastern Europe**

Although the region has seen strong growth in the last three years, we remain highly selective. For example, we see relative value in Romania over Hungary hard currency bonds where we receive a 72bps spread premium. Both countries have positive economic outlooks and continue to be attractive destinations for foreign direct investment given low wages, highly-educated workforces and heavy integration into EU supply chains. However, we are underweight in Hungary as spreads have tightened to an extent where we no longer feel appropriately compensated for risk. Therefore, we have maximized our European exposure through an overweight in Romania.

We are also underweight local debt across central Eastern European countries. Rapid growth has led to tighter labor markets across the region, raising wage growth and, consequently, core inflation. As a result, many constituents have entered rate hiking cycles, which has increased yields. At the same time, the lower yield relative to other benchmark constituents (average yield of JPM Global Diversified Index: 6.67%, as of 30th November 2018) also make Central Eastern European countries less appealing on a relative basis.

**Figure 14. We are underweight across Central Eastern European countries in our local debt portfolios.**

<table>
<thead>
<tr>
<th>Country</th>
<th>Yield</th>
<th>Relative duration positioning</th>
<th>Rate-hiking cycle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>2.37%</td>
<td>Flat</td>
<td>Despite inflationary pressures, central bank has kept rate at 0.90% to prevent a strengthening of the forint and to keep its export industry competitive</td>
</tr>
<tr>
<td>Romania</td>
<td>4.05%</td>
<td>Small underweight</td>
<td>Three rate hikes (+75bps) in last 12 months</td>
</tr>
<tr>
<td>Czech Rep</td>
<td>1.84%</td>
<td>Large underweight</td>
<td>Seven rate hikes (+175bps) since June 2017</td>
</tr>
<tr>
<td>Poland</td>
<td>2.39%</td>
<td>Large underweight</td>
<td>No rate hike – hikes likely in 2019 as inflation expected to rise above 2.5% target.</td>
</tr>
</tbody>
</table>

Where do we find value?

Southeast Asia

Indonesia has long been the darling of Southeast Asia with economic growth consistently at 5% per annum, a fiscal balance at a manageable 2.5% and relatively low public debt levels at 30% of GDP. The country’s focus on infrastructure development in the medium term has led to an uplift in debt issuance, making it more sensitive to foreign investor flows. As a result, investor outflows and rising oil prices in 2018 caused Indonesian spreads, local yields and domestic currency to deteriorate. The volatility forced its central bank to defend the rupiah by implementing counter-cyclical rate hikes of 175bps to 6% (Figure 14) and the government to raise taxes on large consumer goods importers to help alleviate pressure on the current account.

However, we see opportunity here, particularly in local rates, given our view that inflation will remain benign and real rates are close 3.5%, the higher-end of its historical range (Figure 9). Therefore, we are overweight or long in our local debt and total return strategies.

Figure 15. The Indonesian Central Bank has acted quickly in the face of currency depreciation.

Source: HSBC Global Asset Management, Bloomberg, as of 26 Dec 2018.
Conclusion

The global growth outlook for 2019 has shifted gears, still growing, but at a slower pace. Yet, we believe the impact of slower DM growth will be less pronounced on EMD assets. The re-pricing of risk assets through most of 2018 resulted in more attractive risk premia while the yield differential to DM debt remains compelling. At the same time, risks from rising US Treasury yields and US dollar strength have abated as US growth moderates.

2019 will still present challenges as volatility has returned to markets. Idiosyncratic factors will certainly play their part with a heavy EM election calendar (e.g., Argentina, South Africa, India and Indonesia) and a continuation of geopolitical tensions in the Middle East. In terms of macro-risks, the recent pause in US/China tariffs does hold some upside potential, but a meaningful escalation in tensions could weigh on both global trade activity and, most importantly, investor sentiment. Therefore, developments will need to be closely monitored.

In this type of environment, our aim as active investors is to dynamically position our portfolios, retaining sufficient liquidity within the portfolios to be able to take advantage of bouts of idiosyncratic volatility while mitigating risks from what will continue to be a challenging macro-economic backdrop.
Key Risks

There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- **Exchange Rate Risk** Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly.
- **Counterparty Risk** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations.
- **Liquidity Risk** The risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors.
- **Operational Risk** May subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things.
- **Derivatives Risk** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset.
- **Emerging Markets Risk** Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks.
- **Interest Rate Risk** When interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.
- **Default Risk** The issuers of certain bonds could become unwilling or unable to make payments on their bonds.
- **Credit Risk** A bond or money market security could lose value if the issuer’s financial health deteriorates.
- **CoCo Bond Risk** Contingent convertible securities (CoCo bonds) are comparatively untested, their income payments may be cancelled or suspended, and they are more vulnerable to losses than equities and can be highly volatile.

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<th>ARE NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY</th>
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