

Year-End Investment Outlook

The Age of Uncertainty

December 2019

For Professional Clients and Institutional Investors only

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HSBC
Global Asset
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Message from our Global CIO

Joanna Munro

Global Chief Investment Officer, HSBC Global Asset Management

Welcome to our Investment Outlook for 2020, as we continue to live in an “age of uncertainty”.

2019 has been a year of contrast. On one hand, the narrative of the year in financial markets has been rather pessimistic; trade tensions, policy uncertainty, and recession worries have dominated the news headlines. On the other hand, investment market performance has been impressively strong – right across Fixed Income, Equities, and alternative assets.

How the “age of uncertainty” dynamic developed in 2019, and why it still resulted in strong investment market returns, are the first questions we deal with in our Investment Outlook. Our Chief Strategist, Joe Little, explains how a number of factors have been important with a focus on the global pivot toward policy easing. This downward pressure on the discount rate has been the principal catalyst for strong investment market performance in 2019.

Our Chief Strategist and Global CIOs then outline their views on what is coming in 2020, first in terms of the macro-economic and investment strategy outlook and then for asset classes. In Liquidity and Fixed Income our CIOs Jonathan Curry and Xavier Baraton focus on the “lower-for-even-longer” rate environment and what that means for our duration and credit strategies. In the Equities space, Bill Maldonado reflects on a year where corporate earnings have been under significant pressure, but where there are signs of optimism and momentum building, not least given the valuation of Asian Equities today. Finally, Xavier Baraton shares our investment views across our Alternatives capabilities – in Real Estate, Hedge Fund selection, Private Markets, and Infrastructure – where we continue to see selective, but interesting return-enhancement and diversification opportunities.

We hope you enjoy reading.

A handwritten signature in black ink, appearing to be 'JM', with a long horizontal flourish extending to the right.

Joanna Munro

Global CIO



Macro and multi-asset outlook

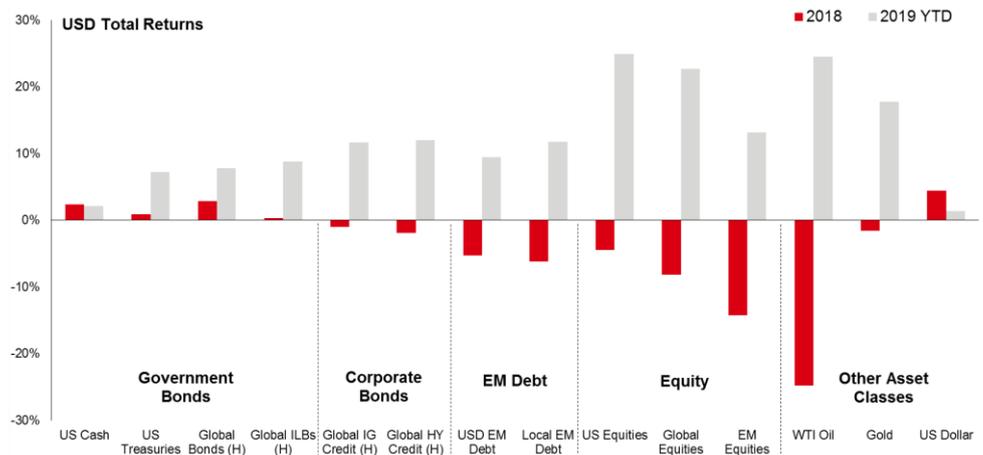
Q&A with Joe Little

Global Co-CIO Multi-Asset, Global Chief Strategist

Can you summarise asset market performance year-to-date?

Investment markets have performed strongly across the board in 2019, with positive performance across fixed income, equity, and alternative asset classes. The breadth of positive returns has been impressive, although not unusually so.

Figure 1: Asset class performance



Source: Bloomberg, HSBC Global Asset Management. Data as of November 2019. All asset class returns shown as USD total returns (unhedged) unless stated. H - Refers to currency-hedged USD total returns.

Past performance is not a guarantee of future performance.

Global equities are the clear standout; total returns are over 20% on a US dollar basis. Within that, “growth equities” have outperformed “value”, and technology has been the strongest sector; consequently, US equities have outperformed the rest of the world in 2019, as they did in 2018. Meanwhile, emerging market equities have lagged.

Fixed income total returns have been strong too. Global bonds and credits have returned around 10% - significantly ahead of long term expected returns at the start of 2019. More exotic fixed income strategies have also performed well. And, in the alternative strategies area, we have seen particularly strong risk-adjusted performance in private equity and hedge funds.

This backdrop of robust, positive cross-asset class returns has created a very benign environment for multi-asset investors. A global 60/40 portfolio has delivered over 15% in total returns during 2019. Bonds have acted as “positive return hedges” for equity risk, which has boosted 60/40 risk-adjusted returns too.

Overall, it has been an impressive year for asset class performance. The quantum of total return is high both in absolute terms, and relative to our own assumptions of long-term expected returns. All the more striking when set against the political and economic uncertainty that has characterised 2019.

With so much uncertainty around, why have markets done so well?

This is a really important and profound question. First of all, I agree – we are living in an “age of uncertainty”.

On the political side, we have had a record number of elections across the G20 in 2019, the most since 1958. Overall, policy and political uncertainty have been elevated. The trade tensions between China and the US have been the dominant story, of course, but other events have also featured too. Moreover, we can track this quantitatively; statistical measures of “global policy uncertainty” are at all-time highs.

Meanwhile in the macro-economy, there has been elevated fear and uncertainty around a potential recession in 2019. Data science techniques can help us see how “recession narratives” have spread intensely through the financial media during 2019.

So what happened? Why were financial market returns so strong?

First, much of what we saw in the policy uncertainty sphere was principally a deterioration in sentiment. While trade “threats” have been very elevated in 2019, the actual policy action on trade has been more muted, although still impactful. In the economy, much of the bad news in 2019 was concentrated in confidence surveys and the manufacturing data. The fear was that this would spill-over into the rest of the economy. But that didn’t happen.

Instead, what did happen was a “global policy pivot” and this was probably the single most important reason why asset class performance in 2019 has been so strong.

Rate cuts from the Fed, negative policy rates and cash injections to banks from the ECB, and fiscal policy support from China have protected markets during the year. Overall, more than 15 global central banks have cut rates in 2019 – it has been a true phase of global easing.

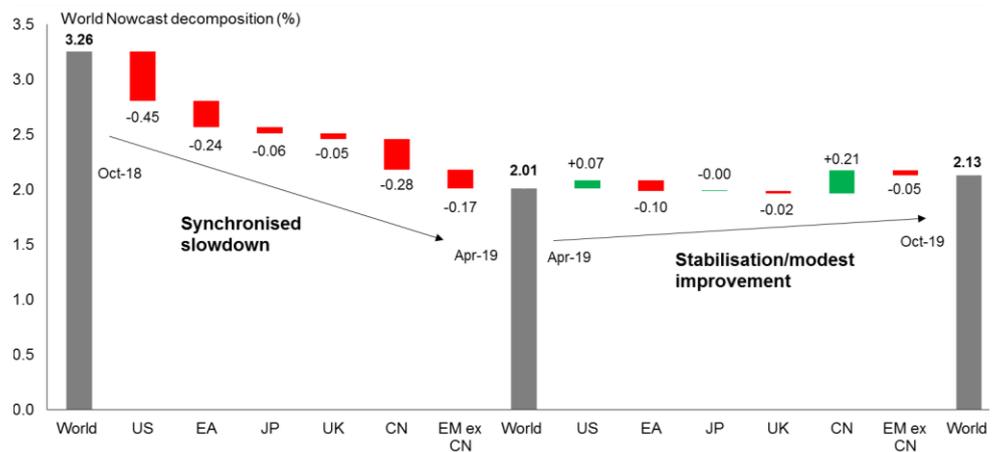
The policy pivot has been an important support for sentiment and the macro-economy. But it had even more immediate and dramatic implications for asset markets. Long-term Treasury yields compressed from 2.6% at the start of the year to lows just above 1.4% in late summer. And, famously, the entire German yield curve moved into negative territory. This trend of falling and negative interest rates supported asset classes right across the risk spectrum.

It is also worth remembering that many risk asset classes began 2019 after a significant phase of “risk-off” at the end of 2018. As always in investment markets, the starting point matters. In the case of global equities, for example, expectations around corporate profits were already reduced at the start of 2019. That’s meant that the weaker news on the economy and on profits that we have received during the year has not destabilised things too much.

Looking ahead now, what is your macro scenario for 2020?

At the global level, we see the outlook as one of slow but steady growth, muted inflation and mildly supportive monetary policy in 2020. We call it the “favourable baseline”.

Figure 2: World Nowcast, regional picture



Source: HSBC Global Asset Management. Data as of November 2019. For illustrative purposes only.

While this might sound uninspiring, it has to be viewed in the context of the existing headwinds (continued geo-political risks and recession worries). While the central scenario is somewhat mediocre when set in historical terms, we see it as “favourable” relative to the macro headwinds of uncertainty and relative to current consensus forecasts.

Early 2019 was characterised by a synchronised slowdown across the major economies. This led to markets fretting about an imminent recession. The collapse in long-bond yields and the inversion of the US Treasury curve further intensified investors’ worries about the macro cycle.

However, at this point, our “big data” Nowcast suggests global growth has stabilised, albeit at a relatively modest pace. A number of leading indicators that we track closely appear to confirm that a pattern of “cyclical bottoming” is now underway.

Understanding the fundamental reasons why growth has stabilised is important. Our view is that two key factors have been at play. First, persistently low global inflation has allowed policy-makers to focus

on supporting growth, rather than worry about an economic over-heating. Global inflation trends remain very subdued as we go into 2020.

Second, global labour markets have remained resilient. The slowdown in macro trends has been very evident in trade and investment, and that has weighed heavily on the global manufacturing cycle. However, consumer spending has held up well, bolstered by continued employment and income growth. In turn, that's supported service-sector activity and has meant that we have avoided the recession predictions of the macro-pessimists.

With tentative signs that the manufacturing cycle is now bottoming out and, importantly, with the impact of looser policy likely to continue to feed through to activity in 2020, the potential for a broader phase of macro weakness has diminished. We expect the global economy to maintain a relatively stable, albeit unspectacular, pace of growth in 2020.

What about the regional economic outlooks for the advanced economies and the main EMs?

The last 18 months have been characterised by US macro outperformance. For 2020, we expect a bit of a reversal of that trend and some "growth convergence".

The boost from tax cuts is fading in the US, uncertainty related to trade policy appears to be weighing on investment, and labour market indicators are moderating. However, policy easing by the Fed and robust consumer finances should prevent growth dropping below trend.

US core inflation remains below 2% and is likely to converge to target only gradually. In fact, the Fed's primary concern is that inflation may continue to undershoot its target. That means that while policy is on hold for now, the bar for rate hikes is much higher than the bar for further rate cuts. Our working assumption is that we see one further rate cut from the Fed in 2020.

The second engine of global growth – China – slowed sharply through 2018. Since Q1, growth has recovered somewhat; our China Nowcast is now running at around 5.5%, up from 4.5% earlier in 2019. We think that any further pick-up is likely to be gradual given that: (i) headwinds from trade uncertainty are likely to persist; and (ii), policy easing by the Chinese authorities has been relatively modest. However, we think that policy makers stand ready to provide further support if needed, limiting the chances of a renewed slowdown.

The bottoming of growth in China has coincided with tentative signs of stabilisation in other emerging markets. According to our Nowcast, Asian emerging markets, in particular, appear to be recovering. In a world of only modest Chinese growth and trend-like US growth, it is unlikely that EMs will experience a strong upturn. However, the recent improvements in the Asian technology and trade cycles are significant developments and augur well for near-term growth momentum.

What's more, with US policy set to remain mildly accommodative (and potentially loosen a little further), no obvious trigger for a rapid appreciation of the US dollar, and muted local EM inflation pressures, the conditions appear to be in place for reasonable EM macro performance in 2020.

Europe and Japan remain the laggards of the global economy – our Nowcast for the Eurozone is running around zero, while for the UK and Japan it is negative. The Eurozone is being hampered by particularly weak conditions in Germany, a result of its high exposure to the global manufacturing cycle. However, a gradual improvement in EM growth should help European export performance and ECB policy easing should also support domestic demand at the margin. Overall, 2020 could see a modest recovery in the Eurozone, which would also benefit the UK – especially if we receive some greater clarity on the future political relations between the two economies.

What does that mean for the corporate outlook?

The "favourable baseline" should mean that, after a modest profits recession in 2019, earnings stabilise and begin to improve somewhat in 2020.

Looking-forward, the scenario looks more constructive. Modest global growth and limited wage inflation should mean that we can expect mid-single digit earnings growth in 2020. Recent trends already point to the beginning of an improved earnings momentum trend, particularly in EM and Asia.

Corporate balance sheets continue to look reasonably strong. We anticipate some modest increase in default rates next year, but nothing outside of historic norms.

Where does that leave us with the investment strategy themes for 2020?

Our thesis is that we are in the "age of uncertainty" – with many political and economic unknowns and unprecedented macro situations playing-out. But after significant political, policy and economic uncertainty already in 2019, an important question is how intensely uncertainty plays out again in 2020.

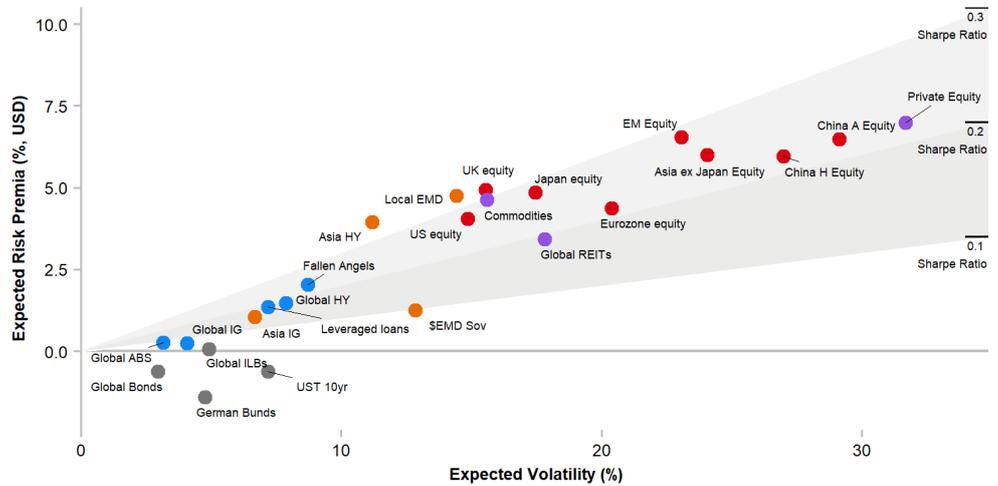
We will need to be vigilant. There are a number of big, unresolved issues and a sequence of other key political events that could play out adversely - or perhaps, better than expected for the macro-economy and financial markets.

The really big lesson from 2019 is that even if uncertainty remains a prevalent feature of the system, we should not automatically be seduced into a cautious investment strategy. Going to cash at the start of 2019 felt safe and sensible, but it turned out to be very costly for those investors who did that.

Our baseline scenario for 2020 is relatively favourable. We anticipate slow and steady growth, low inflation, accommodative policy, and single digit profit growth. Recession seems like more of an issue for 2021, or even beyond.

Meanwhile, market pricing remains attractive for some risky asset classes, especially versus the negative inflation-adjusted returns on cash and on core fixed income (where the bond risk premium is also negative). That means we should still be pro-risk in our asset allocation.

Figure 3: Assessing market-implied odds



Source: HSBC Global Asset Management. Data as of May 2019. Global Fixed Income assets are shown hedged to USD. Local EM debt, Equity and Alternatives assets are shown unhedged.

Any forecast, projection or target contained in this document is indicative only and is not guaranteed in any way.

Yet we have to be realistic about the kinds of returns that are achievable. Downside risks, such as a global growth recession, look more remote at this point, after the insurance policy of the “global policy pivot”. At the same time, prevailing uncertainty caps the upside that we can expect from our investment strategy. At this point, the environment is more one of “clipping coupons” and what we have called “compounding the carry”.

Asset classes like emerging markets equities and European equities offer attractive carry opportunities for investors (high dividend and earnings yields). We also think that parts of fixed income where rate duration is not very high and yields are decent (e.g. Asia credit) are interesting.

The strategy of “compounding the carry” makes sense to us as part of a multi-asset portfolio. But we also need to be thoughtful and disciplined in our portfolio construction.

We advocate “smart diversification”. Government bonds have had an extraordinary return profile over the last couple of years – much stronger than we would have expected based on our long-run asset class modelling. And they have been incredibly successful hedges for global equity risks. However, the forces that have supported bonds so far may be gradually beginning to reverse. That suggests that global bonds might be a less reliable diversifier going-forward than they have been in the past.

As asset allocators, we need to adapt to that change. The key to success in the “age of uncertainty” will be to continue to be dynamic in how we build our asset allocation, and to expand our investment strategy across more geographies (e.g. emerging markets), new asset classes (e.g. liquid alternatives), and new styles (e.g. quality).



Global equities outlook

Q&A with Bill Maldonado

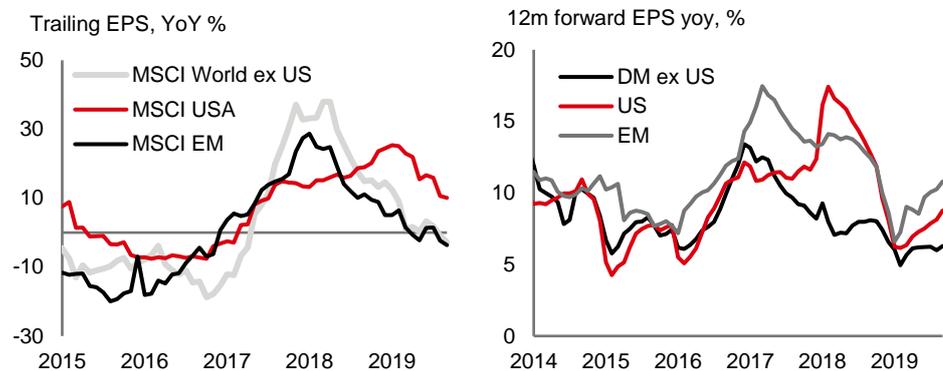
Global CIO Equities, CIO Asia Pacific

Can you give us an overview of global equity markets in 2019?

2019 has been aptly described as a “bull market born on pessimism” by our Chief Strategist - Joe Little (quoting Sir John Templeton). For most of the year market sentiment has, in our opinion, been overly negative even as equity markets notched up solid gains amidst a slew of accommodative policies from central banks across the world.

Despite the rally in the global equity markets – led by the US and Eurozone, with Asia and other parts of the emerging markets (EM) universe bringing up the rear – we have to acknowledge that global growth concerns, trade conflicts and other uncertainties have had an impact on corporate profitability. There has been a well-recognised slowdown in earnings growth across regions as illustrated in the chart below, but at the same time, we have seen recovery in forward earnings growth amidst improving economic data. This positive momentum in earnings expectations has not been fully priced by the market, leading to an increased degree of undervaluation in spite of rising equity prices.

Figure 4: Trailing EPS growth has slowed globally... but forward earnings expectations are improving



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Source: Bloomberg, HSBC Global Asset Management, data as of October 2019.

What do you expect moving forward?

We remain constructive on global equities in 2020, against the backdrop of a potential cyclical upturn driven by a rebound in manufacturing across major manufacturing powerhouses, including the US, China and Germany. Arguably, amidst the ongoing destocking of inventory, even a small increment in demand could potentially create a notable pickup in the manufacturing sector. For example, we have already seen signs of recovery in the tech and semiconductor industries in Asia. Outlook for these industries has improved with better visibility of the turnaround in the flash memory industry, and because of demand driven by new applications in 5G, AI, and automotive segments.

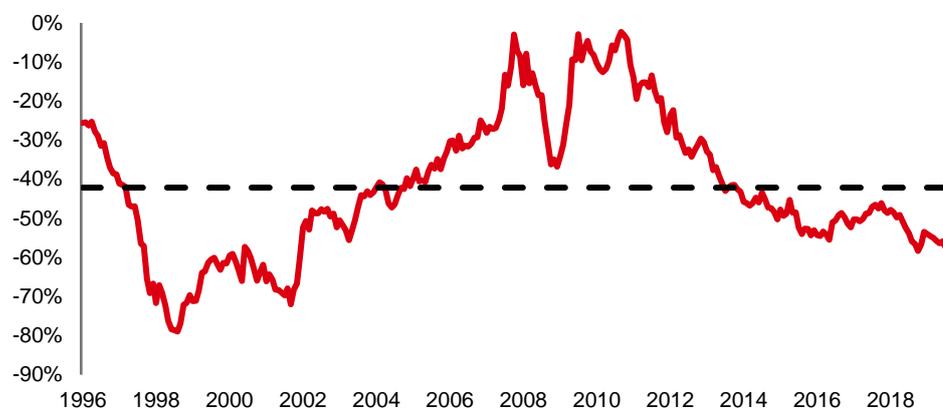
While US-China trade tensions have dragged down global equity market sentiment in 2019, we think trade pessimism has already reached its peak. It is difficult, if not impossible, to predict how a potential trade deal will eventually pan out, yet we can see that investors have been tempering their reactions to trade conflict-related news in recent months, instead focusing on other market drivers such as the Fed's rate direction and global growth indicators. This is partly because, instead of speculating on the hard-to-predict trade deal per se, the market has begun to focus on the possible impact of trade tensions on macroeconomic variables such as wage growth and inflation, and in turn, their impact on the policy stance of central banks. Going into 2020, major global central banks are expected to remain accommodative to prepare for any possible risk of slowdown, as the Fed re-grows its balance sheet and the ECB and the Bank of Japan continue their asset purchase programs.

Where are some of the key opportunities?

Within emerging markets, Asia stands out in our view. Asian equities underperformed other regions in 2019, with MSCI Asia Pacific ex Japan returning just over 10% YTD, primarily because of worries over a slowdown in China, the largest economy in the region. This has created a compelling valuation discount in the asset class. If the aforementioned manufacturing upturn takes place, or if there is a pickup in China's growth in 2020, we may see a material rebound in Asian equities, potentially led by Chinese equity markets.

Figure 5: Asia ex Japan equities trading at an attractive discount vs US market

Trailing PB relative to US



Past performance is not a guarantee of future performance.

Source: Bloomberg, MSCI data as of 30 September 2019

We remain overweight in China. China's economic indicators have started stabilising and it seems that the economy is now in the midst of slowly regaining momentum. Chinese policymakers have introduced adequate fiscal and monetary stimulus measures to support growth, as exemplified by China's rising infrastructure spending, increased issuance of local government special bonds, and cuts in value-added tax and individual income tax. The latest consumption and manufacturing data have added to the narrative of growing resilience in the Chinese economy and its ability to withstand external shocks, thanks to robust domestic consumption. Consensus earnings forecasts for the country remains one of the highest in Asia thanks to ongoing policy support that is expected to reduce taxes and lower funding costs for businesses.

For the rest of emerging markets, India also looks positive thanks to the unexpected corporate income tax cuts and ongoing implementation of its reform agenda to upgrade infrastructure, raise productivity and improve governance. At the same time, we are less convinced about emerging market equities in the EMEA region owing to sluggish activity, subdued demand, and importantly, growing political uncertainties. We are also neutral on LatAm owing to their deteriorating economic growth.

While we remain constructive on developed market equities, we see stronger earnings growth recovery in emerging markets in 2020. US economic and earnings growth remains relatively robust and we do not think the risk of a recession is imminent.

As for Europe, while we have seen a manufacturing slowdown particularly impact Germany and drag the region to near-zero growth, equity prices should pick up if investors become less bearish about manufacturing going forward. Consumer activities, which can drive prices of domestic stocks, may be another positive catalyst. In the UK, while Brexit developments are to be watched, sterling, rather than the stock market, will be exposed to the most direct impact. This is attributable to the fact that two-thirds (for FTSE 100) or half (for FTSE 250) of revenues of FTSE companies originate from overseas.

As for Japan, the corporate restructuring story will continue to play out and drive markets, despite the lack of economic growth. While the country's economy has been faltering owing to its aging population, reliance on debts, close-to-zero rates and tightened fiscal conditions (increase in VAT), we expect to see long-term improvements in governance such as unwinding of cross-shareholding. The central bank's asset purchase program to buy domestic equities through ETFs will also provide support.

What are key considerations for global equity investors in 2020?

Trade conflicts will continue to draw investors' attention in the new year, though the market reactions to related headlines are likely to be less significant. Instead, investors including us will be more focused on the progress in the global growth recovery story as any major disappointments on that front could easily derail a pickup in the asset markets. While we should be wary of the Fed's policy language, it is likely that the Fed and other major central banks will remain accommodative and react to any signs of slowdown. Political uncertainties ranging from Brexit to Hong Kong will also continue to have an effect on equity markets.

In the run-up to US presidential elections in 2020, there are certain developments that may need to be monitored more keenly including US-China trade relations. However, in our experience, the results of the election are less of a concern as markets have typically tended to shrug off early apprehensions and expectations and chart their course, irrespective of the parties or candidates that assume power.



Global fixed income outlook

Q&A with Xavier Baraton

Global CIO Fixed Income, Private Debt and Alternatives

Can you tell us more about the impact of further central bank easing?

Amidst the challenges to global growth this year, a dovish policy pivot by central banks has driven strong returns across fixed income segments. Preliminary indications, along with market sentiment, indicate that the easing by the Fed and ECB have achieved their respective goals of extending the economic cycle.

While we expect slight improvement in economic growth going forward, the global economy remains vulnerable to shocks as part of the ongoing theme of this monetary-fuelled recovery. Excess liquidity and low yields are having limited impact on appetite to invest and borrow, due to high leverage on balance sheets already.

What risks are you anticipating?

In the context of muted economic growth, shocks can come from various sources, including geo-political risks. For instance, next year's US election, Brexit and trade tensions can all be potential contributors in 2020. Ongoing political instability should be expected beyond these particular issues, as a by-product of the lingering impact of the Global Financial Crisis across segments of society. This instability continues to contribute to a sense of vulnerability and hamper confidence. As such, we expect further spikes of volatility next year, with investors moving between risk-on and risk-off scenarios as developments occur. Considering the environment, and high valuations across some fixed income segments after this year's rally, we think investors should be selective moving forward. An emphasis on fundamentals will be important.

Climate change is an often overlooked risk factor of growing importance to both the global economy and investment markets. Climate change will increasingly start to weigh on valuations for companies and countries that are not responding, or are more visibly jeopardised, such as through greater exposure to catastrophes. In the context of current economic growth, dynamics related to climate change are leading to sub-optimal allocation of resources, hampering productivity. For instance, coal is cheap, but its long-term harm outweighs its near-term benefit. As such, today we have to invest in more expensive power solutions. The auto industry offers another example, where consumers are delaying purchases as they await a new generation of electric vehicles. This delayed investment is contributing to a drag on growth and an industry deflationary environment.

What are your expectations on rates in 2020?

In a world of low economic growth, largely absent of inflation, interest rates will remain at relatively low levels over the medium-term. We expect that monetary policy prudence will prevail, but in the absence of further economic deterioration, any additional easing will be minimal. As the bar for rate increases in the US is very high due to the long existing inflation undershoot, the market may stay comfortable with this until the economic outlook improves materially. This should cap any material rise in yields and supports the low-yield environment lasting for longer.

While the US curve has steepened significantly from the late August lows, and some near term flattening is possible, our medium term outlook remains for a steeper curve. With the Fed likely on hold for some time and more likely to cut rates again instead of hiking, this should leave the short end of the curve reasonably anchored. Medium to longer term US Treasuries instead are more subject to risk sentiment and the evolution of economic data. A further improvement in risk sentiment should hence lead to upward pressure for longer rates. On the other hand, should data start to disappoint again and recessionary fears crawl back into the market, the long end will rally. However, increased discounting of lower short-term rates should also follow this.

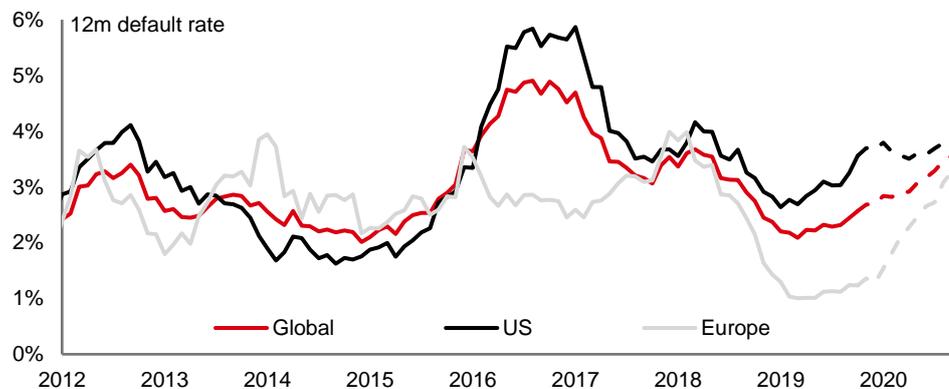
In Europe, the ECB has only limited room for additional rate cuts, while rate hikes are off the table for likely a very long time. Hence, a bearish market environment, particular if it is caused by global developments, could push longer rates up while the yield on short-end bonds stays low, leading to a steeper curve. The situation however, is somewhat complicated by the ECB's QE and the search for yield amidst negative rates, with both factors benefitting the long end of the curve.

What do you expect in credit markets?

In credit markets, the valuation landscape is a contrast to last year. The volatility at the end of 2018 gave us great entry points, particularly for yields in US and Asian High Yield. This fuelled the strong returns of 2019, but we are now ending the year with tight spreads on low yields and greater credit idiosyncratic stories, limiting prospective returns going forward and causing greater spread decompression in high yield. We approach 2020 with a cautious view, holding similar expectations of volatility spikes, but less attractive valuations leaving us more exposed to any shift to a risk-off stance.

Furthermore, leverage keeps increasing, though possibly more in Investment Grade than High Yield. We are keeping an eye on default rates that could start to creep up from excessively low levels. In this regard, it is important to track corporate profitability. In the absence of the benefit of tax cuts and lower rates, companies are now more dependent on top line revenue and economic growth to fuel earnings growth and generate cash.

Figure 6: Expectation of a modest rise in default rates



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Source: Moody's, HSBC Global Asset Management, data as of October 2019.

While idiosyncratic risks are rising and becoming more frequent, a concerning extension would be broader industries falling into fundamental trouble. Currently, we see the problems as company-specific. An historical hallmark of a lead-up to a recession are industries or sub-industries falling onto tough times. Concerning areas in our credit outlook are the REIT sector, especially those with over-exposure to retail, certain commodity and specialty chemical sectors, autos and energy. Prudent issuer selection in IG, and particularly HY, is key to outperform when the economy is in trouble. If fundamentals weaken further, higher default risks could come from firms that have borrowed on inflated earnings multiples based on growth projections that were not met.

We have a slight preference for Europe, partly due to quantitative easing, which will cap volatility. Although spreads are tight and slightly less attractive, if volatility increases European spreads should be more resilient. Furthermore, some technicals are stronger in Europe, particularly in the high yield space where we see better quality.

What are your views on EM debt?

Opportunities remain in EMD hard currency and local currency. Both are positive for diversification with economic growth slightly de-correlated to the US. Major macro headwinds such as trade tensions are largely priced in, and odds of resolution increase as time passes. With next year's US elections offering additional motivation for the Trump administration to reach an agreement, and China wanting to maintain higher growth rates, odds appear to favour some sort of resolution. Emerging markets are more likely to benefit from any positive fallout from the current headwinds. However, we acknowledge that future returns depend significantly more on country selection than a year ago. Particular idiosyncratic risks apply in Argentina, South Africa and Turkey, which are all large components of the market. At the present time Brazil, Mexico, and to a lesser extent Russia, seem to be more stable and have our preference. We think local currencies continue to have room for appreciation, and profit taking will soon be recommended in hard currency given recent spread compression.

Do you have any closing thoughts?

As a broad summary, the overall starting point across fixed income segments contrasts with the end of 2018, with yields currently at multi-year lows. This does not mean that this will necessarily reverse, but we are probably close to the bottom of the range for bond yields across major segments. As such, and to reiterate, we think a focus on fundamentals will be important moving forward to generate returns.



Global liquidity outlook

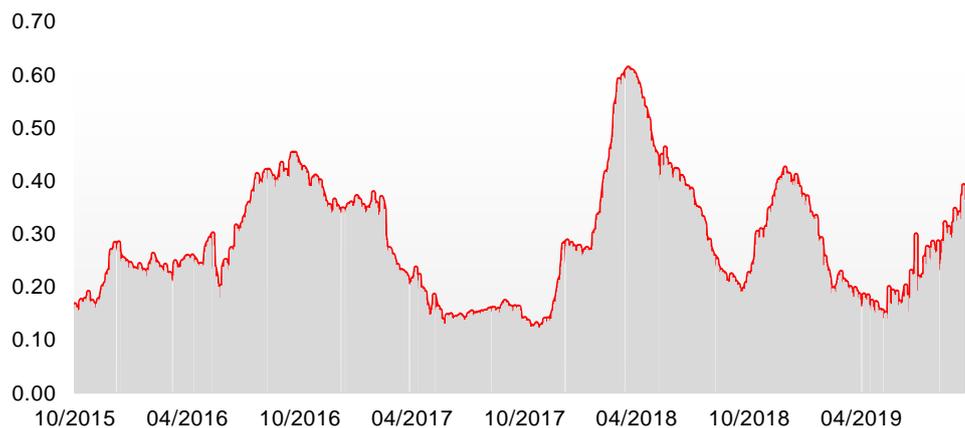
Jonathan Curry

Global CIO Liquidity, CIO USA

What has happened in money markets in 2019?

The year certainly started off with a surprise, or 'pivot', for the money markets as the Fed moved to a rate cutting bias in January. Our response has been to extend weighted average maturity in our liquidity funds. This allowed us to slow the impact of rate cuts on the yield delivered. We remained cautiously optimistic that the global economy would continue to grow around trend in 2019. With this as our base case, it supported our positive view on higher quality credits in our money market fund (MMF) investable universe. We maintained a longer weighted average life across our main liquidity funds, taking advantage of steepness in the credit curve to support fund yields.

Figure 7: USD IBOR-OIS Spread



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Difference between LIBOR and the corresponding maturity Fed Fund swap rate.
Source: Bloomberg, HSBC Global Asset Management as of 4 October 2019.

2019 also saw the culmination of European MMF regulatory changes that were implemented early in the year. The implementation went smoothly across the industry, which was positive for investors in European domiciled MMFs. Assets under management in AAA-rated, short-term MMFs has grown in 2019, serving as a vote of confidence in the regulation and continued value of MMFs.

The new European regulations require funds to put in a redemption fee or gate if weekly liquidity falls below 10%; emphasizing the importance of liquidity risk management. These liquidity mechanisms were already in place in most MMFs, and we are very supportive of them as a tool to protect investors. Clearly all MMFs should be working towards minimising or avoiding reaching the trigger. Nonetheless, liquidity risks are often neglected by investors who take comfort in individual investor concentration limits. However, if these are set too high it can be quite easy for a fund to have a very concentrated investor base without surpassing the prescribed individual concentration caps. In this scenario, it could take as little as two large investors unexpectedly redeeming to cause a major issue.

There is a cost to maintaining higher liquidity, and some more nuanced parts of the new regulation. We are seeing different risks being taken on post regulation, particularly with extension of asset-backed commercial paper (ABCP) maturities. Typically, those were in the 1-3 month maturity range. Now we are seeing an increase in exposures out to 6 to 12 months. This raises not credit, but liquidity concerns from our perspective. Due to the idiosyncratic or systematic risks in the banking sector, it is our view that the ABCP issues won't be as liquid as the debt issued by the same bank ABCP sponsor.

Outside of extended ABCP maturities, we are broadly seeing investors looking to push the envelope in how far they are willing to extend tenors on riskier credits. As investors seek better yields in markets with low or negative rates, they may be taking on more risk than their objectives dictate. Whilst there is this sense that MMFs are all AAA-rated and largely homogeneous, this is not truly the case. Investors should understand a fund's approach and what type of tail risk they might be exposed to, and how that tail risk is being managed.

What are key considerations going forward for money markets?

ESG-screening is becoming a growing consideration for liquidity funds, with a number of ESG-focused MMFs launched in 2019. As sustainability becomes a greater focus across industries, treasury teams will increasingly need to consider it in order to support their firms' objectives. There will need to be a lot of thought put into how they create a policy around sustainability for treasury investment purposes. It is much simpler for corporate investors to think about credit; there are only three global credit rating agencies, which are long established, with clear methodologies that are generally understood. That is very different in comparison to evaluating sustainability. There are many more providers who do some form of scoring. Some are very specific in what they are focusing on, while some are aiming to capture the wider responsible investing spectrum. This creates a far more challenging market to understand, and there are currently knowledge gaps. As such, we expect ESG consideration within MMFs will be an evolving story going forward. Transition to alternative benchmarks to IBORs (interbank offered rates) is another developing issue. We are still 2 years away from the formal demise date for certain IBORs, but there is a lot of work that still needs to be done by all financial market participants to be prepared. It affects many areas for us as an asset manager, but also for our clients. There is still a question of whether there will be a market-wide solution for securities that reference an IBOR due for demise. And whilst the ARRC in the US (Alternative Reference Rates Committee) is looking at a market-wide solution for this, it requires legislative change in the US, which is by no means certain. There is a risk that impacted securities could experience a change in the value or nature of the security itself. As such, the next couple of years will require significant work and preparation to avoid unexpected impacts to investors.



Global alternatives outlook

Q&A with Xavier Baraton

Global CIO Fixed Income, Private Debt and Alternatives

How have alternatives fared?

Like traditional asset classes, alternatives fared well in 2019, delivering strong returns with unique characteristics that proved beneficial for portfolio diversification. Private equity and hedge funds delivered particularly strong risk-adjusted returns.

What are the key developments to be aware of in real estate?

In property, we have seen a significant difference in the performance of physical and listed property. Direct property delivered returns of less than 5% in the US (NCREIF Index) and less than 2% in the UK (MSCI UK Monthly Index) over the nine months to September. Listed property on the other hand, has delivered returns of over 20% globally through September (FTSE EPRA Nareit Developed Index). This strength was not unexpected. Our view was that there was excessive pessimism at the end of last year, which resulted in higher dividend yields being available in listed property to start the year.

Sagging demand for retail space continues to have a negative impact, particularly in weaker locations. The impact varies geographically depending on factors such as the degree of e-commerce penetration. However, we see the most successful retailers effectively leveraging physical locations with online business. This model continues to drive demand for logistics and warehouse properties to support rapid fulfilment of online purchases. Growing demand for flexible workspace also continues to be a market driver in the office sector, with companies valuing the benefits of flexibility, particularly given the current uncertainty of the macro environment limiting capital expenditures.

With low interest rates across developed markets expected to continue for the foreseeable future, the search for yield should benefit property markets. Listed property yields are over 125 bps higher than global equity dividend yields, and over 300 bps higher than developed market bond yields. We continue to favour listed property over physical property in most markets. While infrequent, backwards-looking appraisals can make physical property appear more stable, we believe higher long run returns are available in listed property with lower costs than are typically associated with physical property.

An appealing characteristic across property markets is the ability to serve as a partial inflation hedge, since rents tend to rise over the long run roughly in line with inflation. However, we are monitoring political risk, which can negatively impact this characteristic. There is growing societal unrest over affordable housing needs across some key cities globally, and in response to this unrest, policies have been proposed aimed at capping rising residential rents in some locations.

And in hedge funds?

Hedge funds have delivered relatively steady performance through the year, mitigating downside risks and demonstrating their diversification benefits amidst notable volatility within traditional asset classes. In USD, the largest monthly drawdown for the industry HFR index was roughly 1%, compared to nearly 6% for developed market equities. Risk-on and risk-off strategies contributed relatively equally to performance, with the complimentary nature of the two approaches minimising overall volatility.

Given the uncertainty of the current macro environment, we see advantages in risk-mitigating strategies going forward. Within this segment we favour multi-strategy, multi-manager and market neutral strategies for their specific focus on risk management, diversified sources of returns, and market neutrality. We've seen a recent increase in multi-manager platforms, which is understandable given the benefits mentioned, and a trend we expect to continue as uncertainty persists.

We typically like trend following strategies due to their near-zero correlation to traditional asset classes over the long-term. However, we need to be thoughtful about the vehicles we use, as depending on current positioning these strategies can add risk to portfolios. Reiterating the importance of "smart diversification", we are focused on opportunities to increase risk-adjusted returns.

Within risk-on strategies we maintain limited exposures to credit, primarily through structured credit where yields remain strong enough. In event-driven strategies we favour more 'activist' managers, which by definition are very idiosyncratic based on individual company focus, limiting beta exposure. In long-short equity we are mainly neutral, with a slightly negative view on Europe.

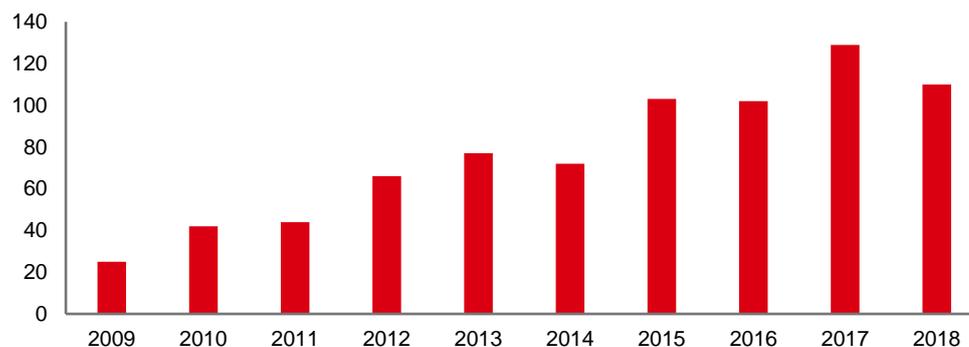
What have you observed in private markets?

Buyouts have been one of the performance drivers for private equity. High levels of M&A have continued, generating steady distributions to investors. This has been bolstered by the final realisations coming from the crisis vintages of 2005-2008 funds near the end of their lives, with highly respectable returns - a median IRR in excess of 10% for those vintages in the US.

Within venture capital, a series of disappointing IPOs of very late stage companies has dominated discussion around companies staying private for longer amidst increased private capital availability. Beyond the headlines, there are still many lower profile private companies delivering significant value and cashflows, driving private equity funds to extend beyond their typical 10-year lives.

While we have seen weak spots in credit – particularly in the more liquid markets – much stronger discipline has been exhibited in private lending. Its bilateral nature has encouraged higher credit quality. Private credit markets continue to grow, with banking regulations fuelling a significant shift in lending from banks to fund structures backed by private lenders. We expect this growth to continue due to the appeal for borrowers of more streamlined, rapid commercial decisions.

Figure 8: Direct lending volumes globally (USD billions)



Source: Preqin, Bloomberg, 2019.

Overall, we like opportunities in infrastructure at this stage of the economic cycle, which offers durable cashflow generating opportunities that are resilient through cycles, with a growing dependency on private capital to fund new developments. From a regional perspective, we continue to like the US and Asia due to stronger growth and opportunities in industries such as healthcare and e-commerce. Opportunities in Europe are limited due to growth challenges and long-term uncertainty. Where we do pursue opportunities in Europe, we focus on defensive companies with idiosyncratic risk profiles not dependent on growth or the economic cycle.

Regardless of the environment, one of the most important considerations for private market investors is to have vintage diversification. The best defence against broad risks is diversification and selecting managers whose methodology delivers consistent results.

What is the outlook for infrastructure debt markets?

In infrastructure debt, various factors have been pressuring yields, including excess demand in the US where many deals are oversubscribed. In our view, this dynamic places added emphasis on an intelligent approach to credit, with specialist analysis required to determine the right opportunities with adequate risk mitigation. This has become increasingly important as borrowers try harder to strip covenant protections amidst the availability of excess funding.

There has been some response to yield pressures through credit spreads moving up slightly in recent months, but not enough to offset the wider yield compression. We are looking wider geographically in order to locate additional yield and value. While there are attractive opportunities in Latin America and the Middle East, we think Asia offers some of the better opportunities today. The region is significantly behind developed markets in infrastructure development, and the lack of a single currency poses challenges to attracting the required funding in any single currency.

Increasingly, sustainability has become a primary factor when we consider opportunities, as it will have a significant impact on long-term cashflows generated by an asset. This does not mean pursuing exclusively green projects. However, given the extended timeframe for cashflows from infrastructure projects to pay back initial capital outlays, we have to be cognisant of the long-term viability of any project. There continue to be opportunities in renewable energy; while conversely, we generally prefer to avoid segments that could be negatively impacted by the environmental transition.

Moving forward, we expect that with high quality credit profiles delinked from economic cycles, and larger spreads due to various premiums (country premium, illiquidity premium, etc.), infrastructure debt will continue to attract capital amidst a lower for longer interest rate scenario.

Contributors



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Joanna Munro is HSBC Global Asset Management's Global Chief Investment Officer, based in London. Her most recent role was as Global Head of Stewardship and Fiduciary Governance (since 2014) and Chair of the UK asset management business (since 2016). Joanna's previous roles included Regional CEO for Asia and CEO for HSBC Multimanager. She joined HSBC in 2005 as Global Chief Investment Officer for HSBC Investments, including Multimanager, Liquidity, Asset Allocation and Solutions. Joanna started working in the industry in 1986. She has a BA (Hons) in Mathematics and Engineering from Queens' College in Cambridge, an MSc in Economics from the London School of Economics and an MBA from Stanford University as well as an MA in Creative Writing from Goldsmiths London. She is also an ASIP (Associate of the Society of Investment Professionals), a member of the Investment Association Board and a founding member of the Diversity Project.



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Bill Maldonado is HSBC Global Asset Management's CIO for Equities globally and the CIO for Asia-Pacific. Based in Hong Kong, Bill oversees the investment strategies in the region and works closely with the local CIOs and investment teams to align our strategies, process and best practices for equity portfolio management globally. Bill has worked in the asset management industry since joining HSBC in 1993 as an European derivative-based portfolio manager and later on headed up a number of investment functions, such as non-traditional investments (including passive indexation mandates, fund-of-funds, structured products and hedge funds) and the Alternative Investments team. He became Global CIO, Equities and CIO for the UK in 2010 and relocated to Hong Kong in July 2011 to take up his current position. He holds a Bachelor's degree in Physics from Sussex & Uppsala Universities, a D.Phil. in Laser Physics from Oxford University and an MBA from the Cranfield School of Management.



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