Mid-Year Investment Outlook

Pivotal Moments

June 2019

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Not for further distribution

HSBC Global Asset Management

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Message from our Global CIO

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Welcome to our 2019 mid-year outlook

I hope you enjoy reading our mid-year Investment Outlook. In the pages that follow we set out to share our current thinking and the investment conclusions that follow. Perhaps surprisingly, given that there is much uncertainty, we have some clear views.

Sometimes the key question for investment managers is less ‘where do we go next?’, but rather ‘how did we get here?’ The reason is that markets move when something changes relative to what’s currently discounted. It follows that our first task is often to understand what is discounted in today’s prices.

That’s not always easy, but it is often very helpful. The situation at the end of last year is a case in point. Investment returns were very disappointing in 2018. This was true across the board, but especially in ‘risk assets’ like equities. The reason is that by the year end markets were discounting the continuation of a very sluggish world economy, if not the risk of outright recession, while fearing that interest rates would continue to rise.

In contrast, asset class performance has been very robust year-to-date, with both equities and fixed income asset classes delivering strong, positive returns, precisely because these fears did not materialise. Indeed, the reverse has been true. The macroeconomic backdrop has been better than expected, relative to consensus forecasts, with the evidence now suggesting that what happened last year, especially in Q4, was a ‘cyclical slowdown’, from which activity is now slowly recovering.

More importantly though, investor confidence was boosted by the US Federal Reserve’s ‘pivot’ at the start of the year to a more accommodative stance. Markets are now expecting rate cuts, not rate hikes. Moreover, the Fed was not the only central bank to ‘pivot’ and, as result, we’re now back to a world of policy accommodation.

So far so good, as far as the year is concerned, but the question is what’s discounted now? Despite better economic data, investors remain anxious about the global growth environment. We continue to believe this cyclical pessimism is overdone. However, on the other hand, inflation has been ‘priced out’ of asset valuations while yield curves imply further rate cuts and a lower-for-even-longer rate environment.

As far as the investment outlook is concerned there is both good news and bad news implied in current market pricing. On the one hand, modest economic growth, low inflation and interest rates, and accommodative monetary policy, combined with still attractive valuations, is positive for global equities, especially if well diversified. On the other hand, falling long-term interest rates have led to a negative ‘term premium’ which is probably bad news for investors in government bonds and high quality credits.

At this point then, our investment conclusions are relatively straightforward. Global equities look reasonably attractive (though don’t expect stellar returns), but bonds do not, though in some segments ‘credit risk’ is still adequately rewarded.

In what follows, my colleagues will build on these themes while adding both colour and nuance.

Chris Cheetham

Chris Cheetham

Global CIO

Macro and multi-asset outlook

Q&A with Joe Little

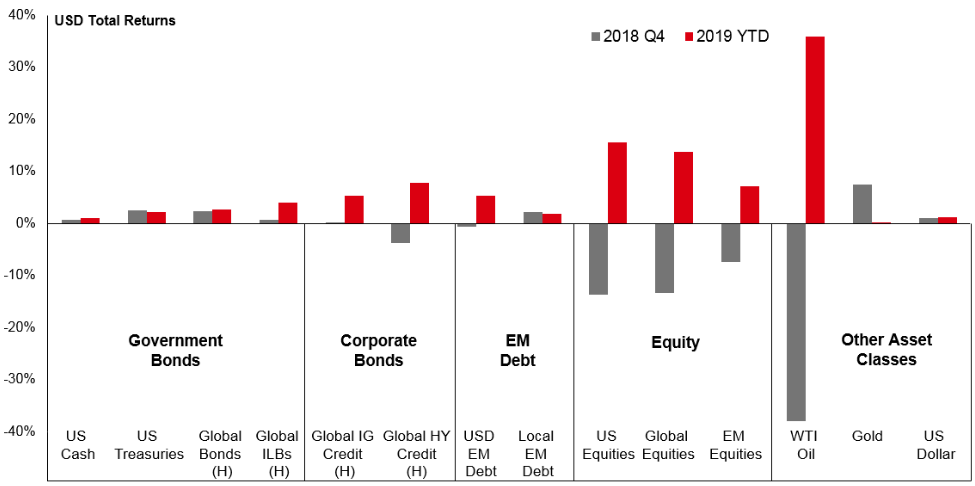
Global Co-CIO Multi-Asset, Global Chief Strategist

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

Asset class performance has been robust year-to-date with both equities and bonds delivering strong, positive returns. Global equities are up by more than 10% in US dollar terms[1] while, on a US dollar-hedged basis, global government bonds and investment grade corporate bonds have returned around 2.5% and 5%, respectively[1] (Figure 1).

However, we need to put these returns into context. In Q4 last year risk asset classes underperformed on the back of a re-emergence of recession worries and fears of a policy mistake from the US Federal Reserve (Fed). The strong performance thus far in 2019 therefore largely reflects a rebound from the disappointing end to 2018. What's more, the strongest cumulative market performance from end-Q3 2018 to 2019 year-to-date has been in fixed income, not equities. While credits have produced positive returns, global equities are flat since the beginning of Q4 2018. This means that, counter-intuitively, despite strong returns this year, equities are actually the laggard.

Figure 1: Asset class performance



Source: Bloomberg, HSBC Global Asset Management. Data as of May 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.

What have been the key themes driving market action in 2019 so far?

In our view, the key moment in investment markets thus far in 2019 has been the global 'policy pivot'. After a large sell-off in December of last year, the Fed 'pivoted' at the start of the year towards a more accommodative stance. It went from communicating a continuation of policy tightening in December, to signalling a more "patient" approach in January.

This shift in policy has had a big impact in investment markets; interest expectations have moved lower, bond yields have fallen, and equity markets have rallied.

But the Fed was not the only central bank to 'pivot'. The European Central Bank (ECB), the Bank of Japan (BoJ) and other central banks across developed and emerging economies have taken a more accommodative position too. Global fiscal policy is loosening as well, especially in China. To us, this episode illustrates familiar behaviour from policymakers over the last couple of years: due to the lack of inflation in the system, their focus can be on stabilising the growth cycle.

The second, related, theme that has driven markets this year has been a better-than-expected macroeconomic backdrop, relative to economists' forecasts.

During the last quarter of 2018 global activity experienced a 'cyclical slowdown'; where all of the main economies slowed on the back of manufacturing weakness and tighter financial conditions.

[1] Source: Bloomberg, HSBC Global Asset Management, MSCI All Country World Index (equiies), FTSE World Government Bond Index, and Bloomberg Barclays Global Aggregate Corporate Index as at 30 April 2019.

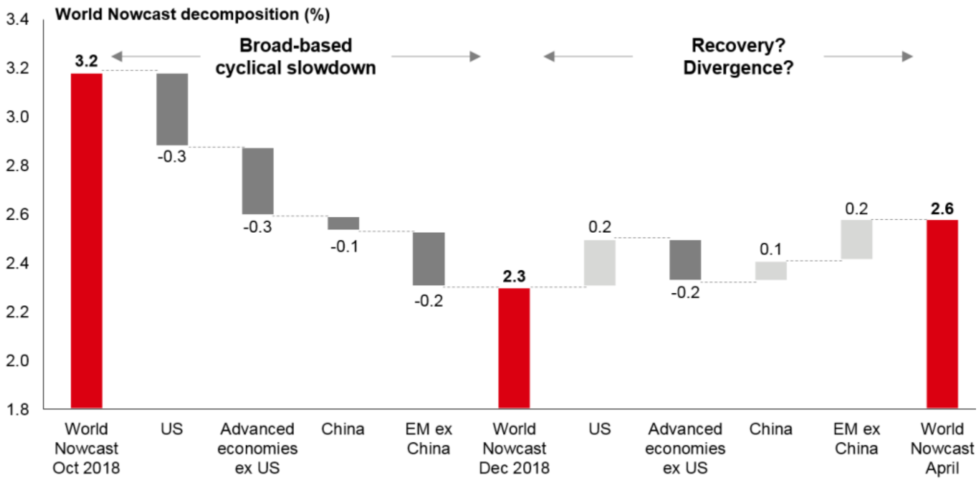
This dampened market sentiment and ignited fears of a severe slowdown and an outright recession. As a result, the market was pricing in an economic scenario of lower growth and material profit weakness. But this didn't play out and the macro data now looks to be stabilising, or improving, in a number of places.

Looking ahead, what's your outlook on global and regional growth?

According to our global Nowcast (a real-time 'big data' measure of economic activity), global growth slowed through 2018, especially in Q4. This 'cyclical slowdown' was broad-based, with both 'engines of growth' (US and China) slowing due to policy-induced domestic weakness in China, tighter financial conditions in the US, and US-China trade tensions.

Through the turn of the year, global growth moved sharply lower to below 2%. This deterioration in the growth picture led to the re-emergence of recession fears. However, global growth has since started to show signs of stabilisation, led by a recovery in the US, China, and emerging markets (Figure 2).

Figure 2: World Nowcast, regional picture



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

Despite this better news of late, investors remain anxious about the global growth environment.

We think this cyclical pessimism is overdone.

For example, the US does not exhibit large imbalances that could trigger a recession. Consumer spending is supported by a tight labour market and the housing market is not showing signs of overheating. High corporate debt is a risk, but current policy is accommodative.

What could change, in our view, is the growth mix. Currently, our US Nowcast is running at around 3%, above-trend and up from the low of around 2% seen earlier in the year. However, moving forward, the boost from last year's tax cuts is set to fade and the lagged impact of increases in the Fed funds rates in 2017 and 2018 also implies that growth will moderate. Nonetheless, with monetary policy still marginally accommodative, we do not expect growth to drop below its trend pace of around 2%.

Outside the US, though, we expect other major economies to see stable or improving growth, led by China. The Fed's dovish policy pivot has been a key factor, shoring up confidence and boosting risk assets. But the policy easing implemented in China since mid-2018 has been at least as important for global growth. Import data suggest Chinese domestic demand is now beginning to recover from last years' slump and this should support growth elsewhere.

Growth in the Eurozone remains more subdued. However, a solid labour market, a resilient service sector and accommodative policy means we expect the bloc to grow around its trend pace, as the manufacturing sector benefits from better conditions in China.

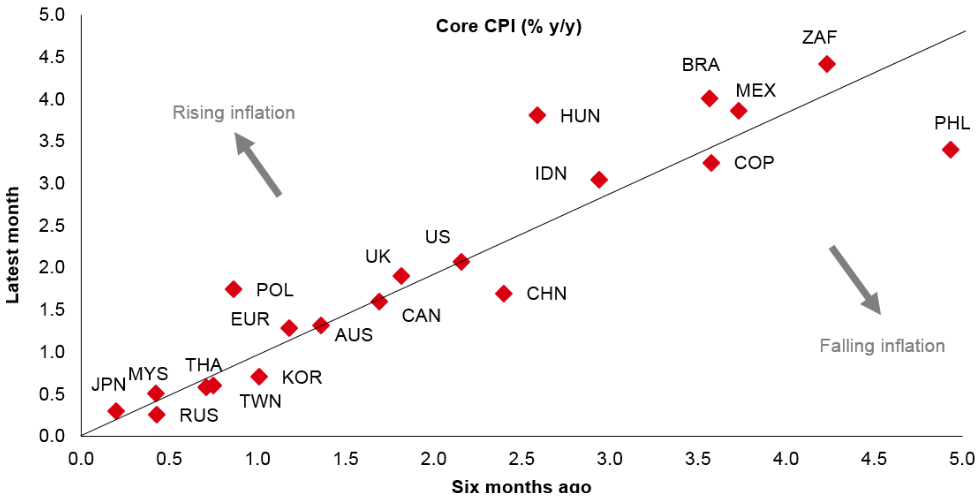
Overall, we see the global economy continuing to expand at a reasonable pace, but with the drivers changing; growth is likely to slow to trend in the US but gradually improve in other economies. Key risks to this outlook are a further intensification of the US-China trade dispute or the action taken thus far having a larger-than-expected negative impact.

And what about global inflation trends?

Currently, global inflation remains contained with only a few exceptions in emerging-markets. The rise in the oil price year-to-date will put upward pressure on headline rates late in 2019, but core inflation is likely to remain subdued given the growth outlook is not strong enough to generate significant, broad-based price pressures this year. Indeed, most economies have not seen a clear trend in core Consumer Price Index (CPI) inflation in either direction over the past six months (Figure 3). Even in the US, where the labour market is tight and growth has remained above trend, core inflation has moderated in recent months. To some extent this reflects transitory factors that should unwind. However, labour costs have been softer than expected, with stronger productivity offsetting the impact of rising wages. This is likely to cap US core inflation throughout 2019.

In the Eurozone and Japan, inflation remains well below desired levels with little prospect that it converges to target over the next couple of years.

Figure 3: Core inflation rates vs 6 months ago: no clear trend in either direction



Source: Bloomberg. Data as of 9 May 2019.

What does this combination of reasonable growth and modest inflation imply for the policy outlook?

Reasonable growth and limited inflation pressures means little need for central banks to tighten policy. Indeed, we do not foresee significant changes to the main central banks' stances.

The Fed has already shifted its view on the policy outlook since late 2018; the so-called Fed 'pivot'. The result is that the Fed appears to have become more willing to tolerate any future overshoot of inflation relative to target. Nonetheless, market expectations for 50-75 basis points (bp) of rate cuts by end-2020 look more like a risk scenario than a central case. Policy tightening looks to be off the table for the ECB and BoJ. Equally, both central banks are running low on conventional "un-conventional" policy ammunition, which limits the scope for significant policy easing. The ECB could look at tiering its negative deposit rate, but would need a macroeconomic rationale to do so.

China has more policy flexibility, but with the authorities not looking to generate a strong upswing they are unlikely to deliver any further significant easing, unless growth looks like it is going to fall short of the government's target.

What about the US dollar? What's the outlook?

The US dollar has crept higher since its recent low in early 2019 – up to around 2% on a trade weighted basis – but remains below the peaks seen in recent years.

Looking ahead, while some fundamentally and politically-challenged emerging markets are susceptible to large currency swings, it is hard to make a case for a significant, broad-based move in the US dollar. Gradually moderating US growth against a backdrop of recoveries in other economies argues for a softer US dollar. However, rate differentials still favour strongly the US dollar over the euro and the Japanese yen; moreover if market expectations for Fed rate cuts prove unfounded, the US dollar could rally.

Barring any large macro shock, the US dollar seems likely to be range-bound over the next year or so, with growth, inflation and rate differentials either moving little or offsetting each other.

Overall, we have identified four investment themes that we believe are key for multi-asset investors for the remainder of this year.

What does all this mean for our multi-asset views?

Mis-placed macro pessimism. Market participants remain anxious about global growth and the risk of a recession or bear market. However, our fundamental analysis on the macroeconomy and corporate sector tells us that these worries are excessive. A combination of reasonable global growth, OK corporate fundamentals, and supportive policy means that the prospect of a recession looks to us more like a risk for 2021 or beyond. This means that as investors we retain a pro-risk allocation.

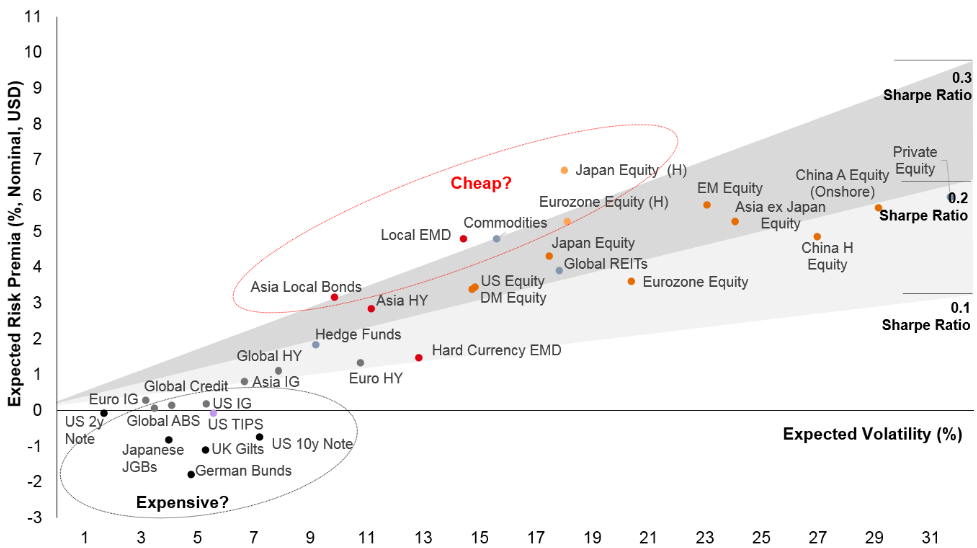
A related theme we highlight is for multi-asset investors to look for opportunities to take carry in selected fixed income and global equity markets where valuations are attractive. Although investment markets are vulnerable to episodic bouts of volatility, as investors we "**keep calm and carry on**".

Inflation is the neglected risk. We don't think underlying inflation will rise materially in the near term but the market is priced as if inflation will remain low forever. In order words, it wouldn't take much of an upward surprise in inflation, nominal growth or interest rates to challenge current pricing in fixed income assets. What's more, our valuation analysis suggests exposure to interest rate risk is not currently being rewarded (negative bond risk premium). Instead, investors are being penalised for taking duration risk. At this point, we want to be underweight global government bonds.

The extreme pricing of interest rate risk has also become a material drag on corporate bond expected returns. Prospective returns on global investment grade (IG) credit have fallen year-to-date and the prospective Sharpe Ratio is now close to zero; we want to be underweight this asset class (Figure 4). While the interest rate component is also a drag on hard-currency Emerging Market (EM) debt and global high yield (HY) expected returns, and valuations become stretched, there is still a reasonable credit risk premium here. We therefore remain neutral, but continue to closely monitor the credit universe.

The upside is in EM. A key aspect of our role as multi-asset investors is to manage downside risk while identifying and trying to capture the upside potential. Currently, we believe that upside is in emerging markets. Growth in emerging economies seems to be recovering, led by improvements in China. Trade tensions may still weigh on sentiment and create adverse feedback loops, but we think that a number of EM asset classes are relatively attractively-priced and have the potential to outperform if key risks don't materialise.

Figure 4: 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.

What are the key risks to this outlook?

Global growth has stabilised this year, and we've moved away from the regime of the 'cyclical slowdown' from the end of 2018 and the early part of 2019. But a number of risks remain for the investment outlook. We've called these risks the 'pivotal moments' because, depending on how they play out, they could alter the scenario for macro markets in H2.

The first risk is that growth trends deteriorate against our expectations, led by either a faster economic slowdown in the US, or by policy failing to ignite economic activity in China. It could manifest itself in a deterioration in corporate profits. This risk scenario would have a material impact on our pro-risk asset allocations.

The second risk is around policy. After the 'policy pivot', which supported investment market performance in H1 2019, could policy 'pivot back' to a more hawkish stance? This would happen if the US economy performed much better than expected, causing inflation and real interest rates to rise. This would have a significant impact on investment markets and it is clearly something we need to be wary of.

Finally, political risks remain a major challenge and a significant hurdle for risk asset classes to perform in H2 2019. To a certain extent, investors have to get used to ongoing political uncertainty and the risk of episodic phases of volatility in invetment markets. It's very likely that political challenges persist through 2019 and into 2020.

As always, it's going to be important to be dynamic and active in how we build our economic scenario, and in terms of how we deploy our risk budgets across our asset allocation strategies.

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 the first half of 2019?

There have been two key developments of note this year. Firstly, the US Federal Reserve's position on interest rates has become clear after an extended 'will they, won't they' waiting game that had investors on tenterhooks last year. The Fed pivoted to a more dovish stance at the beginning of 2019, putting further rates hikes on hold and adopting a data dependent approach for future policy decisions. Secondly, with respect to global economic growth - we've seen a degree of stabilisation, primarily in the US and in China, and this has helped anchor the world economy. To put this in context we need to flash back to 2017 when the key economies were growing strongly, in a synchronised manner, amidst low inflation. Risk assets thrived in that environment. When investors saw signs of economic growth flagging in 2018, amidst an array of other concerns – primarily the Fed's rate hiking path and US-China trade tensions – they punished the markets, particularly in the second half of the year.

While there was no material shift in the economic or business cycle in 2019, there was a change in sentiment as many of last year's pressing concerns - including, for a brief period, the US-China trade standoff - began to fade into the background. This combined with cheap valuations after last year's correction, unleashed the latent value in global equities, and stock markets rallied sharply in the beginning of the year before giving up some gains to the latest round of trade frictions in May.

One area where the narrative has been negative, and unfairly so in our opinion, is earnings growth. There has been a lot of discussion around earnings 'misses' in the fourth quarter of 2018 and the first three months of 2019, but here the focus is on how accurate analysts' estimates are. Instead, we should be thinking about whether companies are delivering better profitability and return on equity (ROE) (Figure 5). Earnings growth has undoubtedly slowed when compared with 2018, trending in single digits for most major markets, but this has largely been factored into the current stock prices. This means any upside we see from here could provide a boost.

Figure 5: Profitability forecast

	EPS growth forecast		PE	PB	RoE
	2019E	**2020E**	**2019E**	**2019E**	**2019E**
China	12.40%	12.10%	11.6x	1.5x	13.10%
Asia ex Japan	4.10%	13.90%	13.2x	1.4x	10.90%
Emerging Markets	0.80%	11.60%	12.1x	1.4x	12.20%
Europe	1.20%	10.80%	13.8x	1.7x	12.20%
US	3.80%	11.70%	17.5x	3.2x	18.90%
World	2.90%	10.90%	15.3x	2.1x	14.10%

Source: Goldman Sachs, data as of May 2019.

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What is your outlook for the rest of 2019?

Based on the most recent round of talks between the US and China, which resulted in tit-for-tat tariffs and no definite timeline for any sort of resolution, it looks like the spectre of a full-fledged trade conflict will spill over into the second half of 2019. In our opinion, the uncertainty and negative sentiment that comes with a prolonged conflict is a bigger threat to companies and markets than the potential increase in tariffs. Even in a scenario (not our base case) where the US imposes a 25% tariff on USD500bn worth of goods it imports from China, and China retaliates with similar measures, estimates suggest that the economic hit may be limited to around 50-60 basis points off their GDP growth. This is certainly not a positive development and will have a disproportionately large impact on the agricultural sector and consumers in the US, but another potential consequence is the removal of uncertainty, which will allow corporates that are currently in limbo to once again make long-term decisions and investments, such as potential supply-chain realignments.

In our view the US and China could reach a deal ultimately, but the timing, format and terms of any deal, let alone details of implementation, are difficult, if not impossible to predict. However, we believe trade frictions are merely a symptom of the deeper running conflict between the two nations which is being likened to a Thucydides Trap – an allusion to the Athenian historian Thucydides and the belief that when an emerging power threatens an incumbent one, it ultimately leads to conflict. Thus investors will potentially need to adjust to a longer period of geo-political uncertainty, especially as we move closer to the campaign for the 2020 US Presidential elections where US-China relations are sure to be on the agenda.

What key opportunities do you see?

Another shifting narrative at the global level is the intersection between conventional economics and the Modern Monetary Theory (MMT), which seems to be gaining traction with the rise of populism and the call for more fiscal stimulus in the face of slowing global economic growth. We are already experiencing this in many parts of the world where governments are choosing fiscal measures over monetary tools, and we could potentially see more if there is a dip in growth.

We are buyers of risk assets, and equities in particular, in this environment. The US markets have run ahead of the others, but Japan and Europe still look undervalued and attractive. Within emerging markets, Asia stands out as others grapple with greater geo-political and economic uncertainties (new regime in Brazil, elections in Argentina and South Africa, below forecast growth in Russia). From a medium to long-term perspective we can see the fundamentals play out and the latent value emerging from these equity markets; but in the more immediate future we have to be prepared for some turbulence.

What are the key considerations for global equity investors in the rest of 2019?

In addition to the re-escalation of trade tensions between the US and China, there are other geo-political factors at play, especially since 2019 is a crucial election year for many emerging markets. It's always difficult to predict political outcomes and it's even harder to predict their impact on asset markets, but one lesson we can learn from history is that the effect of these political events tends to be ephemeral. The most important consideration for us as investors is political stability and policy continuity. The Asia-Pacific region in particular has witnessed a number of key elections this year but the reform agendas in major economies have not shown signs of wavering despite shifts in the political landscape. This is a positive sign for equity markets and should be a continued tailwind over the medium to long term in the region. Unpredictable as they might be, it is clear that geopolitical uncertainties have a huge impact on sentiment and can drive markets in powerful ways in the short term. The only logical action in such situations is to invest according to fundamentals; and the fundamentals as we see them are still favourable - the slowdown in economic growth has moderated, corporate profitability remains intact and inflation is still low.

Another factor that is mostly under-priced at the moment, is inflation. Inflation remains below target in developed markets and low in emerging markets, but the trade conflict between the US and China could change that as tariffs are inflationary and so are counter measures such as onshoring manufacturing. We don't expect inflation to come back in a big way in 2019, but we will continue to monitor it as other risk factors play out.

Global fixed income outlook

Q&A with Xavier Baraton

Global CIO Fixed Income, Alternatives and Real Assets; CIO North America

What has driven fixed income performance so far in 2019?

Looking back at developments leading into the year, most of 2018 was driven by central bank tightening, eventually contributing to a slowdown in economic growth and a market shift to risk aversion. The adverse reaction by markets highlighted an important background theme – secular stagnation forces, such as demographics, deleveraging and environmental change, continue to hold sway. With their drag on global economies, any budgetary or monetary tightening can quickly slow economic growth, revealing a lack of intrinsic strength in the recovery to be sustained at a global level.

We continue to live in a world of moderate economic growth and low inflation, along with significant political uncertainty and geopolitical tensions. This environment is not particularly adverse for fixed income. At the start of 2019 our base scenario was that if a major global economic slowdown was avoided, liquidity and investors were poised to return to bond markets. The Fed policy pivot then reinforced markets. Benign fundamentals, continued global expansion, and monetary policies back to neutral or accommodative have supported all fixed income segments in 2019, with high yield, US dollar EM debt (EMD) and Asian bonds leading the way.

A key driver for high-yield bond performance has been credit default rates remaining low in both Europe and the US. Asia and emerging countries have benefited from a better policy mix (tax cuts and public investment in China as an example), along with global commodity prices creeping up. A more patient Fed and tame inflation have paved the way for more neutral monetary policies across emerging markets, trending towards easing.

There have been notable policy changes across key central banks this year. Looking forward, what is your outlook on rates?

Over the year-end, expectations flipped markedly. We moved from the Fed continuing to bring short-term rates closer to long-term equilibrium rates of roughly 3%, to a more patient Fed no longer prioritising the cyclical hiking path and structural balance sheet reduction. Signalling the massive change in sentiment over US monetary policy, a narrative of the Fed adopting a precautionary rate cut, started to develop as we entered the second quarter, and this was reflected in forward prices. We believe however, that the Fed will maintain a neutral policy over the remainder of the year. Whilst inflation is depressed by some temporary factors, we do not expect a pre-emptive rate cut and believe the Fed will instead react to macro data first and foremost. Keeping this in mind, along with a mostly positive outlook on growth, we maintain our short-duration bias across developed market portfolios.

We acknowledge that it could take time for US and European rates to break their current range, and will pursue tactical adjustments in the near-term. In the UK, rates are also largely range-trading dependent on Brexit scenarios, but again a short-duration bias seems justified overall.

We have maintained our preference for short-duration on inflation bonds and real yields, yet with a more prudent long bias on inflation break-evens, which have recovered relatively well from their trough earlier this year. In Europe, we continue to see some value in the periphery as economic growth recovers or at least holds up. Italy however, remains volatile, justifying political-induced tactical adjustments.

What are your views on credit?

Over the past 3-4 years we have seen leverage progress to relatively high and steady levels in both the US and Europe, as we moved away from the post-global financial crisis environment. Then in Q1 we saw US corporates pursuing balance sheet repair and deleveraging, playing defence to maintain their investment grade ratings and avoid financing challenges. While this behaviour is typical in a post-credit crunch period, in this instance it was the heightened volatility observed in Q4 driving it. The positive is that fundamentals are not expected to deteriorate further, and higher quality balance sheets will be supportive.

However, we see reasons justifying a more prudent stance:

- tighter valuations, following the robust spread compression observed year-to-date
- momentum and technicals fading, with US and European rates having lower potential for positive returns
- levels of corporate leverage remaining high

The latter point makes the lower-rated end of IG and HY indices more vulnerable to market volatility, refinancing conditions and various shocks, particularly in the US. In IG, due to the benign financial environment and reasonable funding position of corporates, we don't expect a cycle shock. Even with possible economic growth deceleration, BBB-companies should be able to effectively deleverage. Yet our beta exposure in fixed income portfolios has returned to the lower end of the range on valuations, and we will look for better entry points during periods of market volatility. We expect investment grade markets to deliver less than carry in the US and Europe, with the latter having our slight preference on relative value and recovering economic growth.

In high yield, our beta exposures are below average but less defensively positioned given the yield advantage. We however, are paying particular attention to low-B and below-rating bonds, which are more vulnerable to slower growth and could quickly suffer from tail risks.

From a sector perspective we believe any challenges and drivers of volatility will come from non-financials, where higher leverage is evident. The financial industry has seen significantly improved solvency ratios and reduced leverage thanks to regulation following the global financial crisis. We maintain a preference for financials, subordinated and hybrid debt.

What do you expect in emerging market debt?

Emerging markets continue to display resilient economic fundamentals, less affected by the perceived slowdown in developed markets over Q4 2018. In our view the most challenging situations have either been identified and are now behind us, or have largely been priced in already and have proven to have a limited contagion effect. EMD markets are relatively well-positioned and have not recovered as significantly as developed markets. Considering that the US dollar has been quite resilient versus other developed and emerging currencies, we feel that local currency bonds still have some upside.

The same arguments apply to Asian bonds, where valuations appear attractive due to the asset class being one of the worst performers in 2018. This was largely the result of concern over a possible sharper economic deceleration in China. However, this has been alleviated by fiscal and monetary stimulus executed by the Chinese authorities in Q1, including infrastructure investment and more targeted measures of monetary easing and tax cuts. This has paid off in Q1 with better than expected macro data in China, which has been supportive of spreads.

What opportunities do you see and what are the key risks?

A lot of valuation potential has been revealed and is materialising already this year with the strong performance across fixed income assets. Investors should be expecting a more muted second half where we see little value in sovereign and investment grade credit. We continue to see some value in high yield, with a bias in Europe for relative value. We still prefer EMD thanks to the strong combination of fundamentals and improving recovery stories. Furthermore, we believe that technical, structural diversification as a tail wind will continue to support this segment.

Geopolitics and trade tensions will continue to pose challenges, and we will be paying close attention to developments in Europe regarding Brexit and the Italian budget. Separately, default rates could start to creep up if any slowdown in the US economy drives notable earnings declines in the second half of the year. A keen eye should be kept on developments in the loan markets and the balance of upgrades and downgrades in the BBB segment, to which the performance in indices is very sensitive.

Global liquidity outlook

Jonathan Curry

Global CIO Liquidity, CIO USA

What is your view on interest rates in 2019?

The big event impacting liquidity markets so far this year occurred in January in the US, with the Fed's 'pivot' to "patience" on raising interest rates further. At the end of 2018, markets had been expecting the Fed to continue its gradual tightening and to hike rates up by 50bps over 2019. Global economic developments coupled with muted inflation drove the Fed's January turnabout, supporting its more dovish stance despite the tight labour market and solid US economic activity.

While the US pivot on rates has attracted the most attention in 2019, we have also seen significant developments and challenges across other developed markets. In the UK, the uncertainty around Brexit has made it difficult to parse UK short-term rates. Views on the front end of the curve have flip-flopped over the first half of the year. The April business confidence survey was neutral and the CPI – at about 2% – seems to be under control even with some concerns about wage growth and its potential impact on inflation.

In the eurozone, the market got ahead of itself in terms of interest rate expectations. At the beginning of the year, markets were pricing in a 40% probability of a 10bps hike. With the deteriorating economic data in the region, the market is now pricing in a 33% probability of a 10bps cut. With weak results across many measures of economic strength in the eurozone, we are anticipating a continued 'lower for longer' scenario for short-term interest rates.

Your views on positioning in liquidity for the rest of 2019?

In terms of US dollar money markets, we remain cautious in terms of duration risk. We think the market may have overreacted to the Fed's pivot. We are selective in fixed-rate securities out to six months, but not beyond that. We are still comfortable with the high quality investment grade credit, despite some spread contraction over the first half of 2019. We think this contraction has been driven largely by market technicals rather than a change in credit fundamentals. All these factors have led us to maintain a weighted average life (WAL) of 65-75 days in our USD money market funds (MMFs) and we expect this to continue for the remainder of 2019.

In our sterling MMFs, we have maintained a neutral weighted average maturities (WAM) due to the difficulties in predicting the course of rates in the UK as a result of Brexit. In our credit positioning, we have incorporated a longer WAL in the 60-65 day range to take advantage of some steepness in the credit curve. In the run-up to a potential Brexit at the end of March, we maintained heighted levels of liquidity in our sterling MMF and reduced the maximum tenor of any UK-headquartered credit exposure. When the Brexit end date was extended, these risk-mitigating strategies were normalised.

In European markets, where we think 'lower-for longer' continues as the most likely outcome for 2019 and where the yield curve is very flat, we have made very few changes to our euro MMF strategies. To take advantage of some curve steepness, our WAMs are longer, with a maximum of 6 months for fixed assets. As credit spreads are tight in the 1-3 month maturity range, we see some value further out the curve in one-year spreads.

Any impacts from money market reform in 2019?

With European money market reform, the bulk of MMFs converted to managing to the new regulation in January, and euro MMFs did so in March of this year. The good news is that we found the transition went smoothly across the industry. Assets under management (AUM) were largely stable - particularly in the US dollar and sterling MMFs. There was some limited reduction in euro MMFs as the new regulation impacted euro MMFs more than US dollar or sterling MMFs.

As a consequence of money market reform, we think it is more important than ever for investors to understand how liquidity risk is now managed in MMFs. This relates to the implementation of liquidity fees and redemption gates. Although we think these are appropriate mechanisms for protecting MMF investors during periods of stress, the new regulation has specific triggers which were not in place before.

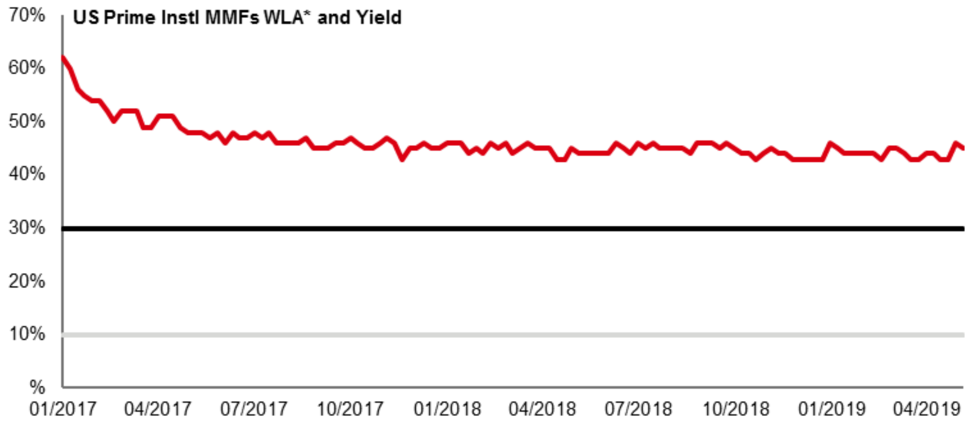
The most significant of which is the requirement that a fee or gate must be applied if weekly liquidity falls below 10%. Hence the heightened importance of liquidity risk management. That said, most MMFs are unlikely to be in situations where fees or gates are warranted. For this reason alone, how liquidity risk is managed has a heightened importance.

There are two considerations in evaluating a MMF's liquidity:

- the liquidity of its assets
- the level of concentration in its investor base

In the US, post money market reform we have seen a significant increase in the liquidity held in US 2a-7 prime funds[2] (Figure 6). While regulation requires a minimum weekly liquidity threshold of 30%, most prime funds are maintaining an average level close to 45%. The theory is that by carrying this level of weekly liquidity, the fund will 'never' drop below the 30% trigger that requires the fund's Board to determine whether a fee or gate should be applied.

Figure 6: US prime funds continue to operate with significant levels of liquidity



*Source: HSBC Global Asset Management, May 2019. * WLA, weekly liquid assets level.*

We've seen a similar pattern in some European prime low volatility NAV (LVNAV) funds - although here the issue is slightly less significant. In Europe, the Board must consider the need to apply a fee or a gate, only if an MMF's weekly liquidity falls below 30%, and this must have been caused by a greater than 10% one-day fall in its assets under management (AUM). The probability of this double trigger being met is very low in our opinion.

Overall, a trade-off exists with excess liquidity in MMFs. Weekly liquidity levels in the 40-45% range in an MMF are not necessarily in the best interest of investors as it can cost them 1-3bps in returns.

Client concentration is the other consideration in managing liquidity risk. Particularly in light of the new regulation, a concentrated investor base without a commensurate increase in overnight or weekly liquidity levels heightens the risk of a fee or gate trigger.

In 2019, developed markets have not been alone in enacting new MMF regulation. India has also implemented new reforms. The change in Indian MMF reform concerns the percentage of assets in a MMF that must use marked-to-market accounting versus amortised cost accounting. Post the new regulation, all Indian MMF assets with maturities between 30 and 90 days have to be marked-to-market; whilst previously, this applied only to assets with a maturity greater than 60 days. We think this is a sensible new regulation in a market like India where short-term interest rates and credit spreads are more volatile.

[2] Regulation introduced by the US Securities and Exchange Commission that sets the maturity and credit quality of money market funds' holdings.

Global alternatives outlook

Q&A with Xavier Baraton

Global CIO Fixed Income, Alternatives and Real Assets; CIO North America

How have alternatives fared?

Year-to-date returns of alternatives have followed the good performance of traditional asset classes. As of end of April, the overall hedge fund industry is up more than 4%, according to HFRI Index. Meanwhile, other alternative asset classes like real estate and trend-following have produced positive returns too. And although private equity returns are not yet reported, it's expected to follow the trend of strong returns seen in public equities.

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

The start of 2019 saw a reversal of the trends experienced in 2018. According to MSCI, physical (direct) property markets delivered a return of 8.8% in USD terms globally last year, outperforming listed property returns of -4.7% as measured by the FTSE EPRA NAREIT Developed Index. By contrast, listed property bounced back strongly in Q1 with a return of 14.9%. This was significantly higher than the direct property returns reported of 1.6% in the US and 0.5% in the UK, according to MSCI.

As has been the case over recent years, the ever-growing role of e-commerce in society continues to be an important factor in real estate markets. We are seeing growing demand for logistics and warehouse properties, particularly urban logistics to support fast delivery for online purchases. Physical retail space located near transport hubs that offer consumers a convenient shopping experience continues to see resilient demand. Likewise, high-quality centres providing consumers an attractive shopping environment (often linked with leisure uses) are also performing relatively well as retailers seek to promote the brand experience. Retailers are reducing their footprint in less productive stores, driving lower demand for poorer quality spaces.

As we continue through the current cycle of economic growth with low unemployment, competition for talented employees is an additional factor impacting property markets. Companies are seeking office space in appealing locations that consider the quality of life (e.g. shorter commute times, desirable amenities, etc.) in order to attract and retain staff. The growth of flexible office spaces is another notable development having a particular impact in cities with concentrations of tech companies such as San Francisco, London and Singapore.

Overall, we believe real estate equities are priced to deliver higher long-run returns than physical property, as public markets have priced in negative expectations more quickly/significantly in our view, creating wide discounts to underlying net asset values in some markets. We currently do not favour prime office markets such as Paris, Tokyo and Hong Kong where yields are very low at around 3% or below.

From a macro perspective, key risks to the asset class are unexpected and sharp rises in interest rates, along with developments that can slow economic growth such as trade tensions. The continued evolution of e-commerce will also be a factor to keep an eye on.

And in hedge funds?

Similar to what we have seen in traditional asset classes, hedge funds started 2019 with significantly positive performance. Equity long-short and event-driven strategies led the way, supported by a relatively benign environment. Trend-following strategies and global macro have also done well, generating returns on the back of positive trends across asset classes. Only market-neutral strategies lagged, but still delivered positive returns.

Looking forward, we focus on understanding the cycle we are in and the possible drivers of future shocks and volatility. In particular, an uptick in inflation or other developments, such as resurfacing trade tensions, could trigger a risk-off scenario. The likelihood of such risks and volatility spikes would influence our sector selection.

We still favour long/short equity approaches, best placed to provide diversification and smoother returns. We also believe that multi-manager strategies are well-positioned; with distinct characteristics of active trading and market neutrality appealing, should volatility increase.

We do not expect significant trends to develop, hence our cautious stance on trend-followers and global macro strategies.

An important consideration is the high levels of liquidity currently being provided to markets by quantitative strategies. An increase in volatility will likely drive substantial deleveraging as liquidity is

Past performance is not a reliable indicator of future returns.

pulled from markets. To mitigate this risk we are cautious on highly leveraged strategies, which would suffer more in this scenario.

We are also cautious in our allocations to credit within our hedge fund strategies. Having observed increased corporate leverage and low defaults under recently more benign financial conditions, we consider some bond segments expensive and prefer to wait for the cycle to change before allocating to distressed-debt managers.

What have you observed in private markets?

The volatility experienced in Q4 created some opportunities in private markets. For instance, there were material mark-to-market declines in leveraged loans. This created several lending opportunities for private-debt investors to find investments at attractive terms that were left otherwise without finance, and demonstrated the resilience within private markets.

On a related note, we've seen a growing availability of funding for private companies, delaying the need for initial public offerings (IPO) until company operations are more established. This is evidenced by recent IPOs setting valuation records by vast margins. With companies choosing to remain private entities for longer in order to focus on their long-term development plans, as opposed to near-term revenue and profitability, this has created a situation where much of the initial entrepreneurship value is being captured by private market investors, long before the IPO stage.

All ideas and opportunities are not created equally, and we continue to have a preference for Asia where there are high rates of growth, fast-developing innovation and relatively cheap valuations, in our view. In terms of sectors, we currently favour technology and energy. Within technology, software companies in particular are appealing in our view, offering firm balance sheets along with steady revenue growth through economic cycles due to the software as a service (SAAS) model supported by large corporate clients and near 100% renewal rates.

When considering high-growth companies, risks related to economic growth are important factors to consider. With this in mind we look at the protective features of potential deals. For instance, we look for companies whose business is driven by factors unrelated to economic growth, aiming to increase diversification benefits in the return profile of a portfolio.

What is the outlook for Infrastructure debt markets?

Supported by a large pipeline of opportunities, robust volumes and strong public policy support, 2018 was a good year for infrastructure debt. However, since the beginning of this year there have been growing headwinds to return objectives, with the continued decline in medium to long-term Treasury rates and downward pressure on infrastructure-debt credit margins fuelled by excess liquidity in US markets. As a result, it has become difficult to achieve deployment targets or yield objectives on USD investments.

Concurrently, we see value in emerging markets which offer US dollar and local currency opportunities with good credit structures and higher credit margins than developed markets. In our view, political risk and lower sovereign ratings can be managed by focusing on well-structured projects along with careful consideration of the long-term political and regulatory environment.

More specifically, we are focusing on Latin America and Asia-Pacific, where economic growth is requiring significant infrastructure development. In these regions, we focus on quality projects that meet our criteria in terms of credit risk, pricing and relative value.

From an investment theme perspective we see renewable energy being a key opportunity. Beyond societal needs and drivers, the direction of regulations and political opinions are primarily supportive of the long-term credit risk. This reinforces the strength of these assets.

Given the long-term nature of infrastructure projects, it's vital to think about how the risk profile might change in the future. Selecting projects that are supported by, and which economies depend on long-term regulationto function, can reinforce the sustainability of returns with minimal correlation to macro events.

Contributors

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Chris Cheetham joined HSBC Global Asset Management in 2003 as Global Chief Investment Officer and has worked in the industry since 1978. Prior to joining HSBC, Chris was Global Chief Investment Officer of AXA Investment Managers, where he also held the position of CEO AXA Sun Life Asset Management. Chris began his career with Prudential Portfolio Managers (now M&G), where he worked in a variety of investment management roles, ultimately as Director of Investment Strategy and Research. He holds a First Class honours degree (BSc) in Economics from Hull University (UK) and a Masters in International Economics from Warwick University (UK).

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