To 2017 and beyond…

Investment Outlook

Year-end review and outlook

December 2016

HSBC Global Asset Management

Contents

Message from the Global CIO

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Welcome to our 2017 investment outlook.

In our mid-year review and outlook, published in June, we reported that, year-to-date, investors had experienced another bumpy ride, with markets initially spooked by what we had dubbed as the ‘phantom recession’ and subsequently recovering as concerns about the growth outlook eased. Plus ça change… The economic and market environment continues to be characterised by unusual uncertainty.

These uncertainties can take many forms, of course, including risks over the outlook for the global economy, potential doubts about the effectiveness of economic policy and, more recently, political developments which have confounded market expectations, including, most obviously, the UK referendum’s majority vote to leave the EU and Donald Trump’s victory in the US Presidential Election. The populist backlash which appears to have been an important factor in both the UK and the US will be a concern in Europe next year as elections in France and Germany, in particular, take centre stage.

Some commentators may have been surprised by the rather sanguine market response to the Brexit and Trump ‘shocks’, but there are at least two good reasons for the collective, casual shrug. First, while the current mix of global growth and inflation may still look lacklustre by historic standards, in the context of likely lower potential growth rates, recent economic data and our Nowcast models suggest that current cyclical trends are really quite encouraging. Joe Little picks up this point in his piece.

Second, while a rise in populism may be a concern for some, its obvious political influence probably increases the likelihood of more pro-cyclical fiscal policy in the developed world. Indeed, we may be witnessing a modest regime shift which we might call ‘the end of austerity’ with, at a minimum, fiscal policy becoming more pragmatic and more in harmony with accommodative monetary policies.

Taken together, these two factors may have begun to gradually shift the mind-set of ‘Mr Market’ from a deflationary bias to a more constructive reflationary perspective and 2017 may even witness a positive growth surprise. If so, after the best part of thirty five years of declining US long-term interest rates, we may finally be moving into a less bond market friendly environment.

However, even if this is true, interest rates are set to remain relatively low for a considerable period. The Federal Reserve is likely to adopt an extremely gradual monetary tightening cycle to ensure the US economy remains on a firm footing. At the same time, other major central banks are expected to keep global liquidity conditions very accommodative, with the European Central Bank, the Bank of Japan and the Bank of England likely to continue their large-scale asset purchase programmes.

As I discussed in June, this low interest rate world has important implications for how risk assets should be priced. While prospective returns on equities, corporate bonds and other risk assets appear very low by historic standards, our analysis concludes that today's valuations 'work' in the sense that risk premiums, the excess returns available over the 'risk free rate' in exchange for taking equity and credit risk, are at fairly normal levels though, as ever, the devil is in the detail and we discuss our relative value preferences in this report.

While we remain constructive on the outlook, therefore, we continue to believe that our ‘Fragile Equilibrium’ framework is the best way to understand today’s world. There are many risks and uncertainties and episodic volatility will continue to feature. Robust valuation discipline will be the key to navigating these troubled waters.

In this Investment Outlook, Joe Little (Global Chief Strategist) Xavier Baraton (Global CIO Fixed Income), Bill Maldonado (Global CIO Equities) and Jonathan Curry (Global CIO Liquidity), explain how the outlook for 2017 is shaping our key investment conclusions.

Macro and multi-asset outlook

Q&A with Joe Little,
Global Chief Strategist

Today's investment environment is characterised by "unusual uncertainties". This makes financial markets prone to episodic bouts of volatility, which can harm returns. Yet although volatility creates risk, it also creates opportunity. In order to navigate the current investment landscape, we believe it is essential to be nimble and active in our investment approach. Exploiting tactical opportunities will be key in a low return world.

Q. Could you summarise the performance of the main asset markets and drivers through 2016?

A. So far in 2016, returns have been quite reasonable across asset classes, especially when compared to the return experience of 2015 (Figure 1). In dollar terms, developed market (DM) equities and bonds have posted solid gains, and high yield credits and emerging market (EM) assets have outperformed.

Yet this doesn't tell the whole story. Markets were rattled by three "shocks" that induced volatility over the course of 2016: a global growth worry in January, the Brexit vote in June, and the US election in November.

Many asset classes have traded within reasonable price ranges this year, even against a broadly stable growth backdrop. For example, the US long bond (market interest rate expectations over the next 30 years) has ranged from a near 2% rate to a yield above 3%. The presence of "shocks", and the observed variability in asset performance, remind us that what we buy and when we buy it are the key asset allocation decisions.

It is also important to note that, despite episodic bouts of volatility throughout 2016, the economic environment has remained relatively stable. For investors, this is a reminder that market-price action is not a pure reflection of economic fundamentals. Changing perceptions of risk are at least as big an influence on market dynamics.

Q. Can you tell us more about Brexit and the US presidential election?

A. We view Brexit and the US election result as related events, and part of a broader anti-establishment and anti-globalisation trend. Populism has moved from the periphery and into power. There remains a high degree of uncertainty over what form Brexit will take, and how the policy agenda in the US will play out. This phase of political uncertainty is likely to persist and is something for which we should be prepared.

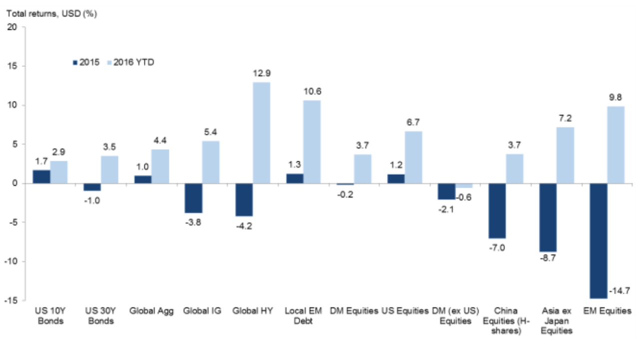
Theoretically, these political events can be treated as "uncertainty shocks" which create volatility in markets, raise risk premia and damage "animal spirits". Yet, fascinatingly, the Brexit case study implies that the short-term, cyclical damage might be a lot smaller than economic studies suggest. As for the US, the cyclical economic shock following the election also seems likely to be minimal.

Given the lack of detail about President-elect Trump's policy agenda, there is a high degree of ambiguity as to what might follow. Many of the proposals are capital and growth-friendly, including lower taxes, deregulation and increased infrastructure spending.

However, we are sceptical that these initiatives will be fully implemented. The Republicans do not have the super-majority in Congress required for legislative changes, and Trump's brand of populism is not widely shared across the House Republicans and the rest of the GOP. As a result, the President-elect may be forced to water down his initial stance on many of his more radical suggestions.

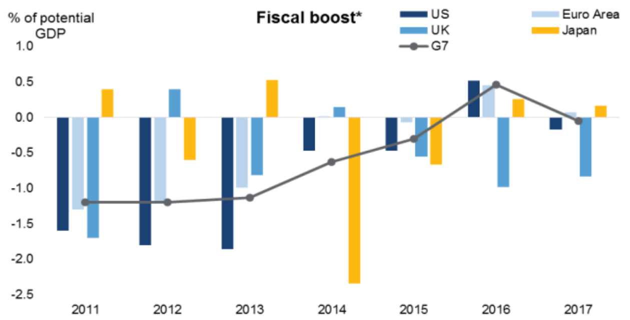
Moreover, Trump's protectionist agenda has the potential to negatively impact global growth. There is also a risk of a policy offset from the Fed should inflation expectations rise significantly.

Figure 1: Asset class performance



Source: HSBC Global Asset Management, as of 11 November 2016. Past performance is not an indicator of future performance

Figure 2: Fiscal boost



*Fiscal boost calculated as the inverse change in the cyclically adjusted primary balance. 2017 estimated using IMF forecasts.
Source: HSBC Global Asset Management, IMF Fiscal Monitor, October 2016. Past performance is not an indicator of future performance

Q. What is your economic outlook for the major economies in 201 7 and beyond?

A. Global economic growth remains lacklustre relative to pre-crisis norms. Muted productivity gains and shrinking working-age populations are weighing on potential growth rates in advanced economies. And EMs are also slowing, albeit from a high base.

A downshift in productive capacity reduces the ability of economies to withstand negative shocks – recession worries are likely to become a more frequent part of the investment environment.

However, cyclical global activity has picked up materially since May and, in 2017, global growth is expected to be above 3%. Set against lower potential growth rates, this actually looks quite good.

Our "Nowcast" model points to resilient growth in the US, accelerating momentum in the Euro area and a bounce-back in activity in the UK and Japan. EM growth has also stabilised - China is benefitting from accommodative policy, while activity in both Brazil and Russia have bottomed out.

Global inflationary pressures are also beginning to build. Headline CPI rates are rising as energy-price base effects fade and fundamentals are also supportive. Although core inflation continues to be subdued and structural headwinds remain intense, a deflationary mind set is gradually being replaced by a reflationary one.

This is helped by the "end of fiscal austerity". Fiscal policy is no longer a drag on global GDP growth and even has the potential to be growth-supportive in 2017. A new populist political agenda, the painfully slow post-crisis recovery and perceived limits of monetary policy are supporting the case for pro-cyclical fiscal easing. Fiscal policy is finally back in fashion.

We are now moving into a regime where global fiscal and monetary policies are more coordinated. This means that the burden of demand management will be shared more evenly between policymakers and it increases the prospect of reflation.

Indeed, as fiscal policy becomes easier, central bankers continue to employ their arsenal of policy tools to ensure global liquidity conditions remain accommodative. Monetary authorities are now pivoting away from policies that target the size of the balance sheet and towards measures that focus on "yield curve control".

This can be in the form of an explicit cap on yields, as employed by the Bank of Japan, or a greater emphasis on forward guidance to keep rates low over the medium term.

Q. How does this impact the outlook for rates?

A. Major global central banks believe that lower trend GDP growth and cautious investor preferences have dragged down equilibrium interest rates (the so-called "r-star"). One example of this trend has been the gradual downward revisions to the Fed's "dot plot" of expected policy interest rates.

A lower "r-star" means that the terminal interest rate in this monetary cycle will be lower than what we have experienced in the past. Interest rates are set to be "lower for ever".

This rate environment implies that prospective returns across asset classes will also be lower relative to history. There is no escaping that we are living in a low return world – investors must be realistic about their return expectations.

More recently, we have observed volatility in the global government bond market. The surprise victory for President-elect Trump and the Republican clean sweep in Congress have increased the likelihood of more pro-cyclical fiscal policy. The market has since moved to price higher odds of reflation.

Indeed, since the US election result, US Treasury yields have jumped by 50bps to around 2.3%. We witnessed similar moves in Eurozone and UK government bond markets. Fascinatingly, Japanese government bonds have not experienced the same volatility – "yield curve control" is working well.

The bond price action in November was certainly abrupt and the sell-off seems to have faded more recently. But we think the direction of the yield moves are correct – we are now operating in a much less bond-friendly environment.

Q. And what about currencies, especially the US dollar?

A. Global monetary policy divergence has re-emerged as a key theme in 2016 and this has supported the US dollar – since August, the dollar has rallied over 7% against a basket of other major currencies.

As inflation picks up in the US, monetary policy will need to respond. Yet we still believe the Fed will adopt an "uber-gradual" approach. Fed Chair Yellen has hinted she is willing to run a "high pressure economy" for a little while in order to reverse some of the longer-lasting effects of the crisis, and the Fed will remain sensitive to external financial conditions.

Policy divergence now appears to be priced by the bond market, but we believe that the combination of gradually tighter monetary policy and easier fiscal policy will support further US dollar strength from here. Despite its recent rally, the dollar is still in the middle of its historical range since 1970 – there appears to be room for further appreciation. Elsewhere, we are cautious on the euro and yen, where expected interest differentials look negative versus the dollar.

Macro and multi-asset outlook

Sterling is trading slightly cheap relative to fair value, but despite sterling's slump after Brexit, the expected spot currency appreciation does not yet seem to be enough to offset the cost of carry. We need to be vigilant for future opportunities.

Most EM currencies continue to be poised for medium-term appreciation based on a range of valuation metrics and, in contrast to other developed market majors, offer an attractive carry relative to the US dollar.

Q. How do you judge which asset classes are attractively priced?

A. Many strategists argue that "all asset classes are overvalued today". This is usually based on the assumption that conventional valuation metrics (such as PE ratios, credit spreads or bond yields) will revert back to their historical norms over time. If these adjustments were to occur, it would imply very poor prospective returns over the medium term.

We believe this view is wrong. Valuation needs to be contextual – we need to control for the low growth, low inflation and low interest rate environment in which we are living today.

In modelling our sustainable return expectations across asset classes, we ensure that our inputs are consistent, not only with our perception of the prevailing economic and policy regime, but also across asset classes. Indeed, the common thread running through all our discount rate estimates is our scenario for cash rates.

We then measure asset class "risk premia" using today's market pricing to give us a sense of how well we are being compensated for the risk we are taking. We carefully evaluate these "implied market odds" to identify areas where we think valuation is anomalous.

Q. What are your key investment strategy views?

A. Looking at our valuation signals and the prevailing macroeconomic environment, we believe the case is still strong to maintain a structural underweight in global government bonds.

Although yields have moved higher in Q4, bond prospective returns still look poor. We continue to estimate a negative term premium – i.e. we are being penalised for taking duration risk.

In a macro environment gradually pivoting towards reflation, we would require at least a small positive reward for holding bonds relative to cash.

To offset this negative carry position in our portfolio, we are long a diversified basket of risk assets. We continue to prefer global equities and selective emerging market equities and debt.

The sustainable return for investing in global equities is low relative to history but, compared to competing asset classes, especially core DM government bonds, the compensation for bearing equity risk looks reasonable to us.

Better cyclical activity data should support the corporate sector and equities should also do well in a reflationary environment. The US equity market is prone to squeezed margins as wage pressures build, but President-elect Trump's capital-friendly policy agenda (including cuts to corporate tax rates and deregulation) now provides some balance to the earnings outlook.

There are of course risks to this view. Political uncertainty remains elevated and the prospect of a more protectionist US has the potential to spill over to corporate fundamentals globally. Yet for now, in the absence of an imminent deterioration in the earnings outlook, we think continuing to harvest the equity premium makes sense.

We also believe selective emerging market assets look attractively priced. We focus on opportunities where the carry is high, currency valuations look attractive and where a relatively closed economy can provide some shelter against a more aggressive "reverse globalisation" trend.

In EM debt markets, we think Brazil and India bonds look interesting, whilst other parts of EM look more vulnerable on macro and valuation grounds. In the equity space, we believe North Asian equities continue to offer us the best risk/reward.

A key risk to our EM view is a strengthening US dollar. This would likely undermine FX returns and challenge those markets with large dollar-denominated debts. However, we are comforted by the "uber-gradual" stance the Fed are likely to adopt in raising rates. We think EM assets can still perform well even when US monetary policy is tightening.

Within the corporate bond universe, investment-grade credits do not look attractive to us. They are exposed to duration risk and there is limited upside in a reflationary regime, in our view. Speculative grade credits have performed strongly this year but, following substantial spread compression, we think this asset class is now close to fair value. We believe selective opportunities still remain, for example in short-duration high yield, but caution is warranted.

Finally, as mentioned above, we expect a combination of loose fiscal policy and monetary policy normalisation in the US to be supportive for the dollar. The bond market already discounts "policy divergence" between the Fed and G10. Yet the Fed can still be gradualist and move rates ahead of the market's expectations.

Q. What are the key risks for next year?

A. The current economic and market environment is characterised by "unusual uncertainties". These are driven by: (i) economic uncertainty (e.g. will there be a more abrupt deleveraging in China?); (ii) political uncertainty (e.g. the uncertainty shocks from the surprise election of Trump and the

UK's Brexit vote), and (iii) policy uncertainty (e.g. policy options at the effective lower bound).

Such an environment creates a lot of noise and episodic volatility in financial markets, but it also creates an opportunity for investors who have conviction and are willing to be contrarian and active. To help us deal with market noise in an analytical way, we use the concept of the "Fragile Equilibrium".

In our "Fragile Equilibrium" framework, the macroeconomic environment remains one of low growth and low inflation. But market perceptions of risk can shift from this "fragile equilibrium" to price in a more pessimistic scenario of "severe secular stagnation" at one end; or a more optimistic "strong demand recovery" at the other.

Most recently, Trump's populist agenda has been perceived as growth-friendly and market expectations appear to have shifted toward the "strong demand recovery" scenario. A key risk here is that, if output gaps become significantly positive (i.e. demand outstrips supply), the Fed may be forced to normalise policy more aggressively than expected. Indeed, market-implied expectations for the future path of US policy rates remain "ultra-dovish" – there is still a low hurdle for an upside surprise to rates.

In this scenario, there may be few places to hide. Faster rate increases would be particularly negative for duration assets and would likely cause a de-rating for credits and equities, in our view. A stronger US dollar could also undermine selective emerging market assets, particularly those with large dollar-denominated debts.

An alternative risk that we see to our outlook is a negative growth shock that would shift market perceptions closer to a bad equilibrium scenario of "secular stagnation". This could be triggered by a sudden slowdown in EM growth, and in particular, China.

The rebound in Chinese industrial production data removes one concern about the cyclical picture. Meanwhile Chinese authorities have made efforts to stabilise activity with fresh monetary stimulus earlier in the year. However, this raises already elevated medium-term leverage risks. A China "hard-landing" could lead to a debt-deflation spiral that would drag the global economy into a recession.

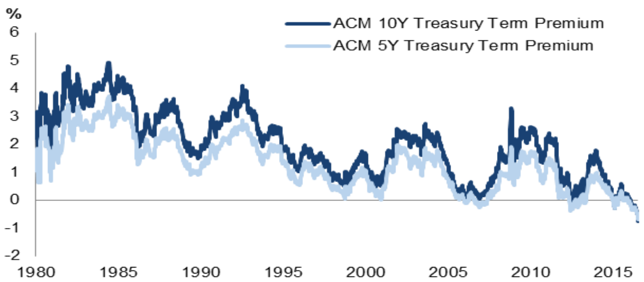
We think this scenario would be positive for developed market government bonds and investment-grade credit, but negative for risky assets such as high-yield credit and equities, particularly in commodity-linked emerging markets.

Another source of downside risk is the fragility of the European banking system. Negative rates, flat yield curves and regulatory pressure have undermined bank profitability. Many European banks now find themselves with squeezed net interest margins and poor capital adequacy ratios. The risk, in our view, is if bank solvency problems affect the wider Eurozone economic system. The reliance on the "bank channel" for credit transmission underlines the threat to nominal growth.

Finally, major political events also have the potential to shock markets in 2017. Market participants will watch the outcomes of the French and German elections closely, and they are still waiting for further clarity on how Brexit and Mr. Trump's election will shape the UK and US economies respectively. As we have already seen this year, political outcomes can inject further volatility into financial markets.

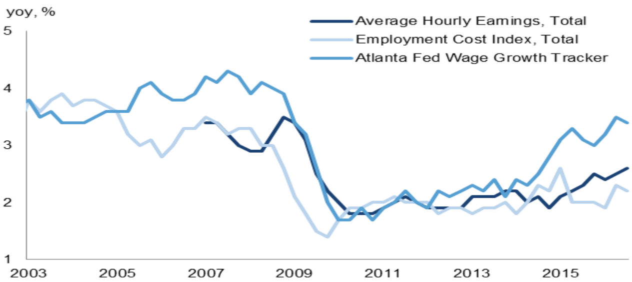
Given the elevated levels of uncertainty present in today's environment, we think episodic bouts of volatility are likely. Current pricing is not very generous, in our view, so the ability for asset classes to absorb bad news is limited. We believe it is therefore essential to take a dynamic approach to investing. The return to skill has increased. In 2017, we think being active, nimble and opportunistic will be crucial for investment success.

Figure 3: Government bonds: implied term premium remains negative



Source: HSBC Global Asset Management, as of October 2016

Figure 4: US wage pressures are building



Source: HSBC Global Asset Management, as of October 2016

Global fixed income outlook

Q&A with Xavier Baraton,
Global CIO Fixed Income

In 2016 we entered into a transition phase within the long-term global deleveraging cycle, with a gradual shift in the monetary and fiscal policy mix. Reflation forces could strengthen, though we remain in a secular "fragile equilibrium" of low growth, low inflation and low rates. We expect to see interesting developments on credit and emerging market debt in particular, but we believe investors should remain cautious on rates and selective on credit and Emerging Market Debt.

Q. What is your analysis of the environment in 2016 from a fixed income perspective?

A. Needless to say, 2016 was an eventful year with the Brexit vote, the US elections, the unexpected outcome of both votes and their equally unexpected impact on financial markets. In June, the reaction was generally muted, with the exception of currency markets on which the British pound depreciated sharply. In November, the reaction to the US election result was more spectacular. Eventually the USD appreciated strongly, stock markets behaved well and US rates overshot, led by rising inflation expectations.

The lesson of those events is that it is, in fact, all about the economy. 2016 saw a gradual shift in the policy mix, with less monetary proactivity and the end of fiscal austerity. Several Asian countries – namely Korea or Japan – announced additional budgetary stimulus, while sliding deficits in the Eurozone achieved the same effect. This paved the way for elections to eventually raise expectations of similar policies in the UK and US.

In contrast, although they were continued, monetary policies showed the first signs of exhaustion. The US Federal Reserve (Fed) was bound to raise rates and, earlier this year, negative interest-rate policies in Europe and Japan became counterproductive when they threatened the stability of the banking industry, which is critical to reflating global economies.

In 2017, we expect to see this new policy mix continue, driven by elections in Germany and France. Supportive budgetary policies should add to the loose monetary conditions still in force across many regions. It may be an energetic cocktail for economies but, if economies like the US run close to capacity, it may generate more inflation than growth and create headwinds for financial markets.

The caveat to this risk is that our long-term scenario of a "fragile equilibrium" remains valid, in our view. We continue to expect low growth, low inflation and low rates maintained for longer, because secular stagnation forces will continue to hold sway over the next decade, meaning feedback loops should contribute to financial stability. Overall, 2016 marked the beginning of an inflection whereby we have entered into a transition phase within the long-term global deleveraging cycle.

Q. Looking forward to 2017, what is your outlook on rates?

A. One year ago, in November 2015, our target for ten-year US rates as of end 2016 ranged between 2.5% and 3%. Further easing from the European Central Bank (ECB) and the Bank of England (BoE) have postponed this objective but we think it remains relevant. We maintain our short-duration bias, particularly on the belly of the curve, around the five-year maturity.

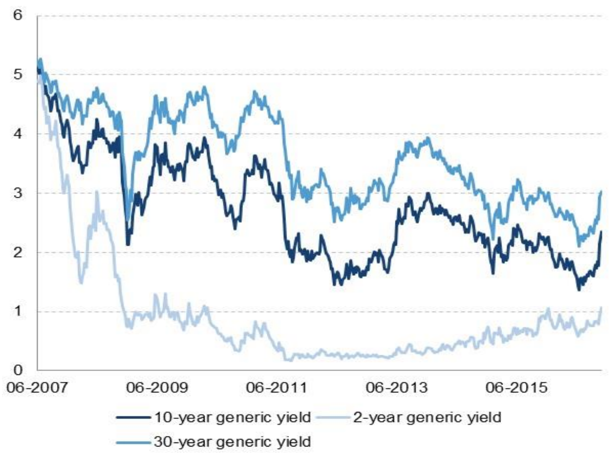
During the transition phase in which we have entered, reflation forces could materialise visibly enough to push US ten-year inflation breakeven above 2% and real yields above 0.5%. We expect European rates, whilst lagging, to evolve along a similar path, which means the ten-year German bund could break 0.5% in the course of 2017.

After two years of a flattening bias, we think developed markets will reconnect with more directional and range trading curves. We will be watching this evolution closely and will remain tactical.

The European periphery should remain resilient despite the negative impact of rapidly rising rates on those markets. The ECB remains in easing mode and will finally have access to more eligible government bonds than it expected to until recently. This will be supportive for the periphery.

On currencies, our bias over 2016 was to a strengthening US dollar, within a convenient range of 1.05-1.15 against the euro. We think going beyond this would renew political and economic resistance. In our view, this is also true of the dollar against other currencies – emerging markets in particular – once the post-election dust settles.

Figure 5: US government yields (%)



Source: HSBC Global Asset management, Bloomberg, as at November 2016. The information above is provided by and represents the opinions of HSBC Global Asset Management and is subject to change without notice.

Q. What are your views on credit?

A. In the USA, the credit cycle is quite unusual in US high-yield at the moment. Traditional end of cycle patterns – such as peaking leverage, deteriorating interest coverage and industry-specific downturns– contrast with credit conditions, which remain ample. As a result, we continue to expect what could be called a “cold” crisis, with above-average default rates of around 5% over the next couple of years. Valuations have also adjusted, as the peak-to-trough that spanned from mid-2015 to February 2016 was of a similar magnitude as a cyclical downturn.

In 2017, the Trump administration is likely to support credit through fiscal stimulus but markets have already priced in much of this. We expect credit markets to be vulnerable to various forms of monetary tightening, from higher short and long rates to investors’ temporary caution around their bond allocations.

In Europe, our central scenario remains positive overall, albeit with a mix of lower yields and lower volatility. The ECB and BoE’s decision to buy corporate bonds has turned them into protective buyers of last resort, which we think should keep spreads low and volatility more muted than in other regions. However, highly-leveraged names appear vulnerable. We will remain selective and focus on BB-B rated names.

Q. And on emerging market debt?

A. Emerging market debt (EMD) has recovered significantly this year, posting double-digit returns until mid-October. This has come after a couple of years in which the asset class recorded sideways flows, many emerging countries implemented structural reforms and currency depreciation was used as the preferred adjustment variable. Combined with recovering commodity prices, cheaper currencies and reforms have enabled fundamentals to stabilise across the asset class.

Whilst we still expect to see slightly more downgrades than upgrades going forward, the overall credit situation in emerging economies is far more balanced than it was two or three years ago. We believe the reasons underlying our overweight position on the asset class at the end of 2015 remain largely relevant today.

Some risks remain, however, and we expect EMD to be volatile until markets gain clarity on the decisions the Trump administration is likely to make, and on how these might impact emerging markets. Once again, the key factor is the economic environment: although potential tariffs and trade barriers would certainly affect emerging markets, most retain some latitude to further loosen their monetary policy and currencies can continue to act as buffers.

We expect to see a slow recovery on these markets in 2017. In addition, EMD yields have over-reacted, which should translate into slightly higher returns over time. Overall, being selective and tactical will continue to be crucial on this asset class.

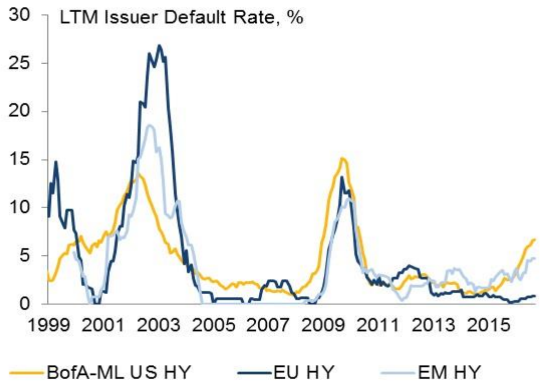
Q. What are the key risks and opportunities for fixed income in 2017 and beyond?

A. Looking to 2017, we maintain our underweight on government bonds. Whilst term premiums have improved, they remain depressed from a historical point of view.

Conversely, we remain overweight on EMD and credit due to the recent improvements in risk premiums and the stabilisation of fundamentals. Regional dispersion will continue to be manifest within these two segments – certain countries will do better than others – and we believe it is important to remain selective and tactical, to avoid most leveraged situations, and to favour global strategies.

In terms of risks, we will closely track inflation expectations on the one hand, and monetary policies on the other. The world remains highly leveraged, and therefore sensitive to interest-rate levels. Whilst we continue to expect a long-term net allocation into fixed income assets, coupled with ongoing vigilance from central banks, a significant overshooting of long-term rates could trigger a wave of volatility.

Figure 6: Growing default rate in the US



Source: HSBC Global Asset Management and Bank of America Merrill Lynch, as of September 2016.

Global equities outlook

Q&A with Bill Maldonado,
Global CIO Equities, CIO Asia-Pacific

After a difficult start, equity markets performed reasonably well in 2016. Whilst we remain in a “fragile equilibrium” with low growth and inflation and continue to grapple with many uncertainties, the economic environment is brightening towards a more reflationary mind-set, which should support equities in 2017.

Q. Can you give us an overview of global equity markets in 2016?

A. 2016 was a bit of a rollercoaster ride. Amidst global worries about fading growth and another recession around the corner, equity markets reacted very negatively and the year started on a rather gloomy note.

However, it soon became clear that we were experiencing a “phantom” recession as the recovery in global growth was actually strengthening and unlikely to diminish. In particular, concerns around a Chinese hard landing faded after macro indicators suggested that the economy had stabilised. This allowed the market to recover and eventually, 2016 turned out to be a decent year for equities.

For the first time in several years, emerging market equities outperformed developed market equities, although the absolute difference was relatively small. Given the relative valuations and the prospects for emerging economies compared to developed countries, this was in line with our expectations.

However, as predicted by our long-term return expectations, neither market posted particularly impressive results – returns were quite meagre – but the performance was notable in light of the many “shocks” that materialised during the year.

Q. How would the global policy landscape support equities in 2017?

A. In 2017, reflationary policies are increasingly likely to take the spotlight, not just in the USA, but also in Asia – Japan and China in particular – and perhaps even in Europe. In the short to medium term, this is probably good news for equity markets. We are therefore reasonably optimistic about the prospect for equities in 2017, bearing in mind that we do not expect outsized returns.

The global monetary policy landscape is quite complicated for 2017, because we have a continuing divergence between the USA and the rest of the world. The USA will have to continue to tighten policy, perhaps more quickly than we were expecting previously, following the more reflationary policies that are likely in store under a Trump presidency.

So we will see rates climb further in the USA, albeit still very gradually but we expect policies to remain relatively accommodative in the rest of the world. That would be a reasonably supportive backdrop for equities.

Particularly, if reflation can translate to real growth, not just inflation, and growth in turn feeds through to corporate earnings, this would be a positive scenario for global equities.

While it is much too early to say how likely this is to play out, this is the optimistic case for equities and could fuel returns in the asset class over the next two to three years.

Q. What is the outlook for equities for next year and beyond? What are some of the key investment opportunities?

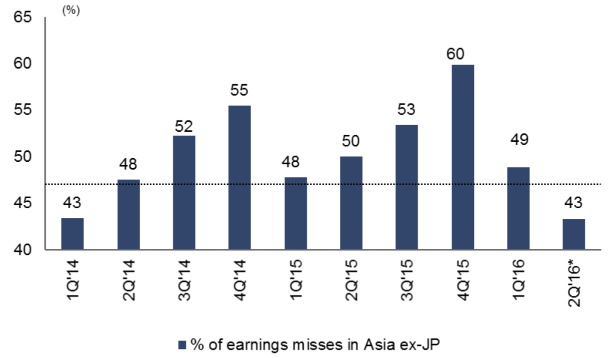
A. Equities continue to look undervalued relative to bonds – particularly government bonds – in our view. We believe the equity risk premium is still attractive and the asset class presents opportunities in both developed and emerging market equities.

Whilst the balance has shifted towards the reflationary end of the “fragile equilibrium” and away from the secular stagnation scenario, we expect equities to continue to deliver rather modest returns.

Figure 7: Valuation – Price to book ratio

Source: HSBC Global Asset Management, DataStream as at 30 September 2016.

Figure 8: Percentage of earning misses in Asia Ex Japan



Source: CLSA, HSBC Global Asset Management, data as of August 2016.

In the USA, profit momentum had slowed with a stronger US dollar, energy price weakness and higher wages. However, following the presidential election, there are increased expectations of favourable tax reforms, increased fiscal spending and reduction in regulations, which are seen as supporting revenue growth and higher margins. In Europe, the economy is strengthening despite concerns around the long-term future of the European project. Emerging market cyclical indicators have been improving and equity earnings are expected to pick up further as better macro data supports the corporate environment. Asian equities in particular continue to stand out in terms of growth prospects, positive earnings revisions and valuations.

In 2016, we saw emerging markets outperform developed markets and we expect this to continue. Emerging markets now contribute about a third of global GDP and half of global GDP growth. On the macroeconomic front, we expect economic fundamentals to be supportive for EM equities. Rapid industrialisation will boost growth while potential upward movement along value chains could improve corporate earnings. Moreover, we think equity valuations look reasonable and EM currencies also look undervalued. Amongst EMs, we see attractive opportunities in Asia Ex Japan Equities.

Economic fundamentals and the policy environment continue to be supportive for Asian equities. More importantly, we continue to see the reform agenda unfolding across the region. Progress on reforms is the key to sustainable growth in Asia and we have seen big reforms in China, India and Indonesia over the past couple of years. These reforms form a positive backdrop for Asian equities in the medium to long term. Another supportive factor for Asian equities is their still inexpensive valuations relative to the level of profitability of equities in the region, amongst the most attractive on that basis around the world. This means that, even without earnings improving, we can expect to see some multiple expansion. A bigger catalyst would be the likely turn in the profitability cycle. Earnings revisions appear to have bottomed in the region as the percentage of companies missing their earnings estimates has been trending down recently. Rising consumption, stable commodity prices and supportive monetary policy are all tailwinds for earnings in Asia.

Q. What are the key risks to your central scenario for 2017?

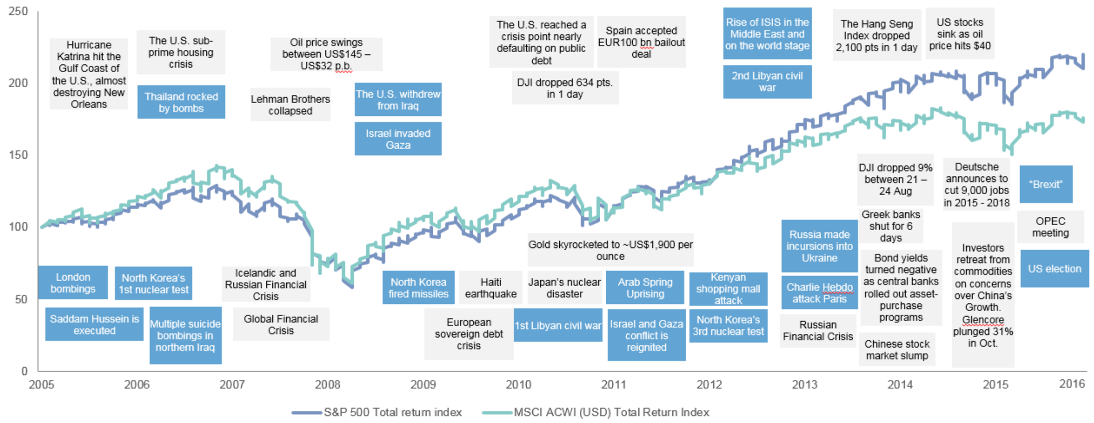
A. Several unexpected risks materialised in 2016, and there is no reason to expect 2017 to be different.

In addition to uncertainties arising from unexpected events that occurred through 2016, the possible adoption of a more protectionist approach to trade and a trend towards de-globalisation, following the US election result, are one of the key risks for equity markets in 2017 and beyond. Another important risk is that of a central bank misstep. While this is not our central scenario, the potential impact of such a misstep has increased, in our view.

Yet it is worth remembering that these big geopolitical events typically do not have the far-reaching, game-changing consequences we expect while they are unfolding. Taking a longer time perspective shows that these events often play a much less important role in the global economy than fundamentals and market developments.

To illustrate, in Figure 9, the equity markets rallied strongly in the period between 2005 and 2016, despite a host of seemingly catastrophic events including natural disasters, terrorist attacks, war, oil price fluctuations, economic slowdown and the worst financial crisis to hit the world since the Great Depression of the 1930s. While the list of events is long and intimidating even in hindsight, investors who may have opted out of the equity markets because of these uncertainties could have lost an opportunity to participate in a significant rally, despite the bumps along the way.

Figure 9: The impacts of unexpected events are diluted in long term



Source: Bloomberg S&P 500 Index, MSCI ACWI USD Total Return Index, as of Nov 18th, 2016.

Liquidity outlook

Q&A with Jonathan Curry,
Global CIO Liquid

After a fascinating year where political events, changes in market expectations for interest-rates and US Money Market Fund ('MMF') reform implementation have shaped money markets, the key question in 2017 will revolve around developments in fiscal policy in the major global economies and the potential for the end of austerity.

Q. What is your overview of liquidity markets in 2016?

A. 2016 has been a fascinating year for liquidity markets. A number of seismic events have shaped the money markets this year. These include the decision of the UK electorate to leave the European Union in the summer, the more recent US presidential election result, the implementation of money market reform in the United States, the ongoing debate around money market fund reform in the EU, and the continued growth in quantitative easing implemented by the European Central Bank (ECB). All of these events have shaped liquidity markets in their own way this year.

In the United States, expectations have changed significantly around the magnitude of interest rate rises over the course of 2016. At the beginning of the year, the Federal Open Market Committee (FOMC) members' 'dot plots' were suggesting a range in rates from just below 1% to just below 2% by the end of 2016. As we now know, this is not what happened. The next rate rise, expected to take place in December, would take the Federal funds rate to a range of 0.5%-0.75%. This has been predicated on inflation remaining well under control, but also on a number of global macroeconomic events which contributed to delaying the FOMC's decision to raise interest rates.

In the UK, the Brexit vote was a game-changer. For the first half of 2016, the market was expecting UK interest rates to rise, giving a 0.25% hike a probability of around 80% at its peak. Within one month of the Brexit vote, market expectations had completely removed this, and instead were giving a 50% probability of a rate cut.

Q. What was your investment strategy in 2016, and what is your outlook for 2017?

A. Regarding sterling and euro money markets, our investment strategy has been broadly consistent throughout 2016.

In the case of US dollar funds, particularly US 2a7 money market funds, investors and asset managers alike have had to deal with the added complexity of implementing US money market fund reform. Exceptionally, our strategy was not driven by our view on interest rates or by our macro view, but by this unique, regulatory-led event.

Nevertheless, overall our view on US dollar money markets remained consistent throughout the year, in terms of weighted average life or credit-spread duration. We maintained our preference for a somewhat longer weighted average life, which reflects our good level of comfort with the investment-grade credits approved for use by our credit analysts.

On sterling markets, of course the uncertainty that stemmed from the Brexit vote partly shaped our outlook, but overall in 2016 we also continued to prefer a slightly longer weighted average life, again based on our comfort around credit, and longer weighted average maturity. Whilst we did not see a lot of value in the longer end of the sterling money market curve for the majority of the year, there was nevertheless some steepness. We also expected rates to be stable at a minimum and, for those reasons, there was an advantage in running a longer weighted average maturity but avoiding the longer end of the curve.

In the case of euro money markets, the story was very simple. Throughout the year we continued to prefer a long weighted average maturity and longer weighted average life. We were very confident that rates would remain negative in the Eurozone, and that there was even potential for further moves into negative territory in market rates. Longer duration paid out for investors in euro money market funds in 2016.

Looking forward into 2017, following the results of the Brexit referendum and the US presidential elections this year, the key question for money markets will be to understand whether the "rise of populism" will lead to the end of austerity through pro-cyclical fiscal easing. If it does, it will be crucial to measure the implications on both official rates and market rates on money markets, particularly the US dollar, sterling and euro markets. In the UK, the change in leadership of the Conservative party has already led us to observe a less austere message. A similar shift is now expected in the USA following the recent election result. In the Eurozone, with a constitutional referendum in Italy coming up in December and French and German elections in 2017, the question is to see if EU governments will heed the message from the UK and US votes. Will they choose more populist policies and ease fiscal policy in 2017?

Q. Can you give us an update on Money market fund reform in the EU?

A. It now looks very likely that we will know the final money market fund reform in the EU by the end of 2016. Once the regulation is passed, however, provided the final reforms are in line with our expectations, we believe its impact will be far less significant than what we have experienced in the US 2a7 market, at least from a structural perspective. Indeed, in the USA, the shift has been significant. Institutional prime funds have been required to convert to a Variable Net Asset Value ('VNAV') and to employ both liquidity fees and redemption gates. This led to a structural shift of assets out of these funds and into US dollar government funds, which were able to keep a constant NAV ('CNAV') and were given the option of applying liquidity fees and redemption gates. As a result, assets under management in institutional prime funds in the USA fell from over USD1 trillion to just over USD100 billion as at mid-November.

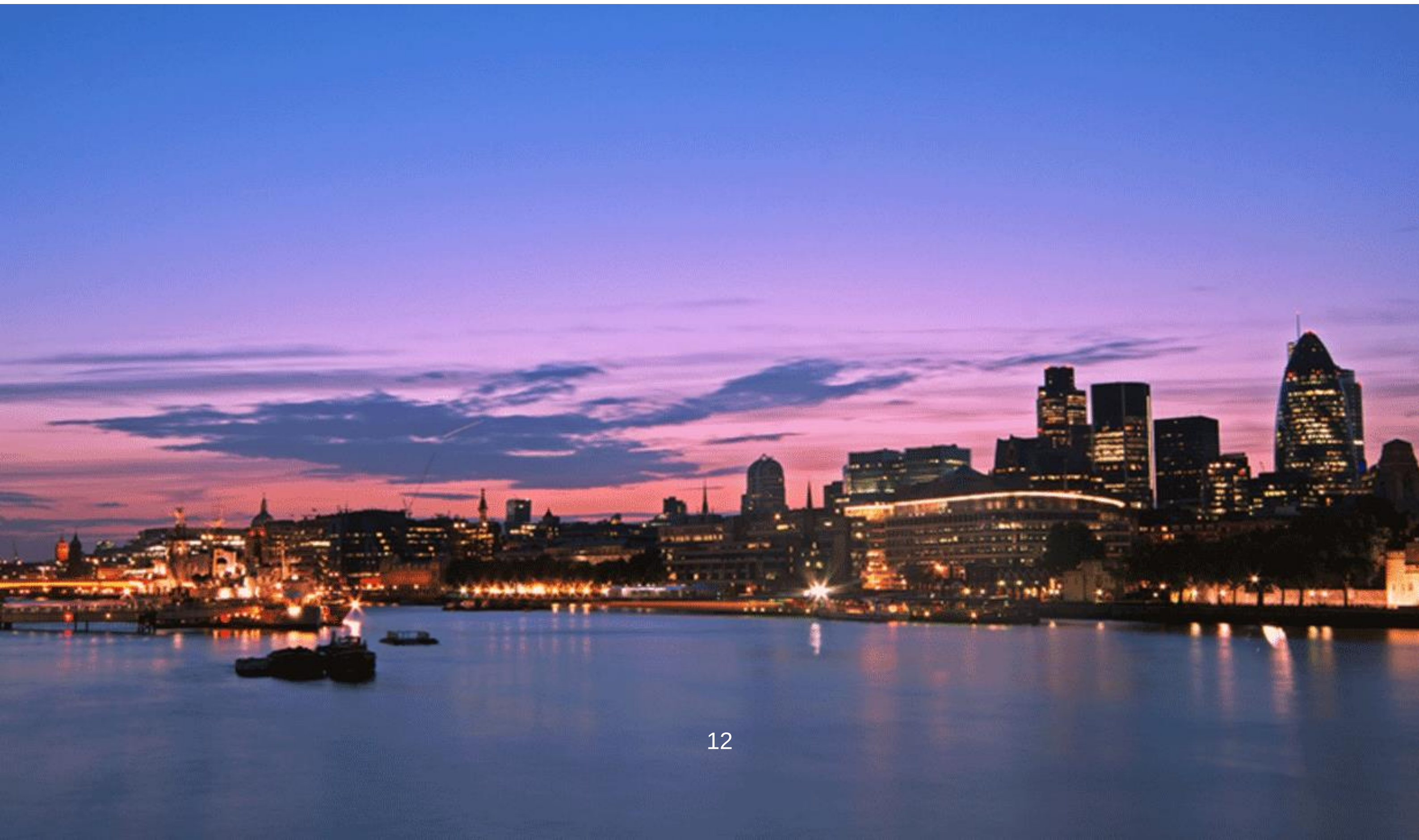
This kind of seismic shift is not our base scenario for the EU money market fund industry. The assets currently invested in CNAV prime funds dwarf the volume of assets held in government funds in Europe. We believe the majority will remain invested in the new product proposed by regulation, known as the low-volatility NAV product ('LVNAV').

Q. And on Basel III?

A. The effects of Basel III regulation continue to be felt in money markets across developed countries. We have seen a continued reduction in banks' appetite for short-dated deposits as implementation progresses and the reforms increasingly bite.

I think the Eurozone is a good illustration of how Basel III reforms are unfolding. Money market funds began delivering a negative yield to investors in 2014 while, at the time, most banks were still shielding depositors from negative interest rates by paying a zero or marginally positive return on deposits. However, as time went by it became clear that negative rates were here to stay – certainly for the foreseeable future. The impact of sustained negative rates on banks' revenue and profitability has meant that, increasingly, banks became unwilling to continue bearing the burden. They have begun passing on negative interest rates to depositors.

As a result, investors are increasingly shifting deposits into liquidity funds. This is interesting because, when rates first entered negative territory, many thought it spelled the end of euro money market funds. It has not been the case, and money market funds continue to offer a relatively secure and liquid option for investors' short-term cash deposits.



Contributors

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Chris is HSBC Global Asset Management's Global Chief Investment Officer, to which he was appointed in 2010. He was previously CEO of Halbis, HSBC's active investment specialist and joined HSBC's asset management business in May 2003 as Global Chief Investment Officer. Chris was previously Global CIO of AXA Investment Managers and 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. Chris holds First Class honours degrees in Economics from Hull (BSc) and Warwick (MA) Universities.

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Global CIO Liquidity

Jonathan is the Global Chief Investment Officer responsible for HSBC Global Asset Management's money market funds. HSBC Global Asset Management has over USD63 billion of assets under management in money market funds across 11 different currencies (at end September 2014). HSBC Global Asset Management offers both CNAV and VNAV ESMA short-term money market funds and US 2-a7 money market funds. Jonathan is Chair of the Institutional Money Market Fund Association, a member of the Bank of England's Money Market Liaison Group and the European Banking Federation's STEP and STEP+ committees.

Bill Maldonado,

Global CIO Equities,
CIO Asia-Pacific

Bill Maldonado is the CIO, Asia-Pacific and Strategy CIO for Equities and has been working in the industry since joining HSBC in 1993. Based in Hong Kong, Bill oversees the investment strategies in the region. Over the past 18 years, Bill 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 Alternative Investments teams. He then became Strategy CIO, Equities and CIO for the UK in 2010. He holds a Bachelor of Science degree in Physics from Sussex & Uppsala Universities, a D. Phil degree in Laser Physics from Oxford University and an MBA from the Cranfield School of Management.

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Joseph joined HSBC's Asset Management business in 2007. He is currently Global Chief Strategist, responsible for leading our work on macroeconomic and multi asset research, and for developing the house investment strategy view. He was previously Chief Strategist for Strategic Asset Allocation and a Fund Manager on HSBC's absolute return Global Macro fund, working on Tactical Asset Allocation strategies. Prior to joining HSBC, he worked as a Global Economist for JP Morgan Cazenove. Joseph holds an MSc in Economics from Warwick University and is a CFA charterholder.

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Xavier Baraton is Global Chief Investment Officer of Fixed Income. He joined HSBC in September 2002 to head the Paris-based Credit Research team and became Global Head of Credit Research in January 2004. From 2006, Xavier managed euro credit strategies before being appointed as Head of European Fixed Income in 2008 and as Global CIO, Fixed Income in 2010. In this role, Xavier moved to our New York office in 2011 and became regional CIO North America. With the same global and regional responsibilities, Xavier relocated to London in Summer 2014 where he took oversight of the Macro and Investment Strategy team. Prior to joining HSBC, Xavier spent six years at Credit Agricole Indosuez, including five years as Head of Credit Research. Xavier began his career in 1994 in the CCF Group. Xavier graduated from the "Ecole Centrale Paris" as an engineer with a degree in Economics and Finance in 1993 and holds a postgraduate degree in Money, Finance and Banking from the Université Paris I – Panthéon Sorbonne (France) in 1994.

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