Q2 / 2019

Issue Date: 04 April 2019

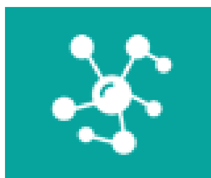
HSBC Jade Perspectives

Shaping your investment portfolio

Together we thrive

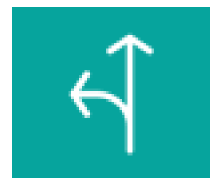
Investment themes

1. Volatility is here to stay



2. Invest in global equities holistically

3. Protect against inflation



4. Diversify your portfolio with high-quality bonds

Investment Views Summary

Bonds	Q1 views	Q2 views	Change
Developed Market Government Bonds	▼	▼	-
Emerging Market Government Bonds (local currency)	▲	▲	-
Global Investment Grade Corporate Bonds	▶	▶	-
Global High Yield Corporate Bonds	▶	▶	-

Equities	Q1 views	Q2 views	Change
Global	▲	▲	-
United States	▶	▲	Upgrade
Japan	▲	▲	-
Eurozone	▲	▲	-
United Kingdom	▶	▲	Upgrade
Central & Eastern Europe and Latin America	▶	▶	-
Asia (excluding Japan)	▲	▲	-
Emerging Markets	▲	▲	-

▲ "Overweight" implies a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

▼ "Underweight" implies a negative tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

▶ "Neutral" implies neither a particularly negative nor a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

Source: HSBC Global Asset Management, as of Apr 2019.
For full investment views, please see page 8.

Opportunities still outweigh the risks

In our last issue, we made a clear case for clients to stay invested in the stock market. That view looks to have been right: global equities are up more than 10% for the year at the time of writing, led by the US, which we upgraded to "Overweight" in January.

Jan-Marc Fergg, CFA
Deputy Head of Group Wealth Management

Xian Chan
Global Head of Wealth Insights

Equities still make sense

At this point it might be tempting to play it safe: take the profits, sell one's equity holdings and move entirely into secure assets like cash or safe haven bonds.

All things considered, however, we believe clients should stay invested in equities for now. But we're talking about a very specific way of investing. The key is to access global equity markets in a truly holistic way, across multiple geographies in both developed and emerging regions. **Full story on page 15.**

Volatility set to return in 2019

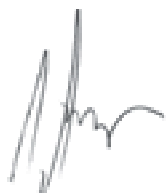
As we've said before, the low volatility of recent years was the exception, not the norm, and in fact there's a considerable chance that short-term volatility could flare up later this year. Not only are we at a late stage of the business cycle, but market sentiment has been dented by geopolitical events like the US-China trade tensions and Brexit uncertainties.

The way forward

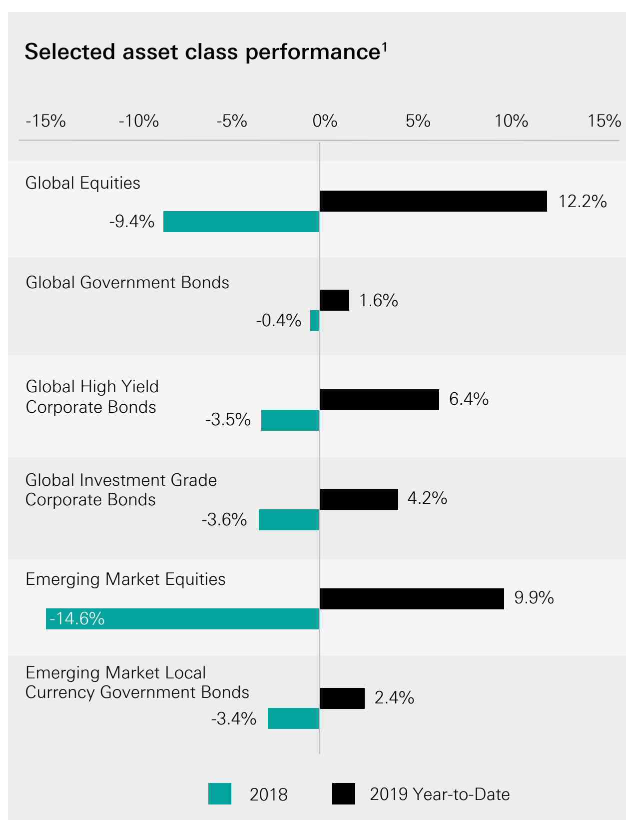
In conditions like these, investors should balance equity investment with continued exposure to high-quality bonds, which can offer some protection from short-term market volatility.

The trick, as always, is to maintain discipline and not get over-excited or scared by short-term market movements. The economic data still favours continued exposure to the stock market and other risk assets.

We hope you enjoy this edition, and wish you every success in your investments this quarter.



Jan-Marc Fergg   Xian Chan



1. Source: Bloomberg, 29 Mar 2019. Investment involves risks. Past performance is not indicative of future performance.

Note: the chart shows total returns of asset classes in USD dollar (USD). Asset class performance is represented by different Indices - Global Equities: MSCI ACWI Net Total Return Index; Global Government Bonds: Bloomberg Barclays Global Aggregate Treasuries Total Return Index; Global High Yield Corporate Bonds: Bloomberg Barclays Global High Yield Corporate Total Return Index; Global Investment Grade Corporate Bonds: Bloomberg Barclays Global Aggregate Corporate Total Return Index; Emerging Market Equities: MSCI Emerging Net Total Return USD Index. Emerging Market Local Currency Government Bonds: Bloomberg Barclays Emerging Market Local Currency Government Total Return Index.

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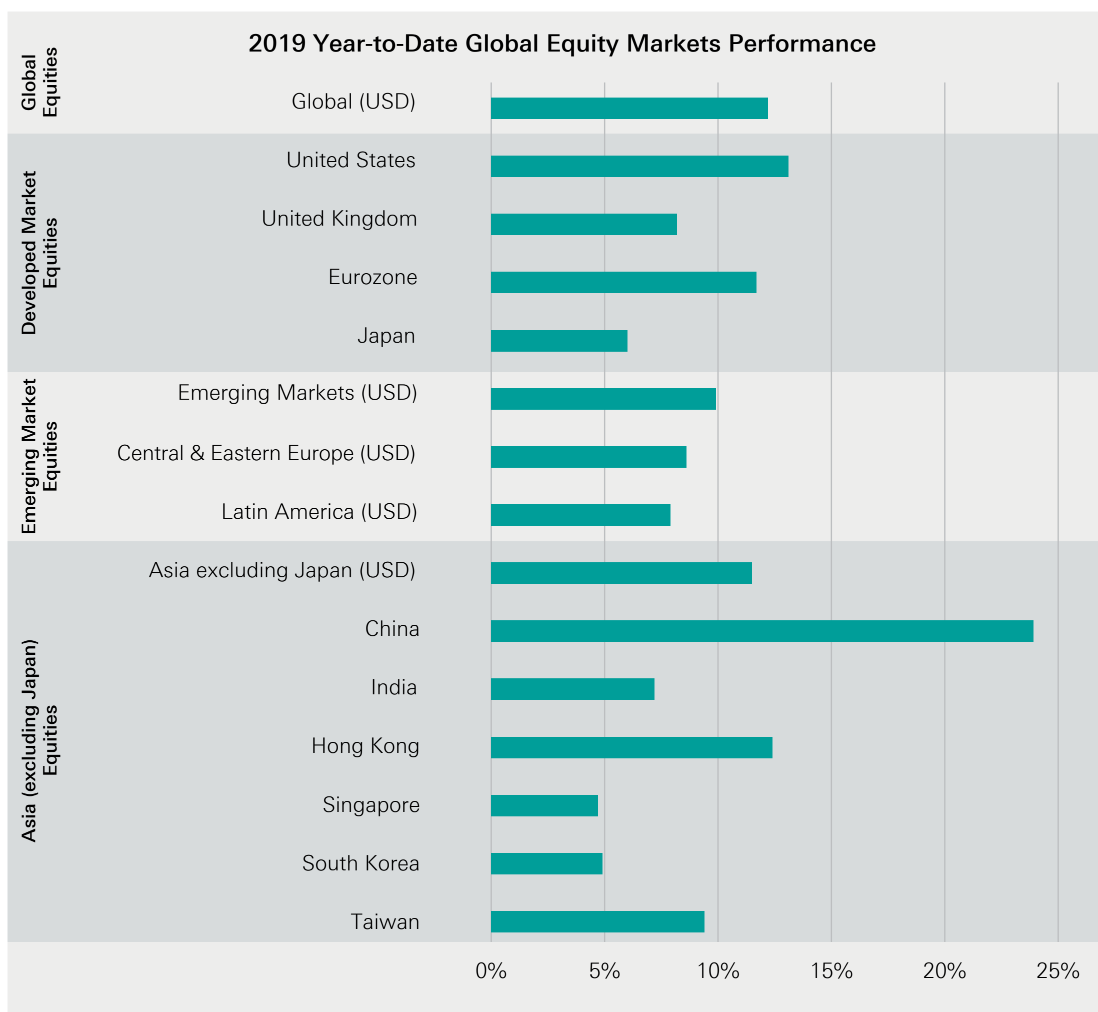
Markets Review

Equities

After disappointing returns last year, equity markets made a positive start in 2019, boosted by upbeat corporate earnings, a softening in US-China trade relations and dovish messages from the US Federal Reserve. In response, global and US equities are up over 10%, while Emerging Markets posted aggregate gains of around 10%.

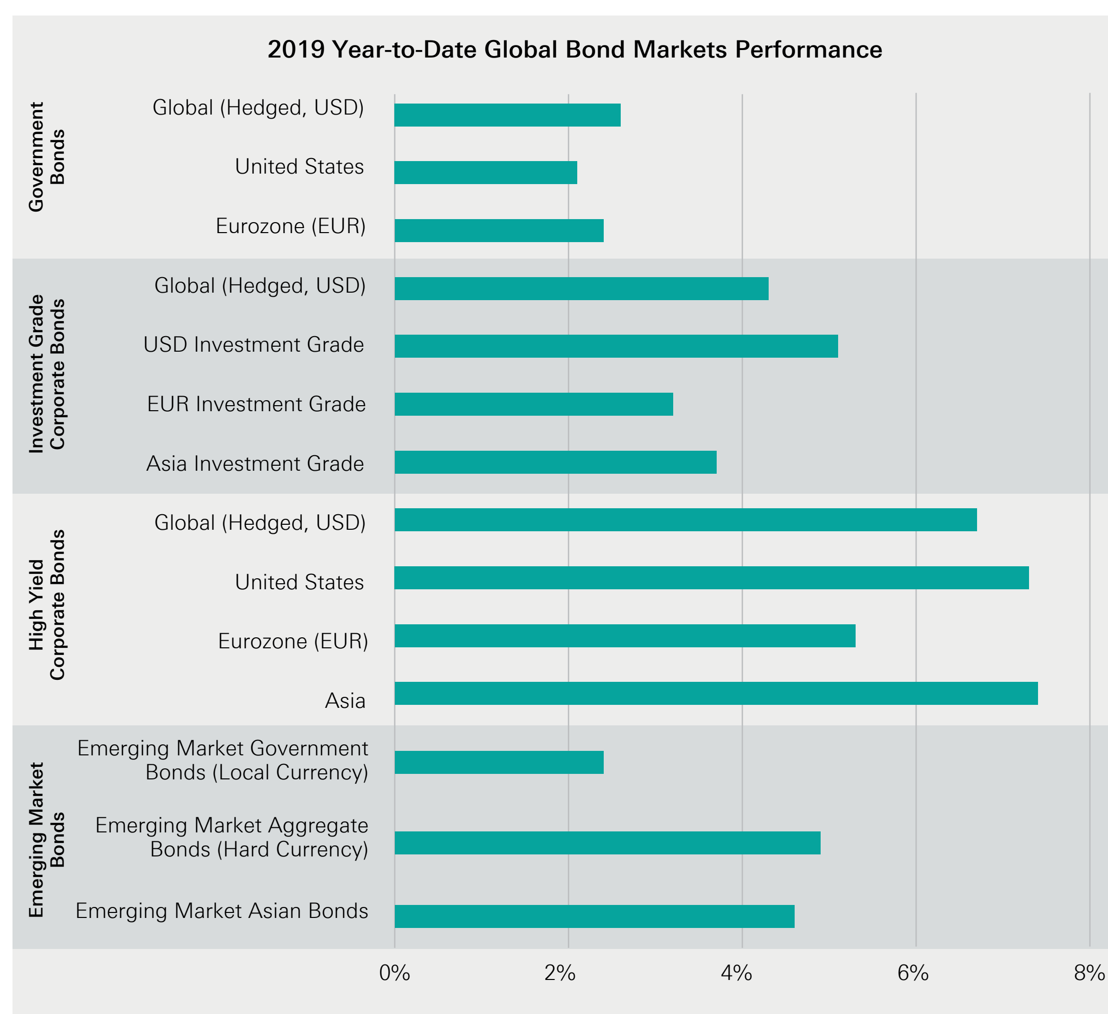


Source: Bloomberg, as of 29 Mar 2019. Investment involves risks. Past performance is not indicative of current or future performance.

Note: total returns of asset classes are shown in local currencies, unless otherwise stated. Equities performance is represented by different Indices – Global Equities: MSCI ACWI Net Total Return Index (USD). US Equities: S&P 500 Index (USD). UK Equities: FTSE 100 Index (GBP). Eurozone Equities: EURO STOXX 50 (EUR). Japan Equities: Nikkei 225 Index (JPY). Emerging Market Equities: MSCI Emerging Net Total Return Index (USD). Central & Eastern Europe Equities: MSCI Emerging Market Eastern Europe Net Total Return Index (USD). Latin America Equities: MSCI Emerging Latin America Net Total Return Index (USD). Asia (excluding Japan) Equities: MSCI AC Asia Pacific ex Japan Net Total Return Index (USD). China Equities: Shanghai Stock Exchange Composite Index (CNY). India equities: S&P BSE SENSEX Index (INR). Hong Kong Equities: Hang Seng Index (HKD). Singapore Equities: FTSE Straits Times Index (SGD). South Korea Equities: Korea Stock Exchange KOSPI Index (KRW). Taiwan Equities: Taiwan Stock Exchange Weighted Index (TWD).

Bonds

US Treasuries and core European bonds saw yields rise and prices decline in Q1, as positive market conditions continued to favour assets at the riskier end of the spectrum. Corporate bonds, meanwhile, saw a strong rebound and outperformed government bonds. Emerging Market government bonds (local currency) rose on the back of a weaker US Dollar and indications from the Fed that it would be patient about interest rate rises.



Source: Bloomberg, as of 29 Mar 2019. Investment involves risks. Past performance is not indicative of current or future performance.

Note: total returns of asset classes are shown in US dollar (USD), unless otherwise stated. Bonds performance is represented by different Indices – Government Bonds: Global Government Bond (Hedged, USD): Bloomberg Barclays Global Aggregate Treasuries Total Return Index (Hedged, USD); US Government Bond: Bloomberg Barclays US Government Total Return Index; Long-dated Treasury Bond: Bloomberg Barclays Long US Treasury Total Return Index; Short-dated Treasury Bond: Bloomberg Barclays Short Treasury Total Return Index; Eurozone Government Bond: S&P Eurozone Sovereign Bond Total Return Index (EUR); Investment Grade Corporate Bonds: Global Investment Grade Corporate Bond (Hedged, USD): Bloomberg Barclays Global Aggregate Corporate Total Return Index (Hedged, USD); USD Investment Grade Corporate Bond: Bloomberg Barclays US Corporate Total Return Index; EUR Investment Grade Corporate Bond: Bloomberg Barclays Euro Aggregate Corporate Total Return Index (EUR); Asian Investment Grade Corporate Bond: Markit iBoxx USD Asia ex-Japan Corporates Investment Grade Total Return Index. High Yield Corporate Bonds: Global High Yield Corporate Bond (Hedged, USD): Bloomberg Barclays Global High Yield Corporate Total Return Index (Hedged, USD); USD High Yield Corporate Bond: Bloomberg Barclays US Corporate High Yield Total Return Index; EUR High Yield Corporate Bond: Bloomberg Barclays Pan-European High Yield Total Return Index (EUR); Asian High Yield Corporate Bond: Markit iBoxx USD Asia excluding Japan High Yield Total Return Index. Emerging Market Bonds: Emerging Market Government Bond (Local Currency): Bloomberg Barclays Emerging Market Local Currency Government Total Return Index; Emerging Market Aggregate Bond (Hard Currency): Bloomberg Barclays Emerging Market Hard Currency Aggregate Total Return Index; Emerging Market Asian Bond: Markit iBoxx USD Asia excluding Japan Total Return Index.

Investment Views Q2 2019

Latest asset class views (>12months)

- ▲ "Overweight" implies that, within the context of a well-diversified, typically multi-asset portfolio, and relative to relevant internal or external benchmarks, HSBC Global Asset Management has (or would have) a positive tilt towards the asset class.
- ▼ "Underweight" implies that, within the context of a well-diversified, typically multi-asset portfolio, and relative to relevant internal or external benchmarks, HSBC Global Asset Management has (or would have) a negative tilt towards the asset class.
- ▶ "Neutral" implies that, within the context of a well-diversified, typically multi-asset portfolio, and relative to relevant internal or external benchmarks, HSBC Global Asset Management has (or would have) neither a particularly negative nor a positive tilt towards the asset class.

▼ Government bonds

Developed Markets

Yields remain low and valuations aren't very attractive, although high-quality government bonds can play a valuable role in diversifying a portfolio.

Government bonds

Emerging Markets, local currency

Expect attractive returns for most countries, boosted by the potential for Emerging Market currency gains.

▶ Corporate bonds

Global Investment Grade

Economic conditions remain supportive and default risks look limited. Asia and US bonds are currently more attractive than their European counterparts.

Corporate bonds

Global High Yield

Corporate fundamentals look solid and defaults are low. We currently favour higher-quality High Yield bonds.

▲ Global equities

Global equities are more attractive than government bonds right now. The growth outlook is positive (albeit slowing somewhat) and corporate fundamentals remain solid.

▶ Commodities

Commodities in general can enhance portfolio diversification and help hedge against inflation. The most attractive potential returns look to be in the energy sub-sector.

Source: HSBC Global Asset Management, as of Apr 2019

Note: views are based on regional HSBC Global Asset Management Asset Allocation meetings held throughout Mar 2019, HSBC Global Asset Management's long- term expected return forecasts generated as at 28 Feb 2019, and our portfolio optimization process and actual portfolio positions. These views are not to be taken as investment advice, a recommendation to buy or sell investments or a guarantee of returns, and are subject to change without prior notice. Please refer to the latest Investment Monthly or your Relationship Manager for more long-term asset class views.

Regional equity views (>12months)

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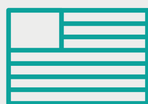
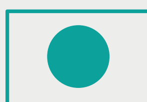


▲ United States

The US economy continues to outperform other Developed Markets and valuations are still reasonable. Upbeat earnings growth and a pause in the Fed's interest rate hikes should continue to support US equities.

▲ Eurozone

Eurozone equities offer potential for attractive returns. We believe the ultra-low ECB policy rates are likely to continue to the end of the decade.



▲ Japan

Japanese equity valuations are currently cheap, while government policy should be supportive of the stock market.

▲ Emerging Markets (EM)

Emerging Markets have attractive growth characteristics at a reasonable price, and would be our top pick in a diversified portfolio.

Source: HSBC Global Asset Management, as of Apr 2019

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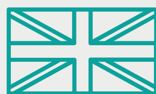
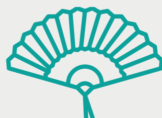


▲ United Kingdom

We've upgraded our position from "Neutral" to "Overweight" as our estimate of UK equity valuations has significantly improved. This is particularly true for GBP investors.

▶ Central & Eastern Europe and Latin America

Despite a decline in growth momentum last year, we see signs of a turning point for Latin America in 2019. Meanwhile, CEE countries offer attractive valuations.



▲ Asia (excluding Japan)

Valuations are attractive, corporate earnings remain strong and economic growth has been relatively solid.

Quarterly Themes Q2 2019

Positioning your portfolio for the coming quarter

Capitalising on a strong start

At the end of last year, we came out in favour of continued investment in equities. That strategy has clearly been productive as global risk assets duly rebounded in 2019, with global equities up over 10% the time of writing and other risk assets following suit.

Overall, investor confidence has risen amid hopes that the Federal Reserve and other central banks would slow the pace of interest rate hikes. Other good news included progress in US-China trade talks and a Chinese stimulus policy aimed at stabilising economic growth.

Are recession fears exaggerated?

We believe the global economy is still growing and should support more earnings growth, albeit at a slower pace. Valuations for global equities remain reasonable, although episodic market volatility is a likelihood at this late stage of the business cycle. The upshot? Shrewd portfolio diversification is especially important right now.

Equities: a holistic, global approach

In our view then, portfolios should continue to favour equities over bonds, while keeping diversification across different geographical areas.

Our slight preference is for Emerging Market equities, given their favourable valuations, improved growth characteristics and supportive external environment. Since our last issue, we've also upgraded US and UK equities from "Neutral" to "Overweight", so our preference is equal across all Developed Market equities.

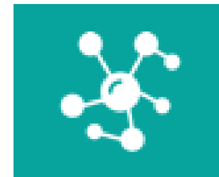
Why it pays to stay alert

Various risks are still in play, of course. A spike in US inflation combined with weak global growth could compel the Fed to increase interest rates, while market sentiment remains vulnerable to Brexit and ongoing trade tensions. It's therefore worth balancing your portfolio's equity allocation with high-quality bonds to help protect against short-term volatility.

Overleaf, we explore **four key themes** that we think will prove central to helping you position your investments in the coming months.

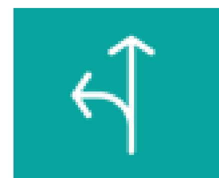
Investment themes

1. Volatility is here to stay



2. Invest in global equities holistically

3. Protect against inflation



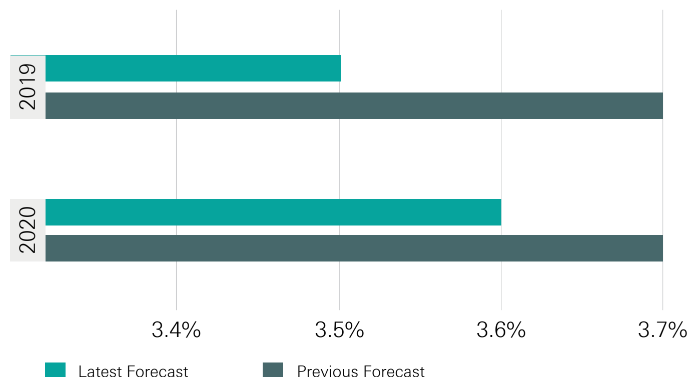
4. Diversify your portfolio with high-quality bonds

Theme 1

Volatility is here to stay

World GDP Forecast (annual percent change)

Positive but weakening global growth expected



Source: International Monetary Fund (IMF), World Economic Outlook, Jan 2019

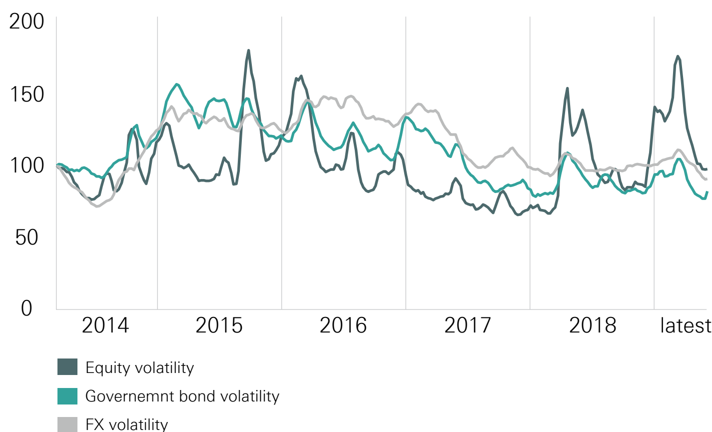
Don't let the slowing economy get you down

Global growth remains decent, albeit slowing. The economic conditions and corporate fundamentals that supported the recent rally look set to continue – these conditions guide our preference for equities over bonds.

IMF global growth projections[1] for 2019 and 2020 have dropped to 3.5% and 3.6% respectively, somewhat souring sentiment. However, we believe growth in general is still positive, albeit slower, driven by a strong US economy. We also expect that Chinese authorities will provide enough stimulus to stabilise growth prospects.

The Volatility Index (1-month moving average)

Low volatility is uncharacteristic at this late stage of the cycle.



Source: Refinitiv Datastream, data as of 29 Mar 2019

Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

Note: Equity volatility, government bonds volatility and FX volatility are represented by different indices: Chicago Board Options Exchange S&P 500 Volatlity Index , Merrill Lynch Option Volatility Estimate (MOVE) Index and JPMorgan G7 Volatility Index, rebased to 100. Data shows volatility index movement for rolling 1-month moving average to smooth outliers.

Volatility is here to stay

As we've said already, a degree of volatility is pretty much expected in the current environment – especially so late in the business cycle.

For us, the key to success lies in discipline. Investors should look to diversify their equity portfolio globally and stay invested for the long-term.

During the early market rally of 2019, equity volatility (measured by VIX) has declined to levels last seen in October 2018. What's more, volatility measures[2] for US Treasuries and G7 currency have also dropped meaningfully. That's promising news, but in our view, low volatility is far from typical at this point in the cycle.

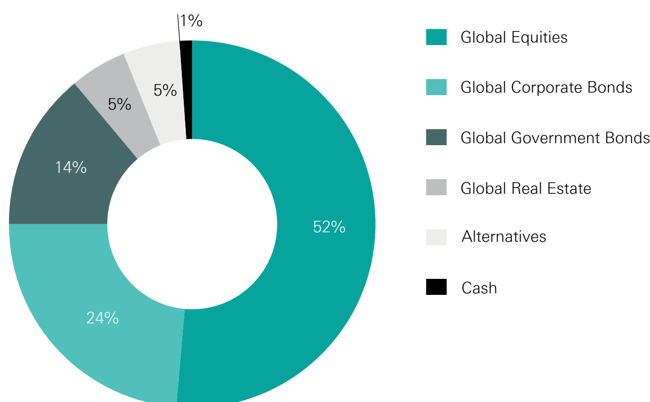
Source: 1. International Monetary Fund (IMF), World Economic Outlook, Jan 2019
2. Merrill Lynch Option Volatility Estimate (MOVE) Index and JPMorgan G7 Volatility Index.

Theme 2

Invest in global equities holistically

Current model portfolio allocation

Global equities remain a core allocation in a diversified portfolio



Source: HSBC Global Asset Management, as of Mar 2018.

Note: The model portfolio allocation is for general reference only and is subject to changes from time to time without any prior notice. The model portfolio allocation is a general reference for the consideration of customers who have completed the Risk Profiling Questionnaire ('RPQ') with a Risk Tolerance level of 'Balanced'. Please note that a model portfolio allocation which matches or is lower than your risk tolerance may not be suitable for you.

A holistic, global approach

With valuations still reasonable and a likelihood that growth may stabilise, we think equities offer the best investment opportunity compared to other asset classes. As always, diversification is the antidote to unpredictability. Investors should look to the global equity market as a whole and cultivate broad exposure across different regions.

Remember that short-term market corrections could bring opportunities. After the sell-off in late 2018, for instance, we found attractive entry points for US and UK equities, subsequently upgrading them from "Neutral" to "Overweight".

Relative valuation of EM equities vs global equities

EM equities are more attractive

Source: Refinitiv Datastream, as of 29 Mar 2019

Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

Note: Emering Markets equities discount to global equities is calculated using 12-month forward Price-to-Earning (P/E) ratio and 12-month forward Price-to-Book (P/B) ratio. Equities are represented by different indices in USD: MSCI Emerging Markets Index and MSCI AC World Index.

Emerging Markets still look good

Right now, Emerging Market (EM) assets offer improved growth characteristics at a reasonable price, particularly in equities and local currency debt. The general environment for EMs has also improved recently, thanks to stimulus policies in China, lower oil prices and a more 'patient' Fed.

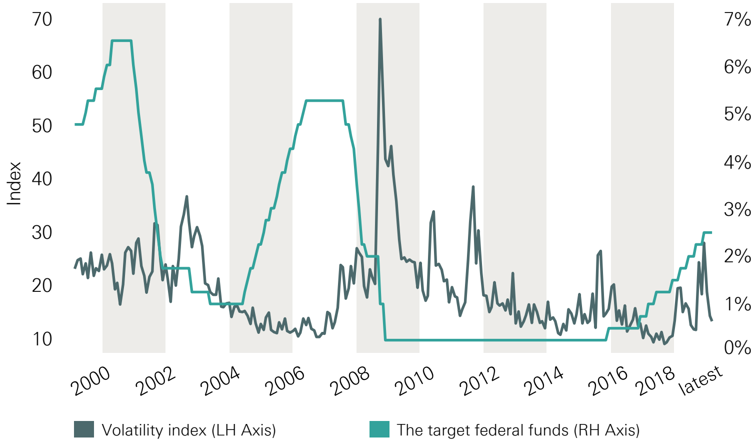
Asian equities have better structural characteristics than other Emerging Markets and still offer appealing prospective returns. China equities, for example, hit the sweet spot by combining favourable valuations, solid earnings growth and active policy support.

Theme 3

Protect against inflation

Volatility index vs Fed funds rate (%)

Rising US interest rates impact on stock market volatility



Source: Refinitiv Datastream, data as of 29 Mar 2019

Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

Note: Volatlity is represented by Chicago Board Options Exchange S&P 500 Volatility Index in USD.

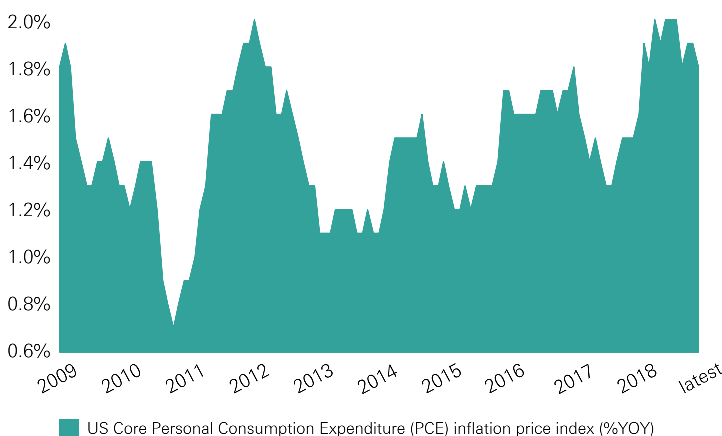
Will a pause in US interest rate hikes boost markets?

The Fed is now less likely to raise interest rates in 2019. A pause like this may help to fuel a global boost, especially in Emerging Markets.

Market sentiment improved after a dovish statement from the Fed in January, which removed references to further rate hikes. The Fed kept rates unchanged at 2.25-2.50% in its March meeting. According to its own projection, no rate hikes are expected this year and only one is expected in 2020.

US inflation (Year-on-year %)

Core inflation in the US is running close to the Fed's 2% target



Source: Refinitiv Datastream, US Bureau of Economic Analysis (BEA), as of 29 Mar 2019.

Protect against inflation

A leap in inflation, driven by rising wage growth, could lead to higher US interest rates and a damaging effect on global market confidence.

Inflation-hedging assets like gold and commodities can help to mitigate the risk, as can short-duration bonds that are less sensitive to rising interest rates.

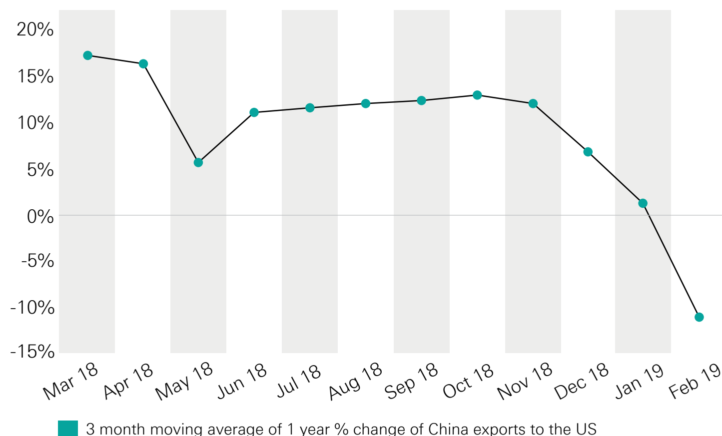
Core inflation is running close to the Fed's 2% target - a key risk scenario that could lead to greater-than-expected Fed tightening.

Theme 4

Diversify your portfolio with high-quality bonds

China trade to the US

Growth in Chinese exports has fallen recently



Source: Refinitiv Datastream, as of 29 Mar 2019

Note: Data shows year-on-year growth for rolling 3-month moving average to smooth outliers.

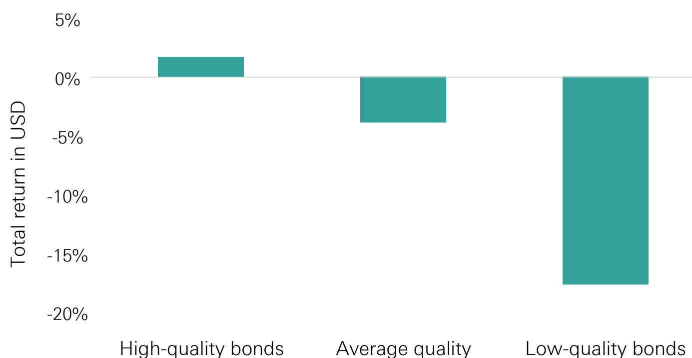
Trade Wars and Brexit risks

Despite signs of optimism, uncertainties remain about US-China relations and the prospects of a Brexit deal. Again, investing in a diversified mix of assets can strengthen your portfolio against negative sentiment caused by geopolitical factors.

The election calendar is packed in 2019, with European Parliament elections and general elections in Indonesia, India and other Emerging Markets. Events like these have the potential to create market "noise". Investors should take steps to protect portfolios from short-term bouts of volatility by diversifying into high-quality bonds.

Quality matters

High-quality bonds tend to reduce downside risk during times of economic slowdown.



Source: Moningstar, Bloomberg, National Bureau of Economic Research (NBER), data covers Dec 2007 - Jun 2009.

Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

Note: Bond performance is represented by Bloomberg Barclays US Aggregate TR index in USD, rated investment grade AA3+/B/CA to D, using the middle rating of Moody's, S&P and Fitch. The index includes US Treasuries, government-related and corporate bonds.

Diversify your portfolio with high-quality bonds

Bonds issued by stable, well-run governments and companies can help soften the blow of a market downturn. Good options to consider include Investment Grade corporate and government bonds.

For Investment Grade bonds, we prefer Asia and the US over the Eurozone. The income offered by Asian credits looks attractive compared to Developed Markets, given their robust underlying activity and supportive monetary policy in the region.

HSBC Perspective

The value in valuations

Joseph Little
Global Co-CIO Multi Asset,
Global Chief Strategist, HSBC
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Hussain Mehdi
Macro and Investment
Strategist, HSBC Global
Asset Management

In the current market environment (slowing growth, tariffs and geopolitical uncertainty), what's attractive about equities over bonds?

Over the last year, global growth has materially slowed, dropping below trend. Downside risks remain, including trade tensions, the outcome of Brexit negotiations, and Italy's fiscal dynamics.

Given this backdrop, it may be tempting to shift portfolio allocations away from equities and into bonds. At this juncture, however, we believe this is the wrong strategy, for three reasons.

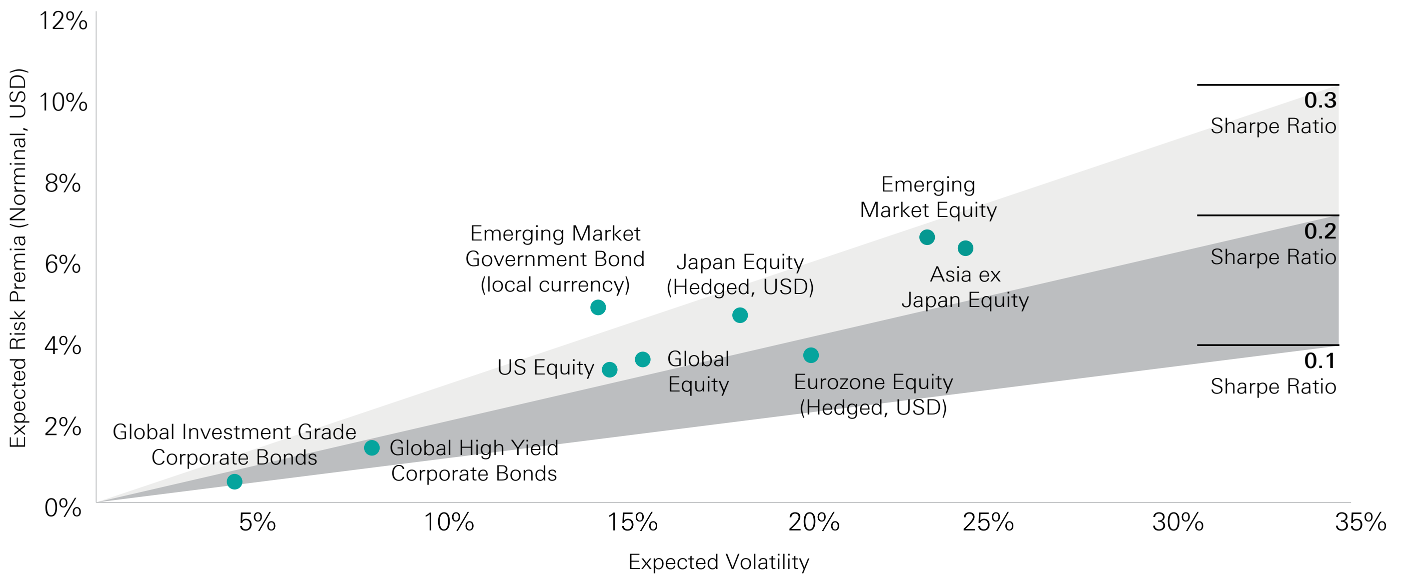
Firstly, we believe bonds are overvalued (key examples are Developed Market government bonds, and Investment-Grade corporate bonds in euros and sterling), which "pushes" us to maintain a pro-risk allocation. However, we also believe that shorter-duration US Treasuries still offer relatively decent expected returns and can act as a "diversifier" for asset allocators.

Secondly, markets continue to neglect the risk of higher inflation, which could hit bond prices. We believe this risk is most relevant to the US, where growth continues to outperform other advanced economies and wages are picking up.

Thirdly, we think the risk of a global recession remains low. Importantly, global monetary policy has become more dovish in recent months, and fiscal policy is also likely to loosen a little across major economies. Meanwhile, authorities in China have enacted significant policy-easing measures, which should help to stabilise domestic growth and subsequently support global activity.

Expected risk and return of asset classes

Equities are more attractive than bonds



Source: HSBC Global Asset Management, as of Mar 2019.
Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.
Note: Asset class returns are shown in unhedged terms, unless otherwise stated. Sharpe Ratio measures risk adjusted performance. Broadly speaking, asset classes towards the top of the wedge appear to be attractively valued and offer attractive returns relative to their risk. Asset classes towards the bottom indicate unattractive valuations.

What's your view on Emerging Market (EM) equities? Do we like EM as a block, or is there a specific preference for Asia?

After a difficult 2018, our outlook for EM economies this year is brighter.

China's policy easing, combined with the Fed's dovish shift and a more stable US dollar, creates a supportive backdrop for many EM economies, especially those with high levels of USD-denominated debt and external financing requirements.

Oil prices remain lower than the average for 2018. This is positive for major net oil importing EM economies, including China and India. Softer oil prices, along with more stable currencies, also help to contain inflation pressures, thus increasing the scope for more accommodative monetary policy.

The improving situation is reflected in Nowcast (our "big data" approach to tracking the economic cycle) which has shown a rebound in EM activity this year. Since we also believe EM equities are attractively valued, we remain comfortable holding an Overweight position.

Within the EM equity category, we have a stronger preference for Asian over Latin American equities.

Valuations look better than what's currently available in the fixed income space, and growth in Asia looks faster and more secure than in Latin America, due to structural characteristics like higher foreign exchange reserves. The increasing weight of China A-shares in the MSCI EM index (a benchmark for EM stocks) also means that many investors are looking at onshore China for the first time.

Markets have been doing reasonably well for some time now. Should investors be concerned about a downturn?

In our view, there's limited scope for a sustained downturn in risk asset classes. We therefore remain pro-risk in our multi-asset portfolios.

While financial markets have performed strongly so far this year, a number of macro and political risks do loom large and it's understandable that investors might feel concerned about the outlook. However, the strength we've observed recently in investment markets speaks more to an excess of recession fear back in December, rather than suggesting investors are overly euphoric right now.

Overall, we think global growth looks okay, while policy is supportive and market volatility is low. For us, this constitutes a good backdrop for staying invested in risky asset classes. Yes, it's been over ten years since the financial crisis, but the economy doesn't run on a clock and, based on our analysis, recession risk looks low and corporations remain profitable.

Of course, we need to remain realistic. Global equities are priced to deliver annual returns of around 7% before inflation, which looks attractive versus the alternatives. But we're also likely to see bouts of volatility in financial markets, given the macro-economic and political uncertainties already discussed. Investors need to be aware of this and prepare by diversifying themselves accordingly.

HSBC Perspective

Chinese equities back in the spotlight

- MSCI announced that it will raise the weight of large-cap A-shares in its indexes in three steps this year.
- We expect around USD10bn of passive inflows in 2019. Inflows from all funds tracking MSCI indices could total around USD10bn.
- We also believe the MSCI China will become more representative of the broader market which could help attract further fund flows.

MSCI, a leading index provider, announced on 28 February 2019 that it will increase the weight of China A-shares (shares listed on Chinese stock exchanges) in its Emerging Market Index this year.

This increase in weighting will be achieved through the following adjustments:

1. Lifting the inclusion factor (the proportion of the shares' market capitalisation to be included in the index) of over 250* large-cap names from 5% to 20%. This will happen in three tranches in May, August and November of this year.
2. Adding 27* ChiNext (China's NASDAQ-style board comprising mostly hi-tech companies) large-cap shares with a 10% inclusion factor from May.
3. Adding 141* MSCI China mid-cap A shares with a 20% inclusion factor from November.

Impact on fund flows

In November 2019, the estimated weight of China A-shares in the MSCI Emerging Market Index will rise from its current level of 0.7% to 3.3%. This index is being tracked by USD1.84 trillion of global assets, about 22% of which are passive funds (funds that aim to track the performance of an index). We calculate that the latest weight increases will lead to inflows of over USD10 billion in 2019 due to passive funds benchmarking the MSCI Emerging Market Index. If we include all funds benchmarked to this index, the MSCI Asia ex Japan Index and the MSCI All Country World Index (ACWI), fund flows could total approximately USD73 billion.

In the next 5-10 years, we expect over USD600 billion of foreign inflows to A-shares as a result of MSCI inclusion.

More to come

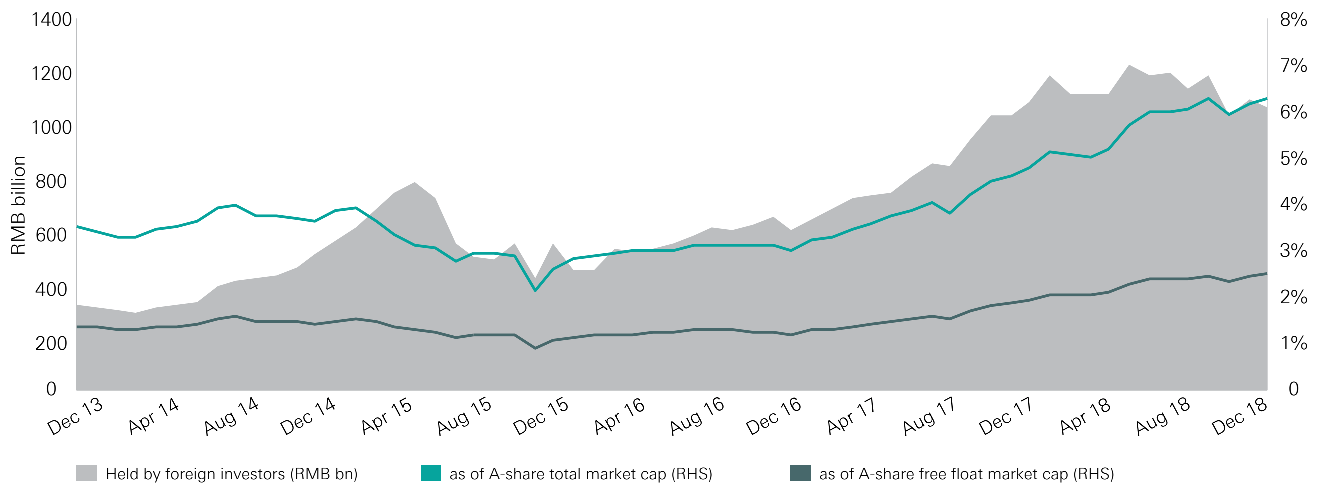
Foreign investors now play a significant role in the A-share market, holding around 7% of the floatable market cap as at end-3Q 2018 (see chart). Aside from MSCI inclusion, we see a number of other factors supporting this rising trend:

1. A doubling of the Qualified Foreign Institutional Investor (QFII)[1] quota to USD300 billion in January.
2. The merging of QFII with its RMB-denominated sibling, RQFII[2], along with a simplified application procedure, relaxed eligibility criteria and the expansion of eligible foreign investments.
3. Inclusion of A-shares in the FTSE Russell's emerging index from June.

Better representation

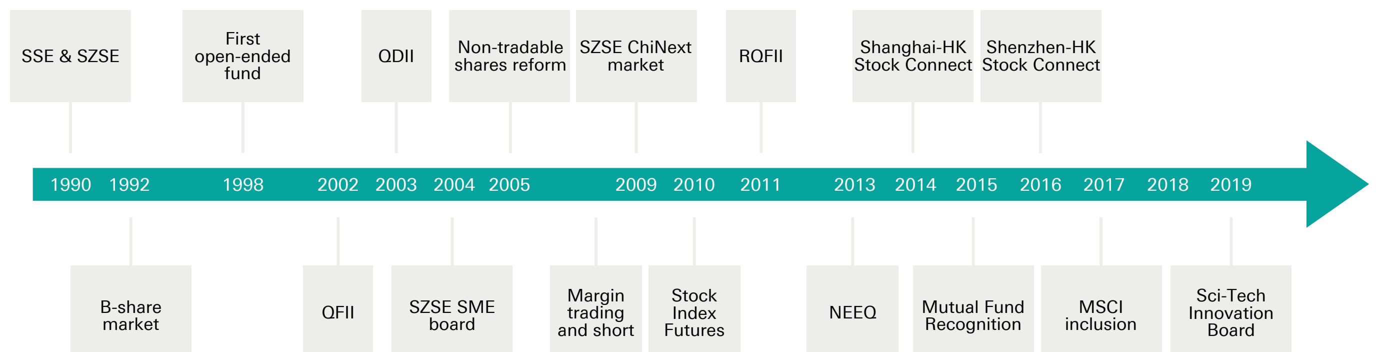
We also believe the MSCI China Index is going to be a better representation of the broader market, with less weight on a few heavyweight sectors like financials. This could help to attract further fund inflows, eager for a more representative index that covers all classes of Chinese equities.

Foreign participation on the A-share market has seen continuous increase in recent years



Source: Wind, People's Bank of China, HSBC Global Research

Capital market developments in China since 1990



Source: HSBC Qianhai Securities

Notes: 1. QFII: Allows qualified foreign institutional investors to access onshore capital market. Quota based in foreign currencies, primarily USD, EUR, JPY and GBP.
2. RQFII: Allows qualified foreign institutional investors to access onshore securities and mutual funds and qualified domestic institutional investors to access offshore markets, both in RMB.

* Exact numbers of these new constituents may change.

External Perspective

Why own high-quality bonds in a portfolio?

Rick Rezek
Global Credit Fund Manager, Fixed Income, Schroders Investment Management

Volatility is returning to financial markets. How can high-quality bonds help protect investors' portfolios, and what are the performance drivers?

After years of tranquillity thanks to accommodating central bank policy, market volatility has returned and is unlikely to go away anytime soon. As a result, investors are likely to migrate up the quality spectrum, selling off cyclical stocks (those that are highly correlated with economic activity) and High Yield (HY) bonds in favour of defensive stocks, higher quality Investment Grade (IG) credit, government bonds and bond proxies like dividend stocks or Real Estate Investment Trusts (REITs).

This is typical during risk-off environments, such as those that arise late in the economic cycle. Increased demand can then drive positive performance in government bonds and IG credit.

As such, an allocation to high-quality fixed income, as part of a balanced portfolio, can help reduce drawdowns and enhance risk-adjusted returns over a market cycle.

How effectively do high-quality IG bonds protect a portfolio compared to HY bonds - especially at this stage of the business cycle?

We believe we're now in the late stage of the business cycle, when economic growth tends to slow and investors rotate into higher quality assets. IG credit will likely fare better than HY for several reasons.

- IG bonds are generally less sensitive to the business environment than HY, and are therefore more insulated from the negative effects of a slowing economy.
- IG bonds tend to have longer maturities than HY and, because of their longer duration, can benefit as lower growth expectations are priced into lower Treasury rates.
- The IG bond market is more liquid than the HY market. In turbulent times, investors expect a discount for holding securities which are harder to exit, which puts downward pressure on HY.
- Many IG names are blue-chip companies with well capitalised balance sheets and diverse revenue sources. They're therefore less susceptible to defaults or downgrades and less affected by sector or geography specific events.

A tilt toward IG bonds in the later stages of a business cycle can be a good defensive play, bringing diversification benefits and helping to improve risk-adjusted returns. The correlation between IG and HY credit over the last 10 years has been 0.62 (as at 28 February 2019).

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Fixed income faces a number of challenges that investors will need to navigate carefully. What needs to be considered when selecting high-quality bonds?

Investors should always remember that corporate bonds carry credit risk. They can be negatively impacted if corporate leverage becomes elevated or companies have difficulty generating cash flow to service their debt.

Fortunately, many IG companies have healthy balance sheets and have historically weathered extreme tail events, like the 2008 financial crisis, with only minor losses or none at all.

Additionally, active investors can move away from lower quality or more cyclical segments of the market which could be vulnerable during the late-cycle period.

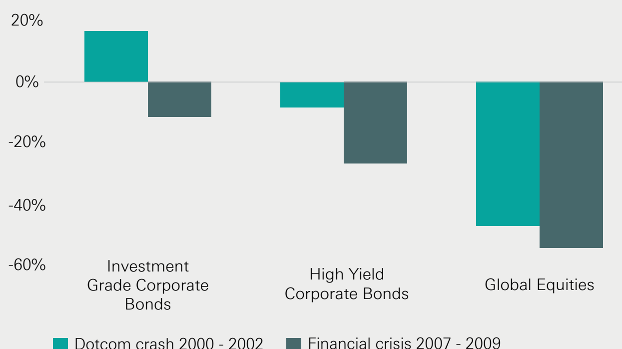
A more emergent challenge for investors is the much-increased capacity for central banks to shape investment returns well into the future. Traditionally, it has been relatively easy to anticipate central bank actions in light of their core purpose to modulate domestic inflation and unemployment. This picture has recently grown more complex, as central banks have become more responsive to external influences such as politics or market movements. One way to mitigate this issue is to hedge market volatility and interest rate duration, either in absolute terms or versus a benchmark.

> **A more effective and consistent way to generate returns is through active bond and sector selection.**

Through a disciplined research process, it's possible to identify and implement high-conviction positions without increasing the overall risk to a portfolio, and while potentially generating outperformance in all market environments.

IG corporate bonds display inherently stable and attractive risk-adjusted characteristics. Additionally, they offer scope to add value through active investment decisions, making a positive case for allocating to this asset class, particularly in times of rising uncertainty.

High-quality bonds have outperformed during times of market stress



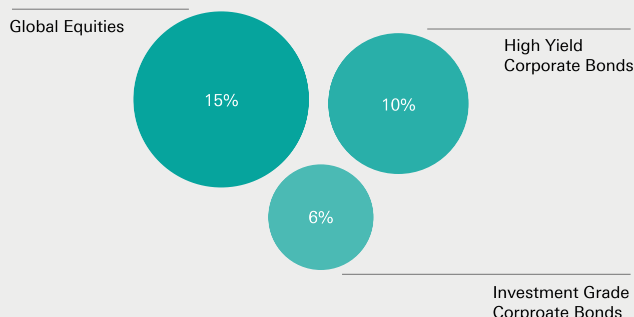
Source: ICE BAML, MSCI, Thomson Reuters, as of 28 Feb 2019.

Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

Note: Asset class performance is represented by different indices in USD: Global Broad Market Corporate Bond index, Global High Yield Bond index, and MSCI World index. Dotcom crash: 31 March 2000-30 September 2002, Financial crisis: 31 October 2007-28 February 2009.

High-quality bonds are a lower risk option

Annualised volatility:



Source: ICE BAML, MSCI, Thomson Reuters, data covers 20 years to 31 March 2019.

Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

Note: Asset class performance is represented by different indices in USD: Global Broad Market Corporate Bond index, Global High Yield Bond index, and MSCI World index. Dotcom crash: 31 March 2000-30 September 2002, Financial crisis: 31 October 2007-28 February 2009.

Key Economic Events

Apr 2019

10 Apr
European Central Bank (ECB) meeting

11 Apr
Indian general election begins

12-14 Apr
Spring meeting of the World Bank Group and the International Monetary Fund

17 Apr
Indonesian general election
175th OPEC meeting

24-25 Apr
Bank of Japan (BoJ) meeting

30 Apr - 1 May
US Federal Open Market Committee (FOMC) meeting

May 2019

2 May
Bank of England (BoE) meeting

23-26 May
European Parliament elections

Jun 2019

6 Jun
ECB meeting

18-19 Jun
US FOMC meeting

19-20 Jun
BoJ meeting

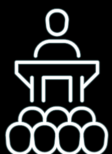
20 Jun
BoE meeting

28-29 Jun
G20 Leaders' Summit

Things we are watching

Central Bank Policy

- Various statements by key central bank members
- Macroeconomic data, in particular for the US and China



Geopolitics

- US-China trade talks
- US protectionism
- Brexit negotiations
- Geopolitical developments in Iran, Venezuela

Glossary

Asset class: a group of securities that show similar characteristics, behave similarly in the marketplace, and are subject to the same laws and regulations. The main asset classes are equities, fixed income, and commodities.

Asset allocation: the allocation of funds held on behalf of an investor to various categories of assets such as equities, bonds and others, based on their investment objectives.

Duration: duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. The longer a fund's average duration, the more sensitive the portfolio is to shifts in interest rates. Duration is expressed as a number of years.

Company fundamentals: the intrinsic value of a company as analysed by looking at its revenue, expenses, assets, liabilities and other financial aspects.

Diversification: often referred to as "not putting all your eggs in one basket", diversification means to invest in a variety of different markets, products and securities to spread the risk of loss.

Dovish: commonly used to describe a conciliatory or unaggressive tone of language, with associated implications for a person's actions. In the case of the US Federal Reserve, a dovish tone suggests the institution is unlikely to take aggressive steps or implement higher interest rates. Opposite of Hawkish.

Fiscal policy: the use of government spending and tax policies to influence macroeconomic conditions such as aggregate demand, employment, inflation and economic growth.

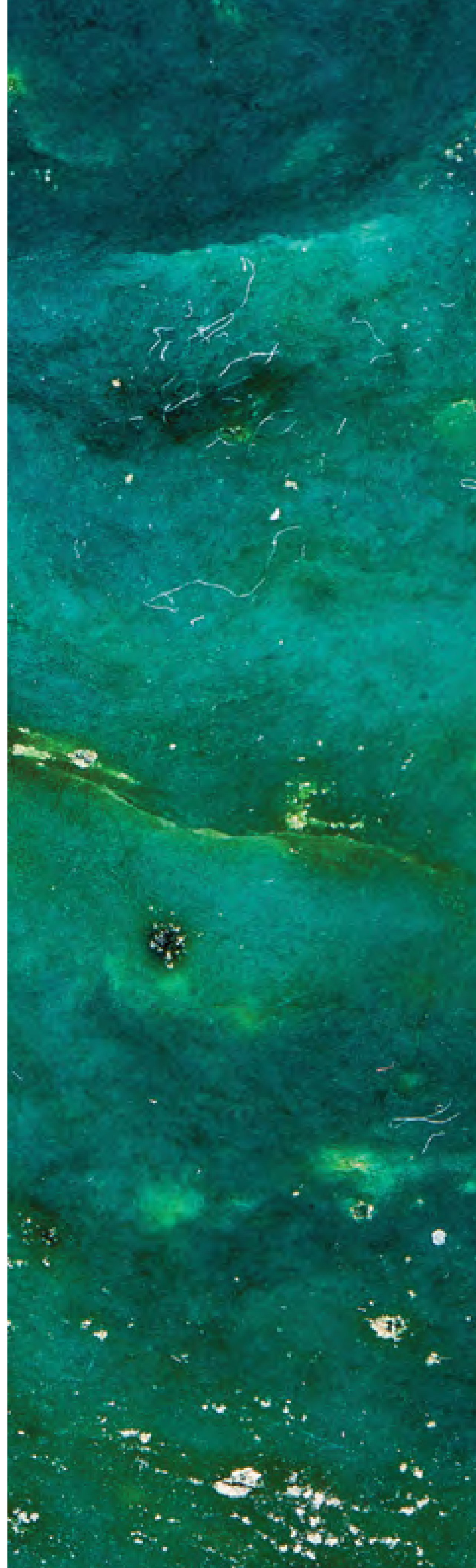
Investment strategy: the internal guidelines that a fund follows in investing the money received from its investors.

Inflation: the rise in the general price levels of goods and services in an economy over a period of time.

Maturity: the date when the issuer of a bond or debt obligation repays the principal (the original amount invested).

Monetary policy: process by which the authorities of a country control the supply of money. This often involves targeting a rate of interest for the purpose of promoting economic growth and stability.

Volatility: a term for the fluctuation in price of financial instruments over time.



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With many years' experience in investment banking, wealth management and financial markets, Jan-Marc has an in-depth perspective on all aspects of the industry. As Deputy Head of Group Wealth Management, he currently leads the development of our investment products, financial planning, and research & insights strategy. He is also responsible for the evolution of HSBC's wealth advisory process.

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Insights and Research Analyst, HSBC Retail Banking and Wealth Management

As the editor of this publication, Simin focuses on helping clients understand global markets to support their investment decision-making. She also leads the production of insights and research for our retail banking and wealth management clients worldwide, ranging from investment strategy to thought leadership.

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Hussain is responsible for global macro and asset allocation research, and contributes to the development of HSBC Global Asset Management's "house view". Prior to joining HSBC in 2015, Hussain was a macroeconomist at Capital Economics and CRU Group in London.

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