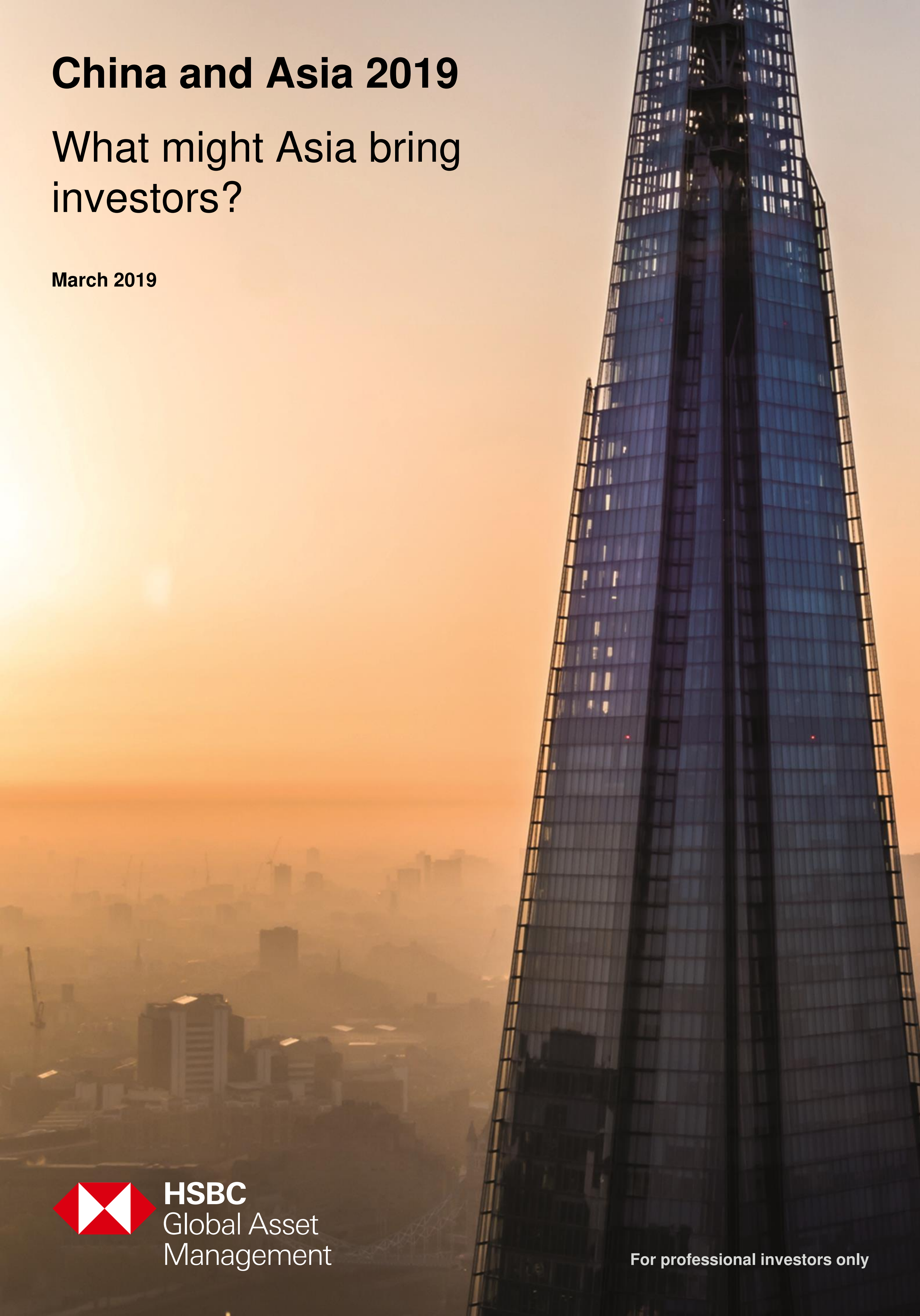
China and Asia 2019

What might Asia bring investors?

March 2019



For professional investors only

Most asset allocators are currently considering the level of exposure they should take to Asia in their investments. To contribute to the debate, HSBC Global Asset Management recently held a roadshow of Chinese New Year events across Europe.

Our Chief Global Strategist was joined by our best minds from Asia to share their analysis of current market conditions and their outlook for the months to come.

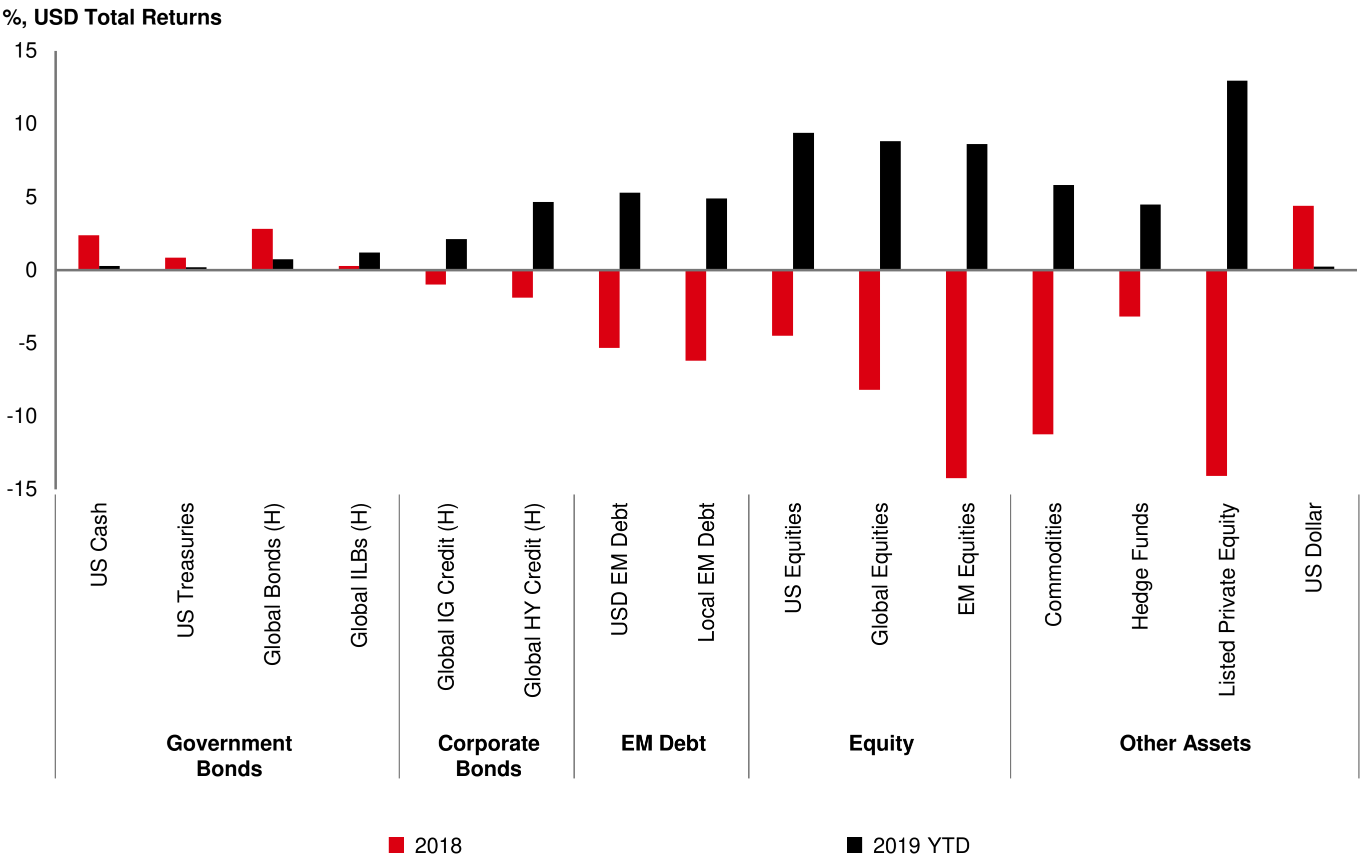
Here are some key takeaways of their thinking.

Investment Outlook 2019 – Back to Reality

Joseph Little, Chief Global Strategist, Global co-CIO multi-asset

It is very interesting to compare asset-class performance over the course of 2018, which was mostly negative, with the same for 2019 to date. Positive performance in just two months this year is almost the mirror-image of the negative performance realised for the whole of last year.

Fig. 1: Asset class performance in 2018 and 2019 year-to-date



In early Q4, markets began to realise that real, inflation-adjusted interest rates were moving significantly higher, which was liable to undermine asset-class performance. This heralded a period of – we believe – overblown fears around the outlook for global growth. In contrast, much of these worries have now lifted, in great part thanks to the US Federal Reserve's (Fed) pivot to a more dovish stance, and very low bond yields, creating a supportive environment for risk assets.

Past performance is no guarantee of future returns.

Source: Bloomberg, HSBC Global Asset Management, February 2019. All asset class returns shown as USD total returns (unhedged) unless stated. (H) - Refers to currency-hedged USD total returns. Any views expressed were held at the time of preparation and are subject to change without notice. Government bonds: Barclay 3m USD LIBOR Cash index (US Cash), Bloomberg Barclays US Treasury Total Return Unhedged USD (US Treasuries), Bloomberg Barclays Global Aggregate Treasuries Total Return Index Hedged USD (Global Bonds (H)), Bloomberg Barclays Global Inflation-Linked Total Return Index Hedged USD (Global ILBs (H); Corporate Bonds: Bloomberg Barclays Global Aggregate Corporate Total Return Index Hedged USD (Global IG Credit (H)), Bloomberg Barclays Global High Yield Corporate Total Return Index Hedged USD (Global HY Credit (H)); EM Debt: J.P. Morgan EMBI Plus Composite (USD EM Debt), J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD (Local EM Debt); Equity: MSCI Daily TR Gross US USD (US Equities), MSCI Daily TR Gross World USD (Global Equities), MSCI Daily TR Gross EM USD (EM Equities);
Other Assets: Bloomberg Commodity Index Total Return (Commodities), Credit Suisse Hedge Fund Index (Hedge Funds), Listed Private Equity Index USD TR (Listed Private Equity), Dollar Index (USD).

Where are we now?

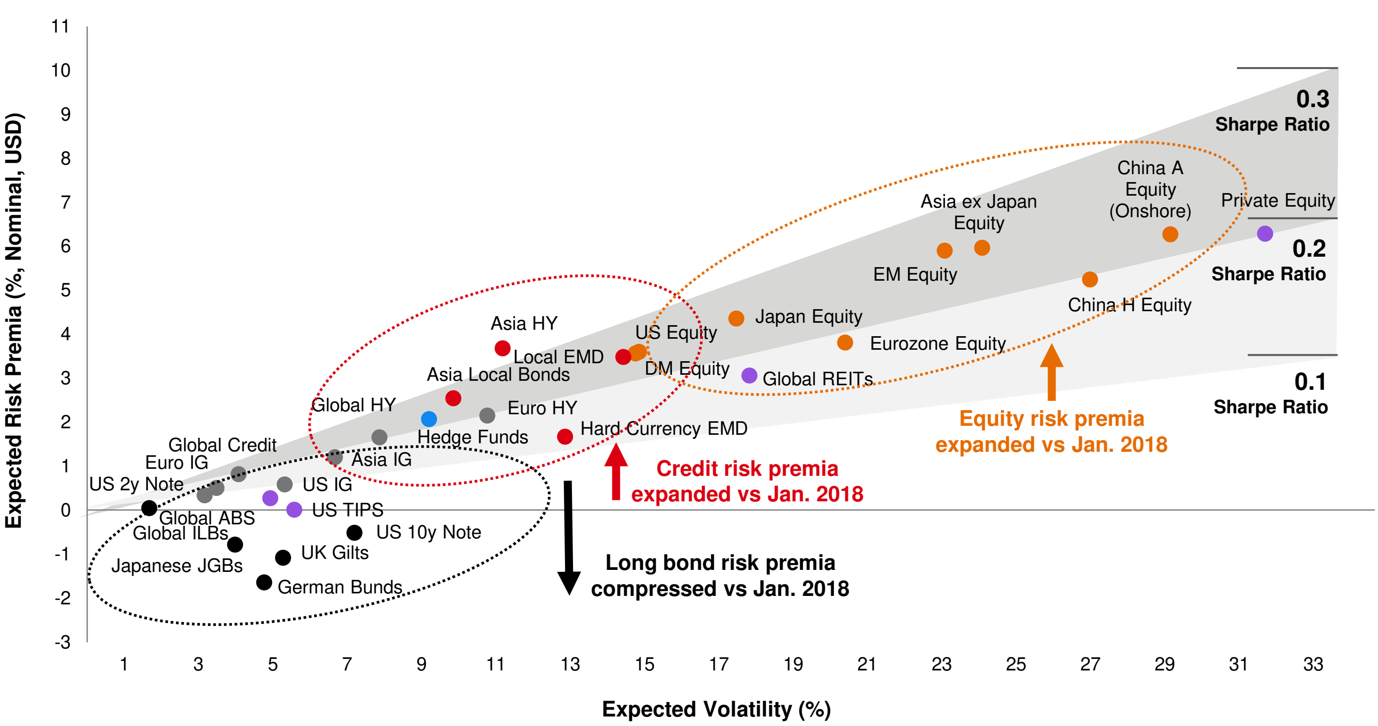
Our Global Nowcast indicates that we are not in recession, but rather in a phase of cyclical slowdown. This means that even if growth is more muted than a year ago, it remains decent, providing a supportive environment for profit growth and credit defaults alike. In addition, there are signs that the trend is improving, particularly after the monetary policy pivot. One point of concern remains euro-area growth, particularly because additional policy support would be hard to find.

In this environment, we continue to monitor recession risks, trade tensions and the Chinese macroeconomic backdrop, but we believe the key risk is that of cyclical inflation. It remains completely overlooked by markets so far, which makes it even more potentially disruptive.

The impact on valuations

Valuations to date reflect the market's strong expectations that inflation will remain low, and continue to price in some growth concerns. This is most obvious in long-term government bonds, for which the risk premium is very negative. Coupled with the very low returns they offer, this means bonds cannot fulfil their traditional role of true portfolio diversifiers – these perceived "safety assets" are no longer safe. In contrast, we see a number of opportunities in risk assets.

Fig. 2: market-implied risk premia



*Global Fixed Income assets are shown hedged to USD. Local EM debt, Equity and Alternative assets are shown unhedged
Source: Bloomberg, HSBC Global Asset Management, as at February 2019. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way.
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Back to reality

Our views on markets and the economy can be summarised in three macroeconomic themes and three investment themes. In terms of macro trends: (1) we are going "back to reality" as growth and inflation move toward trend although we need to watch the eurozone closely; (2) global policy settings are now relatively dovish; and (3) the global economy is reliant on the "two engines" of China and the US. The environment is tricky, and we are expecting more volatility.

In terms of investment themes, first, because we continue to believe in growth, albeit more subdued, and because some growth-sensitive asset classes materially cheapened during 2018, we want to select assets which reflect this, but at a reasonable price. Second, as discussed, we no longer think "safety" assets are safe. Third, we can now buy some short-duration, defensive asset classes at better prices, and we want to use this opportunity to build more resilience into our portfolios.

China and Asia 2019 – The moment of truth

Bill Maldonado, CIO Asia-Pacific and Global CIO Equities

Growth in China has slowed somewhat but remains solid, as it does across Asia.

Are trade tensions a factor?

The market narrative telling us that trade tensions are driving a Chinese slowdown is in fact incorrect. First, it has been a relatively minor slowdown. Second, it has been driven mainly by regulatory tightening: growth in 2017 was very strong, and policymakers used the opportunity to tighten regulations where imbalances existed, such as shadow banking wealth management products or retail leverage in the equity market. This slowed the economy slightly, whilst making it more robust for the future, although in 2018, the global slowdown put a further brake on growth. Overall, there has been very little evidence that trade tensions have contributed to the situation other than through sentiment.

Is another Asian crisis around the corner?

Despite growth data in China being somewhat mixed, inflation remains very well behaved and there is no need for central bank action. We think fears of a repeat of the 1998 financial crisis are simply unfounded, as the Chinese economy – and others in Asia – are much more robust today than they were two decades ago, with, for instance, a much healthier balance of payments.

What are the risks?

There are of course some issues in China (as there are in all economies), they are just different from the ones prevalent in market narratives. One of the most fundamental issues is that the state plays too big a role in the economy. One way it could loosen its grip would be to cut taxes; another would be through gradual cuts in the RRR, which is a particularly burdensome rate compared to other markets. Finally, it is interesting to note that despite its size, the Chinese economy is generally funded by a handful of state-controlled banks. To resolve this issue, we think it is crucial for China to continue opening up its capital markets.

What does the year of the pig hold in store for China?

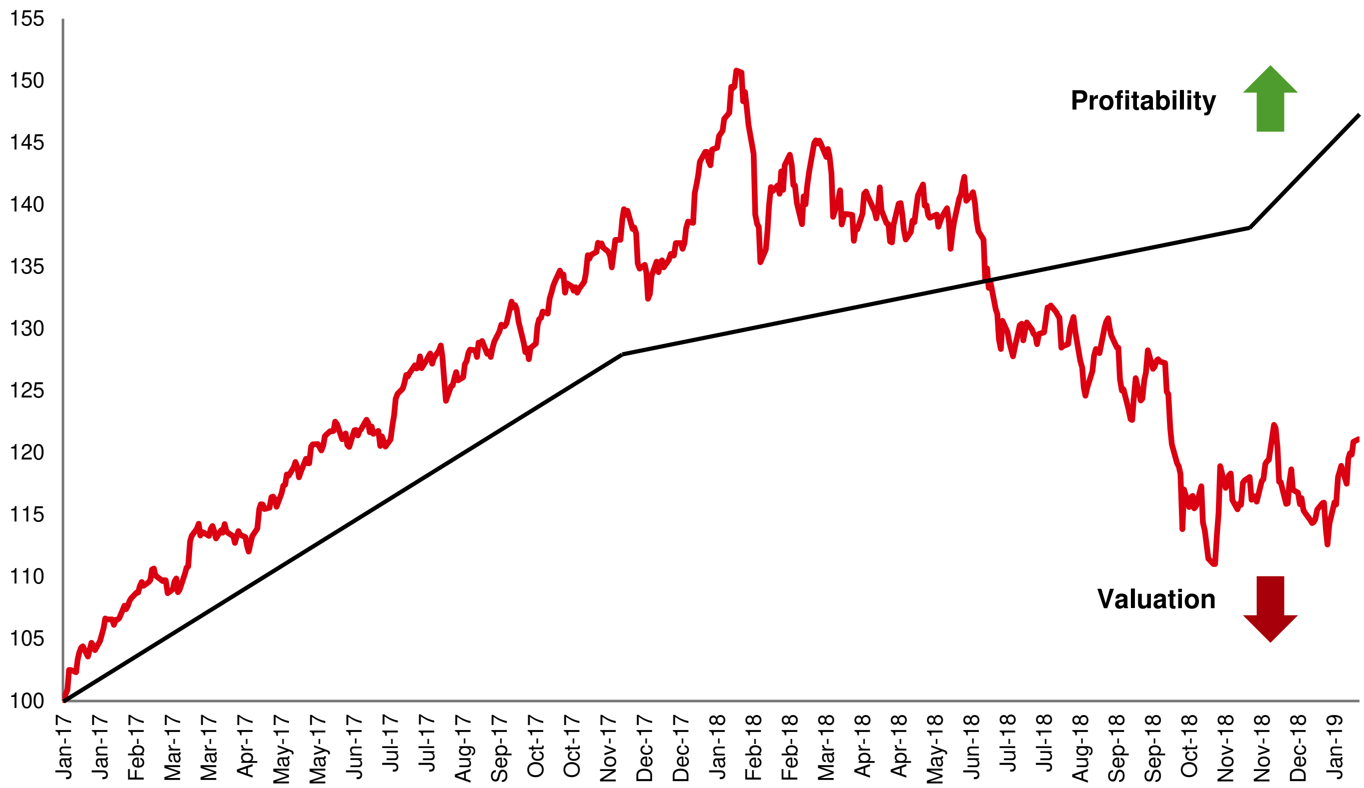
Our view is that economic rebalancing will continue this year, in a context of robust fundamentals and supportive policy, while inflation will remain at bay. We believe credit growth will recover as the state reduces its emphasis on deleveraging the economy. Meanwhile, government policy has recently shifted, giving SOEs clear profit-driven objectives for the first time, leading to a rapid improvement in SOE profitability. Another key trend is the significant rebalancing of the economy to the “New Economy”, notably through FDI. An ever greater share of economic activity stems from sectors such as services, retail, scientific research or real estate.

With regards to the RMB, current account surpluses have shrunk, as has net FDI, helping the currency be more balanced. It has also seen significant inflows, particularly since the inclusion of China in key indices. Interestingly, by the end of the inclusion process in three years’ time, China will represent more than 30% of the MSCI Emerging Equity index, making it far too large to ignore.

Corporate profitability continues to rise

We are seeing a large disconnect between market pessimism on China and rising corporate profitability in an environment with sound fundamentals. Since Q2 2018, Chinese equity valuations have been falling despite the fact that corporate profitability has improved by 15% compounded annually for the last three years.

Fig. 3: rising profits, falling markets in the year of the dog



Investment involves risk. Past performance is no guarantee of future returns
Source: Bloomberg, HSBC Global Asset Management, January 2019.

We see two other compelling reasons to increase Chinese equity exposure: first, ROEs can continue to improve as long as global growth remains decent and, second, corporates pay high dividends, which are an important part of total equity returns in Asia.

Asian Fixed Income – Losing its lustre or finding its feet?

Geoff Lunt, Senior Product Specialist, Asia Fixed Income

2018 was overall a dim year for fixed income, and Asia was no exception. Asian corporate bonds fared better than US ones, mainly because of their lower duration, whilst Asian high-yield (HY) bonds underperformed US HY. However there were some areas of strength, particularly China, where RMB bond market performance remained positive despite USD strength.

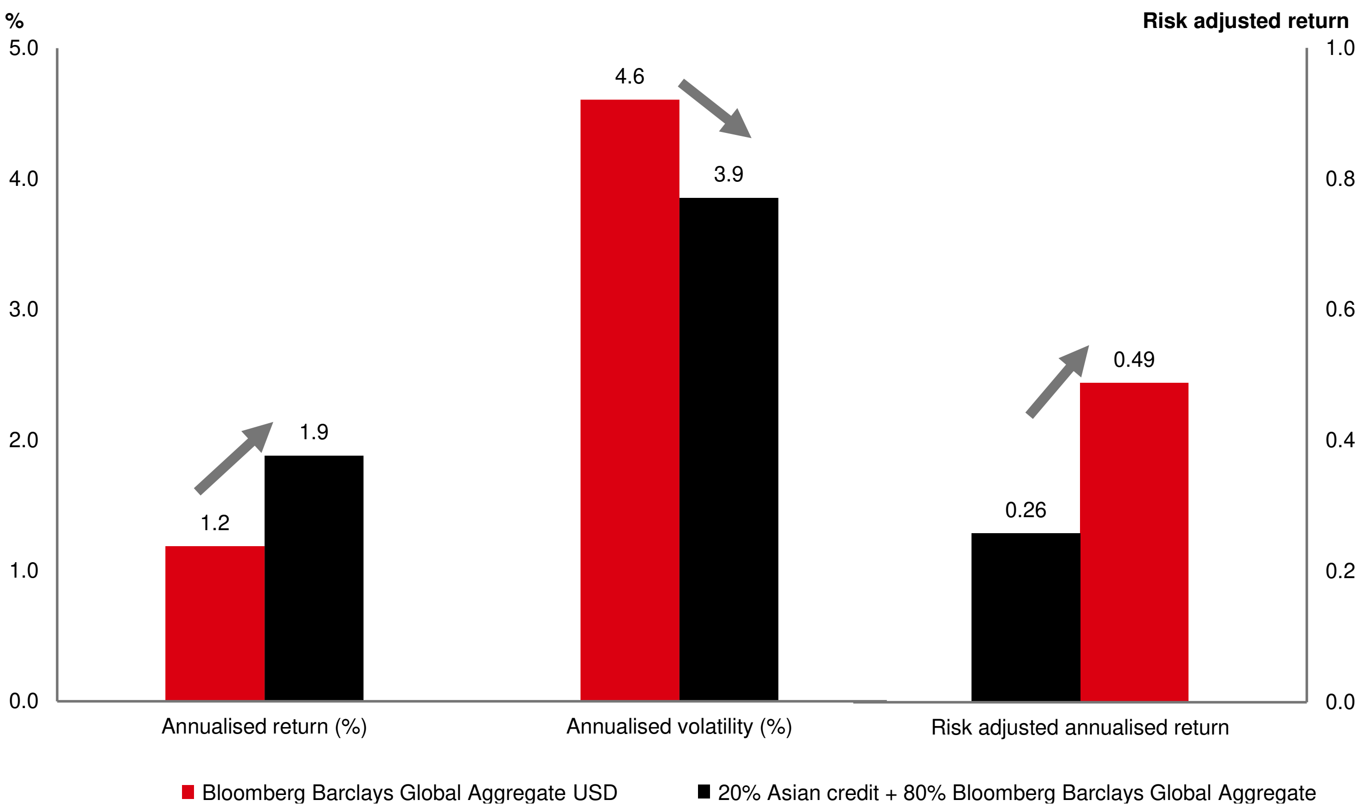
The main drivers of lower performance in 2018

Geopolitics did not really impact markets in 2018, as other drivers held far more sway over performance. First, US interest rate rises impacted markets across the board. The good news is that the Treasury curve has now largely discounted rate rises, which should mute the impact of further tightening. Second, although much of the underperformance was due to idiosyncratic factors (e.g. Argentina or Turkey), all emerging markets were tarred with the same brush – and spreads are now much wider.

2019 is seeing a dramatic improvement

Asian HY is already returning 4.5% year-to-date. Yields have now fallen, but Asian credit remains very compelling compared to the rest of the world, particularly in HY markets. Asian HY also remains attractive compared to its five-year average on a pure valuation basis.

Fig. 4: Adding 20% Asian dollar credit to a global bond portfolio



Simulated results do not represent actual returns and should not be seen as an indication of future returns. Investment involves risk and past performance is not indicative of future performance.
For illustrative purposes only. Source: Barclays Bloomberg Global Aggregate Total Return Index USD unhedged, JACI Total Return Index, HSBC Global Asset Management, for the past 5 years as of 31 January 2019.

Looking at risk, analysis shows that Asian corporates are not overleveraged. Default rates do not look to be rising, and Asian assets offer similar credit quality for a better price than their developed market peers. Generally speaking, a lot of credit fundamentals have also improved, though some individual bonds remain too dangerous, and careful bottom-up analysis is crucial.

China's inclusion in the Bloomberg Global Aggregate index is a tipping point

In bond-market terms, China is set to end up representing around 7% of global investors' benchmarks. Over time we expect inflows to rise dramatically – to the tune of USD150 to USD300 billion, particularly if other indices follow suit.

Inclusion will gradually happen between now and November 2020, and the Chinese assets included will initially only be constituted of sovereign and some quasi-sovereign bonds. On an unhedged basis, the exposure will thus allow for yield gains without compromising on quality. The asset class is also supported by strong economic fundamentals, whilst inflation in China remains very low. We think Chinese inclusion is a great opportunity to truly diversify from hard currencies.

Don't forget India

Indian fixed income is another interesting asset class to consider, offering higher yields than most, whilst the controlled market access limits correlation to other emerging market bonds and inflation is only at 2%. Today, the low levels of inflation are supportive of the INR, and mean we could soon further cuts in the policy rate.

An asset class which deserves more attention

Overall, we believe Asian fixed income deserves more interest, and that it can improve portfolio performance, but investors need to understand these markets and the differences between them.

China – A real opportunity?

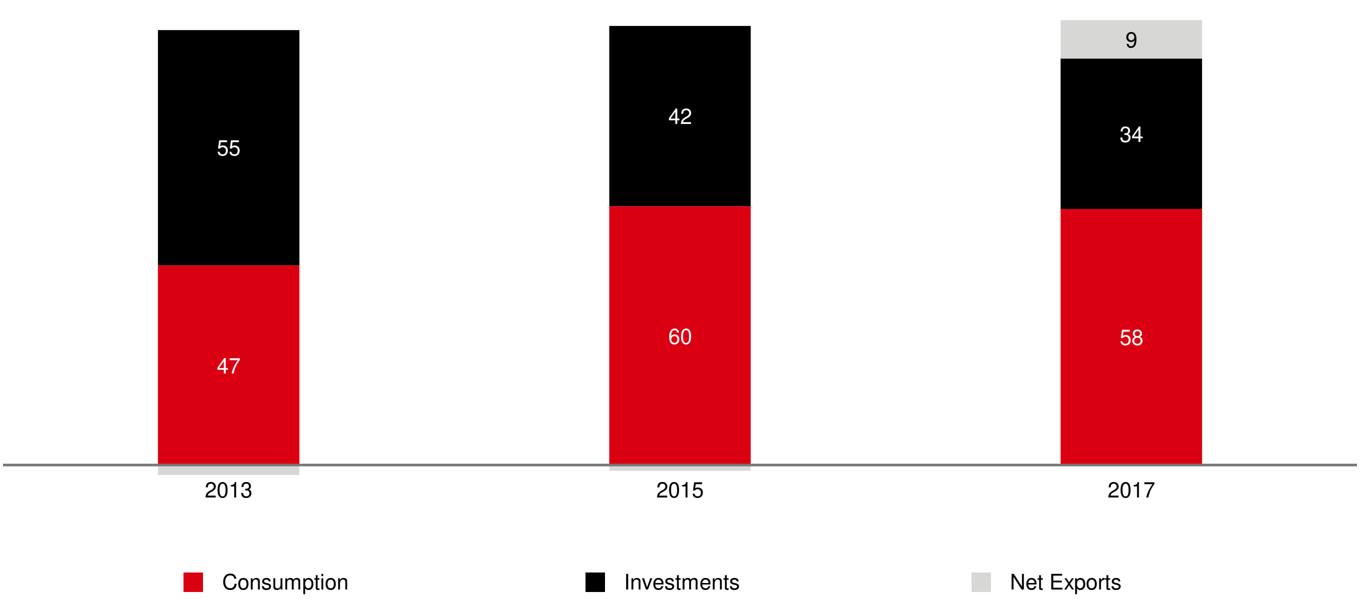
Steve Lee, Head of China and Taiwan

Growth is a theme of particular importance for the outlook on China, revolving around three questions: Can it continue? What are China's sources of growth? How can China sustain its growth levels? To answer these, it is important to look back on China's recent history. In 2018, the country celebrated the 40th anniversary of its market reform and opening up, initiated by Deng Xiaoping in 1978. The generation who came of age in 1978 – which includes the country's current leaders – witnessed an uninterrupted period of strong economic growth and the country's transformation as a result, as have the following generations. In consequence, growth is the highest priority both for China's people and its government, who will take all necessary measures to support it.

Net exports contribute little to China's growth

Despite market noise around the impact of trade tensions, net exports contribute far less than consumption and investment to China's growth. In addition, China is well on the way to its rebalancing, and is already more of a services-led than a manufacturing-led economy. In this context, we see two key drivers of growth to sustain the economy going forward.

Fig. 5: Contribution to GDP growth (%)



Source: National Bureau of Statistics of China, January 2019.

The key drivers of innovation are in place

Innovation will be essential to sustain China's growth, and the country benefits from a number of crucial supporting factors to drive it.

First, there is a large domestic market, with c. 800 million internet users, 98% of whom access the web from a mobile device. This encourages innovation or risk-taking, as a successful offering has the potential to reap extremely large rewards.

Second, China has a highly educated workforce. Many workers have strong backgrounds in STEM and have studied both at domestic and foreign universities, going on to have careers in the private and public sectors. They are key to supporting innovation, as illustrated by successes such as China's EV production or high-speed rail technology.

Third, investment in R&D is quickly catching up with the rest of the world, and both the anniversary of market reform and the recent tensions around IP have led to a debate in China around future direction. Many view IP tensions as a positive, bound to increase protection for China's existing and future patents at a time of rising R&D investments. China is just behind the US in terms of total R&D spending in cash terms, and patent applications have increased five-fold over the last ten years.

Finally, private market investment has increased significantly over the last few years, and many Chinese firms today are in the "unicorn space", in areas as diverse as robotics, education, consumer electronics, AI and fintech.

Consumption is driving economic growth

Not only are Chinese consumers buying more everyday products and services, from pet-care products to sportswear, they are also increasingly buying local: if there is an offering of quality, they tend to buy domestic. Their spending power is continuing to increase as well, and is due to reach US levels by 2035.

With political will, a large market, growing private investment and consumption, a highly-educated workforce and increasing R&D investments, China benefits from very strong support to sustain its innovation- and consumption-led growth story in years to come.

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