Recovering and Rebuilding

Investment Outlook
First Quarter 2021

HSBC
Private Banking

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Click below to watch our Chief Market Strategists team discuss our market views for 2021.

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Welcome

Dear client

After a turbulent 2020, markets have started to look forward to friendlier fundamentals. Global economic growth is improving, and broadening beyond manufacturing and the digital economy. The vaccine should allow consumer confidence to pick up, and the all-important consumer sector to become an additional engine of growth. At the same time, governments are rebuilding their economies, and the healthiest companies are investing to adapt to the new post COVID-19 realities and opportunities. All of this means that the global economy and corporate profits should be bigger and healthier in 2021 than they are currently.

The other piece of good news for riskier assets is that policy rates should remain very low and stable, with US Treasury yields trading in a broad range. Rising profits, combined with low rates, are a powerful combination for risk assets. We therefore maintain our overweight on global equities, investment grade and BB-rated corporate bonds, and EM hard currency bonds.

That does not mean that 2021 will be uneventful. First, the vaccine rollout is unlikely to be an entirely smooth process, and any delay or disappointment in adoption rates could lead to some temporary market volatility. Second, we foresee some temporary upside in inflation readings early in the year, as crude oil's fall from $70 to $20 between January and March 2020 will cause year-on-year base effects between January and March 2021. Third, corporate default rates will probably go up further, before they come down. Fourth, on the political front, Brexit, the new US administration's foreign policy, Georgia's Senate race or frictions with Congress, can all lead to political headlines. And lastly, of course, the run-up in valuations to date can lead to profit taking and adjustments in investor positioning.

All of these factors can lead to volatility, which means that investors need to remain selective and diversified, but it also means that 2021 will present hedge funds with a rich opportunity set. Importantly, none of the potential triggers of volatility we listed above challenge our two fundamental assumptions, that profits will expand and interest rates will remain low. And as long as those two assumptions are valid, it is appropriate to maintain an overweight stance to risk assets and a cyclical sector bias.

The broadening of the economic expansion is naturally also broadening the sector leadership in the stock markets, and we thus hold overweight positions in technology, industrials, materials, consumer discretionary and communication services. But this broadening does not mean that technology – which had been principal engine of stock markets – will underperform in 2021. The digital revolution continues unabated, and technology leaders should continue to see strong growth in the medium term. These tech leaders can be found outside of the tech sector as well, in areas such as automation, health technology and 5G. Technological leadership is one of the key determinants of whether a company is fit for the future. By contrast, we note that many value stocks have outdated business models and investors should beware of falling into such value traps.

Businesses that want to be future-proof not only need to be part of the digital revolution, but also the sustainability revolution. And in our view, their performance will be better if they aren't just part of it, but if they lead it. This is because such businesses that rank best in class will be earlier to identify the ESG-related threats and opportunities, and be more likely to have the talent to adapt to them. For investors, sustainability not only matters because it is a strong and durable trend, but also because 2021 should be a pivotal moment for sustainable investing, due to strong government commitments, rapid technological advances in this area, and the major expansion in investment options.

We continue to see many interesting investment opportunities in EM Asia, which we prefer over other emerging markets. China's dual circulation strategy, focused on measures to boost domestic demand, technological innovation and market liberalisation should boost growth, give long term direction to investors and lead to fund flows into the region.

So, although the uncertainties and changes around us may leave some investors uncomfortable, it is clear that there are plenty of specific areas where companies can do well. And on the aggregate, the cyclical improvement and a strong commitment from central banks to low interest rates not only support the current high valuations of most risk assets, but also keep us invested with an eye on further upside in riskier assets. Holding lots of cash is not the answer to managing the volatility we will undoubtedly experience in 2021. Rather, we remain invested with a pro-risk and cyclical stance, but with a selective approach and plenty of diversifiers, including gold, high rated bonds, hedge funds and other alternative assets.

We would like to wish all of our clients a happy and prosperous New Year.

Willem Sels,
Global Chief Market Strategist

10th December 2020

What will drive markets in 2021?

The basics

Economic outlook:

» **Recovering:** Manufacturing has been stronger than services. Online consumption has been resilient, especially in the US and China. In 2021, the rollout of vaccines against COVID-19 should gradually boost consumption, and hence broaden the recovery.

» **Geographical split:** economic momentum is most positive in the US and China, with China contributing most to global GDP growth in 2021. Europe may accelerate later in the year but COVID is a major challenge for now.

» **Rebuilding:** Fiscal spending is supportive of growth, and is likely to focus on 5G, green infrastructure and housing support. In some EM countries, the scope for fiscal support is more limited. Companies will also invest for the new economic realities, in areas such as automation, supply chain relocation, 5G and data capabilities.

Interest rates and bond yields:

» In developed markets (DM), we expect low and stable interest rates, and central bank support to keep safe haven bond yields low.

» Higher government debt and deficits should not lead to inflation in DM. Some cost pressures and oil price base effects could lead to a small uptick in headline CPI and to temporary bond market volatility, but this should not trigger a change in central bank policy.

» In EM, there is now reduced scope for further rate cuts. In some countries, inflation could pick up following currency depreciation, and the higher weight of oil in their CPI measures when compared to DM.

Risk premia:

» With the US elections and Brexit behind us, and reduced geopolitical uncertainty, risk premia may fall, leading to a relief rally in risk assets and carry assets (especially when there is better news re: COVID).

Equities

» Market cap: the relatively high weight of technology stocks favours US and Chinese benchmarks

» China's Dual Circulation strategy supports consumer demand, which could be helpful for Western firms too. Financial market liberalisation should be a positive for CNY. In technology however, China has a desire to localise core technologies.

» Income through equities: dividends could be raised selectively, and a search for income can help REITs with resilient fundamentals

We expect a global recovery and believe inflation should remain relatively low.

	Real GDP growth			Inflation		
	2020f	2021f	2022f	2020f	2021f	2022f
World	-4.1	4.4	3.3	2.5	2.6	2.6
Developed	-5.7	3.5	2.5	0.7	1.3	1.5
Emerging	-1.8	5.7	4.3	3.7	3.5	3.3
US	-4.1	3.1	2.5	1.2	1.8	1.8
Eurozone	-7.5	4.5	2.8	0.2	0.7	1.4
UK	-11.0	3.7	4.8	0.9	1.5	1.9
Japan	-5.5	2.3	0.8	0.0	0.1	0.1
Mainland China	2.4	7.5	5.6	2.7	2.0	1.7
India	-8.0	7.2	4.5	5.7	4.2	4.4
Russia	-4.3	2.4	1.3	3.2	3.5	3.5
Brazil	-4.2	3.2	2.3	2.7	2.6	3.4

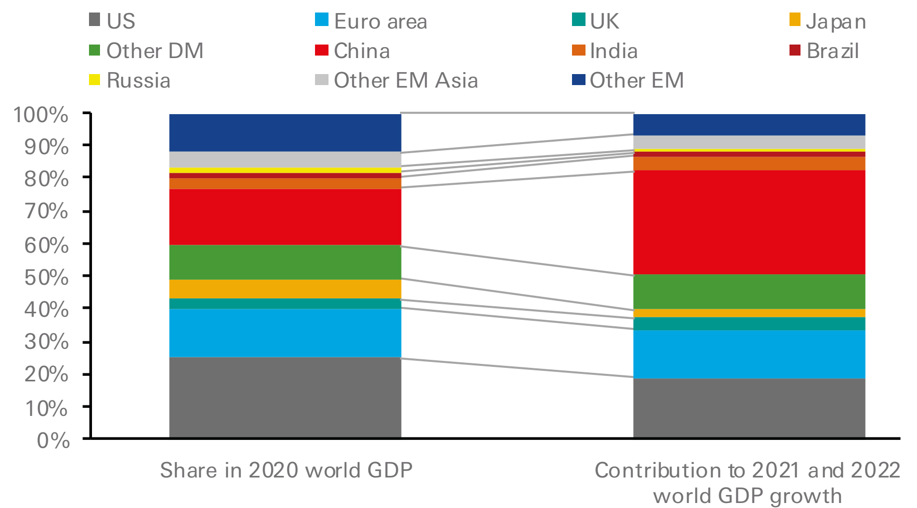
HSBC Global Research, HSBC Private Banking as at 9 December 2020. Forecasts are subject to change.

Sustainability for a better future

» Investor flows and investor scrutiny will force companies to become more sustainable, and will increase share price performance differentiation between firms with high or low sustainability scores.

» Commitments in the 2015 COP21 Paris agreement, and the upcoming UN COP26 Climate Change Conference in the UK will continue to lead to large public investment. Our high conviction themes include Climate Change - Mitigation and Adaptation Opportunities and China's Green Revolution.

China currently accounts for 18% of global GDP, but may be responsible for 32% of the world's growth in 2021 and 2022.



Source: IMF, HSBC Global Research, HSBC Private Banking as at 9 December 2020.

What to watch

The question of rotation:

In 2020, there were several short-lived episodes of market rotation from large cap to small cap, from high quality to lower quality stocks, and from growth to value stocks. None of those were sustained, and we think investors should remain selective when participating in this rotation. We doubt that bond yields will move higher to support the rotation, and we think growth stocks have structural support.

Downside risks:

» **Path of the virus and speed of the vaccine rollout:** it remains unclear how quickly the vaccine rollout will halt lock-downs, when the active population will be vaccinated and how much it lifts consumer confidence and spending.

» **Corporate defaults:** markets currently anticipate a spike in defaults, followed by quick fall. There is a risk that this fall could be delayed.

» **Potential EM stress:** COVID-19 related economic or financial stress could lead to wider spreads and falling currencies in some weaker EM countries

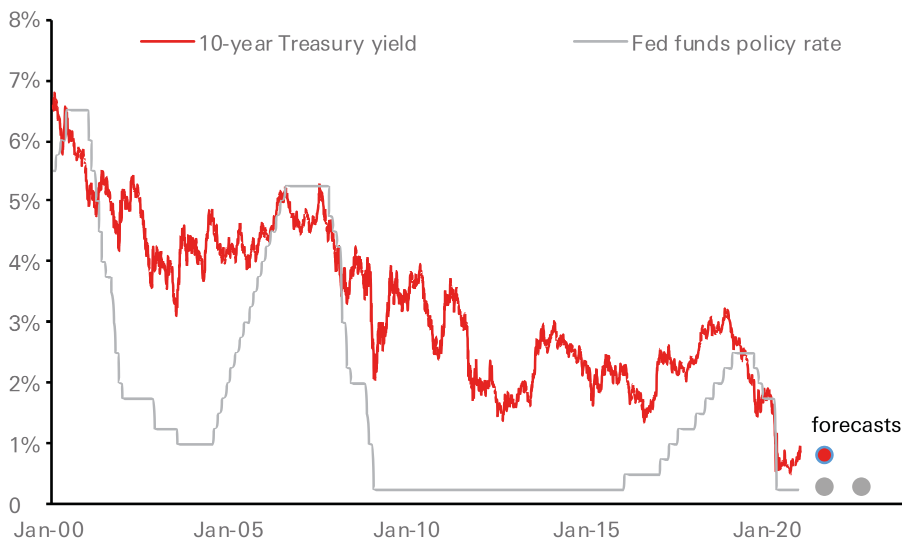
» **Climate risks:** there are bound to be natural disasters in 2021, which will trigger more regulation and investment, or accidents which could hurt specific companies

» **Taxation** will have to increase at some point to finance the increased deficits. This will probably have to wait till 2022, but fears of tax rises could hit confidence.

» The new US administration will likely take a multi-lateral foreign policy approach, but geopolitical risks have not been eliminated.

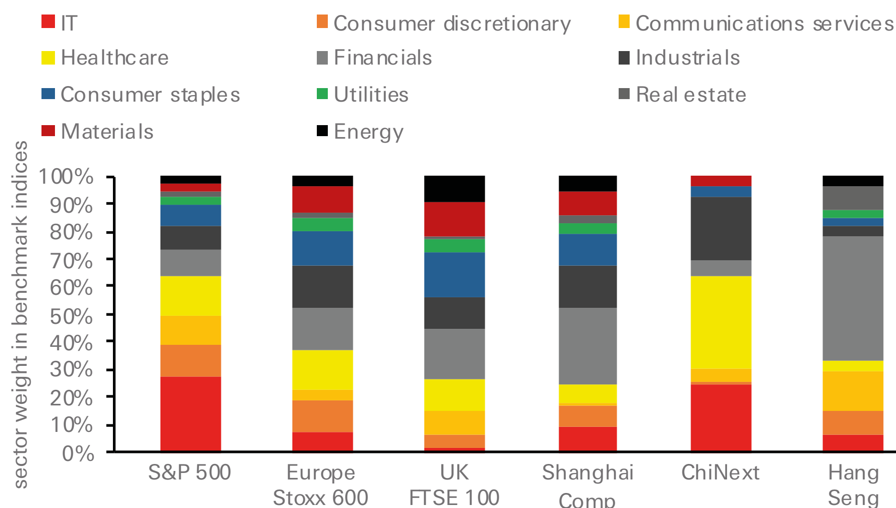
» Positioning and valuations: when market optimism is elevated, and momentum has driven markets towards new highs, there is a risk of profit taking and temporary market volatility.

We believe Fed rates will remain unchanged in 2021, and Treasuries should range trade.



Source: Bloomberg, HSBC Private banking as at 9 December 2020. Past performance is not a reliable indicator of future performance. Forecasts are subject to change.

How tech and new economy stocks fare will impact the relative performance of equity indices.



Source: Bloomberg, HSBC Private Banking as at 9 December 2020.

Portfolio Strategy Top 10 Tips for 2021

1 Ride the 'Recovery and Rebuilding' wave

We have a risk-on stance in our model portfolio, with overweights in global equities, investment grade and BB-rated high yield bonds, and hard currency emerging market bonds. We fund this principally through our underweight on safe haven bonds. In equities, we have a cyclical sector stance. All of this is based on our view that the global economy is recovering and rebuilding, earnings should improve and equity and credit valuations are supported by the low yield environment.

2 Asia stays Ahead

We continue to prefer Asian equity markets over other EM stocks. Asia's growing middle classes boost domestic demand and Asia has a bigger share of technology and advanced manufacturing than in other EM markets. China's dual circulation plan sets a clear direction and should boost investor confidence. And Asian countries on average have more policy flexibility than other EM. Investors are still underweight on EM assets and as they broaden their search for returns in a risk-on environment, Asia should see inflows.

3 Low for a Lot Longer

We stick to our view that bond yields will be kept low by structural factors, and that stronger growth should not push up G7 policy rates. We believe the 10-year Treasury yield will largely range-trade below 1% in 2021. We react to this environment in three ways. First, we avoid holding high cash balances, as the low cash rates present an opportunity cost. Secondly, we look for a yield pickup in Investment Grade, BB High Yield and EM Hard Currency bonds. Third, we see opportunities in stocks with resilient dividends, selective REITs, real estate and private credit.

4 Stick to the Strategy

We believe it is helpful to keep the positive growth and rate fundamentals in front of our minds throughout 2021 to avoid being blown off-course. We foresee volatility on several fronts, but much of it may be noise. During 2021, oil price base effects may give the impression that inflation is picking up, and the economic recovery may trigger speculation about policy normalisation. But ultimately, the low for longer rate environment should prevail. COVID-19 related and other headwinds could create headlines, but ultimately, the gradual recovery should prevail.

5 Digital Dominance

The digital revolution continues to drive much of the profit growth, and separates winners from laggards, across sectors. Although equity leadership is broadening, tech should continue to perform well in 2021.

6 Adopt a Sound Sustainability Strategy

The sustainability revolution is arguably as much as a game changer as the digital revolution. Sustainability should therefore be integrated both in the core portfolio strategy (where it can help investors outperform or reduce risks), and in thematic satellites (focusing on the opportunities).

7 Cheap can be Costly

Our cyclical sector tilt does not mean that we move into low quality. We maintain our focus on quality. Strong balance sheets will be important if COVID-19 keeps cash flow below normal, and allow companies to invest and adapt to the changing economy. And while there may be some opportunities in value stocks, we generally continue to prefer growth stocks. We beware of value stocks with outdated business models, which we see as value traps.

8 Don't Give up on Gold

We foresee mild upside for the gold price and maintain an overweight in our model portfolios. Low rates mean the opportunity cost of foregoing a coupon is small. The market volatility we foresee, and the remaining uncertainties around COVID-19 and geopolitics mean that diversification remains important. Many investors have reduced high rated bond exposure, which raises the importance to add gold.

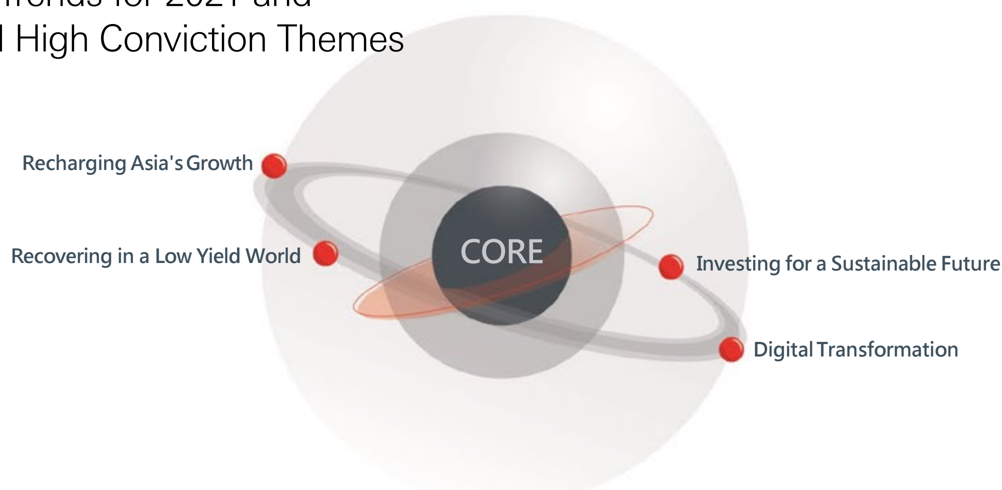
9 Divergent Dollar

The US dollar was strong for many years but fell significantly in 2020. From here, we think it will be more directionless, with diverging paths depending on the currency pair. We think EUR and GBP will see weakness against USD, while AUD, NZD, NOK and SEK should outperform USD.

10 Healthy Fundamentals for Hedge Funds

2021 should provide a rich opportunity set for good hedge fund managers. Markets' focus on where inflation and rates are going can create volatility and opportunities. Hedge funds can pick winners and losers from the changes around COVID-19 and the digital revolution. And defaults and restructuring provide opportunities for distressed hedge fund strategies.

Top Four Trends for 2021 and Q1 Global High Conviction Themes



Recharging Asia's Growth
- Riding on China's Five-Year Plan
- Asia's Supply Chain Revamp
- New Asian Consumer
- Asian Credit Opportunities

Recovering in a Low Yield World
- Reopening America
- Resilient Income
- Focus on Quality
- EM Debt – Carry in a Low Yield Environment
- DM Financials Credit

Digital Transformation
- 5G: NextGen Connectivity
- Healthcare Innovation
- Digital Consumer
- Automation – Shifting up a Gear

Investing for a Sustainable Future
- Climate Change – Mitigation and Adaptation Opportunities
- China's Green Revolution
- Sourcing Income in a Sustainable Way
- Gender Diversity in Business

Asset class	View	Comment
Cash	Underweight	Cash rates are unattractive in most markets and present an opportunity cost.
Government bonds	Underweight	Safe haven government bond yields are likely to mostly range trade at a low level, and provide little attraction. We are mainly underweight to finance the overweight in other asset classes.
Investment Grade bonds (IG)	Overweight	We prefer IG over safe haven bonds to capture the yield pickup. That said, spreads have tightened and investors should be aware that spread or rate volatility can impact returns substantially.
High Yield bonds (HY)	Overweight	We are overweight on BB-rated HY to capture the carry, but believe low rated HY does not adequately compensate for default risk, which we think is still on the rise.
EM Hard Currency bonds (HC)	Overweight	We see carry opportunities in EM HC but focus on countries and companies with resilient fundamentals.
EM Local Currency bonds (LC)	Neutral	EM currencies have a mixed outlook, and this will impact returns. Hence, we remain selective in the EM local currency space.
Equities	Overweight	We are overweight on stocks as earnings should benefit from the economic recovery, and low bond yields should support current valuations. We prefer the US and China over Europe, and Asia over other EM.
Commodities	Overweight	We overweight gold as we see mild upside and appreciate its diversification potential. We have a neutral outlook on oil.
Hedge Funds	Neutral	HF will have a rich opportunity set in 2021 and are an important diversifier in portfolios.

Three hidden insights from the Market Patchwork

Most investors have seen the "market patchwork" chart at least once. One of the key messages in the chart is immediately obvious: performance of individual asset classes is highly unpredictable – in any given year, they can perform either very well or very poorly. Diversifying the portfolio, on the other hand, can help avoid having a very bad year.

However, careful analysis of this chart can also point to several less obvious messages, some of which are quite powerful. In the remainder of this piece, we will discuss three of these "hidden insights" from this chart.

1) Diversifying is important for the long term, not just the short term.

Listed private equity ranks 1st in four different years, but for the overall period its rank is 6. Diversified portfolio's best rank is 3rd in only one single year, its overall period rank is 4, higher than listed private equity. Why is this so? This is because with concentrated investments (such as investments in a specific sector, e.g. listed private equity) long term performance suffers from volatility drag, whilst the diversified portfolio benefits from volatility reduction. As an example, an individual, concentrated asset class could easily sell off by 50%. After that, a 100% return is needed just to break-even. This asymmetry is much smaller when a portfolio is less volatile due to diversification: after a 20% sell-off, a rally of 25% is sufficient to bring us back to the starting point. Volatility drag is the reason why simply investing everything in an asset class with the highest average annual return can lead to disappointing outcomes. This is why diversification is of crucial importance for the long term, not just the short term.

2) Cash outperformed most markets in volatile years such as 2008 and 2018, but remaining invested was key to meeting investment objectives.

Market analysis and forecasts can easily tempt investors to try to liquidate their holdings just before a crash and try to get back in at the lows. But a world in which it is possible to time the markets successfully and consistently would be paradoxical. In such a world, there wouldn't be a risk premium to be earned, and all asset classes would have the same return as cash. In the real world, building a diversified portfolio and remaining invested (both in bad and good times) is the only reliable way of outperforming cash over time, as the rightmost column in the chart would indicate. Indeed, since 2006, the performance of cash lags that of most other asset classes.

3) An individual asset class can do really well even over an extended period of time, but that does not necessarily imply its superiority.

As an example, high yield bonds outperformed the diversified portfolio by a meaningful margin from 2006 to 2020, with a similar level of volatility. But this asset class only represents around 2% of the global, investable equity and bond markets. Superior performance of a narrow asset class or sector may be an outcome of chance, even over a relatively long time horizon. In the case of high yield debt, this strong performance may have been driven by one-off forces, such as an increase in demand for high yield bonds, as the asset class gradually emerged into the mainstream. And while interest rates should stay low, we do not believe they can fall much further over the next decade. On a forward looking basis, a multi-asset portfolio allows investors to cast a wider net and capture a broader opportunity set, thereby minimising unrewarded, idiosyncratic risk.

Market Patchwork.

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020 YTD	Ann. Return (2006-2020.YTD)
Listed Private Equity 31.5%	Gov Bonds 5.8%	EM Hard Currency Debt 43.9%	Listed Private Equity 37.2%	Listed Real Estate 15.9%	Hedge Funds 2.0%	Listed Private Equity 15.4%	EM Equities 37.8%	Gov Bonds 2.7%	Listed Private Equity 46.6%	DM Equities 11.7%	DM Equities 7.7%
Listed Real Estate 20.4%	Investment Grade Bonds 4.9%	Listed Private Equity 31.3%	DM Equities 27.4%	Gov Bonds 8.3%	Gov Bonds 1.3%	High Yield Bonds 14.4%	Listed Private Equity 26.1%	Cash 2.6%	DM Equities 28.4%	EM Equities 10.5%	High Yield Bonds 7.4%
EM Equities 19.2%	High Yield Bonds 4.1%	Listed Real Estate 28.7%	Hedge Funds 9.3%	Investment Grade Bonds 7.7%	EM Hard Currency Debt 0.7%	Commodities 13.3%	DM Equities 23.1%	Leveraged Loans 0.5%	Listed Real Estate 23.1%	Investment Grade Bonds 7.6%	EM Hard Currency Debt 6.7%
Commodities 18.9%	Leveraged Loans 1.5%	EM Equities 18.6%	Diversified portfolio 8.6%	EM Hard Currency Debt 7.2%	Cash 0.4%	EM Equities 11.6%	EM Local Debt 15.2%	Investment Grade Bonds (0.9%)	EM Equities 18.9%	Hedge Funds 6.0%	EM Equities 6.5%
EM Local Debt 15.7%	Cash 0.4%	High Yield Bonds 18.4%	High Yield Bonds 6.2%	DM Equities 5.5%	Listed Real Estate 0.1%	Leveraged Loans 10.1%	Diversified portfolio 14.2%	Hedge Funds (1.1%)	Diversified portfolio 16.9%	Gov Bonds 5.4%	Diversified portfolio 6.4%
High Yield Bonds 14.5%	Hedge Funds (1.7%)	EM Local Debt 16.8%	Leveraged Loans 5.3%	Hedge Funds 5.0%	Investment Grade Bonds (0.2%)	EM Local Debt 9.9%	Listed Real Estate 11.4%	High Yield Bonds (1.7%)	High Yield Bonds 14.7%	Diversified portfolio 5.3%	Hedge Funds 6.2%
Diversified portfolio 13.1%	EM Local Debt (1.8%)	DM Equities 16.5%	Listed Real Estate 4.4%	High Yield Bonds 3.4%	DM Equities (0.3%)	EM Hard Currency Debt 9.1%	Hedge Funds 9.6%	EM Hard Currency Debt (3.7%)	EM Hard Currency Debt 14.5%	High Yield Bonds 5.0%	Listed Private Equity 5.8%
DM Equities 12.3%	Diversified portfolio (3.4%)	Diversified portfolio 15.4%	Cash 0.4%	Diversified portfolio 2.9%	Leveraged Loans (0.7%)	Diversified portfolio 8.3%	EM Hard Currency Debt 9.3%	Listed Real Estate (4.7%)	EM Local Debt 13.5%	EM Hard Currency Debt 3.9%	Investment Grade Bonds 5.3%
EM Hard Currency Debt 11.8%	DM Equities (5.0%)	Investment Grade Bonds 10.8%	Investment Grade Bonds 0.0%	Leveraged Loans 1.6%	High Yield Bonds (1.0%)	DM Equities 8.2%	High Yield Bonds 7.8%	Diversified portfolio (4.8%)	Investment Grade Bonds 12.5%	Leveraged Loans 1.8%	Listed Real Estate 4.9%
Hedge Funds 11.6%	Listed Real Estate (5.8%)	Leveraged Loans 9.6%	Gov Bonds (0.3%)	Cash 0.3%	Listed Private Equity (1.7%)	Investment Grade Bonds 6.1%	Investment Grade Bonds 5.7%	EM Local Debt (6.2%)	Commodities 10.1%	Cash 1.2%	EM Local Debt 4.9%
Leveraged Loans 10.1%	Commodities (8.0%)	Hedge Funds 7.3%	EM Equities (2.3%)	Listed Private Equity (0.1%)	Diversified portfolio (3.3%)	Listed Real Estate 5.0%	Commodities 4.4%	DM Equities (8.2%)	Leveraged Loans 8.6%	EM Local Debt (0.3%)	Leveraged Loans 4.6%
Investment Grade Bonds 7.4%	EM Hard Currency Debt (11.9%)	Gov Bonds 4.4%	EM Hard Currency Debt (6.0%)	EM Equities (1.8%)	EM Equities (14.6%)	Gov Bonds 3.9%	Leveraged Loans 4.1%	Commodities (8.9%)	Gov Bonds 7.2%	Listed Private Equity (0.4%)	Gov Bonds 4.3%
Gov Bonds 3.6%	EM Equities (18.2%)	Commodities 2.9%	Commodities (7.8%)	EM Local Debt (5.7%)	EM Local Debt (14.9%)	Hedge Funds 3.0%	Gov Bonds 2.1%	Listed Private Equity (12.7%)	Hedge Funds 5.6%	Commodities (8.3%)	Cash 1.9%
Cash 0.5%	Listed Private Equity (18.9%)	Cash 0.8%	EM Local Debt (9.0%)	Commodities (18.8%)	Commodities (25.3%)	Cash 1.1%	Cash 1.4%	EM Equities (14.2%)	Cash 2.7%	Listed Real Estate (11.4%)	Commodities (1.9%)

Source: HSBC Private Banking as at 9 December 2020. Past performance is not a reliable indicator of future performance.

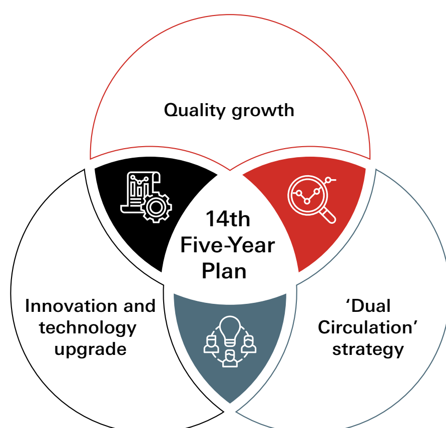
Top Trends for 2021

1. Recharging Asia's Growth

Led by a strong rebound in China, the Asian economy is poised to stay ahead in the global recovery from the pandemic recession. Being the first in and out of the COVID-19 crisis, China has witnessed a broadening recovery with the November Caixin manufacturing PMI hitting a new high for the decade. Supported by robust middle class consumer demand, high policy flexibility, effective virus containment and increasingly robust IT infrastructure, Asia ex-Japan GDP is forecast to recover to 6.7% growth in 2021 from -0.7% contraction in 2020. We see promising growth potential in the digital consumer facing sectors and attractive recovery opportunities in industries which are re-emerging from the economic reopening and normalisation.

Notably China's 14th Five-Year Plan for 2021-2025 will kick-start a new economic expansion cycle with the roadmap for the next phase of structural reforms, market opening and technological innovation to build a higher quality and more sustainable economic growth model. China set the growth target to double its GDP per capita income by 2035 and achieve high-income country status by the end of the five-year plan. The new sustainable growth model will be supported by improvements in productivity, innovation, domestic demand, environment protection, and social development. China's focus on quality and sustainable growth goes hand-in-hand with its long-term goal of achieving carbon neutrality by 2060. We expect the new five-year plan will set aggressive targets for development of electric vehicles and renewable energy for approval by the upcoming National People's Congress in March 2021.

China's 14th Five-Year Plan focuses on quality growth and innovation.



Source: HSBC Private Banking as of 9 December 2020.

The Regional Comprehensive Economic Partnership (RCEP) signed on 15 November by 15 Asian economies marked a key milestone of trade liberalisation in the region. We expect the RCEP, the world's largest free trade bloc covering over 30% of global GDP, to further entrench Asia's role as the centre of global commerce and manufacturing. According to our forecasts, the share of the 15 RCEP members will rise to over 50% of global output by 2030. The largest beneficiaries from RCEP are likely to be South Korea, Japan, Malaysia, Thailand and China. With new structural growth engines, the cyclical recovery in domestic demand and the tailwind from the global economic recovery, Asia should see multiple investment opportunities in the equity and credit markets. We continue to prefer Asian equities and bonds over other EM markets and we stay overweight equities in China, South Korea and Singapore and Chinese credit in both hard currency and local currency.

New Asian Consumer

Asia's digital transformation has seen phenomenal acceleration during the pandemic and we believe this structural trend will gather further momentum after the crisis. When we look at what will recharge Asia's growth in 2021, the rise of its middle class consumers and strong private wealth growth stand out.

Asia's more advanced technology infrastructure than other EM supports the rapid adoption of digital consumption and automation. Our New Asian Consumer theme focuses on opportunities in digital consumer facing companies, healthcare and wellness providers. Despite the outperformance of Chinese and Asian digital economy stocks in 2020, we remain positive on the growth outlook of leaders in ecommerce, online education, fintech, online entertainment and food delivery.

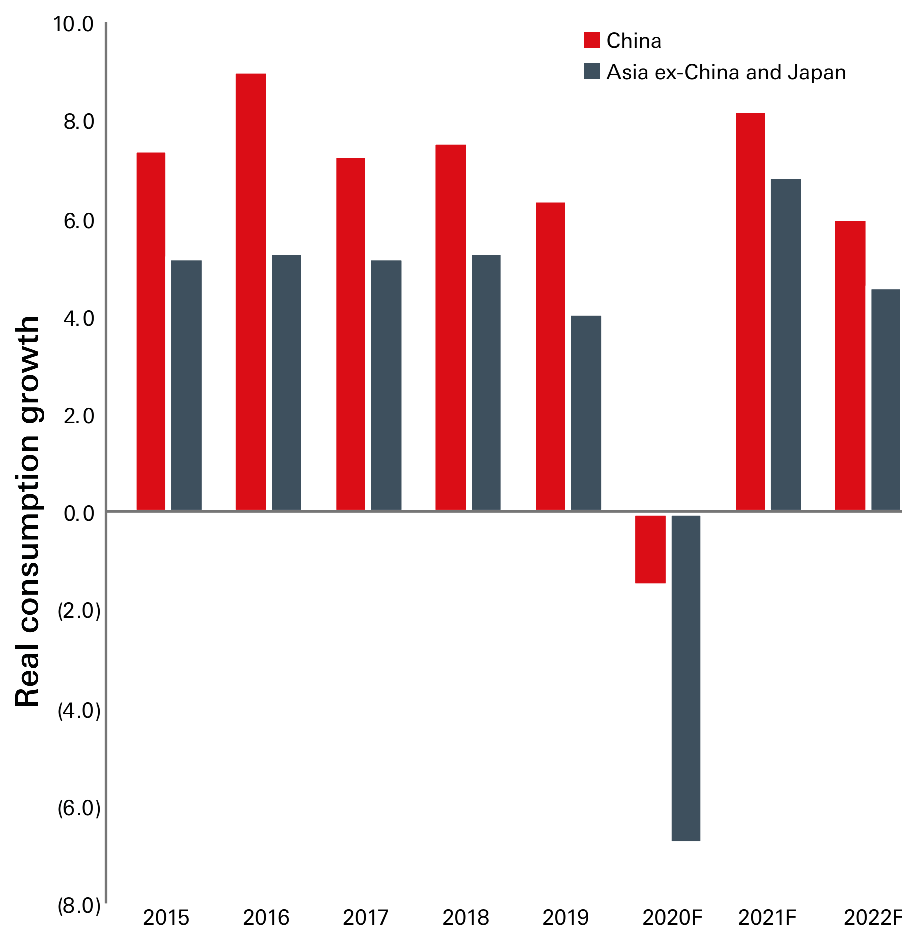
In Southeast Asia, digital consumption has recorded strong growth this year due to impact of the pandemic lockdowns. Southeast Asia added 40m new internet users in 2020 with one-third of the digital service users coming online for the first time due to COVID-19. According to a recent research conducted by Google, Temasek and Bain, online spending in Southeast Asia is projected to triple to more than USD300bn by 2025. We are bullish on ecommerce companies in the ASEAN region on the back of rapid adoption of online consumption.

Riding on China's Five-Year Plan (FYP)

We launched a new theme to ride on China's 14th FYP with focus on opportunities from the "Dual Circulation" strategy that pivots towards domestic consumption, technology upgrade, market opening and financial liberalisation. Under the "Internal Circulation" strategy, China is expected to accelerate the household registration system reform and rural land reform and provide further support for the rising middle class to boost domestic demand and household income. Higher disposable income should bode well for the digital consumer facing companies, healthcare and wellness providers. Under the "Internal Circulation" strategy, China targets to build strong domestic independent growth and promote technological innovation with focus on technology localisation and import substitution. To drive the creativity and productivity gains in longer term, we expect China will significantly increase R&D spending to 3% of GDP for the new FYP, up from 2.2% in 2019.

Beneficiaries of the FYP include domestic industry leaders in the semiconductor, robotics, automation, smart manufacturing, and digital supply chain sectors which would benefit from strong policy support to accelerate digital transformation. We also favour prominent players in cloud technologies, data centers computer servers and 5G technologies. Another area that China would like to further develop and achieve self-sufficiency is likely to be the healthcare sector. Chinese biotech leaders with cutting edge technologies and top talents could perform well with strong private and public funding support. The government's strong policy focus on fundamental and frontier research will boost education spending and support the education sector.

We expect consumption in Asia to rebound sharply in 2021 with new structural trends.



Source: HSBC Global Research forecasts, HSBC Private Banking as of 9 December 2020.

Under the "External Circulation" strategy, China will further accelerate financial market liberalisation and level the playing field for local and foreign companies. We expect the government to cut trade tariffs and allow more foreign investments into various sectors. Further liberalisation of the onshore A-share and bond markets via Stock and Bond Connect programmes, together with global index inclusion and capital market reforms, should accelerate RMB internationalisation and bring new opportunities to domestic and foreign financial institutions and selected fintech leaders. We also favour companies with significant exposure in Shenzhen, China's Silicon Valley, and the Greater Bay Area on the back of favourable government policies to build Shenzhen as a "model city" and key growth engine with deeper integration with Hong Kong and Macau

Asia's Supply Chain Revamp

COVID-19 has caused unprecedented disruptions to Asia's supply chains, as closed borders, pandemic lockdowns and transportation bottlenecks raised concerns about the risks of over-concentration of supply chains. Despite frequent market talk about massive supply chain relocation from China due to US-China tensions and COVID-19, the threat has remained more rhetoric than reality. Chinese supply chains have proven surprisingly resilient in withstanding the pandemic challenges, as reflected by outperformance of China's exports and inward foreign direct investment flows against its main global peers in 2020. In spite of geopolitical tensions between Washington and Beijing, China's exports to the US have posted a strong rebound in 2020 due to robust US demand for medical and pandemic-related products made in China. This suggested that China is still gaining rather than losing global market share due to strong competitiveness of its manufacturing supply chains supported by the strengthening technological capability, strong industrial network effects, well-established transportation and IT infrastructure, and a sizeable pool of skilled labour at a relatively low cost. China's global export share has climbed back to its earlier peak reached in early 2016 while many other Asian economies are not far behind.

Geopolitical factors should continue to reshape Asia's supply chains after COVID-19. President-elect Joe Biden's "Made in America" and "Build Back Better" plans indicate that he is likely to maintain some protectionist measures against China. We expect the Biden administration to promote onshoring supply chains of industries of national importance, like pharmaceutical products and medical equipment and may continue to restrict technology transfer to China. This could benefit Japanese, Taiwanese and Korean technology leaders as Beijing is expected to revamp its supply chains by reducing reliance on US technologies.

We highlight that ASEAN countries are geared beneficiaries of the RCEP as the free trade deal will unleash their growth potential through trade liberalisation and improved outlook for foreign direct investment. We believe that RCEP can further deepen integration of the ASEAN countries into Asia's supply chains. Structural reforms in the ASEAN economies, such as the omnibus law in Indonesia, should attract foreign direct investment inflows as producers are in search for lower operating costs and diversification of supply chains from China. Asian frontier markets, such as Vietnam and Bangladesh, continue to move up the value chain given lower labour costs, market liberalisation and economic reforms. We expect China to increase imports from the rest of Asia after signing the RCEP and this will provide an important catalyst to accelerate Asia's supply chains upgrade. We anticipate the RCEP agreement will concentrate global supply chains further in Asia due to enhanced competitiveness of the region's manufacturing base versus the global peers and further expansion of intra-regional trade.

Asian Credit Opportunities

Positioning for the low yield world, we remain bullish on the theme of Asian Credit Opportunities due to the attractive risk/return trade-off and substantial yield pickup of Asian corporate bonds over developed market credit. The recent China SOE onshore bond defaults have added volatility in the credit market and pushed interbank lending rates higher. But we expect the market impact of the SOE defaults to be temporary, because we believe the government will attempt to put in place a more market-driven default mechanism for SOEs. This should help restore financial discipline in the onshore bond market by adjusting risk-reward assumptions and contribute to more efficient capital allocation in the long term. Within Asian credit, we stay overweight Chinese hard currency and local currency bonds. Based on our base case scenario that the US-China phase-one trade deal will hold and there will be no additional trade tariffs, we forecast RMB to stay firm at 6.60 against the USD by end-2021. A stable RMB supports our overweight position on Chinese local currency bonds.

2. Digital Transformation

2020 has been volatile and far from predictable. However, as events unfolded, it has proven to be a watershed year, accelerating four key trends that should boost activity and innovation, both in 2021 and in the longer term. Together, these trends create a step-change in the process of the world's digital transformation.

Rise of the digital consumer

Traditionally, the adoption of technology tends to be quickest with the younger generations, percolating more slowly to older generations, if at all. But the pandemic has forced all generations to become digital consumers as they have no alternative. For example, retirees have been slower to use online shopping even though they could potentially benefit substantially in the longer term. The silver lining for the silver surfers of the pandemic is that circumstance have forced them online and they are quickly realising the benefits of becoming more tech savvy. There is little joy to be had from hours lost with the weekly trudge to the local supermarket, only to return burdened with heavy shopping bags in all sorts of weather and often using public transport. A few clicks can avoid this thankless task. As these often older, wealthier generations are coming online, it creates threats and opportunities for retailers: 1) as these bulwarks of the high street shift online, many more retail outlets are likely to face a bleak future, but 2) online sales from this new wave of older, generally wealthier buyers provide a new source of growth for retailers as buying becomes easier.

The trend for an ever higher percentage of consumer purchases to shift online is unlikely to abate. It is likely to be self-perpetuating as high streets are hollowed-out, and choice there may become increasingly restricted. In contrast, online stores have a far wider customer base and so are able to carry a wider range of products. This trend has already reached its end game for products such as CDs, DVDs and to a large extent books.

But this is not the end of the story so to speak. Just as book and record stores have largely disappeared from most high streets, and a few large online sellers thought they dominated the market, technology has enabled consumers to access music and literature without owning the CD, DVD, book, magazine or newspaper. The arrival of streaming services is transforming the landscape yet again. New providers have entered the market, whilst existing online stores have adapted quickly. For investors, it is important to keep track and keep evolving with the market trends.

Connectivity and 5G

The rise of the digital consumer is driving the need for ever better infrastructure to facilitate the consumption of these new products and services. Originally, going online was through a personal computer, via a modem using existing fixed-line telephone copper wires and through an internet provider, with purchases paid via a credit card. In contrast today, the majority of purchases are from a mobile device, often paid from a digital wallet, with transactions taking seconds rather than minutes. This poses increasing demands on the infrastructure, particularly mobile networks, and has driven the development and deployment of each new generation of mobile networks. The fifth generation (5G) began its rollout at the end of 2019 in a handful of countries including China, South Korea, the USA and the UK. It happened at a slow pace initially as providers and consumers were both reluctant to invest in new hardware. However, recent upgrades to the 5G technology together with a new range of handsets may trigger a wider adoption.

Why is the introduction of 5G noteworthy? A simple analogy would be the impact of the building of motorways in areas that previously only had simple country roads.

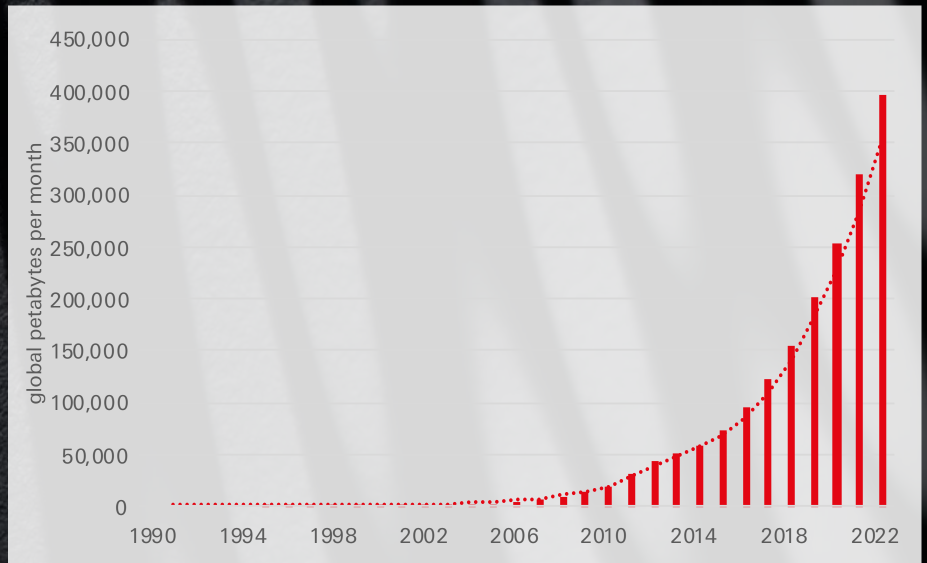
While 5G does not represent a huge improvement on existing 4G technology for consumers, it will immediately improve three key aspects of the customer experience: 1) network capacity, thereby reducing slow or down networks; 2) improving download speeds, which is particularly important for streaming of movies and video services; 3) latency or response time, an important feature for the growing online gaming community.

These three improvements are important in maintaining the momentum of the trends we already mentioned in the consumer market. By comparison, there are other less well-known but more substantial benefits for industrial users, where innovations have been waiting for the development of this key enabling technology. 5G is that technology that will facilitate the interconnectivity of machines and devices (Internet of Things), and the development of augmented and virtual services and products. This super-connectivity offers great potential for automation in both the home and in the office as devices become part of a network. These are just a few examples of the large potential that could be unlocked by the introduction of 5G. For investors, 5G offers opportunities in the related infrastructure, 5G devices and in any company that sees the benefits of 5G to outperform its competitors.

Automation

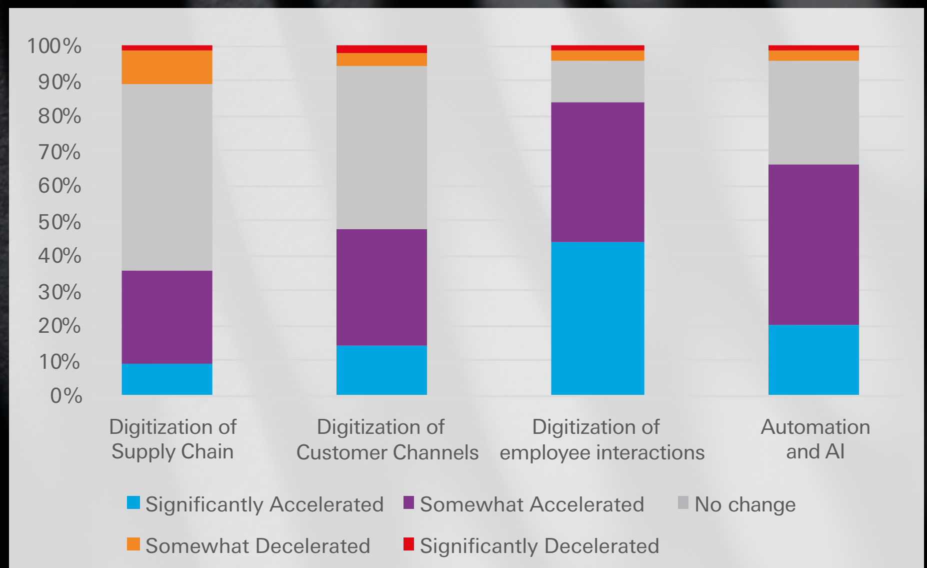
The utilisation of autonomous or semi-autonomous machines has been a feature for some time of the auto industry, which is the largest single industry user of commercial robots. As the technology has advanced, so have its applications, but this has been slow and somewhat limited.

The exponential increase in data usage raises the need for powerful and mobile connections through 5G.



Source: Cisco, HSBC Private Banking as at 9 December 2020. Forecasts are subject to change.

The virus outbreak has quickly changed the adoption of technologies, and much of the change is likely to remain with us.



Source: McKinsey survey of 800 executives, HSBC Private Banking as at 9 December 2020.

Recent developments in AI, visual and orientation technologies should accelerate this, enabling more businesses to automate more aspects of the operations both in manufacturing and service industries. This will be important for many reasons including improving productivity, quality, reliability, but also to address demographic and societal shifts.

China's dramatic manufacturing expansion has been fuelled over the last three decades by the steady flow of rural migrants to urban centres, but the ebbing flow is driving up wages. Automation is addressing this cost challenge, while also lowering business continuity risks. China is already one of the world's largest investors in industrial robots, but its policy of industrial upgrading requires ever more sophisticated levels of automation and boosts domestic technologies related to automation. Meanwhile, in developed markets, the growing desire to re-onshore production may require automation to do it in a competitive way.

Logistics is a big growth area for automation, and much of it is linked to rise in online purchasing mentioned above. Automated ordering and warehousing is better able to cope with large swings in seasonal demand. Automating the 'final mile' of the delivery chain is still a distant dream. In service industries, automated call centres and advisory bots are becoming a reality. A recent development that has gained much ground during the pandemic is the use of automation in the hiring process of new employees. There has been a surge in companies using automated AI-based screening tools provided by third parties, these include online application automated scoring, psychometric testing, video analysis and robo-interviewing. It seems that an ever smaller fraction of applicants will actually get to meet the employees of the company.

Healthcare innovation

Healthcare is a final illustration of the step-change transition technology is bringing in our digital transformation.

As healthcare costs continue to rise often well above the rate of inflation in many countries, the provision of the service is becoming ever more unaffordable to both governments, businesses and individuals in its present form. As we rediscovered in the pandemic, necessity opens minds to new approaches and gives an urgency to developments that may help alleviate the unpleasantness. There are a myriad

of examples of technologies that have become particularly relevant during the pandemic from vaccine development, mass screening, tracing apps to quick diagnostic tests.

However, there are also some less obvious technology-led developments, such as telemedicine. It appeared as a niche, poor alternative to going to a surgery for a "proper" consultation. However, online appointments are sufficient and efficient for both the doctors and patients. It avoids unnecessary traveling to the surgery for the patient and the inevitable long delay as the doctor is behind schedule. The pandemic has repositioned telemedicine as a viable alternative for many consultations.

Another related example is visiting hospitals, something most people dread or loathe, but it is also the fact that there are high costs associated with such visit even for simple routine out-patient procedures. In addition, there are relatively high cross-infection risks with hospital visits. Remote monitoring via sensors placed on the patient may often provide a suitable alternative, for example, a patient with cardiovascular conditions can now easily have their heart rate, blood pressure and other vital indicators monitored remotely. The other big advantage is that monitoring can be done continuously with appropriate pre-set alerts sent to the doctor and patient should their condition need attention.

The four areas that we chose to highlight are not isolated but are to some extent inter-related. For the remote monitor example above, the doctor may first consult the patient by video call when they receive an alert. This will require the patient to be connected to a network both for the ongoing monitoring and the video call, a 5G network connect will allow the client to be full mobile at all times. The doctor may prescribe the patient medicines via a digital script or prescription that is dispensed directly by an online dispensary service that send the medicines from its automated warehouse to the patient. The patient will pay for the consultation and medicine from their digital wallet. This scenario is already an existing reality today that is life changing for many patients especially in rural areas, but also brings better patient outcomes and improves productivity and lowers costs. Because of the inter-relatedness of these innovations, they reinforce each other, push further innovation and increase the profitability of the innovations for investors.

3. Recovering in a Low Yield World

Cyclical improvement and a risk-on tone in markets have driven safe haven bond yields higher in recent weeks. But our view is that yield levels will remain structurally low, and that USD and EUR policy rates will remain unchanged in 2021. The search for yield should thus continue, in bond markets, through dividend stocks and REITs. The low yield environment also supports interest rate sensitive sectors, where we find interesting opportunities.

What the bond bears worry about.

When investors look at historical patterns, the economic recovery we expect to see in 2021 leads many to conclude that bond yields may drift higher. What if central banks start to normalise policy, and would a normalisation be driven by interest rate hikes, or by slower bond purchases (leading to some kind of taper tantrum)? The bears will probably point to oil prices in 2021 as there will be significant oil-price base effects, which may give the impression that inflation is starting to pick up. Indeed, if the Brent crude oil price were to remain at $45/bbl throughout the year, it would have a deflationary effect early in the year (when it is compared to the $70/bbl level from January 2020) but become reflationary by the Spring (when it will be compared to the $22/bbl level of March 2020).

These are valid questions, but they overly emphasize the cyclical and short term aspects, and largely ignore the structural factors. It is because of the structural factors that we stick to our flat Fed and ECB policy rate forecasts, and our view that safe haven bond yields should continue to trade in a range.

Low for much longer: the structural story

US Treasury yields have been drifting down since the early 1980s. The fact that this trend has remained in place, in spite of the ups and downs of the economic cycle during this period, means that the trend is largely structural in nature.

The great moderation: structurally low inflation. We believe inflation is structurally capped by the impact of globalisation and technology. The labour market is global, and there is competition between workers in developed and emerging markets. The online economy and automation help slow wage inflation, and global trade has increased competition between firms. The internet allows consumers to shop around for the best price, reducing consumer price inflation. It is true that globalisation has peaked, but we think that price competition in labour markets, goods and services will remain very high, and that trade barriers will only have a mild impact on inflation. Many companies who see some of their input costs rise, may be forced to absorb this in their margins and not pass it on to consumers, hence keeping CPI in check.

Credible central bank policy in DM and EM: clear central bank mandates, improved communication and market guidance have helped reduce the markets' fears of inflation. Increased market confidence lowers the real rate investors demand on cash and government bonds.

Global ageing: ageing populations tend to save more for their retirement, and the savings surplus from countries like China is being invested in financial assets, including bonds. As people age, they often prefer the more predictable cash flows of bond markets when compared to equity markets.

High government debt and low yields go hand in hand. The Japanese experience shows that high government debt effectively reduces future growth as it limits governments' scope for discretionary spending. Lower trend growth in turn tends to lead to low policy rates and government bond yields. Sovereign debt growth around the world also means that central bank policy will need to remain very accommodative. Governments will probably only be able to grow out of their debt if bond yields remain low for a very long time.

This is topical because deficits have risen significantly during the pandemic, and in the US, President-elect Biden has signalled higher spending. But bond markets should not worry, as taxes may also pick up, when the economy recovers, and a gridlock in Congress means that some of the administration's spending plans may not materialise.

Moreover, we note that during the credit crisis, neither the higher debt, nor the ample central bank liquidity led to higher inflation. And even if inflation were to pick up to 2%, the Fed policy would not immediately need to tighten, as it has adopted an average inflation target of 2%.

So what about credit ratings? In recent years, we have seen a number of credit rating downgrades and negative rating outlook changes for G7 countries. However, this did not lead to higher bond yields or higher central bank policy rates. This reflects our view that there is no major debt sustainability issue in countries like the US, Germany and the UK.

Investing in a low yield environment

In the low global yield environment, investors will need to pull out all the stops to find enough income, while balancing the increased potential yield when going further down the credit spectrum, against the increased risks. An important part of the strategy is to not hold large cash balances, as they present an opportunity cost. Our top themes are as follows:

EM debt – carry in a low yield environment: We believe that EM corporate bonds in HC continue to offer a good risk/return trade-off.

Our focus is on China, on Healthcare, Media and Telecommunication and Financial companies, as well as Chinese Property Developers.

DM financials credit: The DM Financials sector's regime change since the Global Financial Crisis has caused banks to build up significant capital buffers. COVID will undoubtedly put the sector's strong fundamental footing to the test, but central bank liquidity and targeted fiscal measures help. Our focus is on banks' Tier 2 bonds in USD and select Additional Tier 1 securities from banks with the highest quality fundamentals.

Resilient income: Investors are looking beyond the bond market and towards equities to find sources of income. We remain selective in dividend stocks but believe that, some of the healthiest companies may start to raise dividends again. We also see opportunities in REITs but again point to the need to be selective, with a focus on quality.

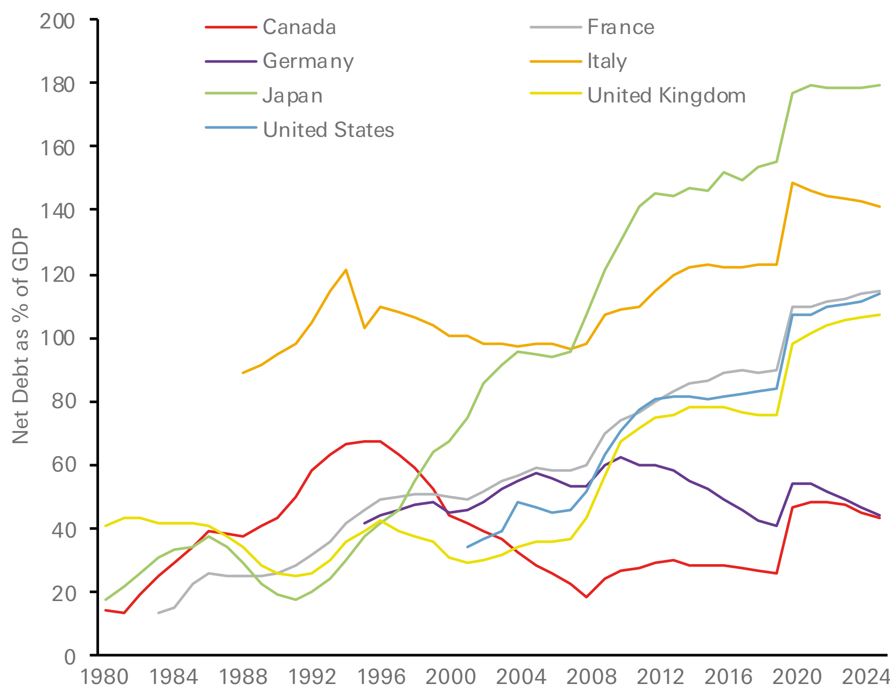
A recovery boosted by low interest rates: There are many signs that the low interest rate environment is helping a number of sectors, and speeding up the recovery. Automotives have seen good demand in the US, and prices and optimism have picked up in housing markets. Low rates should support technology-related stocks and avoid any sustained underperformance of growth stocks.

Focus on quality: The low interest rate environment is largely structural, but also related to the uncertainty we have around us. An improving cycle allows investors to broaden their stock selection, but we note that some 'value' stocks can be value traps, i.e. companies with weak balance sheets or outdated business models. Quality stocks may not outperform the index in 2021, but they should still provide a good risk/return tradeoff amid the uncertainty and volatility we expect.

The fall in safe haven government bond yields is a long term structural phenomenon.

Source: Bloomberg, HSBC Private Banking as at 9 December 2020. Past performance is not a reliable indicator of future performance.

Most countries have seen their debt piles rise since 1980, but global bond yields have still fallen.



Source: IMF World Economic Outlook, HSBC Private Banking as at 9 December 2020. Forecasts post 2019 are subject to change.

4. Investing for a Sustainable Future

It is safe to say that we collectively are happy to turn the page on 2020 and look to 2021 and beyond. As vaccines are approved and a progressive return to normal is expected in 2021, the pandemic has allowed us to pause and reflect on the kind of world we want to be living in and the kind of world we want to be shaping with our wealth. The pandemic has also made us realise how interconnected we all are. It has heightened awareness of environmental and social issues and inequalities. Lockdowns, quarantines and various other confinements have given us the time to reflect on our legacy, or plan for our succession. Alongside wealth, we pass along a world that we do not inherit from past generations, but merely borrow from future ones.

Time is running out if we don't want the manmade impact on climate to be irreversible. The longer we wait, the more drastic and costly measures will have to be taken. Lockdowns were not the drastic cuts in global warming and Greenhouse Gas (GHG) emissions we initially thought they would be. The pandemic hasn't put climate change on hold. Foregoing a few flights in a year for our holidays across the world is simply not sufficient to tackle global warming. This is showing us the extent we must go to in order to curtail and reverse the damage that has already been done. With our investment themes, we look at topics with attractive investment returns, while also building a more sustainable future.

Climate change: commitments, investment and opportunity

2020 has not been all bad for climate. In September, China's President Xi Jinping made the surprising announcement that China would become 'net-zero' emissions by 2060 at the UN General Assembly. This is great news for our planet as China is responsible for a quarter of the world's total carbon emissions, more than the United States and the European Union combined. This is the single largest commitment to climate to date. China is at a crossroad as both the world's biggest emitter of greenhouse gases and the largest producer of renewable energy. Its Green Revolution will require a drastic shift away from their dependence on coal, the most polluting fossil fuel, and into renewable energy like wind, solar and hydro. China is already the world's largest market for Electric Vehicles but it will extend its lead even further as electrification is an essential building block of a 'net-zero' economic model.

The second biggest positive news for climate in 2020 was the victory of Joe Biden in the US presidential election. As the Trump administration exited the United States from the Paris Agreement and reneged on its commitment to tackle climate change, Joe Biden not only announced the United States would rejoin the Paris Agreement, but he went beyond with the 'Biden Plan for a Clean Energy Revolution and Environmental Justice' and its pledge to invest US$2trn over his first term as President. This aims to put the second largest GHG-emitter back on track to become 'net-zero' by 2050, which is what scientists believe will keep us on the path to maintain global warming below 2C by 2100 compared to pre-industrial levels.

Addressing climate change means mitigating the effects of global warming by attempting to keep temperature increase well below 2C degrees by 2100 while climate change adaptation involves reducing material physical climate risks. Tackling climate change by becoming 'net-zero' by 2050 is estimated to cost 1 to 2% of Global GDP annually. Political ambition, growing regulation, citizens' expectations and investors' concern about climate are all aligned to globally tackle climate change. Shareholders in particular are becoming more proactive on climate and demand transparency from companies on their path to 'net-zero'. Even the fixed income market is finding ways to finance 'net-zero'. The green bond market had reached US$850bn of outstanding bonds while companies in carbon intensive sectors have begun to issue transition bonds. All countries and all companies must be fully committed for this to work.

Sourcing income in a sustainable way

In 2020, the COVID-19 pandemic also worsened the 'low yield and low growth' environment investors have been living in. While some investors are chasing yield at all cost in risky markets, sectors or companies, some with questionable sustainability practices, it is possible to find yield in a manner that is respectful

of broader environmental, social and governance (ESG) considerations. Companies that integrate ESG factors and adapt their business model accordingly tend to take a longer-term approach. The investment solutions in our theme "Sourcing income in a sustainable way" look at the way companies benefit the 17 UN Sustainable Development Goals through their activities while shying away from those with a detrimental impact on the environment and society. Certain sectors like in the utilities, healthcare, financial and grid sector have been quicker to adopt more sustainable business practices. Investing sustainably can be beneficial to financial returns. As an example, over the course of 2019 and 2020, the S&P 500 ESG index provided a superior return per unit of tracking error. Sustainable investing is about future proofing investment portfolios for the long-term.

Gender diversity in business

Another outperforming investment strategy in the past few years has been Gender Lens Investing (GLI). Gender Lens Investing means deliberately incorporating gender analysis into financial analysis in order to get better outcomes. Gender diversity in senior roles is a long-term performance driver as more diverse teams often take better decisions, lead to greater diversity of thought and more innovation. Greater gender diversity is usually a sign that companies strive towards better talent and human capital management. Finally, it also means that the company is more representative of their consumer base and more in tune with their expectations. A single token woman sitting at the Board is not sufficient. We must look at the number of women in senior management, the gender pay gap, employee wellbeing, talent management and retention practices when the information is available. Over the past few years, the correlation between a smaller gender pay-gap and total shareholder return has increased. Unfortunately, only four countries in the world require broader diversity disclosures beyond gender, such as ethnicity, religion, or sexual orientation, making it hard to collect sufficient data to find any correlation between greater diversity and company performance. Another caveat is that diversity is only beneficial to the bottom line if it is valued by society. We still have a long way to go before reaching gender equality.

BloombergNEF has found a correlation in companies between better gender diversity in boardrooms and better climate policies. Our sustainability themes have thus come full circle, a virtuous circle. As we look to move on from this pandemic and into 2021, we must ask ourselves if we want to go back to the way things were, or if this is an opportunity to build a more sustainable future.

Sustainability: Moving from responsible to sustainable investing

In recent years, investors have started on a journey in their approach to sustainability, and how they should incorporate it in their investment process. Most people by now agree that totally ignoring sustainability does not make sense. In other words, responsible investing, which incorporates Environmental, Social and Governance (ESG) factors in any stock or bond analysis, as a complement to traditional financial analysis, to minimise such risks, is now seen as the minimum standard. Indeed, the very large majority of fund managers use ESG integration as a minimum, and it is hard to go through corporate earnings calls without analysts asking CFOs and CEOs any ESG-related questions. Over 3,000 asset managers and asset owners representing over $100trn are now PRI signatories, committing to ESG integration, voting and engaging with companies on ESG matters, and promoting ESG standards. Our own HSBC Global Asset management integrates ESG on over 90% of their Assets under Management. ESG integration is the new norm.

But in our view, ESG integration and responsible investing are no longer sufficient. We think that in 2021, we will see substantial further migration of investors towards sustainable investing approaches, which we classify as Inclusion, Thematic or Impact investing. With such investment strategies, we not only look at ESG risks, but also ESG opportunities.

ESG integration could have been sufficient if we were talking about a small change, but in our view, sustainability is a real revolution. Therefore, it is not a good idea to be shy. And in this respect, we think it is helpful to draw some parallels with the digital revolution, to illustrate how investors should be handling it.

When investors consider the effects of the digital revolution, they are not just trying to understand how a company will be impacted, assess the risk and demand a discount for companies that are more at risk than others. Instead, they want to actively pick companies in each sector that use technology to their advantage, to help them to win the race against their competitors. Trying to discover challenged business models like Blockbuster, Xerox, Kodak and Sharp to avoid them in portfolios was helpful, but discovering the FAANGs to overweight them was even more important for investment returns. In fact, in most sectors, most of the earnings growth has taken place in just the top 5% of companies that are particularly innovative, which highlights how much the digital revolution has skewed the profit distribution.

We think investors should keep these things in mind, and take a similar approach for sustainability. They should not just underweight companies with the worst scores, but actively select companies with strong or improving ESG credentials to boost performance (inclusion approach) or seek out companies that are exploiting specific sustainability trends (thematic approach).

For sustainability-related thematic opportunities, this is self-explanatory. For example, airlines and fossil fuel companies are severely challenged,

Responsible investing	Sustainable investing		
	Inclusion	Thematic	Impact
ESG integration, often combined with exclusions (e.g. weapons)	Actively investing in companies with some of the strongest ESG performance relative to peers ('best in class')	Actively investing in ESG related growth areas and trends, by seeking out companies or sectors that align with specific sustainable outcomes	Investing to deliver a direct, positive and measurable impact on society and/or the environment

while battery innovators and clean energy companies are prospering.

But why do we think inclusion can lead to better risk-adjusted returns? Excelling at ESG criteria can create a competitive advantage, and this is illustrated by the rush of many national and city governments to become more sustainable than others. Of course, they want to fulfil their environmental obligations, but they are also rushing because they believe that it will create new industries, attract talent and boost innovation. To achieve this, they do not want to be 45th most sustainable city or country on the list, but in the top 5 or 10, i.e. best in class. Similarly, companies that are not just mitigating ESG risks, but actively want to be best in class, will be attracting talent. According to PwC, two-thirds of employees around the world want to work for an organisation with a powerful social conscience. More diverse talent (part of the 'S' in ESG) should boost innovation, while strong governance and competent boards ('G') should help companies foresee the changes that are coming, and have the financial means to invest for that change. Companies understand that giving the increasing level of transparency and scrutiny on ESG issues by investors, consumers and civil society, it is in their best interest to tackle these issues and be seen at the forefront of embedding ESG into their plans. Most really competitive companies will not allow low scores on any of the ESG measures, but take quick and forceful action. In the long-term, if ESG is not changing the course of a company's long-term business model, then it is not addressing the Environmental, Social & Governance issues properly.

Races are often led by a small group of frontrunners, with the peloton having little chance to catch up. Building up strong ESG credentials quickly is important for companies, because change is happening so fast.

Companies integrating sustainability in their business model show more awareness of long-term trends and greater adaptability to the market environment and expectations. The commitments to the Paris agreement (and any imminent future agreement at COP 26 in Glasgow in November 2021) mean huge imminent investment in green initiatives, but also plenty of new regulation for companies to deal with. There is growing pressure from shareholders for companies to commit to net-zero targets. Technological innovation is happening quickly and creating a real tipping point for the trend in sustainability. In our view, too many companies are not adapting quickly enough, and many of them will see their competitive position challenged – not just the bottom 25%.

For investors who see sustainability as a real revolution, the good news is that the range of investment options is growing rapidly, allowing them to pick the approach that best suits their journey.

Equities

As we begin a new year, cautious optimism remains our mantra. While we acknowledge the uncertainties and risks facing financial markets, we believe that the improving fundamentals should overcome those risks and provide a solid foundation for equity returns throughout the year. We maintain an overweight stance in the US and China, and a pro-cyclical sector stance.

Let's start by examining the fundamentals. First, the outlook for the pandemic seems to be improving. Significantly, the healthcare options, such as vaccines, therapeutics, and antimicrobial products to treat the virus should start to become much more readily available at some point in the first half of the year which should help prevent future infections. Second, the global economy is rebounding with Asia leading the charge and the US seemingly set to reopen fully in 2021. Third, central banks and national governments are maintaining accommodative policies that should be supportive of financial markets. The low interest rate policies of most central banks have kept borrowing costs low, and even enabled some of the healthier corporates and household to improve balance sheets as we enter a new year. Fourth, in 2021 we are beginning a secular technology revolution that should improve productivity and profitability for years to come. Finally, as the recovery broadens and analysts have so far been prudent with their earnings forecasts, we expect those forecasts to bounce back in 2021 after a tough year in 2020.

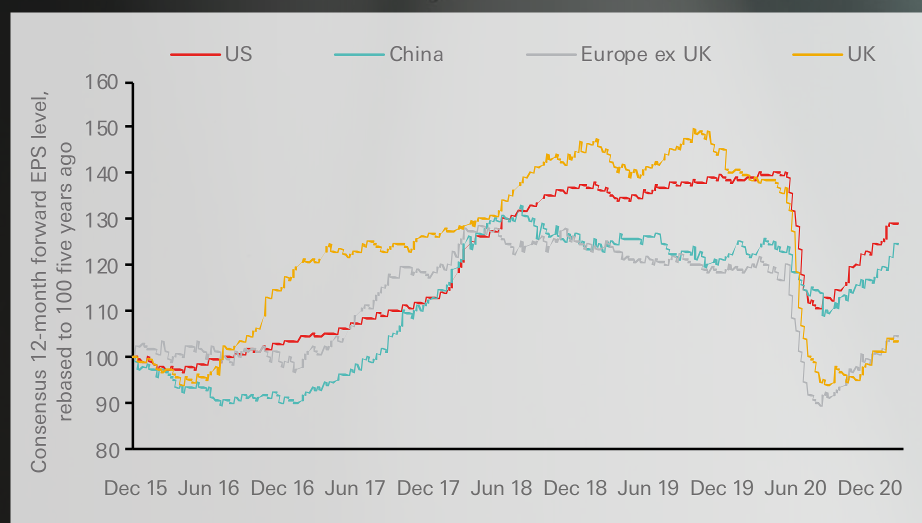
As a result, despite the near-term risks we maintain our risk-on asset allocation strategy with overweights in both the US and China. We also maintain our pro-cyclical sector stance as the reopening of the US economy, combined with the continued expansion throughout Asia, suggests that such a strategy is appropriate at this time.

Equity Styles

Following the run-up in equity valuations, some investors have begun to look toward beaten-down sectors for relative value opportunities, causing a rotation from growth (including the technology sector) into other sectors and styles (including value stocks). While this is natural, and there are some stock-specific opportunities, we think any such move should be done on a selective basis. For us to invest in relative value trades in beaten down sectors such as airlines, hospitality, cruise ships and others, we would need to see widespread use of vaccines and a more fully functioning economy to feel comfortable that the rebound in the services sectors is more sustainable. We also believe that many 'cheap' stocks can be value traps, with weak balance sheets or business models that are not adapted to the digital and sustainability revolutions. Finally, we think that the medium-term outlook for technology remains supportive.

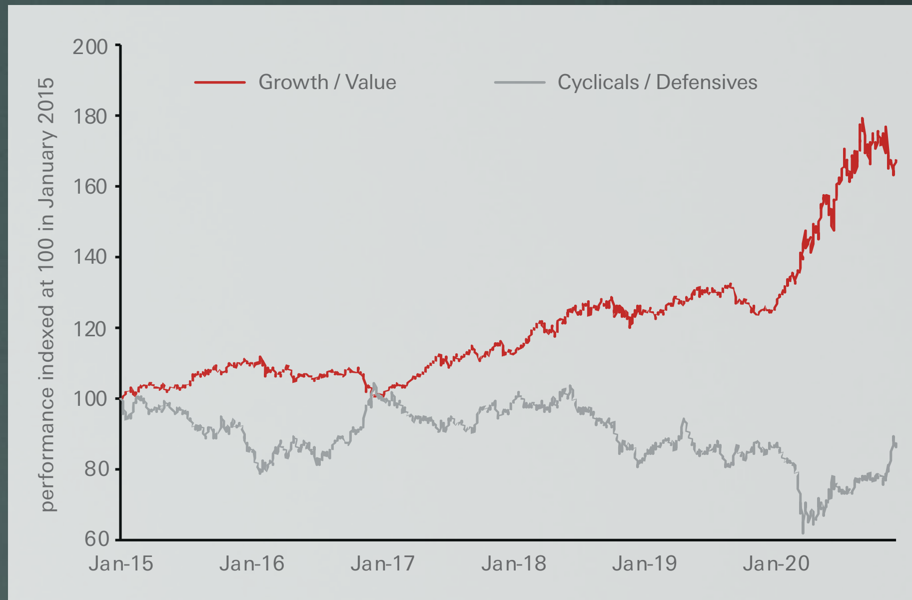
We do believe, however, that a broadening of the sector stance, to include more cyclical sectors such as materials, industrials and consumer discretionary is warranted. In Asia, especially in China, the rebound in the economy and equity markets has been pronounced and as the economy continues to broaden out the business cycle, pro-cyclical sectors should continue to outperform. In the US, the reopening of the US economy in 2021 should continue to benefit pro-cyclical sectors.

The global economic recovery is leading analysts to upgrade their earnings forecasts, with the US and China leading.



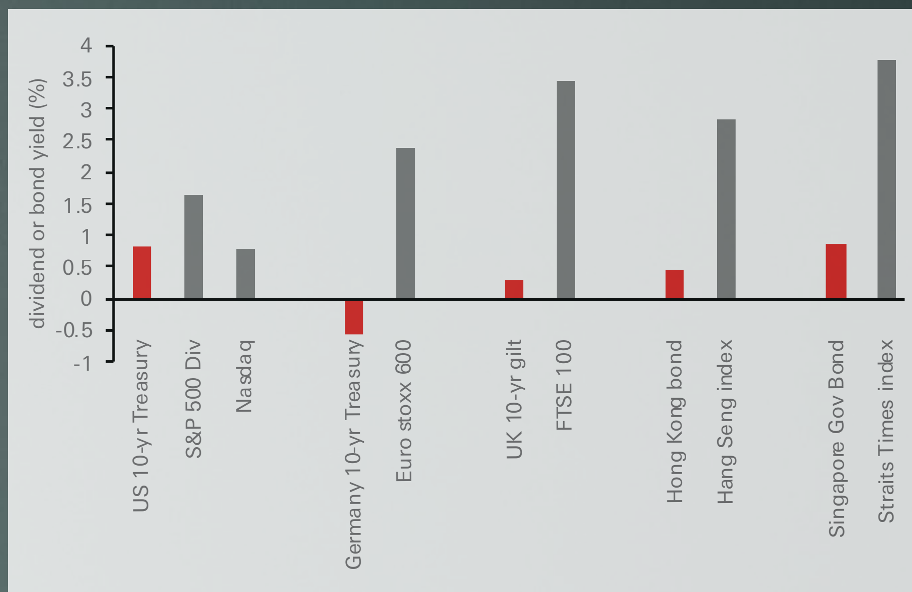
Source: Refinitiv, HSBC Private Banking as at 9 December 2020. Forecasts are subject to change.

US cyclicals have been outperforming since the market's lows in March. Value stocks however have only recently benefited from rotation, and we remain selective there.



Source: Bloomberg, HSBC Private Banking as at 9 December 2020. Past performance is not a reliable indicator of future performance.

Dividend yields vary by region but most often compare favourably to government bond yields.



Source: Bloomberg, HSBC Private Banking as at 9 December 2020.

Investors looking for income in equities may be more successful in 2021 than they were in 2020. With policy rates and safe haven bond yields near record lows, the fundamental support for equity income strategies remains in place, and this can lead to flows into dividend stocks. In fact, the dividend yield in many major market indices is compelling relative to fixed income markets. In 2020, many companies cut their dividends to preserve cash, or because their regulator told them so. But in 2021, as the global economy rebounds, we expect corporations to begin to generate better cash flow, with the healthier companies likely to reinstate or expand their dividend distributions. For investors, returns could thus be lifted both by higher dividends, and by price appreciation of these stocks as markets anticipate higher distributions.

Asia Stays Ahead

As discussed above, the Asian economy has been on the mend longer than most. In 2021, growth in Asia, led by China, is expected to be faster than in most regions. In 2020, Chinese equity markets performed well as the virus was controlled quickly and the government policy response was swift. In 2021, we expect to see the beginning of the implementation of the new five-year plan focused on infrastructure investments especially in the diffusion of technology, the continued development of internal demand and the emerging consumer class, and liberalisation of trade and the financial markets. The boost to the economy coming from these areas, and the visibility for investors coming from a clear long term plan, lead us to remain overweight Chinese stocks. In addition, China's trade policy has become more focused on intra-regional trade which could help boost growth rates and equity markets in the broader region, providing support for our overweight in South Korea and Singapore. Another important area of focus in the new five-year plan is sustainability. The Chinese government remains focused on reducing

carbon emissions, developing alternative energy sources, and incorporating new technologies to create a more sustainable and profitable economy in the future (see also our thematic investment ideas).

US Reopening

The new calendar year provides US equity investors with a new political paradigm, and improving economic and financial fundamentals suggesting better equity returns. The Biden administration has promised to provide a larger fiscal stimulus package, which should boost economic growth and consumer spending in the first quarter and beyond. Although some of it could be blocked in Congress, this should be accretive to earnings and positive for equity market valuations.

As one of our top global equity overweights, in the US we remain constructive on the interest rate sensitive sectors of housing, autos, and technology. In addition, with the reopening of the economy and the rebuilding of inventories a more pro-cyclical stance seems appropriate for US equity investors with a focus on the consumer discretionary, industrial, and materials sectors as well. As the unemployment rate continues to drift lower, improved consumer sentiment and a positive wealth effect should lift consumer spending and equity valuations. As in other regions of the world, income investors should look forward to 2021 as more positive dividend policies could provide better total returns. For US financials, banks and other regulated companies must await approval from the US Federal Reserve to raise dividends and repurchase their own securities. When this opportunity arises it could lift equity valuations in the sector as the potential for improved total returns could attract many investors. Finally, the secular theme of the technology revolution, beginning with 5G, should help drive equity investments higher in 2021. Significantly, the diffusion of those emerging technologies should differentiate returns and the continued digitisation of the US economy should determine outperformance within most sectors in the US economy.

Europe

Europe was hard hit by COVID-19, but in 2021, we foresee a meaningful economic recovery. That said, many uncertainties remain, including the speed of the economic reopening, the impact of Brexit, the speed of the rollout of the EU's Next Generation fund and the German federal elections.

For European equity investors two factors could help drive markets in 2021. First, any improvement in global trade could be accretive to earnings in Europe, and especially to German stocks. In fact, the manufacturing and industrial sectors in Europe, as in most other regions of the world, are already on the rebound. Demand for materials in the construction and manufacturing sectors remain strong, potentially providing further upside impetus. Second, the aforementioned global dividend recapture strategies could work well in Europe, where above average dividend yields in certain more mature markets are compelling to global income investors. The UK market continues to trade at a significant discount to compensate for its value stock bias and for Brexit uncertainty. We thus wait for more clarity on this front and maintain a neutral allocation to the UK for now. Throughout Europe, governments have decided to embrace the sustainability agenda, not just for environmental reasons, but as a strategy that could improve growth rates, create jobs, and lift equity markets.

Investment Summary

As we begin a new year filled with uncertainty and opportunities, we remain vigilant but optimistic. While we are mindful of the near-term risks present in the market, we choose to manage those risks but focus on the gradually improving equity market fundamentals. COVID-19 related headlines, growth and inflation readings and geopolitics can all lead to market volatility but should not seriously challenge the fundamental areas of support for equity markets. Our key assumptions are that the global economy will be bigger and healthier in 2021 than it is now, and that interest rates provide an anchor for both growth and equity market valuations. We thus maintain our risk-on stance with an overweight on global equities and a pro-cyclical sector stance. Our two main global equity overweights are in the US and China.

Fixed Income

The risk-on tone in equity markets and the global recovery do not challenge our view that the Fed's policy rate should remain unchanged, and Treasuries should range trade. As a result, we maintain our risk-on stance, with overweight positions s in Investment Grade, BB-rated High Yield and EM Hard Currency bonds.

Q4 review: a risk-on tone

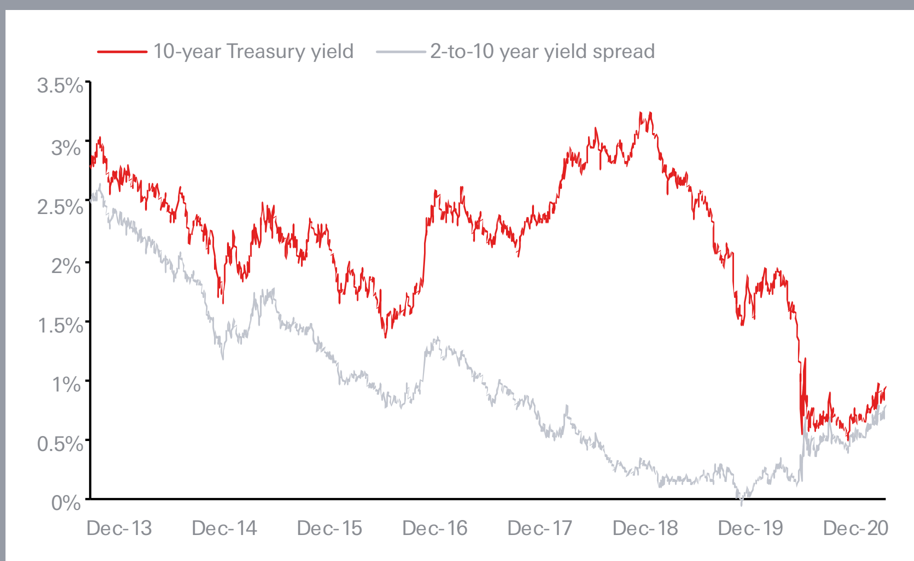
We entered the fourth quarter of 2020 with a Fixed Income investment strategy tilted towards risk, having an underweight positioning in Developed Market (DM) sovereign bonds and an overweight exposure to US Investment Grade (IG) and Emerging Market (EM) corporate and sovereign debt in Hard Currencies (HC), mostly in USD. Credit markets were well supported, in spite of pre-election concerns over major fiscal stimulus, a the renewed COVID-19 outbreak in Europe.

Then November came with a Democratic victory in the US Presidential election (but a delay on the Senate majority result to early January), and unexpectedly positive vaccine news. These two major events were not only supportive for credit markets in general, but spurred a material sector rotation where cyclical companies and businesses impacted disproportionately by COVID-19 outperformed the more defensive sectors and Technology. The market reaction was positive for our positioning that was already positioned towards riskier parts of the bond market, but we decided to increase or investment risk profile further, by upgrading US High Yield (HY) and global HY to a mild overweight, with a focus on BB-rated bonds.

Moving into 2021: Developed Markets

The announcement of successful test results for COVID-19 vaccines is a major development. While our 2021 economic forecasts for developed economies did factor in such an event, this has come earlier than anticipated. Consequently, in early November we decided to adopt a more cyclical stance and favour higher-beta assets, such as US HY and Global HY. The vaccine results offer hope of a return to an earlier-than-expected 'new normal' (or 'new different') and we expect risky assets to continue to benefit from this momentum. Historically,

The Treasury yield curve has steepened on economic optimism, but stable policy rates should provide an anchor.



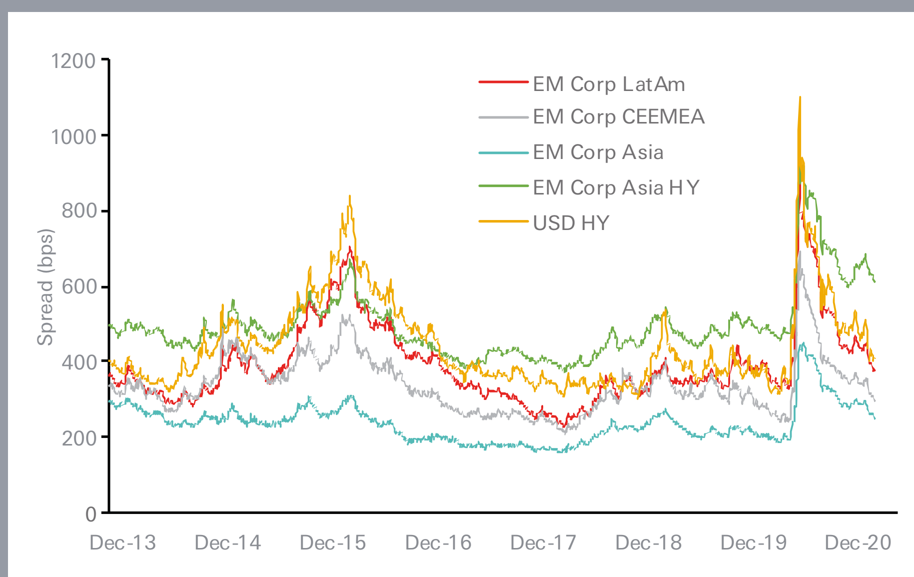
Source: Bloomberg, HSBC Private Banking as at 9 December 2020. Past performance is not a reliable indicator of the future performance.

HY markets tend to outperform more defensive markets when an economy is coming out of recession, which is the case in the US and we expect this cycle to be no different. We are conscious, however, that valuations in HY markets have significantly tightened since the pandemic induced sell-off in March and that default rates, especially in US HY, continue to rise (we expect US default rates to peak at 7% in 1Q21 and slowly recede towards 4% by the end of 2021). In order to avoid elevated credit risks, we focus on relative quality by selecting BB-rated companies with sound balance sheets, stable leverage and good access to funding facilities. In order to take advantage of the sector rotation, we continue to build up exposure to Leisure, Travel and to some extent Energy, in a very selective manner.

In addition to our overweight stance in US HY, we maintain a positive bias on US IG, which has benefited from falling rates and tighter spreads over the past eight months. So far, our strategy has been fruitful, with US IG outperforming other credit markets and importantly, also US Treasuries (9.0% vs. 8.5%, YTD 30Nov). US IG not only benefited from the Fed's 150bp of cumulative rate cuts in 2020 but also from its corporate bond purchase programmes, which are due to expire at the end of this year. We believe the programmes were successful in supporting broader US credit markets, but the quantum of purchases was in fact small ($14bn) relative to the $6tn value of the USD IG asset class. Credit markets are functioning smoothly, with the dislocation witnessed in March now firmly behind us.

The spike in US Treasury yields that followed the constructive market sentiment after the vaccine announcements and the US Election outcome offers an opportunity to buy duration, in our opinion. We reiterate our 'low for a lot longer' view as the Fed has clearly indicated interest rates are unlikely to be raised, even if inflation briefly goes above its target. Ultimately, what matters for bond yields is the path of policy rates, and the near-term optimism about the vaccine is unlikely to trigger a change in the Fed's policy. We prefer to add duration on US IG (5-7 Year) rather than US Treasuries, given the additional carry on offer for investors. Furthermore, technical factors should be supportive for

Emerging markets hard currency bonds continue to offer a significant spread pickup.



Source: Bloomberg, HSBC Private Banking, JPM, ICE BOFAML indices as at 9 December 2020. Past performance is not a reliable indicator of the future performance.

DM corporate credit, with bond supply expected to normalise in 2021 following a very strong year in 2020. This has particularly been the case for US IG, where we expect supply to fall by 15% YoY.

Elsewhere, we remain neutral on GBP credit based on fair valuations and the BoE opting to expand its gilt purchases but leaving its corporate bond purchases unchanged. The UK economy has been hard hit by COVID-19 and the implementation of Brexit adds to further uncertainty around forecasts. In the Eurozone, proactive policy actions from the ECB and governments should temper the negative economic impacts from recent lockdowns. Expectations of further monetary policy support should continue to anchor credit spreads, but low absolute yields make EU HY less attractive compared to US HY, for example. We remain neutral on both European IG and HY markets.

Emerging Markets

We head into 2021 keeping our overweight in Emerging Market corporate and sovereign debt in Hard Currencies. We expect EM Debt in HC (especially corporate bonds) to remain one of the main beneficiaries of the global search for yield as it continues to offer an attractive risk/return combination.

On average, EM credit fundamentals remained quite resilient over 2020 despite unprecedented economic challenges. EM corporates' conservative financial policies before the pandemic with limited CAPEX and focus on maintaining high cash balances have helped to preserve their credit metrics.

Based on the 3Q20 results announced by the companies included in the JPM CEMBI Index, on average EM corporate net leverage is estimated to have risen modestly to 2.0x, from 1.8x at the end of 2019. EM debt metrics look significantly better when compared to US companies. Net Debt/EBITDA is estimated at 1.7x on average for EM IG and 2.9x for EM HY, compared to 3.5x for US IG and 5.1x for US HY.

Default rates for EM corporates also remain significantly lower compared to US HY, as many emerging market companies have been focusing on deleveraging in recent years in order to reduce their vulnerability to external factors. This is in contrast to trends in developed markets, where most companies continued to expand using low funding costs. The average default rate on CEMBI companies year-to-date is fairly low at 2.5% (including 3.2% on CEMBI HY), compared to 6.3% on US HY. Default rates are likely to decline next year with the return to more "normal" economic conditions.

Additionally, we believe there will further re-allocation of capital towards EM debt and to Asia specifically, as positioning remains light in our opinion and we expect risk sentiment to be well supported in 2021.

We expect a broad economic recovery next year and do not have strong regional preferences outside of China. In terms of sectors, we adopt a slightly more cyclical approach, favouring selective Commodity Producers and Financials with stronger balance sheets, China Property and Brazil protein producers.

Currencies and Commodities

The risk-on market sentiment has driven USD sharply lower in recent months, but we are now looking for consolidation for USD in the months ahead. Instead of the "Risk-on Risk-off" sentiment, cyclical outlook should become the main driver of direction in the FX market. EUR and GBP are likely to weaken against USD, while AUD and NZD should appreciate.

The currencies market has been driven by the "Risk-on Risk-off" (RoRo) factor over the last few months. Lately, the "Risk on" mood has dominated, weighing on USD, Gold and other safe-havens, while EM currencies have been the primary beneficiaries of this positive risk appetite. The main factors that triggered the "risk-on" mode are well known, namely the US elections result and positive COVID-19 vaccine news.

On the election side, the victory of Mr. Biden, coupled with market expectations of a policy gridlock boosted equity market confidence, which spilled over into the FX market. Of course, the Congress still needs to be fully constituted, and the US election could therefore continue to be a driver in the FX market in the short term, potentially impacting currencies in line with their "Risk-on" or "Risk-off" characteristics.

However, once the results of the Georgia senate race is known, the US election will become less influential for the FX market in 2021, and other factors will dominate. The outlook for economic growth should become a chief differentiator, in our view. Of particular importance should be the relative experience of different countries towards the pandemic and their ability to secure a recovery amid the remaining uncertainties. As a result, our currency outlook is not for an outright bullish or bearish USD view, but rather of a 'divergent USD', with some currencies showing strength against USD, and others showing relative weakness.

The outlook for the US dollar is mixed as we now base our views more on cyclical factors than on the risk sentiment. Starting with the US outlook, our base scenario of a split Congress could force the administration to reduce the size of its proposed stimulus package, and that could lead to a less pronounced cyclical recovery, limiting USD upside. However, the reaction function of the central banks matters as well. The majority of the central Banks in G10 should leave the rates unchanged, but the European Central Bank (ECB) is expected to deliver a more aggressive expansion of its balance sheet than the Fed. This should halt the appreciation of EUR/USD that we have experienced in recent months.

With USD in the middle ground, currencies with greater policy flexibility and growth potential should outperform the greenback and this is likely to include commodity currencies like AUD, NZD, NOK and SEK, as well as some Asian currencies and EM high-yielders. On the other hand, countries with high governmental debt like EUR and GBP could endure a challenging year with less possibility to provide stimulus to growth. We therefore have a clear situation of a divergent USD.

AUD and NZD with their fiscal flexibility and low debt-to-GDP ratio, would likely have the larger upward potential and would probably attract further inflows. In our view, AUD could also benefit from the Chinese economic recovery as it is one of its major trade partners. Even if NZD could receive slightly less positive traction as negative rates are a lingering possibility for the beginning of 2021, New Zealand's fiscal positioning could help the economy to recover promptly.

By contrast, we believe EUR and GBP will probably remain under pressure due to their comparatively weak and uncertain growth outlook. Government budgets are tight, debt levels are high, and growth is picking up only slowly. While the EU's Recovery Fund will help finance some of the financial burden posed by COVID-19, the debt level in many parts of the Eurozone will remain high. With unemployment also likely to be elevated in those economies most encumbered by debt, the degree of fiscal flexibility will be constrained. As a consequence, EUR could experiment some weakness from the current levels and consolidate in a range. Regarding Sterling, Brexit for now remains the main driver for investors and at the time of writing GBP is boosted by expectations of an imminent deal. However, we believe that GBP, after the short euphoria if a deal is reached, could sustain downward pressure as the currency would face strong headwinds coming from structural and cyclical factors. Even with a deal, the UK is likely to face greater costs of doing business with its largest trade and investment partner, the EU. Also, the UK economy was heavily impacted by the virus outbreak and the hit to employment and businesses' balance sheet may mean it will only recover slowly.

In the EM space, we maintain a selective approach and look for currencies with an attractive yield, resilient fundamentals and a healthy economic recovery. In Asia, we expect some consolidation following the rally triggered by the positive vaccine news. However, we believe that the Chinese Renminbi (RMB) could potentially sustain positive pressure due to its strong economic recovery and yield advantage compared to its peers. Smaller open economies such as South Korea and Singapore should also see their currencies edging higher amid the global recovery. In addition, the newly-signed Regional Comprehensive Economic Partnership (RCEP) deal could ultimately sustain Asian countries that are part of the deal, as trade conditions will be improved. We remain more prudent on IDR and INR as the domestic environment in India and Indonesia is less supportive of these currencies. In Latin America, we have a relative preference for MXN over the rest of the region, as it is a high yielder and has strong links with the US economy. In EMEA, we prefer RUB relative to other regional currencies due its strong current account balance and positive interest rates, although headline risk remains high.

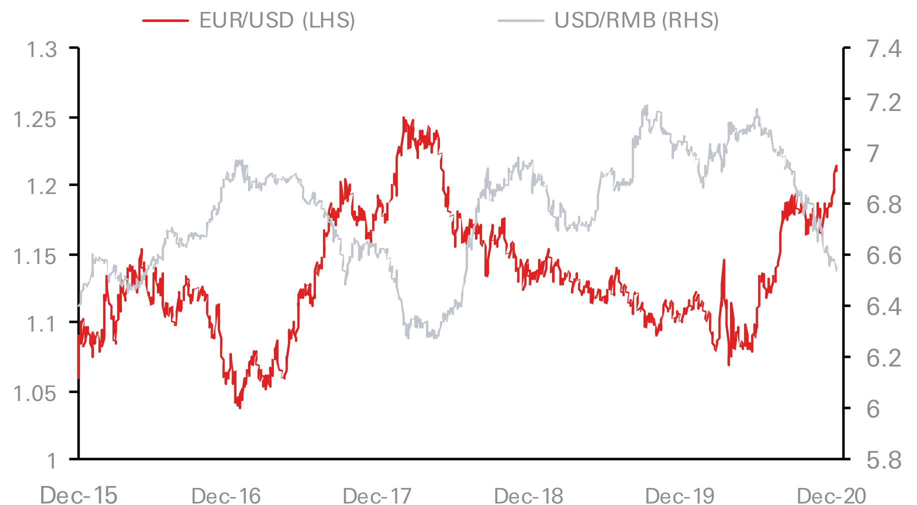
Commodities

The "risk-on" mood and the news around the vaccine pushed gold down as expected, and it lost around 7% from November's high level at $1950/oz. By comparison, the improved economic outlook has helped oil prices higher recently.

We expect gold to continue to be resilient in Q1 2021, although with more modest upside potential, and we keep our overweight position as we continue to believe in gold's diversification potential in a multi-asset portfolio. The reduction in geopolitical tensions could reduce the appeal for gold in 2021 but other aspects remain positive. Most notably, the global monetary policy is highly accommodative and we expect it to remain so. Ultra-low interest rates are gold positive, and if oil price base effects temporarily lead to higher inflation between January and March, this could provide temporary upside to gold. Continued high deficits are also gold-friendly, as some investors worry about high government debt levels, although we do not think debt sustainability is a major issue in any G7 country. However, factors like weak jewellery demand, lower central bank purchases and high scrap supply may limit the upside for gold in 2021.

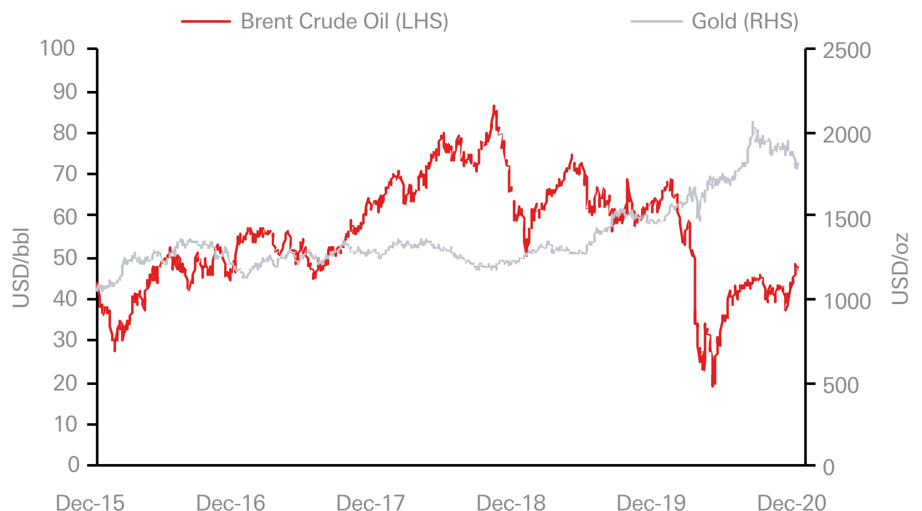
In spite of the recent rally, we keep our neutral view on oil and we believe oil will trade in a range in Q1. We expect demand to slowly normalise post-2020, but note that the recovery could be bumpy as it depends on the vaccine rollout. Travel activity depends on consumer confidence, which is extremely hard to forecast. On the supply side, there are potentially several moving parts that could reduce the ability for oil to rebound including OPEC and Russia's plan for 2021 and the Libyan supply. There is also a possibility that Iranian supply would come back to the market if Mr. Biden were to strike a new nuclear agreement.

USD has weakened against both EUR and RMB. We believe EUR strength is unsustainable, but RMB should be well supported.



Source: Bloomberg, HSBC Private Banking as at 9 December 2020. Past performance is not a reliable indicator of future performance.

The recovery and improved risk appetite are benefiting oil. They have been a headwind for gold, but it remains a good diversifier.



Source: Bloomberg, HSBC Private Banking as at 9 December 2020. Past performance is not a reliable indicator of future performance.

Hedge funds

Hedge funds continue to play a critical role in diversified portfolios, providing the potential for uncorrelated and still attractive returns. We continue to adopt a barbell approach, looking for opportunities in credit and some equity strategies, while keeping our overweight exposure with macro and multi-strategy managers.

We expect the global recovery to be sustainable and supported by monetary and fiscal policies, and believe that the return to more normal economic conditions should be supportive for both equities and credit. While the recent rally in equities has boosted valuations, risk premia remain reasonable when we take into account the low interest rates, the strong central bank guidance, and relatively low volatility levels.

But some uncertainties remain, such as the possibility of a worse than expected winter wave of COVID-19, a smaller fiscal stimulus following the US election results, or monetary policy mistakes. Hence, we maintain our barbell approach which consists of adding risk to the strategies offering interesting opportunities, such as credit strategies and to some extent equity strategies, while adding to strategies which have demonstrated their ability to mitigate the downside and to offer potential de-correlation to risky assets, namely macro and market neutral multi-strategy.

Within macro, we maintain our positive view on developed markets macro and have upgraded the outlook for emerging markets macro. A confluence of socioeconomic and political crosscurrents is keeping markets in a state of flux, including the US Presidential election aftermath, the path of Coronavirus cases, stimulus discussions as well as vaccination process. These events are expected to keep volatility high enough to provide ample opportunities for macro managers. The macro EM strategy was upgraded as the environment is providing more long and short opportunities for managers to exploit in this space.

Within the systematic space, we expect managers to benefit from first mover advantages in new markets such as China A-Shares, frontier markets, and more recently the ESG space, where stock dispersion and alpha potential is high. Despite these encouraging developments, the environment and opportunity set remain challenging as significant macro, central bank, and COVID-19 noise continues to distort models. With these near term headwinds, we retain our neutral rating for the strategy. We retain a slight negative rating within the CTA (trend following) space, however our conviction continues to lie in short-term strategies as these tend to thrive in volatile environments, which we expect to continue into next year. The opportunity set is less clear for medium to long term trend strategies as COVID-19 infections create a challenging environment with risk of market reversals, as we have seen at times in recent months.

The multi-strategy space remains a high conviction strategy. Until a sense of normalcy is restored, we believe it is important to focus on multi strategy managers with diversification and strong risk management. Fundamental equity allocations for our multi-strategy funds should remain a source of strong returns as capital market activity remains robust with companies tapping the public market via IPOs, direct listing and secondary issues given the uncertainty.

We maintain our positive rating on market-neutral multi-PM funds, but the higher volatility has resulted in tighter portfolio composition than usual. These managers are running higher than average idiosyncratic risk, while limiting exposures to style and factor risks.

Our views on equity long/short remain neutral/positive. We maintain a positive view on managers operating a variety of investment styles and time horizons in the equity space enabling us to navigate different environments. The growing clarity around vaccines could maintain equity markets on a positive path, while sector rotation is another important driver of performance (from growth into oversold sectors value like leisure, transport and hospitality). The environment for active stock picking continues to improve, as stock-specific risk and correlations have shown sustained improvement since March.

Across the credit and event driven space, we remain positive in distressed and in structured credit. Our Positive rating in distressed stems from our view that we remain in the early stages of a global distressed cycle which has been postponed due to strong near-term issuance and stimulus. As government support is gradually removed, we expect to see opportunities in industries most directly hit by COVID-19 and facing structural changes. Within structured credit, we continue to favour managers with established sourcing networks, deep credit underwriting skills, with an active management approach. These managers continue to prefer securities involving structural vs. financial leverage, like legacy non-RMBS and opportunistic securitization of residential whole loans.

Private Markets

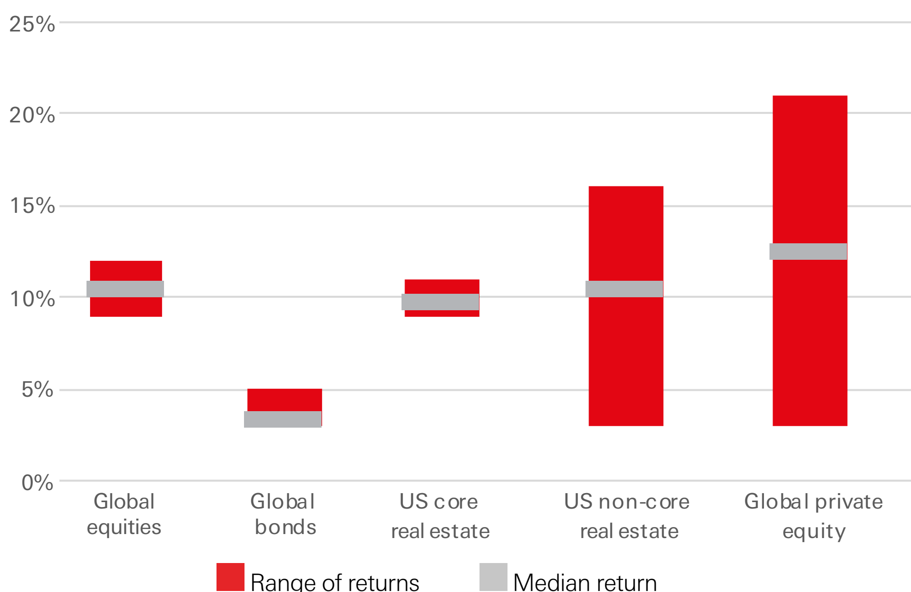
Despite the difficulties faced during 2020, Private Equity as an asset class, has fared well, and significant markdowns in valuations early in the year have largely recovered. In addition to meeting investor expectations in the short term, longer term performance for the asset class also continues to look strong versus public markets. However, manager performance continues to vary significantly and the gap between top and bottom quartile funds is persistent. Thus, manager selection continues to be important to ensure strong private equity returns, which is in line with our view that manager skill is an important driver of Private Equity performance.

Within our portfolio, a focus on quality – at both a manager and company level – has shown to be instrumental in protecting capital through the recent volatility as well as positioning the portfolio to benefit from a market recovery. Through our team's ongoing monitoring and conversations with underlying portfolio managers, we have seen the emphasis on quality express itself through an increased focus on defensive sectors such as technology and healthcare. The technology sector, in particular, has stood out as an area of emphasis from managers, as the sector has generally shown to be resilient during the COVID-19 environment. Technology accounted for 20% of global private equity deal flow 10 years ago, and has grown to account for over 37% of deal flow in 2020.

Although the technology sector recently spiked as a percent of deal flow in 2020, our investment team has focused for the last several years on building our discretionary portfolios to withstand economic volatility and uncertainty, and deliver target returns, through a focus on non-cyclical and defensive sectors, technology and software businesses. Similarly, our portfolio is positioned defensively through commitments focused on proven managers, with long track records of investing through economic cycles. These strategies have been helpful in 2020.

Private and public manager dispersion of returns[1].

Based on returns from 2Q 2009 – 2Q 2019



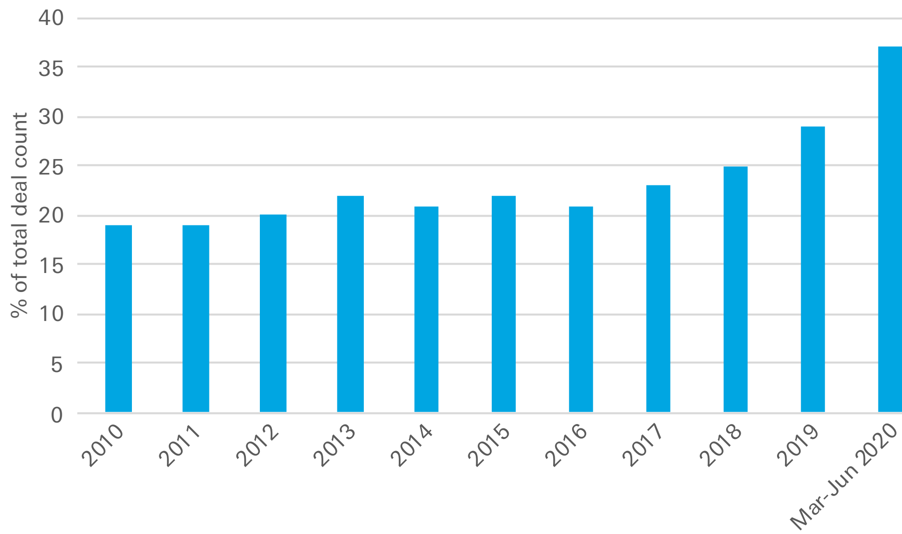
[1] Lipper, J.P Morgan Asset Management. February 2020. Global Equities are represented by the MSCI AS World Index, Global Bonds by the BBG Aggregated Index and Global Private Equity by The Cambridge Associates LLC Private Equity Index. For Global Equities and Global Bonds manager dispersion is based on 2Q 2009 – 2Q 2019 annual returns. Global Private Equity is represented by the 10-year horizon internal rate of return (IRR) ending 2Q 2019.

As we look towards 2021, we continue to pursue a high conviction strategy aimed at building exposure to companies and sectors that demonstrate three main characteristics. First, the team looks for top-down macro or micro conviction in sectors, based on their long-term growth drivers and the need for private capital. Secondly, we look for a compelling need for private capital, preferably demonstrated through success of private investors in the given area. Thirdly, we seek a robust investible universe with sufficient breadth of quality opportunities to ensure the investment team can selectively build a high quality portfolio of the best in class opportunities.

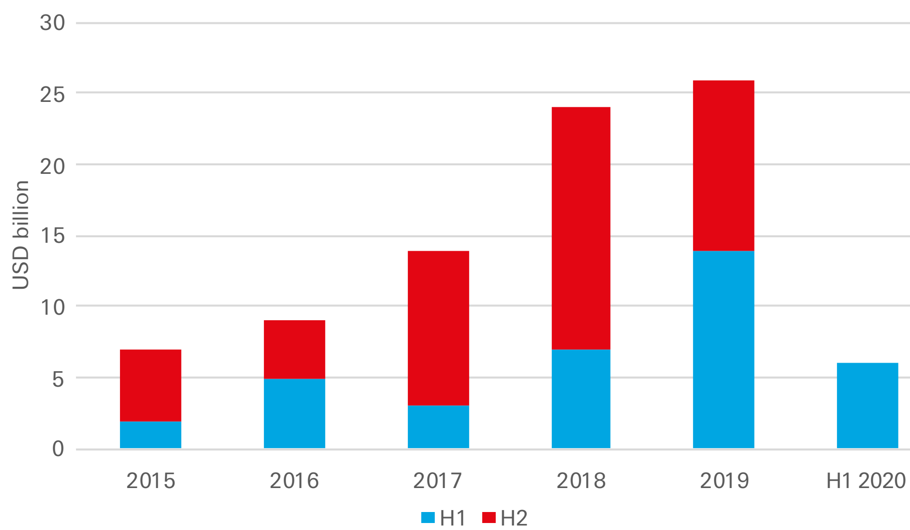
Within our discretionary portfolios we seek to gain access to our high conviction themes through a combination of primary fund investments, secondary transactions and co-investments. Although we aim to build diversified exposure to the three types of investments, in the short term we see an increased opportunity in the manager-led secondary space, in which a manager creates a liquidity event for their current investors and allows new investors to acquire stakes in an existing portfolio. Manager-led transactions have grown to be a large percentage of total annual transaction volume and have formed a new market for secondary investing that did not exist in scale before. Our investment team has had a focus on manager-led secondary transactions and is positioned to take advantage of the increased opportunity set.

Overall, we continue to believe in the benefits of disciplined deployment into the private equity asset class, through a high-conviction approach and consistent vintage diversification.

Technology Sector Share of Total Global PE Deal[2].



Manager-Led Transaction Volume[3].



[2] Landmark.

[3] Landmark.

Real Estate

The pandemic has hit retail-related real estate hard, but accelerated the move to ecommerce, supporting industrial assets. Demand for office space may be mixed, with high quality offices in accessible locations outperforming. Compared to the great financial crisis, there are relatively few signs of distress in real estate outside of retail, and investors continue to show interest for the asset class in the low interest rate environment.

The impact of the Coronavirus on real estate varies by sector and geography. Retail remains the most severely impacted, though the effect has been to exacerbate pre-existing weaknesses rooted in shifting consumer behaviour towards ecommerce. Lockdowns have had a particular impact on non-essential retailers, restaurants and hotels. In particular, retailers in busy office and tourist destinations along with shopping centres have seen footfall evaporate with travel restrictions and government guidelines to work from home.

Where possible, many businesses that have been forced to close have accelerated their digital offerings via delivery or click and collect to preserve some cash flow. However, the retail sector remains impacted by second and third waves of the virus which have prompted further lockdowns and undermined consumer and business confidence.

There are some bright spots, most notably drive-through restaurants in out of town locations and discount retailers, though these won't compensate for what is sadly expected to be a record year for shop closures in several countries.

As a result, rent collection from some retail sub-sectors, leisure, and hospitality tenants has fallen significantly, and is only expected to fully recover once normal life can resume. In some cases, eviction moratoriums for non-payment of rents have prompted retailers, who possibly could afford to pay rent, to withhold it. For these withheld rents, tenants are typically still compelled to pay rents at a later date.

Rent collection has been more resilient elsewhere. Industrial landlords have benefitted from the strong recovery in manufacturing, but more significant has been surging ecommerce activity. Generous fiscal support buttressed online retail spending even as activity in many physical shops fell away. Moreover, although easing lockdowns allowed many shops to reopen, online shopping remains at levels that were not expected to be reached for several years (prior to the pandemic). Looking ahead, as the vaccine is rolled out we expect ecommerce activity to remain significantly above pre-pandemic levels, which will support industrial demand for the foreseeable future.

Although rent collection for office landlords has also been resilient as most businesses continued to pay rent during lockdowns, fundamentals are softening. In some markets this is a reflection of elevated development activity, specifically in some cities in the US and Asia-Pacific. The main reason for rising vacancy rates, however, is the widespread sharp drop in leasing. Rising vacancy rates are beginning to exert downward pressure on rents in some of the world's global gateway cities including New York, San Francisco, London, and Singapore, while elsewhere positive rental growth is moderating.

There remains considerable uncertainty about the long-term balance between home working and working in the office. But despite some cushioning impact from lower office densities, we believe that businesses will need less office space than was the case before the pandemic. The scale of the shift will depend on factors including pre-existing office densities, the success at tackling the Coronavirus, local living condition (such as typical apartment size), and pre-existing office culture.

That said, we expect offices to remain critical as places for collaboration, to reinforce culture, train team members, and drive social interaction. The net result may well be an increase in occupier demand for high quality office assets in the most accessible locations whilst poorer quality secondary assets may struggle without considerable capital expenditure.

Investment activity remains subdued, with volumes during Q1-Q3 of 2020 being 33% below 2019 levels according to Real Capital Analytics. Despite the economic challenges and loss of liquidity, capital value declines have largely been confined to the retail sector as central banks have driven down interest rates and investors seek to allocate significant amounts of "dry powder" to real estate. In particular, investor appetite for industrial property has only intensified, driving yields lower and pushing up values. Where office deals are taking place, evidence suggests yields are unchanged overall, with particularly strong interest for prime assets, where tenant demand should be more resilient in the longer term.

So far there have been few signs of distress, particularly when compared to the GFC. This reflects the resilient rent collection for most tenants away from retail and tighter lending standards during this cycle (giving borrowers a larger cushion should values fall). Any loan-to-value covenants breaches are likely to be concentrated in the retail and hotel sectors, and so further price declines are expected here.

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Risk Disclosures

Risks of investment in fixed income

There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk

Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments

High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures

- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or canceled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal.

Changes in legislation and/or regulation

Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalization risk

The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

Reinvestment risk

A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate.

Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to-market valuation.

Risk disclosure on Dim Sum Bonds

Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.

Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.

There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.

Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

Risk disclosure on Emerging Markets

Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin

The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/ options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

Currency risk – where product relates to other currencies

When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan ("CNY") risks

There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products

In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

Alternative Investments

Investors in Hedge Funds and Private Equity should bear in mind that these products can be highly speculative and may not be suitable for all clients. Investors should ensure they understand the features of the products and fund strategies and the risks involved before deciding whether or not to invest in such products. Such investments are generally intended for experienced and financially sophisticated investors who are willing to bear the risks associated with such investments, which can include: loss of all or a substantial portion of the investment, increased risk of loss due to leveraging, short-selling, or other speculative investment practices; lack of liquidity in that there may be no secondary market for the fund and none expected to develop; volatility of returns; prohibitions and/ or material restrictions on transferring interests in the fund; absence of information regarding valuations and pricing; delays in tax reporting; - key man and adviser risk; limited or no transparency to underlying investments; limited or no regulatory oversight and less regulation and higher fees than mutual funds.

Investments in Commodities

Investments in commodities may involve substantial risk, as the price of the commodity may fluctuate significantly.

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