Investment Outlook

Q4 2021

Slow(er) and steady wins the race

HSBC

Global Private Banking

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Welcome

Dear client

The pace of economic growth has started to slow in most countries around the world. Following the sharp V-shaped recovery earlier this year, we have now entered the mid-cycle stage. But this should not be a negative for markets, as the adage goes that slow and steady wins the race.

Firstly, a slowing economy does not mean a stalling economy. Consumers will want to spend some of their accumulated savings in coming months, companies need to rebuild inventories, and governments are helping extend the economic cycle through huge infrastructure and green energy investments.

Secondly, monetary policy adjustment can be more gradual – and therefore more supportive – while a mild slowdown reduces the risk of overheating. With unemployment still well above normal, and US and global growth easing, the Fed has signalled it is much too early to consider rate hikes.

And thirdly, equity returns in the mid-cycle stage have historically been lower than in the recovery stage, but still very respectable due to continued earnings growth.

That said, the transition to the mid-cycle stage has caused us to reduce exposure to some early-cycle sectors (industrials and materials), and to increase our focus on quality and on large caps. In the continued low rate environment, we also look for dividend income to complement what we can find in global high yield and emerging market bonds.

But while it is clear that the cycle and equity returns are slowing, it is less likely that things will be steady. Vaccinations allow economies to reopen, but the path can be volatile due to the Delta variant. Similarly, supply chain bottlenecks should be resolved over time, but reports of shortages can lead to market nervousness. And while we expect inflation to fall in coming quarters, the risk is that this could be delayed, causing bond yields to remain “low but volatile”.

So investors need to make their portfolios more resilient to volatility, by managing bond duration, by focusing on quality and by actively diversifying their investment portfolios. Asian investors have seen significant market volatility due to COVID-19 and regulation, so we look for secular growth opportunities there (such as advanced technology, automation and the green revolution) while diversifying geographically.

One area where being slow and steady is a very bad idea, though, is sustainability. Recent flooding and fires, and the explicit IPCC Climate report warn us that much more rapid progress needs to be made. This quarter, the German elections and COP-26 will put sustainability squarely on the agenda, for politicians, voters, companies and investors. Our sustainability themes highlight the rising importance of climate adaptation technologies and the increased focus on the social aspect of ESG.

Long-term themes such as sustainability, the digital transformation and Asia’s new growth path allow investors to be somewhat less sensitive to the short-term uncertainties and help create more resilient portfolios. Even for the longer term, expected future returns will be slower, given the sharp run-up we’ve seen in recent years. We don’t think that clients should react to this by moving to the riskiest opportunities. Rather, limiting cash balances and remaining invested in diversified portfolios, looking at the best opportunities across asset classes and regions should help win the marathon.

Willem Sels,
Global Chief Investment Officer

6 of September 2021

Our portfolio strategy for Q4 2021

The macro environment: slow but prolonged recovery

What's clear from the economic data is that global economic momentum is slowing; you can see this in GDP data, PMIs, and economic surprise indices. To some extent this is natural: after the V-shaped recession and quick rebound, sequential growth numbers are bound to slowdown. China entered the recession before others, and thus exited it earlier as well. The US followed, and Europe lagged, which means that Europe is now still enjoying the end of that V-shaped rebound.

But it's a bit more than a natural end to the 'V' shaped recovery. Supply disruptions due to low inventories of manufactured goods such as semiconductors are taking longer to be resolved than many expected, and this is weighing on manufacturing activity. Meanwhile, on the consumer side, it has been a mixed picture, with some areas benefiting from the reopening but others seeing renewed lockdowns. Overall, vaccines are allowing people's lives to return to some normalcy again, but fear of infections is still holding some consumers back.

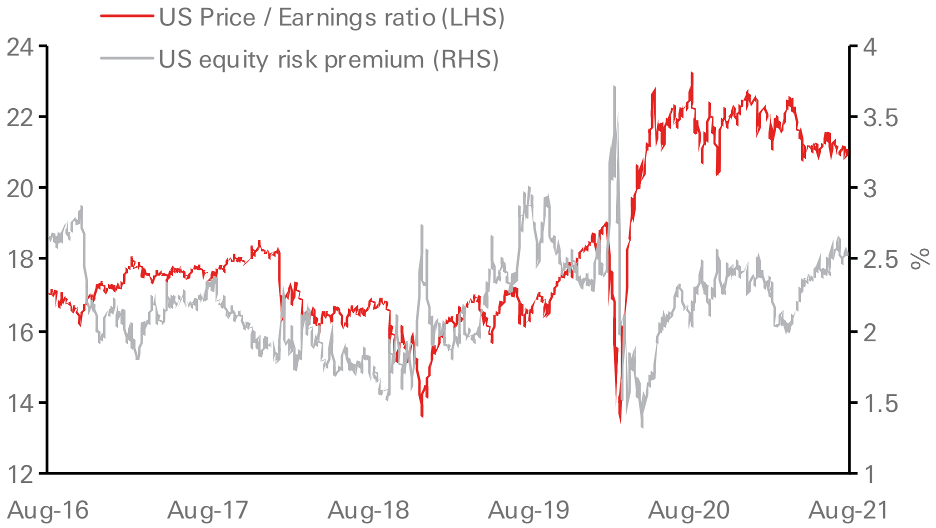
These challenges may be delaying the recovery, but should not derail it. Inventories will still need to be rebuilt, and if it happens at a slower pace, the boost should be smaller but more protracted, keeping the economic recovery going. Consumers may take longer to spend their accumulated savings or go back to work, but they eventually will, which should also help extend the recovery. And the significant investments in infrastructure - most notably through the American Jobs Plan, but also through the EU's Next Generation Fund – should provide further support to growth over the coming years. In China, the government's policy is quite clearly focused on continuity, stability and sustainability of growth. So around the world, we think the picture is one of slightly lower, but gradual and prolonged growth.

A key consequence of this is that policy normalisation can also be slower and more gradual. As a result of somewhat slower global and Chinese growth, commodity prices have started to come down from their peak, leading inflation readings to plateau or edge lower as well. And it is also in part because of the uncertainty around US consumer behaviour, the labour market and the potential impact of China's slowdown on the US that the Fed is adopting a slow and gradual policy. We expect the tapering of US bond purchases to start in November or December, and be a slow process, with US rate hikes following only in 2023. The UK may lift rates by 0.4% in 2022 (to 0.5%) and a few emerging markets may start hiking rates but global financial conditions will remain very accommodative. Slow and gradual seems to be the central banks' mantra.

Market action and levels: high but well-supported valuations

For markets, this move to the mid-cycle stage where growth continues at a slightly slower pace and central bank policy is accommodative, remains a positive backdrop. Economists may no longer be upgrading their growth forecasts, but equity analysts still are. The latest earnings season was strong, with a near-record number of companies exceeding expectations, especially those that adapt to new areas of demand in the post-COVID era and were able to charge through any price increases. Analysts are often much slower than markets to price in the recovery, so in the initial stage of the rally, indices rally more than earnings (leading to higher price/earnings valuations), while later in the process, earnings are revised up (with price/earnings ratios falling a bit, as we saw recently). Somewhat lower price/earnings ratios may make investors more comfortable with current valuations, and should still be compatible with respectable equity returns as long as earnings remain solid.

Equity valuations are off peak levels and the equity risk premium is above average.



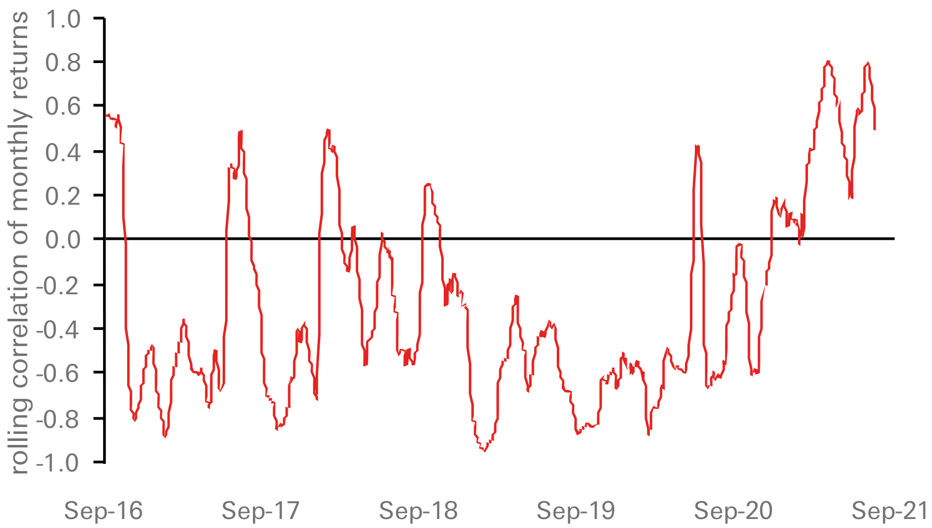
Source: Refinitiv, HSBC Private Banking as at 6 September 2021. Past performance is not a reliable indicator of future performance.

Bond investors are challenged by high valuations as well, but given the very slow nature of policy normalisation, those valuations should be well supported. That said, the relative moves within the bond market matter. Markets' inflation expectations have already dropped somewhat from recent peaks, and we expect this process to continue. That makes Treasury Inflation Protected securities (TIPs) unattractive, and is slowing the reflation trade in equity markets. Real rates on the other hand have started to rise somewhat from their recent record-lows, as we approach the date where Fed tapering could start. Again, this can have wide-ranging consequences, from being a mild headwind for gold to being a positive for the US dollar.

Our portfolio strategy, and what have we changed this quarter

TThe continuation of growth and accommodative monetary policy in the mid-cycle stage motivate us to remain invested and adopt a mild risk-on stance. Cash remains unattractive, and we expect positive returns for equities, credit and emerging market bonds. But we think it is important to make portfolios resilient, because we expect slowing upside for stocks and there is execution risk around the Fed's policy change. With bonds and equities highly correlated to each other and to Fed policy, it's very important to diversify across asset classes, sub-asset classes, geographies and in alternative assets.

Portfolio diversification requires more effort than usual as equities and bonds are currently highly correlated.



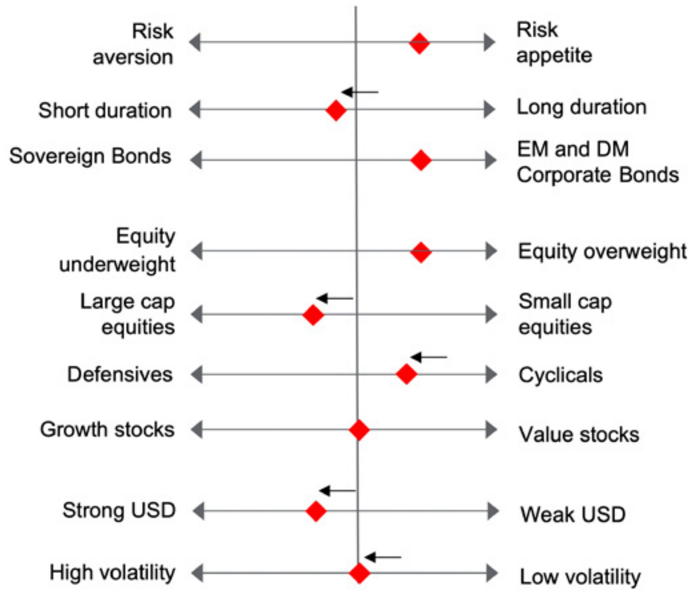
Source: Refinitiv, HSBC Private Banking as at 6 September 2021. Past performance is not a reliable indicator of future performance

We have made a number of changes to our portfolio strategy in the past quarter because of the changes in the growth and policy outlook, and the importance of sustainability.

Implications of slower growth:

To adapt to somewhat slower growth, we have increased our focus on resilience during the past quarter, and have introduced a quality bias, as well as a preference for large cap stocks. We also reduced exposure to industrials and materials, two early-cycle sectors, moving them to a neutral stance. That slightly reduces the cyclicality of our equity strategy, but it is still much too early to be defensive. Lower growth should also be a headwind for industrial metals, and we have downgraded AUD and NZD to neutral.

Our 6-month positioning preferences



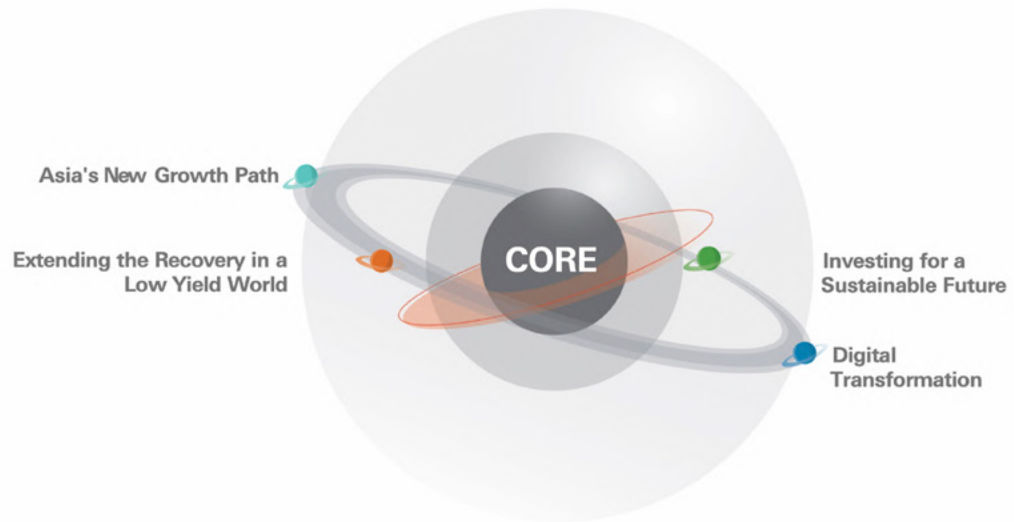
Implications of policy action:

The start of US policy normalisation leads us to expect some USD strength, which is likely to lead EUR lower. In the emerging markets, we are starting to see the potential for some rate hikes, so we have become more selective and have shortened the duration in our bond portfolios. Following the regulatory actions in China's education and internet stocks, we think foreign investors are awaiting more clarity and we have moved our Chinese allocation to neutral. We continue to invest in China's secular growth opportunities exposed to semiconductor, advanced technology, automation and the net zero transition. Asian investors can diversify in the region into Thailand, Taiwan and Singapore, as well as globally.

Sustainability high on the agenda:

The floods and fires around the world, and the UN IPCC's report (Intergovernmental Panel on Climate Change) will keep sustainability high on the list of market considerations ahead of the COP26 summit and the German September elections. It is now clear that we need to approach climate change both from a mitigation and adaptation perspective, and we have changed our investment theme in that sense, putting increased emphasis on adaptation. We have also launched a new theme called *The rise of 'S' in 'ESG'*, focusing on sustainable healthcare and diversity and inclusion issues, as the pandemic has further illustrated inequalities and the importance of companies' social role in society.

Top Four Trends for 2021 and Q4 Global High Conviction Themes



Asia's New Growth Path
- China's Future Society and Technology
- Power of the Asian Consumer
- Asia's Supply Chain Revamp
- Asian Credit Opportunities

Extending the recovery in a low yield world
- Reopening America
- Infrastructure 2.0
- European exporters
- Reaching for High Yields
- EM Debt – Carry in a Low Yield Environment
- DM Financials Credit

Digital Transformation
- Smart mobility
- Automation
- Total security
- Healthcare Innovation

Investing for a Sustainable Future
- Climate Change – Mitigation and Adaptation Opportunities
- China's Green Revolution
- The rise of 'S' in 'ESG'
- Sourcing Income in a Sustainable Way

Quality stocks for the mid-cycle

We examine sector and style performance during historical mid-cycle periods. Sector performance varies, depending on the source and speed of global growth. Style performance is more consistent, and our analysis supports our current preference for quality stocks.

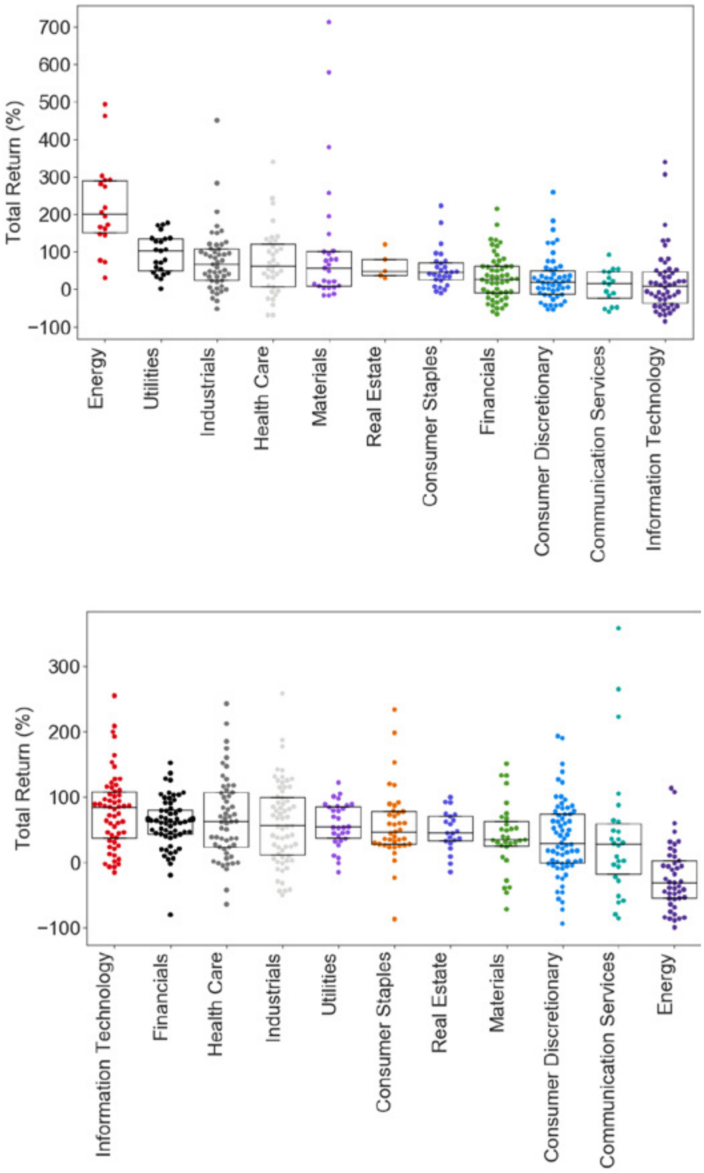
1. Sector performance in the mid-cycle stage

Stock selection based on the analysis of the macroeconomic cycle is where the top-down investment framework truly meets bottom-up analysis. There is no question that stocks belonging to certain sectors tend to perform better when the economy is booming, and that other sectors tend to be in favour during recessions. This observation gave rise to the popularity of "sector rotation" models, the most basic of which label sectors as either cyclical or defensive. Industrials, materials and consumer discretionary are examples of sectors typically labelled as cyclical, whereas utilities, consumer staples and healthcare are considered defensive, based on these sectors' performance patterns during historical expansions and recessions. But rather than simply considering expansions and recessions, the more complex sector rotation models consider multiple stages of the business cycle, such as recoveries, expansions, slowdowns, and contractions. Alternatively, the nomenclature may refer to early, mid, and late cycle stages. What complicates the analysis is the fact that each cycle is different, and secular forces can sometimes overwhelm the typical cyclical forces, adding considerable noise to the underlying sector leadership patterns.

To see this, consider two recent mid-cycle periods. First, during the expansion of 2003-2007, the re-emergence of China and other emerging markets was the dominant global theme. Rising commodity prices, an increasing role of Chinese manufacturing, and growing geopolitical tensions in the Middle East together pushed industrials, materials, and energy to the top of the sector performance charts during this period. In contrast, IT, financials and health-care were the top performing sectors during the mid-cycle period between 2013 and 2017, which is strikingly different from the mid cycle in 2003-2007.

Given that sector leadership is driven by a number of influences that aren't necessarily related to the prototypical business

S&P 500 stocks by sector during mid-cycles in 2003-2007 (top panel) and 2013-2017 (bottom panel).



Source: HSBC Private Banking, Bloomberg, as at 6 September 2021. Dots represent total returns for all index members, grouped by sector, with one outlier removed for presentational purposes. The black boxes represent the median, the upper and the lower quartile for each sector. Sectors are rank-ordered from left to right by median return.

cycle, success in sector rotation requires a consideration of a broader range of factors, such as technological, demographic, and industry-specific developments. Due to specific combination of these forces at any point in time, the sectors that were defensive in one cycle may become cyclical in another. The current mid-cycle is unlikely to closely resemble the 2003-2007 episode, as China is slowing and the services sector is growing. We think IT and healthcare will continue to see strong support in the post-pandemic world, while financials benefit from the ongoing recovery and may be a good hedge if rates were to rise more quickly than we expect.

2. Style performance in the mid-cycle stage

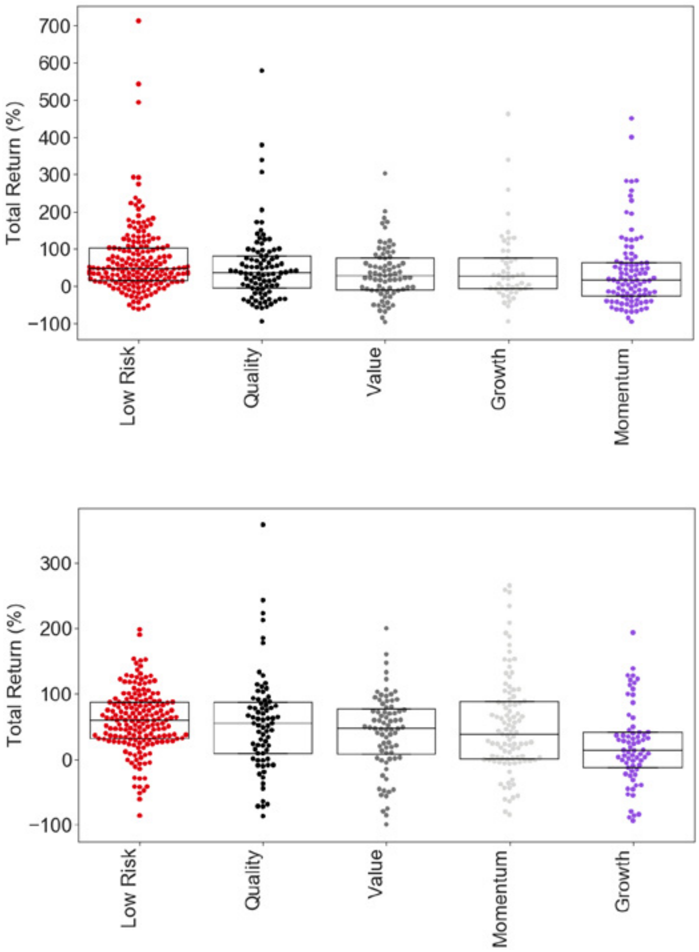
Interestingly, we find that classifying stocks into style buckets leads to more consistent cyclical rotation patterns. This may be in part because different sectors will migrate across different style categories based on the prevailing market conditions.

The charts on the right show that low risk and quality stocks were top performers, and growth and momentum were the laggards in both of the mid-cycle periods we analyse. While value stocks tend to perform well in the early cycle, style rotation favours quality in subsequent periods. This persistence makes style rotation a potentially interesting opportunity for playing the business cycle in the stock market.

Of course, there can be exceptions to the rule. For example, while value stocks typically perform strongly during recoveries and take damage during contractions, value substantially outperformed all other styles during the dot-com bust between 2001 and 2003, in the aftermath of the speculative bubble in growth stocks. But focussing on mid-cycle phases, which can exhibit multiple episodic slowdowns and upswings, stocks with quality characteristics such as low leverage, high profitability and stable earnings have shown fairly consistent resilience.

In summary, positioning across sectors in the context of market cycle requires a range of considerations beyond the macroeconomic analysis, such as valuations, technological developments, and even demographics. On the other hand, style rotation may provide a more predictable behaviour based on the business cycle alone, especially during the mid-cycle, where quality and low risk stocks tend to outperform the rest.

S&P 500 stocks by style during mid-cycles in 2003-2007 (top panel) and 2013-2017 (bottom panel).



Source: HSBC Private Banking, Bloomberg, as at 6 September 2021. Dots represent total returns for all index members, grouped by style, with one outlier removed for presentational purposes. The black boxes represent the median, the upper and the lower quartile for each style. Styles are rank-ordered from left to right by median return.

Top Four Trends and High Conviction Themes

1. Asia's New Growth Path

The Delta variant outbreaks across Asia and China's regulatory clampdown in the education and internet sectors weighed on performance of the Asian equity and credit markets in Q3 2021. We see the market weakness as a tactical setback and do not expect these challenges to derail the medium-term structural growth trends in Asia. Our investment themes focus on secular growth opportunities linked to policy priorities, long term trends and the global search for yield.

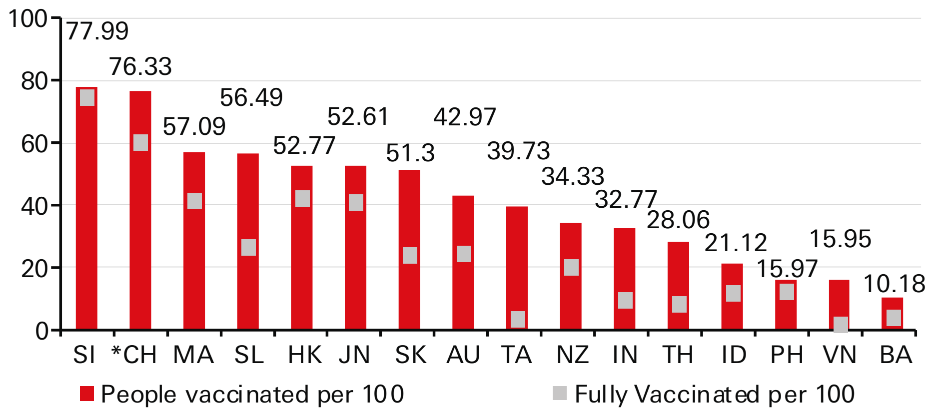
Our four high conviction themes

1. China's Future Society and Technology
2. Power of the Asian consumer
3. Asia's Supply Chain Revamp
4. Asian Credit Opportunities

The Delta headwind caused us to trim our 2021 GDP growth forecasts for ASEAN, but our Asia ex-Japan 2021 GDP forecast is down only mildly from 7.8% to 7.4%, still showing resilient growth. The industrial capex cycle, the digital transformation and solid middle class consumer demand are the key drivers of our Top Trend of Asia's New Growth Path. 80% of global semiconductor manufacturing capacity is located in Asia, which is thus a major beneficiary of the digital disruption and global chip shortage. China's unprecedented regulatory actions reflect a profound shift of its policy focus on social stability and inclusive growth. Under Beijing's strategic priority to achieve "common prosperity" in the 2035 vision, we expect further regulatory changes in the coming quarters to promote income equality, fair competition and personal data protection.

The pandemic and regulatory uncertainties underpin a divergent outlook for the Asian markets depending on vaccination rates and policy support. This calls for a more selective strategy, oriented towards quality recovery leaders and structural growth winners. Singapore and China are leading the vaccination progress with 78% and 76% of their populations having received at least one dose. Singapore is the first Asian country to reopen its borders and lift travel restrictions. We are overweight on equities in Singapore, Taiwan and Thailand which are major beneficiaries of the global economic reopening. Within Asian fixed income, we have overweight positions in Chinese and Indonesian credit.

Vaccination rates are picking up across major Asian economies.



Source: HSBC Global Research, Our World in Data, HSBC Private Banking, 6 September 2021.

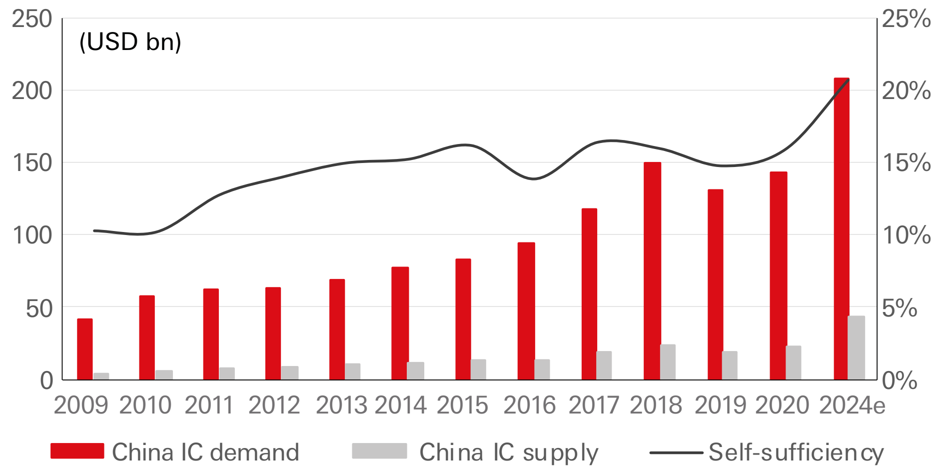
China's Future Society and Technology

To help manage China's regulatory risks, we identify structural growth winners in sectors which are more resilient, defensive and less exposed to policy risks associated with antitrust enforcement, personal data protection and social inequality. We think sector and stock return differentiation will remain high in China's equity market, creating some attractive alpha opportunities in undervalued quality structural growth leaders. Our investment theme focuses on industry leaders exposed to the technology upgrade, digital infrastructure, automation and 5G. We expect continued strong growth in government and corporate spending on innovation and advanced manufacturing in the coming years, in line with the policy goal to achieve technology self-sufficiency.

The policy goal of "common prosperity" aims to reduce income inequality, promote fair market competition, support SMEs and expand the size of the middle class. The latest policy initiatives related to the "New Three Big Mountains" (i.e. high costs of education, healthcare services and housing) intend to reduce the financial burdens on households, and restore their consumption power. The government wants to expand the middle class, as exemplified by the recent initiative to make Zhejiang province a pilot zone for "common prosperity", and where 80% of the population should be in the middle income group by 2025. We believe the policies to achieve "common prosperity" should benefit consumption volumes, and the upgrade to higher quality, digital and green goods and services.

The 14th Five-Year Plan aims to accelerate urbanisation, upgrade traditional infrastructure and promote development of smart cities, and this will bring investment opportunities in the new infrastructure space. The ageing population and rising income levels should boost demand for healthcare services. We expect continued capital market reforms, opening of international capital flows and the development of digital currencies and payments to benefit financial institutions and fintech companies with strong market presence in mainland China and Hong Kong.

China's 14th Five-Year Plan promotes technology self-sufficiency and innovation.

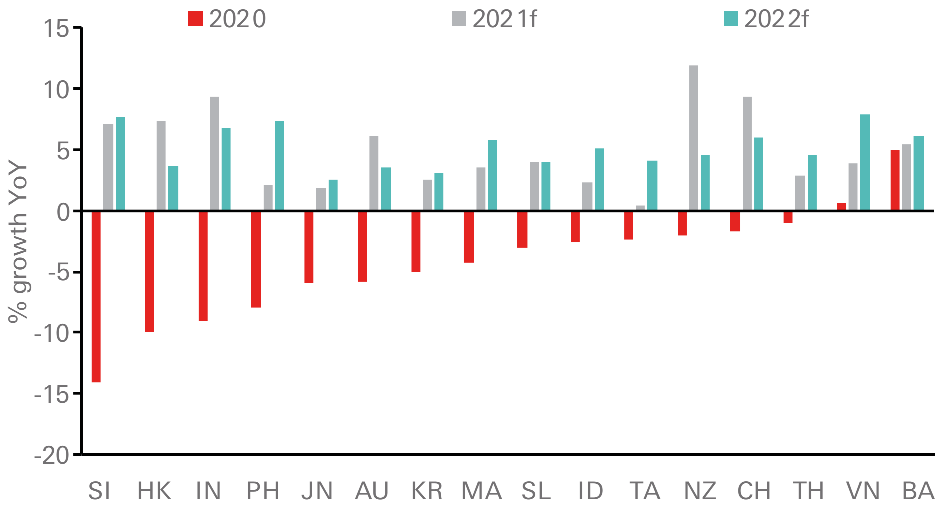


Source: CEIC, IC Insights, HSBC Global Research forecasts, HSBC Private Banking as at 6 September 2021. IC stands for Integrated Circuit.

Power of the Asian Consumer

The Delta variant has hit performance of Asian stocks in recent months, but the good news is that the death and hospitalisation rates remain much lower than in 2020 and the vaccination rate is picking up. Private consumption should therefore continue to recover, and in our view, the market correction presents attractive re-entry opportunities into quality Asian consumption companies. Although vaccine supply was a major concern for Asia earlier this year, especially in ASEAN ex-Singapore, most countries have now secured enough doses to inoculate 80% of their populations. As vaccination rates rise, we should see further relaxation of social distancing restrictions which bodes well for recovery in consumer services.

We expect a sustained expansion in Asia's consumer spending into 2022.



Source: CEIC, IC Insights, HSBC Global Research forecasts, HSBC Private Banking as at 6 September 2021. IC stands for Integrated Circuit.

In China, the latest Delta wave has been quickly brought under containment with daily cases now in single digits. Nanjing has resumed commercial flights since 26 August after a month-long airport closure. And Singapore, which at 80% has the highest vaccination rate in the region, has started to reopen its economy by easing community control measures and travel restrictions. Thailand should be a key beneficiary of the resumption of international travel, given its strong reliance on tourism.

Fiscal stimulus, high saving rates and pent up demand support the outlook for the Asian consumption sector. In China, we expect more targeted monetary and fiscal support later this year, including targeted RRR cuts, tax cuts and subsidies for the SMEs which should support the job market recovery and boost consumer spending. We expect Asia's unemployment rate to fall to 3.8% in 2021 and 3.6% in 2022, from 3.9% in 2020. Better job security and rising wages should encourage Asian consumers to spend more.

The investment opportunities under our 'Power of the Asian Consumer' theme include strong Asian consumer brands. Those companies catering to digital consumers should see a long-term uptrend in total addressable markets, as consumer preferences continue to shift in favour of ecommerce as a result of the pandemic, especially in Southeast Asia. We favour digital consumer-facing companies in the ecommerce, digital payment and fintech service companies in ASEAN.

In China, the government's support for SMEs and efforts to expand the middle income group should benefit the strong national consumer brands, especially the domestic brands that carry cultural heritage. To create a healthier society, China recently announced plans to boost sports' spending in the run-up to the 2022 Winter Olympics in Beijing. The new policy measures include building and renovating more than 2,000 sports parks, fitness centers, public sports stadiums, and raising the percentage of people participating regularly in physical activity to 38.5% by 2025 from 37.2% in 2020. We believe those initiatives should benefit sportswear, sneaker and sports equipment producers.

Asia's Supply Chain Revamp

The Delta-related lockdowns also aggravated Asia's supply chain disruptions and the global semiconductor shortage, with Vietnam, Malaysia and Thailand taking a hard hit. US, Japanese and Korean automakers reported production disruptions due to insufficient chip supply. And in Malaysia, a major centre for chip testing and packaging, Delta outbreaks disrupted local semiconductor supply chains. To ease the semiconductor supply chain bottlenecks, Asian manufacturers are planning to boost capacity and upgrade technology in the coming quarters.

In response to these issues, Asian manufacturers are actively revamping their supplier network and production models to enhance supply chain security. One solution is to relocate parts of the manufacturing capabities from China to lower-cost emerging economies like Vietnam, Thailand, India and Cambodia. But this does not necessarily mean that China will lose market share in global exports. In fact, China's share in international exports surged to 17% in the year ended February 2021 from 14% in 2019. Another solution is to increase the level of vertical integration, which gives a firm better control over its supply chains. Finally, reshoring and nearshoring can help shorten supply chains, and hence reduce the pressure points.

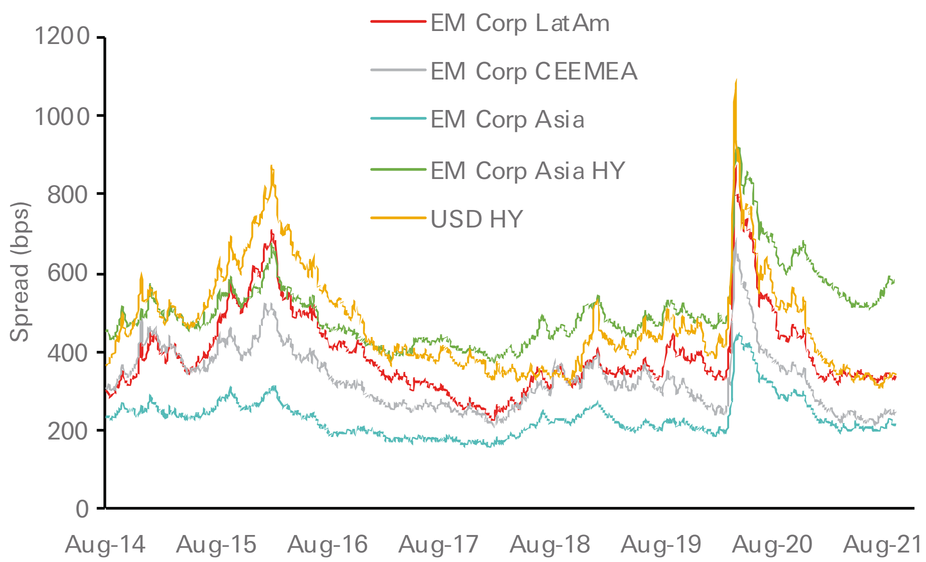
We find plenty of investment opportunities arising from the remodeling of Asia's supply chains, which are pivotal to the global manufacturing engine. The good news is that the combination of fiscal stimulus, improved corporate earnings and export resilience will set the stage for strong investments in Asia's supply chains. The global semiconductor shortage may last beyond 2021, which should help earnings of chip manufacturers, semiconductor equipment and materials producers and automation equipment makers in Taiwan, South Korea, mainland China and Japan. But in the longer term, the global chip shortage will also prompt more governments and companies to consider re-onshoring or relocation of manufacturing capacities, especially for strategic industries such as semiconductors, medical supplies and vaccine production.

Asian Credit Opportunities

The low-for-longer rate environment continues to support our theme on the Asian Credit Opportunities due to the attractive risk-return trade off and resilient credit fundamentals of the Asian bond market. The Fed's gradual approach in policy normalisation should avoid a repeat of "Taper Tantrum" in the Asian credit markets. And given the Delta headwinds, most Asian central banks have maintained their accommodative monetary stance: apart from the Bank of Korea, which hiked rates by 0.25% in August, we do not expect any other hikes this year in Asia. This is positive for Asian credit, and we like short-duration Asian high yield bonds for the substantial yield pickup over developed market credit with similar credit metrics.

In China, the government's clampdown on over-leveraging in the real estate sector and the debt problems of China Huarong have added volatility to both the onshore and offshore credit markets in recent months. But these credit events are idiosyncratic incidents with limited systemic market impact while the People's Bank of China is shifting towards a more growth supportive policy stance, as indicated by the RRR cut in July. The recently announced state-led rescue package for China Huarong represented the government's first major attempt to resolve the debt crisis of this systemically important financial institution. We believe the resolution for Huarong should boost investor confidence in China's USD12trn credit market. Within the Asian credit market, we see the most compelling carry opportunities in China's hard currency and local currency credit and Indonesia's hard currency bonds.

Asian high yield credit spreads offer attractive carry.



Source: Bloomberg, JPM ICE BOFAML indices, HSBC Private Banking as at 6 September 2021.
Past performance is not a reliable indicator of future performance.

2. Extending the recovery in a low yield world

The second set of thematic opportunities positions for the current mid-cycle stage. Three of the themes exploit areas of the global economy that should see continued strong growth, while the other themes help enhance portfolio income in the low yield environment.

Three areas with solid earnings growth

1. Reopening America
2. Infrastructure 2.0
3. European exporters

Finding income in a low yield world

4. Reaching for High Yields
5. EM Debt – Carry in a low yield environment
6. DM financials credit

Three areas with solid earnings growth

In the mid-cycle stage, global economic growth is slowing slightly, but not coming to a halt. The US remains the strongest engine of growth in developed markets, which we exploit in our **Reopening America** theme. US manufacturing optimism is high and inventories need to be rebuilt, while US consumers benefit from rising wages and falling unemployment. This should result in a very respectable 4.3% US GDP growth rate in 2022, and continue to support equity analyst and investor confidence.

The US government is further boosting growth with major investment in roads, bridges, rail, water, clean energy, internet and broadband. But our **Infrastructure 2.0** theme also sees opportunities elsewhere. The disbursement of the EU's EUR 750bn recovery fund is accelerating, for purposes including digital, health and green infrastructure. In China too, the focus is on investment in new technologies such as 5G and strong digital networks, to achieve quality growth and to position the economy for the future.

European Exporters should continue to do well in the mid-cycle stage. The European stock market includes many strong consumer brands that are recognised around the world. These should cater well to resilient global consumption, whilst others will export Europe's green energy, infrastructure or machinery expertise. The mild weakness we foresee in the euro in coming months should be a further tailwind for European exporters.

Finding income in a low yield world

Our core portfolio strategy is centred around the view of a low yield world. With an economy that is neither too hot nor too cold, inflation should start to normalise, allowing central banks to adopt a gradual approach to any policy normalisation. That combination of low rates, gradual monetary policies and just above average growth is almost ideal for emerging market and corporate bonds. Hence, our core portfolio strategy has a significant overweight in yield enhancement strategies, across EM hard and local currency bonds, and high yield.

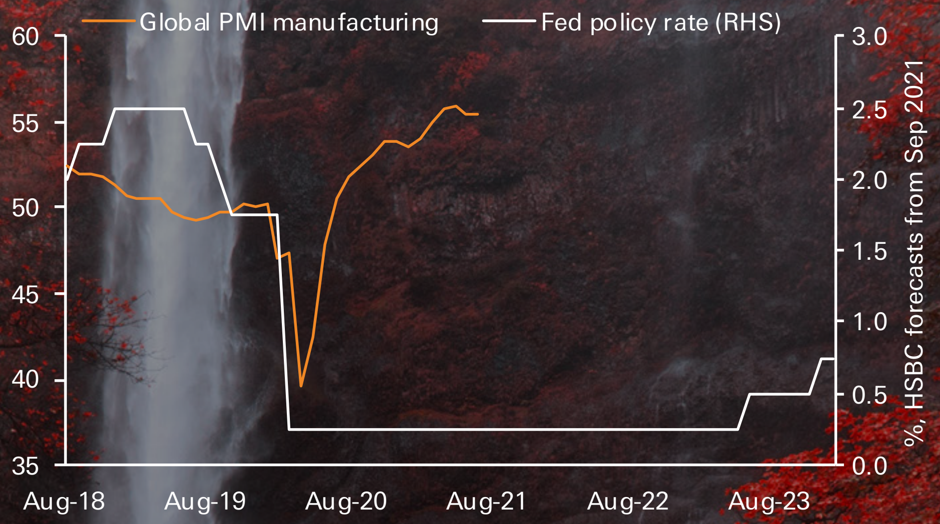
But at current yield levels, investors who have income requirements may not generate enough income just by being overweight on higher yielding fixed income. For those investors, it may make sense to add some of the following three themes as satellites around their core portfolio.

We are **Reaching for High Yield** in… high yield! Credit spreads have already compressed, and there is little scope for further tightening. But as we remain in a low yield environment, we like to clip the coupons in high yield (HY). And the ongoing recovery leads rating agencies to upgrade many HY companies, which should further support valuations.

Emerging market debt similarly provides **carry in a low yield environment**, but we have become somewhat more selective. We shorten duration and, where possible, hold bonds to maturity as some EM countries may need to start hiking rates. We generally see the best opportunities in EM hard currency corporate debt.

Lastly, **DM financials credit** still provides a good yield pickup, especially in subordinated bank and insurance bonds of intermediate maturities. Although banks' profitability suffered during the pandemic, capital buffers remain solid, and loan losses for many banks turned out to be lower than feared, which should provide comfort to investors. Of course, we are selective when going down the capital structure and a close examination of the bonds' features is important.

Cyclical momentum may be slowing but growth continues and rates should remain low.



Source: Bloomberg, HSBC Global Research, HSBC Private Banking as at 6 September 2021. Past performance is not a reliable indicator of future performance. Federal Reserve policy rate forecasts looking ahead are subject to change.

3. Digital Transformation

Digitalisation is not a new phenomenon, so why are we highlighting it now? Like many good things digitalisation takes time and happens in phases and at pivot points, as the technology allows new progress. Digitalisation allows information to become more fluid and usable in a robust format that is easily exchanged, thereby opening up a world of possibilities.

Our four high conviction themes

1. Smart Mobility
2. Automation
3. Total Security
4. Healthcare Innovation

Smart Mobility

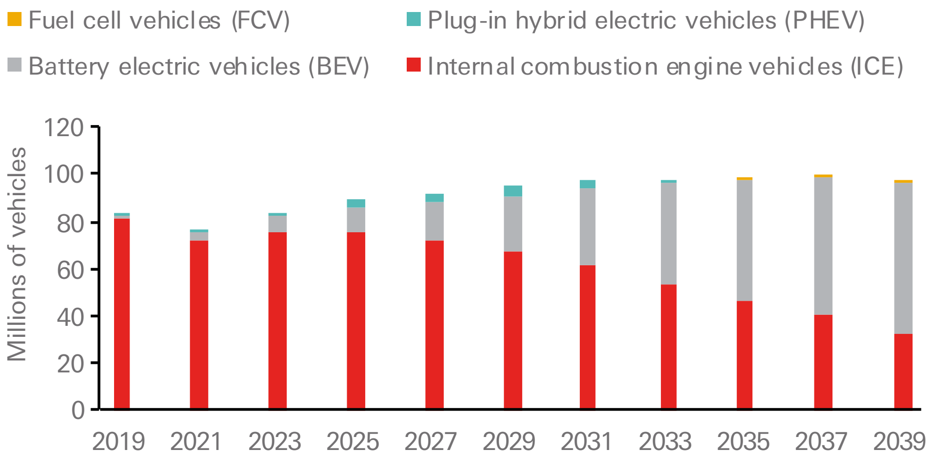
While many forms of traditional transportation may have changed little from the outside over the last 50 years, under the bonnet, there has been major technological innovation. These changes will impact the way transport is used, powered, controlled and the way people interact with it. Basically, transport is becoming smarter. These developments come at a critical time given the climate concerns, but also the issues of pollution and congestion as ever more people move to urban areas. The UN estimates that 68% of the world's population will live in urban areas by 2050, just as the word population reaches 9.8bn people. Therefore, doing nothing is not really an option for governments, corporation and the public. This will require our transport systems to become smarter, more efficient, and decarbonised with a shift to zero-emission transportation such as electric vehicles.

5G mobile networks enable transport to be far more connected to its immediate environment and the planned route and so make more informed or smarter decisions. People can already make smart choices too like using mass public or mobility schemes rather than private transport. Smart mobility is also about making the right social and environmentally responsible decisions.

Automation

The technologies behind the creation and use of robots are improving at a rapid rate. Faster computing, cheaper storage, artificial intelligence, and increased connectivity make today's robots far more productive and profitable. The speed, bandwidth and latency benefits of 5G and associated capabilities of software will only increase the pace and scope of technological improvements, making automation an even more compelling alternative to manual processes. Computing power continues to improve as speed is

Passenger vehicle sales by source of power.



Source: Bloomberg, HSBC Private Banking as at 6 September 2021.

increasing and storage gets cheaper or moves to the cloud. Moreover, the programming and installation of robots is becoming almost routine. Artificial intelligence (AI) continues to make huge strides and the more data are captured, the smarter the machines become.

Total Security

People, governments and companies all need to feel secure from an array of threats, whether real or perceived. Physical security provides a real and a psychological reassurance for many people, but a fast-growing risk to security comes from the digital world.

The recent high-profile SolarWinds attack saw potentially 18,000 companies and government agencies hacked, with emails and other data retrieved by the hackers. As more and more services go on-line and connectivity spreads, so do the risks. Hackers, malware and ransomware have unfortunately become all too familiar words in the news. Following a series of high-profile hacks at the governmental level, cybersecurity has moved back up the agenda. Over the last 12 months there has been a surge in the use of more digitally secure systems and user-related software for corporates and individuals across video software, mobile apps, ecommerce and videogames. The cybersecurity industry is likely to continue to benefit from these developments.

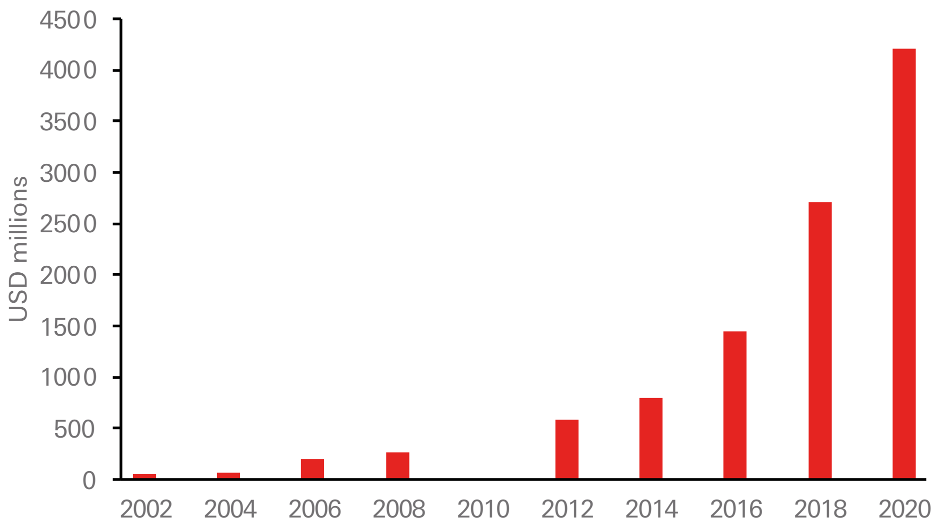
Healthcare Innovation

The latest data from the UN Population Division (updated in 2019) forecasts the world's population to expand from 7.7bn people to 10.9bn people by 2100. In particular, the percentage of the global population aged over 65 is forecast to grow rapidly, from 9% of the total in 2020 to 16% and 23% in 2050 and 2100 respectively. Healthcare spending is far higher on average for older people, presenting additional challenges for countries as their populations age.

The spiraling healthcare costs and the shortage of trained healthcare professionals means that innovative approaches are urgently required.

Historically, healthcare services have been very slow to adopt IT tools that are standard in many businesses. But the pandemic has helped accelerate the adoption process in many ways, from the introduction of healthcare apps that can trace your movements and show your vaccination records to telemedicine and mass automated screening. Also in other ways, private purchases of digital oxygen monitors soared, and on-line bookings and prescriptions have become the norm for all age groups. Digital transformation of the healthcare service is finally underway.

The estimated annual cost of cyber crime continues to rise in the US.



Source: Internet Crime Complaint Centre (IC3), Statista, HSBC Private Banking as at 6 September 2021.

4. Investing for a Sustainable Future

The upcoming COP26 in Glasgow in November, the recent publication of the IPCC report and the extreme weather events this summer, could make you think that the only ESG issue is Climate Change. But in our view, social issues are also taking on more urgency, and for income-seeking investors, we are seeing a rapid expansion of opportunities across asset classes.

Our four high conviction themes

1. Climate Change: Mitigation and Adaptation Opportunities
2. China's Green Revolution
3. Sourcing Income in a Sustainable Way
4. The Rise of 'S' in ESG

Over the summer, climate risk has materialised as a current life-threatening problem rather than an issue to tackle at some point in the future. Extreme rainfall led to deadly flooding in Germany and China, while Italy recorded Europe's hottest temperature ever at 48.8°C (120°F). Canada, Greece and California faced devastating wildfires, destroying entire forests and towns. In California, the Governor recommended drastic cuts in water consumption.

The cause of those extreme weather events is clear, and the Intergovernmental Panel on Climate Change (IPCC) issued a scathing condemnation: "It is unequivocal that human influence has warmed the atmosphere, ocean and land".

Our **Climate Change: Mitigation and Adaptation** theme has mostly focused on the former (mitigation), which are activities and initiatives aimed at reducing the sources of climate change or increasing the Greenhouse Gas sinks, thereby supporting net zero targets. Examples are the production of solar panels, wind turbines or reforestation projects which we must keep investing in. According to the IPCC report, with atmospheric concentration of GHG (Greenhouse Gases) at an all-time high, we are not on track to meet the Paris Agreement of limiting global warming to well below 2°C versus pre-industrial levels unless we take drastic and urgent measures to achieve net-zero emissions. Fund managers owe investors transparency on their climate commitments, on the carbon footprint and intensity of their funds, their fossil fuel exposure and their pathway to net zero. During COP26, countries which have committed to net-zero will need to explain their pathway to achieve that goal in greater detail. The work towards more transparency and accountability on climate is a long-term trend that is bound to influence markets for years or decades to come. And this revolution is happening around the world, in the Americas, Europe and China, which we address to our theme **China's Green Revolution.**

Given the growing number and intensity of extreme weather events, as well as rising ocean levels, mitigation is not enough: we also need to take a closer look at climate change adaptation and the investment opportunities it represents. Climate adaptation consists of activities and initiatives aimed at reducing the vulnerability of both natural and human systems against existing or future climate change effects. Our infrastructure, buildings and food production, for example, must be more resilient in the face of rising temperatures, flooding, rising oceans, hurricanes, and wildfires. In the US, the US$1 trillion Biden infrastructure Bill takes into consideration ways to tackle climate change.

Other environmental issues have also been impacted by human activities, for instance, biodiversity on land and in oceans, freshwater, oceans and agriculture. They must be safeguarded from overexploitation and pollution by governments and the private sector, not only because it is the right thing to do, but also because reduced biodiversity can lead to more rapid climate change.

Within ESG, the E has long been the most scrutinised, partly due to the availability of more tangible data and metrics. But we need to broaden our horizons, hence our investment theme focused on **The Rise of 'S' in ESG**. Sustainability is also about focusing on social UN Sustainable Development Goals like #3 Good Health and Well-being, or #5 Gender Equality or #10 Reduced Inequalities. As highlighted by the pandemic, the healthcare sector needs to tackle issues such as innovation, affordability and accessibility. New treatments, devices, diagnostics, digital-health and services can reduce overall healthcare cost. Progress on gender economic equality has slowed down sharply during the pandemic as many women have been forced out of the workforce, temporarily or permanently, for household and childcare duties. This is regrettable, as it has been shown that a diverse workforce is beneficial for companies' innovation, consumer understanding, and ultimately their bottom line. Only four countries so far require transparency on diversity beyond gender: the US, UK, Australia and Canada. Investors are increasingly holding companies accountable on the diversity of their human capital.

Humankind may be the source of many environmental and social challenges that we are facing today, but we can also be part of the solution should we choose to, as citizens, consumers and investors. This can be through an ESG enhanced or impact approach, through investment thematics or, for income-focused investors, by **Sourcing income in a sustainable way**, across asset classes.

Equities

Global equities should continue to do well, but in the mid-cycle stage, we think the upside will slowdown and we focus on quality, large caps and dividends. The US remains our most significant overweight, and we maintain a cyclical exposure, with a balance between value and growth, and see some of the best opportunities in technology and financials.

Overweight
Countries: US, UK, Germany, France, Italy, Singapore, Taiwan, Thailand and Brazil
Sectors: Consumer Discretionary, Technology, Communications Services, Financials, Real Estate

Underweight
Countries: Switzerland, South Africa, Turkey and Malaysia
Sectors: Consumer Staples, Utilities

Historically, equities continue to do well in the mid-cycle stage. While growth slows down somewhat after the initial recovery, analysts often continue to upgrade earnings, as we have seen. As usual, this is leading to slightly lower price / earnings valuations, but as long as earnings remain strong, this combination should result in respectable stock market returns. Growth will be extended (as inventories still need to be rebuilt, the consumer will want to spend their savings in the future and governments start a lot of infrastructure projects) and when combined with still low rates, stock market fundamentals remain favourable.

While market nervousness over inflation and the rate outlook can lead to volatility, we do not think it will cause a reversal of the uptrend in global stock markets. We think supply chain bottlenecks and labour market adjustments should ultimately be addressed, which should both benefit activity and lower inflation pressures. Quality stocks help address both the growth and inflation challenges, as we look for companies with stable earnings growth and strong margin power.

US growth and volatility

US equities have outperformed other stock markets in the past quarter, especially in USD terms. In our view, the reopening of the economy and solid earnings growth should outweigh the risks of inflation and other headwinds. Even though growth in the economy and earnings will slow from the second quarter peak, they should remain above trend through 2022.

Historical data show that the fourth quarter tends to provide the strongest total returns on average. Over the last 25 years, the S&P has provided an average total return of 10.8% per year, and the fourth quarter has provided almost half (+5.3%) of those returns. But in the fourth quarter, we have also usually seen increased levels of volatility, with the VIX averaging 20.6. This year, we see scope for further solid returns in Q4, albeit with higher volatility due to the Fed tapering plans and the uncertainty around the delta variant.

From a sector perspective, the steady decline in the unemployment rate should provide stability and drive consumer related, technology, and communication services stocks. As net interest margins normalise amidst strong loan demand and falling loan loss provisions, we remain overweight on financial stocks. In past several months, the flattening of the yield curve has been a challenge for this sector, but we think this headwind should now largely be behind us. Finally, declining unemployment, the work from home movement and migratory patterns for US consumers suggest demand for homes should stay strong.

Several other factors may lift US equities. The potential for new taxes could pull forward corporate investments, M&A, and stock repurchase plans into 2021. Also, strong corporate cash levels may cause companies to lift or reinstate dividend policies, increasing total returns. This supports our dividend theme, and will enable income investors to find more dividend opportunities in US equities.

US earnings should continue to grow, albeit at a slow pace.

Source: Refinitiv, Bloomberg, HSBC Private Banking as at 6 September 2021.

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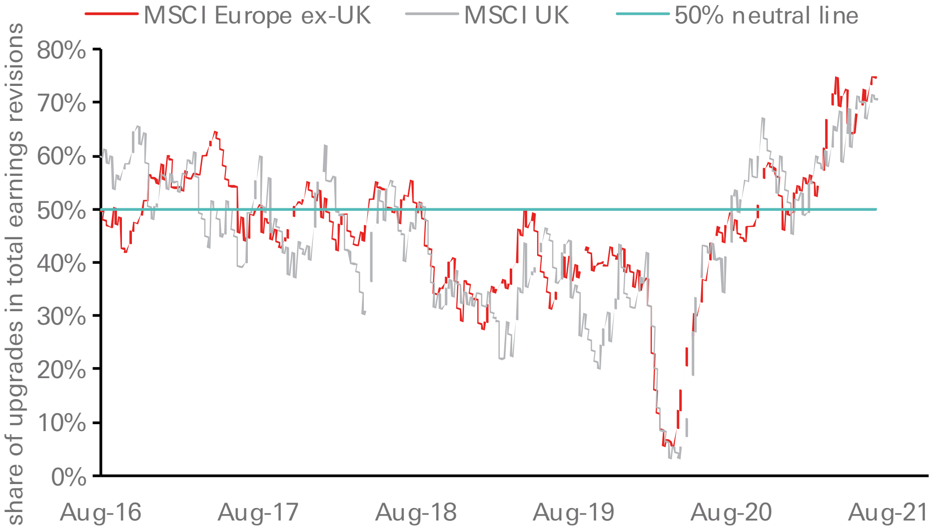
Finding value in Europe

As the reopening continues, European valuations relative to US equities remain compelling, in both the UK and continental Europe and we therefore hold a mild overweight in both markets.

While the number of COVID cases has risen again, the continued policy support from the ECB and EU governments suggest Eurozone equities and economic growth remain well supported. Many European companies benefit from global growth, with exporters of industrial goods and machinery, infrastructure and engineering firms, and strong consumer brands being well positioned to tap into the current areas of strong global demand. The mild EUR weakness we foresee is a further tailwind for our European exporters theme. Secondly, as economic conditions continue to improve, dividend policies should improve. Due to its high level of dividends, Europe is attractive to income-seeking investors.

We remain positive on the UK due to its attractive valuations and continued economic recovery. That said, economic data have slowed somewhat following the initial sharp spike in activity that immediately followed the reopening. Both Brexit and COVID are contributing to labour shortages in areas such as retail, transportation and some manufacturing firms. As the Eurozone economy continues to improve, these challenges suggest that UK outperformance, relative to continental Europe, may narrow. We thus no longer hold a preference for the UK over the Eurozone.

Analysts are rapidly upgrading their earnings forecasts following a strong earnings season.



Source: Refinitiv, Bloomberg, HSBC Private Banking as at 6 September 2021.

Asian focus shifts

Asian markets have struggled with the rising number of COVID cases, increased regulatory risk in China, and the natural slowing of EM equity performance as we move into the mid-cycle stage. Following the correction, valuations are attractive, but it may take time for investor confidence to improve. We expect targeted measures of monetary easing, including a cut to Chinese banks' reserve requirements' ratio and support for SMEs in the private sector. In addition, long-term fiscal spending will also help lift near-term growth, especially in technology and infrastructure. Our growth forecasts for Asia have not been reduced suggesting opportunities continue to exist in the region.

We continue to focus on several key Asian themes. First, manufacturing activity should remain strong as the global economy reopens and inventories are being rebuilt. The region remains a hub of manufacturing and supply chain companies, and the new wave of automation in the emerging digital economy has increased demand for semiconductors and electronics globally. Second, the Asian consumer is essential to market valuations and we expect consumer-related equities to perform accordingly. Third, is the combination of investing in ESG, technology upgrade, and innovation, especially in China, which should keep long-term growth expectations intact. For example, forecasts point to electric vehicles potentially capturing as much as 39% market penetration by 2030. While the future for the region remains focused on the digital economy and the consumer, the strength of the manufacturing sector should not be minimised.

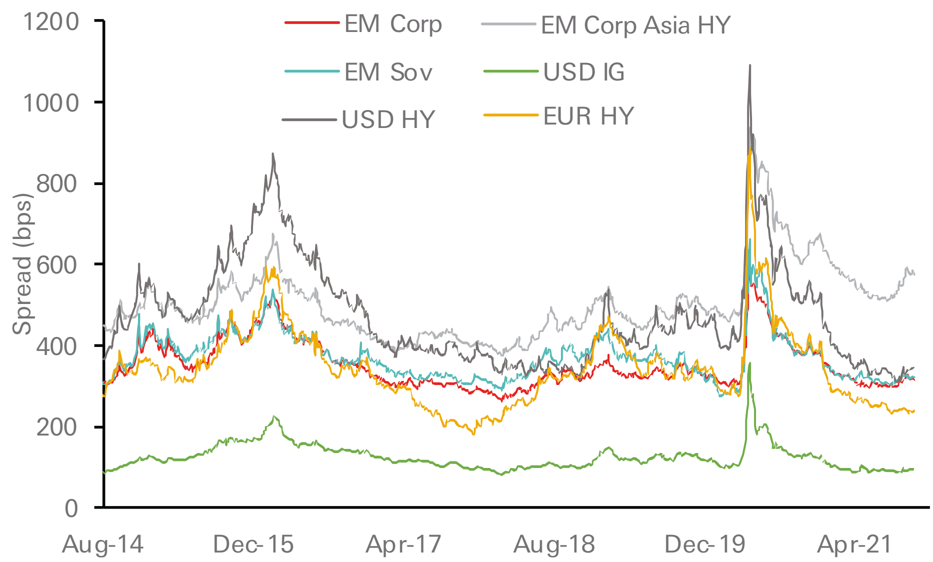
Fixed Income

While US Treasury yields have dropped, global High Yield (HY) and EM corporate bonds, have been relatively directionless recently, due to thin summer trading volumes, slowing economic growth and market uncertainty around tapering. But in our view, tapering should not materially affect US growth or DM rates as it will be well flagged and rate hikes should only materialise in 2023. We do not expect the mild USD strength we foresee to hurt EM bonds much, as potential EM rate hikes have already driven up EM bond yields, supporting EM FX and providing attraction for investors looking for yield.

Overweight
Government bonds: no overweights
Credit and EM: US and European (ex UK) HY, EM Hard Currency bonds (China, Indonesia, Mexico and Brazil) and EM Local Currency bonds (China, Brazil and Mexico)

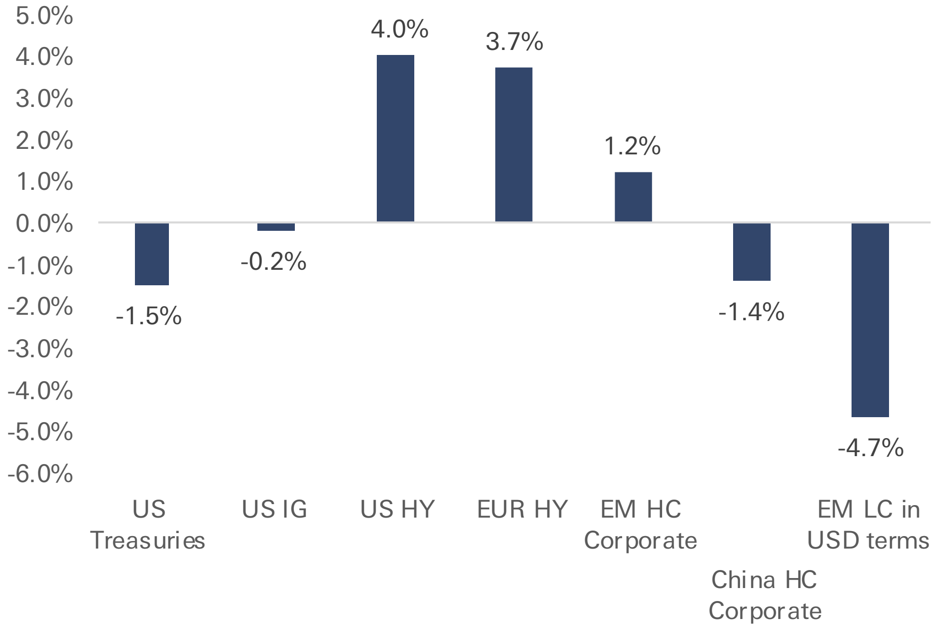
Underweight
Government bonds: US TIPS, German and Japanese government bonds
Credit and EM: Indian sovereign and corporate bonds, Argentinian and Ukrainian bonds

Higher-beta markets have seen their spreads widen over the past months, mostly in EM Asia.



Source: HSBC Private Banking, Bloomberg, JPM, iBoxx, ICE BOFAML indices as at 6 September 2021. Past performance is not a reliable indicator of future performance

YTD Bond Performance.



Source: HSBC Private Banking, JP Morgan, BOFAML indices as at 6 September 2021. Past performance is not a reliable indicator of the future performance

Our bond strategy

We cut our allocation to global Investment Grade (IG) to neutral in mid-June, following the drop in Treasury yields and tight spreads. Since then, we have not made any major changes to our strategy and maintain our risk-on stance and search for yield, with an overweight stance on HY and EM sovereign and corporate debt in both Hard Currency (HC) and Local Currency (LC). Unfortunately, the latter has not performed that well, as the US dollar appreciation came earlier than we thought. We remain underweight in DM Sovereign debt as we are close to our year end yield targets and prefer carry opportunities expressed through credit markets.

It is also important to mention that we keep our overweight on EM Asia unchanged, with a preference for China, despite the recent volatility. The focus of Chinese authorities on deleveraging their economy by improving debt management and tightening regulatory requirements triggered a sell-off in the offshore bond market lately. The recent initiatives pushed investors to reprice the stand-alone risk of State-Owned Enterprises (SOEs) and a regulatory risk premium has built up in corporate credit spreads. This weighed on the Chinese IG bond market, but fortunately, the contagion so far has been limited.

Developed Markets - Don't be afraid of Fed tapering

Perhaps surprisingly to some readers, we do not expect tapering to be a major driver of US bond yields. First of all, the reduction of asset purchases should be well communicated by the Fed and we expect it to be announced in November or December (we think it's a close call). Secondly, it should be gradual, with only modest monthly reductions to the purchases throughout 2022. Thirdly, the US deficit is shrinking, leading to lower supply. Hence, the risk of taper tantrum like in 2013, where real yields surged and risk assets sold off, is very limited in our opinion. And while in 2013, the Fed linked tapering to upcoming rate hikes, it is now clearly separating the two, with rate hikes unlikely to occur before 2023.

Consequently, Treasury yields should remain well below their March peak. We also believe that the reflationary bubble currently priced in breakeven rates will deflate in the coming months, justifying our underweight stance on US Index-Linked bonds (TIPS).

Within the credit markets, we continue to be overweight in US and European HY as they should benefit from the economic rebound, firm oil prices and rating upgrades, resulting from their improving fundamentals. Ratings agencies have started to reverse some of the downgrades they made at the height of the crisis, and 'Rising Stars' now outnumber 'Falling Angels' for the first time in a year.

We continue to adopt a cyclical stance across corporate credit markets and favour the Energy, Leisure and to some extent Travel sectors, but in a very selective manner. We focus on companies with stronger balance sheets and improving credit fundamentals, such as declining leverage and increasing cash flow generation.

Emerging Markets – We remain overweight and expect stabilisation in Asian credit

Despite reflation concerns and COVID related pressures, EM Debt in Hard Currencies continued to outperform DM IG bonds, propped up by the higher carry, continued economic growth and high commodity prices.

The main drag on performance came from volatility in Asian corporate bonds, specifically in Chinese real estate and in some leveraged SOEs, following China's regulatory actions. But as most of the measures introduced by Chinese authorities are aimed at reducing systematic risks and deleveraging of the corporate sector, they should result in improved credit metrics and more corporate transparency in the medium term.

We remain overweight on EM debt with a preference for EM corporates in Hard Currencies (HC). Most are demonstrating strong earnings and are pursuing cautious financial policies, resulting in better debt metrics compared to DM companies. We also keep our positive view on Asian credit, including China, where valuations are appealing and corporate fundamentals should be improving as a result of tighter regulation.

Despite some idiosyncratic corporate stories, China's corporate default rate remains below 1% and while government support for SOEs has become more selective, it will not disappear. This said, the 2021 Asian HY default rate is expected to be at a decade high but still manageable at a level of 3%-4.5%. Thus, we maintain our preference for Chinese HY Property Developers with a focus on quality names which could benefit from the industry consolidation and have demonstrated improving credit metrics on the back of tighter regulations. We also selectively like Indonesian corporate credit in HC, a high beta segment which usually outperforms in an environment of solid economic growth. Outside of Asia, we prefer Brazilian and Mexican corporate bonds in HC.

We prefer to focus on EM debt in HC ahead of the expected tapering of asset purchases in the US. However, selective EM LC bonds with short-to-medium duration also offer value as rate hike expectations have already driven up yield levels. While we foresee some USD strength, EM FX should be relatively resilient, due to the carry and high commodity prices.

Currencies and Commodities

We expect to see mild further upside for the US dollar against EUR, with interest rate differentials, slowing global economic growth and the easing of the risk-on tone setting the direction. GBP, AUD, NZD may range trade, while we foresee some CHF weakness. In emerging markets, RMB should range-trade, but we find BRL and MXN attractive.

Selected currency views

Bullish
USD, MXN, BRL
Neutral
GBP, AUD, NZD, JPY, RMB
Bearish
EUR, CHF, ZAR

The outlook for USD

Since early June, the US dollar has been staging a recovery, boosted by strong global economic data. Further impetus for USD has come from the monetary side, with the market bringing forward the timing of expected Fed hikes and expecting the start of tapering in the coming months. A slightly more volatile equity market, with a slowing upward trend, also reinforced USD purchases due to the currency's safe haven character. Looking ahead, we believe that the deceleration of growth in the mid-cycle stage (as already witnessed in China) and Fed tapering, will probably support the US dollar against the main G10 currencies, allow for USD strength against EUR, and require a selective approach in Emerging markets (EM).

However, the upside we foresee for USD should be gradual and only mild. The dollar has always been a countercyclical currency and it has performed well historically in periods with slowing global growth, but the growth slowdown we foresee is also mild in nature. Relative to 2018, USD upside may be less pronounced, as the support then was exacerbated by the US-China trade conflict (which pushed RMB down more than 10%) and by negative EM news flow (e.g. Turkey). This time, aside from increased regulatory risk and recent related market volatility in China, we think EM fundamentals and sentiment are much healthier. We therefore keep a neutral stance but a selective approach in the EM space with a preference for BRL and MXN.

The US dollar should continue to drift up, but we foresee less upside than in 2018.

Source: Bloomberg, HSBC Private Banking as at 6 September 2021. Past performance is not a reliable indicator of future performance.

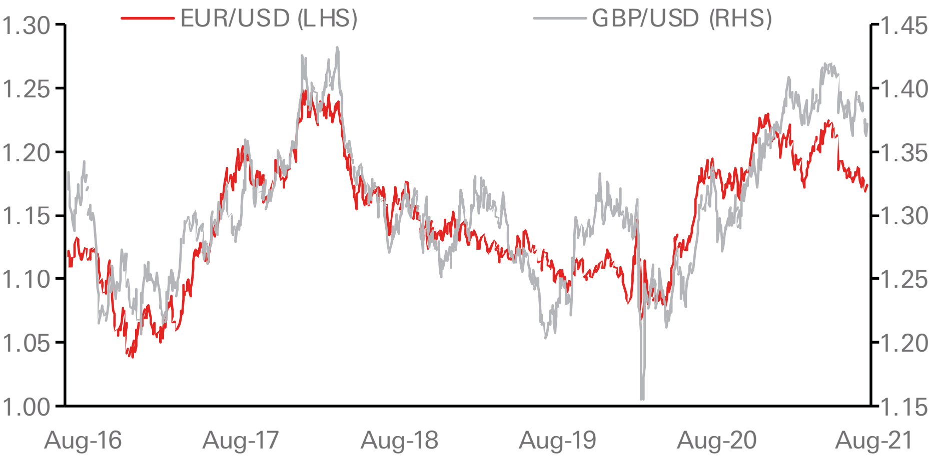
G10 currencies

We expect a stronger US dollar against the Eurozone currency. EUR is still in a downward channel against USD and against GBP. EUR is weighed down by the difference in monetary policy across the Atlantic as the ECB is still relatively dovish. EUR is already suffering from its negative real rates, and any widening of the gap could further increase the selling pressure. Mixed European COVID-19 data could add to the volatility, although cases are rising on in the US as well.

We also continue to be bearish on the Swiss Franc. Our risk-on stance implies that there is limited appetite for CHF's safe haven characteristics, and even if global risk appetite were to dip, investors may prefer to hold USD (also a safe haven and countercyclical currency) due to its more attractive yield. One could potentially argue the same for JPY, but we keep a neutral stance there as we think JPY is undervalued and hedge funds and speculators already have large short positions (negative bets).

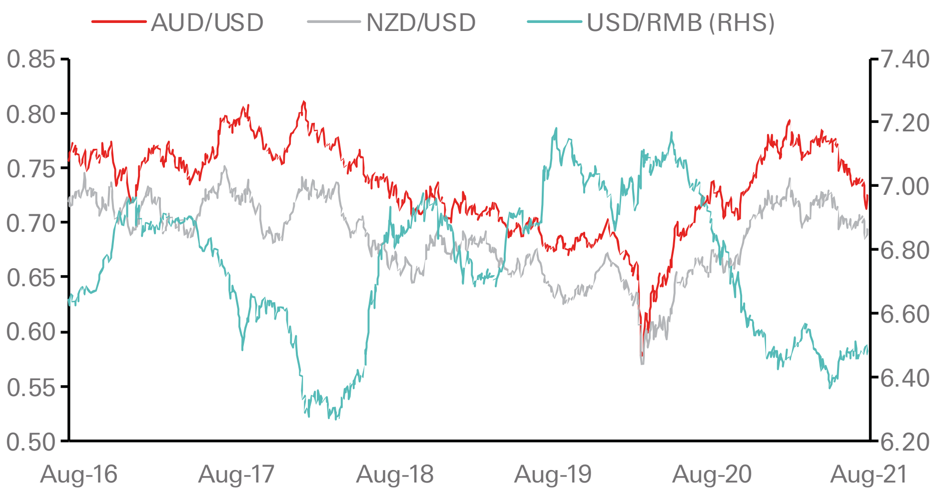
We think that the upside of USD against the other G10 currencies (GBP, AUD, NZD) will be less pronounced, as their domestic conditions are relatively healthy and their central banks are considering rate hikes or tapering. Although Sterling could be capped by the fading of the post-pandemic reopening and lower-than-feared inflation data, the 0.4% rate hike we expect from early 2022 should maintain the currency in a range in the coming months. In the course of Q3, we downgraded the antipodean currencies (AUD and NZD) to neutral, as USD strength, the plateauing of global commodity prices and the slowdown in China's growth momentum weaken their attraction.

We expect some mild further downside for EUR/USD, while GBP/USD should range trade.



Source: Bloomberg, HSBC Private Banking as at 6 September 2021. Past performance is not a reliable indicator of future performance.

We expect to see a side-ways trading pattern for AUD, NZD and RMB.



Source: Bloomberg, HSBC Private Banking as at 6 September 2021. Past performance is not a reliable indicator of future performance.

EM currencies

As we expect the market to be more focused on yield in a period of Fed normalisation, we think RMB, as well as other Asian currencies, will continue to benefit from their relatively high yields and resilient character.

We think the recent RMB sell-off has in part been due to recent equity volatility, but sustained infrastructure spending and the supportive fiscal policy should keep RMB stable. More broadly speaking, we expect that yield differentials for high-yielding currencies such as RMB, MXN, and RUB should limit the downward potential versus USD. We remain constructive on MXN and BRL due to their favourable real rates and hawkish moves from both central banks. The fact that commodity prices flattened recently may have removed one of the positive catalysts, but this should not be material enough to push these currencies lower as the link between these currencies and commodity prices has been fading recently.

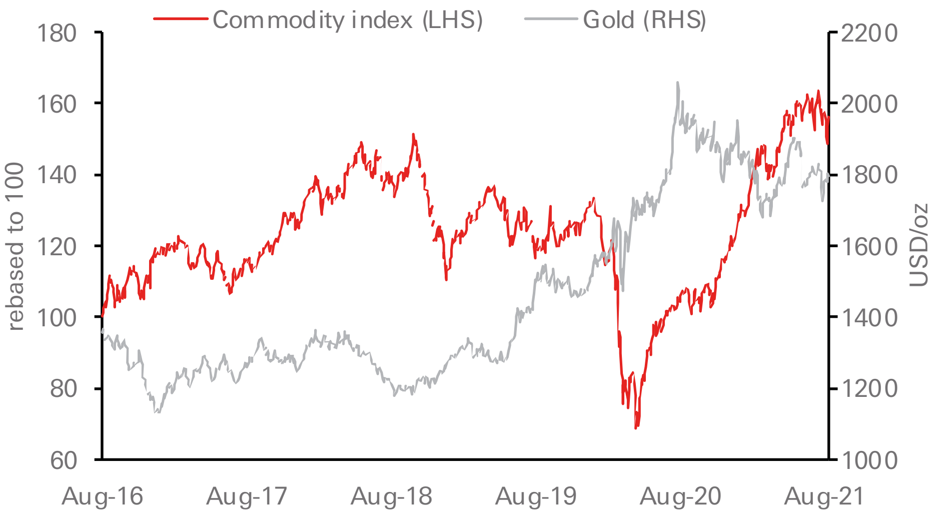
Commodities

As we already mentioned, softer manufacturing activity and economic growth in China reduced the demand for raw materials, hurting prices from the peak reached in the first part of the year. The latest global and Chinese trade data, supply bottle necks and resurgence of COVID cases suggest commodity demand will continue to slowdown. We think prices will continue to normalise gradually, but we do not expect a sharp downtrend either.

We hold a neutral view on gold, as negative factors such as monetary policy normalisation and USD strength, are compensated by healthy physical demand at the current price level and investors' need for portfolio diversifiers. The USD strength we expect is gradual and mild, which should prevent any sharp sell-off in the gold price.

Oil prices have recently retraced their positive trend after Brent crude reached a peak of USD 77/bbl. The resurgence of the Delta variant, the increase in US inventories, and the stronger USD all contributed to the fall. In our view, prices had started to trade too high compared to historical standards and marginal production costs, and this retracement was thus not surprising. From now on, we believe the oil prices will likely range-trade over the coming months, helped by OPEC+ members' commitment to balance the market.

Commodity prices have edged down but we do not expect major downside.



Source: Bloomberg, HSBC Private Banking as at 6 September 2021. Past performance is not a reliable indicator of future performance.

Hedge funds

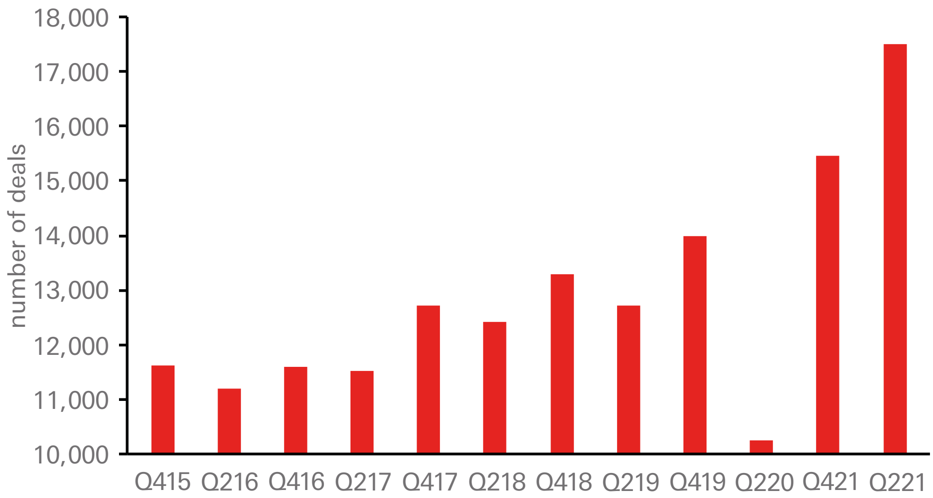
Hedge funds continue to be a key diversifier with a strong opportunity set. We like DM macro managers, multi-strategy and multi-PM managers, US and European equity long/short and event-driven strategies.

We remain constructive on the opportunity set for DM macro managers. The global vaccine rollout and fiscal support provide a strong backdrop for global growth, but with regional differences due to the uneven spread of the Delta variant. Unexpectedly high inflation prints in Q2 upended consensus reopening/reflation themes as the Fed's more hawkish pivot in June led to lower Treasury yields and curve flattening, hurting those with risk-on or bearish bond positions. Looking ahead, rate hikes across DM markets will be uneven while a handful of EM central banks have already begun raising interest rates to counter inflation and currency weakness. The dispersion in policies will provide a fertile opportunity set for discretionary macro managers across both rates and FX markets.

Our overall rating for the systematic space remains neutral. While we caution that performance has already run up a lot over the last 12 months, the managed futures strategy is well positioned to exploit trends related to ups and downs in inflation expectations across asset classes. Positioning across many managers remains long global equities, long commodities, short fixed income and short the US dollar. The risk is that this results in a strong directional risk-on profile that can lead to simultaneous losses in a flight-to-safety scenario.

We maintain our positive outlook on multi-strategy and multi-PM managers (MSPM). The various market rotations thus far in 2021 have been a tough backdrop for equity long/short strategies. Most MSPM managers tend to target a high level of idiosyncratic risks, which has helped to protect against larger drawdowns. Since March 2021, they have further tightened portfolio risk management, but when frequently-shorted stocks surged for a second time during the summer months, this caught some managers off-guard. On the plus side, such volatility

Global M&A volumes have rebounded sharply.



Source: Bloomberg, HSBC Private Banking as at 6 September 2021.

spikes are often followed by a better stock picking environment. Overall, the benefits of MSPM managers' risk management and diversification is illustrated by their limited losses during this year's inflation fears, value rotations and deleveraging.

We maintain our neutral/positive rating for fundamental US and European equity long/short strategies but have downgraded the Asian long/short strategy from neutral/positive to neutral. The environment continues to be broadly favourable for equities, but the past several quarters proved tougher for the equity long/short strategy than the environment might imply. Some managers did not have enough cyclical exposure, and the shorting environment was one of the toughest in several decades, due to the retail short squeeze, and the very positive earnings season and inflows into equity ETFs lifting almost all boats. Looking ahead, slower equity market upside should put a greater focus on fundamentals and discerning winners and losers, which will help stock selection across long/short equity strategies. Whilst many managers had a growth bias last year, many have added value names and are now more balanced, avoiding the extremes (i.e. very expensive hyper-growth, or the deep value stocks), and instead holding greater exposure to GARP (growth at a reasonable price). Lastly, Asian managers see high levels of uncertainty from regulation risks and macro factors and we have therefore downgraded our Q3 outlook for the Asian equity long/short strategy to neutral.

We continue to favour the event driven strategy. The number of activist campaigns continues to rebound from the Q3 2020 lows and M&A has had its strongest first half since 1980, fuelled in part by mega-deal activity. SPAC issuance is rebounding following the Q1 2021 blow-off and plenty of SPAC dry powder is looking for business combinations. With the speculative excess having been let out of the SPAC market, many SPACs are now at or below trust value. In credit, our outlook remains neutral/positive as credit quality continues to improve, but spreads have tightened.

Private equity

Private equity has continued its positive trajectory through the first half of 2021 and shows signs of continued growth and attractive investment opportunities. Many primary funds, secondary transactions and co-investments continue to deliver attractive returns, showing resilience during the COVID-19 crisis.

In a recent survey by Preqin, over 80% of institutional investors say private equity investments have either met or exceeded their expectations over the past 12 months, and 90% expect to maintain or increase their allocation to private equity during the next 12 months. We also maintain conviction in the asset class, but of course continue to highlight the importance of manager skill for driving value creation through operational, strategic and sector expertise.

So far, the private equity market has experienced increased activity through the first half of 2021, which has continued through the usually slower summer months. In fact, according to PEI, the number of transactions in the US is reaching new highs with more than 3,700 deals worth more than $450 billion through the second quarter, due to the continued economic recovery, low interest rates and available capital to invest. Increased deal flow is also matched by a strong recovery in fundraising, with private equity firms raising $415 billion in the first half of 2021 according to PEI data. This is an increase of more than 50% over the same period last year, and is the highest amount raised during a six-month period since the 2008 financial crisis. During such an active market with readily available capital, we believe continued investment discipline is important, and we like to focus on high-quality managers and transactions in high-conviction sectors and themes.

One such theme, secondary transactions, has continued to grow and develop over the last 18 months. Private equity vehicles focused on secondary transactions have raised $30 billion of capital during the first half of 2021, contributing to the over $300 billion assets under management in the sector as of December 2020 (Preqin data). But although the size of the overall secondary market is reaching new heights, there is still room for further growth. According to Preqin estimates, there currently is approximately $137 billion of dry-powder (i.e. capital available for investment) in the secondary market, compared to a projected market volume for secondary transactions in 2021 of $75 billion to $100 billion. This means that at the current expected rate of deal flow, the sector would run out of capital in less than two years unless significant more capital is raised.

Aside from being a growing sector, there is also increased sophistication taking place as seen with the rise of manager-led transactions. As opposed to investor-led transactions, where investors usually seek to exit a portfolio of private equity funds, manager-led, or GP-led, transactions are initiated by private equity managers seeking to extend the holding period of specific assets while giving their investors an option for liquidity. Such transactions can be focused around single assets and require more focus on underwriting and due diligence on growth prospects at the single company level. According to Preqin, the secondary market saw approximately three times as many single-asset manager-led secondary deals in 2020 compared to the year before and expects this type of deal to drive activity during 2021 and 2022. This is in line with our own experience, as manager-led transactions are an area of focus for our investment team, where investors can gain high-conviction in the investment thesis of underlying assets and can partner with highly-skilled private equity partners.

Overall, as the private equity market continues to grow and evolve, it can be beneficial to partner with private equity sponsors with the skills to actively engage with underlying companies to implement operational improvements and strategic initiatives. We also pursue targeted investments such as secondary transactions and co-investments, in areas such as manager-led secondary transactions where we can target company-level quality factors, including counter-cyclical business models, recurring revenues and dominant market positions.

Real estate

The gradual reopening of many developed market economies is providing a strong boost for property fundamentals in several sectors. But accelerated changes to behaviour (working and shopping) and uncertainty over how society will adapt to living with the virus, mean that occupier demand for some types of real estate will continue to suffer.

The easing of lockdown restrictions has boosted footfall and activity for non-essential retailers (such as department and homeware stores) and consumer services (such as restaurants, gyms and cinemas) as consumers have been eager to spend savings accrued during lockdowns.

The near-complete shutdown of international travel was very damaging to both hotels and prime retail. This is particularly true for Asia and Europe, which have become increasingly reliant on high spending consumers from emerging economies such as Mainland China. Chinese consumers have shifted to buying luxury goods locally and even when travel picks up again, we think that a proportion of Chinese spending on luxury items will stay local.

While the reopening has boosted retail and consumer service activity, it has caused a drop in e-commerce. Still, e-commerce spending remains significantly ahead of where it would have been on pre-pandemic trends. Appetite for logistics remains near record levels as retailers and third party logistics providers invest in their supply chain networks. According to Prologis, online fulfilment uses three times the space of traditional retail distribution due to a larger number of goods and to facilitate returns. Whilst logistics demand should remain strong, the diminishing number of suitable sites (particularly in urban areas), point to a potential reduction in the amount of new supply being developed. As a result, this should provide further support for rental growth above inflation.

Office sector fundamentals have been severely shaken by the pandemic as leasing came to a standstill in early 2020 and remains well below trend in Q2 2021. In many cities (most notably in the US and UK) vacancy rates are at their highest levels in decades. Having made considerable investment in providing staff with the technology to work remotely, many firms are making long-term commitments to flexible working, and reducing their office space. The shift to remote working will vary geographically depending on factors such as time spent commuting, amount of space at home, office characteristics and cultural factors.

Although still well below pre-pandemic levels, office utilisation has been steadily rising over recent months as businesses see offices as places to collaborate, meet clients and train staff. Leasing data indicates, that while still subdued, businesses are increasingly targeting modern and well located buildings that support wellbeing and are energy efficient. This points towards a bifurcation in rental performance with lower quality office buildings either changing to alternative uses, such as residential, or requiring substantial capital expenditure.

Along with logistics, alternative sectors have also benefitted from resilient leasing activity during the pandemic. One of the most prominent is the life sciences sector, which combines offices with lab space for R&D-focussed healthcare businesses. The virus has put a spotlight on a sector which was already growing due to ageing demographics, recent scientific breakthroughs and plenty of expansion funding from venture capital funds.

Elsewhere, parts of the residential sector have performed well including suburban apartments and single family housing in the US as people have sought more space. As cities reopen, there may well be some return to urban living, but for many, commuting less frequently may support the case for living further from their place of work.

Thanks to central bank support, overall property yields and capital values have remained largely stable. However, there are variations by sector as investors have followed occupiers by favouring logistics, prime offices and non-traditional sectors. Meanwhile, the long term challenges facing shopping centres, in particular, have been mirrored by rising yields and falling capital values.

Disclaimer

Risks to our View

The key risk factors include adverse regulatory changes, health concerns, spectrum cost and allocation issues excess capital expenditure by telecom operators, trade tensions, evolvement of 5G standards, uncertainties in pricing and demand for new products and services in 5G and related offerings.

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.

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