



# Horizons

Your Investment Bulletin | Issue 8

## MarketFOCUS

### A COOLING OFF ECONOMY IN THE HOT SUMMER

#### MARKET FOCUS

Economic growth in emerging countries has softened over recent months according to the latest HSBC Emerging Markets Index readings. The slower growth should not be a big surprise given the fiscal tightening in Europe and policy measures designed to slow the Chinese economy. However, investors have been quick to fear the worst scenario of entering into a double-dip recession globally.

Although global equity markets have weakened on worries about a double dip and the implications of excessive sovereign debt, valuations imply that investors may have already priced in most of the likely bad news. For example, the MSCI Emerging Market Index is trading at a 12-month forward P/E of around 11x versus an average of 13.7x since 1988. The recent market weakness has thrown up interesting opportunities.

#### SLOWING CHINA IS NOT BAD NEWS

Turning to China, the quantitative tightening by the People's Bank of China, along with austerity property measures, has slowed down Chinese economic growth. The Q2 GDP growth has slowed down to 10.3% y-o-y from 11.9% in the first quarter. However, the cooling economy may not be bad news for the market. It could help contain the inflationary pressure which may ease the concern of a near-term rate hike. The June Consumer Price Index went up 2.9%, lower than the market expected, and the producer price index cooled too.

Investors should note that Chinese government policy focus will continue to shift towards growing domestic demand. The measures will include further curbs on lending and increases in minimum wages which may bring short-term volatility to the market. On the positive side, Chinese equities are expected to have limited downside with current levels of valuation.

- The global economy is recovering though at a slower pace.
- The slowing China economy will help ease inflationary pressure and lower the tightening risk.
- A range bound market is likely ahead for some time given challenging economic conditions.

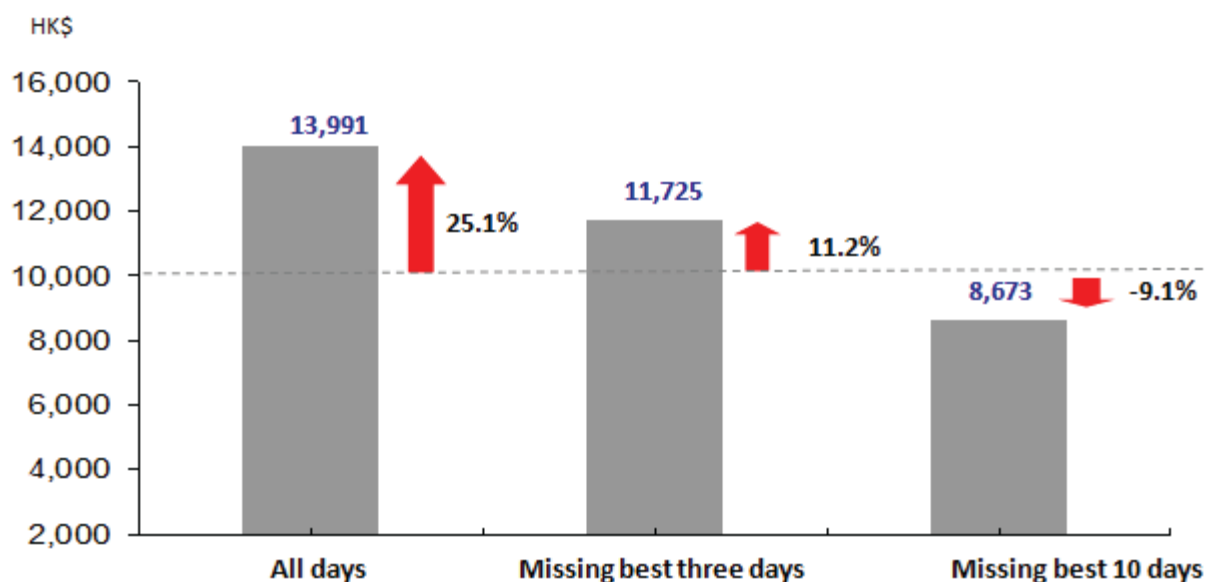
## DONT LET EMOTIONS SWAY YOUR INVESTMENT DECISIONS

The recent US Fed minutes showed that the pace of economic recovery remained a concern and the Fed may consider taking further monetary stimulus action if necessary. Short-term market volatility is expected with the weaker outlook plus the downgrade of Portugal's credit rating by Moody's. For investors, it may be tempting to sit on the sidelines under the current situation. However, you should note that missing even a short period of growth may be costly. Keeping your emotions out of important financial decisions can help grow your investments.

Assuming an investor had invested in a Hang Seng Index tracking fund with initial investment amount of HK\$10,000 at the beginning of 2009, they would have achieved an annualised return of 25.1% by the end of June this year. However, if they missed the three best performing days, the investment value would have dropped to HK\$11,725, or an annualised return of only 11.2%. They would have even made a loss by missing the 10 best performing days (see chart below).

Mixed news is likely to take investors throughout the rest of the year. Sitting on the sidelines might risk being out of the market should the recovery continue to pick up the momentum. Staying invested and keeping your emotions in check are likely to be rewarding for long-term investors.

Hypothetical growth of HK\$10,000 invested in the HSI (1 January 2009 - 30 Jun2010)



Source: HSBC and Bloomberg, data as of 30 June 2010.

**UNITED STATES**

While the recovery in economic activity is progressing in the US and elsewhere, the pace of improvement is generally slowing down. This is fuelling the belief in the market that the sustainability of the recovery is still subject to strong headwinds from unemployment and fragile consumption. The next few months' employment figures will attract great attention, as they should confirm whether the current positive manufacturing sector will lead to improvements in labour markets, or instead a weak jobs market with weak consumption will drag down manufacturing, resulting in a double-dip recession. Although the economy has indeed entered a soft patch with risk, a double-dip recession is unlikely.

**EUROPE**

The European Central Bank left interest rates unchanged for a 14th consecutive month, underscoring the region's need for further economic support. But governments in Europe have announced tough austerity measures to control fiscal deficits. Given the risk of early withdrawal of support measures, this could weaken growth and lead to negative surprises that may have the potential to hurt market performance. This is coming on the back of already weak employment in the Eurozone and subdued consumer demand, supporting the view of moderate economic growth in 2010. The key risk of the Eurozone debt situation remains contagion to other markets in the region. Further credit rating downgrades in Europe could severely affect confidence in the region.

**BONDS**

In the absence of inflationary pressure in developed markets, central banks can continue to maintain low interest rates, which is positive for corporate bonds. Spread-implied default levels appear to more than adequately compensate investors for corporate bond risk. Furthermore, US 2Q corporate earnings results have so far exceeded analyst estimates in aggregate, which is a further supportive factor for corporate bonds. However, investors have to be selective as global markets could remain volatile. Under the current market conditions, a stable income stream and capital preservation are equally important. based on the risk-adjusted profile of bond segments, one can see that bonds rated BBB/BB present a solid risk-adjusted return potential today.

**ASIA-EX JAPAN**

The key concern in Asia is that over-tightening could choke growth. That said, the tightening signals government's confidence that their economies have recovered adequately to being the process of normalising monetary and fiscal conditions following the record stimulus in 2009. With potentially milder growth in the 2H 2010 in Asia as tightening measures take effect, inflation is expected to peak reducing the pressure in the region. This in turn is likely to reduce the pressure on governments to raise interest rates considerably, removing a key risk for the region. Once volatility settles and the tightening cycle ends, investors are likely to return to Asia as it offers the strongest potential for growth.

**JAPAN**

While the Japanese economy is recovering, recent data suggest the sustainability of the economic rebound remains uncertain. The biggest risk for Japan is the continuing strength in the JPY given the country's reliance on exports. A stronger JPY will weaken export competitiveness and add to Japan's deflationary pressure caused by already weak consumption and high unemployment. The government's proposed austerity measures are adding to the growth uncertainties. The fiscal tightening plans being drawn up aim to balance the budget by 2020 by capping public spending for the next three years and raising the sales tax levy. These risk further reducing consumer's appetite to spend and slowing the pace of recovery in Japan.

**CURRENCIES**

The increase in overall market volatility has had a detrimental impact on Asian currencies. This is likely to be a short-term phenomenon. Asia remains the most structurally and cyclically sound of all regions. The medium-term trend for Asian currencies should be positive. The EUR, GBP and JPY are all expensive compared to the USD. The EUR is unlikely to rally on a sustainable basis as it is not cheap. In addition, Europe has a worse growth outlook than the US and the European Central Bank may ease monetary policy. The USD may strengthen in the 2H 2010 against the EUR, JPY and GBP with improving US data. For Japan the level of the JPY is deflationary and with a change of prime minister, a renewed effort by authorities to weaken the JPY can be expected.

# HSBC Global Investment Funds

## Global Emerging Markets Bond

### OBJECTIVE

The Fund seeks total return mainly through a diversified portfolio of investment grade and non-investment grade rated fixed income (e.g. bonds) and other similar securities either issued by companies which have their registered offices in emerging markets around the world, primarily denominated in US dollars or which are issued by governments, government agencies and supranational bodies of emerging markets.

### MARKET REVIEW

- ▶ A strong global rally in equities and riskier investment boosted emerging market debt in July, with higher-risk countries such as Argentina and Venezuela seeing the largest rises.
- ▶ Emerging market corporate bonds made moderate process, while local currency bonds outperformed other bond indices.
- ▶ Unlike emerging market equity indices, the region's bond indices have generated strong positive returns year-to-date for most sovereign, corporate bonds and local currency indices.

### MARKET OUTLOOK

- ▶ Economic fundamentals in emerging markets continue to look strong with record hard currency reserves, as most countries are still growing at healthy rates.
- ▶ While concerns over a slowing Chinese economy have worried investors, China's economy appears merely in slowdown mode, rather than stagnating.
- ▶ We see opportunities in select local currencies which may appreciate, particularly given the tweak economic data coming from the US, Western Europe and Japan.

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