Investment Outlook 2018

December 2017

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What happened in 2017 in markets and the economy?

2017 has been a year of spectacular investment returns across a variety of asset classes.

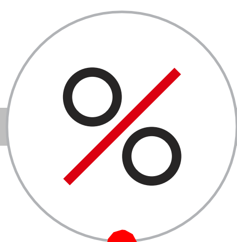
In US dollar terms:

- Higher-yielding corporate bonds delivered returns just under 10%*
- Global equities delivered more than 15%*
- Emerging market equities delivered above 30%*

This stands out against the much lower expectations investors had at the beginning of the year. What's more, when we look back over the past five years, investors have enjoyed strong annual returns over that entire period.

*Source: Bloomberg, HSBC Global Asset Management as at 30 October, 2017

We think there are three main factors that can explain this:



Interest rates have remained lower than expected, for much longer than expected. This supported risk assets like equities.

Investors were worrying about risks that never materialised, in the end. Their expectations were low because they were expecting negative events in terms of interest rates, politics and economic growth. The strong performance of this year is a direct consequence of this, because good news is amplified when people's expectations are low.

The economic environment has been "just right": we have had good growth, low inflation, and low interest rates, which combined to create the ideal environment for businesses around the world. And because businesses were doing well, so did their stocks and bonds.

So after such strong performance, does it mean everything is now overvalued?

That is a popular view at the moment, but we don't think everything is overvalued. What is really important to understand is that, this year, the good performance of markets has been driven by very strong corporate profits, so by the "real economy". It's not just a bubble like the dotcom bubble of the early 2000s, and we think the exuberance on the markets is justified.

What does this mean for 2018, can the ideal economic environment continue?

It seems less likely. The forces that were making the environment "just right" are beginning to wane, and what comes next is "a little less".

There is very little risk of recession but, although in emerging markets there is still some good economic momentum, things are getting a bit flatter in the rest of the world.

Inflation remains low given the current rates of economic growth and low unemployment rates. It is also still below central bank targets. But we expect it to start building up, especially in the US.

Finally, economic policy is becoming a bit less business-friendly. Interest rates will continue going up, and the fiscal policy environment could be a small drag on business too – although the outlook on this is uncertain, and could end up being a bit more positive.

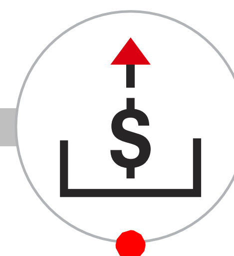
What we think we will have is an economic environment that will still be OK for risk assets like equities, but less positive than what we got in 2017.

What are the biggest risks for 2018?

Investing is not without risk, and the value of investments can go down as well as up. In the current environment, several possible risks stand out in particular. As always, the key thing will be to take an active approach to our asset allocation strategies.

Many analysts have said that we are "due a recession", but economies don't run on clocks, and we don't think this is currently a risk. Global growth is currently going at its fastest rate since 2010, and growth in emerging markets looks solid for the time being.

Another topic markets are worried about is that we might see central banks focusing more and more on financial stability, and making an error in their policy because of this. The fear is that this change in policy could lead to an economic recession. Again, we are not convinced that this is likely to happen.



The major risk that we do see is if inflation started to build up to a point where it forced central banks to raise interest rates faster than expected. The way many asset classes are priced today would mean there would have to be a significant adjustment in financial market prices… And there may not be many 'safe haven' options for investors to retreat to. Watching the economic indicators on global growth and inflation will be critical.

Joseph Little
Global Chief Strategist
HSBC Global Asset Management

> Current prices are still expressing investors' expectations of strong growth and very low inflation.

Link to URL

Multi-asset outlook

Given our analysis of the environment for 2018, we think that the key question for our multi-asset portfolios is to understand how much the "just right" economy is already taken into account in asset prices. Current prices are still expressing investors' expectations of strong growth and very low inflation.

What does this mean for government bonds?

Sustainable returns are still very low for global government bonds, which continue to look unattractive to us. We have underweight positions on global government bonds in our multi-asset portfolios.

What is our view on risk assets?

The outlook for global corporate bonds is trickier. Fundamentally, good growth and low inflation are positive for businesses, and therefore for corporate bonds. But a lot of this positive outlook is already priced in. We feel that there are better opportunities for our multi-asset portfolios in other asset classes.

In our view, the most attractive opportunities are in global equities, and still in emerging markets. Both remain attractive in terms of pricing, and they look less vulnerable than other asset classes to the possibility of a "less than just right" economic environment. In developed markets, we would focus more on equity markets like Europe and Japan, which continue to look cheap compared to other equity markets.

And what about emerging markets?

We also see some interesting opportunities in emerging market bonds that are denominated in their local currency (rather than in US dollars). And we see opportunities in emerging market equities (especially in Asian and European equity markets). Growth is accelerating across emerging markets and, despite many concerns, has not been derailed. It is currently strong in China and India, while countries like Brazil continue to show impressive momentum as they recover from recession. After several years of reforms, many are also in a better position against a surprise rise in the US dollar.

However, a key worry has been the build-up of debt levels, especially in US dollar-denominated debt, in many emerging economies. For the time being, good growth trends imply that the outlook remains okay. But in a slightly tougher, "less than just right" environment, being selective on emerging markets is key.

Jane Davies
Senior Portfolio Manager
HSBC Global Asset Management

> The main investment opportunities we see for next year in equity markets are in Asia, and especially North-Asian markets like South Korea, Taiwan, and China itself. Asia is very geared to continue growing next year, and we think that will benefit Asian equities.

Equities outlook

What happened in 2017

Global equity markets have performed very strongly in 2017. Developed market equities have delivered returns of around 15% in US dollar terms, and emerging market equities have returned more than double that, at over 30% in US dollar terms.

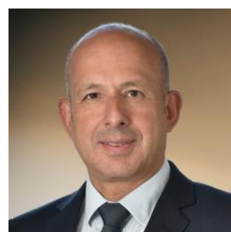
The economic environment has been very supportive of equity prices, especially in the emerging markets, where growth has been stronger. Corporate earnings growth has been the key driver of equity market performance throughout 2017. This is reassuring, and it reaffirms the relevance of the "valuation" framework we use to determine our views on equity investments.

How we see 2018 for equities

We would expect equities to continue performing well in 2018. We also expect emerging markets to outperform developed markets once again, as valuations for emerging market equities remain more attractive despite the strong rally in 2017. However, it's important to note, that even at this stage, we don't believe developed market equities are overvalued and they still have a place in a globally-diversified portfolio. In our view, equities across the board look attractive when compared with other asset classes.

The main investment opportunities we see for next year in equity markets are in Asia, and especially North-Asian markets such as South Korea and China. Asia is geared to continue growing at a faster clip than the rest of the world, and that will benefit Asian equities. This includes Japan where above average growth, low inflation and robust earnings growth will likely continue supporting the equity market. Elsewhere, there are selective valuation opportunities in emerging Europe, namely Russia, Poland, Turkey and Hungary.

On the flip side, the key risk to our expectations for next year is around how the growth and the inflation scenarios are likely to pan out, led by what happens in the United States. If inflation begins to pick up, or if growth remains very strong, then it's likely that central banks around the world, including the Fed, will have to be more aggressive about raising interest rates. As investors, we are not used to this anymore, as interest rates have been at historic lows over the last few years. Though this is not the most likely scenario in our view, a faster-than-expected rise in interest rates could have a negative impact on global equity markets.



Bill Maldonado
Global CIO Equities
HSBC Global Asset Management

After a year of positive returns, bonds paint a more contrasted picture for 2018. Being selective will be essential.

Bonds outlook

What happened in 2017

In 2017 bonds benefitted from good economic growth, low inflation, and lower political risks – there were no events like Brexit or the election of Donald Trump we saw in 2016. Central banks also continued to buy and/or to hold a lot of bonds, which supported the markets as well.

Investors' appetite for bonds remained strong throughout the year, and overall in 2017 bond markets delivered returns between 2% and 10%, across different asset classes.

Emerging market bonds delivered the highest returns, followed by high-yield bonds – riskier corporate bonds that have a credit rating below BBB/Baa. Investment-grade bonds (corporate bonds with the best rating) returned 3% to 5%, and even government bonds posted positive returns of 2% to 3%.

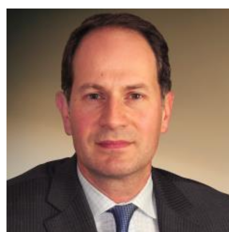
How we see 2018 for bonds

After a year of positive returns, bonds paint a more contrasted picture for 2018. The performance of government bonds will largely depend on what central banks decide, because bond prices fall when interest rates rise. However, we expect interest rates in the US and Europe to increase little next year. We think government bonds in countries in the periphery of the eurozone, like Portugal or Ireland, will continue to be supported by good economic growth.

On the other hand, corporate bond prices could suffer from rising interest rates, and could be hit as central banks end their bond-buying programmes. It will be essential for us to be cautious, and very selective about the corporate bonds in which we invest.

Emerging market bonds remain our preferred investment for bonds, particularly Asian bonds. We believe their medium-term performance will be positive thanks to economic growth, low inflation, and additional factors like improving commodity prices and brisk international trade.

The main risk for bonds will be if central banks raise interest rates faster than the markets expect, which could cause bond values to fall, and shift the balance of the global economy to lower long-term levels.



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