Investment Outlook

Q3 2022

Adapting to Disruption

HSBC

Global Private Banking

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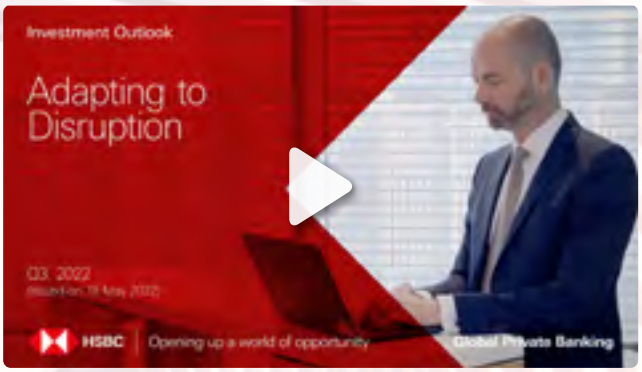
Macro views and portfolio strategy



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High Conviction Themes

Welcome

Dear client

Since late 2021, concerns over stagflation risks have hit both bond and equity markets, creating a double whammy in portfolios. The inflation spike has forced central banks to embark on a tightening path, and bonds have sold off sharply as a result. Equities too were hit by the policy tightening, by concerns that inflation would eat into margins, and by the slowing economic cycle.

With both bonds and equities down, there were few areas to shelter, but we believe the investment environment should gradually start to improve. Further potential downside for bond markets is getting more limited because they already price in more rate hikes than we expect to see in the US, UK and Eurozone. If inflation starts to gradually decline and economic growth slows, some central banks could hike less than markets now price in. Therefore, we are less underweight on bonds than at the start of the year, and could add to duration exposure in coming months.

On the growth side, the global momentum is clearly slowing, but the earnings season has shown that many quality companies still manage to achieve solid profit growth in spite of the cost challenges. The fact that the US and ASEAN countries are experiencing resilient growth while Europe is slowing should help keep the world economy away from recession. And we're hopeful that China's stimulus will start to boost activity in H2 2022. So we manage our exposure carefully, looking for regional resilience (in US and Asia) and quality businesses with strong market positions, while balancing cyclicals and defensives (e.g. underweight industrials vs overweight consumer staples). A more stable bond market will exert less pressure on stock prices going forward, but it is critical to pick regions, sectors and companies with a resilient earnings outlook, because there is much divergence.

To differentiate and pick the companies that are best placed to navigate our complex world and generate alpha in the process, we need to look at the macro, micro and structural factors. Macro-economic factors such as economic growth and interest rates can determine much of our asset allocation, but investing solely on the cyclical outlook is too myopic. The world has faced several structural shocks, and investors need to adapt to their lingering effects. The COVID-19 crisis, the Russia-Ukraine war and the Sustainability revolution are changing supply chains, labour markets, our energy sources and infrastructure, and are turning our globalised world into a more regional one. The transition will require lots of investment that will ultimately help boost growth and make it less volatile, but this will involve costs and cause inflation to remain more elevated than witnessed in the past decade.

For investors, these changes support our high conviction themes. Regionalisation, rising R&D and geopolitical uncertainty support all of our themes under the Digital Transformation, including Automation and AI; Biotech, Genomics and Devices; Smart Mobility, The Metaverse and Total Security. Our Asian HiCo themes focus on the green transformation and undervalued industry champions, and recognise that accelerating economic reopening and new consumption patterns support a consumer revival. And finally, the energy transition and biodiversity themes are clearly becoming a key focus for investors and businesses, while labour market shifts help drive the rising focus of the 'S' in ESG.

The last step in the investment process is to look - at the micro level - for companies that can adapt to the macro challenges and the structural shocks. To do this, we find it helpful to use the ESG framework to complement financial ratios to really understand how future proof a company is, which depends on its market position, its balance sheet, its processes, human talent and foresight. By looking for companies that score well on the macro, structural and micro measures, we can build a portfolio that is fit for the future.

Our strategy remains focused on portfolio resilience, using the 3x3 framework which we introduced in Q2. We focus on quality, income and diversification to dampen volatility but to remain invested and capture the upside we foresee in the second half of the year. Quality helps pick the companies and areas with the most resilient fundamentals; income takes advantage of the increased yields and helps dampen volatility; and diversification helps uncover uncorrelated opportunities in alternative assets.

In an uncertain world undergoing unprecedented change, it is wise to build resilient portfolios to weather the likely bouts of volatility, but it would be unwise to ignore the wide range of opportunities.

Willem Sels,
Global Chief Investment Officer
18 May 2022

Our Portfolio Strategy

We believe global growth will slow down but remain positive (with significant geographical differences), inflation will start to decline slowly, and US rate expectations are close to their peak. As a result, we remain invested but with a focus on quality, income and diversification. With a six-month view, we continue to balance value vs growth stocks, and cyclical vs defensive sectors. In addition to macro variables, we believe it's key to consider the impact of recent shocks and structural changes, and to pick the companies that have the ability and the foresight to adapt to these changes. Dispersion between geographies, sectors, and companies will further rise, in our view, with the most resilient of them continuing to outperform.

Fixed income
Overweight: Global Investment Grade, High Yield and EM Hard Currency corporate bonds
Underweight: Developed market government bonds
Equities
Overweight: USA, Canada, Asia
Underweight: Eurozone, EM EMEA
Alternatives
Overweight: Hedge Funds

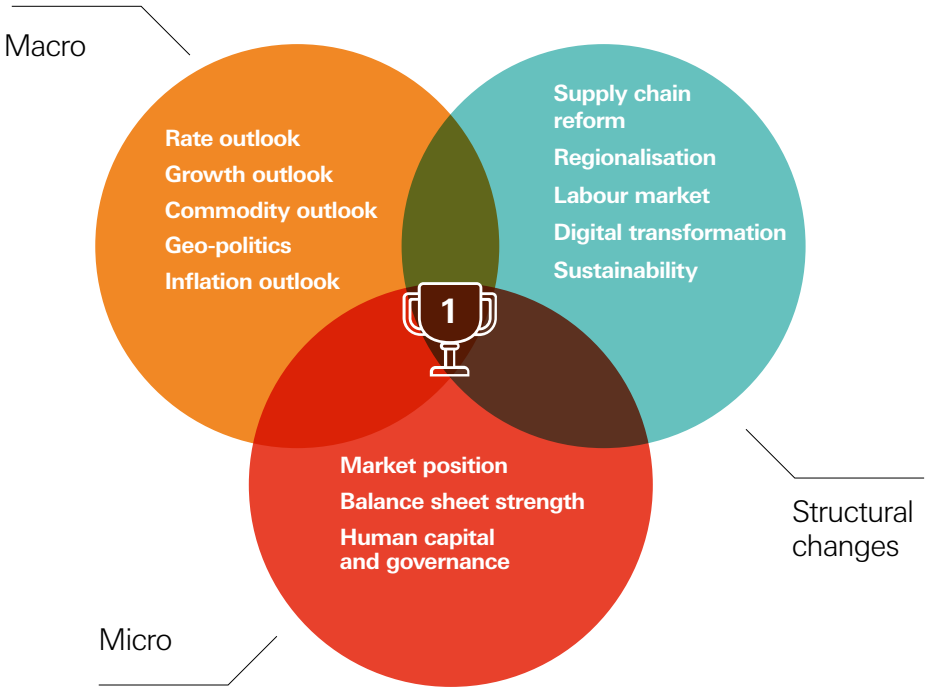
The macro, the structural and the micro

In portfolio strategy discussions, macro-economic factors typically dominate, because they help set asset allocation, geographical choices, sector strategy and style biases. The past few months have not been any different: the inflation and rate debate has been the #1 driver of volatility, while the economic growth cycle, commodity prices and geo-politics have also been key in setting risk appetite and our allocation strategy.

But the investment landscape has seen some big shocks, such as COVID, the Russia-Ukraine war and the sustainability revolution, which are creating structural changes. Investors need to take these factors into account, and assess how each company will react to this. A company's adaptability will depend on its market position, its financial muscle and its management's foresight. The time that everything neatly fell in homogenous geographical and sector boxes is gone, and differentiation is key. So, to develop a solid investment strategy, investors need to look at macro, structural and micro factors – and, of course, try to find those coveted future-proof companies at a reasonable price.

Macro-economic view and our asset allocation

Markets' views on rates, inflation and growth have been setting the tone, and this should continue to be the case. We don't expect a global recession, and hence no global stagflation, but risks are growing. Inflation will come down but only gradually. And there are large regional differences, so we need to drill down, differentiate between geographies and sectors, and take a nuanced approach.



Inflation and rate outlook:

The pendulum has swung far, with US CPI hitting a 40-year high of 8.5% in March (down slightly to 8.3% in April), and markets incorporating another 2% of Fed rate hikes this year after the 0.75% of hikes we've already seen. Markets have also raised rate hike expectations in the UK and the Eurozone, and many emerging market central banks are well advanced on the tightening path.

From here, we believe global inflation will slowly start to ease. The biggest contributor to this fall is lower oil price inflation, because of base effects (though food price inflation is picking up). Supply chain issues have been easing somewhat too in recent months, companies rebuilt some inventories in Q3 and Q4 21, and a slowing economic cycle should also ease some of the inflation pressure. But rising wages (more so in the US than in Europe or Asia) and renewed supply chain fears due to China's COVID-related lockdowns will continue to keep investors glued to their inflation monitors.

In summary, with so many rate hikes already priced in, we see reduced risk of even more hawkish market assumptions. But at the same time, we think it is too early to make big bets on falling bond yields, as the inflation path remains uncertain, central bank policies are data dependent and the recent structural shocks will keep inflation elevated for some time. Therefore, we believe that there is less upside for bond yields and the US dollar from here, short dated corporate bonds are attractive, and investors should benefit from balancing value stocks with growth stocks.

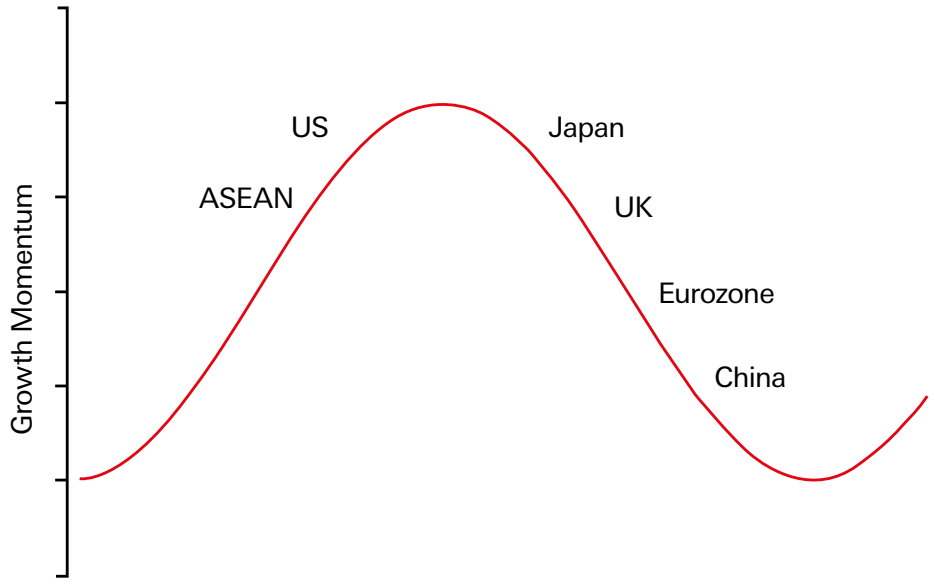
Growth outlook:

Very few economists are calling for a global recession, or for two successive quarters of negative growth in any of the major economies in the next 12 months, and neither are we. The brief inversion of the Treasury yield curve reversed, easing some of the recession angst. But risks remain, especially if the war were to escalate further or the Fed were to hike rates even more quickly than we expect.

What we position for is slowing but still positive growth, with big variations between the regions. As our stylised picture below tries to illustrate, ASEAN economies' reopening is creating strong economic and earnings momentum there, and Hong Kong is now reopening too, while the US will also accelerate from Q1 into Q2 and Q3. By comparison, Japan, the UK and the Eurozone are clearly slowing, with the Eurozone being very vulnerable to further downside due to the war in Ukraine (and its energy dependence and geographical proximity). China's slowing economy has taken a further knock from COVID-related restrictions, but we think that any easing of those restrictions and the lagged effect of policy stimulus should help the economy to recover later in the year.

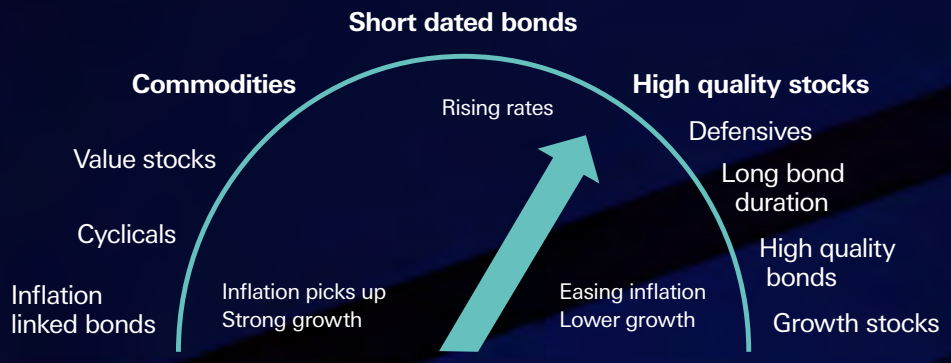
This geographical divergence is important for markets, because it is also reflected in analysts' relative earnings optimism, and has allowed US stocks to outperform Eurozone and Mainland China's stocks, which should continue to be the case. Geo-political factors have also weighed on the Eurozone's performance, while strong commodity prices have helped support our preference for the UK over the Eurozone, and our overweight of Canadian stocks. With high commodity prices remaining an upside risk for inflation, and supporting fundamentals for commodity producing countries and companies, we maintain an overweight to the materials and energy sector, and

Stylised representation of economies' current growth momentum



Source: HSBC Global Private Banking as at 17 May 2022

Our positioning dial: the macro picture directs us towards commodity-related assets, short dated bonds and quality stocks. It seems too early to go into long duration assets or to become outright defensive



Source: HSBC Global Private Banking as at 17 May 2022.

Structural changes: looking for future-proof business models

While cyclical forces around earnings, rates and inflation determine a big part of our strategy, we always cross-check these with the longer term structural forces. This has become even more important because of four big shocks in recent years which will have a lasting impact, in our view.

1) The US-China trade tensions have eased since the Trump presidency, and trade has increased since, but strategic competition remains, especially in technology-related areas. China has been putting more emphasis on technological self-sufficiency, investment in R&D and advanced manufacturing, and there is growing economic integration within Asia.
2) The COVID crisis exposed the vulnerability of global supply chains, changed working habits and consumption patterns, and boosted the online economy. Although people may come out of pre-retirement or part time jobs back into full employment in coming months, we think workers' demand for flexible and hybrid working models and a shift in bargaining power will keep wage inflation higher than it was pre-COVID.
3) The Russia-Ukraine war illustrates the danger of excessively concentrated energy and commodity supplies and heightens calls for more energy independence. It also highlights the importance of commodities in our everyday lives and the need for metals in the energy transition and build-out of the digital economy. And it has heightened interest in cybersecurity, blockchain-based solutions and digital currencies.
4) The sustainability revolution is ongoing, and the COP26 agreement commits to rapid and sustained de-carbonisation of the economy, which requires big investments in sustainable energy and will affect all business models. That cost will be recouped and there are signs that at least some consumers are willing to pay more for sustainable products.

to several commodity exporting nations' currencies and bond markets.

What these shocks have in common is that they question excessive globalisation: just-in-time business models that depend on inputs from one or just a few far-away suppliers have now clearly become obsolete. In our view – and the view of the IMF - this does not mean that everything needs to be produced at home, but that supply chains need to be more diversified. Producing everything at home would be like putting all chips on one colour: if there were a local strike or flooding, the entire supply chain would be halted. Shorter distances would still make sense, though, because of geopolitical reasons and, simply, because we think that the carbon cost of transportation will rise (as a result of rising carbon permit prices, carbon tariffs or consumers demanding local produce). We think the result will be more regional integration, which we're already clearly seeing in Asia, but also to some extent within Europe and between the EU and the US.

The other thing the above four shocks have in common is that they are inflationary. They create increased demand for new and cleaner products, while supply is restricted or takes time to be built. The demand shock for metals and advanced semiconductors coming from the sustainability revolution and the build-out of the digital economy is creating inflation in these areas. If all of this is done more regionally or locally, the work force also needs to be reskilled, creating bottle necks, at least temporarily. This is why we think that global inflation will remain more elevated than in the past decade (even though inflation should come down from its peak in the short term).

What does this mean for investors? In the main, these shocks support the key trends and high conviction (HiCo) themes we have identified. Regionalisation, sticky wages, rising R&D and geopolitical uncertainty support all of our themes under the Digital Transformation, including Automation and AI; Biotech, Genomics and Devices; Smart Mobility, The Metaverse and Total Security. Our Asian HiCo themes focus on the green transformation and undervalued industry champions, and recognise that accelerating economic reopening and new consumption patterns support a consumer revival. And finally, the energy transition and biodiversity themes are clearly becoming a key focus for investors and businesses, while labour market shifts and corporate responsibility highlighted during the war are examples of the rising focus of the 'S' in ESG.

All of this investment and innovation put together will add up to a lot of activity, financed by companies or government infrastructure projects in the US, EU and China. As a result, these initiatives have an important macro implication as well: they should act as a floor under growth and help avoid a global or protracted recession.

Micro: looking for adaptability and resilience

How companies react to these structural changes and the current macro-economic challenges is critical. We believe companies' adaptability and resilience will depend on a number of factors. A strong market position is a good starting point, with quality companies being in a better position to deal with inflation and pass on price increases to their customers. In technology in particular, there has been very wide dispersion between companies that continue to generate strong cash flows, and those that are either not innovating enough or not yet generating any revenues. Companies with strong balance sheets are in a better position to make the necessary investments or buy other companies to make their supply chains cleaner, more secure and diversified or to develop a digital offering. Maybe most crucially, successful firms will need strong human capital and an innovative CEO to adapt

to the big challenges and the rapid pace of change.

It strikes us that the environmental, social and governance (ESG) aspects are all important inputs in the micro-level analysis. At a minimum, we think investors will find it helpful to use the ESG framework to determine the potential for a company to adapt to the structural changes and challenges. But we would go further, and believe that on average, companies with strong ESG practices are more likely to be those adaptable businesses that we see, and outperform in the long term..

Summary of our portfolio strategy

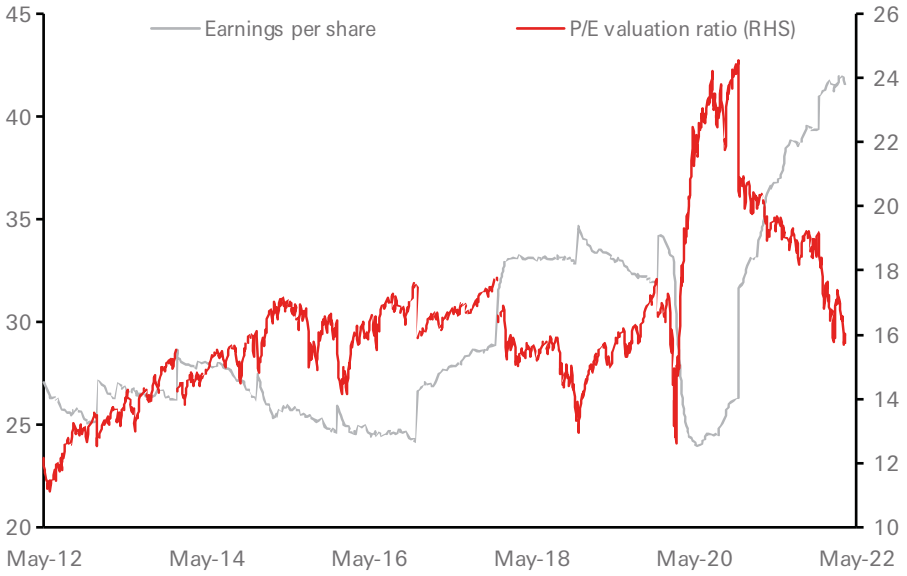
The emphasis we put in our Q2 Investment Outlook on building resilient portfolios remains valid, and we continue to look for quality, income and diversification. But we are putting even more emphasis on differentiation: geographically, we continue to favour the stock markets of the US, ASEAN and Hong Kong over Europe and Mainland China as we think the economic momentum and geopolitical factors are more important for the short term geographical allocation than valuations or relative dividend levels. Our stock picks continue to balance defensives vs cyclicals, and value vs growth, but we have added an emphasis on adaptability to the disruption in the global economy. We look for such companies at a reasonable price, taking into account that valuations have come down but could remain volatile due to policy normalisation, while earnings face the continued headwind of sticky inflation.

In fixed income, we are now less underweight than at the start of the year, given the rise in bond yields we've already seen, but we believe there is too much uncertainty around rates to move fully back to neutral. And in equities, we maintain our neutral view. It is therefore clear that we focus more on alpha and on diversification than on market beta. We aim to achieve this alpha through our geographical and sector choices, our HiCo thematics and our large overweight in hedge funds.

What could change this view? A clear fall in inflation numbers or deterioration in global growth could allow us to extend duration, and would drive us to move to better credit ratings and growth stocks.

An end to the Russia-Ukraine war would probably lead us to upgrade global and European equities and downgrade the commodity sectors. And a clear bottoming of economic activity in China would lead us to upgrade our stock market exposure there. Finally, we will follow the polls ahead of the US election, but traditionally, a gridlock in Congress tends to be relatively favourable for markets.

Global equity valuations have come down a lot already, but we pick quality companies that can sustain earnings growth



Source: Refinitiv, HSBC Global Private Banking as at 17 May 2022. Past performance is not a reliable indicator of future performance

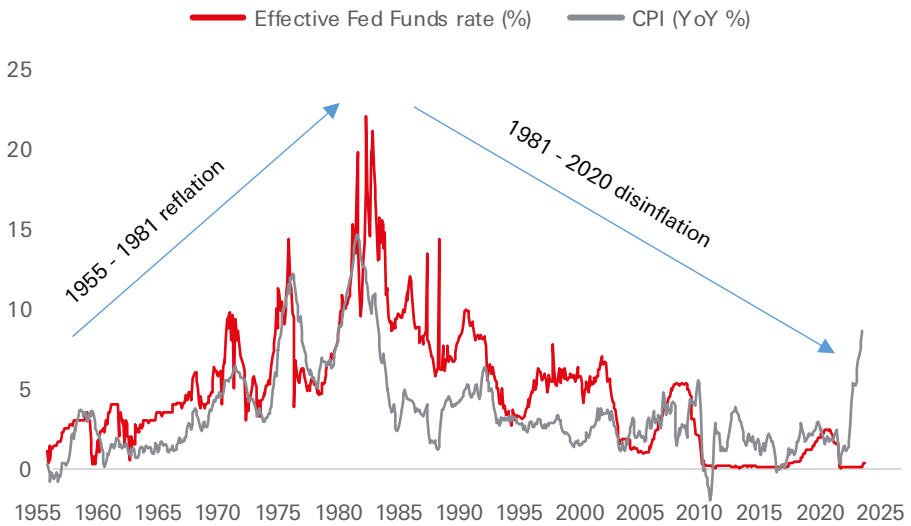
Asset Allocation in an environment of Rising Inflation and Aggressive Policy Tightening

We look at twelve cycles of monetary tightening since 1955 and analyse how markets typically perform in the initial twelve months of the rate hike cycle. Four of those cycles are particularly relevant for the current market macro environment. The common pattern during these episodes was commodities outperforming equities, equities outperforming cash, and cash outperforming bonds (with credit outperforming government bonds). If history rhymes this year, commodities and value stocks stand the best chance of delivering positive real returns in this challenging market environment.

We have identified seven Fed rate hike cycles during the reflationary period between 1950s and 1981, and five more hiking cycles during the disinflationary period from 1981 until 2020. During the reflationary period consumer prices were at first rising at seemingly benign rates, but they eventually escalated to double-digit levels, prompting the Fed to impose a severely restrictive monetary policy in 1980/1981 to halt the inflationary spiral for good. In the disinflationary decades that followed, both interest and inflation rates drifted lower over time, reaching lower lows and lower highs with each cycle.

Separately, we also distinguish between "fast" hiking cycles, where the effective Fed Funds rate rose by

Historical reflationary and disinflationary periods



Source: HSBC Global Private Banking as at 17 May 2022.

more than 2%, from "slow" cycles when the cumulative increase was less than 2% over the first 12 months. Notably, only two out of the twelve hiking cycles resulted in recession within the first twelve months from the initial hike, and both of these were fast hiking cycles in inflationary environments: those commencing in January 1973 and in September 1980.

Historical observations

Across these twelve scenarios, cash rates rose by 1.6% in the first 12 months, and 10 year yields rose by 0.5% on average, implying 1.1% flattening of the yield curve. The flattening pattern was fairly consistent across the different cycles.

Credit spreads tightened by 0.2% during the first 12 months of fast hiking cycles, but they widened by a similar magnitude during slow hiking cycles. On average, across all 12 scenarios, credit spreads were little changed, though we observe a degree of spread widening in disinflationary environments and a slight tightening in reflationary episodes. This is consistent with economic logic, as rising inflation reduces the real debt burden and results in lower defaults.

Corporate earnings rose by an average of 19.3% during the first 12 months of all rate hikes, as the economy continued to expand at rates that justified the tightening of monetary policy. The pattern of rising earnings is consistent across all historical hiking cycles, though somewhat stronger in disinflationary environments.

Scenario analysis across twelve historical rate hikes, with a focus on fast hikes during reflationary times

First hike	Regime	Pace	Recession	Cash rate	10 year yield	Credit spreads	Earnings	Commodities	Cash return	Consumer prices	S&P 500	Value	Growth
Apr 1955	Reflation	Slow	No	+1.37%	+0.15%	-0.03%	24.7%	1.3%	0.5%	0.4%	16.1%	14.1%	27.5%
Sep 1958		Fast	No	+2.00%	+0.52%	-0.10%	18.1%	1.0%	0.7%	1.0%	30.0%	35.6%	22.1%
Jul 1963		Slow	No	+0.25%	+0.16%	-0.15%	12.8%	1.2%	0.9%	1.3%	19.4%	26.4%	23.3%
Nov 1967		Slow	No	+1.38%	-0.11%	+0.43%	7.2%	2.6%	1.4%	4.7%	23.8%	40.3%	18.8%
Jan 1973		Fast	Yes	+3.94%	+0.55%	+0.00%	27.1%	81.6%	1.9%	8.7%	-24.2%	-8.6%	-24.2%
Aug 1977		Fast	No	+2.37%	+1.11%	-0.45%	7.9%	40.5%	1.7%	7.8%	14.2%	33.8%	20.7%
Sep 1980		Fast	Yes	+2.44%	+3.69%	-0.50%	3.0%	-22.7%	3.8%	10.8%	-9.1%	7.0%	-16.0%
Sep 1987	Disinflation	Slow	No	+1.42%	-0.29%	+0.70%	45.5%	7.7%	1.5%	4.0%	-18.2%	-4.9%	-21.4%
Feb 1994		Fast	No	+2.75%	+1.58%	+0.09%	41.0%	-4.7%	1.1%	2.8%	11.2%	1.4%	3.3%
Jun 1999		Slow	No	+1.64%	+0.24%	+0.54%	25.8%	59.6%	1.4%	3.2%	11.4%	0.1%	7.6%
Jun 2004		Slow	No	+1.97%	-0.68%	-0.08%	12.7%	20.7%	0.5%	2.5%	5.4%	22.8%	7.6%
Dec 2015		Slow	No	+0.51%	+0.29%	-0.36%	5.5%	10.2%	0.1%	1.7%	11.9%	23.5%	4.1%
Average	**Reflation**	**Fast**		**+2.70%**	**+1.47%**	**-0.26%**	**14.0%**	**25.1%**	**2.0%**	**7.1%**	**2.8%**	**17.0%**	**0.6%**
Mar 2022	**Reflation**	**Fast**		**+0.75%**	**+0.89%**	**-0.02%**	**0.78%**	**13.3%**	**0.0%**	**-**	**-9.4%**	**-3.1%**	**-8.9%**

Source: HSBC Private Banking, Refinitiv Datastream, Dartmouth University, University of Lausanne, Yale University, as at May 2022. "Recession" column indicates whether a recession occurred within the first 12 months of rate hikes. Factor returns are estimated over 12 month periods from each initial rate hike. S&P 500 returns are simulated on the basis of historical sector returns and present sector exposures of the index. Value and Growth portfolios are comprised of top quantile stocks sorted by value and growth characteristics. Past performance is not a reliable indicator of future performance.

In most scenarios, equity markets posted double digit returns during the first 12 months of rate hikes, in spite of some initial volatility. The notable exceptions were the 1973 and 1980 hikes where the returns were -24.2% and -18.2%, respectively. As noted previously, these were the only two hiking cycles where a recession occurred within the first 12 months since the initial hike. Value stocks outperformed growth stocks in 9 out of 12 hike cycles by 10% on average, and while that outperformance was consistent across all environments, it was particularly pronounced during fast hiking cycles.

The most consistent pattern across these historical episodes is rise of commodity prices, which on average outperformed cash returns by 12.2%. Their performance was particularly high during fast hiking episodes, reflecting strong aggregate demand across the commodity complex.

Implications for the current market environment

With the annual inflation rate approaching the double digits, and around 2% worth of additional Fed hikes priced in by early 2023, the current situation falls into the 'reflationary environment with a fast hiking pace' scenario. In similar historical scenarios, the overall asset class ranking prefers commodities over equities, equities over cash, and cash over bonds (with a preference for credit).

Commodities: On average, commodity prices rose by 25% in excess of cash during fast hiking cycles in reflationary environments. Thus far, they are up 13.3% since the initial rate hike this year, implying further upside from these levels (although commodity prices rose well before the first hike). The exception to rising commodity prices was the September 1980 scenario, when the Fed deliberately triggered a recession in order to stop inflation for good, which is not the Fed's intention this time. Gold of course typically behaves differently from the more cyclical commodities, and the rising real rate and strong dollar are headwinds for gold, while the mixed risk appetite is a tailwind.

Equities: If historical patterns persist, corporate earnings will grow by slightly less than average because of rising costs, but still at a healthy rate (14% on average). Sharply rising discount rates should continue to trigger bursts of volatility, and brief equity selloffs are common during the early phases of rate hikes. The average equity performance during fast hikes in inflationary environments was 2.8% in excess of cash, which is substantially below the average of 7.7% across all rate hike periods. The top quintile of value stocks on average returned as much as 17% in these environments, as rising discount rates are far less damaging for value stocks vs "long duration" growth stocks. The S&P 500 is currently down 9.4% since the first rate hike and value stocks are down 3.1%, suggesting a lot is already in the price. As an analogy, the August 1977 hike initially triggered a 10% sell-off in in the S&P 500 before rebounding and returning +14.2% at the end of the 12-month period. We continue to monitor equity market fundamentals, pricing and technicals to find the right entry point and potentially adjust sector and style positioning.

Cash: It would be reasonable to expect continued volatility as markets fully adjust to the ongoing generational macroeconomic regime shift and global disruption. Against this backdrop, cash is positioned to deliver slowly rising nominal returns with rising rates. However, real returns on cash holdings are likely to be negative for the foreseeable future.

Fixed income: Credit is likely to outperform government bonds, and this is reflected in our positioning. The underlying government bond yields, however, typically sell off by close to 150 basis points on average, which would result in negative total returns for both credit and government bonds. Thus far, the 10-year yield is up around 89 basis points since the first rate hike and 180bp since the recent low, suggesting there is a fair level of anticipation 'in the price'. Credit spreads have started to widen too. Overall, we maintain our underweight on bonds relative to our SAA but because of the move we've already seen, we now have a smaller underweight than at the start of the year.

Shifting Investment Styles and the Resurgence of Value

As markets grapple with growth and inflation fears, volatility has become a mainstay and investors are wondering how should they fine tune their equity style exposure. In our recent CIO Academy publication we provided a framework that should help investors consider what it means to pursue value or growth investment styles. It reveals that in the current environment of heightened uncertainty and bond market volatility, a balanced allocation to value and growth stocks, with a focus on quality and income, should put investors in a good stead.

Growth stocks are, by definition are equities which offer high potential of strong earnings growth, further out in the future and hence they are often called 'long duration' assets. Their stocks trade at above average Price-to-Earnings (P/E) ratios and normally offer low dividends. Growth stocks tend to underperform in a rising interest rates environment because they make distant cash flows less valuable. Technology stocks are a good example of growth stocks.

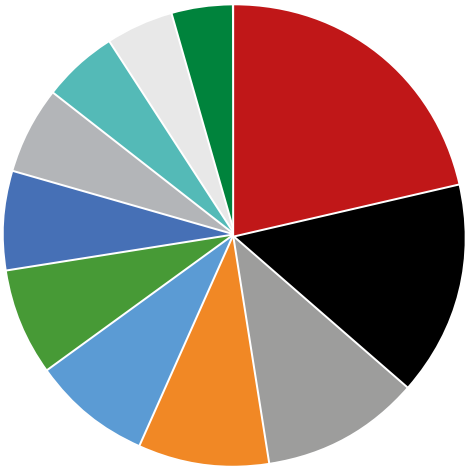
Value stocks on the other hand are less glamorous stocks, which trade at low P/E ratios. They can be categorised as 'low-duration' assets and often provide a steady income profile in the form of dividends.

It is therefore understandable that in the rising rates stage of the business cycle, investors prefer shorter-duration and have pivoted towards value stocks.

Below, we seek to provide a framework through which investors should consider what it means to pursue a value investment style.

1. **Valuations vary across sectors, regimes and market capitalisation.** Stock valuations, mostly measured by P/E ratios, are dynamic and change over time with the rotation of capital. For example, the Utilities sector, by historical definition is largely considered a value sector. But as things stand now, its stock valuations are not cheap relative to

MSCI World Value index sector weights



Financials	21.6%
Healthcare	15.0%
Industrials	11.1%
Consumer Staples	9.1%
Information Technology	8.5%
Energy	7.4%
Consumer Discretionary	7.1%
Materials	6.0%
Utilities	5.4%
Real Estate	4.6%
Communication Services	4.3%

Source: MSCI, HSBC Global Private Banking as at 17 May 2022.

history. Therefore, sectors move in and out of 'investment styles' based on their current valuations. Investors also need to be mindful of the fact that sometimes stocks are cheap for a reason. One needs to look for quality within the value style and avoid 'value traps' i.e. stocks which look attractively cheap on the face, but have little potential to recover due to specific underlying adverse factors.

2. **Dividends remain a key characteristic and differentiator for value stocks:** While growth companies focus on reinvesting free cash flow to aid future growth, value companies typically redistribute capital to shareholders in the form of dividends. Over time, dividends have become a hallmark characteristic of the value investing style, with the dividend yield on value companies more than double the available yield on growth companies (1.99% vs. 0.75%). As income (from dividends) is an important part of the total returns profile in an environment like now, when multiples' expansion is expected to subside or remain muted, a focus on dividend paying stocks would automatically lead one to select many value stocks. Having said that, investors should make sure that the company can sustain its dividend payments – hence our focus on durable dividends. And in our search for quality, we note that some quality companies, by default, would fall in the 'growth' segment of the market too and should not be abandoned.
3. **Rates matter, but volatility in the slope of the yield curve also impacts equity valuations and hence sector rotations:** The rates outlook has driven a lot of market moves YTD. But the slope of the yield-curve (as measured by the 10Y-2Y Treasury spread) provides investors with context about how much additional term-premium investors demand for committing capital for longer periods of time. Empirical data suggest that valuations' dispersion between growth and value stocks tends to compress as the yield curve steepens. Yield curve volatility has led to a lot of flip flopping and rotation between growth and value stocks this year and this trend may continue for now, until market volatility recedes. This therefore implies that instead of favouring one investment style over the other, investors may need to have a balance between growth and value stocks for now, until a clear trend emerges either way.

The Utilities sector by definition is a value sector, but isn't the cheapest (for now)

Source: Refinitiv, HSBC Global Private Banking as of 17 May 2022.

To conclude, we think it is much more important to maintain a balanced approach to investment styles (growth vs. value) led by bottom up research this year than in years prior. Just as investors should not be willing to pay for 'growth at any price', it is equally important to avoid 'value traps', which may eventually prove to be dead investments. Astute investors will take the current rate hike cycle as a cue to rebalance their portfolios towards more neutral positioning between growth and value, and be balanced on cyclicality.

Remaking Asia's Future

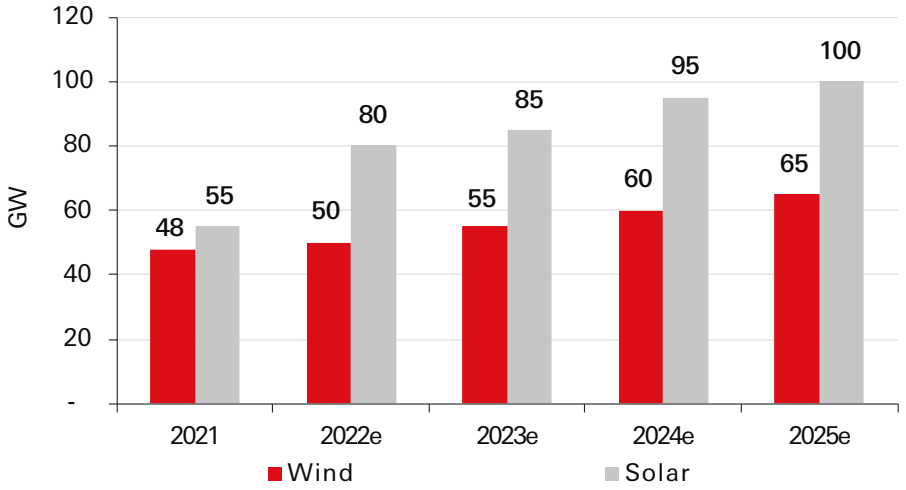
The unprecedented global energy shock and supply chain disruptions exacerbated by the Russia-Ukraine conflict and China's Omicron-related lockdowns have rippled across Asian economies, raising the urgency to take action to counter the headwinds for exports and growth. The disruptive changes have provided new catalysts to accelerate the structural trends of energy transition and manufacturing upgrading in Asia, as governments strive for energy security, supply chain security and technology self-sufficiency. Our Asian investment themes look at opportunities as the region adapts to the disruption caused by recent events, and we scan for quality assets in equity and bond markets at discounted valuations.

Our four high conviction themes

1. Asia's Green Transformation
2. Asia's Consumer Revival
3. Asian Champions at Great Value
4. Asian Quality Credit

The sharp spike in energy and commodity prices has prompted the key Asian commodity importing countries to ramp up investment in the energy transition and green transformation to reduce their reliance on carbon intensive fossil fuel and coal. Chinese President Xi Jinping recently called for an "all-out" infrastructure push at the Central Committee for Financial and Economic Affairs, with top priorities attached to strategic initiatives of building new infrastructure for technology upgrading and green transformation. We expect that China's massive investment in new infrastructure (to be funded by the issuance of RMB2trn special CGBs) will give a strong boost to the construction of its clean energy base, 5G network, smart cities and electrification of the transportation and industrial sectors.

New wind and solar capacity additions in China (2022-2025)



Source: NEA, NDRC, HSBC Global Research estimates, HSBC Global Private Banking as at 17 May 2022.

Notably, Asia is the world's largest and fastest growing energy consumer and the largest carbon emitting region that accounts for 52% of global emissions. Asia is well positioned to adapt and lead global efforts to mitigate climate change by accelerating its energy transition. The five largest Asian economies (China, Japan, India, South Korea and Indonesia) have all committed to achieving carbon neutrality by 2050-2070. We believe climate change and energy transition will continue to take centre stage in Asia's economic transformation amid the ongoing global energy shock.

Asia's Green Transformation

Asia stands out as the world's largest investor in energy transition, accounting for 60% of new global renewable capacity installation in 2021, according to International Renewable Energy Agency. Out of the 154.7GW of new renewable capacity added in Asia last year, 78% or 121GW came from China. Major Asian economies, led by China, have committed to invest significantly to revamp their power mix and industrial processes away from coal power towards renewable energy and electrification.

According to the International Energy Agency (IEA), Asia will account for 64% of new renewable capacity additions globally between 2019 and 2040. It estimates that China will need to invest more than RMB200trn till 2060

in green transformation projects to achieve carbon neutrality. The Asian Development Bank estimates that the ASEAN countries will need to invest USD210bn a year to build climate resilient infrastructure till 2030. Our new investment theme on Asia's Green Transformation focuses on opportunities in renewable energy, including equipment makers of solar, wind and green hydrogen, energy storage providers, smart grid manufacturers and leaders in the new energy vehicles (NEV) supply chains.

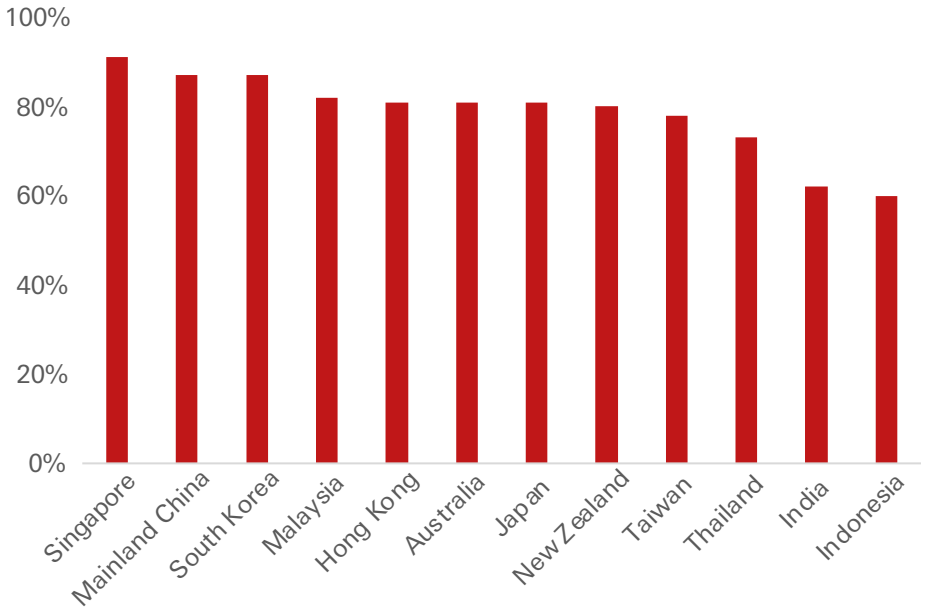
We expect China's annual solar installed capacity to increase at a 16.1% annualised rate, to 100GW in 2025. For wind energy, we expect annual installations to rise from 48GW in 2021 to 65GW in 2025. In India, solar power accounts for 90% of renewable additions. We expect India's annual solar installations to grow at a 13.7% CAGR to 18GW by 2025. Being the world's largest NEV market, China's NEV supply chains command superior competitive advantages and earnings power against the global peers due to their economies of scale and the huge home market. After recording a hefty 155% growth in 2021, China's national NEV sales are expected to surge 52% in 2022 and 29% in 2023, lifting NEV penetration rate to 40% in 2025 and 75% in 2030.

In Singapore's Budget 2022, it has been announced that the carbon tax would be gradually increased from the current SGD5/tonne of carbon emissions to SGD50-80/tonne of emissions by 2030. To encourage the adoption of energy efficient technologies, the Energy Efficiency Fund will provide grants of 50% to 70% of qualifying costs in the manufacturing sector.

Asia's Consumer Revival

Looking ahead into H2 2022, we expect a more favourable economic reopening outlook for most Asian countries given the encouraging vaccination progress. Eight major Asian economies have at least 80% of their populations fully vaccinated. In Singapore and South Korea, over 70% of their residents have had their third booster shots. Further relaxation of COVID containment measures is observed in many Asian countries. We have turned more positive on the Hong Kong market after the government accelerated the reopening process and relaxation of social distancing restrictions in May. While Mainland China has reiterated the "dynamic zero-COVID" policy will remain in place, there could be more flexible adjustments in the local implementation details when the current wave of Omicron outbreaks starts to ease later this year. The central government has introduced various policy stimulus to support the job market and the companies which have been hit by COVID lockdowns. Malaysia and South Korea also removed outdoor mask mandates since the beginning of May.

Most Asian economies have achieved a full vaccination rate of over 80%



Source: Our World in Data, HSBC Global Private Banking as at 17 May 2022.

Under our theme on Asia's Consumer Revival, we see attractive opportunities in the domestic leaders in the travel, hospitality, consumption, healthcare and e-commerce sectors. Consumer service industries in Asia should see improvement in profitability this year. Led by Singapore, Southeast Asian countries are pressing ahead with reopening borders. Some North Asian economies, especially Hong Kong, will continue to relax COVID containment measures after the fifth wave of COVID outbreaks has passed the peak.

In order to revive depressed consumer sentiment from the pandemic lows, the Chinese government is expected to introduce more direct subsidies for households, similar to consumption vouchers issued in Shenzhen and Beijing, in more provinces and cities. Employment stipends and tax cuts for social security contributions to restore consumer confidence may follow. In the medium term, China's pursuit of common prosperity should lead to further urbanisation, rising income levels and the expansion of the middle class. At the National People's Congress in March, policymakers said the supply of affordable rental homes was accelerating, supporting private consumption in the longer term.

Digital consumption in Southeast Asia is unlikely to ebb. Companies that can provide convenient services to customers and insights to retailers should fare better but investors should be selective on country and company fundamentals. Asia's increasing consumer preference for local brands should provide tailwinds for strong domestic consumer brands. According

to NielsenIQ's report, 62% of Fast Moving Consumer Goods (FMCG) sales in the region now comes from local brands.

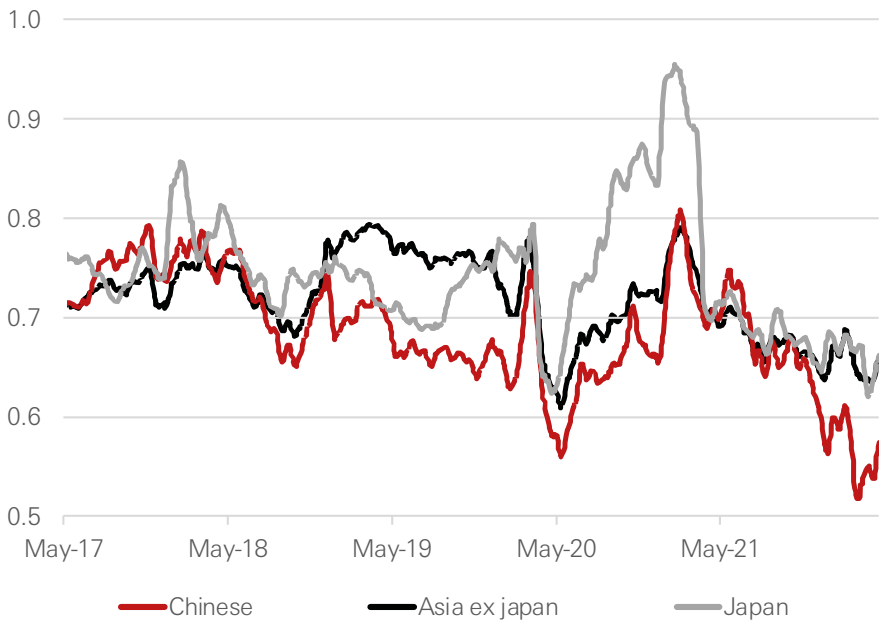
Asian Champions at Great Value

Riding on the structural trends of digital transformation and automation, supply chains revamp, technology upgrading and rising middle class consumers, Asia has become the home of many industry leaders with global leadership position. Among the Fortune Global 500 in 2021, 231 of them (i.e. 46%) have their headquarters in Asia. After the correction of MSCI Asia ex-Japan (-23% circa) and MSCI Asia Pacific (-19% circa) over the past 12 months, many Asian champions with strong brand franchise and resilient earnings power are trading at compelling valuations versus their global peers. The deep valuation discounts in the quality Asian industry leaders present great entry opportunities for investors who seek to build strategic exposure to Asia's structural growth winners.

We highlight that forward P/E of Asia ex-Japan has compressed to a one-third discount vs the US equity markets, mainly led by the sharp correction of the Chinese equity markets. The valuation discount is 1.4 standard deviation larger than its five-year average. Japan's market P/E has nearly halved in the past 15 months. The Asia ex-Japan stock market forward P/E trades at 1.2 standard deviation below its five-year historical average. The structural shift in China's growth model towards high technology and low-carbon industries means that selected sectors will be able to grow faster than the national average as they manage to reinvent their business models to adapt to new regulations and supportive government policies. We see rising profit margins, asset turnover and higher ROE in the renewable energy sector while consumer staples also reported improving margins and profitability.

Asian equity markets have been de-rated compared to the US markets

Chinese, Japan and Asia ex Japan equities forward P/E relative to US market



Source: Bloomberg, HSBC Global Private Banking as at 17 May 2022. Past performance is not a reliable indicator of future performance.

In our view, the expected stabilisation of US bond yields and China's growth stabilisation in H2 2022 should support the re-rating of the Asian equity markets in the next six months, even though day-to-day volatility may remain elevated. If economic growth in Asia is to accelerate with support of China's recovery, the risk premium for the Asian equity markets should gradually contract and earnings growth should have room to be revised upwards. Hence investing in the Asian champions with attractive valuations should offer outsized medium-term upside relative to the broad market. On top of picking the undervalued Asian champions based on bottom-up analysis, we believe screening companies by their key financial ratios, such as ROE, P/E, dividend yields and gearing ratio, should also help identify the best opportunities.

Asian Quality Credit

After the sharp correction over the past year, the Asian credit market offers attractive carry opportunities. As suggested by the theme's name, we have a strong preference for Asian IG and RMB bonds over Asian high yield for their quality appeal and are enticed by the yield pick-up versus DM and other EM IG credit. We prefer focusing on quality issuers, as Asian IG bonds account for 80% of the overall Asian credit market. We see the best opportunities in Indonesian hard currency bonds, Chinese SOEs, Chinese financials, including the better quality local government financing vehicles. To manage rate and FX volatility risks, we stay focused on short dated Asian hard currency corporate bonds which are expected to see lower price volatility relative to longer-dated bonds.

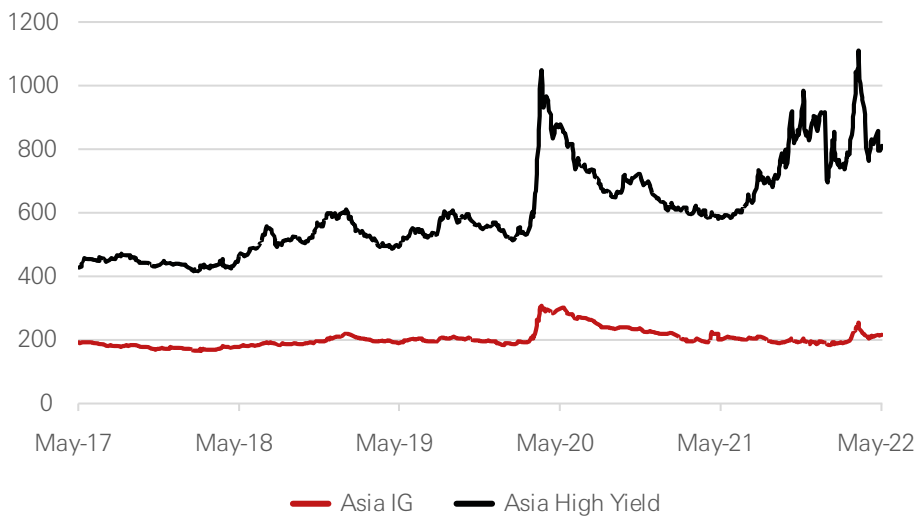
We expect China's rollout of more decisive monetary and fiscal stimulus to drive a stabilisation of economic growth in H2 2022, which will support the recovery of the Chinese credit market.

The RMB2.5trn tax cuts and VAT refunds (2% of nominal GDP) and RMB3.65trn quota for issuance of special local government bonds will improve cash flows and credit worthiness of the Chinese issuers. However, Chinese HY property issuers could see sustained liquidity stress but we do not expect material contagion risk to the Chinese IG, government and quasi government issuers.

Chinese property developers have reported significant y-o-y declines in contracted sales in the first four months of the year, and the COVID-related lockdowns added further uncertainty over the recovery outlook of the real estate sector. Despite the latest relaxation in some property tightening policies, such as lower down-payment ratios for first home purchases and some loosening in Home Purchase Restrictions by the local governments, confidence of potential home buyers continues to stay subdued. We maintain our cautious view on the China property HY sector. We expect to see more negative news headlines related to debt extension of distressed developers or bond restructuring ahead of repayment in H2 2022.

Asian IG credit spreads are attractive

Credit spreads in basis points



Source: Bloomberg, HSBC Global Private Banking as at 17 May 2022. Past performance is not a reliable indicator of future performance.

Within the Asian credit market, we are overweight in Indonesian hard currency sovereign and corporate bonds to reflect their strong credit fundamentals in the face of the easing pandemic headwinds and accelerating reopening. Indonesian credit also benefits from the strong rally of coal and nickel prices. Most Indonesian SOEs with USD bonds will continue to receive support from the government. The HY sector is also reinforced by positive demand vs issuance dynamics. On sector positioning, oil and gas issuers remain our favourite exposure due to tailwinds from elevated energy prices.

Opportunities in Policy Transition

It is no sinecure to normalise the accommodative policies that have been in place since the Great Financial Crisis. Markets are understandably concerned and volatility may remain elevated until inflation has clearly peaked and a few US rate hikes have been digested. In this environment, the themes under this trend are aimed at increasing portfolio resilience, by focusing on quality and income, and by trying to balance value vs growth.

Our four high conviction themes

1. American Resilience
2. Durable Dividends
3. DM Financials – focus on subordination
4. Resilient carry in high yield and EM

A slower growth outlook and sticky inflation

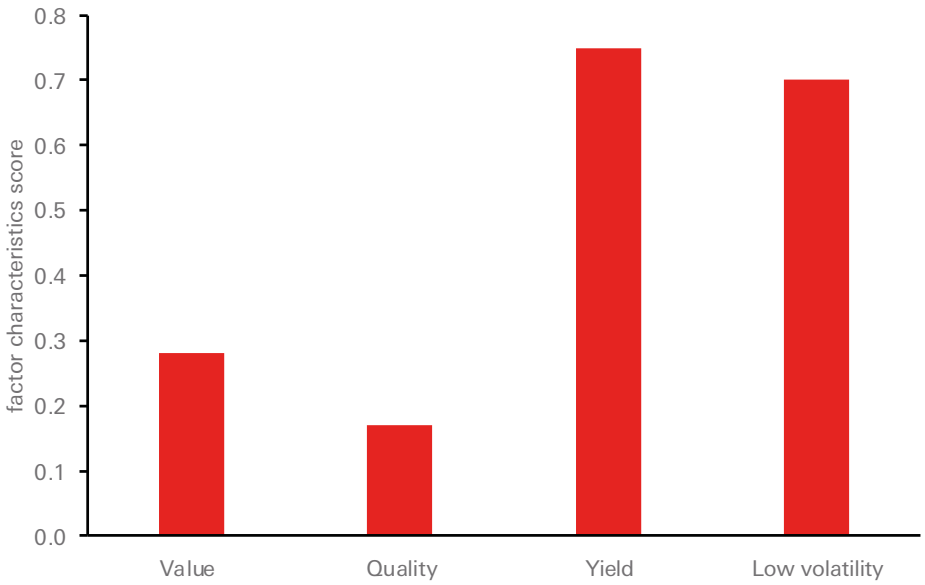
Our portfolio strategy chapter sets out our macro-economic view. In summary, global economic growth is slowing, but with big geographical differences, while inflation should come down gradually. But markets are already incorporating bearish growth and inflation assumptions, and pricing in a solid number of rate hikes. As a result, we see limited further upside for US Treasury yields and actually find short dated corporate bonds attractive. And in equity markets, we believe we can remain invested as long as we focus on quality and look for those areas where profits are best supported.

Durable Dividends

Dividend paying stocks are always a popular strategy with private investors, but are particularly relevant in the current environment. In our view, there are four key reasons to like companies with high and durable dividends.

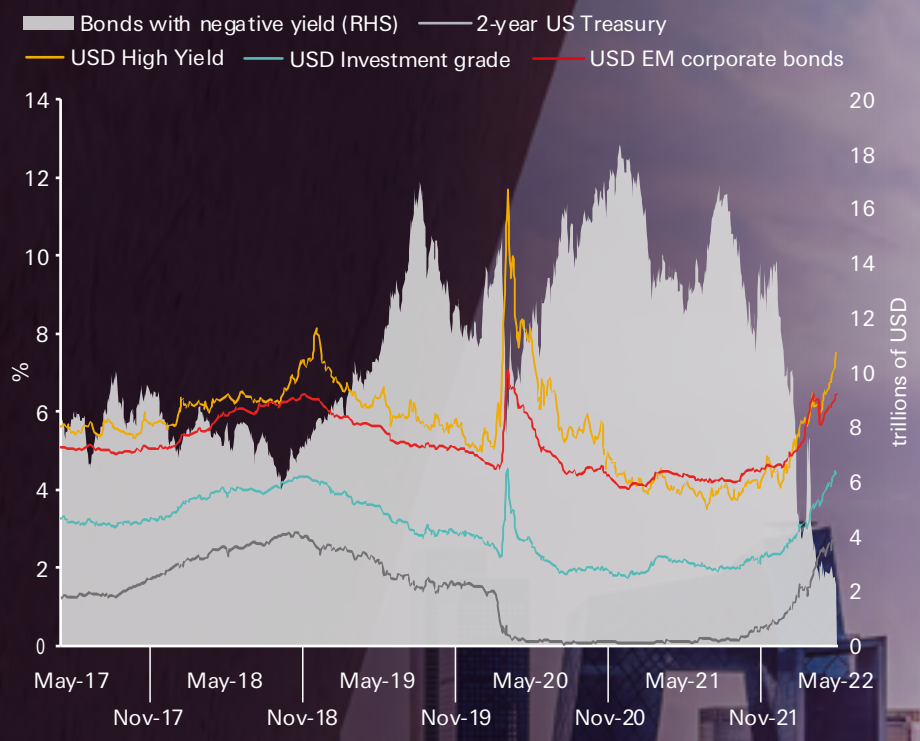
First, in our quest for portfolio resilience, we like strategies that generate income, because income is usually more stable than price appreciation. The more the stock return comes from income, the less volatile that return will tend to be. Second, dividend stocks tend to be value stocks rather than growth stocks, and given that most of our HiCo themes fall under the growth stocks style, the Durable Dividends theme can help balance portfolios' style profile. Third, value stocks tend to do well when interest rates are high or rising, and they did well in the stagflationary environment of the 1970s. Healthcare and consumer staples are the two biggest sectors in the high dividend index, which should be attractive for investors who fear slower growth. Financials have disappointed because of the flatter yield curve, but unless there is an outright recession, the curve should not flatten further from here, and we think that financials' high dividends and attractive valuations should provide support from here. Lastly, high dividend indices tend to have a quality bias, which is in line with what we are currently looking for.

Compared to the MSCI benchmark, dividend stocks tend to have a value, quality, income and low volatility bias



Source: MSCI, HSBC Global Private Banking as at 17 May 2022.

As yields have risen, the amount of bonds around the world with negative yields has collapsed



Source: Bloomberg, HSBC Global Private Banking as at 17 May 2022. Past performance is not a reliable indicator of future performance.

American resilience: As the title suggest, this theme fulfils our quest for resilience by searching for economies, sectors and companies that are likely to be resilient even as the global economy slows. The US economy should re-accelerate from a weak Q1 as it benefits from a strong labour market and solid investment spending. It is a major energy producer, in sharp contrast to Europe and China, which are very dependent on imports of foreign energy. In fact, the US is acting as an alternative supplier of energy and commodities to Europe, as its imports from Russia and Ukraine have fallen. We see some of the best opportunities in the US energy and materials sectors, in healthcare and in financials. The US stock market is the most liquid and deep stock market and has a lot of quality-style companies, in line with our current style preference.

Resilient carry in high yield and EM: in our quest for yield, we believe Global High Yield and EM hard currency corporate bonds can be attractive satellites to add to a well-diversified multi-asset portfolio. The former benefits from positive rating migration on the back of falling leverage, and we think their spreads more than adequately compensate for the relatively low level of default rates we expect to see. EM corporate bonds enjoy a good spread pickup compared to the low levels of interest rates in DM countries, and in some cases, EM issuers can benefit from high commodity prices. Risk premia may remain more elevated until uncertainty subsides, and hence we focus mainly on resilient carry opportunities rather than spread compression, and keep duration in check.

DM Financials – Focus on Subordination: Banks have strengthened their capital and liquidity ratios in response to stringent regulatory requirements under the Basel III accord. We view subordinated debt instruments as a valuable source of carry in the structurally low yield environment but look for issuers with large buffers above minimum regulatory capital requirements.

Digital Transformation

The introduction of numerous digital technologies is disrupting many established business and consumer ecosystems, often with predictable consequences but occasionally with surprising consequences. In our digital transformation theme, we highlight some of these leading edge technologies and explore their impact on society, commerce and the consumer.

Our five high conviction themes

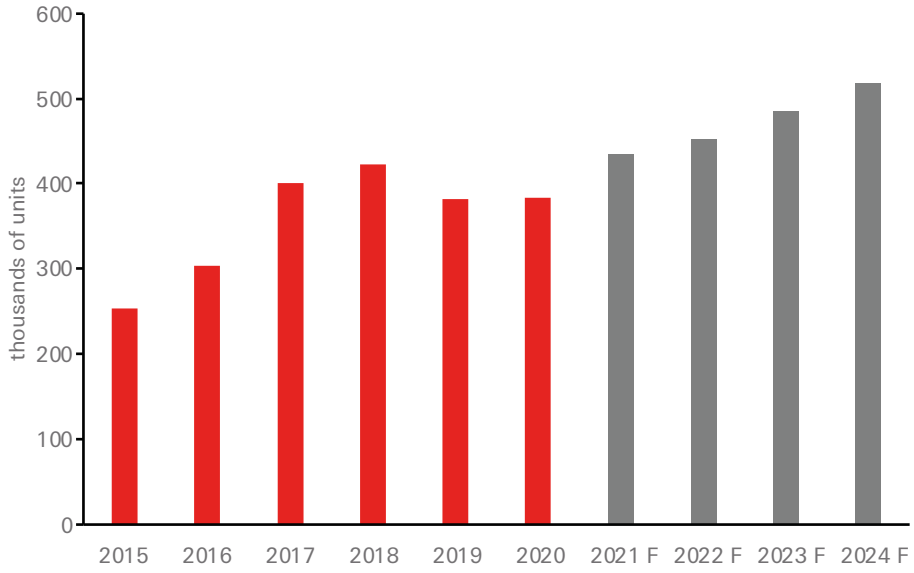
1. Automation and AI
2. Biotech, Genomics and Devices
3. Smart Mobility
4. The Metaverse
5. Total Security

Let's start by taking a look at automation, which has already gone through several iterations over the last two centuries from spinning machines to steam-powered locomotives to mass production lines. Today, many automated processes are hybrid electromechanical arrangements such as manufacturing production lines found in the automotive, food and packaging industries. During the pandemic, automation demand plateaued, but it strongly picked up again in 2021, as rising wages and labour shortages drove automation. According to the World Robotics 2021 report, it is estimated that 435,000 industrial robots were installed globally, a 13% increase on 2020 with demand forecast to grow by a further 6% per annum to the middle of the decade.

Industrial companies may have led the adoption of automation, but recently there has been strong growth in service automation. Other businesses and governments are increasingly looking for ways to automate processes and services to benefit from potential cost savings and increased productivity, but also to provide greater business resilience by minimising service interruption risks caused by factors including labour shortages and sickness. For many years now, physical and web-based self-service options have allowed consumers to perform tasks that were previously done by company or government staff. In our Automation & AI theme we explore how artificial intelligence (AI) is advancing automation in several subtle ways as it strives to better learn, understand and in some cases improve on its assigned tasks. In addition, AI is allowing automated machines to become more autonomous and with that enhanced ability, they are able to perform ever more complex tasks. Practical examples include screening of insurance and credit applications, and voice recognition used to identify people or requests.

Automation and AI are both increasingly being integrated into science. In our Biotechnology, Genomics & Devices investment theme we focus on the three areas in the title as these have made great advances in the last few years through the application of these two technologies. Biotechnology is increasingly using genetic engineering to develop gene-based therapies to treat diseases. Gene therapy is generally considered to be more targeted and has fewer side effects than traditional chemical based medicines. Gene editing tools such as CRISPR (clustered regularly interspaced short palindromic repeats) are enabling scientists to design bespoke therapies for a wide range of

Annual installations of robots



Source: World Robotics report, HSBC Global Private Banking, 2021.

diseases. Gene therapies take many forms from the replacement of missing or faulty gene sequences in a person's DNA to those that trigger the person's immune system to target a particular virus that is evading detection. A wide range of conditions are under study including cystic fibrosis, diabetes, haemophilia, AIDS and several rare diseases. Automated high-throughput screening machines handling hundreds of thousands of samples have been essential to the process as they enable the rapid identification of genetic markers, potential targets and therapies. To provide some context as to the size and complexity of the screening task, typically human DNA has over 20,000 genes each containing between a few hundred to over one million bases.

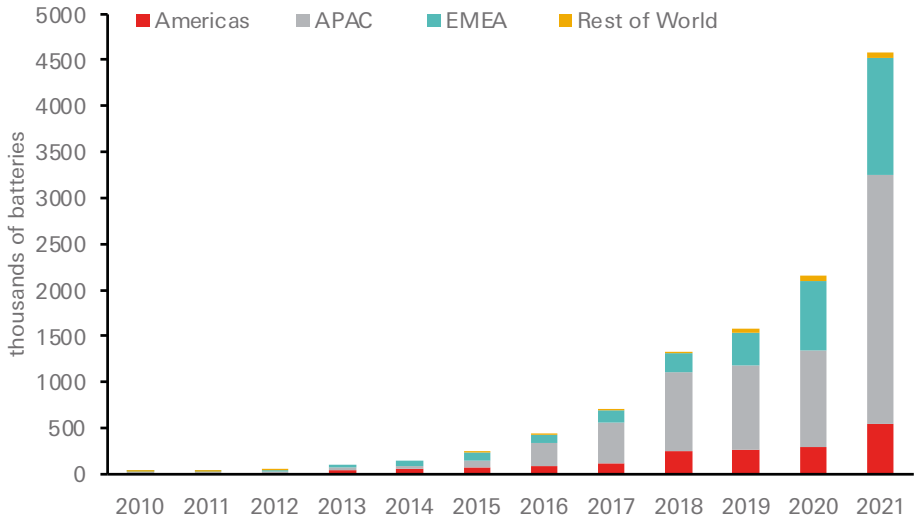
Automation is also assisting surgeons to perform delicate procedures in areas such as the brain, the eye and less accessible areas of the body that were difficult or impossible to perform in the past. Surgical robots have also enabled surgeons to perform operations remotely.

The base enabling technologies described above often have wider applications. For example, the secure high-capacity connectivity required for remote surgery is also an essential pre-requisite for our recent Smart Mobility theme. Connectivity between people, transport infrastructure and their locality thus facilitates advances in efficiencies, safety and integration of various modes of transport with the urban environments in which they operate. The introduction of electric vehicles should accelerate the introduction of smart mobility capabilities. The adoption of electric vehicles is accelerating, helped by government legislation and advances in technology (see chart).

Electric vehicles typically have 6x-8x more semi-conductors than their internal combustion engine equivalents. Electric vehicles are based on electrical rather than mechanical systems facilitating greater connectivity and potential integration into urban transport systems. On-board sensors can provide a wealth of information that could be shared, enabling improvements in efficiencies and information. Whether that is the precise location of a bus and its arrival time; predicting traffic flows and congestion; early identification of maintenance issues and avoidance of a potential breakdown; all these provide an opportunity to optimise mobility through coordinated private and public transport, through improved resource efficiency and better informed travellers.

In addition to the above three digital transition investment themes, we also have the Metaverse and Total Security themes which we discussed in detail in the last investment outlook. If you would like more information on either the themes, please talk to your relationship manager or investment counsellor.

Electric Vehicle Battery Sales by Region



Source: Bloomberg, HSBC Global Private Banking as at 17 May 2022.

Investing for A Sustainable Future

Sustainable investments are subject to the same short-term market shocks as other investments, and many of the tech-oriented stocks have seen rate-related volatility recently. With fossil-fuel companies doing well due to rising oil prices, and some governments boosting oil and even coal output, investors are wondering whether this changes the outlook for sustainable energy. In fact, we think the energy independence governments want to achieve will now require even more rapid investment in sustainable energy. We think the global disruption from COVID and the Russia-Ukraine war support all of our high conviction themes in a structural way.

Our four high conviction themes

1. Energy Transition
2. Financing Biodiversity Action
3. Sourcing Income in a Sustainable Way
4. The Rise of 'S' in ESG

To invest sensibly, we need to step back from the market noise, look through the headlines and review what is happening at the business level. That tells a different story from the recent volatility and some examples such as European energy goals, global solar demand and renewable diesel figures indicate that the future of sustainable investments is still well supported.

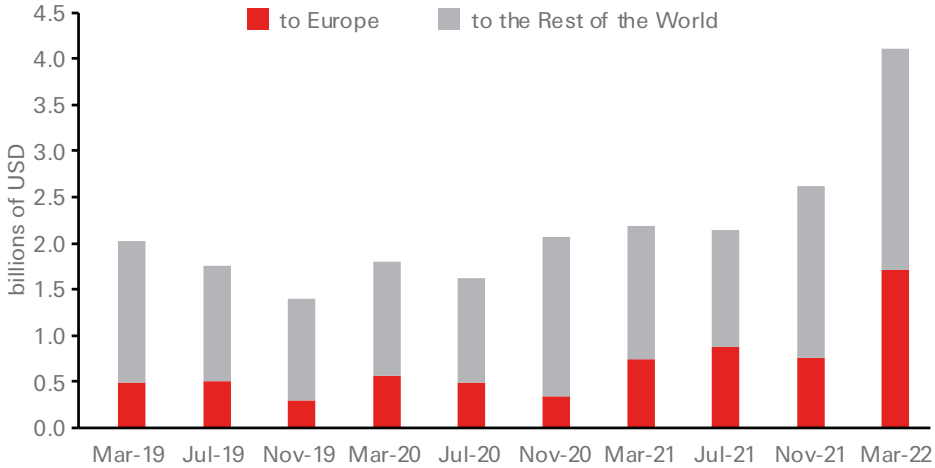
European Demand

The recent large moves in the oil price have given rise to fears that plans for a sustainable energy future are being curtailed but this is not the case. The oil price rise has been driven in large part by sanctions placed on Russia. Europe, and Germany in particular, are heavily reliant on Russian energy and have been faced with the dilemma of enacting their moral position of applying sanctions against the practical position of energy shortfalls and escalating energy prices for their citizens. They have surprised many with the pace at which they are reducing their reliance on Russian energy. The share of oil imports from Russia to Germany is down from 35% to 12%, coal from 50% to 8% and gas from 55% to 35% (source: The Economist, 4 May 2022). Overall, the European Bloc has highlighted that they aim to become independent of Russian fossil fuels over time. In the near term this will mean turning to alternative fossil fuel sources but in planning for the future, renewables will be major beneficiaries. There are 3 reasons why sustainable energy would be a preferred path. Firstly, energy production will be within the bloc, increasing their energy independence which is a stated goal. Second, it will reduce the carbon footprint of the bloc, also in line with stated net-zero goals. Thirdly, the region looks to be heading towards a more difficult economic environment of higher inflation and slower growth so onshore renewable projects would create jobs in the region, a political and economic positive.

Solar Demand

The demand for solar panels is stronger than it's ever been. China, the leading region for solar panel manufacturing, exported more solar cells and modules in March 2022 than any other month on record. The bulk of the exports went to Europe but the distribution of the solar exports was well spread globally

Chinese solar exports



Source: Bloomberg New Energy Finance, HSBC Global Private Banking, 17 May 2022.

(see chart). Moreover, this data does not include China's own solar spending which is expected to be close to 40% of the global market for solar building in 2022.

Renewable Diesel

Elsewhere, in the US, renewable diesel has surpassed biodiesel for the first time, as measured by the number of biofuel credits generated. This is a significant event for a sustainable future. Both are much improved alternatives to traditional diesel but renewable diesel offers lower emissions, is cleaner, has better cold and storage properties and can be used in high concentrations or even as a standalone product in diesel engines, whereas biofuel needs to be mixed with traditional diesel.

At scale, the reduction in emissions from using renewable diesel over fossil fuel diesel can be significant. Tankers, trucks, rail, farming, manufacturing, metals and mining are all reliant on diesel. Importantly, the refinement process for renewable diesel shares many similarities with traditional diesel so major refiners can adjust production processes relatively quickly and easily. Since 2020, more than 730 million gallons of renewable diesel capacity have been brought online and it is estimated that renewable diesel can reduce greenhouse gas emissions by 40% to 90%.

So, in summary, we point out that in the near term, macro-economic variables and broad investor sentiment are impacting the performance of sustainable investments but there is no doubt as to the future of the space: it is one of structural fundamental growth, of significant further investment and with lots of support from all strata of society.

Within sustainable investing, biodiversity is a key area of investor focus. The earth's biodiversity is in sharp decline and there is an increasing realisation that preserving resources by facilitating recycling and further development of circular economy is key to human survival and wellbeing. The economic benefits of biodiversity are substantial and across sectors. Innovative technologies offering sustainable solutions like alternative proteins, renewable sources of energy like solar and renewable diesel and innovative farming solutions not only promote restoration and preservation of our natural ecosystems, they also provide compelling investment opportunities to long term investors.

Sustainable Investing – the Basics

Sustainable investing is a broad topic, with many different approaches, objectives and lingo. But what is right for me and how should I set my investment strategy? In our recent Sustainability Insights publication**, we discussed 6 basic principles. They're not exhaustive, but we believe they're a good place to start.**

1. Know what you want tso achieve: because 'why' you want to invest sustainably will guide the 'how'. Some investors are values-driven, which may lead you to exclude certain sectors and activities, while others will want to engage with companies to help them make the transition. Whatever your approach, you may look at sustainability to discover new opportunities and risks and generate better risk-adjusted returns, or make a direct impact. We think it is helpful to consider the enhanced, thematic and impact approaches and see which one – or which combination – best suits your objectives

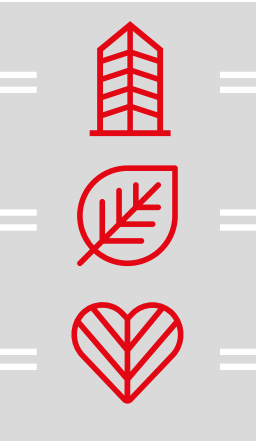
2. Adopt a medium to long term approach: because the net zero transition needs long term capital, corporate engagement takes time to yield results, and some new technologies will take time to become profitable. In our view, companies with strong ESG credentials will on average have a better long term risk/return profile, but like any other company, their short-term performance is principally linked to financial factors, not sustainability factors.

3. Consider sustainability across all asset classes: because all asset classes need to contribute to the funding of the climate transition and are affected by the changing investment environment. Diversification also helps broaden the opportunity set, across public and private markets. Some of the new developments and technologies often start in private markets, and the long term approach of private markets can be well suited to the multi-decade sustainability trend.

4. Incorporate sustainability in both the core portfolio and satellites: because thematic investments can be directly linked to your area of interest, but all companies in the core portfolio are affected by sustainability. How companies in the core portfolio are adapting to sustainability-related factors will help determine how future-proof your portfolio is (see our portfolio strategy section), and influence your portfolio's overall ESG score.

5. Make sure your investments do what it says on the tin (avoid greenwashing): as definitions and practices are still evolving, the role of a strong fund selector or advisor is key to ensure the investment matches the strategy and objectives you have set. Asset managers may design portfolios differently, even where funds have similar names. And while some funds will exclude certain activities or subsectors, others may include them and prefer to make a change through engagement.

6. Evolve with the market: because a growing, more transparent and competitive market will provide more opportunity and liquidity to investors. With time, we see no reason why investors would not incorporate a sustainability approach across the entirety of their portfolio.



ESG Enhanced
Invest in companies based on relative ESG performance

Thematic
Focus on themes and sectors dedicated to resolving climate and sustainability challenges

Impact
Focus on a direct, positive and measurable impact on society and/or the environment

Equities

Equities have been struggling amid investors' stagflation fears, supply chain issues, the Russia-Ukraine war and rising rates. Although we think a global recession remains unlikely, and central banks have given more clarity around their policies, risk appetite will remain mixed. We therefore continue to build resilient portfolios, with a focus on quality and income, and a preference on areas where earnings are best supported (US and Asia, with a preference for ASEAN and Hong Kong). We are underweight in the Eurozone as the region which is most exposed to the Russia-Ukraine war, and overweight in the energy and materials sectors to manage the risk of continued supply chain issues.

Overweight
Countries: US, Canada, Hong Kong, Singapore, Thailand and Indonesia
Sectors: Technology, Communications Services, Financials, Materials, Energy, Consumer Staples and Healthcare
Underweight
Countries: Germany, Spain, South Africa and Turkey
Sectors: Industrials and Utilities
Global style bias
Quality and Income

Global equities remain under pressure as a series of events continue to create uncertainty. Geopolitical conflicts and supply chain disruptions have kept inflation rising, which lifts the level of uncertainty and is impacting margins, as highlighted by many CEOs during the recent earnings season. Many central banks are now normalising monetary policy and while they are trying to raise policy rates just enough to diminish demand and lower inflation without causing a recession, they have no control over the global pandemic or the current supply chain bottle necks.

Equity valuation multiples (e.g. price/earnings ratios) have dropped substantially across the globe to reflect these issues and in fact, in numerous markets, they look increasingly attractive to long-term investors. However, in the short term, concerns over the deceleration in economic growth and the potential for tighter margins and slower growth in corporate profits remain. As a result, for now, we maintain our focus on quality and income, and our selective approach.

We look for quality companies that produce cash and maintain low levels of net debt in this rising rate environment. As valuations have reduced, value opportunities are emerging but investors should still remain focused on quality companies to avoid the pitfalls of value traps. Strong cash levels have lifted payouts to investors and we therefore focus on companies that have the wherewithal to sustain dividends, increase share buyback programs, or conduct M&A, as all three would be accretive to investor returns and potentially improve valuations. As we have noted before, dividend strategies tend to have some of the characteristics of low-volatility strategies as income tends to be more stable than price appreciation. Style-wise, we continue to balance value and growth stocks, even after the recent underperformance of growth stocks, and believe adding dividend strategies is a good way to achieve that balance. And when we look for regional opportunities, we first and foremost look for earnings resilience, as we discuss below.

Asian strength

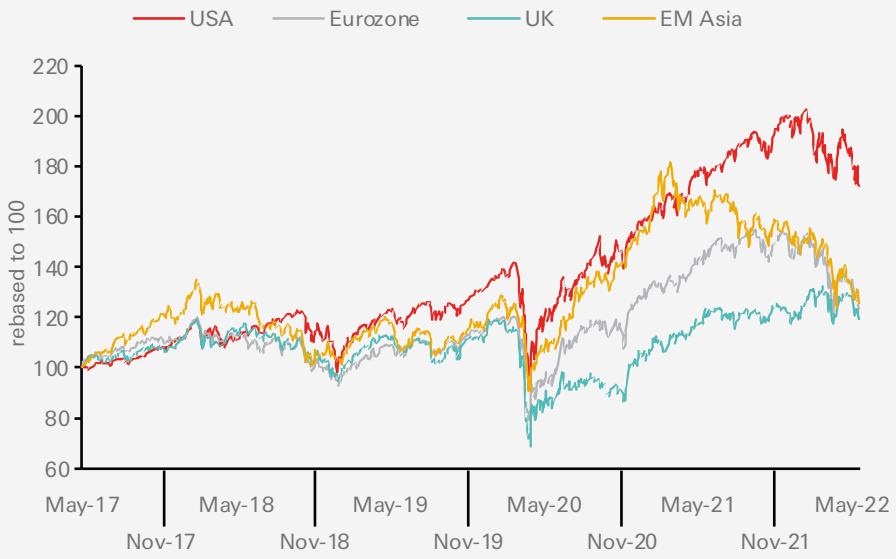
Demand remains healthy in Asia, especially in ASEAN countries and Hong Kong, which are reopening and seeing a catch-up in consumer spending. High goods and energy prices are benefiting the commodity exporters among them, especially as the Russia-Ukraine war has led to renewed shortages in some commodities. In addition, many Asian companies are important participants in the global supply chain logistics networks for numerous industries. The renewed lockdowns in Mainland China have hurt retail spending, industrial production and market sentiment, but we anticipate that the COVID lockdowns should gradually abate and, in conjunction with increased monetary and fiscal stimulus, we should see an improving backdrop for Chinese investors in the second half of the year. Still, we await the improvement in economic data before considering raising Chinese stocks from our current neutral stance. From a medium-to-long term perspective, the expansion of the middle class, combined with increased technological productivity, continues to make the Asian region a key contributor

to global growth, wealth creation, and healthy equity market returns. These trends can be exploited through our Asia-focused High Conviction themes.

US growth despite higher rates

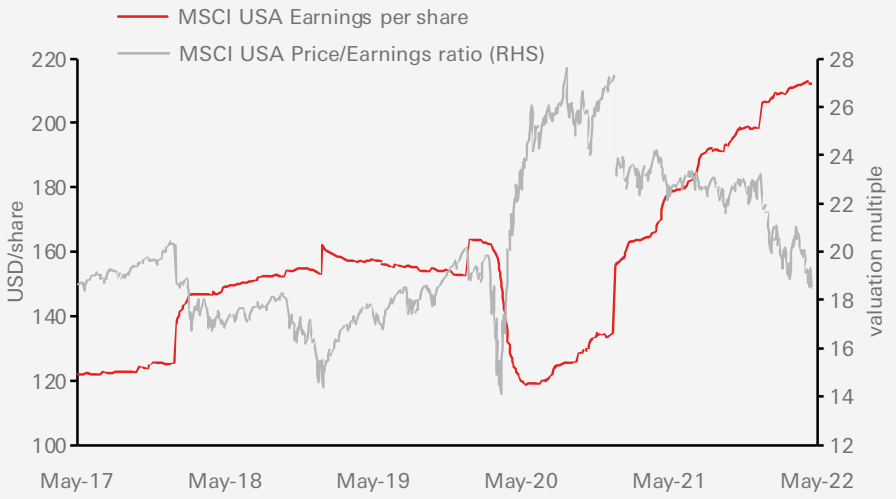
US economic growth was forecast to slow materially from last year's surge in demand. Obviously, that surge led to higher inflation and resulted in a Federal Reserve that must raise policy rates and reduce liquidity in order to diminish demand. That said, the US stands to benefit from strong consumer demand (supported by a vibrant labour market and rising wages), rising exports of food, energy, and materials, and corporate investment activity. The dramatic reduction in the number of COVID cases is enabling the US to reopen the services sector which should boost the economy and markets in the second half of the year. The fall in valuations has made the US less expensive vs other markets than it used to be, and the high quality nature of its stock market has been shown through its relatively resilient earnings, in spite of concern over margin pressure. While rate hikes pose a risk, it is important to remember that in both the corporate and household sectors cash levels remain high and financial obligations have been refinanced so the increase in interest rates may not hamper demand sufficiently to result in the strained cash flows and crimped margins that some have warned about.

The fall in the global equity markets has been broad-based



Source: Bloomberg, HSBC Global Private Banking as at 17 May 2022. Past performance is not a reliable indicator of future performance.

Valuations have corrected, but earnings have so far been resilient. Still, we continue to look for quality stocks and resilience.



Source: Bloomberg, HSBC Global Private Banking as at 17 May 2022. Past performance is not a reliable indicator of future performance

Stagnating Europe

European equity markets have been plagued by a confluence of slowing economic growth prospects and accelerating inflation. Obviously, the Russia-Ukraine war has resulted in increased supply chain constraints and much higher prices, especially in the food and energy businesses. Equities remain under pressure due to the slowing growth and potential margin compression and concerns over the tail risk of an interruption in energy supplies. We maintain an underweight on the Eurozone and a defensive sector view.

Meanwhile, the UK is slightly further removed from the conflict, but is undergoing a big cost of living crisis, which is weighing on consumption and local growth. The effect on the equity market has been dampened by the global nature of its stock market and its exposure to the materials and energy sector. We maintain a neutral view and prefer global large caps over local small caps.

Fixed Income

Bond markets have seen a broad-based sell-off but with many US hikes now priced in, we see some opportunities in short dated corporate bonds. We have added to investment grade exposure in recent months, thereby improving the quality and reducing the extent of our underweight of our overall Fixed Income position. Still, we would need to see further economic pessimism to extend duration or reduce our HY position; instead, we think a selective approach focused on quality is the right policy at the current improved valuations.

Overweight
Government bonds: Australia and New Zealand
Credit and EM: US, European and UK IG and HY; Australian and New Zealand corporate bonds; Indonesian, GCC and Mexican Hard Currency bonds; Chinese and Mexican Local Currency bonds

Underweight
Government bonds: German and Japanese government bonds, European Periphery debt
Credit and EM: Argentinian, Turkish and Ukrainian Hard Currency bonds; Turkish and Indian Local Currency bonds, Russian debt in Hard and Local currency

It has been a very difficult bond market to navigate so far this year as none of its segments or sectors have managed to deliver a positive return. The surge in realised and expected inflation in most economies (China being a major exception) and the late but bold hawkish twist from DM central banks, with the US Federal Reserve leading the movement, have been responsible for a drastic policy repricing in rate markets and to some extent, risk assets. For example, 1Q 2022 has seen the worst quarterly performance for US Treasuries over the last 30 years.

While this sudden change of monetary policy expectations has been detrimental to bond market performance, it has reflated yields, mostly for shorter dated maturities and opened up carry trade opportunities at levels not seen since 2010 (e.g. with a yield of 3.8% for US investment grade bonds with 1-5 year maturities). We think investing in short dated bonds and rolling positions when they mature is more attractive than holding long dated bonds.

Expectations of higher policy rates offer carry opportunities

Source: HSBC Private Banking, JP Morgan, BOFAML indices as of 17 May 2022. Past performance is not a reliable indicator of the future performance

Developed Markets - Focus on Carry Opportunities at the Short-End of the Corporate Credit Curve

While the economic cycle is clearly slowing, we believe that it is too early to trim our overweight exposure to risk assets and increase duration. We will probably reassess this investment strategy, once investors' worries switch from supply side issues (i.e. inflation) to a slowdown in aggregate demand (i.e. economic growth). At that time, worries about growth could justify longer duration positions, and we could then increase our exposure to global Investment Grade (IG) and a reduce our overweight to global HY.

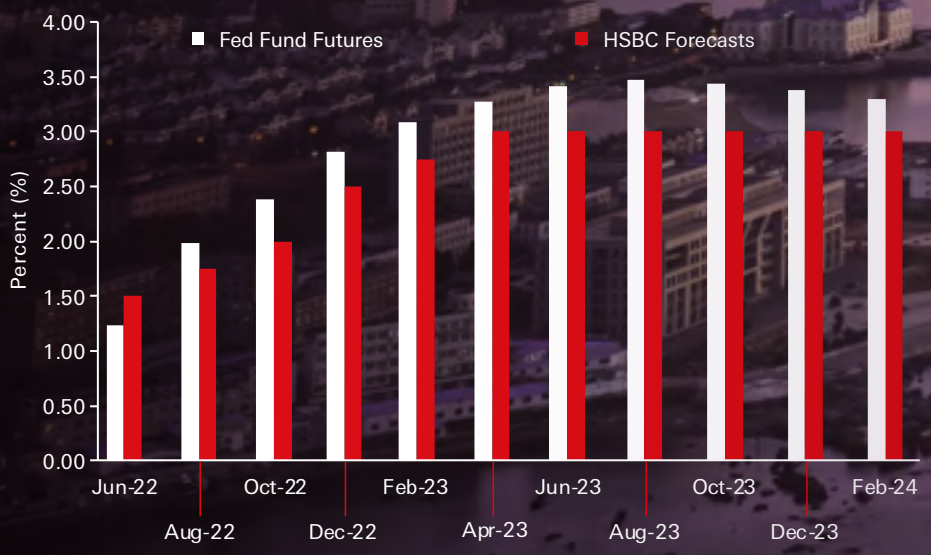
In the meantime, we continue to focus on carry opportunities at the short-end of the corporate credit curves (2-4-year maturities), with our overweight on Global HY and Global IG. The former benefits from positive rating migration on the back of falling leverage. DM default rates for this year should remain benign compared to their peak in 2020. At the sector level, we mostly concentrate on Energy and Financial companies, whose subordinated debt offers attractive valuations, especially for banks, in regards to their strong capital ratios.

As for the other sectors, 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 on Corporate External Debt and focus on quality

EM bonds continue to feel pressured by the challenging macroeconomic background, rising interest rates and geopolitics. EM corporate bonds have delivered a negative return of 13.0% YTD (as of 6 May 2022). However, as most of the risks seem to be priced in, corporate credit spreads have recently started to decline from recent highs and

The bond market is pricing more rate hikes compared to our forecasts



Source: Bloomberg, HSBC Private Banking as at 17 May 2022.

are now 6bp tighter compared to the beginning of the year, at 310bps above US Treasury yields (JPM CEMBI Broad). The main factor providing support is high commodity prices, allowing quality issuers from the Middle East, Latin America and Africa to demonstrate more resilience.

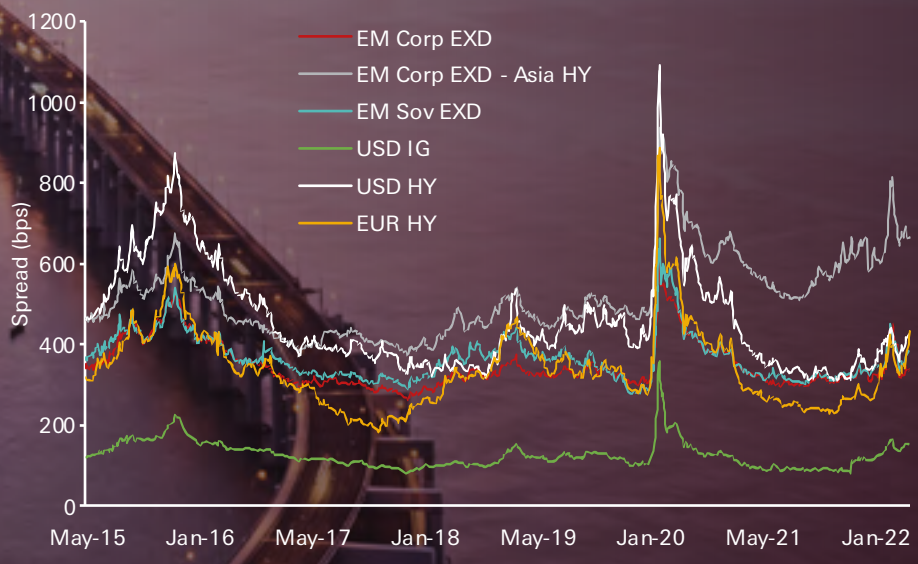
There has also been some recovery in Asian credit markets, driven by the rebound in China's High Yield Property sector. Cheap valuations and a general improvement in sentiment based on expectations of easing measures in the months ahead, have helped prices to recover from the bottom. However, sentiment remains fragile given uncertain macroeconomic prospects and the lockdowns in China. We prefer to stick to quality issuers in Asian credit.

Despite elevated macroeconomic and geopolitical risks, credit fundamentals of many EM companies remain solid. Thanks to a continued focus on cash preservation, cost cutting and de-leveraging coupled with revenue growth last year, EM credit metrics, on average, remain stronger compared to both DM HY and IG companies. At the end of 2021, the average net leverage of EM HY companies was 2.3x and EM IG companies 1.2x (based on companies included in the JPM CEMBI Broad). This is still 1-2x lower than comparable DM companies.

On the technical side, supply trends remain extremely supportive for EM corporates as minimal issuance and strong cash flows are leading to a negative net financing need in the year to date.

We believe resilient EM credits still provide value for diversified portfolios given robust standalone fundamentals and improved valuations. Within EM credit, we focus on GCC and quality Asia credits, as the former should benefit from elevated energy prices, while the latter should be more resilient thanks to more diversified economies and supportive domestic policies.

EM credit spreads have tightened from their peaks in mid-March



Source: HSBC Private Banking, Bloomberg, JPM, iBoxx, ICE BOFAML indices as of 17 May 2022.
Past performance is not a reliable indicator of the future performance

Currencies and Commodities

Amid the global slowdown, heightened geopolitical risk and sticky inflation, FX volatility should stay high, with frequent episodes of negative sentiment. A volatile market should benefit USD, especially against EUR and JPY, though the dollar's upside should slow somewhat as many rate hikes are already priced in. Commodities and commodity currencies should continue see strong structural support but episodes of weakened risk appetite can of course lead to volatility.

Bullish
USD, AUD, NZD, CAD, SGD, IDR, MXN, ZAR and Silver
Neutral
GBP, EM FX (including RMB) and Gold and Oil
Bearish
EUR, JPY, INR

The US dollar tends to benefit from two main factors: firstly, its yield pickup and relatively hawkish Fed make it attractive vs its peers; and secondly, episodes of negative risk appetite causes safe-haven demand for the US dollar. In the past quarter, we have had both, leading the US dollar index to new highs.

Negative risk appetite has dominated the FX market recently, favouring USD and weakening risk-on currencies, such as EM or commodity-related currencies. Increased fears of a more rapid economic slowdown (or even recession) triggered strong USD demand, with all the currencies becoming vulnerable to USD strength, including safe havens like CHF or Gold.

But with a global recession remaining unlikely, we don't think this risk-off driven move will extend. Instead, we believe that the other key driver of the US dollar – i.e. monetary policy divergence - will be the predominant driver, as it was for most of 2021, while mixed risk appetite will lead to temporary volatility.

We believe the recent weakness in some currencies was not necessarily justified by either fundamentals or policy divergence, but a global risk-off mode. This is particularly the case for Sterling and commodity currencies.

Sterling experienced a strong sell-off due to its risk-on nature. While we think it will be difficult for the BoE to deliver all the rate hikes the market is currently pricing in for this year, especially as the Bank has already delivered a warning on the economic outlook. The BoE is nevertheless well advanced on its tightening path vs other G10 countries. Still, due to its risk-on nature and challenging fundamentals, GBP, like RMB, could see more continued volatility than others. We therefore believe that portfolios would benefit from hedging exposure to these currencies.

Commodity prices have risen sharply, and of course, profit taking and growth concerns have caused some commodities to retrace from their recent peaks. But prices are still high, the risk of supply disruption has not been solved, and demand for metals in particular is structurally well supported by the buildout of infrastructure and sustainable energy projects. We therefore maintain a positive view on commodity currencies due to their countries' improved terms of trade and tightening monetary policy. Even though risk-on / risk-off events may affect commodity currencies, we believe that AUD, NZD and CAD will remain a favoured choice in this global outlook.

EUR on the other hand will continue on a downtrend in our view, given the uncertainty over long term economic repercussions of the Russia-Ukraine war. Moreover, EUR doesn't offer investors any attractive yields, and the negative rates clearly don't compensate for the risk. The ECB has sounded slightly more hawkish lately, but the yield differential will probably remain substantial vs USD and other G-10 currencies for a long time. As a result, we think EUR/USD will move to parity by the end of the year.

This could start to benefit CHF. While the Swiss Franc has not reacted to local developments and has mostly been subject to USD dominance, we think it is becoming the beneficiary of regional shifts in positioning, away from EUR into CHF.

Turning to Asia, downside risks should remain predominant for JPY. The Japanese currency has not been benefiting from its historical safe haven allure, even during recent episodes where market sentiment was at its

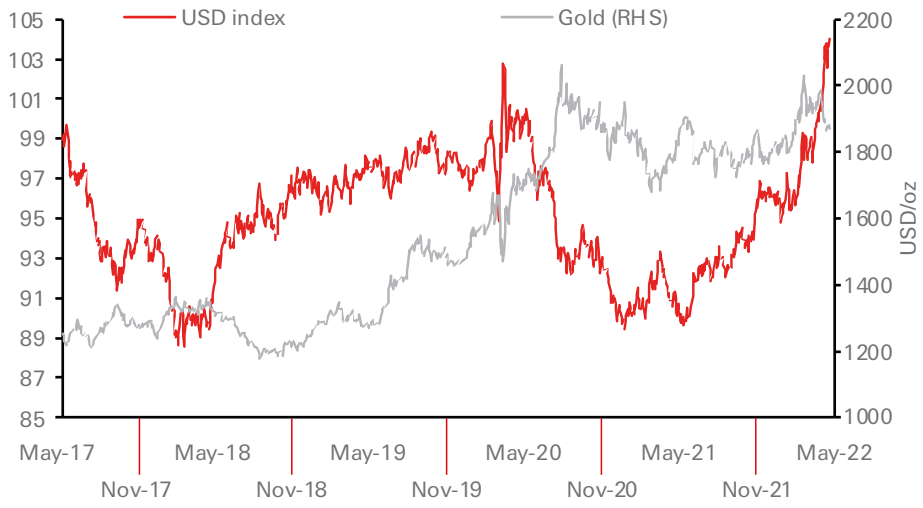
weakest. This is due to a big interest rate differential favouring the US dollar, which is seen as a competing safe haven currency. Moreover, Japan is suffering from a weak balance sheet and high import costs. Still, with JPY trading near the weakest level in 20 years, the risk of an intervention from the policy makers is rising, to dampen volatility and engineer some stability.

In the short term, our view on RMB remains more mixed, as the yield differential supporting the currency is gradually shrinking, due to a relatively accommodative PBOC compared to the hawkish Fed. RMB could still slightly underperform due to the current lockdowns, which are increasing the pressure on the trade balance. But government stimulus measures will probably manage to halt the economic downtrend in coming quarters, and the currency plays an important role in the region. We therefore believe RMB will trade in a range and we hold a neutral view.

More broadly in the EM space, we foresee mixed risk appetite and continued volatility, but maintain our preference for commodity exporters over importers. As a result, we are still comfortable with a bullish view on IDR, MXN and ZAR and a bearish view on INR. We remain neutral on BRL, which benefits from higher prices of agricultural goods, but faces a headwind from China's uncertain economic outlook.

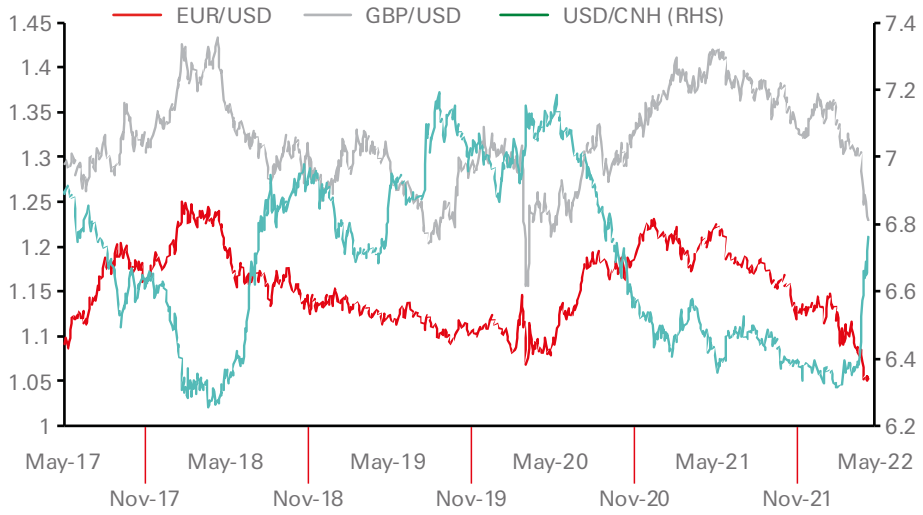
Gold has been affected by USD strength recently, and we don't expect the yellow metal's outlook to improve despite the heightened geopolitical risks. Rising real yields are a stumbling block for gold, and we maintain a neutral view. We prefer Silver as we expect strong demand in the long term, due to broader use in different industries (Energy, IT and other technology). At the same time, silver could probably benefit from its safe-haven allure, like gold. Oil prices and commodity prices overall will still likely stay high as the Russia-Ukraine war continues to cause supply uncertainty, but volatility will stay high, affected by swings in global risk appetite.

The new highs for USD and rising real yields are headwinds for gold



Source: Bloomberg, HSBC Global Private Banking as at 17 May 2022. Past performance is not a reliable indicator of future performance.

All major currencies weakened vs USD, with GBP and RMB recently suffering due to their risk-on nature



Source: Bloomberg, HSBC Global Private Banking as at 17 May 2022. Past performance is not a reliable indicator of future performance.

Hedge Funds

We continue to see a strong opportunity set across a number of hedge fund strategies and they remain important portfolio diversifiers. We are currently overweight multi-strategy and macro strategies and neutral on the other core strategies. This combination has resulted in resilient performance, in what has been a very volatile market environment. Managed futures, multi-strategy/ multi-PM and market neutral have been the strongest performing strategies, whilst equity long/short and event driven strategies have broadly detracted.

Multi Strategy

We currently hold a positive view for Multi-Strategy/Multi-PM managers, and a neutral/positive view on Market Neutral Multi-PM strategies. On specific strategies, we are positive on Commodity strategies, as geopolitical risks persist. We are also neutral/ positive on fundamental equity, as these strategies tend to be more consistent performers in uncertain markets with elevated volatility. We are neutral/ positive on Quantitative strategies, where there is decreased competition in single strategy funds, and the Quantitative strategies' trading-oriented nature allows funds to be versatile in volatile environments.

Macro

Within Macro, we hold a positive rating on Developed Markets (DM) and a neutral view on Emerging Markets (EM). On DM, we are constructive on the opportunity set as divergence in global central bank policy opens the door to relative value trades. The devastating war in Ukraine continues to create volatility and subsequent opportunities in commodities markets. In addition, we expect the elevated levels of volatility in the equity and fixed income space to continue as DM central banks exit QE programs. We expect risk deployment of DM macro managers to increase, with opportunities in directional and relative value trades, as well as tactical trades around geopolitical events.

Emerging markets face a challenging period ahead with spill-over risks from DM, as well as region-specific headwinds such as continued lockdowns in China, and USD strength. There are idiosyncratic opportunities in the space, as a number of EM central banks are well along the way in their hiking cycle, even setting up the potential for rate cuts before DM central banks finish their hiking cycles, according to some managers. Overall, we are neutral on EM Macro, as managers are currently running low levels of VaR and are trading tactically due to the Russian-Ukraine war. Many managers are retaining dry powder to capture future dislocations, such as political dynamics in Turkey and Brazil, oil tailwinds/headwinds for exporting/importing nations, and RMB bonds benefitting from the PBOC cutting interest rates.

Managed Futures

Within Managed Futures strategies, we are neutral on all sub-strategies with the exception of Equity Long Bias Systematic, which has a neutral/ negative rating. The Managed Futures industry posted one of its strongest returns in history earlier in the year. Whilst the rate of Managed Futures' extremely strong performance may not continue through the rest of 2022, we remain positive on trend followers with a commodity bias due to continuing supply-demand imbalances. Short-term CTAs and systematic macro funds should be most capable of capitalising on market moves in 2022, with the latter using non-price data to discover supply-demand imbalances before they are priced into markets. Systematic managers will likely continue to look to add value through using alternative data sources, implementing machine learning in their investment process, as well as entering new markets, such as Credit and Cryptocurrencies.

Equity Long/Short

In the Equity Long/Short space, we currently hold a neutral outlook for the US, Europe, Asia, and Tech. While valuations fell earlier this year, US equities still remain relatively expensive vs. their long-term average, with European equities now at a multi-decade low vs. US equities as they discount the continued impact of the Russia-Ukraine conflict. While valuations may have improved, geopolitical headwinds, greater macroeconomic risks, and reduced risk premiums, mean our base case is for higher equity market volatility with a reduced beta-tailwind.

As the various government COVID policy responses come to an end, so should the second-order impacts they have had on investor behaviour and markets. This should result in higher dispersion as price discovery is determined by market forces, without the bias from stimulus and endless liquidity. So whilst we may see more asymmetry to the downside in equity markets, this is an environment where equity long short managers can perform and a become a natural replacement for longer-biased equity exposure, with increased Alpha and a likely higher contribution from short books.

Event Driven and Credit

For Event-Driven strategies, we currently hold a neutral rating. We see the current environment as supportive of Event-Driven strategies, despite riskier assets being poised to reprice with falling liquidity and rising discount rates. Robust levels of activist campaigns were seen in the US, with further campaigns in Asia, and relatively fewer in Europe. More activist campaigns are becoming ESG-focused, while pressure for M&A and share buyback programmes is waning. SPAC terms continue to tighten as the 2021 'SPAC bubble' bursts, providing an opportunity for managers to add to trusts at a discount to NAV. In M&A, the environment should continue to be supportive.

In Credit, we are neutral on distressed and long/short strategies, and neutral/positive on structured credit. We remain selective in the space due to a lack of distressed opportunities and interest rate risk, despite seeing the default environment as remaining benign for 2022. We are more positive on structured credit, and favour managers with flexible mandates that can trade numerous products.

Strategy Return Drivers	Negative	Neutral / Negative	Neutral	Neutral / Positive	Positive
Macro					
Developed Markets Macro					•
Emerging Markets Macro			•		
Systematic and Managed Futures					
Managed Futures			•		
Market Neutral Systematic			•		
Multi-Strategy Systematic			•		
Equity Long Bias Systematic		•			
Multi-Strategy and Multi-PM					
Multi-Strategy Multi-PM					•
Market Neutral Multi-PM				•	
Equity Long/Short					
Equity L/S US			•		
Equity L/S Europe			•		
Equity L/S Asia			•		
Equity L/S Tech			•		
Event Driven and Credit					
Event Driven			•		
Credit Structured				•	
Credit Distressed			•		
Credit Long/Short			•		

Private Markets

Since the start of 2022, the Private Equity (PE) market has continued to perform in line with expectations. Following a record breaking year for PE in 2021, activity so far this year has been in line with pre-pandemic levels, both in terms of value and volume. However, market volatility, valuation adjustments, geopolitical tensions, and a tighter monetary policy environment have contributed to a slowdown in portfolio exits.

PE dealmaking in the US and European markets was resilient in Q1 2022, with deal value reaching a new quarterly peak in Europe. Record cash levels, softer multiples, and healthy leveraged lending markets helped keep transaction activity strong. According to Pitchbook, PE dealmakers in the US closed 2,166 deals for a combined $330.8 billion. This represents an increase in deal count and value to Q1 2021's figures.

While deal activity continues to be very strong, looking ahead, we anticipate this will continue as PE firms will try to deploy more capital per deal but are anticipating longer hold periods for their portfolio companies.

European and US PE exit activity has had a lethargic start to the year due to the headwinds brought forth by prolonged inflation, geopolitical conflict, the tighter monetary policy environment and elevated market volatility. Moreover, public listings drove a big part of the 2021 exit activity, but there has been a noticeable slowdown of IPOs as PE firms held on to their portfolio companies amid public market corrections.

Looking ahead, the Securities and Exchange Commission's (SEC) newly proposed rules to expand special purpose acquisition companies (SPACs)

Source: Private Equity International, as at 17 May 2022.

regulations may also further impact the exit environment.

The overall fundraising environment has remained strong in the PE space, especially for buyout and growth equity managers. Fundraising has been supported by shortening fundraising cycles as large funds managers are returning to the market more frequently.

According to Private Equity International, PE funds are targeting to raise almost $1.2 trillion across 3,801 funds as of April 2022, compared with just $690 billion across 3,114 funds at the same point last year.

GPs and so called 'mega-funds' are battling for limited resources as numerous managers are currently raising capital. According to Pitchbook, as at March 31, 2022, there are at least nine US PE funds that are either seeking to raise or have already closed on more than $20 billion this year, compared to seven prior to 2022. With an abundance of managers fundraising in the market, and now more than ever, we believe manager selection will be key.

Looking ahead to the remaining quarters of 2022, we believe fundraising and dealmaking will continue to be strong and demand will be matched by a strong pipeline of PE funds. We also anticipate longer holding periods for portfolio companies along with a healthy exit market for private companies. We continue to focus on strategies in which we have the highest conviction, and believe it is important to try to select 'best-in-class' managers, who should be able to reward investors for the illiquidity associated with private equity. Lastly, we continue to be overweight on secondaries and co-investments, and think it is important to have a disciplined approach to co-investments focusing on market-leading companies in sectors outpacing economic growth.

Real Estate

Amid rising rates and slowing growth, real estate has been relatively resilient. This is in part because the market had already differentiated between areas with strong and weak fundamentals in 2021. Some areas are benefiting from reduced supply, while others continue to see strong structural demand, and yet others see their leases linked to inflation. A differentiated approach is needed, with an eye on quality.

The slowdown in the global economy has yet to affect real estate leasing data. This partly reflects timing as the war in Ukraine started when Q1 was nearly complete and more recent data are not yet available. But it is also a reflection of office and retail leasing already running at depressed levels before the war as many businesses continued to delay space decisions until "normality" returned. Still, as economic growth forecasts for 2022 and 2023 are downgraded, one would expect weaker leasing activity across property sectors. A more dramatic correction of property fundamentals would be expected if the economic slowdown turns into a recession.

Declining real household incomes pose a direct risk for retail landlords due to the potential impact on consumer spending. So far, however, retail rents in 2022 have been stable as the decline in consumer confidence has yet to impact retailers. The sector is also in better health than a few years ago, as many distressed retailers have gone out of business, meaning the stronger ones remain. Moreover, rents for many markets have been rebased significantly and are at more sustainable levels for retailers, many of whom are competing with e-commerce retailers.

Recent comments from a major online retailer about overcapacity in the US sent shockwaves through the listed logistics sector, but it may be more of a reflection of that company's enormous expansion rather than a wider logistics market malaise. Whilst e-commerce penetration in many markets has naturally fallen back as governments have relaxed lockdowns, online sales have settled well above their 2019 levels. We see substantial further demand due to e-commerce, re-stocking of inventories, and a shift from just-in-time to just-in-case supply chains (keeping more goods and components in storage). Moreover, rental growth is expected to be focused on the scarce urban logistics sites.

After two years of below-trend leasing activity, many office markets are characterised by vacancy rates at recessionary levels. Despite the easing of lockdowns, office utilisation remains significantly below pre-pandemic levels in many cities, particularly in the UK and US. The long-term impact of remote working for overall office space remains highly uncertain but it is reasonable to expect future leasing requirements to be somewhat lower. The most vulnerable markets are those with older workforces, longer commutes, higher household incomes, and a disproportionate share of IT and financial services workers.

Despite the high vacancy rates and low ongoing office utilisation, prime office rents have been surprisingly stable or rising over recent quarters. This supposed disconnect reflects the flight to quality of occupiers as the best in class space remains in strong demand; vacancy rates for better quality space have been considerably more stable than for the broader market. Moreover, there are signs of future completions slowing due to rising construction costs (materials, labour, debt).

Despite the rapid deterioration in economic sentiment and rapidly rising inflation, there continues to be deep investor demand for real estate. While below the record-breaking final quarter in 2021, investment volumes in Q1 2022 were ahead of pre-pandemic levels in all regions as investors targeted logistics, residential, and prime offices. There is also growing investor demand for specific retail (retail parks) in markets where rents have rebased, occupiers can leverage their online platforms, and the location might support other, potentially higher-value uses, such as residential or urban logistics. In many markets, particularly in Europe, rising inflation is captured by leases with annual inflation indexation. During periods of high inflation, such as now, this protects the landlord's rental income and capital values. Assets with inflation protection have been in particular demand by investors in 2022.

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.

Disclosure concerning sustainable investments

"Sustainable investments" include investment approaches or instruments which consider environmental, social, governance and/or other sustainability factors (collectively, "sustainability") to varying degrees. Certain instruments we include within this category may be in the process of changing to deliver sustainability outcomes.

There is no guarantee that sustainable investments will produce returns similar to those which don't consider these factors. Sustainable investments may diverge from traditional market benchmarks.

In addition, there is no standard definition of, or measurement criteria for sustainable investments, or the impact of sustainable investments ("sustainability impact"). Sustainable investment and sustainability impact measurement criteria are (a) highly subjective and (b) may vary significantly across and within sectors.

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Sustainable investing is an evolving area and new regulations may come into effect which may affect how an investment is categorised or labelled. An investment which is considered to fulfil sustainable criteria today may not meet those criteria at some point in the future.

Greenwashing risk is defined as giving a false impression or misleading information of a product's climate and environmental friendly credentials and, whilst not considered a standalone risk, can manifest through sales outcomes, marketing materials, product design and external disclosures at product and firm level.

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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