Emerging Markets Investor Guide

HSBC
Global Asset Management


2017

HSBC Global Asset Management manages USD82.8 billion in emerging market fixed income.

We never forget that our clients' investments are not just facts and figures but the means to realise their ambitions and support their needs. We are stewards of our clients' imaginations, whether the future imagined is theirs, that of their business or their clients.

HSBC Global Asset Management is among the largest managers of emerging market assets globally with about USD115.5 billion emerging market assets under management worldwide.

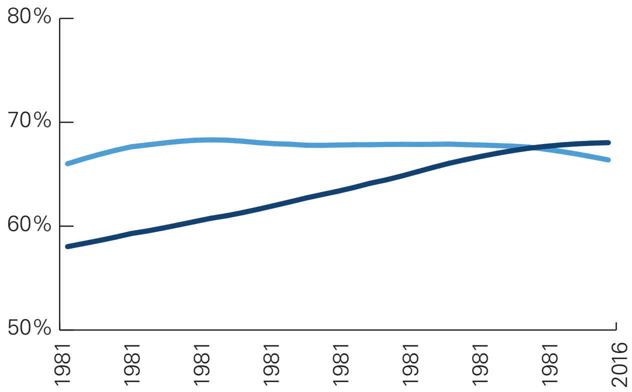
Source: HSBC Global Asset Management, as of September 2016.

Contents

Defining Emerging Markets

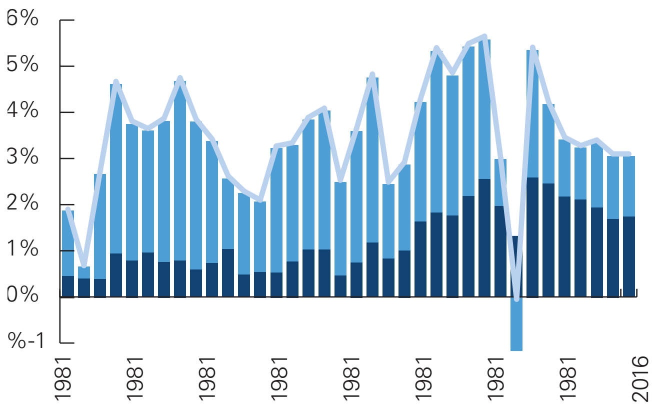
Emerging markets are defined as economies with low to middle per capita income. Such countries constitute approximately two thirds of the global working-age population, and represent 39% of world Gross Domestic Product (GDP)[1]. Although this is loosely defined, countries that fall into this category have begun to open up their markets and "emerge" onto the global scene. Emerging markets are considered to be fast-growing economies which tend to offer an opportunity for higher investment returns, but may also carry more risk relative to developed markets.

Figure 1 - Working age population (Percentage of total population, %)



Source: HSBC Global Asset Management, International Monetary Fund, World Economic Outlook Database, April 2016.

Figure 2 – EM contribution to global GDP growth



Source: HSBC Global Asset Management, DataStream as at 30 September 2016. For illustrative purposes. Any performance information shown refers to the past and should not be seen as an indication of future returns. Any forecast, projection or target when provided is indicative only and is not guaranteed in any way.

[1] International Monetary Fund, World Economic Outlook Database, June 2016.

Why invest?
Emerging Market trends

Emerging markets have become a key part of the global economy. Moreover, emerging market growth rates have consistently outpaced more advanced economies since the beginning of the century and this trend is set to continue.

The move towards emerging markets actually started in the 1970s, as faltering developed world economies and rapidly expanding emerging economies produced a dramatic shift in the centre of gravity of the global economy. 'Popular' emerging markets have driven global growth in recent years with the economies of China, India and Indonesia expanding much more rapidly than many developed world economies.

We believe that emerging markets should be an important consideration within investment portfolios. Debt and equity capital markets should expand over time, in line with this dramatic growth and commensurate need for capital, offering investors unique investment opportunities.

We believe that a long-term investment case for emerging market equities is supported by a number of factors:

- Secular economic development and positive demographic trends, fuelling continued growth
- Inefficiencies in local markets providing investors with attractive opportunities for active returns through fundamental research
- The potential for attractive debt and equity yield, as cash-generative companies have the ability to service their debt, distribute dividends or reinvest for future growth
- A diversification potential for portfolios given the low correlations with developed markets
- The possible appreciation of a number of domestic currencies, offering an additional component of total return

Return potential

In a global environment of low growth and low interest rates, investors are struggling to find meaningful yield. The Federal Reserve is likely to maintain an extremely gradual monetary tightening cycle to ensure the US economy remains on a firm footing. At the same time, other major central banks are expected to keep global liquidity conditions very accommodative. Interest rates look set to remain relatively low for a considerable period.

We believe that emerging markets may provide an answer for investors searching for higher returns. Emerging market growth has stabilised, and many emerging market assets continue to look attractively priced, compounded in a number of countries by attractive currency valuations. All this underpins the return potential of emerging debt and equity markets.

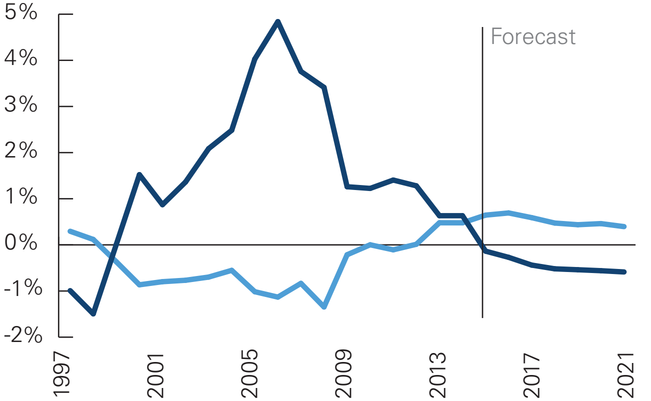
Four key trends support the emerging markets story:

- **Favourable demographics:** In emerging markets, the overall population and the share of the working-age population both continue to grow
- **Increasing urbanisation:** Urbanisation has also increased in a majority of emerging market countries. This is relevant because urbanisation is consistent with a lift in GDP per capita: it creates demand for infrastructure investment while supporting an expanding workforce with a higher consumption potential
- **Growing Industrialisation:** Industrialisation can be illustrated by growth in electricity generation. In fact, electricity generation is often considered a reference for growth, like Gross Domestic Product. Across emerging markets, net electricity generation grew from 5.6 trillion kilowatt-hours (kWh) in 2003 to 10.2 trillion kWh in 2012, an increase of 80%, or 6.9% annualised
- **Developing institutions:** The development of institutions has led the "Ease of Doing Business" ranking of many emerging countries to improve, which can facilitate business development. As an example, patent applications in emerging markets have grown by 21% annually between 2005 and 2014: not only does this reflect positive business dynamics, but patents can help companies move up the value chain in the production of goods and services

Economic growth

This robust development has translated into economic growth. Emerging markets have outpaced developed markets in terms of Gross Domestic Product (GDP) growth, and now contribute about a third of overall global GDP and half of global growth. It is a matter of time before China becomes the world's largest economy. We may also see rapid growth within frontier markets such as Vietnam and Argentina. This tremendous growth has been achieved with an improving current account balance (Figure 3). But countries aren't standing still. Several are planning additional structural reforms, which could continue to reinforce their long-term economic growth (Figure 4).

Figure 3 – Current account balance as a % of GDP



Source: HSBC Global Asset Management, International Monetary Fund, World Economic Outlook Database, October 2016. For illustrative purposes.

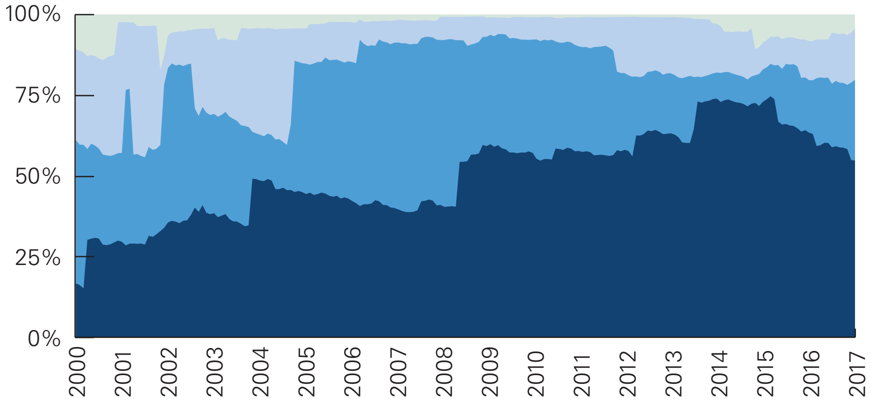
Figure 4 – Examples of potential structural reforms

China	Further privatisation State-owned enterprise reform One-belt, One-road program Hong Kong–Shanghai Stock Connect Interest rate liberalisation Capital account liberalisation, free-floating currency
India	Unlock bottlenecks Goods & Services Tax Bill
Philippines	Infrastructure spending
Korea	Chaebol reform
Brazil	Labour and pension reform Reduce corruption
Mexico	Energy reform Financial reform Labour and education reform Legal and judicial reform

Source: HSBC Global Asset Management as at 30 September 2016.

All these factors have contributed to the way emerging markets are rated. As an example, investors may be surprised to learn that nearly 55% of emerging market corporate bonds are now investment grade (see Figure 5). While developed market ratings have steadily fallen since 2009, particularly in European countries in the course of the credit crisis, emerging markets ratings have seen a significant number of credit ratings upgrades.

Figure 5 – Quality of global emerging market debt



Source: HSBC Global Asset Management, Bloomberg, JP Morgan as at 30 November 2016.

Key:

Investment Grade
B Rated
BB Rated
Residual

The relative change in ratings reflects the improving fundamentals of some emerging market countries that we have explored earlier in this section. Key factors include low debt, controlled inflation, tighter monetary policies and current account surpluses.

Valuable diversification benefits

For the past few years, a general theme among investors in developed economies has been a search for yield. It has not been easy. Despite an interest rate rise in the US at the end of 2016, the change in monetary policy is expected to remain very slow and interest rates are set to stay low for some time to come. Economic growth continues to face challenges in an environment of unusual uncertainty. Investors have had to look elsewhere in search for higher returns and, for many, emerging markets provided an answer.

Having a well-diversified portfolio across different asset classes is a proven method of reducing the portfolio's level of downside risk. It is hard to achieve consistent returns over consecutive years within a single asset class, as shown in figure 6. This explains why diversification is so important:

Figure 6 – Annual asset class returns (2010-2016)

2010	2011	2012	2013	2014	2015	2016
20%	10%	29%	27%	16%	1%	16%
19%	8%	19%	7%	8%	1%	12%
16%	6%	19%	4%	7%	1%	10%
15%	5%	18%	0%	6%	0%	9%
12%	3%	17%	0%	6%	0%	8%
12%	0%	17%	-2%	3%	0%	6%
7%	-2%	11%	-3%	0%	0%	5%
6%	-5%	2%	-4%	0%	-2%	4%
5%	-6%	2%	-6%	-2%	-15%	1%
0%	-18%	0%	-9%	-6%	-15%	0%

- Developed equities
- Global high yield credit
- Property
- Cash
- Global investment grade
- Emerging equities
- US government bonds
- Global government bonds
- Hard currency EMD
- Local currency EMD

Source: HSBC Global Asset Management, performance in USD, as at 31 December 2016. Past performance is not a reliable indicator of future performance.

Correlation

Emerging markets have a relatively low correlation with many developed markets (lower than the correlation between developed markets), meaning that small allocations to emerging markets alongside traditional asset classes can have a surprisingly positive effect on dampening volatility and/or increasing potential risk-adjusted returns.

Correlation is an important concept in portfolio construction because risk (volatility) can be managed by picking securities that do not typically move in the same direction or to the same extent at the same time. For example, as the price of one security decreases and the price of another security increases, they could offset each other's gain (or loss). Correlation of 1 means that two securities move as one – they are perfectly correlated. Any correlation lower than 1 but higher than 0 means that the two securities move in the same direction although not to the same extent. In the case of negative correlation, they move in opposite directions.

When crises occur in emerging markets, caused by either geopolitical, economic or financial issues, investors tend to sell their investments in the so-called 'risk assets' (such as emerging market equities or emerging market bonds) and re-invest in less volatile US Treasuries. This process is known as a 'flight to quality'. Conversely, in a 'risk-on' environment (i.e. where investors have greater appetite for risk) money tends to flow away from the safety of US Treasuries to riskier assets such as emerging market equities and emerging market debt. It should be noted that this negative relationship does not always hold.

Figure 7 – Correlation analysis

	EMBIG	GBI-EM Global Div	CEMBI Broad Div	ELMI+*	JULI	JPM HY	GBI Agg Div*	GBI Global*	EMU IG	Maggie	U.S. Treasury	EM Free	S&P 500	JPMCCI	NEXGEM
EMBIG	**1.00**														
GBI-EM Global Div	0.81	**1.00**													
CEMBI Broad Div	0.92	0.71	**1.00**												
ELMI+*	0.69	0.93	0.64	**1.00**											
JULI	0.72	0.54	0.70	0.39	**1.00**										
JPM HY	0.77	0.65	0.81	0.62	0.52	**1.00**									
GBI Agg Div*	0.65	0.77	0.54	0.74	0.65	0.38	**1.00**								
GBI Global*	0.44	0.51	0.34	0.49	0.60	0.13	0.93	**1.00**							
EMU IG	0.57	0.69	0.49	0.75	0.47	0.36	0.86	0.77	**1.00**						
Maggie	0.63	0.42	0.64	0.28	0.77	0.51	0.42	0.34	0.32	**1.00**					
U.S. Treasury	0.23	0.12	0.14	-0.03	0.54	-0.24	0.50	0.67	0.28	0.29	**1.00**				
EM Free	0.70	0.82	0.68	0.83	0.39	0.74	0.52	0.23	0.52	0.34	-0.19	**1.00**			
S&P 500	0.57	0.62	0.59	0.66	0.26	0.72	0.33	0.07	0.41	0.26	-0.29	0.77	**1.00**		
JPMCCI	0.40	0.53	0.45	0.66	0.13	0.51	0.41	0.21	0.44	0.07	-0.24	0.63	0.48	**1.00**	
NEXGEM	0.84	0.63	0.88	0.60	0.46	0.84	0.39	0.16	0.39	0.49	-0.10	0.69	0.60	0.51	**1.00**

Source: JP Morgan, Emerging Markets Bond Index (EMBI®) Monitor, December 2016.
*Unhedged in USD

Currency appreciation

One of the key attractions for investing in emerging markets is to gain exposure to their local currencies and the potential they present for long-term gains against major currencies. Both fixed income and equity investments can provide exposure to local emerging market currencies. The appreciation of local currency relative to hard currency (USD, EUR or GBP) has the potential to enhance investors' total return.

The following chart shows that emerging market FX long-term expected returns[2] are positive. This is because, over the longer term, the fundamental strength of emerging market economies should continue to improve and emerging market local currencies are therefore likely to continue outperforming developed market currencies. This should support the performance of emerging markets securities, adding positive currency appreciation effects to their returns.

Figure 8 – Emerging market FX long-term expected returns

Currency	Spot FX	Forecasts (as at end Nov 16)	Local-US Rate
CNY	+1.8%	+1.6%	2.0%
KRW	+2.9%	+2.4%	0.3%
TWD	+7.5%	+7.3%	0.6%
SGD	+6.1%	+5.9%	0.0%
INR	+1.4%	+1.1%	3.8%
RUB	+3.5%	+3.5%	5.0%
PLN	+5.7%	+5.6%	0.2%
TRY	+1.4%	+1.3%	5.7%
ZAR	+0.1%	-0.2%	5.3%
BRL	-5.6%	-5.2%	8.4%
MXN	+1.9%	+1.6%	3.9%

Source: HSBC Global Asset Management, as at 30 December 2016.
Any forecast, projection or target provided is indicative only and is not guaranteed in any way.

[2] Our FX expected returns use an adjusted PPP approach based on the Penn effect, taking into account inflation differentials, growth rates and a PPP pricing error correction.

Accessing Emerging Markets

There are three mainstream asset classes offering investors different types of access to emerging economies:

- **Emerging Market Debt (EMD):** Investments can be made in either hard currency (i.e. denominated in US dollars or sometimes euro), or local currency. The universe consists mostly of government bonds, but also corporate bonds
- **Emerging Market Equities:** Investments can be made in shares of emerging market companies, providing exposure to company profit growth, supported by long-term economic development trends and favourable demographics. There is potential for capital appreciation, yield and local currency appreciation
- **Regional exposure:** Investments in emerging market fixed income and/or equities can be made by region. As an example, in some of the following sections we will cover Asian emerging markets

Spotlight on Chinese Markets

We offer investors several ways of gaining exposure to Asian economies, including funds investing in Asian fixed income, Renminbi (RMB) denominated bonds (offshore and onshore) and Chinese Equity (offshore and onshore).

Chinese fixed income

Asian fixed income is a growing asset class which is gaining more interest from global investors. Many Asian economies remain strong, with some of the largest markets in the region, such as China and India, opening up further to foreign investment. It is also a region where, in contrast to most Western economies, the quality of available credit and the level of yields are attractive in our view.

Chinese Bond Markets: Opportunities and Risks

The summer of 2015 gave investors a timely reminder that Chinese financial markets remain a difficult area to negotiate. The dramatic rise, and subsequent crash, of the stock market, followed by the 'head fake devaluation', when the authorities changed the RMB fixing mechanism and sparked fears of a currency war, brought into focus the challenges of bringing markets as big as China's into the global arena. Despite these challenges, investors throughout the world remain understandably keen to explore the potential opportunities opening up in the Chinese capital markets, and to see if there are ways to take advantage of the development of the world's second largest economy. Nowhere is that more the case than for the Chinese bond markets, which can be divided into the following three categories:

Onshore RMB bonds

By far the largest and most important Chinese bond market is the domestic onshore RMB market. At over USD7 trillion,[3] it is one of the largest in the world and has largely been closed to global investors until recently. In line with the liberalisation of the currency and internationalisation of the capital markets, it is now possible for most real money investors with a "medium- or long-term investment horizon" to access the domestic Chinese bond markets. Moreover, the schemes which allow foreign investor access are becoming more straightforward and transparent. Meanwhile, the 'RQFII' scheme, which enables qualified investment funds to buy domestic bonds, is becoming more widespread, providing more capacity to global investors. These developments, in addition to the RMB's inclusion in the Special Drawing Rights (SDR) basket in October 2016, should increase the likelihood of Chinese bonds' inclusion in major global bond indices. Therefore, we expect more and more global investors to access this market in the coming years.

Offshore RMB bonds

The offshore RMB bond market has become a well-known market for European investors, who have invested heavily in the asset class since its launch in 2010. It is probably fair to say that the nature of the opportunity has changed over this period. Initially, investors were keen to be involved on account of the unique qualities of the RMB currency. Recent market developments and movements, though, have reminded us that we will have to accept greater currency volatility in the future. But that does not automatically mean that this asset class should be shunned. As compensation for greater currency volatility, yields in this market have become attractive relative to other markets, especially bearing in mind the average short duration of the bonds available, implying a relatively low sensitivity to interest rates. This provides an interesting, globally diversified, niche credit opportunity for investors looking to diversify, especially in the global context of low government yields and tight credit spreads. The offshore RMB bond market has attracted some of the largest bond issuers from across the world and in this way remains unique for a market denominated in an emerging market currency.

USD Chinese corporate bonds

There is also a US dollar market for Chinese credit which has grown strongly over the past few years. Chinese corporate bonds make up a large portion of around 40% of the overall credit market in Asia, and are usually considered as part of a pan-Asian USD bond strategy. This market provides Chinese companies with an alternate funding channel, while providing investors with an alternate way to access growth opportunities in China, without exposure to the RMB currency. In fact, recently, the market has also seen strong support from onshore Chinese investors looking to diversify their assets away from RMB.

[3] Source: Asian Development Bank as at 30 September 2016.

Chinese equity

Similar to the fixed income markets, the Chinese equity markets can be broadly classified into offshore and onshore markets (see Figure 9).

The Chinese onshore equity market is classified primarily into A-shares and B-shares for which both are listed on the two main exchanges – Shanghai and Shenzhen. The onshore equity market has a market capitalisation of about USD5 trillion (December 2016) where, in comparison, the US stock market is valued at about USD25 trillion. Not insignificant by any means, the China A market capitalisation has surpassed that of the UK and Japan.

A- and B-shares can trade alongside each other on the local stock exchange and domestic investors can invest in both. While denominated in RMB, B-shares are purchased with foreign currency in either USD or HKD through the Shanghai and Shenzhen stock exchanges respectively.

The RQFII initiative, launched by the Chinese Authorities in 2011, allows qualified RQFII licence holders to mobilise RMB funds raised outside of China and invest in the onshore A-Share equities, as well as bonds. HSBC Global Asset Management (UK) became one of the first Western financial institutions awarded a Renminbi Qualified Foreign Institutional Investor (RQFII) licence by China's financial regulator CSRC. The UK was the first European country to be nominated as an offshore RMB centre together with the RQFII status. This can be seen as testament to the progress made on the British-Sino financial cooperation talks between respective governments.

The latest steps towards opening up the domestic equity market is on mutual access agreement between China Securities Regulatory Commission ("CSRC") and Hong Kong's Securities and Futures Commission ("SFC") – the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect programmes were launched in April 2014 and December 2016 respectively. Through the two programmes, investors from Hong Kong and mainland China will be able to trade eligible shares on the other's market through local securities firms or brokers and securities trading service companies. A daily quota is granted to mainland investors trading Hong Kong listed stocks, and Hong Kong investors trading China A-shares.

In addition, through the Mutual Recognition of Funds (MRF) Scheme launched in May 2015, international asset managers are now allowed to sell their Hong Kong-registered fund products directly to Chinese retail investors and likewise, China-registered fund products can be made available to international investors, after going through the relevant registration and approval processes. This acts as another channel for foreign investors to access the A-shares market.

The access now possible to the broader China onshore market further strengthens HSBC's leading position in RMB and allows us to connect our clients to one of the most important and fastest-growing equity and bond markets in the world.

We have long been at the forefront of the Chinese and RMB investment markets and offer a range of innovative equity, fixed income and liquidity products that are designed to address our clients' needs. HSBC Global Asset Management is well-positioned to take advantage of the extensive market reform programme being implemented in China to modernise the domestic economy and financial system.

Investment opportunities presented through access to A-Shares relate to the ongoing process of urbanisation, with the economy becoming less reliant on exports and investment, and more on domestic demand and services. This would help to mobilise low-activity sectors of the economy, such as entertainment and healthcare which, in the case of the latter, will continue to grow rapidly under an aging population.

Beyond Chinese equity, another stream of opportunity comes from the internationalisation of the RMB, promoting greater worldwide usage of the currency.

Investors should not only consider the opportunities but also carefully consider the risks associated with onshore China A-Share market including:

- Corporate governance – widely recognised as well below that of developed markets
- China A market seen as highly influenced by China government policy – this will increase volatility
- The lack of a business model, track record, and ownership background for some companies
- Uncertainty surrounding lack of formal taxation policy on treatment of investment capital gains
- Unproven legal framework

Figure 9 – Chinese equity instruments

<table>
<tr>
<td rowspan="2">A-Shares and B-Shares
▸ A- and B-Shares trade either on the Shanghai (established in 1990) or the Shenzhen (established in 1991) stock exchanges
▸ A- and B-Shares can trade alongside each other on the local exchanges
▸ Currency and ownership
–– A-Shares are only quoted in Chinese RMB and generally only available for purchase by mainland citizens; foreign investment is possible via the QFII/RQFII systems and Shanghai-Hong Kong/Shenzhen-Hong Kong Stock Connect Programmes
–– B-Shares are denominated in RMB but purchased in USD or HKD. Open to both domestic and foreign investment (provided that locals set up a foreign currency account; Shanghai B-Shares: US dollars; Shenzhen B-Shares: Hong Kong dollars)</td>
<td>H shares
▸ H-Shares refer to shares of a company incorporated in mainland China that are listed on the Hong Kong Stock Exchange or other foreign exchanges (eg Singapore)
▸ H-Shares are regulated by Chinese law yet denominated in Hong Kong dollars
▸ In 2007, the Chinese government decided to allow mainland investors to invest in the Hong Kong exchange. Companies may list H-Shares in addition to A-Shares</td>
<td>P-Chips
▸ The term P-Chip refers to Chinese companies listed on the Hong Kong Stock Exchange which are incorporated in the Cayman Islands, Bermuda and the British Virgin Islands with operations in mainland China, and are run by private sector Chinese businessmen</td>
</tr>
<tr>
<td>Red Chips
▸ Red chips (named after the colour of China's flag) refer to companies based in Mainland China that are incorporated internationally and listed on the Hong Kong Stock Exchange
▸ Red chip stocks are expected to maintain the filing and reporting requirements of the Hong Kong exchange which makes them a main outlet for foreign investors who wish to participate in the rapid growth of the Chinese economy
▸ Companies may list red chips in addition to A-Shares</td>
<td>US ADRs
▸ A full inclusion of US ADR stocks into MSCI China index was completed in May 2016
▸ The inclusion increased the weight of the internet sector to >30% of MSCI China, overtaking financials as the largest sector in the index</td>
</tr>
</table>

Source: HSBC Global Asset Management as at January 2017. For illustrative purposes only.

Focus on Emerging Market Debt

Given the historically low yields across developed markets, many investors are looking to emerging market debt assets as an attractive investment opportunity. While there may be a negative impact from a rise in US interest rates given the correlation, the higher level of yields provides a cushion against this rise and as a result, EMD can potentially deliver positive returns over the next 3-years in a rising rate environment unlike other fixed income asset classes. In addition to the attractive valuations, many emerging market countries have experienced an improvement in fundamentals as the sharp depreciation in emerging market currencies over the past few years has translated to stabilizing terms of trade and current account balances for those countries. Emerging markets will continue to face periodic turbulence given the uncertainty over policies under the Trump administration, higher interest rates in the US, and continued geopolitical events across DM and EM countries. However, we believe EMD remains an attractive asset class given the improvement in fundamentals and attractive relative valuations in EM versus DM - both against a backdrop of accommodative global monetary policy.

Investments can be made directly in individual emerging market bonds, or via an allocation to a global bond portfolio. However, this is a large and complex investment universe, comprising a diverse variety of economies, currencies and companies. Therefore, accessing emerging market debt though an actively-managed EMD-focused fund, backed by an experienced and dedicated team may be the best option for most investors.

With rising market volatility, many investors look to active managers to preserve capital and navigate these broad markets investing in hard or local currency debt.

Emerging market debt is divided into two large areas:

- **Hard currency (external) debt:** emerging market debt is denominated predominantly in the US dollar, but also in euro and Japanese yen. These currencies are also referred to as 'hard currencies'
- **Local currency (local) debt:** emerging market local currency debt is sovereign bonds issued in the local currency of their country

In turn, hard currency debt come in three categories that depend on the type of issuer:

- **Government (sovereign) bonds:** issued by emerging market governments
- **Quasi-sovereign bonds:** issued by government agencies, supranational bodies, or other entities which are ultimately guaranteed by controlled by, or are majority-owned by governments in emerging market countries
- **Corporate bonds:** issued by companies located in emerging market countries

Figure 10 – comparison of major emerging market indices

	Hard Currency Sovereign	Hard Currency Corporate	Local Currency FX	Local Currency Bonds	Inflation-Linked
Average Rating	BB+	BBB	A-	BBB	BBB+
Duration (years)	6.66	4.68	0.3	4.91	7.80
Countries	65 countries	51 countries	22 countries	15 countries	9 countries

Source: JP Morgan, Barclays. As of 31 December 2016. Subject to change. Hard Currency Sovereign (JPM EMBIG); Hard Currency Corporate (JPM CEMBI Diversified); Local Currency FX (JPM ELMI+); Local Currency Bonds (JPM GBI-EM Global); Inflation Linked (Barclay's EMTIL).

The combination of higher yields and strong fundamentals in higher-rated countries make a compelling investment case for emerging market bonds. While often being perceived as fundamentally riskier than the US and Europe, emerging economies have relatively low debt levels and high levels of cash reserves.

Three key reasons for investing in emerging market debt:

Yield premium relative to developed market debt	Hard currency debt typically offers a yield premium over the similar rated credit in developed markets. Local currency debt also offers a higher yield to local developed market bonds and is expected to continue trading at this premium.
Portfolio benefits	Local currencies experienced a meaningful correction over the past few years and as a result are trading at historically cheap valuations in many cases, thus compensating investors for the higher volatility associated with currencies.
Diversification	The asset class provides valuable diversification benefits.

What we offer:

Strategy	Strategy inception	Key points
EMD Core (Hard Currency)	October 1998	- Seeks to capture improving credit quality of emerging economies while reducing currency risk - Invests predominantly in emerging market sovereign and quasi-sovereign bonds denominated in hard currency (USD) - Tactical use of emerging market corporate bonds and local currency opportunities offer potential for additional alpha generation - Spread compression and yield have been key drivers of performance
EMD Total Return	November 1999	- Seeks positive absolute returns while reducing volatility normally associated with emerging markets - Flexible access to the full emerging markets debt opportunity set, both hard and local currency - Asset allocation decision has been a key driver of returns - Ability to express short, medium, and long-term views irrespective of a benchmark
EMD Local Debt	August 2007	- The strategy invests in local currency sovereign bonds and emerging market FX - Curve positioning, yield and currency appreciation have been key drivers of performance
EMD Investment Grade	December 2010	- Seeks to capture the growth and relative strength of investment grade rated emerging market debt assets - Invests in debt issued by sovereigns, quasi-sovereigns and corporates in both hard currency and local currency sovereign debt - Split benchmark widens the investment universe and allows for optimal asset allocation between hard and local currency
EMD Corporate	December 2010	- Seeks to capture rapid growth of corporations in developing economies and benefit from improving credit quality - Asset class has demonstrated generally higher yield and lower default rates vs. comparable developed world corporate issuers - Team is able to leverage HSBC's extensive global emerging markets credit platform
EMD Inflation Linked Bond (ILB)	Capability launched in June 2008; brought under the GEM Debt platform 31 July 2012	- The only asset class offering a pure inflation hedge; principal and coupon payments are indexed to inflation - Provides local investors a measure of protection against rising prices and developed market investors potential diversification benefits and attractive expected returns - Efficient diversification tool: low correlation with traditional emerging market debt can help the overall risk-adjusted return of an emerging market debt allocation

Source: HSBC Global Asset Management, as at 31 December 2016.

Focus on Asian Fixed Income

The countries which make up the Asian fixed income universe contain half the world's population and generate up to a third of global economic output, and are expected to grow further. However, Asian bonds make up only a tiny fraction of global investment portfolios, despite having attractive characteristics and obvious diversification benefits. We have three quite simple explanations for this:

1. The Asian markets are quite small, which points to a lower level of indebtedness, particularly for Asian government bonds, a factor which should add to the allure of the asset class. Nevertheless, it does mean that some markets are still relatively illiquid and underdeveloped. It also means that Asian bonds are still significantly underrepresented (when considering their countries' GDP weight) in the most commonly used bond indices, including emerging markets debt indices. This automatically means a low or zero allocation for most global portfolios.

2. Many of the markets are difficult or complicated to access. Few domestic Asian emerging market bonds can be settled on Euroclear (unlike most of the word's bonds) and many are subject to withholding and other taxes. In particular, the large domestic Chinese bond market and the relatively big domestic Indian bond market have been virtually impossible for foreign investors to reach – until recently.

3. The vast majority of global fixed income portfolios are managed in Europe or North America. For these investors, Asia is a complex and difficult region to understand, with seemingly impenetrable culture and language. While developed bond markets have been rallying for most of the 21st century, there seemed little point in adding layers of complexity to seek out new opportunities.

However, Asia does not stay still. The region's bond markets are growing rapidly. This is improving liquidity and pricing transparency for fixed income securities. Meanwhile access to markets is opening dramatically, especially in regard to the very large and interesting markets of China and India.

Lastly, as investors become more globally aware and markets more interconnected, there is undoubtedly more attention focussed on Asian bond markets. As the developed world's bond markets face uncertain times of monetary policy changes, coupled with low yields and low returns – there is more than ever a strong compulsion to seek out new and yield enhancing fixed income opportunities.

The benefits of investing in Asian bonds

Quality

Put simply, Asian (ex Japan) institutions are less indebted than those in other parts of the world. Before the Eurozone debt crisis, it was widely assumed that high levels of government debt in advanced economies were sustainable. This has proven not to be the case and markets have begun to discriminate between countries with manageable debt burdens and those with excessive borrowing, especially smaller countries with less fiscal autonomy. This is a complex question and some of the most egregious cases, such as that of Japan, where government debt is many times the size of the economy, still maintain low bond yields. But a lower debt burden undoubtedly makes a country more creditworthy and consequently more attractive to investors.

Asian companies also tend to have a more manageable debt burden than those in other parts of the world. Participating in generally higher growth economies should enable Asian institutions to service their debts more easily, all other things being equal.

Further comfort for investors can be found in other macro level indicators. Although it is rarely possible to generalise about Asia, it is broadly true to say that Asian economies enjoy good current account positions, floating currencies, sound levels of foreign exchange reserves and low external debt (in fact at least one exception can be made for all of these, but the average position is strong). This is a legacy of the late nineties Asian Crisis when Asia found itself exposed for the very lack of these characteristics. Subsequent policy has somewhat successfully striven to address these issues and Asian economies (which are anyway also much larger and self-reliant than in 1997) are, we believe, much more resilient. These positive indicators should also favour Asian currencies over the medium to long term.

Price

Yields in Asia tend to be higher than in US, Japanese and European markets. In the local currency markets, this may reflect higher levels of interest rates and inflation. But it is also probably because the bonds are less well researched and do not appear in many global portfolios. Whatever the reason, this is a potential source of extra income for investors who diversify into Asian bonds. Of course in the fixed income world, undervaluation is an advantage in almost all scenarios for the investor, who will either enjoy higher levels of carry for as long as yields stay higher, or capital gain if yields converge.

The USD credit markets also tend to provide a premium, and again there are good fundamental reasons why this is the case in terms of emerging market risk, liquidity and lack of history in terms of recovery in the event of default. But it is again likely that a key reason for wider spreads is the lack of coverage from global investors. This leads to inefficient pricing and can be lucrative for the skilled investor.

Underrepresentation and diversification

If an investor is managing against or tracking one of the commonly used global bond indices, there is a good chance that they will have either a zero or tiny allocation to Asia ex Japan. Although the Citi WGBI contains Singapore and Malaysia (together less than 1%), JPMorgan government indices do not have any weighting at all to Asia except Japan. At the same time, a Barclays Aggregate portfolio will also have a tiny weighting to Asia ex Japan.

But it isn't only developed market indices where Asia is significantly underrepresented. Most emerging market indices are also grossly underweight Asia compared to its economic footprint. Some local currency indices weight Asia at less than 20%, even though Asia's share of emerging market GDP is more like 60%. There is nothing sinister going on here - it is a consequence of both the paradox of capitalisation weighted bond indices, where investors end up lending most money to the most indebted institutions, and the fact that the China and India domestic markets are difficult for most foreign investors to access. Consequently, these very large emerging economies have no place at all in most global portfolios. Now that opportunities to access these markets are opening up, we believe that any investor who has the option to explore this source of extra income and diversification should at least be curious.

Capturing the theme

As well as the quantitative reasons to invest in Asian fixed income, which are generally well known to experienced investors, we believe that there is also a more qualitative, subtle and judgemental reason to allocate to this asset class.

The Asian fixed income universe is made up of the countries which are set to contribute to the shift of focus in the world economy from West to East. This argument characterises the Asian fixed income opportunity as a long term secular investment theme rather than a tactical asset allocation and is therefore more a matter for subjective judgement than empirical proof.

In this respect, there is some controversy – not everyone believes in the "Asian Century". There are many investors in the world who believe that the Chinese economy will run into severe difficulties at some point or that as Asian emerging markets mature, they will produce no better results than those in the now developed world, possibly underperforming given some examples of chronic structural obstacles or difficult politics.

But if, like us, you believe that Asia is set to continue to become an increasingly important part of the global economy and that development of the physical, governmental and financial infrastructure will be quicker in Asia than anywhere else in the world, then it stands to reason that the financial markets will provide new and valuable opportunities for investors in the coming years. When this is allied to the positive fundamentals and likely future demand outlined above, we believe that the case for investing in Asian fixed income is very strong indeed.

What we offer

Strategy	Strategy inception	Key points
Asian Local Currency Bond	2011	▸ Invests in Asian bonds denominated in local currencies, primarily government bonds (South Korea, Hong Kong, Philippines, Indonesia, Singapore, Malaysia, Vietnam, Thailand, China and India (tactical positions) ▸ Has 8 country exposures: South Korea, Hong Kong, Philippines, Indonesia, Singapore; Malaysia, Vietnam, Thailand and tactical positions in China and India
RMB Fixed Income	2011	▸ Invests in Offshore RMB bonds Chinese and international issuers invests primarily in traditional fixed income securities (certificates of deposit, public and private sector bonds) ▸ Has regional exposure to Chinese and international names, issuing in RMB offshore bonds
India Fixed Income	2012	▸ Invests in Indian government, agencies, financials and corporates ▸ Has regional exposure to India only
Asian Bond	2016	▸ Invests in Asian bonds denominated in USD, primarily in investment grade bonds ▸ Has exposure to Asian countries including China, Hong Kong, India, Korea, Indonesia, Philippines, Thailand, Singapore and Malaysia

Source: HSBC Global Asset Management, as at 31 December 2016.

Asian fixed income strategies

	Asian Credit	Asian High Yield	Asian Currencies
Launch date	1996	2011	2011
Description	USD denominated government, corporate, investment grade, non-investment grade and non-rated bonds.	Non-investment grade and non-rated government and corporate bonds.	Local currency bonds issued in Asian markets.
Comparative index	HSBC Asian Dollar Bond Index	JACI Non-Investment Grade Index	iBoxx ABF Pan Asia ex China ex Hong Kong (USD)
Assets under management (USDm)	15,767	977	85

	Offshore RMB Bonds	Onshore RMB Bonds	India Fixed Income	HKD Bonds	SGD Bonds	IDR Bonds
Launch date	2011	2014	2012	2004	2005	2010
Assets under management (USDm)	685	913	18,022	28,342	858	522

Source: HSBC Global Asset Management, as of 30 September 2016.

Focus on Emerging Market Equities

Global emerging market equities is a fundamental building block within an equity asset allocation, providing return potential and low correlation relative to developed markets. Emerging market equities are typically represented by the MSCI Emerging Markets Index (MSCI EM) which has over 800 constituents across 23 countries. China, South Korea, Taiwan and India comprise over 60% of the index.[4] Each country offers a different mix of investment opportunities, with some markets more domestically-focused while others add a global dimension through multi-national companies. This breadth and depth of markets provides ample opportunity for active stock selection with the aim of outperforming the core reference index. Given the complexity of investment choices, proprietary fundamental research is critical in stock selection. This insight can be translated into high conviction global, regional and country portfolios that can benefit strategic and tactical investors.

Three key reasons for investing in emerging market equities:

Long-term economic development	Favourable demographics and infrastructure expenditure, coupled with improved country financial positioning
Potential for active returns	Breadth and depth of investment choice offer potential for active returns
Diversification benefits	Low correlation to developed markets

What we offer:

Strategy	Strategy inception	Key points
GEM Equity Volatility Focused	August 2015	• Offers emerging market exposure with a focus on volatility • Follows HSBC's differentiated approach: concentrates on attractive investments based on Profitability-Valuation then uses minimum variance optimisation and fundamental research to deliver a portfolio with lower volatility than the index
Global Emerging Markets	November 1994	• Global emerging market exposure aiming to outperform the MSCI Emerging Markets index • Focuses on stocks with an attractive combination of profitability and valuation • Accesses the insight and perspective of HSBC's global investment team
Chinese Equity	June 1992	• Offers exposure to growth opportunities in China primarily through the country's offshore equity market (H-shares) • Benefits from HSBC's long history and significant presence in China • Dedicated team of 8 investment professionals in Hong Kong and 19 in Shanghai (HSBC Jintrust JV)
Asia ex Japan	April 1993	• Asia ex Japan market exposure aiming to outperform the MSCI Asia ex Japan index • Focuses on stocks with an attractive combination of profitability and valuation • Dedicated team of 11 investment professionals in Hong Kong
Asia ex Japan Smaller Companies	July 2005	• Invests in high growth, smaller and mid cap companies (<US$2bn) in Asia ex Japan • Greater exposure to niche businesses and structural growth trends in Asia ex Japan • Dedicated team of 3 small cap specialists

Source: HSBC Global Asset Management, as at 31 December 2016.

[4] MSCI Emerging Markets Index factsheet as at 30 December 2016.

Focus on ESG in Emerging Markets

Broad support and reinforcement

The attention to Environmental, Social and Governance (ESG) has been reinforced from several directions. The PRI (Principles for Responsible Investment) have been pivotal in increasing awareness and commitment from both asset owners and asset managers. More asset owners are requiring asset managers to communicate how they integrate such analysis in their investment decision-making and their approach to stewardship. Stock exchanges are also involved. Over 60 global stock exchanges have voluntarily committed to promoting improved ESG disclosure and performance among companies listed on their exchanges. Some exchanges in countries including India, Kenya, South Korea, Malaysia, South Africa and Thailand have made this a requirement and others such as Mexico, Chile, Turkey and Qatar have committed to issuing guidance. The Bovespa in Brazil manages its own sustainability index, while the Johannesburg Stock Exchange is working to increase South African corporates' ESG disclosure. Regulators too are seeking to improve standards and disclosure by issuers with Brazil, Russia, India and South Africa revising or defining new recommendations for corporate governance codes since 2012 and South Africa and Taiwan introducing Stewardship Codes for asset managers.

ESG in emerging markets

There is a growing realisation that concerns over bribery & corruption, labour standards, child labour and environmental issues such as pollution, water scarcity, deforestation and climate change can impact returns. The prevalence of energy, industrials and materials in developing market economies further focuses investor attention on ESG issues. With high levels of State-Owned Enterprises and family-owners as majority shareholders governance issues such as capital discipline, related party transactions and shareholder rights remain an investor focus.

Such analysis is important at the company level, as there is a range of performance across companies (Figure 11), and because a company's ESG profile can change. We have seen that, within three and five years, about half of the universe improved while the other half saw their ESG score declining (Figure 12).

This deterioration may be the result of increased availability of emerging market ESG information. Currently, investors can access information for over 1,600 emerging market companies, whereas about 280 companies have a three-year history and only about 80 companies have a five-year history.

The environment and emerging markets

Within the Environment pillar of ESG, it is clear that environmental issues, climate change and carbon pricing can impact long-term profits, and recent environmental initiatives have amplified these ESG trends.

For example, by signing the Dubai declaration in late October 2016, the core of the United Arab Emirates' financial institutions have committed to integrating ESG and Green Investing in their practices. Another illustration is the deal agreed in Kigali, Rwanda, in October 2016, whereby 197 countries signed a legally-binding document committing to reducing the use of hydro-fluorocarbons, a powerful greenhouse gas used in refrigerators and air-conditioners.

Although the latter is undoubtedly important, it cannot eclipse the Paris Agreement at the United Nations Conference on Climate Change, COP21, which brought increased attention to the broad impact of climate change on the global economy.

The Paris Agreement on Climate Change to limit global temperature increase to 2 degrees, whilst targeting 1.5 degrees came into force on 4 November 2016. Some 112 Parties have signed up to the agreement representing 78.8% of global emissions. Three of the largest emerging markets are also among the world's five largest carbon emitters: together Brazil, India and China represent 26% of the world's CO2 emissions, all of whom ratified the Paris Agreement and are considering market mechanisms to achieve their goals. Whilst current country level commitments are insufficient to limit climate change to 2 degrees, there is a ratcheting mechanism built into the Agreement intended to make each countries' 5 year commitment more ambitious than the last. COP22 in Morocco concluded with a renewed sense of urgency in collective action to address climate change with the results of the US election appearing to strengthen momentum.

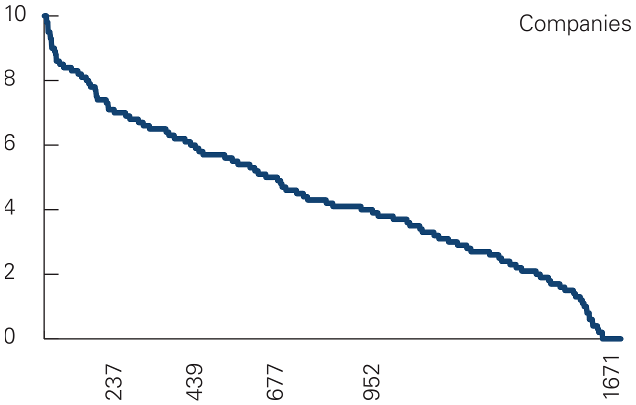
Whilst a global carbon price wasn't agreed in Paris, it was referenced in the Agreement, which recognises the "important role of providing incentives for emission reduction activities, including tools such as domestic policies and carbon pricing." Indeed, more than 90 of the National Determined Contributions to the Paris Agreement included proposals for emissions trading schemes (ETS), carbon taxes and other carbon-pricing initiatives. In fact, in 2015 the World Bank Group and the OECD issued a report on carbon pricing schemes using input from the IMF. Globally, there are already 40 national carbon-pricing schemes – such as ETS or carbon taxes – and another 23 at the level of cities, states and regions (Figure 13). At the time these represented about 7 billion tonnes of CO2, or 12% of global greenhouse-gas emissions.

Carbon pricing took a major step forward in September 2015 when China announced its plans for a national ETS. Chinese President Xi Jinping stated that the national ETS would begin in 2017, and initial indicators suggest that the scheme will cover the iron and steel, non-ferrous metals, power generation, cement and glass, chemicals, petrochemicals, pulp and paper, and aviation sectors.

Going forward, we believe the Paris Agreement will prove to be a game changer, as it will very likely trigger a wave of changes in terms of power generation, smart-grid-related innovation, transport and many other industries as part of an industrial transition to a low carbon economy that creates opportunities and risks as well as winners and losers.

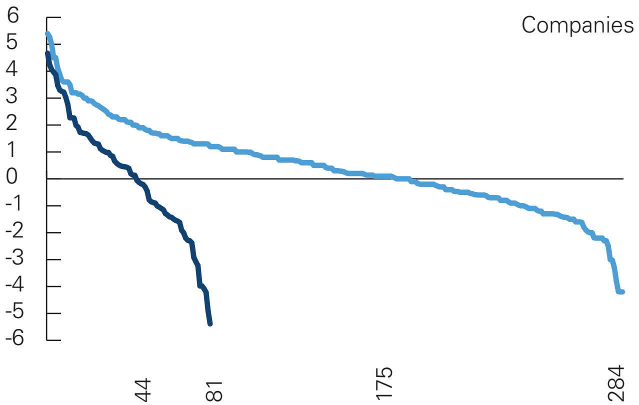
These parameters will increasingly become drivers of investment decisions. Companies that consider this transition within their corporate strategy should be better placed to maintain or enhance their competitive position, with the potential to deliver sustained or improving profitability in the future.

Figure 11 - Distribution of ESG scores (Industry-adjusted score: 2015)



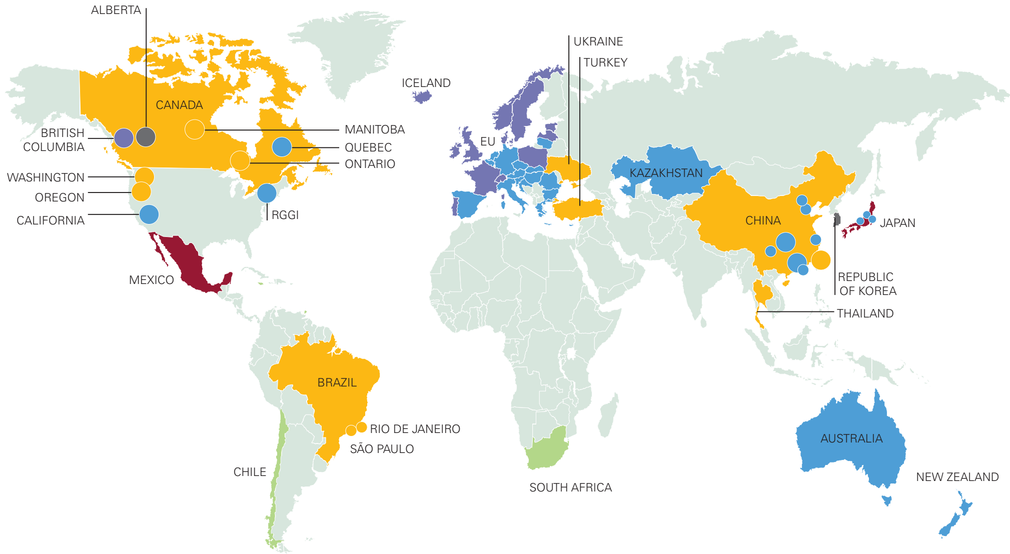
Based on companies within the MSCI ESG database. Source: HSBC Global Asset Management, MSCI as at 30 September 2016. For illustrative purposes.

Figure 12 - Distribution of ESG score change (Industry-adjusted score: 2010-2015, 2012-2015)



Based on companies with historic information within the MSCI ESG database. Source: HSBC Global Asset Management, MSCI as at 30 September 2016. For illustrative purposes.

Figure 13 - Existing, emerging and potential regional, national and subnational carbon pricing initiatives (ETS and tax).



Key

- ETS implemented or scheduled for implementation
- ETS and carbon tax implemented or scheduled
- Carbon tax implemented or scheduled for implementation
- ETS implemented or scheduled, tax under consideration
- ETS or carbon tax under consideration
- Carbon tax implemented or scheduled, ETS under consideration

Source: World Bank Group 2015.

Risks to consider

Whilst emerging and associated Asian markets have strong performance potential, as with any investment they do have risks. In addition, to the general market risk where investment values can fall as well as rise and investors may receive less than originally invested, investments in emerging markets may exhibit a more volatile performance and may be affected by reduced liquidity which make them risky. A few are highlighted below:

Risk	Overview	How to mitigate the risk
Currency	International investing brings with it exchange rate risk, as securities can be denominated in local currencies. When investing in a currency other than your home currency, returns of the investment may be affected by changes in the exchange rate of your home currency and that of the emerging market currency.	Hedging with derivatives. Investors who prefer to limit local currency risk can opt to invest into hard currency which is denominated in US dollars.
Inflation	A mix of strong economic growth and insufficient monetary restraint can result in high inflation, a problem that has periodically affected emerging markets. Although now under control in many emerging markets, investors should be aware of the risk that high inflation can impact a portfolio as it erodes value. Increases in inflation can cause a spike in volatility, devaluation of income on interest-bearing securities like bonds and squeezing of profit margins in certain stocks.	Hedging with derivatives.
Governance	Some emerging markets have made considerable improvements in governance standards. However, in other emerging markets, accounting standards, transparency and disclosure of information are less well established than in developed markets.	Invest with a manager who undertakes their own review of companies to assess governance standards.
Liquidity	Emerging markets typically have lower trading volumes relative to developed markets. This can result in difficulty buying or selling assets. Illiquid markets can result in wide price fluctuations in a short period of time.	If investors have a long-term view then liquidity risk is less of an issue as you do not need to sell it at short notice.
Political	Investors in international markets can face political changes that could adversely affect investment returns. Political instability can negatively affect businesses and markets due to changes affecting tax, laws and regulations, exports and licensing.	Invest with a manager who clearly understands the difficulties facing each country and uses this knowledge to avoid political issues within investments.

Conclusion

In a global environment of low interest rates and unusual uncertainties, we believe emerging and associated Asian markets present opportunities in both equities and fixed income. Taking a selective approach and following a robust valuation discipline, investors can benefit from these markets' characteristics:

Diversification benefits: Many investors are looking at ways to improve risk-adjusted returns or decrease risk. Emerging markets can offer diversification benefits given their comparatively low correlation with developed markets.

Search for yield: Many emerging markets benefit from high growth as well as robust sovereign and corporate balance sheets with strong cash pay outs, and typically offer higher yields relative to developed market assets.

Global growth: Emerging markets have become a dominant force within the global economy, having seen incredible growth over the last 15 years. Even as this growth slows, it remains strong relative to developed markets. It is driven by favourable demographics, increasing urbanisation, growing industrialisation and developing institutions. All these factors should continue into the foreseeable future.

Currency appreciation potential: As emerging market economies grow, so does the potential for their currencies to appreciate and many emerging markets' long-term FX expected returns look attractive today. Appreciation could be an additional source of return for those investors comfortable taking the currency risk.

However, emerging markets do not come without risks. In particular, Donald Trump's recent election to the US presidency has increased uncertainty around emerging markets' economic outlook – on the one hand pro-cyclical policies could support emerging economies, and on the other rising interest rates and increasing trade protectionism could have a negative impact on some markets. It will be important to keep a close watch on developments, and to remain selective and tactical in emerging market allocations.

As an experienced manager, HSBC Global Asset Management can help you manage and mitigate these risks by using their in-depth knowledge of local markets, robust valuation tools and investment discipline to ensure carefully managed exposures and control risks within your investment portfolios.

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