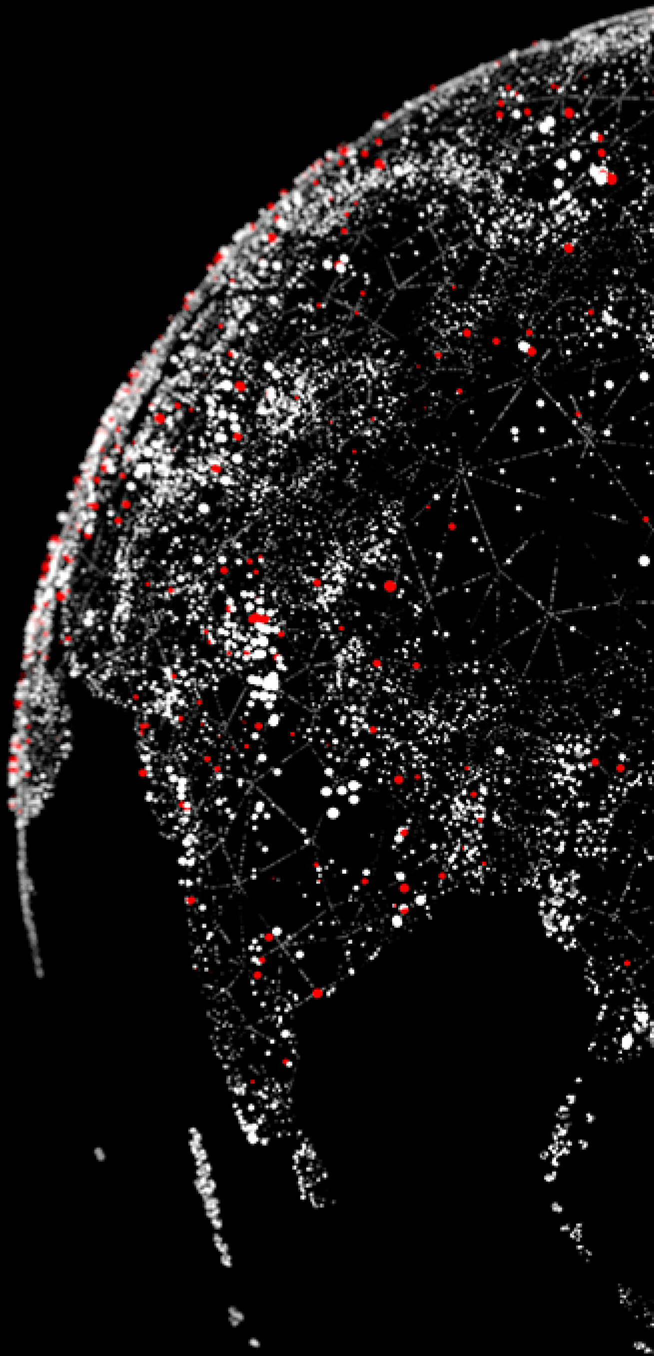
House Views

Q2 2021

For professional clients only

Priced recovery



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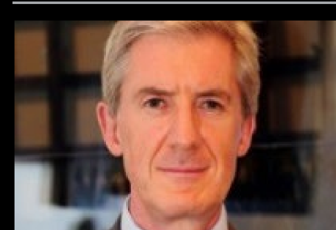
Foreword

In the latest House Views our Chief Strategist, Joe Little, and his colleagues shine a light on the three questions institutional partners are asking: how is the recovery going, and how is that reflected in market prices? will there be a material rise in inflation? What are the investment opportunities?

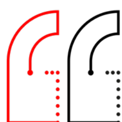
Our answers are:

- the global economy is in a restoration phase, which looks durable but is still uneven, and much of the good news is priced in;
- stronger inflationary pressure is more possible than at any time since the GFC, but is still improbable;
- a cyclical tilt to value in equities makes sense, while the main themes of low-for-long are still in place: a structural tilt to Asia and Emerging Markets reflecting the secular shift in global growth prospects; and a continuing case for the illiquidity and complexity premia, as well as the diversification properties, of Alternatives.



Michael Cross

Vice Chair, Global Institutional Business



Our essentially benign outlook is based on both fiscal and monetary policy continuing to support the recovery. However, unusual uncertainty about the pandemic and the key economic variables are complicating the setting of policy.

No one can be confident about the success of vaccine programmes, or future variants of the virus. Equally, no one can be confident about the size of output gaps, fiscal multipliers, or the propensity to spend pandemic-induced savings – to mention just three major economic uncertainties That's why the Fed is clear that it will be guided by actual inflation, rather than merely forecast inflation, in setting policy.

Our view is likely to be tested by market volatility as the news-flow and data evolve. Most of my client conversations boil down to whether the Fed can succeed in soft-landing the US economy. The landing strip is narrow. Renee Chen's analysis of the monetary policy outlook in Asia is instructive in its own right, and because it illustrates challenges the Fed will also face in easing off stimulus as the US economy recovers. Dominic Bryant emphasises the anchoring role of stable inflation expectations and the importance of looking through the inevitable near-term spike in US inflation out-turns.

Some excitable commentary points to the role of de-anchoring inflation expectations fuelling high inflation in the 1970s, and sees a modern parallel. We think that's mistaken. It took a decade of wars, sub-optimal macro policy, the breakdown of the Bretton Woods System, conflict in labour markets and a major oil price shock to raise inflation and inflation expectations fifty years ago. It's unlikely that a temporary period of predictable inflation base effects and short-run supply bottlenecks will have a similar effect now.

However, investors will need to buckle up as the flight will be bumpy at times. Even if we are correct in our views, we must be prepared for markets to test the Fed's resolve. We will all need strong nerves. And, as Joe emphasises, to be guided by a robust valuation framework, to assess expected returns rigorously, and to identify relative value opportunities outside usual comfort zones.

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Executive summary

Investment strategy when economic restoration is priced

- Higher bond yields in the reflating "restoration economy" seem inevitable, but it is critical for the integrity of the macro system that these moves are not disorderly. At 2%-plus US bond yields, we think the global equity premium (versus long bonds) moves below 2.5%. That is not quite a bubble valuation for stocks, but it is getting close.
- Within fixed income markets, we continue to see value in China bonds, Asia HY, and parts of EM local debt.

Joe Little
Global Chief Strategist

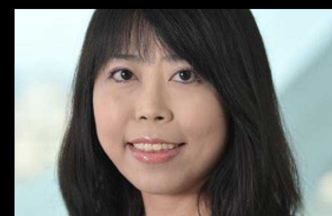
US inflation

- Coming months may see the highest core PCE inflation rate since before the global financial crises. This could grab the attention of investors and commentators and add to markets volatility
- Nevertheless, anchored inflation expectations and significant labour market slack suggest that above-target inflation in the near term should prove to be transitory and inflation is likely to be around target over the medium-to-longer term

Dominic Bryant
Economist and Macro Strategist

Asia monetary policy outlook

- We see limited incremental monetary stimulus and expect policy rates to be on hold this year across the region.
- However, as growth rebounds, financial stability concerns could drive earlier policy normalization in some Asian economies, most notably in China. Macro policies of debt clean-up and controlling leverage – which were interrupted by the COVID-19 shock – may, once again, be given a higher priority



Renee Chen
Senior Economist

Illiquid investments: is now the time to allocate?

- In a world where most asset classes are either neutrally-valued or looking rich, and where bonds don't act as a reliable equity hedge, we think embedding alternatives into institutional asset allocations needs to become more mainstream
- However, we believe it is critical to have an adequate valuation framework to assess the current attractiveness of illiquid and liquid asset classes on a like-for-like basis

Pierre Dongo-Soria
Strategist

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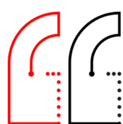
1 – Investment strategy when economic restoration is priced



Risky asset valuations can't absorb meaningfully higher bond yields

Joe Little
Global Chief Strategist

An easy outlook on paper, but not in practice

Our thesis of the "restoration economy" has fared well in Q1. The economic system is in a healing process and global growth is recovering. Economists and analysts have been busy upgrading growth forecasts following the good news on vaccine rollout, the new US fiscal package, and central bankers' commitment to keep rates low.

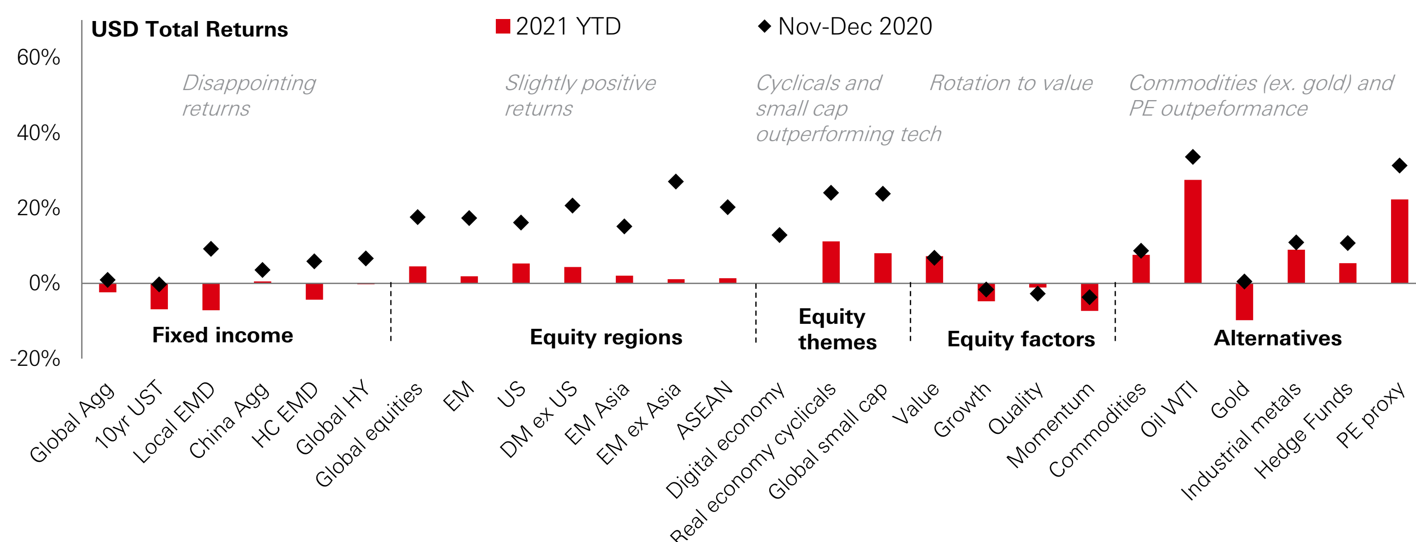
Looking ahead, we think economic restoration continues. In Q2 we are set to see a number of key economies outside of Asia begin to re-open, and a combination of pent-up demand and fiscal stimulus will support a catch-up phase of growth. That, in turn, bolsters an already strong outlook for corporate profits.

Continued recovery should make it easy to favour cyclical asset classes. But what looks easy on paper, is harder in practice. Market price action will be driven not by the incoming good news on the macro-economy, but by how good that news is versus what is already priced. With optimism already discounted, we see an opportunity for strategic tilting of portfolios toward parts of emerging markets and alternatives, and for a modest (and nimble) cyclical tilting toward the restoration economy themes.

A change of regime in markets during Q1

Figure 1 shows asset class performance in Q1. The structure of asset returns already looks somewhat different in 2021 versus last year. In Q1 we had a phase of fast-rising bond yields and negative returns to fixed income, while equities weathered the bond tantrum better than many analysts expected. Overall, market returns had a much flatter profile in Q1 versus what we saw last year. While the macro story of the "restoration economy" remains intact, the market environment appears to have changed.

Figure 1: Market performance suggests a change of regime



Source: Bloomberg, HSBC Asset Management, March 2021.

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The next natural question is: why might this be the case? We think a key factor is the shift in investor psychology and how the market's discounted scenario has reflated over the last six months.

Figure 2 shows our implied growth signal which tracks market prices to assess cyclical optimism[1]. Higher readings on the chart imply that greater confidence in future growth is now reflected in market prices. Market-implied growth has returned to the pre-COVID-19 levels of early 2020[2] and the recent trend even looks similar to the 2016/2017 "Trump bump". Other closely-watched market indicators (copper, freight indices, yield curve bear steepening, analyst earnings forecasts) tell the same story of confidence in a robust global cyclical upswing. As do the global growth upgrades pushed through by OECD economists in March[3].

Figure 2: HSBC AM market implied growth signal

Source: Bloomberg, HSBC Asset Management, March 2021

Investor expectations versus expected returns

Today, a range of popular investor sentiment surveys all point to significantly-higher economic confidence and optimism about future market returns[4]. Given current trends, investor positivity in a cyclical upswing is not unreasonable. However, in practice, the consensus around a cyclical recovery creates a problem for us. This is because more positive investor sentiment is usually negatively correlated with model-based expected returns[5]. As investor confidence grows, we should assume future market returns are falling.

Our own research clearly demonstrates this to be true; expected returns have fallen significantly over the last 12 months. What we are left with today is a combination of lower discount rates, squeezed risk premia, and lower future returns. Most asset classes are either neutrally-valued or looking rich. Altogether, we think it means expected returns on global bonds of c 1% in USD terms and 4.4% for global equities, with a 60/40 portfolio returning around 3% nominal over the next 10 years.

[1] The indicator is a long-short and equal volatility portfolio across asset classes. The chart shows the payoff to growth relative to defensive macro assets.

[2] To be specific, our market-implied growth signal has been driven higher by a combination of factors in Q1, including: rising bond yields, weakness in gold, and the strength in industrial commodities.

[3] https://www.oecd-ilibrary.org/economics/oecd-economic-outlook/volume-2020/issue-2_34bfd999-en;jsessionid=xQDeTmGaQKzDqFDhm0xwobUn.ip-10-240-5-152

[4] For example, the AAII survey asks private investors if they are positive or negative for the next 6 months. The survey is currently at a bullish-bearish balance of +25, close to the highest readings over the last decade. Or consider the latest Graham-Harvey survey of CFO optimism re their own company's growth and on the US economy is substantially higher than it was during 2020.

[5] The classic reference is Greenwood and Shleifer (2013), "Expectations of returns and expected returns", NBER working paper 18686.

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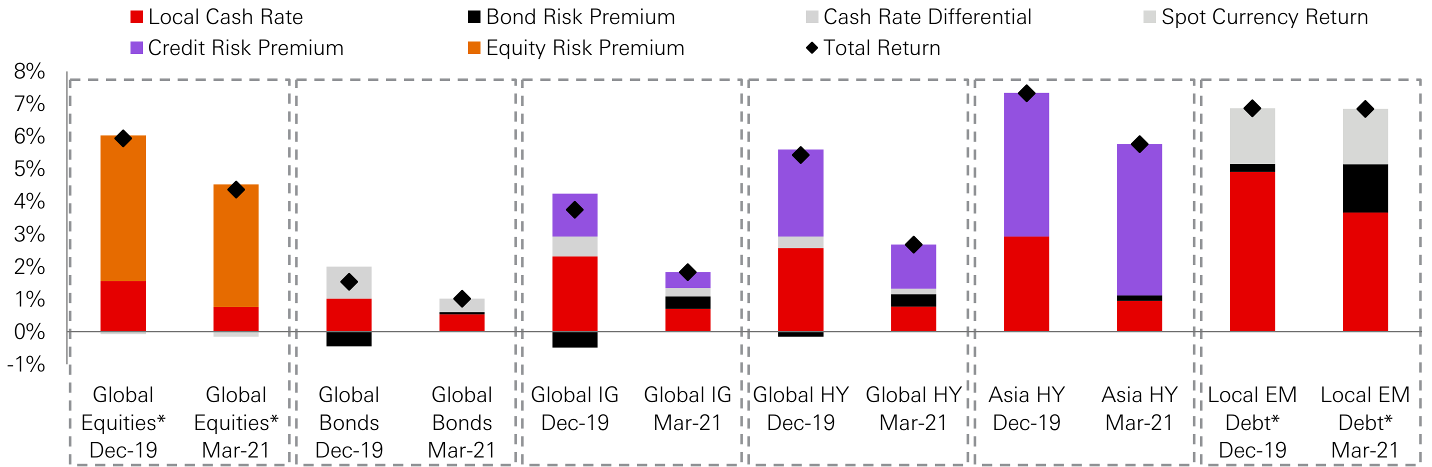
Figure 3: How expected returns have changed across key asset classes



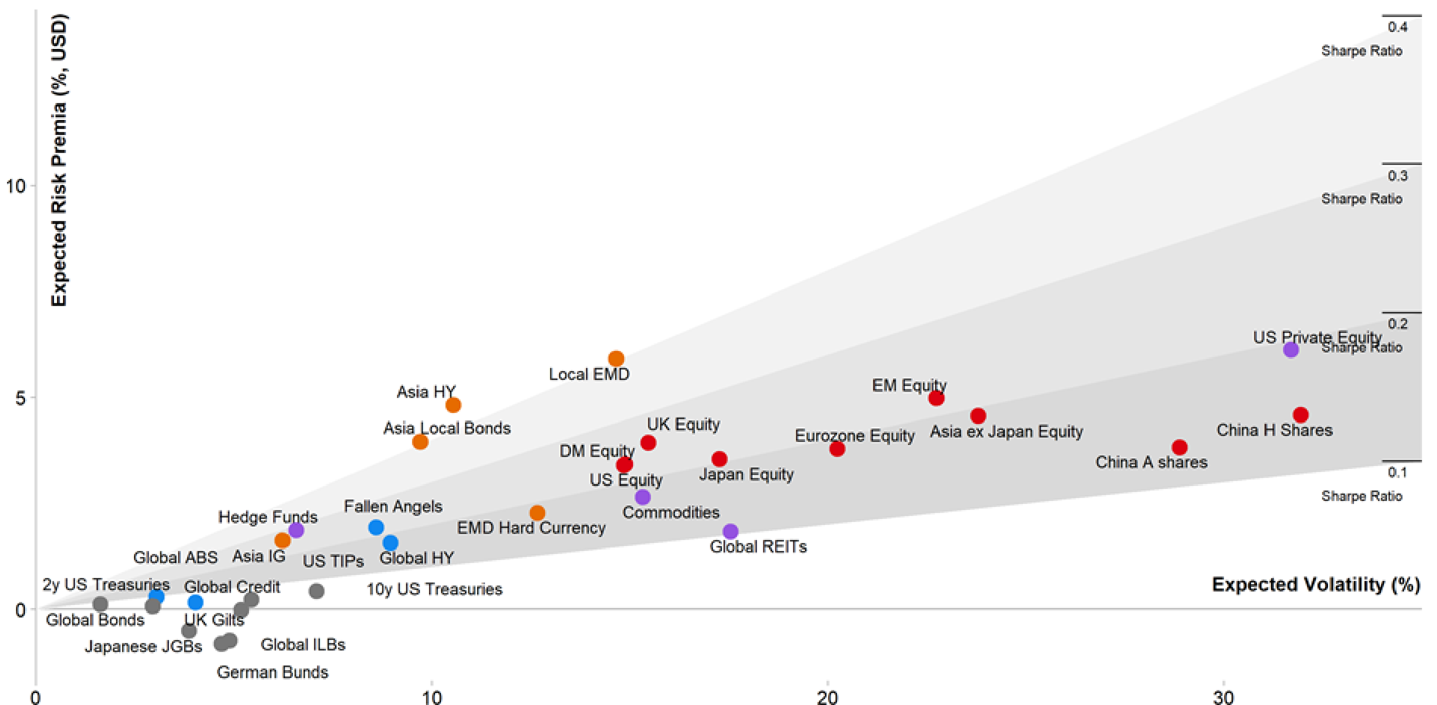
* unhedged. Source: Bloomberg, HSBC Asset Management, March 2021.

Strategic tilting and cyclical tilting

In order to outperform this low return world, macro investors can adopt some strategic tilting, some cyclical tilting, or a bit of both. But it will be important to be nimble and vigilant to the risks. And to assess, in a disciplined way, future asset class risk and return.

The idea of strategic tilting is to twist portfolios to parts of the market which are mis-priced for the medium term. Unfortunately, in the current phase, where the capital market line is low and relatively flat, we don't find many of these margin-of-safety opportunities. Among the 300 asset classes we track each month, the clearest valuation anomaly is in Asian fixed income. We think prospective Sharpe ratios in China bonds, Asia HY, and parts of EM local debt are out-sized. And there is also a strategic opportunity to increase the illiquidity bucket to boost returns using alternative asset classes like infrastructure.

Figure 4: Pecking order of expected returns



Source: HSBC Global Asset Management, Macrobond, March 2021.

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Another approach is to seek to exploit where today's conventional wisdom could be cyclically-surprised.

Firstly, while the hurdle for a growth surprise is a lot higher now, we shouldn't underestimate the importance of how the incoming news will feel for investors as we proceed through the economic re-opening phase.

Secondly, there are still some upside risks to consensus – especially in the US and in the UK. In the US, the passing of the Biden fiscal package creates another boost to household incomes and upside to consumer spending. There is an old economist saw: if you get the US consumer right, you get the US economy right. We think the resulting stronger consumer spending could bring the US GDP trajectory very close to the pre-COVID-19 trend, or even marginally above it, by the middle of 2022. That's ahead of consensus.

Meanwhile, in the UK, the impressive rollout of the vaccine should result in a relatively early re-opening of the economy. And although economic activity is very depressed, there is a significant pent-up demand story in the UK that can deliver a strong growth bounce. Both in the UK, and in Europe, the conventional wisdom among economists looks overly-pessimistic over the next 12-18 months[6].

Taken together, this implies a skew in the future return profile for value and cyclical equities. European markets and ASEAN in Asia have lagged over the last 12 months, but they have a large value and cyclicals bias (and relative underweights in technology and quality). Our analysis suggests that there is still scope for investors to be surprised by the delivery of recovery through the rest of the year – and there is a possibility of an asset price overshooting, as equities move into bubble territory. That means that a cyclical tilt to benefit from a continued revival in value still makes sense.

The big risk is more disorderly price action in bonds

As always, there are a number of important downside risks to be aware of. A COVID-19 resurgence or new mutations could stall out the growth recovery and, in emerging markets, the principal challenge may be around the lack of policy space and a need to respond to external financing conditions.

However, top-of-mind for most investors is the risk that higher bond yields curtail the recovery. In the regime of a flatter capital market line, such concerns about higher bond yields are well-placed.

On balance, our assessment is that there are a number of natural constraints on higher Treasury yields that are now growing in importance. Firstly, the inflation scenario (which we discuss in more detail below) looks noisy in the short-term, but relatively benign over the longer-run. The balance of inflation risks has shifted to become more symmetric, or even tilted to the upside, but bond markets have already priced higher expected inflation and higher inflation uncertainty[7].

Secondly, central bankers remain sanguine about the inflation outlook, financial conditions have not tightened much, and the policy commitment to asset purchases, lower for even longer rates, and further policy innovation remains in place.

[6] Consensus builds in a 5-6% reduction in GDP relative to the pre-COVID-19 trend. This seems too much relative to the level of policy support.

[7] For example, the BIS has recently shown the rise in break-even inflation is closely linked to the inflation premium and higher inflation uncertainty: https://www.bis.org/publ/qtrpdf/r_qt2103x.htm

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Thirdly, investment markets are approaching key levels for US Treasuries. We think a 2% yield on 10y Treasuries implies a positive bond premium of 100bp and a prospective Sharpe ratio of 0.14. We think that is enough compensation for current inflation risks[8].

Higher bond yields in the reflating "restoration economy" seem inevitable, but it is critical for the integrity of the macro system that these moves are not disorderly. At 2%-plus US bond yields, we think the global equity premium (versus long bonds) moves below 2.5%. That is not quite a bubble valuation for stocks, but it is getting close. Risky asset classes are not priced today in a way that they can absorb meaningfully higher bond yields.

Low bond yields and a weaker dollar will deliver economic restoration

Clearly we have to monitor macro, policy and virus trends closely. But, at this point, our story of the restoration economy looks correct and has momentum. That means that the two critical issues for the market outlook are:

1. that we can keep a lid on bond yields and
2. that we can avoid the dollar short squeeze from becoming a trend, and harming global financial conditions.

We think both assumptions will hold. A number of natural constraints on Treasury yields are growing in importance. Meanwhile, dollar short positioning has been cleared-out, and the recent drivers of dollar strength – US growth and yield divergence – are well known. Rising US bond yields limit the scope for marked dollar weakness, but a combination of an easy Fed and global macro restoration should be enough for a mild downward dollar trend over the course of the year.

On that basis, we think it makes sense to continue with a structural tilt to emerging markets and alternatives, and a cyclical tilt to value equities, especially to benefit from a possible risk asset over-shooting. However, in the current market phase where much good news is priced, it's more important than ever to embrace a robust valuation framework, to rigorously assess expected returns, and to fine tune portfolio tilts accordingly.

[8] We also note that the relative spread of Treasury yields versus other bond markets is beginning to look rather wide. The idea of relative value opportunities in global bond markets has recently discussed and tested in a recent Fed research paper. Exploiting differences in term premia looks to be a profitable signal: https://www.federalreserve.gov/econres/feds/international-yield-spillovers.htm

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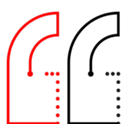
2 – US inflation moving higher, for now



It is important to look through what is likely to be a temporary spike and assess the longer-term prospects

Dominic Bryant
Economist and Macro Strategist

US divergence

The sharp rise in US treasury yields since late last year on the back of positive vaccine developments and President Biden's larger-than-expected USD 1.9trn COVID-19 relief package has put inflation front and centre in the economic debate.

There is now concern among some commentators[1] that the US may be on path to an inflationary boom. How worried should we be about this?

Before getting into detail, an important observation is that the concerns relate to the US, rather than other developed markets. This is because other large developed economies either: start with inflation further away from target; have suffered larger loss of output over the past year; lack an equivalent to President Biden's fiscal support measures; or a combination of all three.

While there will be exceptions, neither do we expect widespread inflation problems across emerging markets, given core inflation is generally lower than it was a year ago and many economies are still struggling with depressed output. North Asian economies weathered the COVID-19 storm far better than most economies but, even here, we regard inflation risks as manageable with still-benign underlying pressures capped by a negative output gap.

Figure 1: US GDP (Q4 2019 = 100)

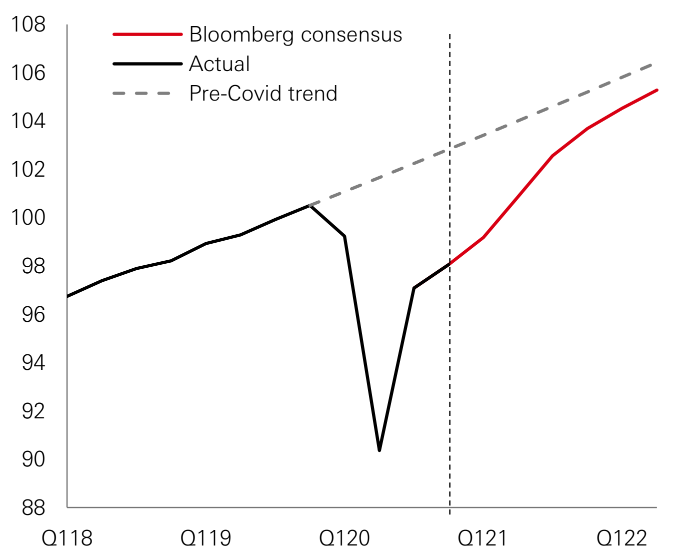
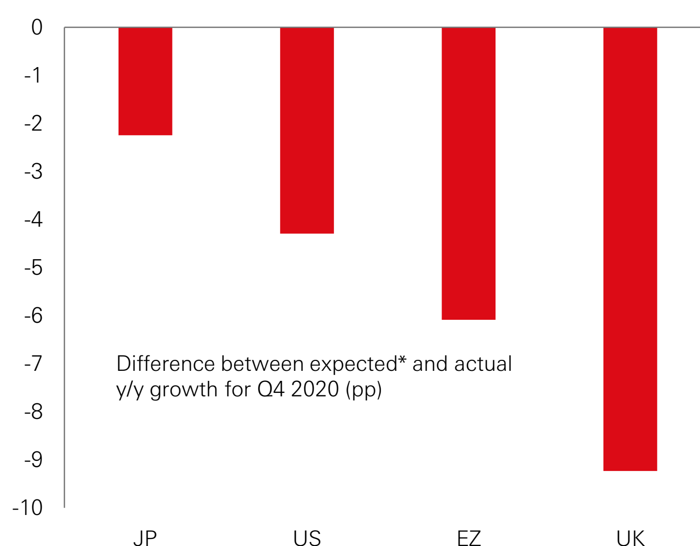


Figure 2: Consumer spending – goods vs services



* expectations as of 30 December 2019.
Sources: HSBC Asset Management, Macrobond, Consensus Economics, March 2021.

[1] "The Biden Stimulus is admirably ambitious, but it brings some big risks too", Lawrence H. Summers

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The return of inflation?

In order to address the concerns around US inflation we need to distinguish between the factors that drive short term price adjustments and those that cause enduring inflation.

On the former, a number of factors are set to push US core inflation above target over the next 12 months or so:

- **Base effects:** Price declines due to the initial collapse in economic activity in Q2 2020 will boost year-on-year inflation in the coming months
- **Relative price adjustments between sectors:** While the pandemic reduced overall consumer demand and core inflation, it boosted spending on goods and reduced spending on services. Goods and services price inflation behaved in a similar way. As spending patterns normalise we expect service sector prices to recover while goods prices may be "sticky" downwards, putting upward pressure on overall core inflation.
- **"Speed-limit" effects:** The combination of a vaccine programme now in full swing and the large fiscal boost is likely to lead to rapid growth in the next few quarters. While this comes in the context of the economy operating with significant spare capacity at present, the sharp acceleration in demand could bump up against short-term supply constraints in some sectors, pushing prices temporarily higher[2].
- **Housing cycle:** The housing component of inflation (rents and owners' equivalent rent) accounts for around 25% of spending on consumer services and has been unusually weak since the pandemic struck. But with housing-sector indicators gathering momentum, this component of consumer prices is also likely to recover during 2021.
- **Energy prices:** The rise in oil prices is also likely to create some "cost-push" increases in core inflation, as well as boosting headline inflation.

Figure 3: Asymmetric shock to demand

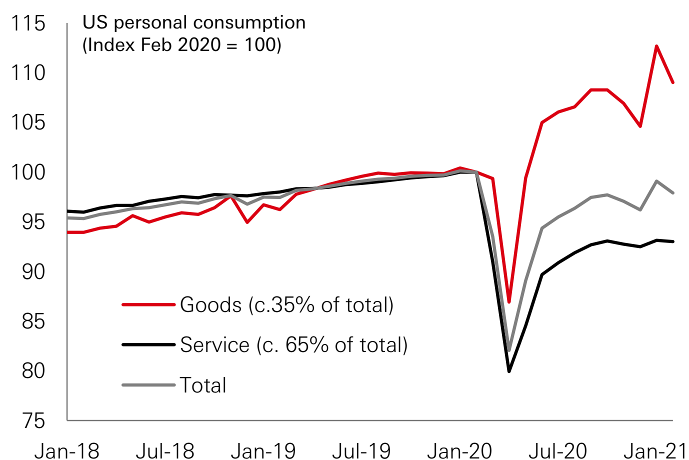
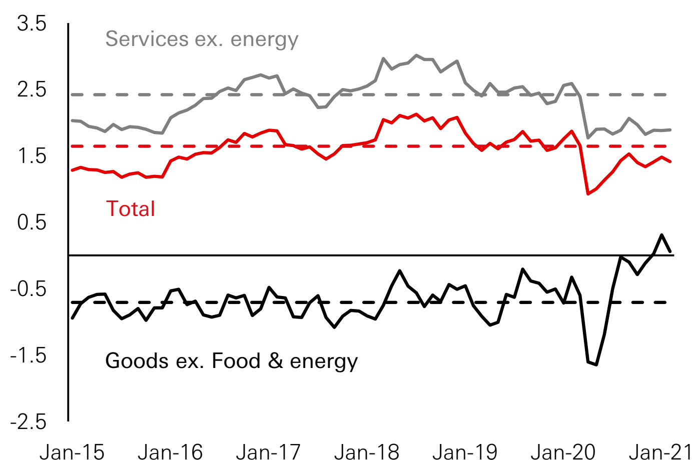


Figure 4: Asymmetric shock to prices



Sources: HSBC Asset Management, Macrobond, March 2021.

All in all, these factors are likely to push core PCE inflation comfortably above the Fed's 2.0% target; the price indicators in the ISM surveys suggest that firms are looking to raise prices in the near-term (Figure 5). Indeed, the coming months may see the highest core PCE inflation rate since before the global financial crises. This could grab the attention of investors and commentators and add to the volatility we have seen in markets in recent weeks.

[2] Chair Powell's Press Conference, March 17, 2021 (page 3)

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Longer-term inflation story – hitting the target

Although we are likely to see inflation above target in the coming months, it is important that we look through what is likely to be a temporary spike and assess the longer-term prospects. The Fed and other central banks still find an "expectations augmented Phillips curve" framework useful as one of the tools for analysing inflation[3, 4] and deriving their forecasts. This views medium-to-longer term inflation as a function of two key components:

- Slack in the economy, particularly in the labour market
- Inflation expectations

Figure 5: Firms looking to raise prices

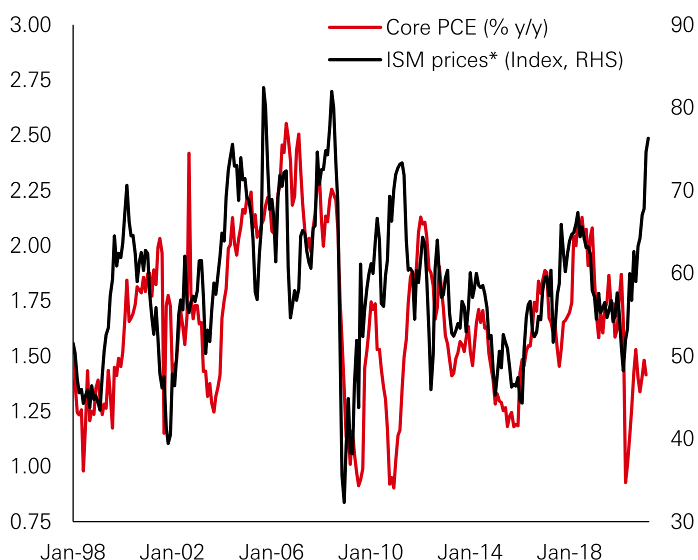
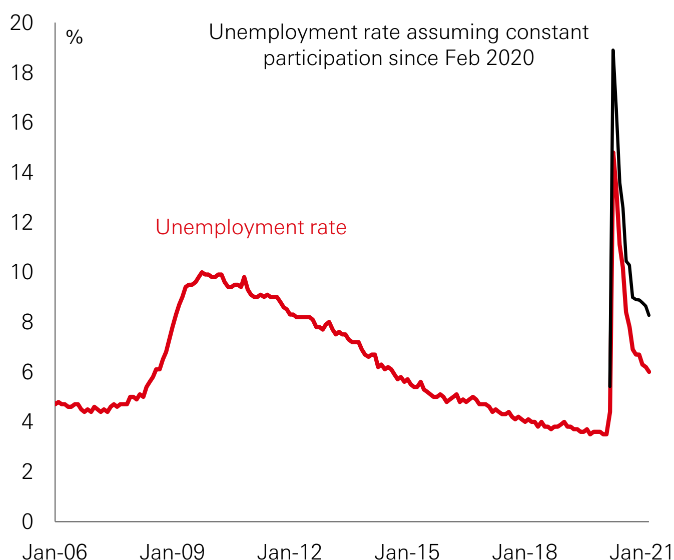


Figure 6: Hidden labour market slack



* 80% services, 20% manufacturing. Source: HSBC Global Asset Management, Macrobond, March 2021.

The labour market is of critical importance given the role of wage growth in determining consumer demand and firms' costs. At face value, the unemployment rate does not look particularly high at this point given the initial severity of the economic shock. However, once it is adjusted for those who have simply left the workforce, very significant slack remains evident (Figure 6). Payrolls are still 8.4mn below pre-pandemic levels so, even with strong employment gains likely in the months ahead, it will take some time to achieve a full recovery.

The skewed nature of the labour market recovery may, however, add some volatility into the wage data. As with inflation itself, sectors that experience a rapid recovery could see some temporary wage pressures, but we believe that it is unlikely that we will see sustained excess wage growth given the weak starting point for the labour market.

In terms of inflation expectations, both market and survey measures have picked up in recent months but remain below the levels seen when the Fed was last able to generate sustained near-target inflation (Figure 7). While expectations are likely to rise further, the previous years of below-target inflation and the Fed's continued focus on inflation as a central part of its policy framework should keep them within an acceptable range.

[3] https://www.newyorkfed.org/newsevents/speeches/2019/wil190222

[4] https://www.federalreserve.gov/newsevents/speech/yellen20150924a.htm

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Figure 7: Recovering inflation expectations

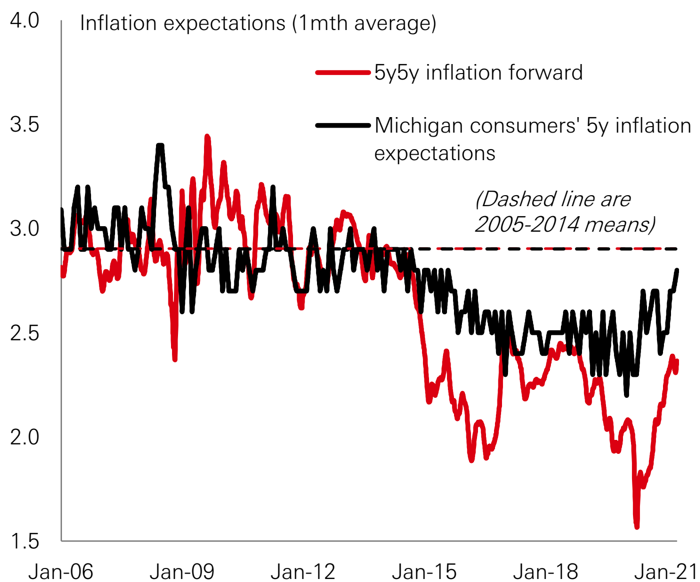
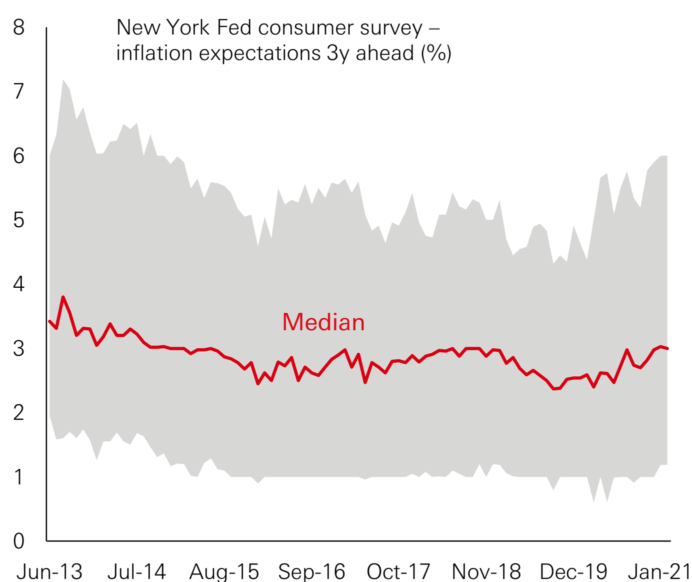


Figure 8: Risks are shifting



Sources: HSBC Asset Management, Macrobond, March 2021.

Overall, anchored inflation expectations and significant labour market slack suggest that above-target inflation in the near term should prove to be transitory and inflation is likely to be around target over the medium-to-longer term. To end up with uncomfortably high and persistent inflation most probably requires a sustained period of substantial overheating in the economy. President Biden's fiscal package is likely to push US GDP back close to, or even a little above, its pre-COVID-19 trend. But the economy was not generating excess inflation before the pandemic, so it is difficult to see such a path for economic activity resulting in a material overheating.

Generating excessive inflation would likely be a multi-year process in which sustained overheating results in persistently above-target inflation, which begets higher inflation expectations, which then feeds back into higher inflation. Crucially it requires policy makers being unwilling to break this cycle.

Risk distribution has shifted

Inflation close to target over the medium term, while a benign outcome, would mark an important departure from the persistently below-target inflation seen since the global financial crisis. Moreover, in our view, the risk distribution has also shifted. Over the previous two decades the primary concern was disinflation, or even deflation. But the Fed's move to an "average inflation targeting" framework combined with a more fiscally expansive Federal government has significantly diminished the downside risks to inflation and probably tilted them to the upside.

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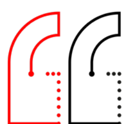
3 – Asia monetary policy outlook



The policy debates in Asia could become a lead indicator of the policy discussion in North America and Europe

Renee Chen
Senior Economist

Multi-speed recoveries and complex policy decisions in Asia

Asia has been the leading edge of the global recovery and a number of economies, including China, Korea, Taiwan, Australia, New Zealand, and India, have already recovered pre-COVID-19 activity levels. However, many labour markets still require significant support to recover lost employment. At the same time, in parts of Asia, core inflation has picked-up and analysts fear inflation risks further down the road. And, as the recovery progresses, Asia policy-makers have increasingly concerned themselves with financial stability risks and the challenge of managing bubbly-looking asset markets.

More recently, the sell-off in US Treasuries has posed risks to financial conditions across Asia, causing local bond yields to widen and increasing equity volatility; could that process go so far as to imperil the Asian recovery?

Asian policy makers are walking a tightrope and face a complex set of tensions and trade-offs, which vary in intensity across the region. Crucially, many of the current Asian policy debates could be a signal of things to come for western economies.

Asian policymakers alert to financial stability risks: housing markets

For a number of Asia's economies, the combination of low interest rates, easy liquidity, higher household savings, and a rapid recovery in aggregate demand has begun to shift the focus of policy makers away from macro stabilization and toward financial stability.

Leverage-fueled asset price inflation in the housing market is the principal concern. And these worries are well-founded; leveraged bubbles are generally viewed by academic economists as the most damaging type of asset bubble for the macro-economy[1]. And policy-makers are also concerned about social dimensions, including housing affordability, wealth distribution, and bank asset quality.

Across Asia, economies are at different stages of the business cycle and property cycle. Tier-1 cities in China, as well as in Korea, New Zealand, and Taiwan – which have fared relatively better during the health crisis and led the recovery – have seen significant house price inflation. And the housing sector has also rebounded in Australia and Singapore. However, in Malaysia, India, Indonesia and Thailand, house price momentum is softer. Policy-makers in Indonesia, for example, have announced an increase in loan-to-value limits for property loans to a maximum of 100% at the February policy meeting.

[1] For example, the well known research of Jorda, Schularick and Taylor on "leveraged bubbles" - https://voxeu.org/article/leveraged-bubbles and https://voxeu.org/article/credit-booms-go-wrong

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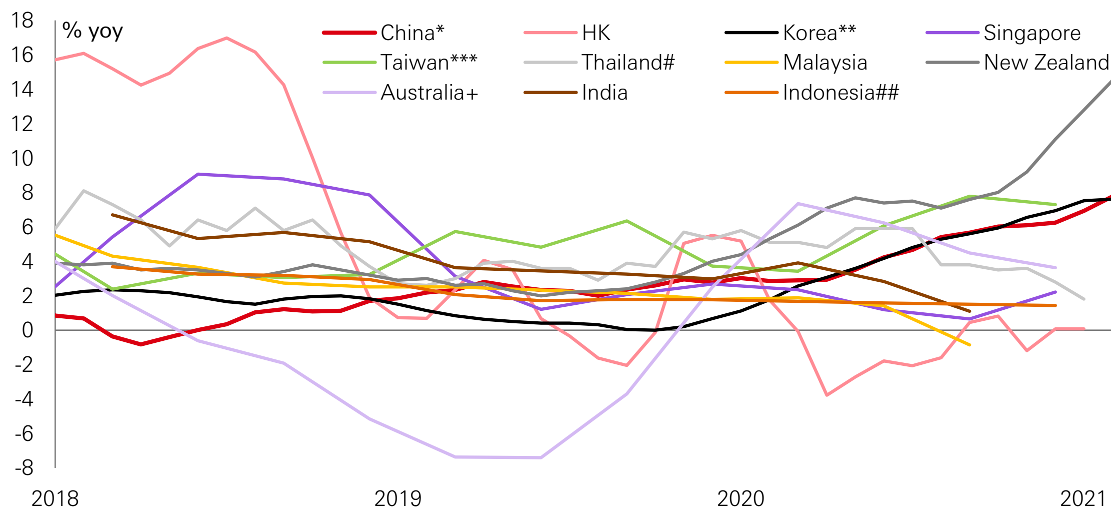
Overall – and especially relative to the magnitude of the pandemic, economic and labour market shock – Asia housing markets have been impressively resilient, and the rebounds have outpaced the broader economy.

That means that excessive leverage and household debt risks are front-of-mind policy issues. Figure 1 shows how household debt ratios are either already elevated, or have risen rapidly across Asia – even if this is somewhat exaggerated by GDP volatility for HK and ASEAN. In Korea, for example, household debt reached 175% of disposable income and exceeded 100% of GDP at the end of 2020.

To get ahead of this dynamic, China, Korea, New Zealand and Taiwan have tightened macro-prudential policy measures (mostly by focusing on real estate lending restrictions and debt service limits for households). In New Zealand, Singapore and Malaysia house price inflation and stability in the real estate market have been re-emphasised as important policy goals.

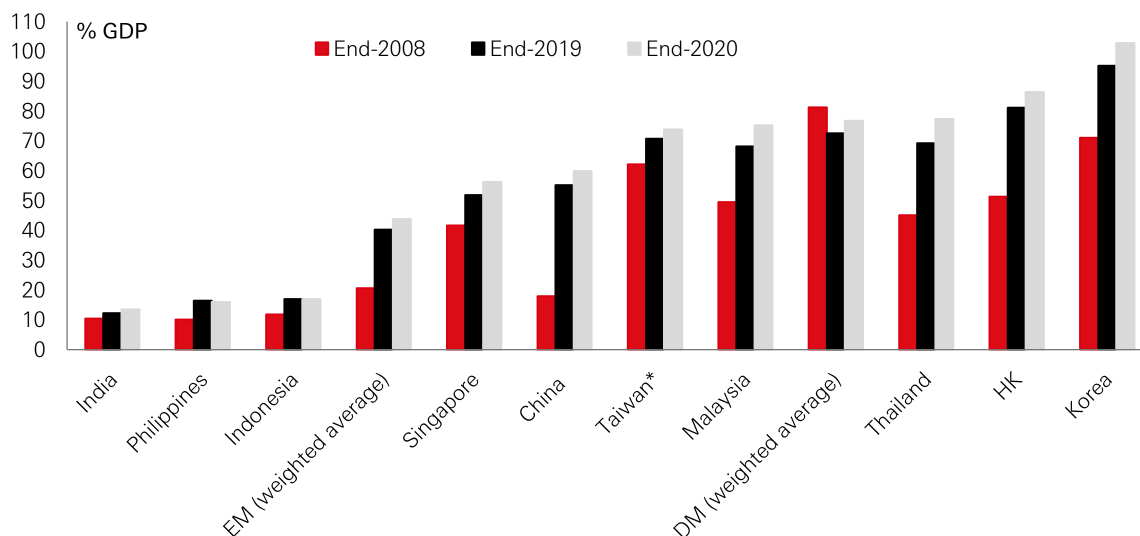
Figure 1: Asian house price indexes



Note: * Tier-1 cities; average of primary and secondary markets; ** Average of Seoul metropolitan area & six largest cities; *** Average of new and existing homes; # Single detached houses; ## 18 cities; ### Capital city region; + eight capital cities.

Source: Bloomberg, CEIC, BIS, HSBC Global Asset Management, March 2021.

Figure 2: Asia household debt ratios 2020 versus history



Note: * Only account for bank credit to households.

Source: IIF, CEIC, HSBC Global Asset Management, March 2021.

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Asian policymakers alert to financial stability risks: financial markets

Policymakers' concerns have also grown over perceived high valuations in equities, credits and other financial assets. The recent bear-steepening of the US Treasury curve has amplified these concerns. In 2013, the "taper tantrum" challenged the "fragile five" emerging markets with the biggest external economic imbalances. This time around, EM external finances are in much better shape. The new concern is that large fiscal deficit financing needs create a different vulnerability and another contagion risk from US liquidity tightening.

That backdrop likely means we are set to see central bank bond purchases in economies like India, Indonesia, Korea and the Philippines, in order to ensure the government's large borrowing needs can be met and to provide some market stability.

Inflation is not a policy concern this year

The Asian inflation headline is in the Philippines, where near-term price rises create a strong case, and growing demands, for the withdrawal of its "short term debt monetization" strategy.

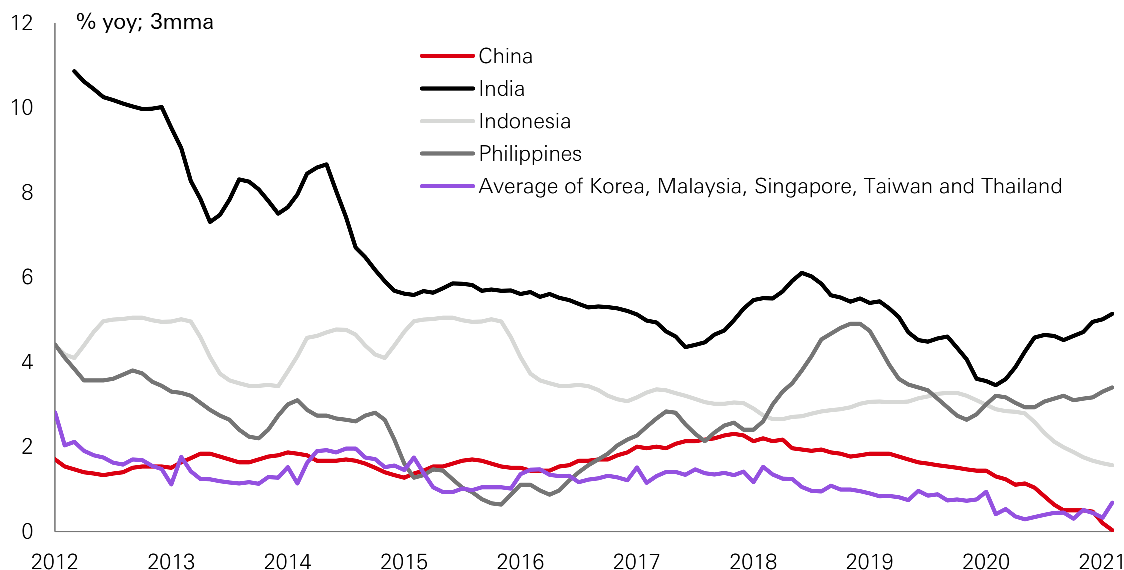
But across the rest of Asia, inflation is running within or below policy-maker targets. In general, inflation trends are set to rise in the near-term due to:

1. supply side cost pressures (e.g. commodity disinflation reverses itself, and supply chains under strain and reconfiguring);
2. the phasing-out of government subsidies (e.g. on electricity); and
3. a broadening demand recovery, lifting services sector activity and prices.

Food and fuel prices remain the wild-cards. More than in advanced economies, food and energy price rises have a tendency to creep into core inflation in Asia, and they are likely to impact household inflation expectations too. This effect can be mitigated by energy subsidies and price controls, especially while services consumption has not yet fully recovered.

Overall, we see no evidence of the improving labour market creating wage pressures or broad evidence of monetary-led inflation. We expect core inflation to pick-up, but remain moderate.

Figure 3: Asian core inflation remains low outside of India and Indonesia



Source: CEIC, Bloomberg, HSBC Global Asset Management, March 2021.

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A balancing act between growth and financial stability, complicated by global forces

Despite improving growth prospects, the domestic recovery is not yet on strong and durable foundation and the output gap is still negative in many economies. We expect the macro policy stance to remain accommodative across most parts of Asia. However, following aggressive monetary easing last year, Asian policymakers have shifted toward a more targeted, calibrated and data-dependent approach. We see limited incremental monetary stimulus and expect policy rates to be on hold this year across the region.

However, as growth rebounds, financial stability concerns could drive earlier policy normalization in some Asian economies, most notably in China. Macro policies of debt clean-up and controlling leverage – which were interrupted by the COVID-19 shock – may, once again, be given a higher priority. For China, we expect gradual interest rate normalisation, neutral to tighter liquidity conditions, moderation in credit growth, and a more hawkish tone on property and financial regulation. We do not anticipate a sharp policy turn or an abrupt exit of policy support.

As output gaps narrow elsewhere across Asia, the monetary policy cycle could be moving closer to a turning point. We believe macro-prudential policies would be the "first line of defense" against any deterioration in financial stability. Rate hikes will be much later given the larger and broader economic impacts, especially while so much labour market slack remains. Increased confidence in the "restoration economy" story could bring-forward those rate hikes, but they are unlikely this year. While policy-makers in Asian economies are increasingly alert to financial stability risks, similar alarm bells are not yet ringing loudly in western economies. As the recovery progresses, that could change. And the policy debates that are currently taking place in Asia could become a lead indicator for the next phase of the policy discussion in North America and Europe.

Figure 4: Policy summary table

	3M avg. inflation*	Inflation target	Debt-to-GDP ratio (end-2020)*	Change in debt rate in 2020*	Key policy concerns (ex. growth)	Select property-related macro-prudential measures (subject to eligibility and conditions) since Covid-19	Policy direction over next 12M (policy rate view) <broader policy bias>
CHINA	-0.10%	<3%	Government (65%) Non-financial private sector (225%)	Government (+12bp) Non-financial private sector (+20bp)	Macro leverage	"Three redlines" policy to control the pace of developer debt expansion with caps on debt-to-asset ratios and net debt ratios as well as a floor for cash-to-short-term-debt ratios Caps on banks' exposure to the real estate sector and residential mortgages City-level property policy measures in response to local conditions	Policy normalisation with gradual interest rate normalisation, neutral to tighter liquidity conditions, moderation in credit growth following last year's strong credit impulse, as well as a tightening bias on property and financial regulation; targeted credit support; de facto policy rates likely on hold in 2021 with lift-off expected in 2022 <Neutral to hawkish; no sharp exit>
INDIA	4.6%	4% +/- 2%	Government (89%) Non-financial private sector (63%)	Government (+17bp) Non-financial private sector (+6bp)	Inflation, policy transmission, bond market stability, INR (competitive-ness)	Stamp duty rate cut in some states	Monetary policy cycle could be moving closer to a turning point later this year with liquidity normalisation and amid a pro-growth FY22 budget; policy rates likely on hold in 2021 with lift-off possible in 2022; unconventional and regulatory measures to improve policy transmission and support government borrowings <A gradual shift from slightly dovish to neutral>

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Figure 4: Policy summary table (continued)

	3M avg. inflation*	Inflation target	Debt-to-GDP ratio (end-2020)*	Change in debt rate in 2020*	Key policy concerns (ex. growth)	Select property-related macro-prudential measures (subject to eligibility and conditions) since Covid-19	Policy direction over next 12M (policy rate view) <broader policy bias>
INDONESIA	1.5%	2-4%	Government (39%) Non-financial private sector (40%)	Government (+9bp) Non-financial private sector (+0bp)	IDR stability, credit growth/ policy transmission, bond market stability	New housing loan subsidies Value-added tax (VAT) cut Loan-to-value (LTV) relaxation for housing loans and declining mortgage rates Mortgage disbursement relaxation for developers	Adjustment of regulatory or liquidity policies to improve policy transmission; triple intervention in the FX spot, domestic NDF and local bond markets; continuing support for government financing requirements; policy rates likely on hold in 2021 (liquidity normalisation possible late in the year) with lift-off possible in 2022 <Marginally dovish to neutral>
KOREA	0.8%	2% avg.	Government (47%) Non-financial private sector (216%)	Government (+8bp) Non-financial private sector (+19bp)	Financial stability (leverage, housing speculation/ bubble risks)	Tightening of mortgage rules (e.g. LTV ratio) Raising real estate tax rate for multiple home owners and capital gains tax rates for these selling homes after owning them for less than a year Government plan to increase residential real estate supply	Targeted credit support; macro-prudential and regulatory measures to address asset/ housing price inflation and leverage risks; financial stability concerns could drive earlier policy normalisation amid the still supportive fiscal policy; policy rates likely on hold in 2021 with liftoff expected in 2022 <Neutral to slightly hawkish>
MALAYSIA	-0.5%	-	Government (64%) Non-financial private sector (151%)	Government (+11bp) Non-financial private sector (+14bp)	Financial stability (leverage)	Tax incentive for the housing market Stamp duty exemption	Accommodative policy to sustain growth recovery given low inflation and constraints on fiscal policy space (despite the recent rollouts of fiscal measures); mindful of financial stability risks related to real estate credit growth; policy rates likely on hold in 2021 <Slightly dovish to neutral>
PHILIPPINES	4.1%	2-4%	Government (48%) Non-financial private sector (49%)	Government (+11bp) Non-financial private sector (+1bp)	Inflation		BSP likely to look through supply-side cost push inflation given its assessment of recent inflation spike being transitory (we see some "falling-behind-the curve" risk); BSP calls for non-monetary measures, i.e. government action to address food supply constraints; BSP to support government's borrowings; policy rates on hold likely in 2021 with liftoff possible in 2022 <Neutral>
TAIWAN	0.4%	-	Government (34%) Non-financial private sector (137%)	Government (+1bp) Non-financial private sector (+4bp)	Financial stability (leverage, housing speculation/ bubble risks)	Five-point plan to curb real estate market speculation Tightening of mortgage rules Legislature-proposed combined property tax revisions to raise the cost of reselling homes within five years of the initial purchase	Targeted credit support; macro-prudential and regulatory measures to address asset/ housing price inflation and leverage risks; financial stability concerns could drive earlier policy normalisation; policy rates likely on hold in 2021 with liftoff expected in 2022 <Neutral to slightly hawkish>
THAILAND	-0.6%	1-3%	Government (44%) Non-financial private sector (132%)	Government (+10bp) Non-financial private sector (+16bp)	Financial stability (leverage, credit risks)	Relaxation of mortgage terms including higher limits on loan-to-value (LTV) ratio for first and second mortgages Reduction in transfer and mortgage fees	Targeted easing of regulatory or liquidity policies; desire to preserve policy space with unconventional policy measures possibly to be considered if necessary; tighter macro-prudential regulation possible to address financial stability risks; policy rates likely on hold in 2021 <Dovish to neutral>

Note: * Data from IIF except Taiwan where government debt data are from the MOF and private sector leverage data only account for bank loans

Source: IIF, Bloomberg, CEIC, Global Asset Management, March 2021

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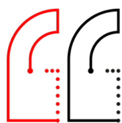
4 – Illiquid investments: is now the time to allocate?



The key challenge is to find a relevant framework to compare traditional and illiquid asset classes against each other

Pierre Dongo-Soria
Strategist

The role of bonds is being challenged

Historically, government bonds have played a number of important roles in our portfolios:

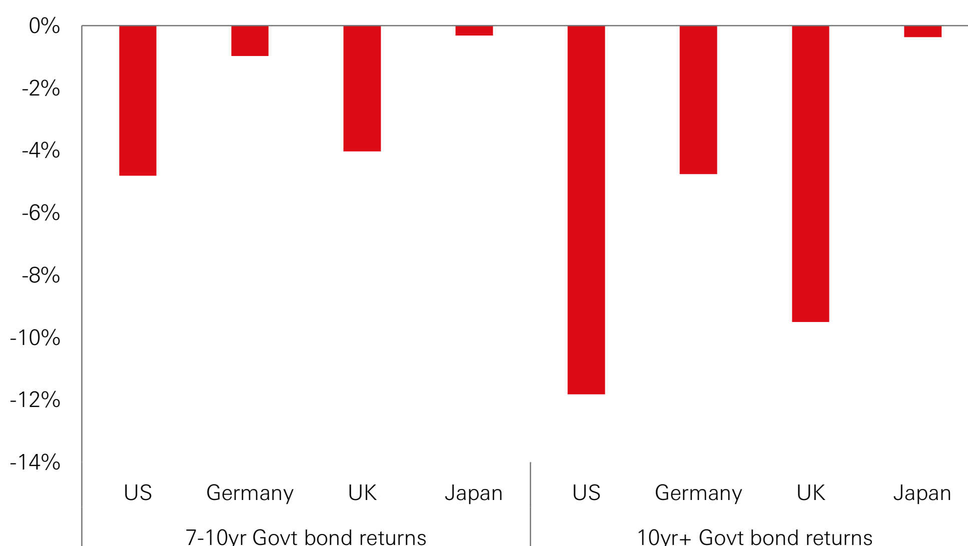
1. they have provided a different factor exposure to equities (i.e. a different economic source of returns),
2. they have offered good and reliable income, and
3. they have helped with portfolio liquidity.

However, the current "restoration economy" phase of the business cycle is challenging these roles[1].

Historically-low bond yields mean little income for investors to enjoy. That means that the main attraction for investing in government bonds has been their hedging property against equity market declines, and the capital gains due to falling yields.

However, year-to-date negative returns across developed bond markets and US long-duration bonds producing a drawdown not seen in the last 40 years showcase the challenges of bond investing in the current environment.

Figure 1: Year to date bond market returns (USD hedged)



Source: Bloomberg, HSBC Asset Management, March 2021.

What's more, government bonds haven not provided portfolio protection in recent episodes of stock market declines (see figure 2). What should investors do about the apparent reduced capacity of bonds to hedge equity risk?

[1] For more details in why we think that's the case see HSBC Asset Management House Views "The Great Rebalancing". September 2020

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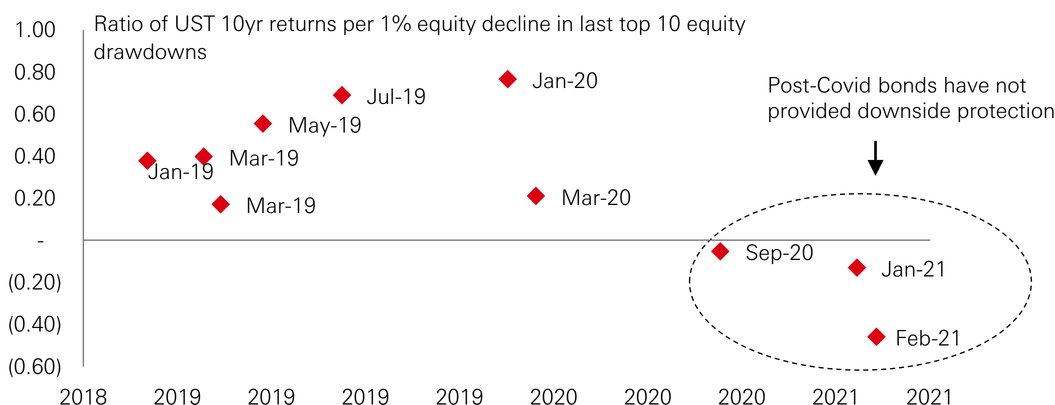
Figure 2: Bond hedging properties have deteriorated post Covid shock



Source: Bloomberg, HSBC Asset Management, March 2021

Recent increase in yields improves the picture for bonds to act as a portfolio diversifier again. However, the capacity of bonds to protect portfolios seems limited; the principal macro risks are overheating and inflation, not recession and deflation. Furthermore, we think the recent rise in US yields reflects a rational repricing of inflation risks, rather than an overshooting. We think it makes sense for investors to reflect on this apparent loss of diversification from bonds, and to think about ways to adapt portfolios to the new reality.

Are Alternatives a good alternative?

In a world where most asset classes are either neutrally-valued or looking rich, and where bonds don't act as a reliable equity hedge, we think embedding alternatives into institutional asset allocations needs to become more mainstream. Until recently, alternatives have been off limits to most but the largest institutional investors. As illustrated by the Mercer European asset allocation survey 2020, the largest European pension funds (above EUR 2.5bn) had 28% of their allocation on alternatives last year, while plans under EUR 50m only allocated 12% in the asset class. The hunt for yield and wider product availability could push more investors to integrate alternatives in their asset allocations.

But not all alternatives are created equal. Understanding the role each investment plays in the portfolio is key. We imagine alternative asset classes falling into one of two distinct groups, linked to the principal role they are playing in the portfolio.

First, there are the diversifiers. These can be either outright hedges (protective puts) or diversifying, independent return streams. Most liquid alternatives and strategies tend to fall into this grouping (e.g. commodities, trend following, some hedge fund strategies). Typically, these assets have different factor exposures to equities (i.e. low market beta and correlation). And while it is true that there is a trade-off between long-term performance and the reliability of the hedge for many liquid alternatives[2], their diversifying attributes remain attractive options in a world where government bonds are losing diversification properties.

Second, is the group of alternative investments that have a good track record of producing long-term excess returns versus traditional asset classes. They play the portfolio role of "return enhancers". We would place illiquid alternatives, such as private equity and infrastructure, in this category.

[2] For a deeper analysis of the relationship between performance and hedging properties of different alternatives see Cambell, et al (2019). 'The Best of Strategies for the Worst of Times: Can Portfolios be Crisis Proofed?'.

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Although there is evidence that illiquid alternatives can increase portfolio diversification, the main economic source of returns is similar to that of liquid asset classes.

Both private equity and public equity returns, for example, are mainly driven by the economic growth risk factor, even if complexity and other idiosyncratic factors also play a role[3].

For institutional investors, the principal reason to buy private assets is not correlations or downside protection, but higher returns over liquid peers. In practice, we think there is a balancing act to perform. Expected returns will time-vary, and we need to think hard about that aspect. And there is a tension between the extra returns of private asset classes versus the need to cover future liability- or cash flow-driven obligations in an efficient way.

The balancing act requires us to think about the size of the allocation to illiquid assets.

The role of expected returns in managing the traditional versus alternatives asset class mix

For asset allocators, a key challenge is to find a way to compare asset classes against each other – including alternative asset classes.

Our approach for calculating market-implied expected returns is based on the future evolution of interest rates and the market price of risk for each asset class. But adding alternatives to this framework comes with a number of additional challenges. Traditional risk metrics (volatility, correlation) are hard to measure for some alternatives since historical returns are overly-smoothed. In addition, the lack of daily market pricing, cash flow generation, and the idiosyncratic nature of these asset classes can make it difficult to measure prospective returns.

An interesting example is infrastructure debt. Gathering data on this important illiquid asset class can be tricky. Researchers typically use proxy benchmarks, like the Bloomberg BBB Utilities index or the iBoxx infrastructure debt index, but these subsets of the corporate bond market are neither aligned with typical infrastructure investments, nor with the underlying risk of the asset class. Appraisal-based models are also popular, but these returns streams are artificially smoothed, which invalidates risk analysis[4]. Our research finds that EDHEC's suite of infrastructure indices overcome many of the natural challenges of illiquid asset class benchmarks and thus provide us with relevant data inputs for our modelling work.

Using our "build up" approach, we can develop an expected return for investment grade infrastructure debt using the Broadmarket Private Infrastructure Debt Index from EDHEC. As previously described, the first step is to develop the risk-free rate component, based on our macro views on how policy rates will evolve in the short-term and into the medium term.

To that, we add a return component that reflects the market price of interest rate risk in infrastructure debt (using the output from our government bond model)[5].

Finally, we add a credit risk premium component. This is calculated as the expected spread return minus the expected losses due to defaults for the infrastructure index[6].

Based on current market pricing and our scenario for macro fundamentals, the resulting expected return for investment-grade-like infrastructure debt is 2.5% (BBB average rated, USD hedged). Given its historical volatility[7] of 4%, the implied prospective Sharpe Ratio is 0.38.

[3] For example, our analysis indicates that private equity investments are exposed to the value and size risk factors.

[4] Appraisal-based valuations and many benchmark indices for illiquid investments exhibit smoothed returns. This means that the time series of returns should not be used calculate volatility and correlations as it is artificially lower.

[5] We adjust the duration risk premium for the duration of the infrastructure debt index - 6 years duration and average maturity of 12 years.

[6] The return spread is based on the current spread, estimated by EDHEC to be 150bp, and an assumption it will mean-revert to the historical average spread of a corporate bond index with a similar credit rating. Then we adjust this return by including expected default losses. These losses are based on EDHEC short-term default estimates and historical default losses from Moodys long-run database.

[7] Based on historical returns since 2000.

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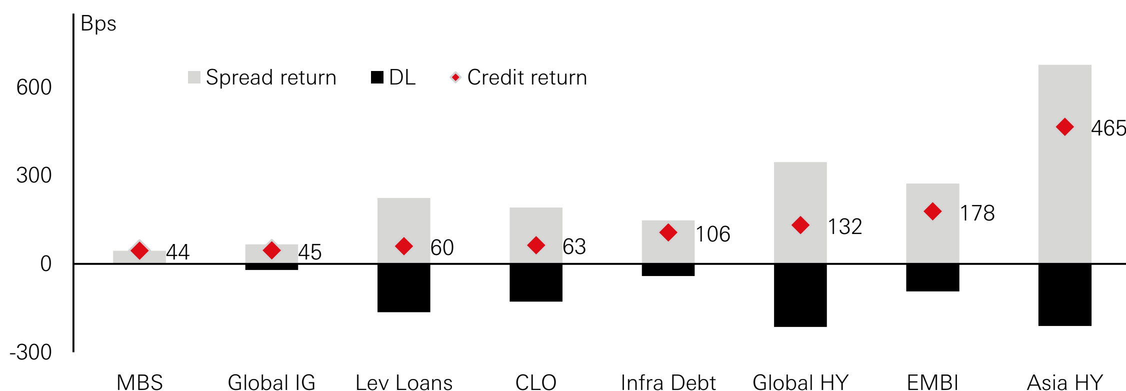
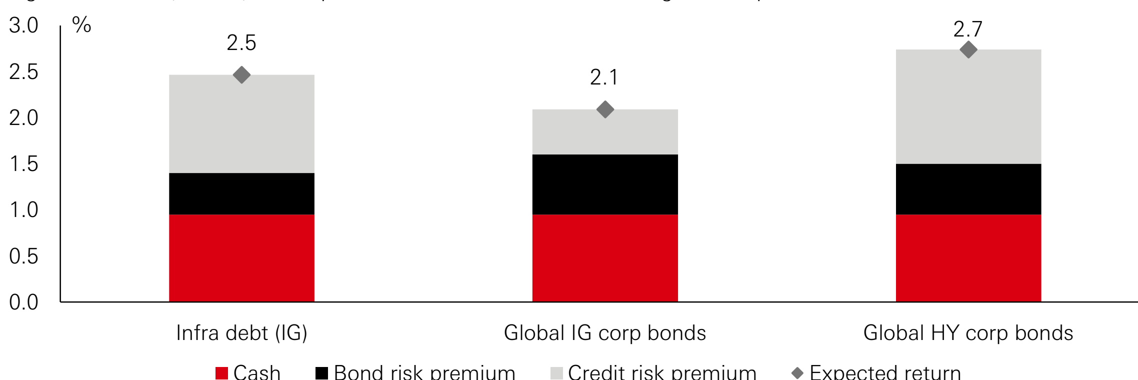
Figure 3: Credit risk premium = Spread return - expected default losses



Credit indices are from Bloomberg Barclays and JPMorgan, Infra Debt index is the EDHECinfra index.
Source: Bloomberg, EDHEC, HSBC Asset Management, March 2021.

This compares to global investment grade corporate bonds which have a similar volatility, but an expected return of 2.1% (Sharpe ratio of 0.28). Riskier bonds like global high-yield can offer a similar return (2.7%), but with higher risk (volatility of 9%)[8]. What's more, our default assumptions are conservative. Historical data shows that credit losses on infrastructure debt are lower than that of corporate bonds[9].

Figure 4: Return (USD H) decomposition for infrastructure debt and global corporate bonds



Source: Bloomberg, HSBC Asset Management, March 2021

The analysis shows that there is an extra return from expanding the opportunity set and adding a bit of illiquidity and complexity to the mix. Infrastructure debt can play the role of "return enhancer" within an institutional asset allocation by replacing some of the allocation to more traditional fixed income segments (i.e. replacing IG corporate bonds with IG infrastructure debt). In the case of portfolios constrained to only fixed income allocations it can be a source of diversification too.

Sizing the opportunity

The restoration economy backdrop is challenging the role of government bonds as a source of diversification and income. It is in this context that alternative asset classes can help – either by supporting diversification, and boosting returns. However, we believe it is critical to have an adequate valuation framework to assess the current attractiveness of illiquid and liquid asset classes on a like-for-like basis. Based on this approach, and using the example of infrastructure debt, we think that there is value in increasing allocations to illiquid alternatives today.

[8] A like-for-like comparison of HY corporate bonds against HY infrastructure debt shows that the latter offers higher yields with lower credit risk.
[9] See Moody's Investor Services, "Infrastructure Default and Recovery Rates 1983-2019", 8th of October 2020.

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