

Global Investment Perspective

November 2011

Highlights

October saw a reversal of the previous month with a strong rally in risky assets driven by positive news from Europe and better-than-expected economic data, especially in the US. However, whilst the economic signals have improved, they still remain relatively soft and are more reflective of the view that the global economy will be facing a slow and gradual recovery. In the US, data was above expectations, following the sharp drops of the previous month. In particular, the Philadelphia Fed Manufacturing survey suggested that the manufacturing outlook in the US may be improving. A 2.5% increase in Gross Domestic Product (GDP) in the third quarter was also encouraging, although the increase in non-farm payrolls in October was less than forecast, at 80,000.

Meanwhile, economic growth in the eurozone continued to disappoint, although aggressive policy actions regarding peripheral sovereign debt issues helped lift sentiment in the region and across the globe. European Central Bank (ECB) introduced additional liquidity measures to the banking system and in early November cut interest rates by 25bps to 1.25% in a surprise move. Elsewhere, economic data in Japan continued to suggest the recent recovery may be affected by headwinds from the global slowdown, following a drop in industrial production and lacklustre retail sales. In contrast, Chinese GDP growth continues to exhibit resilience to the global slowdown, while most of the other emerging markets continue to register healthy economic performance, pointing to a milder downturn rather than a sharp slowdown.

Market Recap

There was a robust rebound in the performance of risky assets in October. Both developed and emerging equity markets were up strongly amid better-than-expected economic data. Attempts by the European Union (EU) to solve the eurozone's sovereign debt crisis have been a positive sign and also buoyed markets. The EU confirmed a 50% write-down of Greek debt, recapitalisation of European banks and an expansion of the European Financial Stability Facility (EFSF) to US\$1.4 trillion. However, further details still need to be outlined and downside risks remain to the resolution, given the precarious state of the Greek government. The Bank of England announced that it will expand the size of its asset purchase programme to a total of £275 billion, a figure that was larger and earlier than expected by the market, whilst keeping the official cash rate on hold at 0.5%. Against this backdrop, equity markets on the whole recovered much of September's dismal performance in October. The S&P 500 rose by 10.9%, closely followed by European equities, which gained 8.6%, while UK equities increased by 8.5% over the month. Diminished concerns over a slowdown in global growth helped export-driven Asian and emerging markets this month, with Asia ex-Japan equities rising by 9.6% and the MSCI Emerging Market index up by 9.1%. However, Japanese equities (0.9%) underperformed other developed countries.

During the month, after achieving their largest quarterly gain in three years during the September quarter, US Treasuries fell by 0.8%, following a reversal in investor risk appetite in reaction to the proposed solution to the European debt issues, as well as better-than-anticipated economic data. Accordingly, eurozone government bonds were also in negative territory, although US dollar-denominated emerging market bonds gained 4.2%.

Outlook and Strategy

The macroeconomic outlook remains soft, with signals continuing to point to a slow recovery for the global economy. Meanwhile, the on-going eurozone debt crisis continues to be a concern for policy makers, although some progress is being made. From a valuation perspective, the picture is much clearer. We continue to hold a constructive view with respect to risky assets, given that equities remain attractively valued and markets have already priced in the high levels of risk. As such, we are confident with our moderate exposure to risky assets, although we continue to stress the need to diversify portfolios, in light of the considerable volatility that remains in markets.

Our central scenario remains fundamentally unaltered. Economic growth is still likely to be subdued across the key developed markets, with growth from the emerging market countries expected to be solid, though at a more moderate pace than in previous years. This view is consistent with the market consensus. Economic data releases continue to be mixed across most regions, though we continue to believe that any global downturn will be soft rather than a deep and lasting recession. Monetary policy remains loose in most developed countries with interest rates likely to remain low in an effort to stimulate an environment of sustained growth. However, downside risks remain higher than previously anticipated at the start of the year.

The recent volatility seen in equity markets is likely to remain, given fundamental and long-term concerns. This will especially be the case in the short term. Accordingly, valuations have adjusted to reflect the greater risks in markets. Government bond yields in developed countries are likely to remain very low, as a reflection of the weak economic environment. Given this scenario, government bond valuations are not compelling at these levels. On the other hand, we favour corporate issues, which are higher yielding, over government bonds. Currently, equities are, on the whole, trading at forward price/earnings (PE) ratios of 15 or under, with some countries and

regions, such as Europe, Russia and China seeing ratios below 10. Even if the level of earnings growth declines in 2012, current equity valuations, in particular when compared to bonds and cash, are considerably more attractive in the long term.

We maintain our modest preference towards risky assets, although we are now neutrally positioned on Japanese stocks (on a currency-hedged basis) within the developed market equities asset class. As the PE ratio is currently below its historical average, the Japanese equity market still offers value relative to history. However, price momentum has recently waned. In the emerging markets, we favour Russian equities, due their attractive valuations, both on a relative and absolute basis, and the signs of robust economic conditions. Nevertheless, we remain aware that a further fall in oil prices, amid declining global demand, may pose a significant risk to the Russian stock market, although this is not our central view. We have maintained a tactically overweight exposure to Chinese equities, which are particularly attractive from a valuation perspective and are trading at a discount both at a historic level and relative to other emerging markets. Monetary policy changes by Chinese authorities earlier in the year appear to be having a dampening impact on inflation in the country. As such, an end to the inflationary cycle may prove to be the catalyst for supportive inflows.

Within fixed income, US dollar-denominated emerging market debt remains attractive compared to developed market government bonds. However, corporate debt in developed markets, notably at the high-yield end of the spectrum, offers more attractive valuations than government bonds overall. Meanwhile, we retain a neutral view towards global developed inflation-linked bonds.

Short-Term Investment Outlook (6-12 months)

	Asset Class	Current View*	Reasoning
EQUITY	Global Developed Market Equity	Neutral	Equity valuations relative to cash and especially government debt remain attractive, plus liquidity remains supportive. There continue to be risks to the economic recovery, but our core scenario is for positive, although sub-trend growth.
	US Equity	Neutral	Corporate earnings have been encouraging for the third quarter, with around 75% of companies beating earnings expectations. The economic backdrop looks more encouraging than previously. However, unemployment remains elevated at 9%.
	Europe Equity (including the UK)	Neutral	Although valuations look cheap, economic conditions remain fragile. UK growth has slowed, while the economic health of peripheral eurozone countries remains uncertain. That said, recent policy action has been favourable with progress made on a number of key issues for the Eurozone debt crisis. However, some of the detailed plans are yet to be unveiled.
	Japan Equity	Positive	We have moved from positive to neutral in Japanese equities, relative to other developed market equities, given that price momentum has declined. Japanese equities are still at attractive valuations relative to history however, though there are signs that the economy is beginning to suffer from the deteriorating global outlook
	Asia ex-Japan Equity	Neutral	In spite of a slowdown in global demand, Asia ex Japan countries still carry more favourable economic prospects than other developed nations. At a country level, we prefer Chinese equities relative to other Asian emerging markets. Valuations are favourable and inflation is now declining.

	Global Emerging Markets	Positive	Emerging countries are likely to continue to lead the economic recovery, due to robust domestic consumption and strong intra-regional trade. While fundamentals remain strong, valuations attractive and interest rates in the developed world at multi year lows, emerging market equities continue to look favourable on a longer term view. Furthermore, emerging market equities have underperformed those in the developed world this year and we therefore recommend a preference for the former versus the latter.
	Latin America Equity	Neutral	The economic performance of Latin American countries remains strong and earnings growth estimates for 2011 look reasonable. Valuation measures relative to other equity markets show no strong signals. We, therefore, retain our neutral stance.
	Middle East Equity	Neutral	Given the political unrest within the region, in the short-term we expect volatility to persist affecting the overall performance. The investment potential will be largely dependent on oil prices and supply uncertainties.
	Eastern Europe Equity	Neutral	At a country level, we continue to favour Russian equities. Russia's economic activity has been encouraging, while valuations for Russian equities are attractive in both absolute and relative terms.
FIXED INCOME	US Government Bonds	Negative	The market is still offering little value relative to history and, downside risks remain, particularly in relation to fiscal policy. Within fixed income, we prefer to own corporate debt, where we see greater total return opportunities.
	Euro Government Bonds	Negative	We have a negative stance on eurozone government bonds relative to cash. This is due to ongoing uncertainties regarding the economic health of eurozone peripheral countries. In addition, valuations of these bonds do not look particularly attractive; they offer limited protection against negative surprises.
	Investment Grade Corporate	Positive	Strong corporate earnings results, the view that major central banks will keep interest rates low and strong demand for yield have boosted investment grade corporate bonds. We continue to be positive on the asset class
	High Yield	Positive	We have retained our positive view on the asset class given robust corporate results, declining default rates and low interest rates.
	Sovereign US dollar-denominated Emerging Markets Debt	Neutral	While sovereign US dollar-denominated emerging market debt continues to look less attractive on valuation grounds than developed market corporate debt, and high yield in particular – they remain more attractive relative to developed market government bonds.
	Global Developed Inflation-linked Bonds	Neutral	Inflation expectations increased only marginally during October. We retain our neutral view on global inflation-linked bonds. Valuations do not yet warrant a more positive view.

	Sovereign US dollar-denominated Emerging Markets Debt	Neutral	While sovereign US dollar-denominated emerging market debt continues to look less attractive on valuation grounds than developed market corporate debt, and high yield in particular – they remain more attractive relative to government bonds.
	Global Developed Inflation-linked Bonds	Neutral	The value of global inflation-linked bonds relative to government issues has improved recently, and we have increased our stance from underweight to neutral.
CURRENCY	Euro, British pound sterling, Japanese yen and the US dollar	Neutral	Valuation indicators are not sending any clear signals at present. We see both event-driven and sentiment-driven risks contributing to ongoing volatility. We thus continue to have a neutral view on currency exposures.

Summary:

We continue to maintain a moderately overweight allocation to global equities overall relative to both government bonds and cash. Within this we have a preference for emerging market equities over developed markets, given relative valuations. Within emerging market equities, we maintain our preference for China and Russia, where valuations are relatively more compelling. Within developed market equities, we have moved to a neutral position on Japanese equities.

With respect to fixed income, we continue to hold a negative view on government bonds relative to cash in light of their poor valuations. We remain positive regarding corporate issues because of the attractive valuations and favourable fundamentals. In the corporate debt segment, we favour high-yield bonds as their extra yield should offer a degree of protection in the event that government bond yields rise. Our central economic scenario has not changed: slow but positive growth in the major developed markets, an environment that is usually positive for credit markets.

We continue to maintain our neutral stance on the four major developed market currencies, given that the elevated levels of volatility are likely to persist. In addition, valuation measures are not sending strong signals at present.

With an environment of continued uncertainty with respect to global growth, and assuming a continuation of volatile conditions in the markets, our key recommendation is to remain well diversified.

Macro Assessment

October saw a strong rally for 'risk assets', driven by positive news from Europe and some better-than-expected economic data, especially in US, although growth remains subdued overall.

US

Economic data releases were, in general, better than expected, following sharp drops last quarter.

- ▶ US GDP grew at 2.5% annualised in the third quarter, alleviating some investor concerns regarding the potential for a double-dip recession. The data matched the consensus expectation, though the composition of GDP displayed better-than-anticipated growth in consumer and business demand.
- ▶ The Philadelphia Fed Manufacturing survey rebounded from -17.5 last month to 8.5 in early October, suggesting an improvement in the manufacturing outlook.
- ▶ Retail sales rose by more than forecast to 1.1% in the month of September against an upwardly revised 0.3% in August, the highest increase since February. The 1.1% increase marks an impressive end to the third quarter for consumer spending, a significant improvement from an almost stagnant second quarter. However, consumer confidence in October unexpectedly dropped to 39.8 (Consensus 46.0) from 46.4.
- ▶ Durable goods orders, excluding transportation, rose by 1.7% on a monthly basis, compared to the consensus estimate of 0.4%. Business demand for durable goods is one of the key factors supporting growth in manufacturing output, even as consumer demand sends conflicting signals.
- ▶ Progress in the employment market remained frustratingly slow. According to the change in the US non-farm payrolls, 80,000 positions (compared to 95,000 Consensus) were created in October, declining from an upwardly revised 158,000 in September. However, the unemployment rate declining marginally, to 9.0%.
- ▶ Casting a shadow on the recovery, the October ISM manufacturing index fell to 50.8 (Consensus 52.0), from 51.6 in September. This shows that underlying momentum in the manufacturing sector is still sluggish. However, the report did show an upturn in new orders (52.4 from 49.6) to its highest level since April.
- ▶ The US All Items Consumer Price Index (CPI) increased to a new two year high of 3.9% on an annual basis in September, led by a

rise in energy prices. The core CPI index, excluding food and energy related goods, was unchanged coming in at 2.0% on an annual basis in September.

- ▶ The October Consensus Economics GDP growth forecast for 2011 was increased slightly to 1.7% (up by 0.1%) but the 2012 forecast downgraded to 1.9% (down by 0.2%).

Europe ex-UK

Economic data in the eurozone continued to disappoint although hopes of a credible framework of a solution to the debt crisis lifted sentiment.

- ▶ Manufacturing and services activity continued to move lower in the region. The eurozone Purchasing Managers Index (PMI) for manufacturing dropped to 47.3 in October from 48.5 in September. In the services sector, there was a notable slowdown as the PMI Services number fell to 47.2 from 48.8.
- ▶ In addition, German factory orders growth fell unexpectedly for the second consecutive month to 3.9% over the year to August from 8.9% in the previous month. However, in the euro area, industrial production remained at odds with business surveys, which posted a strong reading of 1.2% in the month of August.
- ▶ In addition, the unemployment rate rose unexpectedly (consensus 10.0%) to 10.2% for September from an upwardly revised 10.1% in August. This is the highest unemployment level on record in the past decade.
- ▶ On the consumption front, eurozone retail sales dropped to 0.2% in the month of July from an earlier revised 0.7%.
- ▶ With disappointing news across several sectors, the ZEW survey on economic sentiment fell further to -51.2 in October compared to -44.6 last month.
- ▶ While the ECB kept rates on hold at 1.5% as expected, it announced a raft of measures designed to alleviate some of the strains in the banking system.
- ▶ The provision of unlimited amounts of liquidity at a fixed rate remains the main instrument coupled with the announcement of two new 12-month tenders together with the continuation of the full allotment of fixed rate one-week, one-month and three-month liquidity tenders until at least July 2012.
- ▶ Also, the ECB announced that it will re-start the covered bond purchase programme in November.
- ▶ The flash estimate of eurozone CPI was reported at 3.0% yearly basis (Consensus 2.9% annually) due to a further rise in Italian inflation rate to 3.8% over the year to October. This uncomfortably high headline inflation may make ECB rate cuts difficult in the near future.
- ▶ The Consensus Economics inflation forecasts for 2011 and 2012 remain unchanged at 2.6% and 1.8% respectively in October.
- ▶ The Consensus forecasts for 2011 and 2012 eurozone GDP growth were both revised down to 1.6% (-0.1%) and 0.6% (-0.4%) respectively in October.

UK

This month's developments provide a mixed picture.

- ▶ The UK manufacturing PMI surprised on the upside, coming in at 51.1 (Consensus 48.6) in September. Meanwhile, the PMI Services index increased to 52.9 in September from 51.1 in August.
- ▶ Retail sales excluding automobiles increased by 0.7% on a monthly basis in September having declined by a revised 0.4% in the month of August.
- ▶ However, employment data highlighted the weakness in the UK labour market. The unemployment rate rose to 8.1% to its highest ever level in August. The details indicated that redundancies continue to rise while the pace of hiring is showing no real signs of improvement.
- ▶ In the housing market, house prices increased by 0.4% in the month of October, having risen 0.1% last month in September.
- ▶ In the UK, annual CPI rose to 5.2% in September from 4.5% in August, while core inflation increased to 3.3% on a yearly basis. The jump was driven by gas, which rose by 13% over the month and electricity which rose by 7.5% over the month. The Bank of England (BoE) acknowledged that inflation is likely to rise in the next month or so, but the deterioration in the economic outlook meant that it will overshoot the 2% target in the medium term.
- ▶ The BoE announced that it will add another £75 billion of asset purchases to expand the size of the programme to a total of £275 billion. The scale of expansion was £50 billion more, and a month earlier, than that expected by the market.
- ▶ The Consensus Economics September inflation forecasts for 2011 and 2012 were unchanged at 4.4% and 2.7% respectively.
- ▶ Overall, the Consensus Economics 2011 GDP growth forecast was revised downwards to 1.0% (down by -0.2%) while the 2012 forecast was revised down to 1.5% (down by -0.3%) in October.

Japan

Japan continues to recover but has been affected by global economic headwinds.

- ▶ In Japan, a 4% drop in industrial production in September, almost twice the expected decline, has started to point towards a greater global pressure on the Japanese economy. However, October's manufacturing PMI moved back into expansionary territory (50.6) from 49.3 in September.
- ▶ The September Tankan survey from the Bank of Japan reported that sentiment among large manufacturers edged into positive territory (+2) in third quarter, from -9 three months earlier, while the outlook for December rose slightly.

- ▶ Japan's machinery orders rebounded to 11% in the month of August on increased demand for electrical products, the fastest increase this year. In addition, exports surprised on the upside in August, rising by 2.8% on a yearly basis thanks to a recovery in car shipments.
- ▶ Meanwhile, lacklustre activity continues on the domestic side. Retail trade declined by 1.2% on annual terms (Consensus -0.1%) in September and real household spending fell by -1.9% on a yearly basis (Consensus -1.9%) in the same month.
- ▶ The Japanese labour market remains in good shape, with the jobless rate declining to 4.1% in September, the lowest level in almost two years.
- ▶ Japan's CPI declined to 0.0% on annual basis in September from 0.2% in August, while the core CPI (excluding fresh food and energy) fell by 0.4% in yearly terms to be in line with expectations. The October Consensus Economics forecasts for inflation in 2011 and 2012 remain unchanged at -0.2%.
- ▶ The October Consensus GDP growth forecast for 2011 remains depressed at -0.5% and the 2012 forecast has fallen to 2.2% (down by -0.2%).

Emerging Markets

The latest set of cyclical data from emerging markets, specifically China, has been solid and points more towards a soft landing than a sharp slowdown.

- ▶ Despite the growth slowdown in Chinese GDP, the annual rate of 9.1% in September was greater than expected (consensus 9.3% on a yearly basis). Most of the other data releases were strong. While external demand is likely to impact China's exports adversely (down to 17.1% annually in September versus 24.5% annually in August) in the coming months, local demand should support growth as seen in the growth of retail sales.
- ▶ Also, retail sales data has been resilient in most emerging markets and posted broad increases in China (17.7% annually) and Russia (9.2% yearly).
- ▶ China's PMI manufacturing index fell back to 50.4 in October (Consensus 51.8), from 51.2 in September, though it is still in expansionary territory. The HSBC manufacturing PMI for October also moved into expansionary territory (51.0), from 49.9 reported in September.
- ▶ Industrial production data across major emerging countries was mixed this month. September's industrial production declined both in Russian by 3.9% on a yearly basis and Brazilian down to -1.6% in the year to September. Meanwhile industrial production rose in China (13.8% in annual terms in September) and India (4.1% on a yearly basis in August).
- ▶ Indian exports on a annual basis rose to 44.3% in August compared to an all-time high of 81.8% on annual term in July
- ▶ Brazil's PMI manufacturing fell for yet another month to 45.5 in September from 46.0 in August. Retail sales in August declined to 6.2% in annual terms from 7.1% in the previous month.
- ▶ In Eastern Europe, Russian economic activity, with the exception of slower industrial production, remained noteworthy with real wages increasing to 6.2% annually in September compared to 3.9% in August. Retail sales also improved and unemployment level fell by 0.1% to 6.0% in September.
- ▶ Inflation is expected to moderate and is already softening in some countries. In China, September's CPI eased slightly to a four-month low at 6.1% in annual terms from 6.2% in August, in line with consensus expectations. The breakdown suggests that food inflation remained high while non-food inflation eased a little to by 0.1% to 2.9% annually in September. India's September Wholesale Price (WPI) headline inflation eased marginally to 9.7% in annual terms, in line with consensus.
- ▶ Once again this month, despite global economic weakness, the Reserve Bank of India's (RBI) primary concern remains inflation and it continues to tighten its policy rate with another increase in the repo rate by 0.25% to 8.50%.
- ▶ In Brazil, annual CPI increased slightly by 0.1% to 7.3% annually in September to its highest level since May 2005.
- ▶ Overall, the Consensus Economic forecasts for GDP growth for emerging markets were revised down slightly with the biggest revision to 2012 GDP growth for Eastern Europe (from 4.0% to 3.4%) as a direct impact of the slowdown in the eurozone.

Equity Markets

Global Developed Markets:

US:

- ▶ With positive news across the eurozone and better-than-expected economic data, equities in the US (as represented by the S&P 500 index) rebounded strongly over the month, returning 10.9%.
- ▶ The year-end earnings growth estimates at 15.4% for 2011 and 11.6% for 2012 for US companies remain attractive and results for the third quarter of 2011 show high-quality earnings with relatively strong sales. Overall, of the 298 companies in the S&P 500 that have reported thus far for third quarter, 75% of these companies have beaten expectations, which is in line with the second quarter's results.
- ▶ US equity valuation measures, such as the 12-month forward price/earnings ratio of about 11.4x, continue to look undemanding.
- ▶ After an almost stagnant second quarter, economic data in the US has started to surprise on the upside. This suggests that expectations may have sufficiently discounted the lower growth outlook, which, other things being equal, is supportive for equity markets.
- ▶ Overall, we maintain a modest overweight allocation to the US and other equity markets relative to government bonds and cash (based on the attractive valuation measures). Meanwhile, we remain neutral on the US versus other developed equity markets.

Europe:

- ▶ The major news in October concentrated on efforts to find a resolution to the eurozone debt crisis. After intense negotiations between EU leaders and bankers, a plan was reached for a \$1.4 trillion support package for eurozone debt, with an agreement for the private sector to take a 50% voluntary haircut on Greece's debt. A number of potentially significant details remain outstanding but, nevertheless, the initial reaction from markets was positive. Indeed, eurozone equities increased by 8.6% and UK equities were also up by 8.5% over the month.
- ▶ Although the debt resolution package represents important progress, the medium-term success of this plan will depend on whether meaningful fiscal adjustments can be made in the peripheral countries. Furthermore, there remains a question mark over whether future economic growth will prove to be sufficient for countries to grow their way out of their debt burdens over time. As such, risks still remain. Equity valuations appear attractive and our central view is that interest rates will remain accommodative in 2011 and 2012 as growth remains subdued, which is a further supportive factor for the markets.
- ▶ Therefore, with earnings growth still looking positive next year, these valuations, particularly relative to bonds and cash, are compelling and we still favour equities as a long-term investment.

Japan:

- ▶ Japan's equity market edged up by 0.9% during October in part due to increased tolerance for risk among investors. However, it underperformed other developed countries (MSCI World +8.6%)
- ▶ On the negative side, there was a notable weakness in new export orders and real household spending also remained lacklustre, declining by 4.1% annually in August.
- ▶ Overall, recent data suggests that the pace of recovery in Japan is slowing. The outlook for Japan's economy is expected to remain moderate as it struggles against the dual headwinds of the slowdown in global growth and currency appreciation.
- ▶ The 12-month forward PE ratio is trading at around 11.7x, as at the end of October for Japanese equities. While valuations at these levels are attractive, we are starting to question where the catalyst to unlock this value will come from, as the economic boost from the reconstruction effort is fading.
- ▶ Overall, we continue to overweight equities relative to government bonds and cash. For Japanese equities, we are switching our stance from positive to neutral relative to other equity markets for the reasons given above.

Global Emerging Markets:

- ▶ After five consecutive months of negative performance, emerging markets closed the month on a positive note by returning 9.1% on a total return basis, outperforming developed equities by 0.5%.
- ▶ Performance was positive across the regions, with Eastern Europe and Asia returning 11.5% and 9.5% respectively. Within Asia, positive performance from China, Thailand and Indonesia were main contributors to returns, while, in Eastern Europe, it was Russia and Hungary. Latin America (8.9%) and the broader Europe, the Middle East and Africa region (7.9%) were relative underperformers.
- ▶ Economic data over the past month points to a soft landing rather than a sharp slowdown. Retail sales data has been resilient in most emerging markets and posted broad increases in China and Russia rising by 17.7% and 17.0% on annual terms, respectively.
- ▶ While domestic demand remains supportive, external demand in most emerging economies is declining. Annual exports in China declined in September by 17% and in Brazil by 24%. Chinese GDP growth in September at 9.1% on annual terms came in slightly lower than expectations of 9.3% annually.
- ▶ Annual industrial production data showed an improvement across most emerging markets.
- ▶ The decline in emerging market equities has reduced forward PE ratios across most emerging markets. The 12-month forward PE ratio currently stands at 9x, which represents a 20% discount to the five-year average (broadly similar to last month). Relative to the 10-year average valuations, current levels represent a 16% discount (20% last month).
- ▶ Risk appetite over the past month has shown signs of improvement on the back of increased effort and commitment from policy makers to resolve the sovereign debt crisis plaguing the eurozone. This, coupled with generally positive economic news, has seen a reversal of flows into emerging market equity funds, which are now at the highest levels since April 2011. We believe that the probability of a sharp recession in the eurozone is overdone, and, if this is indeed the case, there is now increased potential for upside in emerging markets.
- ▶ While fundamentals remain strong, valuations are attractive and interest rates in the developed world stay at multi-year lows, emerging market equities continue to look favourable on a longer-term view. Furthermore, emerging market equities have underperformed those in the developed world this year. Therefore, we recommend moving portfolios to favour the former versus the latter.
- ▶ At a country level, we maintain our preference for Chinese and Russian equities relative to other emerging markets on valuation grounds. Relative to their five year average, Russia and China equities' 12 month forward PEs are trading at -38% and -40% respectively. These represent the largest discounts in the emerging markets universe.

Asia ex-Japan:

- ▶ Asia ex-Japan equities returned positive performance in October as risk appetite improved on the back of some better economic data and news of increased efforts and commitment from policy makers to resolve the sovereign debt crisis plaguing the eurozone.

The MSCI Asia ex Japan climbed 9.6% during October, outperforming global developed equities by 1%.

- ▶ In China, CPI moderated slightly to a four-month low at 6.1% on annual basis in October, but still remains above the official target of 4%. Chinese GDP remains resilient at 9.1% in yearly terms in September, while October's HSBC China flash manufacturing PMI rebounded back into expansionary territory after three months of readings below 50.
- ▶ Industrial production in Taiwan lost substantial steam in September, rising by only 1.6% on annual terms compared to 4% in the previous month, to reach a two-year low. In Korea, by contrast, industrial production rose by 7% annually, from 3.7% in August, beating expectations.
- ▶ In India, the RBI raised the policy (repo) rate by 0.25% to 8.5%, in line with expectations. The global economic backdrop still poses major downside risks to growth, while continuing upward price pressures have pushed inflation to the forefront of RBI's policy agenda. HSBC's India manufacturing PMI bounced back in October to 52.0, compared to 50.4 in September, surprising the markets, and underscoring the resilience of the domestic economy.
- ▶ The slowdown in global demand continues to weigh on the economic performance of most Asian countries, given their high reliance on exports to the developed world. However, Asia ex Japan countries still enjoy more favourable economic prospects than other developed countries. Given that we have started to see inflation in the region moderating from its peak, future monetary and fiscal policy for those Asian countries should be less restrictive given an extended slower growth situation.
- ▶ We expect equity markets will continue to be affected by higher volatility, while investment sentiment will also be driven considerably by various uncertainties. However, it is not our base case to expect the world to enter into a deep recession and, hence, the lower equity prices we are seeing do offer exceptional investment value over a longer time horizon.
- ▶ Since a deep recession is not expected, we therefore do not anticipate significant adverse earnings revisions. Besides, earnings expectations seem to have already discounted the current slower growth scenario.
- ▶ We reiterate that Asia ex-Japan equities remain attractive in terms of their valuation. The 12-month forward PE ratio is trading at 10.2x as at the end of October, well below the historical average of 13.0x.
- ▶ Given that equity valuations are at low levels, we believe equities should offer a better risk-reward trade-off against low-yield government bonds and cash. Within emerging Asian equities, we continue to favour Chinese equities because of the supportive economic fundamentals and very compelling valuations.

Latin America:

- ▶ Although emerging markets closed the month on a positive note, after five consecutive months of negative performance, Latin America was the bloc's relative underperformers, returning 8.9%.
- ▶ Equity market performance was set against a backdrop of lacklustre data. Industrial production in Brazil fell by 1.6% on annual terms in September compared to 1.8% in August. Brazil's PMI manufacturing fell for yet another month, to 45.5 in September from 46.0 in August and retail sales declined to 6.2% in annual terms in August from 7.1% year on year in July.
- ▶ In Brazil, the CPI on annual terms increased slightly by 0.1% to 7.3% in September to its highest level since May 2005.
- ▶ Nonetheless, the economic performance of Latin American countries overall remains healthy with earnings growth estimates for 2011 still upbeat.
- ▶ Moreover, there has already been some progress in the fight against inflation, although this is not likely to be fully under control until late in the year.
- ▶ As such, the economic news seems to be reflected in market prices and relative valuation measures show no strong signals.

Middle East:

- ▶ The GCC (Gulf Cooperation Council) markets, have outperformed broader emerging market equities this year.
- ▶ The environment in the Middle East and North Africa, amid ongoing civil unrest in many countries across the region, remains an unsettled one.
- ▶ Several countries need to see greater political and economic normalization. In the post-revolution states, there is still no clarity on the economic outlook. For example, in Egypt, the economy continues to struggle despite the country agreeing its 2011/12 budget and terms for an International Monetary Fund financing deal.
- ▶ However, where political pressures have been negligible, such as in the United Arab Emirates, Kuwait and Qatar, the economic ramifications of unrest have been positive. This is due to the partial shift in economic activity from the troubled nations to the neighboring Middle Eastern countries, less affected or not affected at all by the turmoil. We continue to monitor events in the region closely.
- ▶ Overall, valuations remain undemanding and 12-month forward PE ratios are compelling on an historical basis. Valuations are similar to those of the broader emerging market universe, therefore we do not have a strong preference for the Middle East region relative to the broader universe.

Eastern Europe:

- ▶ Eastern European markets led the pick-up in emerging markets performance in October returning 11.5%.
- ▶ Economic data over the past month points to a soft landing rather than a sharp slowdown. Retail sales rose in Russia to 9.2% on a yearly basis compared to 7.8% in August. However, industrial production declined in the world's largest country.

- ▶ From a regional perspective, though economic activity has clearly moderated, encouraging data continues to emanate from the broader Eastern European region.
- ▶ At a country level, we maintain our preference for Russian equities relative to other emerging markets. Russia's economic activity remains robust, while valuations for Russian equities are attractive in both absolute and relative terms.

Fixed Income

US dollar Government Bonds:

- ▶ After achieving their largest quarterly gain in almost three years during third quarter of 2011, US Treasury prices retreated in October, declining by -0.8%.
- ▶ US government bonds were weakest performer amongst the global asset classes over the month amid a sharp turnaround in investor risk appetite. This was driven in part by hopes of a comprehensive solution for the eurozone debt issues at the EU summit. Towards the end of the month, policymakers responded with a range of measures, although more details still need to be clarified.
- ▶ US economic data was the other factor contributing to a rise in US Treasury yields. Expectations had become increasingly pessimistic during the third quarter but, in October, a number of key data releases came in at better-than-expected levels. For example, retail sales, durable goods orders and unemployment data all beat expectations.
- ▶ The US fiscal calendar remains uncertain and we expect market volatility to remain elevated as this unfolds.
- ▶ November 3rd is the deadline for the Joint Select Congressional committee on debt reduction (the "supercommittee") to identify a minimum of \$1.2 trillion in debt reduction over the next ten years in order to begin to move US fiscal policy towards a sustainable long-term path.
- ▶ Pressures relating to the "supercommittee's" mandate augur against additional near-term fiscal stimulus. At the same time, lack of such stimulus means that a sluggish economy will have to contend with a sharp increase in fiscal drag over the next few years.
- ▶ Our central scenario remains one of weak but positive economic growth from the developed world, rather than a double-dip recession. Recent economic data releases in the US are consistent with this scenario.
- ▶ Despite this anaemic growth outlook, US Treasury yields still appear unattractive both relative to history and to other asset classes. This is because US government bond yields are at extremely low levels and are already pricing in a very weak economic scenario. It is therefore difficult to see much value at these yield levels. We re-iterate our cautious view on the asset class and maintain our preference for corporate bonds within fixed income.

Eurozone Government Bonds:

- ▶ Eurozone government bond returns were negative in October, in line with 'risk on' behaviour, posting returns of -1.8% for the month.
- ▶ Eurozone sovereign nations' performance was noticeably less divergent compared to the previous month. All major EMU sovereign bonds posted negative returns in October. For example, France (-2.9%), Germany (-0.6%), Italy (-2.3%), Belgium (-3.7%) and Greece (-4.0%).
- ▶ After a showdown in the eurozone between EU leaders and the bankers, it was agreed that the eurozone will support the markets with a \$1.4 trillion bailout package and 50% voluntary haircut on Greece's debt. On the funding side, it was agreed that guarantees will be required on bank liabilities to provide more direct support for banks accessing term funding.
- ▶ The ECB continued to provide extensive liquidity to the markets through various money markets operations.
- ▶ The European economic outlook remains difficult. Even if the EU is able to execute the recovery plan, the tail risks associated with eurozone sovereign debt may diminish but they will probably not dissipate in the immediate future. For example, Italian borrowing costs failed to decline after the EU summit announcement suggesting that strains are still present.
- ▶ Government bond yields in developed markets are at very low levels (10-year yields are 1.8% in Germany, 2.0% in the US, 1.0% in Japan) having already priced in a weak economic scenario. It is difficult to see much value at these levels.
- ▶ Above-target inflation may make ECB rate cuts less likely in the near future.
- ▶ Therefore, against this mainly negative backdrop, we maintain a cautious outlook for eurozone government bonds against cash. Overall, within fixed income, we believe corporate bonds offer better value and are preferred over government bonds.

Investment Grade Corporate:

- ▶ Global investment grade corporate debt returned 1.6% during October, according to the Bank of America Merrill Lynch index data. This brings the year-to-date return for the asset class to 5.1%.
- ▶ This positive performance was driven by a narrowing of credit spreads, rather than a decline in underlying government bond yields, given that major developed market government bond yields rose during the month as risky assets moved back into favour with investors.
- ▶ Both a removal of some of the uncertainty surrounding the policy response in the eurozone, as well as better-than-expected macroeconomic data releases, particularly in the US, were the main drivers to the sharp reduction in risk aversion seen during the month.
- ▶ The option adjusted credit spread therefore decreased from 2.64% at the end of September to 2.30% at the end of October

(according to the Bank of America Merrill Lynch data) retracing all of the spread widening that was seen during September.

- ▶ Companies are still continuing to take advantage of historically low financing rates by issuing significant amounts of debt. For example, US investment grade companies have raised over \$760 billion in bond issues year-to-date, compared to a total of \$734 billion during the same period in 2010.
- ▶ Our central economic scenario remains an expectation of continued low growth rates in the major developed economies. Whilst financial markets had increasingly begun to discount a more recessionary view during third quarter, economic data releases over the last month have been consistent with our view of low but positive growth.
- ▶ In such an environment, investment grade corporate bonds typically perform well, as they are not dependent upon a strong cyclical growth outlook.
- ▶ Credit spreads continue to more than adequately compensate for the current default risk and therefore valuations in credit markets remain compelling.
- ▶ Furthermore, the ongoing low interest rate backdrop is likely to continue to fuel investor demand for yield. The current yield of 3.81% for a diversified index of global investment grade corporate bonds remains attractive in comparison to developed market cash or government bonds (as measured by Bank of America Merrill Lynch data as at 31 October).
- ▶ Overall, we believe that the current environment and valuation backdrop are still favourable for credit and therefore we continue to prefer investment grade corporate bonds relative to government bonds. Within credit, we favour high-yield corporate debt, since the additional yield offered by these bonds offers greater protection if government bond yields rise.
- ▶ However, given the uncertainty still inherent in the macroeconomic and political environment, investors should expect some ongoing volatility from the riskier asset classes.

High Yield:

- ▶ In September, global high-yield corporate bonds posted a strong monthly positive performance of 6.0%. This takes the year-to-date return back up to 3.4% in October compared to -2.5% in September.
- ▶ In conjunction with a huge rally in equities, risky bonds took the full benefit of decreased investor risk aversion. The positive performance was a direct result of spread tightening, caused by a decrease in tail risk due to encouraging news relating to the eurozone debt situation. Global high-yield option-adjusted credit spreads fell to 7.28% in October, from 8.65% at the end of September, falling back to levels last seen in mid-August.
- ▶ High-yield issuance increased slightly from last month. However, the \$10 billion of high-yield debt issued in October was much lower than the \$55 billion issued during the same time last year. The overall trend of greater total high-yield issuances compared to the same period last year was overturned this month as year-to-date issuance of \$281 billion came in lower than the \$302 billion issued during the same period last year.
- ▶ A continued trend of better-than-expected economics data (in particular the Chinese PMI, US GDP), positive eurozone news, good results in third quarter for US companies and a sharp drop in volatility (as evidenced by the volatility index, VIX) were among the many reasons behind the sharpest rally in high yield since the recession of 2009.
- ▶ The global annualised speculative grade (i.e. high-yield) default rate fell to 1.8% in third quarter, as measured by Moody's. This rate came in below Moody's own forecast of 2.0% a year ago, and reinforces our positive view on the asset class.
- ▶ Our central scenario for a low inflation and modest growth environment in developed economies is likely to keep interest rates in these countries low. Therefore, demand for high-yield bonds with attractive yields of 8.5%, should remain high.
- ▶ We believe that high-yield credit has priced in significant forward growth risks, and given the US economy is starting to exhibit some signs of improvement relative to expectations, riskier asset classes, such as high yield, are expected to remain attractive.
- ▶ Overall, we retain our positive view on the asset class. This view reflects our continued expectation that global growth will be positive, albeit at low levels, monetary policy will remain accommodative, and yield seeking fund flows will continue to be supportive.

Sovereign US dollar-denominated Emerging Markets:

- ▶ During the month, we saw a rebound of risky asset classes. As a result US dollar-denominated emerging market bonds gained 4.2% on a total return basis.
- ▶ The performance was driven mainly by a contraction in the spread relative to the associated credit risk free bond.
- ▶ The Merrill Lynch USD Emerging Market Sovereign Plus index option-adjusted spread decreased by 0.64% to 3.73% and the current spread level is below the historical average of 4.26%.
- ▶ At a single country level, the spread contracted in Russia and Brazil by 1.0% and 0.47% respectively, while it increased in China by 0.22%.
- ▶ Markets continue to be dominated by developments in the sovereign European debt crisis and the slowdown in global growth.
- ▶ Our outlook remains one of mild slowdown and recent economic data is consistent with this view.
- ▶ Within emerging markets, China's HSBC Flash PMI for October was posted at 51, rebounding from 49.9 in September thus confirming robust data for the manufacturing sector.
- ▶ US dollar-denominated emerging market debt continues to be supported by an attractive yield premium, especially when compared against developed countries government bond yields.
- ▶ However we continue to prefer developed market corporate debt (particularly high yield) to US dollar-denominated emerging market sovereign debt, since the latter offers a better risk-return profile.

Global Inflation-Linked Bonds:

- ▶ Among the developed economies, though it is at higher-than-desired levels, inflation is expected to be relatively contained in the near term, although monetary easing programmes could engender inflationary pressures in the longer term.
- ▶ Within fixed income markets, we retain a neutral position on global developed market inflation linked bonds. Valuations have improved in recent months, but not sufficiently to warrant a more positive view.

Currency

- ▶ During October's 'risk on' environment, investors no longer sought the safe-haven attraction of US dollar and the currency suffered as a result. Against the euro, the US dollar fell by 3.4% and against British pound by 3.1%. It rose against the Japanese yen by 1.4%, but this was due to a sharp fall in the yen on the final day of the month following the intervention by the Japanese authorities.
- ▶ Many emerging market currencies experienced strong rebounds from the dramatic declines in August and particularly September. For example, the Brazilian real gained 8.7% against the US dollar and the Russian rouble rose by just over 6%. However, these moves did not fully reverse the previous declines and both these currencies are still significantly below their 2011 highs. The onshore Chinese renminbi was slightly up (0.4%) against US dollar.
- ▶ We have highlighted the risk of intervention to stem the yen's rise on a number of occasions and exactly such action by the Japanese authorities at the end of October underscores our recommendation to have a neutral weighting in this currency.
- ▶ The late October plan for resolution of the eurozone debt crisis was a step in the right direction, not least because it addressed a number of issues simultaneously and reasonably credibly. However, there are still some significant details to be agreed as well as economic and political risks down the line, suggesting a bumpy path for the euro. Indeed, at the time of writing, Greece has just announced a referendum on the bailout plan. Remaining neutral on the euro continues to be our favoured approach.
- ▶ In the immediate future, any further rally in emerging market currencies is probably dependent on a continued reduction in investors' risk aversion – i.e. 'risk on'. In the longer term, the outlook remains positive and, as mentioned above, recent declines provide better entry levels than earlier in the year.

Long-Term Investment Outlook (three to five years)

Asset class	Current View	Reasoning
Developed Market Equities	Positive	Average rate of growth somewhat subdued in the developed world. Yet exposure to higher growth areas like emerging markets will benefit earnings growth and dividend growth and are likely to keep average nominal returns at high single digit levels.
Emerging Market Equities	Positive	Expected to outperform developed market equities thanks to a favourable structural backdrop including improved fiscal management and trade balances, labour force expansion and rapid urbanisation.
Developed Market Sovereign Bonds	Negative	Comparatively low level of yield and issues around public debt are likely to keep average returns relatively subdued.
Developed Markets Credit	Positive	The level of spread continues to be attractive on a historical basis and corporate balance sheets in developed markets are generally in good shape. This is likely to keep average return for credit assets above respective government bonds.
High Yield	Positive	The level of spread continues to be attractive on a historical basis and corporate balance sheets in developed markets are generally in good shape. This is likely to keep average return for high yield credit assets above respective government bonds.
Emerging Market Sovereign Debt	Positive	Structural improvements such as improved fiscal management and trade balances, labour force expansion and rapid urbanisation along with reasonable valuation levels are likely to lead to outperformance of emerging market debt relative to cash and developed market sovereign debt.
Developed Market Inflation-linked bonds	Neutral	Inflation expectations are likely to remain contained due to subdued growth in developed markets. In addition, independent central banks are focused on keeping price pressures under control. Furthermore, valuations for this asset class have deteriorated. However, if higher inflation in emerging markets is not dealt with effectively, it could feed through to developed markets over the medium-term.
Commodities	Positive	Growth in emerging markets likely to remain an element of support for this asset class.
Developed Cash Rates	Negative	Subdued economic growth and stimulus measures are likely to keep rates at low levels for the foreseeable future.

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