Inflation and changing interest rates: Ensuring financial resilience

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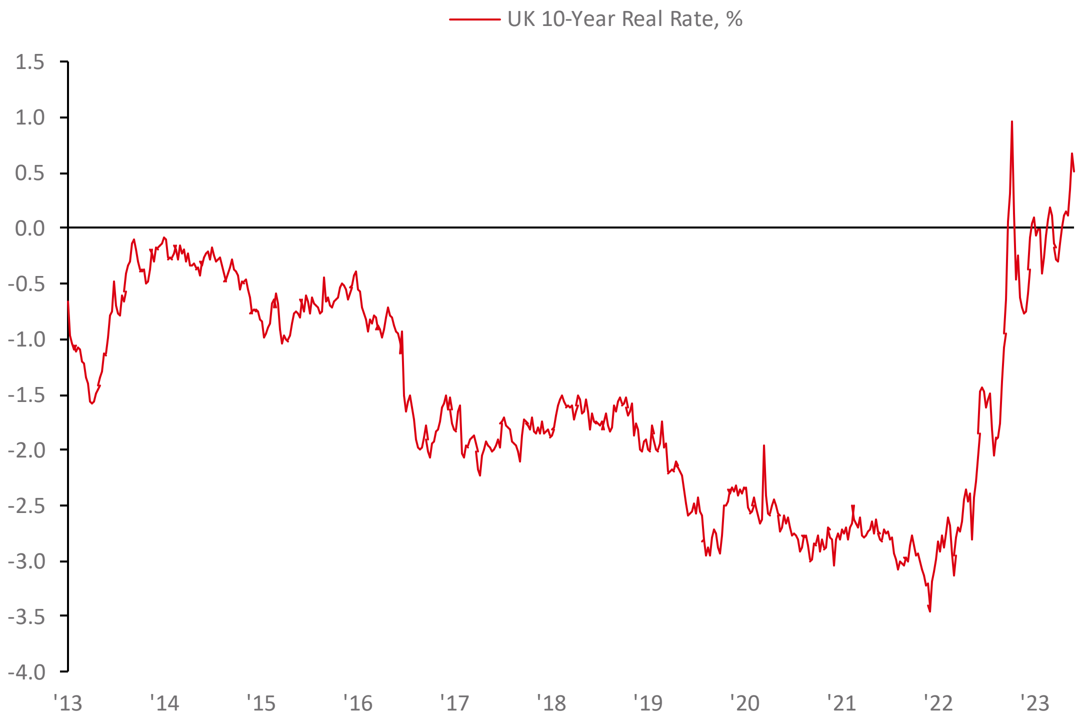
Remember Secular Stagnation? Falling rates were part of the bigger picture of sluggish growth

Real rates had been in decline since for over a decade



- The **“lower for longer”** rate thesis has been **thrown into doubt**
- The decline in rates was part supposed to be down to **structural stagnation….**
- **…. or was it just heavy scarring** from the Great Financial Crisis?

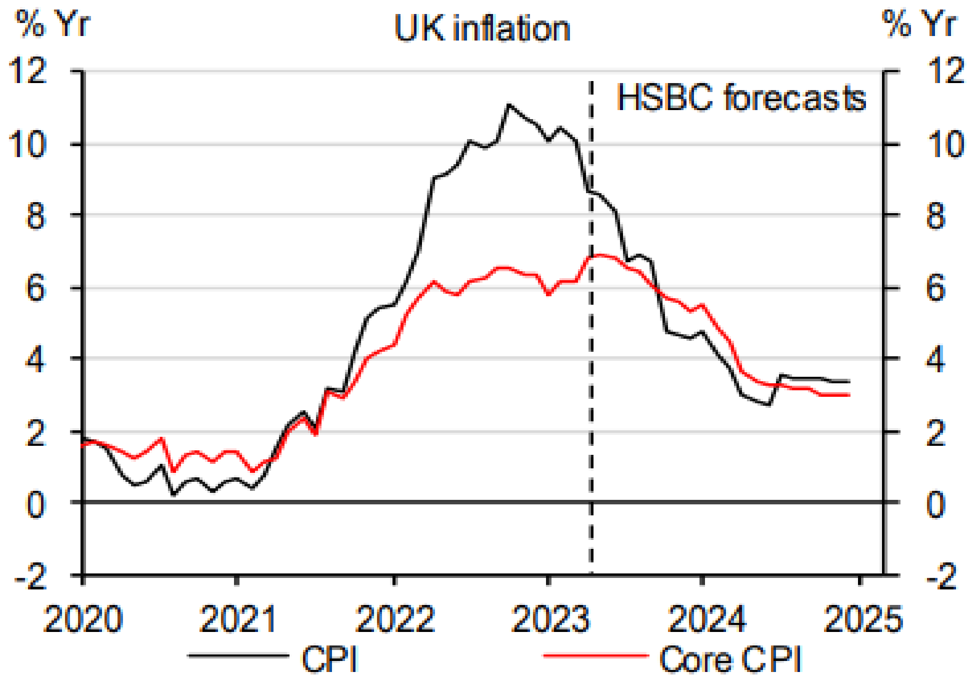
Source: HSBC Global Private Banking and Wealth, WSJ, Bureau of Economic Analysis, Bloomberg data, 2 May 2023. Past performance is not a reliable indicator of future performance. Forecasts are subject to change. * Note: Q3 2022 GDP data is actual data except Greece which reports on 2 May, and therefore Q3 data is HSBC Forecast.

But will inflation stick? Not at double digit rates but getting to 2% may take time

Inflation still above 3% at end of 2024

	2023f	2024f
World	6.8	4.8
Developed	4.7	2.8
Emerging	8.2	6.1
US	4.3	3.3
Eurozone	5.6	2.7
UK	7.0	3.2

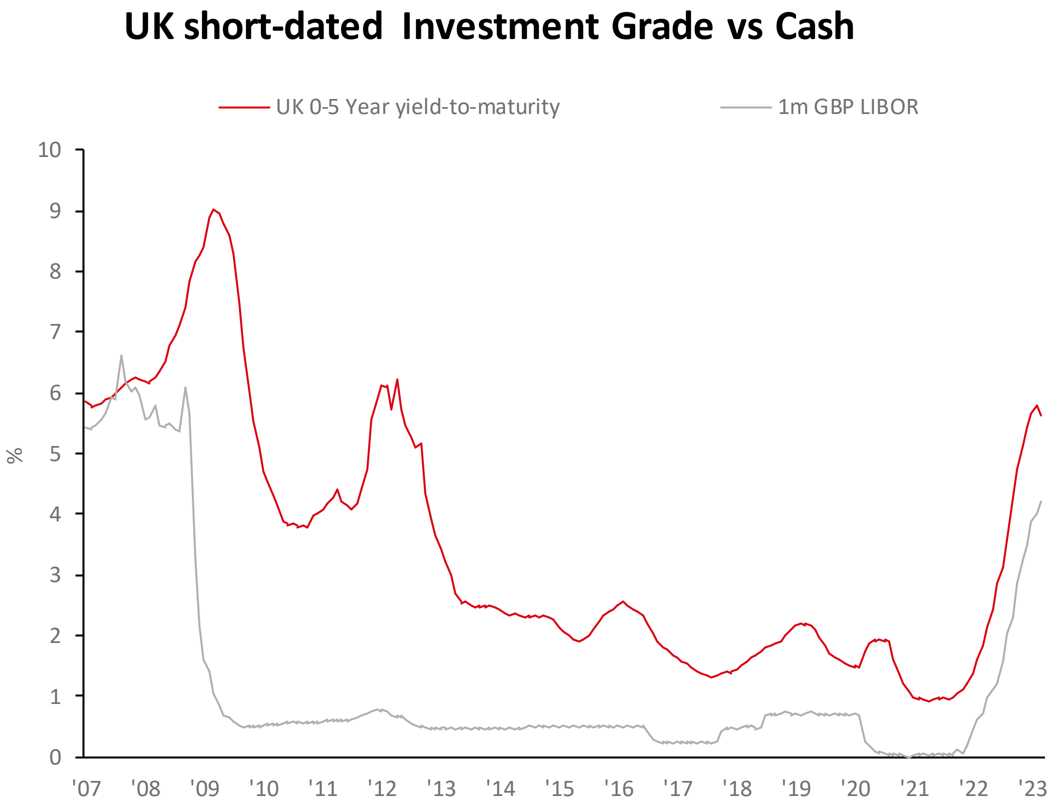
Our forecasts point to much lower headline inflation, but core is sticky



Source: ONS, HSBC forecasts

Source: HSBC Global Private Banking and Wealth, HSBC Global Research, Bloomberg data, 12 April 2023. Past performance is not a reliable indicator of future performance. Forecasts are subject to change.

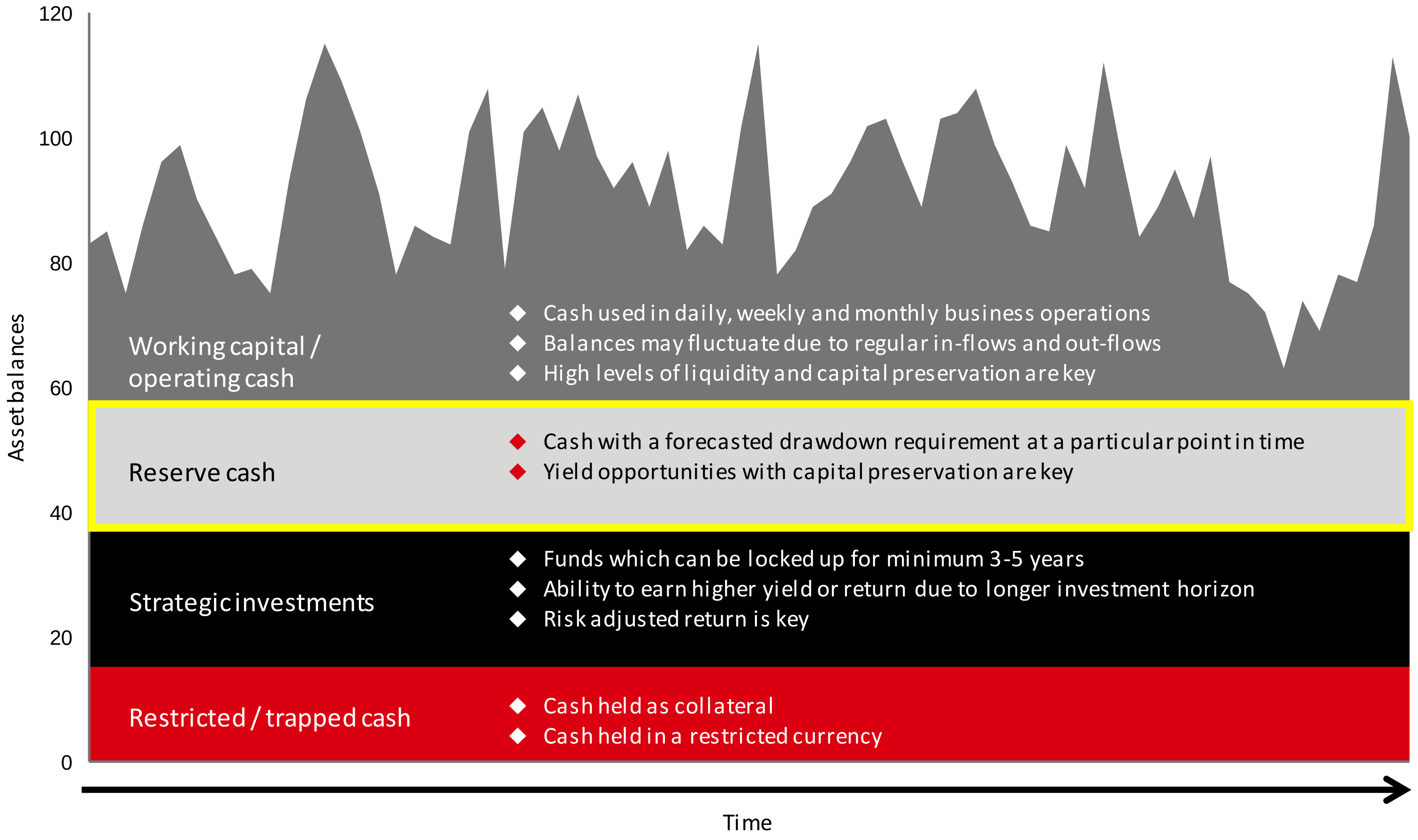
Do higher cash rates change how we invest? Yes, for now



- **Inflation will fall further** towards the end of the year
- **But Central Banks may settle for inflation nearer 3%** as debt levels remain higher and financial system fragile
- Amid tighter policy **cash yields are more attractive** but shorter-dated investment grade bonds still have the edge

Source: HSBC Private Banking, Bloomberg, 10 May 2023, Past performance is not a reliable indicator of future performance.

Reserve cash: finally some opportunities for yield enhancement



Source: HSBC Asset Management / HSBC Global Private Banking. For illustrative purposes only.

3 pool approach to reserve liquidity

Pool 1
Cash and cash deposits with varying levels of liquidity

- Current Account: 0 – 0.5%
- Cash Deposits: 2.7 - 4.2%

Pool 2
Range of AAA Money market funds offering daily liquidity

- Core Liquidity Fund: 4.58%
- ESG Liquidity Fund: 4.57%

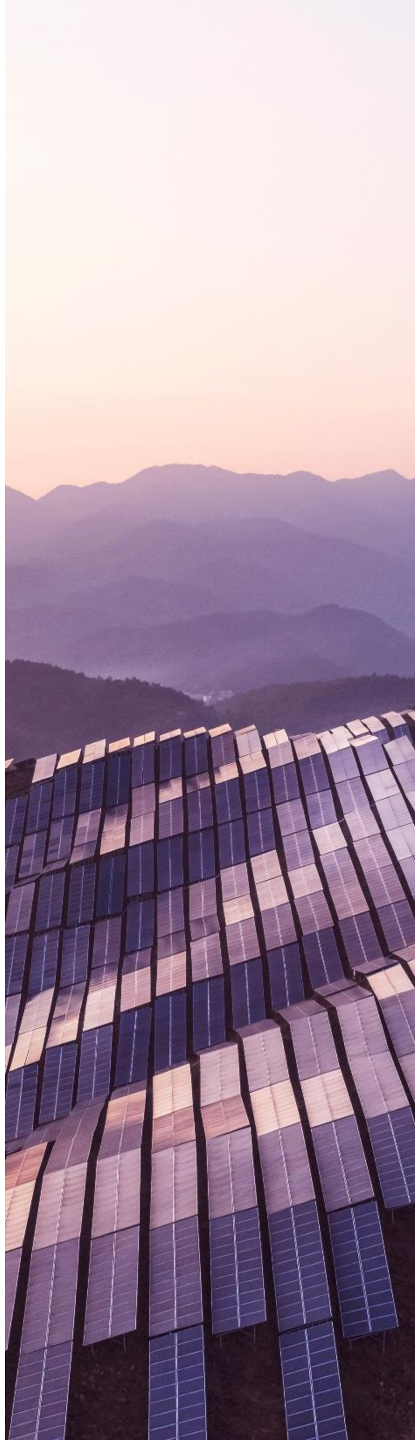
Pool 3
Longer term Yield Enhancement solutions with customisable elements to suit desired level of risk

- UK Gilts: 4.9 - 5.1% (* 1-3 years)
- Fixed & Floating Rate Notes: 5 - 5.5% (* 1-3 years)
- Corporate Bonds: 6%+ (* 5-7 years)
- Capital Protected Equity Linked Notes: 6.5 - 8% (* 3-5 years)

Tenor
- Overnight
- 1 month
- 3 month
- 6 month
- 12 month
- 24 month
- 36 month

● Indicative GBP Yield (20 June 2023)

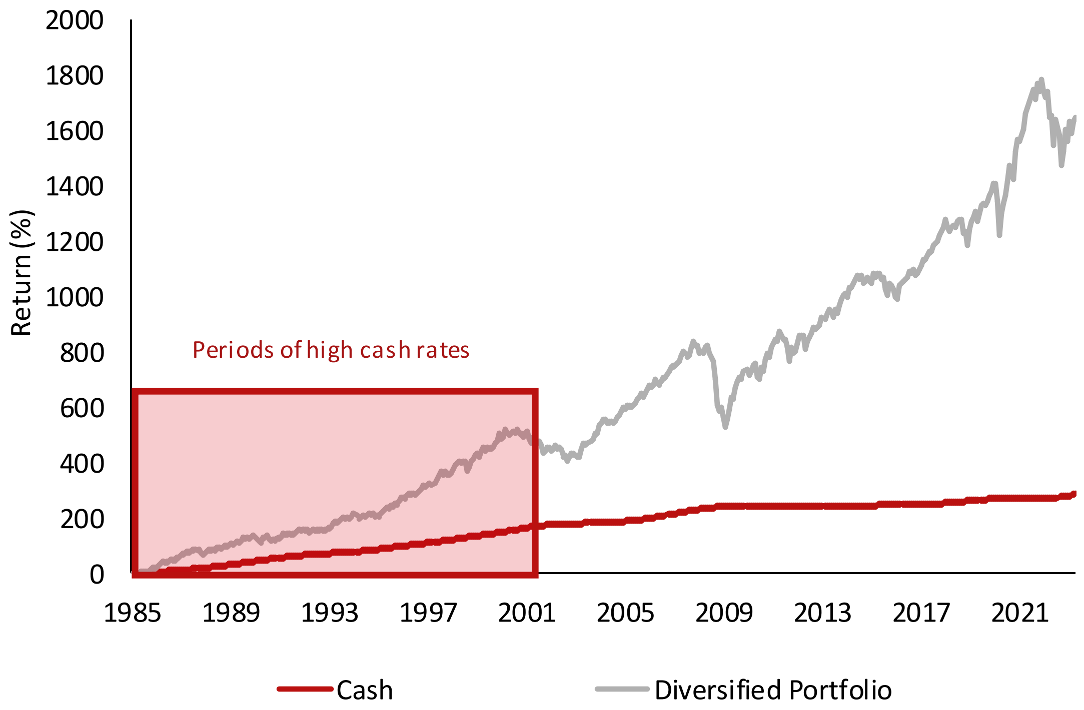
Source: HSBC Global Private Banking as at June 2023. For illustrative purposes only.



History is not kind to cash

Bonds have performed more than three times the rate of inflation over the last 50 years

Historically equity and bonds out-perform inflation, while cash struggles



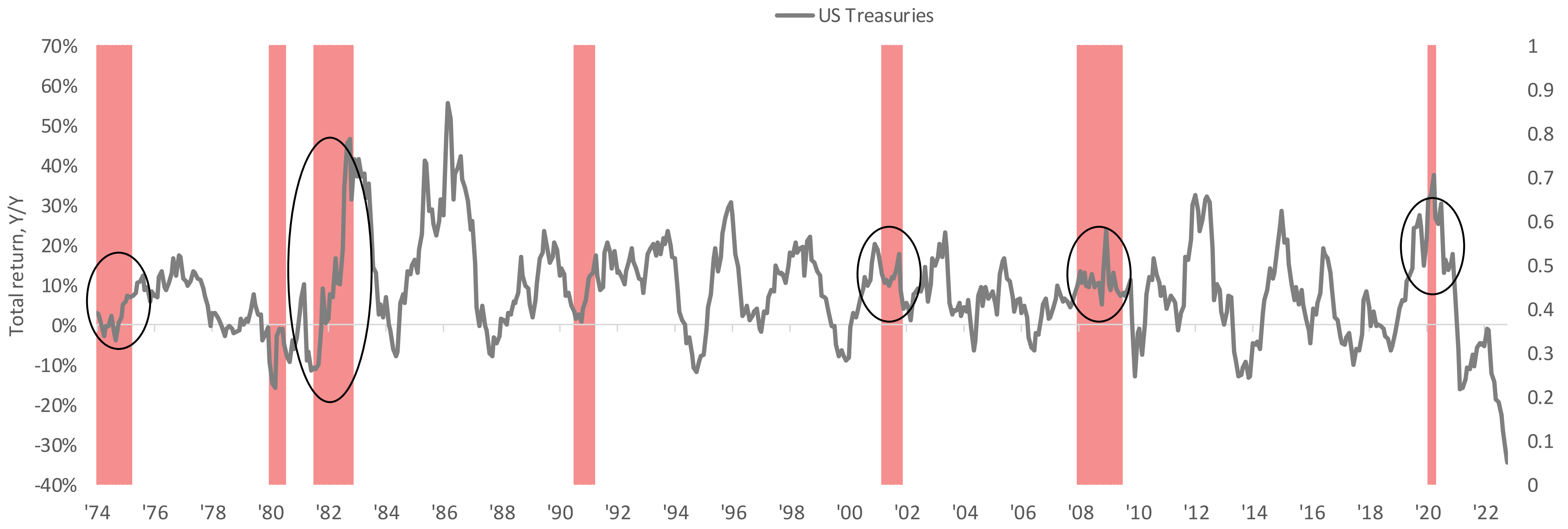
- **Inflation adjusted returns** point to clear equity gains, but with greater volatility
- Bond performance suffered a set-back in 2021, but **longer-term benefit of credit risk premium and better rate/inflation pass through**
- **Cash rarely gives a positive real retu**rn over time

Note: Asset classes are deflated by US CPI and normalised to 1 March 1973.
Source: HSBC Private Banking, Bloomberg, 10 May 2023, Past performance is not a reliable indicator of future performance.

While bonds aren't just a yield play

Bonds have the advantage of providing a potential capital return when the economy falters, with strong performance during most recessions

US Treasuries gain as recession hits



Source: HSBC Private Banking, Bloomberg, 10 May 2023, Past performance is not a reliable indicator of future performance.

What about the next 10-years?

Long-term GBP forecasts

Asset Class	Asset	Expected Return	Expected Volatility
Bonds	EM Corporate	4%	9%
	EMD Hard Currency	4%	13%
	Global Bonds	3%	5%
	Global Credit	4%	4%
	Global HY	5%	9%
	Global ILBs	4%	5%
	Local EMD	5%	14%
Equity	UK Equity	8%	13%
	US Equity	5%	16%
	Europe ex UK Equity	7%	19%
	Japan Equity	10%	18%
	Asia ex Japan Equity	8%	24%
	EM Equity	8%	20%
Alts	Commodities	5%	15%
	Global Listed Real Estate	7%	17%
	Hedge Funds	3%	12%
	Private Equity	11%	25%

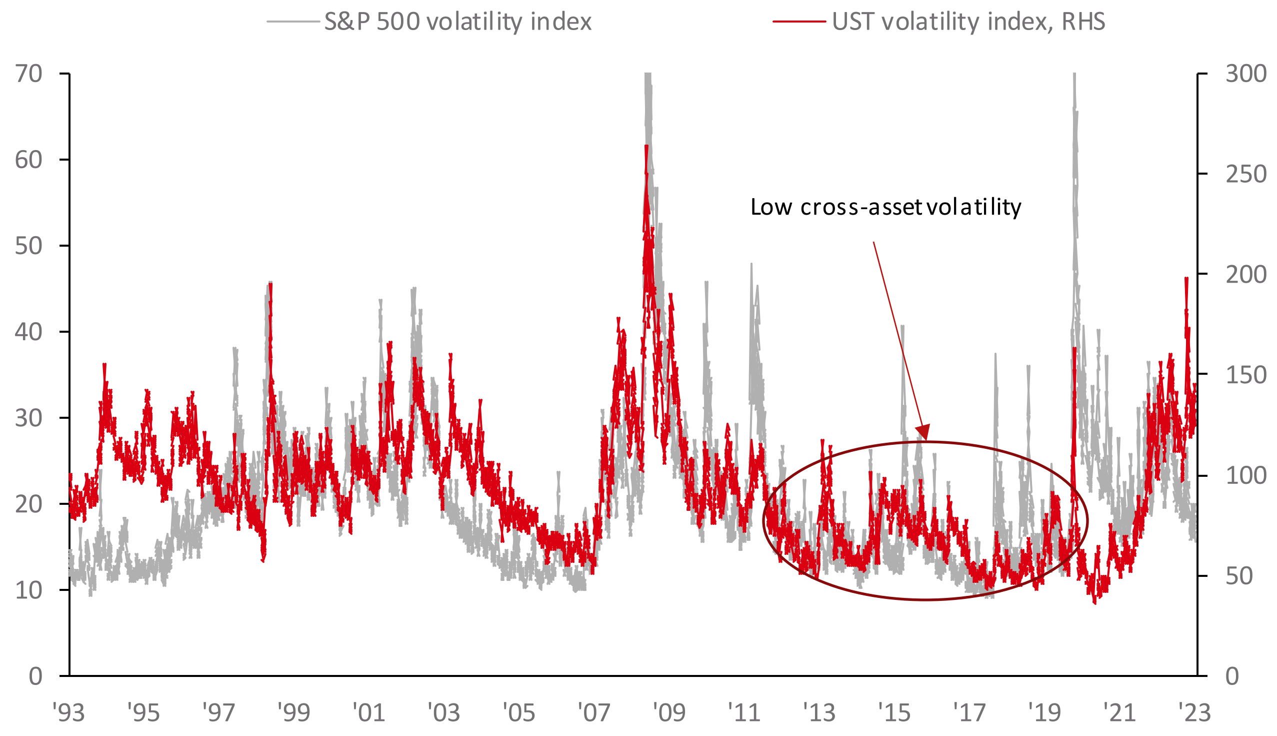
- **Forecast returns point to continued under-performance of cash:** Our longer term cash rate forecast is 2.8% for USD and 1.8% for GBP)
- **Risk = reward**: Equities still expected to offer superior growth
- **How? Generative AI** could lead to productivity gains that we haven't seen in the last 10 years
- And **Emerging Asia** growth likely to far exceed Developed Markets

Note: Asset classes are deflated by US CPI and normalised to 1 March 1973.
Source: HSBC Private Banking, Bloomberg, 10 May 2023. Past performance is not a reliable indicator of future performance.

Moving on from a "follow the Fed" regime

Volatility dynamics looking more like the late-90's than post GFC, and relationship of tech with bonds further underscores this

Volatility regime change?



Moving from sustained low cross asset volatility means:

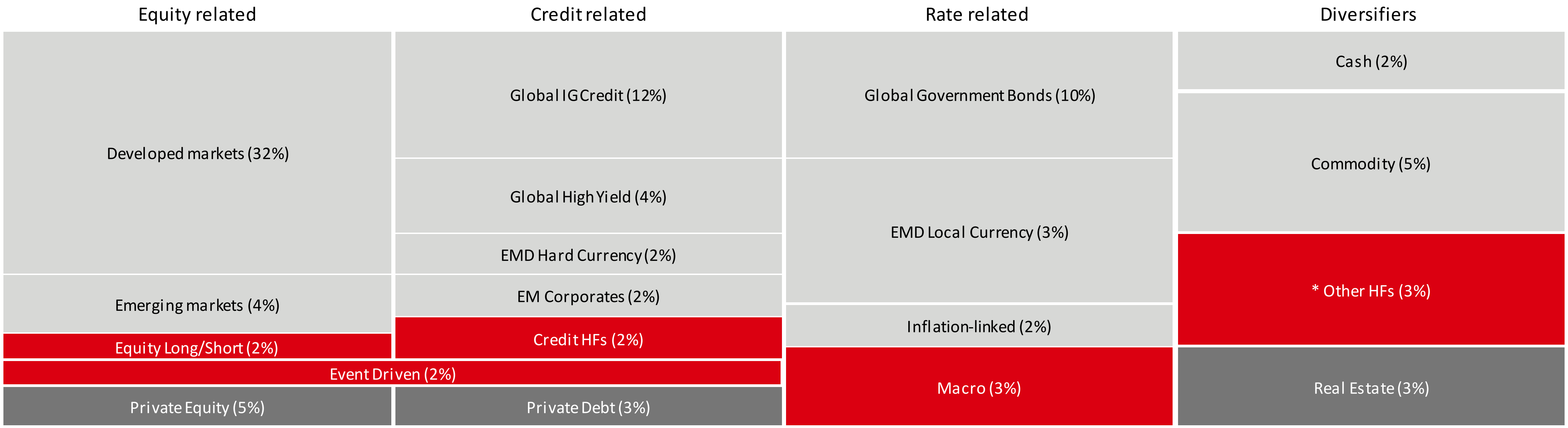
- More value in **alternatives** due to greater **opportunity set** as **investors not all positioned the same way**
- **No longer expect a simple 60/40 portfolio to out-perform –** need more diversified returns
- The **most optimal asset allocation** is for investors with a greater **"illiquidity budget"**

Source: HSBC Global Private Banking and Wealth, WSJ, Bureau of Economic Analysis, Bloomberg data, 2 May 2023. Past performance is not a reliable indicator of future performance. Forecasts are subject to change. * Note: Q3 2022 GDP data is actual data except Greece which reports on 2 May, and therefore Q3 data is HSBC Forecast.

Alternative investments in an investor’s globally diversified portfolio

An illustrative example of a globally diversified portfolio

Figure 1: Strategic Asset Allocation, Moderate risk (USD)



* Other HFs: Market Neutral, Managed Futures, Multi-Strategy
Source: HSBC Private Banking, December 2022

■ Private Markets ■ Hedge Funds ■ Liquid Markets

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Source: HSBC Private Banking. For illustrative purposes only. EMD stands for Emerging Market Debt.

In summary:

- Inflation will come down from current high levels, interest rates will take longer → consider locking in current high rates
- New structural market environment → consider illiquid assets for your longer term strategic portfolio to deliver optimal levels of diversification and performance

Any questions?

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Risk Disclosures

Risks of investment in fixed income

There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk

Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments

High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk – some high-yield bond funds may have fees and/or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions – some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles – during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.
- Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures
- Subordinated debentures – subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures – perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or canceled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures – Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under other than your local or reporting currency, changes in exchange rates may have an adverse effect on the value of that investment. There is no guarantee of positive trading performance.

Changes in legislation and/or regulation

Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalization risk

The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

Reinvestment risk

A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate.

Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to-market valuation.

Risk disclosure on Dim Sum Bonds

Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.

Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.

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There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.

Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

Risk disclosure on Emerging Markets

Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin

The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

Currency risk – where product relates to other currencies

When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan ("CNY") risks

There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products

In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

Alternative Investments

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Investments in Commodities

Investments in commodities may involve substantial risk, as the price of the commodity may fluctuate significantly.

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