# Multi-Asset Insights

## Granular portfolio considerations to support returns

October 2024

For professional investors only

HSBC Asset Management

# Table of contents

# Foreword

> We expect phases of market volatility to return in the months ahead, given various risks on the radar. A granular approach can help navigate such periods, which means considering geographic exposures and their unique implications for portfolio risk and returns.

**Jean Charles Bertrand**
Global CIO, Multi-Asset
HSBC Asset Management

Welcome to the latest edition of our Multi-Asset Insights series, where we present the findings of our quarterly Strategic Forum.

Navigating the current investment landscape amidst portfolios that have been buoyed by strong market returns, we think a granular focus on managing risks and opportunities across portfolios becomes more pertinent and can also drive the search for undervalued areas within markets. Geographic diversification should play an important role in this.

Of course, geographic diversification brings an additional set of risks for investors in the form of foreign exchange movements – notably highlighted by the ructions in capital markets this summer initiated by the unwinding of yen carry trades. In this edition of the publication, we examine how currency exposures can be managed within global asset allocations, studying the relationship between assets and FX movements. We take a look at how currency exposures can be optimised based on an intuitive and rigorous framework. We show that the standard 'one size fits all' industry approach of systematic hedging for bond exposure and unhedging for equity exposure is not optimal, and that any strategic exposure should depend on the base currency.

Separately, we investigate the potential of UK assets as a notable value opportunity in developed markets. As a serial underperformer in terms of economic growth and asset returns over the last decade, valuation discounts have extended to levels which may warrant a reversal. A continuation of promising signs of economic recovery could support a shift in market dynamics ahead, making it an opportune moment to reassess allocations to a market most investors currently have little exposure to.

As always, I trust you will find our analysis insightful and useful in the months ahead.

# In a nutshell

### Currency hedging – an evolving solution to an age-old problem

- Historical data clearly demonstrates that the average investor is better off investing globally rather than locally, due to diversification benefits and improved risk-adjusted returns.
- However, when investors take exposure to foreign assets, they face a decision regarding the associated currency exposure, which will impact returns. Various treatments for this exposure have been discussed and implemented over decades.
- Investors can hedge out their currency exposures, deploy hedging selectively towards certain asset classes, or treat currency like any other asset class in a 'full scale' optimisation.
- We explore how to optimise the hedging strategy, following a systematic approach to formalise considerations including the relationship between currencies and the asset, and the potential return of the holding currencies.

### Considering UK assets as an undervalued opportunity

- The UK economy has faced a decade of sluggish growth, averaging only 1.5% post-global financial crisis. Lack of investment and productivity growth has gone hand-in-hand with a diminished role in financial markets and corresponding valuation discounts across various assets.
- UK equities, for instance, are currently trading at a forward P/E of around 12x, offering a dividend yield of 4.1%, and a total shareholder yield including buybacks of 6%. This is almost twice the level of the S&P 500.
- Growing signs of economic recovery suggest potential opportunity for UK assets, with recent positioning towards Sterling alongside its appreciation creating a tailwind for foreign investors.
- Improved political stability and goals for enhanced EU relations could further bolster UK market confidence, and contribute to a reversal in the trend of declining international investment.

# Currency hedging – an evolving solution to an age-old problem

Global asset exposures bring with them currency risks. Converting these risks into opportunities requires careful analysis in order to both mitigate hedging costs and capture potential performance benefits.


**Nicholas McLoughlin**
Global Head of Multi-Asset Research

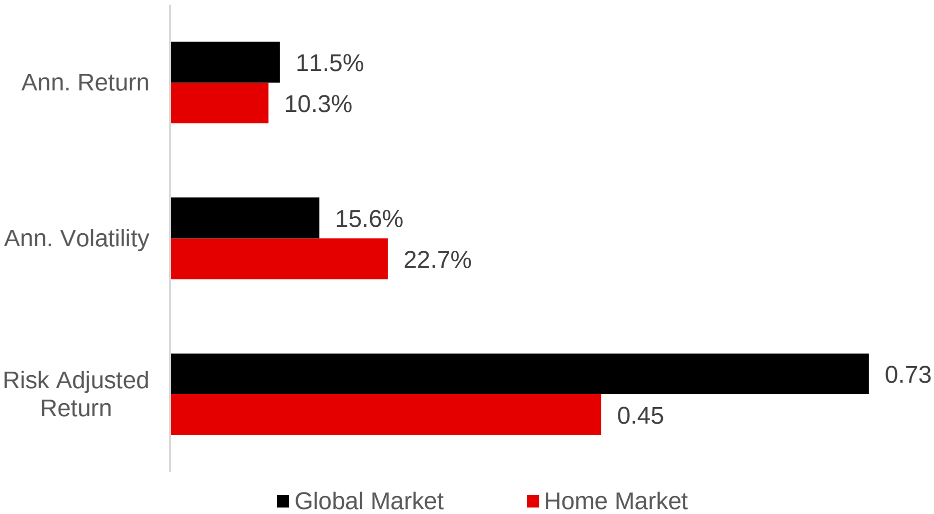

When investors take exposure to foreign assets, they have a decision to make in relation to the associated currency exposure. Over the course of several decades, there have been various treatments for this exposure discussed in academic literature and implemented by practitioners. Here, we recap the main approaches and discuss our current thinking on the topic.

### Option 1: avoid FX risk

The simplest way to treat currency exposure is to remove it from the picture entirely. One way to do this is by only taking exposure to domestic assets, and thus introducing a structural home bias to portfolios. This home bias can be detrimental to the performance of portfolios over time; at any one moment only one country can have the best performing domestic market.

Looking at the historical experience for global equity investors over the last thirty years across thirty six countries, the average investor was better off investing globally than locally. What is also notable is the diversification benefits investors receive by investing globally in the form of reduced volatility, which materially improves risk-adjusted returns.

Figure 1: Risk and return statistics for global investors relative to the average home market investor




**Past performance does not predict future returns.**
Source: HSBC Asset Management, 31 July 2024. Risk adjusted return = return/volatility.

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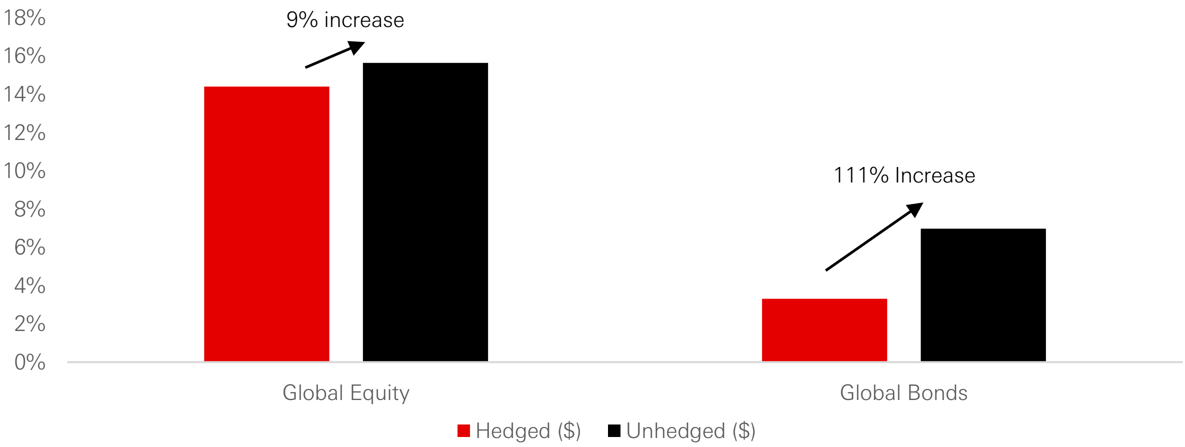
Acknowledging the benefits of investing globally, investors can alternatively hedge out their currency exposures, usually in the belief that currency is an unrewarded risk which is to be managed out of investment returns. This approach brings with it operational complexity and increased costs but achieves the goals of global diversification without currency risks.

### Option 2: vary hedging strategy by asset class

Noting that hedging can be expensive and complex, many investors deploy it selectively. This means targeting hedges towards certain asset classes such as bonds, where the underlying asset volatility is much lower than currency volatility, and thus protecting the underlying return characteristics. Typically, equities are left unhedged, since equity volatility is double that of currencies and therefore the impact of additional currency risk is marginal.

Figure 2: Volatility of global equities and bonds, from a hedged and unhedged stance, for a USD investor




**Past performance is no guarantee of future returns.**
Source: HSBC Asset Management, Bloomberg data, 31 July 2024.

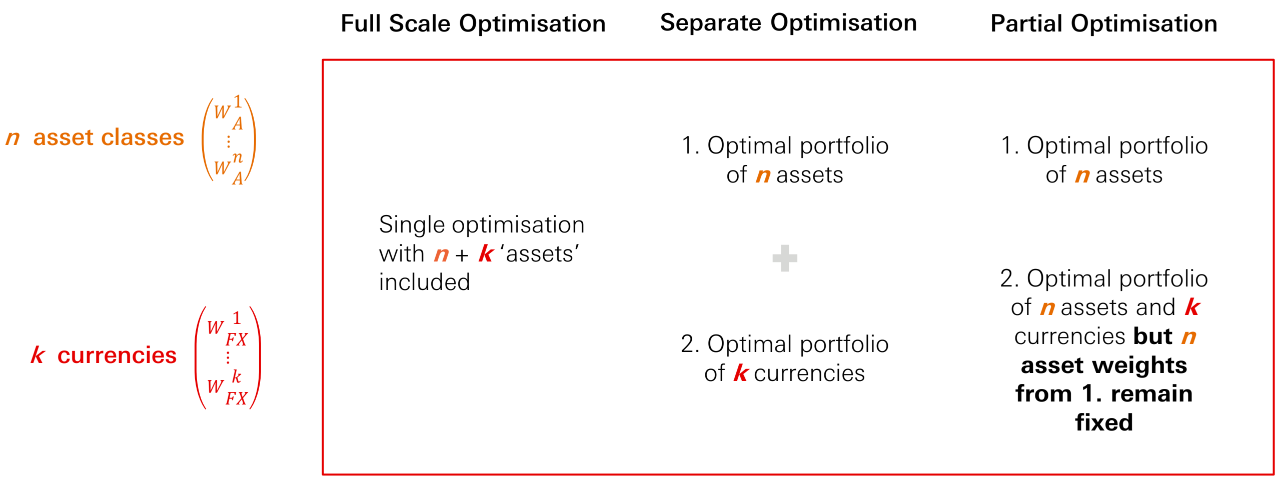
### Option 3: Full scale optimisation

Option 1 and option 2 start from a basis of asset class selection, with currency mostly a secondary concern. One alternative is to treat currency like any other asset class, and select exposures based on what is optimal in a 'full scale' optimisation. In this process, if a currency happens to be attractive given a certain investment view, traditional asset class holdings may actually be reduced or removed to make the portfolio optimal.

Because evidence of a structural foreign currency risk premium is limited (for every currency pair that gives a positive return, the 'inverse' pair gives a negative return), investors typically use currency for tactical purposes. To accommodate this, they may take a 'separated' approach and build optimal asset portfolios and currency portfolios independently. Alternatively, given an optimal asset portfolio, currency exposures can be selected which sit on top of this to improve the risk-adjusted returns in a 'partial' optimisation[1].

[1] A more detailed discussion of this can be found in Jorion, P. (1994) "Mean/Variance Analysis of Currency Overlays" Financial Analysts Journal 50:3, 48-46.

Figure 3: Optimisation menu




Source: HSBC Asset Management, October 2024.

### Which option to pick?

Although full scale optimisation is the optimal choice in theory, it has some practical limitations and challenges. Below we discuss a simplification to this approach along the lines of a partial optimisation, showcasing this through an example.

If we assume investors have pre-selected a portfolio weight to an asset class based on their risk tolerance or investment goals, we can look at how the optimal currency hedging stance changes in light of i) the risk relationship between currencies and the asset, and ii) the potential return to holding currencies. This can be formalised by the equation below[2]:

$$w_{FX}^* = \frac{\sigma_R \mu_{FX} - \rho \mu_A}{\frac{1}{\sigma_R}\mu_A - \rho \mu_{FX}} \qquad (1)$$

Where $w_{FX}^*$ is the optimal currency exposure, $\sigma_R = \frac{\sigma_A}{\sigma_{FX}}$ is the ratio of asset volatility to currency volatility, $\rho = corr(R_A, R_{FX})$ the correlation between asset and currency returns, $\mu_A$ the asset excess return and $\mu_{FX}$ the currency excess return. To keep the focus on hedging and not outright currency risk taking, for simplicity we assume $w_{FX}^*$ will range between zero (asset fully hedged, no currency exposures) and 100% (fully unhedged).

The equation does not give a lot away to a practitioner in terms of the intuition behind the result and consequences for investment. However, if we introduce an assumption of Uncovered Interest Parity (UIP: $\mu_{FX} = 0$), the equation simplifies materially: $w_{FX}^* = -\rho\sigma_R$.

Immediately we find an important result; the higher the correlation between asset and currency, the smaller the foreign FX exposure. Introducing some numbers, based on global equities and taken from the perspective of investors with a selection of base currencies[3], we find the following optimal foreign currency exposures:

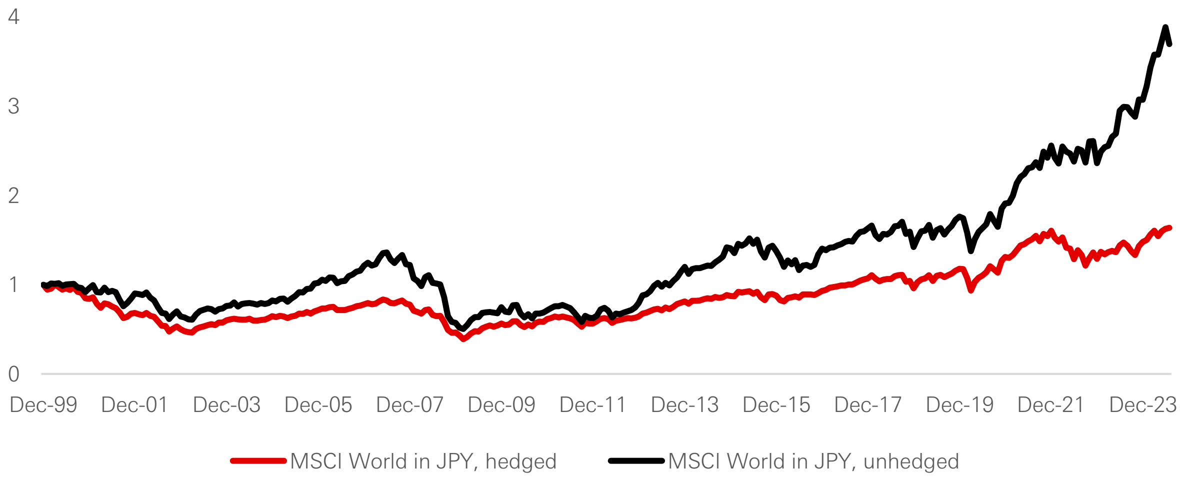
| GBP | EUR | CHF | JPY | AUD |
|---|---|---|---|---|
| 54% | 54% | 28% | 0% | 81% |

[2] See Mcloughlin, N (2023). "Yet another currency hedging paper" SSRN working paper 4426160 for a derivation of this result.
[3] We exclude USD as it is the dominant currency in global equity exposures and so the differences between hedged and unhedged stances is relatively minor.

This 'minimum variance' result is a classic finding in research literature[4]; the more cyclical an investor's base currency, the more they benefit from global currency exposures associated with their equity holdings (cf. Japanese investors vs Australian investors).

The simplifying assumption of UIP for currency returns might however be too extreme, and indeed there is limited empirical evidence for this relationship holding in the data. This is a critical learning for Japanese investors in particular; the realised outcome of not holding FX exposures on the basis of UIP would have been quite detrimental to potential returns in recent years.

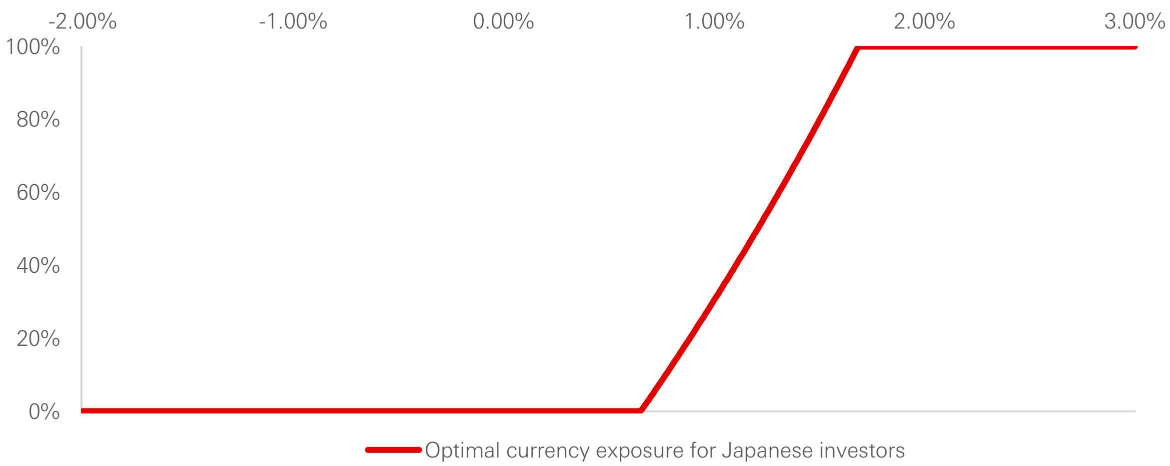
Figure 4: Global equity returns denominated in JPY hedged and JPY unhedged terms




**Past performance is no guarantee of future returns.**
Source: HSBC Asset Management, Bloomberg data, August 2024. Indices rebased to 1 as at 31 December 1999.

It is therefore important to understand the role prospective returns have in the relationship outlined in equation 1. To do this, we plot the trade-off between the expected global currency return and the associated currency exposure:

Figure 4: Relationship between expected global currency returns and currency exposure for Japanese investors




Source: HSBC Asset Management, October 2024.

[4] Campbell, J. et al (2010). "Global Currency Hedging", Journal of Finance February 2010 Volume 65 Issue 1

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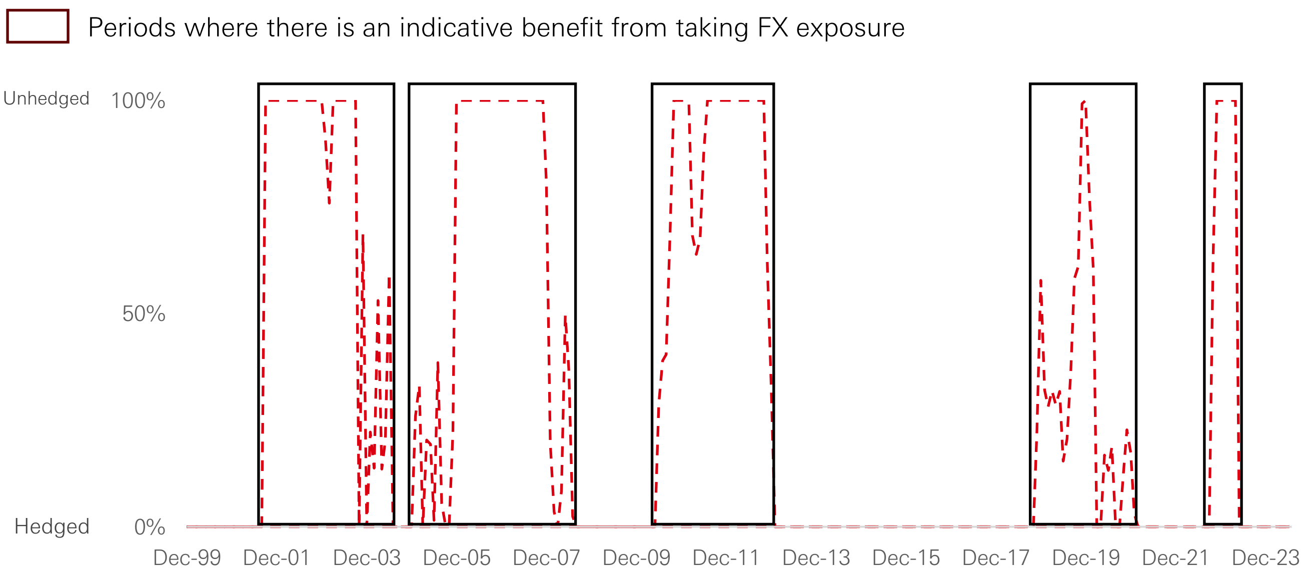
We can see that when currency excess returns are expected to be zero, as is the case under UIP, Japanese investors should be fully hedged. However, as the expected return to holding currencies approaches 1%, the currency hedge is gradually reduced, and beyond a 2% return investors would benefit from a fully unhedged exposure.

The source of currency return comes in two parts; the change in spot exchange rates over the holding period, and the interest rate differentials embedded within currency forward contracts typically used for hedging. For Japanese investors over the past decade, both JPY weakness (-3% annualised vs MSCI World basket) and a low level of interest rates (-1.1% annualised carry on currency hedges) would have pushed the overall ex-post currency return strongly positive, therefore highlighting the improvement that would have been gained by leaving currency exposures unhedged.

Looking back over the past two decades for Japanese investors can demonstrate the usefulness of our framework as an indicative guide in FX hedging decisions. Using a simple currency valuation model to forecast spot currency returns, we see that for the 2014-2017 period, a hedged stance would have been deemed suitable - global interest rates were close to zero and post-2013 weakness, the currency remained fairly stable on a real effective exchange rate basis. In more recent times however, interest rate differentials have widened whilst the yen has cheapened materially, mostly producing offsetting effects to the currency stance but at times highlighting the motivation for taking on global currency exposures.

Figure 6: Implied optimal currency exposure for Japanese investors




**Past performance is no guarantee of future returns.**
Source: HSBC Asset Management, August 2024.

When following this framework, the optimal currency stance is sensitive to a variety of inputs, and therefore the frequency of revision and horizon of the view embedded within those inputs needs to match investor timeframes. Given a high degree of uncertainty in the space of FX forecasting, conservative assumptions which place more emphasis on risk properties rather than return forecasts might be the pragmatic way to approach medium-term hedging decisions.

# Considering UK assets as an undervalued opportunity

> Our house view projects a 'great rotation' ahead in markets, with laggards set to play catch up. In developed markets, UK assets are worthy of closer examination as a potential value stand out.

**Lane Prenevost**
Global Head of Discretionary Asset Management and Head of UK Multi-Asset

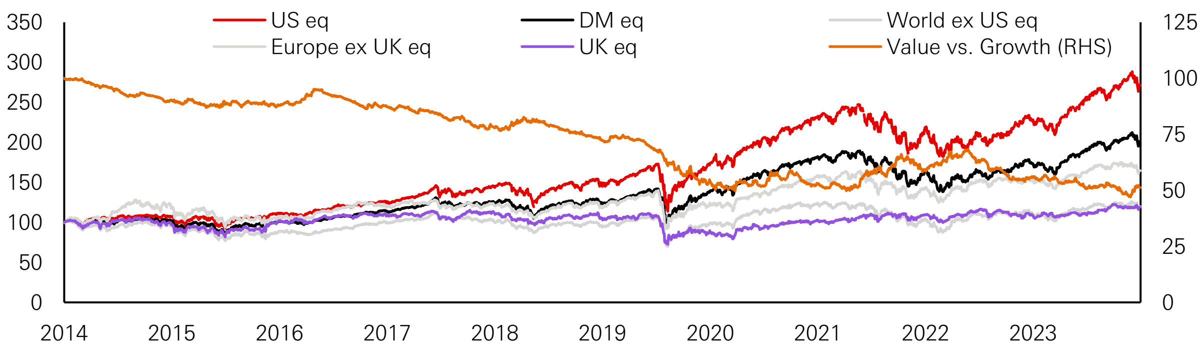
**Ryan McGARRY**
Investment Analyst, UK Multi-Asset

The UK economy and its capital markets have experienced a challenging period during the past decade, with a myriad of factors contributing.

From 1993 to 2007, the UK experienced annual GDP growth averaging 3%. However, this growth rate halved following the global financial crisis, averaging 1.5% between 2009 and 2023. Most developed markets also struggled after the crisis, but the UK never regained its pre-crisis growth trajectory, unlike the US. Per analysis by the International Monetary Fund, sluggish productivity growth and the smallest proportion of investment in GDP among the G7 are the primary reasons for this weak performance.

The US, and by extension the developed markets universe, has embraced technology and innovation, driving exceptional growth in past years. However, the UK remains more reliant on traditional sectors like consumer staples, financials, and energy. This has contributed to challenges in productivity and long-term growth, while the concentration of lower growth sectors has created a structural 'value' bias that has weighed heavily on UK equity market performance.

Figure 1: Developed market equity performance and underperformance of the value factor




**Past performance is no guarantee of future returns.**
Source: HSBC AM, Bloomberg. Data as of August 2024. Index values rebased to 100 as of August 2014.

Alongside this disappointing performance, the UK's global financial standing has diminished. The London Stock Exchange (LSE) now struggles to compete with other major exchanges, such as the NYSE, NASDAQ, and Hong Kong's Hang Seng. The LSE attracted around one-fifth of global public listings in 2005. That proportion has now dropped to only 1%. The UK's weight in the MSCI ACWI index has been dropping at the same time, more than halving from 7.1% to 3.4% over the last decade.

This has been underlined by the decline in net international investments in UK assets and a depreciating currency.

Figure 2: Net international investments in UK – FDI as % GDP

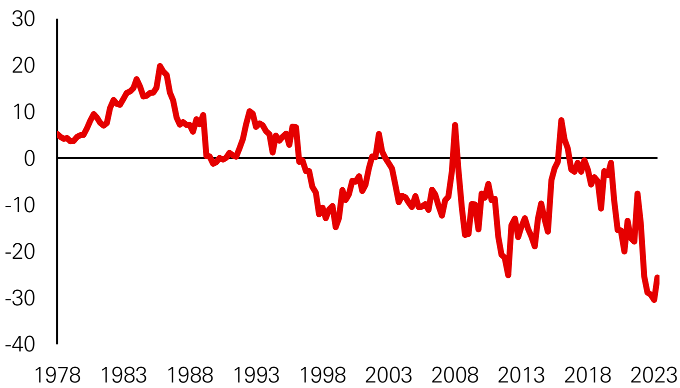
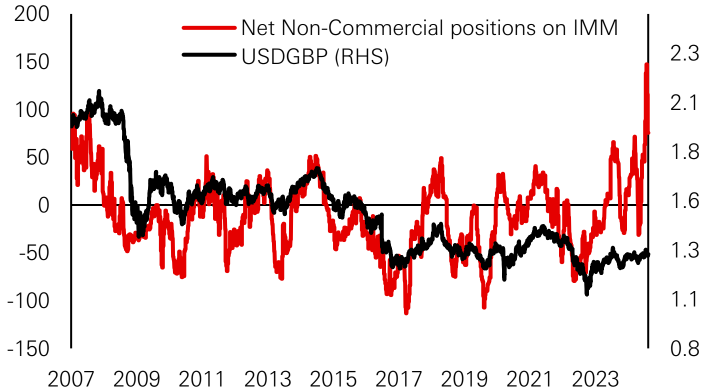



Figure 3: GBP positioning over the years




**Past performance is no guarantee of future returns.**
Source: HSBC AM, Bloomberg. Data as of August 2024. IMM = The International Money Market

However, the sharp reversal in GBP positioning, per the net non-commercial positions above, aligns with our view of positive signals emerging for UK assets. Clear challenges remain, but we will explore these and the positive developments that may indicate a reversal in the trend of the last decade for UK assets. Given UK allocations in most global portfolios are now quite small and not very impactful, a closer look at those allocations may now be warranted as we position for a rotation in market leaders.

## Economic green shoots

The UK economy has shown some signs of recovery in recent quarters, with the purchasing managers index increasing steadily since November 2023. Second quarter GDP growth was 0.63% quarter-on-quarter, marking the second consecutive quarter of growth. While growth still lags that of the US, the UK has fared better than the Eurozone of late.

Although consumer spending remains sluggish, real income growth has improved, and household savings rates exceed their long-term averages - a contrast with the much lower savings rates seen in the US. Over the medium term, though, rising fiscal pressures from accumulated budget deficits will remain a headwind for households, while previous interest rate hikes continue to exert a drag on consumer spending.

Figure 4: Purchasing Managers' Index (PMI) comparison

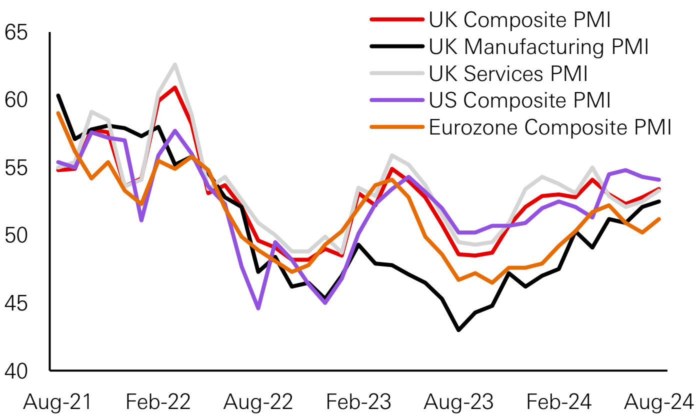
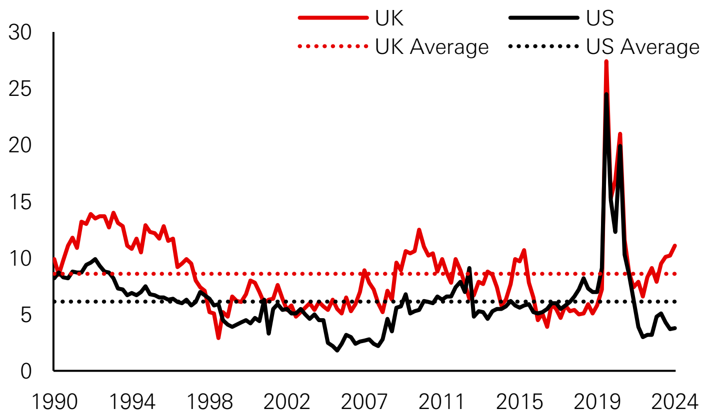



Figure 5: Household savings rate (%)




Source: HSBC AM, Bloomberg. Data as of August 2024.

In the labour market, unemployment rates have remained relatively low. However, the official measure may be somewhat distorted by low response rates. We have seen the latest surveys point to easing labour demand, with job vacancies continuing to decline. While manufacturing and services sector jobs are holding up relatively well, there has been particular weakness in the construction industry.

Private sector wage growth has softened but remains elevated, signalling a generally strong labour market. Notably, there was a considerable drop in public sector wages in the June print, offering encouragement for easing inflation concerns. To this point, the headline inflation rate dropped to 1.7% in September, below the Bank of England's inflation target of 2%. The medium-term inflation outlook, however, remains uncertain. While core inflation has eased, inflation in the services sector remains higher, at around 5%. This can complicate the trajectory of future rate cuts needed to stimulate growth after the 25 basis point cut in August.

Figure 6: Wage growth in public vs private sector

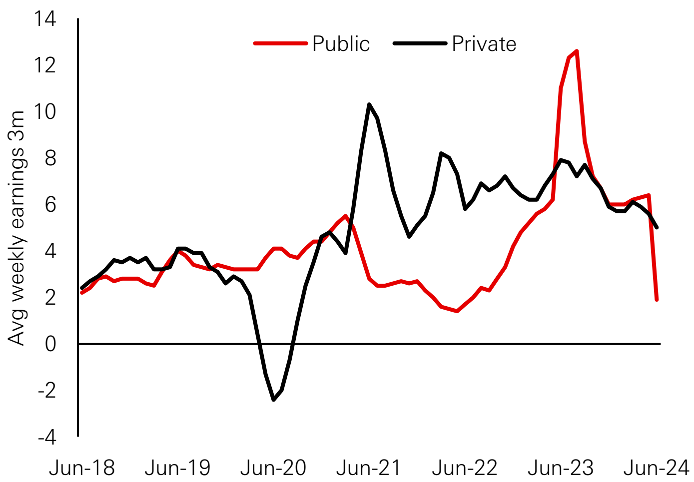
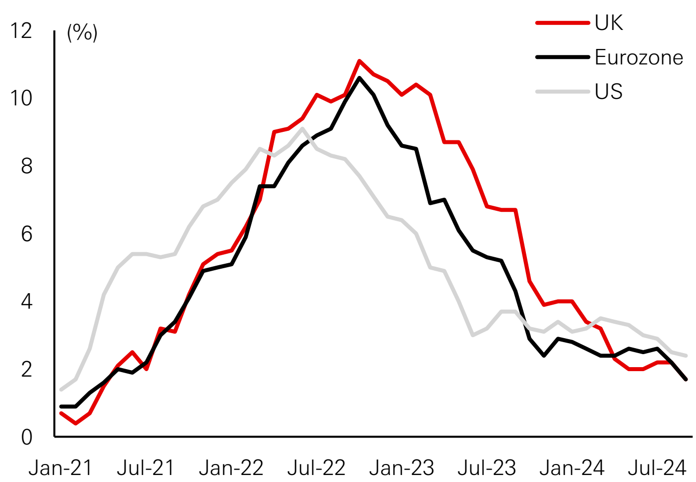



Figure 7: Headline CPI (%)




Source: HSBC AM, Bloomberg. Data as of September 2024.

### Fiscal challenges

The UK's current fiscal position poses some serious challenges for the newly elected government. Public expenditure has increased in recent years, similar to other developed markets, rising from roughly 35% of GDP in the early 2000s to approximately 41% in 2024. Notably, health expenditure has almost doubled from around 4.5% of GDP to 8%, reflecting the increasing strain of public health services. More concerning is the increase in interest payments on debt, which have doubled to roughly 4% of GDP.

Recent government spending has continued to exceed expectations, to the tune of £17 billion in the last fiscal year. The rise in public spending has coincided with a relatively large increase in tax receipts, growing from 32% of GDP in 1992 to around 40% now. Yet, this creates a difficult situation for the government today, as the existing tax burden on consumers cannot be realistically pushed higher to support new public spending commitments.

Fiscal deficits have been a staple of the UK since the early 2000s. Net debt as a percentage of GDP has grown faster than its developed market peers, and now sits just shy of 100%. This fiscal path is clearly not sustainable, leaving limited options for spending to support growth. Labour's plans to borrow £17.5 billion over five years to fund green investments, for example, leaves little room for additional spending without exasperating the debt burden.

Figure 8: UK government tax receipts (% of GDP)

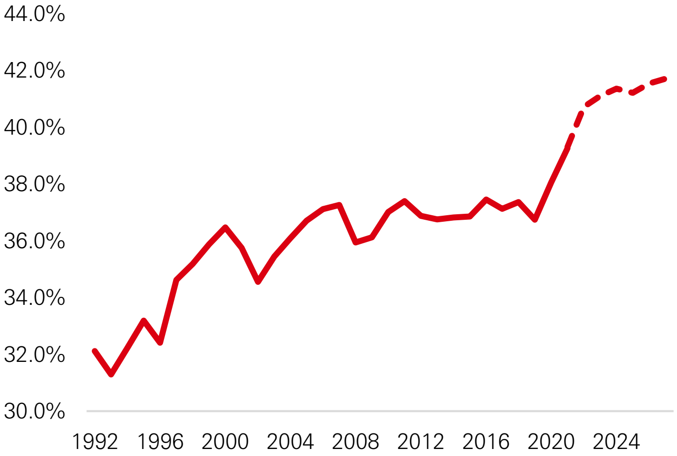
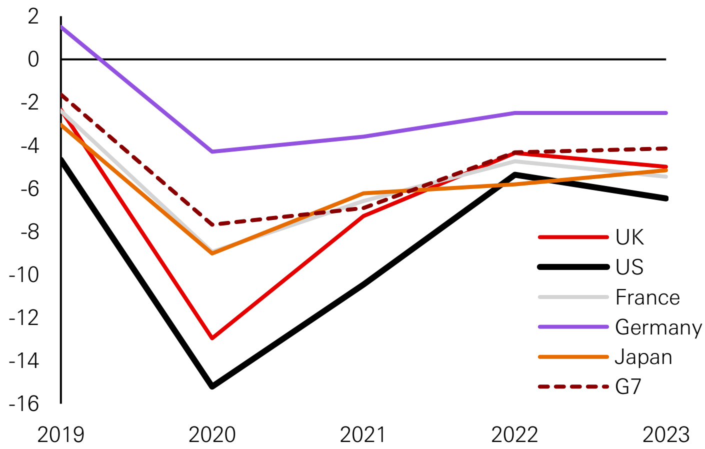



Figure 9: Fiscal deficit as a % of GDP




Source: HSBC AM, Bloomberg. Data as of August 2024.

**Policy impact**

The 2024 general election marked a significant shift in UK economic policy, as the Labour Party secured a landslide victory. With a strong mandate, the new government has committed to enacting a series of economic reforms to achieve a balanced budget and ensure that debt as a share of GDP falls by the end of its first term. Labour's economic strategy includes supply-side reforms aimed at boosting productivity, as well as plans to attract £3 of private investment for every £1 of public spending in key sectors such as carbon capture and electric vehicle production, supported by the National Wealth Fund.

In order to enhance fiscal transparency and accountability, Labour has also pledged to involve the independent Office for Budget Responsibility (OBR) in scrutinising any changes to taxation and spending. Although the new government has refrained from raising taxes on working people, they have introduced measures to increase revenues, such as extending the energy profits levy, removing VAT exemptions for private schools, and closing tax loopholes for private equity. These measures are expected to raise around £7 billion, of which £5 billion will be spent on public services. Corporation tax is set to remain at 25% throughout the first parliamentary term.

Lastly, the government has also promised to build 300,000 homes annually, liberalising planning rules to encourage more housing development. However, concerns remain about the feasibility of Labour's fiscal plans without compromising somewhere on public spending or introducing yet more tax increases. The Institute for Fiscal Studies (IFS) has already warned that the government risks breaking its own fiscal rules if it continues to increase borrowing for green investments while also maintaining high public spending levels elsewhere.

## Considerations for portfolio construction

Based on our tactical allocation signals framework, Sterling currently stands out ahead of all other developed market currencies – fundamentals are broadly supportive, as are factors like momentum, plus its carry is high. While we feel the currency is now starting to look expensive, a more hawkish Bank of England could support further Sterling gains, particularly if the services inflation outlook doesn't improve enough.

Further support could come in the form of Labour's goals for improved EU relations, which could facilitate growth in trade. Less government instability, which has been a mainstay since Brexit, offers another positive for Sterling going forward. While pros appear to outweigh cons, there are important risks, such as the challenge of the UK boosting its productivity and growth longer-term, alongside the risk of fiscal slippage and growing debt.

In the bond market, gilts have outperformed US treasuries and German bunds over the past 12 months, at time of writing. Although real yields are now slightly less attractive than the US, they remain better than bunds. Furthermore, the slope of the gilt curve carry offers more attractive carry than both treasuries and bunds. However, risks to gilt returns arise if economic acceleration reduces the need for rate cuts, or should services inflation remain sticky.

Figure 10: 10-year bond returns (rebased to 100 at August 2023)

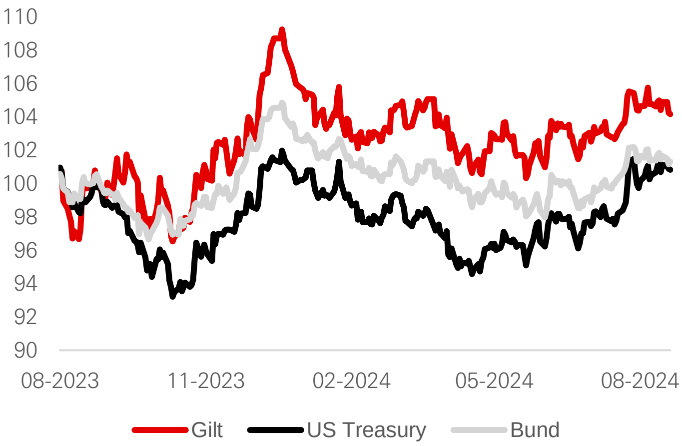
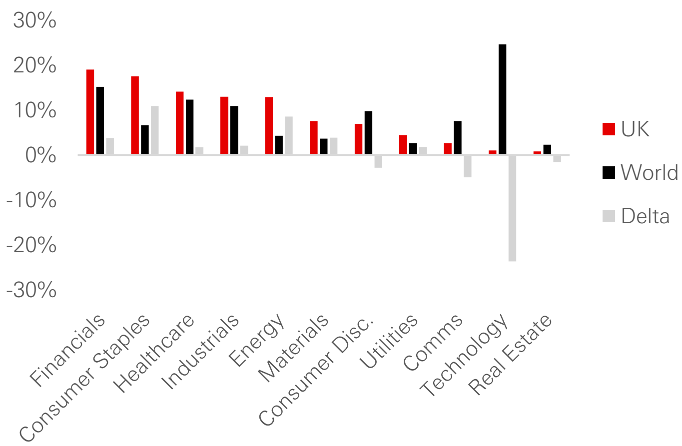



Figure 11: UK equities are relatively cheap, even when accounting for sector differences and a large tech underweight




**Past performance is no guarantee of future returns.**
Source: HSBC AM, Bloomberg. Data as of August 2024.

UK equities are trading near their lows with a forward P/E of around 12x, which is certainly cheap compared to developed market peers. Even if adjustments are made to account for differences in sector composition, UK equities still appear to be a bargain. Alongside the valuation discount, an important benefit for investors is the high dividend yield offered, with the FTSE 100 delivering a dividend payout ratio of 4.1%, and a total shareholder yield including buybacks of 6%. This is almost twice the level of the S&P 500. The standout yield offered will become more appealing as interest rates fall, boding well for UK stocks as slowing global growth poses challenges to markets elsewhere.

Domestically-oriented UK equities have recently shown some signs of strength, with the FTSE 250 index rising by 13.7% since October 2023, compared to just under 4% for the FTSE 100. The FTSE 250, with its higher allocation to consumer discretionary and real estate sectors offers a more direct play on UK growth and its recent positive surprises. In contrast, the FTSE 100 is more exposed to energy and defensive sectors with a greater proportion of overseas sales.

It is important to note that growth risks that could lead to UK equity outperformance versus the rest of the world would likewise hurt the performance of UK small caps versus large caps. Economic deceleration and a need for the Bank of England to ease monetary policy more aggressively would hurt domestic stocks through both lower revenue potential and the additional headwind of a weakening GBP. Conversely, further Sterling strengthening will act as a material headwind for large cap UK companies with overseas earnings. Accordingly, we advocate for balancing the potential outcomes of these scenarios, preferring exposure to both smaller and larger cap UK equities.

Moving on to real assets, which we think offer important portfolio diversification, the UK property market has demonstrated resilience over the last few years. An equally sharp recovery has followed the sharp correction in 2020, driven by an increase in volumes, increasing rental incomes as well as anticipation of easing from the BoE contributing to price growth. Despite a soft spot in industrials spaces, rents have been rising for retail as vacancy rates have fallen. London office rents are also rising despite higher vacancy rates, reflecting stronger growth for prime stock as occupiers have increasingly concentrated on higher quality space.

Notable to the opportunity in UK real estate is that listed market valuations still trade at discounts to NAV, lagging behind other developed markets. Elsewhere in real assets, UK infrastructure remains a relatively stable investment opportunity, given its focus on essential services and strong cash flow generation. UK infrastructure assets remain among the highest quality globally and represent a large portion of the global investable universe, with dominant market positions supporting cash flows. And these infrastructure companies stand to benefit from any capital flows arising from the new government’s plans such as housing development and pension reform.

Figure 12: Property market capital growth (% q-on-q)

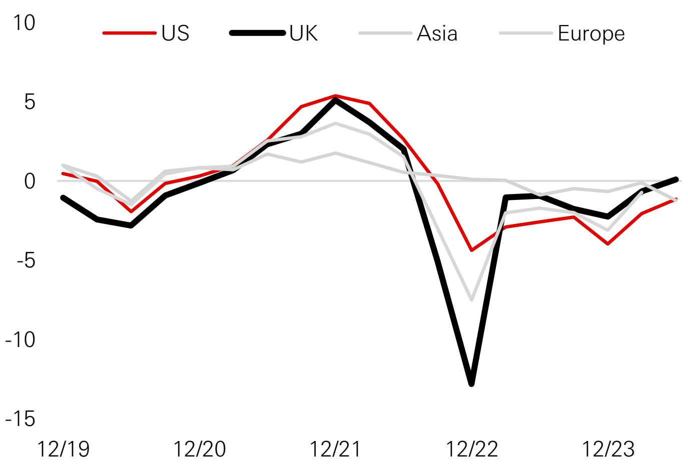
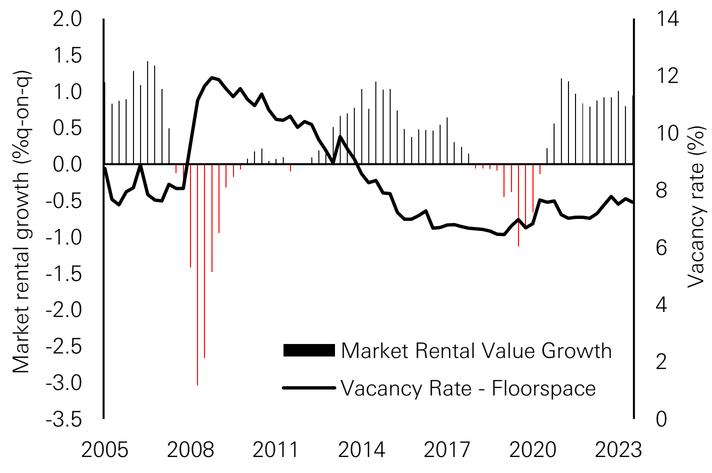



Figure 13: Aggregate UK rental property activity




Source: HSBC AM, Bloomberg. Data as of August 2024.

Overall, should newfound political stability be achieved, we think it can serve as a catalyst for more interest/supply for UK capital markets broadly, which can reverse the last decade’s trend of growing valuation discounts to developed peers. While risks to this outcome are evident, we believe exposure to UK assets are appealing today and warrant a closer look by investors whose allocations have become minimal over recent years.

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