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## Investment Intelligence

October 2009



### Brazil is not just a commodity play

- ▶ Brazil has largely benefited from the sharp rally in commodities this year
- ▶ Besides commodities, robust domestic demand has become an increasingly important growth driver of Brazil. Important events like the 2014 World Cup and 2016 Olympic Games should continue to boost Brazil's infrastructure, consumer and service-related sectors
- ▶ Given the attractive valuations, solid earnings growth and strong capital inflows, the Brazilian market outlook remains positive

Despite the difficult global environment, to date, 2009 has been a very good year for commodities\*. Hard and soft commodity prices have risen across the board. For instance, gold advanced to a record high of over US\$1,000/ounce while sugar has surged by more than 100%.

Generally, the commodity outlook should remain positive in the medium to long term, as the global economy continues to improve gradually. Solid income growth and infrastructure spending in emerging economies should also create a sustainable demand for both hard and soft commodities going forward.

#### Brazil has benefited from the commodity rally

As one of the world's largest producers of hard and soft commodities<sup>^</sup>, Brazil has benefited from the recent strong run of commodities.

As a major oil and metal producer in the world, Brazil is one of the key beneficiaries of the sharp rebound of energy and metal prices. On the soft commodity front, low labour and land costs give Brazil a price advantage in the export market. Taking the Brazilian pulp producers as an example, they are among the world's lowest cost producers and operated at near full capacity even during the crisis.

#### Strong domestic demand has boosted the economy as well

Aside from commodities, robust domestic demand has become an increasingly important growth driver of Brazil. At present, consumer spending contributes to over 60% of Brazil's GDP, and much of the economic recovery has been driven by the sturdy domestic market.

Thanks to the strength of the domestic market, coupled with the help of government intervention and aggressive monetary easing, Brazil surprised the market with GDP expanding by 1.9% q-o-q in 2Q 2009<sup>1</sup>, and pulled the economy out of its first recession since 2003.

*\*Source: Bloomberg. Returns are in USD terms. Data from 31 December 2008 to 30 September 2009*

*<sup>^</sup>Source: USDA, US Department of the Interior and US Geological Survey. Data as at 31 August 2009,*

## Consumption trend should remain strong

Positive job creation and wage growth, coupled with tax breaks, record low borrowing costs and increased government spending are driving consumer spending. After peaking at 9% in March 2009, unemployment has fallen steadily to 8.1% in August<sup>2</sup>. Minimum wage was raised by 12% and interest rate was slashed to a record low of 8.75% from 13.75% at the end of 2008<sup>3</sup>.

All of the above catalysts have created a consumption boom in an economy that is under leveraged on both an individual and corporate basis and this trend will likely continue.

## Infrastructure spending is likely to increase

Similar to China 10 years ago, the next and most important development for Brazil is that it is about to undergo a massive infrastructure development phase. For instance, a public-private partnership scheme worth an estimated US\$250 billion has been approved as part of the country's "acceleration-for-growth programme".

## The World Cup and Olympic Games will speed up these investments

More importantly, with the 2014 World Cup and the 2016 Olympic Games approach, the Brazilian economy will be boosted by higher infrastructure spending, such as the improvement of airports, construction of stadiums, and the enhancement of transportation systems.

The government estimates that total investment spending of about US\$58.9 billion will be involved in these two global events. Such spending should significantly boost the outlook for infrastructure-related sectors such as base materials and construction.

During these events, the influx of foreign visitors should boost consumer and service-related sectors, notably travel-related industries such as airlines, hotels and retails.

## Another credit rating upgrade

The investment rating of Brazil has been raised to investment grade by Moody's in September 2009. Moody's was the last of the three leading ratings agencies to raise its rating for Brazil, with S&P having upgraded Brazil in April and Fitch in May 2008.

Such recognition reflects that the fiscal status of Latin America's largest economy remains strong. Brazil's international reserve increased to a record high of US\$224.2 billion in September this year<sup>3</sup>, and its banking sector faces minimal stress amid the global financial crisis.

The investment grade credit rating will help to stimulate more foreign capital inflows into Brazil. The rating upgrade should also attract longer term capital flows for the local stock and bond markets.

## Brazilian market remains attractive in terms of earnings growth and valuations

With the above catalyst, the Brazilian market has surged by one fold year-to-date and the MSCI Brazil Index have risen by 101.9% as of end September 2009<sup>4</sup>.

Despite the recent rally, the Brazilian market outlook remains positive in the medium term. Corporate earnings are expected to grow by 24.7% in 2010, after declining by 11.2% in 2009<sup>5</sup>. The key drivers for earnings recovery are: 1) robust domestic market; 2) lower financing costs; 3) stronger commodity prices; and 4) a stronger currency.

As for valuations, Brazil is among one of the most attractive markets in the world. The Brazilian market, which is the largest and most liquid market in Latin America, is trading at a forward P/E of 12.6 times, representing a 11.2% and 6% discount to global and Latin American equities, and at 6.0% and 26.7% discount to China and India respectively, based on consensus 12-month forward P/E<sup>5</sup>.

With these reasonable valuations, Brazilian equities saw inflows of R\$29.4 billion as at end September. With the increasing participation of local players, mainly retail and institutional investors, strong capital inflows should remain a key driver for the Brazilian market, together with the solid macro picture and recovering earnings expectations.

## Downside risk

Despite the positive outlook on Brazilian market, certain considerations remain. Brazilian equities can be volatile, and given the rally this year, some profit taking in the near term is possible. Apart from that, external developments may also have an impact. If the global macro economic picture turns down sharply, this may affect the equities given the dominance of export oriented stocks in the local market. However, even if global growth remains sluggish, domestic demand should support domestic economic growth.

<sup>1</sup> Bloomberg. Data as at 30 June 2009.

<sup>2</sup> Bloomberg. Data as at 31 August 2009.

<sup>3</sup> Bloomberg. Data as at 30 September 2009.

<sup>4</sup> Bloomberg. Total return in US dollar terms. Data as at 30 September 2009.

<sup>5</sup> I/B/E/S, MSCI and J.P. Morgan. Data as at 1 October 2009.

# Outlook

## United States

The level of economic activity remains fragile with weak consumption and a high unemployment rate clouding the prospects for an economic recovery. The US jobless rate rose to a 26-year record of 9.8% in September from 9.7% in August. The record level of US default on credit cards served as another reminder that the outlook for consumption remains unclear as households will be more likely to save rather than spend. Given the optimistic level of earnings growth forecasts for 2010, the risk that these numbers are challenged is elevated. Any disappointing results could renew investor pessimism. Government stimulus such as the cash-for-clunkers programme and tax credit for homebuyers have driven sales. However, concerns that the government will reduce the size of the stimulus have been mounting posing significant risk to growth and demand.



## Europe

Despite the upward revisions in growth forecasts, the Eurozone economy is still expected to shrink in 2009 by 3.9%, while GDP is estimated to expand by a moderate 1.0% in 2010. Economic activity remains subdued on an absolute level and uncertainty over the outlook for growth and consumption remains. July retail sales declined by 1.8% y-o-y from -2.2% y-o-y a month earlier, suggesting that despite a moderate improvement, levels of consumption are still weak. With European equity markets up by almost 21% in 3Q 2009, there is concern that current prices reflect an overly optimistic level of growth for 2010. As such, any signs economic activity levels could fall short of estimates may have the potential to hurt equity market performance.

## Bonds

As the Fed Fund rate is not expected to change in the near term, US government bonds are more attractive than cash given the strong yield differential in favour of the former. Quality corporate credit bonds should continue to outperform government bonds in the coming months, as credit bonds yield more than government paper. Asian credits continue to present relatively attractive value. Asian banks remain compelling, given their strong balance sheets and capitalisation compared with global peers. Meanwhile, Asian corporates have benefited from the low interest rate environment and have relatively good access to their local loans market for refinancing. Their earnings outlook has also improved on reviving economic and credit market conditions.



## Asia ex-Japan

Asia (ex- Japan) has rebounded strongly and exports are improving on the back of the pick-up in regional domestic demand. Domestic demand should grow at a healthy pace over the coming quarters. Earnings growth estimates have also improved, although these may reverse if economic data disappoints. A key risk for Asia (ex- Japan) is that loose monetary conditions might lead to a spike in inflation and the formation of asset bubbles in certain sectors. As such, interest rates may increase in Asia (ex- Japan) in 2010 to contain such risk. The outlook for Asia (ex- Japan) is promising but a market consolidation is possible in the near term as valuations appear stretched following the sharp rally this year. Given that markets have benefited strongly from liquidity and momentum, they may refocus on fundamentals and high quality dividend yielding stocks could outperform.

## Japan

There are signs the Japanese economy is recovering. Japan's 2Q 2009 GDP growth remained positive at 0.6% q-o-q, albeit lower than the previous quarter's 0.9% q-o-q reading. Industrial production posted its sixth consecutive monthly gain, coming in at 1.8% m-o-m in August. That said, while there has been more evidence that an economic recovery is under way, the risk of negative surprises remains elevated. Weaker-than-expected economic readings may suggest that the equity markets have been too optimistic, which could be harmful for equity investors in the short term. Despite the recent decline in valuation levels, which were largely driven by the correction in market prices, Japanese stocks remain less attractive than at the start of the year.



## Currencies

Volatility in currency markets has increased over the past months, particularly for the GBP. The JPY and the EUR have been relative winners. The USD has also weakened in line with the rally in US bonds as the yield support for holding USD has diminished. Investors are likely to continue to chase yield in the coming few months and currencies with higher bond and cash rates like the AUD and NZD could do better, although these currencies are quite expensive already. Among the major currencies (the USD, EUR, JPY and GBP) there is little to differentiate them based on fundamentals, and we do not expect major moves to occur.



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