

Recap

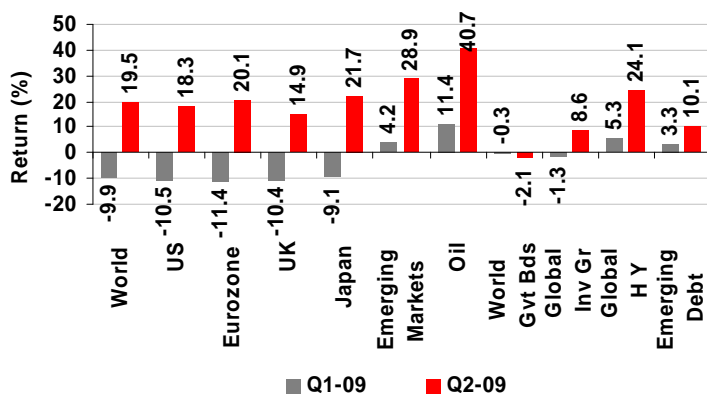
- ▶ Selective improvements in economic data
- ▶ Strong rally in riskier assets during April and May
- ▶ Continued increases in unemployment levels

Sentiment improved in the second quarter of 2009; yet risk remains, given the weak economic activity overall

Optimism helped risky assets to perform well

Over the second quarter of 2009, riskier assets rallied strongly as risk appetite improved, reflecting a broad pick-up in consumer and business confidence. The trend was truly global with the majority of developed equity markets posting gains of about 15% or more and global emerging market equities posting a remarkable 25% return over the quarter. Similarly, credit markets performed strongly, with global high yield bonds climbing more than 24% and global investment grade bonds appreciating by close to 9%. Within commodities, crude oil prices also rallied, surging more than 40% over the quarter as improvements in Chinese economic activity boosted expected levels of demand. Government bonds declined however, as signs of stabilisation in economic readings somewhat lifted the macro economic picture overall, albeit from very low levels. Global government bonds retreated 0.5% in the quarter, led by US treasuries, which were down 3.0% in aggregate.

Figure 1: First quarter and second quarter 2009 markets performance



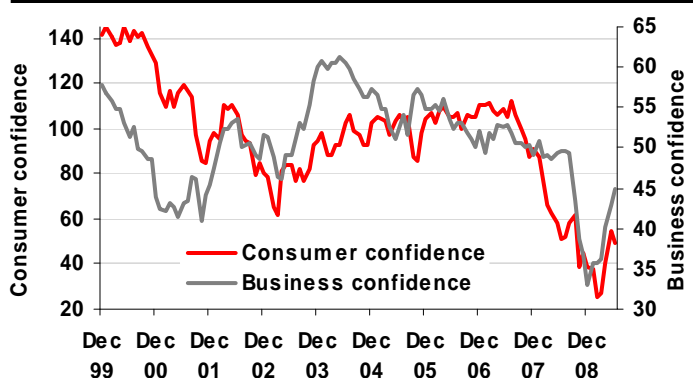
Source: Thomson Financial, Bloomberg.
In total returns, local currencies, June 30th 2009

Outlook

- ▶ Uncertainty over the magnitude and length of the global slowdown remains high
- ▶ Despite early signs of stabilisation in some economic readings, it is still too early to call the start of a sustained recovery
- ▶ Corporate profits remain under pressure

Equity markets benefited strongly from better than expected economic readings and some positive surprises in first quarter earnings releases. These selective improvements led to a strong rebound in risk appetite over the quarter, reflecting the fact that the pace of deterioration in economic activity has been slowing down. Consequently, business and consumer sentiment turned positive in some regions. For example Consumer Confidence in the US climbed to 70.8 in June from 57.3 in March. The improvements were not limited to the US. Several other regions, including emerging markets, provided improving macro-economic data, with China in particular being a key driver in investors' renewed optimism.

Figure 2: US business and consumer confidence

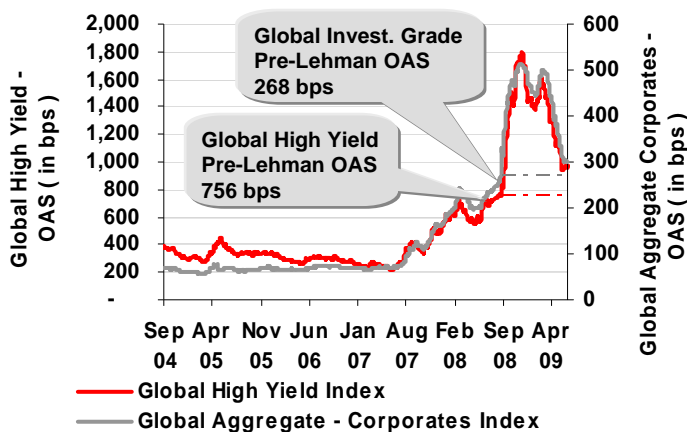


Source: Thomson Financial, June 30th 2009

Corporate news revealed that more than two thirds of 2009 first quarter US corporate earnings came in above analysts' expectations, fuelling the belief that the risk of a depression-like crisis was receding. Nevertheless, it should be noted that forecasts were extremely pessimistic in many cases and therefore there was greater potential for upside surprises. On the whole, while the better than expected results were welcomed, corporate profits remained at very depressed levels relative to history.

Within credit markets, corporate spreads in the US and in other regions narrowed substantially over the quarter. Strong supply of corporate bonds was well received by investors, with companies raising a record amount of money selling debt. For example, 2009 first half issuance for Europe was 55% higher than in 2008 over the same period, with companies selling EUR 699 bn of new bonds. Strong levels of demand were driven by the very attractive valuations offered by corporate bonds compared with other risky asset classes, as well as investors' search for yield. Consequently, performance was robust. Since the first quarter 2009, US investment grade corporate bond spreads fell more than 235 basis points to 3.06%, below their levels preceding the collapse of Lehman Brothers. Similarly, the performance of high yield bonds was particularly impressive over the quarter, vastly outperforming returns from the majority of other asset classes.

Figure 3: Global High Yield and Global Investment Grade bonds Option-Adjusted spreads

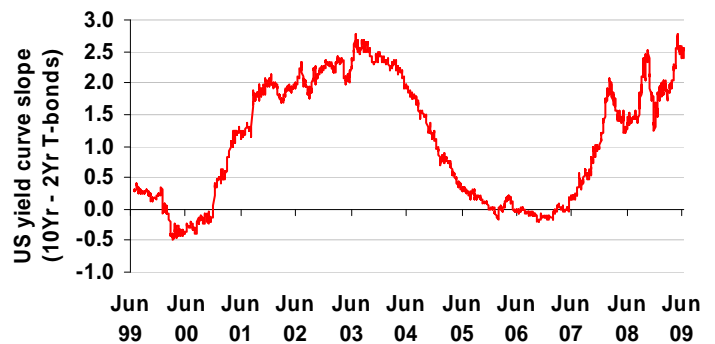


Source: Barclay's Capital Indices, June 30th 2009

Government bonds, on the contrary, performed very poorly, suffering from growing concerns about developed countries' fiscal positions, particularly in the US and the UK. Indeed, Standard & Poor's changed its outlook on the UK credit rating to "negative" from "stable".

In the US, the slope of the yield curve – the difference between the 10 year and 2 year bond yields – reached its steepest level in 20 years as investors became increasingly concerned about the impact of quantitative easing on supply, the rapidly rising budget deficits and the ensuing risk of inflation in coming years. 30 year US Treasury bonds, for example, reached an intra-day yield level of 4.84% on June 11th, compared to their yield of 2.68% at the beginning of the year.

Figure 4: US yield curve slope



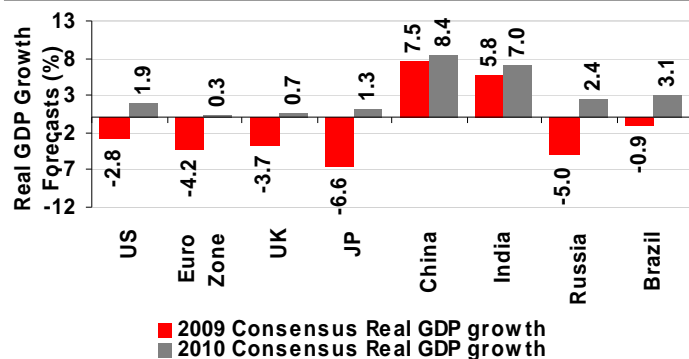
Source: Thomson Financial, HSBC Global Asset Management, June 30th 2009

Overall, we believe that some adjustment in riskier asset prices over the second quarter was justified, given the improvement in sentiment driven by positive surprises from several macro-economic indicators. However, most macro-economic indicators still remained at very weak levels relative to history, with the ongoing deterioration in unemployment readings serving as a painful reminder of the extraordinary magnitude of the crisis. Towards the end of the quarter, investors therefore displayed more caution, amid concerns that the strong rally had left markets pricing in more optimism than might be warranted by fundamentals. This dampened the positive trend in riskier assets, causing equities to lose some of their gains in June.

Looking forward in 2009 and 2010, the outlook for growth remains weak for 2009 and generally subdued for 2010.

Sentiment and the selective improvements in economic readings around the world have clearly contributed to reduce the risk of a very prolonged global recession and threat of a further meltdown in the financial sector. Nevertheless, the overall economic picture remains weak given that all major economies are still expected to contract sharply in 2009 and that growth is likely to be subdued in 2010. We believe that the contraction in developed countries will remain sharp, with the Eurozone, US and Japanese economies expected to decline by 4.2%, 2.8% and 6.6% respectively in 2009. Emerging markets will also see a slowdown in economic activity, but should display more divergence between regions. Indeed, Asia's macroeconomic outlook remains positive overall, while Eastern Europe displays more weakness with growing unemployment, deteriorating consumption and worrying government fiscal positions. Looking towards 2010, we believe that growth will continue to look anaemic, particularly in developed markets, as illustrated in Figure 5.

Figure 5: Real GDP growth Consensus estimates for 2009 and 2010



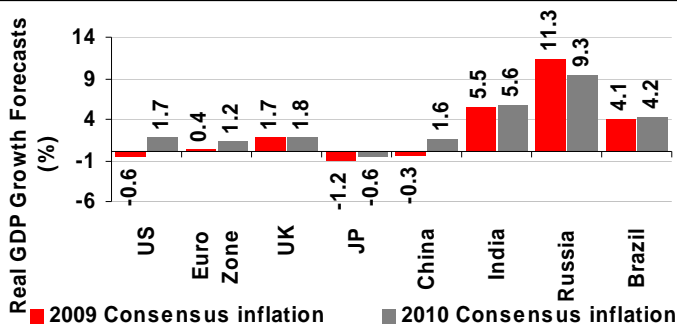
Source: Consensus Economics, June 2009

One of our key concerns is the rising levels of unemployment in both developed and emerging markets, which will add further pressure on consumer spending and thus future economic growth. Retail sales remain at extremely weak levels overall. For example, year over year May retail sales in the Eurozone are down by 3.3% while in emerging markets, Russian retail sales dropped 5.6% year over year in May. Looking at the US economy, unemployment reached 9.5% in June, almost the highest level in five decades after the 10.8% peak in December 1982.

We expect unemployment levels to increase further from current levels. Meanwhile, US household leverage remains at extremely high levels compared to history (128% in March 2009 versus levels of around 65% in the mid-1980s) but is likely to decrease as the household savings rate improves. Both declining household leverage and rising unemployment are likely to place pressure on future consumption.

Turning to inflation, we have seen consumer price indicators easing in 2009 for both developed and emerging countries. Inflation should remain positive but at a moderate level in 2010, as illustrated in Figure 6, which on the whole, is supportive for markets and will allow Central Banks to maintain the low interest rate environment for longer.

Figure 6: Consensus inflation estimates for 2009 and 2010



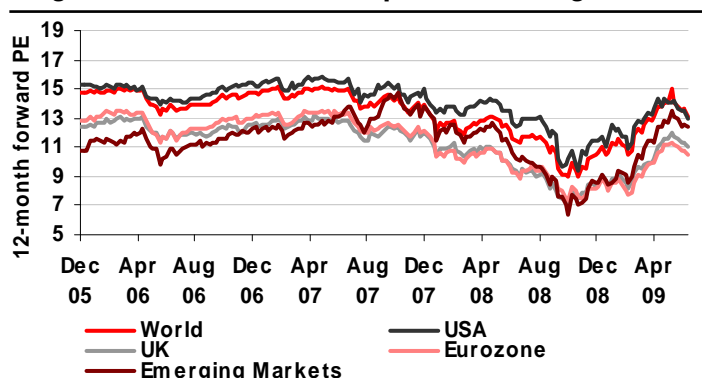
Source: Consensus Economics, June 2009

Market participants are likely to remain in a spirited debate regarding the future path of inflation because there are several counter-balancing forces which could shift the outlook if expectations change. On the one hand, there is still ongoing de-leveraging in many sectors, as well as significant excess capacity worldwide, both of which are disinflationary factors. On the other hand, quantitative easing and loose fiscal policies are potentially inflationary over the longer term. The overall uncertainty over the inflation outlook could fuel market volatility in the coming months.

Global asset allocation

Given the weak outlook for growth and the ongoing risk to profits, we recommend a cautious allocation to equity markets. Moreover, the rally in the second quarter of the year has considerably increased equity valuation levels from the cheap levels seen at the beginning of the year. For example, the rally has brought valuation levels for Japanese equity prices up to 30.5 times the 12-month forward earnings, from 27.5 times in March 2009 and 15.4 times in December 2008. Figure 8 illustrates the similar trend in other markets.

Figure 7: 12-month forward price-to-earning ratio



Source: Thomson Financial, June 2009

Therefore, in our tactical outlook, we continue to prefer a moderate underweight position in equities over the short term until we see further improvements in the risk to corporate profits.

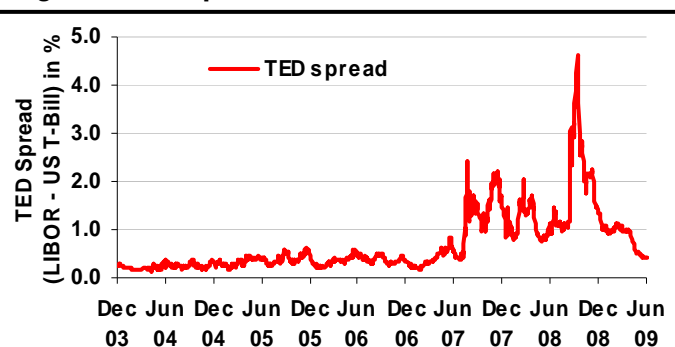
Within fixed income, we retain our preference for high yield and investment grade bonds over government bonds. However, we acknowledge that the valuation case for US and Eurozone government bonds has improved significantly following the correction over the quarter. Consequently we now recommend a neutral position for government bonds relative to cash. On the whole however, budget deficit data will continue to weighing on the economic outlook, and on the asset class, particularly for the UK and the US.

For example, in June the Congressional Budget Office re-affirmed its projections that the US Federal government debt-to-GDP ratio would more than double over the decade ahead, from pre-crisis levels of 40% to more than 80% under the Obama Administration's fiscal program. The debt level shows a large jump in 2009 from the combined effects of financial rescue, the weak economy reducing tax receipts, plus the Obama stimulus package. Similar concerns affect the UK. Public sector borrowing requirements climbed to GBP 18.8bn in May, 96% higher than a year earlier.

Overall, our preference for the riskier segments of fixed income markets reflects the fact that valuations remain attractive relative to history and the extensive government fiscal stimulus will most likely further enhance the lending environment for corporates.

Demand for corporate credit is likely to remain strong, as investors search for yield and continue to display a preference for accessing more secure elements of the corporate balance sheet than equity. Another supportive factor is that overall credit conditions are improving. For example, the TED spread, which measures the difference between the costs that banks and the US government pay to borrow for three months, has declined more than 57 basis points over the quarter. However, the current level of 0.34% remains high relative to longer term history.

Figure 8: TED spread (LIBOR minus US T-Bill rate)



Source: Bloomberg, HSBC Global Asset Management, June 30th 2009

Despite the various signs of improvement in credit conditions though, liquidity risk remain a potential issue and we recommend that investors view the asset class as a medium to long term investment.

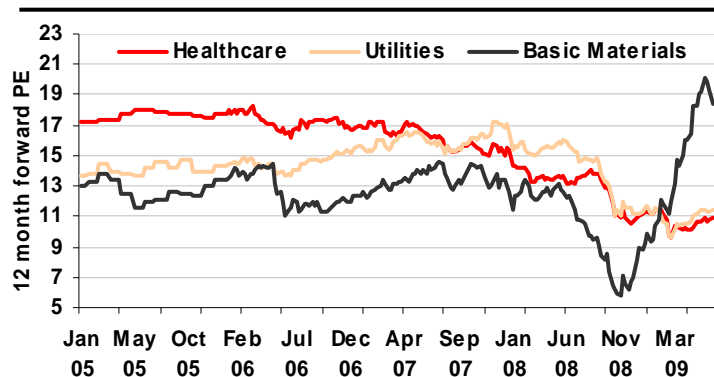
Regional equity allocation

Within equity markets, we continue to see limited scope for tactical allocation between regions or countries as the dispersion in valuations between different regions remains relatively low compared to history. As of the end of the second quarter, the indicator came at 5.1% below its 5 year average.

It is clear however, that Emerging Asia is showing a better macro-economic story, with a strong cyclical and structural growth story. That said, following the recent strong rally, we believe that most of the positive macro-economic news has been largely reflected in Asian equities' valuations relative to other regions.

Nevertheless, we think that the rally in equities in the second quarter of the year has led to some interesting divergence in valuations at the sector level. Indeed, it seems that the rally was driven more by cyclical stocks than the more defensive areas; hence cyclical sectors now look more expensive, as shown in Figure 9. For example, the 12 month forward price-to-earnings ratio for basic materials climbed from 14.7 to 18.4 over the quarter. On the other hand, defensive sectors such as utilities and healthcare have been lagging the market during the equity rally, with their 12-month forward price-to-earnings ratios increasing only moderately, from 10.6 to 11.4 and from 10.4 to 10.9 respectively.

Figure 9: Global sector valuation differentials



Source: Thomson Financial, IBES, MSCI, June 30th 2009

Therefore, we believe these sectors may have potential to outperform, particularly if positive sentiment retreats and investors rotate into more defensive sectors.

Views on currency

Finally, within currencies, we maintain a moderately negative view on the GBP versus EUR as quantitative easing measures adopted by the Bank of England are negative for the currency. As inflation in the UK is higher than in many parts of the world, this is a further reason to be negative on the GBP as it would affect the real yield on UK assets.

Concluding remarks

Our central scenario is that any recovery will be weak, with shallow and below-trend growth for some time in the major developed economies, given the debt overhang in the household sector, the financial system and the corporate sector. Rising unemployment rates will have negative effects on labour income and consumption growth. There is therefore still considerable uncertainty regarding the economic and market outlook, such that volatility is likely to remain higher than its historical levels. Nevertheless, uncertainty can create mis-pricing opportunities for investors to capitalize upon. There are still interesting opportunities available, with valuations for most areas of the market not at overly demanding levels, and certain asset classes where risk-taking is likely to be well rewarded.

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