

# Investment Monthly

## Quality assets remain in favour amid tight financial conditions and market uncertainty

December 2023



### Key takeaways

- ◆ Although developed markets central banks have paused their rate hikes, policy rates should remain high for now, leading to tight financial conditions. We do not think that low quality bonds adequately compensate for rising default risks. So, we continue to favour high quality bonds such as DM government bonds (7-10 years), investment grade credits (5-7 years), and Indian local currency bonds.
- ◆ Continued disinflation in the US (3.2% in October), solid economic growth, lower valuations and the Fed pause are positive for US equities. We remain overweight on US equities and favour US consumer discretionary as disposable income rises while technology is set to lift productivity. Healthcare is also likely to be boosted by innovative technologies and demand for new products.
- ◆ We prefer large-cap companies as they are better positioned amid global economic slowdown and market uncertainty. Apart from US equities, we remain positive on Asia, particularly India and Indonesia. We also see opportunities in South Korea as the global tech cycle improves, alongside reasonable valuations and strong earnings prospects. A focus on quality and diversification remains our core investment strategy to capture growth potential while mitigating risks.



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Asset class	6-month view	Comment
<b>Global equities</b>	▶	While continued disinflation and peak policy rates support valuations and margins, we focus on quality companies amid slower global economic growth and market uncertainty. We prefer the US, Asia and LatAm in particular.
<b>Government bonds</b>	▶	We overweight most developed markets government bonds with a preference for medium-to-long maturities. The exception is Japanese government bonds where yields are unattractive.
<b>Investment grade (IG) corporate bonds</b>	▲	Quality credit tends to outperform during periods of slow economic growth, which supports our overweight on investment grade.
<b>High yield (HY) corporate bonds</b>	▶	Global high yield is quite expensive relative to both economic growth prospects and to investment grade, especially in USD.
<b>Gold</b>	▶	Elevated real yields are a challenge, but global uncertainties and slow growth provide some support.

▲ "Overweight" implies a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

▼ "Underweight" implies a negative tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

▶ "Neutral" implies neither a particularly negative nor a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

Icons: ↑ View on this asset class has been upgraded; ↓ View on this asset class has been downgraded.

# Talking points

Each month, we discuss 3 key issues facing investors

## 1. Why do quality bonds remain in favour?

- ◆ With inflation on a downward trajectory, major central banks paused at their recent meetings, reinforcing our view that rate hikes in these markets are over, and rate cuts will only commence in Q3 2024 led by the US. A high-for-longer rate environment means that financial conditions are likely to remain tight.
- ◆ Bond yields have risen to decade highs driven by aggressive rate hikes in developed markets. Normally, yields for higher risk assets would rise more when markets sell off to compensate investors for taking additional risks, but this has not been the case. In fact, spreads have been relatively stable, meaning that the compensation of risk has risen more for lower risk assets, and the value has shifted to quality bonds.
- ◆ We prefer quality bonds because they are likely to fare better amid global growth slowdown and increased uncertainty. **We maintain medium-to-long exposure in government bonds (7-10 years) in developed markets (DM) and a medium duration positioning (5-7 years) for investment grade credit.** We downgrade EM local currency bonds due to their less risk-adjusted returns than high quality DM bonds, a stronger USD, as well as fund outflows and bond supply concerns. We remain bullish on quality issuers in Asia and LatAm, such as **Indian local currency bonds** due to attractive valuations, investor interest and India's solid fundamentals.

## 2. What is the outlook for US stocks amid continued disinflation?

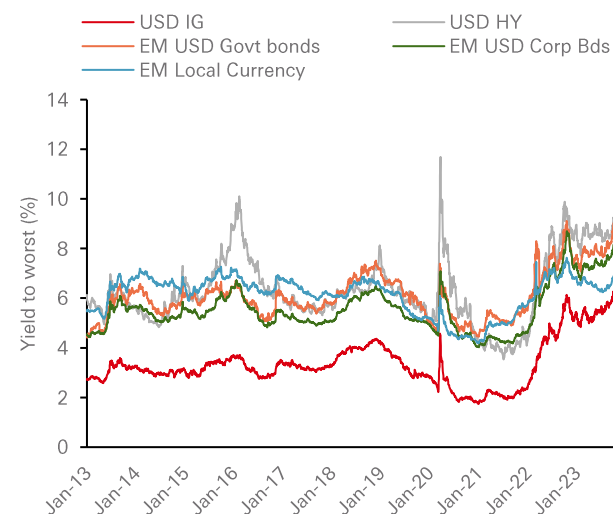
- ◆ Headline inflation in the US for October fell to 3.2% from 3.7% y-o-y, and core inflation also dropped to 4% from 4.1% y-o-y, driven by slower consumption demand, minimised supply chain challenges and constrained global demand on commodity prices.
- ◆ Retail sales held up with a better-than-expected decline of just -0.1% m-o-m (consensus forecast was -0.3%) and the strong momentum is expected to carry into the holiday season. The technology revolution will also contribute to disinflation and outright deflation in most sectors, putting less input cost pressure on the economy. These give the Fed more room to keep rates on hold.
- ◆ Historically, US equities lead global equities for the first 12 months after the Fed pauses. Thanks to solid economic growth, continued disinflation, lower valuations and the Fed pause, we expect to see good equity returns starting from the fourth quarter of this year. **We remain overweight on US equities and favour consumer discretionary** as disposable income rises while **technology** is set to lift productivity, return on invested capital and valuations. **Healthcare** is another bright spot driven by innovative technologies and demand for new products.

## 3. How should investors position their equity strategies?

- ◆ We continue to put cash to work as rate pauses are supportive of equity valuations and margin expansion. Quality large-cap companies with strong balance sheets and earnings power are better positioned against global growth slowdown and market uncertainty.
- ◆ US equities remain our biggest overweight due to the stronger-than-expected Q3 earnings results, a tight labour market and long-term structural opportunities such as the re-industrialisation of North America and rapid innovation. US resilience should remain intact in 2024.
- ◆ Despite divergent growth in Asia, its valuations and fundamentals remain attractive, especially India and Indonesia. An improving global tech cycle, strong AI-led demand for memory and a rebound in DRAM prices, coupled with reasonable valuations (2024 PE at 10x) and strong earnings growth (66% earnings expansion for 2024 forecast by analysts), **support our upgrade of South Korean equities to overweight.** A focus on quality and diversification remains our core investment strategy to capture growth potential while mitigating risks.

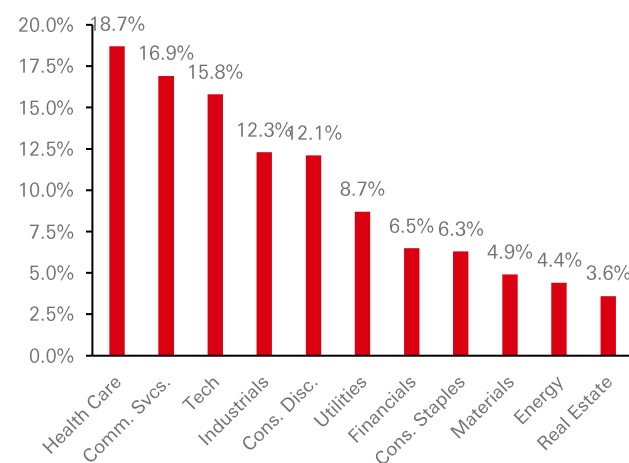
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Chart 1: The value has shifted to high quality bonds amid bond markets sell-off almost in parallel



Source: Bloomberg, HSBC Global Private Banking as at 14 November 2023. Past performance is not a reliable indicator of future performance.

Chart 2: US earnings are expected to remain solid FactSet: 2024 earnings forecasts



Source: Bloomberg, HSBC Global Private Banking as at 16 November 2023

Chart 3: Valuations look attractive across markets, including South Korea for 2024

Market	2023 PE	2024 PE
US	20.8	18.7
Eurozone	13.8	13.0
UK	10.8	10.2
Japan	16.2	14.4
Mainland China	10.8	9.4
Hong Kong	13.0	11.6
Singapore	11.5	11.3
South Korea	17.5	10.4
India	21.6	19.0

Source: Refinitiv, HSBC Global Private Banking as at 21 November 2023. Past performance is not a reliable indicator of future performance. Forecasts are subject to change.

# Asset Class Views

Our latest house view on various asset classes

Asset class	6-month view	Comment
<b>Global equities</b>		
<b>Global</b>	▶	While continued disinflation and peak policy rates support valuations and margins, we focus on quality companies amid slower global economic growth and market uncertainty. We prefer the US, Asia and LatAm in particular.
<b>United States</b>	▲	We remain overweight on US equities as solid economic growth, continued disinflation, lower valuations and the Fed pause all suggest improving margins and better expectations for corporate profits.
<b>United Kingdom</b>	▶	The UK stock market is relatively cheap but sticky inflation and weak domestic demand and household spending remain headwinds.
<b>Europe</b>	▼	We remain underweight as sticky inflation, high reliance on energy imports and high exposure to China are obstacles for European stocks. Europe seems more vulnerable to geopolitical tail risks than the US is.
<b>Japan</b>	▶	While cyclical indicators are supportive, valuations and positioning are elevated.
<b>Emerging Markets (EM)</b>	▶	Weaker Chinese growth, high rates and our strong USD view impact EM markets to different degrees. We prefer Asia due to its positive cyclical momentum and structural growth while LatAm benefits from rate cuts and cheap valuations.
<b>EM EMEA</b>	▼	The region is impacted by high energy prices and weak growth in Europe. Turkey's macroeconomic policies have improved and valuations are attractive but serious challenges remain.
<b>EM LatAm</b>	▲	Local rate cuts and the re-industrialisation of North America are positives. Mexico benefits from the supply chain diversification trend while valuations of Brazil remain attractive.
<b>Asia ex Japan equities</b>		
<b>Asia ex-Japan</b>	▲	Asia remains attractive because of its improving fundamentals, domestic momentum in a number of countries and less inflationary pressures. We prefer India and Indonesia and have become more positive on South Korea.
<b>Mainland China</b>	▶	Headwinds for China's growth recovery remain. As we expect proactive policy stimulus may take time to take effect, we stay neutral on Chinese equities and prefer the internet, consumer discretionary, travel, and Macau gaming sectors.
<b>India</b>	▲	India remains attractive thanks to its strong structural and cyclical growth prospects, favourable demographics, potential monetary easing and a stable currency outlook.
<b>Hong Kong</b>	▶	The weak external trade environment and high interest rates remain headwinds but increased cross-border activity should benefit the financial services and the insurance sectors. Domestic consumption remains robust.
<b>Singapore</b>	▶	We maintain a neutral position but see some signs of Singapore's economy bottoming out driven by an ongoing recovery in travel services and an improved trade cycle.
<b>South Korea</b>	▲↑	We upgrade South Korean equities to overweight as we expect to see a broad-based earnings recovery in 2024 as the global tech cycle improves. Valuations also look reasonable.
<b>Taiwan</b>	▶	Despite weak global demand and elevated inventory levels, the equity market is supported by the AI related themes.
<b>Government bonds</b>		
<b>Developed markets (DM)</b>	▶	We overweight most developed markets' government bonds with a preference for medium-to-long maturities. The exception is Japanese government bonds where yields are unattractive.
<b>United States</b>	▲	US Treasury yields have fallen from recent highs on expectations that policy rates have peaked and may be cut in 2024. We see attractive value in long maturities and maintain our preference for 7-10 years.
<b>United Kingdom</b>	▲	The tax cuts and increase in the minimum wage announced from the Autumn Statement could add upward pressure to inflation. Still, we expect the BoE to keep policy rates on hold and remain positive on gilts for medium-to-long duration.
<b>Eurozone</b>	▶	We extend our duration preference to "medium-to-long" to lock in the current yield levels for longer.
<b>Japan</b>	▼	We find Japanese government bonds unattractive given the potential end of the negative interest rate policy.
<b>Emerging Markets (Local currency)</b>	▼↓	High DM rate volatility and a slowing pace of disinflation across EM economies warrant our downgrade on EM local currency bonds. We focus on quality issuers within Asia (including India) and Latin America.
<b>Emerging Markets (Hard currency)</b>	▶	Amid high Treasury volatility, we still find yield but remain selective, focusing on quality issuers.
<b>Corporate bonds</b>		
<b>Global investment grade (IG)</b>	▲	Quality credit tends to outperform during periods of slow economic growth, which supports our overweight on investment grade.
<b>USD investment grade (IG)</b>	▲	We prefer quality bonds for better risk-adjusted returns as yields for taking on more risks are not attractive
<b>EUR and GBP investment grade (IG)</b>	▲	The Eurozone's Q3 GDP stayed in contraction. We maintain our preference for quality issuers amid a subdued growth outlook with medium maturities.
<b>Asia investment grade (IG)</b>	▲	We focus on locking in attractive yields from quality issuers and favour Asian financials, Indian local currency bonds, Indonesian quasi-sovereign IGs, South Korean IGs, Macau gaming, and Chinese technology, media and telecom credits.
<b>Global high-yield (HY)</b>	▶	Global high yield is quite expensive relative to both economic growth prospects and to investment grade, especially in USD.
<b>US high-yield (HY)</b>	▶	Tight financial conditions weigh on company margins and increase the risk of defaults. We remain selective and prefer quality issuers with strong market positions and manageable debt.
<b>EUR and GBP high-yield (HY)</b>	▶	Economic growth momentum remains weak and elevated rates are weighing on the financing conditions. We remain neutral on high yield in the region.
<b>Asia high-yield (HY)</b>	▶	China's property sector remains a drag on Asian high-yield bonds and we expect default rate to stay high in 2024.
<b>Commodities</b>		
<b>Gold</b>	▶	Real yields and our strong USD view are challenges but uncertainties and slow global growth provide support.
<b>Oil</b>	▶	In spite of production cuts, global growth concerns are weighing on oil prices.

## Sector Views

Global and regional sector views based on a 6-month horizon

Sector	Global	US	Europe	Asia	Comment
<b>Consumer Discretionary</b>	▲	▲	▶	▲	Despite easing inflationary pressures in many regions, spending remains selective, benefitting only some areas of the sector. Demand for car registrations is improving although EV demand has softened on growing frustrations over the slow roll-out of charging infrastructure outside major cities. Tourist activity is also showing some signs of a seasonal pick-up. After a disappointing Q3, hard luxury has seen some positive signs of growth.
<b>Financials</b>	▲	▲	▶	▶	The sector is trading on attractive valuations and high interest rates continue to lift profits. Although the interest rate cycle may have peaked, rates may remain elevated for some time. Regional banks face headwinds as mortgage and loan activity declines mainly due to higher interests. The capital markets business remains buoyant in selected markets, with new issuance and listings driving activity.
<b>Industrials</b>	▲	▲	▶	▶	Sector sentiment appears to be slowly improving following weaker-than-expected Q2/Q3 results, but valuations are elevated. China's growth momentum seems to be improving as greater government support is lifting demand. US industrials are gaining momentum as reshoring, fuelled by the US's Inflation Reduction Act (IRA) and CHIPS Act, is boosting activity. Europe remains in the doldrums. Automation and related businesses are seeing a sharp improvement in orders.
<b>Information Technology</b>	▲	▲	▲	▲	Fundamentals continue to improve, with AI a major catalyst for new areas of growth. Digital infrastructure and software are seeing solid activity. Strong demand for high-end semis is being driven by the buoyant automation and AI areas as businesses and consumer sentiment are improving. Cloud computing and digital advertising growth remains muted.
<b>Communications Services</b>	▶	▶	▼	▲	US sector fundamentals remain positive, with one of the strongest earnings growth rates forecast over the next 12 months driving a strong YTD performance. The outlook in Europe, which is more focused on telecom services, remains challenging. Asia offers a more attractive risk-return profile given the low valuations and stabilising regulatory environment.
<b>Materials</b>	▶	▶	▶	▶	Commodity prices have stabilised with iron ore, copper and steel prices partially recovering over the last few months. For other metals, prices have been flat or negative. Sector valuations are full. Overall, the outlook has improved marginally with government capital programmes and electrification (EVs, tech and renewables) lifting demand in some areas.
<b>Real Estate</b>	▼	▼	▶	▼	Real estate remains in a difficult place with the dual pressures of higher interest rates and inflation hurting margins and consumers alike. Financing is expensive and default risk has increased. Construction activity remains slow, but may have troughed, with some early signs of an increase in activity from iron, steel and cement producers.
<b>Consumer Staples</b>	▶	▶	▶	▲	Cost margins appear secure as cost pressures have somewhat eased. The sector should benefit from strong seasonal demand with solid results going forward despite tough YoY comparables. The sector is trading in line with historical valuations. We focus on quality stocks with strong brands and more resilient pricing power.
<b>Energy</b>	▲	▲	▲	▲	Geopolitical risks remain high as OPEC+ has kept oil and gas supplies tight, but last year's high prices, particularly in Europe, have not recurred so far. Further cuts from OPEC+ could drive prices higher. Valuations are very low relative to other sectors despite robust cash flow and stable high dividends.
<b>Healthcare</b>	▲	▲	▲	▼	New product launches, a less hostile pricing environment and the ebbing wave of major product patent expirations should help lift the sector after a period of underperformance. Healthcare sales growth should benefit from easier comparables, and new pharma products should lift sentiment and expectations. In Asia, valuations remain elevated, trading well above historical levels.
<b>Utilities</b>	▶	▼	▶	▶	European and US renewable energy companies are facing headwinds on anticipated new and existing development projects as rising costs are severely eroding expected returns and projects are facing long delays in grid connections. As a result, US's IRA and Europe's green initiatives have slowed.

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