

# Investment Monthly

## Stay defensive while silver linings emerge

January 2023



### Key takeaways

- ◆ Major central banks raised rates by 0.5% in December as expected. We maintain our view that the Fed will make a final 0.5% hike in February 2023 and only cut policy rates by 0.25% in each of Q2 and Q3 2024. We remain overweight on US equities due to the solid labour market and healthy balance sheets, while underweighting Eurozone and UK equities to mitigate recession and inflation risks.
- ◆ Despite slowing growth, we see silver linings on easing inflation and peaking interest rates which are favourable for bonds, pushing bond yields to historically high levels. We prefer investment grade bonds of up to 5 years to manage growth and interest rate risks. We remain defensive in stocks and look for regional advantages in the US and Asia.
- ◆ While Chinese growth will remain challenged in Q1, a recovery from Q2 2023 is more likely as immunity builds up, and normalisation of consumption, production and pro-growth policies provide positive effects. The relaxation of its zero-COVID restrictions and the funding support for the property market warrant our overweight on Chinese equities.



**Willem Sels**  
Global Chief Investment Officer,  
HSBC Global Private Banking and  
Wealth



**Lucia Ku**  
Head of Wealth Insights  
HSBC Wealth and Personal  
Banking

Asset class	6-month view	Comment
Global equities	▼	As we expect earnings forecasts to decline further, we stay underweight on global equities and prefer companies with healthy balance sheets, strong market positions and solid dividend payouts.
Government bonds	▼	Yields have backed up and government bonds provide diversification, but we prefer high rated corporate bonds.
Investment grade (IG) corporate bonds	▲	Slower inflation and peaking interest rates are positive for high grade bonds across developed markets, emerging markets and Asia. They offer attractive yields pick-up and diversification benefits.
High yield (HY) corporate bonds	▶	Corporate credit spreads continue to widen, especially for lower-rated issuers amid inflation and growth uncertainty. We prefer investment grade over high yield with short-to-medium maturities.
Gold	▶	Despite high inflation and market volatility, real yields remain a challenge and we don't foresee much upside.

▲ "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. Is the hiking cycle going to end soon?

- ◆ The Fed raised funds rate by 0.5% in December as expected. While the pace of rate hikes may slow on easing inflation, the Fed indicated clearly that tightening is not over as inflation will be stickier than previously thought. We expect a final 0.5% hike in February before the first 0.25% cut in Q2 2024, followed by another 0.25% in Q3 2024.
- ◆ The European Central Bank (ECB) and Bank of England (BoE) also hiked rates by 50bps, yet guidance was divergent. We think the BoE will peak policy rate at 3.75% with a 0.25% hike in February, while the market is pricing in a higher deposit rate to over 3% in Europe (currently at 2%) with a hawkish ECB tone, which aligns with our view.
- ◆ Despite slowing growth, we remain overweight on US equities due to the solid labour market and healthy household and corporate balance sheets. Earnings outlook is expected to improve from the H2 of 2023. We stay underweight on Eurozone and UK equities to mitigate recession and inflation risks.

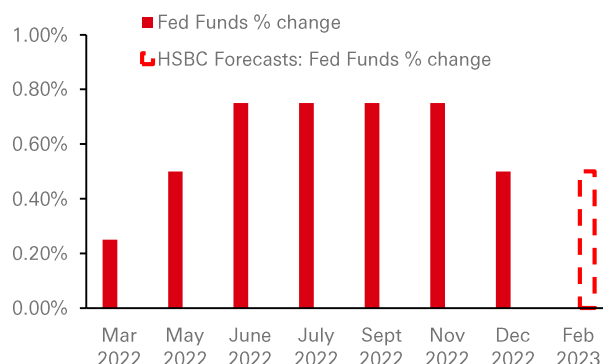
## 2. Is it time to take more risk?

- ◆ While we see silver linings on the back of easing inflation and peaking interest rates, as well as China's decisive policy pivot towards growth stabilisation, there is still uncertainty around geopolitics and the exact timelines of when the rate, inflation and growth cycles will turn.
- ◆ Peaking US rates and easing inflation should create a more favourable environment for bonds, with bond yields having spiked significantly. Expectations on future rate cuts will also benefit bond prices. We prefer investment-grade bonds to manage earnings slowdown, while short-to-medium duration (up to 5 years) can navigate interest rate volatility.
- ◆ As the economic growth cycle lags the interest rate cycle, we believe it's too early to add cyclical risk through equities. We remain defensive in our sector strategy and look for regional advantages in the US and Asia, including Hong Kong, mainland China, Thailand and Indonesia. Economic re-opening is a key growth driver, while Southeast Asia also benefits from supply chain reorientation and China's re-opening.

## 3. Should we expect a quick rebound in mainland China?

- ◆ The additional COVID relaxation measures introduced recently (e.g. negative nucleic acid results for cross-regional travellers and temporary lockdowns discontinued) have materially lifted market confidence. The government has also ramped up funding support for the property sector through increased credit supply, policy support for new bond issuance and equity financing for privately-owned developers.
- ◆ However, we don't expect a quick rebound in growth. A strong recovery from Q2 2023 is more likely as immunity builds up, and normalisation of consumption, production and pro-growth policies provide positive effects. Strong pent-up demand and recovery in service consumption will boost economic growth in the rest of 2023 and into 2024.
- ◆ We are overweight on Chinese equities and constructive on themes that will benefit from long-term policy support (e.g. tech self-reliance and green transition). For those Chinese stocks listed in Hong Kong, we see potential in travel and healthcare but short-term volatility will linger.

Chart 1: The Fed potentially could raise rates only one more time



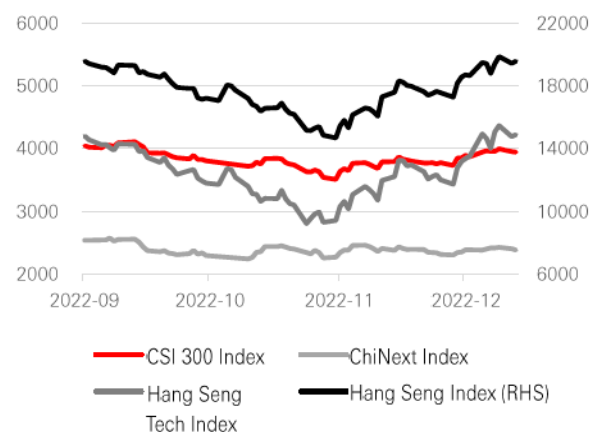
Source: Federal Reserve, Bloomberg, HSBC as at 30 December 2022.

Chart 2: Global bond yields stay at historically high levels, almost back to the pre-2008 highs



Source: HSBC Global Private Banking as at 30 December 2022. Past performance is not a reliable indicator of future performance.

Chart 3: Hong Kong stock market recovered far more than A-share market



Source: Wind, Bloomberg, HSBC Global Private Banking as of 13 December 2022. Past performance is not a reliable indicator of future performance.

## Asset Class Views

Our latest house view on various asset classes

Asset class	6-month view	Comment
<b>Global equities</b>		
Global	▼	As we expect earnings forecasts to decline further, we stay underweight on global equities and prefer companies with healthy balance sheets, strong market positions and solid dividend payouts.
United States	▲	Growth is slowing but we still favour the diversity and quality of US stocks compared to Europe. The lower-than-expected inflation data does not imply an end to the inflation fight but supports our view of nearing peak rates.
United Kingdom	▼	Although November inflation continued to fall, near-term recession and fast-rising cost of living remain key cyclical headwinds. We stay underweight on UK equities.
Eurozone	▼	Amid elevated inflation, a hawkish central bank and our expectation that Europe will stay in recession until mid-2023, we stay underweight on Eurozone equities.
Japan	▶	Slowdown in global growth continues to weigh on demand for exports while limited growth in wages dampens consumer spending amid higher inflation.
Emerging Markets (EM)	▶	Concerns over Fed tightening, global growth slowdown, geopolitical tensions and EU energy crisis linger. Asia should benefit from the reopening trend while LatAm benefits from Mexico's attractive valuations and growth prospects.
EM EMEA	▼	The region is impacted by high energy prices, weak growth in Europe and an uncertain rate outlook.
EM LatAm	▲	The end of the rate hike cycle and less political uncertainty are positive for Brazil and the region.
<b>Asian ex Japan equities</b>		
Asia ex-Japan	▲	Asia shows resilient domestic fundamentals with the tailwinds of economic reopening in Hong Kong and mainland China, as well as solid growth in the ASEAN region and India. We also prefer Indonesia and Thailand for the strong domestic demand and Chinese tourist arrivals.
Mainland China	▲	As the economy moves towards normalisation, a strong recovery in consumption due to pent-up demand is likely. We expect China's reopening rally to broaden beyond travel related sectors into wider growth sensitive sectors in H2 2023.
India	▶	Despite stretched valuations and inflation concerns, India's global market share in high-skill exports and the rise in digital start-ups are key growth drivers. Its green transition ambitions also present investment opportunities.
Hong Kong	▲	The easing of COVID restrictions and the border reopening with mainland China will help boost tourism and domestic consumption. We prefer quality leaders in the travel, airlines, hospitality, F&B, Macau gaming and mass consumption sectors.
Singapore	▶	Inflation has eased but remains elevated, so further policy tightening is likely. Consumer-oriented and travel-related sectors are driving growth and offsetting intensifying trade headwinds and gradually fading re-opening effects.
South Korea	▼	Given the heavy index weighting to tech names which have been hard hit by a deteriorating earnings outlook and the sluggish global demand for memory and smartphone, we remain bearish on South Korean equities.
Taiwan	▼	We maintain bearish on the downturn in the semiconductor and technology hardware sectors, which dominate the Taiwanese equity index. Geopolitical risks remain a key concern.
<b>Government bonds</b>		
Developed markets (DM)	▼	Yields have backed up and government bonds provide diversification, but we prefer high rated corporate bonds.
United States	▶	Easing inflation has triggered rapid repricing in the Treasury market, as we approach peak rates.
United Kingdom	▲	With a more dovish Bank of England, a credible fiscal policy and attractive valuations, we maintain overweight on gilts.
Eurozone	▼	Rising energy, goods and services prices push inflation higher, forcing the ECB to continue raising rates and current absolute yield levels remain unattractive. Deficits are under pressure too as governments support households.
Japan	▼	The Bank of Japan unexpectedly adjusted its yield curve control policy in December, which was seen as the first sign to pivot away from the ultra-loose monetary policy.
Emerging Markets (Local currency)	▶	Select opportunities exist as some countries are slowing rate hikes but others continue. The end of the USD bull run may become a tailwind.
Emerging Markets (Hard currency)	▶	Amid higher Treasury volatility, we still find yield but remain selective.
<b>Corporate bonds</b>		
Global investment grade (IG)	▲	Slower inflation and peaking interest rates are positive for high grade bonds across developed markets, emerging markets and Asia. They offer attractive yields pick-up and diversification benefits.
USD investment grade (IG)	▲	The flat yield curve does not provide sufficient returns to extend duration. A short-to-medium term is preferred.
EUR and GBP investment grade (IG)	▲	European and UK investment grade bonds offer a decent yield pick-up. We prefer higher quality names and short-to-medium maturities amid recession and inflation risks.
Asia investment grade (IG)	▲	Within the Asian credit markets, we stay focused on high-grade bonds to mitigate cyclical headwinds amid a global slowdown, including Hong Kong and Singapore IG bonds, and Chinese TMT (Technology, media and telecom) bonds.
Global high-yield (HY)	▶	Corporate credit spreads continue to widen, especially for lower-rated issuers amid inflation and growth uncertainty. We prefer investment grade over high yield with short-to-medium maturities.
US high-yield (HY)	▶	While US high-yield companies still enjoy solid credit fundamentals and low default rates, tightening financial conditions and the higher Fed fund rates create downside risks.
EUR and GBP high-yield (HY)	▶	As policy tightening continues and European economies continue to weaken, we prefer higher quality investment grade credit and maintain a neutral stance on high yield.
Asia high-yield (HY)	▶	Although most Asian markets face relatively less inflationary pressure compared to the developed markets, the Fed tightening and slowing global demand could be headwinds for credit spreads.
<b>Commodities</b>		
Gold	▶	Despite high inflation and market volatility, real yields remain a challenge and we don't foresee much upside.
Oil	▶	A slowing economic outlook has caused the oil price to fall but inventories and production capacity is tight, which should allow oil to rebound.

## Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▼	▼	▼	►	Inflation, higher energy prices and financing costs are weighing on consumer demand and corporate profits. Weak new orders are weighing on automakers and household appliances. Retailers reported tepid demand pick-up in December. Luxury goods remain resilient while airlines are starting to show signs of stronger demand albeit from a low base.
Financials	►	►	▼	►	The sharp deceleration in investment banking and trading activity is expected to weigh on Q1 results. In addition, retail banking businesses have slower demand for loans and mortgages due to rising interest rates. Insurance companies are facing a significant rise in adverse event risks.
Industrials	▼	►	▼	▼	New orders remain weak as a consequence of the slowing economy. Input costs remain elevated with energy prices and inflation hurting margins. From this low base, we look for signs of a pick-up in orders. Companies supporting renewable energy and electric vehicle production continue to thrive.
Information Technology	►	►	►	▼	Lower valuations for quality large-cap IT stocks are attractive to long-term investors. However, IT stocks are likely to remain range bound on lower digital advertising and corporate capital spending. Consumer-focused electronics is likely to see muted growth under inflationary pressure.
Communications Services	►	►	▲	►	The media & entertainment industry remains challenged while the telecoms industry benefits from steady cash flows and growth from increased data usage as more activity shifts on-line and business digitises.
Materials	►	►	►	▼	Mining stocks are trading on low valuations multiples relative to other industries. With China's re-opening, commodities have started to recover. Higher energy and oil/gas feedstock prices look set to continue in Q1 weighing on the chemicals and construction materials industries.
Real Estate	►	►	▼	►	The sector is challenged by rising interest rates and softening demand in some categories. Retail real estate suffers from long-term structural changes caused by the rise in ecommerce and this is unlikely to change. Office space is being reduced as employers promote work-from-home. The storage and warehousing assets bubble appears to have run its course.
Consumer Staples	▲	▲	▲	▲	Despite elevated valuations and costs, corporates are expected to report solid demand and stable margins following double-digit price increases. We recommend focusing on quality stocks with strong brands and/or pricing power.
Energy	▲	▲	▲	▲	The energy sector should continue to benefit from OPEC keeping supply tight to protect profits, low inventories and supply-demand imbalances. The unseasonably warm weather in Europe has eased demand-supply concerns. Valuations remain very attractive.
Healthcare	►	►	▲	►	Valuations remain attractive versus consumer staples and utilities. Pharma stocks should be most resilient particularly post-US mid-term elections which have effectively removed any major risk of political moves to reduce medicine prices. Higher-beta biotechnology industry typically underperforms in this environment.
Utilities	►	▲	►	►	The sector's stable earnings/cash flow characteristics and high dividend yielding stocks provide a defensive investment. We expect US utility company margins to expand given the strong pricing environment and the fact that the capex cycle has peaked, so free cash flow should start to improve.

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