

Investment Monthly

Monetary policy divergence is driving market sentiment

July 2023



Key takeaways

- ◆ The Fed paused in June to monitor the effect of rate hikes while the BoE and ECB continued their inflation fight with more hikes. This policy divergence supports our preference for US equities over Eurozone and UK equities. Technology is also benefitting from US peak rates and the great enthusiasm for AI. Yet, short-term consolidation is likely as equity valuations have risen.
- ◆ Despite improved performance, global high yield is less preferred due to their relatively high valuations and tighter credit conditions. While yields on cash and short-term bonds are tempting, they may miss returns during periods of looser monetary policy, when yields and deposit rates often fall. We continue to favour global IG bonds with medium maturities to lock in attractive yields.
- ◆ We expect the Chinese government to roll out further stimulus measures to achieve a broader, sustainable recovery. As the drag on the property sector continues, we have lowered our GDP forecast from 6.3% to 5.3%, but remain positive on China's earnings outlook and valuations. We upgrade South Korean equities to neutral, and Asian IT to overweight to reflect the global AI-backed tech stocks boom. The upgrades will help broaden our Asian exposure.



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Asset class	6-month view	Comment
Global equities	►	Divergent economic growth, persistent inflation and higher rates in key DM markets remain headwinds but the economic slowdown is less severe than expected. We are less defensive but remain focused on quality and Asia.
Government bonds	▼	We see better opportunities in investment grade bonds as credit spreads remain fair.
Investment grade (IG) corporate bonds	▲	We prefer quality bonds amid tightening credit conditions and growth slowdown. We maintain a medium duration as we balance yield levels against volatility.
High yield (HY) corporate bonds	►	We favour investment grade over high yield as reduced bank lending could lead to fears of higher default rates.
Gold	►	Gold benefits from USD weakness and central bank buying but valuations seems stretched.

▲ "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. What does DM policy divergence mean to equities?

- ◆ The Fed paused in June to monitor the effect of rate hikes but hinted that there could be two more hikes by year end. We still expect that the hiking cycle will end soon. As inflation remains sticky in Europe, we expect two more hikes there. However, in the UK, we now see the Bank Rate peaking at 5.75% (i.e. 0.5% hike in August and 0.25% in September), while markets have priced in 6.25%. The divergent rate outlook impacts valuations and growth potential, supporting US equities to outperform Eurozone and UK equities, and the USD to weaken versus EUR and GBP.
- ◆ Technology has benefitted from US peak rates as most tech stocks are growth-oriented, and there is great enthusiasm for artificial intelligence (AI). Potential beneficiaries also include tech companies in communications and consumer discretionary. Many of them are trading at attractive valuations with stronger earnings outlook for next year.
- ◆ **We are overweight on technology and US equities** as the Fed is near the end of the tightening cycle, while keeping **Eurozone and UK equities neutral**. Yet, investors should prepare for some consolidation as equity valuations have risen, and further Fed tightening may cut into future earnings estimates and valuations in the short term.

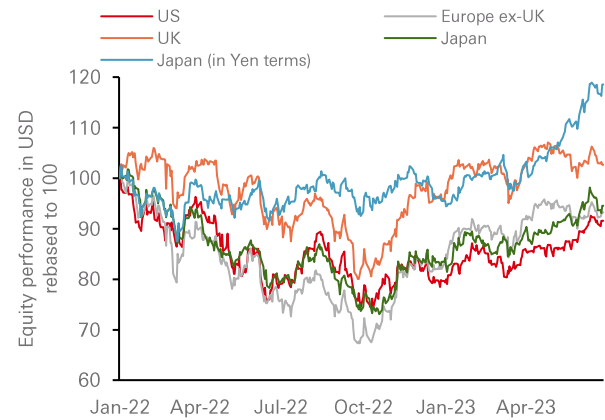
2. Why do investment grade credit remain attractive?

- ◆ Resilient macro-economic data and robust market sentiment have been supportive to global high yield, resulting in better performance relative to global investment grade year-to-date. However, global high yield bonds look quite expensive in USD and the tighter credit conditions remain a concern.
- ◆ Although time deposit rates in DM generally look attractive, especially with inverted yield curves, they are not in favour. Based on data as far back as 2000, bonds have generally outperformed cash when policy rates peak due to higher rate sensitivity of the asset class. While yields on cash and short-term bonds are currently tempting, they come with a high opportunity cost of missing returns during periods of looser monetary policy, as yields often decline alongside central banks easing monetary policy, as do deposit rates.
- ◆ Therefore, **we remain overweight on investment grade corporate bonds with medium maturities** to lock in higher yields while available. In fact, the 5-to-7-year duration has performed better than the shorter end following a new repricing of policy rate expectations.

3. What are the implications of China's mixed economic data?

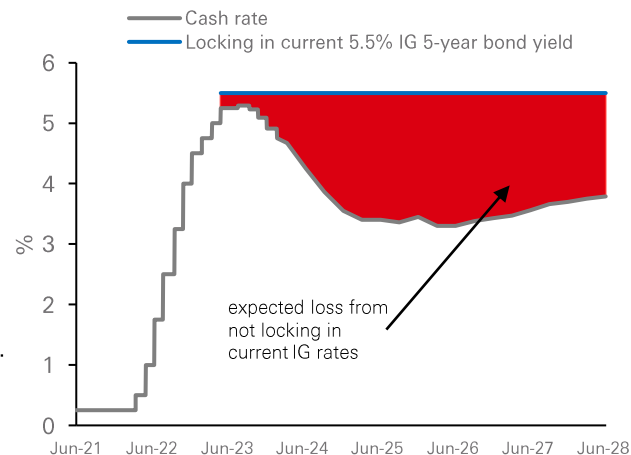
- ◆ After a strong consumption-led economic rebound in Q1, China's growth momentum has softened with slower recovery in property sales and disappointment in manufactory rebound. Retail and services have less immediate lifting impact on mid and upstream industries.
- ◆ We believe the Chinese government will roll out more stimulus in the coming months (e.g. lower interest rates, reserve ratio requirements and lending loan rates), but the pace will be more gradual than before, as their priority has shifted towards a longer-term, structural recovery. We have also lowered our GDP growth forecast from 6.3% to 5.3% with the drag from the property sector. However, both EPS growth forecasts (e.g. 15% for 2023) and valuations remain attractive.
- ◆ India and Indonesia are another two growth engines driving Asia's upturn. Following a recent overweight upgrade of Indian equities, we also upgrade South Korean equities to neutral, and Asian technology to overweight because of the global AI-backed tech stocks boom and increased demand for semiconductor chips. Fundamentals and earnings outlook of the sector are also improving. These upgrades are aligned with our strategy to broaden our Asian exposure.

Chart 1: US equities are outperforming Eurozone and UK equities due to the divergent rate outlook



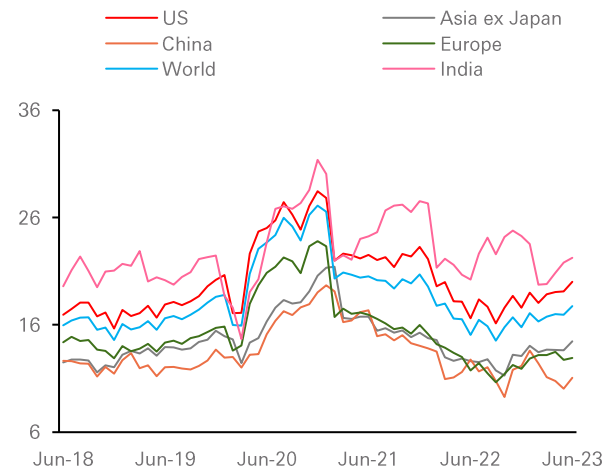
Source: Bloomberg, HSBC Global Private Banking as at 16 June 2023. Past performance is not a reliable indicator of future performance.

Chart 2: Investment grade bonds are more attractive than time deposits via locking in current yields



Source: Bloomberg, HSBC Global Private Banking as at 20 June 2023. Past performance is not a reliable indicator of future performance.

Chart 3: Chinese equity valuations remain relatively attractive compared to other markets



Source: Wind, HSBC Global Private Banking and Wealth as at 20 June 2023. 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
Global equities		
Global	►	Divergent economic growth, persistent inflation and higher rates in key DM markets remain headwinds but the economic slowdown is less severe than expected. We are less defensive but remain focused on quality and Asia.
United States	▲	We like the diversity and quality character of US stocks and the strong tech sector but growth slowdown may drive near-term volatility. A pause from the Fed, combined with continued disinflation, could be a positive boost to fundamentals.
United Kingdom	►	The UK stock market is cheap but inflation is sticky and rate hikes are likely to continue.
Eurozone	►	Europe should benefit from China's reopening and easing energy crisis. However, tighter lending conditions and stubbornly high inflation could keep tightening longer.
Japan	►	We expect the Bank of Japan to widen its Yield Curve Control trading range in Q3, which could reverse recent JPY weakness and equity strength. A stronger currency will weigh on exports.
Emerging Markets (EM)	►	China's reopening and USD weakness are positive for emerging markets, particularly EM Asia, which benefits from a rebound in Chinese demand and tourism.
EM EMEA	▼	The region is impacted by high energy prices and weak growth in Europe.
EM LatAm	▲	A more dovish rate outlook and rising Chinese demand are growth drivers for Brazil and Mexico.
Asian ex Japan equities		
Asia ex-Japan	▲	Supply-chain reorientation, domestic consumption and China's focus on sustainable growth are driving Asia's upturn. We favour the large domestic markets including China, India and Indonesia.
Mainland China	▲	We expect to see more fiscal and monetary stimulus to achieve a broader, sustainable recovery although the pace may slow down. Green transition, manufacturing upgrading and technology innovation remain attractive.
India	▲	Solid economic growth, young demographics and the rise of the middle class are some key drivers supporting our overweight on Indian equities. We like the Indian banks and IT companies, in particular.
Hong Kong	▲	Hong Kong will benefit from mainland China's economic recovery. Consumption and tourism recovery are key drivers and retail landlords, consumption and insurance companies should stand to benefit.
Singapore	►	The trade headwinds continue to weigh on growth but have been partially offset by travel-related services. The return of Chinese tourists could be a catalyst as flight constraints continue to be eased.
South Korea	►↑	We upgrade South Korean equities to neutral on stronger earnings recovery in 2024, attractive forward valuations and the global AI-backed tech stocks boom. Demand for semiconductor chips is also improving.
Taiwan	►	Although domestic consumption and tourism provide some cushion, economic growth is still impacted by ongoing muted demand of the global electronics cycle.
Government bonds		
Developed markets (DM)	▼	We see better opportunities in investment grade bonds as credit spreads remain fair.
United States	►	Treasury yields should remain volatile as the markets are monitoring how inflation, growth and Fed comments unfold.
United Kingdom	▲	We remain overweight on gilts for their attractive yields and potential capital gains. Very short-dated gilts can deliver lucrative returns when held to maturity. We prefer medium durations as the market now prices in too many rate hikes.
Eurozone	►↑	The negative interest rate environment is over. With higher rates, European sovereign bond valuations look more appealing and warrant our upgrade to neutral.
Japan	▼	The BoJ's accommodative policy is not sustainable and yields are low, therefore we maintain our underweight position.
Emerging Markets (Local currency)	►	Select opportunities exist as some economies are slowing rate hikes but others continue. USD weakness remains a tailwind.
Emerging Markets (Hard currency)	►	Amid higher Treasury volatility, we still find yield but remain selective and bearish on USD.
Corporate bonds		
Global investment grade (IG)	▲	We prefer quality bonds amid tightening credit conditions and growth slowdown. We maintain a medium duration as we balance yield levels against volatility.
USD investment grade (IG)	▲	As economic growth is slowing, we continue to focus on investment grade bonds while peaking policy rates support our preference for medium maturities to lock in attractive yields. We prefer senior bonds when investing in financials.
EUR and GBP investment grade (IG)	▲	We remain overweight on investment grade which offers better risk-adjusted returns than high yield. Companies with greater revenue exposure to Asia are preferred.
Asia investment grade (IG)	▲	The outlook for Asian credit has improved given China's growth recovery and improved fundamentals in the region. We prefer medium duration to lock in yields at current compelling levels.
Global high-yield (HY)	►	We favour investment grade over high yield as reduced bank lending could lead to fears of higher default rates.
US high-yield (HY)	►	While US high-yield companies still enjoy low default rates, they should start to rise soon as economic growth slows and financial conditions tighten. Spreads are not particularly generous and higher default rates should lead them to widen.
EUR and GBP high-yield (HY)	►	Despite an improved growth outlook, tighter monetary policy remains a challenge. We maintain a neutral stance on high yield due to their higher exposure to growth risks and expectations for rising default rates.
Asia high-yield (HY)	►	Low inflation means Asian central banks generally do not need to hike rates. But we stay cautious on Chinese property and prefer quality state-owned developers due to their stronger financial positions and lower leverage.
Commodities		
Gold	►	Gold benefits from USD weakness and central bank buying but valuations seems stretched.
Oil	►	Slowing growth weighs on oil prices but we foresee a supply/demand deficit in H2.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	Inflationary pressures are easing in many regions with rising wages for blue-collar workers offsetting some cost-of-living rises. Discretionary spending is improving, especially in the services segment with airlines, hotels, restaurants and resorts benefitting. Automakers are seeing modest improvement in orders while luxury goods continue to benefit from strong demand and pricing power.
Financials	▶	▶	▶	▶	The sector appears to be stabilising with attractive valuations and high interest rates fuelling profits for the lenders. However, markets remain cautious, especially with the interest rate cycle expected to peak soon and investment banking and brokerage revenues being lacklustre.
Industrials	▲	▲	▲	▶	Macro-economic concerns have eased but higher interest rates, inflationary pressures and higher input costs persist. China's growth momentum slows and industrial goods remain muted. European industrials continue to perform well, but the valuation gap with US peers has mostly closed. The US's Inflation Reduction Act (IRA) is boosting companies that supply the electric vehicles and renewables industries.
Information Technology	▲	▲	▲	▲↑	The outlook continues to improve in certain sub-segments including digital, AI and automation as business and consumer sentiment is improving. Cloud computing and digital advertising growth remains muted. We upgrade Asia on improving fundamentals, strong 2024 earnings forecasts, attractive valuations and an improving outlook for semiconductors as demand picks up gradually across the region.
Communications Services	▲	▲	▼↓	▲	The media & entertainment industry is starting to see some limited signs of a demand recovery. Valuations remain moderately attractive. Regulatory concerns remain a headwind to sentiment. We downgrade Europe, which is mainly composed of telecoms stocks, on poor fundamentals, negative earnings growth, rising competitive pressures and the increased risk of dividend cuts in the region.
Materials	▶	▶	▶	▶	After rapidly reopening, China's macro-economic environment is challenged by muted demand for commodities and chemicals. This, together with elevated energy and feedstock prices, is weighing on margins and earnings outlook. Valuations are among the lowest in the market. The long-term outlook for copper remains positive given the drive for renewables and electrification.
Real Estate	▼	▼	▼	▶	The sector is challenged by rising interest rates and softening demand in many categories. Long-term structural changes due to differing consumption and usage patterns as a result of secular trends including ecommerce, digital technologies, urbanisation and work-from-home are hitting many existing and new projects. Declining yields and rising regulation are also headwinds.
Consumer Staples	▶	▶	▶	▲	Global and European consumer staples face a more challenging pricing environment after last year's above inflation rises, tough y-o-y comparables and rich valuations. We focus on quality stocks with strong brands and more resilient pricing power. Dividends are also recommended where attractive.
Energy	▶	▶	▲	▶	Sector valuations remain relatively low and dividend yields are attractive for some companies. Quarterly financial statements are likely to show slower y-o-y revenue and earnings growth after last year's bumper profits. OPEC+ may further tighten oil supplies to put a floor on price declines.
Healthcare	▶	▶	▶↓	▼↓	We remain constructive on the sector, but downgrade Europe and Asia in the absence of obvious catalysts to drive prices and valuations higher. In Asia, valuations are particularly elevated, trading well above historical levels, but also in Europe where valuations are full.
Utilities	▶	▶	▲	▶	Valuations remain attractive in Europe with supportive earnings revisions. US's Inflation Reduction Act (IRA) and Europe's green initiatives should continue to be supportive. The sector's stable earnings/cash flow characteristics and high dividend yielding stocks appeal to more cautious investors.

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