HSBC

Investment Monthly

Policy rates will peak soon but rate cuts are not in sight

June 2023

Key takeaways

- We believe the Fed is likely to peak policy rates in June while sticky core inflation may push the BoE and ECB to hike beyond June. In any case, it's clear that the tightening cycle is largely behind us but we do not expect any rate cuts this year. Asia is ahead of the curve due to moderate inflation. A more certain rate outlook favours risk assets including equities, investment grade bonds and EM assets.
- While the outperformance of tech stocks has led to concerns about their valuations and growth prospects, our optimism is bolstered by over 80% of tech company earnings exceeding expectations in Q1 and AI development. The peak in policy rates is another catalyst that supports our overweight on technology.


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- Given strong growth momentum and the pro-growth policy direction, we have lifted China's 2023 GDP forecast from 5.6% to 6.3%. The return of Chinese tourism and the outbound goods demand also benefit the region, which is projected to deliver a notable GDP growth of 5.1% in 2023, with attractive equity valuations and earnings upgrade expectations. We remain overweight on Asian ex Japan, mainland Chinese and Hong Kong equities, and upgrade Indian equities to overweight to reflect the growth potential from a large and young population and the tech upswing.

Asset class	6-month view	Comment
Global equities	▶	Despite uncertainties around the growth outlook, the path of inflation and geopolitical tensions, we remain neutral on global equities as the peak in DM policy rates and Asia's recovery momentum provide upside risk to growth.
Government bonds	▼	We see better opportunities in investment grade bonds as credit spreads have widened slightly.
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.

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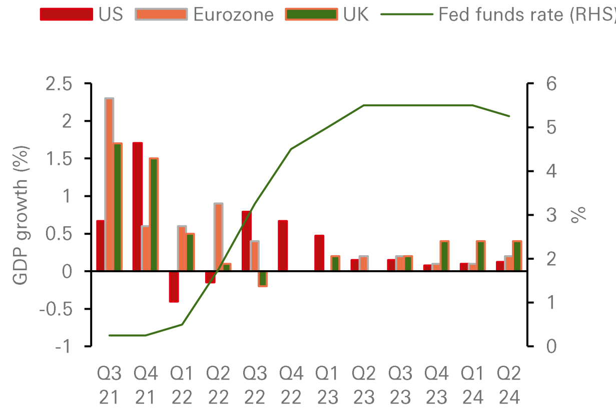
Talking points

Each month, we discuss 3 key issues facing investors

1. What is the rate outlook for developed markets and Asia?

- With Fed Chair's dovish comment that policy rate may not need to rise as much as it would have to combat inflation, we believe that the US is close to the end of the hiking cycle, with a final 0.25% hike in June.
- The UK's core inflation in April surprised on the upside. As a result, we are now looking for three further rate hikes of 0.25%, in June, August and September. The UK is seeing stronger labour cost growth than in the Eurozone (7.5% vs 5%) and food inflation is very sticky as well, reaching almost 20%. In Europe, sticky core inflation driven by the services sector and accelerating wage growth may push the ECB to continue raising rates as well, bringing the key deposit rate to 4%.
- Still, looking across developed markets, monetary policy tightening is largely behind us, but we do not expect any rate cuts until Q2 2024 as inflation will only fall gradually. Easing inflation in Asia allows central banks to end the monetary tightening cycle ahead of the West. In short, as earnings recover in Q3 and Q4, we could see more upside in H2. A more certain rate outlook is generally **supportive of risk assets including equities and EM assets. For investment grade bonds, we prefer medium maturities to lock in attractive yields for longer.**

Chart 1: We foresee slow growth but a deep recession is unlikely. Peak policy rates should support markets

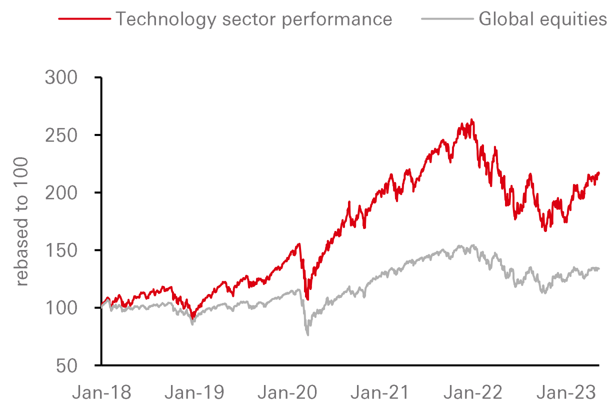


Source: Bloomberg, HSBC Global Research forecasts, HSBC Global Private Banking as at 24 May 2023. Forecasts are subject to change.

2. Can the tech sector continue to lead equity markets higher?

- Tech stocks have outperformed the broader market, leading some investors to worry about their valuations and whether the rally should be more broad-based. The strong Q1 earnings season supports the optimism, with 78% of company earnings exceeding expectations, and that ratio reaching 82% in the tech sector.
- In addition, we believe artificial intelligence (AI) should boost demand for tech firms' goods and services, which will lift earnings expectations and trigger more upgrades. Better earnings means that price/earnings (P/E) ratios will start to look less demanding at current levels. In fact, the current P/E ratio at 26x for the tech sector is still well below the pre-Covid highs of 30x.
- As central banks should stop their rate hikes soon, this should also be a positive for interest-rate sensitive stocks like tech. **We remain overweight on technology globally and in the US and Europe**, and see many long-term positive structural drivers.

Chart 2: Technology-related themes are benefiting from the recovery in the tech sector



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 24 May 2023. Past performance is not a reliable indicator of future performance.

3. How can investors capture the recovery opportunities in Asia?

- Asian growth prospects are spearheaded by its improved fundamentals, and China's robust consumption-led recovery. The Labour Day holiday achieved a new record of 274 million domestic trips in China, 19% above pre-pandemic levels. Given strong growth momentum and the pro-growth policy direction, we have lifted our forecast of China's 2023 GDP growth from 5.6% to 6.3% and expect to see a more balanced recovery with more fiscal and monetary stimulus in H2.
- The return of Chinese tourism and the outbound goods demand also benefit the region, particularly Hong Kong and Indonesia. India is seeing strong investor interest with its large and young population presenting opportunities in consumption and its tech upswing also attracting foreign investment inflows in high-skilled exports (e.g. IT software services) and digital start-ups. The country's economic and earnings growth are expected to be among the strongest in Asia for this and next year. **We therefore upgrade Indian equities to overweight.**
- Asia is the only region where we project a notable GDP growth of 5.1% in 2023, with attractive equity valuations and earnings upgrade potential. A well-diversified portfolio will benefit greatly from adding to Asian assets. In addition to having direct exposure to Asia, investors can also tap into the region's growth through DM exports.

Chart 3: Asia's growth acceleration versus DM slowdown

Source: CEIC, HSBC Global Research Forecasts, HSBC Global Private Banking and Wealth as at 25 May 2023. Forecasts are subject to change

Asset Class Views

Our latest house view on various asset classes

Asset class	6-month view	Comment
Global equities		
Global	▶	Despite uncertainties around the growth outlook, the path of inflation and geopolitical tensions, we remain neutral on global equities as the peak in DM policy rates and Asia's recovery momentum provide upside risk to growth.
United States	▲	We like the diversity and quality character of US stocks, as well as its strong tech sector but near-term volatility will continue amid the overhang from debt-ceiling talks and tightening credit conditions.
United Kingdom	▶	The UK stock market is cheap and the economic cycle seems to have bottomed but inflation remains sticky.
Eurozone	▶	Europe should benefit from China's reopening and easing energy crisis. Tighter credit conditions, elevated inflation and the extent of the hiking cycle create headwinds.
Japan	▶	A weak global outlook remains a key challenge. We now expect the Bank of Japan to widen its Yield Curve Control (YCC) trading band in Q3 2023. JPY strength could drag 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	▲	Asia is expected to drive global growth supported by improved fundamentals, long-term structural opportunities and China's recovery. Most Asian economies have ended the monetary tightening cycle ahead of the West.
Mainland China	▲	We expect to see a more balanced recovery with support of more fiscal and monetary stimulus in H2 and look for opportunities in government-supported areas (e.g. green transition, manufacturing upgrading and technology innovation).
India	▲↑	India's large and young population and the tech upswing present opportunities in domestic consumption, digital economy, green transition and smart manufacturing. Rich valuations are supported by high ROE at 14-15%. We upgrade Indian equities to overweight.
Hong Kong	▲	Consumption and tourism recovery support our revision of Hong Kong's GDP growth forecast from 3.8% to 5% for 2023. Retail landlords, consumption and insurance companies should stand to benefit.
Singapore	▶	Despite manufacturing and trade challenges, we see opportunities in the travel-related sectors, which account for 10% of GDP. Direct flights with China have resumed 50%.
South Korea	▼	Private consumption and trade balance remain weak. The prolonged down cycle in the electronics sector continues to weigh on growth.
Taiwan	▶	GDP surprised on the downside by falling 3% y-o-y in Q1. Domestic consumption boosted by the local pent-up demand and gradual return of tourists is offset by a downturn in global technology demand, which has hampered investment.
Government bonds		
Developed markets (DM)	▼	We see better opportunities in investment grade bonds as credit spreads have widened slightly.
United States	▶	Treasury yields should remain volatile as the markets are monitoring how inflation, growth, and Fed comments unfold.
United Kingdom	▲	Markets have priced in more rate hikes and UK gilts remain attractive. GBP strength vs USD can help returns for foreign investors.
Eurozone	▼	Government bond yields fell on expectations of more rate hikes to tame inflation. We see better opportunities in investment grade credit.
Japan	▼	We expect the Bank of Japan to widen its Yield Curve Control sometime this year as the current pace of government bond purchases is difficult to sustain.
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 attractive yields and 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 a stronger growth recovery in China and resilient fundamentals in the region. We have changed our bond duration to medium 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 solid credit fundamentals and low default rates, spreads are not particularly generous and markets could price in slightly higher default rates ahead as financial conditions tighten.
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)	▶	Default rates have improved but we stay cautious on Chinese property high yield 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	▶	High price levels reflect supply concerns but demand is starting to decline.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲↑	▲	Inflation continues to ease 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 including airlines, hotels, restaurants and resorts. Automakers are seeing modest improvement in orders while luxury goods continue to benefit from strong demand and pricing power. We upgrade Europe as the likelihood of a recession ebbs. Inflation starts to fall while consumer spending remains resilient.
Financials	▶	▶	▶	▶	Positive momentum in the banking sector in earlier months was sharply reversed with the events surrounding Silicon Valley Bank in the US and Credit Suisse in Europe. The sector appears to be stabilising with attractive valuations and high interest rates fuelling profits for the lenders. However, markets remain cautious especially with interest rate cycle expected to peak soon and investment banking and brokerage revenues being lacklustre.
Industrials	▲	▲	▲	▶	Macro-economic concerns have eased but input costs remain a headwind. China's growth has picked up but demand for commodities and industrial goods remains muted. European industrials continue to perform well on robust demand, trading at a slight discount to their US peers that have lagged on uncertainty around the US debt ceiling. Companies supporting renewable energy, electric vehicle production and digital infrastructure should benefit from rising demand and government initiatives.
Information Technology	▲	▲	▲	▶	The outlook is slowly improving in certain sub-segments including digital, AI and automation as business and consumer sentiment is improving, although certain semiconductor markets remain oversupplied. Cloud computing and digital advertising growth continues to slow. We focus on profitable companies with resilient established business models.
Communications Services	▲	▲	▶	▲	The media & entertainment industry is starting to see some limited signs of a demand recovery. Telecoms services are also likely to continue to benefit from higher digital content demand and roaming fees as consumers travel more and become more socially active. Valuations remain attractive but regulatory concerns remain a headwind to improving sentiment.
Materials	▶	▶	▶↓	▶	Mining stocks are trading on low valuations multiples relative to other sectors. Energy prices and oil/gas feedstock prices remain elevated, affecting the outlook for chemicals and construction materials industries in Q2/Q3. We downgrade Europe as the anticipated pick-up in demand for commodities has failed to materialise. The 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 challenges.
Consumer Staples	▶	▶	▶	▲	Global and European consumer staples face a more challenging pricing environment after last year's above inflation rises, tough YoY 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 YoY 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, especially high quality biotechnology and medical technology stocks with profitable business and good product pipelines, but early stage companies or those with higher leverage or financing costs should be avoided given the elevated interest rates.
Utilities	▶	▶	▲	▶	European sector valuations remain attractive with earnings revisions for the sector also supportive. The sector's stable earnings/cash flow characteristics and high dividend yielding stocks appeal to more cautious investors.

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