HSBC

Investment Monthly

Markets torn between cyclical optimism and rate hike fears

March 2023

Key takeaways

- Although stronger-than-expected economic data have triggered the bond markets to price in more Fed rate hikes to combat inflation, we maintain our view that the Fed will keep rates at 5% until Q2 2024. We continue to favour quality bonds amid rate and growth uncertainty and have extended US and European IG duration to 5-7 years to lock in decent yields for a longer period.
- As equity markets have rebounded rapidly on recent good news, we expect to see some short-term consolidation. We stay overweight on US equities but keep US technology neutral due to mixed earnings prospects. Asia remains our top pick with China's reopening being a key driver. We upgraded both Taiwanese equities and Asia technology to neutral due to the improving Asian tech cycle.
- We anticipate increased policy support from China's NPC (e.g. a bigger stimulus package and continued infrastructure investment) to boost economic growth, which support our overweight on Chinese equities and our upgrade of China's full-year GDP growth to 5.6%, led by consumption rebound, property market stabilisation and pro-growth policy support.

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Asset class	6-month view	Comment
Global equities	▶	Global equities are supported by strong growth in Asia and better-than-expected economic data in the US and Europe. As earnings are mixed, we focus on quality companies with strong cash flows and brand positions.
Government bonds	▼	Yields have backed up and government bonds provide diversification, but we prefer high-rated corporate bonds.
Investment grade (IG) corporate bonds	▲	Following the back-up in yields, we have extended our duration preference to medium.
High yield (HY) corporate bonds	▶	We favour investment grade over high yield as spreads should remain volatile amid higher for longer rates. We believe the upcoming default cycle has never really been priced in.
Gold	▶	Gold benefits from USD weakness and central bank buying but real yields are a challenge and mining output is rising.

▲ "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.

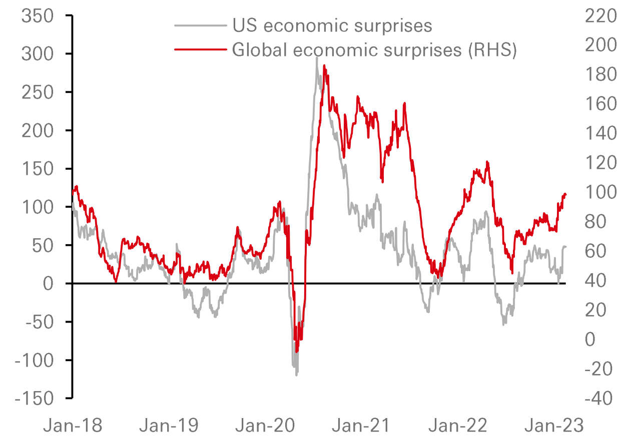
Talking points

Each month, we discuss 3 key issues facing investors

1. What is the latest economic data telling us?

- The US and European economies are slowing but the slowdown is less fearful than expected (e.g. stronger than expected US payroll and retail sales data; improving PMI in Europe). Recent data suggest that a deep recession in these markets is unlikely.
- However, the strong US employment data have led to bond markets being concerned about more Fed rate hikes to bring down wage inflation and raising their peak rate assessment to 5.25% or even 5.5%. As inflation continued to fall in January and we believe rental should start to ease, we hold the view that the Fed will make a final hike of 0.25% in March and keep the policy rate at 5% until Q2 2024.
- Bonds continue to offer attractive carry opportunities and we continue to favour quality credit to mitigate rate and growth uncertainty. Given that developed market rates have now reached the upper-end of their trading ranges, **we have extended duration positioning on US and European investment grade corporate bonds to 5-7 years** to lock in the pickup in yields.

Chart 1: Economic data have been better than expected, causing economists to raise their forecasts

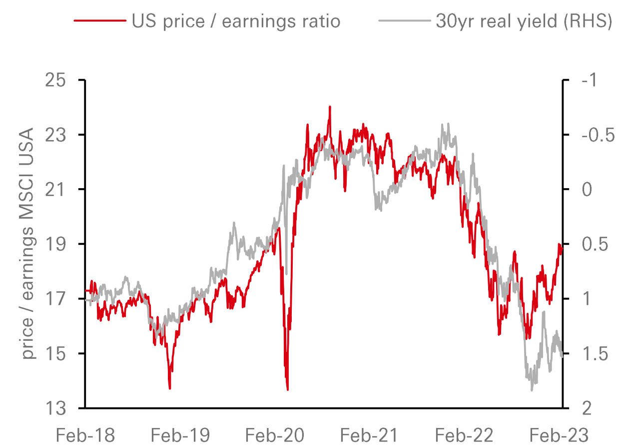


Source: HSBC Global Private Banking as at 15 February 2023.

2. Is recent equity rally sustainable?

- Equity markets see the better data as a good reason to push up cyclicals but further surprises on the upside are challenging. The gap between the price/earnings and Treasuries' real yield has increased, suggesting that equity valuations may have bounced too quickly. Following the recent equity rally and the sharp sell-off in the US dollar, we expect to see some short-term consolidation for both.
- We remain overweight on US equities due to its tight job market, easing inflation and peaking policy rates, and have added more cyclical exposure to our sector stance but remain neutral overall. The recent rally of US technology was driven by OpenAI's ChatGPT innovation and AI-related opportunities, as well as cost cutting measures by some big tech companies. Nevertheless, we remain neutral on US technology due to its mixed earnings prospects.
- Geographically, Asia remains our top pick boosted by China's reopening. As the Asian tech cycle should improve and a gradual recovery in semiconductors globally is expected, **we upgrade Taiwanese equities and Asia technology to neutral.**

Chart 2: Equities' valuation gap with bonds has increased

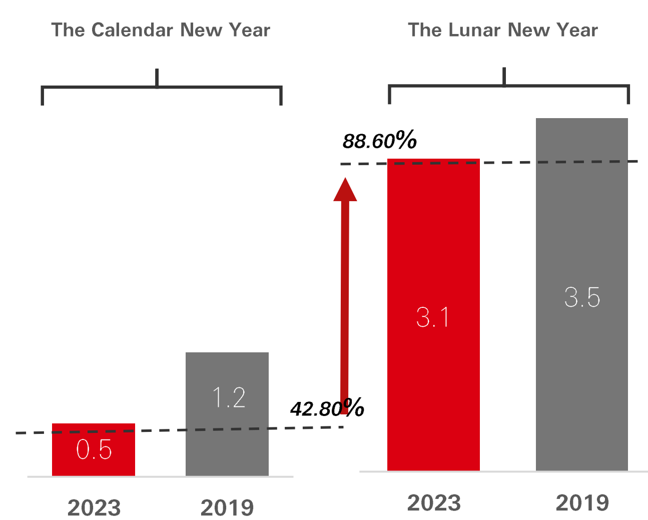


Source: Bloomberg, HSBC Global Private Banking as at 15 February 2023. Past performance is not a reliable indicator of future performance.

3. What to expect from China's National People's Congress?

- The rebound in PMIs and stronger total credit growth for January, as well as a significant increase in travel and mobile data usage during the holiday seasons showed signs of normalisation in China.
- We expect to see more government support on both the fiscal and monetary fronts from the National People's Congress (NPC) to be convened on 5 March. These include continued infrastructure investment through special local government bond issuance of RMB4trn and a bigger stimulus package leading to a national general budget deficit of 3.2% in 2023. Recently, it has also been announced that private equity funds are allowed to invest in residential and commercial properties, as well as infrastructure projects.
- **We remain overweight on Chinese equities and selective on China's property credit** with a preference for state-owned enterprises, TMT (technology, media and telecom) and Financials. We expect China's growth to accelerate from 2.2% y-o-y in Q1 to 7.4% in Q2, and have lifted the full-year growth forecast to 5.6% (from 5%) on a speedier recovery driven by consumption rebound, property market stabilisation and pro-growth policy support.

Chart 3: Chinese travel far exceeded expectations during the Lunar New Year (100 million trips)



Source: China Tourism Academy (Data Center of the Ministry of Culture and Tourism), HSBC Global Private Banking as at 30 January 2023.

Asset Class Views

Our latest house view on various asset classes

Asset class	6-month view	Comment
Global equities		
Global	▶	Global equities are supported by strong growth in Asia and better-than-expected economic data in the US and Europe. As earnings are mixed, we focus on quality companies with strong cash flows and brand positions.
United States	▲	We like the diversity and quality character of US stocks. Earnings are mixed but we see signs of bottoming of earnings downgrades which support our mild overweight position.
United Kingdom	▼	While a technical recession is avoided for Q4 22, falling real incomes amid high inflation and rising interest rates will weigh on Q1 and Q2 GDP. The cost of living crisis and higher taxes remain big headwinds.
Eurozone	▶	Despite elevated inflation and tightening monetary policy resulting in a real income squeeze, latest PMIs are pointing towards economic expansion in Q1. The easing of the energy crisis and China's reopening bring upside growth potential.
Japan	▶	The real GDP growth of 0.6 % for Q4 22 is lower than expected, with private consumption and investment activity remaining weak. JPY strength will weigh on the recent recovery in exports.
Emerging Markets (EM)	▶	China's reopening will likely help EM assets recover but underlying inflation and slowing global growth remain headwinds. Despite substantial inflows, funds remain underweight Chinese equities.
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 rising Chinese demand are positives for Brazil, while Mexico benefits from onshoring.
Asian ex Japan equities		
Asia ex-Japan	▲	Intraregional trade and China's reopening are driving growth in the region. Flows have continued to move into China and other Asian emerging markets but some investors are still under-allocated in our view.
Mainland China	▲	We expect to see more fiscal and monetary stimulus after the National People's Congress to support a strong bounce-back driven by consumption rebound, property market stabilisation and pro-growth policy support.
India	▶	Slowing exports, fading pent-up demand and fiscal consolidation from the union budget weigh on growth. Valuations remain stretched. We see longer-term opportunities in the digital economy, green transition and smart manufacturing.
Hong Kong	▲	In addition to the border reopening with mainland China, more supporting measures (e.g. consumption vouchers, tax credits, as well as transport and electricity subsidies) from the Budget will drive retail spending and normalisation of economic activity.
Singapore	▶	With the Singapore budget targeting to reduce the fiscal deficit, solve short-term issues such as inflation and high cost of living while addressing long-term priorities (e.g. ageing demographics), we expect the economy to remain resilient but economic growth will moderate on slower global growth outlook.
South Korea	▼	Declining consumption and softening private sector employment continue to weigh on the economy. The sectors of memory and smart phones will take a longer time to recover.
Taiwan	▶↑	As the earnings cycle bottoms out, we expect to see a gradual recovery in Asian semiconductors and technology hardware industry. Together with undemanding valuations, we upgrade Taiwanese equities to neutral.
Government bonds		
Developed markets (DM)	▼	Yields have backed up and government bonds provide diversification, but we prefer high-rated corporate bonds.
United States	▶	Markets are pricing in a higher terminal Fed fund rate, pushing Treasury yields up but we see better opportunities in the corporate sector.
United Kingdom	▲	A relatively dovish Bank of England and softening labour market data indicating downside risks to growth warrant our overweight in gilts with a focus on medium duration.
Eurozone	▼	With core inflation on a upward trajectory and improving economic momentum, we expect the ECB to retain a hawkish stance with two additional 0.5% rate hikes and will wait for clear evidence of peaking rates before adjusting our view.
Japan	▼	As core inflation and wage growth continue to slow, we do not expect policy rate hikes this year and forecast the Bank of Japan to widen the yield curve control trading band. We remain our underweight stance .
Emerging Markets (Local currency)	▶	Select opportunities exist as some countries are slowing rate hikes but others continue. The USD recent rally is likely to consolidate and does not change our view on USD weakness.
Emerging Markets (Hard currency)	▶	Amid higher Treasury volatility, we still find yield but remain selective.
Corporate bonds		
Global investment grade (IG)	▲	Following the back-up in yields, we have extended our duration to medium (5-7 years) with a focus on quality.
USD investment grade (IG)	▲	The recent rise in yields on the back of relatively strong economic data and market expectations of a more hawkish Fed offer a good opportunity to extend our duration stance to medium.
EUR and GBP investment grade (IG)	▲	European investment grade may see less pressure on credit spreads in case of downside risks to economic growth, while yields remain compelling. We prefer higher quality names and have increased our duration stance to medium.
Asia investment grade (IG)	▲	We stay focused on high-grade bonds to mitigate cyclical headwinds amid a global slowdown, preferably Hong Kong and Singapore IG bonds, and Chinese TMT (Technology, media and telecom) bonds with short-to-medium maturities.
Global high-yield (HY)	▶	We favour investment grade over high yield as spreads should remain volatile. We believe the upcoming default cycle has not really been priced in, especially after the recent rally and spread tightening.
US high-yield (HY)	▶	While US high-yield companies still enjoy solid credit fundamentals and low default rates, the disinflationary trend suggests that margins might get tighter and could put downward pressure on corporate earnings.
EUR and GBP high-yield (HY)	▶	Despite improved optimism on Europe's growth outlook, tighter monetary policy remains a challenge. We prefer higher quality investment grade credit and maintain a neutral stance on high yield amid expectations for rising default rates.
Asia high-yield (HY)	▶	Inflation, Fed tightening, slowing global demand and China's property debt restructuring remain headwinds for credit spreads.
Commodities		
Gold	▶	Gold benefits from USD weakness and central bank buying but real yields are a challenge and mining output is rising.
Oil	▶	Oil prices may recover on the fall of Russian output in the coming months and further improvement in China's demand to tighten the market in the near-term.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▶	▲	Inflation has eased although remains somewhat sticky in Europe where energy prices are more elevated. Rising wages are helping to lift consumer sentiment. Discretionary spending especially in the services segment with airlines, hotels, restaurants and resorts expected to benefit. Automakers are seeing supply issues ease. Luxury goods segment is seeing strong demand and exceptional pricing power.
Financials	▶	▶	▶↑	▶	We are now neutral on European financials as sentiment continues to improve albeit from a low point. Retail banking businesses have seen demand slowing for new loans and mortgages as higher interest rates bite, but this is more than offset by the positive impact of rising rates on existing business. Investment banking activity is steadily recovering and trade volumes have picked up from their Q4 lows.
Industrials	▶	▶	▲	▼	Concerns as to the severity of an economic slowdown/recession have eased. Input cost inflation is also easing but will still weigh on results into Q1. China's re-opening should benefit particularly European exporters. Low valuations also make the sector attractive. Companies supporting renewable energy and electric vehicle production continue to thrive.
Information Technology	▶	▶	▶	▶↑	Although the sector face multiple challenges, the overall fundamental outlook appears to be slowly improving, triggering our upgrade of Asia IT to neutral. We remain cautious on the sector given the current over-supply in some types of semiconductors, slowing cloud computing and digital advertising growth, as well as tough YoY comparables.
Communications Services	▲	▲	▲	▲	After several challenging quarters, the media & entertainment industry may see some bright spots. 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 are more attractive following last year's sell-off.
Materials	▶	▶	▲	▶	Mining stocks are trading on low valuations multiples relative to other industries but China's re-opening is likely to see modest demand recovery initially. Energy prices and oil/gas feedstock prices may have peaked potentially improving the outlook for chemicals and construction materials industries in Q2/Q3.
Real Estate	▶	▶	▼	▶	Rising interest rates and softening demand in some categories pose short-term challenges. 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 by many companies as employers reduce space and promote work-from-home. The storage and warehousing assets bubble appears to have run its course.
Consumer Staples	▶↓	▶	▶↓	▲	We downgrade global and European consumer staples given the more challenging pricing environment after last year's above inflation rises, tough YoY comparables, and rich sector valuations. We focus on quality stocks with strong brands and more resilient pricing power.
Energy	▲	▲	▲	▶↓	Oil prices have plateaued and gas prices have declined sharply, but company earnings should remain buoyant and the sector should continue to benefit from OPEC keeping supply tight to protect profits. An unseasonably warm weather in Europe has eased demand-supply concerns, but colder snaps in the US has driven increased demand there. Valuations remain very attractive, but we downgrade Asia energy to neutral after a strong run.
Healthcare	▲	▶	▲	▲	We remain constructive on the sector given the attractive valuations and stronger demand expected from Asia due to China's reopening and increase in travel worldwide. Biotechnology and medical technology stocks may benefit from the increasing risk appetite, but companies with higher leverage or financing costs should be avoided given the elevated interest rates.
Utilities	▶	▶↓	▶	▶	We downgrade US utilities as price momentum appears to have peaked and we trim our defensive sector exposure. The sector's stable earnings/cash flow characteristics and high dividend yielding stocks continue to appeal to more cautious investors.

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