

Investment Monthly

Positive data support equity valuations and positive sentiment

August 2023



Key takeaways

- ◆ With improved economic, earnings and inflation data in the US, we remain overweight on US equities and cyclicals. Their solid returns have driven valuations higher, but we believe this is warranted by strong fundamentals and earnings delivery particularly in technology and consumer discretionary. We also upgrade US financials on positive earnings and cheap valuations.
- ◆ European fundamentals are much weaker with falling composite PMI and mixed earnings growth, and we therefore move Eurozone stocks to underweight. In the UK, we extend our duration for UK gilts to medium-to-long on easing inflation and prefer investment grade credit over high yield as the growth outlook remains uncertain.
- ◆ China's Politburo meeting boosted expectations on growth with more positive and targeted policy support. We maintain overweight on Chinese stocks, which remain cheap and offer opportunities in consumer discretionary and staple, oversold internet leaders and quality state-owned enterprises (SOEs). We maintain our broad-based Asia overweight through exposure to India, Indonesia and Hong Kong.



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Asset class	6-month view	Comment
Global equities	▶	The divergence in economic growth, the inflation and rate outlook and credit tightening supports our neutral stance on global equities, with a preference for US and Asia because of their stronger fundamentals.
Government bonds	▼	We see better opportunities in investment grade bonds as credit spreads remain fair and provide a yield pickup.
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 but current prices may limit demand and increase supply.

▲ "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 there more upside for US equities and valuations?

- ◆ Q2 earnings results surprised on the upside thanks to overly pessimistic expectations, lower costs and margin protection measures, and a weaker USD. In fact, US equities have delivered solid returns since their October lows, led by technology, consumer discretionary and communication services. The economy's resilience is reinforcing market expectations that a soft landing should be manageable.
- ◆ Headline and core inflation fell to 3% and 4.8% y-o-y respectively in June. With improved economic, earnings and inflation data, **we remain overweight on US equities and cyclical sectors such as industrials, consumer discretionary, technology and communication services.** Companies that can benefit from the AI investment boom should do well, including data centres and communications.
- ◆ Some short-term consolidation is possible as valuations have risen (21x forward earnings) but are warranted by strong fundamentals and earnings delivery, particularly in IT and consumer discretionary. **We also upgrade Global and US financials to overweight** on positive earnings from most banks and cheap valuations. We believe the Fed delivered its final rate hike in July and will only start rate cuts in Q2 2024. Peaking rates are positive for cyclicals including banks.

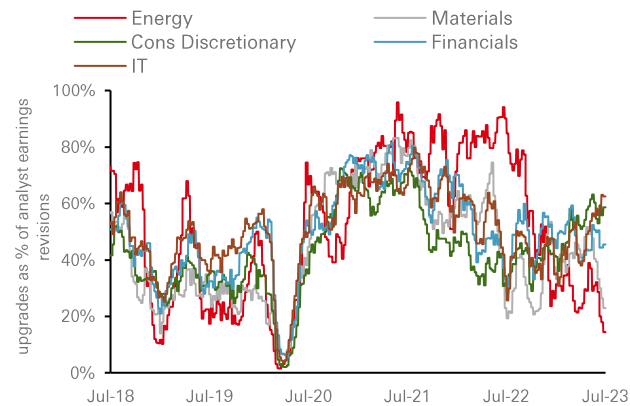
2. How does the Eurozone and UK growth outlook impact assets?

- ◆ European fundamentals are much weaker relative to the US with the composite PMI slipping into contraction in July and earnings misses and beats split almost equally. Germany is challenged by declining economic growth, falling business confidence and subdued activity in the construction and manufacturing sectors. While technology and consumer discretionary should continue to lead gains, large earnings declines in real estate, basic materials and energy have dragged the region's total EPS growth. **We therefore downgrade Eurozone equities to underweight.**
- ◆ Following a 0.25% hike in July, we retain our forecast for a further 0.25% hike in September by the European Central Bank (ECB) to peak policy rate at 4% given that core inflation remains elevated at 5.5% y-o-y.
- ◆ In the UK, the better-than-expected inflation data should allow the Bank of England (BoE) to pause sooner than markets fear. We expect the base rate to peak at 5.75% in September and therefore extend our duration for UK gilts from "medium" to "medium-to-long". We remain neutral on UK equities as growth is uncertain and prefer investment grade over high yield.

3. How should investors position their allocation to Asia?

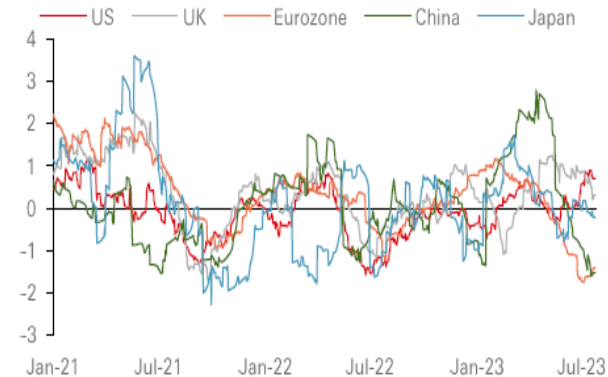
- ◆ China's Politburo meeting concluded on a more dovish note including more counter-cyclical policy support, property easing, target policies to boost consumption, a focus on activating capital markets and restoring investor confidence, and measures to support the internet platform economy and the private sector.
- ◆ Government support will come into play gradually, leading investors to become less worried about a double-dip in the economy and hence helping reduce risk premia in the short term. While expectations for growth have been downgraded, **we remain overweight on Chinese equities** which look cheap and focus on recovery winners in the consumer discretionary and staple sectors, oversold internet leaders and quality state-owned enterprises. We continue to take broad exposure to Asia's stock markets.
- ◆ **We also favour India, Indonesia and Hong Kong in the region.** India's valuations reflect their companies' high return on equity. Strong inflows are motivated by the country's strong cyclical momentum and drive for digitalisation. Indonesia is benefitting from global firms' supply chain diversification and less demanding valuations while consumption and tourism remain growth drivers in Hong Kong.

Chart 1: The sharp rally in IT and consumer discretionary is supported by strong earnings



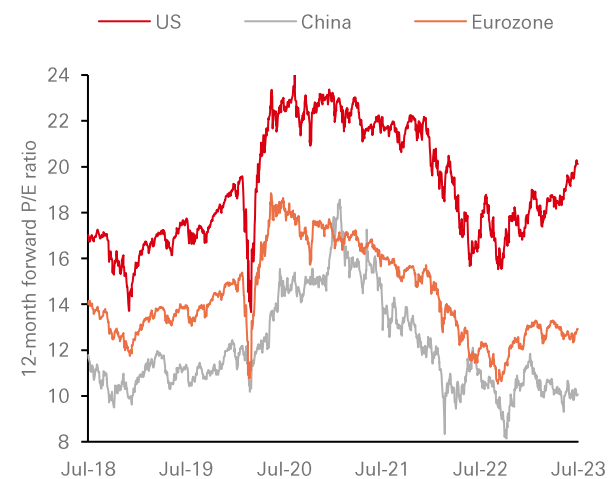
Source: Bloomberg, HSBC Global Private Banking as at 25 July 2023. Past performance is not a reliable indicator of future performance.

Chart 2: Positive economic surprises in the US, but negative in Eurozone and the UK



Source: Bloomberg, HSBC Global Private Banking as at 25 July 2023.

Chart 3: China's cheap valuations present an opportunity as policy should help boost growth



Source: Bloomberg, HSBC Global Private Banking as at 25 July 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	▶	The divergence in economic growth, the inflation and rate outlook and credit tightening supports our neutral stance on global equities, with a preference for US and Asia because of their stronger fundamentals.
United States	▲	The imminent peak in US policy rates, continued disinflation and resilient corporate earnings support our overweight on US equities and cyclical sector positioning. We expect to see upside to Q2 earnings and further improvement in H2.
United Kingdom	▶	Despite easing inflation in June, core inflation remains persistent due to high wage growth. The UK stock market is cheap but the uncertainty around the rate outlook and the housing market adds to downside risk.
Eurozone	▼↓	We downgrade Eurozone equities as activity data have surprised to the downside and growth remains challenged. We expect the ECB to continue with their rate hikes in the coming months.
Japan	▶	The Bank of Japan has adjusted its yield curve control policy to allow greater flexibility. We expect the policy to be removed in Q1 2024. This could reverse the JPY weakness and weigh on exporters.
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 the war and weak growth in Europe. Turkey looks more attractive than before, with macro improvements and undemanding valuations.
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	▲	We expect the region to remain resilient in Q3 with pro-growth monetary and credit policies amid easing inflation, and multiple growth engines including China's consumption recovery and strong structural growth in India and ASEAN.
Mainland China	▲	Valuations remain very cheap and policy support should help offset cyclical challenges. We prefer undervalued recovery winners, oversold internet leaders and quality SoEs which could benefit from structural growth and government support.
India	▲	Economic momentum remains healthy. Strong investment is positive for economic growth. We like the structural growth opportunities supported by the young demographics and the rise of the middle class.
Hong Kong	▲	We expect to see a solid cyclical recovery driven by consumption and tourism. Banks and property stocks have underperformed but valuations look more attractive now.
Singapore	▶	The global trade slowdown remains a drag to growth but has been partially offset by travel-related sectors. The return of Chinese tourists could accelerate the growth in services as more direct flights with China are restored.
South Korea	▶	Robust service activity and consumer spending are supportive but we remain cautious about the global export outlook.
Taiwan	▶	Despite weak global demand and elevated inventory levels, the equity market is supported by a tech and AI-driven rally. We remain neutral as valuations are turning rich.
Government bonds		
Developed markets (DM)	▼	We see better opportunities in investment grade bonds as credit spreads remain fair and provide a yield pickup.
United States	▶	US Treasury yields have probably already peaked as we think the Fed has completed its final rate hike. Treasury yields could start to drift lower (resulting in higher bond prices) when more future rate cuts are anticipated.
United Kingdom	▲	The recent bigger-than-expected fall in inflation should allow the BoE to halt its rate hikes sooner than markets fear. We therefore extend our duration preference from "medium" to "medium-to-long".
Eurozone	▶	The ECB continued its rate hike in July as expected but loosened its hawkish stance. With higher rates, European sovereign bond valuations look more appealing.
Japan	▼	The Bank of Japan has adjusted its policy, allowing the bond yield to drift as high as 1%. As the yield remains unattractive compared to other markets and some price losses are likely, we hold a bearish view on Japanese bonds.
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)	▲	Given the economic slowdown and risk of higher defaults, we prefer investment grade and lock in yields at the current levels.
EUR and GBP investment grade (IG)	▲	Growth concerns should support medium-term investment grade bonds to outperform high-yield issuers. Companies with greater revenue exposure to Asia are preferred.
Asia investment grade (IG)	▲	The outlook for Asian credit has improved given improved fundamentals and resilient growth in the region. We prefer medium duration to lock in yields at current compelling levels.
Global high-yield (HY)	▶	We prefer 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)	▶	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 much further. 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 but current prices may limit demand and increase supply.
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 have eased in many regions. Discretionary spending is improving, especially in the services segment with airlines, hotels, restaurants and resorts benefitting. Automakers are seeing modest improvement in orders. Despite softer US demand for luxury goods in Q2, many companies still reported 20% sales growth, so we may see profit taking after a strong run.
Financials	▲↑	▲↑	▶	▶	The sector trades on attractive valuations and high interest rates fuelling profits for the lenders. Although the interest rate cycle is close to peaking, higher rates are likely to persist. In H2, capital market activity is expected to pick up, but regional banks may underperform as mortgage and loan concerns are weighing on sentiment. We upgrade US and global financials on improving fundamentals, low valuations and an improving earnings outlook.
Industrials	▲	▲	▲	▶	Macro-economic concerns have eased but higher interest rates, inflationary pressures and higher input costs persist. China's growth lacks momentum and industrial goods remain muted. European industrials have performed well but are now taking a pause as US industrials have gained momentum. Asian industrials continue to lag on a slower regional growth outlook and slower demand. 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. Fundamentals continue to improve with solid Q2 sales and earnings reported to date while cloud computing growth is showing signs of slowing from elevated levels.
Communications Services	▲	▲	▼	▲	The media & entertainment industry is starting to see some signs of a demand recovery, but telecom services outlook remains more subdued. Valuations remain moderately attractive.
Materials	▶	▶	▶	▶	Tepid demand for commodities and chemicals, particularly in China, have held back YTD performance. In addition, elevated energy and feedstock prices are weighing on profits. Valuations are among the lowest in the market. There are some tentative signs of a pick-up in demand for commodities with the drive for renewables and electrification being supportive.
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 to some markets.
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	▶	▶	▲	▶	Oil and gas prices remain volatile but range bound. Tougher y-o-y comparables this year may trim growth, although H1 profits remained robust. Valuations remain very low relative to other sectors with above average dividend yields. We focus on quality blue-chip stocks. OPEC+ may further tighten oil supplies to put a floor on price declines.
Healthcare	▶	▶	▶	▼	We remain constructive on the sector but there are no clear catalysts to drive prices and valuations higher. In Asia, valuations remain 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. US valuations are full, so we downgrade the sector on better investment opportunities elsewhere. The sector's stable earnings/cash flow characteristics and high dividend yielding stocks appeal to more cautious investors.

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