

Investment Monthly

Spike in bond yields and China's property slump in the spotlight

September 2023



Key takeaways

- ◆ With Treasury yields rising to their cycle highs, driven by bond supply concerns, we see value in US Treasuries and move to overweight. Investment grade (IG) credit spreads have tightened but yields remain attractive. So our overweight in high quality bonds now includes both Treasuries and IG bonds. Historically, they both do well when the Fed stops hiking interest rates.
- ◆ The property sector continues to weigh on China's growth. Contagion fears regarding the potential default of a large developer and tighter liquidity conditions arising from shadow banking defaults hurt sentiment, warranting a neutral position for mainland Chinese and Hong Kong stocks. Valuations look cheap and we like consumer services and travel-related sectors. We stay overweight on Asia ex-Japan equities, favouring Indian and Indonesian stocks.
- ◆ The outperformance of technology and communications in the US has led to higher valuations of US equities, with the former more justified by stronger earnings prospects. We remain overweight on technology but diversify with consumer discretionary, industrials and financials stocks. We add healthcare to the opportunity set as we see emerging tailwinds of MedTech innovation and structural demand for treatment of age-related and chronic illnesses.



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Asset class	6-month view	Comment
Global equities	▶	The pace of growth is divergent across economies with the US and Asia being better positioned due to easing inflation and stronger fundamentals. We remain neutral on global equities and focus on quality.
Government bonds	▶↑	We upgrade global government bonds to neutral as Treasury yields have overshot.
Investment grade (IG) corporate bonds	▲	We remain overweight but narrow the gap with government bonds as rates have spiked to multi-year highs while spreads trade close to their 5-year average.
High yield (HY) corporate bonds	▶	We prefer investment grade over high yield as reduced bank lending could lead to fears of higher default rates, which should cause high yield spreads to widen.
Gold	▶	Gold is held back by high real yields and falling inflation but is supported by the end of Fed hikes.

▲ "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 the recent spike in US Treasury yields mean?

- ◆ US Treasury yields have reached multi-year highs and there are two reasons for the move. Firstly, the US economy and the consumer market remain resilient, as evidenced by the strong macro and retailers' earnings data. Secondly, rising bond issuance has pushed up the yield at which supply and demand match.
- ◆ The spike in Treasury yields is driven by real yields rather than long-term inflation expectations and provides a good entry point. Markets have now given up on quick rate cuts in the next 12-18 months and priced in just four cuts by December 2024. Although Chair Powell made it clear at Jackson Hole that the FOMC will remain data dependent and restrictive, we maintain our projection of a total cut of 0.75% starting in Q2 2024 and the Fed funds rate to reach 4.50-4.75% by the end of 2024. This gives us greater comfort in the short and medium-dated Treasury yield levels.
- ◆ Since we adopted an overweight positioning for investment grade (IG) in July 2022, spreads have tightened somewhat and are now close to their 5-year average. We take some partial profits and move into US Treasuries, which are now upgraded to overweight, while still maintaining an overweight position for IG credit with medium maturities. Historically, both Treasuries and IG outperform cash in the next 6 months after rates peak.

2. What is our view on the Chinese equity markets?

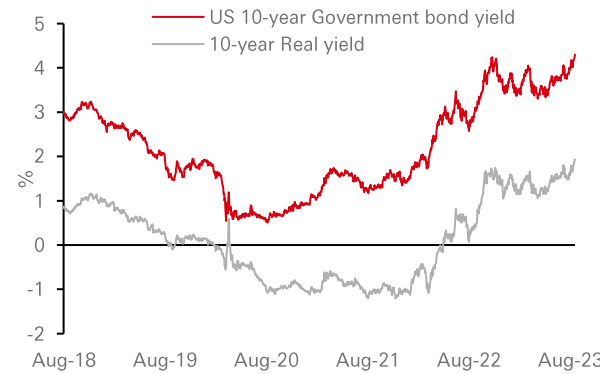
- ◆ China's economic data continue to be disappointing with the property market being a key drag on growth. The news flow has become more challenging recently. The potential default of a large Chinese privately owned developer has raised contagion fears for the broader housing market, shadow banking sector and Chinese banks. Further shadow banking defaults could lead to tighter liquidity conditions for the property and onshore capital markets. We believe the authorities will continue providing positive support but those measures will be gradual given their focus on structural reform direction rather than a "big bang" approach. The scope for a rebound in the short term is limited.
- ◆ As many Hong Kong developers are exposed to mainland China, and because of the continued surge in office supply and low office leasing demand, we expect to see some weakness in stock performance.
- ◆ Therefore, we downgrade both mainland Chinese and Hong Kong equities to neutral and, as a result, Asian real estate to underweight. Valuations remain attractive. The recently announced secondary market measures, including stamp duty cuts, new restrictions on share sales by major stakeholders, and lower deposit ratios for margin financing, help provide technical support to the market. We prefer service consumption and travel-related sectors, such as internet leaders, airlines, travel plays, consumer discretionary and Macau gaming. We remain overweight on Asian ex-Japan equities, favouring Indian and Indonesian stocks.

3. Should we broaden our sector exposure given high valuations of IT?

- ◆ Technology and communications have outperformed in the US equity markets year-to-date, raising markets concerns over their higher valuations. The former is more justified due to its stronger earnings prospects. We choose to take some profits on US communications and move it to neutral.
- ◆ While an improved structural outlook favours cyclicals in general, we see strong tailwinds in the US healthcare sector, compensating the regulatory risks on drug prices. These include innovation around immuno-oncology, obesity and rare diseases. Together with the increasing demand for treatment of age-related and chronic illnesses, we see upside potential for the sector despite its year-to-date underperformance.
- ◆ The upgrade of US healthcare to overweight will help create a balance between value and growth within a portfolio. We maintain a pro-cyclical bias, overweighting technology and consumer discretionary across the regions, and additionally industrials and financials in the US and globally.

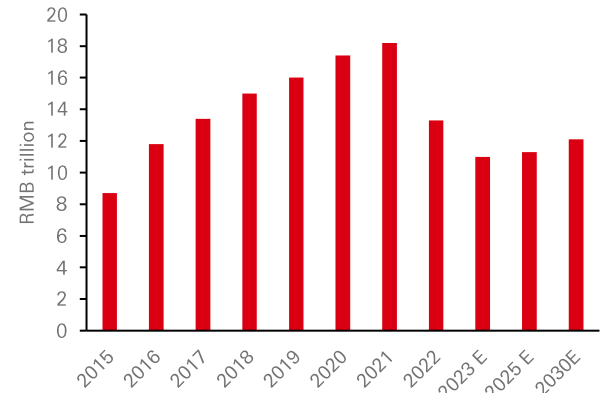
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Chart 1: Treasury yields are near multi-year highs, driven by higher real yields



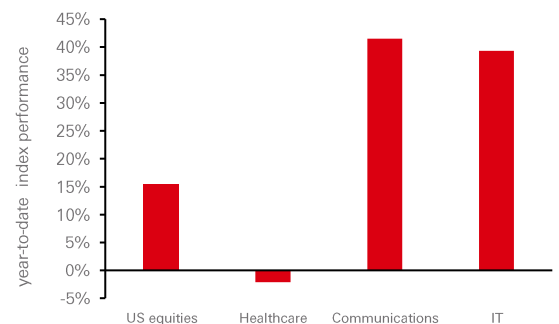
Source: Bloomberg, HSBC Global Private Banking as at 23 August 2023. Past performance is not a reliable indicator of future performance.

Chart 2: Little upside on Chinese home sales after the 40% fall in 2022-2023



Source: NBS, HSBC Global Research estimates as at 23 August 2023. Forecasts are subject to change.

Chart 3: Year-to-date performance of US equities and sector indices



Source: Bloomberg, HSBC Global Private Banking as at 23 August 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 pace of growth is divergent across economies, with the US and Asia being better positioned due to easing inflation and stronger fundamentals. We remain neutral on global equities and focus on quality.
United States	▲	Stronger-than-expected earnings growth, disinflationary trend, peak rates and the potential for rate cuts in 2024 support US equities and warrant equity valuations. We focus on quality stocks and broaden our exposure beyond technology.
United Kingdom	▶	Despite better-than-expected Q2 GDP growth and cheap valuations, wage growth continues to weigh on core inflation, adding market concerns over tightening risk. We remain neutral on UK equities.
Eurozone	▼	European growth remains challenged and inflation is stickier than in the US. Switzerland fares better in terms of its inflation and growth dynamics. Overall, we remain underweight on Eurozone equities.
Japan	▶	The unconvincing actions by the Bank of Japan mean that the path for JPY and the stock market remains unpredictable.
Emerging Markets (EM)	▶	Growth momentum is positive in emerging markets, particularly EM Asia and EM LatAm, which benefit from Chinese demand and tourism and improved fundamentals (including rate cuts in LatAm).
EM EMEA	▼	The region is impacted by the war and weak growth in Europe. Turkey looks relatively attractive on improved macroeconomics and undemanding valuations.
EM LatAm	▲	A more dovish rate outlook and nearshoring of the US supply chain are positives for Brazil and Mexico.
Asian ex Japan equities		
Asia ex-Japan	▲	Structural growth potential and cheaper valuations make Asia a sweet spot to invest. We take broad exposure to Asian markets favouring India and Indonesia, and look for selective opportunities in mainland China and Hong Kong.
Mainland China	▶↓	With weaker-than-expected economic data and property market woes dragging on growth, we downgrade Chinese equities to neutral and focus on the service consumption and travel-related sectors.
India	▲	We stay overweight on Indian equities due to the strong earnings outlook driven by service exports and consumption. Long-term structural growth is supported by demographics dividends, manufacturing renaissance, and the rise of the middle class.
Hong Kong	▶↓	As many Hong Kong developers are exposed to mainland China's property sector and are challenged by continued surge in office supply and lacklustre leasing demand, we downgrade Hong Kong equities to neutral.
Singapore	▶	The slowdown in global trade and elevated inflation remain key challenges. We do not expect the central bank to loosen its monetary policy in the coming months.
South Korea	▶	Global demand for goods remains weak and continues to weigh on South Korea's exports. The global smartphone recovery may take longer to realise, a negative to the equity market.
Taiwan	▶	Despite weak global demand and elevated inventory levels, the equity market is supported by a tech and AI-driven rally.
Government bonds		
Developed markets (DM)	▶↑	We upgrade global government bonds to neutral as Treasury yields have overshot.
United States	▲↑	US Treasury yields are trading at or near their cycle highs. Valuations are attractive.
United Kingdom	▲	Easing inflation should allow the central bank to halt rate hikes sooner than markets expect. We see attractive valuations in the 10-year segment and maintain a "medium-to long" duration preference.
Eurozone	▶	The ECB took a slightly less hawkish tone on weaker growth prospects. Valuations have become more attractive. We remain neutral with a medium duration preference.
Japan	▼	As there is no clear large-scale further intervention from the Bank of Japan regarding the Yield Curve Control on Japanese government bonds, and absolute yield levels are unattractive, we remain underweight.
Emerging Markets (Local currency)	▶	Select opportunities exist but rate cuts in some countries are already priced in.
Emerging Markets (Hard currency)	▶	Amid higher Treasury volatility, we still find yield but remain selective.
Corporate bonds		
Global investment grade (IG)	▲	We remain overweight but narrow the gap with government bonds as rates have spiked to multi-year highs while spreads trade close to their 5-year average.
USD investment grade (IG)	▲	With rising Treasury yields and tightened investment grade credit spreads, we take some partial profits on US investment grade credit but remain overweight as yields remain attractive on an absolute basis.
EUR and GBP investment grade (IG)	▲	We prefer investment grade over high yield which are more immune to recession risk.
Asia investment grade (IG)	▲	As we believe that US policy rates have peaked, we prefer high quality names to lock in yields at current levels, including Indonesian quasi-sovereign IGs, South Korean issuers and select banks and insurers in Asia.
Global high-yield (HY)	▶	We prefer investment grade over high yield as reduced bank lending could lead to fears of higher default rates, which should cause high yield spreads to widen.
US high-yield (HY)	▶	Tighter financial conditions weigh on company margins and increase the risk of defaults. We remain selective and prefer quality issuers with strong market positions and manageable debt.
EUR and GBP high-yield (HY)	▶	Weak earnings growth and rising defaults remain headwinds, which are not priced in credit spreads.
Asia high-yield (HY)	▶	We hold a negative view on Chinese property-related high yield bonds and expect default rate to rise.
Commodities		
Gold	▶	Gold is held back by high real yields and falling inflation but is supported by the end of Fed hikes.
Oil	▶	Slow 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	▲	▲	▲	▲	Inflation 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. The luxury goods segment reported softer US demand in Q2, but many companies still delivered 20% sales growth, so may see profit-taking after a strong run.
Financials	▲	▲	▶	▶	The sector is trading on cheap valuations and high interest rates are fuelling profits for the lenders. Although the 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. US financials are expected to benefit from improving fundamentals, low valuations and stronger earnings prospects.
Industrials	▲	▲	▶↓	▶	Macro-economic concerns have eased but higher interest rates, inflationary pressures and high input costs persist. China's growth lacks momentum and industrial goods remain muted. After a strong start to the year, we downgrade European industrials as momentum is ebbing on slow Asian demand and completion of inventory rebuilding phase. Asian industrials continue to lag on slower regional growth and demand. US industrials are gaining momentum with the Inflation Reduction Act (IRA) and Creating Helpful Incentives to Produce Semiconductors Act (CHIPS) boosting activity.
Information Technology	▲	▲	▲	▲	The outlook continues to improve in certain sub-segments including digital, AI and automation as business and consumer sentiment is improving. Fundamentals continue to improve with solid Q2 sales and earnings reported to date, except for cloud computing growth which is showing signs of slowing from elevated levels.
Communications Services	▶↓	▶↓	▼	▲	The sector has the strongest YTD performance fuelled by earnings upgrades and attractive valuations. We downgrade both Global and US to lock in gains as potential for further outperformance appears more limited. The outlook in Europe which is more focused on telecom services remains challenging. Asia offers a more attractive risk-return profile due to its low valuations and stabilising regulatory environment.
Materials	▶	▶	▶	▶	Tepid demand for commodities and chemicals, particularly in China, has held back YTD performance. In addition, elevated energy and feedstock prices weighed 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. In China, the sector is faced with great uncertainty. We move European real estate to neutral as valuations appear to have troughed.
Consumer Staples	▶	▶	▶	▲	Global and European consumer staples face a more challenging pricing environment after last year's 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	▶	▶	▲	▶	Oil and gas prices remain volatile but range-bound. Tougher YoY 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 tighten oil supplies further to put a floor on price declines.
Healthcare	▶	▲↑	▶	▼	We upgrade US healthcare as fundamentals are improving and valuations are in line with the 10-year average. We expect earnings and sales growth to pick up in the next 12 months on new product launches and less challenging YoY comparables for some companies following major patent expirations. In Asia, valuations remain elevated, trading well above historical levels.
Utilities	▶	▼	▲	▶	European sector valuations remain attractive with supportive earnings revisions. The US Inflation Reduction Act (IRA) and Europe's green initiatives should continue to be supportive. Stable earnings/cash flow characteristics and high dividend yielding stocks appeal to more cautious investors.

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