Investment Monthly

A tug of war between growth and interest rates

August 2022

Key takeaways

- Earnings forecasts are being cut but the positive is that analysts are getting more realistic. As for interest rates, hopes that inflation will peak sooner mean that the Federal Reserve may hike less than markets feared a few months ago. So we remain invested but focus on quality, income and defensive sectors as markets remain volatile.
- Despite yield inversion and a fall of 0.9% GDP growth for Q2, the strong US labour market should keep the economy from slowing sharply. Europe is faced with rising inflation, natural gas disruption risks and prolonged geopolitical tensions. We maintain a defensive sector stance globally and have further downgraded European Financials and Real Estate while upgrading Communication Services.
- Hong Kong equities remain our top pick in Asia. Singapore is no longer cheap, so we take profits and move to neutral. China is still struggling with macro headwinds but valuations and some longer-term themes with government support remain attractive.


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Asset class	6-month view	Comment
Global equities	▶	Uncertainty around the path of inflation, central bank policy and earnings remains high supporting a neutral stance.
Government bonds	▼	Although yields have backed up, we see better opportunities for returns elsewhere.
Investment grade (IG) corporate bonds	▲	Amid uncertainty around growth and profits, we prefer investment grade over high yield and see attractive opportunities in short-to-medium dated IG following the back-up in yields.
High yield (HY) corporate bonds	▶	We favour investment grade over high yield due to concerns over spread widening amid slowing growth.
Gold	▶	Despite high inflation and market volatility, we don't foresee much upside due to rising rates and a strong USD.

▲ "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 earnings outlook for Q2?

- Markets are repricing margins and the growth outlook impacted by inflation and rising rates. Expectations on earnings are more realistic (e.g. 4.3% for the US in Q2), but we expect further downgrades on margin pressure, the impact of FX moves and less ambitious investment plans. That said, the energy, materials and food sectors should remain strong.
- Slowing growth has led to lower demand, falling commodity prices, and a shift in consumption towards cheaper options, which may help to ease inflation in the coming months.
- It is therefore hoped that policy rates may peak earlier than expected but near-term volatility remains. **Investors should focus on quality and income.** Less pressure on bond yields may favour growth stocks but the outlook remains challenging, so a balance between value and growth is preferred. For bonds, **we prefer short-dated investment grade over high yield.**

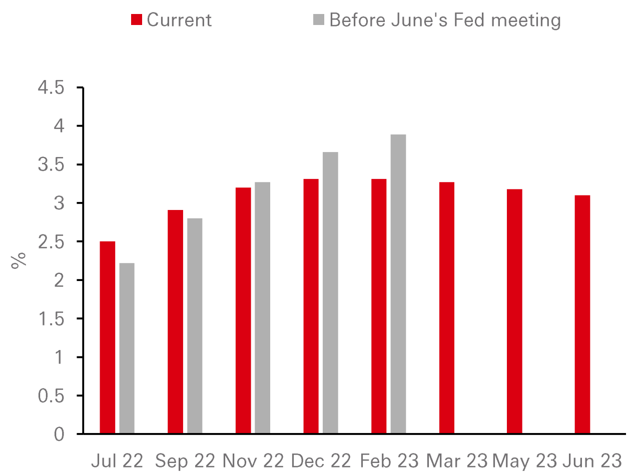
2. Are US and Europe heading into recession?

- Despite a sharp inversion of the 2-10year US Treasury yield lately and a fall of 0.9% GDP growth for Q2, we think the US will avoid a sharp slowdown due to a strong labour market. **We overweight US equities** due to many companies' strong market positions but maintain a defensive sector stance, a focus on quality and a selective approach amid the growth slowdown.
- In Europe, economic growth is likely heading towards stagnation on higher food and energy prices pushing inflation up (8.6% in June), leading to a surprise rate hike of 0.5% by the ECB in at its July meeting. The natural gas disruptions and prolonged geopolitical tensions are downside risks. **We remain underweight on Eurozone equities.**
- We have turned even more defensive by **downgrading the region's Financials and Real Estate to underweight on growth concerns, while upgrading Communication Services to overweight on attractive dividends and M&A opportunities.**

3. What are the opportunities and challenges in Asia?

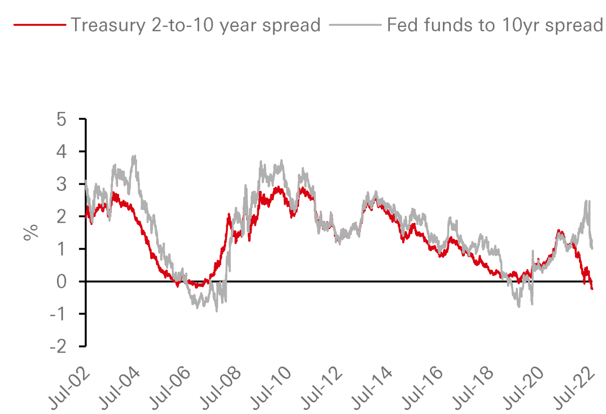
- The global economic slowdown has started to affect inventory levels and companies' order books. Asia is no exception and we've become more selective. **We remain overweight on Asian and Hong Kong stocks** on economic reopening and resilient growth. Taiwan and South Korea see lower demand for technology products globally.
- Valuations of Singapore and Indonesia are no longer cheap. Singapore is challenged by high wages and high exposure to the financial sector which is dragged by slower growth and flatter yield curves. **We take profits and move to neutral.** Thailand looks more attractive within ASEAN.
- China's recent credit issues in the property sector, worsening global demand outlook and weak consumer sentiment warrant our **neutral stance on Chinese equities**. Yet, their valuations and some longer-term themes supported by government policies (e.g. infrastructure and green opportunities) remain attractive.

Chart 1: The market now expects rates to peak earlier



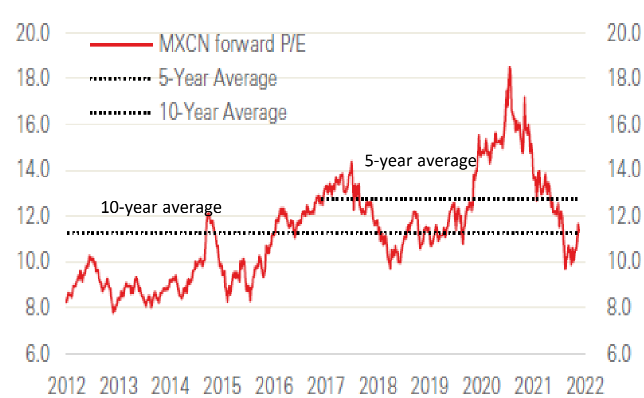
Source: Bloomberg, HSBC Global Private Banking as at 29 July 2022

Chart 2: US Treasury 2-10 year reached its most negative level in more than 20 years



Source: Bloomberg, HSBC Global Private Banking as at 17 July 2022. Past performance is not a reliable indicator of future performance.

Chart 3: Chinese equities 12-month forward P/E ratio remains below its 5-year average



Source: Bloomberg, HSBC Global Private Banking as at 12 July 2022. MXCN – MSCI China Index. 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	▶	Uncertainty around the path of inflation, central bank policy and earnings remains high supporting a neutral stance.
United States	▲	We like the diversity and quality character of US stocks. Growth will slow but remains resilient due to a tight labour market. We look for companies with strong market positions and healthy balance sheets.
United Kingdom	▶	Attractively valued but economic growth is challenged. High cost of living weighs on consumption.
Eurozone	▼	ECB tightening, high energy prices and the region's geographical proximity to the Ukraine war are key challenges.
Japan	▶	Autos and industrials are hit by supply chain issues but capital goods see good demand.
Emerging Markets (EM)	▶	Fund outflows continue as concerns over Fed tightening, global growth slowdown and geopolitical tensions linger. We prefer EM Asia equities due to the region's resilient domestic fundamentals and more benign growth-inflation outlook.
EM EMEA	▼	The region is impacted by a refugee crisis while high energy prices may dampen growth.
EM Latam	▶	Commodity exposure is a tailwind but risks around rate hikes and politics remain.
Asian equities		
Asia ex-Japan	▲	The region remains relatively resilient thanks to lower inflation pressure and therefore fewer rate hikes than elsewhere but slower demand for technology products is a headwind.
China	▶	The credit issues in the property sector, worsening global demand outlook, lingering concerns over COVID lockdowns and weak consumption remain headwinds. Valuations remain reasonable and pro-growth policies are key drivers.
India	▶	H2 growth is likely to moderate on rising oil prices, weaker consumer sentiment and declining exports.
Hong Kong	▲	Economic reopening and attractive valuations are key drivers for an economic rebound. The second half of the consumption vouchers in August and potential easing quarantine measures in discussion will boost consumption.
Singapore	▶↓	Singapore equities have performed well but valuations are not cheap anymore and the financial sector has seen more volatility. We take profits and move to neutral.
South Korea	▶	Domestic consumption has become the key driver to the local economy with external demand remaining weak.
Taiwan	▶	The market is challenged by weaker global demand for consumer electronics products and supply chain issues.
Government bonds		
Developed markets (DM)	▼	Although yields have backed up, we see better opportunities for returns elsewhere.
United States	▶	As markets have been reducing rate hike expectations, yields have dropped somewhat, but this should not continue.
United Kingdom	▶	With inflation at the highest level in 40 years, Gilt volatility may remain elevated.
Eurozone	▼	Rising inflation has resulted in a more hawkish ECB which surprised the markets with a 0.5% hike in July and brought an end to a regime of negative rates but current absolute yield levels remain unattractive.
Japan	▼	The ultra loose monetary policy and a weaker Yen should keep the longer-end of the government bond segment steep.
Emerging Markets (Local currency)	▶	Select opportunities exist but some EM countries are hiking rates and USD remains strong.
Emerging Markets (Hard currency)	▶	Amid higher Treasury volatility, we still find yield but remain selective.
Corporate bonds		
Global investment grade (IG)	▲	Amid uncertainty around growth and profits, we prefer investment grade over high yield and see attractive opportunities in short-to-medium dated investment grade following the back-up in yields.
USD investment grade (IG)	▲	The flat yield curve does not provide sufficient returns to extend duration. A short-to-medium term is preferred.
EUR and GBP investment grade (IG)	▲	The recent cheapening of Eurozone credit represents an opportunity for buy-and-hold investors, while GBP credit has proven to be relatively resilient. We emphasise however a preference for short-to-medium dated quality issuers.
Asia investment grade (IG)	▲	Asia credit offers attractive carry opportunities and stays relatively resilient to the energy supply shock. We prefer quality issuers in Indonesian hard currency bonds, Chinese SOEs, Chinese financials, etc.
Global high-yield (HY)	▶	We favour investment grade over high yield due to concerns over spread widening amid slowing growth.
US high-yield (HY)	▶	While US high-yield companies still enjoy solid credit fundamentals and low default rates, tightening financial conditions and faster Fed fund rate hikes create downside risks.
EUR and GBP high-yield (HY)	▶	European high yield remains vulnerable to the developments of the Ukraine war and its impact on energy provisioning. Spreads underperform on recession concerns.
Asia high-yield (HY)	▲	Asia high yield is more resilient within the HY universe thanks to its more diversified economies and supportive domestic policies. We stay cautious on China property credit and prefer state-owned developers with strong liquidity.
Commodities		
Gold	▶	Despite high inflation and market volatility, we don't foresee much upside due to rising rates and a strong USD.
Oil	▶	High price levels reflect supply concerns but demand is starting to decline. We foresee volatile sideways trading.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	►	►	▼	►	Inflation remains a headwind for demand with rising financing and energy costs hurting consumer sentiment. Margins remain under pressure from same factors plus labour shortages. Luxury goods segment remains resilient. Automakers are still suffering from supply and production issues but offer attractive valuations.
Financials	►	►	▼↓	▲	Rising inflation is driving interest rates higher which is positive for lenders (e.g. retail banks). Investment banking and/or brokerage activities have slowed. Volatile markets have impacted fee income for asset managers. As these challenges are particularly acute in Europe, we downgrade the sector to underweight.
Industrials	▼	►	▼	▼	Despite high input costs, order books and supply issues are improving. Valuations are attractive to value investors who are less bearish on the economy and the potential recovery in production, and the expansion/upgrading in manufacturing facilities with a focus on automation. Cyclical risks may weigh on activity though.
Information Technology	►	►	►	►	Valuations of select large-cap IT are attractive following recent pull-backs. We remain positive on its superior growth prospects as digitalisation, electrification and automation drive long-term, above-average growth for the next decade. We prefer large-cap companies with strong cash-generative businesses and market positions.
Communication Services	▲	▲	▲↑	►	The media & entertainment industry remains challenged, while the telecoms industry benefits from steady cash flows and growth from increased data usage as more activity shifts on-line and business digitises. Investments in telecoms infrastructure hardware remain buoyant.
Materials	▲	▲	▲	►	Commodity prices seem to indicate softer demand particularly from China in H2. We've become cautious with mining stocks. Higher energy and oil/gas feedstock prices could weigh on chemicals and construction materials. The sector trades at the lowest valuation relative to others, but growth prospects may be peaking.
Real Estate	►	►	▼↓	►	Private residential real estate is supported by high savings and historically low interest rates, while demand for commercial real estate is low as corporates look to reduce office space and retail moves online. Rising interest rates and softening demand as the European economy stalls has triggered our downgrade.
Consumer Staples	▲	►	▲	▲	The sector contains many quality stocks with good dividend yields. However, valuations are somewhat elevated, so we prefer companies with strong brands and/or pricing power which allow them to protect margins and earnings as inflationary pressures mount.
Energy	▲	▲	▲	▲	Geopolitical uncertainties, low inventories and supply-demand imbalances continue to drive prices higher. We expect energy prices to either stabilise at these elevated levels or push higher. Chronic under-investment is likely to support prices in the medium term despite the energy transition gaining momentum.
Healthcare	▲	▲	▲	►	Pharma stocks are characterised by strong cash flows and resilient business models somewhat insulated from the ravages of inflation and cyclicality, while offering decent dividend yields. Medical technology sector should benefit from pent-up demand for elective surgical procedures in 2022/2023. The biotechnology sector provides more speculative investment opportunities with their innovative medicines.
Utilities	▼	▼	►	►	Renewable stocks are again attracting attention after stock prices and valuations pulled back significantly from overly optimistic levels. Caution is still required as companies may not be able to pass on rising energy prices which may impact margins negatively.

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