HSBC

Investment Monthly

Markets should rise further but may slow

August 2021

Key Takeaways

- We remain positive on the stock market and other cyclical investments like high yield bonds but momentum may slow.
- We move to Neutral on the Materials and Industrials sectors because we think the recovery will now be driven by services.
- Long-term, we are positive on Chinese equities but we think it is prudent to move to a Neutral allocation shorter-term. We remain Overweight on Asia and are now more positive on Thailand and Taiwan equities.

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Asset class	Short-term view (3-6 months)		Long-term view (>12 months)	
Global equities	▲	Global equities outperformed in the first half of 2021, led by US and European indices across cyclical sectors (e.g. energy, financials and real estate). We maintain our pro-risk stance.	▲	We remain constructive on risky assets, but become more prudent as we foresee earnings cycle to peak and expect normalised returns after a persistent rally that led to new record in the US.
Government bonds	▼	Prospective returns have not improved despite longer-dated government bonds recently gained amid weakened risk appetite and dovish Fed comments. Yields are still negative.	▼	The economy is certainly in recovery and growth mode, but upside in yields are limited as US Treasury yields have stabilised at lower levels. We remain underweight government bonds such as US, UK, EU and Japan.
Investment grade (IG) corporate bonds	►	High levels of inflation are largely priced-in and we now expect implied inflation to remain largely unchanged. Against expectations of lower US Treasury yields, we are neutral IG.	▼	Risk rewards in investment grade bonds are unattractive and spreads are at historically tight levels, especially for longer-dated credit. We prefer shorter duration bonds in anticipation of rising interest rates.
High yield (HY) corporate bonds	▲	We reiterate our positive stance on high yield and EM debt with a focus on Asian credit, despite volatility in the short-run with China's property developers for better carry and yield.	▼	In the long term, High Yield bonds spreads are unattractive and valuations are demanding. Out of the HY universe, Asia bonds are preferred despite regulatory risks and rising volatility in China.
Gold	►	Gold prices have been range-bound due to a lack of catalysts as markets remain largely risk-on.	►	We view limited upside in gold on the back of stronger global economic recovery, a range-bound US Dollar and declining geopolitical risks.

Note: Short-term view (3-6 months): a relatively short-term tactical view on asset classes. Long-term view (> 12 months): a relatively long-term strategic view on asset classes.
▲ "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

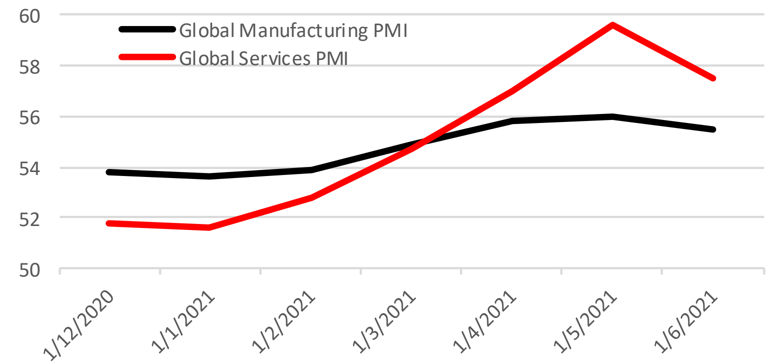
Each month, we discuss 3 key issues facing investors

1. How should investors be positioned?

- The recovery remains on track and equities are our pick. The services sector is now driving the recovery (Chart 1) as more people are going out to consume. Thailand and some countries in Europe have even re-opened for tourists with minimal restrictions.
- Because the services sector is likely to drive the current phase of the recovery, we have downgraded the Materials and Industrials sectors to Neutral. Materials and Industrial companies have also performed well and it is prudent to book some profits.
- Inflation and the spread of COVID variants are risks and investors need to ensure appropriate diversification. Markets have arguably become used to higher inflation but volatility may arise as details emerge around the US Federal Reserve's plans to taper quantitative easing.

Chart 1: The services sector (red line) is now driving the recovery

Purchasing Manager Indices (PMI) – The higher the number, the better the outlook



Source: Bloomberg, data as of 26 July 2021

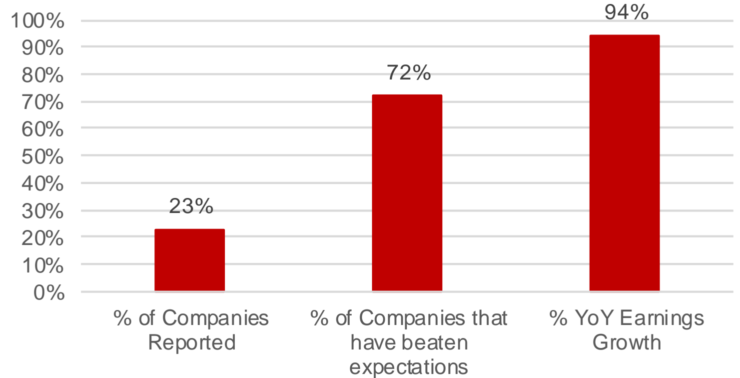
Investment involves risks. Past performance is not an indication for future. For illustrative purpose only.

2. What is the 2Q 2021 earnings outlook?

- US earnings are expected to grow 60% year-on-year and this should drive the stock market higher. It is still early in the reporting season but so far 72% of global companies have beaten expectations (Chart 2). However, expectations are high and this may mean slower upwards momentum in the stock market.
- Our preference is for consumer focused sectors like consumer discretionary, financials and real estate. The financials sector, in particular, has the added benefit of functioning as an inflation hedge.
- The key risk to earnings remains COVID. New cases and Delta variants around the world are rising and this could stall the recovery. However, our base case is that vaccine progress will facilitate continued recovery.

Chart 2: Corporate earnings expected to be strong in Q2

Global Q2 earnings statistics so far (28 July)



Source: Refinitiv Datastream, MSCI All Country World Index, Data as of 28 July 2021.

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3. What do we think about Chinese equities?

- Chinese equities sentiment has been hit following an increase in regulatory risks in the tech and education sectors. The Chinese stock market is down 9%* in July. This has spilled over to the Hong Kong stock market which is down 13%** over the same period.
- We are positive longer-term but it is prudent to take a Neutral position on Chinese equities over the next 3-6 months because of the regulatory uncertainty. Investors shouldn't panic sell because the structural investment case remains strong. Instead, one should ensure their Chinese equities exposure is appropriately diversified (not just in tech stocks) and allocated.
- On a 3-6-month basis, we maintain our Overweight position on Asia and upgraded Taiwan and Thailand equities to Overweight. Thailand has recently re-opened to tourism and should benefit from the recovering tourism trade. Taiwan is a market that stands to benefit from high demand for semi-conductors (Chart 3).

*CSI 300 Index (30 Jun - 27 Jul) ** Hang Seng Index (30 Jun - 27 Jul)

Chart 3: Global semi-conductor demand has spiked

Global billings (USD Billions), 3-month average

Source: Refinitiv Datastream, Data as of 26 July 2021.

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House views

Our latest short-term (3-6 months) and long-term (>12 months) views on various asset classes

Asset class	Short-term view	Long-term view	Comment
Global equities			
Global	▲	▲	Equity markets performed well in the first half of 2021, led by US and European indices and propelled by cyclical sectors across real estate, financials and energy. We maintain our risk-on stance as vaccination picks up, the cycle broadens out and infrastructure spending kicks in to offset inflation and policy risks.
United States	▲	▶	We expect outperformance of US to continue but volatility to pick up due to the Fed's policy shifts on rates and tapering, higher taxes and regulations across industries such as tech. We remain overweight on US and cyclicals.
United Kingdom	▲	▲	The market represents value while it emerges from COVID and Brexit. Notable progress with re-opening and vaccination, UK benefits from its exposure to financials and energy companies, trade deals and exports.
Eurozone	▶	▲	Europe trades at a significant discount to the US with a value tilt, and consumer growth is yet to recover. It is also appealing from the angle of dividend income and quality global export exposures, but UK is currently cheaper.
Japan	▶	▶	Unable to benefit from the Olympics due to COVID concerns, Japan's struggles include a sluggish economic growth outlook, constraint central bank stance and slow vaccination.
Emerging Markets (EM)	▶	▲	We have a positive stance on EM equities in the long run but near-term challenges remain due to the EM's higher level of uncertainty surrounding central banks' policies, path of the virus, vaccine progress and re-opening.
Central & Eastern Europe, Latin America	▼	▶	CEE and LatAm performed well YTD (+19% and 8% respectively, as at 29 July) on higher commodity prices and risk-on mode, but central banks' policy divergence, Delta variants and slow vaccine progress could hinder returns.
Asian equities			
Asian ex-Japan	▲	▲	Asian equities are attractive after recent sell-off and subsequent market stabilisation. Investment merits include high savings ratio, a rising middle class, a tech-savvy generation to lead consumer spending to pick-up. Manufacturing of cyclical goods such as tech and clean energy is another growth angle.
China	▶↓	▲	Dramatic market corrections caused by China's regulatory scrutiny on tech, education and online platforms have rattled investors. China is focused on minimising broader economic risks such as data privacy and antitrust.
India	▶	▶	Virus cases may have peaked, but we remain neutral due to high valuations and risks of earnings downgrade.
Hong Kong	▶	▲	HK is highly exposed to cyclical sectors such as financials and real estate but risks of China's industry regulation and strict border controls cloud its near-term economic potential.
Singapore	▲	▲	Singapore benefits from tech manufacturing and exports, leading vaccination and a strong domestic economy.
South Korea	▶	▶	Korea's clear leadership in tech and semiconductors give rise to its growth, but valuation has already reflected this.
Taiwan	▲↑	▶	Taiwan's tech benefits from the global semiconductor shortage and the rising global demand in 5G, hardware/software and Apple supply chain exposure, but valuations are high and we are neutral long-term.
Government bonds			
Developed markets (DM)	▼	▼	Despite improvement in valuations and a temporary pick-up in US Treasury, negative bond yields remain an unattractive feature for major government bonds including Japan, ECB, Germany and the UK, hence underweight.
United States	▶	▼	US Treasury yields have stabilised after spiking amid risk aversion. Further upside is unlikely as inflation risks are largely priced in and we have a year-end forecast of 1%. Real yields remain very low.
United Kingdom	▶	▼	The BoE's policy stance is supportive with ongoing asset purchases and low interest rates but returns are poor.
Eurozone	▼	▼	The ECB's bond repurchase program and the EU recovery fund are positive but valuations are unattractive.
Japan	▼	▼	Negative yields on Japanese government bonds are not appealing and the bond risk premium remains negative.
Emerging Markets (Local currency)	▲	▲	EM debt is attractive as yields and prospective returns are higher than global peers on the back of higher real rates and risk return. We have a positive view on local EM currencies hence our overweight stance.
Emerging Markets (Hard currency)	▲	▼	Bond yields are at historic lows but there is a divergence of economic impact and policy stance in the EM universe. EM government bond yields attractive, but it will be crucial to monitor economic recovery trends, US bond yields as well as the path of the US dollar.
Corporate bonds			
Global investment grade (IG)	▶	▼	We remain neutral on global and US consistent with the Fed's hawkish tilt and projection of inflation being transitory, although there is a place in clients' portfolios for diversification purposes.
USD investment grade (IG)	▶	▼	Prospective returns have become unattractive as spreads have come down materially whilst index duration remains high. This is largely determined by the path of the Treasury yields. We are less negative in the short term.
EUR and GBP investment grade (IG)	▶	▼	Monetary policies are accommodative as both the ECB and BoE are supportive but valuations and yields are unattractive. Underlying corporate fundamentals have not yet significantly improved and default risks remain.
Asia investment grade (IG)	▲	▲	Credit tightening and more regulatory scrutiny in China suggest moderate growth ahead. Some China IG issuers in certain sectors have recently come under pressure but we remain positive on Asia credits.
Global high-yield (HY)	▲	▼	In the search of yield, global HY can still provide attractive risk returns due to higher real yields and earnings growth. We still prefer Asia to global HY as there are uncertainties on the global outlook but focus on quality.
US high-yield (HY)	▲	▼	We are underweight long term as spreads are compressed but positive on higher growth and yields in the short run.
European high-yield ex UK (HY)	▲	▼	Underlying corporate fundamentals are likely to improve if vaccination picks up and economic recovery gains momentum in the near-term but valuations are unattractive in the long run despite an ultra-accommodative ECB.
Asia high-yield (HY)	▲	▲	We remain constructive on Asia HY bonds as they still have a yield and growth advantage, and spreads still look attractive relative to other global opportunities. Yet China's economy and default risks need to be closely watched.
Commodities			
Gold	▶	▶	Gold's upside is limited after 2020's outperformance, as inflation risks are now priced in, geopolitical tensions abate and economic recovery is in place. However, gold can offer diversification benefits in multi-asset portfolios.
Oil	▶	▶	Oil holds its gains but Delta variant disrupts demand recovery and OPEC+ intends to lift production in August.

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Sector Views

Global and regional sector views based on a 3-6 month horizon

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	Consumer spending continues to recover as economies re-open, thanks to pent-up demand, high levels of savings and low debt levels. Further upward earnings revisions and improving consumer sentiment are expected with additional potential gains for the services industry and luxury goods, autos and hospitality even if travel restrictions remain largely in place.
Financials	▲	▲	▲	▶	The improving economic outlook with the stimulus packages in the US and Europe should offset lower interest rates and the potential for higher taxes in the US. Attractive valuations, higher trading revenues and M&A activity are constructive. Q2 earnings beat expectations on higher capital markets activity, lower loan provisions and a buoyant real estate market.
Industrials	▶ ↓	▶	▲	▶ ↓	Industrial stocks have rallied strongly in anticipation of a demand rebound as economies re-open and the need to rebuild inventories remains strong. However, after one year of outperformance, upside in US and Asian stocks appears limited given valuations. Supply chain issues and higher input costs may weigh on margins. We downgraded Asia and Global industrials sector to neutral.
Information Technology	▲	▲	▶	▲	The IT sector has struggled to gain momentum in 2021 on regulatory risks and valuation concerns. Long-term trends in digitalisation and new technology should deliver above average growth for the long term. However, semiconductors shortage is causing some production challenges. Infrastructure spending should benefit digital infrastructure.
Communication Services	▲	▲	▶	▲	The sector benefits from steady cash flow and growth from increased data usage as more activity shifted online and business digitalised. Media companies are likely to see continued robust demand. The 5G roll-out is positive for telecom equipment providers but neutral/negative initially for service providers.
Materials	▶ ↓	▶	▲	▶ ↓	The economic recovery remains constructive, but is already reflected in valuations so we downgraded Asia and Global materials sector to neutral. Metal prices have lost momentum in the short-term as the Chinese authorities try to cool commodity prices. Infrastructure spending related to fiscal stimulus in the US, Europe and Asia will drive demand in the medium run.
Real Estate	▲	▲	▶	▲	Private residential real estate is seeing strong demand due to a unique combination of record high savings and low interest rates. In contrast, commercial real estate sees more headwinds as corporates look to reduce office space and retail moves online. The high dividend yield is appealing in a low yield world.
Consumer Staples	▼	▼	▼	▼	The defensive staples sector is likely to underperform given the positive economic backdrop. Although valuations appear attractive relative to the cyclical sectors, slower year-on-year growth is expected this year as 2020 benefitted from COVID-19 fears that drove panic buying and stock-piling of consumer essentials.
Energy	▶	▶	▶	▶	Supply-demand imbalances continue to support oil prices with demand rebounding quickly to close to pre-pandemic levels as economies re-open. Volatility in energy prices and stocks may arise with the ebb and flow of geo-politics.
Healthcare	▶	▶	▶	▶	COVID has spurred healthcare spending, which is likely to remain a priority for households and governments as large backlogs in elective surgical procedures should drive strong growth. Medical technology, biotech companies and preventative care benefit from strong demand. We expect volatility to resurface regarding regulation on drug pricing, when COVID is contained.
Utilities	▼	▼	▼	▼	The sector has benefitted from various 'green' initiatives. Global sector valuations remain relatively attractive, but the sector is likely to underperform in the cyclical recovery.

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