HSBC

Investment Monthly

Central banks tighten on high inflation

April 2022

Key takeaways

- Higher inflation has prompted central banks to start tightening. While a recession is not our base scenario, we think investors should focus on quality and income stocks, while diversifying between cyclical and defensive sectors to build portfolio resilience.
- We upgrade Materials to Overweight to take advantage of higher commodity prices. In Asia, we downgrade Consumer Discretionary and Communications to Neutral due to Covid measures in China, and upgrade Utilities to Neutral.
- China's NPC has set a growth target of 5.5% for 2022 with more stimulus to support overseas listings, infrastructure investment and green transformation. But for now, we stay Neutral on China stocks until there is more policy clarity and economic momentum.

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Asset class	6-month view	Comment
Global equities	▶	Geopolitical tensions, high inflation, rising interest rates and Covid are driving market volatility and investor sentiment. Economic growth is expected to moderate but fundamentals remain solid.
Government bonds	▼	Although yields have backed up, they remain volatile and the asset class is unattractive.
Investment grade (IG) corporate bonds	▲	Investment grade bonds are key for portfolio diversification and should be resilient as risk appetite is challenged.
High yield (HY) corporate bonds	▲	Spreads have widened and short-dated bonds have already priced in many rate hikes.
Gold	▶	Gold is benefitting from volatility, but prices are high and real yields may not fall further.

▲ "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.

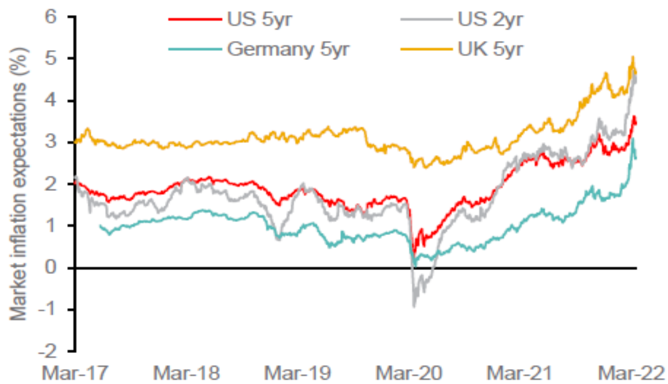
Talking points

Each month, we discuss 3 key issues facing investors

1. How should investors react to central bank policies?

- With inflation soaring to 8.7% in March in the US and 8% for Q2 in the UK, both the Fed and Bank of England (BoE) raised rates by 0.25% at their March meeting.
- We now forecast total rate hikes of 1.75% and 0.75% for the Fed and BoE respectively for 2022. Meanwhile, the European Central Bank also announced a steeper reduction of its QE programme.
- These signalled an expectation of high inflation to persist, driven partly by geopolitics pushing commodity prices higher (e.g. food and energy). This will weigh on disposable income and economic growth. Investors should remain invested but staying diversified is key.

Chart 1: Central banks are forced to hike as inflation expectations are above their comfort level



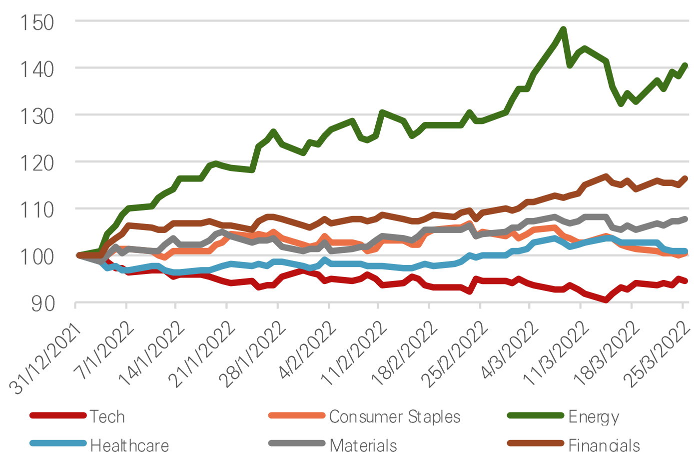
Source: Bloomberg, HSBC Global Private Banking, as at 15 March 2022. Past performance is not a reliable indicator of future performance.

2. Do we face a stagflation or recession risk?

- Despite a flattening yield curve, we do not see a stagflation or recession risk. There is typically a lag of around 14 months between curve inversion and recession, and economic momentum remains strong. However, investors should build portfolio resilience by **focusing on quality and income**, while **diversifying between cyclical and defensive sectors** to weather elevated market volatility.
- **We maintain an Overweight in Energy, Financials and Materials**. Energy prices could remain high due to supply chain disruptions caused by geopolitical tensions, while Financials benefits from rising rates and continued economic growth.
- **We downgrade Consumer Discretionary in most regions, including Asia where Communications is also downgraded to Neutral** as Covid measures in China add near-term uncertainty. We **upgrade Utility to Neutral** as returns from these companies are more stable.

Chart 2: Energy, Materials and Financials should perform well in the current environment

Sector relative performance against global stocks (%)

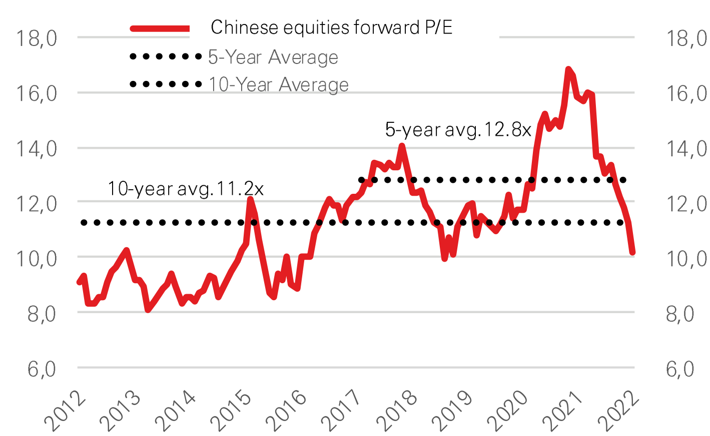


Source: Refinitiv Datastream as of 25 March 2022. Past performance is not a reliable indicator of future performance.

3. Should investors remain invested in Chinese stocks?

- The sharp sell-offs and rebounds in the Chinese equity markets lately have been linked to regulatory and geopolitical tensions. The government has announced a positive policy statement on overseas listings, regulatory transparency for the internet sector and new measures for the property developers, which helps ease concerns. Valuations are at historical low levels.
- The National People's Congress set a GDP target of 5.5% for 2022, with a strong fiscal package related to the SOE fund, tax cuts and VAT refunds to support SMEs, advanced manufacturing, technology upgrade and R&D.
- We stay Neutral on Chinese equities and hard currency bonds until we have more policy clarity and improvement in economic momentum. We are still positive on its long-term structural trends and **prefer companies benefitting from the policy stimulus, infrastructure investment and the green transformation**, as well as **quality Chinese State Owned Enterprises paying high dividends.**

Chart 3: China equities' 12-month forward P/E ratio reaches the lowest level since 2018



Source: Bloomberg, HSBC Global Private Banking as of 21 March 2022. 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	▶	Geopolitical tensions, high inflation, rising interest rates and Covid are driving market volatility and investor sentiment. Economic growth is expected to moderate but fundamentals remain solid.
United States	▲	They are still our biggest equity overweight due to the size and quality character of US stocks.
United Kingdom	▶	The asset class is attractively valued but rate & tax hikes and declining real incomes pose challenges.
Eurozone	▼	Europe is more exposed to the geopolitical tensions and the risk of energy supply disruptions, which keep energy and food costs high and thus might weigh on consumption and economic growth. A more hawkish ECB creates headwind.
Japan	▶	The BOJ decided to keep its extremely accommodative policy unchanged. Autos and industrials are hit by supply chain issues but capital goods see good demand.
Emerging Markets (EM)	▶	Fed tightening is a concern while geopolitical tensions cause repositioning.
EM EMEA	▼	The region is impacted by a refugee crisis, while high energy prices may dampen growth.
EM Latam	▶	Brazil is trading at cheap valuations and benefits from high commodity prices.
Asian equities		
Asia ex-Japan	▲	The markets are exposed to fewer rate hikes and are well positioned to benefit, especially commodity producers, supply chain companies and global trading companies. ASEAN growth accelerates with competitive valuations.
China	▶	The NPC approved a multi-pronged stimulus package to support growth. New lockdowns, regulatory uncertainty and continued concerns related to the health of the real estate and developer companies are headwinds.
India	▶	High oil prices have pushed up inflation which weighs on GDP growth and may widen the current account deficit.
Hong Kong	▶	The widespread of the Omicron variant has derailed growth recovery. More easing pandemic-control measures and fiscal support will be rolled out to revive the economy and support consumer spending.
Singapore	▲	Travel and consumer-facing services will benefit from the country's re-opening plans, thanks to the country's high vaccination rate and its quarantine-free travel corridors with over 30 markets. Most of its virus restrictions will be lifted.
South Korea	▶	The president-elect promises more supportive policies to reform the tax system and promote innovation. Geopolitical tensions and their impact on global demand will be the key risk given the country's high reliance on global trade.
Taiwan	▲	Private consumption and investment are key drivers for growth. Taiwan should continue to ride the electronics wave. Demand for sophisticated technologies such as AI, Internet of Things, and 5G will likely support its tech exports.
Government bonds		
Developed markets (DM)	▼	Although yields have backed up, they remain volatile and the asset class is unattractive.
United States	▶	We now expect six more 25bp Fed rate hikes for the remaining 2022, along with balance sheet shrinkage. Yields are expected to remain low for longer.
United Kingdom	▶	Inflation pressures amid supply chain disruptions support policy tightening. Risk-adjusted returns look poor.
Eurozone	▼	The ECB announced a steeper taper of QE with net asset purchases ending in September, and rate hikes are expected later this year. Recent geopolitical conflicts also added to volatility and the lack of yield remains the biggest challenge.
Japan	▼	Risk aversion has led to lower yields of Japanese government bonds following other DM peers.
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)	▲	Investment grade bonds are key for portfolio diversification and should be resilient as risk appetite is challenged. We focus on carry opportunities more recently.
USD investment grade (IG)	▲	Valuations are not relatively cheap. Shorter-dated bond yields rose and as the yield curve is now flatter, we continue to keep duration short.
EUR and GBP investment grade (IG)	▲↑	The recent cheapening of Eurozone credit represents an opportunity for buy-and-hold investors, while GBP credit has also proven to be relatively resilient in the face of geopolitical uncertainty, with a hawkish BoE already priced in.
Asia investment grade (IG)	▲	Asia IG credit has stayed relatively resilient amid market volatility. It offers an important source of yield pickup over DM and other Emerging Markets IG. Quality issuers and Chinese State Owned Enterprises (SOE) are preferred.
Global high-yield (HY)	▲	Spreads have widened and short-dated bonds have already priced in many rate hikes.
US high-yield (HY)	▲	US high-yield benefits from high exposure to energy. We find attractive income generation opportunities in the short-dated high yield space.
European high-yield ex UK (HY)	▲	Spreads have widened due to the proximity of Europe and its banking system to the geopolitical uncertainty. Cheaper Eurozone credits offer some attractive opportunities in our search for carry and to build resilient portfolios.
Asia high-yield (HY)	▲	We continue to favour Asia high-yield for their attractive carry and will take a selective, diversified quality-focused approach. Short-dated HY offers more resilient returns.
Commodities		
Gold	▶	Gold is benefitting from volatility, but prices are high and real yields may not fall further. It remains key in portfolios as a diversifier but further upside is limited.
Oil	▶	Potential supply disruptions are a big concern but prices are already near record highs.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▶↓	▶↓	▶	▶↓	The sector should benefit as more governments lift Covid restrictions and supply chain issues ease boosting travel, hospitality and autos sectors. However, living costs are rising faster than wages hurting sentiment and crimping demand. We downgrade the sector globally, in the US and Europe to reflect these realities.
Financials	▲	▲	▲	▲	Banking stocks stand to benefit from rising rates. In Europe and Asia, low valuations, robust capital markets activity, rising insurance premiums and thriving mortgage markets are key drivers. In contrast, US financials are trading at a significant premium to their peers after many quarters of strong results.
Industrials	▼	▶	▶	▼	Slowing growth and rising input costs weigh on margins, profits and sentiment. Supply chain issues persist but are easing. Rebuilding historically low inventories should provide some stability to earnings. Valuations have recently declined, but given the slowing growth environment sentiment is likely to remain subdued.
Information Technology	▲	▲	▶	▲	The slowing growth in the US, China and Europe is a challenge. Valuations remain elevated, but are no longer rich. We remain constructive as digitalisation, electrification and automation should drive long-term, above average growth for the next decade. We focus on companies with strong cash-generative businesses.
Communication Services	▲	▲	▶	▶↓	The sector benefits from increased data usage as more activity shifts on-line and business digitises. The 5G roll-out is positive for telecom equipment providers **but neutral/negative initially for service providers**. Having made a lot of progress, 5G in Asia is seeing fewer opportunities while also facing regional macro challenges.
Materials	▲↑	▲↑	▲↑	▶	Slowing growth in China is a concern, but geopolitical instability and under investment in new capacity to meet surging demand as economies reopen will keep commodity prices high. Demand for commodities linked to the electrification of the economy is supportive of mining stocks. Valuations appear attractive.
Real Estate	▶	▶	▶	▶	Private residential real estate is seeing strong demand supported by high savings rate and low interest rates. Commercial real estate is suffering from low demand as corporates look to reduce office space and retail moves online.
Consumer Staples	▶	▶	▶	▶	The sector contains many quality stocks with good dividend yields. However, valuations are somewhat elevated, so a selective approach is required, focusing on quality stocks with strong brands and/or pricing power that will enable 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	▶	▲	▶	▶	Globally, we expect Covid related backlogs in elective surgical procedures should drive strong growth in 2022 for medical technology companies. The biotechnology sector provides more speculative investment opportunities with their innovative medicines.
Utilities	▼	▼	▶	▶↑	Renewable stocks are attracting attention after stock prices and valuation pulled back significantly from overly optimistic levels, we upgrade Asia to Neutral. 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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