

Investment Monthly

Inflation concerns likely a temporary issue

Apr 2021



Key takeaways

- ◆ Inflation concerns have driven bond yields higher. Short-term volatility may persist but we think this will be temporary and mild.
- ◆ Over the next 3-6 months, we think equities will rally further thanks to the earnings recovery but longer-term investors may wish to start reducing exposure in more expensive asset classes.
- ◆ Over a 12 month horizon, we are positive on Global Equities but have downgraded US, South Korea & Taiwan to Neutral. We have also downgraded US High Yield Bonds to Neutral. They have rallied and are now less attractive from a valuation perspective.



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Asset class	Short-term view (3-6 months)	Long-term view (>12 months)
Global equities	▲ Economic data points to a strong global recovery, bolstered by vaccine roll-out. Cyclical stocks stand to benefit.	▲ Policy remains supportive, not least the prospect for further major US fiscal stimulus, while global geopolitical uncertainty has edged lower
Government bonds	▼ The surge in bond yields in a short space of time has limited further upside and overall DM bonds returns are unattractive.	▼ Increasing dependence on targeted fiscal measures to support growth may deteriorate the diversification properties of government bonds
Investment grade corporate bonds	▲ We are positive in the near-term as global IG bonds have a place in portfolio diversification.	▼ Prospective returns have become unattractive, particularly for longer-duration bonds.
High yield corporate bonds	▲ In the 'low but volatile' rate environment that we foresee, we continue to look for a yield pickup in HY bonds.	▶↓ After the recent run-up in Treasury yields, spreads are no longer appealing, although the Fed and ECB are supportive with their policies.
Gold	▲ Gold pulled back as the economy continues to recover, but low rates will continue to support gold. There remains a place for gold in well-diversified portfolios during times of volatility.	▶ Further upside could be limited as economies recover, geopolitical tensions ease, and uncertainty falls

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.

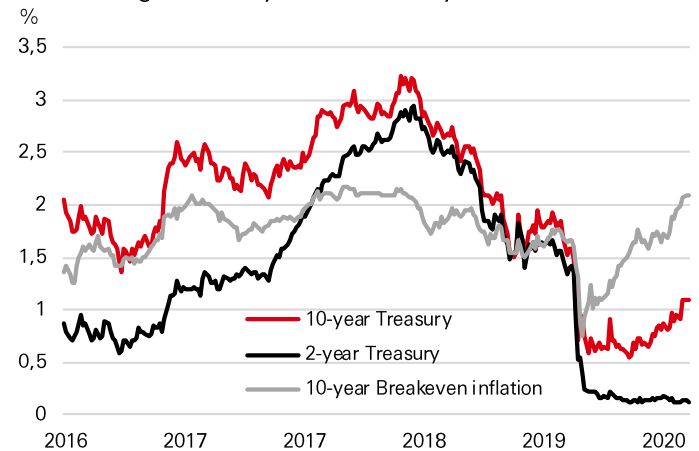
Talking points

Each month, we discuss 3 key issues facing investors

1. What is the impact of higher inflation expectations?

- ◆ Bond yields have risen amid higher inflation expectations driven by an improving outlook, higher commodity prices, supply chain bottlenecks, and \$1.9 trillion US fiscal stimulus. Inflation concerns have also put into focus whether central banks will tighten monetary policy, creating volatility in bonds and equities.
- ◆ We believe inflation concerns to be temporary and mild. The US is operating at below full employment and wage growth is limited. Year-end, we expect **US inflation at 2.1% and the 10-year US Treasury yield to be 1%**. We are optimistic on growth and have **upgraded global and US GDP forecast to 5.6% and 6%**.
- ◆ In fixed income, we like **Asia and China high yield bonds, US Investment Grade** for high quality, low duration exposure, in addition to **Emerging Market debt (denominated in both local currency and USD)** which stand to benefit from the continued recovery.

Chart 1: Higher bond yields caused by inflation concerns

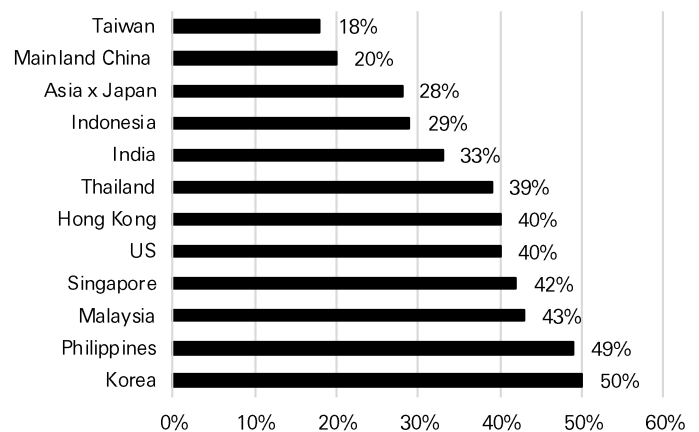


Source: Bloomberg, data as of 30 March 2021. Forecasts are subject to change. Investment involves risks. Past performance is not an indication for future. For illustrative purpose only.

2. Can the equities rally continue?

- ◆ Over 3-6 months, we remain overweight equities because we think the improving earnings outlook will drive stocks higher. Geographically, we like **US, UK and Asia (China and Singapore)**. We prefer cyclical sectors exposed to the recovery like **financials, industrials, materials and consumer discretionary**.
- ◆ While we think the stock market can rally further short-term, **longer-term investors may wish to consider trimming exposure in areas which are now more pricey**.
- ◆ **Over a 12 month horizon, we have downgraded Taiwan and South Korea equities**, which are now more expensively valued. **We have also downgraded US equities** because of the higher valuations of the mega-cap tech sector, which makes up a significant part of the market.

Chart 2: Double-digit earnings upgrade in Asia and US

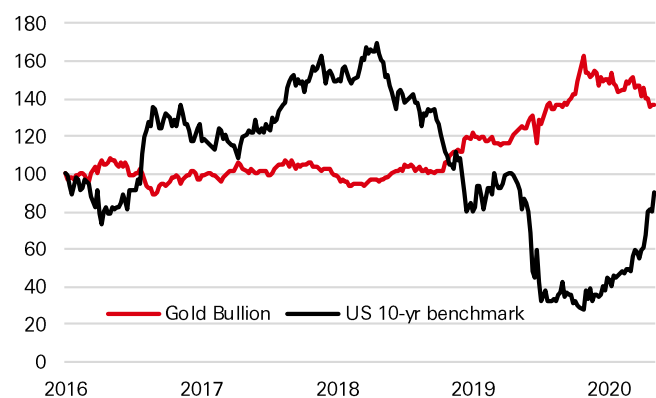


Source: Refinitiv DataStream, HSBC Global Research, data as of 30 March 2021. Investment involves risks. Past performance is not an indication for future. For illustrative purpose only.

3. What are some of the key risks facing investors?

- ◆ **Short-term market volatility may persist if inflation remains elevated**, as markets process whether and when monetary policy may tighten. We think these concerns are temporary and equities will do well over the next 3-6 months. Central banks are committed to keeping policy loose to stimulate the recovery.
- ◆ **If real yields remain elevated, certain growth sectors like tech may suffer short-term**, even though we see tech more as a structural investment. **Gold may also suffer short-term if real yields continue to rise**.
- ◆ **Delays or poor take-up of the Covid-19 vaccine and new variants or waves of virus are risks** to the recovery. We advocate investing via a multi-asset approach that includes a range of asset classes, geographies and sectors, including high quality bonds.

Chart 3: Gold under pressure from higher yields
Rebased to 100



Source: Bloomberg, data as of 30 March 2021. Investment involves risks. Past performance is not an indication for future. For illustrative purpose only.

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	▲	▲	Economic data points to a strong global recovery, bolstered by vaccine roll-out. Cyclical stocks stand to benefit.
United States	▲	▶↓	Earnings outlook is strong and we expect US equities to outperform over 3-6 months. However, longer term investors may wish to trim exposure in light of higher valuations driven by mega-cap tech stocks. We moved to Neutral on US equities on a long-term basis and would focus on real economy names and smaller caps.
United Kingdom	▲	▲	UK equities valuation is attractive and stand to benefit from the expansionary budget, successful large-scale COVID-19 vaccine program and the subsequent re-opening of economies.
Eurozone	▶	▲	A dovish ECB, committed quantitative easing and generous national income support schemes bode well for Eurozone equities, however we remain neutral due to slow pace of vaccine rollout and recovery in the EU.
Japan	▶	▶	Japanese equities are attractively valued, but economic growth is weak and policy space is limited.
Emerging Markets (EM)	▶	▲	The outlook for EM asset classes remains broadly positive driven by global recovery and weaker USD, and we prefer Asia ex-Japan stocks than EM stocks.
Central & Eastern Europe and Latin America	▼	▶	Higher commodity prices may support EM stocks outside of Asia, but new virus variants and slow vaccine rollout remain key challenges
Asian equities			
Asian ex-Japan	▲	▲	Investment merits in Asia are attractive valuations and higher growth potential. We prefer China and Singapore.
China	▲	▲	A global leader in economic recovery with growth potential in manufacturing, consumption and investment from its NPC objectives and 14 th 5-year plan, give us comfort to overweight Chinese stocks as a structural story.
India	▶↑	▲	Having contained COVID-19 challenges, India's economic data is on a strong path to recovery and corporate earnings are likely to be upgraded. Some near-term challenges remain: fiscal constraints and debt sustainability.
Hong Kong	▶	▲	HK has a strong IPO pipeline and benefits from Chinese growth. Cyclical and financial sectors stand to benefit from deflation, but HK is exposed to uncertain global demand and trade outlook.
Singapore	▲	▲	Singapore can attract higher FDI as regional supply chains shift, and it stands to benefit from its cyclical sectors.
South Korea	▶↓	▶↓	As a RCEP beneficiary, South Korea is exposed to the structural tech story, semiconductor demand and global memory shortage. Whilst we remain positive on digital, valuations look full and we downgraded to Neutral.
Taiwan	▶	▶↓	Taiwan is a proxy to the global structural tech, semiconductors, 5G and stay-at-hometrade. It stands to benefit from cyclical rotation but valuations are no longer cheap. We downgraded to Neutral for the long term.
Government bonds			
Developed markets (DM)	▼	▼	The surge in bond yields in a short space of time has limited further upside as it was primarily driven by inflationary concerns which are temporary in nature. Overall DM bonds returns are unattractive.
United States	▶	▼	Reflationary forces have pushed US Treasury yields to new highs in a short space of time, which remain attractive relative to other government bond markets. We think risk-rewards are unattractive in the long term as a dovish Fed limits the risk of higher yields.
United Kingdom	▲	▼	The BoE is accommodative and committed to its QE program, and gilt yields are attractive.
Eurozone	▼	▼	Although the ECB is committed to its monetary policy, European government bond valuations look unattractive.
Japan	▼	▼	Japanese Government bonds face limited policy room and risk-rewards are unattractive.
Emerging Markets (local currency)	▲	▲	We are constructive on EM bonds as higher yields and potential local currency appreciation would benefit this asset class.
Emerging Markets (Hard currency)	▲	▼	EM debt has not been significantly affected by the upward movement in US Treasury yields, which should continue to be supported by the search for carry and yield.
Corporate bonds			
Global investment grade (IG)	▲	▼	We are positive in the near-term as global IG bonds have a place in portfolio diversification. However spreads have come down notably and potential returns have become unattractive in the long run.
USD IG	▲	▼	With government bond yields being low, IG bonds can act as an effective diversifier in a portfolio, but valuations are unattractive in the long term.
EUR and GBP IG	▶	▼	The ECB and BoE are committed to quantitative easing. Spreads are at historically tight levels and we need to monitor any deterioration in trends of corporate fundamentals.
Asia IG	▲	▲	Asia IG is relatively more attractive than developed markets and USD weakness is a positive for corporates with USD-denominated debt. Asian economies are likely to lead in growth recovery.
Global high-yield (HY)	▲	▶↓	Overweight in the short-term because HY should perform well during the recovery. Downgraded to Neutral in the long-term as the difference in yields between Treasuries and HY has narrowed, given the run-up in Treasuries.
US HY	▲	▶↓	We like US HY over 3-6 months because of its exposure to the recovery. However, the credit risk premium for owning US HY over government bonds has fallen, meaning longer-term investors may wish to reduce exposure.
Europe HY	▶	▶	Europe HY valuations warrant a neutral position although the ECB is ultra-accommodative.
Asia HY	▲	▲	Default rates should remain low and spreads look attractive relative to other global opportunities.
Commodities			
Gold	▲	▶	Gold pulled back as the economy continues to recover, but low rates and low real yields will continue to support gold. There remains a place for gold in well-diversified portfolios during times of volatility.
Oil	▶	▶	Supply and demand dynamics are improving for oil, but Brent and WTI prices remain vulnerable to oversupply in a pandemic world where re-opening of economies and vaccine administration may disappoint.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	We are positive on the consumer discretionary sector as it benefits from a low interest rate environment and pent-up demand from COVID lock-down measures. Consumer finance is cheap and readily available which spurs spending, plus household savings are at record levels.
Financials	▲	▲	▲	▶	We recently added Financials to our list of preferred cyclical sectors that we like, led by the improvement in the economic cycle as financial institutions can benefit from more lending activities in a low interest rate environment. In addition, they can benefit from rising inflation and steeper yield curves.
Industrials	▲	▲	▲	▶	Economic data and business capital investment surveys continue to support an improvement in sentiment and our pivot deeper into cyclical exposure. A number of industrial stocks were sold off from the depth of the pandemic and are still trading at compelling valuations as their earnings and margins outlook recover.
Information Technology	▲	▲	▲	▲	The tech sector is at the cusp of a structural super-cycle and a key beneficiary of the stay-at-home plays. The demand for technology ranges greatly from online education, shopping, gaming to tele-consulting, 5G, AI and more. Improving economic conditions support risk assets.
Communication Services	▲	▲	▶	▲	The sector benefits from steady cash flows and growth from increased data usage as businesses and households moved online. The ongoing roll-out of 5G is likely to provide support for telecom equipment providers and enablers. Media companies are likely to see continued robust demand but social media companies may face heightened regulatory headwinds.
Materials	▲	▲	▲	▲	We believe that the cyclical materials sector is consistent to our risk-on approach and overweight to equities. Materials could benefit from higher construction demand provided by the infrastructure stimulus bills across different countries.
Real Estate	▶	▶	▼	▲	The sector's high dividend yield is attractive, and valuations tend to be supported by a low yield environment. However, there could be dispersion in performance, for example, the growth of the online economy which might have a significant impact on commercial real estate.
Consumer Staples	▼	▼	▼	▼	The sector faces headwinds as investors may reduce defensive sector allocation in exchange for a cyclical sector bias with the improvement of economic data. Year-on-year comparison would not be favourable due to panic buying and stock piling of consumer essentials in 1Q and 2Q 2020.
Energy	▶	▶	▶	▶	Traditional fossil-fuels supply curbs by OPEC+ has supported prices and demand may continue to improve with the gradual re-opening of the global economy in 2H2021. We expect some volatility in energy stocks as clean-energy initiatives and ESG measures continue to be in focus.
Healthcare	▶	▶	▶	▲	With the successful roll-out of mass vaccination, concerns will likely turn to drug pricing later in 2021 with the new US administration, which may cause volatility in the sector. Medical technology and biotechnology companies are likely to see strong demand as healthcare and technology grow in tandem in the pandemic-era.
Utilities	▼	▼	▶	▼	The utilities sectors tend to underperform when the markets are risk-on. There has been an increasing pivot towards a more cyclical bias and cheaper sectors by investors which undermines utilities' performance, especially following optimism around carbon-neutral targets.

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