

Investment Monthly

Rebalancing exposure to high quality bonds

November 2022



Key takeaways

- ◆ Stagflation fears and rate hikes have led to rising cash and bond yields but cheaper stocks. While stocks are more vulnerable to the slowing economy, bonds appear more attractive from a risk/return perspective. We prefer short-dated investment grade and EM hard currency corporate bonds for diversification.
- ◆ Despite our underweight on equities, we continue to favour the US over Europe due to its many quality companies to choose. We downgrade South Korean equities on the slowing technology and semi-conductor cycle, and prefer Hong Kong, Thailand and Indonesia on their economic reopening and undemanding valuations. Selection is key.
- ◆ As the new UK's Prime Minister, Rishi Sunak is expected to take a more prudent fiscal path. Yet, tight financial conditions and high inflation remain downside risks to UK equities and warrant our recent downgrade to underweight. While gilts look attractive, they remain volatile and shorter-dated investment grade bonds are preferred.



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| Asset class | 6-month view | Comment |
|---------------------------------------|--------------|---|
| Global equities | ▼↓ | Higher interest rates, inflation and geopolitical uncertainty continue to create further volatility in the equity markets. Our downgrade of the UK equities has resulted in an underweight on global equities. |
| Government bonds | ▼ | Although yields have backed up, we see better opportunities for returns elsewhere. |
| Investment grade (IG) corporate bonds | ▲ | Global investment grade bonds should be more resilient than high yield as risk appetite is challenged and offer a good carry over developed market sovereign bond yields. We focus on short-to-medium maturities. |
| 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. Which asset class is better positioned amid recession risks?

- ◆ The stagflation fears and rate hikes have led to rising cash and bond yields, but the fall in equities have made them much cheaper. However, market concerns will increasingly turn to the slowing economy and equities are vulnerable to this. Earnings growth is expected to be lower in the coming months.
- ◆ Equities and bonds were impacted by the interest rate outlook in the same direction, but equities often perform more poorly if recession fears take over. Cash has become more attractive but its return remains relatively low and its value will be eroded by inflation over time. Sitting on cash is not a good strategy for long-term investors.
- ◆ From a risk/return perspective, bonds appear more attractive than stocks and the bond markets have already priced in a rate path which is in line with the Fed's guidance for 2023. **We prefer short-dated investment grade and EM hard currency corporate bonds for diversification.**

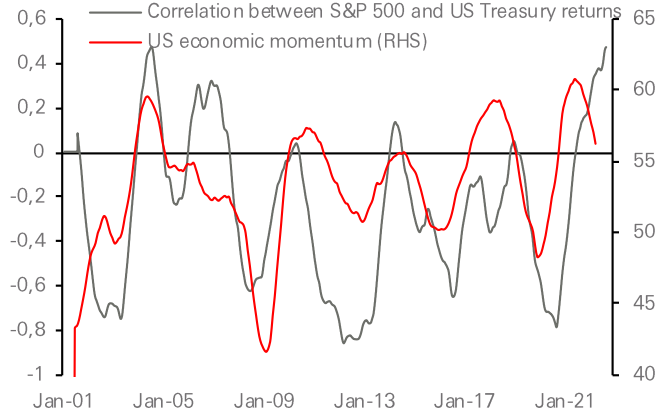
2. What should investors do with their equity holdings?

- ◆ The tightening financial conditions in many developed markets are weighing on their housing markets, consumption and investment spending. These warrant a smaller than normal allocation to equities and selection on quality companies is key. Energy is poised to be the winner in Q3 and we are more positive on renewable energy.
- ◆ **We continue to prefer the US over Europe** due to its many quality companies with strong market positions and low leverage. The mid-term elections may provide an important data point in equity markets as investors recalibrate potential returns in the new political environment. From 1942 to 2018, US equity markets have risen by nearly 15% in the first six months following the election.
- ◆ In Asia, we downgrade South Korean equities to underweight on the slowing technology and semi-conductor cycle. **We prefer Hong Kong Thailand and Indonesia** on their economic reopening and undemanding valuations. We see solid cyclical momentum in Indonesia.

3. What is the outlook for the UK markets?

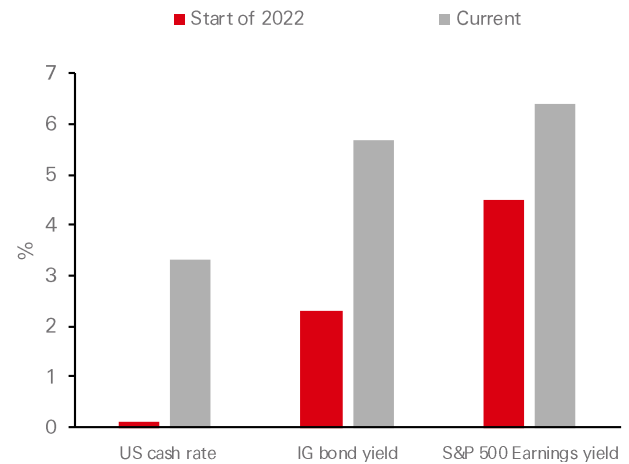
- ◆ Following Liz Truss's just 45 days in office, Rishi Sunak is elected as the new Prime Minister who is expected to take a more prudent fiscal path.
- ◆ Although market volatility may ease temporarily with gilt yields having fallen, the tight financial conditions and high inflation, which hit 10.1% in September, remain headwinds. The Bank of England is likely to take a more hawkish approach to tightening.
- ◆ UK equities have cheapened on a gloomy growth outlook, persistently high inflation and policy tightening, leading to our recent downgrade to underweight. We will look for much cheaper valuations or improved financial conditions to turn more positive. As the economy tips towards a likely recession, we expect more defensive sectors to outperform (e.g. Healthcare). While gilts look more attractive, they may remain volatile, especially if quantitative tightening will start in November. **We prefer shorter-dated European investment grade bonds.**

Chart 1: Historically, equities and bonds are negatively correlated in a slowing economy, with high rated bonds being a good diversifier



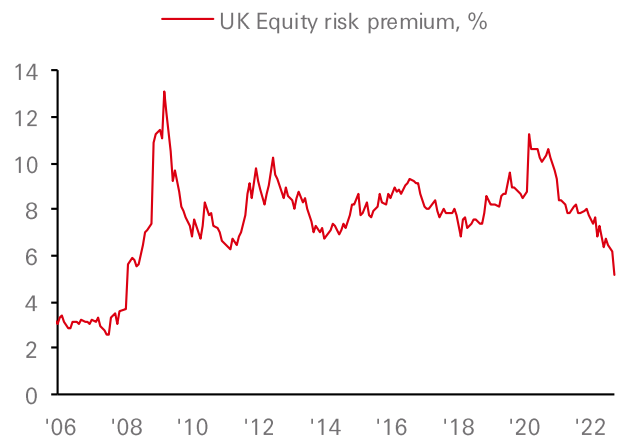
Source: Bloomberg, HSBC Global Private Banking as at 27 September 2022. Past performance is not a reliable indicator of future performance.

Chart 2: Earnings yield has risen less than cash and bond yields



Source: Bloomberg, HSBC Global Private Banking as at 16 October 2022. Past performance is not a reliable indicator of future performance.

Chart 3: UK equities can go cheaper from here



Source: Bloomberg, HSBC Global Private Banking as at 20 October 2022. Past performance is not a reliable of future performance.

Asset Class Views

Our latest house view on various asset classes

| Asset class | 6-month view | Comment |
|-----------------------------------|--------------|---|
| Global equities | | |
| Global | ▼↓ | Higher interest rates, inflation and geopolitical uncertainty continue to create further volatility in the equity markets. Our downgrade of the UK equities has resulted in an underweight on global equities. |
| United States | ▲ | Although growth is slowing, we like the diversity and quality character of US stocks especially compared to Europe but they remain volatile as we get through the mid-term elections. Labour market remains tight. |
| United Kingdom | ▼↓ | The BoE will remain hawkish on rate hikes amid growth slowdown. Coupled with more medium-term pressure on the GBP and the political turmoil, we see more downside risks to UK equities which are not adequately priced in. |
| Eurozone | ▼ | High energy costs, the Ukraine war and the impact of gas supply cuts remain key challenges. The situation may worsen towards winter as the cost of living squeeze intensifies with rising inflation. We expect a recession by Q4. |
| Japan | ▶ | The weak JPY gives companies an advantage but its outlook has become uncertain amid slower global demand and continuation of some global supply chain disruptions. JPY intervention can add to the equity market volatility. |
| Emerging Markets (EM) | ▶ | Concerns over Fed tightening, global growth slowdown and geopolitical tensions linger. Asia is relatively less impacted by policy tightening while LatAm benefits from Mexico's attractive valuations and growth prospects. |
| EM EMEA | ▼ | The region is impacted by high energy prices, weak growth in Europe and an uncertain rate outlook. |
| EM LatAm | ▲ | The Mexican economy benefits from resilient exports to the US, and their rate hikes are far advanced. |
| Asian ex Japan equities | | |
| Asia ex-Japan | ▶ | The Asian IT sector remains a challenge to North Asia and we prefer Hong Kong, Thailand and Indonesia due to their positive reopening outlook and undemanding valuations. Indonesia has the most solid momentum on a relative basis. |
| Mainland China | ▶ | Markets are still awaiting better policy clarity on China's growth recovery initiatives. Balancing near-term growth headwinds and potential policy support further down the road, we stay neutral on China equities. |
| India | ▶ | Stretched valuations and inflation concerns remain but we see structural growth opportunities associated with India's digital economy, green transition and smart manufacturing. |
| Hong Kong | ▲ | The economic reopening and the government focus on reviving Hong Kong as an international business hub, as well as launching infrastructure projects to link Hong Kong and the Greater Bay Area, support our positive view on Hong Kong equities. |
| Singapore | ▶ | The Monetary Authority of Singapore remains on a tightening mode to beat inflation. The reopening and domestic consumption will offset the slowdown from manufacturing. |
| South Korea | ▼↓ | Given the heavy index weighting to tech names, and the deterioration in the semiconductor outlook due to weak global demand and escalating geopolitical tensions, we downgrade South Korean equities to underweight. |
| Taiwan | ▼ | We maintain our bearish view on the deteriorating earnings outlook for the semiconductor sector, which dominates the Taiwanese equity index. Geopolitical risks remain a key concern. |
| Government bonds | | |
| Developed markets (DM) | ▼ | Although yields have backed up, we see better opportunities for returns elsewhere. |
| United States | ▶ | Most of the Fed rate hikes and slowdown in growth are priced in, but upside for investors is limited. |
| United Kingdom | ▶ | With inflation moving higher in September, the Bank of England is likely to take a more hawkish approach to tightening. While gilt volatility may remain elevated, the risk premium in gilts is attractive to buy-and-hold investors. |
| Eurozone | ▼ | Rising energy, goods and services prices push inflation higher, forcing the ECB to continue raising rates and current absolute yield levels remain unattractive. |
| Japan | ▼ | The Bank of Japan is likely to keep its extremely accommodative policy stance until inflation reaches the target of 2%, with the JPY continuing to maintain weak. |
| Emerging Markets (Local currency) | ▶ | Select opportunities exist but some EM countries are hiking rates, while EM currencies could weaken, hurting returns. |
| Emerging Markets (Hard currency) | ▶ | Amid higher Treasury volatility, we still find yield but remain selective. |
| Corporate bonds | | |
| Global investment grade (IG) | ▲ | Global investment grade bonds should be more resilient than high yield as risk appetite is challenged and offer a good carry over developed market sovereign bond yields. We focus on short-to-medium maturities. |
| 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) | ▲ | European and UK investment grade bonds offer decent yields pick-up. We prefer higher quality names and short-to-medium maturities amid the sluggish growth outlook. |
| Asia investment grade (IG) | ▲ | Asia credit offers attractive carry opportunities and we focus on quality credit with short-to-medium maturities. However, China local currency debt is challenged by the rate differential between China and the US, while Indonesia's hard currency bonds are less attractive on a higher rate outlook. |
| 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) | ▶ | With the risk of more aggressive tightening and both EUR and GBP more likely to stay weak, we prefer higher quality investment grade credit and maintain a neutral stance on high yield. |
| Asia high-yield (HY) | ▶ | Although most Asian markets are seeing relatively less inflationary pressure compared to the developed markets, the Fed tightening, a strong USD and slowing global demand are the headwinds. |
| 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 and the OPEC+ production cuts will add upside risks to oil prices over the near term, but demand is starting to decline and 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, rising energy and financing costs are weighing on consumer demand and corporate profits. Corporate margins are impacted by labour shortages and rising wages. Automakers and household appliances see declining new orders. Inventory build-up remains a risk. Luxury goods are more resilient. |
| Financials | ► | ► | ▼ | ► | High inflation has resulted in central banks raising interest rates which is positive for financials. However, slower financial market activity has resulted in flows sharply declining and listings curtailed negatively impacting brokers and investment banks. The global economic slowdown may hurt demand for new mortgages and loans while insurance companies are facing increased event risks. |
| Industrials | ▼ | ► | ▼ | ▼ | Order books remain light as the global economy slows. Input costs remain elevated with energy prices and inflation hurting margins, although easing commodity cost provided some relief. Companies supporting renewable energy and electric vehicle production continue to thrive. |
| Information Technology | ► | ► | ► | ▼ | While IT stocks continue to be range bound amid a risk-off sentiment, low valuations and robust quarterly results make quality large-cap IT stocks particularly attractive. We remain constructive on the sector's long-term growth prospects driven by digitalisation, electrification and automation. Consumer-focused electronics is likely to see muted growth under inflationary pressure. |
| Communications Services | ► | ► | ▲ | ► | The media & entertainment industry remains challenged while the telecoms industry benefits from increased data usage as more activity shifts online and business digitises. The deteriorating economic outlook, rising interest rates and lower capital spending are headwinds for US communication services. |
| Materials | ► | ► | ► | ▼ | Mining stocks remain depressed despite low valuations following the sharp pull-back in commodity prices in Q2. Commodity prices somewhat stabilised at lower levels in Q3 but near-term catalysts for higher prices remain elusive. Higher energy and oil/gas feedstock prices continue to weigh on the chemicals and construction materials industries. The sector trades at the lowest valuation relative to all others. |
| Real Estate | ► | ► | ▼ | ► | Private residential real estate has benefitted from supply-demand imbalances, but rising interest rates may soften demand. Retail real estate suffers from long-term structural changes caused by the rise in ecommerce which is unlikely to change. Elsewhere, office space is being reduced by more employers promote hybrid models including work from home. |
| Consumer Staples | ▲ | ▲ | ▲ | ▲ | Elevated valuations and costs remain a concern. However, corporates have reported robust average price increases in Q3 which have fuelled sales and earnings beats. We focus on quality stocks with strong brands and/or pricing power with above-average dividend yields. |
| Energy | ▲ | ▲ | ▲ | ▲ | OPEC's latest moves to cut supply has set a high floor to protect corporate profitability as low inventories and supply-demand imbalances persist, and the northern hemisphere heads into winter. Valuations remain attractive given the sector's strong outperformance. |
| Healthcare | ► | ► | ▲ | ► | Valuations remain attractive. Pharma stocks should be the most resilient segment although US government's renewed medicine pricing initiatives in the Inflation Reduction Act may be a headwind. Higher-beta biotechnology industry typically underperforms in this environment. |
| Utilities | ► | ► | ► | ► | High valuations limit upside potential, but renewable energy stocks remain attractively valued especially outside of the US. The sector will remain attractive given its stable earnings/cash flow characteristics and high dividend yielding stocks. |

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