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The end of exceptionalism

Q2 2025 Global Investment Outlook

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HSBC Asset Management

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Foreword

Foreword from our Chief Investment Officer

Welcome to our Q2 2025 Global Investment Outlook, titled ‘The end of exceptionalism’, coinciding with shifts in capital flows that point to an erosion of the long-standing mindset of ‘there is no alternative to the US’.

US equity underperformance marks a stark contrast to years past, but is not surprising given relative valuations and growth dynamics coming into the year. A longer-term global trend that appears to be picking up steam is de-dollarisation, contributing to dollar weakness this year as volatility spiked – a contrast to the typical safe haven role of the dollar and US government debt.

The interplay of global trade policy, inflation and recalibrating growth trajectories creates a complex backdrop in a new market regime. Uncertainties look set to be a feature of the economic and market system, rather than a temporary hitch, magnifying the importance of diversification and selectivity in an environment of rotating market leadership.

Alongside this, structural forces—including the evolution of AI, the reconfiguration of supply chains, and policy pivots in Europe and China—are redrawing the investment map.

Despite current turmoil, we maintain a favourable bias for risky assets on a 12-month horizon, but with significant regional preference and acknowledging that further near-term weakness is a significant risk. Should our baseline macroeconomic scenario materialise in the second half of the year, we think markets outside the US which have better policy mixes present more potential.

Valuations in other regions remain more appealing despite underperformance from US stocks since the beginning of the year, leading to our preference for European stocks and some EM equity markets. Europe and Asia also have more room for stimulus measures which can support markets.

Emerging market bonds also appeal based on valuations and real yields that are still high versus historical averages. More broadly, we are slightly long duration, anticipating more rate cuts than are fully priced in. While potential for stickier inflation complicates the outlook, the relative safety of high-quality credit will continue to be important for portfolio resilience and income.

Given the potential for increased volatility and higher correlation between bonds and equities, we think smart diversification remains a priority – elevating the role of alternatives as yield enhancers and core resilience tools.

We also emphasise the importance of active currency management, especially when market downside risk is on the rise and the US dollar’s safe-haven role may have weakened.

In the pages ahead we explore these thoughts more granularly through our baseline and adverse scenarios for the global economy and markets. I trust this will provide valuable insights as you continue with your investment journey in 2025.

> “Flexibility should remain a cornerstone of portfolio allocations today.”

Xavier Baraton
Chief Investment Officer

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Macro outlook and market implications

Macro outlook and market implications

Rising policy uncertainty, shifting growth patterns and volatile investor sentiment mark a changed investment paradigm.

In this new paradigm, the traditional mindset of TINA (there is no alternative) that favoured US equities has quickly faded as global capital flows recalibrate. Even before trade tensions escalated, equity markets had experienced a rotation in leadership - a development we had anticipated coming into the year based on converging growth and corporate earnings trends.

As developments on global trade policy continue to unfold, uncertainty is set to be a staple of investment markets. This creates a volatile environment to traverse.

While trade policy details may vary across trade partners, broader implications should be more uniform: rising costs, potentially slowing growth, and stickier inflation.

From an economic perspective, inflationary forces may re-accelerate due to supply chain frictions and cost pass-throughs. This will offset the improvements suggested by easing shelter inflation and moderating wage growth.

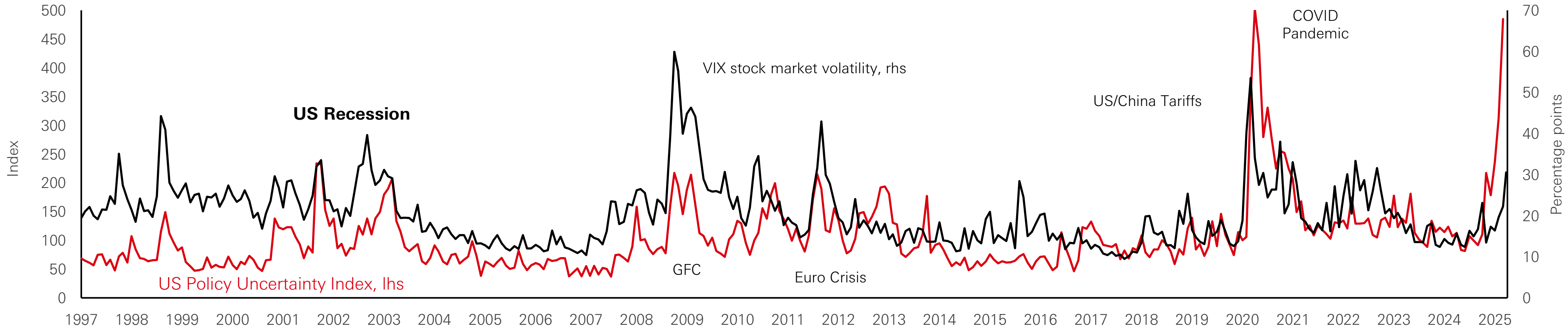
In the US, inflation could edge toward 4% while growth projections are revised downward, possibly dropping below 1% year-over-year by early 2026. These dynamics place the Fed in a difficult position to balance growth and inflation objectives. Business and consumer sentiment has already softened, raising the risk of feedback loops that erode demand further.

The situation raises concerns about stagflation dynamics, where rising price pressures coincide with slowing demand — conditions under which broad asset class performance can struggle.

This points to an agile approach to managing portfolios. Areas like the UK gilt market, high-quality credits, quality equity allocations, infrastructure, and actively-managed emerging market exposures continue to appeal.

We think that areas of alternatives, including hedge funds and private credit, should continue to play an important role as portfolio diversifiers. Additionally, the US dollar's role as a haven may have weakened amid policy uncertainty, shifting attention to alternatives such as gold, alongside the Yen or Swiss Franc.

Figure 1: US policy uncertainty versus stock market volatility



Source: Bloomberg, HSBC Asset Management, April 2025. **Past performance does not predict future returns.** Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target. This shouldn't be considered as a recommendation to invest in the markets provided.

Scenarios

We retain two distinct macro scenarios based on varying degrees of trade policy implementation over the coming months.

The 'spinning around' scenario envisages elevated policy uncertainty driving higher market volatility, with adverse – though relatively mild – consequences for growth, profits, and inflation presenting opportunities outside of the US.

This scenario reflects further downgrades to US GDP and profits growth. While US equity valuations have cheapened, policy uncertainty and 'stagflation-lite' news can further lower profits expectations and market ratings. In just the past six months, 2025 EPS growth expectations for the S&P 500 have been revised down from 15% to 10%.

Moreover, sticky inflation postpones a pre-emptive easing by the Fed, which could have acted as a stock market shock absorber. Currently, market expectations are pricing in just over three 25bp cuts for the remainder of 2025 and a further cut in 2026. However, if the Fed remains in a wait-and-see mode amid tariff uncertainty and sticky inflation, while growth continues to slide, then markets could face further instability.

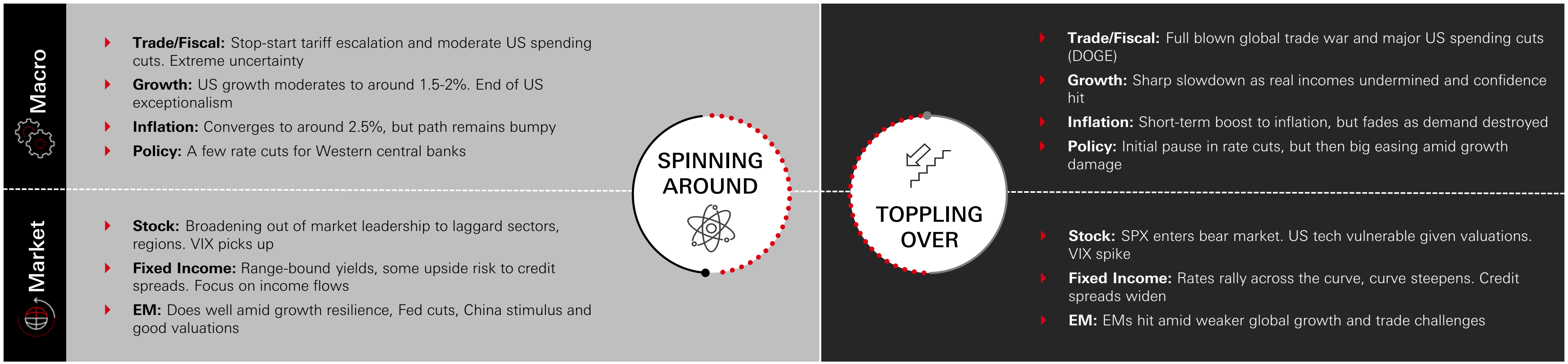
This could bring an alternative, adverse scenario more vividly into play where we could witness a 'toppling over' of growth and profits as a combination of rising tariffs and retaliatory measures could lead to a sharp slowdown. This triggers a decline in consumer confidence and spending, leading to lower corporate profits and increased unemployment. The impact on emerging markets could be particularly severe, especially for those economies heavily reliant on exports to the US.

All of this uncertainty around US economic and trade policy is prompting 'ambiguity aversion', and reduction in exposure to US equities in favour of markets with more predictable outcomes. However, there were already signs that recent profits upgrades in Europe and China were slowing. And history suggests that when the US economy sneezes, the rest of the world catches a cold.

Yet, the emergence of new domestic policy initiatives, especially in Europe and China, provide 'policy puts' that can support growth and market performance – especially with valuations there on the cheap side of long-run norms. Additionally, US dollar weakness could act as a stimulus for international markets.

In any scenario, as global supply chains and trade flows re-adjust, and policy remains fluid, flexibility in portfolio allocations will prove more valuable than forecasts.

Figure 2: A 'spinning around' scenario would see continued rotations in market narratives and drivers, but the risk of growth 'toppling over' has become an equally likely outcome to us.



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Market implications

With policy uncertainty set to remain a core feature of market dynamics, the case for embracing diversifiers is as strong as ever.

While equities will remain part of the solution, the focus shifts towards quality and defensiveness — firms with strong balance sheets, pricing power, and stable earnings streams. Exposure to sectors with secular tailwinds, such as renewable energy, healthcare innovation, and digital infrastructure, can act as both growth engines and defensive allocations.

Global developments and the recent underperformance of growth stocks, particularly in the US tech sector, have also prompted a reassessment of geographic exposures.

The 'policy puts' that have emerged in Europe and China can support market resilience. Germany's EUR 500bn infrastructure investment fund to boost defence spending and public investment, for instance, should contribute to Europe's cyclical rebound. After a couple of years of slowing, we expect the cumulative effect of domestic policy initiatives will lift Chinese nominal GDP in 2025. This could have meaningful implications for corporate earnings and investor sentiment.

Valuation discounts and structural shifts in global trade patterns could support momentum for emerging markets broadly. The growth differential between the US and EMs is narrowing, and in a positive scenario EMs could benefit from upward surprises in growth data. Additionally, a weaker US dollar has eased financial conditions and reduced external debt burdens for many emerging economies. That said, EMs are not without risks.

EMs are clearly vulnerable to policy uncertainty and global trade headwinds. Moreover, the possibility of a stronger US dollar, rising US bond yields, or weaker consumer confidence in China could also disrupt emerging market momentum.

Bonds remain important to portfolio resilience. Inflation complicates the outlook, but high-quality credit continues to offer relative safety, especially when spreads widen during risk-off phases. UK gilts, despite recent turbulence, offer an option for duration exposure without the embedded volatility of US Treasuries.

EM bonds continue to offer attractive valuations with real yields considerably above historical averages, and with positive term premia. As gradual disinflation leads to policy easing in EM, we suggest maintaining FX-hedged exposure to preferred EM local-currency bond markets.

Figure 3: Views per asset class (▲ Positive / ↔ Neutral / ▼ Negative bias)

Equities

Asset Class	House view
Global	↔/▲
US	↔
UK	↔
Eurozone	↔/▲
Japan	↔/▲
Emerging markets (EM)	▲
Latam	▼
Frontier	▲

Government bonds

Asset Class	House view
Global	↔/▲
US10yr	↔/▲
UK10yr	▲
German 10yr	↔
Japan	▼
Inflation-linked	↔/▲
EM (local currency)	▲

Corporate bonds

Asset Class	House view
Global investment grade	↔/▲
USD IG	↔
EUR & GBP IG	↔
Asia IG	↔/▲
Global high-yield	↔/▼
US high-yield	▼
Europe high-yield	▼
Asia high-yield	↔/▲
Securitised credit	▲

Commodities, alternatives and FX

Asset Class	House view
Gold	▲
Oil	▼
Private credit	▲▲
Real assets	▲▲
Hedge funds	▲▲
Private equity	↔
Portfolio hedging	▲
US dollar	↔/▼

Asian assets

Asset Class	House view
Pan-Asia government bonds	▲
Asia ex-Japan equities	↔/▲
China A	▲
India	▲
ASEAN	↔/▲
Hong Kong	▲
Asia FX	↔

Source: HSBC Asset Management, April 2025. House view represents a >12-month investment view across major asset classes in our portfolios. Views reflect our long-term expected return forecasts, our portfolio optimisation process and actual portfolio positions. These views are for general information purposes only and do not constitute advice or a recommendation to buy or sell investments. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target. This information shouldn't be considered as a recommendation to invest in the specific country or sector mentioned.

Top of mind

Top of mind

Why alternatives now?

Sticky inflation, potentially inflamed by trade policy, may further challenge the traditional 60/40 portfolio model. While bonds should continue to play a core role in portfolios, we emphasise the importance of alternatives to support portfolio resilience amidst volatility we expect to persist.

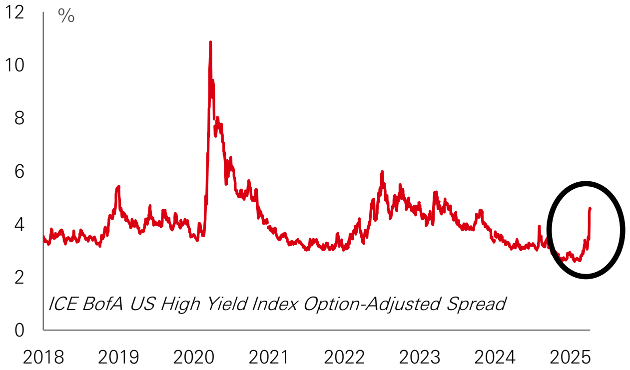
Infrastructure assets, with their inflation-linked revenue streams, can provide both stability and upside. Cashflows that typically rise with inflation support potential for increased nominal returns and stability of real returns if inflationary pressures are revived.

Exposure via both debt and equity instruments offers benefits. Infrastructure equities can provide more stable returns than broader equity markets in the event of a period of economic slowdown, as the assets are generally uncorrelated to the economic cycle. This counter-cyclical stability has long been one of the primary benefits of an infrastructure equity allocation.

Infrastructure debt typically finances physical and digital infrastructure facilitating the function of day-to-day life (energy solutions, communications, etc.). Given that these assets generally carry inelastic demand, this means steady cashflows and more stable credit profiles.

We think the characteristics of private credit more broadly also appeal. Since near-term economic risks could mean lower corporate profit margins, weaker growth, and an increase in the potential for recession, the consequence is spread widening. Spreads on a range of credits across the US, Europe, and Asia widened significantly, with high-yield credits seeing the biggest moves in response to the announcement of newly planned tariffs.

Figure 1: US high yield credit spread



Source: Macrobond, HSBC Asset Management, April 2025.

For private credit, default risk has moved moderately higher, but current market conditions can be positive. Periods of uncertainty and market dislocation can benefit private credit lenders through higher spreads, lower leverage and stronger covenants on new originations.

Furthermore, if tariffs are inflationary and lead to higher interest rates (or a delay in rate cuts), then private credit can benefit because it consists of floating rate loans – a particularly useful diversification characteristic today.

Overall, we believe private credit continues to offer strong all-in yields and an illiquidity premium that suits long-term investors, serving as a useful portfolio diversifier.

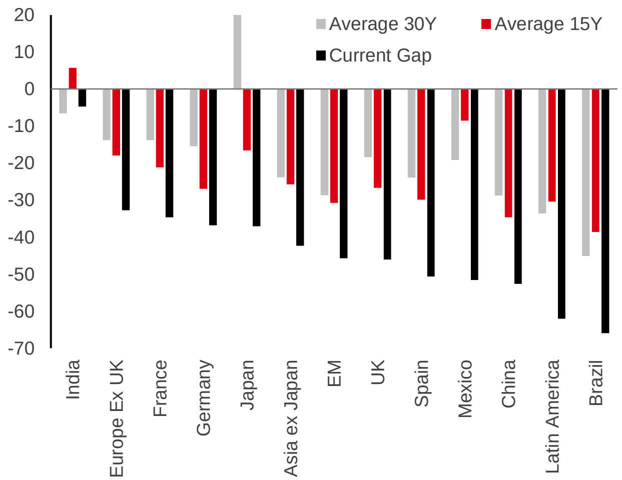
Hedge funds are another area we favour within alternative allocations. The wide array of strategies employed by managers can be diversified across asset classes, including commodities, currencies and derivatives, meaning fund performance is not solely driven by directionality in equities and bonds, supporting uncorrelated returns. Furthermore, the current volatility spikes present opportunities for hedge fund strategies to maximise the benefits of long and short positions to pursue positive performance when traditional asset classes are struggling.

Overall, elevated volatility is no longer an anomaly — it is structural. Hence, the strategic focus pivots toward flexibility and diversification rather than attempts to time volatility or predict the exact trajectory of inflation and rates. We believe active FX management strategies also become more important as the safe-haven role of the US dollar is questioned, which also reasserts gold's status.

Why consider emerging market equities amid so much uncertainty?

Emerging market stocks have outperformed their developed market counterparts so far in 2025. We think this can continue. Ongoing China policy support is a big plus, and many regions remain under-loved by investors, leaving them attractively priced in our view.

Figure 2: PE gap (%) to US



Source: Refinitiv, HSBC Asset Management, March 2025. MSCI Indices.

The world's premium growth rates are still expected to be in Emerging Asia and Frontier economies in 2025. India is projected to be the fastest growing large economy in the world, and we see improving macro fundamentals in Southeast Asia and in MENA. Furthermore, recent dollar weakness eases global financial conditions and dollar-denominated debt burdens, which buoys EM currencies.

Underlying inflation in emerging markets continues to fall, in contrast to US price trends which are displaying signs of stickiness, ahead of any tariff impacts. As such, EM and US inflation could cross paths later this year. This provides breathing space for EM central banks to enact further rate cuts, providing a bulwark against external shocks.

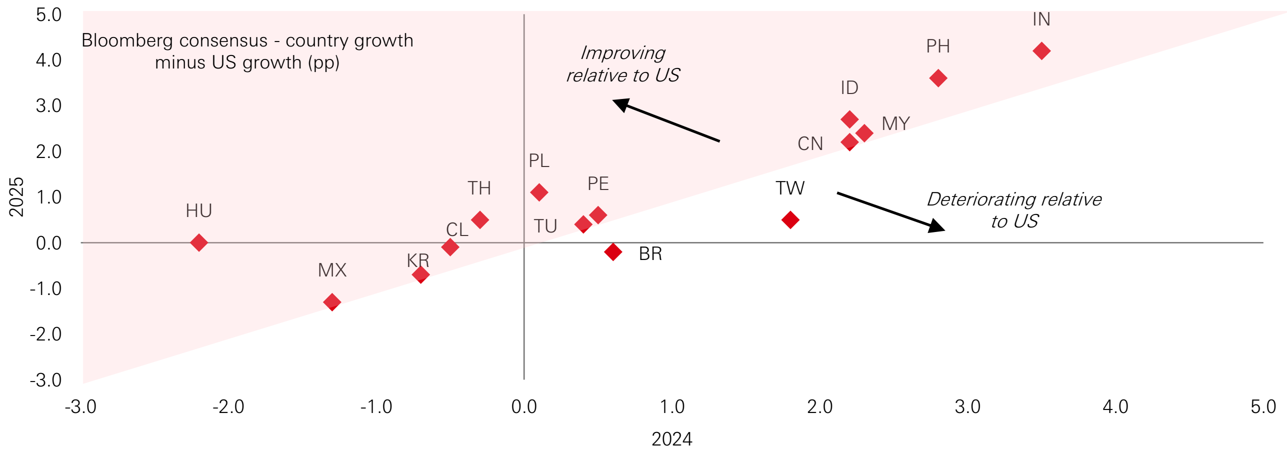
In China, ongoing policy support could mean the economic slowdown is less significant than many forecasters fear. The overall tone has been growth-supportive and market friendly, with the reiteration of "more proactive" fiscal policy and "moderately accommodative" monetary policy. In terms of policy direction, boosting consumption is now top priority. There is also a focus on technology innovation and upgrading industry, especially through AI and digital tech. The government has also pledged more support for the property sector and the stock market.

Overall, the plans confirm a Chinese "policy put" to support growth.

More broadly, emerging markets are vulnerable to rising policy uncertainty and mounting global trade headwinds. There are also lingering worries about fiscal risks in larger emerging economies like Brazil. Other risks include potential for the dollar to strengthen again, US bond yields reversing their recent decline, or China's consumer confidence remaining depressed – exacerbated by a slowdown in trade. A US downturn has also become more likely, which alongside trade tensions could materially damage export growth in many EMs.

But as usual, a one-size-fits-all approach to assessing the outlook for EMs risks over-simplification, and a selective approach will be crucial.

Figure 3: EM growth differentials vs the US



Source: Bloomberg, HSBC Asset Management, March 2025.

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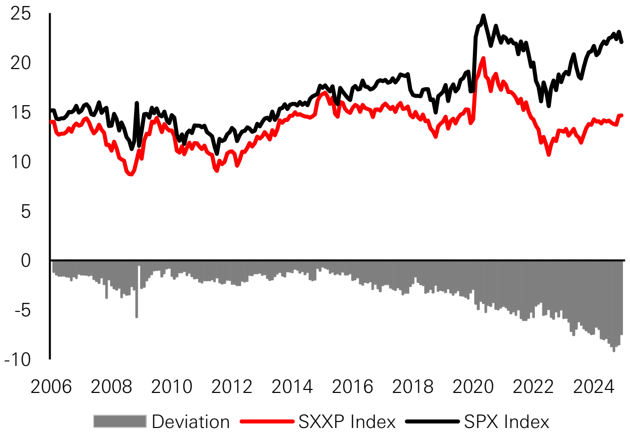
Will 2025 outperformance from European equities extend?

Despite significant challenges facing European economies, the region's equity markets present a compelling catch-up case, with relatively low valuations and potential macroeconomic improvements supporting sector-specific growth.

Figure 4: Price-to-earnings - Stoxx 600 versus S&P 500



Source: HSBC AM, Bloomberg, Goldman Sachs. Data as of March 2025.

Over the past two decades European equities struggled to keep pace with their US counterparts, with the dispersion more pronounced in recent years. While performance has held up better than the US this year, a very large longer-term performance gap remains. One contributor, although it doesn't fully explain the gap, has been lagging earnings growth relative to the US since the European sovereign debt crisis and subsequent fiscal austerity measures.

Broader economic challenges that have emerged include a productivity and innovation gap, higher energy costs, and geopolitical dependencies that have created disadvantages for European firms.

Europe retains substantial investment capacity to counteract these challenges to economic growth. With a debt-to-GDP ratio below 100% – much lower than other developed markets – there is room for significant fiscal intervention. Proposals have been made for special infrastructure and defence investments (e.g. Germany), which will increase Europe's debt-to-GDP ratio and mirror the fiscal strategies deployed during the covid-19 crisis. If executed effectively across the continent, these investments could revitalise European industries and narrow the transatlantic performance disparity.

Green shoots may be starting to present themselves, with a recently positive trend in economic surprise indices which contrasts a negative recent trend for the US. Yet, Europe's trade relationship with the US and China remains a key determinant of its economic trajectory. Since 2020, goods exports to the US have grown by 44%, while exports to China have contracted by 5%, increasing Europe's dependence on American trade. Implications of US tariffs on European goods, particularly in the automotive sector, pose a clear risk.

Still, Eurozone activity continues to be influenced by the macroeconomic environment in China. Extensive policy support from China has reduced downside risks to their economy and could benefit industrial production in Europe ahead, with additional measures expected.

Recent trends support improving profit expectations. The Q4 2024 earnings season saw the Stoxx 600 deliver a positive change in momentum, with sales and earnings growth of nearly 7%. European bank profits have been in a dynamic upward trend since their Covid low, and since 2022, both European banks and healthcare companies exhibit higher profit growth than their US counterparts.

Figure 5: European vs US financial sector PE and growth

Financial sector	Current PE	5Y Profit Growth
Stoxx 600 Banks	7.7	88.5%
S&P 500 Financials	17.9	28.0%
PE Difference	-10.2	
Average Difference	-3.4	

Source: HSBC AM, Bloomberg. Data as of February 2025.

Overall, we believe further catch-up potential in European equities remains after their outperformance to start this year. Some areas look more compelling than others, which means a selective, tactical approach could benefit.

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What has protected portfolios amid tariff uncertainty?

Although US Treasuries – the classic portfolio diversifier – initially worked as a hedge during the market turmoil triggered by 'liberation day' tariffs, yields subsequently jumped higher even as equities continued selling off.

While there are probably multiple culprits behind the Treasury sell-off – including forced selling of liquid assets to meet margin calls – it seems policy uncertainty is undermining investor thinking on the safe-haven properties of US government debt. Geopolitics could be increasing aversion to US assets more widely – which might also help explain the dollar's recent losses.

Currently, gold, the yen, and the Swiss franc stand out as global investors' havens of choice. And alternative assets such as infrastructure equity have also worked. But with Treasury yields still high, and recession risk elevated, it might be too soon to give up on their potential to protect.

Why is the dollar falling? Shouldn't it benefit from global risk aversion?

The dollar selling off amid market turmoil and higher treasury yields breaks two conventional assumptions about dollar behaviour – that it rises in times of financial stress and is positively correlated to yields.

Moreover, US yields have moved in the opposite direction to yields in Europe. Again, not a typical outcome. This suggests there may be a significant asset allocation shift underway. Investors may have offloaded their holdings of US Treasuries to purchase German government bonds in the wake of recent US trade-policy shifts.

A joint sell-off in domestic bonds and the currency is something investors typically associate with EMs rather than the pre-eminent global reserve currency. Ultimately, elevated US policy uncertainty, growth worries and concern over fiscal dynamics mean US assets may require a higher risk premium to attract capital. For global investors in US assets, FX hedging strategies may play a more important part of their decision-making process.

So is this the end of US exceptionalism?

A number of indicators pointed to a US market topping process at the end of last year, not least, the US reaching an all-time high weight in global stock markets. Policy uncertainty catalysed the reversal and now weaker economic data means lower 2025 US growth forecasts.

In markets, we expect more 'EAFE exceptionalism', encouraged by low valuations and policy stimulus, but remain risk aware for short-term reversals. Longer term, a structural rotation toward Europe and Asia could build.

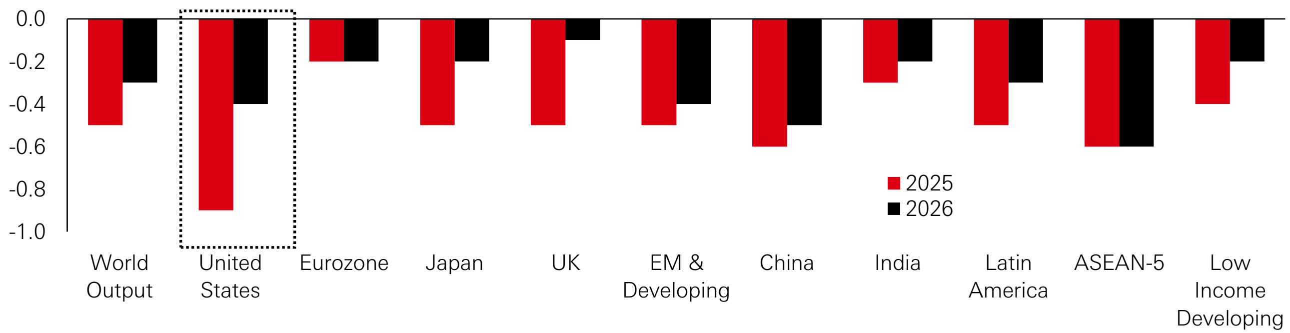
How vulnerable are Europe and EM markets to a global trade war?

Important mitigating factors include the 'policy puts' provided by domestic policy initiatives in Europe and China. The emergence of viable investment themes in China tech or European defence can offer further support.

The direction of the greenback is also important. Strengthening EM currencies is boosting returns for Western investors, and should help ease imported inflation, providing breathing room for EM central banks to ease policy. It will also help loosen global financial conditions and make it easier for sovereigns and local corporations to service their debts. Phases of emerging stock market leadership (such as the early 2000s BRICs mega trend) tend to coincide with a weaker dollar.

Lastly, many EM assets present low market multiples and high real yields, giving a margin of safety against shocks.

Figure 6: IMF World Economic Outlook - Percentage point change to real GDP growth projections versus January 2025



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Promising but unequal potential in European credit

Promising but unequal potential in European credit

"Germany's significant fiscal stimulus and increased defence spending across the region could act as a catalyst for a change in sentiment in the Euro credit markets."

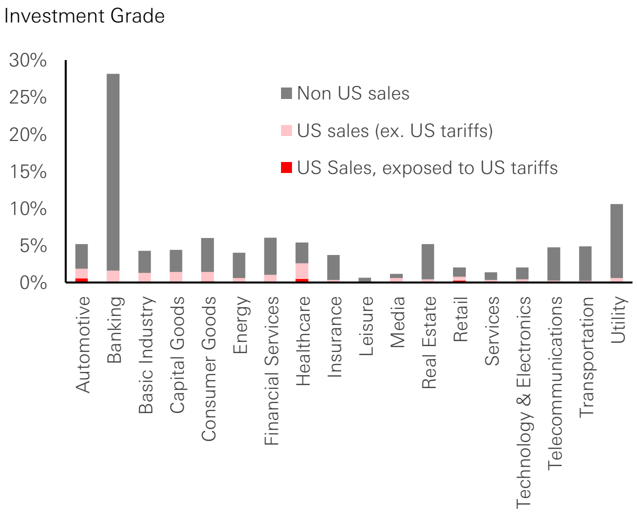
Prospects for the Eurozone economy are improving, with the likelihood of further interest rate cuts and the impending fiscal boost. Euro credit is likely to benefit from these developments, while it should be largely resilient to trade tariffs.

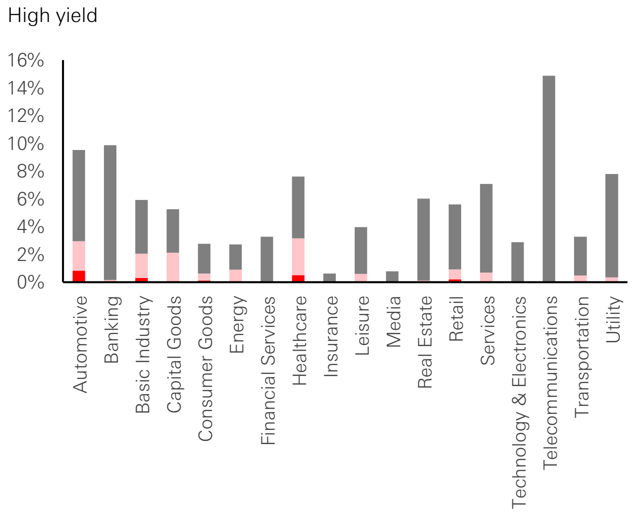
Economic visibility for the Eurozone has been enhanced by the latest developments, especially the German fiscal package, where the direction of travel and political conviction are clear, even if risks to execution remain. Greater certainty will likely drive investment as there is a need for companies to build up capacity, and with around €300bn of EU savings currently invested outside the region each year, this could be reallocated to home markets and particularly early-stage technologies.

Even if tariffs are still an unknown quantity in terms of their scope, size and impact on the Eurozone's economies, it is important to note that the Euro credit market has limited direct exposure. Notably,19% of the Euro Investment Grade (IG) market and 9% of High Yield (HY) is made up of US registered companies, while direct sales exposure to US tariffs remains limited in even the most affected sectors.

European corporate credits are entering this period of geopolitical tensions and economic uncertainty with healthy fundamentals, although there are risks to the downside. Gross leverage is steady, and profitability is resilient. Despite a slight decline in coverage ratios, companies maintain strong cash buffers and projected default rates indicate a stable credit environment, supported by sector diversity.

Figure 1: Euro Corporate sales exposures to US tariffs - Breakdown by sector (%)





Source: BofA ICE indices, Bloomberg, HSBC AM, March 2025

Beneficiaries of the extra fiscal spending include companies in the Defence, Steel, Construction, Electronics, Energy and Infrastructure sectors, while higher rates could be detrimental for vulnerable companies with low debt affordability outside these sectors.

The European defence industry is poised for significant growth, given EU plans to invest around €800 billion in defence over the next four years, made up of €150 billion in loans and €650 billion through waivers on Excessive Deficit Procedures. The urgency of this investment is complicated by the fact that the planned spending amounts are significantly higher than the current output of European defence companies.

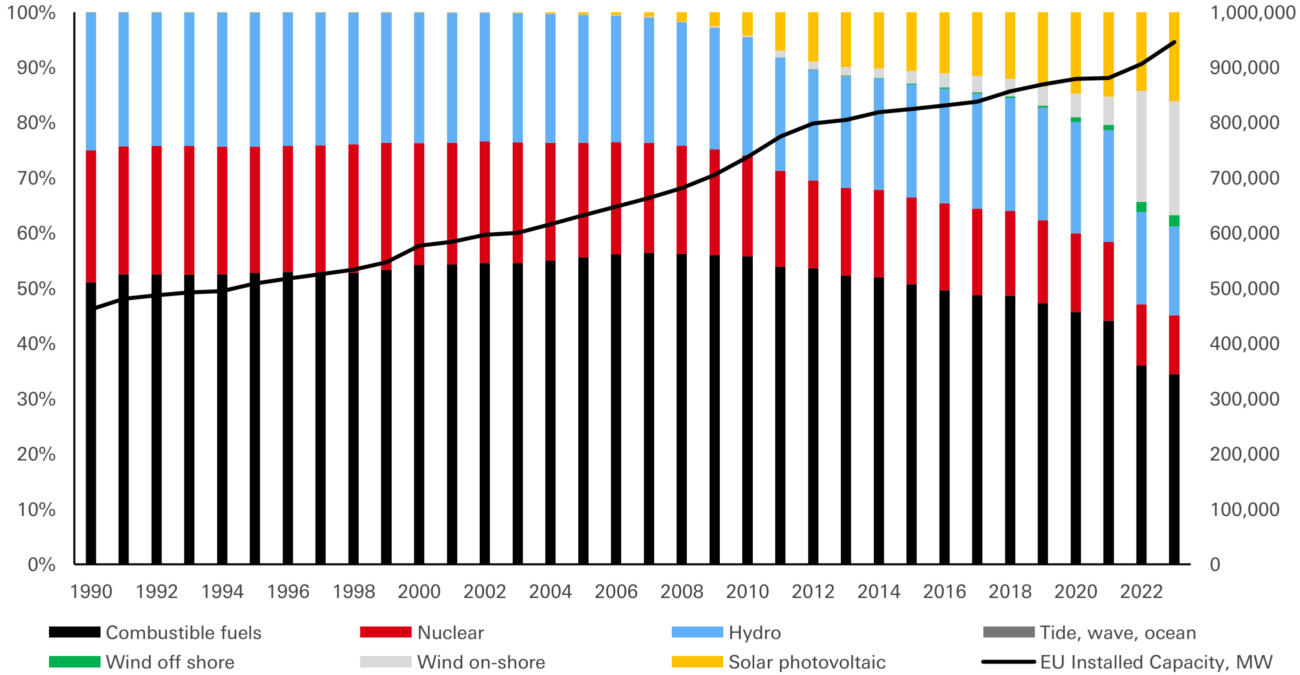
This suggests a need for bond issuance to build capacity, as the additional spending probably can't be digested by the European defence industry alone. Major European players include BAE Systems, with $29.81 billion in arms revenues, followed by Airbus and Leonardo.

Energy security remains a top priority of the Repower EU campaign. Europe successfully transitioned away from Russian oil following the implementation of direct and indirect sanctions in December 2023 and reduced its gas imports by 87%, avoiding the worst-case scenario of de-industrialisation due to high energy prices. With LNG supply expected to outstrip demand by 2027, prices are forecast to decline, providing a positive boost for industrial sectors.

Even more importantly, the European Green Deal has driven a deep and rapid transformation of the EU power sector. Renewables increased their share from 34% in 2019 to 47% in 2024, while fossil fuels declined from 39% to 29%. Solar power remained the EU's fastest-growing energy source in 2024, surpassing coal for the first time. Wind power continued to be the EU's second-largest power source, ranking above gas but below nuclear.

> "Increased defence spending and Germany's fiscal boost could boost investor sentiment, but monitoring sectoral impacts of geopolitical tensions is crucial."

Figure 2: Energy – Installed Capacity and Mix



Source: Moody's rating; HSBC Asset Management, as of March 2025.

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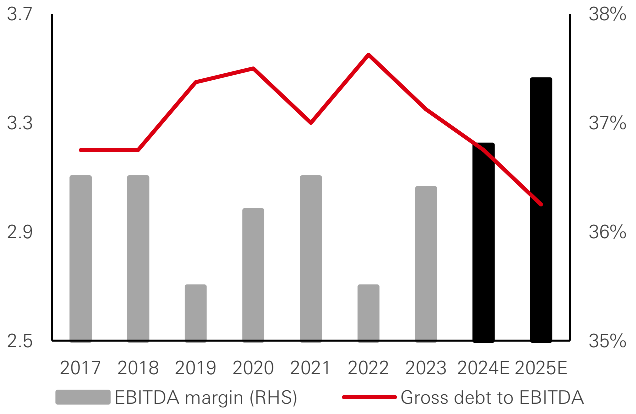
The impact of tariffs should be minimal on the **banking** sector, with the anticipated positive effects of economic stimulus packages likely to bolster loan demand. The sector is characterised by strong capitalisation levels, healthy profitability indicators, and adequate provisions for non-performing loans. Notably, the situation for French banks has improved, reflecting positive political developments which enhance operational stability.

In contrast, the **automotive** sector is particularly vulnerable due to US tariffs and regulatory uncertainties in Europe. Concerns regarding pricing pressures and the potential for increased merger and acquisition risks, could further complicate the sector's outlook.

The **telecommunications** sector presents a more optimistic outlook. The sector is largely insulated from the direct impacts of tariffs, with most activities being locally based.

Figure 3: Gross leverage for EMEA telecom set to decline



Source: Moody's rating; HSBC Asset Management, as of March 2025.

The potential benefits from the EU defence package, particularly in cybersecurity, and the German infrastructure fund are expected to bolster the sector's fundamentals. In addition, the investments in fibre and 5G networks are now mostly done, which reinforces the operational profitability of telecom companies.

Utilities in Europe also exhibit stable fundamentals, supported by a constructive regulatory environment and elevated electricity prices. Despite the challenges posed by a significant increase in supply driven by an investment super-cycle, selective opportunities in hybrid instruments from reputable issuers warrant consideration. Notably, the anticipated growth in regulated asset bases, particularly in the UK and Germany, is expected to drive earnings and support credit metrics.

Most companies in the **capital goods** sector express confidence in their ability to navigate current challenges with localised US manufacturing presence and decent pricing power, although there may be potential headwinds from capex delays in impacted end markets. Meanwhile, order trends from data centres, energy, utilities, mining, aerospace and defence are demonstrating strength.

The **construction** sector faces headwinds due to its indirect exposure to US tariffs. Potential demand tailwinds from infrastructure-related projects and improvements in safeguard measures could support the sector. However, its cyclical nature makes it vulnerable in the event of an economic downturn.

The **healthcare** sector is characterised by a defensive outlook, with solid demand fundamentals. However, the potential for increased pricing pressures stemming from US political developments introduces an element of uncertainty. The pharmaceutical industry, in particular, faces challenges related to tariffs on uncertain treatment of active pharmaceutical ingredients and the potential for regulatory changes that could impact pricing dynamics.

Looking ahead

While certain sectors such as banking, telecommunications, and utilities present promising opportunities, others like automotive and construction warrant caution due to their heightened exposure to external risks. As investors navigate this landscape, a careful assessment of sector fundamentals, technical factors, and valuation metrics will be essential in making informed decisions. The outlook remains uncertain, with potential volatility expected to continue in the coming months.

Evolution of the AI story

Evolution of the AI story

> "A new AI model originating from China dramatically lowered the cost of compute and put Chinese companies firmly in the AI value chain."

Ahead of the March correction in US equities, technology stocks came under pressure since late January. Markets have struggled to evaluate the implications of a new AI model originating from China, which at once dramatically lowered the cost of AI compute. The DeepSeek models – comparable to US models but requiring significantly less investment – contain several important breakthroughs around training, inference and how to improve efficiency by optimising the hardware used.

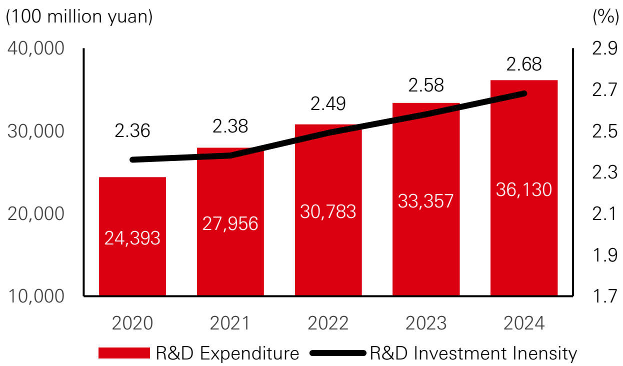
To make up for the restricted communication speeds of the Nvidia H800 (a dialled down version of the higher performance H100 chip), DeepSeek created their own communication protocols at a level below the official programming language. This level of optimisation was of course not necessary for model builders in the US who had greater access to compute.

The arrival of this breakthrough put ex-China IT stocks under selling pressure given the focus on how cheap it had been to train the model, casting the hundreds of billions of dollars spent on infrastructure and training by the industry in a negative light. Significant outperformance from elements of the tech sector that fuelled the post-ChatGPT rally came with expectations of continued heavy investment in AI infrastructure. Accordingly, this part of the market was vulnerable to a correction in the event of a wobble in confidence. We believe, though, that there are important misconceptions as to the true significance of the model developments.

The focus of media attention has been the $5.5m cost of this model. For many reasons we think this is understated and misses the point. The true benefit is the release of important breakthroughs to the model community that could substantially lower the cost of inference and thus accelerate AI adoption and demand. Jevons Paradox states that as we use a resource more efficiently, consumption of that resource goes UP, not down.

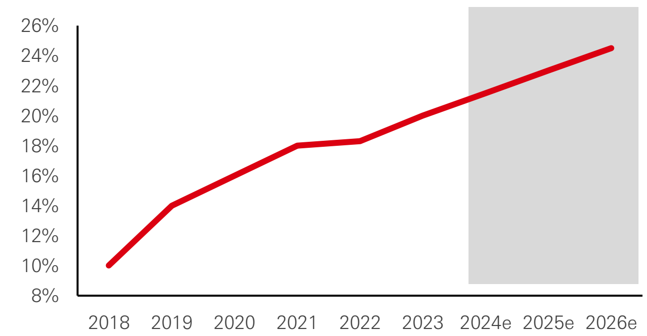
Our Equity insights publication of October discussed our thinking around the growing importance of inference and expectations for model improvements to reduce the cost of compute and lead to a broadening out of the equity landscape. We maintain this view and see varied implications across the tech sector and geographies.

Figure 1: China's tech investment supports local advances



Source: National Bureau of Statistics of China, as of 24 January 2025.

Figure 2: Growth in China semiconductor self-sufficiency is an example of the progress



Source: Gartner, WSTS, Morgan Stanley Research estimates, February 2025

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Infrastructure vs software

In the short term, lower cost of compute should benefit the software sector relative to the semiconductor sector. This shift had started before the recent selling pressure hit US tech as a whole. As the software sector invests and integrates Generative AI into their products, inference is an operating cost to them – anything that can reduce this will be welcomed. Moreover, as demand rises for AI, the need for protecting this data also increases, benefiting cybersecurity companies, for instance.

For the hyperscalers and infrastructure providers, the impact is perhaps more nuanced. Some have continued with their platform approach, allowing models to reside on their infrastructure, thus monetising usage and inference. Others have developed their own models as well as their own compute for internal purposes. Rapid advancements and commoditisation of compute is more likely to be a headwind for the latter approach and a tailwind for the former.

By analogy to previous platform shifts such as the mobile-internet cycle, while the semiconductor industry is currently benefitting from a flood of investment, the impact on the software sector is still in its early stages. Our view, applicable to global technology stocks as a whole, remains that substantial lowering of the cost of compute is a necessary condition for a move to the next stage of the investment cycle to take place.

Implications for China

The release of DeepSeek-R1 boosted investor sentiment toward China's AI competency amid technology export restrictions from the US. Although US companies are still leading globally in terms of original innovations, we believe China could lead globally in terms of engineering optimisations, production and commercialisation at scale. This creates a large growth runway for China's internet/cloud platforms, where consumer-facing LLM-powered applications can lead to improving monetisation and cost optimisation, possibly with lower capex needed.

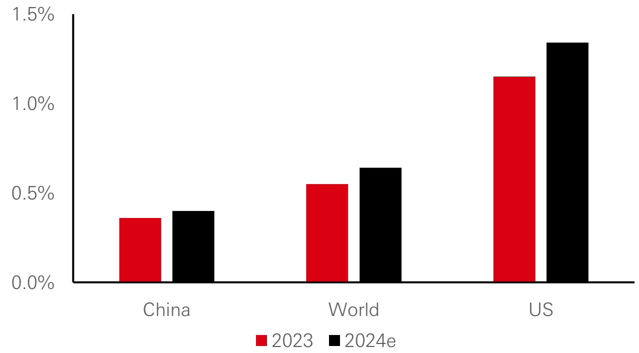
While this runway is increasingly being appreciated by investors amidst the rally in China technology stocks post-DeepSeek, recent rerating still leaves China large cap tech at roughly half the price of US large cap tech relative to earnings.[1] Accordingly, if monetisation and growth is realised, there is ample room for further rerating.

We also believe the increasing popularity of DeepSeek, due to its solid performance and cost efficiency, could stimulate significant enterprise demand for AI services – a long-term positive for computing demand. This further supports China internet companies as the major cloud vendors in the market. AI has become a significant driver of cloud adoption for enterprises, putting the cloud service providers in a position to deliver improving revenue contribution from AI-driven cloud revenue growth. Beyond infrastructure/GPU renting, AI workloads and AI-related services could contribute to growth and margins ahead.

Figure 2: Resources for training of models

	GPT-3 (Open AI)	GPT-4 (Open AI)	Llama-3.1 (Meta)	DeepSeek V2	DeepSeek V3
Model parameters (bn)	175	1,800	430	236	670
Training tokens (bn)	3,700?	13,000	15,000	8,100	14,800
Training chipsets	V100	A100	H100	H800	H800
No. of GPUs	1,024	25,000	16,000	2,000+	2048
Training cost (US$mn)	4.6mn	>100mn	60mn	5mn+ ??	5.57mn

Figure 3: We are in early stages of growth in China cloud spend (Cloud spend as % of GDP)



Source: Statista, Gartner, HSBC Research estimates. March 2025.

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Separately, DeepSeek-R1 has significantly lowered thresholds for app developers, enabling complex applications with high reasoning requirements. Reportedly, DeepSeek's writer API has raised document generation efficiency by 3x and cut error rates by 90%. This could all improve software companies' R&D efficiency, saving costs and driving earnings growth in the medium term, presenting a number of application software beneficiaries.

The greater availability of AI applications will likely shorten device replacement cycles. Smartphone and PC manufacturers and the related supply chains are thus likely to benefit. DeepSeek will also likely speed up AI computation hardware localisation in China. In line with Jevons' Paradox, the reduction in costs should lead to increased demand. Semiconductor manufacturers are set to benefit from demand for advanced chips that power AI applications, enabling faster processing and enhanced capabilities.

Considering EM more broadly

Superapps in emerging markets, particularly Asia, can certainly facilitate the monetisation of AI functionality with consumers, presenting an opportunity that is not replicable in developed markets. As AI is integrated across these large platforms, enhancements should include more targeted advertising to a very broad user base, better e-commerce experiences for these consumers, and more efficient generation of entertainment content including games, allowing for greater production of differentiated content for consumption. This supports the promise of AI leverage in emerging markets picking up steam and supporting earnings growth as the cost of compute continues to reduce.

Should lower cost of compute drive greater enterprise adoption of Generative AI as expected, India could become an interesting beneficiary. Commonly dubbed as "the world's back office", a large part of the technology sector in India consists of IT services. As system integrators, this means the biggest potential pie for Indian IT will be large scale adoption of Gen AI across enterprises.

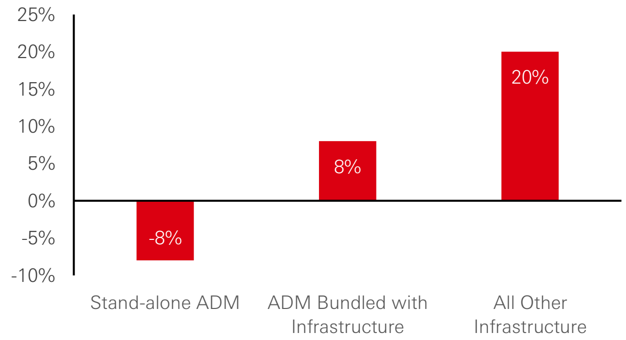
Currently, enterprise adoption of Gen AI remains relatively limited. It is still transitioning from proof of concepts to larger scale adoptions as use cases evolve. Consulting services providers incorporating AI solutions, like Accenture, TCS and Infosys, have spoken about Gen AI gaining scale in their orderbooks. However, it is not at the core of offerings, still primarily focused on enhancing skills, capabilities and reskilling of employees. In other words, it largely remains on the periphery of solutions rather than a core driver.

At the same time as spending on AI infrastructure – data processing and storage – has progressed at a rapid pace, there has been a slowdown in spend on Indian IT services over the last year. This points to spend on AI buildout consuming budgets, leaving smaller slices of the pie for IT Services. Even the hyperscalers, with their near limitless budgets, have cut IT services tech spends as they have grown their substantial AI infrastructure capex. Figure 4 reflects this disparity in spend for stand-alone application development and maintenance services versus infrastructure spend globally.

Of course, the infrastructure buildout comes on the premise of preparation for widescale Gen AI adoption ahead.

"India could become an interesting beneficiary of increased enterprise Gen AI adoption."

Figure 4: 2024 Growth in ADM services



Source: Information Services Group Index, January 2025

The implications of DeepSeek appear to be positive for this point. While DeepSeek may not be adopted in the west, the ideas around optimisation and doing more with less will certainly permeate US tech. The cost of adoption will come down and more domain specific LLMs will likely be developed. Here, Indian IT can participate in optimising LLMs, even with lower processing power. Thus, provided the US macro environment supports continued corporate spending ahead, we expect a revival of discretionary spending for Indian IT Services as the Gen AI story evolves.

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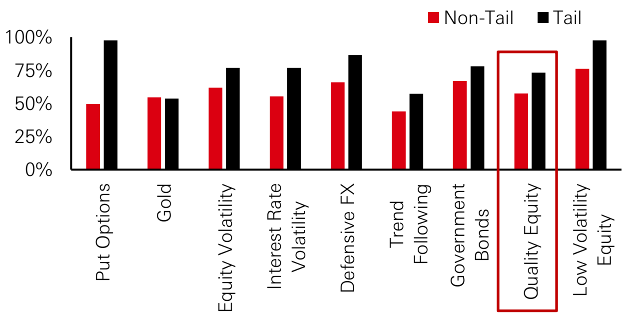
A deep dive into the quality factor

A deep dive into the quality factor

> "Finding portfolio resilience is a priority amid higher bond-equity correlations and tail risk event potential

With economic uncertainty rising alongside geopolitical tension, bringing with it more market volatility, investors are increasingly seeking strategies that provide resilience without sacrificing long-term growth potential. Various approaches exist to bolster resilience within a multi-asset approach, including explicit downside protection strategies and diversifiers. Among diversifiers, equity factors should be considered, with the quality factor standing out for its positive convexity, allowing downside protection while still participating in market upswings.

Figure 1: Defensive consistency



Defining Quality: A three-pillar approach

Quality, unlike other investment factors such as momentum, does not lend itself to a straightforward definition. A notable quote, 'You know it when you see it', encapsulates this sentiment. The vagueness in defining quality necessitates a more structured approach to quantify it, leading to the identification of three distinct pillars: profitability, consistency, and safety.

1. **Profitability:** Positive earnings and cashflow generation to deliver returns on capital are clear requirements for quality. Research consistently shows that companies with higher profitability levels tend to outperform their peers. A notable study by Grantham in the 1990s established a correlation between higher ROE and superior performance, informing the construction methodologies of quality factor equity indices developed by Dow Jones, FTSE, and MSCI.

2. **Consistency:** Companies that maintain stable operating profitability and earnings growth, alongside low sales variance, are classified as higher quality. Consistency in financial performance instils shorter-term confidence among investors while contributing to long-term outperformance. Research indicates that companies with stable earnings are less likely to experience significant downturns during market stress, enhancing portfolio resilience. Separately, a study by Fama and French found firms with stable earnings growth outperformed those with volatile earnings by an average of 3% annually over 20 years. This stability is particularly important during economic uncertainty, where being able to predict future earnings becomes a significant advantage.

3. **Safety:** The third pillar of quality encompasses a company's financial health and risk profile. Companies with stronger financial health are better positioned to weather economic downturns and financial stress. Historical data supports this, revealing that firms with lower leverage and higher interest coverage ratios tend to outperform their higher-leverage counterparts over time.

Overall, the evidence underscores the performance contribution and defensive characteristics of quality. For instance, a study by Jiao and Cooper highlighted that portfolios with a quality overlay outperformed market capitalisation indices by 4.2% during bear markets and by 2.8% in high-volatility regimes. Even in bull markets, outperformance of 1.43% was delivered, supporting the integration of quality in long-term strategic allocations.

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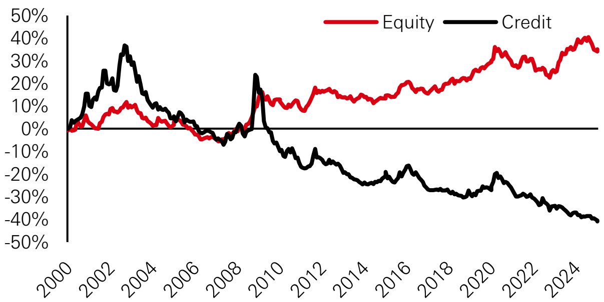
The quality premium: primarily an equity-only phenomenon

Identifying quality in credit markets is more straight-forward, given credit ratings and clear delineation based on companies' ability to meet their debt obligations. While quality in equity markets has demonstrated long-term outperformance, the same is not the case in credit markets.

Figure 2: Quality performance (US)



Source: HSBC AM, as of March 2025.

The logic supporting this is if you invest in a quality security, you're taking less risk and you're being less compensated for it. Yet this begs the question, why is quality compensated in equities?

One reason suggested for this is that models such as the dividend discount model and others undervalue quality companies. Outperformance is consequently derived from that. Another potential cause is that in equity markets, investors tend to bid up 'lottery' stocks offering the promise of big returns. In credit markets, this phenomenon isn't feasible. In a high yield bond, returns are capped to some extent, contrasting to what are theoretically infinite returns possible in equity markets. However, once the euphoric price environment fades, during recessionary periods or periods of stress, those 'lottery' companies tend to suffer much more significantly in a portfolio, underperforming higher quality equities. This observation is supported by research from Baker and Wurgler which found that during market downturns, high-quality stocks outperformed their lower-quality counterparts by an average of 5% annually.

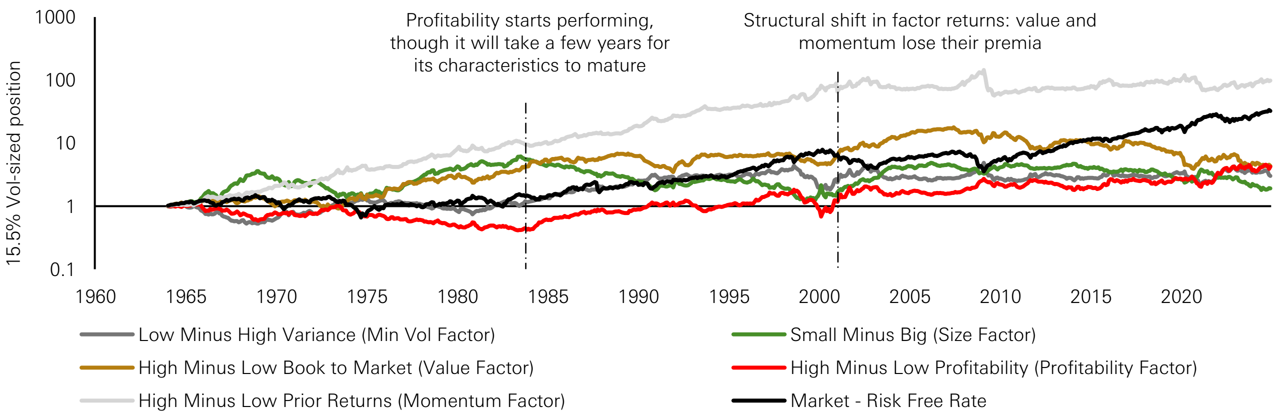
Quality versus other investment factors

We use the Fama-French factor definitions to look back at how factor performance has evolved across history, with the measure for quality simply being profitability.

A fundamental shift in the behaviour of factor premia around the turn of the century has been observed. Since 2001, profitability has delivered the strongest risk-adjusted returns, by a wide margin.

The broader quality factor has consistently generated a premium over time while exhibiting a degree of shorter-term counter-cyclicality, which is expected given the defensive nature of quality investments discussed. Notably, there are two distinct periods that challenge the consistency of quality, specifically during the bull markets of the 1980s and 2000s. Prolonged rallies in lottery or ‘junk’ stocks characterised these times. However, the underperformance of quality during these periods was insufficient to derail the long-term premium available to long-term investors.

Figure 3: Cumulative total value of Fama-French factors[1]



Source: Kenneth French Data Library, HSBC AM. Data as of February 2025.

1 - Andrew Ang’s ‘Trends and Cycles of Style Factors in the 20th and 21st Centuries’ (JPM 2003). The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

The resilience of quality throughout the business cycle

Our analysis finds that quality demonstrates its strongest active returns during economic contractions. While it lags other defensive strategies that provide more explicit downside protection during market slowdowns, it still delivers positive active returns. Other defensive strategies often suffer significant negative returns as the economy recovers, revealing a reliance on perfectly timed exit points. In contrast, quality's underperformance is more muted, allowing for better navigation of market inflection points.

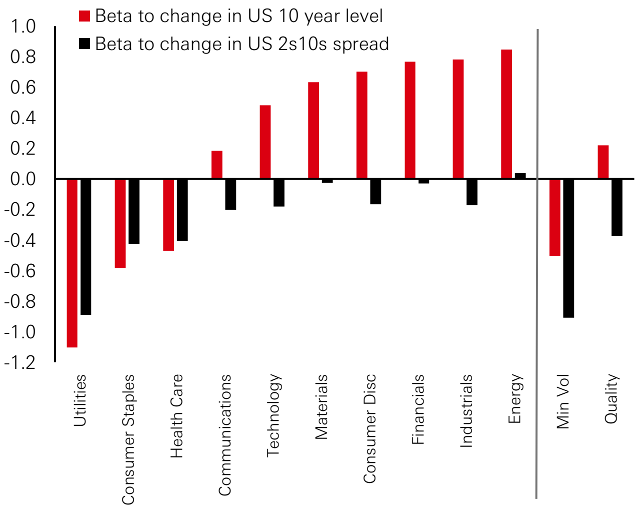
This reduces the dependence on timing the market's bottom, unlike investing in defensive sectors and minimum volatility, which can hinder portfolios if positions aren't exited quickly when the market turns positive. With quality, we can afford to be more wary of potential double-dip recessions or false positives in short-term equity rallies. While it usually lags the market cap index in the first 12 months of recovery, this is not always the case, as seen after the 1990 recession, 2018-19 trade wars, and the 2022 rate hikes.

In terms of the overall investment narrative, quality is useful within strategic allocations to support more stable long-term returns. For those with a high conviction view of a bearish outcome, explicit defensive equity strategies offer a more reliable hedge.

An important consideration to account for with multi-asset allocations is that defensive equity sectors tend to have a stronger equity duration (i.e., negative beta to bond yield levels), which can exacerbate positive stock-bond correlations. This can be explained through two narratives.

The first, termed the low-risk narrative, posits that in low-yield environments, bond investors seek stronger returns and turn to low-risk stocks with stable cash flows, which behave in a bond-like manner. As yield levels rise, this effect diminishes as investors return to higher-yielding fixed income assets. The second narrative relates to the dynamics of certain sectors, which are more leveraged and sensitive to changes in inflation and yield levels, such as utilities.

Figure 4: US rate sensitivities across MSCI World sectors (1995-2024)



Source: HSBC AM, Bloomberg. Data as of February 2025.

By construction, minimum volatility allocates more weight to "bond-like" sectors and has exhibited a structural positive correlation with bonds over the last 25 years. In contrast, we do not observe the same structural correlation for quality. Investing in the quality factor and employing a broad taxonomy helps avoid similar rate sensitivity.

Accessing the quality premium

Quality offers a useful way of building more defensiveness into portfolios. However, any individual allocation must be considered within the context of the broader portfolio. The MSCI quality indices reveal stark differences in individual sector weightings versus standard index weightings. This would be influenced by the business nature and dynamics of certain industries.

Furthermore, from a geographic perspective there is a bias towards defensive markets like the US and Switzerland. Thus, in the context of multi-asset allocations, vigilance must be prioritised to manage sector and geographic biases, along with valuation risks. A sector-neutral approach is one potential way to avoid such biases, but may not be effective in all regions.

Ultimately, different expressions of quality can be achieved in portfolio construction, including through active fundamental managers emphasising strong, cash-generative companies with sustainable earnings growth. We think the quality factor can complement strategic allocations with a longer-term use case that avoids some drawbacks of other defensive strategies.

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