Asset Management

Challenged optimism

House views
Q3 2023

HSBC | Opening up a world of opportunity

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Foreword

Foreword from our Chief Investment Officer

Welcome to our Q3 House Views, reflecting the main findings of our quarterly Strategic Forum. I am pleased to share with you our view on the global economy and investment markets for the months to come.

This update comes at a pivotal juncture when secular global economic trends seem to be shifting. Many forces driving secular stagnation, systemic risk fears and the low-flation phase of 2010s look to be diminishing. We are now entering a medium-term regime of 'spike-flation' where inflation will fall but with a tendency to spike higher intermittently, rather than persistently undershoot inflation targets.

This regime shift is notably driven by demographics, whereby ageing populations will mean dissaving and a reduced pool of labour. Other secular forces such as persistent supply-side shocks, the end of 1990s-style hyper-globalisation, a more fragmented global order, and the reinforcement of climate policies, will also play a role in maintaining inflation to a 2 to 3% range. This implies that policy rates will be structurally higher over this decade, but not necessarily at the current levels assumed by investors.

In the shorter-term, the 'higher-for longer' interest rate narrative is at risk of being challenged by a combination of ongoing disinflation and recession.

Despite the recent pullback in asset prices, current valuations still embed a soft landing outcome for major Western economies. However, we think restrictive monetary policy settings and the risk of a significant deterioration in corporate earnings implies a situation of 'challenged optimism' for investors in the coming months.

And as risk premiums have adjusted in a big way, investors will have to re-think their allocations. Overall, we take a defensive positioning in global stocks – favouring quality and yield. In fixed income, we think 'bonds are back' – yields are higher, term premiums are positive again, while high-quality segments are likely to outperform in recession. Furthermore, quality credits can offer enticing carry opportunities with defaults likely to be limited amid fundamentally sound balance sheets.

Finally, a positive stock-bond correlation means 'intelligent diversification' remains paramount. Exploiting new idiosyncrasies – across asset classes and regions – and allocating to important megatrends, are becoming increasingly important for delivering portfolio resilience.

"The decade ahead will be nothing like the previous one. The impact of higher-for-longer interest rates on risk premiums will push investors to re-think their strategic asset allocation."

Xavier Baraton
Chief Investment Officer

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Macro outlook and market implications

Macro outlook and market implications

Global economic trends are suggesting a mixed bag of opportunities and challenges across different regions.

We see inflation in western economies showing further signs of moderation. Amid further cooling in labour and housing markets - and increased headwinds for consumers - this trend is likely to continue. But the path to lower inflation is not a smooth one, and near-term economic resilience – especially in the US – potentially requires a longer period of restrictive monetary policy. In the eurozone, economic activity remains sluggish amid global growth risks and the fastest European rate hikes since the Bundesbank policies of the 1980s.

In contrast, eastern economies face less inflationary pressures, with the main concern being spillovers from China's economic slowdown. Current policy measures are supporting cyclical growth, but addressing structural concerns may require further action

In equity markets, US stocks are exhibiting stretched valuations, and investor sentiment is deteriorating. A recessionary outcome and deterioration in the earnings outlook, which is not yet fully-factored into current valuations, poses a significant challenge to current market pricing. In particular, European equities are contending with profitability challenges in a sluggish economic environment. In the emerging market space, some parts of Asia remain vulnerable to slower economic growth from China.

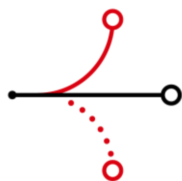
However, signs of a stabilisation in China's cyclical data amid ongoing policy support provides scope for a rebound in investor sentiment. On balance, relative valuations and macroeconomic resilience make emerging markets, chosen selectively, an attractive option for long-run investors.

In bond markets, US Treasuries could provide capital gains under a scenario of US recession and faster-than-expected Fed rate cuts. Similarly, European government bonds have scope for outperformance; we think the ECB could be easing policy from mid-2024 onwards. In an environment of restrictive monetary policy settings, higher yields, and elevated recession risks, our preference is for high-quality bonds and credits.

Figure 1: Economic backdrop

The era of secular stagnation is over

- No return to the low-flation phase of 2010s
- Long awaited return of productivity growth?



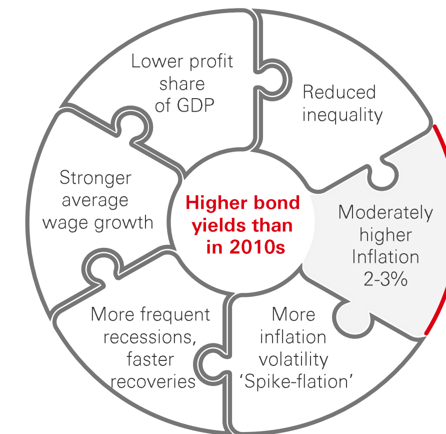
Persistent adverse supply-side forces

- De-globalisation & more fragmented global order
- Climate policy
- Demographics constraining labour supply

Regime of 'spike-flation'

- Inflation will fall - we are not in the 1970s
- Tendency will be for inflation to spike higher, rather than persistently undershoot inflation targets
- Inflation to eventually settle in a 2-3% range

Figure 2: Economic & market outcomes



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Scenarios

Our updated central scenario continues to anticipate a 'choppy' market environment, predominantly hinging on the likelihood of a global slowdown next year.

This view of global recession is based on the impact of restrictive monetary policy which has not yet fully fed through to the real economy. Consumers are also confronting mounting pressures due to the depletion of excess savings, tightening credit conditions, and cooling labour markets.

Rising interest rates and diminishing pricing power are likely to push corporates to retrench.

In this backdrop, corporate earnings are likely to disappoint. With equity risk premiums providing a limited margin of safety against downside risks, we think there is scope for a correction in valuations. Additionally, we foresee a deterioration in credit quality, partially offset by lower discount rates and declining inflation.

In line with this scenario, our core expectation is that the Fed and ECB policy rates have peaked, and we see forceful rate cuts as recession bites in 2024.

In the East, further monetary easing cannot be ruled out in China, while more fiscal support is needed in order to sustain a recovery. Meanwhile, the Bank of Japan still looks likely to dismantle its yield curve control framework.

Nonetheless, as we navigate this recessionary phase, recovery potential emerges, as central banks shift towards easing, lower bond yields enhance relative valuations, and focus turns to the prospective economic revival.

Figure 3: Central and alternative scenarios

	Persistent Inflation	Choppy markets	Soft-ish landing
Macro	**WEST**: Persistent inflation pressures due to supply problems/resilient demand -> higher-than-expected rates. Deeper/delayed recession - US GDP drawdown (>2%), profit recession (-20%) = big delta vs IBES consensus. **EAST**: Weak China property sector, consumption and exports. Higher rates weigh on activity.	**WEST**: Tighter financial conditions induces global recession. Profits recession (≈ -10% in 2023) as nominal growth deteriorates, savings rate rises and corporates retrench. **EAST**: Bumpy recovery in China but sustained policy support helps buoy growth.	**WEST**: Policy only mildly restrictive/takes longer to bite due to solid private sector balance sheets. GDP and profits recession very mild. 2023 consensus zero earnings growth delivered. **EAST**: Pickup in China activity. Western demand holds up, buoying exports.
Policy	**WEST**: Fed funds on hold for sustained period/raised further. **EAST**: Very limited China policy easing, BoJ scraps YCC + raises rates, other CBs struggle to pivot.	**WEST**: 2024 Fed easing > mkt expectations amid recession. Mild fiscal drag, but no rapid austerity. **EAST**: China policy stance remains supportive, BoJ scraps YCC, some CBs start cutting in late 2023.	**WEST**: Gradual policy easing from mid-2024 as inflation eases, resilient labour market => no aggressive cuts. **EAST**: China policy support is accelerated to boost growth. Many CBs cutting rates before year-end.
Market	SPX retests 2022 lows. Long term real yields > 2.0%. Credit spreads widen. ↓ EM assets amid ↑ US rates and USD. ↑ USD cash, CHF, JPY, momentum, macro HFs, infrastructure and defensive equity, FRNs.	Choppy 12m outlook for stocks. Prefer high-quality bonds and carry opportunities in high quality credits. Selective EM opportunities amid better growth, inflation and valuations, Fed 2024 easing.	Reduced pressure on profits and multiples. Further upside to equities. Credit spreads tighten to price more benign default scenario. EM assets gain rally as USD falls. China outperforms.

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Market implications

Current market pricing of riskier asset classes remains consistent with a soft landing scenario, seemingly overlooking the spectre of a significant recession. In this context, we maintain a preference for high-quality bonds, poised to outperform should a recession materialise, and high-quality credits which offer enticing carry opportunities while helping to shield against mounting default risks.

Equities, especially in developed markets, are confronted with a confluence of challenges. A weakening outlook for consumers and the risk of earnings disappointment is a cause for concern.

Moreover, valuations in many equity markets appear to be set at elevated levels when compared to the clear risks of an upcoming economic downturn.

For emerging markets equities, the prevailing cyclical slowdown in China remains a pivotal risk factor. Nevertheless, certain pockets within this asset class exhibit attractive valuations and economies are relatively resilient, making them worthy of consideration in portfolios.

For government bonds, it is conceivable that higher rates persist in the near term. However, our central scenario is grounded in the belief that a recession is the most likely outcome for major developed economies. This, in turn, could see central banks embark on a faster-than-expected rate-cutting trajectory in 2024.

Within the corporate bond space, spreads are anticipated to widen due to a deteriorating growth backdrop and rising default risks. Yet, the investment grade segment remains appealing amid income opportunities and solid balance sheets. In navigating these complex and evolving financial markets, vigilance, a prudent selection, and a diversified approach remain paramount.

Figure 4: Views per asset class

Equities

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

Government bonds

Asset Class	House view
Global	↔/▲
US	▲
UK	▲
Eurozone	↔
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	▲
Copper	▼
Listed Real estate	▲
Infrastructure	▲▲
Hedge funds	↔/▲
Private equity	↔
US dollar	▼
Crypto	↔

Asian assets

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

▲ Positive ↔ Neutral ▼ Negative

Source: HSBC AM, September 2023. 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 does 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 Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Challenging the "higher-for-longer" narrative

The current global economic landscape is marked by elevated uncertainty and contrasting views among financial experts, particularly concerning the outlook for interest rates. At recent meetings, central banks have signalled their intention to keep rates 'higher-for-longer' and that major recession will be averted. Investors have taken this message on board as a signal that economies can withstand a regime of higher rates, leading to a repricing of 2024 interest rate expectations, and helping to push bond yields to multi-year highs.

But the recent increase in bond yields has extended into long-duration maturities. This tells us investors may also be reflecting expectations that interest rates will stay higher than normal well into the future. This could be linked to concerns over a persistent US budget deficit, the impact of a multi-polar world, or other secular forces such as an AI productivity boom or more activist state.

It is hard to know where rates and inflation ultimately settle in the post-covid era. A regime of structurally higher inflation and interest rates makes sense in the context of greater supply-side disruption and the end of the 'monetary policy on steroids' era of the 2010s. But we also think the market could be overestimating the extent to which rates will remain elevated.

In the near-term, the twin forces of weak leading indicators and sustained disinflation still point to the risk of recession and bigger interest rate cuts in 2024. And further out, productivity growth is likely to remain challenged by the rising cost of capital and ongoing economic and geopolitical uncertainty, despite potential gains from AI and more flexible working practices. The slowdown in advanced economies' productivity growth has gone hand in hand with a sustained decline in interest rates over the past 30 years.

We also think that scope for increased fiscal activism and public spending to help address inequality and climate change challenges is fundamentally constrained by higher interest rates. We should remember that the post-GFC period of fiscal austerity was triggered by the major expansion of fiscal deficits in a similar vein to the covid years.

The ultimate test comes in the coming months as the 'long and variable lags' of monetary policy feed through to the economy. But for investors, even in an environment of higher rates and spikey inflation, there are opportunities for active managers.

"With the global financial landscape evolving rapidly, central bank actions can have more adverse effects on the economy than the consensus suggests."

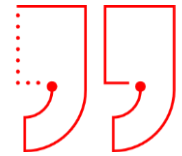
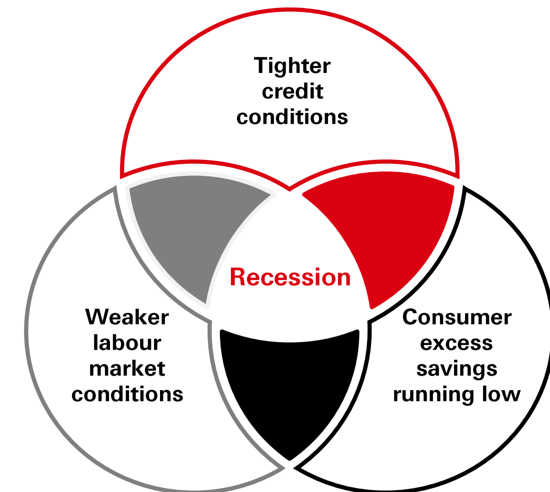


Figure 5: Consumer headwinds set to build



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Top of mind

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What will India's weight in indices be?

India is on the cusp of a major financial milestone with the recent announcement that its government bonds will be included in JP Morgan's benchmark emerging markets government bond indices. This move is poised to have a profound impact, attracting a significant influx of foreign capital estimated at around $25 billion into India's substantial $1 trillion government debt market. Starting from June 2024, India's inclusion in the JPMorgan EMBI, GBI-EM, and CEMBI series will encompass 23 government bonds with a notional value of up to $330 billion, gradually increasing their weightings from 1% to 10% by March 2025. In a market where India's 10-year government bond already yields 7.2% - compared to 4.5% for US bonds and 2.7% for Chinese bonds – this development holds significant importance.

This development is timely, as investors are actively seeking diversification due to Russia's removal from these indices and China's slowing growth. Our analysts specialising in Asia anticipate that increased foreign participation in India's local bond market will lead to diversification, a deeper market, and potentially greater fiscal responsibility. This is expected to boost India's medium-term balance of payments outlook and enhance capital allocation.

In addition to this significant development in the bond indices, India's growth trajectory has been reflected in its representation in the emerging market equity index, increasing from single digits to 15% in recent years. This growth trajectory could lead to India's weighting in the index approaching that of China in the years ahead, diversifying the index and benefiting investors.

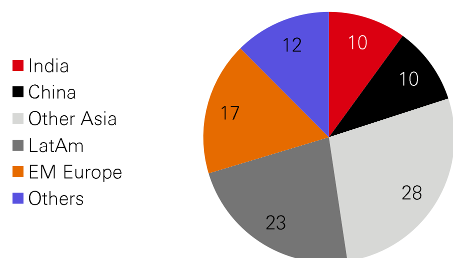
Of course, with all of the positive sentiment around future growth, comes more expensive valuations. The gap in valuation between the Indian stock market and other emerging markets mirrors the divergence between the United States and the rest of the world. Indeed, India's stocks are the most expensive among the developing world, trading at around 20-times expected earnings.

This aligns with valuations in the US and is twice the earnings multiple of the out-of-favour Chinese stock market. While Indian stocks are anticipated to deliver strong double-digit earnings growth in this year and the next, the pace is expected to moderate afterwards.

Investors should be mindful of potential challenges, particularly regarding earnings growth, as any disappointment could diminish the pricing premium.

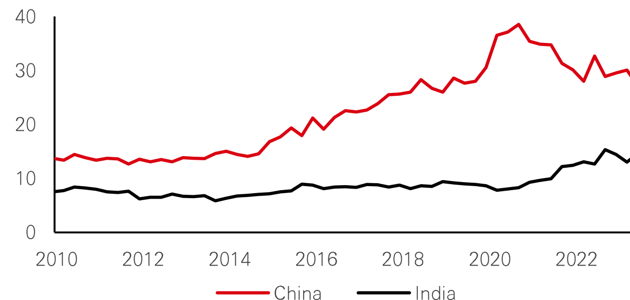
It's worth noting that International Monetary Fund research[1] found that inclusion in major benchmark indices can reduce sensitivity to domestic economic shocks, but might increase exposure to international sentiment and global financial market volatility. Therefore, while India's positive growth outlook is promising, a selective approach to pursue relative value opportunities is required.

Figure 1: New weights in GBI-EM Global Diversified Index (%)



Source: HSBC AM, Macrobond, Bloomberg, October 2023.

Figure 2: China's and India's share in MSCI EM Index



Source: HSBC AM, Bloomberg data, October 2023.

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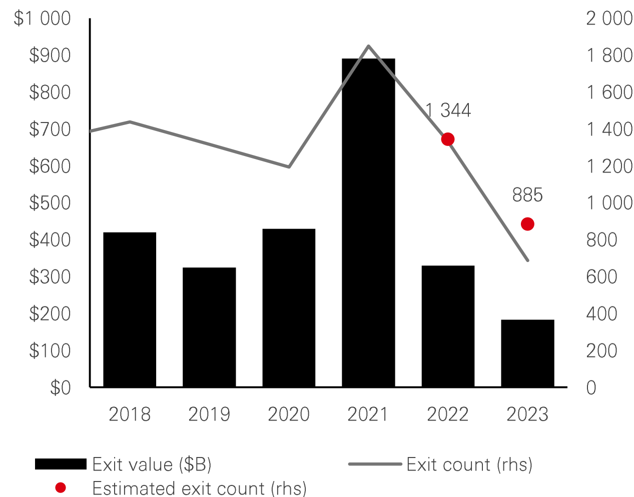
What should be the impact of a higher interest rate environment on private equity?

Private equity and venture capital markets have experienced a slowdown in activity. The US, as the largest and most liquid private equity market, has not been immune. Exit values hit an air pocket in Q3, falling 40.7% from the prior quarter to its lowest quarterly level since the global financial crisis– excluding the lockdown of Q2 2020 – and are now down 83.7% from the Q2 2021 peak. This significant hit to activity also impacts distributions back to investors. It's clear that 2021 was an outlier and is unlikely to be repeated any time soon.

Figure 1: US private equity exit activity



Source: HSBC AM, Preqin data, October 2023.

The resulting impact on distributions (weaker) is to hit fundraising for private equity – although to a lesser extent than might have been expected. Investors have committed significant sums to private equity funds in 2023. While some investors were focused on the denominator effect in 2022, higher public equity markets in 2023 have reduced the impacts.

As a result, while the focus remains on larger funds across longer fund series, private equity fundraising has remained relatively solid, with $618 billion raised in the year to 2nd October. This is above the annual average between 2010-2020 of $549 billion. It is, however, likely to struggle to hit the $949 billion average of 2021 and 2022, when market activity was at its peak.

While higher rates are having an impact upon exit volumes and valuations, many investors could be positioning themselves to take a more proactive stance. Should we move towards more of a recessionary environment, it is likely that we will see additional volatility in private equity markets. This, in turn, will reduce investment volume in the short term. However, over time, it is likely to reverse, as the resulting lower interest rates in this scenario would lower borrowing costs.

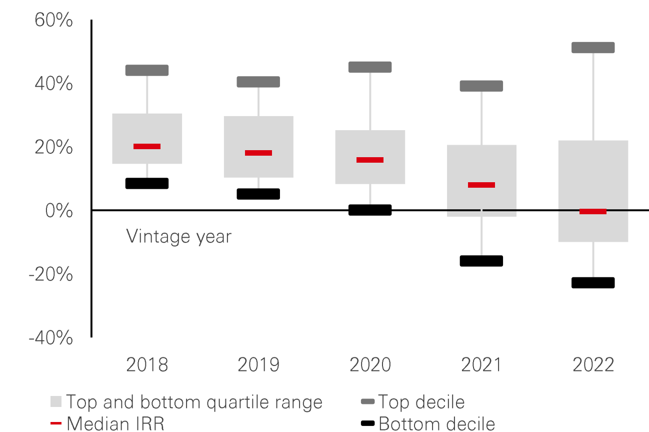
This should increase investment activity in the second half of 2024 and into 2025, when 2024's primary commitments are likely to be deploying. In addition, those funds closing in 2022 and 2023, which have kept stores of dry powder, could begin to deploy capital more aggressively.

In this scenario, entry valuations are especially important, and it would likely pay to be firm on pricing – particularly if the tailwind of rising valuation multiples is diminished in future.

One impact the current higher rate environment has had, and should continue to have, is to widen the performance gap between the winners and losers. For more recently closed funds, the gap between the top and bottom decile has never been wider. While funds of 2021 and 2022 vintages are still in their relative infancy, this dispersion in performance is to be expected.

However, it does highlight the importance of selecting the 'right' manager – a factor that is likely to increase in importance if returns are harder to generate in future and the performance gap does not narrow.

Figure 2: Private equity – IRRs by vintage



Source: HSBC AM, Preqin data, October 2023.

The performance figures displayed relate to the past and should not be seen as an indication of future returns.

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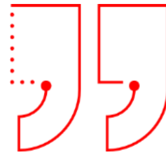
Developing stresses in global credit

Developing stresses in global credit

"Tighter policy has not yet led to widespread credit stress across global markets, although we expected an acceleration of defaults in Europe and Asia."

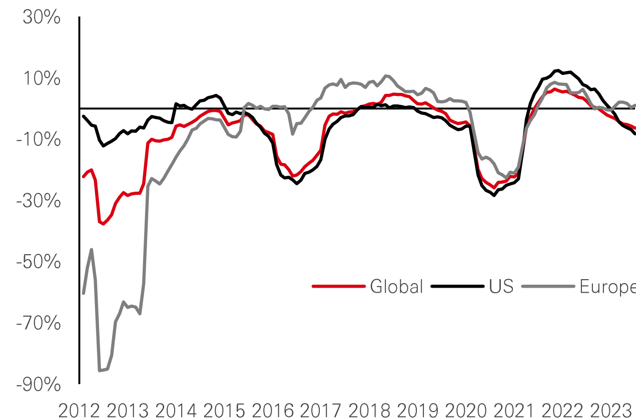


Fallen angel risk seems extremely well contained in developed markets.

Our forecast is for a global fallen angel rate (percentage of issuers downgraded from investment grade to high yield) of 1.2% over the next 12 months. This adds up to just 28 issuers out of the 2,268 we cover globally. The negative trend is much more pronounced in emerging market corporates (2.1%) than in the US (0.3%) and in eurozone (0.6%), where we believe that the Covid and the energy crisis have already triggered the downgrade of the most vulnerable issuers. Likewise, corporates who were able to weather those crisis are better anchored in the Investment grade space. The number of issuers we expect to be downgraded from single-A to the BBB category is even fewer – just 24.

However, these are bigger issuers, namely banks and utilities in the US, Asian banks and developed market capital goods companies.

Figure 1: Rating drift = (notches upgrades – notches downgrades) / rated issuers



Source: Moody's, HSBC AM, September 2023

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Our expectation is for default rates to rise, with a significant acceleration in Europe and continued stress in the China real estate market.

Lending standards in Europe and the US tightened further in the second quarter of 2023 and are expected to continue to do so as illustrated by Central banks' lending surveys, reflecting the negative impact of a weaker and less certain economic environment on banks' risk tolerance.

Sectorally, we expect defaults to be more evenly spread in the US, with transportation, media, services and healthcare experiencing the highest default rates by number of issuers, although no sector should experience more than 10% of its issuers defaulting. In the eurozone, on the other hand, real estate and retail will be by far the biggest hit sectors with possible default rates of around 20% and 14% respectively, including some repeated defaulters. Not surprisingly, statistics for emerging markets are dominated by the China real estate sector, which will continue to experience further stress, although interestingly the default rate for China outside real estate is expected to be low, with just 2.3% of issuers defaulting.

Figure 2: HSBC AM expectations by market

Index	Market	DP # issuers 30.06.2023
H0A0	USD HY	4.5%
HE00	EUR HY	3.8%
JACI HY	Asia HY	10.0%
CEMBI HY	Emerging HY	6.7%

Source: Moody's, HSBC AM, June 2023

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Emerging market (ex-China) sovereign debt trends have diverged from those of developed countries.

Unlike developed markets, which routinely ran deficits of over 7% in 2020-2021, emerging markets made fewer commitments, to an extent because they had fewer degrees of freedom. The International Monetary Fund (IMF) provided a key pre-emptive lifeline during this period, with funding doubling from 2020, replacing some of the need for market borrowing.

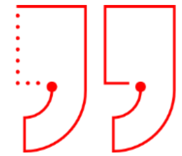
General government external debt of emerging market bond index countries peaked in 2020 and should continue to come down over the next 12-18 months at least, likely creating a favourable technical tailwind for emerging market hard currency bonds.

This is happening because of fiscal consolidation, with most countries keeping expenditure flat, together with greater issuance of local currency debt and a limited supply from quasi sovereigns, which are pursuing alternative funding avenues, including local debt and government support.

As a consequence, sovereign external ratings have an average skew towards a positive outlook for the first time in a decade.

Sovereign default rates probably peaked in 2022, with a high number of countries hit by mainly idiosyncratic issues, and three forced into default for the sole reason of the Russia-Ukraine conflict.

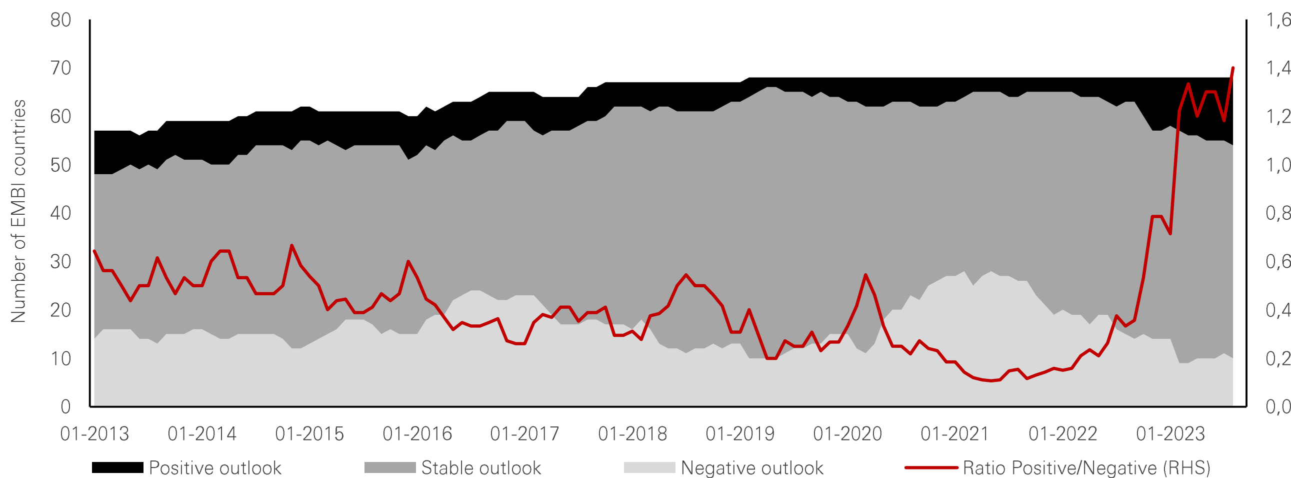
"Emerging market countries ran lower fiscal deficits during the pandemic and have been able to consolidate more quickly."



Emerging markets' overall trend of having raised interest rates pre-emptively to fight inflation and defend currencies post pandemic has now put them in a strong position to ease interest rates over the coming quarters. This should alleviate some of the funding pressures and limit default risk. We continue to see longer timeframes for default resolution, extending the trend of recent years, given a generally more complex composition of creditors. But a more lenient IMF has supported recovery rates near historical averages, offsetting the weight of high global rates.

Nevertheless, we acknowledge the risk that higher rates and non-credible restructuring can hit some of the peripheral players and lead to another wave of defaults.

Figure 3: Emerging market bond index ratings outlook skew



Source: HSBC AM, Moody's, S&P, September 2023. For illustrative purposes only.

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Latest developments in restructuring processes and market conditions are generally negative for recovery values.

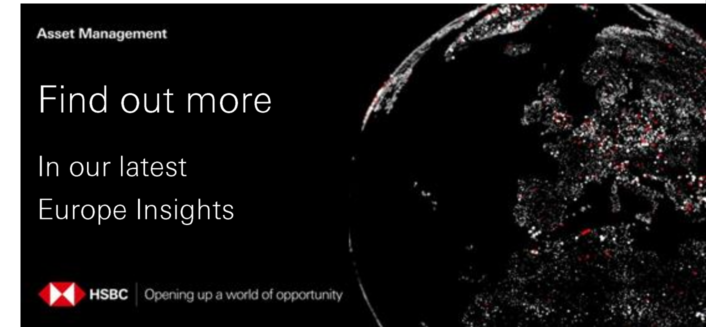
In the US, we are seeing more issuers who have engaged in distressed exchange subsequently filing for reorganisation within two years, suggesting that the initial restructuring merely delayed the inevitable rather than fixing underlying problems, and resulting in lower recovery values. 2023 was particularly weak, with a few very large companies filing with very low recovery. A recent phenomenon is for more aggressive default management from specialist distressed managers, who can push the boundaries of the law in an attempt to disenfranchise other creditors and position lender groups against each other.

A new EU directive implemented into national laws in July 2021 aims to ensure 'a minimal and harmonised preventative restructuring framework within the European Union to enable debtors in financial distress to solve their problems at an early stage and avoid formal insolvency proceedings and promote their efficiency by placing the creditors as leaders within the adoption of the restructuring plans.' There is probably not a large enough observation set at this point to identify a new trend as a consequence of the directive, but 2023 shows a steep decline in recoveries, especially for senior unsecured bond holders, which may be indicative of a more significant differentiation in the treatment of different classes of bond holders in the future. We believe that it is likely that distressed exchanges will become more common as the default cycle turns and as a consequence of the new restructuring framework.

Meanwhile, past loose covenants are also likely to negatively impact recovery values, even if more recently covenants have strengthened as market conditions have become more challenging for high yield issuers.

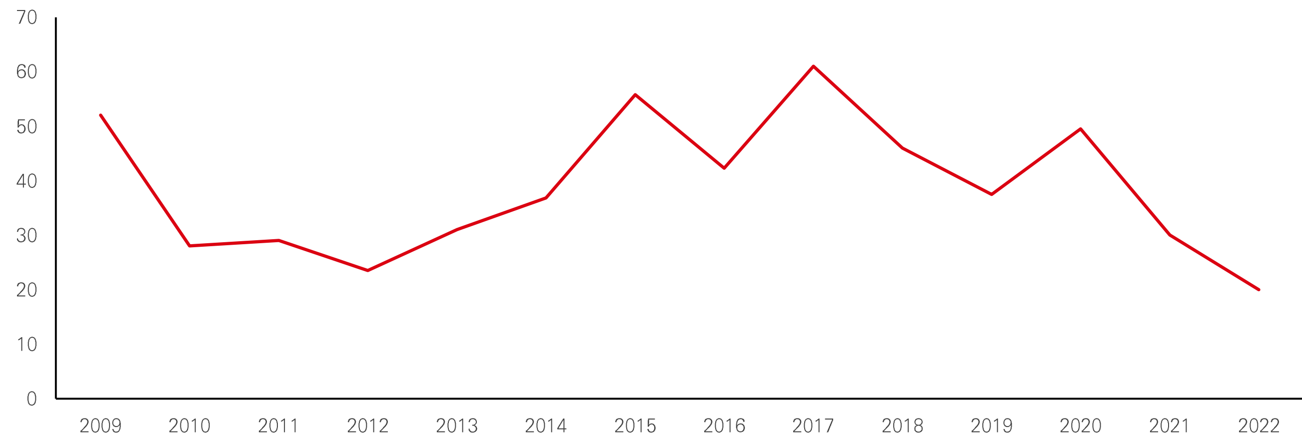
In Asia, a high majority of default cases in Asia are resolved via out-of-court restructuring – despite developments in local bankruptcy laws. Mainland China, Indonesia and Hong Kong SAR have the weakest observed recoveries, while other developed Asia appears higher, although cases are few and highly idiosyncratic.

Overall, market expectations of recovery rates are declining, probably driven by pessimism around the Chinese economy and the distress in the China real estate sector. There are a number of reasons which could explain lower recovery rates in Asia.



Complex capital structures, structural subordination and a lack of enforceable covenants in a cross-border situation can all make recovery challenging for the bond holder. Subordination can also occur when offshore bond holders are governed by English or New York law, while onshore holders receive better treatment from local courts.

Figure 4: Recovery rates (bond price 1 month after default)



Source: BoA, HSBC Asset Management, World Bank. Recovery rates are based on the average bond price observed 1 month after default from 2009 up to August 2022 for bonds issued by Asia ex-Japan issuers

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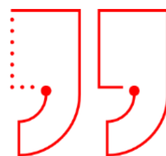
Turning a corner in China?

Turning a corner in China?

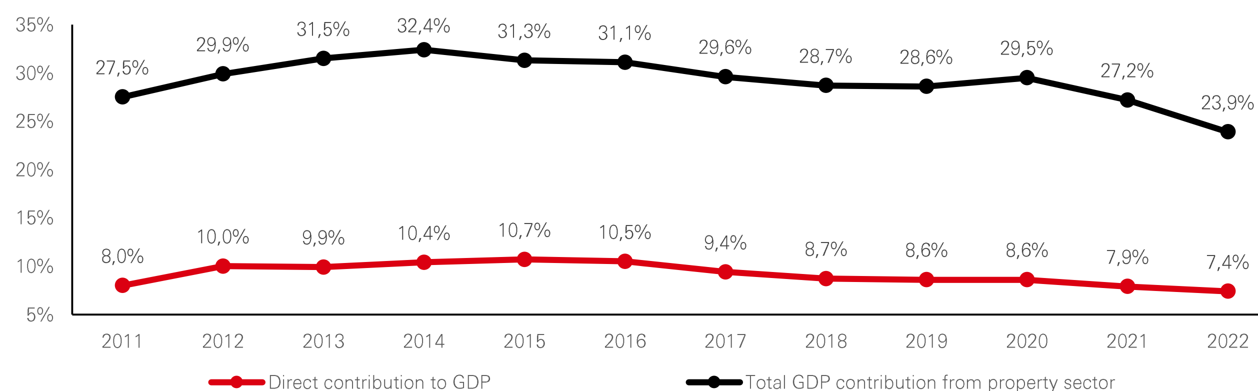
"With signs of bottoming in economic data, many investors are wondering whether this is the elusive start of turning a corner in China and how to approach China equities."



Small positives are beginning to emerge in China's economic data, with recent releases better than feared. Growth advanced from the prior quarter, while September figures for both consumption and industrial output surpassed expectations. Year-over-year growth came in at 4.9% – again, above expectations. Accordingly, China looks set to achieve its growth target of 5% this year.

While signs of stability are positive, it reduces the burden on policymakers to enact more aggressive stimulus to support the economy, given the measured response thus far has shown some success. The lack of positive response to the data seen from China equities reflects investor concerns that a less aggressive response to not so bad economic data today may mean not so good growth tomorrow. Those concerns are warranted, as plenty of challenges remain.

Figure 1: GDP contribution from China property sector



Source: PBOC, Citi Research estimates, August 2023.

The most blatant of these challenges is the property sector, which accounts for roughly a quarter of the economy. Total property investment this year is nearly a tenth lower than a year ago, while sales and new starts have shown significantly worse drop-offs – new starts are now running at less than half the rate they were in the second half of 2020.

Previously, land sales consisted of up to half of local government revenues, adding to why the collapse of the property market boom has placed emphasis on the need for central government support.

Positively, recent mortgage policy relaxation and downward rate adjustment appears to be helping, as household medium-to-long term loans ticked up modestly on a seasonally-adjusted basis in September. And outside of property the situation is starting to look better. Data related to exports, industrial production and manufacturing investment show nascent signs of a turn in the cycle, particularly an increase in mobile phone shipments and continued strength in China's new energy vehicle supply-chain.

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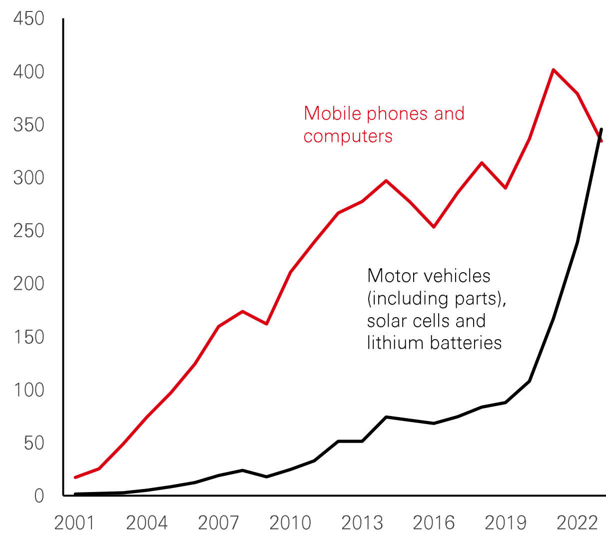
Potential remains

Although we are clearly in a new, multi-polar world that is remapping supply chains, China's export engine remains relatively strong. The country's 15% share of global exports is not far from its 17% peak in 2020. Of note is the changing makeup of its exports, per the chart below.

Figure 2: Export value (USD billion)



Source: General Administration of Customs, Stanley Research, August 2023.

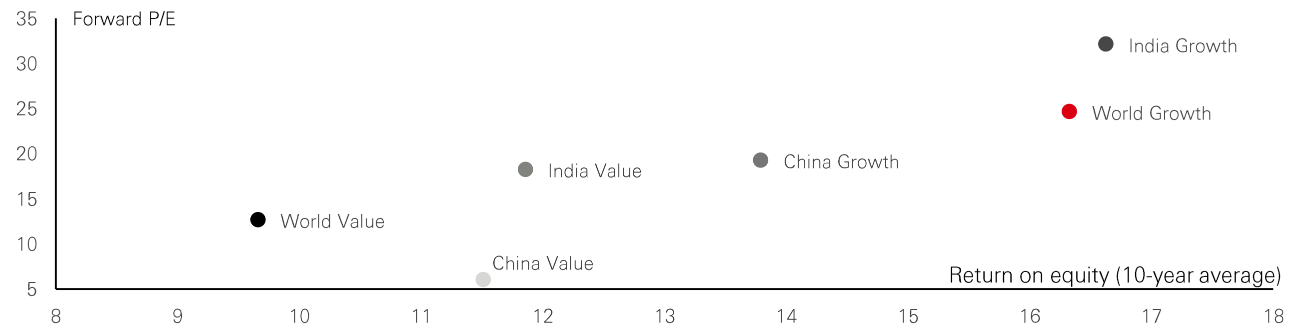
With a much-publicised shrinking population challenge to deal with, productivity growth will become more important for China. Yet, this also faces potential constraints. Beijing's regulatory crackdown on tech companies in 2021 hasn't helped encourage innovation.

However, China's labour force is increasing its skill and education – roughly a quarter of the working age population is expected to have tertiary education by 2030, up from around a tenth in 2020. This supports the argument for productivity growth ahead alongside the shifting makeup of the economy.

While the outlook is certainly mixed, a look at valuations shows that markets have taken a dim view of it (figure 3), with China value stocks in particular standing out for their low price relative to earnings and profitability.

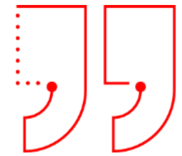
The macro risks have clearly been at least partially reflected in China equity valuations. Meanwhile, policy easing efforts appear to have started bearing some fruit with the aforementioned signs of stabilisation. Looking ahead, countercyclical policy support should particularly favour manufacturers, retailers and state-owned enterprises that are closely aligned with the country's long-term development goals. Some state-owned enterprise reforms to upgrade corporate governance and operational efficiency could also be supportive, alongside the self-driven developments in those industries.

Figure 3: ROE vs valuation



Source: HSBC AM, Bloomberg data, September 2023.

> "China's labour force is increasing its skill and education, supporting the argument for productivity growth ahead."



More high-end manufacturing and green investments will benefit some industrial names, for instance, with significant opportunities in segments such as solar power or electric vehicles, where rapid growth has resulted in China becoming the global leader in passenger car exports. We believe there are opportunities in sectors or stocks with sound valuations benefiting from favourable policy and some corporate reforms.

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Affordable growth

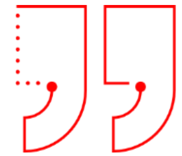
In contrast to the dominating performance of growth stocks in developed markets, Asia and particularly China, have seen the opposite. Possibly due to the faltering economic recovery momentum and more pessimistic market sentiment, investors may have taken a more defensive approach that takes into account the more attractive dividend yield of value stocks. We see an advantage in dividend yield from value stocks In China (figure 4). This aligns with China growth stocks relatively weak performance this year.

Asia being in a different phase of the economic cycle would also have been a factor supporting the value segment. An expansion phase and positive earnings outlook remain supportive of value stocks in the near term. That said, we also see the potential for growth stocks to rebound – given their more robust earnings growth outlook and considering the global backdrop of disinflation and lower bond yields into 2024 as central banks take expected easing policies forward.

Some recovery in investor confidence, following more policy support in China and signs of the semiconductor and broad tech cycle bottoming out, could also lend support to growth stocks in China and the broader region. Relative style performance may continue to hinge on the overall macro environment and corporate earnings outlook.

If economic momentum doesn't continue to build, earnings are likely at risk for the remainder of the year. With the market indicating a belief that the current level of stimulus is not enough to turn things around, we will continue to await next steps from Beijing. Geopolitical risks are another factor that has weighed on sentiment and will play a role in any rerating ahead.

"We see an especially large advantage in dividend yield provided by value stocks in China."

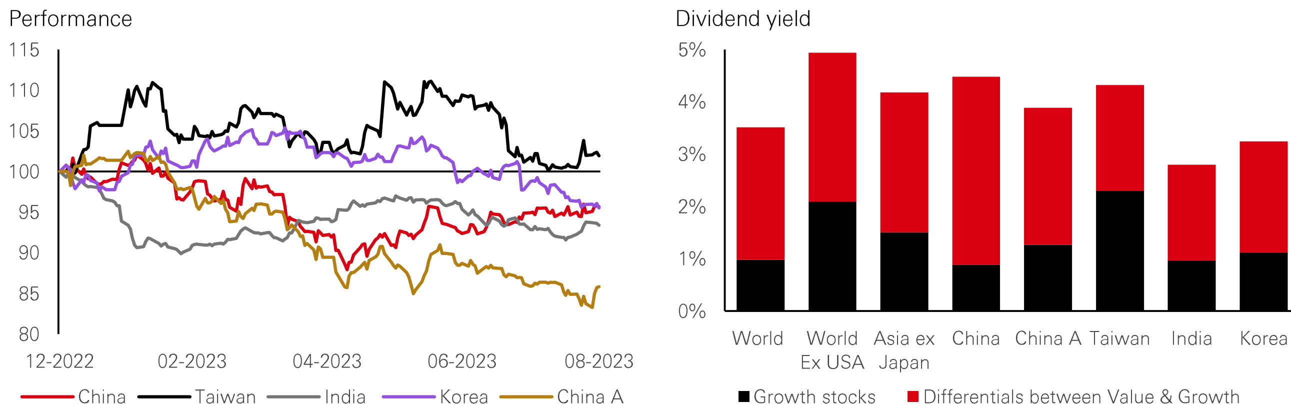


Relative resilience in China equities during the global market sell-off in September highlight the potential appeal of the reasonable price available for growth, in contrast to high valuations elsewhere which look precarious as global risks mount. The MSCI China A index finished the month down under 2% versus a 4.7% decline in the MSCI USA index (on a net total return basis).

Investors may choose to adopt a more balanced "growth at a reasonable price" approach, prioritising equities with solid earnings growth and reasonable valuations amid the continuing uncertainties over the economic and policy outlook. This clearly points to Asia and China in particular.

If we are indeed experiencing signals that sentiment is beginning to firm up, this can ultimately put a floor under valuations. Investor positioning in China remains very light, and we expect it won't take much in terms of stimulus, continued positive economic surprises or a positive shift in geopolitical relations to pull in investors currently waiting on the sidelines. Furthermore, valuations are relatively cheap compared to both developed markets and other emerging markets such as India, which is roughly twice as expensive against forward earnings.

Figure 4: Relative performance of growth over value stocks and dividend yield differentials between growth and value index



Source: HSBC AM, Bloomberg data, September 2023.
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Three act tragedy to US recession?

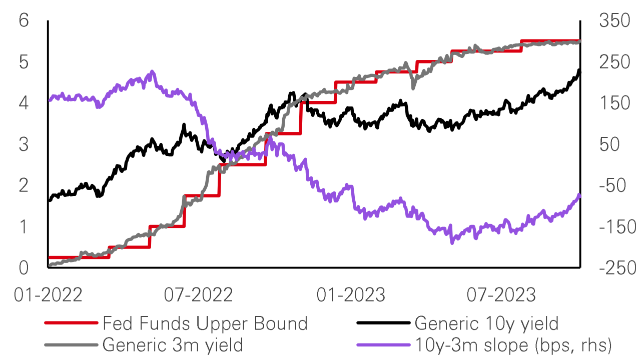
Three act tragedy to US recession?

"Can the Fed defeat inflation without harming financial markets?"

Over the past year, the Fed's messaging has hinted at the need for some form of economic pain as a precursor to policy shifts. A more resilient economy than many expected means such pain has been conspicuously missing for the most part. This has been reflected in crucial domains such as the S&P valuations, corporate earnings, and employment data. The central query now lingers: have we witnessed enough discomfort? Considering that core indicators, like unemployment and the Personal Consumption Expenditures (PCE) Price Index, haven't exhibited adequate advancement to meet the economic discomfort threshold, the Fed can't claim triumph over inflation yet.

Relatively high prices in risky assets can be playing a role, bolstering household spending and supporting corporate sales and earnings, alongside strong employment. After a rough 2022, risky assets rebounded quite strongly until late summer, when concerns over sticky inflation and a 'higher for longer' environment contributed to September being the year's worst month. Despite this setback, the S&P 500 and Nasdaq indices are still up 20% and 36%[1] respectively from their lowest levels of 2022.

Figure 1: 3-M US Rates followed Fed Funds Rate closely



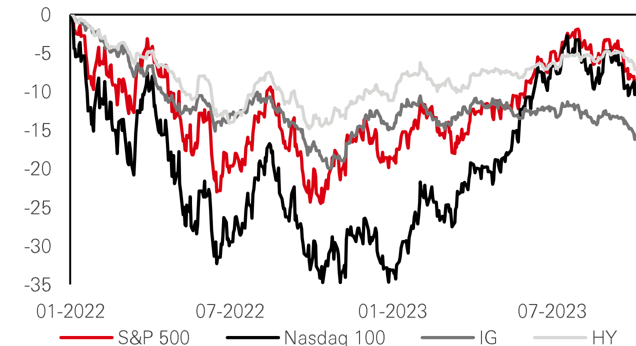
Source: HSBC AM, Bloomberg data, September 2023.

Until the end of 2022, the 3-month rate often moved in advance of the Fed's actions, reflecting forward guidance or market anticipation. However, since the Fed Funds rate reached 4%, this relationship has shifted, with the 3-month rate typically reacting after the Fed's actions. This suggests a behavioural change in the markets for 2023. Notably, the 10-year rate remained stable at around 4% for nearly a year, supporting riskier assets. However, it surged to 4.8%[1], reflecting the Fed's higher for longer stance.

The unconventional response of capital markets to the Fed's actions, where the longer-term yield curve remained unaffected by rate hikes until recently, and equity markets didn't experience extensive discomfort, happened while corporate earnings remained relatively strong and the expected increase in unemployment was absent. Consequently, the question arises regarding whether this is a manifestation of the long and variable lags or has the Fed's monetary policy mechanism for traditional transmission lost its efficacy.

To answer this question, we must delve into the intricate plot of this financial drama as the narrative is not as straightforward as in previous economic cycles. We explore three sequential stages starting with an expansion in fixed income supply, setting the pathway for contraction of equity risk premium and subsequently transmitting the discomfort to the real economy.

Figure 2: Cumulative returns for US risk assets (%)



IG: Investment grade / HY: high yield
Source: HSBC AM, Bloomberg data, September 2023.

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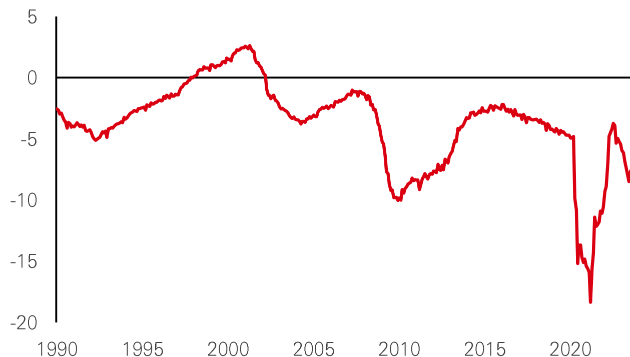
Fixed Income supply expansion

The burgeoning US federal deficit, soaring from less than 5% to approximately 8.5%, is indicative of fiscal support being funnelled into US companies and households. However, this fiscal push necessitates additional borrowing by the Treasury, leading to a surge in the supply of coupon securities and exerting substantial upward pressure on yields.

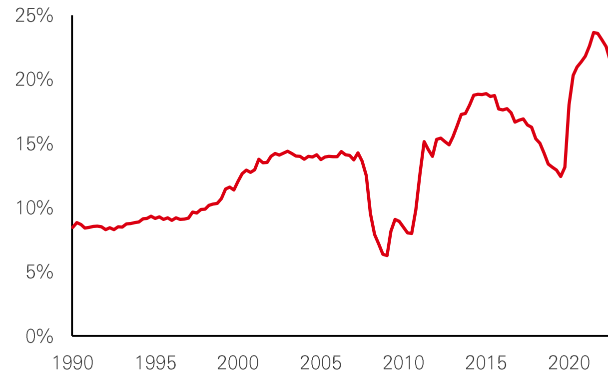
The Federal Reserve's tapering of asset purchases, known as quantitative tightening, further complicates matters. The Fed holds approximately 25% of all treasuries – primarily coupon securities. As the Fed reduces its bond-buying program, other market participants must step in to fill the void. Moreover, if China and Japan opt to prevent currency depreciation, they may employ their vast holdings of US Treasuries, affecting the bond market dynamics even further. This shift in the supply-demand dynamics for bonds can have an impact on interest rates, which is particularly the case at the longer end of the yield curve.

Figure 3: US Treasury Federal Budget Deficit or Surplus as a % of Nominal GDP



Source: HSBC AM, Bloomberg data, September 2023.

Figure 4: Share of Treasuries held by the Fed



Source: HSBC AM, Bloomberg data, September 2023.

If the supply expansion leads to rising yields, investors may consider shorting long-term bonds and betting on a steeper yield curve in anticipation of higher interest rates. This anticipatory behaviour could ripple through the financial markets, influencing asset prices and risk dynamics and resulting in an expansion of the risk premium, ultimately.

Equity risk premium adjustments

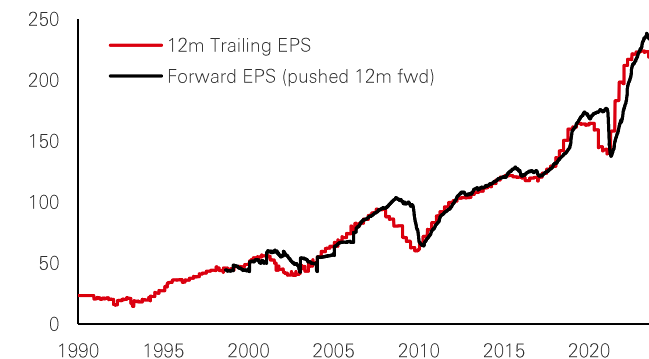
In the scenario that bond yields rise due to the supply expansion, the relative attractiveness of equities may diminish as investors re-evaluate their risk appetite. This can be explained by examining the two primary constituents of the Equity risk premium (ERP): real yields and forward earnings yields. Real yields have ascended, while earnings yields have markedly declined this year. Consequently, the ERP, largely a function of forward earnings yields minus real yields, experiences substantial compression in tandem with increasing bond yields.

This compression would typically trigger a repricing of equities and a contraction in price-to-earnings ratios. The widening gap between trailing and forward earnings is a potential signal of this impending shift, as the gap is especially wide pre- and during recessions, when forward earnings expectations begin to fall. While this divergence has historical precedent, it does not necessarily foreshadow economic calamity. For example in 2016, the gap narrowed without causing significant economic repercussions.

One critical factor in the evolution of this scenario is inflation. If inflation remains persistent, earnings may outpace expectations, providing support for equities.

However, if we do see a substantial drop in earnings, a different scenario emerges. Past recessions have shown that a significant earnings decline (around 15% to 20%) can translate into job losses and economic downturns. High profit margins may initially shield companies from immediate job cuts, causing a lag in employment impact, but an impact transmission to real economy would still be experienced.

Figure 5: Divergence between trailing and forward EPS



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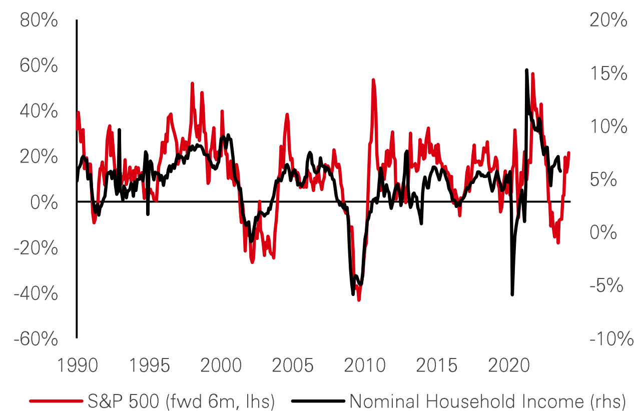
Transmission to the real economy

Finally, the interconnectedness of financial markets and the real world is a key concern. Household income, strongly tied to equity markets, can be significantly affected when the S&P experiences a downturn. Historical data also reveals a correlation between the rate of change in the S&P and nominal household income, with the effect materialising after a six-month lag.

Tax receipts further illustrate this linkage, as they exhibit a correlation with the S&P's rate of change. A negative turn in the equity market can thus translate into real economic consequences, potentially pushing the economy into a recessionary environment characterised by lower earnings, declining asset values, and rising risk premia which may trigger a negative feedback loop resulting in job losses. However, the actual transmission of these events to the real economy can come at a lag.

Figure 6: Correlation between S&P 500 and household income



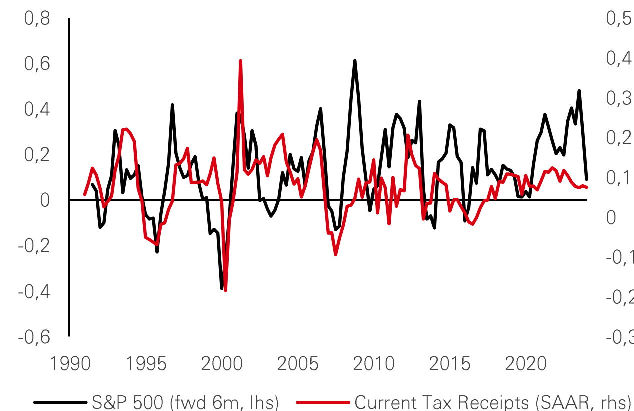
Source: HSBC AM, Bloomberg data, September 2023.

This lag between financial market developments and their impact on the broader economy is a critical factor. Additionally, factors such as corporate profit margins, fiscal policies, and corporate behaviour will influence the severity and timing of economic consequences and determine the extent and pace of job losses.

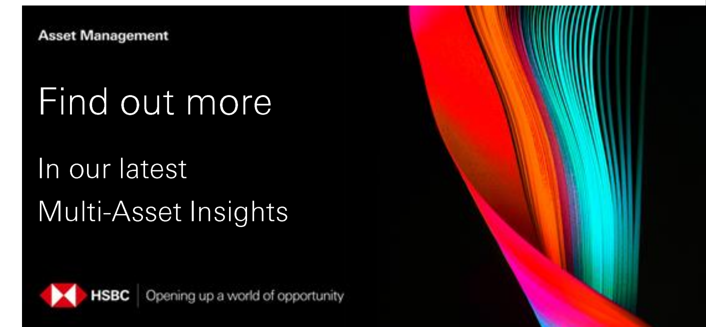
The Fed's dilemma

In summary, the Fed has faced a distinct challenge in navigating disinflation amid an unconventional economic response to the rate hikes indicating potential shifts in the effectiveness of traditional monetary tools. The recent market developments, though, have displayed delayed reactions to the Fed's actions, with the 10-year rate reaching its highest point since the 2007 Global Financial Crisis after remaining stable at around 4% for nearly a year.

Figure 7: Correlation between S&P 500 and tax receipts



Source: HSBC AM, Bloomberg data, September 2023.



This has compressed the ERP, hinting at reduced equity returns compared to real yields and suggesting potential valuation challenges for equities. The recent downturn in the S&P 500 and Nasdaq 100 further underscores this concern. It could be a signal that the economy has finally entered the second act of the three-act tragedy, and as this variable and lagged response permeates the real economy, we could see a potential US recession with lower earnings and rising unemployment. Consequently, it's important to recognise that monetary policy tools may not have entirely lost their efficacy; rather, they may be encountering an atypical economic cycle with variable response times to the Fed's rate adjustments. As the US economy slows and the Fed resorts to rate cuts, a similar delayed response could be expected given households and corporates financed long-term obligations during the period of low interest rates, reducing the potential impact of rate changes. The outcome of this narrative will only materialise over time. Regardless of the ultimate pace and severity, an economic downturn is indeed progressing. Achieving portfolio resilience in what should be choppy markets requires new approaches to diversification and defence, which we discuss in our latest Multi-Asset Insights.

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