Investment Monthly

Earnings support risk assets despite potential rate cut delays

May 2024

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Key takeaways

- As markets are now pricing in a delayed and slower Fed rate cut path due to sticky US inflation and a more hawkish Fed tone, we continue to deploy cash in bonds by locking in the current attractive yields from major government bonds and investment grade credit amid geopolitical uncertainties.
- Thanks to strong earnings and a resilient cyclical outlook in the US, we continue to adopt a pro-cyclical stance, broadening our exposure to IT, communications, consumer discretionary, financials, industrials and healthcare. In Europe, higher wages and good performance from European consumer discretionary companies, with half of the sector's revenue coming from the US, support our upgrade of the sector to overweight.

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- In Asia, we continue to diversify our exposure into Japan, India, Indonesia and South Korea. Robust industrial production and supporting policies in India and China warrant an upgrade of Asian industrials to overweight. Given strong wage growth, a sustained reflationary trend and an uptick of core inflation (excluding fresh food) forecast, we now expect a hike to 0.25% in Q3 2024 by the Bank of Japan. We remain bullish on Japanese equities.

Asset class	6-month view	Comment
Global equities	▲	Despite the risk of high-for-longer rates and inflation, the better-than-expected global economic outlook and a bottoming of activity in Europe and Japan have led us to broaden our geographical and sector exposure.
Government bonds	▶	Rate cuts should still materialise in the West in the coming months, pushing DM government bond yields lower overtime. Japanese government bonds remain unattractive.
Investment grade (IG) corporate bonds	▲	As interest rate risk is more attractively priced than credit risk, we continue to favour quality bonds and lock in the current yield levels with a focus on 5-7 year maturities.
High yield (HY) corporate bonds	▶	Credit spreads are too tight to compensate even for the small pickup in defaults that we expect to see. We maintain our preference for investment grade over high yield bonds.
Gold	▶	The impact of ongoing geopolitical uncertainties and central bank buying is offset by high real yields and USD strength.

▲ "Overweight" implies a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.
▼ "Underweight" implies a negative tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.
▶ "Neutral" implies neither a particularly negative nor a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.
Icons: ↑ View on this asset class has been upgraded; ↓ View on this asset class has been downgraded.

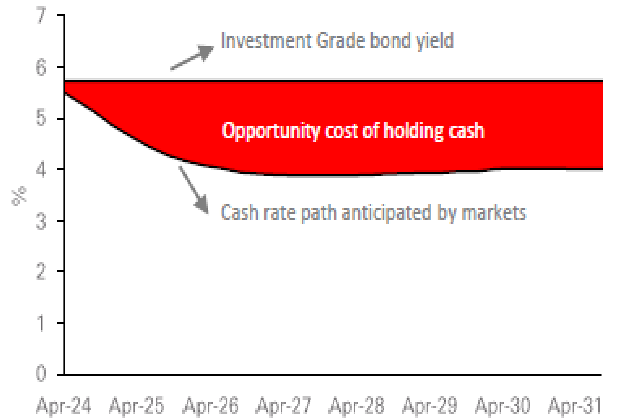
Talking points

Each month, we discuss 3 key issues facing investors

1. What is the impact of a delay in rate cuts on bonds?

- Continued surprises on US inflation and a more hawkish tone from the Fed that they need greater confidence to start policy easing have caused markets to reprice the Fed rate path. Markets have changed from being over-enthusiastic three months ago to over-conversative now, pricing in 0.4% cuts only by December (previously 1.6% of cuts).
- We had been noting that the risk of delayed cuts was rising, and given the bumpy inflation path, we have revised our forecasts to only one 25bp rate cut in September 2024, while retaining our forecast for 75bp rate cuts in 2025. But the September cut is still earlier than what markets price in. The ECB and Bank of England appear to be ready to start policy easing in June as inflation is closer to their targets.
- As markets already price in a later start of Fed cuts and may have gone too far, we continue to deploy cash in bonds by locking in the current attractive yields from major government bonds and investment grade. Cash returns are expected to decline and, if they fall more than expected, the opportunity cost will be even greater. Quality bonds remain in favour amid rate and geopolitical uncertainties.

Chart 1: Estimating the opportunity cost of holding cash

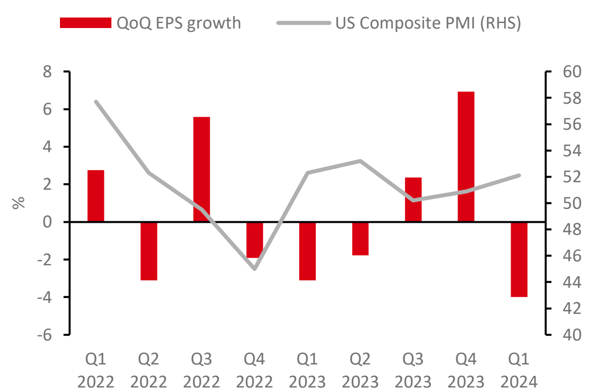


Source: Bloomberg, HSBC Global Private Banking and Wealth as at 23 April 2024. Past performance is not a reliable indicator for future performance.

2. What is our sector stance given a better cyclical outlook in the West?

- As most US economic data surprise on the upside, consensus continues to upgrade GDP growth. We believe equity analysts' negative Q1 earnings growth forecast of -4% compared to Q4 will be exceeded, with communication services, IT and consumer discretionary delivering the fastest earnings growth. For 2024 as a whole, earnings expectations are constructive and remain well above historical averages at 11% for 2024.
- We continue to adopt a pro-cyclical stance in the US amid rising global PMIs, improving trade and resilient labour markets, broadening our sector exposure to IT, communications, consumer discretionary, financials, industrials and healthcare.
- In the UK and Europe, we believe economic growth in Q4 2023 marked the low of the economic cycle. Backed by higher wages and good performance from European consumer discretionary companies, with half of the sector's revenue coming from the US, we upgrade the sector to overweight. Our other overweight positions in IT, financials, energy and healthcare reflect our more balanced sector approach in Europe compared to the US.

Chart 2: Earnings expectations are too low, given the solid US PMI

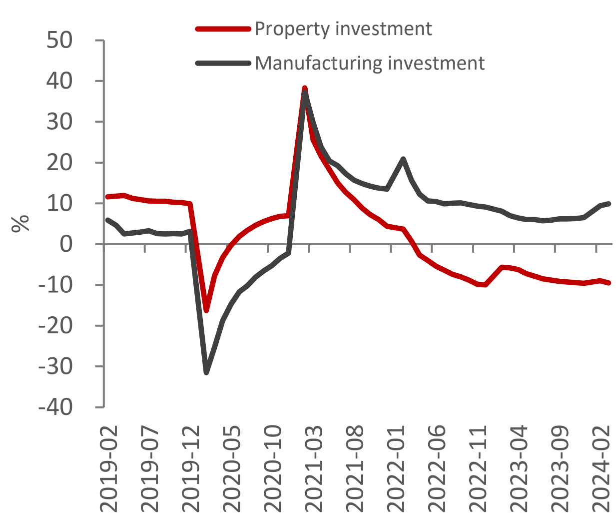


Source: Bloomberg, HSBC Global Private Banking and Wealth as at 23 April 2024. Past performance is not a reliable indicator of future performance.

3. Is Asia in good shape with mixed economic data from China?

- With divergent growth across the region, we continue to diversify our exposure into Japan, India, Indonesia and South Korea.
- India's April Flash PMIs indicated the fastest growth in economic output since June 2010, with strong momentum from manufacturing and services activities. The industrials sector is benefitting from a multi-year investment capex cycle, supply chain diversification, as well as increased manufacturing and industrial spending boosted by government incentives. In China, despite mixed economic data, its Q1 GDP growth of 5.3% was driven partly by acceleration in manufacturing investment. The government's ongoing policy push for high-end manufacturing provides upgrade support. The robust industrial production in these two markets supports our upgrade of Asian industrials to overweight.
- In Japan, while the Bank of Japan kept its rates on hold at its April meeting, we now expect a hike to 0.25% in Q3 2024 because of strong wage growth, a sustained reflationary trend and an uptick of core inflation (excluding fresh food) forecast to 2.8% for 2024. This will take the upper bound interest rate from 0.1% to 0.25%, followed by two 0.25% hikes in 2025. We remain bullish on Japanese equities.

Chart 3: Property investment vs manufacturing investment in China



Source: Wind, HSBC Global Private Banking and Wealth, as at 24 April 2024.

Asset Class Views

Our latest house view on various asset classes

Asset class	6-month view	Comment
Global equities		
Global	▲	Despite the risk of high-for-longer rates and inflation, the better-than-expected global economic slowdown and a bottoming cyclical outlook in Europe and Japan have led us to broaden our geographical and sector exposure.
United States	▲	The prospect of rate cuts, continued disinflation and an improving earnings outlook have provided a boost to equity fundamentals. We prefer a broader exposure including IT, communications, consumer discretionary and healthcare.
United Kingdom	►	Valuations are relatively cheap but local sentiment remains mixed.
Europe ex-UK	►	The economic cycle appears to have bottomed out and we find value in companies with strong earnings power, especially those that can benefit from improving global growth. Valuations remain below their historical average.
Japan	▲	The reflationary trend, corporate governance reforms and the AI investment boom are positives for Japanese stocks.
Emerging Markets (EM)	►	We expect more emerging markets to cut rates following some of the Latin American countries. Corporate earnings growth is expected to rebound sharply for EM Asian markets in 2024.
EM EMEA	▼	The region is impacted by high energy prices and global interest rates, as well as geopolitical uncertainty.
EM LatAm	►	While Brazil's earnings and price momentum are falling, we remain positive on Mexico largely due to the North American re-industrialisation.
Asia ex Japan equities		
Asia ex-Japan	▲	Asia is on track to deliver above global average growth supported by exceptional growth in India, stable performance of ASEAN and more decisive policy stimulus from China. We continue to diversify our exposure to capture the opportunities.
Mainland China	►	Cheap valuations and policy stimulus are positive although economic momentum remains mixed. We prefer service consumption leaders, high-end manufacturing winners driven by AI and EV innovation, and beneficiaries of SOE reforms.
India	▲	We prefer large-cap quality stocks backed by India's strong economic fundamentals, supply chain diversification, a rising middle class and young demographics. An NDA victory – as suggested by polls - would help policy continuity and stability.
Hong Kong	►	We remain neutral amid attractive valuations with a preference for the insurance, telecom and utility sectors.
Singapore	►	A rebound in industrial production and travel-related services suggest stronger GDP growth this year.
South Korea	▲	We see solid momentum in South Korea's tech exports thanks to strong AI-driven demand and ongoing memory upcycle globally. The Corporate Value-up Program is also a long-term positive driver.
Taiwan	►	The increasing AI and tech-related demand continues to support the equity market but much has already been priced in and geopolitical uncertainty remains a headwind, so we maintain a neutral stance.
Government bonds		
Developed markets (DM)	►	Rate cuts should still materialise in the West in the coming months, pushing DM government bond yields lower overtime. Japanese government bonds remain unattractive.
United States	▲	10-year Treasury yield rose on a hawkish shift in the Fed rhetoric. We continue to lock in current yields with medium-to-long duration exposures.
United Kingdom	▲	The continued disinflation trend provides room for the Bank of England to deliver the first rate cut in June. We remain positive on UK gilts.
Eurozone	►	The recent cut from the Swiss National Bank paves the way for the ECB to cut rates this summer, which should provide some relief to European bond yields, where we maintain a neutral stance as absolute yield levels are lower than in the US.
Japan	▼	We expect the BoJ to hold policy rate at the upcoming meeting and would watch closely on the potential guidance of rate and economic outlook, as well as on the purchases of Japanese government bonds, which remain unattractive in our view.
Emerging Markets (Local currency)	▼	The stronger USD puts pressure on several EM currencies. While we remain underweight on EM local currency bonds, we continue to favour Indian local currency bonds due to the country's robust structural and cyclical growth outlook.
Emerging Markets (Hard currency)	►	We prefer developed market investment grade on a relative basis. However, we still find opportunities in selected quality issuers in emerging markets, where the yields remain appealing.
Corporate bonds		
Global investment grade (IG)	▲	As interest rate risk is more attractively priced than credit risk, we continue to favour quality bonds and lock in the current yield levels with a focus on 5-7 years' maturities.
USD investment grade (IG)	▲	USD investment grade credit offers attractive spreads with the deepest liquidity.
EUR and GBP investment grade (IG)	▲	Although spreads have tightened, yields remain attractive and should be supported by the prospect of rate cuts this summer. Our preference for quality warrants our overweight on EUR and GBP investment grade credit.
Asia investment grade (IG)	▲	We believe Asian IG credit can deliver higher total returns versus high yield and favour Asian financials, Indian local currency bonds, Indonesian quasi-sovereign bonds, Macau gaming and Chinese IT, media and telecom.
Global high-yield (HY)	►	Credit spreads are too tight to compensate even for the small pickup in defaults that we expect to see. We maintain our preference for investment grade over high yield bonds.
US high-yield (HY)	►	Although defaults remain low and refinancing risk is manageable, risk premia are too low in our view, so we continue to prefer investment grade on a relative basis.
EUR and GBP high-yield (HY)	►	European high yield issuers often have lower leverage than in the US, but economic growth is lower, hurting cash flows. Our neutral stance reflects our preference for quality, even though growth may have bottomed at the end of last year.
Asia high-yield (HY)	►	We stay highly selective in the China credit space and prefer quality issuers for better risk-adjusted returns.
Commodities		
Gold	►	The impact of ongoing geopolitical uncertainties and central bank buying is offset by high real yields and USD strength.
Oil	►	While geopolitics provide support for oil, spare capacity limits the upside. We expect oil prices to trade sideways.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲↑	▲	Easing inflation and higher wages have improved consumer sentiment and spending, supporting our upgrade of European consumer discretionary to overweight. The outlook for hospitality and tourism looks particularly constructive. Apparel sales pick-up is patchy with unpredictable weather disrupting seasonal buying patterns. Despite weak EV demand hurting auto stock sentiment, ICE-powered vehicles are seeing steady growth in demand.
Financials	▲	▲	▲	▶	An improving economic and corporate outlook combined with solid fundamentals and low valuations should support the sector, in particular, capital markets which have had a good start to the year with a pick-up in trading volumes, M&A activity, IPOs and bond issuance. Interest rates look set to decline only slowly with a modest impact on earnings in 2024. Regional banks with significant exposure to the real estate sector are experiencing some challenges.
Industrials	▲	▲	▶	▲↑	We upgrade Asian industrials on tentative signs of an improvement in the macro-economic outlook and early signs of a demand pick-up. US industrials are benefitting from both robust domestic demand and reshoring/near-shoring initiatives fuelled by the US's Inflation Reduction Act (IRA) and CHIPS Act. In other regions, Q4/Q1 results, and management guidance provide some optimism of a demand pick-up. Aerospace, defence and automation remain potential bright spots.
Information Technology	▲	▲	▲	▲	Big tech stocks have seen some pull-back as the rally broadens. AI will be the key driver for the sector as the technology becomes increasingly embedded leading to product and service capability enhancements, productivity gains and competitive differentiation. The next wave of AI development should benefit digital infrastructure companies focused on cloud, data centres, software and cooling technologies.
Communications Services	▶	▲	▼	▲	US Communications continue to deliver stellar earnings growth as fundamentals and prices remain attractive. In Asia, the stabilising regulatory environment and low valuations offer an attractive risk-return profile. In contrast, Europe's telecom services sector has little room for optimism.
Materials	▶	▶	▶	▶	Since the beginning of March, copper and aluminium prices have started to rebound with iron ore and steel prices also off their lows. Mining stocks have recovered somewhat in tandem. Markets are anticipating demand pick-up from the renewables sector, electrical and digital infrastructure, selected real estate segments and some inventory restocking. Chemicals stocks remain range bound.
Real Estate	▼	▼	▶	▼	The outlook for commercial real estate is mixed with retail and office segments still looking unattractive, while warehousing is seeing improved demand and prices after a sustained period of weakness. The housing sector in some markets is showing tentative signs of improving sentiment in anticipation of lower interest rates. Chinese real estate remains problematic. Easing inflation and interest rates may lift sentiment and activity.
Consumer Staples	▶	▶	▶	▲	Cost margins appear secure as cost pressures have somewhat eased. The sector should benefit from strong seasonal demand with solid results going forward despite tough YoY comparables. The sector trades in line with historical valuations. We focus on quality stocks with strong brands and more resilient pricing power.
Energy	▶	▶	▲	▶	Low valuations, strong cashflow and high dividends appear to be insufficient to change sentiment towards the sector as energy prices remain range-bound. On a seasonally adjusted basis, supplies appear plentiful and inventories adequate, helped by the relatively mild winter in Europe. In 2024, energy prices may not benefit from geopolitical uncertainties as they have over the last two years.
Healthcare	▲	▲	▲	▼	New product launches, a less hostile pricing environment and the ebbing wave of major product patent expirations should help lift the sector after a period of under-performance. Healthcare sales growth should start to benefit from easier comparables and new pharma products should lift sentiment and expectations. In Asia, valuations remain elevated, trading well above historical levels.
Utilities	▶	▼	▶	▲	The outlook for European and US renewable energy projects continues to improve as governments have started to adopt more realistic pricing for new project auctions following a period of unprecedented cost increases. Interest rate cuts could provide a tailwind and improve sentiment further. Utilities may benefit as interest rates fall and investors look to high dividend paying stocks.

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