October 7, 2021

Special Coverage:

Energy market volatility: outlook and implications

For Client Use

The material contained in this document is for general education information purposes only and is neither intended as, nor does it constitute, advice or a recommendation to buy or sell investments, as defined by the US Securities and Exchange Commission. For individualized tailored recommendations based on your needs or objectives, please contact your financial professional directly for more information.

Investments, annuity and insurance products

ARE NOT A BANK DEPOSIT OR OBLIGATION OF THE BANK OR ANY OF ITS AFFILIATES	ARE NOT FDIC INSURED	ARE NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY	ARE NOT GUARANTEED BY THE BANK OR ANY OF ITS AFFILIATES	MAY LOSE VALUE

HSBC

Special Coverage:

Energy market volatility: outlook and implications

Key takeaways

- Oil prices are at the highest level in three years and natural gas prices have spiked sharply, which have triggered **concerns about higher inflation and/or slower growth** (combined effects would be called 'stagflation').
- We believe that economic growth is slowing but not stalling, and that US inflation should come down, though not yet in Q4. Central banks share the view of **continued growth and transitory inflation**.
- We therefore remain invested, but prefer **quality, large-cap and dividend stocks,** as well as **shorter dated high yield and emerging markets bonds**, with a focus on portfolio resilience.

Willem Sels
Global Chief Investment Officer, Global Private Banking and Wealth, HSBC

Global oil prices have been boosted by the economic re-opening and OPEC+ supply discipline. Natural gas prices have spiked due to low inventories, strong Chinese demand and limited output. Looking ahead, the US and OPEC+ could increase oil supply, and slightly lower growth should also help cap further upside for oil, but prices may remain high for now.

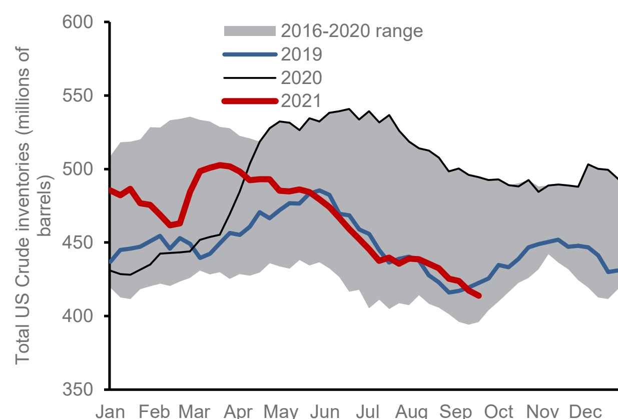
We expect commodity price inflation to ease due to base effects. This should help ensure that central banks see inflation as transitory and keep policy rates low. We also do not believe inflation will continue to trend up. We maintain our "low but volatile" Treasury yield view and continue search for yield in high yield and EM bonds.

Rising gas prices in Europe and power curtailment in China could lead to some volatility and will have a short-term impact on economic data, but the economic cycle will continue.

What has driven up energy prices this much?

- Oil prices have been moving up for a while driven by the recovery of the global economy. As demand has been recovering, US inventory of crude oil have been falling and are now below the historical average for this time of the year (see chart 1).
- OPEC+ members have been increasing supply but are careful not to oversupply, as there is still a high degree of uncertainty around the pace of recovery and the impact of the Delta variant on activities, such as travel.
- We think global oil demand in 2H 2021 will be about 5% higher than in 1H, and foresee further growth in 2022. Although US production is picking up (higher prices tend to increase shale output), there is strong fundamental global support for oil prices to justify at USD70/bbl, but the most recent spike has brought prices much higher.

Chart 1: US crude oil inventories are low for the first time of the year



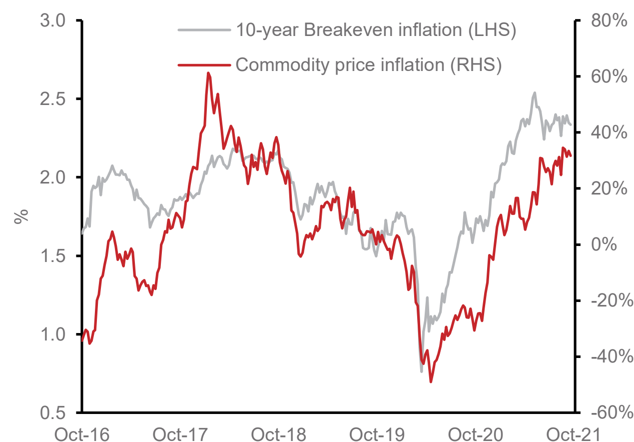
Source: US Department of Energy, HSBC Global Private Banking, as of 1 October 2021.

- We attribute this largely to the sharp rally in natural gas prices. Low global gas inventories (resulting from a cold winter), rising Asian demand and insufficient increases in production have all contributed to the sharp rise in the gas price.
- Oil traders now fear that gas markets could remain tight during the winter, leading to some substitution from other sources, including oil. We think there should be a limit to further upside in oil prices as OPEC+ members could raise production further if demand continues to recover. The US administration also does not want gasoline prices to rise excessively.

Implications for inflation and interest rates

- Higher commodity prices can have a significant impact on markets' **inflation expectations** (see chart 2). However, **breakeven inflation** has remained relatively range-bound in recent weeks. This is because inflation compares this year's prices to last year's prices (base effects), and oil's sharp rise late last year will therefore start to weigh on CPI numbers in coming months.
- Besides oil, **aluminium** and **copper** prices could fall in 2022, and we expect the global commodity index to drop by 7% after a more than 50% increase in 2021.
- Central banks refer to core inflation or look through/ignore short-term oil price spikes to set interest rate policies, and many of them maintained their view that inflation pressures are largely due to supply constraints and will be temporary. We therefore believe that **policy normalisation will be gradual**.

Chart 2: Commodity price inflation can have a big impact on breakeven inflation



Source: Bloomberg, HSBC Global Private Banking, as of 1 October 2021. Past performance is not a reliable indicator of future performance.

What are our views?

- Although we believe that base effects and supply chain interruptions should ultimately fade, it is possible that further upward pressure on energy prices could feed through into production costs and keep CPI higher for longer. However, we maintain our view that Treasury yields should be low but volatile. In credit and EM bond markets, we **keep bond duration in check to manage interest rate risk**. In equities, our focus on quality stocks is largely motivated by our search for **companies that can maintain margins and charge through any increase in input costs to their customers**.
- The most recent volatility in the bond market is more related to **increased real rates than rising inflation expectations.** Markets seem overly worried about the tapering process, which is well flagged by the Fed. As a result, real rates should not move up much from here but come down in coming months.
- In Europe, although higher utility bills could hurt consumer sentiment and lead to market volatility, we think the economic recovery is not seriously at risk. Fuel shortages could also add to the existing supply chain disruptions and hamper deliveries in the short term. We address the risk of weaker economic data by a **reduction in cyclicality of our sector stance** (e.g. we recently downgraded the region's Materials to neutral).
- Lastly, the recent curtailment in China's power supply is related to their annual energy reduction targets, lower coal production, higher coal prices and margin pressure on coal-fired power suppliers. While the economic slowdown is one of reasons for our neutral stance on Chinese equities, the power curtailment will **support building increased renewable energy capacity in China**.

Important information

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorized reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general education information purposes only and is neither intended as, nor does it constitute, advice or a recommendation to buy or sell investments, as defined by the US Securities and Exchange Commission. For individualized tailored recommendations based on your needs or objectives, please contact your financial professional directly for more information.

Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views and opinions expressed herein are those of HSBC Global Asset Management Global Investment Strategy Unit and HSBC Securities (USA) Inc. at the time of preparation, and are subject to change at any time. These views may not necessarily indicate current portfolios' composition. Individual portfolios managed by HSBC Global Asset Management primarily reflect individual clients' objectives, risk preferences, time horizon, and market liquidity.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance while any forecasts, projections and simulations contained herein should not be relied upon as an indication of future results. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. Investments in emerging markets are by their nature higher risk and potentially more volatile than those inherent in some established markets. Economies in Emerging Markets generally are heavily dependent upon international trade and, accordingly, have been and may continue to be affected adversely by trade barriers, exchange controls, managed adjustments in relative currency values and other protectionist measures imposed or negotiated by the countries with which they trade. These economies also have been and may continue to be affected adversely by economic conditions in the countries in which they trade. Mutual fund investments are subject to market risks, read all related documents carefully. **Please consider the investment objectives, risks, charges and expenses carefully before investing. The prospectus, which contains this and other information, can be obtained by calling an HSBC Securities (USA) Inc. Financial Consultant or call 888-525-5757. Read it carefully before you invest.** Bonds are subject generally to interest rate, credit, liquidity and market risks. Investors should consider the investment objectives, risks and charges and expenses associated with bonds before investing. Further information about a bond is available in the issuer's official statement. The official statement should be read carefully before investing.

Investment, annuities, and variable life insurance products are offered by HSBC Securities (USA) Inc. ("HSI"), member NYSE/FINRA/SIPC. In California, HSI conducts insurance business as HSBC Securities Insurance Services. License #: **OE67746**. HSI is an affiliate of HSBC Bank USA, N.A. Whole life, universal life, term life, and other types of insurance are offered by HSBC Insurance Agency (USA) Inc., a wholly owned subsidiary of HSBC Bank USA, N.A. Products and services may vary by state and are not available in all states. California license #: **OD36843**. **Investments, Annuity and Insurance Products: Are not a deposit or other obligation of the bank or any of its affiliates; Not FDIC insured or insured by any federal government agency of the United States; Not guaranteed by the bank or any of its affiliates; and subject to investment risk, including possible loss of principal invested.**

All decisions regarding the tax implications of your investment(s) should be made in consultation with your independent tax advisor.