Investment Monthly

Geopolitical Tensions: Modestly reducing portfolio risk

March 2022

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Key takeaways

- Escalated geopolitical tensions have led to rising energy prices and higher inflation. To reduce risk, we downgrade global equities to Neutral and Eurozone equities to Underweight, upgrading investment-grade corporate bonds to Overweight.
- Economic and earnings fundamentals are still positive. However, we have rebalanced our equities exposure between cyclicals and defensive stocks. We have upgraded Consumer Staples in Europe and Healthcare in the US.
- We are still positive on the Energy and Financials sectors. Energy stocks benefit from high energy prices and Financials from higher rates.

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Asset class		Short-term view (3-6 months)		Long-term view (>12 months)
Global equities	▶↓	Escalated geopolitical tensions, rising interest rates and high inflation continue to be headwinds and warrant our downgrade to Neutral. Longer-term fundamentals still look solid.	▲	Risk assets can still provide decent returns in an environment of robust economic growth, albeit lower than in the recent past amid policy normalisation, sticky inflation and geopolitical tensions.
Government bonds	▼	Although yields have backed up, they remain volatile and the asset class is unattractive.	▼	Risks to yields remain tilted to the upside amid inflation uncertainties even if gradual policy normalisation limits the risk of a sharp jump higher. Sticky inflation is a key risk to this asset class.
Investment grade (IG) corporate bonds	▲↑	Investment grade bonds are key for portfolio diversification but rate volatility remains an issue.	▼	Prospective returns are unattractive amid low spreads, while Fed policy tightening adds to risks of capital losses. We maintain a defensive positioning and are more positive on Asia IG.
High yield (HY) corporate bonds	▲	Spreads have widened and short-dated bonds have already priced in many rate hikes.	▼	Default-adjusted spreads are at multi-year lows. This implies an asymmetric return profile where positive surprises have limited impact on performance. We continue to prefer Asia credits to DM.
Gold	▶	Gold is benefitting from volatility but higher real yields and strong dollar are headwinds.	▼	Performance as a risk-off diversifier is unreliable. Upside is also limited by higher bond yields amid Fed policy tightening.

Note: Short-term view (3-6 months): a relatively short-term tactical view on asset classes. Long-term view (> 12 months): a relatively long-term strategic view on asset classes.
▲ "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. Investment implications of Russia-Ukraine tensions

- Escalated tensions are hitting risk appetite. One impact is on energy prices (Russia represents 11% of the world's oil production and exports three quarters of its production either as crude oil or products), which have surged above USD100/ barrel. We **downgrade global equities to Neutral and upgrade investment-grade bonds to Overweight to reduce portfolio risk.**
- Europe is impacted most on energy. The rise in prices will weigh on household consumption and inflation, and potentially rate tightening which **warrant our downgrade on Eurozone stocks to Underweight. To add quality, we upgrade Europe Consumer Staples to Neutral and US Healthcare to Overweight.**
- Gold (reached a 13-month high) and Treasuries are benefitting from the conflict but we think this will be short-lived. We think economic and earnings fundamentals are still strong, so investors should not panic sell but stay diversified instead.

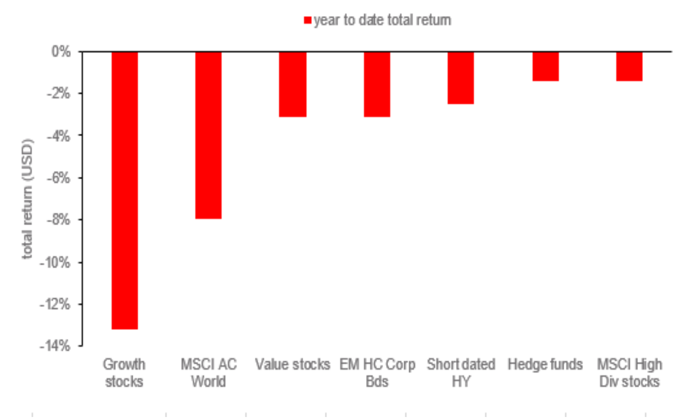
2. Where do we see opportunities in equities?

- The Q4 earnings season has been strong so far. We prefer **quality stocks with strong market positions and business models** as they are in a better position to pass on higher input costs to customers and are less disrupted by higher rates. Their P/E ratios also tend to rise when inflation rises compared to the rest of the market.
- **We are overweight Energy stocks** to benefit from high energy prices and hedge against geo-political risks, and **overweight Financials** as they can benefit from higher rates. Asian banks are more attractively valued.
- In Asia, we continue to **favour ASEAN stocks due to continued growth and attractive valuations.** We will monitor the policy direction from the National People's Congress in March to evaluate our view on Chinese assets.

3. What should bond investors watch out?

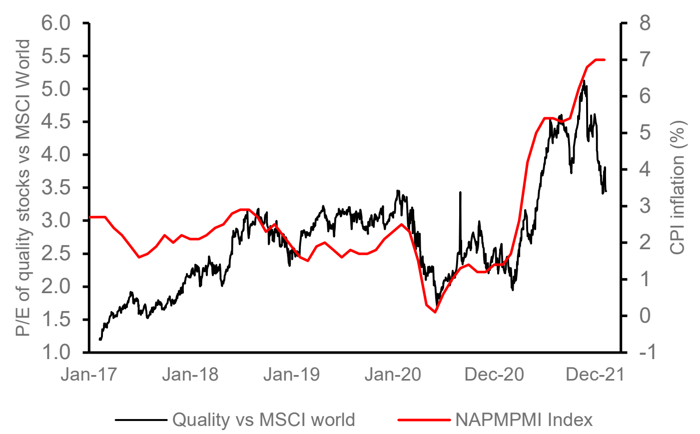
- With a more hawkish tone among the developed market central banks amid rising inflation, we now forecast 1.5% in Fed rate hikes (0.25% in Mar), three 0.25% hikes by the BOE (Mar, May & Aug), and two 0.25% hikes (Oct & Mar) by the ECB.
- The flattening of the yield curve has historically signalled increased recession risk but there could be false alarms. Past data shows that when the curve started to invert, there would be an average lag of 14 months before a recession began. We do not expect inversion to happen this year.
- Following mild spread widening and more rate hikes priced in, **short-dated high yield** offers the best risk-reward profile. We also like **emerging markets hard-currency corporate bonds** due to more attractive spreads than DM bonds with the same rating, and US strength.

Chart 1: Growth stocks have suffered while quality high dividend stocks have suffered less



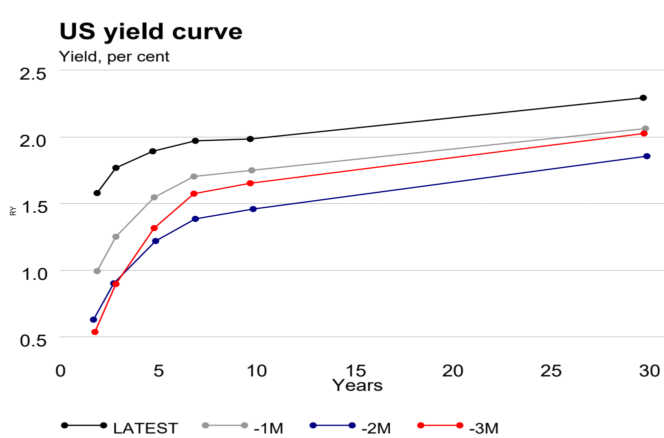
Source: Bloomberg, HSBC Global Private Banking, as at 18 February 2022. Past performance is not a reliable indicator of future performance.

Chart 2: Quality stocks tend to appreciate vs the market in a high inflation environment



Source: Bloomberg, HSBC Global Private Banking, as at 18 February 2022. Past performance is not a reliable indicator of future performance.

Chart 3: The US Yield Curve has become quite flat



Source: Refinitiv Datastream, as at 24 February 2022. Past performance is not a reliable indicator of future performance.

House views

Our latest short-term (3-6 months) and long-term (>12 months) views on various asset classes

Asset class	Short-term view	Long-term view	Comment
Global equities			
Global	▶↓	▲	Escalated geopolitical tensions, rising interest rates and high inflation continue to be short-term headwinds and warrant our downgrade to Neutral. Longer-term fundamentals still look solid.
United States	▲	▲	It remains our biggest equity overweight due to the size and quality character of US stocks. Valuations are relatively high which implies some caution.
United Kingdom	▶	▲	The asset class is attractively valued but rate & tax hikes and declining real incomes pose challenges. Longer term, UK indices are heavily exposed to the value factor which still have scope to perform well.
Eurozone	▼↓	▲	Europe equities are likely to be volatile due to its geographical and economic proximity to Russia-Ukraine tensions. Higher energy prices will keep inflation high and challenge businesses. We move to Underweight short-term.
Japan	▶	▲	Autos and industrials are hit by supply chain issues but capital goods see good demand. This market benefits from relatively good earnings performance and a decent macro outlook as global capex spending increases.
Emerging Markets (EM)	▶	▶	Policy headwinds are likely to weigh on performance (e.g. Fed tightening) while valuations are not particularly cheap.
Central & Eastern Europe, Latin America	▼	▶	The benefit of rising commodity prices may fade and further rate hikes are coming. Policy tightening is a key challenge, and geopolitics will weigh on returns in the near term.
Asian equities			
Asia ex-Japan	▲	▶	It is our preferred EM region with fewer rate hikes than elsewhere and ASEAN growth accelerates.
China	▶	▲	Regulatory overhang, the property downturn and "zero-Covid" strategy are near-term headwinds. The outlook is supported by macro policy easing and efforts to stabilise the housing market, undemanding valuations, etc.
India	▶	▶	The medium-term growth outlook remains intact amid positive reform prospects. However, elevated valuation and the prospect of tightening liquidity and higher rates are concerns. High oil prices pose macro and margin risks.
Hong Kong	▶	▲	A ramp-up in social distancing measures to tackle the fifth wave of the Covid-19 are headwinds to its recovery. Longer-term, the market's exposure to financials/value sectors could be beneficial as interest rates rise.
Singapore	▲	▲	The Singapore Budget for 2022 reflects the country's focus on long-term spending. Tourism and aviated related activities are expected to bounce back as quarantine restrictions are lifted. The market benefits from global growth.
South Korea	▶	▶	EPS growth is likely to slow following 2021's exceptional strength. Exposure to growth stocks implies vulnerability to higher global yields, despite undemanding valuations and Korea's leading innovations in the digital economy.
Taiwan	▲	▶	Structural demand in 5G and semiconductors is key driver. Taiwan equities have significant exposure to growth/tech sectors which are sensitive to US yields, though the high dividend yield is supportive. Geopolitical risks remain.
Government bonds			
Developed markets (DM)	▼	▼	Although yields have backed up, they remain volatile and the asset class is unattractive.
United States	▶	▼	Global growth expansion, central bank policy normalisation and inflation uncertainties pose downside risks although a big move higher in yields is unlikely.
United Kingdom	▶	▼	Inflation pressures amid supply chain disruption support policy tightening. Risk-adjusted returns look poor.
Eurozone	▼	▼	We now expect the ECB to announce a considerably steeper taper of QE with net asset purchases ending completely in September.
Japan	▼	▼	Japanese government bonds (JGBs) are overvalued and the bond risk premium remains negative. However, the "Yield Curve Control" framework should limit volatility and the risk of significantly higher yields in the near-term.
Emerging Markets (Local currency)	▶	▲	Select opportunities exist but some EM countries are hiking rates and USD remains strong.
Emerging Markets (Hard currency)	▶	▶	Amid higher Treasury volatility, we still find yield but have become more selective.
Corporate bonds			
Global investment grade (IG)	▲↑	▼	Investment-grade bonds are key for portfolio diversification but rate volatility remains an issue. Despite this, we upgrade to Overweight taking into account recent volatility.
USD investment grade (IG)	▲↑	▼	USD Investment grade is our pick to help weather expected short-term volatility in portfolios even if valuations are relatively unattractive.
EUR and GBP investment grade (IG)	▶	▼	Spreads are at historically tight levels and it is important to monitor trends in corporate fundamentals.
Asia investment grade (IG)	▲	▲	Asia investment grade offers quality names and issuers with strong implicit government support.
Global high-yield (HY)	▲	▼	Spreads have widened and short-dated bonds have already priced in many rate hikes.
US high-yield (HY)	▲	▼	Improving leverage levels in the US HY space should help cope well with higher interest rates, while the US economy is still expanding, resulting in an historically low default rate.
European high-yield ex UK (HY)	▲	▼	Valuations have improved on the ECB's hawkish tone and geopolitical developments. Spreads may be affected by the risk-off sentiment in the short-term but the market will ultimately shift to the broader economic context.
Asia high-yield (HY)	▲	▲	Default rates remain low and spreads look relatively attractive. China's economy and default rates need to be monitored in the context of tightening policy, deleveraging efforts and regulatory pressures.
Commodities			
Gold	▶	▼	Gold is benefitting from volatility but higher real yields and strong dollar are headwinds. Performance as a risk-off diversifier is unreliable.
Oil	▶	▲	Demand should weaken in Q1 but inventories are low and OPEC's spare capacity is low.

Sector Views

Global and regional sector views based on a 3-6 month horizon

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▶↓	▲	As governments consider COVID endemic and lift all restrictions, this should boost the travel and hospitality sectors. Rising wages are being offset by higher living costs, but pent-up demand and high savings should keep demand buoyant. Supply chain constraints have somewhat eased in some areas. We downgrade Europe given the present geopolitical uncertainties.
Financials	▲	▲	▲	▲	Inflationary pressures are increasing rate-rise expectations helping to lift banking stocks. In Europe and Asia, low valuations, robust capital markets activity, rising insurance premiums, thriving mortgage market make the sector particularly attractive. In contrast US financials are trading at a significant premium to their peers after many quarters of strong results.
Industrials	▼	▶	▶	▼	Slowing growth and rising input costs (commodities, labour and energy) weigh on margins, profits and sentiment, accelerating the trend for greater automation. Supply chain issues persist but are easing. Rebuilding historically low Inventories should provide some stability to earnings. Valuations have become more attractive but sentiment is likely to remain subdued.
Information Technology	▲	▲	▶	▲	The sector remains under pressure from the slowing economies in US and China, and lacks lustre growth in Europe. Valuations remain elevated but are no longer rich. Digitalisation, electrification and automation should drive long-term above average growth for the next decade. We focus on strong cash-generative businesses with strong market positions.
Communication Services	▲	▲	▶	▲	The sector benefits from steady cash flows & growth from increased data usage as more activity shifted on-line and business digitalised. Media companies are likely to see continued robust demand. The 5G roll-out is positive for telecom equipment provider but neutral/negative initially for service providers.
Materials	▶	▶	▶	▶	Although slowing growth in China remains a concern, growth in DM, especially related to the extensive fiscal stimulus packages should be supportive of demand and prices. Valuations appear attractive. Post-super cycle, lowered investment in new capacity may limit supply in some metals in the medium-term, especially in commodities linked to the electrification of the economy.
Real Estate	▶	▶	▶	▶	Private residential real estate is seeing strong demand supported by high savings rate and lower interest rates. Commercial real estate is suffering from low demand as corporates look to reduce office space and retail moves online.
Consumer Staples	▶	▶	▶↑	▶	The sector contains many quality stocks with good dividend yields. We upgrade European consumer staples to Neutral given these attractive characteristics. However, valuations are somewhat elevated. So a selective approach is required focusing on those with strong brands and/or pricing power which can protect margins and earnings as inflationary pressures mount.
Energy	▲	▲	▲	▲	Low inventories and supply-demand imbalances continue to drive prices higher. We expect energy prices to either stabilise at these elevated levels or push higher. Chronic under-investment is likely to support prices in the medium term despite the energy transition gaining momentum.
Healthcare	▶	▲↑	▶	▶	We are more positive on large pharmaceutical companies in the US with their strong cash flows, above-average dividend yields and attractive valuations. COVID related backlogs in elective surgical procedures should drive strong growth for 2022 for medical technology companies. Biotechnology sector provides more speculative investment opportunities with their innovative medicines.
Utilities	▼	▼	▶	▼	Renewable stocks are attracting attention after stock prices and valuation pulled back significantly from overly optimistic levels. Caution is still required as companies may not be able to pass on rising energy prices which may impact margins negatively.

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