HSBC

Investment Monthly

Markets to push higher despite Fed comments

July 2021

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Key Takeaways

- **Fed policy tightening should be viewed positively** because it affirms the recovery. Inflation remains high but should normalise going into 2022. However, volatility may arise as tapering details emerge.
- In equities, we've **upgraded the real estate sector to Overweight.** Real estate equities should benefit from the reopening of the economy. Financials and consumer discretionary stocks remain our pick.
- A **multi-asset approach** that includes a strategic allocation to high quality bonds remains our preferred approach to investing.

Xian Chan
Chief Investment Officer, Wealth Management
HSBC Wealth and Personal Banking

Cynthia Leung
Senior Investment Strategist
HSBC Wealth and Personal Banking

Asset class	Short-term view (3-6 months)		Long-term view (>12 months)	
Global equities	▲	We continue to look for marked improvement in equity markets as the global economy continues to reopen and we remain risk-on with our overweight in global equities.	▲	As we enter the expansion phase of the economic cycle, we have a preference for 'value' over 'growth' stocks, and for Europe and ASEAN regions based on better valuation and stronger re-opening prospects.
Government bonds	▼	The outlook for DM government bonds is still poor on the back of negative real yields across UK gilts, German bunds, Japanese Government Bonds so we remain underweight.	▼	Although valuations have improved in 2021, as investors have priced in a stronger inflation outlook, relative valuations remain unfavourable and hedging properties are being challenged.
Investment grade corporate bonds	▶ ↓	The Fed's hawkish pivot and higher inflation have tightened long-term US Treasury yields, causing spreads to be compressed. We are taking profit and have reduced to neutral.	▼	We remain underweight on investment grade bonds as valuations are unattractive and spreads are at historically tight levels, especially for longer-duration credit.
High yield corporate bonds	▲	The search for yield continues and we are overweight high yield in the short term as an asset class, for more attractive carry and yield, although being selective is always key.	▼↓	We downgrade Global, US and Europe High Yield bonds due to unattractive spreads and valuations. Out of the HY universe, Asia bonds are preferred despite some risks related to deleveraging efforts in China.
Gold	▶	The moves in gold recently seems overdone on the Fed's change of path which initially spooked the markets. Going forward we expect more range-bound trading and are neutral.	▶	Higher bond yields, a resilient US dollar, a reduction in global economic and geopolitical uncertainty remain key risks.

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.

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Talking points

Each month, we discuss 3 key issues facing investors

1. Why do the Fed's comments matter?

- In the latest FOMC meeting, the Fed implies it is now in favour of rate hikes in 2023 and intends to begin tapering quantitative easing, but left the Fed funds rate unchanged at 0-0.25%.
- Markets had a knee-jerk reaction to this news and risky assets were sold off. We believe that headline inflation is temporary and should normalise going into 2022. Further, we view the Fed becoming more optimistic on the economic recovery (lifting GDP growth forecast to 7% from 6.5% and PCE Core inflation to 3%) as a positive development rather than a negative move.
- Over the short term, we are still overweight equities and high yield bonds, given favorable earnings and growth outlook. We like exposure to interest-rate sensitive sectors (financials and consumer discretionary), and prefer shorter duration bonds in the face of higher interest rates going forward.

Chart 1: US Inflation expectations have actually fallen since May

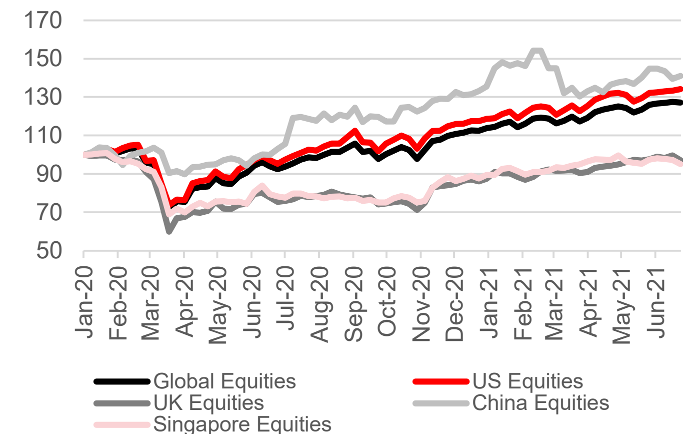
5-year implied forward inflation expectation rate

Source: St Louis Fed, Data from Dec 2019 till June 2021

2. Should investors be worried about the Fed tightening?

- We may see volatility as details emerge around the Fed's intentions on reducing asset purchases. But investors shouldn't be concerned if their portfolios are appropriately positioned and diversified.
- The best place to be invested remains equities (particularly US, UK and China) thanks to the earnings recovery. In fact, we downgraded Investment-grade corporate bonds to Neutral which are relatively less attractive than equities. We upgraded global real estate with a strong preference for US and Asia.
- Longer-term investors may consider reducing exposure to High Yield bonds because valuations are now less attractive. We move to Underweight over a 12-month period. However, over 3-6 months, High Yield should still do well thanks to better corporate earnings and Asian High Yield remains our preference.

Chart 2: Equities performance is still strong and trending up with economic recovery

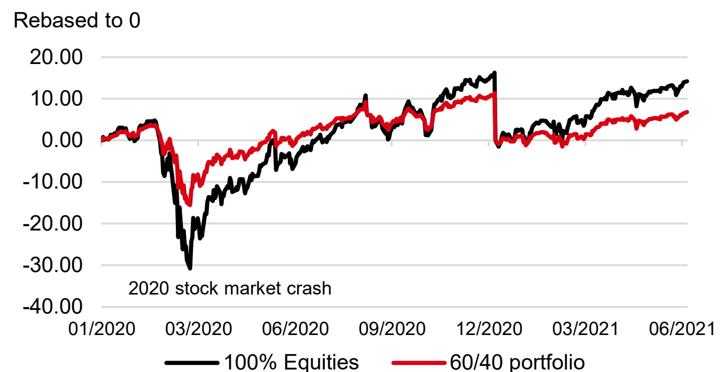


Source: Bloomberg, data as of 25 June 2021. Investment involves risks. Past performance is not an indication for future. For illustrative purpose only.

3. How to brace for market volatility?

- To account for higher volatility as markets digest the Fed's new path, multi-asset investing is a useful way to diversify risks.
- There is still a lot of cash on the sideline (average savings ratio of 27%) and deploying it into investment is an effective way to beat inflation.
- We are still pro-risk, with an overweight on equities and high yield bonds over the short term. However, the path of the virus is still uncertain and investors should be well diversified with a strategic allocation to high quality bonds to guard against market swings expected in the second half.

Chart 3: Multi-asset investments can help navigate volatile markets



Source: Refinitiv Datastream, data as of 28 Jun 2021. Note: 60/40 portfolio allocates 60% to equities and 40% to government bonds. Index: S&P 500 and Bloomberg Barclays US Treasury Index. Investment involves risks. Past performance is not an indication for future. For illustrative purpose only.

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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	▲	▲	Global economic recovery prospects are supported by the rollout of vaccines and the re-opening of economies. Markets exposed to cyclical sectors can continue to perform well even as bond yields rise. High frequency data generally supports economic rebound in a number of major economies.
United States	▲	▶	US indices' greater weight to "growth" stocks makes them vulnerable to higher US bond yields. This implies some relative caution, although exposure to quality names, mega-cap tech, and the digital economy remains beneficial.
United Kingdom	▲	▲	UK equities are heavily exposed to the value and domestic factor which have scope to outperform in the current market environment. Services-related sectors benefit from UK's strong cyclical rebound amid successful vaccination. However, Covid variants need to be monitored over summer as travel bans may resurface.
Eurozone	▶	▲	Europe is on track with its path of recovery with improving Covid cases, reopening and attractive valuation.
Japan	▶	▶	Structurally weak economic growth, slow vaccination and constrained monetary policy warrant a neutral stance.
Emerging Markets (EM)	▶	▲	Outlook of EM remains mainly positive on USD weakness in the long run, but near-term challenges remain in ASEAN which underperformed due to severe Covid cases and reliance on its economic reliance on tourism.
Central & Eastern Europe, Latin America	▼	▶	EMs outside of Asia has the potential to perform well against a backdrop of global economic recovery, but new virus variants and slow vaccine rollout remain major headwinds.
Asian equities			
Asian ex-Japan	▲	▲	The region is blessed with high growth, exposure to cyclical stocks tied to the global growth recovery and to structural themes including electric vehicles and batteries, data server demand and semiconductor manufacturing, coupled with a rising middle class and tech-savvy population.
China	▲	▲	Regulatory concerns and policy normalisation have not been fully removed and have become consensus risks, but are largely priced-in. Quality growth and under-allocation from global investors and expanding institutionalisation of local markets are positives for both the short and long run.
India	▶	▶	Near-term outlook is uncertain due to wide-spread Covid cases. Inflation risks remain and valuation is high.
Hong Kong	▶	▲	Hong Kong remains an attractive capital market underpinned by primary and secondary market activity; cyclical and financial sector exposure benefits from reflation but risks of prolonged border restrictions weigh on growth.
Singapore	▲	▲	A key beneficiary from global rotation into cyclical and manufacturing sectors, with attractive dividend yield.
South Korea	▶	▶	Korea gives beta exposure to growth via EV and tech, but is challenged by elevated Covid cases and slow vaccine.
Taiwan	▶	▶	Taiwan benefits from structural digital demand in semiconductors and 5G but we are neutral on high valuation.
Government bonds			
Developed markets (DM)	▼	▼	Despite recent pick-up in US Treasury yields, we do not have a positive view on this asset class as negative bond yields remain an unattractive feature for major government bonds including Japan, German and UK instruments.
United States	▶	▼	Bond prices are unlikely to be volatile as the Fed has now demonstrated confidence in the recovery in the latest FOMC meeting. Yield increase in 2021 has improved prospective returns, especially for long dated US Treasuries.
United Kingdom	▶	▼	The BoE is supportive in the near term and there is scope for stronger-than-expected UK economic recovery. However prospective risk-adjusted returns and gilt yields are unattractive in the long term.
Eurozone	▼	▼	Valuations look unattractive and governments are issuing high levels of fresh debt.
Japan	▼	▼	Japanese government bonds (JGBs) are overvalued and the bond risk premium remains negative.
Emerging Markets (Local currency)	▲	▲	As bond yields are at historical lows, our positive stance on EM debt is unchanged on higher yields and undervalued EM currencies. Divergence in virus containment and politics mean that being selective is key.
Emerging Markets (Hard currency)	▲	▼	Prospective returns are relatively high as we view EM government bond yields attractive, but it will be crucial to monitor economic recovery trends, US bond yields as well as the path of the US dollar.
Corporate bonds			
Global investment grade (IG)	▶↓	▼	We move global and US IG to neutral along with the Fed's hawkish tilt and projection of inflation being transitory, but it remains important for investors to continue to have an allocation to IG for portfolio diversification reasons.
USD investment grade (IG)	▶↓	▼	Long-term US Treasury yields have tightened and IG bonds spreads are compressed, hence we are taking profits.
EUR and GBP investment grade (IG)	▶	▼	Europe and UK economies are catching up on economic recovery as the re-opening continues but spreads and returns are unattractive. Meanwhile we keep a close watch on corporate fundamentals and the variants of the virus.
Asia investment grade (IG)	▲	▲	We have a preference for Asian credit despite the negative developments on Chinese Asset management companies, which negatively impacted the Chinese IG bond market, but we believe these concerns are priced-in.
Global high-yield (HY)	▲	▼↓	We downgraded HY for the long term as default-adjusted spreads are at multi-year lows and uncertainties remain, implying an asymmetric return profile. In the near-term, we are still positive due to higher real yields and earnings.
US high-yield (HY)	▲	▼↓	The US economy is performing well on stimulus and low rates and we are positive in the short run, but downgraded in the long run as market action has compressed spreads to a level consistent with an underweight view.
European high-yield ex UK (HY)	▲	▼↓	Long-term European HY bonds valuations are now consistent with an underweight position while default rates may tick upwards. In the short term, underlying corporate fundamentals are likely to improve if re-opening is on track.
Asia high-yield (HY)	▲	▲	Asia HY can benefit from robust macro trends in the region. Default rates should remain low and spreads look attractive relative to other global opportunities.
Commodities			
Gold	▶	▶	Lower for longer rates, rising inflation risks and uncertainty relating to the recovery can support gold, with reasonable diversification benefits to multi-asset portfolios. However further price upside is limited as these levels.
Oil	▶	▶	Oil demand is still vulnerable to global growth shortfall although OPEC+ producers' supply discipline helps prices.

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Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	We expect further positive earnings revision and improving consumer sentiment driven by pent-up demand, falling debt levels and record high savings, particularly in Asia. There may be further gains in luxury and autos, as well as leisure and hospitality in developed markets in 2H if re-opening momentum picks up.
Financials	▲	▲	▲	▶	Fiscal packages in the US and Europe may help offset lower interest rates and the potential for higher taxes in the US. Attractive valuations, high trading revenues and lower loan provisions provide further support. Q1 US earnings were strong. Buoyant capital and real estate markets should also provide a tailwind for the sector.
Industrials	▲	▶	▲	▲	The Industrials sector is a key beneficiary of infrastructure stimulus and companies restocking inventory. After strong performance over the last 12 months, upside potential is greater in Europe and Asia than the US. Capex and investment are picking up especially with respect to automation, infrastructure, agriculture and mining equipment.
Information Technology	▲	▲	▶	▲	Valuation remains a concern for the next 1-2 quarters. That said, long-term structural trends in digitalisation and new technologies are intact. Although semiconductor and chip shortage is causing near-term headwinds, Infrastructure spending should benefit digital infrastructure.
Communication Services	▲	▲	▶	▲	Steady cash flows and growth from increased data usage as more activity shifted on-line and business digitalised are key drivers. Media companies are likely to see continued robust demand. The 5G roll-out is positive for telecom equipment.
Materials	▲	▶	▲	▲	A constructive economic outlook has lifted hard commodity prices. Infrastructure focused fiscal stimulus plans, rebounding Chinese economy, and relatively attractive valuations should continue to support this sector, but volatility is likely to remain elevated.
Real Estate	▲↑	▲↑	▶	▲	We upgraded US and global real estate as demand for private residential runs strong on the back of high savings rate and lower interest rates. Supply chain issues and materials shortage have eased. However, commercial property suffers due to corporates reducing office space and moving online.
Consumer Staples	▼	▼	▼	▼	We anticipated the rotation out of defensive sectors into cyclical sectors with the rebound in economic activity and the roll-out of vaccines. Valuations have since fallen away. Slower YoY growth is expected in 2021 as 2020 benefitted from COVID-19 fears that drove panic buying and stock piling of consumer essentials.
Energy	▶	▶	▶	▶	Supply control is beneficial to energy prices and demand is picking up as economies reopen. A nuclear weapons deal with Iran, a major oil producer, could put pressure on oil prices. We expect geo-politics to continue to drive volatility of energy prices.
Healthcare	▶	▶	▶	▶	Healthcare spending should remain a priority for households and governments as large backlogs in elective surgical procedures should drive strong growth in 2021. Medical technology and biotechnology companies are likely to see strong demand. However, as pandemic tailwind ebbs, we expect volatility to resurface regarding drug pricing.
Utilities	▼	▼	▼	▼	After benefitting from various green initiatives, short-term potential for the sector appears. Global sector valuations remain relatively attractive, but the defensive sector is likely to underperform in the cyclical recovery.

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