HSBC

Investment Monthly

Stay invested but prepare for possible volatility

December 2021

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Key Takeaways

- We still like equities. Consumer discretionary remains our current pick over industrials. But stubbornly high inflation, supply chain challenges and the new Omicron Covid-19 variant could produce volatility short-term.
- We upgrade Financials in Asia to overweight to take into account continued economic and earnings growth in 2022, albeit at a slower pace.
- COP26 shows that more measures to tackle climate change are imminent. We see long-term opportunities in areas such as sustainable infrastructure, sustainable aviation fuel, and carbon removal technologies.

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Asset class	Short-term view (3-6 months)		Long-term view (>12 months)	
Global equities	▲	The outlook is still positive for equities although inflation, supply chain constraints and the new Covid-19 variant remain headwinds and may lead to market volatility in the short run.	▲	Risk assets can still provide decent returns in the expansion phase of the economic cycle, despite the fact that upside growth surprises are limited and policy normalisation begins. Sticky inflation is a key risk.
Government bonds	▼	Low bond yields and unattractive valuations support our underweight position.	▼	Valuations have improved amid a repricing of inflation and interest rate risks, but risks to yields remain tilted to the upside.
Investment grade (IG) corporate bonds	▶	Corporate bonds are more attractive than government bonds because of higher yields and improving rating trends. We prefer shorter bond duration due to the risks of Fed rate hikes.	▼	Prospective returns are unattractive, particularly for longer-duration bonds although spreads are likely to remain tight on the back of accommodative monetary policy. We maintain a defensive positioning and prefer Asia IG.
High yield (HY) corporate bonds	▲	US Treasury yields will stay "low but volatile" as markets look for clues about the tapering plan. We prefer short-dated Global High Yield to mitigate interest rate volatility.	▼	Default-adjusted spreads are at multi-year lows, implying an asymmetric return profile where positive surprises have limited impact on performance. We prefer Asia credits to developed markets.
Gold	▶	Gold offers diversification and hedging benefits but further upside is limited by higher bond yields, a stronger USD, and a reduction in global economic and geopolitical uncertainty.	▶	The environment of "lower-for-even-longer" interest rates and inflation risks remains supportive. Gold offers reasonable diversification benefits but upside is limited by economic recovery, higher bond yields, etc.

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. How to position for potential volatility?

- The new Covid-19 variant has heightened short-term market volatility, **making it important to diversify and include high quality bonds. A focus on large-cap, high quality stocks also helps.** Our recent downgrade of EM local currency bonds also cuts risk by reducing exposure to the volatile EM currency component. We prefer **Global High Yield and EM US Dollar (hard currency) bonds, which are less volatile.**
- Higher commodity prices have benefited Latin America but prices are unlikely to rise further, **reinforcing our preference for Asia over Latin America as a region.**
- Although supply chain bottlenecks seem to be easing, particularly in Asia, semi-conductor challenges still pose a problem for Industrials. Hence, we still **prefer the consumer discretionary sector over industrials.**

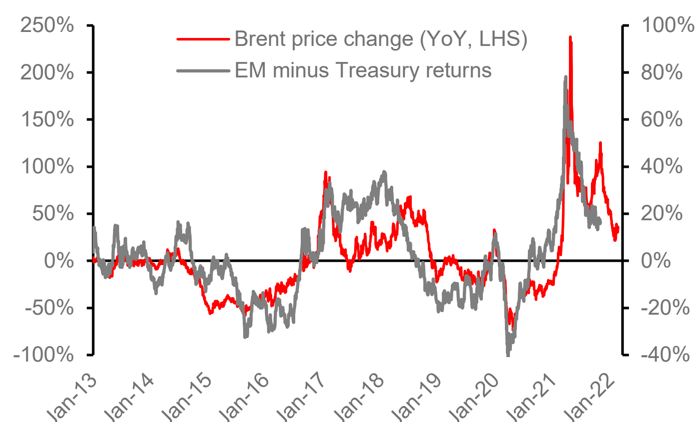
2. Where do we see opportunities?

- We still like equities but have reduced cyclical exposure due to moderating growth. Governments continue to spend on infrastructure (eg USD1tn infrastructure bill passed in the US), health technology and green initiatives, while **corporate investment activity on automation and total security is also strong**.
- In addition to consumer discretionary, we are **positive on Financials and upgrade this sector in Asia to overweight** as it should benefit from continued growth. It is also a hedge against higher inflation and potential higher rates.
- We like the outlook for Europe although rising Covid-19 cases and supply chain disruption are still challenging in places such as Germany. In Asia, **Southeast Asia is a beneficiary of the reopening** with Indonesia benefitting from higher commodity prices while Malaysia has been a lagged performer.

3. What are the outcomes of COP26?

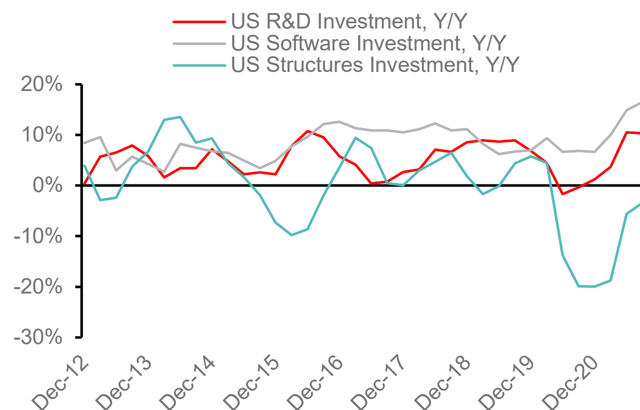
- **COP 26** saw countries re-affirming their commitment to combat climate change. However, the commitments made were not enough to limit temperature rises to 1.5° C.
- **However, the agreement is still significant** because it focusses efforts to reduce coal, develop clean technology and end deforestation, etc. The US-China declaration to work together on climate change was a positive surprise.
- A longer term approach to investing sustainably is essential. Companies that adopt sustainability will do better than others in the long run. We see opportunities in **sustainable infrastructure, sustainable aviation fuel, hydrogen**, and **carbon removal technologies.**

Chart 1: Lower oil price inflation is less favourable for EM stocks, particularly Latin America



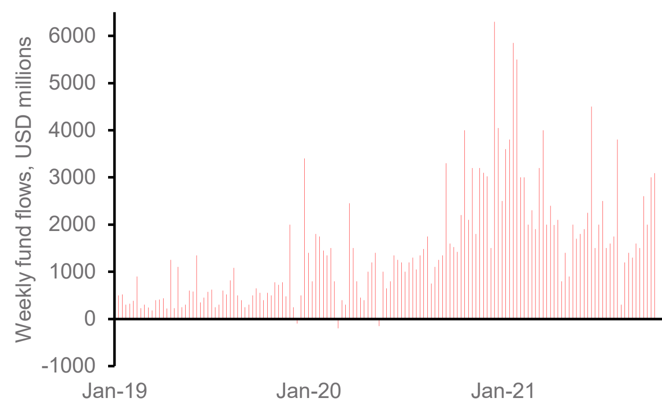
Source: Bloomberg, HSBC Global Private Banking as at 15 November 2021. Past performance is not a reliable indicator of future performance.

Chart 2: Technology and automation should benefit from increased corporate spending



Source: Bloomberg, HSBC Global Private Banking as at 14 November 2021. Past performance is not a reliable indicator of future performance.

Chart 3: ESG ETF flows show a structural rise in investor interest



Source: Bloomberg, HSBC Global Private Banking as at 14 November 2021. 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	▲	▲	The outlook is still positive for equities although inflation, supply chain constraints and the new Covid-19 variant remain headwinds and may lead to market volatility in the short run.
United States	▲	▲↑	Infrastructure, health technology and climate change spending support growth. US stocks provide a hedge against weaker growth and higher inflation due to its high quality characteristics and exposure to the digital economy.
United Kingdom	▶	▲	Labour shortages, supply chain disruptions, potential rate hikes in 2022, tax rises and Brexit related pressures pose short-term risks. Longer term, UK equities could be an interesting value proposition and offer upside potential.
Eurozone	▲	▲	Rising Covid-19 cases and supply chain disruptions weigh on some parts of Europe (eg Germany) but the outlook of the region remains constructive. The economic recovery is supported by the EU Next Generation fund investments.
Japan	▶	▲	Japan benefits from reasonable valuations and good earnings performance, but how the new government rolls out structural reforms remains uncertain, making us more cautious in the short-term.
Emerging Markets (EM)	▶	▶	Renewed inflation fears, a stronger USD and slower growth weigh on EM equities. Additional inflation pressures could prompt central banks to hike earlier than expected (e.g. Brazil). Valuations are not particularly cheap.
Central & Eastern Europe, Latin America	▼	▶	Higher commodity prices have benefited Latin America recently but we do not see further upside. Longer term, new virus variants, slow vaccine rollout and relatively constrained policy space remain key challenges.
Asian equities			
Asia ex-Japan	▲	▶	With most Asian countries having at least 75% of their populations fully vaccinated by end-2021, the region is on the road to further reopening, which will help Southeast Asia (eg Indonesia and Malaysia). Policy normalisation and regulatory headwinds are key concerns over the long term.
China	▶	▶	We expect more favourable policies to support the strategic growth model with focus on capex spending in high-end manufacturing and green investments. Moderating domestic growth and regulatory uncertainty are key concerns.
India	▶	▶	India's economy benefits from market reopening. The medium-term growth outlook remains intact amid continued fiscal support, and recent progress with land and labour reforms. Valuations remain stretched.
Hong Kong	▶	▲	The economy is hit by the restrictions of tourism from mainland China and other markets. Should the China-Hong Kong border be reopened, tourism and consumer spending will stand to benefit.
Singapore	▲	▲	Singapore will benefit from the reopening in Southeast Asia specifically and globally. The country has further loosened their social distancing restrictions from late November onwards. Risk-adjusted returns are attractive.
South Korea	▶	▶	Chip shortage may hurt automobile and tech output. A tighter monetary policy outlook further weighs on valuations.
Taiwan	▲	▶	Taiwan benefits from the global recovery cycle and demand growth in tech, 5G and semi-conductors making us positive short-term. Geopolitical risks continue to linger.
Government bonds			
Developed markets (DM)	▼	▼	Valuations have recently improved amid a repricing of inflation and interest rate risks but both valuations and bond yields are still not attractive in our view.
United States	▶	▼	Further upside in US Treasuries yields are unlikely given the pricing in of inflation risks and the Fed's normalisation plans. The pick-up in yields has improved longer-dated Treasuries but we remain neutral short term.
United Kingdom	▶	▼	Inflation pressures amid supply chain disruptions may lead to policy tightening. Risk-adjusted returns look poor.
Eurozone	▼	▼	Prospective returns and diversification benefits are limited. Central bank looks set to decrease bond buying in 2022.
Japan	▼	▼	Given Bank of Japan's accommodative policy stance, JGB yields are likely to remain low.
Emerging Markets (Local currency)	▶	▲	The EM currency component in the asset class adds to its volatility as US dollar is expected to strengthen. Longer term, prospective returns are relatively high due to EM currencies being undervalued. Being selective is key.
Emerging Markets (Hard currency)	▲	▼	We remain constructive on EM hard currency debt which tends to be less volatile. They also offer attractive yields and market factors continue to point to mild USD strength. Defaults are to be monitored over the long term.
Corporate bonds			
Global investment grade (IG)	▶	▼	Prospective returns are unattractive and we are more positive on shorter-duration bonds and Asia investment grade within the universe.
USD investment grade (IG)	▶	▼	We believe the Fed will start raising rates only if the economy is in a good health, so expect spreads to continue trading sideways in the near term. Valuations are relatively unattractive especially for longer duration bonds.
EUR and GBP investment grade (IG)	▶	▼	EUR IG spreads continue to trade sideways. Bank of England stands out as relatively hawkish compared to the Fed and the ECB. We had expected the faster rate of policy normalisation to put pressure on long-dated GBP credit.
Asia investment grade (IG)	▲	▲	Asia investment grade offers quality names and issuers with strong implicit government support.
Global high-yield (HY)	▲	▼	Global high yield suffers from surging implied inflation leading to higher DM rates, but search for yield continues to make HY bonds appealing. We prefer short-dated Global HY to mitigate interest rate volatility.
US high-yield (HY)	▲	▼	There is further room for spreads to tighten. High energy prices have boosted the cash flows of oil & gas companies, which is a major constituent of the USD HY index. Longer term, default outlook is uncertain.
European high-yield ex UK (HY)	▲	▼	With improved credit fundamentals and low default risk, we see better value in HY versus IG. Spreads continue to trade near the upper end of their six-month range. However, valuations support our long-term underweight position.
Asia high-yield (HY)	▲	▲	Despite rising investor concerns over refinancing and limited visibility on the timing of any potential policy support, the longer-term outlook remains positive as the stronger developers will prevail. Default rates should remain low.
Commodities			
Gold	▶	▶	Gold can offer diversification and hedging benefits but upside is limited by economic recovery, higher bond yields, a stronger USD, and declining geopolitical tensions.
Oil	▶	▶	Near-term demand is strong and oil prices are expected to drop in 2022 with the US and OPEC+ resuming supply. But the outlook for global spare capacity is a concern over a longer term.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	Rising wages, robust employment prospects, high levels of savings and lower debt levels support consumer sentiment. We expect upward earnings revisions. Domestic travel and hospitality is picking up in many developed markets. Auto makers see robust demand but production is constrained by supplies chain issues, especially semi-conductors.
Financials	▲	▲	▲	▲↑	Banking stocks benefit from inflationary pressures lifting rate hike expectations. The economic outlook is positive on stimulus packages in the US and Europe, low valuations, as well as higher trading revenues and M&A activity. Q3 results are strong due to higher capital markets activity, lower loan provisions and a hot real estate market. We upgrade Asia on continued growth.
Industrials	▼	▶	▶	▼	Rising input costs (labour, materials and energy) and supply chain issues continue to weigh on margins and profits for the coming quarters. Historically, low inventories and the shift to greater automation ensure future potential once the immediate issues are addressed.
Information Technology	▲	▲	▶	▲	The trend of digitalisation and new technologies driving long-term, above-average growth remains intact. Shortage in semiconductors is still challenging but infrastructure spending should benefit digital infrastructure. Regulatory authority actions could potentially weigh on sentiment but the focus has shifted from the US to Asian companies.
Communication Services	▲	▲	▶	▲	Steady cash flows and increased data usage as more activity shifted online and business digitalised are key drivers. The 5G roll-out is positive for telecom equipment providers but is neutral/negative initially for service providers. Media companies see continued robust demand.
Materials	▶	▶	▶	▶	The constructive economic outlook is reflected in valuations. Further upside on metal prices is not likely as the Chinese authorities try to cool commodity prices. In the medium term, demand is supported by infrastructure spending related to fiscal stimulus plans in Europe, Asia and the US.
Real Estate	▶	▶	▶	▶	High savings and low interest rates are positive for private residential real estate, while commercial real estate is suffering from corporates looking to reduce office space and retail moving online. High dividend yield provides attraction in a low yield environment.
Consumer Staples	▼	▼	▼	▶	Although valuations looks relatively more attractive than the cyclical sectors, slower growth is expected in 2021 due to stock piling of consumer essentials in 2020. Rising Input costs and labour shortage may hurt margins in some industries.
Energy	▶	▶	▶	▶	Energy prices and stocks will remain volatile. Low inventories and supply-demand imbalances will likely keep prices high. In the medium term, continuing chronic under-investment will support prices despite the clean energy transition gaining momentum.
Healthcare	▶	▶	▶	▶	Medical technology companies stand to benefit from large backlogs in elective surgical procedures, while new innovative medicines drive sales and positive news flow for the biotechnology sector. Pricing remains a headwind for pharmaceutical companies due to policy and regulations.
Utilities	▼	▼	▶	▼	Renewable stocks look more attractive after stock prices and valuation pulled back significantly from overly optimistic levels. However, margins may be under pressure as companies may not be able to pass on rising energy prices.

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