Investment Monthly

Stock Market Volatility: Down But Not Out

February 2022

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HSBC

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Key takeaways

- Markets have sold off due to inflation and higher expected interest rates. Despite this, we think equities will do well and upgrade the Energy and Consumer Staples sectors to Overweight and Neutral respectively.
- We are still positive on US, Europe and Asia equities thanks to strong economic and corporate fundamentals. Inflation should ease and policy should remain stimulative. Recent volatility has made stocks more attractive.
- Some ASEAN markets have re-opened and are "living with COVID", making them attractive. We remain Neutral on China over the short term, but see upside potential later this year with monetary easing policies coming into play.

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Asset class	Short-term view (3-6 months)		Long-term view (>12 months)	
Global equities	▲	Equities have struggled as the Omicron variant has cut into near-term growth, but the outlook for equities remains positive thanks to solid fundamentals and supportive policies.	▲	Risk assets can still provide decent returns in the expansion phase of the cycle, albeit lower than in the past as upside growth surprises are limited and policy normalisation begins. Sticky inflation is a key risk.
Government bonds	▼	Although yields should range trade, we prefer to capture more yield elsewhere.	▼	Valuations have recently improved amid a repricing of inflation and interest rate risks, but both valuations and yields are still not attractive.
Investment grade (IG) corporate bonds	▶	It is key for portfolio diversification but spreads have tightened a lot in recent years.	▼	Prospective returns are unattractive amid low spreads, while Fed policy tightening adds to risks of capital losses in the short term. We maintain a defensive positioning and are more positive on Asia IG.
High yield (HY) corporate bonds	▲	High yield should be well supported in the mid-cycle but we stick to short-to-medium maturities.	▼	Defaulted-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 not benefitting from higher inflation as higher real yields and strong dollar are headwinds.	▼↓	Performance as a risk-off diversifier is unreliable. Upside is also limited by robust growth and 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

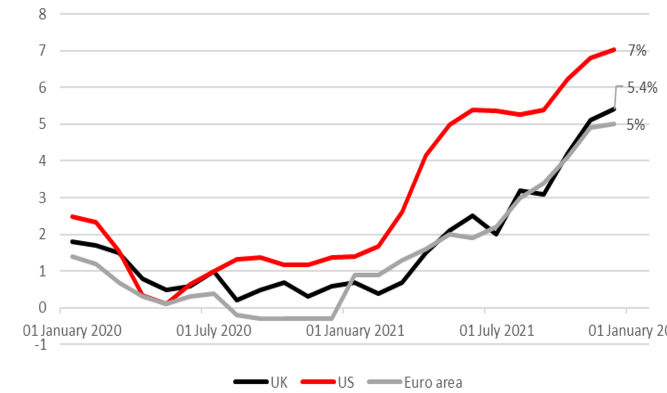
Each month, we discuss 3 key issues facing investors

1. Higher inflation and interest rates: How to position?

- Inflation has hit 7% in the US and 5.4% in the UK due to rising energy, auto prices and rent. But we think prices are peaking, meaning inflation could start to fall by March or even earlier.
- The Fed has signaled a rate hike and the end of quantitative easing (QE) in March. We still expect three 0.25% rate hikes in 2022, less than the four the market is expecting. Hence, we think Treasury yields are unlikely to rise materially further. But there could be volatility due to the uncertainty of how the Fed intends to reverse QE over the coming months, and we now believe that quantitative tightening will start in Q3.
- We upgrade Energy stocks to Overweight to benefit from high energy prices and hedge inflation. We've also upgraded Consumer Staples to Neutral (Global & US) to add portfolio resilience. We remain Overweight on Financials.

Chart 1: A surge in inflation has coincided with the sell-off

Year-on-year % change in prices (CPI)

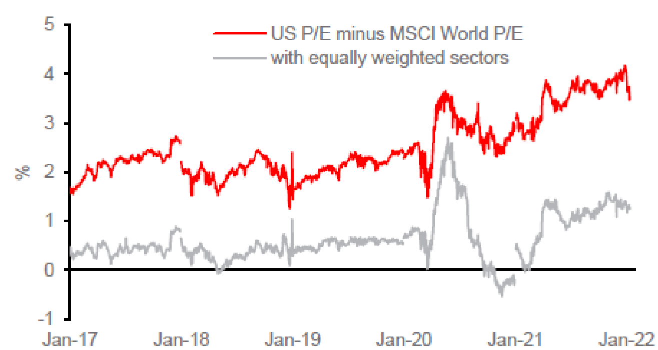


Source: Datastream as at 26 January 2022. Past performance is not a reliable indicator of future performance.

2. Will US equities continue to rise this year?

- US equities delivered a stellar return of more than 26% in 2021. It remains our largest overweight mainly because many US companies have strong market positions to protect their margins.
- But are US equities valuations too high? On the face of it, yes. But upon closer inspection, a lot of their valuation comes from a large weighting in tech. Once you equalize the different sectors, you start to see that US stock valuations are similar to its global counterpart. In fact, the recent sell-off has made US equities more attractively valued.
- However, markets could remain volatile as markets navigate higher inflation and interest rates. We are still bullish on equities, especially in the US, Europe and Asia but a rocky ride is likely. Stay diversified and focus on high quality companies that are better positioned to ride the storm.

Chart 2: The US equity market no longer looks as expensive when we give all sectors the same weight



Source: Bloomberg, HSBC Global Private Banking, 19 January 2022. Past performance is not a reliable indicator of future performance.

3. Where do we see growth in Asia?

- The net zero transition will bring abundant opportunities given that Asia accounts for 52% of all CO_2 emissions. China's manufacturing upgrade will drive capex spending and benefit future tech leaders. Demand for higher quality goods and services will continue to support consumption.
- We prefer ASEAN stocks because consumption should pick up as more markets reopen towards Q2 and start "living with COVID". GDP growth is expected to rise 5.2% for 2022 (3.6% for 2021). Singapore should benefit from resilient global growth, while Indonesia is supported by local demand and infrastructure spending.
- In China, economic activity may stay weak in Q1 due to controls around emission standards and COVID-management. However, the government remains focused on continued growth stability. We remain Neutral on both China stocks and corporate bonds over the short term, but may start to become more positive later this year.

Chart 3: ASEAN is expected to grow stronger in 2022

	GDP	
	2021f	2022f
World	5.7	4.1
Eurozone	5.2	3.8
Asia ex Japan	7.2	5.3
ASEAN	3.6	5.2
Singapore	7.1	3.8
Malaysia	3.6	5.6
Indonesia	3.8	5.1
Mainland China	8.0	5.6

Source: HSBC Global Research, as of 17 December 2021. ASEAN includes Singapore, Malaysia, Indonesia, Thailand, Philippines and Vietnam. GDP aggregates use chain nominal GDP (USD) weights.

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	▲	▲	Equities have struggled as the Omicron variant has cut into near-term growth, but the outlook for equities remains positive thanks to solid fundamentals and supportive policies.
United States	▲	▲	It is our biggest equity overweight due to the size and quality character of our US stock market. Infrastructure, health technology and climate change spending continue to support growth.
United Kingdom	►	▲	The asset class is attractively valued but rate & tax hikes and declining real incomes pose challenge. Longer term, UK indices are heavily exposure to the value factors which offer upside potential.
Eurozone	▲	▲	Valuations are relatively attractive. Growth is well supported by the Next Generation EU fund.
Japan	►	▲	Autos and industrials are hit by supply chain issues but capital goods see good demand.
Emerging Markets (EM)	►	►	Valuations are not particularly cheap. We prefer EM Asia which has fewer rate hikes than elsewhere and ASEAN growth accelerates.
Central & Eastern Europe, Latin America	▼	►	Rate hikes in central Europe & unconventional policies in Turkey pose headwinds in the EMEA region. In Latin America, the benefit of rising commodity prices may fade and further rate hikes are coming.
Asian equities			
Asia ex-Japan	▲	►	COVID has affected growth in the region but it should remain resilient with positive policy support. We look for Asian markets to benefit from the global recovery, particularly ASEAN markets. A stronger consumer class should be a driver of valuations.
China	►	▲↑	In the short term, Chinese markets are struggling with regulatory issues but the long-term fundamentals remain positive enough to make current valuations compelling. Broad policy easing efforts should support growth.
India	►	►	Macro and earnings are supportive, but inflation and monetary tapering are headwinds. Valuations remain stretched.
Hong Kong	►	▲	The economy is being hit by rising Omicron cases and travel restrictions, However, it remains an attractive listing hub underpinned by greater primary and secondary market activity.
Singapore	▲	▲	Singapore is well positioned for a solid recovery benefitting from resilient global growth and government support in the tech space.
South Korea	►	►	Korea can offer exposure to electric vehicle and battery themes, but exposure to growth stocks implies vulnerability to higher global bond yields. Domestic demand will have to play a larger role in supporting growth.
Taiwan	▲	►	Global recovery and demand growth in tech, 5G and semi-conductors warrant our positive stance. Widespread application of sophisticated technologies will drive tech exports. Geopolitical risks remain.
Government bonds			
Developed markets (DM)	▼	▼	Although yields should range trade, we prefer to capture more yield elsewhere.
United States	►	▼	Structural factors such as demographics, globalisation and high indebtedness will continue to keep yields low in the long run, but they could go slightly higher in the short term. We expect a new 1.5%-2% range for the 10-year yield.
United Kingdom	►	▼	Inflation pressures amid supply chain disruption support policy tightening. Risk-adjusted returns look poor.
Eurozone	▼	▼	Prospective returns and diversification benefits are limited. The ECB's bond-buying is also set to decrease in 2022.
Japan	▼	▼	Given Bank of Japan's accommodative policy stance, government bonds yields are likely to remain low.
Emerging Markets (Local currency)	►	▲	Selected opportunities exist but some EM countries are hiking rate and USD remains strong.
Emerging Markets (Hard currency)	►↓	►	Amid higher Treasury volatility and idiosyncratic risks in some EM countries, we still find yield but have become more selective.
Corporate bonds			
Global investment grade (IG)	►	▼	Prospective returns are still unattractive, particularly for longer-duration bonds. We remain defensive and are more positive on shorter-duration bonds and Asia IG.
USD investment grade (IG)	►	▼	Valuations are relatively unattractive especially for longer duration bonds.
EUR and GBP investment grade (IG)	►	▼	Spreads are at historically tight levels and it is important to monitor trends in corporate fundamentals. The ECB is still engaged in substantial corporate bond purchases and the GDP growth should remain robust in the coming quarters.
Asia investment grade (IG)	▲	▲	Asia investment grade offers quality names and issuers with strong implicit government support.
Global high-yield (HY)	▲	▼	High Yield bonds are a good way to invest in the economic growth story. We prefer short-dated Global High Yield to mitigate interest rate volatility. Default-adjusted spreads are at multi-year lows.
US high-yield (HY)	▲	▼	The market is less sensitive to rate volatility, geopolitical risks and benefits from the strength of the US economy, historically low default rate and continues to offer some carry relative to other bond segments.
European high-yield ex UK (HY)	▲	▼	Monetary policy is ultra-accommodative, including ECB measures to support the market. We are positive short-term because of the expected recovery. However, valuations support our long-term underweight position.
Asia high-yield (HY)	▲	▲	Default rates should 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 not benefitting from higher inflation as higher real yields and strong dollar are headwinds. Longer term, upside is also limited by robust growth and higher bond yields amid Fed policy tightening.
Oil	►	▲↑	Demand should weaken in Q1 but inventories are low and OPEC's spare capacity is low. But ongoing robust demand in the expansion phase of the economic cycle (with limited impact from Omicron) and tightening supply-side conditions are supportive over the longer term.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	Consumer sentiment in the US and Europe has slipped on higher energy costs and inflation. Supply chain constraints are likely to remain persistent, albeit easing through H1. The sector may benefit in Q2 from easing COVID restrictions as countries consider the virus endemic. Seasonally, Q1 is usually slower for the sector.
Financials	▲	▲	▲	▲	Banking stocks benefit from rate hikes expectations in an inflationary environment, improving economic outlook and the stimulus package in the US and Europe. Moreover, low valuations, higher trading revenues and M&A activity are supportive. Quarterly earnings results are solid due to higher capital market activity, lower loan provisions and a buoyant real estate market.
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	▲	▲	▶	▲	We remain constructive on the sector and its superior growth prospects as digitalisation, electrification and automation drive long-term above average growth for the next decade. We focus on strong cash-generative businesses and take a more cautious approach to unprofitable companies especially those that lack a strong market position.
Communication Services	▲	▲	▶	▲	The sector benefits from steady cash flows and growth from increased data usage as more activity has shifted online and business digitalised. 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	▶	▶	▶	▶	Slowing growth in China remains a concern. Growth in developed markets, 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	▶	▶	▶	▶	High savings rate and relatively low interest rates support strong demand in private residential real estate. Commercial real estate suffers from low demand as corporates look to reduce office space and retail moves online. The high dividend yield provides attraction in a low yield environment.
Consumer Staples	▶↑	▶↑	▼	▶	Valuations are comparable or higher than some of the cyclical sectors following recent decline in some cyclical sectors. Earnings growth is under inflationary pressures due to higher input material cost and labour shortages. However, the sector contains many quality stocks with good dividend yields, which warrants the upgrade.
Energy	▲↑	▲↑	▲↑	▲↑	Low inventories and supply-demand imbalances continue to drive prices higher. We upgrade the sector to Overweight as we expect energy prices to either stabilise at these levels or push higher. Chronic under-investment is likely to support prices in the medium term despite the energy transition gaining momentum.
Healthcare	▶	▶	▶	▶	Large backlogs in elective surgical procedures should drive strong growth for 2022 for medical technology companies. Biotechnology sector is likely to remain “in play” as new innovative medicines drive sales and positive news flow. Medicine pricing remains a headwind for pharmaceutical stocks.
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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