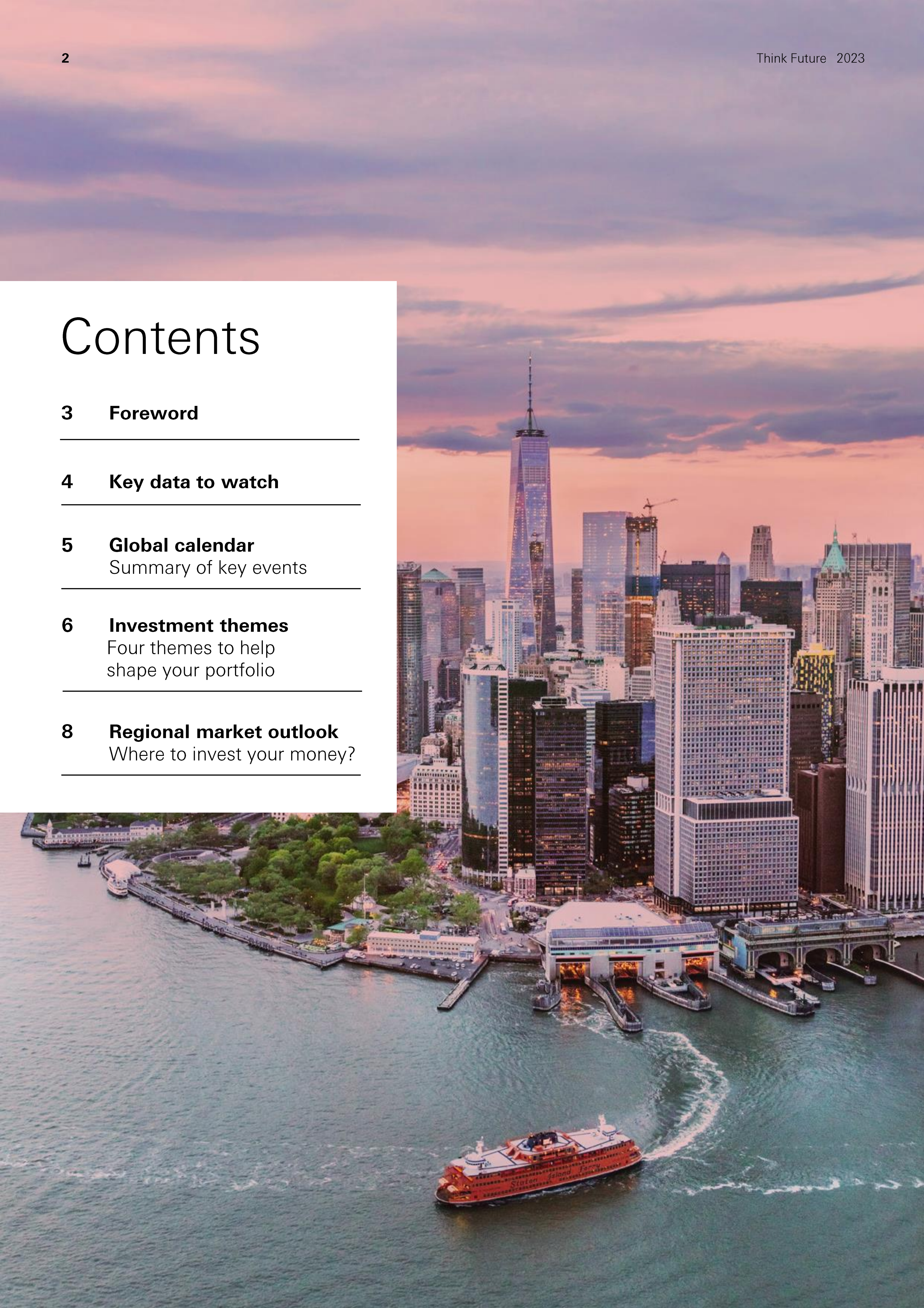
Think Future 2023

Your guide to the global investment landscape

HSBC | Opening up a world of opportunity



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Staying defensive while on the lookout for silver linings

As 2023 dawns, markets will continue to face the familiar twin headwinds of rising interest rates and slowing economic momentum, with US growth well below normal (though still resilient), and the Eurozone and UK in recession. But is the worst behind us?

Despite the ongoing cyclical challenges, opportunities can still be found and a silver lining may be emerging on the rate front. We see key inflation drivers in the US easing – as commodity price pressures, transportation costs and product shortages linked to supply chain disruption have all passed their worst level. Core inflation remains sticky for now but the latest data also provides some hope here, allowing the Fed and other central banks to slow interest hikes in the coming months.

What does this mean for investors?

As bonds have sold off sharply in 2022, they look cheap and attractive from a risk-return perspective when compared to equities. In particular, we **prefer short-dated and investment grade bonds.** Why? Because aggressive rate hikes have already been priced in, and these bonds can be useful diversifiers when economic growth is slowing. We'll start to add more risk (for example, by extending the duration) when both inflation and policy tightening have peaked.

Equities aren't out of the woods yet. Although they're much cheaper than earlier in the year, they remain vulnerable to the slowdown, leading us to seek out **regional advantages and quality stocks** with strong market positions. US stocks continue to stand out from their European counterparts thanks to their diversity and quality characteristics. Meanwhile, some markets in Southeast Asia are well placed to benefit from post-Covid reopening, bringing them into the spotlight.

Mainland China is another silver lining as we see the gradual relaxation of the zero-Covid policy and more stimulative measures coming into play, leading us to turn more positive on Chinese assets. Structural trends are gaining momentum, and those companies in a position to exploit them are most likely to deliver. Better still, many of these stocks are currently trading at attractive values. **Sustainability** is a case in point. While short-term energy security concerns have caused governments to invest in more oil and gas, the long-term investment case is squarely in favour of climate mitigation, renewable power, energy-efficient production and green technologies of all kinds. Infrastructure is another long-term driver where massive funding from governments and corporates will be prioritised to spark economic recovery.

Stay diversified and watch for key milestones

After a volatile, challenging year, investors are at a crossroads. Despite uncertainty around geopolitics and exactly when the rate, inflation and growth cycles will turn, it's worth noting that almost all assets have repriced since early 2022. It's therefore important to stay invested and build a diversified portfolio of high quality assets, while waiting for more clarity to take riskier bets.

Best wishes for a smooth, successful investment journey in 2023.

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

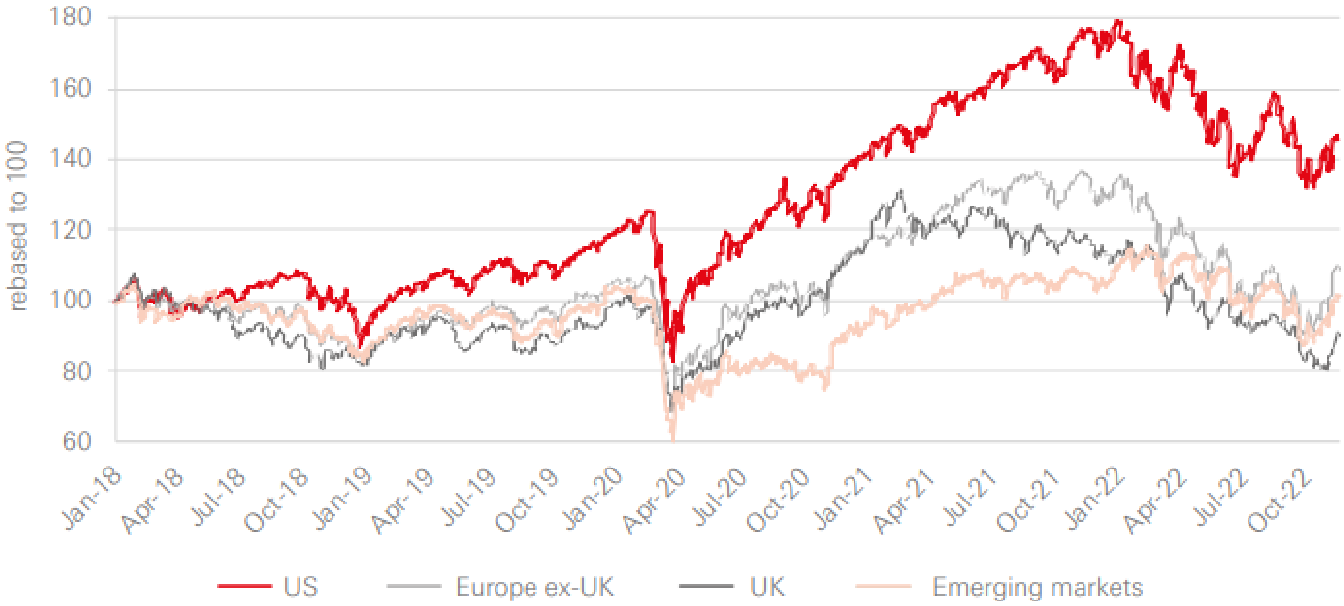
Key data to watch

We expect growth to moderate but global recession is not our base case in 2023

	GDP		Inflation	
	2022f	2023f	2022f	2023f
World	2.9	1.8	8.5	6.7
US	1.7	0.4	8.1	4.7
Eurozone	3.1	-0.2	8.6	6.9
UK	4.3	-0.2	9.1	8.0
Japan	1.2	0.9	2.2	1.0
Mainland China	3.5	5.2	2.2	2.6

Source: HSBC Global Research, as of 18 November 2022. The forecasts are subject to change.

The US market continues to perform more strongly than most other global markets



Source: Refinitiv Datastream, as of 18 November 2022. Past performance is not indicative of future performance. For illustrative purposes only.

High dividend, quality and defensive stocks tend to fall less when equity markets are down

Source: Refinitiv Datastream. Calculation from 2020 to 18 November 2022. Past performance is not indicative of future performance. For illustrative purposes only.

How could our views change when rates peak or growth bottoms?

Current position

- Overweight bonds but with a focus on short maturities and quality borrowers
- Underweight equities to build recession-resistant portfolios
- Less support for USD

Scenarios

What could we change after rates have peaked?

Actions

- Extend duration of bond holdings
- Less challenging environment for tech and other growth stocks
- Stick to quality stocks and bonds

What could we change when economic growth and earnings stabilise?

Actions

- Add to equity exposure and become less defensive
- Selectively add to credit risk
- Geographical preferences depend on improvement to key local challenges
- USD to decline

Global calendar

Key events – First half of 2023

Feb 1	Federal Open Market Committee (FOMC) policy decision
Feb 2	Bank of England (BoE) and European Central Bank (ECB) policy decision
Mar (date TBC)	The 14th National People's Congress of the Chinese Communist Party
Mar 16	ECB policy decision
Mar 22	FOMC policy decision
Mar 23	BoE policy decision
May 3	FOMC policy decision
May 4	ECB policy decision
May 11	BoE policy decision
May 19-21	G7 summit
Jun 14	FOMC policy decision
Jun 15	ECB policy decision
Jun 22	BoE policy decision

Four investment themes to help shape your portfolio

1. Take shelter in quality bonds

Although we see some signs of inflation and interest rates peaking in 2023, they're likely to stay high for a while yet, driving market volatility. Growth isn't likely to come to the rescue, and the Fed is likely to prioritise inflation control while keeping rates in restrictive territory.

Since bond yields have spiked significantly, bonds look more attractive than cash and equities from a risk-return perspective. With aggressive hikes from major central banks already priced in, short-dated bonds with maturities of two to five years can help to navigate interest rate volatility. Meanwhile, as markets focus increasingly on the earnings slowdown, investment-grade credit issued by corporates with strong fundamentals offers compelling yields and a buffer against downturns.

We suggest using high-quality bonds to help diversify your holdings and generate income. Floating-rate instruments like securitised credit, which generally move in line with interest rates, might also be considered. Inflation will erode the value of cash over time, so letting money stand idle is not a sound strategy for long-term investors.

- Short-dated investment-grade bonds in developed markets, emerging markets and Asia offer attractive risk-adjusted returns and diversification benefits
- Floating-rate instruments (e.g. securitised credit) are also favoured

2. Look for regional advantages in the US and Asia

Although the macro outlook isn't positive for equities, the US and Asia continue to benefit from economic reopening, while offering different growth dynamics. Nonetheless, a focus on quality and relative advantages is critical.

Even with the prospect of one or two negative growth quarters in 2023, the US economy remains resilient compared to Europe thanks to strong balance sheets, a healthy labour market, the ongoing tech revolution and increased spending on infrastructure and sustainability. Additionally, political gridlock has historically been positive for equities.

In Asia, some export-oriented, technology-driven economies like Taiwan and South Korea face challenges. But the region's young, increasingly affluent population bodes well for the future: Asia is expected to provide 50% of global consumption growth in the next decade, fuelled by rising incomes and shifting consumption habits.[1] Meanwhile, successful adaptation to pandemic-related disruption, supply chain challenges and the drive towards net zero create further compelling opportunities. Overall, Hong Kong and Southeast Asia are attractive as they continue to reopen and the latter has benefitted from supply chain reorientation. In mainland China, we expect supportive monetary policy to take shape, while structural trends such as infrastructure investment and the green transition should thrive.

- Geographically, the US, Latin America, mainland China and Hong Kong remain our top picks. We focus on quality companies with robust balance sheets, low debt and high profit margins
- We also favour Southeast Asia, in particular Thailand and Indonesia on their economic reopening and undemanding valuations

Note: 1. Source: McKinsey Themes, January 2022

3. Build resilience with defensive sectors

With cyclical risks set to remain high, we continue to favour defensive sectors which are less sensitive to economic downturns.

Energy security and increased investment in renewables are high on most government agendas, so energy stocks, especially upstream companies focusing on exploration and production, should fare well. Meanwhile, consumer staples offer an effective inflationary hedge since companies can protect their margins as prices rise. Conversely, with wages failing to keep pace with inflation in most markets, the consumer discretionary sector is likely to suffer as people spend less on non-essential items due to rising mortgage, food and utility costs.

Investors may also look selectively at the healthcare and real estate sectors for potential opportunities. Europe’s pharma-oriented healthcare sector is in better shape than the US, where biotechnology stocks face financing pressures. While rising interest rates are weighing on residential and commercial property prices, rentals remain a resilient source of income. We also see long-term growth potential in infrastructure as many governments, including the US and mainland China, have embraced infrastructure investment as a policy tool to boost economic recovery.

- We prefer energy and consumer staples (Global, the US, Europe and Asia), healthcare in Europe and utilities in the US
- We explore selective opportunities in the real estate sector and favour infrastructure in general

4. Catch the ESG momentum

Extreme weather events have posed a greater threat than ever before. The need for urgent action on emissions reduction, adaptation measures and higher climate financing was duly reinforced at the 27th Conference of the Parties (COP 27). As government policy, technological innovation and capital expenditure increasingly align with ESG goals, we see growing momentum in clean energy and sourcing income from sustainable companies in particular.

The Russia-Ukraine war has triggered the need for energy independence and diversified energy sources. This imperative is driving government investments in infrastructure, products and services focused on clean energy. For example, the US Inflation Reduction Act includes USD369bn of energy and climate provisions. Mainland China’s multi-year plan to create an innovative economy is also directly tied to energy transition and climate change programmes.

In this complex investment landscape, it’s important for investors to secure diversified sources of income. Companies that prioritise ESG in their strategy and risk management are typically characterised by robust business models and healthy earnings streams. They’re central to our search for quality and their bonds can offer the kind of stable income for investors to manoeuvre in uncertain times

- Focus on renewable power (such as solar, wind, hydro and waste-to-energy), energy efficiency strategies, green infrastructure, and energy-efficient construction materials
- Look for regular income from quality companies with sustainability as their core value

Regional market outlook

▲ Asia (excluding Japan)

In general, inflationary pressures are lower for most Asian nations than for those in the West, allowing central banks to keep rate rises more limited. We have turned more positive on Chinese equities thanks to the gradual relaxation of zero-Covid policy, more stimulative measures for the property market, and attractive valuations. Southeast Asia, which is traditionally a more defensive market, and Hong Kong benefit from their economic reopening.

Meanwhile, a slowing global appetite for consumer electronics is holding back the Asian technology cycle, which impacts Taiwan and South Korea in particular.

Over the next 6 months, we are overweight on:

- **Mainland Chinese equities and Hong Kong equities**
- **Southeast Asia**, particularly Thailand and Indonesian equities
- **Energy and consumer staples sectors**

► Japan

Exports are recovering thanks to improved supply chain conditions in the automotive industry, but this will only partially offset domestic weakness. In inflation terms, Japan continues to be an outlier with slow inflation and meagre wage increases. In contrast to the rest of the world, this will probably keep the Bank of Japan on an accommodative policy path, maintaining downward pressure on JPY. A weak JPY has been giving Japanese companies a competitive advantage so far, but as the USD momentum fades and should JPY see an upside from here, that advantage will fall away.

Our neutral stance on Japanese equities remains unchanged, due to tepid growth expectations.

▲ United States

The US economy is slowing and could endure one or even two negative growth quarters in 2023. It should, however, prove more resilient than Europe. As a net exporter of oil, the country also benefits from current high prices. Turning to the stock market, we see many US companies with strong market positions, allowing them to protect their earnings and margins in today's tough macroeconomic environment. Fed rate hikes should continue to support the USD, although we expect its upward momentum to fade later in the year.

Over the next 6 months, we are overweight on:

- **US equities**, particularly energy, consumer staples and utilities
- **US investment-grade bonds**

▼ Eurozone and ▼ UK

The Eurozone and UK are in recession as a severe cost of living crisis damages consumers' real disposable incomes. We expect further rate hikes from the European Central Bank and the Bank of England to drive up mortgage rates and hurt the housing market. Meanwhile, geopolitical uncertainty and higher borrowing costs are limiting investment.

The ability of governments to act is constrained by rising yields, as seen recently in the UK, where spending increases had to be abandoned. European stocks are cheap compared to US stocks, but risks are higher, and unless growth stabilises or the Russia-Ukraine conflict eases, we see limited scope for a market bounce.

Over the next 6 months, we are overweight on:

- **Energy, consumer staples, healthcare and communication services sectors**
- **European and UK investment-grade bond**

▼ EM EMEA and ▲ EM Latin America

When global risk appetite is under pressure, a selective stance towards emerging markets is advisable.

In equities, we favour Latin America, where Mexico in particular is benefitting from re-onshoring of manufacturing chains and the relative resilience of the US economy. Brazil's inflation is falling and should allow the central bank to cut rates and support the economy. In contrast, we're significantly underweight in EM EMEA, which is impacted by weak EU growth, higher energy prices and low global risk appetite. The exception is the Gulf area, which benefits from high oil prices and is diversifying its economy.

In EM bond markets, we're being selective and focusing on quality borrowers with strong balance sheets, given the considerable increase in USD borrowing costs.

Over the next 6 months, we are overweight on:

- **EM Latin American equities**
- **Bonds from high quality borrowers**, preferably in USD

Notes: The above reflects a 6-month view (relatively short-term) on asset classes for a tactical asset allocation. For a full listing of HSBC's house views on asset classes and sectors, please refer to our Investment Monthly issued at the beginning of each month.

▲ "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.

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