HSBC

Investment Monthly

Volatility ahead, but stay invested

November 2021

Key Takeaways

- We remain positive on risky assets like global and US equities. However, we expect markets to be volatile amidst inflation and supply chain risks.
- We downgrade UK equities to neutral. The UK is suffering from supply chain issues while rising Covid cases and monetary tightening may be headwinds.
- To manage portfolio risk, we downgrade Emerging Market Local Currency Bonds because of their higher volatility within the fixed income universe. Also, they may underperform should the US Dollar strengthen.

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	▲	Inflation and supply chain constraints will keep volatility elevated but mid-cycle profits are still positive, supported by infrastructure spending and inventory rebuild.	▲	Risk assets can still provide decent returns in the expansion phase of the economic cycle, although upside growth surprises are limited and policy normalisation begins. Sticky inflation is a key risk.
Government bonds	▼	Developed markets government bond yields are extremely low and valuations are unattractive, hence we remain underweight.	▼	Valuations have improved amid a repricing of inflation and interest rate risks. Risks to yields remain even if gradual policy normalisation limits the risk of a sharp jump higher.
Investment grade (IG) corporate bonds	▶	We prefer corporate bonds over government bonds given the yield pickup and improving rating trends. We prefer shorter bond duration as markets start to price in Fed rate hikes.	▼	Prospective returns are unattractive and spreads are still tight on the back of accommodative monetary policy, especially for longer-duration credit. Shorter-duration bonds and Asia IG are preferred.
High yield (HY) corporate bonds	▲	As the economy remains healthy and oil prices are high, corporate cash flows are strong. The search for yield continues and High Yield bonds remain appealing.	▼	Default-adjusted spreads are at multi-year lows, implying an asymmetric return profile where positive surprises have limited impact on performance. Asia credits are more attractive.
Gold	▶	Gold could be negatively impacted by the strength of the USD and global central banks' tapering intentions, but still plays a role as an effective inflation hedge and portfolio diversifier.	▶	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.

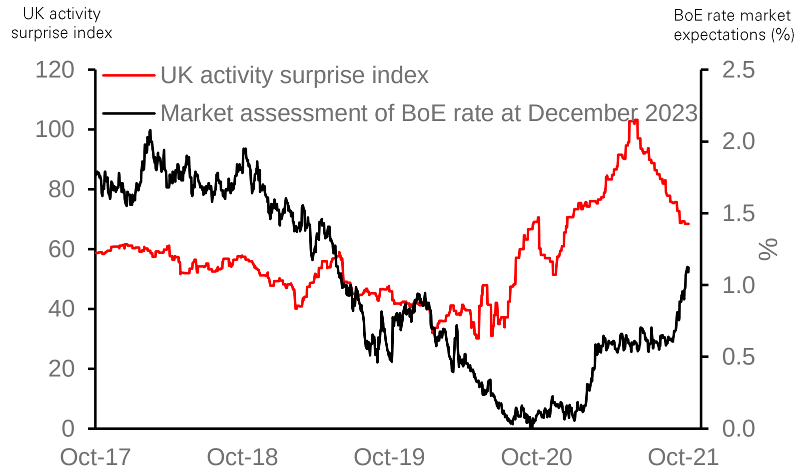
Talking points

Each month, we discuss 3 key issues facing investors

1. What do we think about markets right now?

- **We remain positive on Global and US equities** even if there are concerns about higher inflation and supply chain challenges. While volatility may persist, corporate earnings should remain robust and support stocks. We prefer the financials and consumer discretionary sectors.
- **We downgrade UK equities to neutral**. UK equities have performed well, supported by a weaker Pound Sterling. However, the UK has been hit hard by supply chain issues while rising Covid cases and monetary tightening will become a headwind. The recent UK budget includes some measures for lower income households but higher cost of living remains a challenge.
- **We also downgrade Emerging Market local currency bonds to neutral** in order to reduce portfolio risk. EM local currency bonds tend to be the most volatile fixed income asset class due to its currency component. It may also underperform should the US Dollar strengthen.

Chart 1: UK is hurt by supply chain issues and policy tightening may become an additional headwind



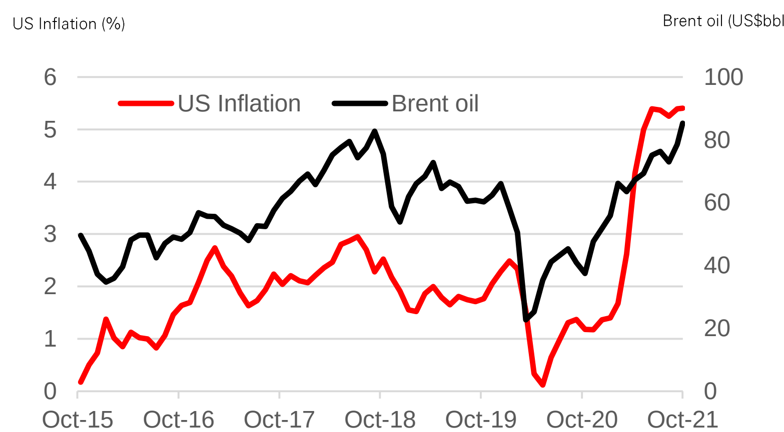
Source: Bloomberg, HSBC Global Private Banking, data as of 17 October 2021. Investment involves risks. Past performance is not an indication for future performance. For illustrative purpose only.

2. Do we still think inflation is transitory?

- **Yes, we expect inflation to be transitory but risks are now higher, and inflation will only fall in Q2 2022.** We think energy prices may remain high short-term even if there may be limited further upside. Supply chain challenges have also proven more difficult to address and may take time to resolve.
- **Central banks should continue to see inflation as transitory and keep policy rates low.** However, markets have started to factor in higher inflation expectations, pushing bond yields higher. This could cause market volatility.
- **The surge in fossil fuel prices is likely to accelerate central banks' commitment to climate change initiatives.** COP 26 underpins the urgency to transition to net zero**.** Copper, steel and cement prices have reached new highs as these are all energy intensive construction materials.

Chart 2: Inflation and energy prices reached new highs

But likely to have peaked as supply should improve with stronger demand



Source: Refinitiv Datastream, Bloomberg, Data as of 21 October 2021.
Indices: US inflation CPI Urban Consumers (YoY) and Brent Oil (generic 1st crude oil).
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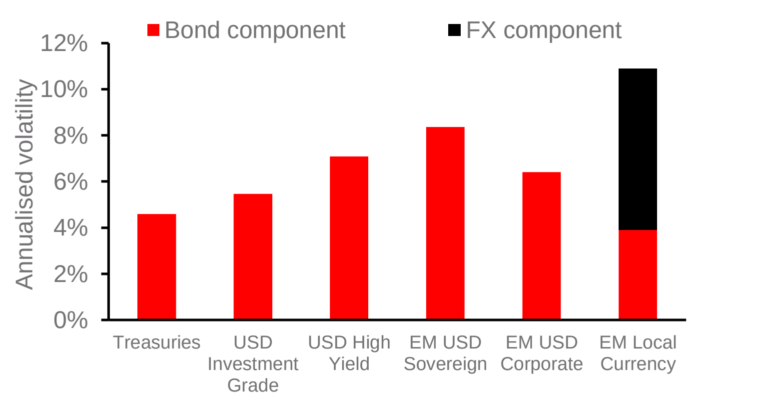
3. Are we worried about volatility and stagflation?

- **Markets could remain volatile if inflation and supply chain concerns continue into 2022.** It is normal for equity returns to slow and volatility to pick up in mid cycle but we tighten the investment opportunity set and focus on active selection, quality companies and portfolio resilience.
- **We are not overly concerned with stagflation** because inflation should tame and the labour shortages should eventually ease, even if this may take more time than previously believed.
- **Our downgrades of UK equities and Emerging Market local currency bonds are driven by a desire to manage overall portfolio risk.** We remain positive on risky assets overall.

Chart 3: Volatility of fixed income sub-asset classes

We downgrade EM local currency bonds to manage portfolio risk



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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	▲	▲	Inflation and supply chain constraints will keep volatility elevated but mid-cycle profits are still positive, supported by infrastructure spending and inventory rebuild. The normalisation planned by several central banks should be gradual.
United States	▲	▶	The third-quarter earnings are expected to look strong. We expect cash-rich companies to increase dividends, share buyback programs and investment spending in Q4, in anticipation of higher corporate taxes next year.
United Kingdom	▶↓	▲	We downgrade UK equities due to rising COVID cases, labour shortages, supply chain disruptions, potential rate hikes in early 2022 and the burden of tax rises, along with the energy crisis and Brexit related pressures.
Eurozone	▲	▲	Economic data was mixed in Europe and slower global growth has impacted European exporters. Longer term, Eurozone equities should continue to benefit from robust economic growth but the upside may be capped.
Japan	▶	▲	Japan benefits from reasonable valuations, strong earnings growth and potential support from a new government, but structural reforms may not be easy and total returns may be negatively affected by JPY weakness.
Emerging Markets (EM)	▶	▶	The renewed inflation fears, stronger USD and slower growth can have a negative impact on EM equities. Additional inflation pressures could prompt central banks to hike earlier than expected (e.g. Brazil).
Central & Eastern Europe, Latin America	▼	▶	EMs in this region face policy headwinds, Covid variants and spikes in inflation. Stubbornly high inflation could drive EM central banks to hike rates, a case in point is Brazil's four consecutive 75bp hikes to 5.25%.
Asian equities			
Asia ex-Japan	▲	▶	The continued expansion of the middle class and the development of an innovative technology sector that creates jobs and wealth are expected to drive long-term wealth creation and short-term growth in the region.
China	▶	▶	China's growth is expected to slow due to new lockdowns. Although valuations have dropped, short-term returns may remain challenged by the property sector fall-out, coal energy crunch and regulatory crackdown. We see opportunities related to its manufacturing upgrade and net-zero transition in the long run.
India	▶	▶	India's economy benefits from market reopening. Pent-up demand will boost consumer discretionary spending, but valuations remain stretched.
Hong Kong	▶	▲	Despite the government's consumption stimulus and an improved labour market, the strict 'zero Covid cases' policy and restrictions of tourism from mainland China and other markets is hurting the local economy in the near term.
Singapore	▲	▲	Singapore equities benefit from strong manufacturing and exports but another spike in local cases is a headwind.
South Korea	▶	▶	Valuations for South Korean equities are demanding. Chip shortage may hurt automobile and tech output.
Taiwan	▲	▶	Taiwan stands out as a beneficiary of global recovery cycle and demand growth in tech, 5G and semiconductors.
Government bonds			
Developed markets (DM)	▼	▼	DM government bond yields are extremely low and valuations are unattractive, hence we remain underweight.
United States	▶	▼	Further jumps in US Treasuries yields are unlikely given the recent run-up pricing in 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	▶	▼	The start of tightening by the Bank of England is a headwind, but reduced deficits support gilts.
Eurozone	▼	▼	Prospective returns are negative and diversification benefits are limited. The ECB's bond-buying is set to decrease in 2022.
Japan	▼	▼	Japanese government bonds (JGB) are overvalued and the bond risk premium remains negative hence we remain underweight. However, the yield curve control framework should limit volatility and higher yields are unlikely.
Emerging Markets (Local currency)	▶↓	▲	Higher inflationary pressures, idiosyncratic risks like China's property tightening and a strong US dollar warrant our downgrade over the short term. EM local debt also represents the most volatile segment within our bond allocation. Longer term, prospective returns are relatively high due to EM currencies being undervalued.
Emerging Markets (Hard currency)	▲	▼	There is a negative correlation between EM debt fund flows and strength of the dollar. We remain constructive on EM hard currency debt because of attractive yields and market factors continue to point to mild USD strength.
Corporate bonds			
Global investment grade (IG)	▶	▼	Bond market pricing implies vulnerability to higher inflation and policy normalisation. Real bond yields remain depressed hence we are neutral in the near-term on Investment Grade corporate bonds.
USD investment grade (IG)	▶	▼	US companies continue to demonstrate strong earnings but USD IG spreads have been compressed and valuations warrant a neutral position, in particular for longer-duration bonds.
EUR and GBP investment grade (IG)	▶	▼	There has been a lot of yield and spread compression this year. Given a relatively flat credit curve and a more dovish ECB relative to the Fed, we are neutral on safe haven bonds due to low yields.
Asia investment grade (IG)	▲	▲	We focus on portfolio resilience and quality selection in mid-cycle, which is why we remain overweight Asia IG.
Global high-yield (HY)	▲	▼	Credit spreads on Global HY have modestly widened, after having well resisted to the shock of the sell-off in Chinese HY markets, which has remained largely contained within China.
US high-yield (HY)	▲	▼	The move to mid-cycle should see USD HY offer attractive carry on a risk-reward perspective over the near term. In the long term, there are uncertainties on the default outlook.
European high-yield ex UK (HY)	▲	▼	European HY bonds, despite mixed economic data in the region, remain a beneficiary of broad economic recovery, a dovish ECB, and exporters benefit from a weaker EUR against the USD.
Asia high-yield (HY)	▲	▲	We remain selectively constructive on Asia credit due to its above-peers growth metrics and high real yields. We think the Chinese government's policy guidelines will strengthen the debt dynamics of the property sector.
Commodities			
Gold	▶	▶	Gold can offer diversification and hedging benefits but upside is limited by higher bond yields, a stronger US dollar, and a reduction in global economic and geopolitical uncertainty after a strong run year-to-date.
Oil	▶	▶	Energy shortage, especially in China and in Europe, has caused a reaction for the commodities sector (excluding precious metals) and for the whole supply chain of industrial and base metals, but market will normalise as supply increases.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	Seasonal demand and supply chain constraints provide a strong pricing environment for companies. Sentiment is positive thanks to rising wages, robust employment prospects, high levels of savings and lower debt levels. We expect upward earnings revisions as domestic travel and hospitality picks up in many developed markets.
Financials	▲	▲	▲	▶	Inflationary pressures are accelerating rate hike expectations, lifting banking stocks performance. The improving economic outlook with stimulus packages in the US and Europe, low valuations, higher trading revenues and M&A activity should be supportive. Q3 results beat expectations on higher capital markets activity, lower loan provisions and a hot real estate market.
Industrials	▼↓	▶	▶↓	▼↓	We downgrade the sector, as input costs (labour, materials and energy) continue to rise which could weigh on margins and profits for the next few quarters. Persistent supply chain issues have weighed on earnings. Historically, low inventories and the shift to greater automation ensure future potential once the immediate issues are addressed.
Information Technology	▲	▲	▶	▲	Trends in digitalisation and new technologies should drive long-term, above-average growth. Shortage in semiconductors is causing short-term challenges, but infrastructure spending should benefit digital infrastructure. The potential impact of regulatory authority actions continues to weigh on sentiment but the focus has shifted from the US to Asian companies.
Communication Services	▲	▲	▶	▲	The sector benefits from steady cash flows and increased data usage as more activity shifted online and business digitalised. Media companies are likely to see robust demand. The 5G roll-out is positive for telecom equipment providers but is neutral/negative initially for service providers.
Materials	▶	▶	▶	▶	The constructive economic outlook is somewhat reflected in valuations. Metal prices have lost momentum in the short term as the Chinese authorities try to cool commodity prices. In the medium term, infrastructure spending related to fiscal stimulus plans in Europe, Asia and the US will likely boost demand.
Real Estate	▶	▶	▶	▶	Demand for private residential real estate is supported by high savings and lower interest rates. Commercial real estate is suffering from low demand as corporates look to reduce office space and retail moves online. High dividend yield continues to be appealing in a low yield environment.
Consumer Staples	▼	▼	▼	▶↑	Valuations appear attractive relative to the cyclical sectors. Slower YoY 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. We upgrade this defensive sector in Asia to make our sector strategy there less cyclical.
Energy	▶	▶	▶	▶	Low inventories combined with supply-demand imbalances will drive prices higher. Continuing chronic under-investment is likely to support prices in the medium term despite the transition of clean energy gaining momentum. We expect further volatility in energy prices and stocks.
Healthcare	▶	▶	▶	▶	Large backlogs in elective surgical procedures should drive growth for medical technology companies. Biotechnology sector will benefit as new innovative medicines drive sales and positive news flow. Pricing remains a headwind for pharmaceutical companies due to policy and regulations.
Utilities	▼	▼	▶	▼	Renewable stocks are gaining 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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