Investment Monthly

When rates plateau, markets focus on growth differentials

October 2023

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Key takeaways

- As we believe the Fed is done with rate hikes, the question now lies in the length of time of the "rate plateau" and markets should turn their focus on growth differentials. The resilient US economic and earnings outlook supports our preference for US stocks over Europe, and we continue to diversify our sector exposure to IT, consumer discretionary, industrials and healthcare.
- With real rates standing at 18-year highs, we see opportunities in US Treasuries and global IG credit with medium durations to lock in attractive yields for longer. Higher rates for longer may lead to further credit tightening which is less favourable to high yield, and we thus reiterate our preference for quality bonds.

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- India stands out as a bright spot in Asia with its strong structural growth, favourable demographics and focus on digitalisation. Strong earnings prospects warrant their higher valuations and our overweight on Indian stocks, particularly in banks and IT companies. The inclusion of local sovereign bonds by JP Morgan in their GBI-EM benchmark indices presents attractive opportunities in Indian local currency bonds. The investment case for both equities and bonds in India is compelling and we maintain our broad-based exposure to capture the dynamic growth in Asia.

Asset class	6-month view	Comment
Global equities	►	The global slowdown in economic activity is less severe than expected but divergent economic growth, persistent inflation and higher interest rates remain headwinds. We prefer the US, ASEAN and India and focus on quality.
Government bonds	►	We believe peak rates and slow global growth should support government bond performance.
Investment grade (IG) corporate bonds	▲	We maintain our overweight as spreads adequately compensate investors and prefer medium durations to lock in yields at high levels for longer.
High yield (HY) corporate bonds	►	We prefer investment grade over high yield as reduced bank lending could lead to fears of higher default rates, which should cause high yield spreads to widen.
Gold	►	While peak interest rates can provide some support, the strengthening dollar may be an obstacle for gold.

▲ "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.

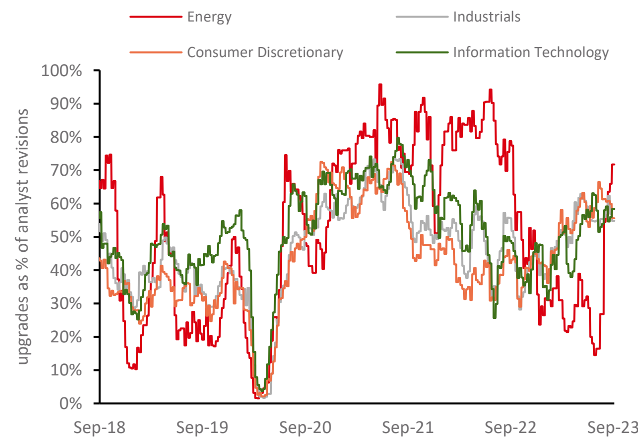
Talking points

Each month, we discuss 3 key issues facing investors

1. What are the implications of policy rate plateau in the US?

- The Fed pause in its September meeting indicated that policy makers have shifted their focus from rate hikes to how long they should leave policy rates at the peak (the "rate plateau"). Given falling core inflation and the lagged effects of all the rate hikes, we believe the Fed is done with the hikes although markets have priced in a 50% chance of one more hike this year. We expect policy rates to remain unchanged at 5.25-5.50%, with 0.5% in rate cuts starting in Q3 2024.
- Rate plateaus are historically good for riskier assets in the 6 to 12 months following the final rate hike. The end of the hikes also means that policy rates will now give less direction to markets, and the focus should turn to economic growth. The US economy is well supported by a resilient labour market, falling inflation and the stimulus of the Biden administration (e.g. the Inflation Reduction Act which supports re-onshoring and other activities), reinforcing our view of a soft landing this year.
- **We maintain our preference for the US over Europe,** focusing on companies that can deliver on earnings. Although the end of the rate hikes should ease the headwinds for growth stocks, we diversify our sector exposure to **IT, consumer discretionary, industrials and healthcare to capture the growth potential.** We have also shifted to a bullish USD stance.

Chart 1: US earnings momentum is positive in IT and other sectors, supporting broad-based exposure

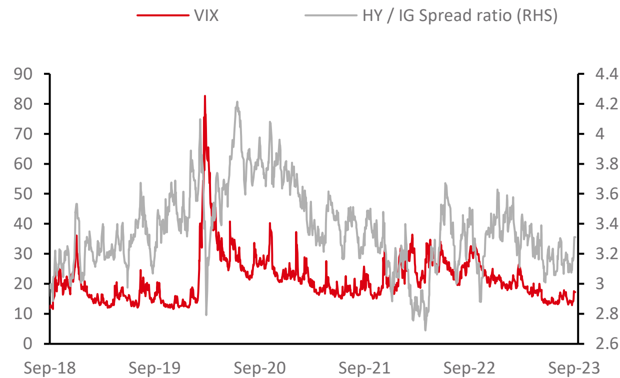


Source: Bloomberg, HSBC Global Private Banking and Wealth as at 25 September 2023. Past performance is not a reliable indicator of future performance.

2. What is our bond outlook amid a "higher for longer" scenario?

- The end of the hike cycle has historically signalled the peak in bond yields, which is negative for cash but constructive for bonds. Peak policy rates and high real yields, which are currently at 18-year highs, support our preference for high quality bonds.
- Our overweight positions in bonds include US Treasuries, investment grade credit and selective EM hard currency corporate bonds with a medium duration preference (5-7 years) to lock in attractive yields for longer, while the dovish BoE tone allows us to go longer for UK gilts (medium-to-long).
- The longer rates stay elevated, the more the tightening of lending conditions, which is less favourable to the weaker and lower-rated companies and will potentially lead to higher default rates. We continue to prefer investment grade over high yield, which appears expensive relative to investment grade, especially in USD.

Chart 2: A long rate plateau could hurt high yield while investment grade should be more resilient

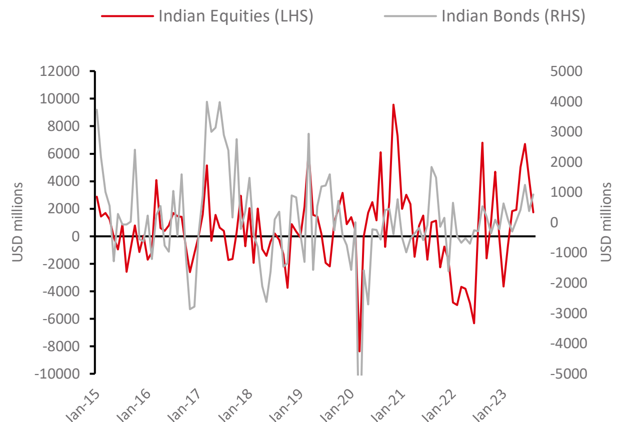


Source: Bloomberg, HSBC Private Banking as at 7 September 2023. Past performance is not a reliable indicator of future performance.

3. What makes India stand out in Asia?

- Asia remains attractive because of its improving fundamentals, domestic momentum and less inflationary pressure, leaving room for central banks to loosen monetary policies. **We remain overweight on Asia ex Japan equities** and adopt a broad-based exposure to capture growth momentum.
- Within the region, India is a bright spot with its strong structural growth, favourable demographics and focus on digitalisation. According to Bloomberg, consensus 2024 earnings growth is projected at 16% y-o-y, supported by a potential rebound in rural demand and margin expansion. **We overweight Indian stocks and prefer banks and IT companies**.
- The Indian bond markets should benefit from the inclusion of their local sovereign bonds by JP Morgan in their GBI-EM benchmark indices. The move is expected to attract more than USD20bn from local and foreign investors, **providing attractive opportunities in Indian local currency bonds.** We are turning more bullish despite short-term inflationary pressures, and foresee further strengthening of the macroeconomic backdrop, the local economy and the rupee.

Chart 3: Investment flows continue to be positive for India, in both equities and bonds



Source: IIF, HSBC Global Private Banking as at 25 September 2023.

Asset Class Views

Our latest house view on various asset classes

Asset class	6-month view	Comment
Global equities		
Global	▶	The global slowdown in economic activity is less severe than expected but divergent economic growth, persistent inflation and higher interest rates remain headwinds. We prefer the US, ASEAN and India and focus on quality.
United States	▲	Solid economic growth, continued disinflation and potential rate cuts in 2024 are positive for US equities and reinforce market expectations for a soft landing this year. The potential for a government shutdown and ongoing strikes may create short-term volatility.
United Kingdom	▶	Weak economic momentum, sticky inflation and rising wages remain headwinds for growth but valuations of the equity market remain relatively cheap.
Eurozone	▼	Services and manufacturing data continue to weigh on growth. Sticky inflation and high exposure to China are obstacles for European stocks. Germany is hard hit by weak local demand and high exposure to China.
Japan	▶	While cyclical indicators are supportive, valuations are elevated. We stay neutral on Japanese equities.
Emerging Markets (EM)	▶	Growth momentum is positive in emerging markets, particularly parts of EM Asia and EM LatAm, which benefit from a rebound in tourism and improved fundamentals (including rate cuts in LatAm).
EM EMEA	▼	The region is impacted by high energy prices and weak growth in Europe. Turkey looks relatively attractive on improved macroeconomics and attractive valuations.
EM LatAm	▲	Local rate cuts and the re-industrialisation of North America are positives.
Asia ex Japan equities		
Asia ex-Japan	▲	Asia remains attractive because of its improving fundamentals, domestic momentum and less inflationary pressure. We take broad exposure to Asian markets favouring India and Indonesia and look for selective opportunities in mainland China and Hong Kong.
Mainland China	▶	The resumption of Chinese group tours abroad and improvement in international flight capacity could boost consumer spending, airlines and Macau gaming within the service consumption sector. The property sector remains challenged.
India	▲	Service exports and consumption are still gaining momentum. Long-term structural growth is supported by demographics dividends, manufacturing renaissance and the rise of the middle class.
Hong Kong	▶	Despite new policy measures, the sentiment of the housing market remains weak. That said, valuations are reasonable and we see opportunities in insurance and consumption sectors.
Singapore	▶	We expect ongoing recovery in the travel and consumer-related sectors could potentially absorb some negative impact from the global demand slowdown and prevent Singapore from entering into a recession this year.
South Korea	▶	Weak global demand for goods and the slow recovery in global smartphones remain headwinds to the equity market.
Taiwan	▶	Despite weak global demand and elevated inventory levels, the equity market is supported by a tech and AI-driven rally.
Government bonds		
Developed markets (DM)	▶	We believe peak rates and slow global growth should support government bond performance.
United States	▲	We remain overweight on US Treasuries to capture attractive yields at cycle-peak levels. As we expect 10-year Treasury yields to decline more gradually, we have changed our rate cut projection to start in Q3 2024.
United Kingdom	▲	Gilts remain at attractive levels. With the prospects of rate cuts, we expect further falls in yields and prefer a medium-to-long duration.
Eurozone	▶	EUR investment grade credit of medium duration are attractive on a valuation basis. Credit spreads have shown signs of resilience.
Japan	▼	Based on our central view that the Bank of Japan will remove its Yield Curve Control in 1Q 2024 and absolute yields remain unattractive, we remain underweight on Japanese government bonds.
Emerging Markets (Local currency)	▶	Select opportunities exist as some countries cut rates but much is priced in. We upgrade Indian bonds this month.
Emerging Markets (Hard currency)	▶	Amid higher Treasury volatility, we still find yield but remain selective.
Corporate bonds		
Global investment grade (IG)	▲	We maintain our overweight as spreads adequately compensate investors and prefer medium durations to lock in yields at high levels for longer.
USD investment grade (IG)	▲	We remain overweight on USD investment grade which offers attractive yields on an absolute basis.
EUR and GBP investment grade (IG)	▲	With rates plateauing, we continue to favour investment grade bonds to lock in current attractive yields.
Asia investment grade (IG)	▲	As we believe that US policy rates have peaked, we prefer high quality names to lock in yields at current levels, including Indian IGs, Indonesian quasi-sovereign IGs, South Korean issuers and select banks and insurers in Asia.
Global high-yield (HY)	▶	We prefer investment grade over high yield as reduced bank lending could lead to fears of higher default rates, which should cause high yield spreads to widen.
US high-yield (HY)	▶	Tighter financial conditions weigh on company margins and increase the risk of defaults. We remain selective and prefer quality issuers with strong market positions and manageable debt.
EUR and GBP high-yield (HY)	▶	Weak earnings growth and rising defaults remain headwinds, which are not priced in credit spreads.
Asia high-yield (HY)	▶	We remain negative on Chinese property-related high yield bonds and expect default rate to rise.
Commodities		
Gold	▶	While peak interest rates can provide some support, the strengthening dollar may be an obstacle for gold.
Oil	▶	The combination of tighter fundamentals and improved market sentiment will likely keep oil prices elevated in the coming months.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	Inflationary pressures have eased in many regions. Discretionary spending is improving, especially in the services segment with airlines, hotels, restaurants and resorts benefitting. Automakers are seeing modest improvement in orders. The luxury goods segment reported softer US demand in Q2, but many companies still delivered 20% sales growth, so may see profit taking after a strong run.
Financials	▲	▲	▶	▶	The sector is trading on attractive valuations and high interest rates are fuelling profits for the lenders. Although the interest rate cycle is close to peaking, higher rates are likely to persist. Regional banks face headwinds as mortgage and loan activity declines mainly due to higher interest rates. US financials are expected to benefit from improving fundamentals and low valuations, as well as a pick-up in capital market activity, triggering upgrades to revenue and earnings forecasts.
Industrials	▲	▲	▶	▶	After an optimistic start to the year, slowing economic growth, sticky inflation and the possibility that interest rates will remain elevated are weighing on sector sentiment. China's growth lacks momentum, with demand for industrial goods remaining somewhat muted. Asian industrials continue to lag on a slower regional growth outlook and slower demand. In contrast, US industrials are gaining momentum as reshoring, fuelled by the US's Inflation Reduction Act (IRA) and Creating Helpful Incentives to Produce Semiconductors Act (CHIPS), is boosting activity.
Information Technology	▲	▲	▲	▲	Improved business and consumer sentiment is driving demand in certain sub-segments including digital, AI and automation. Fundamentals continue to improve with solid Q2 sales and earnings reported to date while cloud computing growth is showing signs of slowing from elevated levels.
Communications Services	▶	▶	▼	▲	The fundamentals remain positive, particularly in the US where earnings growth is expected to be strong, and valuations remain attractive even after a strong YTD performance. The outlook in Europe, which is more focused on telecom services, remains challenging. Asia offers a more attractive risk-return profile due to its low valuations and stabilising regulatory environment.
Materials	▶	▶	▶	▶	Weak demand coupled with rising energy and feedstock prices remain major headwinds for base metals and chemicals producers. Unsurprisingly, sector stock valuations are depressed. Demand for commodities for electrification (EVs, tech and renewables) continues to be supportive.
Real Estate	▼	▼	▶	▼	The sector is challenged by rising interest rates and softening demand in many categories. In China, the sector is again entering a period of uncertainty. As a result, overall activity has declined, with new build projects being delayed because of uncertain demand and spiralling costs.
Consumer Staples	▶	▶	▶	▲	Global and European consumer staples are experiencing a more challenging pricing environment, especially as cost pressures have receded. Following last year's above-inflation price rises, tough YoY comparables and full valuations, we expect lack-lustre results going forward. We focus on quality stocks with strong brands and more resilient pricing power.
Energy	▶	▶	▲	▶	OPEC+ continues to tighten oil supplies, leading to higher oil and gas prices. Stock performance has somewhat lagged as markets question the sustainability of higher prices. Valuations remain very low relative to other sectors despite robust cash flow and stable high dividends.
Healthcare	▶	▲	▶	▼	We remain positive on the US sector and expect earnings and sales growth to pick-up in the next 12 months on new product launches and less challenging YoY comparables for some companies following major patent expirations. In Asia, valuations remain elevated, trading well above historical levels.
Utilities	▶	▼	▲	▶	European sector valuations remain attractive with supportive earnings revisions. The US Inflation Reduction Act (IRA) and Europe's green initiatives should continue to be supportive. Stable earnings/cash flow characteristics and high dividend yielding stocks appeal to more cautious investors.

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