HSBC

Investment Monthly

A more positive outlook for UK equities further broadens our equity exposure

July 2024

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Key takeaways

- While fundamentals remain resilient in the US, the slowdown from excessively strong to more average growth levels should help the Fed decide on a rate cut in September. We remain overweight on US stocks but have moved to a more balanced sector stance by upgrading Utilities and downgrading Industrials.
- With an improved UK economic outlook, falling inflation supporting an August rate cut, cheap valuations and attractive dividend yields, we upgrade UK stocks to overweight. While the UK elections do not seem to concern markets, the French snap elections have increased political uncertainty. We remain neutral on Europe ex-UK stocks but see opportunities in global leaders in the IT, Consumer Discretionary, Energy and Healthcare sectors.


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- Following the rate cut by the ECB in June, we expect the Bank of England and the Fed to act in August and September, respectively. As bond yields have likely peaked, we focus on locking in current attractive yields from US Treasuries and UK gilts with medium-to-long duration, and investment grade (IG) credit with medium duration. Any sizeable widening in European IG bond spreads is seen as a buying opportunity. The rate differentials and a strong USD make USD investment grade relatively more attractive.

Asset class	6-month view	Comment
Global equities	▲	Global manufacturing is on a recovery path. With an improving global cyclical outlook, positive earnings momentum and the prospect of rate cuts, we look beyond the US and Technology to capture more broad-based upside.
Government bonds	▶	As rate cuts should come soon in the US and UK, we focus on locking in current bond yields which are still near decade-high levels. Japanese government bonds remain unattractive.
Investment grade (IG) corporate bonds	▲	Amid slowing global growth and rising geopolitical uncertainty, we continue to prefer investment grade over high yield bonds as interest rate risk is more attractively priced than credit risk.
High yield (HY) corporate bonds	▶	We remain neutral as the spread pick-up in high yield bonds is insufficient for rising default risks.
Gold	▶	Uncertainty has driven gold to high levels but demand is likely to be capped at the current price.

▲ "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.

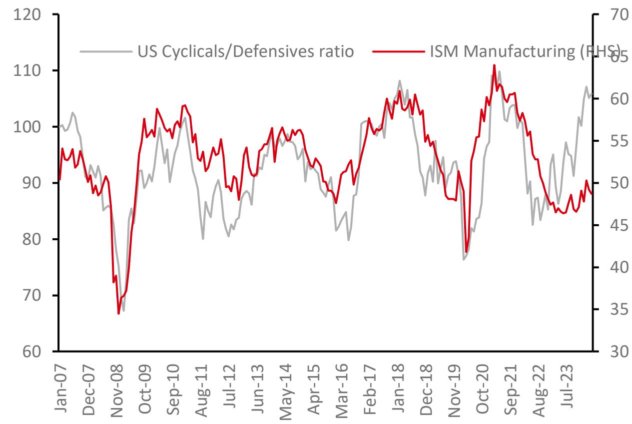
Talking points

Each month, we discuss 3 key issues facing investors

1. How should investors read the mixed economic data in the US?

- US earnings momentum continues to remain strong in Q2 which is forecast to grow 8.8%, marking the highest year-on-year growth since Q1 2022. However, economic activity is slowing from a peak of 4.9% in Q3 2023 to an expected 2.4% rate for 2024.
- The slowdown from excessively strong to more average growth levels and easing labour market pressures are not bad for equities as they allow the Fed to cut rates in September. The projection from the Fed of only one 0.25% cut in 2024 and a total of 2.25% through year-end 2026 is supportive of US equities.
- While strong earnings momentum, the prospect of rate cuts and secular trends warrant our overweight on US equities across sectors, we have moved from a cyclical to a more balanced sector stance by downgrading Industrials where performance has started to struggle and valuations are relatively high. We upgrade Utilities due to their cheap valuations and indirect exposure to the data economy and AI, which will drive increased electricity consumption. We continue to stay bullish on IT, Communications, Consumer discretionary, Financials and Healthcare.

Chart 1: The outperformance of cyclical sectors is not supported by economic indicators

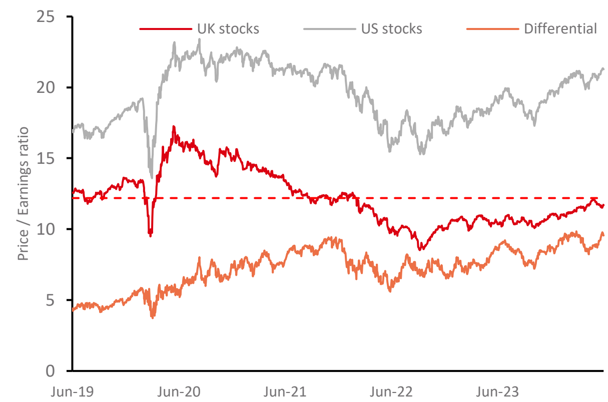


Source: Bloomberg, HSBC Global Private Banking and Wealth as at 23 June 2024. Past performance is not a reliable indicator for future performance.

2. As the economic cycle of the UK has bottomed, what is its outlook?

- With expected GDP growth of 0.9% for 2024 and 1.3% for 2025, along with improving PMIs, we believe the UK has come out of recession. Falling inflation should ease cost pressures and support the Bank of England to start cutting rates in August.
- Currently, the UK equity market is offering attractive dividend yields (e.g. 4% from FTSE100), well above the US (1.3%) and Europe ex-UK (3.2%). Moreover, valuations are at their 5-year average and the cheapest level compared to US stocks in many years, further boosting M&A activity. Despite the upcoming UK elections, monthly ETF flows reached a multi-year high in May. The fiscal prudence promised by the Labour lead has gained some confidence from the markets.
- Elsewhere in Europe, the announcement of the French snap legislative elections following a heavy defeat of the French incumbent party in the European Parliament Elections has created rising economic and political uncertainties. We have reduced exposure to French equities and downgrade European financials to neutral. While we maintain neutral on Europe ex-UK equities, we see opportunities in the IT, Consumer Discretionary, Energy and Healthcare sectors in the region, preferably those global companies with strong earnings power.

Chart 2: UK stocks are trading at cheap levels compared to markets and in line with their history

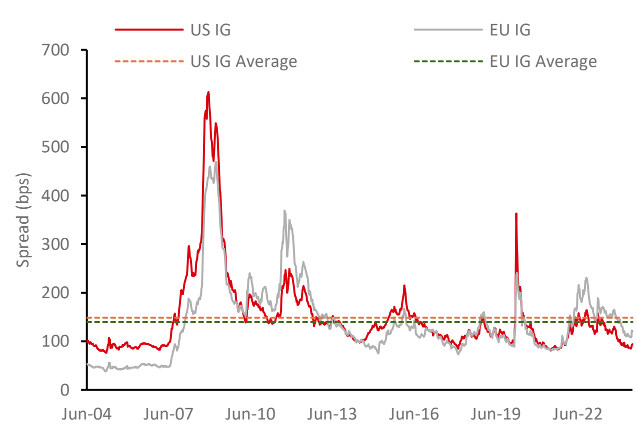


Source: LSEG, HSBC Global Private Banking and Wealth as at 26 June 2024. Past performance is not a reliable indicator of future performance.

3. How will rate cuts and politics affect the bond markets?

- Following the central banks in Switzerland, Sweden and Canada, the ECB delivered its first rate cut in June. Our base case remains for two further cuts this year. All eyes are now on the Bank of England and the Fed, which are expected to act in August and September, respectively.
- While France represents the second largest country in the EUR investment grade universe, we see limited contagion impact on other countries in the region. The ECB policy and the pace of future cuts should remain the key driver for bonds over the medium term.
- As the start of the cutting cycle reinforces our view that bond yields have peaked, we focus on locking in current attractive yields from quality bonds for better risk-adjusted returns, including US Treasuries and UK gilts with medium-to-long duration. We continue to hold our overweight stance on investment grade (IG) with medium duration and see any sizeable widening in European IG bond spreads as a buying opportunity. The rate differentials and a strong USD make USD investment grade relatively more attractive than that of the EUR and GBP.

Chart 3: Muted reaction from European credit spreads



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 21 June 2024. Pas performance is not a reliable indicator of future performance.

Asset Class Views

Our latest house view on various asset classes

Asset class	6-month view	Comment
Global equities		
Global	▲	Global manufacturing is on a recovery path. With an improving global cyclical outlook, positive earnings momentum and the prospect of rate cuts, we look beyond the US and Technology to capture more broad-based upside.
United States	▲	While fundamentals remain supportive with strong earnings momentum, the prospect of rate cuts and secular trends, our sector stance is more balanced with exposure to IT, Communications, Consumer Discretionary, Utilities and Healthcare.
United Kingdom	▲↑	Given the tailwinds of a better growth outlook, falling inflation and the prospect of rate cuts, combined with cheap valuations and attractive dividend yields, we upgrade UK equities to overweight.
Europe ex-UK	▶	As the economic cycle has likely bottomed, we expect earnings to recover in H2 and favour quality large-cap companies. However, political uncertainty has increased around the snap legislative elections in France. We maintain our neutral stance.
Japan	▲	The reflationary trend supported by solid wage growth, corporate governance reforms, recovering earnings growth and the AI boom are key drivers for Japanese stocks. We expect the BoJ to keep the financial condition accommodative.
Emerging Markets (EM)	▶	We expect more emerging markets to cut rates in H2 2024. Corporate earnings growth is expected to rebound sharply for EM Asian markets in 2024.
EM EMEA	▼	The region is impacted by high energy prices and global interest rates, as well as geopolitical uncertainty.
EM LatAm	▼↓	We see greater political uncertainty in Mexico following a larger-than-expected victory for the incumbent party and ahead of the US elections. Sticky inflation and slowing rate cuts may also trigger selling in Brazil. Earnings are weakening too.
Asia ex Japan equities		
Asia ex-Japan	▲	The region is expected to deliver well-above global average economic growth thanks to strong growth momentum in India and the global AI-driven investment benefitting South Korea.
Mainland China	▶	The recent economic data still suggested an uneven path to growth recovery. We prefer undervalued quality stocks in the service consumption and high-end manufacturing sectors, as well as quality SOEs. Valuations remain attractive.
India	▲	As India's pro-growth structural reforms are expected to continue under the newly formed NDA government, we stay bullish on Indian equities and prefer large-cap companies given their stronger fundamentals and better valuations.
Hong Kong	▶	Investors are reassessing the policy and growth outlook. We prefer the insurance, telecom and utility sectors, as well as quality REITs and developers amid cyclical headwinds from high interest rates and mainland China's economic transition.
Singapore	▶	As core inflation remains sticky, we expect the central bank to keep interest rates on hold in 2024 and see pockets of opportunity in high-quality REITs on their undemanding valuations.
South Korea	▲	The AI investment boom, improving memory pricing trend and robust earnings growth support strong consensus EPS earnings forecasts for 2024 while the "Corporate Value-Up Programme" brings attractive re-rating opportunities.
Taiwan	▶	The equity market is benefitting from the AI boom and tech recovery cycle. However, valuations are not cheap compared to historical levels and geopolitical concerns remain.
Government bonds		
Developed markets (DM)	▶	As rate cuts should come soon in the US and UK, we focus on locking in current bond yields which are still near decade-high levels. Japanese government bonds remain unattractive.
United States	▲	With lower-than-expected headline and core CPI data in May, and the Fed's median dot plot suggesting one 0.25% rate cut in 2024, we focus on locking in attractive bond yields ahead of the policy easing cycle likely to start in September.
United Kingdom	▲	As markets are pricing in a higher chance of the first rate cut in August, we focus on locking in current attractive yields and look for more dovish guidance from the BoE after the election.
Eurozone	▶	Despite widening spreads in French government bonds, we see limited spill-over risks across other countries. As the absolute yield levels are still lower in Europe than in the US, we maintain our neutral stance.
Japan	▼	With a gradual normalisation of monetary policy that keeps the current economic recovery and the reflationary momentum going, we expect the BoJ to lift its policy rate to 0.75% by end-2025. Japanese government bonds remain unattractive.
Emerging Markets (Local currency)	▼	The stronger USD and slowing disinflation put pressure on some EM economies. We stay positive on Indian local currency bonds for yield pick-up and diversification benefits.
Emerging Markets (Hard currency)	▶	We prefer developed market investment grade on a relative basis. However, we still find opportunities in selected quality issuers in emerging markets, where the yields remain appealing.
Corporate bonds		
Global investment grade (IG)	▲	Amid slowing global growth and rising geopolitical uncertainty, we continue to prefer investment grade over high yield bonds as interest rate risk is more attractively priced than credit risk.
USD investment grade (IG)	▲	A slowdown in economic activity and attractive spreads support our focus on quality credit. A strong dollar makes USD investment grade more attractive than its counterparts.
EUR and GBP investment grade (IG)	▲	We see any sizeable widening in European investment grade bond spreads as a buying opportunity and prefer large-cap companies with well diversified business models across countries and regions.
Asian investment grade (IG)	▲	The fundamentals for Asian IG bonds remain solid with the current valuations well supported by the tight supply. We prefer Asian financials, Indian local currency bonds, Indonesian quasi-sovereign bonds, Macau gaming and Chinese TMT.
Global high-yield (HY)	▶	We remain neutral as the spread pick-up in high yield bonds is insufficient for rising default risks.
USD high-yield (HY)	▶	Although defaults remain low and refinancing risk is manageable, risk premia are too low in our view, so we continue to prefer investment grade on a relative basis.
EUR and GBP high-yield (HY)	▶	Although growth may have bottomed at the end of last year, spreads in high yield remain on the tighter end of historical averages, so are less attractive in our view.
Asian high-yield (HY)	▶	We focus on quality issuers in the region as lingering headwinds in the property market and mixed economic recovery trajectory in mainland China and Hong Kong remain challenging.
Commodities		
Gold	▶	Uncertainty has driven gold to high levels but demand is likely to be capped at the current price.
Oil	▶	While geopolitics provide support for oil, spare capacity limits the upside. We expect oil prices to trade sideways.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▲	▲	▲	▲	Consumers have adapted to the higher interest rate environment helped by easing inflation and higher wages. The outlook for hospitality and tourism looks particularly constructive although luxury goods sales growth is more muted. Unseasonal weather is again disrupting seasonal buying patterns. Autos remain in turmoil as consumers are switching to hybrid vehicles rather than EVs due to poor EV charging infrastructure. Home appliance demand remains subdued pending a recovery in home sales.
Financials	▲	▲	▶↓	▶	After a period of outperformance, we downgrade European Financials given the less attractive risk-reward scenarios particularly in France and to a lesser extent in Germany. Globally and in the US, the sector continues to benefit from a steadily improving economic backdrop and capital market activity, including M&A, IPOs and bond issuance. Interest rates look set to decline slowly with a modest impact on earnings in 2024. Regional banks with significant exposure to the real estate sector and loans remain an area of concern.
Industrials	▶↓	▶↓	▶	▲	Tactically, we downgrade US and Global Industrials following a period of outperformance as price momentum has stalled on negative news flow related to the aerospace segment there. Medium term, we remain constructive on the sector as government policy remains supportive in China, Europe and especially the US where the Inflation Reduction Act (IRA) and CHIPS Act are driving significant investments in new production capacity and infrastructure.
Information Technology	▲	▲	▲	▲	Big tech stocks have seen some pull-back as the rally broadens. AI will be the key driver for the sector as the technology becomes increasingly embedded leading to product and service capability enhancements, productivity gains and competitive differentiation. The next wave of AI development should benefit digital infrastructure companies focused on cloud, data centres, software and cooling technologies.
Communications Services	▶	▲	▼	▲	The US Communications sector continues to deliver stellar earnings growth as fundamentals and attractive prices continue to attract investors. In Asia, the stabilising regulatory environment and low valuations offer an attractive risk-return profile. In contrast, Europe's telecom services sector has little room for optimism.
Materials	▶	▶	▶	▶	Copper prices are well supported by rising renewables, electrical and digital infrastructure demand plus some strategic inventory building in China. Iron ore, steel and EV battery materials remain lacklustre. M&A has sparked interest in the miners while chemical stocks remain range-bound.
Real Estate	▼	▼	▶	▼	The outlook for commercial real estate is mixed, with retail and office segments still looking unattractive, while warehousing is seeing improved demand and prices after a sustained period of weakness. The housing sector in some markets is showing tentative signs of improving sentiment in anticipation of lower interest rates. Chinese real estate remains problematic. Easing inflation and interest rates may lift sentiment and activity.
Consumer Staples	▶	▶	▶	▲	The cost margins appear secure as cost pressures have somewhat eased. The sector should benefit from strong seasonal demand with solid results going forward despite tough YoY comparables and is trading in line with historical valuations. We focus on quality stocks with strong brands and more resilient pricing power.
Energy	▶	▶	▲	▶	Low valuations, strong cashflow and high dividends appear to be insufficient to change sentiment towards the sector as energy prices remain range-bound. On a seasonally-adjusted basis, supplies appear plentiful and inventories remain adequate, helped by the relatively mild winter in Europe. In 2024, energy prices may not benefit from geopolitical uncertainty as they have over the last two years.
Healthcare	▲	▲	▲	▼	New product launches, a less hostile pricing environment and the ebbing wave of major product patent expirations should help lift the sector after a period of under-performance. Healthcare sales growth should start to benefit from easier comparables and new pharma products should lift sentiment and expectations. In Asia, valuations remain elevated, trading well above historical levels.
Utilities	▶	▶↑	▶	▲	We upgrade US Utilities to neutral as demand for power continues to accelerate with rising temperatures and data centre expansion. Momentum is accelerating on renewable energy projects as governments have started to adopt more realistic pricing for new projects. Interest rate cuts could provide a tailwind and improve sentiment further. Utilities may benefit from investors looking to high dividend paying stocks as interest rates fall.

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