

Investment Monthly

Short-term rate volatility offers buying opportunities in quality bonds

February 2024



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Key takeaways

- ◆ As market expectations of a March Fed rate cut are too premature, we believe it will need to be priced out, leading to short-term volatility. But we see dips as buying opportunities as current real yields are too high, and as they fall, bond prices will rise. We prefer quality bonds such as major government bonds (7-10 years), investment grade credit (5-7 years) and Indian local currency bonds.
- ◆ Lower bond yields and rate cuts are positive for equities, which tend to rally before the first rate cut. US equities are supported by strong earnings prospects and secular drivers in the US benefitting IT, Consumer Discretionary and Healthcare. We diversify into the strong growth leaders in Asia, such as India, Indonesia and South Korea. In Europe, we overweight IT, Energy and Healthcare, and upgrade Financials on the improved profitability of banks.
- ◆ As tail risks remain, we will focus on quality assets and diversification. When major central banks are driving market direction, the correlation between equities and bonds tends to be high.



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



Lucia Ku
Global Head of Wealth Insights
HSBC Wealth and Personal Banking

Asset class	6-month view	Comment
Global equities	▶	We maintain a neutral view as economic growth is still weakening, even though we do not expect a global recession. Rate cuts by the Fed and other central banks will help stocks, but we focus on companies with solid earnings.
Government bonds	▶	The current levels of yields represent an attractive entry point and this justifies our overweight on US and UK government bonds with a preference for medium-to-long maturities. Overall we remain neutral on government bonds as a whole.
Investment grade (IG) corporate bonds	▲	Interest rate risk is more attractively priced than credit risk, so we stick to quality with a preference for 5-7 years of maturities.
High yield (HY) corporate bonds	▶	We favor investment grade over high yield bonds as the spread pick-up is insufficient with default risks rising.
Gold	▶	We maintain a neutral stance on gold: US real yields remain a key headwind to gold, but Fed rate cuts may ease some of the negative pressure.

▲ “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 has caused the bond market volatility?

- ◆ Although the Fed continues to push back expectations of earlier rate cuts, the market is still pricing in a good chance of a cut by March, and six cuts in total for 2024. We think it is too premature and excessive.
- ◆ Instead, we believe the Fed will cut rates three times (totalling 0.75%) in 2024, starting from June onwards. As the market will need to price out the March cut, it is likely to create some volatility in the short term. But we see those dips as buying opportunities.
- ◆ Given the current level of economic activity, with US economic growth projected at 1.7% in 2024 (below the historical average), we think real yields are too high and unsustainable. As real yields come down, bond prices will rise. We prefer to lock in the current attractive yields of major government bonds (7-10 years) and investment grade credit (5-7 years). We also like Indian local currency bonds due to their inclusion in a global EM bond index, attractive yields and India's growth prospects.

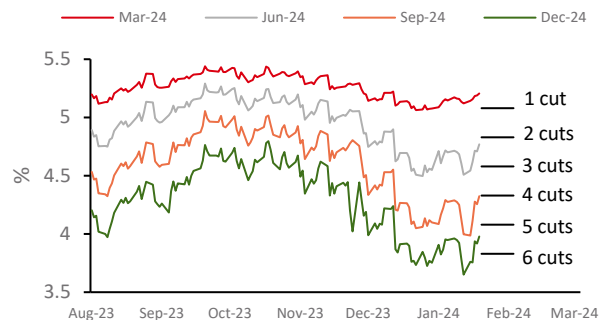
2. Where do we see opportunities in equities amid slowing growth?

- ◆ Lower bond yields and potential rate cuts support valuations and earnings. Historically, markets tend to rally before the first rate cut. While US economic growth is expected to moderate in 2024, consumption remains healthy backed by higher real disposable income. Together with secular drivers such as technology revolution, healthcare innovation, the nearshoring of industry and re-industrialisation, US equities remain our most preferred equity market. We also upgrade Communication Services on solid earnings and potential M&A activity.
- ◆ Slow growth, weak earnings momentum and wage pressures in Europe warrant our underweight on Eurozone equities. Yet, the divergent sectoral outlook supports our preference for IT, Energy and Healthcare there. We upgrade Financials to overweight as profitability of banks has improved while the price discount remains significant.
- ◆ Asia remains fundamentally attractive despite continued property market stress in China. We continue to diversify in Asia by focusing on earnings and structural growth leaders. India and Indonesia stand to benefit from global supply chain diversification, robust foreign and domestic investment growth, and young demographics. South Korean equities are well positioned to capture the AI-driven recovery of the memory sector. Defensive sectors like Utilities will benefit from lower rates, which justifies our upgrade of Asian Utilities to overweight.

3. How can investors manage the tail risks?

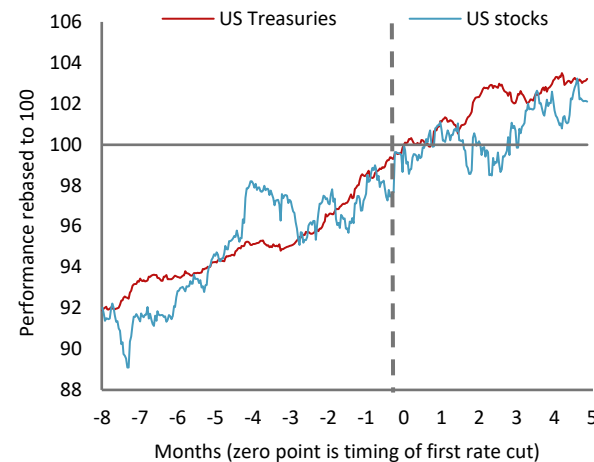
- ◆ In addition to slowing growth, geopolitics remain a wild card, with a busy election calendar in 2024 and the rising geopolitical conflict in the Middle East adding to market uncertainty.
- ◆ Election results have so far been aligned with market expectations while oil prices have been range-bound despite the Red Sea situation as Saudi Arabia cut its price for exports to Asia. Energy prices may remain directionless in spite of the oil supply deficit supporting fundamentals. With limited upside, we downgrade the energy sector in all regions to neutral, except for Europe. As tail risks remain, we will continue to focus on quality assets and diversification.
- ◆ When the Fed and other central banks determine much of the market direction, the correlation between equities and bonds tends to be high.

Chart 1: The market is still pricing in almost 6 cuts in 2024 which are too many in our view



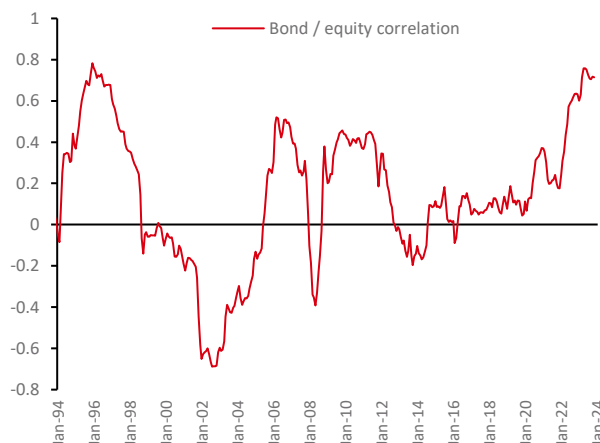
Source: Bloomberg, HSBC Global Private Banking as at 24 January 2024. Past performance is not a reliable indicator of future performance.

Chart 2: Markets tend to rally well before the first rate cut



Source: Bloomberg, HSBC Global Private Banking, 8 January 2024. Past performance is not a reliable indicator of future performance.

Chart 3: Diversification through alternatives is key due to high equity/bond correlation



Source: Bloomberg, HSBC Global Private Banking as at 24 January 2024. Past 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	▶	We maintain a neutral view for now as economic growth is still weakening, even though we do not expect a global recession. Rate cuts by the Fed and other central banks will help stocks, but we focus on companies with solid earnings.
United States	▲	The US is the most resilient major Western economy, and with inflation falling, many sector leaders have the ability to produce solid earnings. We like a broad range of sectors including IT, Consumer Discretionary, Industrials and Healthcare.
United Kingdom	▶	The UK stock market is relatively cheap but inflation remains a headwind. We remain neutral on UK equities.
Europe	▼	Valuations remain cheap in Europe but economic growth and earnings momentum are weak, particularly in Germany. Sticky inflation, the reliance on energy imports, geopolitical uncertainty and high exposure to China are also obstacles.
Japan	▶	While cyclical indicators are supportive, valuations and positioning are elevated, and monetary policy is uncertain.
Emerging Markets (EM)	▶	We expect more emerging markets to cut rates following some of the Latin American countries. We prefer structural growth leaders including India, Indonesia and South Korea in Asia, as well as Mexico and Brazil in Latin America.
EM EMEA	▼	Weak growth in Europe and high global interest rate levels continue to pose challenges for the region.
EM LatAm	▲	Local rate cuts and the re-industrialisation of North America are positive catalysts. Mexico benefits from the supply chain diversification while valuations of Brazil remain attractive.
Asia ex Japan equities		
Asia ex-Japan	▲	Valuations and earnings growth remain attractive but economic growth is expected to moderate. We continue to diversify in Asia with a focus on earnings and structural leaders including India, Indonesia and South Korea.
Mainland China	▶	More forceful and effective measures are required to deliver a sustainable structural recovery in the real economy. We remain selective and see opportunities in the internet leaders, consumer discretionary, travel and Macau gaming sectors.
India	▲	India stands out as a structural growth leader in Asia supported by global supply chain diversification, robust foreign and domestic investment growth, and young demographics. Cyclical data and investor flows are supportive as well.
Hong Kong	▶	Slowing growth in mainland China weighs on investment sentiment but steep valuation discounts are already priced in. Expected Fed rate cuts should allow local cuts too, benefiting the financial services, insurance and utilities sectors.
Singapore	▶	A stronger growth outlook, sticky core inflation and a tight labour market suggest that the central bank is in no rush to ease its monetary policy. We remain neutral on Singapore equities.
South Korea	▲	South Korean equities are expected to deliver a sharp earnings turnaround thanks to the AI-driven recovery of the memory sector and the turn in the semiconductor cycle.
Taiwan	▶	We expect the markets to refocus on fundamentals after the election. In view of strong global AI-related demand and the cyclical recovery in the broader tech sector, we continue to prefer the semiconductor and tech hardware sectors.
Government bonds		
Developed markets (DM)	▶	The current levels of yields represent an attractive entry point and this justifies our overweight on US and UK government bonds with a preference for medium-to-long maturities. Overall we remain neutral on government bonds as a whole.
United States	▲	Despite the fall in Treasury yields late last year, real yields remain elevated and we expect them to come down in coming months. Volatility can offer entry opportunities and we maintain our preference for 7-10 years.
United Kingdom	▲	We expect the Bank of England to start cutting in the summer and remain positive on gilts with medium-to-long maturities.
Eurozone	▶	Aggressive rate cut expectations have pushed European sovereign bonds to decline but hawkish rhetoric of most ECB governors has forced markets to consolidate. We maintain a neutral stance on sovereign debt.
Japan	▼	We expect the Bank of Japan to remove yield curve control in March and end the negative interest rate policy in Q2. Japanese government bonds remain unattractive due to likely policy normalisation ahead.
Emerging Markets (Local currency)	▼	Policy rate expectations are changing, with a rebuild of risk premia.
Emerging Markets (Hard currency)	▶	Amid high Treasury volatility, we still find yield but remain selective, focusing on quality issuers.
Corporate bonds		
Global investment grade (IG)	▲	Interest rate risk is more attractively priced than credit risk, so we stick to quality with a preference for 5-7 years of maturities.
USD investment grade (IG)	▲	We see many opportunities in the big USD investment grade bond market and look for companies with strong cash flows.
EUR and GBP investment grade (IG)	▲	The latest PMI and labour market data reflected sticky underlying inflation pressures. It is unlikely for the ECB to start cutting rates before June in our view. The recent rally in yields provides a new entry point for a medium duration.
Asia investment grade (IG)	▲	We focus on locking in attractive yields from quality issuers and favour Asian financials, Indian local currency bonds, Indonesian quasi-sovereign IGs, South Korean IGs, Macau gaming, and Chinese technology, media and telecom credits.
Global high-yield (HY)	▶	We favor investment grade over high yield bonds as the spread pick-up is insufficient with default risks rising.
US high-yield (HY)	▶	Although defaults remain low and refinancing risk is manageable, risk premia are too low in our view.
EUR and GBP high-yield (HY)	▶	European HY issuers often have lower leverage than in the US, but economic growth is lower, hurting cash flows.
Asia high-yield (HY)	▶	China's property related sector remains a drag on Asian high-yield bonds and we expect default rate to stay high in 2024.
Commodities		
Oil	▶	Despite increasing risks in the Middle East, oil prices remain range-bound amid global growth concerns and broadly balanced supply and demand. We expect prices to move sideways. Global demand is likely to soften this year after a strong 2023
Gold	▶	We maintain a neutral stance on gold: US real yields remain a key headwind to gold, but Fed rate cuts may ease some of the negative pressure.

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, but spending remains selective, benefitting only certain areas of the sector. There are some tentative signs of improving demand for car registrations although EV demand has softened on growing frustrations over the slow roll-out of charging infrastructure outside major cities. Tourist activity is also showing some signs of a seasonal pick-up after a lull. After a disappointing Q3, hard luxury (e.g. Swiss watches) has seen some positive signs of growth.
Financials	▲	▲	▲↑	▶	We upgrade European financials on slowly improving fundamentals and low valuations relative to other regions. Capital markets business has started the year well with reasonable trading and issuance volumes. Higher interest rates look set to decline only slowly in 2024, helping to keep earnings elevated.
Industrials	▲	▲	▶	▶	US industrials are benefitting both from the reshoring/near-shoring initiatives fuelled by the US's Inflation Reduction Act (IRA) and CHIPS Act. China and Europe's industrials continue to see soft demand as sentiment remains muted and capital investments hampered by uncertainty and higher financing costs. Aerospace and automation remain potential bright spots.
Information Technology	▲	▲	▲	▲	Fundamentals continue to improve with AI being a major catalyst for new areas of growth. Digital infrastructure and software are seeing solid activity. Strong demand for high-end semis is being driven by the buoyant automation and AI as business and consumer sentiment improves. Cloud computing and digital advertising growth remain muted.
Communications Services	▶	▲↑	▼	▲	We upgrade US Communications as its double-digit earnings growth is among the strongest for 2024, supported by strong fundamentals and attractive prices to investors. In contrast, Europe's telecom services heavy sector has little room for optimism. Asia offers a more attractive risk-return profile given the low valuations and stabilising regulatory environment.
Materials	▶	▶	▶	▶	Commodity prices have stabilised with iron ore, copper and steel prices partially recovering over the last few months. For other metals, prices have been flat or negative. Construction materials have also seen some recovery in demand. Sector valuations are full. Overall, the outlook has improved marginally with government capital programmes and electrification (EVs, tech and renewables) lifting demand in some areas.
Real Estate	▼	▼	▶	▼	Retail and private housing real estate continues to suffer from soft demand in many markets. Sentiment remains weak due to high interest rates, elevated costs and ongoing negative news flow from developments in Chinese real estate. New and existing construction projects are being challenged by higher financing costs, and increased material and labour costs.
Consumer Staples	▶	▶	▶	▲	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. The sector is trading in line with historical valuations. We focus on quality stocks with strong brands and more resilient pricing power.
Energy	▶↓	▶↓	▲	▶↓	We downgrade the sector as energy prices have eased, and oil and natural gas supplies have been sufficient to meet demand, while national energy stores remain relatively full. Although valuations are low relative to other sectors despite robust cash flow and stable high dividends, 2024 YoY sales and earnings growth are likely to be muted given higher prices last year.
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, while new pharma products should lift sentiment and expectations. In Asia, valuations remain high, trading well above historical levels.
Utilities	▶	▼	▶	▲↑	European and US renewable energy companies are facing headwinds on anticipated new and existing development projects as rising costs are severely eroding expected returns, and projects are facing long delays in grid connections. We upgrade Asian utilities on low historical valuations and they should benefit as interest rates fall and investors look to high dividend paying stocks.

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