Soft landing, hard truths

Steering towards a soft-ish landing

Global Investment Outlook Q2

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HSBC Asset Management

Contents

Foreword 03

Macro outlook and market implications 05

Top of mind 10

Deep dives

Why Asian currency bonds are worth a second look **14**

The ongoing contrast of Asia's two largest markets **18**

Should US equity market concentration be a concern? **22**

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Foreword

Foreword from our Chief Investment Officer

Welcome to our Global Investment Outlook, reflecting the main findings of our quarterly Strategic Forum. I am pleased to share our view on the global economy and investment markets for the months ahead.

We remain in the midst of elevated policy rates and tight credit conditions where the prospect of a successful 'soft-landing', while comforting, must be scrutinized through a lens of pragmatism. Signs that inflationary pressures have not entirely dissipated and the narrative of reaccelerating growth, led by the US, suggest that central banks may be on hold for a little while longer. This means that monetary policy looks set to be a drag on growth ahead in western economies.

A more-than-expected growth slowdown is a risk, driven by firms increasingly refinancing debt at higher rates and the exhaustion of excess household savings accumulated in the pandemic. This would help bring inflation down to target levels and open the door to policy easing later in the year, but it looks like global policy makers will pursue different exit strategies. This adds to the importance of country selection, with Japan being one of our top picks in developed market equities for instance, for several reasons, including Bank of Japan policy normalisation.

Against the backdrop of risks, we maintain a 'defensive growth' stance, with a bias towards quality and selectivity in stocks and credits. At the core of our defensive approach is the return opportunity in global government bonds, such as US Treasuries or UK gilts. Bonds are back as a source of return for investors and may even surprise by providing diversified returns under the adverse scenario of slowdown and disinflation.

This presents good opportunities in selective areas of global fixed income. We broadly maintain a bias to quality and selectivity in both stocks and credit, and look to take advantage of equity-like returns for bond-like risk in areas of the investment grade bond segment. Of course, a selective approach is important in the context of slowing nominal growth and default risks should profits come under pressure. Furthermore, we are mindful of the current compressed level of credit spreads.

Areas of the market like floating rate ABS remain very popular with investors and support portfolio diversification amidst rate volatility. Separately, emerging market bonds and broader EM assets appeal amidst better valuations, structural tailwinds and diversification benefits. While many emerging markets continue to see lacklustre growth, we see areas of optimism, especially in structural and cyclical growth stories that exist in Asian EMs like India, or separately in Mexico.

Ultimately, even if the proverbial soft landing sticks in developed markets, the runway is in an earthquake zone. Given the path to stability is fraught with uncertainties, our baseline scenario, aptly termed 'soft-ish landing', urges caution against complacency in portfolios.

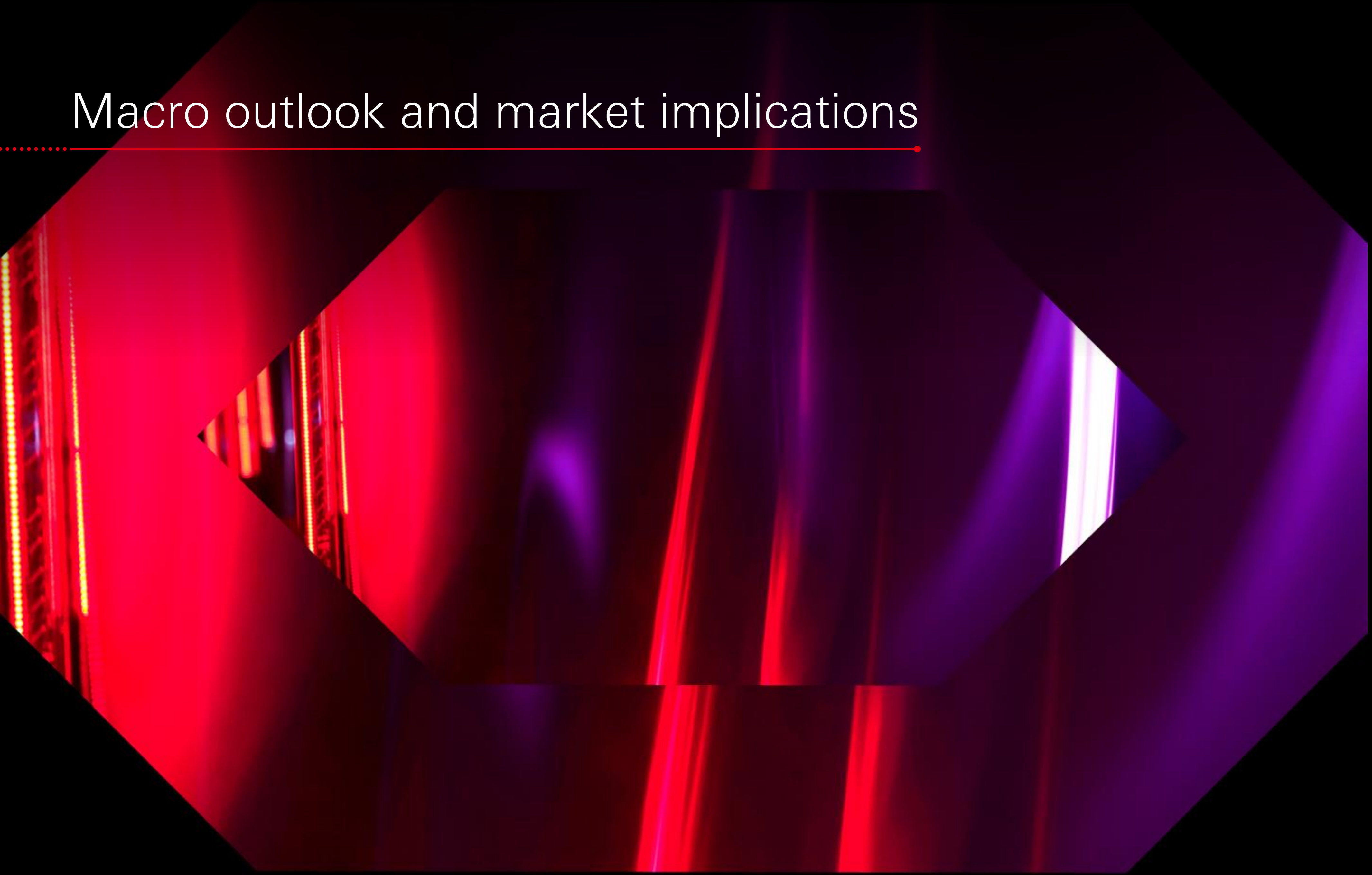
This means we can't overlook the importance of finding intelligent diversification while maintaining growth exposures, such as in alternatives and emerging markets.

> "The formidable task of steering towards a 'soft-ish landing' could result in more turbulence for markets ahead."

Xavier Baraton
Chief Investment Officer

Source: HSBC AM, April 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Macro outlook and market implications



Macro outlook and market implications

A continuation of elevated policy rates and tight credit conditions could be threats to a successful 'soft landing'.

This means that the possibility of an economic slowdown, amidst stickier-than-expected inflation and geopolitical tensions, could introduce volatility while challenging earnings growth. With expectations of slower economic growth ahead in 2024, there is a looming risk of profit disappointment not adequately factored into current market pricing.

To secure a soft landing, progress on disinflation, resilient economic growth, labour market stability, and positive profit trends are all essential. Even then, ongoing risks such as geopolitics, elections, and fiscal constraints could influence the market outlook throughout the year, as we've seen in the most recent flare up of volatility.

The US economy has led the charge towards a soft landing, being the standout performer in developed markets and showing remarkable resilience. However, more corporate debt refinancing at higher rates and the depletion of excess household savings poses challenges to maintaining such continued strength. This underlies the risk of growth and profits disappointment ahead, for which we feel investors should be prepared.

On the inflation front, some recent upside surprises have dampened the mood around solid improvement from 2022 peaks, and could prompt central banks to delay easing, potentially derailing the soft-landing trajectory.

Accordingly, market attention is now centred on the timing and magnitude of rate cuts. Growth could disappoint expectations in the second half, particularly in the US, meaning investors price in more cuts. We anticipate yield curve steepening by the end of the year.

Maintaining a defensive and selective stance, our preference is for investment-grade credit. However, a range of credit segments, including private credit and emerging market bonds, have an important role to play in strategic asset allocations. Likewise, we think that alternatives should continue to play an important role in diversifying risk exposures while capturing return potential.

In the long-term, we envision a 'new paradigm' featuring shorter economic cycles and more frequent supply shocks. In this scenario, stock-bond correlations are expected to be typically around zero, with intermittent phases of positive correlation amid geopolitical and fiscal policy tensions. Positioning in high-quality bonds makes sense tactically, but investors will need to take advantage of other assets as 'new diversifiers'.

Figure 1: Key themes to consider

New Paradigm

We are in a new economic regime of tighter money and more active fiscal policy. That means different macro dynamics, higher inflation and interest rates.

Defensive Growth

Market expectations are for a soft landing. But as the cycle slows and inflation falls, bonds are back. We focus on defensive strategies in portfolios.

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Heading to a new paradigm

Our ‘Soft-ish landing’ baseline scenario anticipates a nominal growth slowdown and mid-single digit corporate profits growth due to tighter monetary conditions. This means that current market anticipation of a 'soft landing' is priced for perfection.

Our scenario expects lower-than-expected growth ahead as firms increasingly refinance debt at higher rates and the excess savings that households accumulated in the pandemic are finally exhausted. The timing of Fed rate cuts hinges on sustained disinflation, particularly in services, and the resilience of economic growth and labour markets.

In Europe, better progress on disinflation and weaker growth means there is a good chance the European Central Bank (ECB) and the Bank of England move ahead of the Fed on policy easing.

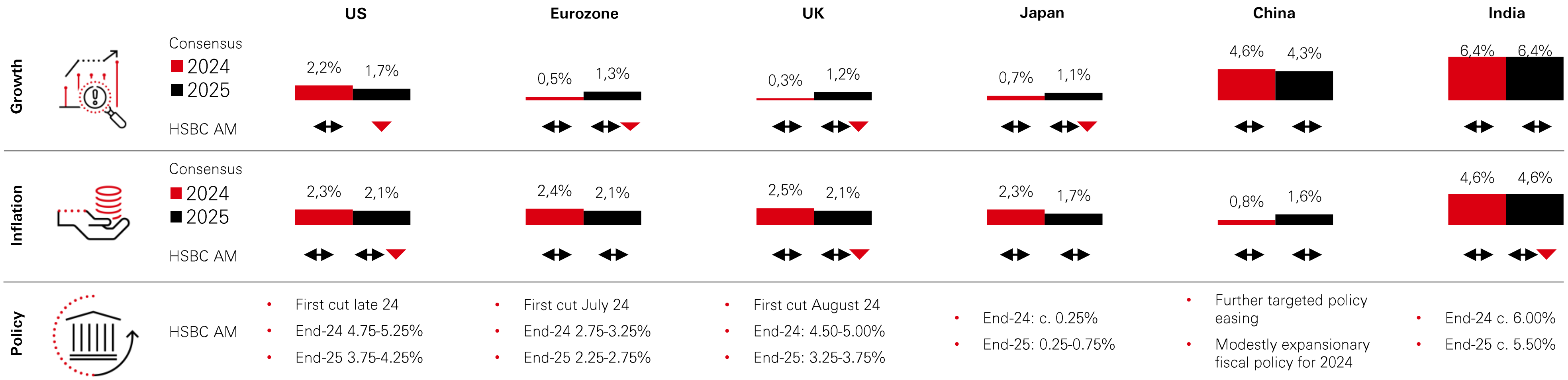
In China, despite growth challenges and a piecemeal policy response, we think recent policy interventions coupled with the potential for additional fiscal support may stabilize sentiment.

Overall, we expect emerging market central banks in Latin America and Europe to continue leading the global easing cycle, with Asian central banks likely to follow suit in the latter half of 2024. Meanwhile, we maintain our view that the Bank of Japan will continue very gradual normalisation.

Our central market scenario favours bonds over equities in multi-asset portfolios, as we see promising opportunities in select segments of global fixed income, including emerging markets, and high-quality corporate bonds. We focus on ‘defensive growth’ and see the importance of diversification through alternative asset classes and emerging markets – particularly those with structural and cyclical growth stories, such as India, Mexico, and Indonesia.

Our alternative risk scenarios are centred on the risk of higher interest rates, either because of stickier-than-expected inflation, or stronger than expected productivity growth. In the former scenario we anticipate market sell-offs, whereas the latter scenario would likely support a rally in most risk assets.

Figure 2: Economic scenario 2024 & 2025 (↔ Neutral / ▼ Negative bias)



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Market implications

Current market pricing aligns with a soft-landing under ideal conditions. Hence, we maintain our preference for a 'defensive growth' stance and emphasise that 'bonds are back', including in emerging markets.

Despite a strong run for equity markets since the fall, economic headwinds and disinflation suggest government bonds could find support while corporate earnings face challenges. In general, we see good opportunities in areas of fixed income, notably in longer term bonds and global investment-grade credit. However, volatility in core Western bond markets necessitates active duration management.

In our view, developed market equities appear to have priced in much of the positive news, with high valuations and profit optimism. While there is scope for near-term gains given economic resilience, especially in the US, a combination of falling nominal growth and elevated input costs may pose a challenge to profit margins not fully anticipated by markets. The high concentration of large and megacap stocks in the US and Europe has left areas of small caps overlooked and undervalued, presenting potential long-term opportunities.

We think Japanese stocks continue to stand out among developed markets, due to attractive valuations and robust profit momentum – supported by a large equity risk premium, monetary policy normalisation, and yen revival, amid structural tailwinds.

For emerging markets, the combination of pre-emptive tightening by central banks in Latin America and Europe, and structural de-risking, has altered the risk behaviour of bonds. In such an environment we emphasize a number of markets like Mexico, Indonesia and India, which are offering high nominal and real yields amid rather low FX volatility.

Although parts of Asia remain vulnerable to China growth concerns, meaningful China policy support could provide a sizable uplift. Promising growth outlooks, policy easing, and less demanding valuations make emerging and frontier market stocks strong portfolio considerations.

Figure 3: Views per asset class (▲ Positive / ↔ Neutral / ▼ Negative bias)

Equities

Asset Class	House view
Global	↔/▼
US	↔/▼
UK	↔/▼
Eurozone	↔/▼
Japan	↔/▲
Emerging markets (EM)	▲
Latam	▼
Frontier	▲

Government bonds

Asset Class	House view
Global	↔/▲
US10yr	▲
UK10yr	▲
German 10yr	↔
Euro Periphery	▼▼
Japan	▼
Inflation-linked	↔
EM (local currency)	▲▲

Corporate bonds

Asset Class	House view
Global investment grade	↔/▲
USD IG	↔/▲
EUR & GBP IG	▲
Asia IG	↔/▲
Global high-yield	↔/▼
US high-yield	▼
Europe high-yield	▼▼
Asia high-yield	↔/▲
Securitised credit	▲▲

Commodities, alternatives and FX

Asset Class	House view
Gold	↔/▲
Oil	↔
Listed Real estate	▲▲
Infrastructure	▲▲
Hedge funds	▲▲
Private equity	↔
Direct lending	▲▲
US dollar	↔/▼

Asian assets

Asset Class	House view
Pan-Asia government bonds	▲
Asia ex-Japan equities	▲
China A	▲
India	↔/▲
ASEAN	↔
Hong Kong	↔/▲
Asia FX	▲

Source: HSBC AM, April 2024. House view represents a >12-month investment view across major asset classes in our portfolios. Views reflect our long-term expected return forecasts, our portfolio optimisation process and actual portfolio positions. These views are for general information purposes only and does not constitute advice or a recommendation to buy or sell investments. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Precarious path to a soft landing

In contrast to market expectations, our view of a ‘soft-ish’ landing suggests the potential for more significant monetary policy easing versus current market expectations.

The economic landscape over the past few months has ignited a narrative of reaccelerating growth, led by the United States. This resurgence in economic activity has been marked by upward surprises in various indicators. Vitally, consumer spending strength has held up amid a decrease in the savings rate, contributing to an environment of strong jobs growth and resilient profits.

However, this seemingly positive backdrop poses risks to the prospect of a soft-landing scenario. The sustainability of this growth trajectory hinges on several factors, including the pass-through of monetary policy tightening and the behaviour of households and businesses in response to changing economic conditions.

One concern is the blunted transmission of monetary policy, where rising market rates have yet to significantly impact corporate financing costs. As firms face higher interest payments, profits could come under pressure, leading to a slowdown in investment and hiring.

Moreover, the consumer outlook is also clouded by a likely cooling labour market and diminishing excess savings. As employment growth moderates and wage growth stalls, households may become more cautious in their spending behaviour, dampening overall economic activity.

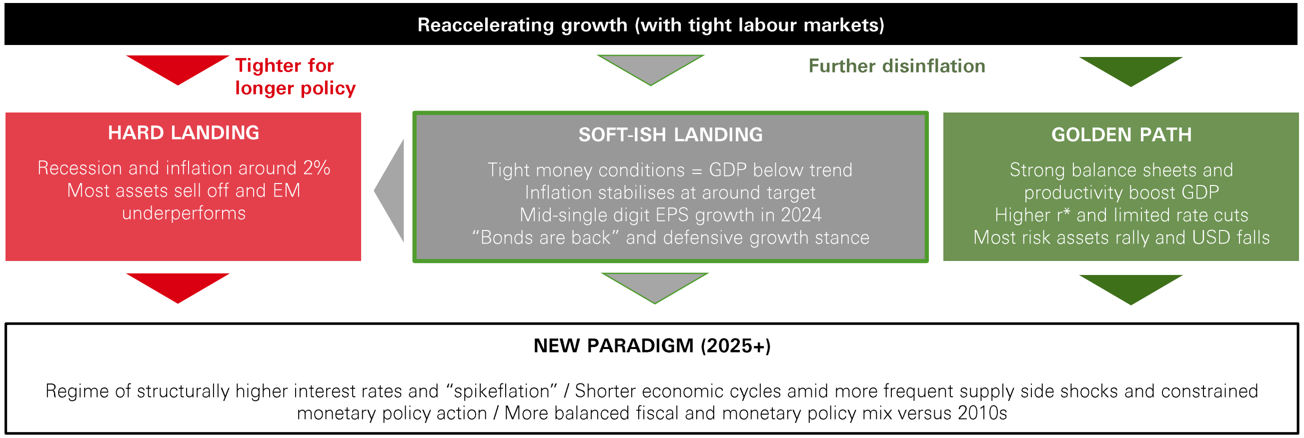
Inflation dynamics add another layer of complexity to the scenario. While there has been significant improvement in inflation rates, particularly in services prices, the persistence of inflation above target levels could prompt central banks to delay policy easing, potentially derailing the soft-landing trajectory. Furthermore, risks from areas such as small businesses and commercial real estate pose additional challenges to the economic outlook. Stresses in these sectors could amplify downward pressures on growth, exacerbating the risk of a harder landing scenario.

Amid these uncertainties, some market participants have considered the potential for a productivity-led golden path scenario, similar to the 1990s era of strong growth and bull run in markets.

However, the realisation of such a scenario hinges on several factors, including the ability of productivity to accelerate and a higher neutral fed funds rate. While plausible, challenges in the timing and magnitude of each of these elements necessitates caution in our opinion, supporting our preference for defensive positioning in portfolios today.

Amidst a backdrop of reaccelerating growth, policymakers face the formidable task of steering towards a soft-ish landing while mitigating risks of overheating and entrenched inflation. The path ahead demands careful monitoring and adaptive policymaking to navigate the complexities of an evolving economic landscape. Accordingly, in this environment we continue to advocate for a ‘defensive growth’ approach and ‘intelligent diversification’.

Figure 4: Reaccelerated growth could lead to different paths



Reaccelerating growth (with tight labour markets)

Tighter for longer policy

Further disinflation

HARD LANDING

Recession and inflation around 2%
Most assets sell off and EM underperforms

SOFT-ISH LANDING

Tight money conditions = GDP below trend
Inflation stabilises at around target
Mid-single digit EPS growth in 2024
“Bonds are back” and defensive growth stance

GOLDEN PATH

Strong balance sheets and productivity boost GDP
Higher r* and limited rate cuts
Most risk assets rally and USD falls

NEW PARADIGM (2025+)

Regime of structurally higher interest rates and “spikeflation” / Shorter economic cycles amid more frequent supply side shocks and constrained monetary policy action / More balanced fiscal and monetary policy mix versus 2010s

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Top of mind

Foreword
Macro
Top of mind
Fixed income deep dive
Equity deep dive
Multi-asset deep dive

Top of mind

Should we remain concerned about the breakdown of bond-equity correlations?

Short-run bond-equity correlations are at their most positive since the 1990s. Usually, stocks and bonds move together when the source of volatility is inflation. But as the global disinflation process continues in 2024, growth volatility is set to become more important again.

That should mean a lower stock/bond correlation – good news for investors. However, we argue that the future inflation profile will be somewhat higher and spikier, compared to how it was in the 2010s. In the longer-run, we think 2% becomes the floor rather than the ceiling for inflation in Western economies. This is because there is a “new paradigm” facing the global economy. This includes inflationary forces such as a more fragmented global order which results in the end of hyperglobalisation, more active fiscal policy which contrasts with the austerity measures and monetary policy dominance of the past decade, and policies to address climate change.

The search for new diversifiers is on, Solutions can be found in alternative asset classes such as hedge funds and private credit. Country allocations can also help, especially in emerging and frontier markets, which are increasingly going their own way. And don’t forget the role of factor investing and thematics.

How should we look at EM and frontier?

We continue to favour emerging and frontier equities. Market valuations look less demanding, policy is already being eased with economies either in disinflation or low inflation states, and growth outlooks are relatively strong.

The big story in emerging markets continues to be one of divergence. The idea that the asset class can be seen as one big homogenous lump is old-fashioned, with country correlations much lower than you may think. Even in monetary policy, the trends are diverging and regional. Latam central banks, for example, were early rate hikers, and the monetary cycle seems to be ‘first in, first out’.

Against a backdrop of divergent policy and market outcomes, we prefer an active and selective strategy.

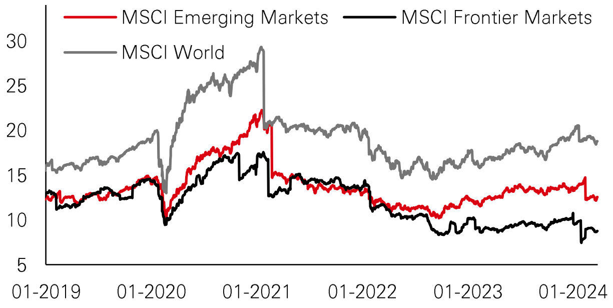
Meanwhile, Frontier equity markets also offer low correlation of returns versus EM and DM indices, as well as between individual frontier economies. Thus, as group, returns have been less volatile than both EM and DM over the past 10 years. Even so, they remain under-owned by investors. That’s contributing to appealing regional valuations versus strong returns on equity.

We also think emerging market local currency bonds will deliver strong risk-adjusted returns ahead. That continues a market trend since late 2023, with EM bond yields falling relative to the US. Attractive valuations and global disinflation should mean further strong performance.

The investment opportunity arises from EM central banks tightening monetary policy well before the Fed and the ECB. Proactive EM central bankers then created a valuation buffer for their bond markets to weather the fastest global tightening of financial conditions since the 1980s. Recent IMF analysis reflected on how this policy strategy, plus country-specific structural reforms have materially improved the risk behaviour of the asset class.

The near-term path could yet be choppy, but the medium-term outlook is backed up by solid fundamentals – strong growth and buffers against external pressures, and improved policy credibility – as well as cheap valuations.

Figure 1: P/E ratios across different asset classes



Past performance is not an indicator of future returns.
Source: HSBC Asset Management, Bloomberg, as of 25 April 2024.

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Has private credit reached peak?

Typically being floating rate structures, private credit investments clearly benefited during the sharp rise in interest rates since 2022 that hurt most other fixed income markets. With rate cuts on the horizon, investors now have a more complex decision to make within their credit allocations than they have had over the last 18 months. Clearly, since many private credit rates can be reset regularly, the cost of borrowing should fall. While this is good for borrowers, which may see financial metrics improve, it is potentially less so for lenders. Still, direct lending investments are currently delivering higher yields than most other investments, and per the chart to the right, higher than average returns of global equities over the last decade.

In addition, uncertainty over completing the last mile of disinflation and what neutral interest rates will ultimately become may contribute to ongoing investor interest, with floating rates and relatively high yields maintaining their appeal as markets reprice for a 'higher for longer' scenario. Of course, credit risk remains a key determinant of returns in private credit as it does elsewhere in fixed income. And since private credit consists of lending to relatively small borrowers, higher financing costs could lead to higher default rates.

However, there are other reasons for investors' continuous interest for an asset class that boomed from $310 billion at the end of 2010 to an impressive $1.52 trillion today – according to Preqin's most recent figures.

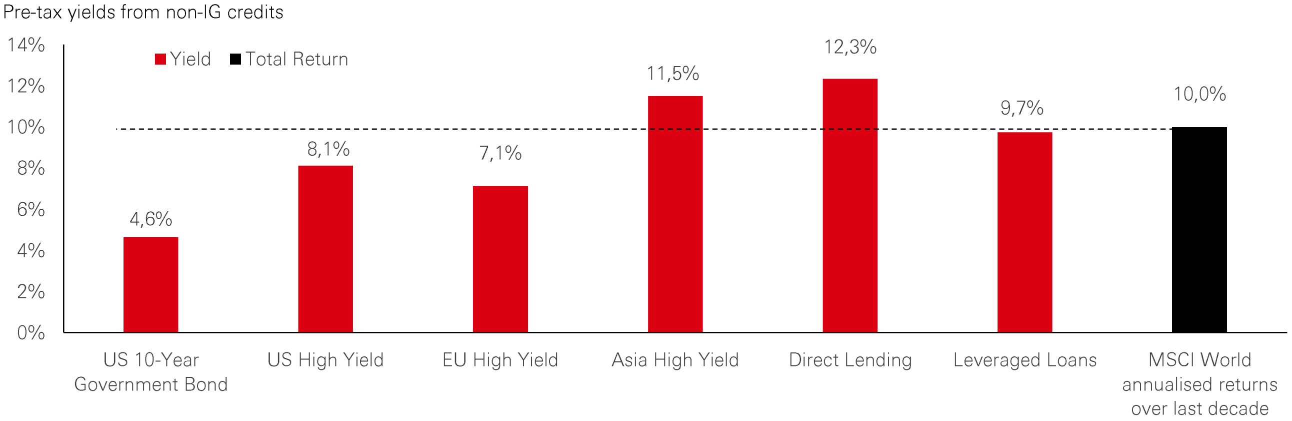
The most obvious enduring benefits of private credit are to provide investors with a yield and illiquidity premium over fixed rate or long-duration fixed income assets, as well as a source of diversification. This is indeed suitable for insurance and pension companies, but the market is now attracting other institutional investors, and retail funds are emerging. In the meantime, the continued retrenchment of banks from many areas in which they were historically dominant should also mean the market for private lending continues to grow, regardless of the outlook for rates.

Of course, while recent movements in rates have boosted private credit returns in the short-term, they should reduce and could become more volatile in future when we begin to see interest rate cuts.

Another important point for investors to consider in this context is that now that private credit has matured and grown, it offers greater heterogeneity with very different risk / return profile segments. As an illustration, 'covenant lite' loans (which come with less protection for lenders) represent around 90% of new deals issued over the last year across the syndicated loans segment, but 'only' around 20% in the direct lending segment[1].

Overall, the asset class offers interesting characteristics within a diversified fixed income portfolio, but current market conditions should push investors towards greater selectivity in their market segments, solutions and manager selection decisions.

Figure 2: Some non-IG credit yields exceed average annual returns from equity



Past performance is not an indicator of future returns.
Source: HSBC Asset Management, Macrobond, Bloomberg, 24 April 2024. Data indices used: US 10 year: US Generic Govt 10 year Index, US High Yield: Bloomberg US Corporate High Yield to Worst Index, EU High Yield: Bloomberg Pan- European High Yield ISMA yield to worst, Asia High Yield: Bloomberg Asia USD High Yield Bond Index yield to worst, Direct lending: Cliffwater Senior income return as of Q3 2023 annualised, Leveraged Loans: Credit Suisse Leveraged Loan Index Yield to mat, MSCI World: MSCI World Index as of March 2024.

[1] Source: J.P. Morgan Investment Bank, data as of 28 February 2024. Source: HSBC AM, April 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

What do evolving sustainability disclosure frameworks mean for companies and investors?

Within the first few months of 2024, notable regulatory adjustments have emerged from both the US and the EU concerning sustainability disclosures. The EU's enforcement of the Corporate Sustainability Reporting Directive is a concerted effort to elevate sustainability reporting standards. The rules pose challenging new standards including assurance. In the US, the adoption of climate disclosure rules by the SEC has also been a material step forward despite some controversy, particularly around the exclusion of scope 3 emissions reporting requirements.

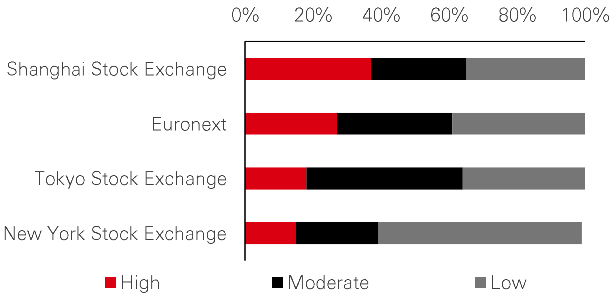
Differences in standards pose challenges for investors looking to evaluate and compare reporting of emissions data from companies across jurisdictions. Notably, scope 3 disclosures have been much debated and where they are included, will enable investors to understand emissions across a company's value chain. This is significant for evaluating true impacts and risks, given the majority of corporate emissions are occurring across the extended value chain. We believe engagement will play a key role and are encouraged by building momentum for voluntary disclosures aligned with recommendations from the Taskforce on Climate-Related Financial Disclosures and the International Sustainability Standards Board (ISSB).

Also encouraging is the fact that regulatory initiatives addressing ESG issues have expanded significantly, such as the EU's Sustainable Finance Disclosure Regulation and the ISSB frameworks mandating disclosure of greenhouse gas emissions (Scope 1, 2, and 3) as well as a wider set of metrics concerning topics such as human rights and biodiversity.

Emphasis on preserving and enhancing biodiversity has been building recently due to the realisation that ongoing biodiversity loss is becoming a critical issue – given it both contributes to climate change and increases exposure to impacts, such as flooding, by removing the land's natural defences.

Economic consequences are significant, with more than half of global output having at least a moderate reliance on nature. This means investor risk exposures are likewise significant. The chart below shows PWC estimates of the market value dependence on nature for listed companies across major stock exchanges, with variations due to the mix of companies on each exchange.

Figure 3: Listed market value exposed to financial risk through dependence on nature



Source: Morningstar Direct, Morningstar Research, as of June 2023

Find out more

In our latest RI Insights

HSBC Asset Management

For investors looking to mitigate relevant risks in their portfolio, nature-related data remains a key challenge. We expect further developments in this area as the ISSB recently announced that they will commence a programme of work related to biodiversity, ecosystems and ecosystem services (BEES).

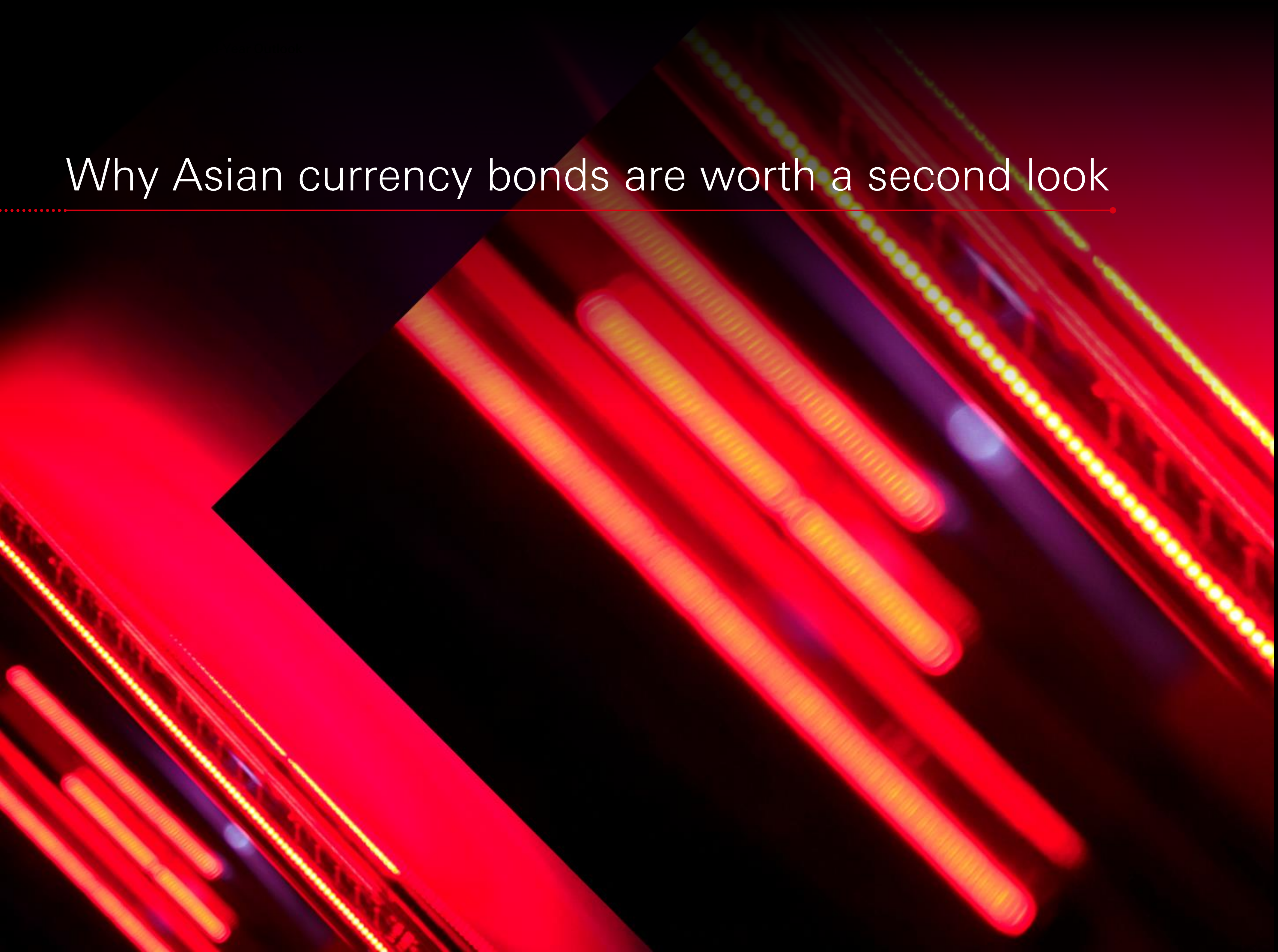
Challenges will remain regarding the consistency and interoperability of disclosure frameworks across jurisdictions. However, progress is evident, such as in Asia where we are also seeing increased emphasis on disclosures, with Shanghai, Shenzen and Beijing, as well as the Hong Kong stock exchange announcing a flurry of environmental and social disclosure expectations. Elements of international standards are evident, including double materiality and encouraging scope 3 disclosures.

Gradual harmonisation of standards will reduce the difficulty for both companies and investors in navigating disparate reporting systems. Most importantly, the momentum towards enhanced disclosure and accountability signals a shift towards more sustainable and responsible business practices, driven by both regulatory mandates and investor expectations.

Source: HSBC AM, April 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Foreword
Macro
Top of mind
Fixed income deep dive
Equity deep dive
Multi-asset deep dive

Why Asian currency bonds are worth a second look



Foreword

Macro

Top of mind

Fixed income deep dive

Equity deep dive

Multi-asset deep dive

Why Asian currency bonds are worth a second look

> “Decent growth forecasts for most of emerging Asia and less need for monetary stimulus means local bonds can continue to provide solid carry opportunities.”

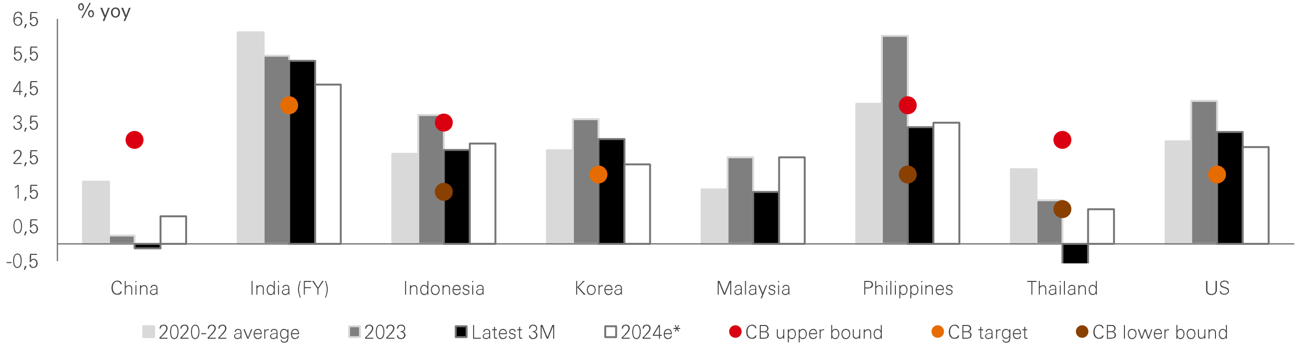
Most Asian currency bonds have not gained great favour among global investors in recent years given the strong US dollar and a perception that these markets are difficult to access. Yet, low correlation with other currencies, appealing real yields and favourable macro trends could change asset allocators’ minds.

Outside of China, emerging Asia experienced a marked post pandemic inflationary cycle, but never suffered the same extraordinary pressures as the United States, Eurozone or some other emerging markets. Policy rates, therefore, could be set at levels which were not severely disruptive to economies, and now that we are seeing inflation falling back to central bank targets, markets are discounting interest cuts in the coming months.

With inflation on a downwards path and a global environment of monetary easing expectation, it might be reasonable to question whether Asian central banks should already be cutting rates. However, there are two key reasons why it is likely that policymakers will wait to follow or synchronise with the US.

The first is that growth prospects for most of emerging Asia are reasonable without the need for monetary stimulus. A gradual export recovery has been especially beneficial to economies like Korea and Taiwan which have high exposure to the global semiconductor rebound, while India and Indonesia are enjoying the economic tailwinds of secular policy measures implemented in past years. In addition, although obviously an important partner for the ASEAN region, a recalibrating Chinese economy is not as dominant a force in the Asian complex as may sometimes be assumed. Although there are pockets of high exposure, such as exports from Indonesia and foreign direct investment (FDI) to Thailand, other region and intra region ties are just as, if not more, important. Moreover, the economic ties between India and China are slight, with India positioning itself as an alternative option to China in many global offshoring ventures. Meanwhile, as already implied, rates never had to go as high in emerging Asia in the first place and therefore are not at significantly restrictive levels.

Figure 1: Inflation has gradually eased back within central bank targets



*Bloomberg consensus forecast as of 8 March 2024. Source: HSBC AM, Bloomberg data, March 2024.

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The second reason is that Asian central banks may be keen to avoid currency weakness at a point when it may be unnecessarily disruptive to economic prospects. The experiences of economies such as China and Chile, which were amongst the first central banks to cut rates and have some of the weakest currencies in the past two years, may be cautionary to those where depreciation has been damaging in the past. Some Asian economies can no longer rely on rock solid current account fundamentals as domestic demand grows stronger, while interest rate differentials are not as favourable to Asian currencies as has been the case in previous cycles. The notable exceptions to these drivers are India and Indonesia, where better export performance and inflows have improved current accounts and basic balances, while interest rates are still high by global standards. Generally, Asian currency fundamentals remain sound, with prudent fiscal consolidation providing macro stability at the same time that FDI is recovering, especially in greenfield development and manufacturing. There seems little benefit, though, in risking hard won stability and credibility by easing too quickly.

> "While each market has its unique features and frameworks, Asian currency bonds enjoy sound fundamentals and attractive diversification potential."

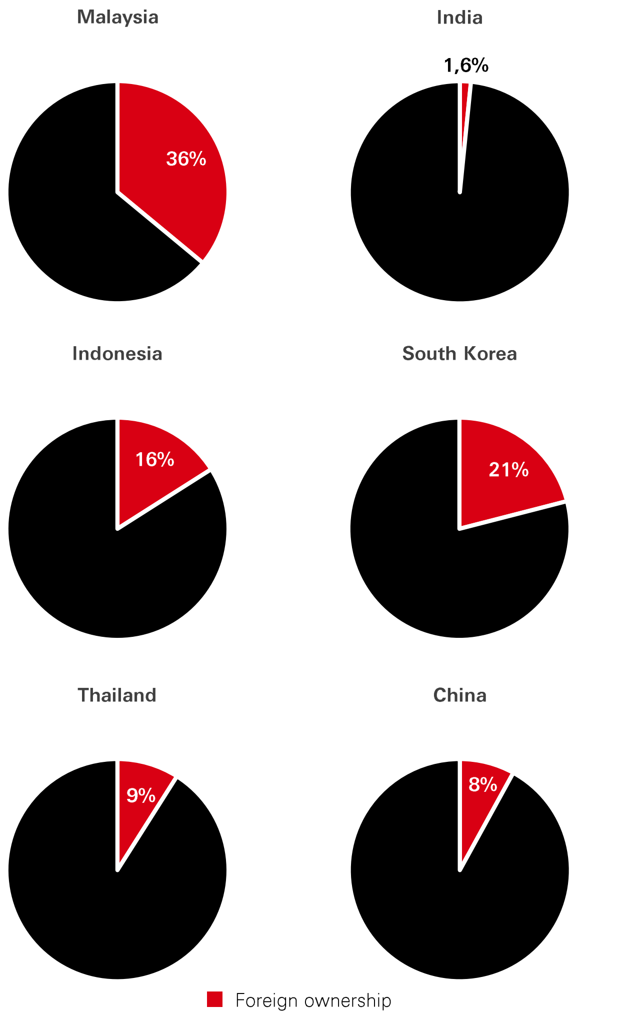
China is by far the largest bond market in Asia (ex-Japan), with a capitalisation of around $15 trillion equivalent (depending on how we exactly define 'bond').

Korea and India are the next largest, at around $2.5 trillion, featuring a combination of sovereign, quasi sovereign, local government and corporate bonds. There is a significant dispersion in the extent of foreign ownership across Asian local bond markets, with Malaysia having the largest share of foreign participation at over one third and, at the other end of the spectrum, India with a notably low figure of 1.6%. These numbers broadly correlate with a combination of the ease of accessing the market and the size of it. Malaysia is a relatively small economy and market, but its authorities have long pursued an open access policy attractive to global investors.

India's market is relatively large but was only made available to global investors under any circumstances around 15 years ago, and although the market has opened up significantly over the intervening period, there remain some restrictions.

High foreign investment share is something of a double-edged sword. There is an obvious benefit in terms of investor diversity lowering the cost of funding, but also vulnerability in times of global risk aversion when investors tend to withdraw from peripheral markets and thereby exacerbate financial stress. Overall, though, foreign investment share in Asia's domestic bond markets is way below the economic footprint of the Asia ex-Japan region, which makes up around 38% of global GDP.

Figure 2: : Foreign bond ownership



Source: Treasury International Capital, Bloomberg data, December 2023.

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Foreign ownership

But it is the diversification quality of some of the key Asian markets which is perhaps the strongest argument for inclusion in a strategic asset allocation. China, India and Indonesia markets in particular exhibit a lack of correlation, which should be beneficial to long-term risk-adjusted returns. These markets tend to follow domestic interest rate cycles and local supply and demand conditions, while having enough critical mass to be less driven by the global risk cycle. They also have relatively low volatility both on a hedged and unhedged basis.

Current valuations indicate that long-term real yields are relatively attractive, with inflation under control and around central bank targets. This implies not only that investors can enjoy good levels of real carry, but also that over time rates can be cut with a cushion of comfort that conditions will not become overly accommodative, potentially lowering nominal yields and creating capital gain.

The supply and demand conditions in the India bond market are particularly auspicious at the moment, given that the inclusion of Indian sovereign bonds in the JPMorgan GBI-EM should drive around $25 billion of flows over the ten months from June 2024, with further index inclusion announcements likely over the course of this year. On the supply side, India's fiscal consolidation, driven by strong growth and prudent policy, should also ensure continued downwards pressure on yields.

Our current preference across both Asian and Emerging market portfolios, therefore, is to have an overweight exposure to India with its high carry, positive growth fundamentals and modest inflation. We favour the intermediate to longer end of the curve to take advantage of declining yields from the index inclusion. We are also constructive on Indonesian longer bonds for similar reasons as well as its swing into a positive current account position. In other Asian bond markets, we prefer the shorter end to capture the rate cut opportunity more exactly on relatively flat yield curves.

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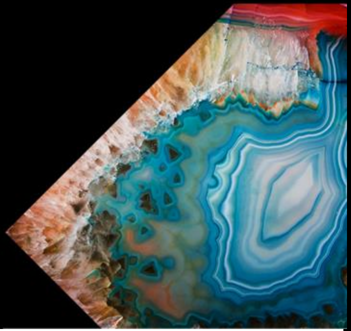


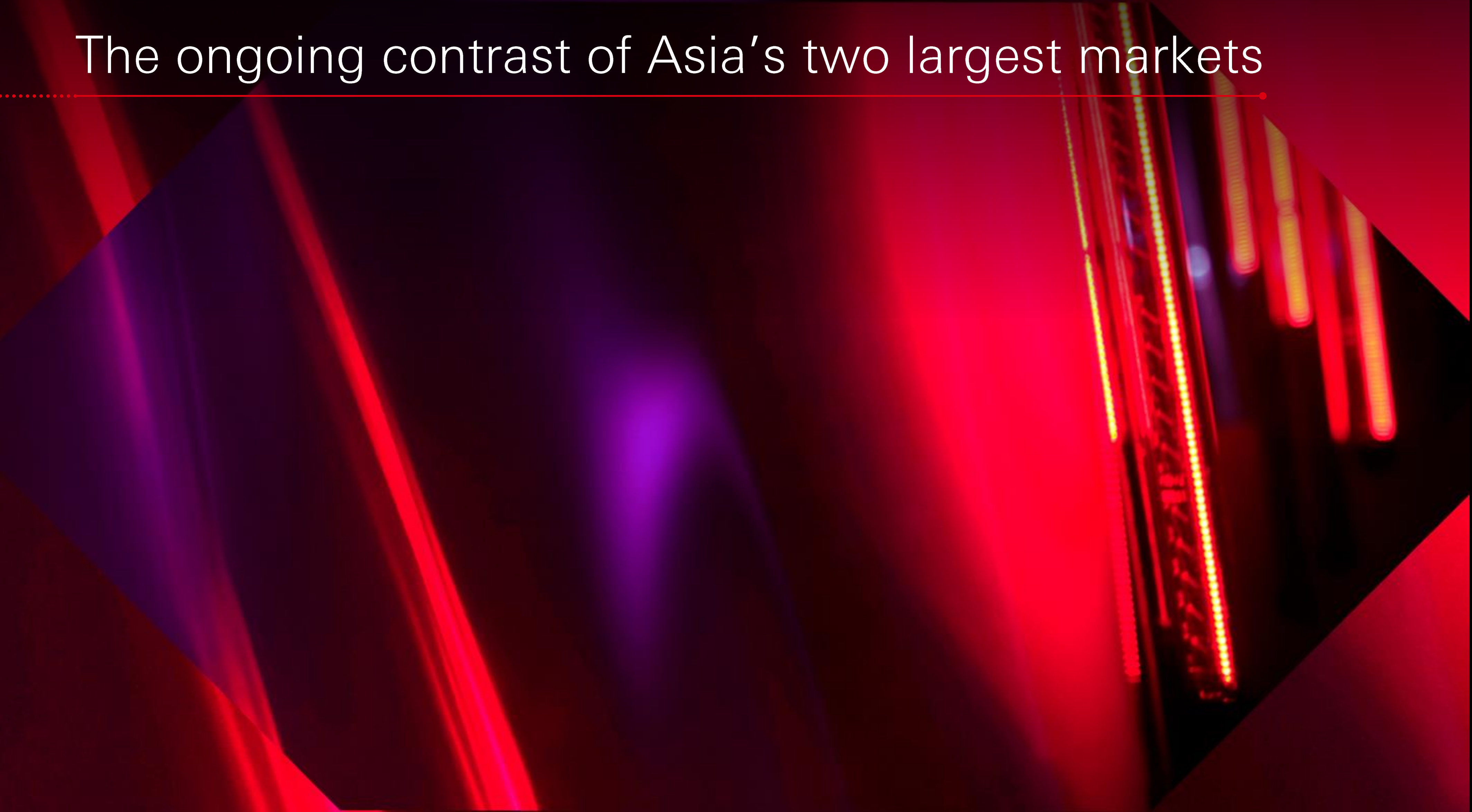
Figure 3: Correlation of returns between Asia, US and global bonds (5-y period of Asian local currency bonds hedged in USD versus US, global and emerging market bonds hedged in USD)

	USD bonds	US Treasuries	Global bonds	Asia	China onshore	China offshore	India	Indonesia	Thailand	Malaysia	Philippines	Korea	Singapore	EM
USD bonds	1.00													
US Treasuries	0.93	1.00												
Global bonds	0.96	0.91	1.00											
Asia	0.68	0.62	0.71	1.00										
China onshore	0.11	0.11	0.12	0.29	1.00									
China offshore	0.11	0.08	0.13	0.23	0.21	1.00								
India	0.30	0.27	0.32	0.43	0.13	0.11	1.00							
Indonesia	0.18	0.11	0.19	0.53	0.02	0.08	0.16	1.00						
Thailand	0.52	0.45	0.53	0.75	0.21	0.19	0.31	0.32	1.00					
Malaysia	0.47	0.35	0.47	0.68	0.13	0.18	0.20	0.39	0.54	1.00				
Philippines	0.34	0.29	0.35	0.57	0.12	0.17	0.18	0.30	0.37	0.41	1.00			
Korea	0.58	0.55	0.63	0.73	0.11	0.08	0.24	0.10	0.46	0.36	0.27	1.00		
Singapore	0.61	0.61	0.64	0.78	0.16	0.16	0.26	0.23	0.53	0.47	0.36	0.57	1.00	
Emerging market	0.55	0.41	0.55	0.63	0.13	0.16	0.32	0.48	0.53	0.50	0.34	0.37	0.40	1.00

Past performance is not an indicator of future returns.
Source: HSBC AM, Bloomberg, Markit, FTSE, JPMorgan, 13 March 2024.

Source: HSBC AM, April 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

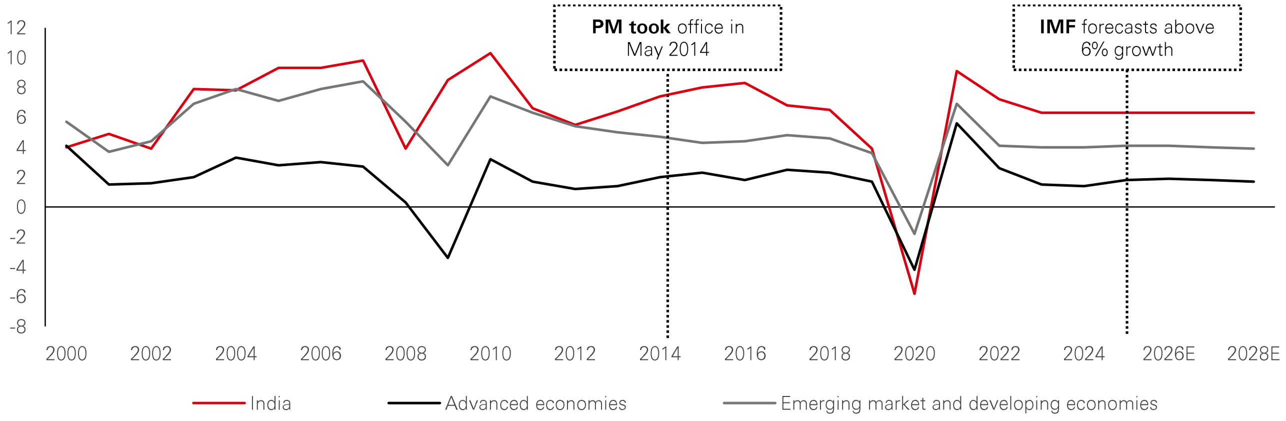
The ongoing contrast of Asia's two largest markets



The ongoing contrast of Asia’s two largest markets

> “India’s strategic reforms and economic ascent contrast negative sentiment around China, yet both markets offer interesting investment opportunities.”

Figure 1: Year-on-year real GDP growth (%)



Source: HSBC AM, IMF, October 2023.

In recent years, Indian equities have shown resilience despite global economic challenges. The country’s standout economic performance, coupled with strategic reforms and demographic advantages that bode well for the future, has positioned it as a promising investment destination. Notably, India's economy grew by 8.1% in the last quarter, with expectations of sustained growth over 6% in the years ahead. This growth trajectory positions India to potentially become the third-largest economy by 2027, surpassing Germany and Japan.

With prudent fiscal policies leading to a decrease in deficits and a declining debt-to-GDP ratio, the responsible nature of this growth has helped in bolstering investor confidence in the economy's stability. Furthermore, rising incomes and the changing consumer preferences which coincide with this, form the basis of an expected long-term consumption growth catalyst.

The shift from a $2,500 average per capita income to what should become much higher levels is triggering a significant increase in discretionary spending, with this particularly being seen in higher income regions. Expansion of this trend drives potential for sustained growth across sectors of the economy.

Coinciding with India surpassing China as the world’s most populous country, Chinese equities have had the opposite trajectory of late, due to important concerns related to the stability and growth potential of the Chinese economy. Various factors have influenced China's economic trajectory, from the derailment of the property market to geopolitical tensions. However, there are potential indicators for a turnaround and market recovery.

For instance, consumer savings in China remain high, supporting hopes for strengthening in consumption and activity ahead. Furthermore, the economy continues its shift to more technologically advanced and higher value-add manufacturing, with rapid growth in areas such as renewable energy and electric vehicles. Yet, broader economic uncertainty following the property crash continues to be an inhibitor, and the Chinese government is maintaining a cautious approach to fiscal stimulus.

Source: HSBC AM, April 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

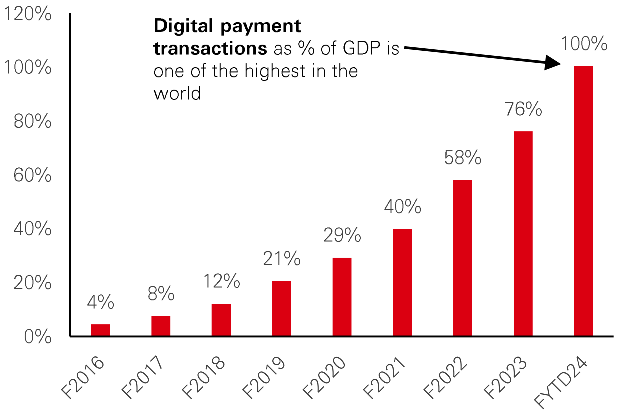
Influence of policy measures

The Indian government's concerted efforts to liberalize the economy, streamline regulatory frameworks, and foster an investor-friendly ecosystem through initiatives like "Make in India" and the implementation of Goods and Services Tax (GST) have bolstered investor confidence and propelled economic growth. Infrastructure development has been another critical factor in driving the growth engine. Significant strides have been made in expanding transportation networks, including doubling the number of airports and expanding metro systems across urban centres. This has enhanced connectivity and generated employment opportunities. Additionally, opportunities have been created through a notable shift towards renewable energy sources, with ambitious targets set for solar and wind power generation by 2030.

India’s forward-looking approach to economic development is also supported by the implementation of digital public infrastructure via India Stack. This comprehensive framework encompasses key elements to revolutionise financial inclusion, identity verification, and digital payments in the country.

The combination of these elements have enabled seamless transactions and access to government assistance schemes. Additionally, the widespread adoption of mobile networks, growing India’s mobile network to the second largest behind China, has facilitated easy and secure digital payments across the country. This unified payment infrastructure has not only streamlined financial transactions, but also paved the way for efficient delivery of public goods and services.

Figure 2: Total value of digital transactions as % of GDP in India



Digital payment transactions as % of GDP is one of the highest in the world

Source: RBI, Morgan Stanley forecasts, data as of October 2023
Note: Transactions include IMPS, UPI, PPI and Credit and Debit card POS

Importantly for the long-term picture, with successive governments prioritizing economic reforms and infrastructure development, the upcoming elections are unlikely to derail the nation's economic trajectory.

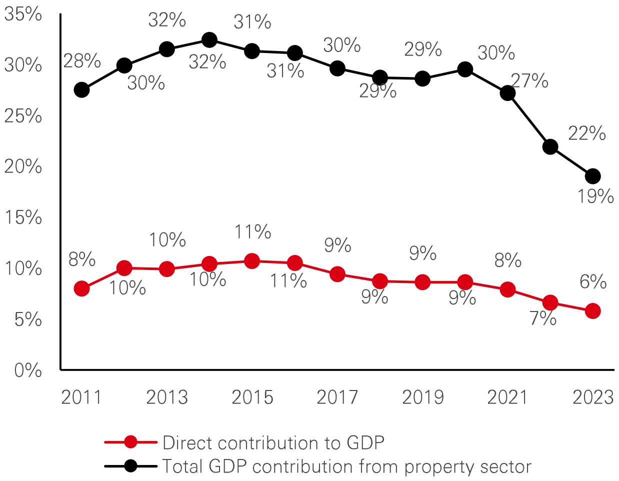
On the opposite end of the spectrum, China's economic landscape also presents a myriad of opportunities but interwoven with prior regulatory interventions and geopolitical tensions that have generated apprehension among investors. Of course, the most severe impact of such interventions was seen in the slowdown of the property market.

Tightening measures which were implemented, particularly aimed at property developers, have led to liquidity issues for private-owned property developers and a halving of housing transactions in recent years.

Aggressive credit tightening measures, particularly aimed at property developers and households, have led to a halving of housing transactions in recent years. Despite the severity of this slowdown, it is crucial to note that it didn’t crater the broader economy and result in a financial crisis akin to those witnessed in the US in 2008 or Japan in the 1990s - indicating a degree of resilience within the system. Moreover, the shift away from speculative demand towards genuine housing needs signifies a positive development.

However, the repercussions of the property market slowdown still extend beyond the real estate sector, exerting a significant drag on China's GDP growth. Historically, property-related investments contributed substantially to growth, peaking at 30%.

Figure 3: GDP contribution from China’s property sector



Source: PBOC, Citi Research estimates, HSBC AM. February 2024.

Source: HSBC AM, April 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

GDP growth has faced clear pressures from the malaise in the property sector, albeit remaining positive even through an extended period of Covid restrictions. Nonetheless, as property's contribution to GDP diminishes, there is a need for alternative growth drivers.

The Chinese government has strategically pivoted towards higher-end manufacturing and technological advancement. This shift entails a redirection of resources and policies, steering away from virtualized sectors like internet-based industries. Investments in areas such as mobile phones, new energy vehicles, and renewable energy sources have shown promising and rapid growth. These sectors accounted for less than a tenth of GDP in 2019, but are now estimated to reach around 16% by the end of this year, matching the contribution of the property sector.

While concerns over trade tensions and geopolitical uncertainties persist, China's export resilience leveraging competitive pricing and technological advancements, and diversified supply chains have mitigated some of these challenges. China also extended its export prowess beyond traditional markets like the US and Europe, increasing penetration in emerging markets.

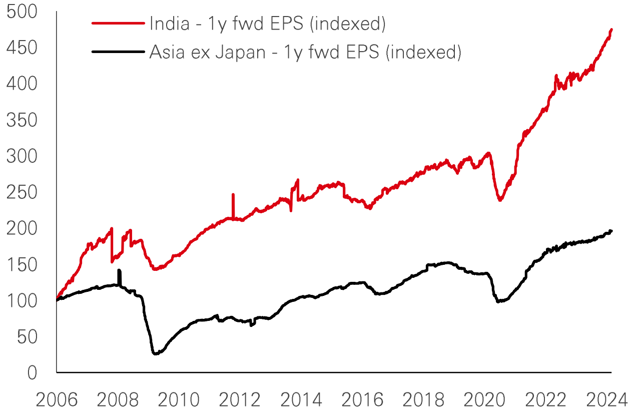
Despite these headwinds, China's economy has demonstrated resilience, buoyed by robust economic fundamentals, entrepreneurial dynamism, and adeptness in navigating regulatory challenges. Efforts to deleverage the shadow banking system and moderate debt levels, coupled with a strategic pivot towards consumer-driven growth and technological innovation, underscore China's resilience amidst evolving economic paradigms.

Evaluating the investment opportunity

Indian equities may appear relatively expensive compared to global benchmarks, with P/E multiples higher than their long-term 10-year average. However, India’s market performance is primarily driven by higher return on equity compared to its peers. This is supported by a sustained corporate earnings growth trend outpacing other regions, as evidenced by the widening disparity between India and Asia’s 1-year forward EPS.

Driven primarily by domestic factors, EPS for India’s Nifty index is expected to more than double between 2020 and 2025, with a CAGR of around 19%. Thus, the emphasis is on quality growth stocks in sectors poised for long-term expansion. Additionally, investors can reap diversification benefits given India’s low correlation to global and regional markets.

Figure 4: 1-year forward EPS of India vs Asia ex-Japan (indexed)

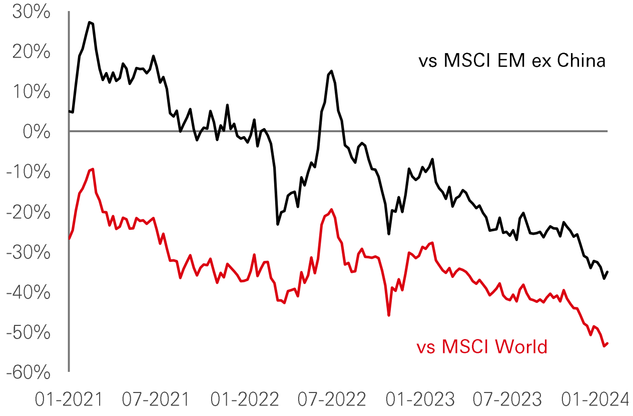


Source: Bloomberg, data as of February 2024
India: MXIN Index, Asia ex Japan: MXAP Index

In contrast, pessimism surrounding Chinese equities may be creating an opportunity. Global funds have cut China allocations to an historic level, leaving little room for further selling, especially given current valuations. The valuation gap between China and other Asian markets has expanded dramatically since 2023. Chinese equities now trade at a P/E of less than 9, dropping from 11.9x at the start of last year, now far below its 10-year average and trading at the lowest valuations in Asia. With a transitioning economy and undervalued assets, there is potential for significant upside over the long-term in Chinese equities, but structural reforms and geopolitical uncertainties will warrant caution.

While India’s continued growth trajectory is certainly not guaranteed, China’s faces far more pressing uncertainty. This is reflected in valuations, presenting differing and inherently diverse opportunities for investors.

Figure 5: MSCI China relative valuations (12M Fwd P/E)



Source: Bloomberg, EPFR, Wind, Goldman Sachs Prime Services, MSCI, FactSet, Morgan Stanley, February 2024.

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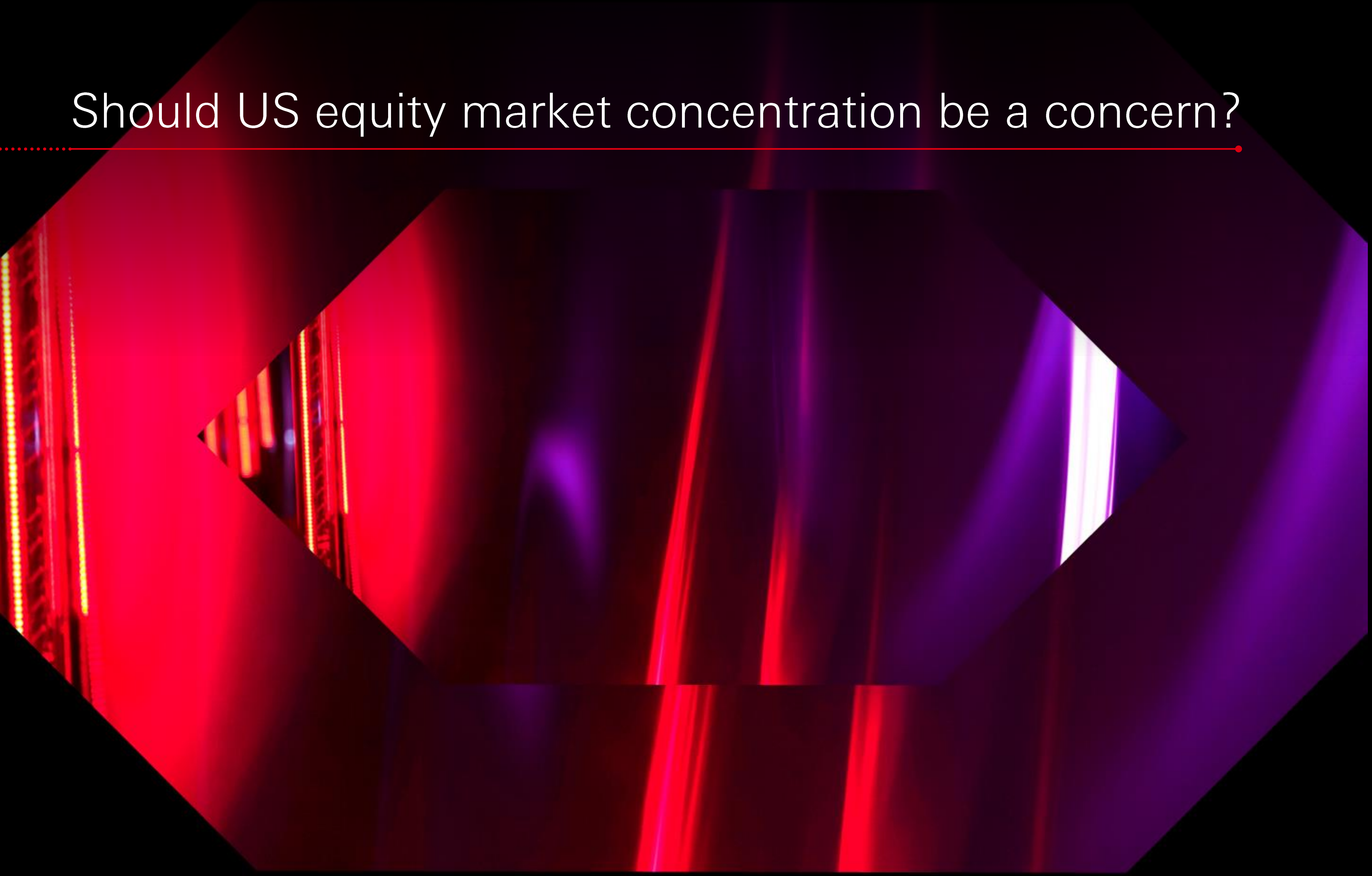
Should US equity market concentration be a concern?



Should US equity market concentration be a concern?

> "Concentration of the US equity market could raise challenges related to diversification and drawdown risks."

Market concentration has been a hot topic of discussion in equity markets. The top ten names in the US equity market have a cumulative market cap larger than the combined stock markets of Japan, Germany, France and the UK. While much emphasis has been on the gargantuan scale of US megacap market capitalisations, concentration in European equity markets is significantly higher when measured purely by the proportion of market capitalisation in the ten biggest stocks. However, by other, more relevant measures discussed later, European equity markets offer better diversification than the US. Concentration in the US is especially impactful given it now accounts for over 40% of global market capitalisation, a level last seen in the mid-1970s and the notorious late 1990s dot-com bubble. By contrast, the US economy only accounts for 20% of global GDP, which is much lower than the proportion in the 1970s. Of course, globalisation has reshaped today's economy with much of the operations and revenue for US megacap stocks derived outside of the US.

Nonetheless, even sticking to comparisons against strictly US stock market history paints a similar picture. Currently, the top ten names in the S&P 500 account for nearly a third of the index, which is the most concentrated since the 1970s.

Many factors have driven us here. The aforementioned economic shifts of globalisation enabled the large tech companies to shed costs and acquire a global consumer base. Separately, sluggish domestic GDP growth and low rates have contributed to the appeal of the growth and free cash flow generation of the megacaps.

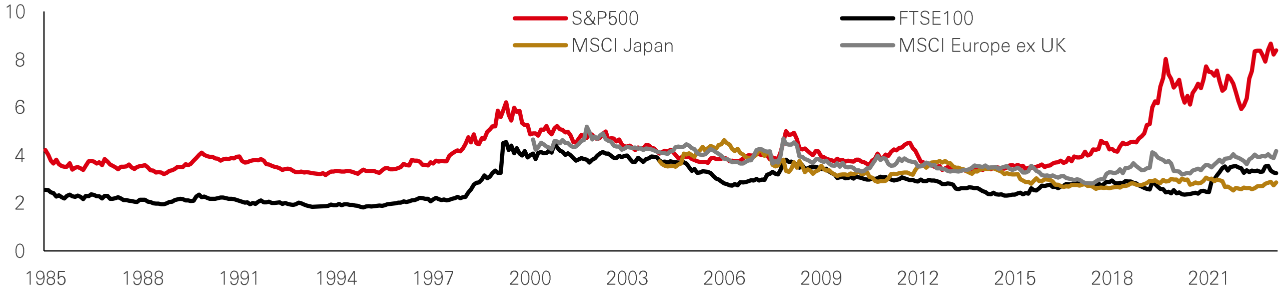
Higher interest rates today could provide a reason for their valuation premium to narrow, but there appears to be scepticism that the macro environment is indeed changing from the low rate policies of the past decade.

US exceptionalism

A relevant measure used to calculate market concentration is the Herfindahl-Hirschmann Index (HHI). The HHI is the sum of the square of individual market share, which can be applied to index weights to gauge the concentration of a market index. However, the number of constituents in an index differs across the core markets – e.g. S&P500 vs FTSE100 – and can also differ over time. To adjust for this, we divide the HHI by the HHI of an equally weighted index, which adjusts it for the number of constituents and makes it more comparable across markets and time.

By doing so, we see that the US is currently an outlier in terms of equity market concentration, both relative to other core markets and its own history.

Figure 1: Adjusted HHI by Market Index



Past performance is not an indicator of future returns. Source: HSBC AM, Bloomberg, February 2024.

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From a sector perspective, again, the US is an outlier. Technology is dominating S&P 500 sector exposures, while other major markets such as Europe and Japan continue to provide more balanced and diversified exposures. Below, we observe that elevated US concentration levels tend to not be persistent. For example, industrials peaked around the turn of the century, with General Electric being 45% of a sector in which concentration has been divided by seven since.

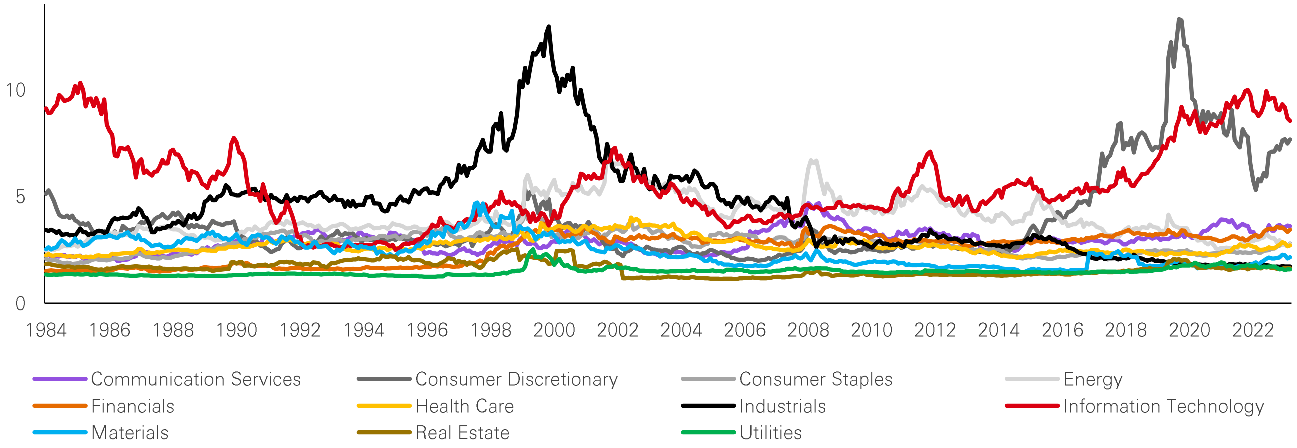
Today, consumer discretionary follows information technology as the most concentrated sector. Of course, tech is where most of the Magnificent 7 lies, with only Google and Meta not being in these sectors – instead sitting in communication services. The Magnificent 7's weight in the S&P 500 has grown massively over the past few years, representing 28% of the index at the end of last year, nearly double the roughly 15% at the end of 2018. Microsoft alone now has a weight of 7%.

While the comparison between the current environment and the Dot Com bubble seems inevitable, there is a key distinction that makes the current situation different. The Magnificent 7 are more mature companies that are already backed by solid earnings, so are not just a punt on what the future of technology can deliver. According to IBES forecasts, they are expected to contribute to over 20% of earnings this year, and over a third of overall earnings growth for the index.

In addition to their already solid earnings, the revenue growth potential of the Magnificent 7 from advances in generative AI will play a key role in their path forward.

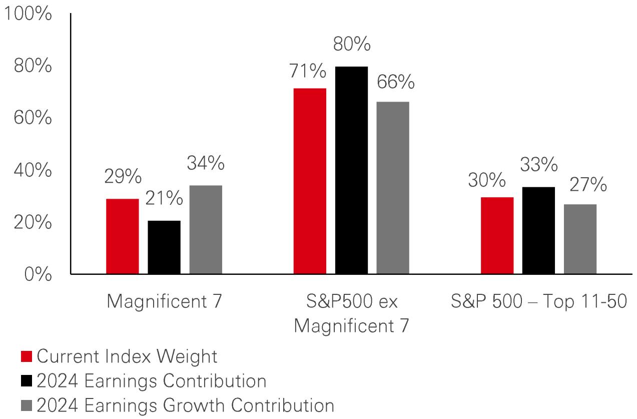
Another structural factor that is driving more momentum into these stocks is the growth of passive management. Passive strategies have continued to grow while active funds have been experiencing outflows for an extended time.

Figure 2: S&P 500 Sector Adjusted Herfindahl-Hirschman Index



Past performance is not an indicator of future returns. Source: HSBC AM, Bloomberg, February 2024.

Figure 3: 2024 earnings breakdown



Past performance is no guarantee of future returns.
Source: JP Morgan Research, Bloomberg, HSBC AM, February 2024.
*Earnings refers to net income, where growth is calculated as the difference between 2023 actuals and 2024 IBES estimates

This can contribute to share price appreciation and generate more hype around these stocks, which causes a headache for active managers that are underweight the stocks or hedge funds that are short and may need to close these positions due to stop losses – which generates more share price appreciation.

Implications for portfolio construction

Magnificent 7 stock returns have been positively correlated to the performance of global government bonds since 2020, which has wide-ranging consequences for portfolio construction. These stocks are also highly correlated to each other as they share common risk factors, such as being almost uniformly sensitive to the path of interest rates.

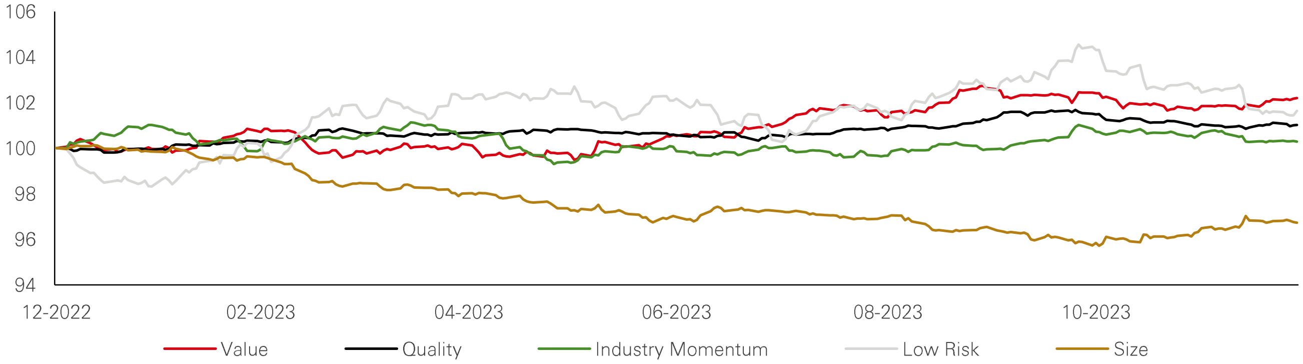
Source: HSBC AM, April 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

This has important implications as looking forward, some of the factors that supported the rise of the Magnificent 7, such as globalisation and ultra-low interest rates, are under threat. Additional risks extend to the US stock market and economy. Concentrated equity markets dominated by a handful of very successful firms are associated with less efficient capital allocation, sluggish initial public offering and innovation activity, and slower economic growth[1]. Furthermore, risks from anti-trust regulatory action, disruptive competition, de-globalization, and geopolitics are heightened for the largest stocks, and these risks are passed on to the market as a whole due to the elevated concentration.

Inevitably, the outperformance of mega-cap tech has led to a sharp narrowing in equity market breadth, reducing diversification potential. The concentration of the US Equity market, coupled with high correlations of the top names within it, has led to an increase in idiosyncratic risks in market cap weighted indices. Implications extend to a balanced portfolio. Our analysis using a standard 60/40 portfolio identified higher volatility, a lower Sharpe ratio and deeper drawdowns in prior periods of elevated market concentrations historically.

There may be opportunities to tilt portfolios towards certain factors going forward, which should be assessed against the macro and market backdrop. For example, short-term factor tilts via an equal-weighted index could bring value. Market studies show that an equal weighted equity portfolio outperforms a market cap weighted over the long term[2]. However, in the short-term, the equal weighted portfolio can suffer significant under performance, as has been the case in recent years. These periods have, primarily, either coincided with higher levels of concentration in the cap weighted portfolio and/or lower benefits of diversification due to lower average volatilities and higher correlations among stocks. With this in mind, concentration alone shouldn't lead us to adjust strategic asset allocations.

Figure 4: Global factor cumulative returns – having an equal-weighted exposure removes concentration but has a size factor bias which has underperformed of late



Past performance is not an indicator of future returns. Source: HSBC AM, Bloomberg, February 2024.

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Using market capitalisation remains to be the most efficient way to access the equity risk premium in the absence of an active view. In addition, the current macro environment doesn't support a switch to equal weighted exposures today, as it would effectively introduce a 'size' factor bias towards small caps. This may not be beneficial at this late stage of the economic cycle, given that small-caps tend to outperform when real interest rates drop substantially or after a recession ends. Moreover, mega-cap tech stocks, which historically benefited from falling yields due to the long duration of their cash flows, have also outperformed in the high interest rate environment of the last two years on the back of their strong balance sheets and elevated margins.

We think it is a bit too early to consider short-term factor tilts via an equal-weighted index given the current macro and market backdrop. Alternatively, active management within US equity exposures is a potential consideration, but the environment has been a challenging one for active managers. Preparing for an eventual market regime shift favouring small caps, or active management amidst more dispersion, appears the most prudent approach today.

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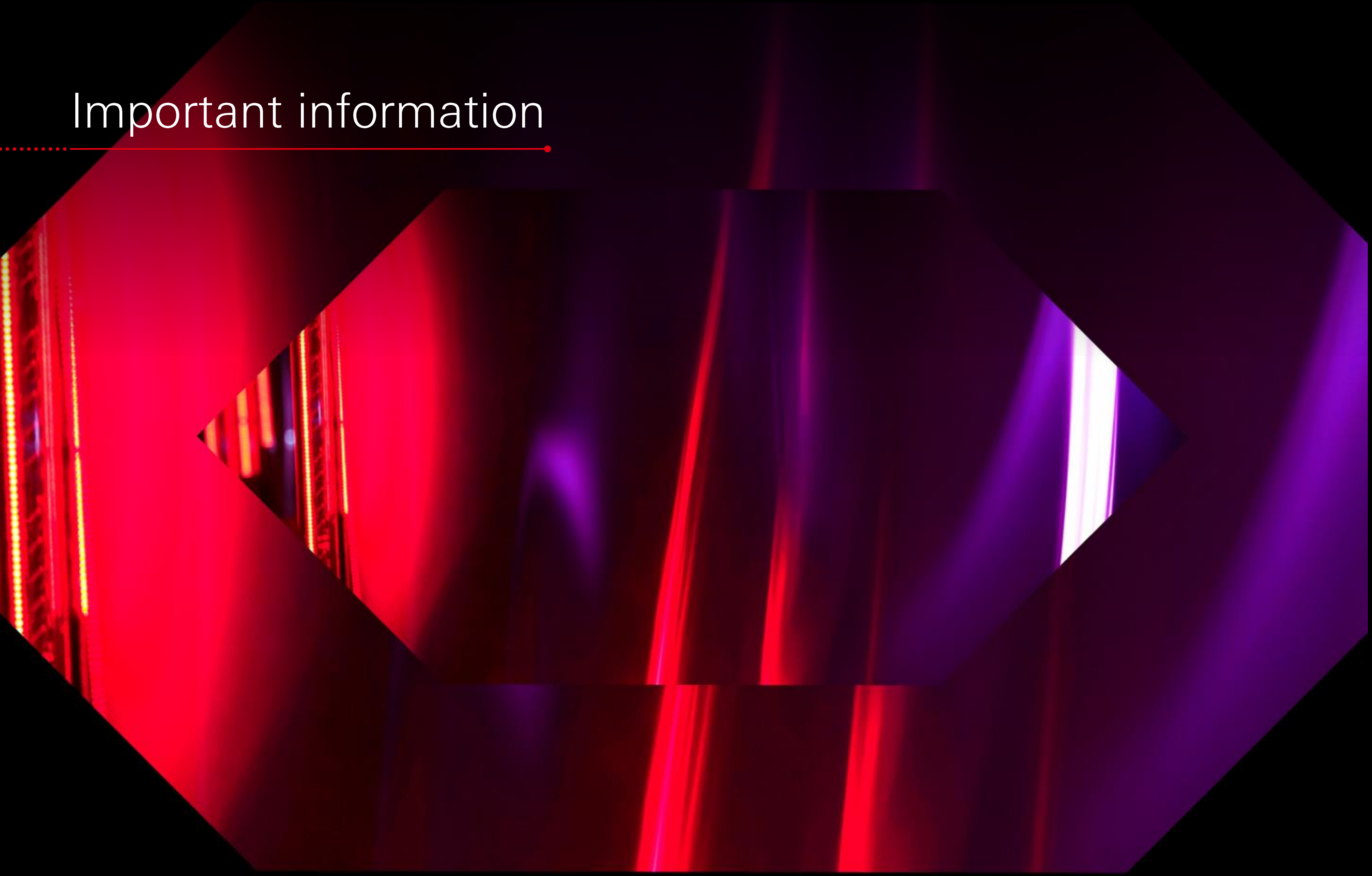

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