

Investment Monthly

Slowing US inflation raises hopes of rates peaking

December 2022



Key takeaways

- ◆ Markets have reacted positively to the lower-than-expected US inflation with headline and core inflation at 7.7% and 6.3% y-o-y, respectively, raising hopes that rates are peaking. We expect two hikes of 0.5% each in December and February to end the hiking cycle. Short-dated investment grade credit and quality stocks are preferred to build resilience.
- ◆ With the gradual relaxation of the zero-Covid policy and more pro-growth measures coming into play, we upgrade Chinese equities to overweight. Quality industry leaders in the travel, airlines, hospitality, food and beverages, Macau gaming and mass consumption sectors should stand to benefit. Valuations remain attractive.
- ◆ As the rate differentials between the USD and other currencies are not likely to widen further, we expect the USD to weaken in 2023. Peaking USD, rising retail physical demand and ongoing geopolitical risks are supportive of gold but we maintain our neutral stance as real yields remain a challenge.



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Asset class	6-month view	Comment
Global equities	▼	Although equities have bounced lately, we don't think this is sustainable as the economic downturn puts earnings under pressure. We focus on quality companies with healthy balance sheets, strong market positions and dividend payouts.
Government bonds	▼	Yields have backed up and government bonds provide diversification, but we prefer high rated corporate bonds.
Investment grade (IG) corporate bonds	▲	Slower inflation and peaking interest rates are positive for high grade bonds across developed markets, emerging markets and Asia. They offer attractive yields pick-up and diversification benefits. Short-dated IG credit is preferred.
High yield (HY) corporate bonds	▶	Corporate credit spreads continue to widen, especially for lower-rated issuers amid inflation and growth uncertainty. We prefer investment grade over high yield with short-to-medium maturities.
Gold	▶	Despite high inflation and market volatility, real yields remain a challenge and we don't foresee much upside.

▲ "Overweight" implies a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

▼ "Underweight" implies a negative tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

▶ "Neutral" implies neither a particularly negative nor a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

Icons: ↑ View on this asset class has been upgraded; ↓ View on this asset class has been downgraded.

Talking points

Each month, we discuss 3 key issues facing investors

1. What are the implications of the US inflation in October?

- ◆ The decline in US October headline (7.7%) and core (6.3%) inflation y-o-y supports our view that rates are peaking, even if we are not there yet. We expect the Fed to hike 0.5% in both December and February, with rates staying in restrictive territory (i.e. around 5% through 2023 and 2024).
- ◆ We prefer short-to-medium, high-rated bonds amid a very flat yield curve (or inverted in some cases), and a slowing economic cycle should continue to create some spread volatility. The dovish tone of the Bank of England and the conservative fiscal management of the new government warrant our overweight on gilts.
- ◆ We remain defensive on equities due to the deteriorating cycle and exceedingly high earnings expectations but stay overweight on US equities due to their diversity and quality characteristics. We also upgrade US utilities on expanded margins and improving cash flow.

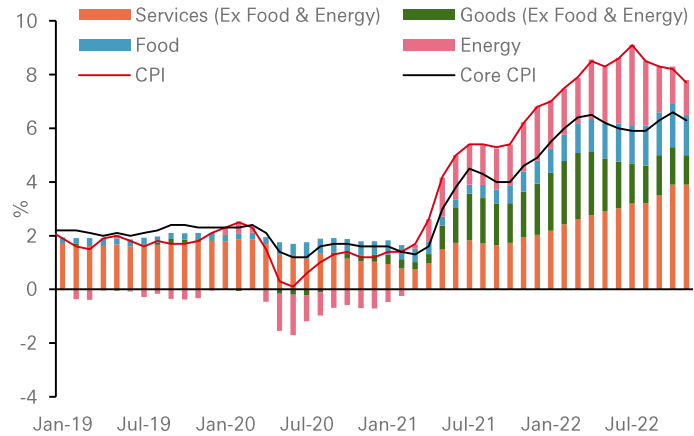
2. Is there a turning point in the China market?

- ◆ Policy tailwinds are coming into play. The National Health Commission has announced 20 new measures for further optimisation of virus prevention and control work, which includes shortening of inbound quarantine time, targeted removal of mass PCR testing, etc. New and upgraded vaccination programmes will also be rolled out. These should boost economic activity in services and consumption. Leaders in consumption and travel-related sectors should stand to benefit.
- ◆ The government has also ramped up efforts to stabilise the property sector, such as more funding support to both state-owned-enterprises (SOE) and private-owned-enterprises (POE) equally. Outstanding bank loans and trust borrowings (due within the next six months) can be extended for a year. Within the property and bank sectors, we prefer SOE developers and large SOE banks for their better financial positions.
- ◆ After the rebound since the end of October, Chinese equity valuations remain attractive. The positive drivers will support a re-rating of Chinese stocks and our upgrade to overweight, although near-term volatility will linger. Given that China is the largest market in the region, we have also moved Asian ex Japan equities to overweight.

3. Where are the Dollar and gold heading?

- ◆ The USD has risen more than 10% year to date driven by attractive rate differentials between USD and other G10 currencies, global economic weakness and relative US resilience. However, the latest US inflation data may mark an end to the widening of rate differentials.
- ◆ Although global economic weakness still provides a floor for the USD, its bull run is likely to reverse in 2023. Foreign investors may look to protect their currency gains by hedging their unwanted USD holdings.
- ◆ Gold has corrected sharply since March when the Fed became hawkish. Peaking USD, rising retail physical demand and ongoing geopolitical risks are supportive of gold. Year-to-date physical demand rose 18% versus the same period in 2021, putting gold back at pre-pandemic levels. However, real yields remain a challenge and we maintain neutral on gold.

Chart 1: Lower-than-expected CPI: not a big move, but a good start



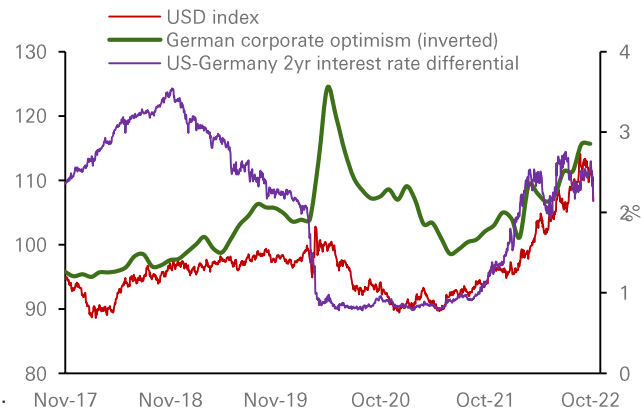
Source: Bloomberg, HSBC Global Private Banking as at 13 November 2022.

Chart 2: As downside risks have eased, we see an improved risk/return profile of Chinese stocks



Source: Bloomberg, HSBC Global Private Banking as at 13 November 2022. Past performance is not a reliable indicator of future performance.

Chart 3: Interest rate differentials should no longer widen, providing much less support to USD



Source: Bloomberg, HSBC Global Private Banking as at 13 November 2022. 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	▼	Although equities have bounced lately, we don't think this is sustainable as the economic downturn puts earnings under pressure. We focus on quality companies with healthy balance sheets, strong market positions and dividend payouts.
United States	▲	Growth is slowing but we still favour the diversity and quality of US stocks compared to Europe. The lower-than-expected inflation data does not imply an end to the inflation fight but supports our view of nearing peak rates.
United Kingdom	▼	With weak consumption and investment amid rising inflation and interest rates, Q3 GDP fell 0.6% y-o-y which marks the beginning of a recession. The political turmoil, cost of living crisis and rising interest rates remain headwinds.
Eurozone	▼	High food and energy costs, the Ukraine war and the impact of gas supply cuts remain key domestic challenges while slowing global trade flows add to the downside risk.
Japan	▶	Exports are recovering but domestic demand is weak. JPY is volatile and impacts returns.
Emerging Markets (EM)	▶	Concerns over Fed tightening, global growth slowdown, geopolitical tensions and EU energy crisis linger. Asia should benefit from their reopening trend while LatAm benefits from Mexico's attractive valuations and growth prospects.
EM EMEA	▼	The region is impacted by high energy prices, weak growth in Europe and an uncertain rate outlook.
EM LatAm	▲	The end of the rate hike cycle and less political uncertainty are positive for Brazil and the region.
Asian ex Japan equities		
Asia ex-Japan	▲↑	Asia shows resilient domestic fundamentals with the tailwinds of economic reopening and supportive policy initiatives. A recovery in China's economy would further boost the overall growth outlook for the region. We move to overweight.
Mainland China	▲↑	The government's pivot towards gradual relaxation of the zero-Covid policy and more comprehensive policy support for the property sector, along with attractive valuations support our upgrade to overweight.
India	▶	Stretched valuations and inflation concerns remain but we see structural growth opportunities associated with India's digital economy, green transition and smart manufacturing.
Hong Kong	▲	Although weak investment and property demand weigh on economic growth, consumption should benefit from the economic reopening and further relaxation of Covid measures domestically and in mainland China.
Singapore	▶	With inflation remaining high and the labour market tight, further policy tightening is likely.
South Korea	▼	Given the heavy index weighting to tech names which are hard hit by a deteriorating earnings outlook and the sluggish global demand for semiconductors, we remain bearish on South Korean equities
Taiwan	▼	We maintain our bearish view on the deteriorating earnings outlook for the semiconductor sector, which dominates the Taiwanese equity index. Geopolitical risks remain a key concern.
Government bonds		
Developed markets (DM)	▼	Yields have backed up and government bonds provide diversification, but we prefer high rated corporate bonds.
United States	▶	Downside surprise from October CPI has triggered rapid repricing in the Treasury market, as we approach peak rates.
United Kingdom	▲↑	With a more dovish Bank of England, a credible fiscal policy and attractive valuations, we upgrade gilts to overweight.
Eurozone	▼	Rising energy, goods and services prices push inflation higher, forcing the ECB to continue raising rates and current absolute yield levels remain unattractive. Deficits are under pressure too as governments support households.
Japan	▼	The Bank of Japan is likely to keep its extremely accommodative policy stance until inflation reaches the target of 2%. We expect JPY to appreciate as the rate differentials with the USD narrow.
Emerging Markets (Local currency)	▶	Select opportunities exist as some countries are slowing rate hikes but others continue. The end of the USD bull run may become a tailwind.
Emerging Markets (Hard currency)	▶	Amid higher Treasury volatility, we still find yield but remain selective.
Corporate bonds		
Global investment grade (IG)	▲	Slower inflation and peaking interest rates are positive for high grade bonds across developed markets, emerging markets and Asia. They offer attractive yields pick-up and diversification benefits. Short-dated IG credit is preferred.
USD investment grade (IG)	▲	The flat yield curve does not provide sufficient returns to extend duration. A short-to-medium term is preferred.
EUR and GBP investment grade (IG)	▲	European and UK investment grade bonds offer a decent yield pick-up. We prefer higher quality names and short-to-medium maturities amid the sluggish growth outlook.
Asia investment grade (IG)	▲	We prefer short-to-medium duration Asian investment grade bonds which are expected to see lower price volatility amid rate uncertainty.
Global high-yield (HY)	▶	Corporate credit spreads continue to widen, especially for lower-rated issuers amid inflation and growth uncertainty. We prefer investment grade over high yield with short-to-medium maturities.
US high-yield (HY)	▶	While US high-yield companies still enjoy solid credit fundamentals and low default rates, tightening financial conditions and the higher Fed fund rates create downside risks.
EUR and GBP high-yield (HY)	▶	As policy tightening continues and European economies continue to weaken, we prefer higher quality investment grade credit and maintain a neutral stance on high yield.
Asia high-yield (HY)	▶	Although most Asian markets face relatively less inflationary pressure compared to the developed markets, the Fed tightening and slowing global demand remain headwinds.
Commodities		
Gold	▶	Despite high inflation and market volatility, real yields remain a challenge and we don't foresee much upside.
Oil	▶	High price levels reflect supply concerns but demand is starting to decline.

Sector Views

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

Sector	Global	US	Europe	Asia	Comment
Consumer Discretionary	▼	▼	▼	▶	Inflation, rising energy and financing costs are weighing on consumer demand and corporate profits. Corporate margins are also impacted by labour shortages and rising wages. Automakers and retailers are hard hit by slowing demand. Luxury goods remain resilient while airlines show signs of stronger demand albeit from a low base.
Financials	▶	▶	▼	▶	High inflation has resulted in central banks raising interest rates which is positive for financials. However, slower financial market activity has resulted in flows sharply declining and listings curtailed negatively impacting brokers and investment banks. The global economic slowdown may hurt demand for new mortgages and loans while insurance companies are facing increased event risks.
Industrials	▼	▶	▼	▼	New orders remain weak as a consequence of the slowing economy. Input costs remain elevated with energy prices and inflation hurting margins, although easing commodity cost provided some relief. The cycle may have reached its bottom with the potential for an improving outlook early next year. Companies supporting renewable energy and electric vehicle production continue to thrive.
Information Technology	▶	▶	▶	▼	Although IT stocks continue to be range bound due to the risk-off sentiment and several stock specific factors (e.g. lower digital advertising spend), low valuations and robust quarterly results make some quality, large-cap IT stocks attractive. We remain positive on the sector's long-term growth prospects driven by digitalisation, electrification and automation. Consumer-focused electronics are likely to see muted growth under inflationary pressure.
Communications Services	▶	▶	▲	▶	The media & entertainment industry remains challenged while the telecoms industry benefits from steady cash flows and growth from increased data usage as more activity shifts online and business digitises.
Materials	▶	▶	▶	▼	Mining stocks remain depressed despite low valuations as commodities prices remain range bound after the sharp pull-back. Near-term catalysts for higher prices remain elusive. Higher energy and oil/gas feedstock prices continue to weigh on the chemicals and construction materials industries. The sector trades at the lowest valuation relative to all others.
Real Estate	▶	▶	▼	▶	Private residential real estate has benefitted from supply-demand imbalances, but rising interest rates may soften demand. Retail real estate suffers from long-term structural changes caused by the rise in ecommerce which is unlikely to change. Elsewhere, office space is being reduced by more employers promoting hybrid models. In addition, we see a surge in demand for storage and warehousing assets.
Consumer Staples	▲	▲	▲	▲	Elevated valuations and costs remain a concern. However, corporates have reported robust double-digit average price increases for Q3 earnings which have fuelled sales. We focus on quality stocks with strong brands and/or pricing power with above-average dividend yields.
Energy	▲	▲	▲	▲	The energy sector should continue to benefit from OPEC keeping supply tight to protect profits, low inventories, supply-demand imbalances, and the northern hemisphere starting to experience colder weather. Valuations remain very attractive, especially following the recent sell-off.
Healthcare	▶	▶	▲	▶	Valuations remain attractive versus consumer staples and utilities. Pharma stocks should be most resilient particularly post-US mid-term elections which has effectively removed any major risk of political moves to reduce medicine prices. Higher-beta biotechnology industry typically underperforms in this environment.
Utilities	▶	▲↑	▶	▶	The sector tends to have stable earnings/cash flow characteristics and high dividend yielding stocks. We upgrade US utilities as margins should expand on the strong pricing environment and capex cycle reaching its peak, so free cash flow should start to improve.

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