Mid-Year Investment Outlook

The trend accelerator

June 2020

HSBC Global Asset Management

What has happened in markets and the economy in 2020 so far?

The economic "sudden stop" created a colossal surge in risk aversion in financial markets.

- Safe haven asset classes, like the US dollar and treasuries, strengthened, while credit spreads surged
- In equities, investors reacted strongly with a sharp sell-off that quickly rippled through global equity markets
- We ultimately saw an over 30% decline in US dollar terms in both developed and emerging markets equities

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Backdrop

The global pandemic and the "great lockdown" have been historic moments. What began as regional shocks to the global supply chain, evolved into a brutal collapse in consumer spending and demand. It was as if the electricity to the economic system had been turned off.

Response

Central banks and governments have acted quickly to aid economies through varying measures, such as cutting interest rates, providing funding to businesses and financial support for individuals. The goal is to limit an inevitable recession and try to stimulate faster recovery as the lights come back on in the economy.

Impact to investment markets

As various industries ground to a halt, such as travel and manufacturing, this sparked a plunge in oil prices, exacerbating stress in financial markets. This resulted in the fastest bear market of all time.

Since the middle of March, financial markets began to stabilise, and then rally. The extent of the rebound has varied across asset classes and regions. However, it is hard to over-state the damage that has been done to the global economy. It has been a truly remarkable first half of the year.

Investment involves risk. Past performance is not a reliable indicator of future performance.

Did you know

A **bear market** is when a financial market, like global stocks, experiences a persistent fall in prices, generally at least 20% or more.

A **rally** is a period of sustained increases in financial market prices, usually following a period of declining prices like a bear market.

Credit spread is the difference in yield between government bonds and less secure corporate debt securities.

What is our outlook as we head into the second half of 2020?

The rapid reversal of the "bear market" has led many investors to label the stock-market action as irrational. But this view is incorrect.

Markets are forward-looking

First, we should remember that investment markets are forward-looking, whereas economic data is lagging.

For example, unemployment rates typically keep rising well after equities have bottomed. With a third wiped off stock prices early in the pandemic, investors were already fearing the worst.

Bold policy support

Second, bolder than expected policy support has improved the outlook for the economy and lifted investors' mind set.

As a comparison, in 2008, it took 2 months after Lehman collapsed for the US central bank to cut interest rates. This time it happened in less than two weeks, and policy innovation has kept going.

Asia as an indicator

Third, while the global economic data remains negative, parts of China and industrialised Asia have begun the road to recovery faster than many expected. Asia has been the lead indicator through this crisis, and the latest statistics show a clear back-to-work dynamic.

Consider the market drivers

Finally, the stock market is not the economy. Parts of the economy most impacted by the pandemic, such as hospitality and tourism, are not large index weights. And even though it appears that US equities have dramatically outperformed the rest of the world, that gap is not so large when considering differences in sector exposures.

Looking ahead

Recovering global growth

Our base-case scenario assumes a ramp-up of testing and tracing, only isolated further outbreaks of the virus and a vaccine available in the middle of 2021, with some restrictions persisting until mid-2021. Working backwards, it means the recovery has begun already in this quarter. By the end of next year, the global economy should be fully-established on a new, lower trajectory but with a roughly similar trend growth rate.

Downside risks

Different economies have differing capacities to deal with crises, for example around policy flexibility. The risk of a second wave of infections also looms. Another worry is economies suffer long-term damage, for example to trade flows or labour markets.

Selective opportunities

Investors need to think harder about how they diversify. We believe alternatives such as liquid hedge fund strategies, which can prove useful in shielding portfolios when there is a reversal in markets, should play a greater role. We see value in high quality corporate bonds which offer a notable yield differential over government bonds. More emphasis on regional allocation, styles and sectors also follows.

Sustainability

With the social issues that have come to the fore most recently, the pandemic only elevates the importance of sustainable investment considerations. The environmental ramifications of the lockdown may also be a motivator to accelerate the transition to a low carbon economy.

Following the fast decline experienced, our main scenario is for a "swoosh", gradual recovery.

We see that Covid-19 is accelerating trends already in play before the crisis. Some, such as increased take-up of technology and sustainability issues, are positive for long-term returns. Others, such as the retreat of globalisation, are less so.

Multi-asset outlook

What were the main impacts on financial markets?

The performance story this year has come in two distinct phases, the first being the sell-off in March. While its speed was surprising, the relative returns of asset classes were typical of a market crash.

The rally that followed, however, was uncharacteristic. For a start, it has been relatively defensive, meaning assets that are considered safer have done well. Government bonds remain near their year to date highs, with interest rates being held low and stable, and Gold has also performed well. This is contrary to recoveries in the past where perceived 'safe assets' suffered as risk appetites returned. Even within risky assets, defensive ones have outperformed, such as US stocks which have fared better than other equity markets.

Can we look at China as an economic baseline?

It is positive that China is getting back on track, but its economy is manufacturing-focused and easier to restart than service-led economies. It is also worth noting that data remain weak in other sectors such as travel and entertainment. China has returned to work, but its people are not yet socialising or spending to the same degree.

Therefore, market expectations for a rapid normalisation may be optimistic. If global growth is slower to pick up, there is also a higher risk that broader cyclical issues emerge. For example, corporate debt defaults is a risk we are watching closely. Markets are currently applying a low probability to these types of risks.

What are the opportunities amidst turbulence?

Although notable risks remain, the market declines have created opportunities for long-term investors. Our approach to navigate this environment is to build portfolios that effectively combine defensive assets (which provide resilience if further falls occur) with riskier assets (to benefit from longer-term gains). This combination can enable portfolios to perform well in different scenarios.

For those with a shorter-term horizon (12 months or less), however, it may be opportune to take some risk off the table after the rally since March. Near-term vulnerabilities could provide attractive re-entry points later in the year.

Generally, we favour assets supported by central banks. We are overweight investment grade bonds, where yields look appealing and backstops by the Federal Reserve and the European Central Bank limit downside risk.

Our exposure to government bonds has been reduced. In our view, they are not very attractive from a valuation perspective and their hedging properties become increasingly limited as interest rates approach zero, leaving prices range-bound.

We believe alternative asset classes can be more useful in shielding portfolios if there is a reversal in risky markets. Lastly, we think it is important to diversify through other defensive assets, including gold and currencies such as the US dollar, Swiss franc and yen, depending on the portfolio.

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Relative returns of asset classes were typical in the market sell-off, but the rally that followed was unusual.

If global growth is slower to pick up, there is a higher risk that broader cyclical issues emerge.

We see opportunities in asset classes supported by central banks' policies and value the diversification properties of particular alternative investments.

Jean-Charles Bertrand

Global CIO Multi-Asset
HSBC Global Asset Management

Equities outlook

How has the first half of the year been for equities?

As the COVID-19 story began to unfold in late January, a number of sharp sell-offs resulted in a one third drop in US dollar terms across developed and emerging equity markets by mid-March. The sudden crash in crude oil prices in the same period compounded the crisis.

Since then, equity markets have rebounded as governments and central banks implemented various fiscal and monetary controls. The recovery has been uneven, however. US technology stocks raced ahead and onshore Chinese equities have clawed back most of their losses. Meanwhile, certain emerging markets (India, Indonesia, the Philippines, Brazil and Colombia) are still reeling from currency devaluations, local dynamics and worries that the pandemic is not behind them.

How do we see equity investment opportunities for 2020?

We believe regional and country differentiation has come to the fore during this crisis, highlighting the importance of selectivity. Our preferred region for equities remains Asia, but with a bigger focus on the more developed markets such as China, South Korea, Taiwan and Hong Kong. In addition to being attractively valued, they have lower exposure to commodities and oil, and have proven themselves to be better equipped to cope with the COVID-19 crisis.

Despite a significant hit to corporate earnings and dividends, our equity valuation model suggests that the return investors can expect from equities over risk free assets – the so-called equity risk premium – remains attractive. Though there are several unknowns that could potentially impact our projections, we believe that in the long run – despite any near term hit to earnings and dividends – equities currently look well priced.

There could be different but equally uneven recoveries, perhaps where demand is more resilient but the supply side takes longer to get back on track. Obviously, a major development such as the availability of a vaccine could trigger a rally in equity markets.

And what about the longer-term picture?

We are seeing many changes in human behaviour, supply-demand dynamics, consumption patterns and environmental factors due to the pandemic. While we are doubtful about the lasting impact of many, we believe some will endure and accelerate existing trends. As an example, a number of e-commerce enabled companies have proven to have robust business models and can potentially reap the benefits of changing consumption behaviour in future.

Likewise, it is reasonable to expect public and private entities to take steps to strengthen healthcare infrastructure, increase capacity and build adequate buffers – which is a positive for companies in related sectors.

Equity markets have rebounded since the rapid sell-off, but the recovery has been uneven.

Our preferred region remains Asia, with focus on markets that have proven to be better equipped to cope with COVID-19.

We believe some changes are here to stay and may influence equity opportunities for years to come.

Bill Maldonado

Global CIO Equities,
CIO Asia Pacific,
HSBC Global Asset Management

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Bonds outlook

What themes have emerged?

We see the COVID-19 pandemic, like most shocks and major events, as an accelerator of pre-existing patterns, more than a disruptor. It is reinforcing key trends that were already developing in fixed income, such as low inflation connected to workforce vulnerability, differences in central bank support causing dispersion between countries, and acceleration of responsible investing.

However, the pandemic is also a credit shock, causing some trends to reverse. A clear example will be credit tightening and balance sheet repair in response to a wave of defaults and ratings downgrades.

How do we see 2020 for bonds?

A key driver will be the renewed ‘low for long’ theme in developed market interest rates, resulting in what we expect to be modest returns for government bonds.

For corporate bonds, we expect some bifurcation within developed markets, with a split between companies that are in scope of central bank support programmes, and those that aren’t. This creates strong incentive for companies to maintain their investment grade ratings in order to benefit from lower coupon rates and cheaper funding.

Companies not in scope will be challenged. Funding difficulties will magnify concerns with lower quality bonds, adding to industry-specific issues (for example in retail, leisure, transportation and energy).

Regionally, we see relative value in Asia, where yields have increased. This preference is also driven by the region’s effectiveness in coping with the pandemic, along with a rapid monetary and fiscal response. Asian markets have more latitude to digest rises in public deficits and are better equipped for the current environment due to social discipline and broad use of technology.

Credit selection remains crucial however, given divergent paths of companies and industries.

Within the high yield space, our preference is for US over Euro. We expect greater challenges to economic growth recovery in Europe, which has had a more wide scale spread of COVID-19 infections, along with more constrained public finances to support growth recovery compared to the US.

What are the key risks to our outlook?

Looking ahead, one important long-term consideration will be the debt overhang, as companies and governments move to pile on more debt. This does not bode well for a prolonged recovery.

In a bleaker scenario with a very slow recovery, the debt overhang would create a situation where companies don’t invest and governments have to raise taxes to reduce deficits. In this situation with nationalisation of debt, yields get lower and lower, which is not a very negative scenario for credit.

The pandemic has strengthened existing trends in fixed income, but also led some trends to reverse.

There will be diversion between bonds supported by central bank programmes, and those that are not.

Increasing debt levels could be challenging if stronger growth doesn't materialise.

Xavier Baraton

Global CIO Fixed Income, Private Debt and Alternatives
HSBC Global Asset Management

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