Multi-Asset Insights

A catch-up case for European equity and a deep dive into the quality factor

April 2025

For professional investors only

HSBC Asset Management

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Foreword

Our expectations for higher market volatility have come to bear. With more choppiness likely ahead, diversification is back at the top of investor agendas. We suggest positioning for continued country rotations while adapting factor exposures to enhance resilience.

Jean Charles Bertrand
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Welcome to the latest edition of our Multi-Asset Insights series, where we present the findings of our quarterly Strategic Forum.

The continuing geopolitical tensions of our 'multi-polar' world mean that unexpected events can further impact the macroeconomic environment and investment markets ahead. Accordingly, asset allocators must stay vigilant in pursuing opportunities amidst market volatility, while protecting portfolios from unnecessary risk exposure. In this edition of the publication, we explore the argument for continued catch-up from European equities, where valuations are still relatively low. We then evaluate the quality factor as a means to achieving more resilience within equity allocations.

As we navigate a complex economic environment, the case for European equities is interesting to us. Following a prolonged period of underperformance relative to their US counterparts, we think European markets now present selective opportunities for investors. Valuation discounts, improving earnings trajectories, and a more favourable macroeconomic backdrop suggest that a catch-up phase can continue. We explore structural factors contributing to the current rebound and highlight specific sectors that stand to benefit most, and where earnings growth is beating their US peers.

In addition, we explore the quality factor as an effective approach to build defensive qualities into equity allocations. With rising market volatility and heightened geopolitical tensions, investors are prioritising strategies that enhance resilience without compromising long-term growth potential. Quality equities, characterised by strong profitability, consistent earnings, and superior financial health, can provide a buffer during turbulent times. The quality factor has proven to reduce downside risk while allowing for participation in market upswings, making it a viable consideration for strategic allocations that avoids some of the drawbacks of more explicit defensive strategies.

As always, we trust that the insights shared will inform your investment strategies and support your decision-making in the months ahead.

In a nutshell

European equities: the catch-up case

- Despite significant challenges facing European economies, the region's equity markets present a compelling catch-up case, with relatively low valuations and potential macroeconomic improvements supporting sector-specific growth.
- Explosive growth of the US technology sector is one driver of underperformance for European equities over the last decade. The sector constitutes around 26% of the S&P 500, compared to only 7% in European indices, where tech company performance has been more moderate.
- Weaker economic growth in Europe has likewise been a detriment, with key macroeconomic challenges identified by former ECB President Mario Draghi including a productivity and innovation gap, high energy costs, and geopolitical dependencies.
- However, recent trends indicate improving corporate profit expectations in Europe, particularly in sectors like financials and healthcare, which are showing stronger growth than their US counterparts. With valuations still relatively low, a potential boost from more active fiscal spending supports the catch-up story, particularly in areas where valuations contrast earnings growth that exceeds US peers.

The role of quality in defensive portfolio construction

- As economic uncertainty and geopolitical tensions increase market volatility, strategies that enhance portfolio resilience without sacrificing long-term growth stand to gain prominence.
- Amongst diversifiers, equity factors should be a consideration. We evaluate the quality factor, which has consistently generated a premium over time while displaying a degree of shorter-term counter cyclicality, reflecting its defensive nature.
- Quality demonstrates its strongest active returns when the economic cycle moves into contractionary phase. While it lags other defensive strategies offering more explicit downside protection, these strategies hinder returns as the economy recovers, requiring a reliance on perfectly timed exits.
- Quality's superior navigation of market inflection points supports its role in strategic allocations, but sector and geographic biases require a thoughtful approach to incorporating the factor into multi-asset allocations.

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European equities: the catch-up case

With valuations still relatively low, a catch-up case remains. European economies face significant challenges, but potential macroeconomic improvements and sector-specific growth present selective opportunities in European stocks.

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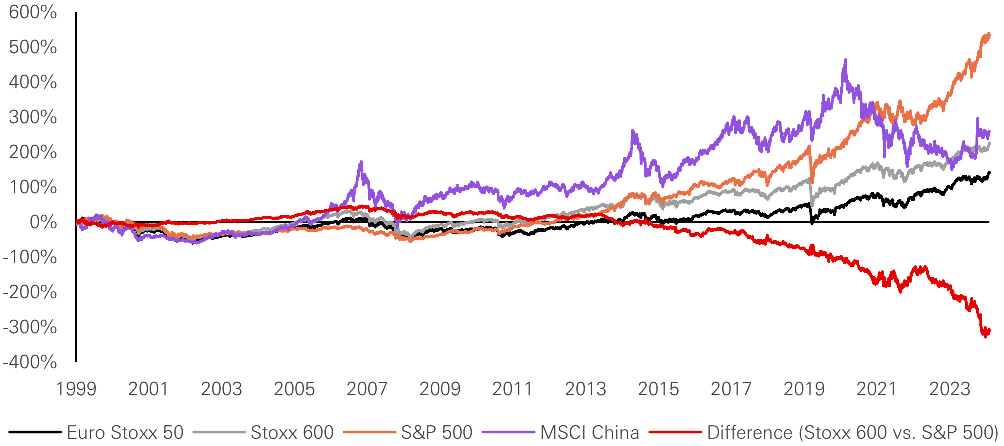
From 2000 to 2015, European equities demonstrated a trajectory that closely mirrored that of the S&P 500. However, the divergence that has since emerged highlights stark structural differences between the two markets.

Figure 1: Performance since 2000 (EUR)



Past performance is no guarantee of future returns.
Source: HSBC AM, Bloomberg. Data as of January 2025.

Sector disparities and the technology deficit

One of the primary catalysts of this performance gap has been the explosive growth of the technology sector in the US, juxtaposed with Europe's heavy reliance on financials, industrials, and healthcare. Tech companies now account for around 26% of the S&P 500 index – a figure that increases when considering firms like Meta and Alphabet, which are categorised under communication services. In stark contrast, technology represents only about 7% of European indices.

Over the past five years, US technology companies have consistently outperformed all other sectors, with an average annual return of 27%. The gap between European and US technology firms is even more pronounced, as US tech companies have grown at nearly twice the rate of their European counterparts. This disparity underscores Europe's struggle to foster a thriving technology ecosystem that can compete with Silicon Valley’s dynamism.

Figure 2: Top 10 Sector Allocation - Stoxx 600 (S&P 500)

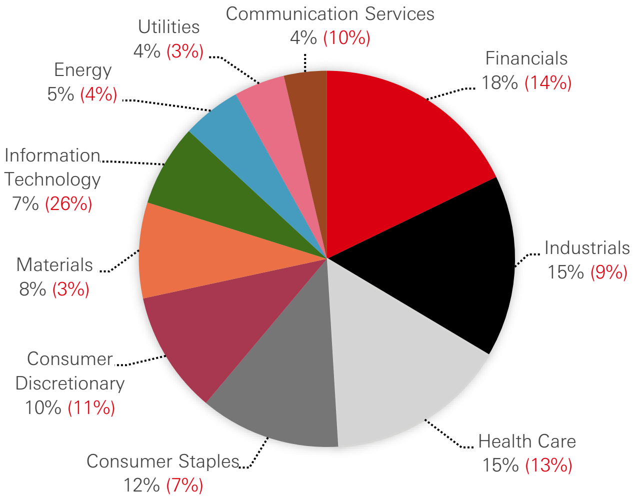
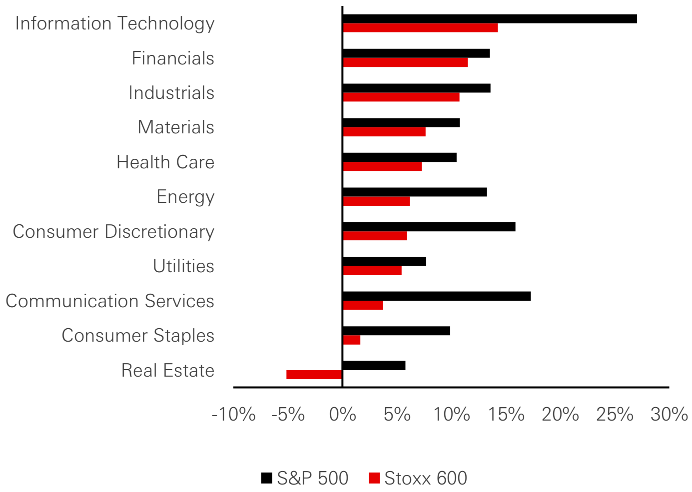


Figure 3: Annualised sector performance since 2020 (EUR)



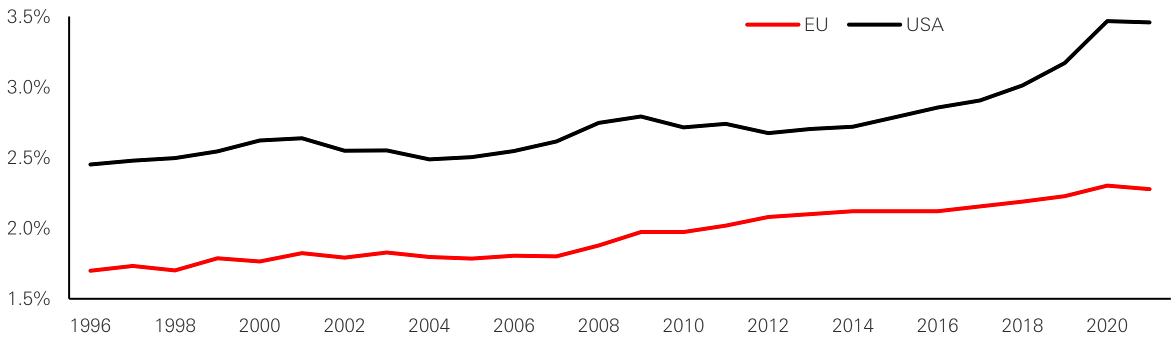
Past performance does not predict future returns.
Source: HSBC AM, Bloomberg. Data as of January 2025.

The macro challenge

Underperformance of European equities across all sectors reflects broader economic challenges. In a 2024 paper, former European Central Bank President, Mario Draghi, identified three fundamental challenges facing Europe: a productivity and innovation gap, high energy costs and decarbonisation, and geopolitical dependencies. We describe these below.

- Productivity and innovation gap – European productivity growth has steadily declined, falling to below 80% of US levels from to 95% in 1995. This decline is largely attributed to the technology sector, where Europe has not kept pace with advancements seen in the US. Europe has been investing approximately €270 billion less annually in research and development compared to the US. In conjunction, it has struggled to produce leading tech companies and breakthrough technologies – only four out of the top 50 tech firms globally are based in Europe.

Figure 4: R&D expenditure (% of GDP)



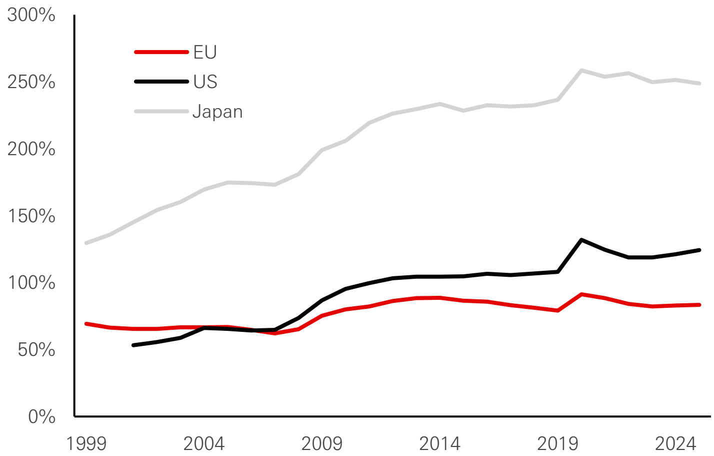
Source: HSBC AM, European Commission, World Bank. Data as of January 2025.

An aging workforce exacerbates the problem. Europe could lose approximately two million workers per year until 2040, requiring productivity improvements to maintain growth. Yet, a growing elderly population requires investment to shift into sectors such as healthcare and retirement services, which may not provide the same level of growth as more dynamic sectors like technology.

- Energy Costs and decarbonisation —High energy costs place Europe in a competitive disadvantage. Electricity prices are two to three times higher than the US, while gas prices can be up to five times higher. This not only affects the profitability and global competitiveness of European firms but also deters foreign investment, as companies seek to operate in regions with lower operational costs. Although the transition to renewable energy presents long-term opportunities, short-term reliance on fossil fuels combined with fierce competition from China in clean technology and electric vehicles poses hurdles.
- Geopolitical risks — Dependence on external sources for critical raw materials and technology raises concerns about supply chain vulnerabilities. Europe remains heavily reliant on China for raw materials, while semiconductor production, vital for technological advancement, remains concentrated in Taiwan and other parts of Asia. Additionally, while Europe is the second-largest military investor globally, its defence industry remains fragmented and inefficient. In addition to creating potential vulnerabilities in an increasingly unstable world, this highlights the lack of coordinated investment across the continent contributing to the productivity gap.

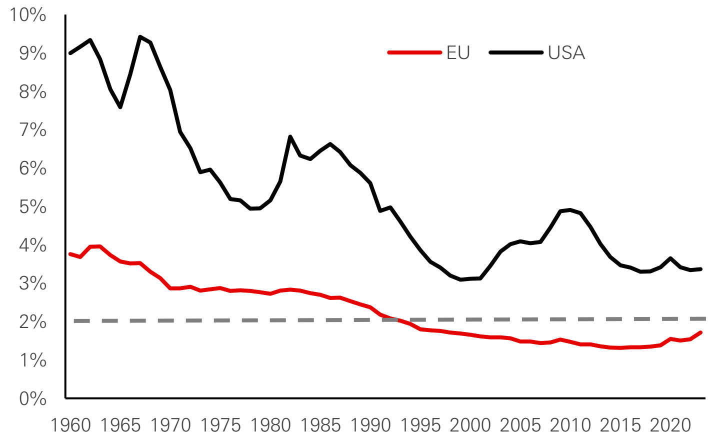
Europe retains substantial investment capacity to counteract these challenges to economic growth. With a debt-to-GDP ratio below 100% – much lower than other developed markets – there is room for significant fiscal intervention. Proposals have been made for special infrastructure and defence investments (e.g. Germany), which will increase Europe's debt-to-GDP ratio and mirror the fiscal strategies deployed during the Covid-19 crisis. If executed effectively across the continent, these investments could revitalise European industries and narrow the transatlantic performance disparity.

Figure 5: IMF debt (% of GDP)



Source: HSBC AM, Bloomberg. Data as of January 2025.

Figure 6: Military expenditure currently below 2% target (% of GDP)



Source: HSBC AM, European Commission, World Bank. Data as of January 2025.

Green shoots may be starting to present themselves, with pessimism on European growth prospects being overcome by a recently positive trend in economic surprise indices, which contrasts a negative recent trend for the US.

Trade relations and external risks

Europe's trade relationship with the US and China remains a key determinant of its economic trajectory. Since 2020, goods exports to the US have grown by 44%, while exports to China have contracted by 5%, increasing Europe's dependence on American trade. However, implications of US tariffs on European goods, particularly in the automotive sector, pose a clear risk.

Figure 7: Trade between EU and the US

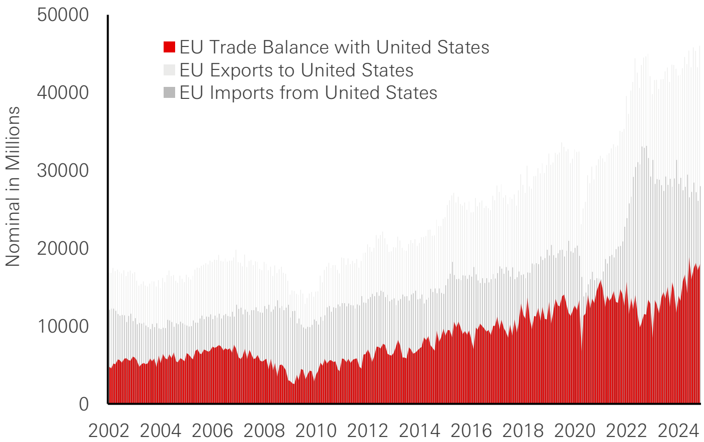
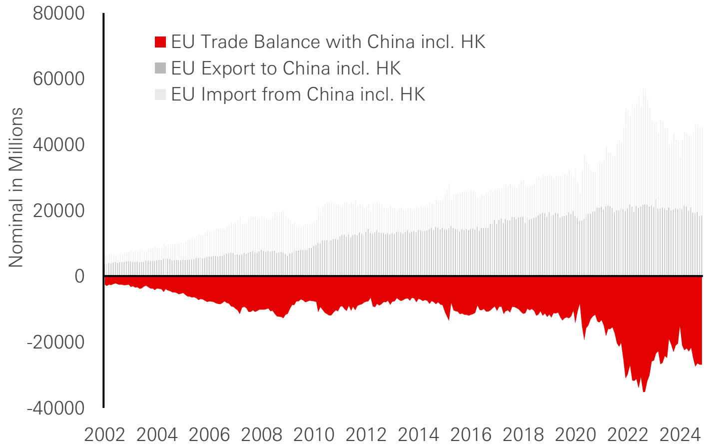


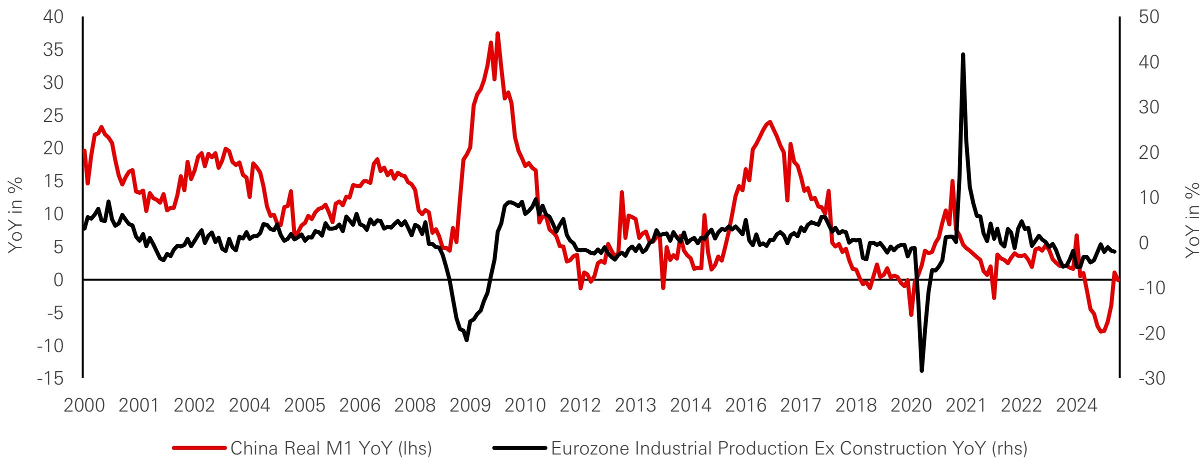
Figure 8: Trade between EU and China



Source: HSBC AM, Bloomberg. Data as of March 2025.

Slower growth in China has been a contributing factor in Europe's widening trade deficit with the country. However, challenges to the competitiveness of European companies alongside progress in China's industries have also altered the trade relationship. Advancements in China have resulted in their import dependencies shifting away from technology-driven advanced economies and towards commodity-exporting nations. The rise of Chinese electric vehicles (EVs) as a major export product to the EU and elsewhere globally are an example of this trend. Nonetheless, Eurozone activity continues to be influenced by the macroeconomic environment in China, at a lag. Extensive policy support introduced by Chinese authorities in recent months reduced downside risks to the Chinese economy and could benefit industrial production in Europe ahead, with additional measures expected later this year.

Figure 9: Relationship between Eurozone industrial production and China real M1



Source: HSBC AM, European Commission, World Bank. Data as of January 2025.

The valuation gap

For the past two decades, European equities have struggled to keep pace with their US counterparts in terms of profit growth and market performance. Since the European sovereign debt crisis and subsequent fiscal austerity measures, corporate earnings in Europe have lagged those in the US. However, recent indicators suggest that this trend may be shifting. A combination of valuation discounts, improving earnings trajectories, and more favourable macroeconomic conditions is creating a compelling case for renewed investor interest in European markets.

European equities have traded at a discount to US markets historically, with an average price-to-earnings gap of around three points since 2006. However, this gap has widened significantly since 2023. After the rebound to start this year, European equities are still trading close to an 8-point discount to the US market – far exceeding historical norms.

Currently, the Stoxx Europe 600 index trades at a P/E ratio that is 7% above its historical average but remains nearly 30% below its peak. In contrast, the US market is trading more than 30% above its historical average. In terms of sector differences, 42% of all European sectors are below respective historical averages, while only 18% of US sectors trade at a discount. Accordingly, this is not simply a difference due to technology exposure. The range in discount/premium to historical averages is wide, with European banks at a 13% discount while technology companies trade at a 24% premium – presenting interesting opportunities for a selective approach. In contrast, all of the main US sectors are trading at a significant premium to their average.

Even when accounting for Europe’s growth disadvantage to the US, recent performance disparity appears unjustified. In terms of PEG ratios, there was no notable divergence between the US and Europe from 2005 to 2023. Since 2024, Europe devalued notably relative to the US in PEG terms as well.

Across metrics the story remains the same. The price-to-book (P/B) ratio for European equities is around 60% of global market valuations, despite return on equity (RoE) being nearly equal to that of global markets. This discrepancy suggests significantly undervaluation relative to underlying profitability. Even if we adjust for sector differences by comparing sector-adjusted PE, the spread relative to the US is nearly two standard deviations below the 30-year average.

Figure 10: Price-to-earnings - Stoxx 600 (SXXP) versus S&P 500 (SPX)

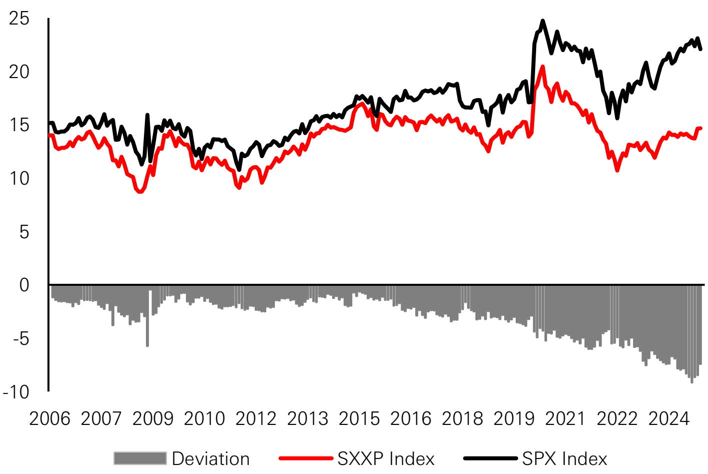
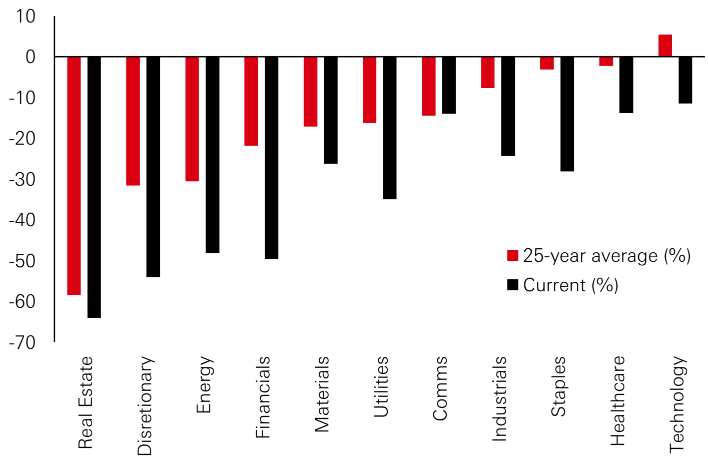


Figure 11: PE discount of European sectors vs US



Source: HSBC AM, Bloomberg, Goldman Sachs. Data as of March 2025.

Taking total shareholder yield into account, including buybacks and dividends, the total yield for European equity markets is two percentage points above that of US markets, which is an all-time high.

Closing the gap in profit growth will be important to the outlook

While European equities have seen their earnings per share increase by only 60% over the past 10 years, EPS in the US has risen by approximately 125%. Profit trends are different across European sectors, with a constant upward trend seen in defensive growth sectors (healthcare, technology, etc.) and a subdued profit trend in most cyclical sectors since 2022. Of course, profit growth in the US IT sector multiplied over the past two decades, while European IT profits ‘only’ doubled.

Figure 12: Profit trend - Stoxx 600 (SXXP) versus S&P 500 (SPX)

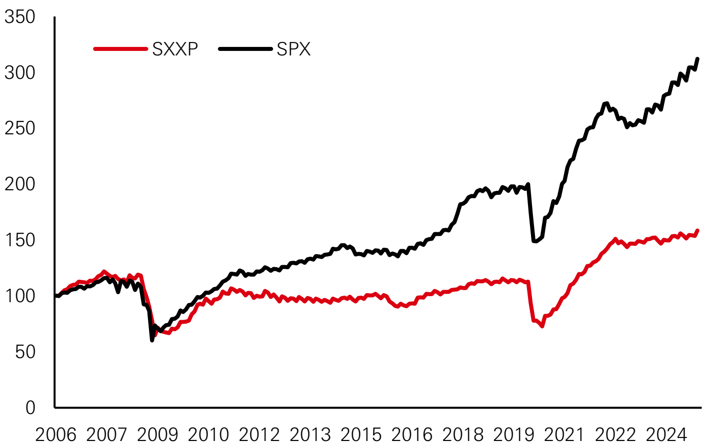
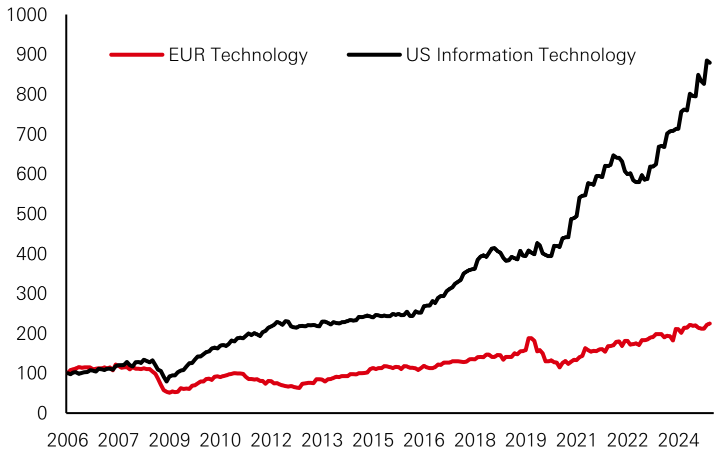


Figure 13: Tech sector profit trend - Europe versus US



Source: HSBC AM, Bloomberg. Data as of March 2025. Data for the European equity market based on SXXP and ICB schema. Data for the US equity market based on SPX and GICS schema. Data since March 2006.

European bank profits have been in a dynamic upward trend since their Covid low. And since 2022, both European banks and healthcare companies exhibit higher profit growth than their US counterparts, offering compelling considerations for granular allocations.

Recent trends indicate improving profit expectations for European companies broadly, with the Q4 2024 earnings season providing encouraging signs. While still below that of the S&P 500, the Stoxx 600 posted both sales and earnings growth of nearly 7%, indicating a positive change in momentum. Looking ahead, there are expectations for further momentum in Q2 2025, supported by macroeconomic indicators suggesting a recovery phase.

Tactical versus structural opportunities

The outlook for European equities hinges on several factors, including the potential for a continued rebound in earnings, the resolution of geopolitical tensions, and the effectiveness of fiscal policies aimed at stimulating growth. The EU's capacity to invest more, given its relatively low debt-to-GDP ratio, could provide a much-needed boost to the economy and, by extension, equity markets. This comes at a moment in time where asset allocators might be looking for diversification opportunities to reduce their exposure to expensive growth stocks while capitalising on the potential for a catch-up in European equities. However, the European equity market is wide and deep, and a potential bullish sentiment wouldn’t reflect on all sectors and countries evenly.

Amongst the numerous options available to investors, one involves going long on specific European sectors while shorting their US counterparts. This contrarian trade idea is based on the premise that European sectors are currently undervalued relative to their US equivalents, yet exhibit higher profit growth potential.

For instance, one consideration could be to go long on European financials while shorting US financials. The rationale behind this trade is that European financial institutions are trading at lower valuations and have the potential for higher profit growth as the macroeconomic environment improves. Similarly, a long position in European healthcare stocks against a short position in US healthcare stocks could also be beneficial, given the relative valuation discrepancies and growth prospects.

Figure 14: European vs US sectors

Financial sector	Current PE	5Y Profit Growth
Stoxx 600 Banks	7.7	88.5%
S&P 500 Financials	17.9	28.0%
PE Difference	-10.2	
Average Difference	-3.4	

Healthcare sector	Current PE	5Y Profit Growth
Stoxx 600 Healthcare	17.2	38.7%
S&P 500 Healthcare	18.6	32.5%
PE Difference	-1.4	
Average Difference	0.8	

Consumer staples sector	Current PE	5Y Profit Growth
Stoxx 600 Food & Beverages	16.8	7.8%
S&P 500 Consumer Staples	21.8	25.6%
PE Difference	-5.0	
Average Difference	0.9	

Utilities sector	Current PE	5Y Profit Growth
Stoxx 600 Utilities	12.2	40.5%
S&P 500 Utilities	18.2	29.9%
PE Difference	-6.0	
Average Difference	-2.6	

Source: HSBC AM, Bloomberg. Data as of February 2025.

In the same manner, European consumer-related sectors could benefit from rising consumer confidence across the region, which should boost spending and growth. Any one or combination of a ceasefire in Ukraine, fiscal stimulus in Germany, and potential rate cuts by the ECB could support improvement in consumer confidence and unlock pent-up demand in the form of high excess savings relative to the US today. Such a release in pent-up demand could significantly benefit retail companies, which are currently trading on low relative valuations compared to their US counterparts.

From an intra-region perspective, periphery markets, specifically the Italian and Spanish equity markets, exhibit lower performance sensitivity to potential trade war escalations due to their reduced revenue exposure to the US, rendering them less vulnerable to tariffs. While forward earnings expectations in these markets signal ongoing high momentum, they carry downside risk of equity risk premia that is more stretched than in the core countries.

Another allocation option would be German mid-caps, which have strongly underperformed large-caps over the last two years. Mid-caps are more reliant on the domestic economy, which, despite its current weakness, presents a potential upside case if conditions improve, such as through lower energy prices and/or positive impact of stimulus measures.

Overall, we believe further catch-up potential in European equities remains after their outperformance to start this year. Some areas look more compelling than others, which means a selective, tactical approach could yield benefits going forward.

The role of quality in defensive portfolio construction

> As we navigate an environment marked by higher bond-equity correlations and potential for tail risk events, avenues to strengthen resilience in portfolios remain high on investor priorities.

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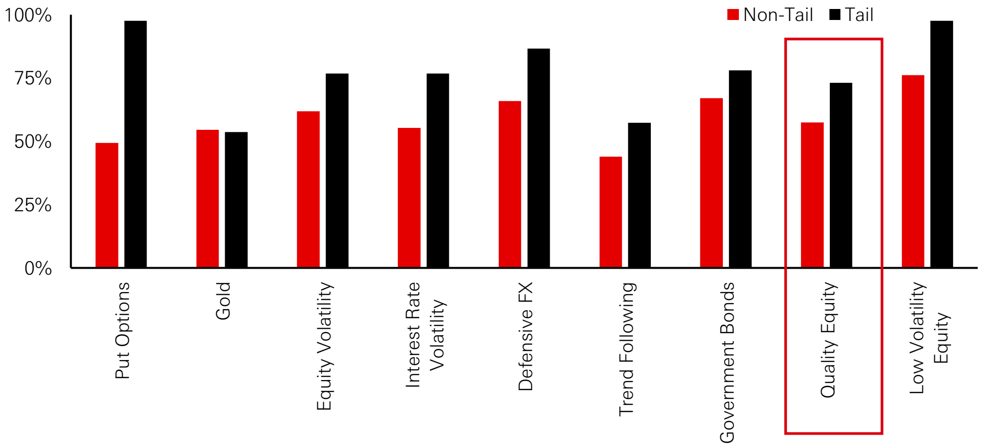
Olivia Skilbeck
Portfolio Manager, Multi Asset

With economic uncertainty rising alongside geopolitical tension, bringing with it more market volatility, investors are increasingly seeking strategies that provide resilience without sacrificing long-term growth potential. There are various approaches to bolster resilience within a multi-asset approach, including explicit downside protection strategies and diversifiers.

Explicit defensive assets offer effective capital protection during periods of market stress, albeit typically at a higher cost of carry in terms of lack of participation in equity market rallies. Conversely, diversifiers are characterised by their low correlation to traditional asset classes and present a lower cost of carry, contributing to portfolio outcomes across cycles. This makes them more suitable candidates for a strategic asset allocation

Among diversifiers, equity factors should be a consideration. The quality factor in particular stands out, exhibiting positive convexity which allows for downside protection while still participating in market upswings.

Figure 1: Defensive consistency



Source: HSBC AM, Bloomberg. Data as of February 2025.

Defining Quality: A three-pillar approach

Quality, unlike other investment factors such as momentum, does not lend itself to a straightforward definition. A notable quote, 'You know it when you see it', encapsulates this sentiment. The vagueness in defining quality necessitates a more structured approach to quantify it, leading to the identification of three distinct pillars: profitability, consistency, and safety.

Figure 2: A three-pillar approach

Metrics	Profitability	Consistency	Safety
	Operating profitability	Stability of operating profitability	Total Leverage
	Gross profitability	Stability of gross profitability	Interest Coverage
	ROE	5-year volatility of EPS YOY growth	Debt to Equity
	ROA	Long-term change in ROA	Accruals Ratio
	ROIC	Sales Variance	Net Debt to EBITDA

Source: HSBC AM, as of February 2025.

1. **Profitability:** Positive earnings and cashflow generation to deliver returns on capital are clear requirements for quality. And research has consistently backed up the logic that companies exhibiting higher levels of profitability tend to outperform their peers. A notable study by Grantham in the 1990s established a correlation between higher ROE and superior performance, which has informed the construction methodologies of quality factor equity indices, including those developed by Dow Jones, FTSE, and MSCI.
2. **Consistency:** Companies that maintain stable levels of operating profitability and earnings growth, alongside low sales variance, are typically classified as higher quality. Consistency in financial performance instils shorter-term confidence among investors while also contributing to long-term outperformance. Research indicates that companies with stable earnings are less likely to experience significant downturns during market stress, thereby enhancing portfolio resilience. Separately, a study by Fama and French found firms with stable earnings growth outperformed those with volatile earnings by an average of 3% annually over a 20-year period. This stability is particularly important during periods of economic uncertainty, where the ability to predict future earnings becomes a significant advantage.
3. **Safety:** The third pillar of quality encompasses a company's financial health and risk profile. Companies that exhibit stronger financial health are better positioned to weather economic downturns and financial stress. Historical data supports this notion, revealing that firms with lower leverage and higher interest coverage ratios tend to outperform their higher-leverage counterparts over time.

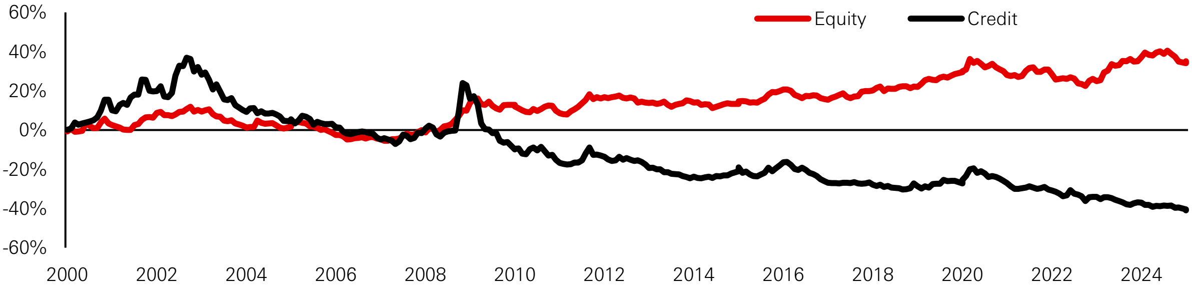
Overall, the evidence underscores the performance contribution and defensive characteristics of quality. For instance, a study by Jiao and Cooper highlighted that portfolios with a quality overlay outperformed market capitalisation indices by 4.2% during bear markets and by 2.8% in high-volatility regimes. Even in bull markets, outperformance of 1.43% was delivered, supporting the integration of quality in long-term strategic allocations.

While the pillars of quality provide a framework for understanding and measuring this investment factor, the research landscape is replete with varying perspectives on which metrics are most predictive of future performance. For instance, Novy-Marx posited that growth profitability is a more reliable indicator of future stock returns than traditional metrics like ROE, suggesting a potential annual outperformance of 2.7%. This could be a result of ROE discounting key operating expenses, unlike gross profitability. For example, a high ROE could be generated in part due to lower R&D expenses, which could have otherwise contributed to expanding a company’s competitive moat. Such variations highlight the importance of considering a broader range of metrics when evaluating quality.

The quality premium: primarily an equity-only phenomenon

Identifying quality in credit markets is more straightforward, given credit ratings and clear delineation based on companies' ability to meet their debt obligations. While quality in equity markets has demonstrated long-term outperformance, the same is not the case in credit markets.

Figure 3: Quality performance (US)



Source: HSBC AM, as of March 2025.

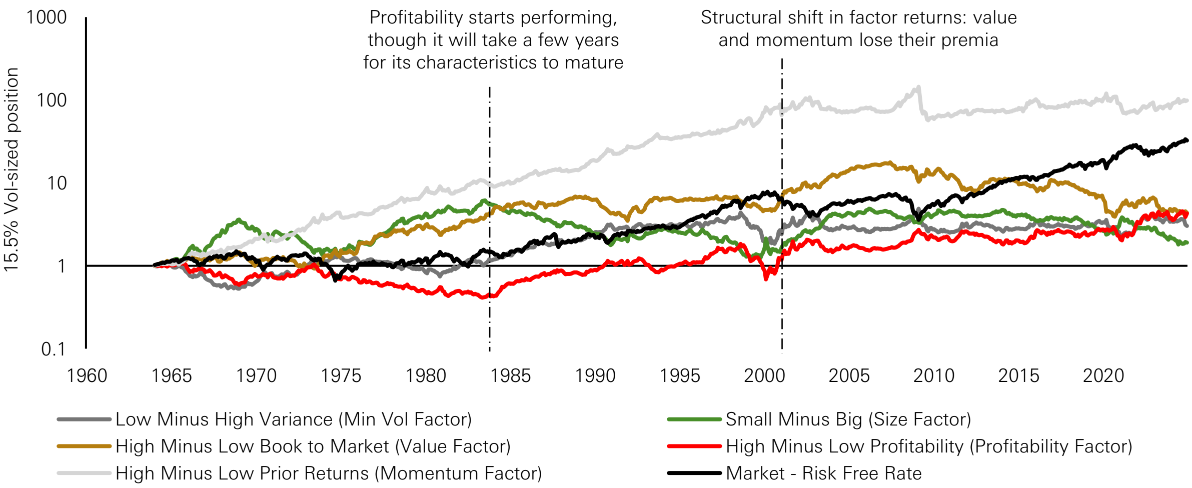
The logic supporting this is if you invest in a quality security, you're taking less risk and you're being less compensated for it. Yet this begs the question, why is quality compensated in equities?

One reason suggested for this is that models such as the dividend discount model and others undervalue quality companies. Outperformance is consequently derived from that. Another potential cause is that in equity markets, investors tend to bid up 'lottery' stocks offering the promise of big returns. In credit markets, this phenomenon isn't feasible. In a high yield bond, returns are capped to some extent, contrasting to what are theoretically infinite returns possible in equity markets. However, once the euphoric price environment fades, during recessionary periods or periods of stress, those 'lottery' companies tend to suffer much more significantly in a portfolio, underperforming higher quality equities. This observation is supported by research from Baker and Wurgler which found that during market downturns, high-quality stocks outperformed their lower-quality counterparts by an average of 5% annually.

Quality versus other investment factors

We use the Fama-French factor definitions to look back at how factor performance has evolved across history, with the measure for quality simply being profitability. Figure 4 demonstrates a fundamental shift in the behaviour of factor premia around the turn of the century. And since 2001, profitability has delivered the strongest risk-adjusted returns, by a wide margin.

Figure 4: Cumulative total value of Fama-French factors[1]



Source: Kenneth French Data Library, HSBC AM. Data as of February 2025.

1 - Andrew Ang's 'Trends and Cycles of Style Factors in the 20th and 21st Centuries' (JPM 2003). Past performance does not predict future returns. The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

The broader quality factor has consistently generated a premium over time while displaying a degree of shorter-term counter cyclicality, which is expected given the defensive nature of quality investments discussed. There are only two periods which stand out in challenging the consistency of quality, highlighted in figure 5. Prolonged rallies in lottery or 'junk' stocks single out these periods. Still, the underperformance of quality during these times was insufficient to derail the long-term premium afforded to long-term investors.

Figure 5: MSCI World Quality cumulative active return

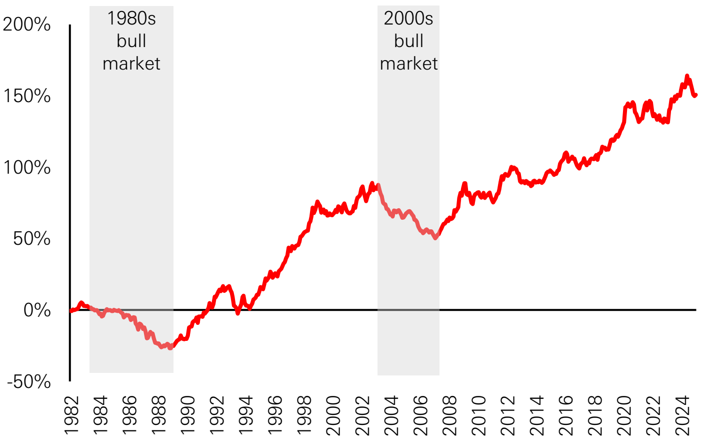
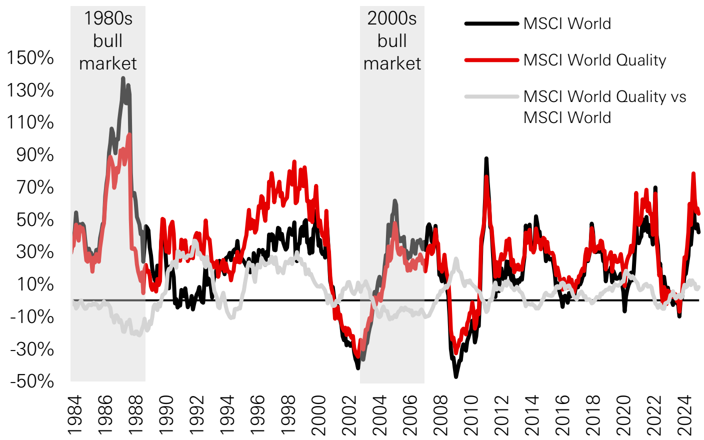


Figure 6: Rolling 2 year net total returns



Source: HSBC AM, Bloomberg, MSCI. Data as of February 2025.

The resilience of quality throughout the business cycle

Quality demonstrates its strongest active returns when the economic cycle moves into contractionary phase. While it lags other defensive strategies offering more explicit downside protection during market slowdowns, it still delivers positive active returns. Other defensive strategies suffer significant negative returns as the economy recovers, betraying a reliance on perfectly timed exit points. Meanwhile, quality's underperformance is much more subdued, showing superior navigation of market inflection points.

Figure 7: Returns for defensive strategies during different market cycles

	MSCI World Total Return Betas			G7 CLI Regime Returns vs MSCI World			
MSCI World Indices	**Beta**	**Downside Conditional Beta**	**Upside Conditional Beta**	**Boom**	**Slowdown**	**Contraction**	**Recovery**
Defensive Sectors	0.707	0.698	0.690	-5.03%	8.39%	3.44%	-11.90%
Minimum Volatility	0.639	0.727	0.597	-5.36%	6.97%	6.56%	-9.81%
High Dividend Yield	0.874	0.901	0.898	-4.34%	4.12%	1.93%	-4.18%
Quality	0.897	0.871	0.899	-1.23%	2.88%	6.23%	-1.51%
Sector Neutral Quality	0.951	0.951	0.984	-1.38%	3.91%	2.87%	-1.64%

Downside conditional beta – beta during months where market monthly return < 0. Upside conditional beta – beta during months where market monthly return > 0. Boom regime: G7 CLI > 100 & positive 3m change, Slowdown regime: G7 CLI > 100 & negative 3m change. Contraction regime: G7 CLI < 100 & negative 3m change, Recovery regime: G7 CLI < 100 & positive 3m change.
Source: HSBC AM, Bloomberg, MSCI. Data as of February 2025.

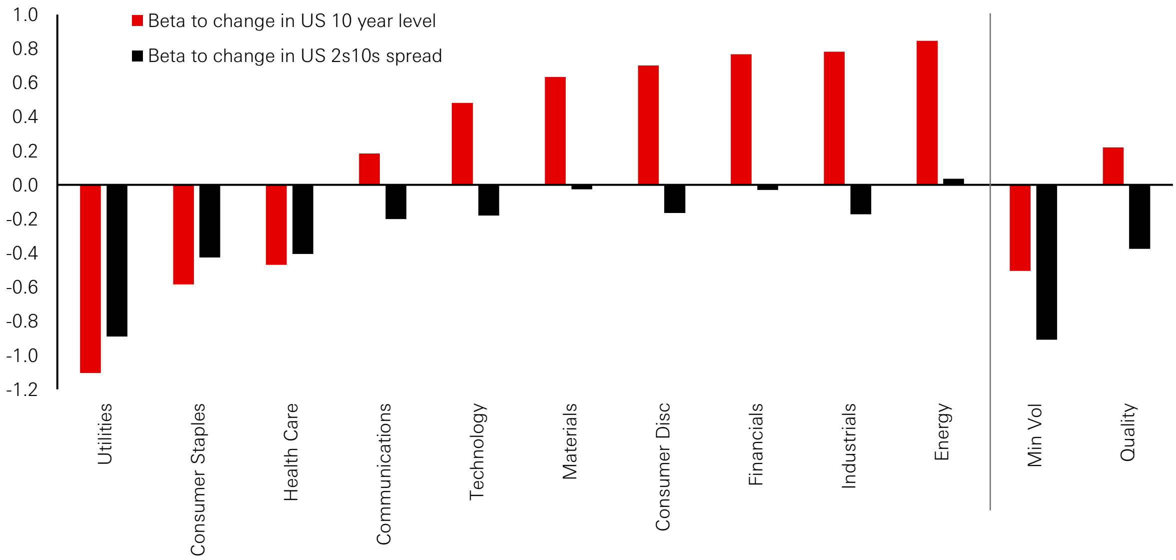
This means there isn't the same reliance on timing the bottom of the market, as is the case when investing in defensive sectors and minimum volatility, which can significantly hinder the portfolio if the position isn't exited quickly when the market turns positive again. With quality, we can afford to be a little bit more wary of incidents such as double-dip recessions or false positives when it comes to shorter-term equity rallies. And while quality usually lags the market cap index in the first 12 months of the recovery period, this is not always the case, as was seen following the 1990 recession, 2018-19 trade wars, and 2022 rate hikes.

In terms of the overall investment narrative, we see the usefulness of quality within strategic allocations to support more stable returns over the long term. Of course, if you have a high conviction view of a bearish outcome, some of the more explicit defensive equity strategies from figure 7 offer a more reliable hedge.

One important consideration to account for with multi-asset allocations is that defensive equity sectors tend to have a stronger equity duration (i.e. negative beta to bond yield levels), which can thus exacerbate positive stock-bond correlations. This phenomenon can be explained through two narratives.

The first, termed the low-risk narrative, posits that in low-yield environments, bond investors unsatisfied with the level of carry available seek stronger returns and turn to low-risk stocks with stable cash flows, which behave in a bond-like manner. In these low-yield environments, we tend to see the price dynamics of these low-risk stocks act in a bond-like way. As yield levels rise, this effect diminishes as investors return to higher-yielding fixed income assets. The second narrative is tied to the inherent dynamics of certain sectors, which are naturally more leveraged and sensitive to changes in inflation and yield levels. This is the case with utilities, for instance.

Figure 8: US rate sensitivities across MSCI World sectors (1995-2024)



Source: HSBC AM, Bloomberg. Data as of February 2025.

By construction, minimum volatility allocates more weight to “bond-like” sectors and has therefore exhibited a structural positive correlation with bonds over the last 25 years. In contrast, we do not observe the same structural correlation for quality. Although profitability and consistency will favour companies generating reliable cash flows, the safety component actively screens out companies with higher leverage levels. Furthermore, consistency may underweight companies whose margins are squeezed by rates and inflation.

Thus, investing in the quality factor and employing a broad taxonomy helps to avoid the rate sensitivity exhibited by other defensive equity strategies.

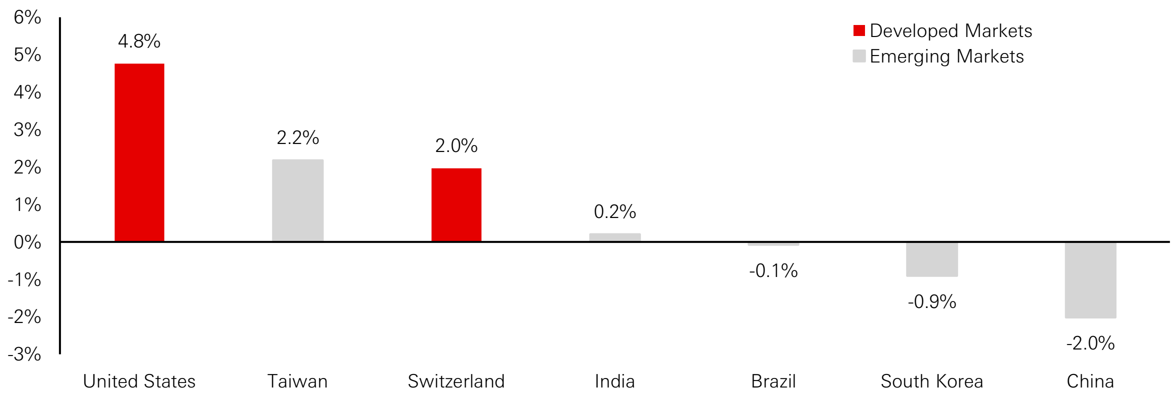
Accessing the quality premium

At the core of the quality premium is the fact that not all equities are created equal. Particularly during times of heightened uncertainty, the quality factor can offer a useful way of building more defensiveness into portfolios. Of course, any individual allocation must be considered within the context of the broader portfolio. Below we utilise the MSCI quality indices to assess granular sector and geographic implications of allocating to quality equities globally.

Of note, there are stark differences in individual sector weightings, with consistent overweights to IT, healthcare and consumer staples in the MSCI World Quality index over the last decade. This is countered by underweights to financials, energy and consumer discretionary stocks. Again, this would be influenced by the business nature and dynamics of these industries. Financials, for example, tend to exhibit higher leverage and more volatile earnings, which detracts from their quality scores. Conversely, sectors like healthcare, with their stable cash flows and strong balance sheets, align more closely with the quality investment thesis.

We see similar issues present themselves from a geographic perspective. Per the chart below, the quality slant in the MSCI index produces country bias towards defensive markets like the US and Switzerland and their high-quality underlying firms.

Figure 9: ACWI Quality country overweights and underweights (%)



Source: HSBC AM, Bloomberg, MSCI. Data as of February 2025.

This positioning has translated to elevated valuations for the index, which could introduce a potential risk to performance moving forward. It is important to note from a diversification perspective, however, that the Herfindahl-Hirschman Index measuring market concentration shows that the MSCI World Quality index is significantly less concentrated than the standard MSCI World index. Nonetheless, in the context of multi-asset allocations, vigilance must be prioritised to manage sector and geographic biases, along with valuation risks.

A sector-neutral approach to quality is one potential way to avoid such biases. However, it is important to recognise that sector neutralisation may not be as effective in all regions. In Europe, sector concentration can significantly impact country exposure. The MSCI Europe sector-neutral quality index delivers an 8% overweight position in Switzerland for instance, while underweighting France and Germany by roughly 6% each.

Ultimately, different expressions of quality can be achieved in portfolio construction, including through active fundamental managers emphasizing investment in strong, cash generative companies with sustainable earnings growth. While portfolio defensiveness can be achieved in several ways, we think the quality factor can complement strategic allocations with a longer-term use case that avoids some of the drawbacks of other defensive strategies.

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