

The roaring 2020s are over: what next?

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For Professional Clients only

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Summary

- ◆ We are fast reaching an inflection point in terms of the global cycle and markets are sensing a regime change
- ◆ US equities may not remain the leaders going forward, asset allocators should consider diversifying their equity exposure away from the US
- ◆ We recommend considering China, Emerging Markets and Europe as alternatives to US exposure

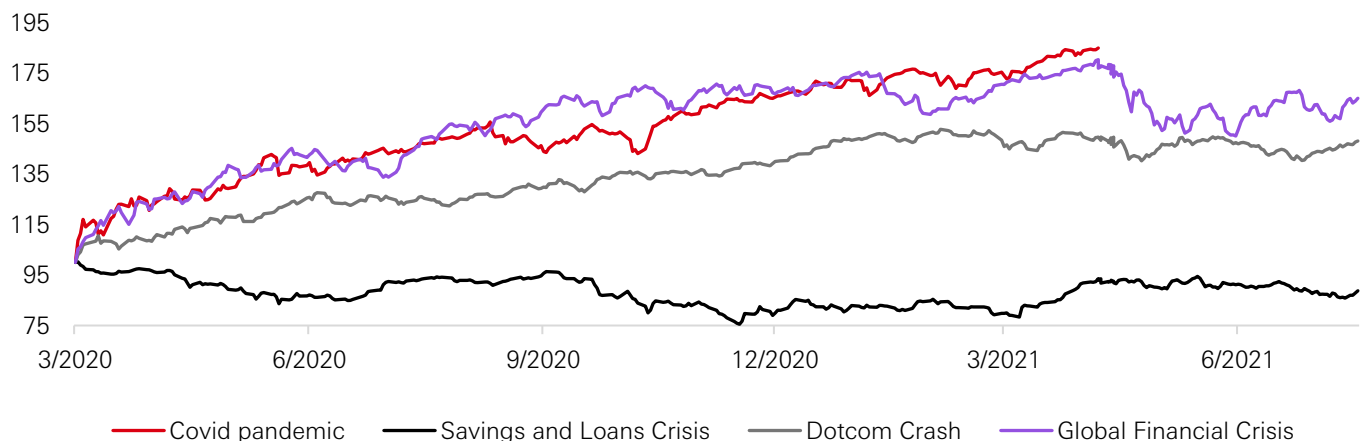
It was the best of times, it was the worst of times

The rally in global stock markets from the pandemic nadir has been astounding and one of the fastest post-WW2 rebounds on record (Chart 1). Whilst the global macroeconomic backdrop is still suggestive of a continued rally, we may have reached an inflection point which requires asset allocators to stop and think.

There are several factors to take into account when thinking about regional and country risk allocations going forward:

1. Interest rates curves are likely to continue to steepen
2. Commodity prices are likely to remain elevated and expectations are picking up globally (Chart 2)
3. Monetary conditions are likely to only be gradually tightened and policy makers are likely to be tolerant of higher inflation prints
4. Fiscal policy is likely to continue in a selective fashion though policy maker attitude towards fiscal policy has changed in many countries

Chart 1 – MSCI World recovery trajectories after various crises (USD %)

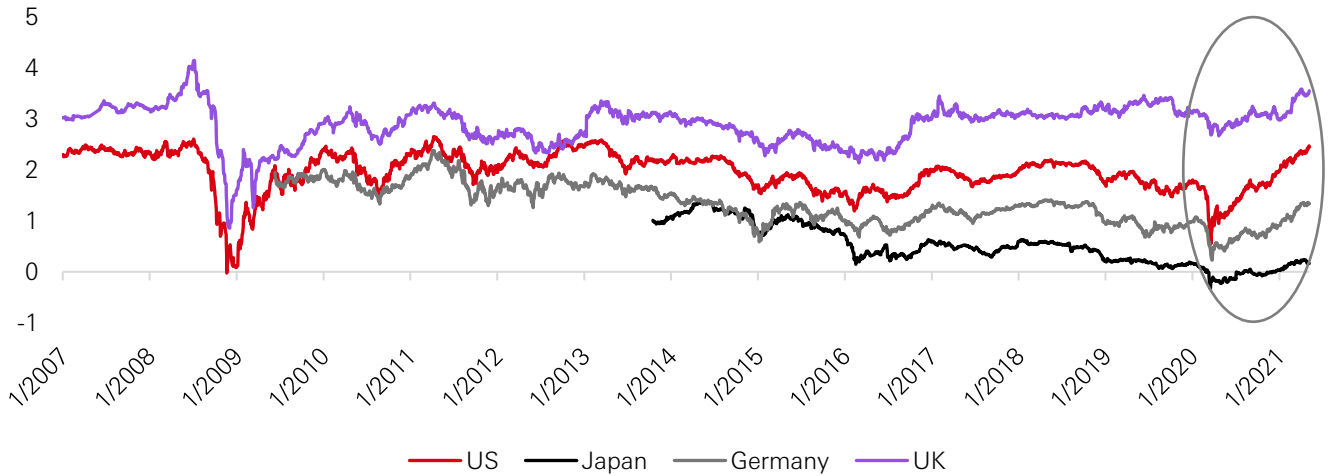


Source: HSBC Asset Management, Bloomberg, as at May 2021. Comparison for illustrative purposes only.

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Chart 2 – 10y breakeven inflation by country (USD %)



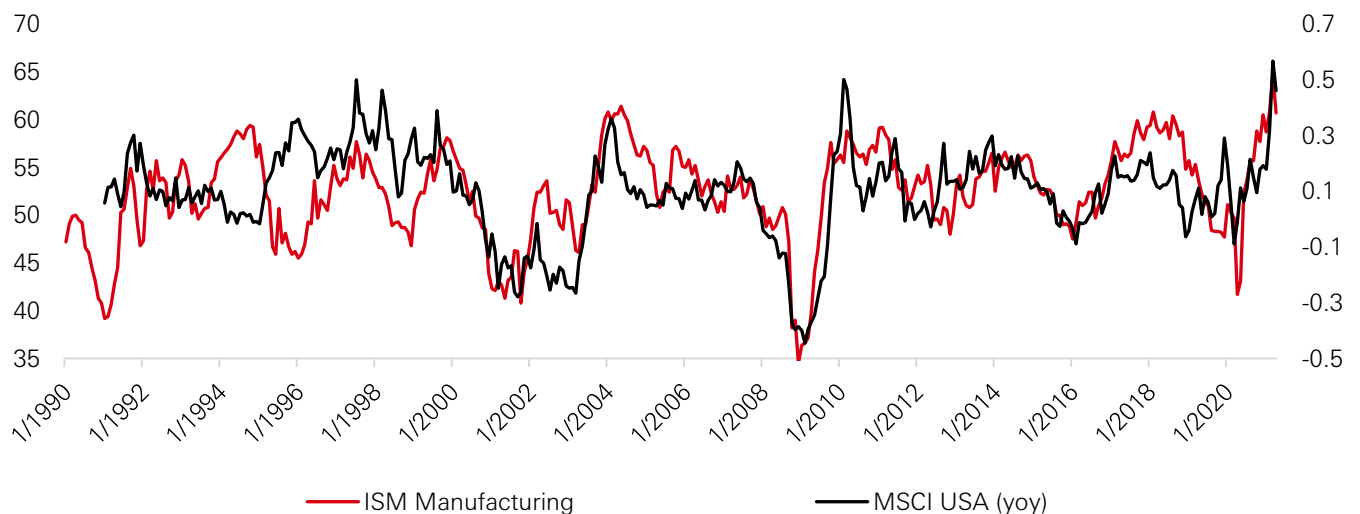
Source: HSBC Asset Management, Bloomberg, as at May 2021

In particular, there is room for US equities to disappoint, given the reasons below:

1. US equities are heavily orientated towards growth stocks, the technology sector in particular, and the combination of the extreme bullishness associated with technology stocks (the 'work from home' trade) and rising interest rates that impact 'longer duration' growth stocks could put a ceiling over performance for the time being
2. Expectations of fiscal stimulus have been shifting in the US from another sizeable and immediate package to a fiscal package enacted over a number of years – possibly couple with tax increases
3. Whilst the tone of the Fed is not hawkish, it is not uber dovish either, and Fed speakers are increasingly finding themselves having to comment on the forward looking inflation picture
4. The ISM looks to be peaking and historically equity markets have followed the movement in the ISM closely (Chart 3)
5. US equities are not cheap. The recent move in US yields and the associated impact on the 'discount rate' should mean that – together with a pickup in earnings – there should be downward pressure on the PE ratio

For these reasons, US stocks may possibly underperform many of their peers over the next few months.

Chart 3 – US ISM Manufacturing correlates well with MSCI USA rolling returns (USD %)



Source: HSBC Asset Management, Bloomberg, as at May 2021

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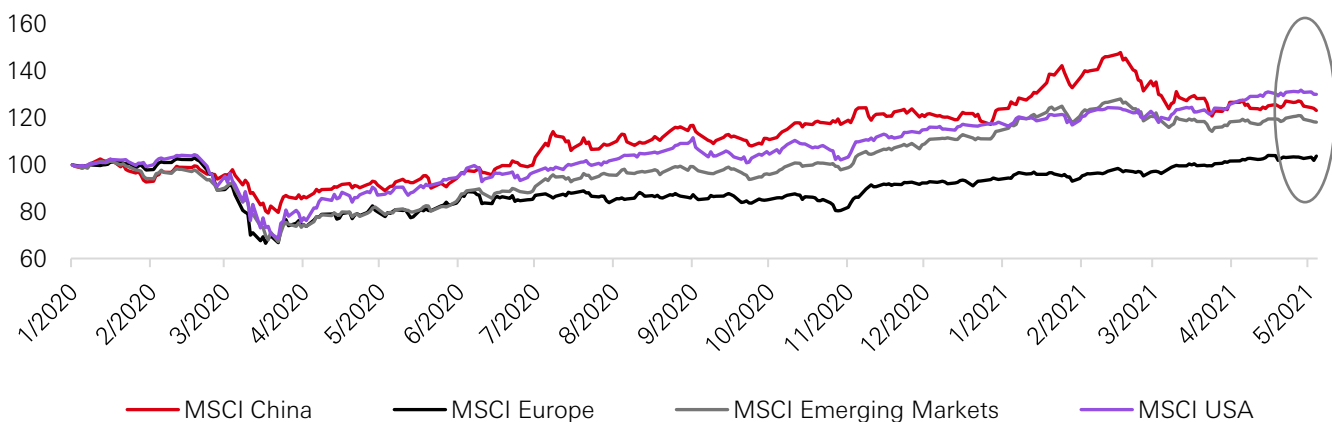
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Sell in May and go away perhaps, but in the meantime capital has to be deployed. The question is what are possible options for an asset allocator looking to tactically diversify?

Before we outline the options as we see them, a quick word on inflation and balanced portfolios. In an environment where we transition into a regime with elevated inflation prints globally – even if transitory – it may put downward pressure on bonds (prices). In that respect, we are wary of reallocating towards fixed income away from equities in that instance unless there are clear signs of cyclical slowdown. Our preference is to tilt towards equity markets that will be less affected by a near term pickup in inflation and inflation expectations.

Here are the diversification options as we see them (Chart 4):

Chart 4 – MSCI USA is currently ahead of the pack though this may now change (USD %)



Source: HSBC Asset Management, Bloomberg, as at May 2021

China

Chinese equities displayed ‘safe haven’ type characteristics over the course of the pandemic period as the equity market outperformed other countries. Granted this was due to their swift action to contain the pandemic and the positive economic benefits associated with that, but there is every possibility that if we see a global rout in stock markets over the summer period, Chinese stocks may outperform once again as the macroeconomic picture continues to be carefully managed by policy makers.

Whilst Chinese equities are typically less cyclical in nature, they do also offer exposure to the burgeoning tech scene which has taken hold in China over the past few years.

Europe

Whilst the roll out of a vaccine programme across Europe has been marred with delays, hiccups and bad press, we believe that there could be a period of ‘catch up’ over the summer which would be a tailwind for European equities. In addition to this, the macro data remains supportive and so far the earnings season has been positive as numbers continue to come in ahead of expectations.

European equities have significant exposure to the ‘value’ factor and any further steepening of interest rate curves and a continued rally in energy prices could act as a material tailwind.

Emerging Markets

We expect emerging markets to do well broadly speaking, as we believe the macro picture in China will remain stable, the USD will remain relatively range bound and for policy makers to generally err on the side of caution. We don’t believe that a steepening of the US interest rate curve will necessarily impact the USD in a persistent way as the front end should remain pinned.

There will of course be countries that are winners and losers according to whether they are commodity importers or exporters, so country selection is important. However, broad based exposure to emerging markets through a generic emerging market vehicle is fine for those that don’t have a strong tactical view on specific countries.

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About the author

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Sefian Kasem is an Investment Strategist within the ETF team at HSBC Asset Management. He has been working in the industry since 2007. Prior to joining HSBC Asset Management, Sefian worked for HSBC Global Banking and Markets for over 13 years, where he held positions within Cross-Asset Trading and Global Credit Trading. He joined the ETF team in October 2020, bringing extensive global macro expertise as well as cross asset experience.

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