

# Out of sync



## 2023 Mid-Year Investment Outlook

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## Economies and markets are **out of sync**

So often we talk about ‘the’ global economy, or ‘the’ equity market, but that’s not the right approach in an out of sync world. There are big differences between markets and regions that have important implications for investors.



### **Negative watch for developed markets**

Economies in developed markets will be hit hard by the fastest rate of interest rate hikes since the 1980s. We expect a scenario like the early 1990s recession – a downturn that will impact jobs, spending, and profits, but not a severe recession.



### **Extend to emerging markets**

Emerging markets look very different amid better growth and lower inflation. Having been unloved, with lower valuations as a result, investors should consider extending their exposure here.



### **Exploit out of sync opportunities**

Complex, divergent economics creates unsynchronised investment markets. This environment means there are new opportunities for diversification and relative outperformance.



# Negative watch for developed market economies

We see many recession warning signs flashing red now for the US and Europe, with our projections below. However, a smooth and very positive first half of the year for investment markets looks out of sync with that. Volatility has fallen, despite a lot of turbulence and key events – interest rate hikes, banking turmoil and political events.

The picture looks different in Japan. It hasn't had the same challenge of high inflation and rapid interest rate hikes to hinder growth. Plus, low valuations and a relatively good corporate profits outlook makes the situation more appealing for investors. Furthermore, the yen has significant scope to appreciate against the dollar.

Our projections	US	Eurozone	UK	Japan
<b>Growth</b> 	<b>Recession starts Q4 2023</b> ■ 2023 1.25% ■ 2024 -1.0%	<b>Recession starts Q1 2024</b> ■ 1.0%    ■ 0%	<b>Recession starts Q1 2024</b> ■ 0.5%    ■ -0.5%	<b>Resilient growth</b> ■ 1.5%    ■ 1.25%
<b>Inflation</b> 	<b>Trending lower</b> ■ 2023 4.0% ■ 2024 2.0%	<b>Turning down</b> ■ 5.5%    ■ 2.5%	<b>Slower improvement</b> ■ 7.0%    ■ 3.0%	<b>Breaking free of deflation?</b> ■ 3.0%    ■ 2.0%
<b>Policy &amp; rates</b> 	<ul style="list-style-type: none"> <li>• Peak 5.00-5.50%</li> <li>• First cut end of 2023</li> <li>• 2.75% lower by end of 2024</li> </ul>	<ul style="list-style-type: none"> <li>• Peak 3.50-4.00%</li> <li>• First cut Q1 2024</li> <li>• 1.75% lower by end of 2024</li> </ul>	<ul style="list-style-type: none"> <li>• Peak 5.00-5.50%</li> <li>• First cut Q2 2024</li> <li>• 1.25% lower by end of 2024</li> </ul>	<ul style="list-style-type: none"> <li>• End negative rates 2024</li> </ul>

Source: HSBC Asset Management, June 2023. 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.



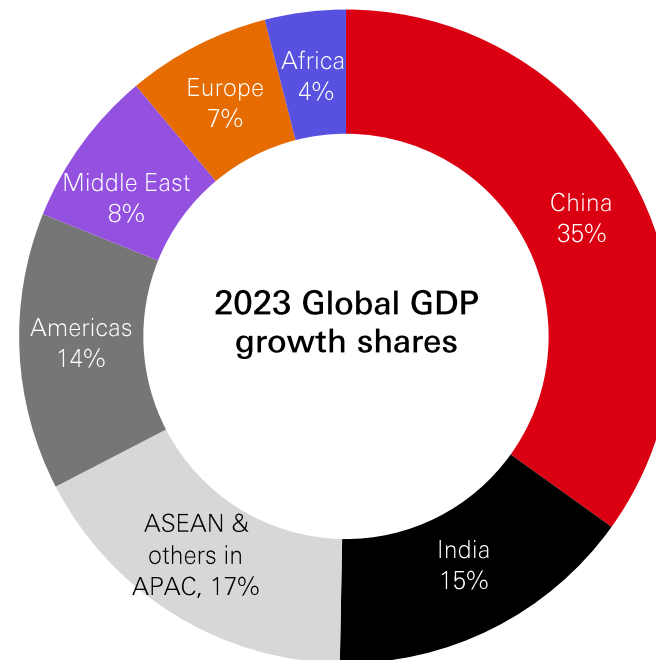
## Extend to emerging markets

Continuing the out of sync theme, emerging markets have lagged this year but the economic outlook is much better than in developed markets. In fact, very little of this year's economic growth will come from outside of emerging markets.

Positives range from the cyclical rebound and economic reopening in China, structural growth stories in India and Indonesia, strong performance from Gulf economies, and much better inflation news in Brazil and Mexico, where central banks could be cutting interest rates before the US Federal Reserve.

Separately, an important theme for us is that emerging market assets are exhibiting lower country correlations. This isn't necessarily that surprising considering the backdrop of unsynchronised economic and political cycles and a shift to a global order with multiple powers across regions.

### Nearly 70% of 2023 global growth will come from Asia and the Pacific



Source: HSBC Asset Management, IMF, June 2023. 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 importance of this point is that growth stories for individual emerging countries differ, creating diversification within emerging assets. The long-run story in India, for instance – revolving around productivity, digitisation and high-end manufacturing, infrastructure, and a young, growing population – remains strongly intact.

Valuations for emerging markets are generally much lower than those of developed markets, and also lower compared to their own history. The price to earnings ratio for Brazil, for example, is less than half of its 10-year average.

At the same time, forward earnings expectations look much more solid for emerging markets. And looking ahead more long term, emerging economies' increasing share of the global economy alongside demographic advantages bodes well for investment opportunities.



## Exploit out of sync opportunities

A key implication of the out of sync theme is how market correlations are shifting. The correlation between bonds and equities has fallen back from high levels last year. However, it is still unclear that bonds will offer reliable diversification ahead. The traditional 'balanced' portfolio of 60 per cent bonds and 40 per cent equities may not suit the new environment we are entering.

The good news is that the diversification opportunity within emerging and frontier markets has never been better. We call this 'intelligent diversification'. It means that investors can capture idiosyncratic stories, such as the transformation on the right.

Alternatives – especially allocations to real assets – should play an important role too. Here, investors can gain exposure to returns that are disconnected from traditional stocks and bonds.

### Seven of the top ten economies in 2075 projected to come from emerging markets

Ranking (USD)	1980	2000	2022	2050	2075
1	US	US	US	China	China
2	Japan	Japan	China	US	India
3	Germany	Germany	Japan	India	US
4	France	UK	Germany	Indonesia	Indonesia
5	UK	France	India	Germany	Nigeria
6	Italy	China	UK	Japan	Pakistan
7	China	Italy	France	UK	Egypt
8	Canada	Canada	Canada	Brazil	Brazil
9	Argentina	Mexico	Russia	France	Germany
10	Spain	Brazil	Italy	Russia	UK
11	Mexico	Spain	Brazil	Mexico	Mexico
12	Netherlands	Korea	Korea	Egypt	Japan
13	India	India	Australia	Saudi Arabia	Russia
14	Saudi Arabia	Netherlands	Mexico	Canada	Philippines
15	Australia	Australia	Spain	Nigeria	France

Source: HSBC Asset Management, Daly and Gedminas & CEPR, January 2023. 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.





# New rules for a new environment

## Intelligent diversification

Economic cycles are increasingly disconnected around the world. Shifting political situations and a new 'multi-polar world' amplify this process. The economic outlook is uncertain and a new economic regime is coming into view. Investors need new rules to construct portfolios for this new environment.

We expect a somewhat higher inflation regime in the medium term. A pending recession is not going to be big enough to purge all of the inflation pressures out of the system. Many economies face labour shortages and there are a number of supply-side factors, such as energy shocks and climate policy, which can cause spikes in inflation. We have called it 'spike-flation'.

This points to a regime of higher inflation and interest rates over time. We are not going back to the ultra-low interest rate environment of the 2010s, and can no longer count on the Federal Reserve to cut interest rates and boost markets as soon as economic growth stalls. Although relied upon as traditionally reliable diversifiers, government bonds may not be quite as effective in this new environment as they have been in the past.

Alternatives must now be part of the asset mix. The asset class offers an idiosyncratic range of potential exposures, with everything from a windfarm in Taiwan to a market-neutral hedge fund or a loan to a mid-sized UK corporate. Of course, we are not proposing that investors seek out windfarms in far-flung locations or begin lending all of their cash to smaller companies. What we are suggesting is exposure to a diverse range of assets with unique return drivers that are unrelated to returns in traditional stocks and bonds.

Exposing portfolios to important megatrends – like technology – can also be a unique source of return and diversification. It is important here to take a systematic and disciplined approach, in order to avoid the well-documented hype cycle and inherent risks to capital in thematic investments.



### New diversifiers

- Stock/bond correlation unreliable
- Seek out new liquid or illiquid diversifiers

### New idiosyncrasies

- Country correlations have fallen
- Exploit new idiosyncratic returns in emerging and frontier markets

### New themes

- Emerging 'transformational trends'
- Emphasise thematic strategies

# Portfolios taking shape

## Interest rate exposure can benefit

We take a cautious overall view on risk and cyclicity in portfolios. Right now, interest rate exposure is appealing to us - particularly in short to mid-term treasuries since US rates should already be near their peak.

We see some value in European bonds too, but there is a need to be selective in corporate bonds given a deteriorating economic environment will raise the risk of defaults. We focus on higher quality bonds in investment grade over more speculative grade bonds.

## Be cautious but creative in equities

In developed market stocks we are cautious. Valuations are not too elevated, but the profits outlook is concerning given the recession risks. Growth companies and defensive ones, whose earnings are resilient through economic cycles, still make sense. And we suggest a focus on long-term quality.

While the AI trade this year supports our view that exposing portfolios to important megatrends can result in unique return drivers to enhance returns and provide a means of diversification, valuations appear rich.

Nonetheless, any substantial societal change means disruption to current industries and opportunities that are less tied to the economic cycle. We see other interesting megatrends which will result in profound change not currently trading at such elevated levels. This includes the green transformation, and evolving societies which are driving the aforementioned economic power shift towards emerging markets.

## Extend to emerging markets

The combination of future interest rate cuts by the Federal Reserve, a weakening of the dollar, and relative growth and inflation point to emerging markets as the appropriate asset allocation tilt.

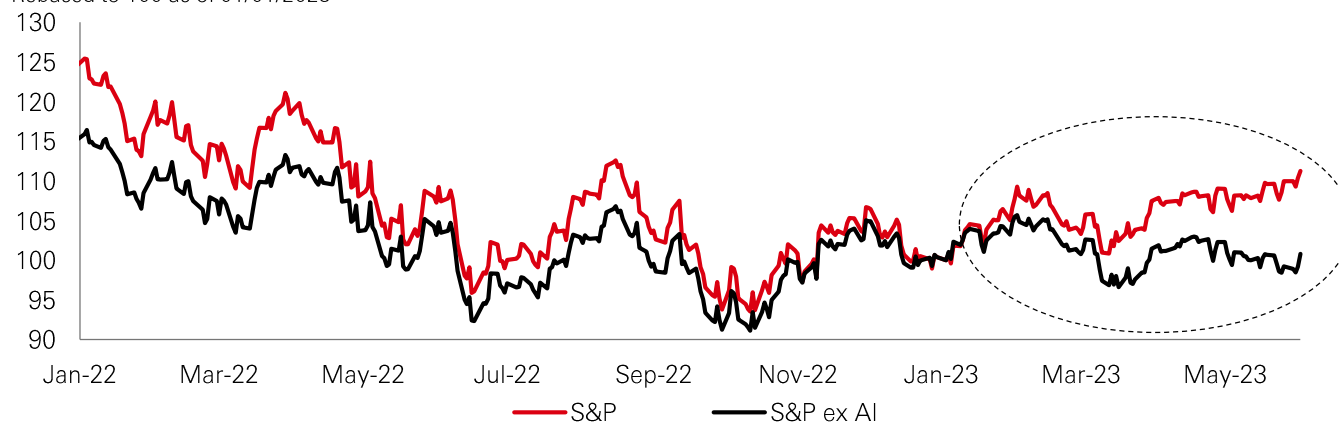
Emerging markets offer return potential but in the context of investment stories that are decoupled from western economies. Emerging stocks and local currency bonds are our preferred options.

## Alternative exposures

Alternatives continue to provide portfolio benefits, offering exposure to real assets whose value tend to rise with inflation, and other types of assets such as hedge funds that are designed to deliver returns disconnected from traditional markets.

## The rise of AI has fuelled a rally in related companies, particularly big tech

Rebased to 100 as of 01/01/2023



**Past performance is no guarantee of future returns.** Source: HSBC Asset Management, Bloomberg, June 2023. Any views expressed were held at the time of preparation and are subject to change without notice.

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