Video Transcript

HSBC Investment Outlook Q1 2023 (Released 23 November 2022)
Willem Sels, Laurent Lacroix

Willem:

2022 has been a very difficult year for investors as high inflation, rising interest rates and the economic slowdown hit portfolios hard and left very few places to hide. As we enter 2023, we remain cautious with an underweight in equities, balanced with overweights in bonds and hedge funds. But we also look for the silver lining and examine what could eventually make us more constructive later in 2023.

Let's start with the current economic situation. The world economy continues to slow, with the Eurozone and the UK in recession, the US being more resilient but growing well below trend, and China showing limited potential for a quick or sustained recovery. This negative global momentum means that earnings expectations should fall further, which is an obstacle for equities. It also explains why we have a defensive sector positioning and focus on quality stocks with strong earnings power. Our geographical preferences are in line with this cyclical view, with a preference for the US and Latin America over the Eurozone and the UK.

High inflation and rising rates are a key reason for the slowdown, as inflation eats into consumers' disposable income and rising rates hurt the housing market and investment spending. The good news is that commodity price inflation and transportation costs for example are already falling, but services price inflation is still sticky. So the Fed and other central banks are not yet done with their rate hikes and may keep rates in restrictive territory throughout 2023 or even longer, until they're sure the inflation dragon is slain. Let me ask Laurent Lacroix, our Global Head of Fixed Income, what this means for bonds.

Laurent:

Thanks Willem. For many years, investors generally found bond yields and the carry they offered too low to be enticed by them, but higher yields have much improved the investment case for bonds. Short-dated yields now price in most of the rate hikes we expect to see, and that gives us comfort. We like to keep duration short-to-medium because bond volatility is higher for longer dated bonds and the flat or even inverted yield curves mean that they are not adequately compensating for extending duration. The economic slowdown you mentioned is important too, because high-rated bonds should become less correlated with equities when growth slows, and be a valuable portfolio diversifier. But of course, the economic slowdown means that we prefer bonds issued by high-rated companies with strong credit fundamentals across developed and emerging markets. And from a thematic perspective, we focus on short-dated quality credit, including Asia, and on financials at the top end of the capital structure.

Willem:

Thanks Laurent. Amid all the cyclical gloom, the improved investment case for bonds is indeed a first silver lining. We haven't yet seen the peak in interest rates, but we are getting closer, and adding to bonds is our first priority. The second priority is to make portfolios more resilient against the economic downturn. We look for quality stocks of companies with strong market positions and earnings power. Dividend income can help make portfolios less cyclical. And we like companies in the energy, food, staples and infrastructure business as their income can move up with inflation. Diversification is key, because of the many macroeconomic and geopolitical uncertainties. In addition to bonds, we also overweight hedge funds, which should benefit from volatility, from the sector and style rotation, and from the different economic and policy fundamentals around the world. Many hedge funds hold cash in addition to their derivatives positions, so they benefit when cash rates rise. And we maintain our core allocations to private markets and real estate. And finally, we look at structural trends through our high conviction themes. We don't agree with some commentators' assertion that governments' recent investments in oil and gas mean that the case for sustainable investments is weakened. Households and companies have reacted to high energy costs by installing more solar panels, insulating their houses better and trying to reduce energy consumption, while governments have also invested in renewable energy and nuclear. So the structural support for sustainability themes is complemented by the short term need to save on costly energy.

Now, coming back to our asset allocation, it's clear that we are still cautious currently, but what could make us more positive? Clear signs that rates have peaked would of course be a first milestone. When that will happen is difficult to know for sure, but further declines in core inflation and an end to Fed hikes could lead us to extend bond duration. It would also mean less support for the US dollar, and a less challenging environment for tech stocks. The second milestone would probably only follow later. To become more positive on stocks, we would first need to see economic growth bottom, and more conservative earnings expectations to be priced in; that would make us more positive on stocks and high yield credit. For now though, we maintain our cautious portfolio composition, but we think it is useful to continue to watch key milestones as we are hopeful that markets will see a rebound sometime in 2023 and we need to be nimble.