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Global Investment Views

Growth outlook remains anaemic even though risk of a meltdown has eased

News Release

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The Global Investment Views represents the market view of HSBC Global Asset Management.

This document offers our view and outlook on stocks, fixed income and currencies and is updated on a monthly basis.

Global Investment Views are formed by a committee of professionals at HSBC Global Asset Management.

Overview

- Sentiment and certain macroeconomic data have clearly improved in the last few months, and the risk of a prolonged global recession and threat of a meltdown in the financial system has eased. However, the outlook for growth remains anaemic, and will be at a much lower rate than before, particularly in the developed economies, which could limit the potential upside for corporate profits. Although there may be an economic recovery next year, the level of rebound will remain subdued for an extended period due to the need for households to continue to deleverage after many years of easy credit.
- Meanwhile, we believe Asia's stronger fundamentals are largely priced in. What is clear is Asia's better macroeconomic story, as it has a strong cyclical and structural growth story. That said, following the recent strong rally, valuations of Asian markets have expanded significantly and they do not allow for much room for disappointment or slowdown in terms of corporate earnings and economic growth. As such, the good news at the macro level appears to have been largely reflected in Asian equities' valuations.
- The market rally in the second quarter seems to have benefited cyclical stocks such as basic materials, and has led to a divergence in valuations between cyclical and defensive sectors. As sectors such as utilities and healthcare have lagged, they could outperform if investors rotate into more defensive sectors.
- Within the bonds universe, while acknowledging that the valuation case for US and Eurozone government bonds has improved significantly following the correction in second quarter, we maintain our preference for investment-grade corporate and high-yield bonds. Not only are valuations more attractive, both these asset classes are likely to benefit from extensive government fiscal stimulus, which will further enhance the lending environment for corporates.
- In terms of currencies, we maintain a moderate negative view on the GBP versus EUR as quantitative easing measures adopted by the Bank of England are negative for the currency. As inflation in the UK is higher than in many parts of the world, this is a further reason to be negative on the GBP as it would affect the real yield on UK assets.

Stock Markets

US

The valuation discount of defensive sectors relative to cyclicals reveals opportunities

- The MSCI World Index was flat in June while the MSCI USA Index gained 0.2% as investors turned more cautious following a downbeat assessment by the Federal Open Market Committee (FOMC)
- The FOMC in June noted that "the pace of economic contraction is slowing" but concluded that "economic activity is likely to remain weak for a while"
- Valuation wise, we note some interesting divergences at the sector level
- We see defensive sectors, such as healthcare and utilities, that usually trade at a premium to the more cyclical sectors, now trading in line or even at a discount
- On valuation grounds, a shift to more defensive sectors may be appealing.

Europe

We maintain a cautious stance on UK and Eurozone equities relative to cash

- European and UK equity markets generally underperformed other developed markets, ending the month down 1.8% and 3.3% respectively
- The bearish tone of the World Bank report and the OECD's warning on developed countries' fiscal position, particularly the UK, weakened risk appetite
- Eurozone economic activity continued to disappoint
- Therefore, we prefer to maintain our cautious stance on UK and Eurozone equities relative to cash
- Given the similar macroeconomic outlook, we expect European equities to perform in line with their developed market peers.

Japan

An uneasy combination of stretched valuations and weak economic activity

- Japanese equities displayed some volatility in June but, overall, outperformed most other developed equity markets. The MSCI Japan index climbed 2.9% in June
- That said, Japan's economic activity remains extremely weak as a rise in the jobless rate adds pressure to domestic demand
- The rally in the second quarter of 2009 has stretched Japanese equity valuation levels considerably. Markets are now trading at a 12-month price-to-earnings ratio of above 30 times
- The increase was largely price-driven but also reflects a significant downward revision in forward earnings
- Given the ongoing uncertainty on Japan's economic outlook for 2009 and 2010, we reiterate our moderate defensive stance.

Emerging Markets

Still too much uncertainty to consider a more positive stance on emerging equities

- Global emerging markets declined by 1.3% in June, whereas China posted strong positive returns of 4.1%
- There were overall further signs of stabilisation and economic activity continued to pick up, particularly in China, which is a good sign for Asian equities
- However, there is still too much uncertainty on global growth and demand to consider a more positive stance on emerging equities
- Overall, given that valuation broadly reflects the better macroeconomic prospect for Asia, we continue to see limited space for a tactical preference
- Therefore, we retain our neutral position against other equity markets.

Asia ex-Japan

Valuations appear to already reflect better economic fundamentals relative to developed markets

- Asia ex-Japan markets gained 0.1% in June, outperforming a number of other equity markets, led by China and India, which surged 4.1% and 5.9% respectively
- Asia's better macroeconomic fundamentals relative to the developed world is already reflected in relative valuations.
- Indeed, Asian markets are trading at a 12-month forward price-to-earnings ratio of 14.6 times, which is close to twice the level in October 2008 (7.8 times)
- Despite further signs of improvement in economic readings in Asia, it is too early to consider a more positive stance on Asian equities relative to other markets
- Valuations appear to already reflect the more positive macro picture. Overall we keep our neutral stance and expect it to perform in line with other equity markets.

Interest Rate/Fixed Income

US

Moved to a neutral position in Treasuries relative to cash

- US Treasuries posted further losses during June, declining by 0.20%, bringing their year-to-date decline to -4.4%.
- Over the course of the year so far, we have held a negative view on US Treasuries, recommending an underweight position in portfolios.
- Firstly, we have believed that interest rates could remain at zero for some time given the sluggish economic outlook.
- Secondly, we have been concerned that very high and increasing levels of indebtedness arising from quantitative easing could eventually threaten fiscal stability and lead to rising expectations of inflation.
- These themes have played out in market activity given the sell-off in Treasury prices year-to-date. In recognition that valuations have therefore improved, we now recommend a neutral position in Treasuries relative to cash.
- Within the fixed income universe however, we prefer corporate debt to US Treasuries as the former has more attractive valuations.

Eurozone

Maintain negative view relative to corporate bonds

- Eurozone government bonds posted positive returns of 1.2% over the month, with yield levels declining across all maturities along the yield curve
- Despite some improvements in valuations, yields remain at generally low levels relative to history
- Also, we expect supply concerns to continue to place pressure on Eurozone bond prices, as governments continue to issue record debt to support their economies
- The increased supply, coupled with the potential for the ECB to announce further asset-buying programmes, could lead to rising expectations of inflation in future
- The tick up in yields relative to the second quarter shows that some of the supply and global inflation risks are already reflected in valuations. However, within the fixed income universe we continue to prefer corporate debt due to its more appealing valuations.

Investment Grade

Valuations remain attractive, although not at the bargain levels of the start of the year

- US Investment-grade corporate bonds returned 3.04% in June. Year-to-date, the asset class has gained 9.23%, outperforming developed market equities
- Although there is likely to be some credit deterioration over the next year given the economic downturn, current valuations provide a more than sufficient cushion
- Also, government stimulus packages continue to be supportive for credit markets
- We therefore maintain our positive stance on investment grade credit
- However, despite the improvement in credit conditions, liquidity risk remains a potential issue and we recommend this as a medium to longer-term investment.

Commodity

High Yield

Valuations remain attractive, although not at the bargain levels of the start of the year

- Global High yield corporate debt posted further gains during June, climbing by 3.40% (as measured by the Merrill Lynch Global High Yield Index).
- Although we expect defaults to increase, current valuations for high-yield bonds remain attractive, albeit less so than earlier in the year.
- Corporate debt is still benefitting from investors' search for yield, as well as from the pro-active government and central bank policy responses.
- Our positive stance on the asset class has proven highly beneficial since the start of the year and we maintain this view.
- However, we continue to stress that volatility is likely to stay high and liquidity risks remain. Therefore, investors should view this as a longer-term investment.

Emerging Markets Debt

Appealing valuations, but less so than corporate debt

- Sovereign USD emerging-market debt posted a marginal positive performance of 1.1% in June, thus taking its quarterly gain to 10.1%.
- While the asset class performed positively over the quarter, its gains are not as impressive as our preferred segment of corporate debt.
- For example, a representative portfolio of US HY gained 23.2% in the quarter, whereas EM corporate bonds are even more impressive with a 28.3% over the same period.
- Valuations for the asset class are attractive on a stand-alone basis, and the resilience of oil price and good economic numbers out of Asia are also supportive.
- However, on a valuation basis, the segment does not compare favourably with corporate bonds, hence we reiterate our preference for the latter over the former.

Oil

Prices moved higher again in June, but subdued demand is likely to keep it range-bound

- Oil price moved higher in June with the West Texas Intermediate spot price climbing from US$66.31 per barrel to US$69.89.
- The pick-up in price reflects, in part at least, supply disruptions in Nigeria.
- The future market is pricing in a modest increase from current levels by year end; the 6 month future contract is trading at US$73.13, only 4.6% above the spot price.
- GDP growth is expected to remain rather subdued even in 2010 and this has led the International Energy Agency to revise down their forecast for oil consumption.
- Subdued demand is likely to keep the oil price fluctuating around the US$50-70 range for the rest of the year

Currency

US Dollar (USD)

No clear direction in currencies as the growth profile of the major economies are similar

- In June, the USD gained against the EUR and the JPY (0.9% and 1.1% respectively) but its depreciation against the GBP continued (-1.7%).
- On valuation grounds, the USD is at fair value against the GBP and the EUR, but is marginally undervalued against the JPY (-2.9%) over a 12-month period.
- The macro picture has seen some improvements, but the outlook remains uncertain and any recovery is likely to be subdued due to the high unemployment.
- That said, inflation remains broadly under control.
- With valuations largely in neutral territory versus the major currencies (EUR, GBP, JPY) and a fairly similar growth outlook, we maintain our neutral stance.

Euro (EUR)

Interest rate differential could help currency to standout, but poor economic data remains a headwind

- Performance of the EUR in June was negative overall. The EUR lost 2.6% against the GBP and 0.9% against the USD, and it was basically flat versus the JPY (0.2%).
- From a valuation perspective, the EUR is a fair value against the USD.
- From an interest rate point of view the EUR remains the most attractive among the major currencies and this could be of some help in the medium term.
- However, the poor macroeconomic data in the Eurozone is a headwind.
- Hence, we maintain our neutral stance relative to the USD

Sterling (GBP)

Maintain moderately negative view relative to EUR as economic conditions remain weak

- The GBP continued to rally in June, gaining 1.7% against the USD, 2.6% relative to the EUR and 2.7% versus the JPY.
- The macro picture has seen some improvement, although economic growth continues to be weak and UK inflation is high versus other developed countries.
- The difficulty for the ECB to implement quantitative easing, and a marginally favourable interest rate differential of the EUR against the GBP supports a moderate preference for the EUR versus the GBP.
- Volatility is likely to remain high and should caution against taking any aggressive position.

Japanese Yen (JPY)

The familiar theme of "high volatility but no clear direction" likely to continue to dominate

- The JPY lost against all the major currencies (1.1% relative to the USD, 2.7% versus the GBP) and it was flat relative to the EUR.
- The macroeconomic picture is showing little sign of recovery. For example, exports plunged 40.9% year-on-year in May, accelerating from a 39.1% drop in April.
- Carry trade continues to play a minor role as interest rates are close to zero in both Japan and the US.
- With balanced risks from a macro perspective we continue to see the USD/JPY exchange rates dominated by high volatility, but without any clear trend.
- We maintain our neutral stance

Further Information

Notes to editors:

Photo available upon request

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