

Asset Management

Markets more cautious

Investment event | 6 October 2023



Market pessimism increasing

2023 has been characterised by surprising resiliency in economic growth and risk asset performance. This is in contrast to last year’s environment of “poly crisis” and very poor market returns. More recently, however, risk assets have come under pressure, with the S&P 500 declining over 7% since its 2023 peak in late July (and even worse when stripping out megacap tech names). A number of measures of investor sentiment have also deteriorated, while fund flows to cash have increased.

What’s driving these moves?

We think there are multiple issues pushing investors into a more cautious stance.

First and foremost, the **recent push higher in government bond yields** has reduced the attractiveness of risk assets and raised investor concerns about future economic growth.

The trigger for higher yields is debatable, but may be linked to ongoing US economic resiliency in the face of higher interest rates and the Fed’s communication of a **“higher-for-longer” interest rate regime**. This could be driving upward revisions to investor assumptions around the “neutral” rate of interest for the US economy (i.e. the interest rate consistent with steady growth). The market has been ratcheting up its expectation of the fed funds rate at the end of next year (Figure 1).

Other factors that may be exerting upward pressure on Treasury yields is the Fed’s quantitative tightening programme, strained US fiscal dynamics, and a poor recent performance. Many investors have worried that bonds may have become less reliable diversifiers in portfolios.

Second, although **US economic activity** is holding up, upside surprises are not as prevalent as in July. There are **signs of weakness** in underlying demand and a slew of forward-looking indicators signal a significant deterioration in the jobs market. Higher interest rates are yet to fully feed through into the real economy and credit conditions have tightened substantially. Other headwinds include the recent tick higher in oil prices amid OPEC+ output cuts, North American auto worker strikes, and the impact of US student loan repayments restarting after a three-year pandemic related pause.

Outside of the US, economic conditions look worse. European PMIs are already in recessionary territory, while China’s economy continues to face challenges stemming from a stuttering property market and related confidence effects. Overall, worsening global economic prospects and higher interest rates is reflected in the **recent weak performance of global small cap stocks** (which are usually more cyclically exposed) relative to large caps (Figure 2).

Investment implications

Our central scenario remains that the US and European economies will fall into recession amid restrictive monetary policy and a raft of headwinds facing consumers, including the exhaustion of pandemic excess savings sometime next year. Even after the recent correction in risky asset class valuations, we think developed market equity and credit risk premiums are still not generous enough to compensate for multiple headwinds facing GDP and corporate profits growth. Market pricing remains broadly consistent with a “soft landing” outcome and disconnected from forward-looking macro indicators. Therefore, **we continue to advocate a cautious and defensive positioning in portfolios**, and anticipate a pickup in market volatility as recession risks crystallise.

For the time being we **prefer exposure to high quality fixed income** which benefits from good carry as well as scope for capital gains as economic downturn and ongoing disinflation pushes the Fed to adopt a less restrictive monetary policy stance in 2024.

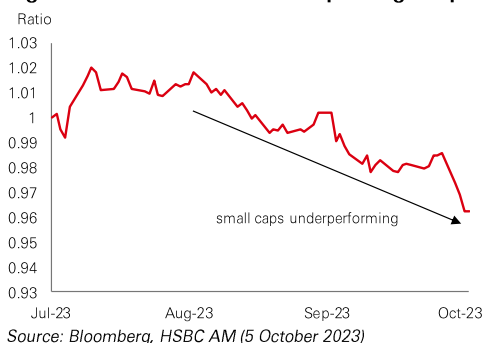
The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested. Past performance does not predict future returns.

Source: HSBC Asset Management, as at 05.10.2024

Figure 1: Market expectation of December 2024 fed funds rate



Figure 2: MSCI World small cap v large cap



Risk assets have come under pressure, with the S&P 500 declining over 7% since its 2023 peak in late July

This has come amid higher bond yields and deteriorating economic conditions as the Fed signals a “higher-for-longer” interest rate regime

Our view:

We think developed market equity and credit risk premiums are still not generous enough to compensate for multiple headwinds facing GDP and corporate earnings growth

We continue to advocate a cautious and defensive positioning in portfolios, and anticipate a pickup in market volatility as recession risks crystallise

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