Signal versus noise
Investment Strategy House Views

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Overview: Signal versus noise

A lot has happened since the summer. Investors have been forced to digest a sequence of complex news about emerging markets, trade tensions, Brexit, the Fed, China, as well as earnings and economic data. There has been a lot of “noise” around, and investment returns have been very disappointing.

As the economist Fischer Black put it: “why do people trade on noise? One reason is that they like to do it. Another is that there is so much noise around that they don’t know they are trading on noise. They think they are trading on information.”

So as we sort the “signal” from the “noise” and work out what has really been going on, let’s start with recent market performance. The bumper returns of 2017 have given way to something more disappointing – low overall total returns, negative performance in emerging markets, and more volatility in financial markets.

Figure 1: Asset class performance: 2017 versus 2018 so far (% USD Total Returns)

Source: HSBC Global Asset Management and Bloomberg, as at October 2018.
Past performance is no guarantee of future results.

The macro-economic regime has shifted. We have moved away from the globally-synchronised growth of 2017 to an environment of “cyclical divergence”. Today, there are divergent growth and inflation trends in the US versus Japan and Europe, and versus emerging economies (where growth has gone into reverse).

It is this changed macro regime that has forced the market to make two important re-pricings - which ultimately explain most of the return disappointment this year. First is the shift in US interest rate expectations. The second (related) is the abrupt appreciation of the US dollar - especially versus emerging markets since April. This market dynamic has precipitated a “doom loop” in many emerging economies. They face a vicious and reinforcing cycle of deteriorating macro, negative collective psychology, and weakening asset prices.

This is where markets have got to. It leaves investors with two critical questions as we plan investment strategy going-forward.

Question #1: how much more cyclical divergence between the US and the rest of the world can we reasonably expect versus what investment markets now assume?

Question #2: can a new narrative emerge in the market to break the “doom loop” that has engulfed emerging markets?

We explore both of these questions and the implications for asset allocation in this note. Broadly, we remain constructive on global growth and corporate fundamentals but, at this stage, we need to be thoughtful about how we back that view in risk asset classes.
The global economy

Peak divergence?
Following the period of synchronised strong growth in 2016-17, growth and inflation paths of major economies are diverging. In particular, US growth has diverged from the rest of the world.

Our Nowcast shows that the US is growing at a healthy annualised rate of around 3.8%, little changed from the pace seen at the start of the year. In contrast, eurozone and Japanese growth has slowed. After a phase of significant cyclical divergence, it seems natural to now ask whether we have reached “peak divergence”.

Figure 2: Diverging paths: growth/inflation mix vs 2017

Source: HSBC Global Asset Management and Bloomberg, as at October 2018. Any forecast, projection or target contained in this document is indicative only and is not guaranteed in any way.

Further US economic outperformance seems likely on the back of fiscal stimulus, which should continue to boost the economy in H1 2019 (+1% point to US 2019 growth on the basis of our analysis). However, the potential for a marked further divergence in global growth seems capped at this point.

Figure 3: US – Developed economies Nowcast spread (%)

Source: HSBC Global Asset Management and Bloomberg, as at October 2018.

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Recession risk is low

Even though economies are on diverging paths, global growth remains solid (marginally above its five year average) and recession risks are low.

This global environment of stable and good growth supports corporate fundamentals. World profits are growing at a healthy pace (over 10%) and global corporate default rates remain on a downward trend. However, there is clear evidence of divergence between advanced economy profits (earnings growing at 14%) versus emerging economies (earnings growing at 7%), with Latam lagging the most and Asia performing more in line with developed markets.

Policy divergence likely to continue

Divergence has also been the theme for inflation. US core inflation has risen this year and is now around target. This is at odds with the situation in other advanced countries, where core inflation is currently either below target or falling, or both.

In terms of the outlook, the balance of risks point to a further increase in underlying US inflation over the cycle, given strong growth and a tight labour market. Furthermore, a range of indicators in other advanced economies point to rising capacity constraints and recent data has shown some signs of life in eurozone and Japanese wage growth too.

However, it is important to remember that while there is potential for a further cyclical rise in inflation, we are still in a structurally low inflation regime. Inflation expectations remain relatively subdued, central banks remain credible and factors that are commonly thought to have weighed on deflationary forces in recent years – such as technology or the globalisation of production chains – remain in place.

While it is not clear that US-DM growth and inflation differentials will widen further, they are likely to persist and this means further policy divergence is probable. This is because starting points matter. On the one hand, US inflation is around target and the economy is growing at well above its trend pace, which means that the Fed is likely to continue its gradual tightening path. On the other hand, the starting point for the ECB and BoJ is a much more subdued core inflation rate, therefore they are still a long way from tightening policy.

Critically then, our reflections need to move to understanding how much of this cyclical economic divergence is already discounted by financial markets. This would seem to be the most likely source of surprise for investors now.
Emerging economies have moved from the “sweet-spot” to the “doom loop”

What is going on in emerging markets?

Emerging economies have moved away from the economic “sweet-spot” of strong growth and low inflation. Sentiment has deteriorated and growth momentum has faded since early 2018. Our latest EM ex China Nowcast is 3.2%, down from 4.5% at the end of Q1.

The narrative around emerging markets is complex with multiple forces seemingly at play (unresolved trade tensions, EM macro fundamentals, Chinese activity data). However, much of this is either just speculation or information that was already well-known to the market. The key issue that has changed and initiated market volatility since April has been the shift in US interest rate expectations and the abrupt way in which the dollar has re-priced itself versus emerging market currencies.

The effects on emerging markets have not been uniform. Economies that are more fragile in terms of structural and macro indicators (e.g. current account and structural budget deficit – the “twin-deficit” problem), or that face idiosyncratic risks, have suffered greater losses.

The real question is how emerging markets find their way out of this bad equilibrium. They are in a “doom loop”. Rapid EM currency depreciations act as a form of monetary tightening which damages economic growth, but also forces inflation higher. This damages market sentiment which, in turn, further impacts market prices and fundamentals. It is a vicious cycle. Investors are now asking themselves “who is next?”

![Figure 5: EM doom loop](source: HSBC Global Asset Management as at October 2018)

The key argument against this is that while some emerging economies have weak fundamentals, many do not. Therefore, most emerging markets should be able to “weather the storm”.

Inflation is generally well contained across emerging economies and large “twin-deficits” are not the norm. Furthermore, many emerging economies have improved their government finances and current account positions in recent years which makes them less reliant on external financing to plug these gaps.

Nevertheless, for emerging economies to stage a wide-spread, near-term recovery they require a “circuit breaker” to bring about a change in investor sentiment – a catalyst to stop the “doom loop”. Are there any?
China policy outlook is key

China is more likely to be a “circuit breaker” than the Fed

In previous episodes of high risk aversion and EM underperformance (Q1 2016’s phantom recession or 2013’s taper tantrum), central banks acted as the circuit breaker by injecting liquidity to support financial markets (or by backing away from a proposed tightening). The situation today is different. There does not seem to be an obvious back-stop from central banks. The Fed is on a path of gradual rate hikes – driven by a focus on US domestic conditions.

One possible positive influence could be policy easing in China. Emerging economies have become used to seeing China add large amounts of liquidity and using fiscal policy to support demand, particularly fixed-asset investment, in times of market stress.

Recently, on the back of trade concerns and slower economic activity, Chinese authorities have eased policy (the reserve requirement ratio has been cut and SHIBOR rates have fallen quickly). This could lead to a loosening of broader financial and monetary conditions in the coming months. If this prompts an upturn in Chinese growth indicators, investor sentiment around emerging economies could improve.

Faster-than-expected inflation, and a growth slowdown are key risks

What are the risks to the outlook?

This year political risk has been dominated by trade tensions. So far it has been limited to a bilateral spat between the US and China. While fears of a broader trade war have receded, they could re-emerge, especially if the US trade account deteriorates further. A multilateral trade war would be much more damaging than the current US-China tensions to global growth. Elsewhere, other political uncertainties, for example in Italy, have the capacity to shock investment markets.

A key market risk is faster-than-expected inflation, particularly in the US. Our inflation model suggests US core inflation will increase to around 2.5% in the near term. However, there is a risk that a further fiscal boost next year could lead to the US economy to “over-heat”. An inflation shock could force the Fed to tighten further and faster. As we will expand on over the next few pages, this could be a challenge for asset markets given how market pricing is currently set.

While the probability of a global recession remains low, an unexpected growth slowdown cannot be completely ruled out and may impact asset market returns. This could come from further deterioration in emerging economies, mainly through a China slowdown, or a turn in the US business cycle.

Figure 6: Balance of economic and market risks

Source: HSBC Global Asset Management as at October 2018. Any forecast, projection or target contained in this document is indicative only and is not guaranteed in any way.
Market-implied risk premia

The risk premium framework

- We have developed a systematic and integrated framework for assessing asset class attractiveness across the entire opportunity set.
- Starting with a scenario for cash rates, we add to each asset class our estimates of the market-implied reward of bearing specific asset class risk (e.g. risk premium).
- This build-up of cash rates plus risk premia produce our measure of expected returns (e.g. asset class valuation).
- Risk premia change over time, so we need to frequently update our market-implied reward for taking risk.

The pecking order of asset classes

- The chart below shows the expected risk premium (the excess return over cash) in USD terms for a range of asset classes in our investment universe. These are plotted against adjusted historic data on volatility as a proxy for risk.
- Broadly speaking, asset classes towards the top of the wedge appear to be attractively valued and offer attractive returns relative to their risk. Asset classes towards the bottom indicate unattractive valuations.
- Equity returns and emerging market assets are shown in unhedged terms, unless labelled with (H). Developed fixed income asset classes are shown in hedged currency terms.

Source: HSBC Global Asset Management and Bloomberg, as at October 2018.
Global bonds

Different bond risk premia, different inflation risks

Developed market government bonds continue to look unattractive. The return compensation for taking interest rate risk is negative in many markets. We believe investors are not rewarded for taking duration risk today.

We measure a bond risk premium in US 10 year government bonds of 10bps, compared to -110bps for Germany and -50bps for Japan (Figure 7). Poor valuations, in an environment of building cyclical inflation, are a major challenge for bonds going forward. We are in a bond unfriendly economic and market environment where global bonds should not be perceived as a “safe haven” asset.

Figure 7: 10-year bond risk premia (future excess returns over cash)

Source: HSBC Global Asset Management and Bloomberg, as at October 2018. Any forecast, projection or target contained in this document is indicative only and is not guaranteed in any way.

The return profile of the short-end of the US Treasury curve has changed dramatically

Importantly, the return profile of the short-end of the US Treasury curve has changed (Figure 8). Expectations that the Fed will continue raising rates produced a sharp increase in short-maturity bond yields, which improved prospective returns on short-duration US government bonds. For example, our expectations of the two-year US note prospective Sharpe ratio increased from 0.05 a year ago, to 0.21 as of end of September.

We also think that inflation-linked bonds continue to look attractive within the DM space against their nominal counterparts. Prospective returns are higher, and they provide a better hedge against inflation risk.

Figure 8: US 2-year treasury yield (%)

Source: HSBC Global Asset Management and Bloomberg, as at October 2018. Past performance is no guarantee of future results.
Global credits

Corporate health looks good

The current environment continues to be one of low recession risk and subdued default rates. Corporate health appears to be in good shape. High corporate debt levels are a cause for concern, but interest coverage ratios are stable/rising (Figure 9), and there is low rollover risk.

Figure 9: Interest coverage charge ratio

![Interest coverage charge ratio chart]

Source: HSBC Global Asset Management and Bloomberg, as at October 2018. Past performance is no guarantee of future results.

Prospective returns on corporate bonds have improved but the compensation for interest and credit risk is not quite enough

Although this environment is supportive for credits, we held an “underweight” view for most of this year because, in our view, the price we were being asked to pay to access this asset class was not enough to compensate for the risks.

Over the summer this view changed. Prospective returns of corporate bonds have improved due to a re-pricing in the underlying Treasury curve, and spread widening has increased the credit risk premium.

However, the compensation for interest and credit risk is still not quite enough, in our view. Although the compensation for taking duration risk has risen, it is still low. Better, we think, to take growth risk through other asset classes such as equities, where valuation is more favourable.

Figure 10: US IG Yield (%)

![US IG Yield chart]

Source: HSBC Global Asset Management and Bloomberg, as at October 2018. Past performance is no guarantee of future results.
Global equities

US equity outperformance is due to both growth divergences and index composition.

We believe equities continue to be the best asset class to access global growth. However, nowhere is it easier to see the impact of growth divergence at play than in the year-to-date performance of global equity markets. Global equity ex-US is down over 2% while the US is up 10% (in US dollar terms, as of end of September 2018).

However, half of the US outperformance against Europe is explained by the sector compositions of the two universes (Figure 11). This is due to the strong performance in some of the closely-weighted US sectors such as technology, coupled with weaker performance in financials, which dominate the European market.

Figure 11: Equity market performance

Source: HSBC Global Asset Management and Bloomberg, as at October 2018.
Past performance is no guarantee of future results.

US valuations have improved slightly, but the highest risk premia can be found in Europe and Japan.

So far, corporate earnings growth continues to be robust, especially in DMs. But equity valuations have also improved this year (Figure 12). In other words, the market believes that current earnings trends are not sustainable.

In our view, the current US equity risk premium of 3.0% looks OK, but is unattractive when compared to late cycle developed markets such and Europe (current ERP = 5.3%) and Japan (current ERP = 6.4%). With tightening monetary policy and more optimistic forecasts of growth, US equity market outperformance could be set to wane.

Figure 12: Year-to-date return decomposition

Source: HSBC Global Asset Management and Bloomberg, as at October 2018.
Past performance is no guarantee of future results.
Emerging markets

Prospective returns across EM assets have improved. Taking EM risk is well-rewarded.

Emerging markets have faced a challenging environment in 2018 where it seems that market perceptions of risk have moved ahead of fundamentals. Global growth trends still look OK and there is low risk of recession. Policy hikes are still only proceeding gradually. And most emerging economies are growing at reasonable levels with well-behaved inflation. External vulnerabilities (current account balances, reserve adequacy ratios and government structural balances) have improved, and EMs appear to be in a much stronger macro position than in the so-called “taper tantrum” of 2013.

However, investors “feel” EMs are more risky today. The constant negative news headlines and the bad psychology of the “doom loop” hardly help. Even so, our valuation work suggests that investors are now being well rewarded for taking on EM risk. If good news on EMs is delivered to the market, asset class performance could be strong. This means that emerging markets should still form an important part of our multi-asset portfolios today.

Figure 13: EM asset prospective Sharpe ratios

Source: HSBC Global Asset Management and Bloomberg, as at October 2018. Any forecast, projection or target contained in this document is indicative only and is not guaranteed in any way.

Local EMD is the best way to take on EM risk

The important question for investors, then, is which is the best way to take on EM risk? Should we focus on bonds (nominal/index-linked), or credits (sovereign/corporate), or equities (Asia/Latam/EMEA/Frontier)?

In our view, the answer is unhedged local currency debt. This asset is offering high prospective returns on the back of high carry, decent compensation for duration risk, and undervalued currencies. What’s more, current valuations provide a meaningful “margin of safety”.

Another option is EM equities. Valuations are attractive, but not as high as local EMD (see page 7), and corporate earnings growth is lower than that of developed markets.

However, the recent deterioration has not been uniform across the EM space. We prefer to fulfil our EM equity exposure in Asia, where economic growth has been comparatively robust (compared to Latin America for example) and where structural macro characteristics are better.

Prospective returns of EM credits have improved, but they are far from what local EMD and Asia ex Japan equities offer. In addition to this, credits are more exposed to interest rate risk (they have higher duration). As discussed above, this could still become a headwind for asset class performance.
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