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CREATING OPPORTUNITIES

Global Equity Markets
1H23 Update
14 July 2023

Executive Summary

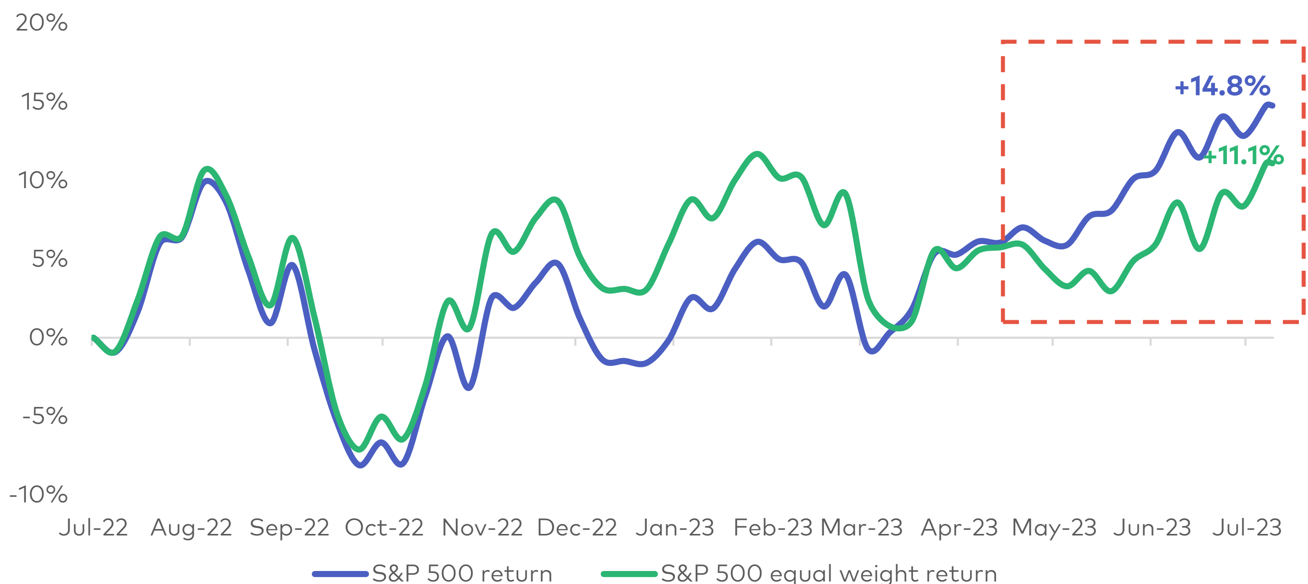
Equities strongly outperformed 2022 year-end expectations. A quicker-than-expected retreat in inflation, a stronger-than-expected economic activity, and advances in emerging technologies, such as artificial intelligence, all contributed to the recent rally. Importantly, gains were largely concentrated in large growth companies.

EM economies are expected to outperform their DM peers. Developed markets have avoided recession thus far but are likely to experience one in late-2023. Meanwhile, emerging markets, led by India and China, are expected to contribute around 70% of global GDP growth in 2023.

Central bank rates are expected to remain elevated for years. Structural shifts in supply and demand suggest inflation pressures will persist. This will push monetary authorities to maintain restrictive policy in short-to-medium term.

Given the strong performance in 1H23, investors should stay diversified and focus on quality. The recent rally in US equities suggests there is less room for growth in broad markets. Instead, investors should focus on growth opportunities in quality companies, emerging technologies, other specific segments

Figure 1: Mega-cap stocks have outperformed their smaller peers in S&P 500



Source: Bloomberg

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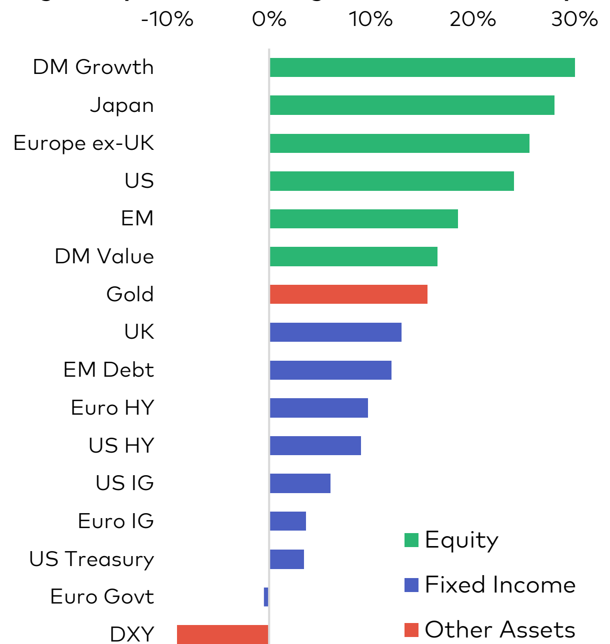
Markets Recap

The strong year-to-date returns in both fixed income and equity markets confirm the view that high inflation and future rate hikes were already priced in by markets in 2022. Moreover, developed markets (primarily the US and Euro Area) saw stronger-than-expected economic activity, as compared to an anticipated recession for 1H23.

It must be noted, however, that this year's rally was far from broad-based. As illustrated in Figure 3, the S&P 500 rally predominantly came from large tech stocks from Technology, Communications, and Consumer Discretionary sectors. The major catalyst underlying this performance was the technological advances in and commercialization of AI-related products and services. In addition, the quicker-than-expected moderation in the US inflation level has investor optimism around the idea of quick Fed pivot.

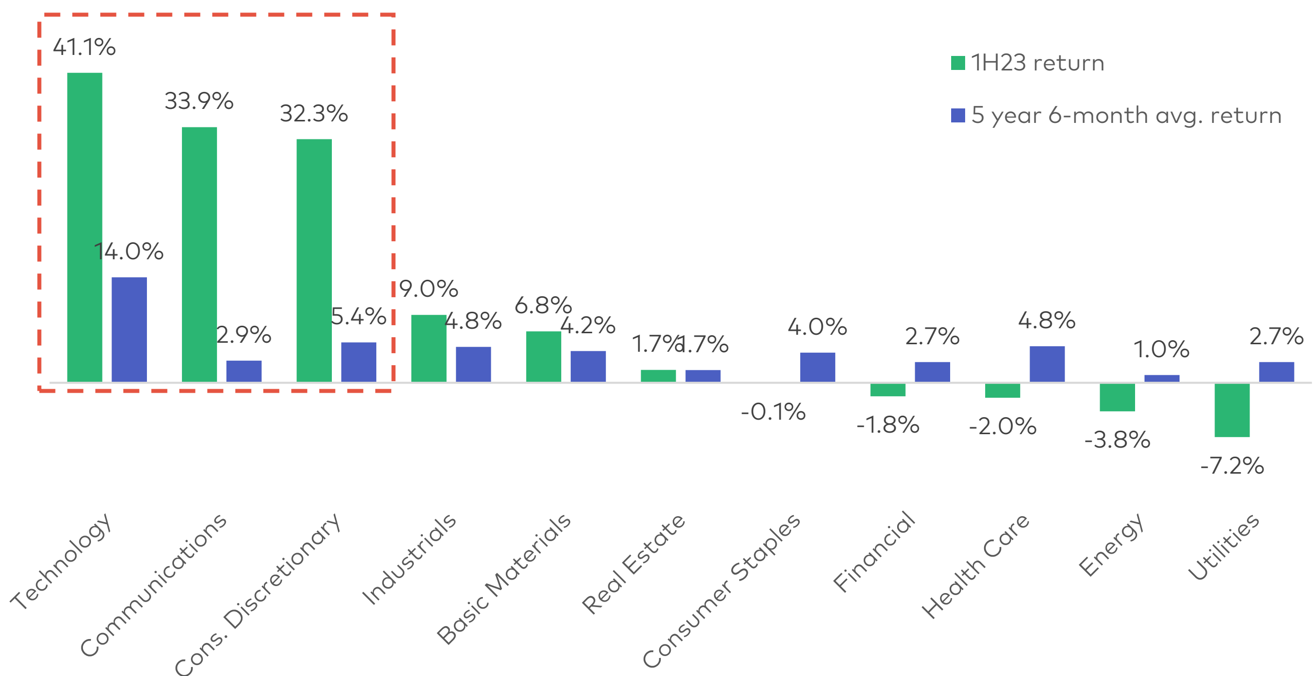
Apart from sectors, the rally was concentrated in terms of equity styles too. Large-cap growth stocks from developed markets were the main beneficiaries, with examples including Tesla, Apple, Nvidia, Amazon, Microsoft, and likes.

Figure 2: performance of global assets since Sep-22



Source: Bloomberg, JPMorgan

Figure 3: S&P cyclical sectors delivered strong returns, while defensive sectors have struggled



Source: Bloomberg

Global economy

In 1H23, global economy has proven more resilient than most have anticipated. However, the likely scenario still includes a delayed recession in developed markets (US, Euro Area, and UK predominantly). Meanwhile emerging markets are expected to outperform significantly. As shown in Figure 4, nearly 70% of global GDP growth in 2023 is expected to come from China, India, and Asia-Pacific, while Europe and Americas are expected to contribute only around 20%. In India, strong consumer spending and improved corporate balance sheets allow for rapid economic growth. Similarly, Chinese consumers show good appetite for spending, as demonstrated by a strong rebound of retail sales in 1H23.

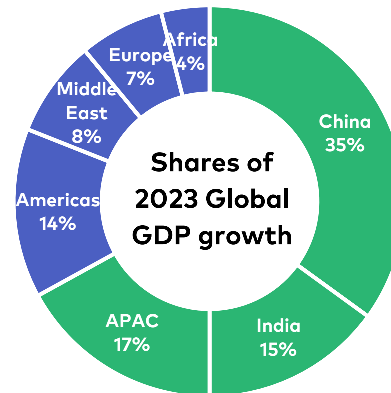
In the US and Euro Area, manufacturing activity, which accounts for a larger part of total economic output, has declined considerably since the post-pandemic recovery. Soaring inflation, reduced consumer demand, and uncertain economic outlook have all contributed to deterioration in the health of the manufacturing sector.

In contrast, China has shown relative stability, flirting with a 50-point threshold, which separates contraction from expansion. Notably, China's manufacturing PMI has outperformed that of Western peers for most of 2023. Despite the recent decline in China's PMI, the low-inflation environment gives space to the government to implement expansionary fiscal and monetary policies.

Unlike manufacturing, the services sector has demonstrated strength in 2023. Services PMIs have rebounded from contraction territory in both China and the West, however, showing decline in past months.

This is partly explained by the long-lived impact of post-pandemic shifts in consumption from goods to services. Because the supply side of the economy takes time to readjust to the structural changes in demand, inflationary pressures are created during the process. The result is rooted in the mismatch of supply and demand and because prices are downwards-sticky, the overall impact is that inflation increases.

Figure 4: almost 70% of global GDP growth is expected to come from Asia



Source: International Monetary Fund

Figure 5: Manufacturing Purchasing Manager's Indices (PMIs)

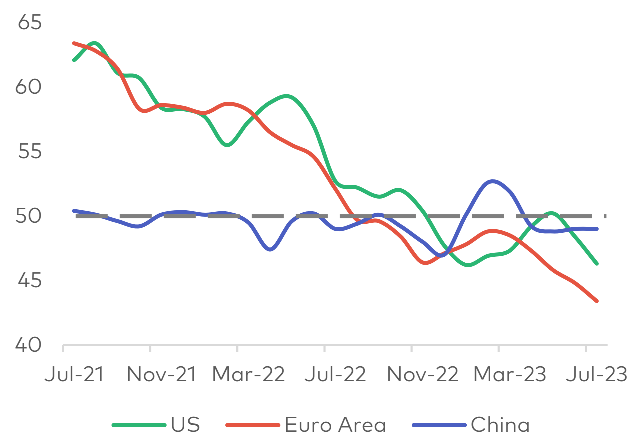
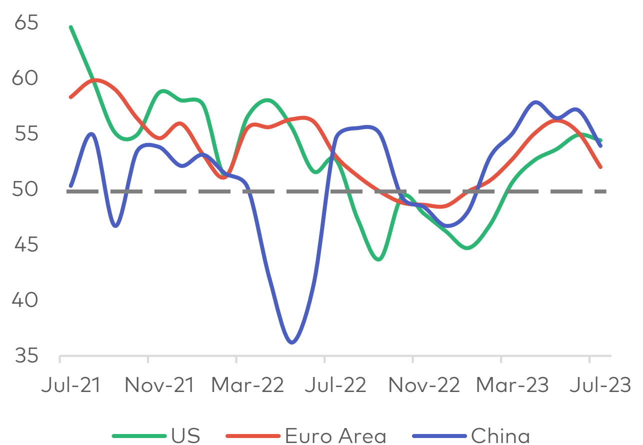


Figure 6: Services Purchasing Manager's Indices (PMIs)



Source: Bloomberg

Global economy

Global macroeconomic regime has changed. In the past 40 years, the global economy saw strong and steady growth with low inflation (i.e., the era of Great Moderation). In recent years, however, global pandemic, the Russia-Ukraine war, and disturbed supply chains have produced soaring inflation in developed economies. In Europe, both Euro Area and the UK still exhibit strongly elevated inflation levels. In the US, on the other hand, the headline inflation has moderated dramatically recently, with June's figure standing at a lower-than-expected 3.0% y/y. Importantly, this is partly due to the base effect, as June 2022 was the peak of US inflation.

Moreover, the policymakers are more concerned with core CPI which excludes the volatile components of food and energy. In the US, the June's core CPI stood at 4.8% y/y, which is well above the Fed target rate of 2.0%.

It must be noted that inflation puzzle is fundamentally rooted in structural shifts which suggest that further moderation will be harder to achieve. One factor supporting this view is the aging population in developed economies. Because this limits the supply of workers, the labor market is expected to remain tight in years to come. This, naturally, makes the low inflation environment unlikely to be achieved.

In response to soaring inflation, central banks of developing economies have implemented the most intense hiking cycles in decades. While this has pushed inflation in the US and Euro Area to retreat, most monetary authorities believe the restrictive policy should stay for a while. Figure 9 illustrates expectations on rates of US Fed, European Central Bank, Bank of England, and Bank of Japan. As shown, the zero or near-zero policy rates highly unlikely in short to medium term in developed markets. While bad for equities, high rates imply that income is back in debt securities. Importantly, increased central bank interest rates mean higher yields on not only treasury securities but for private credit too.

Figure 7: headline consumer price index (CPI) in DMs

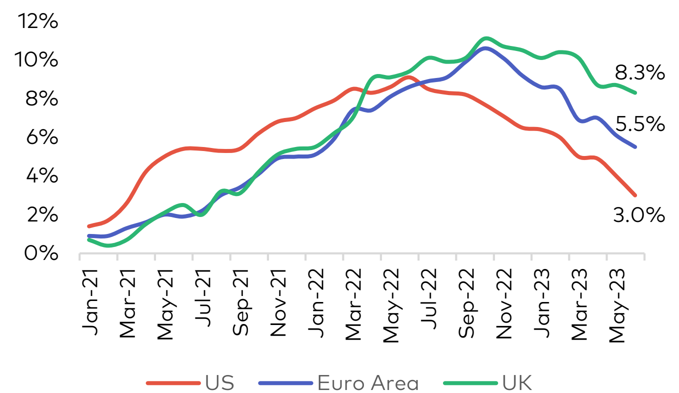


Figure 8: core consumer price index (CPI) in DMs

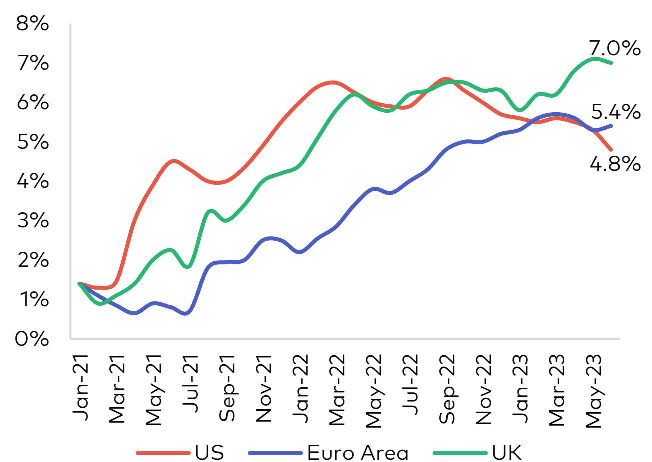
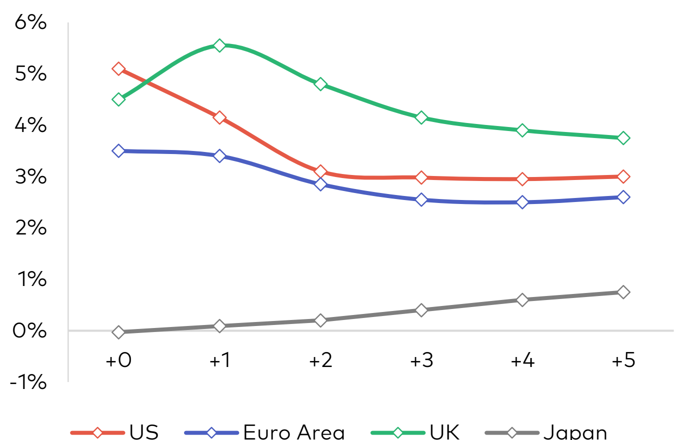


Figure 9: policy rate forecasts for DM central banks



Note: horizontal axis indicates the sequence of monetary policy meetings that are held every two months

Source: Bloomberg, respective national bureaus of statistics

Markets outlook

While 2023 macroeconomic outlook is not particularly appealing, there is some room for positive surprises. Given, a quicker-than-expected easing in supply chains and a reduction in geopolitical tensions (especially between the US and China), equity markets may rally further in the face of lower inflation and higher growth prospects. On the other hand, if geopolitical tensions intensify or inflation proves stickier-than-expected, equities are likely to decline.

Despite a weak general outlook, there are numerous opportunities of growth that are fundamentally tied to the current global megatrends. Firstly, implementation of AI technologies suggests there will be significant improvements in productivity. Companies that integrate these emerging technologies in their production are likely to achieve cost efficiency and, therefore, stronger profit margins. These cost reduction benefits are likely to be the highest in labor-intensive companies (i.e., in the services industries).

On the other hand, deglobalization due to an increased competition between the US and China will likely lead to reshoring by governments, which implies a loss in productivity due to less cost-efficient production. Under such scenario, defense, aerospace, and cybersecurity companies are likely to deliver gains.

Possible short-term scenarios

Negative	Baseline	Positive
Macro Resilient demand for labor market and constrained supply chains produce tough inflationary pressures. US GDP contracts by min. 2%. Corporate profits decline by 20%. China sees week domestic consumption and exports.	**Macro** The hiking cycle pushes global economy into recession. Corporate profits decline by 10%. China's reopening is delayed, but materializes in late-2023, partially offsetting declining demand in the West.	**Macro** As supply chains improve quickly, business and consumer confidence improves. GDP and corporate profits decline slightly, leading to stagnant earnings in 2023. China sees strong consumption and stable Western demand, helping exports.
Policy Fed raises rates further and does not pivot for long time. China does not ease policy, while Bank of Japan rises rates.	**Policy** As depressed demand pushed inflation down, Fed pivots when recession hits the US. China maintains supportive policy.	**Policy** Fed and ECB pivot in 2023. Lower yields reduce pressure on sovereign debt payments. China policy turns even more expansionary.
Markets S&P 500 flirts with 3,600 (2022 low). Credit spreads widen. Emerging Market equities also decline in the face of higher Fed rates and rallying USD. USD, CHF, JPY rally, while defensive equities provide better returns.	**Markets** As multiples and corporate profits decline, 1 year outlook for US stocks remains uncertain and volatile. Sustainable gains in US equities expected in 2024. EM stocks likely to outperform as USD declines. Asia provides best valuations in EM.	**Markets** Equities rally in the face of central bank pivoting, with growth assets (tech stocks, crypto) and cyclical stocks outperforming. Credit spreads compress as default probabilities fall due to lower rates. USD declines sharply.

Source: HSBC Asset Management

Markets outlook

As global macroeconomic outlook remains unfavorable, investors are likely to benefit more from investing in specific segments of equities rather than broad markets. During the times of economic downturns, quality companies with strong balance sheets and competitive positioning tend to deliver better-than-average returns. Moreover, defensive assets like non-cyclical equities, sovereign debt, and safe alternatives (e.g., gold) are also worth considering.

This, however, does not imply the lack of growth opportunities. Companies that embrace megatrends, such as the rise of AI and other emerging technologies, are likely to deliver strong results even in the face of macroeconomic headwinds.

Lastly, emerging markets seem to be well priced as compared to DMs. Furthermore, EMs have better economic outlook for near future, which, naturally, will impact equities positively.

Table 1: performance of major global equity indices

Equity index	Level	1H23 (%)	2022 (%)
US			
S&P 500	4,450	**16.4**	-19.4
Russell 2000	1,889	**7.9**	-21.6
Nasdaq 100	15,179	**39.7**	-33
Europe			
MSCI Europe	52.63	**9.6**	-18.3
UK FTSE 100	7,532	**-0.3**	0.9
Germany DAX	16,148	**14.8**	-12.4
France CAC	7,400	**12.2**	-9.5
Asia			
MSCI China	44.74	**-8.9**	-24.3
Nikkei 225	33,189	**29.1**	-9.4
MSCI APAC	66.44	**1.2**	-21.7
MSCI World	124.52	**14.1**	-19.3

Source: Bloomberg

Tactical (next 12 months) expectations for equities

S&P Sectors	ETF	Tactical View
Communications	XLC	Positive
Health Care	XLV	Positive
Energy	XLE	Positive
Materials	XLB	Neutral
Financial	XLF	Neutral
Real Estate	XLRE	Neutral
Consumer Staples	XLP	Neutral
Utilities	XLU	Neutral
Consumer Discretionary	XLY	Negative
Technology	XLK	Negative
Industrials	XLI	Negative

Source: S&P Capital IQ estimates

Markets	ETF	Tactical View
Emerging Markets	EEM	Positive
China	MCHI	Positive
DM AI mega force	BOTZ	Positive
Japan	EWJ	Neutral
APAC ex. Japan	AAXJ	Neutral
US	SPY	Negative
Europe	IEUR	Negative
UK	EWU	Negative

Source: BlackRock Investment Institute

Positive
Neutral
Negative

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