Q4 / 2021

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# HSBC Jade Perspectives

Shaping your investment portfolio

HSBC Jade

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**HSBC Jade Perspectives** is a publication specifically created for our Jade clients.

It explores the key global themes relevant to today's investors, while explaining their diverse implications.

# A promising outlook, but portfolio resilience is more important than ever

**Xian Chan**
Chief Investment Officer, Wealth Management, HSBC

**Willem Sels**
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So far this year, one could say that investors have relatively little to complain about. The global economy is recovering decisively from the pandemic. Vaccination has been broadly successful, especially in developed markets, with Singapore, the UK and US having vaccinated most of their populations to date.

As a result, these economies are able to resume a degree of normality. Corporate earnings have benefited, particularly in the services sector, as restaurants and shops reopen. This is taking place against a backdrop of loose monetary policy, coupled with strong fiscal support.

Looking back, it's no surprise that financial markets, and the stock market in particular, have had a strong comeback. Can the rally continue? The answer is "yes". Why? Because there's good reason to expect these favourable conditions to persist, with earnings likely to stay strong and more people being vaccinated daily in the coming months.

**So what does this mean for your portfolio?**

We still favour equities and high yield bonds – a reflection of our view that the recovery trade can continue, fuelled by the services sector. Our preference for financial and consumer discretionary companies also reflects this. In addition to US, UK and Asian stocks, we are now positive on European equities. We have also upgraded our Europe GDP forecast from 4.4% to 4.9% as a result of the region's rapid growth momentum and fiscal support.

And yet, there are risks – not least the possibility of new waves or variants of Covid-19. A rise in inflation may cause monetary policy to tighten earlier than expected, while the planned tapering of policy by the Fed could spark volatility if not handled delicately.

It's important to stress that these risks aren't part of our base-case expectation. Nonetheless, the prudent thing to do right now is factor in a strong "quality" bias to make your portfolio more resilient. This means focusing your equity allocation on large companies whose balance sheets and cash flows are likely to be dependable in volatile times. These companies often pay out a significant portion of earnings, offering the chance to compound dividend income in a low-yield environment.

Sustainable investing is another way to optimise portfolio "quality". The recent UN Intergovernmental Panel on Climate Change (IPCC) report reinforced the urgent need to achieve carbon neutrality, while the upcoming Climate Change Conference (COP26) will likely drive intensified action to lower global emissions. In our view, companies that wholeheartedly embrace sustainable practices are more likely to be rewarded in the longer term, while those that lag behind may suffer higher costs of capital and lower valuations.

Overall, we expect an inevitable acceleration in ESG investing, making it key to our approach. We invite investors to position their portfolios accordingly.

We wish you a safe and fruitful end to the year.

Xian Chan

Willem Sels

## At a glance:

We believe that the global recovery is likely to continue over the coming months. Equities are still a key focus and we are now positive on European equities in addition to US, UK and Asian stocks.

But risks remain, leading us to focus on large cap, high-quality, dividend-paying stocks that can reinforce portfolio resilience if volatility strikes.

As global events bring sustainability themes more starkly to the fore, ESG investments are becoming ever more central to our thinking.

# At a glance

A summary of Q4 2021 HSBC Jade Perspectives

## Investment themes

1

Remain invested in the recovery

2

Focus on the Asian growth story

3

Add resilience to your portfolio

4

ESG: Now is the time

## Investment Views Summary

| Bonds | Short term (3-6 months) |
|---|---|
| **Developed Markets Government Bonds** | ▼ |
| **Emerging Markets Government Bonds** (local currency) | ▲ |
| **Global Investment Grade Corporate Bonds** | ▶ |
| **Global High Yield Corporate Bonds** | ▲ |

| Equities | |
|---|---|
| **Global** | ▲ |
| **United States** | ▲ |
| **Eurozone** | ▲ |
| **United Kingdom** | ▲ |
| **Japan** | ▶ |
| **Emerging Markets** | ▶ |
| **Central & Eastern Europe and Latin America** | ▼ |
| **Asia** (excluding Japan) | ▲ |

Note:
Views presented above have a 3-6 month time horizon; a relatively short-term view on asset classes for tactical asset allocation.

▲ "Overweight" implies a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

▼ "Underweight" implies a negative tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

▶ "Neutral" implies neither a particularly negative nor a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

Source: HSBC Global Investment Committee, as of 25 August 2021.

## Key events

### Sept 2021

**9 Sept**
European Central Bank (ECB) policy decision

**22 Sept**
The Federal Open Market Committee (FOMC) policy decision

**23 Sept**
Bank of England (BoE) policy decision

**26 Sept**
German federal election

### Oct 2021

**15 – 17 Oct**
Annual meeting of IMF and World Bank in Marrakech

**28 Oct**
ECB policy decision

**31 Oct – 12 Nov**
UN Climate Change Conference (COP26) in Glasgow

### Nov 2021

**3 Nov**
FOMC policy decision

**4 Nov**
BoE policy decision

### Dec 2021

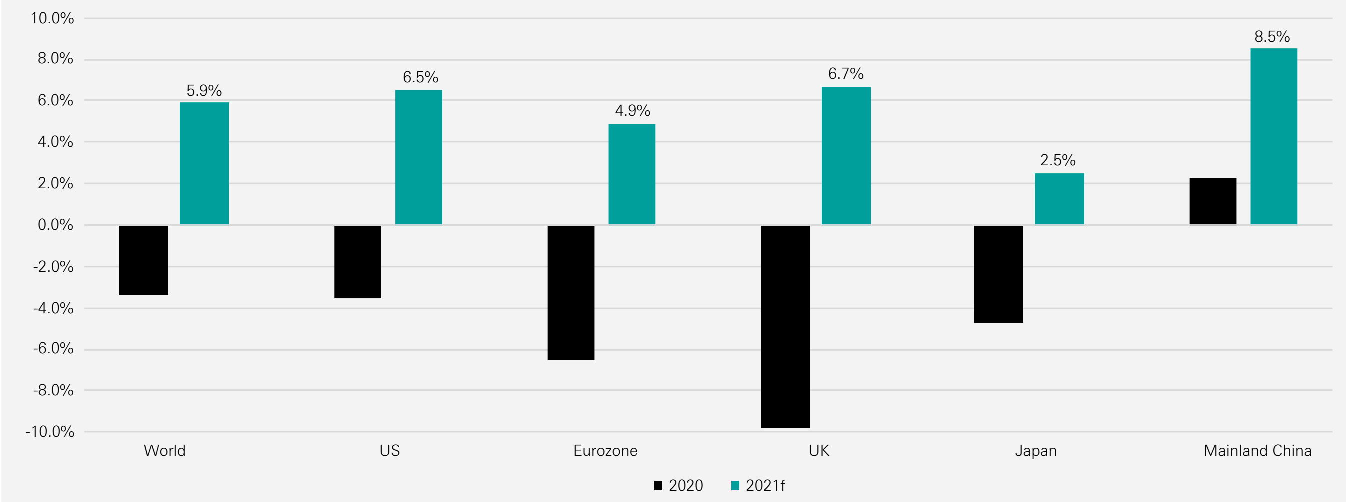
**15 Dec**
FOMC policy decision

**16 Dec**
ECB policy decision

**16 Dec**
BoE policy decision

## Chart of the Quarter

**Favourable fiscal policies and vaccination progress power GDP growth**




Source: HSBC Economics. GDP aggregates use chain nominal GDP (USD) weights.

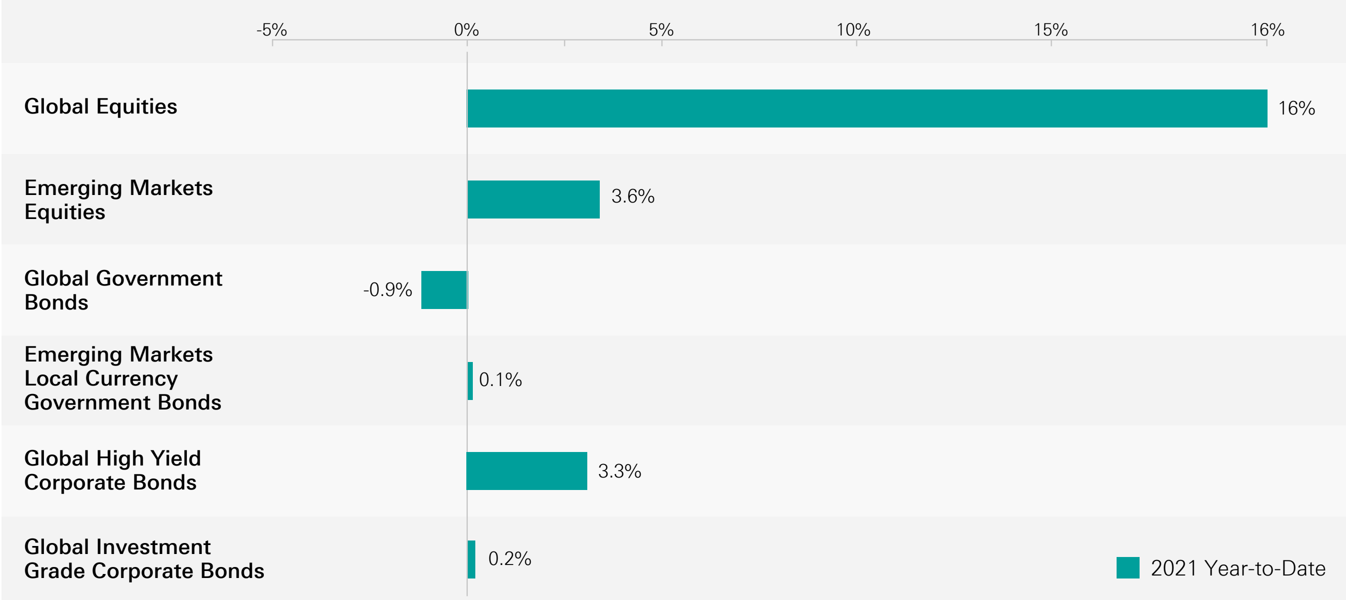
## Equities

Global equities are up about 16% YTD thanks to strong corporate earnings and economic momentum, with the US and Europe leading (up about 21% and 15% respectively). After a robust first half, equities saw some temporary sell-offs but stayed positive. The divergence between emerging and developed markets widened due to China's regulatory clampdowns in certain sectors. Emerging markets in Asia and Latin America also struggled with rising Covid infections, returning just below 4% YTD. For developed markets, positive sentiment and an encouraging earnings season bolstered performance, particularly in the US, UK and Europe.

## Bonds

Bonds have underperformed relative to equities, with Global High Yield Corporate Bonds up 3.3%, Investment Grade Corporate Bonds close to flat and Global Government Bonds down at around 1% YTD. This asset class has suffered from a shortage of catalysts in the current low-interest environment, while yields and spreads remain at historic lows. Corporate credit underperformed a rally in government bonds amid concerns regarding the Delta variants, while CCC-rated bonds, the riskiest category within high yield, has been undergoing a pandemic-induced sell-off since March 2020. Despite this, Global High Yield Bonds are still the best performing within the fixed income universe, with US and European markets outperforming their Asia counterparts (+4.8% and +3.9% vs -2%).

## Selected asset class performance




Source: Refinitiv Datastream, data as of 03 September 2021. Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

Note: the chart shows total returns of asset classes in USD dollar (USD). Asset class performance is represented by different Indices – Global Equities: MSCI ACWI Net Total Return Index (USD); Global Government Bonds: Bloomberg Barclays Global Aggregate Treasuries Total Return Index (Hedged, USD); Global High Yield Corporate Bonds: Bloomberg Barclays Global High Yield Corporate Total Return Index (Hedged, USD); Global Investment Grade Corporate Bonds: Bloomberg Barclays Global Aggregate Corporate Total Return Index (Hedged, USD); Emerging Market Equities: MSCI Emerging Net Total Return Index (USD); Emerging Market Local Currency Government Bonds: Bloomberg Barclays Emerging Market Local Currency Government Total Return Index.

# Recovery with a change of focus

Stocks and other risky investments have done well this year, bolstered by supportive government policy, higher vaccination rates and the reopening of economies. But what do the remaining months have in store?

We believe that stocks can sustain their rally as the global recovery drives strong corporate earnings. This is especially true for the US, where strong earnings are expected for the rest of the year, justifying our continued “overweight” position.

In Asia, growth remains on track thanks to structural factors like the region’s growing middle class and healthy levels of digital consumption, aided by an effective response to Covid-19. In light of this, as well as strong policy support and the attractive nature of current valuations, we’re maintaining our positive outlook despite recent market volatility. Specific economies such as Singapore and Taiwan are especially well positioned to benefit from the global trade recovery and resulting semiconductor shortage.

We have liked UK equities for some time with their attractive valuations. In the Eurozone, we have upgraded our 2021 GDP forecast to 4.9% and are additionally positive on European equities, thanks to rapid growth momentum and central bank support.

While our overwhelming expectation is for continued recovery, some risks do remain. Further variants of Covid-19 are always possible, and new containment measures may be necessary to protect the economic rebound. In addition, the Fed’s communication on tapering could rattle markets if not handled cautiously.

As a consequence, our focus for Q4 is on increasing portfolio resilience. When choosing stocks, the emphasis should be on large, high-quality companies with strong balance sheets and robust cash flows. High quality, dividend-paying stocks are particularly attractive in the current environment.

There has also never been a better time to consider sustainable investments. Recent global events will most likely accelerate the drive towards carbon neutrality, in which companies that operate sustainably and responsibly in the face of climate change are expected to benefit.

The following themes will help you position your portfolio as we enter the final quarter:

1

## Remain invested in the recovery

The stock market is still our pick, along with other risky assets like high yield bonds. As vaccination allows more economies to reopen, corporate earnings will benefit, driving stocks higher. However, the pace of growth may slow as the recovery progresses.

2

## Focus on the Asian growth story

Asia is still a driving force in the global recovery, with long-term structural dynamics in place and other positive indicators such as Taiwan's competitive position on semiconductors, China's 14th Five-Year Plan, the Regional Comprehensive Economic Partnership (RCEP) trade agreement and Singapore's global exposure.

3

## Add resilience to your portfolio

Portfolio resilience is critical at this phase of the recovery. Although we expect stocks and other risky assets to keep performing well, Covid-19 and the potential tightening of central bank policy could still pose a threat. Our focus is on large, high-quality (particularly dividend-paying) companies with strong balance sheets and cash flows.

4

## ESG: now is the time

Investor interest is growing in sustainable companies, which should lead to higher valuations and a lower cost of capital for them. The IPCC report on climate science and the COP26 conference are likely to enhance the profile and attractiveness of these companies.

Read on to explore each of these themes in detail.

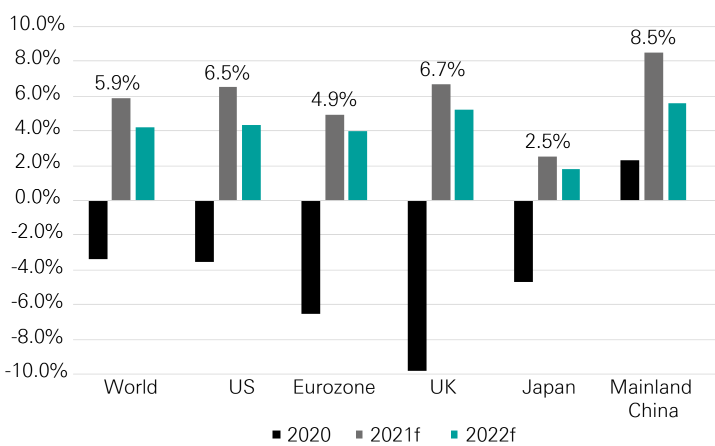
1

## Theme 1

# Remain invested in the recovery

**Strong economic growth expected for 2021**

Global GDP forecasts to exceed pre-Covid levels




Source: HSBC Economics. GDP aggregates use chain nominal GDP (USD) weights.

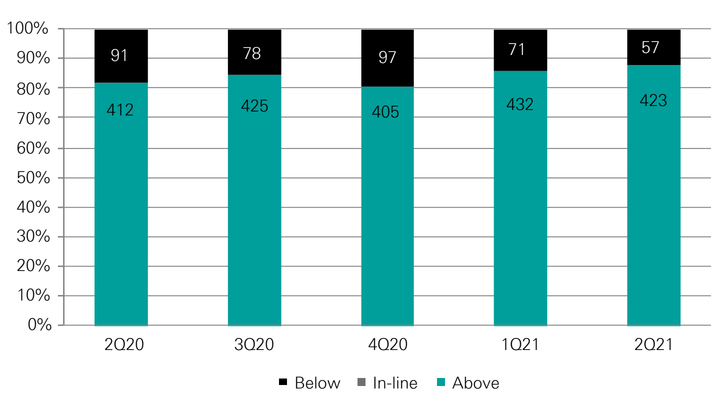
## Play the recovery theme

The economic recovery from the pandemic has been strong, but we believe there's room for more. Vaccination progress is allowing economies around the world to reopen, which in turn should drive up corporate earnings, particularly in the services sector. The consumer discretionary, financial and technology sectors remain our picks.

We still like equities, as well as high yield and Emerging Markets bonds. The continued improvement in consumption should drive these asset classes higher, aided by strong monetary and fiscal stimulus, such as the USD1tn infrastructure plan in the US.

**Corporate earnings surprised on the upside**

Earnings have beaten S&P500 consensus forecasts since 2008




Source: Refinitiv Datstream, as at 03 September 2021. Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

## Selectively "risk-on"

Our overweight position on global equities is driven by our expectation of robust corporate earnings. In addition to our preferences for US, UK and Asian stocks, we have upgraded European equities to Overweight due to stronger growth momentum and a supportive European Central Bank.

Corporate earnings have dramatically beaten expectations in 2021. In Q2, of the 96% of the S&P500 companies that have reported their earnings, 88% have beaten expectations. Solid earnings growth should continue, driving stocks higher, though at a reduced momentum following the already strong rise this year.

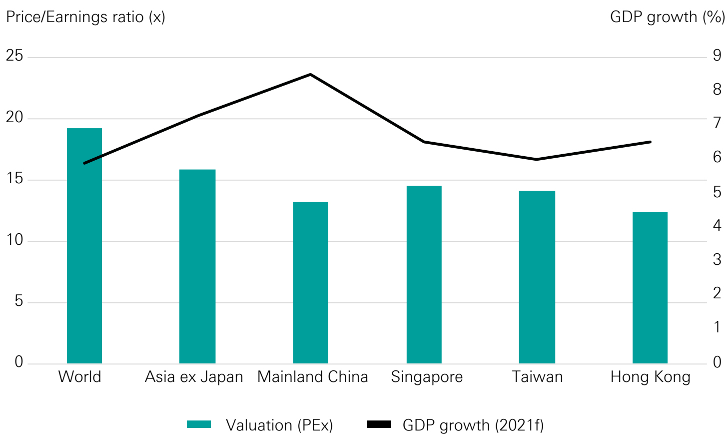
2

## Theme 2

# Focus on the Asian growth story

**World GDP growth and valuations**

Growth for developed markets in Asia is on track, while valuations are not unreasonable




Source: HSBC Economics. GDP aggregates use chain nominal GDP (USD) weights. Valuation data sourced from Bloomberg, as at 2 September 2021.

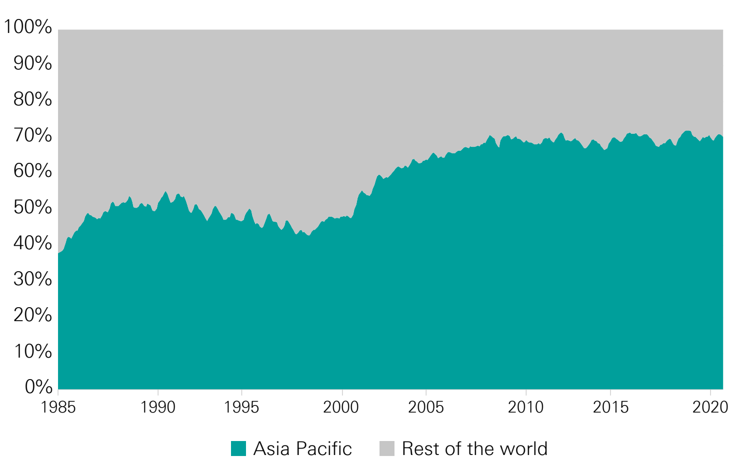
## Still positioned for structural growth

In spite of recent volatility, Asia's strong appeal stems from multiple structural factors, including the RCEP trade agreement and China's 14th Five-Year Plan. These policies should drive attractive consumer demographics, competitive supply chain dynamics and a shift to radical decarbonisation.

From a cyclical perspective, some parts of Asia have a track record of managing new waves of Covid-19 well, giving us confidence that the broad recovery in the region can continue. As the chart shows, valuations of Asian stocks are relatively inexpensive compared to global and US markets.

**Asia accounts for 70% of global semiconductor sales**

Percentage of total sales (3-month moving average)




Source: Refinitive Datastream, as of 3 September 2021. Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

## Identifying the opportunities

Due to regulatory uncertainty in sectors like tech and education, we've adopted a neutral position on Chinese equities for the next 3-6 months. Despite this, the structural growth factors support a positive outlook for China. We believe that a diversified exposure across a broad range of sectors, as opposed to concentrated allocations to sectors like tech, is the right way forward.

We like Singapore and Taiwan's competitive position, which benefits from attractive supply and demand dynamics in semiconductors. This is a cyclical play within the tech sector that is expected to benefit from the ongoing recovery.

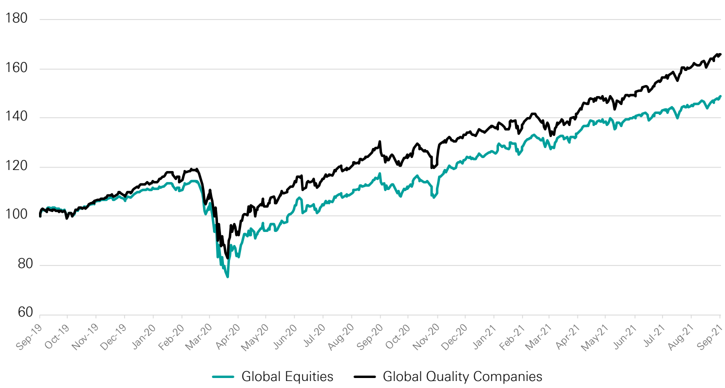
3

# Theme 3

# Add resilience to your portfolio

**Quality stocks are more resilient in both good and bad times**

Momentum had been steady before and after the Covid-downturn



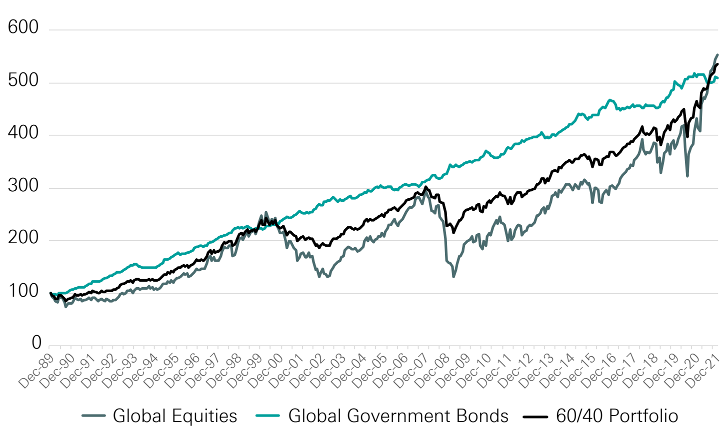

Source: Refinitiv Datastream, as of 3 September 2021; Global Equities: MSCI World Index; Global Quality Companies: MSCI World Quality Index. Source: Refinitive Datastream, as of 3 September 2021. Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

## Quality is key at this stage of the cycle

Equities have rallied strongly since the start of the pandemic, while valuations are more demanding and earnings expectations higher than ever. It's therefore prudent to focus on large "quality" companies with strong cash flows and robust business models, able to sustain dividend payouts in a low-yield world.

Our core expectation is that recovery will continue and that economic reopening will gain momentum. However, a number of risks add an element of uncertainty. These include inflationary expectations, the progress of the Delta variants and the Fed's communication on the tapering of quantitative easing.

**A multi-asset portfolio strategy can help reduce risk and deliver returns**




Source: Refinitiv Datastream, as of 3 September 2021. HSBC Calculations, Global Equities: MSCI World Index; Global Government Bonds: FTSE World Government Bond Index (WGBI); 60/40 Portfolio is constructed using 60% MSCI World; 40% FTSE World Government Bond Index. Investment involves risks. Past performance is not indicative of future performance. For illustrative purpose only.

## A multi-asset approach works

The risks highlighted above mean that a multi-asset approach (with allocations to high quality bonds) will play an important role in protecting your portfolio against volatility.

Although high quality bonds might offer unattractive yields right now (with high quality Government and Corporate Bonds yielding about 1% on average),[1] they play an important role in protecting portfolios during volatile times. As the chart shows, investing in a multi-asset portfolio over the long term has delivered comparable returns to a pure stock portfolio but with lower volatility and fewer sleepless nights.

[1]Barclays Global Aggregate Bond Index Yield-to-Maturity; as of 25 August 2021.

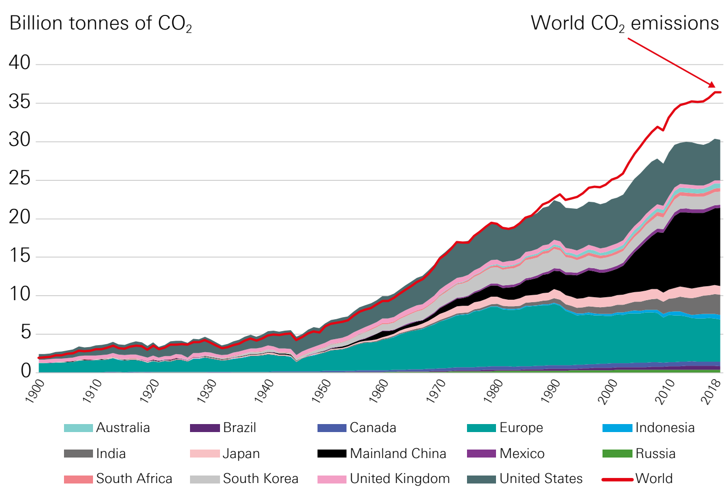
4

## Theme 4

# ESG: now is the time

**Annual global $CO_2$ emissions**

Listed economies are responsible for more than 80% of emissions




Source: Our World in Data

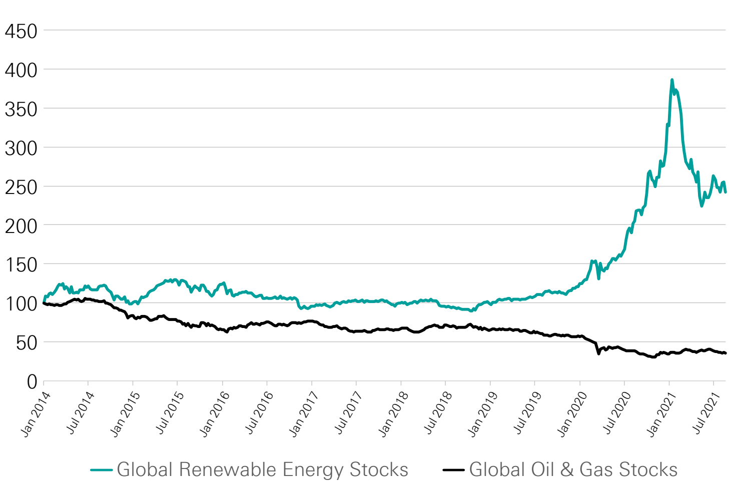
## Climate change is a real threat

The UN IPCC report highlights the severity of global warming, as well as its human causes. Disruptive events are occurring more frequently due to a global temperature rise of 1.09°C, a 7% average increase in precipitation, a 20cm rise in sea levels and an increased proportion of heavy pollutants in the atmosphere.

At the current pace of emissions, these numbers will continue to trend and by 2040, average global temperatures are expected to increase by 1.5 degrees. Unless radical decarbonisation takes place in the coming decades, passing this threshold means even more frequent and severe weather upheaval than today.

**Strong interest in green investments in the transition to net zero**

Renewable energy stocks have outperformed oil & gas stocks since 2014




Source: Refinitiv Datastream, data as of 24 August 2021. Global Renewable Energy Stocks: World Renewable Index; Global Oil & Gas Stocks: MSCI Oil, Gas and Fuels Index.

## The race towards carbon neutrality

Since much of the existing damage cannot be reversed overnight, we must take action now. The path to carbon neutrality can help to drive better climate change mitigation, for example, through the wider global use of renewable energy. It will also create increased opportunities for investors to explore.

Our research shows that adopting a sustainable investment strategy does not hurt investment returns. In fact, we think financial markets will reward companies that demonstrate better corporate governance and sustainable business practices as this ultimately improves margins, lowers costs of capital and increases valuations.

## ▲ Asia (excluding Japan)

While we've turned neutral on Chinese equities, we still see investment opportunities in pockets of 5G infrastructure and smart manufacturing. China's policy environment is relatively hawkish, and global investors are underweight on the back of recent industry scrutiny. We continue to like Singapore for its successful containment of the virus and global manufacturing trade, and Taiwan for its ability to benefit from the semiconductor shortage.

ASEAN, although behind the curve in containing Covid-19 variants, can benefit from a cyclical rebound and exposure to value. India is recovering and looks to have contained its second wave, with our economic recovery tracker back to near pre-pandemic levels.

**Over the next 3-6 months, we like:**

- **The following sectors in Asia: consumer discretionary, real estate, communications and technology**
- **Singaporean and Taiwanese equities**

# Regional market outlook

## ▶ Japan

The Bank of Japan has not moved its bond yields and continues its quantitative easing (QE) programme. Already lagging behind global peers in terms of growth, the country has seen its tourism industry and consumption levels hit hard by the pandemic, while the spectator-free Tokyo Olympics did little to benefit the economy. In the longer term, we believe Japan may benefit from its competitive edge in technology, due to the global demand for robotics and automation.

We continue to hold a neutral stance on **Japanese equities in the next 3-6 months**.

## ▲ United States

In addition to Biden's American Rescue Plan Act, two more proposals are under discussion: the American Jobs Plan and the American Families Plan, focusing on infrastructure and household support respectively. On the back of this USD5.7trn stimulus and the economic reopening, we expect GDP to expand by 6.5% in 2021. Policy support combined with robust consumer spending and a booming housing market should help boost GDP to pre-pandemic levels.

**Over the next 3-6 months, we like:**

- **US equities in general, particularly the following sectors: consumer discretionary, financials, communications, real estate and technology**
- **US high yield corporate bonds**

## ▲ Eurozone and UK

We are now more positive on the Eurozone and have upgraded our GDP forecast to 4.9%, with sentiment and economic growth momentum seemingly strong. Service-based economies like Italy and Spain are benefiting from the reopening of the economy. The manufacturing powerhouses of Germany and France are already benefiting from the recovery in global trade and consumption.

We are also positive on the UK, whose stock market offers attractive valuations. Its economy is also performing better than expected, with consumption rising as restrictions have eased. We expect UK GDP to grow by 6.7% in 2021 and 5.2% in 2022.

**Over the next 3-6 months, we like:**

- **UK and Eurozone equities in general**
- **The following European & UK sectors in particular: consumer discretionary, industrials, materials and financials**

## ▼ Central & Eastern Europe (CEE) and Latin America (LatAm)

Performance has diverged across Emerging Markets (EMs), with Central and Eastern Europe significantly outperforming LatAm and Asia year-to-date. Brazil, badly hit by the economic impact of Covid-19, looks to be over the worst and ready to benefit from increased commodities demand as the world economy reopens. Mexico's growth outlook is also improving, thanks to a resilient US and generous infrastructure spending, as well as improving domestic growth. Overall, we are underweight on LatAm as vaccination rates appear patchy and policy risks remain.

**Over the next 3-6 months:**

- **We are underweight on CEE and LatAm equities; neutral on Emerging Markets (EMs) equities**

Notes:

**Short-term view** (3-6 months): a relatively short-term view on asset classes for tactical asset allocation.

For a full listing of HSBC's house views on asset classes and sectors, please refer our Investment Monthly issued at the beginning of each month.

▲ "Overweight" implies a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

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▶ "Neutral" implies neither a particularly negative nor a positive tilt towards the asset class, within the context of a well-diversified, typically multi-asset portfolio.

# Sustainable investing: where urgency, responsibility and opportunity meet

**Xian Chan**
Chief Investment Officer, Wealth Management, HSBC

**Willem Sels**
Global Chief Investment Officer, Private Banking and Wealth Management, HSBC

## At a glance

According to the recent UN report, a 1.5-degree Celsius rise in global temperatures is all but inevitable, making extreme weather conditions even more frequent.

As governments promote radical mitigation and adaptation measures, companies that align their practices and products are more likely to prosper.

This creates investment opportunities in green innovation and activities that support the drive to "net zero", with the potential to generate long-term capital growth without compromising returns.

Global weather patterns have evolved rapidly in the last few decades, and many more of us now have personal experience of unusual or disruptive climate events. In recent months, parts of Asia, Europe and the Americas have suffered extremes of heat or rainfall, together with widespread bushfires and flooding.

In August, the UN Intergovernmental Panel on Climate Change (IPCC) published a report entitled **Climate Change 2021: The Physical Science Basis** as part of its concurrent assessment cycle. This gave scientific confirmation to what many had long suspected: that our climate has indeed changed, and that humankind is responsible.

With over 4,000 pages and 200 contributing authors, the report offers clear takeaways both for investors and for all of us as global citizens. As so often in life, there is both good news and bad news.

**First, the bad news: the damage has already been done**. By 2040, average global temperatures will have risen by 1.5 degrees, regardless of what we do between now and then. Passing that threshold means even more frequent and severe weather upheaval than we're experiencing today.

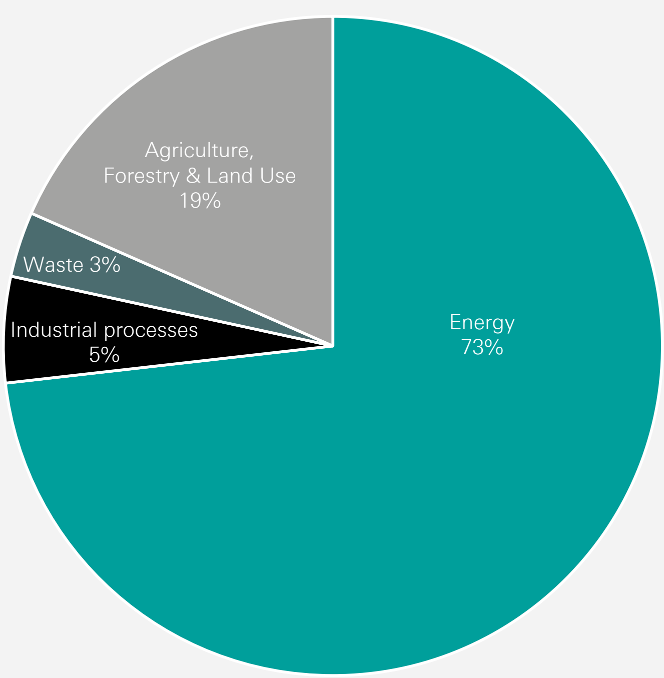
This makes adaptation a critical requirement. We need to live with climate change and manage the physical risks that come with it – for example, by improving flood and fire management measures to counter the effects of extreme rainfall or heat.

The big question is whether we can also mitigate the projected temperature rises. Global warming is fuelled by atmospheric heat-absorbing gases known as greenhouse gases, of which carbon dioxide ($CO_2$) is a major component. The human race has emitted about 2,390bn tonnes of $CO_2$ since 1850, which has led to the current temperature rises. According to the report, there's a 50% chance that 500bn more tonnes will push us to the 1.5 degree brink, and since humanity creates about 40bn tonnes of $CO_2$ per year, we'll hit that critical threshold in just twelve years if emissions don't come down.

**Now the good news: the damage caused by going beyond 1.5 degrees can be managed if we achieve net zero emissions by 2050**. But what exactly does "net zero", or "carbon neutrality" mean? It means all of us living daily life and running our economies more cleanly, so that carbon emissions can be dramatically reduced, rather than being released into the atmosphere. Any residual emissions can be captured through modern storage technology, or natural methods like reforestation. In essence, the balance between what's emitted and what is captured should be zero.

The IPCC believes temperature rises can be limited to 1.5 degrees if we achieve net zero by 2050. To this end, governments around the world are pushing technologies for radical decarbonisation, with renewable energy, infrastructure and sustainable transport likely to be pivotal.

**Global greenhouse gas emissions by sector, 2020**




Source: Climate Watch, the World Resources Institute (2020)

**The net zero transition presents opportunities for investors to drive a more sustainable future**. Our strong view is that it makes sense to align one's investment strategy accordingly. From a historical perspective, it's clear that investing sustainably doesn't harm returns, so investors can be confident in adopting a sustainable approach.

This report serves as a wake-up call: humanity is on a ship headed for the rocks, and urgently needs to change course. The need for radical and immediate action has never been clearer.

Both "push" and "pull" factors will come into play. Companies will be pushed by government policy to become more sustainable. We also believe financial markets will reward those that are better adapted to the sustainability revolution. Less sustainable organisations may receive lower valuations, as investors factor in their higher regulatory risk and growing disconnect with changing consumer priorities.

Pull factors are likely to be just as strong. Governments are committing serious funds to the net zero project, with the Biden administration proposing a USD1tn infrastructure bill (with USD73bn explicitly for clean energy) and the European Green Deal set to invest up to EUR1tn in the coming decade. While these investments are by no means certain and are subject to the workings of politics, they demonstrate how seriously those in power are taking the climate challenge. These initiatives will undoubtedly create investment opportunities, particularly in clean infrastructure and renewable energy.

Through their decisions and behaviours, consumers and investors also play a significant role in influencing businesses to become more sustainable. Demand is expected to climb for products and services that help us mitigate or adapt to the climate crisis. In addition, the broader investor and consumer appeal enjoyed by sustainable companies should enhance their earnings, lower the cost of capital and lead to higher valuation multiples.

In conclusion, the IPCC report has confirmed our fears about the severity of our situation. As investors, we can be even more certain that sustainability will be a mainstay of portfolio strategy over the coming decade. As human beings, we don't want future generations to inherit a world where life cannot thrive.

The time for change has to be now, and the sustainable investment opportunities are ripe. What are we waiting for?

# Adjusting your portfolio in response to tapering monetary policy

## At a glance

- As the likelihood grows that the US will reduce quantitative easing, investors should consider what that means for their strategy.
- While past examples offer helpful clues as to how markets might react, we examine several specific factors which make the current scenario unique.
- Investors may consider a range of diversification measures to increase portfolio resilience and maximise potential returns.

**Tai Hui**
Managing Director and
Chief Market Strategist (Asia),
J.P. Morgan Asset Management

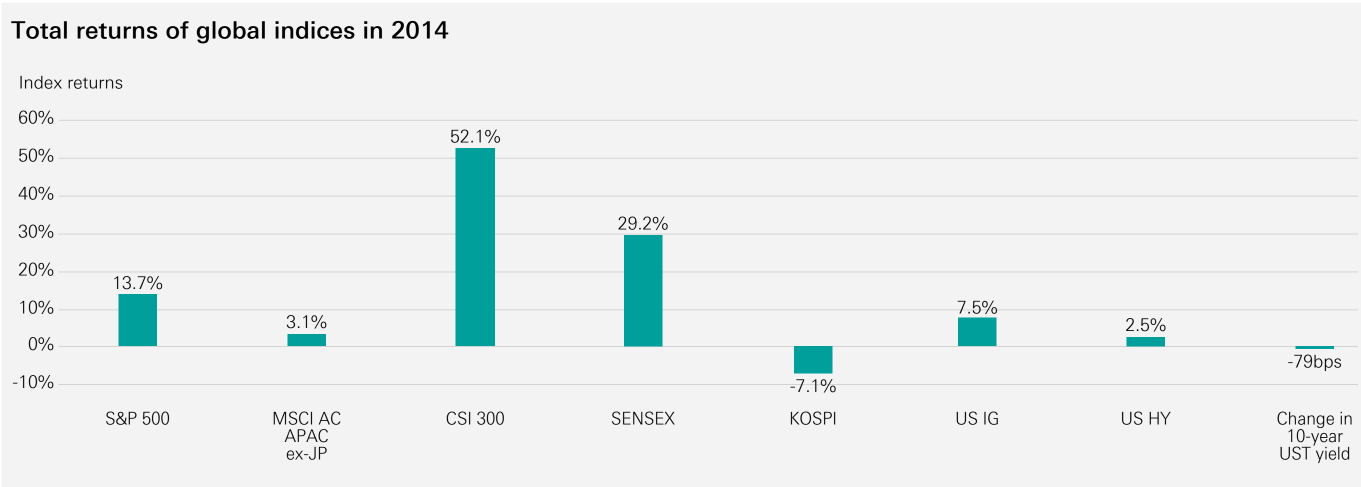
The ongoing economic recovery in the US is fueling expectations that the Federal Reserve may soon start to rein in its extraordinary monetary policy measures.

This is likely to start around the end of this year, with a gradual reduction in bond purchases (currently at USD120bn per month). Although previous moves by the Fed to unwind its quantitative easing (QE) programme didn't mark an end to the bull market in equities and other risk assets, investors may still need to adjust their asset allocation if policy begins to normalise.

Let's start with a few facts about tapering. Firstly, the Fed wouldn't be the first central bank to reduce asset purchases. The Bank of Canada began cutting back on bond buying in April 2021, while the Reserve Bank of Australia plans to taper its programme from September. Similar actions by the Fed will of course have a far greater influence on global markets and investor behavior.

Secondly, QE tapering doesn't drain liquidity from the financial system. It merely adds liquidity at a slower pace. Assuming the Fed begins reducing bond purchases by USD10bn a month from January 2022 onwards, it will still end up buying USD660bn of government bonds and mortgage-backed securities during that year. Moreover, if the Fed decides to maintain the size of its balance sheet once QE is officially over, it will still need to buy bonds to replace any that mature.

Thirdly and most importantly, the Fed has repeatedly stated that policy normalisation will only take place when the dual economic objectives of price stability and full employment are in sight. Since healthy economies don't




Sources: Bloomberg L.P., FactSet, MSCI Global, J.P. Morgan Asset Management; data as of 18 August 2021.

need policy easing in order to thrive, the implication is that normalisation will signal an expanding economy where corporate earnings can continue to grow.

### Learnings from 2014

December 2013 was another occasion when the Fed began tapering asset purchases, and it's informative to revisit how markets performed in the months thereafter.

In 2014, US and Asian equities[1] delivered returns of 14% and 3% respectively, showing that lower government bond purchases didn't automatically damage investor sentiment or risk assets. More significantly, there was considerable variation in equity performance across Asia, with India, Taiwan and Mainland China's onshore market all delivering double digit returns, while South Korea ended the year in negative territory.

In the case of fixed income, policy normalisation didn't lead to higher US government bond yields. In fact, contrary to expectations, 10-year Treasury yields actually fell from 3% to 2% over the course of 2014. This benefited US government bonds and investment grade corporate debt, which are longer duration and perform better as yields drop.

What's more, despite these falling yields, the US dollar actually strengthened during this period, especially towards the end of the year. As a result, hard currency Emerging Markets debt significantly outperformed its local currency equivalent.

### Looking ahead to 2022

There are several significant differences between 2014 and 2022, so markets may not react in the same way and investors may need a slightly different playbook. While the Fed's policy is key, it's still just one of many factors that will influence asset allocation strategy in the months ahead.

For one thing, US equities were notably cheaper in 2014. The S&P 500 price-to-earnings ratio at the start of 2014 was 15x, compared with 21x (12-mth forward P/E) at present. Although we still expect US corporate earnings to keep growing as the national economy recovers, investors should also look to diversify their equity allocation via markets outside the US.

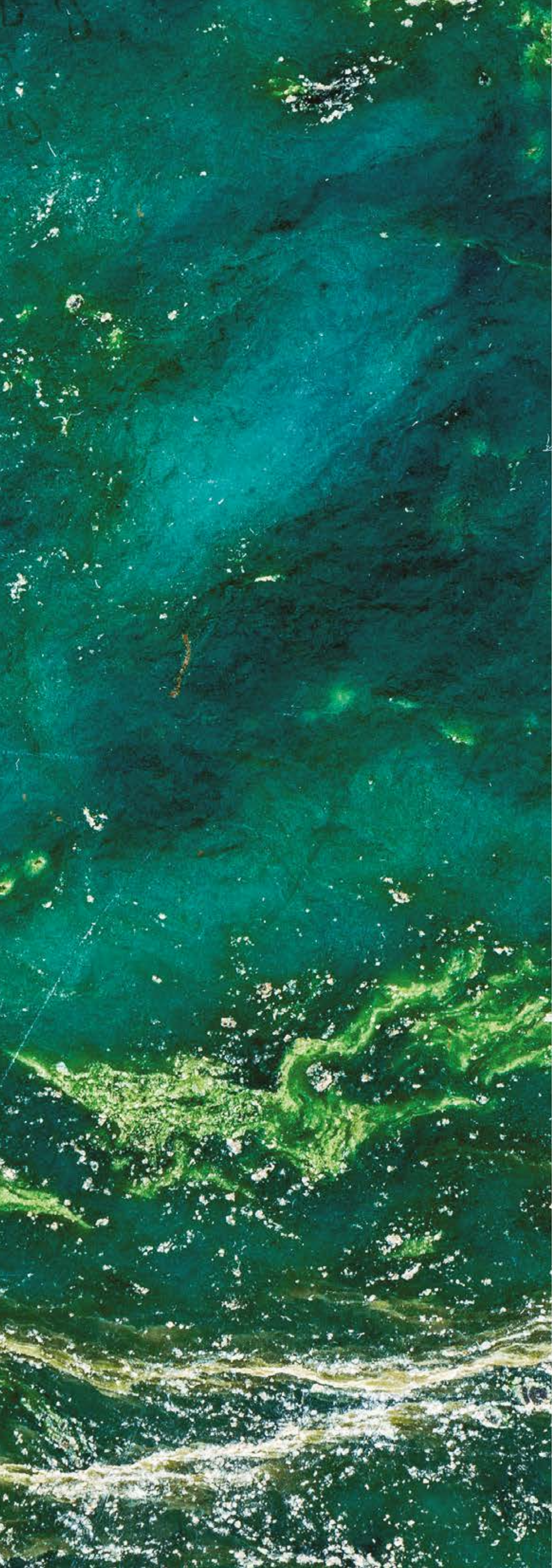
In the near term, things look bright for European equities given the continent's continuing rebound and relatively high vaccination rate. Looking further ahead, Asia is also likely to draw investors' attention.

In the latter region, a number of factors are at work. Firstly, the gradual rising vaccination rate is laying the groundwork for a more sustained recovery in domestic demand, probably by late 2021 or early 2022. Secondly, a number of markets (notably within ASEAN) that have lagged in the last 18 months due to weak economic performance, now potentially herald some attractive future valuations.

Turning again to fixed income: in 2014, bond yields had been rising sharply prior to policy tapering. The Fed's announcement caught markets by surprise as the US economy was at a very different point in its recovery than it is today (the event has since become known as the "Taper Tantrum"). This time however, the Fed has been more pragmatic in managing market expectations. As a consequence, 10-year US Treasury yields are currently well below 1.5%, compared with 3% at the start of 2014. If Treasury yields continue to rise beyond year end, it could create a more challenging environment for fixed income returns, due to duration risk and relatively expensive valuations.

This can be addressed in three ways. First, investors should look for fixed income assets with short duration or low sensitivity to rising rates. Secondly, high yield bonds (either US corporate or Emerging Markets) can help to generate much-needed returns due to their relatively high coupons. Finally, investors can consider alternative assets, such as real estate or infrastructure, that generate high levels of income but have a weaker relationship to the bond market.

[1] US equities based on the S&P500 index and Asian equities based on the MSCI Asia ex. Japan index



# Glossary

**Alternative investments:** a broad term referring to investments other than traditional cash and bonds and may include real estate, hedge funds, private equities and commodities investments, among other things. Some of these investments may offer diversification benefits within a portfolio.

**Asset class:** a group of securities that show similar characteristics, behave similarly in the marketplace, and are subject to the same laws and regulations. The main asset classes are equities, fixed income, and commodities.

**Asset allocation:** the allocation of funds held on behalf of an investor to various categories of assets such as equities, bonds and others, based on their investment objectives.

**Company fundamentals:** the intrinsic value of a company as analysed by looking at its revenue, expenses, assets, liabilities and other financial aspects.

**Diversification:** often referred to as "not putting all your eggs in one basket", diversification means to invest in a variety of different markets, products and securities to spread the risk of loss.

**Fiscal policy:** the use of government spending and tax policies to influence macroeconomic conditions such as aggregate demand, employment, inflation and economic growth.

**Investment strategy:** the internal guidelines that a fund follows in investing the money received from its investors.

**Inflation:** the rise in the general price levels of goods and services in an economy over a period of time.

**Monetary policy:** process by which the authorities of a country control the supply of money. This often involves targeting a rate of interest for the purpose of promoting economic growth and stability.

**Quantitative easing (QE):** also known as large-scale asset purchases, is a monetary policy whereby a central bank buys government securities or other financial assets from the market in order to increase the money supply and encourage lending and investment.

**Strategic asset allocation:** a practice of maintaining a mix of asset classes which should meet an investor's risk and return objectives over a long-term horizon and is not intended to take advantage of short-term market opportunities.

**Tactical asset allocation:** an active management strategy that deviates from the long-term strategic asset allocation in order to capitalise on economic or market conditions that may offer near-term opportunities.

**Tapering:** the reduction of the interest rate at which a central bank accumulates new assets on its balance sheet under a policy of QE.

**Volatility:** a term for the fluctuation in price of financial instruments over time.

# Contributors

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