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A problem of interest

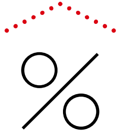
How rates affect investment strategy in 2024

2024 Global Investment Outlook

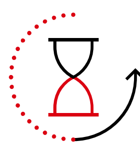
HSBC Asset Management

Higher rates and tighter credit conditions have created **'a problem of interest'**

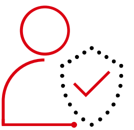
This environment challenges economic and business growth, which is something investors should be prepared for.



A problem of interest
Higher interest rates and less availability of credit has helped reduce inflation. However, it risks sending economies into recession in the months ahead.



New paradigm
We are in a new economic regime that is very different to the 2010s. Investors should not expect a return to the very low interest rates and abundant availability of credit to fund growth as seen in the previous decade.



Defensive growth
Market expectations are for a 'soft landing' – where inflation continues to fall back as economies slow, but growth remains positive. We focus on defensive strategies in portfolios to protect against adverse scenarios and think 'bonds are back'.

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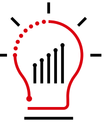
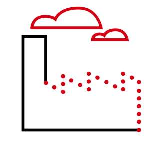
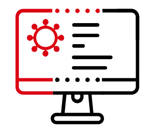


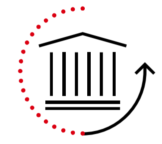
Key market themes from the past year



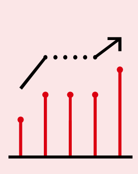
China economic disappointment



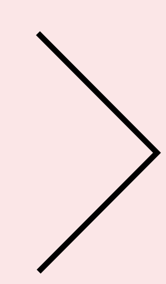
Artificial intelligence boom



Developed market central banks pivot on interest rates



US economic resilience



The surprising resilience in the US economy this year has come from the high level of excess savings – the piggy banks consumers built up during the pandemic years – which have continued to support spending. Corporate profits have also been resilient, with firms able to benefit from markups in a higher-inflation environment, and from cash piles earning more interest. Accordingly, US stocks have outperformed. The aforementioned forces are becoming less important now so have delayed a recession, rather than averted one, in our view.

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Looking ahead

The inflation data will probably be bumpy, but the broad trend is for inflation to fall back towards central bank inflation targets over 2024.

Our baseline scenario embeds an elevated risk of economic slowdown and unimpressive corporate profits growth. This is somewhat less optimistic than the outlook consistent with current market pricing.

Our inflation scenario means that we expect interest rate cuts in the second half of 2024. We think the US Federal Reserve could surprise the market by cutting rates by more than is currently anticipated – depending on labour market trends.

Looking further ahead, we think there are a number of forces that will keep inflation higher over the medium term versus what we became used to in the 2010s.

Overall, we think we are heading towards a new paradigm, with inflation and interest rates somewhat higher than we were used to during the 2010s. This environment leads us to take a defensive approach in our investment strategy for next year.

Our central scenario
Problem of interest

Macro

West: Tight financial conditions induce economic and corporate profits recession

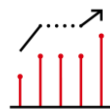
East: Lacklustre growth in China. Japan and India outperform

Policy

West: Mid-2024 Federal Reserve and European Central Bank interest rate cuts to start. Government spending decline is a mild drag

East: China pursues piecemeal stimulus, and most Asia central banks are lowering interest rates in the second half of 2024

Market



Bonds are back, but other liquid alternative diversifiers lose their shine in 2024

Defensive growth favours selective approach towards higher quality in global bond and equity markets, with an emphasis on country selection

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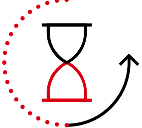


Transitioning to a new paradigm

We think there are three key drivers of the new paradigm:

1. A new, multi-polar world with less cooperation and a retreat from globalisation. This can contribute to higher manufacturing and supply chain costs, and thus inflation.
2. More active government spending driven by political priorities in an age of populism, environmental concerns and high levels of inequality. This contrasts against austerity and budget cuts seen in the previous decade, alongside extensive central bank efforts to stimulate economies back then.
3. Implications from and policies to address climate change and the transition to net zero.

New paradigm means a different economic environment

Populism / economic inequality / low productivity

Multi-polar world

More spending on defence / energy security

Active fiscal policy

Transition to net zero

Climate change

Economic fragmentation

Higher deficits and debt

Fossil fuel divestment

Extreme weather

Slowdown in globalisation and shift to nearshoring / onshoring of supply chains

War and resource nationalism

Commodity price volatility

New paradigm of higher inflation & interest rates

Source: HSBC Asset Management, December 2023

Emerging markets offer appeal

The current backdrop of rising US interest rates and weaker Chinese economic growth hasn't boded well for emerging markets. However, investment markets will trade on future trends.

We know that a Federal Reserve rate cutting cycle can be very supportive for emerging markets performance, just like it was in the early 1990s when Fed cuts encouraged a flow of capital into emerging markets.

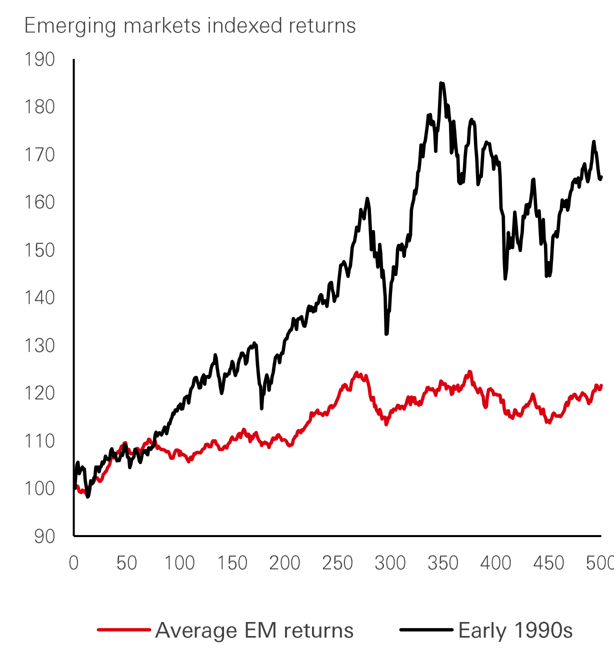
While history may not repeat itself precisely, the possibility of faster than expected interest rate cuts in the second half of 2024 suggests that investors should closely monitor emerging markets in the coming year – notably India and Mexico bonds, as well as Chinese A-share stocks.

Valuations matter, and for emerging markets they are generally much lower than those of developed markets, and also lower compared to their own history. Based on corporate earnings, the cost of Brazilian stocks, for example, is less than half of its 10-year average.

Importantly, growth stories for individual emerging countries differ, creating diversification within emerging assets. The long-run story in India, for instance – revolving around productivity, digitisation and high-end manufacturing, infrastructure, and a young, growing population – remains strongly intact.

And emerging economies' increasing share of the global economy, alongside demographic advantages, bodes well for broad investment opportunities over the long term.

Emerging markets can perform after the last Federal Reserve rate hike



Source: HSBC AM, Macrobond data, November 2023.

Past performance is no guarantee of future returns.

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.

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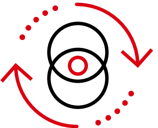


Portfolios taking shape – defensive growth

Bonds are back

A weaker economy and disinflation should be a supportive environment for government bonds and a challenging one for stocks. In general, we see good opportunities in global fixed income, but emphasize being selective. Our preferences include US treasuries, parts of core European bond markets such as the UK and Germany, and investment grade bonds, generally. While high yield bonds are now paying as much as historical equity returns, slowing economies increase the risk of defaults by lower quality companies.

Divergent stories in equities

US equities are confronted with two challenges necessitating a cautious view, from our perspective. First, earnings growth expectations for next year are high amidst a potential economic slowdown. Second, valuations now appear stretched when compared to yields available from government bond markets.

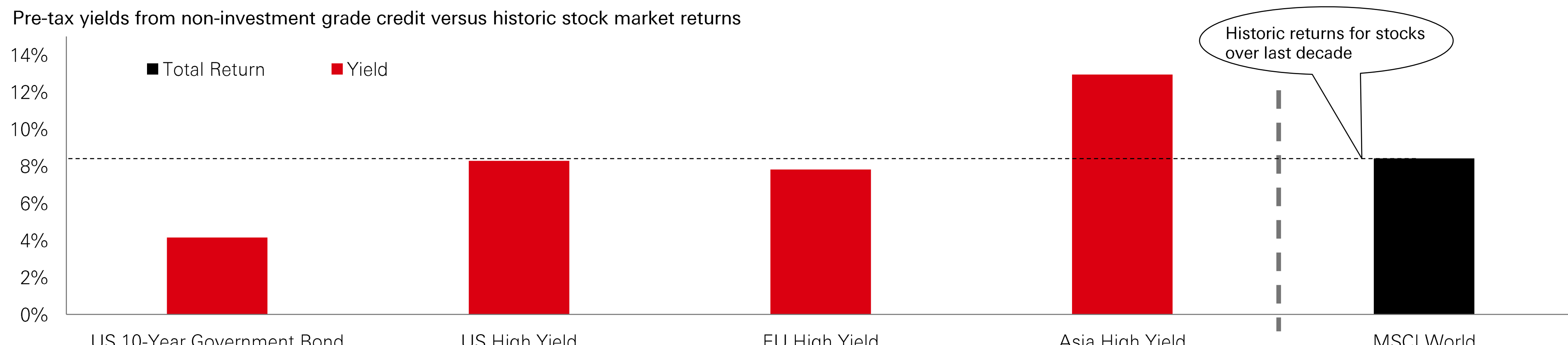
In comparison, European stocks look cheaper, and hence downside could be limited – unless a bad recession materialises.

We expect that Japanese stocks could be an outperformer among developed markets over the short and longer term. Structural tailwinds include rearranging supply changes, new investment in semiconductors, and corporate sector reforms.

Keep an eye on emerging markets

The Federal Reserve cutting interest rates can be very positive for emerging markets performance. Both equity and local bonds should be a part of the investor consideration set.

Average non-investment grade bond yields exceed historic returns from equity



Past performance is no guarantee of future returns. Returns are for market indices and do not reflect any fees or currency considerations. Source: HSBC AM, Bloomberg, December 2023.

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