24 December 2020

Macro Insight

Markets lead economic recovery

Despite the sharpest economic slump in almost a century, risk assets registered gains in 2020

Market action has benefited from unprecedented economic policy measures

Our views

In a year of restoration, a pro-risk stance still makes sense, although expected returns are likely to be lower for longer

With bond yields ultra-low, the case for "new diversifiers" in our portfolios is compelling

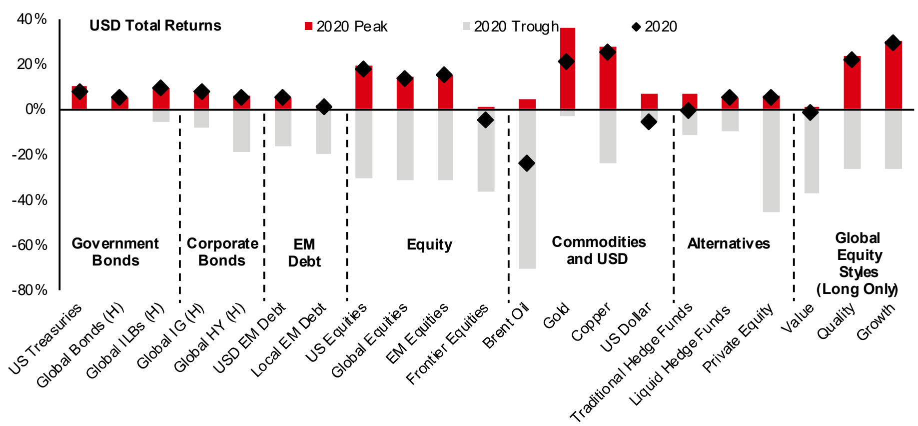
The speed and magnitude of asset price moves this year have been remarkable. 2020 was a year of fast markets, in which many risk assets not only exhibited one of their fastest sell-offs in March but then staged their swiftest ever recovery, rallying above their levels at the end of 2019. All this took place in a year in which the Covid-19 pandemic caused the sharpest economic slump since the Great Depression.

These developments have confused many economists, and led them to claim there is a disconnect, and a bubble in markets. We think that view is mistaken. While market action this year has defied conventional experience, it has not been irrational. Markets always lead the economy in the recovery phase. In particular, the market rally has reflected two crucial drivers: first unprecedented economic policy support and then fading disaster risks surrounding Covid-19.

Markets and economies disconnected in 2020

Almost all asset classes sold off in March (Figure 1), as investors reacted to the news that a novel coronavirus was spreading quickly beyond China, with the World Health Organisation declaring a global pandemic on 11 March. The fast down market in global equities reflected extreme uncertainty surrounding the disease, which introduced a disaster risk premium (compensation for extreme risk) into asset pricing. Never before in economic history had global governments shut down economic activity in such a comprehensive, coordinated and indefinite manner.

Figure 1: A bull market in almost everything



Source: Bloomberg, HSBC Global Asset Management. All asset class returns shown as USD total returns (unhedged) unless stated. H refers to currency-hedged USD total returns. Data correct as at 16 December 2020

Disaster risks surrounding Covid-19 eased after policymakers committed to exceptional economic policy support, governments progressively eased economic restrictions and – later in the year – scientists developed a suite of highly effective coronavirus vaccines faster than expected. The outlook for the economy and earnings brightened and valuations recovered.

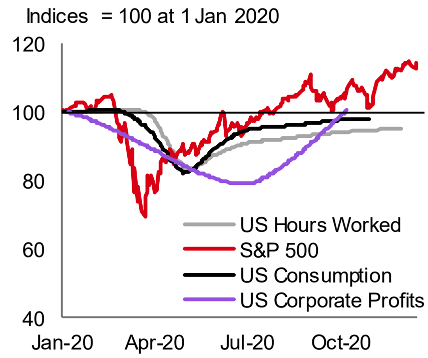
In the rebound phase during the spring and summer months, equities, credits and industrial commodities such copper and iron saw a particularly strong bounce back.

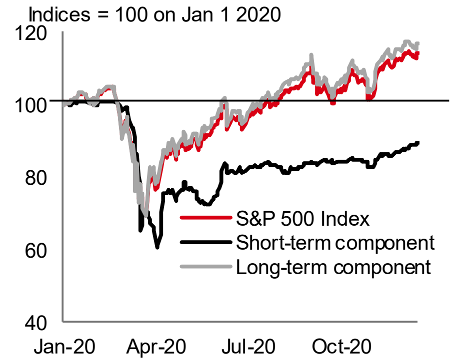
It was at this point that a disconnect between markets and the current state of the economy became apparent and was a major source of confusion. The performance of the S&P 500 is particularly illustrative (Figure 2). The index recovered its year-to-date (YTD) losses as early as June despite US total consumption and hours worked being around 10% below their levels in January. At the end of June, US aggregate profits were 20% down YTD.

HSBC

Nevertheless, an apparent disconnect between the economy and markets in 2020 has raised concerns about valuations

Figures 2 and 3: The long-run part of S&P 500 has run ahead of key economic indicators





Source: Bloomberg, Macrobond, BIS, HSBC Global Asset Management. Data correct as at 16 December 2020

However, a strong factor in the valuation of most risk assets is their long-term outlook

A closer look at the anatomy of equity markets suggests that there is no 'irrational exuberance' at play. Figure 3 shows a breakdown of the S&P 500 Index by the market value of dividends received in next four years (short-term component) and those received after. Investors continued to discount dividends expected in the near term, reflecting the challenging current environment, but not those received further out which make up the majority of the value in the index. This reflected a reasonable belief that the crisis has not structurally reduced future cash-flows among most of the firms that make up global equity indices, on the back of an unprecedented degree of policy support.

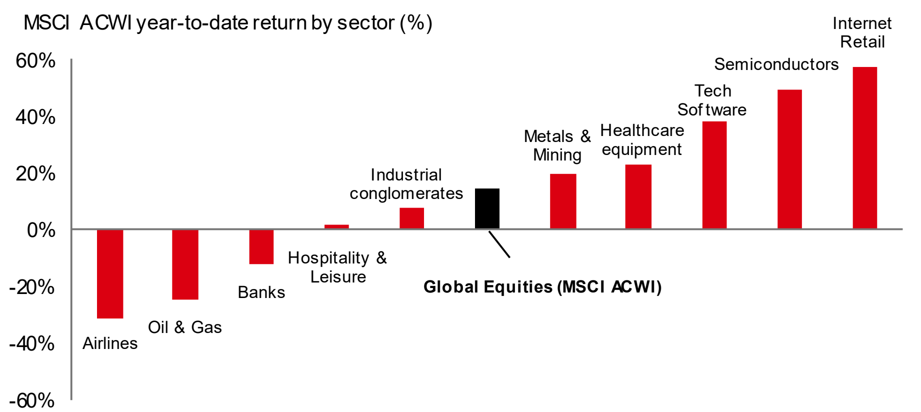
Nevertheless, headline indices have obscured significant winners and losers in 2020. Strong virus control in North Asia saw risk asset classes there outperform. In contrast, parts of the equity market that are more sensitive to the economic outlook, such as Europe or emerging markets ex-Asia, have lagged.

Further, within global equities, the worst performing industries in the MSCI ACWI index – such as Airlines and Hospitality & Leisure – have business models that are sensitive to social distancing measures and are more likely to face longer-term challenges in a post-Covid world. The best performers – such as Internet Retail and Technology Software – have been those that have benefitted from the work-from-home revolution started by the pandemic (Figure 4).

Meanwhile, in the commodities space, a shift in global consumer demand to goods from services impaired by Covid-19 restrictions has lifted commodity prices.

Long-term prospects brightened following substantial policy support, the reopening of economies, and faster-than-expected vaccine development

Figure 4: Global equity returns by industrial sector



Source: Bloomberg, HSBC Global Asset Management. All asset class returns shown as USD total returns. Data correct as at 16 December 2020

Pricing action to-date reflects beliefs that the pandemic will leave scars in some parts of the economy. However, these have not been fully reflected in headline performance because hard-hit sectors take relatively low weights in equity indices. In the US, for example, the highly visible Hospitality and Leisure industry made up 11% of US employment and 4% of GDP in 2019, but had a weight in the MSCI US index of just 2%. Meanwhile, the technology sector made up 2% of employment, 7% of GDP and an outsized 35% of the MSCI US index.

Notwithstanding the significant divergence in asset class performance at the sector and regional level during 2020, actions taken by global policymakers were essential in not just stabilising the economy, but also supporting the long-term factors on which investors base their asset class valuations. These actions were the basis for the very strong recovery in risk assets after March.

Interest rate cuts have boosted the value of cash flows received far into the future

Monetary policy and valuations

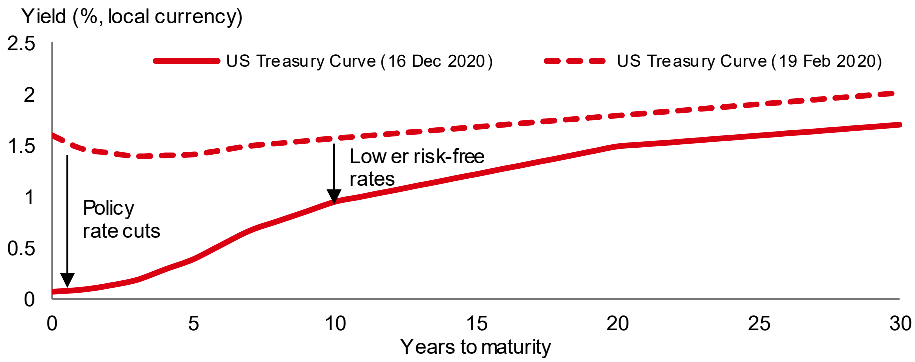
Strong asset price performance supports monetary policymakers in their objectives to stabilise the economy by boosting household wealth. **A particularly important reason for the gain in global equity markets as well as other risk assets has been the fall in risk-free rates** – typically yields on 10-year Treasuries – driven by lower policy interest rates set by global central banks.

An investor who buys a stock gets paid a stream of dividend payments for the period over which the stock is held. The current price of a stock reflects the expected value of all its future dividends, discounted by a risk-free interest rate that rewards investors for deferring consumption and an equity risk premium that compensates them for taking investment risk.

Therefore, the 150bp cut in rates by the US Federal Reserve (Fed) in March coupled with aggressive buying of US Treasuries lowered risk-free rates across the curve (Figure 5) and boosted the value of dividends received far out into the future. Long duration asset classes – such as technology stocks and other growth equities whose profits (and dividends) are expected to be considerably higher in the future – benefitted the most.

Policy-driven asset price support is a key reason why markets lead the recovery. Research by Avalos and Xia for the Bank for International Settlements finds that rate cuts were responsible for roughly 50% of the rebound in US stock prices up to early September.

Figure 5: The US yield curve



Source: Bloomberg, HSBC Global Asset Management. December 2020

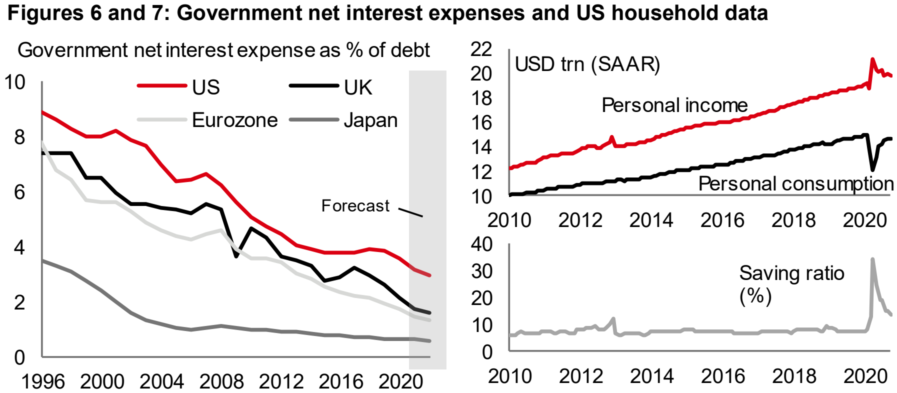
Fiscal policy and earnings

Expansive fiscal policies have increased earnings prospects and limited corporate defaults

Global interest rate cuts have also been important because they have enabled highly expansive fiscal spending measures. Despite government debt ratios rising by 20-30 percentage points of GDP in 2020, debt service costs continued to fall (Figure 6).

Low servicing costs provided governments the policy space to stabilise global household incomes and lift consumer spending despite a drop in employment (Figure 7). In addition, fixed income asset classes were buttressed by government credit programmes and corporate bond support schemes. Year-to-date gains in global investment grade and high yield bonds encouraged corporates to refinance at low rates. Such support has been a critical ingredient in expediting a corporate earnings recovery and limiting corporate defaults after virus restrictions were lifted.

Figures 6 and 7: Government net interest expenses and US household data



Source: EU Commission, BEA, BLS, HSBC Global Asset Management. December 2020

Elevated global savings rates at the end of 2020 suggest that the fiscal policy impulse was remarkably strong. Robust household finances going into 2021 mean that the recovery in the global economy and corporate profits can maintain momentum as the rollout of vaccines helps to normalise activity. Earnings are now expected to exceed pre-pandemic levels in the US and Asia ex-Japan next year, while in Europe and Japan that outcome is more likely to come in 2022.

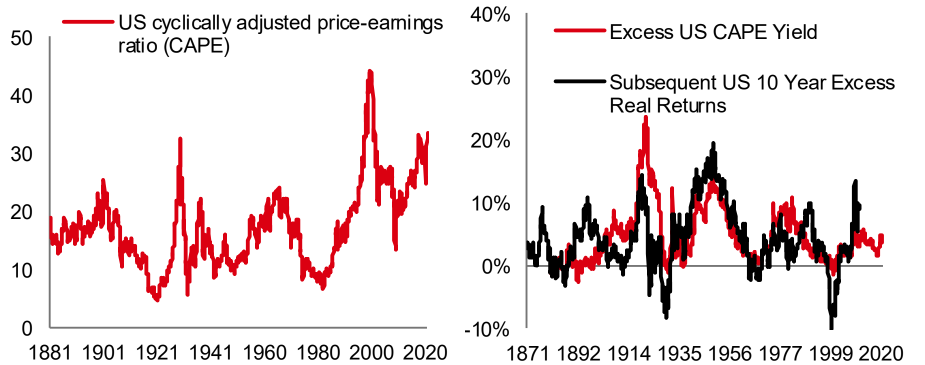
Ongoing policy support and "lower for even longer" interest rate policies favour equities over government bonds

Relative valuations still favour risk assets

While strong policy action and fading Covid-19 disaster risks offer a clear explanation for why risk assets moved higher over 2020, there are still concerns over the current level of valuations of some asset classes in their own right. For example, the cyclically-adjusted price-earnings ratio for US stocks is back above 30, a level seen on only three other occasions (Figure 8) since 1881.

However, if we invert the ratio to get an earnings yield and subtract the yield on risk-free assets (10-year Treasuries), we get what Nobel Laureate Robert Shiller calls the Excess CAPE yield – a measure of the equity risk premium. As Figure 9 shows, the Excess CAPE yield has moved higher during 2020. This makes sense; policy action has compressed returns on risk-free assets, making equities relatively more attractive than government bonds, even after the fast market rally of 2020.

Figures 8 and 9: US stock market valuation, yield and excess return metrics



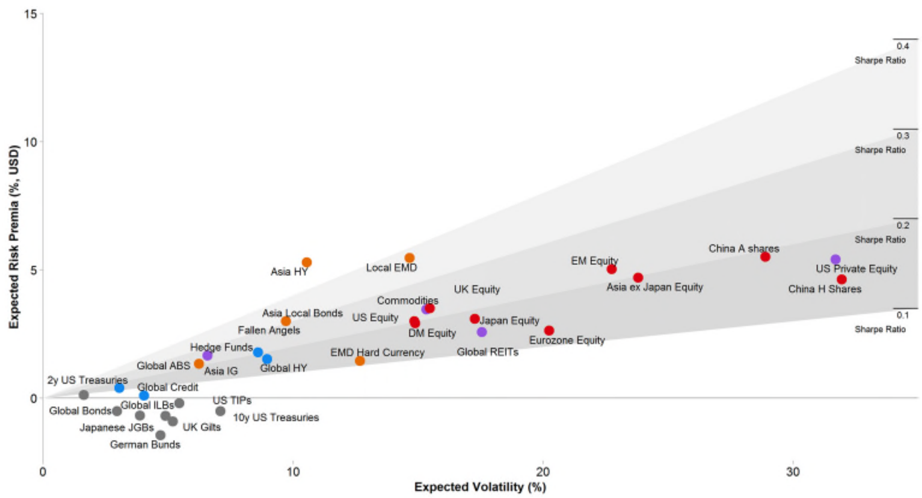
Source: Robert Shiller, Yale University, HSBC Global Asset Management. December 2020

However, following the recent rally, we will need to have realistic return expectations for the medium-term

As we explored in our Outlook for 2021 – *The Restoration Economy*, we expect the global economic recovery to continue, with pace of recovery depending on where we are in the world, on the successful delivery of Covid-19 vaccines, and on further policy support. Given this and lower-for-longer interest rates, we believe it is costly to underweight risk assets during the recovery.

Nevertheless, after the fast market rally in 2020, the capital market line linking expected returns with volatility (i.e. risk) is now lower and flatter (Figure 10), meaning expected returns across risk assets are also lower-for-longer. It is critical, therefore, that we have realistic return expectations.

Figure 10: Expected asset class returns



Source: HSBC Global Asset Management. December 2020

Investment implications

In a year of restoration, allocating to equities still makes sense, but we will need to be dynamic in tilting between countries and regions. We also believe there are good opportunities in emerging markets fixed income – which should benefit from a weaker dollar and low US real interest rates – and also in a range of alternative asset classes such as private equity.

Meanwhile, it is much harder to be confident allocating to global government bonds government bonds, which have become lower-returning and riskier than before. The case for "new diversifiers" such as commodities, securitised debt and hedge fund strategies in our portfolios is compelling.

Zac Tate, Joe Little and Hussain Mehdi, Global Investment Strategy Team

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