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Special Coverage:

Broad-based market volatility as investors assess chances of a soft landing

Key takeaways

- Equity markets saw a further big fall yesterday, with the Nasdaq down 25.7% year to date.
- Investors are concerned that central banks' monetary tightening could lead to a hard rather than a soft landing (i.e. a recession). Real rates have continued to rise, which is particularly negative for growth stocks.
- Investors should remain invested with a focus on quality, income and diversification to build portfolio resilience. Short dated bonds of investment grade and BB rating should be relatively well supported, as should be the US dollar and gold.

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

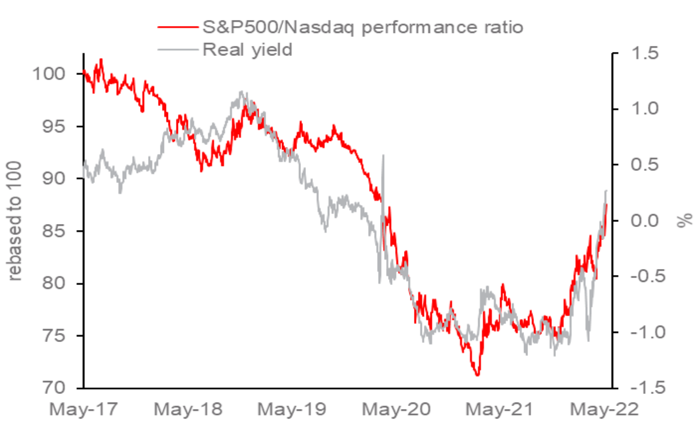
What's happened

- Equity markets saw a further big fall yesterday, with the Nasdaq and growth stocks again underperforming the S&P500. The Nasdaq is in bear market territory, down 25.7% year to date (futures are up overnight).
- The acute turmoil that arguably started in the FX markets last week is now also affecting equities and the riskier part of the bond markets. There are signs of capitulation taking place, as evidenced by the widespread nature of the moves, the very high intraday volatility, and the fact that even defensive sectors are down.
- The key fundamental driver of the market turmoil is investors' concern that central banks' monetary tightening could lead to a hard rather than a soft landing (i.e. a recession). Last week's Fed meeting, which clarified that 75bp hikes were not on the table, apparently did not put concerns over excessive tightening to bed. Real rates have continued to rise, which is particularly negative for growth stocks and have led to the weakness.
- Markets will be hugely interested in the latest US CPI number to be released, which we expect to moderate from 8.5% last month to 8.1% this month (in line with consensus) and could help stabilise Fed rate hike expectations and short-dated Treasury yields. If inflation falls however and with the likely Fed path now priced in, real yields could widen further, and we therefore continue to tactically see further upside for value stocks vs growth. Even with more clarity on the Fed policy, clarity on the economic cycle will only gradually show in the numbers, and volatility could therefore continue.

Investment implications

- The underperformance of the Nasdaq and tech stocks has been in the spotlight. This is closely linked to the move in the real yield, which could rise a bit more and be a further obstacle for tech and growth stocks. Capitulation by investors who may be new to the market or less diversified (and typically own a lot of tech stocks) may play a role as well.
- The market's concern about the economic cycle is visible in relative performance of cyclical vs defensives as well. We believe that the US economy should rebound after a weak Q1, and the strong labour market and energy sector activity form obstacles to a recession. Still, the US is vulnerable to global market sentiment. That view on the cycle could improve, for example, on better news related to COVID-lockdowns in China, or additional policy stimulus there.
- On the subject of the cycle, investors may find some comfort from the fact that the Treasury yield curve is no longer inverted. Indeed, at the start of April, it was the inversion that caused jitters. However, we've started to see more spread widening in the lower end of the credit space. As a result of both the flat curve and the spread widening, we keep the duration in our bond portfolios short and focus on investment grade and the better ratings in the high yield space.
- Finally, as the market moves are clearly impacted by positioning adjustment, it's important to have a look at overall market sentiment, which could lead to a bottom forming at some point, but of course it is difficult to see when, and at what level. Given the very fundamental questions (growth, earnings, inflation and rates) that markets are asking, it will be the answer to those questions that dominates. As that answer will probably only come gradually, **we stick to our focus on quality, income and diversification to build portfolio resilience.** Quality stocks with structural thematic support should fare well.

The move in the real yield is largely responsible for the underperformance of tech stocks



Source: Bloomberg, HSBC Global Private Banking as at 10 May 2022. Past performance is not a reliable indicator of future performance.

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