HSBC Global Private Banking – August 2024

Zooming In: Episode 4 – What are US companies telling us about the state of the economy?

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Willem:
Welcome everyone to the fourth episode of our Zooming In series. And we're going to talk about US equities this time. Of course we've seen quite significant volatility over the last number of weeks, with a sell-off in mid-July but then a quite sharp rebound. Now one of the reasons for this sell-off was concern about the state of the US economy and the question as to whether the US would go into recession. Now, I wanted to take a bottom-up approach to this and look at what US companies are telling us about the state of the US economy.

And to do this, I'm here with Nicole Inui, who is US equity strategist at HSBC Global Research.

So, Nicole, can we start with the consumer space because people have been looking at the labour market figures, which have been weakening, and therefore, are you observing anything from the consumer-related companies – are they telling us that consumption is falling or that consumption patterns are changing?

Nicole:
What we're seeing in terms of the consumer is a moderation in consumer spending and not necessarily a pullback. And we're seeing that both on a macro perspective, so we are seeing slower wage growth, we are seeing rising unemployment and also on a micro perspective,so this is based on company commentary from the second quarter, especially in certain sectors, such as home improvement where you are seeing some weakness. But, we continue to see kind of this K-shaped consumer in the US – so this high-end consumer that is benefiting from wealth effects, from higher home prices, from higher equity prices and a low-end consumer that is really feeling the pinch of higher inflation and is seeking value. So, if you look at the Q2, the consumer sector had some of the lowest earnings beats among other sectors, but half of the companies reported double-digit EPS growth. So, you really need to find these pockets of strength, the subsectors that are benefiting from this K-shaped consumer, such as leisure, such as certain restaurants, such as some consumer brands and some consumer staples companies.

Willem:
So, Nicole, basically on the consumer side, this is a stock pickers' market, with some companies that are doing more poorly but still a lot of winners there as well with good earnings growth, which is comforting. But let's look at two other sectors, Industrials and Financials, which of course are as well quite cyclical sectors. What are you seeing on the industrials side in the US? Is it still benefiting from that re-onshoring process? And what about financials? From a macro perspective, we see delinquencies that are starting to rise but still being relatively low. And I imagine that rate cuts should help some activities, for example, M&A.

Nicole:
On the industrials, yes, the sector is benefiting from all these legislative acts as well such as the Infrastructure Act. And we're starting to see some of that in the data with construction spending growing at a 20% rate and this is despite the fact that we have, high rates in the US.

And as we expect rates to come down, this should be supportive of the sector as well. For the financials in second quarter we saw earnings growing at a double-digit pace. So this is across many of the subsectors, what we're hearing from the banks is that asset quality remains resilient. We're not seeing data of credit quality going into a recessionary environment. We are seeing some increases in delinquencies, so, auto loans, credit card loans. So this is something that we need to keep an eye on, but as rates come down, this should alleviate some of the cost pressure, the deposit pressure on the banks. And we do expect a recovery in Net Interest Income (NII), over the second half of the year. On M&A that you mentioned, we did see an increase in M&A fees. As rates come down, this could spur this increase even more, and it remains well below historical averages. So that could set the stage for even better growth in this sector going forward.

Willem:
Now this leads us to the technology sector, where there was this concern around mixed technology results together with high valuations – especially for the Magnificent-7 companies, leading to a rotation away from technology. So what's your take on this, Nicole? You know, are those concerns around earnings overstated in the technology sector? And can technology actually continue to deliver that higher earnings growth than in other sectors as has been the case in the past?

Nicole:
In tech, we are seeing a moderation in earnings growth, so slowing down a little bit. But this is because they're starting to have a much tougher comp base than what we've seen over the past couple of quarters. So this is a sector that's continuing to grow sales at a double-digit pace, it is improving its margins. This is driving EPS growth and keeping ROE at very high levels. So yes, when you look at valuations, they are high compared to historical averages. But this is the sector that is delivering on earnings. I think what we're seeing is that is different, it's no longer an outlier in terms of earnings growth. So other sectors are catching up. We mentioned Financials, Healthcare as well is growing earnings at a similar pace as the tech sector. So this kind of goes into the theme of this broadening of this equity rally. As we're seeing earnings growth being now more widespread across different areas of the economy. And this should continue as rates come down starting in September.

Willem:
So, given that many of the mega caps are technology companies, where does this leave us on the debate around mega caps vs mid caps vs small caps? We had this puzzling episode a few weeks ago where those hopes of rate cuts on the back of a weak economy were helping small caps, whilst actually small caps are sensitive to slowing growth.

Nicole:
Small caps is a sector that tends to benefit as rates come down, disproportionately more. Most of the companies that are in the small-cap space do tend to have higher leverage, do tend to have a higher proportion of floating rate debt and they are more economically sensitive. So, in a recessionary environment, though, they do tend to underperform.

We are of the view that the Fed cuts rates in September, the US economy avoids a recession,and this is a very powerful combination for equities and for this broadening of earnings growth to other sectors that will benefit as rates come down and as the economy stays resilient. And again, as I mentioned, we've seen this in earnings growth

starting to see this in the second quarter. And we expect to see this over the next few quarters with earnings growth broadening across different sectors, tech being less of an outlier, but other sectors also benefiting from rates coming down and the economy avoiding a recession in the US.

Willem:
I would agree with that. The way that we handle this is that we don't flee from those large cap technology companies, but we're also looking at, you know, Mid-caps in the technology space or companies in other sectors that actually benefit from this innovation. Especially as earnings growth in other sectors is accelerating to some extent, there are many opportunities in those other sectors as well. I'm happy also to hear from your side that you don't see too much evidence from a bottom-up perspective that we would go into a recession. So our core case is we maintain moderate positive growth. Therefore, we don't have to be very defensive and we balance cyclical and defensive sectors. Nicole, thank you so much for your insights and thank you all for watching.