CIO Academy

US Equities Shape Up in the Summer: Shed Excess Flab from One Sector, Add Muscle to Others

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- **US equities are in pandemonium and a confluence of catalysts is to be blamed for it**. To begin with, benign June CPI data drove up markets' expectations of Fed rate cuts in 2024, boosting the prospects of less favoured segments in S&P500. Then, the angst over US tariffs on chips' manufacturers and market concerns over monetisation of big tech's AI spend triggered a rotation out of tech into small caps. Towards July end, the BoJ delivered a rate hike, which triggered a sudden unwinding of the Yen carry trade globally, exacerbating the US sell-off. The final straw that broke the camel's back was the slightly higher than expected July unemployment rate, which, on paper, triggered the "Sahm Rule" – historically seen as an early recession indicator – creating a downward vortex in market sentiment.
- **This sudden reversal in market narrative from 'US resilience' to 'an impending US recession' caught several market participants off guard** - leaving the average investor wondering whether to stay the course or shoot for the exit! In this report, we look under the bonnet of key market concerns on the US labour market and the well-televised 'Sahm-Rule trigger' indicating 'an impending recession'. This should hopefully put the recent unwarranted "data-point driven" market moves into context and provide clarity.
- **So, did the markets throw the baby out with the bath water? They sure did!** We think this episode of market panic was unwarranted. Yes, the US economy is slowing, but there's no risk of an imminent recession. The US jobs market is seeing a welcome cooling rather than an unwelcome deterioration. While hiring has slowed, there's no rise in layoffs and the weekly jobless claims have recently fallen the most in a year. **On the US consumer front, there's a clear bifurcation** – the top half is more resilient than the lower income cohorts, but overall retail spending is strong. Plus, the imminent start of a front-loaded Fed easing cycle should provide monetary policy tailwinds to the US economy.
- **The S&P500 bull run remains intact driven by decent earnings. Plus, the nature of the current US rally is changing for the better** – positioning readjustment means that the US rally is becoming less concentrated in the Magnificent -7 stocks and broadening out into the under-owned, under-valued areas of the market. While excess froth has now come off the tech sector, we still find several opportunities in technology beyond just the Mag-7. We think AI is a secular long-term trend that is yet to permeate other sectors like industrials and utilities and will enhance their efficiency and productivity.
- **We call for a broadening out of US exposure and manage risk through 'Beta with a Backstop'**. Accordingly, we prefer a balanced sector allocation - maintaining selectivity across the US equity market capitalisation/size spectrum - effectively diversifying our growth style exposure (tech), with cyclicals (financials, materials) and defensives like healthcare. Panic driven market volatility always creates opportunities. We think this sell-off creates a great '**Buy the Dip**' opportunity for long term investors.

Sudden shake-off helps S&P500 shed 'excess flab' in tech

US equities have been on a tear this year, with the rally mainly driven by the Mag-7, until recently. However, they hit an air pocket in recent weeks, pulled down by a confluence of concerns over big tech's AI capex monetisation, an 'impending' US recession and the unwind of the Yen carry trade, just as the BoJ suddenly hiked rate again in July 2024. And while all these were the initial fundamental catalysts, huge flips and counter flips in the intraday VIX (from c.66 level to c.31 on August 5) indicate to us that fundamentals took a backseat and this market turbulence fast became technical in nature, driven in part by positioning readjustment and low summer liquidity.

A proper look under the bonnet reveals that fundamentals, driven by US growth (slowing in pace, but intact), a still resilient US labour market and decent overall corporate earnings indicate to us that there is no risk of an imminent recession:

1. **US growth**: While the overheated 2024 US labour market is undergoing a welcome slowdown (we discuss this in detail further in this report), some other key economic indicators like strong spend in private investment and buoyant business investment indicate that the US economy still remains relatively resilient, even if its pace of growth may start to slow. The US services sector, which accounts for circa 85% of US activity is still expanding. This was demonstrated by the latest services ISM PMI data, which remains in an expansionary zone.

   And yes – the US consumer bifurcation is real. There's certainly differentiation between the high and low-income cohorts, but in aggregate, the US consumer is doing well. Overall US consumer spending, as seen in the strong retail sales, remains robust. Aggregate consumer wealth has gone up by c.$40Trn since 2019, yet, at the same time consumers' debt service ratio is below 10% of their overall balance sheet aided by fixed rate US mortgages and the positive wealth effect from the US stock market (Source: Bloomberg, August 2024).

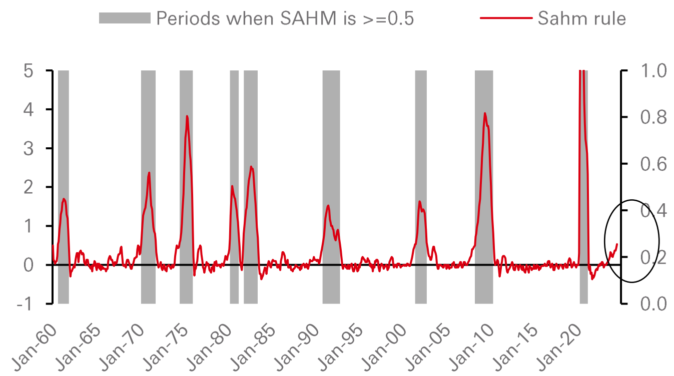
   Furthermore, Fed rate cuts in H2 2024 should be another big tailwind to US growth. And in terms of their impact on US sectors, lower cost of borrowing should boost the so far depressed M&A activity, which should be supportive of US financials. Overall, lower discount rates favour US equities in aggregate.

2. **US labour Market**: While the jump in the July unemployment rate from 4.1% to 4.3% triggered the 'Sahm rule' - a historically accurate early indicator of recession that says such a downturn is underway when the three-months' moving average of the unemployment rate rises 0.5% above its low from the previous 12 months - Claudia Sahm (the creator of this rule) has herself cautioned against taking too much of a signal from her rule, given the labour market disruptions of the COVID-19 pandemic (Source: Reuters, August 2024).

   'A Sahm rule trigger' also DOES NOT mean that the U.S. economy is already in a recession. Having said that, there's no doubt that the US labour market is cooling down.

   The behaviour of the Sahm Rule has also been different in the last 3 years versus the last 65 years. Effectively, the rule magnifies the unemployment rate. So, it's either close to zero or moves sharply higher. But since September 2021, it's moved gradually higher. This suggests a rather gradual cooling of the US labour market, rather than the labour market falling off a cliff.

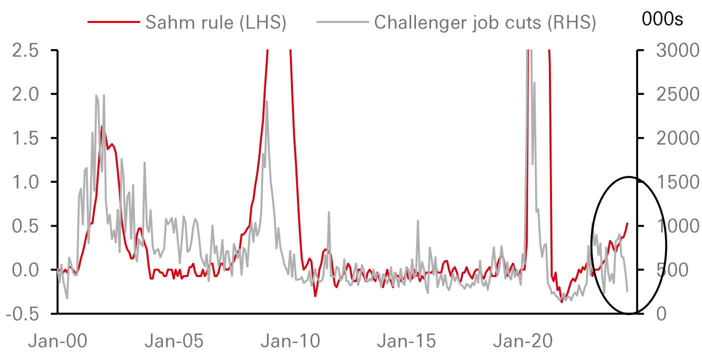
Sahm Rile is behaving differently this time around



Source: HSBC Global Research, HSBC Global Private Banking, August 2024.

   So far, this slowdown in jobs is driven by weak hiring rather than layoffs. Not only have job cuts and layoffs remained low in the past three years, but they've actually gone down, recently. Challenger job cuts are not quite at their all-time lows, for example, whereas layoffs tracked by the JOLTs survey are still lower compared to the 2010 lows. Finally, the absolute level of unemployment is below the previous cycles (4.3% vs c.6%), when this rule triggered.

Sahm Rule vs Challenger job cuts

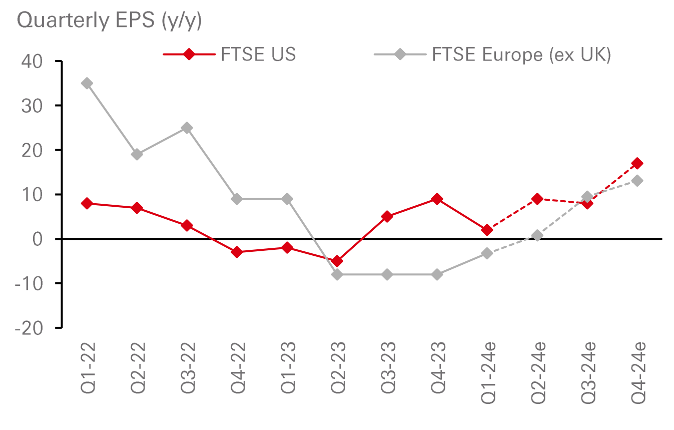


Source: HSBC Global Research, HSBC Global Private Banking, August 2024.

There has also been an immigration induced jump in the labour supply. Plus, the July jobs report was impacted by inclement weather. While the BLS said Hurricane Beryl, which slammed Texas during the survey week of the July employment report, had "no discernible effect" on the data, the household survey showed 436,000 people reported that they could not report to work because of bad weather last month, the highest on record for July. The most recent initial jobless claims fell 17,000 to a seasonally adjusted 233,000 for the week ended August 3, declining most in a year, which again shows that the labour market is just slowing rather than falling off a cliff (Data Source: BLS, August 2024).

3. **Strong Earnings**: While the hurdle rate is high for the US earnings to grow from 7% in Q1 2024 to 17% in Q4 2024 (Source: FactSet, July 2024), and therefore some scepticism prevails, we think analysts' expectations are achievable, especially as CEOs' optimism on earnings' calls remains high. S&P 500 EPS estimates for Q2 2024 are 4% below the 2016-2019 trend levels, and even lower, at 11% below trend, when excluding the Magnificent-7 (Source: HSBC Global Research, July 2024). This suggests that earnings are far from stretched, and there remains potential for earnings to catch-up, especially in the left-out sectors. Moreover, while some Mag-7 earnings may slow down from here on given their extraordinary earnings trajectory thus far, they still remain huge cash generators. Moreover, the S&P500 earnings season has so far delivered 79% positive surprises and corporate margins are at a record high – hardly typical for a recession.

US versus European Earnings Growth

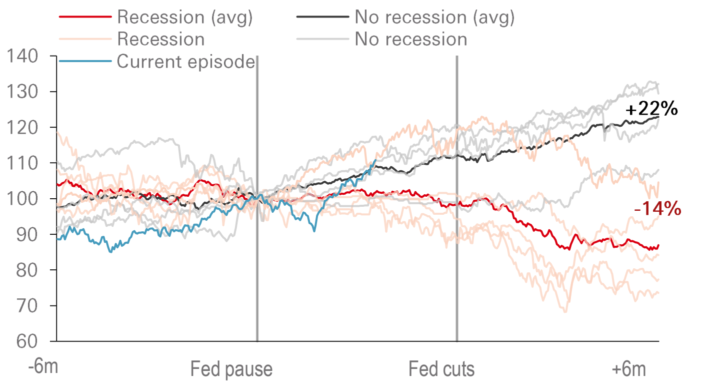


Source: HSBC Global Research, HSBC Global Private Banking, August 2024.

The recent cooling in inflation underpins a scenario favourable for equities, buoyed by a slowing but stable US economy and anticipated Fed easing. Indeed, the historical performance of equities around prior Fed pivots shows that the direction of equities has hinged primarily on the course of the US economy. When the central bank has engineered a soft landing, the S&P 500 has rallied 10% in the subsequent six months after the Fed's first cut.

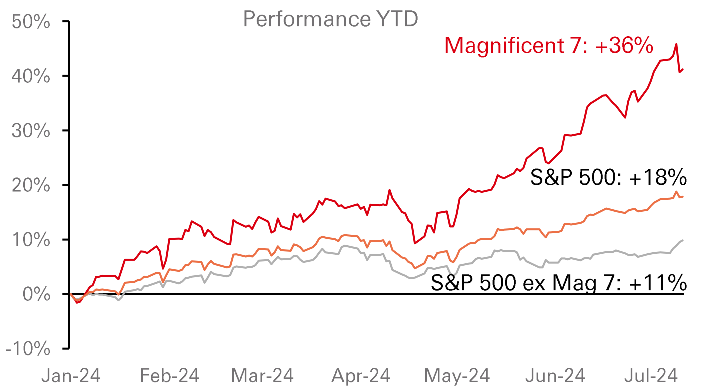
S&P 500 performance around Fed cuts

S&P500 performance around Fed cuts is conditional on whether a recession materialises in the next 6 months.



Source: HSBC Global Research, HSBC Global Private Banking, Bloomberg, August 2024.

US performance YTD has been mainly driven by the Mag-7. Now the S&P493 are catching up.

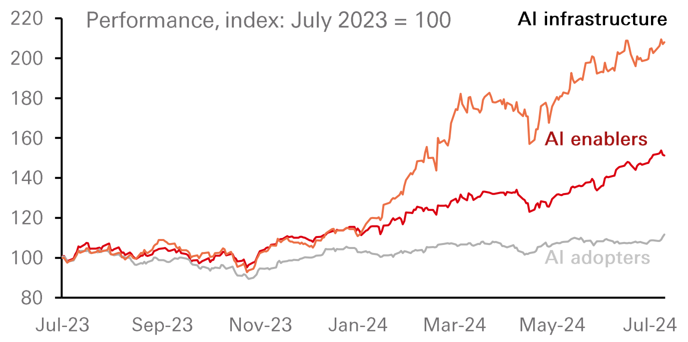


Source: HSBC Global Research, HSBC Global Private Banking, Bloomberg, August 2024.

4. **Continuation of the AI promise**: Markets recently got spooked with the high amount of AI spend, especially in the Mag-7. But we believe AI a structural theme, with further upside and is poised to boost ROEs through improved margins and asset turnover.

Hypothetically, even if the mega-tech companies are over-building their AI capacity now, we think an overspend is better than an under-spend because the downside of being behind in the most important technology (AI) for the next 10-15 years could be enormous. Plus, these companies are great cash generators. Their earnings profile, high revenues and high levels of Free Cash Flows give them the luxury to spend a little extra and invest in their future growth without having any adverse impact on the health of their balance sheets.

AI Trade Breakdown



Source: HSBC Global Research, HSBC Global Private Banking, Bloomberg, August 2024.

Magnificent 7 valuations Versus Dot-com bubble

Magnificent 7				Tech Bubble (2000's)		
	12m fwd PE	ROE			12m fwd PE	ROE
Apple	29.2	160.6		Microsoft	65.3	36.0
Microsoft	30.6	37.1		Cisco	96.6	22.3
Alphabet	21.7	30.9		Intel	31.0	26.2
Amazon	36.4	21.9		Oracle	92.1	38.8
NVIDIA	40.0	115		IBM	25.2	39.0
Tesla	81.3	20.9		Qualcomm	169.6	10.5
Meta	25.6	35.4				
Median	**30.6**	**35.4**		**Median**	**78.7**	**31.1**

Source: FTSE Russell, Factset, Refinitiv, Yahoo Finance, HSBC Global Research, HSBC Global Private Banking, 12 August 2024.

So, where are the opportunities?

We see attractive opportunities across the size and sector spectrum of S&P500, hence adopt a balanced but selective approach, with a preference for companies which have quality business models, strong balance sheets and good earnings growth trajectory.

In our view, this broadening out of the US rally is **NOT the 'passing-on of the baton'** from Tech to the value sectors. It's rather a **'sharing of the baton'**, wherein the mega-caps' dominance decreases in favour of a more balanced sector performance, but they still remain important given their strong balance sheets, earnings and Free-Cash-Flows (FCF). We like a good mix of cyclical and defensive sectors. In cyclicals, we like financials which should benefit from the re-steepening of the yield curve and a pick-up in M&A activity. In defensives, we like the healthcare sector which should benefit from future innovation. Healthcare valuations are relatively attractive too. Continuation of the secular AI trend and its permeation into other sectors should benefit sectors like industrials, which we had tactically downgraded recently due to some idiosyncratic short term company specific issues but remain structurally bullish on.

The secular theme of energy transition and greater demand for electricity and grid upgradation should eventually benefit utilities. Imminent Fed rate cuts should also benefit both Industrials and Utilities. Therefore, a good mix of quality cyclicals and defensives, across the size spectrum of S&P500 offers investors an attractive opportunity set, in our view.

Summary

Notwithstanding the recent sell-off and volatility spike, we are still positive on US equities and call for a broadening out of the US equities exposure. To manage risk though, we adopt a **'Beta with a Backstop'** approach by maintaining a balanced sector approach and remaining selective, while taking advantage of the **'Buy the Dip'** opportunity this higher volatility period offers. We think this sudden shake-off has helped S&P500 shed the excess flab (valuations) in the mega-tech space, while the prospect of earnings growth and imminent Fed cuts from September 2024 are adding muscle to the left-behind value sectors. We therefore prefer earnings' growers across the US market capitalisation.

We avoid a blanket exposure to the small caps though. Circa 40% of small caps remain loss making. A similar percentage hold high amounts of floating rate debt. With rates unlikely to go back to the pre-pandemic levels, we think it's best to avoid a high exposure to small caps and remain selective. Even if the Fed cuts a few times over the next 12 months, we're still going to have rates above the high-water mark from the last decade.

Markets are too concerned over the monetisation of tech sector's AI spend and want to see top and bottom-line growth directly attributable to it. While some tech companies are already starting to see benefits of AI in their day-to day operations and advertisement revenues, we think a broad-based permeation of AI in other sectors is yet to materialise. AI, therefore, is a secular growth story. As such, we continue to believe in our **Generative AI and Robotics theme** and see any tech capex in AI as an investment in the future. While the burden is off the mega-cap tech names to pull the market higher with their earnings – these companies are still huge money makers. We therefore continue to like tech, whilst broadening out our equities exposure and maintaining selectivity across the US equity market capitalisation/size spectrum - effectively diversifying our growth style exposure (tech), with cyclicals (financials, materials) and defensives like healthcare. Lastly, it also appears that the huge stock meltdown had little to do with increased odds of recession, but more to do with investors' panic and herd behaviour. As always, separating emotional responses from investment decisions is tricky but warranted. **Investors need to be mindful of a broad narrative fallacy** driven by a "data-point dependent" market, which lacks broader context. They should rather focus on fundamentals and take the totality of macro data into account.

Risk Disclosures

Risks of investment in fixed income

There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk

Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments

High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures

- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or cancelled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. cotractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non viability. These features can introduce notable risks to investors who may lose all their invested principal.

Contingent convertible securities (CoCos) or bail-in debentures are highly complex, high risk hybrid capital instruments with unusual loss-absorbency features written into their contractual terms. Investors should note that their capital is at risk and they may lose some or all of their capital.

Changes in legislation and/or regulation

Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalisation risk

The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalisation.

Reinvestment risk

A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate. Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may have a negative effect on the prices, mark-to-market valuations and your overall investment.

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Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government. Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond. There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk. Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

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Private Equity - Please note Private Equity is generally illiquid, involving long term investments that do not display the liquid or transparency characteristics often found in other investments (e.g. Listed securities). It can take time for money to be invested (cash drag) and for investments to produce returns after initial losses.

Risk disclosure on Emerging Markets

Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalisation or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

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The leverage of a product can work against you and losses can exceed those of a direct investment. If the market value of a portfolio falls by a certain amount, this could result in a situation where the value of collateral no longer covers all outstanding loan amounts. This means that investors might have to respond promptly to margin calls. If a portfolio's return is lower than its financing cost then leverage would reduce a portfolio's overall performance and even generate a negative return.

Currency risk – where product relates to other currencies

When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

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There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

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In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

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