CIO Academy

Why global uncertainty may fail to derail innovation-driven growth

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Written by:

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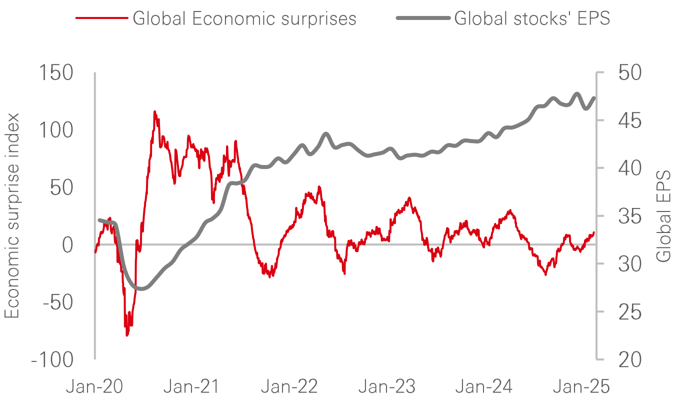
Highlights: While the global economy is weakening a bit, it is still resilient, thanks to innovation lifting productivity and investment. In many economies, consumers are benefiting from real wage growth as inflation has eased. And in China, we believe there was an important pivot towards a friendlier and more supportive stance to the private sector. This should boost Chinese business confidence and investment, with positive spillover effects to the rest of the economy.

- **In this context, the global economy should be able to weather tariffs and more complex international relations.** We do not think that tariffs will lead to stagflation, as some trade can be reoriented and services are largely unaffected. Tariffs may also be up for negotiation, and to the extent they do apply, some of the revenue may be used to finance US tax cuts.
- **The resilience of the economy and the rapid innovation mean that we maintain our risk-on approach, with a continued overweight on US stocks.** We upgraded Chinese equities to overweight in February and further diversify with overweights in Japan, India, Singapore and the UAE.
- **Tariffs do lead us to make some tweaks to our strategy however.** On the positive side, we think tariffs will cause foreign companies to invest more in the US, supporting our North American Re-Industrialisation theme. However, we are selective in the consumer space and are underweight on materials as we think these sectors can be more affected than others. Around the world, consumer preferences may continue to shift towards local brands. And to manage tail risks, we maintain our overweight on gold.

Context is everything.

Discussions of trade tariffs and other geopolitical headlines often miss one of the most important points, namely the quite resilient global economy in which these shocks currently occur. As we show in our chart, while the economy has weakened a bit, corporate earnings are quite resilient.

While the global economy is weakening a bit, corporate earnings are resilient



Source: Bloomberg, HSBC Global Private Banking, February 2025.

The US has been the key driver of this, and for the past 18 months, US economists have continuously been forced to upgrade their growth forecasts. This is, firstly, because they underestimated the boost to investment and productivity coming from technology. In our view, this should accelerate further as AI applications spread thanks to cheaper AI models. And secondly, economists overestimated the impact of past rate hikes. Households' mortgages are usually fixed for 30 years, and as such, only the unlucky ones who need to refinance see their payments go up. Corporates extended the maturities of their loans when rates were still low, reducing the damage when the Fed started hiking rates. In fact, US corporate balance sheets are generally in quite good health.

Falling inflation is helping consumers around the world, as wage growth generally exceeds CPI, boosting their real buying power.

And recently, we believe there was an important policy pivot in China towards a friendlier and more supportive central government stance to the private sector. This took place at the high-level symposium chaired by Chinese President Xi Jinping, where he supported the view that private businesses should "get rich first, and then promote common prosperity." We think more supportive government policies towards the private sector and technological innovation will likely lead to more investment in capex, with positive spillovers into other sectors, employment and ultimately consumer confidence too.

Two macro shocks: tariffs and more uncertain international relations

Given this global economic resilience and the multiple engines of growth, we think the shocks coming from higher trade tariffs and policy uncertainty are manageable.

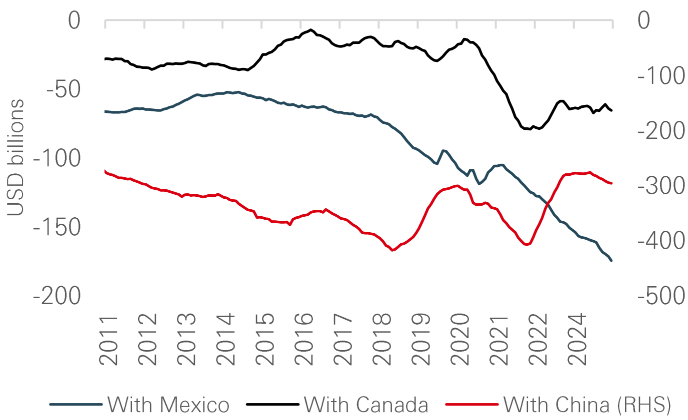
Trade tariffs are unloved by economists, and the general perception is that they can lead to stagflation – i.e. hurt growth while also boosting inflation.

But that is not a given. For the country that imposes the tariffs, higher import costs can indeed lift inflation if those costs are charged through to the consumer. Meanwhile, for the country on which the tariffs are raised, lower export demand can lead to lower economic growth.

Even those rules of thumb do not always apply. For example, imposing tariffs on commodity imports can just lead to trade diversion. Importers will just choose to import commodity inputs from country Y instead of country X, and the producers in country X will find another export destination. In the current situation, European exporters will worry that any tariffs on Chinese exports to the US will lead to Chinese products ending up in the European market, lowering growth but also capping inflation in the EU.

History shows that when the US increased tariffs on Chinese goods during Mr Trump's first presidency, its overall trade deficit did not decline. China's share in US imports did decline (at least temporarily), but Mexico's and Canada's increased. Universal tariffs would probably be more effective in balancing trade but would probably come at the expense of economic growth. To the extent that higher import costs were charged through to the consumer, they would weigh on consumption and be problematic for companies in the consumer staples or consumer discretionary sector (e.g. automotives). That negative effect could of course be partially offset by tax cuts (or, to be more precise, an extension of the expiring tax cuts) if Congress deems that enough revenue is generated through tariffs to finance part of the tax cuts.

While tariffs on China reduced the US deficit with China, the deficit with Mexico continued to grow



Source: Bloomberg, US Census Bureau, HSBC Global Private Banking, February 2025.

There are some additional aspects to consider that may limit the impact even further. For one, the tariffs mostly target trading in goods but not services, which is a relief in economies that are increasingly service-oriented. And in America, the hope is that the economy will get a boost from increased investment spending. Indeed, while re-industrialisation in the US after COVID was principally driven by US companies that brought production back home to secure supply chains, the re-industrialisation process may now be given a new boost by foreign companies investing and producing more in the US to escape tariffs. As for Europe and China, they are busy building new trade networks to find additional markets to keep exports going: the EU signed a trade agreement with Mercosur; the UK joined CPTPP and China continues to speed up regional integration.

Markets are also hoping that some of the proposed tariffs are part of a negotiating tactic. In fact, the US government has been quite open about this point, and we already saw illustrations of it in the cases of Colombia, Mexico and Canada. If tariff negotiations trigger new activities or reforms, this may not be a bad thing. A case in point is Europe, which is often said to only progress with reforms in times of crisis. US pressures and the realities of the Russian invasion of Ukraine may lead to more defence spending. And following the German election, there is even talk of a relaxation of the budgetary constraints there. If the EU were to couple reforms with some measures to raise competitiveness in innovation and AI, these could be further positives.

Global uncertainties of course go beyond just tariffs. It is clear that the new US administration is less supportive of a multi-lateral approach in its international relations, preferring bilateral negotiations. As well-established frameworks and rules no longer apply, we think governments around the world will react by focusing on security, in three key aspects.

- Firstly, there is defence, in its traditional form as well as cybersecurity, which is key in our data-led and connected economies.

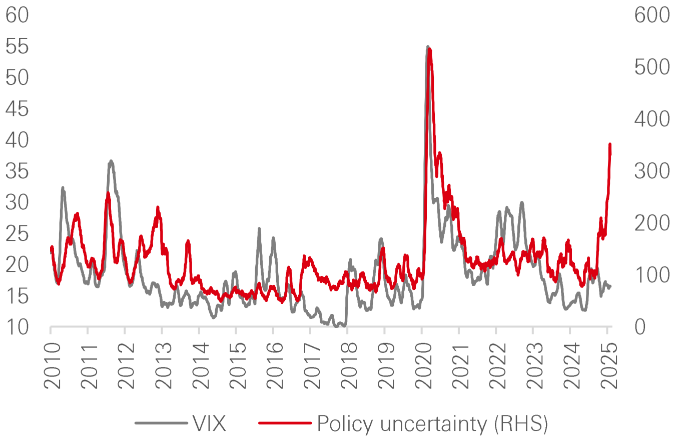
- Secondly, governments will want to ensure access to electricity and resources. Electrification is a long-term trend that is well established, but the rise of AI is rapidly accelerating our hunger for electrical power. This will require very rapid investment, which is key as governments will want to avoid blackouts, and situations where spiking energy prices re-fuel inflation. Access to other resources is key too, especially those that are rare and are important inputs in technological processes (e.g. rare earth metals).

- Lastly, economic security in a multi-polar and competitive world requires a solid plan to keep up with innovation and be competitive in the strategically important industries. It is no surprise that the big economic blocks are all formulating strong industrial policies. The one laggard is the EU, which, according to Mario Draghi's report on competitiveness, needs to create more funding for R&D, reduce regulatory burdens and invest more in education and skills training.

Market implications: maintaining our pro-risk stance

The main takeaway is that investors should set their risk appetite based on the global cycle and structural trends. Only after that should they look to make tweaks in portfolio positioning to adapt to the tariffs. Indeed, while policy uncertainty is currently very high, equity volatility has risen much less; we think this is not only principally because the economy is resilient, but also because some of the news headlines turn out to be just 'noise' (e.g. some recent policy announcements have been reversed or tweaked).

Policy uncertainty is not fully translating into equity volatility as some headlines are perceived as 'noise'



Source: Bloomberg, HSBC Global Private Banking, February 2025. Past performance is not a reliable indicator of future performance.

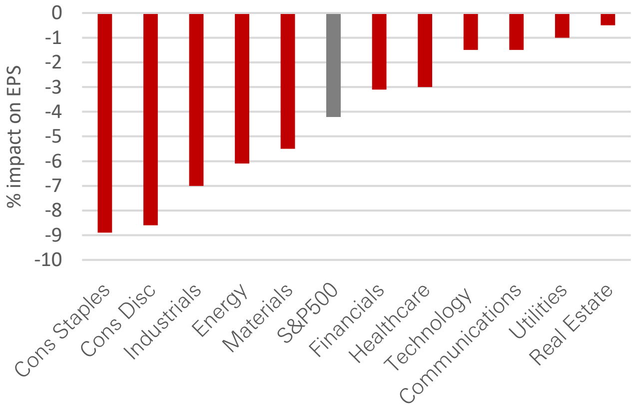
To recap, the economy is healthy, and we do not think tariffs and geopolitical uncertainty will lead to stagflation. As AI and innovation are currently accelerating and governments around the world are taking initiatives to make their economies more competitive, we think investment and productivity growth will support economic activity and earnings growth.

Therefore, we continue to adopt a pro-risk stance, with a solid overweight on US stocks. We upgraded China to an overweight in February, thanks to the more business-friendly environment and the rapid technological innovation – as illustrated by DeepSeek. We are also positive on the Japanese, Indian, Singaporean and UAE's stock markets, illustrating the opportunity for regional diversification. We maintain a neutral view on the UK and an underweight in the Eurozone as the news flow and growth levels may remain more challenging in the coming months.

How do tariffs influence our positioning?

Given that tariffs are focused on goods, we look for opportunities in services rather than goods, wherever we can. Consumer goods companies require a selective approach, as many of them are vulnerable to higher import costs. This is not only the case for consumer staples, but also for automotives, where US companies are very dependent on the perfect functioning of supply chains with Mexico. We also underweight the global materials sector, including steel, as it is subject to tariffs and the risk of oversupply from other countries when they re-direct goods that they would otherwise have exported to the US.

Estimated impact of a hypothetical 10% universal tariff on S&P500 companies' earnings per share



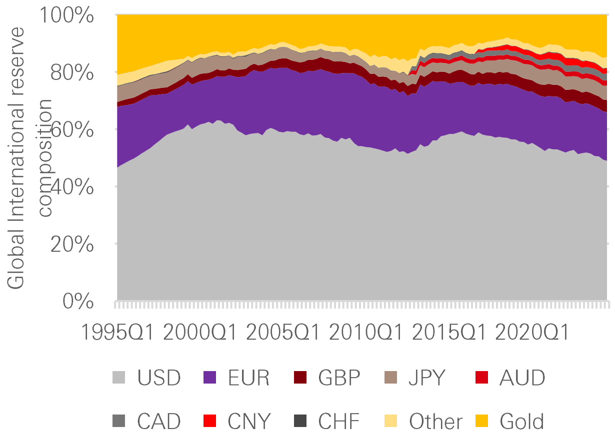
Source: HSBC Global Research, HSBC Global Private Banking, February 2025.

As we have discussed, we think the North American re-industrialisation will see another wave of activity, by foreign companies that will try to produce more in the US to escape tariffs. This build-out will benefit US infrastructure, logistics and engineering companies. In addition, we think there are some European companies that trade at low valuations due to perceived tariff risk, but in fact produce a lot in the US already.

If geopolitics remain challenging, we think it is possible that companies and consumers increasingly switch to local or regional products – to avoid the cost of tariffs or to support local producers. The increased interest in local brands is not a new trend, but we think it could intensify.

Lastly, we think our complex multi-polar world will continue to support gold. While prices have already run up substantially, we hold on to our overweight as we see gold as a hedge against tail risks in our portfolio. Central banks remain important buyers as they diversify their reserves away from the US dollar. Especially as there does not seem to be any other currency that can take the US dollar's crown for trade, investment or reserve activity, gold is likely to remain an attractive alternative for many central banks.

Gold's share in global central bank reserves may continue to rise, supporting the gold price



Source: IMF, HSBC Global Private Banking, February 2025.

Abbreviation

AI – Artificial Intelligence
AUD – Australian Dollar
CAD – Canadian dollar
CHF – Swiss Franc
CNY – Chinese Yuan
CPI – Consumer Price Index
CPTPP – Comprehensive and Progressive Agreement for Trans-Pacific Partnership
EPS – Earnings per share
EU – European Union
EUR – Euro
Fed – The Federal Reserve
GBP – British Pound
JPY – Japanese Yen
R&D – Research and development
UAE – United Arab Emirates
UK – United Kingdom
US – United States
USD – US Dollar

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.

Risk disclosure on Dim Sum Bonds

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.

Alternative Investments

Hedge Fund - Please note Hedge Funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. They can also be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and may involve complex tax structures and delays in distributing important information. Alternative investments are often not subject to the same regulatory requirements as, say, mutual funds, and often charge high fees that may potentially offset trading profits when they occur.

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.

Risk disclosure on FX Margin

The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer.

Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

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.

Chinese Yuan ("CNY") risks

There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

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.

Illiquid markets/products

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.

Environmental, Social and Governance ("ESG") Customer Disclosure

In broad terms "ESG and sustainable investing" products include investment approaches or instruments which consider environmental, social, governance and/or other sustainability factors to varying degrees. Certain instruments we classify as ESG or sustainable investing products may be in the process of changing to deliver sustainability outcomes. There is no guarantee that ESG and Sustainable investing products will produce returns similar to those which don't have any ESG or sustainable characteristics. ESG and Sustainable investing products may diverge from traditional market benchmarks. In addition, there is no standard definition of, or measurement criteria for, ESG and Sustainable investing or the effect of ESG and Sustainable investing products. ESG and Sustainable investing and related measurement criteria are (a) highly subjective and (b) may vary significantly across and within sectors.

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An investment which is considered to fulfil sustainable criteria today may not meet those criteria at some point in the future. When we allocate an HSBC ESG and Sustainable Investing (SI) classification: HSBC ESG Enhanced, HSBC Thematic or HSBC Impact (this is known as HSBC Purpose in the UK) to an investment product, this does not mean that all individual underlying holdings in the investment product or portfolio individually qualify for the classification. Similarly, when we classify an equity or fixed income under an HSBC ESG Enhanced, HSBC Thematic or HSBC Impact (this is known as HSBC Purpose in the UK) category, this does not mean that the underlying issuer's activities are fully aligned with the relevant ESG or sustainable characteristics attributable to the classification. Not all investments, portfolios or services are eligible to be classified under our ESG and SI classifications. This may be because there is insufficient information available or because a particular investment product does not meet HSBC's SI classifications criteria.

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