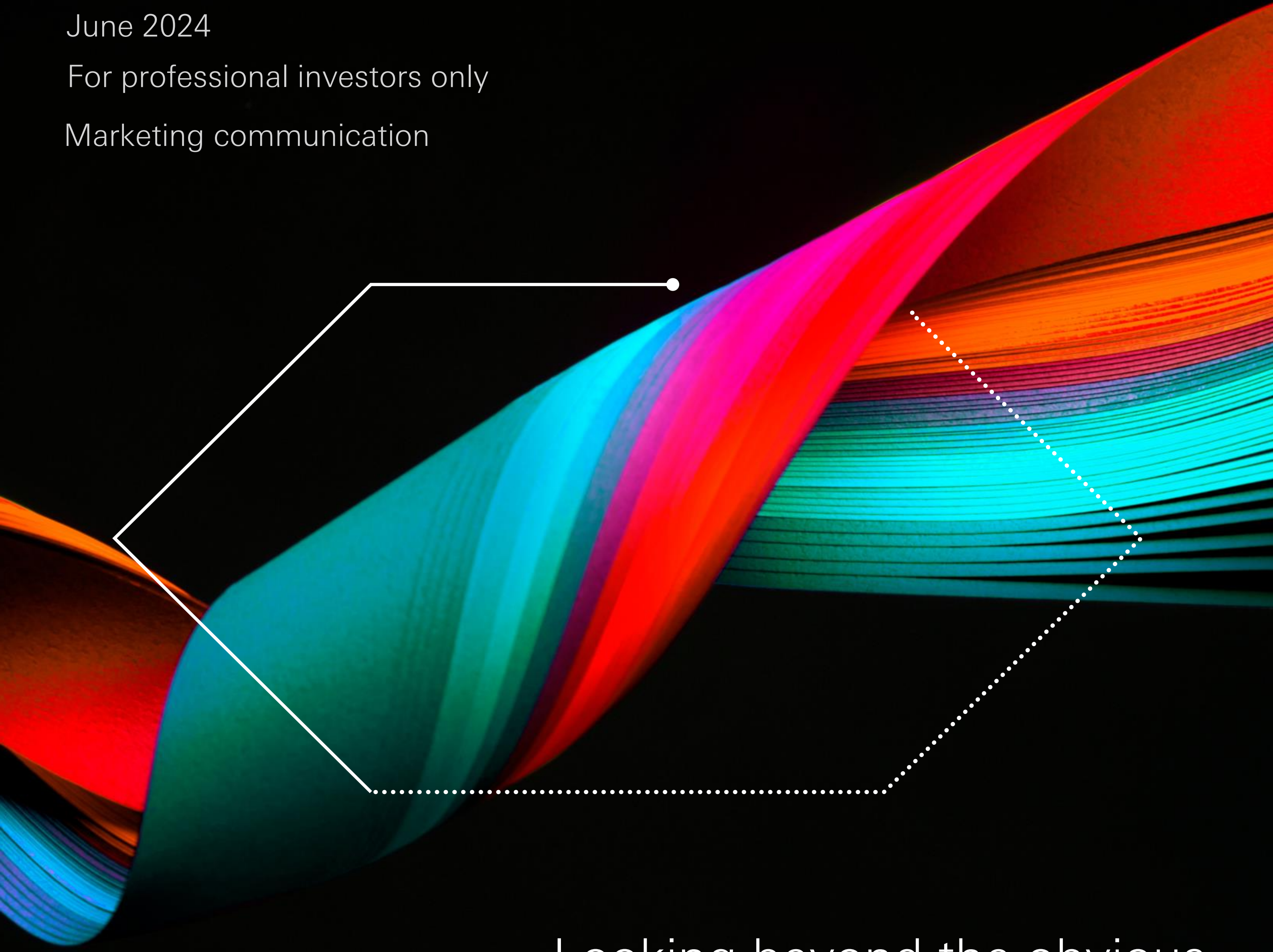
Multi-Asset Insights

June 2024

For professional investors only

Marketing communication



Looking beyond the obvious scenarios priced into markets

HSBC Asset Management

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Foreword

> Amidst a strong run in risk assets based on favourable macro scenarios, we examine how scenarios most investors remain unprepared for could come to the fore, and what it means for portfolios.

Jean Charles Bertrand
Global CIO, Multi-Asset
HSBC Asset Management

Welcome to the latest edition of our Multi-Asset Insights series, where we present the findings of our quarterly Strategic Forum.

We have previously discussed the need to protect portfolios against risks not necessarily priced into markets. In this edition of the publication, we take a closer look at a set of longer-term risks for which many portfolios are likely unprepared.

First, we explore the idea that 'higher-for-longer' rates are not as detrimental to economic growth as previously understood and expected. With resilient growth in the US and rebounding growth in Europe in the face of interest rates which remain at their highest levels in over 15 years, the idea is certainly not without merit – even if it is not part of any base case scenario for us. Nonetheless, being prepared for the unexpected typically lies at the heart of success. We analyse the potential implications from alternative economic and market scenarios playing out, such as the absence of a material growth slowdown and elevated interest rates being here to stay.

Looking even further out, we next examine the potential impact of climate change on asset class risks and implications for asset allocations. Of course, unlike most macro variables, looking back at historical relationships between climate change impacts and asset prices offers little value. The cumulative effects of climate change and potential tipping points ahead mean future impacts will be more consequential. Accordingly, we focus on long run relationships between asset price risks and macro variables such as GDP growth and inflation, before considering how climate change may influence those variables in the future, relying on NGFS scenarios.

This second article is a summary version of a more extensive analysis published in the The Journal of Portfolio Management, which we are proud to say reflects the depth of research being conducted within our multi-asset platform and applied to the portfolios we manage.

I trust you will find our research useful in preparing for what may lie ahead.

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In a nutshell

What if ‘higher-for-longer’ rates were not (that) detrimental to GDP growth?

- Elevated interest rates have been maintained across much of the globe for well over a year. While implemented to slow down economic activity, recent data suggests a nuanced reality.
- We take a thought-provoking stance to challenge prevailing market assumptions, considering a "higher-for-longer" scenario outside of the narrow range of outcomes currently priced into markets.
- Amidst many complications around future growth and inflation trends, today’s narrow market focus continues to benefit strategies like FX carry and long equities, but it also means that markets may be underestimating potential volatility and broader economic outcomes.
- Such outcomes create potential for yield curve steepening, either bull or bear, which presents risks but also opportunities for prepared investors.

The impact of climate change on long-term asset allocation

- We examine climate change as a macro phenomenon by nature, expected to have impact at a global level across multiple asset classes.
- Focusing on the relationship between asset prices and macro variables such as GDP growth and inflation, we consider how climate change may impact those variables in the future.
- In the majority of cases, individual variables themselves may not be too heavily impacted, but there are larger outliers in the case of severe events.
- Combining these variables into a wider portfolio allocation shows that effects can compound, leading to lower prospective risk-adjusted returns and an optimal portfolio position which is more defensive.

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What if ‘higher-for-longer’ rates were not (that) detrimental to GDP growth?

> The likelihood of expected scenarios coming to fruition are always lower than the odds given by market participants. With this in mind, we take an open-minded look at the path of the global economy and implications for markets.

Philippe Declerck
Multi-Asset Fund Manager and Head of multi-asset research (Paris)

The hiking cycle for developed markets began around early 2022, and was even earlier for some emerging markets. Following swift hikes, rates in the main developed markets were kept above 4% for at least a year, with some regions having experienced this for up to 18 months. This monetary policy shift was of course aimed at combatting inflation, yet its long-term effects on GDP growth remain uncertain. Despite the inherent lag in the impact of monetary policy on the economy, such an elevation in rates should now be influencing economic activities. While higher interest rates are implemented to slow down economic activity, recent data suggests a nuanced reality.

This article uses a thought-provoking stance to challenge prevailing market assumptions – what if higher interest rates over an extended period were not as detrimental to GDP growth as traditionally assumed? This hypothesis considers a "higher-for-longer" scenario, challenging the narrow range of outcomes currently priced into markets. The premise is that market participants often underestimate the breadth of potential economic developments, necessitating an open-minded approach.

Growth dynamics

Over the past 15 months, we have observed lacklustre real GDP growth, particularly in Europe, with the UK and euro area experiencing near-zero or negative growth at times. In contrast, despite the aggressive rate hikes, real GDP growth has shown resilience in the United States. This divergence raises a question of whether we are at an inflection point where GDP growth is now converging towards its potential.

Figure 1: Central bank rates (%)

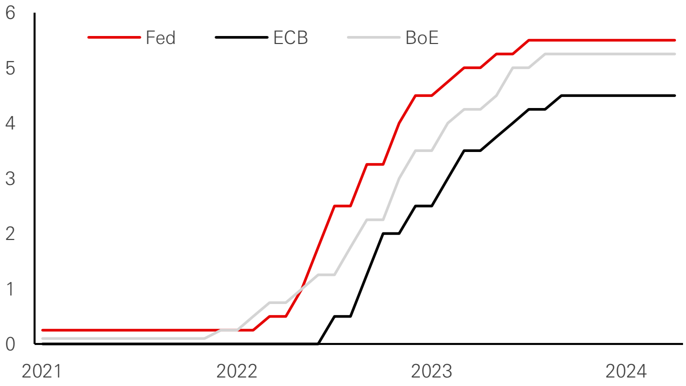
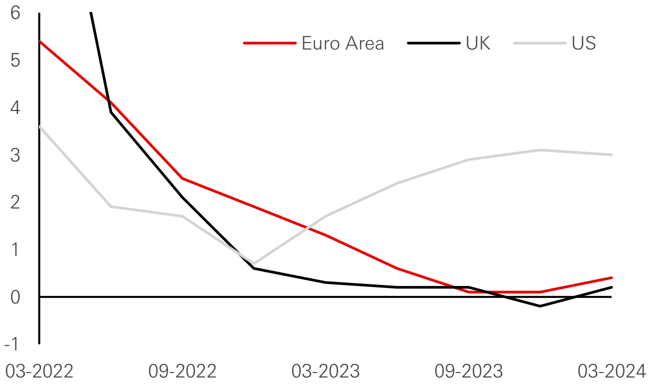


Figure 2: Real GDP growth (YoY, %)



Source: HSBC AM, Bloomberg. Data as of May 2024.

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According to estimates from institutions like the Bank of England and the US Congressional Budget Office, potential growth rates are approximately 1.5% for the euro area, slightly higher for the UK, and around 2% for the US. If these estimates hold, it would not be surprising to see US GDP growth decelerate towards these potential levels while Europe and the UK experience a slight uptick.

To this point, manufacturing and services in the eurozone have stopped declining and are showing signs of recovery. Such a recovery challenges the notion that elevated rates continuously drag down economic growth. Instead, it suggests that the initial rate hikes caused a sharp adjustment in marginal activities that were viable only at zero rates, but economies may now be stabilising and even recovering.

Figure 3: Manufacturing PMI

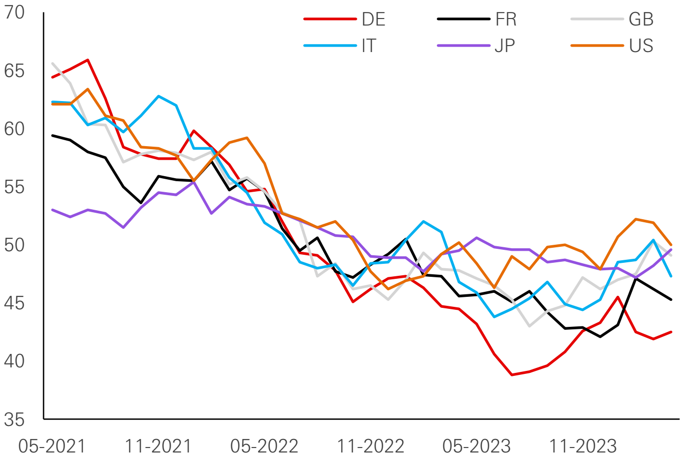
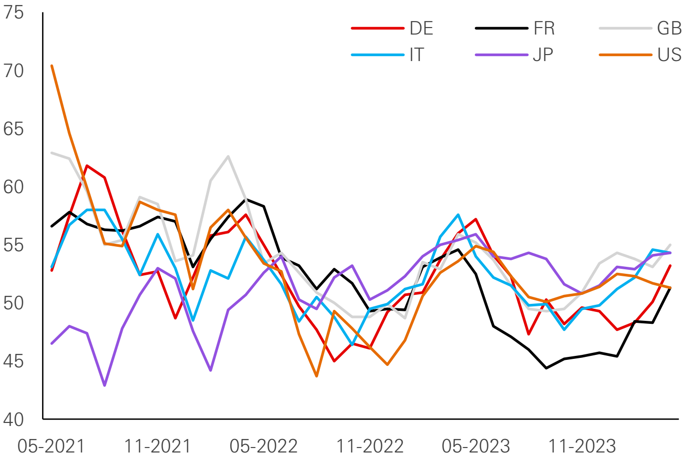


Figure 4: Services PMI



Source: HSBC AM, Bloomberg. Data as of May 2024.

This hypothesis aligns with a working paper by the European Central Bank (ECB) in 2023 which projected that the most substantial impact of monetary tightening would be felt that year, with diminishing effects in subsequent years. According to their optimistic models, the largest impact was felt in 2023, with minimal additional drag expected in 2024 and none in 2025. This implies that economies can adapt to higher rates and potentially return to their growth potential without prolonged negative impacts.

Adapting to higher rates

Another positive sign of economic adaptation taking place is the resurgence in global trade. Export-oriented economies like Taiwan, South Korea, and Thailand have seen a noticeable uptick in exports, reflecting increased global demand for manufactured goods. Likewise, in Japan, export growth has picked up, partly driven by a weaker yen, while eurozone exports are stabilising after a period of decline. This global trend is mirrored by a rise in commodities indices, indicating solid manufacturing demand.

Year-on-year loan growth from US and European commercial banks demonstrates that the initial negative impact of higher rates on lending may be easing and provides further signs of economic stabilization. Related to this progress, the UK real estate market, previously an area of significant concern, offers another example of revival. The year-on-year change in the value of BoE mortgage approvals has jumped from negative levels throughout last year to 22% at the end of May. This has occurred alongside a rebound in national asking prices, providing a clear indicator of real estate activity picking up.

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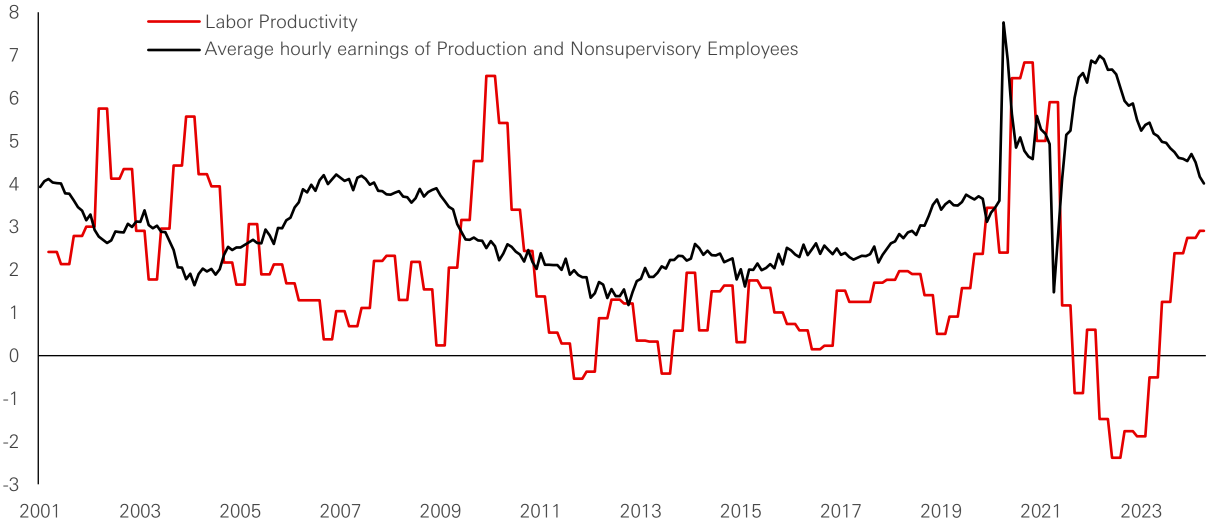
In the US, developments in the labour market have been key to its resilient growth, with immigration along with increased labour participation rates, particularly among prime-aged women, providing an important boost in labour supply that has supported growing demand and helped contain inflation. Historically low unemployment rates have been slowly rising, while the gap between jobs and workers to fill them has been narrowing from an all-time high, indicating a loosening market today - a trend that is typical of large developed economies, which tend to move slowly outside of crisis periods. The gradual cooling has not reached a level where the Fed feels a need to pre-emptively intervene. And while the job market is cooling, wage growth remains higher than pre-Covid levels and productivity growth has not matched the increase.

Figure 5: YoY Productivity and Compensation Growth (%)



Source: HSBC AM, Bloomberg. Data as of May 2024.

This failure of productivity growth to keep pace with wage growth poses a critical challenge. Labour compensation has grown substantially, leading to a scenario where nominal incomes are growing, and spending is increasing. This situation creates a sustainable expansion if productivity eventually catches up, but it also poses risks for persistent inflationary pressures.

For the Fed, the situation is complicated. Its policy tools primarily influence borrowing, so do not directly addressing the issue of nominal incomes outpacing productivity. The situation we are left with is one of elevated nominal demand, a tight but loosening labour market, and high (though decreasing) inflation, which does not create a clear impetus for rapid rate cuts. Furthermore, treasury funding needs will continue to place supply pressure on longer duration bonds. All of this points to rates remaining elevated longer, which is not reflected in the current yield curve. The situation is not drastically different in Europe, with inflation still above target as growth picks up.

Market implications

Current market pricing reflects a narrow range of expectations for future outcomes, with corresponding low implied volatilities across various assets. This complacency could be attributed to a lack of imagination. For instance, the implied odds for Fed Funds rates show a concentrated expectation around a narrow band, with low probabilities assigned to extreme scenarios.

The persistence of an inverted yield curve, particularly the 2-10 year spread, also indicates market scepticism about long-term growth prospects. However, the correlation between Fed Fund rates and the VIX index suggests that higher interest rates could lead to increased equity market volatility.

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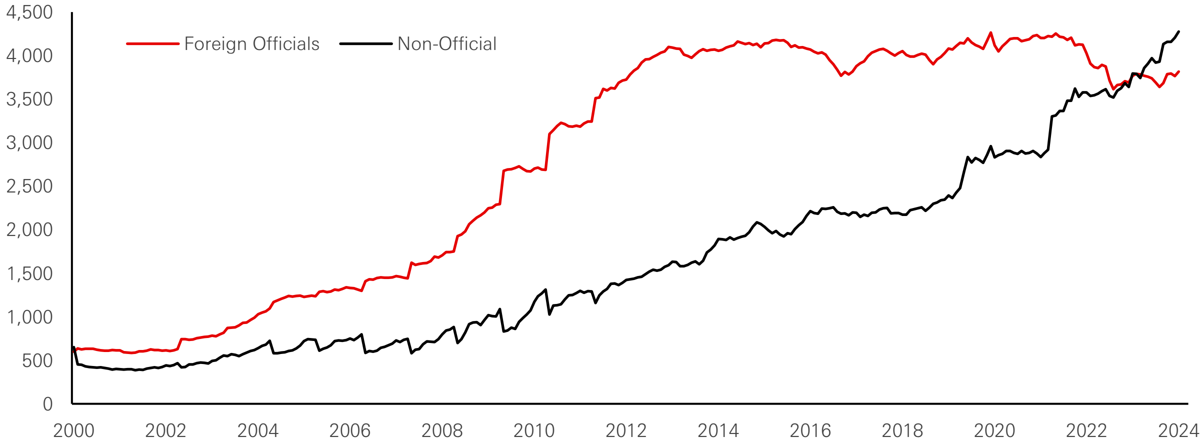
Today's narrow market focus benefits strategies like FX carry trade and long equities, but it also means that markets are underestimating potential volatility and broader economic outcomes. Furthermore, greater issuance of coupon-bearing securities as part of the US Treasury's financing needs could further influence long-term rates and increase volatility in fixed income markets.

Adding to complexities, the shift in US government financing from global central banks to the global private sector introduces new dynamics. Unlike central banks which typically manage FX reserves without frequent buying and selling based on profit motivations, private investors are more price-sensitive. This could generate higher fixed income volatility as private investors' actions drive market dynamics. Separately, the ongoing accumulation of gold by foreign officials, possibly at the expense of US treasuries, further complicates the outlook for fixed income markets while creating a tailwind for gold.

Figure 6: Foreign holdings of US treasury securities ($ billion)



Source: HSBC AM, Bloomberg. Data as of May 2024.

Strategic considerations

A key question that remains for markets is whether the long end of the rates curve can remain inverted for yet another 6 to 12 months. The pricing of the easing cycle is not only important in the US, but also in Europe, where inflation is coming down, but growth is picking up from very low levels. This environment does not create particular urgency for significant rate cuts by central banks, who predicate their decision on falling demand and inflation pressures, supported by falling commodity prices, which are not being realised.

Given the current economic and market conditions, and broad range of interest rate paths being largely overlooked by market participants, several strategies may be considered. It is hard to argue against following the trend of subdued volatility with positions in equities and FX carry-trades that have been a winning formula. Combining such exposures with cheap protections could hedge against potential market volatility ahead. In this vein, commodities stand to benefit from a pick-up in global goods demand, while gold may continue to benefit from central banks' shift to the asset, from treasuries.

Separately, the potential for yield curve steepening, either bull or bear, may present particular opportunity both in the US and euro area. We've outlined the arguments for mispricing of longer-term versus shorter-term rates today. While the central scenario of steady growth and moderate inflation is certainly plausible, the range of possible outcomes is broader than current market pricing suggests. As quoted from George Soros,

"Markets are constantly in a state of uncertainty and flux and money is made by discounting the obvious and betting on the unexpected".

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The impact of climate change on long-term asset allocation

> Given the potential magnitude of the impact of climate change on the global economy, we recently conducted research into broad portfolio implications for long-term investors. Here, we recap some of the main findings and conclusions.

Nicholas McLoughlin
Global Head of Multi-Asset Research

Stephane Mesnard
Global Head of ESG Multi-Asset

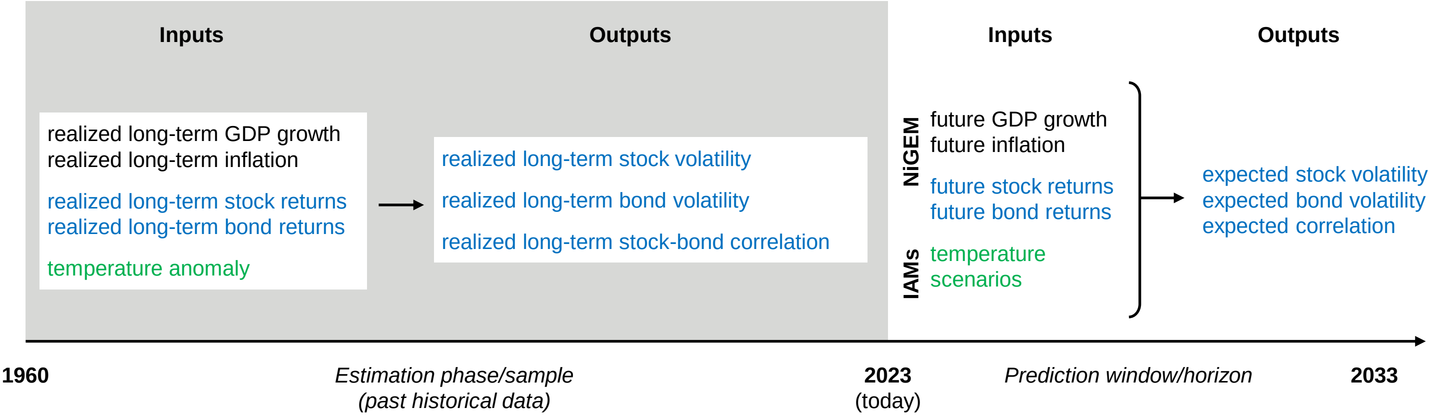
A top down, forward-looking approach

The majority of academic studies linking investment decisions and ESG considerations have been performed at a granular scale, comparing the impact of sustainability at a corporate entity level. Climate change is however a macro phenomenon by nature, expected to have impact at a global level across multiple asset classes.

What's more, climate change is expected to play a larger role in financial outcomes going forward, whereas there is limited evidence of a strong relationship looking back at history. This exacts a change in the way we can link the two topics: it is not enough to simply look back in time at the correlation between climate change and asset prices and expect this to be a reliable guide to future outcomes. The potential for climate 'tipping points' indicates a more nuanced approach is needed for climate studies in the context of portfolio outcomes.

To avoid this critique, we focus instead on the relationship between asset price risks and macro variables such as GDP growth and inflation, before considering how climate change may impact those variables in the future. The inter-linkage between macro fundamentals and asset prices is likely to be a repeatable process, and one for which we have extensive long run data to investigate relationships.

Figure 1: Schematic of the approach



Inputs
Outputs
Inputs
Outputs
realized long-term GDP growth
realized long-term inflation
realized long-term stock returns
realized long-term bond returns
temperature anomaly
realized long-term stock volatility
realized long-term bond volatility
realized long-term stock-bond correlation
NiGEM
future GDP growth
future inflation
future stock returns
future bond returns
IAMs
temperature scenarios
expected stock volatility
expected bond volatility
expected correlation
1960
Estimation phase/sample (past historical data)
2023 (today)
Prediction window/horizon
2033

Source: HSBC Asset Management, June 2024.

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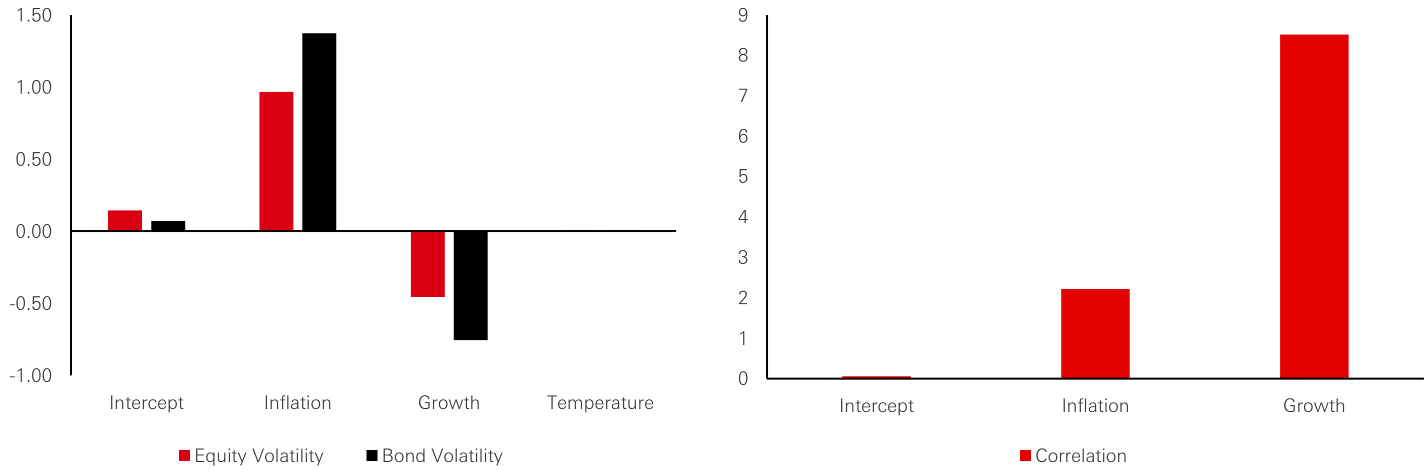
Key portfolio building blocks

Our study concentrates on the three major components of risk to a typical multi-asset portfolio:

1. Equity volatility
2. Bond volatility
3. Equity-bond correlation

We relate these variables to macro variables by a series of regressions, preferring the simplicity and transparency of the approach to alternative specifications such as vector autoregressive models or theoretical asset pricing models. The charts below show the regression coefficients from selected models.

Figure 2: Regressions coefficients



Past performance is no guarantee of future returns. Source: HSBC AM, February 2024.

Although the size of coefficients does not tell a full picture, each variable is significant at a 1% level with adjusted model R2's above 0.6.

We can see that a rise in inflation increases asset price risk, whilst the same is true of declining growth rates. An increase in temperature has historically had a positive link to risk, however as mentioned earlier this is not the primary channel for climate change impact within the framework.

Equity-bond correlation has been seen to have a positive link to inflation and growth, the former relationship having strong academic support and being visible in the post-covid market experience.

Forward-looking predictions

Having established relationships between macro and portfolio variables, we can use forward-looking, 'climate aware' projections for macro variables to see what impact these have on risk estimates. To do this, we leverage Phase 3 outputs from the National Institute Global Econometric Model (NiGEM) – a large scale economic model which produces climate-based estimates for growth and inflation under a variety of climate models, scenarios and severities developed by the Network for Greening the Financial System (NGFS). These are complimented with temperature scenarios from the International Panel on Climate Change (IPCC). The figure below shows a sample of these outputs for GDP growth under various scenarios relative to a baseline scenario. The figures are shown as a percentage adjustment, meaning a -10% adjustment to a baseline of 2.2% results in a 2% growth outcome.

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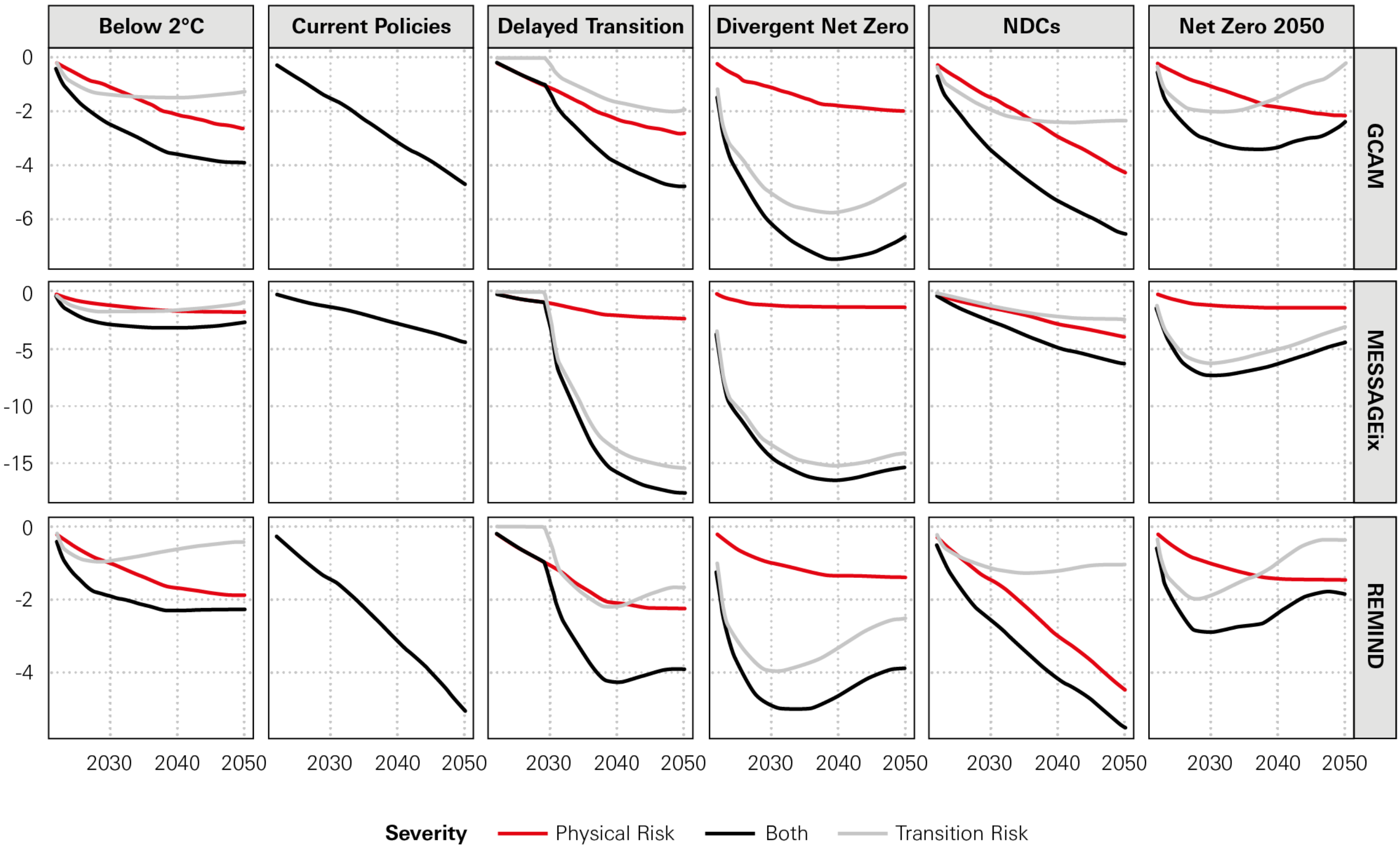
Figure 3: Climate adjustment for US GDP Growth



Source: HSBC Asset Management, February 2024. Notes: We plot the time-series of correction for GDP growth implied by climate models, scenarios, and severities compared with the baseline situation (in %). The values are in percentages of adjustment to the baseline growth value. For the period 2023–2033, it is equal to +2.2%.

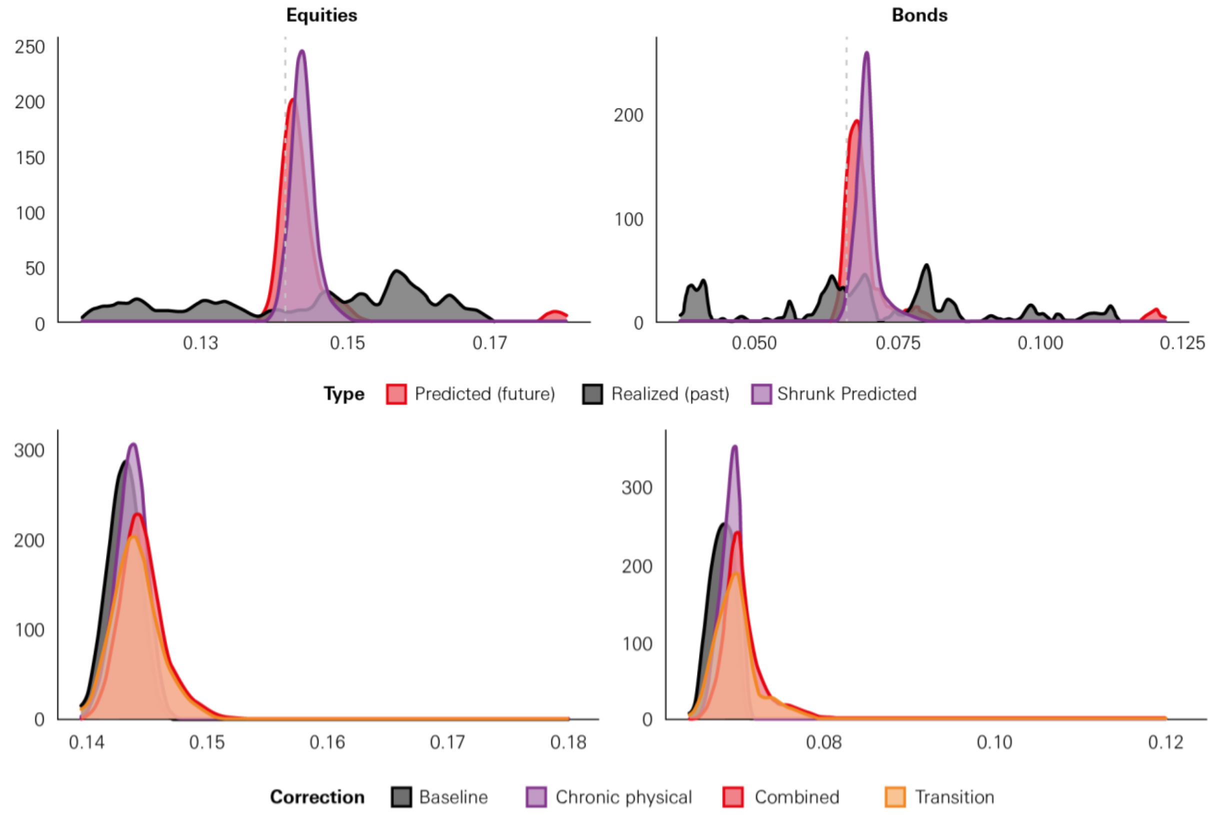
Armed with these scenarios and the results of our modelling, we can plot a distribution of outcomes for our variables of interest. We deploy a shrinkage between prior historical values and our new estimates to produce a distribution of future outcomes.

In the upper panels of figure 3, we illustrate the difference between past realized and future predicted volatility. For equities, historical volatility has ranged from 11% to 17% with an average of 14.5%, whereas our forecasts lie mostly between 14% and 15%, with thin tails around 18%. Similar conclusions hold for bonds as well.

One important takeaway from these figures is that both asset classes see a very similar pattern in the shift of their risk; a minority of scenarios predict lower volatility, whilst the majority of them indicate marginally larger risks. A very small proportion of cases imply much larger risks.

In the lower panels of the same figure, we show the distribution of predicted volatility, but conditional on the severity of climate scenarios. As the severity increases from baseline to combined (physical plus transition risk), the distribution slowly shifts to the right and the average risk increases, as one would expect.

Figure 4: Long-term volatility prediction

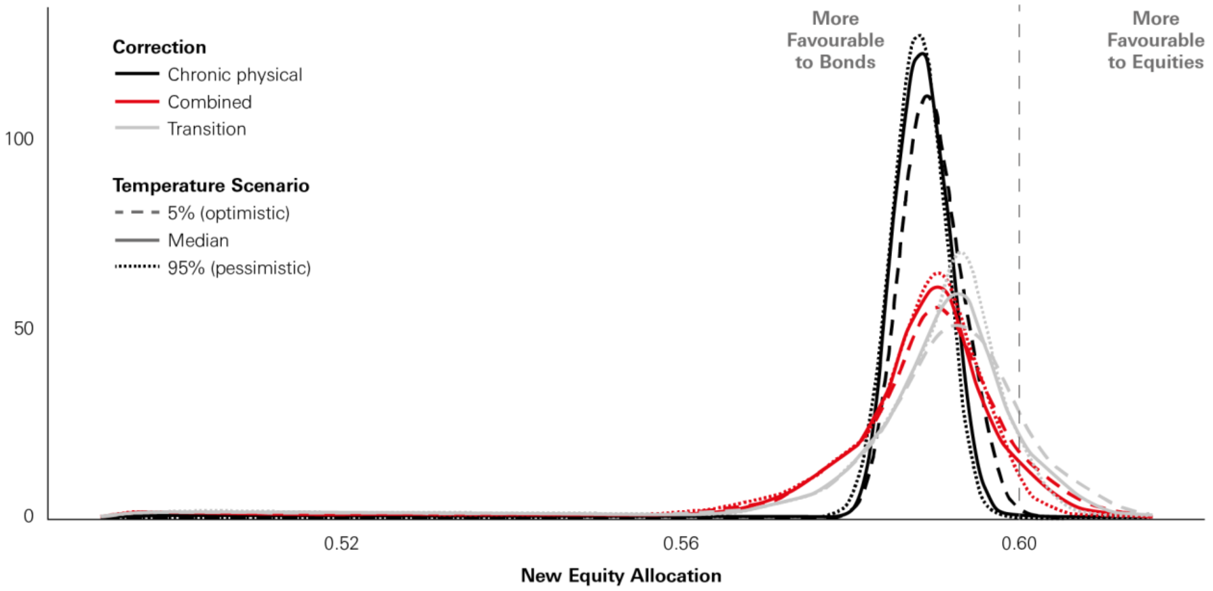


Source: HSBC Asset Management, February 2024.

Portfolio implications

One of the main objectives of the paper is to examine the impact of these climate aware variables on portfolio asset allocations. To do this, we start from a baseline 60% equity 40% bond portfolio and examine how the portfolio allocation shifts in light of this new climate awareness.

Figure 5: Climate-based adjustment to the 60/40 allocation, without long-term returns



Source: HSBC Asset Management, February 2024.

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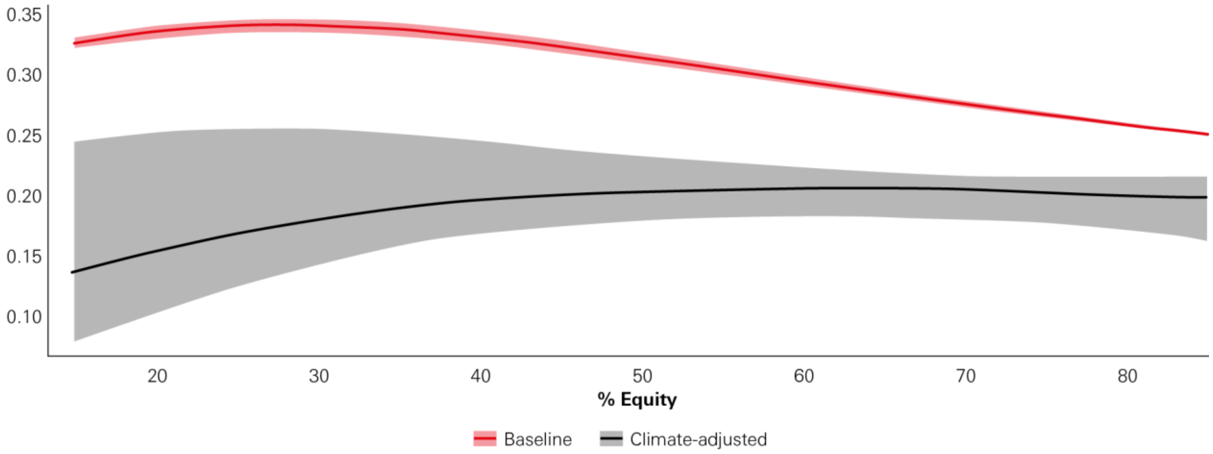
We can see that given updates to a portfolio's risk model, the asset allocations shifts to a more 'defensive' stance, with bonds favoured over equities. This is due to the increase in risk anticipated by climate concerns. Finally, we extend the framework to introduce returns which are impacted by climate (generated by the National Institute Global Econometric Model) and compare the Sharpe ratios of portfolios before and after adjustment.

Figure 6: Projected risk-adjusted performance



Source: HSBC Asset Management, February 2024. For expected returns, to remain consistent with climate-driven estimates, we pursue an exercise that takes as inputs the long-term returns generated by the NiGEM model (Phase 3). This is an arbitrary choice and serves only as illustration of the flexibility of our approach. We do not attest to their predictive power or accuracy, which is outside the scope of this article.

Here, we can see a clear deterioration in portfolio properties once the capital market assumptions embed a degree of climate awareness. This is the prospective challenge for asset allocators; in efficient frontier terms, most portfolios are likely to see a shift down (lower returns) and to the right (higher risk) in the face of climate concerns.

Conclusion

The impact of climate change on financial outcomes is a key concern for long term investors. In this research, we have sought to quantify the potential impact for multi-asset investors via their main portfolio building blocks. We can see that although in the majority of cases, individual variables themselves may not be too heavily impacted, there are still larger outliers in the case of severe events. Furthermore, combining these variables into a wider portfolio allocation shows that effects can compound, leading to lower prospective risk-adjusted returns and an optimal portfolio position which is more defensive.

For further analysis and portfolio considerations,
please refer to our full research article published in the
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Jean-Charles Bertrand, Guillaume Coqueret, Nicholas McLoughlin, and Stéphane Mesnard
HSBC Asset Management

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