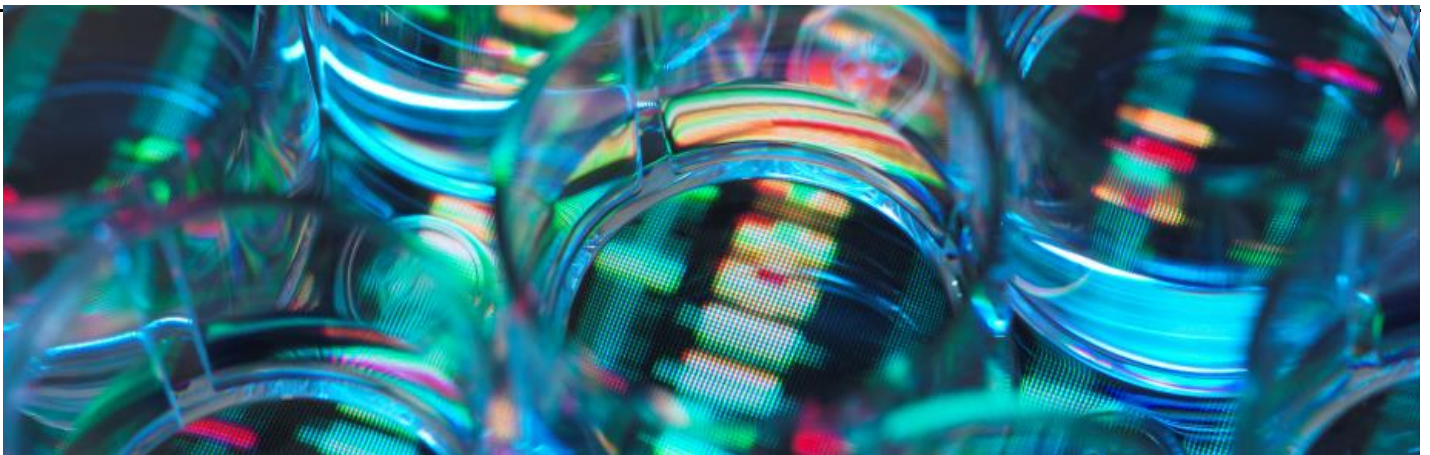


Market Update

Deep dive into equity valuations: how high are they, and where are the remaining opportunities?

1 February 2021



Many clients worry about high equity valuations compared to history. But on aggregate, there are good reasons for equity valuations to be where they currently are. That said, volatility is possible, and it is important to differentiate within markets and sectors. Cheap can be costly, while some of the expensive winners may keep winning. Valuations are important to watch, but not the start and end of investing.

- ◆ Equity market valuations are higher than the historical average, but not at a bubble range. Fundamentally, the current high valuations are in line with our top trend for 2021 of 'Recovering in a Low Yield World': it is because of low rates, global liquidity and positive and improving growth, that high valuations are warranted.
- ◆ Unless growth or rate assumptions change, P/E ratios should not drift lower. But volatile inflation numbers and the unpredictable impact of COVID on growth may lead to some temporary volatility in P/Es, which investors may want to manage. What should provide comfort is that even if P/E ratios were to fall slightly, equity returns should still be positive, given market expectations of 20%+ earnings growth this year, depending on the region.
- ◆ Concerns over valuations may principally reflect nervousness about some of the largest technology stocks. But we do not think a comparison with tech during the dot-com bubble would be fair, as most tech companies generate healthy earnings. Still, we continue to diversify from US large names into tech-related themes such as 5G, automation, health technology and the digital consumer, where we often see better value or less headline risk.
- ◆ We also note that across and within sectors, there is a large dispersion in valuations. Some companies warrant much higher valuations than others, often because they are better adapted to the digital and sustainability revolutions, have stronger balance sheets or better management. So, we see opportunities in both growth companies and also in select value stocks (where we try to avoid the value traps).
- ◆ Any analysis should weigh valuations against fundamentals. Recently, some stocks have been pushed higher by retail flows that are based on momentum rather than fundamentals. This is feeding more inflows and more positive momentum. Of course this can be dangerous, as it is very difficult to know when that momentum would stop. If stock prices become more erratic because of this new phenomenon, this could hurt equities, as it would make the risk/return relationship less attractive.
- ◆ As for EM, even after the recent sharp rally, China's equity risk premium is reasonable. Any changes to credit policy will be targeted and gradual, and we continue to overweight Chinese stocks, with many opportunities in our themes of 'Recharging Asia's Growth' and 'China's Green Revolution'.

Equity valuations around the world are at levels higher than they have been for much of history and some investors are worried we are in a bubble that is set to burst. However, we believe that there is still plenty of opportunity in equity markets if you take a bottom up approach and can look across the universe.

When valuations get stretched beyond what we're used to it is worth revisiting the words of Sir John Templeton who said: "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria."

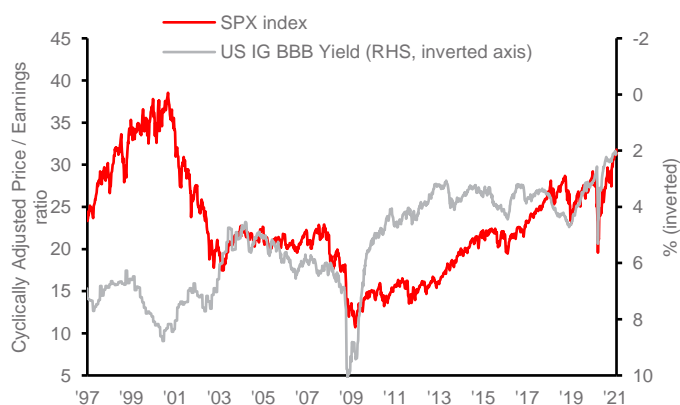
There are certainly pockets of euphoria evident in the markets today but when we look across the markets we see that there are also pockets of pessimism, scepticism and optimism and knowing which pockets to back at this time is critical to maximise upside opportunities and limit downside potential.

How High Are Equity Valuations?

Taking price-to-earnings as a rough guideline for equity valuations, the S&P 500 is currently trading at c.30x price-to-earnings (P/E) levels while the NASDAQ 100 is trading close to 40x, levels which have only been surpassed during the Dotcom crisis and the Global Financial Crisis. The MSCI World is trading at c.33x too so elevated price levels are not specific to the US markets. Also, the top 10 companies in the S&P 500 make up 31% of the index, a very high level of concentration not seen previously.

Relative valuations matter as well and the available alternatives to equity markets are in many cases highly priced as well. Moreover, market valuations adjusted for difference phases of economic and business cycles are also relevant. Analysis of the Schiller P/E or Cyclically Adjusted P/E supports this. Below, we compare P/E ratios to BBB-rated bond yields (BBB yields are most commonly used in equity valuation models), and conclude that there is no clear overvaluation, at least at the aggregate index level. Practically speaking, lower interest rates make it increasingly difficult for the large money managers of the world to decide to move en masse out of equities. For example, during the dotcom bubble, BBB yields were much higher than today, making it easier for bearish equity investors to move into highly rated bonds than it is today, at current BBB yield levels.

Current equity market valuations are in line with credit market valuations



Source: Bloomberg, HSBC Private Banking as at 31 January 2021. Past performance is not a reliable indicator of future performance.

What has driven up valuations?

Firstly, because of the mathematics. It may seem odd that valuation multiples have been pushed up during the pandemic of 2020. But in fact, much of the rise in the P/E ratio is simply due to the fall in earnings (E, the denominator of P/E). Looking forward, as the world returns to normal and economic activity resumes, rising earnings should reverse this effect, making equity valuations more reasonable at current price levels. And when we look at the market consensus, many commentators expect the S&P 500 to be up 10-15% this year with earnings rising by 23%, which should automatically lead P/E ratios to drop by about 3 points, making them look less stretched. Markets thus already factor in a mild fall in P/E ratios, which we think is reasonable. Analysts are often quite slow to adjust earnings, and if companies do better than analyst forecasts suggest, forcing analysts to upgrade their earnings forecasts going forward, P/E ratios could drop even further (or prices could rise even more, or both).

There are many more fundamental reasons for current high valuations too. "This time it's different" can reasonably be considered to be one of the most dangerous phrases in investing but likewise, thinking that nothing is different this time could be a very costly assumption. Today there are a few structural factors which can explain a lot of the current environment when compared to previous bubbles such as the dotcom crisis and the global financial crisis – namely - liquidity, buybacks and issuance, the digital economy and retail investors.

- Liquidity:** In 2008, the GFC was a crisis of liquidity but coming in to this pandemic we were still enjoying relatively high levels of central bank liquidity and the current economic crisis quickly gave rise to a raft of liquidity measures and assurances from governments and central banks that liquidity would remain as long as needed. Driving this liquidity is a low/negative rate environment that gives governments comfort in raising debt levels. While much of the liquidity ends up in the economy, a large part also ends up in the financial markets, supporting valuations. Key here is that we think global liquidity will remain ample, and that any tapering of central bank purchases will be very slow to materialize. So liquidity will continue to support equity valuations.
- Buybacks & issuance:** stock buybacks have been at all-time highs for the recent decade while initial public offerings have been relatively low historically (in part because private markets provide ample funding possibilities for companies). The combination of the two has resulted in a more concentrated market for the amount of capital in the system flowing through it. This has the effect of raising stock price levels relative to earnings.
- The Digital Economy:** The dotcom crisis was a bubble built almost entirely on hopes and dreams. 20 years later though, the situation is different: the digital economy is an integral part of the economy, it is well established, trusted, growing fast, generates lots of revenues and has been accelerated by the pandemic. The tech sector's increased weight is raising P/E multiples of benchmark indices, because growth stocks tend to trade at higher multiples

than 'old economy' stocks. With growth scarcity in a low-for-a-lot-longer rate environment, the growth premium could arguably be higher compared to the pre-zero bound interest rate era.

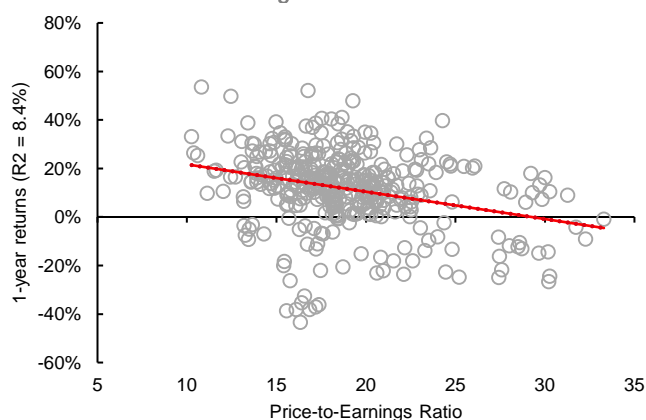
- Retail investors:** Some of the current euphoria being seen in the headlines is linked to retail enthusiasm. The lockdowns of 2020 were the perfect storm of people stuck in their homes, given stimulus checks, no sports to watch / bet on and having access to the relatively new phenomenon of commission free, gamified trading. This has given rise to online forums where retail investors are coordinating their trading and creating volatility in very specific areas of the markets. So far however, this has been specific to certain names and not sectors or markets but they have created valuation extremes in story stocks which are then the names that occupy the headlines.

Will Markets Crash?

It is never possible to know when markets will crash or likewise when they will surge. Trying to time a market can be counterproductive and a very costly exercise. The pandemic is a great example of where many investors exited the markets after the initial fall but as a result they missed the subsequent rally and opportunity to get great companies at better value.

Moreover, markets don't just correct because of high valuations. We show below that there is, in fact, only a very loose correlation between valuations levels and the return you can expect to get in the following 12 months. This can be deduced from the low R-squared number (8.4%), which denotes the significance of the regression of valuations on forward one-year total returns. If you were to look at longer term returns, valuations do matter: the R-squared of valuations and 10-year returns is 73.8%. In the short term, high valuations can just as well lead to even higher valuations, if investment fundamentals and momentum remain positive; for valuations to correct, there needs to be a trigger.

Typically, there only a very loose link between today's valuations and returns in the following 12 months

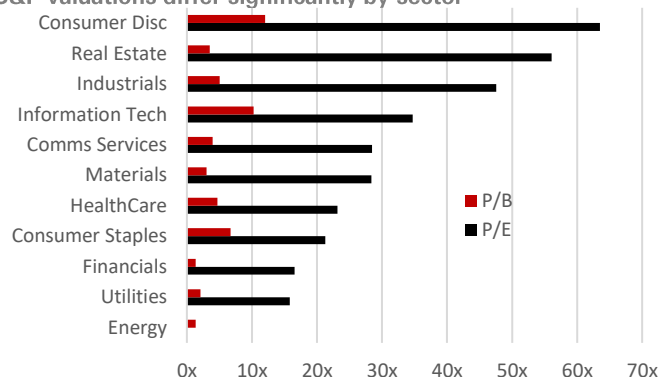


Source: Bloomberg, HSBC Private Banking as at 31 January 2021. Past performance is not a reliable indicator of future performance. S&P 500 returns since 1987.

Market and sector dispersion

At the market index level, opportunities appear to be limited but the deeper we drill down the better the opportunity set looks and at the company level there are many opportunities available. This is because there is significant dispersion in the markets. This occurs even at the sector level with in-favour sectors such as Consumer Discretionary (which includes Amazon) and Information Technology trading at the higher end of the P/E scale while out of favour sectors such as Energy and Financials trade at a much lower end. This is directly correlated to the value vs growth story too as these are the sectors which predominantly populate the respective styles.

S&P valuations differ significantly by sector

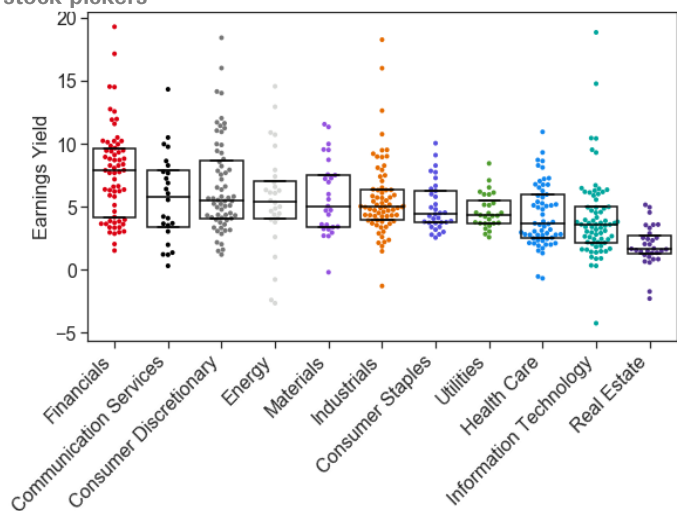


Source: MSCI, Bloomberg, HSBC Private Banking as at 31 January 2021.

Dispersion occurs again within the individual sectors. For example, we know that the Energy sector is undergoing significant change as government policies and society look to reduce our carbon footprint. The fossil fuel titans of the last century are being upended by green newcomers as the world sets about the task of getting to carbon neutral. This is a space with lots of opportunity but also lots of risk of being caught in value traps where business models are in decline and not adaptive. Financials is another interesting sector where we are seeing lots of downward pressure as a result of low rates but there are companies who are insulated against this. For example, there are banks who have relatively small retail exposures but high trading exposure, a great mix in highly volatile, economically impacted times. Each sector brings its own nuances and from here, knowing what to look for can yield attractive upside opportunities with attractive downside characteristics.

This dispersion is also evident in the bifurcation happening across sectors driven by technology. Technology is increasingly becoming the wedge between the winners and losers within any industry and the pandemic shone a light on any digital weaknesses companies have. The strong growth that many technology companies had been experiencing can be expected to continue or in some cases even accelerate as this dispersion continues so elevated prices for some companies are justified.

Very significant valuation dispersion offers opportunities to stock pickers



Source: Bloomberg, HSBC Private Banking as at 31 January 2021.

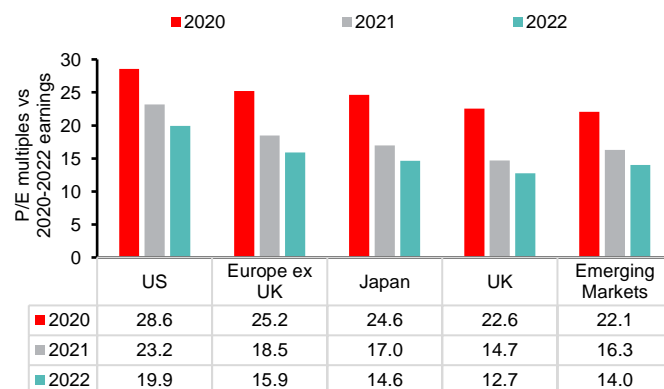
Where can we find Opportunities?

Paul Getty said it best when he said: “In times of rapid change, experience could be your worst enemy.” As investors we need to be continually growing, learning, adapting and recalibrating our beliefs to a shifting landscape. Mindset is extremely important at a time like this. Holding tight to beliefs that served us in the past can be a recipe for disaster in the future. For example, many say that value cannot be found but those same people are often only looking at one or two markets, typically developed ones.

Emerging markets are growing, they have demographics on their side, they adopt technology quicker and they do not attract the same attention as developed markets so the opportunity to find better value is higher. But an investor who cannot shift their mindset away from their own market may not see these opportunities. For example, even after the recent rally, Chinese equity valuations still look fair with an equity risk premium (12-month forward earnings yield minus US 10-year TIPS yield) of 7.5%, which is in line with the average in the last 15 years. This is on the back of a robust earnings recovery in the coming 12-month period and the low for a lot longer interest rate environment. The economic improvement in China may allow for some gradual normalization of monetary policy, and credit growth may slow somewhat in particular in relation to local governments, property developers and some highly leveraged state owned enterprises. But we think these measures will be targeted rather than broad based, and relatively gradual, given that the consumption recovery is still in its early stages and policy tightening would be premature. Therefore, we think headlines about credit policy changes will only lead to some mild short term movements, and they should not derail the earnings recovery or become a major challenge to 2021 returns. We maintain an **overweight on Chinese equities**, and our high conviction themes of Riding on China’s Five-Year Plan, New Asian Consumer, Asia’s Supply Chain Revamp and China’s Green Revolution.

For US and Asian investors, we also see some good value and diversification potential in UK stocks, which we overweight. However, in our stock picks, we typically focus on **UK exporters**, as the outlook for the domestic UK economy remains challenged in light of the high number of COVID cases, and the significant long term consequences of the many bankruptcies and high unemployment (i.e. the ‘scarring’ of the economy).

At 16.3x and 14.7x forward earnings respectively, emerging markets and the UK are relatively cheap stock markets



Source: Refinitiv, HSBC Private Banking as at 31 January 2021.

Going back to the issue of investors’ mindset, on the other side of the spectrum, thinking that because a stock has a high valuation it is destined to crash can be a very costly mindset. Warren Buffett himself acknowledged that if he had been dogmatic in his mindset around value he never would have been as successful as he was. He credited Charlie Munger with shifting his understanding that some companies deserve higher valuations because their growth opportunity is greater. We see these opportunities for structurally superior growth principally in our themes around **Digital Transformation** and **Investing in a Sustainable Future**. In technology, we continue to look for tech-related names to diversify from the very popular big names; these can often be somewhat cheaper and less prone to headline risks. 5G, healthcare innovation, digital consumption and automation all include names where we find a good balance between the growth outlook and current valuations.

We reiterate that valuations are an important aspect of stock selection, but it should not be the only one. **Cheap can be costly**, as there are plenty of opportunities in value stocks, but also plenty of value traps. We do not think investors need to choose between growth or value; we think there are opportunities in both.

Right now the landscape is moving fast and we are currently in an environment not seen before in many respects but many who draw too much comparison with historic events or who gain comfort from investment beliefs that served them in the past may find themselves punished while those willing to shift their mindset to changes that are happening will find plenty of opportunities.



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 canceled. 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. contractual 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.

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.

Nationalization 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 nationalization.

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 significantly affect the prices and mark-to-market valuation.

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.

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 nationalization or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (e) 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.

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.

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