EMEA Perspectives

Presidential elections during times of geopolitical uncertainty

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- European, but also global markets are currently rattled by intensifying geopolitical tensions surrounding the Ukraine and consequently the political calendar in European countries is taking a back seat. Even though there are many factors that point to continuing political stability across major European countries, given the proximity to the Russia/Ukraine crisis, we downgrade our Eurozone (EZ) equity view to mild underweight.
- In Italy, after weeks of political impasse around the presidential election, the status-quo prevailed positioning Italy for continuity and expansionary fiscal policies. Ahead of the French presidential election in April, polls point to political continuity with the current President Macron leading the polls. Purchasing power is a key concern among the French electorate, which puts the topics of inflation, energy costs as well the geopolitical impact on European energy prices at the top of campaign agendas.
- We see upside risk to EZ inflation from the recent surge in energy prices, even though we still expect it to come down later in 2022. This intensifies the squeeze on real incomes, and we cut our view to EZ consumer discretionary and lower our stance on sector cyclicality.
- Within EZ equities we see opportunities in strong consumer brand companies with pricing power and stable earnings, such as the majority of the European consumer staples sector, and seek dividend income in financials. Given the recent EUR rate market volatility, we are cautious on EUR sovereign periphery bonds but seek out good quality corporate bonds primarily in the high yield space to diversify our income search.

Europe's political calendar, overshadowed by geopolitical tensions

As financial markets have dramatically repriced the outlook for monetary policy rates and interest-rate sensitive growth stocks since the start of the year, the value-tilted European market seemed well placed in this year of policy and growth normalisation. But the sharp escalation in geopolitical tensions surrounding the Ukraine has lifted market volatility and added an element of uncertainty to the European investment outlook that remains marked by a persisting energy crisis, downside risks on consumer and business sentiment from high inflation and geopolitical uncertainty as well as a busy political calendar. Even though European political developments take a back seat at the moment, they can add to the already volatile market sentiment so far in 2022. Investors should thus brace for more potential volatility and take a prudent stance.

Political stability prevails in Italy

At the start of 2022, Italy's presidential election caught much attention among investors given the political risk of early parliamentary elections in case Italy's Prime Minister Mario Draghi were to be elected President. After weeks of impasse, this scenario was avoided leaving the status quo, with Sergio Mattarella being re-elected for a second term as Italy's President and Mario Draghi continuing to serve as Prime Minister. The near-term political risk has thus been significantly reduced, and we expect Draghi to lead the Italian government until the end of his term in spring 2023.

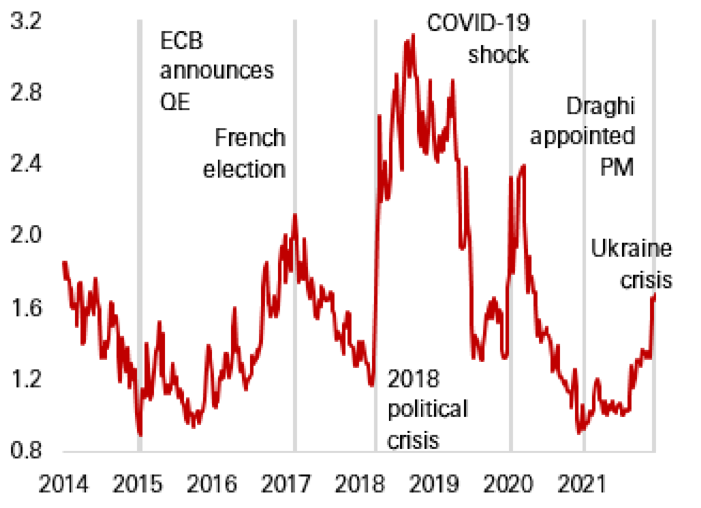
Despite the political continuity, the outcome highlighted the deep divide especially across centre-right parties, which could create some challenges to Draghi's governing. Yet given that the majority supporting the current government remains intact after the presidential election, Italy should be in a good place to progress towards meeting the 45 targets and milestones under its Recovery and Resilience Plan in order to unlock the next tranche of Next Generation EU funding worth EUR24bn for 2022. This should leave Italy's fiscal policy stance more expansionary compared to its some of its European peers, which should help to sustain the robust growth backdrop.

Italy's manufacturing sector has remained strong thanks to its lower exposure to the auto industry and consequent supply-side challenges (compared to Germany). Investment spending stands well above pre-pandemic levels and household as well as business sentiment remains resilient despite the more restrictive COVID-19 backdrop compared to other EZ countries. We thus see Italy's economy to expand by a strong 4.3% in 2022 and by 2.2% next year.

Attention will however move to the fiscal policy implications from

Spreads have widened recently, reflecting geopolitical tensions instead of European politics

10-year BTP-Bund spread (in %)



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 22 February 2022.

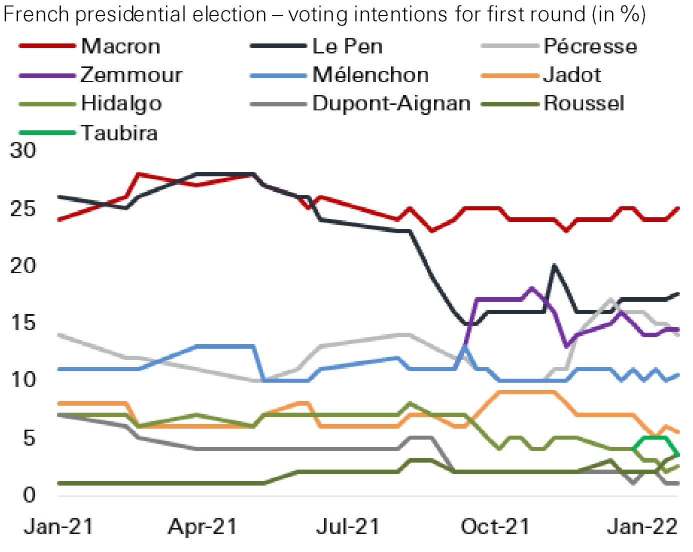
the policy change at the European Central Bank (ECB). Italy is one of the main beneficiaries of the Pandemic Emergency Purchase Program (PEPP) and with the end of net asset purchases under PEPP in sight at the end of Q1 2022 and an announced reinvestment flexibility until 2024, markets might test the ECB's end of quantitative easing and trigger some potential market turmoil. It thus remains crucial for Italy to return to a sustainable debt path in order to reduce its reliance on financing in the market directly once the ECB stops reinvestments, which could add pressure on Italy's spread over the German Bund.

French presidential election preview

Turning to France, the interest in the French presidential election in April 2022 is still rather muted among the French population but also in the media coverage with 3.2 fewer articles mentioning "French election" in January 2022 compared to the same time five years ago, according to Bloomberg and Societe Generale, a bank. This lack of interest might be a reflection of pandemic-related concerns overshadowing political developments, but it might also be linked to the fact that the front-runner in recent polls, the current President Emmanuel Macron, has not yet officially entered the race. Macron is widely expected to announce his candidacy, possibly just before the deadline on 4 March 2022, as geopolitical tensions keep EU leaders busy elsewhere, offside the campaigning track.

Macron leads, but markets will closely watch if Le Pen or Zemmour will make it to the second round

French presidential election – voting intentions for first round (in %)



Source: Harris-Interactive polls, HSBC Global Private Banking and Wealth as at 22 February 2022.

Recent polls underscore the less dynamic race so far ahead of the first round vote on 10 April 2022. Current polls show a constant lead of Macron (Party: La République en Marche) over the other candidates, with Marine Le Pen (Rassemblement National), Valerie Pécresse (Les Républicans) and Eric Zemmour (Reconquête) being the strong contenders for second place. Given that polls suggest that none of the candidates might secure more than 50% of the vote in the first round, a second round vote between the top two candidates will take place on 24 April. Another popular vote with two-round system will then be held in mid-June to determine the composition of the National Assembly, the lower house of the legislative branch, which is usually won by the incoming President (as it was the case in 2017 under Macron).

While there is always an element of unpredictability of polls, currently they point to a scenario of political continuity (assuming Macron enters the presidential race). There is still lack of clarity on Macron's political agenda for the next five years, but his campaign would likely focus again on business friendly policies, especially for entrepreneurs in the tech sector, further European integration as well as education reform and retirement law changes. But given the current economic backdrop, elevated inflation weighing on households' purchasing power, the sizeable increase in the debt level during the pandemic and the continued market share loss in global trade might drive the campaign period and voter sentiment.

At a glance: Key parties in the French presidential election

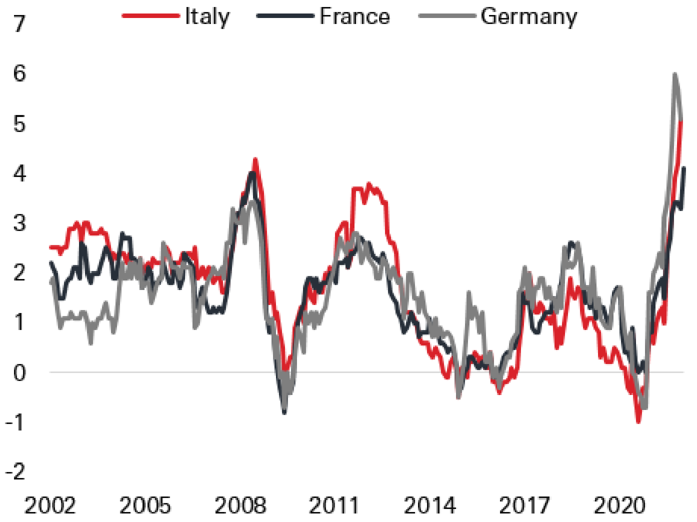
Party Name Candidate	Short description
La République en Marche Emmanuel Macron	Policy focus will likely centre around more reforms on security, immigration and pensions, as well as a post-COVID investment plan until 2030, focused on specific industries such as digital, green industry, biotech and agriculture. Positioned in the centre of the policy spectrum.
Les Républicains Valerie Pécresse	While her policy agenda has similarities to Macron's, the proposals envision more public spending cuts, more deregulation and a tougher stance on immigration than Macron. Tilted to the right on the policy spectrum.
Rassemblement National (RN) Marine Le Pen	Campaign proposes modification of European treaties and institutions to reduce the integration (instead of an outright "Frexit"). Other policy focuses include to stop illegal immigration and enhance security, while increasing the national preference to consume locally. Far-right on the policy spectrum.
Reconquête Eric Zemmour	Another far-right party that exhibits a more controversial tone than RN. Established in late 2021, and uncertainty remains whether Zemmour will secure the sufficient support to confirm his candidacy in mid-March.

Source: HSBC Global Private Banking and Wealth, 27 February 2022.

In general, France's economy is in a solid position. GDP growth stands at a 25-year high with almost no economic scarring from the pandemic. The economy has returned to pre-pandemic growth in Q3 2021, well before the broader Eurozone by the end of 2021 while Italy, Germany and Spain are still not yet fully back there. France has not been spared from the recent sharp acceleration in consumer prices, driven by energy and manufactured goods prices. However, at 3.3% y-o-y in January, the rise in France's harmonized index of consumer price (HICP) is less pronounced compared to its European peers. EZ HICP stood at 5.1% in January. This difference is largely due to the government's intervention to cap the surge in gas and electricity prices. Still French households are experiencing a drag on their purchasing power and according to a recent Ipsos poll, they note purchasing power as the main concern ahead of the presidential election. It is thus not surprising that consumer confidence surveys have rolled over even though unemployment stands at historically low levels (8%).

High inflation and rising energy costs are a key concerns among European households

Regional harmonized index of consumer price (in %)



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 27 February 2022.

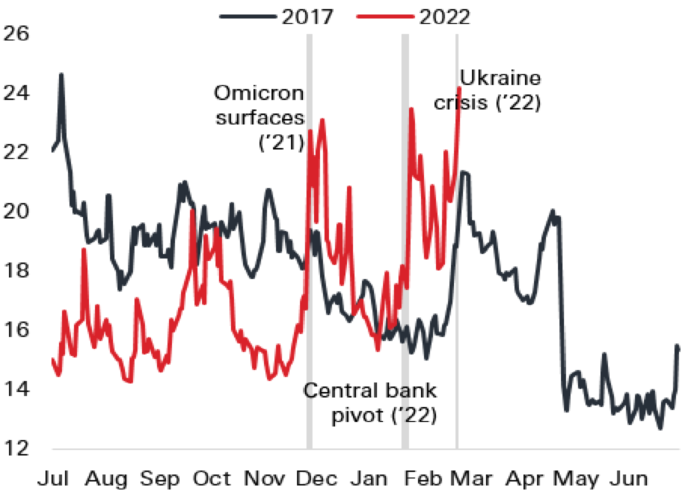
While we expect inflationary pressures to ease in the second half of 2022 across Europe, the recent minimum wage hike and a pick-up in collective wage negotiations might turn the outlook more favorable for the French consumer later this year. This will however be too late for the presidential election. Consequently, the political debate, especially by Macron's contenders, will likely focus on this topic, which might undermine Macron's re-election chances.

The rise in the debt level to c.115% of GDP in 2021, according to latest government estimates and well above the pre-pandemic level of 98% of GDP in 2019, coupled with prospects of higher interest rates, raise concerns about France's long-term debt sustainability, and might become a key topic to secure votes especially among the center-right electorate, which is highly contented by Mr Macron and Ms Pécresse.

Macron will likely remind the French electorate of the quick economic recovery under his leadership from the pandemic-induced shock. His current handling of the geopolitical conflict surrounding the Ukraine will also drive voter sentiment, likely strengthening his position, especially compared to the far right opponents that have financial ties with Russia.

French stock market volatility has been mainly driven by COVID and geopolitics lately

CAC 40 Implied Volatility in the months prior the 2017 and 2022 presidential election (in %)



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 22 February 2022.

At the moment, financial markets appear to price in a very little risk premium related to the French presidential election, and market sentiment is significantly moved by geopolitics. Election-related volatility might be sparked once all candidates confirm their bid for presidency and once the election date approaches more closely. Yet Macron's re-election would be a positive for risk assets in our view given his political direction and policy continuity.

Looking at the 2017 election, France's equity benchmark, the CAC 40 index, rose by 6% to a nine-year high, in the two weeks surrounding Macron's run-off against Le Pen. However, the rally was short-lived as markets realized Macron's challenges to implement his reform agenda. So far this year the CAC 40 struggles amid the broader market re-pricing of central bank policy tightening and geopolitical tensions, but bond markets have remained relatively calm. Yet it is worth adding that the political context is also very different from the 2017 election, when euro skepticism and "Frexit" (the French withdrawal from the EU) were high on the agenda. This year all presidential candidates show support – to a differing degree – for the EU and the euro currency.

Germany's state elections can drive sentiment

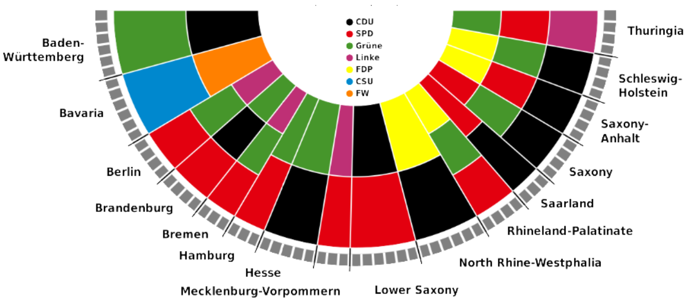
After the federal election in September 2021, appointing the three-party coalition government under the new Chancellor Olaf Scholz, one might think that politics move into the background in Germany this year. This however is not the case. Germany already held its presidential election in mid-February, which however compared to Italy and to some degree France, has gathered little attention given the rather limited executive powers of this role in Germany's political system (it primarily covers representative tasks only). Frank-Walter Steinmeier was reaffirmed for another five-year tenure.

Looking ahead and more important will be the regional elections in four of Germany's 16 federal states that take place over the course of 2022:

- 27 March in Saarland
- 8 May in Schleswig-Holstein
- 15 May in North Rhine-Westphalia
- 9 October in Lower Saxony

More than 1/3 of German voters will return to the regional polls deciding on the four state parliaments, which will feed into the policy direction of the upper house of Germany's parliament, the Bundesrat. The Bundesrat is formed by the 16 state governments that nominate 69 Bundesrat members and has decision power on new legislation from the Lower House, the Bundestag, which touches on vital interest of the federal states. It is worth adding that unlike the US Senate, the Bundesrat currently exhibits a robust balance of political forces as almost all 16 states are governed by a coalition, which also includes at least one of the governing parties of the federal government (SPD, Greens, Liberal Democrats) – with the exception of Bavaria.

Composition of the German Bundesrat



Source: Bundesrat, HSBC Global Private Banking and Wealth, 22 February 2022.

The political situations across the four states differ but historically there has been a certain tradition of centre-left SPD governments across the four states, not least because three of them are home to very traditional manufacturers and their workers. Yet with the Conservatives (CDU) being part of the government in all four states, the outcome will be important for political sentiment after the Conservatives' loss in the general election last autumn.

From an economic perspective, the state election in North Rhine-Westphalia (NRW) should be watched closely. Indeed, if NRW was an independent member of the EU, it would rank #6 in terms of GDP and #7 in terms of population when comparing with other EU countries. The economic importance is underpinned by its various industrial clusters including the lion's share of the German fossil fuel industry. Similarly, the medium-sized Lower Saxony holds economic power given their blocking minority ownership in the Volkswagen Group. Consequently, the regional policy direction will have obvious repercussions for the course of politics on the national level, especially on key policy agenda items such as sustainable energy supply and the decarbonisation of the economy. While we do not expect major market reactions to the results of the state elections, the results may confirm the shifts in preferences triggered by the 2021 federal election, where green investment spending emerged as a top priority.

Investment implications

European, but also global markets are currently rattled by intensifying geopolitical tensions surrounding the Ukraine and consequently the political calendar in European countries is taking a back seat. In our latest Monthly View March 2022, **we have downgraded our tactical view on Eurozone equities to a mild underweight** given the region's proximity to the conflict and reliance on importing energy. Especially Germany and Italy are more dependent on supply flows from Russia, compared to France and Spain, making them more vulnerable, should on-going geopolitical developments start to disrupt energy supply.

As Europe's energy crisis is reinforced by the latest surge in energy prices and the upward adjustment in wholesale gas and electricity prices in various European economies in early 2022, we anticipate an intensifying drag on household consumption. The income squeeze on household balance sheets will also likely continue given the still elevated and upside-surprising inflation data. We have thus cut our view on European consumer discretionary to neutral and **adopt a neutral cyclicality stance in our global sector positioning**. We prefer financials and energy stocks in the current backdrop of high inflation, rising rates and strong energy prices and **focus on companies with pricing power and stable earnings, such as the majority of the European consumer staples sector**, which is made up of companies with relatively high margins and high pricing power.

With regards to the French presidential elections, we cannot rule out a further pick-up in market volatility closer to the election day. But the current outcome of a Macron re-election, as signaled by polls, should support risk sentiment towards French assets. Within our EZ equity exposure, we prefer French, alongside Italian, stocks, given the strength of their respective economies and value bias. The French equity index also still trades at attractive valuations compared to the US even though the valuation gap against other European markets has narrowed recently. The French equity index is also tilted towards international consumer brands, energy names and financials, which aligns with our wider sector preferences but also increases its exposure to global drivers of consumption, central bank tightening and energy developments.

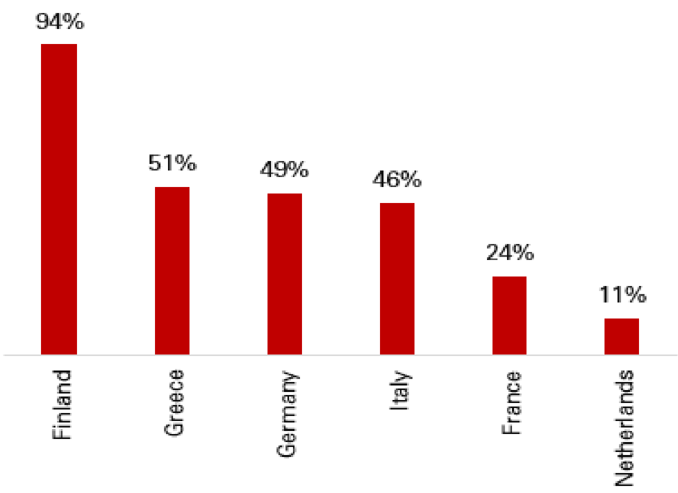
While we expect the ECB to lift rates in late 2022, following the hawkish central bank pivot across other major economies, it still remains a laggard in the tightening process in our view. German Bund yields have rallied already; however, we think forward markets might have gotten ahead of themselves in pricing in over 50bp of rate hikes this year, and we only envision a 25bp rate hike in October 2022 (and another one in March 2023).

Consequently, the yield support remains low for the EUR and the nearing end of the PEPP might put further strain on peripheral spreads, limiting the extent of ECB tightening, in our view. Given the recent volatility in EUR rates markets, we prefer to err on the side of caution with a **mild underweight view on EUR sovereign periphery bonds**. It also underscores our continued view of structurally low yields, due to the rising debt overhang and ageing populations, and we thus remain on the search for income, and **within Europe we seek out good quality corporate bonds primarily in the high yield space and attractive dividend income** in our equity strategy.

Structurally Europe is still pursuing "*to be the first climate neutral continent*" under the Fit for 55 agenda. In light of the persisting energy crisis at the moment and natural gas reliance on Russia, EU members must act to diversify energy sources and strengthen its infrastructure system and the technologies for renewable energy power in order to meet demand reliably. With 37% of the Recovery and Resilience Facility, which underpins the Next Gen EU funding, earmarked for green investments, there are opportunities in Green/Blue Hydrogen, wind and solar power, carbon capture and sustainable fuels. These are areas we explore in our high conviction theme "**Energy Transition**".

The EU relies heavily on importing energy, and for several Russia is a key source of gas supply

Percent of gas supply coming from Russia for select European countries



Source: HSBC Global Private Banking and Wealth, Agency for the Cooperation of Energy Regulators, 25 February 2022. Note latest available data (2019 or 2020).

Abbreviation

Bn – Billion
GDP – Gross Domestic Product
EMEA – Europe, Middle East and Africa
EZ - Eurozone
IG – Investment grade
H2 – Second half
HY – High Yield
IG - Investment Grade

M – Million
NAV – Net asset value
P/E – Price-earnings ratio
SOE – State-owned enterprise
Trn - Trillion
y-o-y – Year on year

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.

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 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.
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(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.

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
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