Family Office Horizons
October 2022

US equity strategy:

Lessons from past lows and essential indictors to watch

Executive Summary

Markets spend most of their time thinking ahead, but ultimately depend on the state of the economy. When the economic outlook becomes very turbulent, forward looking markets can become very displaced from the here and now. With this in mind, the answer to these two questions are pivotal for the outlook for markets: What is the current state of the economy and what are markets pricing in? If we can gather a clear understanding of current economic conditions, we can weigh them against what is priced in by markets and then see where the risks lie. If markets have become too fearful, to bearish for the current state of the economy it could mean that the risks are skewed to the upside. Conversely, overly optimistic markets may need too much to go right to be plausible in a central scenario.

We therefore have two objectives in this paper: Firstly, to condense the vast array of noise economic data into the underlying momentum of economy, asking if it points to a recession; and, secondly, to broadly assess the market for tell-tail signs that a recession have become priced in. In the first instance we create a dashboard of economic indicators to cover the broad health of the US economy and compared this to two key downturns – the end of the Dotcom bubble and the Great Financial Crisis (GFC). We also boil this down to create an economic activity indicator. Together both can give us a clearer picture of where the economy is heading and does it look like a recession. Turning to the markets, we have sifted through dozens of financial and market based indicators before we isolated almost 20 that can build a strong understanding of what the investors are collectively thinking.

We find than in previous recessions the decline in economic indicators was more broad-based than it is now, particularly with the improvement we saw in July's data, that carried through until August - this means that we are probably not yet in a recession in the US at this stage. But we are not out of the woods because our activity index is heading lower and the momentum is yet to slow. This index tends to slight lead corporate earnings and one of the key insights is that during severe downturns this index has to improve before we then see a follow through into earnings. This means that an improvement in this index can increase our conviction during turning points.

We track the financial and market data from June onwards and compare the peak-to-trough changes with the peak-to-trough changes during the Dotcom bubble bursting and the GFC. This gives us an insight into what we can expect should the economy go into a deeper downturn synonymous with a recession.

We conclude that the slowdown in US growth is not broad based enough yet for a prolonged bear market, but year-on-year activity is nevertheless in decline. Labour market resilience will be pivotal in preserving a softer landing. If the slowdown in activity wanes, then that would be a clearer signal to the market to become more positive, especially if alongside a genuine Fed pivot. We also think that a post Dotcom bubble secular decline is unlikely too because equity risk premiums look much more fairly valued now than in 2000. This means that if a significant recession is avoided, in line with our central scenario, and the US economy is only bruised by the current economic headwinds, then equities can consolidate from here. Of the indicators to watch we will pay close attention to labour markets, earnings, the yield curve and equity risk premium. These are key for signs economic momentum, corporate health, monetary policy direction and risk aversion. They will also give us some direction as to whether the US equity market will break out from the top of bottom of the range after a period of consolidation.

What to expect when markets price in a recession

One of the most effective ways of predicting a recession is to look at financial markets. The Conference Board's Leading indicator, for example, contains the S&P 500 and the yield curve among its 10 sub-indices. This stands to reason: the S&P 500 is a barometer of where corporate earnings are heading while a flattening yield curve speaks of tightening policy. Also, when there is stress in markets, this can feed through to tightening financial conditions and hurt activity. But markets don't always get it right and, if driven by sentiment, can overreact and quickly reverse course.

Economics can show a clearer trend, so that while markets react first, they then wait nervously while the economic data drips in. Therefore, we can pick through the markets, as we do below, to get a sense of what the collective thinking is, but this needs to be done in tandem with a firm grasp of the economic data.

In June, the S&P 500 entered bear market territory with a decline of -21% (ytd). At that point we knew that the market was pricing in a good chance of a recession. Since then the market has rollercoastered through a bear market rally and is now down 24% (ytd). The question is, does the data continue to point to a bear market?

Economic dashboard

To make sense of the economic data, we introduce two concepts: an economic dashboard that boils down the economic data into trends and an indicator of the current activity. An economic dashboard is useful because it can illustrate broad areas of weakness or strength. Should the US post a poor quarterly GDP reading, the dashboard gives a sense of where the weakness lies and, importantly, whether it is broad based. After all, the NBER definition of a recession is a "significant decline in economic activity that is spread across the economy and that lasts more than a few months.".

The dashboard below captures the decline across May and particularly June, with 13 key economic indicators declining. By May, US confidence was beginning to fall across consumers and businesses, but the rest of the economy was holding up well. Come June and declines across confidence is still broad

Dashboard of US economic activity

Classification	Indicator	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22
Consumer	Conference Board consumer confidence (Base =100)	↓	↓	↑	↑	↓	↓	↓	↑
	Retail Sales (YoY%) Change	↓	↑	↓	↑	↑	↓	↑	↓
	Vehicles Sales (Millions)	↑	↓	↑	↑	↓	↑	↑	↓
	Consumer Spending (Billions)	↑	↑	↑	↑	↑	↑	↑	↑
	NFIB Small Business Optimism (Base =100)	↓	↓	↓	→	↓	↓	↑	↑
	University of Michigan Consumer sentiment (Base=100)	↓	↓	↓	↑	↓	↓	↑	↑
Business Activity	ISM Manufacturing PMI SA	↓	↑	↓	↓	↑	↓	↓	→
	ISM-Non Manufacturing	↓	↓	↑	↓	↓	↓	↑	↑
	Industrial Product Manufacturing (Base =100)	↑	↑	↑	↑	↑	↓	↑	↓
	Philadelphia Fed Index	↑	↓	↑	↓	↓	↓	↓	↑
Employment Activity	US Initial Jobless Claims SA (000')	↑	↑	↑	↓	→	↓	↓	↑
	Aggregarate Hours worked	↑	↑	↑	↑	↓	↑	↑	↓
	Employees Nonfarm Payroll Total MoM Net Change	↓	↑	↓	↓	↑	↓	↑	↓
Housing Activity	NAHB Homebuilder sentiment	↓	↓	↓	↓	↓	↓	↓	↓
	Building Permits (000)'	↓	↑	↑	↓	↓	↑	↓	↓
	Construction Spending Total SA (Millions)	↓	↑	↓	↑	↓	↓	↓	
	Housing Units Started (000)'	↓	↑	↓	↑	↓	↓	↓	↑
No. Of Negative Indicators		12.00	7.00	8.00	8.00	11.00	13.00	8.00	7.00

Sources: Bloomberg, HSBC Private Banking as at 3 October 2022.

and housing looks to be suffering on the back of higher interest rates. There are some signs of resilience though, as employment is far from capitulating and consumer spending is still holding up. By July though, the strength of the labour market has come through again and some confidence data shows a little improvement. We don't interpret this as a broad-based decline and would therefore view the couple of quarters of negative US growth as not enough to fit the NBER definition of a recession.

Not only does a broadly based downturn signal a recession, it also tends to tie in with a deep market downturn. A yearly view of the dashboard shows that the broader decline in 2000/01 and 2006-08 coincided with large drawdowns in the equity market. These were two very different downturns, with the financial crisis of 2008 being a sharper shock, while the dot-com bust in 2000 was more of a slow decline. But in both cases there was a persistence in the weakness.

Going back to recent data, July and August economic data looked better so it is no surprise that the market has bounced back from the June lows. This is on the back of a very tight labour market that added over 500,000 jobs in July and 315,000 jobs in August. Even accounting for the improved data, the year-on-year trend in activity is declining because of the comparatively strong rebound from last year.

Obviously, there are some limitations to our dashboard: the level of each index is important too, not just the trend. We take this into consideration in more detail in Appendix A. Here you can see more detail on each index, with each showing a comparison between the last couple of months and previous recessionary downturns. This shows a clear recessionary downturn in many of the sentiment indicators, while the labour market holds up well. In fact, the declines in the labour market, such as in jobs lost and overall hours worked, are the clear outlier between now and a recession. Housing is on a worrying trend though.

The dot-com and financial crisis recessions had a broad downturn across the US economy

Classification	Indicator	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Consumer	Conference Board consumer confidence (Base =100)	↓	↓	↓	↓	↑	↓	↑	↓	↓	↓	↑	↑	↓	↓	↑	↑	↑	↑	↑	↓	↓	↑
	Retail Sales (YoY%) Change	↑	↓	↓	↓	↑	↓	↑	↓	↑	↑	↓	↓	↑	↓	↓	↑	↓	↓	↑	↓	↓	↓
	Vehicles Sales (Millions)	↑	↑	↑	↓	↓	↓	↑	↓	↓	↓	↓	↓	↑	↓	↑	↓	↓	↓	↑	↓	↓	↓
	Consumer Spending (Billions)	↑	↑	↑	↑	↑	↑	↑	↑	↓	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑
	NFIB Small Business Optimism (Base =100)	↓	↑	↓	↑	↓	↓	↓	↓	↓	↓	↑	↑	↑	↑	↑	↑	↑	↓	↓	↑	↑	↑
	University of Michigan Consumer sentiment (Base=100)	↓	↓	↓	↓	↓	↓	↓	↓	↓	↑	↑	↑	↑	↑	↑	↓	↓	↓	↓	↑	↑	↓
Business Activity	ISM Manufacturing PMI SA	↓	↓	↑	↑	↓	↓	↓	↓	↓	↑	↓	↓	↓	↑	↑	↓	↑	↑	↓	↓	↑	↓
	ISM-Non Manufacturing	↓	↓	↑	↑	↑	↓	↓	↓	↓	↑	↑	↓	↓	↑	↑	↓	↓	↓	↓	↓	↑	↑
	Industrial Product Manufacturing (Base =100)	↑	↓	↑	↑	↑	↑	↑	↑	↓	↓	↑	↑	↑	↑	↑	↓	↓	↑	↓	↓	↑	↑
	Philadelphia Fed Index	↑	↑	↑	↓	↑	↓	↓	↓	↓	↑	↓	↓	↓	↓	↑	↓	↓	↑	↓	↓	↓	↓
Employment Activity	US Initial Jobless Claims SA (000')	↓	↓	↓	↑	↓	↑	↓	↓	↓	↑	↑	↑	↑	↑	↑	↑	↑	↓	↓	↓	↑	↑
	Aggregarate Hours worked	↓	↓	↓	↓	↑	↑	↑	↑	↓	↓	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑
	Employees Nonfarm Payroll Total MoM Net Change	↑	↑	↑	↓	↑		↑	↑	↑	↓	↓	↓	↓	↓	↑	↑	↑	↑	↑	↑	↓	↑
Housing Activity	NAHB Homebuilder sentiment	↑	↓	↑	↑	↑	↓	↓	↓	↑	↑	↑	↑	↑	↑	↑	↓	↑	↓	↓	↑	↑	↑
	Building Permits (000)'	↑	↑	↓	↑	↑	↑	↓	↓	↓	↑	↓	↓	↑	↓	↑	↑	↑	↓	↓	↑	↑	↓
	Construction Spending Total SA (Millions)	↓	↓	↓	↓	↓	↓	↓	↓	↓	↓	↓	↓	↑	↑	↑	↓	↓	↓	↓	↓	↓	↓
	Housing Units Started (000)'	↓	↓	↓	↑	↓	↑	↓	↓	↓	↓	↓	↑	↑	↑	↑	↓	↓	↓	↓	↑	↑	↑
No. Of Negative Indicators		10	13	9	8	7	10	10	13	16	8	8	8	7	7	2	11	8	10	12	10	6	7
S&P 500 Return (YoY)		-5%	-16%	-22%	30%	7%	6%	11%	2%	-35%	35%	17%	-2%	9%	23%	16%	3%	15%	17%	-11%	20%	16%	28%

Sources: Bloomberg, HSBC Private Banking as at 3 October 2022. Past performance is not a reliable indicator of future performance.

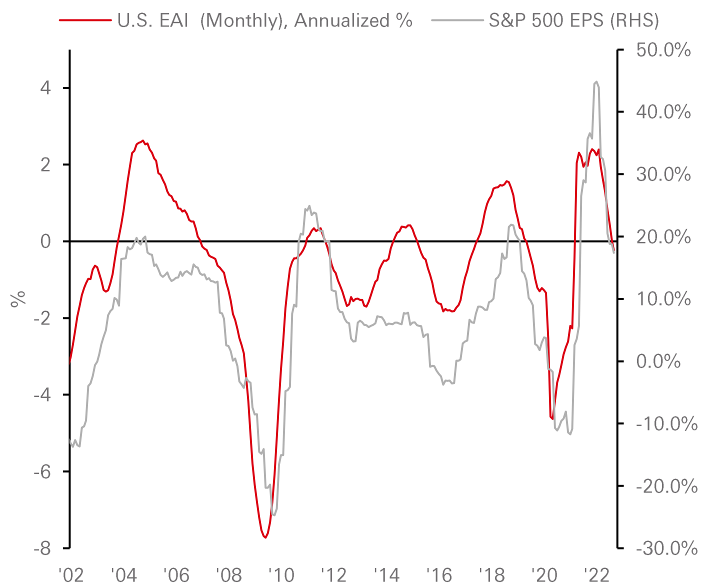
Our **economic activity indicator** charts the trend in activity, based on a number of economic indicators. The advantage of this index is that it gives a sense of the amplitude of the decline, as well as the direction of the trend. As the dashboard shows, the US economy has been resilient in the all important labour market, which, in turn, helps prop up spending. But given the strength of the recovery last year, it was inevitable that the economy would come to the boil. But its more than that – there is obviously some weakness in trade and the squeeze on incomes that is hurting confidence. This has led to a sharp decline in the trend. As with the dashboard, this trend is some distance from recessionary levels so we can feel so comfortable that, indeed, the economic backdrop does not yet support a recession.

This index works as a good fit for corporate earnings and equity investors will find some hope that earnings growth has fallen more relative to the index, pointing to a pricing in of the downturn.

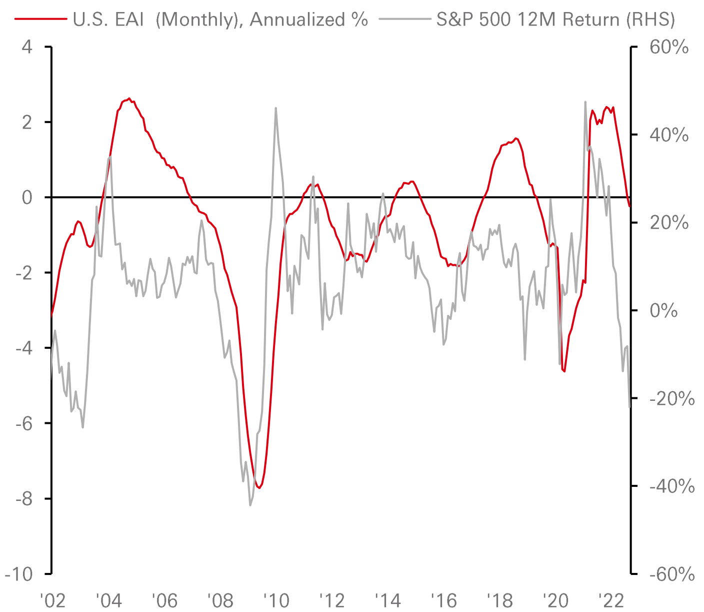
The issue is that the index is still in decline and, as we can see from previous recessions, the bottom in earnings has previously occurred when the bottom is reached. We haven't seen that bottom yet, which is a strong argument for taking a cautious approach. When the bottom does occur earnings start to improve soon after, so we can watch this index for a clear bottom before taking a more aggressive overweight on US equities.

The price moves ahead of earnings and, likewise, it moves ahead of our index. But price moves are more volatile, and as we point out above, can over or under react. Likely, before our indicator points to a clear improvement markets would have bounced higher, but missing out on the initial bounce should not prove too costly over the medium term. Instead, when the market bounce happens alongside a change in trend of the activity index, we can be more confident of a lasting bull market.

Activity index moves slightly ahead of earnings



Price leads activity but is also more volatile



Sources: Bloomberg, HSBC Private Banking as at 3 October 2022. Past performance is not a reliable indicator of future performance.

What does the market tell us?

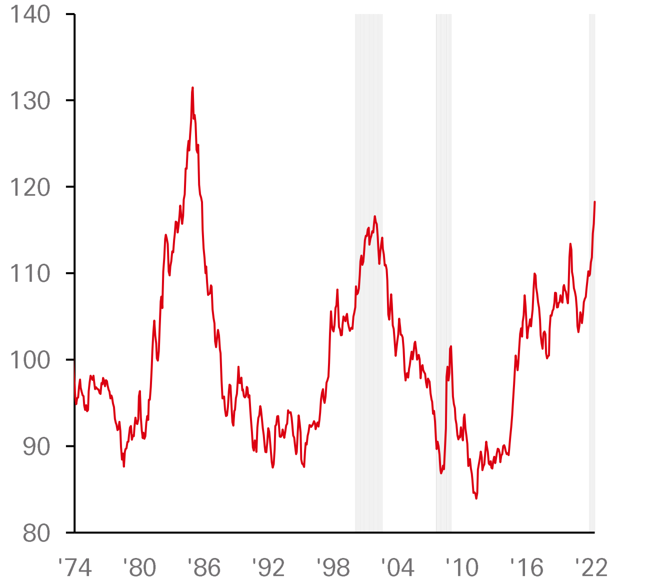
The economy points to an uncertain outlook, but how does this compare to the financial markets? On the next page we introduce another comprehensive list of indicators (this time focused on markets rather than economics) that we think are key pointers to a recession. From here we can get a clear sense of what the market is thinking and then tally this with the above observations as well as our expectations over the coming months. With each indicator, we take the reading at the peak of the bull market leading into the recession, followed by the reading when the market reacts to the ultimate trough. We then compare this to the December 2021 peak and the last couple of months. As with the economic data checklist, we do not include the COVID crisis as this extremely sharp shock isn't well captured by some of the monthly data.

Appendix B gives a detailed taxonomy of each indicator and what it implies. Some are flashing red, which we reason is in line with recessionary moves. As with economics, these are typically sentiment based: US investor sentiment had fallen to extremely low levels by June and the VIX had picked up to high levels, expressing uncertainty about the market ahead.

Another indicator to watch is the USD. Much like the current climate, leading up to the dot-com peak, the USD has been strengthening. However, when the market started to turn lower the USD saw another surge higher, as it did too during the financial crisis, even though the US was the catalyst for both crisis. Such is the size of the US economy, if it hits a downturn, the rest of the world suffers. The consequent de-risking drives investors towards the USD, much in the same way as we have seen this year. In fact, the rise in the USD is on a par with both of the dot-com and financial crisis recessions.

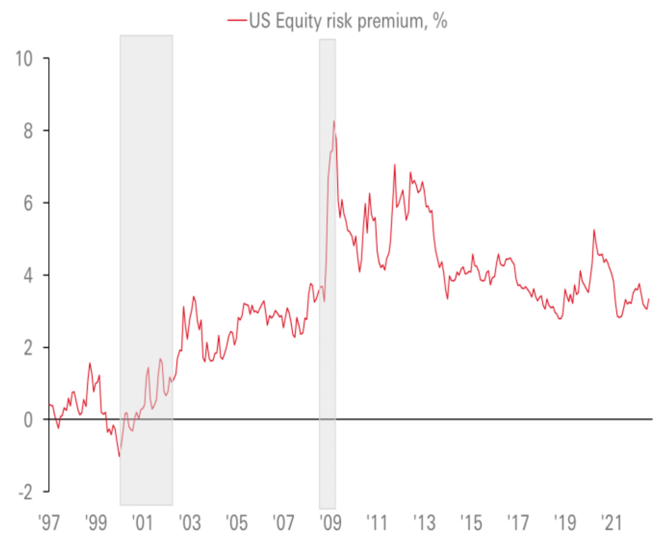
This is backed up, to a lesser extent, by the rotation into defensive stocks. Staples is a slam dunk defensive sector that dramatically out-performed during the two recessions. By June, this sector had out-performed by 18%, but by July this had eased back.

Real USD has rallied as in previous bear markets



Note: grey are shows 200/02 and 2007/09 equity bear markets as well as current year-to-date decline.

Equity risk premium hasn't moved as it did in previous bear markets



Note: grey are shows 200/02 and 2007/09 equity bear markets

Sources: Bloomberg, HSBC Private Banking as at 3 October 2022. Past performance is not a reliable indicator of future performance.

Some indicators point to more of a mid-cycle correction, as with consumer staples, which we colour coded amber because of the recessionary trend but lack of a clear signal. The total S&P drawdown fits into this bracket as the drawdown was half of what we saw during the recessions. Valuations tell a similar story – here we use the cyclically adjusted valuation to remove the earnings volatility.

One notable conclusion is that much of the decline was due to the move higher in rates. This can be seen by the non-existent move in the equity risk premium. This measure looks at the risk of owning equities over "risk free" bonds. If equities sell off amid higher rates, then the extra return from owning equities over bonds may be little changed. Arguably this has been true of this downturn, which is a bit at odds with the rise in volatility and rotation into defensives. It also is starkly different from the two recessions, where this measure surged. Therefore, it seems that the investors were clearly worried but didn't run for the door, instead preferring to rotate into more defensive sectors. In other words, there is room for the market to fall should risk aversion really bite amid a serious recession.

For now, though, earnings growth have stopped rising from the high levels of last year, but are generally holding up. This could be a different story later this year as we can see that profit margins remain very high and haven't come down anywhere near the levels in the previous troughs. Companies have been effective at passing through many of these costs

Dashboard of key indicators compared with Dotcom bubble and Financial Crisis

		Start of Bear Market			Trough		Current Condition*			
		Mar-00	Oct-07	Dec-21	Oct-02	Mar-09	Jun-22	Jul-22	Aug-22	Sep-22
Classification	Indicator									
Financial	US Yield Curve (10Y minus 2Y)	-0.5	0.5	0.8	2.2	1.9	-0.2	-0.2	-0.3	-0.5
	Change from Start of Bear Market				*2.7*	*1.3*	*-1.0*	*-1.0*	*-1.1*	*-1.2*
	M2 YoY % Change (Money Supply) %	6.3	6.1	12.4	6.8	9.3	5.9	5.3	4.1	
	Change from Start of Bear Market				*50bps*	*320bps*	*-650bps*	*-710bps*	*-830bps*	
	SPX Index - Trailing 12M Profit Margin	7.7	8.7	13.1	1.5	6.4	12.5	11.8	11.8	
	Change from Start of Bear Market				*-80.3%*	*-26.1%*	*-4.5%*	*-9.6%*	*-9.5%*	
	US Breakeven 10 Year	2.0	2.4	2.6	1.5	1.3	2.3	2.6	2.5	2.2
	Change from Start of Bear Market				*-25.3%*	*-44.4%*	*-9.5%*	*-1.5%*	*-3.1%*	*-16.9%*
	EPS (Drawdown from peak)				-25%	-50%				
	Dollar Index Spot	100.8	83.9	98.4	108.1	94.0	104.2	105.3	107.4	110.6
	Change from Start of Bear Market				*7.2%*	*12.0%*	*5.9%*	*7.0%*	*9.1%*	*12.4%*
	VIX	24.1	18.5	17.2	31.1	44.1	28.7	21.3	25.87	31.62
	Change from Start of Bear Market				*29.2%*	*138.2%*	*66.7%*	*23.9%*	*50.2%*	*83.6%*
	Chicago Fed Adjusted National Financial Conditions Index	-0.0033	0.3	-0.6	-0.5	2.1	0.12	-0.1	-0.2	0.0
	Change from Start of Bear Market				*-46bps*	*186bps*	*72bps*	*50bps*	*44bps*	*67bps*
Market Indicators	Market Cap % of GDP	1.0	1.0	2.4	0.6	0.5	1.9	2.1	2.0	1.85
	Change from Start of Bear Market				*-40.5%*	*-46.4%*	*-21.8%*	*-13.3%*	*-18.0%*	*-24.2%*
	US Equity risk premium, %	0.2	2.4	3.6	2.6	7.8	3.1	3.3	3.1	3.3
	Change from Start of Bear Market				*238bps*	*535bps*	*-56bps*	*-33bps*	*-56bps*	*-35bps*
	US Investor sentiment (% Bull - % Bear)	31.0	19.5	-3.0	-17.7	-30.9	-32.5	-19.5	-14.7	-40.8
	Change from Start of Bear Market				*-4870bps*	*-5040bps*	*-2950bps*	*-1950bps*	*-1170bps*	*-3780bps*
	S&P 500 Long Term P/E Ratio	35.6	22.0	34.9	19.6	11.8	27.4	29.4	28.3	25.9021
	Change from Start of Bear Market				*-44.9%*	*-46.4%*	*-21.4%*	*-15.7%*	*-19.0%*	*-25.7%*
	US earnings revisions	0.6	0.5	0.5	0.2	0.2	0.4	0.3	0.4	0.4
	Change from Start of Bear Market				*-62.4%*	*-61.9%*	*-30.6%*	*-46.4%*	*-14.1%*	
	Oil (CO1 Comdty)	24.8	90.6	77.8	25.7	49.2	114.8	110.1	96.5	88.0
	Change from Start of Bear Market				*3.8%*	*-45.7%*	*47.6%*	*41.6%*	*24.1%*	*13.1%*
	Copper	80.5	347.3	446.4	71.7	184.5	371.5	357.4	351.9	341.25
	Change from Start of Bear Market				*-10.9%*	*-46.9%*	*-16.8%*	*-19.9%*	*-21.2%*	*-23.5%*
	S&P 500 Drawdown				-45%	-43%	-21%	-13%	-18%	-25%
	Consumer Staple vs Market (increase from Market Peak)				115%	50%	18%	11%	14%	16%
	Skew Index	113.4	116.9	154.4	109.1	112.9	119.9	122.3	119.7	123.59
	Change from Start of Bear Market				*-3.8%*	*-3.4%*	*-22.3%*	*-20.8%*	*-22.5%*	*-19.9%*
EAI	Economic Activity Indicator YoY (%) (HSBC)		-0.8%	2.4%	-1.0%	-7.2%	0.8%	0.4%	0.02%	-0.2%
	Change from Start of Bear Market					*-654bps*	*-140bps*	*-170bps*	*-314bps*	*-340bps*

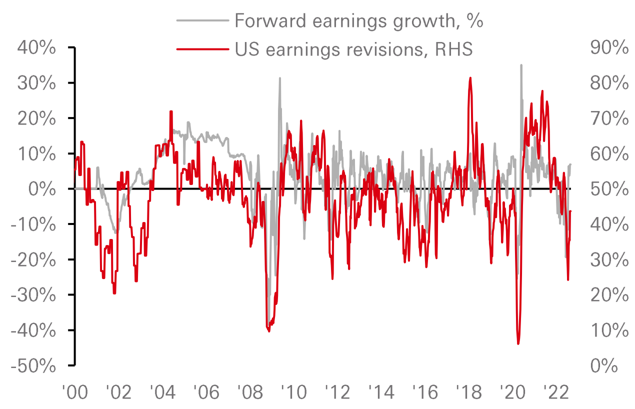
Sources: Bloomberg, HSBC Private Banking as at 3 October 2022. Past performance is not a reliable indicator of future performance
*June-22, July-22 & Aug-22 Comparison is with Dec-21;
Colour Coding: Amber-Weakening with further chance of deterioration; Red- At Recession level

but as rates rise and incomes are squeezed this could become much harder. A more leading indicator of earnings revisions did move significantly lower and was not far off a recessionary level. Its seems that analyst have been relatively quick to downgrade some of their earnings estimates but with only modest downwards revisions. This may prove to be the best approach as profit margins come under pressure but the economy battles on and revenues prove resilient. The third quarter earnings results should be very closely watched for signs of a turning point on revenues and margins. Recent data has shows some promising signs as earnings revisions have bounced back, which didn't happen in the previous bear markets, which showed a more persistent downtrend.

What is abundantly clear is that in recent history, markets have taken a persistent turn high on the back of a pivot in central bank policy. The financial indicators show that policy hasn't eased and is, in fact, tightening: Money supply growth is falling (albeit from high levels); the yield curve isn't steepening because the market is pricing higher policy rates, not lower; breakeven rates are still above the 2% inflation target, rather than falling to reflect a recessionary absence of demand; and financial conditions haven't begun to ease, with mortgage rates having risen very sharply. This may well be fine if this is just a mid-cycle correction as growth can pick up again and the market can move back into a late-cycle move higher. A catalyst for this would be a return of the missing labour supply, lost to the pandemic through either early retirement, ill health or simply taking a break from working due to high savings. A possibility that we wouldn't bet against.

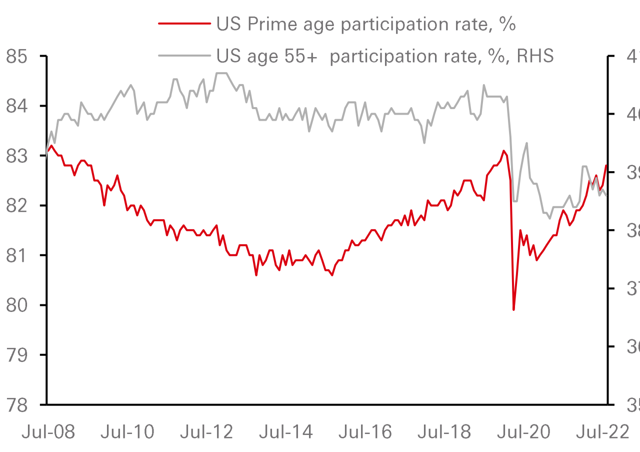
Financially, some signals might be less reliable this time around. Oil rose significantly due to the Ukraine war before falling partially. Copper is behaving more typically, softening on weaker expected activity. Market skew, a measure of the demand for tail risk hedging, was high going into the market peak because investors were still reeling from COVID. That said, there are signs now that investors are more comfortable with tail risk and that part of the recent strong returns has been driven by investors unwinding short positioning – previously a positive sign of a market low.

Earnings have held up despite the analyst downward revisions



Recessionary bear markets turn when yields curves steepen

There is room for labour market to growth if over 55s return



Sources: Bloomberg, HSBC Private Banking as at 3 October 2022. Past performance is not a reliable indicator of future performance.

Conclusion

The overall picture is of a market that has behaved as if we are in a mid-cycle correction: sentiment was braced for a downturn in June but earnings were generally more positive than expected in Q2. Our indicators show that in June there were some of the hallmarks of a market bottoming during a recession but with some key omissions: Investor sentiment had plummeted to recessionary lows and there was a significant rotation into more defensive sectors, but "hard" data on earnings and the economy was still proving to be resilient – and there wasn't even a glimmer of a Fed "pivot".

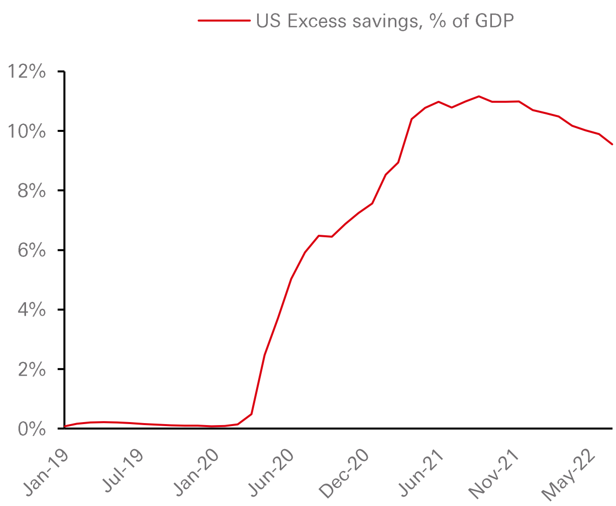
From mid-June to mid-August, markets recovered while economic data remained mixed. As visible in our indicators, there was a sign that investors had become a little too complacent, as they have treated the recent bear market as a mid-cycle correction. Since Fed Chairman Powell delivered a more hawkish message at Jackson Hole, higher interest rates and squeeze incomes means the economy is not out of the woods yet, leading to another leg down in markets. As it stands, the market is currently some distance off from pricing in a recession.

On a more positive note, **there are some more idiosyncratic pluses** for the outlook. We think that excess savings, tight labour markets and comparative advantages will lead to a resilient US economy. There hasn't been a liquidity squeeze either, meaning that the type of crisis that we saw in 2008 is unlikely – especially with banks far better capitalised than in 2007. The ability of banks to provide lending and act in a less pro-cyclical manner should not be underestimated.

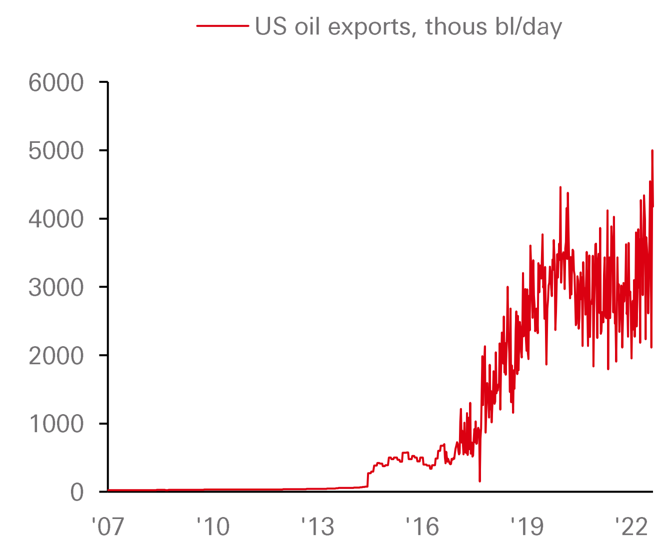
But we have to **acknowledge that the data is mixed** and the economic trend has turned higher, or at least slowed meaningfully. This makes us reluctant to forecast a quick and sustained market bounce for now or have an overly cyclical positioning. Instead, we keep a diversified approach and keep a mix across value

and growth styles. We also continue to reach for quality and prefer investment grade over high yield debt. To further manage the risks, our largest overweight is in hedge funds.

High accumulated saving could help prevent serious downturn



The US is more self-sufficient on energy and is now a major oil exporter



Structurally, we think rates are likely to remain low, as illustrated by the long-term 'DOT' plot from the Fed, where the expected long-term rates is still at 2.5%. This is pivotal for the outlook for high growth stocks that performed so well during the "secular stagnation" narrative. Obviously, the US market hinges more on growth due to its large technology bias, so an easing of inflation and an eventual return to lower rates should eventually support the pre-crisis level of equity valuations. In other words we do not expect a structural unwind of the post-financial crisis bull market. More likely, the demographic headwinds to rates and growth, not to mention high leverage, led to a more likely scenario of low rates and relatively high equity valuations. In the meantime, we will share how our indicators develop and act accordingly.

Sources: Bloomberg, HSBC Private Banking as at 3 October 2022. Past performance is not a reliable indicator of future performance.

Appendix A – Breakdown of economic data

Economic indicator comparison with previous recessionary bear markets

		Start of Bear Market			Trough		Current Condition*			
		Mar-00	Oct-07	Dec-21	Oct-02	Mar-09	Jun-22	Jul-22	Aug-22	Sep-22
Classification	**Indicator**									
Consumer	Conference Board consumer confidence (Base =100)	137.1	95.2	115.2	115.2	26.9	98.4	95.7	103.2	108
	Change from Start of Bear Market				*-16.0%*	*-71.7%*	*-14.6%*	*-16.9%*	*-10.4%*	*-6.3%*
	Retail Sales (YoY%) Change	6.8%	3.9%	12.5%	3.2%	-3.3%	5.7%	8.7%	6.6%	
	Change from Start of Bear Market				*-360bps*	*-720bps*	*-720bps*	*-380bps*	*-590bps*	
	Auto Sales Total (Millions)	18.0	16.1	12.4	15.9	9.6	13.0	13.4	13.2	
	Change from Start of Bear Market				*-11.3%*	*-40.4%*	*4.5%*	*7.3%*	*5.9%*	
	Consumer Spending (YoY%) Growth	9.0%	5.2%	12.9%	3.2%	-2.6%	8.4%	8.7%	8.2%	
	Change from Start of Bear Market				*-580bps*	*-780bps*	*-450bps*	*-420bps*	*-470bps*	
	US Excess savings, % of GDP			10.7%			9.9%			
	NFIB Small Business Optimism (Base =100)	101.7	96.1	98.9	100.3	81.6	89.5	89.9	91.8	
	Change from Start of Bear Market				*-1.4%*	*-15.1%*	*-9.5%*	*-9.1%*	*-7.2%*	
	University of MIchigan Consumer sentiment (Base=100)	107.1	80.9	70.6	80.6	57.3	50	51.5	58.2	
	Change from Start of Bear Market				*-24.7%*	*-29.2%*	*-29.2%*	*-27.1%*	*-17.6%*	
Business Activity	ISM Manufacturing PMI SA (Base =50)	54.9	52.8	58.8	49	37.2	53	52.8	58.2	58.6
	Change from Start of Bear Market				*-10.7%*	*-29.5%*	*-9.9%*	*-10.2%*	*-1.0%*	*-0.3%*
	ISM-Non Manufacturing	57.4	53.6	62.3	51.4	40.1	55.3	56.70	56.90	
	Change from Start of Bear Market				*-10.5%*	*-25.2%*	*-11.2%*	*-9.0%*	*-8.7%*	
	Industrial Product Manufacturing (Base =100)	92.3	101.7	101.8	90.5	86.6	104.4	104.81	104.55	
	Change from Start of Bear Market				*-2.0%*	*-14.9%*	*2.6%*	*3.0%*	*2.7%*	
	Goods Exports (YoY%) Growth	14%	13.2%	20.6%	2.4%	-21.7%	22.3%	23.7%		
	Change from Start of Bear Market				*-1110bps*	*-3490bps*	*170bps*	310bps		
	ISM New Order	56.2	55.8	*61.0*	*52.1*	*41.3*	49.2	48.0	51.3	
	Change from Start of Bear Market				*-7.3%*	*-26.0%*	*-19.3%*	*-21.3%*	*-15.9%*	
	Goods Import (YoY%) Growth	25.4%	9.1%	20.7%	6.2%	-31.0%	21.7%	16.0%		
	Change from Start of Bear Market				*-1920bps*	*-4010bps*	*-100bps*	-438bps		
	Philadelphia Fed Index	19.4	7.8	15.4	-7.6	-34.7	-3.3	-12.3	6.2	
	Change from Start of Bear Market				*-139.2%*	*-544.9%*	*-121.4%*	*-179.9%*	*-59.7%*	
Employment Activity	US Initial Jobless Claims SA (000')	266.0	328.0	224.0	409.0	665.0	231.0	248.0	232	193.0
	Change from Start of Bear Market				*53.8%*	*102.7%*	*3.1%*	*10.7%*	*3.6%*	*-13.8%*
	Aggregarate Hours worked (YoY%) Growth	2.9%	1.2%	4.1%	-0.9%	-7.2%	4.1%	3.8%	3.6%	
	Change from Start of Bear Market				*-380bps*	*-840bps*	-	*-28bps*	*-50bps*	
	Employees Nonfarm Payroll (YoY%) Growth	2.6%	1.0%	4.7%	-0.2%	-4.2%	4.3%	4.2%	4.0%	
	Change from Start of Bear Market				*-280bps*	*-520bps*	*-40bps*	*-50bps*	*-70bps*	
Housing Activity	NAHB Homebuilder sentiment	64.0	19.0	84.0	61.0	9.0	67.0	55.0	49.0	
	Change from Start of Bear Market				*-4.7%*	*-52.6%*	*-20.2%*	*-34.5%*	*-41.7%*	
	Building Permits (000)'	1651.0	1192.0	1896.0	1799.0	513.0	1696.0	1685.0	1542.0	
	Change from Start of Bear Market				*9.0%*	*-57.0%*	*-10.5%*	*-11.1%*	*-18.7%*	
	Construction Spending Total SA (YoY%) Growth	9.8%	-3.3%	7.3%	2.0%	-12.7%	9.6%	8.5%		
	Change from Start of Bear Market				*-780bps*	*-940bps*	*230bps*	*120bps*		
	US New One Family Houses Monthly Supply SA	4.3	8.5	5.6	4.0	11.0	9.2	10.9	8.1	
	Change from Start of Bear Market				*-7.0%*	*29.4%*	*64.3%*	*94.6%*	*44.6%*	
	Housing Units Started (000)'	1604.0	1264.0	1768.0	1648.0	505.0	1559.0	1446.0	1575.0	
	Change from Start of Bear Market				*2.7%*	*-60.0%*	*-11.8%*	*-18.2%*	*-10.9%*	
EAI	Economic Activity Indicator YoY (%) (HSBC)		-0.8%	2.4%	-1.0%	-7.2%	0.8%	0.4%	0.02%	-0.2%
	Change from Start of Bear Market					*-654bps*	*-140bps*	*-170bps*	*-314bps*	*-340bps*

Sources: Bloomberg, HSBC Private Banking as at 3 October 2022. Past performance is not a reliable indicator of future performance .*June-22 & July-22 Comparison is with Dec-21;
Colour Coding: Amber-Weakening with further chance of deterioration; Red- At Recession level

Appendix B – Market/financial indicators

Yield curve

Leading into a late cycle, the yield curve famously flattens to the point of inversion. This tightening of policy rates beyond the market's longer-term view is usually enough to bring the economy into a recession, but sometimes only a growth slowdown. When the resulting bear market reaches a low it is increasingly the case that the turn around in sentiment comes hand-in-hand with a pivot in policy from the Fed. The consequent fall in policy rate expectations forces the yield curve higher through a bull-steepening. Current debate is over whether the Fed will hike at a slow pace or pause at levels lower to expectations – this is a far cry from the steepening we saw in the previous recessions, where Fed policy headed in the opposite direction, with rate cuts and QE.

Result: no bear market trough.

Money supply (M2)

As with policy rates, money supply tends to increase as the market touches bear market lows. This measure was very high leading into the market peak as QE became a large part of the COVID stimulus response, so comparisons between then and now may not provide a clear signal. Yet, with money supply growth set to face further headwinds from QT, this is unlikely to provide the signal to buy any time soon and seeing that QE is a fundamental part of the policy toolkit a rise to higher levels of growth can be expected in a true Fed pivot.

Result: no bear market trough.

Profit margins

The financial crisis and dot-com bubble were followed by large falls in profit margins as revenues dried up. Profit margins entered into the market peak at much higher levels than these two prior highs, pointing to a key vulnerability to the market. Higher input costs would stress these levels and higher rates could also make borrowing costs harder to service. Therefore, this should be a key metric to follow and Q3 earnings results will be keenly watched for signs of a deterioration.

Result: No signs of bear market pressure but Q3/Q4 results will be key.

US Breakeven rates

Much like a steepening yield curve, falling breakeven rates go hand-in-hand with looser Fed policy. After all, the Fed targets inflation and if it looks like inflation is set to miss on the downside over the medium term that they can cut rates. The fact that breakeven rates have held up reasonably well, shows that the Fed would find it hard to argue that inflation is firmly under control.

Result: Expectations have moved lower but the level remains too high for a bear market.

US Dollar

That the USD strengthens during bear markets isn't surprising: falling growth leads to risk aversion and the USD is seen as a safe haven currency. Because falling US demand affects the global economy, funds seek haven in US Treasury markets rather than more vulnerable emerging markets or more cyclical European markets. In this case, the USD has been boosted by the more hawkish Fed but they are not the only central banks hiking and there has been a risk-off tone to the markets.

Result: In line with bear market low.

Volatility (VIX)

There's no denying that volatility is ranging at higher levels compared to pre-crisis lows. During the depth of the COVID crisis, it touched over 80 and in market this year it reached 36. This high would be in line with spikes seen during the deflating of the dot-com bubble but short of a crisis. After peaking in June, this measure has eased so it would could retrospectively have been a signal calling for a June low. If we are yet to touch a bear market low we would expect this to rise substantially again.

Result: High but stops short of typical low.

Financial conditions (Chicago Fed survey)

We use the Chicago Fed survey because of its breadth and focus on the broader economy – we are not fans of using purely market-based measures because it becomes too narrow and is of doubtful for us when comparing to what's priced in to the market. Higher mortgage rates, and tighter bank funding have played a part in tightening financial conditions. In the financial crisis, financial conditions peaked further into the down market so that by the time of the bear market low that had eased. Right now, we see little signs of easing, with the Fed's hiking likely to be a continued headwind.

Result: Some easing needed before matching bear market low.

Market cap as percent of GDP

The fall in total equity market cap compared to GDP is strikingly similar to the previous two crises, with both down by just under a half. An investor consensus around a lower for longer rates environment has pushed this metric up to very high levels and matches profit margins as a key vulnerability to the market: should rates structurally move higher, then this could lead to a rebalancing of investors away from equity towards fixed income. We doubt this is likely though, as many of the structural factors, such as high debt, low potential GDP growth, inequality and demographics are likely to be persistent drivers of lower rates, even after the pandemic. Therefore we think the change from peak levels is the more important factor to look at, and here higher nominal GDP and falling markets have made a significant dent.

Result: Some correction but room for more falls for a bear market low

Equity risk premium

Earlier in the year, the sell-off in equities was largely driven by rising real interest rates. With such a tech-heavy index composition, the US market has been vulnerable to rising real rates. This is because a higher discount rate for cash flows favors near term returns to shareholders above longer term growth stocks. The small change in the equity risk premium underscores that relative to the change in the bond market, equities haven't cheapened significantly – in other words, the premium for taking equity risk is a similar level to pre-crisis levels. In a recession, the risk premium would widen significantly to reflect the risk aversion of investors.

Result: Little changed and not representative of a bear market

Investor sentiment

This is one indicator that was in tune with a recession in June and has since improved. Although still firmly negative, the improvement since June points to a market unwinding from especially bearish sentiment

Result: June typical of a recession but improvement since

Cyclically adjusted valuation

We use the cyclically adjusted valuation as this smooths out the earnings cycle across 10 years. With less earnings volatility, we can get a better understanding of how the market is valued based on longer term trends, taking out the volatility of the near term earnings cycle. On this measure, markets certainly corrected in June, very much in line with a mid-cycle downturn, but still some distance from a recession.

Result: Some correction but room for more falls for a bear market low

Earnings revisions

This reading expresses the ratio of analysts upgrading earnings forecasts compared to those that are downgrading forecasts. Much like other sentiment positioning, this indicator is well on the way towards recessionary levels in July. Recent data shows an improvement which is a positive sign for the market as during the last two recessions, once sentiment improved, it didn't touch new lows.

Result: A large way towards recessionary lows

Oil

During a recession, oil falls on the back of lower demand. This time, the unusual circumstances of reduced investment following COVID and the Ukraine war mean that this indicators is more volatile and less reliable – it has played a large part in the downturn rather than a symptom. However, it is down from the highs of June as the market began to focus on the economic cost.

Result: Price too high for recession but signs of slowdown

Copper

"Dr Copper" is used as an indication of an investment slowdown. This price has eased lower and is closer to a recessionary low. Our forecasts are more neutral on industrial commodities and copper could gain from the pick-up in clean energy infrastructure – again potentially blunting this as a signal.

Result: Some correction but room for more falls for a bear market low

Consumer staple vs market

Consumer staples are a relative safe-haven during times of hardship because of their more stable cash flows and established position. Also, the out-performance occurs as the more cyclical sectors suffer as earnings struggle amid lower discretionary spending.

Result: Some correction but room for more falls for a bear market low

Skew

Skew is a measure of expected volatility of out of the money options compared to in the money options. As this increases, it implies that there is more demand for significant negative downside protection. As this index eases low the implication is that investors see less risk of downside, presumably because the market is reaching a perceived low point or that most hedging has been down and, therefore, there is room for a bounce in sentiment from low levels. This heading into the peak in December 2021 at high levels since COVID was still creating uncertainty and rate hikes were being more aggressively priced in. This has since moved lower, typically indicating a promising sign of recovery. However, the level is still relatively high compared to a longer term history

Result: Fallen by significant amount, similar to recessionary bear market, but level still relatively high

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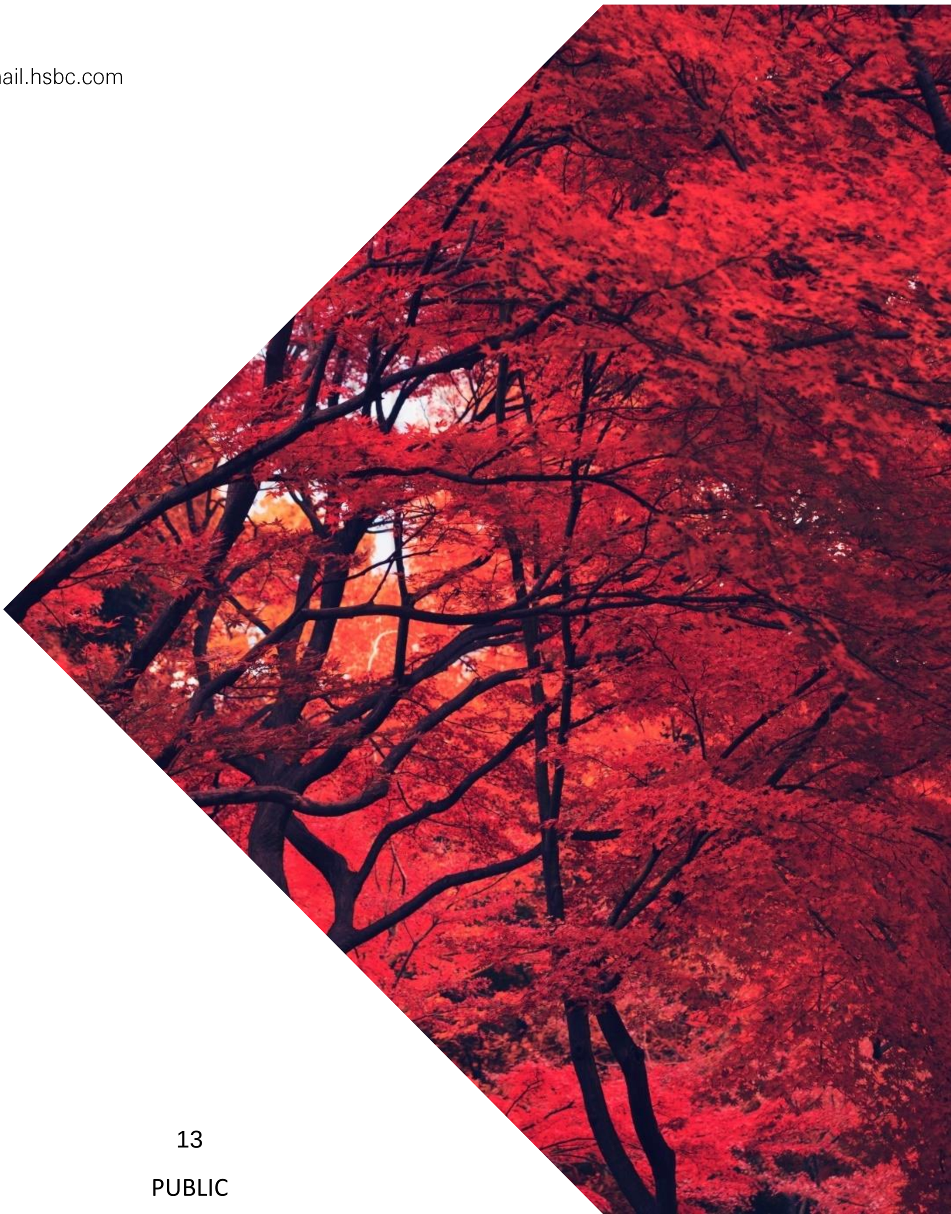

Risk Disclosures

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.

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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

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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.

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