Equity Insights

A new global equity regime

July 2025

For professional investors only

HSBC Asset Management

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Foreword

The global equity landscape is no longer defined by growth, momentum and US dominance, but by a broadening of opportunities across regions and factors.

Pierin Menzli
Global CIO, Equity
HSBC Asset Management

Welcome to the July 2025 edition of our Equity Insights publication. This year has marked a significant turning point in global equity markets, as the long-standing era of US outperformance faces mounting challenges.

For over a decade, US equities have benefited from the dominance of the 'Mag 7' technology giants, a resilient economy, and a strong dollar. However, stretched valuations, a potential economic slowdown, and the diminishing certainty of dollar strength have prompted investors to explore opportunities beyond the US.

In this edition, we examine the structural changes and valuation fundamentals driving this shift. Europe, long underweight in global portfolios, now presents a compelling case as changes in fiscal policies and more room for monetary support coincide with a brightening economic outlook. Emerging markets likewise present interesting entry points with significant valuation discounts.

As part of our discussion, we also explore the shifting dynamics of factor performance. It is no longer as simple as allocating to US large caps, growth and momentum to achieve outperformance. This year has seen much rotation between factor leadership as investors played defence while chasing earnings momentum.

As it stands today, valuation anomalies are still near historical extremes that we think present opportunities for long-term investors. Even in the absence of rerating, this year has demonstrated how discerning equity investors can outperform through exposure to carry.

We trust this publication offers valuable perspectives as you consider the implications of these trends for your investment strategies. As always, we aim to provide actionable insights to help you navigate the complexities of global equity markets.

In a nutshell

- Global equity markets are transitioning. Post the Global Financial Crisis, the US led the way in economic growth, corporate profits, and equity market performance, while the rest of the world focused on recovery. However, today, US dominance is being tested by stretched valuations, economic headwinds, and growing uncertainty surrounding the resilience of the US dollar.
- After years of being neglected, Europe and emerging markets are now well-positioned to challenge the leadership of the US in global equity markets. This shift is supported by more attractive valuations, improving economic conditions, a shift away from austerity to widely applauded fiscal initiatives and more supportive monetary policy backdrop
- In Europe, value and small caps particularly stand out, with discounts near extreme levels creating a significant potential for mean reversion. This is supported by stabilising economic indicators which offer the potential for improving growth for these select parts of the market.
- Factor performance is also shifting as part of this year's transition within equity markets. In a sign of regime change, markets are no longer confident in any one style, but are rotating defensively.
- Ultimately, we think valuation gaps between the US and other regions have significant room for at least partial mean reversion after reaching levels that are difficult to justify given cycles don't often repeat themselves. International diversification should take on growing importance, but a bumpy path for markets means a nuanced approach can be beneficial.

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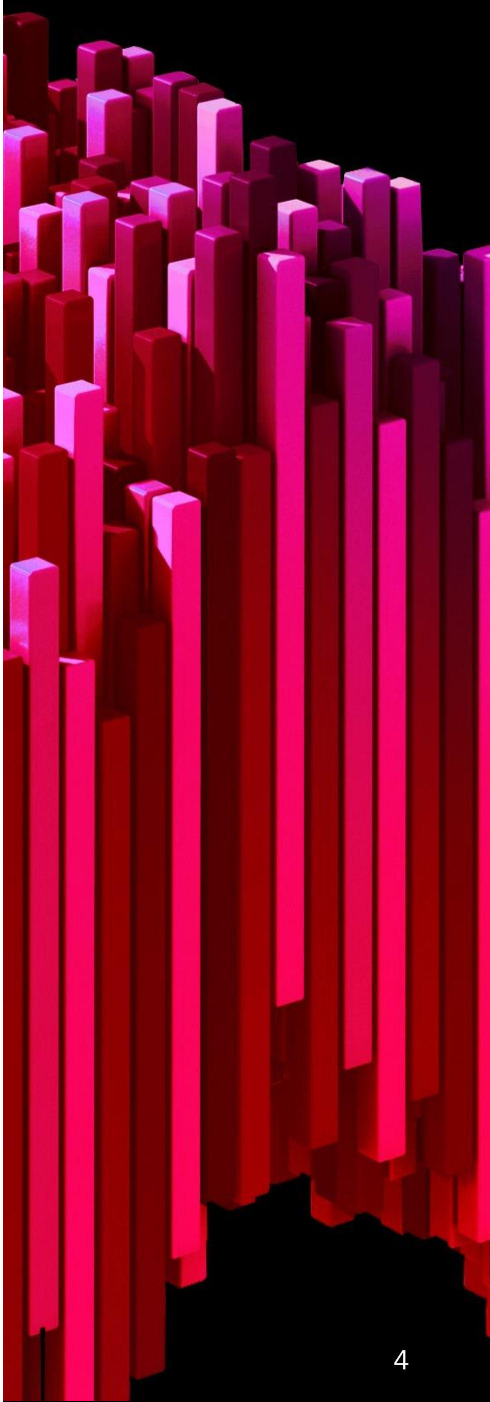


A new global equity regime

The broadening out of equity markets this year has been a bumpy ride. More than a single disruptive event, we see an accumulation of pressures that have reset investor expectations."

Pascal Pierre
Head of European Equity
HSBC Asset Management

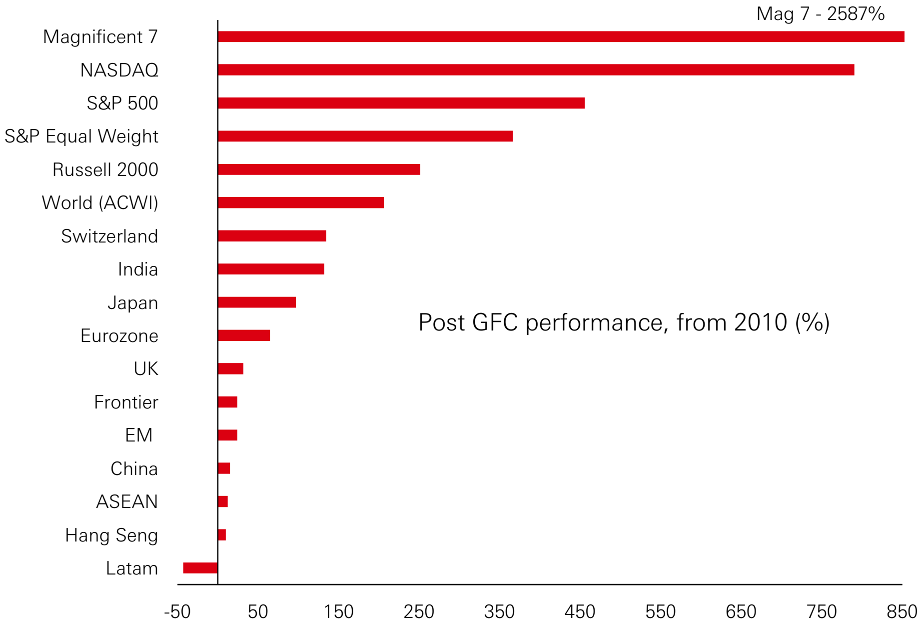
Ben Potts
Quantitative Equity Analyst

Karen Olney
Investment Strategist – Global multi asset research

Global equity markets appear to have reached an inflection point this year, marked by significant shifts in market dynamics that have coincided with historical valuation anomalies. Since the Great Financial Crisis, US equities have enjoyed a period of pronounced outperformance, driven more recently by the dominance of the 'Mag 7' technology giants alongside a resilient economy and a strong dollar. However, the era of 'US exceptionalism' is now facing headwinds, including stretched valuations, a potential economic slowdown, and the diminishing certainty of the dollar as a one-way bet. These factors have prompted investors to explore opportunities beyond the US, particularly in Europe and China, where improving economic conditions and less demanding valuations have created compelling investment cases even after the recent outperformance.

Since the global financial crisis, the US has benefited from above-average fiscal stimulus and tech-driven growth, with the former becoming more difficult in the context of current debt dynamics. Plus, today, we see more active fiscal support elsewhere. Germany's sizeable fiscal commitments for infrastructure and defence – a sharp departure from the past – and China's pro-growth policies are helping to trigger an end to years of US profit dominance and non-US profit scarcity during an era of 'US exceptionalism'.

Figure 1: Rest of World - EM still lags S&P by 400%



Source: Refinitiv, MSCI, HSBC Asset Management, July 2025.

Rewriting the playbook

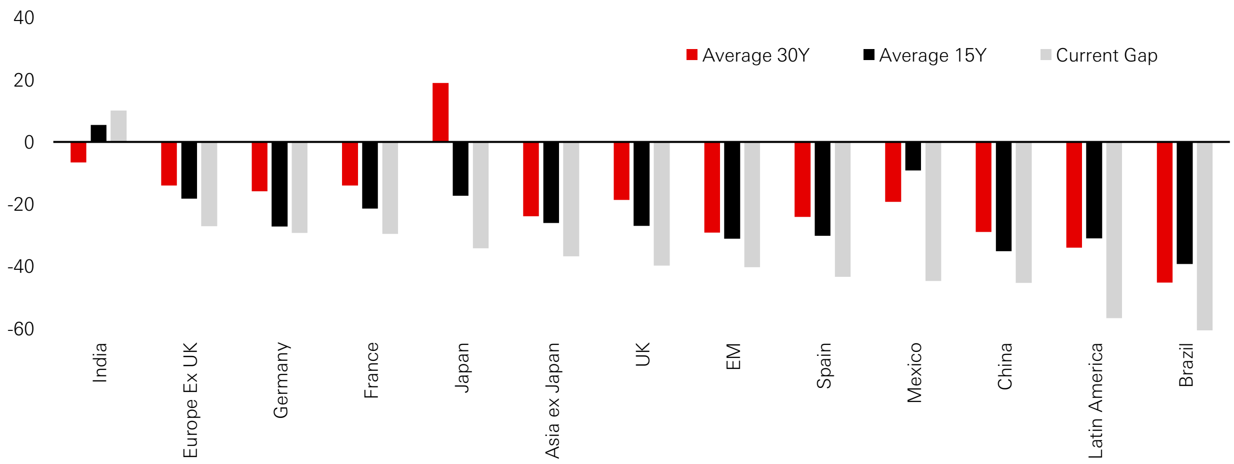
US outperformance was supported by its ability to recover quickly from crises, such as the Global Financial Crisis, where aggressive fiscal and monetary policies were implemented to drive an economic rebound. This drove US equity market dominance amid profit scarcity in other regions, particularly Europe, which took years to repair its banking sector and stabilise its economies. Accordingly, the investment playbook was straightforward. Allocate to above-average US economic growth and the big tech profit growth engine. Watch as passive flows, low rates, and dollar strength compressed volatility and magnified growth.

That regime now looks exhausted, with the rules governing equity investing being rewritten. The once-dependable growth engine of the US is encountering resistance: not just from rising bond yields, uneven economic data, and political uncertainty, but also from the rest of the world beginning to reassert its relevance in investors' portfolios.

In this noisy and unpredictable environment, investors must cut through narrative whiplash and re-anchor in structural and valuation fundamentals.

We learned that cycles don't often repeat themselves consecutively. Different regions have taken turns leading the market, from Europe in the 1980s to Emerging Markets in the 2000s and the US in the 2010s. This historical context underscores that starting valuations matter, which currently favour emerging markets like Latin America and China, trading at price-to-earnings (P/E) ratios of 9.4x and 11.4x compared to the US at 22.5x. Such large discrepancies in valuations support the case for upside potential outside the US, particularly where we see value meeting improving economic fundamentals and structural change.

Figure 2: PE gaps versus US over time (long/medium term vs current)



Source: HSBC AM, Refinitiv, MSCI. Data as of May 2025.

In developed markets, Europe offers compelling starting points after having been overlooked for years. Importantly, the European Central Bank has more room to manoeuvre, given lower inflation levels, while significant fiscal spending initiatives such as those in Germany support improving growth expectations after years of post-crisis repair and austerity. Data supports this, with stabilising economic indicators such as PMIs. Further re-rating of European markets may be in store, which would also be helped by prospects for an end to the Ukraine war.

The case for European equities

Europe is one of the global value plays and was left behind in an era of profit scarcity, leaving it underweight in global portfolios. Austerity politics, bank repair, and low growth meant that investors stayed away, preferring the seemingly endless dynamism of US equities in developed markets. But that cycle may now be turning for reasons that go beyond tactical rotation. In the past, US equities have commanded a valuation premium over their European peers that reflected higher growth expectations. However, since 2021, this valuation gap has widened to extremes that appear to be an overshoot, leaving us with expectations for mean reversion. The relative price-to-earnings (P/E) of US stocks versus those of Europe has reached levels that are difficult to justify based on current growth differentials, with US tariffs forecast to impact US economic growth more than non-US.

In figure 3, we compare earnings growth differentials between the US and Europe against relative valuations, with the growth differential (red line) lagged by one year. This allows us to visualise the strength of valuations in predicting future relative earnings growth. We can see that this relationship was quite strong before breaking down around 2021. Based on relative valuations today, markets are pricing in a roughly 20% growth advantage for the US. We think this is unrealistic.

Figure 3: Relative valuation and growth of US versus Eurozone

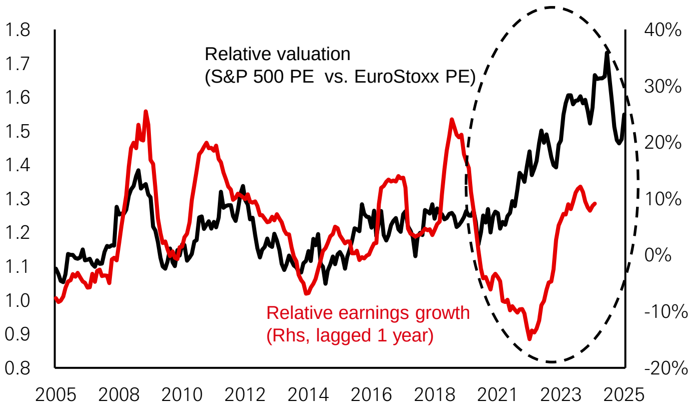
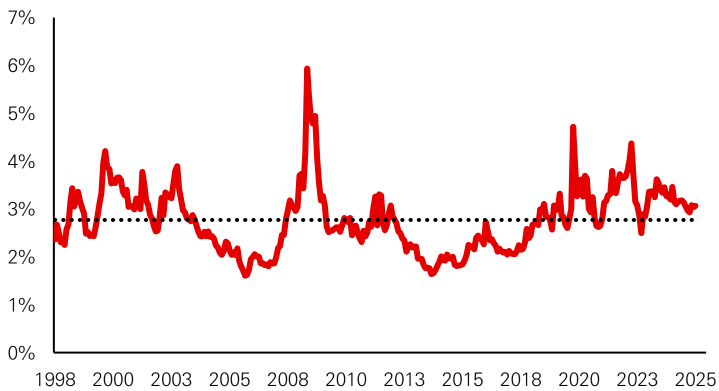


Figure 4: Relative valuation – Europe value vs overall market



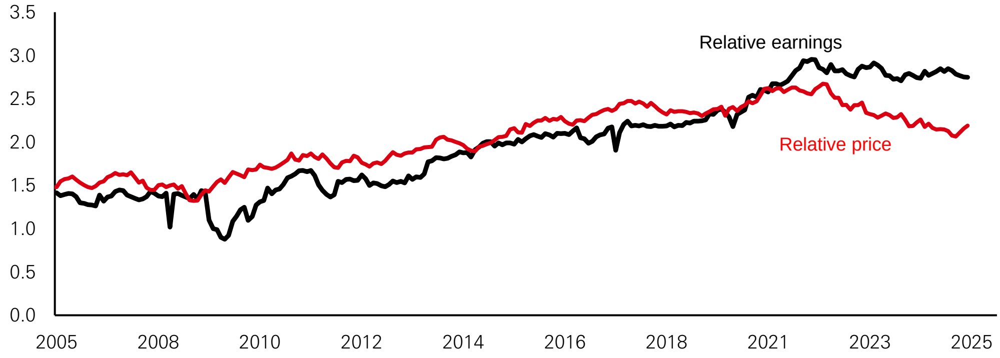
Source: HSBC AM, Bloomberg. Data as of July 2025.

Within European equities, one of the most striking anomalies is the historical discount for value stocks relative to the broader market. Using earnings yields as proxies for discount rates, we see that the risk premium for value stocks has risen substantially since 2021. This contrasts a past relationship that saw any premium in the valuation spread between value and growth stocks quickly normalise. Although this spread has partly normalised in recent months due to the strong performance of value stocks, it remains above long-term averages.

European banking sector P/Es have even fallen to levels last seen during the global financial crisis of 2008. Even in the absence of a valuation rerating, this presents an opportunity to profit from carry. Accordingly, European banks have quietly become one of the best-performing areas in developed markets, powered not by rerating but by dividends and share buybacks, alongside a bit of growth.

Similar to European value stocks, small caps have experienced a significant de-rating and are now trading at all-time lows relative to large caps, despite stable earnings growth. These divergences between price and fundamentals highlight potential market inefficiencies that could offer alpha for investors willing to take a contrarian stance.

Figure 5: Relative earnings and price of European small vs large cap

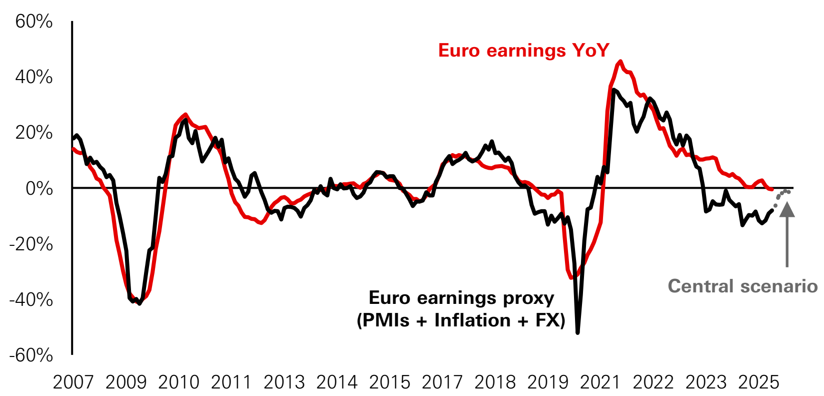


Source: HSBC AM, Bloomberg. Data as of April 2025.

The potential in small caps is supported by signs of improvement in economic conditions in Europe. Germany's recently announced fiscal stimulus package will only support improvement and could spur a more active fiscal approach elsewhere in the region. Defence spending is a particular area likely to benefit from this fiscal push, creating specific beneficiaries for investors seeking thematic opportunities within their equity allocations.

Together with room for the ECB to be accommodative in stimulating growth, given low inflation, these factors build the case for a structural rerating of European equities. However, a key risk is dollar weakness hurting European corporate earnings growth. According to our sensitivity analysis, a 10% appreciation in the euro could reduce European corporate earnings by approximately 3.65%.

Figure 6: A stronger EUR could weight on earnings



	PMIs	CPI	PPI CPI	EUR
ΔMacro (Model)	+5 pts	+0.5 ppt	+0.5 ppt	+10%
ΔEPS (Model)	+2.5 ppt	+2.15 ppt	-0.3 ppt	-3.65 ppt
Ytd Δ Macro	+3.3 pts	-0.2 ppt	+2.7 ppt	+12.4%
Ytd Δ EPS	+1.85 ppt	-1.3 ppt	-1.54 ppt	-3.78 ppt

Source: HSBC AM, Bloomberg. Data as of July 2025.

With economic surprise indices turning positive, newly found supportive fiscal and monetary policies, along with inexpensive valuations – Eurozone stocks are trading at a 30% discount to the S&P 500 ex Magnificent 7, while delivering the same growth – we think European equities present a compelling investment case.

Ultimately, deglobalisation, trade tensions, emerging competition and the democratisation of technology might negatively impact the global winners of the past decade, paving the way for a correction in the valuation anomalies we've highlighted. European value and small cap stocks stand out as particularly exposed to domestic demand improvement in Europe, along with developing trends related to fiscal policies, defence, and possible Ukraine reconstruction.

Factor performance shifting from status quo

Since the recovery from the Global Financial Crisis over 15 years ago, growth, quality, and momentum factors have steadily outperformed in developed markets, while size, value, and low volatility factors have lagged considerably. This trend accelerated post pandemic, driven by the dominance of large-cap technology stocks, including the 'Mag 7', which benefited from earnings growth and improved profitability relative to the broader market. The rise of passive investing has further amplified the performance of large-cap stocks, while the emergence of artificial intelligence as a transformative theme has sustained the outperformance of growth and momentum factors.

Figure 7: Post-GFC factor performance in developed markets

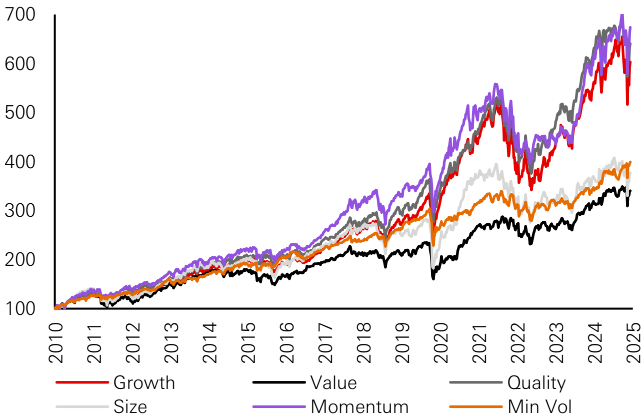
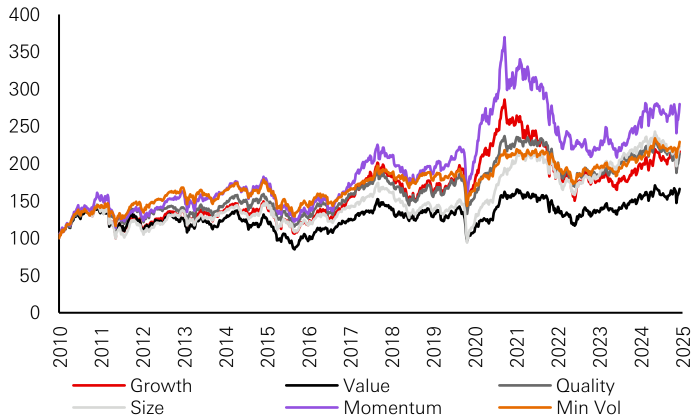


Figure 8: Post-GFC factor performance in emerging markets



Source: Bloomberg, MSCI, HSBC AM. Factor Performance show total returns on MSCI Factor Indices, May 2010 - May 2025.

In emerging markets, factor performance has been somewhat similar, though less pronounced. Growth has still led, but the gap has narrowed since 2021 amid a period of growth deceleration in China. And momentum has continued to deliver excess returns, supported by the rise of tech and AI themes in key Asian markets.

Regional divergence in small versus large caps has been much more notable. In the US, large caps have consistently outperformed small caps since 2010, underpinned by a growth differential in earnings per share of approximately 2% annually. This came amidst a significant expansion in profitability for large caps, with their return on equity increasing by about 70% over the same period.

Figure 9: Different picture for small vs large cap across regions

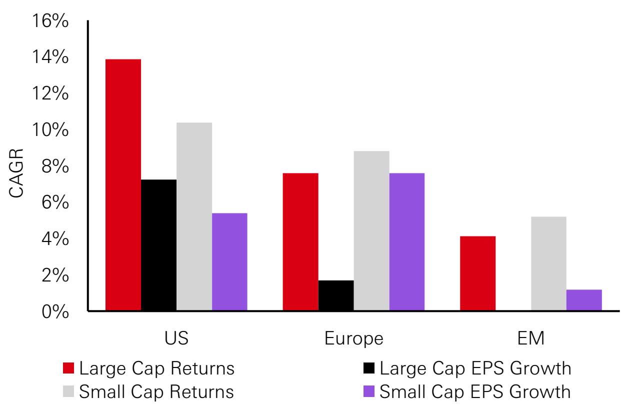
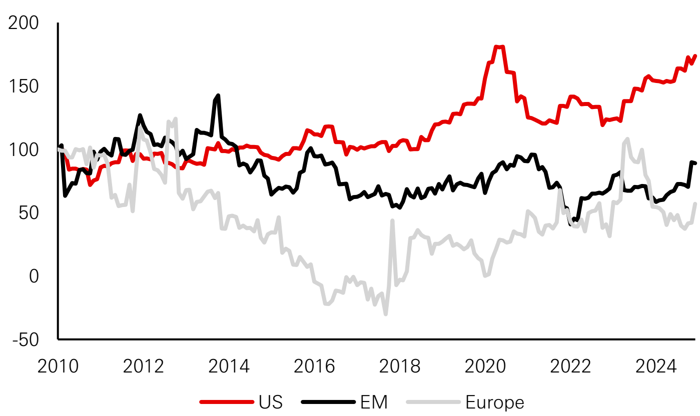


Figure 10: Relative ROE (Large – Small)



Source: Bloomberg, MSCI, S&P, Russell, HSBC AM. Data for the period May 2010 - May 2025.

In Europe and emerging markets, the relationship between small caps and large caps has been reversed. Small caps in these regions have outperformed large caps on an annualised basis, with earnings growth in Europe particularly strong for small caps. This outperformance is largely attributable to the recovery of small-cap profitability from a low base following the global financial crisis. In emerging markets, large caps have shown negligible earnings growth over the past 15 years, while small caps have achieved a positive, albeit small compound annual growth rate of approximately 1%. In countries like India and Korea, small/mid cap stocks staged multi-year rallies backed by improving fundamentals and domestic demand resilience.

Since the US election in November, factor performance has been characterised by significant rotation. Growth and momentum factors initially outperformed, driven by a strong risk-on rally in the US. Small caps also rallied strongly in the immediate aftermath of the election but subsequently reversed their gains, underperforming in the first and second quarters of the year. Low volatility has emerged as an outperformer during this period of heightened uncertainty.

In a sign of a regime change, markets are no longer confident in any one style, but are rotating defensively – or spinning around – while still chasing earnings momentum. The behaviour of defensive factors such as low volatility has been telling. Quality's defensive power seem to have been neglected during periods of elevated uncertainty potentially due to some overlap with profitable tech. Small caps and momentum have been more sensitive to rotations and regime shifts, underscoring the importance of context when assessing factor exposures.

In emerging markets we've seen a bit more strength in performance this year. Again, one of the main winners has been low vol as a defensive factor. Still, large growth momentum has held up, particularly in China on the back of the DeepSeek news which produced China tech beneficiaries. Underperformance of quality and small caps in emerging markets has been persistent, particularly driven by India where small and mid-caps derated considerably following their multi-year rally, as growth in the region decelerated.

Of course, global growth momentum has most recently bounced back strongly as tariff concerns have eased, resulting in a situation where growth momentum and low vol have done well together – a fairly unusual occurrence.

Figure 11: Developed markets factor performance since US election

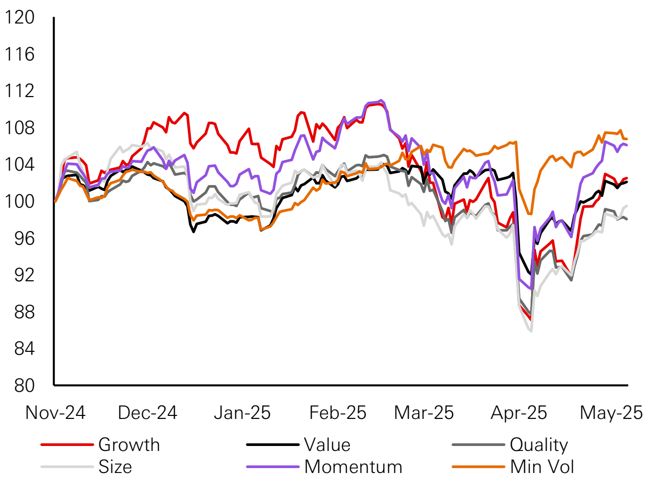
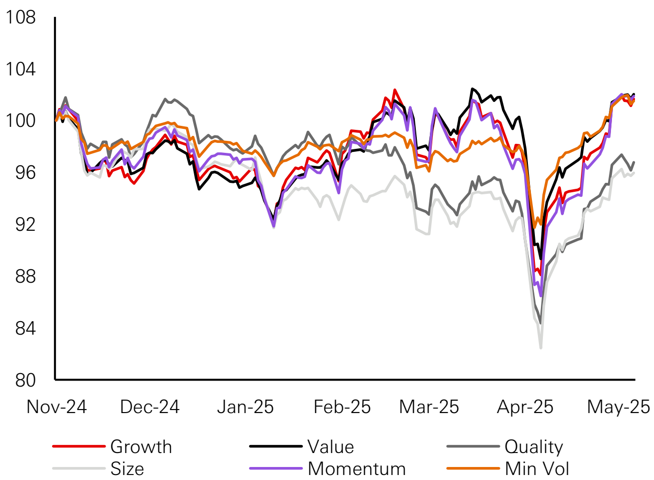


Figure 12: Emerging markets factor performance since US election



Source: Bloomberg, MSCI, HSBC AM. Factor Performance show total returns on MSCI Factor Indices, Nov 2024 - May 2025.

Valuation anomalies present opportunities

This year's shift in trade policy may have marked a political inflection, but the investment inflection point may run deeper. Over the last few years, the return on equity (ROE) for US tech companies has reached highs of 28%, surpassing the peak seen in 2000. However, it is now beginning to soften slightly. This rise in ROE has been driven by strong profits in an asset-light sector, characterised by lower capital expenditure (capex). That said, after years of operating as a tech-light sector, there are growing concerns that rising capex-to-sales ratios—now at record highs—could signal a shift towards becoming more asset-heavy. Such a transition could place pressure on these elevated ROE levels.

Considering this alongside trade tensions and other headwinds to US economic growth may mean the global investment regime that favoured US large-cap growth could face headwinds, while anomalies across European equities, small caps, and value styles are too large to ignore.

Accordingly, we think the current phase of global equity markets is not merely turbulent – it is transitional. Europe in particular stands at a turning point. The combination of deep valuation discounts, improving macro conditions, and underappreciated earnings potential make it a compelling candidate for structural rotation. Factor dynamics also point to a more balanced landscape ahead, where defensives, small caps, and value regain relevance, especially in markets where fundamentals no longer justify persistently wide discounts.

While currency effects, geopolitical shocks, and tariff uncertainty could disrupt some of these themes, we don't think near-term volatility de-rails the start of a bigger structural unwind after years of neglect. Even after this outperformance for many non-US markets (Europe and China are up 20% and 24% respectively versus the US up 8%), valuation gaps are still compelling especially versus longer run averages (charts below). We seek opportunities where value meets structural change. While it won't be a straight line up, we still promote a change in market leadership and see selective opportunities in Europe and emerging markets.

The S&P 500 has already rebounded nearly 27% from its April lows, suggesting that the market may now be approaching the top end of a 'fat and flat' trading range.

Figure 13: Dividend yield gaps versus US over time

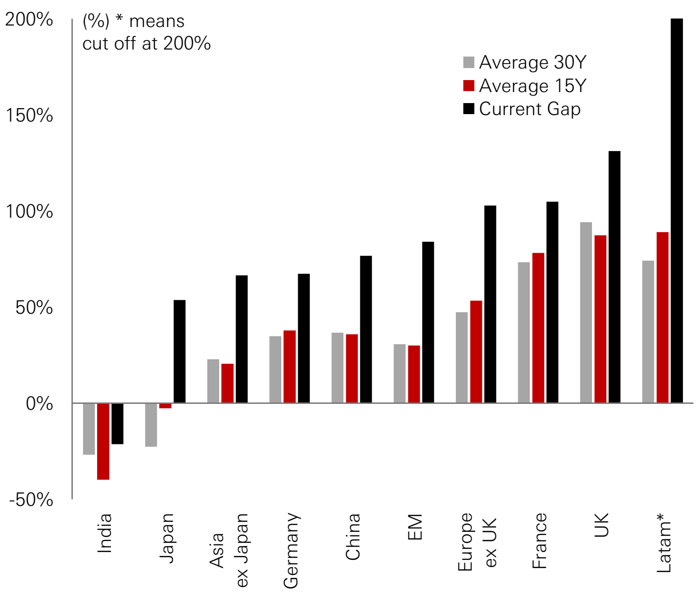
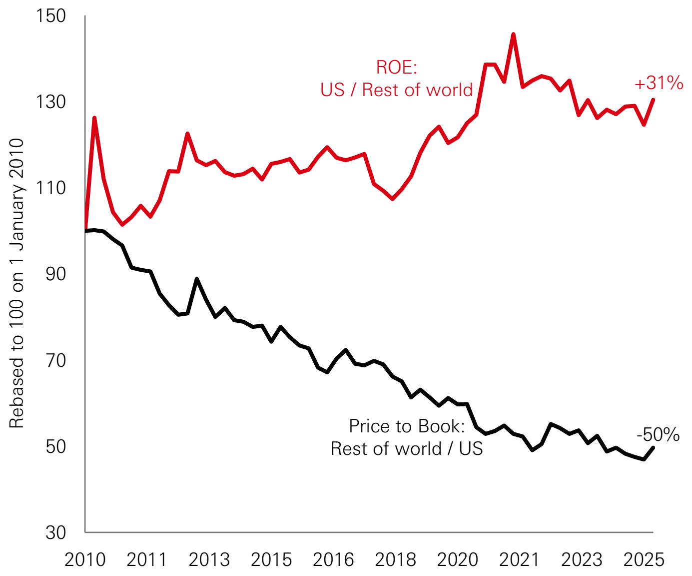


Figure 14: ROE and Price to Book comparison for US versus rest of world



Source: HSBC AM, Refinitiv, MSCI. Data as of July 2025.

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Content ID: D049798_V1.0; Expiry date: 30.06.2026.