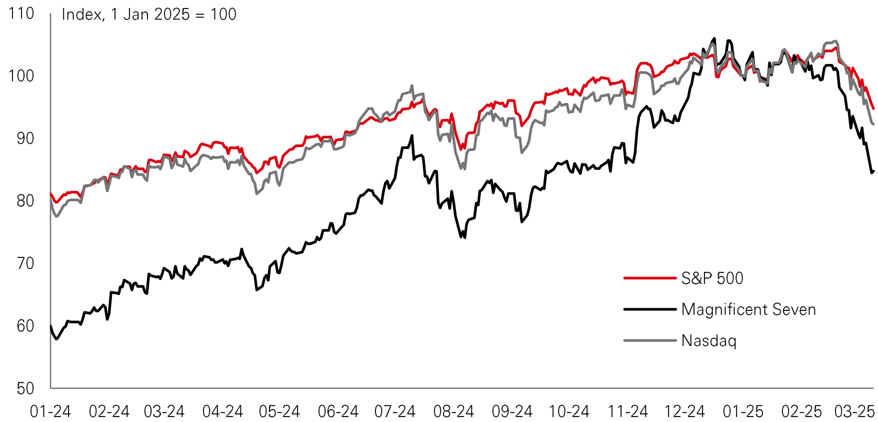
Growth concerns rising

Investment Event | 13 March 2025

Growth concerns and volatility rising

US stock markets have seen a significant correction over the past few weeks. The S&P 500 is now down around 9% from its mid-February high. The drawdown in US tech stocks has been larger, with the Nasdaq losing around 13% amid big losses in "Magnificent Seven" names (Figure 1). Stock market implied volatility – as measured by the VIX index – has touched its highest level since last summer's August market tantrum.

Figure 1: US equity market performance



Source: Bloomberg, HSBC AM as of 12 March 2025. Past performance does not predict future returns.

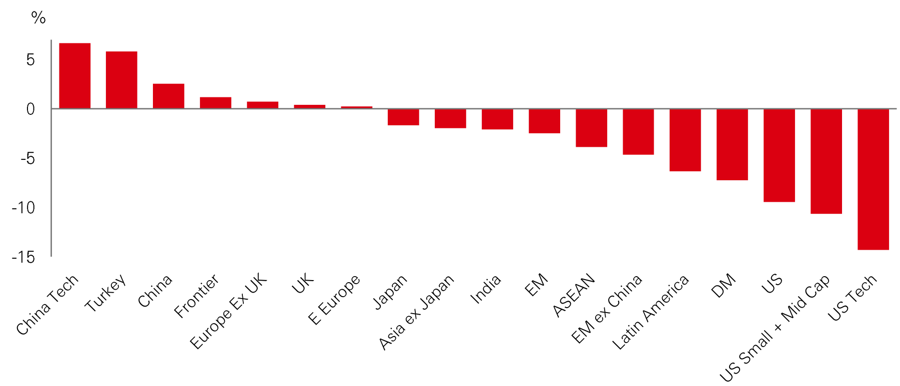
A backdrop of extreme uncertainty

Why are investors turning more cautious on the US? **Trade and economic policy uncertainty is elevated**, and investors may be increasingly concerned this will start to impact US GDP growth and the corporate earnings outlook. Since mid-February, US economic data have surprised to the downside, with consumer spending data an area of weakness in early 2025. Recession probabilities have been nudged up.

Meanwhile, **earnings expectations have been on a downward trajectory**. Full-year 2025 EPS growth is now expected at 12% For the S&P 500, down from around 15% six months ago, and 22% for the Nasdaq, from 25%.

All of this is **jarring against stretched stock valuations in the US**. Following two years of stellar gains, the 12-month forward price-to-earnings ratio of the Nasdaq hit 29x late last year, well above the 10-year average (24x).

Figure 2: MSCI performance since S&P 500 high on 19 February 2025



Source: Bloomberg, HSBC AM as of 12 March 2025. Past performance does not predict future returns.

Elevated trade and economic policy uncertainty has contributed to a significant correction in US stock markets

Recent developments outside the US may also be forcing a reassessment of TINA – "there is no alternative" to US stocks

Recent market action shows a very clear dynamic – a broadening out of returns relative to 2024, with previous losers now winning

A US recession isn't our base case. Amid ongoing evidence of the end of US exceptionalism, rest-of-the world valuation discounts and a broadening of profits growth, we think this dynamic can continue in 2025

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From TINA to TIA

Recent developments outside the US may also be forcing a reassessment of TINA – "there is no alternative" to US stocks. Last week's announcement of a major fiscal stimulus package by the German government may have forced a fundamental reassessment around Europe's long-term growth and earnings prospects.

Furthermore, January's release of R1, by Chinese company DeepSeek is likely to have continued to ripple through global markets as investors question US tech firms' dominance of AI and associated technologies. There have also been some question marks over the returns to record levels of US tech capex. Since the 19 February high of the S&P 500, European stocks have gained, while Chinese tech stocks have rallied hard (Figure 2).

Amplification mechanisms

Recent moves have been outsized. But they may have been exaggerated by the way investors were positioned heading into 2025. Late last year, as investors priced in a pro-growth policy agenda and the potential for higher inflation, consensus trades had formed betting on further upside to US stocks and the dollar and higher US bond yields. But as these assumptions about US growth were challenged, these very crowded trades have been quickly unwound.

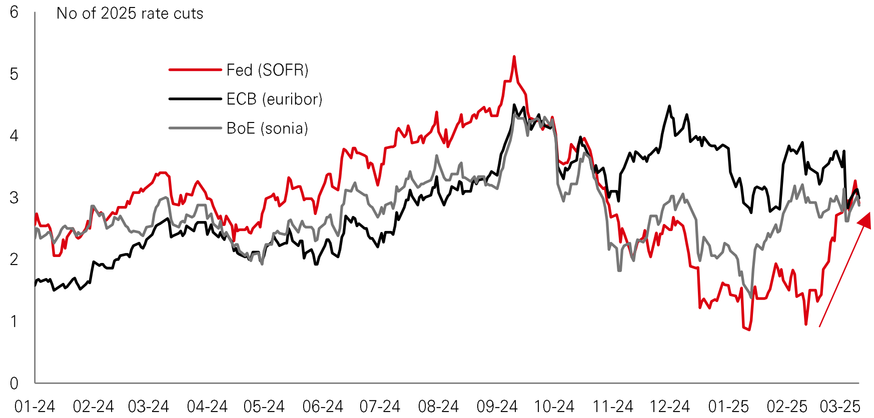
Highly leveraged hedge funds - rapidly selling down their positions to meet internal volatility targets - may have also magnified market moves. The Federal Reserve has talked about this as a contributing factor to last August's selloff.

The idea of "ambiguity aversion" could also be at play. The extreme uncertainty surrounding the US policy outlook may be pushing some investors out of US stocks and into markets where the probability distribution of potential outcomes is easier to judge. For these investors, the base case view around the US outlook may not have materially shifted, although the unknown risks are too difficult to bear.

Dampening effects

It can be argued the market sell off would have been worse if bond yields hadn't fallen and 2025 Fed rate cut expectations hadn't risen (Figure 3). This makes the "Fed put" an important shock absorber against a bumpy global environment.

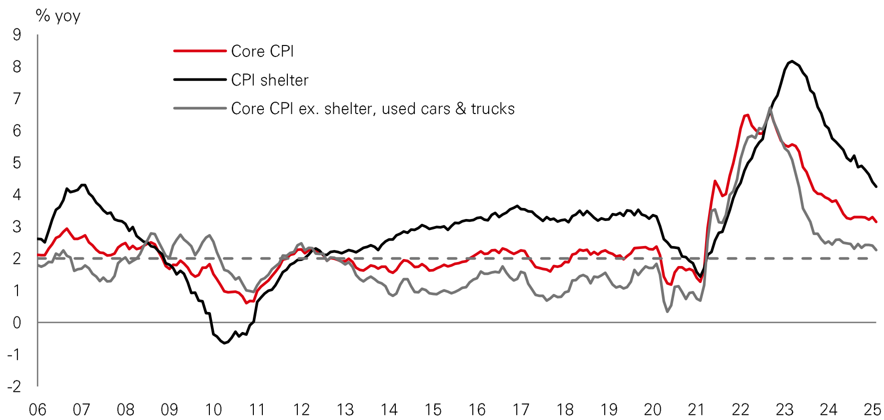
Figure 3: Market pricing of 2025 rate cuts



Source: Bloomberg, HSBC AM as of 12 March 2025

If the Fed stays in wait-and-see mode amid tariff uncertainty and sticky inflation, while growth continues to slide, then markets have a problem. But if inflation can stay low, the Fed has a lot of policy space and cut rates hard if needed.

Figure 4: US CPI inflation



Source: Macrobond, Bloomberg, HSBC AM as of 12 March 2025

So far, inflation progress looks good. Core CPI inflation is still running around 3% yoy, but once shelter and the volatile used car components are removed, it is much close to 2% (Figure 4).

Moreover, shelter price inflation is now coming down at a brisk pace and market rent data suggests this will continue through 2025. With the labour market also back in balance, wage growth is moderating and leading indicators suggest this trend will remain in place, helping to reduce residual inflation pressures still in the system.

Still a case for "spinning around" in 2025

Recent market action shows a very clear dynamic – a broadening out of returns relative to 2024, with previous losers (Europe, value, defensives) now winning.

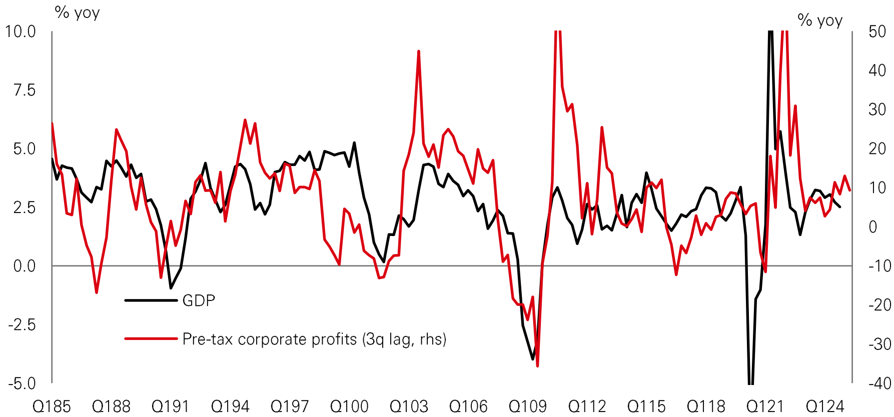
In 2025, we think this rotation into previously unloved parts of the global investment universe can continue. Why?

1. The first point to make is that risk assets at the global level are unlikely to do well in the event of a **US recession**. But this **isn't our base case**.

   Much of the recent volatility in consumer spending is due to consumers getting ahead of potential tariff-induced price rises, pulling forward their purchase of big-ticket items into November and December, leaving an "air pocket" in January.

   Looking through the volatility, consumer spending is likely to slow in 2025 vs 2024, as wage growth moderates. However, a sharp slowdown is not our base case given underlying conditions appear solid; unemployment remains low, and, in aggregate, household balance sheets are robust. On the corporate side, profits remain elevated and, while analysts' expectations for EPS growth has come down, they are still in double-digit territory. Typically, **recessions are preceded by a marked decline in profits** (Figure 5).

Figure 5: US "macro profits" and GDP growth

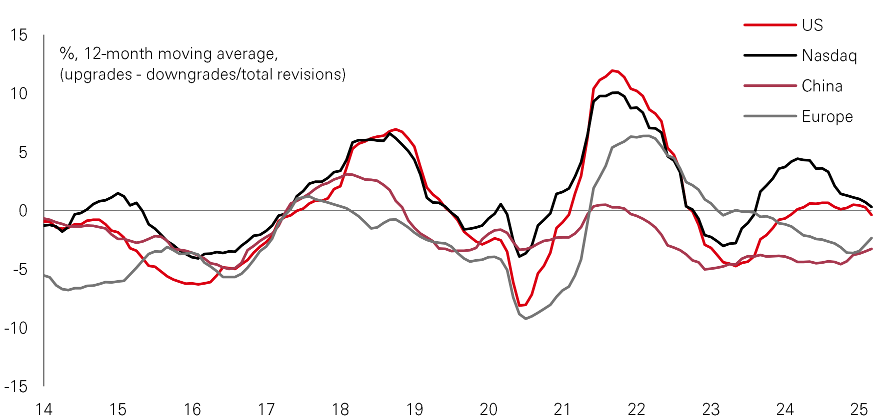


Source: Macrobond, HSBC AM as of 12 March 2025/ Past performance doesn't predict future returns.

2. **Global GDP and profits growth should converge**. Even before the recent spike in uncertainty, US growth was expected to slow in 2025 amid a cooling labour market. German stimulus boosts Europe from a low base.

   Recent policy developments will accelerate the broadening out of global profits growth this year, with the gap between US tech and other markets significantly narrowing. This is reflected in earnings revisions trends (Figure 6).

Figure 6: Earnings revisions



Source: IBES, HSBC AM as of 12 March 2025. Past performance does not predict future returns.

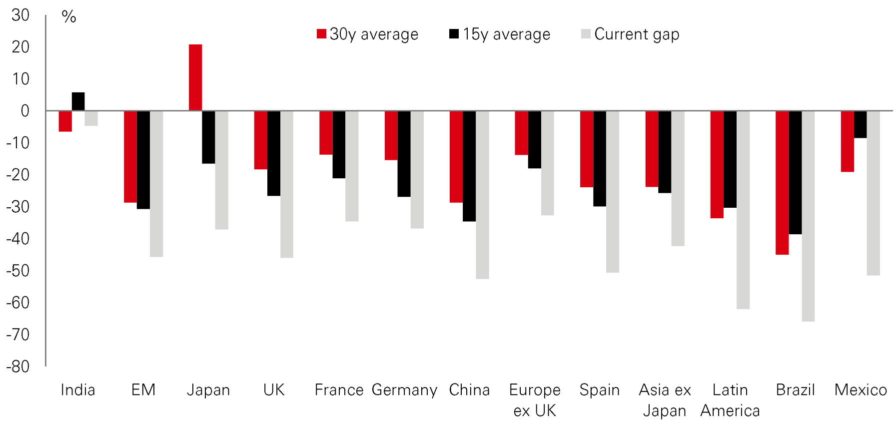
3. **Global central banks are still on course to cuts rates**. Tariff policies present an upside risk to inflation, but should also weigh on growth (which is disinflationary), Services inflation should continue to fall as labour markets cool.
4. **China policy easing remains on course to buoy growth**. Boosting consumption is a top policy priority for 2025. The recent rally in the country's stock markets can help reinvigorate consumer confidence too (Figure 7).

Figure 7: MSCI China and consumer confidence

Source: Bloomberg, HSBC AM as of 12 March 2025

5. **Rest-of-the world valuation discounts remain unusually high** (Figure 8).

Figure 8: Price-earnings ratio discount/(premium) versus MSCI US



Source: MSCI, HSBC AM as of 12 March 2025

However, even with sound underlying conditions for households and businesses, elevated policy uncertainty presents a risk of a sharper than expected downturn, especially if a negative feedback loop develops between markets and the economy. **The probability that growth "topples over" has clearly risen**.

In the current environment, **it will also be important to think about which asset classes can hedge against market volatility**. The US dollar seems to have lost some of its traditional role as a haven in times of market stress. And policy uncertainty may undermine investor thinking on the safe-haven properties of US government debt, even if weaker data and Fed action would clearly boost the appeal of quality fixed income assets. That leaves other contenders such as gold, the yen or swiss franc in the limelight.

Taking everything together, investors have endured several episodic waves of market volatility already in 2025. And while we can't know the future, we do expect investment markets to remain volatile against a backdrop of elevated policy uncertainty. Our "spinning around" market thesis points to several actionable investment themes - including a stock market broadening out and opportunities in private and securitised credits. **But it will also be important to remain agile and dynamic in investment portfolios in today's highly complex macro reality**. We continue to watch macro and market developments closely.

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