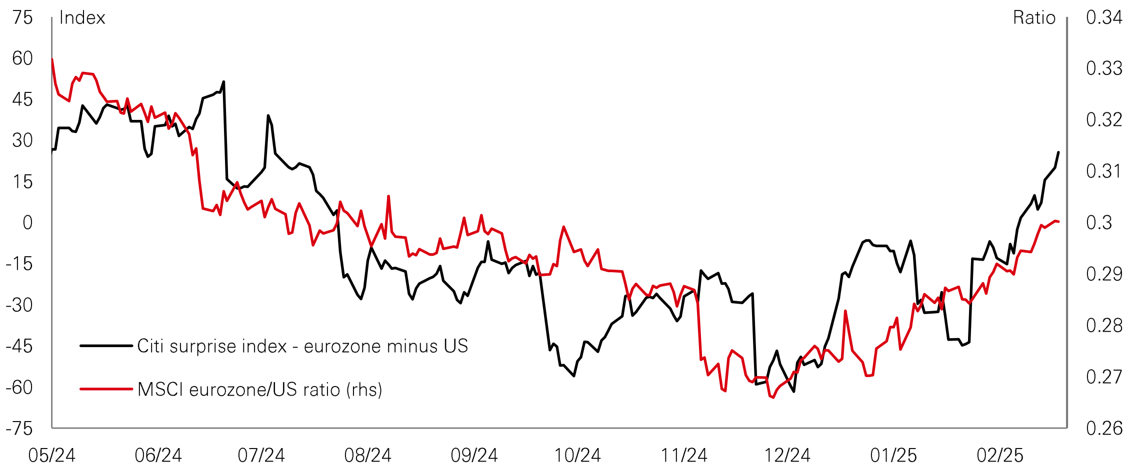
Investment Weekly

24 February 2025

Chart of the week – What next for eurozone stocks?



Eurozone equities have outperformed year-to-date with the MSCI index up by c.12% versus a c.4% gain in the S&P 500. The move is rooted in the low valuations seen late last year, with several factors recently starting to unlock this potential – upward revisions to analysts' overly pessimistic 2025 earnings expectations, a weaker euro, upward surprises on eurozone growth data, improving sentiment towards China, and expectations for looser European fiscal policy.

However, **eurozone stocks have risen a long way relatively quickly, so some near-term caution may be warranted**. While data have surprised marginally to the upside, they have been against low expectations. Equally, optimism over fiscal easing hinges, partly, on the German election outcome and prospects for easing the German debt brake. Rule changes would require a two-thirds majority vote in the Bundestag, which is not a given.

The fiscally conservative CDU/CSU is leading in the polls and while its leader, Friedrich Merz, has signalled some possible flexibility on the debt brake regarding defence spending, he favours exploring expenditure restraint in other areas first. Moreover, while the centre-left SPD – a potential coalition partner – is open to some reform, if the CDU/CSU requires the support of the FDP, agreement on this issue could prove more difficult. **Nonetheless, with eurozone equities trading at a larger than normal discount to the US, any positive European growth or policy surprises could further extend the recent outperformance**.

Neutral Rates →

Latest estimates and key drivers behind 'r-star'

Japanese Equities →

Lessons from Q4 -24 earnings season

US Dollar →

Factors driving recent moves in the greenback

Market Spotlight

Shariah-compliant strategies in demand

Islamic finance – also known as Shariah-compliant finance – accounts for around 1% of global financial assets. Yet it's a sector seeing rapid growth, delivering some strong recent performances, and potentially appealing to growing demand for socially-responsible investing.

Shariah-compliant assets are screened using principles commonly associated with Shariah law. They include areas like risk sharing, limiting unnecessary uncertainty, and the prohibition of interest. There is a strong emphasis on property rights and fair treatment of employers, employees, customers, and other stakeholders. The screening also excludes exposure to certain business sectors, and sets tolerance limits for certain types of investment income.

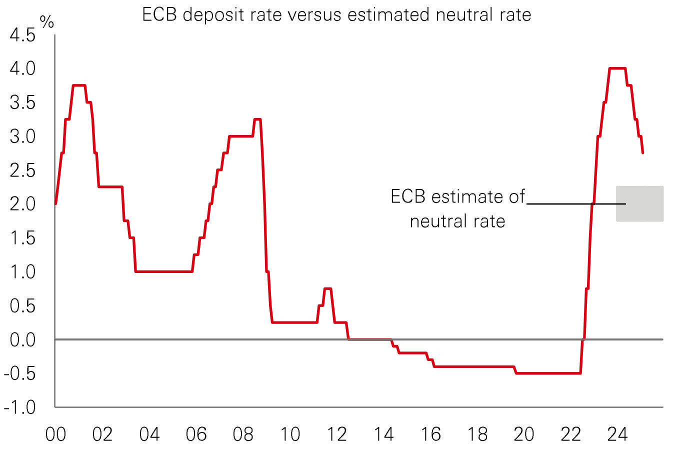
Although guided by different principles, Shariah screening has similarities with strategies that use environmental, social and governance factors. Both commit to promoting investments that minimise harm to society and uphold ethical conduct. They also tend to focus on stability and risk reduction. **That makes them a useful diversification option for asset allocators**. As for performance, some Shariah-compliant indices have been delivering strong returns, with the Dow Jones Islamic Market Titans 100 index outperforming the S&P 500 over three and five years.

The guiding r-star

The ECB has formally updated its estimate of the nominal neutral rate of interest, concluding it is in the range of 1.75% to 2.25%. Commonly referred to as r-star, or r*, the neutral rate is the interest rate that allows full employment and stable inflation over the medium term.

Yet, while r* is an important benchmark, its unobservable nature makes its estimation difficult. The Bank of England noted recently that an ageing population, global trade disintegration, and higher global risks may be weighing on growth potential, and thus r*. Meanwhile, other factors, such as financial fragmentation, climate change, expansionary fiscal policy, and AI are creating upward pressure. The BoE opted not to give an estimate of the UK's neutral rate. For the US, the FOMC's estimated range is c.2.50%-4.00% with a median figure of 3.00% and rising.

Lower estimates of the neutral rate in Europe, alongside a more sluggish economy, suggest a long duration positions in Europe. Still-robust growth in the US could imply the neutral rate there is higher than estimated.

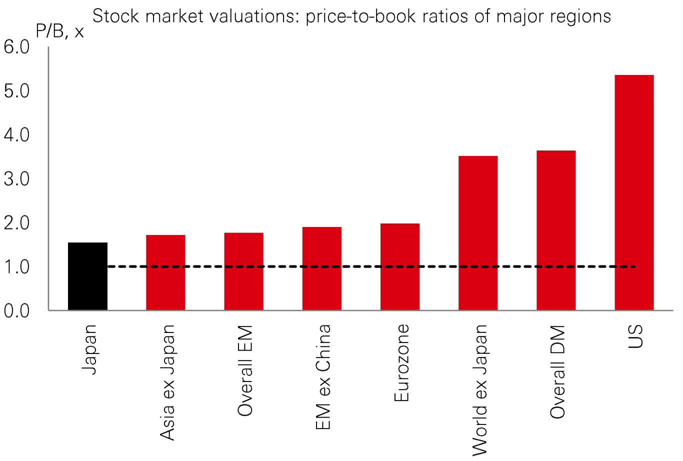


Japanese surprise

Japanese stocks have surprised to the upside in the current Q4 2024 earnings season. Most companies in the Topix index have now reported, and y-o-y earnings growth is about 13%. The industrials and consumer discretionary sectors have been the strongest, buoyed by high overseas exposure. Financials have also done well on higher net interest margins as the Bank of Japan gradually heads towards normalisation.

The results have been helped by a tailwind of improving economic momentum, with Q4-24 GDP coming in stronger-than-expected. Government-led corporate governance reforms have also played a part, as are targeted budget stimulus, including inflation relief and support for industries like AI and semiconductors.

In response, Japanese stocks have seen a pick-up in analyst earnings upgrades for the coming 12 months. Yet they trade at a discount to peers, with a forward 12-month price-earnings ratio of 15.3x, versus 22.6x in the US. **They also trade on a relatively low price-to-book ratio of around 1.5x**. Overall, the outlook for Japanese stocks remains positive, although exporters could face headwinds from global policy uncertainty.

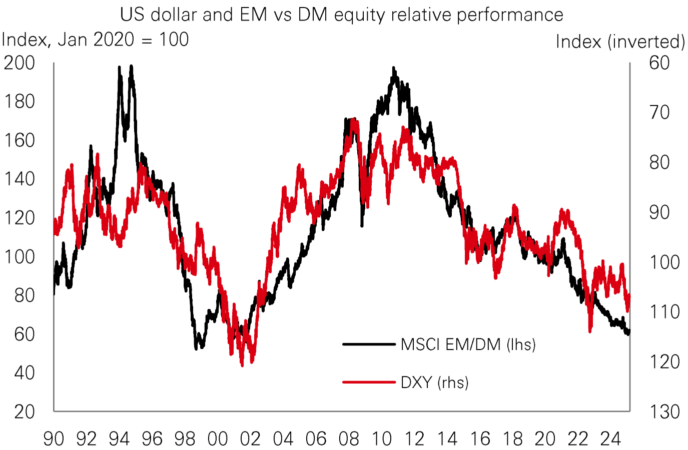


Toppy dollar?

Is the recent US dollar rally looking tired? It is quite telling that an upside surprise for January US CPI did not lead to any material dollar outperformance. If anything, the modest gains were more than unwound following softer underlying details of the PPI print and a weak retail sales release. What we are seeing is that the dollar and US yields are not rising hard on strong US data but falling on any signs of softness.

Global factors may also be limiting the dollar's appreciation trajectory. China's January credit data suggests a turning point may be at hand. Equally, strong wage and GDP data out of Japan and recent positive eurozone data surprises also lean in this direction.

With the USD expensive on a historical basis and plenty of positives already priced in, any disappointing US-related developments, or positive non-US developments relative to pretty downbeat expectations, could start to weigh on the greenback.



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Source: HSBC Asset Management. Macrobond, Bloomberg, Datastream. Data as at 7.30am UK time 21 February 2025.

Key Events and Data Releases

Last week

Date	Country	Indicator	Data as of	Actual	Prior
Sun. 16 February	JP	GDP (qoq)	Q4	0.7%	0.4%
Tue. 18 February	UK	Unemployment Rate, ILO	Dec	4.4%	4.4%
	AU	RBA Cash Target Rate	Feb	4.10%	4.35%
Wed. 19 February	ID	Bank Indonesia Rate	Feb	5.75%	5.75%
	UK	CPI (yoy)	Jan	3.0%	2.5%
	NZ	RBNZ Official Cash Rate	Feb	3.75%	4.25%
	US	FOMC Minutes	Jan		
Thu. 20 February	JP	CPI (yoy)	Jan	4.0%	3.6%
Fri. 21 February	US	S&P Global Composite PMI (Flash)	Feb	-	52.7
	EZ	S&P Global Composite PMI (Flash)	Feb	-	50.2
	UK	S&P Global Composite PMI (Flash)	Feb	-	50.6
	IN	S&P Global Composite PMI (Flash)	Feb	-	57.7

The week ahead

Date	Country	Indicator	Data as of	Survey	Prior
Sun. 23 February	GE	Federal Election	Feb		
Mon. 24 February	US	Earnings	Q4		
	GE	IFO Business Confidence Index	Feb	85.8	85.1
Tue. 25 February	US	Consumer Confidence Index, Conference Board	Feb	102.1	104.1
	KO	Bank of Korea Base Rate	Feb	2.75%	3.00%
Thu. 27 February	JP	Tokyo CPI excluding food and energy (yoy)	Feb	3.3%	3.4%
	US	GDP, 2nd Estimate (qoq annualised)	Q4	2.3%	2.3%
Fri. 28 February	US	PCE Price Index (yoy)	Jan	2.5%	2.6%
Sat. 01 March	CN	NBS Composite PMI	Feb	-	50.1

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Market review

Risk markets remain resilient despite ongoing geopolitical tensions. The US dollar weakened against developed and EM currencies. Rising fiscal worries weighed on eurozone government bonds, and disappointing UK inflation data pressured Gilts. US Treasuries were range-bound ahead of core PCE figures, with January's FOMC minutes reiterating the Fed is in no hurry to ease. In the US, the S&P 500 touched a fresh high mid-week, with the Nasdaq slipping on mixed Q4-24 earnings reports. The Euro Stoxx 50 paused for breath after recent gains, and Germany's DAX was steady. Japan's Nikkei 225 lost ground as a higher yen weighed on exporters amid a re-pricing of BoJ rate expectations. EM equities were mixed. South Korea's Kospi index posted decent gains, the Shanghai Composite nudged higher, and the Hang Seng and India's Sensex drifted lower. In commodities, oil and gold rose. Copper fell.

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