

Data Matters

Reflation and Sentiment

- ◆ Reflation and sentiment are the main factors driving markets now
- ◆ Cross-asset correlations show a reflation-on rather than a risk-on pattern...
- ◆ ...suggesting greater differentiation amongst asset classes

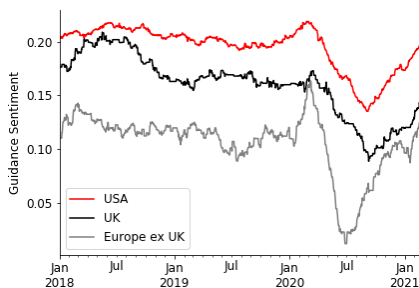
Reflation

Whilst 2020 was dominated by periods where either 'everything rallied' or 'everything fell', so far in 2021 we are seeing much greater differentiation. Much of the price action this year feels more a function of *reflation-on* than either *risk-on* or *risk-off*. We also see unusual behaviour in cross-asset correlations whereby correlations amongst classic risk-off assets are low but correlations amongst risk-on assets remain high.

Sentiment

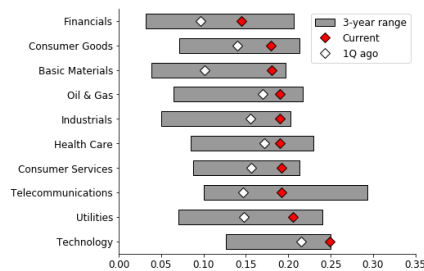
Sentiment on company earnings calls has continued to rebound in the Q4-2020 reporting season. The rebound in sentiment when company management discuss the future has been broad-based with all sectors higher on this measure than three months ago.

Sentiment rebounding in DM...



Source: FTSE Russell, Refinitiv TRKD, HSBC

... across all sectors



Source: FTSE Russell, Refinitiv TRKD, HSBC

Wait, there's more

This edition also contains analysis of which topics have been trending on Q4-2020 earnings calls, high-frequency alternative data, and updates of many of our predictive machine learning models. These models currently suggest a sanguine outlook for risk assets.

This is a redacted version of a report by the same title published on 1-Mar-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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How to ride the data wave

Live Insights: 24th March

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it.

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Contents

Taking a dip in the data	3
Get real	3
Listen Up	5
Inflation breakevens	9
Data Pulse	10
Disclosure appendix	11
Disclaimer	16

Taking a dip in the data

Get real

We've seen much greater differentiation amongst cross-asset returns in January and February than we did during the post-COVID-19 rally (Chart 1). Whereas May 2020-December 2020 mostly saw either an 'everything rallies' or 'everything down' environment, this has changed drastically now.

For example, in January we didn't really see a clear risk-on picture. Granted, EM equities and commodities rose, but DM equities and EMD in both local and hard currency terms fell. Risk assets mostly recovered in February, as commodities and EM equities again performed best. Yet EMD still remained laggards. Most notably, DM sovereigns had a very tough start to 2021, driven by reflationary hopes and expectations for better global growth. But yet again, with EMD again down on the month, this doesn't 'feel' like just a classic risk-on picture.

1. Recent returns by asset class

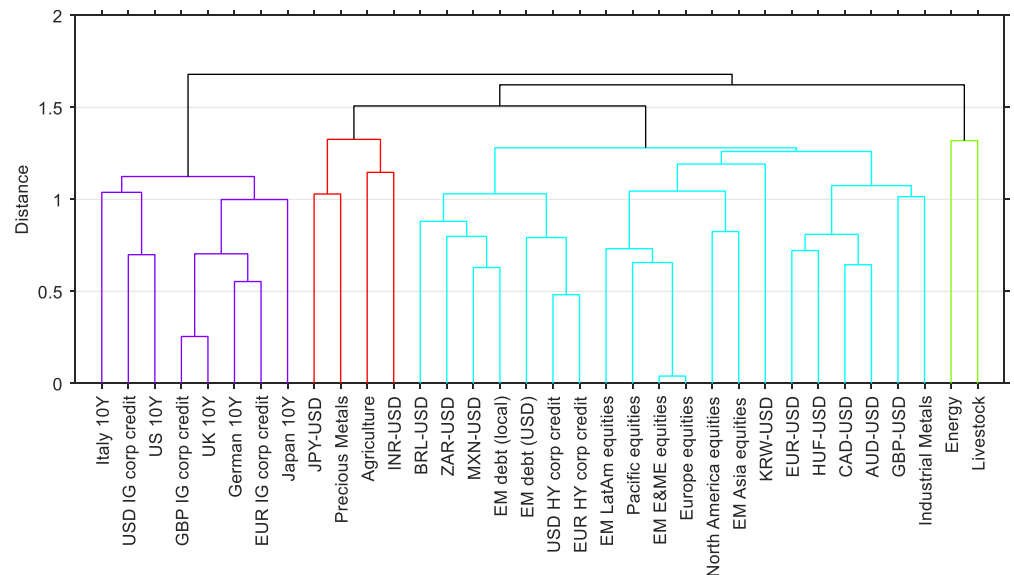


Source: Refinitiv Datastream, Bloomberg, HSBC

Note: DM equity = FTSE World Index; EM equity = FTSE Emerging Index; DM rates = Global Treasury Index; DM IL = Global Aggregate Inflation-Linked Index; USD IG = US Investment Grade Corporate Credit Index; USD HY = US High Yield Corporate Index; EMD USD = EM USD debt; EM Local = EM local-currency debt; Comdty = Composite Commodity Index; REITs = Real Estate Investment Trusts Index. Total return in equities measures price appreciation, dividend payments, and FX translation. Total return in fixed income measures price appreciation, accrual, coupon payments, and FX translation.

To investigate the recent relationships amongst asset classes in more detail, we turn to our cross-asset dendrogram in Chart 2 below. There are quite a few peculiarities:

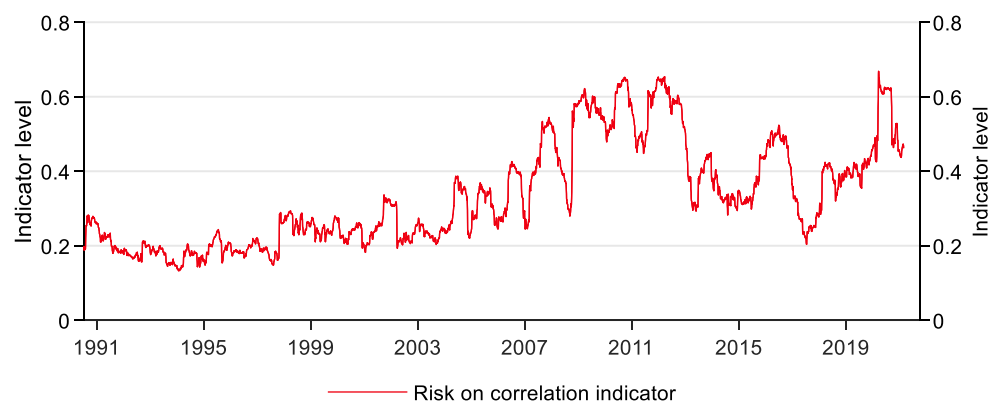
2. Dendrogram showing the key cross-asset correlations over the past 6 months



Source: Bloomberg, Refinitiv Datastream, HSBC

1. A big *reflation* risk-on block that covers EM FX, risk-on G10 FX, EM debt, HY credit, DM and EM equities, and even industrial metals. What this is probably telling us is that particularly on the risky asset side of things, this remains a highly correlated rally (Chart 3).

3. Correlations amongst only risk-on assets remain high



Source: Refinitiv, Bloomberg, HSBC

2. Energy is not part of this big risk-on block but forms its own risk-on block along with livestock. Effectively, oil prices have defied any sort of gravity in the past few months, and have continued to rise almost uninterruptedly. Whilst this has influenced other asset classes as well through the reflation channel, oil prices also benefited from some idiosyncratic positive news flow in the past few months, most notably the large inventory drawdowns and faster-than-expected demand recovery in the US.

- JPY and precious metals not being included in the classic risk-off block. This makes sense to us: JPY has been largely correlated with US yields rather than risk-on/risk-off lately. Gold was trailing relative to real US Treasury yields for quite a few weeks already, and as such also left the 'classic' risk-on/risk-off pattern.

What all this is showing us is that, in contrast to much of 2019 and 2020, **this year is beginning to shape as a year of much greater differentiation across and within asset classes**. We would argue a strong, consistent framework is needed to steer through the noise and discern what's really important. We believe our rigorous set of quantitative, machine-learning and data science models can help us guide through this.

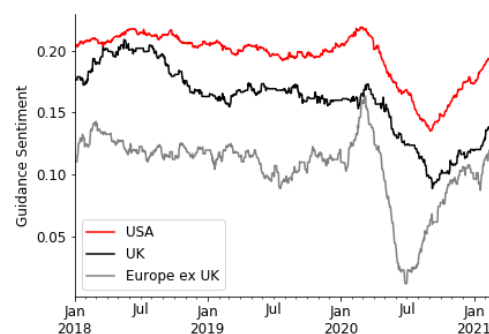
Listen Up

A large proportion of US and European Q4-2020 earnings calls have taken place now. This means that we can turn to our proprietary natural language processing NLP analysis to assess what company management have been saying this reporting season.

Guidance Sentiment

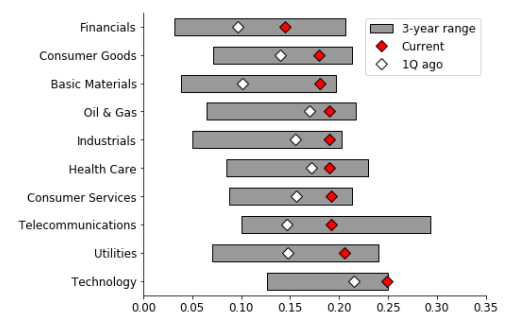
We first analyse the general tone of discussions when company management have been discussing the future. This so-called Guidance Sentiment measure has continued to bounce back strongly on developed market earnings calls (Chart 4). Indeed, Guidance Sentiment in the US has rebounded so sharply that it has almost returned to pre-COVID-19 levels.

4. Sentiment continues to improve in developed markets



Source: FTSE Russell, Refinitiv TRKD, HSBC

5. Guidance Sentiment has jumped in all sectors



Source: FTSE Russell, Refinitiv TRKD, HSBC

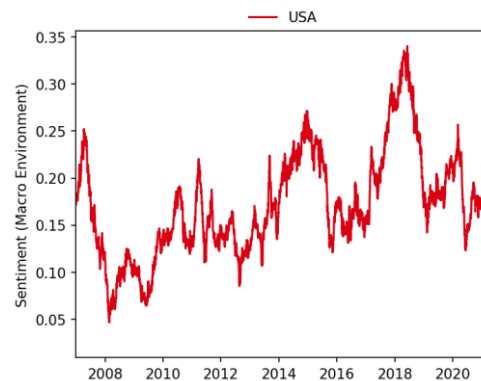
The improvement in Guidance Sentiment has been broad-based, with all sectors showing more positive sentiment now than they were three months ago (Chart 5). This suggests that the management of many companies are becoming notably more positive about the future.

Other fine-grained sentiment measures

Our modern NLP approach to sentiment analysis also allows us to measure sentiment towards other themes. In essence, if we can identify the sentences which discuss a particular theme, we are able to track the sentiment of company management when discussing that theme.

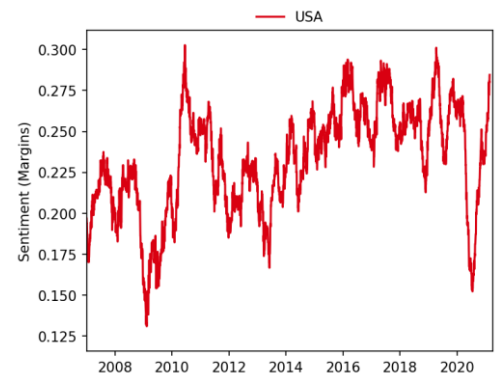
For example, whilst we can see that the sentiment towards key macro themes has continued to improve this earnings season, it is still at quite moderate levels (Chart 6). In contrast, the sentiment when discussing margins has seen a sharp improvement which has pushed this sentiment measure **above pre-COVID-19 levels** (Chart 7).

6. Macro Environment Sentiment



Source: FTSE Russell, Factset, Bloomberg HSBC

7. Margins Sentiment

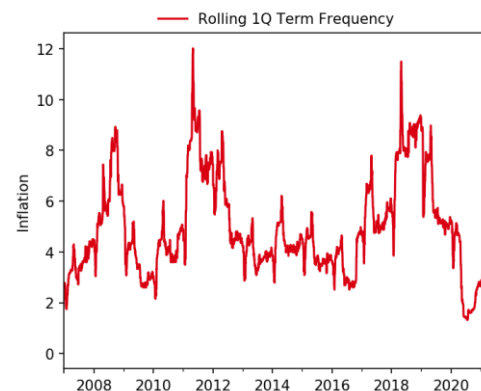


Source: FTSE Russell, Factset, Bloomberg HSBC

Inflation

It may feel as though the reflation theme is the only macro game in town at the moment; to what degree are we seeing this feed through at the micro level? We can see that discussions of inflation on company earnings calls have increased during Q4. However, they are far from elevated when compared to even recent history (Chart 8).

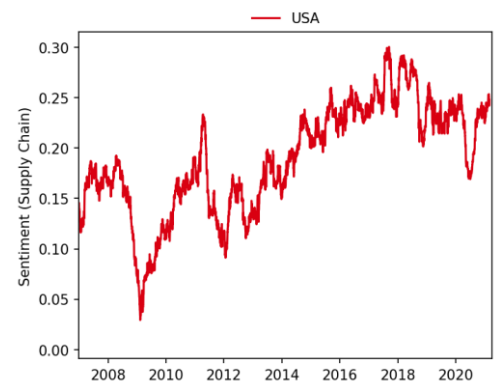
8. Inflation is being discussed more often on earnings calls



Source: FTSE Russell, Refinitiv TRKD, HSBC

Note: vertical axis shows the average number of times inflation discussions happen per day across US, Europe ex. UK, and UK earnings calls over a rolling 1Q window

9. Sentiment when discussing supply chains is still recovering



Source: FTSE Russell, Refinitiv TRKD, HSBC

Furthermore, the sentiment of company management when discussing supply chains is still recovering (Chart 9). This suggests that whatever inflationary pressures are being discussed on earnings calls, they are not yet impacting the supply side for most companies.

This is understandable: the reflation trade so far has been about markets pricing in the prospect of higher inflation, rather than the reality of it. For the reflation trade to develop further we will need to start seeing the reflation theme being borne out in more micro level data. As such, we will be tracking these discussions with care over the coming reporting seasons.

Trending topics

We use a technique called "lift analysis" to identify which topics have been trending during the Q4-2020 reporting season. One sector which would be expected to be a significant beneficiary of reflation is the Industrials sector... so what have company management been talking about this quarter?

10. Trending terms on Q4-2020 earnings call from Industrials companies

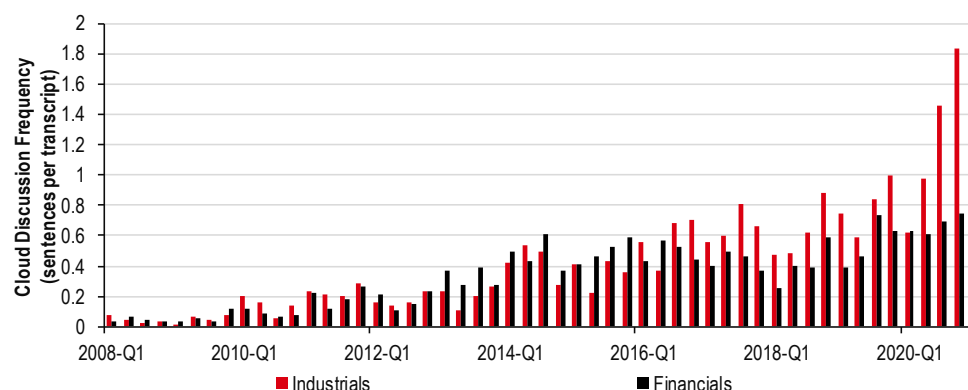


Source: FTSE Russell, Refinitiv TRKD, HSBC

The trending terms for the Industrials sector (Chart 10) are mostly very positive this quarter. For example, there are discussions of *resilience*, *significant growth*, *sequential improvement*, and *pent-up demand*. There are, however, some more negative trending terms such as *bad debt*, *restriction*, and *shortage*. These negative terms probably help to explain Industrials position in the middle of the pack for Guidance Sentiment (Chart 5).

One trending term in the Industrials Q4 transcripts is “cloud”. This is an interesting example of a disruptive technology maturing. Discussions of cloud have clearly been commonplace on Technology earnings calls for many years now. However, it is typically the proliferation of disruptive technologies throughout the economy which causes the largest impact.

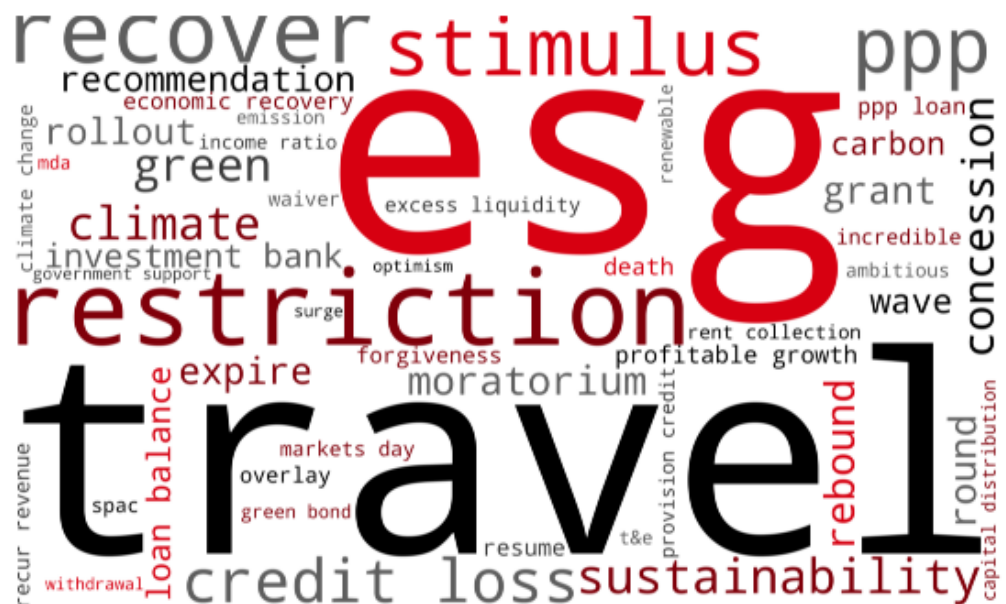
11. Cloud technology discussions have surged in Industrials



Source: FTSE Russell, Refinitiv TRKD, HSBC

Cloud technology has been important for Industrials and Financials for several years now – indeed the very NLP analysis we are discussing in this section is only possible because we have access to a powerful cloud environment. However, over the last year the frequency with which cloud technologies are discussed on Industrials calls has surged (Chart 11).

12. Trending terms on Q4-2020 earnings call from Financials companies



There is also a very notable discussion of ESG in Chart 12. It is notable that the specific term “ESG” is trending very strongly here, with less frequent discussion of terms such as *climate* and *green*. This suggests that much of the focus of these discussions has been focused on incorporating ESG into the investment process, rather than discussing the specific ESG themes which are pertinent to companies in the Financials sector.

[illegible]

This is stark contrast to the trending topics in Q4-2020 earnings calls in the Utilities sector (Chart 13). Here the trending terms are dominated specific ESG discussions of *clean energy*, plus trending terms such as *carbon*, *sustainability*, *emission*, and *community*.

Inflation breakevens

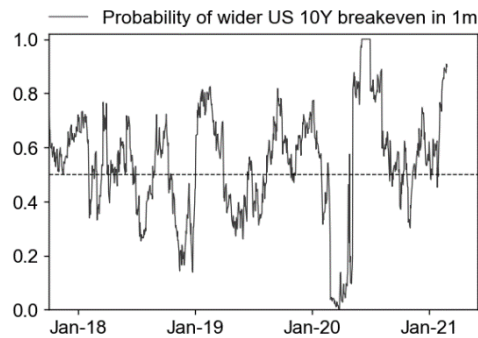
Our breakeven scorecards suggest that the reflation theme could well continue over the next month. Our US 10Y breakeven scorecard expects breakevens to widen with a 90% probability (see Chart 14). This high expectation is similar for the Euro area, with the model looking for 10Y breakevens in to widen in one month's time with a probability of 91%.

Both models have clearly become very confident of breakevens rising in the near term – particularly the US model (Charts 14-15). Dominant factors which are driving the predictions in the US and Euro area include the recent surge in the oil price, the monthly effect, and our economists' inflation forecasts.

Indeed, in both cases our economists' forecasts are pushing these probabilities higher by the most that this factor has done at any point in the last two years (for details see the Breakevens Scorecard section on Page 12). In part, this is because this factor measures the change from the last inflation print to where our economists forecast inflation to be in three months' time. Hence it captures the inflation momentum from January to April – a point when energy base effects will be strongly positive and possibly peaking.

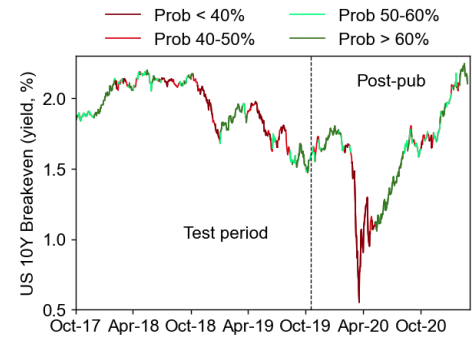
April represents a local peak in our economists' Eurozone inflation forecasts in particular as they expect inflation to fall back sharply in July due to the impact of new inflation weights and the unwinding of last year's delayed summer seasonal sales. Keeping in mind this inflation profile, perhaps our economists' forecasts are pushing our model probability a little too high. In any case, we will continue to closely monitor these models for signs of the reflation trade reversing.

14. The probability has recently risen...



Source: HSBC, Bloomberg

15. ...as 10Y BEs hit recent highs

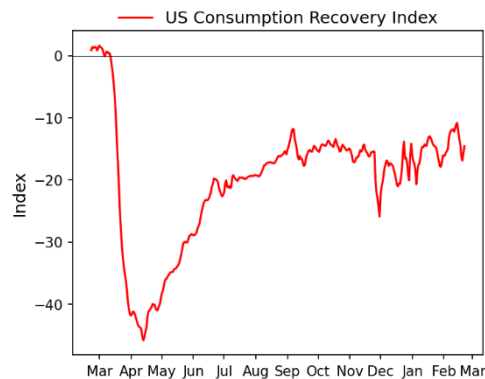


Source: HSBC, Bloomberg

Data Pulse

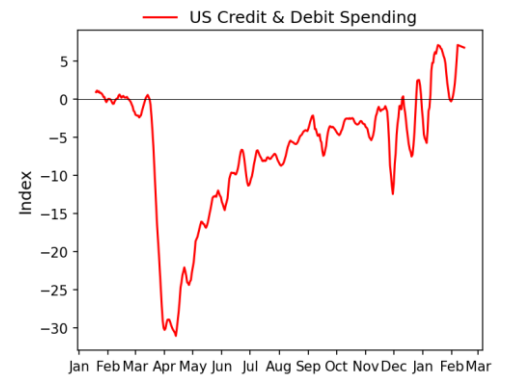
The high frequency alternative datasets we track have been pointing to consumption in the US continuing to recover. Our US-CORI Index (Chart 16) has started creeping upwards recently after moving sideways for the past four months. Overall credit and debit card spending in US has also picked up since the second round of stimulus started in the US (Chart 17).

16. US- CORI



Source: Google, OpportunityInsights, OpenTable, OAG, HSBC

17. US Overall Spending



Source: OpportunityInsights, HSBC

Disclosure appendix

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Important disclosures

Foreign exchange: Basis for financial analysis

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Buy: refers to buying the first currency in the named pair in exchange for the second currency in the named pair.

Sell: refers to selling the first currency in the named pair in exchange for the second currency in the named pair.

The tenor of the instrument will be denoted and will refer to a settlement date relative to the opening date of the trade idea e.g. 1m refers to a settlement date 1 month forward from the open date of the trade idea. NDF trades normally fix two working days prior to the settlement date.

Distribution of currency trades

The nature of foreign exchange forward trade ideas is such that there will always be an equal number of buy and sell trades (buying one currency in exchange for selling another), both outstanding and historically.

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

Prior to this date, HSBC's rating structure was applied on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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Hold	36%	(27% of these provided with Investment Banking Services)
Sell	9%	(23% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

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Definitions for fundamental credit and covered bond recommendations

Overweight: For corporate credit, the issuer's fundamental credit profile is expected to improve within the next six months. For covered bonds, the bonds issued in this country are expected to outperform those of the other countries in our coverage over the next six months.

Neutral: For corporate credit, the issuer's fundamental credit profile is expected to remain stable for up to six months. For covered bonds, the bonds issued in this country are expected to perform in line with those of the other countries in our coverage over the next six months.

Underweight: For corporate credit, the issuer's fundamental credit profile is expected to deteriorate within the next six months. For covered bonds, the bonds issued in this country are expected to underperform those of other countries in our coverage over the next six months.

Definitions for trades (Rates & Credit)

Buy and **Sell** refer to a trade call to buy or sell a bond, option on an interest rate swap ("**swaption**"), interest rate cap or floor, inflation cap or floor, or Total Return Swap ("**TRS**"). The buyer/seller of a TRS receives/pays the total return of the underlying instrument or index at the end of the period and pays/receives the funding leg.

Buy protection and **Sell protection** refer to a credit default swap (CDS): the protection buyer/seller is effectively selling/buying the reference entity's credit risk.

Pay and **receive** refer to a trade call to pay or receive the fixed leg of an interest rate swap (IRS), a non-deliverable IRS, the first-named leg of a basis swap, the realised inflation leg of an inflation swap, or a forward rate agreement (FRA). An investor that executes a pay or receive trade is said to be "**paid**" or "**received**."

Payer and **receiver** refer to inflation caps or floors and to swaptions: a payer is an option giving the right but not the obligation to enter a paid position in an interest rate or inflation swap, and a receiver is an option giving the right but not the obligation to enter a received position in an interest rate or inflation swap.

ASW (also asset-swap, Buy on asset swap, Buy on an asset-swapped basis): Buy a bond packaged with a swap that is tailored to eliminate the bond's interest rate risk, effectively transforming the bond to a floating rate instrument whilst preserving the credit exposure to the bond issuer.

RASW (also reverse asset-swap, Sell on asset swap, Sell on an asset swapped basis): Sell a bond packaged with a swap that is tailored to eliminate the bond's interest rate risk, effectively transforming the bond to a floating rate instrument whilst preserving the credit exposure to the bond issuer.

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	Count	Percentage	Count	Percentage
Overweight	126	27	69	55
Neutral	220	47	89	40
Underweight	127	27	47	37

Source: HSBC

For the purposes of the distribution above the following mapping structure is used: Overweight = Buy, Neutral = Hold and Underweight = Sell. For rating definitions under both models, please see "Definitions for fundamental credit and covered bond recommendations" above.

Distribution of trades

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	All Covered instruments		Issuers to whom HSBC has provided Investment Banking in the past 12 months	
Recommendation	Count	Percentage	Count	Percentage
Buy	143	76	90	63
Sell	46	24	21	46

Source: HSBC

For the purposes of the distribution above the following mapping structure is used: Buy/Sell protection/Receive/Buy Receiver/Sell Payer = Buy; and Sell/Buy protection/Pay/Buy Payer/Sell Receiver = Sell. ASW is counted as a buy of the bond and a paid swap, and RASW as a sell of the bond and a received swap. For rating definitions under both models, please see "Definitions for trades (Rates and Credit)" above.

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