

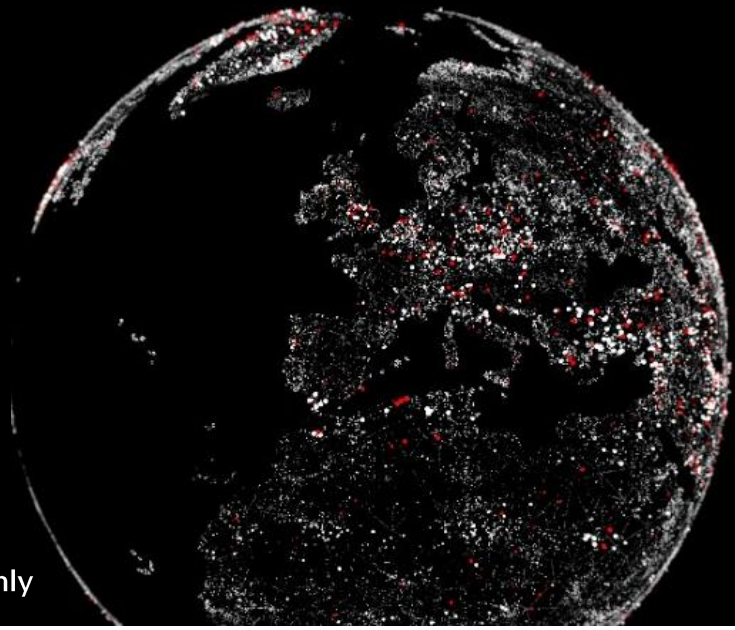
Asset Management

Europe Insights

The path after crises

Summer 2023

For professional clients and institutional investors only



In a nutshell:

What is the future of tourism in Europe?

- Over the past 4 years, and even at times of crisis, Europe's net travel balance has kept positive and has now fully recovered to 2019 levels with the help of domestic EU travellers, who generated EU travel receipts 40 per cent above 2019 levels at the end of 2022.
- This period demonstrated how domestic travellers can generate high value that could potentially offset the losses of international visitors.
- The future scope for tourism growth in Europe is vast. New tools including mobile applications, online platform and translation devices shape the way tourists travel, with more efficient and easy access to accommodation and personalised experiences. Changing patterns in tourism and digitisation offer opportunities in visitors' experiences, through tracking via the intellectual property (IP) ecosystem.

Fixed Income: The aftermath of the bank crisis

- Though overall market volatility has reduced, and credit spreads have compressed since the recent banking turmoil, the gap between financials and industrials spreads remains twice as high as its 5-year average.
- Overall, the financial industry seems to remain haunted by the potential risk of a financial crisis – this could come from the impact of higher interest rates on local real estate markets or a more severe than expected recession.
- Relative-value opportunities can arise within European fixed income markets from the caution surrounding the financial sector.

Equities: After the energy crisis, what comes next?

- The impact of the Ukraine-Russia crisis on energy prices and the stock market was relatively contained – energy prices are now below pre-crisis levels and stock markets are up.
- The lower energy prices are partially attributable to a growing consensus around the imminency of a global recession. But stock markets, still hovering around their all-time highs, do not seem to be discounting this eventuality.
- Cyclically adjusted valuations are lower than what could be expected at this point of the profit cycle, but the combination of central bank tightening, corporate earnings weakness and valuation concerns in the US could prove tough to overcome.

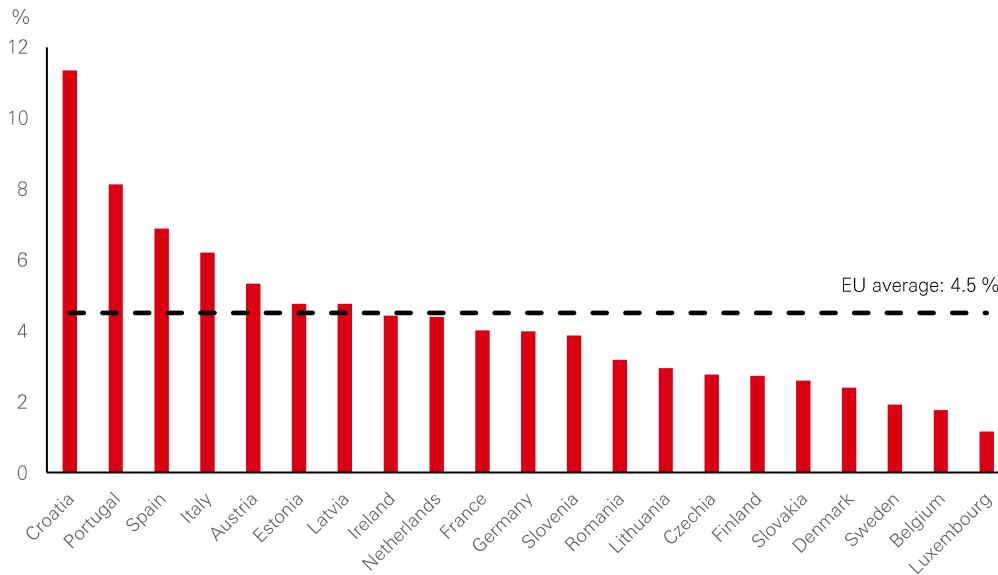
What is the future of tourism in Europe?

Two crises later, where do we stand now?

In 2019, the year before we felt the full force of the pandemic, the tourism sector generated a gross value added (GVA) of around €572 billion, or 5 per cent of the total EU economy (see Figure 1). Croatia led with a share of the tourism sector in total GVA at 11 per cent, followed by Portugal (8 per cent), Spain (7 per cent), Italy (6 per cent) and Austria (5 per cent).

The gross value added of the EU's tourism sector was 5 per cent of the total EU economy in 2019.

Figure 1: Share of tourism direct gross value added (GVA) in total GVA, 2019 (%)



Source: Eurostat, Refinitiv – Data as of 22/06/2023

Tourism receipts are more important for the region today, as the current account has turned negative in the aftermath of the Russia-Ukraine crisis and the surge in gas prices. Over the past 4 years, and even at times of crisis, the net travel balance has kept positive and has now fully recovered to 2019 levels (see Figure 2).

Over the past 4 years, and even at times of crisis, the net travel balance has kept positive and has now fully recovered to 2019 levels.

Figure 2: EU tourism net balance (total in € billion)

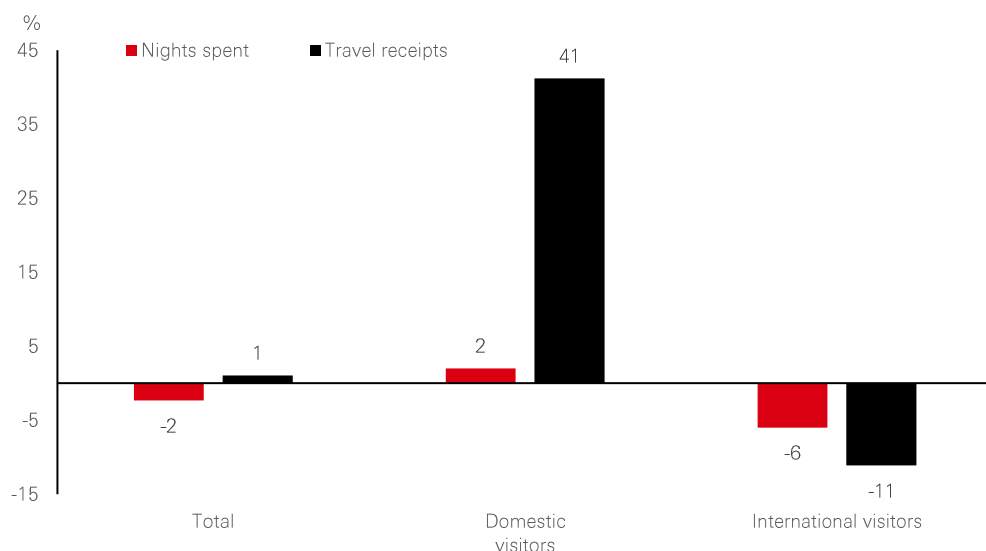


Source: Eurostat, Refinitiv – Data as of 22/06/2023

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Despite much lower international (non-EU) visitors, overall tourism receipts just reached their pre-pandemic level, mainly thanks to much higher spending from domestic travellers within the EU, who generated receipts forty per cent above 2019 levels.

Figure 3 : Tourism receipts versus number of nights spent
Gap since pre-COVID: Q4-2022/Q4-2019 change (%)



Source: Eurostat, Refinitiv – Data as of 22/06/2023

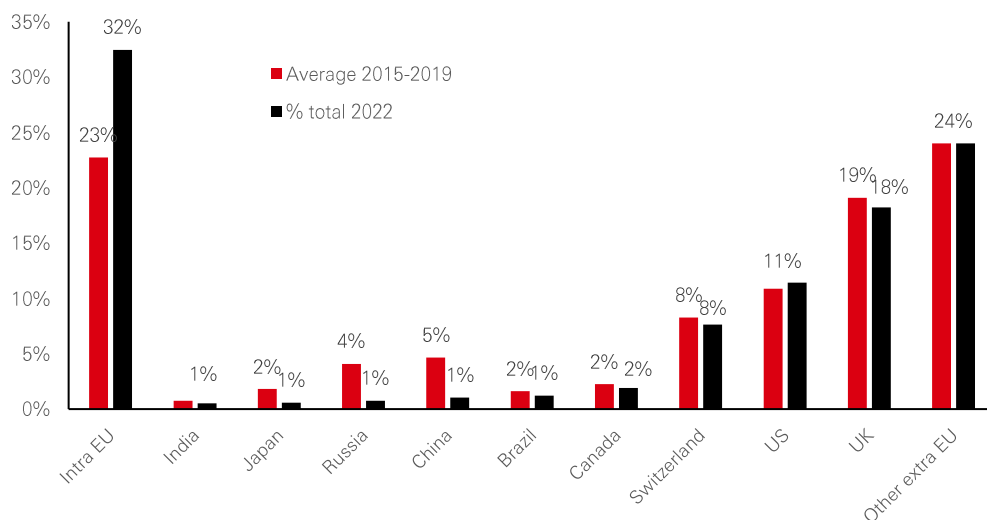
Is there further scope for tourism growth?

At a time of climate challenges, and as travellers are becoming more conscious of their environmental impact, international tourism, long haul airline travels and destinations will likely be increasingly affected, which could imply less value added for European tourism. However, the recent period showed how domestic travellers can generate high value that could potentially offset the loss of international visitors. Also, visitors from neighbouring countries like Switzerland or the UK are major EU guests, with relatively elevated income levels.

At the end of 2022, domestic EU travellers generated EU travel receipts 40 per cent above 2019 levels.

The recent period showed how domestic travellers can generate high value that could potentially offset the loss of international visitors.

Figure 4 : Tourism receipts by origin of travelers - share in total (%) - As of Q4 2022



Source: Eurostat, Refinitiv – Data as of 22/06/2023

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The development of digital technologies with an improved network coverage brings many new opportunities. Mobile applications and online platforms offer a large choice of personalised information and services, including gastronomy, health, professional events, or education. Translation devices enhance connections to local communities. These new tools shape the way tourists travel, with more efficient and easy access to accommodation and personalised experiences.

New tools from online platforms and mobile applications provide easy access to personalised tourist experiences.

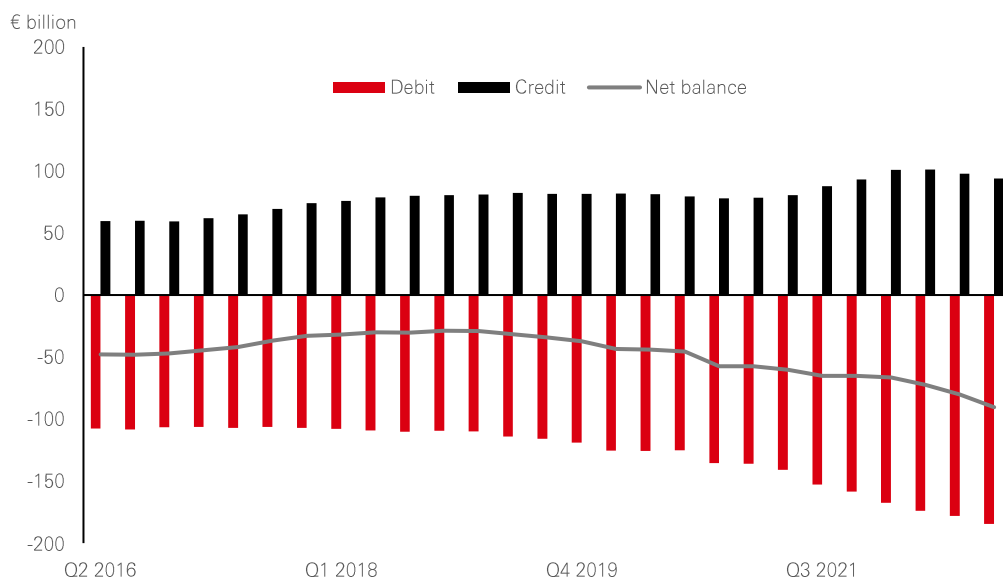
Meanwhile, with the demographic shifts, younger generations may value more cultural immersion, authentic experiences, or sustainability in comparison to older generations. The expansion of remote work also allows more extended stays in foreign destinations than in the past. Finally big data analysis and digital platforms may improve the issue of mass tourism, with the regulation of traffic and bottlenecks during peak seasons. New tourist experiences may increasingly be offered in alternative destinations which used to be less popular, such as the countryside instead of the seashore.

Changing patterns in tourism and digitisation offer opportunities in visitors' experiences. This may be tracked via the intellectual property (IP) ecosystem which generates financing, investment and revenues, via licensing, franchising, or merchandising. The IP ecosystem is rather new, and promising. According to a recent United Nations report¹, intellectual property rights create and promote value to the tourist sector, as it protects local knowledge, traditions, and cultural heritage. At this stage however, detailed data on IP derived from tourism products are not available.

Changing patterns in tourism and digitisation offer opportunities in visitors' experiences, which can be tracked via the intellectual property ecosystem.

The rapid increase in overall intellectual property charges tells us where the trend dynamics are. But the rising deficit in the EU IP balance may also signal opportunities that should not be missed.

Figure 5: EU intellectual property charges in the balance of payments – € billion



Source: Eurostat, Refinitiv – Data as of 22/06/2023

¹ United Nations World Tourism Organisation (2021) https://www.wipo.int/edocs/pubdocs/en/wipo_pub_1054.pdf

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Fixed Income: The aftermath of the bank crisis

In March this year, European fixed income markets were impacted by a volatility peak triggered by a series of idiosyncratic events across the banking sector on both sides of the Atlantic. Since then, overall market volatility has reduced, and credit spreads have compressed. However, not all sectors have benefited from the same spread compression. As illustrated below, the gap between financials and industrials remains twice as high as its 5-year average (Figure 6).

Despite its recent tightening, the gap between financials and industrials spreads remains twice as high as its 5-year average.

This situation might look surprising in the context of higher interest rates and a challenging macroeconomic environment. Especially since, overall, European financials benefit from solid fundamentals. For example, EU banks' average annualised return on equity (RoE) as of end of March was reported as double digits (10.4 per cent) for the first time after the global financial crisis², illustrating that their profitability benefits from higher interest rates and low loan loss provisions. Most recent earning publications are also encouraging for the sector. Nevertheless – and after the authorities' supervision in the US exposed its weaknesses – the European Central Bank (ECB) has decided to implement new surveillance measures on the sector. On 22 July, the ECB announced its intention to monitor the liquidity status of eurozone banks more frequently. Accordingly, European banks will have to communicate data on a weekly basis starting in September, including the maturity of the liquidity in their accounts, their counterparts, and the refinancing operations carried out with the ECB.

This measure, together with current spreads levels, reflects the distrust that has affected financial markets following the failure of US regional banks and Credit Suisse in Europe, and has strongly dented impacted investors' sentiment. In particular, the fact that Credit Suisse's Additional Tier 1 Capital (AT1) has been written-off to zero before equity holders (a first for a globally systemic bank) changed the market's perception of AT1 issues, as capital hierarchy was not respected. Since, AT1 spreads have compressed significantly (from 778 basis points at their peak in March to 566 as of 20 July). Still, they remain around 15 per cent above their 5-year average. Similarly, the difference between AT1 and industrial spreads remains 18 per cent higher than its 5-year average (Figure 7).

Overall, the financial industry seems to remain haunted by the potential risk of a financial crisis – this could come from the impact of higher interest rates on local real estate markets or a more severe than expected recession. Should this risk be overestimated, the sector can offer relative-value opportunities within the European fixed income markets, assuming investors focus their attention to issuer's credit quality and the risks embedded in the structure of subordinated instruments.

Figure 6: Credit spreads (%) and market volatility

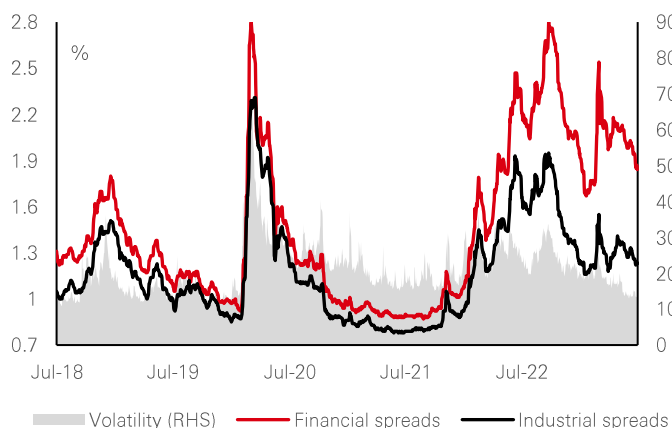


Figure 7: Difference between AT1 and industrial spreads



Indices OAS to Treasury Curve Basis Points. Financials: LEEFOAS Index. Industrials: LEEIOAS Index. AT1: I30904EU Index. Volatility: VIX
Sources: HSBC AM, Bloomberg - Data as of 20/07/2023.

² European Banking Authority Q1 dashboard, 13/07/2023.

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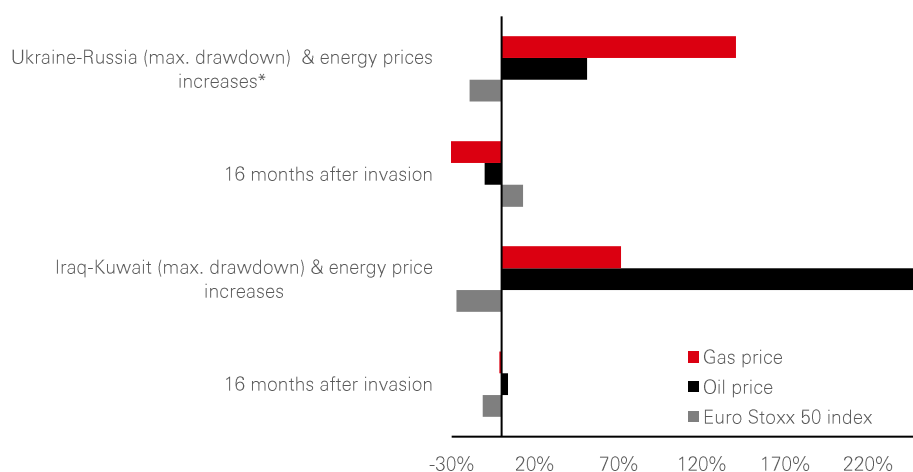
Equities: After the ‘energy crisis’, what comes next?

Back in March of last year, we estimated the impact of the impending energy shock, following the beginning of the Ukraine-Russia crisis. We posited that a complete European ban on Russian crude oil imports could remove three percent from total world production, but the impact on European stock markets and energy prices would likely be less severe than feared. At the time, market commentators were very bearish on Europe, drawing parallels with the deleterious effects of the 1973 Oil Embargo: we pointed out that the magnitude of this energy supply shock was relatively low – not even comparable to Iraq’s invasion of Kuwait in 1990 when 7 per cent of oil production was taken off the market.

Our overall thesis turned out to be correct, even though Europe’s vulnerability was more related to gas than oil. Unlike previous shocks, global energy supply was never taken off the market: it was simply redirected away from Europe and towards new customers, thus keeping global demand and supply dynamics in place. OPEC and its allies even tried to take advantage of the situation by cutting production to boost oil prices. But this failed to work due to US shale, a relatively new player in the global energy market.

In the Figure below, we note that despite OPEC’s uncooperative stance, the impact of the Ukraine-Russia crisis on energy prices and the stock market was relatively contained. Energy prices are now below pre-crisis levels and stock markets are up. The lower energy prices are partially attributable to a growing consensus around the imminency of an economic downturn in most developed markets. But stock markets, still hovering around their all-time highs, do not seem to be discounting this eventuality.

Figure 8: Impact of Oil supply shocks during two conflicts (Ukraine and Kuwait)



*Prices have been calculated starting one month before the invasion to account for mounting worries about a potential conflict
Source: HSBC Asset Management / Bloomberg – Data as of 22/06/2023

Recent market gains in the US could be attributable to the wonders of a future productivity miracle driven by AI. The narrative for market gains in Europe is different. Could reasonable valuations and better-than-expected earnings resiliency be the answer? As cracks in the expanding profit expansion are appearing, the perennial question comes up: to what degree is it baked into the price? In Europe we can safely say that cyclically adjusted valuations are lower than what could be expected at this point of the profit cycle. However, that does not suggest that the music will continue to play. The combination of central bank tightening, corporate earnings weakness and valuation concerns in the US could prove tough to overcome.

Europe’s vulnerability was tied more to gas than oil dynamics.

Stock markets, still hovering around their all-time highs, do not seem to be discounting the likelihood of an economic downturn.

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Data watch

As of 27 July 2023

Eurozone growth is proving sluggish, with the economy entering a technical recession. Headline inflation is falling, but core inflation is proving sticky. The ECB now have a seemingly more dovish tone than in June, noting that interest rates are increasingly dampening demand.

Economic Indicator	Data as of	Last data	Consensus	Previous data	Analysis
PMI composite	Jun	49.9	50.3	52.8	The composite PMI indicator points to further economic weakness, along with much reduced inflationary pressures and employment. Growth in services activity slowed sharply from its April peak. The manufacturing sector deteriorated again this month, with another decline in factory output and new orders.
GDP growth qoq	Q1 2023	-0.1%	0.1%	-0.1%	The eurozone has entered a technical recession, mainly driven by Germany (-0.3% qoq), Netherlands (-0.3% qoq) and Ireland (-2.8% qoq), and despite growth in Italy (+0.6% qoq), Spain (+0.6% qoq), and France (+0.2% qoq). Cuts in government spending, notably in Germany, a contraction in household consumption and a negative contribution from inventories more than offset a positive contribution from net exports, and to a lesser extent from private investment.
Industrial production % yoy	May	-2.2%	-1.2%	0.2%	Eurozone industrial production surprised to the downside, with a broad-based decline in output, except for in the automotive and food industries. Energy-intensive industries producing chemicals, plastic and paper, metal and various intermediate goods continued to be affected by relatively higher energy and transition costs compared to their international competitors. Also manufacturers have reduced their input purchases, as supply chain disruptions have normalised, allowing much faster and more reliable delivery times.
Unemployment rate	May	6.5%	6.5%	6.5%	The eurozone unemployment rate stabilised for the second consecutive month at a record low level of 6.5%, albeit with dispersions across countries: flat in Germany (2.9%) and France (7.0%), decreasing in Italy (from 7.8% to 7.6%), and increasing slightly in Spain (from 12.6% to 10.7%) and the Netherlands (from 3.4% to 3.5%). Despite activity weakness, companies have been hoarding labour so far.
Trade balance (goods, ex EMU) € billion (12Mth cumulative)	May	-235.8	-217.4	-265.3	The eurozone trade deficit improved somewhat, from a record level observed last year, thanks to the fall in gas prices. However, the eurozone trade deficit is still larger than expected as export growth keeps softening, mainly driven by the US and the UK.
Retail sales % yoy	May	-2.9%	-2.7%	-2.9%	Eurozone retail sales in volume terms remained weak, but stopped deteriorating, signalling flat consumer spending in Q2 (versus a contraction in Q1). The post-pandemic rotation from goods to services continued to weigh on retail sales data which only covers goods.
Inflation					
- Headline CPI, % yoy	May	5.5%	5.6%	6.1%	Eurozone June inflation fell to 5.5% in June, while core inflation edged up to 5.4%. Disinflation was broad-based across the region, with one exception, Germany (6.8% against 6.4% in May). This was expected due to some distortions : 1/ the base effect from the temporary combined transport ticket (at €9 in June 2022) ; 2/ the weight changes in the eurozone basket at the start of the year that lifts services inflation (mainly in Germany driven by package holiday prices).
- CPI core*, % yoy	May	5.4%	5.4%	5.3%	
ECB Refinancing rate	27 July	4.25%	4.25%	4.00%	As expected, the ECB hiked rates by another 25bps, amid concerns that inflation will "remain too high for too long". Meanwhile, the ECB stopped the reinvestment of maturing assets under its Asset Purchase Programme (APP) in July. The ECB staff updated its economic outlook in June, with marginal revisions, except for eurozone core inflation, up 0.5ppt for 2023 (5.1%) and 2024 (3.0%). In the July press conference, President Lagarde stated that the Governing Council "have an open mind as to what the decisions will be in September and in subsequent meetings".
Deposit rate		3.75%	3.75%	3.50%	

■	Improved or better-than-expected
■	Worsened or below-expectations
■	Unchanged or in line with expectations

* Eurozone Core CPI is CPI excluding energy, food, alcohol & tobacco
Sources: Bloomberg, Refinitiv, Eurostat, HSBC Asset Management – data as of 27/07/2023

F: Final A: Advanced P: Preliminary estimate

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