Global Market Outlook

27 June 2016

H2 2016 Outlook: Navigating headwinds

Finding value is getting more challenging. It has been a difficult 18 months for investors. In 2015, almost all asset classes struggled. In H1 2016, last year's outperformers (eg. DM equities) underperformed EM equities, bonds and commodities. This has led us to A.D.A.P.T. our recommended positioning even more than we anticipated going into 2016.

How has our outlook changed? We are more cautious on equity markets. European political challenges were on the rise even prior to the Brexit vote, the US economic expansion is likely in its late stages and China is working to avoid a hard landing. With traditional asset classes hardly cheap, the 12-month outlook is increasingly challenging to predict with confidence. That said, we retain our preference for multi-asset income strategies.

Diversify or be dynamic. Against this backdrop, we believe there are two valid approaches. First, now more than ever, it is important to take a scenario-based approach to investing. This naturally leads to a more balanced allocation – our 'moderate' risk allocation has delivered low-single-digit returns since our Outlook 2016 was published. Alternatively, investors could decide on being more dynamic and focus on short-term tactical opportunities that may arise when asset classes become oversold.

This Outlook provides our key long-term as well as tactical ideas which should guide investors through what is likely to remain a challenging environment for the rest of the year.

The team

Alexis Calla*

Global Head, Investment Advisory and Strategy, Chair of the Global Investment Committee

Steve Brice*

Chief Investment Strategist

Aditya Monappa*, CFA

Head, Asset Allocation and Portfolio Solutions

Clive McDonnell*

Head, Equity Investment Strategy

Audrey Goh, CFA

Director, Asset Allocation and Portfolio Solutions

Manpreet Gill*

Head, FICC Investment Strategy

Rajat Bhattacharya

Investment Strategist

Arun Kelshiker, CFA

Executive Director Asset Allocation and Portfolio Solutions

TuVi Nguyen

Investment Strategist

Victor Teo, CFA

Investment Strategist

Tariq Ali, CFA

Investment Strategist

Abhilash Narayan

Investment Strategist

Trang Nguyen

Analyst, Asset Allocation and Portfolio Solutions

Our experience and expertise help you navigate the markets and provide actionable insights to reach your investment goals.

* Core Global Investment Committee voting members

Contents

1

Highlights
01 Navigating headwinds

2

Perspectives from our Global Investment Committee
Global Investment Committee 04

3

Scenarios
Potential H2 scenarios 08
Investment strategy 11
Macro overview 13

4

Asset classes
18 Bonds
22 Equities
27 Commodities
29 Alternative Strategies
30 Foreign Exchange

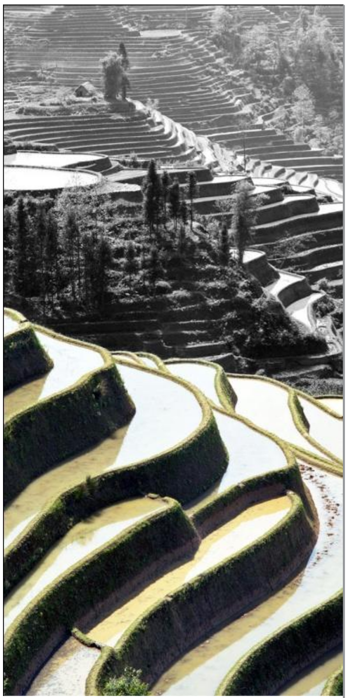
5

Multi-asset
Multi-asset 33
Leverage 39

6

Performance review
H1 performance review 41
Market performance summary 43
FY 2016 performance themes 44
Events calendar 47
Important information 48

Perspectives from our Global Investment Committee



Q What are the key challenges facing investors?

A The key challenge investors are facing is finding sources of strong potential returns in a world where low or even negative yields are commonplace and equity prices, in many cases, are fully valued. This becomes even more crucial as we enter the later stages of the US economic cycle, political pressures in Europe are on the rise and China tries to avoid a hard landing.

Against this backdrop, we believe identifying key plausible scenarios is important. The current economic environment of modest growth and limited inflationary pressure could continue for an extended period, but we believe the risks to this outlook are increasing, on both the upside and downside.

On pages 8-10, we outline four scenarios and their potential implications for different asset classes. The bottom line is that focusing on one asset class, whether bonds or equities, is risky. Investors should adopt a balanced approach, including having some inflation hedges.

As an example, from a multi-asset investment perspective, we would supplement an income approach with global macro strategies to cushion against extreme macroeconomic scenarios.

Q Are you being too cautious on the outlook for equity markets?

A We see significant upside and downside risks to the outlook for global equities, and we outline some of the potential scenarios in the next section.

On the positive side, the worst of the earnings recession appears to be behind us, and fund managers still hold excessive levels of cash. The latter suggests they are already prepared for weakness, which could limit the size of any short-term pullback.

However, with equity markets fully valued, markets pricing in a strong earnings rebound and the US economy likely late in its expansion cycle, we prefer to err on the side of caution by trimming equity exposure where appropriate and focusing on more defensive areas.

That said, we would still hold an allocation to equities given the risk of a "melt-up" scenario – where fund managers are forced to buy equities on a break higher – and positive earnings surprises.

Equity options markets, particularly in Japan and to some extent in Europe, are pricing in a greater probability of sizeable moves than usual – either up or down – highlighting rising uncertainty over potential outcomes. Therefore, the upside scenarios should not be discounted lightly.

How does Brexit change your outlook?

The Brexit vote came as a surprise and is symptomatic of a global trend of rising distrust of the political and economic elites and a questioning of the benefits of globalisation. Political developments in the US and elsewhere in Europe tell the same story. We believe this is a strong headwind for risky assets.

Of course, it would be great if this was to trigger a wake-up call amongst European voters - we note the Brexit vote was very tight and far from a tidal wave. However, recent history makes us believe the root causes of these trends are too deep to be knocked off course just yet.

We have been dialling back risk significantly over the past 6 months and we do not believe markets have become sufficiently undervalued to reverse this trend.

Of course, our preference for Euro area equities has come under increased scrutiny. We expect European authorities to be alert to signs of financial market stress, limiting the short-term contagion from the Brexit vote. However, rising uncertainty is likely to keep the risk premia attached to holding Euro area equities higher, reducing the scope for a relative re-rating versus other markets.

Has the outlook for EM assets improved?

The unwinding of US interest rate hike expectations and the related weakness of the USD so far this year have clearly boosted Emerging Market (EM) sentiment. Looking ahead, we believe relative GDP and earnings growth expectations between Developed Markets (DM) and EM are a key factor behind the relative performance of DM and EM equity markets.

We are not convinced that the conditions for a reversal of this trend are in place yet, with China quickly backtracking on the economic stimulus implemented earlier this year. However, we acknowledge that other countries in the EM world are seeing interesting developments. Brazil may best epitomise this, as the promise of economic reforms has helped its currency appreciate, bond yields fall sharply and equity market rally. Corporate earnings expectations have also soared, albeit from extremely subdued levels.

We are not ready, at this stage, to fully buy into this story. That said, our Global Investment Committee (GIC) has less conviction on the outlook for DM to outperform EM over the coming 12 months. This suggests a more balanced exposure within equities is prudent.

What is the outlook for the CNY and what are the implications for global financial markets?

Authorities in China want to reduce the economy's reliance on debt financing. While real economic growth (excluding inflation) is critical for expanding income and wealth, nominal economic growth (including inflation) is key to managing debt levels.

Against this backdrop, we believe a weaker currency makes sense. Not only does it support exports and thus real GDP growth, but also supports inflation.

Therefore, we believe the authorities will continue to push the CNY weaker. This view has been reinforced with the authorities allowing the CNY to weaken significantly against a basket of currencies (of China's key trading partners) as soon as the USD weakens, and then only partially offsetting the impact of the ensuing USD rebound (see Figure 6 on the next page).

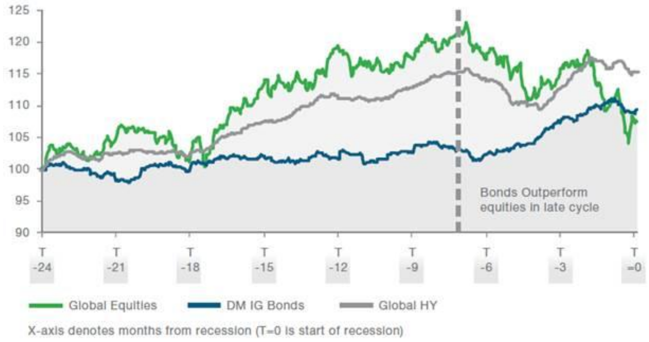
The main constraint in this policy is the risk of renewed capital flight, which could tighten domestic liquidity conditions and undermine the economy. Therefore, we expect the authorities to allow the CNY to weaken gradually over time.

From an international investor's perspective, in August 2015 and early this year when USD/CNY hit new highs, we saw significant weakness in global equity markets. Recently, we saw equity markets shudder as USD/CNY breached the January 2016 high, although this was largely put down to rising Brexit fears.

As markets come to terms with the implications of Brexit, USD/CNY is likely to come back into focus, especially if the USD rebounds. That said, the authorities' communication around their currency policy has improved, which may slightly reduce risks.

Figure 1: We prefer to err on the side of caution with the US in the late stage of its economic cycle

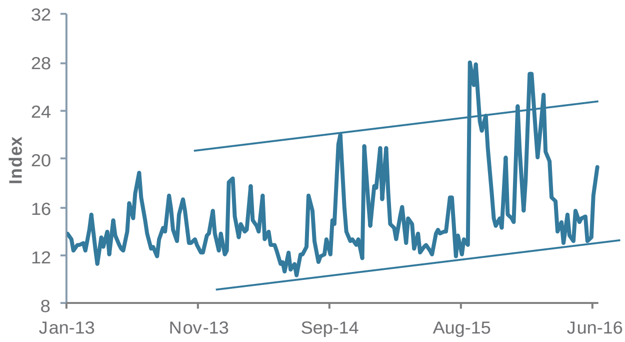
Average performance of different asset classes ahead of the last two US recessions



Source: Bloomberg, Standard Chartered

Figure 2: Volatility is trending higher; spikes are more frequent

S&P500 VIX volatility index



Source: Bloomberg, Standard Chartered

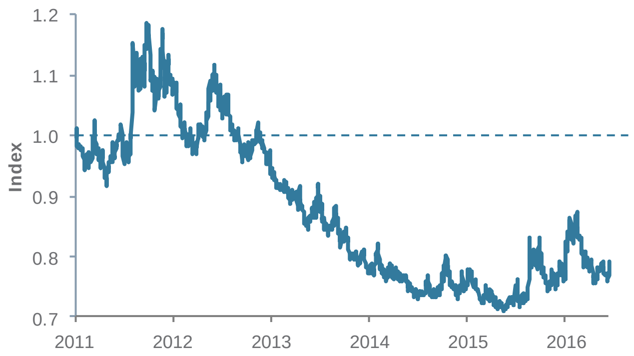
Figure 3: Increased uncertainty following Brexit may reduce the likelihood of a Euro area equity re-rating

Relative valuations (using forward price-earnings ratio) of Euro area equities versus the US market

Source: Factset, Standard Chartered

Figure 4: EM equities have reversed only some of their previous underperformance

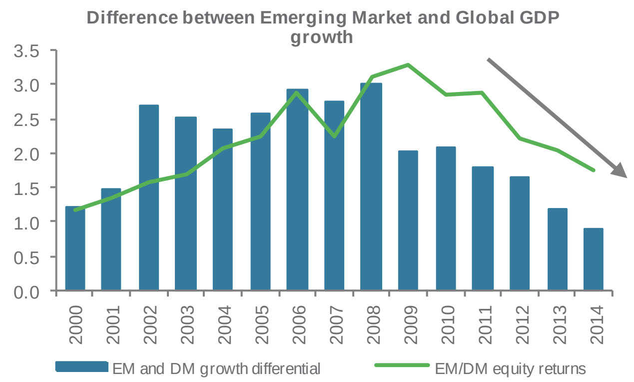
Relative performance of MSCI EM to MSCI DM equity markets



Source: Bloomberg, Standard Chartered

Figure 5: Bottoming of EM relative growth expectations critical to sustained EM outperformance

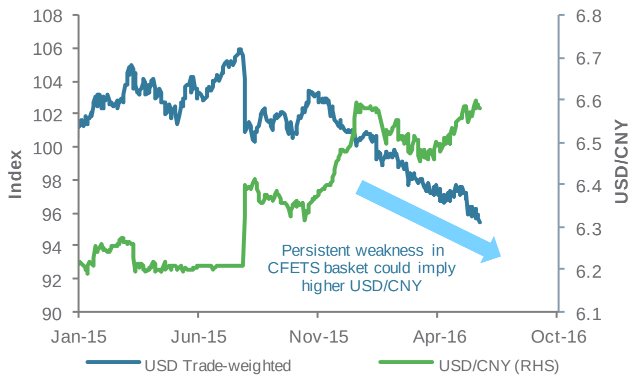
EM and global GDP growth differential and relative equity performance between EM and DM



Source: IMF, Bloomberg, Standard Chartered

Figure 6: China's authorities continue to push the CNY weaker

USD/CNY and the CNY CFETS trade-weighted exchange rate



Source: Bloomberg, Standard Chartered

Potential H2 scenarios

The global economic outlook is getting increasingly uncertain. Given this, our approach is to take a scenario-based, data-dependent view on investing. This involves identifying key plausible scenarios, understanding the implications of these scenarios for current investment allocations and then taking measures to try to maximise returns and reduce risks, taking into account each scenario's probability and its expected impact.

Naturally, any such process should encourage investors to take a more balanced approach rather than focus on one asset class.

Any attempt to define scenarios is a huge simplification as, in reality, there are an infinite number of potential scenarios. Our approach is to identify, what we believe, are key macro variables and then use them to outline four potential scenarios that we believe investors cannot ignore.

We have identified nine macro variables for this purpose. Their impact on risk appetite under the different scenarios is listed in the table below. We have assumed that slower growth, lower inflation, tighter monetary policies, higher bond yields and a stronger USD are all negative for risk assets. While these assumptions can be questioned, we believe they reflect the way markets are interpreting them currently.

Interpreting oil prices is more contentious. In recent times, higher oil prices have been viewed as positive for risk appetite as they boost corporate earnings and reduce deflationary pressures. However, we are starting to see this correlation breaking down, and we take the view that much higher or much lower oil prices would be negative for risk appetite.

A brief description of each scenario is included with the spider charts. What we attempt to do here is understand the implications of each scenario for each asset class and, thus, investors.

Factor	Good for risk appetite
US growth (GDP)	Higher
US inflation (PCE deflator)	Higher
China growth (PMI)	Higher
US 10yr Treasury yield	Lower
US dollar (trade-weighted index)	Lower
Oil price (Brent)	No extreme move
Fed policy	Easier
ECB policy	Easier
BoJ policy	Easier

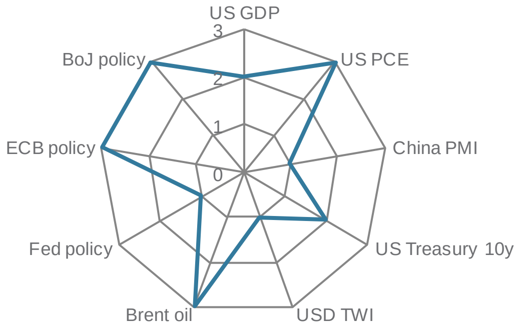
Core scenario – 45% probability

The muddle-through continues with the Fed continuing to tighten policy very gradually; China slows (but avoids a hard landing) and the ECB and BoJ continue to ease monetary policy to address deflationary pressures. The probability attached to this scenario has likely fallen significantly in recent times.

Upside scenario – 15% probability

US and China's economies accelerate modestly, but inflationary pressures remain benign given global excess capacity. The Fed continues to tighten monetary policy very gradually, while the recovery in global demand reduces pressure on the ECB and BoJ to ease monetary policy.

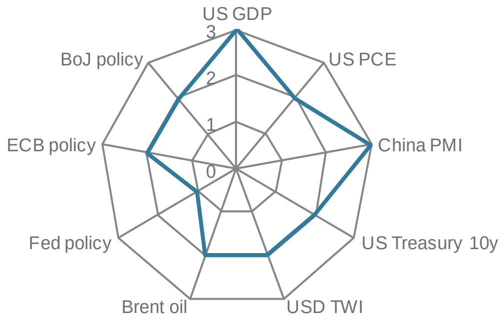
Core scenario



1- most negative for risky assets; 2- Neutral; 3- most positive for risky assets

Source: Standard Chartered Global Investment Committee

Upside scenario



Source: Standard Chartered Global Investment Committee

The lack of a recession means that, while we see bouts of financial market volatility, an equity bear market is avoided. This allows investors to use sell-offs as a buying opportunity.

Bond yields rise gradually in a way that is still consistent with positive returns outside of G3 government bonds.

Gradual US monetary policy tightening contrasts with further monetary policy easing in Japan and, possibly, Europe, which pushes the USD towards the top end of its recent range.

This, together with a resumption of the downtrend in China's growth (albeit with a hard landing avoided), is enough to keep investors nervous about chasing the EM equity rally.

That said, bottoming commodity prices and the potential for countries to embark on economic reforms may sow the seeds for future EM outperformance.

This is the true 'Goldilocks' environment, where global growth accelerates modestly, but excess capacity at the global level means inflationary pressures remain benign.

The Fed is likely to hike interest rates, but this is still gradual enough to avoid a bond market rout; global equities rally strongly, aided by a recovery in earnings expectations and fund managers deploying excessive cash positions into equities.

The global recovery helps boost the economy and inflation expectations in Europe and Japan, which means that the ECB and BoJ refrain from further easing. The USD stabilises, reducing pressure on EM currencies and allowing EM central banks to pursue pro-growth policies.

When combined with economic reforms and recovering commodity prices, this enables a strong outperformance of EM equities.

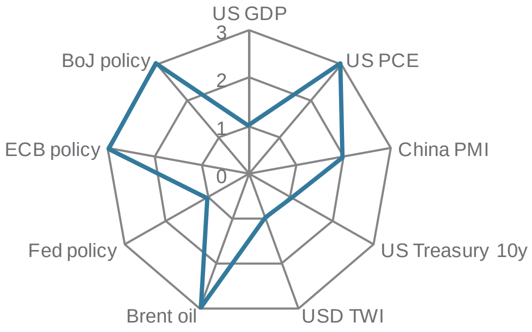
Inflationary scenario – 20% probability

Inflationary pressures pick up in the US as the economy hits full capacity despite unimpressive growth. The Fed is forced to tighten policy more aggressively than expected. China, Europe and Japan, faced with increased concerns about the path of the US economy, ease policies to support domestic growth.

Deflationary scenario – 20% probability

Deflationary pressures intensify as the US economy starts to weaken. This leads to another round of coordinated monetary, and potentially fiscal policy, easing. The USD strengthens as risk appetite wanes and oil prices fall. China's policy response is key to the outlook for global growth and commodity demand.

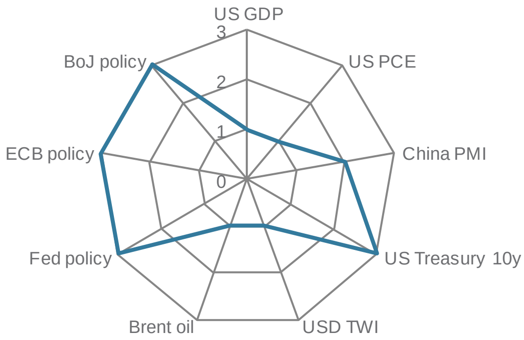
Inflationary downside



1- most negative for risky assets; 2- Neutral; 3- most positive for risky assets

Source: Standard Chartered Global Investment Committee

Deflationary downside



Source: Standard Chartered Global Investment Committee

This is a very challenging environment for a traditional equity-bond balanced allocation. US inflation accelerates as the economy runs into supply-side constraints due to low productivity and limited labour market slack.

Stagflation or recession is the outcome, and tighter US monetary policies in the absence of strengthening growth undermine support for global equity markets, especially in EM, given USD strength.

Bond yields spike, at least temporarily, while credit spreads widen, with bond investors incurring negative returns.

Commodities and commodity producers may outperform in this environment.

Global macro strategies and trend-following strategies (CTAs) are also areas that have the potential to generate strongly positive returns.

Real estate should also perform well in this environment.

In this scenario, the US economy weakens to such an extent that deflationary concerns increase substantially.

Coordinated monetary policy easing is insufficient to offset these deflationary forces at the global level, but Japan becomes the first central bank to employ 'helicopter money' by printing money to directly finance an increase in fiscal spending. Japan's equities would likely outperform significantly in this scenario.

Credit spreads widen significantly as corporate default expectations increase, but US Investment Grade (IG) bonds outperform significantly as the Fed cuts rates and moves towards quantitative easing once again.

Elsewhere, global macro strategies and CTAs have the potential to generate strongly positive returns, while gold prices are likely to increase despite a strengthening USD.

Investment strategy

A

Advanced economies at different stages of the economic cycle. US expansion mature, but consumer spending to drive growth in 2016. Europe and Japan in mid-cycle

D

Deflationary pressures to abate in Developed Markets due to gradually tightening labour markets and bottoming oil prices

A

Asia and Emerging Markets still dependent on China, which is transitioning towards consumer-led growth. Oil prices also key

P

Policies of central banks to remain supportive of growth, Fed tightening notwithstanding

T

Transition to late cycle likely to lead to higher volatility

Balancing the cycle

- At the start of 2016, we argued the US economic expansion may have further to run while China would avoid an imminent hard landing. This meant we remained constructive on equities, but favoured balancing this with a rising allocation to bonds.
- Today, six months further into the cycle, we are more cautious amid rising risks. We still believe a balanced allocation is key, consistent with our core scenario, but our preference for bonds has risen further, while we are more selective in equities.
- Multi-asset income strategies remain attractive, in our view, but volatility of the sort witnessed after the 'Brexit' vote is a key risk in H2; we would complement with multi-asset macro strategies to manage the risk of a sharp correction.

US and China economic cycles remain key

At the beginning of the year, we argued where we are in the US and China economic cycles is key to making investment decisions in 2016. We believe this trade-off – balancing the possibility of continued growth versus descending into either the inflationary or deflationary scenarios – remains a cornerstone of our investment preferences.

The risk of higher inflation is a key consideration; bottoming oil prices, combined with rising US wages, mean there is a risk we could end up in an inflationary scenario.

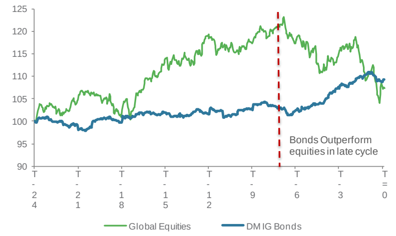
Finally, further Chinese Renminbi weakness or an event shock are risks. An extended bout of post-Brexit volatility accompanied by further CNY losses would not surprise us.

Bonds preferred, both as a hedge and as a source of return

Our preference for bonds has been on a rising trend through H1 16. It is tempting to view this as a hedge against volatility alone; indeed, our preferred sub-asset class – US Investment Grade (IG) corporates – has done well during market volatility both early in the year as well as post-Brexit.

Figure 7: US cycle is key; IG bonds begin to outperform 6-9 months ahead of a recession

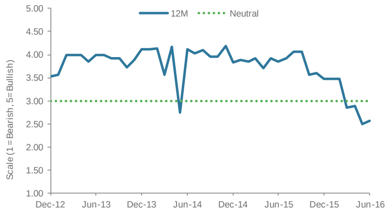
Equities and IG bonds – average total returns ahead of a US recession



Source: Bloomberg, Standard Chartered

Figure 8: Our investment committee has been turning more cautious on risk assets

SCB Investment Committee view on risk assets (higher score=more bullish)



Source: Standard Chartered

Investment strategy

- However, we believe bonds can be an active source of return in a more benign scenario, where
  - High Yield (HY),
  - Emerging Markets (EM) USD sovereign and
  - Asian corporate bonds

  are likely to do well. In an uncertain second half of 2016, we believe holding a combination of both IG and riskier bonds is a sensible investment decision. See page 18 for more on bonds.

We would err on the side of caution in equities

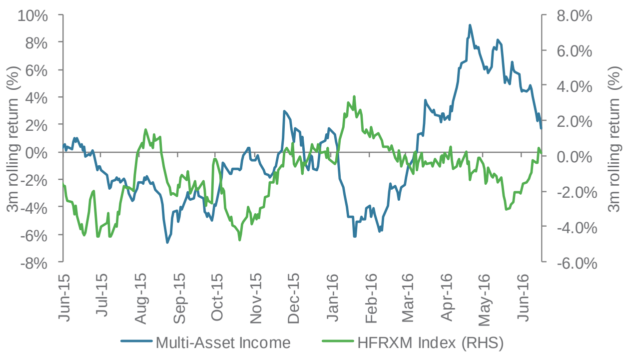
- Relative to the start of the year, we have become considerably more selective within equities. 'Late cycle' in the current context is likely to be characterised by narrowing margins for US companies, Fed tightening and/or volatile commodity prices challenging EM equities. Event-risks such as the upcoming US election are also a risk. This means maintaining exposure to equities, but being much more selective. Earnings are key, given stretched valuations.
- We favour US equities. While fundamentals, in terms of earnings and profit margins, favour Euro area equities, the US is likely to outperform during pullbacks. In Asia, we prefer India and Korea. From a global sector perspective, though, we increasingly favour defensive sectors in H2. See page 22 for more.

Multi-asset income strategy still favoured, but focus on risk of correction

- Putting together our views on key market drivers, bonds and equities, the emphasis is on maintaining a cautious, but balanced, approach to investing over the remainder of 2016. This is not only consistent with our scenario-based approach – history suggests markets face the risk of a series of drawdowns late in the economic cycle. Hence, we are equally focused on managing the risk of a correction.
- Multi-asset income strategies remain one of our most favoured strategies within A.D.A.P.T. on this basis. However, we prefer balancing multi-asset income assets with multi-asset macro strategies. See page 33 for more.

Figure 9: Low correlation between multi-asset income and multi-asset macro strategies support a blended approach

Multi-asset income allocation performance versus HRFX global macro strategy index, % 3mth rolling return



Source: Bloomberg, Standard Chartered

Figure 10: Our Tactical Asset Allocation views (12m) USD

Asset class	Sub-asset class	Outlook
Cash		N
Fixed Income (OW)	Developed Markets Investment Grade government bonds	UW
	Developed Markets Investment Grade corporate bonds	OW
	Developed Market High Yield corporate bonds	N
	Emerging Markets USD government bonds	N
	Emerging Markets local currency government bonds	UW
	Asia USD corporate bonds	N
Equities (UW)	US	OW
	Euro Area	N
	UK	N
	Japan	N
	Asia ex-Japan	N
	Other EMs	UW
Commodities		N
Alternatives		OW

Source: Standard Chartered

Macro overview

Key View

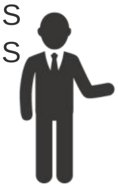
Global economic growth, already below trend since the Global Financial Crisis, is slowing. Brexit could potentially hurt growth.

The US faces growing risk of a recession

The Euro area and Japan face continued deflationary pressures

China is likely to slow further, but avoid a hard landing

IMPLICATIONS FOR INVESTORS



Slowing growth, rising inflation

- The world faces increasing challenges in reversing a growth slowdown. We believe the US is in the late stages of its business cycle. The Brexit shock could hurt Europe's recovery. Japan's expansion may have peaked. China is likely to slow further, although it may still avoid a hard landing – this should provide some respite to EMs.
- US inflation appears to have bottomed amid tighter job markets and rising oil prices.
- We expect the Fed to stay cautious, raising rates only once this year. The ECB and BoJ are likely to increase stimulus in H2 as they battle rising deflationary pressures. China is likely to provide targeted stimuli to prevent a sharp downturn.

A policymakers' dilemma

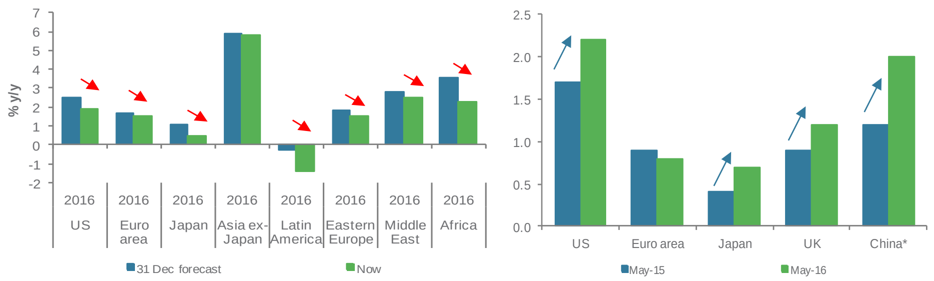
Global economic growth, already below trend since the Global Financial Crisis, is slowing. Consensus estimates suggest the pace of growth is likely to ease in 2016 for the fifth time in six years, having peaked in 2010. And yet, for the first time since 2011, inflation is rising, partly due to higher oil prices and tightening labour markets, which is fuelling wage pressures, although Brexit could potentially hurt growth and renew disinflation pressures.

The combination of slowing growth and rising inflation presents a rare dilemma for policymakers. Our Global Investment Committee considered some policy implications:

- The US economy is likely to grind on at below-trend growth, with growing risk of a recession in 12-18 months. Yet, rising wage pressures mean the Fed may have to raise rates, albeit at a modest pace – we expect one 25bps rate hike this year.
- Europe and Japan face rising deflationary pressures. With benchmark rates already below zero, the ECB and BoJ may have to get more aggressive. BoE may cut rates. China too may need more stimulus to meet its target of at least 6.5% annual growth.
- We assign a 45% probability to the above muddle-through scenario. There is a 40% chance of a downturn caused by either an inflation spike or deepening deflation.

Figure 11: Growth has slowed across the world, although inflation is picking up in major economies

Consensus GDP growth forecasts on 31 December 2015 and on 17 June 2016, %, y/y; Core CPI in May 2015 and May 2016, %, y/y (*CPI in the case of China)



Source: Bloomberg, Standard Chartered

Macro overview

Is the US facing stagflation risks?

The US economy has been growing below its post-crisis trend (around 2.5%) since Q4 15. The manufacturing and export sectors remain weak due to continued strains on energy and resource industries and a still-strong USD. Slower global growth amid the Brexit uncertainty could hurt export prospects further. Domestic consumption remains the bedrock of the expansion, with retail sales picking up in April and May, helped by a tighter job market, after a lacklustre Q1. The housing sector remains another key growth driver.

The headwind to growth notwithstanding, inflation is finally ticking higher. A tight job market is starting to push up wages, while residential rents are rising sharply as demand for multi-family homes among millennials rises. Thus, we believe inflation in the face of slowing growth and falling productivity is a key risk for the US economy.

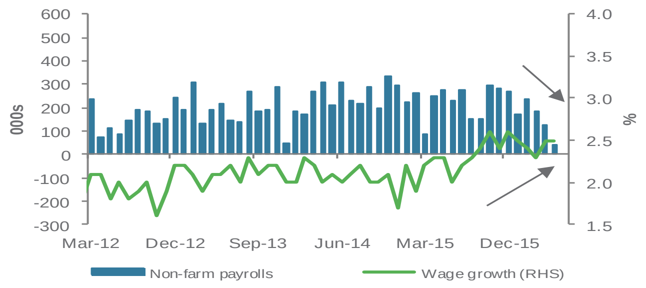
Our central scenario has the US economy continuing at its below-trend growth for the next 12-18 months, but at just enough pace to create additonal jobs without causing a sharp rise in wage pressures or inflation. The slowdown in the US job market seen so far this year fits into this scenario as it could cap wage gains in coming months, relieving some pressure on inflation. Such an outcome is likely to allow the Fed to maintain a very gradual pace of tightening.

However, a persistent slowdown in job creation remains a key risk for the US economy, especially as policy uncertainty increases in the run-up to the US Presidential elections in November and due to the impact of Brexit. In an alternative risk scenario, increasing domestic wage pressures, combined with rising oil prices and house rentals, cause a sharp spike in inflation, forcing the Fed to raise rates earlier and faster than market expectations.

At its June policy meeting, Fed policymakers took note of the weakening job market and rising global uncertainty, pushing back expectations of a rate hike this year. The latest Fed data shows more policymakers now expect only one rate hike in 2016, while Fed funds futures suggest the market expects less than a 20% chance of any rate hike this year. On balance, we remain in the 'one hike in 2016' camp given the growth headwinds.

Figure 12: US job growth has slowed, while wages are rising

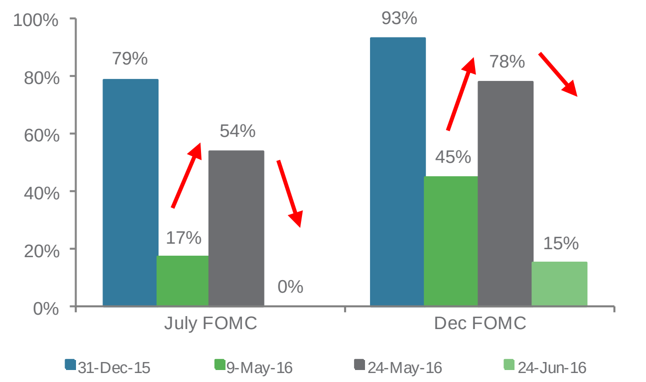
US non-farm payrolls, '000s; average hourly earnings, %, y/y



Source: Bloomberg, Standard Chartered

Figure 13: Fed rate hike expectations have plunged in the past month

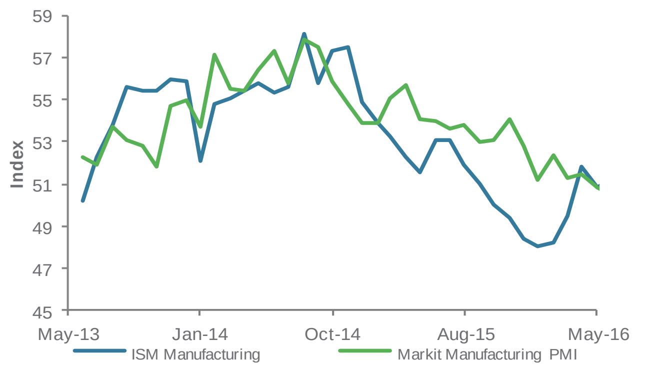
Probability of a Fed rate hike at the July and December Fed policy meetings



Source: Bloomberg, Standard Chartered

Figure 14: US manufacturing has slowed sharply since last year

US ISM Manufacturing index and US Markit Manufacturing PMI



Source: Bloomberg, Standard Chartered

Macro overview

Europe faces rising risk from Brexit shock

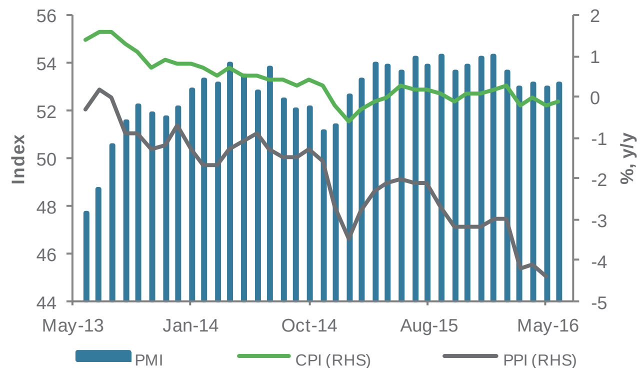
Growth has surprised on the upside in the Euro area lately on the back of rising domestic consumption. Business confidence has held up well in the major economies. However, the Brexit surprise could hamper the recovery. The UK economy, already undergoing a pronounced slowdown since the start of the year, faces rising uncertainty as it begins negotiations to leave the the European Union.

Disinflationary pressures could rise following the Brexit vote, clouding the Euro area outlook. The EUR's strength this year had also been a negative for the pricing power of businesses as they face increasing competition from imports. Excess productive capacities and downward pressure on wages due to a still-high jobless rate in the peripheral economies remain major challenges. In the UK, the GBP's sharp devaluation may fuel near-term inflation pressures, although slower growth may dampen price pressures over the medium term.

With long-term inflation expectations still subdued, there is increased pressure on the ECB and BoE to act. We expect both to add stimulus in H2. The ECB could extend the scope and duration of its ongoing easing programme while the BoE could cut rates and boost bond buying.

Figure 15: Euro area business confidence had been robust before the Brexit vote, although disinflationary pressures appear to be rising

Euro area PMI; consumer and producer price inflation, %, y/y



Source: Bloomberg, Standard Chartered

Key factors to watch

Economic indicators	What to look for
Business confidence	Euro area Purchasing Managers Indices have held up well so far
Bank lending	Euro area consumer credit demand has been picking up; business lending remains lacklustre
Inflation	Euro area producer price declines need to end; consumer prices are subdued

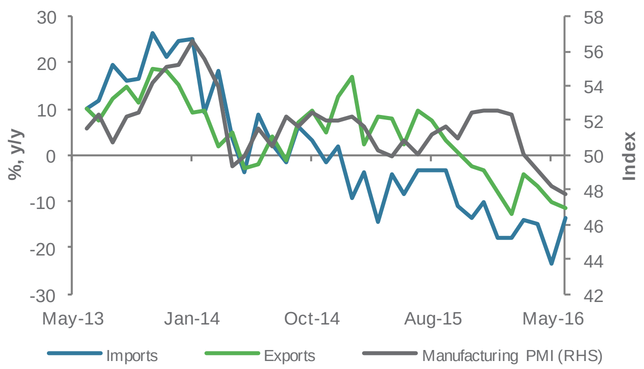
Japan faces growing deflation risks

Japan's growth rebounded sharply in Q1 from late last year's contraction on the back of resilient domestic demand. However, the economy is likely to slow once again due to headwinds facing its export and manufacturing sectors from the JPY's sharp rebound and amid Brexit uncertainty.

The persistence of deflation risks despite years of extremely easy monetary policies has raised questions about the efficacy of central banks in reviving growth and inflation. With long-term inflation expectations in Japan still hovering close to 0.5%, there is increasing talk of the BoJ writing-off or monetising government debt, though it may take a sharper downturn for the authorities to embark on such a risky initiative. The government's decision to push back the planned sales tax hike until 2019 removes a key uncertainty. We also expect a fiscal stimulus package in H2 to add weight to the increasingly stretched monetary policy.

Figure 16: Japan's manufacturing sector confidence has slumped with continued contraction in exports

Japan's exports and imports, %, y/y; Manufacturing PMI



Source: Bloomberg, Standard Chartered

Macro overview

Asia – continued trade slump clouds outlook

The downturn in global trade continues to dampen the outlook for Asia's export-oriented economies. Brexit uncertainties could worsen the slowdown. Asian exports have contracted for the second year running. This is adding to excess manufacturing capacity and increasing disinflationary pressures for key exporters such as South Korea, Taiwan, Hong Kong and Singapore as well as the manufacturing sector in China. However, the more domestic-demand driven economies such as India and Indonesia are likely to continue to outperform in terms of growth.

China, still the region's main growth driver, faces a significant challenge – that of keeping growth within its 6.5-7.0% annual target while persisting with economic reforms to reduce excess capacities and debt levels. This requires a fine balancing act – implementing targeted stimulus measures when growth slows (as in Q1), and gradually withdrawing it when growth picks up (as in Q2).

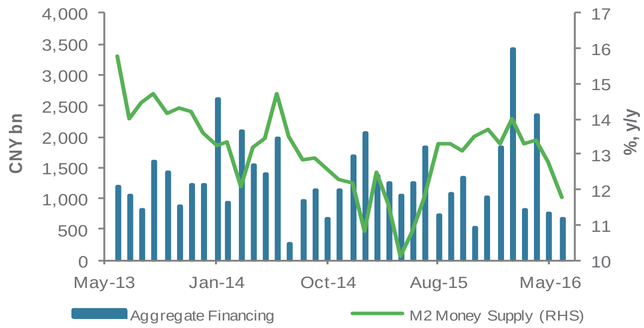
We believe authorities are likely to persist with this strategy through the rest of the year, enabling the economy to avoid a hard landing. However, excessive corporate sector debt levels remain a key risk. The challenges to its manufacturing sector notwithstanding, data shows China's consumption-driven services sector continues to expand, albeit at a slower pace than previous years.

Elsewhere in Asia, India remains an economic bright spot, with its domestic-demand driven economy growing by more than 7%. India's twin deficits – fiscal and current account – have declined significantly in recent years, helped by lower average oil prices; its external reserves have risen, helped by a rise in foreign investment.

However, the decision by RBI governor, Raghuram Rajan, to step down in September has raised questions about the sustainability of some of the reforms Rajan initiated in the banking sector to clean up bad loans. The quality of the coming monsoon, after two years of below-average rainfall, is the next focus. A good monsoon is likely to boost rural consumption and keep inflation pressures in check, allowing the central bank to cut rates further.

Figure 17: China has pared back credit stimulus after a surge in Q1

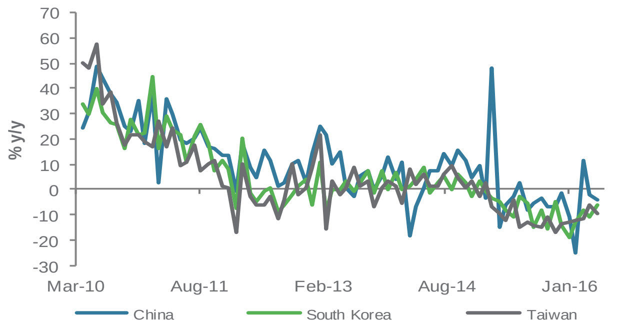
China's aggregate financing, CNY bn; M2 money supply growth, %, y/y



Source: Bloomberg, Standard Chartered

Figure 18: Asia's export contraction continues

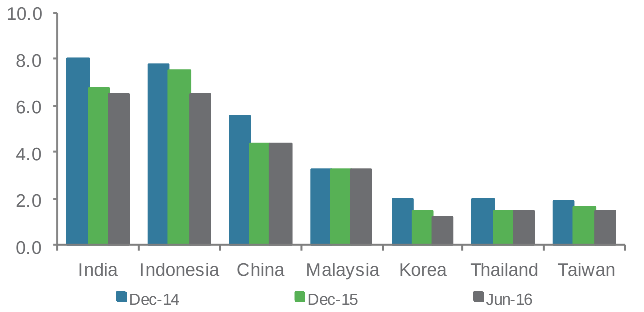
Export growth in China, South Korea and Taiwan, %, y/y



Source: Bloomberg, Standard Chartered

Figure 19: Central banks in India, Taiwan, South Korea and Indonesia have cut rates this year; further cuts are likely if the USD and oil prices do not rise significantly

Central bank policy interest rates in major Asian economies, %



Source: Bloomberg, Standard Chartered

Macro overview

Brazil and Russia may be turning the corner

Brazil, Latin America's largest economy, is likely to contract for the second straight year. However, it may have seen the worst of the downturn, with consensus estimates suggesting a slower annual contraction for rest of the year and the economy likely to start growing again in Q2 17.

The new government led by acting President Michel Temer, who replaced President Dilma Rousseff, has been able to get the parliament's approval for key reform measures aimed at reviving business and investor confidence.

The measures have lifted consumer confidence and have led to a rebound in stocks, bonds and the currency. However, we would watch for further measures that are needed to curb public spending, cut the fiscal deficit (currently close to 10% of GDP) and bring down inflation (currently above 9%). These measures are likely to enable the central bank to start cutting rates, currently at a 10-year high of 14.25%.

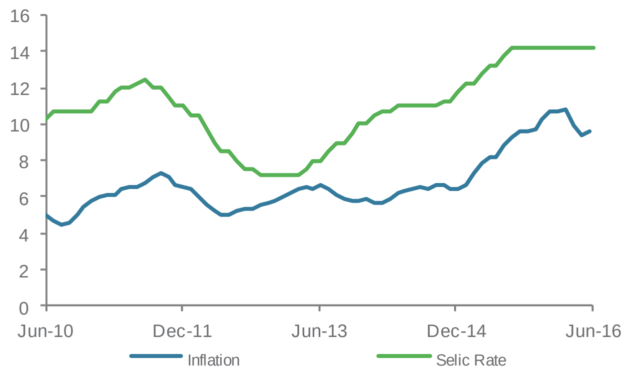
The recovery in commodities is also helping Brazil and other resource-driven EM such as Russia emerge from two years of downturn. Russia, in particular, is benefitting from the sharp rebound in crude oil prices since February, with consensus estimates suggesting the economy is likely to start growing again by Q4 16. However, a renewed downturn in commodities amid Brexit concerns could hurt the recovery.

While Russia's manufacturing sector continues to contract, the services sector has returned to growth. Inflation has plunged from a peak above 16% last year to just above 7% as the impact of last year's currency depreciation fades (the RUB has appreciated almost 20% since its record low in February) and the recession curbs demand pressures.

Although Russia's inflation rate remains well above the authorities' 4% target, the central bank cut rates in June for the first time in a year, by 50bps. The key rate at 10.5% implies Russia's real (inflation-adjusted) rates remain among the highest among major EMs, leaving scope for further cuts, especially if consumer inflation continues to decline.

Figure 20: Brazil's inflation rate has fallen lately; a continuation of the trend should allow the central bank to cut rates

Brazil's consumer inflation, %, y/y; Central bank's benchmark Selic Rate, %



Source: Bloomberg, Standard Chartered

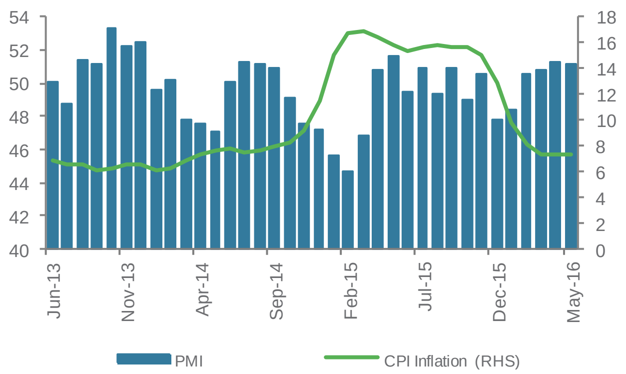
Key factors to watch

Economic indicators	What to look for
Brazil fiscal deficit and inflation	Measures to cut the fiscal deficit are critical for bringing down inflation
Commodity prices	The rebound, which has helped the EM recovery, may stall amid Brexit risks
Russia's inflation	Russia's inflation remains well above the central bank's target, despite declines since last year

Source: Bloomberg, Standard Chartered

Figure 21: Russia's inflation has stabilised recently after a sharp decline over the past year, while business confidence has risen

Russia's Purchasing Managers' Index; Consumer inflation, %, y/y



Source: Bloomberg, Standard Chartered

Bonds

Key View

We prefer corporate bonds over sovereign bonds. A balance of quality and yield can serve to provide income as well as a hedge against volatility

US IG corporate bonds are our top pick

Maintain exposure to HY bonds to generate income

Take EM exposure through USD-denominated bonds

IMPLICATIONS FOR INVESTORS

Constructive on bonds

- Bonds remain one of our preferred asset classes. In today's world of rising uncertainty, we continue to expect bonds to deliver positive absolute returns and a better risk/reward compared to equities and commodities.
- Balanced exposure to high-quality bonds as well as higher yielding bonds should offer both a hedge against volatility and a source of return, as demonstrated after the recent Brexit vote and the sell-off at the beginning of the year.
- We prefer corporate bonds over government bonds. US Investment Grade (IG) corporate bonds are our top pick due to the attractive combination of quality and reasonable yields on offer. Asian USD bonds are next in our preference order of corporate bonds, followed by Developed Market (DM) High Yield (HY) bonds.
- We prefer to take Emerging Market (EM) exposure through USD-denominated government bonds as we view currency weakness as a risk for local currency bonds.

Bonds preferred, both as a hedge and a source of return

Bonds have delivered solid high-single-digit returns in 2016 and we continue to like the asset class both as a hedge against growth concerns and as offering an attractive risk/reward from a total return perspective. Bonds have demonstrated their value as a hedge in volatile markets both after the Brexit vote as well as in the sell-off at the beginning of the year.

We acknowledge the recent rally has reduced bond yields compared to the start of the year. However, we believe the change in the investment landscape, including lower growth expectations, geopolitical risks and easy monetary policy, are likely to be supportive of global bonds and keep yields close to current levels. After the recent rally in high-quality government bonds, any substantial weakness in EM USD government bonds and High Yield bonds may provide attractive entry points to rebalance.

Figure 22: Our preferred areas within bonds

Bond Asset Class	Preference	Yield	Value	FX
Investment Grade corporate bonds in Developed Markets (DM)	Strongly preferred (US over Europe)	Yellow	Yellow	Yellow
USD government bonds in Emerging Markets (EM)	Core holding	Green	Green	Yellow
USD corporate bonds in Asia	Core holding	Yellow	Yellow	Yellow
High Yield corporate bonds in Developed Markets	Core holding (US over Europe)	Green	Yellow	Yellow
Investment Grade government bonds in DM	Least preferred	Red	Red	Yellow
Local currency government bonds in EM	Least preferred	Green	Yellow	Red

Traffic light signal refers to whether the factor is positive, neutral or negative for each asset class.
Source: Standard Chartered

Bonds

We prefer corporate bonds over government bonds as they offer an attractive yield pick-up for the additional risk on offer. Within this, we like US IG corporate bonds for their quality. We also like EM USD government bonds, US HY bonds and Asian bonds as a source of return and income.

The key risk to our view is a sudden uptick in inflation (see pages 8-10 for an analysis of different macro scenarios). This could raise expectations of less supportive policy or higher rates from major central banks. This, in turn, could lead to negative bond returns. Our preference for corporate bonds (and their spread over Treasury yields) should help mitigate, but not eradicate, this risk.

Long-maturity bonds offer higher yields, but their prices are very sensitive to changes in yield. On the other hand, shorter-maturity bond prices are less sensitive to changes in yields, but offer lower yields. On balance, we believe an average maturity profile centered around 5-7 years for USD-denominated bonds optimises the risk-reward. However, with the reduction in the difference between 10-year and 2-year yields, we close our view expecting the 10-2 yield curve to flatten.

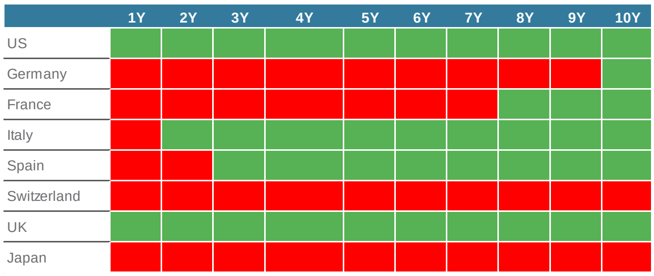
Government bonds – Developed Markets

G3 government bonds have performed better than expected – delivering high-single digit returns with lower volatility than many other asset classes. However, the recent rally has caused a reduction in yields across the board. Indeed, 10-year Japanese Government Bonds and German Bunds are trading at negative yields. Admittedly, it is difficult to get excited by the low yields on offer. However, we continue to believe the high-quality bonds offer diversification benefits and act as a hedge in times of market stress. IG corporate bonds may offer the best way to gain this exposure – see the section on corporate bonds.

Within G3 government bonds, we retain our preference for the US over Europe and Japan. US Treasuries offer a relatively attractive yield over German Bunds and Japanese Government Bonds. Additionally, the headwind of rate hikes appears to have eased with the latest Fed communication suggesting a reduction in rate hike expectations and following financial market volatility after the UK referendum result.

Figure 23: Negative government bond yields support demand for corporate credit

Positive or negative yields offered by government bonds of various maturities



Red indicates that the bonds offer negative yield. Green indicates positive yield. As of 20 June 2016.

Source: Bloomberg, Standard Chartered

Government bonds – Emerging Market USD government bonds

EM USD government bonds are our preferred choice within the government bond space. We believe EM USD government bonds are likely to outperform government bonds from DMs. Despite the stellar performance this year (over 8% return in 2016), they continue to offer an attractive yield of close to 5.6% and valuations remain cheap relative to history.

The combination of supportive factors over the past six months is likely to remain in place. We believe USD yields are likely to remain rangebound. A sharp decline in commodity prices and currency weakness remain the key risks. Additionally, the structural EM challenges remain and a slowing China is likely to impact a number of countries. Therefore, we have a bias towards IG bonds within EM USD government bonds.

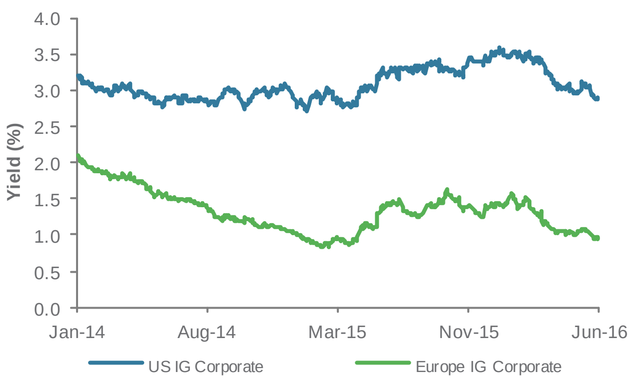
Bonds

Corporate bonds – DM Investment Grade corporate bonds

IG corporate bonds remain our preferred asset class within bonds as we believe they offer the best risk-reward. We prefer to take our exposure to high-quality bonds through IG corporate bonds as they offer the attractive combination of good credit quality and slightly higher yields than government bonds due to the credit spread on offer, but exposure to government bond-like behaviour in the event of volatile markets.

Figure 24: US IG corporate bonds offer a higher yield than European IG corporate bonds

US IG corporate and European IG corporate bond yields



Source: Barclays, Bloomberg, Standard Chartered

Within DM IG corporate bonds, we retain our preference for US IG corporate bonds ahead of EUR-denominated bonds due to substantially higher yields on offer. We also believe that the benefits of ECB easing are largely in the price for European bonds.

The yield premium on US IG corporate bonds has compressed since the start of the year; however, they still offer a yield of close to 3%, which we view as attractive in today's low-yield environment. Valuations are marginally expensive versus history, but we believe the search for yield and the demand for defensive and less-volatile high-quality bonds could drive valuations further into expensive territory. Brexit has merely reinforced this bias.

Figure 25: Corporate bond yield premium over government bonds

	Current	52w high	52w low	Long-term average*
US IG	1.85	2.33	1.52	1.98
US HY	5.98	8.39	4.45	5.79
Europe IG	1.34	1.67	1.12	1.34
Europe HY	4.61	5.81	3.68	6.25
Asia IG**	2.34	2.60	1.95	2.52
Asia HY**	5.65	6.97	5.12	6.74

Note: Government bond for US and Asia is US Treasuries, Europe is German Bunds. * Long-term spread average from 2001 onwards. **Long-term spread average from 2006 onwards.

As of 16 June 2016. Source: JP Morgan, Barclays, Bloomberg, Standard Chartered

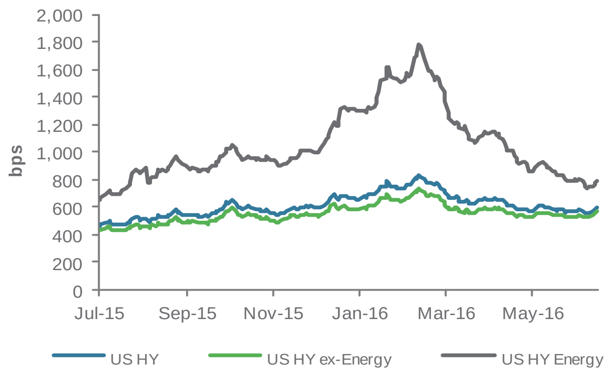
Corporate bonds – DM High Yield corporate bonds

US HY corporate bonds, which were our top pick at the start of the year, have fallen down in our preference order. Though US HY bonds continue to offer an attractive yield of 7.2%, in our opinion they are not cheap anymore as the valuation gap has closed. Despite this, we continue to believe they should be a core holding within a well-diversified investment allocation.

On a positive note, the recent rally in oil prices has helped energy sector bonds, which have delivered approximately 21% returns in 2016. A material decline in oil prices remains the key risk, as it could lead to underperformance of energy sector bonds.

Figure 26: US HY has delivered strong returns led by energy sector

US HY, US HY energy and US HY ex-energy sector spreads



Source: Barclays, Bloomberg, Standard Chartered

Bonds

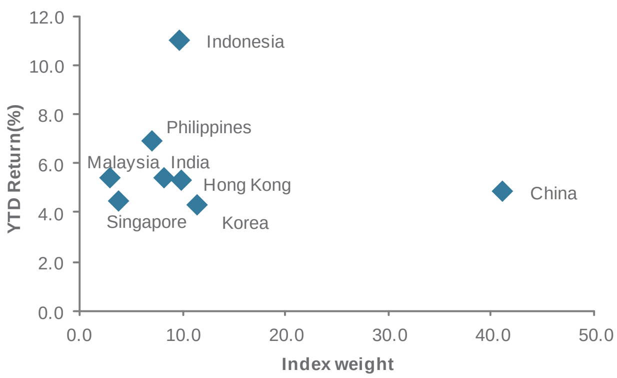
Corporate bonds – Asian credit

Asian corporate bonds remain a defensive play and have performed their role remarkably well in 2016. While valuations are marginally expensive, we believe that they are justified by the low volatility Asian bonds offer. The strong performance has also been helped by supportive technicals as lower supply and strong in-region demand have led to rising valuations for Asian bonds.

That said, the Asian credit universe is dominated by Chinese issuers. While we believe that China is unlikely to witness a hard landing in the next 12-18 months, developments in China are likely to be a big driver of Asian credit valuations. The rise in onshore defaults remains a risk that could lead to a temporary spillover effect in the Asian USD bond asset class. This could lead to a spike in volatility in the asset class. Thus, we believe it is prudent to prefer the IG component over HY bonds in the region.

Figure 27: China has a huge influence on Asian credit returns

YTD returns by country and their weight in Asia's credit index



Source: Bloomberg, JP Morgan, Standard Chartered

Emerging Market local currency bonds

Within EMs, we prefer USD-denominated bonds over local currency bonds due to our continued concerns over currency risks, which remain an important driver of returns for international investors.

While local currency bonds outperformed EM USD government bonds, the performance was driven largely by currency returns. They also had higher volatility than USD-denominated bonds. The strong performance of Brazilian bonds was a key contributor to overall returns. We believe reforms initiated by the new regime in Brazil have the potential to drive significant positive returns for Brazilian assets in the medium term. However, we prefer to wait and see concrete positive developments before turning positive on Brazilian assets in the short term.

In the local currency bond space, we continue to prefer Asia over other EMs due to its defensive characteristics, lower exposure to commodities, relatively stronger economic growth and better outlook for currencies. We take profit on our trade on INR bonds. Our decision is driven by the uncertainty arising from the change in leadership of the central bank, the recent uptick in inflation and the risk of further rise in inflation due to higher oil prices. We believe a lot of good news is in the price and believe it is a good opportunity to take profit. Nevertheless, we remain fundamentally constructive on India and will continue to watch for better entry levels.

Figure 28: Local currency bonds offer attractive yields for most local investors, but we are wary of currency risks for USD investors

Country	Current 10yr yield	Currency view*	Investor flows**
India	7.51%	Green	Red
Indonesia	7.54%	Green	Green
Malaysia	3.86%	Red	Green
Philippines	3.49%	Yellow	Green
S. Korea	1.58%	Yellow	Green
Thailand	2.07%	Yellow	Green

*Standard Chartered Wealth Management currency views. **Bloomberg Foreign Portfolio flows, greater than USD 100mn over 1month.

Traffic light signal refers to whether the factor is positive, neutral or negative for each country. Source: Bloomberg, Standard Chartered.

Standard Chartered

Equities

Key View

US equities may outperform during pullbacks. Within Asia, we prefer India and Korea

We are cautious on global equities

Non-Asia EMs have performed well YTD, but may pause for breath in H2 16

Earnings in US energy sector are likely to turn positive in 2016

IMPLICATIONS FOR INVESTORS

Erring on the side of caution

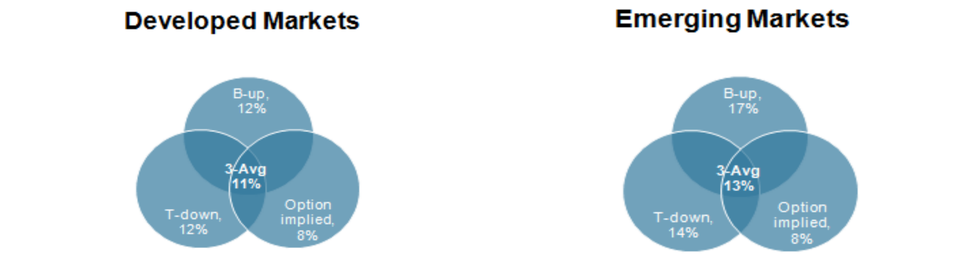
- Global equities declined 1.6% YTD, with Emerging Markets (EM) outperforming Developed Markets (DM). In our coverage universe, Brazil has been the best EM performer, and the US has been the best DM performer.
- In an environment of rising uncertainty, exacerbated by the UK's decision to exit the European Union, we are likely to see heightened volatility in equity markets in the coming months and would prefer to err on the side of caution. We prefer DM over EM and defensive sectors over cyclicals.
- Within equities, we have a preference for US equities. While fundamentals, in terms of earnings and profit margins, favour Euro area equities, the US is likely to outperform during pullbacks. In Asia, we prefer India and Korea.
- Valuations in major markets, with the exception of Asia, remain elevated. Gains over the remainder of the year may be reliant on upward revisions to earnings forecasts, as opposed to PE multiple expansion, given the slow growth outlook.

Late-cycle investing

Our belief that we are in a late-cycle environment is the over-riding driver of our cautious view towards equities. The hallmarks of a late-cycle environment include declining corporate margins, which in turn can act as a driver of M&As, elevated valuations and disapointing earnings growth. All of these factors are currently in place in DM. The recovery in commodity prices has provided a boost to EM. However, we are cautious in extrapolating the recent recovery in commodity prices and in turn EM performance.

There are selected equity themes where we are constructive, including US technology. Aside from these specific views, we believe that returns from global equities are likely to be below those in other asset classes and, on a risk-adjusted basis, below the returns likely to be generated from fixed income.

Figure 29: Estimated 12-month market returns using different approaches



B-up: Consensus estimates based on analyst price forecasts: Bottom-up method. 2. **T-down:** Estimates using consensus earnings and the estimated P/E ratio expansion/contraction: Top down method. 3. **Option implied:** Option potential return estimates are based on selling a 12-month Put at current levels and expressing the potential return using the premium earned as a % of the current level. The estimates should be considered a best case with a probability of <50%.
Source: Bloomberg, Standard Chartered

Equities

US – energy sector outlook improving

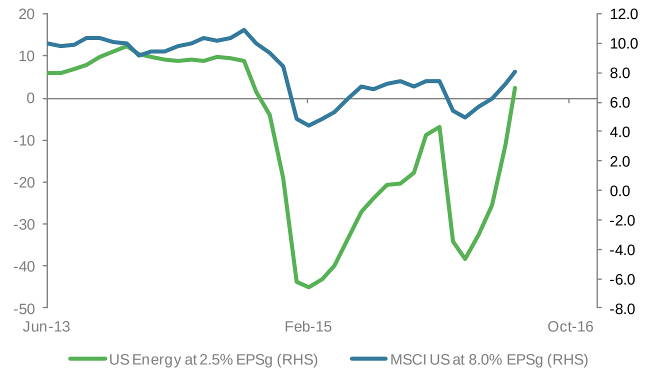
We remain cautiously positive on US equities, noting the S&P500 broke through key resistance in early June. While it has since retraced, it is still in a higher trading range and sentiment has started to improve. Besides moderating expectations for the pace of Fed rate hikes, a key fundamental factor that has supported the market centres around the potential for a return to rising corporate earnings in Q3 16.

We are slightly more cautious on earnings, believing they will only turn positive in Q4 16. The banking sector is expected to experience continued downward pressure on earnings forecasts in Q2-Q4. A delay in Fed rate hikes, which has pushed bond yields lower, has undermined a key driver of profitability. Looking ahead, the sector is likely to remain under pressure as investors factor in lower trend interest rates as per Fed guidance.

On a brighter note, the energy sector's outlook has improved. The S&P500 energy sector used to contribute almost 10% to index earnings, but this fell to zero in Q1 16. Consensus expectations for the energy sector are brighter than other sectors. The sector is expected to contribute 5% to S&P500 earnings in Q2-Q4. Upside could come from an end to impairments and further increases to consensus earnings as analysts update their forecasts to reflect rising oil prices.

Figure 30: US energy sector earnings growth has spiked higher

MSCI US energy sector and MSCI US index 12 Mth forward earnings growth



Source: Factset, Standard Chartered

Euro area – short term downside risks

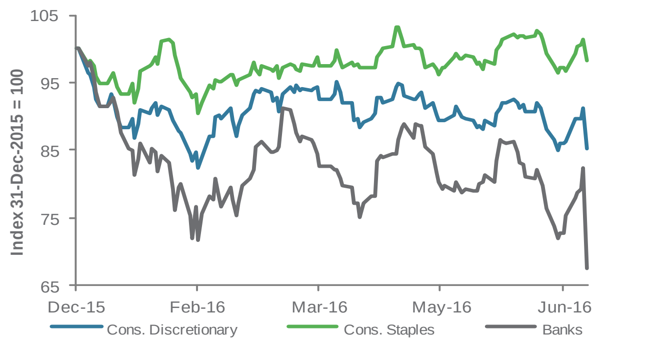
We are no longer convinced that Euro area equities will outperform, at least in the near term, as the market prices in the global repurcussions of the Brexit. Longer term, we believe EU equities will be underpinned by improving corporate profit margins leading to an acceleration in earnings growth. Consensus expectations for Euro area earnings are for 5% growth in 2016. The pace of growth is supported by improving leading indicators, including an easing of credit standards and an acceleration in loan demand.

Trading at a PE of 12.8x 12-month forward consensus earnings, Euro area equities are trading a touch above their long-term average of 12.5x. As such, we see downside risks to valuations in the near term, as investors demand a higher risk premium post-Brexit. However, we believe any upside surprise to earnings in the coming quarters should limit further downside to performance.

A key theme within Euro area equity markets is the performance of defensive sectors relative to cyclicals, which we believe will be a key focus going forward. In particular, the positive performance of the consumer staples sector stands in contrast to the negative performance of the consumer discretionary sector.

Figure 31: Euro area consumer staples are the best performers YTD, while banks have been the worst performers

Euro area consumer staples, and consumer discretionary performance



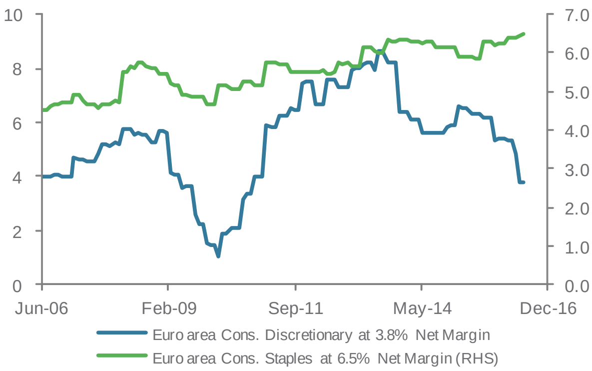
Source: Factset, Standard Chartered

Equities

A contributing factor to the resilience of the consumer staples sector versus consumer discretionary is the increase in margins. Corporate margins in the consumer staples sector have increased almost 1ppt since 2013, whereas consumer discretionary margins have halved to 4% from 8%.

Figure 32: Euro area consumer staples margins are rising; consumer discretionary margins are under downward pressure

Euro area consumer discretionary and consumer staples margins



Source: Factset, Standard Chartered

The ECB's policy of negative interest rates has weighed heavily on the performance of the Euro area banking sector, which has declined 30% YTD. We expect the banking sector, especially weaker peripheral banks, to underperform in the near term as investors weigh the negative implications that Brexit will have on the financial sector.

We do not underestimate the challenges facing the Euro area. Nevertheless, we believe a continued focus on defensive stocks or stocks that generate a majority of revenue outside the region, may better position investors for the uncertainty ahead.

UK – outcome adds uncertainty

UK voters' decision to exit from the EU has resulted in a sharp pullback in global risk assets. The UK equity market will likely continue to face downward pressure on concerns about the negative political and economic implications of Brexit on UK companies.

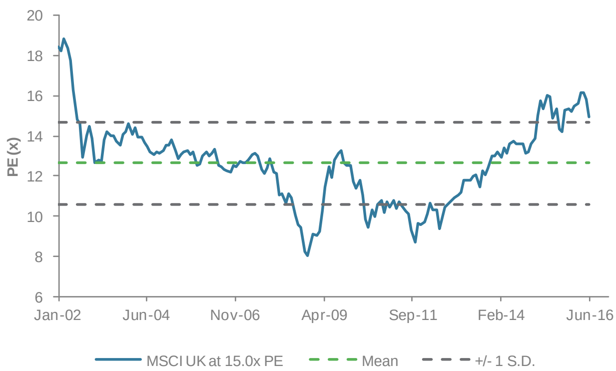
The casualties of a Brexit will primarily be domestic consumption and investment as consumers and businesses hold back spending, which will likely result in a drag on growth and earnings.

The worst hit will likely be the banking sector, which faces elevated risks from increased funding costs, lower loan growth and possible deterioration in asset quality, especially if the referendum outcome leads to a recession scenario. Further rate cuts by the Bank of England to backstop the economy may also weigh on banks' net interest margins. However, we believe the major UK banks have adequate capital buffers to withstand the coming challenges but expect their share prices to reflect the increase in risk premiums.

Domestically-focused sectors are likely to underperform those with a greater focus on overseas earnings, as the latter's earnings are bolstered by FX translation gains from a weaker GBP. We have a strong preference for defensive sectors, as we believe the uncertainty caused by Brexit may lead investors to rotate out of more volatile, cyclical sectors.

Figure 33: Elevated valuations put UK equities at risk post-Brexit

MSCI UK forward P/E ratio



Source: Factset,, Standard Chartered

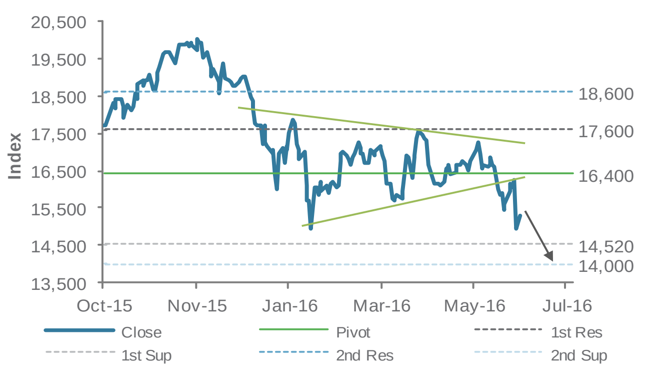
Equities

Japan – JPY holds the key

We remain cautious on the outlook for Japan's equity market. In a weak growth environment, the JPY holds the key to performance. We expect the BoJ to ease policy further in the coming quarters, most likely in Q3 16. Nevertheless, its ability to push interest rates further into negative territory is limited and it has already undertaken significant quantitative easing (QE). The BoJ's negative interest rate policy has weighed heavily on local banks, which are the worst performers YTD, down 36%.

Figure 34: Technicals for Japan's equity market look poor

Nikkei 225 index



Source: Trading Central, Bloomberg, Standard Chartered

The importance of the JPY is reflected in the breakdown of growth in recurring earnings in FY16. The translation effect of JPY strength reduced earnings growth by 17%. Double-digit growth in margins and an increase in sales helped offset the drag from the JPY – but only slightly, as reflected in the paltry 1% earnings growth.

For investors, the outlook for the market appears increasingly binary. If the authorities deliver a dramatic easing package, potentially including direct financing of an increased fiscal deficit, the JPY could weaken and the equity market rally. However, disappointment on further QE would likely have the reverse effect. Such a binary outcome implies elevated risk and suggests an outsized holding at this stage is not warranted.

Asia ex-Japan – we favour India

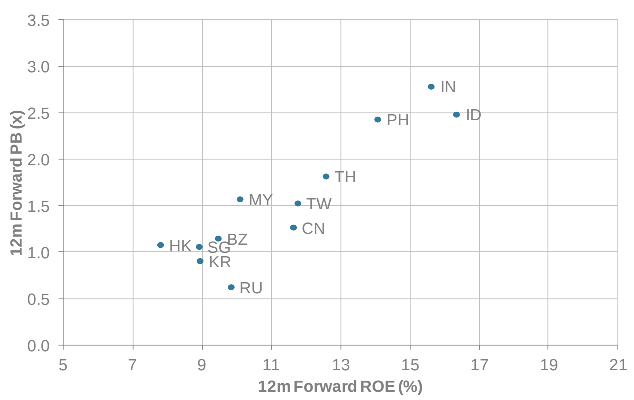
We remain cautiously positive towards Asia, noting it sits below Europe and the US in our order of preference among the major markets/regions. Interest rates have been cut in Korea, Taiwan and Indonesia over the past month, reflecting the confidence among policymakers in pursuing a path independent of the Fed. Such a strategy is only possible due to improving fundamentals, including low inflation.

India continues to rank as our most preferred market within Asia. We believe that continuing structural reforms leading to lower inflation and an improvement in fiscal policy, reduce risks at a time of rising uncertainty globally. Add in a more domestically focused economy and equity market, and the ingredients are in place for outperformance. We note investor concerns about valuations, but as chart 36 highlights, India's RoE supports a higher valuation.

The recent announcement that RBI Governer Rajan will be stepping down is a near-term risk as it creates uncertainty about the continuity of inflation-targeting policy. However, we believe the central bank has a robust framework, and the initiative to form a monetary policy committee is a positive.

Figure 35: India trades at a high P/B, but this is justified by a high RoE

Asian market P/B and RoE



Source: Factset, Standard Chartered

Equities

Korea ranks as our second most preferred market in the region. Drivers of our positive view include:

1) Increased focus on shareholder returns leading to higher dividend payouts.
2) Fall in household debt servicing ratio as interest rates decline.
3) Increased buying of domestic equities by the National Pension Reserve Fund.

Korea's equity market has surprised on the upside YTD as domestic demand has proved to be resilient, driven by a recovery in tourist arrivals. This has offset the weakness in cyclical sectors with exposure to Developed Markets and China.

China has dropped down in our ranking of preferred markets on concerns that growth will slow once again, now that policymakers have reversed course on earlier fiscal and credit easing measures.

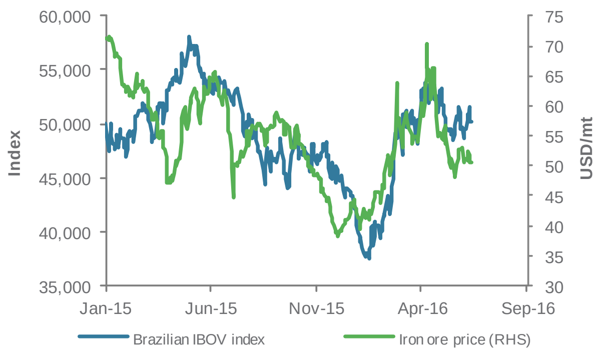
Non-Asia EM – Brazil rising

Non-Asia EM has been the best performer YTD, thanks to a 35% gain in Brazil in USD terms. Nevertheless, we are cautious on the region as we believe that oil prices are unlikely to spike substantially above USD 55 in the coming months, as the bulls suggest. Iron ore has also reversed course, following the surge in Q1, and is likely to remain soft in light of weaker fixed asset investment trends in China.

While commodity prices are not the only driver of Non-Asia EM, they play a major role, as reflected in the surge in consensus earnings expectations: 21% growth in 2016.

Figure 36: Rebound in iron ore prices has boosted the Brazilian market

Iron ore prices (USD) Brazilian IBOV index



Source: Bloomberg, Standard Chartered

Commodities

Key Views

Gold likely to move into a higher range. Oil prices to gradually recover on rebalancing; industrial metals continue to face supply headwinds

We turn modestly constructive on oil prices

Gold expected to stay in the USD 1,250-1,400 range in Q3

Do not favour broad-based exposure to industrial metals

IMPLICATIONS FOR INVESTORS

Selective opportunities

- We believe oil prices have likely bottomed, and may trade around USD 45-55/bbl in the short term, before eventually moving higher.
- We expect gold prices to settle in a new range, trading between USD 1,250-1,400 in the short term (3 months) amid increased safe-haven demand following UK vote.

Supply-demand improving in energy

We expect commodity prices to continue to consolidate in the months ahead, as some of the major headwinds, including China growth risks, significant overcapacity and a stronger USD, have abated somewhat. We expect gold and oil to outperform base metals, with gold likely to move higher short term.

In commodities as a whole, while inventories remain largely elevated, we see the process of rebalancing taking shape. This is more visible in the case of oil. Given current rates of US production declines, we believe prices are likely to gradually move higher in H2 2016, but remain capped around USD 60-65/bbl this year. In contrast, persistent supply declines have not been forthcoming in the industrial metals space as margins remain attractive with plenty of spare capacity.

On the demand side, there are some indications of a pick-up in oil demand in both OECD and Emerging Markets (EM). While higher China fiscal spending is likely to increase demand for base metals, we believe this can be absorbed through current capacity.

With USD strength less likely to pose a significant headwind, we believe the focus is now likely to turn to fundamentals. Key upside risks to our commodity outlook are stronger-than-expected producer cutbacks and a weaker USD; downside risks include a deterioration in China's growth outlook, more aggressive Fed hikes and increased financial market volatility amid increased political uncertainty in Europe.

Figure 37: Stabilisation in China's growth outlook limiting downside in commodities

China Leading Economic Index and Bloomberg Commodity Index

Source: Bloomberg, Standard Chartered

Commodities

Crude oil: gradually moving higher

We expect crude oil prices to gradually recover through the year, but remain capped at USD 60-65/bbl. In our view, the supply-demand balance has begun to favour higher prices. US production has continued to decline consistently, while temporary outages in Canada and Nigeria have further tightened markets. Although inventories remain elevated, there is some evidence US inventories may have peaked.

Meanwhile, demand has continued to show resilience. Gasoline demand in the US, China and India is likely to remain robust, absent a major economic shock. Finally, the USD is less likely to be a headwind for commodities going forward as it stabilises (see pages 30-32 for more details).

Gold: sideways for now

Gold is expected to trade in the USD 1,250-1,400 range over a three month period. Among the key drivers, we expect lower interest rates (outside the US), eventually rising US inflation and increased safe-haven demand amid renewed policitcal stress in Europe to be supportive for gold. However, gradual Fed rate hikes should ultimately cap prices

In our view, one scenario for sustained gains in gold could be a significant slowdown in the US, prompting the Fed to move towards a neutral or easing policy. Moreover, a greater than expected political fallout from the recent UK vote could also allow gold to rally significantly.

Industrial metals: further rally unlikely

We broadly expect any upside in industrial metals to remain limited. While China's demand so far has remained more resilient, the supply side continues to present challenges in some areas. In particular, China's copper production has grown much faster than expected, resulting in increased inventory build-up, which is likely to restrict the upside in prices. While the supply-demand picture is slightly better in case of aluminium, zinc and nickel, we observe any pick-up in prices has been met by a quick increase in production, given still healthy margins and significant spare capacity. Overall, we continue to expect metals linked to consumption (aluminium, zinc and nickel) to outperform those linked to investment (copper and iron ore).

Commodity	Summary of key views
Crude Oil	USD60-65/bbl likely to cap upside
Gold	Neutral within commodities, USD 1,250-1,400 range in the short term
Industrial Metals	Negative within commodities, expect aluminum, zinc, nickel to outperform copper and iron ore

What has changed – Oil

Factor	Recent moves
Supply	Supply deterioration continues at a modest pace
Demand	Demand has remained strong
USD outlook	USD remains in consolidation mode

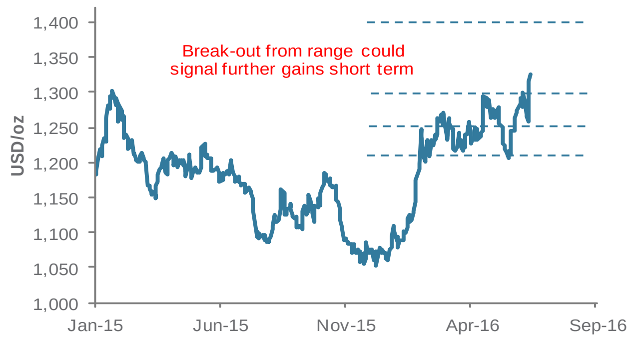
What has changed – Gold

Factor	Recent moves
Interest rate expectations	Fed rate hike expectations have been scaled back
Inflation expectations	Inflation expectations have picked up somewhat
USD outlook	USD remains in consolidation mode

Source: Standard Chartered

Figure 38: Gold likely to settle in a higher range (1250 – 1400)

Gold price spot



Source: Bloomberg, Standard Chartered

Alternative Strategies

Key View

We retain our conviction in alternative strategies amid a focus on managing volatility

Global macro, a source of diversification

Equity long/short a substitute for long-only

Managing volatility is a key focus

IMPLICATIONS FOR INVESTORS

Retain conviction in H2

- Our cautious outlook means we retain our conviction in alternative strategies.
- Our focus on managing volatility, particularly alongside multi-asset income strategies, drives our preference for global macro strategies. See pages 33-42 for more details
- We also like equity long/short strategies, especially as a long-only substitute.

Diversify with global macro strategies

We believe strategies that offer a source of diversification within an investment allocation are attractive in H2 16 as markets grapple with the relative likelihood of various scenarios. Macro and trend-following strategies' (CTA) track record during the 2008 crisis, early-2016 volatility and, most recently, in the days following Brexit, or their role in reducing volatility of a multi-asset income strategy demonstrate their value as a diversifier in uncertain times.

CTAs have had more generalised success recently, despite the lack of apparent financial market trends. We continue to believe discretionary macro strategies can still offer an attractive proposition.

Long/short as a substitute for equity exposure

We have emphasised the importance of maintaining exposure to equities in today's environment, given the balance of risks, albeit with a more cautious approach. Equity long/short strategies may offer an attractive substitute for long-only exposure, in our view, given the risk of bouts of volatility in H2 16.

While the strategy does underperform equity indices during periods of strong equity market gains, we anticipate more modest equity returns punctuated with volatility. Long/short strategies' outperformance during periods of equity market drawdowns is likely to be valuable in the second half of the year, in our opinion.

Our preferences within alternative strategies

Sub-strategy	Our view
Equity long/short	**Positive:** Attractive substitute to long-only equities in volatile markets
Relative value	**Neutral:** Volatility has increased opportunities, but liquidity challenging
Event-driven	**Neutral:** M&A activity a positive, but vulnerable to broad market volatility
Credit	**Neutral:** Volatility/sector-stress positive for long/short, but defaults are a risk
Global macro	**Positive:** Most preferred sub-strategy as it offers diversification amid volatility
Commodities	**Neutral:** Rising oil prices may be supportive
Insurance-linked	**Negative:** Insurance losses below average in 2015, which could reverse

Source: Standard Chartered

FX

Sideways for now

Key View

USD likely to maintain its 2016 range, short of a significant catalyst from the Fed or China

EUR to remain largely within the 1.05-1.15 range

AUD likely to remain above its 2016 low if China remains stable

USD/CNY likely to rise further

IMPLICATIONS FOR INVESTORS

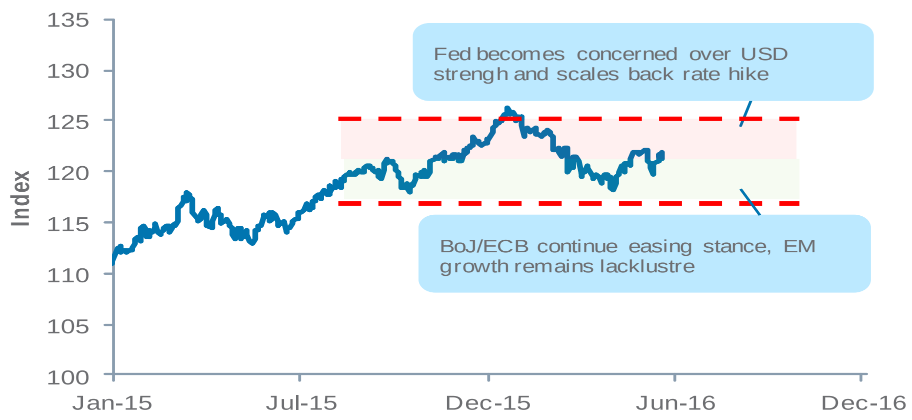
- We expect the USD to remain relatively stable, largely trading within its 2016 range. In the short term, bouts of USD strength are possible, but unlikely to extend beyond 2016 highs.
- We expect the EUR to largely trade sideways in the absence of a major surprise from central banks. The GBP is likely to extend weakness amid continued political uncertainty and possibility of BOE easing.

USD to continue trading sideways

- We expect the USD to remain broadly stable over a 12-month horizon, essentially trading within its 2016 range (116-126 range in USD Broad TWI). In the short term, however, the USD could strengthen in either a risk-off scenario or one where the Fed turns more constructive towards rate hikes.
- We believe USD gains may not be protracted for two reasons. First, USD strength might be self defeating; should the USD continue to rally, the Fed is more likely to delay rate hikes. Second, we expect only one rate hike this year, though risks to this have increased significantly following the EU referendum. A single rate hike may not push interest rate differentials wide enough to justify a renewed USD rally.
- We also believe the USD is unlikely to suffer extended weakness for two reasons. First, most major central banks, including the ECB, BoJ and PBoC, are still contemplating additional easing measures. Second, without a significant upside growth surprise from China and Emerging Markets (EM), the USD could remain supported amid limited capital outflows from EM.

Figure 39: USD to remain rangebound amid a confluence of both positive and negative factors

USD broad trade-weighted index



Source: Bloomberg, Standard Chartered

FX

EUR: looking to maintain its range

The EUR is expected to largely trade in the 1.05-1.15 range over the next three months, though in the short term a move towards the lower end can be expected. Two assumptions drive medium term EUR outlook. First, the Fed hikes by no more than once in 2016, which could limit EUR downside. Second, inflation expectations could remain depressed in Europe with the ECB likely to remain focused on easing. A significant shift in Fed policy or extreme political stress in the Euro area following the UK EU vote are key risks.

JPY: volatility seems assured

The key for the JPY is likely to be the BoJ's policy actions. If the BoJ fails to deliver significant monetary policy easing, the risk is that JPY strength extends, especially in the aftermath of the UK's EU referendum. However, unconventional BoJ policy easing measures, especially amid stretched speculator long JPY positioning, could push the JPY lower. It is quite possible that JPY strength in the near term encourages more significant policy easing in the coming months, ultimately pushing the JPY weaker.

GBP: further drift lower likely

Following the UK's decision to leave the EU, we see a number of risks that could drive additional GBP weakness. First, an economic slowdown may push the BoE towards policy easing, narrowing rate differentials. Second, concerns regarding UK's record current account deficit are likely to be renewed amid risks of significant capital flight. Third, further political stress including a second Scottish referendum could further weaken sentiment. Hence, we expect continued volatility and a drift lower following recent weakness.

AUD: likely to maintain this year's low

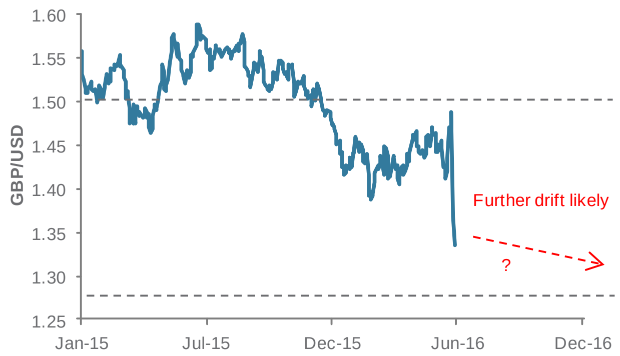
Despite some possible near-term weakness after the 'Brexit' vote, we expect the AUD to remain above 2016 lows. We believe significant weakness is unlikely in a broadly stable China scenario provided the Fed stays on a gradual rate hike path. On the other hand, we believe the Reserve Bank of Australia is likely to push-back against AUD strength while iron-ore prices are unlikely to rally. The main upside risk to our outlook is a significant pick-up in commodity prices while on the downside, signiifcant deterioration in China is key.

What has changed – G3

Factor	Recent moves
Interest rate differentials	Yields across major economies have fallen along with US Treasuries, leading to little change in yield differentials
Economic differentials	Positive economic surprises in the UK and Japan have picked up relative to the US and UK
Speculator positioning	USD positioning has now balanced out; JPY positioning remains excessively net long

Figure 40: GBP likely to weaken further amid uncertainty

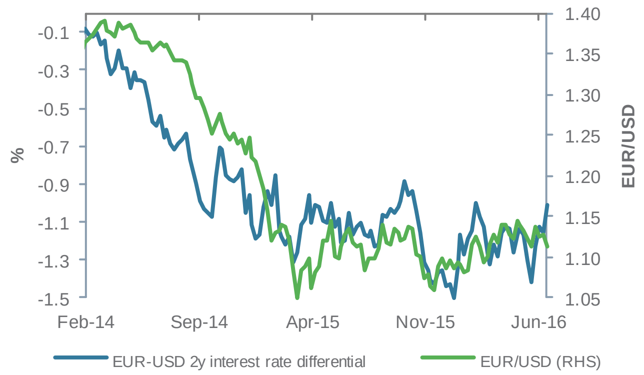
GBP/USD spot



Source: Bloomberg, Standard Chartered

Figure 41: EUR-USD rate differentials remain largely rangebound, supporting a similar sideways move in the EUR

EUR/USD and 2-year Euro area-US interest rate differentials



Source: Bloomberg, Standard Chartered

FX

NZD: more weakness later in the year

We believe there could be some modest NZD weakness as another rate cut in the August RBNZ policy meeting is still likely. However, similar to our view on the AUD, sustained weakness in the NZD may not take place without increased probability of a hard landing in China and significant USD strength.

Asia ex-Japan: CNY the main risk to stability

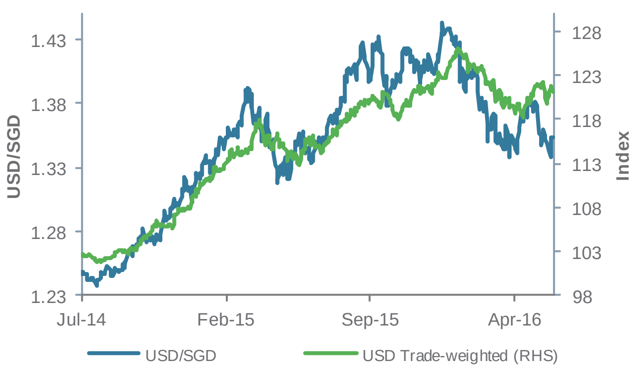
Short term weaknes following the EU referendum nothwidstanidng, Asia ex-Japan currencies are expected to largely trade in a range, along with the broad USD.

The SGD is highly correlated to the broad USD given its policy regime. Hence, we would expect USD/SGD to trade largely within its 2016 range. We believe there is likely to be further weakness in the CNY as China lowers its trade-weighted basket to ease domestic monetary conditions. Currencies more exposed to China, namely the KRW, TWD and MYR, may experience some weakness as a result, though a breach of the 2016 low is unlikely.

Currencies with lower exposure to growth and China risks, namely the INR, IDR, PHP, are likely to be more resilient, given their focus on domestic growth fundamentals.

Figure 42: SGD largely follows the broad USD

USD/SGD and USD trade-weighted index



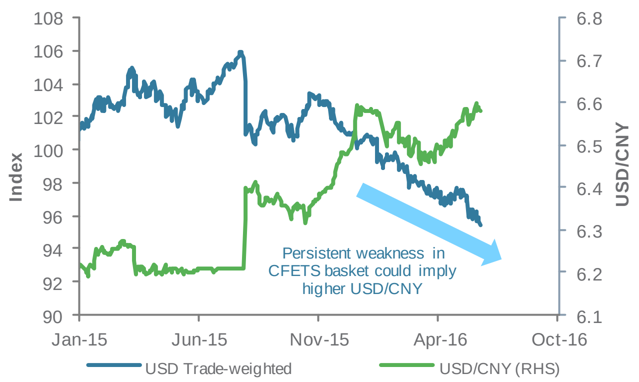
Source: Bloomberg, Standard Chartered

What has changed in Asia ex-Japan currencies

Factor	Recent moves
USD outlook	USD has regained some ground against Asia-ex-Japan currencies, but remains well within recent ranges
China risks	Slightly weaker China data has increased concerns
Capital flows	Capital flows to Asia have not picked up in the region in a meaningful way

Figure 43: China authorities continue to weaken the CNY

USD/CNY and CFETS CNY trade-weighted index



Source: Bloomberg, Standard Chartered

Currency	Summary of key views
USD	Remains within 2016 range
EUR	Remains broadly within 1.05-1.15
JPY	Expect volatility for now, BoJ action key
GBP	Likely to weaken further amid continued economic and political uncertainty
AUD, NZD	Remains above 2016 lows
CNY	Further weakness likely
SGD	Remains within 2016 range
KRW, TWD, MYR	China focused currencies - Weakness limited to 2016 lows
INR, IDR, PHP, THB	Other Asia ex-Japan currencies - Resilient; likely to outperform other regional currencies

Source: Bloomberg, Standard Chartered

Standard Chartered

Multi-asset

Key View

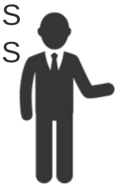
Alternative strategies – the new best friend for the multi-asset income investor in a potentially volatile market environment

Diversified approach to multi-asset income remains valid

Tilt income allocation towards low-medium drawdown assets

Use leverage prudently to enhance income

IMPLICATIONS FOR INVESTORS



Income has a new best friend

- In a low-interest-rate world, a diversified approach to income investing remains valid.
- Market volatility suggests a conservative multi-asset income allocation is appropriate.
- Investors can generate additional income through use of leverage.
- Alternative strategies are the new best friend for a multi-asset income investor; these strategies could help cushion drawdowns in income-generating assets.

Income strategy remains valid – risk management is crucial

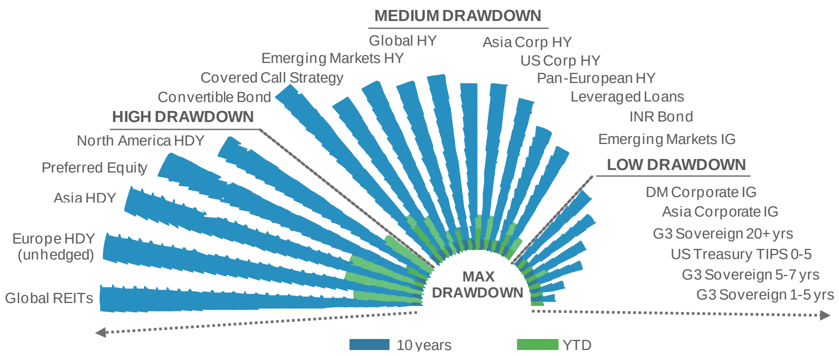
For the past few years, in a regime of low-to-negative interest rates, our focus has been on finding diversified sources of yield for our multi-asset income allocation. While this continues to be a key focus, this year we have been placing greater emphasis on managing drawdown risks. In this section, we discuss two topics to help an income-oriented investor not only **manage volatility, but also potentially benefit from it:**

- Alternative strategies to cushion the allocation – With low correlation to traditional assets, alternative strategies (preference for global macro) might offer a degree of protection to the income investor and cushion the allocation from potential drawdown.
- Prudent use of leverage to enhance yield – Leverage represents an opportunity to enhance investment returns. Investors should remain prudent in their use of leverage, given the potential for additional volatility and drawdown risks on a leveraged position.

We remain cautious in our current investment stance and, for multi-asset income, we pay particular attention to drawdown risks. Market events in January and June provided a window into the potential reaction of various asset classes in periods of elevated volatility.

Figure 44: Our multi-asset income allocation is now tilted towards the low/medium drawdown buckets

Maximum drawdown of income assets YTD and over ten years



Source: Barclays, Citi, Crisil, J.P. Morgan, FTSE, S&P, MSCI, Bloomberg, Standard Chartered

Multi-asset

Income assets can be broadly categorised into three drawdown buckets:

1. High drawdown – Dividend equity, preferred equity and REITs

2. Medium drawdown – High Yield (HY) bonds, leveraged loans, Emerging Market (EM) bonds, convertible bonds and covered call strategies

3. Low drawdown – Sovereign bonds, Investment Grade (IG) corporate credit

While this is a generalised framework, it does help characterise the drawdown we might see from the income allocation. For reference, after our Q1 rebalancing, we have 67% of assets in the low-medium drawdown bucket and about 33% (from 41% previously) of assets in the high-drawdown bucket. We continue to monitor our traffic light table (see page 37) for signs of stress in the high-drawdown bucket. *As we move further along in the market cycle, the bar gets raised for allocating to assets in the high-drawdown bucket.*

Investors in multi-asset income should be aware that low-medium drawdown does not imply the absence of a drawdown. A historical review of maximum drawdown across various income asset classes suggests the income allocation could see a 10-15% drawdown in a sharp market pullback, and potentially double this number in a market crisis. While asset diversification might mitigate a potential drawdown, it is not likely to eliminate it.

With this in mind, we suggest multi-asset income investors look at alternative strategies as their new best friend – a strategy they can lean on to diversify their risk and cushion some of the drawdown (see following section on page 36).

Our cautious tilt has supported performance

In the spirit of A.D.A.P.T., at the end of Q1 16, we used the rally in risk assets to shift the multi-asset income allocation to a more conservative stance. This involved reducing equity exposure to 25% from 33% of the allocation.

The move has worked in our favour. Since our Outlook, the allocation has returned 6.1%. Our rebalancing reduced exposure to equity in favour of corporate credit. A comparison of equity returns to US HY and Developed Market (DM) IG corporate credit substantiates our decision from a few months ago. Credit, in general, has kept pace or outperformed equity with a lower level of risk.

Figure 45: End of Q1 rebalancing has proved profitable

Comparison of asset returns and risk post-rebalancing

For the period from 25 March 2016 to 21 June 2016

	Return	Vol	Drawdown
US Divi Equity	4.1%	8.5%	-2.6%
Europe Divi Equity (FX-hedged)	2.9%	19.2%	-9.2%
Asia Divi Equity	0.4%	14.7%	-9.0%
US HY	5.9%	4.2%	-1.1%
DM IG Corporates	3.0%	3.8%	-1.4%
CNY bonds	-1.2%	3.3%	-2.2%
Asia IG Corporates	2.2%	2.3%	-0.7%

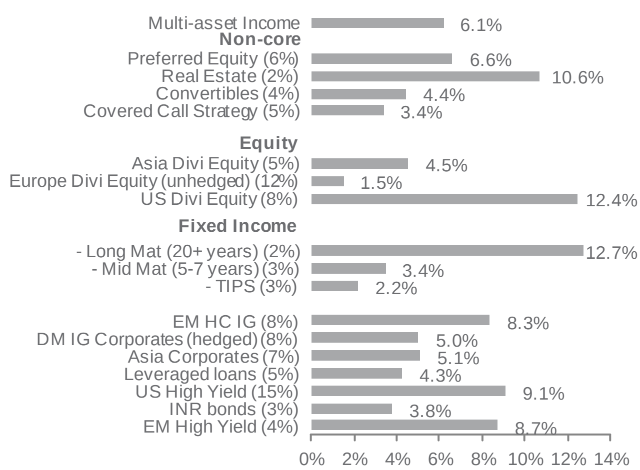
Reduced exposure on 25 March 2016

Increased exposure on 25 March 2016

Source: Barclays, J.P. Morgan, S&P, MSCI, Bloomberg, Standard Chartered

Figure 46: Multi-asset income performs well despite a difficult start

YTD performance of the multi-asset income allocation



Performance as of 21 June 2016

Source: Barclays, Citi, Crisil, J.P. Morgan, FTSE, S&P, MSCI, Bloomberg, Standard Chartered

Income basket is weighted performance of global high-dividend-yielding equities, fixed income and non-core income as described in the 2016 Outlook and revised in the Global Market Outlook, 25 March 2016. Please see Explanatory Note 1 on page 52.

Standard Chartered

Multi-asset

Asset allocation (Multi-asset income)	Yield	Income potential	Capital growth	Drawdown potential	Comments
Equity income	4.8	🟡	🟡	🔴	**Key source of income and modest upside from capital growth**
North America	3.4	🟡	🟡	🟡	Fair to slightly rich valuations; subdued sales/profit growth means below average returns; some sectors attractive
Europe ex-UK	5.4	🟢	🟢	🔴	Fair valuation; ECB support; attractive yield; challenges from global growth; still consensus trade; poor momentum. FX a wild card
Asia ex-Japan	5.5	🟢	🟡	🔴	Good payouts; selectively attractive valuations, but drawdown a risk from challenges in China/US growth, earnings, Fed and leverage. Themes > markets
Non-core income	4.9	🟡	🟡	🟡	**Useful diversifier for income and growth**
Preferred	5.3	🟢	🟡	🟡	Benefits from "global search for yield", supported by strong Financials B/S. Potential benefit from higher rates fading; high sensitivity to investor flows
Convertibles	4.1	🟡	🟡	🟡	Moderate economic expansion + gradual pace of rate hikes should be good for converts. Risk: Policy mistake
Property	3.9	🟡	🟡	🔴	Yield diversifier; stable real estate market; risk from higher rates dissipating, but valuations (mostly) stretched. Asymmetric risk profile
Covered calls	5.3	🟢	🟡	🟡	Useful income enhancer assuming limited equity upside
Fixed income	4.9	🟡	🟡	🟡	**Portfolio anchor; source of yield, but not without risks**
Corporate - DM HY	6.9	🟢	🟡	🟡	Valuations have tightened recently; attractive yield; biggest obstacles fund flows, oil, and speed of default cycle (falling US credit quality)
EM HC Sovereign Debt	5.7	🟢	🟡	🟡	Need to be selective given diverse risk/reward in IG, HY bonds. US interest rate exposure +ve, commodity exposure -ve, valuations fair
Asia LC bonds	3.8	🟡	🟡	🔴	Broad risk/reward unattractive. Local outlook stable, rate cut cycle well advanced, FX is the main risk. Idiosyncratic stories only
INR bonds	8.2	🟢	🟡	🔴	Structural story playing out; carry play; credible central bank, reforms; foreign demand a recent risk. FX stability needed
Investment Grade		🔴	🔴	🟢	Portfolio anchor, structural carry; some interesting areas
Corporate - DM IG	2.4	🟡	🟡	🟢	Yield premiums have narrowed but prices fair, not expensive; long-term US corporate bonds look appealing if Fed hiking cycle muted
Corporate - Asia IG	3.6	🟡	🟡	🟢	Cautiously positive. Fairly valued, stable quality, but Chinese issuers face economic growth headwinds. Risk(s): China, reversal in flows
TIPS	0.8	🔴	🔴	🟢	Offers value as an alternative to nominal sovereign bonds; impact of rate rise similar to G3 sov but offers exposure to an eventual jump in US inflation
Sovereign	1.3	🔴	🔴	🟢	Risk-off momentum, disinflation, QE offer strong anchors for sov. yields, but little, if any, value left. Prefer higher-yielding / high-quality markets (US Treasury, AU, NZ)

Standard Chartered

Multi-asset

Key View

Alternative strategies can improve overall risk-return characteristics and potentially reduce drawdown of an investment allocation

Alternative strategies have become popular for private investors

Alternative strategies have historically helped capital preservation

Alternative strategies may allow investors to benefit from rising and falling markets

IMPLICATIONS FOR INVESTORS

Market scenarios fit alternative strategies

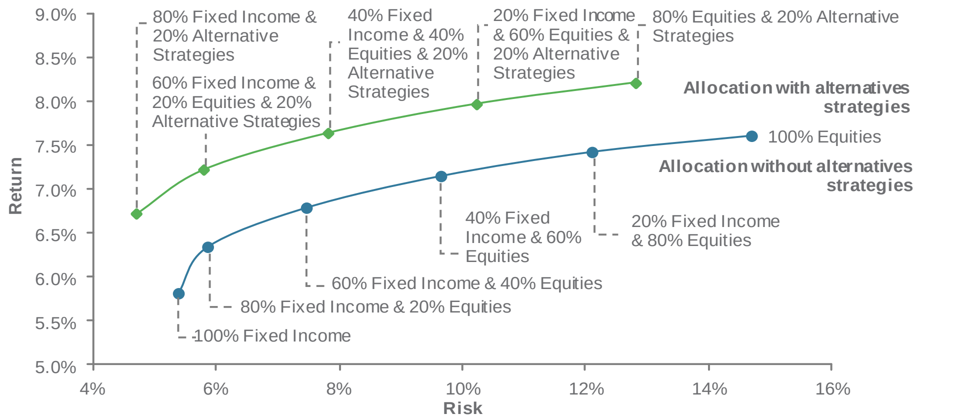
- Alternative investments have become more transparent and liquid with better exit terms today — making them more accessible for private investors.
- They can have potentially lower correlations and lower drawdowns when compared with traditional equities and bonds.
- The uncertain market environment and potential scenarios require a strategy to protect capital and mitigate volatility — alternative strategies, including both 'diversifiers' and 'substitutes' can be a beneficial complement to an investment allocation in equity and fixed income.

Role of alternative strategies in multi-asset investing

Investors often combine higher-risk assets (eg, equity) with lower-risk assets (eg, bonds) in a mix that fits their investment objective. When investors have a larger proportion of risky assets in their allocation, they demand a higher level of return to compensate for higher risk they might experience. The blue curve in Figure 48 illustrates this.

Adding alternative strategies to an allocation may help generate greater return for the same level of risk taken when compared with allocations containing traditional equities and bonds. This effectively gives us better risk-return profiles for our combinations (as illustrated by the green curve in the figure 48 below). In an environment where rising volatility could lead to greater correlation between equity and fixed income assets, the inclusion of alternative strategies with lower correlation to both equities and some fixed income assets might offer just the cushion that investors are looking for.

Figure 47: Adding alternative strategies has historically improved an allocation's return for the same level of risk



Source: HRFX, MSCI, Barclays, Bloomberg, Standard Chartered

Multi-asset

Diversifiers and substitutes – a framework to add alternative strategies to asset allocation

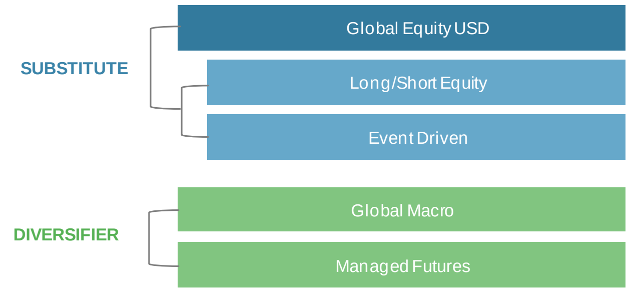
History allows us limited insight as to which alternative assets may outperform going forward. Strategies have had varied performances over shifting market regimes. The picture is further complicated by new innovations in strategies. A case in point is the new category of liquid alternatives – while they offer investors greater access to alternative strategies, their recent introduction implies that historical record is difficult to use as a basis for future allocation decisions.

With this background, adopting a structured approach to alternative allocation is beneficial and we explore a framework of "diversifiers" and "substitutes". The conventional approach has been to view alternative strategies as a standalone allocation, attributing a fixed weight (eg, 20%) to alternative strategies, alongside equities and fixed income.

We can think of two categories of alternatives. The first one, "diversifiers", generally have lower correlations to other assets, and so improve the risk-return profile of an allocation. Their primary role is to cushion the overall allocation against market volatility, which would be helpful in majority of our market scenarios shared earlier.

Also beneficial, with the evolution of liquid alternative strategies, is the second category ("substitutes") that could replace traditional assets under specific market scenarios. "Substitutes" carry strong correlation, but provide a larger strategy set over traditional exposure – a good example would be using equity long/short as a substitute for long-only equity. While correlated to traditional equity (hence, its role as a substitute), it can benefit from both falling and rising equity markets and provide a better risk-adjusted return.

Figure 48: Clustering "substitutes" and "diversifiers"

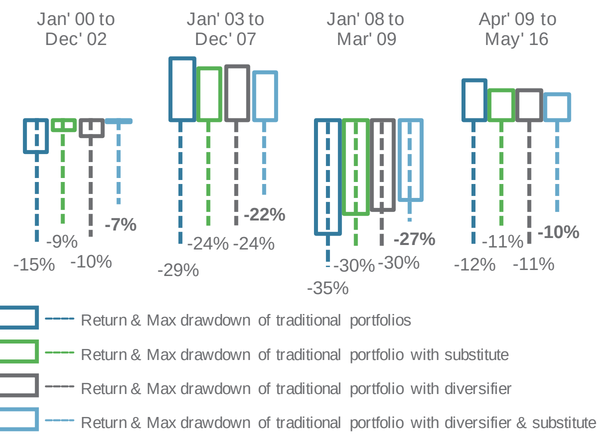


Source: AIMA, CAIA, Standard Chartered

The best way to see the benefit of using these strategies is to compare the performance of a "traditional" 60% equity and 40% bonds (60:40) investment allocation with allocations that also hold alternative strategies – we run this exercise over different periods.

Figure 49: Returns are comparable and drawdowns are lower on average for allocations with alternative strategies

Comparing returns and drawdowns of various investment allocations across different periods



Source: HRFX, MSCI, Barclays, Bloomberg, Standard Chartered

Multi-asset

Using only "diversifiers" in our allocations, the return over the full period was comparable (around 4% for both allocations). The drawdown on average was lower, with the allocation including "diversifiers" only experiencing 81% of the full drawdown across all periods.

Adding both "diversifiers" and "substitutes", the performance over the full period was still comparable (around 4% for both allocations). Again, a lower drawdown on average is achieved, with the allocation including alternative strategies only experiencing 71% of the full drawdown across all periods.

A trade-off when using alternative strategies is that performance may not keep up during strong trending up-markets, eg, 60:40 performances in both up-markets (January 2003 to December 2007 and April 2009 to May 2016) are ahead of the allocations that include alternative strategies. Returning to our market scenarios, we currently envisage a lower likelihood of this taking place.

Today's uncertain market environment necessitates a strategy of protecting capital and dampening volatility within an allocation. An investment allocation, including both "diversifiers" and "substitutes" alternative strategies, has yielded the best results during periods of market volatility and highlight the key role alternative strategies can play in meeting an investor's goals.

Leverage

Leverage to a more optimal outcome

- Using leverage could be an alternative to enhance investment returns in the current environment.
- Given a benign rate outlook, modest levels of leverage may outweigh amplification in risks.
- Investors should be aware that while leverage helps enhance returns, it also magnifies risk.
- It is prudent to employ leverage for investments with lower price volatility (or to a diversified allocation).

Investors today face a paradox when it comes to generating returns. On one hand, growth is lacklustre, which could constrain the potential return from equities. On the other hand, bond yields are depressed globally, with a significant percentage of DM sovereign bond yields now in negative terrority. Against this backdrop, investors are challenged to generate meaningful return on their allocation.

- For multi-asset investors, an option is to concentrate their allocation in assets (within the limits of their risk capacity) with the highest potential upside e.g. equities or riskier bonds, to try and achieve higher returns. This potentially creates a concentration risk within the allocation, reducing the benefits of diversification this class of investor traditionally enjoys.
- For investors with a preference for a pure bond allocation, an option is to invest in a longer-maturity bond. This can boost income, but at the cost of greater bond price sensitivity to interest rates. An alternative is to consider investing in the higher-yielding, but potentially riskier, spectrum of the bond market. This, however, can result in a lower-quality allocation and losses from default. Investors, therefore, face a trade-off between quality and level of yield.

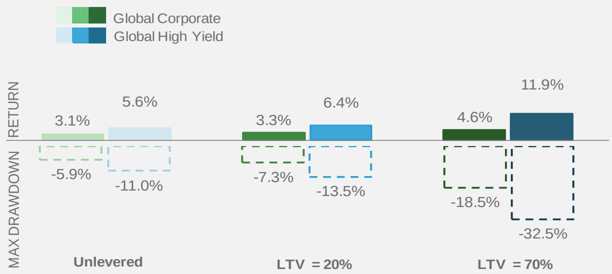
However, our core scenario advocates a cautious approach and a more balanced allocation as we progress to later stages of the economic cycle. The options outlined above would leave the investor exposed to a considerable amount of risk. Another strategy for investors to consider is the use of leverage – the strategy of borrowing to fund additional investments.

Leverage as an option to enhance returns

Prudent use of leverage should allow investors to enhance returns on their investment assets. However, while returns are enhanced, using leverage also scales up the extent of drawdown and volatility. We illustrate this in Figure 50 from the context of a bond investor. Using leverage on a higher risk asset (high-yield bonds, for example) further exacerbates the already high volatility and drawdown risks inherent in the asset class.

Figure 50: Leverage may increase returns, but also subject the returns from levered assets to greater volatility and drawdown risks

Max drawdown and returns* of Global Investment Grade Corporate and High Yield bonds over the last five years across various loan-to-value (LTV) levels



Notes: *denotes monthly returns. Assumes borrowing cost at 2%.

Source: Barclays, Bloomberg, Standard Chartered

Leverage

With this background, it may be sensible to employ leverage for investments with lower levels of price volatility or to a diversified allocation. This should help manage the extent of downside risks while modestly enhancing returns.

Leverage still relevant in current environment

To think of leverage in the current environment, we outline four illustrative scenarios (Figure 51). They attempt to capture the sensitivity of levered Investment Grade (IG) and High Yield (HY) fixed income assets to changes in credit spreads and interest rates. In a bear case scenario, where the Fed hikes aggressively to fight inflation, both HY and IG assets will experience negative returns at various leverage levels.

However, a HY bond behaves more like equity and experiences greater downside at higher levels of leverage relative to a similarly levered IG. A more likely scenario is for the Fed to hike moderately and for yields to move up gradually, with some spread compression. This could support the use of modest leverage to enhance returns.

Given yields are expected to stay low globally, if the risk profile of an asset is reasonable, then the increase in return from leverage may outweigh the amplification in risks an investor has to bear.

Figure 51: Use of leverage in a low to moderately rising interest rate environment can be an attractive strategy to boost returns

Estimated interest-rate sensitivity for IG and HY bonds across various rate scenarios

	Global HY			Global IG		
Loan-to-value (LTV)	0%	**20%**	**70%**	0%	**20%**	**70%**
Yield to maturity	6.9%	**8.1%**	**18.3%**	2.6%	**2.8%**	**4.0%**
Duration	4.3	**5.4**	**14.3**	6.6	**8.2**	**21.8**
Expected total returns						
1. Risk aversion	-5%	**-7%**	**-21%**	-2%	**-3%**	**-12%**
2. Fed clamps down on inflation	-8%	**-11%**	**-32%**	-7%	**-10%**	**-29%**
3. More policy easing by central bank	14%	**17%**	**43%**	8%	**9%**	**20%**
4. Modest pick-up in growth and inflation	11%	**13%**	**33%**	3%	**3%**	**4%**

Scenario assumptions: Assume (1) 25bps rate decline but 100bps and 300bps spread increase in both IG and HY (2) 50bps rate increase and 100bps and 300bps spread increase in both IG and HY. (3) 25bps rate decline and 50bps and 150bps spread decline in both IG and HY. (4) 50bps rise in rates but a 50bps and 150bps spread decline in both IG and HY

Source: Barclays, Bloomberg, Standard Chartered

Review

H1 performance review

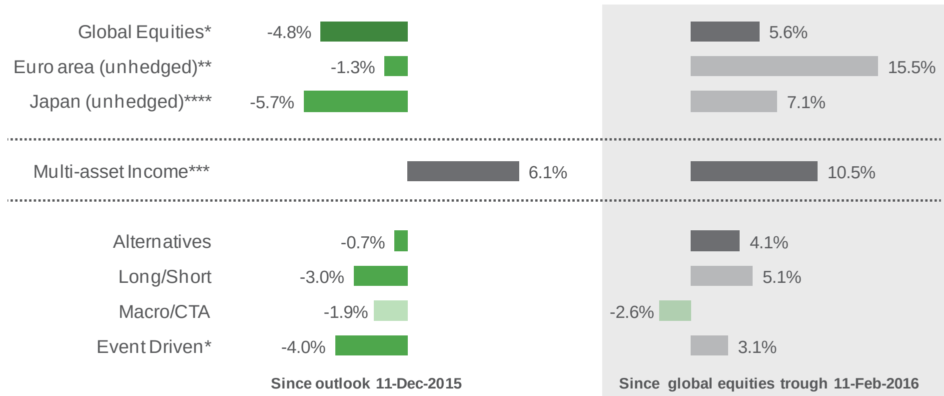
- Volatile markets in the first half of 2016 meant bond-related themes delivered positive returns while equity-related themes were mixed.
- Multi-asset income strategies outperformed equity and alternative strategy themes in H1 16. Alternative strategies helped reduce volatility, but we were early in closing some of our equity themes.

Reviewing our themes amid a volatile H1

A bout of sharp volatility meant the first half of 2016 proved to be a challenging investing environment. Against this backdrop, broad asset class returns dominated performance of our key themes – most bond themes delivered positive returns while equity-related themes were more mixed. Despite this, our tactical asset allocation decisions still delivered positive absolute returns[1] since we published *Outlook 2016* on 11 December 2016.

Figure 52: Multi-asset income was a strong performer

Performance of A.D.A.P.T. since Outlook 2016***



* Closed on 25 February 2016
**FX-hedge removed as of 25 February 2016
*** For the period 11 December 2015 to 21 June 2016. Income basket is as described in Outlook 2016: A year to A.D.A.P.T. to a changing landscape,
Figure 38 on page 60, and revised in the Global Market Outlook, 28 March 2016
**** Closed on 25 March 2016; Source: Bloomberg, Standard Chartered

[1] Based on a moderate asset allocation – see page 50 for current allocations.

Review

A.D.A.P.T. in a volatile H1

Of our three key investment themes within A.D.A.P.T., multi-asset income stands out as a significant outperformer. A continued search for yield, supportive policymakers and significant diversification across asset classes within this strategy helped. This performance was helped by our decision to reduce equity exposure in favour of fixed income in late March 2016.

At the other extreme, equities disappointed amid significant volatility in Q1. While global equities have recovered to deliver slightly positive returns over H1, with the benefit of hindsight, our decision to close our equities overweight in late February was premature (though we had argued in favour of participating in the subsequent rebound on a short-term basis).

Finally, alternative strategies did a good job of buffering against volatility (exhibiting about half the volatility compared with equities), though they were almost flat over the full period.

Variations across asset classes

Our 11 **bond themes** delivered positive absolute returns across the board, in line with strong asset class returns. The strength in European and Japanese government bonds against US Treasuries and global corporate bonds surprised us, as did the underperformance of hard currency bonds within Emerging Markets (EM). However, our preference for Asia over other EM regions and a flatter US yield curve panned out as expected.

Our 12 **equity themes** were more challenged by volatile markets. The sharp rebound in EMs came as a surprise, providing a challenge to our preference for the Euro area and Japan, though Asia ex-Japan equities provided positive absolute returns, as expected. Removing the currency hedge on Euro area equities helped as the currency gained since the removal. Our decision to cut losses in Japan was borne out as markets failed to rebound. Our conviction on US technology and banking sectors disappointed.

Our 6 **commodity themes** contained significant winners and losers. Oil rose and consumption-linked metals outperformed investment-focused metals, in line with our expectations. However, the strength of the rebound in commodities overall, and gold in particular, surprised us.

Our 4 **alternative strategy themes** did their job in terms of dampening volatility in Q1, but disappointed over the full period by ending H1 slightly lower overall.

Finally, **within currencies**, our view that the MYR, IDR and INR would outperform was borne out in the early part of the year. However, the rebound in the EUR, JPY and AUD was unexpected and, with the exception of the EUR, the pairs broke out of our expected ranges.

Market performance summary *

Equity	Year to date		1 month	
Global Equities	-1.6%	↓	-2.1%	↓
Global High Dividend Yield Equities	3.7%	↑	-0.8%	↓
Developed Markets (DM)	-2.1%	↓	-2.6%	↓
Emerging Markets (EM)	2.5%	↑	2.7%	↑
By country				
US	0.2%	↑	-1.7%	↓
Western Europe (Local)	-6.9%	↓	-4.2%	↓
Western Europe (USD)	-7.6%	↓	-6.1%	↓
Japan (Local)	-22.1%	↓	-9.0%	↓
Japan (USD)	-8.2%	↓	-2.1%	↓
Australia	0.5%	↑	0.3%	↑
Asia ex- Japan	-1.4%	↓	2.8%	↑
Africa	9.6%	↑	4.0%	↑
Eastern Europe	10.9%	↑	0.0%	↑
Latam	18.1%	↑	2.9%	↑
Middle East	-0.1%	↓	1.2%	↑
China	-7.9%	↓	2.3%	↑
India	-1.7%	↓	3.6%	↑
South Korea	-0.6%	↓	2.5%	↑
Taiwan	4.4%	↑	4.4%	↑
By sector				
Consumer Discretionary	-5.7%	↓	-3.1%	↓
Consumer Staples	5.1%	↑	-0.1%	↓
Energy	14.1%	↑	1.6%	↑
Financial	-7.0%	↓	-4.8%	↓
Healthcare	-5.4%	↓	-1.8%	↓
Industrial	1.1%	↑	-2.1%	↓
IT	-2.6%	↓	-2.0%	↓
Materials	7.0%	↑	-0.7%	↓
Telecom	5.8%	↑	0.5%	↑
Utilities	7.3%	↑	1.2%	↑
Global Property Equity/REITS	4.7%	↑	0.7%	↑

Bonds	Year to date		1 month	
Sovereign				
Global IG Sovereign	9.3%	↑	2.7%	↑
Global HY Sovereign	8.9%	↑	2.2%	↑
EM IG Sovereign	8.2%	↑	1.9%	↑
US Sovereign	4.8%	↑	1.8%	↑
EU Sovereign	8.3%	↑	1.6%	↑
Asia EM Local Currency	8.3%	↑	2.4%	↑
Credit				
Global IG Corporates	6.2%	↑	1.2%	↑
Global HY Corporates	7.6%	↑	0.6%	↑
US High Yield	8.9%	↑	1.3%	↑
Europe High Yield	3.2%	↑	-2.1%	↓
Asia High Yield Corporates	7.0%	↑	1.0%	↑

Commodity	Year to date		1 month	
Diversified Commodity	10.8%	↑	3.3%	↑
Agriculture	11.4%	↑	2.2%	↑
Energy	6.2%	↑	1.9%	↑
Industrial Metal	4.7%	↑	4.7%	↑
Precious Metal	25.5%	↑	7.9%	↑
Crude Oil	15.8%	↑	-1.6%	↓
Gold	23.9%	↑	7.2%	↑

FX (against USD)	Year to date		1 month	
Asia ex- Japan	-0.1%	↓	0.1%	↑
AUD	2.5%	↑	3.9%	↑
EUR	2.3%	↑	-0.2%	↓
GBP	-7.2%	↓	-6.5%	↓
JPY	17.7%	↑	7.6%	↑
SGD	4.7%	↑	2.0%	↑

Alternatives	Year to date		1 month	
Composite (All strategies)	-0.6%	↓	1.0%	↑
Arbitrage	-1.5%	↓	0.8%	↑
Event Driven	3.6%	↑	2.7%	↑
Equity Long/Short	-3.1%	↓	0.2%	↑
Macro CTAs	-1.5%	↓	0.0%	↑

*All performance shown in USD terms, unless otherwise stated.

*Until 24 June 2016 (for YTD) and from 24 May 2016 to 24 June 2016 for 1-month performance

Sources: MSCI, JP Morgan, Barclays Capital, Citigroup, Dow Jones, HFRX, FTSE, Bloomberg, Standard Chartered

FY 2016 performance themes

Theme	Index Name	Relative Benchmark	Status	Date Open	Date Closed	Absolute[#]	Relative[##]
Bonds							
Bonds to outperform Commodities (bonds FX-hedged)	SAA Blended Benchmark Index[1]	Bloomberg Commodity Index	Open	11-12-2015		✓	x
Bonds to outperform Cash (bonds FX-hedged)	SAA Blended Benchmark Index[1]	JPMorgan Global Cash Index 3M	Open	11-12-2015		✓	✓
Prefer US Treasuries over German Bunds	Citi US GBI LCL	Citi Germany GBI USD	Open	11-12-2015		✓	x
Prefer US Treasuries over Japanese Govt Bonds	Citi US GBI LCL	Citi Japan GBI USD	Open	11-12-2015		✓	x
Prefer Corporate Bonds over Sovereign Bonds in DMs	Barclays Global Agg Corporate Total Return Index Value Unhedged USD	Citi WorldBIG Govt/Govt Sponsored Index USD	Open	11-12-2015		✓	x
Prefer US HY vs. global bonds	Barclays US Corporate High Yield Total Return Index Value Unhedged USD	Citi WorldBIG Index USD	Closed	11-12-2015	28-4-2016	✓	✓
Prefer US IG Corporate credit vs. global bonds	Barclays US Agg Credit Total Return Value Unhedged USD	Citi WorldBIG Index USD	Open	11-12-2015		✓	x
Prefer EM USD over Local currency	JPMorgan EMBI Global Total Return Index	JPMorgan GBI-EM Broad Diversified USD Unhedged	Open	11-12-2015		✓	x
Within LCY, prefer Asia over EMEA	JPMorgan GBI-EM Diversified Asia USD Unhedged	JPMorgan GBI-EM Global Diversified EMEAUnhedged USD	Open	11-12-2015		✓	x
Within LCY, prefer Asia over Latam	JPMorgan GBI-EM Diversified Asia USD Unhedged	JPMorgan GBI-EM Global Diversified Latin America Unhedged USD	Open	11-12-2015		✓	x
US 10-2 yield curve to flatten*	US Treasury 10-2 yield spread	N/A	Closed	11-12-2015	21-6-2016	✓	N/A
Equities							
Equities preferred over Bonds	MSCI All-Country World Daily Total Return Net USD	Citi WorldBIG Index USD	Closed	11-12-2015	25-5-2016	✓	x
Overweight Euro area (Hedged)	MSCI EMU Index Hedged to USD	MSCI All-Country World Daily Total Return Net USD	Closed	11-12-2015	25-2-2016	x	✓
Overweight Euro area (Unhedged)	MSCI EMU TR Net Index	MSCI All-Country World Daily Total Return Net USD	Open	26-2-2016		✓	x
Overweight Japan	MSCI Japan Local Net Index	MSCI All-Country World Daily Total Return Net USD	Closed	11-12-2015	25-3-2016	x	x
Prefer Small/mid caps over Large caps in Europe	MSCI Europe Mid and Small Cap TR Index (Blended)	MSCI Europe Large Cap TR Index	Open	11-12-2015		N/A	✓

Theme	Index Name	Relative Benchmark	Status	Date Open	Date Closed	Absolute#	Relative##
Cautiously positive on US	MSCI Daily Total Return Net USA USD Index	MSCI All-Country World Daily Total Return Net USD	Open	11-12-2015		✓	✓
Cautiously positive on Asia ex-Japan	MSCI All-Country Daily Total Return Net Asia ex-Japan USD Index	N/A	Open	11-12-2015		✓	N/A
Prefer US Technology	US Listed Technology Sector Index[2]	MSCI United States Index	Open	11-12-2015		x	x
Prefer US Banks	MSCI USA Banks Index	MSCI United States Index	Closed	11-12-2015	28-4-2016	x	x
Prefer China within Asia ex-Japan	MSCI China TR Net USD Index	MSCI AC Asia ex-Japan TR Net Index	Closed	11-12-2015	25-5-2016	x	x
Prefer India within Asia ex-Japan	MSCI India TR Net USD Index	MSCI AC Asia ex-Japan TR Net Index	Open	27-5-2016		✓	x
Underweight on Non-Asia Emerging Markets	MSCI EM ex Asia Net TR USD Index	MSCI Emerging Markets TR Net Index	Open	11-12-2015		x	x
Commodities							
Underweight Commodities	Bloomberg Commodity Index	MSCI All-Country World Daily Total Return Net USD	Closed	11-12-2015	25-3-2016	x	x
Underweight Commodities	Bloomberg Commodity Index	MSCI All-Country World Daily Total Return Net USD	Open	27-5-2016		x	x
Oil to rise by year-end	Brent Crude Spot	N/A	Open	11-12-2015		✓	N/A
Gold to stay within $1000-1200 in Q1 16	Gold spot	N/A	Closed	11-12-2015	31-3-2016	x	N/A
Negative on Industial Commodities	Bloomberg Industrial Metals Index	N/A	Open	11-12-2015		x	N/A
Prefer (zinc/aluminium/nickel) to (iron-ore/copper)	Zinc/Aluminium/ Nickel Blend Index[3]	Iron Ore/ Copper Blend Index[4]	Open	11-12-2015		✓	✓
Alternatives							
Overweight Alternative Strategies	HFRX Global Hedge Fund Index		Open			x	N/A
Equity Long/Short Strategies	HFRX Equity Hedge Index	HFRX Global Hedge Fund Index	Open	11-12-2015		x	x
Event-driven strategies	HFRX Event Driven Index	HFRX Global Hedge Fund Index	Closed	11-12-2015	25-2-2016	x	x
Macro/Commodity Trading Advisors	HFRX Macro/CTA Index	HFRX Global Hedge Fund Index	Open	11-12-2015		x	x
Currencies							
Bearish EUR/USD	EUR/USD	N/A	Closed	11-12-2015	28-4-2016	x	N/A
EUR/USD to stay within 1.05-1.15	EUR/USD	N/A	Open	29-4-2016		✓	N/A
Bullish USD/CHF	USD/CHF	N/A	Open	11-12-2015		x	N/A
Bearish AUD/USD	AUD/USD	N/A	Closed	11-12-2015	28-4-2016	x	N/A
Bearish AUD/USD	AUD/USD	N/A	Open	27-5-2016		x	N/A

Theme	Index Name	Relative Benchmark	Status	Date Open	Date Closed	Absolute[#]	Relative[##]
Bearish NZD/USD	NZD/USD	N/A	Open	11-12-2015		x	N/A
USD/JPY to stay within 116-126 in Q1 2016	USD/JPY	N/A	Closed	11-12-2015	20-1-2016	x	N/A
USD/JPY to stay within 110-115	USD/JPY	N/A	Closed	27-5-2016	1-6-2016	x	N/A
GBP/USD to stay within 1.45-1.60	GBP/USD	N/A	Closed	11-12-2015	11-1-2016	x	N/A
USD/CAD to stay within 1.28-1.40	USD/CAD	N/A	Closed	11-12-2015	12-4-2016	x	N/A
ADXY to bottom in 2016	Bloomberg JP Morgan Asia Dollar Index	N/A	Open	11-12-2015		✓	N/A
Prefer MYR relative to ADXY	MYR Currency	Bloomberg JP Morgan Asia Dollar Index	Closed	11-12-2015	28-4-2016	✓	✓
Prefer IDR relative to ADXY	IDR Currency	Bloomberg JP Morgan Asia Dollar Index	Open	11-12-2015		✓	✓
Prefer INR relative to ADXY	INR Currency	Bloomberg JP Morgan Asia Dollar Index	Closed	11-12-2015	25-3-2016	✓	x
Prefer INR relative to ADXY	INR Currency	Bloomberg JP Morgan Asia Dollar Index	Open	27-5-2015		x	x
Bearish SGD/MYR	SGD/MYR	Bloomberg JP Morgan Asia Dollar Index	Open	11-12-2015		✓	✓
Bearish USD/SGD	USD/SGD	Bloomberg JP Morgan Asia Dollar Index	Open	26-2-2016		✓	✓
Bearish USD/CNY	USD/CNY	Bloomberg JP Morgan Asia Dollar Index	Open	28-3-2016		x	x
Multi-asset Income							
Multi-asset Income			Open	11-12-2015		✓	N/A
- Fixed Income[5]			Open	11-12-2015		✓	N/A
- Equity Income[6]			Open	11-12-2015		✓	N/A
- Non-core Income[7]			Open	11-12-2015		✓	N/A

Source: Bloomberg, Standard Chartered

Performance measured from 11-Dec-2015 (release date of our 2016 Outlook) to 21-Jun-2016 or when the view was closed

1: SAA Blended Benchmark is a composite of 50% Citi Non-MBS WorldBIG index US, 25% JPM EMBI Global Diversified IG, 12.5% Barcap Global HY TR, 12.5% JPM EMBI Global Diversified HY

2: US Listed Technology sector is a composite of 83% MSCI US Tech index and 17% Bloomberg China ADR Index

3: Zinc/Aluminium/Nickel Blend Index is an equal weighted composite of Zinc, Aluminium and Nickel 3m LME Rolling Forwards

4: Iron Ore/ Copper Blend Index is an equal weighted composite of Iron ore prices (62% Fe Qingdao China) and Copper 3m LME Rolling Forwards

5,6,7: Please refer to page 34 for descriptions of the various Income baskets

Explanatory Notes:

✓ - Correct call; **x** - Missed call; N/A – Not Applicable

- Simple absolute returns of the Index name

- Relative returns = Absolute returns net of Benchmark returns

*Flattening - A narrowing spread between long maturity and short-maturity yields

Past performance is not an indication of future performance. There is no assurance, representation or prediction given as to any results or returns that would actually be achieved in a transaction based on any historical data.

Standard Chartered

Events calendar

Jul

18-21 US Republican Party National Convention

21 ECB Policy Meeting

25-28 US Democratic Party National Convention

26-27 US Federal Reserve Policy Meeting

28-29 Bank of Japan Policy Meeting

Aug

Brazil – Congress convenes; likely impeachment proceedings against former President Dilma Rousseff

Sep

04-05 G20 Summit in Hangzhou, China

08 ECB Policy Meeting

21 US Federal Reserve Policy Meeting

20-21 Bank of Japan Policy Meeting

India New RBI Governor takes charge

Oct

20 ECB Policy Meeting

31 Oct-01 Nov Bank of Japan Policy Meeting

Italy Constitutional Referendum

Nov

02 US Federal Reserve Policy Meeting

08 US Presidential Elections

30 Australia Parliamentary Elections

APEC Annual APEC Summit, Peru

Dec

08 ECB Policy Meeting

14 US Federal Reserve Policy Meeting

19-20 Bank of Japan Policy Meeting

11 WTO – China expects to gain “market economy” status

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