global **market outlook**

This reflects the views of the Wealth Management Group

macro strategy | June 14

'Sell in May': Don't count on it

Global equity remains our preferred asset class, with a slight preference for US and Europe. US and European corporate earnings have surprised on the upside in Q1 and look likely to accelerate in the coming quarters. Meanwhile, loose monetary policy settings are expected to extend through the rest of the year, at least. It is also important to note that we expect Emerging Market equities to generate positive returns over the next 12 months.

Many investors are worried about potential 'sell in May'-like behaviour. In our opinion, there are three aspects to consider: will it happen, what is the likely size and how should investors prepare?

On the first, it is important to note the 'sell in May' performance does not survive scrutiny over long horizons. Over the past 80 years, the average US stock market performance within a year is almost a straight line up.

The indicators of a potential imminent short term US equity market peak are generally flashing amber, but not red (see table). Therefore, the risk is that those looking for the 'sell in May' phenomenon to repeat itself this year may be disappointed.

Even if we did see some weakness, we expect it to be limited in both magnitude and duration. We believe there is a two-third probability that any weakness will be less than 5%.

Given the complexity of timing any pullback – and then ensuring that you get back in before the following rebound – means we would not be reducing our equity allocation. Investors who are underweight global equities would likely need to be very A.G.I.L.E. in order to take advantage of any weakness.

CNY- and CNH-denominated bonds are attractive, in our opinion, given attractive bond yields, a likely stabilisation of the CNY and a low correlation between CNY, CNH bonds and global equities.

Asian political cycle tailwinds. Indian election results were much better than expected. Indonesian elections are likely to deliver a positive outcome, although this has become less clear cut in recent times. This may support South/Southeast Asian equity markets long term.

The strong performance of Investment Grade USD bonds has surprised us. However, we still expect yields to rise going forward and prefer Developed Market High Yield bonds, which we expect to eke out positive returns over the next 12 months.

Contents

Flashing amber, but not red

Indicators of short-term risk to S&P 500

Indicator	Signal
Current level vs. 200 DMA	🟢
Advance/Decline Ratio	🟡
Relative Strength Index (RSI)	🟡
VIX	🔴
MACD (Momentum) Weekly	🟡
MACD (Momentum) Daily	🟡

Source: Standard Chartered

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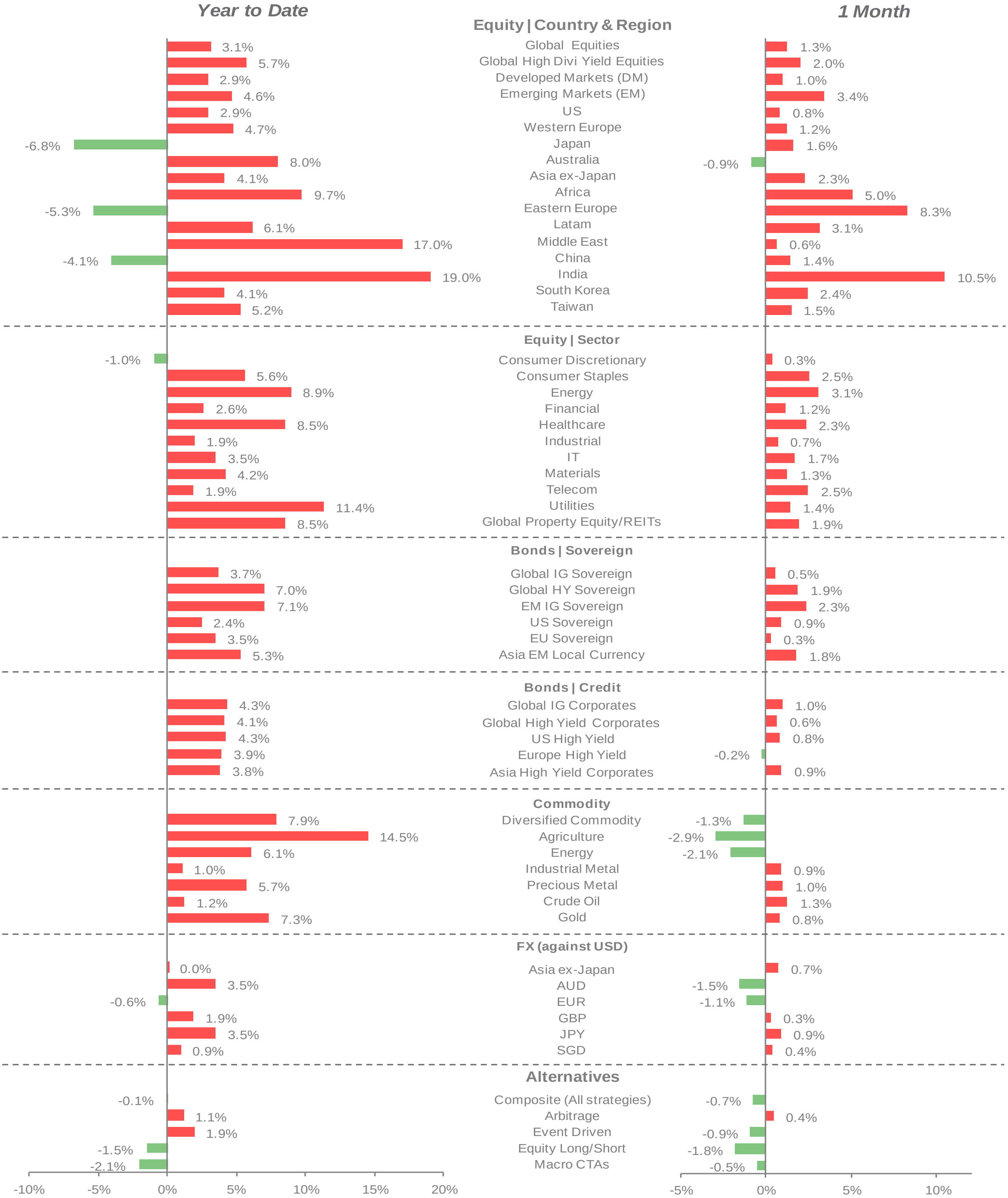
The trend has been your friend: Global equities continue to push higher

MSCI AC World equity market index

Source: Bloomberg, Standard Chartered

Market Performance Summary (Year to Date & 1 Month)*



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

**YTD performance data from 31 Dec 2013 to 22 May 2014 and 1-month performance from 22 April to 22 May 2014*

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

Investment strategy overview

- **Prepare to be A.G.I.L.E.** Global equities are still our preferred asset class over the next year. We are entering a seasonally challenging period (in recent times at least), but significant cash on the sidelines/positive fundamentals mean any pullback, if indeed we see one, should be limited. Investors may need to be very A.G.I.L.E. to take advantage of any weakness.
- **Positive on CNY, CNH bonds.** We are positive for three reasons – attractive yields, limited scope for CNY weakness and low correlation with other asset classes

Global equities still preferred to global bonds. Global equities have been supported by better than expected Q1 US/Europe earnings results. Monetary policy is likely to remain accommodative in the coming months – Europe/Japan may ease policy further. Also, history suggests that as long as inflation remains benign, there is scope for further increases in US and European equity valuations.

Positive returns in Emerging Market (EM) equities expected over the next 12 months. Economic/earnings growth expectations have fallen to less demanding levels, external imbalances have improved and political developments have generally been positive. The main reason for not being Overweight EM equities is the potential impact of rising US interest rate expectations, which could support the USD.

'Sell in May' phenomenon may not repeat. We are not convinced that the 'sell in May' type behaviour will repeat this year (see front page for more details). Even if it does, we expect volatility to be relatively limited. We attach a 90% probability to any global equity market weakness over the next 3 months being less than 10% and see a two-thirds probability that it may be less than 5%. Given these uncertainties, we would not be reducing exposure to global equities. For those yet to build an overweight position, we would be taking a time-bound approach – say, over the next 6 months – to doing so.

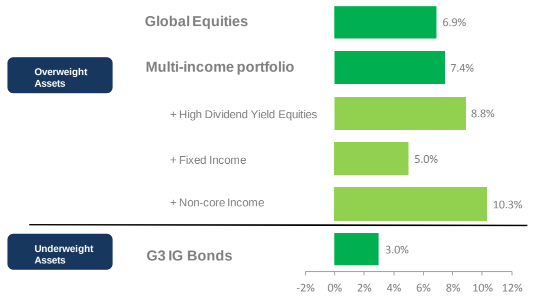
CNY, CNH bonds favoured. The rationale for this is threefold:

- Yields on short maturity bonds are relatively attractive versus US Treasury yields.
- Currency risks are lower than in other EM bond markets, in our opinion. This is reinforced by the recent stabilisation in USD/CNY.
- The economic drivers of CNY, CNH bonds are very different to global equities. As such, the low correlation between these two asset classes is likely to stay. Therefore, this asset class acts as a good portfolio diversifier.

US and European equity markets remain supported by better-than-expected earnings growth. Any seasonal weakness would provide an opportunity to move to an overweight equity allocation, in our opinion. We still favour CNY, CNH bonds.

A.G.I.L.E. themes off to a slow start in 2014

*AGILE performance since Outlook 2014 was published**



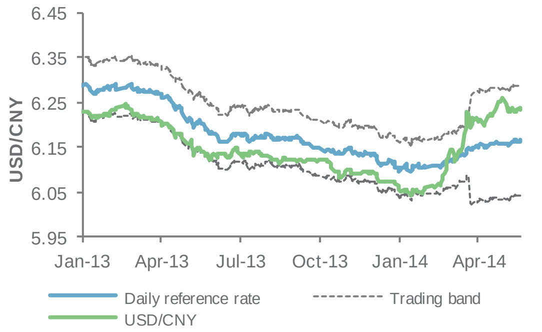
** For the period 16 December 2013 to 22 May 2014*

Source: Bloomberg, Standard Chartered

** Income basket is as described in the Outlook 2014: A Year to be A.G.I.L.E., Figure 53.*

CNY weakness looks unlikely to extend much further

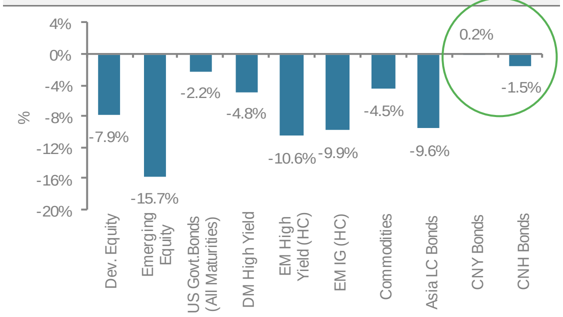
USD/CNY and the authorities' USD/CNY reference rate and policy band within which USD/CNY can fluctuate



Source: Bloomberg,Standard Chartered

Performance of select asset classes during the Fed's 'taper tantrum' last year

Performance of select asset classes during Bernanke's 'taper tantrum' (21 May-24 June 2013)



Source: Bloomberg, Standard Chartered

Asset Class	Relative Outlook	Start Date
Cash	UW	Feb-12
Fixed Income	UW	Jan-11
Equity	OW	Aug-12
Commodities	N	Nov-13
Alternatives	OW	Jun-13

Legend

Start Date - Date at which this tactical stance was initiated

OW - Overweight N - Neutral UW - Underweight

DM - Developed Markets

EM - Emerging Markets

	Sub-asset Class	Relative Outlook	Start Date
Cash		UW	Feb-12
Fixed Income	DM IG	UW	Jan-11
	EM IG	N	Feb-14
	DM HY	OW	Sep-11
	EM HY	N	Sep-12
Equity	US	OW	Apr-12
	Europe	OW	Jul-13
	Japan	N	Apr-13
	Asia ex-Japan	N	Apr-14
	Other EM	UW	Aug-12
Commodities		N	Nov-13
Alternatives		OW	Jun-13

Source: Standard Chartered

Economic and policy outlook

US data surprises point to accelerating economy

- **US** economic data has started to surprise on the upside after temporary softness in Q1 that was caused by the harsh winter. The Fed is likely to retain its extremely accommodative stance until there are signs of a pickup in inflation pressures.
- In **Europe,** economic confidence unexpectedly declined in April, while extremely low inflation remained a key concern. ECB Chairman Draghi strongly hinted at further policy easing at the central bank's June meeting.
- In **Emerging Markets (EM)**, China's data pointed to a continued slowdown in the domestic economy. We expect policymakers to step in if the domestic slowdown impacts job creation. Meanwhile, for the first time in 30 years, India elected a government with a strong majority in parliament, raising hopes it will be able to implement economic reforms that are required to jump-start growth.

US: `Goldilocks' economy for now

In a sweet spot, with improving labour market, low inflation

- **Strong US jobs data should boost consumer spending.** The US economy created 288,000 net new jobs in April, the biggest gain in two years, pushing the unemployment rate to 6.3%, the lowest since September 2008. The strong numbers alleviated concerns about the job market after a temporary dip in 1Q. Coming against the backdrop of improving consumer sentiment (partly boosted by healthcare spending) and April's strong increase in manufacturing and small business confidence, the numbers point to higher consumer spending going forward.
- **Housing market slowly picking up.** The housing market showed early signs of recovery after weakening in Q1, with April housing starts climbing 13% from the previous month to its highest level in five months and building permits rising 8%. A further pickup in the housing market could take away a key reason for the Fed to delaying its rate hiking cycle.
- **Inflation pressures increase:** Consumer prices picked up in April. Core prices rose at an annualised pace of 2.3% over the past three months, pushing inflation above the Fed's historical comfort level of 2%. While wage inflation decelerated in April, we believe the trend for faster wage growth is clear. This will be a key focus in the coming months, in our opinion.

Fed: Steady as she goes

- **Fed to stay accommodative, but keep a close watch on inflation pressures.** Fed Chair Janet Yellen has stressed that the slack in the labour market and the lack of wage pressures justify maintaining the Fed's extremely easy monetary policy over the coming months. We expect the Fed to continue tapering its quantitative easing (bond purchase) programme by USD 10bn a month, ending the course by 4Q. It is likely to then embark on a gradual rate-hike cycle in Q1 2015 – earlier than market expectations – as we believe wages are likely to pick up sooner than widely expected, forcing the Fed's hand.

Europe: All set for further policy easing

- **Economic sentiment weakens.** European industrial and service sector confidence weakened in April. German retail sales also fell short of expectations amid concerns about the rising tensions with Russia over Ukraine. An indicator of Euro area growth expectations (ZEW Survey) fell in May to the lowest level in nine months. The weak data, which follows declining inflation expectations, further supports policy easing by the ECB in June.

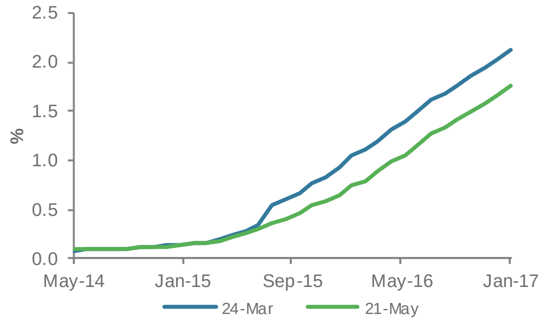
US economic surprises rise, Europe's disappoint
Economic surprise indices – US and Europe

Source: Citigroup, Bloomberg, Standard Chartered

US unemployment drops, wage inflation trends up
US unemployment and average earnings growth, y/y %

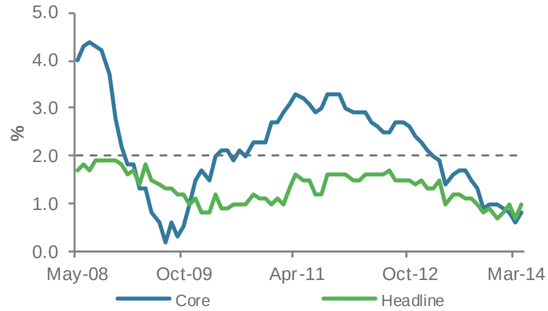
Source: Bloomberg, Standard Chartered

US interest rate expectations decline
30-day Fed fund future (21 May vs. 24 March 2014)



Source: Bloomberg, Standard Chartered

Europe faces deflationary pressures
Euro area inflation – core and headline, y/y, %



Source: Bloomberg, Standard Chartered

- **ECB likely to ease policy.** ECB President Mario Draghi gave the strongest hint yet of a policy easing at the next meeting in early June, noting that the Governing Council was "comfortable with acting next time". We believe a small rate cut (10-15bps) would disappoint the market. While it may be too early for an outright quantitative easing programme, we would not be surprised if the ECB embarks on a more ambitious set of policy easing measures over time, with deflation a greater concern than inflation.

EM: Policy stimulus, reforms talk back on the agenda

China: Further downgrades of growth outlook limited

- **Stabilisation in exports may offset weak domestic economy.** China's exports and imports recovered in April after a sharp decline in the previous month, providing support to a domestic manufacturing sector which stayed weak. The authorities continued to tighten credit conditions as they try and wean the economy off excessive investment. Meanwhile, property sales continued its downward slide.
- Growth estimates for this year have been downgraded to 7.3%. Given the government's 7.5% forecast, any further weakness may prompt authorities to implement targeted measures to support rural and social sectors – as they did earlier this year. The key determinant for further stimulus measures, albeit on a limited scale, may be a slowdown in job creation. Strong labour market indicators suggest that a large-scale stimulus is not imminent.

Elections: India back on investors' radar

- **India: A thumping majority for the BJP augurs well for reforms.** The medium-to-longer-term India story got a boost after the opposition Bharatiya Janata Party won a resounding majority – the first by any party in 30 years – in India's parliamentary elections. The strong mandate should provide the incoming government the necessary support to push through tough economic reforms required to revive growth in Asia's third-largest economy. The immediate challenges for the new government include cutting back on public spending and reducing high inflation. Success on these fronts would likely enable the central bank to start easing policy. Indian companies need lower borrowing costs and more enabling regulatory policies to restart large-scale investments.
- **Indonesia:** Indonesia's presidential poll front-runner, Jakarta Governor Joko Widodo, faces a tough election in July as his main contender Prabowo Subianto formed a coalition with the country's second-biggest party. This development implies that Widodo will face a strong opposition that has a majority in the parliament, even if he is successful in his presidential bid. That may make it difficult to push through tough reform measures needed to revive growth.

Japan: Weak after the tax hike

- **Weak April, as expected, but next few months key.** Japan's economic data weakened in April, with declines in department store sales and vehicle sales, after the sales tax increase went into force at the start of the month. We expect the BOJ to hold back on further policy easing at least until Q3 to see the medium-term impact of the sales tax increase.

The US economy is currently in a sweet spot, with an improving jobs market and low inflation. A pickup in wage inflation over the coming quarters could force the Fed to start raising rates by Q1 15, sooner than market expectations. Europe remains weak, which could force the ECB's hand at its June meeting. China is also likely to see easier policies in the immediate future, although they may be limited in size.

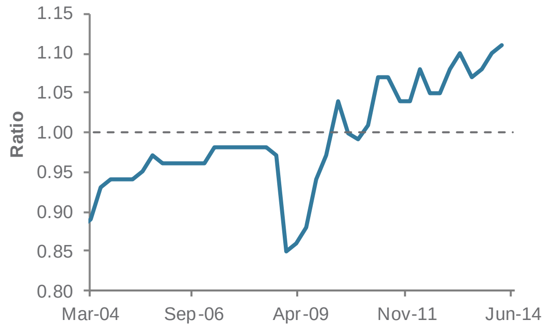
China industrial and housing sectors slow down

China electricity production and floor space sold, y/y, %

Source: Bloomberg, Standard Chartered

China labour market remains robust

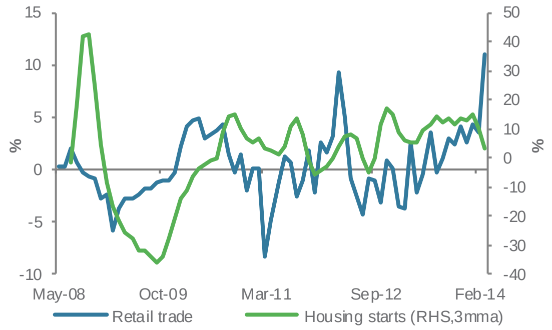
China job vacancies vs. job applicants ratio



Source: Datastream, Standard Chartered

Japan retail sales jump before tax hike, housing weak

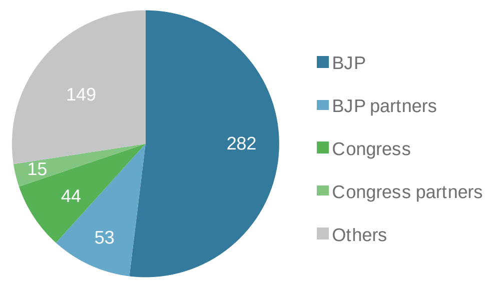
Japan retail trade and housing starts (3mma), y/y %



Source: Bloomberg, Standard Chartered

BJP wins a thumping majority in Indian elections

Results of India election 2014 – by seats



Source: Bloomberg, Standard Chartered

Fixed Income – Underweight

- We retain our Underweight on G3 government bonds and believe US Treasury bond yields are in the process of bottoming
- We remain Overweight Developed Market High Yield (DM HY). Our scorecard suggests further, albeit modest, gains are likely
- We continue to like CNY and CNH bonds, but do not favour broadening this to other local currency markets at this time

G3 and EM sovereign bonds:

- **Long-dated US Treasury yields have remained surprisingly soft. We believe four factors help explain this.** First, a change in rules means there has likely been a rise in pension fund demand for long-dated bonds. Second, this has come against increasingly tight supply of such bonds in light of Fed purchases and the lack of significant new supply as US budget deficits shrink. Third, rising geopolitical risks recently may have raised incremental demand for safe-haven assets. Fourth, market positioning was already very short Treasury bonds.
- **We believe yields may be in the process of bottoming.** We struggle to reconcile significantly lower Treasury yields with continued improvement in US growth data. We have also argued previously that markets appear to be too sanguine regarding the timing of a first rate hike. Both these factors suggest fundamentals remain supportive for higher yields. It is also worth noting that, while yields may have softened close to the 2.4-2.5% levels we witnessed when the US growth outlook was far less optimistic, they have not broken lower. Putting this all together, we believe 10-year Treasury yields are poised to rise from here.
- **A flatter yield curve still likely, but not until short-term rates begin to rise.** A flatter yield curve (i.e. a narrowing gap between 10-year and 2-year bond yields) is consistent with an improving growth picture. However, this has been usually driven by a gradual rise in short-term rates (as markets increasingly price in Fed rate hikes) rather than a fall in long-term rates. We believe this will become increasingly likely around year-end.

Corporate credit (USD):

- **A risk checklist suggests an Overweight position on DM HY remains justified.** At the beginning of the year, we noted it was important to track lending conditions, expected default rates, the magnitude of repayments and valuations in order to track the risk/reward of staying Overweight on this asset class. We summarise our subjective assessment of these factors in the table on the right. Based on this tracker, we believe an Overweight position on DM HY remains justified for now, but we expect returns to be moderate.

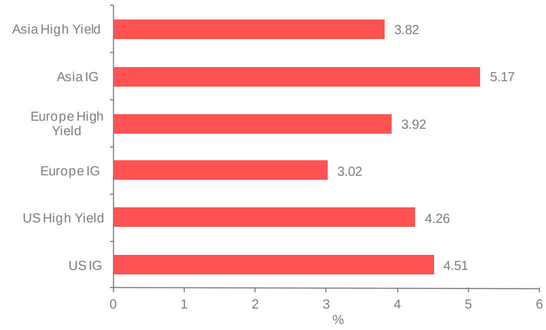
Local currency bonds:

- **We favour CNY and CNH bonds over broader exposure to regional local currency bonds.** Our chief concern is many Asian currencies may not offer an attractive entry point following their strong recent performance. CNY and CNH, on the other hand, do offer an attractive entry point, in our view, as well as continued attractive yields. We, therefore, believe CNY and CNH bonds offer a more attractive risk/reward proposition (see page 3).

Conclusion

We maintain Underweight on G3 soveriegn bond on expectation of higher US Treasury yields. We stay Overweight DM HY, but track key risk indicators. We continue to prefer CNY and CNH bonds in Asia.

Performance of Fixed income YTD* (USD)



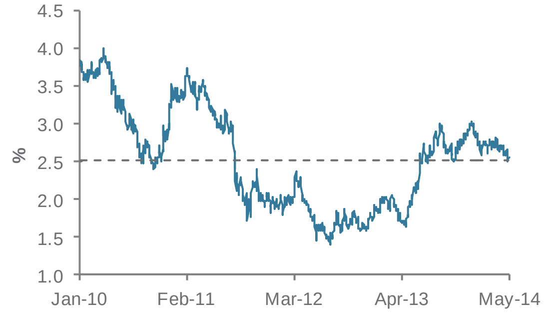
** For the period 31 Dec 2013 to 22 May 2014*
Source: Barclays Capital, JPMorgan, Bloomberg, Standard Chartered. Indices are Barclays Capital US Agg, US High Yield, Euro Agg, Pan-Euro High Yield, JPMorgan Asia Credit Index

Most factors still supportive for DM HY bonds
HY score card

	US	Europe
Lending conditions	✓	✓
Expected defaults	✓	✓
Repayments	✓	✓
Valuations	✗	✗

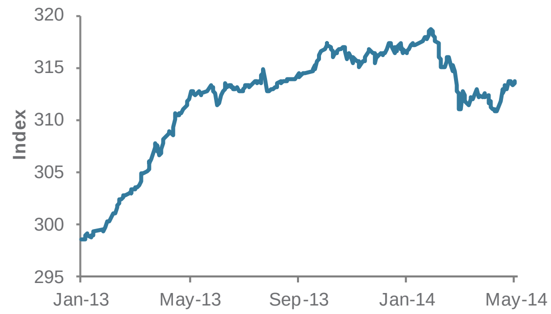
Source: Bloomberg, Standard Chartered

Yields are likely to move higher from here
US Treasury 10y yield (%)



Source: Bloomberg, Standard Chartered

Current levels remain attractive to add to CNY corporate bonds, in our view
S&P/CITIC China corporate bond total return index (USD)



Source: S&P/CITIC, Bloomberg, Standard Chartered

Equity – Overweight

- We remain Overweight Developed Markets (DM), but are becoming more constructive on Emerging Markets (EM), given positive policy developments in select EM countries and valuations. Key is to be selective.
- Within Asia ex-Japan, we retain our Overweight on Taiwan and Korea, but are becoming more constructive on India and ASEAN.
- Signs of rotation to value and mid-to-late cycle sectors. Remain Overweight Tech, a DM capex recovery proxy.

Prefer DM (US and EU) but more sanguine on EM

- **The 'sell in May' phenomenon has not played out so far**, with global equities making new highs. The lack of negative impetus amidst better macro and earnings outlook has been supportive. While markets may have to digest rising US interest rate expectations at some point, we believe any market pullback would likely be muted, given elevated cash levels, loose monetary policy settings and strengthening fundamentals (see page 1).
- **We expect US and Europe equities to continue to outperform.** This view is reinforced by Q1 earnings, which were better than expected. More than two-thirds of the companies that reported in the US surprised positively, and Europe is finally starting to surprise on the upside.
- While EM earnings continue to disappoint, expectations are already low and there appear to be some pockets of earnings stabilising within EM.

Negative sentiment on EM receding. Neutral Asia ex-Japan

- **EM equities outperformed DM again this month.** Good performance was seen across India, Russia and South Africa, while China continued to languish on the back of decelerating growth. We remain Overweight on Taiwan and Korea, the former has outperformed Asia ex-Japan this year. Both the tech-heavy markets are leveraged to a recovery in DM capex against the backdrop of improving utilisation and healthy corporate profits.
- **We are turning more constructive on India and Indonesia.** Positive electoral developments, particularly in India, may result in a virtuous cycle of improving confidence on fund flows, reforms and growth. We would not, however, chase the rally, cognisant that the impending monsoon and recent spike in soft grain prices may provide better opportunities ahead.
- **We remain Underweight on non-Asia EM.** However, cheap valuations, significantly lowered expectations and underweight positions suggest it may not need much for a short-term bounce.

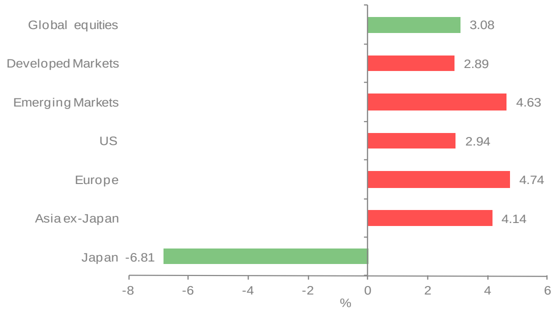
Rotation to value and late cyclicals as the market matures

- **Some of the lagging sectors last year (energy, utilities and materials) are starting to outperform.** As the recovery becomes more self-sustaining, it should not be surprising to see interest broadening out from growth to value companies and corporates starting to exhibit mid/late cycle behaviour on capex and M&A.
- **We remain Overweight Technology** (software, mobile-related), a capex recovery proxy. We also like Energy, which offers value and dividend yields, with a focus on upstream E&P companies.

Conclusion

We expect US/Europe equities to continue to outperform. We remain Neutral on Asia ex-Japan and are less negative on non-Asia EM on the back of low expectations.

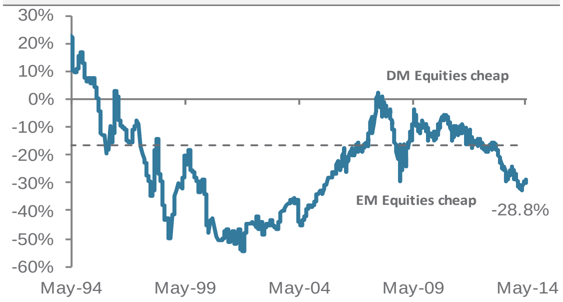
Performance of equity markets YTD* (USD)



** For the period 31 Dec 2013 to 22 May 2014*
Source: Bloomberg, Standard Chartered. Indices are MSCI World TR, MSCI Emerging Markets TR, MSCI USA TR, MSCI Europe TR USD, MSCI Asia ex-Japan TR USD, MSCI Japan TR USD

EM equities trade at a significant discount to DM

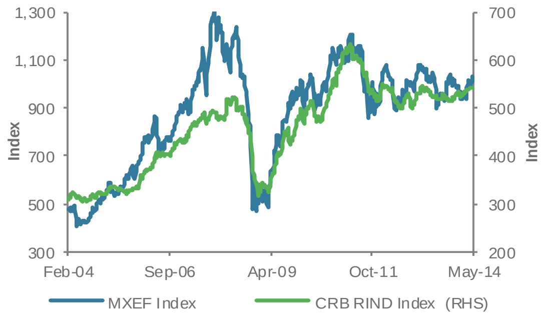
MSCI Emerging Markets vs. Developed Markets 12m forward P/E premium/discount ratio



Source: IBES, Datastream, Standard Chartered

EM performance has a strong correlation with base metal prices

MSCI Emerging Markets vs. CRB raw industrials metal index



Source: Bloomberg, Standard Chartered

Value started outperforming since the beginning of the year

MSCI AC World Growth vs. Value index ratio

Source: MSCI, Bloomberg, Standard Chartered

Commodities – Neutral

- We retain our Neutral view on commodities. The turn in agricultural commodity prices (we are Neutral) and a rebound in the US dollar are two trends that point to the risk of near-term downside. However, industrial metals (Neutral) may help offset this to some extent, given relatively extreme positioning in some key metals.
- Oil prices (Overweight) are now closer to the top of this range. Meanwhile, gold (Underweight) has continued to lack support even in the presence of rising geopolitical risk.

We remain Underweight gold. Gold prices have been relatively range-bound over the past month, likely led by the lack of significant US dollar strength. However, we do not believe any of the long-term factors in favour of further gold price weakness have changed:

- The inflation-adjusted price of gold remains high. Even a gradual pickup in inflation, as we expect, is unlikely to support gold
- Further gains in equity returns and bond yields are expected to continue, increasing the opportunity cost of holding gold
- We continue to expect modest long-term USD strength, which would also work against the metal

Geopolitical risk is one factor often cited as a potential source of support for gold. However, recent evidence has been mixed on this count. As illustrated by the chart on the right, gold prices have failed to respond to rising geopolitical risk, particularly over the past year. We would not count on geopolitical risk being sufficient to reverse downward pressure on gold prices.

We remain Overweight oil. Brent oil prices have continued to hold within a relatively tight range, though they have moved closer to the top of this recent range over the past month. Two factors that remain key sources of support for energy are (i) the lack of any significant shift lower in demand growth from China despite softer growth data, and (ii) somewhat lower OPEC production levels. Russia's large share of global oil and gas output also means any escalation of Ukraine-related tensions pose upside risks to oil prices, in our view.

We remain Neutral on industrial metals. A rebound in prices is likely over the short term, in our view. While metals, such as nickel, have already performed strongly, we note market positioning for copper remains very bearish, posing the risk of a rebound. LME (London Metals Exchange) data also shows inventory levels for key metals, including copper, have begun to fall. Together, we believe these factors may trigger a short-lived bounce in industrial metal prices.

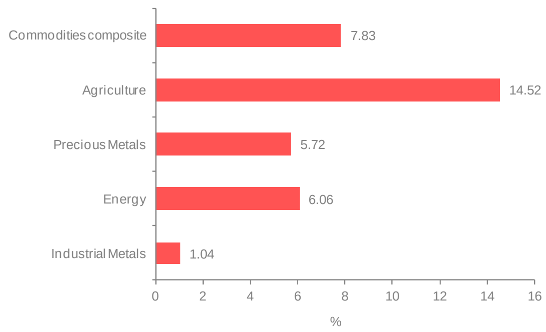
We remain Neutral on agricultural commodities. We remain cautious on the near-term outlook. While prices have begun to turn lower from their recent surge, positioning does remain somewhat extreme for some agricultural commodities (such as corn), suggesting the risk of more price weakness ahead.

Many questions have been raised recently on the risk of an El Nino weather event later this year and the type of risk this poses to agricultural prices. Evidence suggests the price impact can be mixed and is dependent on a number of factors. We believe commodities such as crude palm oil and sugar face the biggest upside risks.

Conclusion

We retain our Neutral stance on commodities. We continue to believe gold prices have room to fall further from here. Industrial metals may rebound in the short term. Evidence of the impact of any El Nino weather phenomenon is mixed.

Performance of commodities YTD* (USD)



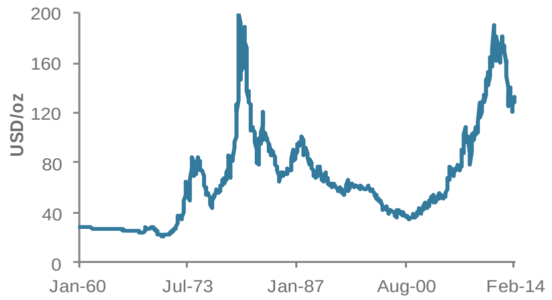
** For the period 31 Dec 2013 to 22 May 2014*

Source: DJUBS, Bloomberg, Standard Chartered

DJUBS, DJUBS Agri, DJUBS Precious metals, DJUBS Energy, DJUBS Industrial metals

Inflation-adjusted gold prices remain elevated

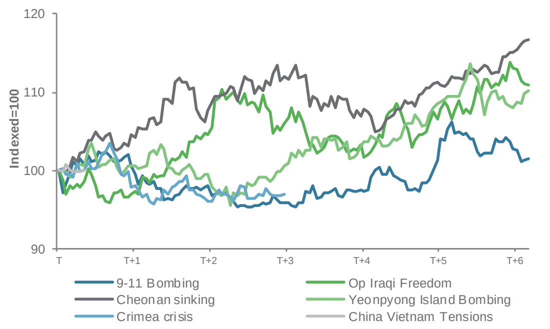
Gold in constant 2013 prices



Source: Bloomberg, Standard Chartered

Gold's role as a geopolitical risk hedge is mixed

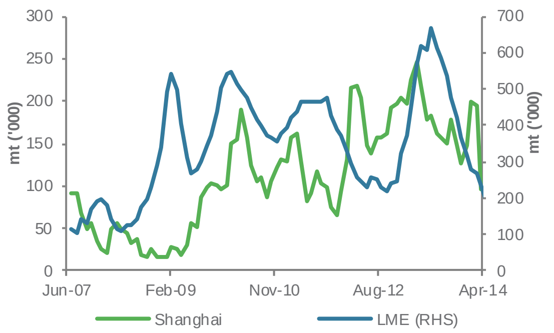
Gold performance around global geo-political events
Time unit in months from event



Source: Bloomberg, Standard Chartered

Copper inventories have finally begun to fall

Copper inventory (LME and Shanghai)



Source: Bloomberg, Standard Chartered

Alternative Strategies – Overweight

- We remain Overweight alternative strategies, based on our view that the asset class offers exposure to our preferred asset classes, despite the potential for lower volatility. We believe the asset class may be especially attractive in an environment where the risk of a pullback in equity markets is rising.
- A diversified approach offers attractive exposure by itself, but a long/short equity long/short offers an alternative way of gaining exposure to equities, our preferred asset class.

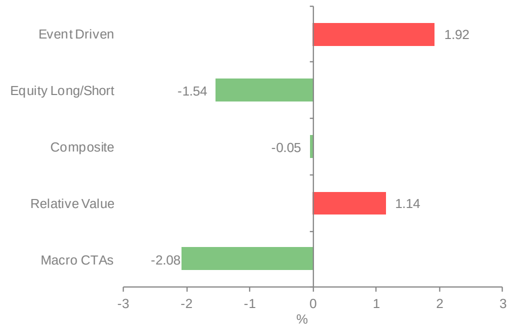
We continue to see equity long/short strategies as attractive for investors who are uncomfortable with accepting the volatility associated with long-only exposure. These strategies can be interesting for investors wanting to raise their equity exposure to benefit from what we view to be an attractive long-term trend, but are uncomfortable with the volatility associated with a long-only position.

Alternative strategies' may be particularly attractive now due to seasonality, correlations and acquisitions activity. While we expect equities to outperform over the next 12 months, we believe two factors stack up in favour of an Overweight position towards alternative strategies. First, stock correlations remain low, suggesting a more positive environment for equity long/short strategies. Second, merger and acquisitions (M&A) activity has begun to rise sharply.

Conclusion

We maintain our Overweight on alternative strategies. We favour diversified exposure and equity long/short strategies to ensure portfolio diversification and lower volatility relative to long-only equities.

Performance of alternative strategies YTD* (USD)



** For the period 31 Dec 2013 to 22 May 2014*

Source: HFRX, Bloomberg, Standard Chartered

HFRX global hedge, HFRX equity hedge, HFRX event driven, HFRX relative value, HFRX macro/CTA

Short term

refers to a horizon of less than 3 months

Medium term

refers to a time horizon of 6 to12 months

Foreign Exchange

USD – We remain medium-term bullish

We remain bullish on the USD. In our view, the US economic recovery is likely to accelerate, particularly in the second half of the year. Economic surprises in the US have again become positive, after disappointing in Q1 amid harsh winter conditions. This will likely increase speculation of an earlier-than-expected rate hike, particularly if core inflation begins to pick up. Since most other central banks are likely to remain in easing territory for some time, the monetary policy divergence is likely to drive USD strength. In this regard, we believe USD has likely bottomed out (see chart) and is poised for a reversal.

EUR – We turn medium-term bearish (from neutral earlier)

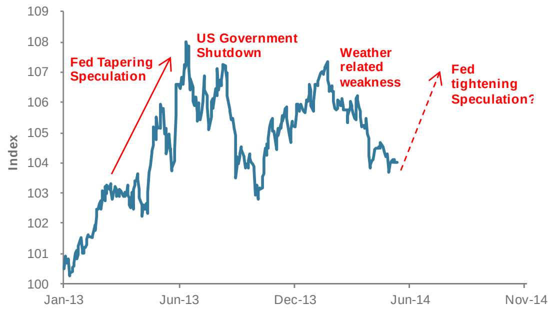
We turn bearish on the EUR, as we believe the currency is poised for a downturn in the medium term. The more explicit language by ECB President Draghi regarding monetary easing at its next meeting suggests interest rates are likely to be cut. As a result, real rates that have strongly supported the currency (see chart) are also likely to decrease. In addition, economic surprises in the EU have disappointed, which may put the currency under pressure in the short term. The pair recently broke key support at 1.37. The main risk to our view is that, in the short term, additional easing might see European assets rally, which may lead to increase in capital flows in the EU.

JPY – We remain bearish medium term

The yen has remained largely range-bound amid demand for safe-haven currencies. Going forward, the impact of the consumption tax hike on the recovery and the BOJ's response will be key. We believe further policy stimulus will be required to sustain inflation expectations, which, in turn, is ultimately likely to trigger further JPY weakness.

USD has likely bottomed near term

*Equally weighted dollar index**

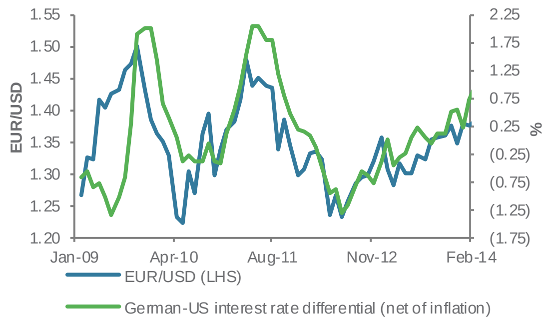


Source: Bloomberg, Standard Chartered

**EUR, JPY, CAD, GBP, CHF, CNH, KRW, BRL, MXN, AUD*

Interest rate differentials may taper off; likely to put pressure on the EUR

German-US 2-year real (inflation-adjusted) interest rate differentials vs. EUR/USD



Source: Bloomberg, Standard Chartered

GBP – We remain medium-term neutral (bearish bias)

We maintain our medium-term neutral stance, but hold a bearish bias. The UK recorded the highest current account deficit (as a percentage of GDP) in 30 years. In addition, economic surprises have become less buoyant and are less likely to continue to push the currency higher. However, so far, positive interest rate differentials (net of inflation) have attracted foreign inflows, supporting the currency. Furthermore, market positioning also remains considerably net long as consensus expectations continue to see BOE's rate hike cycle before the US Federal Reserve's. In our opinion, the UK rate-hike cycle is likely to lag the Fed's. Therefore, the overall environment does not support a continued strengthening of the GBP, in our view.

AUD – We remain medium-term neutral

We expect the AUD to remain range-bound in the medium term. Continued weakness in commodity prices, especially iron ore, and the still weak Chinese data are likely to keep the currency's strength in check. On the other hand, demand for the AUD as a carry trade as well as eventual interest rate hike expectations amid improving economic data will likely halt any significant downside, barring any steep fall in commodity prices.

Asia ex-Japan – We remain medium-term neutral

In Asia ex-Japan, we remain medium-term neutral overall, but favour those with strong external surplus and correlations to accelerating global growth

We remain medium-term bullish on the CNY. In our opinion, the weakness in the CNY over the last few months has reached its end, as the daily reference rate has more or less stabilised. We expect the CNY to appreciate gradually over the next 12 months, albeit with higher volatility.

We expect the USD/SGD pair to remain largely range-bound in the medium term. Recent data shows Singapore's growth momentum remains strong, supported by both external and internal factors. We believe any strength in the SGD will be contained once the market starts to fully price in Fed rate-hike expectations later this year and US treasury yields begin to rise

We remain neutral on the INR, IDR and MYR. We acknowledge that political risk has reduced in India where a majority government in the centre is more likely to push thorough economic reforms. We believe this will draw in foreign capital, but caution that the RBI is unlikely to allow a significant currency appreciation in order to avoid damaging export competitiveness.

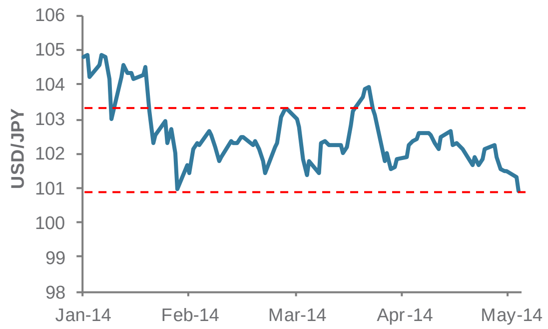
In Indonesia, the political situation is less clear cut, with a hung parliament being the most likely scenario. In both countries, however, fundamentals have continued to show improvement, although inflation has remained stubbornly high. Recent hawkish statements by the Malaysian central bank and the possibility of additional rate hikes have supported the MYR but, as a relatively low-yielding currency and large foreign ownership of local debt, the risk of a sell-off on rising US interest rate expectations cannot be ruled out. We continue to see the THB as the most vulnerable currency in Asia ex-Japan amid heightened political turmoil, sluggish exports and growth scenario

Conclusion

We remain medium-term bullish on the USD and CNY, turn bearish on the EUR from neutral previously and remain bearish on the JPY. We remain neutral on Asia ex-Japan currencies and favour KRW and TWD in this space.

JPY likely to remain range-bound in the short term before the next leg of weakness

USD/JPY chart



Source:, Bloomberg, Standard Chartered

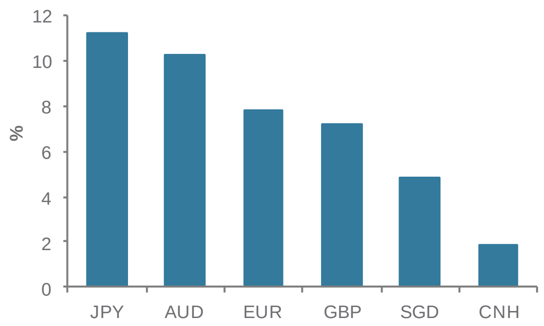
UK-US interest rate differentials (net of inflation) key to GBP outlook

UK-US 2-year real (inflation-adjusted) interest rate differentials vs. GBP/USD

Source: Bloomberg, Standard Chartered

CNH volatility still considerably lower than most major currencies

1-year historical volatility



Source: Bloomberg, Standard Chartered

Disclosure Appendix

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