



OUTLOOK 2014

A YEAR TO BE A.G.I.L.E.



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All performance returns in this document are as of 5 December 2013

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Editorial

| Alexis Calla |

Welcome to our 2014 Outlook.

We see this publication as one of the most important events in the year. A lot of work goes into determining what might be the key themes and investment opportunities over the coming 12 months.

However, to us, **it is not just about how we see the world next year.** It is also an opportunity for us to come back to you and review the suggestions we made, how they fared and how they have impacted your investment holdings.

Reviewing what we say in our publications is a key component of our investment philosophy. Analysing what worked well (and why), and what we missed, provides us with key insights that help us to strengthen our process and to ultimately help you, our valued client, manage your asset allocation in line with your needs in the face of changing opportunities and risks.

Overall, we are pleased with the way our key views captured in B.R.I.D.G.E. have panned out in 2013. Back in December 2012, we believed powerful policy forces would be at work for most of 2013 and that investors' best approach would be to get invested and stay the course. It is said that a picture is worth a thousand words, and we found that the image of a B.R.I.D.G.E. communicated this sentiment.

As we enter 2014, **we believe some of the macro forces will start to change, differentiation within asset classes will become even more important and the journey will become more fluid even if ultimately rewarding.** The image of people hopping from rock to rock to cross a river came to mind. We found the word A.G.I.L.E. a great way to communicate this. As with B.R.I.D.G.E., we also use A.G.I.L.E. as an acronym to help communicate some of our key macro views, as you will discover in this publication.

A great example of this is the outlook for equity markets. **We continue to believe equities will outperform in the near term and, indeed, over the long term.** However, we also

believe there may be larger 'speed bumps' in 2014 than there have been over the past 18 months. These may come, in part, from increased competition from bond yields, although ultimately stronger growth is likely to be positive for equities in a continued low-inflation environment. Indeed, we take comfort from the fact that major turning points in USD bond yields have generally led to a positive equity market environment on a multi-year basis.

Within equities, the biggest debate raging is whether Developed Market (DM) or Emerging Market (EM) equities will outperform. At this stage, we do not see a reason to change our current preference for DM, but this may change at some point in 2014 as reforms come through and the bullish trend in DM matures.

Another hot topic we address is the outlook for the income theme. Income generation was one of our core investment themes in 2012 and 2013, and a multi-income asset allocation has proven to be very successful solution for investors over this period. Some income areas are looking expensive at this stage, and many are wondering what the future may hold. We looked at potential income-generating asset classes, discussed various scenarios and reached the view that a **multi-asset income strategy can still generate a decent yield and deliver positive total returns in 2014.** However, in line with the A.G.I.L.E. theme, we believe the composition of such an allocation could require some adjustments as the year unfolds.

Finally, within fixed income we enter 2014 as we entered 2013: Underweight and bearish investment grade bonds. However, assuming yields rise as we expect, this is something that may also come under review at some point in 2014. Therefore, we believe we are getting closer to the end of our Overweight high yield bond view. Time will tell.

This 2014 outlook explores these, and many other, themes in greater detail. We hope you enjoy reading it and discussing it with your Relationship Manager. **More importantly, we hope you benefit from its views and further progress your goals in the coming months.**

We wish you a happy holiday and a prosperous 2014...



2014 strategy and introducing A.G.I.L.E.

| Steve Brice |

Introducing A.G.I.L.E.

We are following up on the success of the B.R.I.D.G.E. investment framework with our **A.G.I.L.E.** macro framework.

We believe A.G.I.L.E. captures the mindset that investors will need when making investment decisions in 2014. Over the past two years, investors who were Overweight equities and, within fixed income, high yield bonds, have seen their asset allocations perform relatively well. In 2014, we expect more speed bumps for both asset classes. However, if managed with some agility, it should prove another positive year for investors.

A	A dvanced economies key to global recovery
G	G rowth and earnings key to equity returns
I	I ncome to remain in high demand
L	L iquidity to remain ample, despite Fed tapering
E	E merging economies embarking on reform

A. Advanced economies key to global recovery.

Developed Markets (DM) need to deliver stronger growth in 2014 in order for the global economy to accelerate. This is especially important as the Emerging world has to balance the need to deliver an acceptable growth rate while slowing the pace of credit creation and undertaking structural reforms.

G. Growth and earnings key to equity returns. Equity market performance over the past two years has largely been driven by the re-rating of Developed equity markets (increasing valuations) and the de-rating of Emerging equity markets. With Developed equity markets approaching fair value, the market will likely become more reliant on earnings growth to support returns in the coming 12-18 months.

I. Income to remain in high demand. Given the continued low interest rate environment, we expect investors to remain attracted to assets that generate an income. Traditionally, investors have relied largely on fixed income assets to fulfil this requirement. However, given the much lower yields currently on offer, we continue to suggest a more diversified approach is now required to generate sufficient income for most investors, with a significant Overweight to high dividend-yielding equities. This is another supportive factor for equity markets in 2014.

L. Liquidity to remain ample, despite Fed tapering.

The market's focus is clearly on if, when, and by how much, the Federal Reserve will start reducing the size of liquidity injections. However, it is important to note that inflation is likely to remain benign across the Developed world, which should encourage central banks to remain focused on supporting growth. Meanwhile, even when 'tapering' starts, the Fed will still be injecting liquidity into the economy, just at a slower pace. This loose monetary policy stance will likely be reinforced by the use of 'forward guidance' to moderate interest rate expectations. At the same time, we expect Japan to accelerate liquidity injections in Q2 2014. Also, there is a risk the European Central Bank (ECB) will ease monetary policy further if inflation falls early in the year, as we expect. Therefore, we expect global liquidity to remain ample and cheap.

E. Emerging economies embarking on long-term reform.

We expect reform in Emerging Markets to accelerate on a multi-year basis. This is most clearly the case in China following the Third Plenum, where the authorities signalled a need to increase private sector participation and the use of market signals to allocate capital more effectively. However, many other Emerging countries, such as Brazil, India and Ukraine, are facing pressures to accelerate reform in order to reinvigorate growth.

We hope our new A.G.I.L.E. framework will help our clients navigate 2014 as successfully as our B.R.I.D.G.E. framework did in 2013 (see the next page for the performance of our key 2013 investment themes).

Key investment themes as we head into 2014

Global Equities	<ul style="list-style-type: none"> A global diversified equity allocation
Diversified Income*	<ul style="list-style-type: none"> High dividend equities (50%) Fixed Income (40%) Non-core income (10%)
Underweight Bonds	<ul style="list-style-type: none"> Underweight G3 investment grade bonds

Source: Standard Chartered Bank
*Please see pages 28-32 for more details

2013 in review – Retiring B.R.I.D.G.E.

| Steve Brice |

2013 review – Performance of key themes

Economy

At the beginning of the year, we argued 2013 was likely to be a year of 'Transition to Stronger Growth'. We believe this was indeed the case.

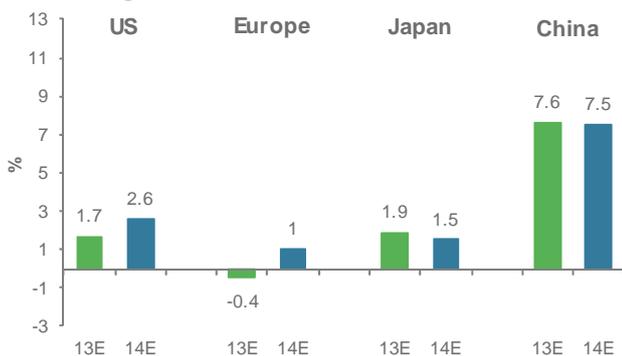
- The **US** economy has already weathered significant fiscal tightening, which is estimated to have shaved around 0.7% off 2013 economic growth.
- **Europe** has emerged from recession, supported by loose monetary and less tight fiscal policy settings.
- **Japan** has experienced a strong recovery on the back of a new policy framework.
- The main area of disappointment has emanated from **China**, which failed to build on the strong momentum the economy had built in Q4 2012 and slowed slightly.

The second macro theme was 'Receding Tail Risks'. The main risks highlighted in the 2013 Outlook publication were 1) the US economy going into recession as the fiscal cliff came to pass, 2) a Euro area break-up, 3) a hard landing in China and 4) a rise in geo-political tensions.

Apart from the final risk, all of these receded in 2013. Geo-political tensions eased in the Middle East, but rose in the East China Sea.

Figure 1: Economic environment generally disappointed in 2013, but looks brighter for 2014

Consensus growth forecasts for 2013 and 2014



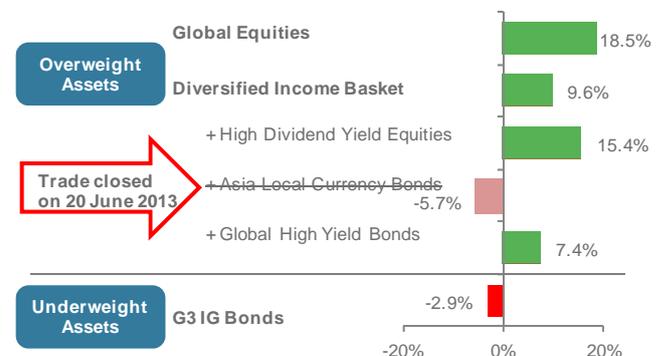
Source: Bloomberg, Standard Chartered Bank

2013 B.R.I.D.G.E. investment theme performance

Our key three investment calls from the B.R.I.D.G.E. investment framework – a strong preference for global equities, a diversified income basket and an expectation that G3 investment grade bonds would deliver negative returns – have been proven right (see 2013 Outlook: A Year of Transition – From V.I.P. to B.R.I.D.G.E., December 2012).

- **Global equities** – Posted another very strong performance in 2013, up 18.5% year-to-date.
- **Diversified income basket** – We highlighted three areas within this theme (high dividend-yielding equities, Asian local currency bonds and global high yield bonds). Assuming an equal investment in all three on 1 January 2013, the return would have been 8.8%. If investors had rebalanced their income asset allocation away from Asian local currency bonds when we closed this theme in June 2013, then the performance would have been modestly enhanced to 9.6%.
- **Underweight G3 investment grade bonds** – These have not only under-performed other bond sub-asset classes, but also generated negative returns (-2.9%).

Figure 2: Key 2013 themes have worked well thus far
Performance of three key themes from the 2013 Outlook*



Source: Citigroup, MSCI, Barclays, Bloomberg, Standard Chartered Bank

* Income basket is equally weighted performance of global high dividend yielding equities (MSCI ACWI High Dividend Yield USD), Global HY bonds (BarCap Global HY TR USD) and Asian local currency bonds (BarCap Asia Local Net TR USD, until 20 June); other indices include MSCI AC World TR and Citi WBIG USD

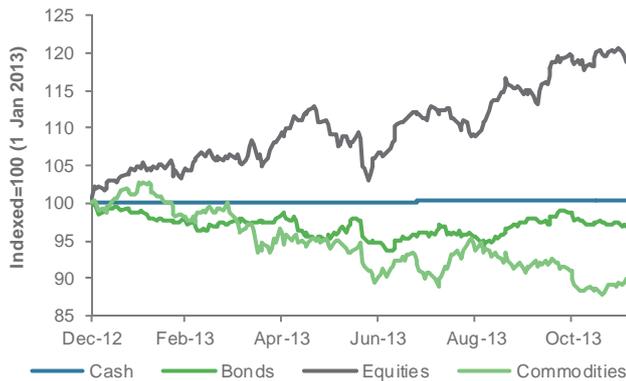
2013 in review – Retiring B.R.I.D.G.E. (cont'd)

Performance of asset class views

The above were our key themes for 2013. Outside of these, we started the year with an Overweight to global equities and an Underweight to global fixed income. These helped us significantly out-perform our benchmark.

Figure 3: Global equities performed well, while bonds and commodities faltered

Level 1 asset class performance



Source: JPMorgan, MSCI, DJ-UBS, Bloomberg, Standard Chartered Bank
Indices are JPMorgan 3m Cash, Citigroup WBIG Sovereigns, MSCI AC World TR, DJUBS Commodity

Within bonds – We were Overweight DM HY and Underweight DM investment grade (IG) bonds, views we held through the year. This worked well, with DM HY posting positive returns of 6.3% and DM IG posting losses of -1.9%.

Figure 4: High yield bonds outperformed investment grade bonds

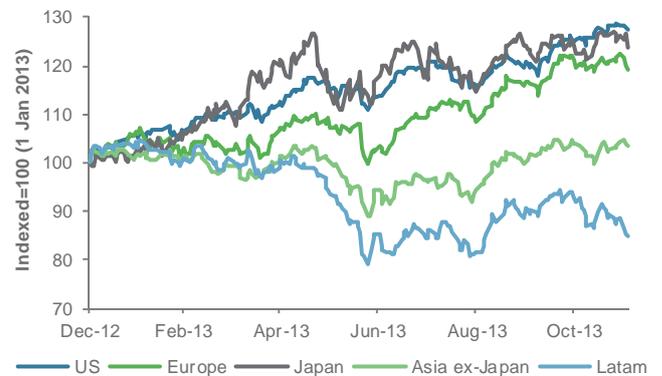
Level 2 (bonds) performance



Source: Citigroup, Barclays Capital, JPMorgan, Bloomberg, Standard Chartered Bank
Indices are Citigroup WBIG USD, Barclays Global HY TR unh USD, JPMorgan EMBI Global IG, JPMorgan EMBI Global HY

Within equities – While our key call of being Overweight global equities convincingly proved to be the right stance, within equities our report card is more mixed. Our Overweight US position (maintained through the year) clearly helped us, while our Overweight Asia ex-Japan (cut to Underweight in June) and Underweight Japan (moved to Neutral in April) hurt us, at least early in the year.

Figure 5: DM equities outperformed EM equities
Level 2 (equities) performance (USD)

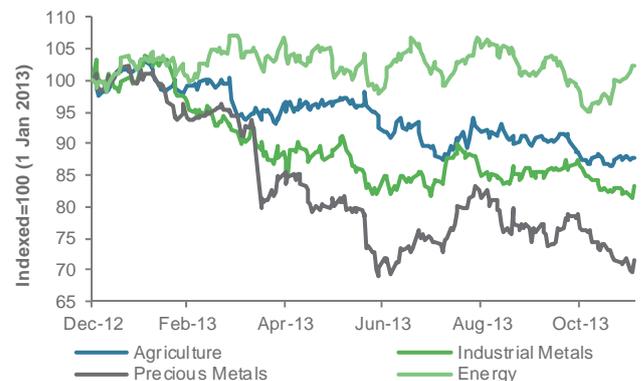


Source: MSCI, Bloomberg, Standard Chartered Bank
Indices are MSCI US TR, MSCI Europe TR USD, MSCI Japan TR USD, MSCI Asia ex-Japan TR, MSCI Latam TR

Commodities performed poorly in 2013. Coming into the year, we highlighted near-term headwinds, but we expected stronger growth to ultimately support Commodities in H2 2013. However, we were disappointed with the pace of China's growth and went Underweight Commodities in June, before going Neutral in late November. Within commodities, we started the year Neutral across the board, but revised our **gold** allocation to Underweight in February, before the heavy sell-off began.

Figure 6: We went Underweight gold just prior to the major sell-off

Level 2 (commodities) performance



Source: DJ-UBS, Bloomberg, Standard Chartered Bank
Indices are DJUBS Agriculture, DJUBS Industrial Metals, DJUBS Precious Metals, DJUBS Energy

Conclusion: Overall, the key themes and asset classes highlighted in our 2013 Outlook publication have generally performed well. Below this, some themes we highlighted performed better than others, but we believe we got the big calls right. However, we see 2014 as a new stage of the recovery process. This will bring some challenges, but also many opportunities. In 2014, we believe investors may have to be more **A.G.I.L.E.** in order to navigate the investment environment in 2014.

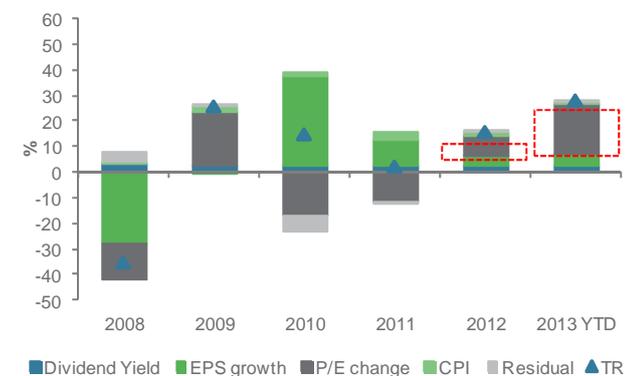
Macro overview – A time to deliver DM growth, EM reform

| Steve Brice |

Why Macro matters

Developed market (DM) equities managed to rally strongly in 2013 (up 21.8%). This was driven largely by a re-rating of stocks rather than increased earnings and dividend yields. Naturally, this cannot go on forever, and we believe 2014 is the 'Time to Deliver' on both growth and earnings. Otherwise, we may see equities falter at some point in 2014.

Figure 7: Why Macro matters – Equity performance so far driven by re-rating, not earnings growth
S&P 500 decomposition of historical performance



Source: Bloomberg, Standard Chartered Bank

'Time to Deliver'

If 2013 was a 'Year of Transition' towards stronger growth, we see 2014 as a time for DM economies to finally deliver stronger growth. Emerging markets (EM) will need to manage the balancing act of delivering reasonable growth while curtailing the pace of credit expansion and pursuing economic reforms.

Neither objective is without challenges. In **the US**, a shift away from the super-easy monetary policy is likely in 2014. In **Europe**, banks' Asset Quality Review and stress tests will be key to the longer-term sustainability of the recovery. **Japan's** recovery faces its biggest hurdle yet in the form of the consumption tax hike. Finally, the **Emerging** world may face headwinds as the Fed tapers.

However, despite these challenges, we expect DM to see a material acceleration in growth in 2014. Monetary policy is expected to remain very accommodative, potentially easing further in some markets such as Japan and possibly Europe. Meanwhile, in the US and Europe, fiscal austerity is expected to ease somewhat in 2014.

A DM economic recovery should make EM's balancing act significantly easier.

The more export-driven markets of Korea and Taiwan should benefit directly from this. However, we doubt we will see a significant acceleration in EM growth in 2014 overall.

China is likely to use the export rebound as an opportunity to constrain domestic loan growth. Additionally, while tapering defences have been built up, countries with current account deficits, such as India, Indonesia and Brazil, remain vulnerable to currency weakness and, as a result, are likely to tighten monetary policy.

Scenarios

- Recession risk down to 5%, from 20% in Dec 2012
- Transition to stronger growth up to 55%, from 40%

We have four main Macro scenarios for 2014. These are similar to our 2013 scenarios, but the probabilities have shifted significantly with the risk of a global recession dropping (to 5% from 20%) and the probability of a transition to stronger growth increasing (to 55% from 40%). The main change in our thinking has been with regard to the outlook for China. Here, we believe the authorities are very focused on reforming the economy. While the external outlook should support China's growth, we believe the authorities will use this opportunity to tighten domestic credit creation in order to ensure a more efficient allocation of capital going forward. Therefore, we doubt growth will re-accelerate above 8%.

Strong growth: 15% probability (vs. 15% probability in December 2012)

Under this scenario, US consumer and capital spending picks up, the latter significantly. Europe accelerates, helped by buoyant bank lending and domestic demand. Japan's economy recovers quickly from the consumption tax hike and net exports boost growth in Asia. China thus allows the export recovery to push growth back above the 8% level.

Transition to stronger growth: 55% probability (vs. 40%)

Global growth accelerates, largely led by the US. Europe's recovery continues, but bank lending remains constrained. Asia continues to muddle through as policy tightens modestly. In China, this is led by the desire to control credit growth. In Indonesia and India, this is a response to currency weakness as Fed tapering concerns rise.

Muddle through: 25% probability (vs. 25%)

Growth continues, but investors and business leaders remain concerned about the possibility of dipping back into recession/crisis. In this environment, we would likely see continued policy responses to stabilise periodic market volatility and drops in confidence.

Global recession: 5% probability (vs. 20%)

High debt levels in both DM and EM mean that this risk cannot be ruled out. There is also the risk that central banks fail to successfully exit super-loose monetary policies.

Macro overview – A time to deliver DM growth, EM reform (cont'd)

Growth

- US economy expected to accelerate
- Europe’s economic expansion to continue
- Japan’s weathering of the consumption tax hike will be key
- EM expected to muddle through economically

We expect global growth to accelerate in 2014, led by DM. The key to this outlook remains the performance of the US economy.

Figure 8: DM growth expected to accelerate, inflation to remain benign

US and Europe growth and inflation consensus forecasts

	GDP y/y		CPI y/y	
	US	Europe	US	Europe
2012	2.8	-0.7	2.1	2.5
2013E	1.7	-0.4	1.5	1.4
2014E	2.6	1	1.9	1.3
2015E	3	1.4	2.1	1.5

Source: Bloomberg, Standard Chartered Bank

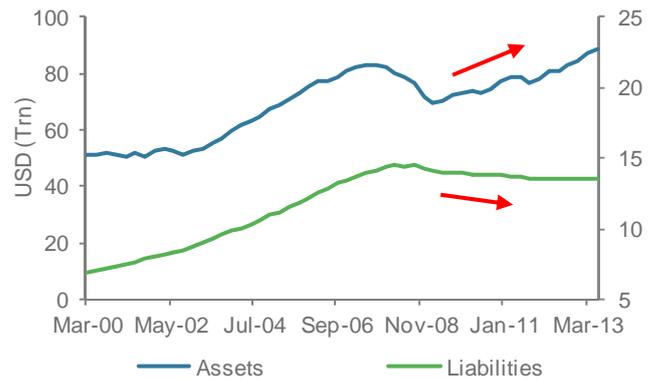
The underlying US economy is robust. We see three key positives when looking at the 2014 outlook – fiscal policy, business investment and consumer spending.

- 1) Reduced fiscal tightening and policy uncertainty expected to support the economy.** 2013 saw a significantly larger-than-expected fiscal contraction due to the January payroll tax hikes, the spending sequester and the temporary government shutdown in October. This probably shaved around 0.7% off GDP in 2013. We doubt this will be replicated in 2014, and should provide a significant lift to growth.
- 2) There is scope for US business investment to accelerate significantly.** Business investment is likely to pick up, given the ageing capital stock, strengthening business confidence and stronger new orders. Greater certainty surrounding the government’s medium-term spending and taxation policies would also be a huge positive for business investment.
- 3) US consumer spending remains supported.** Consumer spending remains critical to the US economy, as it accounts for around 70% of GDP. Labour market conditions appear to be improving, with net job creation having accelerated modestly in 2013. This has recently been accompanied by a modest acceleration in wage growth. Meanwhile, gains in house prices continue to accelerate which, together with rising equity prices, have imparted a significant and positive wealth effect at

the same time that the debt servicing burden has fallen. We expect house and equity prices to rise further in 2014, and this should support consumer spending.

Figure 9: Wealth effect should support consumer spending

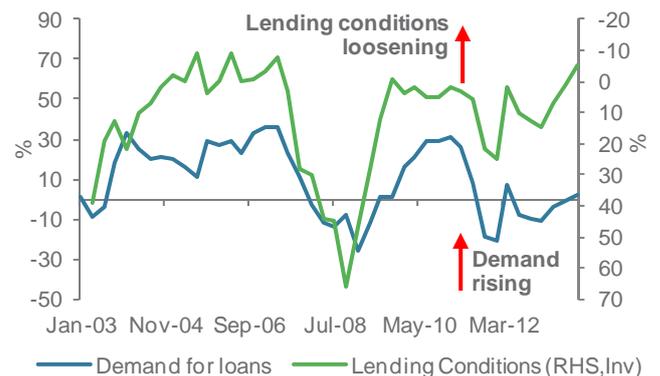
US household and non-profit organisation, gross assets and liabilities



Source: Bloomberg, Standard Chartered Bank

There are already signs of recovery in Europe. Last year, the most contentious call was that not only would the Euro area remain intact, but it would also experience an economic recovery. Indeed, there are still many concerns the economy will return to recession in 2014. We doubt this will happen for three reasons.

Figure 10: European bank lending continues to fall, but outlook is picking up. Regulatory bank sector tests key ECB lending survey, expected change in demand for loans and net lending to businesses (enterprises)



Source: ECB, Bloomberg, Standard Chartered Bank

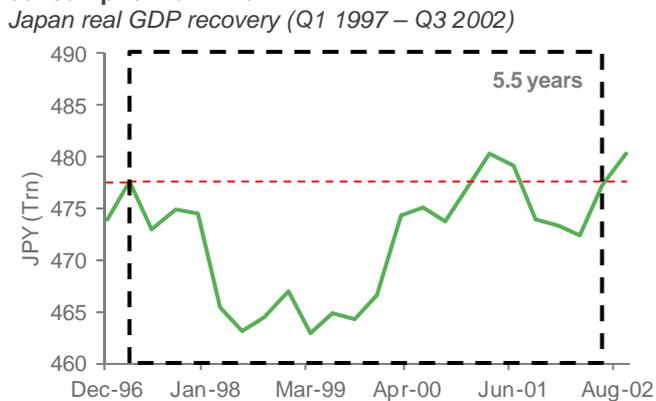
- 1) Europe capital spending likely to recover.** While sovereign borrowing costs have been falling significantly across the peripheral countries over the past 12-18 months, business borrowing costs have started falling only recently. This is further evidence of the loosening of lending conditions for companies, which are starting to increase their demand for funding. The banking sector’s regulatory stress tests and their impact on banks’ willingness to lend will also be key.

Macro overview – A time to deliver DM growth, EM reform (cont'd)

- 2) **Fiscal contraction is likely to diminish.** Much of the fiscal adjustment required has already been achieved and a return to growth could be self-reinforcing as tax receipts increase. This, together with increased competitiveness following painful economic restructuring, is likely to allow the peripheral economies to continue recovering in the coming months.
- 3) **The recovery in the US should help support EU exports.** This is clearly a positive for the Euro area as a whole, although the more subdued recovery in Asia will likely limit the extent to which this will support the economy in 2014.

In Japan, the new economic policy framework introduced by Prime Minister Shinzo Abe (and often referred to as ‘Abenomics’) faces its first major test. Japan has been the only major economy to surprise on the upside in 2013. At the beginning of the year, the consensus expectation for 2013 GDP growth was 0.65%. At the time of writing, it had increased to 1.9%. Expectations for 2014 growth have also risen to 1.55% from 1% over the same time period. This is clearly very encouraging.

Figure 11: Japan took 5.5 years to recover from the 1997 consumption tax hike



Source: Bloomberg, Standard Chartered Bank

However, 2014 offers a significant test in the form of the consumption tax being hiked to 8% in April, from 5% currently. The last time Japan hiked the consumption tax – to 5% from 3% in April 1997 – the economy went into recession (see Figure 11) and only sustainably surpassed the Q1 1997 GDP level (in inflation-adjusted terms) 5.5 years later. Both the government and the central bank are cognisant of this precedent. The government has put together a supplementary budget to try to smoothen the impact of the tax hike and the Bank of Japan (BoJ) has promised to act ‘appropriately’ should the economy weaken. However, it will clearly be a key test for the success or otherwise of ‘Abenomics’. Also important, but less pressing,

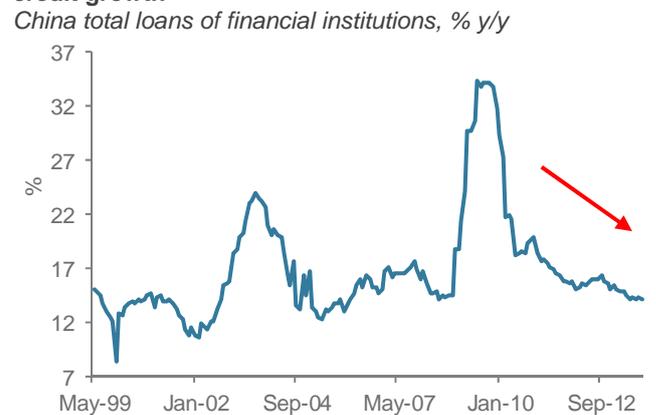
will be the government’s ability to push through the third arrow of ‘Abenomics’ – namely structural reform.

EM/Asia likely to be supported by DM recovery. We break EM/Asia into three groups – export-oriented economies, China and the larger, more domestically focused economies, often with significant current account deficits.

Export-oriented countries (Singapore, Taiwan and Korea) naturally have the most to gain from acceleration in DM, especially if business investment accelerates significantly. Meanwhile, they are likely to be less affected by Fed tapering given their current account surpluses and lower reliance on foreign capital flows.

China is also expected to benefit from the DM recovery and be relatively protected from the impact of Fed tapering. However, the authorities are clearly concerned about the rapid rise in credit in the economy and are looking to shift the economy from debt-financed investment towards more sustainable consumer spending-driven growth. Therefore, we expect the authorities to use any opportunity provided by the pick-up in export growth to further tighten domestic monetary policy, thereby constraining domestic activity. We expect a growth target of 7.0-7.5% for 2014.

Figure 12: China likely to increase focus on controlling credit growth



Source: Bloomberg, Standard Chartered Bank

On the reform front, the government appears very keen to give the private sector a greater role in the economy and increasingly use market dynamics to help allocate resources to their most productive areas. We are still awaiting more details on how these policies will be implemented and over what time horizon. We expect a gradual process in order to control any unintended consequences of such reforms.

In the **more domestically-focused, current account deficit countries** (such as India, Indonesia, Brazil, Turkey and South Africa), the tightening of monetary policy is likely to be more reactive than proactive in nature. As Fed

Macro overview – A time to deliver DM growth, EM reform (cont'd)

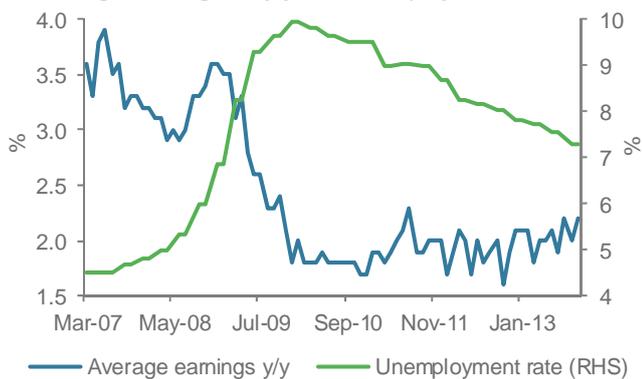
tapering risks increase once again, we expect their currencies to be more susceptible to weakness, given their reliance on foreign portfolio inflows. This may require further interest rate hikes. Some countries, such as Indonesia and Brazil, have already hiked policy rates significantly while others, most notably Turkey, have been reluctant to do so. This policy tightening is likely to limit any acceleration in EM economic growth.

Inflation

- Still large output gaps suggest US and Europe inflation to remain benign
- European inflation expected to flirt with deflation before rising later in the year
- Asia inflation to rise only gradually

We expect inflation to remain low, particularly in DM. Output gaps – the difference between potential and actual economic activity – remain wide, which suggests demand-driven price pressures are unlikely. This is reinforced by the still-high unemployment rates seen in the US and Europe. We have started to see US wage growth accelerate very modestly, but at 2.2% it is well below levels that would be concerning from an inflation perspective. Indeed, inflation has been falling in recent times, a trend that needs to be watched if growth does not accelerate.

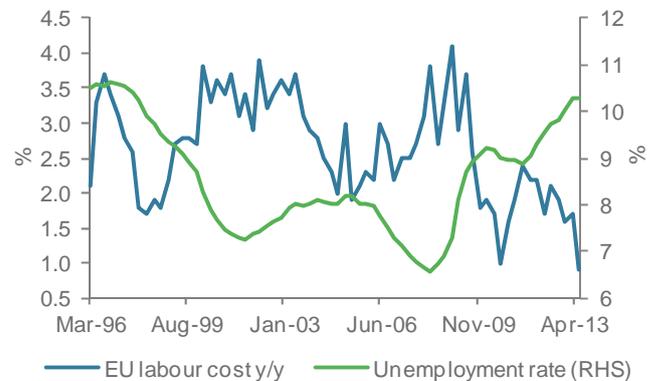
Figure 13: Still-high unemployment means US inflationary pressures are likely to remain muted
US average earnings, % y/y and unemployment rate



Source: Bloomberg, Standard Chartered Bank

In the Euro area, unit labour costs have fallen markedly in many peripheral countries as they embark on structural reforms. This should help to keep any pressure on inflation muted. If anything, the risk is for further declines in the near term, and we expect inflation to fall temporarily to around 0.5% for 2-3 months before rising gradually. While a move into actual deflation appears unlikely, it cannot be ruled out and is something the central bank is likely to remain alert to.

Figure 14: Disinflationary pressures still present in Europe
Euro area nominal labour cost, % y/y and unemployment rate



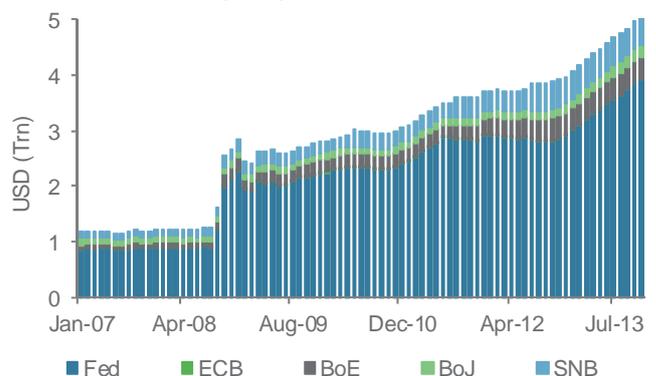
Source: Bloomberg, Standard Chartered Bank

In Asia, we expect a modest increase across the region as a whole. To some extent, this will be due to a modest pick-up in global growth. However, other countries may see increased pressure on their currencies due to Fed tapering and this will likely reinforce the upside bias to inflation.

Monetary policy

- Monetary policy to remain loose, despite Fed tapering
- Monetary easing bias in Europe and Japan remains intact for now
- Emerging world's monetary tightening bias remains

Figure 15: Central banks continue to add huge amounts of stimulus to the global economy
Central bank assets (USD)



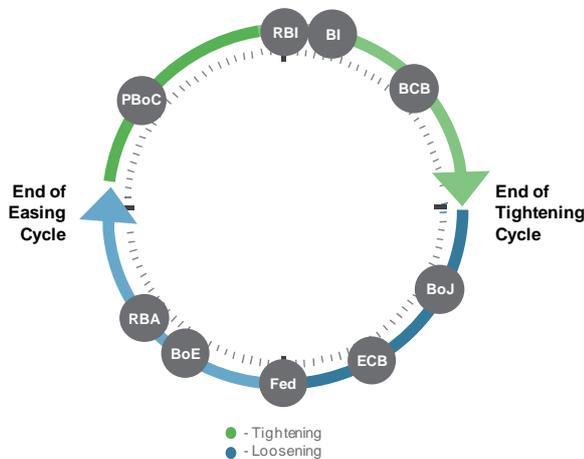
Source: Bloomberg, Standard Chartered Bank
Fed-US, ECB-Euro area, BoE-UK, BoJ-Japan, SNB-Switzerland

In the US, the focus is on when and if the Fed will ‘taper’ quantitative easing (QE), and by how much. We believe there are three factors supportive of tapering beginning in the first half of the year, most likely in Q1 2014.

Macro overview – A time to deliver DM growth, EM reform (cont'd)

- Economic data is strengthening.
- While the appointment of Janet Yellen as Fed chairperson is expected to keep a dove in charge of the Fed, the rotation of Fed voters is widely viewed as implying the Fed will be more hawkish in 2014 than has been the case in the past two years.
- Fed members appear to be more concerned about the scale of asset holdings and the potential risks this could hold for the economy, as well as inflation, further down the road.

Figure 16: Monetary policy clock
Easing/tightening bias of global central banks



Source: Standard Chartered Bank
RBA-Australia, BCB-Brazil, PBoC-China, ECB-Euro area, RBI-India, BI-Indonesia, BoJ-Japan, BoE-UK, Fed-US

Watch the labour/housing markets, inflation, as well as Congress. The Fed continues to stress any decision to taper QE will be data-dependent, with a focus on the labour market. However, the housing market is also important, in our view. When Federal Reserve chairman Ben Bernanke mentioned the possibility of tapering QE in May, the housing market recovery largely stalled. The Fed will likely want to see firm signs that the housing market is strengthening again before pushing through with tapering.

Inflation is also something to watch. Historically, inflation expectations, which have been range-bound in recent times, have been a useful indicator in predicting potential monetary policy shifts. If the recent decline in realised inflation was to bring medium-term inflation expectations significantly lower, then this may dissuade the Fed from tapering.

The final factor that would give the Fed greater comfort is a long-term fiscal deal that balances the short-term and long-term requirements of the economy.

We expect tapering to be coupled with intensified 'forward guidance'. This would most likely involve a reduction in the unemployment rate before a rate hike is

considered. The aim here is to reduce the impact of tapering on interest-rate expectations and the economy.

Figure 17: Inflation expectations also important
US CPI y/y and 5y forward breakeven



Source: Bloomberg, Standard Chartered Bank

In Europe, the bias to ease remains. The European Central Bank (ECB) has been very clear in its desire to support the economic recovery and avoid a deflationary outcome. However, the second rate cut in 2013 was far from unanimous within the ECB. Therefore, the key risk comes from what would happen should inflation fall further and threaten a move into negative territory. Will it really cut the interest rate on bank cash balances with the ECB into negative territory? Or would it decide to undertake some form of central bank balance sheet expansion, reversing the contraction seen throughout 2013?

What appears fairly clear is tightening policy appears off the agenda in 2014. Our central scenario for the economy and inflation data will mean the ECB will not have to ease further, but that it remains willing to do so if needed. Speculation of easing is likely to escalate in the first half of the year.

Figure 18: Different policy stances clear
Bloomberg financial conditions' indices



Source: Bloomberg, Standard Chartered Bank

In the Emerging world, we expect monetary policy to retain a tightening bias in 2014. For China, this is expected to be a deliberate policy aimed at purging excess credit creation. For countries with significant current account deficits, it is possible we see currency weakness similar to

Macro overview – A time to deliver DM growth, EM reform (cont'd)

that seen from May-August after Bernanke mentioned QE may be tapered later in the year. If we were to see such an outcome, then central banks are likely to take measures to mitigate the inflationary pressures this may create.

Figure 19: Countries with large current account deficits more susceptible to policy tightening amidst tapering
Current account balances, IMF 2014 forecast



Source: IMF, Standard Chartered Bank

Risks

As always, there are several risks to our outlook.

Upside

- **US Congress acts.** The key upside risk to the outlook is that the US Congress puts in place a long-term fiscal plan. On paper, this should not be too difficult to achieve because much of the fiscal tightening required to put medium-term government finances on a sustainable path has already been implemented and the incentive for politicians to avoid a repeat of the debt ceiling debacle appears clear. However, we are used to being disappointed on this front.

Downside

- **The Fed mis-steps.** 2014 looks to be the year the Fed embarks on a multi-year normalisation of policy. This process holds risks if the Fed moves too quickly. However, if it moves too slowly, the risk of inflation accelerating significantly increases.
- **European politics.** Parties opposed to the single currency have risen in stature in the core countries. Meanwhile, as peripheral countries improve their finances, the imperative for them to stay in the single currency diminishes. For now, the ECB's promise to 'do whatever it takes' to keep the Euro area intact has been sufficient to limit any volatility. If this were to change, it would significantly undermine the growth outlook.
- **Japan's consumption tax hike.** The consumption tax hike could push Japan back into recession as it did in 1997. Both the government and the central bank are prepared to counter any negative consequences, but markets may be nervous going into Q2 2014.

- **China's hard landing.** We are one of the more cautious investment houses on Chinese GDP growth. However, should the economy weaken markedly, we would expect the authorities to ease both fiscal and monetary policy as required to avoid a hard landing.
- **Geopolitical tensions escalate.** Iran looks likely to be gradually reintegrated into the world's trading system. While this eradicates some tensions, it increases others, as responses from Israel and Saudi Arabia have highlighted. Meanwhile, the situation in Iraq continues to deteriorate, with violence escalating once again.

The more immediate concern is rising tensions in **Asia**, specifically between China and Japan. Direct conflict looks unlikely, but there are few signs of compromise. Any closure of the Asian sea lanes would have catastrophic implications for the global economy, given the reliance of supply chains on this region.

Conclusion

We view 2014 as the 'Time to Deliver'. The US needs to deliver stronger growth against the backdrop of a reduced fiscal headwind, but higher long-term bond yields.

Europe needs to deliver more sustainable growth. The regulatory bank examinations and the ECB's response to near-term deflationary pressures are key to confidence.

Japan needs to continue growing in the face of the consumption tax hike. An ability to do this would hugely increase confidence in 'Abenomics'. Meanwhile, **China** needs to manage the credit cycle, probably by tightening domestic credit as exports accelerate. Therefore, growth is likely to remain relatively subdued in 2014.

On balance, we expect the global economy to exit 2014 in better shape than it started. However, we doubt this will be a linear improvement with the risk of significant 'bumps' along the way.

That we are right is getting more and more important for our favoured asset class – equities – to continue outperforming in 2014 as IG bonds become increasingly competitive. The coming pages focus on the outlook for individual asset classes. However, we feel less and less comfortable with projecting drivers and trends over the coming 12 months. Therefore, we believe investors will need to be more A.G.I.L.E. in determining their tactical allocations.

Fixed Income – Prepare to be A.G.I.L.E.

Manpreet Gill |

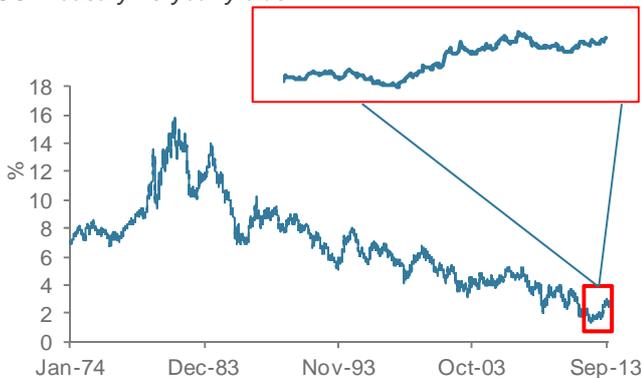
Key themes

- **Stay Underweight Fixed Income.** Overweight Developed Markets HY, Neutral Emerging Markets HY, Underweight Developed Markets IG and Emerging Markets IG.
- **Maintain Developed Market HY Overweight entering 2014.** Rising yields likely to make IG increasingly attractive later in the year. Prepare to be A.G.I.L.E.
- **Take a barbell approach** to the US yield curve. Keep bond maturity profiles generally short. Spread between 30-year and 10-year bonds likely to narrow.
- **Favour Developed Markets over Emerging Markets** across both IG and HY bonds.

Key views – Asset allocation

Higher yields, steeper yield curves, tighter credit spreads characterised USD bond markets in 2013. 10-year Treasury yields rose by over 100bps, with the bulk of the rise concentrated in the May-September period when it became more apparent the Fed was considering slowing the pace of its monetary stimulus. The yield curve (10-year and below) steepened over the same period. Unsurprisingly, both government bonds and global investment grade (IG) corporate bonds have lost money year-to-date. Global high yield (HY), however, outperformed and returned a respectable mid-single-digit total return as spread tightening and a low sensitivity to rising yields helped cushion some of the impact.

Figure 20: 30-year Treasury bull market likely over US Treasury 10-year yields

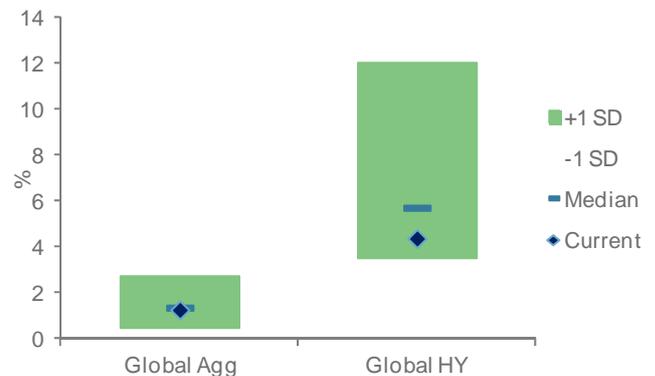


Source: Bloomberg, Standard Chartered Bank

First half of 2014 likely to see more of the same. Stay Underweight Fixed Income. In our view, fixed income still doesn't offer value, despite the rise in yields so far. Real (i.e.

inflation-adjusted) yields are barely above zero in the US and Europe. HY credit spreads remain significantly tighter than historical averages. It is possible to make a case that this can extend for some more time, but it is much harder to argue for the presence of value. At current yields, for example, the total return on IG bonds is still likely to be negative if 10-year Treasury yields rise to 3.50-3.75%, as we expect. The asset class may still offer some opportunities for income-oriented investors (see our discussion on pages 28-32), but further under-performance relative to equities, commodities and alternative strategies looks likely at this time.

Figure 21: HY expensive relative to history, but IG is not
Credit spreads relative to history

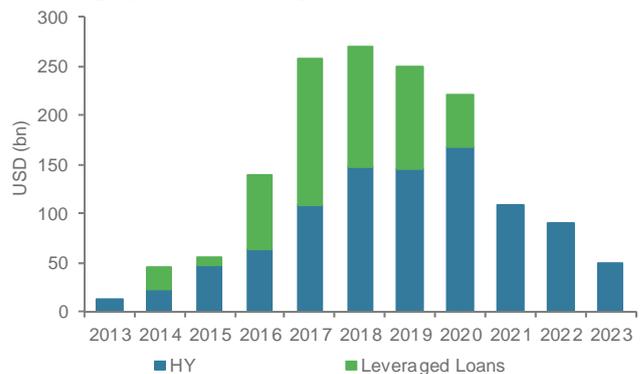


Source: Barclays Capital, Bloomberg, Standard Chartered Bank

Developed Market (DM) HY bonds may become even more expensive in the early part of 2014. US HY has returned almost 28% since we went Overweight in September 2011. Loosening lending standards in the US and increasingly loose standards in Europe will remain the key source of support for HY in early 2014, in our view.

Figure 22: HY repayments begin to tick higher in 2014 before rising significantly in 2016

Global high yield and leveraged loan expected repayments



Source: IMF, Standard Chartered Bank

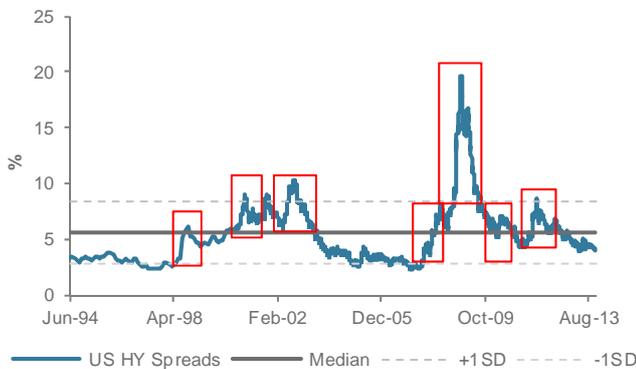
Fixed Income – Prepare to be A.G.I.L.E. (cont'd)

However, other factors that have been a significant source of support for HY over the past few years are clearly waning. Spreads have tightened well beyond the historical average, raising valuation concerns. The prospect of rising yields would reduce the yield attractiveness of the asset class, eating into total returns. Finally, bond repayments begin to rise significantly from 2016 onwards, an event that has historically tended to correlate with a rise in default rates.

We believe DM HY has some further room to deliver in the early part of 2014. Beyond that, however, we are cautious the trade may become increasingly akin to picking up coins in front of the proverbial steamroller – providing a dangerously comforting stream of carry until the point one is run over.

Figure 23 below illustrates this point – in the past two cycles, spreads have tended to be fairly stable right through to the end of the cycle, after which they widened dramatically over a very short period of time. As an investor, the best approach would likely have been to reduce exposure well ahead of the end of the cycle rather than trying to time the precise bottom.

Figure 23: Historically, credit spread-widening has been sudden and sharp
US High Yield spreads



Source: Barclays Capital, Bloomberg, Standard Chartered Bank

Factors that may potentially cause us to become more cautious on global HY as we move through the year include the following:

- Worsening trends in credit quality (e.g. downgrades vs. upgrades)
- Magnitude of upcoming repayments
- Signs of lending conditions tightening
- Spreads approaching 2007 lows
- A rise in yields that would change the relative attractiveness of IG vs. HY

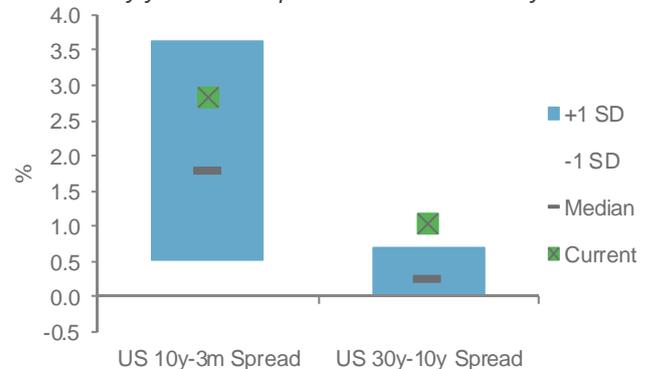
A rise in 10-year Treasury yields well above 3% may increase the attractiveness of IG debt. We expect 10-year US Treasury yields to rise to about 3.50-3.75% in 12 months' time. At this point, it becomes much more likely the annual yield would equal, or outweigh, any potential capital loss from further weakness in bond prices. This 'break-even-plus' possibility is in sharp contrast to the past year, where total returns were negative as the low carry was overwhelmed by rapid capital losses thanks to sharply higher yields. Higher yields may cause IG bonds to look attractive once again as risks to HY bonds rise. We are not there yet, but we believe there will be value in being nimble.

Opportunities in the yield curve

US Treasury yield curve likely to steepen (below 10 years) and flatten (above 10 years). In other words, we expect the spread between the 10-year and 3-month bonds to *widen*, but we expect the spread between the 10-year and 30-year bonds to *narrow*.

3-month/10-year yield curve likely to steepen. In the first segment, we note the yield curve for the 3-month to 10-year segment is already fairly steep, at c.260bps. Historically, however, it has steepened to 360-380bps a number of times. A Fed tapering scenario that includes a combination of a cutback in asset purchases and interest rate guidance is likely to mean short-term (3-month) yields remain anchored at today's low levels, but long-term (10-year) yields rise further (to 3.50-3.75%). This would be entirely consistent with the 3-month/10-year yield curve steepening further, but within its historical range.

Figure 24: 30-year/10-year curve exceptionally steep while 10-year/3-month has room to steepen further
US Treasury yield curve spreads relative to history



Source: Bloomberg, Standard Chartered Bank

10-year/30-year curve likely to flatten. This part of the curve, however, has remained at extraordinarily steep levels since 2009-2010 (i.e. more than 1 standard deviation above its historical median). Any process of bond market

Fixed Income – Prepare to be A.G.I.L.E. (cont'd)

'normalisation' following the eventual end of ultra-loose Fed policy should lead to a narrowing of the spread between 30-year and 10-year bonds. This suggests there may be some value in 30-year bonds relative to the rest of the yield curve.

Such an outcome would also be ideal from the Fed's point of view as it allows yields to begin rising while minimising their impact on variable home mortgage yields (the majority of which are linked to 30-year Treasury yields).

We believe this view on the 10-year/30-year curve can be implemented in two ways:

- Go short the spread between 30-year and 10-year bonds
- Hold a very small amount of 30-year bonds within a well-diversified investment allocation (see figure 53 on page 29 for a possible weight).

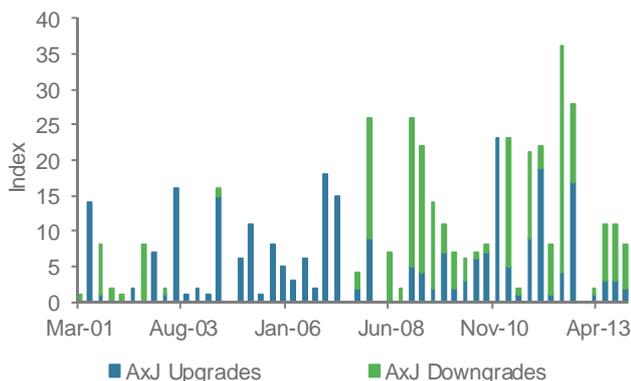
DM vs. EM bond markets

Maintain preference for Developed Markets (DM) over Emerging Markets (EM). Most of the asset allocation arguments we have made above hold across the USD-denominated bond universe in both DMs and EMs.

However, we believe there are good reasons to expect DM bonds to outperform their EM counterparts on a tactical basis:

- In the IG space, EM bonds carry more interest-rate risk (duration) than their DM counterparts, implying they are likely to underperform if US Treasury yields rise.
- In the HY space, credit quality continues to deteriorate, implying spreads are likely to widen further in the near term. Absolute yields in EM HY look attractive relative to other asset classes, but the continued presence of rising risks means we prefer to wait for wider spreads before adding to this asset class.

Figure 25: Ratings downgrades have significantly outnumbered upgrades in Asia in 2013
Asia ex-Japan (AxJ) ratings upgrades and downgrades



Source: Bloomberg, Standard Chartered Bank

We hold a Neutral view towards Middle East credits.

Evidence suggests USD-denominated Middle East credits offer a somewhat lower correlation to Asia ex-Japan corporate bonds than the rest of the EM universe. This makes them valuable from a diversification point of view. However, their relatively high sensitivity to changes in US Treasury yields means they are likely to suffer if yields rise (as we expect). There is some evidence that suggests Sharia-compliant debt (i.e. Sukuks) is somewhat less volatile than its conventional non-Sharia counterpart, possibly due to the longer-term horizon of the majority of bond holders. While this is an appealing characteristic, the limited history of this sub-asset class means it is difficult to say whether this lower volatility will be maintained over the long term.

Local currency markets

EM local currency bonds likely to remain under pressure due to currency risks. While we have some concerns on EM local currency bonds from a yield perspective, with the exception of a few key countries, policy rates are not likely to rise significantly. However, our main concern is currency exposure. As we detail in our FX section (pages 25-27), we believe there is a risk of EM currencies weakening in the event the Fed tapers asset purchases and Treasury yields begin rising. The magnitude of any such shift is likely to overwhelm the yield on offer at the moment. We believe it makes sense to stay away for now until the risks are more adequately priced in.

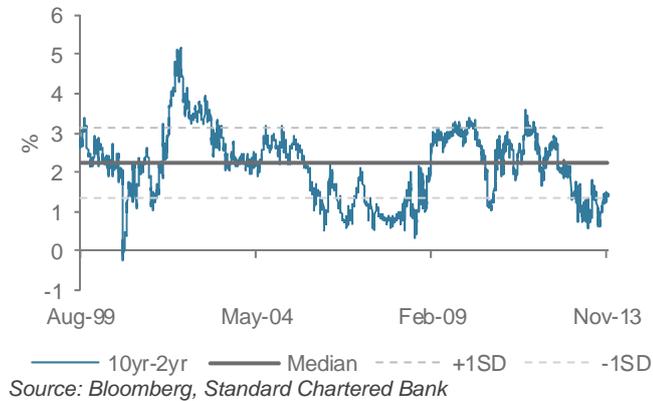
Our views on local currency bonds in Asia are largely the same, with a few caveats. In our view, risks are higher in South and South-East Asia where we see greater risks to currencies and the possibility of further policy rate hikes. At the opposite end of the spectrum, we believe the CNH (Dim Sum) bond market faces a much smaller FX risk. We would still avoid broad exposure to CNH bonds due to our discomfort with corporate credit risk, but would be perfectly comfortable owning short-maturity (less than five years) government bonds within this market.



Fixed Income – Prepare to be A.G.I.L.E. (cont'd)

Figure 26: China's yield curve remains very flat, arguing investors should keep maturity profiles short

China domestic yield curve (10-year/2-year spread)



Subordinated and perpetual bonds

Subordinated debt: Pockets of value may still exist. The key attraction within this asset class is that 'old-style' subordinated instruments that are not Basel-III compliant are limited in supply, since banks no longer issue them and will need to gradually phase them out. Spreads have naturally compressed, in aggregate, but pockets of value may still exist as the risk/reward trade-off is attractive.

Perpetual bonds: Likely maturity profile is crucial. A perpetual bond can theoretically remain outstanding in perpetuity, as the name suggests. In practice, however, issuers generally (though not always) tend to buy them back at pre-announced call dates with a view to maintaining investor interest in future bond issues.

Perpetual bond prices can be very sensitive to changes in US Treasury yields, though the extent of this sensitivity varies. Bonds with a call date quite far in the future are likely to behave very much like long-maturity bonds – i.e. they are likely to be extremely sensitive to changes in Treasury yields. Conversely, bonds with a high likelihood of being called within a relatively short time-frame are likely to behave like short-maturity bonds – i.e. they may not be very sensitive to changes in Treasury yields. This distinction is key to investing in perpetual bonds in today's environment, in our view.

We have a strong preference to be very selective within this asset class, favouring perpetuals with a shorter effective maturity profile. Given our expectations for Treasury yields to rise further from here, we hold a strong preference for perpetual bonds with a short effective maturity profile (i.e. there is a high probability of the bond being called within a relatively short period of time). We have a strong preference to avoid perpetual bonds when it

does not appear likely the bond will be called within a relatively short period of time.

Risks

Upside

- **Economic disappointment poses upside risks to fixed income**, as this may result in monetary stimulus accelerating. Such an outcome would likely result in yields falling, spreads tightening and EM currencies gaining (the latter being a key source of support for EM local currency bonds).

Downside

- **Yields could rise more sharply than we expect**, risking capital losses in USD bond allocations. Keeping maturity profiles short and favouring corporate over sovereign bonds would help mitigate this risk.
- While yields on HY bonds remain attractive on a relative basis, **downside risks are rising as valuations become increasingly stretched.**
- Asian FX weakness or an inflation shock could pose a **downside risk to Asian local currency bonds.**

Conclusion

We believe it makes sense to enter 2014 Underweight on the fixed income asset class, and Overweight DM HY within that. However, we believe it makes sense to be A.G.I.L.E. and be prepared to alter this asset allocation as macroeconomic conditions and valuations change. We also favour a barbell approach to maturity profiles, generally favouring short maturities, but offsetting them with a very small position in ultra-long maturities.

Equities – Still preferred

Robert Aspin, CFA | Audrey Goh, CFA | Victor Teo, CFA |

Key themes for the year ahead

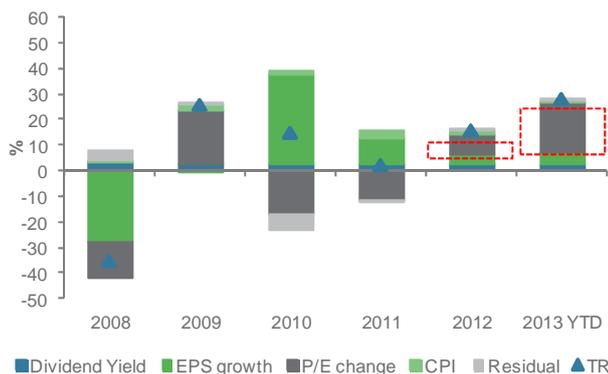
- **Stay Overweight Equities** which still offer value vs. bonds
- **Preference for US and EU**, but be A.G.I.L.E. should the fundamentals and valuations change
- **Buying on the dip worked** and may continue to do so, but volatility likely to increase
- **Cyclicals preferred over expensive defensives**

Summary – “Show me the earnings”

Equity markets, particularly those in the Developed world, rallied strongly in 2013 as they climbed the “wall of worry”. Having exposure to global equities, including the US, which we preferred in 2013, was key for investors to outperform.

This year, we expect equities to once again generate positive returns, outperforming both cash and fixed income. The environment, though, has changed significantly. Last year, with earnings revisions largely downward, equity re-rating drove strong equity returns, as valuation multiples such as price-to-book and price-earnings expanded. This was particularly the case in the Developed Markets (DM).

Figure 27: Equity performance so far driven by re-rating, S&P 500 decomposition of historical performance



Source: Bloomberg, Standard Chartered Bank

2014 is likely to be very different. Tapering is now expected in Q1 2014 and the ‘easy lifting’ provided by the re-rating of equities has already largely played out, with markets trading more or less in line with median valuations, on both P/B and P/E. Bouts of higher volatility are also likely, as the market goes through worrying about tapering to focussing on its impact and the possibility of rising interest rates. It is against this backdrop that earnings and dividends are expected to grow.

Figure 28: Basic assumptions to estimate total returns of global equities in 2014

MSCI AC World - Earnings growth and dividends

Target return assuming no re-rating/de-rating	Our Bias
Consensus earnings growth	11.30% ↓
Historical dividend yield	2.80% →
Total return	14.10% ↓

Source: IBES, MSCI, Datastream, Standard Chartered Bank

Legend: ↑ Significantly higher bias; ↗ Moderately higher bias; → No strong bias; ↓ Moderately lower bias; ↘ Significantly lower bias

Even if one assumes earnings per share growth at the global level comes in between 8% and 10%, which is the lower side of consensus, equity markets should, in our opinion, generate relatively strong returns.

Given the above views, we advocate that investors consider having the following positioning in 2014:

- Equities preferred relative to other asset classes.
- Diversified equity exposure, but with an initial bias towards the US and EU. Our current preference for the US and EU may change through the year.
- Favour cyclical sectors such as Technology, Energy and Industrials, which should outperform in our base case of improving economic growth.

Equities – Our largest overweight

Many of the reasons for liking equities in 2013 remain valid in 2014.

- **Economic outlook is still favourable:** We expect an improvement in 2014, led by DM. The markets have re-rated around this expectation, so it is increasingly important that underlying data improves materially and translates into greater earnings for corporates.
- **Monetary policy and excess liquidity supportive:** While we expect the US Fed to start tapering quantitative easing (QE) in Q1 2014, DM central banks are still injecting an enormous amount of liquidity and benchmark rates remain at record lows. It is likely to be specific Emerging Markets (EM) that will be most impacted by tapering, such as India and Indonesia.
- **Low cost of debt:** Companies continue to benefit from the access to ‘cheap’ financing, helping both margins and facilitating share buybacks.
- **Low inflation:** Inflation is expected to remain benign and has recently been trending down in markets such as the US and EU. We believe the risk of deflation is relatively low at this point and, should it become a

Equities – Still preferred (cont'd)

greater threat, the central banks will counteract it with additional stimulus. Going into 2014, there is greater inflationary pressure in EM, in our opinion.

- **Equities are still cheap relative to bonds and cash:** This is particularly the case in DM, but now less so in EM. While we expect US sovereign bond yields to increase over the next 12 months, equities still offer relative value even if yields rise further, as we expect.

Key 2014 themes

We highlight these with the caveat that these themes may need to be revised as we move through the year. Therefore, investors are likely to need to be more agile than in 2012/3.

Our key themes for 2014 are:

- **Equity valuations fair, but still cheap against bonds**
- **Earnings growth, dividend yield and share buybacks to be key drivers of returns**
- **Buying on the dip worked and should continue to work, but pullbacks may be more severe**
- **Cyclicals preferred over 'expensive defensives'**

Equities still cheap against bonds: Within an asset allocation framework, we still have a very clear preference for global equities over bonds, taking the view that the latter are expensive. We generally expect bond yields to move higher (see pages 13-16) and that the equity risk premium will continue to narrow. This is particularly the case in DM.

While the great rotation from bonds into equities never really took hold in 2013, we take the view that the 30-year bond bull market, which saw US Treasury bond yields decline from around 15% in 1980 to less than 2%, is over. It is possible 2014 will mark an increased shift out of cash, and perhaps bonds, into equities. While not our base case, should this switch start to occur, it would be very supportive for the equity market.

Figure 29: Equities still cheap compared to bonds
Earnings yield-bond yield gap across regions



Source: Datastream, MSCI, Standard Chartered Bank

Earnings growth, dividend yield and share buybacks to be key drivers of returns: We believe a substantial part of the equity re-rating is now behind us and that 2014 equity returns will increasingly be driven by earnings growth, dividends and share buybacks. This is not to say, however, that markets could not re-rate higher, as valuations are still not stretched. Rather, the impact of any further re-rating may be more muted as earnings growth starts to improve with the stronger underlying economic performance.

- **Base case:** Taking a relatively conservative view for earnings per share growth, global equity markets could generate a positive return of c.10% in 2014 (see box on page 17). Any further re-rating of multiples could drive total returns even higher.
- **Bull case:** If economic growth is better than expected, the Fed does not taper and fiscal policies are eased in parts of DM, markets could move substantially higher. Equities would likely re-rate higher in such a scenario.
- **Bear case:** Should the US Fed taper QE too aggressively and other central banks tighten too quickly, it would likely cause a significant pullback in the markets as the US housing market and economic outlook weakens substantially. This would likely result in a significant sell-off across the equity markets, made worse by the current high level of margin debt.

Buying on the dip worked and may continue to do so: A successful strategy of ours since 2012 has been to 'buy the dip' on the expectation that any pullback was going to be limited and quickly reversed. We expect more of the same in 2014, though with a number of key distinctions:

- Pullbacks may ultimately become more severe than in 2013
- The first half of the year likely to be characterised by fears of tapering and then its actual implementation
- The second half of the year may be characterised by fears of tightening in 2015

Figure 30: Buying the dips worked in 2013
S&P 500 12-month performance

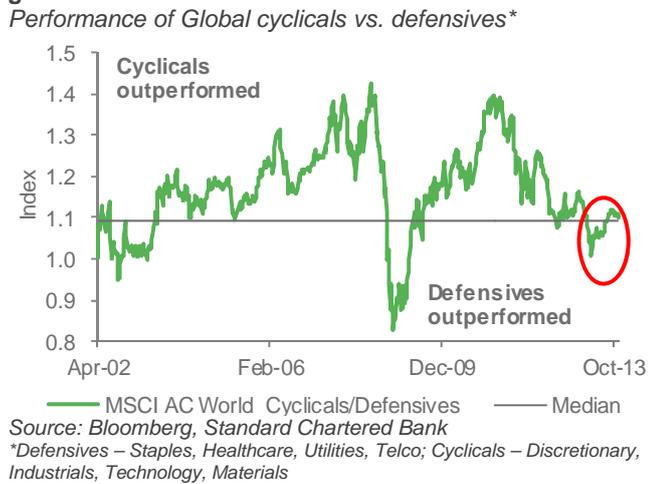


Source: Bloomberg, Standard Chartered Bank

Equities – Still preferred (cont'd)

Cyclicals preferred over ‘expensive defensives’: Given our expectation of an improvement in the global economy, cyclicals should extend their gains over the more defensive areas of the market such as Staples, Telecoms and Utilities. Cyclicals would include Technology, Energy, Industrials, Consumer Discretionary and Financials. Typically, it is the more cyclical areas of the market that tend to outperform as economic growth picks up and we move through the expansion phase of the business cycle. We believe the US and Asia are both now in the middle of the cycle while Europe is more early-cycle.

Figure 31: Cyclicals to outperform as economic growth gains traction



Current preferred markets and sectors

We highlight these with the caveat that our country and sector preferences may be revised as we move through the year. Therefore, investors are likely to need to be more agile than in 2012/3. Our preferred markets and sectors for 2014 are:

DM vs. EM: In early 2013, we highlighted our preference for DM, which worked well. We expect this trend to continue into 2014, though we may review our preference should the fundamentals or valuations require it. We should note that we do not expect negative returns from EM, but rather that EM will lag the performance of DM.

The economic outlook is an important consideration for determining our preference for the US and EU. EM economic expectations continue to get revised down and we expect tapering and the subsequently stronger USD to also support our US call. At the moment, we expect the Fed to start tapering only in Q1 2014. Should the pace of Fed tapering be greater than what the market is currently pricing in, parts of EM are, in our opinion, likely to significantly underperform.

Figure 32: DM significantly outperformed EM in 2013
 DM vs. EM market performance



Source: Bloomberg, Standard Chartered Bank

Given our preference for the US and EU, both of which we are Overweight, we would advocate investors consider having sizeable allocations to the following regions/countries:

US and EU – Overweight: Having exposure to these two markets was key to outperforming last year and we enter the year Overweight both.

Should Europe’s economic growth come in in-line with, or ahead of, market expectations, EU markets offer the greatest return potential due to the positive impact this would have on operating leverage/corporate margins and, thus, earnings. Similarly, however, the market also poses a greater risk to disappoint should economic growth fail to improve.

Figure 33: Corporate margins in the EU expected to stabilise and improve with a strengthening economy
 MSCI US and Europe – operating margins



Source: MSCI, Bloomberg, Standard Chartered Bank

The US market is not as cheap as it was at the start of 2013, but it is still not expensive even after the significant rally. We expect the US to continue being a strong performer on the back of an improving economic outlook and earnings growth. Consensus earnings are expected to grow by 9.8% over the next 12 months. While we do expect tapering in Q1 2014, we still see the Fed as very committed to providing liquidity should it prove necessary.



Equities – Still preferred (cont'd)

Japan: Investors tend to have little or no exposure to Japan and we would advocate that investors consider investing on a currency-hedged basis.

We believe Japanese equities should perform well due to fiscal stimulus, a weaker yen and, at the time of writing, attractive technicals. Furthermore, the BoJ is also very comfortable adding further liquidity should be it be required, which may well be the case given the planned increase in consumption tax. Our central scenario is that the market should be a relatively strong performer for the full year. We are not Overweight Japan, though, as there is, in our opinion, a greater risk of policy mistakes.

Asia ex-Japan: Investors should also have exposure to Asia ex-Japan equities. While the market may lag DM, we do expect this market to generate positive returns in excess of cash.

Within Asia ex-Japan, we continue to favour North over South Asia due to valuations and the potential impact of tapering on the latter. Markets such as South Korea and Taiwan are more exposed to the improving economic outlook in DM as well as the technology capex cycle, which we expect to improve into 2014. Both markets are relatively attractive against their history, though we prefer South Korea overall on the back of its improving economy and attractive valuation. We also like Malaysia as a relatively defensive market that is trading at fair valuations.

In terms of China (where we are Neutral), we are constructive on the results of the Third Plenum and the shift to more of a market focus. These are, however, longer term-orientated policies and implementation is still unclear, particularly around the State Owned Enterprises (SOEs).

While we highlight a relative preference above, we would still advocate that investors consider having some exposure to the rest of the region including markets such as India, Singapore and Hong Kong. We are initially a little more cautious on Indonesia due to the impact of tapering.

Other EM: Of the major economies within other EM, we have a preference for Russia. The market is, in our opinion, very cheap and offers significant upside potential. Investors have to be cautious, however, as corporate governance is very questionable. Also, Russia's economy is relatively weak (c.1.2% GDP growth in Q3 2013) and retail sales continue to trend lower. We are more cautious on both South Africa and Brazil on the grounds of valuations and currency risks.

In terms of sectors, we have the following preferences:

Global Technology: It was one of our preferred sectors in 2013, and this is also the case for 2014. The sector has

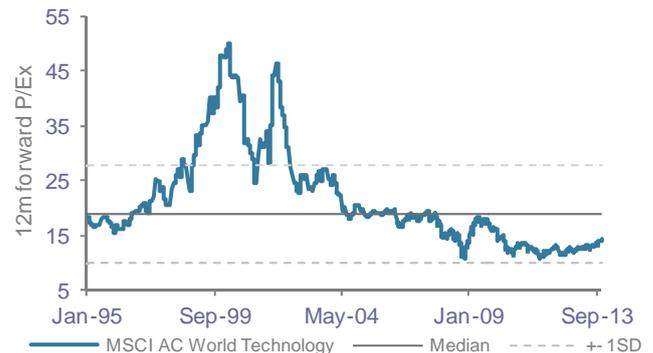
outperformed so far in 2013 and is, in our view, well positioned to do so again.

This may surprise some, given some news headlines making the comparison between now and the 1999 Technology bubble. While the recent spate of IPOs has received significant attention, the underlying Technology index is still trading well below its historical valuations and, in the US at least, just below market valuations. We like the sector for the following reasons:

- Attractive valuation, trading below its historical average.
- Net cash positive, which allows for share buybacks and increased dividend yield.
- Higher-than-average return on equity and free cash flow.
- Well positioned to benefit from our expectation that the capex cycle will improve as the underlying economy strengthens.

Figure 34: Technology sector offers attractive valuations and fundamentals

MSCI AC World Technology 12m forward P/E



Source: IBES, Datastream, Standard Chartered Bank

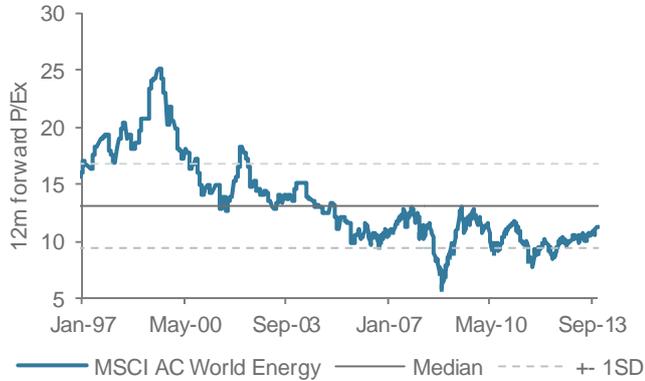
Global Energy: Remains a key Overweight for us, with a particular focus on the Exploration & Production (E&P) and on the services segment.

- Valuations are attractive, with the sector trading substantially below its historical average.
- We have a preference for the exploration and production (E&P) industry as well as the energy services segment. Rising activity in shale gas and deep-sea drilling has been supportive to the earnings of companies in these areas. We see this continuing into 2014.
- China's fuel price reform is positive for the downstream sector. Initiatives to reduce air pollution should also be supportive for a number of players in the natural gas space, including those in services and transportation.



Equities – Still preferred (cont'd)

Figure 35: Energy sector still trading at attractive valuations against both the market & historical average
MSCI AC World Energy 12-month forward P/E



Source: IBES, Datastream, Standard Chartered Bank

Global Industrials: Should also outperform in the midst of an improving economy.

The industrials sector has a high correlation to underlying economic growth – rising consumption drives increasing industrial output demand across trade, travel and equipment.

Risks

Upside

- Better-than-expected improvement in the underlying economy and earnings.
- Improving trend in earnings revisions.
- Rise in inflation expectations.
- Rotation from bonds to equities. The 'great rotation' never really took hold in 2013; 2014 may be different if the economy does improve as expected.

Downside

- Decline in margins due to higher input prices.
- Faltering growth induced by policy mistakes: Premature Fed policy tightening, banking sector stress in the EU and the consumption tax hike in Japan.
- Contagion risks: EM growth slows significantly on the back of a credit crunch.
- Breakup of Europe: With high levels of unemployment and a focus on austerity, anti-European political movements are gaining traction.
- Escalation of tensions between Japan and China.

Conclusion

In conclusion, we expect Equities to continue 'climbing the wall of worry'. While we remain in a very policy-driven environment, for the moment at least, these policies are still largely in favour of equities.

Where our view may change through the year:

Preference for US and EU vs. EM and North Asia (NA) vs. South Asia (SA):

Should tapering be delayed beyond 2014, we would be more constructive on EM and SA. EM has benefitted from the Fed's QE and a decision not to taper would likely see a pick-up in fund flows to these markets. Similarly, a decision not to taper would likely impact our FX forecasts making us less constructive on the USD.

Should the economic outlook in DM fail to meet our expectations, DM earnings are likely to be revised down significantly, more so than in the case of EM. SA would also perform better in relative terms as the market is less exposed to a DM recovery.

Preference for cyclicals vs. defensives?

Our 'cyclical' call would come under question if the economy disappoints. As we saw in the earlier part of 2013, investors can bid up the valuations of defensive sectors such as Staples and Healthcare, when in search of safe havens, while at the same time selling out of the more cyclical areas of the market.

Given the continued uncertainty over the economic outlook, we would advocate that investors consider having diversified exposure, with a bias in favour of the more cyclical areas of the market to capture the improving growth dynamic.

Commodities – Little to see here

Manpreet Gill

Key themes

- **Neutral Commodities.** Further downside likely limited, but upside catalysts are largely absent.
- **Underweight gold. Prices still not in the support zone.** 50-year average of inflation-adjusted price is USD 660.

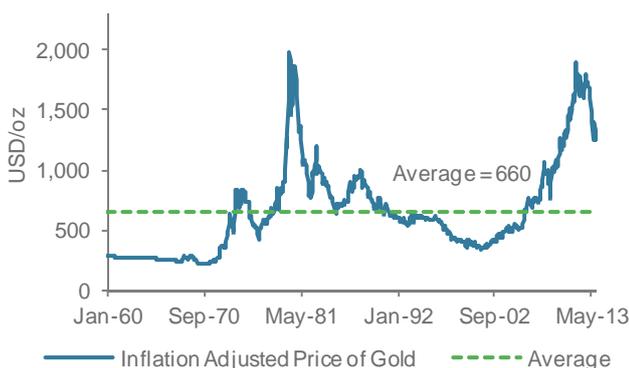
Key views

We retain a Neutral stance towards commodities. Commodity prices have fallen c.28.6% since their most recent peak in mid-2011. Downside risk, arguably, is more limited from here.

However, upside catalysts remain largely absent. Fed tapering and USD strength are likely to weigh on commodities, particularly impacting precious metals. We expect economic growth to accelerate globally, but this is expected to come largely from less commodity-intensive regions. It remains tough to find positive catalysts for commodities.

Gold – Underweight. More weakness remains likely. The key drivers of gold argue for a bearish outlook going into the new year. Tapering action by the Fed, USD strength and rising bond yields continue to argue for lower gold prices. Inflation-adjusted prices remain well above long-term averages, suggesting there is room for prices to fall further.

Figure 36: Adjusted for inflation, gold prices remain very elevated relative to history
Gold price, adjusted for inflation

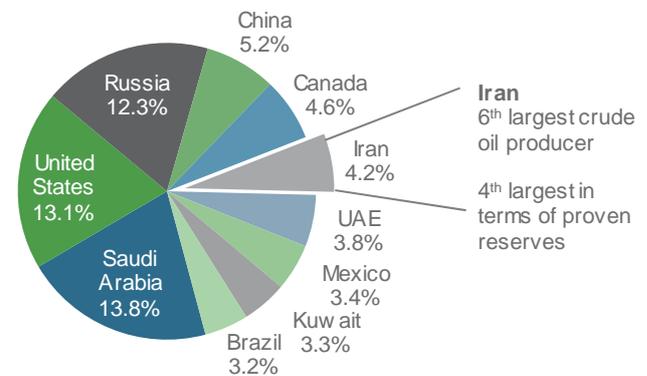


Source: Datastream, Standard Chartered Bank

One key risk is inflation. Gold's role as a long-term inflation hedge remains uncertain, in our view, but recently, gold has maintained a sizeable correlation with inflation expectations. Rising US inflation expectations could pose an upside risk to gold. Geopolitical risks have also been traditionally positive for the metal, but its weak price action during the recent China-Japan dispute suggest this is unlikely to pose upside risks to gold prices in 2014, absent a dramatic increase in tensions.

Energy – Overweight. Range-bound outcome likely, but we hold a positive bias. Global demand and supply remain largely in balance. The geopolitical issues, though, are likely to be far more dominant in 2014, in our view. Iran's tentative deal paves the way for it to play a greater role in global energy supply. This is likely to take time to come on-stream, so the impact may only be visible on a multi-year basis rather than over the next 12 months. Over the next year, other major oil producers' reactions to the tentative Iran deal are likely to be much more important. Greater volatility is possible over the next 12 months.

Figure 37: Iran is already a significant oil producer. Easing of tensions could grow this share significantly
Global crude oil output, share (%)



Source: EIA, Standard Chartered Bank

Industrial metals – Neutral. China unlikely to stimulate prices, in our view. The challenges for industrial metals remain largely unchanged from 12 months ago. Chinese demand remains lacklustre, and its efforts at economic restructuring mean demand growth is unlikely to rebound to pre-crisis levels. Inventory levels also remain high, so any rise in final demand would likely take time to work its way into prices.

Risks

Upside

- Any reversal of Fed tapering intentions would likely be positive for commodities, and gold in particular.
- A rise in geopolitical risk, particularly in the Middle East or any key oil supply routes, poses an upside risk to oil prices.

Downside

- Any slowing of growth in China poses a downside risk for base metals.

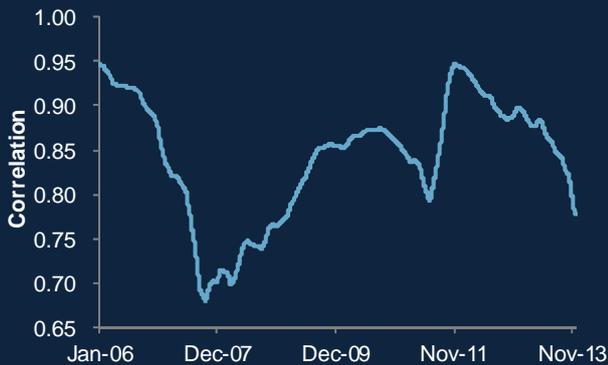
Commodities – Little to see here (cont'd)

Equities as an implementation route

Equities are one of the more commonly chosen approaches to implementing commodities views, often because of the ease of execution. However, we believe some issues need to be kept in mind when going down this route:

1. There is a reasonably high correlation between commodity prices and commodity stocks, but this holds only over long periods of time. It is not obvious that commodity equities can be used to implement short-term views on commodities accurately. Prices of commodity equities can often disconnect from those of the commodities themselves over shorter periods of time (and indeed have done so over the last two years).

Figure 38: Correlation between commodities and commodity equities high, but far from one
Rolling 3-year correlation between the S&P global mining index and the DJ-UBS Commodity Index



Source: S&P, DJ-UBS, Bloomberg, Standard Chartered Bank

2. Commodity equities offer more implementation options in some parts of the commodities universe, but less so elsewhere. Mining equities provide exposure to base and precious metals while energy companies provide exposure to oil and gas. The mix of commodities in a commodity equity index, however, may differ substantially from the mix obtained by owning direct exposure to a commodities index, such as the Dow Jones-UBS Commodity Price Index.

Our outlook for commodity equities

There are parts of the commodities equities universe that we find attractive at this time, while there are other areas that we do not.

As we set out in more detail on page 20, we believe energy equities are attractive and are a key Overweight for us. Valuations are attractive, particularly the exploration and production (E&P) industry. We also like the energy services segment and the rising activity around shale gas and deep-sea drilling have been supportive to the earnings of companies in these areas. China's fuel price reform is positive for the downstream sector and its initiatives to reduce air pollution should also prove supportive for a number of energy players in the natural gas space.

However, we believe it may be too soon to begin adding to the mining sector as yet. Valuations have undoubtedly become increasingly attractive over time, but there is a risk they could become even more attractive. Our less-than-constructive outlook, particularly on precious metals, means companies in this sector are likely to continue facing pressure from weaker prices for their commodities. As with the underlying commodities themselves, we struggle to find a positive catalyst at this time.

Figure 39: Searching for a catalyst and change in trend
Datastream global mining equities historical v-shaped recoveries (from 1985)*



Source: Datastream, Standard Chartered Bank
 *peak to trough of more than 35% before recovering 100% of losses (with exception of 2008-2011)

Alternatives – Long/short strategies increasingly relevant

| Manpreet Gill |

Key themes
<ul style="list-style-type: none"> • Overweight Alternative Strategies.
<ul style="list-style-type: none"> • Overweight Equity long/short strategies. This offers an attractive alternative to gaining equity exposure.
<ul style="list-style-type: none"> • Neutral Macro/CTA strategies. Long-term correlation with equities remains low, but they may not necessarily offer low correlation in the short-term.
<ul style="list-style-type: none"> • Selling volatility in order to gain yield can be an appropriate strategy when volatility is high, but not necessarily so when it is as low as today.

Key views

Alternative Strategies are likely to outperform Fixed Income and Commodities. Remain Overweight. In the Macro section, we note our base case looks for a continued transition towards stronger growth. In this environment, alternative strategies' likely positive absolute returns and lower level of volatility mean outperformance relative to cash, fixed income and commodities is likely.

Overweight Equity long/short strategies – they can offer an attractive alternative to direct equity exposure. While long-only exposure to equities may outperform during a period of strong equity market performance, not all investors will be comfortable with the volatility that is inevitable with a simple long-only position. For such investors, equity long/short strategies can offer an attractive alternative as they offer exposure to equities, but with a lower level of volatility.

Figure 40: Equity long/short strategies offer lower volatility relative to long-only equities exposure
Volatility of MSCI AC World vs. HFRX equity hedge index

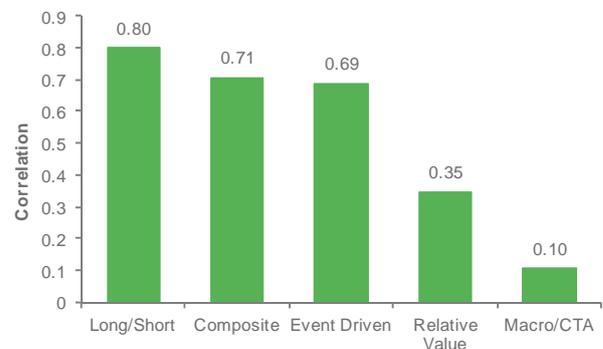


Source: MSCI, HFRX, Bloomberg, Standard Chartered Bank

We believe, therefore, these strategies offer an interesting addition, or alternative, within an asset allocation, especially if equity markets experience significant speed bumps.

Neutral Macro/CTA strategies – A key diversifier over the long run, but could underperform over shorter time horizons. Macro/CTA strategies offer lower correlations with equities over a multi-year time horizon and thus, from a diversification point of view, remain a key component of a well-diversified asset allocation. In the short term, however, there is a risk that these strategies could underperform even if equities weaken. In today's strong equity market, it is likely most Macro/CTA strategies are long equities, a position that would take time to reverse if equity markets weaken.

Figure 41: Macro/CTA remains the only sub-strategy offering low correlation with global equities
Alternative strategies' 10-year correlation with global equities*



Source: MSCI, HFRX, Bloomberg, Standard Chartered Bank
*Indices are MSCI AC World, HFRX global hedge, HFRX event driven, HFRX relative value, HFRX Macro/CTA index

Be selective when choosing to be long volatility (buy insurance) or sell volatility (gain yield). Alternative strategies ultimately come down to a simple choice of being long or short volatility. 'Insurance' strategies like Macro/CTA are essentially long volatility (i.e. they gain when the volatility of risky assets rises). Popular yield-enhancement strategies, on the other hand, are short volatility. Both can be attractive when used at the right time, but not at the same time.

Risks

Downside

- Long/short strategies could underperform long-only strategies in the event markets continue to rally.
- A rise in mergers and acquisitions activity could cause event-driven strategies to outperform equity long/short.

Upside

- Greater-than-expected equity market volatility would likely raise the potential for equity long/short strategies to outperform long-only strategies.



FX – Monetary policy the key differentiator

| Manpreet Gill |

Key themes

- **US Dollar strength likely to anchor FX market.** We expect moderate strength vs. European currencies and greater strength vs. Emerging Market currencies.
- **Monetary policy divergence likely to be a key driver.** The Fed and the BoE are likely to slow easing, while the ECB may need to keep policy loose for longer. The BoJ is likely to ease further.
- **Asia is a diverse basket of currencies.** CNY likely to be largely flat while the INR and the IDR bear the brunt of tapering-related outflows.
- **Bearish AUD. Risk/reward remains unattractive.** Fed tapering may be a trigger pushing it over the edge.

Key views

In 2013, the USD strengthened for the first half of the year before dropping back, as the Fed chose to delay tapering of asset purchases. The net result was that the US Dollar index had gained over 6% by mid-year before falling back to record just over a 1% gain year-to-date. Emerging Market (EM) currencies suffered disproportionately while European currencies remained remarkably resilient.

Figure 42: US dollar rose slightly over 2013 year-to-date
US Dollar (DXY), Asia-US Dollar (ADXY) indices

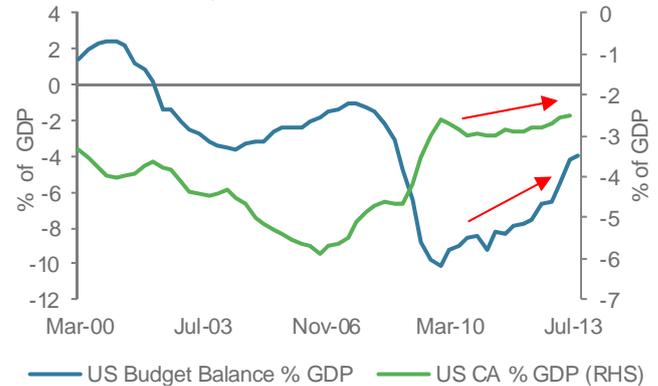


Source: Bloomberg, Standard Chartered Bank

We expect the USD to strengthen on a multi-year horizon. Fed tapering remains a key component of this view. We recognise the risks both to tapering itself and the possibility it could be accompanied by interest rate guidance that keeps rates somewhat lower than we expect. On balance, however, we believe a tapering of asset purchases is more likely than not. A slowing, and eventual reversal, of asset purchases means the expansion of the monetary base (i.e. the supply of dollars) is likely to slow. Higher yields (both nominal and real), a gradually shrinking external deficit

and accelerating capital inflows are likely to be key USD-supportive factors.

Figure 43: US twin deficits have been improving
US current account, fiscal account balance



Source: Bloomberg, Standard Chartered Bank

USD strength is likely to be a key anchor in currency markets in 2014. A look back at history suggests that periods of USD strength tend to be broad-based, with few exceptions. It would be unusual, for instance, for the USD to strengthen only against EM currencies, but not the majors.

The magnitude of USD strength is likely to differ across pairs. We expect more strength against EM currencies, especially those with weak external balances, and commodity currencies, where yield attractiveness is likely to reduce. US dollar strength against European currencies, on the other hand, may be more moderate in the face of the European Central Bank's (ECB) challenges to easing policy further and more evidence of economic strength in the UK.

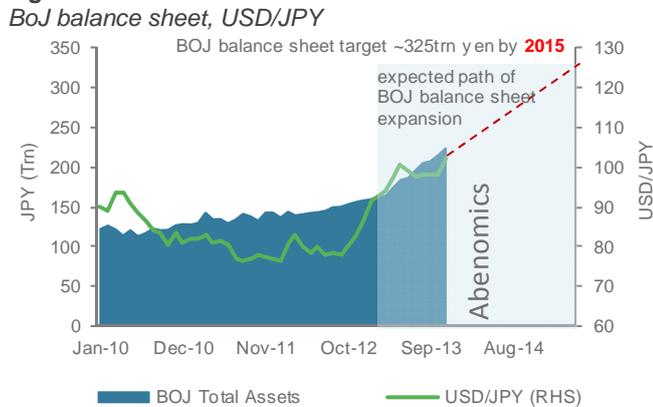
European currencies hold the greatest potential to surprise, in our view. The GBP holds the greatest risk of strengthening despite broader USD strength, if economic growth continues to surprise on the upside. The EUR, on the other hand, holds the greatest potential to surprise on the downside should policymakers end up acting more quickly than markets currently expect.

Major currencies (EUR, GBP and JPY) – Monetary policy differentiation likely to be the main driver

- **We are bearish on the JPY.** The Bank of Japan (BoJ) is clearly the most willing of the major central banks to add further to asset purchases, which is likely to be negative for the currency. However, we do not expect this weakness to occur without volatility – it is quite possible the yen goes through a temporary period of strength mid-year as markets doubt the BoJ's willingness to act. We believe, though, that it will indeed follow up with further action, if needed.

FX – Monetary policy the key differentiator (cont'd)

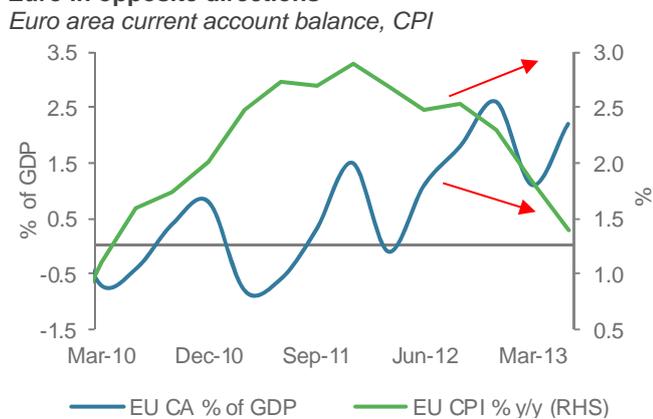
Figure 44: BoJ's balance sheet expansion suggests significant JPY weakness ahead



Source: Bloomberg, Standard Chartered Bank

- **We are bearish on the EUR.** Weak inflation data likely means the ECB will need to keep monetary policy conditions looser for longer than the UK and other parts of Europe (such as Switzerland), in our view. The Euro area's current account surplus is a key risk to our view.

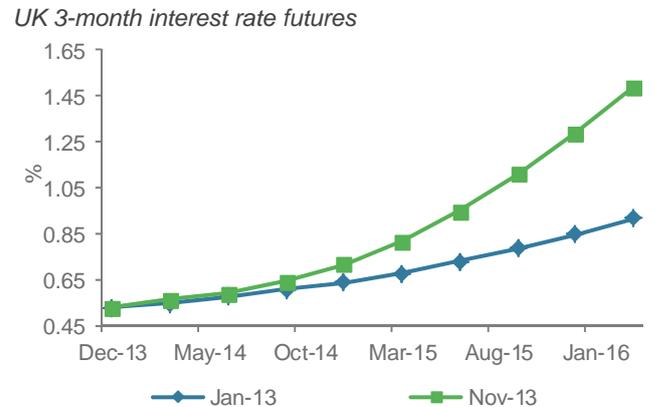
Figure 45: Current account balance and CPI pulling Euro in opposite directions



Source: Bloomberg, Standard Chartered Bank

- **We are neutral on the GBP.** The BoE's increasingly positive stance, as communicated in its most recently published Quarterly Inflation Report, suggests the end of ultra-loose policy is likely to occur sooner than markets currently expect. This is positive for the currency, in our view. We believe GBP/USD may still be weighed down, to some degree, by USD strength; hence **our preferred approach is to gain exposure against other European currencies (i.e. short EUR/GBP or CHF/GBP).**

Figure 46: UK interest rate futures beginning to respond to less dovish tone from the BoE



Source: Bloomberg, Standard Chartered Bank

Commodity currencies (AUD, NZD and CAD) – Risk/reward tilted to the downside

- **We are bearish on the AUD.** The risk/reward trade-off for this currency is not attractive, in our view. Yield has been a key driver of the currency during its ascent and this is the one factor that is changing the most. The Reserve Bank of Australia (RBA) has cut Australian rates significantly, with the possibility of further cuts. On the other side, US yields are likely to rise further. Hence, the yield attractiveness is likely to continue fading.

Figure 47: Receding AUD yield premium over USD reducing currency's carry attractiveness

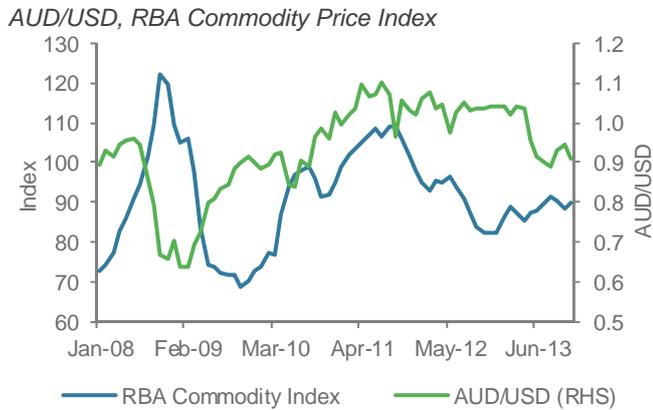


Source: Bloomberg, Standard Chartered Bank

- Commodities are the other key driver, where the outlook also appears to be unsupportive, given China's efforts at structural reform. Both these come against the backdrop of an (arguably) overvalued currency. The RBA's stance is the final nail in the coffin, in our view – it has made its preference for a significantly weaker currency very clear on a number of occasions, and have, more recently, not ruled out intervening in currency markets.

FX – Monetary policy the key differentiator (cont'd)

Figure 48: Weak commodity prices also argue for a lower AUD



Source: Bloomberg, Standard Chartered Bank

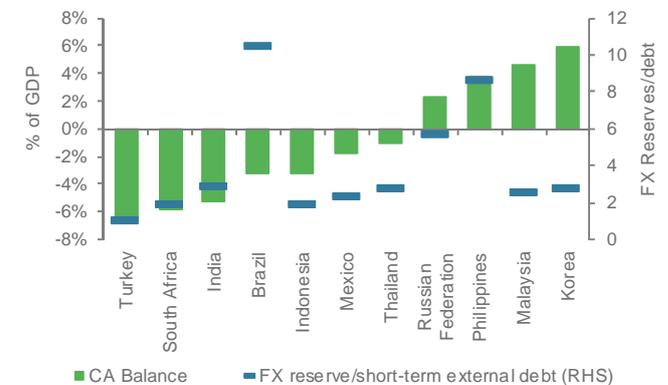
- We recognise there are risks to our view – inflation may hold back the RBA from cutting rates further, the Fed may keep rates lower for longer and commodity prices could rise. However, we do not believe these alter the unattractive risk/reward outlook for the AUD. In the most optimistic scenario, they suggest a flat-to-very-mild appreciation in the currency. Our base case, however, suggests a sizeable depreciation of the currency. The risk/reward trade-off is very unattractive, in our view.
- **We are mildly bearish on the NZD.** The pressure from lower commodity prices is similar to that on the AUD – though the commodity mix in New Zealand's exports (primarily agricultural goods) is less negative relative to Australia's more China growth-centric commodities exports. Interest rates, however, are likely to rise. We believe this leads to a somewhat more positive outcome for the NZD relative to the AUD.
- **We are neutral the CAD.** The key driver for the currency remains oil prices, where we hold a more positive bias. This is likely to be offset by USD strength to a large extent, in our view, causing us to hold a Neutral view on the currency.

Asia ex-Japan and other EM currencies – Fed tapering risk

- **We are bearish Asia ex-Japan currencies.** Our key concern is the risk of outflows in an environment of Fed tapering. A rise in *expected* US dollar yields is likely to lead to further capital flows away from the region.

Figure 49: External balances remain a risk for some EM currencies

Current account balance, FX reserves as a multiple of short-term external debt



Source: IMF, Bloomberg, Standard Chartered Bank

- **However, the impact is unlikely to be uniform across the region.** The IDR and INR may, once again, underperform the region due to their weaker external fundamentals. We do expect the extent of weakness to be smaller than in 2013 due to some policy efforts over the last few months of the year. However, it is likely markets will disproportionately focus on currencies of current-account-deficit countries, both in Asia ex-Japan as well as the broader EM universe. At the other extreme, we believe the CNY and the SGD are likely to offer greater stability. We believe Chinese policymakers continue to have an incentive to maintain currency stability.
- **Key EM currencies like BRL and TRY are at risk from a capital flows reversal.** Turkey's external balances remain relatively weak, posing the risk of further currency downside. Brazil's current account deficit remains relatively small as a share of GDP, but its recent attractiveness for yield-seeking capital (due to high interest rates) means the currency is likely to be vulnerable if capital flows reverse.

Risks

- Any unexpected delay, or reversal, of Fed asset purchase tapering poses a key risk to our USD view.
- Unexpectedly strong opposition within the ECB to loosen policy further poses upside risk to the EUR.



Special focus: Investing for income generation

| Aditya Monappa, CFA |

Key themes

- **Successful income generation in 2014 remains an objective for many investors.** A low interest rate environment for the foreseeable future suggests investors should continue to explore income-generating assets beyond traditional fixed income.
- **Focus on a diversified allocation of income generating assets.** Accessing multiple sources (rather than a few) of yield is the most appropriate path to income stability, in our view.
- **Income asset allocation to generate positive, but more muted, returns.** Rising yields are likely to eat into total return as we move through the year.
- **Prepare to be A.G.I.L.E. with income-related assets.** A potential shift in relative attractiveness of income assets through 2014 demands that investors remain A.G.I.L.E. in their allocation.

Key views

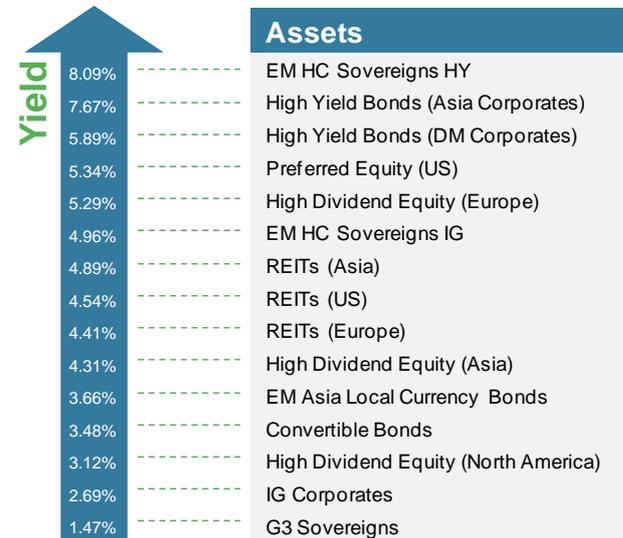
A multi-asset approach to income investing is prudent. In a post financial crisis world, central bankers have engaged in monetary policy aimed at keeping interest rates low with a view to stimulate growth. We have seen this phenomenon play out in the US following the crisis in 2008 and in Europe with the debt crisis soon after. In fact, central banks have adopted an approach of “forward guidance”, a method of communicating their likely policy stance in the future, to indicate a low level of interest rates for an extended period of time.

The policy environment has created a challenge for income sensitive investors. Depressed bond yields have made it difficult for income-sensitive investors who have looked to traditional fixed income instruments in the past as a source of income stability. Looking further ahead, an eventual rise in yields will likely result in capital losses for fixed income investments, reducing the total return delivered by the asset class (for some sub-asset classes, total returns may be negative).

Addressing the dual challenges of low current yields and the impact of rising rates should be the focus of an income investor. Broadening the investment universe beyond traditional fixed income is crucial in tackling these headwinds to income generation.

Figure 50: Broaden the mix – a range of yields on offer beyond core fixed income

Yield to maturity/dividend yield (%)

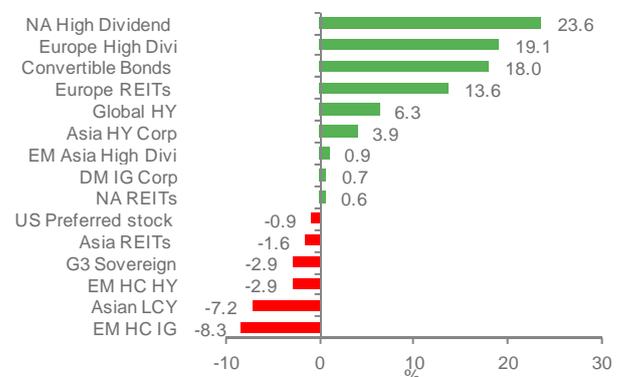


Sources: JP Morgan, Barclays Capital, Citigroup, FTSE, iShares, MSCI, Bloomberg, Standard Chartered Bank

Chasing the highest yield was not the best strategy in 2013. Investors with a propensity to focus on yield at the expense of total return were penalised in 2013. While EM Hard Currency (HC/USD) HY offered an attractive yield, it lost 2.9% in 2013 on a total return basis. Similarly, while preferred stock looked attractive on a yield basis, it experienced a capital loss of 5.4% resulting in a net total return of -0.9% year-to-date.

Figure 51: Performance of income generating assets

Year-to-date total return performance (%)



Sources: JP Morgan, SPDR, Barclays Capital, Citigroup, FTSE, iShares, MSCI, Bloomberg, Standard Chartered Bank
For indices used, refer to end note at the conclusion of this section.

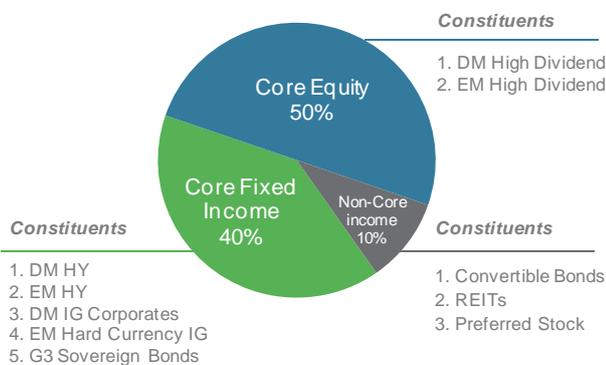
Special focus: Investing for income generation (cont'd)

Our approach to multi-income investing

A balanced approach is the preferred path to building a multi-asset income basket. A simple focus on yield maximisation would result in concentrated holdings with a high level of risk. To counter the tendency to focus solely on yield, the sample allocation focuses on multiple assets across the equity, fixed income and hybrid asset classes. The objective of this USD asset allocation would be to capture the most attractive income opportunities available (without sacrificing total return), while smoothing overall volatility.

Figure 52: A sample multi-asset income allocation

Combination of core and non-core income assets



Sources: Standard Chartered Bank
For illustrative purposes only. Please refer to the Important Information section at the end of this document for more details.

- Core Fixed Income (40%).** Our preference within fixed income is for Developed Markets (DM) over Emerging Markets (EM) and corporates over sovereigns. In constructing a fixed income basket, we would approach the universe in the following manner in order of preference: 1) DM HY, 2) EM HY, 3) DM IG corporates, 4) EM hard currency IG, and 5) G3 sovereign bonds.

The fixed income allocation could experience a capital loss if yields were to rise more sharply than expected. Keeping maturity profiles short and favouring corporate over sovereign bonds help mitigate this risk. However, it also reduces the yield offered and the diversification benefit to some extent.

An option to tackle the dual challenges of risk management and diversification could be to adopt a 'barbell approach' – maintain broadly short maturity profiles (below 5 years to maturity), but offset with a small holding of ultra-long (20+ years) bonds as well.

- Core Equity (50%).** A key objective of multi-income investing is to widen the opportunity set. Investing in high dividend equity fulfils this objective. We expect equities to outperform relative to cash and fixed income.

This return expectation, combined with reasonable yields, reinforces the role of dividend equities within an income basket. Within the equity allocation, our current preference is for DM over EM, with a preference for Europe and the US.

While the announcement of Fed tapering may create risks for the equity allocation, an improving growth picture, particularly in DM, should be supportive of the asset class in the long term.

- Non-core income (10%).** This allocation includes a combination of convertible bonds, REITs and preferred stock. Given valuations appear fair for these asset classes, we would not recommend an Overweight allocation to any individual asset class. That said, the attractive levels of yield currently on offer suggest that a 10% allocation to non-core income assets could be appropriate.

Additionally, should equity markets weaken, convertible bonds are likely to provide greater downside protection than equities, though losses will not be eliminated.

Figure 53: Suggested weights for multi-income allocation

All figures are in percentages

Asset Class	Sub-Asset Class	Weight
Fixed Income	DM High Yield	10.00%
	EM High Yield	7.50%
	DM IG Corporates	7.50%
	EM HC IG	5.00%
	G3 Sovereigns (Barbell)	10.00%
	– Short Maturity (1-5 years)	8%
	– Long Maturity (20+ years)	2%
Sub-total		40.00%
Equity	US Divi Equity	18.00%
	Europe Divi Equity	20.00%
	Asia Divi Equity	12.00%
Sub-total		50.00%
Non-Core	Convertibles	3.33%
	Real Estate	3.33%
	Preferred Equity	3.33%
Sub-total		10.00%
Total		100%

Sources: Standard Chartered Bank
*For indices used, refer to end note² at the conclusion of this section.

Investors should prepare to be nimble in their choice of income assets. It is important to highlight that the sample income basket reflects our current convictions around various asset classes. As we transition through 2014, the relative attractiveness of these assets, within both equity

Special focus: Investing for income generation (cont'd)

and fixed income, are expected to shift. As an example, higher yields may cause IG bonds to look attractive once again as risks to HY bonds rise. This could trigger a rethink of our fixed income Underweight.

It is also important to note this is a generic asset allocation and individual investor preferences and tolerance to risk might necessitate a different allocation.

Income asset classes in 2014

A clear understanding of the risk and reward trade-off of various income assets is essential in building an asset allocation. Exploring the various asset classes on an individual basis will allow us to fully appreciate their risk profile and return drivers. Not only is this important in setting the tactical allocation today, but it also provides a view on rebalancing actions that might be necessary as risks evolve over the course of the year.

Core Fixed Income

Traditional fixed income remains a key component of multi-asset income. In this role, it continues to fulfil its primary objective of providing regular income while balancing the risk of the overall basket. Key to fixed income investing in 2014 is to build an allocation that mitigates USD interest rate sensitivity and smoothens volatility.

- **Underweight within core fixed income.** Our expectation is for Treasury yields to move higher in the coming 12 months. Under this scenario, we would be Underweight G3 government bonds as well as EM IG sovereign bonds. While EM IG offers materially higher yields, it also has a greater sensitivity to USD interest rates than the rest of the global IG bond asset class.
- **Yield attractive in the HY asset class; Prefer DM over EM.** DM HY bonds have done well over the past few years. We believe they will continue to be supported by accommodative lending standards in early

2014. However, a tightening of spreads well beyond historical average levels and rising yields could undermine total returns later in the year. For the moment, we would maintain an Overweight in DM HY bonds within the income basket.

While EM HY offers an attractive yield, we believe DM HY is likely to outperform. Of principal concern in EM is the continued credit quality risk, suggesting spreads may widen further near-term. However, EM HY may offer an interesting carry opportunity once credit quality stabilises, but we believe that will likely occur at much wider spreads.

- **Underweight EM local currency bonds driven by pressures from FX.** While offering a reasonable yield, the main threat to EM local currency bond returns emanates from Fed tapering. As highlighted in our FX section, EM currencies might weaken when the Fed begins to taper its asset purchase programme. Such a move in FX might erase any return delivered by the yield on this asset class. We got a brief preview of the impact of reduction in asset purchases following Bernanke's talk of tapering in May 2013.

Interest rate risk – attractive yield might not compensate for capital loss. Interest rate sensitivity is an issue that cannot be ignored. It is useful to measure the impact of a change in yields on various fixed income asset classes. We use a simplified analysis combining yield-to-maturity and interest rate sensitivity to understand this impact. The shaded region in Figure 54 below represents the range of probable outcomes, in our opinion. For a number of asset classes, the yield available may not be sufficient to offset the capital loss arising from a rise in yield, resulting in negative total return. This, again, should serve as a sign of caution for investors prone to chasing headline yields.

Figure 54: Estimated interest rate sensitivity of fixed income assets

Expected total returns (12M) based on change in yields (%)

	Asia LCY	Asia HY Corp	Global HY	EM HC HY	EM HC IG	G3 Sov	DM IG Corp	
Yield to Maturity	3.9%	7.7%	5.6%	8.1%	5.0%	1.4%	3.1%	
Duration*	6.43	4.33	4.2	5.46	7.42	6.7	6.81	
Change in yield	-1.50%	13.6%	14.2%	11.9%	16.3%	16.1%	11.5%	13.3%
	-1.00%	10.4%	12.0%	9.8%	13.6%	12.4%	8.1%	9.9%
	-0.50%	7.2%	9.8%	7.7%	10.8%	8.7%	4.8%	6.5%
	0.0%	3.9%	7.7%	5.6%	8.1%	5.0%	1.4%	3.1%
	0.50%	0.7%	5.5%	3.5%	5.4%	1.3%	-1.9%	-0.3%
	1.00%	-2.5%	3.3%	1.4%	2.6%	-2.5%	-5.3%	-3.7%
	1.50%	-5.7%	1.2%	-0.7%	-0.1%	-6.2%	-8.6%	-7.1%

Sources: JPMorgan, Barclays Capital, Citigroup, Bloomberg, Standard Chartered Bank
 *Duration is an approximate measure of interest rate sensitivity; LCY = local currency, HC = hard currency



Special focus: Investing for income generation (cont'd)

Another perspective on interest rate risk associated with fixed income assets can be gained using their performance during the May/June 2013 timeframe. This is the period during which Bernanke initially sketched out the Fed's expectations for reducing its asset purchases. Some of the largest losses were observed in the EM fixed income space. Under a similar scenario in 2014, a high coupon may not compensate for the large mark-to-market loss. In the G3 sovereign bond space, the mark-to-market loss might be smaller. However, the lower yield on offer means the buffer against capital loss may be insufficient. DM HY is partially shielded from the rise in yields by its above-average coupon.

High-dividend equity

Equity dividends a source of income diversification.

Given the challenges associated with generating yield through fixed income, high dividend equities offer a viable (albeit riskier) alternative to fulfilling this objective. Some of the highlights of investing in high dividend equity include:

- **Equity dividend yield comparable (or better) than current bond yield.** Bond yields have typically been above yields offered by stocks in the past. However, the current macro environment presents a situation where equity dividend yields, in many cases, are above bond yields. These yields, coupled with the potential for capital appreciation, make high dividend equity investing an attractive proposition.
- **Corporate balance sheets are in good health,** indicating the capacity for companies to pay dividends is strong. While some cash will be put to work in stock-buybacks and mergers and acquisitions, a portion of it should filter through to dividend payouts.
- **Dividend equities typically offer a lower volatility profile versus other equity,** making them more palatable for income-seeking investors.
- **Ongoing 'search for yield' implies valuation is important.** Investors should pay attention to valuations before investing in income equity. Given recent investor interest in this segment, valuations of certain regions and sectors within the dividend equity space are potentially a little rich. At the global level, the Consumer Staples and Telecom sectors are relatively expensive, both against their history as well as other sectors.

Our preferred sector, Technology, has a limited weighting in the dividend equity benchmark as it has a relatively low yield. However, the sector has excellent cash flows and should, in our view, be able to increase dividends or undertake further share buybacks.

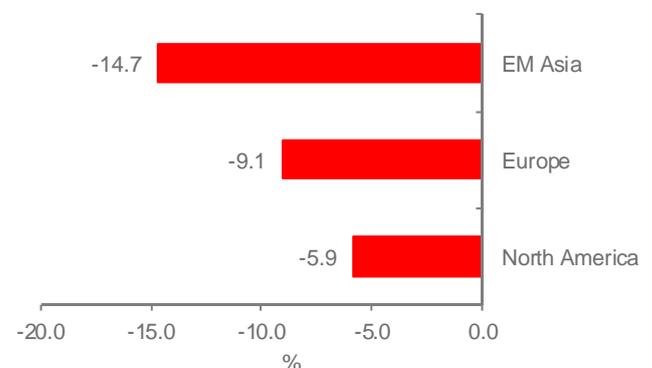
- **Yield and sustainability are equally important.** Rather than focus solely on the yield provided, investors should focus on equities that have a history of consistent dividend payments as well as the ability to sustain and grow future dividend payments. This will ensure stability in the income stream.
- **Equity dividends offer some protection against inflation.** While inflation might erode the purchasing power of low-yielding fixed income assets, equities have the capacity to provide a hedge against inflation through capital appreciation and the ability of certain companies to pass price increases on to customers. It is important to note the inflation hedge works best during periods of moderate inflation rather than periods where inflation is extremely low or high.

Equity is riskier than Fixed Income. While equity can provide a source of income, it is important to understand the risk (volatility) of the asset class isn't comparable to fixed income. Equity investing generally comes with a higher level of risk. During the same May/June 2013 timeframe referenced in our earlier discussion on fixed income, dividend equity indices fell between 6% and 15%, depending on the region. This additional risk further supports the case for building an income basket that is diversified across asset classes.

Adding a growth bias to the income allocation. While eventual tapering by the Fed should have an impact on equity returns, the improving growth outlook, particularly in DM, should be positive for equity assets in the long-term.

Figure 55: High Dividend Equity Index performance during the May/June 2013 'taper scare'

Index return from 2 May to 25 June 2013 (%)*



Sources: MSCI, Bloomberg, Standard Chartered

*Indices are MSCI North America High Divi TR, MSCI Europe High Divi TR USD, MSCI EM Asia High Divi TR USD



Special focus: Investing for income generation (cont'd)

Non-core assets

Look beyond core assets for income. Convertible bonds, REITs and Preferred Equity can offer additional sources of income while providing diversification within a multi-asset income approach.

- **Convertible bonds offer an attractive opportunity to straddle equities and bonds.** They are hybrid securities, sharing many characteristics with traditional fixed income instruments, but also containing an option to convert the bond into common stock of the underlying company. The bond-like features provide a degree of downside price support while the embedded equity option provides upside potential. There are a number of attributes of this asset class that make it attractive in today's environment, in our view:
 - Historical evidence suggests the asset class tends to outperform global bonds during periods of rising interest rates. Examples of this include the June 2003 to June 2004 and October 2010 to February 2011 periods where convertible bonds returned in excess of 12% and 10-year Treasury yields rose over 100bps.
 - Currently, convertible bonds provide high equity participation, suggesting investors can use this asset class to gain equity exposure with potentially lower risk.
 - Downside risk profile is cushioned. Should equity markets weaken, convertibles are likely to provide greater downside protection than equities, though losses will not be eliminated.

Although convertibles are not cheap on traditional valuation measures, we believe they offer a good option for investors interested in raising their equity exposure, but are not comfortable with taking on the full extent of volatility associated with a long-only position.

- **A REIT is a listed vehicle that normally invests in a collection of income-generating properties.** It gives investors access to the property market without sacrificing liquidity. REITs typically offer higher yields than equity while diversifying the income basket. A few observations regarding the various REIT markets around the globe:
 - Yields of REITs in DM continue to look attractive relative to government bond yields. However, relative to history they appear fairly priced.
 - In the Asia-Pacific region, Japanese and Australian REITs appear expensive relative to history.

- Finally, Asian REITs are likely to have the highest sensitivity to Fed tapering. From a valuation perspective, they now appear fairly priced versus being expensive previously.

Given current valuations, we wouldn't recommend an outsized position in REITs. However, relatively attractive yield suggests a small tactical position is appropriate in an income basket.

- **Preferred equity is a hybrid security offering characteristics of both stocks and bonds.** It pays a dividend, but does not grant voting rights to the holder. Within the capital structure it is subordinate to bonds, but senior to common stock in its claim to company assets. A review of this asset class suggests a neutral to cautious approach is warranted in terms of allocation:
 - Yields on preferred equity are attractive, but the asset class comes with equity-like volatility.
 - A large component of preferred equity indices is within the financial sector, leading to a concentrated bet on a single sector and potentially higher volatility.

Conclusion

The current environment is challenging for income-focused investors. Facing low yields on traditional fixed income today and the prospect of capital loss generated by rising yields in the future, investors are squeezed between a rock and a hard place. It would therefore be prudent for investors to broaden their investment universe beyond core fixed income to high dividend equity, hybrid instruments (convertibles and preferred stock) and REITs. However, a simple strategy of chasing the highest yields might result in a fairly concentrated and risky asset allocation. A diversified approach to asset selection, that balances the need for income while keeping in mind total return, should deliver the stability of yield which is much prized by this class of investor.

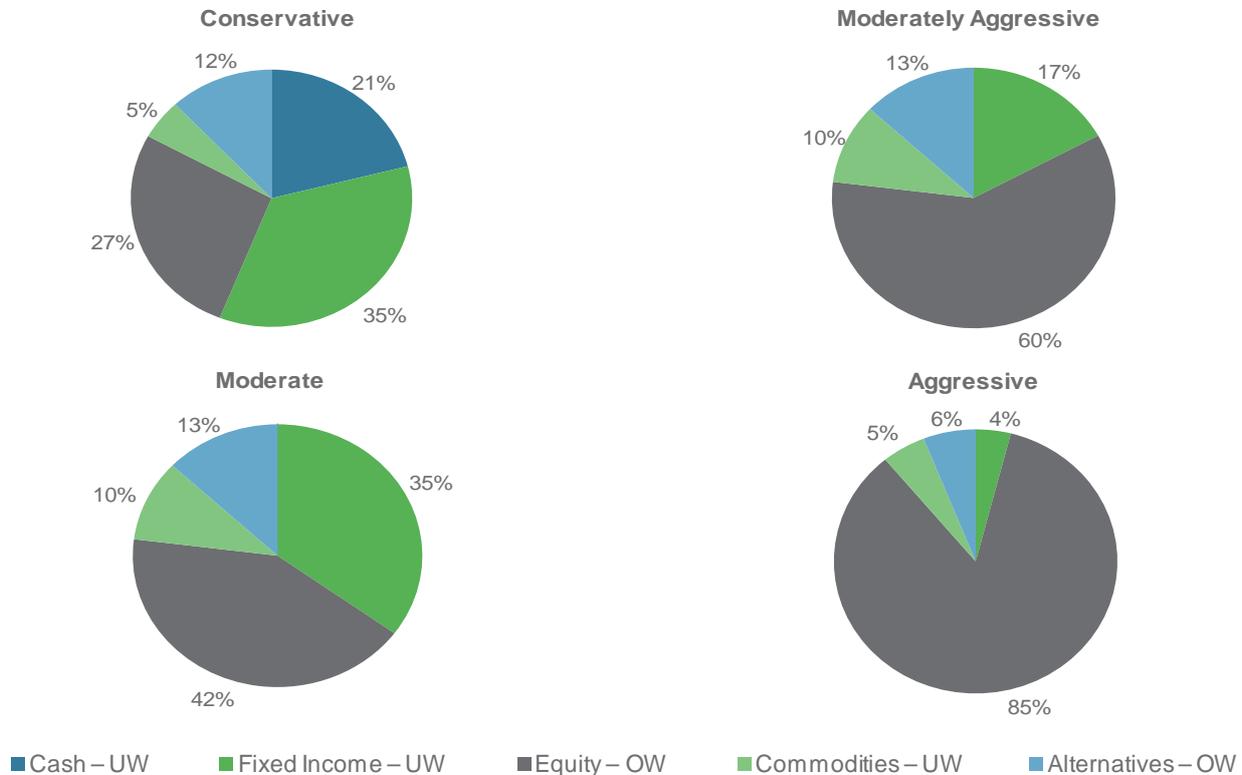
End note:

¹ Indices are MSCI North America High Divi TR, MSCI Europe High Divi USD, SPDR Barclays convertible ETF, FTSE Europe REITs TR US, Barclays Global high yield TR USD, JACI Non-IG Corp, MSCI EM Asia High Divi TR USD, Citigroup WBIG Corp USD, FTSE North America REITs TR, IShares preferred stock ETF, FTSE Asia REITs TR USD, Citigroup WBIG Sovereigns, JPMorgan EMBI HY, BarCap Asian Local Currency TR unh USD, JPMorgan EMBI IG

² Indices are Barclays Global HY TR unh USD, JPMorgan EMBI HY, Citigroup WBIG Corp USD, JPMorgan EMBI IG, Citigroup WBIG Sovereigns, Citigroup WBIG 1-5y USD, Citigroup WBIG 20+y USD, MSCI North America High Divi TR, MSCI Europe High Divi USD, MSCI EM Asia High Divi TR, SPDR Barclays convertible ETF, FTSE NAREIT global index TR USD, IShares preferred stock ETF

Asset allocation summary

| Aditya Monappa, CFA |



	Conservative	Moderate	Moderately Aggressive	Aggressive
Cash – UW	21	0	0	0
Fixed Income – UW	35	35	17	4
Equity – OW	27	42	60	85
Commodities – UW	5	10	10	5
Alternatives – OW	12	13	13	6

Asset Class	Region	View vs. SAA	Conservative	Moderate	Moderately Aggressive	Aggressive
Cash & Cash Equivalents	USD Cash	UW	21	0	0	0
Investment Grade	IG Developed World	UW	24	15	0	0
	IG Emerging World	UW	4	9	3	0
High Yield	HY Developed World	OW	2	6	6	2
	HY Emerging World	N	5	5	8	2
Developed Market Equity	North America	OW	8	12	17	23
	Europe	OW	9	12	17	25
	Japan	N	0	2	2	3
	Asia ex-Japan	UW	8	13	20	27
Emerging Market Equity	Other EM	UW	2	3	4	7
Commodities	Commodities	N	5	10	10	5
Hedge FoF/CTAs		OW	12	13	13	6

All figures in percentages

For illustrative purposes only. Please refer to the Important Information section at the end of this document for more details.

Source: Standard Chartered Bank



Consensus forecasts

Real GDP (% y/y)	Consensus Forecasts			
	2013E	Our Bias	2014E	Our Bias
US	1.70	→	2.60	→
Euro area	-0.40	→	1.00	↗
Japan	1.80	→	1.50	→
China	7.60	→	7.50	→

Inflation (% y/y)	2013E	Our Bias	2014E	Our Bias
US	1.50	↘	1.90	↘
Euro area	1.40	↘	1.30	↓
Japan	0.30	↘	2.40	↗
China	2.70	→	3.20	→

Policy rate (%)	1H 2014	Our Bias	2H 2014	Our Bias
US	0-0.25	→	0-0.25	→
Euro area	0.25	→	0.25	→
Japan	0.10	→	0.10	→
China	6.00	→	6.00	→

FX	1H 2014	Our Bias	2H 2014	Our Bias
EUR/USD	1.30	↘	1.28	↘
GBP/USD	1.58	↗	1.58	↗
USD/CHF	0.96	↗	0.99	↗
AUD/USD	0.89	↘	0.89	↘
NZD/USD	0.80	↘	0.80	↘
USD/CAD	1.07	→	1.08	→
USD/JPY	104	→	108	→
USD/CNY	6.05	→	6.01	→
USD/SGD	1.26	→	1.25	→
USD/INR	63.0	↗	62.0	↗
USD/IDR	11750	↗	11645	↗
USD/BRL	2.32	↗	2.35	↗
USD/TRY	2.06	↗	2.05	↗

Legend

↗ Significantly higher bias; ↗ Moderately higher bias; → No strong bias; ↘ Moderately lower bias; ↓ Significantly lower bias

Source: Bloomberg, Standard Chartered Bank



2014 key events

Month	Country/Region	Event
Dec 13-Jan 14	U.S.	Presidential fast-track trade authority to be re-authorized
January-March	Egypt	General election
January	Japan	Ordinary Diet session begins
January	U.S.	FOMC meeting
March	Turkey	Local elections
March	France	Municipal elections
March	U.S.	FOMC meeting
April-May	Japan	Annual wage negotiations between labour unions and employers
April-July	South Africa	Parliamentary elections and provincial elections
April	Japan	VAT increase from 5% to 8%
April	Indonesia	Parliamentary elections
April	U.S.	FOMC meeting
May	India	Parliamentary elections
May	Iran	Expiry of interim nuclear agreement
May-August	U.S.	Important Republican primary elections
May	Portugal	IMF/euro area programme expires
May	EU	EU parliamentary elections
June	OPEC	OPEC meeting
June (17-18)	U.S.	FOMC meeting
July	Indonesia	Presidential election
July (29-30)	U.S.	FOMC meeting
August	Turkey	Presidential election
September (16-17)	U.S.	FOMC meeting
September	Scotland	Secession referendum
October	EU	Asset Quality Review (AQR) deadline
October	Brazil	General election
October (28-29)	U.S.	FOMC meeting
November	U.S.	Mid-term election
Dec (16-17)	U.S.	FOMC meeting

Source: Bank Credit Analyst, Bloomberg, Standard Chartered Bank



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