Global Market Outlook macro strategy | 31 August 2015

This reflects the views of the Wealth Management Group

Standard Chartered

Short-term risks vs. medium-term drivers

- **Medium-term supportive drivers remain intact, but signs of market exhaustion are increasing.**
- Continued economic growth and ample liquidity remains positive for global equities over the next 12-24 months, in our opinion.
- However, there are some signs of exhaustion, particularly in the US, which may further extend the short-term pullback.

Looking back…

Markets were range-bound for much of the past month, but recently came under renewed pressure on increased China, Greece concerns and the prospect of a Fed hike. We previously highlighted Greece, volatility in the Chinese market and the first US Fed rate hike as three key risks. The Greek crisis re-appeared on investors' radar screens following the announcement of new elections. China's decision to change its FX policy removed another anchor of stability. However, the above factors have, at the margin, reduced the likelihood of a September rate hike.

Looking forward…

The end of the equity bull market is not in sight. The economic recovery is continuing, and there are few reasons to expect this to reverse. Meanwhile, global liquidity is expected to remain very loose. These factors are likely to support global equities over the coming 12-18 months. (*See pages 4-5*)

However, when our Group Investment Council met earlier this week, we noted many short-term concerns facing equities (see table on right). High fund manager cash holdings should help limit any such equity market weakness. (*See pages 7-9*)

Against this backdrop, we retain our positive outlook on global equities over the coming 12 months and retain our preference for Euro area and Japanese equities on a currency-hedged basis. Use volatility to your advantage by averaging into equities (see table below for key support levels for different markets). Within Asia, we maintain our preference for China's HK-listed H-shares. We have also become more positive on Indian equities. (*See pages 7-9*)

Favour USD and INR bonds. Within Asian fixed income, we retain our preference for INR bonds, having cut our CNY bond theme three weeks ago, just before significant CNY weakness. Within USD bonds, we have become less concerned about the risks of a short-term spike in yields and prefer EM Investment Grade (IG) sovereign bonds, as well as US High Yield (HY) bonds. (*See page 6*)

Contents

US equities facing elevated short-term risks

Check list of short-term US equity market risks

Market Indicators	
17x forward multiple for S&P500	1/2
Domestic outperforming global	X
Defensives outperforming cyclicals	X
Credit sensitivities	1/2
Declining breath	X
Flattening yield curve	1/2
Global Indicators	
Slowing global growth	1/2
Rising EM credit risk	X
Significant USD strength	X
International contagion into the US	
Domestic Indicators	
Fading employment momentum	
Stalled housing recovery	
Policy wildcard	
Inflation/deflation scare	1/2

Source: BCA, Standard Chartered

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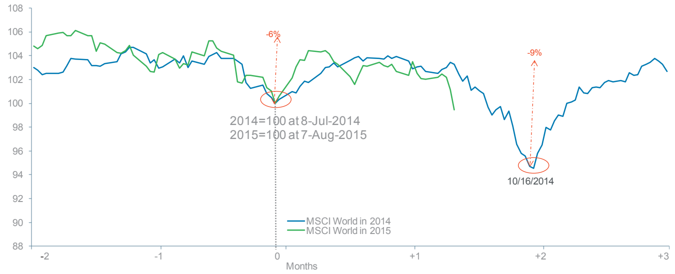
Global equities in a seasonally soft period

Global equity markets performance this year vs. last year
Indexed to 100 on indicated dates. 2015 index lagged by one month



Source: Bloomberg, Standard Chartered

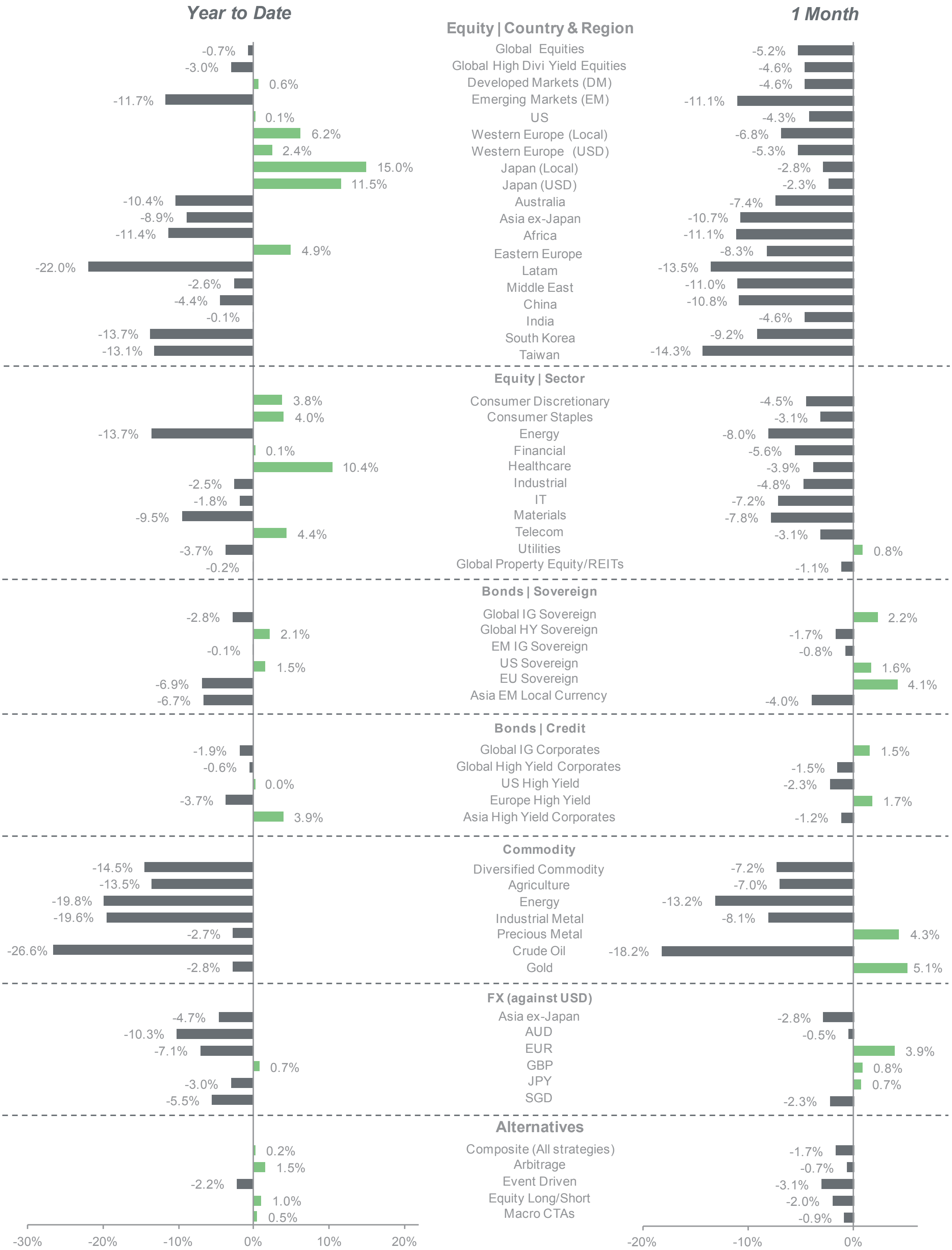
Major equity markets not far from technical support levels

Major market technical levels, % from current levels

Asset class	Secondary support	Primary support	Spot	Primary Resistance	Secondary resistance
S&P500	-2.4%	-0.8%	2036	1.5%	3.1%
EuroStoxx Index	-4.9%	-2.1%	3353	2.1%	4.7%
Nikkei	-3.6%	-1.9%	19613	2.0%	4.0%
MSCI Asia ex-Japan	-5.1%	-1.9%	504.54	3.3%	6.4%
MSCI China	-6.3%	-2.2%	61.88	2.8%	5.9%
MSCI India	-3.6%	-1.9%	490.53	2.3%	4.8%

Source: Reuters, Standard Chartered

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



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

**YTD performance data from 31 December 2014 to 20 August 2015 and 1-month performance from 20 July to 20 August 2015*

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

Investment Strategy

- **Financial markets appear to be facing renewed concerns despite their earlier 6.5% correction over the summer.**
- **We do not see short-term concerns detracting from our long-term preference for Euro area and Japanese equities (FX-hedged), a situation not too dissimilar to last year. Instead, we would take advantage of recent volatility to gradually average into our preferred markets. Investors concerned about the risk of short-term US equity market weakness could also consider taking exposure via US High Yield (HY), which has already corrected significantly.**
- **We do not expect China's CNY policy shift to be the start of significant CNY devaluation, though moderate weakness, in line with the last 12 months, is possible.**

Equity market concerns appear to have persisted. Last month, we indicated that the outlook for global equities was likely to improve following its 6.5% correction over the summer. However, US equities, in particular, appear to face renewed concerns heading into a Fed rate hike as many indicators of short-term market stress remain elevated.

US HY offers one alternative for US equity investors, but maintain long-term focus on Euro area and Japanese equities. History suggests equity market volatility related to a Fed lift-off tends to be temporary in nature. However, US HY offers an interesting alternative to obtain similar exposure at this point in time, given its high correlation to equities and the fact that it has already weakened considerably.

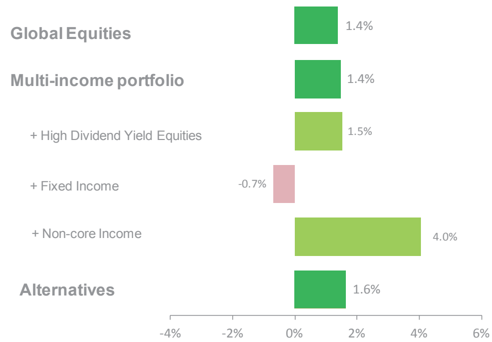
Modest CNY weakness expected. The desire to meet IMF Special Drawing Rights (SDR) inclusion requirements appears to have been the key driver behind China's FX policy shift. We would not be surprised to see further mild weakness, but if anything, this supports our positive view on the USD.

Implications for investors:

- **Maintain long-term focus on Euro area and Japanese equities (FX-hedged).** We do not see short-term concerns in the US derailing our long-term focus on these attractive markets. However, we would keep FX-hedges in place ahead of a Fed rate hike. In Asia, we would add to Indian equities given their historically lower propensity to weaken ahead of Fed rate hikes.
- **Take advantage of recent volatility by gradually averaging into our preferred equity markets.** We also believe US HY offers an interesting alternative to US equities given they have already corrected significantly. Last year provides a good roadmap.
- **The USD outlook remains positive.** We continue to expect the USD to be the prime beneficiary of a Fed rate hike through higher short-term yields. China's CNY policy shift only adds to this outlook. This adds to negative pressure on commodities.

W.I.D.E.N. themes have held up well YTD

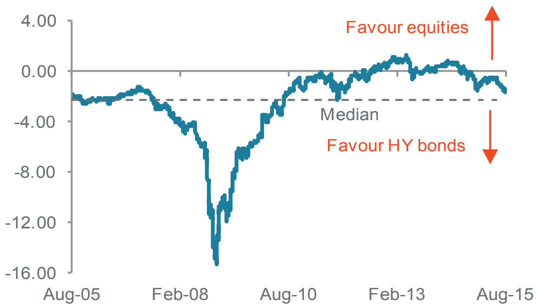
*W.I.D.E.N. performance since Outlook 2015 publication**



** For the period 12 December 2014 to 20 Aug 2015*
Source: Bloomberg, Standard Chartered
** Income basket is as described in the Outlook 2015: A Year to W.I.D.E.N. Investment Horizons, Figure 60*

US HY yields increasingly attractive relative to equities, but only just

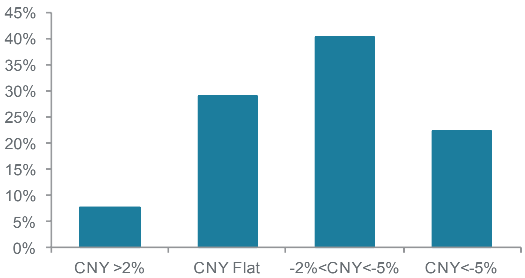
US equities earnings yield – US HY yield



Source: Bloomberg, Standard Chartered

Modest CNY weakness expected

GIC expectations of CNY gains or losses against the USD over the next one year (% probability)*



**Standard Chartered Group Investment Council*
Source: Bloomberg, Standard Chartered

Asset Class	Relative Outlook	Start Date
Cash	UW	Feb-12
Fixed Income	UW	Jan-11
Equity	OW	Aug-12
Commodities	UW	Dec-14
Alternatives	OW	Jun-13

Legend
Start Date - Date at which this tactical stance was initiated
OW - Overweight N - Neutral UW - Underweight
DM - Developed Markets
EM - Emerging Markets

Source: Standard Chartered

	Sub-asset Class	Relative Outlook	Start Date
Cash		UW	Feb-12
Fixed Income	DM IG	UW	Jan-11
	EM IG	OW	Dec-14
	DM HY	OW↑	Aug-15
	EM HY	N	Dec-14
Equity	US	N	Feb-15
	Euro area	OW*	Jul-13
	UK	UW↓	Aug-15
	Japan	OW*	Nov-14
	Asia ex-Japan	N	Jul-15
	Other EM	UW	Aug-12
Commodities		UW	Dec-14
Alternatives		OW	Jun-13

**Currency-hedged*

Economic and policy outlook

The US economy extended its recovery into July on the back of a robust job and housing markets, although low inflation and external risks mean the pace of hikes is likely to be gradual. Euro area uncertainty returned with Greece holding snap elections. Low inflation and headwind from China implies continued ECB easing. Japan's economy contracted in Q2 on weak domestic consumption, but strong machinery orders suggest a recovery is likely in H2. China slowed further, building the case for more policy easing.

- **US recovery turns focus on the September Fed meeting**. A robust job market helped sustain domestic consumption and support the housing market in July. We believe this would provide the Fed ample reason to start raising rates this year, although external risks could delay the start to December. Subsequent rate hikes are likely to be very gradual as inflation remained subdued.
- **Greek uncertainty, China headwind imply continued ECB stimulus**. Business and investor confidence held up reasonably well through the Greek debt impasse. However, the announcement of fresh Greek elections has revived uncertainty. Moreover, low inflation and headwinds from China suggest the ECB will continue with its record-easing plan well into 2016.
- **Japan business spending may revive economy after a Q2 slump**. The economy contracted in Q2 due to weak private consumption and slow export growth, especially to China. However, strong machinery orders point to a pick-up in business spending in H2. Still-low inflation and weakness in China and other export markets imply continued BoJ easing at the current record pace.
- **China's continued slowdown to hurt Emerging Markets (EM), trigger further policy easing**. Major indicators pointed to a further slowdown in July. The slowdown has dragged commodity prices to multi-year lows, hurting key EMs. We expect further easing of rates and bank reserve requirements in China, with chances of fiscal stimulus, aiming to stabilise growth close to 7%.

US: Strong job market sets the stage for a rate hike this year

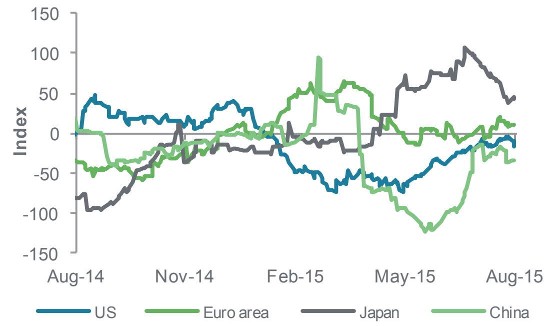
- **Economy driven by consumption, housing recovery**. The US economy expanded 2.3% in Q2, after an upwardly revised 0.6% growth in Q1, aided by a robust job market, especially in the services sector. Housing provided another boost, with housing starts and existing homes sales rising to their highest since 2007.
- **Strong payrolls likely to sustain a recovery**. US employers created 215,000 net new jobs in July, following upwardly revised 231,000 jobs in June. Job openings remained close to a record high, suggesting a strong pipeline in H2. The strong job market is helping sales of big-ticket items (auto sales rose to a 9-year high) and boosting services sector confidence (10-year high). This is helping offset weak manufacturing hurt by the USD's strength.
- **Sustained upturn provides the Fed the base to start raising rates**. The steady recovery has helped cut unemployment to a seven-year low of 5.3%. This, and the broad-based gains in the services and housing markets, is likely to provide ample support for the Fed to start raising rates this year. However, external risks, subdued wage growth and low inflation could delay the start to December. Also, the pace of hikes is likely to be gradual.

Euro area: Greece, China uncertainty suggest continued ECB boost

- **Euro area economy holding up well despite Greek impasse**. Before Thursday's announcement of snaps polls in Greece, Euro area investor confidence had held near an eight-year high while economic growth expectations recovered after falling for three months.

Japan and Euro area data continue to surprise positively, while China data rolled over

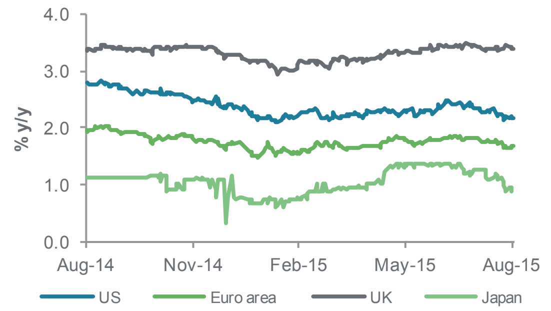
Citigroup economic surprises index for major economies



Source: Citigroup, Bloomberg, Standard Chartered

Long-term inflation expectations have declined across major economies over the past month

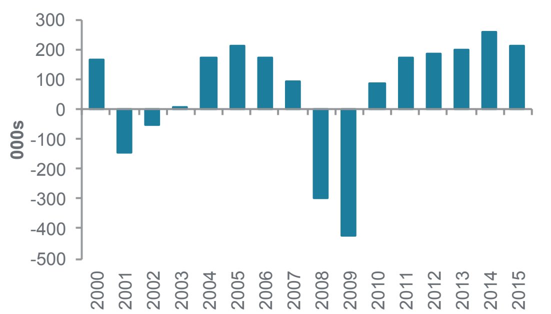
Market expectations of long-term inflation (%, y/y)



Source: Bloomberg, Standard Chartered

US average monthly job creation this year has been the second highest since 2000

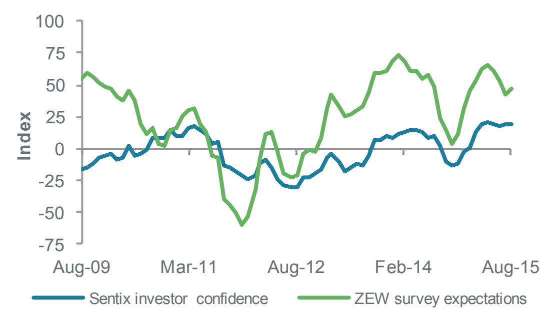
US average monthly net non-farm payrolls ('000s)



Source: Bloomberg, Standard Chartered

Euro area investor confidence held near an eight-year high while economic growth expectations recovered

Sentix Investor Confidence Index and ZEW survey expectations for economic growth



Source: Bloomberg, Standard Chartered

- **Greek elections revive uncertainty**. Euro area growth slowed to 0.3% in Q2 from 0.4% in Q1, partly due to the Greek uncertainty. The Greek election prolongs the uncertainty into Q3. However, low energy and borrowing costs and the weak EUR are helping European exporters offset headwinds from Greece and China. Euro area trade surplus rose in June close to a record high.
- **Low inflation, headwinds mean prolonged ECB easing**. Euro area inflation (0.2%) remained well below the ECB's 2% target and producer price deflation accelerated, partly due to falling commodity prices. The renewed Greek uncertainty, subdued inflation and the slowdown in external demand imply the ECB is likely to continue the pace of its bond buying well into 2016.

UK: Low unemployment, rising wages build case for a BoE hike

- **Core inflation rises to a five-month high in July**. The measure, which excludes volatile food and energy prices, jumped to 1.2%, from 0.8% in June. A key driver is rising wages, caused by a tighter job market, as unemployment remains close to its lowest since 2008. Although headline inflation at 0.1% remains well below the BoE's 2% target, policymakers expect it to rise as the effect of commodity price declines fade by the end of the year.
- **Wage pressures mean the BoE may follow the Fed in hiking rates**. The build-up of wage pressures is likely to prepare the ground for the BoE to raise rates early next year. BoE monetary policymaker Kristin Forbes said waiting too long to hike raises 'would risk undermining the recovery' if rates have to be eventually raised at a faster pace.

Japan: Business spending likely to revive growth after Q2 slump

- **Strong machinery orders herald a pick-up in business spending**. Machinery orders in Q2 rose to their highest since 2008, pointing to a pick-up in business investment in the coming months. This, combined with lower commodity prices and a weak JPY, should help revive the economy after slowing private consumption and exports led to a 1.6% economic contraction in Q2.
- **Low inflation, China headwinds mean sustained BoJ easing**. Headline consumer inflation fell in June to a two-year low of 0.4% while China's slowdown led to a deceleration in Japan's export growth in July. As a result, we expect the BoJ to maintain its record pace of monetary easing well into next year.

China: Further slowdown hurts EMs, implies more policy easing

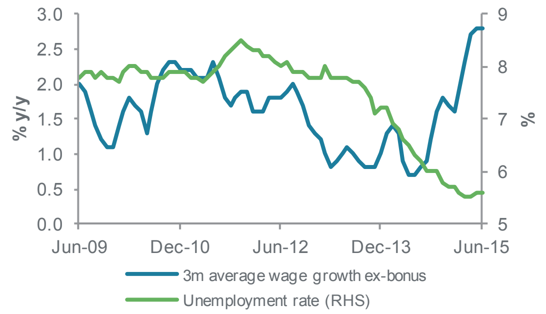
- **Indicators point to a continued slowdown**. Growth in fixed asset investment, industrial production and retail sales fell to multi-year lows in July while new bank lending to the real economy halved. Exports contracted for the fifth month since January while a private manufacturing sector index showed continued contraction.
- **Weak data suggests more policy easing is likely**. We expect further cuts in interest rates, bank reserve requirements and more targeted lending, with the aim to stabilise growth close to the 7% target. Asia and other EMs, especially in Latin America, which have been hurt by the slowdown in China and further declines in commodity prices, are likely to benefit from such stimulus.

Other EMs: Indian inflation drops, raising rate cut expectations

- **Near-normal monsoon revives rate cut hopes**. India's consumer inflation fell to an eight-month low of 3.8% in July helped by slowing food inflation, while producer price deflation worsened. With exports contracting for the eighth month in a row, government officials called for the central bank to cut rates. However, RBI Governor Raghuram Rajan expects inflation to rebound close to the upper end of RBI's 6% target by next year, raising hurdles for the central bank to cut.

UK unemployment held near a seven-year low, driving wages higher

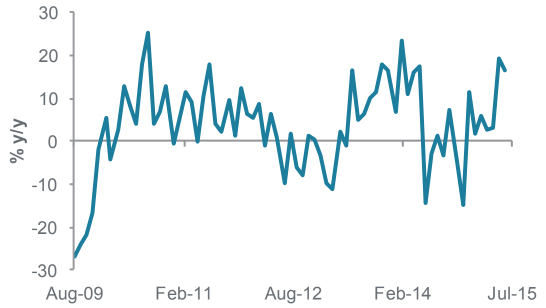
UK three-month average wage growth, ex-bonus (%, y/y); unemployment rate (%) (RHS)



Source: Bloomberg, Standard Chartered

Japan's machinery orders in Q2 rose to a seven-year high, suggesting a pick-up in business investment in H2

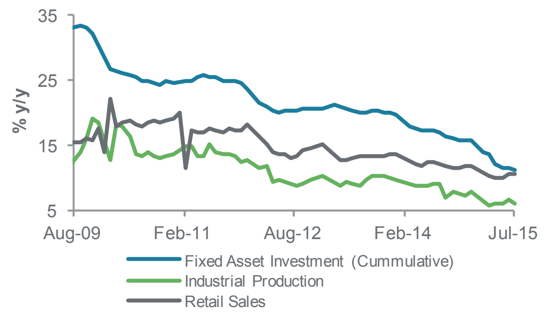
Japan machinery orders (%, y/y)



Source: Bloomberg, Standard Chartered

China's key economic indicators continued to weaken in July, raising the chances of more stimulus

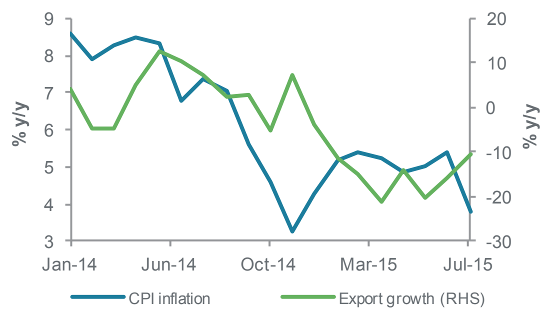
Growth in China's fixed income investment (cumulative YTD), industrial production, retail sales (%, y/y)



Source: Bloomberg, Standard Chartered

India's inflation dipped in July, while exports continued to contract, raising rate cut expectations

India's CPI, exports (%, y/y) (RHS)



Source: Bloomberg, Standard Chartered

Bonds – Underweight

- We increasingly favour US High Yield (HY) bonds relative to other regions, given their increasingly attractive yields. Our positive view on USD Emerging Market (EM) Investment Grade (IG) sovereign bonds remains unchanged.
- We prefer INR bonds within the local currency universe. Our decision to take profits on CNY and CNH bonds ahead of China's policy move was timed well.

G3 and EM (USD) sovereign bonds

- **Lower inflation worries help offset Fed concerns.** A Fed rate hike has been an over-arching risk in fixed income investors' minds. However, it may surprise many that the benchmark 10-year yield has stayed almost flat from the start of the year. The missing link is inflation expectations; weaker commodity prices and slower-than-expected wage growth have led to lower inflation expectations, which has helped cap long-term yields. We continue to believe long-term yields will gradually trend higher.
- However, we would not lose sight of the risk that short-term yields could still rise sharply following an initial Fed rate hike. Hence, we continue to prefer moderate maturity profiles (averaging five years) across USD bond allocations.
- **We continue to like EM government bonds, strongly preferring the IG component.** While Brazil and commodity prices have been a concern, we believe many risks are already reflected in the price. The HY component has substantial commodity price risk, and we would be far more selective there.

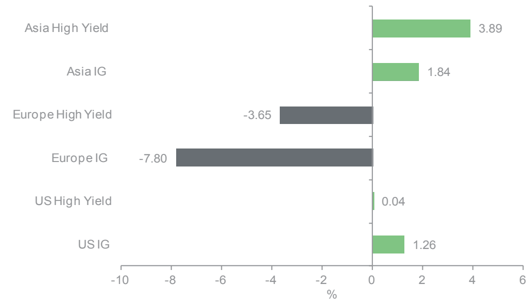
Corporate credit (USD)

- **Favour US HY within HY bonds.** US HY bonds have cheapened over the past few months due to concerns around energy and mining sector bonds. However, we believe market concerns are becoming somewhat excessive. While we are not ignoring the credit quality deterioration, we believe the high carry on offer and the tailwind from a stronger US economy mean US HY offers an increasingly favourable risk-reward, both relative to history, as well as relative to other regions within the HY bond universe.
- **Limited impact of CNY weakness on Asian USD credit.** We believe that the ensuing CNY weakness should have a limited credit impact on Chinese issuers (and, therefore, Asian credit, given the market's disproportionate China exposure). In our opinion, the IG segment should comfortably be able to absorb the impact given its stronger credit profile. We also note that the HY sector should incrementally benefit from the lower cost onshore bond issuance, which can help offset the currency impact to a significant extent given offshore (non-CNY) bonds account for approximately 40% of total debt.

Asian local currency bonds

- **We continue to favour INR bonds**. We remain comfortable with INR, expecting it to remain resilient relative to other Asian currencies, and believe the monsoon season so far gives us greater comfort that food inflation should remain contained. This increases the probability of policy rate cuts, which combined with already attractive yields, make INR bonds compelling.
- **Our decision to close our positive view on CNY and CNH bonds was well-timed**. We took profit about two weeks ahead of China's currency policy shift. (*See Weekly Market View, 31 July*) Consistent with this view, we reduce our allocation to CNY bonds in our multi-income allocation and raise exposure to US HY bonds to compensate.

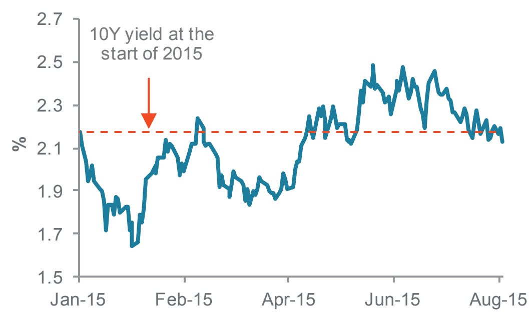
Performance of fixed income YTD* (USD)



** For the period 31 December 2014 to 20 August 2015*
Source: Barclays Capital, JPMorgan, Bloomberg, Standard Chartered. Indices are Barclays Capital US Agg, US High Yield, Euro Agg, Pan-Euro High Yield, JPMorgan Asia Credit Index

US Treasury yields have been roughly flat in 2015

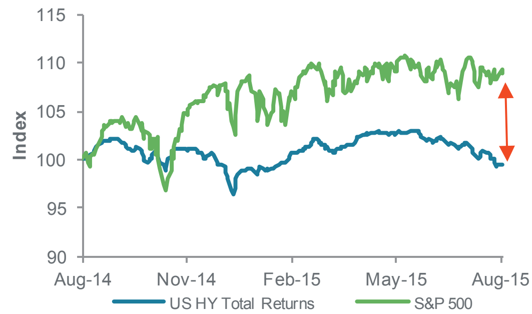
10-year US Treasury yields



Source: Bloomberg, Standard Chartered

Recent divergence between US HY and S&P increases attractiveness of US HY

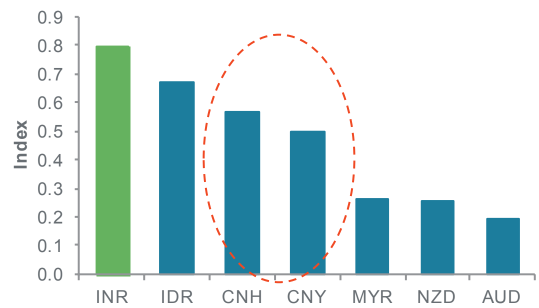
Relative performance of US HY and S&P 500. Normalised to 100 as on 1 August 2014



Source: Barclays, Bloomberg, Standard Chartered

Risk-reward has turned less favourable for CNY and CNH bonds; we favour INR bonds

Higher currency volatility reduces the volatility adjusted returns (yield - implied vol) on CNY and CNH bonds



Source: Bloomberg, Standard Chartered

Equity – Overweight

- Our key equity views are unchanged over the next 12 months. We remain bullish on the Euro area and Japan on an FX-hedged basis and constructive on the US and Asia ex-Japan. Nevertheless, we concede that increasing our conviction towards Asia ex-Japan last month may have been premature. At the country level, we have turned more bullish on India and less constructive on the UK.
- The primary source of market volatility over the past month has been China and its decision to allow the CNY to weaken. Global equities have fallen 5% over this period. Reflecting a 11% drop in Emerging Markets, a 7% drop in Europe and a 4% drop in US equity markets.
- Q2 corporate earnings in the US have been better than expected. However, EPS growth of a mere 1% highlights the damage caused by the USD's strength and lower oil prices. Conversely in Europe, a weak EUR boosted Q2 EPS growth, which is up 8%.

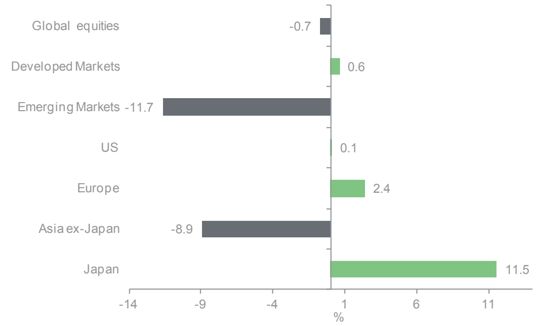
US – Rising risks 12 months

- We are positive on the outlook for US stocks. However, we note that as the bull market matures, the risk of significant correction increases, particularly at a time when we have not witnessed a 10% correction for almost 1,000 days, the third-longest rally without a 10% correction since 1932.
- The equity checklist opposite highlights six factors for investors to monitor for signs of stress in the US equity market. Currently, three of the six are flashing red, three amber and none are signalling green. As a rule of thumb, risk is at the highest when all six factors flash red. We are closely monitoring the following factors:
  1. Market P/E rising above 17x forward earnings, potentially signalling overvalued equity markets.
  2. Outperformance of the investment banking sector, signalling increasing excess in the financial system.
  3. Flattening of the yield curve, signalling downside risks to growth.
- A red flag on one of these factors is a cause for concern as opposed to signalling an impending correction in the market. Nevertheless, if all indicators are flashing red, we would review our current positive stance towards US equities. In the near term, we are monitoring the yield curve for any signs of further flattening, which would be a red flag for investors.

Europe – Remain bullish on the Euro area, cut exposure to the UK

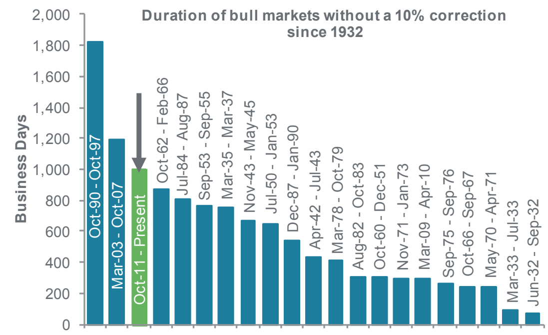
- European equities have been weak over the past month, but the DJ Euro Stoxx remains the second-best performing region/country in our universe during 2015, rising 9%.
- Their solid performance has been helped by the weak EUR, which contributed to an 8% increase in Q2 earnings. European banks, which account for a fifth of the index, have also been performing well, as lending conditions normalise and demand for credit recovers.
- We have become more cautious about the outlook for UK equities. Earnings growth in the UK was a mere 2% in Q2 as the large weight of commodities in the index weighed on corporate earnings. Materials and energy account for 33% of the MSCI UK index, and the weakness in commodities, such as oil and iron, has dragged down earnings significantly.
- Within Europe, we now have a clear preference for Euro area equities on a currency–hedged basis, where we are bullish.

Performance of equity markets YTD* (USD) update



** For the period 31 December 2014 to 20 August 2015*
Source: Bloomberg, Standard Chartered. MSCI Indices are USD total return

Third-longest US rally without a 10% correction
Length of time US equities rallied without a 10% correction



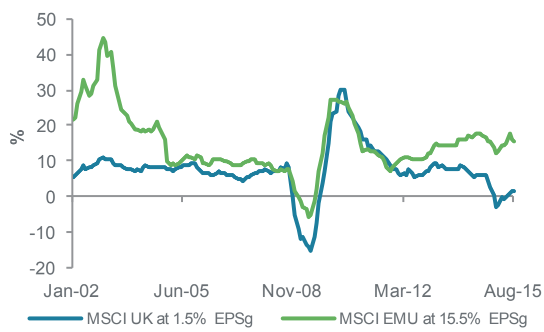
Source: FactSet, Standard Chartered

Three reds, three amber lights for US equity markets
US equity market checklist

Market Indicators	
17x forward multiple (S&P500 ~ 2,080)	1/2
Domestic outperforming global	X
Defensives outperforming cyclicals	X
Credit sensitives	1/2
Declining breadth	X
Flattening yield curve	1/2

Source: BCA, Standard Chartered

Euro area earnings growth faster
DJ Stoxx and MSCI UK earnings growth



Source: Bloomberg, Standard Chartered

Japan – Remain bullish supported by corporate earnings

- We remain bullish on Japanese equities, with the market posting a healthy 15% gain YTD. Similar to Europe, Japanese equity markets have been boosted by solid corporate earnings growth aided by a weak currency. Latest estimates for the Q2 period highlight a Japanese hit/miss ratio of 1.6, whereas in Asia, the ratio is <1, implying more companies missed earnings estimates relative to those who exceeded them.
- The Toshiba accounting scandal is a clear blemish on Japan Inc. Nevertheless, we do not believe it is systemic or specific to Japanese companies, noting that accounting scandals have also happened in America (Enron in 2001) and Europe (Parmalat in 2003).

Grouping Emerging Markets by risk factors

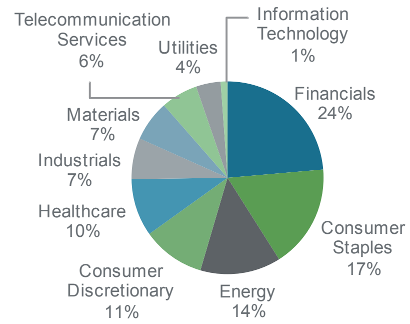
- Two main risks for EMs stand out in the coming months: the impact of higher US interest rates and the slowdown in China. The chart opposite is a stylised grouping of EMs into different categories based on an assessment of exposure to three different factors.
  - Markets primarily exposed to a Fed rate hike: Malaysia, Indonesia, Thailand, Philippines and Turkey.
  - Those exposed to China /commodities: Brazil, South Africa, Russia and Chile.
  - Exposure to Developed Markets (DM): Korea, Taiwan and Mexico
- China and India tend to be driven by domestic factors. Since 2012, markets with exposure to China/Commodities have performed the worst based on this grouping, falling 30%, those exposed to the Fed have been flat, while those exposed to DMs have risen 10%. India is up 40%, China up 20%.
- Looking ahead, despite the uncertainty, for investors with exposure to other EMs, now may not be the appropriate time to cut exposure to the China/Commodity grouping. This view is based on the view that the risk of a significant policy response by the Chinese government has been high when lead indicators for growth, such as the Li Keqiang index, weaken significantly. (See chart)
- Markets exposed to the Fed factor have been under significant stress recently and are likely to continue to struggle as we approach the first rate hike by the Fed. Nevertheless, we expect the pace of future Fed rate hikes to be slow compared with prior cycles, which should dampen the negative effect of the hiking cycle on these markets.

Equity market implications of China's decision to weaken the CNY

- The biggest event in equity markets over the past month has come from foreign exchange movements. The 2.7% depreciation on the CNY on 11 August and 12 August has shaken investor faith in China's role as a provider of stability in the region.
- We view the move as specifically related to the inclusion of the CNY in the IMF's Special Drawing Rights (SDR) basket, as opposed to a move to increase the competitiveness of exports. Nevertheless, it is worth noting that USD/CNY has depreciated 5% over the last two years, a trend which we expect to continue.
- The key equity market implications of this centre on a negative translation effect on earnings for H-shares listed in Hong Kong and higher CNY liability of foreign currency debt. The latter is particularly relevant for Chinese real estate companies that have raised foreign currency debt in recent years. Nevertheless, a change in regulation in January allowed them to issue local currency debt, which has helped mitigate this concern.

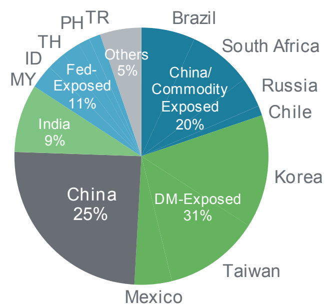
UK market has one-third weighting in energy and materials

MSCI UK sector breakdown



Source: Standard Chartered

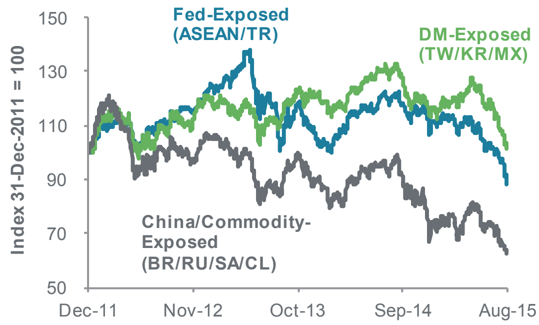
Classifying EMs according to factors



Source: FactSet, Standard Chartered

China/Commodities exposed markets have fallen significantly since 2012

Performance of different factor groupings since 2001



Source: Bloomberg, Standard Chartered

Chinese economic activity index remains weak

Li Keqiang Index

Source: Bloomberg, Standard Chartered

Asia ex-Japan, 12-month view unchanged

- Our decision to turn more constructive on Asia last month was premature, given the subsequent 8% decline in the index. Nevertheless, we continue to believe that while markets have been undermined by developments in China, a constructive view is warranted on a 12-month basis.
- Over the next 12 months, concerns about the Fed rate hike are likely to recede and global growth should witness incremental improvement, boosting those markets dependent on DMs for exports, including Taiwan and Korea.
- We remain positive on Chinese equity markets, with a clear preference for H-shares listed offshore in Hong Kong as opposed to A-shares listed onshore. Over the past month, we have witnessed H-shares outperform A-shares, although we concede that in absolute terms both have declined.
- Our optimism towards H-shares has been hit over the past month, driven in part by the negative translation effects of profits generated in CNY, but recorded in HKD. We also note the negative effect of the decline in the CNY on foreign currency debt in China. Our decision to remain overweight China is driven by our expectation of a policy response to support growth via cuts in interest rates or reserve requirements. The PBOC's decision on August 20th to inject CNY150m via reverse repurchase agreements reflects an intention to not stand by as growth weakens.

India – Positive on the outlook, but could be choppy short-term

We have become more bullish on India, reversing a decision made three months ago.

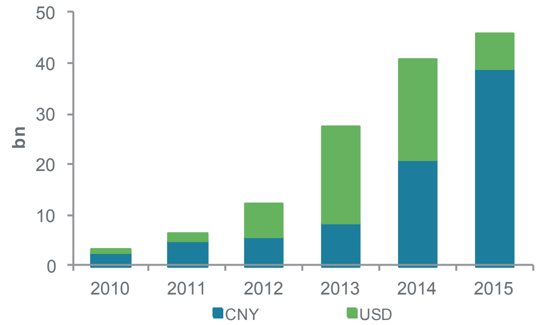
- Factors driving our optimistic stance on India centre on three drivers that we cited before as risks, but have since turned positive:
  1. Signs of progress in Prime Minister Modi's 'Make in India' drive. Foxconn announced plans over the past month for a USD 5bn investment in Maharashtra, with plans for as many as 12 factories across India.
  2. Falling inflationary pressures. A positive monsoon season with rain less than 8% 'below normal'. This reduces the risk of a spike in food price inflation. An additional factor helping to ease inflationary pressures is the continued decline in energy prices. Taken together, there is increased probability of rate cuts by the RBI in the months ahead.
  3. Resilient earnings growth: EPSg has been steady in recent months with a 16% 12-month forward EPSg; this is better than our earlier expectations.
- An additional factor supporting our more bullish view on India is its tendency to do well when Chinese equity markets are struggling and vice versa. This provides a good hedge for investors who are invested in China, where we are also bullish, but acknowledge the short-term risks.

Conclusion

Our optimism towards DM equities remains intact, believing that the bull market still has 12-24 months to run before the risk-reward may turn unattractive. Our positive stance towards India can provide investors with a hedge against China and the Fed, noting that the Indian market is less correlated to these two factors.

Outstanding foreign currency debt issued by Chinese real estate companies has fallen

Chinese real estate local and foreign currency debt outstanding



Source: FactSet, Standard Chartered

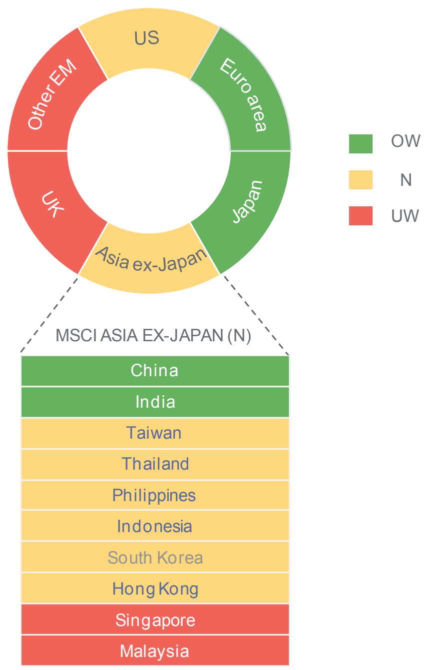
During times of stress India outperforms China and vice versa

India and China equity performance trend since 2012

Source: BCA, Standard Chartered

Bullish on the Euro area and Japan, currency hedged

Regional and country preferences



Source: Standard Chartered

Commodities – Underweight

- A continued demand-supply imbalance is likely to keep oil prices capped.
- We continue to expect gold to fall, noting that the recent rebound remained well within its long-term downtrend.

We remain bearish on commodities overall. Despite short-lived rebounds, most major commodities remain significantly oversupplied. We maintain our bearish view on commodities as there is little sign of this imbalance being bridged.

Oil prices likely to stay capped. We continue to expect oil prices to remain under pressure, with any rebounds likely limited to USD 60/bbl-USD 65/bbl. An over-supplied market remains at the core of our view, and little has changed on this front over the past month. Both OPEC and non-OPEC oil production remain elevated, and there is little sign of production slowing – a key factor needed to put a solid floor under oil prices, in our view. We believe this will eventually occur, though this may end up being a multi-year process.

On the demand side, the outlook remains poor. Asia ex-Japan's role as an increasingly large share of global demand is currently working against oil given soft growth indicators across the region.

Gold remains in a firm downtrend. China's CNY policy shift and the recent episode of market volatility offered some support to gold. However, we expect this to be temporary. Similar risk-off events in the recent past have failed to offer anything more than very temporary bouts of support, and we expect this episode to be no different. If anything, we see this rebound as an opportunity to reduce exposure further.

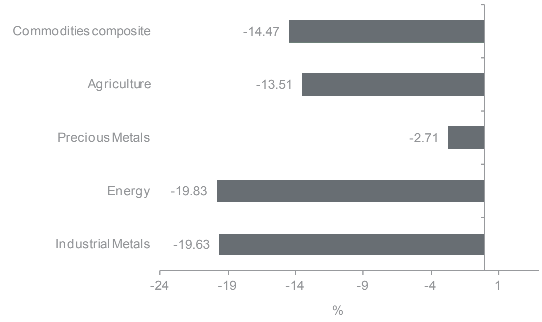
Long-term fundamentals remain poor for gold. Likely higher interest rates in the US and UK and further USD strength both firmly work against gold. Technically, the precious metal remains firmly within a long-term downtrend despite short-lived rebounds. Overall, we believe a bearish view remains justified, at least until the price falls to long-term average production costs or long-term average inflation-adjusted prices. A range of estimates suggest both are at least 20% lower from here.

CNY policy shift worsens outlook for base metals. The fact that China continues to account for almost half of global base metals demand starkly highlights the importance of the China growth outlook for base metal prices. Relatively softer growth there has meant the demand outlook continues to be weak amid few signs of a cutback in excess supply.

The unfortunate events at the Tianjin port mean that a short-term supply disruption could occur, providing a temporary support to some industrial metals. The continued risk of an El Nino weather phenomenon also poses upside risks to prices. However, in our view, neither offers a sufficient basis to change our bearish outlook on base metals.

We remain on the sidelines with respect to agricultural commodities. A reasonably positive Indian monsoon season has provided one good reason to expect key agricultural prices to remain contained. However, the latter half of the season remains key to the overall outcome. Hence, we would continue to watch the rain pattern closely. Outside of this, we continue to prefer staying on the sidelines in agricultural commodities given the divergent impact on prices in the event of a strong El Nino weather phenomenon.

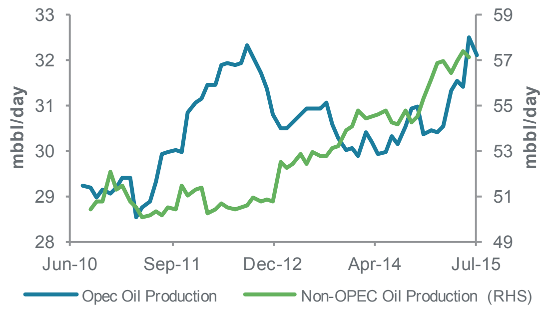
Performance of commodities YTD* (USD)



** For the period 31 December 2014 to 20 August 2015*
Source: DJUBS, Bloomberg, Standard Chartered
DJUBS, DJUBS Agri, DJUBS Precious metals, DJUBS Energy, DJUBS Industrial metals

Crude production shows few signs of falling to close the demand-supply gap

OPEC and non-OPEC daily crude production



Source: Bloomberg, Standard Chartered

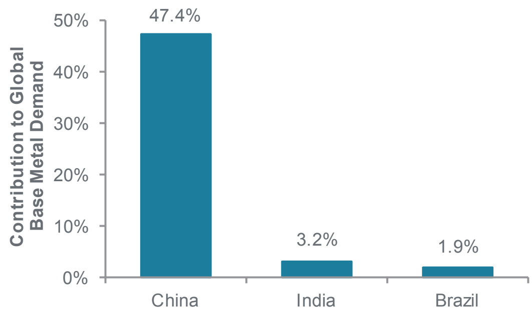
Gold price remains elevated relative to inflation despite significant falls thus far from the peak

Real (inflation-adjusted) price of gold

Source: Bloomberg, Standard Chartered

China continues to be the overwhelmingly largest source of demand for base metals

Country share of global base metals demand



Source: BCA, Standard Chartered

Alternative Strategies – Overweight

- Alternative strategies remain a preferred asset class. Policy divergence, clearer market trends and demand for protection against volatility remain key asset class drivers. We continue to favour equity long/short, macro/CTA and event-driven strategies.
- The asset class outperformed global equities over the most recent period of market volatility, demonstrating their value in a well-diversified allocation.

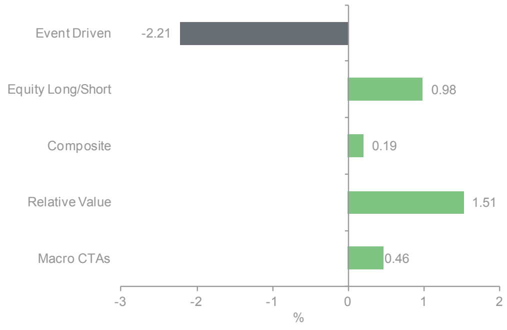
Alternative Strategies demonstrate their mettle over recent equity market volatility. Most major equity markets were lower over the month, but most alternative strategies outperformed over this period. Performance over this recent bout of market volatility underscores our preference for Alternative Strategies.

Key drivers for the strategy remain in place. A Fed rate hike is ultimately likely to intensify policy divergence, favouring macro strategies. Further gains in global mergers and acquisitions are likely to continue supporting event-driven strategies. Finally, equity long/short strategies are likely to prove beneficial in an environment that favours global equities, but is also buffeted by bouts of volatility. We continue to see alternative strategies as a key stalwart of a well-constructed investment allocation.

Conclusion

Alternative strategies remains one of our most preferred asset classes. We favour diversified exposure. Within the asset class, we like equity long/short, event-driven and macro/CTA strategies.

Performance of alternative strategies YTD* (USD)



** For the period 31 December 2014 to 20 August 2015*
Source: HFRX, Bloomberg, Standard Chartered
HFRX global hedge, HFRX equity hedge, HFRX event driven, HFRX relative value, HFRX macro/CTA

Foreign Exchange

- We continue to expect (a) USD strength against the EUR, JPY and AUD and (b) GBP strength against non-USD pairs.
- The CNY policy shift may pose downside risk to the KRW, TWD, MYR and SGD, but we expect the INR to be more resilient.

USD: We expect medium-term appreciation: Our long-term positive view continues to be based on our expectations of higher short-term bond yields in the US following a Fed rate hike later this year. As the chart on the right illustrates, divergence in interest rates (which, in turn, result from a divergence in central bank policy between the Fed and elsewhere) remains the dominant driver of the USD. We do not expect this to change. Therefore, we believe the USD remains an attractive currency going into the first Fed rate hike likely later this year.

While we acknowledge the USD has faced some resistance in rising further over the past few months, we believe extreme long-USD market positioning has been at least partially responsible for this. Another factor has likely been shifting expectations of a Fed rate hike. While the first has not adjusted completely, we continue to believe an actual Fed rate hike is likely to trigger a rise in short-maturity bond yields. This, in turn, should trigger the next leg higher in the USD. We would stay the course and, at a minimum, maintain a bullish view on the USD until at least after the Fed has begun a new rate hiking cycle.

EUR and JPY: We expect medium-term depreciation: The outlook for both the EUR and JPY remains a mirror image of the USD. Unlike the Fed, the ECB and BoJ continue to favour extremely loose monetary policy centred around quantitative easing (QE). In Europe, the ECB is likely to keep QE in place and has provided some indication that it could consider extending this further, given the recovery in economic indicators and inflation has not been unambiguous.

Short term

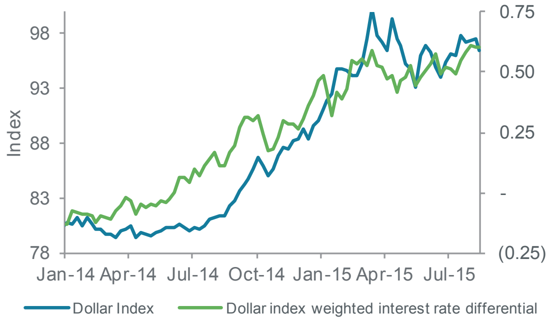
refers to a horizon of less than 3 months

Medium term

refers to a time horizon of 6 to12 months

Fed rate hikes remain key to USD strength

USD Index weighted interest rate differentials and USD Index



Source: Bloomberg, Standard Chartered

The outlook is similar in Japan. While it remains unclear whether the BoJ will indeed need to add another round of QE, mixed achievements on its inflation target suggests a very loose policy is likely to stay in place for now.

GBP: We remain medium-term neutral: We continue to believe that it is important not to lose sight of the possibility that the BoE may be next in line, after the Fed, to raise rates. Economic data, on balance, continues to improve and policymaker comments suggest a rate hike off zero may be in the offing. We acknowledge USD strength could still be dominant. Hence, we believe the real opportunity is to begin positioning for GBP strength against currencies other than the USD.

AUD: We remain bearish on the AUD: China's CNY policy change has been the main recent event. While the absolute size of the move in the currency has been small, any intensified China growth concerns are negative for commodity prices. This, in turn, is negative for the AUD. Domestic economic concerns mean further rate cuts cannot be ruled out either. Given our negative view on both key drivers of the AUD (commodity prices and interest rates), we believe a continued bearish view on the currency remains justified.

NZD: We are medium-term neutral: While the NZD faces many similar constraints as the AUD, we believe two factors argue for a 'less-worse' outlook: the risk of a rebound in dairy prices and the RBNZ's stance that interest rate cuts may not necessarily be imminent.

Asia ex-Japan: We remain medium-term neutral, recent weakness notwithstanding: We believe CNY policy, USD strength and individual idiosyncratic factors will remain key drivers of Asian currencies over the next 6-12 months.

China's policy shift is negative for Asian currencies given the linkages are most direct. However, a bulk of the immediate reaction now appears to have occurred. We believe China's policy move was led by a desire to meet the IMF's requirements for Special Drawing Rights (SDR) inclusion, suggesting the policy shift was not intended to weaken the CNY outright on a trend basis. However, given the marginally greater role for the market and China's soft economic indicators, we would not be surprised to see mild CNY weakness over the coming year. This has mildly bearish implications for the rest of the Asian region's currencies overall, though there is likely to be a high level of divergence within this universe.

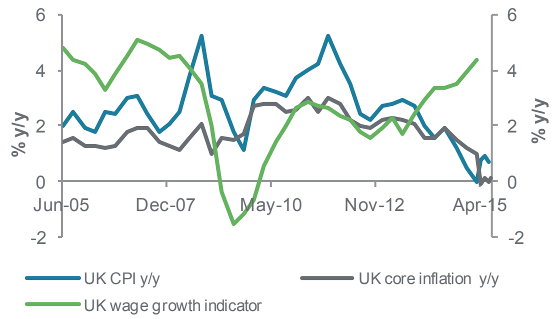
On the upside, we continue to expect the INR to be resilient relative to the region. The attractive yield on offer (especially relative to lower inflation), improving external balances and the likelihood of further investment inflows provide a more positive outlook for the INR.

On the downside, countries with weak fundamentals may see greater downward pressure on their currencies. In this respect, the IDR and MYR stand out. Both countries have a high foreign investor share in their domestic bond markets, creating outflow risks in the event of risk aversion. Indonesia also faces weaker external balances, at least relative to other Asian countries. In Malaysia, significant currency weakness thus far argues the currency may be closer to bottoming. However, we believe FX reserves are the key indicator to watch – a fall in reserves below 1x short-term foreign debt (translating into approximately USD 90bn of reserves) may cause the currency to overshoot on the downside.

The KRW and TWD also face the possibility of weaker domestic growth fundamentals, raising the risk of further interest rate cuts, which, in turn, may result in further currency weakness.

Accelerating UK wages to eventually exert pressure on prices

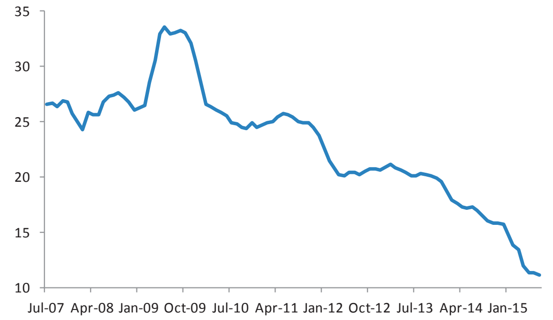
UK CPI, UK core CPI and UK weekly wage growth



Source: Bloomberg, Standard Chartered

Continued slowing in China fixed asset investment hurting commodities and the AUD

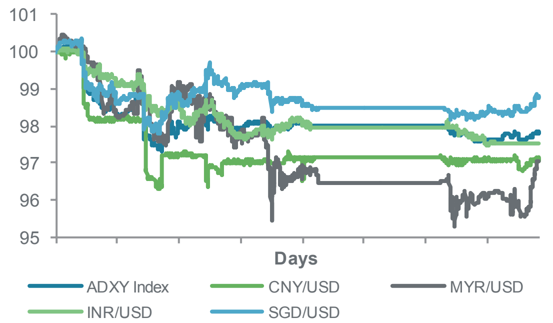
China fixed asset investment growth (% y/y)



Source: Bloomberg, Standard Chartered

Asian FX took a hit after CNY's policy shift, but a rebound is now underway

Aggregate (ADXY) and individual Asian currencies vs. the USD



Source: Bloomberg, Standard Chartered

Standard Chartered

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