VIP Strategy Update

- Sentiment has been tempered in recent weeks by the risk of disappointing US economic data, weak Chinese growth and renewed concerns in Europe.

- We continue to see a VIP strategy as the best framework within which to evaluate investment opportunities across asset classes.

Positive factors expected to outweigh short-term weakness

- US economic surprises may turn negative, but pent-up demand, employment gains, reduced oil shock concerns likely supportive.

- We do not, however, downplay risks to our outlook. Europe, in particular, faces some upcoming risk events.

Investment strategy implications

- **Cash:** Retain 12m Underweight
  Improved environment, inflation reinforce underweight position. Tactically, raise cash to Overweight to keep some powder dry.

- **Bonds:** Retain 12m Underweight
  Short-term, we reduce EM HY exposure due to rising risks, less distressed valuations and to take some profit. Maintain corporate credit Overweight 12m. CNH remains our preferred Asian local currency market.

- **Equities:** Retain 12m Overweight, but cautious short term
  Many indicators suggest need for caution short-term. Long term, we continue to believe equities offer more upside than cash or bonds. Use any weakness to increase exposure.

- **Gold:** Retain 12m Overweight
  Diminishing US monetary easing expectations a short-term risk.

- **Commodities:** Retain 12m Neutral
  Oil faces upside risks on geopolitical concerns, constrained supply. Slowing China growth prospects negative for industrial metals.

- **Alternatives:** Retain 12m Neutral
  Focus on volatility strategies, CTAs to help manage portfolio volatility.

- **Currencies:** USD strength likely to extend
  Major currencies with potential for higher policy rates to benefit. Asian FX to stay volatile, but currencies with exposure to electronics cycle may be supported. China uncertainties likely to pressure commodity currencies.

Market performance

Equity markets have paused in the past month after very strong gains in the first quarter. Meanwhile, bonds have started to outperform, partially reversing the underperformance seen in the past few months. Commodities have weakened driven by weaker oil and base metal prices, despite a slightly weaker USD.

VIP Strategy update

At the end of last year, we launched our VIP Strategy as a lens through which to consider investment options. This strategy highlighted three main ideas as well as implementation options for investors to consider. To recap:
1) **manage** Volatility

have diversified portfolios, have significant exposure to asset classes that have low correlations to equities (gold and macro hedge funds/ commodity trading advisors, CTA) and use volatility to your advantage by averaging into undervalued asset classes (namely global equities, particularly Asia ex-Japan, and high yield corporate debt).

2) **protect** against Inflation

gold and gold equities. We also added oil and oil equities as a focus area in January.

3) **be** Paid

high dividend yielding equities and high yield corporate debt.

The chart on the left shows the absolute return of these different investment ideas so far this year. Most of the investment ideas have performed well.

Of course, with equities performing so well, being diversified in other asset classes reduced portfolio returns. However, we continue to believe significant diversification is vital to any investment strategy.

Using volatility to average into undervalued asset classes – equities and high yield debt – is something that has worked incredibly well as both asset classes have generated strong year-to-date returns.

Gold fits into both ‘managing volatility’ and ‘protecting against inflation’ categories and performed very well at the start of the year, but has been largely range-bound for two months.

Finally, in the ‘be paid’ category, high yield bonds have continued where they left off in 2011 by appreciating strongly in the beginning of the year with spreads now moving back to their median levels in the US.

High dividend equities are, by nature, more defensive and therefore, while they have posted positive returns year-to-date, they have underperformed global equities. However, we would expect managing volatility to be more important in Q2 than it was in Q1 and this should help boost high dividend yielding equities from a relative performance perspective. We have already seen this becoming more important, as we predicted last month, in April.

The two areas that have not done well are macro hedge funds/CTA and commodity equities. Macro hedge funds/CTA had posted positive returns at the asset class level for 14 consecutive years before 2011. The negative performance seen last year has extended into the beginning of 2012.

On the commodity equity front, despite trough valuations and generally supportive commodity price developments, both gold and energy equities have significantly underperformed both the underlying commodity and equity markets in general. Please see the equity section for an update on these themes.

**Economic and monetary outlook**

The global economy is starting to disappoint once again. While US economic surprises are still hovering around zero, history suggests that a move into negative territory is likely. Europe, after surprising on the upside in recent months, has fallen back in the past few days. While Asia is generally surprising on the upside, China continues to surprise on the downside.

This suggests the recent cooling off in equity markets may continue for a little longer. However, while we see some similarities between 2011 and developments so far this year, we believe there are significant differences that lead us to remain overweight global equities on a long term basis. From a macroeconomic perspective, the three key regions dominating the headlines are the US, Europe and China.

**US:**

Economic surprises are likely to move into negative territory in the coming weeks as the weather-related acceleration fades. However, we believe there are significant positive factors that are reducing the likelihood of a sustained slowdown and move towards recession:

- Significant pent-up demand in both the housing and auto markets and signs that consumers are starting to give in to this pent-up demand
- Accelerating employment gains, which we believe are only partially due to the weather effect
- Reduced concerns on oil prices short term – normally it takes 80%+ y/y gains to induce a recession and currently oil prices are flat in y/y terms. Gasoline prices also appear to have peaked short term.

**Source:** Bloomberg, Standard Chartered
Global Market Outlook-May 2012

Manufacturing looks set to slow modestly short term

![US ISM new orders to inventory ratio graph]

Source: Bloomberg, Standard Chartered

Renewed European sovereign debt crisis concerns

![Italy and Spain 10y govt yields graph]

Source: Bloomberg, Standard Chartered

Bank liquidity improves, but watch banking sector CDS spreads

![3m Euribor - Eonia Spread and European Financials 5y CDS spread graph]

Source: Bloomberg, Standard Chartered

Official data paints a better picture than private sector data

![China PMI new orders to finished goods ratio graph]

Source: Bloomberg, Standard Chartered

Much higher oil prices required to shock the global economy

![Oil price (WTI 4wma, % 6m change) and US recessions graph]

Source: Bloomberg, Standard Chartered

However, we should not downplay the risks to this outlook. Cyclically, the new orders to inventory ratio has started to weaken, which could herald a slowdown in industrial production. Structurally, while consumer debt levels have moderated slightly, they still remain high in a historical context. Meanwhile, the fiscal drag is only likely to accelerate in 2013 after the elections. However, on balance, we are less concerned about the US economic outlook now than we were at the beginning of the year.

Therefore, we describe the US situation as ‘muddle through-plus’. We do not expect a sharp acceleration in growth to over 3%, but the hurdle for the US to surprise on the upside is lower than last year. In March 2011, the expectation for 2011 US growth was 3.2% versus the outturn of 1.7%. Currently, the consensus forecast is for 2.3% growth in 2012.

Europe:

It is difficult to be optimistic about the situation in Europe. On the positive side, core Europe does appear to be recovering. However, there does not appear to be an end in sight to the periphery’s woes. Spanish and Italian yields have once again started increasing, highlighting the fact that the European Central Bank’s (ECB) Long Term Refinancing Operations (LTRO) did not resolve the region’s problems.

What LTRO has done, however, is remove the tail risk – that we seemed incredibly close to in the autumn of 2011 – of a systemic banking collapse. This, in our opinion, is likely to reduce the contagion effect of European developments on the rest of the world, with the feedback mechanism being largely limited to the impact of the crisis on the European, and thus the world, economy. On this front, bank deleveraging is likely to keep the European economy very weak indeed, with the core outperforming the periphery. For Europe, this is unlikely to be better than a ‘muddle through-minus’ scenario.

China:

Data in China continues to point to near-term economic weakness. Import growth slowed further according to March data. Some of this can be explained by lower commodity prices. While the official new orders-inventory ratio is suggesting the economy may be recovering, private sector data is suggesting the soft patch is likely to continue in the near-term.

Meanwhile, the authorities do not appear to be excessively concerned about the situation and are focused on targeted easing measures rather than a broader brush (and more significant) approach. Given recent political developments, this is leading many to believe that the authorities’ attention is elsewhere. However, a more likely explanation is they do not want to repeat the policy mistakes of 2008, when an, arguably, overly aggressive policy easing led to the problems of a systemic banking collapse. This, in our opinion, is likely to reduce the contagion effect of European developments on the rest of the world, with the feedback mechanism being largely limited to the impact of the crisis on the European, and thus the world, economy. On this front, bank deleveraging is likely to keep the European economy very weak indeed, with the core outperforming the periphery. For Europe, this is unlikely to be better than a ‘muddle through-minus’ scenario.

Overall, we continue to believe in a muddle through scenario. We are still recovering from the effects of the global financial crisis and this adjustment phase is likely to take many more years to complete. That said, this does not preclude cycles within this healing process. In the US, the cycle appears to have improved since the beginning of the year, although markets may be slightly disappointed in the coming weeks. Europe has actually followed a similar profile, but it is much harder to be upbeat here on a multi-month basis. China has generally been disappointing in our opinion, is likely to reduce the contagion effect of European developments on the rest of the world, with the feedback mechanism being largely limited to the impact of the crisis on the European, and thus the world, economy. On this front, bank deleveraging is likely to keep the European economy very weak indeed, with the core outperforming the periphery. For Europe, this is unlikely to be better than a ‘muddle through-minus’ scenario.

Middle East tensions: Recent developments on negotiations between Iran and the West have been positive, but they remain highly unpredictable. We believe sharply higher oil prices would be required to push the world economy into a recession, but such a possibility cannot be ruled out with many measures of spare capacity falling.
Global Market Outlook - May 2012

US debt levels still need to fall as a % of GDP

- **European sovereign debt crisis**: Banking sector liquidity indicators are still pointing to reduced stress levels at this juncture. As long as this lasts, the contagion effect of developments in Europe should be reduced. However, if they were to reverse, then correlations between European asset prices and the rest of the world could increase again. The good news here is the ECB appears likely to step up as lender of last resort – as it did last year – in such a scenario.

- **DM debt levels**: This remains a major cloud over the landscape. While US debt levels as a percentage of GDP have fallen significantly from their peak without inducing a double-dip, we still have a long way to go. We estimate the total debt to GDP ratio needs to fall from around 320% currently to around 250% of GDP before the all-clear can be sounded. Clearly, the focus is going to be increasingly on US public sector finances as we move towards the end of the year and people try to infer what different Presidential election outcomes mean for fiscal policy.

- **DM real rates**: Continued to linger close to record lows, which remains in good shape from a fundamental perspective.

- **Asian HY spreads**: Wide slightly, but remained in good shape from a fundamental perspective. EM HY has performed very strongly since November 2011. Valuations and our concerns of a potential rise in short-term risks compared to levels one standard deviation higher a few months ago.

- **IG credit**: Continues to offer value. We have turned slightly more cautious in the near term with regards to EM high yield. Our preference for both IG and HY credit on a 12M view, however, remains unchanged.

- **Fixed income**: We have turned slightly more cautious in the near term with regards to EM high yield. Our preference for both IG and HY credit on a 12M view, however, remains unchanged.

**Investment Strategy**

- **Fixed income - Retain UW on a 12M basis, while remaining OW corporate credit**

  We have turned slightly more cautious in the near term with regards to EM high yield. Our preference for both IG and HY credit on a 12M view, however, remains unchanged.

  Our decision to be slightly more cautious EM HY on a tactical basis is based on four factors:

  (a) Renewed Europe-related concerns and a heavy election calendar could be a source of risk in the short term. Downside US economic surprises may add to any pressure on risky assets.

  (b) Valuations now provide less downside protection. Most credit spreads are now approximately at historical median levels, compared to levels one standard deviation higher a few months ago.

  (c) EM HY has performed very strongly since November 2011. Valuations and our concerns of a potential rise in short-term risks mean it may be prudent to take some profit at this juncture.

  (d) We chose to focus our reduction on EM HY because it is arguably the most risk-sensitive component of the corporate credit universe.

It is important to understand our more cautious short-term stance is limited to EM HY only. Our assessment suggests a slight reduction in risk at a portfolio level is prudent. However, upside risks remain very much in place. Hence, we believe it is important to maintain exposure to corporate credit; we remain overweight Developed Markets, IG and HY, as well as Emerging Market IG.

On a 12M view, however, we maintain our preference for US and Asian corporate credit, both investment grade and high yield:

- **Spreads continue to offer value relative to the low default rates we expect over the next 12 months. The corporate sector remains in good shape from a fundamental perspective.**

- **The hunt for yield is likely to continue supporting corporate credit as the Fed maintains zero interest rates through 2014. We continue to see the lack of value in US Treasuries in the absence of deflation, causing us to retain our UW on G3 government debt and our preference to keep duration short in US Dollar bond portfolios.**
A key change we have made to our 12m view, is to shift our preference between the US (increased to OW from N) and Asia ex-Japan (reduced to N from OW). We remain UW Europe and N Japan.

This shift was done on the basis of the following:

a) Attractive valuation of US market, particularly those companies in the Technology, Energy and, to a lesser extent, the Staples space

b) Expectations that the US economy will continue to improve, while in Asia the easing cycle appears to have paused for most markets

c) A number of markets in Asia, excluding China and Korea, are looking a little overbought while India looks vulnerable.

It is important to note that on a shorter term basis, we already favoured the US to Asia ex-Japan. We now believe the factors that supported that view might persist for a longer period.

While not a direct factor in the DM/EM decision, it is worth highlighting that an alternative way to play the EM consumer story is to take exposure to attractively valued DM companies, with significant exposure to the EM consumer. In this way, we capture the higher consumer lead growth, but stay invested in companies that have liquidity, global brands and franchises and, in many cases, trade at lower valuation points than their EM counterparts.

In summary, we have the following positioning for equities:

**US**
- Improving macroeconomic outlook supportive of US equities; OW on a 12m view.

**Europe**
- While we remain underweight overall, Germany and the UK are preferred markets.
- There are many high quality names in the Oil, Staples, and Healthcare space that offer significant exposure to the EM consumer, trade at attractive valuations and, in many cases, have excellent dividend yields.

**Asia ex-Japan**
- Shift to N on a 12m view on a preference for the US market
- Continue to like China and Korea within the Asian context

**Equities – Retain Overweight**

We remain Overweight equities on a 12-month basis. While we are cautious short term – expecting near term performance to be volatile with markets vulnerable to a further pullback from here – we hold the longer term view that equities are a better bet than G3 sovereign debt or cash, and possibly safer. As we highlight above, we would use any short term volatility to add exposure to those areas of the equity markets that we like.

Equity markets are largely playing out as we have been expecting. A month ago, we highlighted the risk of a 5-10% correction following very strong gains in the previous 3-4 months. From a peak to trough perspective, the MSCI All-country World Index fell around 5.5%, but after a rebound is currently only down 3.0% from the peak. In the near term, there are still some downside risks due to the following:

a) The market is currently very complacent, with the VIX index still close to lows.
b) Markets look extended relative to moving averages
c) Up volumes are low relative to down volumes
d) EM growth is slowing
e) US economic surprises’ index is declining and has turned marginally negative
f) We are seeing renewed tensions in Europe with CDS and periphery yields rising

Longer term, however, equity market valuations have generally improved since last year and companies are expected, particularly in the US, to increase dividends or undertake share buybacks. The environment for equities is generally pretty healthy with access to cheap capital, a steadily improving US economy and clear support from the central banks to do what they can to backstop any crisis should one unfold.

A key change we have made to our 12m view, is to shift our preference between the US (increased to OW from N) and Asia ex-Japan (reduced to N from OW). We remain UW Europe and N Japan.
Other EM

- While we retain our OW 12m stance, we are cautious in the short term, as these markets are highly sensitive to fund flows and investor sentiment.
- Longer term, we continue to like the space, with Russia a key pick as an oil-related play

In terms of our key investment themes, these remain unchanged.

Energy

- We are overweight the Energy sector across all the markets we follow.
- We prefer the oil majors (E&P players) and those service companies involved in this space.
- While energy stocks have lagged, we continue to overweight them as the sector is relatively cheap and oil stocks are a great hedge against increased geopolitical risk.

Technology

- We continue to be OW technology in the US and South Korea.
- While Technology has outperformed in general, we continue to see value, with many of the names offering very attractive valuations particularly when considering their growth and ROC characteristics.
- As we highlight earlier, US and some South Korea technology companies offer excellent exposure to the EM consumer.

DM Consumer Staples

- While the sector is trading at higher than average multiples, these companies have significant brand and franchise value.
- ROCE for the Staples is well above average and they provide a good entry point to the EM consumer base.

Miners

- From a valuations perspective, both precious and base metals producers are increasingly attractive plays.
- Gold remains an excellent hedge for higher future inflation.
- Last month, we highlighted our view that the market may fall further, but we would advocate current levels to be a good entry point, particularly given gold’s excellent hedging characteristics.
- As we highlighted last month, we are less positive on Base metals, which have indeed underperformed. We believe this underperformance may have further to run. At the same time, though, the equities are in good shape with strong balance sheets, free cash flow generation and attractive valuations. We see some excellent value here.

Financials

- We remain UW Financials and recently closed a trading idea on US financials, which was up some 7%.
- CDS’s have risen for the US financials and are at elevated levels in the case of the EU. This is not, we believe, reflected in the price action of the stocks and we take the view that with CDS and EU periphery yields rising, an UW stance is still warranted.
- In the West, we still prefer the top tier financials and the credit card companies. In Asia, we like Chinese, HK and Singaporean names.

Conclusion: Market risks have risen and an extension of the current pullback is likely in our opinion. Should we see such a pullback, we would take advantage of such weakness to increase exposure to equities, being selective of the markets and names to invest.
Commodities-Retained Gold OW, Non-gold N

We are now neutral on both gold and non-gold commodities in the short term on diminishing expectations for further easing in the US and slowing growth prospects in China and the Euro area. However, we remain overweight commodities as a whole on a longer term basis given our long term fundamental reasoning remains intact.

Gold continued its decline driven mainly by falling inflation expectations and steadily declining expectations of further monetary policy easing in the US. Though we expect the moderation in gold prices to continue in the short term, broad fundamental drivers for higher gold prices remain. Namely,

- high and rising G7 government debt levels, especially in the US
- negative real interest rates in the US
- the likelihood of further monetary easing globally
- strong demand from India and China
- increasing central bank demand
- limited growth in gold supply.

From a technical analysis perspective, gold has drifted lower with a decline in momentum and volume. We expect this bias to last for a while with near term support at 1630 and 1600 and resistance at 1664 and 1720.

Brent crude oil prices have stabilised at around USD 118 per barrel given some moderation in geo-political tensions in the Middle East and higher than expected crude oil supply stock. However, we believe risks remain to the upside. The impact of the upcoming deadline on EU and US embargoes on Iran is likely to overpower the additional supplies of crude brought about by either the US (the release of strategic reserves) or OPEC (announced that they have capacity to increase production). The situation in the Middle East also has the tail risk of erupting given the complexity and uncertainties around the issue. We remain bullish on crude oil prices and advocate it as a hedge against rising risks of geo-political tensions in the Middle East. The approaching end June deadline will be key.

From a technical perspective, Brent crude oil has broken trend line support at 122 and we expect a continuation of the downtrend in the near term towards key support at 116. We see tough resistance between 120 and 122.

Industrial metals will likely be driven by growth prospects in China and the Euro area. The recent flash China PMI data, which continued to show a contraction in China’s manufacturing activity, is expected to continue to weigh on industrial metals together with slowing demand from the Euro area. We believe industrial metals are likely to face short term downward pressures before picking up again on tighter supply conditions.

Conclusion: Commodity prices in general are expected to stay choppy given market varying expectations for further monetary easing in the US. We see the gold price being heavily reliant on US economic data while oil (aside from geo-political risks) and industrial metals prices will be driven mainly by the economic developments in China and the Euro area.
Alternative strategies-Retained Neutral

We maintain our view on using alternatives to help manage volatility within a ‘VIP’ investment strategy, and believe two strategies can help do this in particular.

First, we continue to believe commodity trading advisors (CTAs) add value to investment portfolios. They tend to have low correlation with equities while also holding a strong historical track record of performing well in both benign and difficult market conditions. Their role in helping manage volatility can be very helpful if we do see a rise in risk aversion in the short term.

Second, we maintain our view to add volatility-linked strategies. Volatility remains very low and we would not be surprised to see a rebound. Volatility-linked strategies tend to do well in such environments because they seek to buy volatility when it is low and sell when it is high. As a tool to help manage portfolio volatility, thus, volatility-linked strategies can add real value.

Conclusion: We continue to believe in the benefits of inclusion of alternative investments into a portfolio. We believe a combination of volatility-linked strategies and commodity trading advisors (CTAs) is likely to add a lot of value in terms of helping manage volatility of an investment portfolio.

Foreign Exchange

The USD remained resilient with broadly lower expectations of further monetary policy easing in the US than we had a month ago. As such, we expect the USD to remain resilient on the back of a steady economic recovery and firm USD safe haven demand. However, we expect volatility to remain elevated given the varying expectations for further monetary easing in the US and bouts of risk aversion arising from the Euro area sovereign debt crisis.

Most major currency performances are likely to be driven by expectations of monetary policy decisions over the next month. While most central banks are biased to monetary easing (Fed, BoJ, ECB, BoE, PBoC and RBA), there is at least one biased towards tightening (Bank of Canada).

In Asia ex-Japan, currencies within the region are expected to remain volatile with some weakness. This is driven by a decline in exports as the moderation in China’s growth is expected to outweigh that of the US recovery in the short term. Currencies with exposure to the improving electronics cycle (TWD, SGD, MYR, KRW) are expected to be supported (based on historical correlation) along with some of the commodity currencies (IDR, MYR). Given elevated levels of inflation, central banks are expected to keep their benchmark rates on hold.

Commodity currencies (AUD, NZD and CAD) are expected to moderate as global growth prospects remain within a muddle through scenario with growing downside risks. A lower probability of further monetary easing in the US is also expected to weigh on commodity prices and ultimately affect commodity currencies.

We see a divergence within this group of currencies depending on the type of commodity being exported and its destination. Commodity currencies exporting more to the recovering economies, like the US (CAD), are likely to outperform those with moderating growth prospects such as China (AUD, NZD) and the Euro area. Also, those exporting crude oil are expected to fare better than those exporting industrial metals from a price perspective.

Conclusion: Currencies likely to benefit include those,
> With positive correlation to US economic growth
> Who are oil/crude palm oil exporters
> Whose central banks have indicated a potential for higher benchmark rates
> We also recommend a value strategy whereby investors buy/sell based on historical and relative valuations.

Conclusion

We expect volatility management to remain important in the coming weeks with the US economic surprises index trending lower, renewed concerns in Europe and continued weakness in Chinese economic data. However, for those underweight equities and High Yield debt, we see any weakness as an opportunity to continue averaging in.
# Global Market Outlook—May 2012

## 12 Month Market Outlook

### Central bank policy rates

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<thead>
<tr>
<th>Country</th>
<th>Spot</th>
<th>Q2 2012</th>
<th>Q3 2012</th>
<th>Q4 2012</th>
<th>Q1 2013</th>
<th>Q2 2013</th>
<th>Q3 2013</th>
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### Commodities

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<th>Commodity</th>
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<th>Q3 2012</th>
<th>Q4 2012</th>
<th>Q1 2013</th>
<th>Q2 2013</th>
<th>Q3 2013</th>
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<td>2300</td>
<td>2300</td>
<td>2500</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Corn</td>
<td>609.00</td>
<td>700</td>
<td>700</td>
<td>675</td>
<td>650</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Soybeans</td>
<td>1485.50</td>
<td>1475</td>
<td>1550</td>
<td>1625</td>
<td>1400</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Wheat</td>
<td>637.00</td>
<td>700</td>
<td>695</td>
<td>650</td>
<td>675</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Standard Chartered (Data and forecasts as of 27th April 2012)

* Period averages for each quarter.
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