

Weekly Market View

Canaries in the coalmine?

→ The two US banks that failed over the past week and the liquidity problems at some other US and European lenders are early symptoms that the central bank rate hikes are starting to bite, especially in the weakest parts of the economy.

→ As such, we believe we are in the late stage of the economic cycle, which implies we are near, if not at, the peak of interest rates. ECB President Lagarde's comments this week suggest that central banks are starting to worry about, if not prioritise, financial stability over their fight against inflation.

→ While the regulatory response so far should reassure bank depositors of the safety of their deposits, the evolving macro backdrop reconfirms our SAFE investment approach, which prefers high grade bonds and, more broadly, a diversified basket focussed on income generation to ride out the end of the economic cycle.

What are the investment implications from the recent events on the US and European financial sector?

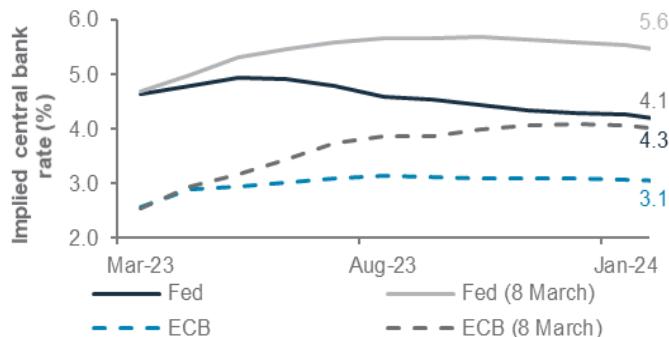
What is the likely impact on Asian USD bonds from the recently concluded China Congress and recent market events?

Is safe haven demand likely to push the USD higher?

Charts of the week: Rates outlook softens, lifting SAFE assets

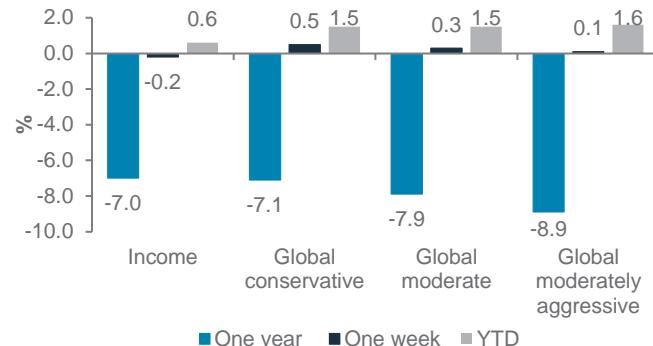
The pricing of Fed rate cuts later this year has helped bonds and our defensive asset allocation year-to-date

Market estimates of Fed and ECB rates, today vs 8 March



Source: Bloomberg, Standard Chartered

Performance of our four key asset allocation baskets



Editorial

Canaries in the coalmine?

History shows something usually breaks when central banks raise rates sharply. This time, we have seen the steepest ECB rate hiking cycle and the second steepest Fed hiking cycle in history. The two US banks that failed over the past week and the liquidity problems at some other US lenders and Credit Suisse are early symptoms that the central bank rate hikes are starting to bite, especially in the weakest parts of the economy. As such, we believe we are in the late stage of the economic cycle, which implies we are near, if not at, the peak of interest rates. ECB President Lagarde's comments this week suggest that central banks are starting to worry about, if not prioritise, financial stability over their fight against inflation. While the regulatory response so far should reassure bank depositors of the safety of their deposits, the evolving macro backdrop reconfirms our SAFE investment approach, which prefers high grade bonds and, more broadly, a diversified basket focussed on income generation to ride out the end of the economic cycle.

The collapse of Silicon Valley Bank (SVB) and Signature Bank represent two of the three biggest bank failures in US history. While SVB was an outlier among US banks due to its excessive reliance on technology sector start-ups, its sudden collapse is an example of how tight financial conditions first hurt the most vulnerable businesses. After 450bps of Fed rate hikes in the past year, US money supply has started to contract, banks have started to tighten lending conditions and savers are seeking refuge in the most secure banks for their deposits. Consumer spending is likely the next shoe to drop. Credit Suisse's liquidity crunch is a symptom of the same malaise in Europe, where the ECB has raised rates by 350bps over the past year.

US and Swiss regulators and major US banks have taken decisive steps over the past week to inject liquidity into the troubled lenders and protect bank depositors. Regulators at other major economies are likely to take a leaf out of the same playbook in the event of a liquidity crisis elsewhere. However,

like the proverbial canary which first senses trouble in a coalmine (carbon monoxide leaks), we believe these financial stresses signal financial conditions have tightened enough to cause a recession likely sooner than markets are pricing in. While inflation remains elevated in the US and Europe and job markets are tight, these are historically lagging indicators.

Given this, the window for further rate hikes have significantly narrowed, in our view. We now see only a 60% probability of a 25bps Fed rate hike on 22 March, and a 25% chance the Fed pauses. This compares with market expectations of a 50bps Fed rate hike just last week, after Chair Powell's testimony to the Congress. The ECB, which arguably faces a more difficult inflation backdrop, is likely done with its rate hikes for now after it went through with its planned 50bps rate hike this week.

Investment implications: The above backdrop reinforces our belief in the SAFE investment strategy that we have highlighted since late last year: a) Recent market performance confirm our preference for high grade bonds over all other assets. While Developed Market (DM) government bonds have delivered, DM investment grade and Asia USD corporate bonds have also gained over the past week. We would look to increase maturity in our high grade bond allocations on any bounce in bond yields; b) Within equities, we would continue to rebalance from DM equities to more attractively valued Asia ex-Japan (particularly China) as Asian growth remains resilient, in contrast with looming recessions in the US and Europe; c) Among sectors, the technology sector (where long-term growth drives much of its value and is thus most sensitive to rates) is a proxy for those seeking to benefit from the rates pullback; d) We would sell into any USD rally. JPY's outperformance this week amid troubles in the West reinforces its defensive qualities; we see scope for further gains if the Dollar index (DXY) fails to decisively break above a key resistance at 104.7; e) Gold, which has also delivered in recent weeks as a volatility hedge, is likely to benefit near-term, especially if USD weakens.

— Rajat Bhattacharya

The weekly macro balance sheet

Our weekly net assessment: On balance, we see the past week's data and policy as negative for risk assets in the near term.

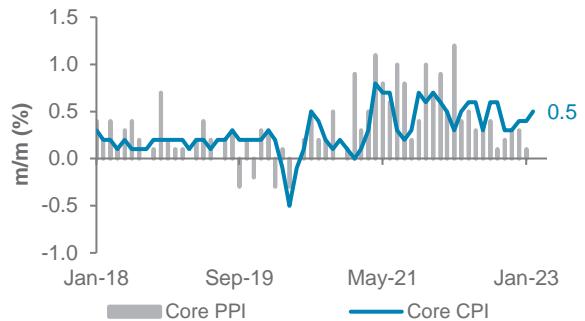
(+ factors: Fed backstop, China economic bounce

(- factors: Financial system instability, hot US consumer inflation

	Positive for risk assets	Negative for risk assets
Macro data	<ul style="list-style-type: none"> US producer inflation fell unexpectedly by -0.1% m/m US housing starts rose more than expected China infrastructure and property investment beat estimates; retail sales in line with expectations; factory output missed China residential property sales grew y/y for the first time since 2021 	<ul style="list-style-type: none"> US consumer inflation topped estimates at 6% y/y, while core inflation beat estimates by rising 0.5% m/m US retail sales fell as expected by 0.4% m/m
	Our assessment: Neutral – Hot US consumer inflation vs China economic bounce	
Policy developments	<ul style="list-style-type: none"> Fed intervened to protect all deposits at the two failed banks; set up a lending facility to provide all banks additional funding against collateral valued at par Swiss National Bank pledged liquidity backstop for Credit Suisse PBoC kept 1-year medium-term lending facility rate unchanged, while injecting more liquidity than expected 	<ul style="list-style-type: none"> Credit Suisse liquidity concerns added to European banking sector stress SVB and Signature Bank collapsed and were taken over by regulators Fed is considering tightening its rules governing mid-sized banks The ECB hiked 50bps as planned, against market estimates of a 25bps hike BoJ bought fewer long-dated bonds than planned as yields fell
	Our assessment: Neutral – Fed, SNB backstops for banks vs the banking sector turmoil	
Other developments	<ul style="list-style-type: none"> China resumed issuing all types of visas, further reopening its borders 	<ul style="list-style-type: none"> Russian jet downed a US drone over the Black Sea North Korea launched the most powerful ballistic missile before a summit between Japan and South Korea
	Our assessment: Negative – Geopolitical tensions	

US core inflation remains elevated, but producer prices have started to cool, raising the prospects of softer consumer inflation prints later this year

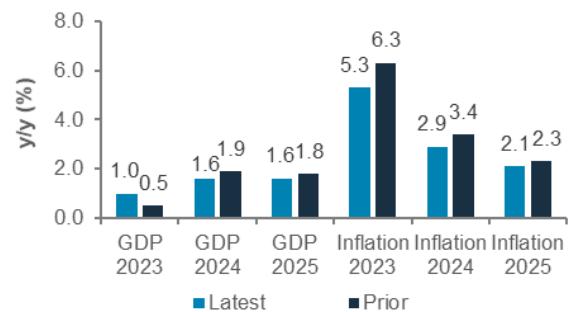
US core consumer and core producer price inflation



Source: Bloomberg; Standard Chartered

The ECB cut its inflation forecast but raised its growth forecast for 2023

ECB's new growth and inflation forecasts



Source: Bloomberg, Standard Chartered

China's fixed asset investment beat estimates and retail sales met expectations, while factory output missed estimates

China's retail sales, industrial output and fixed asset investment growth (YTD)



Source: Bloomberg, Standard Chartered

Top client questions

Q What are the investment implications from the recent events on the US and European financial sector?

The past week saw two US regional bank failures, resulting in the Fed putting in place measures to limit potential contagion. We expect the fallout to the wider financial sector to be limited, though elevated financial stress reinforces our view that a recession is on its way. Within the US banking sector, regulatory costs are likely to rise for the regional and smaller banks (which thus far faced lighter regulation) and competition for deposits could reduce net interest income (NII). We believe large US banks are likely to gain market share from smaller banks and benefit on a relative basis.

Meanwhile, the sharp drop in Credit Suisse stock and bond prices dragged European banks and broader equities lower. We believe this is a good opportunity to review the rationale behind our Overweight view on European financials and what has changed:

1. **Rising interest rates supporting NII growth:** Markets expect rates to rise to 3.1% by end-2022, down from the 3.8% expected just 3 weeks ago. Rising rates should support NII growth, but to a lesser extent, and competition for deposits could erode NII.
2. **Valuations are cheap:** Consensus 12m forward P/E has corrected to 8.1x, at the low end of history and a 35% discount to the broader market. We believe they remain attractive.
3. **Strong balance sheets to withstand a recession:** A crisis of confidence could test the sufficiency of banks' liquidity buffers and regulatory response. Higher funding costs and less business activity could also necessitate capital raisings.
4. **Better macro environment in Europe, a mild winter averting an energy crisis and China reopening supporting exports:** This could be at risk from financial sector instability.

Overall, we believe these factors warrant caution for now as fundamental conditions remain fluid and market prices can overshoot during volatile periods. The elevated volatility and cheap valuations do, however, create opportunities in structured strategies.

From a bondholder perspective, we see limited impact on the broader market. In the US corporate bond market, regional bank bonds account for a small fraction of the total market (c.2%). This means the rise in regional bank bond credit spreads has had only a marginal impact on the overall market.

We believe the reaction of the subordinated bank debt market has also been largely in line with expectations given the concerns around the European banking sector. Credit spreads have widened across the board, but more so for the most junior (Additional Tier-1 perpetuities) bonds and less so for global High Yield bonds. We continue to like diversified exposure to the subordinated bank debt asset class but would wait for a better entry point.

Financial sector equities in the US and Europe have seen a sharp correction recently

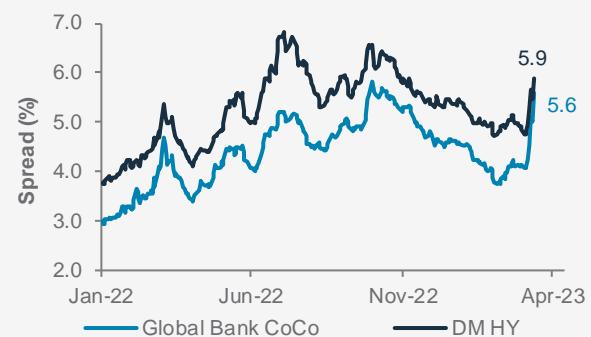
Total return from MSCI US Financials and MSCI Europe Financials indices in the past year



Source: Bloomberg, Standard Chartered

The yield premium on junior bank debt* has risen slightly more than that for DM High Yield bonds

Yield premium on DM High Yield bonds and global bank Contingent Convertible bonds (CoCos)* over US government bonds



Source: Bloomberg, Standard Chartered

*See explanatory note on page 9

Top client questions (cont'd)

Q What is the likely impact on Asia USD bonds from the National People's Congress and recent financial sector stress?

We believe Asia USD bonds – of which c.40% comprises Chinese issuers – should remain supported by policies from the National People's Congress. First, the expansionary yet conservative GDP growth target of 5% should support corporate earnings. Second, several cross-organisation reforms should help improve supervision efficiencies. Areas of focus include containing future housing market spillover risks, optimizing local government financial health, improving corporate governance and fighting irregularities and personal misbehaviours.

We also believe the fallout on Asia USD bonds from the recent stress in the US and European financial sectors is likely to be minimal. While bond yield premiums (over risk-free rates) have widened somewhat, we expect the direct impact on Asian financial bonds to be minimal given their regional business bias. We would assess the risk of Asian financials facing similar problem in the future as low. Their asset base remains well-diversified, with a tilt towards traditional business segments. Also, many of the largest Asian banks are fully or partly controlled by their respective governments due to strategic importance, which in our view, improves credit resilience.

— **Cedric Lam, Senior Investment Strategist**

The spillover of financial sector stress to Asian financial bonds has been limited

YTD changes of yield premium for USD-denominated US, Euro Area and Asian financial sector bonds over US government bonds



Source: Bloomberg, Standard Chartered

Q Is safe haven demand likely to push the USD higher?

The USD index (DXY) has had a fairly volatile week. It declined by nearly 1.5% from its 8 March high, following the rapid repricing of Fed rate hike expectations in the aftermath of SVB and Signature Bank closures. Through the week, the USD bounced back on renewed concerns around Credit Suisse and possible implications for the European banking system. While a continued risk-off sentiment could push the USD higher towards 105.7 or 107.10, we would use any rallies to sell it for three main reasons:

1. Our base case is that the recent bout of concern in the US and European banking system is unlikely to turn into a full-blown contagion. Hence demand for safe havens is likely to ebb.
2. We expect the differential between 2-year US and European government bond yields to narrow.
3. China's re-opening should help boost non-US growth, which would argue for a weaker USD.

For investors looking for a hedge against a risk-off scenario, we would look to consider the JPY. In our assessment, JPY appreciation over the past few days has not fully reflected the decline in US and European bond yields.

— **Abhilash Narayan, Senior Investment Strategist**

JPY has gained this week from the risk-off sentiment and could benefit further to reflect the narrowing of yield differential with the US since the start of the year

USD/JPY and 2-year yield differential between US



Source: Bloomberg, Standard Chartered

Top client questions (cont'd)

Q Should we add exposure to gold as a hedge now?

Gold appreciated strongly over the past week amid concerns over a widening banking crisis as investors sought shelter from the sell-off in risk assets. It was also supported by the fall in real (inflation-adjusted) yields and the weaker USD, which are both inversely related to gold.

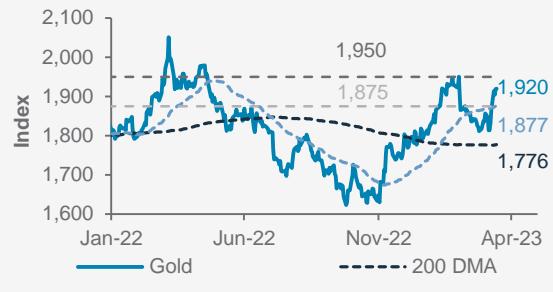
If history is any guide, gold tends to deliver a positive return whenever there is short-term stress in the financial system. On average, gold delivered a daily return of 1.6% whenever the Forward Rate Agreement-Overnight Index Swap spread, one indicator of potential banking sector stress, jumps 1 standard deviation (SD) above its long-term mean. This is consistent with our view of gold as a portfolio ballast.

On technical charts, gold broke above its 50DMA, signalling a positive turn in short-term momentum. Investor positioning remains far from extremes, suggesting it is unlikely to stand in the way of further gains. These suggest there is a reasonably high probability of gold overshooting towards 1,950 in the very short term, especially if banking sector fears persist. Having said that, we are mindful that gold helps mitigate volatility over relatively short time horizons. Hence, over a longer three-month period, we would not chase recent gains excessively and instead expect gold to settle back at around USD 1,875.

— **Zhong Liang Han, CFA, Investment Strategist**

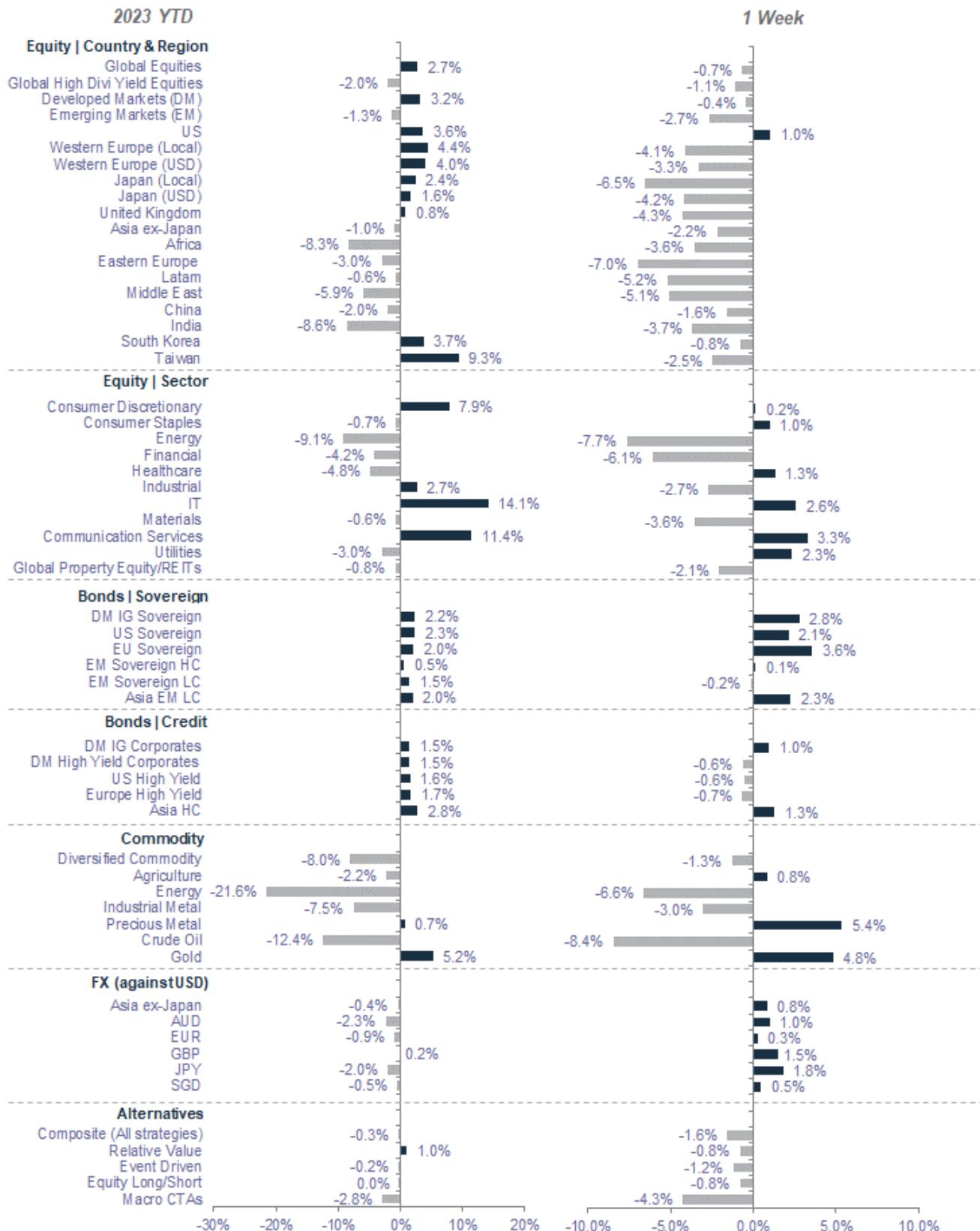
Gold tends to deliver a positive return whenever there is short-term stress in the financial system such as the one seen over the past week

XAU/USD



Source: Bloomberg, Standard Chartered

Market performance summary *



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

*Performance in USD terms unless otherwise stated, 2023 YTD performance from 31 December 2022 to 16 March 2023; 1-week period: 9 March 2023 to 16 March 2023

Our 12-month asset class views at a glance

Asset class		Preferred Sectors	
Equities	▼		
Euro area	◆	US Energy	▲
US	◆	US Staples	▲
UK	◆	US Healthcare	▲
Asia ex-Japan	▲	Europe Energy	▲
Japan	▼	Europe Financials	▲
Other EM	◆	China Comm. Services	▲
		China Discretionary	▲
Bonds (Credit)	▲		
Asia USD	▲		
Corp DM HY	▼		
Govt EM USD	◆		
Corp DM IG	◆		
Bonds (Govt)	▲		
Govt EM Local	◆		
Govt DM IG	◆		

Source: Standard Chartered Global Investment Committee

Legend: ▲ Most preferred | ▼ Less preferred | ◆ Core holding

Next support for the US 10-year bond yield is at 3.39%

Technical indicators for key markets as of 16 March close

Index	Spot	1st support	1st resistance
S&P 500	3,960	3,891	3,995
STOXX 50	4,117	4,006	4,257
FTSE 100	7,410	7,210	7,745
Nikkei 225	27,011	26,473	28,086
Shanghai Comp	3,227	3,210	3,260
Hang Seng	19,204	18,963	19,685
MSCI Asia ex-Japan	612	608	622
MSCI EM	941	932	959
WTI (Spot)	68	65	74
Gold	1,920	1,861	1,949
UST 10y Yield	3.58	3.39	3.84

Source: Bloomberg, Standard Chartered

Note: These short-term technical levels are based on models and may differ from a more qualitative analysis provided in other pages

Economic and market calendar

	Event	Next week	Period	Expected	Prior
MON	UK	Rightmove House Prices y/y	Mar	–	3.9%
TUE	EC	ZEW Survey Expectations	Mar	–	29.7
	US	Existing Home Sales	Feb	4.15m	4.00m
WED	UK	CPI y/y	Feb	–	10.1%
	UK	CPI Core y/y	Feb	–	5.8%
THU	US	FOMC Rate Decision (Upper Bound)	22-Mar-23	5.0%	4.8%
	UK	Bank of England Bank Rate	23-Mar-23	–	4.0%
	US	Chicago Fed Nat Activity Index	Feb	–	0.23
	US	New Home Sales	Feb	650k	670k
	EC	Consumer Confidence	Mar P	–	-19.0
	UK	Retail Sales Ex Auto Fuel y/y	Feb	–	-5.3%
	EC	S&P Global Eurozone Manufacturing PMI	Mar P	–	48.5
	EC	S&P Global Eurozone Services PMI	Mar P	–	52.7
	UK	S&P Global/CIPS UK Manufacturing PMI	Mar P	–	49.3
	UK	S&P Global/CIPS UK Services PMI	Mar P	–	53.5
	US	Durable Goods Orders	Feb P	1.7%	-4.5%
	US	S&P Global US Manufacturing PMI	Mar P	–	47.3
	US	S&P Global US Services PMI	Mar P	–	50.6

Source: Bloomberg, Standard Chartered

Prior data are for the preceding period unless otherwise indicated. Data are % change on previous period unless otherwise indicated
P - preliminary data, F - final data, sa - seasonally adjusted, y/y - year-on-year, m/m - month-on-month

Investor diversity remains healthy across asset classes

Our proprietary market diversity indicators as of 16 March

Level 1	Diversity	1-month trend	Fractal dimension
Global Bonds	●	↑	1.93
Global Equities	●	↑	1.68
Gold	○	↑	1.44
Equity			
MSCI US	●	↑	1.70
MSCI Europe	●	↑	1.72
MSCI AC AXJ	●	↑	1.68
Fixed Income			
DM Corp Bond	●	↑	1.80
DM High Yield	●	↑	1.89
EM USD	●	↑	1.84
EM Local	●	↑	1.63
Asia USD	●	↑	1.68
Currencies			
EUR/USD	●	↑	1.98

Source: Bloomberg, Standard Chartered; **Fractal dimensions below 1.25 indicate extremely low market diversity/high risk of a reversal**

Legend: ● High | ○ Low to mid | ○ Critically low

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