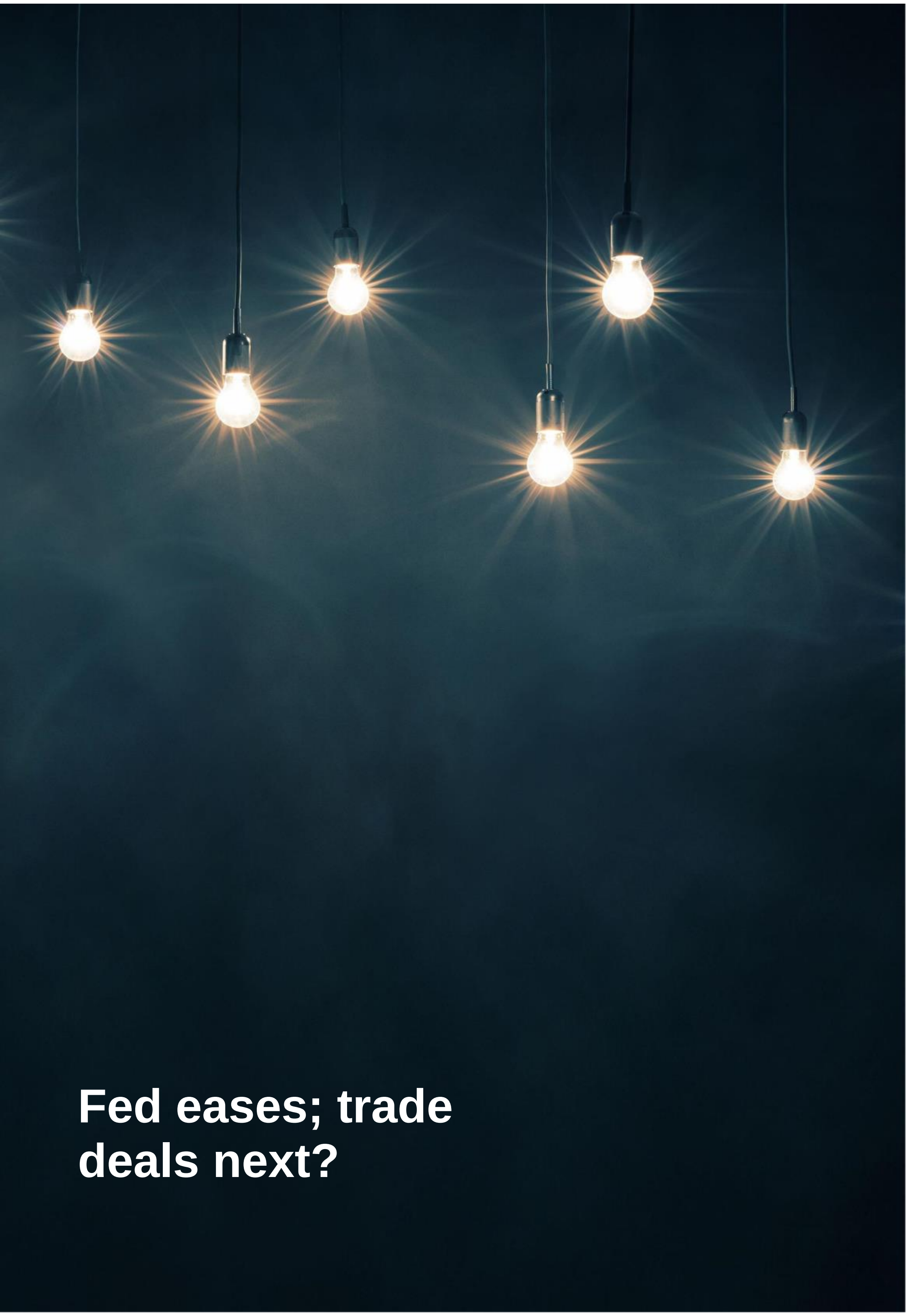
Macro Strategy | 20 September 2019

Weekly Market View



Fed eases; trade deals next?

The Fed eased monetary policy further, following ECB easing earlier. Potential US trade deals with Japan and China could be the next drivers of risk assets

Equities: We remain cautious on Japanese equities, despite the latest outperformance, given weak earnings expectations

Bonds: The brief spike in a section of the US money market due to tight liquidity raises the chances of the Fed expanding its balance sheet

FX: A US-Japan trade deal could be one trigger for a weaker USD

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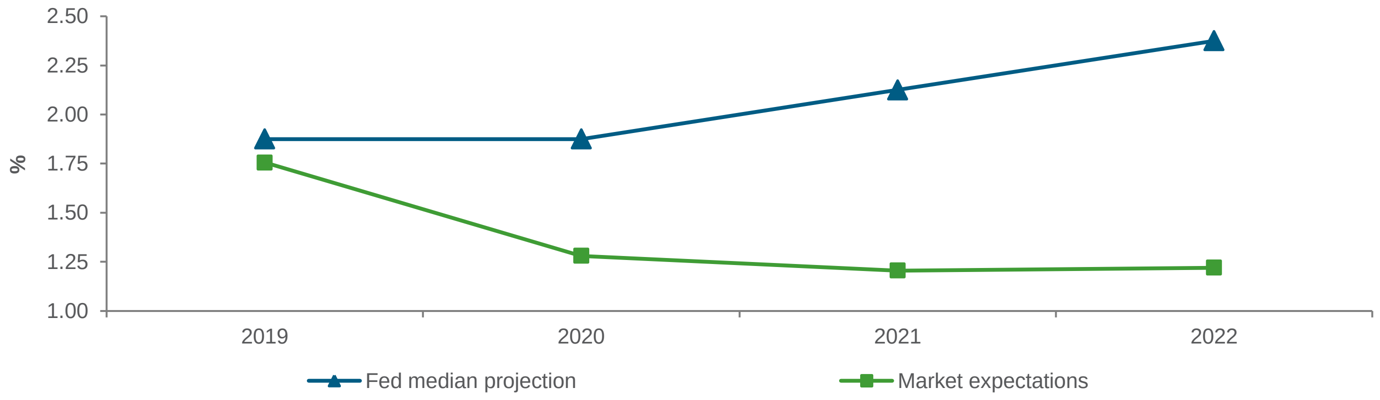
Chart of the week: Wide gap between Fed and the market

The Fed remains non-committal on further rate cuts despite market expectations of lower rates

Fed policymakers' median projections and US money markets' expectations of Fed rates over the next three years



Source: Bloomberg, Standard Chartered

Editorial

Fed eases; trade deals next?

Global equities consolidated after three weeks of gains, while US and European government bond yields stabilised after two weeks of sharp rises. The Fed's reluctance to commit to further rate cuts, after delivering a much-anticipated 25bps reduction, likely put a brake to the bullish uptrend in risk assets since late August. The drone strike on Saudi Arabia's critical oil facilities has also revived geopolitical risks.

However, we believe the Fed stance should not come as a surprise, given its increasingly data-dependent policy direction. US labour market, consumption, housing and services sector data remain robust, while there were some signs this week of stabilisation in industrial production data.

The focus now turns to the UN meetings, at the sidelines of which the US and Japan are slated to finalise a free-trade agreement. Recent changes in the US foreign policy team and President Trump's latest comments also raise the possibility of an interim US-China trade agreement. Such an outcome could remove a key source of uncertainty.

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A non-committal Fed

The Fed cut its benchmark rate by 25bps, as expected, delivering its second rate reduction in this decade-long economic expansion cycle. While it cited external risks to the economy caused by global trade uncertainty as the reason for the insurance cuts, it did not commit to further rate reductions, highlighting a still-robust domestic economy. The central bank's updated forecasts show only seven of its 17 policymakers now expect another rate cut this year, while the others either expect a rate hike or no further change.

We have some sympathy with the Fed's non-committal, data-dependent policy stance. After a series of healthy consumption and services sector indicators in recent weeks, data this week showed housing starts and building permits rising to their strongest since 2007, underscoring how low mortgage rates and a strong job market are enticing home buyers. Also, a broad rebound in industrial production raises the chances the manufacturing downturn is close to bottoming.

Against this constructive backdrop, we do see scope for one more rate cut this year; but, this is dependent on the outcome of US-China trade talks. Any interim trade agreement in October, as President Trump signalled, could revive global sentiment and lead the Fed to leave rates on hold. That suggests bond yields, which are factoring in 2-3 more rate cuts by end-2020, are unlikely to decline significantly lower from here. They are more likely to trade around current levels, in our view.

Saudi attacks revive geopolitical risks

Oil prices initially jumped almost 20% following last weekend's drone attacks on facilities in Saudi Arabia, the world's largest oil exporter. The attacks shut down nearly half of the Kingdom's production capacity (5% of global output), but authorities expect most of the shuttered facilities to come back online in a few weeks. This has helped prices to pull back and stabilise 8% higher from the levels prior to the attacks.

The still-elevated prices suggest geopolitical risk premium has returned to oil markets, given the vulnerability of critical Saudi facilities to external attacks. The focus remains on how soon production can be restored and on whether the US or Saudi Arabia retaliates against the attackers (the US blamed Iran for the attacks, though Iran has denied any involvement). Nevertheless, chances of a significant price spike appear low, given assurance from the International Energy Agency that it has more than 1.5bn barrels of oil stockpiles and the likelihood of increased US production at elevated oil prices. On technical charts, WTI crude has not been able to break past key resistance at July's high of USD 60.94/bbl. However, since it has held above a strong support area (100- and 200-DMAs), a retest of Monday's high of 63.38 cannot be ruled out (see page 5 for implications for markets).

More stimulus in China

In the run-up to 1 October National Day, China continues to roll out measures to revive consumption. The Guiyang Municipal Government has recently lifted the purchase ban on automobiles, while Hainan province has announced measures to boost auto demand. Although data this week showed investment and industrial output continued to slow amid trade uncertainty, consumer spending remains relatively robust. Increasing government incentives for consumption is one of the reasons why the consumer sector is preferred within China equities.

What we are watching

US-Japan/China trade deal; Euro area PMI; US durable goods orders.

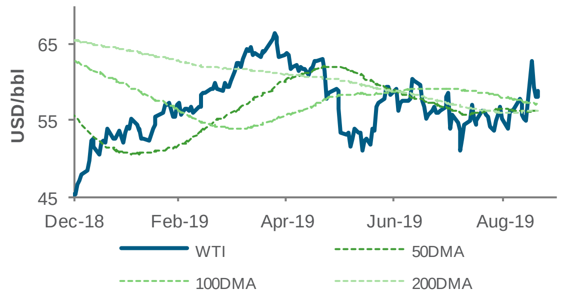
US housing starts and building permits rose to their strongest levels since 2007 as lower interest rates and a strong job market entice home buyers

US housing starts and building permits, annualised

Source: Bloomberg, Standard Chartered

Crude oil prices remain elevated, despite paring initial gains, amid the return of geopolitical risks following the attack on Saudi oil facilities

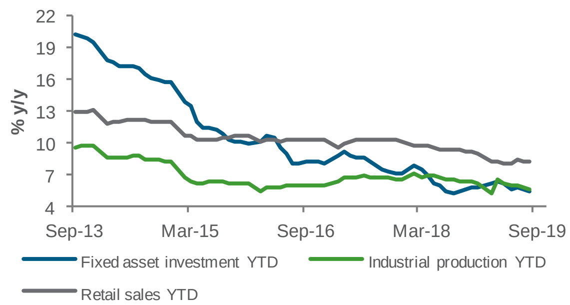
WTI crude oil, with 50-,100-, 200-day moving averages



Source: Bloomberg, Standard Chartered

China's consumption growth has remained relatively resilient despite continued weakness in fixed asset investment and industrial production

YTD growth in China's retail sales, industrial production and fixed asset investment



Source: Bloomberg, Standard Chartered

What does this mean for investors?

Equities

Is it time to turn bullish on Japanese equities? Japanese equities have outperformed peers since the start of the month, with the Topix staging a 6.9% rally. The strength of the rebound, coupled with a break above resistance on the 200DMA, suggests that its multi-month downtrend could be reversing. We would wait for a break above resistance at the April high of 1,634 (which could be associated with a break above August's high in USD/JPY) before confirming an uptrend.

A likely driving force behind the Topix rally is the banking sector, which rallied 10.5%. Japanese banks have been underperforming the market for each of the past seven months, tracking the flattening course of the yield curve, but the outperformance in September came as the yield curve steepened significantly. Japan is our least preferred equity market because of low earnings growth. A reversal of the weak earnings trend would be needed to justify a more positive view.

Bonds

What are the implications of the recent surge in short-term US money market rates? Earlier this week, a segment of the US money market that determines short-term funding costs for banks (overnight repo rate) saw a sharp surge, which prompted the Fed to inject liquidity into the market. The spike in borrowing costs serves to highlight tight liquidity in financial markets and has caused some concern. However, it is important to note that the liquidity squeeze around this time of the year is a seasonal phenomenon, caused by quarterly corporate tax payments, with the current instance exacerbated by a large US Treasury coupon payment. Having said that, there is likely a structural element as well due to lower excess reserves in the banking system caused by the Fed's balance sheet reduction in recent years.

In the near term, we believe the Fed's decision to inject liquidity whenever required should calm the markets. However, over the next few months, it raises the possibility that the Fed may need to expand its balance sheet by restarting bond purchases to improve liquidity.

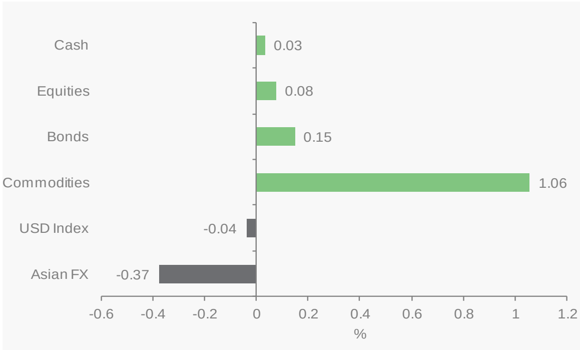
FX

What could drive the USD lower? The USD barely changed after the Fed's decision to cut benchmark rates by 25bps as the move was widely anticipated. The focus now turns to possible trade agreements, including the finalisation of the US-Japan trade pact. Any agreement to strengthen the JPY as part of the trade deal could be one trigger for USD weakness, especially if such a deal becomes a template for future trade deals with Europe and China. Overall, reduced trade tensions have the potential to revive global growth, which, in turn, could weaken the USD as investments flow back to the rest of the world.

USD/JPY failed to break strong resistance at 108.50 and fell as low as 107.79 after the BoJ left policy unchanged, only offering to review its policy stance in October. This came after the ECB and Fed both eased at this month's meetings. We believe this sets the stage for renewed USD/JPY weakness, with a possible test of support at 105.0.

EUR/USD appears to be building a base, with a double-bottom around 1.0925. A clear break of 1.1165 would be bullish. Although expectations of fiscal stimulus, especially in Germany, are low, further deterioration in data could lead to an easing of Germany's hardline stance. Such a move could boost the EUR and weaken the USD.

Benchmark (USD) performance w/w*



Source: MSCI, JP Morgan, DJ-UBS, Citigroup, Bloomberg, Standard Chartered (Indices used are JP Morgan Cash, MSCI AC World TR, Citi World Big, DJ-UBS Commodity, DXY and ADXY)

*Week of 12 September 2019 to 19 September 2019

Equity market technicals remain positive globally

Technical levels of key markets as of 19 September 2019

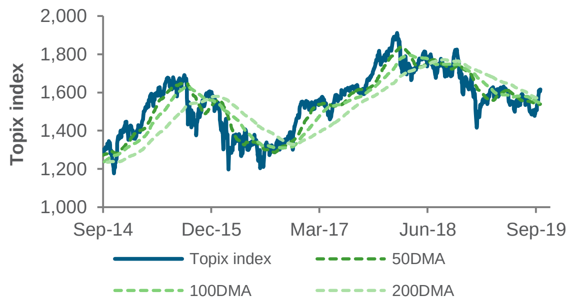
Index	Spot	1st support	1st resistance	Short-term trend
S&P	3,007	2,950	3,028	↑
STOXX 50	3,553	3,477	3,570	↗
FTSE 100	7,356	7,200	7,438	↗
Nikkei 225	22,044	21,450	22,350	↑
Shanghai Comp	2,999	2,915	3,045	↑
Hang Seng	26,469	26,000	27,500	↗
MSCI Asia ex-Japan	626	612	640	↗
MSCI EM	1,017	988	1,041	↗
Brent (ICE)	64	63	68	↗
Gold	1,499	1,480	1,525	↘
UST 10Y Yield	1.78	1.59	1.94	↗

Source: Trading Central, Standard Chartered

Note: Arrows represent short-term trend opinions

Japan's Topix stock index has outperformed its peers this month; we remain skeptical, given weak earnings

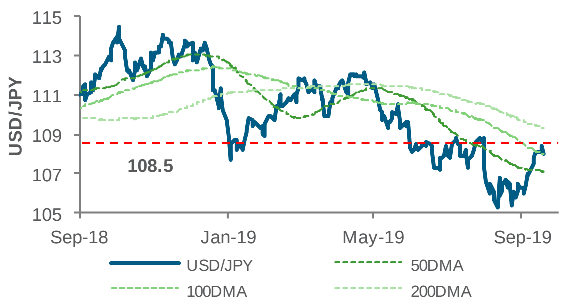
Topix index, with 50-, 100- and 200-DMAs



Source: Bloomberg, Standard Chartered

USD/JPY failed to break above the 108.50 resistance

USD/JPY



Source: Bloomberg, Standard Chartered

Top client question

What are the implications of the recent attack on Saudi oil facilities?

Over the weekend, coordinated drone attacks were carried out on two oil facilities in Saudi Arabia. Half of Saudi oil production (estimated 5.7mbd; ~5% of global oil supply) was initially halted, with crude oil prices surging higher on inventory drawdown fears. The extent of the damage remains highly uncertain.

The duration of the output disruption and potential for additional risk premium are key, in our view. Prices have corrected amid increased optimism that Saudi oil output could return to "normal levels" sooner than expected following recent announcements made by Saudi authorities. The availability and willingness to use significant global oil reserves also likely helped temper supply concerns.

The attack also likely signals the return of the 'geopolitical risk premium' (i.e. in this case a return of Iran tensions). In our assessment, this latest development could see market focus turn back to supply, especially if we see some form of retaliation.

Geopolitical risk premium aside, we retain a largely range-bound view of oil prices as markets will likely look past these short-term dislocations, while the tug of war between supply and demand-side factors continues to play out.

Impact on bonds:

Emerging Market USD government bond yield premiums were relatively resilient in the aftermath of the attack on Saudi oil infrastructure. Yield premiums for Saudi Arabia and GCC sovereign bonds rose by nearly 15-20bps as markets priced in a greater geopolitical risk premium. Investors could start demanding risk premium for bonds from the Middle East, something which has arguably already occurred to some extent. Any impact on Emerging Market oil exporters and importers outside the Middle East should largely offset each other. Hence, we continue to view EM USD bonds as a preferred asset class.

The rise in oil prices also supported a rally in US High Yield (HY) corporate bonds. While higher oil prices are generally supportive for the energy sector which forms almost 15% of the US HY bond market, we remain cautious of the gradual deterioration in fundamentals, which could lead to higher default rates over the next 12 months. Thus, we retain US HY bonds as a core holding.

Impact on equities:

In equities, the jump in oil price led the energy sector to significantly outperform the broader market this week. In the US, energy is the best performing sector up +7% month-to-date, whilst in Europe and China, it is up +6% month-to-date. Upstream oil producers would directly benefit from higher oil prices, while oil services providers could also benefit if the elevated oil price is sustained.

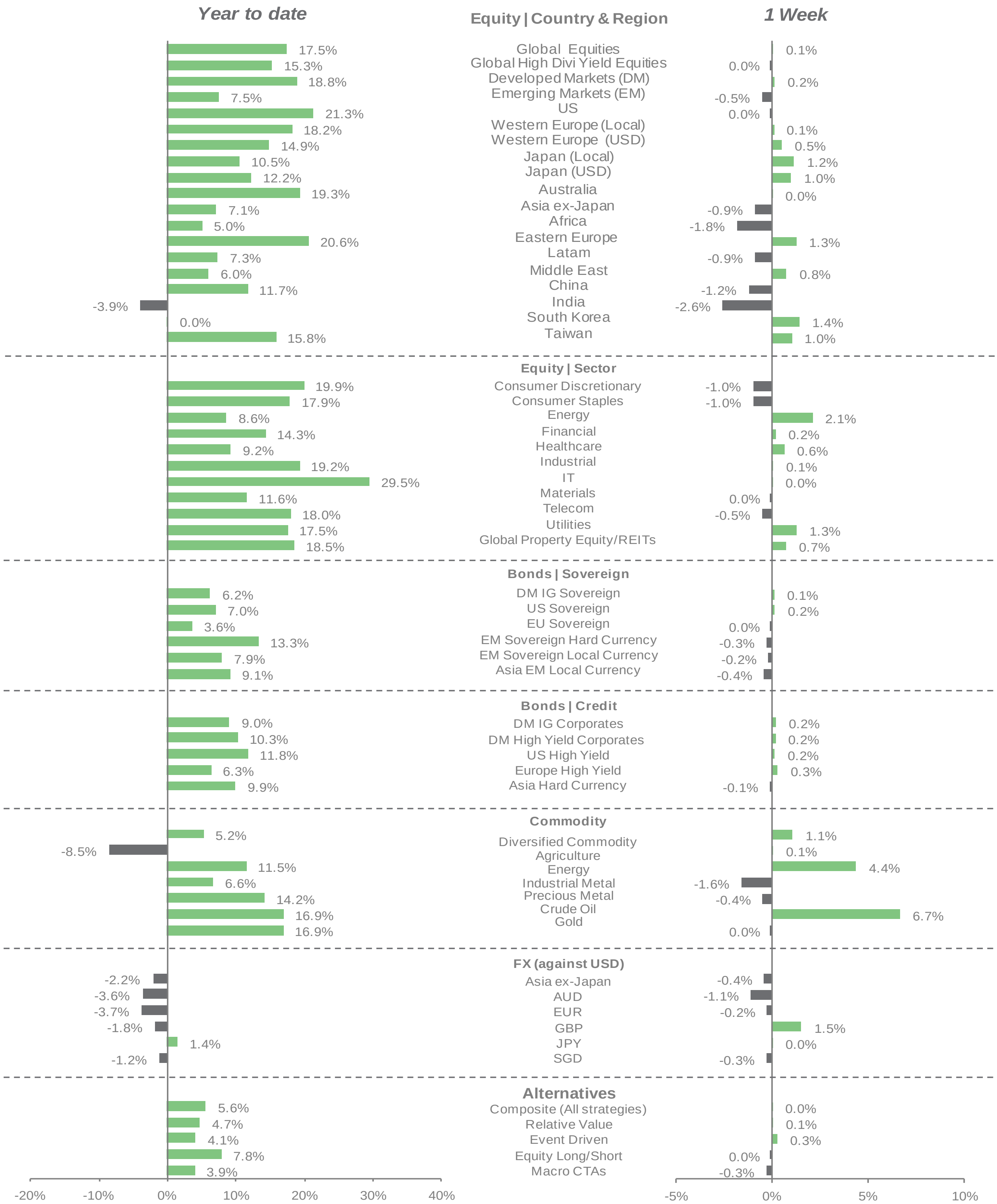
The energy sector in Europe is a preferred sector for us given the attractive dividend yield is supported by strong cashflows. Evidently, some other sectors like airlines and transportation would feel the direct impact of higher fuel costs, but a wider impact on companies' profit margins will only be visible if oil price gains are sustained.

US High yield and EM USD government bonds have both benefitted from higher oil prices, despite elevated geopolitical risk after the attack on Saudi facilities

Yield premium of US High Yield and EM USD government bonds over US Treasuries

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, YTD period from 31 December 2018 to 19 September 2019, 1 week period: 12 September 2019 to 19 September 2019

Economic and market calendar

	Event	Next Week	Date	Period	Expected	Prior
MON	GE	Markit/BME Germany Composite PMI	23-Sep-19	Sep P	51.4	51.7
	EC	Markit Eurozone Composite PMI	23-Sep-19	Sep P	52	51.9
	US	Markit US Composite PMI	23-Sep-19	Sep P	–	50.7
TUE	GE	IFO Expectations	24-Sep-19	Sep	91.8	91.3
	US	Conf. Board Consumer Confidence	24-Sep-19	Sep	133.5	135.1
WED						
THUR	US	GDP Annualized q/q	26-Sep-19	2Q T	2.0%	2.0%
	US	Personal Consumption	26-Sep-19	2Q T	–	4.7%
	US	Core PCE q/q	26-Sep-19	2Q T	–	1.7%
FRI/SAT	CH	Industrial Profits y/y	27-Sep-19	Aug	–	2.6%
	EC	Economic Confidence	27-Sep-19	Sep	103	103.1
	US	Personal Income	27-Sep-19	Aug	0.4%	0.1%
	US	Durable Goods Orders	27-Sep-19	Aug P	-1.3%	2.0%
	US	Real Personal Spending	27-Sep-19	Aug	–	0.4%
	US	Cap Goods Orders Nondef Ex Air	27-Sep-19	Aug P	–	0.2%
	GE	Retail Sales NSA y/y	27-Sep-19	Aug	–	4.4%

	Event	This Week	Date	Period	Actual	Prior
MON	CH	Fixed Assets Ex Rural YTD y/y	16-Sep-19	Aug	5.5%	5.7%
	CH	Industrial Production y/y	16-Sep-19	Aug	4.4%	4.8%
	CH	Retail Sales y/y	16-Sep-19	Aug	7.5%	7.6%
TUE	EC	ZEW Survey Expectations	17-Sep-19	Sep	-22.4	-43.6
	US	Industrial Production m/m	17-Sep-19	Aug	0.6%	-0.1%
WED	JN	Exports y/y	18-Sep-19	Aug	-8.2%	-1.5%
	UK	CPI Core y/y	18-Sep-19	Aug	1.5%	1.9%
	US	Building Permits	18-Sep-19	Aug	1419k	1317k
	US	Housing Starts	18-Sep-19	Aug	1364k	1215k
	BZ	Selic Rate	18-Sep-19	18-Sep	5.5%	6.0%
THUR	US	FOMC Rate Decision (Upper Bound)	19-Sep-19	18-Sep	2.0%	2.25%
	UK	Bank of England Bank Rate	19-Sep-19	19-Sep	0.75%	0.75%
	US	Leading Index	19-Sep-19	Aug	0.0%	0.4%
	US	Existing Home Sales	19-Sep-19	Aug	5.49m	5.42m
	JN	BOJ Policy Balance Rate	19-Sep-19	19-Sep	-0.1%	-0.1%
FRI/ SAT	JN	Natl CPI Ex Fresh Food, Energy y/y	20-Sep-19	Aug	0.6%	0.6%
	GE	PPI y/y	20-Sep-19	Aug	–	1.1%

Source: Bloomberg, Standard Chartered; key indicators highlighted in blue
Previous 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

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