

Weekly Market View

Getting hotter still

→ Hotter-than-expected US inflation in June, which followed a tighter-than-expected job market report, has further clouded the market outlook. It has added urgency among central banks worldwide to accelerate the pace of policy tightening, in turn bringing forward the risk of a sharper growth downturn in the coming quarters.

→ As flagged in our H2 Outlook, this is not the time to take excessively concentrated positions in any particular asset class. We continue to prefer broadly diversified exposure across equities, bonds and alternative assets in our benchmark asset allocation.

→ We would continue adding exposure to defensive equity sectors such as healthcare in the US and Europe, and maintaining inflation hedges through energy sector equities, gold and private assets. It is also a good time for income-seeking investors – our model income allocation for investors with moderate risk profile now yields more than 6%.

Why are China property stocks and bonds taking another leg lower?

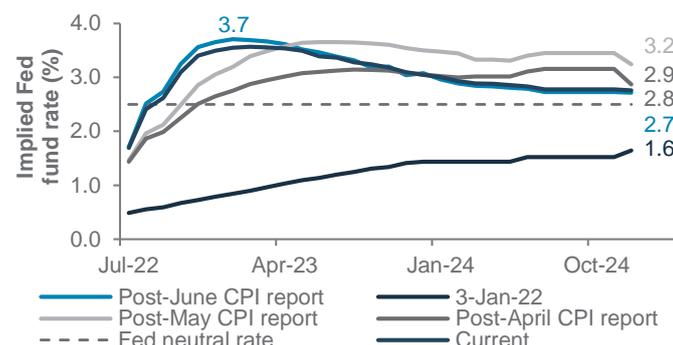
Could the fall in oil and other commodities extend amid rising recession worries?

Deep Dive: Is the US dollar's strength likely to extend into H2? What are the implications for major currency pairs?

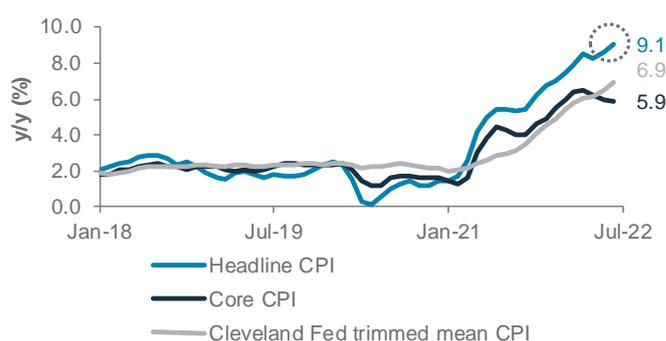
Charts of the week: Accelerated pace of Fed rate hikes?

Markets brought forward Fed rate hike expectations after yet another month of hotter-than-expected inflation

Market expectations of the Fed rate after past inflation reports



US headline, ex-food-and-energy and trimmed-mean* inflation



Source: Bloomberg, Standard Chartered; Trimmed-mean inflation excludes the most extreme monthly price changes

Editorial

Getting hotter still

Hotter-than-expected US inflation in June, which followed a tighter-than-expected job market report, has further clouded the market outlook. It has added urgency among central banks worldwide to accelerate the pace of policy tightening, in turn bringing forward the risk of a sharper growth downturn in the coming quarters. As flagged in our H2 Outlook, this is not the time to take excessively concentrated positions in any particular asset class. We continue to prefer broadly diversified exposure across equities, bonds and alternative assets in our benchmark asset allocation, while adding exposure to defensive equity sectors such as healthcare in the US and Europe, and maintaining inflation hedges through energy sector equities, gold and private assets.

The latest US inflation report showed headline inflation accelerated to a new 40-year high of 9.1%. Core inflation (excluding food and energy prices) accelerated m/m to 0.7%. Broad-based gains in inflation have raised the risk of a 100bps Fed rate hike in July, followed by 75bps hike in September, in our opinion. This is based on Chair Powell's avowed view that taming inflation is a priority and that the Fed will need to see a few months of consistent m/m declines in inflation before slowing the pace of rate hikes. Other central banks have already responded to ongoing inflation pressure – the Bank of Canada this week delivered a bigger-than-expected 100bps rate hike, while in Asia, the central banks of Singapore and Philippines followed suit with unscheduled policy tightening.

The good news is that negative correlation between stocks and bonds appears to have returned, ie, in recent weeks, bonds gained in weeks stocks declined (and vice versa), thus bringing back the benefits of portfolio diversification, unlike most of H1. In fact, after the inflation report, long-term US government bonds rose (yields fell). The US 2-year bond yield rose sharply above the 10-year yield, with the 10-year vs 2-year gap at its most negative since 2000, suggesting investors have brought forward expectations of Fed rate hikes. The market's terminal (end-of-cycle) rate expectation remains below June's c.4%

peak (see chart above), which means investors believe a US recession is a bigger concern in the medium term than inflation. This should put a lid on the US 10-year government bond yield around June's 11-year high of 3.5% and hasten a peak in the USD (see page 4 for a deep-dive on the USD).

The apparent peak in US long-term government bond yields supports our preference for a diversified income allocation, compared with a traditional balanced allocation. We believe bonds, on balance, have already significantly priced in upside inflation risks and central bank tightening expectations and are better placed to benefit from any growth downside. Our model income allocation for investors with a moderate risk profile – which allocates 52% to bonds, 28% to high dividend yielding equities and 20% to non-core assets – now yields more than 6%, the highest in more than a decade.

Meanwhile, another COVID-19 wave in China and renewed concerns about the property sector (see page 5) has clouded the near-term outlook for China's economy. Nevertheless, China has the advantage of growing policy support, unlike in the US and Europe where fiscal and monetary policies are tightening. China's credit growth accelerated further in June and the government is now proposing to bring forward its CNY 2.6trn infrastructure financing from 2023 to H2 22. While the accelerated financing will primarily make up for the lost revenue suffered by local governments from a slump in land sales to property developers, such credit stimulus is likely to support the domestic industrial, material and energy equity sectors.

Also on our radar: a. US Q2 earnings – some bank earnings missed estimates (see page 6); b. President Biden's trip to Saudi Arabia – will Saudi pump more oil? c. G20 finance ministers' meet (ending 17 July) – any breakthrough on Ukraine crisis? d. ECB and BoJ meetings – the ECB is in a tight spot, with still-accelerating inflation, rising growth risks, renewed political crisis in Italy, and the possibility of an energy crisis this winter. We will look out for details on the ECB's mechanisms to contain bond yields in southern Europe. e. PMIs in the US and Europe.

— 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: Strong US labour report, robust China credit growth

(-) factors: China lockdowns, regulatory fines; hotter US inflation

	Positive for risk assets	Negative for risk assets
COVID	<ul style="list-style-type: none"> Hong Kong is weighing conditional quarantine-free travel by November 	<ul style="list-style-type: none"> Shanghai reported rising cases, sparking fears of another lockdown WHO highlighted rising deaths from new waves
	Our assessment: Negative – China rising cases, lockdowns	
Macro data	<ul style="list-style-type: none"> Stronger-than-expected US job creation, with wage growth moderating slightly China credit growth climbed more than expected; M2 money supply growth unexpectedly rose China retail sales and fixed investment beat consensus 	<ul style="list-style-type: none"> US consumer and producer inflation rose more than consensus Euro area ZEW survey expectations sank to new post-COVID-19 low China Q2 GDP growth and industrial production missed expectations
	Our assessment: Neutral – Strong US labour report, robust China credit growth vs hotter US inflation, China GDP miss	
Policy developments	<ul style="list-style-type: none"> PBoC pledged more support for pandemic-hit sectors and reassured current financial risks are controllable 	<ul style="list-style-type: none"> New anti-monopoly fines on Chinese internet firms BoC raised rates by larger-than-expected 100bps RBNZ raised rates by 50bps to 2.5% as expected
	Our assessment: Negative – China regulatory fines, larger-than-expected BoC rate hike	
Other developments	<ul style="list-style-type: none"> Japan's ruling coalition expanded its upper house majority US Foreign Secretary Blinken said President Biden and President Xi Jinping are set to talk again in the coming weeks 	<ul style="list-style-type: none"> Italy Premier Draghi offered to resign after a coalition partner left his alliance, but President Mattarella rejected his resignation Concerns of a cut in Russia gas supply amid Nord Stream 1 maintenance Some China homebuyers refusing to pay mortgages OPEC's outlook suggested continued supply shortages
	Our assessment: Negative – Italy crisis, energy supply worry	

US job creation continued to exceed expectations in June as job openings stay close to record highs

US net new non-farm jobs, job openings



Source: Bloomberg; Standard Chartered

Euro area economic expectations sank to a new post-pandemic low

Euro area expectations of economic growth (ZEW)



Source: Bloomberg; Standard Chartered

China's retail sales and industrial output continued to recover in June, but fixed asset investment has yet to turn around

China fixed asset investment, retail sales and industrial output



Source: Bloomberg; Standard Chartered

Top client questions

Q Is USD strength likely to extend in H2 2022 or is the USD close to a peak? What are the implications for major FX pairs?

Over the long term (12m), we are bearish on the USD, but in the shorter-term (1-3m), we hold a neutral view but see risks it could push higher in the short term.

While we usually focus on relative (i) real bond yields, (ii) equities, (iii) inflation, (iv) current account balances, and (v) commodity prices as key drivers of the USD, real bond yield differentials continue to be the dominant driver of the USD, helping it surge this year as the Fed guided interest rate expectations higher.

In our H2 Outlook, we noted that a rise in the DXY towards 109 in the short term was possible, a move that has played out to a large extent. However, this move may not have exhausted itself given this week's US inflation surprise, the USD's safe haven demand amid geopolitical risks and the currency's strong momentum.

Our 1-3m view on the USD means the move lower in other majors may also have not fully completed. This is most visible in the JPY, where the BoJ's persistence with policies to boost inflation makes the gap in yield differentials most extreme. This suggests a USD/JPY test of 140 is possible before the pair peaks. The differential is less extreme for EUR/USD, but the ECB's relatively more balanced signals on rate hikes mean the 1.00 level is now being tested, with 0.98-0.99 being the subsequent support. GBP/USD faces rising growth challenges of its own, despite a relatively more hawkish BoE, suggesting 1.179 and subsequently 1.160 are key supports.

On a longer 12m horizon, though, a combination of very expensive valuations and our long-term view on key drivers keep us bearish on the USD. Valuations based on the real effective exchange rate argue the USD is at the most expensive level in decades. The markets have significantly priced in Fed rate hikes, in our view, which could limit further USD gains (unless US inflation continues to deliver upside surprises and the Fed tightens more than expected). Also, Asia ex-Japan equities are likely to lead outperformance of non-US equity markets, US inflation is likely to peak in H2, US external balances are USD-negative and commodity price gains are slowing.

Among the majors, the EUR/USD is likely to be one of the key beneficiaries of the USD's eventual weakness, given the EUR's large size in the DXY index and given the scope for the ECB to tighten policy. We expect a move back to 1.08. USD/JPY is arguably most susceptible to a sharp reversal on any shift in fundamentals, given valuations are close to multi-decade lows and positioning is largely one-sided in favour of further JPY weakness. We expect a move to 126. Finally, the GBP should ultimately benefit from an eventual bottoming of global growth, although stagflation remains a risk. We expect inexpensive valuations to help GBP/USD rise to 1.27.

— **Manpreet Gill**, Head, FICC strategy

The USD (DXY) index has surged this year largely due to interest rate differentials as Fed rate expectations soared

USD Index, 2-year DXY index-weighted interest rate differentials between the US and key trade partners



Source: Bloomberg, Standard Chartered

The USD looks very expensive, with valuation at its highest level since 2002

USD real effective exchange rate (REER)



Source: Bloomberg, Standard Chartered

The JPY is very undervalued on a historical basis

JPY real effective exchange rate (REER)



Source: Bloomberg, Standard Chartered

Top client questions (cont'd)

Q What are the implications of the bond market's response to the high US inflation print?

The higher-than-expected US inflation print has led to a sharp repricing of Fed rate hike expectations for the upcoming July and September FOMC meetings. As a result, while 2-year US government yield jumped higher, the 10-year yield actually ended the day modestly lower. As a result, the yield curve (difference between 10-year and 2-year yields), a widely followed recession indicator, is at the most negative level since 2000. Bond markets are clearly flagging recessionary concerns.

In our assessment, recessionary fears are likely to exert downward pressure on 10-year yields, potentially pushing the yield curve further into negative territory. We would caution, though, that one-sided positioning means yields could retest 3.0% and 3.26% levels in the coming months should recession fears ease, even if temporarily.

From a corporate bond perspective, higher inflation is likely to focus further attention on corporate margins and management guidance. While higher borrowing costs and tighter liquidity are likely to lead to an uptick in defaults, we remain constructive on Developed Market High Yield bonds as we believe they have already priced in a mild recessionary scenario.

— **Abhilash Narayan**, *Senior Investment Strategist*

Q Why are we seeing another leg down in China property stocks and bonds?

Some disgruntled mainland Chinese owners of select property projects threatened this week to suspend mortgage repayments, as troubled developers have halted building completion since last year due to a credit crunch. The sector's equity and bond prices have weakened notably on this.

While this is project-specific for now, the market's concern is that this spirals into a confidence crisis, with further risks of a spillover to the financial sector via worsening bank loan provisioning. This suggests more active intervention by Chinese authorities is increasingly likely.

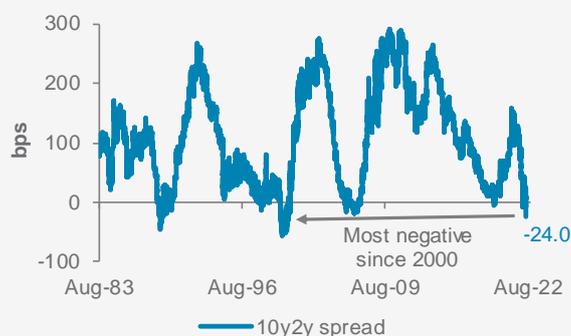
Equity implications: We reiterate our cautious stance on China's property sector until we see signs of easing policy for developers and homebuyers.

Bond market implications: We retain our preferred view on Asia USD bonds. There are concerns of contagion risk to Investment Grade developers and the Asia USD bonds more broadly. However, we would note that affected projects are currently largely limited to financially weaker developers. The real estate sector also forms only c.15% of the Asia USD bonds asset class. This is why we retain our positive view on the diversified Asia USD bonds asset class.

— **Cedric Lam**, *Senior Investment Strategist*

The US 10-year vs 2-year government bond yield gap fell to its most negative level since 2000

US 10-year government bond yield premium/discount vs 2-year government bond yield



Source: Bloomberg, Standard Chartered

China's Investment Grade property sector bonds have significantly outperformed their High Yield peers this year

Total returns of China IG and HY USD-denominated property sector bonds and their difference, YTD



Source: IBOXX, Bloomberg, Standard Chartered

Top client questions (cont'd)

Q What are the key takeaways from the US financial sector earnings so far?

The US financial sector remains one of our preferred US equity sectors as rising interest rates lead to higher net interest margins and, in turn, higher underlying earnings.

However, this earnings season, markets are likely to scrutinise the sector more broadly given rising recession concerns. Investors would be watching company guidance on loan demand, amid a slump in mortgage applications. Consumer credit has risen in 2022 as lower-income households depleted their pandemic-era savings. This trend is likely to extend if the US job market holds up, which may help offset lower demand for mortgages in the coming quarters.

So far, a few major banks have missed earnings estimates. Comments from the financial sector companies that have reported earnings this week showed: 1) increase in bad loans provisions and 2) impact from falling capital market activities, such as IPOs for equities and debt.

In terms of valuation, the US financial sector is inexpensive, at 11x 12-month forward P/E - a reasonable discount to the 10-year average of 13x. Technically, the S&P500 financial sector Index has stabilised over the last four weeks and is in an accumulation pattern.

— Daniel Lam, Head, Equity Strategy

Q Could the fall in oil and other commodities extend amid rising recession worries?

Oil (WTI) prices fell below USD 100/bbl amid fears that aggressive central bank rate hikes to stem inflation could weigh on global growth and curb oil demand. Both OPEC and the IEA also warned of a slowdown in oil demand growth. Copper – often viewed as a leading economic growth indicator – also recorded its biggest quarterly drop since 2011, falling 20% in Q2 22. Momentum indicators for oil continue to trend lower, nearing oversold levels, as oil tests its 200-DMA at 93.

We remain bullish on oil as tight global supply likely outweighs the expected slowdown in demand. OPEC said output needs to reach 30.1m/bpd in 2023 to balance global demand, an increase of another 900k bpd from 2022. Adding this additional supply may not be easy given OPEC+ has struggled to deliver on current pledged output. Any delays to the restart of the Nord Stream 1 pipeline pose additional risks to energy supply in Europe, though we would watch US President Biden's visit to Saudi Arabia closely for any positives.

On technicals, a drop below 93 could see key support of 85 tested, which we expect to hold. A break above 105 would suggest the near-term downward pressure has faded.

— Nataniel Tang, Investment Strategist

US financial sector equity valuations are attractive after the recent sell-off

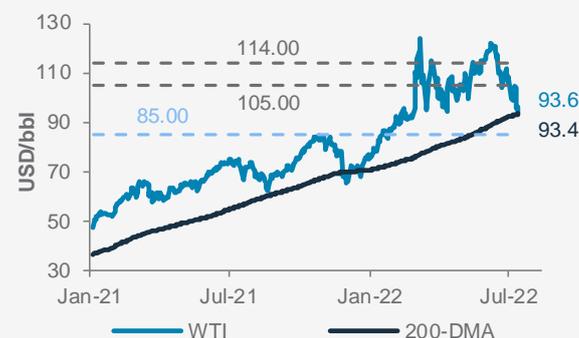
Price-to-earnings ratio of the MSCI US financial sector



Source: Bloomberg, MSCI, Standard Chartered

Crude oil has support around USD 93/bbl; a break below could see a test of USD 85/bbl

WTI crude oil price, with technical levels

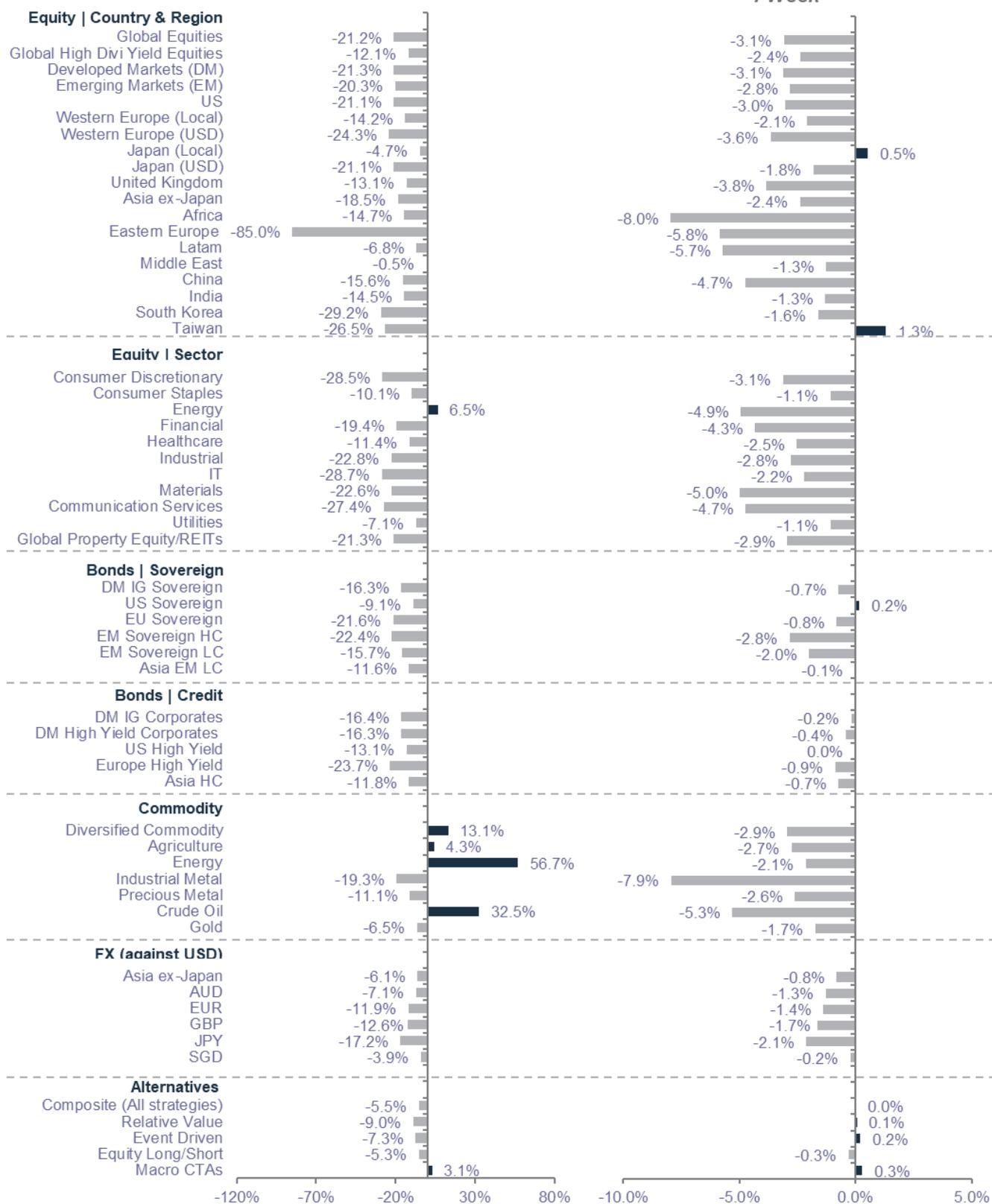


Source: Bloomberg, Standard Chartered

Market performance summary *

2022 YTD

1 Week



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

*Performance in USD terms unless otherwise stated, 2022 YTD performance from 31 December 2021 to 14 July 2022; 1-week period: 07 July 2022 to 14 July 2022

Our 12-month asset class views at a glance

Asset class	
Equities ◆	Alternatives ◆
Euro area ◆	Equity hedge ◆
US ◆	Event-driven ▼
UK ▲	Relative value ▼
Asia ex-Japan ▲	Global macro ▲
Japan ◆	
Other EM ◆	Cash ◆
	USD ▼
Bonds (Credit) ◆	EUR ▲
Asia USD ▲	GBP ▲
Corp DM HY ▲	CNY ▲
Govt EM USD ◆	JPY ▲
Corp DM IG ▼	AUD ▲
	NZD ▲
Bonds (Govt) ◆	CAD ▲
Govt EM Local ◆	
Govt DM IG ◆	Gold ▲

Source: Standard Chartered Global Investment Committee

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

US 10-yr government bond yield faces resistance at 3.1%

Technical indicators for key markets as on 14 July 2022

Index	Spot	1st support	1st resistance
S&P 500	3,785	3,743	3,870
STOXX 50	3,455	3,411	3,524
FTSE 100	7,169	7,019	7,322
Nikkei 225	25,917	25,709	26,587
Shanghai Comp	3,392	3,338	3,427
Hang Seng	21,860	21,283	22,428
MSCI Asia ex-Japan	653	643	667
MSCI EM	1,001	987	1,022
Brent (ICE)	109	107	115
Gold	1,801	1,797	1,816
UST 10y Yield	2.96	2.91	3.10

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	Jobless Claims Change	Jun	- -19.7k
	UK	ILO Unemployment Rate 3Mths	May	- 3.8%
TUE	US	Housing Starts	Jun	1600k 1549k
	UK	CPI y/y	Jun	- 9.1%
	UK	CPI Core y/y	Jun	- 5.9%
WED	US	Existing Home Sales	Jun	5.40m 5.41m
	EC	Consumer Confidence	Jul P	- -23.6
	EC	ECB Deposit Facility Rate	Jul	- -0.5%
THUR	US	Leading Index	Jun	-0.5% -0.4%
	UK	Retail Sales Ex Auto Fuel y/y	Jun	- -5.7%
FRI/SAT	EC	S&P Global Eurozone Manufacturing PMI	Jul P	- 52.1
	EC	S&P Global Eurozone Services PMI	Jul P	- 53.0
	UK	S&P Global/CIPS UK Manufacturing PMI	Jul P	- 52.8
	UK	S&P Global/CIPS UK Services PMI	Jul P	- 54.3
	US	S&P Global US Manufacturing PMI	Jul P	- 52.7
	US	S&P Global US Services PMI	Jul P	- 52.7
	JP	Bank of Japan Monetary Policy Meeting	Jul	- -

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 has normalised in global bonds

Our proprietary market diversity indicators as of 13 July

Level 1	Diversity	1-month trend	Fractal dimension
Global Bonds	●	→	1.32
Global Equities	●	↓	1.36
Gold	●	↓	1.25
Equity			
MSCI US	●	↓	1.39
MSCI Europe	●	↓	1.33
MSCI AC AXJ	●	↓	1.43
Fixed Income			
DM Corp Bond	●	→	1.36
DM High Yield	●	↓	1.30
EM USD	●	↓	1.28
EM Local	○	↓	1.24
Asia USD	●	→	1.37
Currencies			
EUR/USD	●	↓	1.32

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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