Macro Strategy | 14 August 2020

Standard Chartered Private Bank

Weekly Market View

Should we worry about rising yields?

Rising bond yields reflect improving economic growth expectations and waning concerns about the pandemic, in our assessment. We expect central banks to cap bond yields beyond a point which, combined with rising inflation expectations, is positive for equities and other risk assets

Equities: We see gold miner equities as a reasonable proxy for gold, but they come with higher risk than physical gold, given relatively higher volatility

Bonds: Rising bond yields likely reflect improving economic fundamentals, which supports better corporate profitability; this is positive for corporate and Emerging Market bonds

FX: We see near-term upside to USD/JPY, given high correlation with US Treasury yields

Also find out...

Does gold's recent pullback mean the bull run is over?

Are gold equities a good proxy for physical gold?

What are the macroeconomic factors driving improving risk appetite?

Charts of the week: Challenging the 'double-top'

As the S&P500 index tests its February all-time high, rising bond yields pose a near-term risk; we expect the Fed to cap bond yields

S&P500 index

US 10-year Treasury yield and 10-year real (net of inflation) yield

Source: Bloomberg, Standard Chartered

Editorial

Should we worry about rising bond yields?

As the S&P500 index tests its February all-time high amid improving fundamentals, a recurring question is whether a sudden rise in bond yields threatens the stock market rally. We acknowledge these near-term risks, notably from the recent rise in bond yields and stretched investor positioning in some bond and other markets, but our net assessment is that economic and corporate fundamentals are turning positive, supporting our medium-term positive view on equities and other risk assets. Thus, we would view any near-term setback to the risk asset rally as an opportunity to add to our preferred asset classes (see pages 4-5).

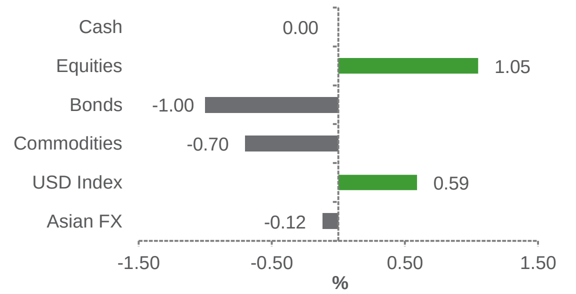
In our assessment, the recent rebound in bond yields reflects growing investor confidence that the world's major economies are recovering from the COVID-19-led recession faster than previously expected. We see some valid reasons behind this optimism: 1) business confidence indicators (PMIs) and job market data from the US, Europe and China have exceeded expectations in recent months; 2) the pandemic appears to be past the peak in north Asia, Europe and most recently in the US (despite nascent signs of a revival in some parts) and mortality rates continue to fall; 3) positive surprise in vaccine developments in the US, Europe and most recently in Russia and China, which raises the chances of a sooner-than-expected global rollout; 4) sustained policy stimulus worldwide, most recently with US President Trump's decision to use his executive powers to extend jobless insurance payments.

Improving activity is also reflected in the revival of inflation expectations in recent months. As bond yields rise to reflect this economic recovery, we expect central banks to weigh in and limit the rise in yields, given their primary focus for the next few quarters will likely be on sustaining the economic rebound. Improving growth and a policy-driven cap on bond yields despite rising inflation expectations (resulting in further falls in net-of-inflation 'real' yields) are a recipe for outperformance of stocks and other risk assets and gold, in our view.

This positive outlook notwithstanding, some near-term risks remain, namely: 1) extremely one-sided bullish trades in most bonds, EUR/USD and AUD/USD (less so for gold after this week's pullback); 2) rising US-China tensions; and 3) a possible resurgence in COVID-19 cases. In our opinion, while these risks could create near-term volatility, they are unlikely to negate the long-term bullish case for risk assets.

Equities and USD rose and commodities fell in the past week as bonds fell amid rising inflation expectations

Benchmark market performance w/w*



Source: Bloomberg; *Week of 06 August 2020 to 13 August 2020

Our proprietary analysis shows market diversity is extremely low in most bonds, EUR and AUD

Market diversity across key asset classes

Level 1	Diversity	Diversity trend since 14-July-20	Price trend since 14-July-20	Fractal Dimension
Global Bonds	○	→		1.17
MSCI ACWI	○	↓		1.24
Gold	◐	↓		1.32
Equity				
MSCI US	◐	↓		1.31
MSCI Europe	◐	↓		1.36
MSCI AC AXJ	◐	→		1.27
Fixed Income				
DM Corp Bond	○	→		1.13
DM High Yield	○	↓		1.24
EM USD	○	↓		1.21
EM Local Currency	◐	→		1.29
Asia Hard Currency	○	→		1.20
Currencies				
USD/CNY	◐	↓		1.46
EUR/USD	○	↓		1.20
USD/JPY	●	↓		1.97
GBP/USD	◐	↓		1.28
AUD/USD	○	→		1.25

Source: Bloomberg, Standard Chartered; **Fractal dimensions below 1.25 indicate extremely low market diversity**

Legend: ○ Very low ◐ Low ● Moderate/high

The weekly macro balance-sheet

	Positive for risk assets	Negative for risk assets
COVID-19	• US daily new COVID-19 cases continued to decline for the third week after peaking in mid-July; cases in Japan, Australia, Spain showed signs of peaking • Russia became the first country to approve a COVID-19 vaccine • Reports (Financial Times) suggested China could roll out a vaccine widely from October	• Daily new cases continued their uptrend in India and Indonesia and remained close to peak in Brazil • Nascent signs of a resurgence in new cases in Germany and New Zealand
	Our assessment: The continued downtrend in the US is positive for risk appetite. Russia's vaccine may hasten others in the pipeline.	
Macro data	• US job creation in July beat expectations and initial jobless claims fell below 1 million for the first time since March • Euro area's ZEW and Sentix investor sentiment indices rose more than expected in August, sustaining their post-May recovery • German exports and industrial output were stronger than expected m/m in June; China's export growth accelerated in July, beating expectations	• US' consumer and producer price inflation accelerated faster than expected in July, raising concerns about long-term inflation expectations • German consumer inflation continued to contract m/m in July, indicating deflationary pressures in Europe • China's credit growth slowed in July, missing estimates, underlining policy caution against excessive lending
	Our assessment: Strong data points to a sustained economic recovery; revival of inflation is a risk, especially if growth recovers faster than expected, as policies remain highly accommodative.	
Policy developments	• President Trump used executive powers to extend jobless insurance payments and defer payroll taxes, and mulled cutting capital gains taxes, as Democrats and Republicans remained divided over a new stimulus package • BoE deputy governor said the bank would step up its bond-buying programme, if needed • RBNZ raised its bond-buying programme to NZD 100bn from NZD 40bn and proposed other steps to support the economy	• Richmond Fed President Barkin said the US economy was facing a "sinkhole", urging Congress to extend stimulus
	Our assessment: On balance, President Trump's executive action to extend fiscal aid raises pressure on Congress to reach a deal.	
Other developments	• US presidential candidate Biden's pick of moderate Kamala Harris as his running mate eases concerns about extreme leftist policies • President Trump's adviser Kudlow said the US-China trade deal was 'fine', with China boosting imports, ahead of trade talks this weekend • The UK and Japan unveiled plans for a post-Brexit trade deal	• China announced sanctions against 11 top US officials, responding to US sanctions against China/Hong Kong officials • International Energy Agency cut its global crude oil demand forecast for H2
	Our assessment: Biden's choice of a moderate running mate eases policy concerns, although rising US-China tensions remain a risk.	

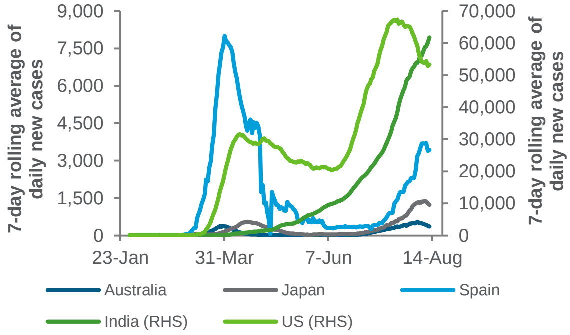
Our weekly net assessment: On balance, this week's data and policy are positive for risk assets, although a revival of inflation is a potential risk

(+) factor: potential peak in US COVID-19, strong data, policy support

(-) factor: potential revival of inflation expectations, US-China tensions

COVID-19 new cases appear to have peaked in the US, Spain, Japan and Australia, though cases continue to rise in India

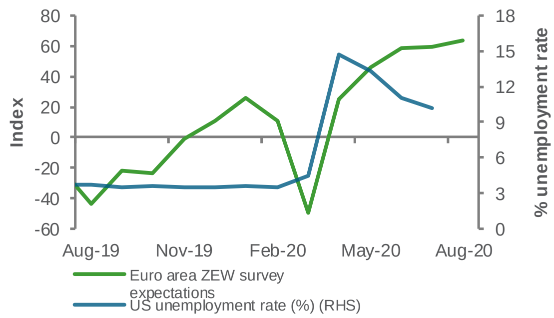
Daily new COVID-19 cases in the US and other recent hot-spots



Source: Bloomberg, Standard Chartered

The improvement in the US job market and Euro area investor sentiment reflects a faster-than-expected economic recovery

US unemployment rate and Euro area ZEW survey of economic growth expectations



Source: Bloomberg, Standard Chartered

The US economic recovery is reflected in rising near-term inflation

Headline and core consumer inflation in the US

Source: Bloomberg, Standard Chartered

Top client questions

What are the implications of rising bond yields on your outlook for bonds?

The c.15bps rise in 10-year US Treasury yields since recent lows on 4 August has led to renewed concerns about whether bond yields could start to trend higher in both nominal and real (ie. net-of-inflation) terms. However, we are less concerned and instead view the recent rise in US Treasury yields as a relatively contained move that reflects the recent improvement in macroeconomic data and brings yields within our expected range of 0.75-1.00%.

A key component of our view is the Fed's commitment to maintaining easy policy, which suggests an effort is likely to limit any significant rise in bond yields. On technical charts, the US Treasury 10-year yield continues to be in a 0.50%-0.96% range. The yield needs to break above the upper end of this range for meaningful upward pressure to start building.

Given that (i) the rise in yields can be attributed to growth optimism and better prospects for vaccine development and that (ii) rising inflation expectations mean real yields are likely to stay capped or even fall further, our conviction in corporate and EM bonds remains intact. These factors support further improvement in corporate profitability, which could help improve credit quality and result in lower yield premiums over Treasuries. Given that yield premiums in most markets are higher or close to their long-term average, we see room for them to compress and offset any further rise in US Treasury yields.

Does gold's recent pullback mean that the bull run is over from a technical point of view?

The recent retreat in gold prices does not alter the medium- and long-term uptrend, in our view. However, from a one-month (short-term) perspective, the pause in the rally could extend a bit further.

Despite the retreat, gold is still quite overbought on longer-term charts. The 14-week Relative Strength Index (RSI) is around 68 and the 14-month RSI is around 80 – levels above 70 are considered overbought. In our Global Markets Outlook published on 30 July, we had highlighted the risk of a pause in the yellow metal's rally as it tested resistance at its 2011 high of 1,920 given very overbought conditions.

Our market diversity indicator last week flashed the risk of an imminent reversal. The indicator over a 65-day window dropped below the key threshold of 1.25 last week, signalling a red flag. Moreover, just before the fall, the 14-day RSI hit unsustainable levels of 90. Our charting model over a one-month timeframe, based on the Moving Average Convergence Divergence indicator (MACD), turned short-term bearish – for the first time since June – after a key support at 2015 was broken.

However, while short-term dynamics have changed, the outlook beyond a few weeks remains bullish, in our assessment. Despite the slide, gold remains well above its long-term moving averages, which is a sign of a well-established uptrend. The 200-day moving average is currently at 1,655, 15% below Thursday's close. Immediate support for gold is at the psychological 1,900 mark, followed by 1,835 (the 38.2% retracement of the March-August rise), while stronger support is at 1,760 (the 50% retracement).

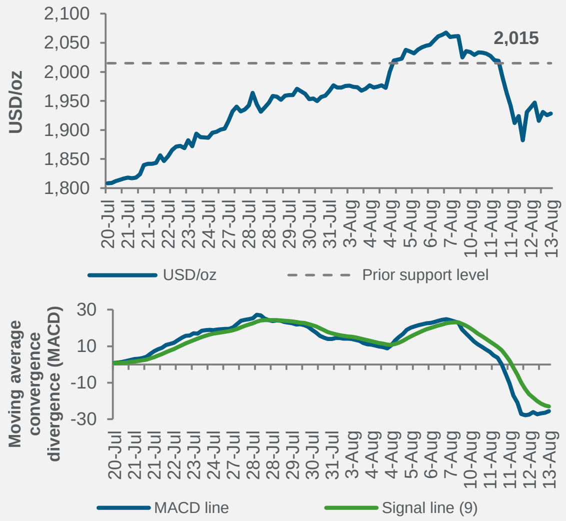
While US Treasury yields have risen lately, they remain well below pre-pandemic levels and within our expected range of 0.75%-1.00% for the 10-year yield

US 10-year Treasury yield and 10-year real (inflation-adjusted) yield

Source: Bloomberg, Standard Chartered

Gold's technical indicators point to a short-term pause in the medium-term uptrend

Gold intra-day price trend since 20 July, 2020



Source: Bloomberg, Standard Chartered

Gold has initial support 2.9% below current level

Technical indicators for key markets as on 13 August 2020

Index	Spot	1st support	1st resistance
S&P	3,373	3,345	3,391
STOXX 50	3,343	3,276	3,386
FTSE 100	6,186	6,052	6,300
Nikkei 225	23,250	22,636	23,556
Shanghai Comp	3,321	3,300	3,360
Hang Seng	25,231	24,657	25,524
MSCI Asia ex-Japan	716	711	719
MSCI EM	1,096	1,090	1,099
Brent (ICE)	45.1	44.5	45.6
Gold	1,956	1,900	2,024
UST 10Y Yield	0.72	0.61	0.77

Source: Bloomberg, Standard Chartered

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Top client questions (cont'd)

Are gold equities a good proxy for physical gold?

We continue to view gold as a preferred asset class on a 6-12 month horizon. Despite the recent pullback in prices amid stretched investor positioning and overbought technicals, we believe fundamentals for the precious metal are still supportive. Real (net of inflation) yields, which remain a key driver of the asset class, are still expected to remain low, underpinning our favourable view on gold.

To gain exposure to gold, one route investors may consider is gold equities, essentially equities of companies that produce gold. Gold equities do have a positive correlation with physical gold (see chart). The average correlation of 0.76 is reasonably high, too (relative to a min/max correlation range of 0-1), which one would expect, given the companies are mining and selling gold.

Having said that, we note other factors over and above gold prices also influence gold equities, such as production costs, licensing restrictions, financing costs and bond yields.

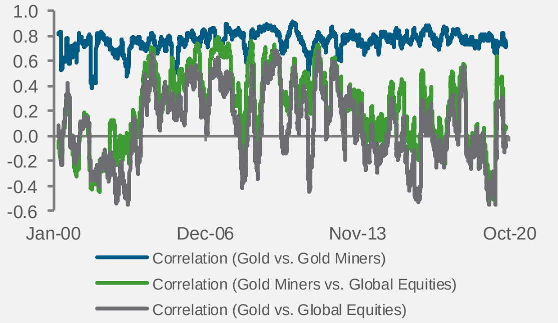
This is reflected in the correlation of gold equities to global equities, which stands at 0.24, on average. However, at various points in time, the correlation can be much higher. This implies that if there is an equity market sell-off, it is reasonable to expect that gold equities could weaken as well. In contrast, the average correlation of physical gold with global equities is significantly lower at 0.09 as physical gold often behaves like a safe haven during bouts of equity market weakness.

Another factor to consider is that gold equities are much more volatile than gold itself. On average, gold equities have been more than twice as volatile as physical gold over the last ten years.

On balance, we see gold equities as a reasonable proxy for physical gold given its high correlation. However, investors need to be aware that gold equities likely come with higher risk (and potential reward) than physical gold given their significantly higher volatility.

Gold miner equities have a high correlation with gold, which makes them a reasonable proxy for gold, but they come with higher risk than physical gold, given their significantly higher volatility

Correlation of gold with gold miners and global equities and that of gold miners with global equities



Source: Bloomberg, Standard Chartered

Does the rise in US Treasury yields point to upside in USD/JPY?

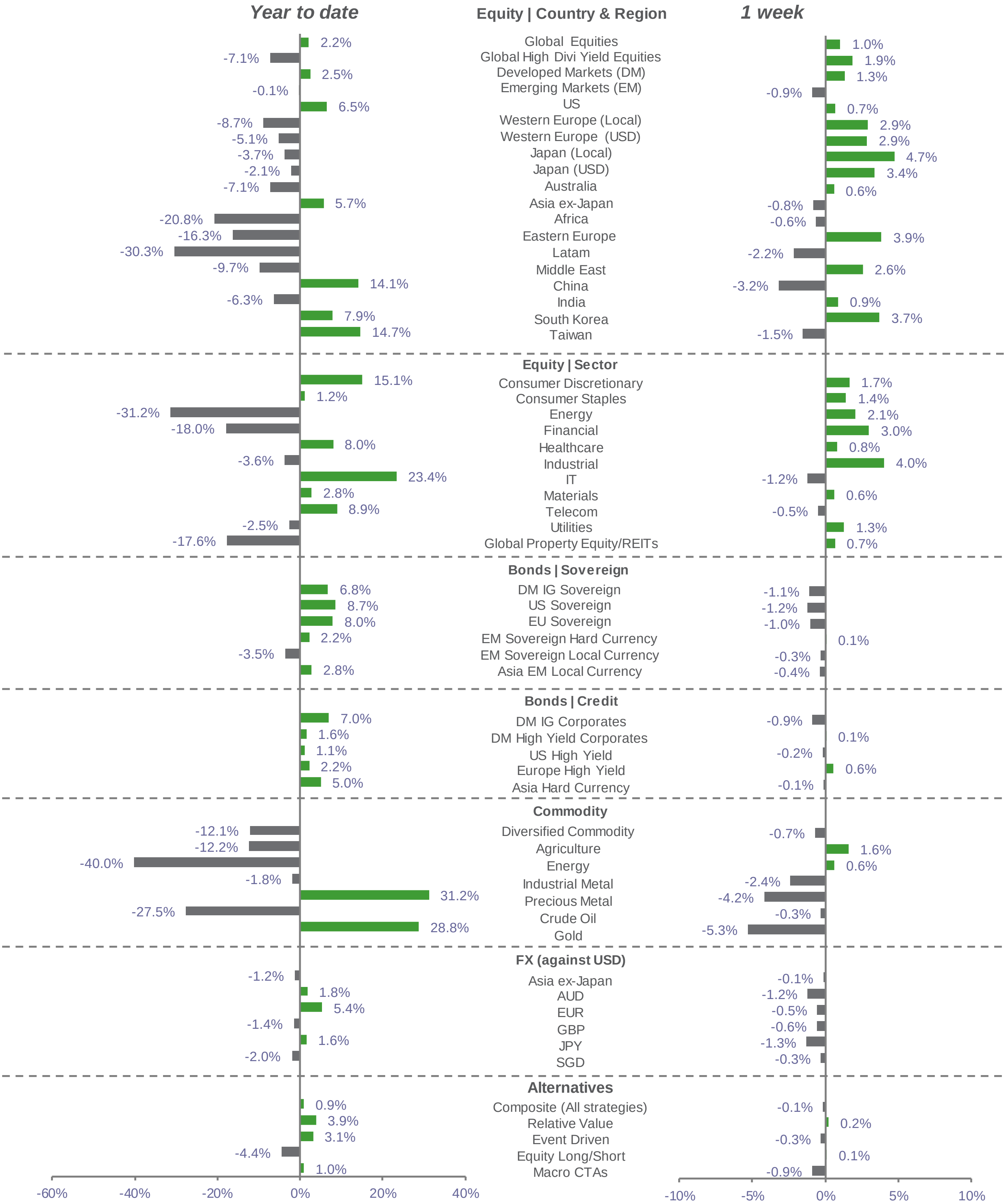
The 10-day rolling correlation between the US Treasury 2-year yield and USD/JPY is very high at 0.9, hence the recent jump in US Treasury yields raises the question of whether USD/JPY could follow suit. Mirroring US Treasury yields, USD/JPY has been hovering in a 104.50-114.50 range since 2018 (notwithstanding the brief fall to 101.17 during the COVID-19 selloff in March). However, given that 104.50 seems like a good base for now, there is a possibility that USD/JPY could rise towards its 200-week moving average (now at 110.00). The long-term moving average has provided stiff resistance in recent years. Attempts to clear the resistance decisively have failed, and there is a high possibility that the resistance could prove to be a strong hurdle to break this time around too. The implication is that while there could be interim support for USD/JPY, which could push it towards the middle of the recent years range (at 110.00), it is probably premature to conclude this is the start of a sustained uptrend. Major resistance is at the 2018 high of 114.50. On the other hand, the case for a break below the lower end of the range at 104.50 is harder to conceive while US Treasury yields remain supported, at least in the short term.

We see near-term upside to USD/JPY, given its high correlation with US Treasury yields, but the pair faces strong resistance at 110.00, followed by 114.50

USD/JPY

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, 2019 performance from 31 December 2019 to 13 August 2020, 1 week period: 06 August 2020 to 13 August 2020

Economic and market calendar

	Event	Next Week	Date	Period	Expected	Prior
MON	JN	GDP Annualized SA q/q	17-Aug-2020	2Q P	-27.0%	-2.2%
TUE	US	Building Permits	18-Aug-2020	Jul	1325k	1258k
WED	JN	Exports y/y	19-Aug-2020	Jul	–	-26.2%
	JN	Trade Balance Adjusted	19-Aug-2020	Jul	–	-¥423.9b
	JN	Core Machine Orders y/y	19-Aug-2020	Jun	–	-16.3%
	UK	CPI Core y/y	19-Aug-2020	Jul	–	1.4%
THUR	US	FOMC Meeting Minutes	20-Aug-2020	29-Jul		
	EC	ECB July Monetary Policy Meeting Account	20-Aug-2020	July		
FRI/SAT	JN	Natl CPI Ex Fresh Food, Energy y/y	21-Aug-2020	Jul	–	0.4%
	UK	Retail Sales Ex Auto Fuel y/y	21-Aug-2020	Jul	–	1.7%
	EC	Consumer Confidence	21-Aug-2020	Aug A	–	-15.0
	JN	Jibun Bank Japan PMI Composite	21-Aug-2020	Aug P	–	44.9
	GE	Markit/BME Germany Composite PMI	21-Aug-2020	Aug P	–	55.3
	EC	Markit Eurozone Composite PMI	21-Aug-2020	Aug P	–	54.9
	US	Markit US Composite PMI	21-Aug-2020	Aug P	–	50.3
	UK	Markit/CIPS UK Composite PMI	21-Aug-2020	Aug P	–	57.0

	Event	This Week	Date	Period	Actual	Prior
MON	CH	Money Supply M2 y/y	10-Aug-202010	Jul	10.7%	11.1%
	CH	CPI y/y	10-Aug-2020	Jul	2.7%	2.5%
	CH	PPI y/y	10-Aug-2020	Jul	-2.4%	-3.0%
	EC	Sentix Investor Confidence	10-Aug-2020	Aug	-13.4	-18.2
TUE	EC	ZEW Survey Expectations	11-Aug-2020	Aug	71.5	59.3
WED	UK	Industrial Production y/y	12-Aug-2020	Jun	-12.5%	-20.0%
	UK	GDP y/y	12-Aug-2020	2Q P	-21.7%	-1.7%
	JN	Machine Tool Orders y/y	12-Aug-2020	Jul P	-31.1%	-32.1%
	US	CPI Ex Food and Energy y/y	12-Aug-2020	Jul	1.6%	1.2%
	US	Real Avg Weekly Earnings y/y	12-Aug-2020	Jul	4.3%	4.7%
THUR	JN	PPI y/y	13-Aug-2020	Jul	-0.9%	-1.6%
FRI/SAT	CH	Industrial Production y/y	14-Aug-2020	Jul	–	4.8%
	CH	Retail Sales y/y	14-Aug-2020	Jul	–	-1.8%
	US	Retail Sales Ex Auto and Gas	14-Aug-2020	Jul	–	6.7%
	US	U. of Mich. Sentiment	14-Aug-2020	Aug P	–	72.5

Source: Bloomberg, Standard Chartered; key indicators highlighted in blue; *refers to Jan-Feb 2020 combined data
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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