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Wealth Management Chief Investment Office
17 June 2022

Weekly Market View

US recession risk rising

- The hotter-than-expected US inflation report for May has transformed the narrative for markets. The report negated the notion that inflation - running at a 40-year high - had peaked.

- The inflation surprise forced the Fed to deliver a 75bps rate hike this week and consider a similar hike in July, reigniting stagflation fears and dragging the S&P500 index into a bear market. As a result, our US recession checklist is flashing two new warning signals.

- In this report, we discuss whether a recession is likely, how long and deep it could be, and how much is already priced in by markets.

How should investors position for global equities following the Fed policy meeting?

Does the rise in yields offer a good entry point for corporate bonds?

What is the near-term outlook for EUR/USD and gold?

Charts of the week: US markets increasingly pricing in a recession

As the Fed accelerates its rate hiking cycle, our US recession monitor is flagging rising risk of a recession

Our US recession risk monitor as of 16 June

Recession dashboard		Trigger	Current
Yield curve	UST 2y10y (bps) inversion#	< 0	10
	UST 3m10y (bps) inversion	< 0	162
Markets	US bear market (% fall in S&P500)	< -20	-23.6
Leading indicator	US Leading Economic Indicator (y/y %)	< 0	4.7
Fed Fund Rate	Fed Funds/Neutral Rate** ratio	> 1	0.7
Labour data	Jobless claims, 4w MA (y/y %)	> 0	-49.1
	1y change in jobless rate (ppt)	> 0	-2.2
Consumer spending	Michigan Consumer Confidence Index	< 75	50.2
	Consumer Confidence (y/y %)	< 0	-11.3
	Real Personal Consumption (y/y %)	< 2.1*	2.8
Business sentiment	ISM Manufacturing (Index)	< 50	56.1
	ISM New Orders/Inventories (Ratio)	< 1	0.99
Credit spreads	Corporate credit Spreads, Baa (bps)	> 194.5*	178.0

US equity market drawdowns during past recessions

Recession start	Recession end	S&P500 peak	S&P500 trough	S&P500 peak-trough ^	Drawdown
Jul-53	Apr-54	Jan-53	Sep-53	8	-11%
Aug-57	Mar-58	Jul-56	Dec-57	17	-17%
Apr-60	Jan-61	Jul-59	Oct-60	15	-10%
Dec-69	Oct-70	Nov-68	May-70	18	-36%
Nov-73	Feb-75	Oct-73	Oct-74	12	-44%
Jan-80	Jun-80	Jan-80	Mar-80	2	-15%
Jul-81	Oct-82	Nov-80	Aug-82	21	-27%
Jul-90	Feb-91	Jul-90	Oct-90	3	-20%
Mar-01	Oct-01	Aug-00	Oct-02	26	-49%
Dec-07	May-09	Oct-07	Mar-09	17	-57%
Feb-20	Aug-20	Feb-20	Mar-20	1	-34%
Median				15	-27%

Source: Bloomberg, Standard Chartered; *Average value for past 5 recessions at T=0; **2.5%; #2y10y curve briefly inverted this week; ^Months

Editorial

US recession risk rising

The US inflation report for May has transformed the narrative for markets: both headline (8.6%) and core inflation (6%) beat expectations, negating the notion that inflation, running at a 40-year high, had peaked. The inflation surprise forced the Fed to deliver a 75bps rate hike this week – the biggest since 1994 – and consider a similar hike in July. The inflation surprise and the resultant repricing higher of rate hike expectations has reignited stagflation fears (characterised by stagnant growth, high inflation). Those fears dragged the US S&P500 stock index into a 'bear market' (over 20% decline from last peak) and led the 10yr-2yr US government bond yield curve to briefly invert for the second time in two months. These are new warnings from our checklist that the economy faces rising recession risk.

If the US economy is indeed headed for a recession, the key questions include how soon is a recession likely, how long will it last, how deep is it likely to be and how much is priced in by markets? Let's take the questions in turn. The latest model forecasts from the Atlanta Fed show the US economy is flatlining in Q2, after contracting in Q1. A q/q contraction in Q2 growth would mean the US entered a technical recession in H1. However, the model is yet to account for June's economic data (including manufacturing and services sector activity indicators due next week), which likely remained robust. Consensus estimates still point to 3% q/q annualised growth in Q2.

The robust job market continues to underpin a constructive view of the economy, so any downturn would make a recession more likely. We have argued that plentiful jobs, reflected in record-high job openings, and savings built up during the pandemic are likely to encourage consumers to continue spending. Spending is likely to pick up in services as the economy normalises. This is being borne out by the surge in airline travel recently (a key driver of May's inflation data) as the summer holiday season started. However, the unexpected contraction in retail sales in May, the first m/m drop this year, raises questions about whether consumers are starting to tighten their purse strings as costs of essential goods (gasoline, food) surge.

If a recession does arrive, its length and depth would primarily depend on how aggressive and persistent the Fed remains in its hiking cycle. Fed Chair Powell made it clear this week that the central bank wants to see a consistent decline in m/m inflation for a few months before it can slow the pace of rate hikes. The US 10-year government bond yield is a good indicator of how high the Fed is likely to take policy rates. The yield broke above key technical resistance at 3.26% this week after the May inflation data surprise, before falling back. The next key resistance levels are 3.4%, followed by 4%. These levels compare with the Fed's latest projection for its terminal policy rate at 3.8% for end-2023, which suggests the bond market has priced in a significant amount of Fed tightening.

The Fed will need to perform a deft balancing act, though, as it tightens policy. For now, the Fed has unequivocally turned its focus towards supressing demand in its bid to tamp down inflation, given its limited capacity to counter supply-side inflation drivers. By raising rates, it aims to slow activity enough to reduce demand for labour and housing to subdue wages and rents, without causing unemployment to spiral or triggering a disorderly financial market collapse. We expect the Fed to shift its focus back to supporting growth if financial conditions deteriorate significantly further and/or unemployment starts to surge. Hence, watch initial jobless claims data, which has been rising slowly, but steadily, after bottoming in March. The monthly jobless rate is another good indicator: the Fed is likely to get uncomfortable if the jobless rate rises significantly above its long-run target of 4%, from 3.6% in May.

After the past week's 8.7% drop in the S&P500 index, how much of a downturn is priced in by equity markets? The table above shows that the median peak-to-trough decline in the S&P500 index around recessions over the past 70 years has been 27%. In this year's drawdown, the index has declined 23.6% since peaking on 3 Jan, which suggests a significant chance of a recession has been priced in. The index's next major technical support is at 3,589, 2.1% below current levels.

— 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.

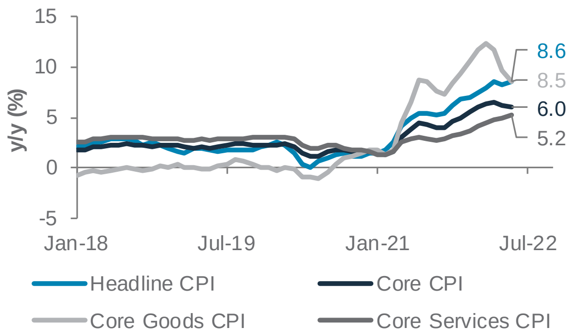
(+) factors: China activity rebound, ECB support for weaker economies

(-) factors: Higher US CPI; Fed, BoE rate hikes; China COVID-19 cases

	Positive for risk assets	Negative for risk assets
COVID		• Beijing cases crept up and remain elevated; mass testing resumed • Hong Kong added more COVID-19 clusters; new testing rules for bar-goers
	Our assessment: Negative – Cases rose in China	
Macro data	• China fixed-asset investment, retail sales and industrial output better than consensus; jobless rate lower than anticipated • US headline and core PPI lower than forecast • Euro area ZEW economic growth expectations improved marginally • China's consumer inflation rose less than forecast	• US consumer inflation rose more than expected; core inflation moderated, but still higher than expected • US Michigan consumer sentiment slumped to record low • US retail sales fell for the first time in five months • US housing starts and building permits fell below estimates
	Our assessment: Neutral – Rebounding China activity vs rising US inflation, weak US consumer and housing data	
Policy developments	• ECB proposed support for weaker Euro area bond markets • China kept key policy interest rate unchanged as expected	• Fed hinted at another 75bps hike in July after raising rates by 75bps • Swiss National Bank surprised with a 50bps hike • BoE hiked rate by 25bps, as expected
	Our assessment: Neutral – Fed rate hike vs ECB support	
Other developments		• China issued stern warning to US over Taiwan at Shangri-La Dialogue • Boris Johnson announced intention to override Northern Ireland Protocol, raising the risk of breaching the Brexit agreement
	Our assessment: Negative – Geopolitical tensions rose	

US headline inflation accelerated further, aided by a pickup in services sector inflation, but core and goods inflation continued to decelerate

US headline and core services and goods inflation



Source: Bloomberg; Standard Chartered

The Fed projected a higher terminal rate for the end of the hiking cycle; it also cut growth and raised unemployment and inflation forecasts

The Fed's June vs March economic forecasts

	GDP		Unemployment		Core PCE		Rates estimates	
Dates	**Old**	**New**	**Old**	**New**	**Old**	**New**	**Old**	**New**
2022	2.8	1.7	3.5	3.7	4.1	4.3	1.9	3.4
2023	2.2	1.7	3.5	3.9	2.6	2.7	2.8	3.8
2024	2.0	1.9	3.6	4.1	2.3	2.3	2.8	3.4
Longer run	1.8	1.8	4.0	4.0			2.4	2.5

Source: Federal Reserve, Standard Chartered

China's investment, consumption and industrial output data for May exceeded expectations, although retail sales remain weak

China fixed asset investment, retail sales and industrial production

Source: Bloomberg, Standard Chartered

Top client questions

How should investors position for global equities, following the Fed policy meeting this week?

We believe it remains attractive to add Asia ex-Japan equities on corrections, with a constructive outlook for Chinese equites. China equities, trading at a 17% discount to global equities in terms of 12-month forward P/E, is a key component of this view.

Policy divergence has become even more prominent between the US and China – the latter making up more than 40% of Asia ex-Japan equities. Depending on future inflation prints, there is a risk the Fed may tighten more than what is expected. On the other hand, policy is easing in China. Chinese macro data, such as this week's retail sales, continues to be weak, but the government maintains its ambitious GDP growth target at 5.5% this year. China's credit impulse is already recovering, but further fiscal stimulus remains likely while regulatory tightening is likely to continue to subside.

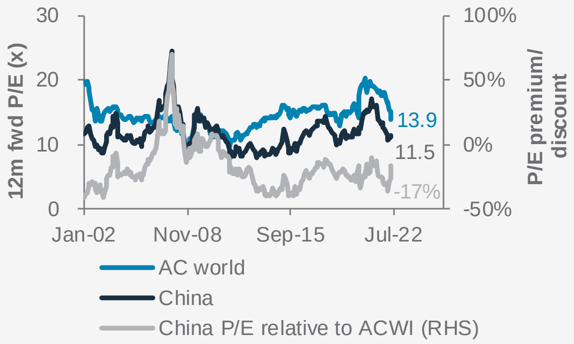
Fund flows have started to reflect this divergence in policies. For June 2022 so far, the Hong Kong market's average daily turnover is nearly 20% higher than that in the previous two months. Higher volume on positive days and low volume (ie, lack of significant selling) on pullback days is a positive indicator, in our view.

Technically, we see 20,000 to 20,800 on the Hang Seng Index as an attractive zone to add exposure to Hong Kong/China equities.

— **Daniel Lam,** *Head, Equity Strategy*

China stocks are valued at a 17% discount to global equities

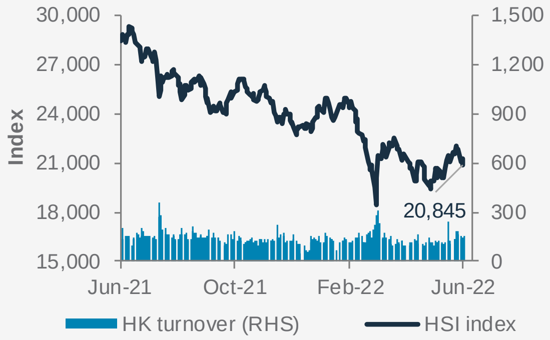
12m forward P/E of MSCI China and MSCI All Country World indices; premium/discount between the two



Source: Bloomberg, Standard Chartered

Hong Kong stocks have found support lately, amid rising volumes

Hang Seng index and volumes



Source: Bloomberg, Standard Chartered

What is the near-term outlook for EUR/USD and Gold?

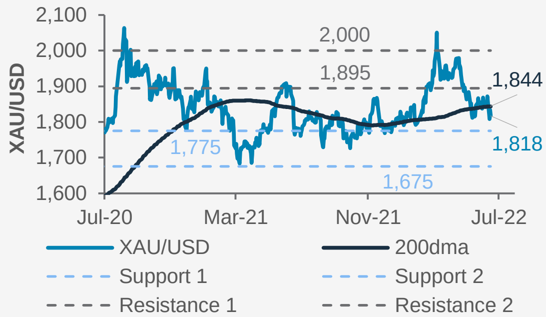
Over the past week, the Fed pushed ahead with its monetary policy tightening and signalled there is more to come. In Europe, the ECB also met to address immediate concerns of "fragmentation" in Euro area bond yields, likely in an attempt to create an environment supportive for policy tightening without creating debt market stress. Both central banks are likely pursuing policy normalisation while trying to avoid damaging economic and financial stability.

EUR/USD continued to test key support at 1.0340-60 as markets probe how far the current USD strength can continue. The pair failed to break key resistance at 1.0785-1.0820 recently and, as this level holds, we see potential for a push lower towards 1.00-1.01, where greater ECB concern about the currency becomes more likely.

Meanwhile, key support for Gold at 1,775-1,800 has held thus far, despite two typically negative headwinds in the form of a strong USD and rapidly rising real yields. Geopolitical uncertainty and elevated worries of policy mistakes are likely to continue to be supportive, and any escalation on either worry could see gold breaking above the 1,875-1,895 resistance, with a target near 1,960, especially if USD strength starts to slow. A break below 1,775 would risk a positioning-led sell-off towards 1,675.

Gold is pivoting around the 200-day moving average; Escalation of geopolitical tensions could see a break above 1895

XAU/USD, with technical levels



Source: Bloomberg, Standard Chartered

Top client questions (cont'd)

Does the rise in yields offer a good entry point for corporate bonds?

Corporate bond yields have increased by c.2.5%-4.0% across various markets since the start of the year. The magnitude and speed with which the yields has been rising is unprecedented for non-recessionary periods. As a result, current yields are now a far cry from the low-yield environment that has plagued bond investors for the better part of the past decade, with key bond asset class yields close to their highest levels since 2010.

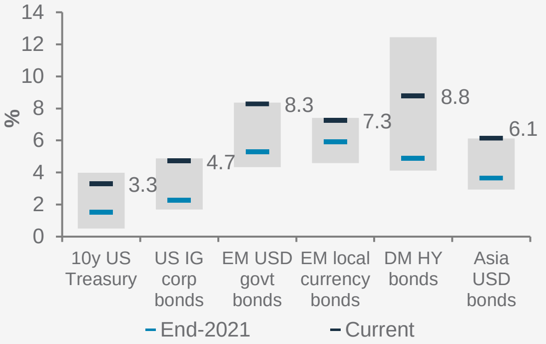
Higher yields have sparked renewed interest in corporate bonds, but also raised concerns about issuers' interest-servicing capability. While we'd agree the rise in borrowing costs is a negative, we believe the impact is manageable for a majority of the market. First, most bond issuers generally have a well spread-out maturity profile, meaning that they will only need to refinance a fraction of their total debt at today's higher yields. Second, over a decade of low interest rates has meant that average borrowing cost have declined, leading to today's high interest coverage ratios starting point.

If we break down the drivers of this year's increase in yields for US Investment Grade and Asian USD bonds, the increase in credit spreads (ie. The yield premium over Treasuries) has been relatively modest, implying limited concerns about debt repayment capability. Credit spreads have increased to a greater extent for Developed Market High Yield and Emerging Market USD government bonds, which is not surprising given the lower average credit quality of these segments. However, for Developed Market High Yield bonds, we believe markets have already priced in a fairly high default rate. Thus, from a risk reward perspective, we view the current yields on offer as attractive for adding exposure to corporate bonds, especially when viewed through the lens of an income-oriented investor.

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

Yields in several bond asset classes are close to their highest levels since 2010

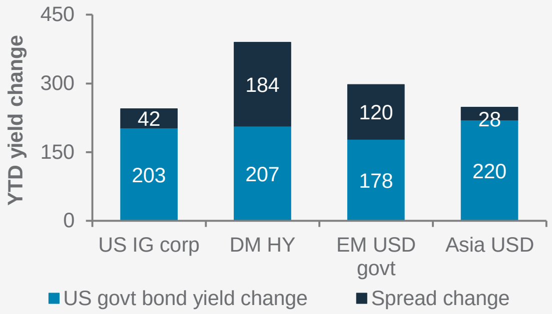
Yields across bond asset classes and their range since 2010



Source: Bloomberg, Standard Chartered

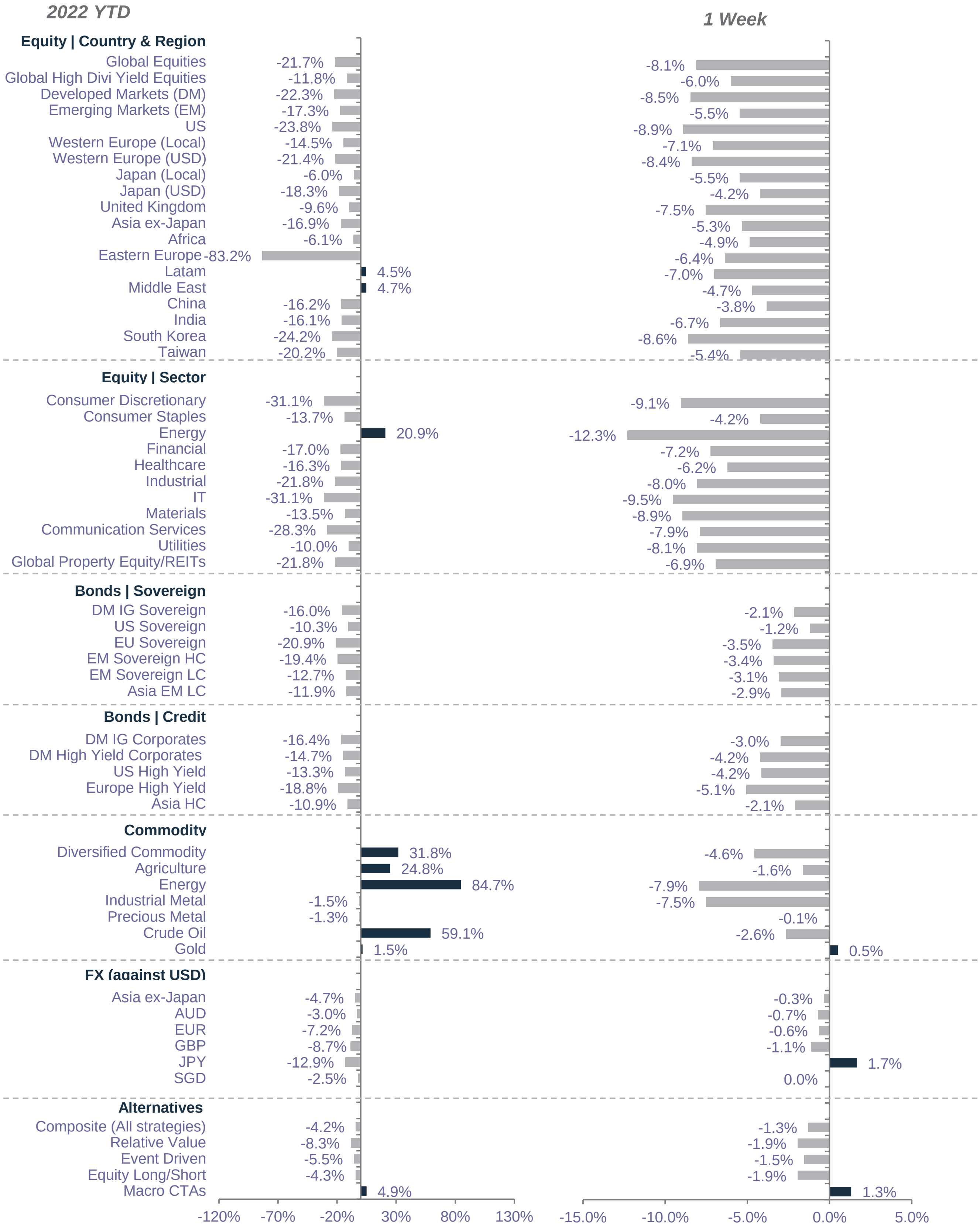
We believe markets have already priced in a fairly high default rate for Developed Market High Yield bonds, making them attractive from a risk-reward perspective

Breakdown this year's rise in yields for various higher yielding bond asset classes between rise in government bond yields and change in spreads



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, 2022 YTD performance from 31 December 2021 to 16 June 2022; 1-week period: 09 June 2022 to 16 June 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

Economic and market calendar

	Event	Next week	Period	Expected	Prior
MON					
TUE	US	Chicago Fed Nat Activity Index	May	–	0.47
	US	Existing Home Sales	May	5.41m	5.61m
WED	UK	CPI y/y	May	–	9.0%
	UK	CPI Core y/y	May	–	6.2%
	EC	Consumer Confidence	Jun P	–	-21.1
THUR	EC	S&P Global Eurozone Manufacturing PMI	Jun P	–	54.6
	EC	S&P Global Eurozone Services PMI	Jun P	–	56.1
	UK	S&P Global/CIPS UK Manufacturing PMI	Jun P	–	54.6
	UK	S&P Global/CIPS UK Services PMI	Jun P	–	53.4
	US	S&P Global US Manufacturing PMI	Jun P	–	57.0
	US	S&P Global US Services PMI	Jun P	–	53.4
FRI/SAT	UK	Retail Sales Ex Auto Fuel y/y	May	-5.0%	-6.1%
	US	New Home Sales	May	625k	591k

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

The S&P500 has next support 2.1% below current level

Technical indicators for key markets as on 16 June 2022

Index	Spot	1st support	1st resistance
S&P 500	3,667	3,589	3,823
STOXX 50	3,428	3,371	3,542
FTSE 100	7,045	6,954	7,227
Nikkei 225	26,431	25,897	27,395
Shanghai Comp	3,285	3,259	3,309
Hang Seng	20,845	20,525	21,486
MSCI Asia ex-Japan	651	640	671
MSCI EM	1,008	993	1,039
Brent (ICE)	119.8	118.1	121.9
Gold	1,850	1,815	1,879
UST 10y Yield	3.23	3.10	3.41

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

Investor diversity remains very low in global bonds

Our proprietary market diversity indicators as of 15 June

Level 1	Diversity	1-month trend	Fractal dimension
Global Bonds	○	→	1.18
Global Equities	◐	→	1.40
Gold	◐	→	1.49
Equity			
MSCI US	◐	↓	1.41
MSCI Europe	◐	→	1.35
MSCI AC AXJ	●	↑	1.66
Fixed Income			
DM Corp Bond	◐	→	1.26
DM High Yield	◐	→	1.37
EM USD	◐	→	1.34
EM Local	◐	→	1.32
Asia USD	●	↑	1.57
Currencies			
EUR/USD	◐	→	1.34

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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