Wealth Management Advisory

Standard Chartered
Priority

Turning up the heat

2018 Outlook

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Published on 8 December 2017.

Welcome to **2018** Outlook

2017 surprised on the upside and was a great year for investors. Global equities rallied over 20%, while commodities, bonds and alternative strategies also generated positive returns.

Our recommended gradual pivot towards more growth areas of the equity market – away from high dividend yielding equities and corporate bonds – paid off. As an example, our Asia-focused tactical asset allocation model for a moderate risk investor rose 14.2% since our Outlook 2017 publication, significantly outperforming its strategic benchmark*. Meanwhile, our preferred multi-asset income allocation still rose a very healthy 11.4% over the same period. Of course, not all our views worked as we expected, but even where our relative preferences did not play out, they generally delivered positive returns for investors (see page 98 for a more detailed analysis of the performance of our views).

So, what about the outlook for 2018? Investors are understandably concerned about high valuations in both equity and bond markets, including corporate bonds.

In the Goldilocks ("not too hot, not too cold") economic environment we have been experiencing, where global growth has become more synchronised, inflation pressures are still muted and central banks have remained accommodative, one can find solid arguments to justify the high levels of valuation. However, we are cognisant that such an environment cannot go on forever.

In 2017, we predicted a pivot to a more reflationary outcome combining stronger economic growth with rising inflation. Growth accelerated in 2017, but inflation did not. We believe this process is still under way and that a gradual 'heating up' of the global economy is likely in 2018.

Global growth is expected to remain relatively strong, weakening somewhat in China, but accelerating in the US and in Emerging Markets excluding China. Meanwhile, rising commodity prices and declining slack in the global economy, whether it be in labour markets or product markets, are likely to be tailwinds for inflation.

Rising inflation is likely to put upward pressure on interest rates and bond yields. Our core scenario is this happens gradually, but even then, it will be increasingly difficult for investors relying predominantly on bonds to generate the level of total returns witnessed in the recent past, even on a leveraged basis, as rising yields will lead to lower prices.

Against this backdrop of waning support for income assets, we have two overarching suggestions for investors. First, we believe investors should continue pivoting towards pro-growth areas of the markets as we recommended in 2017. Despite elevated valuations, we believe equity markets will continue to do well. Still-strong growth and relatively modest increase in inflation are likely to support global corporate earnings growth of 10% in 2018.

Second, as we move even more clearly into the late stage of the global economic cycle, we believe it is time to start thinking about protecting against sharp drawdowns once the cycle turns. Our central scenario is that a recession is unlikely in 2018 given significant excess capacity in many major economies (eg. southern Europe, China, India, Brazil and Russia) and very well-anchored inflation expectations after years of low inflation. However, we are also cognisant that predicting recessions is incredibly difficult and, by the time a recession becomes apparent, the damage to investment portfolios is already severe.

Against this backdrop, in addition to pivoting to pro-growth assets, we would consider increasing, as the year progresses, our allocation to less volatile, less correlated and relative investment strategies. In particular, a diversified allocation to alternative strategies can help improve the risk-reward profile of investment allocations over the long run and can be particularly valuable in times of stress. For now, given our constructive view on global equities, we would continue to have a tilt to Equity Hedge strategies, but this should not be at the expense of a more diversified approach, including Global Macro strategies, which can offer insurance-like characteristics in times of severe risk-off environments.

Alexis Calla

Global Head Investment Advisory and Strategy &
Chief Investment Officer

*Views taken from the Outlook 2017 publication, updated in the Global Market Outlook publication through the year. The benchmark used is our Strategic Asset Allocation model as updated in February 2017.

Our diversity-driven, adaptive approach to investment decisions

Alexis Calla

When meeting our clients, we are often asked how we come up with our investment views and what makes us different. We thought this annual Outlook publication was a good opportunity to share our approach to investment decision-making with a wider audience.

Our current process originated in 2011, when we started researching the theoretical challenges and behavioural biases both individuals and committees face when making decisions in an environment of significant complexity and uncertainty. This included extensive research of academic behavioural finance literature, but also included non-finance areas such as decision-making cognitive psychology, the intelligence field and studies into how superior forecasters operate.

Of course, theory is fine in theory, but the key was to turn these insights into practical processes which lead to superior outcomes.

Here are some of the concepts that over the years have become absolutely key to our decision-making process. On the following two pages, we discuss some of our core beliefs that differentiate us from most other investment advisory firms.

Human Diversity

Building on the unique footprint of Standard Chartered Bank, we have deliberately formed an investment committee that is very diverse in terms of expertise, geographic experience and, more importantly, ways of thinking, as well as legacy diversity such as gender, race and nationality. This helps to ensure the discussions uncover many different perspectives.

Open Source

There is a plethora of data, views, research, analysis, and information that we have access to. We scout and scour an immense amount of material constantly to identify different ways of looking at the key questions faced by our clients and uncover valuable insights. This 'open source' approach means we are agnostic as to the source of insight (academia, institutional research, independent research, fund manager views, magazines and newspapers). All we care about is whether its helps to enrich the investment committee's discussions.

Open Mindedness

We actively seek various sources of diversity, but require that all our investment committee members understand that nobody (including themselves) knows with certainty what is going to happen in the future, are always trying to learn and are open to different perspectives and sources of input. This sounds obvious, but it is not actually a natural characteristic within the research/analyst universe where it is taught very early that having high conviction in your views is a positive attribute.

Outside View vs Inside View

This is a key distinction to make. The Outside View can be thought of as a helicopter view that helps provide a probabilistic perspective on different outcomes based on past or related information from a class of events similar to the one being analysed. This often involves a quantitative approach. For example, one of the Outside Views generated for this publication was looking at the historical probability distribution for equity returns taking into account valuations similar to current levels. We are constantly scouring research for potential areas where we can refine the Outside View. Of course, the Outside View is only a starting point. The Inside View, which is like the view from the ground and is often more qualitative in nature, then tries to understand what are the current or unique factors that might skew the likelihood of an event or outcome one way or another.

Dialectic Debate

This is the core of our investment process. It drives our Inside View. We actively seek and discuss different views in order to understand different perspectives and arguments. This not only makes sure that we consider alternative views to our own individual and collective view, but also encourages us to keep an eye on arguments that we initially disagree with.

No Hierarchy, Full Anonymity

In the investment committee, hierarchy does not matter. What is important is how each member contributes their knowledge, diversity and perspectives to the process, irrespective of seniority. Importantly, each member's vote is cast anonymously the day after the committee concludes, to allow individuals to make up their own mind without external interference and to give members time to reflect on the information presented and debated.

Not Seeking Consensus

The above process is all about uncovering very diverse sources of information and analytical frameworks, but is not about producing a consensus. It helps feed everybody's analytical framework with the information they require to come up with a view. This helps reduce both the individual error while also reducing the collective error through embracing diversity of input, debate and cognitive frameworks. This also helps ensure that we can adapt quickly and methodically to changing market conditions and drivers.

Our core investment beliefs

Alexis Calla

Adaptive markets require an adaptive process

We believe markets are a complex ecosystem that cannot be entirely modelled as relationships are not always stable and linear. In an ecosystem, “complexity arises as many agents interact and adapt to one another and their environments. These interactions and adaptations result in evolutionary processes and often surprising ‘emergent’ behaviours at the macro level.”[1] This presents opportunities for investors who can adapt to the current and future market conditions, rather than relying solely on quantitative models or on the opinions of overly specialised individual experts. This is not to say that quantitative models cannot add value. However, we believe we need to keep an eye out for potential changes in well-established relationships.

Collective diversity more important than individual expertise

This is probably one of the more controversial beliefs. We have been brought up to believe that if you have a problem to solve you should seek expert advice. If your chest hurts, you see a doctor (preferably quickly). If your car breaks down, you consult a mechanic. Assuming you can trust them to give you an unbiased opinion, this is rational.

However, as the complexity and uncertainty surrounding a problem we are trying to solve increases, evidence suggests the value of an individual expert diminishes. There are several reasons for this, but a key one is the ability to digest the copious amount of information in a way that is as free from cognitive biases[2].

A growing number of recent academic studies have highlighted that a diverse set of individuals is likely to think about the problem in different ways, seek out different types of information and reduce the risk of collective error. Our investment process aims to reduce both individual errors as well as the collective error by maximising diversity.

1 Santa Fe Institute

2 “Cognitive biases are tendencies to think in certain ways that can lead to systematic deviations from a standard of rationality or good judgment, and are often studied in psychology and behavioural economics,” Wikipedia.

Collective error = individual error – prediction diversity

Decision making more important than information gathering

In the Information Age, a key challenge is how to manage the volume of information that is available. Just to try to put this in context, every day we put together a summary of research that our team members found interesting. In October alone, these *summaries* totalled over 500 pages. While not all these reports are widely available to individual investors, investment practitioners generally have access to a lot of this material. In themselves, they are unlikely to be a source of competitive advantage. We believe the true potential source of differentiation is how to incorporate available information into the decision-making process.

Diversity of perspectives key

How do we try to reduce 'individual errors'? One of the key biases when it comes to individual decision-making is confirmation bias. We all have views on different topics, either consciously or sub-consciously. Meanwhile, we tend to place excessive weight on information that reaffirms these views.

To address these biases, we run a thorough "dialectic" debate of the pros and cons so that everyone in our committee is forced to consider an alternative outcome to their current outlook. This is achieved by actively seeking the rationale for views on both sides of any question we are asking ourselves.

Debiasing critical to success

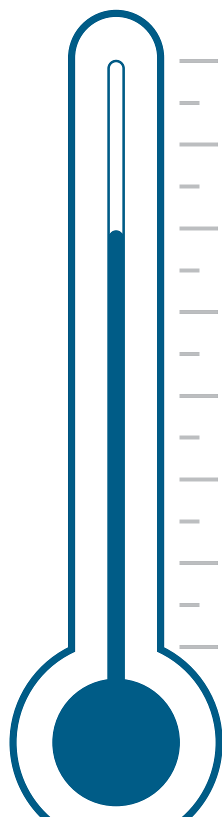
Our decision making process is also aimed at addressing Committee biases, which can be dominated by the most senior or last or most vocal speaker in the room.

To address these biases, our Investment Committee members vote anonymously the day after the discussions take place to give them time to process the huge volume of information they have digested and to limit the influence of any individual. Meanwhile, our process is aimed at ensuring diversity of input so members are not unaware of the opposite point of view and can incorporate it into their decision-making process.

STRATEGY

Turning up the heat

Steve Brice | Manpreet Gill



- **Economic growth continues to simmer**: The "Goldilocks" environment (ie. not too hot, not too cold) of strong growth and limited inflation is likely to extend into the early part of 2018. Continued earnings growth means equities and corporate bonds have room to extend gains going into 2018, in our view.
- **Turning up the heat on inflation**: Inflation is the main risk to this "Goldilocks" scenario, especially further into 2018. A larger-than-expected rise in inflation would mean the environment could turn too hot, forcing central banks to slam on the brakes.
- **Investment implications**: Our view is that we are at a mature stage in the US business cycle. Equities tend to do very well late in the cycle, a trend which is behind our preference for equities. Our view that the US Dollar will weaken modestly supports our preference for bonds in Emerging Markets – specifically USD sovereign and Asia corporate bonds. However, we believe there is value in staying nimble as we go through 2018. An allocation towards Alternative Strategies is likely to help maintain exposure to our preferred asset classes while starting to contain potential downside risks, in our view.

2017 proved to be a very positive year for financial markets against a Goldilocks (ie. not too hot, not too cold) economic backdrop. The strong performance of equities and corporate bonds was led by earnings growth across major regions, range-bound government bond yields and rising valuations. The fact that inflation in the US and Euro area has remained contained meant that worries over excessive monetary policy tightening and a turn in direction towards unwinding monetary stimulus failed to derail markets. Emerging Market assets fared very well amid this environment of optimism, especially as the US Dollar softened.

Recent strong economic data suggests this "Goldilocks" environment can spill over at least into the start of 2018. Having said that, we are cognizant that Goldilocks environments cannot carry on forever. Our Group Investment Committee continues to be of the view that we are at a fairly late stage in the business cycle, with the US further along than the Euro area or Asia ex-Japan. The historical perspective that equities tend to see some of the strongest gains in the final stages of the business cycle is one key factor behind our preference for equity markets. This largely holds true for other pro-cyclical assets like corporate bonds as well.

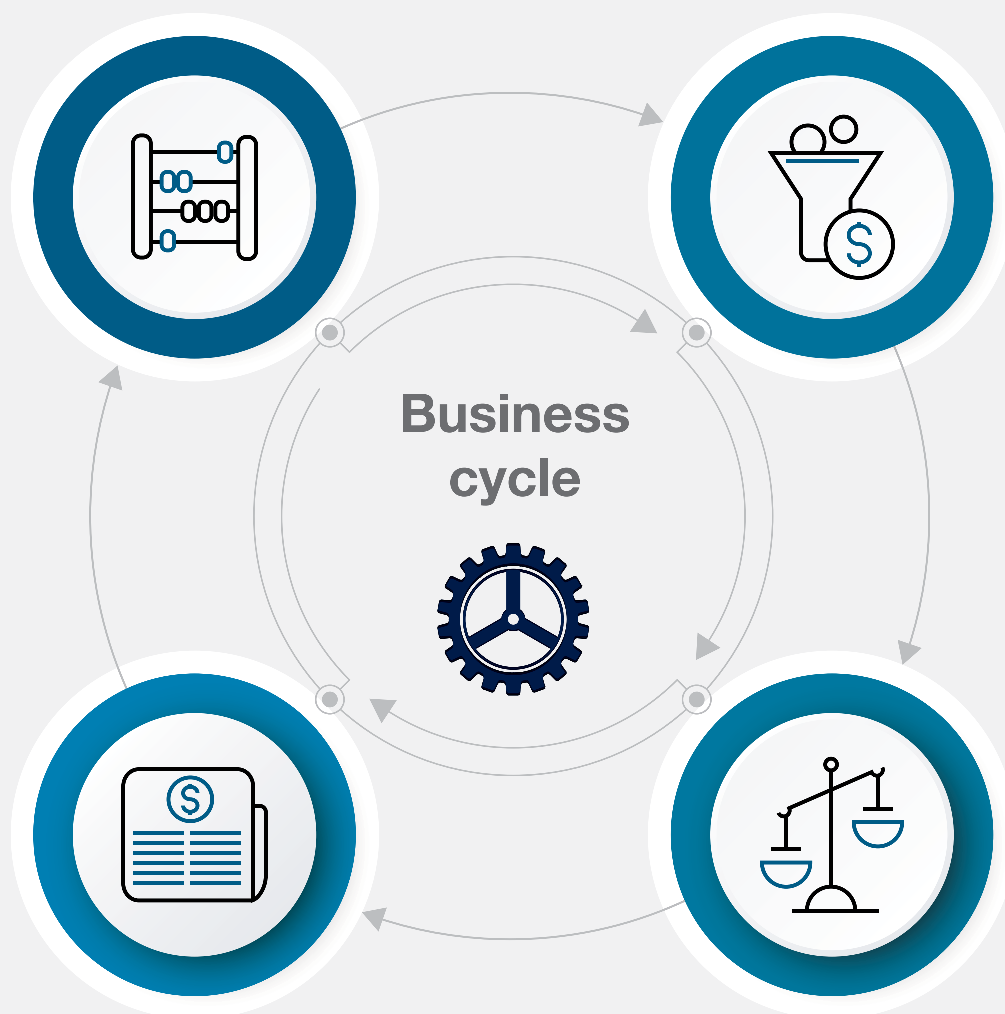
However, it is extremely difficult to time the end of the cycle. The fact that US equities and high yield bond markets have historically peaked six to nine months ahead of a US recession makes the investment decision even harder. Therefore, we believe there is value in starting the year continuing to favour equities, while also starting to think about managing downside risks by allocating to alternative strategies which have lower drawdown risks and correlations with traditional asset classes.

Late stage business cycle

- Equities tend to outperform in the late cycle. Valuations not yet a constraint
- US economy likely at a later stage than the Euro area or Asia ex-Japan
- However, need to stay nimble as we could reach a turning point in 2018

Inflation

- Modest, continued reflation likely to extend Goldilocks environment near term
- Faster-than-expected inflation creates risk of accelerated monetary policy tightening



Policy shifts

- QE withdrawal, higher US and potentially Euro area interest rates could pose a headwind
- Magnitude of China deleveraging efforts key to its market impact
- US fiscal stimulus could offer a positive offset

External risks

- Number of geopolitical flashpoints exist (Korea, Middle-East)
- Trade policy an ongoing risk

Investment implications and key themes

EQUITIES

Equities our preferred asset class

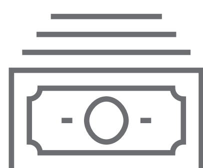
Key themes

- Asia ex-Japan equities to outperform global equities
- Euro area equities to outperform global equities
- South Korea equities to outperform Asia ex-Japan equities
- China equities to outperform Asia ex-Japan equities

Our preference for equities stems from two sources. First, equity valuations still offer room for gains; while they are undoubtedly above long-term averages in most regions, historically they have, on average, delivered positive returns from similar levels in the past. Second, earnings growth remains reasonably strong, driven in many regions by margin expansion, offering grounds for further gains beyond just higher valuations.

Asia ex-Japan is one of our preferred regions, supported by both margin expansion as well as valuations that remain inexpensive relative to Developed Markets. See the equities section for more details on our country preferences within the region.

The Euro area is also a preferred equity region. Strong domestic consumption and the likelihood of greater investment spending favour continued earnings growth. Italian elections pose a political risk, but we believe these will remain well-contained and short-lived.



BONDS

We see bonds as a core holding

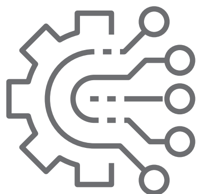
Key themes

- Emerging Market (EM) USD government bonds to outperform global bonds
- Asia USD corporate bonds to outperform global bonds

We have a preference for Emerging Markets within bonds as we believe they offer an attractive balance between yield and quality at this time.

Within this, we prefer Emerging Market USD government bonds given our view that the asset class offers a combination of a reasonably attractive yield (at c.5%) sourced from a mix of both investment grade and high yield sovereigns. While a high sensitivity to rising US Treasury yields is a risk, our view that the 10-year Treasury yield will remain centred around 2.50%, together with the relatively higher yield buffer on offer, is positive.

We also prefer Asia USD corporate bonds, though we have a strong preference for investment grade over high yield within this. One of the most remarkable characteristics of this bond asset class has been the low volatility relative to Developed Market bonds, which we believe is likely to be valuable late in the economic cycle and/or if volatility broadly rises unexpectedly. Accelerated Chinese deleveraging is a risk, though we believe this is likely to be a greater risk for HY bonds rather than IG.



MULTI-ASSET AND ALTERNATIVE STRATEGIES

Diversification via Multi-Asset and Alternative Strategies

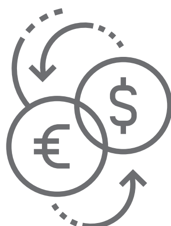
Key themes

- Multi-asset balanced strategies to outperform multi-asset income strategies
- Equity Hedge strategies to outperform other alternative strategies

The high likelihood of further equity market gains late in the economic cycle is a significant factor behind our preference for multi-asset balanced strategies. The higher presence of growth assets relative to an income strategy should be the main source of this outperformance, in our view.

Having said that, we still believe multi-asset income strategies are likely to deliver positive absolute returns given our view that, short of a major inflation surprise, any rise in yields should remain contained.

Meanwhile, we believe alternative strategies offer attractive exposure given the difficulty in timing the market peak towards the end of the economic cycle. Equity Hedge strategies offer room to obtain equity and bond market exposure, albeit giving up some upside in return for more contained downside. At the other extreme, macro strategies continue to offer what we believe to be insurance-like characteristics, should the cycle turn sooner than we expect.



CURRENCIES

Modest USD weakness to drive FX markets

Key themes

- US Dollar to weaken modestly
- EM currencies to gain against the USD
- EUR, KRW to strengthen against the USD
- JPY to weaken against the USD

We believe the USD is likely to continue to weaken modestly in 2018, short-term reversals notwithstanding. A greater room for monetary policy surprises in Europe is largely responsible for this view given further Fed rate hikes are unlikely to dramatically surprise the market, while the start of European Central Bank (ECB) rate hikes would likely be a surprise.

The context of this US Dollar view means that we expect the EUR to extend gains, especially if the ECB remains on the path of gradually removing monetary policy accommodation. The JPY, though, is unlikely to benefit from this support given what appears to be a continued lack of domestic inflation.

A softer US Dollar is also likely to be beneficial for the broad Emerging Market currency universe. Within this, though, we believe the KRW is likely to be one of the biggest beneficiaries as the Korean economy benefits from continued improvement in US growth via exports.

Key asset class views

Equities (Preferred)		Bonds (Core holding)		Commodities (Core holding)		Alternative Strategies (Core holding)		Cash (Less preferred)	
US	Core holding	Govt DM IG	Less preferred	Energy	Core holding	Equity Hedge	Preferred		
Euro area	Preferred	Govt EM USD	Preferred	Precious	Core holding	Relative Value	Less preferred	EUR (FX)	Preferred
UK	Less preferred	Govt EM LCY	Core holding	Base	Core holding	Event Driven	Less preferred	KRW (FX)	Preferred
Japan	Core holding	Corp DM IG	Core holding			Global Macro	Less preferred	JPY (FX)	Less preferred
Asia ex-JP	Preferred	Corp DM HY	Core holding						
Other EM	Core holding	Corp Asia USD	Preferred						

Preferred | Less preferred | Core holding

MACRO OVERVIEW

Macro overview
At a glance

Rajat Bhattacharya

Key themes

Global growth is expected to accelerate in 2018 for the second straight year, led by the US and Latin America, while China, Japan and the Euro area stabilise after a strong pick-up in 2017. We expect the ongoing synchronised economic expansion across regions to continue, on the back of still-easy financial conditions and robust consumer and business confidence.

We expect a modest upturn in core inflation worldwide, especially in the US, as tightening labour markets fuel wage pressures and spare productive capacity narrows.

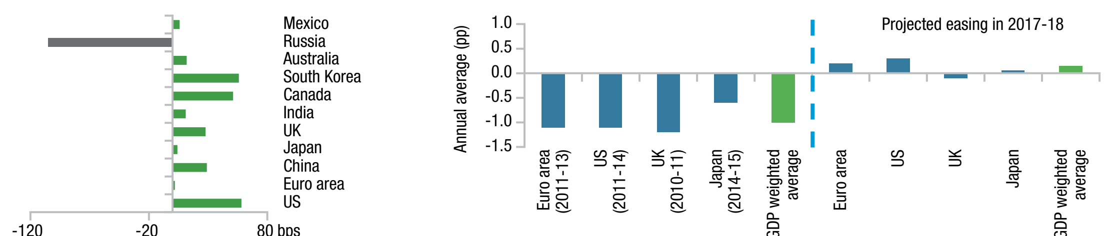
Monetary policy outlook is turning less accommodative. We expect the Fed and some Asian central banks to raise rates at a gradual pace over the coming year. However, inflation-adjusted policy rates are likely to remain negative in major economies, including the Euro area and Japan.

The key risk scenarios, we believe, are two-fold: 1. Inflationary downside, or a sharp upturn in inflation, eventually leading to tighter monetary policies and a growth downturn (15% probability). 2. Return to deflation, likely caused by a hard-landing in China or a too-early/too-fast pace of Fed rate hikes (10% probability).

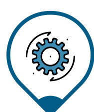
Key chart

Figure 1

Monetary policy is likely to tighten gradually worldwide; this is likely to be offset by less stringent fiscal policies



Source: Bloomberg, Fitch Ratings, Standard Chartered



Key drivers

Region	Growth	Inflation	Benchmark Rates	Fiscal Deficit	Comments
US	● (green)	● (yellow)	● (yellow)	● (green)	Growth to accelerate for second year. Fed to stick to gradual rate hikes under Powell amid muted inflation. Risk of overheating from tax cut
Euro Area	● (green)	● (yellow)	● (green)	● (yellow)	Synchronised expansion to continue. Inflation to remain tepid amid slack in southern Europe. ECB to withdraw stimulus, but rate hikes unlikely
UK	● (red)	● (red)	● (yellow)	● (yellow)	Brexit uncertainty remains key risk. Purchasing power further hit by rising inflation, slowing wages. BoE likely guided by Brexit talk outcome
Japan	● (green)	● (yellow)	● (green)	● (yellow)	Abe's re-election positive for stimulus, growth. BoJ to maintain easy monetary policy as inflation remains well below target, despite recent uptick
Asia ex-Japan	● (green)	● (yellow)	● (green)	● (yellow)	President Xi to focus on quality of growth, while ensuring financial stability. India's growth to recover. South Korea expected to hike rates
Emerging Markets ex-Asia	● (green)	● (yellow)	● (green)	● (yellow)	Brazil and Russia rate cutting cycle coming to a close as inflation rebounds. Mexico to cut rates

Source: Standard Chartered Global Investment Committee
Legend: ● (green) Supportive of risk assets | ● (yellow) Neutral | ● (red) Not supportive of risk assets

A subtle shift towards reflation

A year ago, we noted subtle shifts in the world economy which promised to lift growth and inflation gradually above the lacklustre levels seen since the Global Financial Crisis. We expect the process to continue in 2018.

Core scenarios (75% probability)

While world economic activity has indeed picked up almost in sync across most regions, making 2017 the strongest year for global growth since 2014, inflation has largely remained subdued. The continued lack of widespread inflationary pressures leaves our Global Investment Committee split between envisioning '**muddle-through**' (mediocre growth, low inflation) and **'reflation**' (accelerating growth, rising inflation) as the dominant theme for the global economy in 2018. We assign a combined 75% probability to the two scenarios unfolding over the coming year, with a GROWING bias towards '**reflation**' (40% vs 35% a year ago and 15% in early 2016).

So, what would move the needle towards an outright reflationary environment? For one, the US would need to see a modest pick-up in inflation in 2018, while sustaining this year's above-trend growth. This is possible, especially if the proposed tax cuts fuel consumer demand and business spending at a time when the economy is arguably running above its potential and is at the late stage of its expansion cycle. For now, we expect any such fiscal stimulus to be modest. Such a controlled-reflationary environment is likely to allow the Federal Reserve (Fed) to raise interest rates gradually (two-to-three times) over the course of 2018.

The other route to global reflation could be a pick-up in inflation in the Euro area and Japan due to the whittling away of excess productive capacity and tightening labour markets. This is possible, especially if the two regions continue to grow above their potential for a second straight year, aided by extremely accommodative monetary policies, less restrictive fiscal policies and still-robust outlook for global trade (albeit growing at a slower pace than in 2017). A global economy increasingly powered by the Euro area would make the ongoing global expansion more sustainable given that the region is in an earlier stage of its business cycle compared with the US or China.

While we expect the Euro area to continue growing above potential for a second year, we see inflation pressures rising only modestly, given the still-substantial under-employment across southern European economies such as Italy, Spain and Portugal.

Meanwhile, in Japan, although excess productive capacities have disappeared and labour markets are tight, structural issues, such as aging demographics as well as the controlled process of wage negotiations in the manufacturing sector, are likely to keep wage growth subdued.

In many ways, China holds the key to whether the world economy decisively shifts from years of muddle-through to a reflationary regime, or falls back towards deflation. China, and more broadly Asia, has been a key driver of global growth since the Global Financial Crisis. China's credit-fuelled, investment-led growth helped offset the substantial slack in the developed economies after the crisis, keeping global growth humming along,

albeit at a slower pace than before the financial crisis. However, this growth model has resulted in a surge in China's corporate sector leverage, which is clearly unsustainable. With growth in the rest of the world picking up, there is a window for China to once again focus on rebalancing its economy from investment towards domestic consumption. We believe President Xi Jinping's consolidation of power at the recent Chinese Communist Party Congress will provide his administration the necessary political influence to renew its efforts to deleverage the economy.

We, however, expect this process to be gradual and well-controlled, with China's economic growth settling in the 6.0-6.5% range over the next two years, from 6.5-7.0% range over the past couple of years. This cautiously constructive outlook for China, which should also be moderately positive for Asia, commodity prices, as well as the major commodity-producing Emerging Markets such as Brazil and Russia, informs our view that the world economy will continue to slowly pivot towards reflation.

Inflationary downside risk (15% probability)

However, there is an outside risk that US income tax cuts stoke consumption and wage pressures to such an extent that the Fed needs to raise interest rates at a much faster pace than currently forecast. This would eventually cause a sharp slowdown in the US economy, with the inevitable impact on the rest of the world.

The other source of inflationary risk could be a flare-up in geopolitical tensions, whether around North Korea or South China Sea, leading to a trade war between the US and China. Such an outcome would disrupt global supply chains, causing shortages in some markets (especially in the US) and excess productive capacities in others (especially in Asia). For now, we assign a low (15%) probability for this extreme risk scenario.

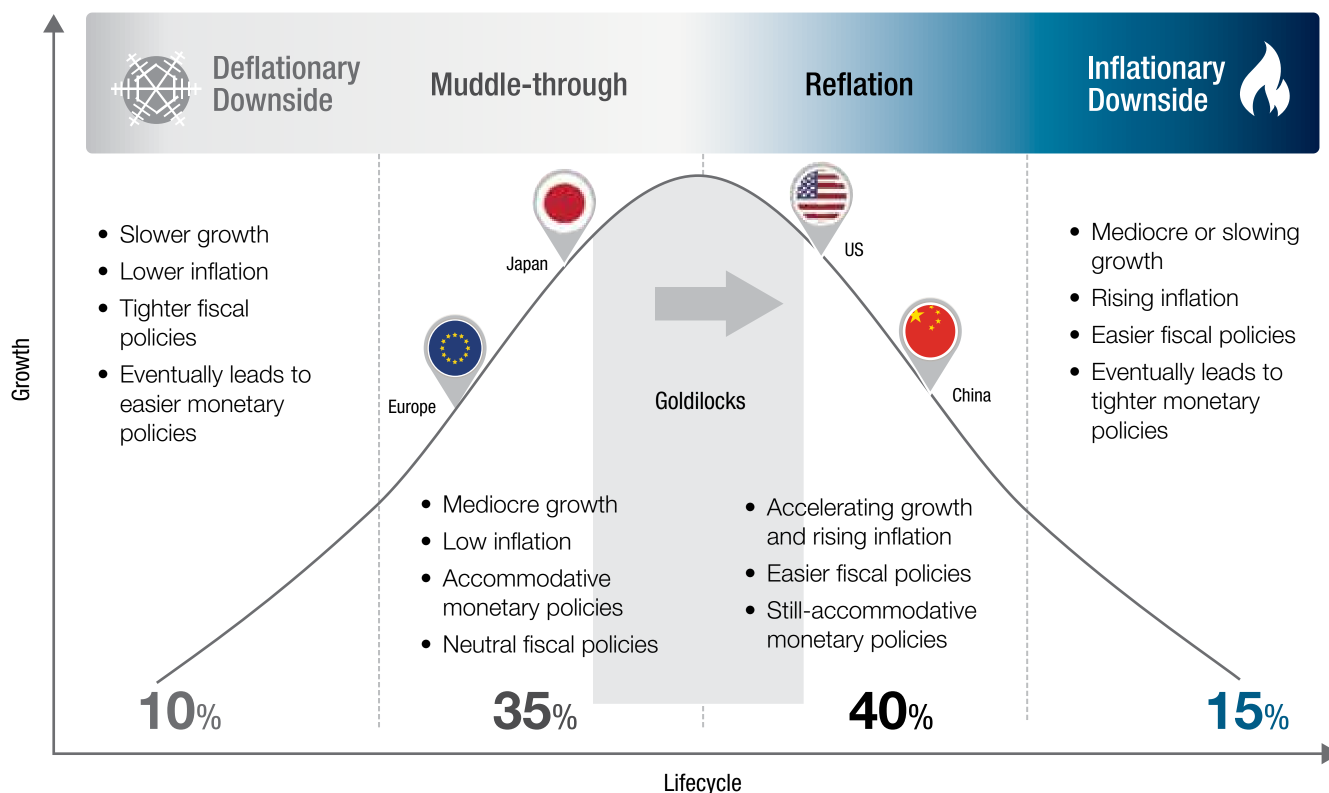
Deflationary downside risk (10% probability)

The other downside risk to our constructive scenario is a sharp slowdown in growth in China, in the event it struggles to manage a gradual economic deceleration. Such an outcome would be deflationary for the world. The other likely sources of deflationary risks would be a policy mistake by the Fed or the ECB in the event they raise rates too quickly, causing a downturn in their economies. Alternatively, a political crisis in Italy, Spain, the UK or Germany, which renews concerns about the stability of the Euro area, could revive deflationary pressures. For now, we assign a low (10%) probability to this extreme outcome.

Figure 2

The world's major economies are transitioning between Muddle-through and Reflation scenarios, with China and US in an advanced stage of their business cycles

The percentages refer to Global Investment Committee's assigned probability on each of the scenarios for the global economy in 2018



Source: Standard Chartered Global Investment Committee

US

Late cycle, but some room to grow

- US growth to accelerate for second year on the back of consumer and business spending, making it the second-longest expansion in modern history
- We expect the Fed to stick to its gradual pace of rate hikes (2-3 25bps hikes in 2018) under Chair Jerome Powell, in line with a gradual pick-up in inflation
- There is a risk of the economy overheating because of potential tax cuts, forcing the Fed to hike rates at a faster pace
- USD expected to weaken modestly as policy divergence comes to an end

The US economy is expected to grow 2.5% in 2018, accelerating for the second straight year and up from 2.2% growth in 2017. This is well above the economy's 1.6% potential growth rate estimated by the Congressional Budget Office and suggests a step-up in the pace after mediocre 2% trend growth since the financial crisis. Part of the acceleration over the past year has been due to a boost to business investment, mainly in the energy sector, which added to continued robust consumer spending on the back of the strongest job market in a decade.

Business investment and consumer spending are likely to remain strong over the coming year. This is especially so if the Republicans succeed in enacting personal income and corporate tax cuts over the coming months. Although the fiscal boost is likely to be modest and temporary, given the limitations of sticking to the government debt ceiling, it is likely to stimulate wages and corporate spending, lifting growth at the margin.

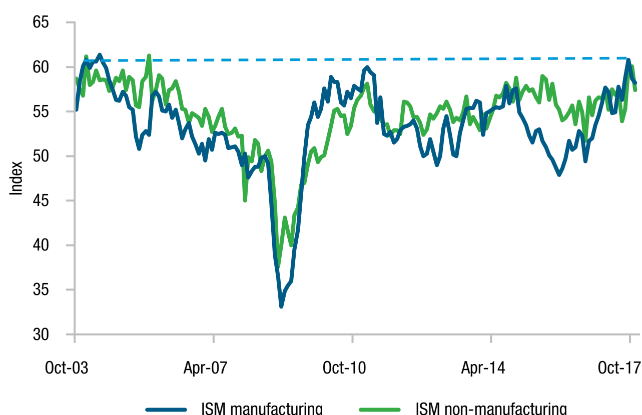
Housing investment, which has slowed lately, is also likely to get a boost over the next few quarters from rebuilding and renovation activity following the recent hurricanes, adding another leg to growth. Finally, government spending is expected to contribute positively in 2018, after being a drag in 2017, especially if the Trump administration increases spending on defence and infrastructure as promised (although this is likely to be partly offset by cuts in other government departments).

The continued growth of the US economy above its potential rate points to a gradual pick-up in inflation over the course of 2018, especially if tax cuts are enacted. Although inflation has underwhelmed this year, most of the drag came from a temporary softness in telecom and medicine prices. We expect these factors to fall away, helping revive underlying inflationary pressures at some point over the coming year. The USD's weakness and the recovery in oil prices over the past year are also likely to help revive price pressures, with a 6-12-month lag. The latest data suggests core inflation has started to turn higher on a quarter-on-quarter basis. Wage pressures are also likely to build up as unemployment falls below the equilibrium level.

Figure 3

US business confidence indicators are close to their highest in more than a decade

US manufacturing and services sector business confidence

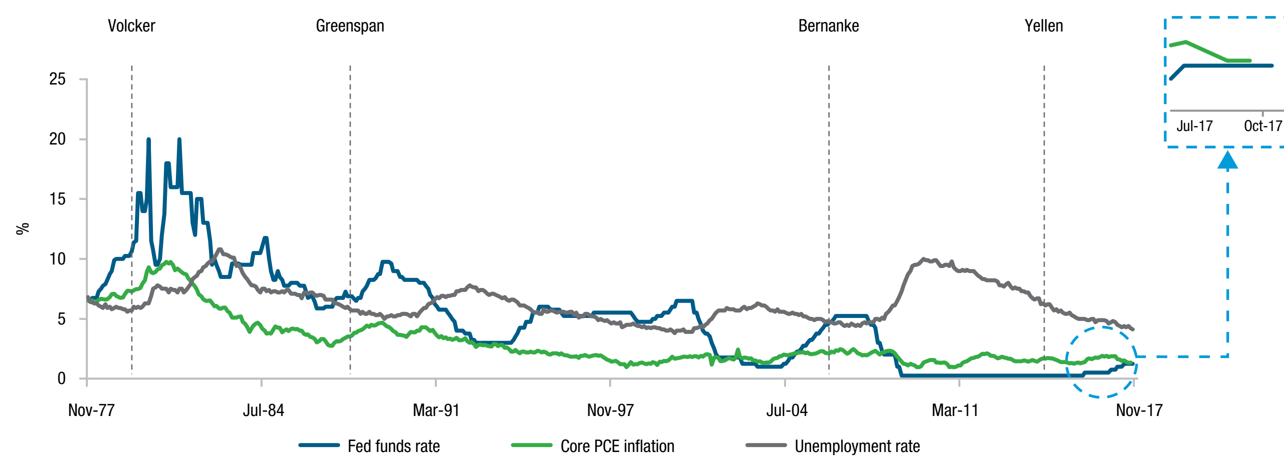


Source: Bloomberg, Standard Chartered

Figure 4

Monetary policy in the US is set to turn less accommodative for the first time since the financial crisis as the Fed's policy rate rises above inflation

US core inflation, unemployment rate and Fed policy rate under various Fed Chairs over the past 40 years



Source: Bloomberg, Standard Chartered

Late-cycle dynamics

There is a risk that continued above-potential economic growth could stoke price and wage pressures. This is especially so as the US is at a late stage of its business cycle (If the current cycle extends to Q2 of 2018, it would make it the US's second-longest modern history expansion. If it stretches until Q2 of 2019, it would be the longest in modern history). This is where the Fed's policy reaction is likely to be a key determinant for the sustainability of the US economic expansion. The Fed will need to tighten policy just enough to prevent the economy and the job market from overheating and financial imbalances from developing, without choking the underlying growth drivers. We expect this balancing act to become more challenging over the coming 12-18 months.

The nomination of Jerome Powell as the next Fed Chair replacing Janet Yellen suggests the Trump administration favours policy continuity at the central bank. This, we believe, points to 2-3 more 25bps rate hikes in 2018. To put this in context, the Fed raised rates by an average 225 bps a year in the past four rate hiking cycles. This hints at the risk of a faster pace of Fed rate hikes if growth and/or inflation surprise on the upside and unemployment continues to decline.

For now, we expect the Fed to err on the side of caution and act only when it is more confident of inflation sustainably picking up. This is especially so, given that financial conditions are likely to start tightening somewhat by the middle of 2018 as the Fed gradually reduces the size of its bond holdings accumulated through its quantitative easing programme following the financial crisis.

Apart from sharp monetary policy tightening, economic cycles could also end due to severe imbalances. We see little sign of such imbalances in the US economy for now. Overall borrowing by households has been restrained since the financial crisis. While corporate leverage has risen, this is against the backdrop of rising profitability and very low interest rates, which have helped keep debt-servicing ratios at sustainable levels. Meanwhile, the US current account deficit has halved from pre-crisis levels and has remained stable in recent years. Against this backdrop, we assign a 25% probability to a US recession in the next 12 months, same as a year ago.

US domestic politics or external shocks are the other possible sources of risk for the US economy. President Trump has so far struggled to implement some of his key political and economic agenda through the US Congress, despite a Republican majority in both houses. Any shift in control of the US House or the Senate towards Democrats after the mid-term elections in Q4 2018 could lead to legislative logjams, reducing the chances of any economic or regulatory reform.

An electoral setback in Congress or further escalation in the Federal investigation on Russia's alleged meddling in the last US elections could encourage the administration to step up trade disputes with US neighbours (NAFTA) or with Asian trade partners. This could hurt global trade at a time when the economic expansion is already mature. For now, we assign a low probability to this outcome.

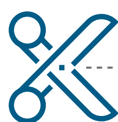
Euro area

Growing above potential

- The Euro area's synchronised expansion is likely to continue for a second year amid easy monetary and financial conditions
- Inflation is likely to remain tepid because of substantial slack across southern Europe
- The ECB is likely to withdraw stimulus gradually, as planned, but rate hikes are unlikely at least until 2019
- The main risk to the region is political, with upcoming elections in Italy potentially causing short-term uncertainty
- The EUR is likely to extend gains on the back of strong growth and contained political risks

The Euro area provided one of the biggest positive surprises to global growth in 2017, expanding at an above-potential 2.2% (based on consensus estimates), aided by extremely easy monetary and financial conditions. A strong pick-up in domestic consumer spending emerged as a key driver of growth as job markets continued to improve, leading to a synchronised expansion across southern and northern Europe for the first time since the financial crisis. While a rebound in the EUR in the first half of the year provided a limited headwind, continued strength in global demand helped support exports. Meanwhile, fiscal policy remained less restrictive across the region, providing additional support.

Consensus estimates suggest the Euro area, like the US, will continue to grow above its potential for the second straight year in 2018, albeit at a slightly slower pace (of 1.9%) compared with 2017. Consumer confidence is currently at its strongest level since 2001, despite the recent recovery in oil prices and political uncertainty in Spain, Italy and Germany. This points to another robust year for consumption. Strong and synchronised global growth is likely to keep supporting exports. Meanwhile, there are growing expectations of fiscal easing, albeit on the margin, across major economies, including possible tax cuts in Germany, France, the Netherlands and Austria.



POSSIBLE TAX CUTS IN GERMANY, FRANCE, THE NETHERLANDS & AUSTRIA

We expect Euro area monetary policy to remain extremely accommodative over the next 12 months, with inflation remaining well below the ECB's 2% target despite picking up from very low levels in recent months. Although Germany and other northern European economies have substantially narrowed excess productive capacities, labour markets in Italy, Spain and other major economies in southern Europe are still saddled with significant levels of under-employment. This leads us to believe that the ECB is unlikely to raise rates at least until 2019, despite announcing further cuts to its bond-buying programme over the coming year. Given this, inflation-adjusted interest rates are likely to stay negative over the coming quarters, providing a significant boost to economic activity.

We expect the EUR to extend gains over the coming year on the back of the region's improving growth, which is boosting demand for the region's assets, and contained political risks following the defeat of Eurosceptic parties in the elections in France and the Netherlands earlier this year. However, broadening and deepening domestic growth is likely to offset the impact of a stronger currency.

Political risks

The main risks to this constructive outlook are political. The recent election in Catalonia (Spain) and Germany point to the challenges facing centrist parties across the region. We are less concerned about Spain as the issue is likely to be eventually resolved with a greater transfer of fiscal powers from the federal

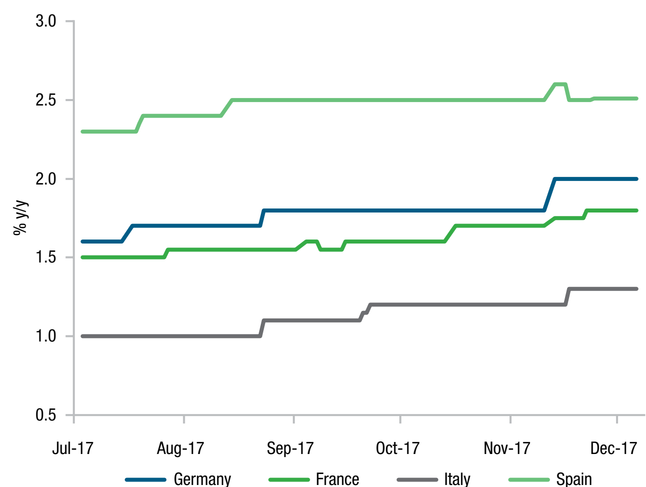
to the provincial governments. The possibility of a minority government in Germany, while unprecedented, is unlikely to lead to any significant changes in economic policy.

However, the upcoming elections in Italy – which must be held by May – could potentially lead to uncertainty, albeit for the short term. The bar for Eurosceptic parties to win in Italy is high, given their lack of agreement on a common agenda. Most Eurosceptic parties have backed away from their demand for a referendum on whether to remain in the Euro area. Even if they come to power and still want Italy to leave the Euro area, they will need to change the constitution to allow for such a binding referendum. Meanwhile, the ongoing economic recovery in Italy, enabled by the recapitalisation and aggressive bad loan write-offs at some of its weakest banks earlier this year, is likely to provide support for more moderate and centrist political parties at the polls. Thus, we continue to believe that political risks are likely to be contained in Italy as well as the Euro area over the coming year.

Figure 5

The Euro area has seen broad-based growth upgrades across the region

Consensus 2018 growth estimates for Euro area economies

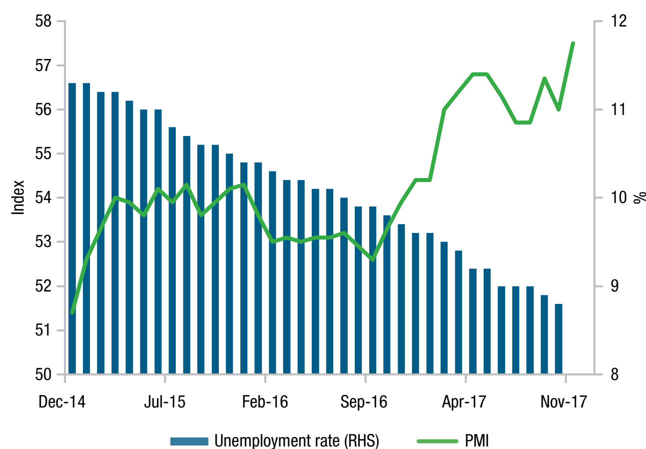


Source: Bloomberg, Standard Chartered

Figure 6

Job markets have improved across the Euro area, especially in southern Europe, as business confidence recovered

Euro area unemployment rate and PMI



Source: Bloomberg, Standard Chartered

UK

Brexit woes

- The UK continues to face uncertainty around the terms of Brexit, undermining its growth outlook
- Purchasing power is likely to be further hit by rising inflation caused by the GBP's earlier weakness and slowing wages
- The BoE has raised rates for the first time since the financial crisis, but is likely to be guided by the outcome of Brexit talks going forward
- The GBP is unlikely to extend gains into 2018, unless Brexit issues are resolved

The UK economy is an exception to our overall positive economic outlook for the major regions. With the outcome for Brexit talks still uncertain, the economy faces a double-whammy from high inflation, caused by the earlier depreciation of the GBP, and falling real incomes, as wages fail to keep up with inflation. The resulting decline in purchasing power has already led to a slowdown in consumption, previously the main driver of the economy. Continued Brexit uncertainty could encourage more companies to shift their operations to the Euro area, dealing a blow to already-weak business sentiment.

The outcome of Brexit talks is likely to be a key determinant for the outlook. For now, consensus estimates point to a slowdown in growth to around 1.4% in 2018, from 1.5% in 2017 and 1.8% in 2016. Any agreement that would allow an extension of the UK's existing trade and financial transaction arrangements with the European Union beyond the 2019 deadline (the UK has sought a two-year extension until 2021), would help significantly reduce business uncertainty. However, there is a risk of further instability in the current minority UK government, given deep divisions within the cabinet, which could hamper the UK's ability to negotiate a favourable agreement. The UK's opposition to the free movement of labour among European Union members is likely to be a key sticking point. The status of the existing 'soft' border between the Republic of Ireland and the UK territory of Northern Ireland following Brexit is another potentially vexing issue.

Monetary policy remains accommodative, but has turned less supportive lately. The Bank of England raised interest rates for the first time since the financial crisis in response to rising inflation, which has stayed well above its 2% target for almost a year. Although the GBP has gained in 2017, we do not expect the gains to extend into 2018 as the outlook for monetary policy remains uncertain and is likely to be data-driven, given the ambiguity around Brexit talks.

Japan

Abenomics 2.0

- Japan's economy is expected to continue growing above trend, making it the longest expansion in recent history
- Prime Minister Abe's re-election is positive for the continuation of monetary and fiscal stimulus and structural reform
- The BoJ is likely to maintain easy monetary policy as inflation remains well below target, despite the recent uptick
- We expect the JPY to weaken as the BoJ's extremely easy monetary policy contrasts with less accommodative policies elsewhere

As in the US and Euro area, Japan's economy expanded above its potential in 2017, growing an estimated 1.5%. Barring external shocks caused by geopolitics or any slump in global trade, growth is likely to remain above potential at around 1.2% in 2018, based on consensus, which would make the current expansion the longest in Japan's post World War II history. An extremely easy monetary policy, the JPY's prior weakness and robust global demand is helping support exports. Meanwhile, multi-decade low unemployment rates have helped revive domestic consumption and modest inflation pressures. The combination of strong external and domestic demand has helped close the excess productive capacities, encouraging companies to boost investment to expand.

Prime Minister Abe's recent victory at the snap general elections should give him the political backing to continue with his policy of aggressive monetary easing, supportive fiscal policies and structural reform to boost productivity and encourage wider labour participation. This implies BoJ Governor Haruhiko Kuroda is likely to get an extension after his current term expires in April, enabling him to continue with the BoJ's easy monetary policy. As a result, we expect the JPY to weaken against the backdrop of less accommodative central banks elsewhere. A weaker JPY is likely to keep supporting exports.

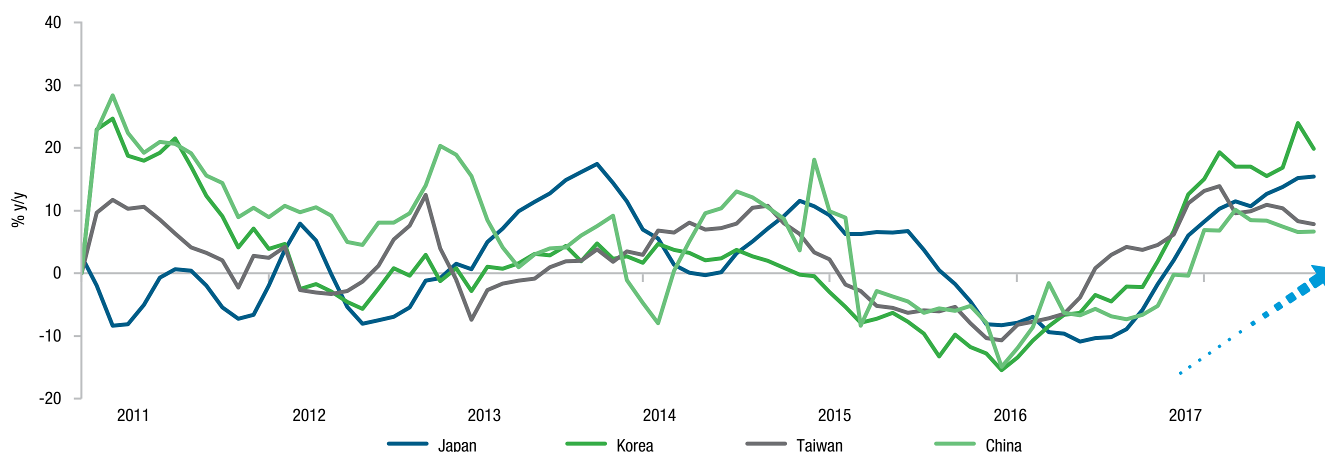
The key question is whether Japan's economy has reached 'escape velocity'. The pick-up in inflation this year suggests a reversal in trend, although inflation is likely to stay well below the BoJ's medium-term target of 2% for the foreseeable future. Any upside surprise to inflation, given the tight productive capacities and labour markets, could lead the BoJ to turn less accommodative. For now, we assign a low probability to such an outcome, but would remain watchful of evolving inflation trends.

Record low unemployment rates have helped revive domestic consumption and modest inflation pressures.

Figure 7

Japan and other major export-oriented economies in Asia are benefitting from a robust lift to global trade

Export growth in key Asian economies, rolling 3-month moving average



Source: Bloomberg, Standard Chartered

Asia ex-Japan

Boosted by strong global trade

- Asia ex-Japan is benefitting from robust global trade and a domestic recovery in major economies such as India and South Korea
- China's growth to slow modestly as it focuses on the quality of growth, while ensuring financial stability and long-term sustainability
- India's growth to recover from twin shocks of demonetisation and roll-out of goods and services tax (GST), aided by increased government spending and a revival in bank lending
- South Korea's growth outlook has improved since the election of the new government. The central bank is expected to hike rates only gradually

Asia ex-Japan remained the biggest regional contributor to global growth in 2017, powered by a stronger-than-expected expansion in China and a pick-up in global trade. We expect China's growth to slow moderately in 2018, but remain strong enough to keep supporting global demand. This, in turn, is likely to be supportive for the more open Asian economies such as South Korea, Taiwan, Malaysia and Singapore. Meanwhile, the more domestic-oriented economies such as India, Indonesia and the Philippines are likely to benefit from a mix of increased government spending and a revival in bank lending.

China's outlook remains critical for the region. We believe China's economy will slow modestly from the 6.5-7.0% growth rates seen over the past couple of years to a more sustainable 6.0-6.5% rate as President Xi Jinping, following his recent consolidation of power, renews the focus on the quality of growth. This necessarily means a moderate slowdown in property investment, with the slack taken over by continued strong growth in services and consumption.

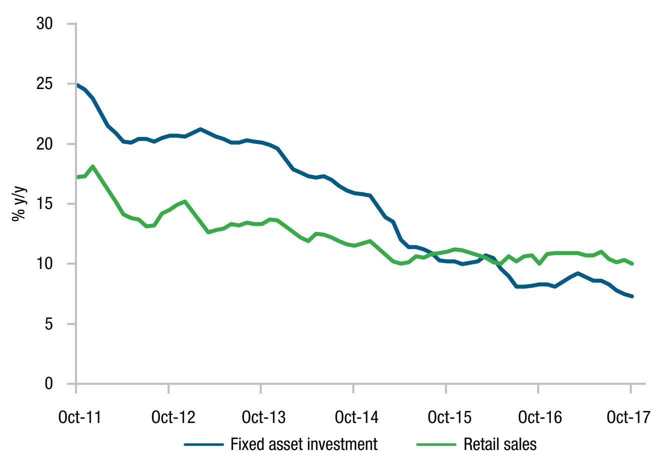
China's reforms would entail cuts to excess industrial capacities, more stringent environmental regulations and tighter credit to certain sectors (reflected in the recent rise in bond yields). However, we note that a key fallout of shuttering of excess capacities has been a strong pick-up in producer prices over the past couple of years, after a period of deflation, which has boosted industrial profit margins. Sustained strong corporate earnings should help support business investment. Meanwhile, the 'new economy' areas are benefitting from strong domestic consumption, driven by continued urbanisation and expansion of the middle class. Additionally, China's One-Belt-One-Road initiative to revive ancient trade routes across Asia is likely positive for infrastructure investment in the broader region over the coming years, especially across Southeast Asia. Fixed asset investment across Asia is likely to help offset slowing investment growth in China as it deleverages.

China's high, and rising debt levels, remains a key risk to the global outlook, with the IMF forecasting non-financial debt to rise to 298% of GDP by 2022 from 236% in 2016. However, we note that most of the leverage is in the corporate sector, while government debt remains relatively low. This means the government has the room to write-off bad debts to underperforming state-linked companies and entities, should it choose to do so, shielding the overall economy from excessive stress.

Figure 8

China's domestic consumption growth has remained robust, while investment growth has slowed

China's growth in retail sales and fixed asset investment



Source: Bloomberg, Standard Chartered

Outlook improving for rest of Asia

In India, there are signs of a revival in the economy after the twin shocks of demonetisation and implementation of GST slowed growth to multi-year lows earlier this year. The government's reform efforts are helping ease some structural bottlenecks, as seen from the latest rise in India's ranking in the World Bank's 'Ease of Doing Business'. The recent move to recapitalise banks and unveil a highway construction programme are positive for bank lending and economic growth in the coming quarters, especially in the run-up to the general elections in 2019.

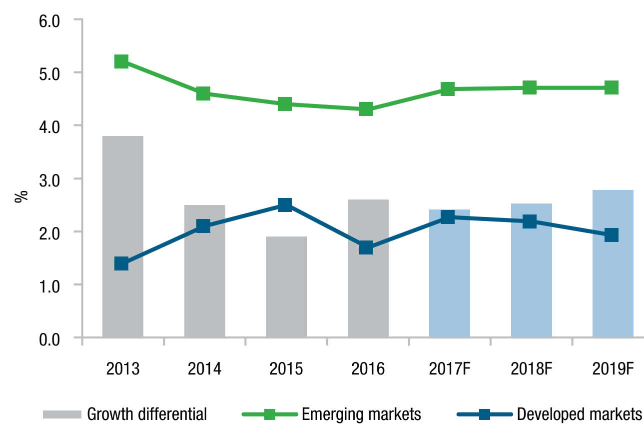
South Korea's growth outlook has improved since the formation of the new government earlier in 2017, with consensus estimates pointing to around 3% GDP growth for 2017 and 2018. The growth pick-up has been driven by supportive fiscal policies, a rise in minimum wages and improved relations with China (following the temporary impasse around the US's deployment of the THAAD missile defence system earlier in 2017), which has helped revive tourist inflows from China. The improved outlook has led the Bank of Korea to raise rates for the first time since 2011. We expect future rate hikes to be limited, given still subdued inflation and high household debt levels. Policymakers will also be restrained, lest higher rates lead to further strength in the KRW, hurting export competitiveness.

Overall, Asia ex-Japan is likely to grow 5.8% in 2018, vs 6.0% in 2017, per consensus estimates. Continued strong growth is likely to lift inflation moderately, especially with the recent recovery in oil prices. Meanwhile, a weaker USD is helping sustain capital flows to the region. Hence, there are growing expectations of a likely turn in monetary policy trends, with most central banks across the region shifting to a tightening bias for the first time in years. Consensus forecasts point to 25-50 bps rate hikes by Asian central banks over the next 12 months, led by 2-3 hikes in South Korea. In India, the window for further rate cuts has likely closed, although it would take a sustained rise in inflation for the central bank to raise rates.

Figure 9

The growth differential between EM and DM is expected to widen gradually as the global expansion broadens and becomes more synchronised

Growth in Emerging Markets and Developed Markets and their differential



Source: Bloomberg, Standard Chartered

Emerging Markets ex-Asia

Recovery aided by modest gains in commodity prices, weak USD

- Emerging Market growth likely to be supported by strong global trade environment, modest gains in commodity prices and weak USD
- Brazil's and Russia are likely getting close to the end of their easing cycles as inflation rebounds, although Mexico is likely to cut rates as inflation peaks
- The main risk to the region is political, given upcoming elections in Mexico, Brazil and South Africa

Emerging Markets outside Asia posted a turnaround in 2017, with major commodity-producing economies such as Brazil and Russia returning to growth after two years of contraction. The positive surprise in China's growth, driven by continued strength in the construction sector, helped sustain demand for raw materials. The agreement between OPEC and Russia to curtail crude oil production helped revive oil prices, benefitting Russia and other major oil producers. Meanwhile, the USD's weakness through 2017 has helped keep financial conditions easy across Emerging Markets. We expect the growth differential between EM and DM to widen gradually as the global expansion broadens and becomes more synchronised.

Consensus estimates point to a continued recovery in Latin America over the coming year on the back of constructive global growth and supportive commodity prices. All major economies, except for Venezuela, are likely to see acceleration in growth, although the region is likely to continue underperforming other major Emerging Markets.

Inflation appears to have bottomed in most markets (except in Mexico, Argentina and Venezuela), which is likely to constrain central banks from cutting interest rates significantly. However, monetary policy is likely to remain broadly accommodative, given substantial economic slack, stable currencies and improved external balances. In Mexico, inflation appears to have peaked, which should enable the central bank to cut rates.

Politics remains a key risk across Latin America, with upcoming elections in Mexico (July) and Brazil (October). In Mexico, the front-runner Andres Manuel Lopez Obrador has promised to unwind key structural reforms and review some state contracts, increasing investor uncertainty. Any decision by the US to pull out of NAFTA would deal a blow to Mexico's nascent recovery. In Brazil, populist candidates are rising in the polls, putting at risk further fiscal consolidation which is critical for the economy's medium-term sustainability.

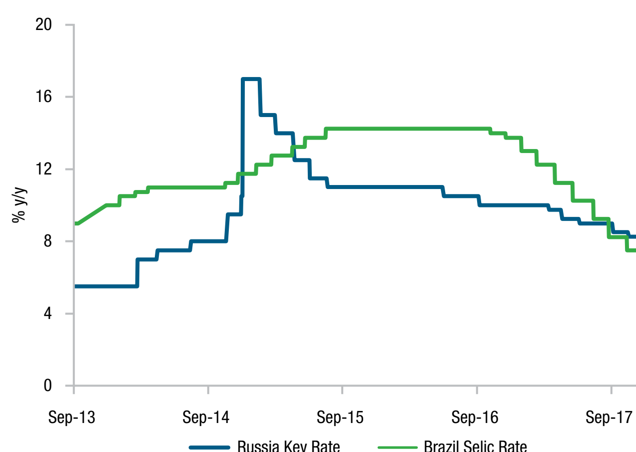
In Eastern Europe, Russia's growth is likely to plateau at around 1.8% in 2018, after a sharp recovery this year from two years of recession. Oil prices are likely to remain supportive. A key focus would be the direction of economic reform after the March elections when President Putin is expected to return for another term in office. A fall in inflation has enabled the central bank to cut rates in 2017; the window for further rate cuts has narrowed, although the market still expects 1-2 more cuts.

Among Emerging Markets, Turkey and South Africa remain the most vulnerable to any significant rise in global interest rates, given their negative external imbalances. In South Africa, the outcome of the ANC presidential election will be closely watched for the path of future policy and economic reform after President Jacob Zuma steps down from power.

Figure 10

Rate cuts in Brazil and Russia may be coming to a close as inflation bottoms

Central bank benchmark rates



Source: Bloomberg, Standard Chartered

The key risks

US monetary policy mistake

For now, this is primarily centred around the Fed and how it reacts to evolving inflation. There are two potential pitfalls:

- **The Fed raises rates too early/too fast**: The US economy is at the late stage of its business cycle after expanding for 8 years. However, inflation has remained subdued. There is a risk the Fed raises rates at a much faster pace than current market estimates to stay ahead of the curve (financial markets point to 1-2, 25bps Fed rate hikes, while the Fed expects 75bps increase in 2018), causing a sharp economic slowdown.
- **The Fed is too slow to react to inflation**: There is the counter-risk that the Fed waits too long to raise rates, even as a tightening job market builds up wage pressures, leading to a significant surge in inflation. Alternatively, the Trump administration's proposed tax cuts could lead to an overheating of the economy. In these cases, the Fed may be forced to accelerate the pace of rate hikes, potentially causing a sharp slowdown in the economy.

We expect the Fed under new Chair Jerome Powell to continue erring on the side of caution and stick with the current pace of gradual rate hikes until policymakers are convinced of a sustainable upturn in inflation.

US domestic policies and trade protectionism

President Trump's administration has had little success so far in terms of legislative wins, despite the Republican party's majority in both houses of Congress. There is risk that the Republicans lose control of one or both Houses of Congress following the mid-term elections late in 2018, scuppering the President's economic reform agenda. Alternatively, the investigations on Russia's alleged interference in US elections could implicate senior US administration officials.

Such events could encourage the President to focus on external issues, including renegotiating, or even abandoning, existing trade agreements with major trade partners such as Mexico and economies across Asia. Such an outcome would hurt global trade, clouding the outlook for Emerging Markets and the export-oriented economies of Europe.

Hard-landing in China

China's debt levels, especially in the corporate sector, have continued to rise significantly, increasing financial stability risks. Rising bond yields could pose additional challenges for overleveraged companies.

However, policymakers have been reasonably successful in recent years in gradually rebalancing the economy from investment to domestic consumption. We believe President Xi Jinping's administration now has the political might to tackle the debt problem head-on. The administration's record of maintaining a stable growth environment, even as it pursues structural reform, gives us confidence that it is likely to succeed in stabilising the economy at a slightly slower rate of growth.

Global politics/geopolitics

- **Multi-polar world**: Geopolitical risks have increased over the past year. We believe this is part of an evolving structural trend as the world becomes increasingly multi-polar, whereby multiple countries are competing for international influence. The US's economic and military power, unchallenged since the end of the cold war, is likely to be gradually eroded as China's economic and military strength increases. The US withdrawal from the Trans-Pacific Partnership and the Paris Climate Accord offers further opportunity for China and the European Union to expand their sphere of influence. History teaches us multi-polarity can often lead to extreme 'black swan' events.
- **North Korea**: More immediately, North Korea's increased belligerence could lead to a flare-up in tensions in North Asia, including direct confrontation between the US and China.
- **Middle East**: The domestic and regional fallout of the recent political changes in Saudi Arabia remains uncertain. A region-wide conflagration involving other Middle East economies could lead to further rise in oil prices, causing a significant tightening of global financial conditions.
- **Italy**: The upcoming general election in Italy could yet lead to short-term uncertainty if Eurosceptic parties win. So far, most parties have stepped back from their earlier calls for a referendum. The ongoing upturn in Italy's economy and success of pro-European parties in elections in France and the Netherlands earlier this year is likely to dampen the Euroscepticism of Italian voters.

MULTI-ASSET

Multi-asset
At a glance

Aditya Monappa, CFA | Audrey Goh, CFA | Trang Nguyen

Key themes

Broadening growth coupled with rising inflation solidify the pivot towards reflation in our scenario-based outlook, in our view. In 2018, we continue to prefer a growth-tilted allocation and expect it to outperform a multi-asset income strategy focused on yielding assets.

A multi-asset income allocation, while underperforming its growth-tilted counterpart, should deliver a positive return alongside a yield in the 4-5% range. However, expensive income assets suggest yields are likely to be at the lower end of this range.

Despite increasing confidence in Emerging Market assets, we prefer a globally diversified multi-asset income allocation versus one purely focused on EM assets, which has potentially much higher risk. We do, however, suggest a large (~40%) allocation to EM within a global allocation.

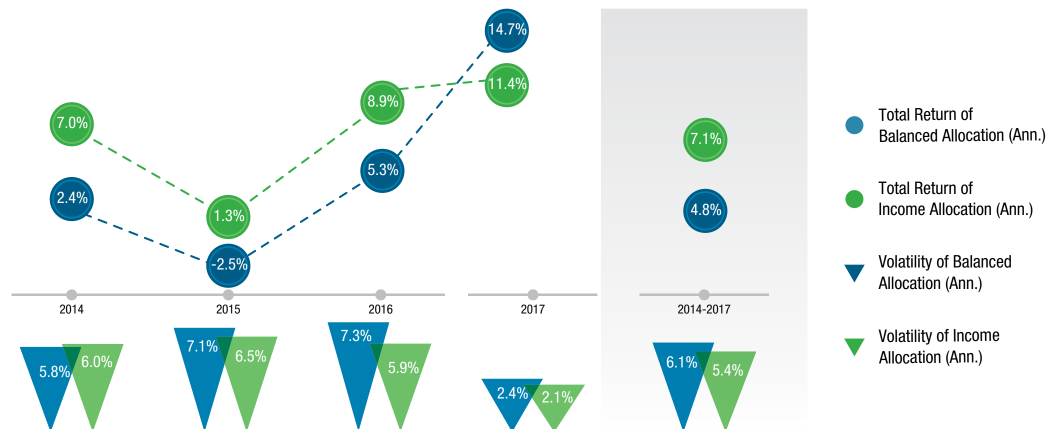
For investors focused on leveraged strategies to generate yield, returns in 2018 are unlikely to match the strong 2017 performance as borrowing costs rise amidst still compressed longer term bond yields.

Key chart

Figure 1

For the first time in four years, a balanced allocation outperformed the multi-asset income allocation in 2017

Performance comparison of balanced and income allocation between 2014 and 2017



Source: Bloomberg, Standard Chartered. For indices used, refer to end note at the conclusion of this section.
Income allocation is as described in our H2 Outlook, Should I stay, or…?, 30 June 2017, page 30.
Balanced allocation as described our Global Market Outlook, Fresh opportunities to pivot, 31 March 2017, page 28.

Key drivers

Income Asset Classes	Weight	Yield	Income Potential	Capital Growth	Risk of Pullback	Comments
Bonds	58%	4.4	Moderate	Moderate	Moderate	Portfolio anchor; source of yield; sharp move in yields a risk
Equity Income	20%	4.7	Moderate	Moderate	Unattractive	Key source of income and modest upside from capital growth, potential for large pullbacks
Non-core Income	22%	4.6	Moderate	Moderate	Moderate	Useful diversifier for income and growth; sharp move in yields a risk for certain non-core assets

Source: Bloomberg, Standard Chartered. Non-core income includes Preferred Equity, Global REITs, Convertible Bonds, Contingent Convertible Bonds and Covered Calls. Refer to Important information related to Contingent Convertibles at the end of this document.
Legend: ● Attractive potential/low risk | ● Moderate potential/medium risk | ● Unattractive potential/high risk

The big picture – multi-year trends in asset class returns

This multi-asset section describes our suggested approach for various categories of investors to implement our individual asset class views in a cross-asset allocation framework. We recognise there are several classes of investors and a single approach to asset allocation might not meet their needs. As a result, we suggest different approaches for investors focused on total-return (yield plus capital appreciation) versus those focused on income or yield.

Long term asset class expected returns to decline

The past two decades have seen rapid growth in emerging economies; nations have been expanding labour-forces and making productivity gains through advances in global supply chains, increased global trade and automation. More recently, global productivity has trended lower and major economies, previously growing at a rapid pace, are now moderating; e.g. China's growth is expected to slow as the economy continues to transition from an investment-driven to consumption driven growth in the coming years.

Our Global Investment Committee collaborates with Mercer Consulting to generate proprietary seven-year forward-looking forecasts as a source of inputs for our long-term Strategic Asset Allocation (SAA). We compare historical asset class returns versus these forecasts and share implications for our asset allocations, both Global-focused and Asia-focused (Figure 2).

Historically, an Asia-focused allocation would have delivered a marginally better return compared with a Global Allocation, albeit with more volatility. As global growth has been driven by

Figure 2

For our asset allocation models, seven-year forecast returns point to lower returns and similar levels for volatility versus history

Historical (1993-2017) return/volatility statistics vs. seven-year forecasts (returns and volatility are annualised in %)

	HISTORICAL		7-YEAR FORECAST	
	Returns (Ann.)	Volatility (Ann.)	Returns (Ann.)	Volatility (Ann.)
Global-focused SAA*	6.3	7.1	3.6	7.8
Asia-focused SAA*	6.8	8.9	4.4	8.9

Source: Bloomberg, Standard Chartered, Mercer Consulting
For indices used, refer to end note at the conclusion of this section.
*SAA is our moderate strategic asset allocation. This is made up of 5% USD cash, 45% bonds, 35% equities, 5% commodities and 10% alternatives.

Emerging economies, this result is intuitive given the higher exposure to Emerging Markets within an Asia-focused allocation.

Looking forward, seven-year forecasts see lower expected returns for both Global and Asia-focused Allocations; expected volatility vs historical is slightly higher for Global and similar for Asia-focused.

Expected bond market returns are noticeably lower, across both Developed and Emerging Markets, as global interest rates and yields rise from extremely depressed levels.

Within equities, outside of the US market, forecast returns are generally in line or higher for other regions versus history. US equity returns are lower given the strong run we've seen since the Global Financial Crisis. In other markets, which lag the US cycle, the return outlook is more positive.

Figure 3

Seven-year forecast returns point to lower returns and similar levels for volatility versus history

Historical (1993-2017) return/volatility statistics vs. seven-year forecasts (returns and volatility are annualised in %)

	HISTORICAL		7-YEAR FORECAST	
	Returns (Ann.)	Volatility (Ann.)	Returns (Ann.)	Volatility (Ann.)
Cash	3.1	0.7	2.1	1.5
DM IG Govt	5.0	5.4	1.2	7.0
DM IG Corp	6.1	5.3	2.0	6.8
DM HY Corp	8.3	9.7	2.8	10.5
EM Debt	9.4	11.8	4.1	9.0
North America	9.1	14.5	4.9	18.0
Europe ex-UK	7.6	18.7	7.6	21.5
UK	6.2	15.5	6.7	20.0
Japan	2.1	17.7	6.1	25.1
Asia ex-Japan	4.5	23.0	8.6	25.3
Other EM	6.6	25.8	7.4	28.9
Commodities	2.5	15.3	3.5	20.7
Alternatives	5.0	5.5	4.7	5.0

Source: Bloomberg, Standard Chartered, Mercer Consulting
For indices used, refer to end note at the conclusion of this section.

2018: We remain in the growth quadrant

Between 2014-2016, our leading scenario was a "muddle through" economic environment (structurally slow growth and low inflation). Under such a scenario, we suggested a multi-asset income approach to investing was the appropriate strategy for both yield-seeking and total return-seeking investors.

In 2017, we saw a marked increase in the likelihood of a "reflationary" scenario (controlled recovery in growth and inflation) versus previous years leading us to call for a pivot to more pro-growth assets. To coincide with this increase, we suggested (for the first time since 2014) that a growth-tilted rather than a pure income-focused allocation made sense for a total-return seeking investor. Our suggestion to tilt towards growth has paid off in terms of performance with the growth-tilted balanced allocation (14.7%) outperforming our multi-asset income allocation (11.4%) by 330bps since we published our 2017 Outlook (Figure 1).

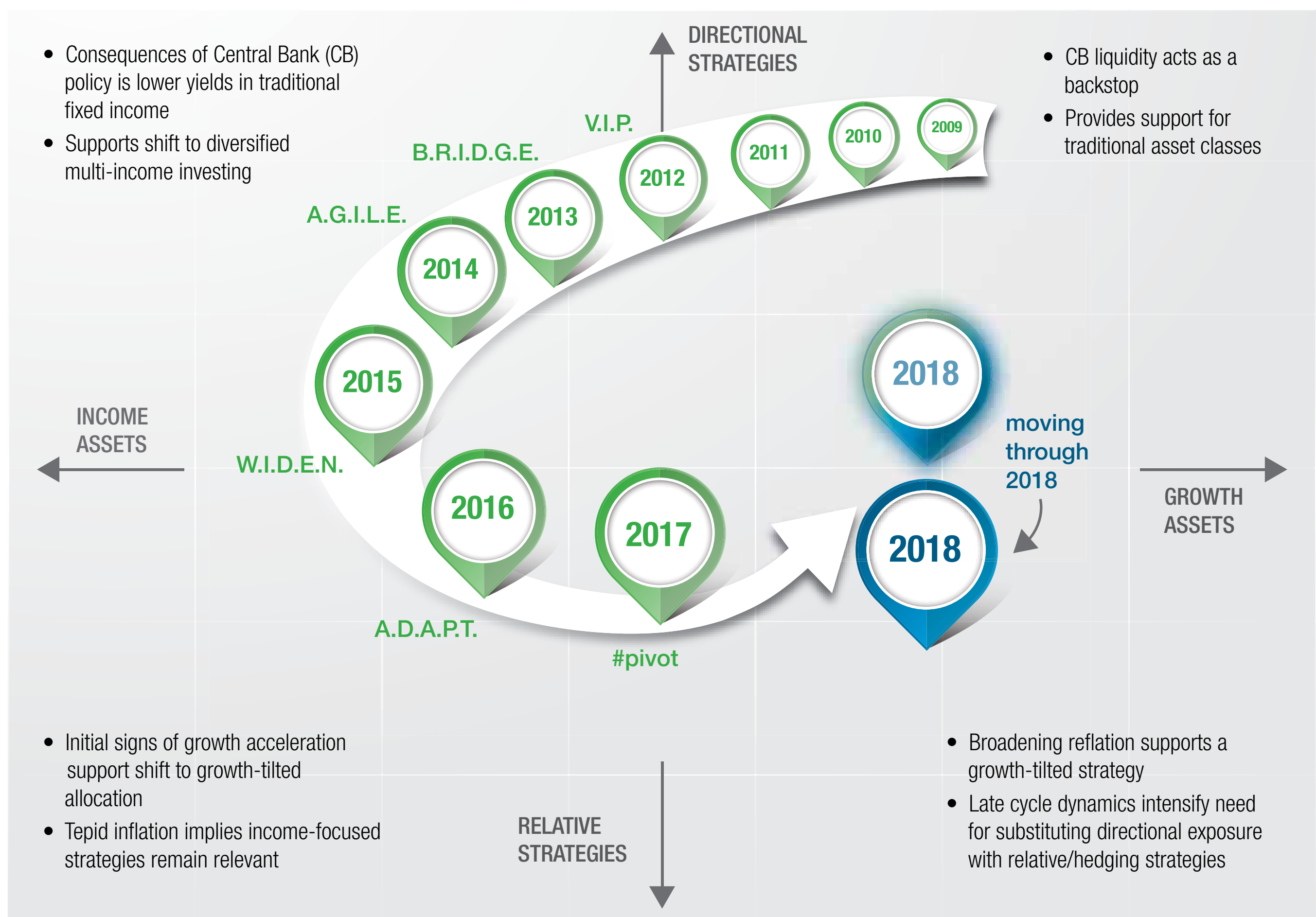
It has also been a year of extremely low volatility for both allocations resulting in the best year of risk-adjusted performance since 2014 (the first year we published a multi-asset income allocation).

Following a stellar run in 2017, a key question for investors is whether this outperformance from the growth-tilted allocation might continue into 2018? Our expectation is the trend in improving economic momentum continues and we maintain our conviction in the outperformance of the growth-tilted allocation. In 2018, as illustrated in Figure 4, we remain squarely in the growth quadrant of our multi-asset investing spectrum. Positive economic momentum combined with a still accommodative policy environment should be supportive for risk assets (Figure 5).

Figure 4

Trends in multi-asset investing (2009 – today)

Evolution of multi-asset trends reflecting a tilt between growth/income and directional/relative strategies



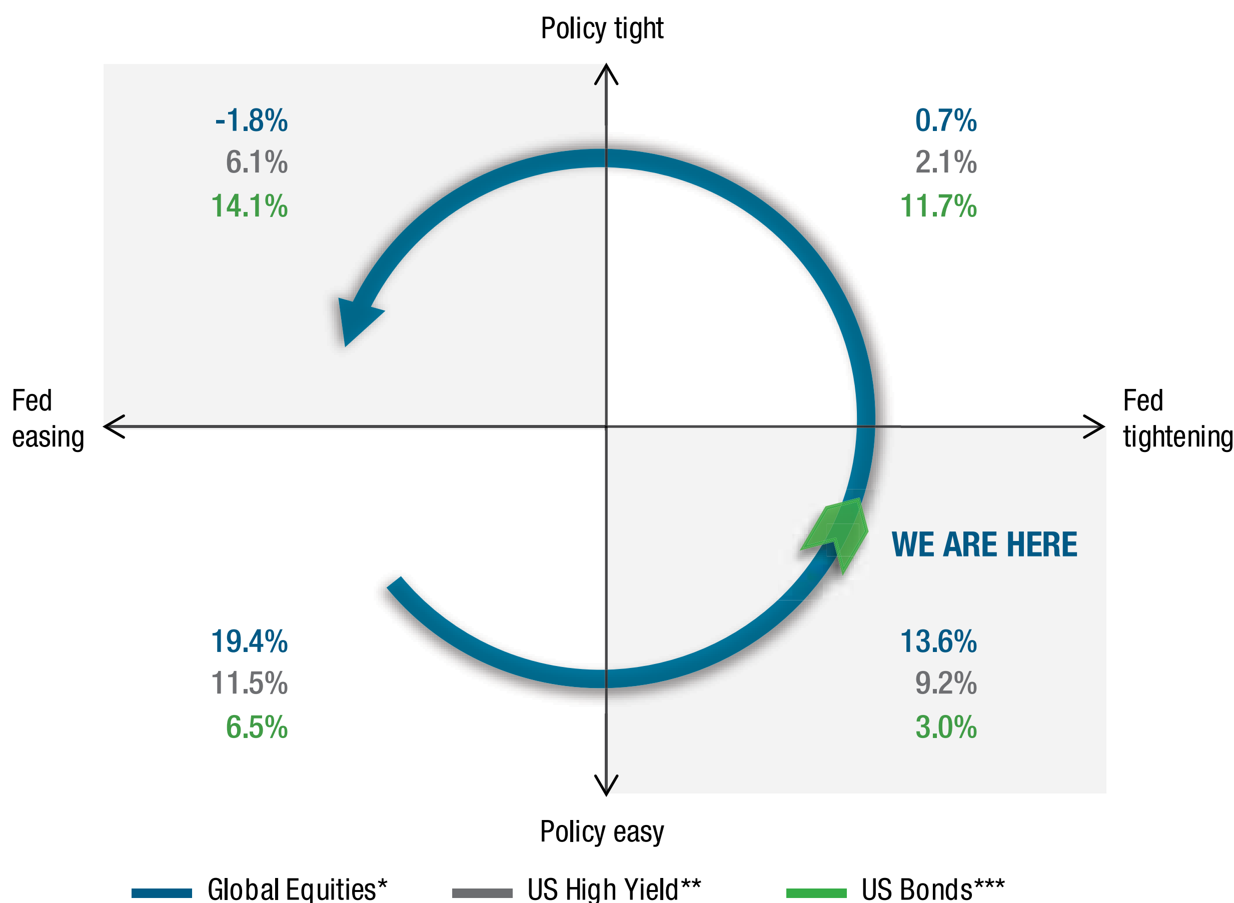
Source: Standard Chartered

Against this backdrop, it is also important to note that 2018 is expected to see the peak in the size of global central bank balance sheets. While this highlights the confidence policymakers have in the strength of the global economy, a withdrawal of liquidity could move us into a higher volatility regime. Although strong economic data suggests a Goldilocks environment can spill over at least into the start of 2018, investors should prepare to be nimble as we proceed further into the year. As a result, we believe substituting some directional exposure for relative/hedging strategies should grow in importance as we move further along into 2018. The ability of these strategies to deliver superior risk-adjusted returns with lower volatility and correlations with traditional asset classes make them a valuable addition to an investor's allocation especially in the late stages of the market cycle (see our dedicated section on Alternative Strategies for more details).

Figure 5

Policy setting remains constructive for risk assets (bottom right quadrant); policy tightening could change the equation (top right quadrant) in the coming 12-24 months

Average annualised returns of equity and bonds during various tight/easy policy and Fed easing/tightening cycles



Note: Policy is defined as tight when real Fed Fund Rate is above neutral rate.
Source: BCA Research, MSCI, Bloomberg Barclays, Standard Chartered
*Data from January 1970 to October 2017; **Data from June 1983 to October 2017; ***Data from January 1976 to October 2017.

2017
A rear-view assessment of multi-asset performance

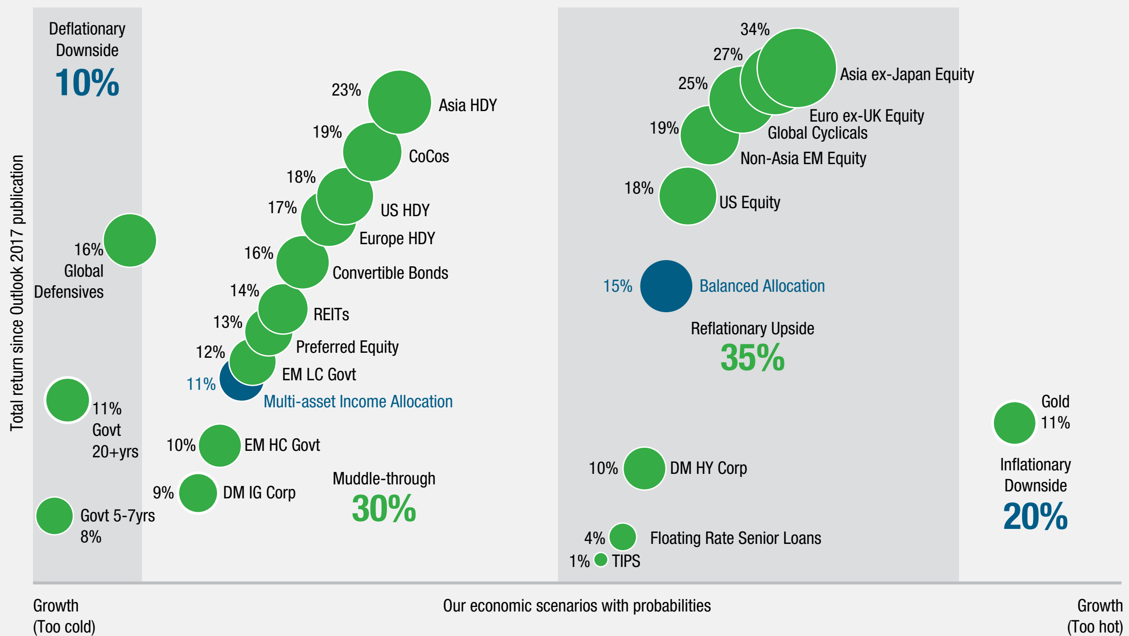
Much of the performance in 2017 has been driven by a broadening trend in growth led by Asia-ex Japan and the Euro-area (Figure 6). This has translated into outsized returns in traditional equity markets in these two regions, with Asia ex-Japan equity being the standout. This impetus from growth has also resulted in traditional equity outperforming high-dividend equity by a wide margin in both these regions.

Another indirect beneficiary of the growth trend has been non-core income assets (convertible bonds, REITs, preferred equity, CoCos), which are hybrid instruments containing characteristics of both equity and bonds. The equity component of these assets has allowed them deliver double-digit returns in 2017 and helped to boost the performance of our multi-asset income allocation (non-core assets represent 17% of this strategy) into double-digit territory. Within bonds, Emerging Market (EM) asset classes have outperformed their Developed Market (DM) counterparts in line with a positive shift in sentiment towards Emerging economies.

Figure 6

In 2017, broadening growth trend led to strong performance from equity linked asset class

Performance of various asset classes from Outlook 2017 publication to 5 December 2017



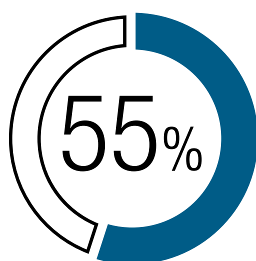
Source: Bloomberg, Standard Chartered. For indices used, refer to end note at the conclusion of this section.
Size of bubble represents total return of asset class; Scenario probabilities as described in 'Outlook 2017: #pivot', Figure 1, page 11.

Total-return focused investors
Maintain the growth tilt; manage inflation risk

- Growth-tilted allocation to again deliver positive absolute returns in 2018 on broadening economic momentum
- Increase Asia ex-Japan equity exposure on widening growth differential between EM and DM
- Prepare for a pick-up in inflation with a basket of floating rate senior loans, TIPS and commodities
- Substitute some traditional strategies for alternative strategies to deliver better risk-adjusted returns

The growth-tilted allocation was designed to benefit from a reflationary economic scenario i.e. controlled recovery in growth and inflation. While the growth side of this scenario came to fruition in 2017 (resulting in the outperformance of this strategy), inflation has yet to pick up in a meaningful way.

Entering 2018, we focus on assets that benefit from a reflationary environment when constructing the balanced allocation.

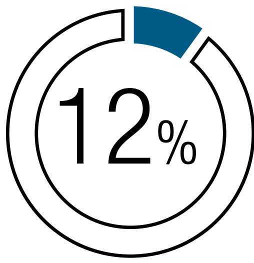


Growth basket

We introduce the concept of a "Growth basket" to reflect assets that might benefit from broadening growth momentum. This basket contains exposure to equity and a small amount of Developed Market High Yield (DM HY). Given a widening growth differential between Emerging Markets (EM) and DM, we've turned increasingly positive on EM assets.

We make the following changes to our mix of growth-focused assets versus our previous allocation:

- We increase our allocation to Asia ex-Japan equity at the expense of Euro-area equity.
- We reduce our allocation to DM high yield bonds given relatively expensive valuations and our expectation that the total return is likely limited to the yield on offer.



Inflation basket

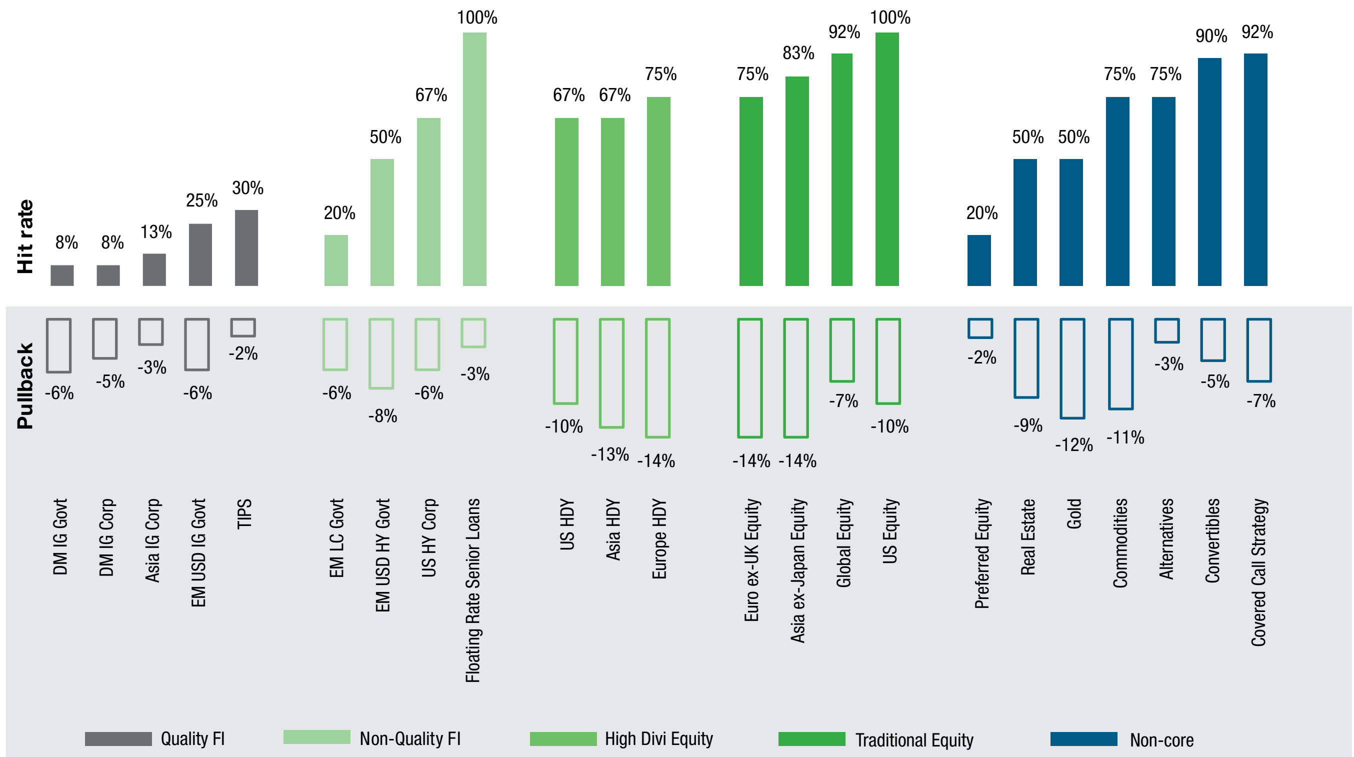
As inflationary pressures continue to build, albeit gradually so far, we believe it is best to introduce the concept of an “Inflation Basket”, which contains assets that should benefit from higher inflation:

- Add an allocation to TIPS: We introduce an allocation to Treasury Inflation-Protected Securities (TIPS). In an environment of potentially increasing inflation expectations (driven by labour market tightness and accelerating wage growth), this asset class represents a good alternative to DM Investment Grade Government bonds. Based on historical data (Figure 7), the hit rate for TIPS is also significantly better than DM IG Government bonds (or any other high quality bonds for that matter) further bolstering the case for this relative preference.
- Include a floating rate senior loan allocation: As shown in Figure 7, floating rate senior loans have the highest hit rate (100%) along with US equity acting as a more defensive form of high yield exposure, particularly in a rising rate environment.
- Introduce an allocation to Commodities: This asset class typically delivers superior performance in a late-cycle environment amid a pick-up in global growth. However, potential China deleveraging and reform could present a headwind to commodity prices. We introduce a small commodity allocation in our inflation risk basket.

Figure 7

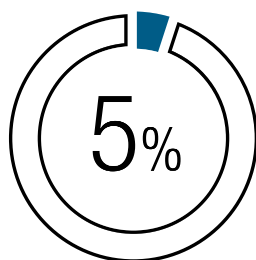
Floating rate senior loans and non-core income asset classes have some of the highest hit rates*

Percentage of periods with positive returns over various rising yield periods (>50bps) since 2000

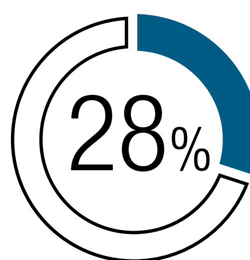


Source: Bloomberg, Standard Chartered; Quality FI includes G3 Sov, TIPS, DM IG Corp, EM HC Sov IG, Asia IG Corp. Non-quality FI includes floating rate senior loans, US HY, EM HC Sov HY, EM LC Sov

*Hit rate for an asset class is the percentage of rising yield periods (yields rose >50bps) where the asset class delivered positive returns.



Alternative strategies



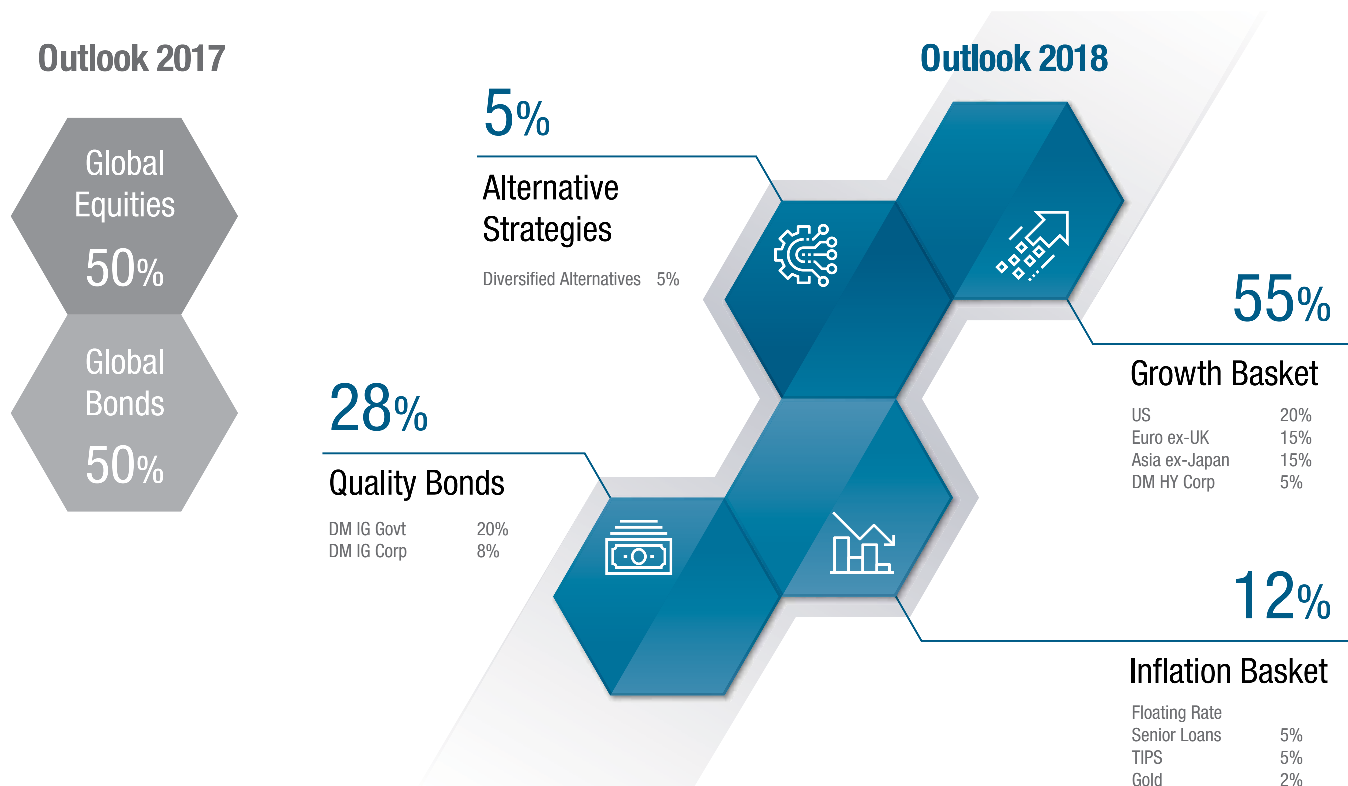
Quality bonds

In the later stages of an economic cycle, diversified alternative strategies are likely to deliver better risk-adjusted returns versus a number of traditional asset classes. Our hit rate analysis highlights the superior performance of these strategies particularly in periods of rising yields. We introduce a diversified alternative allocation to help improve the risk-reward profile of our balanced allocation given their lower volatility and correlation with traditional asset classes Additional detail on this allocation can be found in the Alternatives section on page 89.

We maintain an allocation to quality bonds accepting a lower yield for a degree of protection against adverse market developments. A deflationary downside scenario is one such event. If markets get concerned about lower growth and inflation, high quality bonds could outperform risk assets.

Figure 8

Comparison of growth-tilted allocation published in Outlook 2017 vs Outlook 2018 publication (asset class weight in %)



Source: Standard Chartered
Growth-tilted allocation was last revised in our Global Market Outlook, Fresh opportunities to pivot, 31 March 2017, page 28.

Income-focused investors
Global approach remains valid

- A positive absolute return is expected from our income allocation given we haven't fully pivoted from a 'muddle through' scenario (slow growth, low inflation) to 'reflation' (controlled recovery in growth/inflation).
- Investors should adjust yield expectations to the lower end of the 4-5% range as yields offered by key income asset classes have fallen significantly.
- We prefer a globally diversified approach to multi-asset income investing versus a dedicated EM multi-asset income strategy. However, EM assets should represent a healthy allocation (we suggest 40%) of equity income and bonds within the global allocation.

Given our preference for a growth-tilted allocation, a key question for a yield-seeking investor is whether a multi-asset income approach still makes sense in 2018. Primary concerns for this category of investor are whether the strategy can generate a sustainable yield and deliver a positive absolute return. Our macroeconomic outlook suggests a relapse into a muddle-through scenario (slow growth and low inflation) is still a possibility with a meaningful probability (35%).

Until we've truly pivoted to a reflationary environment, a multi-asset approach to income investing should generate a positive absolute return and deliver a yield in the 4-5% range. However, we state this view with the following qualifications:

- **Yield expectations need to be managed**: The unleveraged yield generated by our suggested multi-asset income allocation is likely to be at the lower end of the 4-5% range versus being close to 5% at end-2016.
- **Managing pullback risk takes on greater importance**: With a falling yield buffer, managing the risk of pullback, especially in an environment of rising interest rates, takes on greater urgency.

Previously, we have classified our income assets into three buckets – Preservation yield (lower yield <3% but downside protection), Maintenance yield (3-5%) and Aspiration yield (higher yields >5% with measured risk). The basic approach was to find a balance between risk and reward by allocating to these buckets in a way that allowed for the overall strategy to generate 4-5% of sustainable income.

Over the past year, we have seen a fall in the yield on offer across several assets, particularly those in the Aspirational Yield category. This includes assets such as US high yield which has traditionally been the mainstay of the income strategy. Contingent convertible bonds have also had a tremendous run in 2017 and, as a result, have seen yields fall from 7.4% to 4.4% at the time of writing.

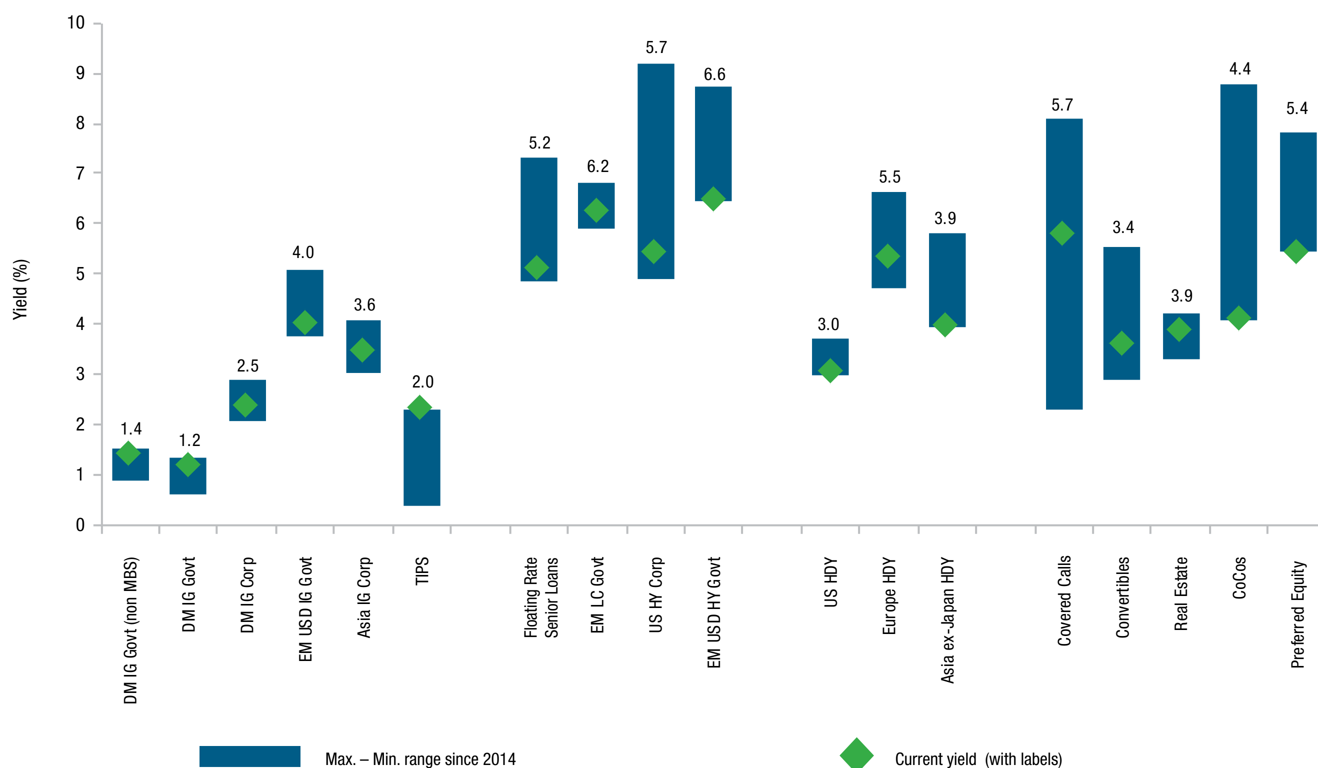
The implication is it's becoming increasingly difficult to generate the target yield of 4-5% in a sustainable way, i.e. without taking concentrated risk in a few asset classes that offer the highest yields.

Additionally, it also means there is a lower yield buffer to shield against a potential rise in interest rates. While a sharp increase in rates is not our central scenario, a shift in probability of this outcome could leave the multi-asset income allocation exposed to lower total returns given the reduced yield buffer and increased interest rate sensitivity of the bond allocation. With this backdrop of lower starting yields and a risk from rising interest rates, yield-seeking investors will likely have to adjust their aspirations as we enter 2018.

Figure 9

A rare breed – income asset classes generating yield in excess of 5%

Yield (%) available from various income asset classes including yield range from 2014-2017 and current yield



Source: Bloomberg, Standard Chartered. For indices used, refer to end note at the conclusion of this section.
Yield data as of 5 December 2017.

Can Emerging Market assets help boost returns for multi-asset income?

In an environment of falling yields, one might question whether an income approach dedicated to Emerging Market assets might be a better alternative to a globally diversified approach? Given our positive view on EM assets across both equity and bonds, this approach might help generate a higher total-return for the income allocation, but with significantly higher risk of sizeable drawdowns.

Our universe of EM income assets includes EM USD government bonds, EM local currency government bonds, Asia USD corporate bonds, Asia REITs and Asia high dividend yield equities. While this is by no means an exhaustive set of income assets, we feel it provides us with sufficient tools across the risk spectrum to create a reasonably diversified income allocation (Figure 10). We compare the dedicated EM/Asia allocation to the globally diversified allocation to better understand its characteristics:

Asset class exposure

- **Bonds**: EM multi-asset income is concentrated in EM government and Asia corporate bonds while the global income model is diversified across DM and EM bonds. This results in a higher average yield for the EM-focused allocation versus the globally diversified allocation.
- **Equity**: EM multi-asset income is completely allocated to Asia ex-Japan versus a more diversified approach in the global version. Our positive view on Asia ex-Japan equity suggests higher potential for capital appreciation. However, this should be balanced with the understanding that we generally see higher pullbacks from dividend equity in this region compared to Developed Markets.
- **Non-core**: Aside from REITs, non-core income asset classes are absent within EM multi-asset income. In addition to their attractive yield, some non-core assets could also deliver capital appreciation as their embedded equity exposure would benefit in a reflationary scenario.

Risk and pullback

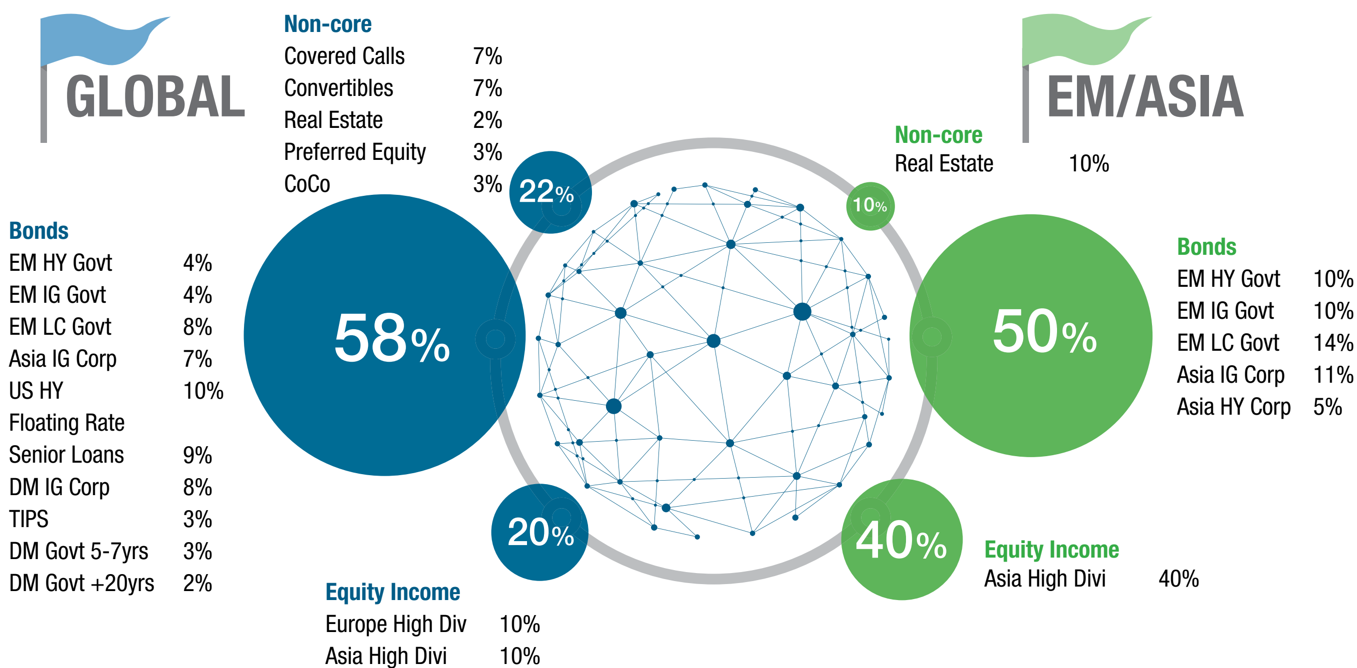
While the EM multi-asset income allocation might deliver higher yield and capital appreciation compared to its global counterpart, it is also useful to evaluate the other side of the coin i.e. risk and pullback. The EM version comes with significantly higher annualised risk and pullback based on historical analysis over the past five years.

An improving growth environment in EM going forward (compared to the past five years) might reduce the overall level of risk of the EM/Asia multi-asset income allocation. However, the high correlation between Emerging Market assets (including between equity and bonds) suggests the risk of this strategy is likely to remain significantly higher than a globally diversified income strategy.

Figure 10

Greater concentration and lower exposure to non-core assets in an EM multi-asset income allocation

A comparison of global and EM multi-asset income allocations (percentages represent weights in each asset class)

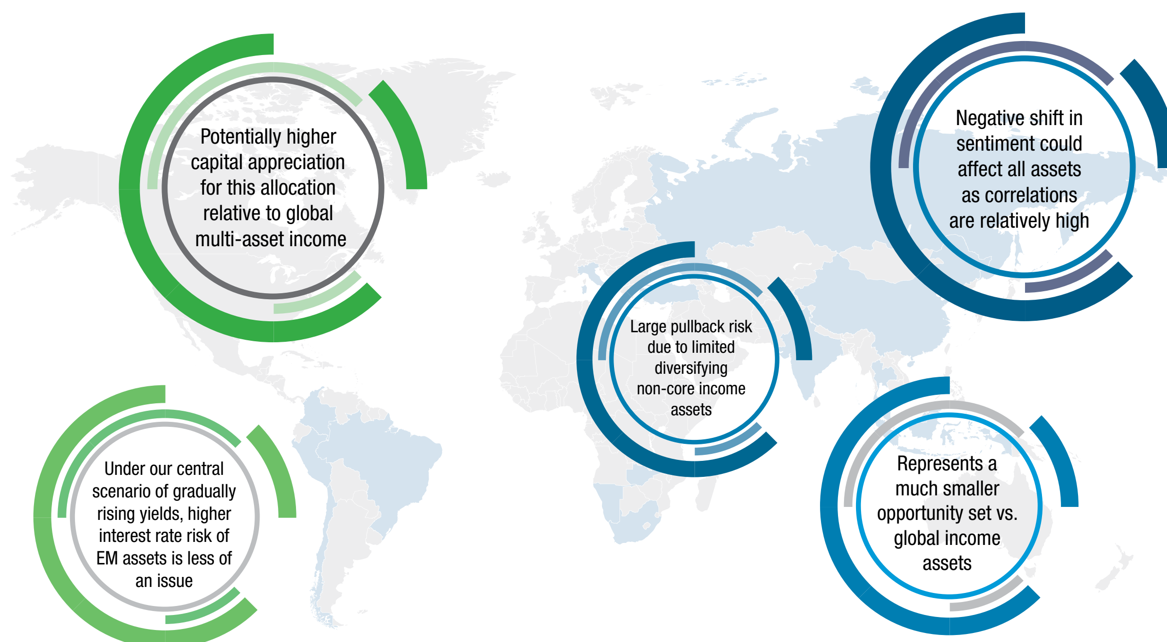


Source: Standard Chartered

Figure 11

EM/Asia Multi-Asset Income

Pros (green) and cons (blue)



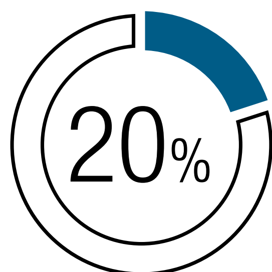
	1 RISK	2 PULLBACK	3 YIELD	4 DURATION (USD)
EM/ASIA	9.9%	-13.4%	4.9%	5.8%
GLOBAL	5.9%	-5.6%	4.5%	4.8%

Source: Bloomberg, Standard Chartered
Historical statistics are calculated using data from January 2012 to October 2017.

The analysis above suggests that while a dedicated EM/Asia multi-asset income allocation might provide potential for higher capital appreciation in 2018, it comes with significantly higher risk. Against this backdrop, we suggest investors simply maintain a healthy allocation (we suggest 40%) to EM assets within a globally diversified income allocation.

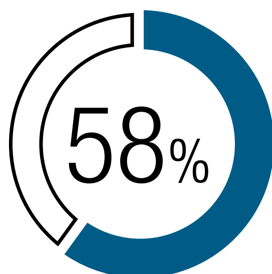
Positioning the income allocation for 2018

For global multi-asset income investors, we take a look at the key areas for 2018:



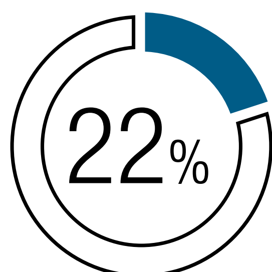
Equity income

We retain our conviction in equity income as a key component of a multi-asset income strategy where Asia ex-Japan (3.9% dividend yield) and Europe (5.5% dividend yield) offer attractive yields and potential for capital appreciation. With our increased conviction in Emerging Market assets (and therefore greater potential for capital appreciation), we choose to increase the weight of Asia ex-Japan dividend equity and reduce our allocation in European dividend equity. Our Asia ex-Japan exposure has increased from 25% two years ago to around 50% of our equity allocation today. We retain an unhedged stance on our European exposure given our expectations of EUR strength. Finally, we exit our allocation in US high dividend equity and move this exposure to non-core income. Rich valuations and low yield (3% dividend yield) make this asset class relatively unappealing.



Bonds

Our bond allocation is a diversified basket of asset classes across Developed and Emerging Markets. In the context of our earlier discussion on EM assets, it is also important to note that EM bonds account for a significant proportion (40%) within our bond allocation. We choose not to make any changes to the mix at this point. Specifically, we resist the urge to add to the aspirational yield (>5%) bucket in Emerging Market bonds given significant interest rate risk associated with these investments (Figure 12). Instead, we increase our EM exposure via Asia ex-Japan equity.



Non-core income

Perhaps the area that could benefit the most from the pivot to reflation is the non-core income category. Assets in this category are considered hybrids, i.e. they possess characteristics of both equity and bonds. As a result, this group of assets provides a reasonable yield (driven by their bond features), could deliver capital appreciation (based on their equity features) driven by an improving growth environment and, in many cases, are relatively unaffected by rising interest rate risk (Figure 7). We believe this could be a crucial component in delivering performance for the multi-asset income strategy in 2018. Investors should ensure that strategies such as convertible bonds, covered calls, REITS, CoCos and preferred equity find a home in their income allocation.

We use the allocation raised by exiting US high dividend equity to increase our allocation to covered calls and convertible bonds. These asset classes also offer US equity market exposure but with higher yield, better performance in a rising rate environment and better risk-adjusted return (by virtue of their lower correlation to traditional asset classes).

Figure 12

Total return of fixed income assets assuming different changes in yield

Yield to maturity, duration* for fixed income assets as at 5 December 2017

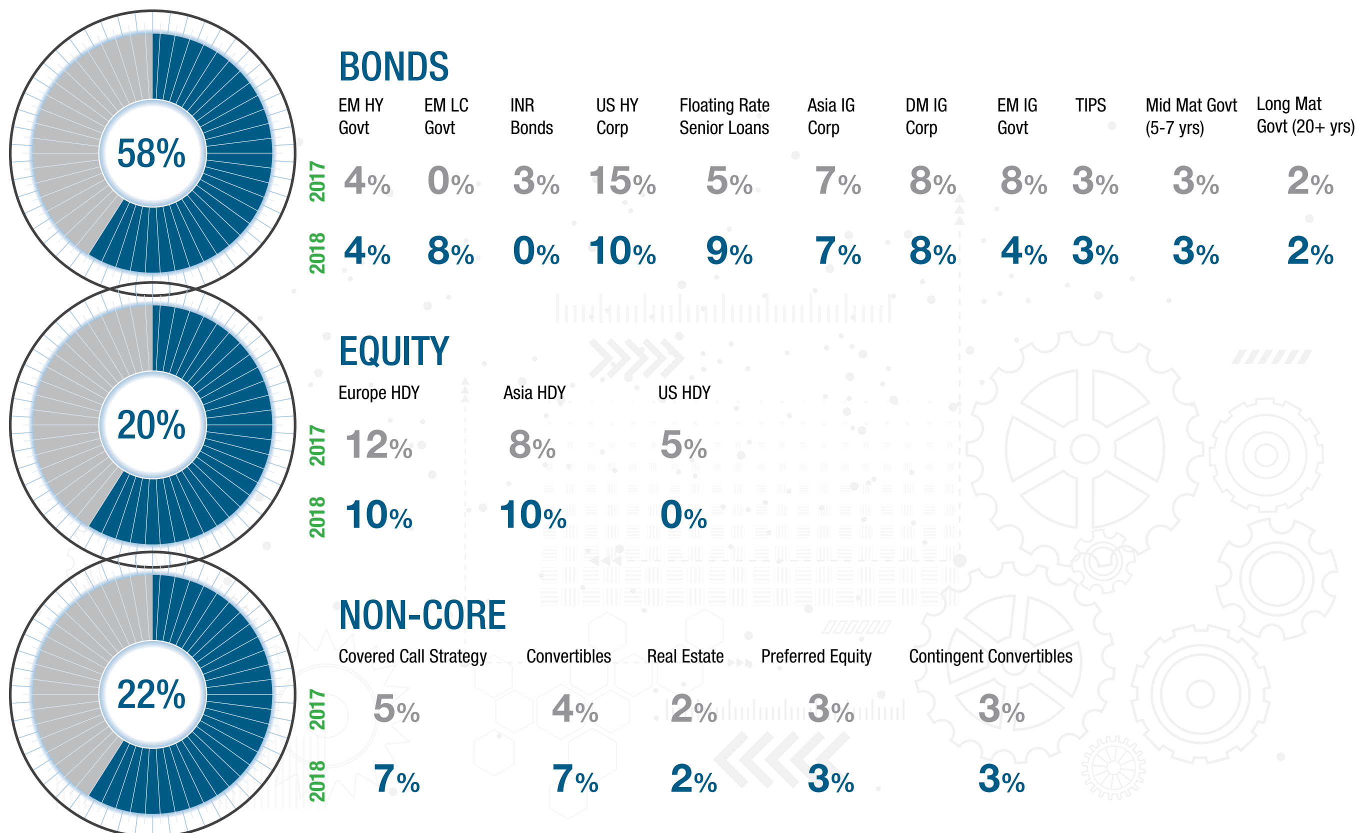
		INR bonds	EM USD HY Government	EM LC Government	US HY Corporate	CoCos	EM USD IG Government	Asia IG Corporate	Convertibles	DM Gorverment 20+y	DM IG Corporate	TIPS	DM Government 5-7yr	DM IG Government
Yield to maturity		7.3%	6.6%	6.2%	5.7%	4.4%	4.0%	3.6%	3.4%	2.6%	2.5%	2.0%	1.3%	1.2%
Duration		5.4	6.1	5.1	3.8	4.1	7.7	5.1	2.9	18.4	6.8	2.0	5.6	7.5
Change in yield*	-1.5%	15.5%	15.6%	13.8%	11.4%	10.4%	15.5%	11.2%	7.8%	30.2%	12.7%	4.9%	9.7%	12.5%
	-1.0%	12.8%	12.7%	11.3%	9.5%	8.4%	11.7%	8.6%	6.3%	21.0%	9.3%	4.0%	6.9%	8.7%
	-0.5%	10.1%	9.6%	8.7%	7.6%	6.4%	7.8%	6.1%	4.8%	11.8%	5.9%	3.0%	4.1%	5.0%
	0.0%	7.3%	6.6%	6.2%	5.7%	4.4%	4.0%	3.6%	3.4%	2.6%	2.5%	2.0%	1.3%	1.2%
	0.5%	4.6%	3.6%	3.7%	3.7%	2.3%	0.1%	1.0%	1.9%	-6.6%	-0.9%	1.0%	-1.5%	-2.5%
	1.0%	1.9%	0.6%	1.2%	1.8%	0.3%	-3.7%	-1.5%	0.5%	-15.8%	-4.3%	0.0%	-4.2%	-6.3%
	1.5%	-0.8%	-2.5%	-1.4%	-0.1%	-1.7%	-7.5%	-4.0%	-1.0%	-25.0%	-7.7%	-0.9%	-7.0%	-10.0%

Source: Bloomberg, Standard Chartered. For indices used, refer to end note at the conclusion of this section.
*Duration is a measure of the sensitivity of price of a fixed income investment to a change in interest rates.

Figure 13

Multi-asset income allocation 2017 vs. 2018

Asset class weight in %



Source: Standard Chartered

Leveraged bonds

Multi-asset income is not the only yield game in town

- Leverage as a tool, when used prudently can help income focused investors access different sources of return to meet their yield objective.
- Returns on leveraged bonds in 2018 are unlikely to match this year's performance as borrowing costs rise amidst still compressed longer term bond yields.
- Leverage introduces additional risks including higher volatility, exposure to higher borrowing costs and margin calls. Hence, it should only be used suitably and combined with drawdown control to manage the risk of margin calls.

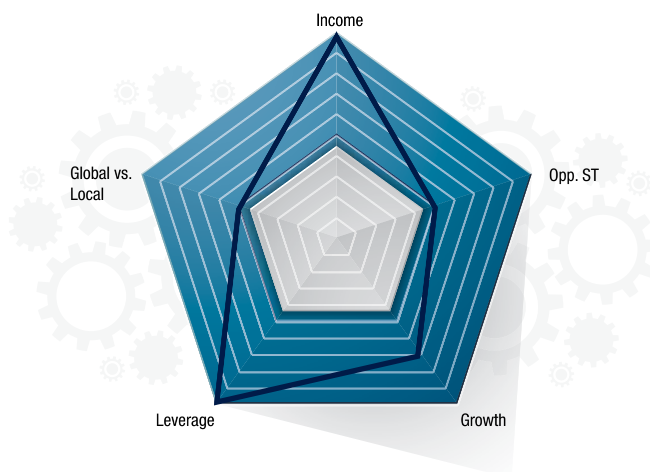
For a certain category of investors, focusing on leveraged bond investments has been an approach to meeting their yield objective. We don't disagree with this approach – in fact, as mentioned in our previous publication (H2 Outlook, Should I stay, or…?, 30 June 2017, page 30), it is perfectly reasonable for various categories of investors to adopt different investment approaches based on their individual preferences. As an example, the chart in Figure 14 illustrates the key traits of this type of investor. They typically devote the bulk of their allocation to bonds and layer on leverage to enhance the realised yield.

Low borrowing costs relative to bond yields have made leveraged investing in bonds a profitable strategy over the past few years. In 2017 (as of this writing), applying a 50% loan-to-value to DM HY bonds at a funding cost of 2.5% in US dollar terms, delivered equity-like returns of 11.5% (S&P 500 return over the same period is 17.6%), more than the 7.1% base return on the pure unleveraged allocation. This comes with a similar increase in volatility, with the leveraged DM HY bond allocation at 4%, compared to 6.8% for the S&P 500 over the same period. As we enter 2018, it may be worthwhile to look at the impact of the current macroeconomic environment on this type of investment approach.

Figure 14

Sample profile of a leveraged bond investor

Investor preference along five dimensions including income vs. growth, short-term opportunities vs. long term investments, home bias, willingness to leverage



Source: Standard Chartered

What can we expect from leveraging bonds in 2018?

With a continued pivot towards a reflationary scenario, we anticipate an environment of gradually rising short-term USD funding costs in 2018. This leads to the question of whether a leveraged bond approach still makes sense? As a rule of thumb, a higher borrowing cost reduces the returns of any leveraged bond allocation. If the yield on the underlying bonds are higher than one's funding cost, a leveraged bond approach can still make sense. However, this is predicated on:

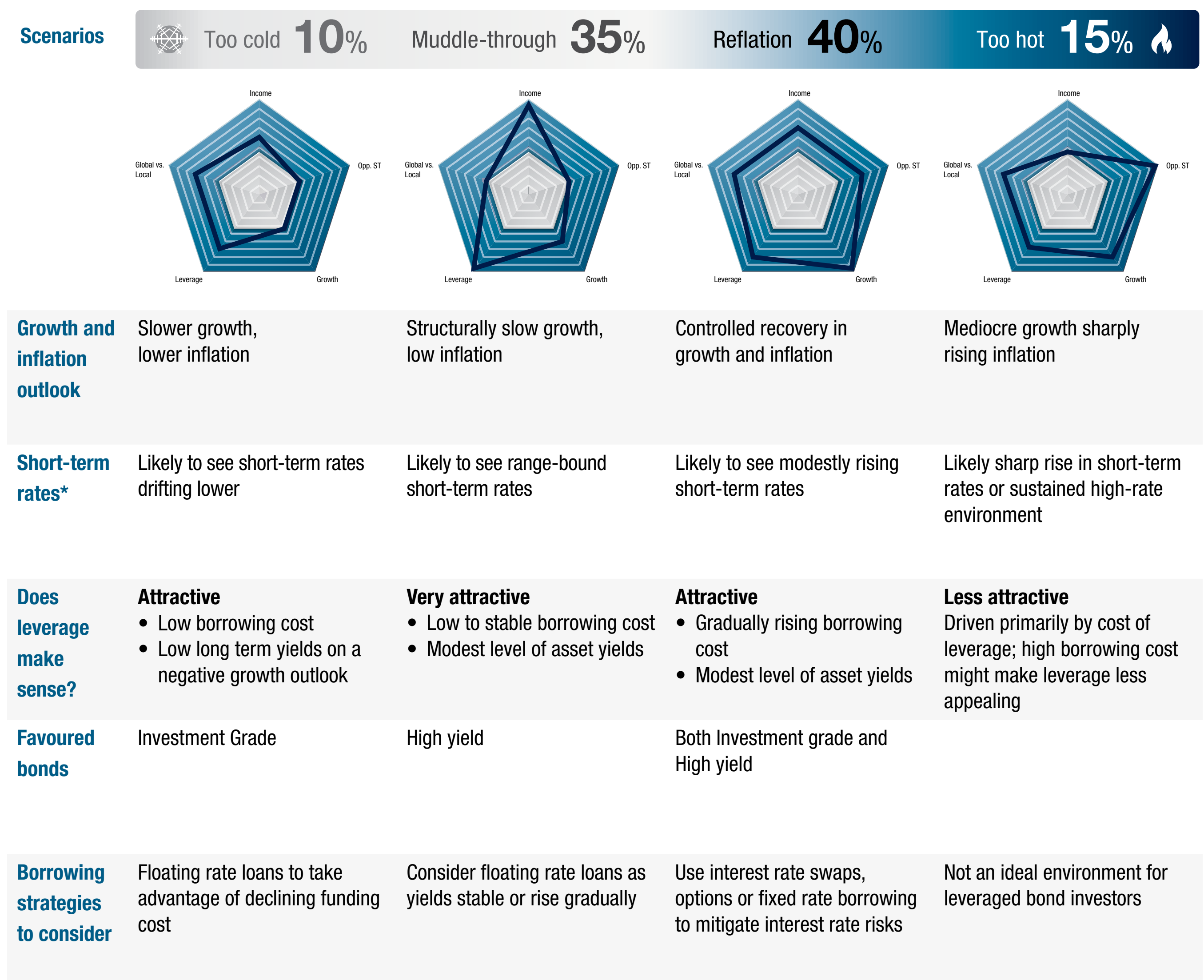
- *Applying leverage on a high quality, diversified bond allocation.* The probability of default on a lower-rated or unrated bond can be much higher. Hence, a sharp rise in interest rates resulting in higher defaults, would impact the long term potential returns in a leveraged allocation.
- *Managing interest rate risks to mitigate the impact of higher borrowing costs.* With rates expected to rise in 2018, eligible investors might consider strategies including interest rate swaps, options or using fixed rate borrowings to lock in borrowing costs.

- *Managing drawdown risks to reduce the probability of a margin call.* With a lower yield buffer, investors may be called upon short notice to deposit additional funds or face forced liquidation of the leveraged position in event of adverse market conditions. Hence, leverage should be employed judiciously for an optimal leverage strategy.

Below, we illustrate potential strategies for a leveraged bond allocation in the context of our four macro scenarios. Our core scenario centers around Muddle through and Reflation, with a slight bias towards Reflation. Improvements in economic momentum coupled with a gradual rise in borrowing cost may continue to support a leveraged bond allocation. The risk is periods of sharp rising rates or market dislocations (not our core scenario). This will hurt any allocation, but particularly more so for a leveraged, bond allocation.

Figure 15

An approach to leverage in the context of our macroeconomic scenarios for 2018



Scenarios	Too cold 10%	Muddle-through 35%	Reflation 40%	Too hot 15%
Growth and inflation outlook	Slower growth, lower inflation	Structurally slow growth, low inflation	Controlled recovery in growth and inflation	Mediocre growth sharply rising inflation
Short-term rates*	Likely to see short-term rates drifting lower	Likely to see range-bound short-term rates	Likely to see modestly rising short-term rates	Likely sharp rise in short-term rates or sustained high-rate environment
Does leverage make sense?	**Attractive** • Low borrowing cost • Low long term yields on a negative growth outlook	**Very attractive** • Low to stable borrowing cost • Modest level of asset yields	**Attractive** • Gradually rising borrowing cost • Modest level of asset yields	**Less attractive** Driven primarily by cost of leverage; high borrowing cost might make leverage less appealing
Favoured bonds	Investment Grade	High yield	Both Investment grade and High yield	
Borrowing strategies to consider	Floating rate loans to take advantage of declining funding cost	Consider floating rate loans as yields stable or rise gradually	Use interest rate swaps, options or fixed rate borrowing to mitigate interest rate risks	Not an ideal environment for leveraged bond investors

Note: Numbers adjacent to scenario names reflect probability of economic scenarios.
*At the point of writing, LIBOR is at a range of 1.3% to 1.5% between September to November 2017.
Source: Standard Chartered

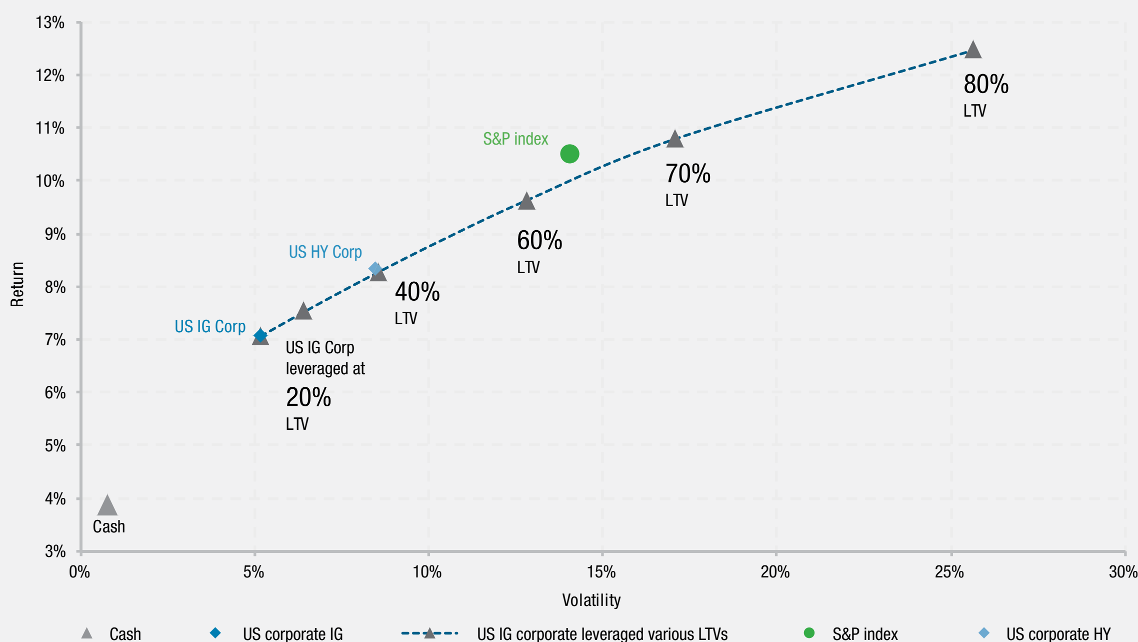
The role of leverage in a bond allocation

- Leverage, as a tool, is often misunderstood. It is typically associated with risk, given the use of leverage tends to magnify returns on both the upside and downside, and may result in financial losses, if used recklessly. However, when used judiciously, it can be a useful tool to structure sources of return differently in an allocation, when paired with robust risk management.
- The current environment of low yield and high valuations suggests a bond investor may struggle to generate a meaningful, diversified return on their traditional allocation. To achieve a higher yield, an investor has two choices, 1) invest more in lower quality bonds or 2) invest in longer maturity bonds, both of which will provide a higher yield, at the expense of a greater concentration in credit default risk and/or greater sensitivity to higher interest rates.
- An alternative would be to layer leverage over a bond allocation. As an example (Figure 16), employing a 40% leverage to US investment grade bonds would have resulted in similar returns and volatility as US HY, without taking on undue credit default risk. If one has a greater appetite for risk, the leveraged allocation can be scaled up further, resulting in risk/return characteristics like equities. Hence, instead of looking for the single asset that potentially delivers the highest return (though with a higher level of risk), leverage can be used as a tool to adjust one's desired return/risk level. In some cases, modest use of leverage combined with drawdown control, will likely help bond investors build a better allocation to meet their income objective.

Figure 16

Applying leverage can scale up return but also brings with it an increase in volatility

Risk and return comparison across equity, bonds and a leveraged bond allocation



Source: Bloomberg, Standard Chartered. For indices used, refer to end note at the conclusion of this section.
Note: Cash refers to JPM 3-month cash index. Increasing loan-to-value levels are applied to a bond allocation to derive the various risk, return levels. Borrowing cost is LIBOR + 110bp across January 1988 to October 2017.

Concluding thoughts

We enter 2018 with a tailwind of strong economic momentum across the globe. Our expectation is this momentum continues as we enter the new year. This should lead to continued outperformance from our balanced growth-tilted allocation relative to an income-focused allocation, except for any temporary correction. We adjust the balanced allocation to focus more on Asia ex-Japan equity taking advantage of a widening growth differential between EM and DM economies. Additionally, to prepare for a move to a truly reflationary scenario, where inflation expectations pick up markedly, we introduce an allocation to TIPS, include a floating rate senior loan allocation and introduce a commodity allocation. These asset classes could prove resilient in a rising rate environment.

A yield-seeking investor can draw comfort from the fact that a multi-asset approach to generating income should provide a sustainable, although slightly lower (closer to 4% versus 5% at end-2016) yield in 2018. However, there is reduced potential for capital appreciation and the potential for higher interest rates could move us away from the benign volatility environment we saw in 2017, resulting in the risk of larger pullbacks. To manage this risk, we suggest income investors look to non-core income assets which benefit from the growth momentum, but also provide a measure of resilience in an environment of rising yields. Despite increasing confidence in Emerging Market assets, we prefer a globally diversified multi-asset income allocation versus one purely focused on EM assets. We do, however, suggest a large (~40%) allocation to EM assets within the global model.

End note:
Indices are Barclays US Corporate High Yield TR, J.P. Morgan EMBI Global Diversified High Yield, Barclays Global High Yield TR, JACI Non-Investment Grade TR, S&P Leveraged Loan TR, MSCI AC Europe High Dividend Yield, SPDR Wells Fargo Preferred Stock ETF, MSCI EM Asia High Dividend Yield, J.P. Morgan EMBI Global Diversified Investment Grade, Barclays Pan-European High Yield, FTSE EPRA/NAREIT Asia REITs TR, Chicago Board Options Exchange S&P 500 BuyWrite, FTSE EPRA/NAREIT Developed North America REITs TR, S&P China Corporate Bond, JACI Investment Grade TR, FTSE EPRA/NAREIT Europe REITs TR, MSCI North America High Dividend Yield, Citi Non-MBS WorldBIG 20+ Yr, Citi WorldBIG Corporate, BC US Conv 500MM Face Liquidity Constraint TR, Citi Non-MBS WorldBIG 5-7 Yr, Citi Non-MBS WorldBIG 1-5 Yr, Barclays US Treasury TIPS 0-5 Yr TR, MSCI EMU High Dividend Yield Net Local, MSCI ACWI High Dividend Yield Net TR, MSCI Daily TR Net USA, MSCI Daily Net TR Europe Euro, MSCI AC Daily TR Net Asia Ex Japan, MSCI AC World Daily TR Net, Barclays Global Contingent Capital TR Index Value Unhedged USD

Figure 17

A three-pronged approach to assessing income assets

Income potential, capital growth and risk of pullback

Asset Classes	Yield	Income Potential	Capital Growth	Risk of Pullback	Comments
Bonds	**4.4**	Yellow	Yellow	Yellow	**Portfolio anchor; source of yield; some pockets of value, but not without risks**
Floating Rate Senior Loans	5.2	Green	Yellow	Yellow	Attractive alternative to traditional HY exposure; senior in capital structure to simple HY bonds; small yield penalty in return; returns positively correlated to short-term US interest rates, but loan callability a risk
US HY Corporate	5.7	Green	Yellow	Yellow	Attractive yields on offer, offset by increasingly expensive valuations
EM USD Government	5.3	Green	Yellow	Red	Attractive yields, relative value, positive EM sentiment
EM LC Government	6.2	Green	Yellow	Red	Attractive yield balanced by high volatility and drawdown risk
Investment Grade*	2.6	Red	Yellow	Yellow	Portfolio anchor, structural carry; some interesting ideas, but interest rate sensitivity a risk
DM IG Corporate*	2.5	Red	Yellow	Yellow	Likely to outperform DM IG government bonds. Yield premium is relatively low
Asia IG Corporate	3.6	Yellow	Yellow	Green	High credit quality, defensive allocation. Influenced by China risk sentiment
TIPS	2.0	Red	Green	Yellow	Offers value as an alternative to nominal sovereign bonds; impact of a rate rise similar to G3 sovereigns, but offers exposure to a further rise in US inflation
Sovereign*	1.4	Red	Red	Yellow	Returns challenged by normalising Fed and ECB monetary policy
Equity Income	**4.7**	Yellow	Yellow	Red	**Key source of income and modest upside from capital growth**
Europe	5.5	Green	Green	Yellow	Fair valuations; attractive yields; overhang from political risk, mitigated by improving global growth outlook; improving momentum
Asia ex-Japan	3.9	Yellow	Green	Red	Good payouts; selectively attractive valuations, but pullback a risk from challenges in China/US growth, earnings, Fed and leverage.
Non-core Income	**4.6**	Yellow	Yellow	Yellow	**Useful diversifier for income and growth; sharp move in yields a risk for certain non-core assets**
Preferred	5.4	Green	Yellow	Red	Attractive yields and exposure to financials; risk from higher rates may not be completely offset by improvement in banks' underlying credit
Convertibles	3.4	Yellow	Yellow	Yellow	Moderate economic expansion and gradual pace of rate hikes should be good for converts. Risk: policy mistake
Property	3.9	Yellow	Yellow	Red	Yield diversifier; stable real estate market; risk from higher rates, valuations stretched in some regions. Potential for large pullbacks
Covered Calls	5.7	Green	Yellow	Yellow	Useful income enhancer assuming limited equity upside
CoCos	4.4	Yellow	Yellow	Red	Yields have fallen sharply; relatively low sensitivity to rising yields and improving bank credit quality over the past few years

Source: Bloomberg, Standard Chartered Global Investment Committee; Yield data as of 5 December 2017; *Yield data as of 30 November 2017.
For indices used, refer to the end note at the conclusion of this section.
Refer to Important information related to Contingent Convertibles at the end of this document.
Legend: (Green) Attractive potential/low risk | (Yellow) Moderate potential/medium risk | (Red) Unattractive potential/high risk

BONDS

Bonds
at a glance

Manpreet Gill | Abhilash Narayan

Key themes

We view bonds as a core holding in a well-diversified investment allocation as we expect only a gradual rise in Developed Market (DM) government bond yields. We expect the 10-year US Treasury yield to remain anchored around 2.50% as we see a low likelihood of a sharp rise in long-term inflation expectations.

Emerging Market (EM) bonds are expected to outperform bonds from the US and Europe on the back of a modestly weaker USD and relatively attractive yields. EM USD government and Asian USD bonds are our preferred areas in bonds.

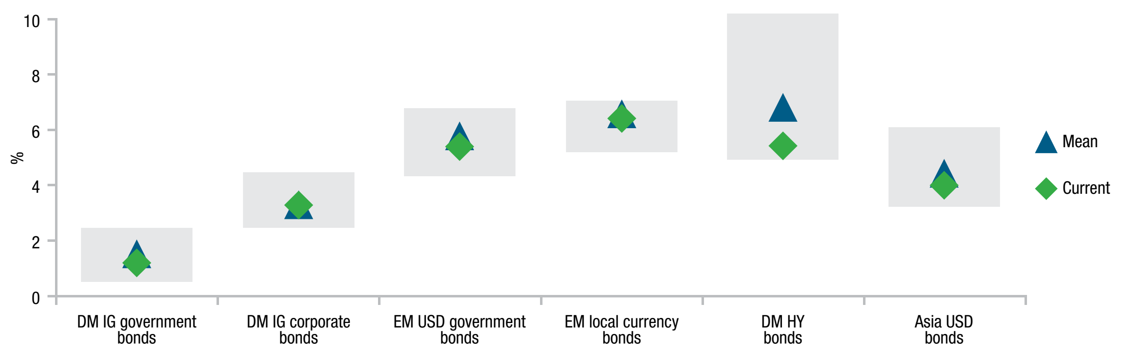
Within DM, we prefer corporate bonds, both Investment Grade (IG) and High Yield (HY), over government bonds. While valuations are elevated, they are supported by strong earnings and low default rates.

We favour a moderate maturity profile of 5-7 years as we believe it offers a balance between yields and interest rate sensitivity. In the US, we expect short-term (2-year) yields to rise faster than long-term (10-year) yields, which could be a headwind for short-maturity bonds and leveraged bond investing.

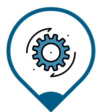
Key chart

Figure 1

EM bonds offer relatively attractive yields



Note: Grey bars represent yield ranges from 2010 onwards. Source: Citigroup, JP Morgan, Barclays, Bloomberg, Standard Chartered



Key drivers

Asset Allocation	View	Rates Policy	Macro Factors	Valuation	FX	Comments	Yield*
EM USD govt	▲	🔴	🟢	🟡	n/a	Attractive yields, relative value, positive EM sentiment	5.3%
Asian USD	▲	🔴	🟢	🟡	n/a	High credit quality, defensive allocation. Influenced by China risk sentiment	3.9%
EM Local currency	◆	🟡	🟡	🟡	🟢	Attractive yield and positive EM sentiment balanced by high volatility and drawdown risk	6.2%
DM HY corporate	◆	🔴	🟡	🔴	🟡	Attractive yields on offer, offset by increasingly expensive valuations	5.2%
DM IG corporate	◆	🔴	🟡	🟡	🟡	Likely to outperform DM IG government bonds. Yield premium is relatively low	2.5%**
DM IG govt	▼	🔴	🔴	n/a	🟡	Returns challenged by normalising Fed and ECB monetary policy	1.2%**

Source: Citigroup, JP Morgan, Barclays, Bloomberg, Standard Chartered; *As of 5 December 2017, **As of 30 November 2017
Legend: ▲ Most preferred | ▼ Least preferred | ◆ Core | 🔴 Not supportive | 🟡 Neutral | 🟢 Supportive

The year of Emerging Market bonds

Emerging Market bonds are expected to outperform bonds from the US and Europe on the back of a modestly weaker USD and relatively attractive yields.

Figure 2

We expect a relatively benign environment for bonds as we expect 10-year US Treasury yields and inflation expectations to rise gradually

10-year inflation breakeven (inflation expectation) and 10-year US Treasury yields

Source: Bloomberg, Standard Chartered

2017 – Much ado about nothing?

2017 was a good year for bond investors. While bonds lagged behind equities, they still delivered high single-digit returns, surpassing our expectations at the start of 2017.

We entered 2017 being cautious on bonds as we believed market expectations of fiscal stimulus, tax cuts and higher US inflation would lead to higher yields which would be a headwind for bond returns. We also started the year favouring Developed Market (DM) High Yield (HY) bonds, which outperformed other areas within bonds before we chose to take profit, in light of increasingly expensive valuations. Since the start of the year, DM HY bonds have delivered close to double-digit returns.

During 2017, markets reset their expectations for what the Trump administration can realistically deliver. This, combined with persistently low inflation, has been supportive for bond returns, which led us to become more optimistic towards bonds around mid-year. Around the same time, we upgraded our view on EM bonds given expectations for a modestly weaker USD, strong macro-economic fundamentals and high commodity prices.

However, the stellar performance over the last 12 months means valuations for most DM and Asian corporate bonds as well as for EM government bonds have become more expensive. This creates a headwind for future returns as it reduces the scope for capital gains in 2018.

Nevertheless, we expect a relatively benign environment for bonds in 2018. We expect the 10-year US Treasury yield to remain anchored around 2.50% as we see a low likelihood of a sharp rise in long-term inflation expectations. Thus we favour maintaining a benchmark-holding of bonds heading into 2018. We continue to like EM bonds, both USD and local currency, as we believe the key supportive factors remain in place.

Emerging Market USD government bonds – Preferred

- *High yield and positive fundamentals to compensate for higher interest rate sensitivity*

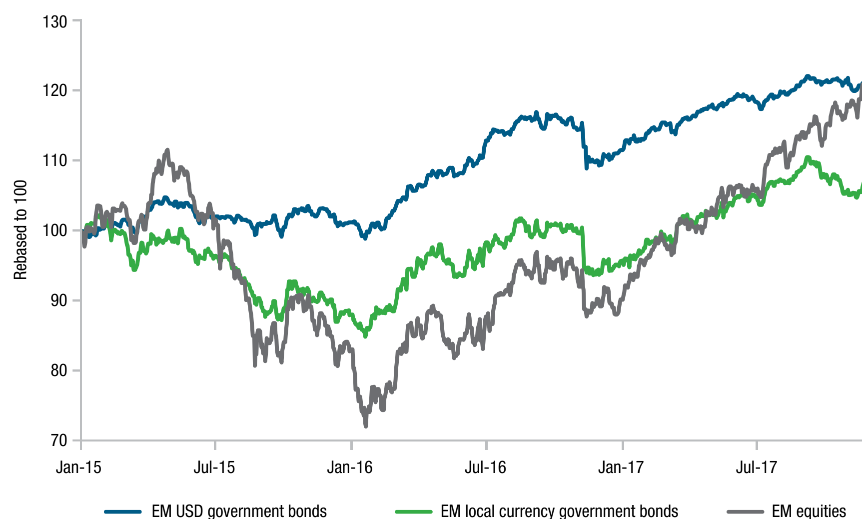
Emerging Market (EM) USD government bonds are a preferred sub-asset class within bonds. Admittedly, they have performed broadly in line with other bond markets since we turned positive on them in mid-2017. However, excluding the one-off factors, such as the drag from Venezuela's default and some geopolitical concerns, we believe a number of supportive factors are likely to help them outperform in 2018.

They offer a relatively attractive yield of over 5% and though valuations, measured by yield premiums, are somewhat expensive compared to their own history, they remain cheap compared to other areas within bonds.

Figure 3

EM USD government bonds have offered superior risk-adjusted returns since start of 2015

Total returns for EM USD government bonds, EM local currency government bonds and EM equities (rebased to 100)



Source: JP Morgan, MSCI, Bloomberg, Standard Chartered

Although investors can get a similar yield from DM HY bonds, we prefer EM USD government bonds as they have a higher average credit quality by offering exposure to a mix of Investment Grade and High Yield rated bonds.

From a fundamental basis, EM USD government bonds remain well-supported by improving growth across most countries, higher commodity prices and a modestly weaker outlook for the USD. Reduced concern about China's growth outlook has also contributed to a stronger outlook for Emerging Market countries. Over the past year, a number of EM countries have used USD weakness to build their FX reserves which, in our opinion, has reduced their vulnerability to external shocks. We also like EM USD government bonds due to their diversified exposure to over 60 countries and, thus, low concentration risk, as top 5 countries account for around 20% of the total exposure.

A key investor concern towards Emerging Market USD government bonds has been their relatively high interest rate sensitivity, which means that they are more vulnerable to rising yields. However, we are not too concerned for two reasons – (i) we expect long-term US Treasury yields to rise only moderately and (ii) historically, EM USD government bond returns have shown a low correlation with US Treasury yields. During rate hiking cycles, EM countries usually benefit from strong global growth and thus yield premiums have often reduced to compensate for higher US Treasury yields.

In our opinion, a sharp slowdown in China's growth outlook and EM-specific credit and geopolitical events are key risks to the performance of the asset class. Nonetheless, we take comfort from the fact that EM USD government bonds offer a diversified exposure which provides some protection from country-specific risks.

We prefer EM USD government bonds as they have a higher average credit quality by offering exposure to a mix of Investment Grade and High Yield rated bonds.

Asian USD bonds – Preferred

- *High credit quality and stable outlook for China, offset moderate valuations*

We upgrade Asian USD bonds to one of our preferred areas within bonds as we like their defensive characteristics and aggregate investment grade credit quality (nearly 80% of the bonds are IG-rated). Asian IG bonds are our most-preferred route for taking high quality bond exposure as they have offered more stable returns and a reasonable premium over DM IG corporate and government bonds. In fact, Asian USD bonds have demonstrated lower volatility than even DM IG government bonds – a trend we expect to continue well into 2018, due to the strong regional buyer base.

Asian IG bonds are our most-preferred route for taking high quality bond exposure as they offer more stable returns and a reasonable premium over DM IG corporate and government bonds.

Asian USD corporate bonds are among the highest rated segments within EM bond universe, along with Middle-Eastern bonds. However, Asian bonds arguably benefit from significantly lower geopolitical uncertainty as well as stronger growth in key countries such as China, India and Indonesia. Combined with their defensive nature, we view Asian USD bonds as a ballast to our broad preference for EM bonds, which can be more volatile in instances of risk aversion.

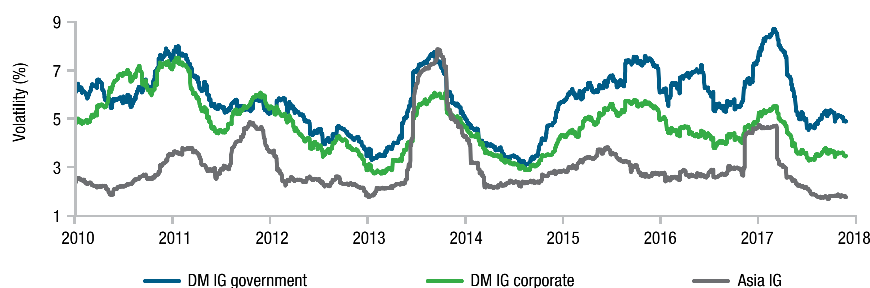
Though they have delivered positive returns, Asian USD bonds have lagged other markets due to the substantial supply from Chinese issuers who account for nearly half of the total market. We expect the supply to remain fairly robust in 2018, as Chinese issuers are likely to continue to look to diversify funding sources. Demand from Chinese investors remains key to the market's ability to absorb this supply.

The concentration of Chinese issuers clearly creates a risk in case the macroeconomic picture in China deteriorates significantly. However, we remain fairly optimistic about China's outlook, which is supportive for Asian USD bonds. Even in a scenario where Chinese or global growth decelerates, Asian USD bonds are still likely to be resilient compared to other EM bonds, owing to their higher credit quality. The market also benefits from a strong regional investor base, who have bought over 70% of bond issuance in recent years, making it less vulnerable to sell-offs.

Figure 4

Asian IG bonds have demonstrated more stable returns compared to other high quality bonds

90-day returns volatility for Asia USD IG bonds, DM IG corporate bonds and DM IG government bonds



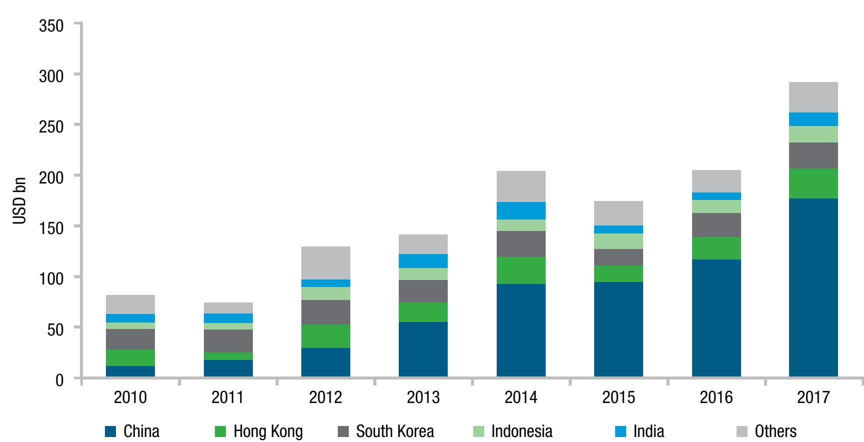
Source: Citigroup, JP Morgan, Bloomberg, Standard Chartered

Although we expect default rates to remain contained, we prefer IG bonds over HY bonds within Asia as we believe valuations in the latter have run ahead of fundamentals and have become expensive. The valuations for HY bonds look even more expensive once we factor in the surge in supply from lower-rated issuers and lower bondholder protection (weaker legal protection in the bond documentation) in the recent past.

Figure 5

Chinese issuers have led the surge in bond supply in recent years

Breakdown of Asian G3 currency (USD, EUR, JPY) bond issuance by geography



Source: Bloomberg, Standard Chartered

EM local currency government bonds – Core holding

- *Attractive yield and positive EM sentiment balanced by higher volatility and drawdown risk*

In line with our overall preference for EM bonds, we remain comfortable with EM local currency government bonds, which are currently the highest yielding sub-asset class within bonds. The bonds benefit from the positive macro-economic backdrop, which is supportive for even USD-denominated bonds. However, we believe the rate-cut cycle, which has helped capital gains over the past year, is coming to an end in most EM countries. In fact, we would not be surprised to see moderate rate hikes in a few countries, which could lead to decline in bond prices in those countries.

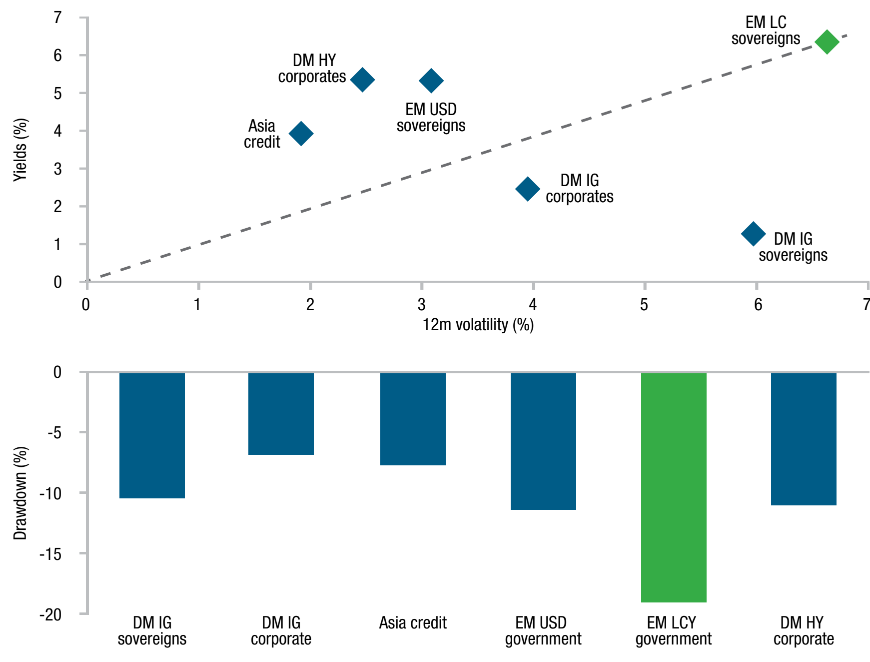
EM local currency government bonds are also likely to benefit from our of outlook for a modestly weaker USD. This is an important consideration, given FX returns have historically contributed nearly half the returns for local currency bonds. However, the contribution of currency to the overall returns is a double-edged sword as it makes the asset class more prone to drawdowns in a risk-off environment.

EM local currency government bonds are likely to benefit from a modestly weaker USD. This is an important consideration, given FX returns have historically contributed nearly half the returns for local currency bonds.

Figure 6

Higher volatility and drawdown potential balance the higher yield offered by EM local currency government bonds

Current yields, 12-month volatility and maximum drawdown since 2010 for various bond sub-asset classes



Source: Citigroup, JP Morgan, Barclays, Bloomberg, Standard Chartered

The rise in CNY bond yields has drawn investor attention in the last few months of 2017. Heading into 2018, we are not excessively concerned as (i) CNY bonds account for 10% of the market which limits any potential negative impact, and (ii) we believe the Chinese authorities are likely to proactively monitor the bond market and prevent a prolonged spike in yields as that could negatively impact growth and lead to excessive onshore corporate bond defaults.

Over the past year, EM local currency bonds have seen significant foreign investor inflows. In our view, a reversal of foreign flows remains a key risk as the elevated positioning creates a possibility of significant drawdown. A faster than expected pace of Fed rate hikes is also a key risk, as it could lead to a stronger USD and lead to negative currency returns.

Thus, we view the risk-reward for EM local currency bonds as balanced and believe EM USD government bonds offer a better investment opportunity.

Developed Market High Yield corporate bonds – Core holding

- *Attractive yield is balanced by expensive valuations and risk of higher defaults*

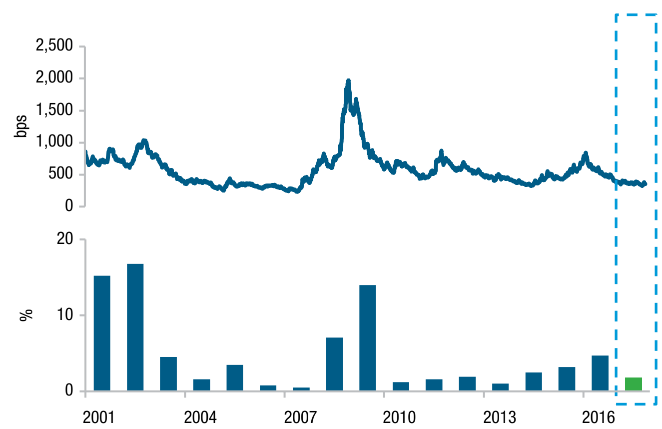
Heading into 2018, DM HY bonds are possibly one of the most scrutinised areas within bonds given (i) the sell-off in the last few months of 2017, (ii) persistent talks about relatively expensive valuations and (iii) the allure of the high absolute yield on offer, which continues to entice investors.

In our opinion, the risks to the asset class remain balanced. While valuations are admittedly elevated, they remain supported by a number of fundamental factors. Over the last two years, default rates have declined significantly and while balance

Figure 7

Expensive valuations in US HY bonds are supported by lower default rates

Credit spread (yield premium) and default rate for US HY bonds



Source: Fitch, Bloomberg, Standard Chartered

sheets remain stretched, the aggregate credit quality seems to have stabilised. This combined with potential tax cuts in US is supportive for the asset class. DM HY bonds have been one of the few bond sub-asset classes where the market size has remained broadly stable over the past few years, whereas the overall bond supply has increased in other areas. This has created favourable demand-supply dynamics, especially in an environment where search for yield remains valid.

Historically, DM HY bonds have delivered a strong performance in the late stage of a US economic cycle. Their performance only starts to taper off 6-9 months before a US recession. As we believe there is still some room to go in the current economic cycle, DM HY bonds can continue to deliver positive returns, at least in the first half of 2018. Given the current backdrop, we also view US floating rate senior loans as an alternative to US HY bonds. Following the improvement in the capitalisation of banks globally, Contingent Convertibles (CoCo)* offer an attractive alternative to generate income as they offer a reasonable yield, exposure to improving sector and a higher average credit quality.

Hence, unless we see a surge in bond supply, valuations are likely to remain broadly supported and DM HY bonds could deliver coupon-like returns. While default rates could rise from their current low levels, we expect them to remain capped around 2%. Other key risks to our view include a significant deterioration in credit quality, a substantial decline in oil prices and a sharp slowdown in the economic momentum in US and/or Europe.

Developed Market Investment Grade corporate bonds – Core holding

- *Expected to outperform respective government bonds, but deterioration in credit quality is the key risk*

We head into 2018 with a mildly cautious bias toward DM IG corporate bonds. Though we expect the sub-asset class – which primarily comprises of IG corporate bonds from US and Europe – to outperform their respective government bonds, we expect returns to be relatively muted.

Even though the rally in 2017 was supported by strong corporate earnings growth, we see limited room for capital appreciation going forward, given expensive valuations and low yields. Despite strong earnings, credit quality has not improved significantly as overall debt has increased substantially over the last few years. Given current valuations, we see limited scope for capital gains through a decline in yield premium.

We have a preference for US IG corporates over European IG corporates. We believe the latter face a more challenging outlook for generating positive returns in EUR terms, for two key reasons – (i) a gradual reduction in the ECB's easy monetary policy stance could lead to higher German Bund yields and (ii) the reduction of ECB corporate bond purchases is likely to lead to higher yield premiums. While both these factors are likely to drag the returns lower, a stronger EUR could help offset some losses for USD-denominated investors.

A deterioration in credit quality, either through lower earnings or higher leverage, and a sharp rise in yields are the key risks to DM IG corporate bonds. Given their low yield and high interest rate sensitivity, a mere 0.3% rise in yields could lead to negative returns in 2018.

Developed Market Investment Grade government bonds – Least preferred

- *Least preferred area within bonds as a likely normalisation of central bank policy will drag returns lower*

DM IG government bonds are our least favoured area within bonds as they could struggle to deliver positive returns (in local currency terms) given the low yield of around 1% on offer, which provides little buffer against rising yields as central banks across US, Europe and UK normalise monetary policy.

*Refer to Important information related to Contingent Convertibles at the end of this document.

In the US, we expect the 10-year US Treasury yield to edge moderately higher and remain centred around 2.5% over the next 6-12 months. That said, there could be periods of sharp movements in yields given the event-packed calendar in the year ahead. As discussed earlier, markets are likely to focus on tax cuts as well as the new leadership at the Fed for cues to the future rate hike trajectory. Nonetheless, long-term yields continue to be driven by inflation expectations, which remain anchored for now. A sustained uptick in core inflation remains a key risk to our view for US government bonds. In this context, we believe US Treasury Inflation Protected Securities (TIPS) could serve as a diversifier. TIPS are designed to protect bond investors from rising inflation and have historically outperformed US Treasuries in US rate hiking cycles and when long-term inflation expectations rose.

We are more cautious towards European and Japanese government bonds. The ECB's move to reduce monetary stimulus is likely to lead to higher German Bund yields and lower bond prices which could easily offset the low coupons on offer. While the Bank of Japan arguably remains the only major central bank still committed to keeping easy monetary policy, it is hard to get excited about investing in a 10-year bond which offers a yield of around 0%. The key risk to our cautious view includes renewed concerns regarding the unity of the Euro area if we see unexpected results in the upcoming elections.

Given our expectation for 2-3 Fed rates hikes in 2018 and the 10-year yield to remain around 2.5%, we expect the differential between 2-year and 10-year yields ("yield curve") to decline in 2018. We thus maintain our preference for the 5-7 year maturity bucket for USD-denominated bonds. For USD-denominated investors, we prefer to gain exposure to DM IG government and corporate bonds without hedging the currency exposure as our views for stronger EUR and weaker JPY are likely to offset each others impact.

Given our expectation for 2-3 Fed rates hikes in 2018 and the 10-year yield to remain around 2.5%, we expect the differential between 2-year and 10-year yields ("yield curve") to decline in 2018.

A deflationary downside scenario is the key risk to our cautious view on DM IG government bonds. If markets start to get concerned about lower growth and inflation again, DM IG government bond yields could decline in anticipation of central bank easing and higher demand for safe-haven assets. In such a scenario, high quality government bonds could comfortably outperform equities and corporate bonds.

Figure 8

Negative or modestly positive yields offered by government bonds offer little buffer to the likely normalisation of central bank policy

Positive or negative yields offered by government bonds of various maturities

	1yr	2yr	3yr	4yr	5yr	6yr	7yr	8yr	9yr	10yr
US										
Germany										
France										
Italy										
Spain										
Switzerland										
UK										
Japan										

Grey colour indicates that the bonds offer negative yield. Green colour indicates positive yield.
Source: Bloomberg, Standard Chartered

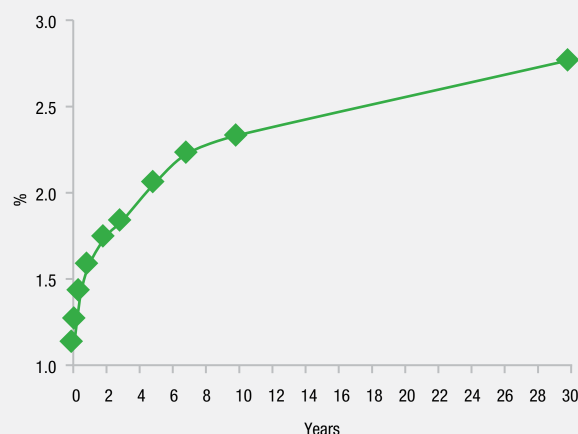
Yield curve: What you should know?

What is a "yield curve"?

Simply put, the yield curve refers to yields offered by government bonds of different maturities. Under normal circumstances, the yield curve is upward sloping, which means that bonds with longer maturity offer higher yields or higher compensation to investors, compared to shorter maturity bonds which offer lower yields. Intuitively, this makes sense as investors should demand more compensation for lending money for a longer time.

Figure 9

Current US yield curve



Source: Bloomberg, Standard Chartered

What does yield curve matter?

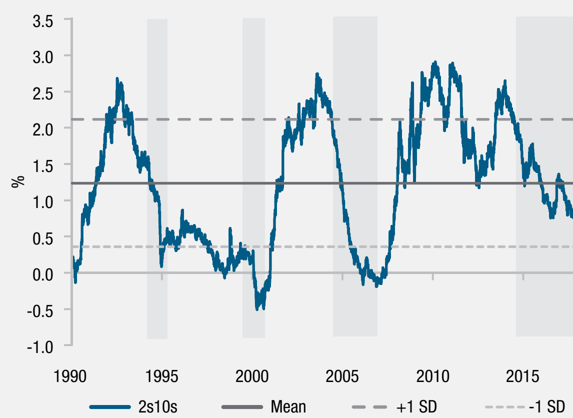
When talking about changes in the yield curve, investors frequently look at the difference between 2-year and 10-year yields (2s10s curve). A key learning from history is that US Fed rate hiking cycles have normally been associated with the yield curve flattening – the difference between 2-year and 10-year yields narrows. This happens because the 2-year yields, which are more influenced by short-term rates, rise faster than long-term yields. We do not see any reason for the current cycle to be any different. We expect the gap between short-term and long-term yields to narrow in 2018.

Historically, the yield curve (2s10s) has been a good indicator for impending recessions. In the past, recessions have occurred within a few months or quarters after the yield curve flattened (negligible difference between 2-year and 10-year yields) or inverted (investors demanded more compensation for 2-year bonds compared to 10-year government bonds). This happens when investors start getting concerned about the economy and look to move into safe assets, such as 10-year US Treasuries, leading to higher demand and lower yield. However, given our view of robust economic momentum in 2018, we see a low risk of yield curve inversion next year.

Figure 10

US yield curve usually flattens during a Fed rate hiking cycle

The difference between 10-year and 2-year US Treasury yields. Grey boxes denote Fed rate hiking cycles



Source: Bloomberg, Standard Chartered

EQUITY

Equity
At a glance

Clive McDonnell | Belle Chan | Jill Yip

Key themes

We remain positive on global equity markets in 2018. Low double digit growth in earnings is anticipated in 2018. The US technology sector is expected to continue to perform well and US banks may benefit from rising interest rates.

Asia ex-Japan is a preferred region,. Within Asia ex-Japan, we are most positive on Korea and China, driven by a significant increase in corporate margins.

Euro Area is a preferred region. Close to double digit earnings growth driven by strong domestic consumption is anticipated. We believe Euro area bond yields curve could rise, which has historically been a positive for Euro area banks.

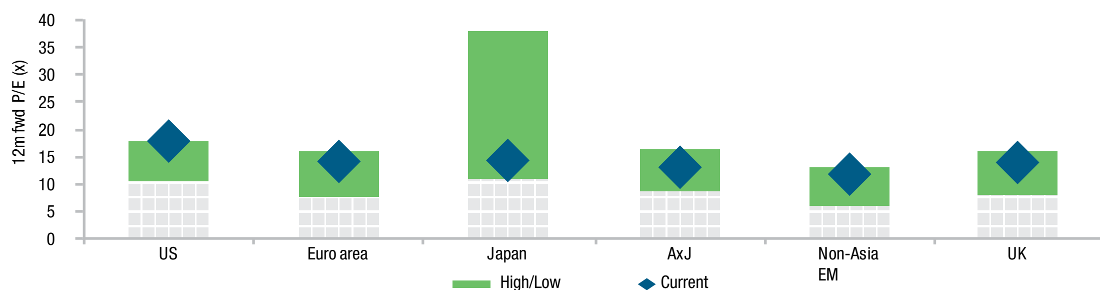
Upside inflation surprises and the impact of reduced monetary policy stimulus are the biggest risks for equity markets in 2018. Our base case is for two to three rate hikes by the Fed in 2018, a pace of tightening which is likely to be conducive of sustainable equity returns. The risk is a faster pace of tightening.

Key chart

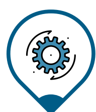
Figure 1

Euro area, Asia ex-Japan and Japan remain relatively attractive from a valuation perspective

Global equity market valuations relative history



Source: Standard Chartered



Key drivers

Asia ex-Japan is our most preferred region in 2018, followed by the Euro area

Equity	View	Valuations	Earnings	Return on Equity	Economic Data	Bond Yields	Comments
Asia ex-Japan	▲	● Neutral	● Supportive	● Supportive	● Supportive	● Neutral	Earnings upgrades and ROE recovery combined with attractive valuations
Euro area	▲	● Neutral	● Neutral	● Supportive	● Supportive	● Supportive	Double digit earning growth, ROE improving
Japan	◆	● Supportive	● Neutral	● Supportive	● Neutral	● Neutral	Lead indicators of earnings point towards future improvement
US	◆	● Not supportive	● Supportive	● Neutral	● Neutral	● Neutral	2018 earnings growth will increase modestly. Elevated valuations a drag
EM ex-Asia	◆	● Neutral	● Neutral	● Neutral	● Neutral	● Neutral	Lead indicators of earnings point towards future deterioration
UK	▼	● Neutral	● Not supportive	● Neutral	● Neutral	● Neutral	Earnings under pressure and economic data is weak

Source: Standard Chartered

Legend: ▲ Preferred | ◆ Core holding | ▼ Least preferred | ● Not supportive | ● Neutral | ● Supportive

Note: The colour of each signal refers to its relevance as a driver as opposed to its current positive/neutral/negative status.

Margins in focus

We remain positive on global equity markets in 2018. Low double digit growth in earnings is anticipated in 2018.

Earnings recovery, fiscal stimulus, lower corporate taxes and yen weakness are all positive catalysts for equity markets as we enter 2017.

2017 – An excellent year for equities

We entered 2017 with equities as a preferred asset class and it was an excellent year for them. Global equities returned 21% and Emerging Markets rose over 30% – which was the best year for returns since 2009.

At the start of 2017 we were positive on the US and Japan on an FX-hedged basis. This evolved through the year with both being reduced to core holdings and Asia ex-Japan and Euro area equities being upgraded to preferred regions.

In 2017, we focused on the need for earnings follow-through to sustain markets and companies delivered on this. Global earnings growth expectations in 2017 increased from 12% at the start of the year to 14%. Valuations have remained broadly stable at 17x 2018 consensus earnings forecasts.

Margin expansion driving markets higher

A key driver of market performance in the coming 12 months will be margin expansion, particularly in Asia, in our opinion. The improvement in Asia ex-Japan, our most preferred region, should enable valuations to re-rate higher. Margin expansion is likely to continue to be driven by China and Korea led by the technology sector. Margins in the US may be softer.

Elevated valuations in Developed Markets

Investors remain concerned about the elevated nature of market valuations, focusing on the 17x price-earnings (P/E) ratio for global equities. We acknowledge the elevated level of valuations, but our analysis shows that when historic valuations were similar, returns in the subsequent 12 months has averaged 9% with a 76% probability of positive returns.

Figure 2

Estimated index returns using different approaches

All numbers in local currency except Asia ex-Japan and EM ex-Asia, which are in USD

	Top down	Bottom up	Option implied	Average of three
Asia ex-Japan	16%	16%	8%	13%
Euro area	13%	9%	8%	10%
Japan	12%	6%	7%	8%
US	13%	8%	7%	9%
EM ex-Asia	17%	14%	15%	15%
UK	11%	12%	7%	10%

Source: MSCI Factset, Standard Chartered
Top down: aggregate of strategist index forecasts
Bottom up: aggregate of analyst target prices for index stocks
Option implied: the return from holding the stock and selling a 12 month call option

We also note that valuations in Emerging Markets remain broadly fair. Asia ex-Japan is trading on a 2018 P/E ratio of 13x, compared to a long term average of 12x. Earnings growth of 12% in 2018 implies there is likely room for low double-digit index gains in Asia ex-Japan, without stretching valuations.

Technology sector earnings lead

A breakdown of global earnings by sector highlights that since 2015, the recovery has been led by the technology sector which is also the best performer. The technology sector in the US is one of our most preferred sectors in 2018.

Risks to equity markets

An upside inflation surprise and faster than expected reduction in policy stimulus by the Fed are the biggest risks for equity markets. Our base case is for two to three rate hikes by the Fed in 2018, a pace of tightening we believe is conducive to positive equity returns. The risk is a faster pace of tightening than expected.

Figure 3

US sector views

US equities sector preferences	
Technology	Preferred
Energy	Preferred
Financials	Preferred
Industrials	Preferred
Materials	Preferred
Consumer Discretionary	Core holding
Real Estate	Core holding
Healthcare	Core holding
Utilities	Least preferred
Consumer Staples	Least preferred
Telecom	Least preferred

Source: Standard Chartered

Asia ex-Japan equities

Preferred – Margin expansion and attractive valuations

Key drivers of our view include:

- Margin improvement and attractive valuations are amongst the primary drivers for Asia ex-Japan equities. We believe continued margin expansion could lead to further re-rating.
- A modestly weaker US dollar is a key positive for fund flows into the region while the rebalancing of the H share index in 2018 is positive as it gives higher weight to fast growing private sector companies.
- Korea and China are our most preferred markets within Asia ex-Japan.

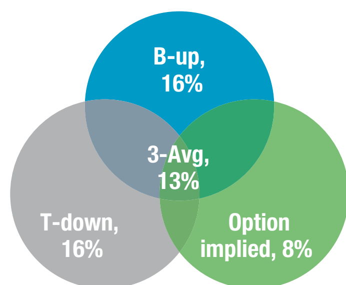
Asia ex-Japan equities is a **preferred** region as we enter 2018

A three-factor framework incorporating consensus bottom up, top down earnings forecasts and option pricing indicates the potential for a 13% gain in 2018.

Our three factor model incorporates 1) an average of all analyst target prices for stocks in the index, the bottom up factor, 2) an average of strategists top down index forecasts and 3) an option implied return. These three factors are averaged to generate an expected return for the index, in USD terms.

Figure 4

Asia ex-Japan market return estimates



Source: MSCI Factset, Standard Chartered
B-up = Bottom Up | T-down = Top Down | 3-Avg = average of the three estimates
Note: The estimates are not forecasts, rather they reflect a range of potential outcomes for the index, which we average.

Driven by sustainable global economic growth and steady export growth, the consensus expectation is for 12% earnings growth in Asia ex-Japan in 2018, much higher than the 5-year average of 4.3%. Technology is seen as the biggest contributor to earnings growth, with consensus expectation for an 18% increase in earnings for 2018.

Margin improvement is one of the drivers for Asia ex-Japan equities. Non-financial net margins have expanded to 8.7% from 6.9% at the end of 2016, led by the technology and industrial sectors. Net margins for the technology sector rose to 11% while the industrial sector saw an increase to 5.2%. Looking into 2018, we expect further margin expansion and return on equity (ROE) improvement on the back of cost discipline and healthy sales growth driven by synchronised global growth.

Asia ex-Japan should also benefit from a modestly weaker USD environment as funds continue to flow into the region in search of higher returns. Year-to-date Asia ex-Japan equity markets have benefited from a net inflow of USD3 billion. The rebalancing of the H-share index in 2018 is positive as it gives higher weight to fast growing private sector companies at the expense of state-owned enterprises. This is expected to attract more fund flows into the region. The inclusion of China A-shares in MSCI indices, effective June 2018, could gradually induce foreign participation into China A-share equities.

Asia ex-Japan's valuations are attractive trading on a P/E ratio of 14x 2018 earnings. This represent a 17% discount to global equities, a slightly larger discount than the historic average of 13%. Continued margin expansion could enable valuations for Asia ex-Japan to re-rate higher.

As the technology sector accounts for 33% of MSCI Asia ex-Japan, any weakness in the sector could negatively affect investor sentiment. In addition, a greater than expected slowdown in Chinese economic growth is a risk to our positive view towards Asia ex-Japan equities. However, as China strives for quality development, the switch in focus from industry-led growth to one driven by services and consumption could give rise to new sustainable economic drivers.

Korea – Geopolitical tensions priced in

Korea is a preferred equity market within Asia ex-Japan in 2018. An attractive P/E ratio of 9x and 11% consensus earnings growth forecasts in 2018 are positives with room for further expansion should earnings continue to improve and the trade relationship between China and Korea normalise. Global economic growth is supportive of Korean exports and its technology sector. Geopolitical tensions remain manageable and we believe risks have already been priced in given the attractive valuation.

China – Striving for quality growth

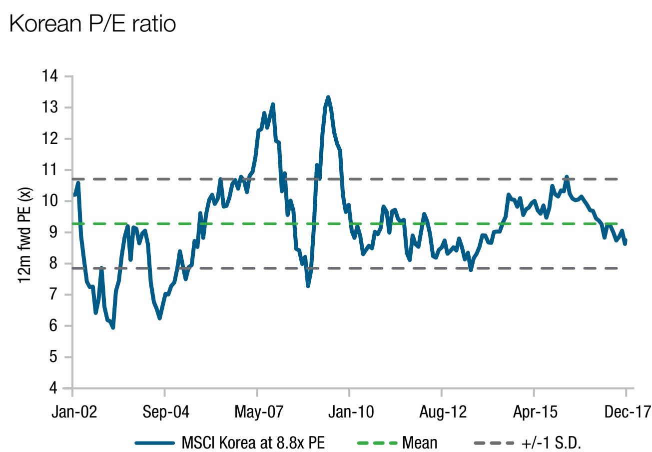
China is a preferred market within Asia ex-Japan as we enter 2018. Consensus expectations for earnings growth are 15% in 2018 while the P/E ratio is a reasonable 13x on 2018 earnings forecasts. Undemanding valuations together with the MSCI inclusion of A-shares effective June 2018 are supportive for equity fund inflows. China has aggressively pursued supply side reforms in sectors such as coal and steel during 2017, leading to some upward pressure on input prices. Nevertheless, as other input costs have been well managed, margins have expanded.

Margin improvement and attractive valuations are amongst the primary drivers for Asia ex-Japan equities.

Figure 5

Korea's P/E has declined as earnings growth has outpaced index gains

Korean P/E ratio



Source: Fitch, Bloomberg, Standard Chartered

Figure 6

Asia ex-Japan net margin recovery accelerated in 2017, led by China

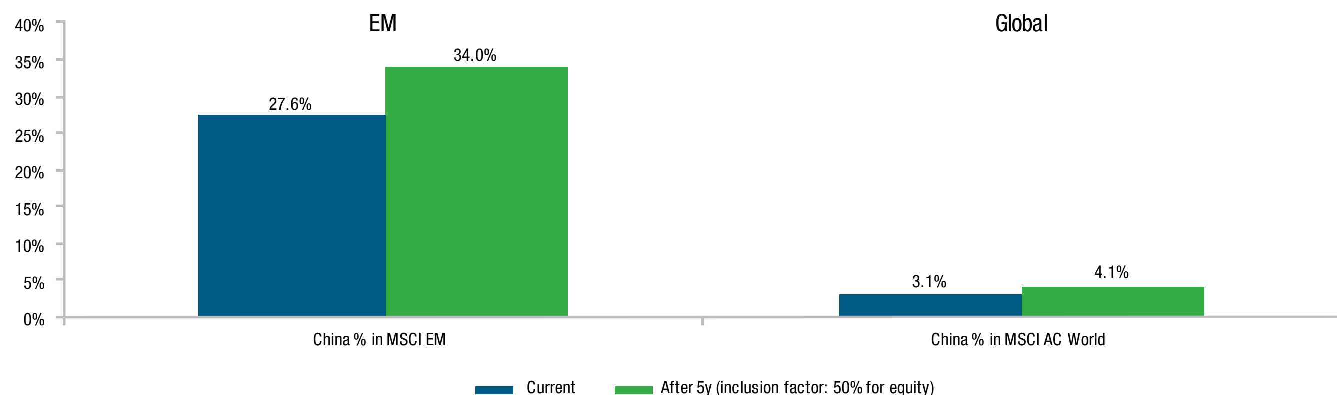
Net margins for our preferred markets in Asia

Source: Fitch, Bloomberg, Standard Chartered

Figure 7

Higher China weight in key indices will increase the flow of funds into these benchmarks

China's weight in MSCI indices to increase over 5 years



Source: Bloomberg, Standard Chartered

Euro area equities

Preferred – Room for Euro area growth to catch up

Key drivers of our view include:

- Close to double-digit earnings growth underpinned by strong domestic consumption and export growth are amongst the drivers for Euro area equities.
- Solid macro environment should incentivise corporates to increase investment spending, which has been historically been positive for the market.
- Higher bond yields are a potential positive for Euro area banks.

Euro area equities is a preferred region as we enter 2018

The Euro area is in the mid-stage of the economic cycle, compared to late stage in the US. Consensus expectations for Euro area growth is for a modest slowdown to 1.9% from an estimated 2.2% growth in 2017. Better consumer and business sentiment as well as relatively benign monetary conditions, could ultimately filter through into better corporate earnings. This should support the Euro area's 2018 consensus EPS growth forecast of 9.3%. A three-factor framework incorporating consensus bottom up, top down earnings forecasts and option pricing indicates the potential for Euro area equities to gain 10% in 2018.

We anticipate strong demand driven by a sustained recovery in domestic consumption to lead to higher investment spending in 2018. While we recognise that investment spending could curtail the short-term outlook for ROE, over the long run, we believe it should be beneficial for Euro area earnings and hence, the equity market.

Positive equity fund inflows should also help buoy the Euro area market, particularly as the average pension fund allocation to equities (relative to bonds) in Euro area is still low.

Given our base case scenario that the Euro area yield curve could steepen in 2018, this is expected to be positive for net interest margins for Euro area banks. Likewise, a less accommodative bias from the ECB could result in an increase in investment yields for Euro area insurers.

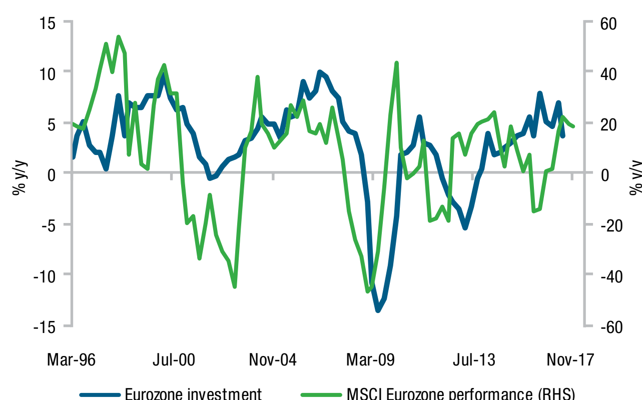
Euro area equity market gains in 2017 were driven by rising earnings as opposed to multiple expansion. With a sanguine macro backdrop, we believe that valuations have room to re-rate higher in 2018, given that the market is trading at an attractive P/E ratio of 15x 2018 earnings, which is a 9% discount to global equities.

We are mindful that sustained EUR strength could dampen the profit outlook for Euro area exporters. Quicker-than-expected monetary tightening could also hurt Euro area companies with elevated debt levels, although this is not our central scenario. Heightened political noise from Southern Europe could weigh on markets in H1 2018. Lastly, Euro area equities could miss the tailwind from the growth in information technology as the sector has only a 8% weight compared to 19% for global equities.

Figure 8

Capital spending in Euro area is linked to Euro area equity performance

Euro area investment and equity market performance



Source: Standard Chartered, Bloomberg

Japan equities

Core holding – Upward earnings momentum

Key drivers of our view include:

- Broad-based earnings upgrades and lower than average historic valuations are amongst the drivers for Japanese equities.
- Share buybacks have increased return on equity to 9% in 2017. Recently they have slowed leading to an increase in cash levels which could be used for increased capital spending.
- A weak yen together with a pick up in the global economy is positive for the Japanese equity market, in particular, the export-oriented industrial sector.

Japanese equities are a core holding as we enter 2018

A three-factor framework incorporating consensus bottom up, top down earnings forecasts and option pricing indicates the potential for Japanese equities to gain 8% in 2018.

Consensus expectations for earnings growth is 8% in 2018. The broad-based earnings recovery has been the major driver for Japanese equities. Earnings upgrades accelerated in late 2017 as analysts turned more optimistic on global demand together with domestic consumption recovery. Information technology and materials are the two sectors which contributed most to the earnings recovery in Japan, with the consensus earnings growth estimate for the former at 15% and the latter 12% for 2018.

Earnings growth together with the rise in share buyback activities have raised the return on equity from 8% in 2015 to a forecast 9% in 2017. We have, however, seen a reduction in share buybacks since April 2017, increasing corporate cash balances to USD 4trn which could be used for capital spending in the future.

As 30% of Japan's corporate sales are derived from overseas, Japanese exports become more competitive in a weak yen environment. This is positive for the Japanese industrial stocks which are heavily export-oriented.

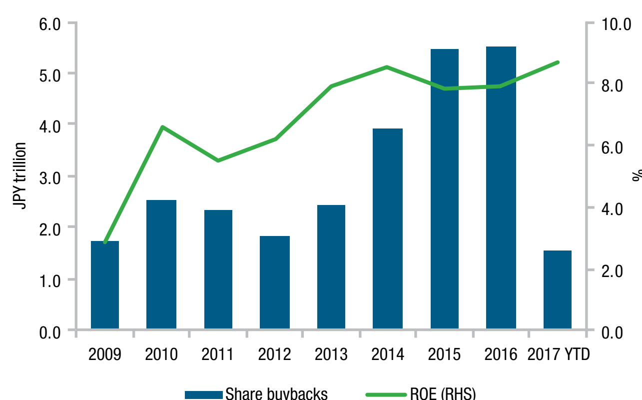
The recent election victory by Prime Minister Abe is viewed as positive for the Japanese market as he now has a renewed mandate to complete Abenomics. The election win increases the likelihood Prime Minister Abe will re-appoint Bank of Japan governor Haruhiko Kuroda when his term expires in early 2018. We expect monetary policies remain loose which compares favourably with the gradual tightening in the US.

Higher input costs, including wages, could reverse the trend for margin improvement. Yen strength is a key risk for the market as it would undermine the outlook for the export-orientated sector. There is also a negative link between a strengthening yen and the equity market.

Figure 9

Rising share buybacks has lifted RoE in recent years

Japanese share buybacks and RoE trends



Source: Bloomberg, Standard Chartered

US equities

Core holding – Capex and policy reforms

Key drivers of our view include:

- Robust consumer spending and job creation trends are amongst the drivers of US equities. Corporate tax cuts are a potential further catalyst for the market.
- A benign USD environment and upside surprise in corporate margins are potential positives for US equities.
- Elevated valuations are a risk and a correction could occur if earnings growth expectations disappoint. A significant increase in corporate debt levels over the past six years is also a concern.

US a core holding

US equities are a core holding as we enter 2018. As the US is in the late stage of the economic cycle, which could continue for some time, we expect consumers to increase spending as job creation remains healthy. Low inventory levels and new orders could also spur capital spending. This, in turn, could lead to better corporate earnings, as margins surprise on the upside buoyed by robust growth and tight cost control. Energy and financials lead consensus earnings growth forecasts in 2018 with growth of 51% and 15%, respectively. A three-factor framework incorporating consensus bottom up, top down earnings forecasts and option pricing indicates the potential for US equities to gain 9% in 2018.

With a modestly weaker USD view going into 2018, US corporate profits could benefit as companies' derive 29% of their revenue from abroad. Consensus expectation is for 11% earnings growth in 2018, up from 10% in 2017. This is backed by stable GDP growth, and to a lesser extent, buoyant external environment.

If President Trump and the Republican party are successful in implementing the proposed tax cuts, it could have a positive effect on investment and spending at the margin. The proposed expiry of personal tax cuts after 10 years, to adhere to debt ceiling requirements, could dilute the effect of lower personal taxes over the long term. Nevertheless, it is expected to increase the disposable income of middle America in the short-to-medium term with the corporate tax cut potentially lifting investment, which could result in higher wages given the tight labour market.

Figure 10

US equity valuations are elevated, both relative to history and peers

US equity market valuations

Source: Bloomberg, Standard Chartered

US companies could benefit from a modestly weaker USD in 2018, as they derive 29% of their revenue from abroad.

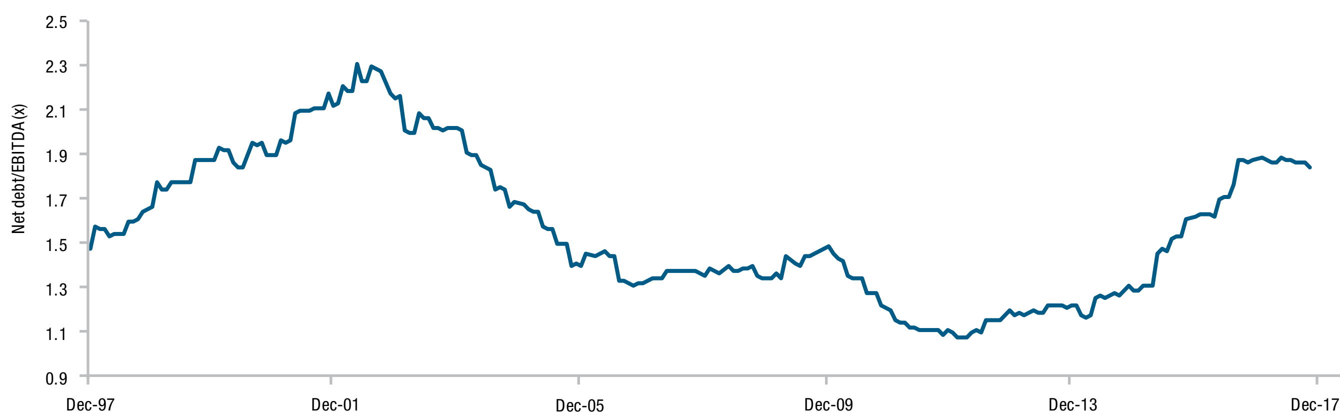
Share buybacks among US companies, which had been a key contributor to earnings per share (EPS) growth in prior years, may slow in 2018, in the absence of a favourable policy outcome regarding US profit repatriation. We perceive this positively, as it suggests that corporates are spending more on investing for future growth, rather than buying back their own shares.

Risks from expensive valuations and rising corporate debts. The US equity market is trading on a P/E ratio of 18x 2018 earnings, which is elevated versus its historical average and relative to global equities. A pull-back could occur if earnings growth expectations disappoint. Debt levels have increased with net debt to EBITDA, a measure of earnings, rising from 1.1x to 1.9X over the past six years in the US.

Figure 11

Net debt to EBITDA has risen sharply in recent years

US leverage ratio



Source: Bloomberg, Standard Chartered

Emerging Markets (EM) ex-Asia equities

Core holding – Stable outlook on moderate earnings growth

Key drivers of our view include:

- Commodity prices are amongst the drivers of EM ex-Asia equities. We are neutral on the commodity sector in 2018, which influences our stance towards the region.
- Consensus expectations is for 12% growth earnings growth in 2018 with slight margin improvement on solid cost controls.
- A modestly weaker US dollar is supportive of Emerging Markets, but political uncertainty in the region is a risk.

EM ex-Asia a core holding

EM ex-Asia equities are a core holding as we enter 2018. A three-factor framework incorporating consensus bottom up, top down earnings forecasts and option pricing indicates the potential for EM-ex Asia equities to gain 15% in 2018.

The outlook for EM ex-Asia is linked to commodity prices. We believe that commodity prices could trend moderately higher in the next 12 months. This cautious view implies catalysts for upward revisions to earnings, relative to current expectations, could be limited.

Consensus expectations is for earnings growth of 12% in 2018, down from 25% in 2017, while the return on equity holds steady at a reasonable 12%. Solid cost discipline, better global demand and moderately higher commodity prices could lift consensus net margins marginally to 8.2% in 2018 from 7.4% in 2017.

EM ex-Asia could benefit from a modestly weaker USD environment as funds continue to flow into the region seeking higher returns. EM ex-Asia equity markets have benefited from a net inflow of USD1.5 billion through November 2017. Should the USD remain soft, we expect fund inflows into EM ex-Asia equities to continue in 2018.

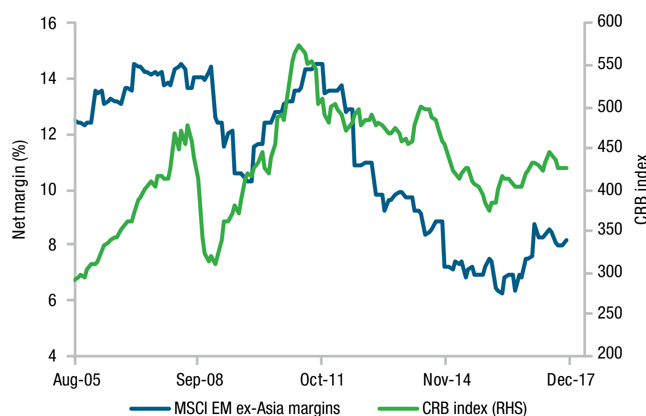
Trading on a P/E ratio of 12x 2018 earnings forecasts, valuations in EM ex-Asia are at a 25% discount to global equities, comparable to its historical average discount. Although recent earnings revisions have turned positive on the oil price rebound, political uncertainty, remains a risk. Brazil is our preferred market in EM ex-Asia. The economic growth outlook in 2018 is improving, while inflation is expected to remain subdued. This should lend support to corporate earnings.

Elections, are scheduled in Brazil and Mexico in 2018. The likelihood of continuing with the reform agenda in Brazil, an important market driver, is heavily dependent on the winner of the upcoming election. Mexico is faced with the renegotiation of the North American Free Trade Agreement, with the market pricing in a low probability of a trade dispute.

Figure 12

EM ex-Asia margins are linked to commodity price trends

EM ex-Asia margins and commodity prices



Source: Bloomberg, Standard Chartered

UK equities

Less preferred – Repercussion from Brexit

Key drivers of our view include:

- Profit downgrades for domestic-oriented stocks, funds outflows and commodity exposure are amongst the drivers for UK equities.
- Rising interest rates may hurt UK equities, as higher rates reduce the attractiveness of its status as a high dividend yielding equity market.
- UK equity valuations are elevated, with risks of further EPS downward revision.

UK equities are **least preferred** as we enter 2018

We have a cautious stance on UK equities going into 2018 relative to consensus. The negative impact from Brexit-related uncertainties is anticipated to increase in 2018, as rising inflationary pressures, as well as weak consumer and business sentiment, takes hold. A three-factor framework incorporating consensus bottom up, top down earnings forecasts and option pricing indicates the potential for UK equities to gain 10% in 2018 in local currency terms, but we believe that optimistic scenario may not materialise.

Uncertainty over the likelihood of negotiations with the EU concluding by the exit date, i.e. March 2019, could also weigh on the market. The downbeat political and economic backdrop, may lead to downside risks to UK's consensus EPS growth of 6% for 2018, led by domestic-oriented companies. These may also deter investors from altering their already cautious stance on the UK equity market.

The performance of UK equities hinges on commodity prices and EM market performance, as the FTSE 100 index's commodity and EM exposure are meaningful at 22% and 25%, respectively. We are neutral on the commodity price outlook in 2018.

Our base case scenario is that the Fed will hike rates two to three times in 2018 and Bank of England had guided for "gradual further increases" to their benchmark interest rate. This in turn, may cap upside for UK equities, as rising rates are expected to reduce the attractiveness of UK equities as the highest dividend yielding market at 4.3% among the six regions/countries we track. UK equities also tend to underperform global equities when domestic bond yields are rising.

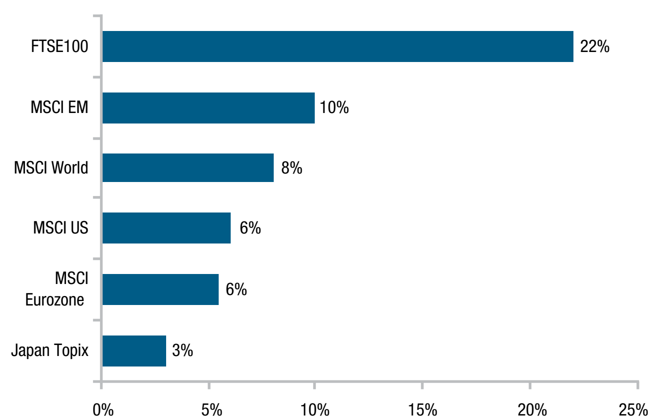
The valuation of UK equities are elevated, trading on P/E ratio of 14x 2018 earnings, which is above its long term average of 13x, with risks of further downward earnings revisions negatively impacting valuations.

Factors which could derail our cautious view on the UK market include a weaker GBP in the next 12 months. This could lead to a recovery in corporate profits, as c. 62% of UK companies' revenues is derived from abroad. Likewise, overly bearish sentiment could change and spur significant upward re-rating in UK equities, especially if Brexit negotiations surprise positively.

Figure 13

UK and peer index weight in commodity sectors

UK has significantly higher weight to commodity sectors relative to peers



Source: Bloomberg, Standard Chartered

FX

FX
at a glance

Tariq Ali, CFA | *Manpreet Gill*

Key themes

We expect a modest decline in the USD index, mostly as a result of a stronger EUR and marginally offset by a weaker JPY.

GBP and AUD likely to trade in a broad range as risks remain balanced.

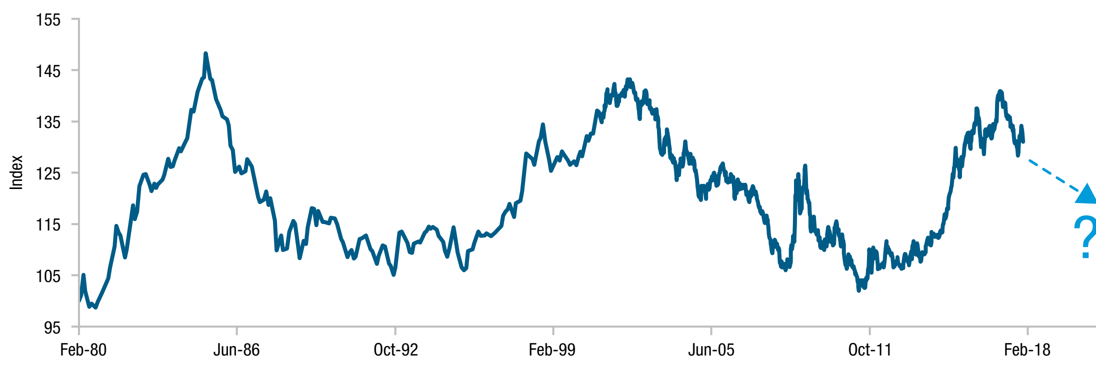
EM currencies likely to strengthen further on a widening EM-DM growth differential, higher commodity prices and a modestly weaker USD.

Key chart

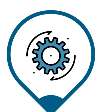
Figure 1

End of a bullish USD super cycle?

USD real effective exchange rate



Source: Bloomberg, Standard Chartered



Key drivers

Currency	Outlook	Real Interest Rate Differentials	Risk Sentiment	Commodity Prices	Broad USD Strength	Comments
USD	▼	🔴	🔴	n/a	n/a	US monetary policy divergence with the rest of the world likely peaking, interest rate differentials to narrow
EUR	▲	🟢	🟢	n/a	n/a	Increasing likelihood of an earlier ECB stimulus withdrawal to support EUR. Political risks contained
JPY	▼	🔴	🔴	n/a	n/a	BoJ likely to maintain easing policy, further widening of interest rate differentials to weaken JPY
GBP	◆	🟡	🟡	n/a	n/a	Further BoE rate hikes remain at risk from Brexit-related uncertainty and its potential impact on growth
AUD	◆	🔴	🟢	🟡	🔴	Supportive risk environment balanced by likely status quo in monetary policy
EM FX	▲	n/a	🟢	🟡	🟢	A weaker USD, moderately higher commodity prices and positive risk sentiment to support EM FX

Source: Bloomberg, Standard Chartered

Legend: ▲ Bullish | ▼ Bearish | ◆ Neutral | 🔴 Not Supportive | 🟡 Neutral | 🟢 Supportive

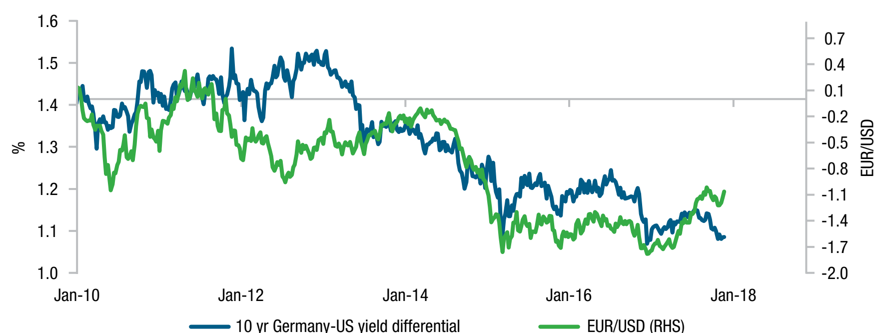
No longer just about the Fed

In our view, the USD is likely to weaken modestly in 2018 as we believe the possibility of the Fed hiking interest rates faster than market expectations is remote given the current US inflation backdrop. On the other hand, there is greater potential for other central banks, including the European Central Bank, to withdraw stimulus faster than consensus expectations.

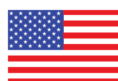
Figure 2

Germany-US real yield differentials still at low levels historically

Germany-US 10 year real yield differentials



Source: Bloomberg, Standard Chartered



US DOLLAR (USD) |

The USD index extended its weakness in 2017, despite the fact that the Fed hiked interest rates three times during the year. This may imply that expectations of policy elsewhere in the world are now dominating the USD outlook. With robust economic momentum and a significant reduction in perceived political risk in Europe, the European Central Bank (ECB) now appears more confident in contemplating stimulus withdrawal. Elsewhere, the Bank of England (BoE) and the Bank of Canada (BoC) hiked interest rates in 2017 after further improvements in their respective labour markets. The only exception among the major central banks here is the Bank of Japan (BoJ), which continues to communicate status quo for the foreseeable future.

In our view, the USD is likely to weaken modestly in 2018 as we believe the possibility of the Fed hiking interest rates faster than market expectations is remote given the current US inflation backdrop. On the other hand, there is greater potential for other central banks, including the European Central Bank, to withdraw stimulus faster than consensus expectations. Hence, we expect narrowing real interest rate differentials between the US and major peers, which is likely to be moderately negative for the USD. From a long term perspective, the USD trade weighted index, adjusted for inflation, is still near its peak levels.

Risks to our USD outlook include the realisation of the two extreme scenarios highlighted in the Macro overview section. A surge in US inflation expectations might compel the Fed to hike interest rates more aggressively. Similarly, a return to a deflationary scenario would likely increase flight to safety from risk assets and increase demand for the USD. Outside of these scenarios, major developments on tax reform that lead to a repatriation of capital back into the US could drive short term USD gains.

EUROPEAN EURO (EURO) |

We expect the EUR to extend gains in 2018, albeit more moderately than in 2017. We believe cyclical and political factors are likely to impact the outlook for the EUR.

With respect to cyclical factors, we believe the EUR has room to extend gains as the economy gathers pace, resulting in further clarity with respect to ECB stimulus withdrawal and potential rate hikes. We believe the initiation of ECB's Quantitative Easing (QE) had excessively weakened the EUR through 2015-2016. This can be gauged from the fact that interest rate differentials with the US still remain close to historical lows Hence, any withdrawal of QE is likely to reverse these trends to some extent.

Global investors and central banks further re-allocating capital towards Euro area assets should once again become a source of EUR support. With greater confidence in the Euro area economy and potential ECB stimulus withdrawal, we are likely to see an improving net balance of payments, which is fundamentally positive for the EUR.

Finally, political risks are still important, even though these have diminished significantly over the past year. Elections in Italy H1 2018 could cause short term volatility, although as of now, the possibility on non-mainstream party gaining significant ground remains low.

We expect the JPY to weaken in 2018. Both internal and external factors influence our thinking regarding the JPY outlook.

With respect to internal factors, a continuation of the Bank of Japan's Yield Curve Control (YCC) policy of keeping Japan 10 year yield close to zero is critical, as it can potentially lead to a further widening of real interest rate differentials in favour of a weaker JPY. This year, the BoJ has reiterated its commitment to maintaining the current policy with no guidance on a potential exit strategy. While PM Abe's re-election has diminished challenges to 'Abenomics' and the continuation of excessive easing policy, any significant shift here remains the main domestic risk to our weaker JPY view.

Among external factors, our view of a modest rise in US long-end yields is likely to further weaken the JPY. With yields in Japan on hold, US 10-year yields have been the most significant variable affecting the real interest rate differential between the US and Japan. Other than this, a low volatility environment similar to 2017 is supportive of continued capital outflows from Japan towards risky assets and the continued use of JPY as a funding currency. Conversely, a rise in volatility or increased deflationary concerns pose a risk to our weaker JPY outlook.

While the GBP has recovered from its post 'Brexit' lows, we doubt these gains can extend much further into 2018. Key issues include the lack of a transitional trade agreement with the EU and a weak balance of payments profile.

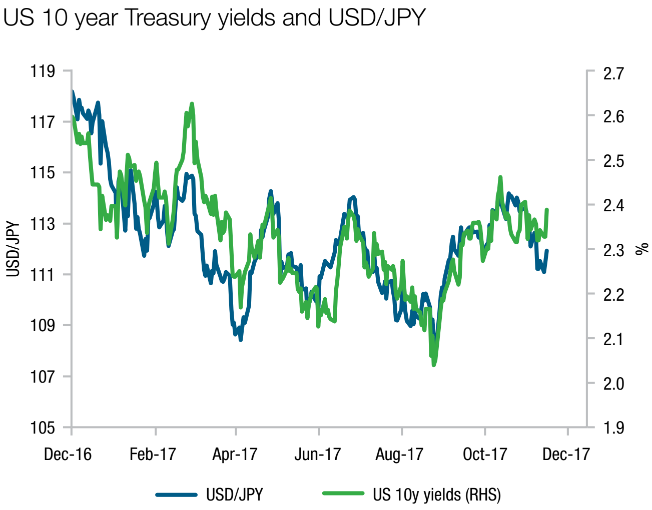
In 2017, market expectations for modest Bank of England (BoE) rate hikes in 2018 have supported the GBP. Nevertheless, we believe the BoE's approach is likely to remain fluid in view of the evolving Brexit-related and economic risks. In this regard, a transitional agreement ahead of the March 2019 deadline is critical. Should an agreement be reached, we are likely to see reduced uncertainty, leading to further GBP gains. Although an agreement is ultimately our base-case scenario, the possibility of a 'no deal' prompts a more cautious approach.

The UK's balance of payments' position remains challenging, especially as the weaker GBP has not resulted in a significant improvement in export growth. Furthermore, the current account deficit remains close to record levels and hence any significant capital outflows are likely to weigh on the exchange rate. In this context, we believe the GBP's 'undervaluation' is justified once the impact of this notably weaker balance of payment profile is incorporated.

Figure 3

US 10-year yield remains a key driver of the JPY

US 10 year Treasury yields and USD/JPY

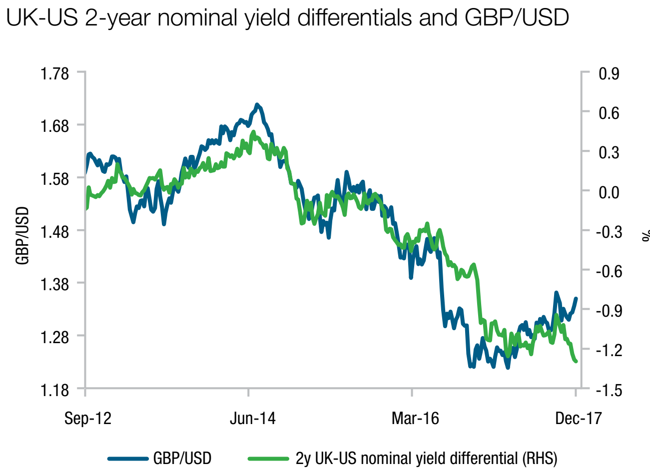


Source: Bloomberg, Standard Chartered

Figure 4

Scaling back of UK interest rate hike expectations poses a risk to the GBP

UK-US 2-year nominal yield differentials and GBP/USD



Source: Bloomberg, Standard Chartered

AUSTRALIAN DOLLAR (AUD) | ↔

While the AUD trended modestly higher in 2017, it traded in one of its tightest ranges relative to the last two decades. Looking ahead into 2018, we see little reason for the AUD to rally strongly as risks remain balanced. The outlook for the AUD remains dependent upon three key factors: Reserve Bank of Australia's (RBA) policy and real interest rate differentials, the outlook for iron ore prices and global financial market volatility.

The RBA has continued to highlight its preference for steady monetary policy settings. However, it has left room open for rate hikes should the economy gain further ground and inflationary pressures rise. Overall, the case for a rate hike looks balanced. Business confidence is improving and the labour market is tightening, which argues for a less accommodative policy, whereas high household leverage coupled with flat wage growth suggests rates should not go higher.

Higher iron ore prices have been a source of support for the AUD since bottoming in 2016. However, we expect this to fade as we go into 2018. Supply side issues in the iron-ore market as well as a modest slowdown in China's growth suggest consolidation.

The excessively low volatility environment has also been a major source of support for the AUD in 2017. In general, we remain constructive on risk assets in 2018 and this factor is likely to be limit downside for the pro-cyclical AUD.

Figure 5

Iron ore prices unlikely to strongly support AUD in 2018

China iron ore price and AUD/USD

Source: Bloomberg, Standard Chartered

EMERGING MARKET CURRENCIES | ↑

We believe the overall macroeconomic environment in 2018 remains supportive for EM currencies, although we do not expect the same magnitude of gains as in 2017. Broadly, three factors drive our positive view on EM currencies; a modestly weaker USD, higher commodity prices and a bottoming of the EM-DM growth differential. Our view on individual currency pairs is as follows:

- We expect the KRW to strengthen further amid further recovery in the global economy, a hawkish shift by the Korean central bank and a weaker USD.
- We expect modest gains in the SGD and MYR, in line with our view of a weaker USD, a pick-up in global growth and supportive domestic monetary policies.
- We expect the CNY and INR to trade largely range-bound. Policy bias to favour exchange rate stability in China while a slower pace of capital inflows into India to limit INR gains.

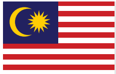
SOUTH KOREAN WON (KRW) | ↑

We believe there are three factors that will likely drive further KRW gains. First, through the export channel, the KRW is heavily exposed to global growth. With a strong synchronised pick-up in global growth indicators and PMI's near cyclical highs, we believe there is potential for further KRW appreciation.

Second, the hawkish turn by the Bank of Korea (BoK) amid strong domestic consumption and export growth is likely to improve the currently thin interest rate differential with the US.

Finally, the modest weakening trend in the USD is likely to allow further room for appreciation.

We believe policymakers in Korea are likely to tolerate further KRW strength as long as the balance of payments situation continues to improve. Tensions with North Korea remain a potential risk, although similar to this year, we do not think investors will pay much attention to this outside of an extreme scenario.



MALAYSIAN RINGGIT (MYR) |

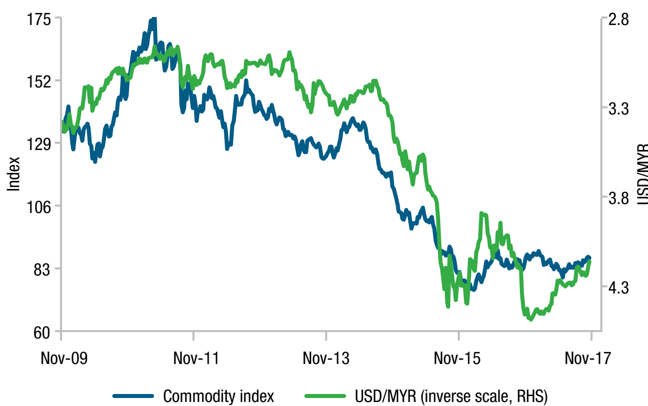
We believe the outlook for commodity prices and the USD are the most significant driver of the MYR. Given our view of modest USD weakness and higher commodity prices, we expect modest MYR appreciation to continue into 2018. Furthermore, we believe significant undervaluation and possible increase in investor allocation to Malaysian debt is likely to be a further tailwind. Arguably, sentiment towards the MYR and local assets is likely to improve following a continued improvement in the country's balance of payments and a gradual build-up of FX reserves.

As a risk, a hard landing in China and/or a marked slowdown in global growth would likely result in MYR underperformance with respect to regional currencies. Among major Asian economies, Malaysia has one the lowest FX reserves to protect against a potential EM crisis.

Figure 6

Modestly positive commodity price outlook to support MYR

Global commodity price index and USD/MYR



Source: Bloomberg, Standard Chartered

SINGAPORE DOLLAR (SGD) |

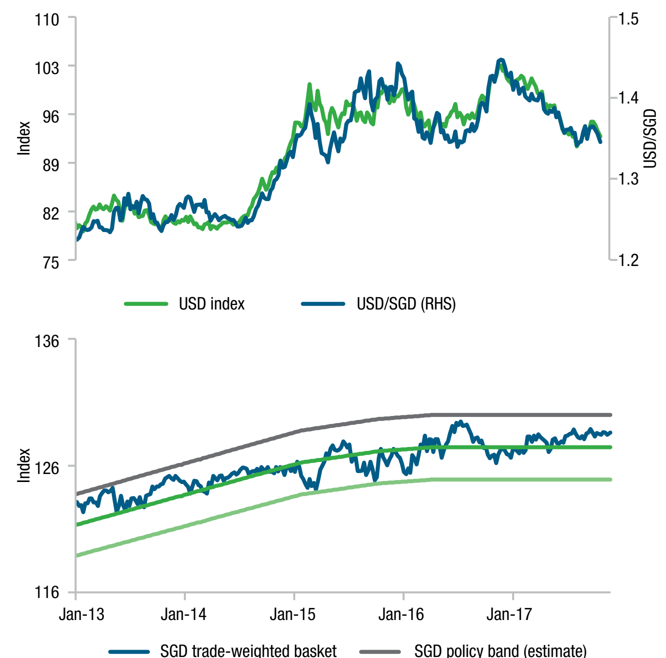
The outlook for the SGD is likely to be shaped by the Monetary Authority of Singapore's (MAS) policy bias as well as the USD trend. On the first point, we believe there is a reasonable probability of the MAS modifying its policy to support a slight appreciation in the Singapore trade-weighted exchange rate basket. In our view, the more balanced outlook on growth and core inflation suggested in the last policy review, paves the way for this adjustment in 2018. Furthermore, with a shift towards a less accommodative policy in many key trade partners it is natural for a small open economy like Singapore to follow suit.

SGD strength has been strongly correlated with USD weakness and we expect this to continue in 2018. Our expectations for further gains in the EUR and MYR, which likely account for approximately 30% of Singapore's trade-weighted exchange rate basket, is likely to support further modest SGD appreciation.

Figure 7

USD and MAS policy outlook key for SGD direction

USD index and USD/SGD (top); SGD trade-weighted exchange rate and policy band estimate (bottom)



Source: Bloomberg, Standard Chartered

The CNY stabilised in 2017 amid a stabilisation in China's growth and capital outflows and a weaker USD. Since the introduction of the China Foreign Exchange Trading System's trade-weighted policy basket, we observe that the correlation between the USD/CNY and the USD index has improved significantly. Hence, in our view, in addition to PBoC's policy bias, the outlook for the USD is now key.

We expect policy makers to prefer a broadly stable CNY relative to trade partner currencies. This is due to the profound impact of the exchange rate on China's domestic monetary conditions. We expect authorities to favour a balance between reform and growth which does not favour significant monetary tightening from current levels. Against the backdrop of a stable exchange rate policy, we expect the USD to be the main driver of the CNY. An outlook for a modestly weaker USD is also likely to discourage further capital outflows with the potential for some repatriation going forward.

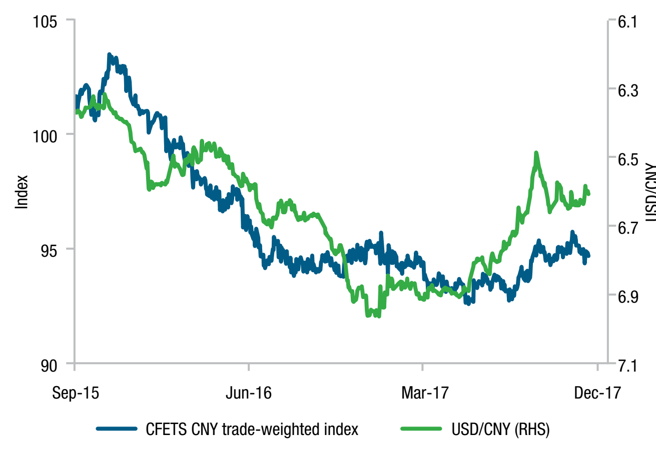
The INR gained strongly in 2017. This has been mainly due to strong capital inflows amid a stellar performance in the local equity and bond markets. However, going forward, we expect the INR to be range-bound as some of these factors are likely to turn less supportive in 2018.

High valuations in the domestic equity market coupled with foreign debt ownership quotas are likely to limit additional capital inflows. In addition, some deterioration in the current account can be expected amid recent gains in oil prices. Nevertheless, a still relatively healthy balance of payments position is likely to limit significant INR weakness. We also expect the Reserve Bank of India (RBI) to continue to manage volatility resulting in a fairly stable INR in 2018. A significant surge in oil prices remains the main downside risk, in our view.

Figure 8

Policy bias likely to favour a sideways trend in the trade-weighted CNY

CFETS CNY trade weighted index and USD/CNY

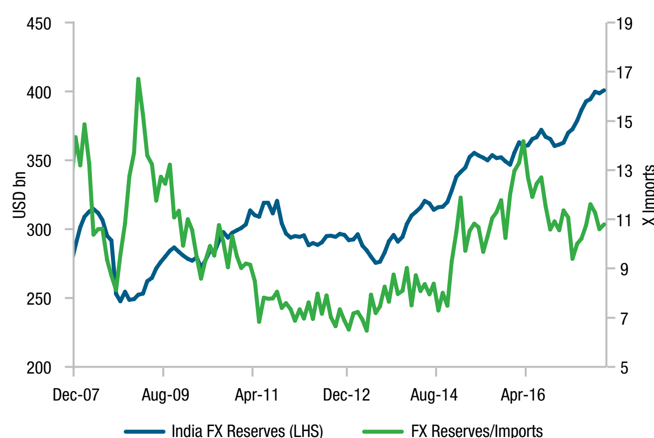


Source: Bloomberg, Standard Chartered

Figure 9

India's FX reserve position has improved over time, reducing vulnerability to external shocks

India FX reserves and FX reserves as a multiple of monthly imports



Source: Bloomberg, Standard Chartered

COMMODITIES

Commodities
at a glance

Tariq Ali, CFA | Manpreet Gill

Key themes

We expect ***commodity prices to rise modestly in 2018***, amid a moderately positive demand environment, but still elevated supply levels in many cases.

Gold prices to rise modestly, most likely trading in the USD 1250–1350 per ounce range amid a slightly weaker USD, balanced with largely range-bound real yields.

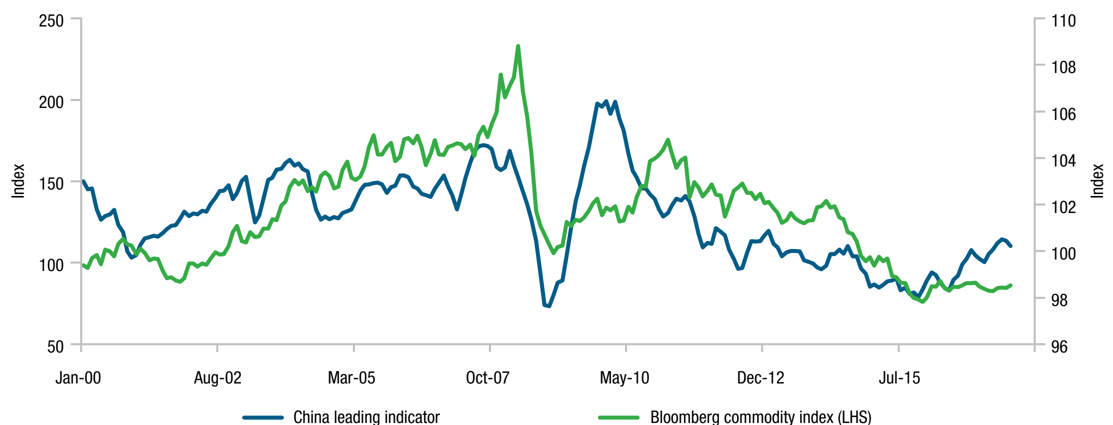
Oil prices likely to remain broadly range-bound, most likely trading in the USD55–65 per barrel range.

Key chart

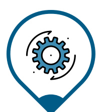
Figure 1

Outlook for China growth still a key driver of commodity prices

China leading indicator and Bloomberg commodity index



Source: Bloomberg, Standard Chartered



Key drivers

Commodity	View	Inventory	Production	Demand	Real Interest Rates	USD	Risk Sentiment	Comments
Oil	◆	🔴	🟡	🟢	n/a	🟢	🟢	OPEC cut backs likely to be offset by US production increase. Inventories remain elevated
Gold	◆	🟡	🔴	🟢	🟡	🟢	🔴	US rate increases expected to be in-line with inflation
Metals	◆	🟡	🟡	🟡	n/a	🟢	🟢	China demand a support; market still over supplied

Source: Bloomberg, Standard Chartered

Legend: ◆ Neutral | 🔴 Not supportive | 🟡 Neutral | 🟢 Supportive

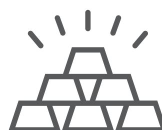
China growth still key

In a typical late-cycle environment, commodities tend to deliver strong performance as capital expenditure accelerates and the economy performs above its potential. However, we believe a number of factors could contain commodity price gains in 2018. Chief among these is China's likely focus on deleveraging and reform as opposed to supporting growth alone.

A late cycle approach

Compliance with agreed crude oil production cuts among OPEC and some non-OPEC members has resulted in higher oil prices. Gold has delivered positive returns against the backdrop of declining US long-end Treasury yields.

In a typical late-cycle environment, commodities tend to deliver a strong performance as capital expenditure accelerates and the economy performs above its potential. However, we believe a number of factors could contain commodity price gains in 2018. Chief among these is China's likely focus on deleveraging and reform as opposed to supporting growth alone. In addition, the likely response by US shale oil producers to prices in excess of USD 60 per barrel creates headwinds for oil prices. Finally, our expectations of range-bound real yields globally place a limit on sustained gains in gold.



Gold

- We believe there is some room for gold to rise modestly in 2018, with the highest probability of it trading in the USD 1250 – 1350 per ounce range.
- We believe real yields (proxied by the US 5 year TIPS yields), the USD and safe-haven demand due to geopolitical concerns remain the main drivers of gold prices.

In 2017, the relationship with the USD has been stronger and with real yields weaker, than historically has been the case. On the same note, limited concerns of a spillover in key geopolitical flashpoints have created little safe-haven demand for gold.

Figure 2

A modestly weaker USD in 2018 to be supportive for gold prices

USD Index and gold price (inverse scale)

Source: Bloomberg, Standard Chartered

Moving into 2018, we believe modest USD weakness is likely to provide support to gold prices. However, real yields are likely to remain range-bound; hence we do not see strong gains in gold prices. For real yields to rise substantially, central banks would have to hike rates ahead of inflation, which we do not think is likely as data so far has been disappointing. For real yields to fall substantially, we would need to see central banks letting inflation get ahead before raising rates; we also doubt is likely at this stage of the business cycle. As a result, real yields are likely to remain largely range-bound.

With a number of potential flashpoints, geopolitics remains an area which we would monitor closely in 2018. Hence, we would not discount gold's role as a hedge against uncertainty but would limit any allocation to 2-5%.

Figure 3

Real yields to remain range-bound in 2018

US 5-year TIPS yield (inverse scale) and gold

Source: Bloomberg, Standard Chartered

Oil

- We expect oil prices to be generally capped at USD65 per barrel in 2018.
- We believe the outlook for oil prices is likely to be determined mainly by supply-side factors; the extension of OPEC cuts and compliance and the response of US shale oil producers to higher oil prices.

Oil prices recovered in 2017, amid a narrowing of the supply-demand imbalance. We believe two main factors have contributed to this. First, in a break from the past, compliance with OPEC cuts has been in excess of 90%. Second, US shale oil production growth has slowed, owing to a decline in productivity from wells. Finally, weather-related disruption in the Gulf of Mexico also contributed to curtailing supply growth in the short term.

In the year ahead, we believe OPEC producers as well as some non-OPEC members, including Russia, are likely to follow through with their commitment to cap production. In 2017, Saudi Arabia took the leadership role, delivering output cutbacks well in excess of its quota. In 2018, compliance is likely to remain firm, as gradually rising oil prices appear consistent with a number of goals of the Saudi leadership. Nevertheless, there are risks to compliance. For example, it may be difficult to hold back Russian firms should they feel their market share is being threatened.

Increasing output by US shale producers could dampen the impact of the OPEC cut extension. We believe US crude production is likely to increase further as many firms are able to produce profitably at above USD60 per barrel. Nevertheless, we also highlight declining well productivity amid rising costs to extract more geologically challenging assets will eventually put a cap on US production growth.

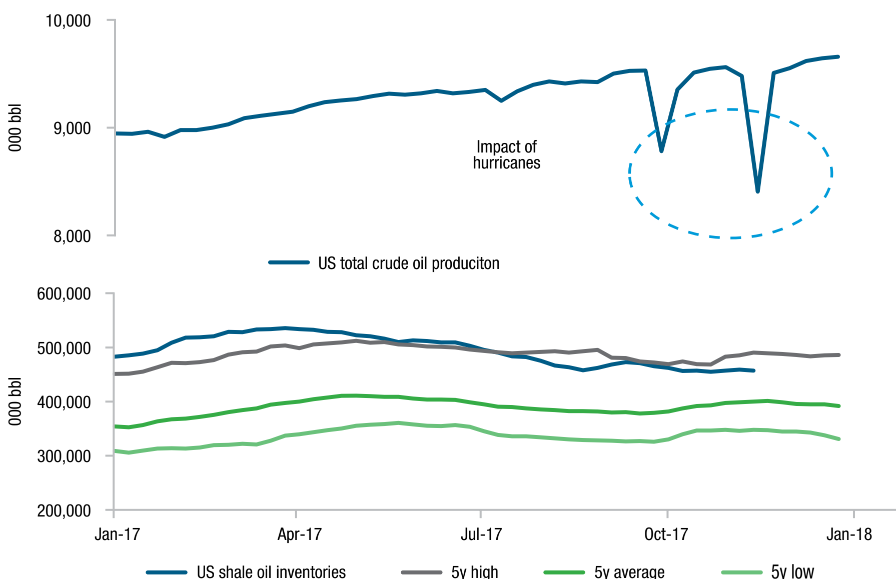
We believe demand growth is likely to be supportive in 2018, though this will likely have a modest impact. In our view, higher growth in Developed Markets could be offset by slightly slower growth in China.

Finally, while geopolitics has not played a very significant role in 2017, this should not be ignored going into 2018. A number of key geopolitical flashpoints including Saudi-Iran tensions and its manifestations through the region remain a source of upside risk to our view in 2018.

Figure 4

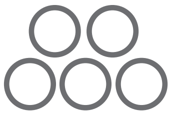
US production growth to remain healthy while inventories still remain elevated

US total crude oil production (top); US total inventories and 5 year ranges (bottom)



Source: Bloomberg, Standard Chartered

Increasing output by shale producers could dampen the impact of OPEC cut extension.



Industrial metals

- We expect industrial metal prices to consolidate in 2018, following strong gains in 2017, amid moderating China fixed asset investment indicators.
- Most major industrial metal markets including copper, aluminium and iron ore are still experiencing excess supply, which is likely to limit further price gains.

Industrial metals have outperformed commodities in general this year, rising over 15%. However, we doubt such a stellar performance can continue in 2018. One of the biggest supportive factors has been China's growth surprises in 2017 and we expect these to moderate in 2018. In particular, data related to fixed asset investment, credit growth and the property sector, which has a strong relationship with industrial metals, has been deteriorating. Hence, we believe some of the gains in industrial metals may have an element of speculation and other short term factors.

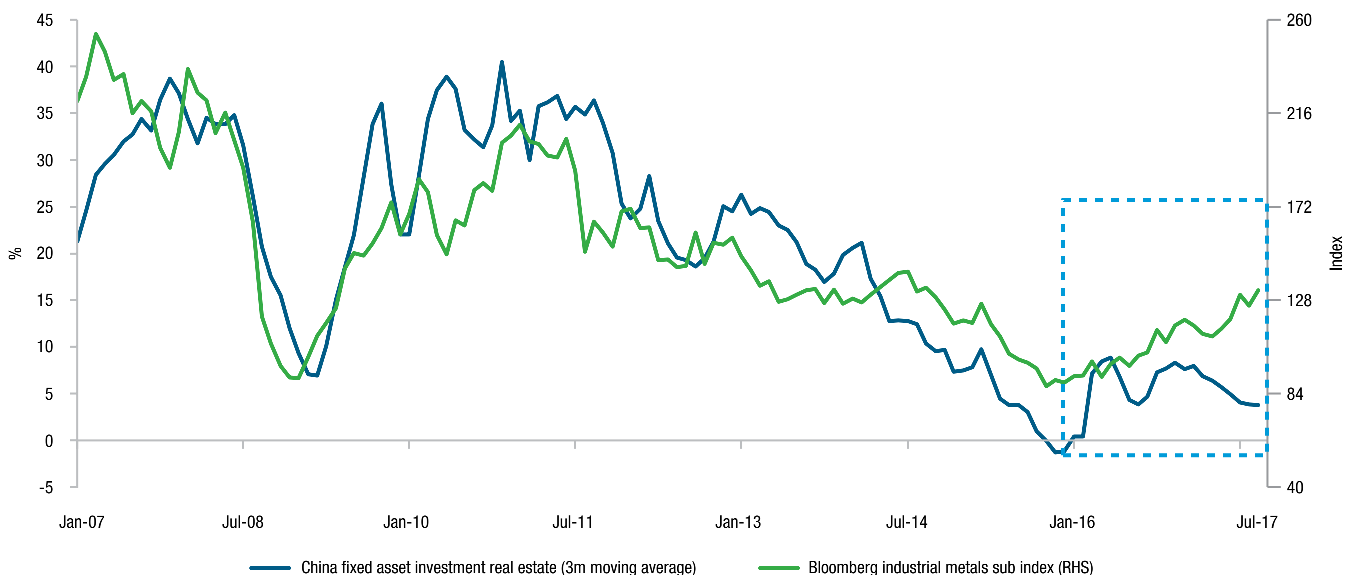
In addition to this, we believe supply side factors are likely to be less supportive heading into 2018. Copper and aluminium prices have been the main contributors to the rally in metal prices. With respect to copper, a temporary disruption of supplies and low inventories in China has supported the exceptionally strong performance. However, in the year ahead, we see a high probability of the copper market returning to surplus. Aluminium has been boosted by the unprecedented production caps on production by China which could continue into 2018. However, despite this, the market is in surplus as a result of high inventory levels so any further gains are likely to be modest.

With respect to nickel, stainless steel production comprises of the majority of demand. In this regard, a cut-back in China's steel capacity is likely to reduce demand. While nickel is also the main beneficiary with respect to rising demand for electric cars, as of now, the battery sector accounts for only a small section of the global nickel demand with. On the same note, iron ore prices are unlikely to recover substantially in 2018 with China inventories swelling with record supply levels, while steel demand is likely to cool.

Figure 5

Industrial metal prices diverging from fundamentals

Bloomberg industrial metals sub-index and China fixed asset investment – real estate



Source: Bloomberg, Standard Chartered

ALTERNATIVE STRATEGIES

Alternative Strategies **at a glance**

Arun Kelshiker, CFA | Trang Nguyen

Key themes

Alternative Strategies are ranked as one of our highest asset class convictions going into 2018 and we expect our Alternatives Allocation to deliver positive returns within a rising interest rate environment.

We continue to advocate a diversified alternatives allocation into Equity Hedge, Relative Value, Event Driven and Global Macro with a tilt towards Equity Hedge.

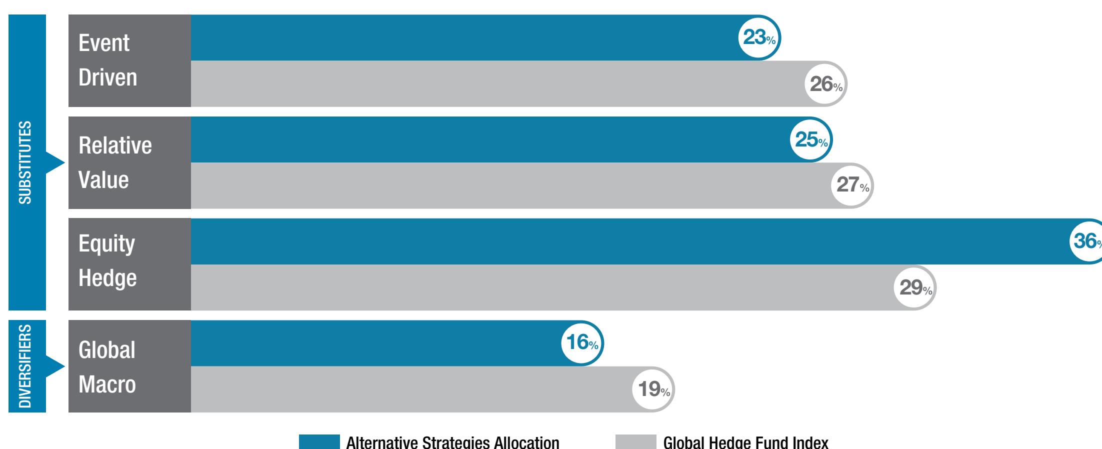
Our Alternatives Allocation delivered +5.3% in line with our call of positive returns since last year's Outlook; amongst sub-strategies, Equity Hedge has been the best performer, up 7.9%.

Key chart

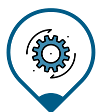
Figure 1

Prefer a diversified Alternatives Allocation with a tilt towards Equity Hedge

Our suggested allocation relative to the HFRX index weights



Source: Bloomberg, Standard Chartered, UBS, Hedge Fund Research Inc., HFRX Hedge Fund Index is a common benchmark used to represent all of the main hedge fund strategies. Composition of benchmark proxied by UBS HFRX Global Hedge Fund Index ETF (end-October 2017).



Key drivers

		Description	View	Drivers for strategies to perform	
SUBSTITUTES	**Equity Hedge**	In essence, buying undervalued stocks and selling overvalued stocks	▲	• Positively trending equity markets • Rising equity market dispersion	● (green) ● (yellow)
SUBSTITUTES	**Event Driven**	Taking positions based on an event such as a merger or acquisition	▼	• Positively trending equity markets • Rising mergers and acquisitions • Narrowing credit spreads	● (green) ● (yellow) ● (yellow)
SUBSTITUTES	**Relative Value**	Looking to take advantage of differences in pricing of related financial instruments	▼	• Lower interest rate levels • Cost of funding, narrowing credit spreads	● (green) ● (yellow)
DIVERSIFIERS	**Global Macro**	Looking to exploit themes, trends and asset class relationships (correlations) at a global level, generally with leverage	▼	• Rising volatility and credit spreads • Increasing cross asset dispersion • Clear market trends (up/down)	● (red) ● (yellow) ● (green)

Source: Standard Chartered Global Investment Committee
Legend: ▲ Most preferred | ▼ Least preferred | ◆ Neutral | ● Not supportive | ● Neutral | ● Supportive

Amongst Global Investment Committee's highest asset class convictions

Our suggested Alternatives Allocation for 2018 is diversified across alternative strategies with a tilt towards Equity Hedge.

Our Global Investment Committee introduced an Alternatives Allocation in our Outlook 2017 with sub-strategies including Equity Hedge, Relative Value, Event Driven and Global Macro. We've highlighted that liquid alternative strategies can provide investors with increased transparency and greater liquidity in traditionally "harder to access" alternative asset class hedge fund strategies.

We also discussed viewing these strategies as potential (1) substitute and (2) diversifying additions to an investment allocation. In brief, "substitutes" are strategies that carry higher correlations, or perform more similarly, with traditional asset classes, but generally with lower volatility, e.g. Equity Hedge strategies as a substitute for traditional equity. A "diversifier" like Global Macro, carries a lower correlation to traditional assets, and can provide insurance-like benefits to an allocation when markets may be falling.

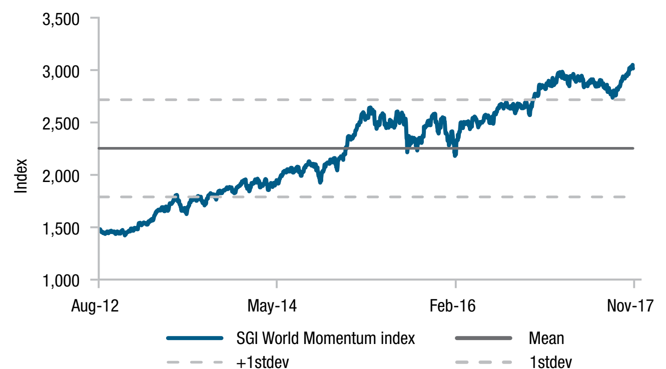
Over the course of the year, we developed a practical framework of key drivers for the sub-strategies and regularly provided commentary on both the allocation as well as its performance. We now take stock, reflect on the +5.3% performance of the allocation over the past twelve months and share our views for the coming year.

Potential benefits of an Alternatives Allocation during rising yields

In a rising yield environment, we believe that an Alternatives Allocation can be beneficial within a longer-term investment allocation. Analysing periods of yield rising environments, we see that individual alternatives strategies are impacted differently. We analysed periods of a rising 10-year US Treasury yield from 2001 to 2017 (Figure 3) and observed that the hit rate, the percentage of positive returning periods, was clearly highest for our Alternatives Allocation[1] i.e. 92% of the periods of rising yields resulted in positive performance for our Alternatives Allocation. When comparing amongst strategies, the Alternatives Allocation was in line with the average return and captured one of the lowest average pullbacks across strategies.

Figure 2

Equity Hedge supported by strong equity market momentum



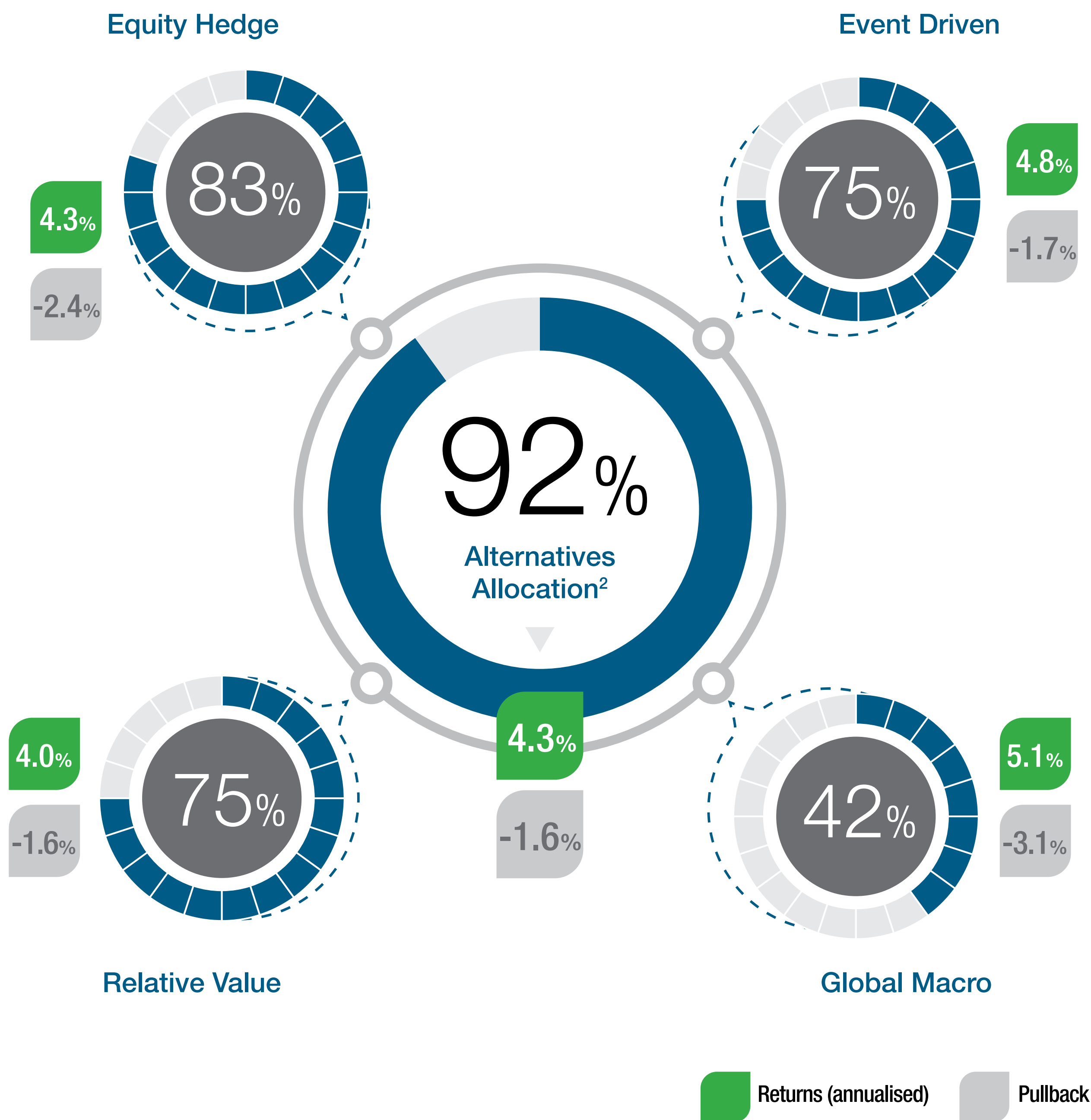
Source: Societe Generale, Bloomberg, Standard Chartered

1 Alternatives Allocation used in study was published on page 23, Global Market Outlook, November 2017.

Figure 3

During rising yields – Diversified Alternatives Allocation has highest capital preservation qualities

The percentage (in the circles) reflects the historical probabilities of each asset class generating positive returns when yields rise

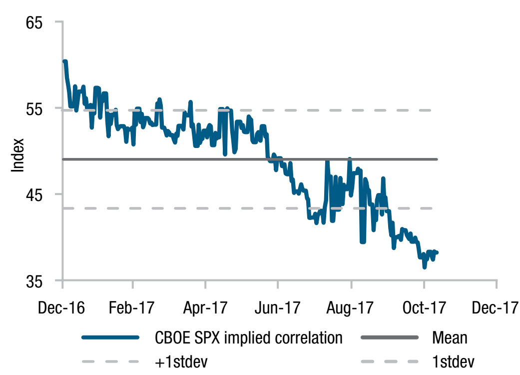


Source: HFRX, Bloomberg, Standard Chartered

2 Alternatives Allocation used in study was published on page 23, Global Market Outlook, November 2017.

Figure 4

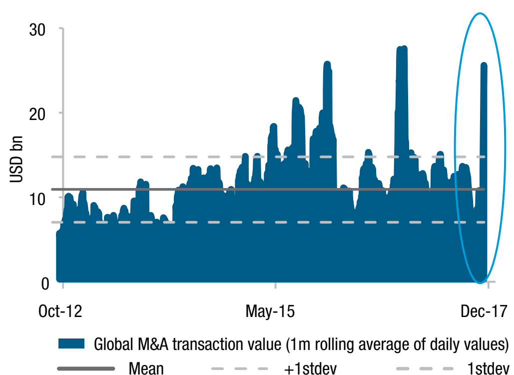
S&P stock correlations have been falling within the index, leading to increasing opportunities for Equity Hedge managers



Source: CBOE, Bloomberg, Standard Chartered

Figure 5

Recent Global M&A transaction value in-line multi-year averages, supporting Event Driven



Source: Bloomberg, Standard Chartered

Equity Hedge

Relative preference for the strategy entering 2018

Equity Hedge has been the top performer amongst alternative strategies, delivering +7.9% since our Outlook 2017. Our Global Investment Committee raised Equity Hedge to preferred in February 2017 and continue to hold this view. A robust global growth backdrop, increasing corporate earnings and continuing discussions on fiscal reforms have continued to lead equity markets higher. As positively trending equity markets or equity market momentum is a key driver for Equity Hedge, the strong equity market performance laid the foundations for a positive Equity Hedge performance in 2017.

Despite challenging equity market valuations, Equity Hedge strategies have continued to find performance enhancing trades with both long and short selling strategies. Rising equity market dispersion, while somewhat volatile, has also been key in providing Equity Hedge strategies increased opportunities this year. As correlations between stocks and sectors fall (Figure 4), dispersion rises. A "greater scattering of returns" increases the potential for relative trades between different stocks and sectors. One equity sector which has performed particularly well this year has been global technology, which is also well represented within Equity Hedge strategies.

As we continue to favour equities over other asset classes going into 2018, Equity Hedge remains a relative preference within a diversified alternatives allocation, given a constructive outlook for its key drivers. A risk for this strategy is that there is a high correlation to equity market performance. If equity markets were to come under pressure, Equity Hedge would most likely be similarly impacted, albeit with lower drawdowns.

Relative Value and Event Driven

Core strategies within a diversified alternatives allocation

While our clear relative preference has been for Equity Hedge, Relative Value and Event Driven remained core strategies through 2017, delivering 3.3% and 6.9% since Outlook 2017. In recent years, Relative Value has been supported by a low interest rate regime as strategies, which can often employ amounts of leverage, benefitted from cheaper funding costs. This year's benign inflation outlook and potentially gradual interest rate rising cycle, suggests Relative Value could continue to benefit from comparatively lower funding costs. We have also seen rising dispersion across fixed income, both within sectors and across countries. As an example, US credit spread dispersion has increased, giving greater potential for credit long and short strategies.

Event Driven key drivers have continued to flourish this year. Equity markets have trended strongly and recent global and regional M&A activity has remained consistently near multi-year averages (Figure 5). Potential tax cuts and the repatriation of overseas funds by US companies may also be supportive for M&A transactions. However, with further interest rate rises on the horizon, companies may rush to "push through" deals prior to the hiking cycle. While we may continue to see good performance within Event Driven for months to come, potential rate rises may signal headwinds going forward as liquidity to finance deals may be harder to source.

Global Macro

Core strategy within a diversified alternatives allocation; the outlook is brightening

While Global Macro was our most preferred strategy going into 2017, we reduced our conviction in March due to the increasing pivot to reflation and the reduced need for insurance-like assets. Global Macro strategies have continued their multi-year struggle, lagging other strategies in 2017 and delivering 1.2% since Outlook 2017. Our Global Investment Committee's conviction for Global Macro has risen of late, as the current environment may provide some welcome support for the beleaguered strategy.

While volatility levels have remained at lows (Figure 6), this year saw cross asset correlations break down (Figure 7), i.e. not all assets moved in the same direction as had most recently been the case for periods in 2016 and early 2017. This rising dispersion, or greater scattering of asset class returns, has been driven in part through diverging central bank policies. These have given rise to variations in interest rates and currencies and potentially provided fertile ground for trading opportunities. The positioning of Global Macro as a "diversifier", with lower correlations to traditional assets and potentially insurance-like characteristics, can be beneficial when putting together a longer-term diversified investment allocation.

Conclusion

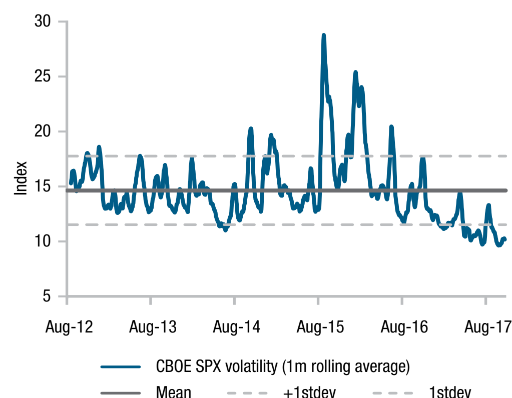
Diversified Alternatives Allocation can be a good approach

Our Global Investment Committee ranks Alternatives as one of its highest convictions amongst asset classes. Going into 2018, we believe an alternatives allocation can be beneficial within a longer-term diversified investment allocation as we navigate through an environment of potentially rising yields.

We continue to advocate a diversified allocation of alternatives strategies, and tilt our allocation in favour of our relative preference of Equity Hedge amongst sub-strategies. Our allocation weights are: Equity Hedge 36%, Relative Value 25%, Event Driven 23%, and Global Macro 16%. For more on how to build an alternatives allocation, please refer to the Outlook 2017 report.

Figure 6

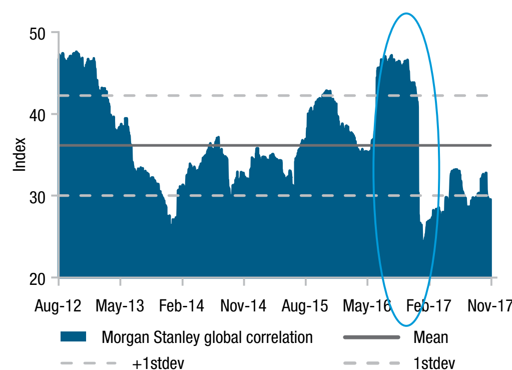
S&P equity volatility at multi-year lows



Source: CBOE, Bloomberg, Standard Chartered

Figure 7

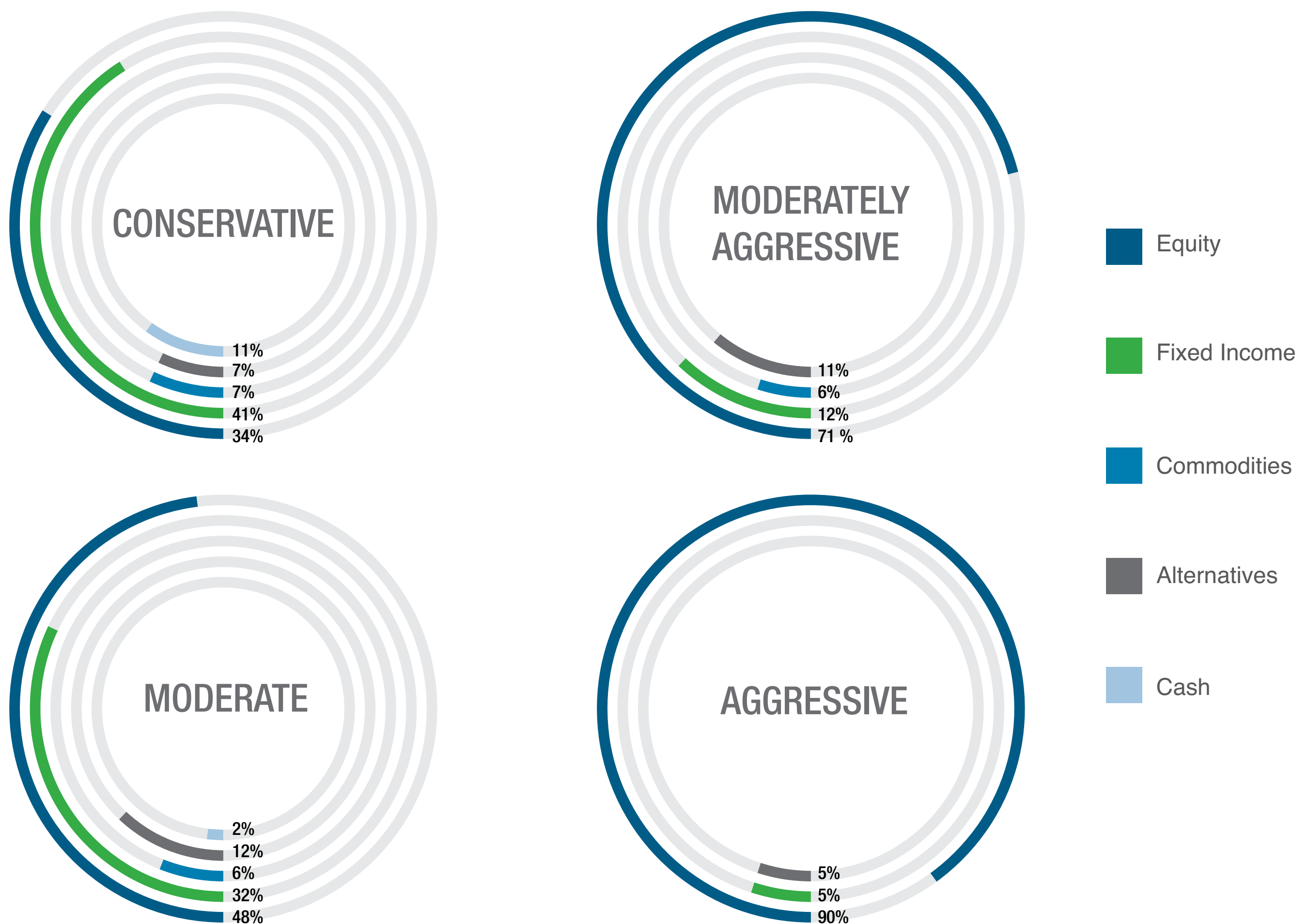
Cross Asset correlations collapsed early this year



Source: Morgan Stanley, Bloomberg, Standard Chartered

APPENDIX

Asset allocation **Global**



		View vs. SAA	Conservative	Moderate	Moderately Aggressive	Aggressive
Cash		Underweight	11	2	0	0
Fixed Income		Neutral	41	32	12	5
Equity		Overweight	34	48	71	90
Commodities		Neutral	7	6	6	0
Alternative Strategies		Neutral	7	12	11	5
Asset Class	**Region**					
Cash & Cash Equivalents	USD Cash	Underweight	11	2	0	0
Developed Market (DM) Investment Grade (IG) Bonds	DM IG Sovereign	Underweight	18	14	6	2
	DM IG Corporate	Neutral	14	11	4	3
Developed Market High Yield (HY) Bonds	DM HY	Neutral	4	3	2	0
Emerging Market Bonds	EM Sovereign HC	Overweight	5	4	0	0
	EM Sovereign LC	Neutral	0	0	0	0
	Asia Corporate HC	Overweight	0	0	0	0
Developed Market Equity	North America	Neutral	16	24	36	46
	Europe ex-UK	Overweight	8	10	15	18
	UK	Underweight	0	0	0	0
	Japan	Neutral	3	4	5	7
Emerging Market Equity	Asia ex-Japan	Overweight	7	10	13	16
	Non-Asia EM	Neutral	0	0	2	3
Commodities	Commodities	Neutral	7	6	6	0
Hedge FoF/CTAs	Alternatives	Neutral	7	12	11	5

All figures in %. For illustrative purpose only. Please refer to the Important information section at the end of this document for more details.
Source: Standard Chartered

Asset allocation **Asia**

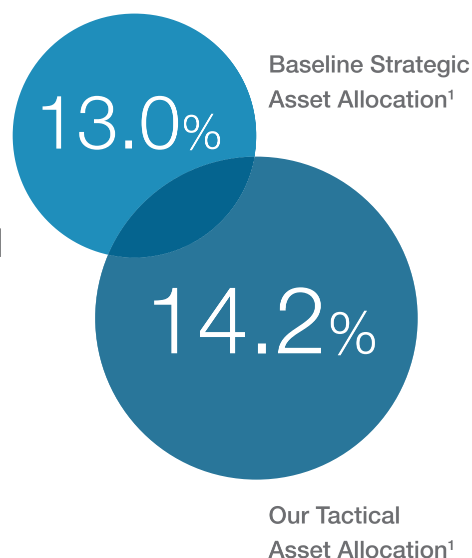
		View vs. SAA	Conservative	Moderate	Moderately Aggressive	Aggressive
Cash		Underweight	9	0	0	0
Fixed Income		Neutral	54	42	18	4
Equity		Overweight	25	43	68	87
Commodities		Neutral	6	5	5	4
Alternative Strategies		Neutral	6	10	9	5
Asset Class	**Region**					
Cash & Cash Equivalents	Cash	Underweight	9	0	0	0
Developed Market (DM) Investment Grade (IG) Bonds	DM IG Sovereign	Underweight	9	7	2	0
	DM IG Corporate	Neutral	8	6	3	0
Developed Market High Yield (HY) Bonds	DM HY	Neutral	3	3	0	0
Emerging Market Bonds	EM Sovereign HC	Overweight	13	10	5	0
	EM Sovereign LC	Neutral	8	6	3	0
	Asia Corporate HC	Overweight	13	10	5	4
Developed Market Equity	North America	Neutral	6	11	17	22
	Europe ex-UK	Overweight	5	10	15	19
	UK	Underweight	0	0	0	0
	Japan	Neutral	2	0	3	3
Emerging Market Equity	Asia ex-Japan	Overweight	10	19	28	36
	Non-Asia EM	Neutral	2	3	5	7
Commodities	Commodities	Neutral	6	5	5	4
Hedge FoF/CTAs	Alternatives	Neutral	6	10	9	5

All figures in %. For illustrative purpose only. Please refer to the Important information section at the end of this document for more details.
Source: Standard Chartered

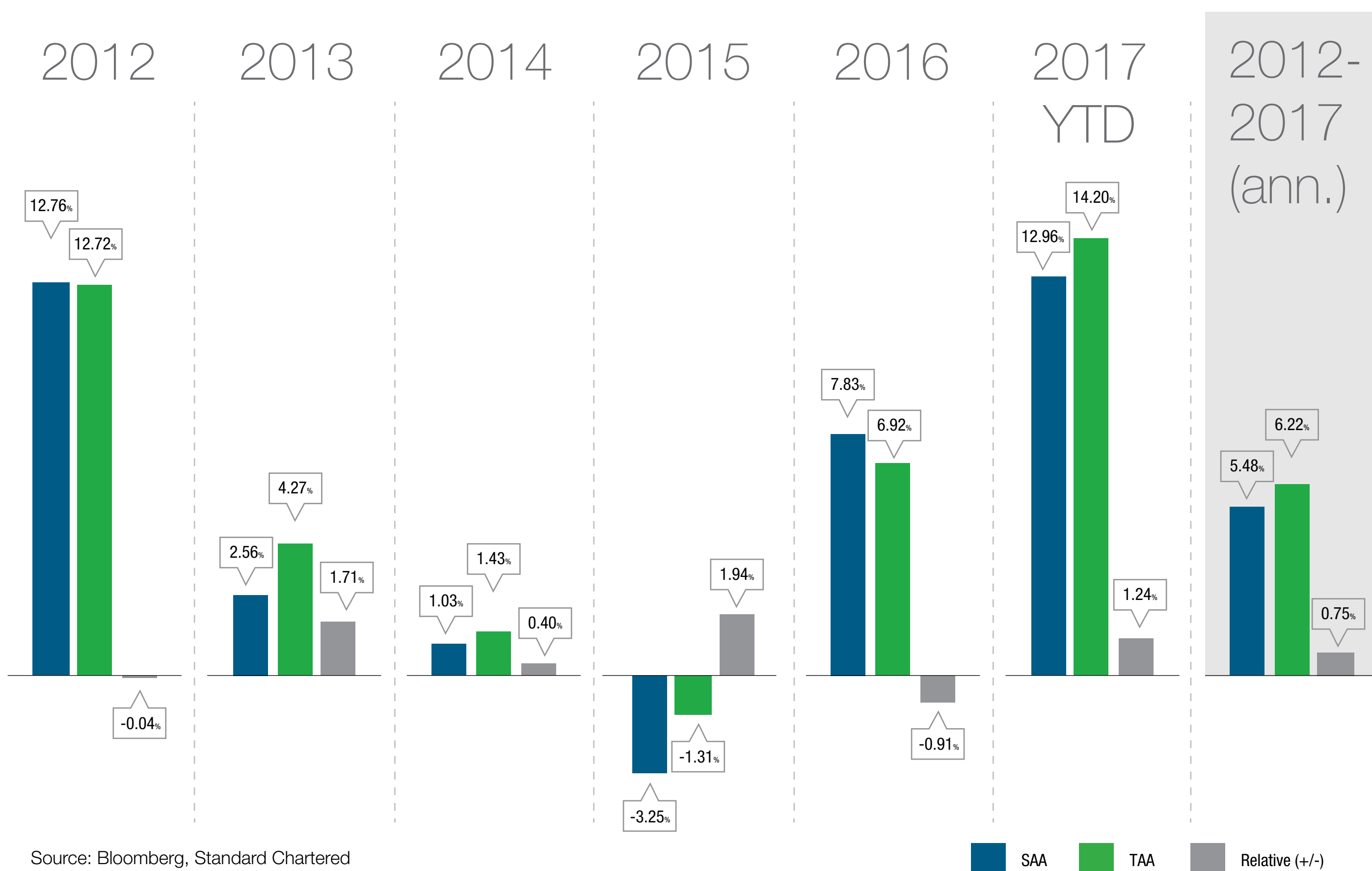
Our 2017 calls in review

Manpreet Gill

Equity and bond markets both delivered strong performance in 2017. This provided significant support for the performance of our views. As a reference point, our moderate risk, *Asia-focused strategic asset allocation* baseline model generated total returns of 13.0%[1] since we released our Outlook 2017. The corresponding *tactical allocation model* – which incorporates our tactical asset class preferences through the year – was up 14.2%[1].



Annual performance of our Tactical Asset Allocation[1] relative to the Strategic Asset Allocation[1] baseline model



Source: Bloomberg, Standard Chartered

1 SAA is our Asia-focused moderate **strategic** asset allocation. This is made up of 5% USD cash, 45% bonds, 35% equities, 5% commodities and 10% alternatives. TAA is our Asia-focused moderate **tactical** asset allocation which tilts the SAA allocation according to the SCB Global Investment Committee's views. TAA and SAA performance measure from 15 December 2016 to 5 December 2017.

Our Outlook 2017, published on 15 December 2016, highlighted the likelihood that we would see a 'pivot' towards reflation (ie. rising growth and modestly higher inflation), although we emphasised that 'the magnitude, pace and implications are all open to significant debate and may have been overly priced in, especially in the near term.' This proved prescient. While growth expectations have been continually revised higher through 2017, inflation has remained extremely benign. Meanwhile, euphoria over the prospects of a significant US fiscal stimulus went full circle through the year, waning only a few months after Trump's election before gaining a second, albeit weaker tailwind very late in the year; this path was echoed in both US Treasury yields as well as tax reform-sensitive assets like US small & mid-cap equities.

"We suggest investors keep one foot firmly planted in asset classes that might benefit from a muddle-through scenario while taking a step (pivoting) towards assets that might do well in a reflationary scenario."

– Page 7, #pivot?, Outlook 2017

The above outlook led us to argue that we would see a more balanced investment allocation outperform a pure multi-asset income approach, while still expecting both to generate positive returns. In essence, this was a view that a more growth-oriented bias to equity investments made sense relative to a continued focus on income-oriented assets like high yield bonds and high dividend yielding equities. Again, this view has worked well, with our balanced allocation delivering absolute returns of 14.7% and the multi-asset income allocation posting returns of 11.4%. Within multi-asset income, all of the selected asset classes generated positive returns over the course of the year.

Our final theme was that our suggested alternative strategy allocation would deliver positive returns. This has also worked with the allocation rising 5.3% over the same period.

Our more detailed asset class views have generally performed well, although there has been some dispersion around this. In absolute terms, the vast majority of our asset class views through the year generated positive returns (only four delivered negative returns). However, the relative performance is more mixed. See the table for more details.

Equities

Being overweight global equities throughout 2017 clearly helped as they outperformed bonds, rising 21.3% since we published our Outlook 2017 on 15 December 2016. Meanwhile, our decision to shift our regional preference to Euro area and Asia ex-Japan equities, in February and March respectively, was well-timed and helped to offset underperformance from our overweight US and Japan equity views earlier in the year.

Within Asia, we successfully picked two markets (China and Korea) that outperformed the region's benchmark index, although we were late on highlighting a preference for Korean equities which meant that the outperformance here was ultimately minimal. These picks followed an earlier preference for Indian and Indonesian equity markets, where the expected outperformance failed to materialise by the time we closed these views in May and April, respectively, though both did end up delivering solid positive absolute returns.

GLOBAL EQUITIES ROSE

21.3%

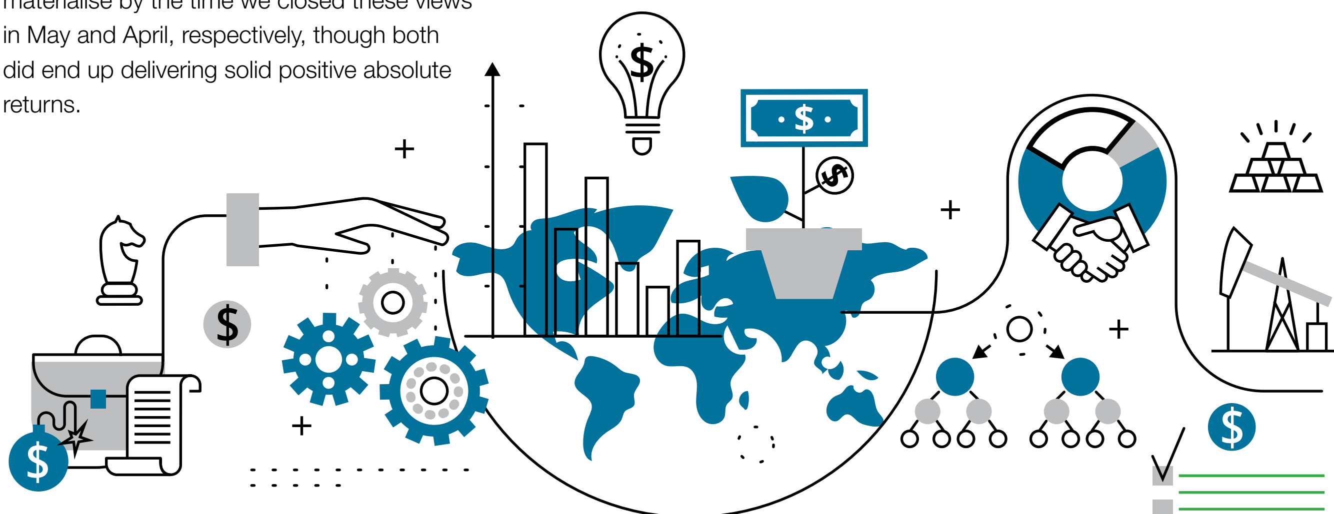
SINCE WE PUBLISHED OUR OUTLOOK 2017 ON 15 DECEMBER 2016

FX

Our views were disappointing, with only half of our views generating positive absolute returns. However, closing underperforming views reasonably early meant average returns were still positive. While our basket of high yielding EM currencies generated positive returns, they underperformed the benchmark, which set a very high bar due to very strong East European currency returns.

Commodities

Brent oil prices have thus far remained largely capped at USD 60-65/bbl. This was consistent with our expectations, though we closed the view too early. Gold remained broadly within a USD 1150-1350 range whilst offering numerous tactical opportunities, as expected.



Bonds

Within bonds, our preference for corporate bonds over government bonds once again worked well, with corporate bond spreads narrowing significantly. This was epitomised by the strong performance of Developed Market High Yield bonds through May, when increasing valuations and deteriorating fundamentals made us more cautious. However, the shift to Emerging Market USD government bonds from that time has only just kept up with our bond benchmark and failed to outperform developed market high yield bonds since the switch.

Thematic and absolute return

Performance of our thematic and absolute return views was again generally positive. We hit the sweet spot with our China 'new economy' theme, with the chosen reference basket of stocks rising 35.7% in just under 6 months. Meanwhile, our positive view on the US technology sector similarly performed very well. In hindsight, our mistake was to 'take profit' on these views too early. Our preference for US small cap stocks failed to outperform the broader equity market benchmark, despite delivering positive returns, as hopes of a swift fiscal stimulus faded. Finally, our positive view on Euro area banks and US floating rate senior loans played out as expected, delivering 11.7% and 4.2% respectively.

Performance of key #pivot? themes since Outlook 2017

	Date Open	Absolute	Relative
Key themes (12 months)			
Balanced allocation to outperform multi-asset income allocation[1]	15 Dec 2016	-	✔
Multi-asset income allocation to deliver positive absolute return[2]	15 Dec 2016	✔	-
Alternative strategies allocation to deliver positive absolute returns[3]	15 Dec 2016	✔	-
Key asset allocation calls (12 months)			
Corporate Bonds to outperform Government Bonds[4]	15 Dec 2016	-	✔
EM USD government bonds to outperform broader bond universe	26 May 2017	-	✔
Europe ex UK to outperform global equities	24 Feb 2017	-	✔
Asia ex-Japan to outperform global equities	30 Mar 2017	-	✔
China to outperform Asia ex-Japan equities	24 Feb 2017	-	✔
Korea to outperform Asia ex-Japan equities	23 Jun 2017	-	✔
Absolute return calls (Less than 12 months)			
Bullish USD/JPY	30 Jun 2017	✔	-
Bullish Euro area bank sector equities	28 Apr 2017	✔	-
Bullish US floating rate senior loans	15 Dec 2016	✔	-
Closed calls (Less than 12 months)			
EM LC government bonds to outperform broader bond universe (closed on 21 Sep 2017)	23 Jun 2017	-	✔
BRL, RUB, IDR and INR basket[5] to outperform EM FX Index (closed on 24 Aug 2017)	15 Dec 2016	-	✘
Bullish EUR/USD (closed on 24 Aug 2017)	28 Apr 2017	✔	-
Bullish Brent crude oil price (closed on 24 Aug 2017)	15 Dec 2016	✘	-
Bullish Korea equities (closed on 10 Aug 2017)	5 May 2017	✔	-
Bearish AUD/USD (closed on 21 Jul 2017)	30 Jun 2017	✘	-
US Technology to deliver positive returns and outperform US equities (closed on 23 Jun 2017)	15 Dec 2016	✔	✔
'New China' equities[6] to deliver positive returns (closed on 09 Jun 2017)	15 Dec 2016	✔	-
Positive USD/CNY (closed on 2 Jun 2017)	15 Dec 2016	✘	-
DM HY Bonds to outperform broader bond universe (closed on 25 May 2017)	15 Dec 2016	-	✔
India to deliver positive returns and outperform Asia ex Japan equities (closed on 25 May 2017)	15 Dec 2016	✔	✘
Japan (FX-hedged) to deliver positive returns and outperform global equities (closed on 27 Apr 2017)	15 Dec 2016	✔	✘
US Small Cap to deliver positive returns and outperform US equities (closed on 27 Apr 2017)	15 Dec 2016	✔	✘
Indonesia to deliver positive returns and outperform Asia ex Japan equities (closed on 27 Apr 2017)	15 Dec 2016	✔	✘
US equities to deliver positive returns and outperform global equities (closed on 30 Mar 2017)	15 Dec 2016	✔	✘
Negative EUR/USD (closed on 17 Feb 2017)	15 Dec 2016	✘	-
Positive AUD/USD (closed on 17 Feb 2017)	15 Dec 2016	✔	-

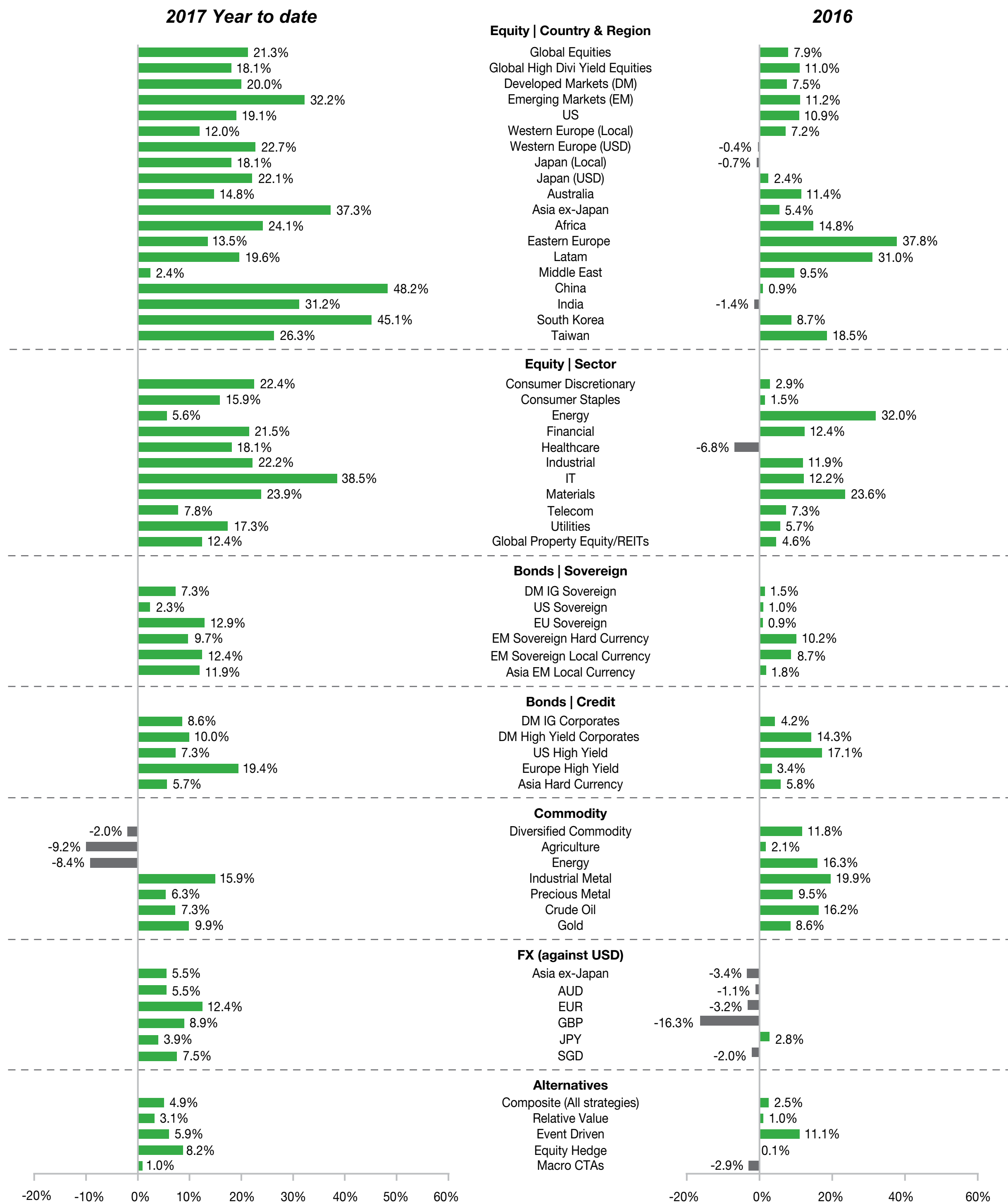
Source: Bloomberg, Standard Chartered. Performance measured from 15 December 2016 (release date of our 2017 Outlook) to 5 December 2017 or when the view was closed.

1 Balanced allocation as described in our Global Market Outlook, Fresh opportunities to pivot, 31 March 2017, page 28
2 Income allocation is as described in our H2 Outlook, Should I stay, or…?, 30 June 2017, page 30
3 Alternative strategies allocation is described in 'Outlook 2017: #pivot', Figure 13, page 36
4 A custom-made composite of 44% Citi WorldBIG Corp Index Currency
5 A custom-made equally weighted index of the BRL, RUB, IDR and INR currencies
6 'New China' index is a custom-made market-cap-weighted index of the following MSCI China industry groups: pharmaceuticals, biotech and life sciences, healthcare equipment

✔ – Correct call; ✘ – Missed call

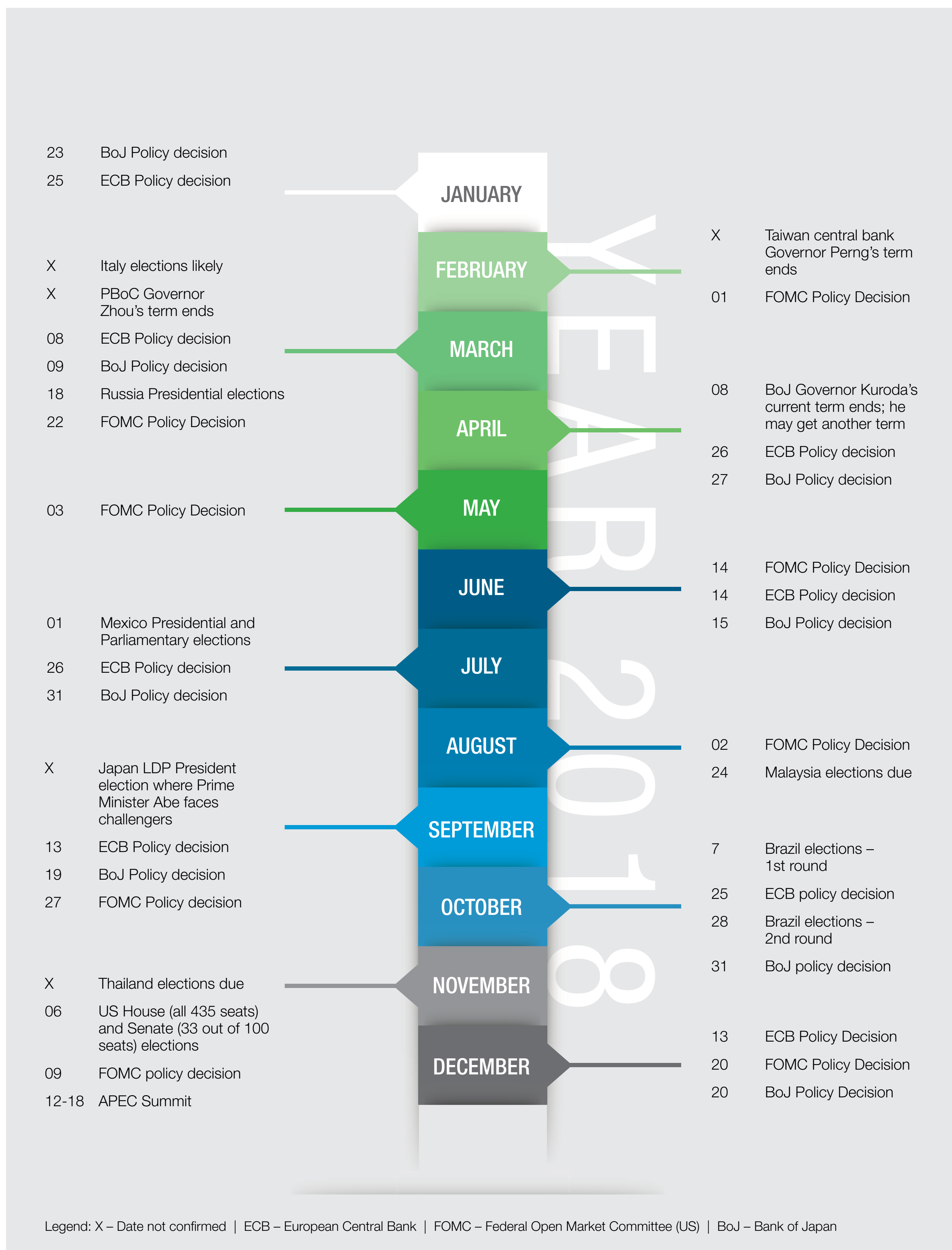
Past performance is not an indication of future performance. There is no assurance, representation or prediction given as to any results or returns that would actually be achieved in a transaction based on any historical data.

2017 markets summary



Source: MSCI, JP Morgan, Barclays, Citigroup, Dow Jones, HFRX, FTSE, Bloomberg, Standard Chartered
*All performance shown in USD terms, unless otherwise stated.
The column '2017 Year to date' indicates performance from 31 December 2016 to 5 December 2017.
The column '2016' indicates performance from 31 December 2015 to 31 December 2016.

2018 key events



Legend: X – Date not confirmed | ECB – European Central Bank | FOMC – Federal Open Market Committee (US) | BoJ – Bank of Japan

Meet the team

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DJ Cheong
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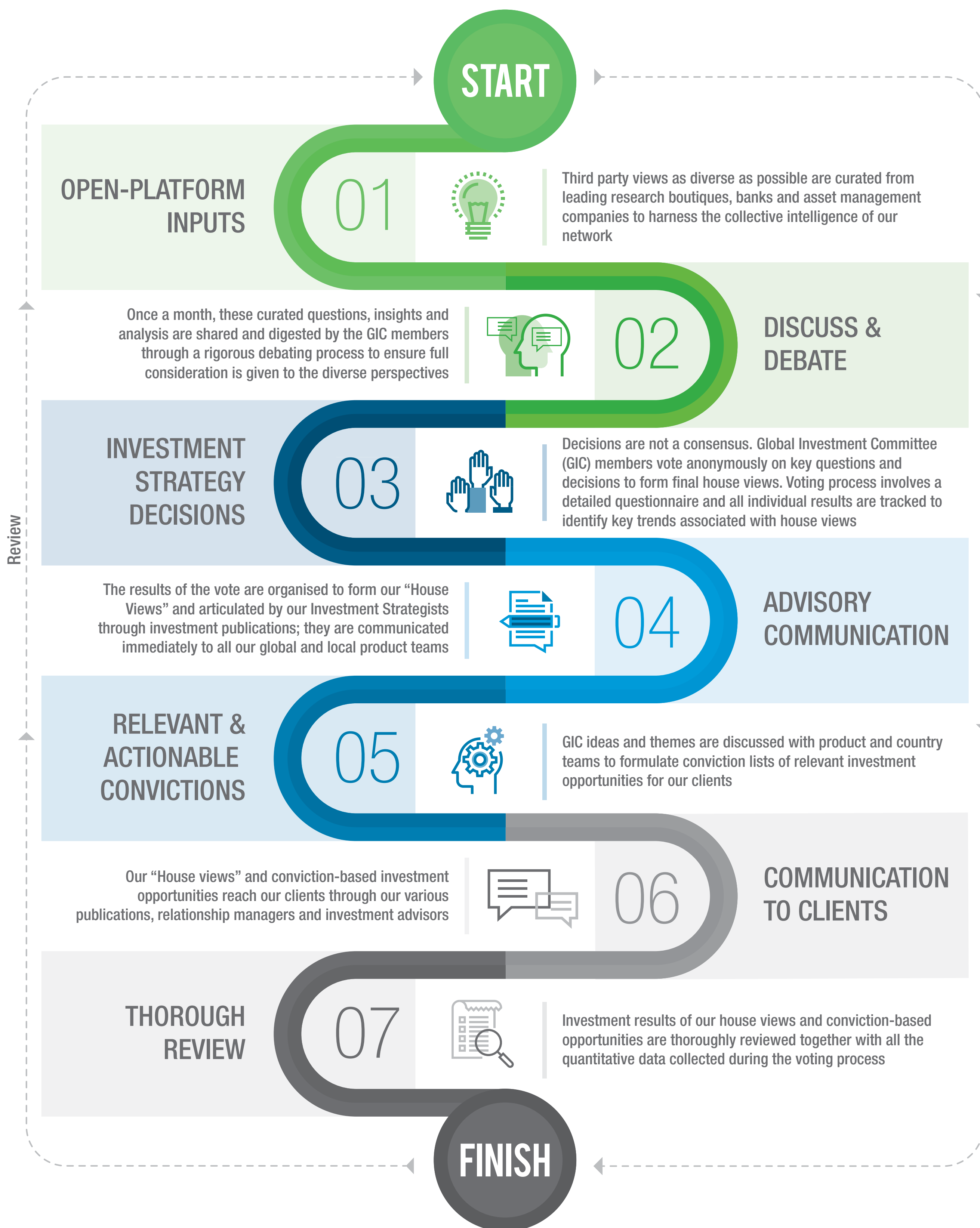
Investment view generation
Our adaptive process

We have a robust advisory process ensuring we deliver high-quality insights and solutions to our clients.



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