Global Market Outlook

24 February 2017

Reflationary pivot continues

Reflationary pivot continues. Consensus global economic growth and inflation forecasts have risen in recent months. Expectations of a pivot from a reliance on monetary policy to more supportive fiscal policies remain strong, with the market awaiting clarity on how easy it will be for President Trump to implement his pro-growth agenda. Emerging Market economies are bottoming, with China's growth stabilising and Brazil easing monetary policy dramatically.

Equity markets break to new highs, Euro area prospects improve. Global equities, our preferred asset class, broke to new all-time highs in February on the back of upgrades to earnings growth forecasts. We believe any pullback is likely to be limited. We add Euro area as a preferred equity market, alongside the US, as we expect earnings growth to accelerate and political risks to ultimately decline over the next 12 months. We would use anticipated bouts of volatility to average into Euro area equities. We continue to believe that scenario-based investing is important, especially as we get closer to the end of the global economic cycle.

Managing interest rate risks key. We prefer US senior loans and Developed Market high yield bonds as they are less sensitive to rising US interest rates. From a currency perspective, rising US interest rates may offer the US dollar some support in the near term. We closed our positive Australian dollar and negative Euro calls last week (see pages 24-26).

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Following the reflation trend

- Equity markets and High Yield (HY) bonds have continued to post positive returns since we published our 2017 Outlook in mid-December. However, government bond yields and the USD have been range-bound.
- Some technical and positioning indicators argue the ‘Trump rally’ may take a breather. However, we caution against trying aggressively to time the market as any pullback is likely to be relatively shallow.
- We would continue to pivot towards raising our equity market exposure, particularly in the US and the Euro area. We continue to like senior floating rate loans, although we would look for a better entry point to US and European HY bonds.

Evidence of reflation underpins risk asset rally

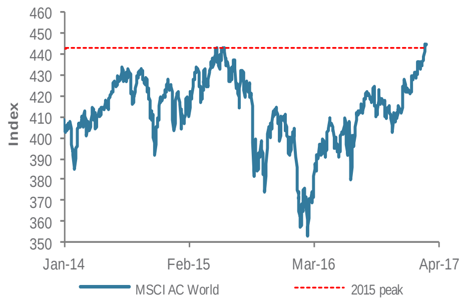
Recent economic data makes us increasingly confident that we are pivoting towards a reflationary economic environment. This is particularly so in the US, where consumer and business confidence survey results have improved significantly and the recent earnings season has been strong. The Euro area increasingly appears to be following suit, Japan less so. Most Asia economies are seeing a rebound in inflation, but growth is patchy.

While higher growth and earnings are positive for equities, the main question is whether central banks will turn less supportive. In our view, the Fed remains on track to raise rates twice this year, while the BoJ will struggle to tighten policy. Although the ECB is currently signalling no change, we would watch incoming data closely as this could change. In Asia, central banks (most recently the RBI) appear to have brought easing cycles to an end.

Finally, the new US administration’s policies will be key and would focus on three areas: (a) corporate tax reforms, (b) any rise in fiscal spending and (c) trade policies.

Figure 1: Global equity market benchmark breaks through the 2015 high

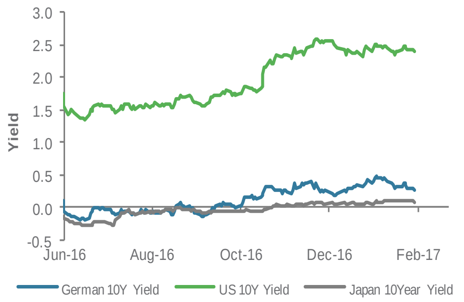
MSCI All-Country World index



Source: Bloomberg, Standard Chartered

Figure 2: Government bond yields have risen over the past six months, led by US yields

US, Germany and Japan 10-year government bond yields, % y/y



Source: Bloomberg, Standard Chartered

We prefer equities over bonds

We still expect a multi-asset income allocation to generate positive returns

Diversified alternative strategies to generate positive returns

IMPLICATIONS FOR INVESTORS

Investment strategy

Tweak equity exposure, be patient on HY

Our rising confidence in reflation means equities overall remain our most preferred asset class. The US and the Euro area are our most preferred regions given the reflationary trend appears strongest there. While we expect any global equity market pullbacks to be relatively limited in nature, spikes of volatility in Europe are quite likely as we head towards key elections.

Our conviction on Japan's equity market over the next 12 months, though, has reduced. Positive equity market returns remain highly dependent on a view of further yen weakness, a view that we believe is at risk from two fronts. First, a bout of safe-haven demand (for the yen) and, second, a rise in inflation-adjusted yields as inflation fails to firmly take hold. That said, in the short term, Japan's equity market looks set to break higher on the back of a sharp upgrade to earnings forecasts.

While Emerging Market (EM) equities have performed well over the past two months against the backdrop of rising commodity prices and USD stability. While we remain optimistic about the outlook for relative economic growth differentials to move in EM's favour over the next 12-24 months, we believe commodity prices such as iron ore, copper and (in the short term at least) oil may have got ahead of themselves. Meanwhile, we believe the USD may strengthen marginally in the coming months as we move towards the next rate hike. As such, we retain Emerging Market equities, including Asia ex-Japan equities, as a core holding for now.

In bonds, our conviction on reflationary bond asset classes that are less sensitive to a rise in US Treasury yields remains in place. This means, we continue to like senior floating rate loans and US and European HY bonds, though given the magnitude of the rally in the latter, we would await a better opportunity to raise exposure further. Income investors could, instead, look to multi-asset income solutions in the short term.

Lock in some profit

The figure on page 6 illustrates that most of our key investment themes from '#pivot?' are generally performing well, albeit with a few exceptions.

Given our evolving views and the recent market performance, we believe there is a case to close two ideas. We took profit on the positive AUD/USD view last week, given the pair may have already priced in an increasingly reflationary environment. We have also closed our negative view on the EUR/USD outlook, given our concerns that absent a sharp increase in the political risk premium in Europe, the ECB could reduce the size ('taper') of its quantitative easing programme at some point later this year.

Standard Chartered

Investment strategy

Figure 3: Our Tactical Asset Allocation views (12M) USD

Asset class	Sub-asset class	Relative outlook	Rationale
Multi-Asset Strategies	Multi-Asset Income	Overweight	Low policy rates, low/negative yields expected to remain a support
	Multi-Asset Macro	Overweight	Insurance-like asset against a surge in yields or an abrupt end of the US cycle
Equities (Overweight)	US	Overweight	Earnings recovery underway; full valuations; Fed rate hike a risk
	Euro area	Overweight	Earnings visibility poor; valuations high; European politics a concern
	UK	Underweight	Brexit vote clouds earnings outlook; full valuations; weak GBP helps
	Japan	Neutral	Inexpensive valuations; risk of extreme outcomes (up or down) is high
	Asia ex-Japan	Neutral	Earnings uptick positive; valuations reasonable; USD strength a worry
	Non-Asia EM	Neutral	Commodities key to earnings; valuations full; flows supportive
Bonds (Underweight)	DM govt	Underweight	Low yield; full valuations; Fed policy and higher inflation are risks
	EM govt (USD)	Neutral	Attractive yield; reasonable valuations; trade policy is a risk
	DM IG corporate	Neutral	Reasonable yield; full valuations; defensive characteristics
	DM HY corporate	Overweight	Attractive yield; expensive valuations; default rates should trend lower
	Asian corporate	Neutral	Moderate yield; reasonable valuations; demand/supply favourable
	EM (LCY)	Neutral	Attractive yield; reasonable valuation; stronger USD is a risk
Currencies	USD	Neutral	Rate differentials stabilising; Fed rate trajectory key for further strength
	EUR	Neutral	Near-term politics to weigh in, however, longer-term outlook improving
	JPY	Neutral	More range-bound movement amid a confluence of risks in both directions
	GBP	Neutral	Near-term politics to limit upside, however, a lot of negatives may be priced
	AUD	Neutral	Surge in iron ore prices unlikely to sustain; a potential rise in volatility negative
	Asia ex-Japan	Neutral	Capital flows supportive, however, USD strength and trade tensions key risks

Legend: Overweight Neutral Underweight

Source: Standard Chartered

Investment strategy

Figure 4: #pivot? is key to investing in 2017

Performance of #pivot? themes since Outlook 2017

Asset class	View	Theme	Date open	Absolute	Relative
Bonds	Overweight	Corporate Bonds to outperform Government Bonds [1]	15 Dec 2016	NA	✓
	Overweight	DM HY Bonds to outperform Broader Bond universe	15 Dec 2016	NA	✓
	Overweight	US floating rate senior loans to deliver positive returns	15 Dec 2016	✓	NA
Equities	Overweight	US equities to deliver positive returns and outperform global equities	15 Dec 2016	✓	✓
	Overweight	Japan (FX-hedged) to deliver positive returns and outperform global equities	15 Dec 2016	✓	×
	Overweight	Europe ex UK to deliver positive returns and outperform global equities	24 Feb 2017	---	---
	Overweight	India to deliver positive returns and outperform Asia ex Japan equities	15 Dec 2016	✓	✓
	Overweight	China to deliver positive returns and outperform Asia ex Japan equities	24 Feb 2017	---	---
	Overweight	Indonesia to deliver positive returns and outperform Asia ex Japan equities	15 Dec 2016	✓	×
	Overweight	US Technology to deliver positive returns and outperform US equities	15 Dec 2016	✓	✓
	Overweight	US Small Cap to deliver positive returns and outperform US equities	15 Dec 2016	✓	×
	Overweight	'New China' equities to deliver positive returns[2]	15 Dec 2016	✓	NA
Commodities	Overweight	Brent Crude Oil to be higher in 2017	15 Dec 2016	✓	NA
Alternatives	Overweight	Alternative strategies allocation to deliver positive absolute returns[3]	15 Dec 2016	✓	NA
Currencies	Underweight	Negative EUR/USD (Closed as of 17-02-2017)	15 Dec 2016	×	NA
	Overweight	Positive AUD/USD (Closed as of 17-02-2017)	15 Dec 2016	✓	NA
	Overweight	Positive USD/CNY	15 Dec 2016	×	NA
	Overweight	BRL, RUB, IDR and INR basket[4] to outperform EM FX Index	15 Dec 2016	NA	✓
Multi-asset	Overweight	Multi-asset income allocation to deliver positive absolute return[5]	15 Dec 2016	✓	NA
	Overweight	Balanced allocation to outperform multi-asset income allocation[6]	15 Dec 2016	NA	×

Source: Bloomberg, Standard Chartered. Performance measured from 15 Dec 2016 (release date of our 2017 Outlook) to 23 Feb 2017 or when the view was closed

[1] A custom-made composite of 44% Citi WorldBIG Corp Index Currency Hedged USD and 56% Bloomberg Barclays Global High Yield Total Return Index

[2] '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 and services, software and services, retailing, telco services and consumer service

[3] Alternative strategies allocation is described in 'Outlook 2017: #pivot', Figure 13, page 36

[4] A custom-made equally weighted index of BRL, RUB, IDR and INR currencies

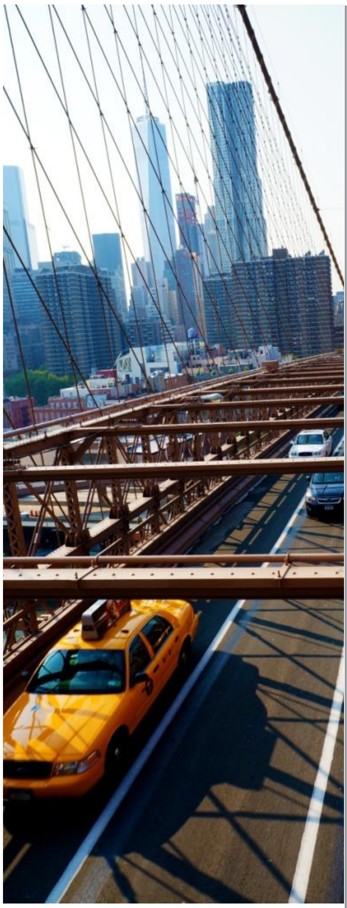
[5] Income allocation is as described in 'Outlook 2017: #pivot', Figure 11, page 34

[6] Balanced allocation is a mix of 50% global equity and 50% global fixed income

✓- Correct call; × - Missed call; NA - Not Applicable
Overweight (↑) - Expected to return more than the relative benchmark
Underweight (↓) - Expected to return less than the relative benchmark

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.

Perspectives on key client questions



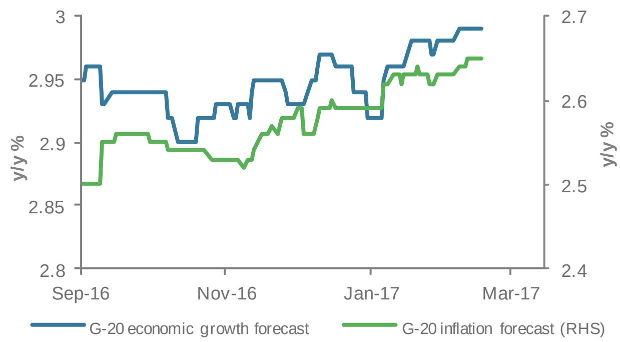
It has been two months since your 2017 Outlook was released. What has changed in these two months?

It is really a continuation of what we highlighted in our 2017 Outlook, with the pivot towards reflation or 'growflation' continuing. Global growth data has generally surprised on the upside and inflationary pressures, while certainly not out of control, are building.

One slight caveat is that soft data, such as business and consumer confidence, has been stronger than hard data, such as industrial production and business investment. We believe this is likely to be a leading indicator of future economic activity.

Figure 5: Growth and inflation expectations are on the rise

Consensus G-20 GDP growth and consumer price inflation forecasts



Source: Bloomberg, Standard Chartered

Against this backdrop, the key will be the outlook for the US administration's proposals on tax cuts, regulatory reforms, Obamacare and trade policies. So far, we have little detail in these areas, but we expect more clarity in the coming months.

Your preference for global equities has worked well so far. Do you expect this to continue and is now a good time to invest?

When looking over the next 12 months, we continue to believe that global equities will be the top-performing asset class. Normally, the start of the year is a time when analysts start downgrading their expectations for both economic and earnings growth. However, this has not been the case this year with growth forecasts being raised.

Of course, there is still significant uncertainty about the earnings outlook. However, there are many reasons to be positive, including accelerating global economic growth, potential corporate tax cuts and financial sector reforms in the US.

The short-term outlook is always difficult to judge. Some indicators suggest markets may be complacent. However, fund managers still have higher-than-normal cash holdings and there are increasing signs that investors are hedging the downside risks (hardly signs of complacency). Therefore, while there are always risks of a short-term pullback, we believe any such pullback will likely be limited to around 5% from current levels.

Q Euro area equities now rank alongside the US market in terms of preference. Are you not concerned about the political outlook?

A From a 12-month perspective, we are not too concerned about the political outlook. Indeed, we expect political risks to decline over that period as we move beyond key elections in the Netherlands, France and Germany.

That said, the path to reduced uncertainty may be very bumpy. France appears the most likely country to cause an upset, with the decline in François Fillon's popularity increasing the risk that the National Front candidate, Marine Le Pen, could even win the presidency.

However, this is not a central scenario. And even if she did, Le Pen would likely have to deal with an opposition-led National Assembly, which would severely curtail her ability to take France out of the Euro area.

Therefore, on a 12-month time horizon, we believe the reflationary story will dominate sentiment and support both earnings and equity markets. We would thus take advantage of any short-term equity market weakness to add to holdings, where appropriate.

Figure 6: Euro area growth expectations are rising, but so are political concerns

Consensus Euro area GDP growth expectations and the 10y French government bond yield spread over its German equivalent

Source: Bloomberg, Standard Chartered

Q What is your latest thinking on Emerging Market assets?

A We believe there are three main factors that are important for EMs: economic growth differentials and the outlook for the USD and commodity prices.

As we noted in our 2017 Outlook, the growth differential between EMs and Developed Markets (DMs) is expected to widen, a positive for EM assets. Meanwhile, commodity prices are expected to be relatively stable.

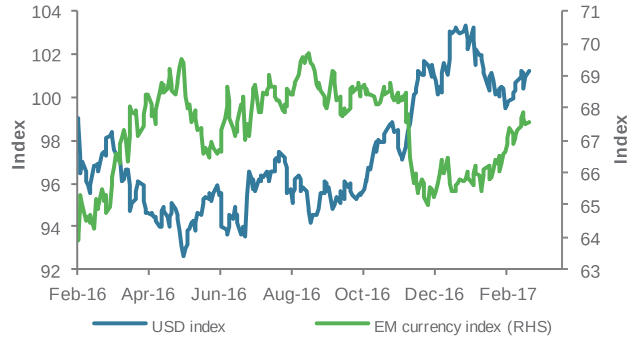
The key uncertainty is the USD outlook. While we have continually argued that the USD is unlikely to see a dramatic rise, there are significant risks to this view. In particular, should the US take an aggressively protectionist stance, it could undermine EM currencies significantly.

The good news is that the trade rhetoric appears to have softened significantly in recent times, but the US's precise policy stance on China remains unclear.

In summary, we are becoming more constructive on the outlook for Emerging Market assets. However, the presence of significant risks relating to the outlook for the USD and US trade policies, mean we prefer to retain our 'core holding' status for now.

Figure 7: EM currencies have performed well so far this year

USD (DXY) index and the JP Morgan EM currency index



Source: Bloomberg, Standard Chartered

Q You are still expecting US Treasury yields to rise. What is driving this and how much higher are they likely to go?

A We believe slightly stronger growth and rising inflationary pressures are consistent with higher US Treasury bond yields. We expect the Fed to gradually tighten monetary policy with two further interest rate hikes expected in 2017.

Therefore, we expect the US 10-year Treasury yield to rise as we move through 2017. Our central expectation is that the yield will rise to around 2.50-2.75% over the next 12 months. However, we see a 1 in 3 probability that yields will rise more than this.

Against this backdrop, we prefer to focus on areas that are less vulnerable to rising interest rates. DM High Yield bonds remain a key preference. That said, the fall in the yield premium available on these bonds has already been significant, suggesting investors may want to wait for a better opportunity before rotating their bond allocation in this direction.

The second area of preference is US senior loans, which are generally more defensive in nature. They also have the benefit of being floating rate assets. This means that higher interest rates actually benefit investors, another reason we like this asset class.

Within EM bonds, we continue to prefer USD-denominated bonds due to the currency risks outlined above.

Macro overview

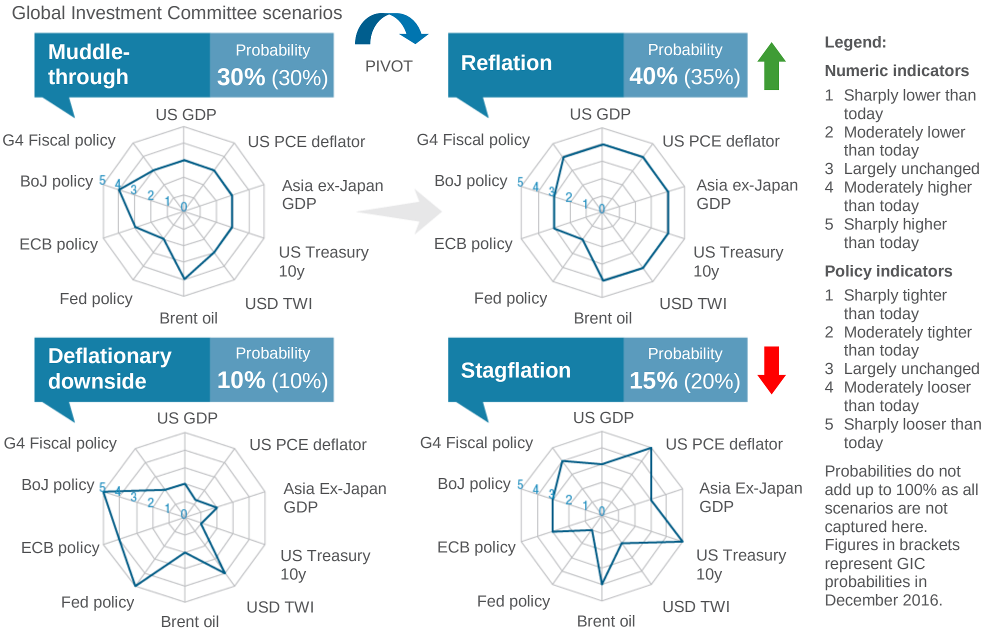
‘Reflation’ theme gains traction

- **Core scenario:** The global economy’s pivot towards reflation after years of a muddle-through environment of slow growth and low inflation appears to be continuing. Rising Euro area growth expectations have added a new dimension to the narrative.
- **Key risk:** A sharp rise in inflation is a potential risk to sustainable reflation. However, we believe excess capacities in the Euro area and China are likely to keep price rises in check. European politics and US trade disputes could also raise uncertainty.
- **Policy implication:** The pick-up in US growth and inflation and continued tightening in labour markets point to at least two Fed rate hikes this year. There is also rising expectations of less-accommodative policies from the ECB and the PBoC.

Euro area joins reflation story

Our Global Investment Committee (GIC) is becoming gradually more confident that the shift towards global reflation is sustainable. We now assign a 70% probability to reflation or muddle-through scenarios playing out this year, helped by a pick-up in growth and reduced deflation expectations in the Euro area. The risk of a slower-growth/higher-inflation (stagflation) scenario has declined as growth broadens out globally. Deflation remains a tail risk, especially if Trump’s stimulus plans fail to win Congress support, China slows down sharply or Europe elects anti-Euro area governments.

Figure 8: Pivot towards reflation continues



Source: Standard Chartered Global Investment Committee

The Fed likely to raise rates at least twice this year

Rising probability of the ECB tapering bond purchases this year

China to increasingly focus on fiscal policies to manage growth

IMPLICATIONS FOR INVESTORS

Macro overview

US – Trump stimulus key to sustaining growth

Confidence boost: The US economy continues to pick up pace as a tighter job market drives consumption, while the oil price rebound lifts energy and manufacturing sectors. While Trump's election has boosted business and consumer confidence, the key to extending an already mature economic cycle rests on a pick-up in productivity through business spending. Trump's ability to implement stimulus plans, including tax cuts and deregulation, will be key.

Fed to tighten: Despite the rise in headline inflation, the Fed's preferred inflation measure (1.7%) remains below its 2% target and wages remain subdued. We believe the Fed is likely to hike interest rates at a gradual pace (around two times this year). Fed Chair Yellen's recent warning against 'waiting too long' suggests a hike is likely in H1.

Euro area – growth picking up

Rising confidence belies political risks: The Euro area's business confidence has risen to a six-year high, extending its recovery since the UK's Brexit vote. Record-low borrowing costs, a weak EUR and an improving job market are helping offset political risks around the upcoming elections in France, where an anti-Euro area candidate is leading the polls.

Less accommodative ECB? Euro area headline inflation has accelerated due to oil price gains, although core inflation (0.9%) remains well below the ECB's 2% target. We do not expect anti-Euro area parties to form governments. Thus, there is an increasing risk the ECB may withdraw stimulus once upcoming poll uncertainties are out of the way by Q4.

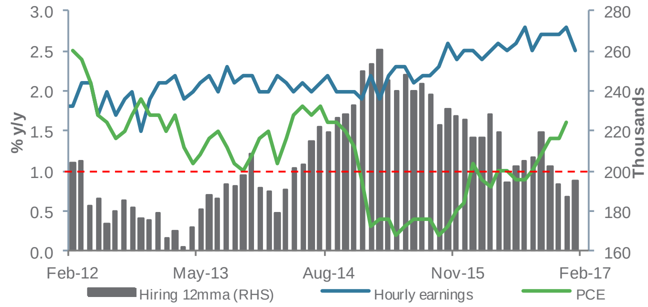
UK – consumption slows as Brexit talks near

Brexit talks cloud outlook: UK consumption, which had led the rebound since June's Brexit vote, has slowed sharply. Rising inflation has cut into stagnant wage growth, hurting real incomes. We expect consumer and business confidence to wane as the UK starts Brexit talks, likely in April.

Tolerant BoE: We expect the BoE to look through inflation caused by energy and import price gains for now. However, it is likely to be less tolerant if inflation climbs above 3%.

Figure 9: US hiring has averaged around a healthy 200,000 jobs/month, but wage growth remains contained and the Fed's preferred measure of inflation is still below its 2% target

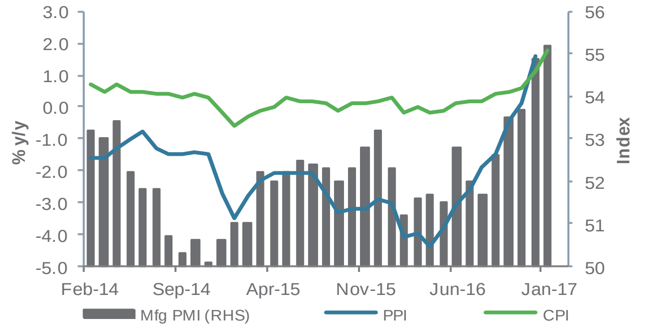
US hourly earnings, personal consumption expenditure deflator, % y/y; average job creation, 12mma, thousands (RHS)



Source: Bloomberg, Standard Chartered

Figure 10: Euro area business confidence has surged in recent months, while inflation has turned higher due to commodity prices

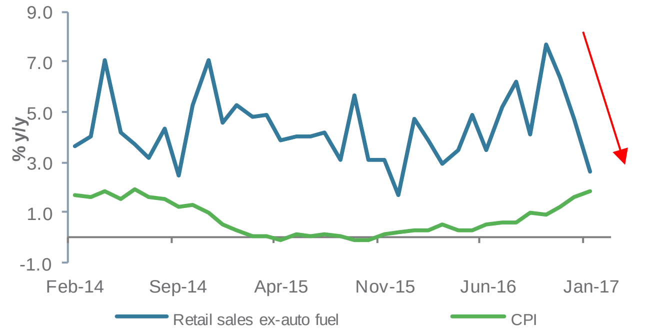
Euro area producer and consumer inflation, % y/y; manufacturing PMI (RHS)



Source: Bloomberg, Standard Chartered

Figure 11: UK consumption growth has slowed sharply in recent months as real incomes take a hit from rising inflation

UK retail sales, excluding auto fuel, % y/y; consumer inflation, % y/y



Source: Bloomberg, Standard Chartered

Macro overview

Japan – strong growth, weak inflation

Weak JPY boosts manufacturing: The JPY's weakness since November, after the BoJ adopted a policy of anchoring 10-year government bond yields around 0%, has helped exports and boosted manufacturing. However, consumption remains lacklustre amid weak real income growth, turning the focus on upcoming annual wage negotiations in March.

BoJ tapering concerns premature: The sustained decline in inflation, despite a pick-up in growth expectations, is likely to make it harder for the BoJ to taper bond-buying anytime soon. However, rising long-term inflation expectations and global yields raise the risk of the BoJ tapering later this year. Although, we would put a low probability to such an outcome.

China – fiscal stimulus to sustain growth

Stable growth: China's economy remains stable as it rebalances towards domestic consumption. The services sector continues to grow faster than manufacturing. We believe the government is likely to target growth around 6.5%, while reigning in leverage, as it focuses on economic and financial stability ahead of the party congress in Q4.

Fiscal easing, monetary tightening: The PBoC has started to tighten monetary policy this year, after years of loosening, as inflation pressures rise, driven by higher producer prices, and still-robust credit growth raises financial risks. As the PBoC tightens, we expect the focus to shift further towards fiscal policy as the government tries to keep growth stable.

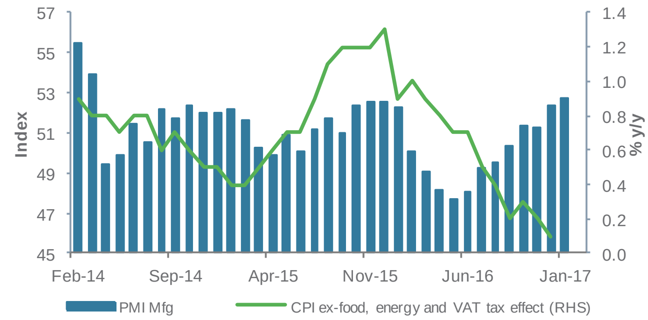
Emerging Markets – India turns neutral

Asia shifting to neutral/tightening bias: Rising inflation and the risk of capital outflows due to higher US rates suggest the region's central banks may be done with their monetary easing cycle. India's central bank unexpectedly turned neutral recently from an earlier dovish bias, while the Philippine central bank set the stage for tightening policy.

Brazil and Russia may ease: Inflation in Russia and Brazil has declined further, which should allow further monetary policy easing. In Brazil, curtailing the fiscal deficit is key to currency stability and monetary policy easing longer term.

Figure 12: Japan's manufacturing sector continues to recover on the back of stronger exports, but deflationary pressures remain

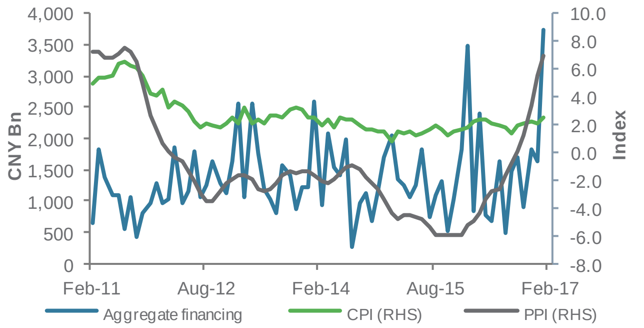
Japan manufacturing PMI; CPI ex-food, energy and VAT effect, % y/y (RHS)



Source: Bloomberg, Standard Chartered

Figure 13: China's surging credit growth and rising inflation pressures may lead the PBoC to tighten monetary policy

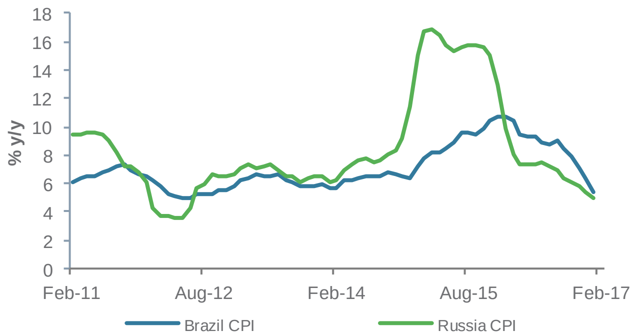
China's aggregate financing, CNY bn; consumer and producer inflation, %, y/y



Source: Bloomberg, Standard Chartered

Figure 14: Inflation continues to decline in Brazil and Russia, enabling their central banks to ease monetary policies

Consumer inflation in Brazil and Russia, % y/y



Source: Bloomberg, Standard Chartered

Bonds

Easing concerns for EM bonds

- We retain our preference for corporate bonds over government bonds. Our expectations of higher government bond yields in most developed economies act as a headwind for government bond returns. The yield premium offered by corporate bonds provides higher income and potentially cushions the impact of rising yields.
- Developed Market (DM) High Yield (HY) bonds remain our preferred bond sub-asset class. However, somewhat expensive valuations lead us to look for better entry points. Senior floating-rate loans offer an attractive alternative to DM HY exposure.
- We turn incrementally more positive on Emerging Market (EM) USD government bonds as risks of a full-scale trade war have likely been postponed. We still view Asia USD bonds and DM Investment Grade corporate bonds as core holdings.

Figure 15: Our preferred areas within bonds

Bond Asset Class	Preference	Yield	Value	FX	YTW
High Yield corporate bonds in DMs	Preferred (Loans over bonds)				5.43%
USD government bonds in EMs	Core Holding			n/a	5.45%
Asian USD Credit	Core holding (IG over HY)			n/a	3.86%
Investment Grade (IG) corporate bonds in DMs	Preferred				2.62%*
Local currency government bonds in EMs	Core holding				6.44%
IG government bonds in DMs	Least preferred				1.19%*

Traffic light signal refers to whether the factor is positive, neutral or negative for each asset class, in our opinion. YTW = yield to worst

* As of 31 January 2017. Source: Standard Chartered

We favour corporate bonds over government bonds

DM HY bonds remain our preferred assets within bonds

Less concerned about EM bonds. Retain them as core holdings

IMPLICATIONS FOR INVESTORS

Government bonds – Developed Market

DM Investment Grade (IG) government bond yields have remained broadly range-bound since the publication of our 2017 Outlook. However, on a longer horizon, we see US, European government bond yields edging higher. In the US, the prospect of Fed rate hikes, higher inflation and possibly higher supply due to fiscal stimulus leads us to expect 10-year Treasury yields rising to 2.50-2.75% by end-2017. In Europe, higher inflation and the prospects of a decrease (tapering) or end of bond purchases under the quantitative easing programme could alter supply-demand dynamics and lead to higher bond yields.

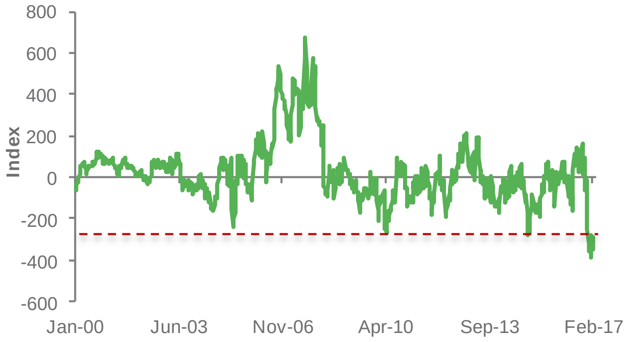
However, in the near term, government bonds remain oversold and an increase in risks, either from European politics or global growth, could result in a short-term pull-back in yields. We would view any such pullback as an opportunity to trim our exposure to G3 government bonds and allocate to our preferred areas in equities and corporate bonds. We favour gaining exposure to high quality bonds through DM IG corporate bonds.

Bonds

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

Figure 16: Investors remain extremely bearish on US Treasuries

CFTC 10y US Treasury net non-commercial combined positions



Source: Bloomberg, Standard Chartered

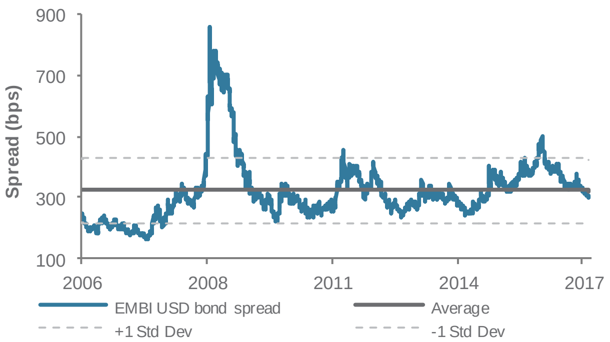
Given our expectations of higher yields, we favour maintaining a maturity profile centred around five years for USD-denominated bonds. Additionally, given our near-term positive stance on the USD (see pages 24-26), we prefer to keep FX exposure hedged in DM IG government bonds.

Government bonds – EM USD government bonds

We turn incrementally positive on EM USD government bonds as some of the headwinds have eased, in our opinion. As we highlighted in the past, we continue to like the attractive 5.5% yield on offer and the inexpensive valuations compared to the historical average. In fact, the recent strong performance of US corporate bonds means EM USD government bonds have cheapened on a relative basis.

Figure 17: EM USD govt bond valuations are not expensive

EM USD government bond spreads or yield premium



Source: JP Morgan, Bloomberg, Standard Chartered

At the time of the publication of our 2017 Outlook, we had highlighted higher Treasury yields and trade restrictions as key risks. In our opinion, the risk of a full-scale trade war between US and China has declined over the past two months, which is supportive of EMs.

Stabilisation of EM growth and more supportive commodity prices should ease the downward pressure on credit quality. We, therefore, believe there is a high likelihood of positive returns from EM USD government bonds.

Corporate bonds – DM IG corporate bonds

As we have highlighted earlier, we favour taking exposure to high-quality bonds through DM IG corporate bonds and maintain them as a core holding.

Apart from offering higher yields than government bonds, IG corporate bonds are also likely to benefit from improving fundamentals. We retain a favourable bias towards US over European IG corporate bonds due to the higher yields on offer and the potential for increase in yield premiums (lower bond prices) in Europe once the ECB ends its corporate bond buying programme.

In the US, the risk of elimination of the interest expense deductibility for debt has led to front-loading of issuances this year. However, depending on the exact details, it may end up being a positive as it could lead to lower future issuances, improvement in credit metrics and lower incentive for debt-funded share buybacks.

Corporate bonds – DM HY corporate bonds

DM HY corporate bonds and US floating rate senior loans continue to be our preferred sub-asset classes. DM HY bonds have delivered better-than-expected returns, buoyed by strong demand for short-maturity, high-yielding bonds.

HY bonds have also been supported by higher oil prices, which have led to increased drilling activity by shale oil producers. This could lead to higher profits and lower default risks in 2017. Additionally, HY bonds have a high correlation with equities and should be beneficiaries of strong US growth, which should lead to higher revenues and improved debt servicing ability.

Bonds

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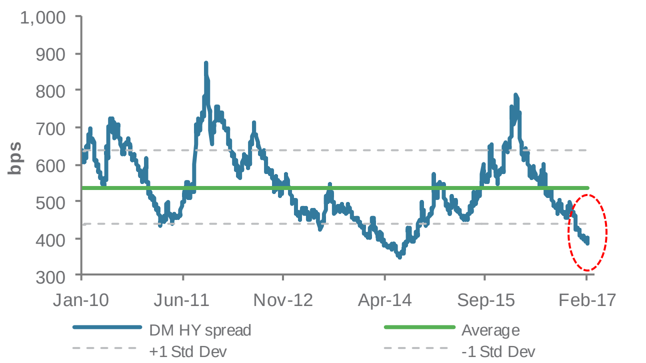
However, the recent rally means the spreads or yield premiums are close to 2014 lows. While we continue to like HY corporate bonds, we believe there could be better entry points.

Figure 18: DM HY bond spreads have reduced substantially

DM HY bond spreads or yield premium



Source: Bloomberg, Standard Chartered

We also maintain our preference for US senior floating rate loans as an attractive alternative to HY bonds. While the recent strong performance limits their price upside potential, they remain a good source of stable carry.

Corporate bonds – Asia credit

We continue to like Asia USD bonds for their defensive characteristics within EM bonds. The asset class remains supported by likely lower net-supply and the continued local demand, especially from China.

While the relatively expensive valuations are somewhat justified by the stronger credit quality than other regions, we believe they do not fully price in the geopolitical and trade-related risks and the risk of reduction in China demand due to further capital controls. While we expect Asia USD bonds to deliver positive returns in 2017, we would not be surprised if they did so with higher volatility.

Within Asia credit, HY bonds have rallied a lot and the pick-up offered over IG bonds is now close to multi-year lows. We prefer the IG component and remain selective in the HY space.

Figure 19: Yield pick-up offered by Asia HY bonds at multi-year lows

Spread differential between Asian HY and Asian IG corporate bonds

Source: JP Morgan, Bloomberg, Standard Chartered

EM local currency bonds

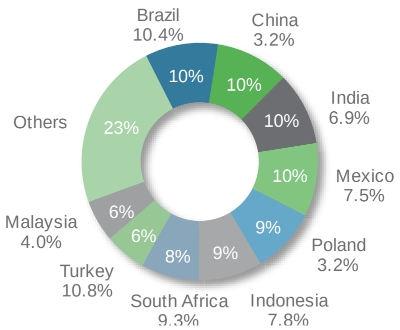
We turn somewhat more constructive towards EM local currency bonds. This is driven by our more positive view of EM assets in light of lower risks of a damaging trade war. However, we still prefer to take EM bond exposure through USD-denominated bonds due to lower currency risk.

Though we expect EM currencies to weaken against the USD (see page 26), the high yield on offer should help offset some currency weakness. However, we believe that apart from a few high-yielding countries such as Brazil and Russia, the rate cutting cycle has paused or ended, which reduces the scope for further price gains.

We favour Latin America and Asia local currency bonds over those from Europe and Middle East.

Figure 20: Composition of the EM local currency bond universe

GBI broad diversified index country weights (inside) and yields (outside)



Source: JP Morgan, Bloomberg, Standard Chartered

Equities

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

Strong start to 2017

- Global equities have performed well since we published our Outlook 2017 report on 15 December and have risen 4.5%, led by Emerging Markets (EMs), which are up almost 6%. The US equity market, which was our most preferred, is up 5%. Among our key themes, the China new economy theme leads the way and is up 12%.
- We remain positive on the outlook for global equities, which is our most preferred asset class. Concerns over market valuations have eased following the positive earnings trend. Nevertheless, the undervaluation of equities relative to bonds has declined as bond yields have risen and equity markets have rallied. As the economic cycle appears to be lengthening, there is scope for valuations to remain high for an extended period. We suggest investors consider staying invested in equities, pivoting towards a growth tilt while retaining some exposure to income.
- The US equities market is our most preferred globally. In late 2016, we highlighted the need for US earnings to follow through, given the high level of market valuations. We have started to see this coming through in Q4 16 earnings, which are expected to grow almost 8% (consensus expectations for 2017 earnings are for 11% growth).
- Within our equity allocation, we have made some changes to our preferences. We have upgraded Euro area and China to preferred from neutral and downgraded Japan and Indonesia to neutral from preferred. In our list of global market preferences, the Euro area ranks just below the US and, in Asia, China ranks just below India.
- We have become more optimistic towards EMs since we published our Outlook 2017 report. Nevertheless, we retain our neutral view on concerns over USD strength and a likely slowdown in commodity price gains (which have surprised to the upside so far this year), which may mean that EM equities, including Asia ex-Japan, will struggle to outperform the global equity market.

We are positive on global equities, led by the US

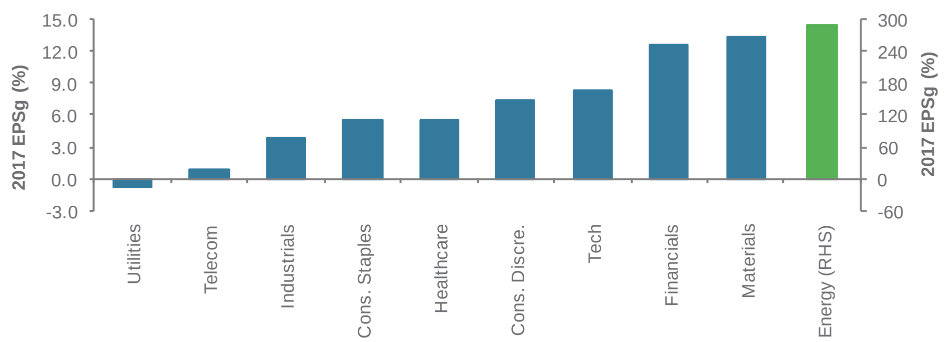
US corporate earnings are surprising positively

China and Euro area equities are upgraded to preferred status

IMPLICATIONS FOR INVESTORS

Figure 21: US corporate earnings on a firm upward trend, led by energy

S&P500 earnings by sector



Source: FactSet, Standard Chartered

Equities

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

US – delivering on earnings growth expectations

The US is one of our preferred equity markets with the big driver over the past month being earnings. Q4 earnings beat expectations by a wide margin, with consensus expectations rising from 6% growth at the start of the year to 8% today. Almost 70% of Q4 earnings releases have beaten expectations, with technology leading the pack.

An additional driver of US equity market performance is the potential for tax reforms. Analysis of the potential benefits of a cut in the headline corporate tax rate from 35% to 20% indicates around a 5ppt increase in US corporate earnings, on an annual basis.

The outlook for the US banking sector has improved following President Trump's request for a review of the Dodd-Frank legislation within 120 days. As this legislation has increased the cost of doing business for banks, a repeal (or, more likely, a watering down) of the laws could have a positive effect on the sector. The banking sector is up 6% since we published our Outlook 2017 report.

We believe there are two key risks for US equities: valuations and bond yields. The S&P500 index is currently trading at 18 times 2017 earnings forecasts, making them susceptible to any earnings disappointment. Meanwhile, a sharp rise in bond yields to reflect a reflationary environment could undermine equities, especially if it were driven more by an acceleration of inflationary pressures.

Figure 22: US equity market valuations are high

MSCI US P/E ratio

Source: MSCI, FactSet, Standard Chartered

Euro area – improving outlook

We have upgraded Euro area equities to preferred status, alongside the US. The upgrade reflects the improving trend of leading economic indicators and corporate earnings. Consensus expects Euro area corporate earnings to increase 19% in 2017.

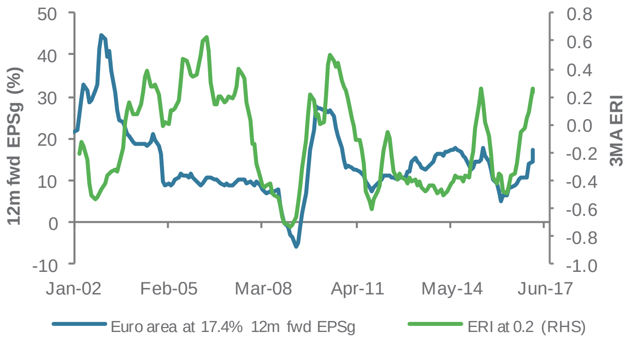
The banking sector, which is the largest sector in the market with a weight of 21%, is benefitting from the trend of higher US rates which can support interest income, especially for bank with a more international business. For regional banks, Euro area yields are expected to remain low, acting as a continued drag on interest income.

An added factor is the still weak EUR, which is not only positive for the region's exporters, but it could also result in increased merger and acquisition activity in the Euro area in 2017, as cash rich US companies try to buy growth to make up for prior subdued investment trends. Export-orientated companies in the capital goods and transportation sectors are likely to be on shopping lists.

Euro area valuations are high relative to history, although at 14 times 2017 earnings forecasts they trade at an 11% discount to global equities, down from parity in 2015. We see two key risks for the Euro area: politics and earnings. Developments in the French polls have unnerved some investors (see page 11). Meanwhile, there is the potential for earnings disappoint in the upcoming Q4 earnings season.

Figure 23: Euro area earnings forecasts are surging higher

Euro area earnings forecasts and earnings revisions



Source: FactSet, Standard Chartered

Equities

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

Asia ex-Japan – upgrading China to preferred

Our outlook for Asia ex-Japan equities has improved on the back an improving outlook for China equities. That said, on a 12-month time horizon, we forecast modest USD strength and continued uncertainty over Trump's trade policies. Each of these has the potential to weigh on economic growth and equity market performance. We retain Asia ex-Japan equities as a core holding.

Reflecting these concerns, we are more constructive on Asia equity markets with a greater focus on domestic demand, including India, which is our most preferred market in Asia, and China, which we recently upgraded from neutral.

Our China upgrade reflects our rising confidence on the outlook for the real estate sector and the success of our new China economy theme, which has performed well since we published our 2017 Outlook. While transaction volumes and price appreciations in the China real estate sector have slowed, inventory levels have declined sharply and the sell through rate (percentage of projects sold at launch) has increased to 80% from 60%.

The outlook for India equities remains positive. The market is up 8% since we published our 2017 Outlook and remains our most preferred market in the region. Relative to other markets in the region, India has a greater exposure to the domestic demand theme and, excluding the technology sector, it offers investors some protection from the risk of changes to US policies on trade.

Figure 24: Asia ex-Japan remains inversely correlated to the USD

MSCI Asia ex-Japan and DXY index

Source: MSCI, FactSet, Standard Chartered

Non-Asia EM – non-oil commodity prices jump

We are neutral on non-Asia EM, which is one of the best performing regions since we published our 2017 Outlook, rising 7%. The key driver of the rally in non-Asia EM equities centre on the rise in non-energy commodity prices, in particular iron ore, which is up 20%. This has driven markets that are linked to iron ore prices: Brazil is up 15%.

The strength in iron ore prices is partially a reflection of the recovery in China's growth and increased optimism over growth globally. The surge in iron ore prices has encouraged miners to propose tiered pricing for different grades of the ore, which sets up a conflict similar to that which resulted in the decision to move from annual to quarterly pricing. If this were to result in a reduction in supply as a negotiating tactic, prices and the Brazilian equity market could rise further.

There are concerns over geopolitical implications of Trump's stance on trade, and these have weighed on sentiment towards Mexico. However, similar to Asia which is dependent on trade, this does not necessarily translate to a negative equity market view. The biggest sector in Mexico's market is food beverage and tobacco, which has a 20% weight.

Similar to other regions, valuations in non-Asia EM are high at 12x 2017 consensus earnings forecasts. Earnings are forecast to grow 18% in 2017, led by Brazil and Mexico, which are expected to witness earnings growth close to 30% in local currency terms.

Figure 25: Non-Asia EM performance is linked to the CRB index

Non-Asia EM and CRB commodity price index

Source: FactSet, Standard Chartered

Equities

BONDS | EQUITIES | COMMODITIES | ALTERNATIVE STRATEGIES | FX | MULTI-ASSET

Japan – turning more cautious

We have downgraded Japan to core from preferred, reflecting our reduced conviction over the growth outlook and diminishing upward revisions to earnings. However, we are retaining our thematic positive view on Japan's equities on a currency-hedged basis as we believe the short term (1-3 month) outlook is constructive.

Japan's corporates have been able to significantly increase profits in recent years, aided by JPY weakness. Looking ahead, we are less bullish on USD/JPY, reducing our conviction over the 12-month outlook for corporate profits.

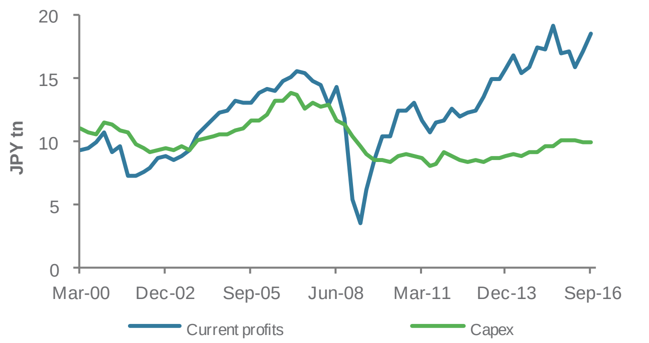
Another factor that could weigh on the 12-month outlook is US trade policies with companies listed in the auto and capital goods sectors particularly at risk. While Japan has made significant strides to localise production following the period of significant JPY appreciation from the mid-1980s to mid-1990s, the US remains a significant export market.

Japan's equity market performance has been positive since President Trump's election, rising 11%, possibly reflecting that optimism over global growth is outweighing concerns related to Trump's policies on trade.

Valuations in the Japanese market are characterised as fair relative to history, trading at 15x 2017 consensus forecasts.

Figure 26: Corporate profits in Japan have surged on a weaker JPY, capex has lagged behind

Corporate profits in Japan and capex trends



Source: MSCI, Bloomberg, Standard Chartered

UK – Brexit uncertainties remain

UK equities remain our least preferred market, reflecting continued concerns over the impact of Brexit on domestic demand and the GBP. Prime Minister May has indicated she will trigger Article 50, which will start official negotiations to leave the EU, by the end of March.

We view the start of Article 50 negotiations as impacting the equity market via two transmission channels:

1) It may lead to a weaker GBP, which is good news for the FTSE100 index in local currency terms as it is heavily weighted towards overseas earnings.

2) Uncertainty over the path to exit, in particular the impact on the financial sector, could lead to the postponement of investment decisions and the transfer of jobs dependent on access to the EU.

Economic growth has surprised positively since the Brexit vote. Nevertheless, there are significant uncertainties ahead, which could hit UK equity markets due to weaker share prices and negative translation effects from a weaker GBP.

Following an initial reduction in market valuations after the Brexit vote, the UK P/E ratio has since risen to 15x 2017 consensus forecasts, which we would characterise as high, particularly given the uncertainties associated with the start of Article 50 negotiations.

Figure 27: Divergence between FTSE100 performance in GBP and USD

FTSE100 index in GBP and USD

Source: FactSet, Standard Chartered

Equity derivatives

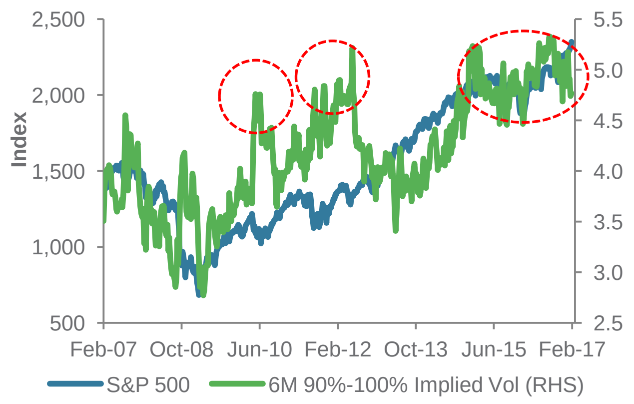
Options market activity suggest equity markets are not complacent

Investors continue to ponder if low volatility means complacency in the markets. It is true that volatility continues to be subdued at the equity index level, with the VIX around the lows seen in 2007 and 2014. A key contributor to low index volatility is high dispersion, or low correlation, among index constituents. This is particularly evident since Trump's victory in November 2016, when investors started focusing on reflationary sectors, shunning defensive ones. If stocks move in different directions, ie, the correlation between stocks is low, their movements can "cancel each other out" at the index level, reducing overall volatility of the indices.

However, digging deeper, we noticed S&P500 index put options are relatively expensive than index call options (Figure 28). In fact, the skew in S&P500 options (the difference in six-month implied volatility between 90% put and at-the-money call options) has been consistently above the high level at 4.5% since September 2014. There have been three periods over the last 10 years, when the S&P500 index skew was above this level. The maximum drawdown over any rolling six-month periods was 16%, in August 2011, during the US sovereign downgrade.

Figure 28: S&P500 index puts relatively expensive versus calls. Protection in place, limiting downside to US equities

S&P500, difference in 6M 90% and at-the-money implied volatility



Source: Bloomberg, Standard Chartered
As of 20 February 2017

We believe such a high skew, or the expensiveness of S&P500 index put options relative to calls, means market participants have been keeping a good level of protection against a potential sharp drop in equities. This should cushion any pullback from developing into larger-scale sell-offs, because panic-sells are less likely. This adds a 'technical support' angle to our overweight stance on US equities.

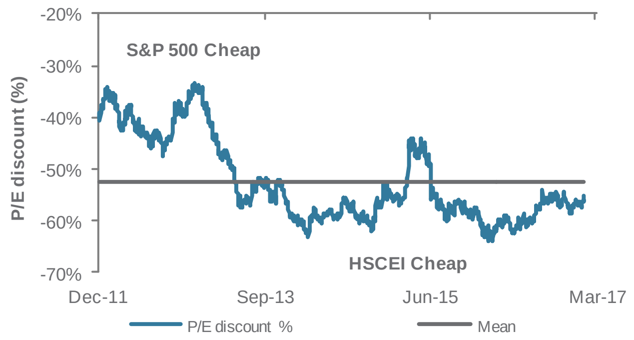
Moreover, yield-seeking investors may take advantage of the 'steepness' in skew via selling put options, particularly in sectors with good fundamentals. We believe selling volatility for yields on US technology names continues to be attractive, as tax reform policies and overseas cash repatriation unfold.

Selling puts on Hong Kong/China equities give good entry points

Elsewhere, as we raise China equities to the preferred market status within the Asia ex-Japan region, we would like to reiterate the cheap valuation of China equities than global peers (Figure 29). With improving economic data, Beijing's fiscal stimulus and 'trapped liquidity' within the system, we believe China equities will be well supported. Selling put options on China equities can give investors a decent yield, with the risk of owning shares at even more potential attractive entry points than the already low valuations that we are seeing.

Figure 29: China equities' undemanding valuations compared to global peers

HSCEI 12M forward P/E at discount to S&P500



Source: Bloomberg, Standard Chartered
As of 20 February 2017

Commodities

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

Short-term pullback likely

- We believe commodities could continue their modest uptrend in the medium term, in line with our main reflationary scenario.
- Although we expect higher oil prices by the year end, we scale back our view in the short term, amid increased indications of a potential pullback.
- Gold is expected to trade largely range-bound. However, we favour reducing exposure near levels around USD 1,250/oz.

Longer-term outlook remains constructive

At the broad index level, commodity prices are likely to continue their uptrend over the medium term. Most factors, including a stable China growth outlook and a further recovery in the US and the Euro area economies, are broadly supportive. In addition, prospects of a major trade conflict have not come through with President Trump hinting at a more conciliatory approach thus far.

Oil prices are likely to continue to recover through 2017. Although, we do not believe this will happen in a straight line. We believe positive developments following OPEC's cuts may have been already priced in for the short term, judging from stretched speculator positioning. At the same time, US production has surprised to the upside. Longer-term, we believe the re-balancing towards tighter markets is likely to continue. However, a short-term pullback is seen as likely.

Gold is likely to remain range-bound amid a confluence of positive and negative factors. On the positive side, continued political concerns in Europe and lingering prospects of a trade conflict are supportive. In contrast, continued modest Fed rate hikes would restrict upside. Faster-than-expected rate hikes could be a clear negative for gold.

We believe downside risks to industrial metals have increased since we published our 2017 Outlook. First, we believe prices for a number of key metals have rallied quite strongly, despite the build-up of inventory, a looming expansion in supply and lower demand compared to 2017. Therefore, we would reduce exposure to this space for now.

Higher oil prices by the year end, but look for a pullback

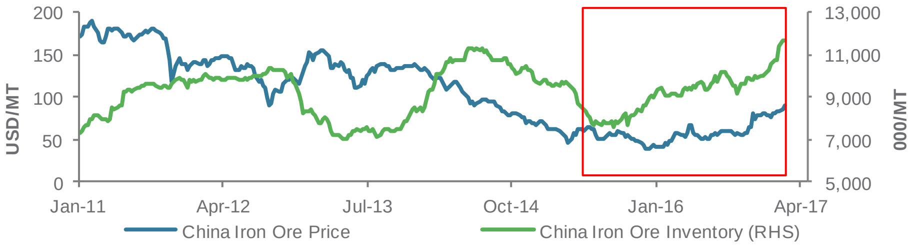
Reduce allocation to gold, buy at lower levels

Reduce exposure to iron ore and copper

IMPLICATIONS FOR INVESTORS

Figure 30: Surge in China iron ore inventory could hurt the price rally

China iron ore price and China iron ore inventory



Source: Bloomberg, Standard Chartered

Commodities

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

Crude oil – prepare for a pullback

Although we expect crude oil to maintain its medium-term uptrend towards USD 60-65/bbl, we believe near-term risks of a pullback have increased. We believe this is due to two factors. First, speculator positioning remains close to extreme levels suggesting OPEC cuts have largely been priced in. Second, US production has risen faster than we expected, while both US crude and gasoline inventories rise.

Beyond short-term dynamics, we believe the larger oil rebalancing story remains valid. OPEC cuts are likely to reduce supply more than US production can expand. This, coupled with strong demand from both Developed Markets and Emerging Markets, is likely to lead to a supply deficit and put upward pressure on prices.

Gold – range-bound tactical opportunities

We believe gold is likely to remain range-bound amid a confluence of positive and negative factors. At levels around USD 1,250/oz, we prefer to reduce exposure, while expecting downside to be limited to around USD 1,140/oz.

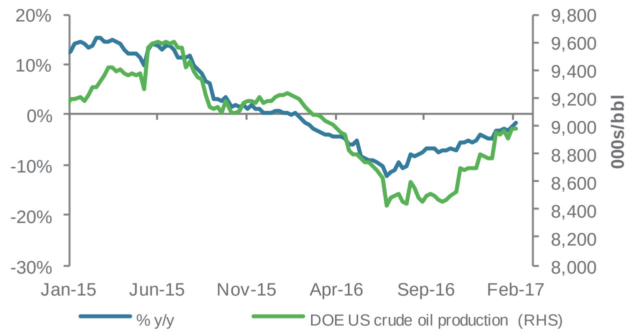
Net-of-inflation (real) interest rates remain the most consistent driver of gold. A faster-than-expected Fed rate hike cycle could drive real rates higher, which would be negative for gold. However, a significant rise in inflation would depress real rates and result in a gold rally. For now, our 2017 base case expects real rates to remain largely range-bound amid countervailing forces of reflation and rising interest rates. Beyond near-term tactical plays, we like gold as a longer-term portfolio hedge against late-cycle dynamics and any significant escalation of trade conflict.

Industrial metals – stellar rally not sustainable

We believe the rally in industrial metals, especially in copper and iron ore, has run ahead of fundamentals. The build-up in inventory is alarming. Moreover, demand for iron ore and copper is likely to ease amid a slowing China property market. Also, supply is likely to surge considerably this year, as producers cut back costs. Longer term, our central reflationary scenario is positive for industrial metals amid a pick-up in capital expenditure. For the short term, we would favour reducing exposure.

Figure 31: US crude production recovering faster than expected

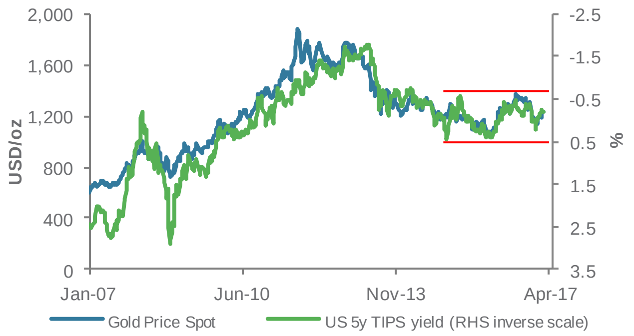
DOE US crude oil production and y/y change



Source: Bloomberg, Standard Chartered

Figure 32: Gold to follow largely range-bound real interest rate expectations (TIPS proxy)

US 5y TIPS yields (inverted) and gold prices



Source: Bloomberg, Standard Chartered

Figure 33: What has changed – Oil

Factor	Recent moves
Supply	OPEC cut-backs continue, but US supply increasing strongly
Demand	Demand growth led by Emerging Markets
USD outlook	USD has traded range-bound after the recent pullback

Source: Standard Chartered

Figure 34: What has changed – Gold

Factor	Recent moves
Interest rate expectations	US 10-year yields trade range-bound after touching a high of 2.6%
Inflation expectations	Inflation expectations in both the US and the Euro area have flattened recently
USD outlook	USD has traded range-bound after the recent pullback

Source: Standard Chartered

Substitute strategies perform

- Alternative strategies, which can be seen as a substitute for equity exposure (equity-hedge and event-driven), and which have a higher correlation to traditional equity, have performed better recently, helped by the continuing reflationary theme, as equity markets reach new highs.
- We continue to favour global macro and add equity hedge to our preferred strategies.
- Cross-asset correlations, individual stock and FX correlations, and regional correlations have all been falling, providing increased opportunities for strategies that benefit from greater dispersion.

Event-driven and equity hedge benefit from buoyant equity markets

Both event-driven and equity hedge strategies have higher correlations to equities, which have really helped them to perform recently, delivering 3.6% and 2.1% respectively, since our Outlook 2017. We add equity hedge to our preferred strategies, given increased probabilities of our positive economic scenarios and greater dispersion within equities.

Benefits of using an alternative strategies allocation

As noted in our Outlook 2017 report, there are benefits of using a diversified mix of alternatives strategies within an investment allocation. Our conclusion was that, over 2000-2016, an optimal alternatives allocation had a similar annualised performance of 3.1% to global equities, but with better capital preservation characteristics.

We increase our exposure to equity hedge, which, with global macro, are our two preferred areas. Our allocation is: equity hedge (31%), event-driven (26%), global macro (21%) and relative value (22%). See our Outlook 2017 report for more details.

Figure 35: Factors supportive of individual alternative strategies

Conditions which may be favourable	
Equity hedge	Equity hedge strategies generally perform well when stocks and sectors have wide performance dispersion within an equities universe
Event-driven	Event-driven strategies can flourish where companies pursue value enhancing actions, including spin-offs and buybacks
Global macro	Global macro strategies perform well in the absence of short and frequent upward and downward movements in the market. Global Macro strategies are highly dependent on specific discretionary themes
Relative value	Sharp sell-offs and sharp rallies in credit can provide opportunities for long short credit strategies within relative value

Source: Standard Chartered, Hedge Fund Research Inc., Bloomberg

Global macro strategies offer diversification

Equity hedge and event-driven are substitutes for equity exposure

Alternative allocation can offer risk-adjusted benefits

IMPLICATIONS FOR INVESTORS

FX

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

Short-term USD gains likely

- We expect the EUR to be under episodic pressure, but have begun to note an improvement in longer-term fundamentals. The JPY is likely to remain range-bound, as monetary policy divergence with the US gives way to some safe-haven demand.
- Short-term downside risks to the GBP remain ahead of Brexit negotiations. However, from a longer-term perspective, we are cognisant that a lot may be priced in.
- We believe short-term risks of an AUD pullback have risen amid an excessive rise in iron ore prices. We expect Emerging Market (EM) currencies to remain generally stable, but investors should stay attuned to any signs of rising trade tensions.

Medium-term USD gains may be limited

- The USD has given up most of its gains following the US election. We believe there may have been two reasons for this. First, markets may have overestimated the probability of a significant US fiscal stimulus plan, as forming a political consensus remains challenging. Second, other regions, most notably the Euro area, have shown further improvement, suggesting less scope for monetary divergence in the future.
- Going forward, our base case is for modest USD strength in the short term, followed by eventual stability as US rate hikes get priced in. In the short term, political concerns, both in the Euro area and the UK, will likely keep their respective currencies under pressure. Longer term, their core fundamental improvements are likely to be reflected in stimulus withdrawal and less monetary policy divergence.
- President Trump's policies in key areas of tax reforms and international trade remain a key uncertainty. We can see scenarios where this could lead to both USD gains and losses. A border-adjustment tax, for example, could lead to broad USD strength, while a trade war like scenario could lead to risk-off sentiment, which would favour the EUR, CHF and JPY against the USD, but further weaken EM currencies.

Short-term EUR risks, constructive long term

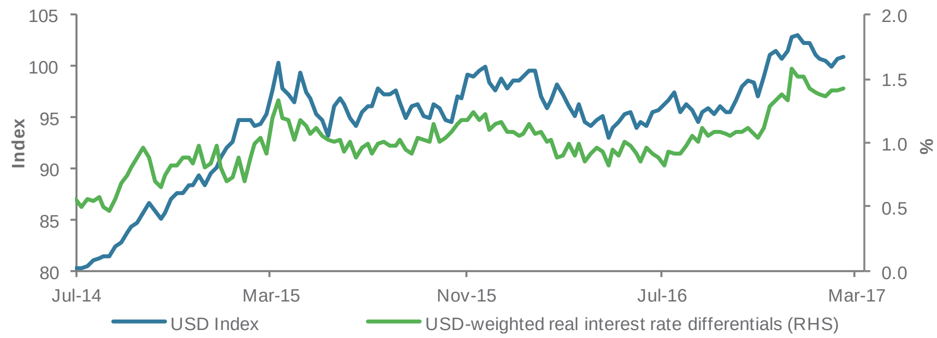
USD/JPY to trade range-bound

Short-term AUD pullback likely

IMPLICATIONS FOR INVESTORS

Figure 36: A modest pick-up in US real interest rate differentials to support the USD

USD index (DXY) and 10y DXY weighted real interest rate differentials



Source: Bloomberg, Standard Chartered

FX

EUR – scaling back our 12M negative outlook

Although we expect the EUR to remain under pressure in the short term, we are turning more constructive longer term. We believe two factors are driving the EUR presently: 1) political concerns regarding the rise of Euro-sceptic parties and 2) the possibility of a scale-back in the ECB stimulus amid continued economic recovery.

We believe the possibility of the French far-right candidate Le Pen winning the election and having the political capital to implement such policy is still low. Regardless, we believe the EUR could remain depressed in the lead up to the elections. Longer term, improvement in the Euro area economy could lead to the ECB withdrawing stimulus. Though the ECB prefers status quo now, a gradual recovery could lead to a possible stimulus withdrawal.

JPY – risks of extreme moves rising

Monetary policy divergence remains a key driver for the JPY in the near term, as the BoJ is likely to maintain its current yield-curve control policy while the Fed hikes rates gradually. However, near-term risks to this have increased against the back-drop of possible US tax reforms and trade tensions. The JPY might still strengthen amid substantial risk-off and safe-haven demand in such a scenario. A border-adjustment tax, if announced, could result in knee-jerk USD strength, weakening the JPY. Therefore, considering the confluence of the above risk factors, we would expect a largely range-bound movement (112.00–119.00) in the short term.

GBP – the price is right?

The GBP has stabilised recently, trading in a range. Still, we believe short-term risks are skewed to the downside, as Article 50 is triggered and post-Brexit negotiation begins. However, longer term, we contend that some of the risks we highlighted earlier, such as a sharp slowdown in the UK economy, have not occurred. In this regard, we also expect the BoE to maintain status quo for the rest of the year. While structural issues, such as a large current account deficit and potential for capital outflows remain, we are increasingly seeing signs of these being priced in.

Figure 37: What has changed – G3 currencies

Factor	Recent moves
Rea interest rate differentials	Modest scaling back of real interest rate differentials in favour of a weaker USD against G3
Risk sentiment	Risk sentiment has increased in the Euro area, though volatility generally remains low elsewhere
Speculator positioning	USD net-long speculator positioning has eased but remains considerable

Source: Bloomberg, Standard Chartered

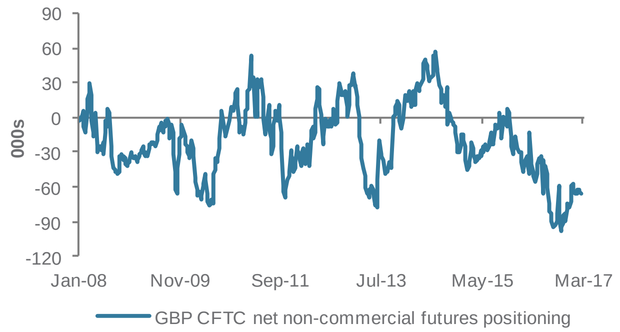
Figure 38: Pricing in of political risks could continue to pressure the EUR in the short term

France-Germany government bond yield spread

Source: Bloomberg, Standard Chartered

Figure 39: GBP speculative net-short positioning remains stretched, suggesting a lot may have been already priced in.

GBP CFTC net-long non-commercial futures positioning



Source: Bloomberg, Standard Chartered

FX

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

AUD and NZD – short-term pain ahead

We scale-back our view on the AUD to neutral. Three key considerations shape our view: 1) the rise in iron ore prices is largely unsustainable short term (see pg. 24), 2) the recent weaker-than-expected Australia inflation data is beginning to challenge our outlook of a RBA status quo, and 3) financial market volatility is low given the mix of near-term risks and any rise could threaten carry currencies.

Similar to our AUD view, we believe risks to the NZD are skewed to the downside with a possible rise in volatility. In addition to this, we believe the significant trade-weighted currency strength is likely to discourage RBNZ from raising interest rates despite strong domestic growth. Longer term, our central scenario of global reflation remains positive for the pro-cyclical and high-carry AUD and NZD.

Asia ex-Japan – trade tensions key risk

Our base case is that Asia ex-Japan currencies remain broadly stable as China continues to grow moderately. However, we also highlight the risks from a major trade conflict and US tax measures. We expect the INR and the IDR to outperform the region amid high carry and better fundamentals, while the CNY is likely to remain vulnerable.

The USD/CNY outlook is likely to be driven by the outlook for the broad USD index, in the absence of CNY trade-weighted weakness. We believe there are two reasons to expect stability in the CNY basket. First, authorities have been working to stem excessive CNY depreciation expectations and resulting capital outflows. Second, a basket depreciation is likely to further exacerbate trade tensions with the US. Therefore, we expect modest CNY weakness against the backdrop of a modest, broad USD appreciation.

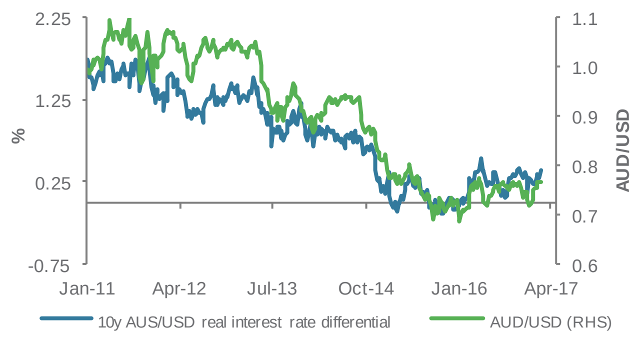
We expect moderate SGD weakness in the short term, mainly in line with its key trade partner currencies, including the CNY and MYR. Longer term, the SGD could stabilise along with the broad USD outlook.

Other EM currencies – commodities key

Most major currencies in this space are sensitive to commodity prices and volatility, both of which have been supportive thus far. However, a pullback would not be unusual given near-term risks. We expect the RUB and the BRL to continue to outperform, given strong balance-of-payment fundamentals.

Figure 40: The AUD has moved in line with real interest rate differentials; RBA status quo remains key to limit downside

Australia 10y real interest rate differential and AUD/USD



Source: Bloomberg, Standard Chartered

Figure 41: What has changed in EM currencies

Factor	Recent moves
USD outlook	USD has traded range-bound recently
China risks	China data continues to improve, reducing risks
Capital flows	Capital inflows to EMs have picked-up strongly

Source: Standard Chartered

Figure 42: CNY trade-weighted stability needed to limit downside

CFETS CNY trade-weighted basket and USD/CNY

Source: Bloomberg, Standard Chartered

Multi-asset

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

A scenario approach to multi-asset investing remains valid

Look for opportunities to pivot to reflationary assets

Reduce interest rate sensitivity in multi-asset income

IMPLICATIONS FOR INVESTORS

Stay with a scenario approach

- Balanced allocation (benefits in a reflationary scenario) and multi-asset income (benefits in a muddle-through scenario) running neck and neck in performance terms.
- Adjust a balanced allocation to better reflect a reflationary state of the world and our tactical views in fixed income—reduce large exposure in government bonds in favour of corporate credit.
- For multi-asset income allocation, reduce sensitivity to rising interest rates by increasing allocation to leveraged loans.

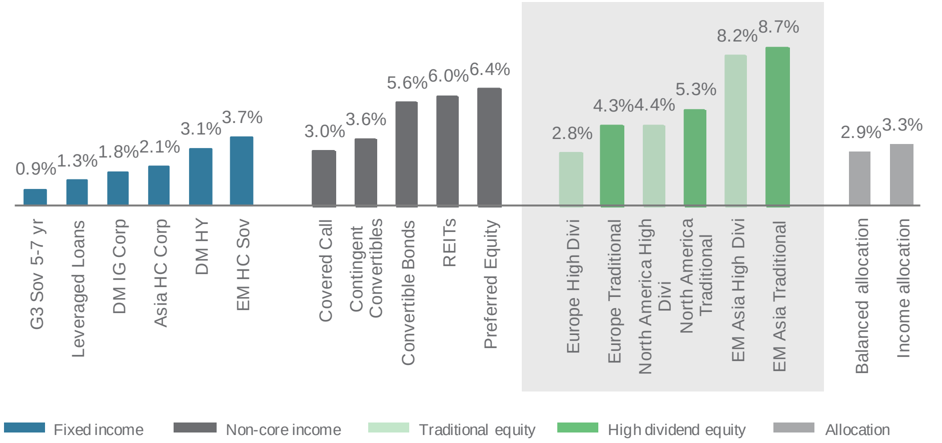
Reflation and muddle-through – it's a two-horse race at the moment

In our 2017 Outlook, we highlighted two likely economic scenarios for 2017—reflation and muddle-through—with almost equal probabilities. For multi-asset investors, we suggested a total-return approach might be appropriate to benefit from the pivot to reflation. We put in place a balanced allocation to track the performance of this category of investors. Given the almost equal probability assigned to muddle-through, we suggested an income investor continue to utilise a multi-asset income approach to allocation, which might do well in an environment of sluggish growth and tepid yields.

At this juncture, the two allocations are running neck and neck in terms of performance (multi-asset income has slightly outpaced the balanced allocation). While the balanced allocation has been driven by strong performance from global equities (up 5.4% since our Outlook publication), multi-asset income has seen equally strong performance from credit, Emerging Market (EM) bonds and non-core assets such as preferred equity and convertible bonds.

Figure 43: Key assets associated with a pivot to reflation have performed well

Performance of asset classes since 2017 Outlook publication



Performance measured from 15 Dec 2016 to 23 Feb 2017

Source: Barclays, Citi, CRISIL, JP Morgan, S&P, MSCI, Bloomberg, Standard Chartered

Multi-asset

BONDS EQUITIES COMMODITIES ALTERNATIVE STRATEGIES FX MULTI-ASSET

Since our Outlook publication, global equities outperformed high-dividend equities, given a greater focus on growth and reflation. This has benefitted the balanced allocation. An exception to this broad trend has been Asia high-dividend equities. With their more cyclical tilt they have outperformed both Asia and global traditional equities, driving performance in our multi-asset income allocation. Our allocation to Europe high- dividend equities, however, did not pan out as well. It underperformed other dividend regions as a result of rising political risks in Europe, which weighed on financials, the largest allocation within Europe high-dividend equities.

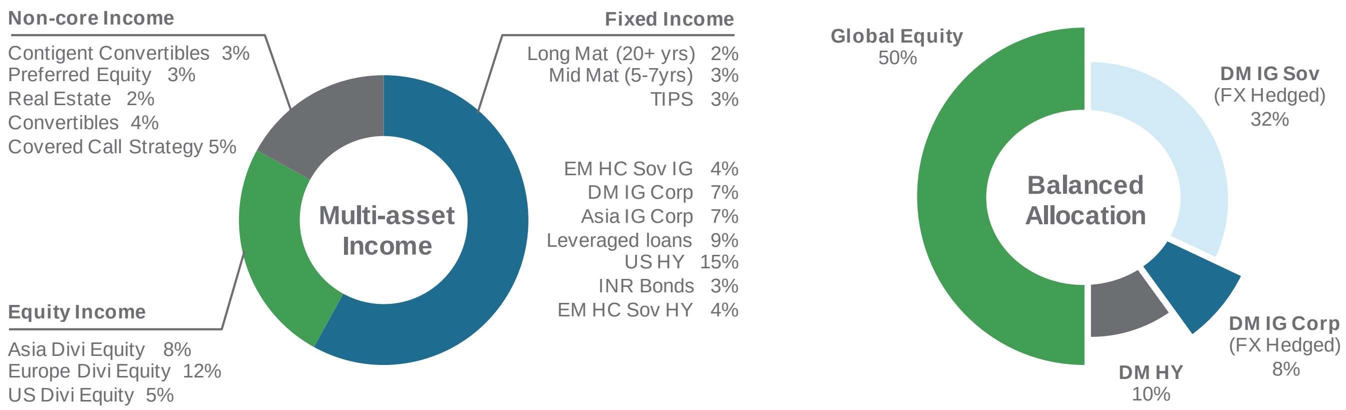
It should be noted that EM Hard Currency sovereign bond Investment Grade (IG) and non-core assets (particularly preferred equity and REITs) were merely recovering the performance they gave up in the last quarter of 2016. Going forward, in an environment of rising rates, we expect these asset classes to deliver a more muted performance. Moreover, given the larger allocation to fixed income within multi-asset income, a rising rate environment could also suggest future underperformance for this strategy versus a balanced allocation.

Tweaking our allocation for reflation

We adjust our balanced allocation to better reflect our preference for corporate credit over government bonds. Instead of the previous allocation, which was based on the Barclays Capital Global Aggregate Bond index, we introduce a well-defined allocation to government bonds and corporate credit. The revised allocation is illustrated in Figure 44. In addition, we also adjust our multi-asset income allocation to reduce interest rate sensitivity. We reduce EM Hard Currency sovereign bond (IG) exposure in favour of leverage loans. This change gives us a 100bps pick-up in yield and provides better defensive characteristics in a rising rate environment.

We are introducing a 'global' asset allocation model starting with this publication. This is to complement our existing asset allocation model which will be rebranded 'Asia-focused'. Across various risk profiles, this brings the total number of allocations to nine—four global models, four Asia-focused models and a multi-asset income model. Please refer to page 31 for the various allocation models.

Figure 44: Revised multi-asset income and balanced allocation (asset class weights in %)



Source: Barclays, JP Morgan, S&P, MSCI, Bloomberg, Standard Chartered

Multi-asset

Figure 45: 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
Fixed Income	4.6	🟡	🟡	🟡	Portfolio anchor; source of yield; some interesting ideas but not without risks
Leveraged Loans	5.4	🟢	🟡	🟡	Attractive alternative to traditional HY exposure; senior in capital structure to simple HY bonds; small yield penalty in return; low sensitivity to changes in US interest rates
Corporate - US HY	5.5	🟢	🟡	🟡	Valuations have tightened recently; attractive yields; default rates should trend lower
EM HC Sovereign Debt	5.7	🟢	🟡	🔴	Need to be selective given diverse risk/reward in IG, HY bonds; US interest rates and commodity exposure are key drivers; valuations reasonable
INR Bonds	7.1	🟢	🟡	🔴	Structural story playing out; carry play; credible central bank, reforms; foreign demand a recent risk. FX stability a positive
Investment Grade	2.6	🔴	🟡	🟡	Portfolio anchor, structural carry; some interesting ideas but interest rate sensitivity a risk
Corporate - DM IG	2.6	🔴	🟡	🟡	Yield premiums have narrowed but prices fair; long-term US corporate bonds look appealing if Fed hiking cycle is muted
Corporate - Asia IG	3.8	🟡	🟡	🟢	Cautiously positive. Fairly valued, marginally improving credit quality; key risks include concentration risk from China issuers and risk of lower regional demand
TIPS	1.1	🔴	🟢	🟢	Offers value as an alternative to nominal sovereign bonds; impact of rate rise similar to G3 Sov but offers exposure to an eventual jump in US inflation
Sovereign	1.5	🔴	🔴	🟡	QE offers strong anchors for Sov yields, but little, if any, value left. Risks include rate hikes and higher inflation. Prefer higher-yielding/high-quality markets (US Treasury, AU, NZ)
Equity Income	4.6	🟡	🟡	🔴	Key source of income and modest upside from capital growth
North America	3.3	🔴	🟡	🟡	Fair to slightly rich valuations; low yields; some sectors attractive
Europe	5.3	🟢	🟢	🟡	Fair valuations; attractive yield; overhang from political risks, mitigated by improving global growth outlook; poor momentum. FX a wild card
Asia ex-Japan	4.5	🟡	🟡	🔴	Good payouts; selectively attractive valuations, but pullback a risk from challenges in China/US growth, earnings, Fed and leverage.
Non-core Income	4.2	🟡	🟡	🟡	Useful diversifier for income and growth
Preferred	5.7	🟢	🟡	🔴	Attractive yield and exposure to financials; risk from higher rates may not be completely offset by improvement in bank's underlying credit
Convertibles	3.8	🟡	🟡	🟡	Moderate economic expansion + gradual pace of rate hikes should be good for converts. Risk: policy mistake
Property	4.0	🟡	🟡	🔴	Yield diversifier; stable real estate market; risk from higher rates, stretched valuations in some regions. Potential for large pullbacks
Covered Calls	2.5	🔴	🟡	🟡	Useful income enhancer assuming limited equity upside
CoCos	6.4	🟢	🟡	🔴	Attractive due to high yields on offer, relatively low sensitivity to rising yields and improving bank credit quality over the past few years

Yield data as of 31 January 2017.
Source: Bloomberg, Standard Chartered
Please note: The Financial Conduct Authority (FCA) has introduced Permanent Marketing Restrictions on the sale of CoCos to residents of the EEA.

Legend: 🟢 Attractive potential/low risk 🟡 Moderate potential/medium risk 🔴 Unattractive potential/high risk

Market performance summary *

Equity	Year to date	1 month
Global Equities	6.1% ↑	4.0% ↑
Global High Dividend Yield Equities	5.2% ↑	4.1% ↑
Developed Markets (DM)	5.6% ↑	3.8% ↑
Emerging Markets (EM)	10.5% ↑	5.6% ↑
By country		
US	6.0% ↑	4.5% ↑
Western Europe (Local)	2.8% ↑	2.7% ↑
Western Europe (USD)	3.7% ↑	1.9% ↑
Japan (Local)	2.1% ↑	2.4% ↑
Japan (USD)	5.7% ↑	2.7% ↑
Australia	10.1% ↑	6.1% ↑
Asia ex- Japan	10.8% ↑	5.6% ↑
Africa	8.1% ↑	3.9% ↑
Eastern Europe	3.0% ↑	3.4% ↑
Latam	14.4% ↑	6.2% ↑
Middle East	2.1% ↑	0.8% ↑
China	12.7% ↑	7.3% ↑
India	10.7% ↑	8.4% ↑
South Korea	11.8% ↑	4.7% ↑
Taiwan	10.0% ↑	5.2% ↑
By sector		
Consumer Discretionary	5.7% ↑	2.5% ↑
Consumer Staples	6.3% ↑	4.7% ↑
Energy	-2.8% ↓	-1.5% ↓
Financial	6.6% ↑	5.3% ↑
Healthcare	7.6% ↑	6.7% ↑
Industrial	5.7% ↑	3.3% ↑
IT	10.4% ↑	6.1% ↑
Materials	8.5% ↑	2.4% ↑
Telecom	2.2% ↑	-0.4% ↓
Utilities	4.0% ↑	3.4% ↑
Global Property Equity/REITS	4.6% ↑	3.0% ↑

Bonds	Year to date	1 month
Sovereign		
Global IG Sovereign	0.8% ↑	-0.2% ↓
US Sovereign	0.4% ↑	-0.1% ↓
EU Sovereign	-0.6% ↓	-1.2% ↓
EM Sovereign Hard Currency	3.2% ↑	1.7% ↑
EM Sovereign Local Currency	4.4% ↑	3.0% ↑
Asia EM Local Currency	3.7% ↑	1.2% ↑
Credit		
Global IG Corporates	1.3% ↑	0.4% ↑
Global HY Corporates	2.7% ↑	1.3% ↑
US High Yield	2.5% ↑	1.4% ↑
Europe High Yield	2.3% ↑	-0.2% ↓
Asia High Yield Corporates	2.9% ↑	1.6% ↑

Commodity	Year to date	1 month
Diversified Commodity	-0.1% ↓	-1.3% ↓
Agriculture	3.4% ↑	-2.5% ↓
Energy	-10.0% ↓	-4.2% ↓
Industrial Metal	7.1% ↑	1.3% ↑
Precious Metal	9.7% ↑	3.4% ↑
Crude Oil	-0.4% ↓	1.7% ↑
Gold	8.5% ↑	2.6% ↑

FX (against USD)	Year to date	1 month
Asia ex- Japan	2.0% ↑	0.5% ↑
AUD	7.0% ↑	1.7% ↑
EUR	0.6% ↑	-1.7% ↓
GBP	1.8% ↑	0.2% ↑
JPY	3.9% ↑	0.1% ↑
SGD	3.0% ↑	0.8% ↑

Alternatives	Year to date	1 month
Composite (All strategies)	1.8% ↑	1.5% ↑
Relative Value	1.3% ↑	0.8% ↑
Event Driven	2.6% ↑	1.8% ↑
Equity Long/Short	2.4% ↑	1.7% ↑
Macro CTAs	0.5% ↑	1.7% ↑

*All performance shown in USD terms, unless otherwise stated.

*YTD performance data from 31 December 2016 to 23 February 2017 and 1-month performance from 23 January 2017 to 23 February 2017

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

Standard Chartered

Events calendar

JAN

- **19** ECB Policy Decision
- **20** US Presidential Inauguration Day
- **31** BoJ Policy Decision

FEB

- **02** FOMC Policy Decision
- **28** US President Trump to address joint session of Congress

MAR

- **09** ECB Policy Decision
- **11** Results of India's state polls
- **15** Netherlands Elections
- **16** FOMC Policy Decision
- **16** BoJ Policy Decision
- **X** China National People's Congress

APR

- **15** US Treasury department's semi-annual forex report
- **20** Deadline for Greece's debt repayment
- **23** France's Presidential Elections (first round)
- **27** BoJ/ECB Policy Decision

MAY

- **07** France's Presidential Elections (final round)
- **04** FOMC Policy Decision
- **26-27** G7 summit in Italy

JUN

- **08** ECB Policy Decision
- **11, 18** French Legislative Elections
- **15** FMOC Policy Decision
- **16** BoJ Policy Decision
- **17-20** Greek debt repayment
- **30** OPEC output agreement expires

JUL

- **01** India's likely rollout of nationwide Goods and Services Tax (GST)
- **20** BoJ Policy Decision
- **20** ECB Policy Decision
- **27** FOMC Policy Decision

AUG

NA

SEP

- **24** Germany's General Elections
- **07** ECB Policy Decision
- **21** FMOC Policy Decision
- **21** BoJ Policy Decision

OCT

- **X** China's 19th National Party Congress
- **26** ECB Policy Decision
- **31** BoJ Policy Decision

NOV

- **02** FOMC Policy Decision

DEC

- **14** ECB meeting
- **14** FOMC Policy Decision
- **20** Korea official election due date
- **21** BoJ Policy Decision

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

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