Equity – Overweight

- The US and European Q3 earnings season has started, with consensus expecting a 4% decline in the US earnings and a 6% decline in Europe. Weakness in the energy sector is primarily responsible for this decline. Excluding energy, US earnings are forecast to increase 4%.
- Corporate margins in the US have started to move lower, with potentially negative consequences for the market. However, the decline is primarily driven by lower energy prices, which gives comfort to our constructive US equity view.
- The recovery in Euro area and Japanese equity markets has outpaced that in the US from the September low. However, concerns exist over the impact of currency strength on earnings.
- India will remain in focus in the run-up to the Bihar election on 7 November; a BJP win would be positive for equities.
- High-dividend-yielding equities in Europe continue to do well, rising 12% YTD. As banks start to increase dividends, the strategy should continue to do well in the coming months.

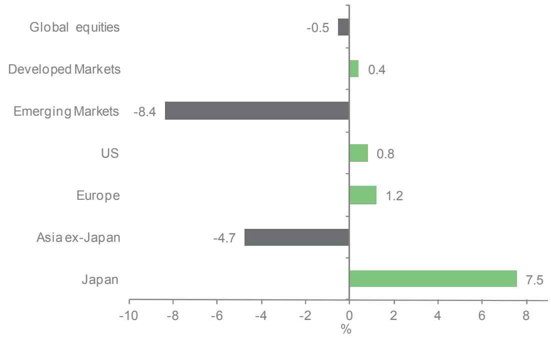
US – 2016 earnings recovery driven by energy

- We remain positive on US equities, albeit with a preference for other regions. We are focusing on earnings and margins.
- Consensus expectations for US corporate earnings are for a 4% decline in the Q3 period. The energy sector is the primary drag on earnings: the sector is forecast to witness a 60% drop in earnings over the same period.
- The market has already discounted the 45% decline in WTI crude on a year-average basis from 2014. Looking ahead, under a scenario where oil prices average similar levels as 2015 next year, the consensus forecast of a 5% recovery in energy sector earnings growth in 2016 appears achievable.
- Corporate margins in the US have rolled over lower. For non financials they have declining from 9% to 8.5% currently. Five of the past six US recessions have coincided with a decline in margins – see page 3.
- The one outlier was 1985, when oil prices declined 60% peak to trough. Given the similar drop in oil prices in the current cycle, we believe 2015/16 will also be an outlier and not a recession year.

Euro area and Japan – currency concerns

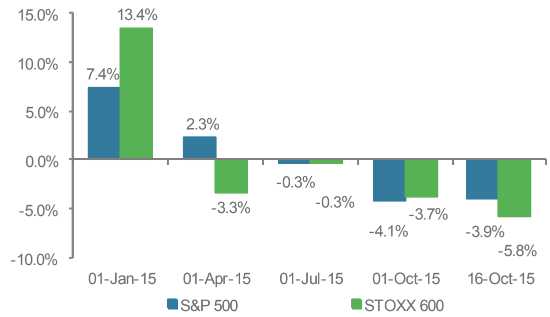
- We remain bullish on equities in the Euro area and Japan on a currency-hedged basis; however, we are shortening the tenure of our currency hedge. This reflects our conviction of dollar strength in three to six months, but declining conviction over 12 months.
- There are concerns that the recent period of euro and yen strength against the dollar will undermine the earnings recovery. We acknowledge that the euro and yen have strengthened in recent months, but not to the extent to hit earnings next year.
- Supporting our bullish view on euro area equities is the recent acceleration in household and corporate loan growth, as well as bank loan officer surveys, indicating an easing in lending conditions. This signals domestic demand is recovering.
- There are concerns that as the Japanese government pension investment fund (GPIF) has achieved its target allocation to domestic equities, a key support for the market is gone. We disagree, as private sector pension funds hold only 10% in domestic equities, down from 30%. If they increase their allocation in line with GPIF, further support for the market exists.

Performance of equity markets YTD* (USD)



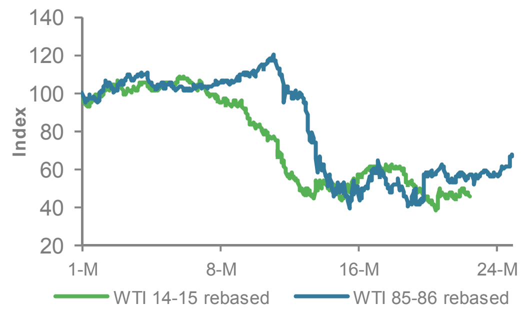
** For the period 31 December 2014 to 22 October 2015*
Source: Bloomberg, Standard Chartered. MSCI Indices are USD total return

EU + US earnings are forecast to decline in Q3
Earnings in the US + EU have been under pressure YTD



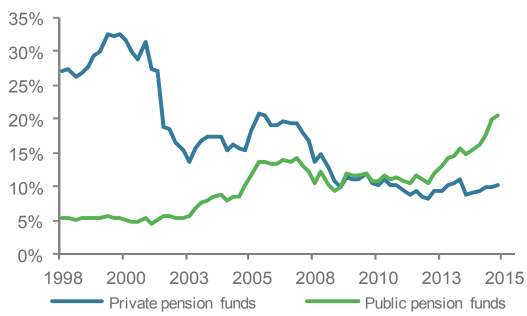
Source: FactSet, Standard Chartered

Similarities in WTI oil price trend in 1985 and the current one
WTI crude oil price trend



Source: Bloomberg, Standard Chartered

Japanese Government Pension Fund has reached target domestic equity allocation – private may follow
Domestic equity allocation of Japanese pension funds



Source: BoJ, Standard Chartered

China – No big-bang easing

- We remain bullish towards the China market, but see value in making sector-specific investments and focusing on funds with specific sector bias. Sectors we favour include consumer and technology with a focus on internet and e-commerce.
- China continues to shy away from aggressively easing policy, specifically large cuts in the reserve requirement ratio (RRR). We believe cuts in RRR are warranted given the tighter domestic liquidity environment due to capital outflows.
- Currently, the RRR in China is 18%, compared to a low of 6% in the 2000-2003 period. While the high level of the RRR was warranted in the 2008-2011 period of excess liquidity, the situation is different now. Signals from Beijing indicate it will be lowered at a measured as opposed to rapid pace.
- Reforms announced in the China telecom sector have been interpreted positively. The sector-specific announcement follows a broad SoE reform announcement in September.

Asia ex-Japan – elections and commodities in focus

- We are positive on equity markets in Asia ex-Japan, with a preference for India and China, noting that the former has more catalysts. Historically, India has been the second-best performer in the Q4 period, with a higher success rate than the best performer.
- India has recovered strongly from its early September lows, with low inflation and, in particular, energy prices benefitting the economy and in turn expectations for corporate earnings.
- The political timetable does have the potential to upset this market recovery. The state of Bihar will hold an election on 7 November and a win or loss by the ruling BJP will significantly impact the legislative agenda going forward.
- Malaysia and Indonesia have bounced back strongly over the past 30 days, benefitting from a reversal in currency and macro pessimism. We are cautious on both markets, believing that the combination of a strong dollar and uncertain commodity price outlook will weigh on the markets once the relief rally is over.

High-dividend-yielding equities – focus on Europe

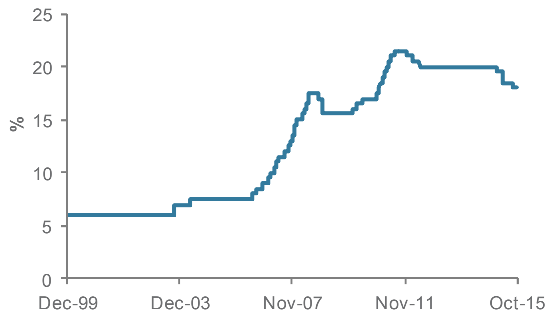
- We remain bullish on the high-dividend-yield equity (HDYE) theme. Europe, with a 5.75% yield, is our preferred region. European HDYE have risen 12% in USD since our Outlook 2015 publication, reflecting the hunger for yield as bond yields decline.
- European HDYE have a 54% weight in the UK, where we are cautious on the outlook. However, telecoms and utilities have a high weighting in EU HDYE, offsetting this concern (see page 3).
- US HDYE equities are flat YTD, indicating the greater focus on growth as opposed to dividends, which reflects the expectations for higher rates in the months ahead.
- Investors focusing on HDYE in Asia should note that they have significant exposure to China, where there may be some risks to dividends as growth continues to slow. This category has been the worst performer YTD, falling 6% in USD.

Conclusion

US and European earnings likely contracted in Q3. However, there are reasons to believe this year's earnings drag – energy – will reverse in 2016. This should provide a sufficient margin of safety to ensure earnings are market supportive in 2016. We remain positive on Euro area and Japanese equities and remain bullish on HDYE in Europe. The latter is up 12% YTD in USD terms and offers a yield of 5.75%.

Chinese reserve requirement ratio has potentially far to fall

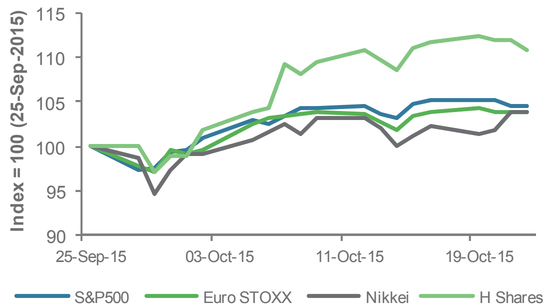
Chinese Reserve Requirement ratio (RRR) trend



Source: Bloomberg, Standard Chartered

Chinese shares have led markets higher from the September lows

Performance of select equity indices



Source: Bloomberg, Standard Chartered

EU high-dividend-yielding equities witness best performance trend since our 2015 Outlook publication

EU, US + Asian high-dividend-yielding equities performance

Source: MSCI, Bloomberg, Standard Chartered

Disclosure Appendix

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