Global Market Outlook

H2 Outlook: Should I stay, or …?
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## Investment strategy

<table>
<thead>
<tr>
<th>Currencies</th>
<th>Likely to outperform</th>
<th>Likely to underperform</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR</td>
<td>Strong economic momentum likely to enable the ECB to withdraw stimulus</td>
<td></td>
</tr>
<tr>
<td>USD</td>
<td>Policy divergence may be reaching its limits as the ECB prepares to taper</td>
<td></td>
</tr>
<tr>
<td>GBP</td>
<td>Tug-of-war between hawkish BoE and political uncertainty</td>
<td></td>
</tr>
<tr>
<td>Asia ex-Japan</td>
<td>Supported by consolidating USD and stable China growth</td>
<td></td>
</tr>
<tr>
<td>AUD</td>
<td>Shrinking bond yield differential and weaker iron ore prices</td>
<td></td>
</tr>
<tr>
<td>JPY</td>
<td>BoJ policy to restrict upside in Japan bond yields, while US yields rise</td>
<td></td>
</tr>
</tbody>
</table>

**Legend:**
- 🟢 Likely to outperform
- 🟠 Core holding
- 🔴 Likely to underperform

Source: Bloomberg, Standard Chartered
Perspectives on key client questions

Do you still believe in the ‘pivot towards reflation’?

Our ‘pivot towards reflation’ theme has two aspects: accelerating growth and moderately higher inflation. In our Outlook 2017 report, we stated we were ‘not convinced these shifts will be as seismic as many expect’. This has proved prescient. Global growth is still expected to accelerate this year, but inflation expectations have fallen back to 2016 levels.

As we look ahead to H2, we expect inflationary pressures to rise modestly, but this would likely require commodity prices to bottom out again and/or wage pressures to accelerate. This trend would likely be reinforced if we were to see a pivot towards greater fiscal stimulus in Developed Markets.

From an investment perspective, this means we continue to expect a multi-asset income allocation to generate 4-5% yields as interest rates and bond yields are expected to rise only gradually. However, it also means that we would continue to allocate to more cyclical areas of equity markets, rather than being solely reliant on high dividend-yielding equities.

Have political and geopolitical concerns peaked?

We continue to see significant risks in the coming years. In the US, the political environment remains fluid, with the president struggling to develop a constructive working relationship with Congress. In Asia, it is still unclear how competing territorial claims and North Korea’s increasing belligerence will be resolved peacefully. In the Middle East, the recent embargo against Qatar highlights a more confrontational geopolitical landscape. Euro area political risks declined in H1, as we expected, although, we believe Italian polls, due by Q2 18, remain a major risk to European unity.

The good news is US President Trump has moved back from a large number of his pre-election promises on the trade front (trade has actually accelerated). Trump has notably not followed through on labelling China a currency manipulator. However, it is not clear how this calm would survive if and when the US goes into recession (not something we see as likely in the short-term). A recession would merely exacerbate the longer-term trend towards populist and nationalist sentiment.

Figure 1: Growth strengthens, inflation expectations decline

How consensus estimates of 2017 global economic growth and inflation have evolved over time

Source: Bloomberg, Standard Chartered
As of 22 June 2017
When do you expect the next recession?

Normally there are three causes of a recession: an external shock, significant credit excesses or rising inflationary pressures. The first is clearly very difficult to forecast, but one could argue the risk an external shock could knock us into a recession is slightly higher than normal, given the above political/geopolitical landscape.

On the second, while financial asset valuations have risen broadly and significantly over the past few years, we do not believe there are generalised excesses that will induce a recession in the next 12 months.

This leads us to the risk of a sharp rise in inflation, which could encourage the Fed to prioritise fighting inflation over supporting growth, risking a recession. However, inflation expectations have fallen in recent months as oil prices have fallen and US wage pressures have failed to increase. As such, we believe the risk of the economy getting too hot has actually declined in the recent months.

Our central scenario is that the US as well as the global economy will continue to grow at a reasonable pace in the coming 12-18 months. Purely statistically speaking, at any point in time, there is a one in five chance of a recession in the next 12 months. Given the length of the recovery and the tightness in the US labour market, we believe the conditional probability is currently slightly higher.

Figure 2: Risks of overheating have likely fallen

<table>
<thead>
<tr>
<th>Broad global economic scenarios and our view on their probabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Too Cold</td>
</tr>
<tr>
<td>10%</td>
</tr>
</tbody>
</table>

Source: Standard Chartered Global Investment Committee
What is your outlook for oil prices?

Most of our investment views have worked well in the first half of the year. However, the worst performing view so far has been our expectation that oil prices will rise in 2017.

We continue to believe that the excess supply situation is getting eroded and that this will ultimately push oil prices higher. For sure, US shale production has recovered faster than we anticipated and breakeven costs appear to have fallen sharply. However, oil demand continues to grow, OPEC is proving effective at constraining supply and inventories are falling.

Assuming this continues, the time is likely to come when oil prices will rebound. We are less convinced that oil prices will end the year in the USD 60-65/bbl range, but we see a 75% probability that they will close the year higher than USD 45/bbl.

Figure 3: Oil markets have been focusing on rising US production

Source: Bloomberg, Standard Chartered
Macro overview

Steady growth, slowing inflation

- **Core scenario**: We see the global economy still slowly pivoting towards moderately stronger growth, although inflation expectations have softened. Economic activity in the Euro area and Asia is holding up, offsetting moderation in the US.

- **Policy outlook**: The Fed is likely to raise rates twice over the next year, amid full employment and below-target inflation. The ECB may trim stimulus by H1 18. China is likely to sustain fiscal/credit stimulus, while tightening monetary policy.

- **Key risks**: a) Deflation surprise; b) weaker growth in Emerging Markets; c) faster-than-expected Fed rate hikes caused by an inflation surprise; d) early ECB tapering; e) geopolitical risks in the Middle East, North Asia and related to Italy’s elections.

**Tussle between muddle-through and reflation**

Our Global Investment Committee (GIC) assigns a combined 75% probability to reflation or muddle-through scenarios unfolding over the next 12 months. However, prospects for a muddle-through scenario (40%) of moderate growth and low inflation have increased modestly in recent months amid a decline in inflation worldwide. The Euro area and Asia continue to see growth expectations revised upwards, helping offset a moderation in US activity. Inflationary or deflationary downside remains outside risks (at 15% and 10%, respectively), highlighting the tussle between tightening job markets in developed economies and lower oil prices. Geopolitics remain another source of risk.

**Figure 4:** Growth upside in the Euro area and Asia is helping offset moderation in the US

<table>
<thead>
<tr>
<th>Region</th>
<th>Growth</th>
<th>Inflation</th>
<th>Benchmark rates</th>
<th>Fiscal deficit</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>Growth, inflation indicators have moderated from Q1 highs. Fed is likely to raise rates twice in the next 12 months</td>
</tr>
<tr>
<td>Euro area</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>Growth expectations remain on an uptrend, but inflation has slowed from Q1 highs. ECB could signal less stimulus later in the year</td>
</tr>
<tr>
<td>UK</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>Consumers squeezed by slowing wage growth and rising inflation. BoE is under pressure to raise rates as inflation rises</td>
</tr>
<tr>
<td>Japan</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>Growth remains above trend amid strong exports. BoJ to maintain stimulus as deflation concerns return</td>
</tr>
<tr>
<td>Asia ex-Japan</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>Growth expectations have been revised higher. Fiscal, credit policy in China to remain supportive despite PBoC tightening</td>
</tr>
<tr>
<td>EM ex-Asia</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>🔴</td>
<td>Brazil and Russia emerge from two years of recession. Falling inflation could support further central bank easing</td>
</tr>
</tbody>
</table>

Source: Standard Chartered Global Investment Committee

**Legend:**
- 🔴 Supportive of risk assets
- 🔵 Neutral
- 🔴 Not supportive of risk assets
US – robust job market fails to lift inflation

**Strong job market fuelling consumption:** The subdued US jobless rate, at a 16-year low, is helping sustain consumption-driven growth. This is reflected in rising home sales and healthy services sector activity. However, some sectors, notably auto sales, are showing signs of saturation. Economic data has surprised negatively of late amid fading expectations of fiscal stimulus.

**Gradual Fed tightening:** US inflation expectations have declined amid lower oil prices and subdued wage growth. This is likely to enable the Fed maintain its gradual path for withdrawing its stimulus. We expect two rate hikes over the next 12 months, although the pace could change depending on the impact of a plan to slowly reduce its balance sheet.

**Euro area – growth forecasts revised higher**

**Easing political risk lifts confidence:** Euro area confidence indicators continue to rise amid easing political risk. There is growing expectation that France’s President Macron will push for wide-ranging reforms after winning the parliamentary elections. However, a significant slack exists in southern Europe, leaving regional inflation subdued.

**ECB gets some space as inflation slows:** The decline in inflation expectations, partly due to lower oil prices, provides the ECB some time before it starts to unwind its stimulus. We expect the ECB to start tapering bond purchases by H1 18.

**UK – consumer economy at risk**

**Inflation to hurt purchasing power:** UK retail sales continued its downtrend, highlighting the risk to the consumption-led economy from rising inflation and slowing wage growth. PM May’s failure to win a majority in the snap general election adds to the uncertainty around Brexit talks.

**BoE’s balancing act:** There is growing pressure within the BoE to raise rates as inflation approaches 3%. Governor Carney has cited Brexit risks for keeping rates unchanged. However, a further rise in inflation may force the BoE to act.
Japan – above-trend growth, zero inflation

Export-driven growth: Japan’s economy continues to grow above its trend-rate of recent years. The JPY’s weakness since last year, combined with a recovery in global trade, is boosting exports. There are also signs of a gradual pick-up in domestic demand given low oil prices and the impact of last year’s fiscal stimulus. However, momentum may be peaking.

Deflationary pressures to keep BoJ accommodative: Japan’s core inflation, excluding food and energy, is now at 0%, highlighting continued significant deflationary pressure despite the recovery in growth indicators. Thus, we do not expect the central bank to tighten policy – by raising its 10-year JGB yield target – over the next 12 months.

China – consumption holding up

Shift towards consumption drivers continues: China’s services sector activity and domestic retail sales remained robust, despite signs of a slowdown in the manufacturing sector. Rising short-term rates and credit tightening appear to have impacted the small-scale manufacturing sector. However, money supply and ‘real’ economic data remain robust, suggesting overall economic activity is holding up.

Focus on stable growth: We expect policymakers to maintain growth close to the 6.5% target, while taking steps to mitigate financial sector risks, ahead of the Communist Party Congress in Q4. This would entail sustaining the selective fiscal and credit stimulus, while tightening short-term monetary policy to curb excessive financial leverage.

Emerging Markets – gradually re-emerging

Asia’s domestic drivers of growth: Growth expectations in Asia have been revised higher in recent months, partly aided by robust global trade. As exports slow due to base effects, we expect sustained fiscal stimulus in China and India and from the new government in South Korea to buoy domestic consumption, sustaining the region’s growth outperformance.

Brazil, Russia emerge from recession: Brazil and Russia emerged from two years of recession in H1. Falling inflation is likely to enable further rate cuts. However, renewed political uncertainty in Brazil has led to a downgrade in growth expectations and has clouded the outlook.
Commodities

Down, but not out

- We expect commodities to rise modestly as global growth remains resilient and risks of a slowdown in China remain contained.
- We expect crude oil prices to move higher in H2 17 as demand-supply fundamentals remain supportive, although an adjustment higher could take time.
- Gold is expected to trade largely range-bound (USD 1,200-1,300/oz); significant upside unlikely amid gradually rising yields globally.

Oil supply fundamentals key

We remain constructive on commodities overall as the broader demand-supply picture remains supportive. Although the likelihood of a ‘muddle-through’ scenario has increased of late, global growth prospects remain on track with China likely maintaining stability in the medium term.

The sharp decline in oil prices has been the key focus of markets with investors zooming in on stubbornly high US oil inventories. We believe seasonal demand trends and OPEC and Russia’s resolve to maintain production cuts to be supportive of oil prices, but we are less convinced that oil prices will end the year in the USD 60-65/bbl range.

Gold prices have been supported by declining US Treasury yields, but we do not expect gold to extend its gains. Given our views for gradually higher yields globally, we think gold’s upside will likely be limited.

For industrial metals, the immediate demand picture remains broadly unchanged, although supply-side concerns and China’s policy path remain key risk factors.
Crude oil – remain constructive longer term

The recent sharp decline in oil prices was due to concerns over higher-than-expected US shale production undermining OPEC efforts to curb supply. While geopolitical risks have risen in the Middle East, we believe this will have a marginal impact on oil prices. Overall, we do not expect any significant downside to oil prices from current levels.

In our view, while OPEC and Russia’s agreement to extend supply cuts is supportive of prices, the surge in output from the US, Nigeria and Libya could offset some of these cuts. As US shale production approaches previous peak levels, we believe production is unlikely to be sustained as prices decline past producer breakeven levels. We believe OPEC compliance should remain high, in line with historical data, which should allow markets to rebalance.

Gold – reduce exposure on gains

We expect gold prices to move in a range of around USD 1200-1300/oz until early 2018. In our view, the recent uptick in prices was sparked by concerns over lower real yields, and we are biased towards reducing exposure should gold moves higher towards USD 1,300/oz.

While the odds of a Fed rate hike later this year have fallen, we still believe central banks will gradually raise interest rates and the USD will not weaken significantly. As a result, we think US Treasury and Bund yields could move higher, pushing real yields higher. Against this backdrop, gold’s upside should likely be limited.

Industrial metals – maintain limited exposure

Fundamentals in the industrial metals market have not shown significant improvement for us to have a constructive view. We note that there has been some divergence in recent performance as copper prices rose while iron ore prices continued their decline.

Copper’s recent outperformance was largely driven by a drop in copper-refined inventories. While inventory levels remain high, industrial metal demand should slow given the ongoing targeted monetary tightening in China.
Rising Differentiation

- We remain constructive on the EUR for the medium term, amid increasing possibility of an ECB stimulus withdrawal and reduced political concerns.
- We remain bearish on the JPY, as we believe the BoJ will maintain its current yield curve control policy, and we expect US Treasury yields to rebound modestly.
- We turn bearish on the AUD, as a combination of shrinking interest-rate differentials and declining iron ore prices are likely to weigh.
- Emerging Market (EM) currencies are likely to be stable for now, amid a combination of a sideways USD, low volatility and attractive yields.

Figure 18: Foreign exchange: key driving factors and outlook

<table>
<thead>
<tr>
<th>Currency</th>
<th>View</th>
<th>Real interest rate differentials</th>
<th>Risk sentiment</th>
<th>Commodity prices</th>
<th>Broad USD strength</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD</td>
<td></td>
<td></td>
<td></td>
<td>NA</td>
<td>NA</td>
<td>US not exceptional in withdrawing stimulus</td>
</tr>
<tr>
<td>EUR</td>
<td>▲</td>
<td></td>
<td>▲</td>
<td>NA</td>
<td></td>
<td>Economic momentum to support ECB stimulus withdrawal</td>
</tr>
<tr>
<td>JPY</td>
<td>▼</td>
<td></td>
<td>▼</td>
<td>NA</td>
<td></td>
<td>BoJ policy to restrict upside in Japan yields</td>
</tr>
<tr>
<td>GBP</td>
<td></td>
<td></td>
<td></td>
<td>NA</td>
<td></td>
<td>Lower risks, but BoE likely to maintain policy</td>
</tr>
<tr>
<td>AUD, NZD</td>
<td>▼</td>
<td></td>
<td>▼</td>
<td></td>
<td></td>
<td>Worsening real-yield differentials negative</td>
</tr>
<tr>
<td>EM FX</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Low volatility and commodity prices key</td>
</tr>
</tbody>
</table>

Source: Standard Chartered Global Investment Committee

Legend: ⬆️ Supportive ⬇️ Neutral ❌ Not Supportive ⬆️ Preferred ➡️ Less Preferred ⬇️ Neutral

Limited upside left in the USD, prefer EUR longer term

- We believe the USD is likely to modestly rise in the short term, with risks to the downside over the medium term. However, there is considerable room for differentiation with respect to individual currencies. We believe the EUR is likely to extend gains further amid a continued Euro area recovery and the possibility of an earlier-than-expected withdrawal of monetary stimulus. We believe further JPY weakness is likely as US yields rise modestly and weigh on US-Japan interest rate differentials. We highlight a change in our medium-term AUD outlook to bearish amid shrinking real yields relative to the US and continued weakness in iron ore prices. We expect EM currencies to remain broadly stable.
- In the immediate term, the USD could recover some of its losses as we believe the decline in US yields may have been excessive. We would use this opportunity to accumulate the EUR and EM currencies.
EUR – further gains likely medium term

We expect the EUR to extend gains further over the medium term, based on two key assumptions. First, we believe a continued recovery in the Euro area economy will eventually cause the ECB to withdraw stimulus, sooner than markets currently expect. Second, Euro area political risks have receded; Italian elections will likely take place next year.

The Euro area economic recovery is likely to continue to gather pace, further closing the gap with the US. As a result, we expect the ECB to eventually come under pressure to either reduce bond purchases or hike interest rates. We also believe the sharp reduction in political risks (Figure 46) is likely to further improve sentiment towards Euro area assets, which is likely to support the EUR. In the immediate term, we believe the EUR could continue to trade range-bound as markets grapple with the possibility of the ECB changing policy direction.

JPY – likely to weaken medium term

We remain bearish on the JPY. We believe YTD strength has largely been explained by lower US long-end yields. From current levels, we expect a modest rise in US 10-year yields. Simultaneously, we expect the BoJ’s yield curve control policy to likely remain in place, effectively anchoring Japan 10-year yields close to zero. As a result, we believe a widening of yield differentials is likely to weaken the JPY. We also believe geopolitical risks, a potential supporting factor for the JPY, remain largely contained and do not form part of our base case scenarios.

GBP – still looking for a catalyst

We believe the GBP is likely to remain largely range-bound as it is in a tug-of-war between continued political concerns and the possibility of an earlier than expected BoE rate hike. On the first point, near-term political uncertainty is likely to weigh on sentiment, while longer-term concerns over capital outflows and a large current account deficit could justify inexpensive valuations for now. However, the BoE’s concerns regarding inflation have begun to surface, resulting in a slight hawkish tilt in policy messaging. This could lead to an earlier BoE rate hike than what markets expect, which would be supportive of the GBP.
AUD – looking for more downside

We scale down our view on the AUD, as we believe fundamentals suggest potential for a further medium-term downside. Two key considerations motivate our thinking.

First, we believe fundamentals in the iron ore market remain weak as suppliers have not cut output while inventories remain high. In this context, we believe there are still considerable risks to the downside. We also see the significant improvement in Australia’s current account balance as largely a result of the earlier surge in iron ore price and is now likely to reverse. Second, Australia’s real interest rate differentials with the US continue to deteriorate as the Fed hikes interest rates while the RBA maintains policy for an extended period (see Figure 48).

Emerging Market currencies – fundamentals still supportive

We believe overall fundamentals are still constructive for risk assets and EM currencies. In this context, high carry (currencies supported by high bond yields), contained volatility and continued capital flows to the region are likely to be supportive. As a result, we still expect EM currencies to remain broadly stable, although we expect respective central banks to push back against any further strength.

We continue to favour high-yielding currencies in the EM space as these provide a good carry cushion. While respective central banks are likely to push back against significant strength due to its adverse impact on exports, on a total return basis (ie, including the yield on offer), these currencies are likely to remain attractive (also see pg 15).

Elsewhere, we believe risks to further CNY downside remain contained because of 1) limited USD strength and 2) limited capital outflows. With policy continuing to favour a largely neutral stance, we expect the outlook for the SGD to be driven by key trade partner currencies (CNY, MYR, EUR). In the case of the MYR, we believe the recent decline in commodity prices, in addition to any push back from the central bank, is likely to limit further strength. The trade-focused KRW is likely to see limited further gains this year as we believe it has already incorporated some of the recent positives.
Market performance summary*

Source: MSCI, JP Morgan, Barclays, Citigroup, Dow Jones, HFRX, FTSE, Bloomberg, Standard Chartered
*All performance shown in USD terms, unless otherwise stated.
*YTD performance data from 31 December 2016 to 29 June 2017 and 1-month performance from 29 May 2017 to 29 June 2017

### Commodity

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Year to date</th>
<th>1 month</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversified Commodity</td>
<td>-6.7%</td>
<td>-3.1%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>-6.7%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Energy</td>
<td>-21.6%</td>
<td>-9.2%</td>
</tr>
<tr>
<td>Industrial Metal</td>
<td>5.5%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Precious Metal</td>
<td>6.1%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>Crude Oil</td>
<td>-19.2%</td>
<td>-9.9%</td>
</tr>
<tr>
<td>Gold</td>
<td>8.1%</td>
<td>-1.9%</td>
</tr>
</tbody>
</table>

### FX (against USD)

<table>
<thead>
<tr>
<th>Currency</th>
<th>Year to date</th>
<th>1 month</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia ex- Japan</td>
<td>3.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>AUD</td>
<td>6.6%</td>
<td>3.3%</td>
</tr>
<tr>
<td>EUR</td>
<td>8.8%</td>
<td>2.5%</td>
</tr>
<tr>
<td>GBP</td>
<td>5.4%</td>
<td>1.3%</td>
</tr>
<tr>
<td>JPY</td>
<td>4.3%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>SGD</td>
<td>5.0%</td>
<td>0.5%</td>
</tr>
</tbody>
</table>
Events calendar

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

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Disclosure appendix

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