Standard Chartered

# 2017 OUTLOOK

# CONTENTS


## Not a bad year for investors

As we prepared for this 2017 Outlook, once again our starting point was to look back on the past 12 months to see what happened, what we got right, what we got wrong and what we missed.

In some ways, 2016 was the mirror image of 2015. In 2015, markets were very challenging, but we managed to pick most of the key themes and asset classes that did well to help boost the performance of our model allocations.

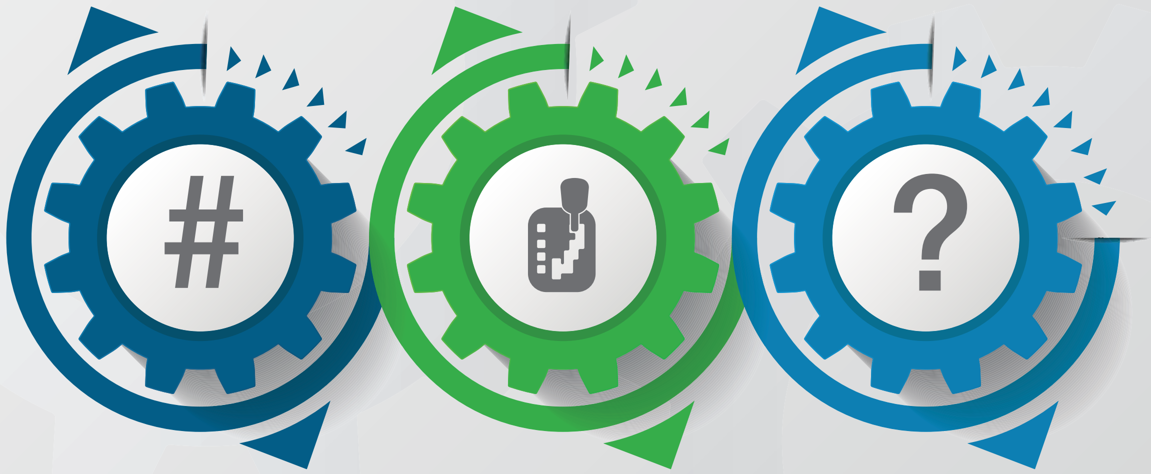
This year, markets were much kinder than in 2015. Our multi asset income approach to investing once again performed well (+8.9%). Meanwhile, oil prices and Emerging Market equities bottomed as we expected and the US dollar remained largely range bound. However, in hindsight, our decisions to reduce our suggested allocation to global equities in February and again in May were mistakes.

The net result of this is clients are probably happier this year as

returns have been much healthier (our tactical asset allocation model for a moderate risk profile shows a return of 7.4% since our 2016 Outlook publication vs -1.7% in 2015).

The key thing we missed was speed of the rise of populism, which crystallised itself in the UK's referendum on European Union membership and the US Presidential election. In hindsight, there was some evidence a year ago of rising dissatisfaction with the status quo, but few (ourselves included) were expecting the shift to be significant enough to deliver such a resounding message of the need for change. The lesson to be learned is that emerging trends can develop much quicker than many anticipate, especially in the world of social media.

There has been a very fast shift in sentiment towards a reflationary scenario in recent times. A continuation of this momentum is contingent on fiscal policies being implemented that would support this scenario.



**01**

Fast changing world where information/misinformation travels at an ever-increasing speed through cyber-space.

**02**

Pivot can be defined as ‘keeping one foot firmly grounded while you shift the other in a new direction’.

**03**

Degree to uncertainty surrounds the magnitude and pace of the pivots.

## What does this mean for 2017?

Given the uncertainties facing the global economy, we continue to believe it is really important for investors to take into account the possibility of different scenarios when investing. Naturally, these probabilities are as they stand today for the next 6-12 months and are expected to evolve as we move through 2017 and start looking into 2018.

We have tried to capture our thoughts via our '#pivot?' theme. This has 3 aspects to it.

First, the # symbolises a fast changing world where information (and misinformation) travels at an ever-increasing speed through cyber-space, which can accelerate the emergence of trends, both positive and negative.

Second, our preferred definition of pivot is 'to keep one foot firmly grounded while shifting the other in a new direction'. While muddle-through is no longer the dominant central view, it still remains one of two possible scenarios that form our core view (the other being reflationary upside or 'growflation'). We suggest investors keep one foot firmly planted in asset classes that might benefit from a muddle-through scenario while taking a step (pivoting) towards assets that might do well in a reflationary scenario.

Finally, we have included a '?" to highlight the uncertainty regarding the potential pivots, despite the recent market enthusiasm. While in some cases, the direction looks reasonably clear, the magnitude, pace and implications are all open to significant debate and may have been overly priced in, especially in the near term. For instance, it is not clear what form any US fiscal stimulus will take with some measures likely to find an easier and quicker passage through the legislature than others. Finally, it is easy to assume that, in a growth-starved world, a fiscal stimulus is a positive development. However, with the US already approaching full capacity, it is quite possible that increased government spending and tax cuts feed through to more inflation rather than faster growth.

There has been a very fast shift in sentiment towards a reflationary scenario in recent times. A continuation of this momentum is contingent on fiscal policies being implemented that would support this scenario. While initial signs look promising, we highlight it is early in the game. It is still unclear whether this pivot towards reflation is a sustainable trend and, even if it is, we doubt it will be a smooth process.

This leads us to recommend clients to keep a diversified allocation, with the majority focused on the muddle-through and growflation scenarios, albeit with some hedges on the tail risks, particularly in the area of accelerating inflation. This publication aims to be a map for 2017 that helps you navigate through uncharted waters in 2017. As always, we will provide regular updates as we go through the year on emerging opportunities and risks.

## What you should do

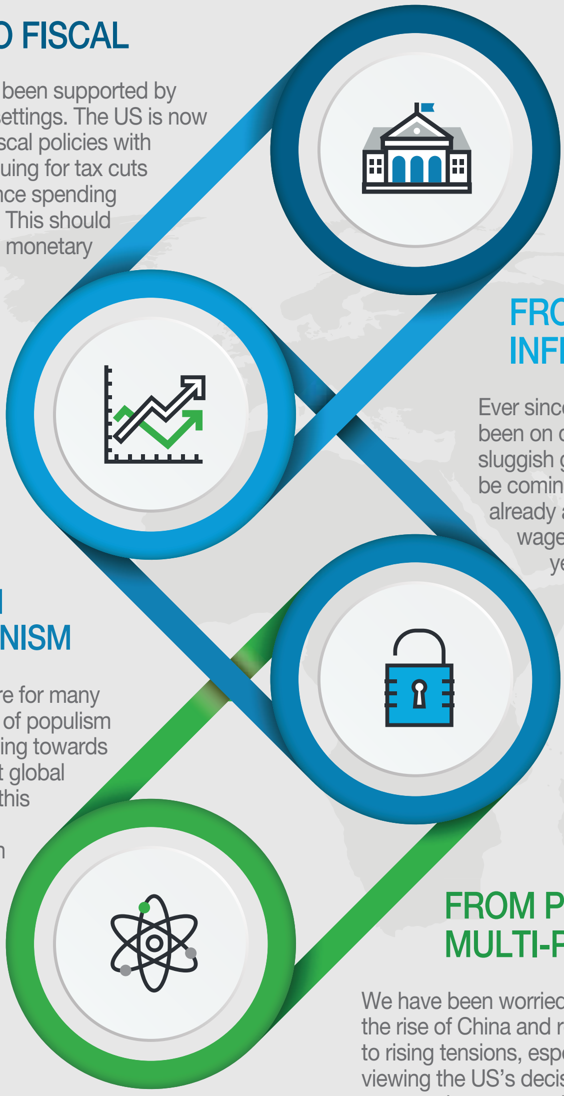
We highly recommend that you reach out to your relationship manager to understand fully the implications of our views for you and to consider whether any changes to your investment allocations are warranted.

Meanwhile, we wish everybody a very Happy New Year and all thebest in the year ahead.

**[ Alexis Calla ]**

# 2017: THE YEAR OF THE #PIVOT?

[ Steve Brice ]



## FROM MONETARY TO FISCAL

Ever since 1999, economies have been supported by extremely loose monetary policy settings. The US is now taking a leading role in boosting fiscal policies with President-elect Donald Trump arguing for tax cuts and increased infrastructure/defence spending in order to spur economic activity. This should cause the Fed to gradually tighten monetary policy.

## FROM DEFLATION TO INFLATION

Ever since the Global Financial Crisis, the focus has been on deflationary fears against the backdrop of sluggish growth and very high debt levels. This may be coming to an end. In the US, unemployment is already at levels which usually trigger accelerating wages. Meanwhile, after declining for almost 5 years, Chinese producer prices have started rising modestly, removing another large disinflationary force. Finally, rising oil prices are expected to contribute to gradually rising inflationary pressures in the coming 12 months.

## FROM GLOBALISATION TOWARDS PROTECTIONISM

Globalisation has been a key feature for many decades. The dramatic expression of populism over the past 12 months risks a swing towards a more protectionist stance against global trade. The US is at the forefront of this shift. For now, the US has merely called a halt to further globalisation rather than embarking on protectionist measures, with the Trans-Pacific Partnership (TPP) the main casualty. The risk of protectionist measures is rising, although for now we expect them to be targeted.

## FROM PAX AMERICANA TO MULTI-POLARITY

We have been worried about this theme for some time with the rise of China and relative decline of the US likely leading to rising tensions, especially in Asia. China appears to be viewing the US's decision to pull out of the TPP as an opportunity to expand its sphere of influence. This infers a potential Asian pivot away from the US towards China. History teaches us that multi-polarity can often lead to extreme 'black swan' events.

Financial markets have moved rapidly since the US election in the belief that 2017 willshape up to be a pivotal year. We agree that global economic confidence has been boosted by increased expectations of faster growth and inflation, possibly ending years of a deflationary mindset. Some examples of expected changes (or pivots) to the global economic and financial landscape that we see evolving in 2017 are highlighted below. However, we would take a more balanced view as we are not convinced these shifts will be as seismic as many expect.

## Implications for investors

Of course, there is still much uncertainty in the world, including how long the above pivots will last, how quickly they will happen and what the implications will be. However, we still see this pivot lens as a useful one for investors to bear in mind when making investment decisions.

Thus far, markets are clearly focusing more on the positive aspects of the reflation pivot. Equities have rallied, led by Developed Markets, bond yields have risen and the US dollar has rallied.

Stronger global economic growth in 2017, which would be only the second global acceleration since 2009, a modest rise in inflation and corporate tax cuts should benefit equities, especially in the US. Meanwhile, a weaker JPY should boost Japan corporate profitability, increasing the attractiveness of Japanese equities on a currency-hedged basis. US dollar strength and fears over protectionism have proven to be a headwind for Emerging Market equities.

Within bonds, the rising inflationary pressures suggest we would look for opportunities to reduce our exposure and shorten our maturity profile. Our favoured spaces within bonds are US high yield – due to its higher yields, lower interest rate sensitivity, exposure to rising oil prices and potential for corporate credit quality to improve should the economy recover – and US leveraged loans – due to their exposure to rising interest rates.

Finally, we still believe the highly successful multi-asset income strategy is appropriate for income investors to the extent that we believe it can generate a sustainable 4-5% yield. However, we have less confidence that it will outper form a multi-asset growth allocation as it did these recent years. Therefore, we selectively identify growth areas that we believe should be added for 2017.

However, as highlighted above, nothing is certain in this world. Exactly what policies will be implemented is still unknown. For instance, if the US government focuses on tax cuts for the rich, the economic impact is likely to be lower than an increase in infrastructure spending. Meanwhile, it is quite possible that inflation, which was already expected to rise slightly, will rise more dramatically. This could push up interest rates and yields more swiftly, undermining equities.

Given these uncertainties, which will only increase as the economic recovery extends, we believe investors will find useful a scenario-based approach to investing, which naturally results in a balanced investment profile. This should include some hedges against a less favourable scenario the markets are currently pricing in, especially with regards to the risk of higher inflation. The table below summarises our preferred asset classes as we head into 2017.

# MACRO OVERVIEW
# AT A GLANCE

[ Rajat Bhattacharya ]

**Global growth is likely to accelerate in 2017 for only the second year since the financial crisis**, as Russia and Brazil emerge from two years of recession and as US growth accelerates modestly. Asia, including China, is likely to remain the biggest contributor of global growth.

**Deflationary pressures are fading.** We expect an upturn in inflation worldwide, especially in the US, as tightening labour markets fuel wage pressures and amid a recovery in oil and commodity prices.

**Policy focus in the Developed Markets to shift from monetary to fiscal measures to revive growth and inflation.** Donald Trump's election in the US has raised expectation of a strong fiscal stimulus package. Monetary policy is likely to remain accommodative across major economies.

**The key alternative scenarios, we believe, are three-fold: 1)** Continuation of muddle-through growth as a result of a sharp rise in bond yields/rates and a stronger USD. **2)** Stagflation, or a sharp upturn in inflation caused by reflationary policies, without generating any growth upsurge. **3)** Return to deflation.

| | GDP (%) | | CPI (%) | | Ngân sách (% GDP) | | | Chỉ số chính (%) | |
|---|---|---|---|---|---|---|---|---|---|
| | 2016 | 2017 | 2016 | 2017 | 2015 | 2016 | 2017 | 2016 | 2017 |
| United States | 1.60 | 2.20 | 1.30 | 2.30 | -2.60 | -3.20 | -3.20 | 0.75 | 1.25 |
| Eurozone | 1.60 | 1.30 | 0.20 | 1.30 | -2.10 | -1.90 | -1.70 | 0.00 | 0.00 |
| China | 6.70 | 6.40 | 2.00 | 2.10 | -3.40 | -3.10 | -3.50 | 4.35 | 4.20 |
| Japan | 0.60 | 0.80 | -0.20 | 0.50 | -6.70 | -5.80 | -5.30 | 0.00 | -0.10 |
| United Kingdom | 2.00 | 1.00 | 0.70 | 2.40 | -4.30 | -3.70 | -3.50 | 0.25 | 0.25 |
| India | 7.30 | 7.60 | 4.80 | 5.00 | -3.50 | -3.50 | -3.30 | 6.25 | 6.00 |
| Brazil | -3.30 | 1.00 | 8.70 | 5.40 | -8.20 | -9.10 | -8.90 | 13.75 | 10.75 |
| Canada | 1.30 | 1.80 | 1.50 | 1.90 | 0.10 | -1.30 | -1.50 | 0.50 | 0.50 |
| South Korea | 2.70 | 2.60 | 1.00 | 1.70 | 0.00 | 0.10 | 0.30 | 1.25 | 1.05 |
| Australia | 2.90 | 2.70 | 1.30 | 2.00 | -1.90 | -2.40 | -2.00 | 1.50 | 1.35 |
| Russia | -0.60 | 1.30 | 7.10 | 5.20 | -2.80 | -3.80 | -3.00 | 10.00 | 8.25 |
| Mexico | 2.10 | 1.80 | 2.80 | 3.70 | -3.50 | -3.00 | -2.50 | 5.50 | 6.10 |

Source: Bloomberg consensus forecasts for the world's top 12 economies; Standard Chartered

## Global outlook improves on easier fiscal policies.

The global outlook is constructive at the time of going to print. Consensus forecasts show global growth is expected to accelerate to 3.2% in 2017, from an estimated 2.9% in 2016. That would make it only the second such instance of year-on-year acceleration since the Global Financial Crisis.

Some emerging economies are likely to lead this turnaround as Brazil and Russia return to growth after a couple of years of recession, aided by a recovery in commodity prices from multi decade lows. In this base reflationary scenario, China's fiscal and credit stimulus – implemented over the past couple of years – continues to provide stability for Emerging Markets, besides sustaining the recovery in commodity prices. Asia is likely to contribute 60% of global growth in 2017.

Fiscal policy in the Developed Markets has the potential to positively lift global growth. This is especially important as monetary policy remains supportive (and real interest rates negative), even with the Fed likely raising benchmark rates by around 50bps over the next 12 months. We expect the ECB, BoJ and PBoC to maintain their already accommodative monetary policies through 2017.

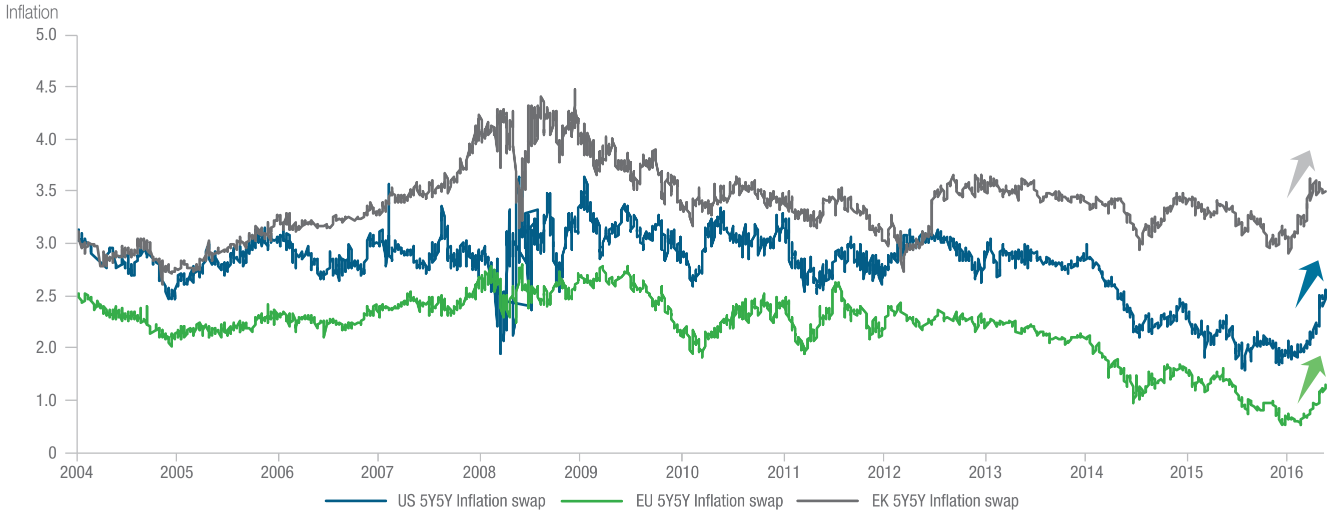
Fiscal policy has already started to ease in several economies – the US fiscal deficit rose in 2016 for the first time since 2009. Further easing as a result of simplification of tax policies (or cutting taxes) and higher spending on infrastructure could lift US growth above recent trend of around 2%. However, this risks stoking inflation, forcing the Fed to raise rates a lot faster than the expected two hikes and boosting the USD. Higher rates and stronger USD could act as powerful brakes in this scenario.

New governments in the UK and Canada have abandoned earlier plans to achieve budget surpluses and have instead proposed tax cuts and higher infrastructure spending.

Meanwhile, Japan's policy of controlling long-term government bond yields is likely to enable the government to sell long-term bonds to finance infrastructure spending, while a weaker JPY helps its exporters. China, which started implementing its fiscal boost two years ago, is likely to maintain its stimulus as it stabilises growth in the run-up to the crucial, once-in-five-years, Communist Party Congress in Q4 2017 (which will select the next batch of leaders). Only Europe appears to be refraining from expanding fiscal policy either due to political reluctance (Germany) or perceived financial constraints (in southern Europe).

Figure 1: Inflation expectations are rising amid tighter labour markets and higher commodity prices

Long-term market-based inflation expectations in the US, UK and the Euro area (5-year, 5-year inflation swap rates) US 5Y5Y inflation swap EU 5Y5Y inflation swap UK 5Y5Y inflation swap 2004.




Source: Bloomberg, Standard Chartered

# US: Going fiscal

1. US economy to see an eighth year of expansion, with consumption and business investment accelerating on the back of easier fiscal policies
2. We expect President-elect Trump to at least partially deliver on his promise to cut taxes, ease business regulations and boost spending on infrastructure, helping lengthen an already-extended business cycle
3. The key risk is a sharp rise in inflation as Trump's stimulus measures accentuate an already tight job market, fuelling wage pressures. This could lift yields higher and boost the USD, eventually dampening growth
4. The Fed is likely to hike rates at least twice in 2017 as inflationary pressures start to build, but a strong US dollar means further rate rises are likely to be gradual

## Trump's policy priorities

The impact of the US Presidential election is debatable, but one issue which both sides agreed on in the run-up to the polls was the use of fiscal policy tools, including the need for more investment in infrastructure to boost growth and productivity. Markets have priced in growth-supportive policies, which implies expectations have been set high for 2017-2018.

In his first public statement since the election, President-elect Trump highlighted several policy priorities, all of which are focused on boosting US manufacturing and jobs. These include: abandoning the Trans-Pacific Partnership trade agreement (which the US was due to sign with 11 other Pacificrim economies such as Japan, Australia, Canada, Mexico); relaxing environmental restrictions on the energy sector to revive the domestic shale oil and gas and clean-coal sectors; easing business regulations (especially related to banks); boosting infrastructure and defence spending (including cyber-security); and tightening immigra tion rules.

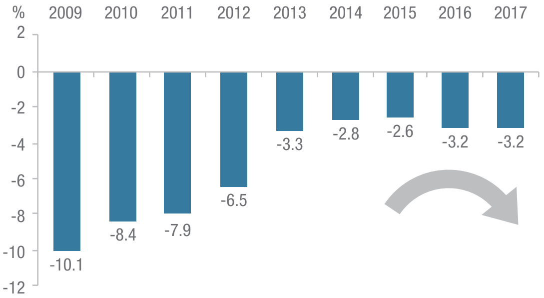
The US economic outlook is likely to depend significantly on how a Trump administration prioritises these policies. For instance, a focus on trade disputes in the early stages (including punitive tariffs on China and other trade partners pledged during the election campaign) could be negative for growth and may fuel inflationary pressures. Similarly, tougher immigration policies could impact critical sectors including construction, energy and retail industries.

The Republicans control over both houses of Congress is likely to help the Trump administration push through many of its policy priorities. However, our base case is that the new administration will initially focus on areas where there is broader consensus among both parties. These include revamping tax laws, lowering corporate and personal taxes, incentivising companies to repatriate overseas-held cash and invest in the US; and implementing a plan to boost infrastruc - ture-spending (Trump's campaign noted a USD1 trillion infrastructure spending gap over 10 years).

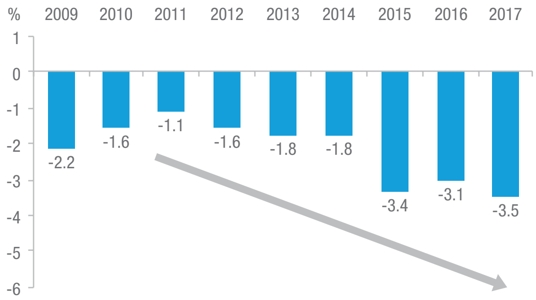
How the incoming administration chooses to fund the proposed tax cuts and infrastructure investments is likely to have a significant impact on financial markets. Trump has pledged a deficit-neutral plan. Any slippage is likely to boost borrowing costs.

Overall, we expect US economic activity to pick-up on the back of sustained consumption as the job market remains robust and wages continue to accelerate. Proposed personal tax cuts are likely to further boost consumption, while corporate tax cuts are expected to help revive business investment at least to some degree, improving productivity over the longer term. The housing market is expected to remain a growth engine as pentup demand for residential housing stays high amid a continued recovery in the job market. However, the recent rebound in longterm interest rates risks increasing mortgage costs, potentially thwarting the sector's expansion.

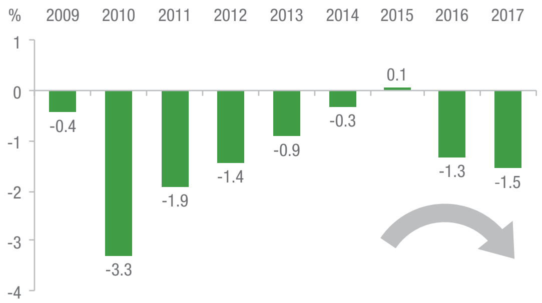
US Fiscal Deficit



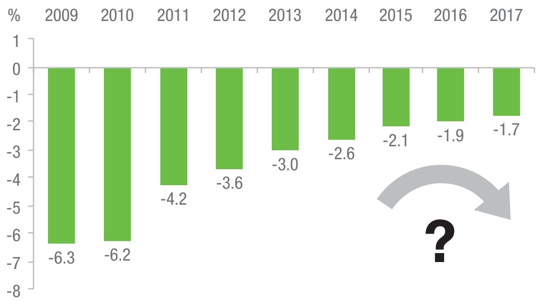

China Fiscal Deficit




Canada Fiscal Deficit




Eurozone Fiscal Deficit



## Monitoring inflation

We will also monitor the implications of Trump's policies on inflation. Long-term inflation expectations have picked up significantly since the election victory, partly on expectations that a fiscal stimulus and tougher immigration policies at a time when unemployment is close to the Fed's optimal target could lead to higher wage pressures. Thus, a stronger upsurge in inflation, driven by supply constraints, remains a key risk for the US economic outlook, although it is important to note that the relationship between wages and inflation is not clear-cut.

There may be sufficient 'hidden' labour market slack, given the low job market participation rates and still high levels of part time workers, to absorb increased demand for workers as infrastructure projects are implemented over the next few years.

## Hawkish Fed?

Thus, we believe, the Fed is likely to raise rates at least twice in 2017. However, changes (by member rotation) to the Fed's policy rate-setting committee in 2017 are expected to bring in more members to the board who are biased towards raising rates. The Trump administration is also likely to nominate at least two members to the Fed's board – which could bring a slightly more hawkish bias. Thus, as with inflation, the risk to US interest rates in 2017 is on the upside.

# Europe: Politics in focus

1. Euro area growth is likely to slow in 2017 as political uncertainty and excess capacity hold back business investment, offsetting a likely boost to exports from a weak EUR. The UK faces Brexit-related uncertainty
2. Inflation expectations are rising across Europe on higher commodity prices, particularly in the UK because of the sharp devaluation in the GBP. However, Euro area inflation remains well below the ECB's 2% target
3. The biggest risk to the region is a rise in populist or anti-establishment parties in the upcoming elections. The UK faces the risk of a 'hard-Brexit' if Euro area policymakers deny it open access to its common market
4. The ECB is likely to maintain stimulus as inflation stays below target. The BoE is likely to tolerate a rise in inflation above its 2% target to support growth. However, inflation above 3% may increase pressure to raise rates

## Election watch

While the US economy has the potential to deliver an upside surprise, the Euro area carries negative risks. The main uncertainty originates from its busy political calendar next year. Italy's referendum, wherein voters rejected the government's reform proposal leading to the resignation of Prime Minister Matteo Renzi, highlights the potential risks from elections in France, the Netherlands and Germany in 2017.

German Chancellor Angela Merkel's decision to run for a fourth term and Austria rejecting a right-wing party this month are positive for Euro area political stability and continuity in policies. However, the prospect of France's far-right candidate, Marine Le Pen, proceeding to the final round of the French presidential elections may raise concerns about another electoral upset similar to the Brexit vote and Trump's win in the US. While Le Pen is significantly trailing the Republican candidate in opinion polls, investors will have learned to be sceptical of such polls over the past 12 months, especially so many months before elections.

For now, data suggests the Euro area economy has weathered the post-Brexit slowdown. Business and investor confidence indicators have recovered from their Q3 slump. The weaker EUR continues to support exports, and could yet help Euro area growth surprise on the upside, while record low borrowing costs are helping consumers and businesses.

## Accommodative ECB

Excess capacity persists both in manufacturing and labour markets, the latter caused by still-high unemployment rates in southern Europe. This remains a challenge as it continues to dampen inflation expectations. While producer price deflation appears to be receding (aided by a recovery in oil prices) and consumer prices have started to rise again, inflation remains well below the ECB's 2% target. The ECB acknowledged the risk as it extended its bond purchase plan until the end of 2017, while reducing the amount of bonds it would buy each month.

## UK: Preparing for Brexit

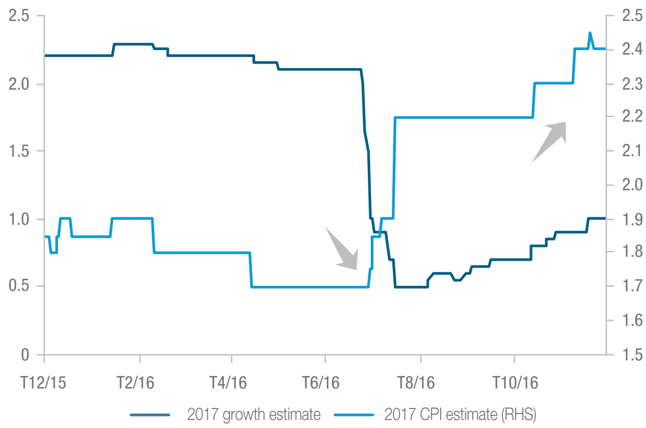
The UK economy has been surprisingly resilient since the Brexit vote, with business confidence bouncing back after an initial slump. However, 2017 is likely to be more challenging as uncertainty around the Brexit negotiations eventually curbs business investment and a weaker GBP boosts inflation, hurting real incomes and consumption. The government has cut its 2017 growth forecast to 1.4% from pre-Brexit estimates of 2.1%, although that remains much higher than consensus estimates which see 0.9% growth next year, the weakest since the 2009 financial crisis.

One of the main casualties of the Brexit vote is the government's fiscal austerity plan. In its first half-yearly budget statement after Brexit, the government abandoned plans to eliminate the budget deficit by 2021, and instead forecasts GBP122 billion of additional deficits over the next five years, half of it due to increased Brexit-related costs. The government will proceed with planned cuts in corporate taxes to 17%, making it the lowest among G20 economies. It also raised income thresholds for tax deductions and announced plans to boost spending on housing, transport and broadband networks to boost productivity. The UK's upcoming negotiations with Euro area policymakers aimed at retaining access to the European Union common market for British goods and services will be closely watched.

The impact of the Brexit talks on the job market remains our key focus – jobless claims have started to rise. A pick-up in unemployment, combined with higher inflation (due to rising import costs from a weaker GBP), could hurt consumption, which accounts for almost 70% of the economy. The BoE, which has already cut interest rates to a record low is likely to tolerate an overshoot in inflation above its 2% target. However, it may come under pressure to raise rates if inflation exceeds 3%.

The UK's 2017 growth forecasts have been downgraded since the Brexit vote, while inflation forecasts have risen as a weaker GBP raises import costs

UK consensus GDP and CPI forecasts for 2017, % y/y




Source: Bloomberg, Standard Chartered

# Japan: Tailwind from a weaker JPY

1. Japan's economy remains the most sluggish among major Developed Market economies. However, a weakening JPY, if persistent, is likely to help revive exports, providing a moderate lift to growth
2. Government spending remains a key driver of the economy as business investment and consumption remain lacklustre Prime Minister Abe's four-year old policy ('Abenomics') to re_ate the economy is increasingly being questioned due to its inability to deliver on reforms, especially in labour markets
3. Meanwhile, US President-elect Trump's decision to abandon Trans-Pacific Partnership talks is negative for Japan's export sector; it could also delay progress in reforms to open up the economy to competition.

Japan's economy is estimated to grow less than 1% in 2017, while in_ation is estimated to average around 0.5%, highlighting the economy's persistent deflationary challenges. There is a silver lining – the JPY has weakened more than 12% since the BoJ's policy-shift in September from inflation-targeting to pegging the 10-year government bond yield close to 0%. The decision is likely to put further downward pressure on the JPY in a broadly strong-USD environment.

A weaker JPY, in turn, is likely to provide some boost to the export sector and revive inflationary pressures in 2017. However, significant JPY weakness could lift the cost of raw material imports, especially for energy products whose consumption has surged since Japan shut down its nuclear reactors. We believe the BoJ's anchoring of long-term yields is also likely to clear the way for the government to issue long-term bonds to fund infrastructure, especially those related to the 2020 Olympics. This could provide an additional lift to growth.

# Emerging Markets Recovering

1. China is likely to maintain a stable growth of around 6.5% in the run-up to its once-in-five years Communist Party Congress. This should support growth across the region.
2. Asia is likely to remain the biggest contributor to global growth, aided by accommodative monetary policies and robust consumption, especially in domestic demand-focused economies such as India and Indonesia
3. In other Emerging Markets, Brazil and Russia are expected to emerge from two years of recession on the back of a recovery in oil and commodity prices. Falling inflation in both economies should allow central banks to cut rates, supporting the growth upturn
4. The biggest source of risk for Emerging Markets is likely to be external, in particular any protectionist or punitive trade measures from the incoming US administration or from a stronger USD

## Asia: China provides stability

Asia ex-Japan is likely to remain the biggest contributor to global growth, with consensus estimates forecasting 5.8% expansion in 2017, compared with 5.7% this year. The region's outlook has shifted from 'uncertainty' to 'stability' over the past year as China's fiscal and credit stimulus helped its economy to stabilise. China's stability, in turn, has helped support the rest of Asia and other Emerging Markets, by putting a floor under global trade and by reviving commodity prices from multi-decade lows.

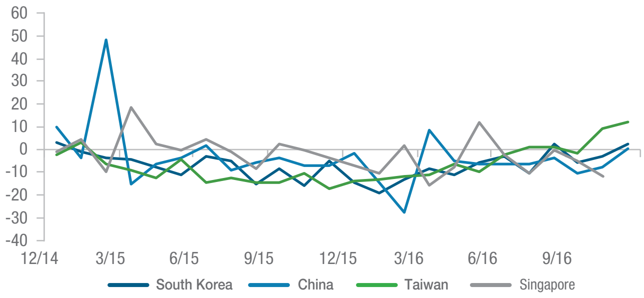
We expect China to maintain its stimulus, as it seeks stability ahead of the Communist Party Congress in Q4 2017 (which will elect the next generation of leaders). Recent measures to control runaway property prices suggest the authorities recognise the risk to financial stability from unbridled property sector expansion and high debt levels. Measures to revamp local government finances and tackle bank bad loans are also positive, as are steps to shift the economy's drivers towards domestic consumption.

One of the biggest risks for Asia is likely to be external. Trump campaigned in the US election to renegotiate trade agreements and impose punitive tariffs on China and other trade partners. Although Trump has been more conciliatory on some issues after the elections, he has reiterated his plans to abandon the Trans-Pacific Partnership trade agreement. Any effort to renegotiate trade pacts is likely to increase uncertainty across Asia, especially in the export-oriented economies including South Korea, Taiwan, Hong Kong, Singapore and Malaysia, which are already struggling with weak exports. Domestic demand-driven economies such as India and Indonesia are less vulnerable to these policy risks.

The USD's recent strength increased capital outflows from the region. The PBoC and other regional central banks are likely to welcome modest currency weakness to support exports which have been contracting for the past couple of years. However, any significant weakness in currencies and higher global rates could undermine financial stability, given the significant rise in the region's debt burden over the past decade. Hence, the recent tightening of capital controls by China to stem a rise in outflows.

Asian exports have been under pressure for the past two years, but there are nascent signs of an upturn

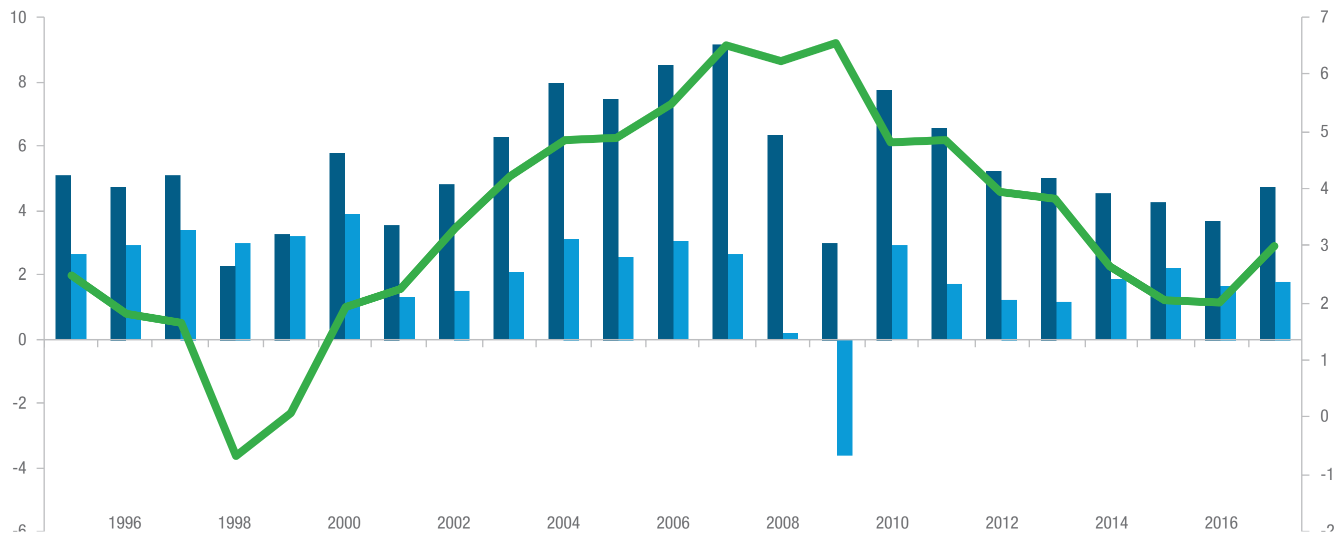
Export growth trend for major Asian exporters, % y/y




Source: Bloomberg, Standard Chartered

Emerging Market growth outperformance over Developed Markets is likely to widen for the first time since the Global Financial Crisis

Emerging Maket and Developed Market growth trend and consensus estimate for 2017 (%); Growth differential between EM and DM (%)




Source: Bloomberg, Standard Chartered

## KEY RISKS

**Stagflation.** This involves a sharp rise in inflation without any significant upturn in growth due to structural supply side limitations such as aging demographics and declining productivity. This scenario is particularly relevant for the US, where the Trump administration's plans to boost spending on infrastructure and cut taxes to stimulate growth clashes with an economy which is already in its eighth year of its expansion and faces an increasingly tight labour market. A stagflation scenario could force the Fed to raise rates faster than expected, further hurting growth.

**European political uncertainty.** The likelihood of antiestablishment parties gaining ground in the upcoming Euro area elections could call into question the stability of the common market and the future of the euro as a common currency. These concerns are already heightened after the UK's Brexit vote and the Italian referendum, dampening the outlook for business investment. (For instance, in the UK, fixed investment is expected to contract 2.1% in 2017, the biggest decline since the financial crisis). Any resulting growth slump or a return to deflation in Europe could add pressure on European lenders, leading to a full-blown banking crisis.

**Trade protectionism.** Trump's campaign proposals included imposing punitive tariffs on imports from China and Mexico, abandoning the Trans-Pacific Partnership and renegotiating existing trade agreements such as NAFTA. If implemented, these policies could dampen the outlook for global trade which has already experienced years of slowdown. Emerging Markets face the greatest risk from such an outcome.

**Sustained USD gains** could hurt US exporters, while encouraging further capital outflows from Emerging Markets. This could dampen global growth. We see US dollar gains as self-limiting, as excessive gains lead to a slowdown in the US economy, causing the USD to give up its gains. The self adjusting mechanism was apparent in 2015 as well as in H1 2016.

**An Emerging Market crisis** caused by a hard-landing in China remains a risk. This risk seems more remote today compared with a year ago, given the reforms implemented by China in recent years and the government's proven willingness and ability (seen over the past couple of years) to stabilise growth. We expect China to continue supporting growth ahead of the crucial Communist Party Congress in Q4 2017.

# FX AT A GLANCE

[ Tariq Ali, CFA | Manpreet Gill ]

**We expect moderate USD strength going into 2017.** We expect weakness in the EUR, JPY, GBP and CNY heading into 2017 amid higher expectation of US interest rates and continued policy easing by the respective central bank. Our highest conviction views are short EUR/USD and long USD/CNY.

**We expect the AUD and NZD to extend gains in 2017.** We expect strength in the AUD and NZD against the backdrop of rising inflation, higher commodity prices and the likely absence of further easing from the local central banks. Our highest conviction view is long AUD/USD.

**Selective currency performance within Emerging Market currencies.** We expect commodity linked currencies with improving balance of payment fundamentals and high interest rates (RUB, BRL, IDR and INR) to outperform other Emerging Market currencies against the USD.

| Curency | Outlook | Real Interest Rate Differentials | Commodities Prices | Risk Sentiment | Broad USD Strength | Comments |
|---|---|---|---|---|---|---|
| USD | ▲ | 🟢 | 🟢 | 🔴 | n/a | Higher US rates coupled with maintenance of policy easing in major economies |
| EUR | ▼ | 🔴 | 🔴 | n/a | n/a | Widening rate differentials as ECB maintains easy policy settings |
| JPY | ▼ | 🔴 | 🟡 | n/a | n/a | Widening rate differentials amid BoJ's yeld curve control policy |
| GBP | ▼ | 🔴 | 🔴 | n/a | n/a | Weak sentiment amid post Brexit uncertainty and weak balance of payment fundamentals |
| AUD, NZD | ▲ | 🟡 | 🟢 | 🟢 | 🔴 | Moderately higher commodity prices to be supportive while easing cycle has likely troughed |
| EM FX | ◆ | 🔴 | 🟢 | 🟢 | 🔴 | Modestly stronger USD is a headwind, but moderately higher commodity prices and stable China growth to limit downside |

Source: Bloomberg, Standard Chartered
Legend: ▲ Bullish | ▼ Bearish ◆ Neutral 🔴 Not Supportive 🟡 Neutral| 🟢 Supportive

# FED OUTLOOK KEY

## USD: Riding on higher US rate expectations

In 2016, the USD (trade weighted) stalled as Fed rate hike expectations were scaled back owing to lacklustre US growth and inflation expectations. Recently, USD gains resumed following the US elections amid increased fiscal stimulus expectations and a surge in US yields. A reflationary or a high inflation scenario would be positive for the USD as long as Fed rate hikes do not underwhelm market expectations. We expect a range-bound outcome in a muddle-through scenario.

We believe the USD could modestly extend gains into early 2017, in our base case, predicated on two assumptions. First, in response to higher inflationary pressures, the Fed proactively hikes interest rates while most other central banks and, in particular, the BoJ, ECB, BoE and at least PBoC at least maintain their current accommodative policies. This would likely widen net-of-inflation (real) interest rate differentials in favour of the USD. Second, while we expect EM growth to stabilise, a strong rebound remains unlikely and, hence, sentiment towards them remains cautious. A significant part of the USD trade-weighted index is onstituted of EM currencies. We see two major risks to our outlook for modest USD strength in 2017. First, the Fed could adopt an objective of allowing inflation to move above its target for a certain period (sometimes referred to as running a 'hot' economy). This would narrow real interest rate differentials and weaken the USD. Second, Emerging Markets stage a strong rebound, attracting increased capital flows and weakening the USD.

EUR | Short term | Medium term

JPY | Short term | Medium term

## EUR: Political risks could dominate

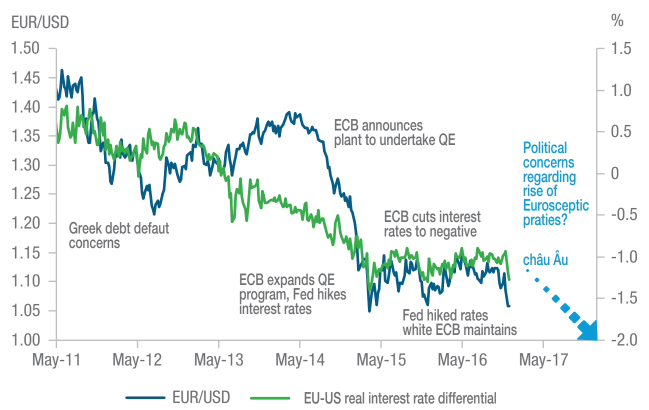
The EUR/USD has traded in a relatively tight range (largely 1.05- 1.15) over the past two years. However, we believe the EUR is likely to break lower in 2017. Outside of the broad USD trend, two key factors shape our EUR outlook. First, ECB monetary policy and second, Euro area political risks. On the first point, our base case is that the ECB retains its loose policy settings in order to entrench inflation expectations. This is likely to keep real yields in Europe low, while those in the US continue to increase. On the second point, markets are likely to become increasingly focused on the risk of populist/Eurosceptic political parties in the Euro area following Brexit and the US elections. The main risk to our view of a weaker EUR is the ECB switches its policy to a less accommodative stance and begins to significantly scale-back asset purchases. This risk is likely to increase as we move through 2017 if reflation takes hold globally.

## JPY: US interest rate outlook key

The JPY strengthened significantly in 2016 amid limited success by the BoJ to lower (net of inflation) Japanese interest rates.The JPY, however, gave up half its gains following the surge in the USD near year-end. We believe JPY can further weaken moderately in 2017. With the BoJ capping 10-year Japan yields, the JPY outlook for 2017 depends to a significant extent on the outlook for US yields. With the Fed likely to hike rates at least 2 times in 2017, a widening of US-Japan real interest rate spreads could exacerbate capital outflows from Japan and weaken the JPY. We see two main risks to this outlook. First, should Japan inflation continue to fall, it could increase real interest rates in favour of a stronger JPY. Second, higher global risk aversion or a significant pick-up in trade disputes would be supportive for the JPY as Japan remains a significant net-lender to the rest of the world.

With the ECB likely to maintain current easing policy for now, real  interest rate differentials are expected to fall further amid higher US rates

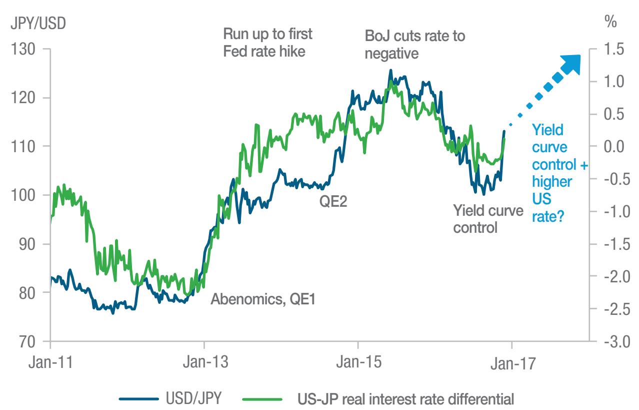
EU-US 10-year rael interest rate differential and EUR/USD




Source: Bloomberg, Standard Chartered

Japan's policy of capping 10-year yields means US rates are now key to dragging USD/JPY higher

US-Japan 10-year real interest rate differential and USD/JPY




Source: Bloomberg, Standard Chartered

GBP

Short term ↔ Medium term ↓

**GBP: Not out of the woods yet**

The GBP plummeted following the Brexit vote in 2016. Despite this, we retain our medium term negative outlook on the GBP for three main reasons. First, the UK has the highest current account deficit among major developed economies which has historically not adjusted quickly to a weaker GBP. Second, capital outflows could accelerate as bond holders capitulate amid narrowing real yield differentials with the US. Third, uncertainty regarding the UK's future relationship with the EU will continue to hurt investor sentiment and reduce appetite for UK assets. The main risk to this view is an increasing willingness by UK authorities to retain the existing economic engagement with the EU. Another risk is that should the Supreme Court require a parliamentary debate, UK lawmakers could agree to remain within the European Union, though the likelihood of this is low, in our opinion.

AUD

Short term ↔ Medium term ↑

NZD

Short term ↔ Medium term ↑

CAD

Short term ↔ Medium term ↔

**AUD, NZD and CAD: Riding on the back of reflation**

We expect the AUD to extend its strength into 2017 against the backdrop of higher inflation scenarios which is positive for commodity-linked currencies.

In our view, there are two main drivers of the AUD: commodity prices and central bank policy. We believe iron-ore prices bottomed in 2016 and could remain stable or gradually edge higher amid continued stimulus by China authorities. In addition, the rate cutting cycle has likely ended, in our opinion, as global inflation spills over into Australia and the Reserve Bank of Australia (RBA) grows less concerned about currency strength.

A move towards a deflationary scenario would be the main risk to our constructive AUD outlook. Similar to the AUD, two key factors shape the outlook for the NZD and the CAD: key commodity prices and interest rate differentials with the US. An improved outlook for key commodities (Dairy for NZD and Oil for CAD) is likely to be supportive for the currencies. Moreover, we do not expect further monetary easing by either the Reserve Bank of New Zealand (RBNZ) or the Bank of Canada (BoC) which is likely to limit the widening of interest rate differentials in favour of the USD. Global deflationary threats are the main risk to our view.

## Emerging Market Currencies

We expect Emerging Market (EM) currencies to remain under pressure as we head into 2017. This is likely to be due to rising US rates and a stronger USD. However, a reflationary environ ment driven by higher commodity prices and a better growth outlook in Developed Markets is likely to be supportive for EM currencies. For this reason, we do not believe further declines in EM currencies are likely to be as broad-based as in the 2014-2015 period (see Figure 6 on page 63). We also see room for differentiation in the EM currency space.

Higher commodity prices amid growth stability in China likely to Drive the AUD/USD higher

China iron-ore prices and AUD/USD


Source: Bloomberg, Standard Chartered

# COMMODITIES
# AT A GLANCE

[ Tariq Ali, CFA I Manpreet Gill ]

**We expect commodities to moderately extend their upside into 2017**, amid an improving outlook for inflation and the global capital expenditure cycle.

**Oil prices likely to rise further.** The improving demand-supply fundamentals suggest oil prices are likely to move higher in 2017, but remain capped around USD60-65/bbl.

**Gold likely to remain range-bound.** Very limited gold exposure remains justified as a hedge against an inflationary downside scenario.

**Modest upside in industrial metals to continue into 2017** on the back of a reflationary environment, though significant demand-supply imbalances do not provide conviction for a strong bullish view.

## Overall commodity outlook

After posting a decline for several years, commodity prices rose in 2016 as demand-supply imbalances grew less severe and as China implemented policy stimulus (both fiscal and monetary). In 2017, we are more constructive on commodities than in 2016. We highlight the following factors which support a moderately bullish commodities outlook. First, our expectations of higher inflation scenarios are constructive for commodities as these usually coincide with a pick-up in demand as companies increase capital expenditure. Second, demand-supply imbalances will likely further narrow, although this is likely to be more pronounced in the case of oil. Third, China is likely to maintain stability through continued monetary and fiscal expansion.

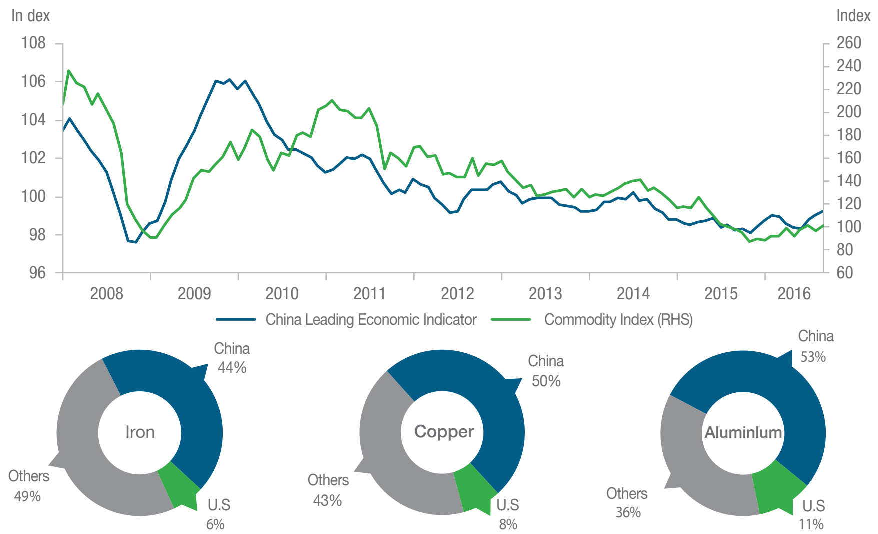
Key risks to our outlook include resurgence of deflationary risks, OPEC producers failing to effectively implement agreed production cuts and a significant deterioration in China's growth outlook.

### Energy: Tightening markets...Finally

Oil prices recovered in Q1 2016, after falling through most of 2014-2015. Since then, the move higher in oil has been gradual and subject to pullbacks. In 2017, we expect factors favouring a higher oil price to take hold, although we still do not expect prices to sustain above USD60-65/bbl.

Figure 1: Pick-up in China growth improves outlook commodities

China leading economic indicator and Bloomberg commodity industrial metals sub-index, China's consumption share of key industrial metals (below)



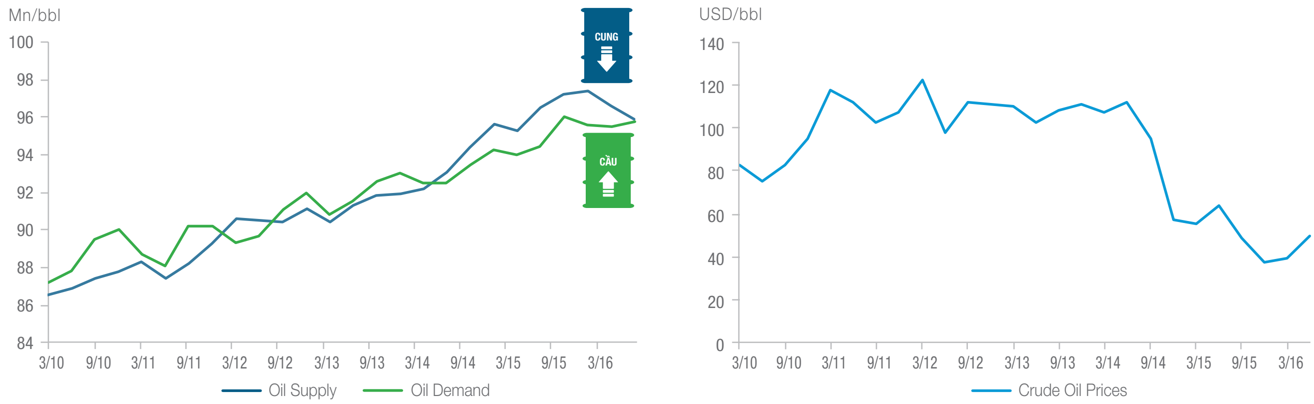

Source: Bloomberg, Standard Chartered

Slower supply growth remains the main driver behind our expectation of higher prices next year. The deal among OPEC members is significant. Key OPEC players and Russia also reached a consensus to cut production. Meanwhile, US production growth continues to decline consistently, while inventory build-up stabilised in 2016. Against this backdrop, we see demand-supply gap moving into deficit by mid next year, which may accelerate price gains into the second half of 2017.

Nonetheless, for three reasons, we do not believe the adjustment higher in oil prices is likely to be smooth. First, there are considerable headwinds to a smooth implementation of production curtailment among OPEC members and, hence, this will be a key source of volatility for oil markets. Second, we believe prices in excess of USD60-65/bbl are likely to bring in an additional layer of supply from higher cost producers (including US shale) notably limiting price gains beyond this. Third, modest USD strength could present an additional headwind, though the effect is likely to be modest.

Figure 2: Tightening of supply-demand gap and eventual supply deficit to put upward pressure on prices

IEA total oil supply and demand and Brent oil prices (right)




Source: Bloomberg, Standard Chartered

We see the demand side as being supportive for oil prices into 2017. Most of the new demand for oil is coming from large Asian economies including China, India and Indonesia where we expect growth to remain resilient in 2017. In addition to this, US growth is also likely to pick up pace in 2017, which would be incrementally supportive to demand.

## KEY INVESTMENT THEMES AT A GLANCE

Brent crude oil price to be higher by end 2017

**Gold: Glittering less than before**

Gold prices have edged lower over 2012-2015 but rebounded in 2016 as the Fed scaled back interest rate hike expectations. We turned positive on gold in mid-2016 as we expected a tepid Fed rate hike scenario, limited headwind from the USD and persistent risks in some areas of global growth. Looking into 2017, we believe positive and negative factors have become more balanced.

We believe US interest rates will rise in-line with inflation expectations in 2017, which is neutral for gold. Our expectation of a stronger USD is likely to be a headwind for gold. Finally, we see a number of possible avenues for political tensions in 2017 which would increase safe-haven demand for gold, including possible trade related tensions and Euro area politics. Given the balance of risks, we maintain a neutral outlook for gold heading into 2017 and see opportunities in being tactical through the year.

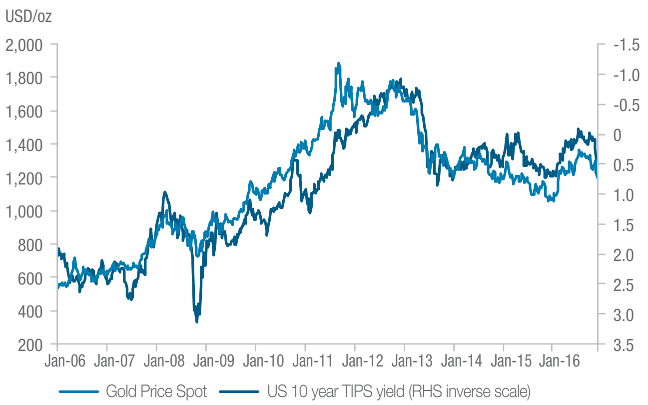
We believe three factors are likely to shape the outlook for gold price in 2017:

- interest rates net-of-inflation,
- the USD outlook, and
- safe-haven demand amid bouts of political and financial market stress.

Downside risks to gold include a much faster rise in interest rates relative to inflation, driving TIPS yields higher and a decline political stress. Upside risks to gold include a significant scale back in interest rates relative to inflation expectations, a broadly weaker USD and significant rise in political and banking sector stress.

Figure 3: Gold price have followed 10-years TIPS yields inversely (a proxy for real interest rate expectations) very closed in recent times

US-10 year TIPS yield, gold price spot




US-10 year TIPS yield and 10-year ìnlation expectations


Nguồn: Bloomberg, Standard Chartered

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