Outlook 2013

2013: A Year of Transition
From ‘V.I.P.’ to ‘B.R.I.D.G.E.’

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This commentary reflects the views of the Wealth Management Group of Standard Chartered Bank
Executive summary

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We are pleased to introduce our 2013 outlook. In the following pages, you will be presented with our favoured asset classes for the next 12-18 months.

Macro backdrop

- **2012** was best characterised as a **Muddle Through recovery**. The global economy continued to recover, but concerns over tail risks remained elevated.

- **2013** is likely to be a **Year of Transition towards stronger growth**. This will not be a straight line improvement with Q1 expected to be weak, particularly in the Developed markets, but the combination of reduced policy uncertainty and receding tail risks should allow consumers and businesses to gradually increase spending and investment.

- **Inflation** is likely to remain relatively subdued, although in Asia it is likely to bottom in H1 and gradually accelerate.

- **Fiscal policies** are unlikely to be loosened with the focus in the US and Japan being on how and how quickly governments tighten policy. However, fiscal policy in the Euro area is likely to be less restrictive in 2013 than in 2012.

- The bias for further monetary stimulus remains in the short term. However, as we go through 2013 and into 2014 the focus is likely to shift away from easing and possibly towards tightening measures, particularly in Asia.

Investment strategy

- **2012 VIP** (manage Volatility, protect against Inflation and be Paid) Investment Strategy served investors well with high yield bonds and high dividend yielding equities outperforming within their asset classes while gold also rose over the course of the year. The additional focus on value and global equities at the end of June (VVIP) was well timed.

- **2013 focus** is on our BRIDGE framework.

<table>
<thead>
<tr>
<th>B</th>
<th>R</th>
<th>I</th>
<th>D</th>
<th>G</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broadening global recovery</td>
<td>Receding tail risks</td>
<td>Income generation still relevant</td>
<td>Diversification increasingly important</td>
<td>Go local (bond) and global (equity)</td>
<td>Equity offers the best value</td>
</tr>
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- **Equities remain our favoured asset class** given the expectation that growth will start to accelerate in the latter part of the year while tail risks will still be managed. This should reduce the equity risk premium and allow for a gradual and modest re-rating of equities.

- **Within fixed income**, we continue to have a preference for **Asian local currency bonds and corporate credit**, in particular US high yield. For high yield bonds, investors should expect returns to decrease significantly from 2012 and are likely to be mainly limited to the yield on offer.

- **We are positive on commodities** as the prospect for significantly faster global growth in H2 2013 and 2014 should reduce excess supply over time.

- **The alternatives asset class offers a good way to hedge downside risks**: Macro/CTA strategies, in particular.

- The USD is expected to remain robust short term, particularly against other major currencies, **but Asian currencies are favoured over the course of 2013** as the region sees continued capital inflows, particularly into bond markets.

Our best wishes for 2013
2013 strategy and introducing B.R.I.D.G.E.

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Introducing B.R.I.D.G.E.

We are following up on the success of the VIP strategy with B.R.I.D.G.E., which is our way to summarise the key factors we believe investors should keep in mind as we enter 2013:

- **B** = Broadening global recovery
- **R** = Receding tail risks
- **I** = Income generation still relevant
- **D** = Diversification increasingly important
- **G** = Go local (bond) and global (equity)
- **E** = Equity offers the best value

We believe the B.R.I.D.G.E. framework can help guide investors through 2013 and 2014.

- **B.** We believe the global recovery will broaden and accelerate modestly.
- **R.** We have already seen tail risks recede due to strong policy actions.
- **I.** The relevance of income generation or cash flows is a theme we carry over from 2012, given very low interest rates and relative cautiousness amongst investors.

That said, we are keen to avoid an over-reliance on high yield bonds to generate income. While we remain overweight US high yield, we have cut Asian high yield to Neutral and we stress on pages 12-13 that investors should be 1) tempering their expectations with regards to future returns and 2) ensure holdings are consistent with their risk tolerance.

**Equity offers the best value amongst asset markets.** This is particularly true on a relative basis. The dividend yield in most major markets exceeds the respective 10-year government bond yield. The decline in High Yield bond yields means equity is now favoured over this asset class as well. The expectation that equity market volatility will decline over time reinforces this theme.

We hope our new B.R.I.D.G.E. framework will help us and our clients navigate 2013 as successfully as our VIP Strategy did in 2012.

**Figure 1:** US Economic Surprises Index may gradually lose its usefulness in predicting equity market swings

**Figure 2:** Volatility index has been a useful indicator as well

**Sources:** Bloomberg, Standard Chartered
Towards a more normal world?
The past 5 years have been characterised by policy-driven markets, higher than average volatility and tighter correlations between risk-on asset classes. We believe 2013 will start to see things normalise. This does not mean we will not see bouts of market volatility. Indeed, we believe we may well see one in the first quarter if US data disappoints. However, we expect these bouts of volatility to become less frequent/severe than over the course of the last 5 years.

We have been stressing the importance of deleveraging in the Developed markets as being the main reason for sluggish growth. However, we have already seen significant deleveraging in the western economies and we expect the pace of this to slow in the coming years. This is expected to support growth somewhat in 2013, but more significantly in 2014. Naturally, as discussed above, we believe the need for further monetary stimulus is also going to decline in the months ahead as the economy strengthens.

One of the indicators we have used successfully for judging potential swings in the US equity market has been the US economic surprises index (ESI). Since the crisis, this has had a reasonable record in helping to predict short term peaks and troughs for the stock market. With the US ESI having likely peaked, this could have significant connotations for the near term stock market outlook.

However, it is important to note the ESI was not always a useful predictor of stock market performance prior to the crisis. We expect the usefulness of this indicator to decline slowly over time as the macro environment normalises.

Move to lower volatility
Another aspect we have been talking about is the frequency and magnitude of bouts of volatility. As Figure 2 shows, since the global financial crisis, whenever the VIX index has fallen below 15, this has heralded a short term pullback in equity markets. While equities have generally recovered their losses swiftly, this volatility has unsettled investors.

We expect the recent trend for reduced volatility to extend into 2013 (Figure 3). Prior to the global financial crisis, the VIX index averaged 15 and we expect a return to these levels in the next 12-18 months. This should not be interpreted as saying riskier asset classes will enter an uninterrupted upward trajectory. While tail risks have receded, they are still significant. However, we expect bouts of volatility to reduce in frequency and/or magnitude as we move through 2013.

Normalising correlations?
One aspect of the environment just as unsettling for investors has been the increased correlations between risk-on assets such as equities, commodities and high yield bonds. This dramatically reduced the benefits of portfolio diversification, particularly when it is required most.

Looking forward, we expect a gradual shift towards more ‘normal’ correlations. We believe the macro cycle is going to become less important over time. As we head into 2013, we are still largely in a macro driven environment and, therefore, the correlation between risk assets will remain relatively high in the short term. However, asset class specific issues are likely to become increasingly important, leading to more normal correlations.

Figure 3: Equity market volatility expected to decline over time

**VIX index**

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**Figure 4: Correlations likely to normalise over time**

Correlation between global equities and commodities

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Sources: Citi, Bloomberg, Standard Chartered
2013 Outlook – A Year of Transition

2012 in review – Retiring VIP
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2012 review – Performance of key themes
In our 2012 Outlook at the end of last year, we argued that the most likely macro outcome was the Muddle Through scenario where growth would continue, but would be below the trend we saw ahead of the Global Financial Crisis.

Meanwhile, we launched our VIP Strategy which focused on the need to manage Volatility, protect against Inflation and be Paid. Within this framework, our favoured asset classes were high yield bonds, high dividend equities, gold, macro/CTA hedge funds and gold equities (see 2012 Outlook: VIP Investment Strategy, December 2011).

In general, these asset classes have performed well.

- **High yield bonds** – one of the strongest performing asset classes in 2012, particularly when one takes into account the relatively low volatility it has experienced through the year. At the global level, this asset class is up 18.3% year-to-date on a total return basis.

- **High dividend yielding equities** – also had a strong year with investors taking comfort in their high, inflation-protected income potential. While global equities performed well, high dividend yield equities outperformed.

- **Gold** – has exhibited a reasonable performance, up year-to-date by 9.5% helped by continued monetary easing and currency debasement in the developed markets. The ride was far from smooth, however.

- **Macro/CTA** – has struggled, falling 1.0% so far in 2012. This was always a hedge against the global recession downside risk. Looking forward, we attach around a 20% probability to a global recession. We also believe macro/CTA remains the best hedge against such an outcome given its negative correlation with equities in an extreme risk-off environment.

- **Gold equities** – this has been the worst performing of our highlighted themes, down 9.5% ytd as companies were de-rated and faced higher costs.

Global equities also had a stellar year, up 14.2% year-to-date on a total return basis, albeit with significant volatility. We managed to flag the likelihood of a short term pullback in both March and October, just before the ensuing sell-off, while also stressing that a decline of 5-10% in both cases would represent a buying opportunity. This proved to be the case. Moreover, we added a Value overlay at the end of June, increasing the emphasis on global equities. Since then, global equities have rallied 8.1%.

Overall, the themes and asset classes highlighted at the end of the last year have performed well. However, we see 2013 more as a year of ‘transition’ rather than ‘muddle through’ and therefore we are retiring our VIP Strategy.

Of course, one could argue that investors always need to manage Volatility, protect against Inflation and be Paid for their investment. To some degree, this is true. However, we believe that looking ahead to 2013, there should be a new emphasis. With 2013 viewed as a Year of Transition, we unveil a new way of looking at the world and things to look out for under our **B.R.I.D.G.E.** banner.

Figure 5: Performance of key 2012 themes, YTD

<table>
<thead>
<tr>
<th>Performance of 5 key themes from 2012 Outlook</th>
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<tbody>
<tr>
<td>Global HY Bonds</td>
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<tr>
<td>S&amp;P Aristocrats TR</td>
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<tr>
<td>Gold</td>
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<tr>
<td>Macro CTA</td>
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<tr>
<td>Gold Equities</td>
</tr>
<tr>
<td>18.3%</td>
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<tr>
<td>17.1%</td>
</tr>
<tr>
<td>9.5%</td>
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<tr>
<td>-1.0%</td>
</tr>
<tr>
<td>-9.5%</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, Standard Chartered
Data as of 10 Dec 2012

Figure 6: Addition of Value overlay well timed

Global equity performance YTD

Values in equities flagged in VVIP update*

Sources: Bloomberg, Standard Chartered
*Global Market Outlook July 2012
Introduction

2013 is likely to be a Year of Transition. 2009-2012 has been associated with heightened tail risks. 2013 is likely to be characterised by gradually increasing confidence in the global recovery, receding tail risks and reduced policy driven uncertainty.

Areas of progress in 2012 included 1) European Central Bank action, which has significantly reduced the risk of a Euro area implosion, 2) China taking action to stabilise growth and 3) energy price pressures receding. Of course, the key uncertainty in the short term is the US fiscal cliff, but we expect this to be resolved in the coming weeks/months.

Scenarios

We have four main macro scenarios for 2013:

Strong recovery: 15% probability
Under this scenario, US consumer and capital spending picks up, the latter significantly, helping Asia to accelerate more dramatically and dragging Europe out of recession. Meanwhile, the 2012 China stimulus has a larger than expected impact, with GDP growth accelerating back towards 9%.

Transition to stronger growth: 40% probability
This is the most likely outcome in our opinion. This is where the transition to stronger growth takes longer, but the policy actions taken gradually increase consumer and business confidence leading to a significant acceleration in growth in H2 2013 which extends into 2014.

Muddle through: 25% probability
This is a very similar environment to 2012 whereby growth continues, but investors and business leaders remain very concerned about the possibility of dipping back into recession/crisis. Kicking the US ‘fiscal cliff can’ down the road would increase the probability of a continued Muddle Through outlook. In this environment, we would be likely to see continued policy responses to stabilise periodic market volatility and drops in confidence.

Global recession: 20% probability
This probability naturally remains higher than we would like. The fiscal cliff is clearly a key hurdle to negotiate before this probability can fall somewhat. However, high debt levels and continued uncertainty in Europe and the Middle East mean that even assuming the fiscal cliff and debt ceiling negotiations go well, the recession risk will remain through 2013.

Growth

- US expected to recover strongly from a weak Q1
- Europe likely to exit recession in H2
- Asia continues on a gradual recovery path

We expect a modest acceleration of global growth in 2013 with the second half being significantly stronger than H1. This should set the stage for a significant acceleration in growth in 2014. Moreover, whereas in recent times the risks have always been skewed to the downside, we now see more balanced risks, both positive and negative, to this outlook.

We expect growth in the US and Europe to weaken into Q1 and rebound thereafter. In the US, uncertainty created by the fiscal cliff is likely to subdue growth in Q4 2012 and into the beginning of the year. In Europe, confidence indicators remain very weak, which suggest the recession is likely to continue into Q1.

However, there are good reasons to be more optimistic about the outlook for the global economy as the year progresses. The US economy is expected to rebound once fiscal cliff negotiations are out of the way. Consumer confidence is firm and the recent strengthening in the labour market, rising asset prices and lower gasoline prices all suggest that consumer spending is likely to strengthen further as we move through 2013. The key question for us is whether companies accelerate their investment once fiscal uncertainty is reduced following a resolution to the fiscal cliff. This is an upside risk to the global economy, in our opinion.

There are already signs of recovery in Asia. China has been a key focus given its influence on the region. It is
increasingly clear the Chinese economy has turned the corner and is in gradual recovery mode (Figure 13). This is starting to spill over into the rest of the region with new orders, exports and industrial production all having shown signs of recovery in the past couple of months. We expect this to continue through 2013, although the pace of the improvement is expected to be relatively modest.

While it is difficult to argue for a strong recovery in the European economy, there are two factors that warrant reduced pessimism.

First, we believe the so-called ‘fiscal drag’ will be less significant in 2013 than in 2012. While fiscal policy is still in tightening mode, the magnitude of tightening is likely to be less significant in 2013 than in 2012. This suggests a slight improvement in economic performance over the full year recession in 2012.

Second, the pick up in growth expected in the US and Asia should support European exports. Therefore, while we expect Europe to remain in recession in Q1, we expect a significant improvement in its economic fortunes in the second half of the year.

A key question for the global economy is whether or not Japan will come to life once again. For now, we prefer to think of this as an upside risk, but do not factor it into our central scenario. The crux of the matter is whether the impending elections will result in a change in government (likely) and an ensuing change in BOJ leadership (this is likely also dependent on upper house elections in June). Therefore, we prefer to wait for signs that Japan is really going to go down this path before upgrading our outlook.

**Inflation**

- Large output gaps suggest US and Europe inflation to remain benign
- Asia inflation likely to bottom in H1 and rise on higher food prices in H2

We expect inflation to remain generally benign, particularly in the Developed markets. Output gaps – the difference between potential and actual economic activity – remain wide which suggest that demand-driven price pressures are unlikely. This is reinforced by the still high unemployment rates seen in the US and Europe. In the US, income growth is still at its weakest in over 45 years and unit labour cost inflation is below 2%.

In Europe, unit labour costs in some peripheral countries have actually been falling on the back of structural labour market reforms (Figure 14).

The key concern from an inflation perspective would, therefore, be from a supply-side shock. The first area one normally worries about here is energy markets. While a spike in oil prices can never be ruled out, this is not a central scenario and its impact would likely be muted by the limited ability of manufacturers to pass on such costs to the end consumer.

Our bigger concern is the outlook for food prices and the impact this could have on Asian inflation. Here, the focus is mainly on China. We believe inflation will bottom in the coming months. However, pork prices are expected to rise significantly in 2013. We have seen in previous cycles that this can have a substantial impact on overall inflation.

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**Figure 8:** Q1 to remains weak, but strengthen significantly thereafter

**Figure 9:** High unemployment rates suggests inflationary pressures likely to remain muted

Source: Standard Chartered

Sources: Bloomberg, Standard Chartered
Macro overview – A year of transition

Policy

- No need for further stimulus in the US
- European Central Bank likely to limit easing to interest rate cuts
- Asia to gradually move away from its monetary easing bias

In the US, we expect the economy to remain strong enough to avoid the need for further monetary stimulus. Naturally, this would require the government to address the fiscal cliff in a way that does not cripple the economy – this remains our central scenario.

That said, the Fed sent a very important signal in September 2012 by indicating that its monetary policy was outcome-based with the labour market performance critical to its decisions. While the target of full employment is explicitly in the Fed’s mandate, directly tying monetary policy decisions to the path of the labour market sent a strong signal that any economic weakness would lead to further easing.

If the US economy recovers along the path we expect, markets are likely to start speculating that policy could be tightened in 2014. While such speculation is likely to be very muted in the first half of 2013, it may build towards the end of the year. This is currently not priced into interest rate markets (Figure 15).

In Europe, we have scaled back our hopes for further stimulus in recent months. While the economic arguments remain compelling for significant quantitative easing in our opinion, the European Central Bank (ECB) has preferred to focus on actions that directly alleviate the sovereign debt crisis. Therefore, we expect the ECB to limit itself to possibly one further rate cut in 2013. This view is reinforced by the fact that the data may become less negative in Q2 next year.

Another key question for Europe is whether the Outright Monetary Transactions program will be operationalised with Spain seen as the most likely candidate for assistance. So far, merely the promise to intervene in bond markets has been sufficient to bring yields significantly lower, easing refinancing concerns (Figure 16). It is possible that this will change in 2013, but we believe OMT would be operationalised in need and therefore betting on a significant Euro area break-up is unlikely to be profitable for investors. Markets have significantly reduced the probability attached to a Euro area break-up in recent times (Figure 17).

In Asia, we expect the bias to shift from easier monetary policy settings to a more balanced approach later in the year. There is even the risk that monetary policy may need to be tightened marginally by the end of the year if food prices accelerate significantly. However, that is more likely to be an issue for growth in 2014 than 2013.

Risks

As always, there are several risks to any outlook.

Upside risks

- If the fiscal cliff negotiations result in a process of gradual fiscal consolidation, we could see a significant pick up in US capital spending which would spur growth to accelerate by more than we currently expect. This would be a significant positive for the global economy, particularly for the US, Asia and core Europe.

- More aggressive monetary policy in Japan could lead to a recovery in the economy in H2 2013. This is seen as less likely with a smaller impact, but the Japanese elections and BOJ Governor succession plans should be watched carefully. Of course, to some extent a weaker JPY could undermine the competitiveness of Asian exporters.

Downside risks

- The first key risk is that the fiscal cliff negotiations lead to a political stand-off, resulting in the US economy ‘going over the cliff’ and into recession. Recent comments in this regard have been encouraging, indicating that this worst case outcome could be avoided. However, the impact of such a failure would be significant (see Figure 10).

- Europe remains a key source of risk. We believe the ECB’s policy actions in 2012 have significantly reduced the risks of a material break-up of the
single currency. However, it is clear Greece and Cyprus are still experiencing difficulties and the possibility of one or both leaving is still significant. Meanwhile, Italy has also been under increasing pressure as political uncertainty rises and Spain has yet to plot a clear path towards debt sustainability. If that were to happen, the pressure on the authorities to act to protect the integrity of the single currency area would increase exponentially. The outlook is potentially complicated by German elections in September, although we believe Merkel has already accepted that closer integration is the way to resolve Europe’s challenges over the long term.

- **China’s nascent recovery could falter.** This looks unlikely and even if it did, we believe the authorities have the firepower to turn the economy around relatively quickly.

- **Geopolitical tensions could escalate.** 2013 sees elections in both Israel and Iran, with the latter likely more concerning from a geopolitical perspective. While tensions in the South China Sea appear to have moderated, it is still unclear how different countries’ territorial claims will be resolved.

- **Unknown unknowns.** There are always risks that we have yet to identify as potential key challenges that could come from ‘left field’ and hit us.

**Conclusion**

We are gradually moving towards a more normal macro environment, in our opinion. This will not happen overnight. There are still many areas of stress within the global financial system and macro landscape. We have to remind ourselves that global financial crises normally take 10 years to fully recover from. 2013 will represent the 6th year since the 2008 crisis took hold. However, at the global level, the recovery phase is broadly in line with historical experience (Figure 11).

We see 2013 as a Year of Transition, moving gradually towards stronger growth, less policy-driven economic cycles, lower volatility and more normalised correlations between pro-risk asset classes.
Macro overview – A year of transition

Figure 12: Rise in US house prices to generate a positive wealth effect

Case-Shiller house price index, y/y

Sources: Case-Shiller Index, Bloomberg, Standard Chartered

Figure 13: Chinese business confidence rising once again

Government PMI data, above 50 represents expansion

Sources: China Federation of Logistics & Purchasing and National Bureau of Statistics, Bloomberg, Standard Chartered

Figure 14: Peripheral unit labour costs falling outside of Italy

Unit labour costs indexed to Jan 2005

Sources: Bloomberg, Standard Chartered

Figure 15: Market expects sub 1% interest rates through 2015

Implied market expectations for 3m USD interest rates

Sources: Bloomberg, Standard Chartered

Figure 16: Talking has so far proven sufficient for the bond market

10yr government bond yields

Sources: Bloomberg, Standard Chartered

Figure 17: Risk of Euro area collapse declining

Probability of one country leaving the single currency

Sources: Intrade, Standard Chartered
Fixed income – It’s only about the yield

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Key themes

- Stay Underweight Fixed Income, but favour corporates over sovereigns.
- Yield likely to provide bulk of returns over 2013; Significant further capital gains unlikely.
- Asia local currency bonds favoured; Positive real rates and stronger currencies likely to be supportive.
- Within USD bonds, we prefer US HY, Neutral EM HY/EM IG, and Underweight Developed market IG.
- Keep maturity profile short in USD bond portfolios; Yields on long-dated bonds, which are much more sensitive to changes in interest rates, remain poor.

Key views

Asia local currency government bonds: one of our top 2013 conviction ideas. An argument can still be made for the presence of value in this asset class. Positive real interest rates and rising currencies (albeit after a possible speed-bump in Q1) are likely to be key pillars, though rising yields may impose some drag towards the end of the year.

US high yield (HY): continues to look attractive, though momentum is likely overshadowing value as the main driver. We increasingly struggle to find value and are mindful of rising risks. Nevertheless, we do not expect the ‘search for yield’ to go away in hurry and this is likely to be a key source of support at least for the first half of the year (see page 13).

Developed Market Investment Grade (IG): We would remain cautious on G3 sovereign bonds. Current low yields can only be justified under a scenario of sustained deflation, which is not our baseline scenario. Low yields are likely to result in low total returns, with the risk any rise in yields can quickly wipe out meagre gains. We recognise these bonds can offer a useful portfolio hedge against downside risks and bouts of volatility, but believe an Underweight view captures this.

Emerging Markets IG & HY: Selectivity will likely be key. In Asia, we see greater value in IG corporates, moderate value in quasi-sovereigns, and little value in USD sovereign bonds. This is both a function of value (which we see a lack of, particularly in sovereigns) and risk (which we see incrementally more of, particularly in high yield). While we recognise the possibility that momentum could cause strength in Asian high yield to extend, we hold a Neutral view as we do not believe today’s record low yields and increasingly tight spreads compensate for rising risks.

Subordinated debt: Bonds that rank lower down in the seniority hierarchy offer value in certain circumstances. The group of bonds ranked ‘Tier-I’, for example, offer some value. Regulatory changes also mean the supply of many of these types of instruments will decline over time.

Perpetual bonds: Minimising duration risk and focusing on quality are likely to be key. Extremely high sensitivity to interest rate risk (due to their long maturity profile) is one of the main risks posed to perpetual bonds. While perpetual bonds can offer a materially higher yield versus regular bonds, we remain very uncomfortable with their long maturity profile. Therefore, we believe the best approach is to focus on perpetuals with a high probability of being called, as the expected interest rate sensitivity on these is much smaller.

Figure 18: Our preference for corporate credit served us well in 2012

Year-to-date performance (%)

<table>
<thead>
<tr>
<th>Bonds</th>
<th>YTD Return</th>
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<tr>
<td>EM HY Bonds</td>
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<td>EM IG Bonds</td>
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<td>DM HY Bonds</td>
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</tr>
<tr>
<td>DM IG Bonds</td>
<td></td>
</tr>
</tbody>
</table>

Sources: JP Morgan, Barclays Capital, Citigroup, Bloomberg, Standard Chartered

Risks

Downside

- Yields could rise, risking capital losses in USD bond portfolios. Keeping maturity profiles short and favouring corporate over sovereign bonds help mitigate this risk.
- While yields on high yield bonds remain attractive on a relative basis, downside risks are rising as valuations become increasingly stretched.
- Asian FX weakness or an inflation shock could pose a downside risk to Asian local currency bonds.

Upside

- Economic disappointment poses upside risks to fixed income as yields fall and spreads tighten.
Fixed income – The risks to high yield bonds

While we maintain our Overweight view on US high yield credit at this time, we have been highlighting that risks to this asset class have also been rising. In this short feature, we aim to summarise the main risks to high yield credit, and simulate their potential effects on an investment portfolio.

1. Interest rate risk

Bond prices are inversely related to interest rates. A rise in US Treasury yields would likely lead to a rise in yields (or interest rates) across all USD-denominated corporate bonds, including high yield, leading to a fall in the price of the bond.

Investors also need to take into account the duration, or sensitivity of the bond price to a given change in interest rates. This sensitivity varies depending on the time to maturity of the bond. For example, a 10 year corporate bond has a higher sensitivity to a 1% change in interest rates than a 1 year corporate bond from the same issuer.

It is easy to visualise these risks by way of a few examples. If US yields go up by 1% uniformly across maturities,

(a) The BarCap US High Yield Index would fall in value by approximately 4.3%*

(b) A portfolio of bonds with an average duration of 3 years would fall in value by approximately 3%*

(c) A portfolio of bonds with an average duration of 7 years would fall in value by approximately 7%*

While we see any rise in long term yields as being limited in H1, a strengthening economy could change this outlook in H2.

2. Credit risk

Market worries about higher corporate bond defaults (for the high yield asset class as a whole) in the future can lead to lower bond prices today. These worries can arise in a structural manner (i.e. a broader deterioration of the economic environment or average corporate credit profile) or in a temporary manner, such as a bout of risk aversion we witnessed in May 2011.

In May-October 2011, for example, the yield on the BarCap US High Yield Index rose by 3.4%. The index (total returns) fell by 11% over this period.

3. Liquidity risk

Limited total issuance of a bond means liquidity can dry up completely during periods of stress. This makes risk management difficult as an investor may not always be able to find a buyer for their bonds regardless of the price. Asian corporate bond markets are at somewhat greater risk than US markets due to their smaller size. Bond issues that are too small to be included in the benchmark indices also face lower liquidity than larger bond issues.

Conclusion

In our view, the most appropriate way to balance these risks against the still-attractive yield on offer is to focus on the percentage allocation towards high yield within an investment portfolio. Too large a share magnifies the risk while too small a share fails to take advantage of attractive yields on offer. See page 29 for what we believe to be an appropriate weight for high yield within a diversified portfolio for investors with different risk profiles.

* This is an approximation using duration alone to calculate approximate changes in the index for a given change in yields. The BarCap US High Yield Index had a duration of 4.3 for the month of October 2012, a figure used for all calculations on this page. Actual changes will likely vary from the approximations provided here.
Fixed income – Charts of the year

Figure 20: Asian HY no longer offers a premium over US HY to compensate for additional risk. US HY looks more attractive, in our view.

BarCap US HY Index, JACI HY Index spreads (bp)

Sources: Barclays Capital, JP Morgan, Standard Chartered

Figure 21: Relative valuations suggest favouring IG corporate bonds over sovereigns in Asia USD market

JACI corporate IG - JACI sovereigns spread (bp)

Sources: JP Morgan, Bloomberg, Standard Chartered

Figure 22: Many Asian local markets still offer positive real returns, making them attractive in our view.

10yr government bond yield - CPI inflation (%)

Sources: Bloomberg, Standard Chartered

Figure 23: Most Asian local currency government bonds offer sizable premium over US Treasury bonds

Local market 10yr bond yield - US Treasury 10yr yield

Sources: Bloomberg, Standard Chartered

Figure 24: Yield remains the most significant and consistent source of return in HY over time, not price movement

Decomposed returns of the BarCap Global HY Index

Sources: Bloomberg, Standard Chartered
2012 returns are for H1 only

Figure 25: Keep return expectations moderate. Spread tightening was a key driver of returns in 2012 and will almost certainly be much more limited in 2013

Decomposing global HY returns by factor

Sources: BIS, Standard Chartered
Key themes

Before we look at our key calls, we believe it is important to emphasise that the appropriate allocation to equities is far more important than the allocation within equities.

That said, our preferences are outlined below:

- **High yielding, high quality equities**
- **Developed market companies with significant emerging market exposure**: many US and EU companies offer excellent and relatively cheap exposure to the burgeoning consumer trends in the emerging markets.
- **Market calls**: US and China. Generally, we prefer North Asia over Southeast Asia. We are Neutral Europe and Underweight Japan.
- **Sector calls**: We see excellent value in US Technology, particularly related to the smartphone space; In Asia, we prefer Consumer Discretionary, Financials; In Europe, it is more difficult to have clear sector preferences as the underlying dynamics of each market are very different. Our favoured sectors are Energy, Industrials and Healthcare.
- **Sectors where caution is warranted**: In the US, Telecoms and Utilities look unattractive. Staples increasingly expensive. In Asia, our least preferred sector is Telecoms.
- **Style**: Large capitalisation preferred over small in the US and EU. Value-growth mix preferred in US/EU, but prefer growth at a reasonable price (GARP) in Asia.

Equities – Our largest overweight

Equities had a strong 2012 and are expected to outperform again in 2013. There are a number of reasons for this outlook:

- **Macro outlook is favourable**: With GDP growth stabilising or improving in most markets, the environment is supportive for continued sales and earnings growth.
- **Monetary policy and excess liquidity supportive**: Central banks should keep short-term interest rates very low, particularly in the US. Liquidity caused by exceptionally easy monetary policy (QE3) is expected to work its way back into the equity markets, both in the US, but particularly in Asia.
- **Low cost of debt**: with low real rates in the US and EU, developed market companies generally have lower borrowing costs and will keep using this to their advantage to undertake share buybacks and reduce interest cost.
- **Search for yield to continue**: Equities now yield substantially more than sovereign bonds and even the spread between dividend yield and high yield bonds has narrowed significantly. Within a low yield environment, investors will likely be gradually drawn towards equities.
  
  **Indeed, we question why investors would hold a 10yr UST or JGB yielding 1.6% and 0.7%, respectively, when the respective equity market has a higher dividend yield (c.2.5%) and offers a greater degree of inflation protection.**
- **Valuations are attractive**: The equity risk premium (ERP, the difference between the equity earnings yield and 10yr government bond yield) is elevated with investors still fretting over the economic growth outlook. As the macro environment stabilises and improves, we expect the ERP to fall, allowing for a gradual re-rating of the asset class.
- **Earnings revisions stabilising in parts of market**: Earnings revisions in Asia appear to have stabilised and may start to improve. In the US, there may be some further downward revisions, but this is likely to improve as we move through 2013. Typically, the equity market will trend up 3 to 6 months before earnings revisions turn positive.

Themes and country/sector calls

**High yielding, high quality equities**: Dividends are a large component of total returns and high dividend yielders have the additional benefit of being less volatile. While we like high yielding equity, we would stress the importance of ensuring that the yield is sustainable.

The significance of this is obvious with many of the traditionally high yielding sectors, such as Telecoms and Utilities in Europe, suffering from high debt burdens and weak demand forcing them to reduce yields, resulting in underperformance.
Equity – Simply the best

**DM companies with EM exposure:** With GDP and consumer growth significantly higher in the emerging markets than developed, an increasing proportion of corporate earnings growth is coming from EM. This trend is likely to continue for some time given the burgeoning per capita consumption trends in EM.

The European auto sector is a good example of how earnings can be impacted by EM exposure; with the luxury car segment enjoying over 25% revenue growth in EM, largely from China, whilst domestic sales have fallen.

We take the view that investors are still not fully pricing in this theme and continue to see good value in many segments of the US market, particularly in Technology, Energy and parts of Consumer Discretionary, as well as in parts of Europe, particularly in Discretionary, Healthcare, Industrials and Energy.

**US:** The US market is preferred for its liquidity, depth, structural benefits from lower energy costs and a strengthening housing market. Corporate governance is generally better and there are many segments of the market that offer excellent exposure to the emerging markets with highly valued brands and franchises. Profit margins are already high, but with labour and debt servicing costs remaining low, they should remain elevated through 2013.

- **Technology** remains our preferred sector in the US. The sector offers significant exposure to EM, a higher than average ROE, strong balance sheets and attractive valuations. As economic growth recovers the sector will also benefit from an improved corporate capital investment (capex) outlook. Within the Technology sector, the smartphones/tablets space is our preferred segment.

**North Asia over ASEAN:** We have a relative preference for the markets in North Asia. Improvements in global economic indicators such as the PMIs and stabilisation in global demand are usually positive for the higher beta North Asia markets, where exports remain a key driver of their economies. Notably, as a bloc, the North Asia markets are also trading at a much lower P/B relative to their southern domestically focused neighbours. We are Overweight most markets in North Asia, other than Taiwan where we view earnings momentum to be relatively muted.

- **China:** Infrastructure spending and property sales are improving, and this should lead to a modest recovery in construction activities helping to stabilise growth. While the recent pick up in house prices could be a potential negative on the policy front, we expect the government’s immediate priority will be to ensure the recovery is sustained.

**A-Shares near a bottom:** The continued under-performance of the A-share relative to the H-share is puzzling, in light of improving economic data, liquidity and earnings generally not worse than expected. The main reasons for the disparity in performance, in our opinion, could be due to a higher proportion of retail investors and smaller companies in the A-share relative to H-share market, contributing to greater volatility and sometimes, divergent performance. Nevertheless, we view the disconnect between economic fundamentals of China and A-shares to be an interesting phenomenon. With mainstream media now exceedingly bearish on A-shares and local investors having seemingly capitulated, with record low trading volumes, this may herald a potential market bottom.

**Figure 27:** Emerging markets to drive vehicle sales

**Asia – current car ownership rate by country**

**Figure 28:** Emerging markets to drive smartphone shipments

**Smartphone shipment forecast (mn)**

Sources: World Bank, Standard Chartered
Equity – Simply the best

Valuations of the A-share market are now at a record low not dissimilar to recent bottoms in 2005 and 2008. Also the current high cash holdings by local mutual funds, investing in the A share market, should be positive for market momentum should the space come back in favour.

- Hong Kong/Korea: We are Overweight Hong Kong and Korea. For HK, tight regulation of the property market is likely to drive investors into equities given excess liquidity and the positive spillover effects from China. With the exception of the Technology sector, South Korean equities have been a laggard versus the broader Asia ex-Japan market. Stabilising global economic growth, a likely trough in earnings and attractive valuations suggest a stronger performance going forward. Within Korea, we like the Technology sector particularly the segment with exposure to the smartphone space which continues to enjoy strong growth.

- In Asia, our preferred sectors are Consumer Discretionary and Financials (banks, exchanges, insurance and property). The Discretionary sector is attractively valued and benefits from consumption growth, underpinned by higher wage growth in Asia. In the case of Financials, a stable to improving economic outlook should translate to a more benign outlook on non-performing loans - a key risk the market was concerned about, particularly in China.

Neutral Europe: While there are some excellent long term value opportunities, one still needs to be cautious given the current recessionary environment and, in the case of Utilities and Telecoms, high levels of leverage. With European growth, currently negative and expected to stabilise in 2013, some of those areas focused on domestic demand should perform much better going forward and offer significant value. With the peripheral markets still weak, and some remaining tail risk, we continue to have a preference for the core over the periphery.

Underweight Japan: While the valuation of Japanese equities is starting to look compelling, we are Underweight the market on concerns that any outperformance of the equity market will be concurrent with Yen weakness.

While Underweight the Japanese market in USD terms, it may be highly profitable to undertake a short term tactical trade that hedges out Yen risk, but gives exposure to the underlying performance of the market – capturing the market move should local investors price in the LDP’s target of higher inflation through mass money printing. Japanese equities look cheap at current levels trading on c.1x P/B and with a real dividend yield in excess of 3%.

Risks

Upside

- Improvement in earnings revisions
- Rise in inflation expectations
- Fiscal cliff deal minimises economic drag

Downside

- Policy mistakes around Greece and periphery (can also be an upside risk)
- Decline in margins due to higher input prices
- Weakness in US housing market
- Sudden and sharp rise in interest rates
- Only partial resolution of fiscal cliff

Figure 29: A-share has underperformed H-share
A-share to H-share ratio of indices

Figure 30: China equities are trading at the low end of their historical range
MSCI China forward Price to book ratio
Equities – Charts of the year

Figure 31: Equities are attractive relative to bonds
MSCI AC World Equity-Bond yield gap

Figure 32: Valuations remain attractive relative to history
MSCI AC World forward P/B

Figure 33: Strong performance by high dividend equities
S&P500 Dividends Aristocrat total return vs S&P 500

Figure 34: Return on capital for Tech outpacing market
Return on capital for S&P Tech, S&P 500 and S&P Tech P/B

Figure 35: Asia ex-Japan earnings revision turned positive
MSCI AxJ earnings revision index and EPS % change

Figure 36: Japan equities cheap and have high real yield
Topix Index – P/B and real dividend yields

Sources: MSCI, Bloomberg, Standard Chartered

Sources: Bloomberg, Standard Chartered

Sources: MSCI, Bloomberg, Standard Chartered
Key Themes

- **We remain positive on commodities.** From a sub-commodity class perspective, we are Neutral across the board to highlight our equal preference with a positive bias.

- **Global growth is likely to be on a firmer footing from H2 2013 onwards, supporting commodities.** As discussed in our macro overview, while we see the Q1 2013 economic outlook as providing short term headwinds for commodities, we believe global growth will likely firm from H2 2013 onwards. Although we believe there is a less need for monetary easing, central banks stand ready to provide further stimulus should the need arise. Either way, we see this as being positive for commodities.

- **Broad exposure to commodities is the most efficient means of capturing potential gains in 2013** (our benchmark weight is approx. 35% in Agri, 30% in Energy, 20% in Industrial Metals and 15% in Precious Metals).

- **Gold and oil provide a vital hedge against inflation and geo-political risks**, respectively from a portfolio perspective.

Key Views

**Precious metals – We retain a positive bias for gold.** We expect some softness in gold prices in the short term arising from a stronger USD and moderating inflation expectations. However, the ongoing monetary easing by the US Fed, purchases by major central banks and the recovery in physical demand is likely to continue supporting the steady rise in gold prices.

**Energy – We retain a positive bias towards oil.** Demand growth resulting from the expected global economic recovery is likely to diminish the excess supply in the crude oil market and provide firm support to oil prices. Moreover, we continue to emphasise the importance of having exposure to oil as a hedge against geo-political risk.

**Industrial metals – We retain a positive bias.** The economic growth improvement in China, despite the lower probability of further stimulus, is likely to support demand and overcome the softer demand from the Euro area and relatively elevated levels of inventory stocks.

**Agriculture – Though grain markets are expected to remain choppy, prices are likely to remain elevated.** A steady recovery in 2013 is also likely to boost the soft and fibre complexes. However, price volatility is likely to persist as weather factors continue to dominate in 2013.

Risks

**Downside**

- A failure by US policymakers to reach an agreement on the fiscal cliff issue would likely lead to a fall in commodity prices, apart from gold, given recessionary fears and a strong USD.

- A crisis in the Euro area would likely have significant downside effects on commodity prices.

- An escalation in geo-political tensions would likely drive commodity prices lower on reduced growth prospects. Oil prices would likely benefit under such a scenario.

**Upside**

- Further monetary stimulus measures by central banks will be positive for commodities, but with some (eg. Gold) likely to benefit more than others.

Figure 37: Commodities performed marginally better than last year

*Dow Jones UBS Commodity Price Index*

<table>
<thead>
<tr>
<th>Year</th>
<th>DJ UBS Agriculture Index</th>
<th>DJ UBS Precious Metals Index</th>
<th>DJ UBS Energy Index</th>
<th>DJ UBS Industrial Metals Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>11.0</td>
<td>8.1</td>
<td>-11.0</td>
<td>2.7</td>
</tr>
<tr>
<td>2011</td>
<td>-15.0</td>
<td>-10.0</td>
<td>0</td>
<td>5.0</td>
</tr>
</tbody>
</table>

*Sources: Bloomberg, Standard Chartered* *For the period 30 Dec 2011 to 10 Dec 2012*
Commodities – Charts of the year

Figure 39: Inflation expectations have been key for gold prices in 2012

Gold price vs US 5 yr breakeven inflation

Figure 40: Purchase of gold by central banks picking up
International Monetary Fund (IMF) world gold reserves

Figure 41: US crude oil inventories starting to decline
US Department of Energy vs WTI crude oil prices reversed

Figure 42: US production likely to have peaked
US Department of Energy crude oil production

Figure 43: Recovery in China to boost copper prices
China PMI Manufacturing Index vs copper price

Figure 44: Iron ore and coal prices likely to have bottomed
China Tianjin Port spot price and ICE coal active future

Sources: Bloomberg, Standard Chartered

Sources: Bloomberg, Standard Chartered

Sources: Bloomberg, Standard Chartered

Sources: Bloomberg, Standard Chartered

Sources: Bloomberg, Standard Chartered
Key themes
- Neutral on Alternative Strategies
- Diversified exposure can be a source of low volatility returns if equity markets do reasonably well
- Maintain focus on Macro/CTA strategies as an insurance policy

Key views
We believe a diversified holding of major alternative strategies is attractive at this time. Most alternative strategies continue to have a relatively high correlation with equities, albeit with a few important exceptions. However, they are considerably less volatile than global equities. For example, a simple, equally-weighted portfolio of four of the largest alternative strategies has a high correlation with global equities, but provides much lower volatility (Figure 45).

Actual returns and volatility will, of course, vary depending on the specific weights assigned to different strategies. The point, however, is that a diversified basket of alternative strategies could provide a good way of gaining exposure to an improving economic environment for investors uncomfortable with taking on the volatility associated with simple equities exposure.

Macro/CTA (Commodity Trading Advisors) strategies remain a key component of diversified portfolios. These strategies have had a relatively difficult patch over the last two years as markets whipsawed on the back of policy-led uncertainty. However, what makes them particularly attractive is that they offer very low correlation with global equities – the lowest amongst the major alternative strategies. A transition towards a more normalised environment characterised by longer-lasting macro trends is likely to be positive for macro/CTA strategies.

Figure 45: Most alternative strategies offer lower volatility than global equities, though correlation varies

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Correlation with global equities*</th>
<th>Daily volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macro/CTA strategies</td>
<td>0.10</td>
<td>0.43</td>
</tr>
<tr>
<td>Equity Hedge</td>
<td>0.80</td>
<td>0.42</td>
</tr>
<tr>
<td>Event-driven</td>
<td>0.69</td>
<td>0.30</td>
</tr>
<tr>
<td>Relative Value</td>
<td>0.36</td>
<td>0.29</td>
</tr>
<tr>
<td>Equal weight of all 4 strategies</td>
<td>0.92</td>
<td>0.39</td>
</tr>
<tr>
<td>*MSCI AC World</td>
<td>1.12</td>
<td></td>
</tr>
</tbody>
</table>

However, we also note that the trending nature of these strategies mean they can also be a good hedge against an extreme outcome, when considered in the context of our range of possible economic scenarios (recession/muddle-through/transition/strong growth). Macro/CTA strategies are likely to be an appropriate portfolio hedge against the risk of a recessionary outcome.

Volatility strategies have done well, but we would begin to scale back now. Strong performance through recent periods of volatility mean the strategy has played its role in providing insurance to a well-diversified investment portfolio. However, we would now start scaling back. Outside of short-term risks in Q1, a reduction in tail risks implies the risk of higher volatility is likely lower over 2013. This suggests less room for volatility strategies to perform.

The case for other alternative strategies in isolation remains weak. A case could be made for event-driven strategies, for instance, if one were to take the view that an improving economic climate would lead to a rise in mergers & acquisitions. However, we believe it may be premature to consider such a shift, and believe a diversified approach holds more merit at this time.

Risks

Downside
- Further policy surprises would continue to pose a challenge to Macro/CTA strategies.
- A worsening economic environment poses downside risk to a diversified basket of alternative strategies.

Upside
- Risk of higher volatility has reduced, but not been eliminated, posing upside risks to volatility strategies.
- Improving economic environment could lead to upside surprises in strategies like event-driven if M&A activity recovers.
Alternatives – Charts of the year

Figure 46: Most alternative strategies have done reasonably well in 2012
HFRX Indices, total returns 2012 YTD (%)

Figure 47: Macro/CTA strategies are relatively uncorrelated with global equities
HFRX Macro/CTA strategies vs. MSCI AC World Indices

Figure 48: However, equity hedge strategies have a relatively high correlation with global equities
HFRX Equity Hedge strategies vs. MSCI AC World Indices

Figure 49: Alternative strategies offer lower volatility than simple global equity exposure
Standard deviation of returns

Figure 50: Volatility-linked strategies helped insure portfolios against equity volatility
HFRX Volatility Index vs. S&P 500

Figure 51: Data does not yet support a focus on event-driven strategies
Global M&A activity

Sources: Bloomberg, Standard Chartered

Sources: MSCI, Bloomberg, Standard Chartered

Sources: MSCI, Bloomberg, Standard Chartered

Sources: MSCI, Bloomberg, Standard Chartered

Sources: Bloomberg, Standard Chartered

Sources: Bloomberg, Standard Chartered
Key themes

- **USD likely to strengthen in early 2013 before softening again in H2 2013.** Navigating the USD is key to our FX outlook in 2013. In light of the uncertainty surrounding the outcome of the US fiscal cliff and the Euro area debt crisis, we see possible strong safe-haven demand for the USD in the early part of 2013. The USD is expected to weaken in H2 2013 as global growth recovers.

- **Central bank stimulus expectations reduced.** A crucial factor to note is that we have significantly reduced our expectations of further stimulus measure by policymakers.

- **Asia ex-Japan currencies attractive.** In terms of ranking, we place Asia ex-Japan currencies at the top of expected returns, followed by commodity currencies with major currencies expected to underperform.

**FX groups**

**Asia ex-Japan currencies – Strong resilience**

- **We remain medium term bullish on Asia ex-Japan given improving economic growth, external demand recovery, increased portfolio inflows and the continued search for yield.** Within this context, we favour the CNH, KRW, PHP and IDR.

- However, in the early part of 2013, the possibility of a temporary correction, given the strong rally over the last few months, cannot be ruled out.

- Asia ex-Japan currencies are expected to continue on their appreciation path in 2H 2013 on the back of higher portfolio inflows and the fact that the majority of Asian currencies remain somewhat undervalued in our opinion.

- **Commodity currencies (AUD, NZD and CAD) – Uninspiring, but tilting to the upside**

  - We remain neutral on commodity currencies (AUD, NZD and CAD) with a positive bias, as further upside in commodity prices will likely be limited.

  - Though we have significantly lowered our expectations of further monetary easing by major central banks, the expected gradual recovery in global economic growth is likely to provide some support for commodity currencies. We have a positive bias on commodity currencies due to three factors:

    - **Demand for Australian, New Zealand and Canadian government securities by various other central banks has been strong, although we believe this is likely to moderate over the next year.**

    - **We believe the Reserve Bank of New Zealand (RBNZ) and the Bank of Canada (BoC) have ended their interest rate easing cycle. However, any policy tightening is only likely to come at the end of the year.**

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**Figure 52: Asian currencies likely to sustain strength**

*DXY and ADXY Indices*

**Figure 53: Commodity currencies looking for drivers**

*Commodity currencies – Average performance of the AUD, NZD and CAD*

Sources: Bloomberg, Standard Chartered

Note: **DXY Index** comprises of the weighted performance of the USD against the EUR, JPY, GBP, CAD, SEK and CHF. **ADXY Index** comprises of the weighted performance of the CNY, HKD, INR, IDR, KRW, MYR, PHP, SGD, TWD and THB against the USD.
FX – USD to dictate

- As for the Reserve Bank of Australia (RBA), we do not rule out further rate cuts due to the expected long term shift from fiscal to monetary support for the domestic economy and softening domestic economic growth. Concerns that the AUD may be somewhat overvalued, is also likely to weigh on the AUD. However, Australia’s stable AAA sovereign rating and the fact that it offers relatively high yields is likely to keep the AUD supported.

Major currencies (EUR, JPY and GBP) – A glimmer of hope

We are Neutral on major currencies against the USD as the domestic growth recovery is expected to be gradual, with significantly reduced expectations of further policy stimulus measures; the exception being Japan. Our views on the three major currencies are as follows:

- EUR – The resilience in the EUR, despite the ongoing debt crisis, confirms our long standing view that the EUR is elastic to the upside on positive developments and inelastic to the downside on disappointments. We believe this will likely continue to hold over the next year. However, any upside is likely to be temporary as the recovery is expected to be prolonged.

- JPY – Any Bank of Japan (BoJ) action is key for the JPY over the next year. Political campaigning by the Liberal Democratic Party (LDP) has significantly raised market expectations of aggressive monetary easing. We believe that any political pressure to influence the independence of the BoJ will come under significant resistance from the current Governor. The LDP’s ability to influence the appointment of the new Governor come April 2013 will also likely come under resistance given the expected lack of support in the Upper House. Given the high level of uncertainty in the matter, we choose to remain neutral for now.

GBP – Above target inflation, subdued domestic growth and continued uncertainty over developments in the Euro area are expected to continue to haunt the GBP. We remain Neutral on the GBP, despite it being somewhat undervalued, given the challenges faced by policymakers in assessing the impact of past actions and the dilemma in taking the next course of action.

Risks

- A failure by US policymakers to reach an agreement on the fiscal cliff issue would likely lead to a sharp rise in the USD that would likely to persist for a considerable period.

- A crisis in the Euro area would likely have significant downside effects on most currencies except for the USD and JPY, which would likely appreciate on stronger safe-haven demand.

Figure 54: AUD strength driven by portfolio inflows
Reserve Bank of Australia (RBA) foreign holdings of government securities vs AUD-USD

Figure 55: EUR-USD resilient despite debt crisis and weak growth
EUR-USD vs Germany 5yr bond yield

Sources: Reserve Bank of Australia, Bloomberg, Standard Chartered

Sources: Bloomberg, Standard Chartered
Asset allocation – A diversification challenge

Aditya Monappa, CFA
Aditya.Monappa@sc.com

Key messages

• Asset allocation the primary driver of long term positive risk adjusted return. We continue to advocate a disciplined investment process around building a portfolio. This means creating a diversified mix among and within different asset classes.

• Strategic Asset Allocation still valid in 2013. Despite numerous challenges, the world economy continues to grow. Our Strategic Asset Allocation, which is predicated on sustained global growth, is still valid. It encourages investors to build strategic positions in Emerging Equity, Commodities, and Emerging Market Fixed Income.

• Correlations test asset allocators, but slowly normalising. Finding uncorrelated asset classes continues to be a challenge with correlation for certain asset class pairs remaining elevated. However, we are seeing a slow transition to normal levels.

• Challenging search for diversification. In an increasingly interconnected world, investors need to be more nuanced in their search for diversification; a broad-brush approach is less effective. Some key themes to help with portfolio diversification include:
  1. Emerging market (with Asia ex-Japan being a key contributor) exposure focused on economies driven by domestic demand, large populations and potential for regional free-trade agreements.
  2. Emerging market fixed income including local currency debt.

Key views

In our 2011 asset allocation publication, ‘The Super-Cycle Report Investor Supplement’, we described the world as being in a period of high growth lasting more than a generation driven by trade, investment, demographics and technological change. A large portion of this growth cycle, commonly referred to as a Super-Cycle, would be driven by emerging economies. On the back of the Super-Cycle, our strategic asset allocation showed a preference for Emerging Market Equity, Commodities and Emerging Market Fixed Income. Within Emerging Markets, we expect Asia ex-Japan to play a major role with China and India being leading contributors.

Events of the past few years might lead one to challenge the notion of a Super-Cycle. Fiscal issues in the US, systemic problems in the Euro area, and reform agenda in China continue to pose a formidable roadblock to sustained global growth. While we shouldn’t underestimate the downside risk presented by these issues, there have been quite a few positive developments which reassure us about the pace of global growth going forward.

As we highlighted in the macro section, 2013 is likely to be characterised by gradually increasing confidence in the global recovery. In the US, we anticipate a resolution of the fiscal cliff situation after a period of political back-and-forth. In Europe, a majority of the tail-risks look to have been removed after strong words of support from the ECB. Finally, in China there are initial signs of stabilisation in growth as economic data has started to turn higher. The transition towards a better growth environment is reflected in our global growth estimates of 2.6% in 2012, 2.8% in 2013, and 3.4% in 2014. In this setting, we feel our strategic allocation is still valid going into 2013.

Figure 56: Real GDP growth forecasts (2012-2014)

Figure 57: Cross-asset correlation transitioning to trend levels

Sources: IMF, Standard Chartered

Sources: Bloomberg, Standard Chartered
Asset allocation – A diversification challenge

Diversification still key

For asset allocators, a challenge has been a high level of correlation across various asset classes in the post-financial crisis world. While correlations have by no means returned to “normal” levels, for some asset class pairs we are starting to see a transition back to trend correlation.

To take advantage of this decreasing cross-asset correlation, a key theme remains portfolio diversification. However, a traditional diversification approach may not be effective. Top level correlations between Developed Market (DM) and Emerging Market (EM) Equity are high (12M correlation currently at 0.8). Given changing levels of public debt globally, a conventional approach to fixed income investing may not offer the best risk-adjusted return.

In light of this, we encourage investors to think about diversification of their portfolio in non-traditional ways. While not an all-inclusive list, there are two themes we’d like to highlight:

- **Equity – Diversification of Regional Exposure**
- **Fixed Income – Emerging Market Debt**

Equity – Evaluating regional exposure

Traditional equity portfolios provide regional exposure based on the country of incorporation or domicile of the component stocks. This often leads investors to make an equity allocation without fully understanding the true exposure to various geographies across the world.

In an increasingly inter-dependent world, it is important to understand the sources of revenue for firms prior to making an investment. For instance, an EM-based corporate might derive a large percentage of revenues from Western markets, reducing its participation in home country growth. On the other hand, companies in developed countries might benefit from the increasing consumption in emerging countries.

International companies with a strong EM business, especially those that can maintain their technological or brand position as emerging countries catch up, would fall into this category.

An investor can tap into emerging market growth in two ways:

1. **Direct investment in emerging market companies.** The focus should be on companies that derive a large portion of revenue based on domestic demand rather than exports. This allows the investor to truly access EM economic growth.

2. **DM companies with EM Exposure.** This is currently a key theme within our equity strategy. Investors should pay attention to strong developed market franchises with a significant proportion of their revenues in emerging markets. This option might be suitable for investors looking to tap into emerging market growth, but uncomfortable with the volatility, liquidity, and share dilution issues that arise in certain markets. While such investments are still correlated to developed markets, they offer an alternative way to access EM beta.

It is important for investors to understand their regional exposure – equity portfolios that look well diversified based on their country of domicile might be highly concentrated when evaluated using geographic distribution of company revenue. Additionally, EM cannot be viewed as a broad aggregation. Within EM, we see varying approaches to monetary policy, differing domestic demand and countries in various stages of reform. Some action steps for an investor in this regard:

1. **Evaluate equity portfolio mandate.** Understand the equity benchmark/mandate in context of economic exposure. A global benchmark like MSCI ACWI Index has a 32% exposure to EM when evaluated based on revenue exposure versus a 13% weighting when using a traditional market cap weighted methodology.

Figure 58: 12mo. rolling correlation between Developed (MSCI World) and Emerging (MSCI EM) Equity

![Figure 58](image1.png)

Sources: MSCI, Bloomberg, Standard Chartered

Figure 59: Mkt. Cap vs. Revenue Exposure of Global Equity Index

**EM exposure increases from 13% to 32%**

![Figure 59](image2.png)

Sources: MSCI, Standard Chartered
Asset allocation – A diversification challenge

2. **Aggregate portfolio positions.** Investors have a reasonable idea of geographic distribution of revenues for individual companies. However, an effort should be made to aggregate this revenue distribution on a portfolio basis. Understanding this distinction will allow the investor to better align their macroeconomic views with stock selection.

3. **Re-assess risk.** To round out the portfolio construction process, an investor should use the revised allocation, aggregated by revenue exposure, for risk attribution. This will allow for better sensitivity analysis to changes in macroeconomic conditions.

**Fixed income – Emerging market debt**

The term emerging market fixed income has often been used interchangeably with high yield fixed income. However, characteristics of this asset class have changed considerably over time. We continue to advocate this asset class as a strategic holding within a portfolio. This approach carries additional value especially given concern of sovereign creditworthiness in developed markets. Traditional bond indices have an inherent structural bias to overweight countries with high levels of debt, leading many investors to be under-allocated to EM fixed income.

We see three drivers of strategic return for EM Fixed Income:

- **Growth of EM debt asset class.** We anticipate large-scale expansion of this asset class driven by significant fund flows and as issuers turn to local markets for financing. A large portion of fund flows will come from pension funds in the US and Europe. For these funds, the funding gap between assets and liabilities has widened consistently over the past decade. To address this gap, pension funds will increasingly look to add asset classes such as EM debt to their portfolio. A survey by Mercer indicates allocations to emerging asset classes have been steadily rising over the past few years.

- **Change in credit profile.** The credit characteristics of EM debt have been steadily improving. A majority of the EMBIG index is now investment grade. Contrary to misconceptions that EM is a risky asset class, an analysis of various asset classes shows that EM USD and EM local currency debt offer some of the best risk adjusted returns.

- **Attractive Carry.** The asset class continues to offer an opportunity for incremental return over DM fixed income.

A sub-sector of Emerging market fixed income worth highlighting is the local currency space. As mentioned earlier in this publication, the combination of attractive real yield spreads and nominal currency appreciation bodes well for EM local currency debt.

A consequence of rapid economic development is a need for corporates to raise capital to fund the growth. Economies become more capital intensive as they develop. As local currency debt markets in EM present improved options in terms of size and tenor, we expect local corporates to switch to these markets and away from international debt.

Another result of economic growth is an expansion of corporate and consumer financing demands on financial institutions. Banks and other financial institutions will turn to public market financing as a means to bolster their capital base. Governments are increasingly raising financing in local currency terms. This arrangement reduces variability in cash flow requirements to service their debt.
Asset allocation – A diversification challenge

Conclusion

As we enter 2013, economies are transitioning to a more traditional growth environment. Asset classes are slowly moving from a period of high correlation to historical averages. Against this backdrop, it is important to remember that characteristics of certain asset classes have changed.

- EM and DM equities show a strong correlation. While portfolios should have a healthy mix of DM and EM equity, it is important for diversification that EM equity exposure includes countries with strong or growing domestic demand rather than dependence on export revenue. As a first step, investors should redraw their portfolios and benchmarks using the revenue exposure lens. This will allow for a more targeted country and sector allocation aligned with macroeconomic views.

- EM debt is increasingly an asset class in its own right. Given the explosion of public debt levels in industrialised countries, investors should look strategic investment in the deepening EM fixed income asset class.

- While the concept of diversification is still valid, investors will need to work harder to ensure their portfolios are exposed to non-correlated sources of return.
### Strategic Asset Allocation 2013 (Global)

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<tr>
<th>Asset Class</th>
<th>Region</th>
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<th>Moderate</th>
<th>Moderately Aggressive</th>
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**Summary**

Cash: 25 5 5 5 5
Fixed Income: 40 40 20 5 5
Equity: 20 35 55 80
Commodities: 5 10 10 5
Alternatives: 10 10 10 5

### Tactical Asset Allocation - January 2013 (12M)

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**Summary**

Cash: UW 22 0 0 0
Fixed Income: UW 37 37 18 5
Equity: OW 21 40 59 80
Commodities: OW 10 13 13 10
Alternatives: N 10 10 10 5
## Forecasts

### Central bank policy rates

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Source: Bloomberg, Standard Chartered Global Research (7 December 2012 Economics Weekly)

* Period averages for each quarter.

^ Q4 2013 and Q1 2014 commodity forecasts from the 7 Dec 2012 Commodity Roadmap
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