Standard Chartered Private Bank

weekly market view

macro strategy | 15 February 2019

This reflects the views of the Wealth Management Group

Editorial

A trade deal in the works?

- **The US and China appear to be closer to a trade agreement, a key hurdle to the ongoing rally in risk assets.**
- **Equities:** China remains our preferred equity market in Asia ex-Japan. Trade deal optimism and expectations of further A-shares inclusion in MSCI indices to extend positive momentum.
- **Bonds:** A sustained increase in US High Yield (HY) bond supply could impose a drag on returns. We prefer EM USD government bonds which offer similar yields and lesser risk.
- **FX:** We expect any near-term GBP decline to be short-lived as the chances of a "no-deal Brexit" recede.

What's new?

- **A trade deal would be positive for China, Asia equities.** Hong Kong and China equities have picked up momentum after the Lunar New Year holidays. Key drivers include: a) President Trump's comments that he was willing to push back the 1 March deadline for raising tariffs as the two sides ended another round of trade talks b) expectation that MSCI will increase the weight of China A-shares in the MSCI Emerging Markets index later this month, leading to a rise in foreign institutional allocations, and c) expectations of more market-friendly measures from Beijing, including measures to boost bank lending and brokers' margin financing. Technicals also suggest the Shanghai Composite is poised for a sustained rebound following a two-year downtrend (see chart). Both China offshore and China onshore equity markets are preferred within Asia ex Japan.
- **US earnings upgrade/downgrade trend turning favourable.** Following a strong Q4 18 earnings season (earnings rose c. 16% y/y), US earnings are estimated to decline 0.3% y/y in Q1 19 amid broad-based cuts to earnings estimates. Nevertheless, analysts have started to reduce the pace of 2019 earnings downgrades, while the pace of upgrades has started to tick higher, with consensus now estimating a 4.2% y/y rise in 2019 earnings. This may explain the sustained strength in US equity markets, despite the weak Q1 earnings estimates. The US remains one of our two preferred equity markets as we believe the weak Q1 earnings have already been discounted by markets.
- **Prefer US banks over Euro area banks sector.** US banks are benefitting from easing regulations, pick-up in M&As, especially among mid-sized banks, and expectations of share buybacks. Meanwhile, European banks continue to be weighed by slowing regional growth and concerns about capital adequacy (with the cost of debt rising for some leading banks). Although Euro area banks are trading at a significant discount to US banks, we prefer the latter. However, any reduction in political risks (Brexit, Italy), easing regulations and recovery in regional economic growth would be positive for European banks (see page 3).

What we are watching

- a) Outcome of US-China trade talks and next steps b) US decision on auto import tariffs (focus on European imports) c) Will President Trump's plan to declare a national emergency to fund a Mexican border wall (while approving a bill to avert another government shutdown) escalate US political tensions?

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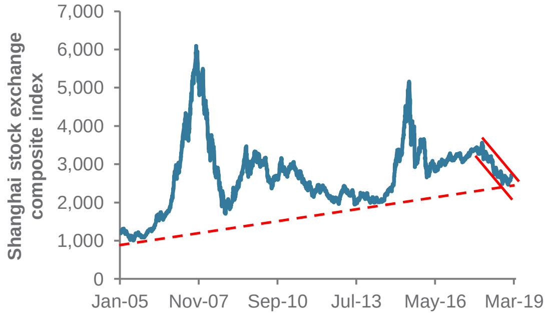
The Shanghai Composite Index appears poised for a rebound following a two-year downtrend

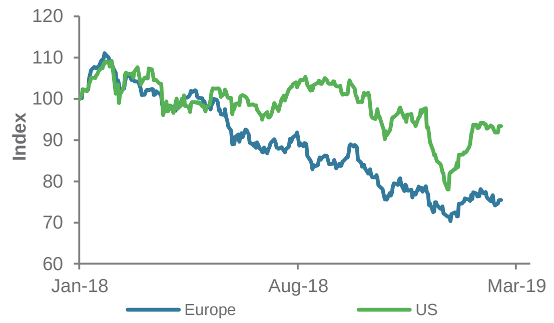
Shanghai Composite Index



Source: Bloomberg, Standard Chartered

We expect US banks to extend gains and continue to outperform European banks amid easing regulations, pick-up in M&As and share buybacks

MSCI US and European bank indices (100=1 Jan 2018)



Source: Bloomberg, Standard Chartered

Steve Brice
Chief Investment Strategist

Francis Lim
Senior Investment Strategist

Clive McDonnell
Head, Equity Investment Strategy

Thursten Cheok, CFA
Senior Portfolio Strategist

Manpreet Gill
Head, FICC Investment Strategy

Abhilash Narayan
Investment Strategist

Manish Jaradi
Senior Investment Strategist

Cedric Lam
Investment Strategist

Audrey Goh, CFA
Senior Cross-asset Strategist

Trang Nguyen
Portfolio Strategist

Daniel Lam, CFA
Senior Cross-asset Strategist

DJ Cheong
Investment Strategist

Belle Chan
Senior Investment Strategist

Marco Iachini
Cross-Asset Strategist

Rajat Bhattacharya
Senior Investment Strategist

What does this mean for investors?

Global equities extended gains, led by US and China markets, amid signs of easing trade tensions. The USD extended gains, especially against GBP, amid Brexit concerns.

Equities: China shares rebounding

- **China A-shares to get a boost from MSCI index inclusion.** MSCI is carrying out a consultation for an increase in the weight of A-shares in its Emerging Market (EM) index universe. The consultation period ends on 15 February, with the final decision to be announced on or before 28 February. Based on positive feedback so far, the market expects the weight of A-shares in the MSCI EM index to rise to 2.8% by August 2019 from 0.7% and their weight in the MSCI China index to rise to 8.8% from 2.3% currently. This would result in increased institutional inflows from funds benchmarked to the indices. We believe this would be positive for China stocks, our preferred equity market in Asia.
- **Easing regulations would be positive for China market.** We expect the newly appointed head of China's securities regulator, Yi Huiman, to reintroduce various measures to vitalise stock-trading activities. This potentially includes deregulation of brokers' margin financing and prime brokerage business.
- **Technical charts turning supportive.** The Shanghai Composite Index has rebounded from major support levels: a long-term uptrend line from 2005 and the lower edge of a downtrend channel from 2018. The index's subsequent rise above the upper edge of the channel (see chart on page 1) is a confirmation that the downward pressure has faded, in our view, raising the probability of further gains. A decisive break above the September high of around 2,820 (3.7% above current levels) would open the possibility of a larger retracement upward toward the psychological 3,000 level. However, given the extent and the duration of the decline since 2015, the potential rebound is likely to be choppy.

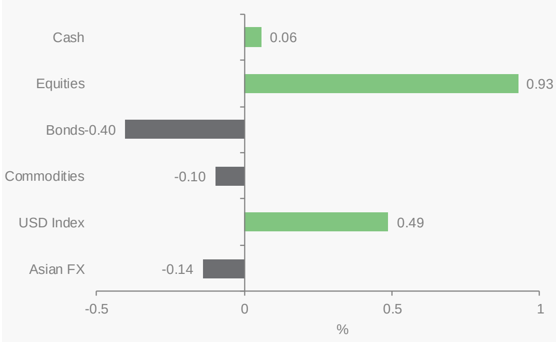
Bonds: Likely headwind for US High Yield bonds

- **US High Yield (HY) bonds face supply glut.** Corporate bonds weakened late last week amid trade concerns, before rebounding over the last few days amid better market sentiment and higher oil prices. However, the decline in Fed rate hike expectations has led to a notable increase in bond supply in the US as issuers gradually switch from loans to HY bonds. A sustained increase in supply could act as a drag. We prefer EM USD government bonds, which offer similar yields but carry lower credit risk.
- **Asian USD bonds outperformed global bonds** over the past week as yield premiums declined modestly, despite a pick-up in supply. While our preferred bond asset class, EM USD government bonds have outperformed global bonds in 2019, they were choppy last week as risk sentiment was subdued. The contrasting performance highlights the defensive nature of Asian USD bonds. We believe pairing them with EM USD government bonds would reduce the volatility of riskier bond holdings as Asian bonds usually outperform in challenging market conditions, as they did in 2018.

FX: Opportunities in GBP

- **GBP likely to recover in the medium term**. GBP/USD declined after PM May lost another vote on the terms of Brexit in the UK parliament. We believe there is low risk of a "no-deal Brexit", given the division in both the ruling coalition and opposition parties on Brexit. Any pushback in Brexit beyond the 29 March deadline would be positive for GBP; 1.2650 is a key support.

Benchmark (USD) performance w/w*



**Week of 07 February 2019 to 14 February 2019*

Source: MSCI, JP Morgan, DJ-UBS, Citigroup, Bloomberg, Standard Chartered (Indices used are JP Morgan Cash, MSCI AC World TR, Citi World Big, DJ-UBS Commodity, DXY and ADXY)

Equity market technicals remain supportive globally

Technical levels of key market indicators as on 14 Feb.

Index	Spot	1st support	1st resistance	Short-term trend
S&P500	2,746	2,680	2,817	↑
STOXX 50	3,183	3,068	3,216	↗
FTSE 100	7,197	6,995	7,219	↗
Nikkei 225	21,140	20,100	21,880	↗
Shanghai Comp	2,720	2,555	2,830	↗
Hang Seng	28,432	27,200	29,100	↑
MSCI Asia ex-Japan	645	615	660	↗
MSCI EM	1,039	1,009	1,075	↗
Brent (ICE)	65	59	68	↗
Gold	1,313	1,287	1,347	↗
UST 10Y Yield	2.65	2.52	2.82	↘

Source: Trading Central, Standard Chartered
Note: Arrows represent short-term trend opinions

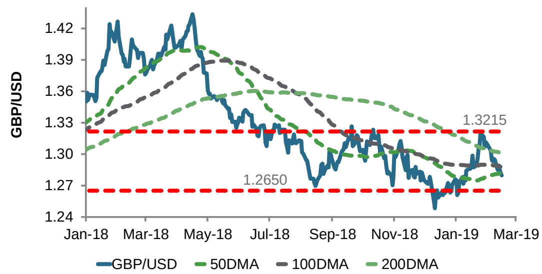
EM USD government bonds have outperformed global bonds over the past two months

Performance of EM USD government bond index, Asia USD bond index and global bond index (100 = 07 Dec. 2018 i.e. since we published Outlook 2019)

Source: Bloomberg, Standard Chartered

GBP/USD has strong support around 1.2650

GBP/USD



Source: Bloomberg, Standard Chartered

Top client questions

Q1. What is the outlook for US and European banks?

There has been a lot of news related to the banking sector in the past couple of weeks, and, in general, it has been supportive of the continued underperformance of the European banking sector relative to the US (see chart).

In the US, the regulatory burden is being gradually eased for both large- and medium-sized US banks. This should not only support profitability metrics, but we are also seeing some signs that it may encourage some merger and acquisition activity in the sector, particularly among medium-sized banks. Finally, we are also seeing positive indications on the share buyback front. Forecasts for over USD 900bn of share buybacks in 2019 are being touted for the US market, with banks and technology companies being seen as major drivers of this number.

However, on the other side of the Atlantic, the news flow is much less positive. Economic data remains very weak in the European Union, with the consensus 2019 economic growth forecasts falling to 1.6% from 1.9% in the past three months. Meanwhile, much has been made about Deutsche Bank's high cost of debt raised in the past few days. Finally, Banco Santander decided not to 'call' one of its perpetuals this week. While this is totally within Santander's rights, it has not been conventional practice, was not expected and led to some, albeit seemingly short-lived and modest, volatility in the European bank perpetuals market.

Looking forward, there are two key questions.

First, will the absolute performance of the US banking sector improve in the coming 12 months? As the chart shows, while US banks have outperformed European banks in aggregate since the beginning of 2018, they have still lost value over that timeframe. Our sense is the US banks are in the process of bottoming out and if we are right that US growth is likely to remain strong, albeit slower than in 2018, credit demand and net interest margins are likely to stay robust. This may provide a catalyst for US bank share prices to rise over the next 3-6 months.

The second question: Will European banks continue to lag the US? As mentioned above, the news flow argues that the underperformance will continue. However, the table highlights three key valuation metrics for the two regions, and on two of these metrics (price-to-book ratio and dividend yield) the European banking sector is trading at a huge valuation discount. Of course, we know valuation is rarely a good indicator when it comes to short-term (3-6 month) returns. What is needed is a catalyst. In this instance, anything that leads to either a significant reduction in the risk profile of the banking sector (eg. reduced Brexit concerns) and/or a sustainable improvement in earnings potential (eg. reduced regulation, stronger growth) could allow the sector to recover both in absolute and relative (to the US) terms. For now, we have a neutral weight on US banks, while we remain underweight on Euro area banks.

US banks have outperformed European banks over the past year on the back of easing regulations, M&As and share buybacks

MSCI US and European bank indices (100=1 Jan 2018)

Source: Bloomberg, Standard Chartered

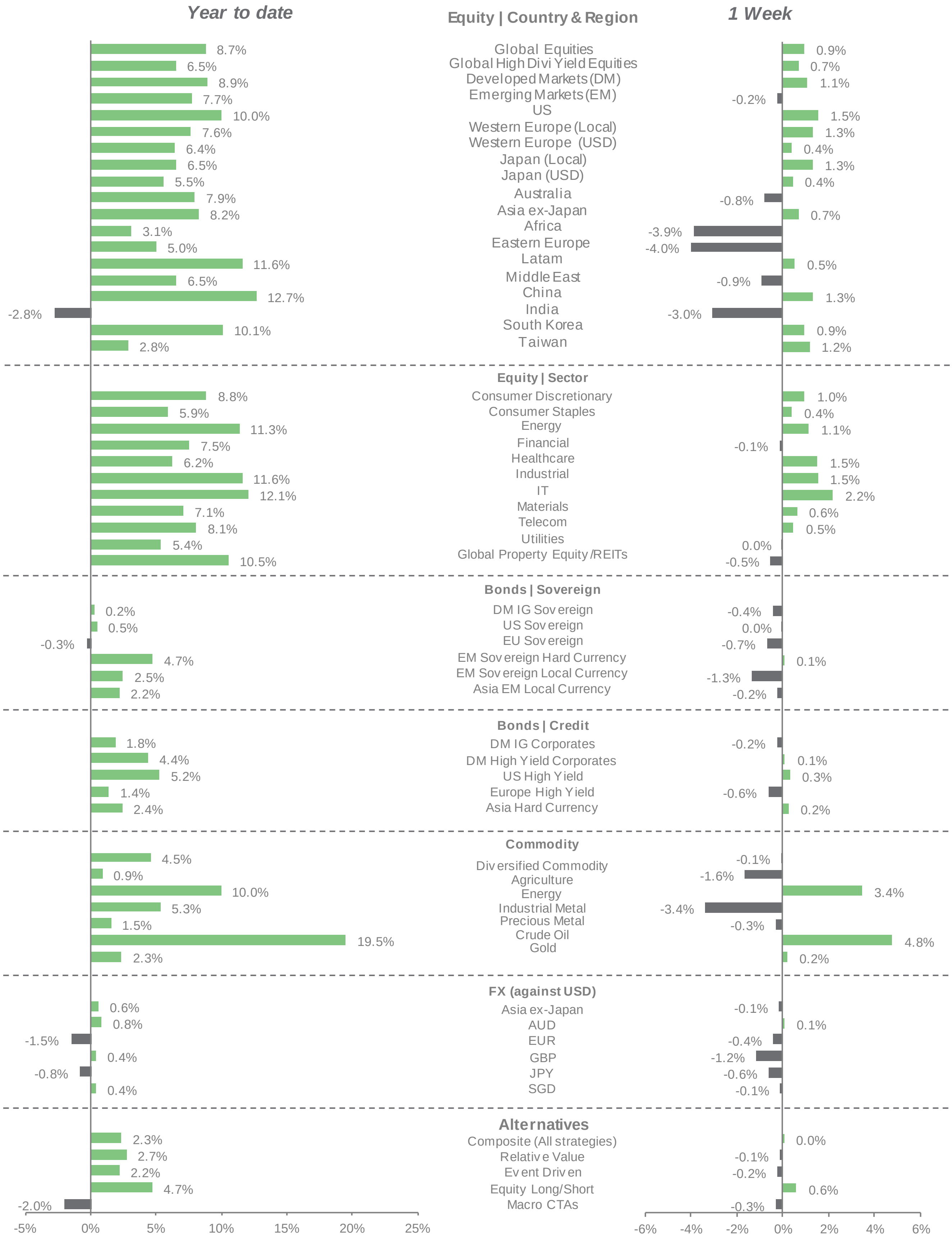
European banks are a value opportunity still waiting for catalysts

Key valuation metrics for MSCI US and European bank indices

	US	Europe
Forward price-earnings ratio	11.42	10.32
Price-book ratio	1.27	0.73
Dividend yield, %	2.57	5.68

Source: MSCI, Bloomberg, Standard Chartered

Market performance summary*



**Performance in USD terms unless otherwise stated, YTD period from 31 December 2018 to 14 February 2019, 1 week period: 07 February 2019 to 14 February 2019*

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

Economic & Market Calendar

	Event	Next Week	Date	Period	Expected	Prior
TUE	EC	ECB Current Account SA	19-Feb-19	Dec	–	20.3b
	UK	Average Weekly Earnings 3M/ y/y	19-Feb-19	Dec	–	3.4%
WED	JN	Exports y/y	20-Feb-19	Jan	-5.5%	-3.9%
	EC	Consumer Confidence	20-Feb-19	Feb A	–	-7.9
THUR	FR	Markit France Composite PMI	21-Feb-19	Feb P	–	48.2
	GE	Markit/BME Germany Composite PMI	21-Feb-19	Feb P	–	52.1
	EC	Markit Eurozone Manufacturing PMI	21-Feb-19	Feb P	–	50.5
	EC	Markit Eurozone Services PMI	21-Feb-19	Feb P	–	51.2
	EC	Markit Eurozone Composite PMI	21-Feb-19	Feb P	–	51
	US	Cap Goods Orders Nondef Ex Air	21-Feb-19	Dec P	0.002	-0.006
	US	Markit US Composite PMI	21-Feb-19	Feb P	–	54.4
	US	Leading Index	21-Feb-19	Jan	0.002	-0.001
	US	Existing Home Sales	21-Feb-19	Jan	5.00m	4.99m
FRI/ SAT	JN	Natl CPI y/y	22-Feb-19	Jan	0.3%	0.3%
	JN	Natl CPI Ex Fresh Food, Energy y/y	22-Feb-19	Jan	0.4%	0.3%

	Event	This Week	Date	Period	Actual	Prior
MON	UK	GDP y/y	11-Feb-19	4Q P	1.3%	1.5%
	CH	Foreign Reserves	11-Feb-19	Jan	$3087.92b	$3072.71b
TUE	IN	CPI y/y	12-Feb-19	Jan	2.1%	2.2%
	IN	Industrial Production y/y	12-Feb-19	Dec	2.4%	0.5%
WED	UK	CPI Core y/y	13-Feb-19	Jan	1.9%	1.9%
	US	CPI Ex Food and Energy y/y	13-Feb-19	Jan	2.2%	2.2%
THUR	JN	GDP Annualized SA q/q	14-Feb-19	4Q P	1.4%	-2.5%
	US	PPI Ex Food and Energy y/y	14-Feb-19	Jan	2.6%	2.7%
	US	Retail Sales Ex Auto and Gas	14-Feb-19	Dec	-1.4%	0.5%
	CH	Exports y/y	14-Feb-19	Jan	9.1%	-4.4%
FRI/SAT	CH	CPI y/y	15-Feb-19	Jan	1.7%	1.9%
	CH	PPI y/y	15-Feb-19	Jan	0.1%	0.9%
	UK	Retail Sales Ex Auto Fuel y/y	15-Feb-19	Jan	–	2.6%
	US	Industrial Production m/m	15-Feb-19	Jan	–	0.3%
	IN	Exports y/y	15-Feb-19	Jan	–	0.3%

Previous data are for the preceding period unless otherwise indicated
Data are % change on previous period unless otherwise indicated
P - preliminary data, F - final data, sa - seasonally adjusted
y/y – year-on-year, m/m - month-on-month

Source: Bloomberg, Standard Chartered; key indicators highlighted in blue

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