Standard Chartered Private Bank

weekly market view

macro strategy | 9 February 2018

This reflects the views of the Wealth Management Group

Editorial

Correction sets stage for next rebound

- **The sharp pullback in risk assets has reversed overly bullish sentiment, setting the stage for the next rebound. We are watching technical signals to re-enter preferred markets.**
- **Equities:** Indicators for investor sentiment, positioning and valuations are no longer stretched. A rebound from key technical levels (see page 2) would provide a chance to re-enter equities.
- **Bonds:** US 10-year Treasury yields face key resistance at 2.85%. EMs remain our preferred area in bonds, given the rise in yields and the temporary weakness of EM currencies.
- **FX:** USD index needs to break above 91.0 to signal a reversal of its downtrend. We further weakness in GBP and gold.

What's new?

- **An overdue equity correction.** Global equities have lost 9% and US S&P500 index has lost 10% since their January record highs amid selling by institutional investors and computer-based algorithms in reaction to rising expectations for growth, inflation and the US budget deficit. The correction has helped reverse extremely bullish sentiment and overbought investor positions, which we had flagged in recent weeks. As valuations have normalised amid strong earnings estimates, we believe the decline has more in common with a correction as opposed to the end of the bull market. We are watching key technical levels to re-enter our preferred markets – Asia ex-Japan and the Euro area. Nevertheless, we are in the late stage of the economic cycle, and market gyrations are likely to become more frequent.
- **US Treasury yields face resistance.** One of the triggers of the equity correction was the sustained rise in US 10-year Treasury yields. We view the rise in yields as a positive development, as they indicate a reflationary world seeing growth upgrades and a revival in inflation expectations. US 10-year Treasury yields now face a key resistance at 2.85%. We expect the yields to stay within 2.5%-3.0% over the next 12 months, although rising US budget deficit following the tax cuts is a risk to this view. Fed policymakers in the week of 9 February signalled a continuation of their plan to hike rates gradually despite the market volatility, which confirms their confidence in the fundamental outlook.
- **USD rebounds, EUR weakens.** The USD index has rebounded over 2% from a three-year low. However, it would need to break above 91.0 to confirm it has reversed its downtrend. The EUR has struggled to break above 1.25, as it has run ahead of interest rate expectations. It would need to break below 1.21 to confirm a downtrend. We expect the GBP to weaken towards 1.350 in the near term amid renewed political and Brexit uncertainty, despite BoE Governor Carney's hawkish comments.

What we are watching

- **Key equity technical levels.** The S&P500 and Hang Seng indices have fallen below their 100DMAs. Their 200DMAs 1.6% and 4.5% below current levels are likely to provide strong technical support. The Nikkei remains above its 200DMA, although the Euro Stoxx 50 has broken below its 200DMA, raising the risk of further near-term downside.

Contents

Near-term technical indicators turn supportive for US equity markets after correction

Short-term indicators for S&P500

Indicators	Signal
Current level vs. 200DMA	Green
Put/call ratio	Amber
Relative strength index	Green
VIX	Amber
MACD (momentum) weekly	Amber
Fund manager cash holding	Amber
Valuation backdrop	Amber

Source: CBOE, BofA Merrill Lynch, Bloomberg, Standard Chartered

Red: Higher risk of profit taking; Green: Lower risk of profit taking; Amber: Moderate risk of profit taking

US equity valuations are no longer as stretched after the market correction

12-month forward price-earnings ratio for S&P500 index

Source: Bloomberg, Standard Chartered

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What does this mean for investors?

Global stocks and bonds declined sharply, with broad-based losses across markets. Bonds outperformed stocks, while the USD rebounded.

Equities: Focus on preferred sectors, markets

- **Rising bond yields to benefit US financial sector.** The correction in US equities has lowered S&P500's 2018 P/E to a more attractive 16.6x. This supports US equities as a core holding. Within this market, we continue to prefer the financial sector. The recent rise in US 10-year Treasury yields has been particularly concentrated in the longer maturity periods. As a result, the difference between the 10- and 2-year Treasury yields has risen almost by 20bps since the start of 2018. This is positive for bank lending margins and profitability.
- **Lunar New Year holidays likely to weigh on HK market near term.** The Hang Seng has declined more than 12% from its January peak, falling below its 100DMA. Average daily turnover soared to HKD 200bn on 6-7 February compared with the 2017 average of HKD 87bn. The Shanghai-Hong Kong (HK) Stock Connect mechanism, which allows investors in both countries to invest in each other's securities, witnessed active buying by China investors via the 'Southbound' flow to HK. As the Stock Connect will close between 13 February and 21 February for the Lunar New Year, a key marginal buyer in the HK market will be absent, which could weigh on the market in the near-term. However, the fundamentals for HK and China equities remain positive, and we retain China as a preferred market.

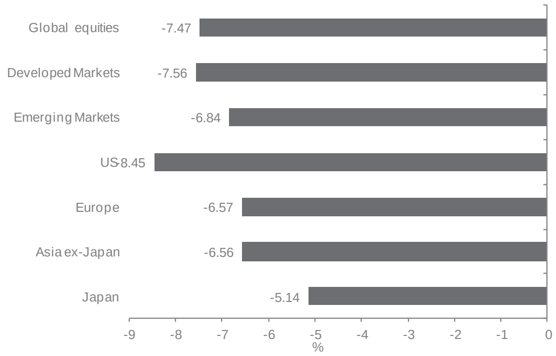
Bonds: EM bonds preferred

- **Emerging Market (EM) government bonds,** both USD and local currency denominated, delivered negative returns over the past week, as riskier bond asset classes were impacted by the sell-off in equities. EM USD government bonds saw yield premiums increase, while local currency bonds were hurt by the USD rebound. Despite the sell-off, fundamentals remain strong for EMs, and we would use this current pullback as an opportunity to add exposure to EM USD and local currency bonds.
- **High Yield (HY) bonds see healthy correction.** The sell-off in risk assets cascaded down to the riskier HY bonds, which delivered negative returns. Yield premiums rose due to sell-offs in risk assets and oil price declines. Contingent convertible bonds and floating rate senior loans also fell in line with the weak market sentiment. We view the recent moves as a healthy correction. Developed Market (DM) HY bonds remain a core holding.

FX: Expect further weakness in GBP

- **GBP vulnerable to politics.** The GBP broke below the 1.400 support, pulling back from its 1-1/2-year high of 1.435, suggesting further downside. The risk of a challenge to Prime Minister May's leadership in the Conservative Party and the possibility of a no-confidence vote and general election continue to cloud the outlook. The next phase of Brexit talks on trade is likely to be divisive. Meanwhile, the USD's rebound is a headwind for GBP. We expect the GBP to weaken towards 1.350 in the near term.
- **AUD, gold likely face further downside.** The AUD fell 4% from its 2-1/2-year high above 0.81 amid a rebound in the USD. The RBA held rates at a record low, as expected, as inflation remains well below its target. RBA Governor Lowe's statement, downplaying the possibility of a near-term rate hike, suggests the AUD is likely to remain under pressure. Gold also remains under pressure from the USD rebound and higher US interest rates.

Benchmark (USD) performance w/w*



**Week of 01 February 2018 to 08 February 2018*

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)

S&P500 is 1.6% from its first technical support level

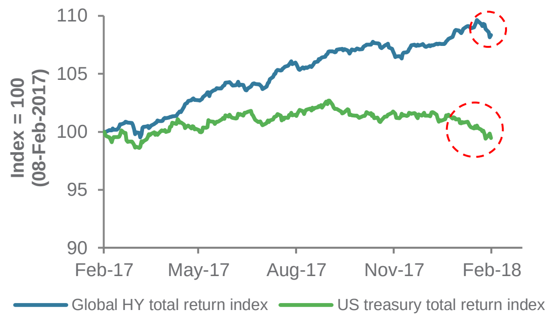
Technical levels of key market indicators as on 08 Feb

Index	Spot	1st support	1st resistance	Short-term trend
S&P500	2,581	2,540	2,728	↘
STOXX 50	3,377	3,363	3,478	↘
FTSE 100	7,171	7,079	7,351	→
Nikkei 225	21,140	21,000	23,100	→
Shanghai Comp	3,262	3,250	3,450	→
Hang Seng	30,451	30,200	32,400	↓
MSCI Asia ex-Japan	711	700	752	→
MSCI EM	1,163	1,125	1,235	→
Brent crude oil (ICE)	65	61	68	↓
Gold	1,321	1,305	1,366	↑
UST 10Y Yield	2.83	2.50	2.93	↗

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

DM HY bonds barely impacted by drawdown in US Treasuries

DM HY bond and US Treasuries total return indices



Source: JP Morgan, Bloomberg, Standard Chartered

GBP broken below its 1.40 support and likely to weaken to 1.350

GBP/USD

Source: Bloomberg, Standard Chartered

Top client questions

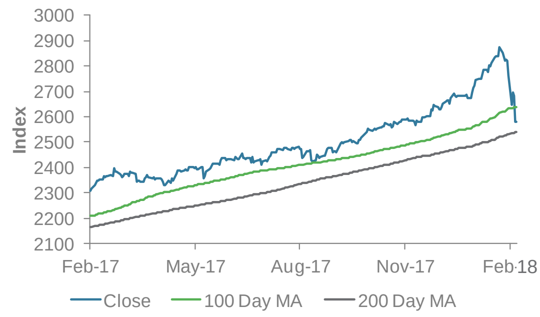
Q1. What could be the performance of the S&P500 over the rest of the year after the recent correction?

The S&P500 has corrected by more than 10% since its record high in January. We maintain our view on US equities as our core holding, given corporate fundamentals remain intact. We continue to see near-term weakness as a buying opportunity.

The S&P500 index fell below the key technical level of 2,637 (the 100DMA of the index) on Thursday after testing this level briefly on Tuesday. To put it in perspective, the S&P500 closing price has historically crossed below its 100DMA 166 times over the last 27 years. It rebounded 127 times after such crosses, and the average return of these rebounds was 13% over the next 12 months. Interestingly, this implies that the return of the S&P500 for the full year of 2018 could be around 7%, if a subsequent rebound ensues. This is close to the market implied return of 9%, based on our three-factor model for the US equity market that was indicated in our *Annual Outlook 2018*.

The S&P500 index has fallen below its 100DMA; our analysis implies 13% return is possible over the next 12 months

S&P500 index



Source: Bloomberg, Standard Chartered

Q2. What role did target volatility funds and algorithmic trading have in the recent market correction?

Target volatility funds have become increasingly popular among investors in the US as a tool to control risk in their portfolio. Target volatility refers to a targeted level of risk. It is estimated that USD 500bn of assets are indexed to these products. As the name suggests, target volatility funds target a specific level of volatility, frequently at 10%.The fund rebalances its assets between risky and risk-free assets to achieve the targeted level of volatility. The most popular funds rebalance between the S&P500 and short-term US Treasury bills.

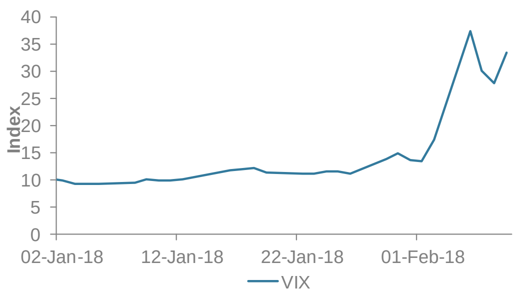
Algorithmic trading is linked to these funds, as the rebalancing is driven by an algorithm as opposed to human decision making. When S&P500 volatility (VIX) surges – as it did on Tuesday, 6 February – with the VIX rising to an intra-day high of 50, the rebalancing or selling of risky assets, such as the S&P500, and purchasing of risk-free assets, such as Treasury bills, is swift, as the algorithm instructs a computer program to execute the trades automatically.

One of the shortcomings of this strategy is that rising market volatility tends to beget more volatility. Hence, there can be a surge in selling pressure, as rising equity volatility requires re-balancing in favour of Treasury bills, with the selling pushing volatility higher, creating a spiral similar to the flash crash observed towards the end of the trading day on Monday, 5 February.

Historically, as we enter the later part of the economic cycle, volatility tends to increase. This does not imply that markets could decline. Rather, as uncertainty rises, market volatility could rise futher. The market can perform well during this period. However, the frequency of declines tends to increase. What is uncertain is the impact target volatility funds will have in the current cycle, as their size has grown significantly since the current bull run began.

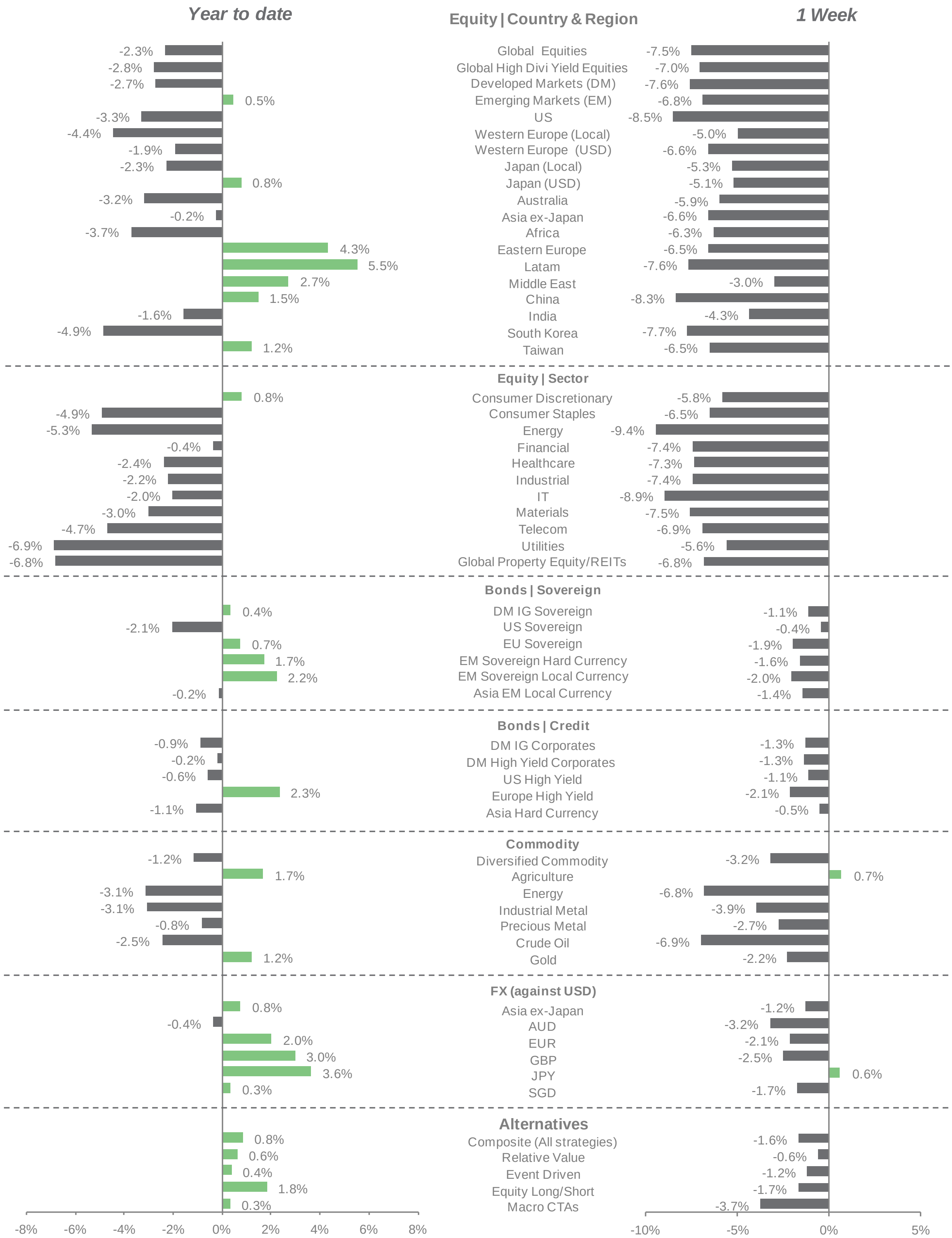
S&P500 index volatility has surged from record low levels over the past couple of weeks

S&P500 index volatility index



Source: Bloomberg, Standard Chartered

Market performance summary*



**Performance in USD terms unless otherwise stated, YTD period from 31 December 2017 to 08 Feb 2018, 1 week period: 01 Feb 2018 to 08 Feb 2018*

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

Economic & Market Calendar

	Event	Next Week	Date	Period	Expected	Prior
MON	IN	CPI y/y	12-Feb-18	Jan	–	5.2%
TUE	UK	CPI Core y/y	13-Feb-18	Jan	2.6%	2.5%
WED	JN	GDP Annualized SA q/q	14-Feb-18	4Q P	0.9%	2.5%
	EC	Industrial Production WDA y/y	14-Feb-18	Dec	–	3.2%
	EC	GDP SA y/y	14-Feb-18	4Q P	–	2.7%
	US	CPI Ex Food and Energy y/y	14-Feb-18	Jan	1.7%	1.8%
	US	Retail Sales Control Group	14-Feb-18	Jan	0.4%	0.3%
THUR	JN	Core Machine Orders y/y	15-Feb-18	Dec	0.5%	4.1%
	US	PPI Ex Food and Energy y/y	15-Feb-18	Jan	2.1%	2.3%
	US	Industrial Production m/m	15-Feb-18	Jan	0.2%	0.9%
	ID	Bank Indonesia 7D Reverse Repo	15-Feb-18	15-Feb	–	4.3%
	IN	Exports y/y	15-Feb-18	Jan	–	12.4%
FRI/SAT	UK	Retail Sales Ex Auto Fuel y/y	16-Feb-18	Jan	2.3%	1.3%
	US	Housing Starts	16-Feb-18	Jan	1225k	1192k
	US	Building Permits	16-Feb-18	Jan	1300k	1302k

	Event	This Week	Date	Period	Actual	Prior
MON	JN	Nikkei Japan PMI Composite	05-Feb-18	Jan	52.8	52.2
	CH	Caixin China PMI Composite	05-Feb-18	Jan	53.7	53.0
	IN	Nikkei India PMI Composite	05-Feb-18	Jan	52.5	53.0
	UK	Markit/CIPS UK Composite PMI	05-Feb-18	Jan	53.5	54.9
	EC	Sentix Investor Confidence	05-Feb-18	Feb	31.9	32.9
	EC	Retail Sales y/y	05-Feb-18	Dec	1.9%	3.9%
	US	ISM Non-Manf. Composite	05-Feb-18	Jan	59.9	56.0
TUE	AU	RBA Cash Rate Target	06-Feb-18	6-Feb	1.5%	1.5%
	GE	Factory Orders WDA y/y	06-Feb-18	Dec	7.2%	9.1%
	US	Trade Balance	06-Feb-18	Dec	-$53.1b	-$50.5b
WED	IN	RBI Repurchase Rate	07-Feb-18	7-Feb	6.0%	6.0%
	BZ	Selic Rate	07-Feb-18	7-Feb	6.75%	7.0%
THUR	UK	Bank of England Bank Rate	08-Feb-18	8-Feb	0.5%	0.5%
	CH	Exports y/y	08-Feb-18	Jan	11.1%	10.9%
FRI/SAT	MX	Overnight Rate	09-Feb-18	8-Feb	7.50%	7.25%
	CH	CPI y/y	09-Feb-18	Jan	1.5%	1.8%
	RU	Key Rate	09-Feb-18	9-Feb	-	7.8%

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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