Standard Chartered Private Bank

weekly market view

macro strategy | 13 July 2018

This reflects the views of the Wealth Management Group

Editorial

Earnings signal vs. trade tension noise

- **Trade tensions have escalated, but we expect strong corporate earnings to lift equities in the coming year.**
- **Equities:** US Q2 earnings are expected to outperform Euro area earnings significantly, underlining our preference for US equities. China profit estimates have also risen, despite trade tensions.
- **Bonds:** Investment Grade (IG) Asia USD bonds continued to outperform their High Yield (HY) peers, underscoring our preference for the former (see page 3).
- **FX:** USD/JPY broke above a key resistance that capped rallies since 2015, raising the prospect of further upside. EUR/USD momentum appears weak; the pair could test 1.15 support.

What's new?

- **Earnings signal vs. trade tension noise.** The ongoing tussle between strong economic and corporate fundamentals and trade tensions appeared to tilt towards the latter, with the US listing another USD 200bn of imports from China for potentially higher tariffs. The apparent escalation in trade disputes stalled a nascent recovery in equities and other risk assets. However, we note the trade uncertainty has failed to dent corporate earnings estimates: consensus estimates for US Q2 earnings growth have risen to 21%, from 20% at the start of April; Euro area earnings growth estimates have remained resilient since April; China's 12-month forward earnings growth estimates have risen to 17%, from 16% at the start of June. We believe a strong delivery against these expectations and robust forward guidance are likely to drive equities higher over the next 12 months.
- **USD/JPY breaks higher.** We believe the break through 111.50 resistance that has capped rallies since 2015 is significant. The USD got a boost from continued strength in US job market and rising US consumer and producer price inflation (the latter rose to six-year high), raising prospects for two more Fed rate hikes this year. Fed Chair Jerome Powell said the recent tax cuts and government spending plans could boost the economy for at least three years. USD/JPY is likely to test 113.25, followed by 2017 high of 114.70. The pair has strong support around 110.
- **Commodities slump on trade risks.** Brent crude oil is testing its 100-DMA technical support around USD 73/bbl following a sharp drop, amid worries trade tensions could slow global growth. We believe the continued decline in US crude oil inventory (which fell to its lowest since 2015), the sustained rise in global demand and outages at key OPEC suppliers are likely to contain downside risk. Copper, another global growth indicator, extended its slump and has now lost 15% from June's four-year high. We do not expect commodities to fall significantly, unless tensions escalate into a full-scale trade war (which is not our base case).

What we are watching

- **US-China trade talks.** There are signs that US and China may be willing to resume trade talks. Any easing of tensions is likely to cap USD/CNH upside below early-July's 11-month high of 6.7330, especially given the pair is extremely overbought.

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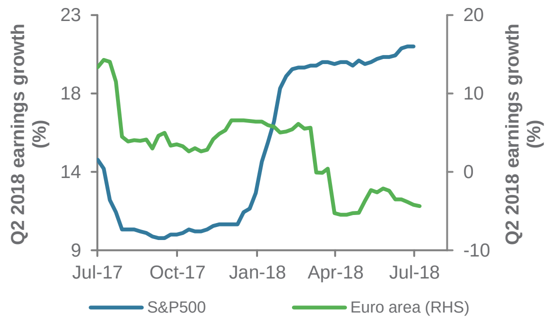
US Q2 earnings estimates have risen, while Euro area earnings estimates have remained resilient in recent months, despite the trade tensions

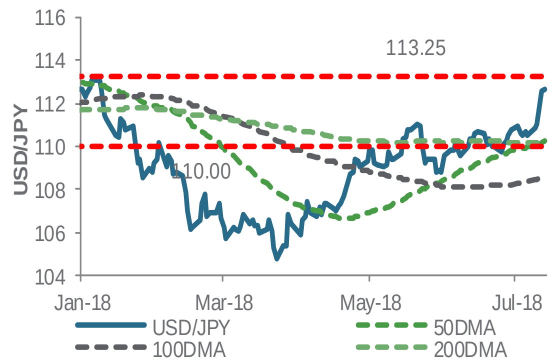
US and Euro area Q2 consensus earnings estimates



Source: ThomsonReuters, FactSet, Standard Chartered

USD/JPY's break of 111.50 resistance opens door for further uptrend

USD/JPY and 50-, 100- and 200-day moving averages



Source: Bloomberg, Standard Chartered

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What does this mean for investors?

Global stocks extended gains, led by the US. Emerging Market bonds led a recovery in debt markets. Crude oil declined sharply, leading a broad-based decline in commodities.

Equities: Strong Q2 earnings expected

- **Rising US earnings estimates.** US Q2 earnings season is under way. Consensus expects earnings growth of 21% - up modestly from the 20% estimate at the start of April, but significantly higher than the c. 11% estimated at the start of the year. Energy and materials sectors are forecast to post the highest earnings growth, followed by technology and financial sectors. Technology, financials and energy are our preferred sectors.
- **Euro area earnings impacted by previous EUR strength.** Euro area earnings season will start slightly later than in the US. Consensus expectations for Stoxx600 index, which is heavily weighed by Euro area equities, are for 9% earnings growth in the Q2 period. The effect of EUR/USD strength in 2017 is clearly having an effect, with the export-dependent industrials sector expected to report only 4% earnings growth in Q2. Looking ahead, industrials sector earnings are forecast to rise 9% in H2, reflecting the more recent weakness in EUR/USD. The industrial sector is a preferred area in the Euro area.
- **China earnings estimates unhurt by trade tensions.** A rebound in China and HK equities stalled after the US announced plans for fresh tariffs. However, we note that China's earnings estimates remain resilient despite the trade rift, with consensus growth forecasts of 17% for the next 12 months, up from 16% at the start of June. Given the robust earnings outlook, we believe the MSCI China index is trading at an attractive P/E of 12.6x on 2018 earnings. China remains our preferred market in Asia.

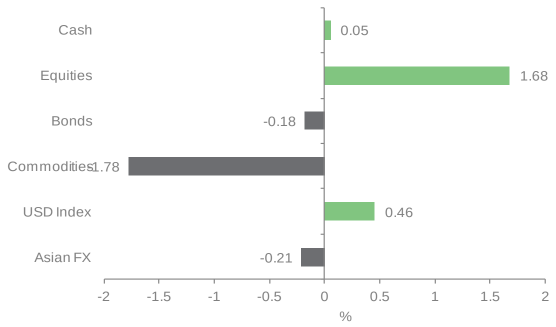
Bonds: EM, Asian USD bonds rebound

- **Stick to quality with Asian USD bonds.** Sentiment towards EM bonds improved over the past week, before the latest US tariff plan. EM USD government bonds rose as yield premiums declined sharply across most regions. Asian USD bonds gained as well, although High Yield (HY) bonds underperformed Investment Grade (IG) peers due to the weak sentiment towards Chinese property developers. Despite the recent concerns, we remain comfortable holding Asian USD bonds, with a preference for IG-rated bonds, given reduced supply and stable credit quality.
- **US Treasuries boxed by trade concerns, strong data.** US Treasuries traded in a tight range as trade tensions prevent yields from rising, despite strong economic data. Yields were also capped by comments from certain Fed members citing concerns about the continued decline in the yield premium on long-term bonds over short-term debt, although Fed Chair Powell remained upbeat on the economic outlook on the back of Trump tax cuts.

FX: EUR likely poised for next leg down

- **EUR fails to break higher.** EUR/USD peaked around 1.1790, before falling below 1.17. With trade risk hanging over exporters, further USD strength could see the EUR resuming its downtrend, targeting the double-bottom at 1.15 initially, with further support at 1.1450. Extension of the downtrend could take it towards 1.12.
- **AUD rebound thwarted by renewed trade concerns.** AUD/USD gave up most of its early-July gains as US-China trade tensions returned to market focus, given Australia's vulnerability to global trade uncertainty and the potential economic slowdown of its key trading partner, China. The AUD's failure to recover 0.75 on the rebound implies the support at 0.7310 could soon be challenged, with the next support at the 2016 low of 0.7150.

Benchmark (USD) performance w/w*



**Week of 05 July 2018 to 12 July 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)

US equity market technical indicators have recovered

Technical levels of key market indicators as on 12 July

Index	Spot	1st support	1st resistance	Short-term trend
S&P500	2,798	2,744	2,839	↑
STOXX 50	3,445	3,397	3,493	↗
FTSE 100	7,651	7,578	7,715	↗
Nikkei 225	22,378	21,450	22,500	↘
Shanghai Comp	2,838	2,630	2,980	↘
Hang Seng	28,481	27,300	29,100	↘
MSCI Asia ex-Japan	668	637	690	↓
MSCI EM	1,070	1,022	1,097	↓
Brent crude oil (ICE)	74	72	76	↑
Gold	1,247	1,235	1,285	↗
UST 10Y Yield	2.85	2.71	3.00	↗

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

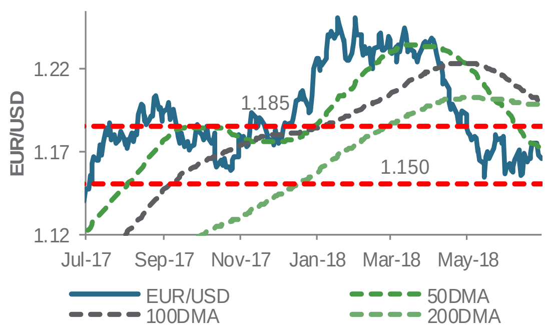
Yield premiums on EM USD and Asian USD bonds over US Treasuries have risen significantly in recent months, increasing their attractiveness

Yield premium (spread) on EM USD and Asia USD bonds

Source: Bloomberg, Standard Chartered

EUR's failure to break higher raises the risk of renewed downtrend, especially if trade tensions rise

EUR/USD



Source: Bloomberg, Standard Chartered

Top client questions

Q1. What is your outlook for Asia High Yield (HY) bonds?

Asia HY bonds (China, in particular) have continued to underperform the broader Asia credit complex as yield premiums (spreads) continue to widen. This can be attributed to (1) increased market volatility, given escalating US-China trade concerns, (2) regulatory limitations in China on offshore bond issuance quotas, (3) policy tightening in China's property market, (4) spillover concerns due to rising onshore defaults, as well as (5) growing doubts over debt repayment and refinancing abilities of China's local government financing vehicles (LGFVs). The following highlights two specific areas of risk to HY bonds:

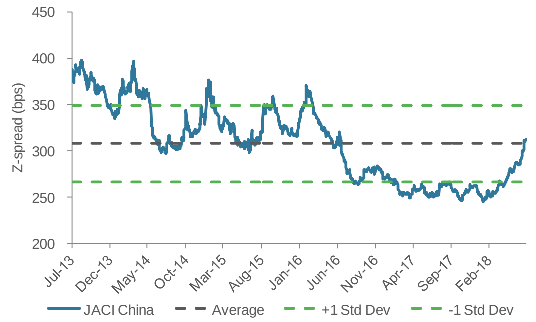
China Property bonds: Chinese regulators have reiterated their intentions of lowering credit risk for most corporates. Policy tightening has been predominantly aimed at controlling financial risks and curbing market speculation, with particular focus on the property sector, which has a large USD loan exposure and could be disproportionately hurt by the CNY's weakness. As a result, we would stick to larger, higher quality developers as the regulatory policies are likely to support them.

China local Government Financing Vehicles (LGFV): The tightening in funding channels has resulted in several onshore corporate bond defaults. While there has not been any default within the offshore LGFV bond space, there is a sizeable debt maturity wall ahead (see chart). Hence, concerns about refinancing risk have resurfaced, driving LGFV offshore bond prices down. Although contagion risk looks fairly contained at this stage, we believe a lack of financial transparency, risk of further tightening in policy and support from parent government bodies could hinder performance in this sub-sector.

The above indicates risks in the lower-rated segment of the market are rising. However, the significant rise in yield premiums offered by the broader China (and Asia) bond markets suggests investors are not differentiating between Asia Investment Grade bonds, which are likely to maintain a stable credit quality, and the deteriorating outlook for the HY bonds. Hence, we see value in the Investment Grade space within Asia, while avoiding the HY segment.

China bond yield premiums have risen significantly in recent months; we remain selective, preferring higher quality bonds

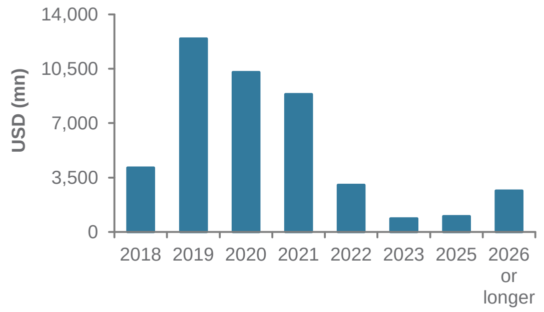
China bond yield spread



Source: Bloomberg, Standard Chartered

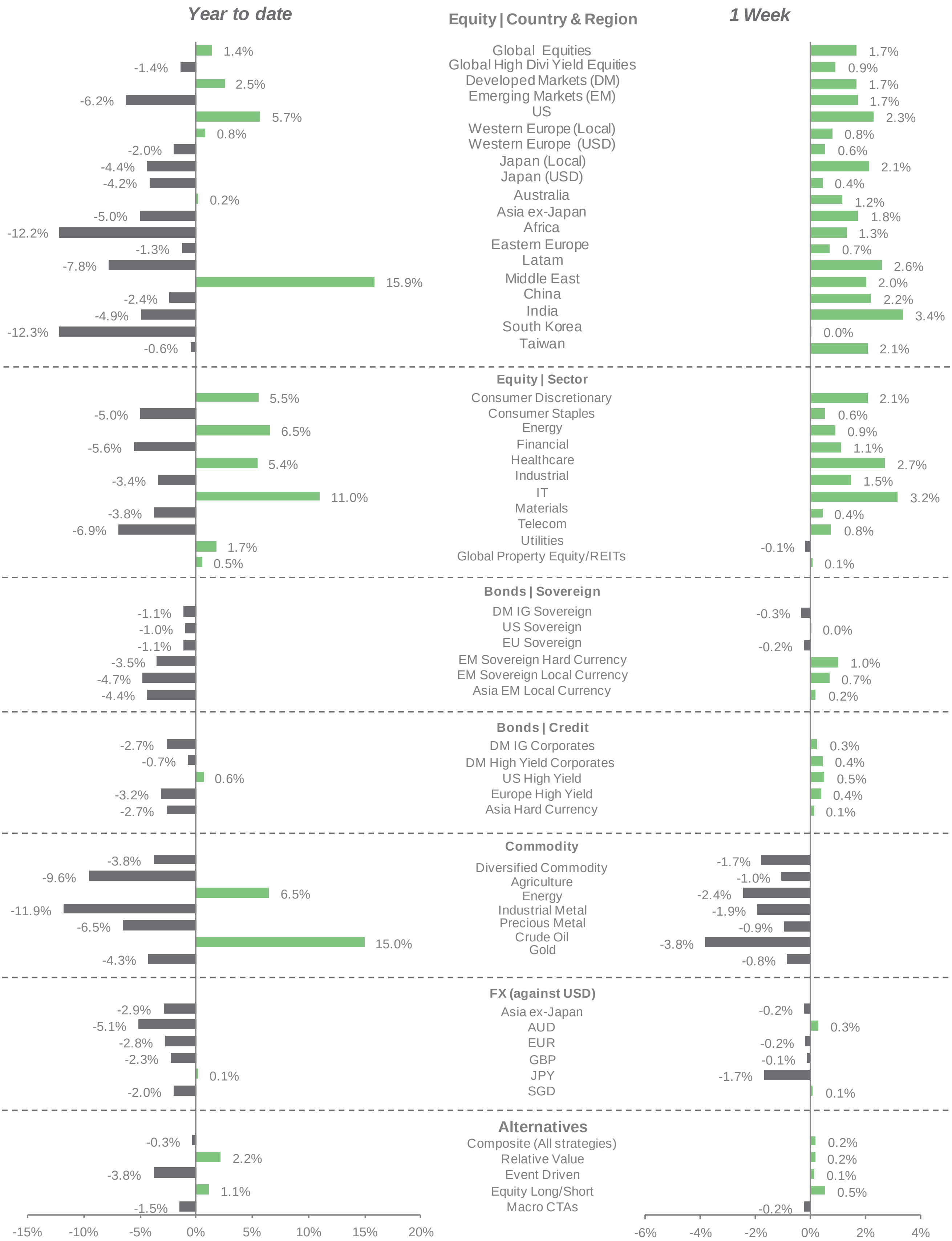
A sizeable debt maturity wall looms for China local government financing vehicles

Debt maturity profile, USD bn (As of 9 July 2018)



Source: Bloomberg, Standard Chartered

Market performance summary*



*Performance in USD terms unless otherwise stated, YTD period from 31 December 2017 to 12 July 2018, 1 week period: 05 July 2018 to 12 July 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	CH	GDP y/y	16-Jul-18	2Q	6.7%	6.8%
	CH	Retail Sales y/y	16-Jul-18	Jun	8.9%	8.5%
	CH	Industrial Production y/y	16-Jul-18	Jun	6.5%	6.8%
	CH	Fixed Assets Ex Rural YTD y/y	16-Jul-18	Jun	6.0%	6.1%
	US	Retail Sales Ex Auto and Gas	16-Jul-18	Jun	0.5%	0.8%
TUE	UK	Average Weekly Earnings 3M/y/y	17-Jul-18	May	–	2.5%
	US	Industrial Production MoM	17-Jul-18	Jun	0.6%	-0.1%
WED	UK	CPI Core y/y	18-Jul-18	Jun	–	2.1%
	EC	CPI Core y/y	18-Jul-18	Jun F	–	1.0%
	US	Housing Starts	18-Jul-18	Jun	1325k	1350k
	US	Building Permits	18-Jul-18	Jun	1323k	1301k
THUR	JN	Exports y/y	19-Jul-18	Jun	–	8.1%
	UK	Retail Sales Ex Auto Fuel y/y	19-Jul-18	Jun	–	4.4%
FRI/ SAT	JN	Natl CPI Ex Fresh Food, Energy y/y	20-Jul-18	Jun	–	0.3%
	EC	ECB Current Account SA	20-Jul-18	May	–	28.4b

	Event	This Week	Date	Period	Actual	Prior
MON	JN	BoP Current Account Adjusted	09-Jul-18	May	¥1850.0b	¥1885.5b
	GE	Exports SA m/m	09-Jul-18	May	1.8%	-0.3%
	EC	Sentix Investor Confidence	09-Jul-18	Jul	12.1	9.3
	CH	Foreign Reserves	09-Jul-18	Jun	$3112.13b	$3110.62b
TUE	CH	CPI y/y	10-Jul-18	Jun	1.9%	1.8%
	UK	Industrial Production y/y	10-Jul-18	May	0.8%	1.6%
	EC	ZEW Survey Expectations	10-Jul-18	Jul	-18.7	-12.6
WED	JN	Core Machine Orders y/y	11-Jul-18	May	16.5%	9.6%
	US	PPI Final Demand y/y	11-Jul-18	Jun	3.4%	3.1%
	CA	Bank of Canada Rate Decision	11-Jul-18	11-Jul	1.50%	1.25%
THUR	IN	CPI y/y	12-Jul-18	Jun	5.0%	4.9%
	US	CPI Ex Food and Energy y/y	12-Jul-18	Jun	2.3%	2.2%
	SK	BoK 7-Day Repo Rate	12-Jul-18	12-Jul	1.5%	1.5%
	IN	Industrial Production y/y	12-Jul-18	May	3.2%	4.8%
FRI/ SAT	US	U. of Mich. Sentiment	13-Jul-18	Jul P	–	98.2
	CH	Exports y/y	13-Jul-18	Jun	11.3%	12.2%

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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