weekly **market view**

macro strategy | 19 May 2017

This reflects the views of the Wealth Management Group

Editorial

The return of volatility

- **The return of volatility due to rising US political risks could open up opportunities. Fundamentals such as earnings and data are strong, especially in the Euro area and Asia.**
- **Equities:** Asia ex-Japan equities have been stable amid the volatility, underscoring our strong preference for the market. The S&P500 faces a technical support 2% below current levels.
- **Bonds:** We expect Treasury yields to return to the 2.30-2.65% range once political risks abate. This means we would await better entry points for rate-sensitive USD bonds.
- **FX:** We take profit on our short-term EUR/USD view after it hit our 1.115 target. However, we still expect the pair to strengthen in the medium-term.

What's new?

- **Rise in US political risk shatters calm.** Equity volatility surged from near-record lows as US stocks suffered their biggest one-day decline since September. There is concern that political uncertainty after the firing of the FBI Director may delay, if not derail, Trump's pro-growth reform agenda, including tax cuts, deregulation and infrastructure spending. While a pullback is not surprising after the record-breaking rally in the past six months, we would use any wider drawdown to add exposure to our preferred equity markets – Euro area and Asia ex-Japan – where fundamentals and valuations remain attractive, in our view.
- **Fed rate hike expectations lowered.** US 10-year Treasury yields fell close to the bottom of their six-month range and the USD index fell to a six-month low as money markets pared back expectations of Fed rate hikes for the rest of the year. We still expect the Fed to raise rates twice more this year, especially with growth recovering in Q2 and a tightening labour market likely boosting wages and inflation. This week's industrial output data showed a continued and strong recovery.
- **Strong Euro area, Asia ex-Japan data.** Euro area growth expectations (ZEW survey) rose to its strongest since 2015, mirroring region-wide improvement. In Asia, though China's fixed investment and industrial output growth slowed, retail sales stayed robust. The government unveiled an approximately USD 500bn investment programme under its One-Belt-One-Road initiative, which is positive for Asia's medium-term growth.

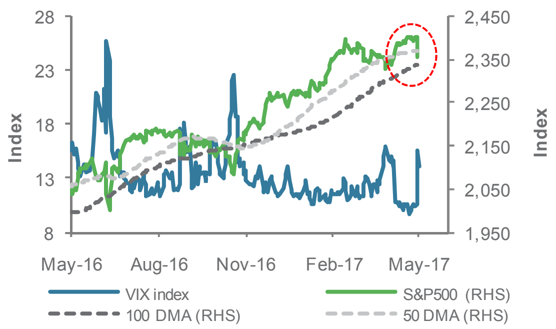
Implications

- **Opportunity to rebalance.** While there is a risk of near-term downside, investors overweight on US equities have a chance to lock in six months of gains and rebalance towards Euro area and Asia ex-Japan equities. Renewed political uncertainty in Brazil underlines our preference for Asia within EM equities.
- **Technical levels key.** The S&P500 fell below its 50DMA and is 2% above its technical support level. A further breach could extend losses. Indices in Europe and Asia remained above their 50DMAs, indicating resilience amid increased US volatility.
- **What we are watching?** US political developments; US home sales and durable goods orders; Euro area PMI; Japan inflation.

Contents

S&P500 fell below its 50DMA as volatility spiked from close to record low levels

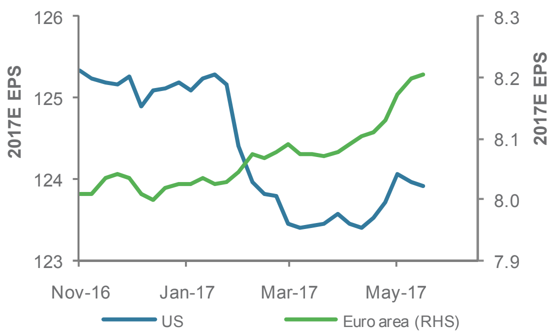
S&P500 index, with 50- and 100DMAs; S&P500 volatility index



Source: CBOE, Bloomberg, Standard Chartered

US and Euro area earnings expectations revised higher in the past month after strong Q1 earnings

2017 earnings estimates for MSCI US and MSCI EMU



Source: Bloomberg, Standard Chartered

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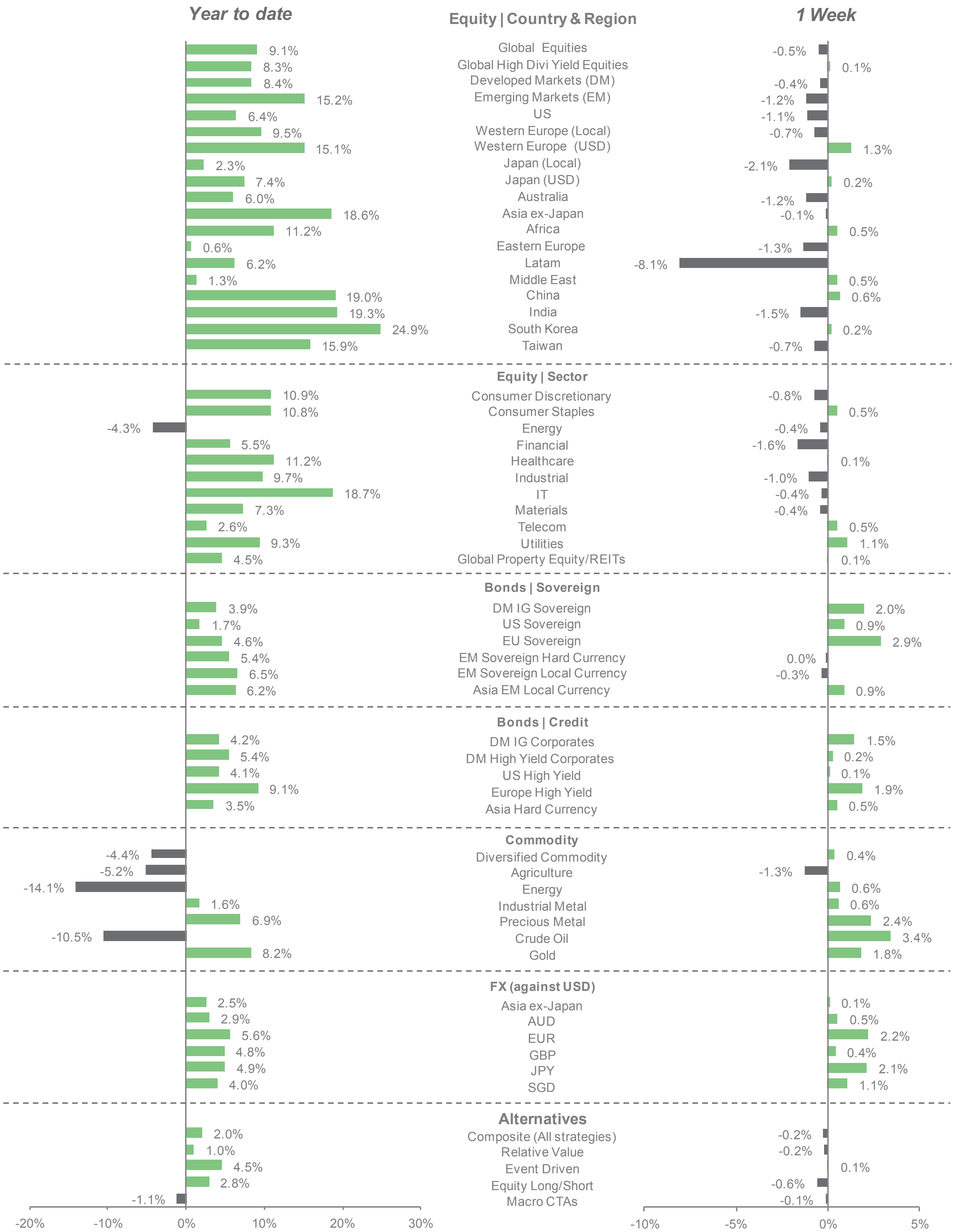
Market performance summary*



**Performance in USD terms unless otherwise stated, YTD period from 31 December 2016 to 18 May 2017, 1 week period: 11 May 2017 to 18 May 2017*

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

What does this mean for investors?

US stocks led global equities lower amid a rise in political risk. In Emerging Markets, Asia ex-Japan equities were stable while Brazilian equities plunged amid renewed political uncertainty. Safe-havens such as government bonds, gold and JPY gained.

Equities: Improving earnings outlook

- **Earnings revised higher.** US and Euro area 2017 earnings growth estimates have been revised up by 0.4% to 11% and 20%, respectively, since 1 April on upbeat Q1 earnings and strong corporate guidance. We do not believe Q1 earnings growth was solely due to higher commodity prices and favourable base effects. Rising business spending and improving business sentiment point to continued strong demand, providing room for earnings to deliver positive surprises.
- **China's One-Belt-One-Road plan positive for infrastructure.** President Xi Jinping unveiled a multinational investment programme that could total up to USD 500bn over the next five years. The plan is likely to drive valuation multiples higher for the engineering and construction sector in the short term as the proposed investment could boost revenue for the sector.
- **Strong Korean earnings.** Q1 earnings exceeded expectations by almost 8%. This further supports our bullish view on Korean equities amid expectations of fiscal stimulus and measures to improve corporate governance by the new government.

Bonds: Treasury yields downside limited

- **US political risk drags yields lower.** US 10-year Treasury yields fell towards 2.2%, while German and Japanese yields remained resilient. We expect US 10-year yields to recover towards 2.30-2.65% as very long investor positioning normalises and markets refocus on the prospect for higher Fed rates.
- **Waiting for better entry levels for EM bonds.** Emerging Market (EM) bonds have performed well in recent weeks. However, given our expectations of a likely rebound in US Treasury yields and their elevated interest rate sensitivity, we would wait for better entry points for USD-denominated bonds. Similarly, we believe a likely short-term rebound in the USD may present better entry opportunities in local currency bonds.

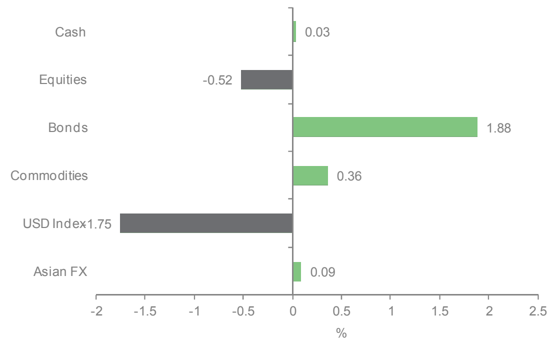
FX: Further USD downside likely limited

- **USD falls to a six-month low.** The USD extended its losses, especially against the JPY and EUR, as US Treasury yields fell amid concerns the Fed may delay its hikes on rising political risks. We do not believe the Fed will alter its rate hikes trajectory, given the expected pick up in US growth in Q2.
- **Locking in EUR/USD gains.** The EUR extended its gains amid continued optimism following pro-business Macron's win in the French elections and a broadly weak USD. Although we took profits on our short-term EUR/USD trade idea (see *FX Trade Note, 18 May*), we continue to expect gains in the medium term.
- **Remain short AUD/USD.** Asian currencies have remained resilient against the USD. Nonetheless, likely softening of China data over the next few months, an expected Fed rate hike in June and a seasonally strong month for the USD in May is likely to result in some downside in the near term. Technically, we remain bearish AUD/USD as long as it remains below 0.755.

Commodities: Significant upside in gold unlikely

- **Fed rate hike expectations likely to limit gold gains.** Although gold rose amid US political risk, renewed expectations of Fed rate hikes amid solid US data is likely to limit further significant upside.

Benchmark (USD) performance w/w*



**Week of 11 May 2017 to 18 May 2017*

Source: MSCI, JP Morgan, Citigroup, Bloomberg, Standard Chartered (Indices used are JP Morgan Cash, MSCI AC World TR, Citi Non-MBS WorldBig Govt/Govt Sponsored, Bloomberg Commodity, DXY and ADXY)

S&P500 is 0.7% away from its technical support

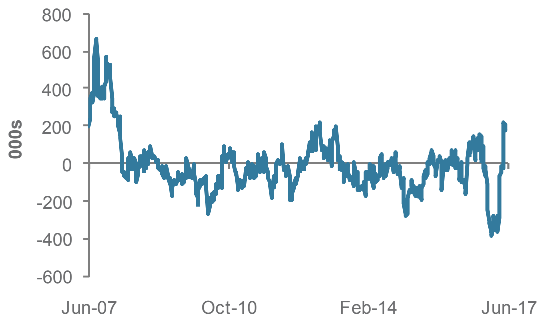
Technical levels of key market indicators as of 18 May

Index	Spot	2nd support	1st resistance	Short-term trend
S&P500	2,366	2,320	2,405	↑
STOXX 50	3,562	3,390	3,674	↗
FTSE 100	7,436	7,195	7,535	↗
Nikkei 225	19,551	18,600	20,400	↗
Shanghai Comp	3,090	2,920	3,135	↘
Hang Seng	25,137	24,350	25,500	↗
MSCI Asia ex-Japan	607	575	625	↗
MSCI EM	988	920	1,015	↘
Brent crude oil (ICE)	53	44	54	↗
Gold	1,251	1,194	1,278	↗
UST 10Y Yield	2.23	2.0	2.53	↘

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

Bullish investor positioning on US 10-year Treasury yields have risen to their highest since 2008

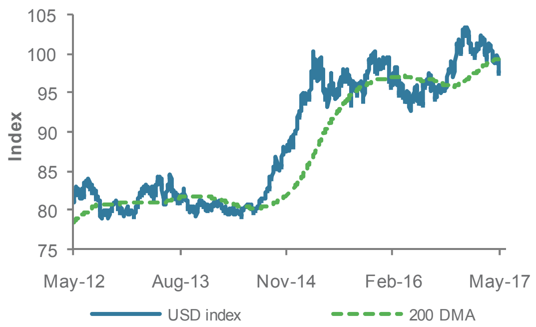
Net non-commercial positions on US 10-year Treasuries



Source: CFTC, Bloomberg, Standard Chartered

The USD index fell below its 200DMA to a six-month low, giving up all its gains since Trump's election

USD index and 200DMA



Source: Bloomberg, Standard Chartered

Top client questions

Q. What are the potential implications of the recent political developments in the US for global equities?

One of our core views for 2017 is that equities will outperform bonds. So far, this has worked very well, with global equities up 9.1% and global bonds up 4.0% year-to-date. However, recent developments in the US have significantly raised the risk of impeachment proceedings against the president. According to PredictIt, the risk of Trump being impeached this year has risen from 7%, on the day before Comey was fired as FBI Director, to 24% after a special counsel was appointed to investigate potential inappropriate Trump campaign officials' dealings with Russia. This is causing many to question the longevity of the equity market's outperformance.

Indeed, the knee-jerk reaction to this increase in political uncertainty has been for equity markets to sell-off, the USD to weaken and safe-haven assets, such as the JPY, government bonds and gold, to rally. However, we believe the historical precedent suggests the economic cycle will ultimately dominate, pushing equity markets higher.

There are only two examples of impeachment proceedings being concluded in the 20th century.

1) In the early 1970s, President Richard Nixon was engulfed in the Watergate scandal. The chart on the right shows performance of the equity market during the process, which ultimately led to Nixon's resignation. Stocks fell almost 50% during the period.

   However, as always, there were other factors at play. The economic cycle peaked in early 1973 and the US fell into recession in November 1973 in response to the first oil shock. Historically, the equity market peak is normally 6-9 months prior a recession. However, in 1973, it was 10 months prior. Therefore, the stock market decline was probably more influenced by the economic, rather than political, environment. This reading is supported in our next example.

2) In the late 1990s, when President Bill Clinton underwent impeachment proceedings, but ultimately served out his term, equities continued to rally against the backdrop of strong growth and low inflation – a perfect scenario for equities (see chart). The technology boom added another dimension that ultimately pushed equity market valuations to historical extremes.

   In 1998, there was an almost 20% pullback in the S&P500, but this was more due to concerns about a financial crisis following the collapse of Long Term Capital Management (LTCM), a large hedge fund. Therefore, the bull market in equities continued throughout the impeachment process.

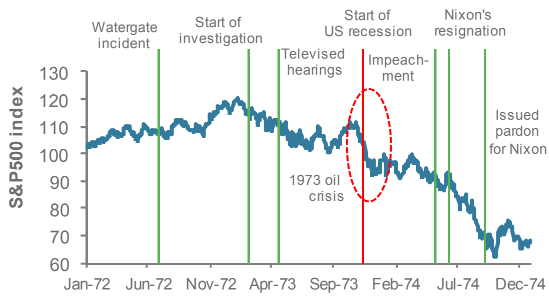
This suggests that the macro outlook is likely to ultimately dominate when we examine the 6-18 month equity market outlook.

It is, of course, possible that the economy could go into recession. Indeed, we have been arguing for some time that the US is in the late stage of the economic cycle. Against this backdrop, our biggest fear is a massive fiscal stimulus as this would, in our opinion, lead to an even tighter labour market and higher inflationary pressures, which would force the Fed to accelerate its policy tightening.

If anything, continued political challenges for the US president would likely reduce his ability to push through any major policy initiatives, such as infrastructure spending. Therefore, it is possible that any continued political uncertainty may actually prolong the economic recovery and equity bull market.

S&P500 fell almost 50% through President Nixon's impeachment proceedings, but this was likely due to the recession caused by the global oil price shock

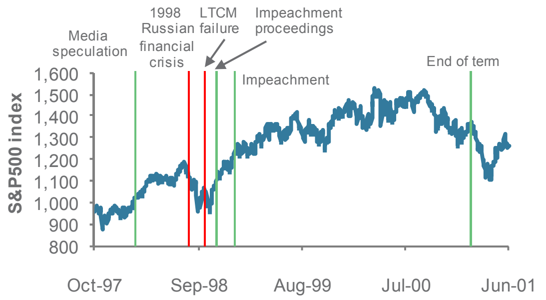
S&P500 index during Nixon's impeachment; red line: economic event, green lines: impeachment events



Source: Bloomberg, Standard Chartered

S&P500 continued to rise through President Clinton's impeachment proceedings amid strong growth, low inflation and a technology boom

S&P500 index through Clinton's impeachment; red lines: economic events, green lines: impeachment events



Source: Bloomberg, Standard Chartered

Economic & Market Calendar

	Event	Next Week	Date	Period	Expected	Prior
MON	JN	Exports y/y	22-05-2017	Apr	6.6%	12.0%
		Fed's Harker speaks in Philadelphia	22-05-2017			
TUE	GE	IFO Expectations	23-05-2017	May	–	105.2
	US	New Home Sales	23-05-2017	Apr	620k	621k
		Fed's Evans and Kashkari speaks in different events	23-05-2017			
WED	JN	Nikkei Japan PMI Mfg	24-05-2017	May P	–	52.7
	GE	Markit/BME Germany Composite PMI	24-05-2017	May P	–	56.7
	EC	Markit Eurozone Manufacturing PMI	24-05-2017	May P	–	56.7
	EC	Markit Eurozone Services PMI	24-05-2017	May P	–	56.4
	EC	Markit Eurozone Composite PMI	24-05-2017	May P	–	56.8
	US	Existing Home Sales	24-05-2017	Apr	5.67m	5.71m
		Fed's Kashkari and Harker and ECB's Praet and Draghi speaks at different events	24-05-2017			
THUR	UK	GDP y/y	25-05-2017	1Q P	–	2.1%
	SK	BoK 7-Day Repo Rate	25-05-2017	25-May	1.3%	1.3%
		Fed's Kaplan speaks in Toronto	25-05-2017			
FRI/SAT	JN	Natl CPI Ex Fresh Food, Energy y/y	26-05-2017	Apr	-0.1%	-0.1%
	US	Durable Goods Orders	26-05-2017	Apr P	-1.5%	0.9%
		Fed's Bullard and ECB's Constancio speaks at different events	26-05-2017			

	Event	This Week	Date	Period	Actual	Prior
MON	CH	Retail Sales y/y	15-05-2017	Apr	10.7%	10.9%
	CH	Fixed Assets Ex Rural YTD y/y	15-05-2017	Apr	8.9%	9.2%
	CH	Industrial Production y/y	15-05-2017	Apr	6.5%	7.6%
TUE	UK	CPI Core y/y	16-05-2017	Apr	2.4%	1.8%
	EC	ZEW Survey Expectations	16-05-2017	May	35.1	26.3
	US	Housing Starts	16-05-2017	Apr	1172k	1203k
WED	JN	Machine Orders y/y	17-05-2017	Mar	-0.7%	5.6%
	UK	Average Weekly Earnings 3M/y/y	17-05-2017	Mar	2.4%	2.3%
	UK	ILO Unemployment Rate 3Mths	17-05-2017	Mar	4.6%	4.7%
	UK	Employment Change 3M/3M	17-05-2017	Mar	122k	43k
THUR	JN	GDP Annualized SA q/q	18-05-2017	1Q P	2.2%	1.4%
	UK	Retail Sales Ex Auto Fuel y/y	18-05-2017	Apr	4.5%	2.8%
	US	Philadelphia Fed Business Outlook	18-05-2017	May	38.8	22
FRI/SAT	EC	Consumer Confidence	19-05-2017	May A	–	-3.6
		Fed's Mester and ECB's Praet and Constancio speaks at different events	19-05-2017			

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

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

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