Global Market Outlook

June 2016

Tightening tantrum?

- Tepid market performance in May could be a precursor to an uneasy summer. We are concerned that an earlier-than-expected Fed rate hike could sustain a USD rebound and reignite CNY weakness. Against this backdrop, and given uncertainty over how long the US expansion will continue, we prefer to err on the side of caution.
- Our A.D.A.P.T. framework favours a combination of multi-asset income (MAI) and global macro absolute return strategies; we see this as an attractive way to maintain long-term balanced exposure to equity and bond markets while mitigating summer drawdown risks.
- We have a rising preference for bonds. US Investment Grade (IG) corporate bonds are most attractive, in our view, but Emerging Market (EM) USD government, US High Yield (HY) and Asia USD bonds are not far behind. Within equities, we prefer the Euro area.

Global Investment Council Perspectives

1

What are the recent trends in the Global Investment Council's outlook?

The trend over the past six months has been for the GIC to become more cautious in its investment preferences. Where we are in the US economic and inflation cycle is key. The central scenario is we are in the late-cycle phase, with inflation likely to accelerate. We attach around a 30% probability to a US recession by mid-2017.

Where does this leave us? Multi-asset income (MAI) remains our favoured theme as we believe this has the potential to perform well over the longer term (see page 6 for other key themes). In terms of ranking, equities have fallen from being our preferred asset class to being fourth in the list, behind bonds, alternative strategies and cash; only commodities rank below equities.

2

What is the rationale for ranking cash above equities? Are you expecting a bear market for equities?

The central scenario is equities will still outperform cash over the coming 12 months. However, we believe the risks have increased. In the short term, markets may see significant weakness (see page 5 for potential catalysts). Meanwhile, we are less willing than a year ago to ride this out as we believe 1) the likely upside from current levels may be in the low single digits, 2) drawdowns may become more frequent and 3) we believe we are getting closer to the end of the cycle. As such, we prefer to err on the side of caution and re-evaluate later in the year.

We would not sell all of our equity holdings, as there are upside and downside risks (see page 5), rather we advocate a conservatively balanced allocation (see page 6).

3

How would you manage allocations in the coming months?

In December last year, we paid greater attention to drawdown risks. We believe this remains appropriate as we get closer to the end of the US economic cycle. This is one of the reasons we have been suggesting an increase in allocation to US Investment Grade (IG) bonds and multi-asset global macro strategies, the former despite the low yields on offer.

In addition, assuming risk assets are weak over the summer months, we would look for opportunities to add to MAI strategies and take advantage of rising option premia to generate an upfront yield in sideways markets.

4

Within Emerging Markets (EM), which asset classes do you prefer?

We prefer USD-denominated government bonds to local currency bonds or equity markets. However, recent data in China has been stabilising and political and policy developments in Brazil are also worth monitoring. Therefore, we may become more constructive on EM risk assets later this year.

5

Is the recent rally in both the USD and gold prices sustainable?

In the short term, we believe the USD will continue its recent rally, supported by rising US interest rate expectations. This, together with extreme speculative long gold positions, is likely to be a significant headwind for gold prices in the short term. In the longer term, rising US inflation expectations and negative bond yields in many markets are likely to be supportive of gold. We expect 1300 to cap gold near term.

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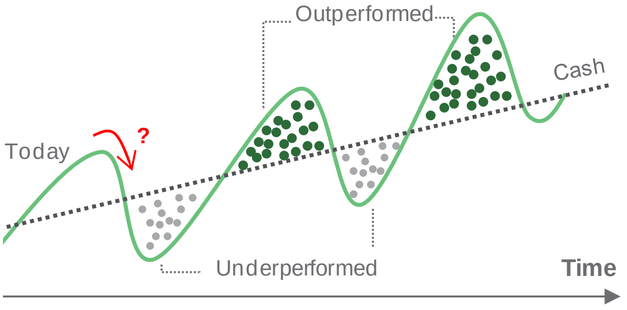
Global Investment Council Perspectives (cont'd)

Risk-return trade-off for equities becoming less attractive

Stylistic illustration of possible equity market scenarios



Source: Bloomberg, Standard Chartered

Fed already becoming more hawkish

Market expectations for end-2016 Fed funds rate

Source: Bloomberg, Standard Chartered

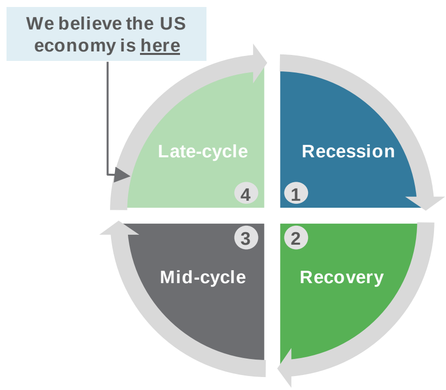
China already guiding the CNY weaker against the USD

CNY CFETS index and USD/CNY (inverted)

Source: Bloomberg, Standard Chartered

US getting closer to the end of its business cycle

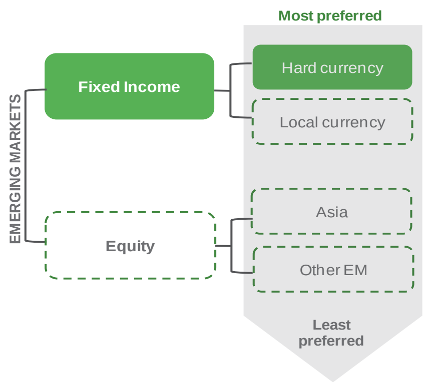
Stylised business cycle



Source: Bloomberg, Standard Chartered

EM USD bonds preferred over other EM asset classes

Our preferences within EM asset classes



Source: Bloomberg, Standard Chartered

Gold facing short-term headwinds

Speculative long positions already elevated

Source: Bloomberg, Standard Chartered

Market performance summary *

Equity	Year to date	1 month
Global Equities	1.6% ↑	-0.9% ↓
Global High Dividend Yield Equities	5.9% ↑	-0.3% ↓
Developed Markets (DM)	1.6% ↑	-0.4% ↓
Emerging Markets (EM)	1.7% ↑	-4.6% ↓
By country		
US	2.6% ↑	0.1% ↑
Western Europe (Local)	-1.5% ↓	0.7% ↑
Western Europe (USD)	0.2% ↑	0.0% ↑
Japan (Local)	-13.2% ↓	-4.3% ↓
Japan (USD)	-4.8% ↓	-3.0% ↓
Australia	2.4% ↑	-3.4% ↓
Asia ex- Japan	-1.9% ↓	-4.1% ↓
Africa	7.6% ↑	-6.2% ↓
Eastern Europe	13.7% ↑	-2.7% ↓
Latam	14.7% ↑	-6.4% ↓
Middle East	-0.8% ↓	-3.8% ↓
China	-8.2% ↓	-4.6% ↓
India	-1.2% ↓	-0.4% ↓
South Korea	-0.6% ↓	-5.8% ↓
Taiwan	1.8% ↑	-2.8% ↓
By sector		
Consumer Discretionary	-1.6% ↓	-1.6% ↓
Consumer Staples	6.1% ↑	1.1% ↑
Energy	14.3% ↑	-0.8% ↓
Financial	-1.0% ↓	-1.1% ↓
Healthcare	-2.9% ↓	-0.9% ↓
Industrial	4.2% ↑	-1.6% ↓
IT	0.5% ↑	0.7% ↑
Materials	9.3% ↑	-2.7% ↓
Telecom	7.0% ↑	-0.5% ↓
Utilities	7.2% ↑	0.6% ↑
Global Property Equity/REITS	4.5% ↑	-1.4% ↓

Bonds	Year to date	1 month
Sovereign		
Global IG Sovereign	6.9% ↑	0.5% ↑
Global HY Sovereign	6.8% ↑	1.2% ↑
EM IG Sovereign	6.4% ↑	0.0% ↑
US Sovereign	3.1% ↑	0.7% ↑
EU Sovereign	7.1% ↑	0.1% ↑
Asia EM Local Currency	6.5% ↑	-2.3% ↓
Credit		
Global IG Corporates	5.4% ↑	0.4% ↑
Global HY Corporates	7.5% ↑	0.7% ↑
US High Yield	7.9% ↑	1.2% ↑
Europe High Yield	6.2% ↑	-0.8% ↓
Asia High Yield Corporates	6.2% ↑	1.4% ↑

Commodity	Year to date	1 month
Diversified Commodity	8.8% ↑	1.8% ↑
Agriculture	12.3% ↑	4.5% ↑
Energy	5.1% ↑	5.3% ↑
Industrial Metal	1.2% ↑	-5.8% ↓
Precious Metal	15.8% ↑	-2.7% ↓
Crude Oil	23.2% ↑	8.8% ↑
Gold	14.9% ↑	-1.9% ↓

FX (against USD)	Year to date	1 month
Asia ex- Japan	0.2% ↑	-1.3% ↓
AUD	-0.8% ↓	-6.7% ↓
EUR	3.1% ↑	-0.9% ↓
GBP	-0.4% ↓	0.6% ↑
JPY	9.5% ↑	1.4% ↑
SGD	3.3% ↑	-1.6% ↓

Alternatives	Year to date	1 month
Composite (All strategies)	-1.2% ↓	0.2% ↑
Arbitrage	-2.1% ↓	0.0% ↑
Event Driven	1.4% ↑	2.0% ↑
Equity Long/Short	-2.9% ↓	-0.4% ↓
Macro CTAs	-1.2% ↓	-1.3% ↓

*All performance shown in USD terms, unless otherwise stated.

*YTD performance data from 31 December 2015 to 26 May 2016 and 1-month performance from 26 April to 26 May 2016

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

Investment strategy

- Equities and multi-asset global macro strategies weakened slightly last month, as did multi-asset income (MAI) strategies. Bonds were flat and the USD rebounded.
- We continue to expect seasonal weakness over the summer. This partly explains our rising preference for bonds and falling preference for commodities. However, history suggests this is far from certain. Therefore, maintaining a balanced approach remains key, in our opinion.
- MAI and multi-asset global macro strategies are our two most preferred asset classes. The latter provides some protection against the end of the cycle, while the former offers exposure to strategies that should keep outperforming in today's low-interest-rate environment.

The summer poses risks in both directions

We expect market weakness this summer. Nevertheless, history suggests this is far from certain; we re-emphasise the importance of a balanced allocation to manage risks.

It is very easy to be gloomy given the presence of upcoming risks – the Fed could end up hiking rates further, USD gains could trigger renewed CNY weakness and geopolitical risks (especially in Europe) could re-open uncomfortable questions. The new high set by the USD/CNY policy fix is worth watching closely. Over the past few months, we have also highlighted the rising risk that the US growth cycle could be closer to an end.

Today's investing environment a little bit different

Table – Key market factors: 2016 vs. previous years

	April 2014	April 2015	April 2016
Global GDP revisions	Flat (3.6%)	Down (3.5%)	Down (3%)
MSCI World earning trend	Up	Up	Down
MSCI World earnings revisions trend	Up	Up	Up
DM HY credit spreads	Down (2.4%)	Down (3.9%)	Down (5.7%)
USD index	Flat (80)	Down (95)	Down (94)
Oil prices	Flat ($100)	Up ($60)	Up ($45)
Fed rate expectations	Flat (0.175%)	Up (0.175%)	Flat (0.375%)
Investor sentiment (global equity flows)	Up ($50bn)	Down ($-1bn)	Down ($-59bn)
US financial condition	Loosening	Tightening	Flattening
Market risk (VIX)	Falling (14)	Rising (15)	Falling (15)
Risks	Europe bank stress tests Russian invasion of Crimea EM corporate debt	Bank capital raising China slowdown	USD-CNY rising Brexit and Spain Fed outlook
GIC 12-month view	Positive	Positive	Cautious

Data as of 25-May-2016
DM high-yield credit spreads refer to Barclays US corporate 10 Year
Source: Bloomberg, Standard Chartered

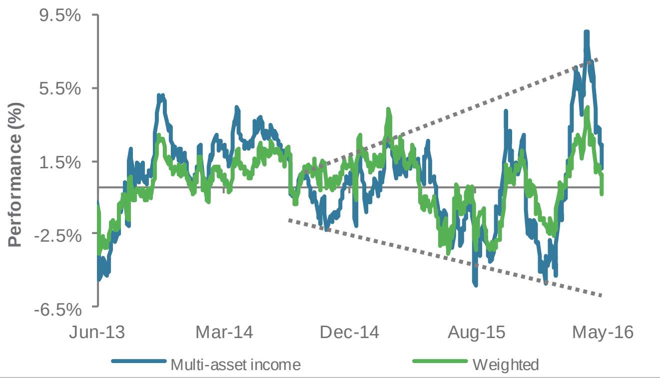
However, we cannot ignore the risk summer weakness is not forthcoming. In the table below, we compare key market factors relative to past years; while some are similar (earnings revisions, credit spreads and nature of risks), many factors do differ (especially earnings trend and our own view of risk).

Furthermore, *'on average'* does not mean the effect occurs in *all* years. Returns in global equities have been negative for only 10 out of 20 past years over the May-September period, with studies looking at longer time periods also showing a balanced outcome.

Stay invested, but insure

Two of our most preferred asset classes balance each other as volatility in both direction rises

50/50 allocation of MAI allocation* and HRFX global macro strategy index, % 3-month rolling return



Data as of 25 May 2016
Source: Standard Chartered * See Global Market Outlook, Looking to Rebalance

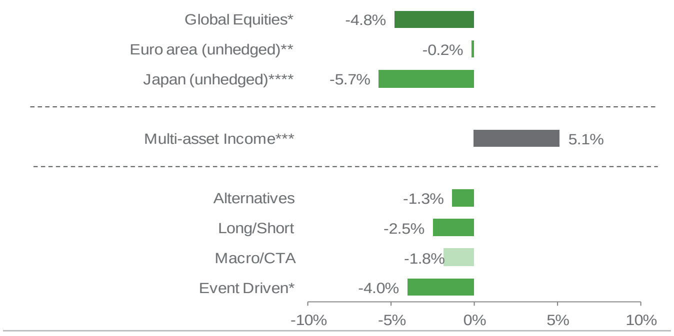
We continue to believe MAI strategies are a very attractive approach in this environment. A Fed rate hike and positioning are risks, but interest rates remain very low globally, fund manager cash holdings are high and policy could ease further in Europe and Japan. We see this as a strong environment for yield-oriented assets.

MAI strategies also offer well-balanced exposure to both bonds (which would help dampen downside risks) and equities (should a lack of summer weakness surprise us).

In the same breath, we also believe MAI strategies should be complemented with multi-asset global macro strategies. While returns here have been tepid recently, the historically insurance-like characteristic of returns (sharp bouts of strong performance during risk-off periods) is what attracts us. We believe this may be valuable over the summer should the 'sell-in-May' effect occur, helping offset a likely drawdown in MAI strategies. In the longer term, the strategy's significant outperformance ahead of previous US recessions means it is an increasingly valuable asset class as the US cycle matures.

Multi-income remains a strong performer

Performance of A.D.A.P.T. since Outlook 2016***



* Closed on 25 February 2016; **FX-hedge removed as of 25 February 2016

*** For the period 11 December 2015 to 25 May 2016. Income basket is as described in the Outlook 2016: A year to A.D.A.P.T. to a changing landscape, Figure 38 on page 60, and revised in the Global Market Outlook, 28 March 2016; **** Closed on 25 March 2016; Source: Bloomberg, Standard Chartered

Implications for investors

- **Global macro strategies – Add.** These have performed well during previous periods of market volatility and at the end of earlier US economic cycles. They could be a valuable source of returns if markets face 'sell-in-May' summer weakness (see page 23).
- **MAI – Add on weakness, but complement with global macro strategies** to manage short-term risks. MAI remains our most preferred strategy in a low-interest-rate world (see page 7).
- **Maintain balanced exposure, with a preference for Euro area equities and US Investment Grade (IG) bonds.** The risk of summer weakness and the likelihood we are late in the US economic cycle mean we have a rising preference for bonds (preferring US IG corporate bonds – see pages 12-14). However, the possibility of less pronounced summer weakness means maintaining equity exposure is important. We continue to like Euro area equities (see pages 15-20).

Our preferred areas within bonds	
Investment Grade corporate bonds in Developed Markets	Strongly preferred (US over Europe)
High Yield corporate bonds in Developed Markets	Core holding (US over Europe)
USD government bonds in Emerging Markets	Core holding
USD corporate bonds in Asia	Core holding
Investment Grade government bonds in Developed Markets	Not preferred
Local currency government bonds in Emerging Markets	Not preferred

Asset class	Sub-asset class	Relative outlook	Start date*
Cash		Neutral ↑	May 2016
Fixed Income	Developed Markets Investment Grade government bonds	Underweight	Jan 2011
	Developed Markets Investment Grade corporate bonds	Overweight	Dec 2015
	Developed Market High Yield corporate bonds	Neutral	April 2016
	Emerging Markets USD government bonds	Neutral	Dec 2015
	Emerging Markets local currency government bonds	Underweight	Dec 2015
	Asia USD corporate bonds	Neutral	Feb 2016
Equity	US	Neutral	Feb 2015
	Euro area	Overweight	Jul 2013
	UK	Neutral	April 2016
	Japan	Neutral	March 2016
	Asia ex-Japan	Neutral	Jul 2015
	Other EMs	Underweight	Aug 2012
Commodities		Underweight ↓	May 2016
Alternatives		Overweight	Jun 2013

*Start Date - Date at which this tactical stance was initiated
Source: Standard Chartered

Multi-asset income

In our annual Outlook publication, in anticipation of increased volatility over 2016, we updated the multi-income framework to look at drawdown potential, in addition to yield and capital appreciation potential. While dividend equity has performed well on a YTD basis (and yields in some areas remain attractive), the higher potential for a drawdown led us to recently shift our allocation towards fixed income. Yields in fixed income are not as attractive and rising interest rates pose a moderate risk. However, the lower potential drawdown presents a better risk-reward scenario for an income investor, in our opinion. Finally, non-core income remains a key contributor of income, as well as a risk diversifier within the portfolio.

Asset allocation (Multi-asset income)	Yield	Income potential	Capital growth	Drawdown potential	Comments
Equity income	4.8	🟡	🟡	🔴	**Key source of income and modest upside from capital growth**
North America	3.4	🟡	🟡	🟡	Fair to slightly rich valuations; subdued sales/profit growth mean below average returns; some sectors attractive
Europe ex-UK	5.4	🟢	🟢	🟡	Fair valuation; ECB and FX support; attractive yield; challenges from global growth; consensus trade; poor momentum
Asia ex-Japan	5.5	🟢	🟡	🔴	Good payouts; selectively attractive valuations, but drawdown a risk from challenges in global growth, earnings, Fed and leverage
Non-core income	4.9	🟡	🟡	🟡	**Useful diversifier for income and growth**
Preferred	5.3	🟢	🟡	🟡	Financials to benefit from potentially higher rates; high sensitivity to investor flows
Convertibles	4.1	🟡	🟡	🟡	Moderate economic expansion and a gradual pace of rate hikes should be good for converts. Risk: Policy mistake
Property	3.9	🟡	🟡	🔴	Yield diversifier; stable real estate market; at risk from higher rates and outflows. Asymmetric risk profile
Covered calls	5.3	🟢	🟡	🟡	Useful income enhancer assuming limited equity upside
Fixed income	4.9	🟡	🟡	🟡	**Portfolio anchor; source of yield, but not without risks**
Corporate - DM HY	6.9	🟢	🟡	🟡	Valuations have tightened recently; attractive yield; biggest obstacles fund flows, Fed, oil and falling US credit quality
EM HC sovereign debt	5.7	🟢	🟡	🟡	Need to be selective given diverse risk/reward in IG, HY bonds. US interest rate exposure +ve, commodity exposure -ve, valuations fair
EM local currency	3.8	🟡	🟡	🔴	Broad risk/reward unattractive. Local outlook stable; Main risk: FX
INR bonds	8.2	🟢	🟡	🔴	Structural story playing out; carry play; credible central bank, reforms; foreign demand a recent risk. FX stability needed
Investment Grade		🔴	🔴	🟢	Portfolio anchor, safe yield; some interesting areas
Corporate - DM IG	2.4	🟡	🟡	🟢	Yield premiums have narrowed but prices fair, not expensive; long-term US bonds look appealing if Fed hiking cycle muted
Corporate - Asia IG	3.6	🟡	🟡	🟢	Cautiously positive. Fairly valued, stable quality, but China issuers face economic growth headwinds
TIPS	0.8	🔴	🔴	🟢	Undervalued and a good alternative to nominal sovereign bonds; impact of rate rise similar to G3 sovereign; exposure to a jump in US inflation
Sovereign	1.3	🔴	🔴	🟢	Momentum, QE offer strong anchors for EU, but little value; long US Treasury; AU, NZ well supported. US Treasury offers yield premium over Europe, Japan

Source: Standard Chartered

Economic and policy outlook

- The renewed possibility of a US rate hike in the coming months led the macroeconomic discussion at our monthly Global Investment Council (GIC) meeting. We see increased chances of a rate hike in Q3 amid hawkish remarks from several Fed policymakers. However, we continue to believe the Fed may struggle to follow up with another hike this year.
- We remain constructive about the Euro area growth outlook. US growth is likely to recover in Q2 after a slump in Q1. We assign a low probability to 'Brexit', which should also help the Euro area recovery. We are also more confident about China's ability to avoid a hard landing.
- However, disinflationary pressures remain a key challenge for major economies, particularly Japan and the Euro area, which should keep monetary policies supportive worldwide. Emerging Markets should get some support with the bottoming of commodity prices, but risks remain.

A gradual rise in inflation and wages has raised the chance of a Fed rate hike by Q3.

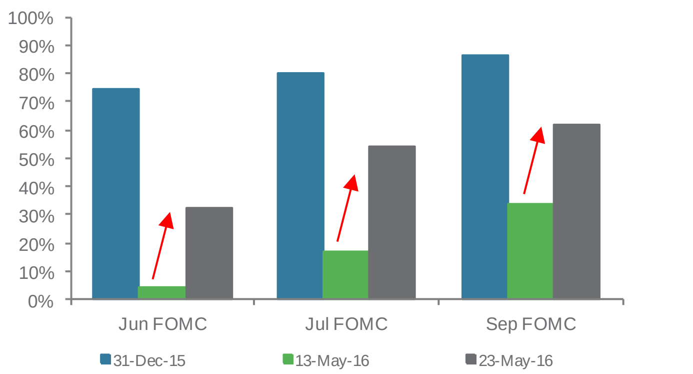
Fed rate hike expectations return to centre stage. Relatively upbeat minutes from the Fed's April meeting and hawkish remarks from several Fed policymakers have revived talks of a rate hike in the coming months. We believe the gradual rise in headline inflation and wage pressures warrant one rate hike this year, possibly in Q3. However, the Fed may struggle to push through a second hike in 2016, given the global disinflationary headwinds (see below).

Constructive on the Euro area and China. Euro area growth continues to hold up against slowing global demand and the rebound in the EUR this year. We believe ECB policies are helping boost credit to households, powering a domestic-demand-driven recovery. Signs of stabilisation in China's growth indicators following months of policy stimulus make us more confident that the economy will be able to avoid a hard landing over the coming 12-18 months. Additionally, fiscal policies have been easing worldwide, which is supportive for global growth.

Disinflationary pressures mean continued accommodative monetary policies. Although economic data has turned up in most major economies lately, excess productive capacities, particularly in Asia and Europe, and high unemployment rates in Europe continue to impart disinflationary pressures worldwide. The recent recovery in commodity prices does remove one deflationary factor and helps many resource-driven EMs find a bottom. However, a renewed strength in the USD, high debt levels and a still-weak global demand are likely to continue to cloud the near-term outlook for EMs.

Fed rate hike expectations have rebounded sharply in May amid hawkish statements from policymakers

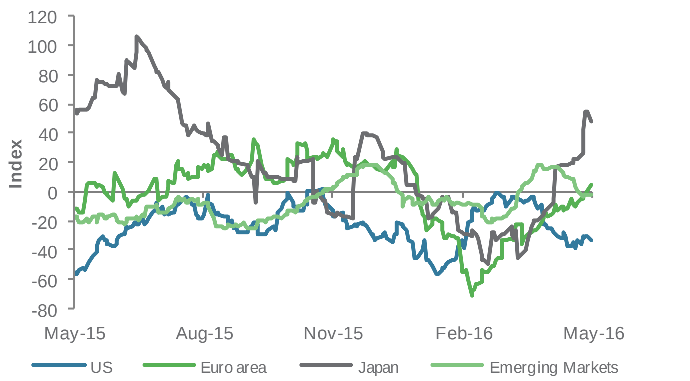
Market expectations of a Fed rate hike by June, July and September



Source: Bloomberg, Standard Chartered

Economic data have positively surprised in most major economies lately, with the exception of the US

Economic surprises indices for major economies



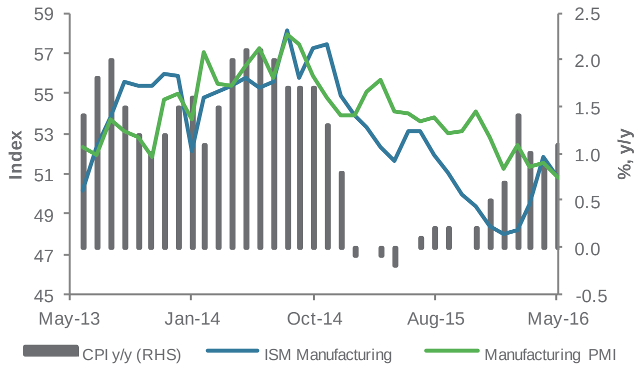
Source: Bloomberg, Standard Chartered

US: Fed rate hike expectations revived as consumption, inflation pick up

- **US consumption recovering from Q1 slowdown.** US retail sales, which account for more than two-thirds of the economy, rebounded strongly in April, as personal income continued to rise on a resilient job market. The recovery in consumption and a robust services sector are helping overcome a weak manufacturing sector. As a result, US growth in Q2 could is likely to rebound to a 0.5% annualised rate from Q1's slump.
- **Inflation trending gradually higher.** US inflation has been on a slow-and-steady uptrend since late last year, helped by the recovery in crude oil prices, while tighter job and housing markets have driven wages and rents higher. Despite these supply-side constraints, financial conditions remain loose, and the USD's renewed strength may act as a headwind to inflation in the coming months.
- **Expect a Fed rate hike in Q3.** Hawkish comments from Fed policymakers, citing robust consumption and building wage pressures, have boosted expectations of a rate hike as early as June. We believe a July or September rate hike is more likely, given the uncertainty surrounding the UK's 23 June 'Brexit' referendum, which falls after the Fed's June monetary policy meeting. However, the Fed may struggle to hike rates for a second time this year, given the external headwinds to growth.

US inflation has been on an uptrend despite a weak manufacturing sector

US ISM Manufacturing and Markit Manufacturing PMI; US Consumer Price index (%, y/y) (RHS)



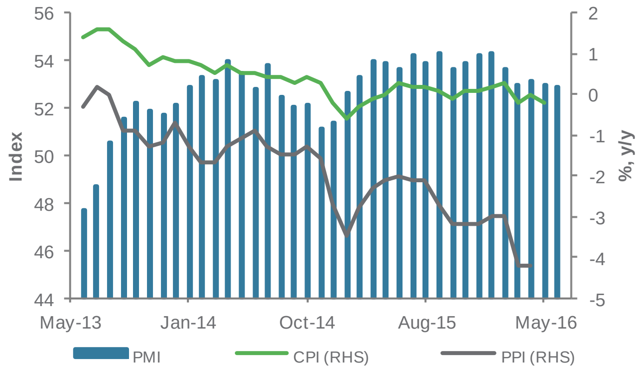
Source: Bloomberg, Standard Chartered

Euro area: Expansion continues, but disinflation pressures persist

- **Euro area business confidence robust.** Strong business confidence indicators for Germany, Italy and Spain in May, combined with the third month of improvement in French business confidence, are positive for Euro area growth. Strong domestic demand amid record-low borrowing costs and easier access to credit continues to drive growth even as renewed EUR strength hurts exports. Also, Greece's debt accord with creditors reduces a key risk for now.
- **Deflationary pressures persist.** Consumer prices fell 0.2% y/y in April, while producer prices contracted 4.2% in March, reflecting deflationary pressures that have dogged the economy since last year. Although the region's unemployment rate has declined since peaking in 2013, it remains well above pre-2008 crisis levels, keeping wage pressures subdued.
- **ECB policy helps boost lending.** Loans to Euro area households and companies have continued to rise as the ECB cut rates and incentivised banks to boost lending. However, the persistently low inflation increases the chance of further ECB easing in the coming months.

Euro area business confidence remains robust, although disinflationary pressures remain persistent

Euro area PMI; consumer and producer inflation (%, y/y)



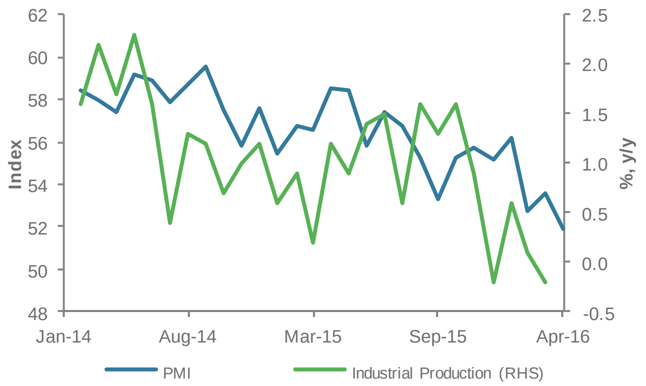
Source: Bloomberg, Standard Chartered

UK: 'Brexit' uncertainty hurts growth outlook

- **UK growth continues to slow.** Business confidence indicators, industrial production and job creation continued to be affected by the uncertainty caused by the 23 June referendum, which would determine whether the UK remains in the EU or not. However, retail sales rebounded in April, providing some support to Q2 growth estimates. Polls and betting markets show the 'Remain' camp – those who want the UK to stay in the EU – has gained ground over the past month.
- **BoE warns of 'Brexit' risks.** BoE Governor Mark Carney has warned of recession risks and a GBP slump in the event of a 'Brexit'. While this may warrant a rate cut and further bond purchases, there is a chance the BoE may have to hold rates as currency depreciation triggers renewed inflation pressures (inflation fell in April amid the 'Brexit' uncertainty). We assign a two-thirds probability that the UK will remain in the EU. Such an outcome could boost the chances of a rate rise, according to the governor. We expect the BoE to hike rates in such an event, as early as Q1 17.

UK business confidence and industrial production have faltered in recent months on 'Brexit' uncertainty

UK PMI; Industrial production growth (%, y/y) (RHS)



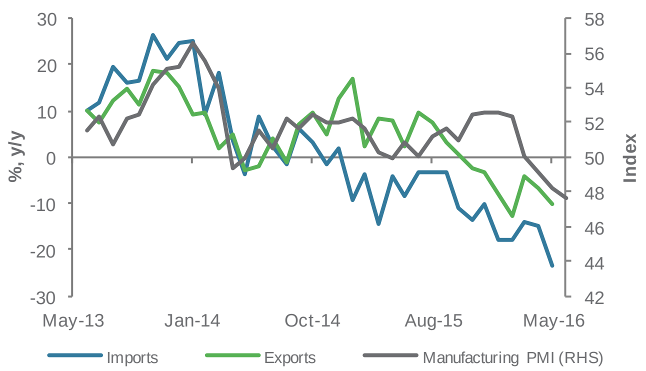
Source: Bloomberg, Standard Chartered

Japan: A strong JPY hurts exports, fuels deflation concerns

- **Japan's economic indicators deteriorate.** Japan's manufacturing sector business confidence fell further into contraction territory in May, while exports fell sharply in April, indicating the continued impact of the strong JPY on external-focused sectors. A 23% slump in imports and continued contraction in department store sales in April suggest domestic drivers of growth may also be weakening, although resilient domestic private consumption helped Japan avoid a technical recession in Q1 as it reported a 1.7% annualised GDP growth, following a 1.7% contraction in the previous quarter.
- **Further fiscal, monetary policy easing likely.** The deterioration in the economy in recent months has raised the pressure on the government and the BoJ to embark on further stimulus measures. There is renewed pressure on Prime Minister Shinzo Abe to postpone the proposed sales tax increase (to 10% from 8%), slated for April next year, although some advisors have suggested going ahead with the tax hike to ensure fiscal stability while compensating with more fiscal stimulus. With headline inflation contracting for the first time since 2013 and the BoJ downgrading growth and inflation outlook last month, we believe the stage is set for further monetary easing by Q3.

Japan's manufacturing sector confidence has slumped with continued contraction in exports; a deceleration in imports may portend weaker domestic demand

Japan's exports and imports (%, y/y); Manufacturing PMI (RHS)



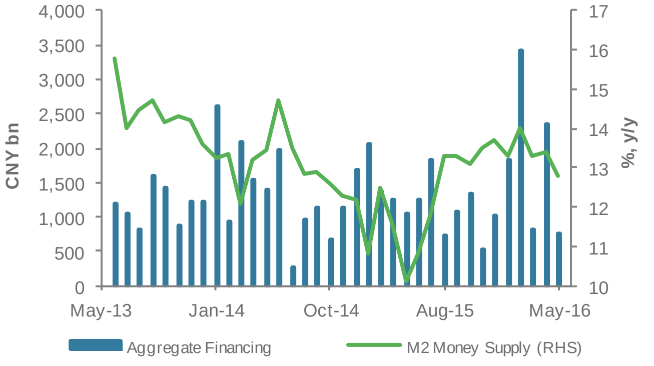
Source: Bloomberg, Standard Chartered

China: Credit stimulus pared back as economy stabilises

- **Bank lending falls as focus returns to sustainable growth.** Bank lending fell sharply in April after a surge in Q1, as data showed a stabilisation in the economy after months of fiscal and monetary stimulus. The official manufacturing sector confidence index suggested a second month of expansion after eight months of contraction, while the services sector continued to expand at a healthy pace. However, retail sales, industrial production and fixed asset investment growth slowed in April, perhaps reflecting the reduced stimulus and renewed focus on reforms.
- **Chances of further broad-based stimulus recedes.** An extensive article on the front page of the People's Daily by an 'authoritative' person warned against the risk of financial stability from debt-fuelled growth. We believe the comments reflect the views of policymakers in Beijing and indicate the growing uneasiness among authorities to stimulate growth at the cost of long-term stability. With hard landing avoided, we see more targeted stimulus in the coming months to support the 6.5% annual growth target. A renewed focus on reforms, including restructuring industries saddled with excess capacity, is likely.

China's policymakers appear to have withheld excessive credit stimulus in April after a surge in Q1

China's aggregate financing (CNY bn); M2 money supply growth (%, y/y) (RHS)



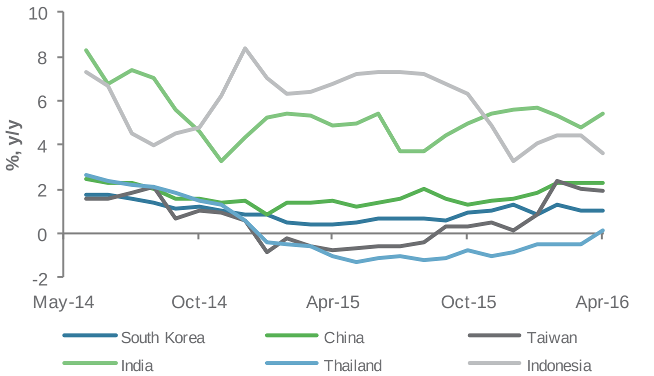
Source: Bloomberg, Standard Chartered

Other EM: Weak external sector continues to weigh on outlook

- **Asia export downturn continues.** Exports continued to contract across Asia, with China rejoining the camp after one month's expansion. The fragile external sector has added to excess capacities in a region saddled with high debt. These pressures have kept domestic inflation below central bank targets. Hence, we expect an easing bias among the region's policymakers, with likelihood of another rate cut in India if the monsoon turns out normal. Indonesia, Malaysia and South Korea could also see further rate cuts.
- **Brazil's new government faces uphill task of reviving confidence.** Vice President Michel Temer, after taking over from President Dilma Rousseff, has appointed two key market-friendly policymakers at the head of the finance ministry and the central bank. This, we believe, is a positive start for the reforms that are required for Brazil to regain investor confidence. We would watch for fiscal measures to cut the budget deficit from 9.7% of GDP. A lower deficit is critical for bringing down inflation (running above 9.0%). It would also create space for the central bank to start cutting rates (now at a 10-year high of 14.25%).

Asia's inflation rates are mostly on a gradual uptrend but remain below central bank targets, opening up prospects for further rate cuts

Consumer price inflation across major economies in Asia (%, y/y)



Source: Bloomberg, Standard Chartered

Bonds

- Bonds are now our most preferred asset class given the risks of seasonal weakness and the fact that we may be getting closer to the end of the US economic cycle.
- We favour corporate bonds over government bonds. Within this, we prefer US Investment Grade (IG) bonds.
- In Emerging Markets (EM), we favour USD-denominated sovereign bonds over local currency bonds that carry currency risk.

Bonds are our most preferred asset class. We prefer high quality corporate credit.

Evolution of key factors over the last month

Factor		What has changed since December 2015
Fed rate outlook	↓	Higher rate hike expectations are a negative for USD-denominated bonds
USD strength	↓	Stronger USD negative for G3 and EM local currency bonds
Credit quality	↓	Worsening credit quality a rising risk for EM USD and Developed Market (DM) corporate bonds. Deterioration relatively limited in Asia USD corporate bonds
Valuations	↑	Valuations have cheapened across EM USD government bonds, while they have remained almost flat across DM corporate and Asia corporate bonds
Absolute yield	↑	Increased due to marginally higher government bond yields
Commodity prices	↔	Higher oil prices positive for DM High Yield (HY) and EM USD bonds. Weaker metal prices a negative

Note: Arrows indicate impact of the factor on potential bond returns.

Source: Standard Chartered

G3 and EM (USD) sovereign bonds

- **Fed and higher inflation expectations emerge as risks.** We believe the strong rally in G3 government bonds may pause as rising inflation expectations, aided by higher oil prices, and rising US wage pressures exert upward pressure on yields. Additionally, recent signals seem to suggest the Fed could hike rates more than the market expects. We still like US Treasuries over other G3 government bonds, given their defensive qualities, and believe they act as a hedge in a well-diversified investment allocation. However, our preference for them has slightly decreased in light of the increased risk of rate hikes.

  If the Fed hikes rates more than expected, we believe short-term yields could rise more than long-term yields. However, negative yields in Japan and Europe mean US Treasury demand is likely to keep 10-year US yields rangebound (1.75-2.25%). We retain our preference for a 5-7-year maturity profile across USD-denominated bonds.

- **EM USD government bonds offer attractive yields.** EM USD government bonds continue to be our most preferred choice within the government bond space. Despite delivering an over 6% return in 2016, they continue to offer an attractive yield of close to 5.8%, something which cannot be ignored in today's low-interest-rate environment. Besides the yield, we like the fact that they provide exposure to EMs through sovereign bonds and do not explicitly carry currency risk.

  However, given their sensitivity to US yields, greater–than-expected rate hikes in the US are a risk, but the yield on offer provides a significant buffer. Additionally, the risk of lower commodity prices and stronger USD are headwinds that are likely to prevent further tightening in valuations. Hence, we prefer to seek the shelter of IG bonds (yielding 4.4%) within EMs. We believe they are likely to deliver positive returns, and we prefer to maintain a benchmark allocation (see page 6) to EM USD government bonds.

Corporate bond spreads versus relevant benchmark*

	Current	52w high	52w low	Long-term average*
US IG	1.75	2.33	1.47	1.98
US HY	5.63	8.39	4.23	5.79
Europe IG	1.30	1.67	0.97	1.34
Europe HY	4.28	5.81	3.44	6.26
Asia IG**	2.21	2.60	1.94	2.52
Asia HY**	5.53	6.97	5.06	6.75

*Relevant benchmark for US and Asia is US Treasuries, Europe is bunds.

** Long-term spread average from 2001 onwards.

**Long-term spread average from 2006 onwards.

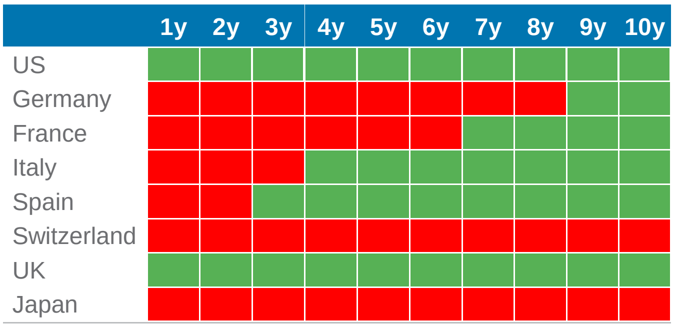
Source: JP Morgan, Barclays, Bloomberg, Standard Chartered

Corporate credit (USD)

- **US IG corporate bonds remain our preferred area.** We continue to like the yield premium they offer over US Treasuries. With a large amount of government bonds trading at negative yields, we believe the search for yield is likely to act as a supportive factor for corporate bonds and could help push valuations higher.
- US IG corporate bonds offer the sweet spot of providing the protection of IG credit quality and a higher yield than US Treasuries, in our opinion. As shown in the second chart alongside, US Treasuries are the primary driver of returns for US IG credit. While the yield on offer has declined notably since the start of the year, valuations are still in line with long-term averages.
- **US HY corporate bonds – An attractive carry play.** While we scaled back on our preference for DM HY corporate bonds last month, they remain our second-most preferred area within global bonds. The recent rally in oil prices has been supportive for US HY bonds as it is likely to ease some pressure for energy companies. That said, the decline in credit quality and seasonal weakness remain key risks.
- **We prefer US corporate bonds over European bonds.** Following last month's publication, where we highlighted our preference for US IG bonds over European IG bonds, we have often been asked whether European HY corporates are more attractive than US HY bonds. We agree European HY corporates have better credit quality and lower exposure to energy than US HY corporates. However, we believe most of the good news is in the price. US HY offers a yield of approximately 7.4% compared to the 4.5% offered by European HY corporates. We believe such a large yield difference adequately compensates for the above-mentioned factors and, hence, prefer US HY corporate bonds. Additionally, US HY bonds may offer even better returns if USD gains add a tailwind.
- **Prefer IG component within Asia credit.** Asia corporate bonds continue to be the defensive space within EM corporate bonds and have offered very stable returns over the past couple of years. While spreads have compressed, valuations remain close their long-term average. Although we continue to believe China is likely to avoid hard landing in the next 12-18 months, the rise in onshore defaults in China could cause a temporary spillover effect into the Asian USD bonds. Hence, we prefer the quality of IG bonds within the Asia credit space.

Negative government bond yields support demand for corporate credit

Positive or negative yields offered by government bonds of various maturities

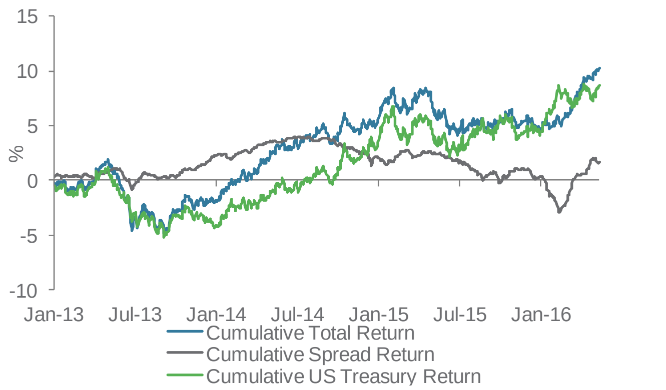


Red colour indicates that the bonds offer negative yield. Green colour indicates positive yield

Source: Bloomberg, Standard Chartered

US Treasury yields are the primary drivers of US IG credit returns

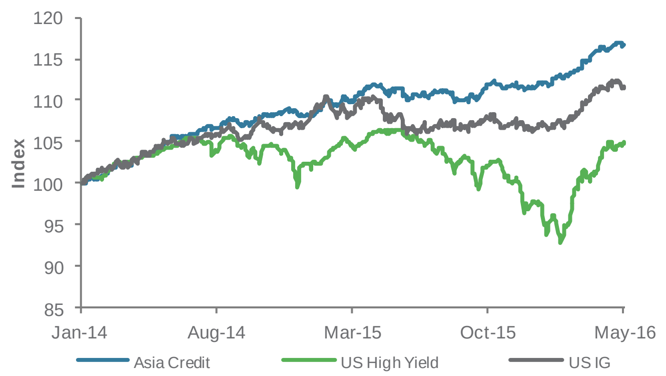
Cumulative returns from January 2013



Source: Bloomberg, Standard Chartered

Asia credit has delivered returns with low volatility

Total returns of various bond classes (rebased to 100 as of 1 January 2014)



Source: Bloomberg, Standard Chartered

Asian local currency bonds

- **We retain our preference for USD-denominated bonds over local-currency bonds.** We believe a decline in commodity prices and a stronger USD due to rate hikes in the US could negatively impact the returns of local-currency bonds.
- Within the local currency space, we continue to prefer Asia over other EMs due to its lower exposure to commodities, stronger growth and its defensive nature relative to other EMs. While Latin American bonds, especially Brazilian bonds, offer attractive yields, we believe a lot of good news is in the price, and there could be better entry points for investors.
- **INR bonds remain our top pick.** Within Asian local currency bonds, INR bonds remain our top pick for international investors. Although the recent tick-up in inflation does reduce the possibility of rate cuts, we continue to like the yield on offer. While the INR could weaken against the USD, we believe it is likely to be among the better-performing currencies within Asia (please see page 27 for further details).
- **CNY and CNH bonds continue to face challenges.** We believe the CNY and CNH are likely to weaken over the next year (see page 27) and, hence, believe international investors are likely to get better risk/reward elsewhere. For local investors, the risk/reward is more nuanced. We believe the monetary policy is likely to retain an easing bias, which is positive for government bonds. The picture turns less favourable when we look at corporate bonds.

  The CNY corporate bond market has captured a number of news headlines due to a higher number of corporate and state-owned enterprise (SOE) defaults this year. Despite the headlines, reports suggest the default rate remains contained below 1%. Thus, while default rates are not alarming yet, they are likely to lead to investors demanding a higher risk premium and could lead to a decline in bond prices. Credit differentiation could become more important, and investors are likely to look beyond local credit ratings. In particular, the differentiation between strategically important SOEs backed by the central government and state-backed entities could sharpen.

  The CNH corporate bond market is dominated by issuers in China and, hence, the above-mentioned factors apply here as well. Additionally, recently liquidity concerns have led to a slowing of new issuances, which has resulted in a shrinkage of market size. If this persists, it could adversely impact market liquidity – a potential risk for local investors.

Local-currency bonds offer an attractive carry

Country	Current 10y yield	Currency view*	Investor flows**
India	7.46%	🟢	🔴
Indonesia	7.87%	🟢	🔴
Malaysia	3.90%	🟡	🟢
Philippines	3.61%	🟡	🔴
S. Korea	1.78%	🟡	🟢
Thailand	1.99%	🟡	🟡

*Standard Chartered Wealth Management currency views.

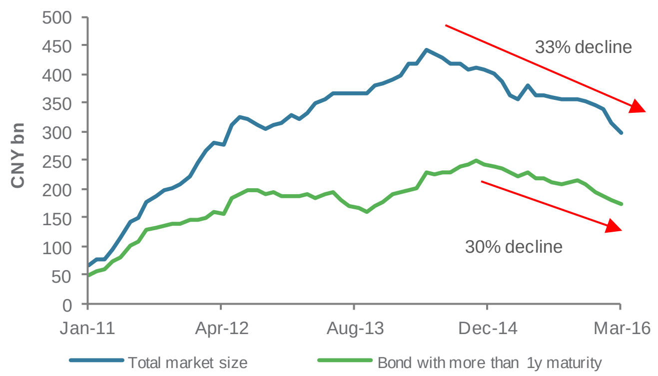
**Bloomberg Foreign flows into bonds, greater than USD 100m.

Traffic light signal refers to whether the factor is positive, neutral or negative for each country

Source: Bloomberg, Standard Chartered

Shrinking CNH bond market size likely to impact liquidity

Total amount of offshore Renminbi bonds outstanding in Hong Kong



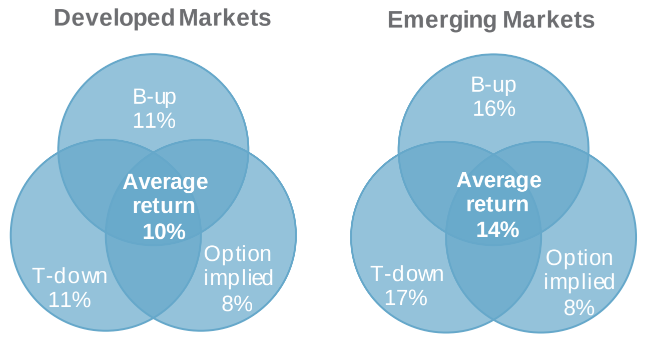
Source: HKMA, Standard Chartered

Equity

- US corporate earnings are nearing an inflection point. Consensus expectations are for US earnings to turn positive in Q3, possibly sooner.
- Weakness over the summer months remains our core short-term (1-3 month) equity view. Nevertheless, we view lower levels in markets as an opportunity to add to Euro area equities. Within Asia ex-Japan, India ranks as our favoured market.
- The UK's vote on EU membership appears to have made a decisive turn in favour of the 'Remain' camp. Small- and mid-cap companies are primary beneficiaries of a vote to remain in the EU.

US corporate earnings are nearing an inflection point.

Estimated potential 12-month market returns using different approaches look optimistic



1. **B-up:** Consensus estimates based on analyst price forecasts: Bottom-up method.

2. **T-down:** Estimates using consensus earnings and the estimated price-earnings ratio expansion/contraction: Top down method.

3. **Option implied:** Option potential return estimates are based on selling a 12-month Put at current levels and expressing the potential return using the premium earned as a % of the current level. The estimates should be considered a best case with a probability of <50%.

Source: Bloomberg, FactSet, Standard Chartered

Key market drivers and recent trends

Factor		What has changed since December 2015
Earnings growth	↑	**YTD:** Following three consecutive quarters of negative growth, US earnings are expected to turn positive by Q3, possibly sooner
DM market valuations	↓	**YTD:** Valuations in the US, the Euro area, Japan and the UK have declined YTD. However, they all remain above long-term averages (ex–Japan)
EM market valuations	↑	**YTD:** Valuations in non-Asia Emerging Markets (EM) have surged YTD, boosted by a re-rating in Brazil, and are now considered expensive. Asia remains attractively valued, but is missing catalysts
Corporate margins	↓	**YTD:** Corporate margins are under downward pressure, as costs, including labour, rise
Oil prices	↑	**YTD:** Oil prices are rebounding, as the forecast surplus of supply over demand declines on the back of US shale output cuts
USD	↑	**YTD:** The USD has rebounded strongly since the start of May. This follows a period of weakness in the January-April period

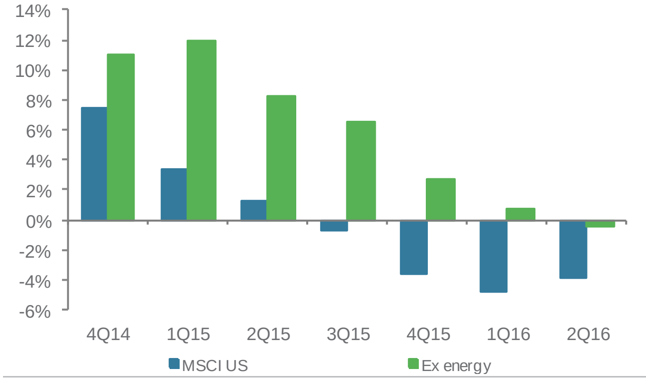
Source: Standard Chartered

US: Earnings turning point ahead

- We are moderately positive on the 12-month outlook for the US equity market from current levels, which is ranked second in order of preference across our key markets/regions. Equity analysts are becoming increasingly positive on the outlook for US corporate earnings with earnings revisions turning positive, helped by the improvement in commodity prices. This trend may continue if the Fed hikes interest rates in the coming months, as it should lift earnings expectations in the banking industry group.
- Following a 5% contraction in Q1 earnings growth, the consensus among analysts is for a lower (3%) contraction in Q2 and growth (2.5%) in Q3. Two factors are working together to improve the outlook for US earnings growth: the improvement in commodity prices and rising interest rate expectations, which, in turn, are lifting earnings expectations in the energy and banking sectors
- Looking beyond the quarterly outlook for earnings growth, our caution towards US equities is based on a number of factors, including:
  - Decline in margins: US corporate margins peaked in 2015 and are under downward pressure as costs rise.
  - High valuations: Trading at almost 18x, US equities are viewed as expensive, albeit not overvalued.
  - Economic cycle: We believe we are in the late stage of the economic cycle. Historically, this is the part of the cycle when reducing allocation to equities is viewed as appropriate.

Inflection point ahead for US earnings

US quarterly earnings forecasts (Headline and ex–energy)



Source: FactSet, Standard Chartered

Europe: Positive on the Euro area, negative on the UK

- We are positive on the outlook for the Euro area equity markets, which are top ranked in order of preference across our key markets/regions. Factors driving our optimism include renewed euro weakness against the USD, which has historically been positive for the performance of export-orientated industry groups, including transport and autos. Ample liquidity provided by the ECB via targeted longer-term refinancing operations (TLTRO) and other measures is also positive for the market.
- The potential for Greece to de-stabilise markets in the coming months appears to have been neutered following the recently announced deal with the Eurogroup of Finance Ministers to release another EUR 10bn in bailout funds. Significantly, the Eurogroup has also agreed that debt relief would eventually be offered to Greece. This is a significant development and is an acknowledgment that Greece's 180% debt-to-GDP ratio is unsustainable.
- Earnings in the Euro area have been dragged down by weakness in energy and financials. Nevertheless, Euro area earnings reached a low in Q4, and recovered in Q1 – a trend expected to continue in Q2.
- The UK is ranked third in order of preference across the key global markets and regions.
- With less than a month to go before UK voters decide whether to remain in the EU or leave, economic arguments appear to be winning. Policymakers have highlighted the risks to jobs and growth as a reason to remain in the EU. The impact of 'Brexit' on the Euro area has also been in focus. The consensus centres on a lower euro in the short term and a negative impact on sentiment.
- There are some clear winners and losers from the outcome of the EU vote. If the UK votes to remain in the EU, small- and mid-cap companies in the FTSE250 may outperform. If the vote is for 'Brexit', then large-cap companies in the FTSE100 may outperform. These performance trends are largely driven by the relative strength of the sterling and the impact it has on the earnings of companies in the FTSE250 and FTSE100 indices. A stronger GBP is viewed as a positive for FTSE250 companies as they generate more of their revenue domestically and are impacted to a lesser extent by sterling strength.

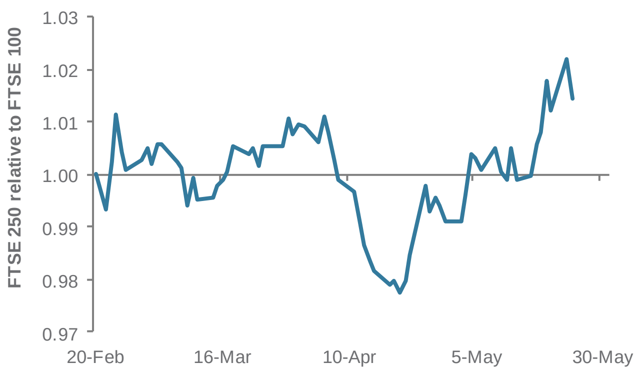
Euro area earnings remains 30% below the 2008 peak

Euro area 12-month trailing EPS

Source: FactSet, Standard Chartered

FTSE250 performance has picked up following sterling strength

FTSE100 and FTSE250 YTD performance (rebased)



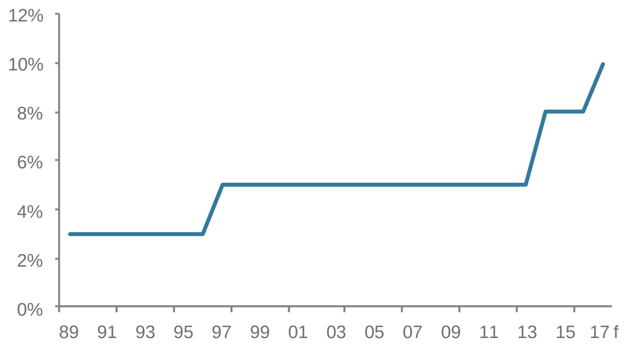
Source: FactSet, Standard Chartered

Japan: Forward-looking earnings pressure

- We are cautious on the outlook for Japan's equity market, which is ranked second from the bottom in order of preference across our key markets/regions. Consensus expectations are for corporate earnings to grow in low double digits this year. However, this reflects the prior positive effect of a weaker JPY, and with the JPY now appreciating and given the market is forward looking, we expect a downward pressure on earnings as we move into 2017.
- An added factor weighing on the market is the prospect of an increase in the sales tax, scheduled to rise to 10% in April 2017 from 8%. Prime Minister Shinzo Abe has set specific conditions for the sales tax increase to be implemented. While it is too early to take a view on whether the increase will be postponed, it is a clear overhang for the market.
- Expectations for further easing by the BoJ appear data dependent in terms of timing. We believe the BoJ may ease policy further in Q3. Communication of any change is viewed as crucial, given the poor handling of the announcements of negative rates in January. The effect of a further reduction/increase in negative rates on the banking sector is also key. YTD, the banking sector is the worst performer in the MSCI Japan index, reflecting the negative effect of negative rates on bank earnings.

Sales tax is scheduled to increase to 10% in 2017

Japan sales tax trend



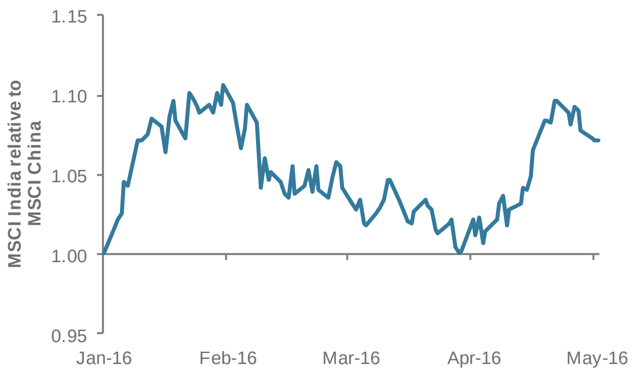
Source: Bloomberg, Standard Chartered

Asia ex-Japan: The ChIndia switch

- We are changing our top-ranked Asian market to India, from China. The latter is now our third-most preferred market in Asia, with Korea being the second. As we head towards a likely summer rate hike in the US, India stands out historically as an EM that is more resilient when the Fed has been hiking rates. While India did come under selling pressure during the 2013 taper-tantrum episode, its fundamentals have improved significantly since then.
- The Global Investment Council (GIC) views China equities as Fairly Valued relative to its growth prospects. On a pure P/E ratio basis, the MSCI China, our preferred China index, can be considered attractively valued, trading at 11.5x 12-month forward consensus earnings – relative a long-term average of 12x. Valuations for the HSCEI, which is our least-preferred China index due to the very high weight of banks, is 7x consensus earnings. This reflects investor concerns over banks' NPLs, which, we believe, are valid. Hence, investors should avoid this index.
- The challenge for investors is that they need to see evidence of acceleration in growth to recognise the value in China. While policymakers did pull the credit/growth lever in Q1, this has since been reversed. The deterioration in the growth profile is a contributing factor to China's decline to our third-most preferred market, from first in prior months.
- Korea stands as our second-most preferred market in the region. The market has Outperformed peers YTD despite the weakness in China, which would ordinarily act as a drag on the market given China's status as Korea's number one export market. Resilient domestic demand has helped lift domestic-orientated exports to offset the export drag.
- Singapore and Hong Kong now stand as our least-preferred markets, mainly due to their heightened sensitivity to rate hikes by the Fed. As we head towards a rate hike in the US, both these markets could come under pressure as bond yields move higher and expectations for future real estate values reset lower.

India has outperformed China YTD

Relative performance of India and China equities



Source: Bloomberg, Standard Chartered

China equities are attractively valued, but missing a growth catalyst

MSCI China forward P/E ratio

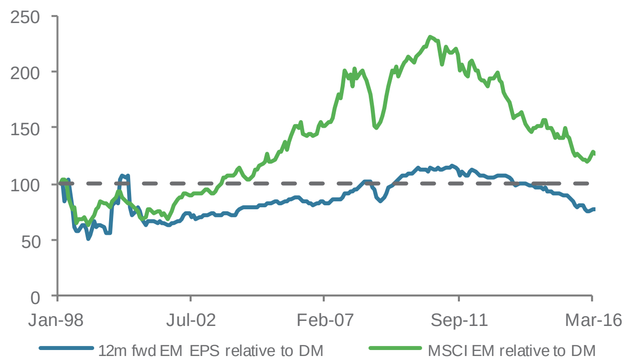
Source: Bloomberg, Standard Chartered

Non-Asia EMs: Rising commodity prices boosting performance

- We remain cautious on non-Asia EMs. The region's equity markets posted solid gains in Q1, but they have come under selling pressure since the start of April as the gains in oil and iron ore commodity prices started to reverse.
- The underperformance of EMs relative to Developed Markets (DMs) over the past 12 months has started to narrow on a YTD basis. This may reflect a change in expectations on the outlook for relative earnings growth in each region. As highlighted in the chart on the right, there is a clear link between relative earnings growth and relative equity market performance.
- The Brazilian equity market has come under selling pressure since reaching a cyclical peak at the end of April. This reflects uncertainty over the potential for the new acting President Michel Temer to implement his proposed reforms in the coming months. As the equity market had risen 45% from the January low, a period of consolidation should not come as a surprise. The GIC is evenly split on the prospect for Brazil's asset markets in the coming six months, but this is an improvement from a majority expecting flat to lower markets in the prior month.

Relative performance of EM and DM track relative earnings growth

EM and DM relative earnings and relative performance



Source: Bloomberg, Standard Chartered

Conclusion

We remain cautious on the outlook for equity markets, with the asset class ranking only above commodities in terms of our conviction across the five key asset classes. While we do see the potential for an inflection point in US earnings in Q2, the longer-term outlook is challenging, given our position in a late-cycle environment. Weakness in markets over the summer months remains our core short-term (1-3 month) equity view. Nevertheless, we recognise the possibility of a more positive scenario and would view lower levels in markets as an opportunity to add to Euro area equities. Within Asia ex-Japan, India ranks as our favoured market. The likelihood the UK will vote to leave the EU appears to be diminishing, and we would prefer small- and mid-cap companies in the FTSE250 if the likelihood of the UK remaining in the EU continues to increase.

Ranking of our key country preferences

No. 1	Euro area	**Most Preferred**
No. 2	US	
No. 3	UK	
No. 4	Asia ex-Japan	
No. 5	Japan	
No. 6	Non-Asia Emerging Markets	**Least Preferred**

Source: Standard Chartered

Commodities

- We expect weakness in commodity prices amid short-term USD strength and a renewed focus on demand-supply imbalance.
- We believe the recent rally in oil prices may have run ahead of fundamentals and expect a pullback in prices.
- Gold prices are unlikely to make new highs amid USD strength, but may remain resilient if risk sentiment weakens.

Headwinds to the recent commodity rally are emerging.

Evolution of key factors since end-2015

Factor	What has changed since December 2015
Demand	Growth rate forecasts cut slightly for oil. Demand for gold has surprised slightly to the upside, but no change in the poor metals demand outlook
Supply	Oil and metals oversupply outlook unchanged, US stocks continue to rise. However, recent temporary oil production outages may have masked this
Sentiment	Excessive positive sentiment in commodities over the last few months could be reversing
USD	Softer USD has been supportive for commodities in March-April, but with the recent USD strength becoming a headwind

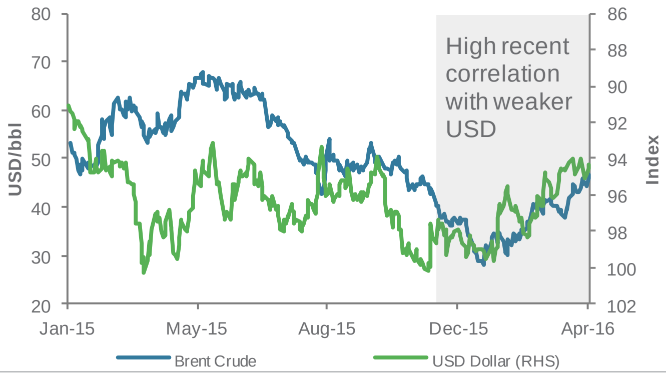
Source: Bloomberg, Standard Chartered

Oil

- **Possibility of a near-term correction in oil.** We believe two factors might result in a correction in oil prices in the near term and, hence we would not chase the current rally higher. First, a resurgence of USD strength amid seasonal tailwinds and focus on the next Fed rate hike. Second, demand-supply fundamentals to come to the forefront with resumption of temporary supply outages.
- Oil prices have moved in line with the USD weakness recently (see adjacent chart). With the resumption of USD strength, we believe this crucial tailwind is likely to become a headwind.
- Despite the very strong rally from its 2016 lows, excess supply conditions have persisted. In fact, oil inventories have continued to increase with higher prices. For example, despite the recent cutbacks in US crude oil production, stocks have continued to build up. The recent strength in oil prices may have also been supported by considerable production outages in Canada and Nigeria, which we believe are likely to reverse quickly.
- Over a longer period, we do expect oil markets to rebalance and USD strength to taper off. However, with current higher prices, this process is likely to be gradual, playing out over a 12-18-month time horizon. Hence, in the interim, a temporary pullback below USD 45/bbl would not surprise us.

Weaker USD has aided oil prices

Brent crude price and DXY index (inverted)



Source: Bloomberg, Standard Chartered

Gold

- **Gold prices likely to remain rangebound.** Gold prices are highly correlated to both real interest rate (ie, interest rates net of inflation) expectations and weakness in the USD. Since we expect USD strength to pick up in the short term alongside possible higher US interest rates, there is potential for a near-term downside in gold.
- The recent rally has been supported by lower interest rate expectations, especially negative rates across Europe and Japan, in addition to the recent USD strength. It would be difficult for rates to fall much further in many markets given policy constraints. On the other hand, higher interest rates in the US could raise real rates in the US and put pressure on gold. Additionally, the recent rally in gold has been accompanied by a sharp jump in speculative positions and rising inventories, which pose further downside risks to gold.
- Having said that, we contend that certain factors could be gold supportive. A cautious investment landscape or a risk-off environment could result in increased demand for safe-haven assets, which could limit downside in gold to some extent. Hence, although we would avoid holding gold in terms of the USD, we are more comfortable in other base currencies, particularly Asia ex-Japan currencies.

Higher US rates in the short term could signal limited upside in gold

Gold prices and 5-year tips yield

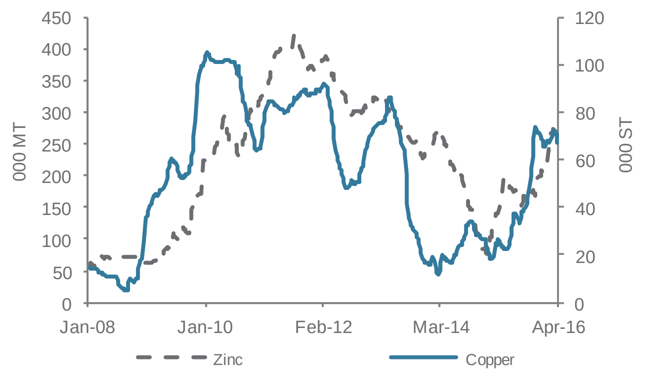
Source: Bloomberg, Standard Chartered

Industrial metals

- **Fundamentals remain challenged; China and USD tailwinds may be fading.** The rally in industrial metals may have already reached its limits. Recent weaker China data may have scaled back some optimism. USD strength and rising inventories are key near-term drivers of weaker industrial metals, we believe.
- Inventories in major industrial metals (zinc, copper iron ore), except aluminium, are at high levels relative to history and continue to build. Key suppliers, in our opinion, are likely to increase production at current higher prices. Moreover, we do not believe the increased uptick in trading activity in hard commodities in China is reflective of fundamental demand and is rather speculative in nature. We doubt the current supply can be absorbed by the current level of demand. Finally, USD strength is expected to act as a headwind and likely to add further pressure.

Industrial metals inventories are on an upward trend

Inventories for copper and zinc



Source: Bloomberg, Standard Chartered

Alternative strategies

- Global macro strategies offer the most attractive risk/reward ahead of the risk of summer weakness and, in the longer term, the risk of an end to the US economic cycle.
- Alternative strategies remain one of our most preferred asset classes within A.D.A.P.T.
- Alternative strategies outperformed equities last month, although they were marginally lower overall.

Macro strategies are our most preferred sub-strategy going into the summer.

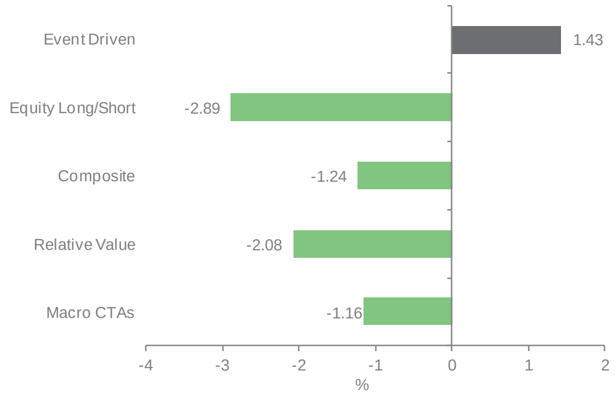
Alternative strategies outperformed equities over the past month, although they were slightly lower overall. Macro strategies disappointed and weakened over the past month. At the other extreme, event-driven strategies rebounded.

Macro strategies are our sub-strategy of focus at this point in time. There have been some concerns regarding this sub-strategy's relatively tepid performance over the past couple of years. However, what is of particular interest to us is its strong bouts of performance during periods of heightened market volatility, especially towards the end of the US economic cycle. We believe this characteristic is likely to become increasingly valuable ahead of the summer; on pages 5-6, we discuss the likelihood of another 'sell-in-May' effect over the summer. This is when the strategy offers the most value, in our opinion, especially when used in combination with a strategy like multi-asset income (MAI).

Equity long/short strategies still preferred, but face risk of temporary drawdowns. Their positive correlation with equities places the strategy at risk of a temporary drawdown should markets be volatile over the summer. However, their long/short approach means they are likely to be less volatile than long-only exposure. In our view, this means they offer an attractive way to gain exposure to equities in today's uncertain environment.

Macro strategies outperformed early in the year; they may deliver again in the coming months

Performance of HFRX sub-strategy indices (%, YTD)



For the period 31 December 2015 to 26 May 2016.
Source: Bloomberg, Standard Chartered

Our views on the main sub-strategies

Sub-strategy	Our view
Equity long/short	**Positive:** Exposure to equities, but likely with lower volatility relative to long-only
Relative value	**Neutral:** Volatility has increased opportunities, but liquidity likely a challenge
Event driven	**Neutral:** M&A activity is a positive, but strategy vulnerable to broader market volatility
Credit	**Neutral:** Volatility/sector stress positive for credit long/short strategies; defaults a risk
Macro	**Positive:** Outperformance during volatility means this is our most preferred sub-asset class going into the summer
Commodities	**Neutral:** Commodity prices are a risk, although an eventual rise in oil prices may support
Insurance linked	**Negative:** Insurance losses below average in 2015, which could reverse in 2016

Source: Standard Chartered

Foreign exchange

- Expect the USD to recover further short term, but maintain the 1.05-1.15 range against the EUR and 110-115 against the JPY. Expect the GBP to strongly outperform short term if the public votes to remain in the EU.
- AUD, NZD and Asia ex-Japan currencies to weaken further. The INR and IDR to remain more resilient to USD strength than peers.

Moving forward, the USD may recover some of its recent losses, but it is unlikely to breach new highs. The EUR and JPY may head lower in the immediate term, but remain resilient against other G10 and Asia ex-Japan currencies. Asia ex-Japan currencies could see further downside with USD strength.

A second possible rate hike dominating FX markets.

Short term: Refers to a horizon of less than 3 months
Medium term: Refers to a time horizon of 6 to12 months

Factor	What has changed since December 2015
Interest rate differentials	Interest rate differentials moved against the USD earlier, as markets scaled back Fed rate hike expectations. Recently, differentials have been USD supportive as a second Fed rate hike is back in focus
Commodity prices	After a strong run, commodity prices have begun to ease again, putting pressure on currencies such as the AUD and NZD
Relative economic performance	Incrementally better data from outside the US have been seen in 2016; however, this is beginning to turn. US core inflation indicators most constructive among peers, suggesting a later business cycle stage
Positioning	Positioning on the USD turned net-short. Earlier, excessive net-long positioning was a barrier to further USD strength

Source: Bloomberg, Standard Chartered

USD: Stronger for the summer

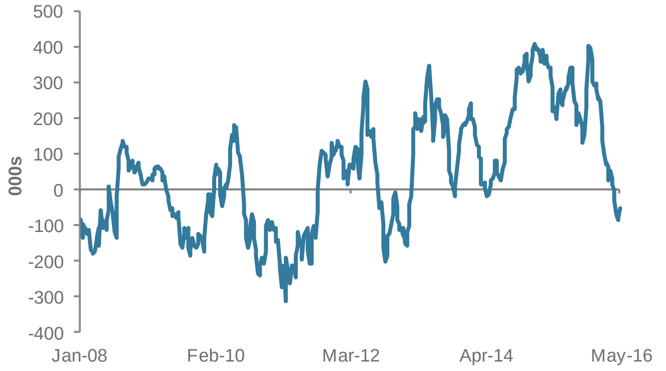
We expect the USD to broadly trade rangebound (ie. 118-126 in the broad trade weighted index) although we may continue to see it extend recent gains in the short term. Recent communication from the Fed suggests increased possibility of a June-July rate hike, which is not fully priced in. Moreover, USD speculative positioning has turned net-short. Covering of short positions could be a further tailwind to the USD.

Over the medium term, we believe significant USD strength is unlikely for two reasons. First, the Fed is likely to hike interest rates cautiously and gradually, being particularly sensitive to USD strength. Second, with the slowing of US growth expectations, the allure of US assets has been tempered.

Similarly, we do not expect substantial USD weakness either. First, while diminished, the monetary policy divergence theme remains in place. The US is still likely to modestly hike interest rates, while most other central banks are more likely to ease. Second, fund flows to non-USD assets are likely to be limited without a strong growth pickup in Emerging Markets (EM).

USD speculator positing had turned net-short

USD net non-commercial positions



Source: Bloomberg, Standard Chartered

EUR: Politics and the ECB to add pressure

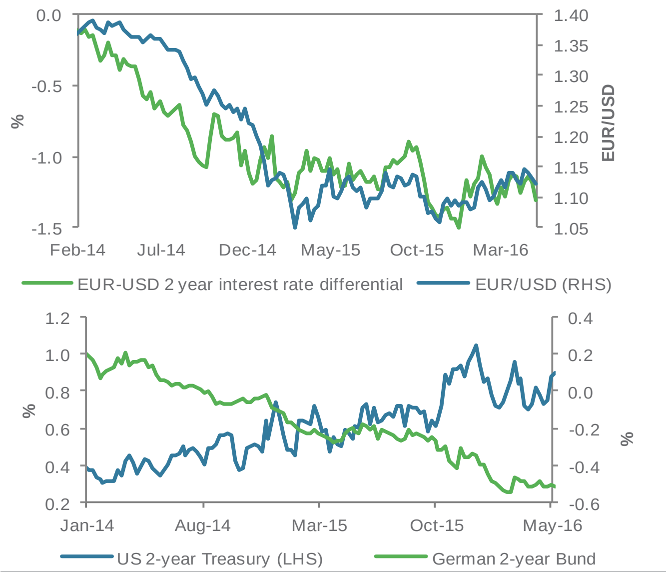
We expect the EUR to broadly trade within the 1.05-1.15 range over the medium-term horizon. However, in the short term, the EUR is likely to weaken further for three reasons:

First, the Fed's second rate hike has come back into focus, resulting in US Treasury yields offering wider differentials with Euro area bonds. Second, the ECB may be planning another round of balance sheet expansion, as weak core inflation has reinvigorated deflationary concerns. Third, political issues including the 'Brexit' referendum and Spanish general elections are likely to result in some volatility in the EUR over the summer.

From a longer-term perspective, however, sustained EUR weakness is unlikely. The Euro area has accumulated a massive current account surplus, which is now substantially offsetting outflows from Euro area debt. Furthermore, periods of significant financial market volatility or 'risk-off' result in outperformance of current-account-surplus countries' currencies. Against this backdrop, the EUR remains cheap.

Rate differentials driving EUR; US 2-year yields rise while those in Europe fall

EUR/USD vs. EUR-USD 2-year government bond yield differential



Source: Bloomberg, Standard Chartered

JPY: BoJ may have to act

We expect the JPY to trade between 110 and 115 in the short term, with a bias towards the upper end of this range. Falling inflation expectations in Japan have been instrumental recently in supporting a stronger JPY (see chart for detail). A short-term JPY weakness is now likely to be driven by the following factors:

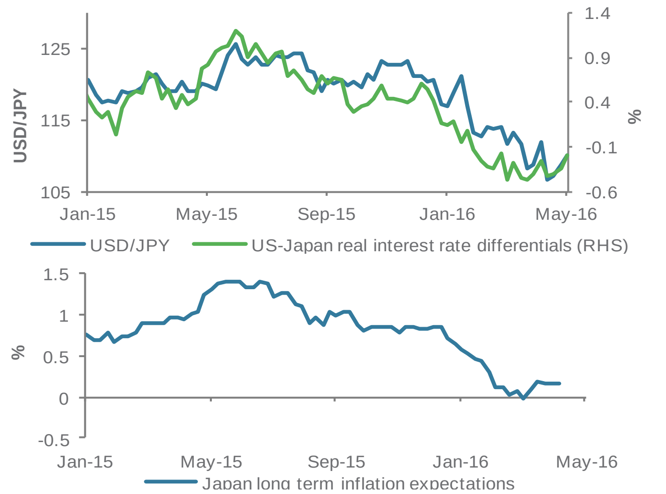
First, USD strength as the Fed moves towards its second rate hike. Second, an increasing possibility of another BoJ balance sheet expansion – larger in magnitude than what markets expect. Third, extremely net-long speculator positioning can add pressure on the JPY if some of it unwinds.

However, from a medium-term perspective, we contend the BoJ's potential to significantly weaken the JPY through additional quantitative easing (QE) and further negative rates are limited. One reason is Japan's pension fund outflows seeking foreign assets may have already reached their limits. Another is that longer-term fundaments (namely, deep currency undervaluation and a large current account surplus) are arguably JPY supportive.

In the near term, we expect a low probability of the BoJ directly intervening in the currency market, especially when taken in the context of red flags raised by the US authorities on anti-competitive behaviour.

USD/JPY has been following real interest rate differentials recently, underscoring the importance of falling Japan domestic inflation (bottom chart)

Japan 10-year real interest rate differentials* and USD/JPY, Japan long-term inflation expectations**



* Interest rates net of inflation

** Based on 5Y5Y breakeven rates

Source: Bloomberg, Standard Chartered

GBP: 'Brexit' unlikely, but gains to be short-lived

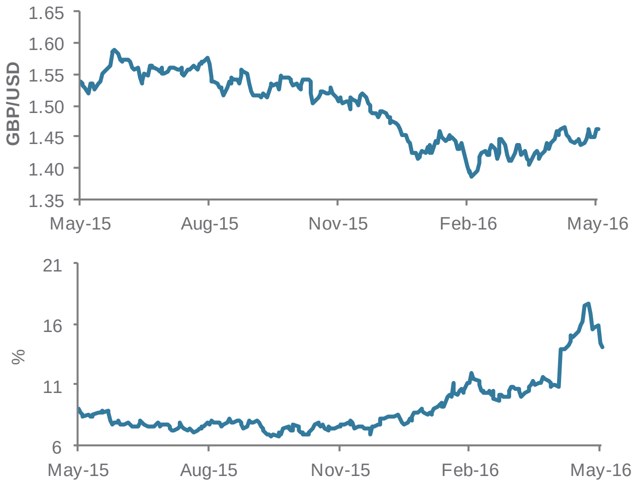
Although the GBP may remain volatile ahead of the June referendum, we believe the UK will remain in the EU.

Recent polls have pointed in favour of remaining in, while both the Cabinet and the BoE have highlighted significant negative economic effects of leaving the EU. Hence, should public opinion move in favour of a 'Remain' vote, we would expect the GBP to rally significantly against most currency pairs, even in a period where we expect USD strength.

Looking beyond the 'Brexit' debate, we also highlight that GBP strength is likely to be limited. The uncertainty over the last six months over the UK referendum may have significantly deteriorated business sentiment, which is now reflecting in weak economic data on several fronts. This may also result in the BoE delaying rate hikes to give the economy some breathing room following the recent deterioration. Finally, the UK's exceptionally large current account deficit is likely to continue to pose funding challenges going forward.

'Brexit' concerns appeared to have eased recently with the GBP edging higher and fall in volatility

GBP/USD and 2-month implied volatility



Source: Bloomberg, Standard Chartered

Commodity currencies: Some more short-term weakness

The AUD may weaken further from current levels in the short term, although we still do not see it breaching this year's lows.

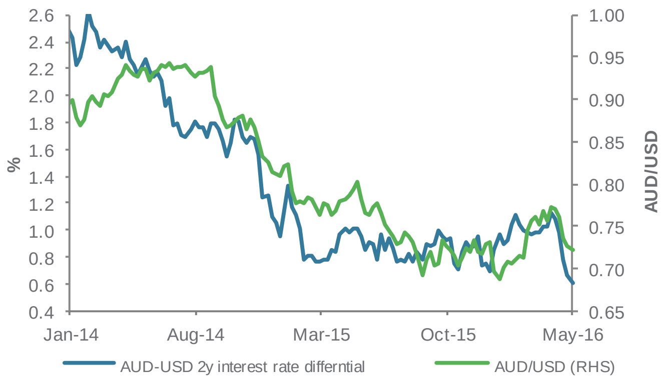
Further short-term weakness in the AUD may come from two areas. First, anticipation of another rate cut by the RBA. Second, a deeper sell-off in equity markets and risk assets, which may hurt the pro-cyclical AUD.

Over a longer-time horizon, we believe downside in the AUD may be limited for three reasons. First, while iron ore prices may weaken further in the short term, we may have already seen the bottom this year, barring any major negative growth surprise from China. Second, relatively high-yielding debt assets are likely to attract interest in Australia's debt assets and support the currency. Third, improvement in Australia's domestic growth and labour market is likely to keep the RBA on the sidelines. Key downside risks are significant commodity price weakness and/or further rate cuts by the RBA.

We expect further weakness in the NZD for two reasons. First, we believe the RBNZ is likely to reduce interest rates further amid weak commodity prices and trade-weighted NZD strength. Second, a stronger USD or risk-off environment is likely to result in weakness of the pro-cyclical NZD. A key risk to this outlook is that the RBNZ remains on hold to mitigate upward pressure on housing prices.

Narrowing rate differentials driving the AUD lower following a policy rate cut

AUD/USD and China iron ore prices



Source: Bloomberg, Standard Chartered

Asia ex-Japan: Look for more weakness amid USD strength

We expect modest weakness in Asia ex-Japan currencies after a strong rally in March-April. We believe this is likely for two main reasons: 1) Seasonal USD strength is likely to be more pronounced as the Fed contemplates its second rate hike, 2) Markets may have become too optimistic on China and Emerging Market (EM) growth, even as there is little evidence of a strong pickup. Within the Asia ex-Japan currency space, we believe the INR and IDR are likely to be most resilient.

The CNY has stabilised against a basket of currencies, but has continued to weaken against the USD. We believe this is likely to continue over the summer. The USD/CNY fixing might move the broader USD trend higher, while authorities keep the trade-weighted CNY stable for the time being. So far, it appears authorities have used periods of USD weakness as an opportunity to weaken the trade-weighted basket, likely in a bid to ease domestic monetary conditions. However, we believe China authorities will continue to use this approach as opposed to a disruptive one-time significant weakness.

We remain bearish on the SGD and expect further weakness over the summer. SGD depreciation has picked up pace, as a Fed rate hike comes into focus. Ultimately, the performance of key trade partner currencies (CNY, MYR and EUR) is likely to guide the SGD's direction near term On the policy band, the SGD has now fallen back into the lower half, and in our view, is likely to move towards the lower bound (see adjacent chart).

Among the regional currency pairs, we are most constructive on the INR and IDR. Although these may weaken slightly further against the USD, they will largely outperform their Asia ex-Japan peers. We believe this outperformance is likely to be for both India and Indonesia, as they are more domestically oriented economies with a continued focus on reform. In addition, high interest rates and prospects of further easing have attracted significant amount of inflows in debt assets, even as flows to the region remains limited.

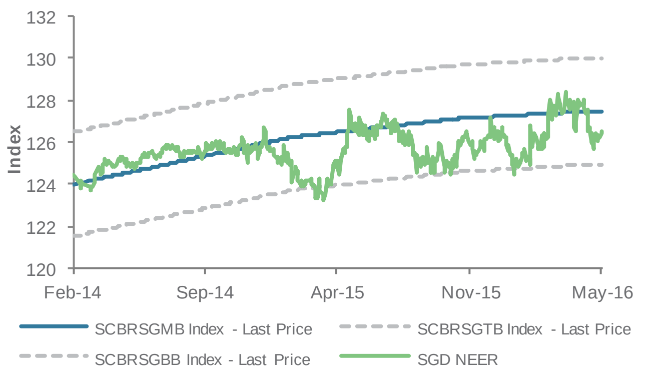
CNY basket stabilising while USD/SGD heads higher

CEFTS CNY basket and USD/CNY

Source: Bloomberg, Standard Chartered

SGD NEER may fall* further to the bottom of the policy band

SGD NEER and policy band



* A weaker SGD NEER means the SGD is weakening against currencies of its trade partners

Source: Bloomberg, Standard Chartered

Disclosure appendix

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