weekly market view

macro strategy | 7 June 2019

This reflects the views of the Wealth Management Group

Editorial

Fed, ECB to the rescue?

- **Increasing signals that Fed officials are open to cutting rates and the ECB is considering restart of bond purchases are likely to provide support to risk assets.**
- **Equities:** We believe fundamentals backing our preference for the energy sector remain supportive, despite the recent declines.
- **Bonds:** Bond markets are pricing in higher chances of Fed rate cuts in the coming months, which could help stabilise growth.
- **FX:** USD is showing signs of fatigue, helping gold to rebound.

What's new?

- **Fed to the rescue?** After a sharp drawdown in May, risk assets reacted positively to first signs from the Fed (including from Chair Jerome Powell) that it is open to cutting rates if growth slows further as trade uncertainty hurts business confidence. Though US services sector activity (PMIs) remained resilient in May, growth is likely to slow in the coming quarters, while inflation stays below the Fed's target. Markets are now pricing in the Fed's first rate cut since 2008 in Q3, followed by 1 more cut by year-end. Waning prospects for a US-China trade agreement in the next few months, coupled with any escalation in tensions with Mexico (which is due to face 5% US tariffs from 10 June), could raise the probability of Fed rate cuts. We saw a similar Fed policy pattern in 1998. (See page 3 for details).
- **ECB hints at restart of its asset purchase program.** The ECB has clearly lost patience with hopes for an economic recovery against the backdrop of 1) weak exports and manufacturing sector activity and 2) disappointing inflation indicators – this week alone saw core consumer inflation slowing to 0.8% in May, producer price inflation continuing its downtrend, and a measure of long-term inflation expectations falling to levels where the ECB last launched its bond-buying programme in 2016.
- **ECB pays banks to borrow.** The main action taken by the ECB was to extend a programme that effectively pays banks to borrow from the ECB, via negative interest rates, and lend to the private sector. However, ECB President Draghi also said that some ECB board members raised the possibility of further rate cuts and restarting the asset purchase program. A supportive ECB (and other global central banks) is a key factor behind our constructive view on risk assets over the next 6-12 months.
- **Oil approaches bear market.** The drop in Brent to c.USD 60/bbl was led by higher-than-expected US supply and stalling global demand. We continue to believe oil markets will remain modestly undersupplied in the coming months as OPEC members continue to restrain output at their 25-26 June meeting. Falling supplies from Venezuela, Iran and Libya and an expected recovery in US demand with the start of the summer driving season should also contribute. These factors are likely to lift prices into the USD65-75/bbl range over the next 6-12 months. From a technical perspective, Brent has next support at its 200-week moving average (c. USD57, 7% below current levels).

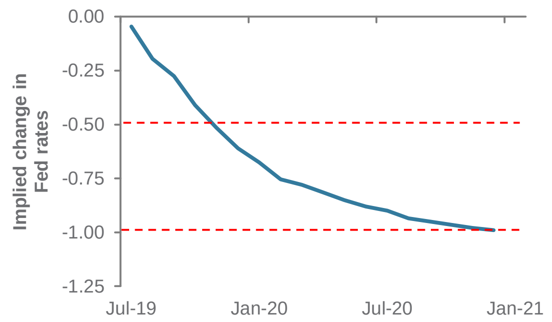
What we are watching

- US-China-Mexico trade; China stimulus; UK premiership contest.

Contents

Markets are pricing in more than two 25bps rate cuts by the end of 2019 and four rate cuts by end-2020

Market implied change in Fed rates over next 18 months



Source: Bloomberg, Standard Chartered

We expect oil prices to recover to USD 65-75/bbl range over the coming months as OPEC supplies tighten and US demand recovers over the summer

Brent crude oil price

Source: Bloomberg, Standard Chartered

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What does this mean for investors?

Global equities rebounded as expectations of Fed rate cuts extended declines in bond yields. The USD weakened.

Equities: What is the energy sector's outlook, given oil prices?

- **Fundamentals remain supportive.** We believe the underlying factors backing our preference for the sector in the US and Europe remain supportive. Valuations are below the long-term average and earnings are recovering from a weak 2018. The consensus estimates 12-month forward earnings growth at 7% in the US and Europe and margins are recovering. Total returns to shareholders are attractive, with a dividend yield of c.6% in Europe and significant share buyback plans by US oil majors.
- **Commodity sectors have historically done well in a late-cycle environment.** Mergers and acquisition activity also picks up in a late-cycle which, given the recently announced deals, further validates our view of where we stand in the cycle.
- **When to add exposure?** We believe investors with exposure to the sector should retain their holdings, while those looking to increase their exposure may wait for the confirmation of support for the Brent price around USD 55/bbl before accumulating. Our 12-month view is for oil prices to rise to the USD 65-75/bbl range.

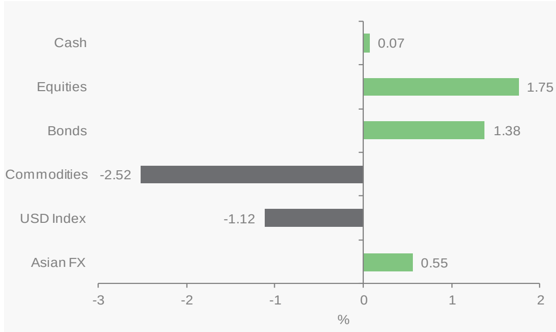
Bonds: What are the low yields in bond markets indicating?

- **Government yields edge lower amid safe-haven demand.** 10-year German government bond yields hit a historical low amid concerns about slowing growth. Also, the premium on the US 10-year government bond yield over the 3-month yield fell further into negative territory. However, the 2-year bond yield has fallen more than long-term yields in the past week, signaling the markets are pricing in higher chances of Fed rate cuts in the coming months, but that this may be enough to stabilise growth.
- **Yields likely near a bottom.** While we do not rule out a further near-term decline in yields should trade tensions escalate, our expectation of an eventual US-China deal leads us to believe that a US recession is unlikely in the next 12 months.
- **EM USD and Asia USD bonds to outperform.** We believe a lot of bad news around global growth has been priced into Emerging Market (EM) bonds. EM USD government bonds continue to offer an attractive yield of nearly 6%, which stands out against a growing share of Developed Market (DM) bonds that now offer negative yields. Meanwhile, Asian bonds remain resilient amid strong regional demand and high credit quality. Indications that China may restrict USD bond sales by local issuers could lead to a reduction in bond supply, which should support Asian bonds.

FX: Is the USD rally fading?

- **USD showing signs of fatigue.** This week's dovish Fed comments triggered a retreat in the USD. The USD index's failure to break past resistance at the April high after two attempts, despite reduced risk appetite, implies that it is not ripe for a bullish breakout. We expect the USD to stay in a range against major currencies (except the GBP). The USD index is now testing key support at the mid-May low of 97.02. Any break below this would further increase the odds that a broader range is developing.
- **Gold shining again.** Gold has risen 4% over the past week amid the USD's weakness and the fall in US real yields. It has rebounded from a strong support of 1,266. The break above resistance at the mid-May high of 1,303 has triggered a double-bottom pattern, implying a rise towards 1,338. Any break above the February high of 1,347 could clear the way toward the 2016 high of 1,375.

Benchmark (USD) performance w/w*



**Week of 30 May 2019 to 06 June 2019*

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

US equity market technicals are positive

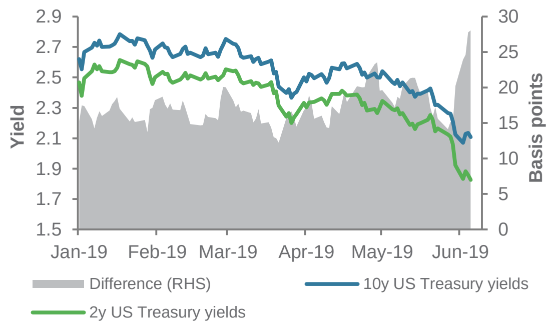
Technical levels of key market indicators as on 06 June

Index	Spot	1st support	1st resistance	Short-term trend
S&P500	2,843	2,765	2,895	↑
STOXX 50	3,338	3,210	3,351	↘
FTSE 100	7,260	7,134	7,287	↘
Nikkei 225	20,774	20,300	21,415	↓
Shanghai Comp	2,828	2,800	2,956	↘
Hang Seng	26,965	26,275	27,950	↓
MSCI Asia ex-Japan	619	595	637	↓
MSCI EM	1,003	982	1,030	↓
Brent (ICE)	62	55	67	↓
Gold	1,333	1,300	1,347	↑
UST 10Y Yield	2.12	1.93	2.35	↓

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

The decline in bond yields, especially for shorter-tenure bonds, indicate markets are pricing in Fed rate cuts, which should help stabilise growth

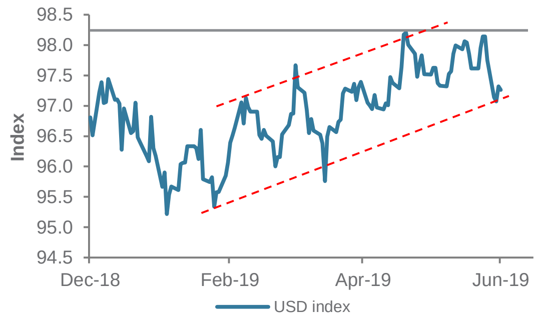
US 2-year and 10-year Treasury yields; yield difference



Source: Bloomberg, Standard Chartered

The USD index is testing a key support

USD index



Source: Bloomberg, Standard Chartered

Top client questions

Q1. What are the implications from a potential Fed rate cut?

Speculation that the US Federal Reserve is about to cut interest rates has intensified as one measure of the yield curve (the difference between the 3-month and 10-year government bond yields) has inverted again. Some recent economic data, especially in the manufacturing sector, have been disappointing, but the Fed has signalled its willingness to ease policy should conditions warrant.

This situation is reminiscent of late 1998. Then business confidence started to fall on the back of concerns over the impact of Long Term Capital Management (LTCM) and the Russian debt crisis on the solvency of the US banking system. This time, business confidence is being undermined by uncertainties created by trade wars and the potential long-term reversal of globalisation.

In 1998, the solution was three rate cuts and a Fed-engineered banking sector bailout of LTCM. The corresponding solution this time might be even looser monetary policy settings and a more conciliatory tone from the White House on trade issues. The benefit for Trump could be a repeat of the 1998-1999 playbook – an accelerating economy in 2020, a US Presidential election year.

While the Fed is, for now, suggesting a steady policy outlook, its tolerance for weaker economic data is probably diminishing. The market is now pricing in more than two rate cuts by the end of this year. The 1998 experience may give us some hints at what could trigger the Fed to cut rates (temporarily).

In 1998, the Fed cut rates when the gap between market implied 3-month interest rate for December 1999 fell to c.1% below the prevailing Fed Funds rate. At 0.8% currently (for Dec. 2020), the gap is fast approaching that level. Hence, a rate cut cannot be ruled out.

For an investor, what a rate cut says about a recession risk is key. Since 1982, the Fed has always cut rates before a recession, but a rate cut does not mean a recession is imminent. The 1998 episode saw the Fed cutting rates thrice, three years prior to the 2001 recession. Credit spreads widened, bond yields and equities fell well in advance of the cut, not dissimilar to today.

However, 12 months after the initial rate cut, risk assets delivered healthy returns, while bonds with high credit quality struggled. Interestingly, unlike the prior Fed cutting episodes, high yield spreads did not widen sharply during 1998, and the economic backdrop was strong enough for the Fed to resume hiking by July 1999.

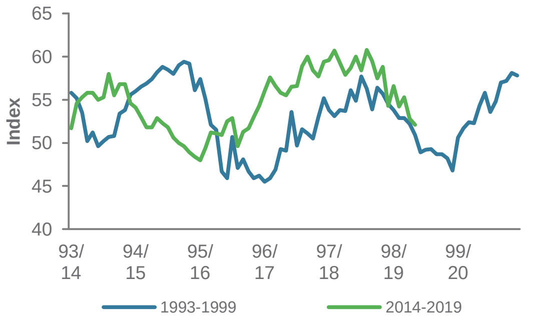
In terms of equities, the US delivered a strong positive performance, but underperformed Emerging Markets (EM). This should not come as a surprise, given EM assets were recovering from the 1997 Asian Financial Crisis and investors' prior concerns about the impact of higher rates on EM assets before the Fed started easing.

In conclusion, there are three key takeaways:

- **Darkest before dawn** – While we remain concerned about the near-term outlook, we do not believe this is the end of the economic cycle or equity bull market. Therefore, we are adopting a buy-on-dips strategy.
- **Value income** – The dovish pivot by the Fed should continue to drive demand for yield and carry-related strategies.
- **Be nimble, be quick** – For investors, a defensive tilt may make sense. Any further dovish pivot may be due to growth concerns, hence may come with more market volatility.

Are we heading for a US interest rate cut?

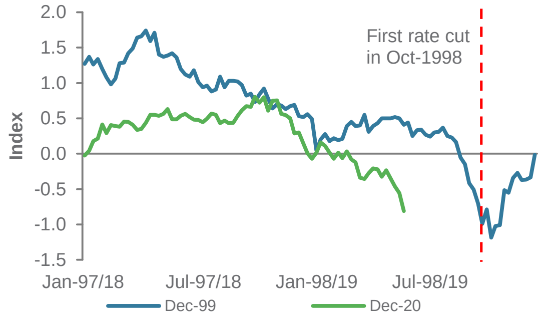
US ISM manufacturing index: A comparison between now and in the run-up to the 3 Fed rate cuts in 1998



Source: Bloomberg, Standard Chartered

It is normal for the Fed to lag the market

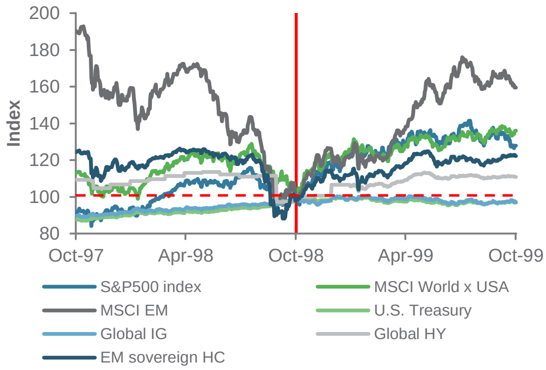
Difference between market-implied 3-month interest rates for end-1999 and end-2020 and the respective prevailing Fed Funds rate before any rate cut



Source: Bloomberg, Standard Chartered

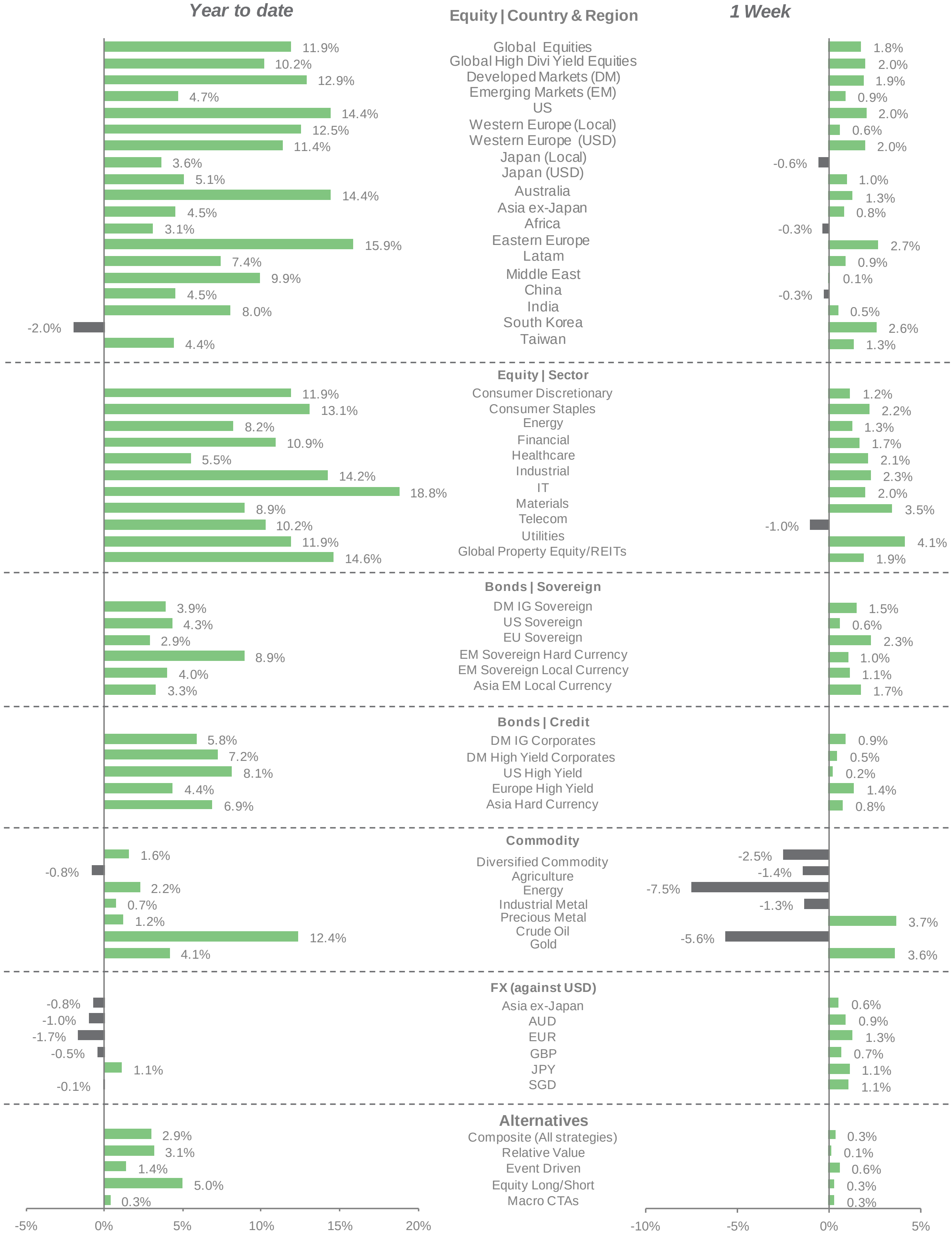
In the 1998 episode, risk assets continued to deliver post the initial Fed rate cut

Performance of various asset classes 1 year before and after the first rate cut in 1998



Source: Bloomberg, Standard Chartered

Market performance summary*



*Performance in USD terms unless otherwise stated, YTD period from 31 December 2018 to 06 June 2019, 1 week period: 30 May 2019 to 06 June 2019

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

Economic & Market Calendar

	Event	Next Week	Date	Period	Expected	Prior
MON	CH	Exports y/y	10-Jun-19	May	-3.8%	-2.7%
TUE	UK	Average Weekly Earnings 3m/y/y	11-Jun-19	Apr	–	3.2%
	EC	Sentix Investor Confidence	11-Jun-19	Jun	–	5.3
	US	PPI Ex Food and Energy y/y	11-Jun-19	May	2.3%	2.4%
WED	JN	Core Machine Orders y/y	12-Jun-19	Apr	-4.5%	-0.7%
	CH	CPI y/y	12-Jun-19	May	2.7%	2.5%
	CH	PPI y/y	12-Jun-19	May	0.6%	0.9%
	IN	CPI y/y	12-Jun-19	May	3.1%	2.9%
	IN	Industrial Production y/y	12-Jun-19	Apr	1.2%	-0.1%
	US	CPI Ex Food and Energy y/y	12-Jun-19	May	2.1%	2.1%
	IN	Exports y/y	12-Jun-19	May	–	0.6%
FRI/SAT	CH	Fixed Assets Ex Rural YTD y/y	14-Jun-19	May	6.1%	6.1%
	CH	Industrial Production y/y	14-Jun-19	May	5.5%	5.4%
	CH	Retail Sales y/y	14-Jun-19	May	8.0%	7.2%
	US	Retail Sales Ex Auto and Gas	14-Jun-19	May	–	-0.2%
	US	Industrial Production m/m	14-Jun-19	May	0.2%	-0.5%
	US	U. of Mich. Sentiment	14-Jun-19	Jun P	97	100

	Event	This Week	Date	Period	Actual	Prior
MON	SK	Nikkei South Korea PMI Mfg	03-Jun-19	May	48.4	50.2
	US	ISM Manufacturing	03-Jun-19	May	52.1	52.8
TUE	AU	RBA Cash Rate Target	04-Jun-19	4-Jun	1.25%	1.5%
	EC	Unemployment Rate	04-Jun-19	Apr	7.6%	7.7%
	EC	CPI Core y/y	04-Jun-19	May A	0.8%	1.3%
WED	JN	Nikkei Japan PMI Composite	05-Jun-19	May	50.7	50.8
	CH	Caixin China PMI Composite	05-Jun-19	May	51.5	52.7
	UK	Markit/CIPS UK Composite PMI	05-Jun-19	May	50.9	50.9
	EC	PPI y/y	05-Jun-19	Apr	2.6%	2.9%
	EC	Retail Sales y/y	05-Jun-19	Apr	1.5%	2.0%
	US	ISM Non-Manufacturing Index	05-Jun-19	May	56.9	55.5
THUR	GE	Factory Orders WDA y/y	06-Jun-19	Apr	-5.3%	-5.9%
	IN	RBI Repurchase Rate	06-Jun-19	6-Jun	5.75%	6.0%
FRI/SAT	GE	Industrial Production WDA y/y	07-Jun-19	Apr	–	-0.9%
	GE	Exports SA m/m	07-Jun-19	Apr	–	1.6%
	US	Change in Nonfarm Payrolls	07-Jun-19	May	–	263k
	US	Average Hourly Earnings y/y	07-Jun-19	May	–	3.2%

Previous data are for the preceding period unless otherwise indicated

Data are % change on previous period unless otherwise indicated

P - preliminary data, F - final data, sa - seasonally adjusted

y/y – year-on-year, m/m - month-on-month

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

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