weekly market view

macro strategy | 4 January 2019

This reflects the views of the Wealth Management Group

Editorial

Growth jitters

- **Fundamentals, technicals argue waiting for confirmation markets are bottoming before considering adding to US equities. Policymaker comments, US and China data are key.**
- **Equities:** Softening US earnings expectations are a concern, but Asian equity outperformance over the US may not last.
- **Bonds:** US 10-year yields may rebound if risk appetite returns.
- **FX:** Short-term bullish on GBP/USD and EUR/USD.

What's new?

- **DM equities face brunt of slowdown fears.** Since we published our *Outlook 2019* on 10 December 2018, global equities have fallen -4.6%. Over this period, Developed Markets (DM) riskier asset classes fell disproportionately: the S&P 500 and US HY bond indices fell -7.1% and -1.6%, respectively, while Asia ex-Japan equities fell a more modest -2.8% and Asia HY rose 0.5%. Gold and the JPY gained, while the USD was slightly lower.
- **Cash, bonds outperform, re-emphasising the importance of diversification.** Since we published our *Outlook 2019* (10 December), our moderate Asia-focused and Global Tactical Asset Allocation have returned -0.5% and -0.8%, respectively. However, our sample 'recession allocation' rose 0.5% as cash (our preferred asset) and bonds outperformed equities.
- **Fundamentals point to slowing, but not collapsing, growth.** Three of our preferred growth (and potential recession) indicators have slowed but not collapsed. Business confidence (PMI) indices have slowed in the US, the Euro area and China, though all remain at or above levels seen over 2014 to 2016. The all-important US yield curve (the gap between 10-year and 2-year yields) has remained rangebound over the past month and is still positive, suggesting markets are not yet expecting a recession for some time to come, a view we share. Finally, US equity earnings and profit margin expectations have been revised lower, but remain firmly in positive territory. Bond markets now expect no Fed rate hikes in 2019. See page 2 for details on earnings and bond yields.
- **Technicals suggest patience before rotating back to equities.** As discussed last week, major equity markets have rebounded from very important technical levels, but we still require a confirmation that markets are bottoming. Hence, we believe risk/reward favours patience for the time being. History also offers some insight – as the chart illustrates, a 1998 mid-cycle style outcome would suggest markets could bottom soon following a growth scare and that strong late-cycle returns are yet ahead of us. However, the equities rebound may fail to sustain in a 2000 recession-style outcome. See page 3 for a detailed discussion.

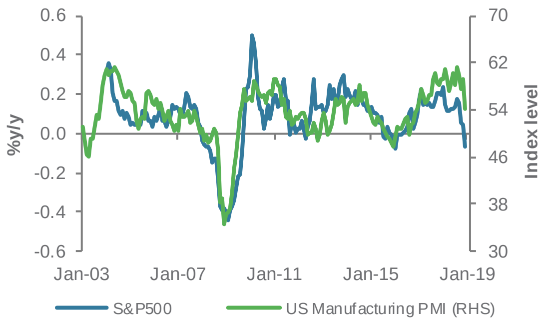
What we are watching

- **Policymaker comments, data are key.** Markets are likely to continue to be sensitive to comments from Fed Chair Powell and other Fed policymakers who are scheduled to speak in the coming week. Signs of progress on ending the US government shutdown, with Congress coming back into session, and any progress on US-China trade talks (starting 7-Jan) would be positives. Global PMI and US employment data due next week will be watched closely.

Contents

US equities pricing in a greater economic slowdown than we expect

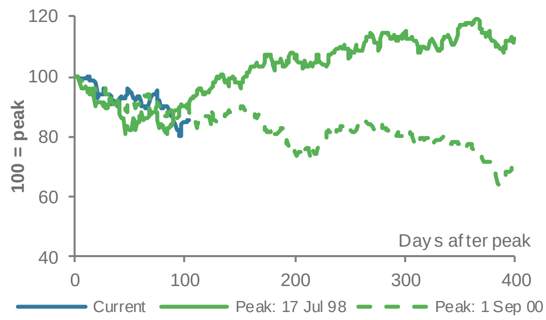
S&P500 %y/y change vs. ISM Manufacturing



Source: Bloomberg, Standard Chartered

If this is another mid-cycle pullback, history suggests weakness may have run its course; however, pre-recession sell-offs have historically run much further

S&P500 performance from 1998, 2000, current peaks



Source: Bloomberg, Standard Chartered

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What does this mean for investors?

Global equities fell further amid US and China growth worries. Treasuries gained while the USD eased.

Equities: Asia outperformance relative to the US may not last

- **Asian equities outperformed the US in December.** Asian equities (MSCI Asia ex-Japan) declined 14% in USD terms in 2018, underperforming US equity markets by 10%. However, December witnessed a sharp reversal, with Asia outperforming the US by almost 7% (though both were lower).
- **Three drivers to watch.** To take a view on whether the outperformance of Asian equities over the US will continue, we need to have a clear view on the outlook for the drivers that brought about the outperformance in December. Three drivers stood out as favouring Asian equites during this period: (i) US analyst earnings downgrades outpacing upgrades, (ii) a reversal of the extreme P/E ratio discount of Asian equities versus global, and (iii) moderate USD weakness.
- **US earnings downgrades outpacing upgrades.** We believe US earnings downgrades are set to continue, noting that December was the first month in two years when downgrades outpaced upgrades. Asian equity valuations relative to global are now back to their long-term average P/E discount. Short-term trading opportunities notwithstanding, we also believe there is more upside than downside risks for the USD in the early part of 2019.
- **Further Asian equity outperformance may be short-lived.** While not wanting to be too mechanical, the sum of these factors suggests Asian equities' outperformance in December may not persist. Risks to this view include a US-China trade deal, which would be positive for Asian equites, and significant liquidity easing in China, which would ease financial conditions.

Bonds: Fed rate hikes in 2019 no longer priced

- **Treasury yields fall as 2019 Fed hike expectations scaled back.** The 10-year Treasury yield fell by 30bps to 2.55% since we published the *Outlook 2019* on 10 December 2018. This has taken the yield below the 2.62-2.64% technical support and opened 2.52% as the next major support level. Markets now also expect no Fed rate hikes in 2019 and, instead, are pricing a partial probability of a Fed rate cut. This raises the risk that yields could rebound should markets conclude the growth slowdown is not as significant as it currently fears.
- **Lower yields partly offset wider yield premiums.** Yield premiums over Treasuries (or credit spreads) widened for most corporate and Emerging Market (EM) bonds. We still believe a maturity profile centred around five years offers the best risk/reward as a rebound in risk appetite from here would mean at least modestly higher bond yields.

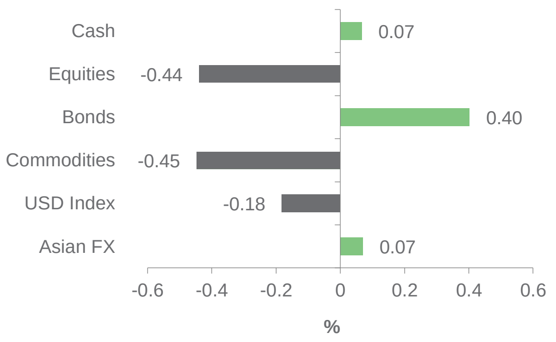
FX: Short-term bullish GBP and EUR

- **Falling US rate expectations, technicals to support.** A pricing out of Fed rate hikes in 2019 may reverse at some point, but we believe this has created a short-term opportunity by reducing one source of support for the USD. We believe GBP may be one beneficiary given a likely pricing in of most negatives and oversold technicals. EUR may gain amid diminishing Italy political worries.

Commodities: Brent oil rebounds, but we favour gold

- **Output cuts support oil.** Supply cuts, both intentional (mainly from Saudi Arabia) and unintentional (including outages in Libya), helped support oil following concerns of a surge in US oil supply and soft demand growth worries.

Benchmark (USD) performance w/w*



**Week of 27 December 2018 to 3 January 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)

Equity technicals remain weak

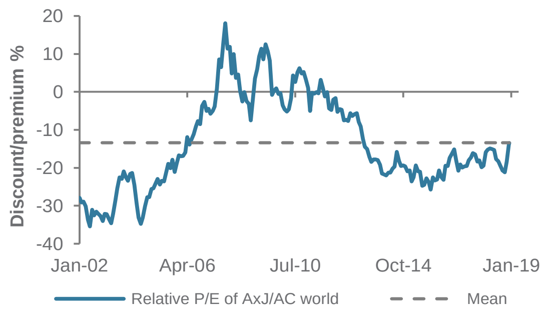
Technical levels of key market indicators as on 3 Jan

Index	Spot	1st support	1st resistance	Short-term trend
S&P500	2,448	2,345	2,530	↘
STOXX 50	2,955	2,908	3,064	↘
FTSE 100	6,693	6,536	6,910	↘
Nikkei 225	20,015	18,950	21,240	↓
Shanghai Comp	2,464	2,380	2,645	↓
Hang Seng	25,064	23,800	26,600	↓
MSCI Asia ex-Japan	579	568	615	↓
MSCI EM	950	930	987	↓
Brent (ICE)	56	48	57	↓
Gold	1,296	1,250	1,305	↗
UST 10Y Yield	2.55	2.52	2.82	↘

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

Asia ex-Japan valuation discount back to historical averages

US-Asia relative P/E valuations



Source: Bloomberg, Standard Chartered

US 10-year Treasury yield close to support

10-year US Treasury yield (%)

Source: Bloomberg, Standard Chartered

Top client questions

Q1. What can we learn from prior equity market corrections of similar magnitude?

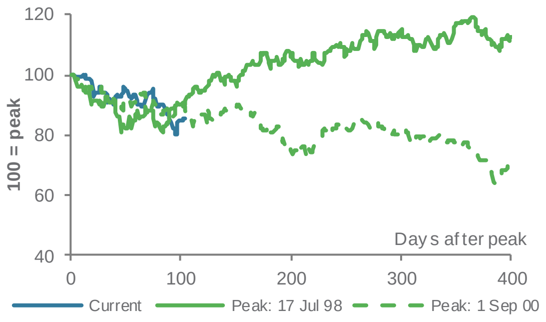
The US S&P 500 index corrected almost 20% peak-to-trough from mid-September to late December 2018. Though this may seem a large move, it remains within the bounds of past mid-cycle corrections of similar magnitude. Specifically, the index fell about 20% in 1998, 2011 and 2015 before eventually recovering and reaching new highs.

This template alone would suggest that the US stock market decline offers an attractive buying opportunity. However, it is not that simple. If one extends the history of this analysis to include past recessions, the market return by itself tells you very little about whether the correction will end here (a mid-cycle correction) or extend further (a recessionary bear market). The range of returns on a prospective 6-12 month basis is very wide.

Therefore, the future path depends on how key catalysts develop in the coming weeks, including recession likelihood indicators, US-China trade talks and US policymaker comments and actions. Our central scenario is current weakness will ultimately prove to be a buying opportunity. However, our expectation for occasional bouts of volatility and a 30% probability of a recession in the next 12 months mean we are keen to ensure any equity market exposure is married with a significant allocation to both bonds and cash.

If this is another mid-cycle pullback, history suggests weakness may have run its course; however, pre-recession sell-offs have historically run much further

S&P500 performance from 1998, 2000, current peaks



Source: Bloomberg, Standard Chartered

Q2. Do technicals argue it is time to buy US equities?

Not yet (timeframe 4-6 weeks). The odds of a consolidation or minor rebound have risen, in our view, but the short-term risk/reward is not yet compelling.

As we outlined last week, sentiment indicators are looking stretched. The put-call ratio (one tool to gauge market sentiment via the ratio of investors taking bearish [put] or bullish [call] views), the American Association of Individual Investors (AAII) Bearish Sentiment index and our own measure of market diversity all suggest that 'peak pessimism' may have been achieved at last week's S&P500 low of 2,347.

Furthermore, the S&P500 is close to strong support: the 200-week moving average (WMA) and an uptrend line from the Global Financial Crisis low. The index has also posted a bullish reversal on the weekly charts from these two supports, and last week's low coincided with the 127.2% Fibonacci projection of the October slide. Therefore, the 'set-up' for a consolidation or rebound seems to be in place.

However, these are necessary but not sufficient conditions, in our view. It is not yet clear whether the rebound from last week is simply a pause in the downtrend or the start of an uptrend.

The most important indicator to watch from here would be any break of resistance. The immediate resistance on the daily chart is the 30-day moving average (DMA), which roughly coincides with the February low of 2,533. A break above the resistance would indicate that the downward pressure had faded.

The November high of 2,815 is the subsequent key resistance level. A break of this level would likely signal an extended rebound, while a failure could indicate a sideways range (likely between 2,350 and 2,800). Other indicators to watch include volume and momentum on any rebound and whether the index makes higher lows or lower lows.

In conclusion, recent market moves have raised the temptation to add to US equity exposure. However, we believe risk/reward favours waiting for a confirmation that markets have indeed bottomed before drawing a firm conclusion.

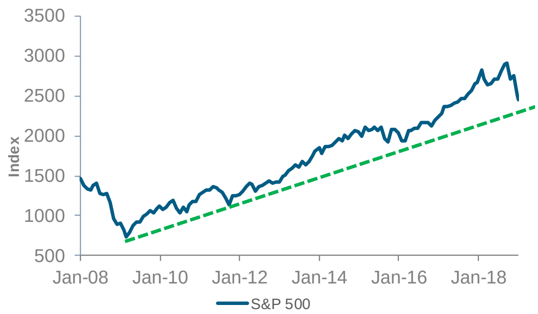
US stock market strong support at the 200WMA

S&P500 Index (short-term)

Source: Bloomberg, Standard Chartered

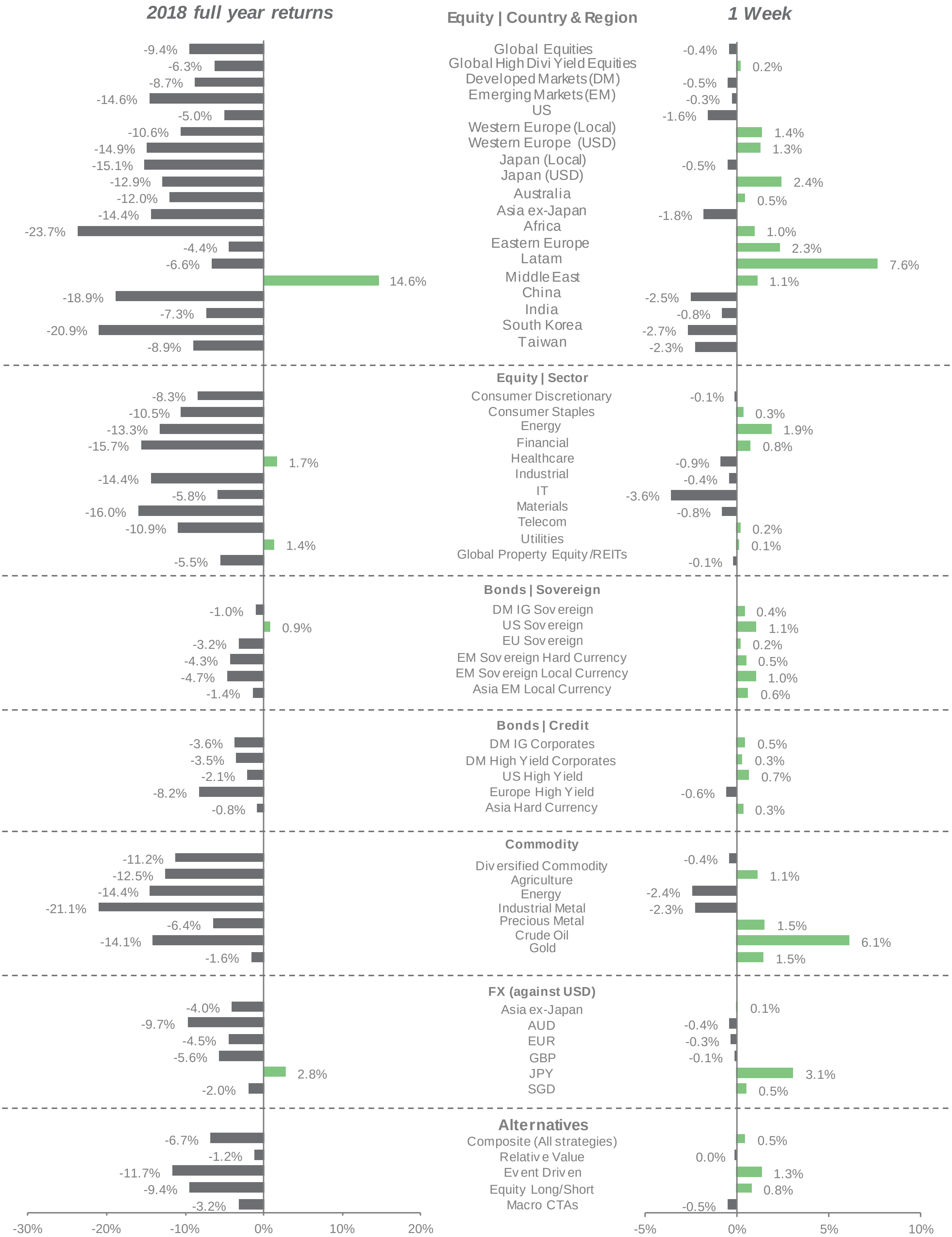
A monthly perspective shows the US equity market remains above the post-2008 uptrend

S&P500 Index (long-term)



Source: Bloomberg, Standard Chartered

Market performance summary*



**Performance in USD terms unless otherwise stated, 2018 full-year returns period from 31 December 2017 to 31 December 2018, 1 week period: 27 December 2018 to 3 January 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	GE	Factory Orders WDA y/y	07-Jan-19	Nov	–	-2.7%
	EC	Sentix Investor Confidence	07-Jan-19	Jan	–	-0.3
	EC	Retail Sales y/y	07-Jan-19	Nov	–	1.7%
	IN	GDP Annual Estimate y/y	07-Jan-19	2019	–	6.7%
	US	ISM Non-Manufacturing Index	07-Jan-19	Dec	59.2	60.7
TUE	GE	Industrial Production WDA y/y	08-Jan-19	Nov	–	1.6%
	EC	Economic Confidence	08-Jan-19	Dec	–	109.5
	US	Trade Balance	08-Jan-19	Nov	-$53.2b	-$55.5b
WED	GE	Exports SA m/m	09-Jan-19	Nov	–	0.9%
	EC	Unemployment Rate	09-Jan-19	Nov	–	8.1%
	CH	CPI y/y	09-Jan-19	Dec	–	2.2%
	CH	PPI y/y	09-Jan-19	Dec	–	2.7%
THUR	US	Initial Jobless Claims	10-Jan-19	5-Jan	–	–
FRI/SAT	IN	Industrial Production y/y	11-Jan-19	Nov	–	8.1%
	US	CPI Ex Food and Energy y/y	11-Jan-19	Dec	2.1%	2.2%

	Event	This Week	Date	Period	Actual	Prior
FRI	US	Advance Goods Trade Balance	28-Dec-18	Nov	–	-$77.2b
	JN	Tokyo CPI y/y	28-Dec-18	Dec	0.3%	0.8%
	JN	Tokyo CPI Ex-Fresh Food y/y	28-Dec-18	Dec	0.9%	1.0%
	JN	Industrial Production y/y	28-Dec-18	Nov P	1.4%	4.2%
	JN	Retail Trade y/y	28-Dec-18	Nov	1.4%	3.5%
	CH	BoP Current Account Balance	28-Dec-18	3Q F	$23.3bn	$16.0b
MON	CH	Manufacturing PMI	31-Dec-18	Dec	49.4	50
WED	EC	Markit Eurozone Manufacturing PMI	02-Jan-19	Dec F	51.4	51.4
	SI	GDP y/y	02-Jan-19	4Q A	2.2%	2.2%
	CH	Caixin China PMI Mfg	02-Jan-19	Dec	49.7	50.2
THUR	US	ADP Employment Change	03-Jan-19	Dec	271k	179k
	US	Initial Jobless Claims	03-Jan-19	29-Dec	231k	–
	US	ISM Manufacturing	03-Jan-19	Dec	54.1	59.3
FRI/SAT	EC	Markit Eurozone Composite PMI	04-Jan-19	Dec F	–	51.3
	EC	PPI y/y	04-Jan-19	Nov	–	4.9%
	EC	CPI Core y/y	04-Jan-19	Dec A	–	1.0%
	US	Change in Nonfarm Payrolls	04-Jan-19	Dec	–	155k
	US	Unemployment Rate	04-Jan-19	Dec	–	3.7%
	US	Average Hourly Earnings y/y	04-Jan-19	Dec	–	3.1%

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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