weekly **market view**

macro strategy | 26 October 2018

This reflects the views of the Wealth Management Group

Editorial

Staying diversified is key

- **Global equities sentiment remains fragile, with near-term technicals challenged, but earnings could offer support. It is important to stay diversified to offset the volatility.**
- **Equities:** Q3 earnings is the main theme in the coming weeks. Reports thus far offer some reassurance against still-weak technicals (see page 3).
- **Bonds:** Italy's budget impasse is a risk for Developed Market bonds; we continue to prefer Emerging Market (EM) bonds.
- **FX:** Prefer to buy the USD on dips vs the EUR. We continue to see opportunities in gold (see page 3 for a detailed discussion).

What's new?

- **Diversification wins as global equities see renewed tumble** amid growth and earnings worries. The S&P500 index almost erased YTD gains, while the tech-heavy Nasdaq index entered a correction phase. The VIX volatility gauge in recent weeks has moved to its highest since February. We see recent weakness as a reminder that, while we expect equities to outperform cash and bonds, market volatility and in turn equity market fluctuations increase as the business cycle matures. This is why we believe increasingly diversified investment allocations remain prudent. Near term, a decisive break in the S&P500's support at the June low would pave the way towards the February low of 2,532, in our view. Upcoming earnings also remain key.
- **Chinese authorities offer measured support.** Recent steps have focused on supporting debt sales by private companies, tax cuts and reduced restrictions on foreign investment. Many measures, including an investment plan by top securities firms, were also specifically aimed at tackling concerns that shares pledged as borrowing collateral could lead to forced selling. However, efforts to support the economy remain specific as policymakers continue to strike a balance between supporting growth while maintaining the focus on deleveraging. We expect this approach to continue. For Chinese equity markets, upcoming Q3 earnings season and the CNY are likely to be key drivers (see page 3). Near term technicals for Hang Seng China Enterprises index (HSCEI) suggest support at 9,600.
- **Italy budget disagreement risks temporary volatility spike.** European Union (EU) policymakers rejected Italy's proposed budget deficit plan. However, Italian policymakers said they would not amend the budget, setting the stage for a showdown. Italy continued to be rated at Investment Grade (IG), despite a rating downgrade, which likely helped assuage market worries. We see the deficit disagreement as potentially posing a risk for near-term sentiment (via rising Italian government bond yield premiums over German Bunds). Having said that, a reasonably strong Q3 earnings season is likely to support Euro area equities, supporting our 'Core Holding' view.

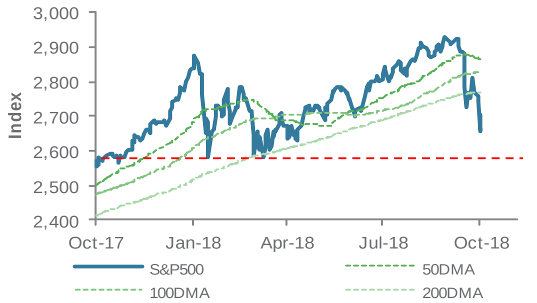
What we are watching

- **US employment report, Bank of Japan meeting and PMI data** across major regions are likely to be in focus next week. The US mid-term elections are also scheduled for November 9.

Contents

US equities are testing June-low support; a decisive break could pave the way towards February lows

S&P500 equity indices



Source: Bloomberg, Standard Chartered

Market behaviour since September illustrates the benefits of staying diversified across asset classes

MSCI AC World Total Return index (equities), Citi WorldBIG Index (bonds), Bloomberg Commodities Gold Sub-Index Total Return

Source: Bloomberg, Standard Chartered; 31-Aug-2018=100

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What does this mean for investors?

Global equities resumed their decline, with broad-based losses across regions amid concerns about global growth and earnings. Commodities extended declines, while the USD extended gains.

Equities: Earnings remain in focus

- **Peak earnings worries.** One key driver of US equity market weakness has been concerns that corporate earnings have peaked. Our analysis highlights that while earnings *growth* peaked in Q2 at 26%, this is not the same as peak earnings. US corporate earnings will continue to grow, rising in 2019 (consensus expects 10% growth), which is above the long-term average earnings growth rate of 9%. Nevertheless, we acknowledge that a growth rate deceleration may increase market volatility as investors adjust to the slower earnings growth environment. US equities remain preferred.
- **Auto and banking sectors drag Euro area earnings.** The auto sector has declined due to a further slump in diesel auto sales in Europe. Sales declined 30% and 20%, respectively, in the UK and Germany in H1 18. Euro area banks have been negatively impacted by weak growth expectations heading into the earnings season. Euro areas equities are a Core holding.
- **China Q3 earnings kick off.** Of the companies which have preannounced profit alerts, materials and healthcare sectors show the most beats, while consumer staples show the most misses. Banking sector earnings available so far indicate in-line results with a slight improvement in non-performing loans. This is reassuring, given the tightened credit and liquidity situation in Q3. Consensus 12-month forward EPS growth for China is 15.4%, which is above the long-term average of 12%.

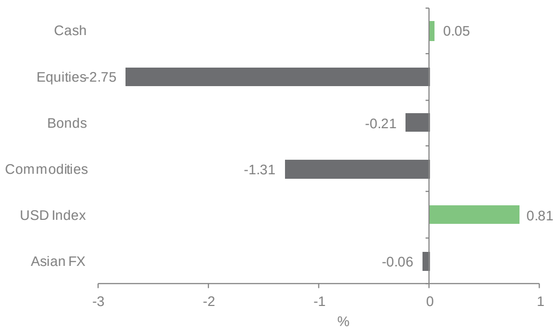
Bonds: US High Yield (HY) hurt

- **Risk-off sentiment drags US HY bonds.** Yield premiums increased amid weak sentiment as well as falling oil prices. The yield premiums have increased by over 50bps since they hit a decade-low in early October. Though valuations have become less extreme, they still remain stretched. Overall, we like the attractive yield and the low interest rate sensitivity of the bonds and continue to view them as a core holding.
- **EM bonds (USD and local currency) declined** amid weak sentiment and USD gains. We continue to favour EM USD government bonds as yield premiums have increased nearly 75bps since the start of the year, suggesting reasonable value. Asian USD bond yield premiums also rose on China concerns and heavy supply. However, we see supply as a short-term headwind; longer term, we continue to like Asia USD bonds as a core holding due to their relatively low volatility.

FX: EUR under pressure amid USD strength

- **EUR/USD likely to test August low.** EUR/USD fell to a two-month low on concerns of slower Euro area growth, Italy's budget worries and Fed policymaker comments that the Fed is likely to maintain its gradual rate hike path. EUR/USD's break below support at 1.1429 has opened the way towards the August low of 1.1297, in our view. We see this as consistent with near-term gains in the USD.
- **GBP/USD under pressure amid renewed Brexit uncertainty.** Reports of renewed challenges to UK Prime Minister May's leadership and a continued flow of Brexit news put downward pressure on the GBP. GBP/USD has broken below the early-October support at 1.2919, paving the way towards 1.2783 (September low), in our view.

Benchmark (USD) performance w/w*



**Week of 18 October 2018 to 25 October 2018*

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

Most equity market technicals remain weak

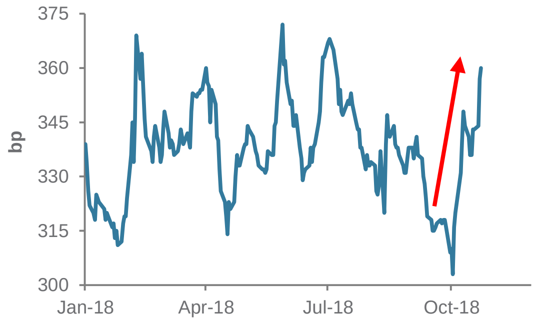
Technical levels of key market indicators as on 25 Oct.

Index	Spot	1st support	1st resistance	Short-term trend
S&P500	2,706	2,630	2,742	↓
STOXX 50	3,164	3,110	3,248	↘
FTSE 100	7,004	6,865	7,115	↘
Nikkei 225	21,413	20,350	22,510	↓
Shanghai Comp	2,604	2,450	2,665	↘
Hang Seng	24,994	23,400	26,250	↓
MSCI Asia ex-Japan	580	560	628	↓
MSCI EM	949	920	1,015	↓
Brent (ICE)	76	73	81	↘
Gold	1,231	1,200	1,240	↑
UST 10Y Yield	3.11	3.02	3.27	↗

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

US HY bonds have weakened vs. government bonds

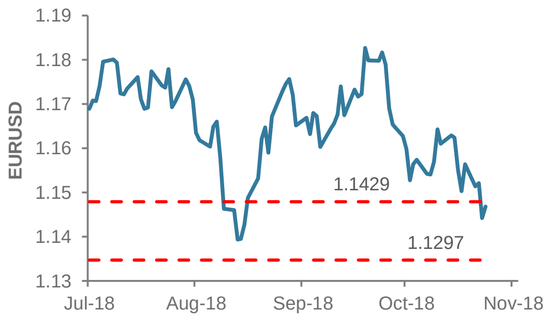
US High Yield spreads (yield premium over Treasuries)



Source: Bloomberg, Standard Chartered

Growth, Italy worries to keep EUR/USD under pressure near term

EUR/USD



Source: Bloomberg, Standard Chartered

Top client questions

Q1. What can technical indicators tell us about the outlook for Asia ex-Japan equity markets?

The MSCI Asia ex-Japan index is down 26% from its peak of 781 hit at the start of the year, raising questions regarding the extent of the downside. In this regard, we could use previous correction episodes as a guide.

There have been two significant corrections since the Great Financial Crisis (GFC) – 2011 and 2015-2016. The 2011 correction, led by a combination of European sovereign crisis and high oil prices, lasted for six months with a peak-to-trough decline of 31%. The 2015-2016 correction, after the US Federal Reserve planted the seeds for reducing monetary accommodation, lasted for nine months with a peak-to-trough decline of 32%. The current downtrend is now into its ninth month with a peak-to-trough decline of 26% so far.

So, in terms of the duration of the decline, the current decline is within the previous ranges. In terms of the extent of the decline, the current correction is lesser. But then price action is still unfolding, and there could be further declines in the near term. Using 31-32% as a guide, the current downtrend could have another 5%-7% decline. A 6% decline from current levels would take the index to 544, which is close to a major support -- the 200-month moving average (now at 560) and a long-term uptrend line from GFC (see chart). While the index did briefly dip below the 200-month moving average during the GFC and in 2015-2016, it wasn't able to sustain decisively below the average. In 2011, the index rebounded from the average. Based on these prior corrections, the current decline could be in its advanced stages.

Major support about 5-7% below current levels

MSCI Asia ex-Japan index

Source: Bloomberg, Standard Chartered

Q2. Can gold rise further?

Gold rallied sharply late last week, breaking through USD 1,210-1,215/oz resistance levels. Subsequent price action has seen USD 1,215/oz support hold as the rally has paused below USD 1,240/oz. The latest rally was triggered and supported by unwinding of short positions that accumulated during the April to August decline from USD 1,365/oz to USD 1,160/oz.

In this context, we view the current recovery as step towards further gains. The short-term momentum is solid, and we expect resistance at USD 1,240/oz could be broken taking gold higher. Support at the USD 1,215/oz area should hold if the rally continues. However, a clear break below would suggest the short-term recovery might be complete.

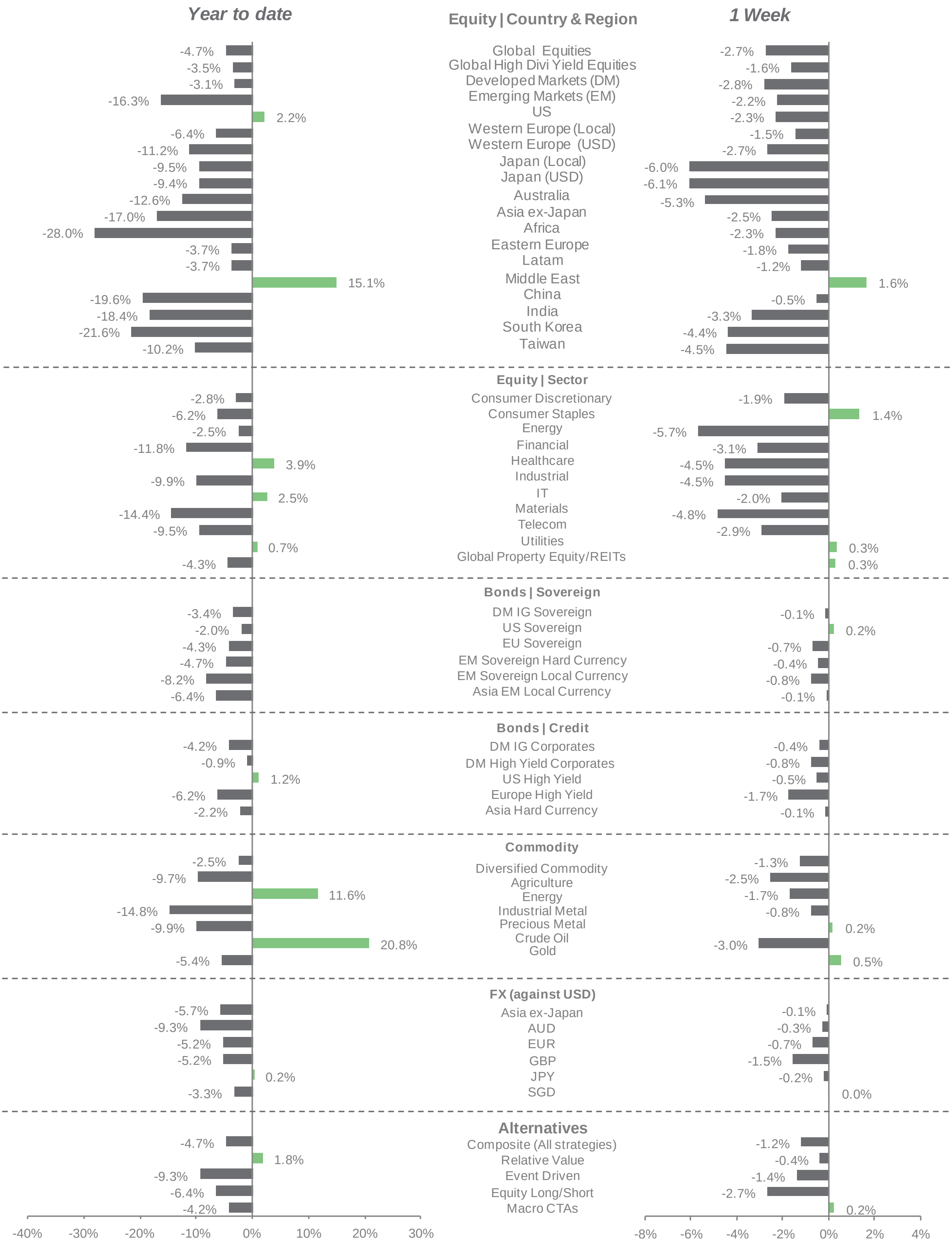
We will be watching how price action unfolds over the coming days to consider gold's longer-term prospects. We currently recommend that diversified portfolios should hold 5% in gold as a hedge, and current levels might be appropriate for longer-term investors to accumulate. From a longer-term perspective, we see strong support between USD 1,160/oz and USD 1,180/oz. A break of the USD 1,287/oz resistance would open a possible move to the April 2018 highs around USD 1,365/oz.

Gold supported by technicals and risk aversion, but rising bond yields can be a risk

Gold vs. US 10-year real (net of inflation) yields

Source: Bloomberg, Standard Chartered

Market performance summary*



**Performance in USD terms unless otherwise stated, YTD period from 31 December 2017 to 25 October 2018, 1 week period: 18 October 2018 to 25 October 2018*

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

Economic & Market Calendar

	Event	Next Week	Date	Period	Expected	Prior
MON	US	Real Personal Spending	29-Oct-18	Sep	–	0.2%
	US	PCE Core YoY	29-Oct-18	Sep	2.0%	2.0%
TUE	EC	GDP SA YoY	30-Oct-18	3Q A	1.8%	2.1%
	GE	CPI YoY	30-Oct-18	Oct P	2.3%	2.2%
	EC	Consumer Confidence	30-Oct-18	Oct F	-2.7	-2.7
	US	Consumer Confidence	30-Oct-18	Oct	136.2	138.4
WED	JN	Industrial Production YoY	31-Oct-18	Sep P	-2.1%	0.2%
	JN	Bank of Japan Policy Balance Rate	31-Oct-18	31-Oct	–	-0.1%
	EC	CPI Estimate YoY	31-Oct-18	Oct	2.1%	2.1%
	CN	Manufacturing PMI	31-Oct-18	Oct	50.9	50.8
	CN	Non- manufacturing PMI	31-Oct-18	Oct	–	54.9
THUR	US	ISM Manufacturing PMI	1-Nov-18	Oct	59.4	59.8
	UK	Bank of England Bank Rate	1-Nov-18	1-Nov	0.75%	0.75%
FRI/SAT	US	Trade Balance	2-Nov-18	Sep	-$52.8b	-$53.2b
	US	Chang in Nonfarm Payrolls	2-Nov-18	Oct	190k	134k
	US	Unemployment Rate	2-Nov-18	Oct	3.7%	3.7%

	Event	This Week	Date	Period	Actual	Prior
MON	US	Chicago Fed activity index	22-Oct-18	Sep	0.17	0.27
TUE	SI	CPI y/y	23-Oct-18	Sep	0.7%	0.7%
	ID	Bank Indonesia policy rate	23-Oct-18	Oct	5.75%	5.75%
WED	US	New home sales	24-Oct-18	Sep	553k	585k
THUR	US	Fed Beige Book	25-Oct-18	–	–	–
	US	Durable goods orders	25-Oct-18	Sep P	0.8%	4.6%
	EU	ECB main refinancing rate	25-Oct-18	Oct	0%	0%
FRI/SAT	US	GDP q/q Annualized	26-Oct-18	Q3 A	–	4.2%
	US	U. of Mich. Sentiment	26-Oct-18	Oct F	–	99.0
	JN	Tokyo CPI ex-Fresh food	26-Oct-18	Oct	1.0%	1.0%

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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