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Wealth Management Chief Investment Office
8 October 2021

Weekly Market View

Stagflation or reflation?

There is a building narrative that the world may be shifting from a reflation to a stagflation regime. While it is likely that global growth will slow as emergency stimuli are unwound and that inflation will stay elevated for longer due to supply constraints, we believe key indicators are not pointing to a stagflation outlook. As such, we would use any market dislocation to add exposure to risk assets.

Equities: Technical indicators and fundamentals point to limited further downside in US and Euro area equities. We prefer the Value sectors, which are likely to benefit from the reflation theme.

Bonds: We continue to believe Asian High Yield bonds offer attractive value. US bond market history suggests High Yield bonds deliver strong returns in the 12 months after a period of substantial yield spread widening.

FX: EUR/USD has strong support near 1.1490, though there is a risk of final capitulation of long EUR positions.

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Do higher oil prices support your equity market view?

Peak USD – are we there yet?

What is the technical outlook for crude oil and energy sector equities?

Important disclosures can be found in the Disclosures Appendix.

Charts of the week: Signs of reflation

A steeper US yield curve[1], rising real[2] US Treasury yield and outperformance of Value stocks are signs of reflation

US 10-year, 2-year Treasury yield curve[1]; real Treasury yield[2]

Ratio of US Value vs Growth stock indices

Source: Bloomberg, Standard Chartered; [1]Yield premium of US 10-year Treasuries over 2-year Treasuries; [2]Net-of-inflation

Editorial

Stagflation or reflation?

A confluence of factors has led risk assets to swoon and bond yields and the USD to rise in recent weeks. Increasingly hawkish central banks, global energy shortages, prolonged supply bottlenecks, China's continued policy-driven slowdown and US debt default concerns have all played a part in building the narrative that the world may be shifting from a reflation to a stagflation regime. While it is likely that global growth will slow as emergency stimuli are unwound and that inflation will stay elevated for longer due to supply constraints, we believe critical indicators are still not pointing to a stagflation outlook.

If anything, the rise in real (net-of-inflation) bond yields and steeper bond yield curves in the US and Europe since the Fed's and ECB's latest policy meetings suggest investors have a renewed faith in reflation. We expect stronger US and Euro area growth and moderately higher inflation in the coming year compared with the pre-pandemic decade. This reflationary outlook is backed by a few other metrics: (i) US and European High Yield (HY) bond spreads over government bonds, often indicators of a downturn in the economic cycle, remain close to record lows; (ii) global business confidence (PMIs) stabilised at robust levels in September, especially in the US, after a few months of slowdown; (iii) US and European new orders-to-inventories remain robust amid severely depleted inventories; (iv) global COVID-19 cases and hospitalisations continue to fall, including in the US, as vaccinations rise; (v) an oral COVID pill from Merck, which could cut hospitalisations; (vi) the US job market continues to improve, with jobless benefit claims at pandemic lows, and; (vii) US long-term inflation expectations remain within their long-term range (though German expectations have risen to the highest since 2013).

Of course, we would closely watch several near-term risks, including US Democrats' ability to get their proposed fiscal spending package approved by the Congress (debt ceiling concerns have eased for now with the Senate agreeing to raise the ceiling till December). The nature of a future German government is important for European risk assets, with a coalition comprising of the socialist SPD, the Greens and the liberal FDP likely to lift fiscal spending. The other focus is on China: will it succeed in ring-fencing Evergrande's challenges and take steps to prop up growth? Finally, we need to see whether Russia's offer of more gas supplies to Europe and China's move to lift coal supplies ease their energy shortages. A harsh winter amid energy shortages risk further fuel inflation, with knock-on effects on growth and inflation expectations.

While these challenges could sustain short-term market volatility, we expect them to be resolved favourably as most are policy-driven and governments are ultimately likely to favour sustaining the reflationary environment. In the US, Democrats can use the so-called reconciliation process to get a spending bill approved by the Congress (albeit with a curtailed spending plan). Meanwhile, major central banks have emphasised they remain data driven. Their recent hawkish stance is based on the significant recovery in job markets since the depths of the pandemic. They are also, arguably, buying insurance against any prolonged burst of inflation. We expect them to push back against rate hike expectations if their economies slow.

As such, we see any further decline in risk assets as an opportunity to add exposure to our preferred assets, especially US and Euro area equities, where the earnings outlook remains robust, and US and European HY corporate and Emerging Market (EM) and Asia USD bonds (see pages 4-5). The renewed outperformance of Value stocks is in line with our long-held view that Value-style is likely to benefit from the reflationary regime. The recent outperformance of sectors linked to the economic reopening theme suggest investors are also backing a reflation, instead of a stagflation, outcome.

— Rajat Bhattacharya

The weekly macro balance sheet

Our weekly net assessment: On balance, we see the past week's data and policy as positive for risk assets

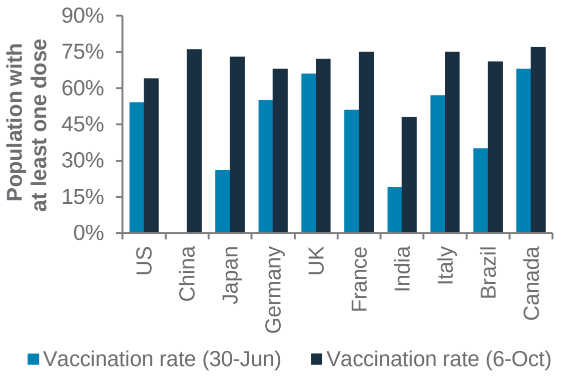
(+) factors: Peak COVID; US, Euro area PMI; US default concerns ease

(-) factors: Weak Euro area retail sales, rising headline inflation

	Positive for risk assets	Negative for risk assets
COVID-19	• New cases in the US, Euro area, Japan, Latin America, Asia continued to fall; US hospitalisations continued to fall as vaccinations rose • Hospitalisations and deaths in the highly vaccinated UK remain well below prior waves despite still-elevated level of infections • Merck said an experimental anti-viral oral pill cut COVID-19-related hospitalisations significantly	• New infections, fatalities hit a new record in Australia and New Zealand extended the lockdown in Auckland amid a renewed rise in cases • New cases, hospitalisations in Canada remained elevated. New cases, fatalities hit a new record in Singapore. Both countries have very high levels of vaccinations
	Our assessment: Positive – Peak global cases, Merck oral pill	
Macro data	• US private payrolls (ADP), ISM Manufacturing/Services PMIs, factory orders rose more than expected; jobless claims fell below estimates • US core PCE inflation rose less than expected • Euro area composite PMI rose more than expected; producer prices accelerated less than expected	• Euro area retail sales gains stalled unexpectedly; Sentix investor confidence fell • Euro area headline inflation rose more than expected • German factory orders fell more than expected; retail sales rose less than expected • Japan's leading economic indicator fell below estimate
	Our assessment: Neutral – Robust US, Euro area PMIs vs weaker Euro area retail sales, rising consumer inflation	
Policy developments	• US Senate approved a short-term debt ceiling increase until December • New Zealand's central bank raised rates for the first time in 7 years, as expected	• Japan's new Prime Minister Kishida proposed a tax rise on capital gains
	Our assessment: Positive – Easing US debt default concerns	
Other developments	• Putin said Russia could export record natural gas to Europe to meet shortages	
	Our assessment: Positive – Easing Europe gas supply concerns	

COVID-19 vaccination rates have risen worldwide in recent weeks

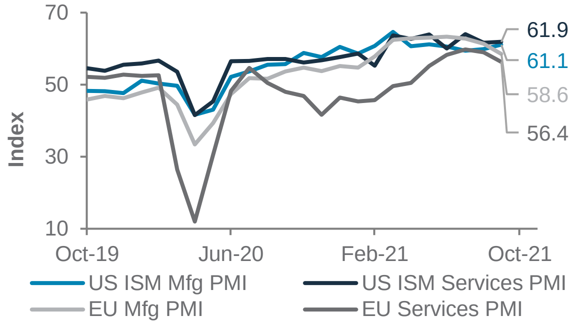
Percentage of population given at least one vaccine dose in the world's 10 largest economies vs end of Q2



Source: Our World in Data, Standard Chartered

Business confidence remains high in both the US and Euro area after a slowdown in recent months

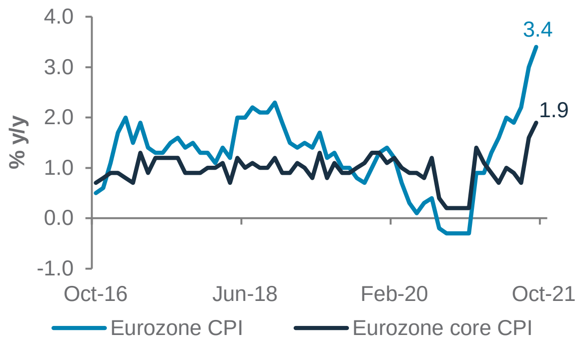
US and Euro area manufacturing/services sector PMIs



Source: Bloomberg, Standard Chartered

Euro area core inflation has started to rise alongside headline inflation due to the impact of rising energy prices

Euro area core and headline consumer inflation



Source: Bloomberg, Standard Chartered

Top client questions

Is further downside likely in US and Euro area equities?

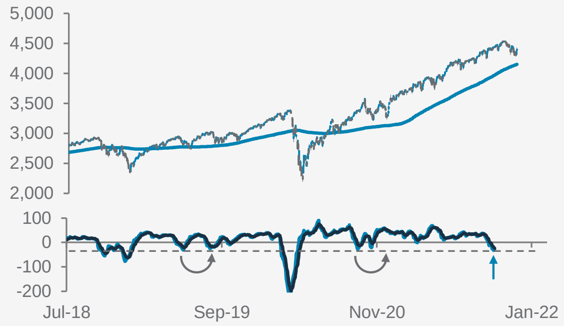
We expect further downside in US and European stock markets to be limited from current levels. On technical grounds, the pullback in the S&P500 index appears similar to past dips – more of a pause than a prolonged correction. As the accompanying charts show, the MACD on the daily chart is approaching levels that triggered a rebound in previous episodes. This comes as the US benchmark index approaches strong support on the 200DMA (Day Moving Average). Furthermore, bearish sentiment is elevated – 5 of our 6 investor sentiment metrics are indicating 'fear'. The Q3 21 earnings season could be a catalyst that sets a floor under the index just as bullish Q4 seasonality kicks in. Q3 21 earnings growth expectations have been raised to 28% y/y, from 24% at the end of June 2021, led by Value sectors such as materials, financials and energy.

The MSCI Euro area index's break below technical support at the mid-August low of 152 indicates that the upward pressure has faded in the short term. Like its US counterpart, though, the index has strong support on the 200DMA, roughly coinciding with the July low at 141 (4% from Thursday's close), followed by the May low of 138. Overall, this suggests the recent retreat does not alter the medium-term upward trajectory. We remain bullish on a 12-month horizon.

— **Manish Jaradi,** *Senior Investment Strategist*
— **Daniel Lam, CFA,** *Senior Cross-asset Strategist*
— **Francis Lim,** *Senior Investment Strategist*

US Equities: Approaching a bottom?

S&P 500 index daily chart with 200-DMA and MACD



Source: Bloomberg, Standard Chartered

Our US sentiment indicators are suggesting a lot of the risks are already priced into the market

US short-term market sentiment indicators; our assessment relative to rolling 3-year average

Indicator	Signal
Market momentum	Fear
Equity strength	Fear
Market breadth	Fear
Equity vs bonds	Fear
Market volatility	Fear
Put-call ratio	Greed

Source: Bloomberg, Standard Chartered

Peak USD – are we there yet?

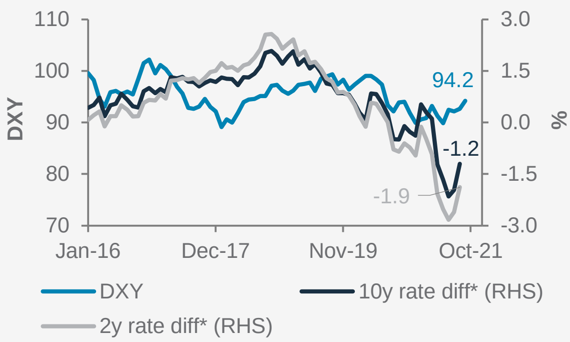
Real interest rate differentials, as shown in the chart, should have weighed on the USD, but a delayed global recovery and recent inflation fears have driven many USD bears to the sidelines.

A weaker USD has been elusive, but a number of potential catalysts could trigger the dollar to turn lower in the coming weeks. A Fed reconfirmation of its Average Inflation Targeting policy, which allows it to tolerate higher inflation, would reduce worries of higher real yields; a new German coalition government could create a strong shift in favour of fiscal expansion in the Euro area; and China could step up policy support to counter slowing growth after regulatory changes. Investor sentiment may also improve as higher post-COVID-19 mobility and key energy producer strategies align to relieve supply-side shortages. All of these factors could trigger flows to non-US assets, which has thus far been the missing component.

EUR/USD is the key focus for a USD turn. Technical support around 1.1490 is key, though there is a risk of a final capitulation of long EUR positions towards 1.1290 if that level breaks. The pair needs to recover above 1.1700-1.1750 to relieve the downward pressure. A sustained break above 1.1900 would be bullish.

The USD has not yet declined in line with real interest rate differentials, but it may simply be awaiting a catalyst

USD (DXY) Index with US-DXY members-weighted interest rate differentials



Source: Bloomberg, Standard Chartered
*Derived using 10-year government bond yields of DXY members, deflated by respective CPI indices

Top client questions (cont'd)

Do higher oil prices support your equity market view?

Oil prices hit multi-year highs recently amid a confluence of factors:

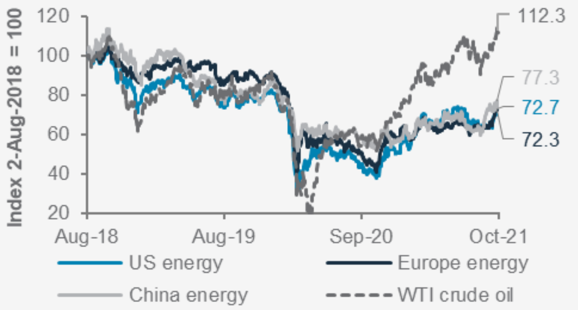
1. OPEC+ stuck to its planned 400,000bpd monthly output increase
2. The coal shortage in China, caused by strong domestic demand and coal mining constraints amid a transition to a green economy
3. Below-average natural gas inventory in Europe, exacerbated by Russia exporting less gas than usual and competing demand from Asia and Brazil
4. A looming winter season, when heating power demand in the northern hemisphere usually rises

However, energy sector equities in the US, Europe and China have lagged oil prices in the past year. We believe this presents a catch-up opportunity for energy sector equities, one of our preferred sectors. Energy companies went through significant cost rationalisation during the pandemic and remain disciplined in capex, which places them in a stronger financial position than during the pre-pandemic days. In the US, Europe and China, the energy sector trades at relatively lower valuation multiples (34-43% discount to the broad market) and attractive dividend yields (4-7%). We believe the sector would also benefit from an investor rotation to Value equities. Higher bond yields and a continued cyclical recovery are primary factors for a rotation to the Value style, including the energy sector.

— **Fook Hien Yap,** *Senior Investment Strategist*

The oil price has recovered back above mid-2018 levels, but energy sector equities now lag the oil price by over 30%

Relative performance of MSCI US energy, MSCI Europe energy, MSCI China energy equity indices and WTI crude oil price



Source: Refinitiv, Standard Chartered

Do data and events support your constructive view on Asia HY bonds?

Asia HY bond valuations (measured by credit spreads) continued to cheapen towards COVID-19 crisis levels amid concerns about more defaults among smaller Chinese property developers.

Despite this, we believe risk/reward favours a constructive view on Asia HY bonds. Contagion risk is likely to be contained given incentives for China's authorities to avoid a broad fallout and the fact that most developers have improved their balance sheet strength since the '3 red lines' policy came into effect. The overnight Shibor rate is also not showing any signs of liquidity stress, unlike 2013.

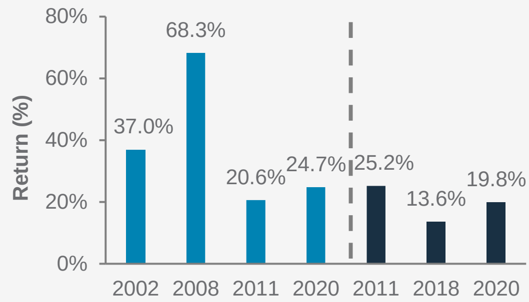
A sharper-than-expected economic growth slowdown in China or margin contraction (from higher input prices with little pass through to end users) are risks to corporate fundamentals we would monitor.

We believe Asian HY bonds offer good value, with the spread rising c. 380bps since end-May. Since 2001, when Developed Market (DM) HY bond spreads widened by at least 350bps within 6 months (based on month-end data), the subsequent 12-month return was more than 20%, significantly higher than the mean historical 12-month return of 8.92%. While Asian HY bonds have a shorter history, the past performance of DM HY bonds could offer a directional reference.

— **Cedric Lam,** *Senior Investment Strategist*

High Yield bonds tend to deliver better-than-historical average returns after a period of substantial yield spread widening

12-month returns after index credit spread widens by at least 350bps, based on month-end data



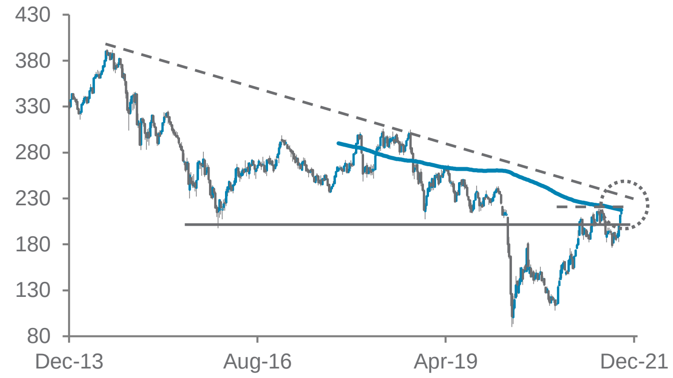
Source: Bloomberg, Standard Chartered
(Blue: DM HY; Black: Asia HY USD)

Technical charts of the week

Manish Jaradi
Senior Investment Strategist

US Energy equities: Encounters stiff resistance

MSCI USA Energy index weekly chart with 200WMA



Source: Bloomberg, Standard Chartered

> Although the US energy index is encountering stiff resistance (the 200WMA, a downtrend line from 2014, a horizontal trendline from 2016 and the June 2021 high), the higher-top-higher-bottom structure from 2020 raises the odds of it overcoming this resistance in the coming weeks/months.

EU Energy equities: Two steps forward, one step back

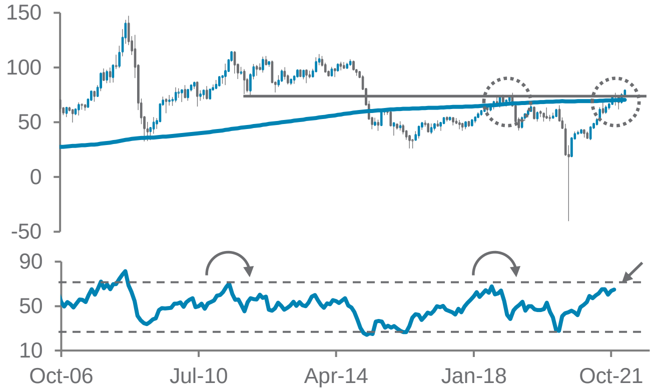
MSCI Europe Energy index weekly chart with 200WMA

Source: Bloomberg, Standard Chartered

> The EU energy sector index is running into stiff resistance. Although a minor retreat cannot be ruled out, the overall recovery trajectory remains intact. Owing to the extent of damage in recent years, the two steps forward, one step back story could continue for some time.

Crude oil: Time for a pause?

WTI crude oil continuous contract monthly chart with 200MMA and RSI

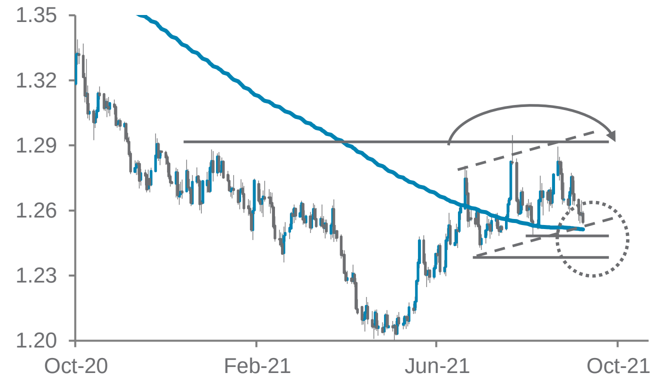


Source: Refinitiv, Standard Chartered

> Crude oil's uptrend could be about to pause as it runs into major resistance. The 14-month Relative Strength Index (RSI) is nearing 70, which has led to a pause in the past. However, oil has fairly strong support on the 200DMA (now at 64.75), which could limit any decline.

USD/CAD: Plenty of support

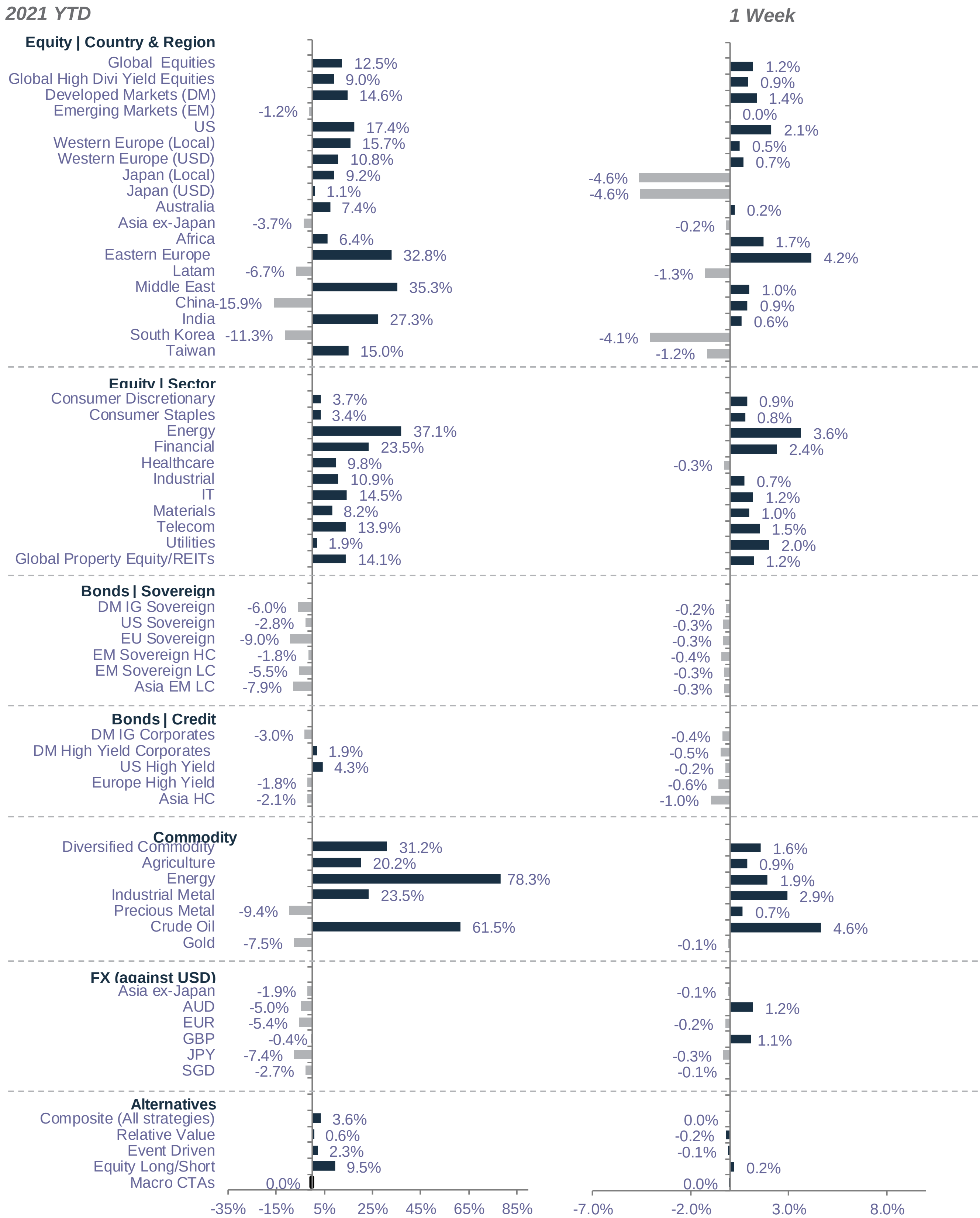
USD/CAD daily chart with 200DMA



Source: Refinitiv, Standard Chartered

> USD/CAD's four-month-long rally is showing signs of fatigue – it has had three failed attempts to clear tough resistance on a horizontal trendline from June 2021. However, there is plenty of support on the downside, which could limit the decline and keep the upward pressure intact.

Market performance summary *



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

*Performance in USD terms unless otherwise stated, 2021 YTD performance from 31 December 2020 to 07 October 2021; 1-week period: 30 September 2021 to 07 October 2021

Our asset class views at a glance

Asset class			
Equities	▲	**Alternatives**	◆
Euro area	▲	Equity hedge	▲
UK	◆	Event-driven	◆
US	▲	Relative value	▼
Asia ex-Japan	▼	Global macro	◆
Japan	◆		
Other EM	◆	**Cash**	▼
		USD	▼
Bonds (Credit)	◆	EUR	▲
Asia USD	▲	GBP	▲
Corp DM HY	▲	CNY	◆
Govt EM USD	▲	JPY	◆
Corp DM IG	▼	AUD	▲
		NZD	▲
Bonds (Govt)	▼	CAD	◆
Govt EM Local	▼		
Govt DM IG	▼	**Gold**	◆

Source: Standard Chartered Global Investment Committee

Legend: ▲ Most preferred | ▼ Less preferred | ◆ Core holding

Economic and market calendar

	Event	Next week	Period	Prior
MON				
TUE	EU	ZEW Survey Expectations	Oct	31.1%
WED	US	CPI y/y	Sep	5.3%
	CH	Trade Balance	Sep	$58.34b
	CH	Exports y/y	Sep	0.256
	CH	Imports y/y	Sep	33.1%
THUR	CH	CPI y/y	Sep	0.008
	CH	PPI y/y	Sep	9.5%
	US	Initial Jobless Claims	9-Oct	–
FRI/SAT	US	Retail Sales Ex Auto and Gas	Sep	2.0%
	US	U. of Mich. Sentiment	Oct P	72.8

Source: Bloomberg, Standard Chartered
Prior 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

S&P500 has first support 1.5% below current level

Technical indicators for key markets as on 07 October 2021

Index	Spot	1st support	1st resistance
S&P500	4,400	4,334	4,433
STOXX 50	4,098	4,030	4,132
FTSE 100	7,078	7,023	7,105
Nikkei 225	27,678	27,214	28,457
Shanghai Comp	3,568	3,536	3,601
Hang Seng	24,702	24,212	24,947
MSCI Asia ex-Japan	800	788	806
MSCI EM	1,253	1,236	1,262
Brent (ICE)	82.0	80.0	83.2
Gold	1,754	1,749	1,764
UST 10Y Yield	1.58	1.50	1.62

Source: Bloomberg, Standard Chartered

Investor diversity remains normal across major assets

Our proprietary market diversity indicators as of 06 October

Level 1	Diversity	1-month trend	Fractal dimension
Global Bonds	◐	↓	1.46
Global Equities	●	↑	1.66
Gold	●	↑	1.61
Equity			
MSCI US	●	↑	2.46
MSCI Europe	●	↓	1.52
MSCI AC AXJ	◐	→	1.39
Fixed Income			
DM Corp Bond	●	↓	1.44
DM High Yield	●	↓	1.61
EM USD	●	→	1.51
EM Local	◐	→	1.50
Asia USD	●	↓	1.52
Currencies			
EUR/USD	◐	↑	1.42

Source: Bloomberg, Standard Chartered; **Fractal dimensions below 1.25 indicate extremely low market diversity/high risk of a reversal**

Legend: ● High | ◐ Low to mid | ○ Critically low

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