Global Market Outlook

Living with COVID?
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Investment strategy and key themes

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Investor implications on a 12-month horizon

- Global equities over bonds and cash
- In equities: US, Euro area, UK favoured
- In bonds: DM HY, Asia USD, EM USD preferred
- In FX: USD likely to fall against EUR, GBP, AUD, CAD, NZD

Key themes

- Ready, Steady, Rotate
- Race for Income
- USD to slump in 2021
- Disruptive Innovation
- Climate change
- A world of yield-free risk

Living with COVID?

- We see equity markets transitioning to a slower, but more sustainable, pace of gains as countries vaccinate and learn to live with COVID-19. US and European equities remain preferred. We view Asia ex-Japan and China equities as core holdings, but await more attractive entry levels.
- Markets are likely to focus on the timing of Fed tapering of bond purchases, China’s policy direction, inflation expectations and the effectiveness of COVID-19 ‘vaccinate-and-normalise’ strategies.
- We expect gradually higher US bond yields once excessively bearish Treasury positioning eases as growth remains well-supported. Gradually rising Treasury yields would not alter our weak USD view and preference for riskier bonds.

Shifting to slower, but sustainable, pace of returns

Since we published our H2 Outlook, most asset classes have been relatively rangebound, with US government (Treasury) yields (which fell 22bps since end-June) and Chinese equities (down 12.7%) being the two notable exceptions. The market narrative is likely to be increasingly focused on (i) how ‘learning to live with COVID-19’ strategies fare, (ii) topping out of inflation expectations, (iii) how soon the Fed signals tapering of bond purchases, and (iv) China’s policy path. In our assessment, these factors remain consistent with a somewhat slower, but more sustainable, pace of equity market gains, accompanied by a higher level of volatility.

From Alpha to Delta

There are concerns that the sharp rise in the Delta variant of COVID-19 could lead to yet another pause in economic recovery as infections rebound amid an incomplete vaccination process. The UK, though, may offer the best gauge of how this could pan out. UK infections appear to have peaked already; if the surge earlier is not accompanied by a similarly sharp rise in hospitalisation rates, fears of further restrictions could reduce significantly. Alternatively, a relapse to increased mobility restrictions could disappoint markets, though this is likely to be short-lived, given how households, businesses and markets have adapted to the pandemic.
The uncertainty is likely feeding into bond yields – while falling inflation expectations partly explain the decline in yields, growth concerns are visible in lower real (net-of-inflation) yields. An incomplete unwind of excessively bearish Treasury positions is also likely a factor, a normalisation of which is eventually likely to see a renewed rebound in yields as growth concerns recede.

Any Fed signalling on the timing and pace of tapering of bond purchases is also likely to support higher bond yields, possibly accompanied by temporary equity volatility. We continue to expect tapering to only start in early 2022, with an announcement later this year.

In China, regulatory policy continues to tighten for specific industries. However, recent signals (including the PBoC’s bank reserve ratio cut) shows authorities are starting to worry more about the growth outlook, potentially setting the stage for further policy easing.

Looking past peak rebound

For global equities, we believe these factors support our view of a return to a slower, but more sustainable, pace of gains, albeit accompanied by somewhat higher volatility compared with earlier this year.

Bad for you is good for me

Higher US Treasury yields usually act as a headwind for most bond asset classes (higher yields translate to lower prices). However, we remain comfortable with our preference for riskier bonds.

Asia USD bonds arguably offer an attractive combination of a valuation buffer and relatively low sensitivity to Treasury yields. Tightening regulatory policies in China remain a headwind, though we believe this is less of a risk to USD bonds (given the policies should eventually improve credit quality), than for equities (tighter regulations can impact future growth).

Higher yielding bonds in Developed Markets (DM) have relatively low sensitivity to US government bond yields. Although Emerging Market (EM) USD bonds are more sensitive, we believe comfortable valuations offer a sufficient buffer.

A recovery in risk appetite and broadening of growth across the globe should support non-US yields, also triggering a reversal in the recent USD strength.
What to make of China’s regulatory crackdown?

Chinese authorities have issued a series of regulatory reforms across internet, fintech, healthcare and education sectors in recent months. These moves have rattled investors, negatively impacting China’s financial markets. The MSCI Asia ex-Japan index is down 12.5% since its peak in February, dragged by China (-10.8% YTD), which makes up 43% of the index. In bonds, Asia USD bonds returned -0.5% this year, outperforming Developed Market Investment Grade (IG) corporate bonds (-0.7%).

Regulatory uncertainties likely to remain an overhang

There are many questions about the motivations behind this crackdown and which sectors may be targeted next. In our view, there remains considerable uncertainty, but the measures announced so far seem to be aimed at advancing China's long-term strategic objectives e.g. to achieve common prosperity, global leadership in technology (high-tech manufacturing, rather than consumer tech) and managing competition with the US. For example, the guidance for companies to pay minimum wage and enhance social benefits to flexible workers are likely aimed at enhancing social equality. Similarly, the crackdown on internet companies may encourage more domestic firms to list in China or HK, helping to develop domestic capital markets, thus supporting China's long-term competition with the US.

We review the 2014-2016 anti-corruption campaign against Macau’s gaming sector, when affected stocks underperformed the Hang Seng Index (HSI) by more than 50%. While Chinese internet and property sectors are currently under pressure, they are of greater strategic importance than casinos/gaming. Moreover, revenue growth, especially in the internet sector, is likely to be an additional pillar of support.

Fig. 4 Chinese (offshore) equities have suffered the brunt of the regulatory pressures. We prefer Asia USD bonds, particularly higher yielding debt, to build exposure to Chinese assets for now

Select indexes rebased to 100 on 31-Dec-2020

Yield difference between Asia IG and HY USD bonds

Source: MSCI, JP Morgan, Bloomberg, Standard Chartered; As of 26-Jul-2021. Rebased to 100 = 31-Dec-2020
SD = Standard Deviation
While the education sector is much smaller in terms of market capitalisation (comprising less than 1% and 1-2% of the broader MSCI China index and the consumer discretionary sector, respectively), the recent reforms do raise the question of which sectors may be at risk next. Sectors seen to exacerbate social inequality or obstruct policy goals may possibly be at risk.

*Fig. 5 The sell-off in China’s technology, real estate sectors has been much shallower since the regulatory moves vs Macau gaming in 2014-2016*

Performance of sector baskets* relative to Hang Seng Index since the onset of regulatory moves (T = days)

Source: Bloomberg, Standard Chartered; As of 26-Jul-2021

**Monetary policy turning more supportive**

We believe regulatory pressure will likely remain an overhang for equity markets near term, but the cut in bank reserve requirement ratio (RRR), is a step in a positive direction. Historically, the PBOC has never stopped with just one RRR cut. Thus, further easing can be expected. Easing monetary policies could signal the bottoming of China’s credit impulse and offer tailwinds to equities – albeit with a lag. However, that alone is unlikely to ease pressure on China equities near term. Although earnings revisions have regained positive momentum, we would watch for signs of further policy easing, especially on the regulatory front.

Overall, we expect China onshore and offshore equities to perform broadly in line with Asia ex-Japan equities over the next 6-12 months. Within China equities, we prefer the industrial and energy sectors that are less impacted by domestic policies and are driven by the global economic expansion cycle. Some Chinese sub-sectors supporting long term policy goals, such as electric vehicles (EVs) or semiconductors, remain attractive routes for adding long-term exposure, in our view. Moreover, these sectors are two key pillars of our structural Disruptive Innovation theme.

**Technicals at key long-term support**

The MSCI China index is testing crucial support on the upward sloping 200-week moving average. Any rebound from here raises the probability of a rebound as it did in 2018, providing a decent entry for long-term investors. In addition, if the intensity and tone of regulators soften over the coming months, this may create buying opportunities in selective sectors, given valuations have eased considerably. We would look for signs of bottoming technicals before considering turning more constructive on the Chinese equities, which remain a core holding.

**Attractive valuations, defensive character work in favour of China USD bonds**

Apart from select equity sectors that are likely to benefit from targeted government policies and the ongoing global economic expansion, we believe USD-denominated corporate bonds are a more attractive route for taking exposure in China.

Asia USD bonds remain one of our preferred areas, given improving corporate sector profitability, contained defaults, low volatility and attractive valuations compared with US corporate bonds. The PBoC’s RRR cut should help ease access to credit for Chinese issuers. This should help improve onshore liquidity via improved supply of onshore financing, thus potentially supporting bond prices.

Nevertheless, in recent weeks, China’s property sector has been under increased scrutiny as regulatory pressures on a large developer resulted in weaker sentiment and underperformance of the sector’s USD bonds. In our view, it is important to differentiate the short- and long-term impact of the regulatory scrutiny, especially in terms of China’s 3 Red Lines (3RL) policy that seeks to improve the balance sheet health of property developers.

In the near term, we believe the underperformance of developers that stack up poorly against the 3RL policy objectives is likely to extend. Idiosyncratic defaults and heightened volatility are likely. However, from a longer-term perspective, we view the 3RL policy as positive as it pushes an increasing number of developers to strengthen their balance sheets, improving overall sector credit quality.

While we cannot rule out further underperformance of Asia HY bonds over the next few months due to property sector concerns, we believe valuations have become increasingly attractive relative to Asia IG and even US HY bonds. Hence, we would consider the current weakness as an opportunity to add exposure to Asia HY bonds.
China’s ESG ambitions offer investment opportunities

China’s sustainable development aspirations

Over the past few years, China has undertaken several environmental protection measures as it seeks to establish leadership in sustainable development. Key announcements related to this topic have been aimed at achieving ambitious targets of reaching a carbon emission peak by 2030 and carbon neutrality by 2060.

While we await further details and actions, we believe setting the ambitious targets is an important first step. It shows that emissions reduction and protection and restoration of ecosystems are a core focus of China’s 14th Five Year Plan (FYP).

China’s FYP is a key policy document that establishes the country’s medium-term goals towards social and economic development and helps orchestrate and accelerate progress in identified areas. For instance, the 13th FYP had a strong focus on reducing pollution levels and this saw PM2.5 levels in the Beijing-Tianjin-Hebei region drop by 36%. This also resulted in a reduction of coal usage in the primary energy mix from 63.7% in 2015 to 56.8% in 2020.

Key policy and regulatory developments

Sustainable finance is critical to the promotion of sustainable development. Here, the 2016 guidelines laid the foundation for a sustainable financial system in China. These reforms have trickled into the way Chinese businesses are conducted.

This year has seen more announcements to promote sustainable finance and development:

Fig. 6 2021 - key announcements

Q1

• China’s State Council releases guidelines to accelerate the building of a green and low-carbon circular economic system
• Details of China’s Carbon Emission Trading system announced in February
• China’s first green finance regulation in Shenzhen takes effect in March, requiring financial institutions to disclose information on their environmental impact
• Targets for carbon emissions reduction and accelerating green development a focus during the Two Sessions (Beijing’s annual parliamentary meetings)

Q2

• 2021 catalogue for green bonds to exclude fossil fuel-related projects
• PBoC Shanghai meets with Chinese and foreign banks to discuss how to further develop carbon finance
• Plans to create a fund to manage carbon credit sales income announced in Shenzhen
• China Securities Regulatory Commission (CSRC) issues revised guidelines requiring listed companies to disclose environmental, social data

July

• The National Emissions Trading Scheme (ETS) officially started on 16 July

Importance of ESG reporting and disclosures in attracting global investment capital

One important outcome of the recent policy and regulatory announcements, besides supporting the development of bond and carbon markets, will be improved ESG data disclosures driven by CSRC’s ESG reporting requirements announced in June.

With CSRC’s revised guidelines on the format of annual and semi-annual reports, listed companies are now required to disclose environmental and social data in greater detail, especially around the measures taken to reduce carbon emissions during the period and the outcome of the efforts.

Fig. 7 ESG reporting has increased in China

ESG reporting of CSI 300 A-shares companies

Source: Government announcements, media reports, Standard Chartered
This data disclosure is important in attracting global investments into Chinese companies. International investors have previously found it challenging to make ESG-themed investments in China due to inadequate data for assessing companies’ ESG performance. This is changing, with 85% of CSI 300 A-shares companies releasing ESG disclosures, matching the 90% rate among S&P companies. This is a good start, though more needs to be done in developing quality reporting as only a small proportion of these releases are audited.

**What does this mean for investors?**

**Significant risks for ESG laggards, especially in climate progress and data disclosures**

We expect increased pressure on reporting material ESG data, with continued efforts by the PBoC to standardise mandatory environmental information disclosure requirements. Companies that are laggards in this area face both regulatory and reputational risks.

The launch of China’s long-anticipated ETS will force carbon-intensive companies to cut pollution or face potential economic/financial risks. While the ETS initially only covers power and heat generation, which accounts for 40% of China’s emissions, plans are under way to eventually include power generation, steel, cement and other key industrial sectors.

**Capturing alpha by identifying leaders in ESG**

An analysis on EM and China equity markets by the Principles for Responsible Investing (PRI) helps highlight the potential value of ESG within a portfolio.

**Fig. 8 ESG portfolios delivered stronger risk-adjusted returns relative to broader markets**

EM and China equity risk & returns from 2013 to 2019

Their analysis suggests portfolios with superior ESG characteristics are able to deliver alpha, while offering relatively lower downside risk compared with broader markets. Between EM and China equity markets, the ESG factor’s alpha generation capability in China equities was also higher than that of EMs.

**Thematic opportunities in addressing climate change remain attractive in the long term**

China’s focus on achieving carbon neutrality by 2060 could create significant investment opportunities related to ecological protection and a low-carbon transition. China has already invested twice as much as the US on climate action to date, strengthening its solar energy capacity to nearly triple that of the US last year. In 2020, the Chinese government launched the National Green Development Fund, a state-run private equity fund currently worth USD 13.6bn, focusing on investing in green projects and firms.

**Fig. 9 Sales of Chinese green bonds have reached a record in 2021**

Issuance of green bonds from 2015 to 2021

Source: Bloomberg, Standard Chartered

While capital flows into ESG-related ETFs rose more than five-fold between 2018 and 2019, a total of 11 new fund launches were recorded in 2020. Sale of China’s green bonds also reached new highs in 2021, with proceeds going to green projects. While sudden policy shifts are a risk, valuations of Chinese ‘green’ stocks – trading on par with that of Euro area ESG leaders (12-month forward P/E of 16.3x vs 17.8x) – remain healthy.

Since committing to carbon neutrality, China has incorporated climate protection measures, aligning more closely with the global environmental agenda. It continues to dominate the production of EV batteries and solar panels globally. We remain optimistic about growth and investment opportunities in this space.
Macro overview – at a glance

Rajat Bhattacharya
Senior Investment Strategist

Key themes

We expect the global recovery to continue as major economies, such as the US, Europe and China, achieve ‘herd immunity’ against COVID-19 in Q3 through high levels of vaccinations, enabling them to resume normal business activity. Growth in the US and Europe is likely to remain firmly above pre-pandemic trend well into 2022, despite a moderation in the pace after this year’s bounce back. China is the only major economy that is likely to have slower growth in 2022 vs pre-pandemic levels, but we see the PBoC’s cut in RRR as the start of a credit easing cycle, which should help stabilise growth. We also expect monetary policies to remain accommodative in major economies, offsetting fiscal policy tightening (most significantly in the US). The ECB’s latest policy shift will enable it to tolerate inflation above 2% for a while, implying that policy is likely to stay easy for longer. In the US, the current surge in inflation is likely to be transitory as supply bottlenecks and labour market distortions fade by Q4. Inflation expectations have also softened. This should allow the Fed to delay tapering of bond purchases until early 2022.

Key chart

Business confidence in major economies remains strong, despite moderating from very high levels. This supports our view of robust economic growth as countries re-open and monetary policies remain highly accommodative.

<table>
<thead>
<tr>
<th>Macro factors positive for risk assets</th>
<th>Macro factors negative for risk assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>− Proposed tax hikes, fiscal drag from 2022</td>
</tr>
<tr>
<td>▼ ◆ ▲</td>
<td>− COVID mutations; precautionary savings</td>
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<tr>
<td></td>
<td>− Slowing goods demand; supply bottleneck</td>
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<tr>
<td></td>
<td>− Weak lending; Fed to taper bond buying</td>
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<tr>
<td>Euro area</td>
<td>− COVID variant risk; slowing vaccinations</td>
</tr>
<tr>
<td>▼ ◆ ▲</td>
<td>− Precautionary savings; high jobless rate</td>
</tr>
<tr>
<td></td>
<td>− Industry supply constraints; fund delays</td>
</tr>
<tr>
<td>China</td>
<td>− Global goods-to-service shift to hit exports</td>
</tr>
<tr>
<td>▼ ◆ ▲</td>
<td>− Regulatory tightening; rising input costs</td>
</tr>
<tr>
<td></td>
<td>− Precautionary savings; geopolitical risk</td>
</tr>
<tr>
<td>Japan</td>
<td>− Global goods-to-service shift to hit exports</td>
</tr>
<tr>
<td>▼ ◆ ▲</td>
<td>− Precautionary savings; COVID variants</td>
</tr>
<tr>
<td></td>
<td>− Structural deflationary forces</td>
</tr>
<tr>
<td>UK</td>
<td>− COVID variant risk; precautionary savings</td>
</tr>
<tr>
<td>▼ ◆ ▲</td>
<td>− Brexit-related supply chain disruptions</td>
</tr>
<tr>
<td></td>
<td>− High inflation risks tighter monetary policy</td>
</tr>
</tbody>
</table>

Source: Standard Chartered Global Investment Committee

Legend: ▲ Tighter policy | ▼ Easier policy | ◆ Neutral policy

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FX – at a glance

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Investment Strategist

Key themes

Our 6 to 12-month outlook remains for a broadly weaker USD, as US growth radiates globally. Euro area and UK growth is likely to accelerate as high vaccination levels lead to ‘herd-immunity’ and fiscal spending is unleashed. The US twin deficits are likely to be a drag on the USD, and capital outflows seeking better risk-adjusted returns will likely boost the EUR, GBP, AUD, NZD and CAD, while the JPY and CNY remain rangebound. The key risks to our 12-month view are slower global growth, a negative shift in risk sentiment and unexpected pandemic setbacks.

We expect a more volatile transition period over the 3-month horizon. The significant reduction in short-USD positioning suggests high levels of investor uncertainty. The outcome of the UK’s COVID-19 “vaccinate and live with it” strategy is key. Low mortality and hospitalisation rates would likely prompt other countries to follow suit, returning the focus to the positive global growth outlook and the potential for other central banks to tighten policy.

Key chart

The USD index (DXY) has responded to near-term uncertainty and short-USD positioning that has now been unwound. Once demand for the safe-haven USD ebbs as global growth rises, we expect a USD decline that reflects fundamentals, including a negative real interest rate spread.

Fig. 12  Real interest rate differentials suggest an eventual USD decline
USD index (DXY), with 2y, 10y real rate differentials* between the US and peers

Fig. 13  Summary of major currency drivers

<table>
<thead>
<tr>
<th>12-month outlook</th>
<th>The bullish case</th>
<th>The bearish case</th>
<th>12-month outlook</th>
<th>The bullish case</th>
<th>The bearish case</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD (DXY) ▼</td>
<td>+ US yield &amp; growth exceptionalism</td>
<td>– Dovish Fed and ample USD supply</td>
<td>USD/JPY ▼</td>
<td>+ Rising nominal US Treasury yields</td>
<td>– Favourable real yield differentials</td>
</tr>
<tr>
<td></td>
<td>+ Safe-haven in a risk-off event</td>
<td>– US twin deficits and global growth</td>
<td></td>
<td>+ Weak safe-haven demand for JPY</td>
<td>– Short positioning; Currency hedging</td>
</tr>
<tr>
<td>EUR/USD ▲</td>
<td>+ Better vaccination &amp; growth recovery</td>
<td>– Pandemic wave lockdowns return</td>
<td>USD/CNY ▼</td>
<td>+ China credit impulse flat</td>
<td>– Rising global trade and exports</td>
</tr>
<tr>
<td></td>
<td>+ Germany vote &amp; fiscal stimulus rise</td>
<td>– China slowdown; less fiscal stimulus</td>
<td></td>
<td>+ Policy stability limits CNY gains</td>
<td>– Continued CNY investment inflows</td>
</tr>
<tr>
<td></td>
<td>+ Bank of England has hawkish bias</td>
<td>– Scotland/N.Ireland post-Brexit risks</td>
<td></td>
<td>+ Faster growth may be priced in</td>
<td>– Bank of Canada remains hawkish</td>
</tr>
<tr>
<td>AUD/USD ▲</td>
<td>+ Global growth and commodity prices</td>
<td>– More dovish RBA; Slow vaccinations</td>
<td>NZD/USD ▼</td>
<td>+ Hawkish RBNZ as growth rises</td>
<td>– Negative global risk sentiment</td>
</tr>
<tr>
<td></td>
<td>+ Stronger domestic demand</td>
<td>– China demand may weaken</td>
<td></td>
<td>+ Terms of Trade; undervalued</td>
<td>– Vulnerability to China demand</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Standard Chartered; *DXY member 10y government bond yields, deflated by CPI

Legend: ▲ Bullish | ▼ Bearish | ★ Rangebound
2021 key events

AUGUST 2021
- 05: BoE policy decision

SEPTEMBER 2021
- 9: ECB policy decision
- 22: FOMC policy decision
- 22: BoJ policy decision
- 23: BoE policy decision
- 28: Federal elections in Germany

OCTOBER 2021
- 22: Deadline for Japan General Elections
- 28: BoJ policy decision
- 28: ECB policy decision

NOVEMBER 2021
- 1-12: UN Climate Change Conference in Glasgow
- 03: FOMC policy decision
- 04: BoE policy decision

DECEMBER 2021
- Dec: China Annual Economic Work Conference
- 15: FOMC policy decision
- 16: BoE policy decision
- 16: ECB policy decision
- 17: BoJ policy decision
- 31: Iran’s deadline for the US to end sanctions

JANUARY 2022
- 20: ECB policy decision
- 26: FOMC policy decision

FEBRUARY 2022
- 3: BoE policy decision

MARCH 2022
- Mar: China National People’s Congress session
- 9: South Korea Presidential election
- 10: ECB policy decision
- 16: FOMC policy decision
- 17: BoE policy decision
- 27: Hong Kong Chief Executive election

APRIL 2022
- Apr: France Presidential elections
- 14: ECB policy decision

MAY 2022
- 4: FOMC policy decision
- 5: BoE policy decision

JUNE 2022
- 9: ECB policy decision
- 15: FOMC policy decision
- 16: BoE policy decision

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