Global Macro Strategy

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Contents

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Summary – Gold in the brave new world

- **Many markets are held hostage to central banks and quantitative easing**
  - Balance sheet expansion and inflation expectations are the new watch words
  - The growing importance of real yields
- **The search for yield affects all asset classes**
  - Structural supply/demand imbalance for fixed income
  - High yield in a low yield world
- **A benign risk backdrop and low yields bring investors back to EM in 2016**
  - EM assets offer attractive valuation discounts to their DM counterparts
  - We have observed significant inflows to EM as investors reduce underweight positions
- **Lower global yields support the medium-term outlook for gold**

Central banks and monetary policy

Brave new world

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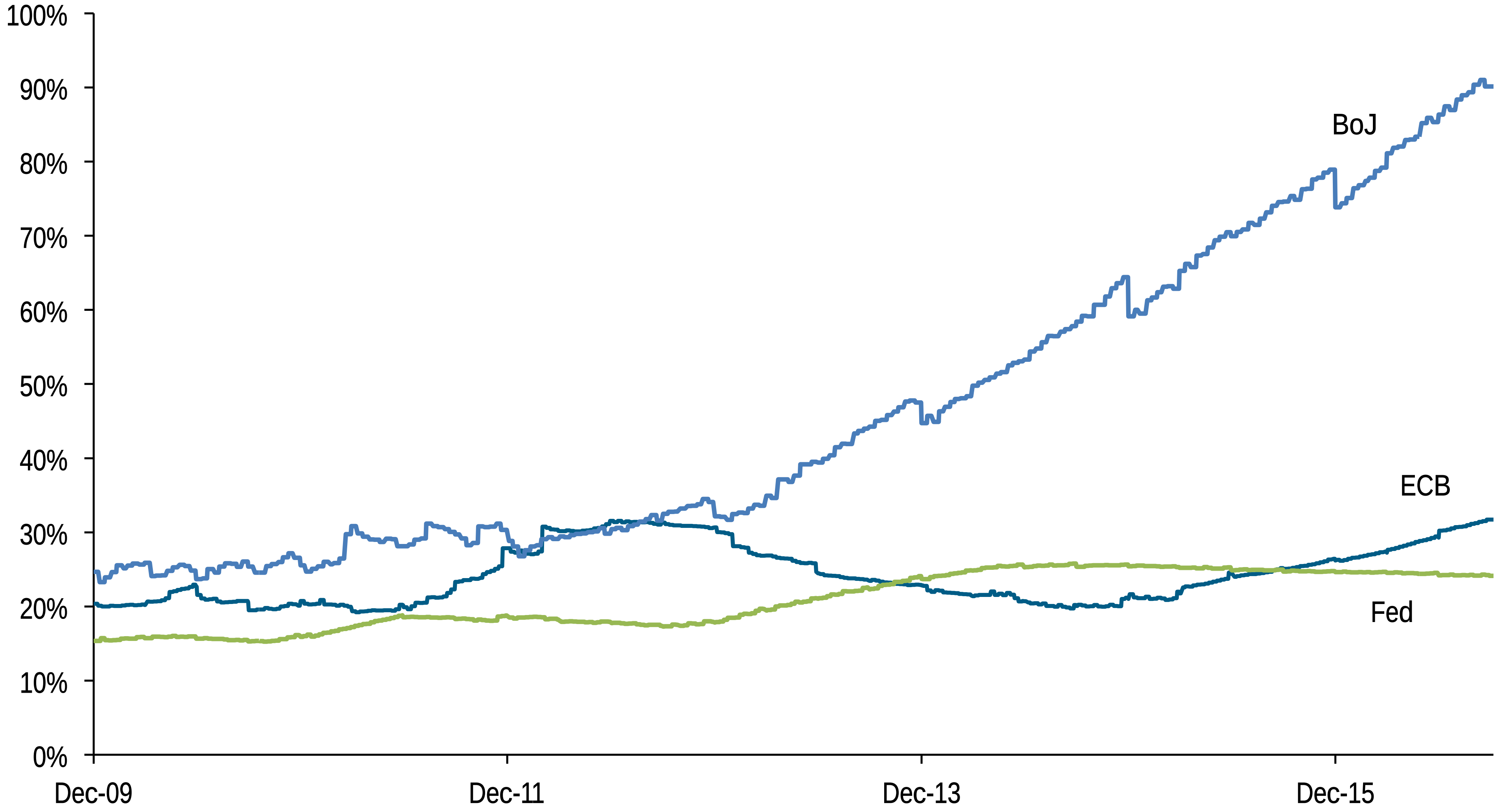
Central bank monetary policy reaches new heights

The expansion of G3 balance sheets

Total balance sheet as % of GDP

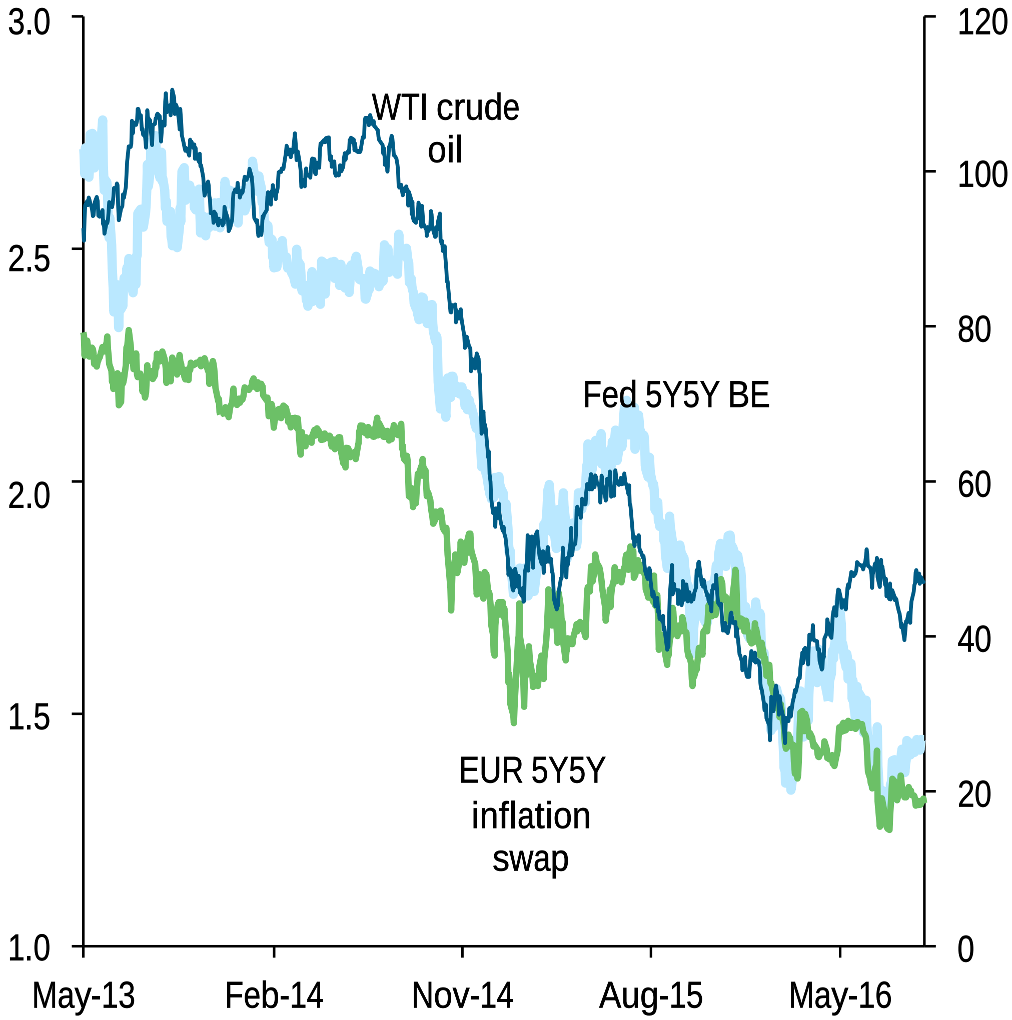


Source: Bloomberg, Standard Chartered Research

Global inflation expectations remain low

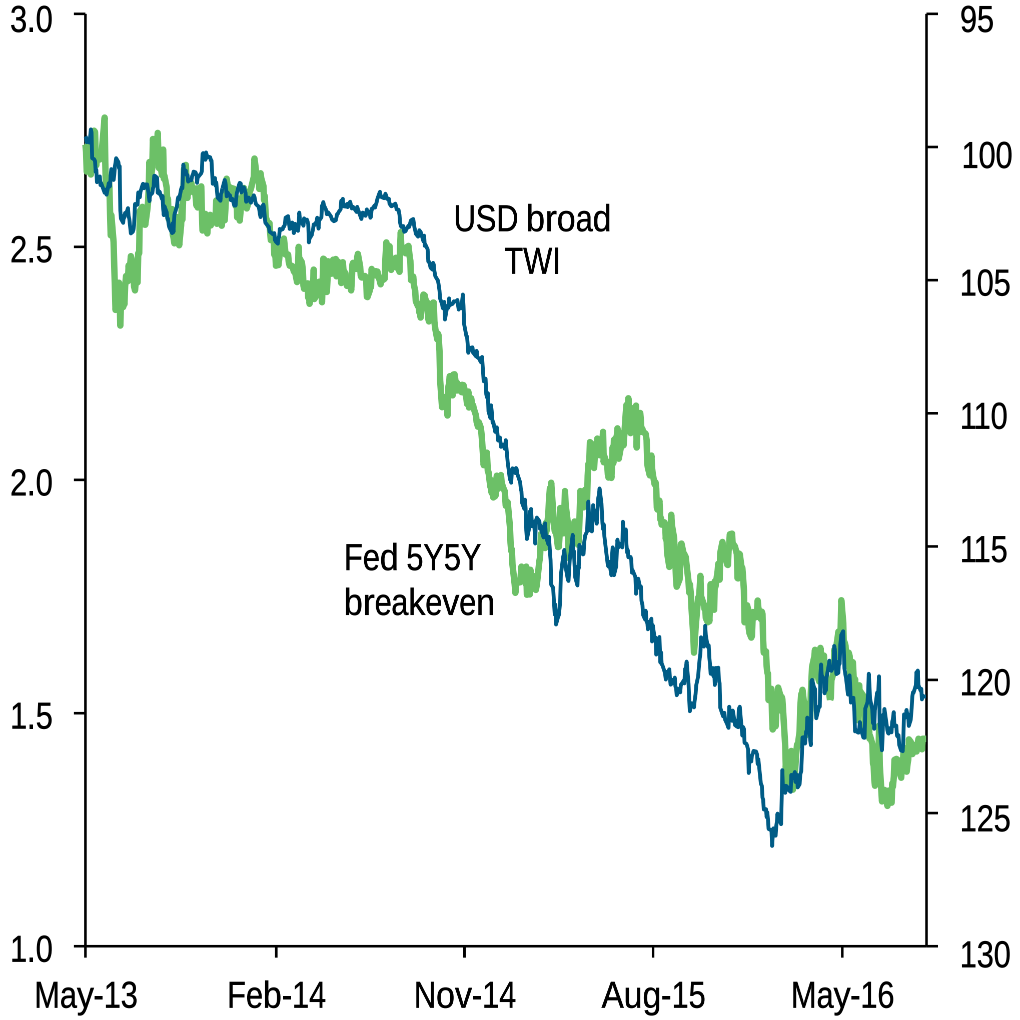
Further weakness in inflation BEs

USD and EUR 5Y5Y BEs, % (LHS) vs WTI, USD/bbl (RHS)



USD strength weighs on inflation expectations

USD 5Y5Y inflation BEs, % (LHS) vs USD TWI (RHS)



Source: Bloomberg, Standard Chartered Research

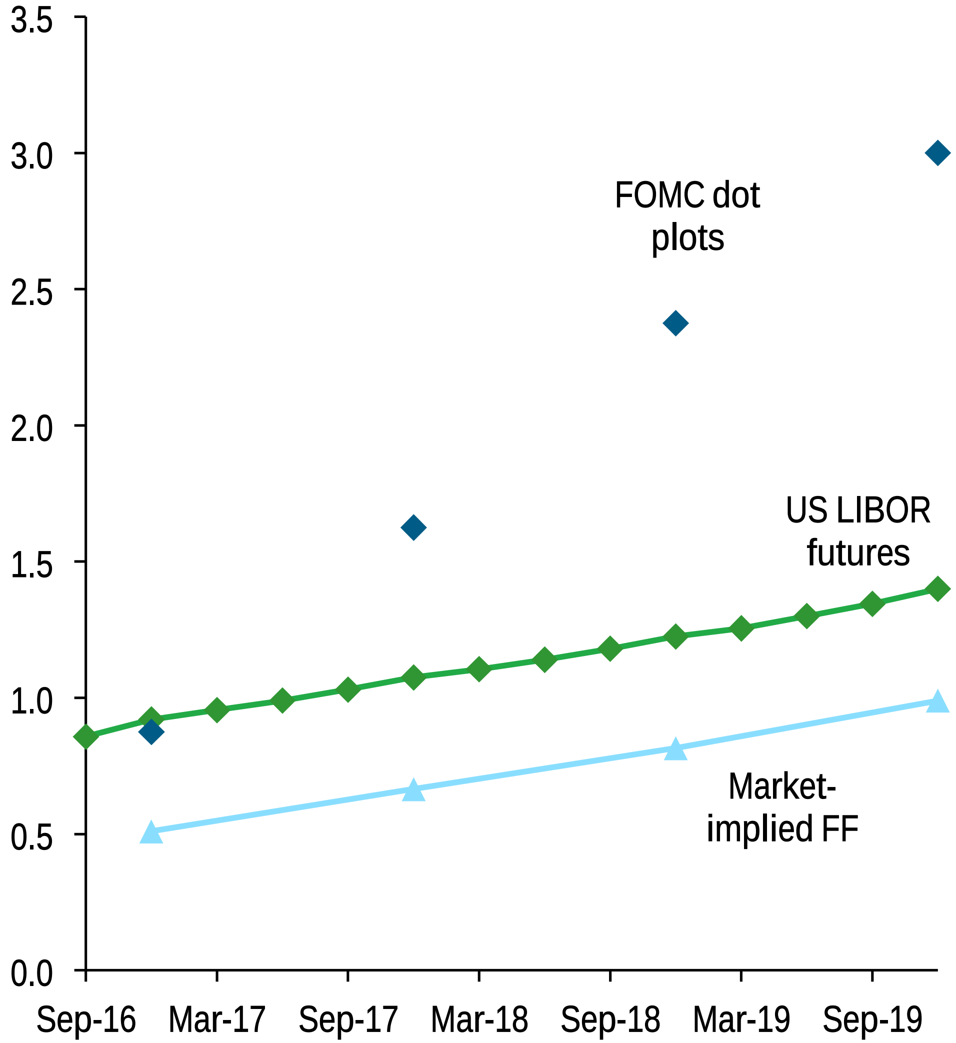
Risk of FOMC rate hikes returns

US rates still price in a flat rate-hike trajectory

US money-market yield curve (EDZ6 minus Z8), %

FOMC dot plots to converge with market

Market-implied rates (ED futures) and FOMC dots, %

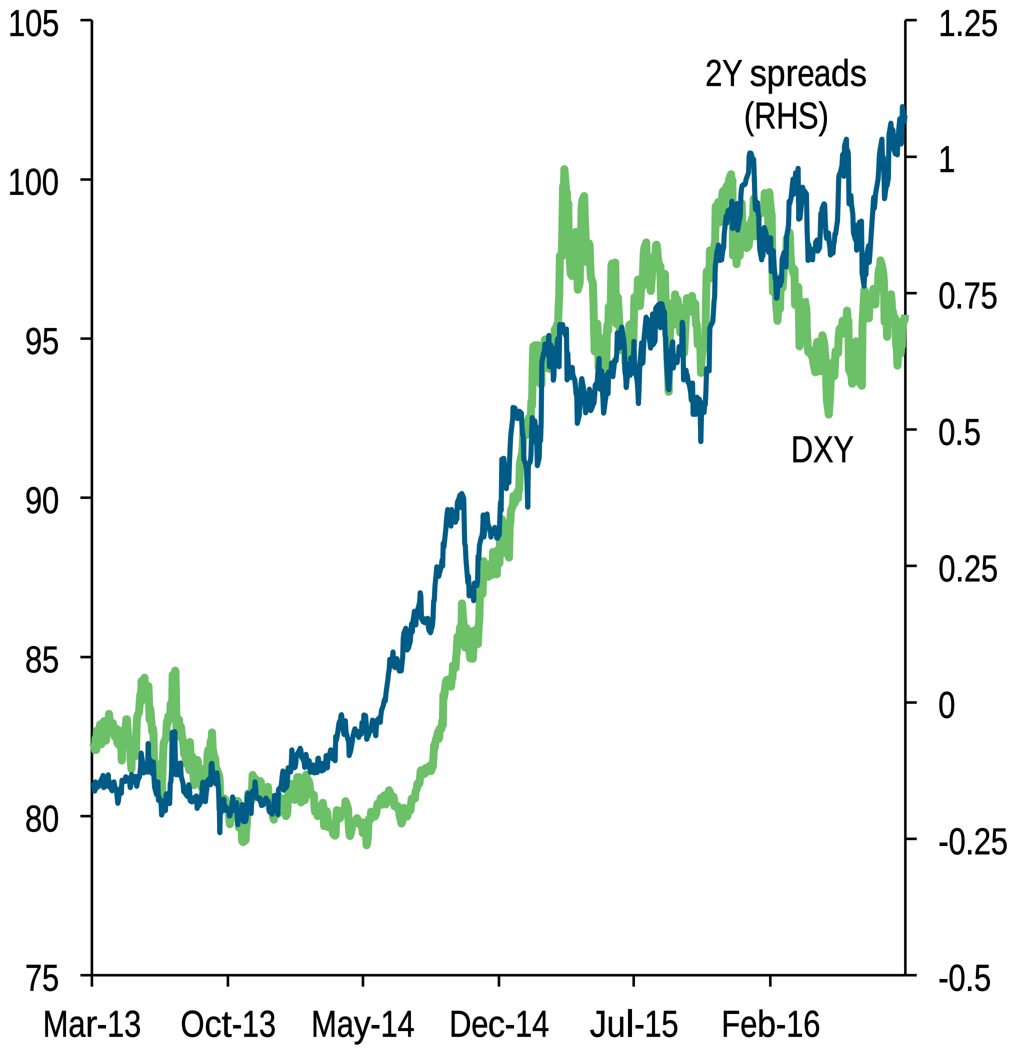


Source: Bloomberg, Standard Chartered Research

USD – We expect moderate strength, but no new highs

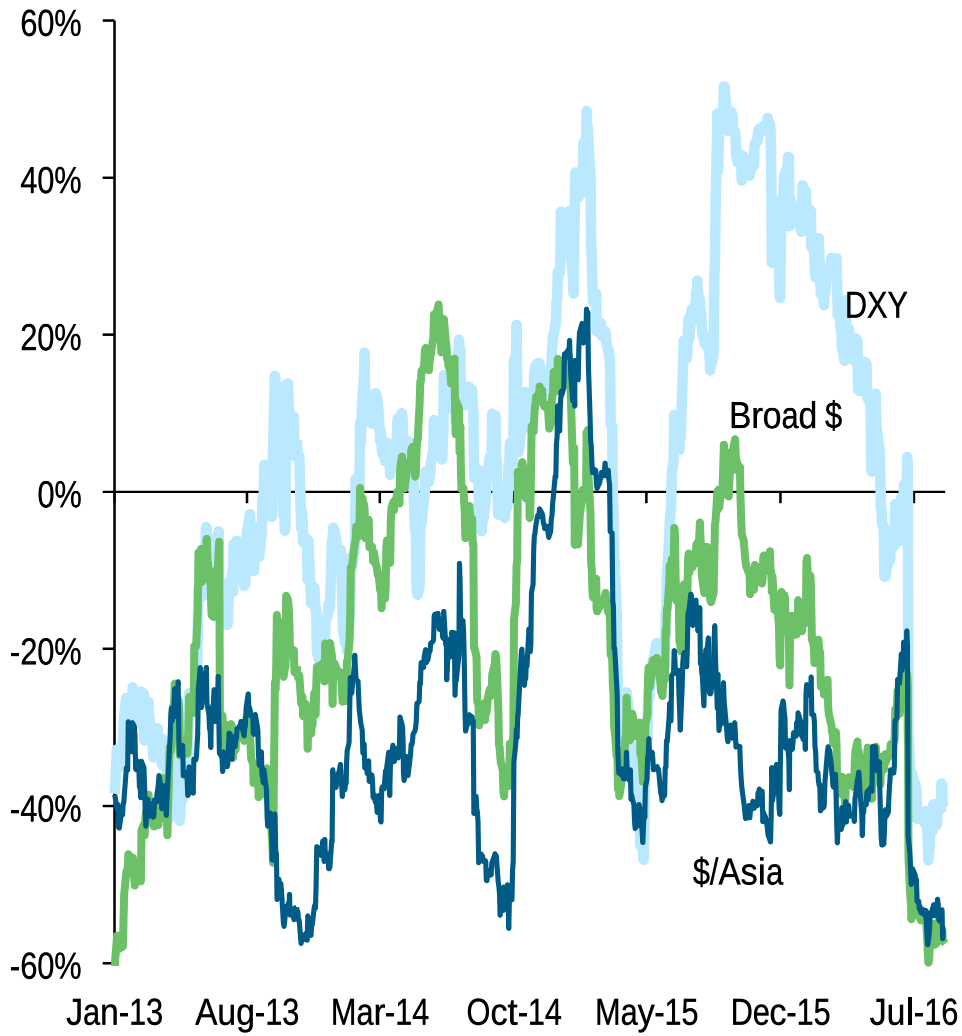
USD is undervalued vs G10 rates

DXY (LHS) vs weighted 2Y rate differentials, % (RHS)



'Dollar smile' in play as USD correlations change

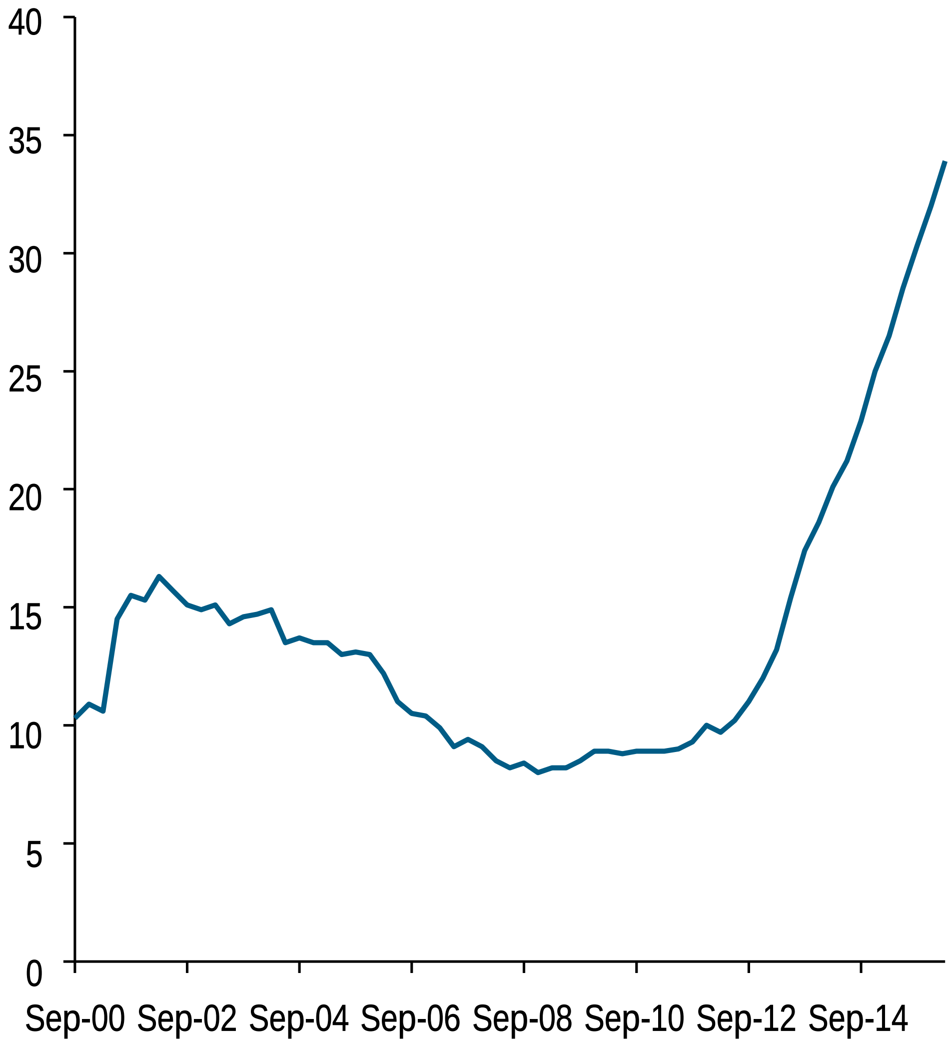
Rolling 60d correlation between USD indices and S&P



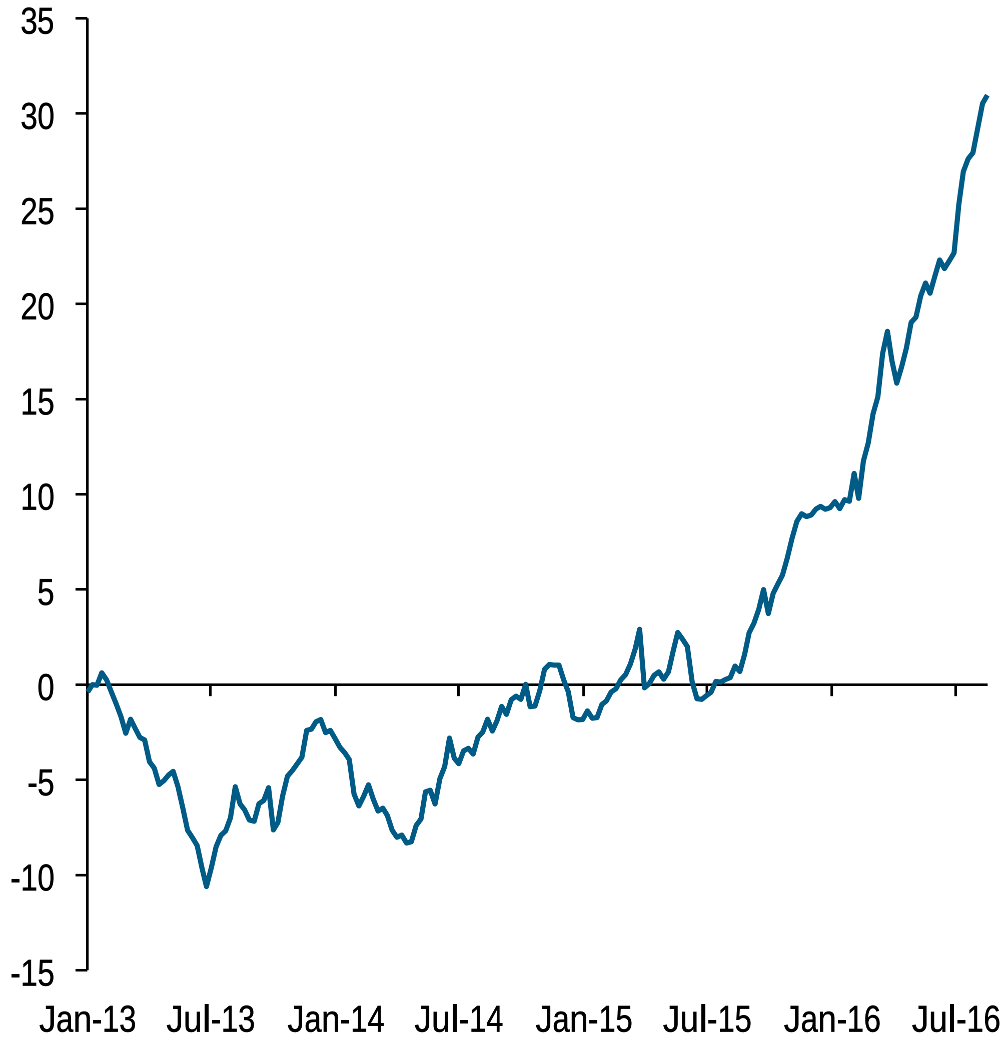
Source: Bloomberg, Standard Chartered Research

The BoJ pushes domestic investors overseas

The BoJ owns the JGB market
BoJ ownership of JGBs as % of outstanding



Japanese investors search overseas
Cumulative foreign bond buying (JPY tn)

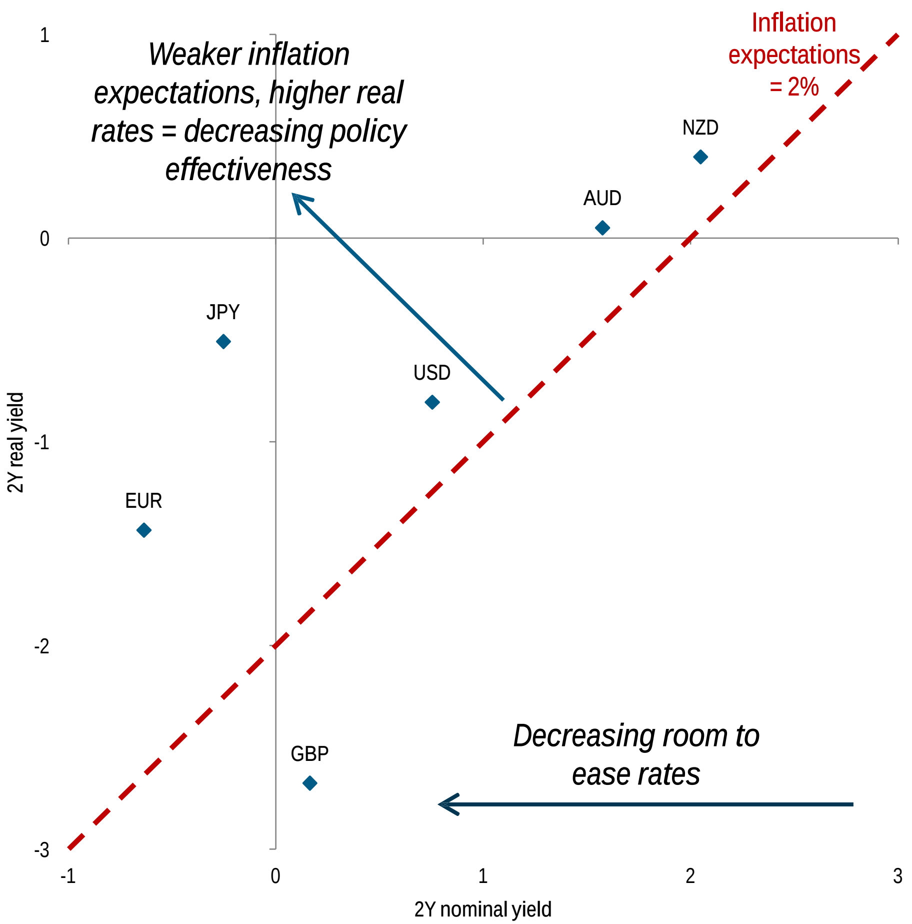


Source: Bloomberg, Standard Chartered Research

Real vs nominal yields: Gauging monetary policy effectiveness

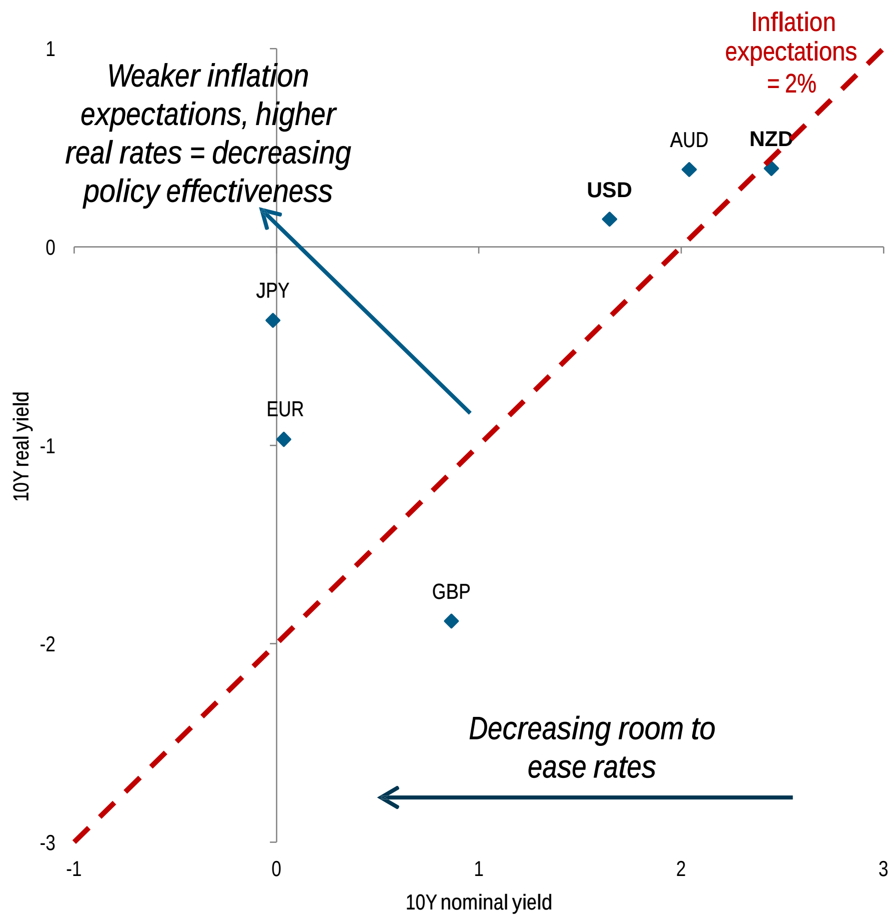
Japan has highest 2Y real yield in G3

2Y real yield vs 2Y nominal yield, %



High real yields mark the failure of BoJ policy

10Y inflation-linked bonds yields vs nominal yields, %



The diagonal red line represents 2% inflation expectations (real yield = nominal yield - 2%), the 'ideal' relationship if inflation expectations were anchored at the 2% target. Points above the line mark weakness in inflation expectations. The further from the line, the weaker the policy.

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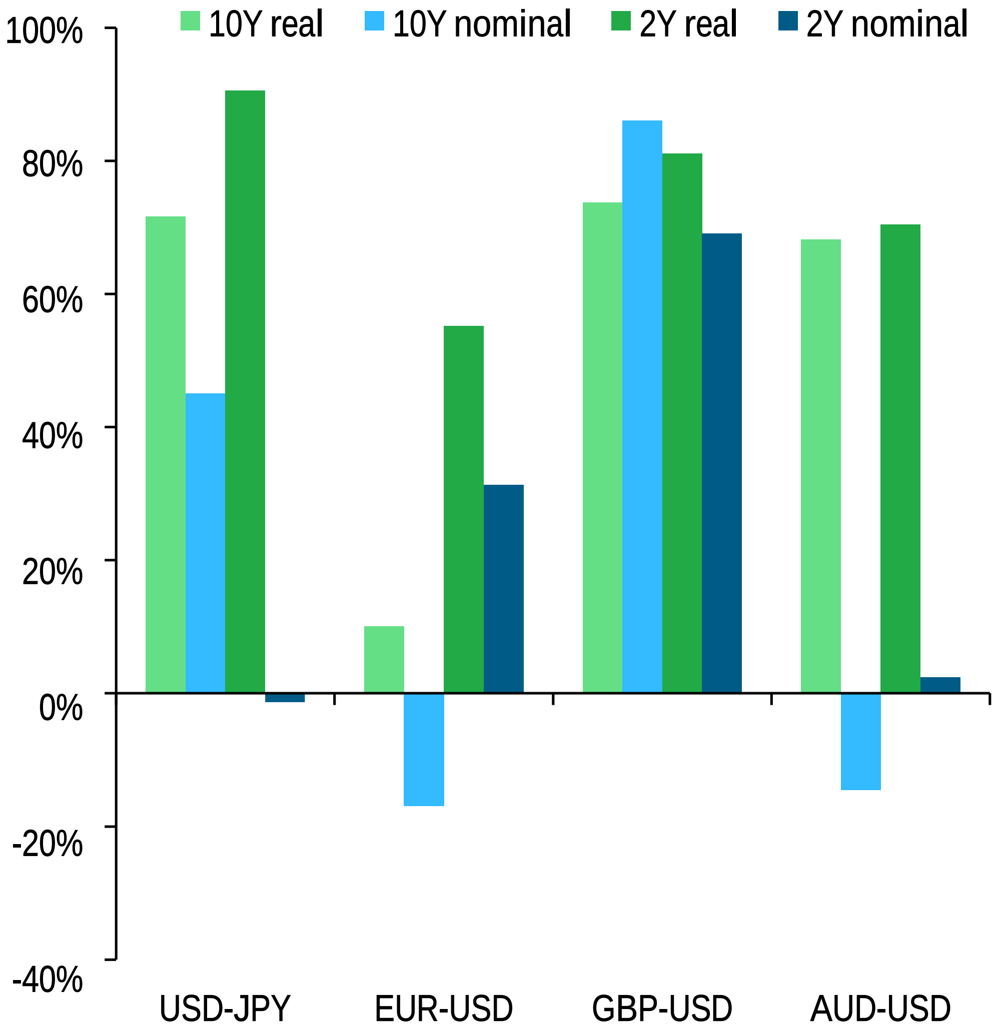
Source: Bloomberg, Standard Chartered Research

G10 FX rates now driven by real yields

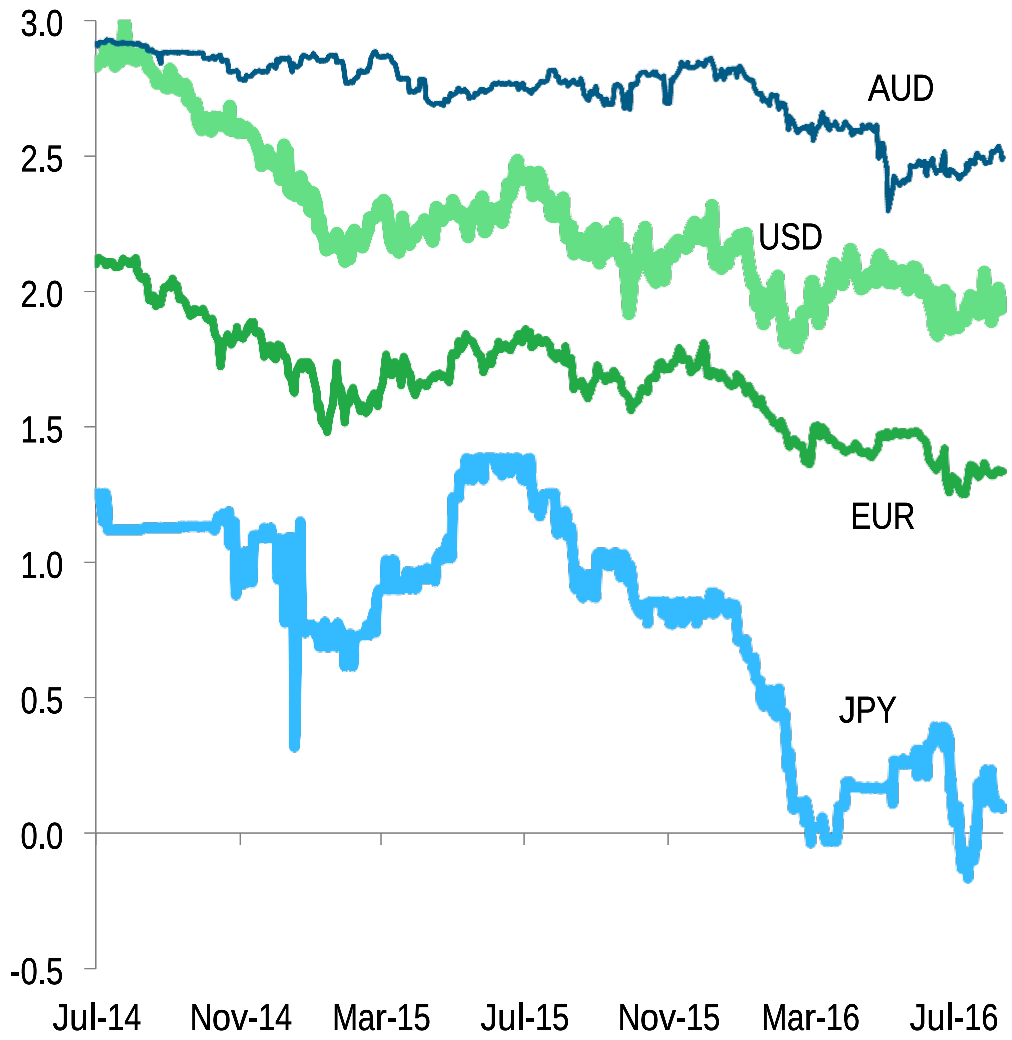
Real yields take over from nominal yields

Correlation of FX with nominal and real yields, 2016



Declining and diverging inflation expectations

5Y5Y inflation swap, (inflation expectations), %



Source: Bloomberg, Standard Chartered Research

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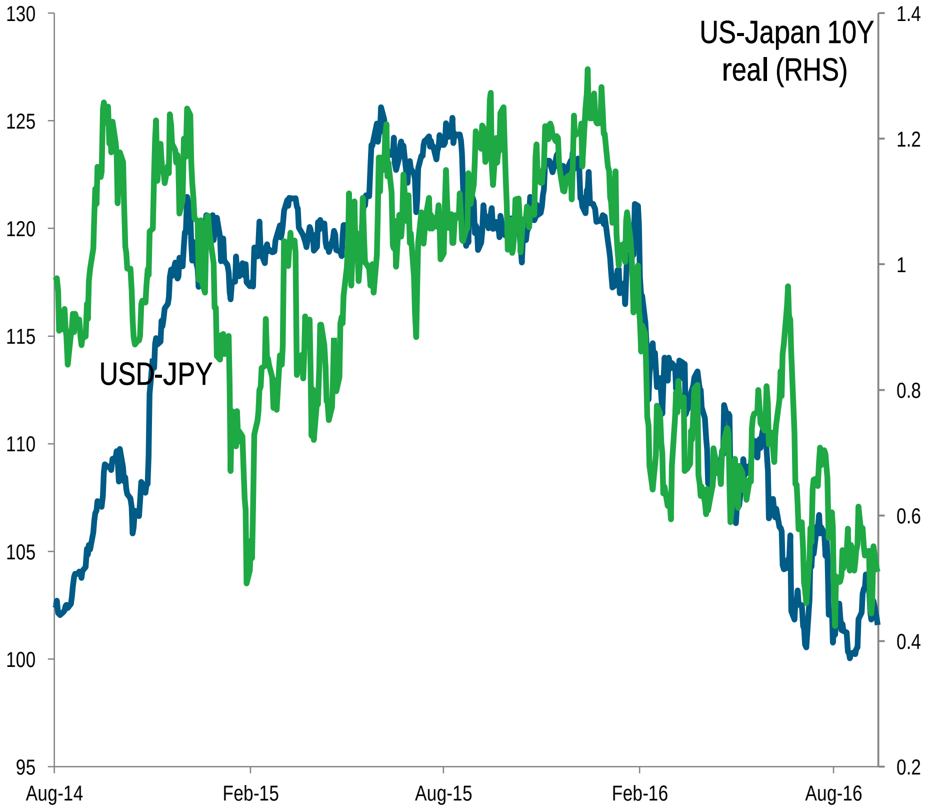
FX majors show strong relationship with real yield differentials

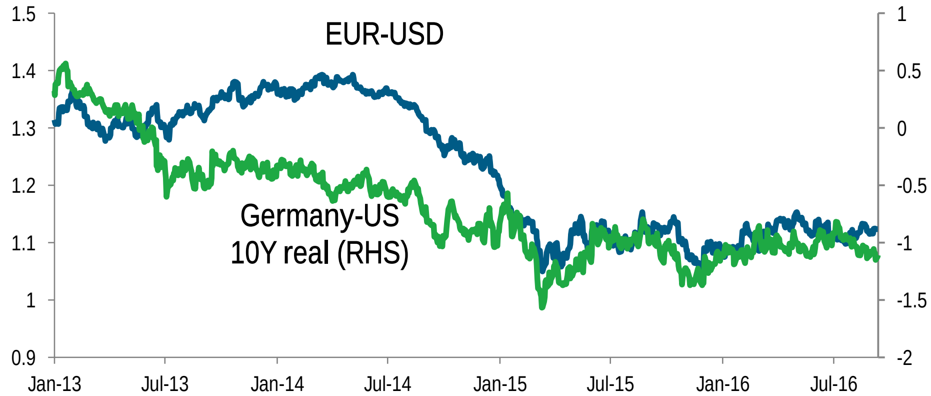
Real yield spreads explain the JPY rally…

USD-JPY (LHS) vs US-Japan 10Y real yield spread (RHS, %)



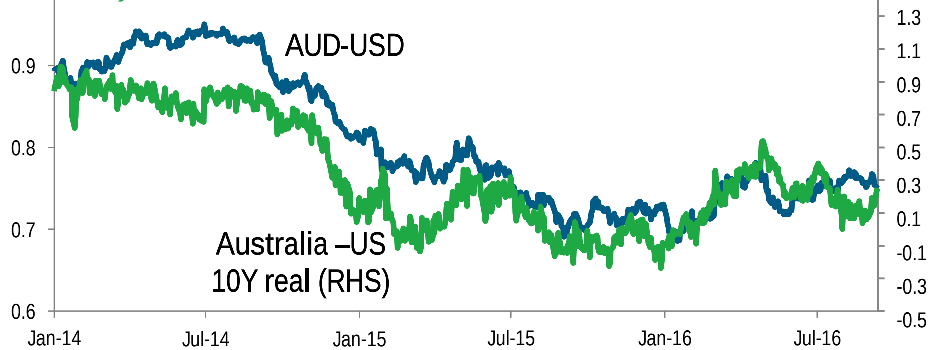
… and EUR strength

EUR-USD (LHS) vs Germany/US 10Y real yield spread (RHS, %)



AUD has also found support from higher real yields

AUD-USD (LHS) vs AU/US 10Y real yield spread (RHS, %)

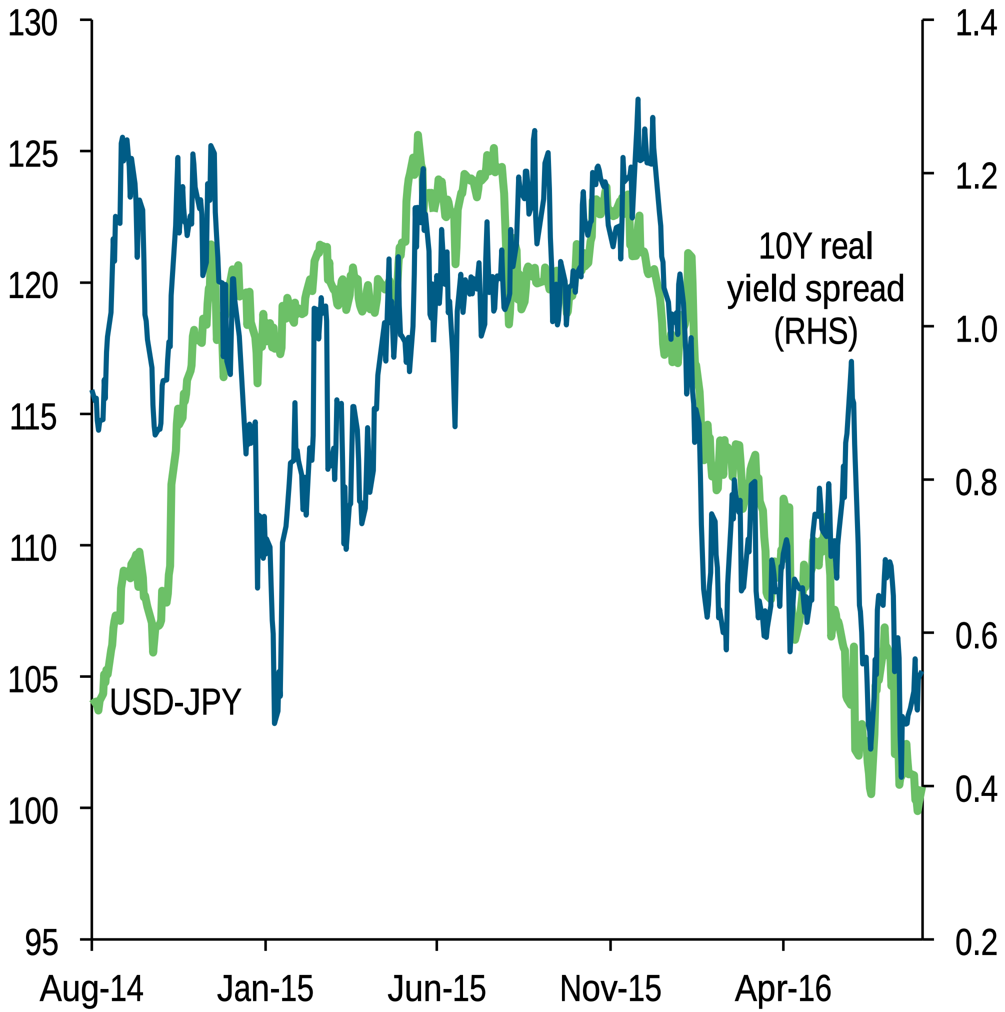


Source: Bloomberg, Standard Chartered Research

JPY – Real rate differentials have driven USD-JPY lower

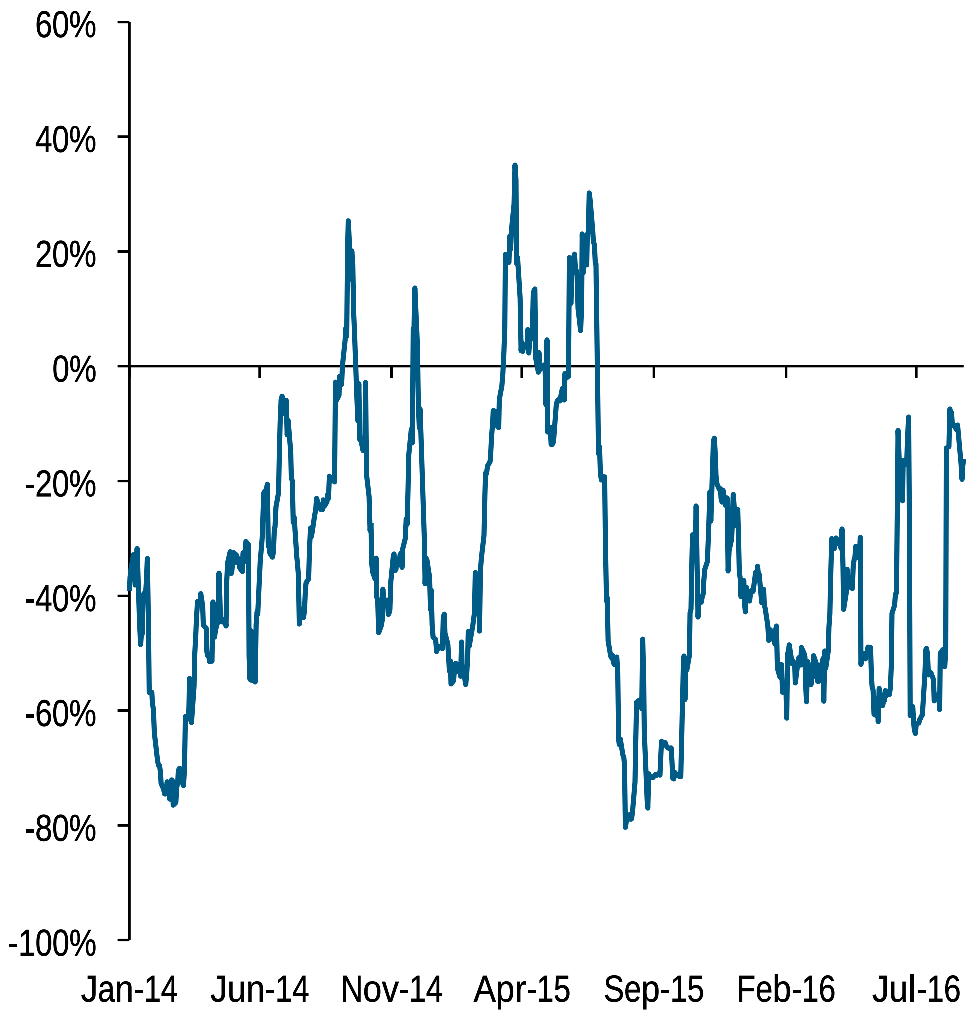
Real yield spreads explain the JPY rally

USD-JPY (LHS) vs 10Y UST real minus 10Y JGB real, % (RHS)



JPY loses its correlation to risk assets

Rolling 30-day correlation between USD-JPY and VIX



Source: Bloomberg, Standard Chartered Research

The search for yield

High yield in a low yield world

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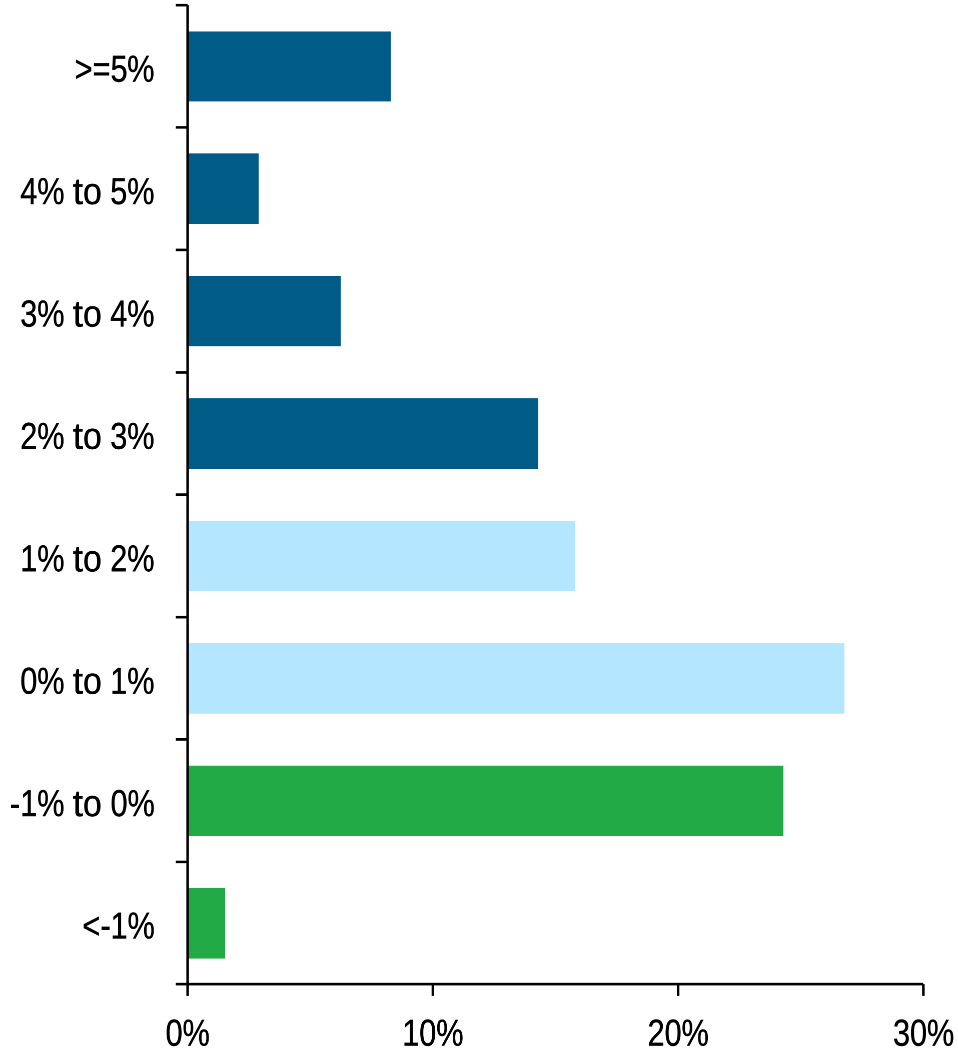
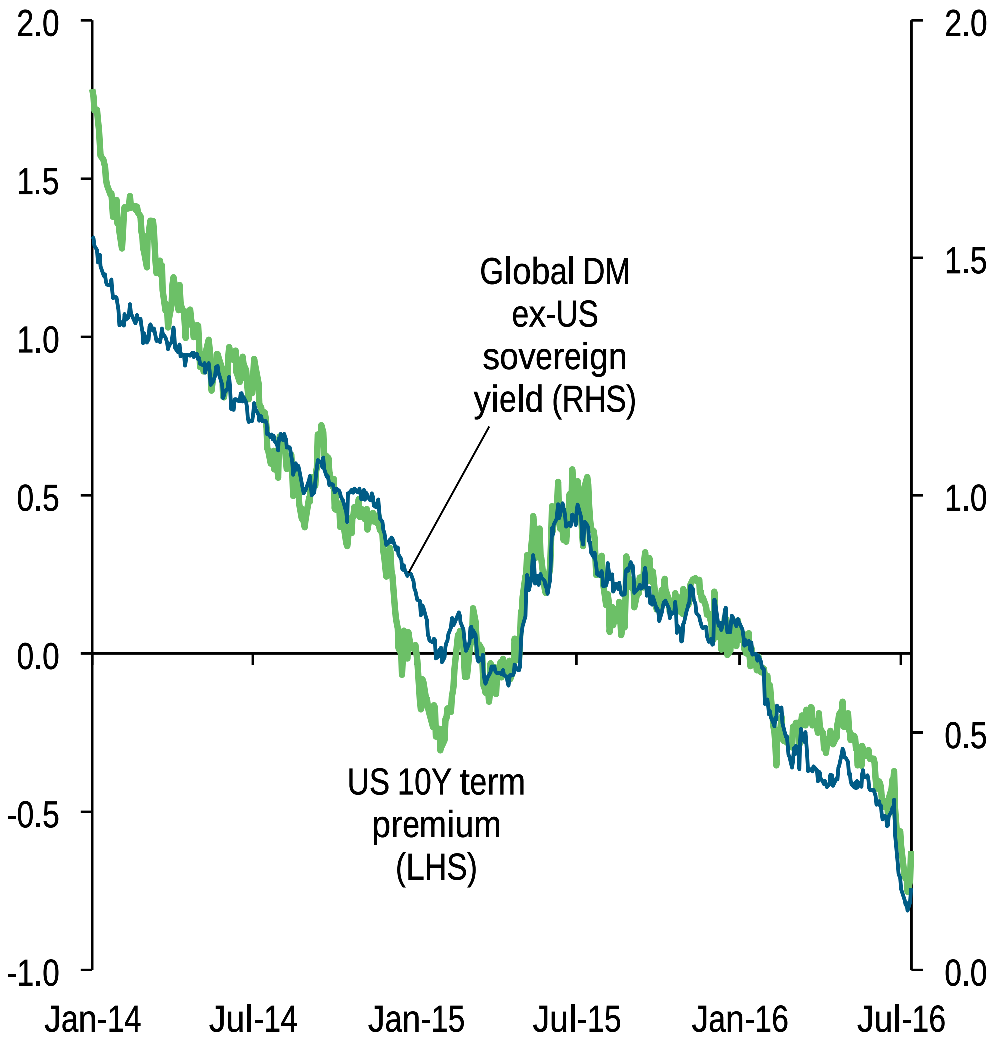
Lack of yield in DM rates is pushing investors to EM

70% of global bond yields are less than 2%, and 26% are negative



Low global DM yields to keep weighing on long-term US rates



Source: Bloomberg, NY Federal Reserve Board, Standard Chartered Research

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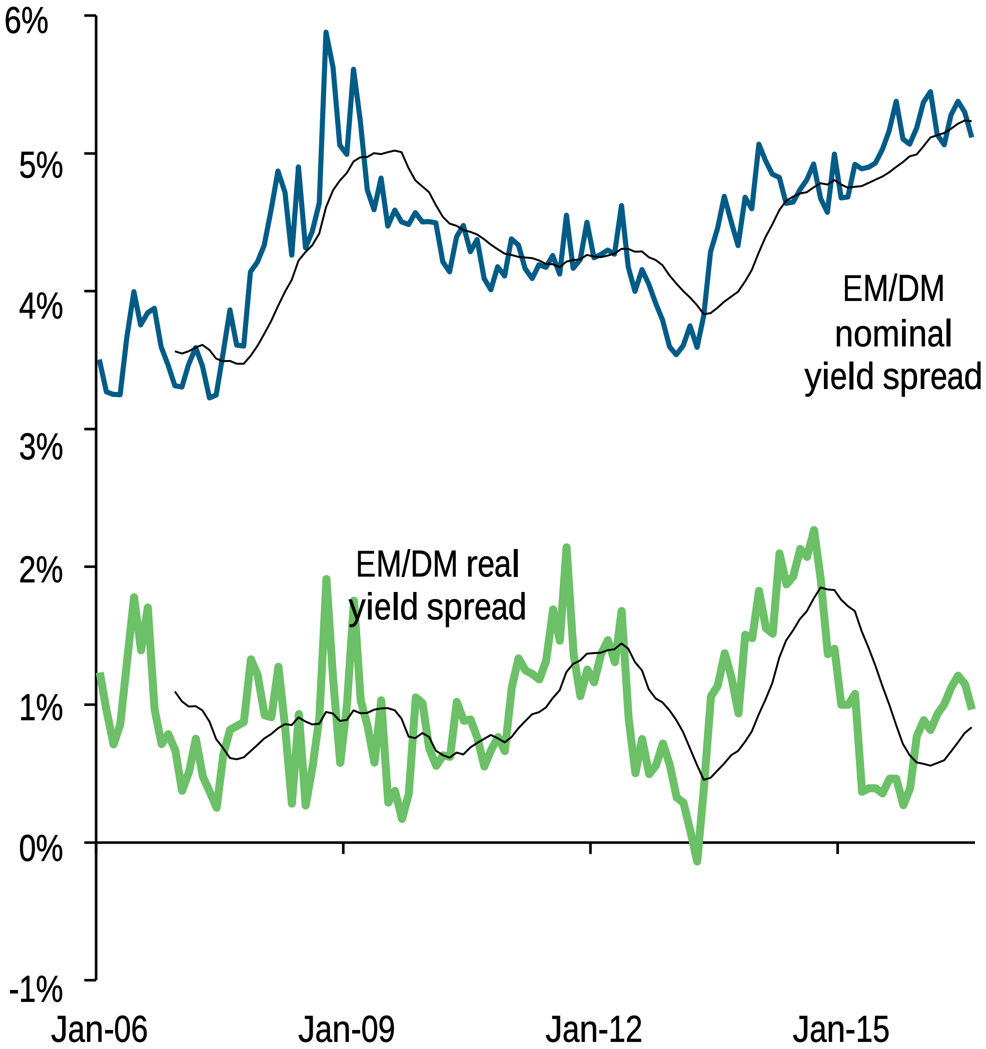
EM assets offer value over DM counterparts

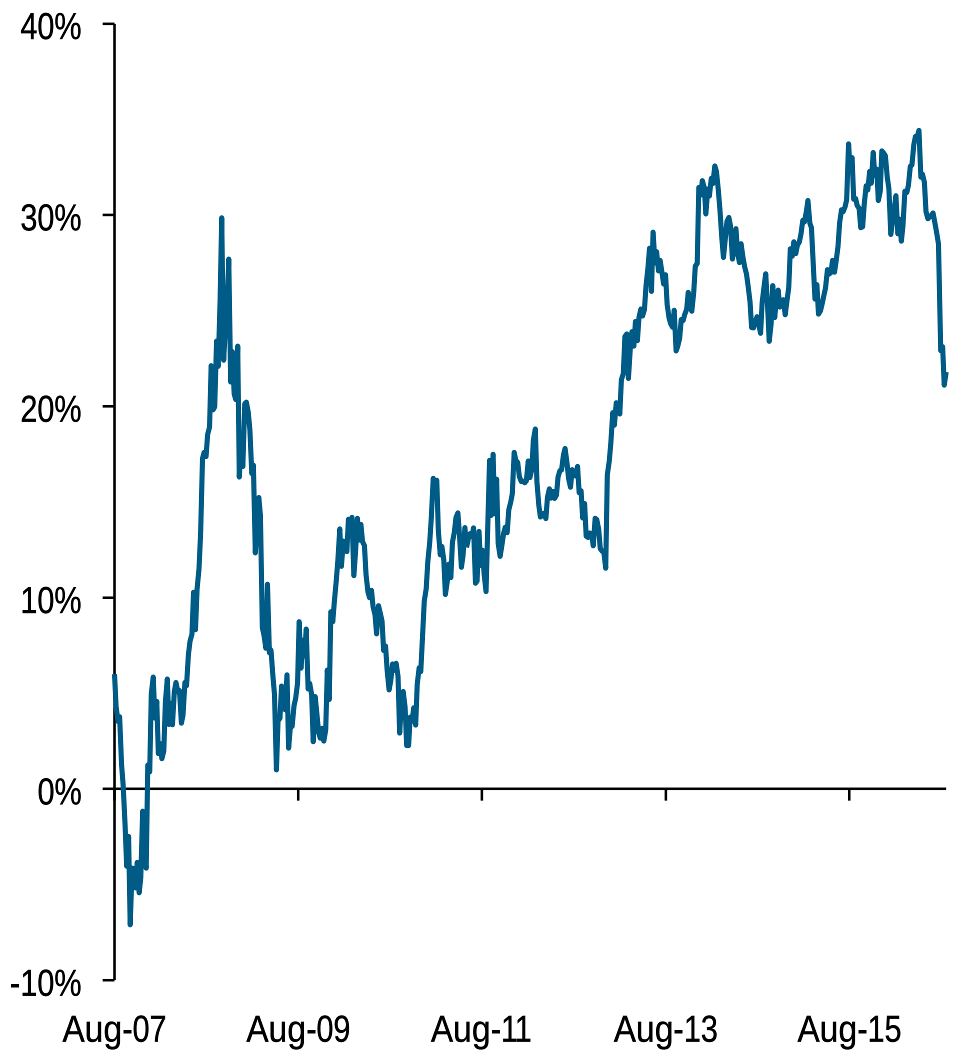
Wide yield spreads make EM rates attractive

Nominal and real yield spread between EM and DM



EM equities still trade at a P/E discount to DM

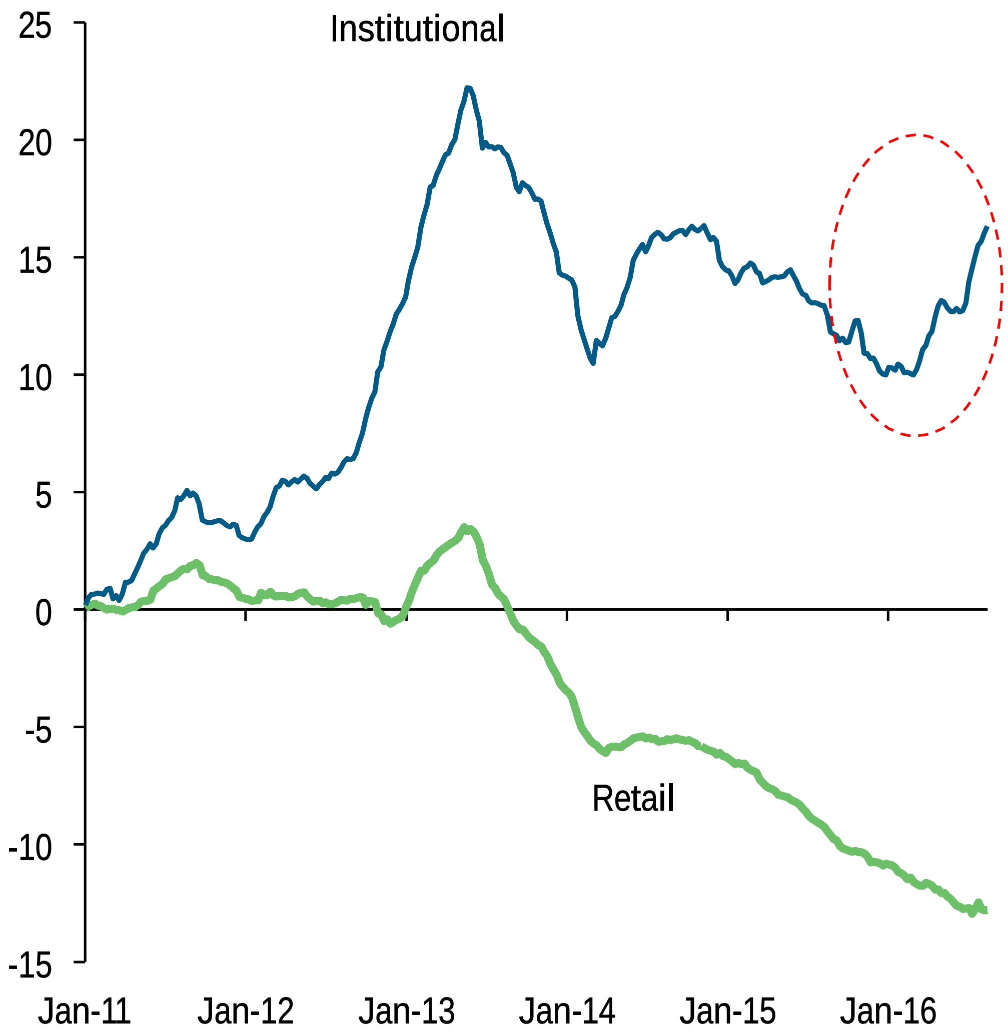
Estimated P/E discount MSCI EM vs DM, %



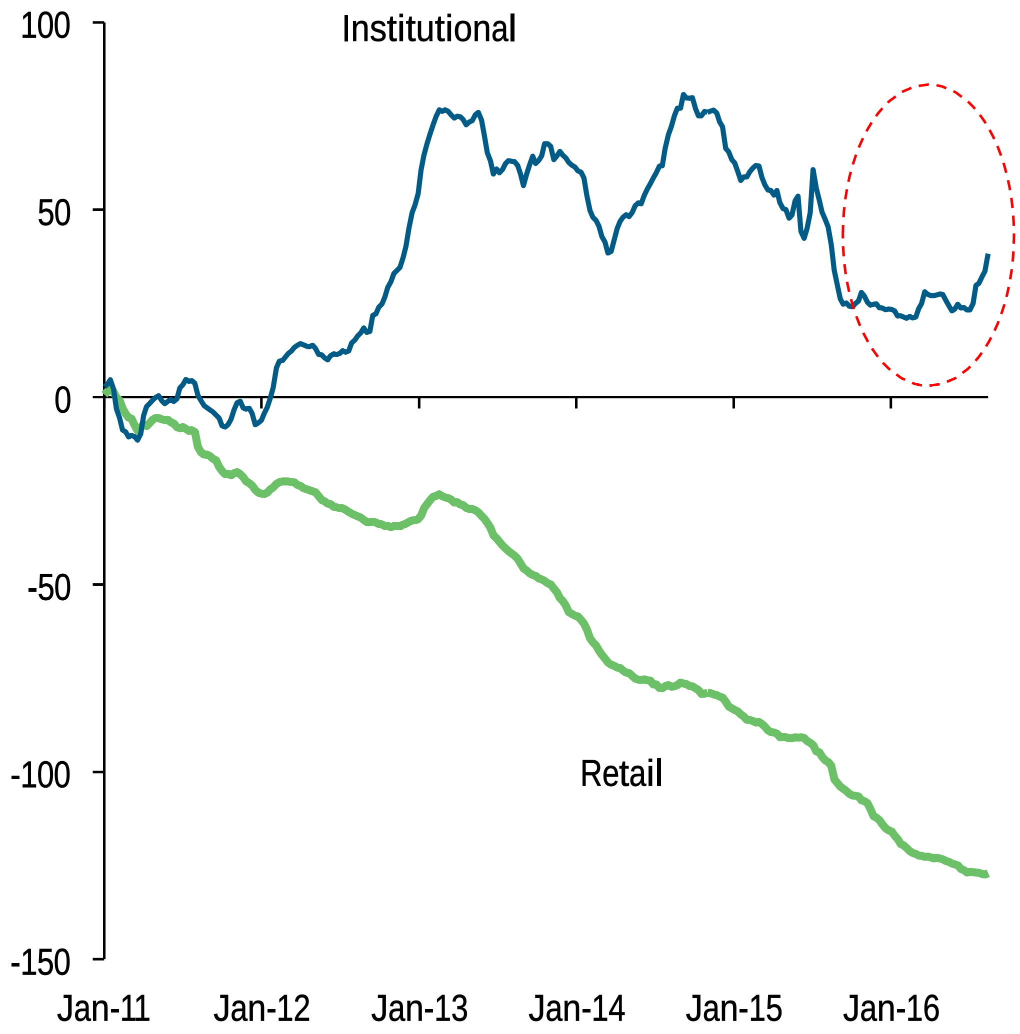
Source: Bloomberg, Standard Chartered Research

The march towards EM continues

EM LCY debt funds
Cumulative flows since 2011, USD bn



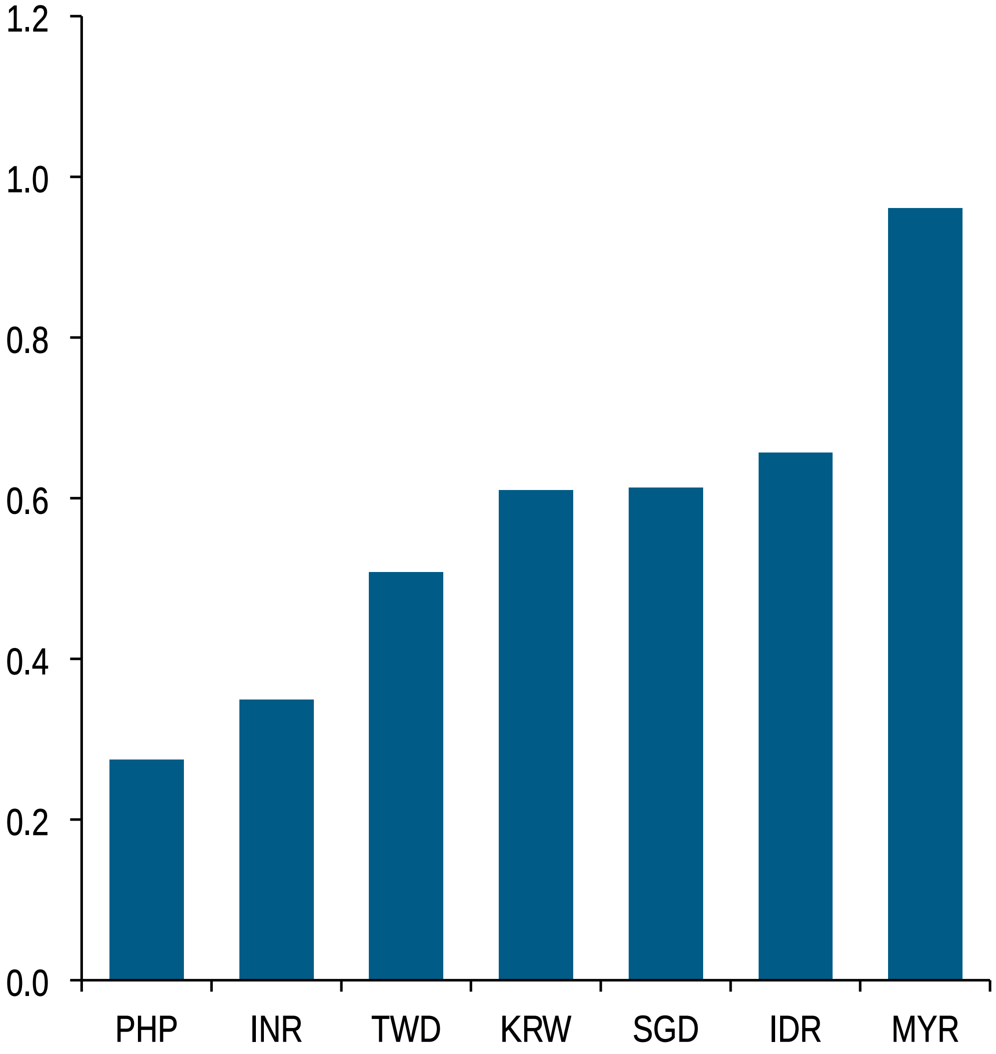
EM equity funds
Cumulative flows since 2011, USD bn



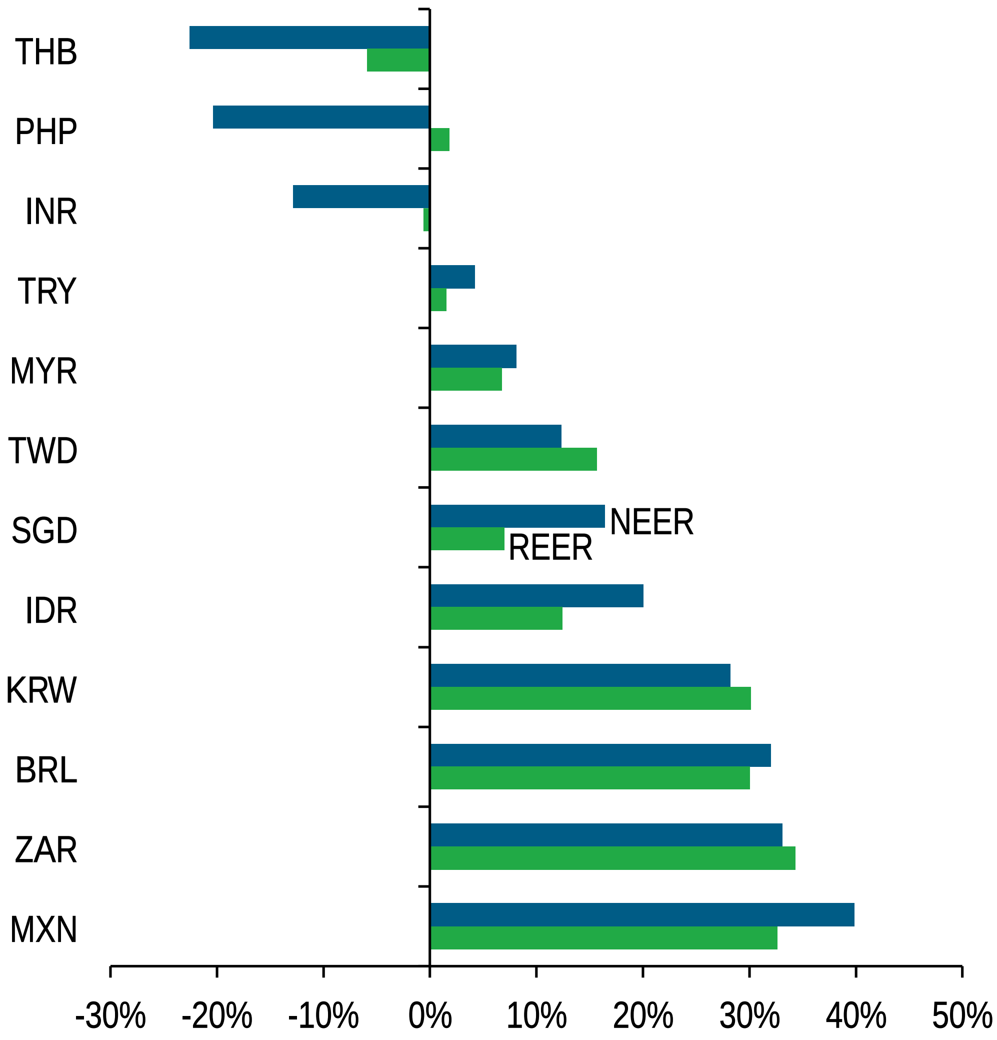
Source: EPFR, Bloomberg, Standard Chartered Research

Stability in China and commodities has improved the EM outlook

China FX stability still supports EM FX
Weekly beta against USD-CNY moves



EM FX correlations to oil
Correlations between rolling 60d returns, 2001-15



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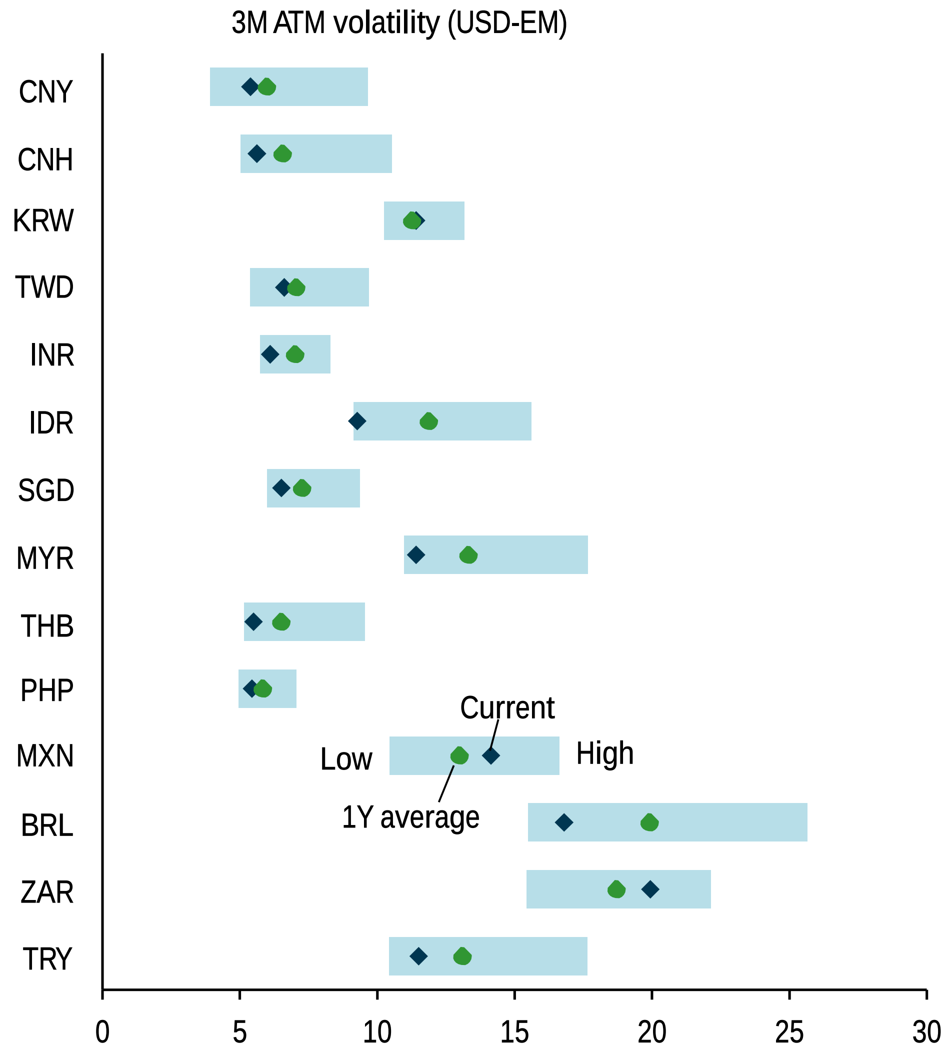
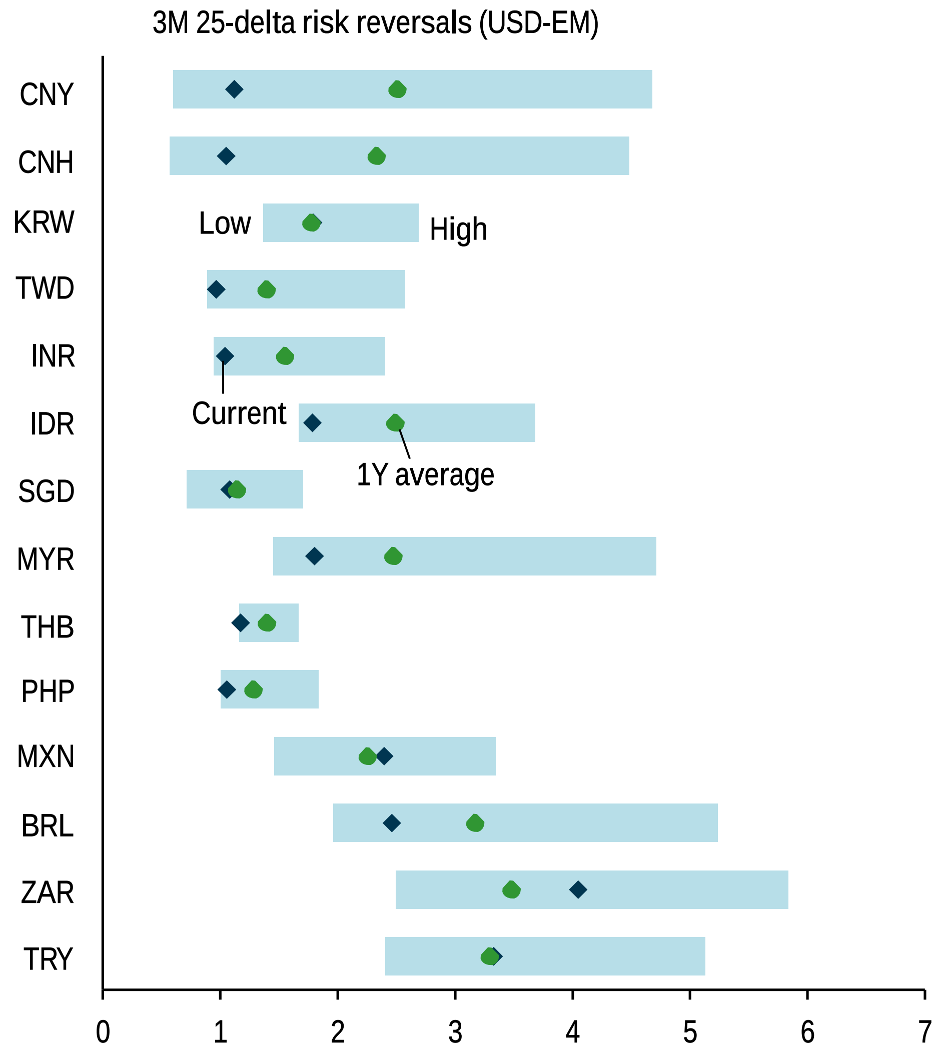
Source: Bloomberg, Standard Chartered Research

EM FX volatility and risk reversals show improved risk sentiment

Volatility and risk reversals are below 1Y average for most EM currencies
Asia FX RRs and vols are close to 1Y lows; CNH, INR, IDR and MYR RRs have declined most





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Source: Bloomberg, Standard Chartered Research

EM FX – Carry is king

INR and IDR offer the most attractive carry

Vulnerabilities and high volatility hurt risk/reward for ZAR, BRL and TRY

Green (red) indicates more (less) attractive carry; darker shades indicate a stronger signal

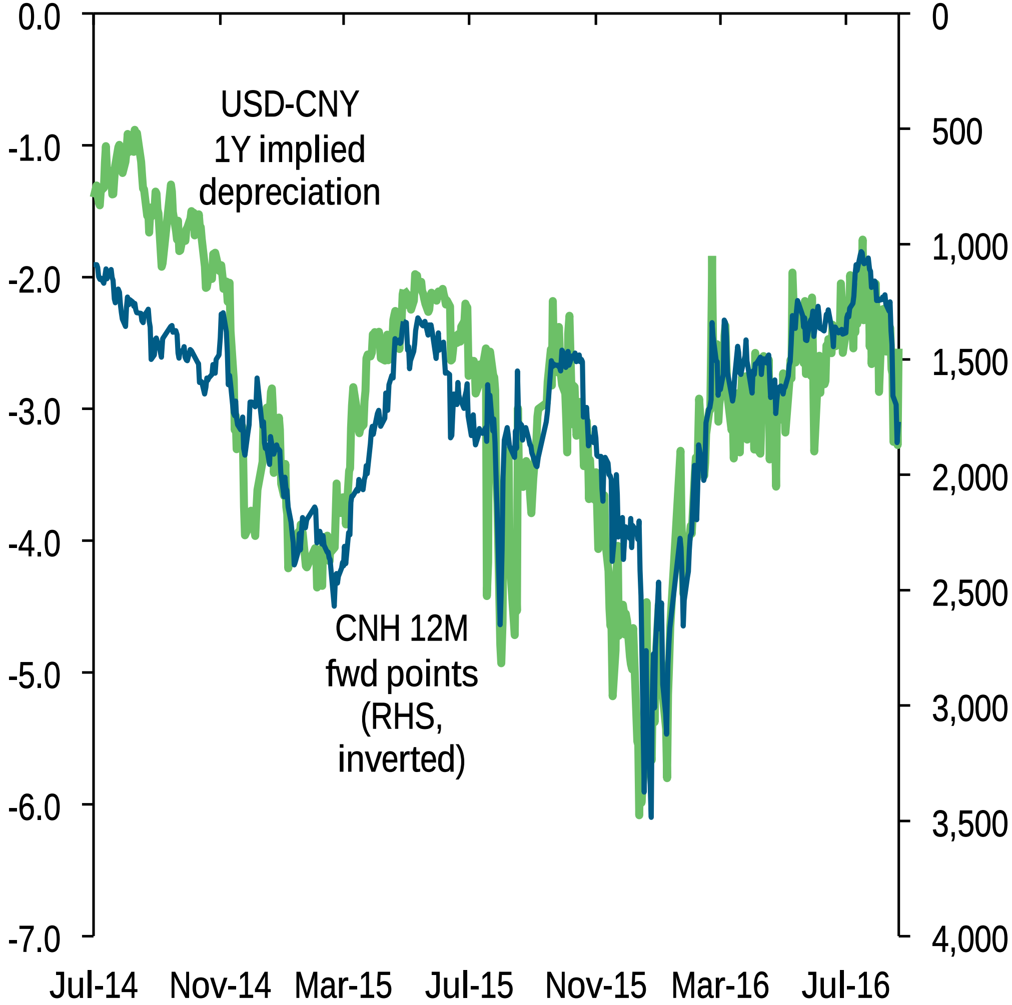
Currency	3M carry	3M vol	3M carry/ vol	3M RR	1Y carry	1Y vol	1Y carry/ vol	1Y RR	C/A % GDP	Valuation on 5Y REER avg	Downside to YTD lows vs USD
KRW	-0.3%	11.4	-0.03	1.8	-0.2%	11.6	-0.02	3.2	7.9	6%	-11%
INR	5.4%	6.1	0.89	1.0	5.6%	7.5	0.74	1.8	-1.1	3%	-3%
IDR	5.4%	9.4	0.57	1.8	5.8%	10.8	0.54	3.9	-2.1	0%	-5%
MYR	1.0%	11.4	0.08	1.8	1.2%	11.4	0.10	3.2	1.9	-7%	-9%
PHP	1.0%	5.4	0.19	1.1	1.2%	6.4	0.20	1.8	2.3	5%	-3%
ZAR	7.2%	19.9	0.36	4.0	7.4%	19.5	0.38	5.2	-5.0	-17%	-18%
TRY	7.7%	11.5	0.67	3.3	8.0%	13.3	0.61	4.5	-4.1	0%	-5%
PLN	0.7%	10.2	0.07	1.6	0.4%	11.5	0.03	2.5	0.3	2%	-6%
BRL	11.2%	16.8	0.67	2.5	10.4%	16.9	0.62	3.9	-2.5	-2%	-28%
MXN	3.6%	14.1	0.26	2.4	3.8%	13.8	0.28	2.8	-3.2	-11%	-2%
CLP	2.4%	11.1	0.22	1.6	2.9%	11.1	0.26	2.7	-2.2	-3%	-8%
COP	6.6%	17.4	0.38	1.9	6.7%	16.9	0.40	2.5	-6.1	-8%	-17%

Source: Bloomberg, Standard Chartered Research

China FX – low volatility for now

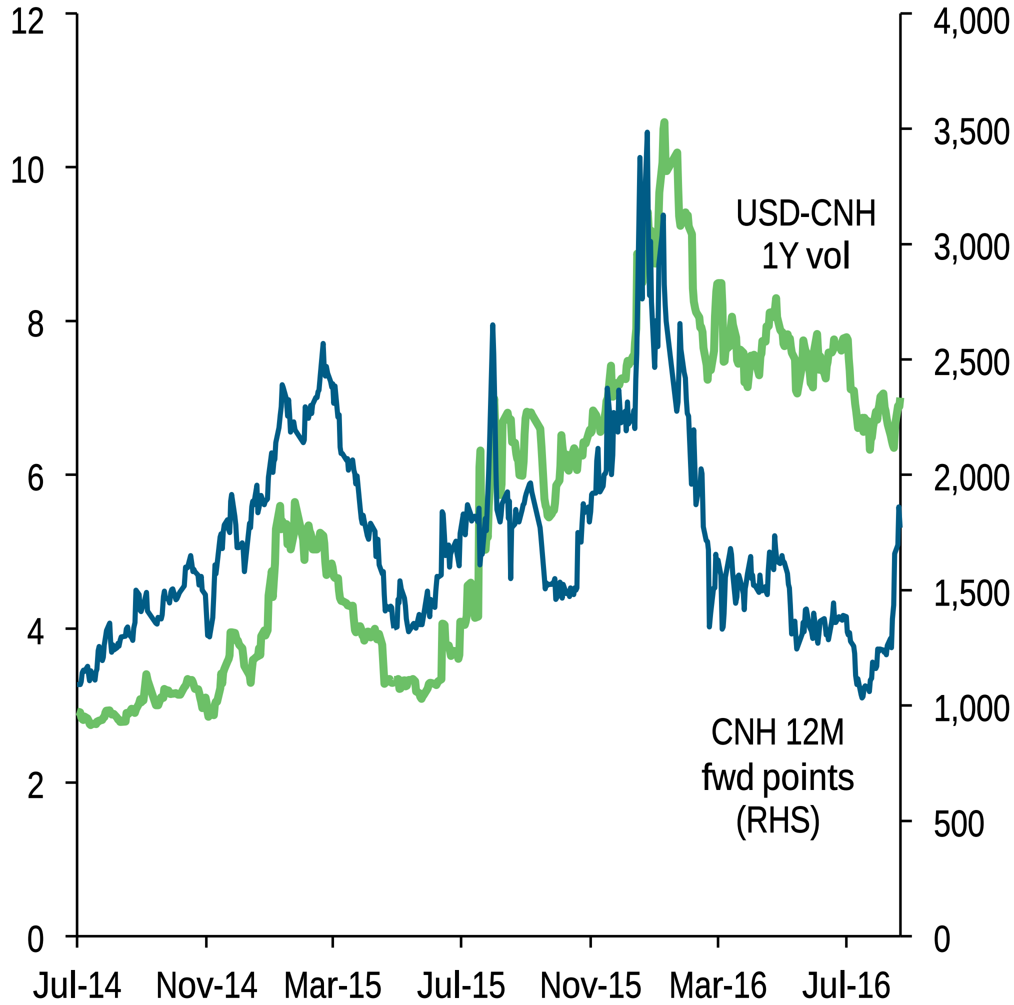
Depreciation expectations remain low

CNY 1Y implied depreciation (LHS) vs CNH 12M forward points, inverted (RHS)



FX risk sentiment rattled on points move

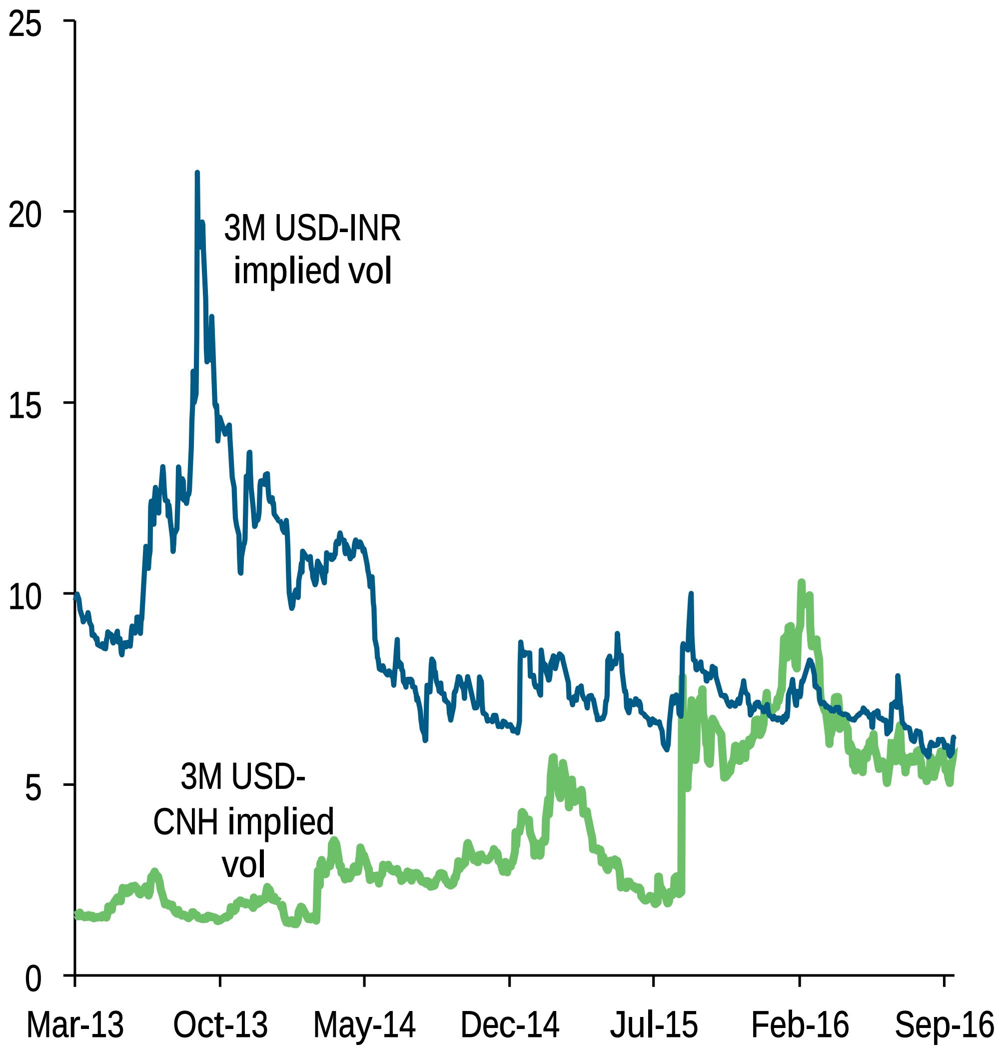
1Y USD-CNH vol, % (LHS) vs 1Y CNH points (RHS)



China FX – Moderate USD strength should not be a problem

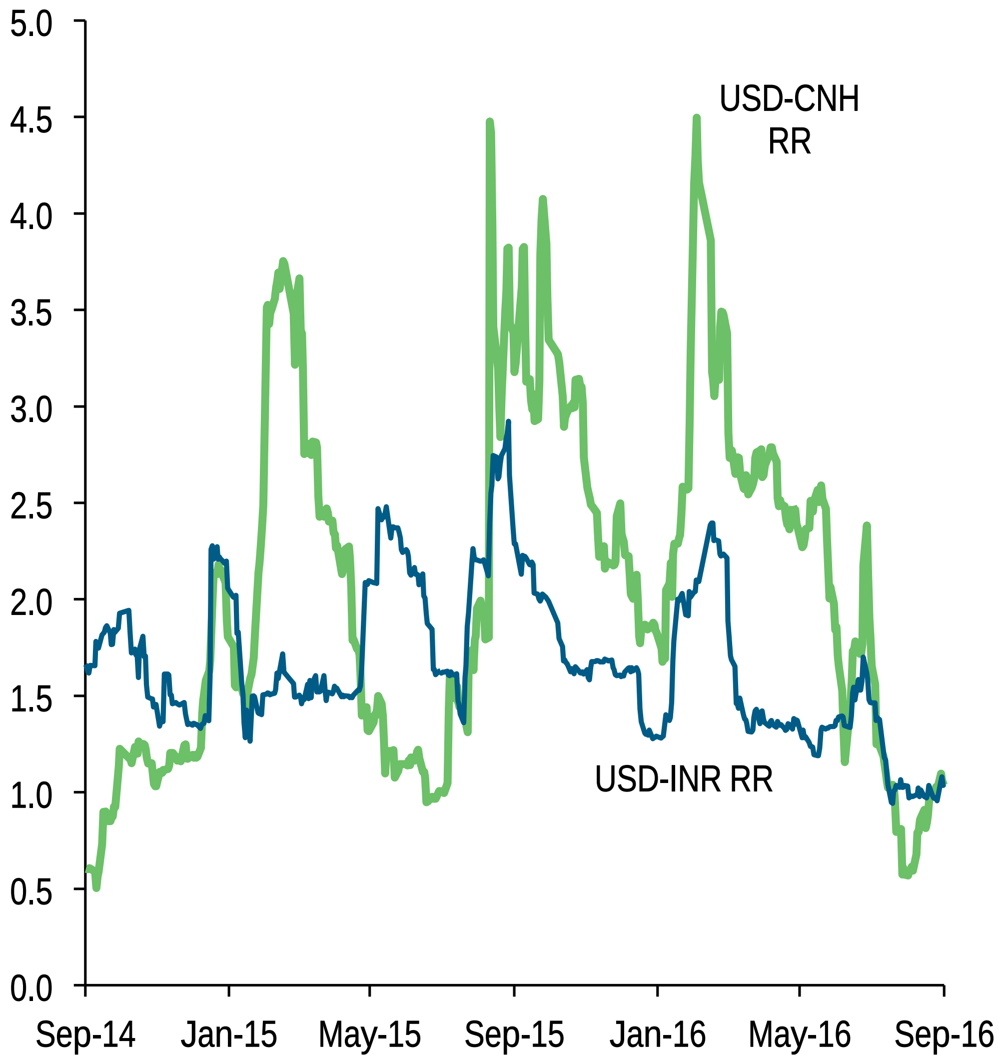
EM FX volatility falls to multi-year lows

USD-CNH and USD-INR 3M implied vol, %



The demise of risk premium in CNH and INR

USD-CNH and USD-INR 3M 25-D risk reversals, %



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Source: Bloomberg, Standard Chartered Research

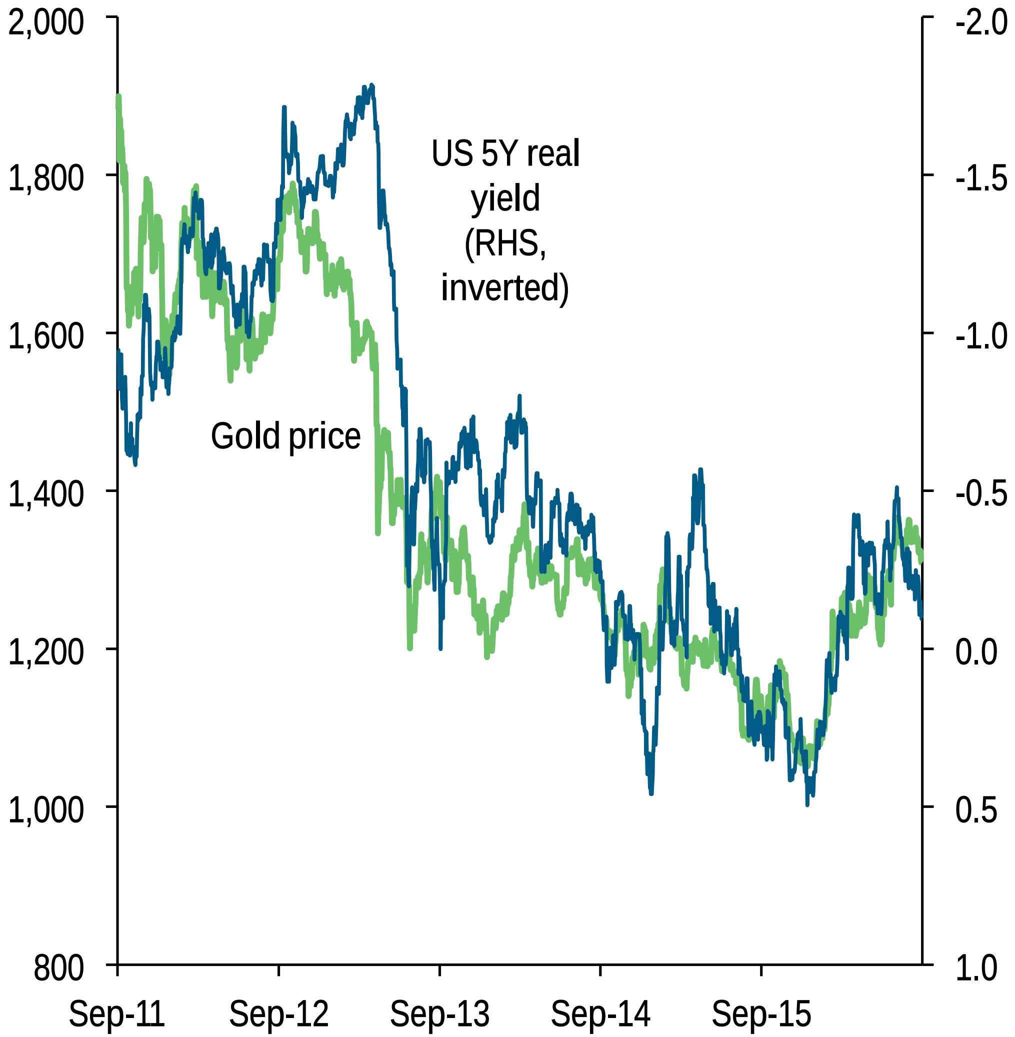
Gold

When 0% yield is high yield

Gold – Low yields support medium-term outlook

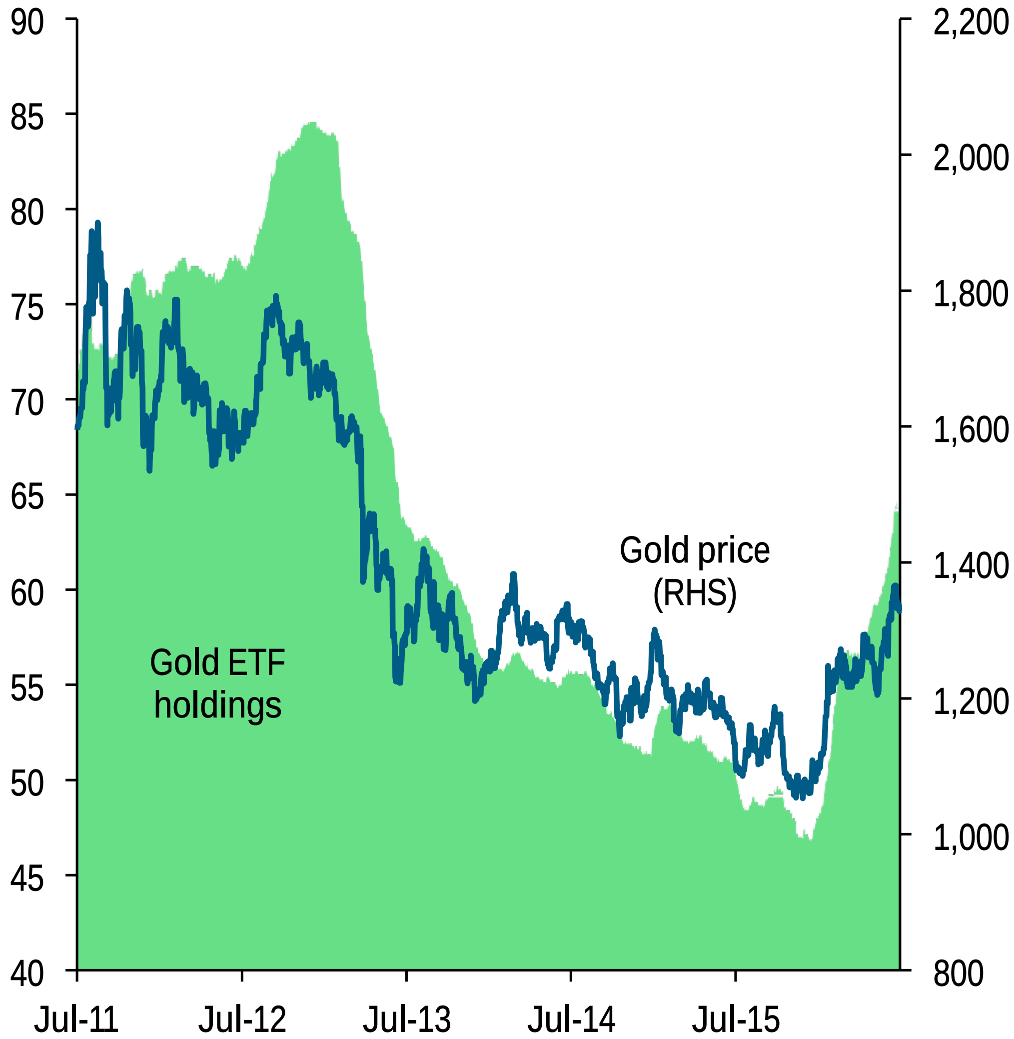
Gold is supported by declining real yields

Gold spot (LHS) vs US 5Y TIPS, % inverted (RHS)



Investor demand remains strong

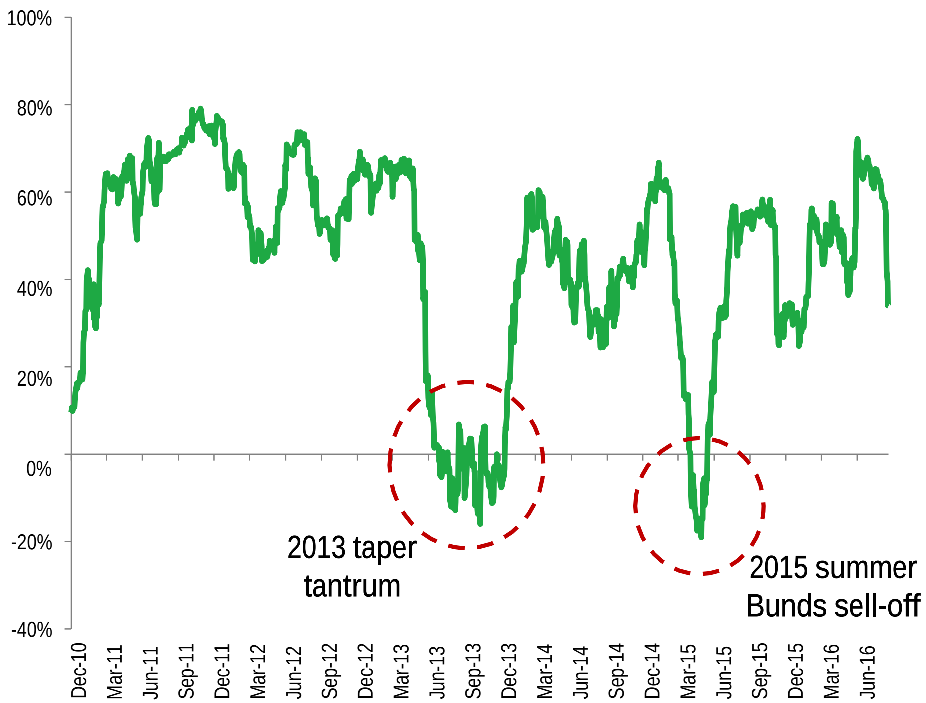
Gold ETF holdings, mn oz (LHS) vs spot (RHS)



Source: Bloomberg, Standard Chartered Research

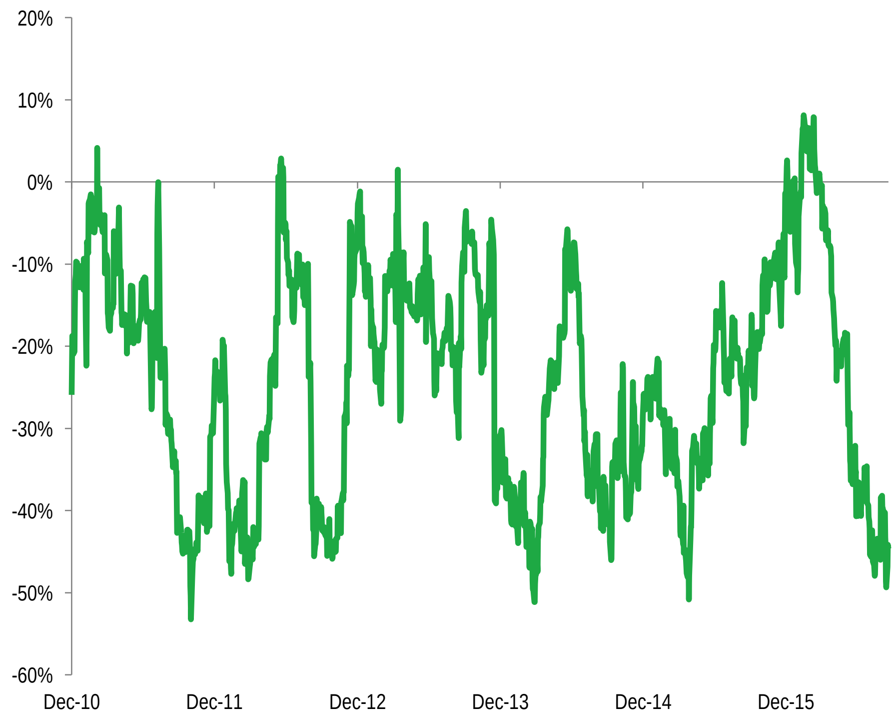
Keeping an eye on rates correlations

Equity vs bond correlation has started to break
Rolling 60d correlations between SPX returns and change in 10Y UST yields



Breakdown in equity-bond correlations worsen bond-led sell-offs (such as the taper tantrum) as natural hedges stop working

Gold remains closely tied to real yields
Rolling 60d correlations between gold returns and change in US 5Y real yields



Recent curve steepening has resulted from rising real yields rather than inflation expectations. This makes gold vulnerable

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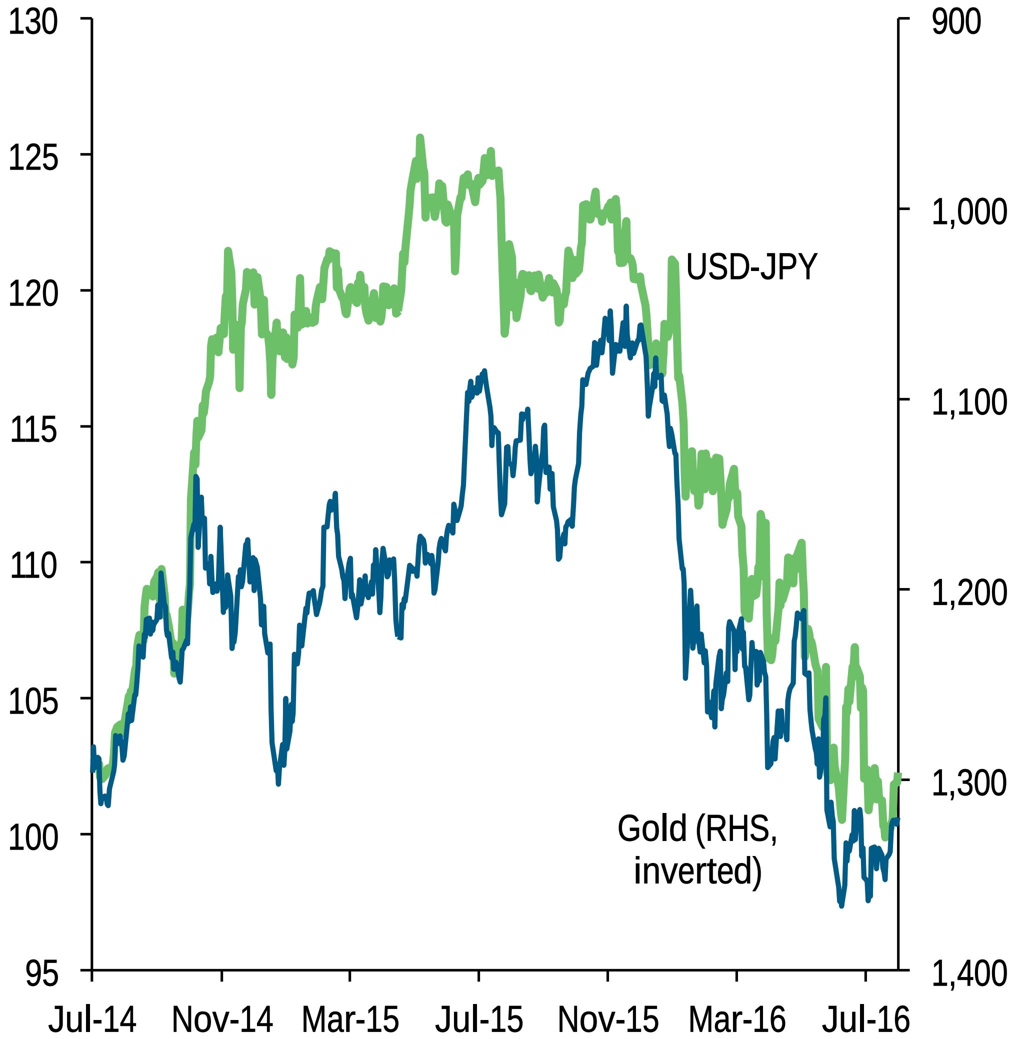
Source: Bloomberg, Standard Chartered Research

JPY – Is the BoJ getting closer to helicopter money?

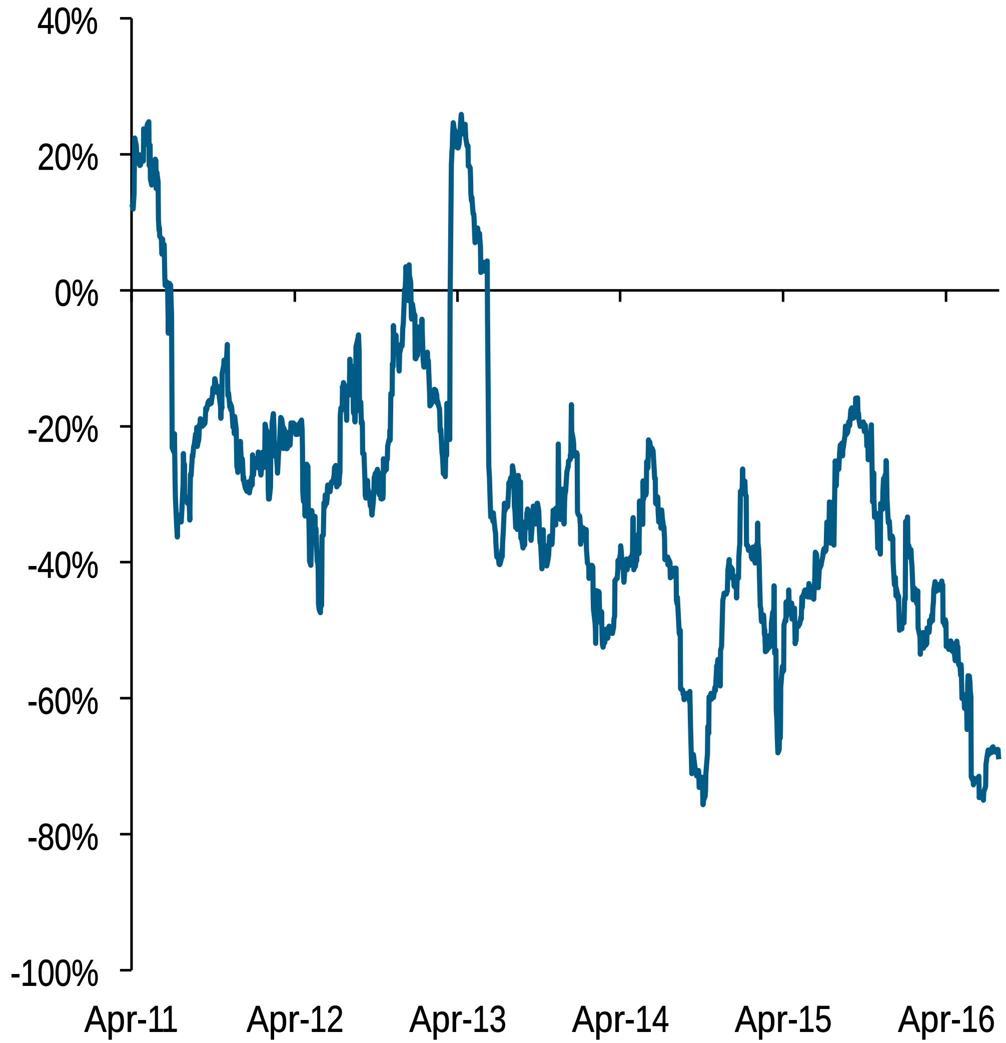
Watch the performance of safe havens

USD-JPY (LHS) vs gold, inverted (RHS)



Watch for a break in JPY vs gold correlation

Rolling 60-day correlation, USD-JPY vs gold



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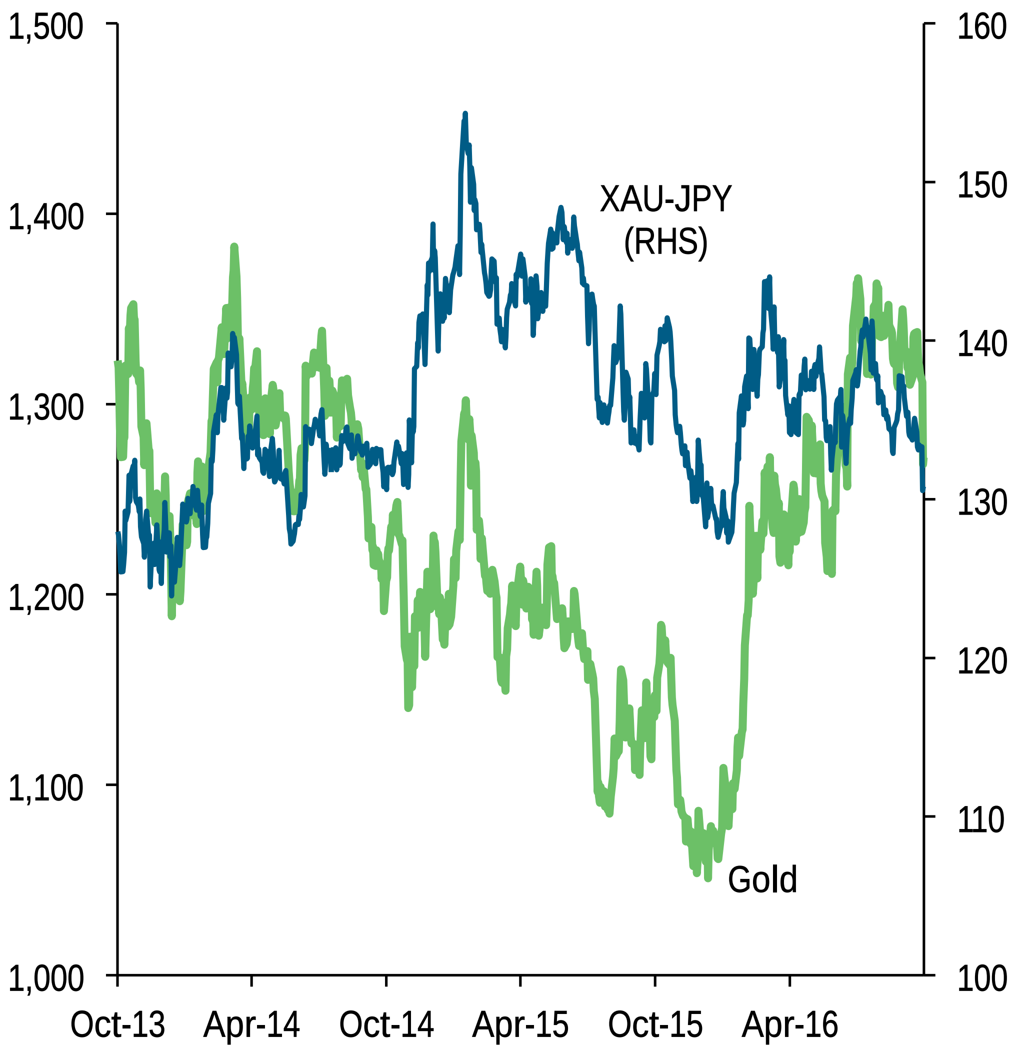
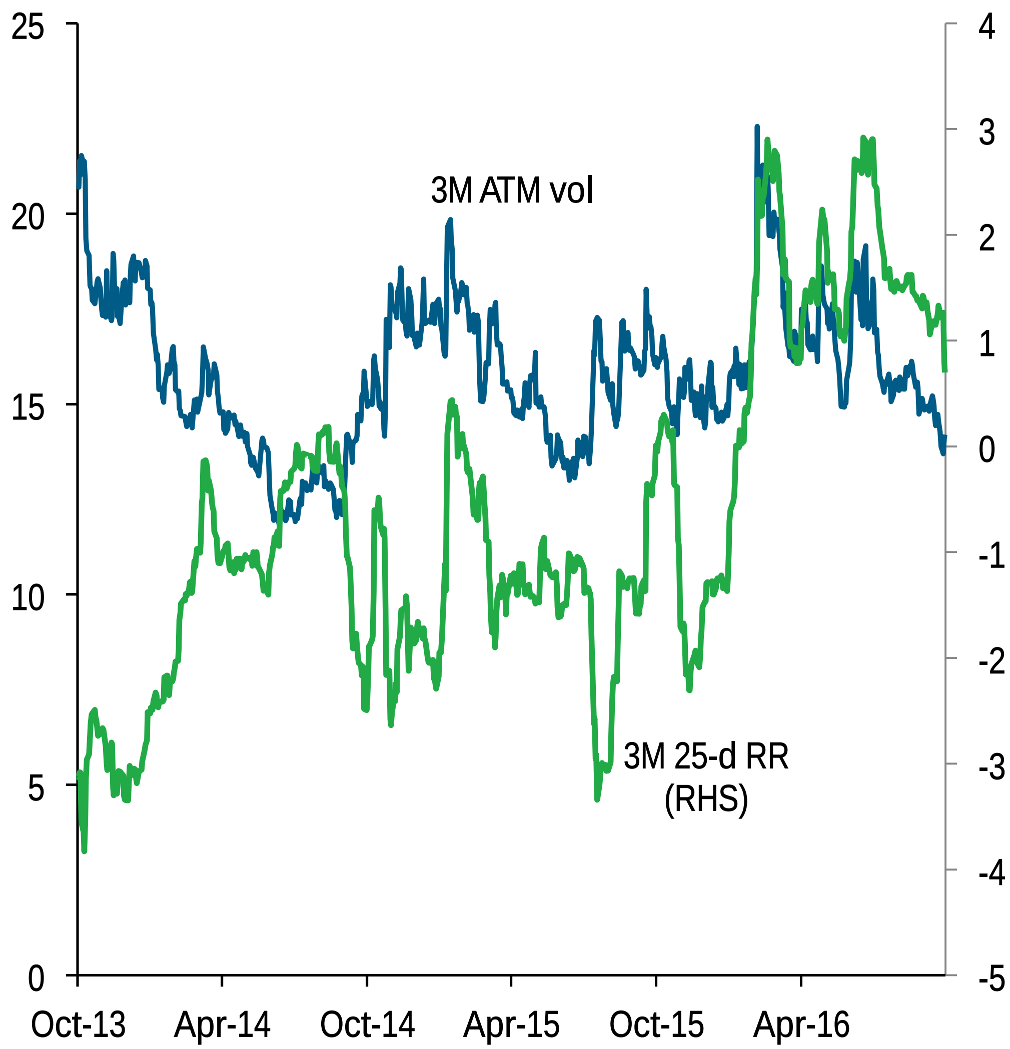
Source: Bloomberg, Standard Chartered Research

Gold as a barometer for policy divergence

Spot gold divergence
Gold vs XAU-JPY (000), RHS



Options markets lose their conviction
Gold 3M implied vol vs 3M 25-delta RR, % (RHS)

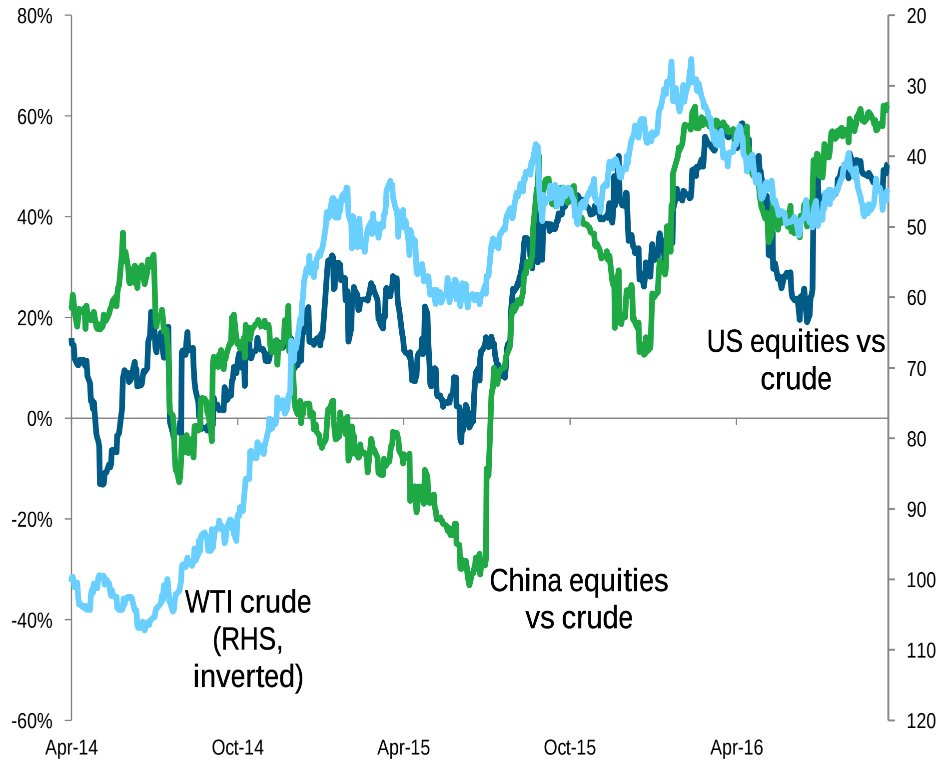


Source: Bloomberg, Standard Chartered Research

Correlations with oil

Oil has a bigger influence on risk sentiment at lower prices

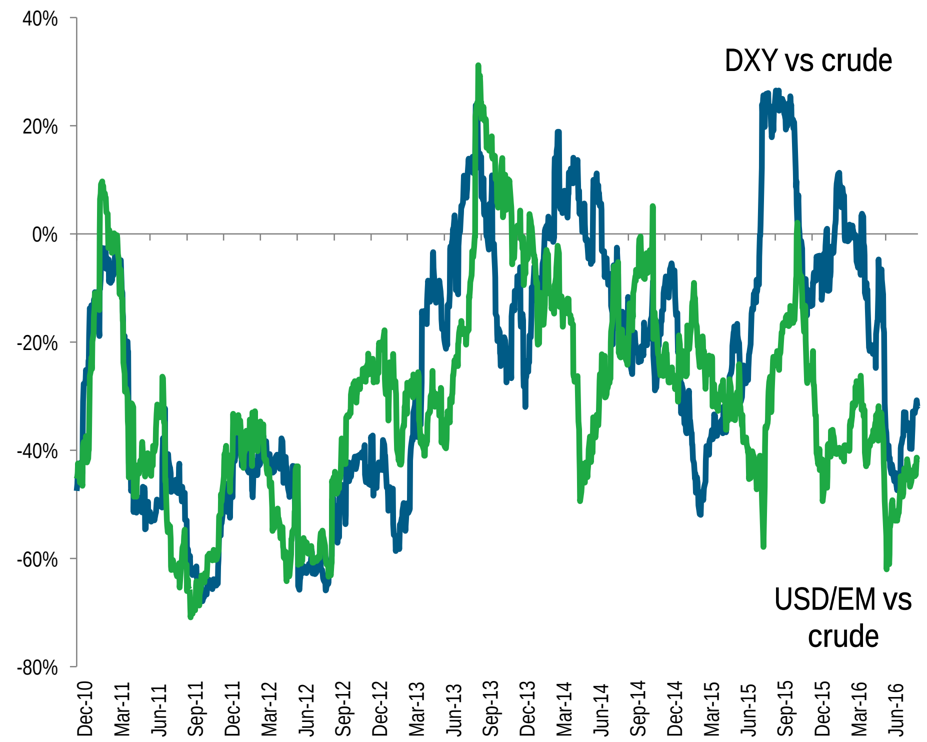
Rolling 60d correlations with WTI crude



Correlations between equities and crude oil increase as oil prices decline

Negative correlation between oil and USD has increased

Rolling 60d correlations with WTI crude



Oil rallies lead to USD weakness against EM FX as well as majors

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