

Monthly Market Outlook

26 August 2011

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Summary

- The risk of a recession in the US has increased while European data has also disappointed
- Japan and Asia data are surprising on the upside
- The investment climate remains challenging for asset allocation
 - Equities expected to produce strongest returns over the next 12 months, although there are significant downside risks in the short-term
 - Alternatives important to reduce portfolio risk profile
 - G3 investment grade debt likely to deliver negative returns over the next 12 months, timing uncertain
 - Commodities expected to rise in coming 12 months

Implications

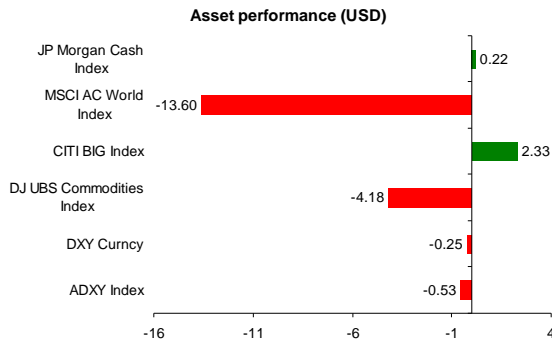
- **Cash:** Neutral stance on a 3m and 12m basis
- **Bonds:** Retain underweight on a 3m and 12m basis
- **Equities:** Reduce equities to neutral on a 3m basis and retain a neutral 12m stance
- **Regional equities:** Switch focus to those economies more reliant on domestic demand in EM and Asia
- **Retain OW Japan equities** stance as economy and earnings outperform
- **Commodities:** Retain neutral stance on a 3m and 12m basis. We favour gold long-term, although there are risks of a short-term correction
- **Increasingly positive** on energy and base metals after recent correction
- **Alternative investments:** Retain full overweight on a 3m & 12m basis
- **Currencies:** USD bounce risks extending in the near-term

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Asset performance* (USD)



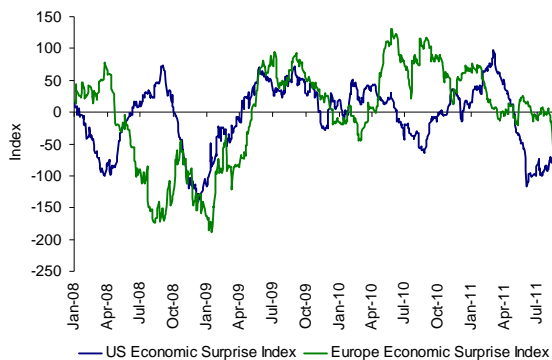
*From 22 July - 26 August 2011
Source: Bloomberg, Standard Chartered

Market performance

Equities have experienced sharp losses almost across the board over the past month while only bonds have managed to post significantly positive returns. Commodity returns were significantly negative, but this hid a significant divergence between different commodity sub-classes with gold (a key overweight in our asset allocation model) rising 10.8%. Interestingly, the USD failed to bounce despite heightened risk aversion which suggests the USD is no longer viewed as a safe-haven currency. Asian currencies weakened marginally on the month as investors bought CHF and JPY.

Economic and monetary outlook

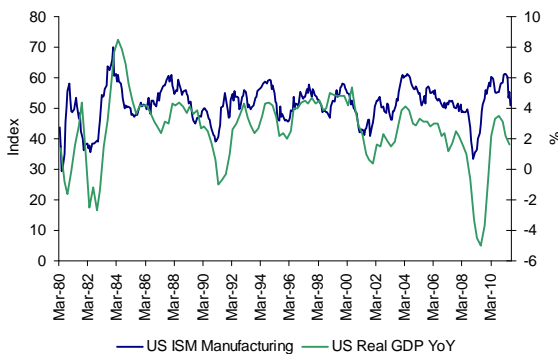
US remains weak, Europe disappoints



Source: Bloomberg, Citi, Standard Chartered

The US debt ceiling issue proved to be a non-event as we had expected, although the political wrangling encouraged Standard and Poor's (S&P), one of the top three rating agencies, to downgrade the US AAA sovereign debt rating to AA+. S&P cited concerns over the political will to address the fiscal deficit and the increased polarisation of the political landscape as reasons for the downgrade. The short term implications of this downgrade are limited as a downgrade at some point was expected. However, it is symbolic of the US' declining influence and reinforces our view that we will continue to see flows going from the West to the East in the coming years.

Weak US business confidence suggests downside risks to growth



Source: Bloomberg, Standard Chartered

Looking forward, there are three key issues facing financial market.

- 1) Global economic outlook
- 2) The continuing crisis in Europe
- 3) The potential for QE3 in the US

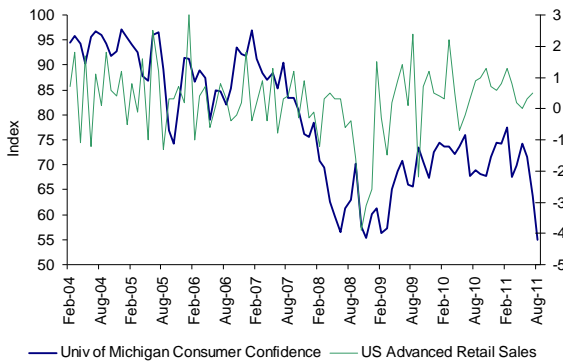
1. Global economic recovery

As far as the growth outlook is concerned, it is a story of East versus West. Data in the East is surprising on the upside with the recovery in Japan taking hold and data out of the Asia-Pacific region as a whole surprising on the upside.

In the West, there are two possible scenarios.

- 1) A muddle through economy (our central scenario, see below)
- 2) A double-dip recession.

Consumer confidence also weak

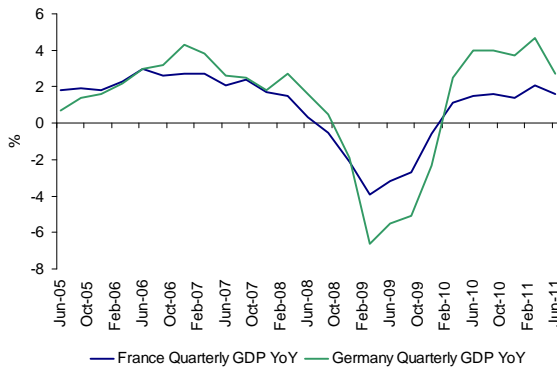


Source: Bloomberg, Standard Chartered

In the former scenario, volatility is likely to decline from elevated levels currently, while a recession would likely result in extended, heightened volatility. Naturally, key for financial markets would be the depth of the recession and the policy response associated with it – President Obama and Fed chairman Bernanke are already talking about the potential need for further stimulus. Key data to watch out for includes the US employment report, business and consumer confidence numbers and any indication these are feeding through to the real economy.

In the US, confidence has dropped significantly and the key question is whether confidence is falling due to the stock market decline and the uncertainty caused by the US debt ceiling debate or is it an indicator of future economic conditions (or both). Our view is that while the risks of a modest recession have clearly increased significantly over the past month, our central scenario is for a recession to be avoided. That said, it does appear clear that real GDP growth is likely to remain sluggish on a multi-year basis and any expectations that growth can sustain a 3%+ pace are likely to be disappointed.

Core European economies weaken significantly in Q2

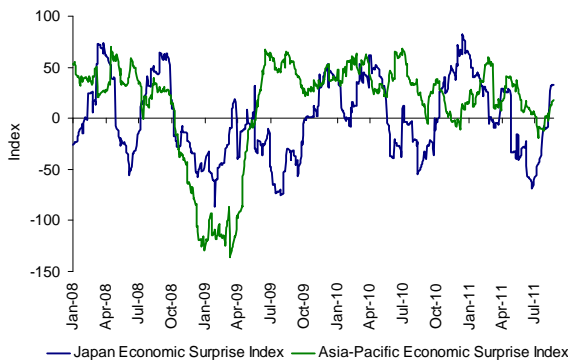


Source: Bloomberg, Standard Chartered

In Europe, the data has also started to disappoint with the latest round of GDP data significantly weaker than expected in both Germany and France. This has destroyed the view that the core countries could continue to grow strongly while the peripheral countries were in crisis. This begs the question of how long the European Central Bank will continue to hike interest rates.

In Asia, the data has been much more positive. Ever since the devastating tsunami hit the shores of Japan, we have been arguing that the Japanese economy would experience a V-shaped recovery in the second half of this year, which we expect to extend into 2012.

Asia data surprises on the upside



Source: Bloomberg, Citi, Standard Chartered

Meanwhile, the data in China and India has been stronger than many expected. In China, manufacturing PMI remains above the 50-level, industrial production rose 14% y/y in July as did the services PMI, both exports and imports accelerated and retail sales continued to grow at a robust 17%.

In India, while exports decelerated significantly, industrial production rebounded strongly. Of course, as with China, inflation remains a major concern, but the recent deceleration of global growth and lower oil prices should help mitigate some of these pressures at least in the short-term (although the potential for QE3 does hold significant risks).

Signs of stress emerging in Europe's banking sector

3mth EURIBOR less EONIA (euro overnight index Average)



Source: Bloomberg, Standard Chartered

2. European politicians need to wake up and smell the coffee

Europe remains our major concern. We have seen signs of increasing stress in the European banking sector, specifically in France. What we find difficult to understand is the apparent lack of urgency being shown in terms of addressing the sovereign crisis. We highlighted a month ago that we believed the measures announced on July 21st to increase the European Financial Stability Facility's (EFSF) flexibility were a significant step in the right direction. However, these measures have yet to be implemented. Meanwhile, it is likely the size of the EFSF will need to be increased to act as a deterrent against market speculation.

While the central scenario postulates these measures will be implemented, we believe Europe will remain a source of downside volatility in the near term. As far as the banking sector is concerned, the lack of urgency on this front is also worrying. However, one has to hope the lesson from 2008 has been learnt. Therefore, should the situation deteriorate dramatically, we would expect the authorities to step in and, in need, bailout any major financial institution that is in trouble.

3. QE3 – Risk of disappointment

At the height of equity market sentiment uncertainty, markets were hoping for the Fed to take further action to try to restore confidence in the form of a third round of quantitative easing (QE3). In response, the Fed all but promised to keep interest rates at current levels for the next two years. This clearly helped market sentiment to some degree, but speculation about the need for QE3 remains.

From our perspective, the challenge for the Fed is twofold. First, opinion on the decision to indicate that rates would be left at extraordinarily low levels over the course of the next two years was divided with 3 out of 10 FOMC members dissenting from the decision. Second, with core inflation accelerating, the case for QE3 is actually not that strong from a fundamental perspective.

Therefore, the risk is for disappointment as to the timing of QE3, which we expect to only happen in Q1 2012. Of course, Bernanke is due to speak today (Friday, 26th August) and he will attempt to positively surprise the market with one option to recycle QE2 into longer dated bonds (10 and 30yr for instance). This would likely depress longer term yields even further and could support consumer spending as it encourages people to refinance mortgages and reduce interest payments going forward.

However, the likelihood of significant equity being taken out of properties is much reduced by the fact that banks will presumably be reluctant to do this and the fall in home prices has reduced the amount of equity people have in their property holdings.

Investment strategies

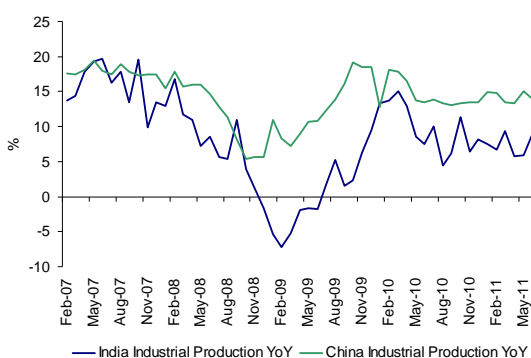
Equities

Our asset allocation is structurally biased towards Asia compared to most competitors; Asian economies are still performing relatively well.

We are maintaining our Neutral view on Equities. Our 12M view is predicated on the expectation that whilst economic growth may muddle through or even slow in the US and Europe, there will be additional stimulus (QE or similar) and some partial resolution of the European 'debt crisis', over the next 12 months.

In the near term, we expect volatility to remain elevated and see significant risk of policy mistakes, particularly at the European level. As a result of this we have reduced our short term Equities outlook to Neutral and are advocating that investors should be relatively defensive in their allocation and not add significantly to high beta names at this point.

We prefer equity markets with strong domestic demand



Source: Bloomberg, Standard Chartered

- Within equities our order of preference over 12M is the Emerging Markets, Asia and Japan followed by the US and EU. In the case of the Emerging Markets and Asia:
 - The economies of both are in far better fiscal shape than their developed market counterparts and their respective policy makers have greater fiscal and monetary flexibility to support their economies and markets.
 - Earnings growth is still relatively strong in these markets.
 - We prefer those sectors that are focused on domestic growth, rather than exports. In this regard, we have a preference for the equity markets of South East Asia over those of the export orientated nations of the North.

- We remain positive on Japan, with a 12M overweight.
 - Valuations are relatively attractive.
 - Economic growth should be relatively strong in 2012 as the economy overcomes the impact of the Tsunami.
 - We prefer sectors that focus on the domestic market such as retail and drug distribution.

- We are less constructive on the US and EU. Whilst the 12M view is predicated on additional stimulus in the US and some resolution of the EU 'debt crisis' we do not see this as the panacea for these markets which have enormous structural imbalances to deal with at the fiscal level. We would thus expect a similar scenario to 2010, with the various measures being positive for fund flows into Asia and the Emerging markets.
 - In terms of equity allocations in the US and EU, we prefer large over small capitalisation and would look to take exposure to those companies that have an international focus particularly to the growing markets of Asia, excellent franchises, strong balance sheets and good management.
 - Whilst financials look 'cheap' on most valuations measures, we would advocate a more conservative approach at this standpoint particularly in terms of equity, which can be diluted.

US Treasuries pricing in a severe recession
US 10yr treasury yield



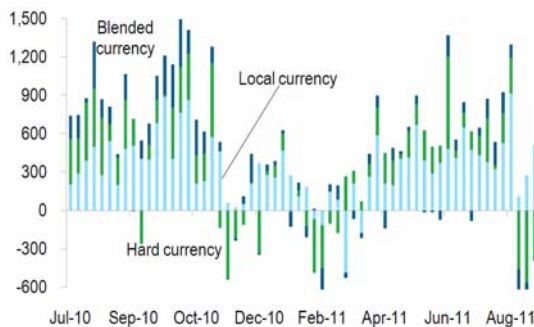
Source: MSCI, Bloomberg, Standard Chartered

▪ **Fixed income**

We remain underweight bonds on both a 3m and 12m basis. There remains the risk that downside economic surprises allow bonds to rally more in the short term. However, US Treasury yields are already at levels last seen at 2008 and our prognosis is far less pessimistic than then. As such, we believe investment grade debt in the developed markets is not offering much value unless the US goes into a sustained recession, which is not our central scenario.

Therefore, we have a preference to look for bonds with higher yields and there are two areas of note here. First, we continue to like Asian local currency debt in countries where interest rates are close to their peak. The Philippines, India, Indonesia and China continue to offer potentially attractive returns over the coming months.

Flows into local currency EM debt continue despite increased volatility



Source: Bloomberg, Standard Chartered

Second, we are getting increasingly interested in Asian High Yield (HY) debt. Spreads have widened significantly in recent times on the back of increased equity market volatility. Given we see continued equity market volatility in the coming weeks, the risk is spreads continue to widen in the short term. However, we believe that starting to average into HY Asian debt makes sense for those with limited exposure.

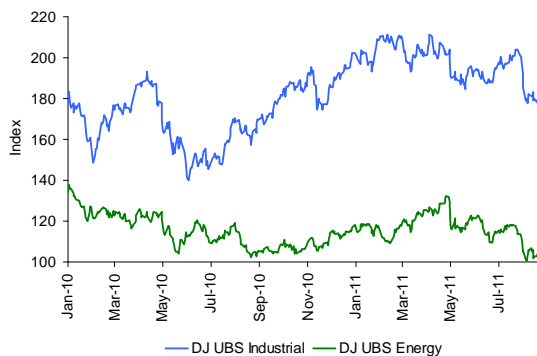
Gold corrects, but long term fundamentals remain positive

Gold price and Junior gold miners' index



Source: Bloomberg, Standard Chartered

Sell-off in energy and industrial metals creates value



Source: Bloomberg, Standard Chartered

▪ **Commodities**

We have retained our 3m and 12m neutral commodity weightings. Gold continues to enjoy positive fundamentals in our opinion, but we have seen a significant correction in late August following accelerated gains over the past two months. Given that we are nowhere near key support levels, it could correct further (to the 1500-1600 area). However, we see this as a healthy correction from recent speculative excess and would still be looking for better levels to add positions for those who are underinvested in gold so far.

An alternative to investing in gold is to buy gold equities which have significantly lagged the performance of gold so far. We believe this will reverse over time. Other alternatives include looking at precious metals such as silver, platinum and palladium. Strikes in South Africa are providing support for platinum.

We are also increasingly positive on base metals and oil following the recent correction in prices, despite revising our oil price forecasts lower. Base metals such as aluminium and copper are being supported by still strong demand emanating from China while elsewhere in the industrial metals complex tight supply and falling stocks are generally supportive of prices.

For oil, we continue to focus on our forecasts for global growth to stabilise and accelerate later in the year amidst still tight supply. Speculation that Libya is likely to quickly restore production is likely overblown in our opinion and we expect supply to be restored to pre-crisis levels only in 2015.

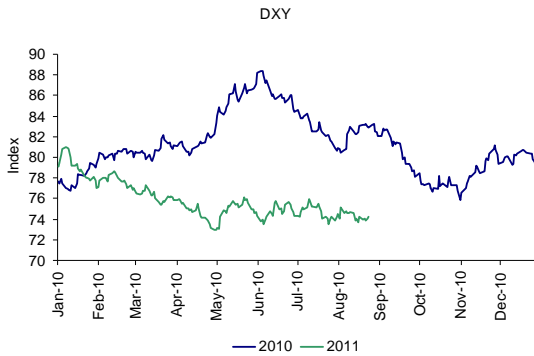
▪ **Alternatives**

We continue to expect equities to outperform other asset classes from a pure return basis. However, as we have discussed for many months now, increased volatility means that on a risk-adjusted return basis, equities are less attractive than pure return forecasts would suggest. Against this backdrop, we continue to favour hedge fund of funds and commodity trading advisors which have the ability to be either long or short different asset classes as they see fit.

This overweight stance has started to deliver benefits in terms of enhanced performance and reduced volatility as equity markets decline. We still believe in the merits of an overweight alternatives stance going forward as we expect heightened volatility to remain a feature of financial markets for the foreseeable future.

Currencies

USD fails to bounce despite heightened risk aversion



Source: Bloomberg, Standard Chartered

Interestingly, the recent bout of risk aversion has not resulted in a significant USD bounce. This suggests the USD is no longer being viewed as a safe-haven currency. At the theoretical level, this makes complete sense as the US has been a major source of policy uncertainty, alongside Europe.

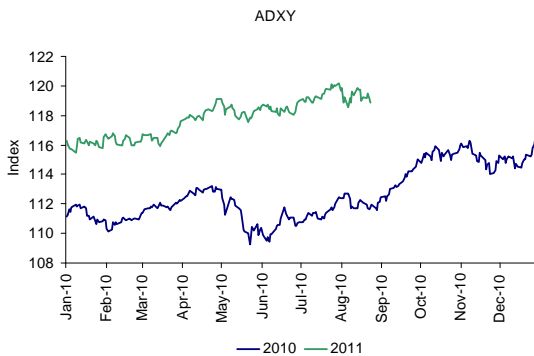
However, it is still a significant development. We take the view that S&P's decision to downgrade the US merely formalises the relative demise of the West versus the East. If one looks at the breakdown of global growth over the past 5 years, we see that Emerging Markets account for over 50% of global growth. The likelihood is that this bias will increase in the coming 5 years and beyond.

More and more, positive fundamentals in Asia are likely to drive inward-bound safe-haven flows. Naturally, this investment will not occur in a straight line and there will be cycles. But the long-term picture is clear in our opinion.

As such, we expect Asian currencies to remain in appreciation mode in the coming months and currency weakness provides an opportunity to increase exposure to both bonds and equities.

The high-yield and commodity related currencies have weakened modestly against the backdrop of heightened risk aversion and falling commodities. However, they have yet to break through key support levels, which suggests the short term (1-3 month) outlook is for further strength. However, we remain concerned about the apparent overvaluation of these currencies from a longer term perspective.

Asian currencies remain in trend appreciation mode



Source: Bloomberg, Standard Chartered

Key Risks

There are three key risks we have identified.

- 1) European sovereign debt crisis leads to a credit crunch. We are assuming any defaults will be managed to ensure the impact on banking sector credit standards is limited. Should this prove not to be the case, the impact on the global economy and financial markets would be dramatic. Unfortunately, it looks as though things are likely to get worse rather than better in the near term.

- 2) A prolonged global economic slowdown. The deleveraging that is required creates a natural drag on the economy and a bias for deflation. Authorities in the West are attempting to counter this with loose fiscal and monetary policies. However, the risk of a policy mistake is very significant. Were the US economy to move into deflation then the outlook for the global economy would change dramatically as debt levels became harder to manage. The Fed is very aware of this risk, hence the talk of QE3. But the reality remains that core inflation is still rising which may make significant steps difficult to justify in the short-term.
- 3) China experiences a hard landing. It is clear that the property sector is seeing excess supply in many cities and this could undermine confidence in the economy and the financial system. We believe the authorities have policy levers to restore confidence quickly, but if we are wrong then the consequences for Asian equity markets would be significant.

Conclusion

In conclusion, the risks of a downturn have increased significantly. At the moment, equity markets are pricing in a mild recession whilst the US bond market is pricing in something more significant. We take the view that, should the US and EU economies slow significantly, the hand of policy makers will be forced and that they will provide the necessary stimulus to reverse the downdraft, at least temporarily.

With this in mind, and given we are more constructive on global growth, we would advocate a neutral stance to equities. However, we would be heavily skewed towards relatively safer equity plays, such as those with exposure to the Asian domestic markets. We would also limit exposure to developed market financials and those equity markets that are leveraged towards developed market growth.

Given this uncertainty, our favoured asset class remains alternatives. Gold has started to correct and we believe there are downside risks to gold in the short-term, but the long term fundamentals for higher prices in the coming years remain intact.

Please note: This document represents the view of Standard Chartered's Global Investment Committee.

Asset Allocation Summary

Tactical Asset Allocation - September 2011 (3M View)

All figures are in percentages

Currency: USD

		View vs. SAA*	Conservative	Moderate	Moderately Aggressive	Aggressive
Cash (N)	Cash & Cash Equivalents	N	20	5	5	5
Fixed Income (UW)	IG Developed World	UW	26	12	0	0
	IG Emerging World	UW	11	10	0	0
	HY Developed World	N	3	6	8	3
	HY Emerging World	N	2	4	7	2
			42	32	15	5
Equity (N)	North America	N	6	11	12	15
	Europe	UW	4	5	7	9
	Japan	OW	4	5	8	10
	Asia ex-Japan	N	6	11	17	20
	Other EM	UW	4	6	11	16
			24	38	55	70
Commodities (N)	Commodities	N	5	5	5	5
Alternatives (OW)	Hedge Fund of Funds/CTA	OW	10	20	20	15

Developed Market Equity
 Emerging + Frontier Market Equity

Tactical Asset Allocation - September 2011 (12M View)

All figures are in percentages

Currency: USD

		View vs. SAA*	Conservative	Moderate	Moderately Aggressive	Aggressive
Cash (N)	Cash & Cash Equivalents	N	20	5	5	5
Fixed Income (UW)	IG Developed World	UW	24	12	0	0
	IG Emerging World	UW	11	8	0	0
	HY Developed World	N	3	6	8	3
	HY Emerging World	N	2	4	7	2
			40	30	15	5
Equity (N)	North America	UW	4	6	8	12
	Europe	UW	3	5	6	7
	Japan	OW	3	4	6	6
	Asia ex-Japan	OW	7	14	18	22
	Other EM	OW	8	11	17	23
			25	40	55	70
Commodities (N)	Commodities	N	5	5	5	5
Alternatives (OW)	Hedge Fund of Funds/CTA	OW	10	20	20	15

Developed Market Equity
 Emerging + Frontier Market Equity

* The above allocations are designed for individual investor portfolios. They are based on a strategic model (SAA) that forecasts asset returns based on projected economic growth, inflation, interest rates, and currency movements.

3 to 12 Month Market Outlook

26 August 2011

Central bank policy rates

	Spot	Q3 2011	Q4 2011	Q1 2012	Q2 2012
US	0.25	0-0.25	0-0.25	0-0.25	0-0.25
Europe	1.50	1.50	1.75	2.00	2.25
UK	0.50	0.50	0.50	0.50	0.50
Australia	4.75	4.75	5.00	5.00	5.25
China	6.56	6.56	6.56	6.56	6.56
Malaysia	3.00	3.00	3.25	3.25	3.50
Indonesia	6.75	6.75	6.75	7.25	7.25
South Korea	3.25	3.50	3.50	3.75	4.00
India	8.00	8.25	8.50	8.50	8.50
Thailand	3.50	3.50	3.50	3.50	3.50

Forex

	Spot	Q3 2011	Q4 2011	Q1 2012	Q2 2012
EUR/USD	1.44	1.42	1.45	1.45	1.42
GBP/USD	1.63	1.60	1.65	1.66	1.65
USD/JPY	76.94	77.00	76.00	80.00	85.00
USD/CAD	0.99	0.96	0.92	0.93	0.94
USD/CHF	0.79	0.77	0.77	0.81	0.85
AUD/USD	1.05	1.08	1.13	1.09	1.06
NZD/USD	0.83	0.86	0.93	0.94	0.89
USD/CNY	6.39	6.39	6.31	6.24	6.18
USD/SGD	1.21	1.19	1.17	1.15	1.18
USD/MYR	2.99	2.93	2.88	2.83	2.90
USD/IDR	8566.00	8500	8300	8200	8300
USD/KRW	1081.85	1045	1020	995	975
USD/INR	46.01	44.00	43.50	43.00	43.00
USD/THB	29.99	29.50	29.00	28.50	29.00

Commodities

	Spot	Q3 2011	Q4 2011	Q1 2012	Q2 2012
Gold	1772.28	1725	1800	1700	1675
Silver	40.48	38	42	40	40
WTI Crude oil	85.14	90	95	97	102
Copper	9030.00	9500	10000	10500	9833
Aluminium	2366.00	2600	2550	2500	2367
Corn	743.25	700	750	775	735
Soybeans	1389.75	1350	1380	1375	1308
Wheat	787.00	715	700	715	642

Source: Bloomberg

* Period averages for each quarter. Forecasts from SCB Global Research.

Disclosure Appendix

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