Weekly market update

6 Dec 2020

US Employment : Rough weather

- U.S. economy added 245,000 jobs in November, missing estimates amid a spike in COVID cases and renewed restrictions in activity.
- More broadly, the unemployment rate has reached the lowest level since the pandemic began, falling from 14.7% in April to below 7% in November ; but the participation rate also declined, indicating that more people exited the labor force.
- Once again, the headline was held down by the layoffs of 93K temporary Census workers. But, the slowdown can be traced entirely to the private sector, where jobs increased 344K after having risen 877K last month.
- Despite a notable slowdown in hiring in the November jobs report, major indexes closed at record highs and Treasury yields rose, reflecting expectations for additional fiscal stimulus
- Employment in trucking and warehousing jumped by a whopping145,000 jobs, much of which wereat couriers and delivery firms. Of course part of that strength comes at the expense of brick and mortar retailers, which hired fewer workers for the holiday season
- Even as the share of permanent job losers rises, the number of unemployed workers on temporary layoff remains high at 26%,so a significant share of the jobless remain connected to their employers. Hiring is likely in for a fitful few months, but should begin strengthening again in the spring.

US Economy - Resilience

- The latest spike in infections is clearly evident in the latest round of economic reports. Consumers began to pull back from high-contact activities in late October and early November, the fallout is expected to become more apparent in the December and January data, when the latest wave of infections is likely to most heavily impact the economy
- Manufacturing held up relatively well in November, despite a larger-than-expected dip in the ISM manufacturing survey.
- Residential construction continues to ramp up, while the commercial construction pipeline appears to be winding down.
- In October, personal income declined at an annualized rate of US$130 billion after rising at a rate of US$147 billion in September. The reversal was mainly due to a sharp decline in the amount of government support for unemployed workers.
- Fed's latest Beige Book reported that firms across the 12 Federal Reserve Districts maintained positive outlooks through November, but optimism is waning
- The Senate voted 48-47 on Thursday to confirm Trump's choice of Christopher Waller to become a member of the Board of Governors of the Federal Reserve System .He holds largely conventional views about monetary policy and the role of the Fed in the economy

Europe : Political Risk 1/2

- EU is in limbo over its next multi-annual budget and, by implication, the Recovery Fund.
- In the week of 16 November, Hungary and Poland voted down the most recent proposals for the EU's next multiannual budget, running from 2021 until 2027.
- Not because they oppose these proposals–in fact they would be among the main beneficiaries of the budget and recover fund-, but out of anger over the new rule-of-law mechanism that was adopted in early November and which is set to come into force next year.
- The new mechanism is supposed to block transfers of EU funds to countries infringing on EU standards in certain areas such as fundamental rights and judicial independence.
- This mechanism should protect the financial interests of the EU, i.e. to protect EU tax payers against the misuse of EU funds.
- Yet Hungary and Poland claim the mechanism to be a vague and therefore a political tool for the EU to interfere with domestic matters.
- Both countries have been at continuous loggerheads with the European Commission over rule-of-law issues over the past few years. Slovenia also supports the claim put forward by Poland and Hungary.

Europe : Political Risk - 2/2

- Strong focus on the EU Council meeting on Thursday and Friday, where highest on the agenda are Hungary and Poland's threat of a veto of Next Generation EU and Brexit negotiations. There are strong interests on both sides (countries need money and stability, not political chaos and market turbulence),
- However , on 26 November, Polish PM Morawiecki and Hungarian PM Orban underscored their view saying that the EU should drop the rule-of-law conditionality altogether and that any enforcement mechanism on democratic standards in future would require an amendment in the treaty. The joint declaration signed by both PMs implies that they are not willing to make substantial concessi ons to overcome impasse.
- The adverse scenario of no solution has the potential to trigger a significant political crisis in EU. It is difficult to predict what will happen and whether either side of the table will blink beforehand. In any case, the risk that no agreement will be found is non-negligible.
- Brexit is entering a 'tunnel', where it seems increasingly plausible that a deal is imminent. Media stories on Brexit focus mostly on the negotiations being in their final stage. A deal is more likely than not and that the days ahead of the EU summit on Thursday are extremely important for where things are heading.

What if… and then what?

- What is perhaps most remarkable is that the market seems to have largely ignored the potential implications of this protracted stasis
- Since ECB launched its PEPP, the euro has clearly appreciated while sovereign spreads have declined to new lows.
- This is an unusual combination of currency and rates moves if we compare it to ECB’s first attempt on quantitative easing: while QE compressed spreads, back in 2015 the additional monetary stimulus also had a profound weakening effect on the currency.
- Fast forward to 2020, in the wake of the PEPP, spreads have acted the same as before, but it is the EUR which did not follow the weakening course
- Ignoring factors that weighed on the US dollar, the fact that the euro appreciated despite more monetary stimulus can be explained by the one key difference in the pandemic response: the fiscal response
- This obviously raises the risk that if the Recovery Plan runs into significant delays we could expect part of that positive sentiment to reverse.
- The market may be under-estimating the potential impact from a delay or even a collapse in the EU’s Recovery Fund plans. In that case, the market could yet revise its positive stance on Europe, although we believe the impact will likely be most noticeable in EURUSD . Some volatility may return in the sovereign bond markets
- Even worse, of course, would be a total collapse of the plan, as that would imply (how unpalatable or even unlikely that may sound) that the market will again start to question the whole European project.

Eurozone : Divergence

- In Eurozone, the economy is clearly bifurcating, with manufacturing doing well and services declining. : The manufacturing PMI for the Eurozone fell from 54.8 in October to 53.6 in November- the deceleration was significant and reflected a marked slowdown in output and growth of new orders. The services PMI, however, fell sharply from 46.9 in October to 41.3 in November, a six-month low. This was due to an especially sharp slowdown in activity in the hospitality and travel industries.
- In Germany, the manufacturing PMI, at 57.9, suggests strong growth. It is likely driven by strong demand for Germany's capital goods exports, especially in China. The services PMI, at 46.2, indicates decline, but at a slower rate than in the rest of Europe
- PMIs for France suggest a far greater decline in overall economic activity. The manufacturing PMI, at 49.1, indicates a modest decline in activity. France's manufacturing sector is more closely driven by domestic demand and exports of consumer-facing industries than Germany's. The French PMI for services fell to 38.0, a six-month low and a level indicating a rapid decline in activity

ECB: Recalibration

- ECB is expected to announce a recalibration of its monetary policy instruments and the uncertainty is what tools it will use.
- PEPP : We expect ECB to add another EUR400bn to the current PEPP envelope running at least until end-2021. ECB may also increase the APP purchase rate, but this is less powerful than the PEPP and it is not as important for the overall ECB monetary policy sta nce unless the purchase rate is increased significantly to, e.g., more than EUR40bn/month. ECB will not commit to a monthly target under th e PEPP.
- TLTRO/PELTROs: Extend the discount window to the entire duration of the liquidity operation (3y). Provide four additional TLTRO liquidity operations until Q1 22 (quarterly basis) and expand the eligibility pool. PELTROs to continue into end -2021 on a monthly basis.
- Tiering : Increase the tiering multiplier to 10x the reserve requirement.
- Collateral : Extending the 7 April grandfathering of the collateral eligibility rules until end-2022.
- No rate cut: Still no rate cut, but repeating the option to cut if needed.
- Recent comments have focused on more PEPP and TLTROs as the main tools but we expect ECB to tweak its more technical paramet ers, such as tiering and collateral rules, as well. We do not expect a material immediate market reaction to the recalibration

Global Trade : Waning Momentum

- As per the data for global trade from Netherlands government's Central Planning Bureau ,Global trade has bounced back after a sharp decline earlier this year, but it decelerated in September. The overall volume of global trade grew 7.9% in June, 4.8% in July, 2.4% in August, and 2.1% in September.
- The volume of trade remains roughly 4% below the level from a year ago. For the third quarter, however, trade volume was up 12.5% from the previous quarter, almost reversing the 12.2% decline in the second quarter.
- In September, the volume of exports was up 2.5% in the Eurozone, 2.6% in the United States, 5.3% in Japan, and down 3.8% in China.
- However, Chinese exports had grown strongly in the previous two months. Exports increased strongly in emerging countries other than China. In the case of China, nominal exports increased modestly in September, but this was due to a rise in prices. The volume declined, indicating a worsening of China's export prowess.
- For all these countries, export volume decelerated in September versus August. It is important to note that growth of export volume is measured as the growth in nominal exports adjusted for changes in prices.
- Globalisation is on track to recovery after facing a major setback due to the Covid-19 pandemic, according to the DHL Global Connectedness Index 2020 report.

China : Credit downgrades

- In the past month, three high profile Chinese state owned entities (SOEs) have defaulted on their outstanding bonds, namely Yongcheng Coal and Electricity, Huachen Automotive Group and semiconductor company Tsinghua Unigroup.
- Not surprisingly, bond market yields have risen sharply in November. In the Chinese corporate bond market for example, the spread between 6 month yields on BBB and AAA- rated bonds (an indicator of default risk) has now increased to 13.6%, its highest level this year.
- The fact that Chinese government has let these large SOEs default at all, could be seen as a signal that Beijing wants to introduce more market discipline in the economy.
- However, in the short to medium term, it could lead to a host of problems for Chinese companies in general and SOEs specifically, such as credit downgrades, difficulty in raising capital and higher interest rates for debt refinancing.
- In a tail risk scenario ,it could even be the start of a debt crisis.

RBI Policy – Unstated Objectives

- Heading into the RBI policy, investors had two apprehensions : 1.Whether the higher-than-expected inflation and growth data would trigger a rethink on the existing "lower-for-longer" guidance 2. whether the RBI would look to temper the surge in liquidity to re-align money market rates with the policy corridor. But RBI has essentially doubled down on its October accommodative guidance

- MPC provided reassurance of maintaining an accommodative stance in the current as well as next financial year and using all available monetary policy tools at its disposal to ensure a revival in growth. This was despite significant upward revisions in inflation (6.3% in H2FY21 vs. 5.4-4.5% estimated earlier) and growth (-7.5% in FY21; our est. at -8 %) forecasts,

- Additionally, there was no change in the RBI's stance on liquidity management, particularly in the wake of persistence of money market rates below the reverse repo rate. The continued expansion of RBI balance sheet while having an ocean of liquidity in the markets make the unstated objectives of the exercise abundantly clear to the markets .

- The irony is that there has been no perceptible increase in credit pickup despite the dovish stance over 2 years - the continued absence of Indian Capex even in this era of historically high negative yields indicates that it is beyond the realm of monetary policy makers to bring growth back – till then distribution of wealth from savers to borrowers ?

Inflation but dovish hold -1/2

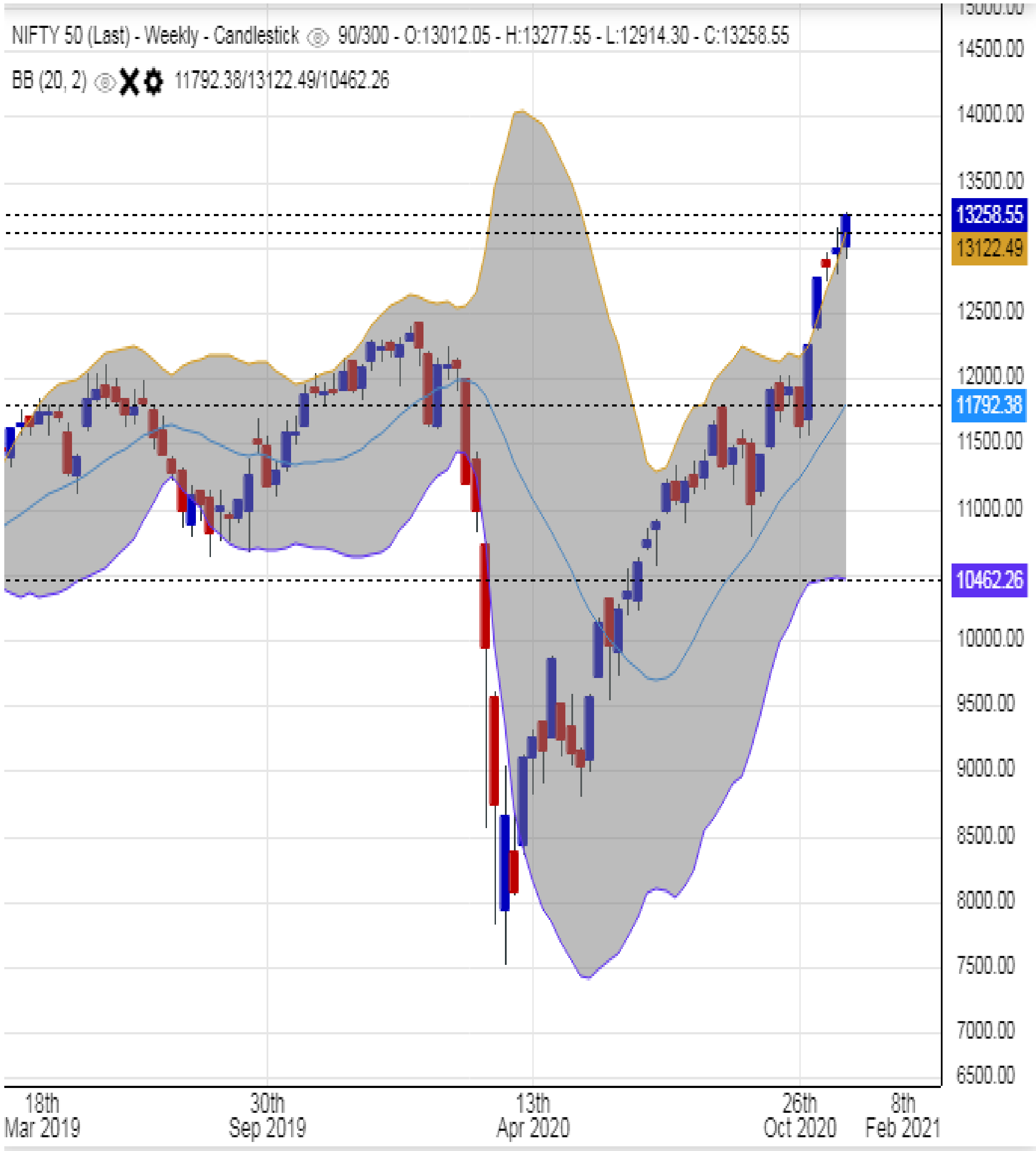
- When it comes to assessing the fundamental drivers of financial markets, faith is hardly a word that comes to mind
- CPI inflation is seen averaging 6.8% in Oct-Dec, 5.8% in Jan-Mar, 5.2% in Apr-Jun, and 4.6% in Jul-Sep.
- If these projections come true, inflation will have remained over 4.0% for roughly two years. However, MPC's stance remains accommodative, with the time-specific guidance on the stance from October also being retained. But if the stance was left unchanged due to growth worries, the committee has made it plenty clear it remains firmly focused on the inflation risks.
- First, the committee has dropped the phrase from October that the high inflation prints "can be looked through" as they were due to supply shocks. Second, the committee has now conceded inflation will likely remain elevated "barring transient relief in the winter months from prices of perishables". Moreover, the committee is now of the opinion that only a "small window" is available to undertake steps "to break the inflation spiral being fuelled by supply chain disruptions, excessive margins and indirect taxes".
- While the RBI has been urging the government for several months now to take steps to smoothen supply and reduce the cost-push pressures on inflation, one wonders if today's statement has put the government on notice.

Inflation but dovish hold -2/2

- Inflation continues to run full steam, growth impulses are picking up, the government's finances are in severe constraint, and the market is faced with an enormous load of debt supply.
- However ,markets repose faith in the central bank's commitment to policy accommodation — a commitment unequivocally reiterated by the RBI in its monetary policy .
- This has balanced the scales for the bond market - otherwise it would have warranted hardening of yields.
- The clear takeaway today was as long as the economy continues to struggle and the Govt revenues remain under pressure, accommodation is here to stay.
- But the market right now is an uneasy calm because regardless of the RBI's assurance of monetary largesse, one cannot wish away the reality of persistently high inflation.
- RBI probably has given the market a quantum of solace, but the markets should start soon focusing on the very basics of bond math — high inflation equals high yields.

Nifty

- This was the fifth consecutive week that index witnessed positive returns. However, there was a tussle between the bulls and the bears wherein repeated efforts to attain new highs were bogged down by the selling pressure from domestic institutions thereby ending the trade with mild gains.
- On the economic front, markets will watch out for IIP and CPI which is scheduled to be released on December 11. , although the fundamental drivers are of very little consequence
- The market's complacency, despite core inflation being sticky, may also be stemming from the perception that demand revival might bring pricing power.



Consumer Confidence

- RBI 's latest Consumer Confidence Survey has painted a grim picture of the economy, with the central bank saying that the survey's results showed confidence "remained very low" in November.
- The Current Situation Index inched up marginally to 52.3 from September's all-time low of 49.9. The index was last above 100 more than a year ago. A reading of less than 100 is indicative of pessimism.
- Worryingly, the survey–conducted Oct 30-Nov 12 in 13 major cities– also showed that respondents' discretionary expenditure contracted, with non-essential spending expected to contract further in the coming year.
- Private final consumption expenditure contracted 11.3% in Jul-Sep on top of a 26.7% fall in Apr-Jun.
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