SYFX Treasury Foundation

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- Weekly Market Update
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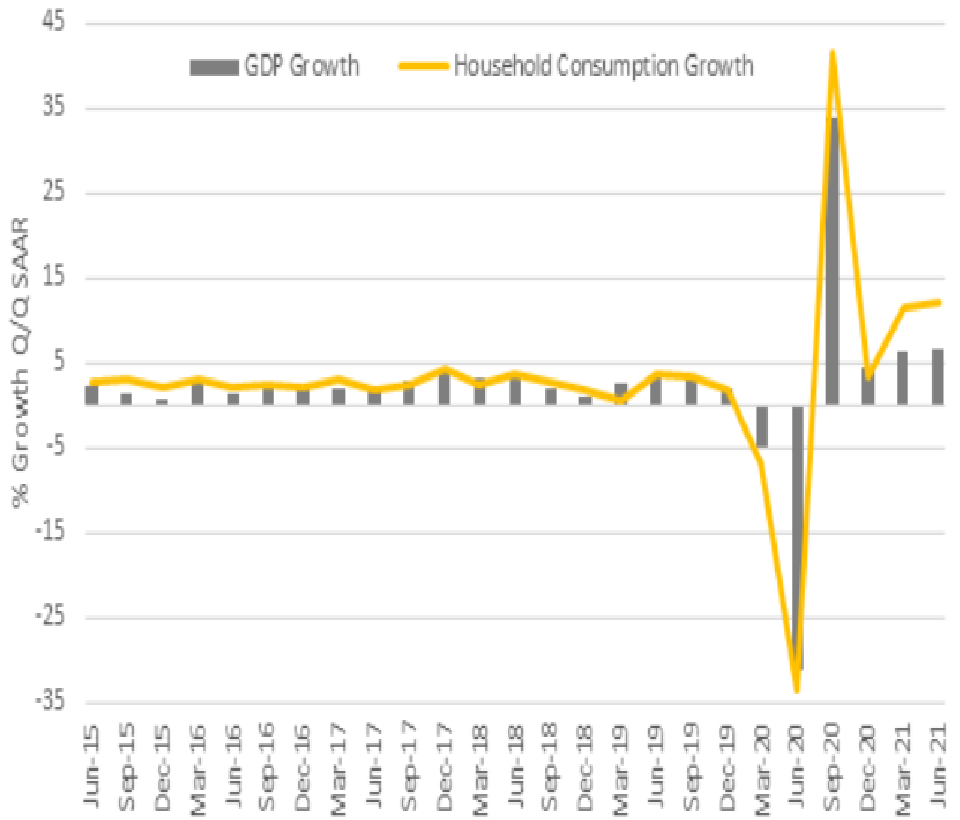
US Economy –Struggle for Equilibrium

- Last week's economic data provided additional evidence that **the economy is struggling to find an equilibrium**.
- **Total job openings** declined modestly in August, but at 10.4 million, they remain roughly 50% above their pre-COVID levels. Despite the decline, a few sectors saw job openings increase, such as transportation, warehousing and utilities. Perhaps more interesting, the quit rate jumped 0.2 percentage points in August and hit the highest level on record. A high quit rate is typically a sign that workers are confident they can voluntarily leave their current job and find gainful employment elsewhere.
- **CPI release** showed inflation picking back up in September after a short-lived August slowdown. Rising costs for basic items were behind September's gain. Until inventories are rebuilt, goods prices are unlikely to revert to the deflationary trend that pervaded for the past two decades.
- September **Retail sales** report showed a 14.3% year-over-year increase in retail spending. This is exceptionally strong by historical standards, Retail sales are reported in nominal figures, so some of the higher sales may simply be reflective of higher prices. However Even after accounting for inflation, consumers outperformed expectations. At the same time, this was half the growth rate seen in May and was the slowest rate of spending growth since March, reflecting the delta-variant-driven lull in consumption.
- October preliminary **University of Michigan Consumer Sentiment Index** decreased to 71.4, versus estimates calling for a rise to 73.1 from September's 72.8 reading. The index posted the second-lowest reading since 2011 as both the current conditions and the expectations portions of the index
- **Empire Manufacturing Index** fell to 19.8 in October from 34.3 that was posted in September, and compared estimates of a decline to 25.0
- **Producer prices** rose 0.5% for the month (8.6% for the year), down from the 0.7% rise in August.

Equities are Permanently Bullish…

- The drift higher in U.S. stocks has defied the gravitational pull of the bearish factors and remains on track for its best October in 6 years .
- The "buy the dip" mindset was on display again last week, as has been the case throughout 2021.
- After the September swoon that produced the first 5% pullback of the year, the stock market has regained its footing, spurred last week by a strong start to corporate earnings season. On Thursday, the S&P 500 Index recorded its biggest daily gain since March
- Only 8% of the S&P 500 index companies reported third-quarter results thus far, but at least 80% of companies have beaten expectations on earnings and revenue.
- Blended net profit margin of 12.3% would mark the third-highest recorded by FactSet since it began tracking that metric in 2008. On June 30, the estimated net profit margin for the third quarter was 12%.
- Evidence that supply pressures and inflation might be peaking seemed to be another major factor in stocks regaining momentum

GDP growth and Household Consumption



- Holiday shopping and more than $2 trillion in accumulated household savings signal that consumer spending will see renewed momentum into 2022, supporting a second wind for the economic expansion.

… Inflation is Persistently Transitory

- If the global economy persistently goes from one transitory source of inflation to the next, it may keep inflation elevated for longer than markets currently anticipate. Following this year's supply disruptions and recent climb in energy prices, markets may begin to price another potential source of inflation: workers demanding higher wages as strikes blanket the news.

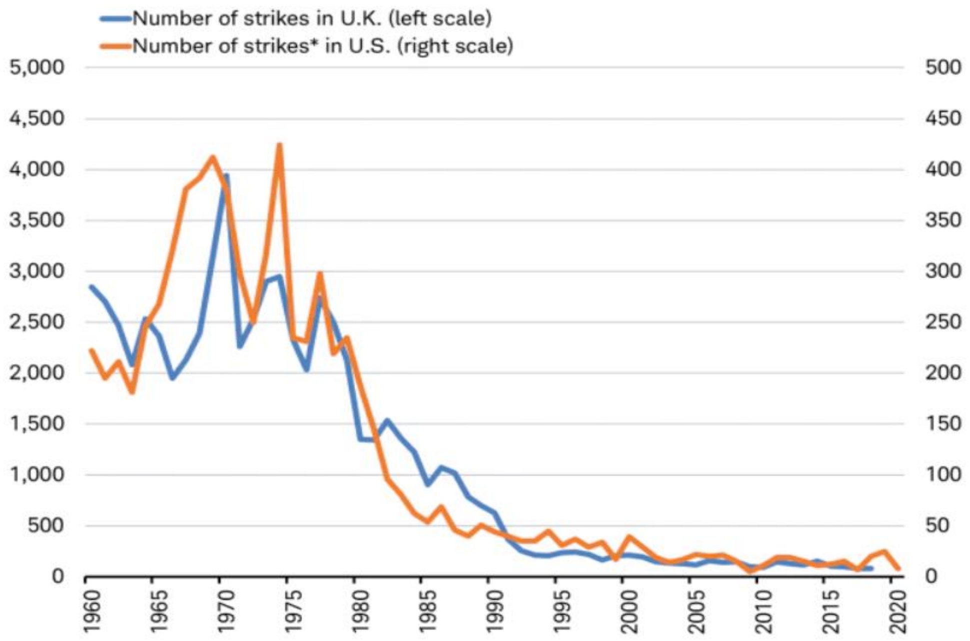
- Recent headlines touting big union pay demands and strike announcements may seem to echo the hyper-inflationary 1970s. In the first week of October, U.S. strikes included nurses in Massachusetts; steelworkers in West Virginia; school bus drivers in Maryland; service workers in Colorado and workers at Kellogg plants in Nebraska, Michigan, Pennsylvania, and Tennessee. The big headline looming is a potential Hollywood strike of nearly 60,000 film and television crews.

- A 1.6% raise to the minimum wage in Spain in September and a 2.2% rise in the French minimum wage beginning in October serve as recent examples, tempering this next transitory driver of inflation and its impact on corporate profit margins.

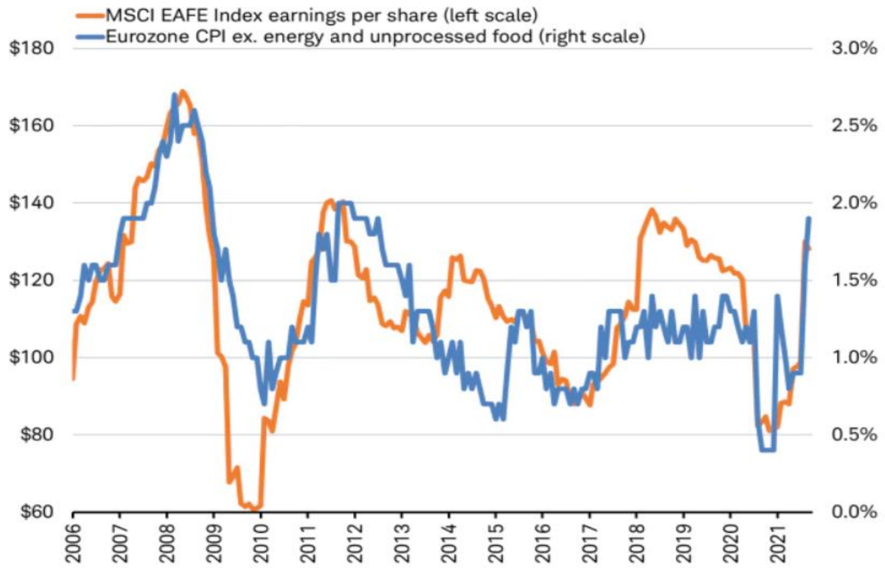
- It is likely that the new sources of inflation may continue to be a cause for concern. Unless the mounting pressures push inflation to significantly higher levels that would provoke central banks into aggressive tightening, the impact on global stock markets may be a positive.

- Impacts on global stock market returns from potentially mild downward pressure on price-to-earnings ratios may be more than offset by the upward lift to earnings provided by inflation.

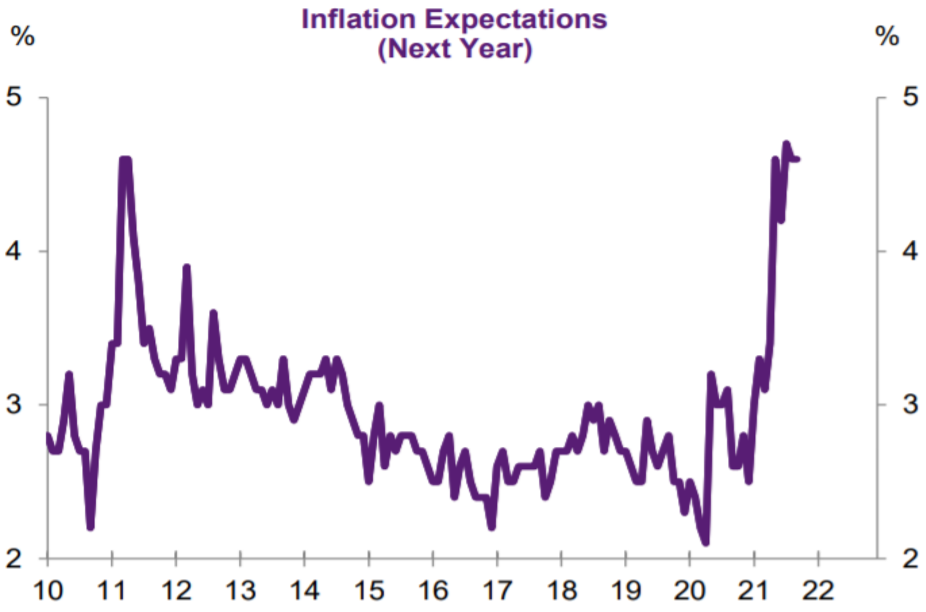
Strikes unlikely to match those of the inflationary 1970s



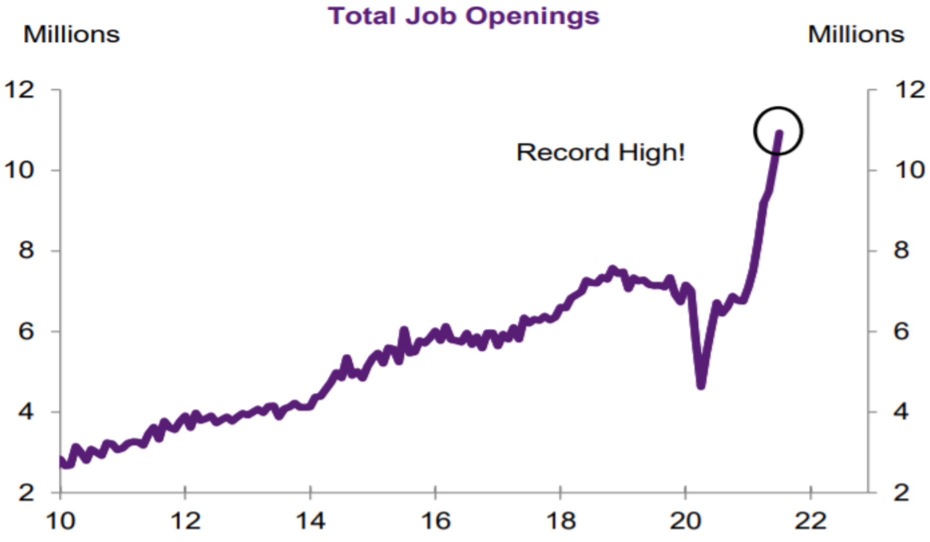
Inflation and earnings



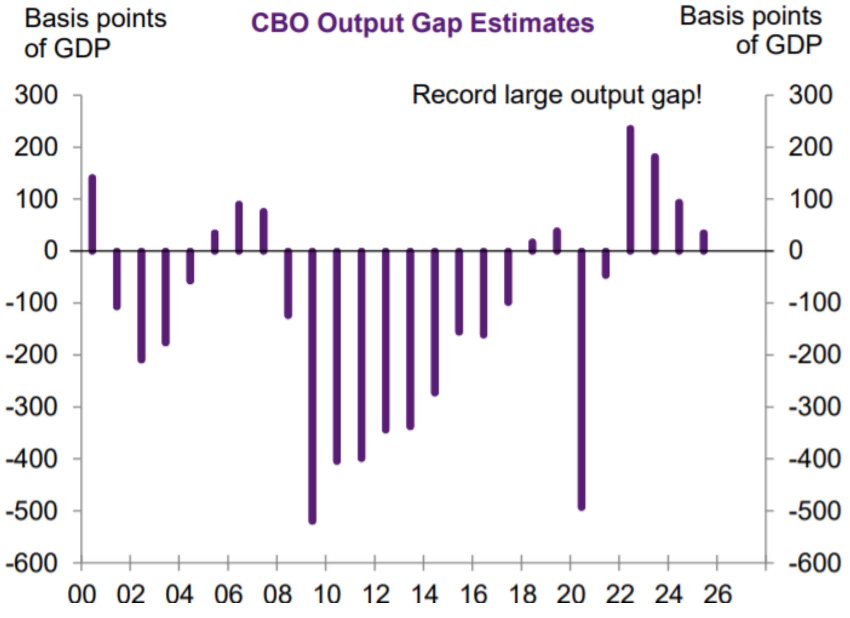
Short-term inflation expectations soaring



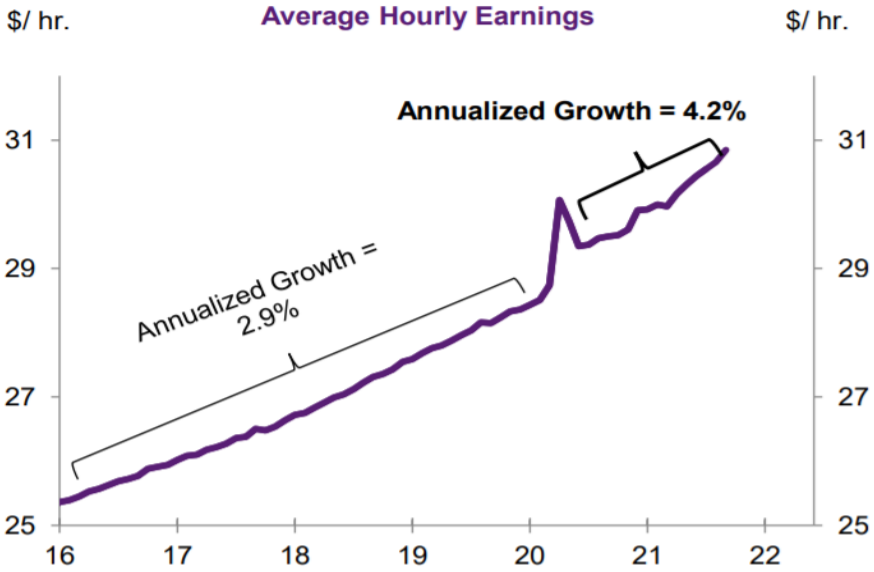
Labour demand never stronger



Economy operating above noninflationary potential



Wage gains rapidly accelerating



Hawkish Fed in 2022

- Biden has a lot of important decisions to make in coming months, which will affect Fed . The most important question is whether Biden will re-nominate Powell, whose term as Fed chair expires on 5 February. It was unprecedented when Trump did not renominate Yellen as Fed Chair and if Biden chooses someone else, it is difficult to say the central bank is as independent as before. At least all future Presidents can say it is now common practice to replace the incumbent Fed chair
- It is not too long ago Senator Elizabeth Warren called Powell a “dangerous man”. The left-wing Democrats are not only concerned about the trading scandal but also relaxation of regulation. Trump nominated Powell on 2 November 2017, which was later than for Bernanke (25 August 2009 and 24 October 2005) and Yellen (9 October 2013). Hence there should be an announcement within a month
- Lael Brainard might succeed Randy Quarles as Vice Chair for Supervision but Quarles may choose to stay on the board as an ordinary governor. Richard Clarida’s term as both governor and vice chair expires soon and hence he would leave the board. This would mean that Biden has another vacant seat to fill (besides the one already vacant) and most likely is searching for a new Vice Chair. Federal Reserve Banks of Boston and Dallas are both looking for a new President amid Fed trading scandal. Biden is not part of these discussions.
- Although it is important to notice in what direction the Fed goes, there is less likely to be any change as to how the Fed conducts monetary policy overall.
- Next year, Loretta Mester (Cleveland Fed), Esther George (Kansas City) and James Bullard (St. Louis) are new voting FOMC members (instead of Thomas Barkin (Richmond), Raphael Bostic (Atlanta), Mary Daly (San Francisco) and Charles Evans (Chicago)). Also the next Boston Fed President is a voting FOMC member. Mester, George and Bullard are all considered more hawkish than the median Fed policymaker. So all else equal, the FOMC becomes more hawkish next year
- Looking at recent Fed communication, not much has changed. Fed is likely to announce tapering at the next meeting in November and is likely to conclude tapering in Q2 22. Fed might hike the target range twice in H2 22 (September and December). The blackout period ahead of the next FOMC meeting starts on Saturday 23 October.

What to Watch in this week

- FX markets will continue to dominated by the **Global energy crisis and resultant disruptions in the commodity sector**.
- China's 3Q GDP will set the tone in the early part of the week, where consensus expects a slowdown to 5% y/y from 7.9% y/y. Such an outcome would normally be seen as a negative for the commodity complex– yet commodities continued to be buoyed by supply not demand trends and continue to add to near term inflationary risks.
- Second tier (US industrial production, housing data) and a few Fed speakers besides Fed's Beige Book ahead of the 3 November FOMC meeting – No catalyst
- October consumer confidence for the Euro area is an important data release of the week,. Markets will be keen to know the response function of ECB from ECB speakers but not until the likes of Lagarde or Lane talk about it , will there be a re-rating of EUR.
- September UK CPI – upside risks seen to the 3.2% YoY consensus. And we will also hear from BoE speakers, including the Governor, Andrew Bailey. Most of his speeches seem to be on climate change topics, but Chief Economist Huw Pill also speaks later in the week.. A rate protest may still be forthcoming from BoE
- The week will also see rate meetings in the likes of Hungary, Turkey and Russia.
- Turkish Lira could come under further pressure if the CBT delivered another surprise rate cut.
- In contrast, the Rouble remains in strong demand on the energy story and with the CBR set to improve RUB yields even further.
- Broader FX trends, including for the dollar, may however be set by events in emerging markets.

Its all about Energy… 1/2

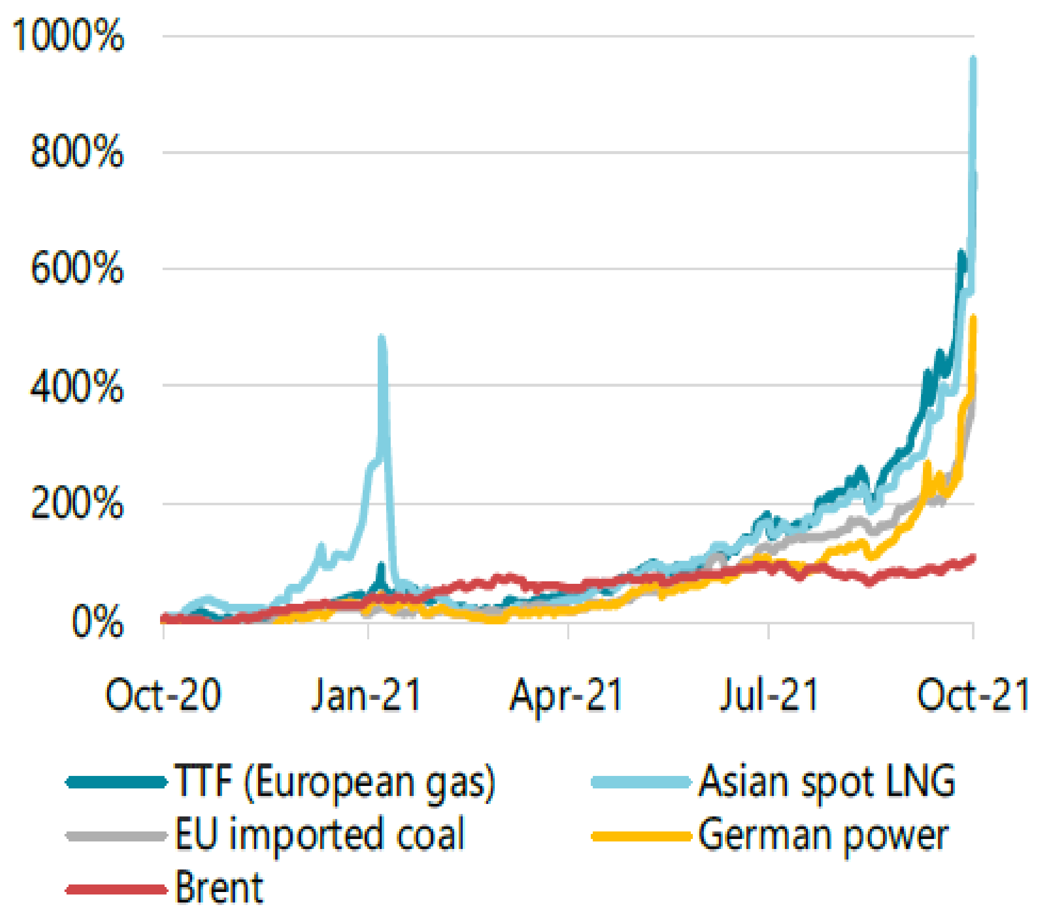
- The energy crisis rumbles-on with no easy answers emerging to bring it under control., potentially causing far more damage than any energy price upheaval since the 1970s.
- If natural gas and coal prices remain at current levels for another six months, the consequences would be worse than those from $100 oil — sparking the most severe global economic recession in five decades.
- Energy would account for approximately 8.8% of global GDP in 2022, up from 3% of global GDP in 2020, which was down from 4.2% in 2019.
- That implies consumers in 2022 would pay an “energy tax” of almost $6 trillion.
- Unless governments in Asia and Europe step in and increase deficit spending, as they did in 2020 after the Covid-19 shutdowns, there is a possibility of a recession in 2022

Rough Estimates of World Expenditures on Oil, Gas and Coal: 2020 vs. 2022

($ billion)	Oil	Natural Gas	Coal	Total	Global GDP	Energy as a % of Global GDP
2020	1,351	568	600	2,519	84,537	3.0
2022	3,219	3,039	2,200	8,458	96,000	8.8

Source: PKVerleger

Evolution of Energy Prices, 2020-2021



Its all about Energy…2/2

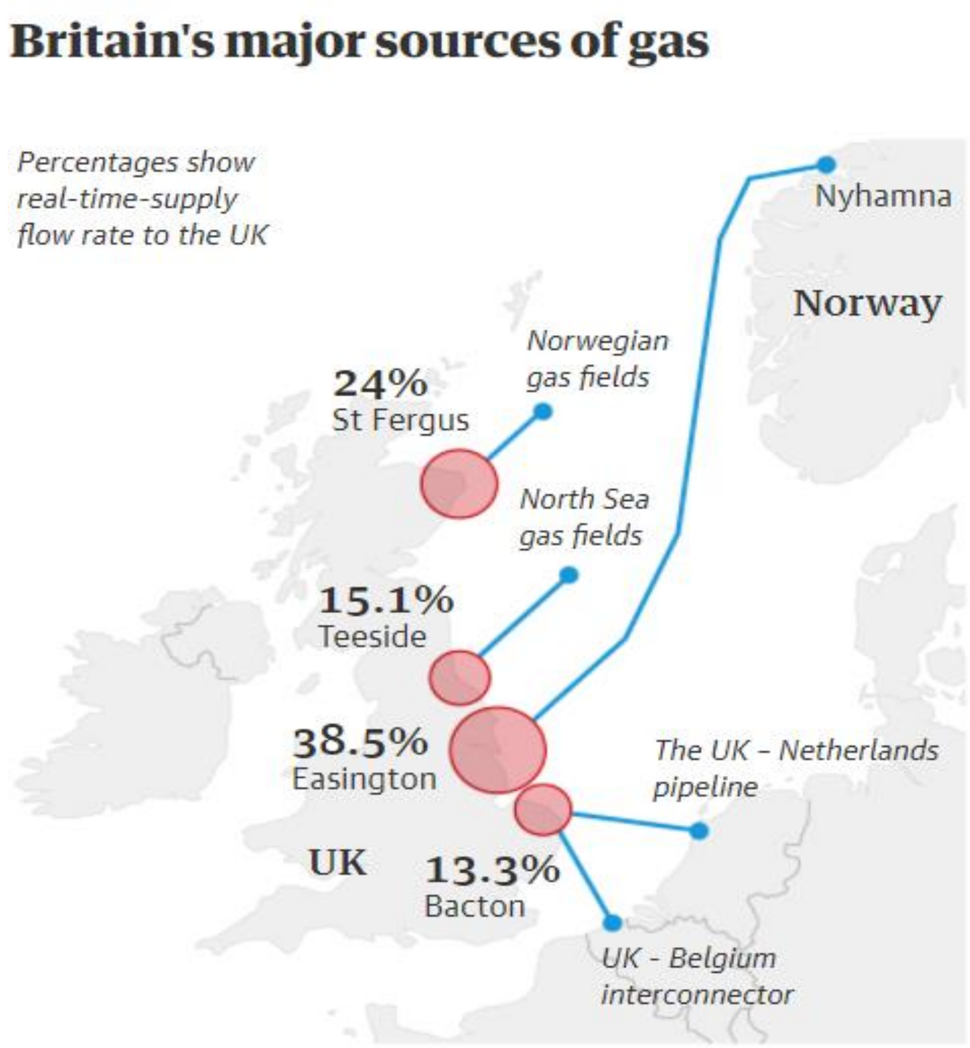
- The energy crunch in Europe and Asia has shown that Europe may have rushed a bit with its energy transition, making itself vulnerable to high commodity prices when renewables fail to deliver as expected.
- After a few bearish days, Asian spot LNG prices are on the rise once again, prompting fear that another spike could happen sooner than later in the world's largest LNG demand zone.
- In addition, shipping rates have increased from $60,000-$70,000 per day to above $135,000/day for a standard size LNG carrier of 160,000 cubic meters .This is due to the limited number of ships in the Pacific at the moment.
- These energy crunches around the world showcase just how much the world is still reliant on fossil fuels to shore up energy security, and the outsized power that this gives to major energy players such as Russia, creating a dangerous and delicate geopolitical (im)balance.
- LNG market is waiting for the outcome of Ukrainian gas pipeline capacity auctions slated to happen this week. If Gazprom books more capacity, something it has been reluctant to do in recent months, then volatility could ease both in Europe and Asia. CEO of Gazprom Alexei Miller, recently stated that his company is “half a business, and half a state policy arm “ – So Geopolitics to dictate the course.
- The Energy Crisis Is Spreading Faster Than The Coronavirus And COP26 Leaders on October 31 in Glasgow, Scotland Face A Faustian Choice.
- They are now tasked with presenting a compelling case to continue their aggressive fight against climate change right when the demand for fossil fuels is rising and causing a huge spike in energy prices.

Gas Crisis Engulfs Europe

- Energy crisis that Europe is currently facing is one of the big unknowns for the economic recovery, and the inflation path, in the months ahead. The outcome of this crisis remains quite uncertain, and the severity of the European winter will matter a lot.
- The spike in gas prices, accompanied by oil prices at a seven-year high, is causing a lot of uncertainty for households as it results in large question marks surrounding energy bills for this winter and possibly beyond. Although it is yet to feed broader inflation, inflation markets price in higher inflation in the euro area in 5-10 year's time to its highest levels since 2014.
- The surge in inflation expectations have also prompted market expectations of a rate hike by the ECB, where 10bp is priced for January 2023, which is far too premature
- ZEW survey for Germany was another print confirming slowing economic activity and outlook in Germany. While the expectations component were still holding up at 22.3 (from 26.5 in Sep), it is nevertheless declining. Not surprisingly the current situation component also declined, but the magnitude of that decline was bigger than expected pointing to headwinds for the German economy in the near future.
- With Euro area negotiated wages growing by only 1.7% in Q2, inflation rates in excess of 3% for the remainder of this year point to an increasing erosion of purchasing power, which would show up in a noticeable slowing in euro area private consumption growth to 1.0% q/q during Q4, after Q3's post-lockdown surge
- Higher energy prices and their impact on inflation and private consumption are clearly stagflationary forces and should result in weaker Currency .
- Energy crisis could accentuate the rift between the doves and hawks and specifically between the 'inflation is transitional' and the 'inflation will be structurally higher' camps.
- October European PMIs this week will shed light on whether supply constraints and mounting energy crisis are affecting companies' order books and cost situation
- Even if the recovery in equities has legs – and supports the risk environment in general –EUR/USD wont trade in tandem with higher risk given the enormity of the energy crisis
- Implied EUR yields via the 3m forwards are now -0.7% and makes the EUR a preferred funding currency.

UK : Misplaced Exuberance

- UK is arguably at the highest risk of Europe's major economies of a winter supply shortfall
- Britain’s main problem is its so-called "windless summer" in which renewable power production was much lower than normal. This put a significant strain on electricity generation as around 24% of its power is produced by Wind.
- However hawkish sentiment from the Bank has supported GBP but fears around the medium-term outlook for the UK economy could hinder the prospects for the pound
- Not only have the markets had to assess the implications of a possible policy mistake from BoE on UK growth but politics also remains a distraction. Tensions between the UK and the EU over fisheries and the Northern Ireland protocol continue to fester. Neither of these political issues has had a significant market impact to date, but both are a potential drag on the outlook for the pound.
- But perhaps the bigger takeaway for markets is that the path of future rate hikes is unlikely to be as steep or lengthy as is currently priced.
- Aggressive rate hike expectations – which are misplaced in the current context - offer some underlying support to sterling and the currency may have to give up recent gains as BoE would certainly underdeliver on monetary tightening.



Source: Energy UK/National Grid. As of Thursday 7 October

Business leaders are worried Britain could run out of gas this year if the winter turns out to be particularly cold. Billionaire industrialist Sir Jim Ratcliffe said the energy crisis would last for months with sky-rocketing prices and concerns over a shortage of supply.

Japan – Oil matters

- Japan is suffering its worst energy crisis since the 2011 Fukushima nuclear disaster, with very tight supply of both electricity and natural gas. Domestic wholesale electricity prices have spiked to a record high. Elevated electricity prices are also reviving memories of last winter when prices hit record highs and Japan's grid nearly failed in the worst energy crisis.
- On the positive side ,Inventories of LNG are now above 2.4 million tonnes, around 600,000 tonnes higher than the four-year average for this time of the year - sufficient enough to last for only 12 days .
- However ,The current global energy crisis has left JPY vulnerable - Japan needs to import 94% of its energy requirements -the world’s fifth-largest crude importer and second-largest LNG importer (having lost the top position to China last year).
- There should be greater interest than usual in Japan’s monthly trade balance. Here the adjusted trade deficit is expected to widen towards the JPY500bn area. Any wider deficit could provide USD/JPY with the nudge through 115.00 as the market sinks its teeth into the energy dependence story.
- The week ends with the release of the September CPI figure, with ex food and energy expected still at -0.4% YoY. Clearly the BoJ is under no pressure to join in the race to tighter policy.

China : Peak Stress

- While Chinese equity markets have been more stable lately, the stress in credit markets for developers have continued unabated with rates on high yield credit reaching new highs.
- However, with high yield rates (dominated by developers) moving above 20% this week, Beijing is probably getting close to the pain threshold
- Another sign of severe stress is faltering home sales as home buyers seem more reluctant to buy property from developers as long as they are not sure they are able to fulfil their obligations and deliver the apartment people put down deposit for.
- During the Golden Week holiday in early October, sales were down 33% y/y and by more than 40% in the big cities like Beijing and Shanghai. Developers cannot survive this kind of stress for long.
- **Peak stress** is likely part of the reason why equities rallied last week and dollar giving back some gains.
- However, there is still a long way from stabilizing financial stress to re-starting the credit cycle in a similar fashion to what was seen post-covid, or post-GFC .
- For Chinese equities, this may simply be a period of more sideways moves, awaiting the next large cyclical reboot of credit.
- For assets which are more indirectly linked to Chinese assets and the credit cycle, E.g. **EUR/USD is likely still in a process of moving lower** as the effects of historical Chinese tightening is moving through the global manufacturing chains.

FAR reaching Policy Step

- As consultation around India's global bond index inclusion gathered pace over the past few months, in a far reaching policy hint, Deputy Governor said that RBI has introduced the Fully Accessible Route, which allows non-resident investors to invest in specified gilts with no investment ceilings. The move was aimed at ensuring non-resident investors have unfettered access to the government securities, since virtually over time, all the government securities will fall under the Fully Accessible Category. JP Morgan in its note had said that bonds which are listed under the Fully Accessible Route will be eligible for listing on the aggregator's Global Bond Index-EM index.
- Every time headline CPI inflation falls sharply--as it did to 4.59% in December, 4.23% in April, and 4.35% last month--to more comfortable levels, it provides a false, and temporary, sense of comfort.
- And while that may allow monetary policy to remain accommodative for longer, it is at the cost of high inflation, as indicated by core inflation. Core inflation came in at 5.8% in September. While this is down from 6.4% in May, it is expected to climb in the second half of 2021-22 (Apr-Mar) and averaging as high as 6.3%.
- History of economies shows that Inflation does not happen the next day you print money. It is a slow process of gradual erosion of the purchasing power of the currency with the implementation of demand-side policies (huge government spending and CB balance sheet expansion)– resulting in massive bubbles
- Not withstanding the differing narratives, Short-term gilts alone would continue outperform those of longer maturities -lack of a scheduled open market operation by the central bank in October may keep long-terms gilt out of favour.
- Similar undertone in Swaps is seen -While the five-year rate has seen a movement of nearly 25 basis points over the last two weeks, the one-year swap rate has been confined to a narrow band of 6 bps.
- Fundraising through corporate bonds in September rose nearly twofold from the previous month to Rs.1.1 trillion - September was also the first time this fiscal year that funds raised through corporate bonds were higher on a year-on-year basis. Green shoot or Speculative bump-up ahead of Policy review ?

Equity Resilience

- The resilience shown by Indian equities in the face of global headwinds over the last three months has been surprising.
- Nifty created history by crossing 16000 on August 3, sprinting to 17000 on August 31 and surpassing 18000 on October 11 – with the journey of adding the last 1000 points being the second fastest since inception.
- The theme of recovery has been underpinning the rally though there are macro negatives such as higher crude oil prices and rising inflation expectations .
- In keeping with the norm of the times , markets are seeing the risks as ‘transitory’ whereas the global scenario calls for realization that these concerns would prove to be significant hurdles
- Upside Momentum has been too strong and it is prudent to expect a pause in the higher range 18000-18500

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