SYFX Treasury Foundation

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Weekly Market Update

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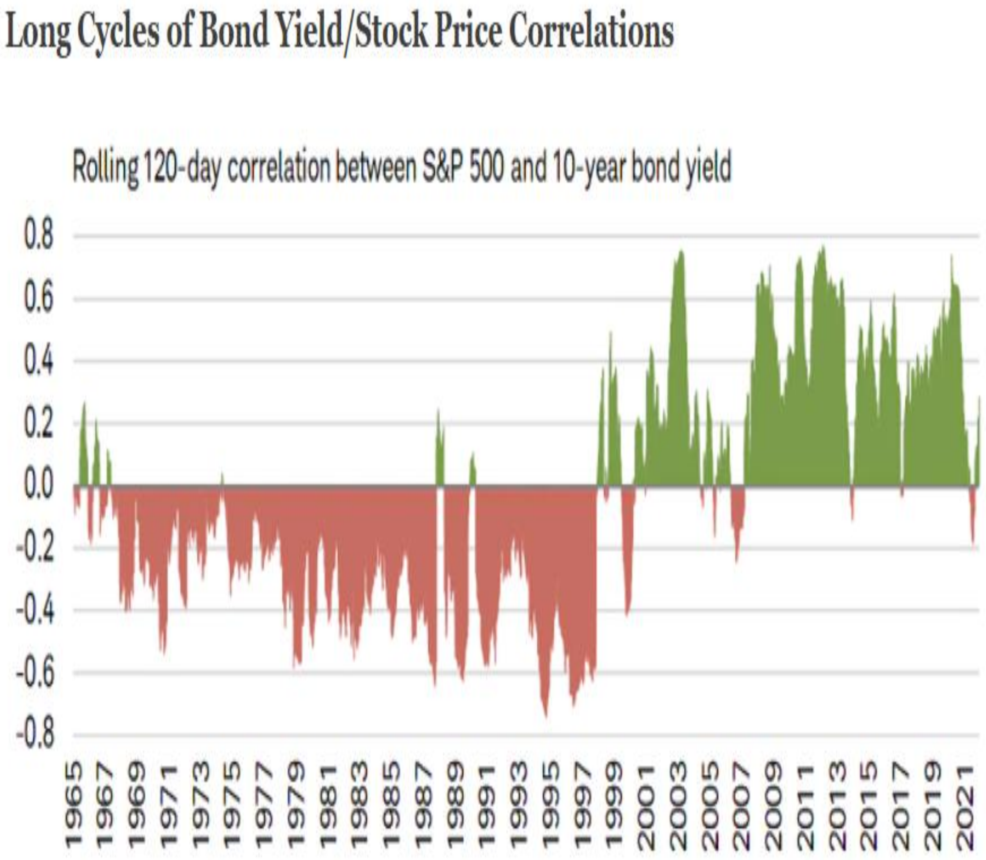
US Economy : Restoring balance

- The number of unemployed workers per job opening reached a fresh record low of 0.67 in October.
- US labour market appears to be very tight with **jobless claims this week hitting the lowest level** since 1969.
- Container ships continue to stack up off the San Pedro Bay ports .Many ships are now simply anchoring further offshore outside the designated 40-mile 'Safety and Air Quality Area', meaning the total number of ships both inside and outside the area awaiting port space remains high. In fact, it is reported higher than ever, with a record 97 ships reported awaiting port space as of December 9, 68 of which were outside the 40-mile area. With little reprieve to supply issues in sight, **price pressure will persist into next year.**
- The big data release last week was consumer prices for November. The consumer price index rose 0.8%, which brought the year-ago rate up to a 39-year high of 6.8%. The gain in prices was broad based -that's little comfort to consumers who are seeing inflation erode their purchasing power
- Imports have outpaced exports throughout the pandemic due to an exceptional pace of domestic demand. But exports surged in October (+8.1%) and were being met with more modest import growth (+0.9%), causing the trade balance to narrow by $14.2 billion. For perspective, this gain was outpaced only once during the financial crisis of 2008 in data going back to the early-1990s and puts the trade balance at its lowest deficit in six months.
- The December preliminary UoM Consumer Sentiment Index came in higher than expected at 70.4, versus estimates calling for a modest improvement to 68.0 from November's 67.4 reading, which was a ten-year low.

How to read Inflation Dynamics

- A relationship that bears watching, and may help lay to rest the debate about whether inflation will turn out to be ultimately transitory, is between bond yields and stock prices.
- For three decades starting in the late-1960s, they were mostly negatively correlated.
- That was an era punctuated by greater frequency of supply shocks, and an over-arching inflationary backdrop.
- For the two decades that followed, bond yields and stock prices were mostly positively correlated.
- This has been an era punctuated by a few demand shocks, but very few supply shocks; and an over-arching disinflationary backdrop.
- The pandemic has exposed instability in complex global supply chains; possibly ushering in a coming secular environment of pervasive supply shocks, vs. the demand shocks that were more commonplace for much of the past two decades.
- After a brief dip into negative territory in mid-2021, the correlation is back in positive territory again.

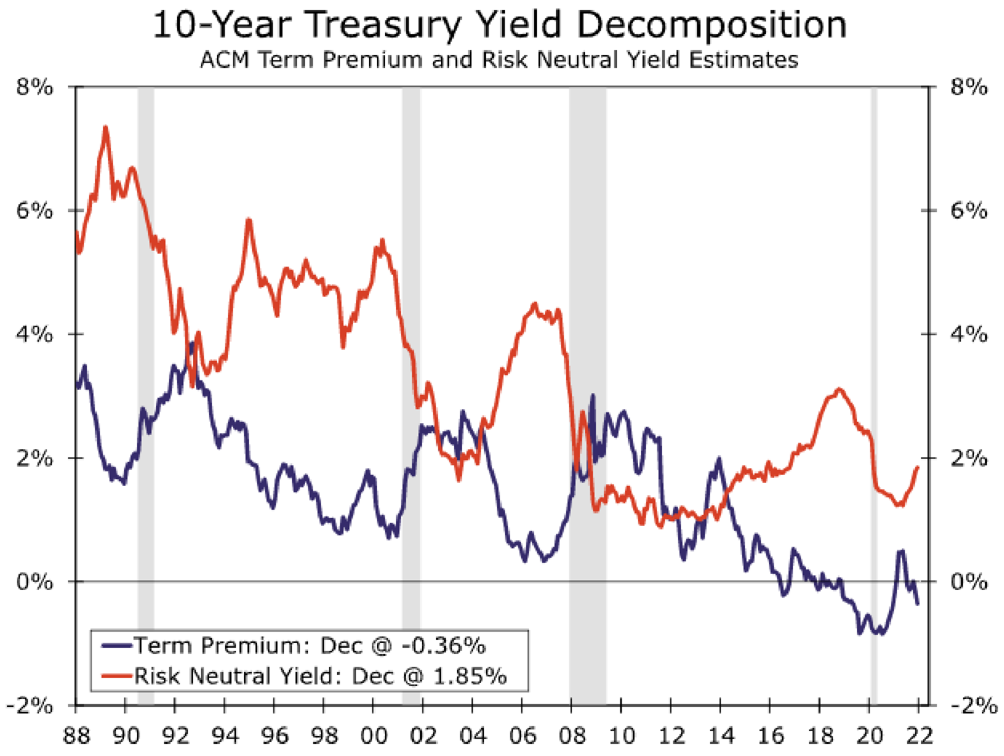


Any sustainable move back into negative territory could signal an inflation regime shift akin to what developed in the late-1960s; which ultimately led to significant policy errors in the 1970s.

Long term yields : Solving the Puzzle

Neutral rate has fallen for several decades, in part a function of global savings and investment relationships.

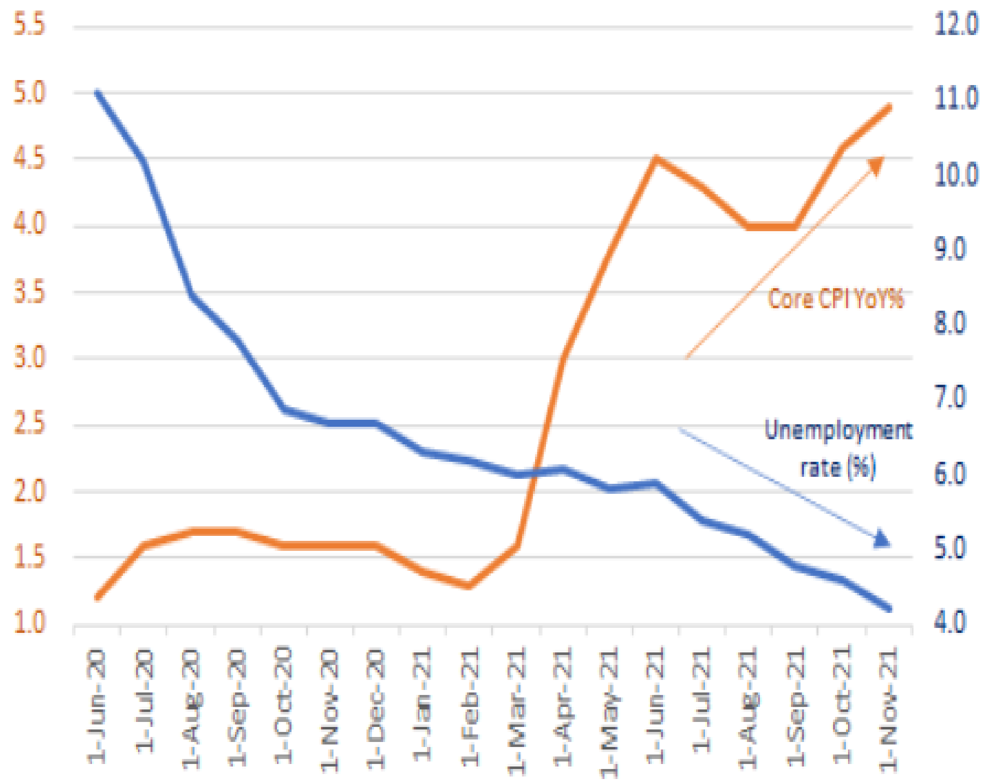
- 10-year Treasury yield remains historically low at 1.48%. Adjusted for the year-over-year pace of inflation, which currently stands at 6.88%, yields are the lowest they have been in decades. So what gives?
- In theory, longer-term interest rates, such as the yield on the 10-year Treasury note, should be a function of two things: the expected short-term interest rates over the period under discussion plus a “term premium” to compensate investors for locking up their money for an extended period of time.
- The expected short-term “risk neutral yield” over the next ten years has risen in 2021 but it remains relatively low at roughly 1.8%. This broadly aligns with market pricing that suggests the Fed will hike a few times in 2022 and 2023 and then stop even as the FOMC's median projection for the “longer-run” neutral rate is 2.5%.
- Perhaps more interesting, the term premium component is negative by about 36 bps. This suggests investors are willing to pay a premium to lock up their money at current yields for an extended period of time.
- This somewhat counterintuitive finding may seem odd, especially during a period when there is sky high inflation and above-average economic uncertainty. Put another way, although 1.5% seems low for the 10-year yield, there have been plenty of times in recent decades where yields "seemed" low, only for them to once again take another leg lower.
- Multi-decade high in inflation seems unlikely to be met by a multi-decade high in longer-term Treasury yields anytime soon.



Ultimately, if the longer-term “neutral” rate is only about 1.8%, and investors are comfortable with a small or even negative term premium, then it is not altogether surprising that long-term interest rates are so low.

FOMC : No more Transitory

- Fed will have to maintain the delicate balance between keeping inflation expectations anchored and allowing for a supportive environment for economic growth.
- As negative supply shocks push inflation higher, they threaten to set off a self-fulfilling cycle of ever higher inflation, which could begin to chip away at demand.
- The inflation reading likely underscores the need for the Fed to take action and accelerating the taper process is a concrete step in battling inflation.
- This also comes as the labour market continues to show signs of improvement, with the unemployment rate now at 4.2%, well below the pandemic peak of 14.8%.
- So, between the Fed's dual mandates – inflation and labour – the Fed may be shifting its focus to battling inflationary pressures over improvements in the labor market, at least for now.
- The pace of tapering will likely increase from $15 billion per month currently, to $30 billion per month. This would allow the Fed to wind down its tapering process by the first quarter of 2022.
- While Fed will likely accelerate the tapering process, it still has room to be patient and deliberate on rate hikes.



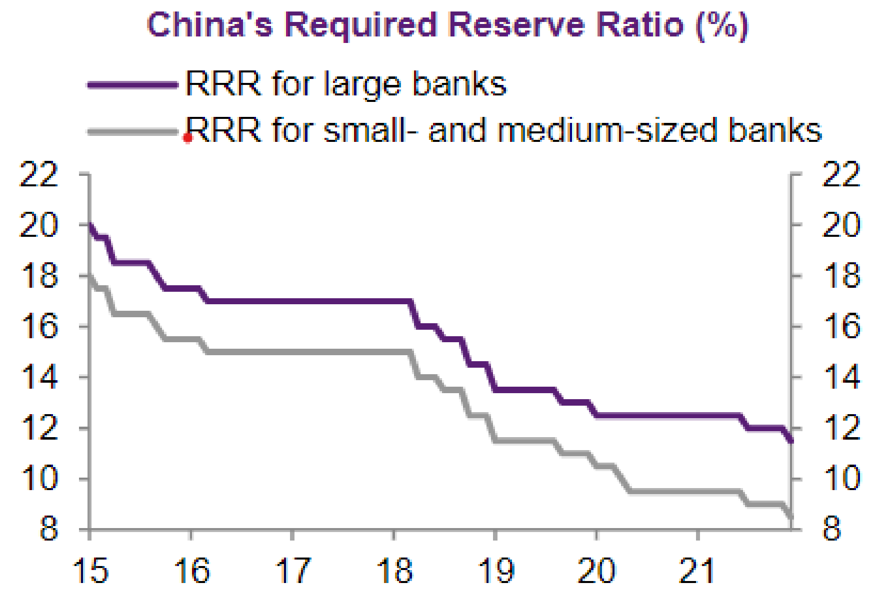
Fed's dual mandate - Inflation continues to remain well above Fed's 2.0% target, while the labour market shows steady improvement

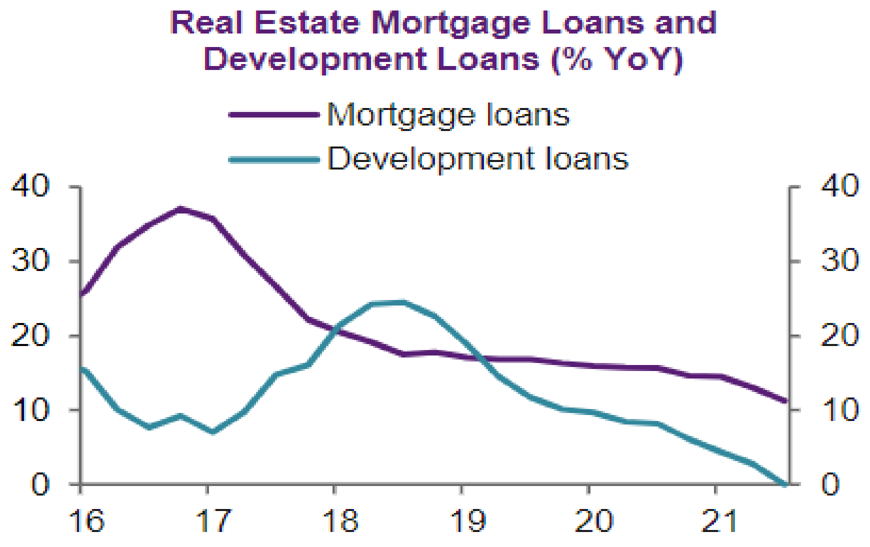
ECB : Persistently Transitory

- ECB meeting on Thursday this week has been a key focal point this year, with a recalibration of the ECB's monetary policy instruments.
- Inflation has picked up quicker than anticipated while the growth outlook is murky, which we expect will result in a patient approach to monetary policy in 2022, but with the optionality to recalibrate in 2023.
- A difficult communication exercise amid growing divisions in the Governing Council about pro-inflationary risks and a stuttering economy.
- The new forecasts to show a marked upward revision in the near-term inflation outlook, but with HICP inflation falling back below 2% in 2023 and 2024, supporting the ECB's communication of a patient approach with regard to rate hikes.
- That said, to placate the 'hawks', a first step towards policy normalisation will likely be done by phasing out the PEPP programme as scheduled in in March 2022
- The link between the first rate hike and the APP (APP to end 'shortly before' the first rate hike is expected to be weakened through a calendar-based forward guidance, with APP running until Q1 23 and first rate hike sometime after that.
- APP is likely to continue at EUR20/month, and with an additional envelope of EUR250bn that is available with flexible implementation, but with the capital key and ISIN limits still in place.

China : Beginning of the easing cycle

- Chinese central bank eased monetary policy further this week lowering reserve requirements and thereby enabling more credit to enter the financial system. In addition to monetary expansion, the government might also go for a easier fiscal stance. . These stimulus measures should support a modest rebound in the Chinese economy in early 2022.,
- It is highly likely that This RRR cut is the first step in the PBoC’s easing cycle. Past experience supports this hypothesis - five RRR cuts during the easing cycle from 2015 to 2016,and six times during the one from 2018 to 2019.
- The situation will be particularly pivoted towards further easing if the economy continues to slow down in the first half of 2022.
- That said, there may be some fine-tuning during the implementation of the monetary easing, i.e., replacing some of the MLF due at the end of the year with the liquidity unleashed through the RRR cut, but the overall tone will only become sharper early next year.

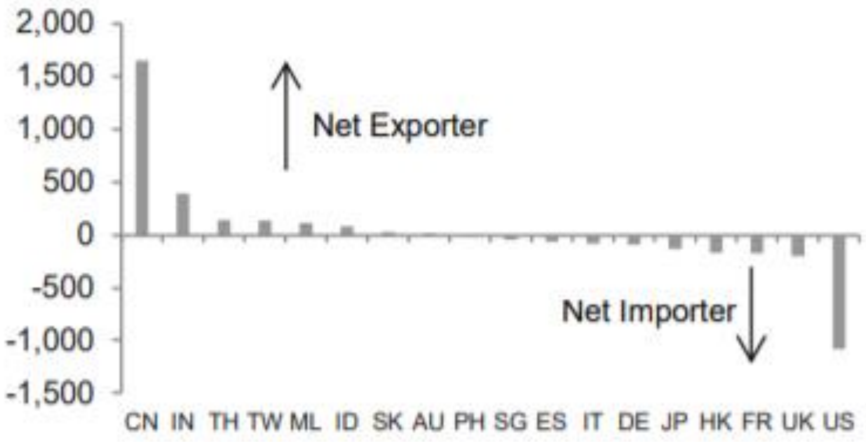




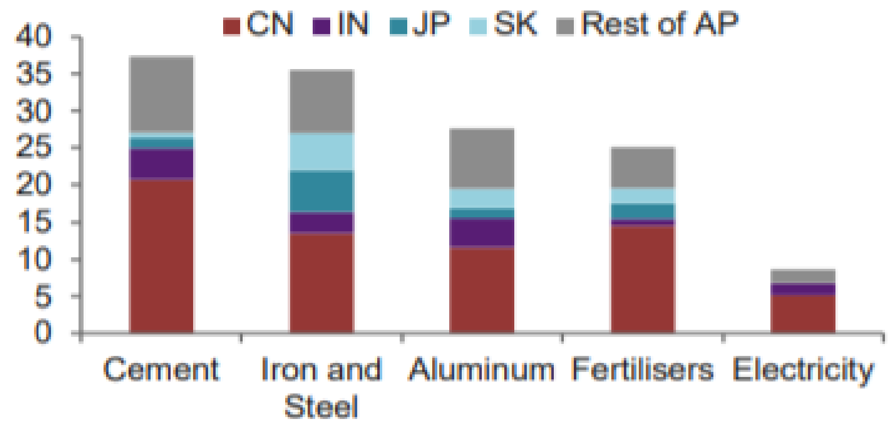
Emerging Risk for Asia

- The rise of the global value chain has amplified the impact of international trade on carbon emissions. In fact, carbon emissions embodied in foreign trade account for roughly 20% of total global carbon emission. This means one fifth of the global carbon emissions generated from the production of goods are ultimately consumed abroad.
- US is the largest consumer of emissions from the rest of the world through imports.
- Against this backdrop, decarbonization across the supply chain has been suggested as a way to overcome the problem of carbon leakage embedded in global trade.
- A key measure so far is the Carbon Border Adjustment Mechanism (CBAM) led by the EU to tax on the imports for a bunch of high-emission industrial products.
- The ramifications are bound to be felt strongly by carbon exporters, in particular in Asia. In fact, almost one-third of the carbon-intensive products defined by EU's CBAM proposal are exported from Asia.
- This is especially true for the exports of cement and iron, which Asia has a global market share of 37.4% and 35.5% respectively

Net Export of Trade-Embodied Carbon Emission (Tonne mn)



Global Market Share of Carbon-Intensive Industrial Goods(%)



India : From Transitory to gradual

- MPC regarded the accentuation of headwinds emanating from global developments as the main risk to the domestic outlook, which is now somewhat clouded by the Omicron
- Moreover, given the slack in the economy and the ongoing catching-up of activity, especially of private consumption, which is still below its pre-pandemic levels, continued policy support is being warranted for a durable and broad-based recovery.
- MPC did not use either 'transitory', 'transient', or 'temporary' to characterise the current supply-side shocks and elevated inflation prints.
- This is a marked shift from August, when 'transitory' and 'temporary' were used four times by the committee in its statement and Governor in his address.
- Rhetoric has shifted to being 'gradual', which Governor used in full effect in his address as he veered off the prepared text to give an idea of how the RBI would normalise the extant accommodation of the policy.
- India's index of industrial production (IIP) grew 3.2% in October, compared to a revised 3.3% rise in September, and 4.5% growth in October 2020
- WPI inflation is expected to have declined to 12.1% in November from 12.54% in October. CPI Inflation is expected to have risen in November due to a surge in prices of key food items .The favourable base effect that had helped drag down inflation to 4.35% in September, has also waned and will turn unfavourable from December.
- RBI conducted a variable rate reverse repo auction on December 7 for a total notified amount of Rs 2 lakh crore against which it received offers amounting to ~Rs 2.69 lakh crore
- Government bond prices ended flat in the week amid volatility. Yield on the 10-year benchmark 6.10% 2031 paper settled at 6.37% on December 10, unchanged from the previous week

Nifty : Staying in Balance

- Yet another week of whipsaws in the market as the broader sentiment continues to remain ‘Sell on Rise’ with Bears countering the Bulls on every significant up move.
- RBI MPC meet helped elevate Markets’ mood as the policy was more dovish than expected.
- Many post earnings management commentaries, especially of the FMCG sector, emphasized that rural demand is losing steam.
- Nifty closed positive for the second week after witnessing a bounce from the demand zone around 16800.
- The index to stay range bound 17250-17650

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