SYFX Treasury Foundation

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# Weekly Market Update

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# Fed Steals the show

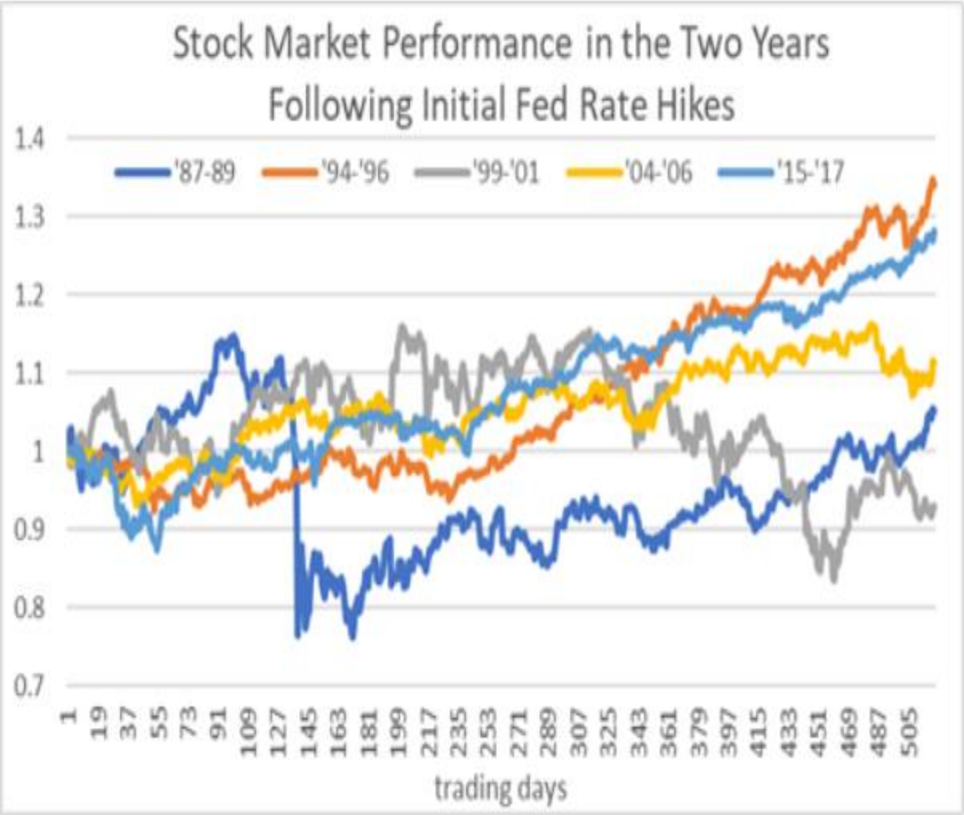
- The more hawkish tone coming out of the Fed's latest policy meeting was the main event grasping markets' attention last week.
- Retail sales data disappointed as higher prices factor into spending and industrial activity continued to recover but remains beset by supply issues.
- Continued supply side disruptions also extended to the housing sector, where the number of homes under construction reached its highest level since 2007.
- Congress faced a slew of December deadlines when it returned to session after Thanksgiving, and many of these “hard” deadlines have been met. However, the “soft” deadline for passing Democrats' Build Back Better plan by year-end appears likely to be missed.
- Now that the Fed hawkish reset is complete, whoever is left working in the markets in this holiday season will have to focus on several economic data points that will show whether the US consumer remains strong :
    - The latest personal spending should show a decline while income might maintain modest growth.
    - Another round of housing data should show existing home and new home sales remain hot.
    - Fed’s preferred inflation gauge will show pricing pressures continued to surge in November.
- Fed is done with speaking appearances for the year, so thin trading conditions should settle in once we get past Thursday’s economic data.
- The biggest risk to the short-term outlook remains omicron – there is a debate whether the spread of the virus would further depress the supply side while decelerating the growth momentum

# Unique Normalisation

- There have been plenty of unique elements to the economic path over the last two years, including a return to pre-pandemic output (GDP) in record time.
- This has created unique conditions on the path toward monetary-policy normalization
  - It will likely be the shortest time between the end of the preceding recession and the first hike. Since 1985, the average time was more than four years. A rate hike next March or June would be roughly half of that.
  - Inflation is the hottest it's been in three decades.
  - The 2/10 yield curve (10-year Treasury yields minus two-year yields) is currently near 0.8%, which would be the second-flattest at the time of the first hike.
  - The 10-year Treasury rate is below 1.5%, the lowest it's been approaching Fed tightening. Since 1985, 10-year rates averaged 5.3% at the time of the first Fed hike.
  - Liquidity is abundant, with Fed balance-sheet assets as a percent of GDP at the highest level since World War II.

# Fed tightening & Equity markets

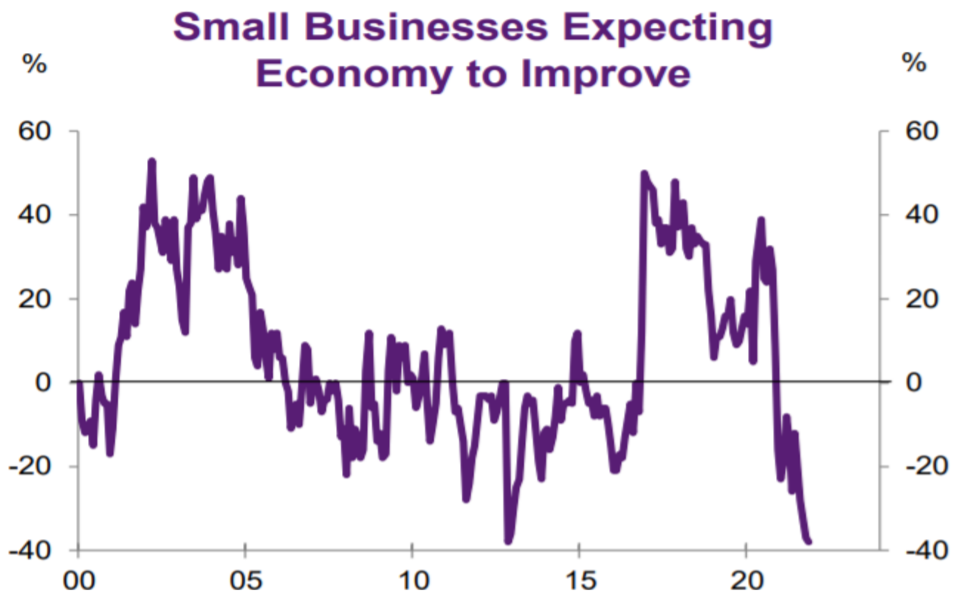
- Shifting expectations around the timing and number of rate hikes in 2022 will be the primary driver of turbulence in the months ahead.
- This was evident last week as equities rallied after the announcement, before giving back those gains in the following days as markets adjusted themselves to an outlook in which the economic expansion should persist, but will have to proceed without the massive tailwind from the Fed.
- Tapering will usher in a new environment of market volatility, as the excess liquidity will no longer serve as the safety net to fully cushion market pullbacks, as was the case over the last year, which contained no 10% corrections and only one 5% decline that saw S&P 500 return to new highs in just 14 days.
- Over the last 35 years, there was only one instance of a 10% stock-market correction in the six months leading up to the first Fed rate hike (2015).
- Initial rate hikes are influential but don't have to be feared. It's the final rate hikes that investors should be more concerned about. As tightening cycles extend, they have the potential to reach the point where interest-rate conditions begin to undermine economic growth and equity-market valuations.

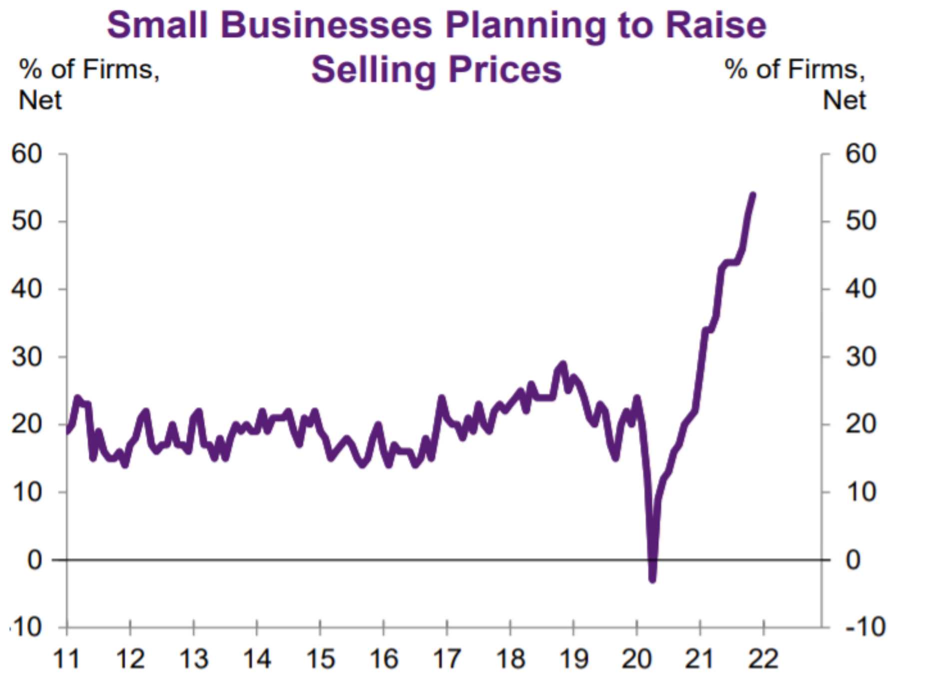



Equity market returns, as represented by the S&P500, during the two years following the first time the Fed began hiking rates in previous rate-hiking cycles over the last 35 years

# Small business : Worrying outlook

- Small businesses, those firms with less than 50 employees, account for roughly 40% of all jobs.  Of course, small firms can grow into large firms, but the former are critical for US labour dynamism.
- Consequently, it is concerning that small businesses are so pessimistic on the broader economic outlook.
- Data last week showed that the net percentage of firms expecting the economy to improve stood at just -38%. This matches the lowest level since November 2012
- The percent of firms planning to raise prices rose three points in November to +54%, which is a new all-time high.
- Arguably, this is the biggest concern for the Fed because policymakers worry that a change in inflation psychology could become self-feeding.
- In other words, higher prices beget higher prices. Under such a scenario, only a meaningful recession might break this pattern.
- Small business says  lower growth and higher inflation ahead ..



# Alternate Case : Reversal of Bullwhip effect

- BIS describes the bullwhip effect as happening when "supply chain participants react to perceived shortages by ordering more, ordering earlier and by hoarding inputs. This kind of reaction is prudent and rational when considered in isolation but can lead to aggregate outcomes that are ultimately self-defeating."
- That is, such behavior exacerbates shortages and contributes to higher prices. However, a deeper analysis of specific ruptures in supply chains reveals that "bottlenecks are not simply a uniform squeeze everywhere along the supply chain. Instead, we have seen commodities demand whipsaw as pressures emerged at different points in the supply chain, resulting in large price fluctuations."
- In other words, prices of some commodities and inputs have soared due to **the bullwhip effect**, only to collapse afterwards.
- BIS points to what happened with the prices of iron ore, lumber, and coal as well as the cost of shipping containers. In each case, prices soared and then fell sharply as capacity increased faster than demand.
- **What are the implications of the BIS analysis?**
- Lately, the conventional wisdom has been that the bullwhip effect will exacerbate supply-chain disruption, thereby prolonging inflationary pressures and boosting expectations of future inflation. Indeed, OECD has called attention to this problem.
- However, the BIS asks, "To what extent will the behavioral responses that gave rise to bottlenecks work in reverse to clear up backlogs once supply chain problems begin to ease? Depending on the answer, we may find that supply bottlenecks may be resolved faster than currently feared, just as they have persisted longer than initially expected." **Thus, the reversal of the bullwhip effect could be the path to lower inflation.**

# Higher US growth on Higher investment

- After a decade of declining capital spending, public infrastructure investment is surging in the US and Europe.
- Scaling up spending on infrastructure has become an essential element of the fiscal stimulus to boost economies after Covid-19.
- The current infrastructure impulse in the US is likely to become the largest public investment program since the 1970s, with infrastructure investment rising from 1.8% of GDP to 2.3% of GDP until 2030.
- In Europe, however, the scale is somewhat smaller and the duration shorter: France's ratio will increase from 2.5% to 2.7% of GDP until 2027, Germany from 1.1% to 1.4%, Italy from 0.9% to 1.3% and Spain from 1% to 1.5%.
- **<u>All this investment should have a significant positive impact on growth:</u>**
- In the US, the infrastructure package should add about 0.9pp to GDP over the next three years, while in Europe the impact will be largest for Spain (+0.90pp) and smallest for Germany (+0.35pp).
- Over the longer term, additional infrastructure investment is expected to boost potential output by 0.4pp and 0.2pp in the US and Europe, respectively.
- However, the current scale of additional capital spending may not be sufficient to meet the investment demands consistent with the intermediate goal to reduce net greenhouse gas emissions by more than 50% from their 1990 levels until 2030

# Exchange rate matters for ECB …

- ECB announced the end of net asset purchases under the PEPP as expected, but also a number of policy changes, which could help cushion the blow.
- ECB expects inflation to undershoot its goal even at the very end of 2024 with no sign of any increase towards the end of the horizon. If this forecast proves correct, it is difficult to see how the conditions for a rate hike will be met in the coming years.
- Of course this is quite a difference from the Fed and BoE that expect inflation to settle above their respective targets over the medium term.
- ECB's forward guidance states that the Governing Council expects 'key ECB interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon'.
- Well ahead has been defined at 12 – 18 months. So it is difficult to see that condition being met during the ECB's forecasting horizon if the central bank's projections for inflation turn out to be right.
- ECB might be deliberately attempting to continue to have divergent monetary policy vis-à-vis US in an attempt to keep EURUSD under pressure to shore up the exports till such time China regains growth momentum .

# ..Inflation matters for BoE

- MPC voted 8-1 to raise Bank Rate by 15bp to 0.25% against consensus expectations for policy to be on hold, but in line with our forecast.
- In the policy statement, the Committee acknowledged the downside risks to growth from the spread of Omicron, but noted that "its impact on medium-term inflationary pressures is unclear at this stage."
- At the same time, "the labour market is tight and has continued to tighten, and there are some signs of greater persistence in domestic cost and price pressures."
- The inflation forecast was further upgraded following the upside surprise in the November CPI reading, with the peak now projected to be nearer 6% in the spring, up from 5% previously.
- While inflation is still expected to moderate in the course of 2022, the Bank of England's own projections suggest inflation will stay above target in the medium term in the absence of further rate hikes.
- Base case continues to be for a further two 25bp hikes in February and August, taking Bank Rate to 0.75%, and another two such hikes in 2023, taking rates to 1.25%.

# Two decades of China's accession to WTO

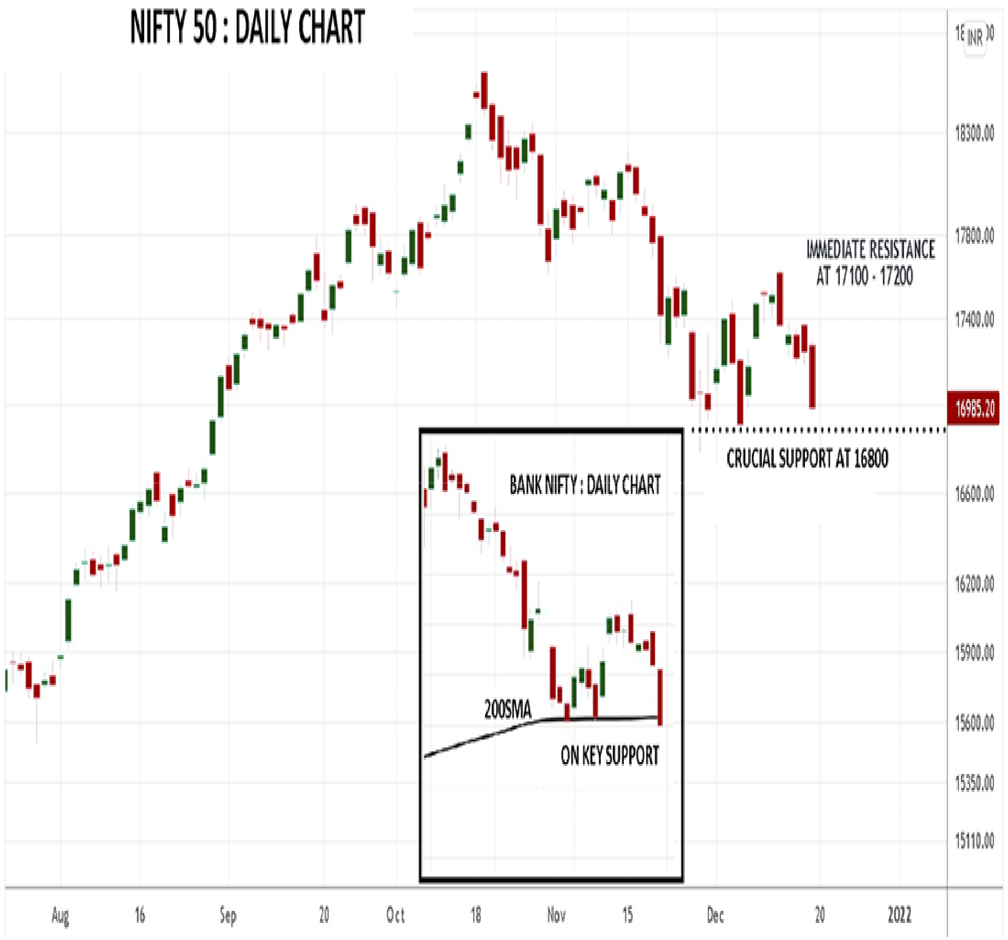
- In retrospect, the final month of 2001 was a pivot point in history. China joined the WTO on 11 December.
- China's accession to the WTO transformed the global economy as well. The vast structural adjustments in China and around the global economy have been disruptive.
- Over half a billion Chinese people were lifted out of poverty in two decades and China is now the largest economy in purchasing power parity terms, second largest measured at market exchange rates, and the world's largest trading nation.
- China implemented its WTO accession protocols not only because it agreed to them but because they propelled the domestic reforms the leadership wanted to put in place'. China is the largest trading partner for 120 countries, including US.
- The growth of Chinese manufacturing meant that consumers in the rest of the world could enjoy better living standards. As the factory of the world, China vacuumed up resources to fuel its production, including intermediate inputs, energy and raw materials from other countries.
- As with WTO accession 20 years ago, China's reform agenda aligns with CPTPP rules. Its bid to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) would mean significant disciplines on industrial subsidies to its state-owned enterprises, liberalisation of its data and cyber barriers and lifting its labour and environmental standards.
- The irony, of course, is that Washington has given up the chance to make any substantive input into China's entry into the CPTPP

# Global headwinds for Indian Bond Markets

- The call for a medium-term glide path for the normalisation of fiscal policy comes from RBI staff even as the Centre is preparing the Budget for 2022-23 (Apr-Mar).
- Centre's fiscal deficit is projected to fall to 6.8% of GDP this year from 9.2% in 2020-21.In their review of the government's finances for Apr-Sep, RBI staff praised both the Centre and states, saying they had nurtured a stimulus-led recovery in the first half of 2021-22 even while pursuing the envisaged fiscal consolidation.
- Markets avoided stocking up on gilts on global central banks turning hawkish and BOE hiking the rates by 15 bp.
- Also , RBI set a lower-than-expected cutoff price for dated securities at the 240-bln-rupee weekly gilt auction .
- The auction of the 2031 bond only attracted a bid-cover ratio of 1.85 for 130 bln rupees of the paper, an indicator of the shaky demand. Typically, a bid-cover ratio of 2.80 indicates firm demand .
- Bankers' strike during the week is one of the reasons for thin liquidity and activity levels.
- The benchmark yield closed at the highest level since Apr 16, 2020 (6.10%, 2031 bond ended at Rs .97.80 or 6.41% yield) and the next objective is at 6.75 %

# Indian Equities : Critical zone

- As markets globally continued to navigate currents surrounding inflation, monetary policies and Omicron, the beacon of pessimism was passed on to the domestic bourses as well.
- A major casualty of this selling spree has been Bank Nifty with majority of the top 10 constituents of the index experiencing a sequential drop in FII holdings for the September quarter.
- In fact, Bank Nifty has been a relative underperformer not only since the pandemic's onset but even on YTD and six month period basis.
- Nifty is resting close to the best possible zone from where it should bounce . However all eyes are on the banking space because the way it's placed; it is likely to dictate the short term trend.
- Range 16800-17200 should hold for the week



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