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- Weekly Market Update
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US Economy : Stall Speed

- The state of the housing market was the predominant theme in what was otherwise a quiet week for economic data. Mounting inflation concerns and ongoing supply chain disruptions weighed on homebuilder confidence in January, yet home construction continues to run at a robust pace. The overall shortfall of housing inventories constrained buying activity in December and pulled existing median home prices higher.
- Initial claims for unemployment benefits were higher than expected, rising to 286,000. Jobless claims have steadily crept up in recent weeks, reaching their highest level since October. Notably, January is typically a big month for seasonal layoffs across the economy.
- That said, the magnitude of the Omicron wave should not be ignored. Nearly 8.8 million people reported they could not work during the first few weeks of January, because they were either sick with or taking care of someone sick, according to the Census Bureau's latest Household Pulse Survey.
- Hiring is expected to moderate this month under the pressure of Omicron. Generally understaffed businesses are hanging onto workers more than usual, which could result in a positive tailwind in January's nonfarm payroll report.
- The Conference Board's Leading Economic Index for December rose 0.8% month-over-month (m/m) above November's downwardly-revised 0.7% increase. The LEI was positive for the tenth-straight month due largely to the positive net contribution from building permits, jobless claims, the interest rate spread, and ISM new orders, while a dip in consumer expectations was the only component of the ten that was a drag on the index.
- US manufacturing seems to have started 2022 on a weak footing, with regional business surveys pointing to a noticeable drop in orders and shipments amid Omicron disruptions, with still high price pressures.

US Equities : Rates vs Earnings

- Rising interest rate fears and growth worries pushed the S&P 500 Index to its biggest decline in more than 14 months over the holiday-shortened week. The Nasdaq Composite index slumped roughly 7.5%, its biggest weekly drop since the start of the pandemic.
- Perhaps the most likely victim of higher interest rates is the price-to-earnings (P/E) ratio for equities. As rates rise, the present value of future cash flows moves lower, which should pull some of the air out from current lofty valuations
- Declining profit margins signal a maturing cycle. Corporate profit margins are at record highs and the path for margins from here is likely somewhat lower, driven in large part by rising wage costs.
- Weakness in semiconductor shares weighed on technology stocks, while weakness in automakers and home improvement retailers dragged down the consumer discretionary sector. Declines in financial giants JPMorgan Chase and Goldman Sachs took a toll on financial services
- A more than 20% decline in Netflix shares following its fourth-quarter earnings report contributed to the indexes' losses on Friday.
- Heavy flows in and out of index-focused exchange-traded funds (ETFs) indicated that many investors were trading equities as an overall asset class rather than based on the week's earnings reports or other fundamentals. Passive ETFs are currently smoothening the decline.
- Further selling appeared to be prompted on Thursday by the Nasdaq crossing below its 200-day moving average for the first time since April 2020.

What to Expect this week

- A busy agenda awaits this week, with the highlight being the FOMC meeting on Wednesday.
- Fed to keep policy rates unchanged, but reinforce signals for a March hike. It is prudent to expect four 25bp rate hikes this year and QT starting in September, with risks skewed towards more hikes and earlier QT.
- On the macro front, flash PMIs for January in the euro area, UK and US will also draw attention, especially to gauge whether manufacturing is slowing and price pressures are easing.
- US GDP figures should still signal that the recovery continued at the end of 2021,– expected near 5% QoQ annualised. More important will be the 4Q Employment Cost Index on Friday. Any above consensus figure could see the dollar end the week on a stronger footing on the view that second-round inflation effects were emerging in the labour market.
- Russia-Ukraine tensions also remain an important risk to watch ,as a decision about military intervention/sanctions will probably have to come sooner rather than later.
- Further insight into German business sentiment comes with the German Ifo in this week.
- Italy's presidential election kicks off on Monday, with a clear risk of political uncertainty returning over the longevity of Italy's unity government, if Mario Draghi is elected as President.

Hawkish Shift in Fed

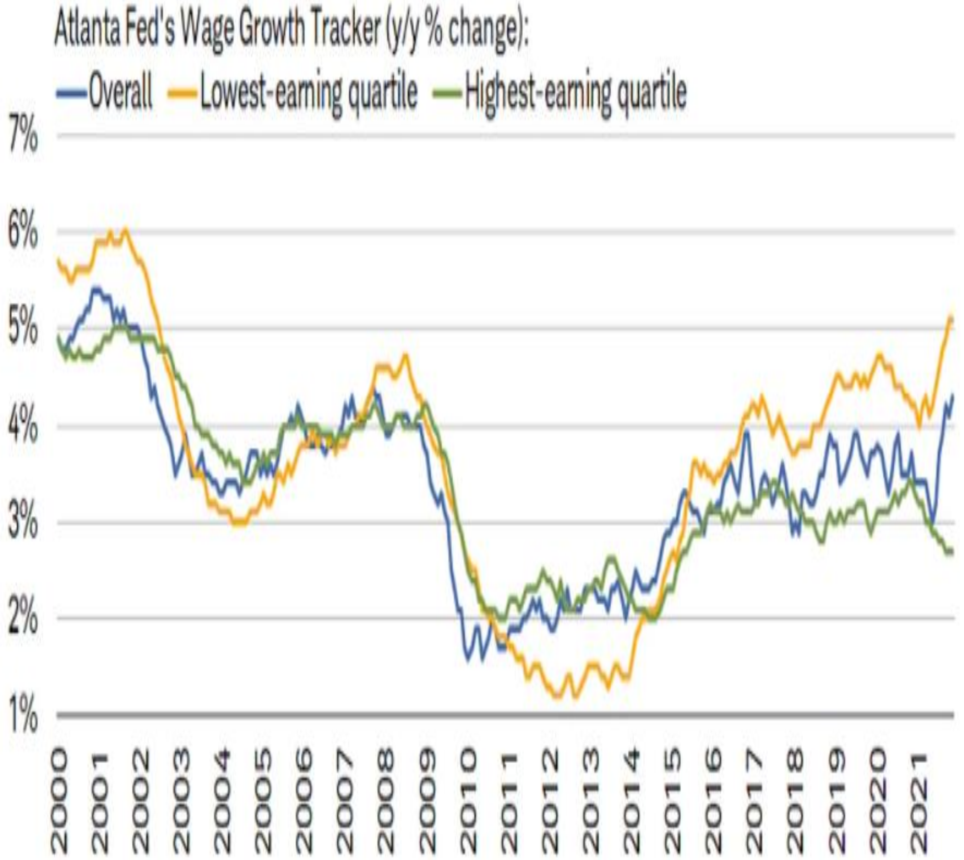
- There are three new candidates for Fed Governorship: Sarah Bloom Raskin, Philip Jefferson and Lisa Cook.
- Little is known about their monetary policy views. Best guess is they will be dovish rather than hawkish because this has been the tendency for the past couple of decades regardless of party affiliation.
- However, on the regulatory front, there are substantial differences.
- Raskin who has been nominated for Vice Chair of Supervision will take a much more “hands on” and arguably less friendly regulatory approach regarding the big banks. This compares to the “light touch” of former Vice Chair Randy Quarles.
- Raskin could face strong opposition because of her comparatively strict views on bank regulation especially related to climate change. Senator Manchin (West Virginia) may push back hard given the importance of West Virginia’s coal industry. However, Philip Jefferson and Lisa Cook are unlikely to see such opposition.
- In the meanwhile, the financial markets will have to contend with a more hawkish FOMC this year compared to last given a more hawkish rotation in regional Fed presidents.

Global Inflation : Raging Tempest

- Labour markets continue to be very tight with labour shortage in both the US and Euro area, adding to upward pressure on wage growth.
- Commodity prices are a mixed bag with electricity prices and gas prices coming down while oil has increased to new highs.
- Bottlenecks are still severe but has eased slightly. Freight rates have stayed at very high levels.
- Notably, the preponderance of inflation was in goods rather than services.
    - The price of durable goods was up 16.8% from a year earlier and the price of nondurable goods was up 10.2%.
    - On the other hand, the price of services was up 4% and the price of nonenergy services was up 3.7%.
    - Airline tickets were up only 1.5%.
- This unusual pattern has been a hallmark of the surge in inflation in the past year. It likely reflects the huge impact of supply chain disruption.
- It also suggests that if supply chain disruption abates, inflation will revert to a lower level. However it is unlikely that the global supply chain disruptions would smoothen any time soon on account of Zero Covid Policy of China – The global economy continues to learn both with Covid and Inflation
- However , based on the optimistic expectations that supply chain would normalize, Market-based inflation expectations move sideways. US household long-term inflation expectations has increased to the highest level in 10 years. Euro household price expectations for next 12 months fell a bit in December.

Wage growth : Inflationary

- One preferred measure for wage growth—especially given the mix-shift problems—is the Atlanta Fed's Wage Tracker. Instead of a simple average, it is a median measure of wage growth and eliminates mix-shift biases.
- As shown, its 4.3% growth rate is climbing closer to that of average hourly earnings, but the volatility in 2020 and 2021 was much more subdued.
- The surge in wages was evident later last year, driven by low-paying jobs coming back online—an unsurprising development, given pay and salaries have had to move up at a faster rate to attract workers who are re-entering the lower-paying services industry.
- Goodnews is that the spread between wage growth for the lowest and highest earners has stopped expanding for now underpinning prices .
- Though convergence can be expected this year, it's too soon to call a reversal in the long term trend of divergence

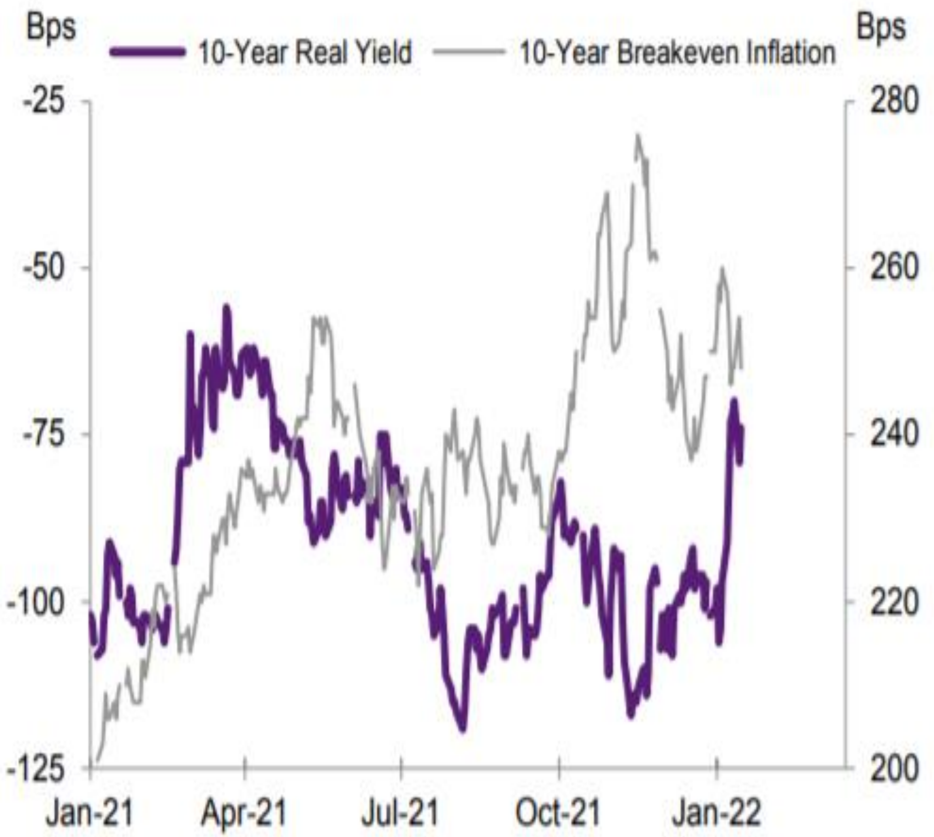


Flattening Yield Curve

- The treasury yield curve is one of the favorite forecasting tools. Presently, the spread between 2- and 10-year treasury notes is hovering near 80 basis points .This is up from 70s bps last month but sharply lower than the 158 bps seen last March.
- Flat curve is seen as a sign of worries over economic growth and uncertainty about monetary policy.
- Importantly, the current yield curve is extremely flat relative to previous periods when the Fed was contemplating interest rate hikes. Since 1977, the average spread between 2- and 10-year treasury notes one month before the Fed raised rates was 115 bps.
- In the last hiking cycle that began in December 2015, it was even higher at around 145 bps in November 2015.
- There have been only two other times when the Fed tightened rates with the curve inside 80 bps. Both were in the 1990s — March 1997 and June 1999. In the former instance, the Fed hiked only once (March 1997) before easing the following year. In the latter instance, fed funds went up only 175 bps before the onset of recession.
- Even though the Fed has not yet lifted interest rates, there is a substantial amount of tightening already priced into the market.
- What is remarkable today is how flat the curve is in the forward space. It is shaped as if the Fed is at the end rather than the beginning of a tightening cycle

Yields : Signals

- Since January 1, the yield on the 10-year treasury has risen nearly 40 bps to a high of 1.88%. The real rate rose from -108 bps on December 31 to -61 bps on January 21 .
- However, breakeven inflation fell from 260 bps to 246 bps. Often, rising real rates are consistent with expectations of faster US growth. But this is not the case at present because consensus expectations for 2022 GDP are falling.
- Bond market is worried about surfeit supply and is repricing in response to it. If so, this complicates Fed policy normalization because of the negative impact on financial asset prices. Since the onset of the pandemic, Fed has purchased nearly 60% of all net marketable treasury issuance. In the process, the Fed now holds roughly 22% of all outstanding TIIPS, which are generally illiquid even in “normal” times.
- What is troubling is that rates may be rising for technical (wrong) rather than fundamental (strong GDP) reasons.
- At present, the stock market is in the former camp. It would be useful to watch the performance of credit to see if the signal is reinforced.



Europe : Dodging the Tempest

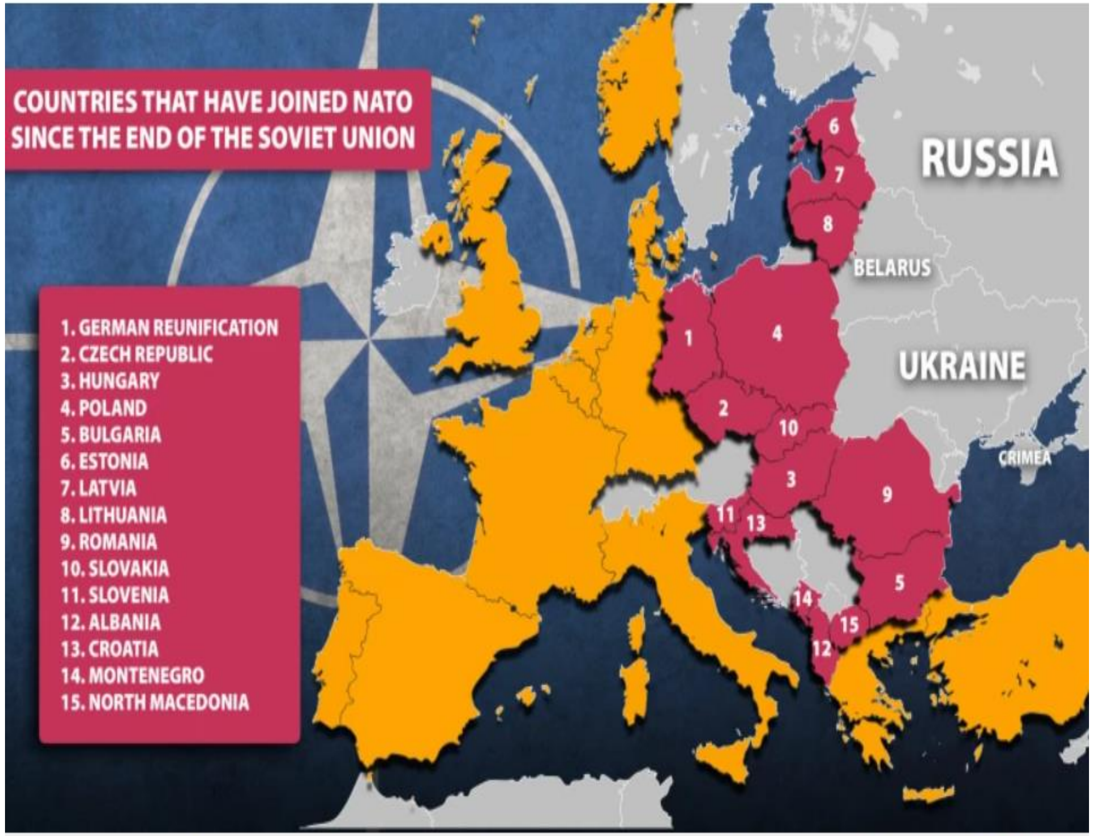
- After a solid growth performance earlier in 2021, softer confidence surveys and a rebound in COVID cases point to more subdued growth late last year and early in 2022.
- Minutes from the ECB ‘s December meeting illustrate that the bank has left 'team transitory', but without transferring into 'team permanent'
- Lagarde again rejected calls for faster policy tightening despite continued high inflation pressures, reiterating that cyclical conditions were weaker in the euro area than in the US.
- Overall, this growth and inflation mix should allow ECB to taper its bond purchases only gradually. That's a stark contrast to the more accelerated tightening from the Fed and should, over time, mean a weaker euro against the U.S. dollar.
- It is hard to see any real geo-political risk premium being priced into the EUR yet. Yet undoubtedly the risks, including aggressive sanctions against Russia, would hit Europe’s growth projects far harder than those of the US – plus the spike in energy costs would hit the Euro via the Terms of Trade channel and that Europe’s dependence on Russia’s energy exports will be exposed even more.
- Q3 household disposable income rose 0.8% Q/Q less than the 1.4% increase in Q2. The household saving rate also fell to 15.0% in Q3 from 19.0% in Q2. Both hint at a somewhat slower pace of consumer recovery in 2022.

Europe : German Bounce

- Sentiment in Germany jumps higher in January, after a dire ending to 2021. Germany's ZEW expectations index jumped higher in January, whereas the current conditions index declined. The combination of the two parts of the survey currently is consistent with robust growth in Germany's economy, at a rate well above trend
- The level of Germany's GDP was probably roughly 1.5% below its pre-pandemic level in 2021Q4, a much wider gap than that for the Eurozone as a whole of around -0.25% (i.e. the Eurozone excluding Germany will be slightly positive).
- Gap between Germany and Eurozone to narrow during the course of this year and the next.
- Activity in the first months of 2022 will probably still be depressed by supply chain problems in global industry and Omicron-related containment measures in services. The impact of these two impediments to German growth will ease after the first quarter of this year. As a result, German economy could be rebounding sharply during 2022 Q2-Q4, outperforming the Eurozone aggregate.
- Business sentiment in France declined in January, with Omicron worsening the outlook for the services sector. Despite a still solid level of activity, the economic slowdown has thus been prolonged

Russia- Ukraine Crisis

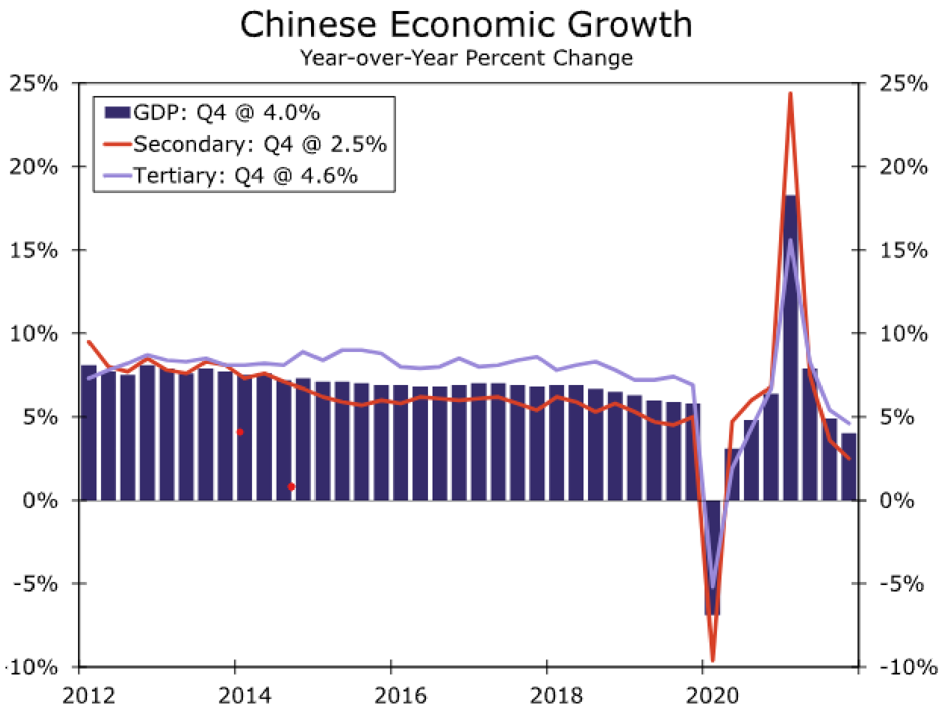
- Since watching the Berlin Wall crumble as a young intelligence officer, Putin has been on a quest to reconstitute Russia's place on the world stage.
- When Russia's sphere of influence crumbled with the fall of communism, the Kremlin watched helplessly as its near neighbours turned westward.
- Eastern European and Baltic countries looked to Western Europe and America as they began to carve out new economic, political and cultural futures
- Ukraine is now closer to the West than ever before but parts of the country with stronger links to Russia have been in open revolt ever since.
- Putin is seizing his moment and triggering more questions than ever. He recently deployed "peacekeeping" forces to Kazakhstan under the pretext of stamping out an anti-government protest when, in fact, he was testing out a potential playbook for invading Ukraine.
- Last week, he flooded Belarus with troops — ostensibly for joint military drills.
- It appears that a number of markets are starting to at least price in some geopolitical risk around the growing tension between Russia and Ukraine. There is still plenty of uncertainty over how the situation will evolve, but it is still worthwhile to look at what the potential impact could be should tensions boil over to a conflict.



Nato has expanded across Europe's east since the fall of the Soviet Union, stretching up to Russia's western border

China : Perilous Waters

- China’s quarterly GDP growth picked up materially in Q4, to 1.6% q/q .The recovery of the growth momentum mainly stems from the production side of the economy while consumption and real estate continue to be weak spots. December activity data also confirmed the continued divergence between the production and the consumption side of the economy.
- China’s piecemeal easing approach continues. It is expected that the Chinese economy could recover moderately, crackdowns to ease but not end and that China's zero-tolerance policy on Covid is here to stay for most of 2022-until the other side of the CPC Congress in Q4
- Zero-tolerance strategy is the alternative to the “learning to live with Covid” approach pursued by West.
- Ever more frequent lockdowns are taking a bigger toll on the economy while failing to contain infections, prompting tougher growth-sapping restrictions.
- The economic impacts of ‘zero-Covid’ are making global recovery harder. The disruption within China, the centre of global manufacturing and home to seven of the world’s top 10 container ports, has contributed to the severe strain on supply chains, causing a worldwide traffic jam that has hit businesses and consumers.



India Bond Markets – Deep red

- It was the fourth time in five weeks that the RBI has devolved a part of one or more bonds on primary dealers, as the appetite for dated securities remains weak due to the recent surge in US Treasury yields and crude oil prices, as well as domestic factors such as large supply of bonds from the central and state governments.
- RBI too has been selling bonds in the secondary market outside auctions in the past few weeks, even as the amount of sales was seen easing this week. There were reports that Centre could slip on its fiscal deficit target of 6.8% of GDP in the current financial year
- The current 10-year benchmark 6.10%, 2031 bond settled at Rs 96.34-6.63% yield. Both 10-year bonds ended in the red because traders made room for supply in the segment in a truncated week ahead.
- The 6.54%, 3032 paper is expected to be up for auction next week, which will see only four trading days because domestic markets will be shut on Wednesday on account of Republic Day.
- As per Govt official , RBI is likely to adjust the pending government borrowing due to partial cancellation of a recent gilt auction by exercising green-shoe options at subsequent debt sales and Govt is unlikely to borrow more than the budgeted 12.06 trln rupees this financial year.
- However, bond market conditions need to be conducive for the government to be able to exercise the green-shoe option without higher cost of borrowing. Such opportunities may be hard to come by right now,

Indian equity Markets : Weak Undertone

- Indian market closed negative during the last week. Nifty and Sensex down this week by 3.50% and 3.57% respectively.
- Rising oil and input prices coupled with a moderating rural economy kept investors watchful as markets turned volatile on account of the hardening Global yields
- History suggests that in 7 out of the last 10 years, Indian indices have delivered negative returns or remained range-bound in the week preceding the budget.
- In case Nifty fails to hold above the 17,500 support zone, then an extension of time and price correction is likely - inclination towards some relief move which could pause at 17700
- Likely Range 17230-17730

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