SYFX Treasury Foundation

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- Weekly Market Update
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US Economy : Resilience

- It was clear from several sections of the minutes that many of the participants are becoming concerned about not only the pace and persistence of inflation, but the broadening out of inflationary pressures beyond the obvious COVID-related categories.
- Notably, these minutes are from a Fed meeting that took place before the elevated Consumer Price Index and Producer Price Index data was released, so those fears have likely been reinforced by the most recent U.S. inflation data.
- U.S. retail sales came in well above expectations, with the headline figure up 3.8% month-over-month, above forecasts of 1.9%, and sharply above last month's reading of -2.5%. The gains were driven by notable increases in non-store retail (online sales), furniture sales, and a rebound in auto sales, which were up the most in 10 months.
- Existing home sales jumped unexpectedly by 6.7% m/m in January to an annual rate of 6.5 million units, versus expectations of 6.1 million units, which would have matched December's downwardly-revised rate. The median existing home price was up 15.4% from a year ago to $350,300, marking the 119th straight month of y/y gains as prices rose in each region.
- The LEI was negative m/m for the first time since February 2021, due largely to the negative net contributions from jobless claims, consumer expectations, stock prices, and average workweek, which more than offset positive reads for the interest rate spread and ISM new orders.

Equities : Slipping Gear

- Last week marked the second consecutive down week for global equities as political risk and tightening central bank policy continued to weigh on risk appetite. Developed ex-U.S. equities declined 2.0%, U.S. equities lost 1.6% and emerging market equities fell 0.6%.
- Economic data confirmed the recent narrative of positive economic growth and elevated inflation across key developed regions compared with more tempered growth and inflation in China
- U.S. stock market slips a gear every so often, dropping sharply as investors search for traction in uncertain terrain.
- Many of the individual stocks in the major U.S. stock indexes are down 20% or more from their peaks this year, creating the equivalent of a stealth bear market, even if the indexes themselves haven’t hit that point
- The markets grapple with the Fed tightening uncertainty and still solid absolute earnings growth during the quarter but some relative deterioration compared to the previous four quarters.
- Uncertainty ramped up to amplify volatility, as Russia contends it does not intend to invade Ukraine and that it has withdrawn some troops from the border, while U.S. has continued to warn that an invasion might be imminent.
- U.S. stocks continued the bearish theme that has accompanied the calendar turn to 2022, with the S&P 500 falling for a fifth week out of the seven we have seen this year.

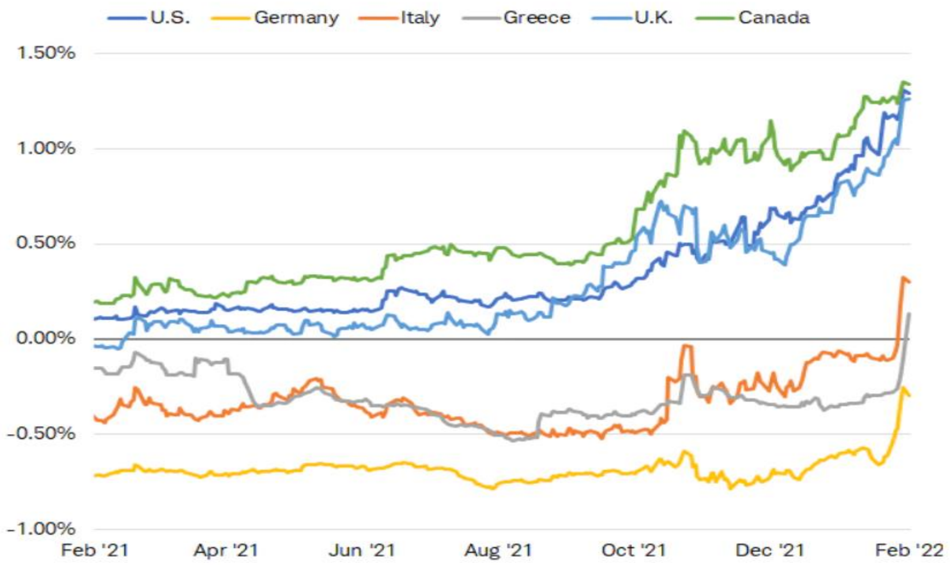
Fiscal Dominance : New normal

- Fiscal dominance has clearly prevailed since the 2008- 2009 subprime crisis in OECD countries, and well before that in Japan. Fiscal dominance is the well-known situation where monetary policy is required to ensure public debt sustainability, which is no longer ensured by fiscal policy.
- **Will the return of inflation get central banks out of fiscal dominance?**
- It is well known that there are large needs for additional public spending (healthcare, education, research, poverty reduction, industry, energy transition, etc.) and that fiscal deficits will spontaneously remain high.
- This raises the question of what level of long-term interest rates will force governments to move to a more restrictive fiscal policy and not implement the necessary public spending (thus putting an end to fiscal dominance).
- The nature of the situation of course would then hinge on whether long-term interest rates remain lower than long-term growth (there is then a maximum primary fiscal deficit) or rise above long-term growth (requiring a primary fiscal surplus).
- There is very little, if any, room for long-term interest rates to rise if fiscal dominance is to remain in place.
- If long-term interest rates cannot rise without central banks getting out of fiscal dominance, then the pressure to reduce fiscal deficits will be intense.

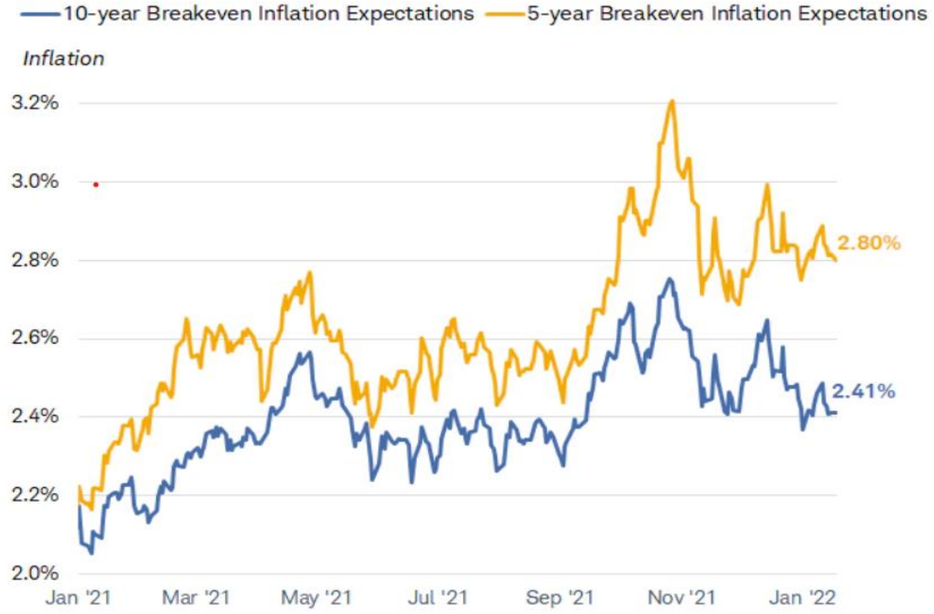
Yields : Uncertain Terrain

- The speed and magnitude of the policy shift is unlike any cycle in recent history.
- Central banks had set policy assuming that very weak economic growth and deflationary pressures would persist due to the pandemic, and have been caught by surprise by the rapid recovery and inflation surge.
- With a rapid change in the outlook, volatility has jumped. Two-year Treasury yields have surged in just the past six weeks in major developed countries.
- The expected inflation rates derived from the Treasury Inflation-Protected Securities (TIPS) market have been falling ever since the Fed signaled it was moving toward tightening policy.
- It’s a vote of confidence in the Fed that markets are pricing in the likelihood of lower inflation longer term. Consequently, 10-year bond yields may not move much above that 2.5% level if the Fed succeeds in reducing inflation down the road.

Global two-year yields are surging



TIPS breakeven inflation rates have been falling



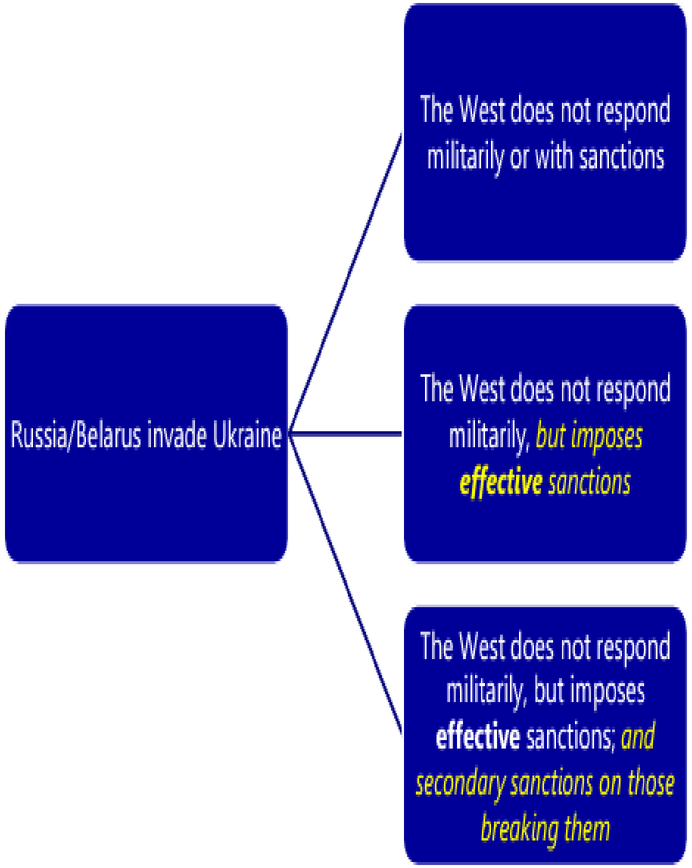
Fed hiking Cycle : Differences

- There are key differences in the current situation compared to previous hiking cycles.
- Most importantly, Fed looks to be a lot behind the curve, which calls for more front-loaded tightening than normal. The hiking cycle should be more front-loaded in order for the Fed to catch up with what it is behind the curve. This is why Fed could begin the cycle with a 50bp hike (for the first time since the 1980's) and follow through with hikes at every meeting in 2022. It is around 50bp more than what the market is currently pricing
- Another key difference important for not least bond markets is, that the yield curve is unusually flat in comparison with previous rate take-offs. There might be outright selling of bonds by the Fed ('active' QT) as part of the tightening in order to postpone an inversion.
- In the previous hiking cycle, the Fed only did what has been called as 'passive QT' and reduced the balance sheet by not reinvesting proceeds from bonds that expired. Without 'active QT' the Fed could very well see an inversion of the 2-10 curve very early in the hiking cycle, because the starting point is a very flat curve to begin with . An inversion has historically been a leading indicator of recession and Fed will aim to postpone an inversion as long as possible.
- Several FOMC members have already expressed concern over a possible inversion. They can work to avoid this by selling longer bonds. This is unchartered territory for hiking cycles and adds upside risk to long bond yields. It also supports the case for higher risk premia in risk markets.
- But all else equal, we see a case for more upward pressure on longer yields on the back of 'active QT' and for higher risk premia in risk assets because of the unchartered path the Fed is embarking on

Fed hiking cycle : Stylized facts

- Hiking cycles have lasted 1-2 years (longest was 24months, shortest 11 months)
- Policy rates were cut within 8 months from the last hike in three cases and 15 months after in one case (2004-06 cycle).
  - In two of the four cycles, the US was in recession within a year from the last hike.
  - In both cases, though, it followed asset bubbles (in 2001 the IT bubble and in 2007 the housing bubble).
- It is more than 20 years ago , Fed has hiked rates by 50bp (changes of 50bp are much more common in rate cut cycles).
- The Fed has not started a hiking cycle with 50bp since the 1980's.
- The most recent 2016-18 cycle was the 'softest' path.
- The Fed hiked four times per year and 25bp at each meeting (we here ignore the lonely hike in December 2015).
- The 2004-06 hiking cycle was the longest. It lasted 25 months and the Fed hiked 25bp at each meeting for 17 meetings in a row. They described it as 'measured pace'.
- The shortest cycle was the 1999-2000 cycle that lasted 7 months (total hikes of 175bp).

Ukraine Crisis : Possible Outcomes



- Economic forecasting is a hazardous exercise with a poor track record - and far more so given a backdrop of binary-outcome geopolitical decisions with very fat tails. Indeed, it is impossible to capture all possible outcomes vis-à-vis Ukraine.
- War would result in global financial market turmoil, and war fears have already seen global equities pressured lower: indeed, Bloomberg recently noted a call that a Ukraine war could be a "polar vortex" for markets.
- To gauge this shift, the investment premium in the model scenarios would rise to reflect wider spreads between risk-free interest rates and the return on risky assets.
- In scenario A, war, a relatively small overall rise in the global investment risk premium is seen, comparable to the rise seen after annexation of Crimea in 2014.
- In scenario B, war and effective sanctions, the global investment risk premium can match the increase seen during the second Gulf War in 2003.

- Scenario A assumes a short disruptive war;
- Scenario B a war and effective sanctions on Russia; and scenario C a war, effective sanctions on Russia, and secondary sanctions on others still trading with Russia
- In scenario A, some economic pain is clear; in B, severe in places; in C, so bad as to be paradigmatic (and unquantifiable with a traditional macro model)

Impact on Oil Prices

- A Ukraine war has the potential to be a major market-mover given Russia's dominant position as a global energy supplier. Russia is one of the world's top three producers of crude oil, alongside the US and Saudi Arabia. Russia currently produces over 10mb/d (10% of global production) and exports roughly half of that to large consumers globally.

- Furthermore, Russia is also a meaningful exporter of refined products, such as diesel and gasoline. Importantly, nearly half of Russian crude oil exports (~2.4mb) are sent to Europe via a major long haul and cost-effective pipeline network that stretches from the oil fields of Western Siberia all the way to Germany with important arteries along the way, giving Russia a significant financial edge over competing waterborne imports.

- This competitive advantage has led to Russia gaining a strong foothold in Europe with a nearly 30% market share of its oil imports and increased geopolitical leverage over its European customers as a result. This dynamic has been on full display recently, with one high ranking Russian official threatening to cut off energy supplies to Europe should Russia be banned from using the SWIFT system in the event of Western sanctions.

- Two scenarios whereby Russian energy exports to Europe are (partly) cut-off and re-routed to Asia.
    - **Scenario A, war,** would result in Brent spiking as hoarding, increased transit costs, and the geopolitical risk premium spikes. The last major oil supply disruption to Europe was during the 2011 Libyan civil war, when its oil exports collapsed due to infighting: as Libyan oil production fell from 1.5mb/d to zero, Brent prices spiked from $90 to more than $125 over four months.
    - **Scenario B, war and effective sanctions,** would see oil at $135 and higher for far longer.

Impact on Food Prices

- War would have a major impact on grains, vegetable oils, and fertilizers.
- **Scenario A, war,** would stop Ukrainian wheat, barley, and corn exports. With very tight global markets, this would drive prices up even if 2/3 of the season's wheat and barley and 1/3 of the corn crop has already been exported. The markets expect a 30% rise in wheat and 20% in corn prices.
- **Scenario B, war and effective sanctions**, would be worse.
- Russian wheat and barley have also been 2/3 exported this season, but Russia and Ukraine account for 30% of world wheat exports, which would drive global prices up 30% if removed. If sanctions were still in place by July, when harvesting of the next crop begins, it would cut deeply into global grain availability.
- Demand rationing would be forced via higher prices: wheat would then double, and corn rise 30%. By autumn 2022, northern hemisphere farmers (where most wheat is grown) could extend their wheat area by cutting back on other crops, especially feed grains; but only by mid-2023, when those crops are harvested, could the wheat market somewhat rebalance.
- Feed grain prices depend on China's trade with Russia. China imports massive amounts of feed grains (corn, barley, sorghum) from world markets: it can buy these volumes almost exclusively from Russia/Ukraine. China could also buy more Russian/Ukrainian wheat for animal feed to replace global corn/barley, while global buyers could buy from origins previously serving China's needs. In such a scenario, the impact on corn/barley would be relatively small.
- However, if China cannot buy from Russia/Ukraine, harvested volumes in Russia have to go into storage, and China buying from world markets would see a further global shortage, driving prices up, albeit not as

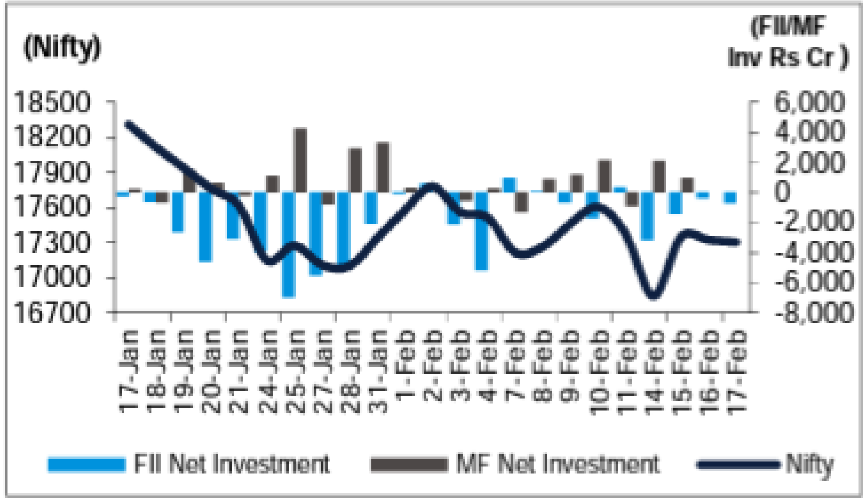
Indian Bond Markets : Mixed undertone

- India’s consumer price inflation rose to a 7-month high of 6.01% on-year in January, compared with 5.66% rise in December, following a rise in prices of food and manufactured items.
- India’s wholesale price inflation eased marginally to 12.96% on-year in January, compared with 13.56% in the previous month.
- India’s trade deficit came in at $17.43 billion in January, from $21.68 billion in December. Exports rose 25.28% to $34.50 billion, while imports rose 23.54% to $51.93 billion.
- Finance ministry’s monthly economic report said that the economy will pick up pace once the uncertainty caused by the pandemic recedes.
- Government bonds ended higher ,led by longer tenure bonds, because lack of fresh supply in the last two weeks prompted the markets to step up purchases while also expecting the Centre to cancel next week's auction.
- 10-year benchmark 6.54%, 2032 bond settled at 99.11 rupees or 6.66% yield. Longer tenure bonds, especially those in the 14-year maturity, rose the most.
- The Centre has cancelled the last two weekly gilt auctions citing a healthy cash balance, which has pushed bond prices higher, and it is widely expected to cancel the last remaining scheduled weekly auction of 2021-22
- Liquidity in the banking system is currently estimated to be in a surplus of over 7.30 trln rupees . During the week, the RBI conducted variable-rate reverse repo auctions for a total notified amount of Rs 5 lakh crore, against which it received offers amounting to ~Rs 3 lakh crore.

Indian equity Markets : Persistent weakness

- Indian equity indices extended last week's losses owing to persistent worries over Russia-Ukraine geopolitical tensions.
- The equity markets began this week with the worst single day drop in the benchmark indices since April 2021.
- Moving on to the geo-political tensions, the behavior of market participants is not consistent with this emerging risk too.
- Generally, when such uncertainties arise , defensive stocks are hoarded. This certainly is not the case currently and on a year-to-date basis, cyclicals like Nifty Auto, Metals, Energy have outperformed defensives like Nifty FMCG, Nifty Pharma.
- Therefore, while it's only in anybody's realm of imagination to predict market movements, this time around it seems that the markets needed a reason to prick the bubble of excess stock prices. Resultantly, while Nifty has fallen nearly 6.5% since October, many stocks, especially the ones with higher retail interest, have seen even a more than 50% drop
- Range for the next week 16800-17300

FII and mutual fund investment versus Nifty



FII – Foreign institutional investor
Source: *Securities and Exchange Board of India (SEBI), NSE*

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