SYFX Treasury Foundation

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- Weekly Market Update
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Mixed US data

- April business activity mixed with services slowing and manufacturing accelerating
  - The preliminary U.S. Manufacturing PMI Index for April unexpectedly rose to 59.7 from March's unrevised 58.8.
  - The preliminary U.S. Services PMI Index showed growth in April surprisingly slowed to 54.7, compared to expectations to remain at March's 58.0.
- The Dallas Fed Manufacturing Index fell more than expected but modestly held onto expansion territory (a reading above zero) for April. The index dropped to 1.1 from 8.7 in March
- The Fed's Beige Book, released eight times per year, qualitatively reports on regional economic conditions. Although activity was generally solid over the survey period, this week's report underscores a growing sense of uncertainty about the economy's path in the coming months.
- Department of Education announced another policy designed to bring student loan borrowers closer to debt forgiveness and ease their ability to pay off debts, affecting an estimated 3.6 million borrowers.

Sluggish Equities

- The markets continued to grapple with the expected Fed aggressiveness, the persisting war in Ukraine, inflation pressures, and further COVID-related lockdowns in China. The major U.S. equity indexes ended the week lower.
- The Russell 1000 Growth Index stocks gave up more ground than its value counterpart, while the large-cap S&P 500 Index posted steeper losses than the S&P SmallCap 600 Index and the S&P MidCap 400 Index.
- The broad increase in rates reflects the progressing inflation environment, as the year-over-year increase in consumer prices has reached 40-year highs. While this is not completely surprising given the ongoing impacts of the pandemic, inflation pressures have received an unanticipated boost from the commodity-price effects stemming from the war in Ukraine.
- Rising rates have been the primary catalyst for equity-market weakness this year, with the S&P 500 falling 12% between January 4 and March 14, as 10-year Treasury yields rose above the 2% mark for the first time since mid-2019.
- Since mid-March, however, equities have signaled a more positive tone, rallying as much as 10%, including signs of strength last week even as interest rates rose to fresh three-and-a-half year highs

Turning Monetary Tide

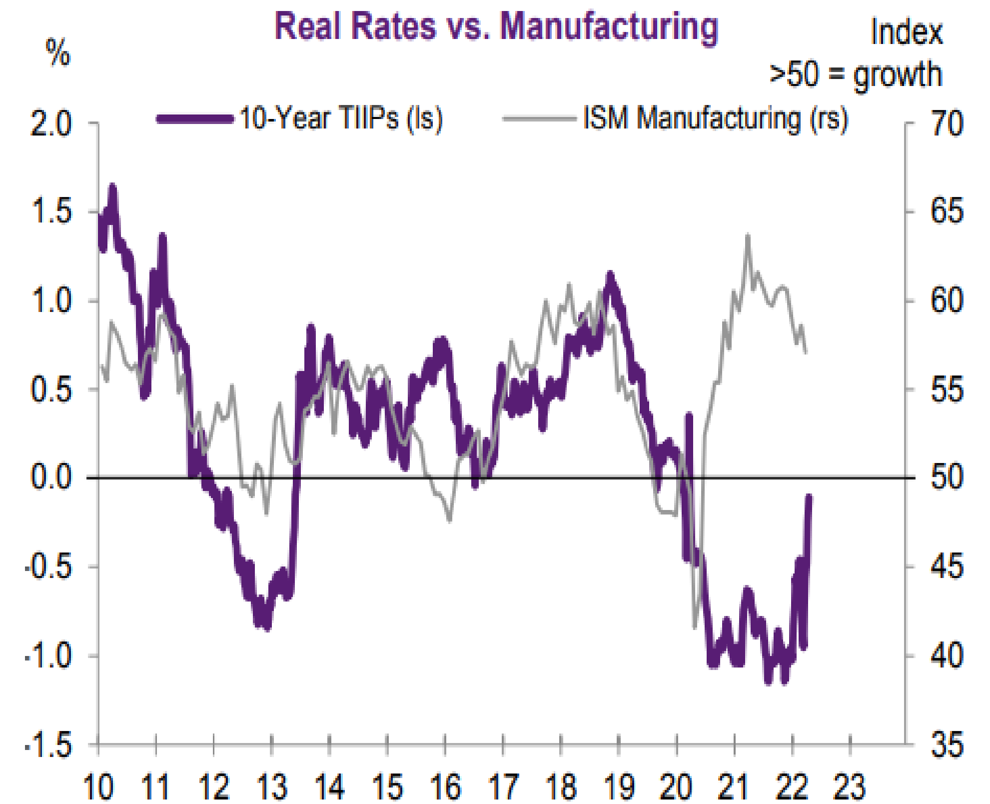
- While Fed rate hikes are nothing new – this will be the fifth tightening cycle in the last 40 years – the speed at which the Fed is likely to travel from liftoff hasn't been experienced in some time. Fed to move quickly in the near term, hiking rates by 50 basis points in May and possibly doing so again in the subsequent meeting.
- In 1994, the Fed raised rates seven times within 12 months (including two 50-basis-point hikes and one 75-basis-point increase whereas the first seven rate hikes took place over a year and a half after the 2004 liftoff, and over more than two and a half years in the phase that commenced in 2015.
- Short- and longer-term interest rates have moved sharply higher in 2022, with 10-year Treasury yields rising 1.4% and two-year yields rising 1.9% year-to-date . Aggressive monetary policy tightening expectations have fostered the rise in yields, along with recent inflation data and comments from Fed officials.
- Fed Chairman Jerome Powell said a rate hike of 50 bps was on the table for its May 4 monetary policy decision, which would be the first time it raised rates in excess of 25 bps in over 20 years.
- Meanwhile Fed officials have suggested that the beginning of its balance sheet reduction program was also set to start soon, with a ramp-up to $95 billion in securities to "mature off" the balance sheet each month.

Growth set to sustain

- US growth in this cycle is not dependent upon ultra-low rates - it is highly likely that economy will continue to expand despite the headwind of higher interest rates, though likely at a more moderate rate in the 2%-3% range this year, compared with close to 6% in 2021.
- Consumers are armed with more than $2 trillion in accumulated savings, and wage growth is running above 5%, which means household consumption (70% of GDP) isn't fully reliant on borrowing.
- Household debt-servicing costs (as a % of disposable income) remain historically low near 9%, compared with 12% in the mid-1980s and 13% in the mid-2000s
- While consumers and the overall economy should be able to weather higher rates, housing does appear vulnerable to rising borrowing costs, with the average 30-year fixed-rate mortgage moving above 5%, from 3% six months ago
- Ten-year Treasury yields averaged 8.1% at the onset of the six recessions from 1973 to 2007. We don't think rates will get anywhere close to that in this cycle, but this highlights just how low rates currently are compared with history. Looking at more recent examples, 10-year yields averaged 4.4% at the start of the 2001 and 2007 recessions.

Hard Landing ?

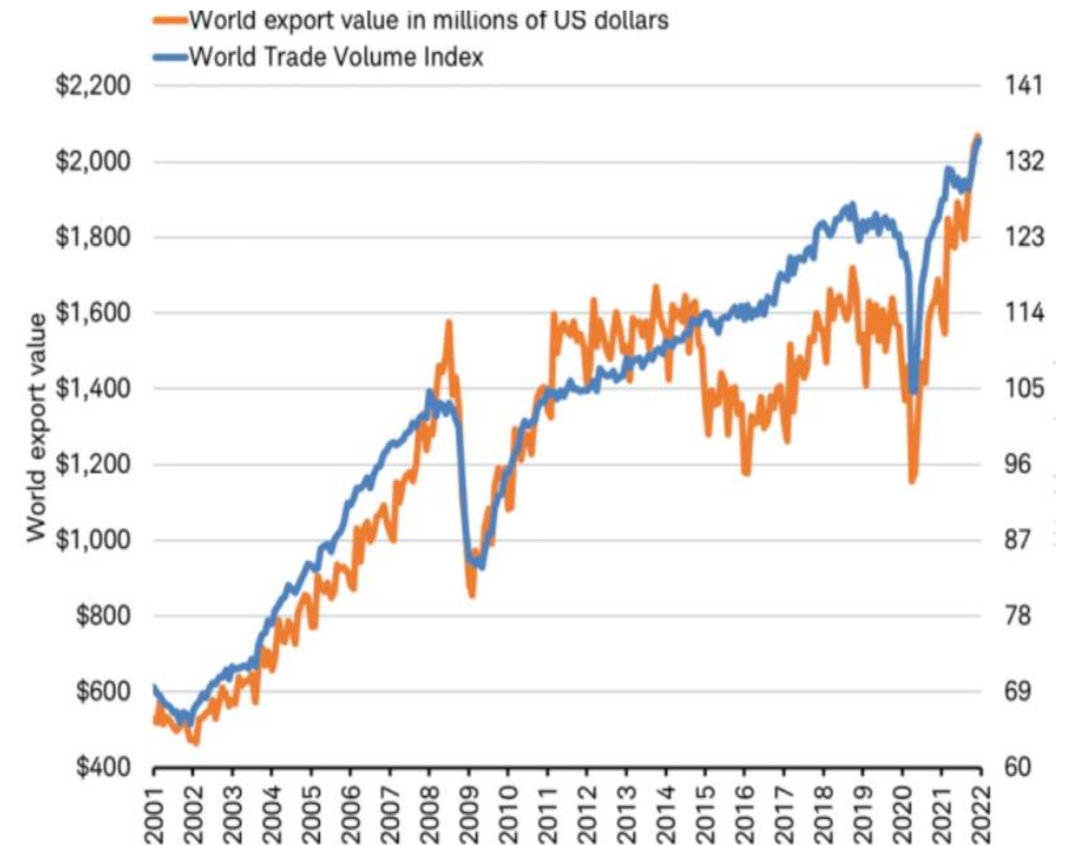
- The recent rise in the 10-year treasury note to over 2.9% has been almost all due to higher real interest rates. They have accounted for over 90% of the move in yields.
- Movements in real yields are highly correlated with economic activity because stronger growth increases the demand for capital which all else being equal causes the cost of capital to rise.
- However, the recent rise in real yields has not been due to strengthening growth .Presently, real rates are nearly zero, which is up from over -100 bps just six weeks ago. The real yield is essentially back to where it was in late 2019, thus helping to stabilize manufacturing activity. The rise in real rates is occurring against the backdrop of slowing economic activity
- Now, manufacturing is trending sharply lower while real rates are trending sharply higher. This is a major concern because real rates are rising for the wrong reason.
- For this reason alone, investors should worry about the prospects of a hard landing later this year. This is always the case when the Fed forces a disconnection in financial markets from economic fundamentals.



- It is clear that the real yields and the ISM manufacturing survey had high positive correlation for the 10 years from 2010 to 2019 or before the onset of the pandemic.
- Simply Put, the Higher real rates were always associated with rising economic activity

Globalisation : set to stay

- For decades, globalization described an economic concept, but more recently it has become blurred with a political concept.
- U.S. and China, who have seen significant political decoupling, remain tightly intertwined economically.
- Brexit was primarily a political decoupling of U.K. from EU, not an economic one—as highlighted by U.K. imports from the EU recently hit their second-highest-ever level in January 2022
- When focusing on the economics of globalization it is important to look at the volume of global trade, since the value of trade can be impacted by many factors that can be misleading.
- The findings show that Political deglobalization may have little impact on economic globalization or corporate profits—the main driver for stock market returns over the long-term. This likely means there is little reason for investors to deglobalize their portfolios, despite the headlines.



The chart shows that world trade momentum measured in dollars appeared to stall from 2008 through 2020, even as the volume of trade advanced steadily.

Euro zone : Economic Woes

- The risk of repeating the stagflation of the 1970s is more real than ever, particularly for Europe.
- Sustained economic reopening is a key driver of eurozone growth, but the war in Ukraine has cast a long shadow over the outlook.
- Pressure on member states to cut their dependence on Russian energy will add to supply chain and inflation woes.
- European consumers will bear the brunt of higher costs. In a worst-case scenario, cutting off supplies from Moscow will deliver a major blow to Germany, the bloc's largest economy.
- Price gains have become more widespread in the Eurozone, although the bulk of recent increases in European inflation have come from surging energy costs. Because these are unlikely to persist over the medium term and the risk of stagflation in Europe is rising, the ECB took a dovish stance at its March meeting.
- Inflation risks remain skewed to the upside despite the latest stabilization in oil, gas and electricity prices. There is likely to be a further climb in the headline HICP rate above 8%, with core inflation remaining elevated at 3.1%
- The ECB has kept the door open to an interest rate hike later this year, but economic and financial conditions are unlikely to offer room for tightening of monetary policy in 2022

Eurozone : Growth Outlook

- The April PMIs for the euro area surprised to the upside, showing little impact from the war in Ukraine
- The Euro area composite PMI rose in April to 55.8 after 54.9, defying expectations of a further decline (consensus expectations stood at 53.9). Sentiment in the services sector increased to 57.7 after 55.7, while the manufacturing PMI declined to 55.3 after 56.6.
- It is not surprising that sentiment in the manufacturing sector declined on the back of the surge in commodity prices, the uncertainty triggered by the war, and new supply chain problems on the back of lockdown measures in China.
- That said, the decline is moderate, and the level remains, based on past correlations, consistent with a further expansion of activity in the industrial sector.
- Overall, the April numbers do not point to an increased recession risk for the Euro area on the back of the many adverse shocks hitting the economy.
- That said, it is noteworthy that the correlation between the hard data and the PMI has weakened over the last two years and a high level of the PMI index seems to correlate now with a lower level of GDP, as seen during Q4:2021.
- We will therefore have to wait for the hard data for Q2 to get an accurate picture of the cyclical stance

Eurozone : Insolvency risk

- The war in Ukraine has put pressure on European corporate margins.
- The conflict has sent (energy) commodity prices soaring, amplified existing supply-chain disruptions and increased uncertainty weighing on investment. So far, high cash balances and rising profitability seem to have shielded most companies from rising input prices. However, leading indicators suggest declining earnings.
- Eurozone consumer confidence levels imply a -2pp y/y margin erosion within the next six months. The impact is expected to vary across sectors, with power and metals most affected by a further increase in energy prices.
- Corporate credit spreads have de-anchored from their 2020-2021 lows due to rising -default risk amid faster-than-expected monetary tightening
- After strong policy support effectively capped insolvency risk for almost two years, the broad-based market sell-off since the onset of war in Ukraine has amplified the progressive widening of credit spreads due to tighter financing conditions.
- It is highly likely that Eurozone business insolvencies might rise by +12% this year from extremely low levels. An even more hawkish monetary stance (also driven by rapidly tightening financing conditions in the US) could precipitate credit constraints and raise default rates
- More than being weighed down by inflation, ECB would be concerned with this Credit risk and insolvency contagion

China : Stumbling Momentum

- With the Lunar New Year passed, China's activity and sentiment data are now being released on a more regular schedule.
- This past week showed that while China's economy started 2022 on a reasonable note, growth slowed sharply toward the end of the first quarter. Q1-2022 GDP rose 1.3% quarter-over-quarter, smaller than the gain in Q4-2021, but still better than the consensus forecast of a small 0.7% gain.
- Helped by favorable base effects, GDP firmed to 4.8% year-over-year in Q1-2022. Manufacturing activity appeared to hold up quite well as growth in secondary sector firmed to 5.8%, but services activity was somewhat softer, with growth in tertiary sector slowing to 4.0%.
- Despite the reasonable outcome for the quarter overall, activity appears to have slowed sharply in March, with several regions across China in lockdown, given a renewed spike in COVID cases.
- In particular, March retail sales fell 3.5% year-over-year, a larger-than-expected decline, while the broader measure of service sector production also fell 0.9%. Again, manufacturing activity held up better, with a gain of 5.0%. March activity figures do not fully capture the effect of lockdowns, and that April data could be even weaker.
- Given these developments, the government's stated annual growth target of 5.5% will be exceedingly difficult to achieve and the risks tilted to the downside.

Indian Bond Markets : Not so Sunny

- The tide has decidedly turned against bonds as a combination of heavy borrowing by the government and an imminent rise in interest rates means yields can only move upward.
- In such a scenario, perhaps the only way to get one's calls right in the bond market is by betting on higher yields, which is just what markets seem to be doing of late, by doubling down on short sales
- With the size of auctions becoming bigger, it is understandable that the quantum of short sales should increase as well. But what is peculiar about the current situation is that the short bets in the 6.67%, 2035 bond exceed even the amount of the paper being auctioned this week.
- Fresh supply of the above paper is likely nearing an end. The additional 100 bln rupees sold last week will push the bond's outstanding close to the 1.50 trln rupees at which the Centre typically issues a new bond.
- The spread between US 10 Year and India has normally been in the range of 4.50 % to 5% over the last decade abd it is expected that the above arithmetic would hold good despite the dramatic difference in the monetary policy regimes .
- The 10-year benchmark 6.54%, 2032 bond settled at 7.17% yield. After some bvack and forth moves between 7.00-7.25 %, it is highly likely that it could see 7.50 % soon .

Indian Equity Markets : Range bound

- Apart from the global headwinds and the fall in index heavyweights, another observation of why Indian markets are failing to hold up is that lately, FII sell-off is not being completely absorbed by the DIIs.
- Between October and February, the combined investments by DIIs and retail investors surpassed the net sales by FIIs.
- Now as signs emerging that incremental retail participation in the short term at least may not be as buoyant, it remains to be seen if retail participation can hold up.
- The domestic segment is not concerned with any conventional factors and slowly is tilting to be speculative in nature – the rise in Global monetary tightening cycle or upcoming Super sized FED rate hikes or the margin pressure on the Indian corporates.
- Likely Weekly Range : 16800-17300

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