SYFX Treasury Foundation

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Weekly Market Update

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US Economy :Regime Shift

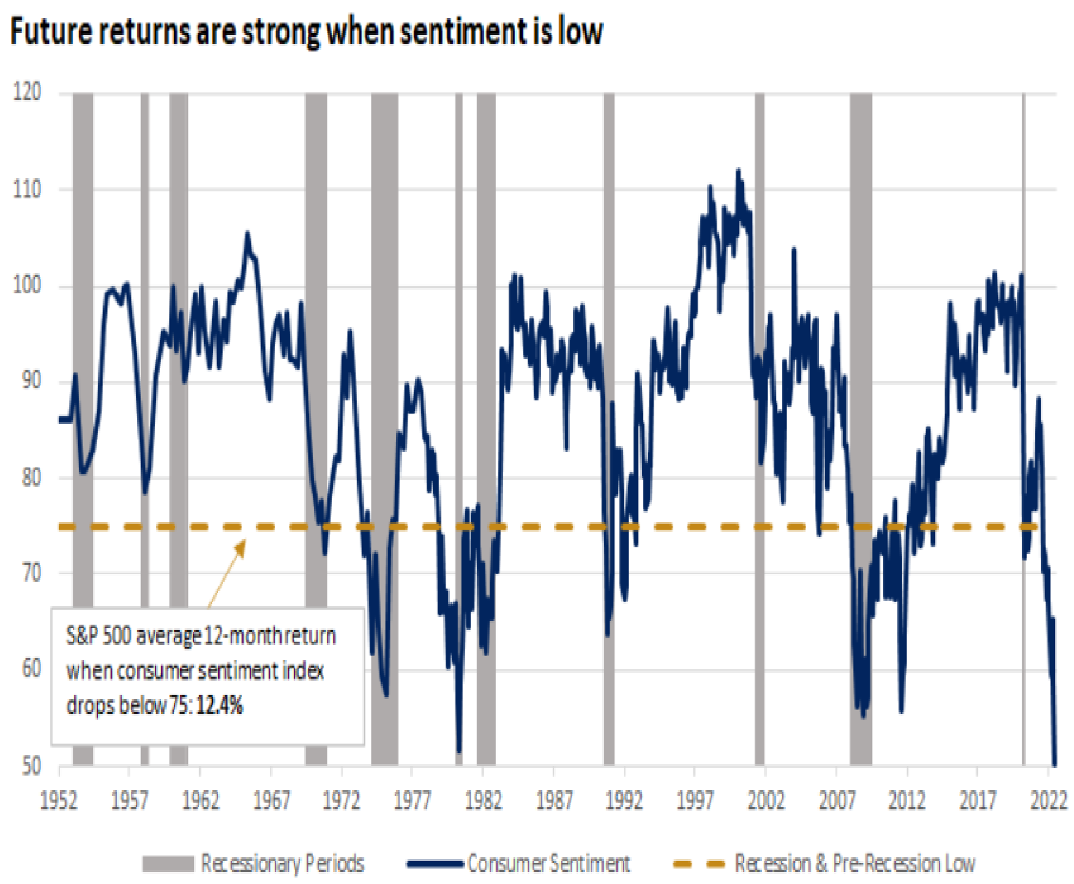
- Headline inflation has remained stubbornly high amid geopolitical shocks to oil and food prices along with lingering supply bottlenecks.
- Fed is being forced to further accelerate its rate-hiking campaign in an effort to quell inflation expectations, raising risks of a Fed-induced recession.
- There are still bright spots for the economy, but headwinds have grown, as the economy appears to be in a phase where consumer anxiety over inflation may have a self-fulfilling effect on weaker personals spending, despite a favorable labour market.
- It's worth emphasizing that conditions - on the face of it - might resemble 2011 and 2016, which proved to be midcycle slowdowns. However this time , it’s a regime shift rather than episode
- And while it is still quite feasible that the economy can avoid an outright recession, the eye of the needle that the Fed is trying to thread (driving inflation lower without tipping a contraction) has narrowed.

Staying the Course

- FOMC had finally reached the conclusion that it needed to catch up and fight inflation by taking policy rates into restrictive territory
- Fed delivered a historical 75bp hike to a target range of 1.5-1.75% and signalled that another 75bp hike in July is possible if there are no signs inflation pressures ease.
- It is striking that just one year ago, the Fed did not expect to deliver any hikes in 2022. And now its the steepest hiking cycle since the 1980’s.
- It is likely that another 75bp in July could be on its way as inflation pressure is not easing in the short term.
- That might be followed by 50bp hikes in September, November and December to take the Fed funds rate to 3.75-4.00% by year-end, which is 25bp higher than current market pricing.

Case for Equity Rebound

- Consumer confidence has been sapped by inflation worries, with the June reading of the University of Michigan Consumer Sentiment Index coming in at the lowest on record.
- With household spending comprising 70% of GDP, consumer incomes and attitudes are currently representing opposing forces to consumption habits.
- Stock-market valuations (price-to-earnings) have already dropped by an amount that is consistent with a recession. So it is likely that a good portion of the pain has already been experienced
- The stock and bond markets have moved significantly faster in front-running the Fed than in the past. Thus, there could be start of a process of finding some footing, which can look more like a "U" shape" than a "V.“
- Markets need several months of moderating inflation before they are convinced that the Fed can find a spot to slow or pause its rate-hiking campaign. This will be a necessary but also positive catalyst for markets to mount a durable rebound.



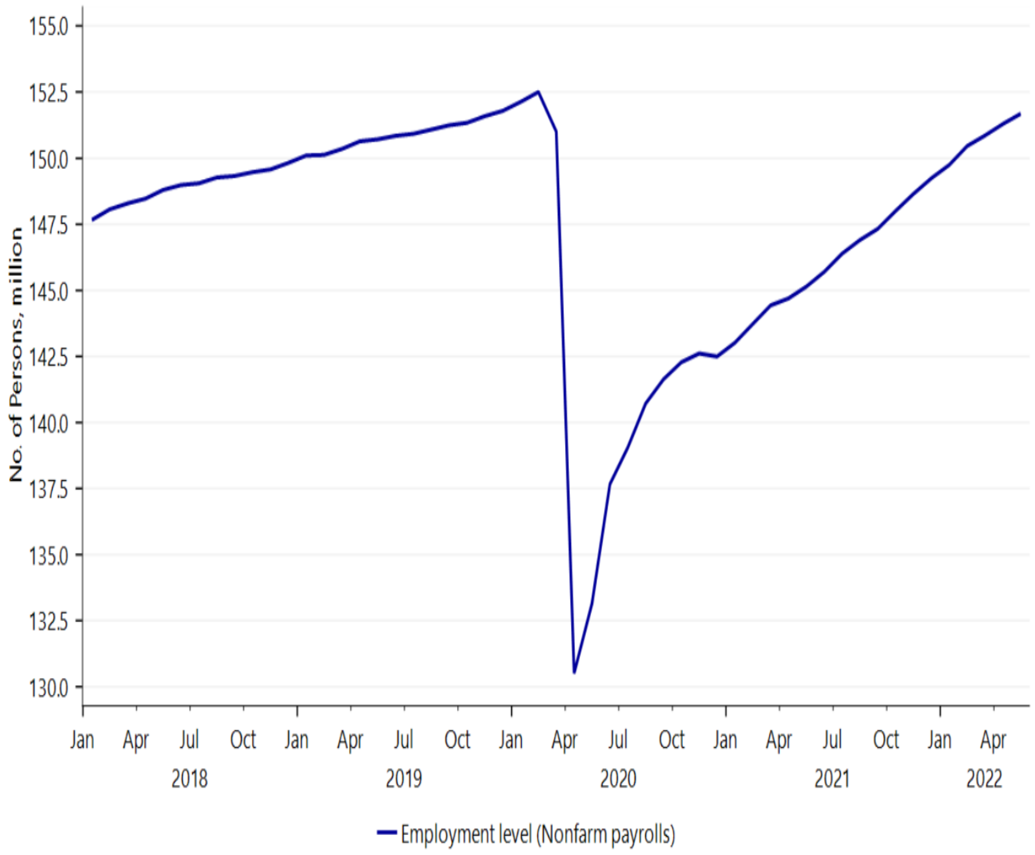
Are we whistling past fundamentals?

- A recession in US seems difficult to avoid.
- The economy is already being hammered by a series of negative supply shocks that could drag down the economy even without the Fed hiking policy rates into restrictive territory. In fact, the US could already be in a recession. After all, GDP growth in Q1 was -1.5%.
- So if Q2 GDP growth turns out negative as well, we are already in a recession according to macroeconomics textbooks. However, this does not seem very likely given robust consumption and investment. What's more, in the US recessions are determined by the NBER which tends to focus more on employment growth than GDP. Employment growth has remained strong this year.
- Either the exogenous supply shocks are going to bring down business activity or the Fed's response to high and persistent inflation is going to do the job. The timing of the recession will depend on whether it is caused by exogenous or endogenous factors.
- Given the strong labour market and robust consumption and investment at the moment we think that the endogenous will be decisive. This means it is more likely going to be the recession of 2023 rather than the recession of 2022.

Endogenous variable : Employment

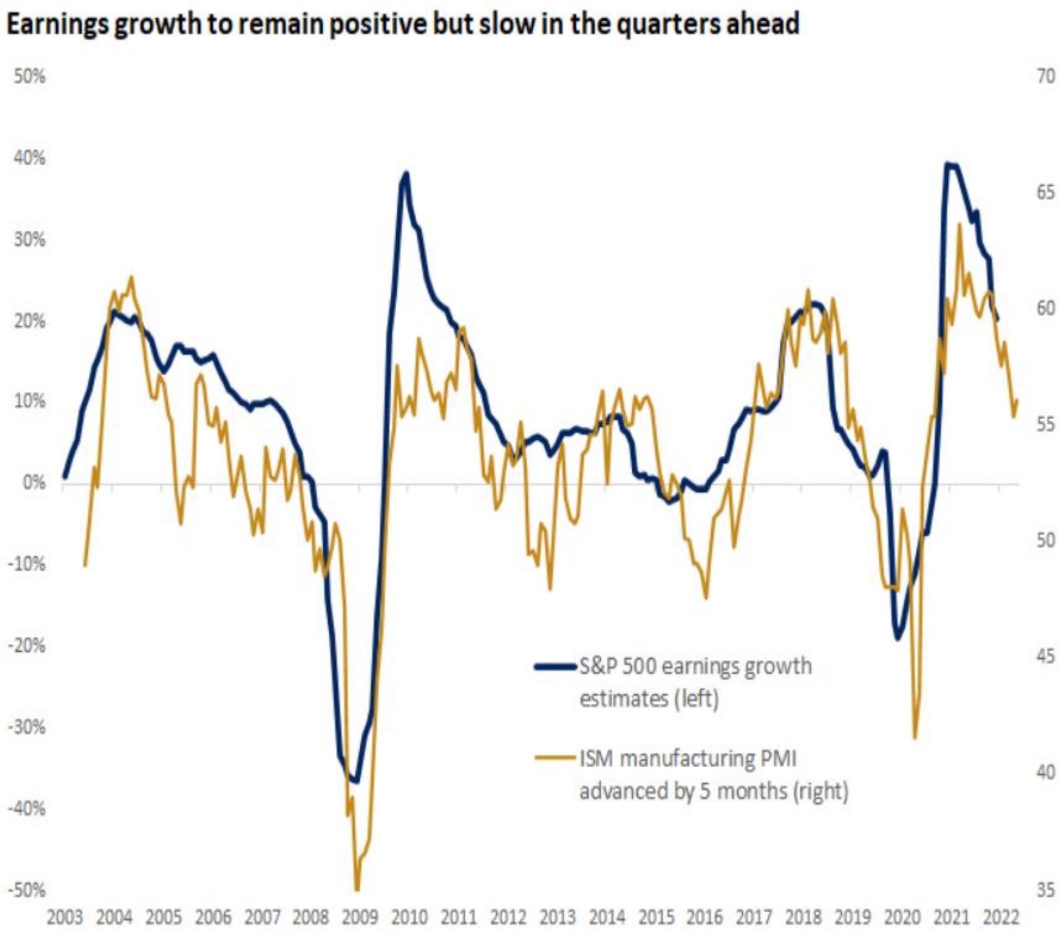
- The labour market still looks strong, as job growth has continued at a solid rate
- Even with more workers rejoining the labor force this year, the job market remains tight, with nearly twice as many openings as unemployed people. And despite investor worries about an imminent recession, the unemployment rate has fallen this year and continues to hover near record lows, at 3.6%.
- For perspective, the U.S. economy has always fallen into recession whenever the three-month average of the unemployment rate (U3) has risen by more than 0.3%.
- With unemployment being a lagging indicator of the market cycle, it is prudent to pay close attention to the more timely applications for initial jobless claims. Jobless claims tend to lead major inflection points in the unemployment rate by six to nine months and have historically risen by 25% before the economy entered a recession.
  - While claims remain low, they have been on an uptrend since April, rising about 20% from their low.
  - As companies look for ways to defend profitability amid slowing demand and rising costs, we would expect to see some moderation in job growth in the months ahead, with the progression of jobless claims being an important gauge to pay attention to.

Robust employment growth



Endogenous variable : Earnings Growth

- The first-quarter earnings results and forward guidance provided some reassurance that corporate earnings can still grow at a solid pace this year, partly offsetting the headwind of declining valuations.
- Despite some high-profile earning misses in the tech space, consensus still expects the S&P 500 earnings to grow 10.5% this year and 9.2% in 2023.
- Based on the softening of some leading indicators of economic activity, like the Purchasing Managers' Index, and because of the fast-rising labor and material costs, the earnings estimates might need to come down some to reflect the more challenging backdrop.
- That said, profits to decline from last year, as resilient demand and strong pricing power provide support. But the likely necessary process of revising earnings expectations lower will weigh on sentiment in the quarters ahead.



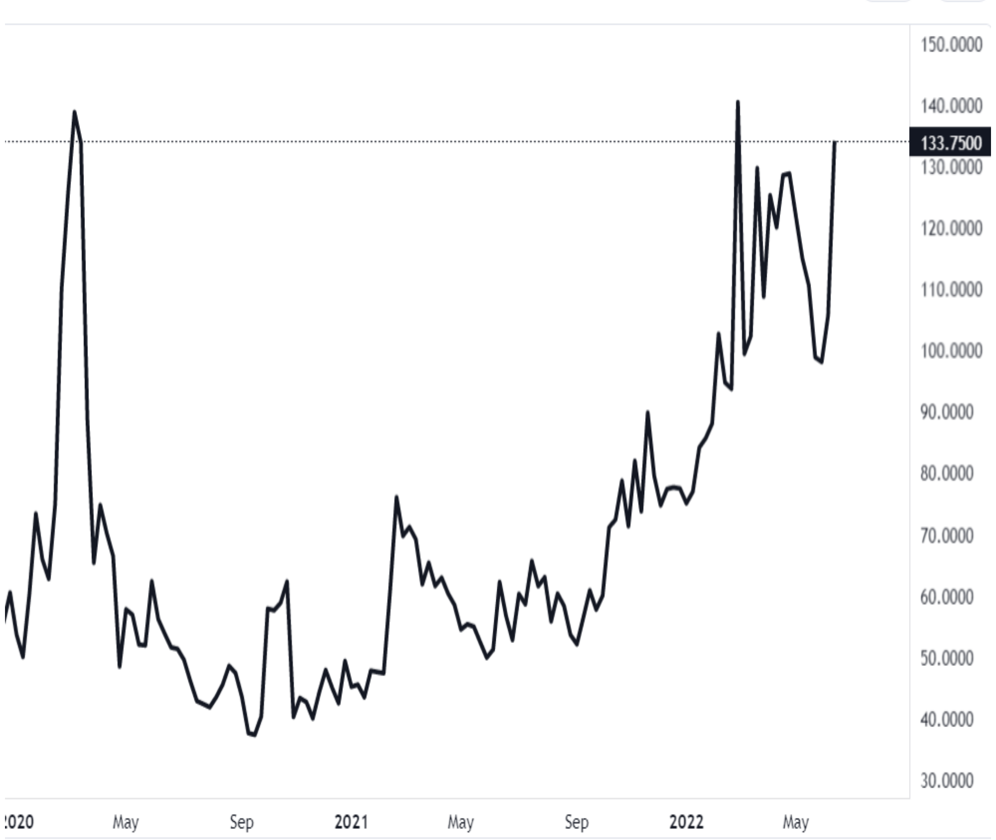
Endogenous variable : Credit Spreads

- High-yield corporate credit spreads – the extra premium of below-investment-grade corporate bonds over safer government bonds – are a good barometer of economic health and, at times, are a leading indicator to equity prices.
- Last week, spreads widened to a near 15-month high, but at 5% are only around their long-term historical average and significantly lower than past periods of financial stress.
- In past recessions spreads have risen to 7.5% or more, so unlike equities, credit markets are not yet pricing in a recessionary outcome.
- As interest rates adjust higher and the cost of capital rises, there is likely to be some further widening in spreads. But so far expectations for credit risk and defaults remain subdued, more consistent with a midcycle slowdown rather than the end of the cycle.

Volatility : MOVE

- While all are familiar with the Chicago Board Options Exchange's market volatility index, the VIX, a spike in another volatility index merits some attention.
- The Merrill Lynch Option Volatility Estimate, or MOVE index tracking U.S. Treasury market volatility, has jumped to a level only seen during the Global Financial Crisis.
- This kind of volatility in the deepest and most liquid market in the world is highly unusual.
- Bond investors are facing daily challenges to adjust expectations on interest rates against data that is changing quickly, and against a central bank that has a still-evolving view on the policy path.
- Given the extreme uncertainty, we would anticipate that volatility for both equities and bonds will continue to be higher than historical average, and this will continue to test investors' resolve to stick to their investment plans.

Merrill Lynch Option Volatility Estimate



ECB : Its about Fragmentation risk

- ECB held an extraordinary meeting last week to discuss 'fragmentation' on the back of the recent sharp widening of the 10-year Italy-Germany bond yields spread, which had increased from 100bp in September last year to 240bp early last week.
- With the end of ECB's purchasing programmes investors have less confidence in holding Italian bonds setting off a negative spiral. In the meeting statement, the ECB said it would
  - a) use flexibility in reinvesting redemptions in ECB's portfolio and
  - b) accelerate the design of a new anti-fragmentation instrument for consideration by the Governing Council.
- The 10-year Italy-Germany spread has narrowed to 205bp in response. Whether the improvement will last will ultimately, depend on the details of the new instrument once it is ready.
- German yields increased yet again to a new cycle high at 1.83%, partly lifted by a 'hawkish' 25bp hike by Bank of England, and a surprise 50bp hike by the Swiss central bank SNB.

ECB : New tool in the box

- The new instrument will likely be a new asset purchase programme. Reasonable analogue might be the Securities Markets Programme, launched by the ECB in 2010 with the aim of capping spreads to ensure the transmission of its monetary policy.
- A look at the SMP provides five lessons about any new tool:

1. The SMP was employed when the 10y spreads of the bonds of the targeted jurisdictions were in excess of 300bp
2. The SMP was sterlised so that it had no impact on the monetary policy stance. This is a limitation on the size of the programme, because there are limits to how much of the liquidity can be absorbed. Overall under the SMP, around EUR 220 bn of bonds were acquired between 2010 and early 2012, which is quite modest compared to the peak periods for the PEPP and APP.
3. The bonds purchased under the SMP had senior status. This undermined the effectiveness of the programme. Subsequent programmes, including the OMT shifted to equal status and we think that is likely with any new tool.
4. The ECB did not announce detailed modalities on the SMP, in terms of maturities or size.
5. The SMP had a significant impact on spreads after announcement but it was ultimately unsuccessful. Hence it was replaced by the OMT, which probably was durably effective because markets speculated that QE would eventually come into place.

UK : Incession Economy   -1/2

- At its June policy meeting, the Bank of England's Monetary Policy Committee raised its policy rate by 25bp to 1.25% in line with expectations
- The vote split was the same as in May, with three members voting for a 50bp hike and six for 25bp, though this time there was no dovish dissent against forward guidance for more rate rises to come.
- Indeed, the policy statement removed reference to 'risks on both sides' of the outlook from the May statement, with the emphasis firmly on inflation: the MPC 'would be particularly alert to indications of more persistent inflationary pressures, and would if necessary act forcefully in response.' **This is a strong signal that a 50bp hike is now very much in play for the majority of MPC members at the August meeting**.
- Although the growth picture has if anything darkened since the last meeting, with the economy expected to contract in Q2, the MPC noted that the outlook for underlying growth was broadly unchanged since May. The MPC appeared instead more concerned by signs of increased labour market tightness, with survey evidence pointing to a pickup in wage settlements since May, and a 'significant minority' of companies reporting 'mid-year top-ups to pay'.
- This 'reinforced the upside risk to the MPC's central projections for pay growth and domestic price pressures highlighted in the May Report.
- The MPC appears increasingly concerned about the formation of a wage-price spiral, a risk that looked smaller at the time of the May policy meeting.

UK : Incession Economy -2/2

- UK economy to grind to a halt in the upcoming quarters, reaching the verge of a technical recession.
- Recessions attract headlines and stoke fears, but it’s not really important whether its technical definition is met or not: the UK faces a negative terms of trade shock and the cost of its energy, food and goods imports rises.
- The financial pain will be felt. Businesses are forced to raise prices to sustain margins, to be able to pay for wage increases and to compensate for output losses. Households see their living standards falling, their budgets squeezed, and could face financial hardship. They are forced to either save less, to trade down or to cut back spending.
- The government uses its balance sheet to redistribute some of these effects across sectors and time, but the next quarters should show there is no escaping the stagflationary consequences of a sudden and deeply negative terms of trade shock.
- It is to forecast the economy to grow by 3.2% in 2022, more than double of UK’s trend growth rate (1.25-1.50%).
- The annual figure is inflated by the so-called ‘carry-over’ effect, a reflection of the artificially low comparison base due to last year’s hit to GDP from the pandemic.

Another Hawk enters the Room

- Last week , SNB joined the hawkish camp by raising its rate by 50 basis points to -0.25%.
- This rate hike is aimed at countering inflationary pressures, as inflation in Switzerland reached 2.9% in May, its highest level since the summer of 2008, which is higher than the SNB's objective of having inflation between 0 and 2%.
- SNB did not want to wait until its meeting on 22 September to raise rates itself and have to catch up with the ECB's 75 basis point rate hike. Raising rates now, therefore, means that it does not have to rush into major rate hikes later on and retains the initiative.
- This also indicates a willingness to take the lead and keep the initiative given the expected rate hikes by the ECB. Over the year, the SNB should nevertheless be less aggressive than the ECB.
- This rapid change in monetary policy is also explained by the situation in FX market. SNB statement marks a sea-change for the Swiss franc. For over a decade, the SNB had been battling deflation and battling Swiss franc strength. Various descriptions of CHF over-valuation had been used over the years and the SNB had accumulated over CHF800bn in FX reserves in fighting that strength.
- While the Swiss franc was considered by the SNB to be overvalued for years, which pushed inflation down, the SNB now believes the franc is no longer highly valued. SNB is indicating that an appreciating Swiss franc is no longer a problem for them.

Trade Recession and China Reopen

- With the omicron crisis in China prolonging supply-chain bottlenecks and bringing port congestions back to the worst levels seen in 2021, global trade of goods in volume terms should decline by -1.3% q/q.
- In value terms, global trade is now set to grow by +10.4% in 2022, with the trade price component more than three times higher than before the war in Ukraine and the lockdowns in China.
- But China’s mild reopening will help the trade recovery.
- Global trade should grow by +1.1 q/q in Q3 2022 and +0.8% in Q4. Barring renewed large waves of Covid-19 infections, the stringency at the national level in China to normalize in July – even if the zero-Covid policy remains a risk. This means that industrial activity should recover mildly, and manufacturers dependent on Chinese goods could experience some relief in the fall as it will take two to three months for port congestion to normalize.
- **Among major Western economies, Germany could see the largest GDP boost thanks to the improved access to inputs from China**. Our analysis of importing countries, supply-chain links and the sectoral breakdown of value added reveals that the Chinese reopening could help German GDP grow by up to an extra 0.5% in 2022 – all else being equal and assuming that the activity boost fully materializes in additional output through consumption or inventory. In France and the UK, the benefit to GDP would reach up to 0.3%, as their share of the manufacturing sector is lower.

Indian Bond Markets : No Generosity from RBI

- On Monday, the yield on 10-year benchmark government bond touched 7.61%, the highest in over three years, due to fears of aggressive rate hikes by RBI to curb inflation and also because of global uncertainties.
- The massive Govt borrowing may have to sail through in this year without the generous support from RBI as was the case in the previous years considering the global backlash against Yield curve control and the current fragility of the Central bank's Balance sheet.
- The government is scheduled to borrow a record Rs 14.31 trln through dated securities in 2022-23, up 27% from last year. The government has so far borrowed Rs. 3.25 trln -22.7% of the gross market borrowing target.
- The rupee's real effective exchange rate against a basket of 40 currencies, in terms of trade-based weights, rose to 104.90 in May from 103.46 in the previous month, according to data from RBI.
- Retail inflation in May'22 as measured by the consumer price index rose 7.04% from a year earlier, a 0.85% decline from the 7.8% growth in the preceding month. This moderation can in large part be attributed to the higher base of a year ago (6.3% YoY growth of May'21) as overall price levels rose 0.94% monthly in May'22 with all sub-segments recording a sequential rise.
- Inflationary pressure is unlikely to abate substantially in the coming 2-3 months. Inflation is likely to be above 6.5% in this period. Persistent price pressures would prompt further tightening by the RBI.

Indian Equity Markets : Key Supports under pressure

- It was the worst week in the current calendar year and in fact, Nifty has closed at the lowest level in last 12 months.
- There has been no respite from the negative global cues and FPI sell off and hence, market is now placed at multi-month lows.
- Indian Retail savings continues to extend their Equity ownership and the depressing performance of the equity markets does not augur well for consumption
- Taking a glance at the weekly time frame chart, we can see prices sliding below ’89-EMA’ for the first time after July 2020.
- So, price-wise it needs to be construed as a breakdown, does not augur well for the Upside
- On the flipside, Nifty is exactly placed at the previous breakout point of May 2021 which is around 15400 – 15300

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