SYFX Treasury Foundation

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Weekly Market Update

28 Aug 2022

V Thiagarajan

thyagoo@syfx.org

Bigger Picture

- Increasing pessimism over the global economic outlook reflects the challenging environment of rising inflation amid an economic slowdown, and the resulting concerns over the growth implications of central banks' inflation-induced policy tightening.
- With inflation, volatility, and cyclicality all increasing, we are also now in a world where we can no longer expect downside risk to be met by rate cuts and QE injections. Instead, fiscal policy will be the more common tool of choice and central banks will be focused on containing inflation pressures.
- The risk to interest rates for the foreseeable future appears to be to the upside, and whether policymakers can bring inflation down to a comfortable level without sparking recession remains a pressing concern
- Another crucial consideration as we navigate the current macro environment is the state of the Chinese economy. As China drives marginal demand for many commodities and exports, we believe this slowdown may have a higher chance of feeding through to the rest of the world due to lower demand, weak supply, and higher inflation.
- Markets are rapidly shifting, and it is prudent to prepare for increased cyclicality, volatility, and inflation.

Jackson hole : Reality Knocks the door

- Since 1982, the Federal Reserve Bank of Kansas City has sponsored a conference in late August in Jackson Hole, WY.
- The conference attracts intense media and financial market attention because the Chair of the Federal Reserve usually makes a speech in which the economic outlook and implications for monetary policy are discussed, at least in part. Eyes have been glued to Jackson Hole all week in anticipation of Chair Powell's speech, which he delivered on August 26.
- The speech was notable in that Powell did not address longer-term considerations for the economy, as some past speeches have. Instead, he led off by saying “my remarks will be shorter, my focus narrower, and my message more direct.”
- Powell devoted his relatively short speech to deliver the message that the FOMC's “overarching focus right now is to bring inflation back down to our two percent goal.” He also cautioned that “restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance.” Powell did not explicitly comment on the next FOMC meeting on September 21, but he reiterated his message, which he made at the conclusion of the July 27 meeting that “another unusually large increase could be appropriate at our next meeting.”
- The bottom line is that the Federal Reserve is determined to rein in inflation and will take whatever steps necessary to achieve that end. We currently forecast that the FOMC will lift its target range for the fed funds rate by 75 bps at the September FOMC meeting with another 50 bps rate hike in November and a follow-up 25 bps increase in December .
- Powell also noted that “restoring price stability will likely require maintaining a restrictive policy stance for some time.” This is a message that other Fed officials have been delivering recently. In other words, the FOMC is not likely to start cutting rates if growth downshifts.

US Economy -Still Expanding -1/2

- Like most economic data, the GDP figures undergo multiple rounds of revisions, which makes using the "two consecutive quarters of GDP declines" rule-of-thumb recession indicator difficult to use in real time. That noted, the updated data show the U.S. economy contracted at a 0.6% annualized pace in the second quarter, slightly better than the advance estimate of a 0.7% decline.
- The upward revision was mostly due to real personal consumption expenditures growing at a slightly stronger pace during the quarter than first reported. The second estimate of GDP also includes a first look at corporate profits. In Q2, nominal profits rose 6.1% (not annualized) during the quarter on a pre-tax basis. The $175 billion gain in profits in Q2 lifted overall corporate profits to a record $3.0 trillion, which is hardly consistent with the economy being in recession.
- Another reason why this year's two straight quarterly drops in real GDP growth can not be called as a recession is that another measure of total economic growth, real Gross Domestic Income (GDI) growth, has been positive during that time. In theory, GDP and GDI should be equal.
- In practice, that is not always the case and the gap between the two has widened significantly this year. The difference is mostly likely due to measurement error. Still, GDI is more reflective of growth in consumer spending and business investment, or "core" parts of the spending side, which further adds to the argument that the economy is slowing but not yet contracting.
- **<u>To be clear, right now the economy still appears to be expanding</u>**

US Economy -Still Expanding -2/2

- The second estimate of Q2 GDP reported earlier this week also included the initial estimates on corporate profits for Q2.
- Nominal profits rose 6.1% (not annualized) during the quarter on a pre-tax basis, the fastest pace in a year. The $175 billion gain in profits in Q2 lifted overall corporate profits to a record $3.0 trillion. On an after-tax basis, profit margins widened to 15.5%, up from 14.0% the previous quarter, and the highest since 1950.
- There is some dissonance in the data when it comes to profits, however. Operating margins for the S&P 500 point to declining profitability, even though the National Income and Product Accounts (NIPA) registered that margins improved slightly in Q2 .
- These economy-wide estimates show that pre-tax margins rose to 12.2%, running above the 11.5% averaged in the previous cycle.
- This suggests companies continue to be able to pass on the rising costs of labor and materials to consumers, even as inflation has squeezed household balance sheets. It is likely that profits might narrow later this year as persistent price pressures lead to a pullback in consumer demand, challenging the ability of firms to continue passing on costs.
- Retail inventories have grown for nine consecutive months as of July. Companies are increasingly searching for space to store their inventory, swamping an already tight warehouse market.
- Net absorption for industrial properties, which includes warehouses, totaled 98.0M square feet in Q2-2022, a touch higher than the previous quarter.

US : Housing Sector

- The broad economy is likely not currently in a downturn, but it is becoming increasingly apparent that the housing sector is.
- Real residential investment fell 16.2% in Q2, more than any other major sub-component of overall GDP.
- The plummet in residential investment reflects the recent pullback in home buying brought on by higher mortgage rates. New home sales fell 12.6% in July, to a 511,000-unit pace.
- Aside from May's modest gain, new home sales have fallen in each month of 2022 so far. Continued weakness in pending home sales suggest that home sales have further to fall.
- Pending home sales, which represent contract signings and lead closings by a month or two, fell 1% in July. Similarly, mortgage application for purchase slipped 0.5% during the week ended August 19, a 21% year-to-year decline.
- While home buying and selling has become more challenged recently, homeowners continue to enjoy record amounts of homeowner equity thanks to the fast run-up in home prices over the past two years.
- The robust rise in homeowner equity has bolstered household balance sheets and is likely helping consumers push through inflationary headwinds,

Student Loan debt

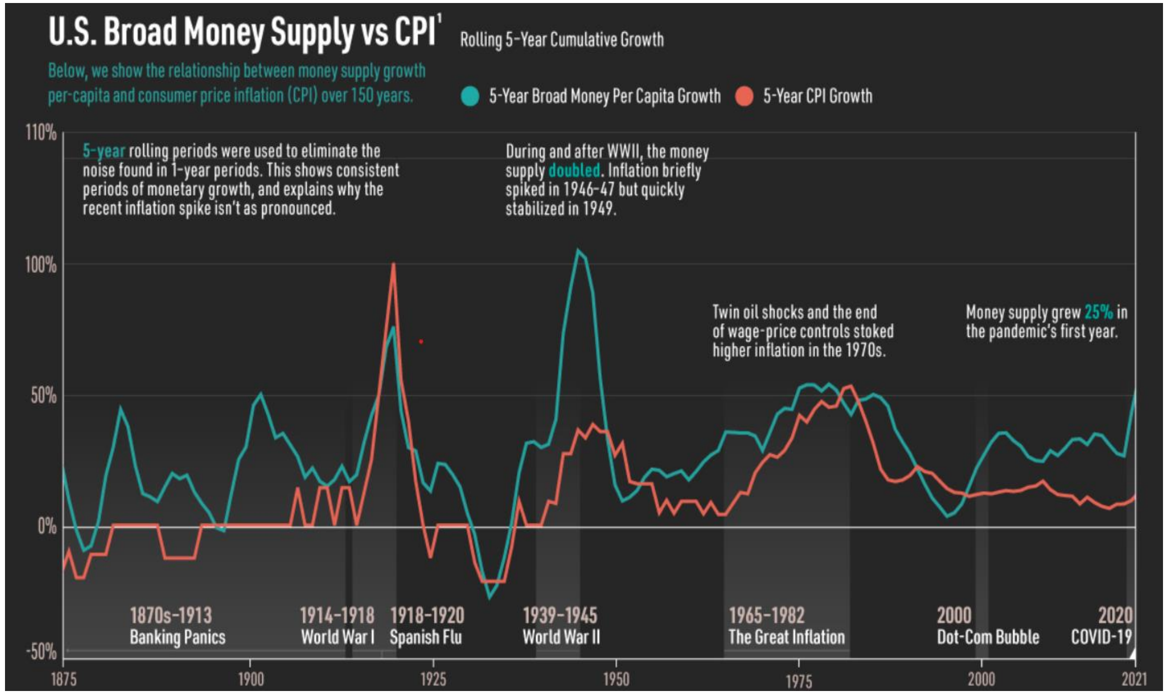
- Amount of student loan debt outstanding has risen rapidly over the course of the past decade, tallying over $1.6 trillion in Q2 this year.
- This cements student loans as the second-largest source of household debt in the U.S., behind mortgages. Between end of the Great Recession and Q1 2022, student loan debt outstanding has risen a striking 160% with auto loans as a distant second at 82%.
- Over 50% of borrowers have less than $20K of student loans outstanding, but they hold less than 20% of the total balance of student debt.
- The distribution of borrowers is skewed both for total borrowers and balances outstanding. The majority of borrowers have balances less than $20K, but less than 10% of borrowers constitute a group that has outstanding balances above $100K, holding a total of 37% of outstanding federal loan balances.
- The White House finally made its months-awaited announcement on federal student loan debt relief this week.
- Student loan debt forgiveness is different from previous pandemic-era fiscal stimulus in that it does not provide households with a direct cash infusion but rather reduces their debt liabilities. This may lead to a marginally stimulative effect on aggregate demand; however, the effect of this may be mitigated by the resumption of payments on these loans in January 2023.
- This proposal may provide moderate inflationary pressure to the current macroeconomic environment but will not become a massive inflationary catalyst

US Data : Mixed tone

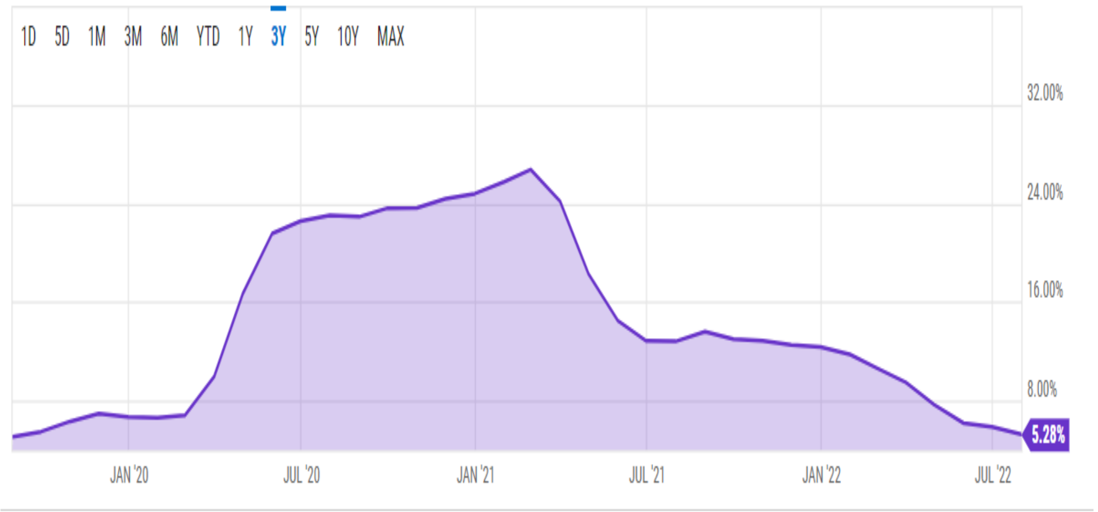
- The economic calendar delivered some upbeat inflation news, as well as a favorable revision to August consumer sentiment, while personal income and spending both increased but by a smaller amount than expected.
- PCE showed a year-over-year increase of 6.3% compared with last month’s reading of 6.8%. At the core, excluding the volatile food and energy sectors, PCE rose 4.6% year-over-year and only 0.1% month-over-month, solidly below economists’ estimates.
- The advance goods trade deficit narrowed much more than forecasted and wholesale inventories rose by a smaller amount than predicted.
- PMIs indicate service sector is slowing faster than expected. On a positive note, businesses' selling prices are increasing at a softer pace.
- New orders for nondefense capital goods excluding aircraft, a proxy for business investment, rose 0.4% in July, and weekly jobless claims fell back to their lowest level in a month.
- The University of Michigan’s index of consumer sentiment also rose more than expected, hitting 58.2 in August after bottoming at a record low of 50 in June. The upward revision came as both the current conditions and the expectations components of the survey were revised solidly higher from the preliminary estimate. The 1-year inflation forecast was revised lower to 4.8% from the preliminary estimate of 5.0%, where it was expected to remain, and down from July's 5.2% rate. The 5-10 year inflation forecast was revised slightly lower to 2.9%, from the preliminary read of 3.0%, where it was expected to remain, and matching July's rate.

Money Supply & Inflation

- The massive surge in the US money supply (M2), as the Fed bought the bonds used to finance the stimulus programs and prompted the massive surge in prices, has ceased.
- M2 growth has historically averaged about 6% per annum, but it exploded above 40% in the years following the COVID shutdowns.
- However, the money explosion braked to just 1.7% in the first half of the year and, if this slow growth trend continues , M2 would return near normal levels sometime in late 2023, taking hefty inflation down
- Helping, too, is the surge in the US Dollar (USD) boosting demand for USD around the world which, along with continued economic growth, helps to absorb the excess cash currently in circulation.



US M2 Growth y/y



Eurozone : Slipping into Recession

- This week's data from Europe offered further insight on how this year's surge in energy prices, and inflation pressures more broadly, are weighing on the region's economy.
- The Eurozone August PMI surveys point to a further slowdown in growth over the second half of 2022. In particular, for the economically important service sector, the headline PMI fell more than expected to 50.2, essentially consistent with a stagnation in activity.
- While the index remained above the breakeven 50 level, it was still at the lowest level since March 2021. The new business sub-component also fell to 49.2, and while the price components eased, they are still at elevated levels.
- The Eurozone manufacturing PMI dipped to 49.7 in August, the second month below 50, and the new orders component hinted at the potential for further softening in months ahead.
- Finally, the composite (economy-wide) PMI fell to 49.2, broadly consistent with our view that the Eurozone may fall into recession in Q4 this year. Meanwhile, while the news from Germany was not as bad as feared, it was also consistent with Germany falling into recession in the months ahead.
- The IFO Business Climate index fell less than expected to 88.5, with the expectations component easing slightly to 80.3—the latter a level that has historically been consistent with a marked contraction in Germany's economy.

Eurozone : Stagflation

- Another record high for HICP (8.9%) and core inflation (4.0%) during July, keeps the pressure for another 50bp September ECB hike alive, as inflation concerns still take precedence over the clouding growth outlook.
- Firms' pricing power is coming under pressure from the weaker demand environment and inflation expectations (both survey and market-based) have moderated amid rising recession fears.
- That said, the inflation drag from Germany's energy relief measures will vanish at the end of August and higher consumer gas prices will bring another boost to energy price inflation in Q4.
- The drought in Europe, low water levels in the Rhine and surging electricity prices are also adding to pro-inflationary risks.
- All this makes any significant retreat of headline inflation in 2022 unlikely and it will take at least until mid-2023 before negative base effects pull the headline rate towards 2% again.

China going the Japanese Way ?

- Economic history always offers clues for those wanting to learn from it, but it is important to choose the closest experiences to the case in point.
- As China enters its second year of real estate blues, much has been written about Evergrande's default potentially being China's Lehman moment, but the US sub-prime crisis is probably not the most similar situation to that of China today. In fact, China's macroeconomic imbalances leading to excess saving trapped in a bloated real estate market are the mirror problem of the US with a very low saving ratio and high household indebtedness.
- The experience of Japan in the 1980s and 1990s seems like a much closer situation, with similar macroeconomic imbalances, namely excess saving which equates to a protracted current account surplus. Furthermore, asset bubbles, including in the real estate market, played a critical role during Japan's bubble period in the 1980s. With rapidly rising disposable income and a young population, high household savings were first directed to finance companies, the government, and the overseas sector.
- The most prominent common factor between China and Japan is the emergence of external pressure during the slowdown period.
- For China, the US-led trade war which started in 2018 heralds a new era in terms of US-China economic relations. In 2018, the Trump administration slapped tariffs on Chinese imports, and then pushed China into reaching an interim trade agreement which promised to purchase as much as USD 200 billion in additional US goods.
- Beyond that, the US tightened regulations over China's acquisitions into the US and put limits to Chinese companies listing in US stock markets. These events echoed the Japanese experience in the 1985 when the US, along with other major Western economies, pressed Japan to reach the historic Plaza Accord, aiming to tackle trade imbalances between the US and Japan

Indian Bond markets : Eternally Optimistic

- GDP Print this week is expected at 15.2% during April to June 2022 and a GDP figure of Rs 37.4 lakh crore. This implies a GDP growth or economic growth of 1.76 % per year over a three-year period from April to June 2019 to April to June 2022.
- The credit-deposit ratio was 73.5% in Apr-Jun, the highest since the March quarter of 2020. In addition to continued growth in retail segment, the overall loan growth in recent months has been supported by revival in demand for corporate credit, especially for working capital requirement. Rise in bond yields, which led companies to shift from the corporate bond market to banks for borrowing, also aided credit growth in the banking system. At the same, deposit growth has been lagging. In the past five quarters, aggregate deposit growth remained in the range of 9.5-10.2% compared to a credit growth of 6.0-14.2% in the same period.
- Reports Govt was exploring options that would enable India's inclusion in global bond indices without listing its securities on overseas settlement platform.
- India's foreign exchange reserves fell by $6.69 bln during the week ended Aug 19 to $564.05 bln, the lowest level since Oct 2020
- Bond yields were softer after RBI rejected all bids for the 2028 floating rate bond, which forced short sellers to cover their bets in the secondary market.
- While the government could still make the fiscal balance sustainable thanks to the large share of government-controlled resources, it will affect the long-term effectiveness of resource reallocation which is key for economic growth .
- The global melt down in bond markets should continue to underpin G sec yields and it is highly likely that it can be closer to 8 %

Indian Equity markets : Signs of Bubble

- Indian equities continued with their upward momentum for the second straight derivative series in August.
- The optical illusion of Q1 GDP growth could underpin the euphoria where as receding global liquidity (QT) and higher cost of leverages should affect Capital importing countries like India
- The misplaced notion that the negative global headwinds wont reach Indian shores could get revisited soon as RBI gives up the defence of Rupee in the face of the USD storm that could hit in the near future .
- The exuberance stems from Increasing household as well as Corporate leverages despite the paradigm shift that is happening in the global markets -is the equity market at the matured phase of the bubble ?
- 16800-17800 Range in Nifty could continue to hold for a long period of time

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