SYFX Treasury Foundation

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Weekly Market Update

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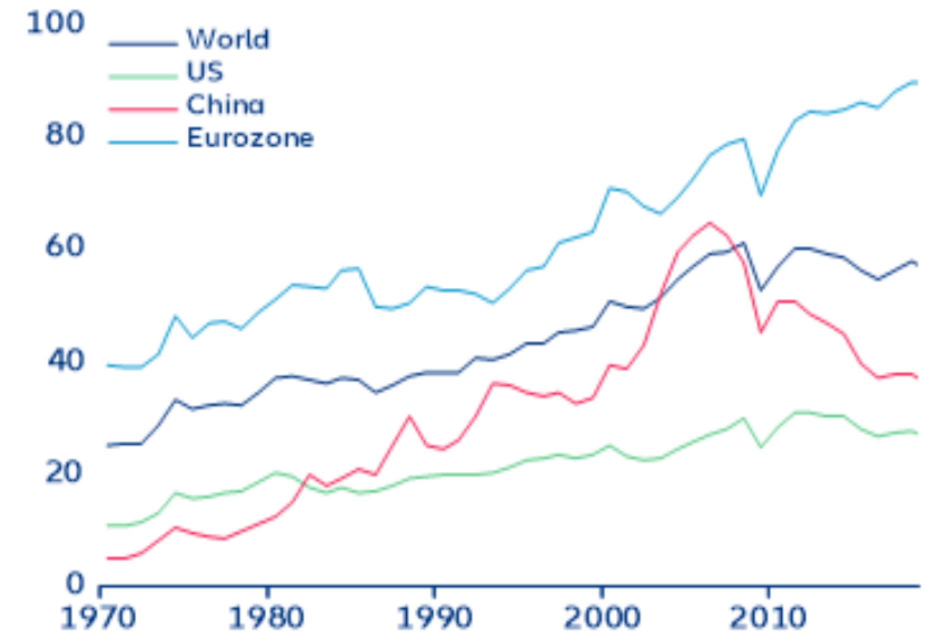
Whiplash

- Whiplash may be the most apt label for a year that has turned out to be nothing but tumultuous. Last week was no exception, nor was the third quarter that just wrapped up.
- What looked like a relatively rosy backdrop in July (from the stock market's perspective) turned quite sour by the middle of August, only to worsen further in September.
- Stocks' midsummer gains were quashed by the Fed's persistent determination to rein in inflation at any cost, even recession.
- Some inflation components have started to roll over, but sticky components have taken longer to fall, stalling the Fed's victory lap.
- Barring a major exogenous shock, there is not likely to be an imminent pause or pivot in policy, even though some of the Fed's foreign peers have taken a different turn recently—most notably, the Bank of England's attempt to stabilize markets and stem the bleeding from severe currency and bond volatility
- Unrest in markets around the world has cast a wider, darker cloud over the global economy and added to the laundry list of risks that have weighed on asset markets.

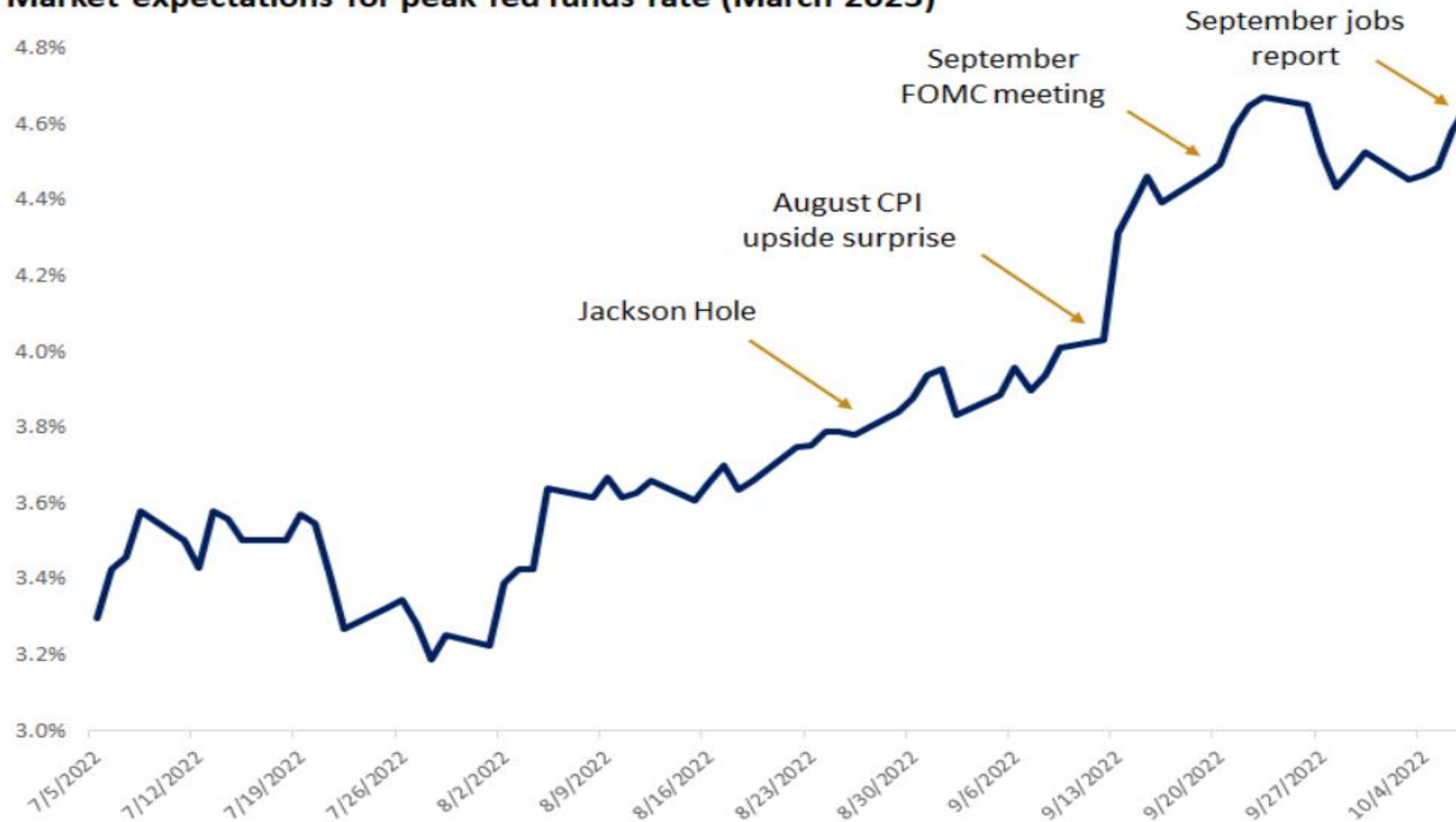
Global Trade

- China is a critical supplier for 276 types of goods for the US, and 141 types of goods for the EU. Conversely, the US is a critical supplier to China for just 22 types of goods, and the EU for 188 types of goods.
- This means that, in an extreme scenario where US-China and EU-China trade relations are completely cut off, the US and Europe have more to lose: The loss of critical supplies would cost 1.3% of GDP for the US and 0.5% of GDP for the EU, but 0.3% of GDP for China. Note that as recently as 2018, the US' critical dependence on China was around half of what it is today (0.7% of GDP vs. 1.3%).
- Mexico, South Korea, Japan, Vietnam, Indonesia, Brazil and Malaysia could be the best positioned as 'friendshoring candidates' for closer trade relations with the US and the EU.
- But the US and the EU could also look to increase bilateral trade cooperation. With 300 types of goods concerned, the EU actually comes up as the most frequent critical supplier for the US. But in terms of size of imports, these supplies represent just 4% of total US imports – compared with nearly 10% when it comes to US critical imports from China.
- A free-trade agreement could be an option to close this gap, especially as the EU is becoming very dependent on the US for energy supply (oil and gas).



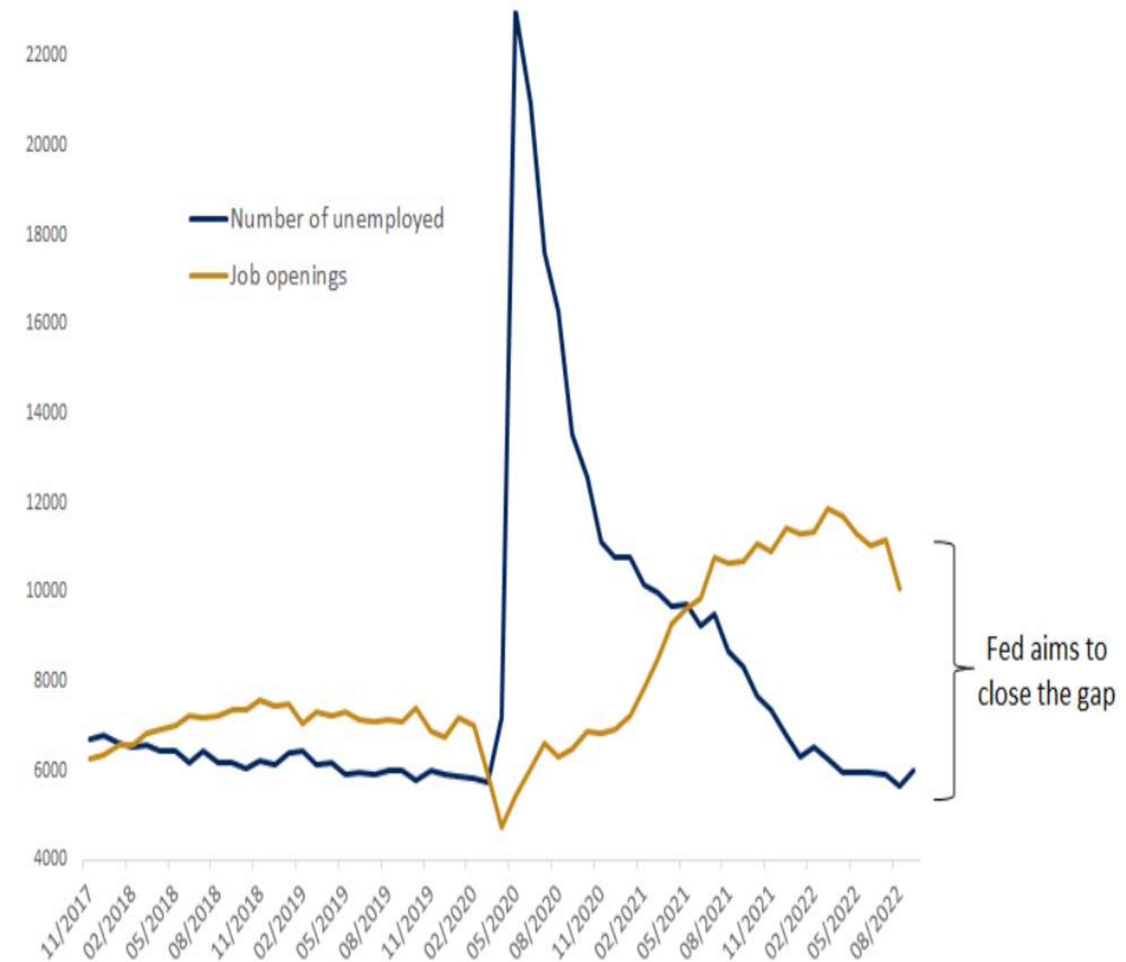
- Quantitative measure, i.e. trade as a percentage of GDP, shows that overall globalization seems to be on pause – but it is not retreating.
- The share increased from 25% in 1970 to a peak of 61% in 2008. Beyond the volatility around the global financial crisis, the timid declining trend observed in the past decade is the result of a very visible decline in the share of trade in China's GDP (36% in 2019 vs. a peak of 64% in 2006)

- Evolution of market expectations for the Fed's terminal rate over the past three months.



JOLTS gaining Importance

- According to the latest Job Openings and Labor Turnover Survey (JOLTS), the count of job openings plummeted by 1.1 million vacancies in August. The monthly decline was the sharpest drop since 2020 during the throes of the pandemic.
- The JOLTS plunge will come as welcome news to the FOMC. Fed Chair Powell has frequently cited the high number of openings relative to the number of unemployed workers as indicative of a labor market that is too tight.
- August's plunge in openings is a sign that tighter monetary policy is starting to slow hiring, and possibly the inflation pressures stemming from rapid wage growth.



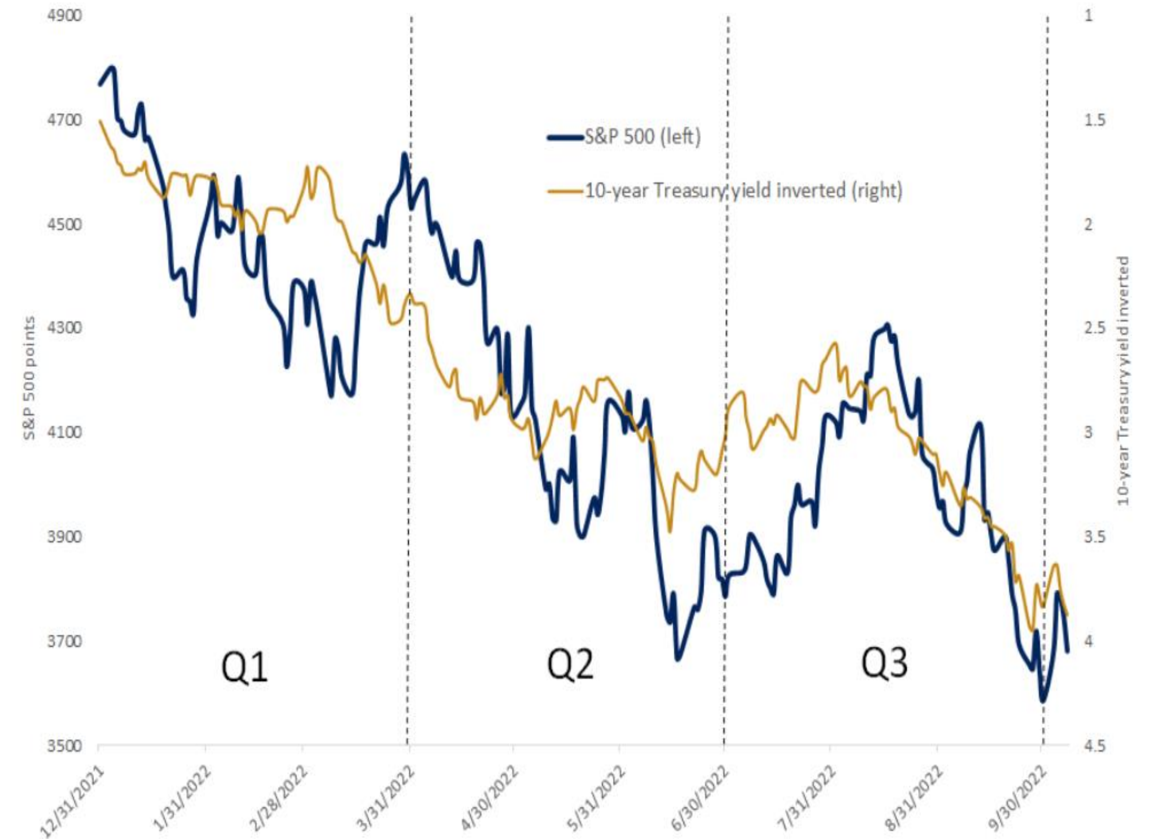
The wide gap between job openings and the number of unemployed, driving wages higher.

Fed : No Pivot Around the corner

- Given the steep drop in job openings, Friday's employment report took on new significance. Payrolls rose by 263K jobs during September, a gain just a shade above market expectations.
- The monthly improvement reflects a slowing pace of job growth this year, however labor markets remain remarkably tight. The unemployment rate ticked back down to 3.5% during the month, matching a 50-year low.
- The dip in the jobless rate occurred alongside a solid rise in household employment and only mild decline in the labor force. The labor force participation rate, which is still hovering below pre-pandemic averages, inched down to 62.3%.
- Importantly, wage growth did not appear to accelerate during September.
- Average hourly earnings increased 0.3% during the month, in line with market expectations. On a yearly basis, average hourly earnings growth softened a bit, rising by 5.0%, a touch slower than August's 5.2% increase. The cool down will come as a welcome development, but wage growth remains well above rates that are consistent with the Fed's 2% inflation target.
- All told, none of the last week's labour market data change the view that the Fed will continue to aggressively tighten monetary policy to tame inflation, and the markets continue to have a consensus call of 75 bps hike at the November FOMC meeting.
- Peak fed funds target range forecast remains at 4.75%-5.00%, implying 175 bps of additional hikes through Q1-2023.

Bond Yields and Equity indices

- This inverse relationship was on full display at the end of last quarter, with stocks falling below the June lows as the 10-year Treasury yields surged briefly to 4%, the highest in more than a decade.
- On the flip side, a brief easing in yields helped lift equities from the lows. The catalyst was a surprise move by Australia's central bank to slow its pace of rate hikes, citing the deteriorating global outlook.
- Together with the Bank of England's (BoE) intervention pledging unlimited purchases of long-dated bonds to calm markets, it raised hopes that Fed officials might become more sensitive to signs of financial stress from the sharp tightening of financial conditions.
- The market expecting the Fed to back off and the Fed not blinking?
- That's how the midsummer rally quickly fizzled after Fed officials reaffirmed the bank's determination to tame inflation. And Friday's labour-market strength once again dashed hopes for a Fed pivot.



- Swings in interest-rate expectations and bond yields continue to be a major driver of valuations and stock performance this year.

Eurozone : Tug of War

- A 'tug of war' is increasingly visible between fiscal easing and monetary tightening. While high inflation keeps pressure on ECB to front-load more rate hikes (we expect another 75bp in October), governments are coming up with ever more creative ways to shield consumers and firms from the adverse repercussions of the energy crisis.
- Germany announced an up to EUR 200bn (5.5% of GDP) aid package, financed through new borrowing and channelled through the Economic Stabilisation Fund (WSF), with the aim to cap gas and electricity prices.
- While this could limit inflation pressures in the near-term, we doubt that it will be enough to prevent the economy falling into recession in H2 22. Germany's display of fiscal largesse has antagonised some EU countries lacking the same fiscal firepower and behind the scenes discussions are intensifying over another round of EU-wide borrowing to confront the current crisis, by for example reviving the Covid-era SURE lending scheme.
- In contrast to the US, an inflation peak remains out of sight in Europe, where HICP inflation rose to 10% in September.
- Heterogeneous country developments (with rising inflation in Germany, Netherlands and Italy vs. falling inflation in Spain and France), reflecting idiosyncratic country measures to limit price increases, further complicate the job of finding the right policy calibration for ECB.

Eurozone : Structural Shift

- It is no surprise that Europe remains in the eye of the storm. The war in Ukraine continues to rage on and the risk of further escalation seems higher than a peace deal being reached any time soon. High energy prices have increasingly found their way into the real economy, denting private consumption, industrial production and shrinking profit margins. The silver lining of filled national gas reserves has recently become clouded again by the stoppage of the Nordstream 1 pipeline and the cold September weather.
- The risk of energy supply disruptions is back again. Even worse, there is an increasing awareness that high energy prices will not only be a problem for this winter but also for next.
- While everyone is still assessing the depth of a potential winter recession, another risk has not yet received sufficient attention; the eurozone may be witnessing the end of the business cycle as we knew it. Energy prices are very likely to remain high – very high – in the coming years.
- This will be a structural, not just cyclical burden on companies’ cost competitiveness and households’ purchasing power. It is a structural shift that could be compared with the deleveraging many Eurozone countries saw after the financial crisis and which led to subdued growth for many years.
- Consequently, the risk is high that the Eurozone economy will not experience a V-shaped or U-shaped recovery

UK : Misery Mounts -1/2

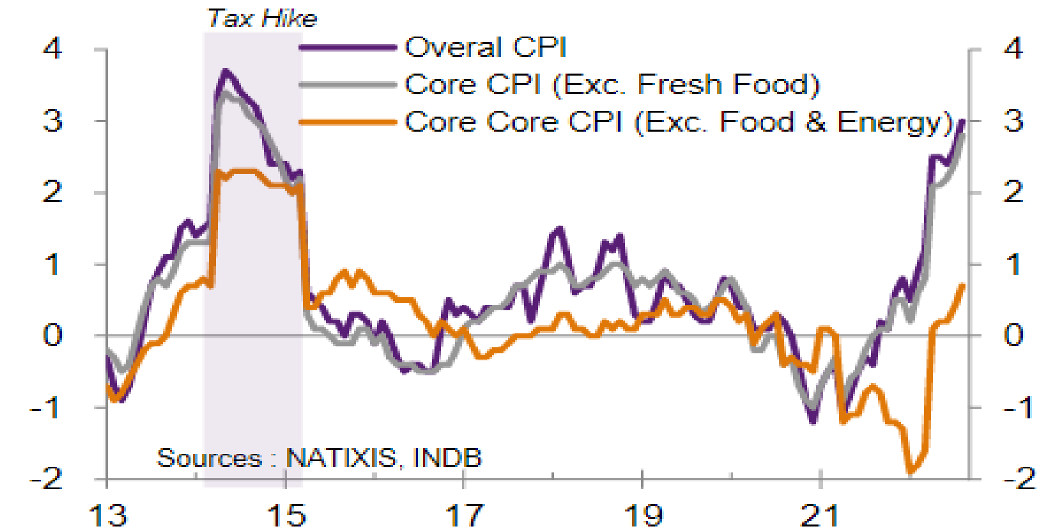
- Markets challenged the UK's massive fiscal easing package, which was to be entirely financed by additional bills and bond issuance, even as the BoE was starting to sell gilts. Scrapping the tax cut for top earners is a step in the right direction, but more will be needed to get to a credible medium-term path. On 23 September, Chancellor Kwasi Kwarteng announced an ambitious Package of around 7% of GDP (or more than GBP200bn) over the next two years to fight the energy crisis.
- The package included GBP45bn of tax cuts, expected to be funded by additional borrowing, and represents the biggest fiscal easing since 1972, GBP15bn larger than expected. It is equivalent to more than 50% of the total Covid-19 package and should push public debt to 103% of GDP in 2023, from 96% in 2022, creating a budget deficit of -7% of GDP. The announcement of the fiscal stimulus when the UK already has a sizeable current account deficit, and when the Bank of England was set to start quantitative tightening, triggered a crisis of confidence in the markets.
- The pound plunged against the US dollar on 23 September (-3.5%), reaching its lowest level since 1985. While the BoE's recent announcement of engagement in targeted QE purchases of long-dated gilts has given some relief to the markets, the effect will certainly be short-lived as the reasons of the sell-off have not been fully addressed.
- The U-turn in the tax cuts for higher incomes has given some breathing space to the currency, but there is still a long way to go to recover fiscal and government credibility. After all, this part of the package costs the least and doubts about the financing of the fiscal deficit have yet to be clarified.

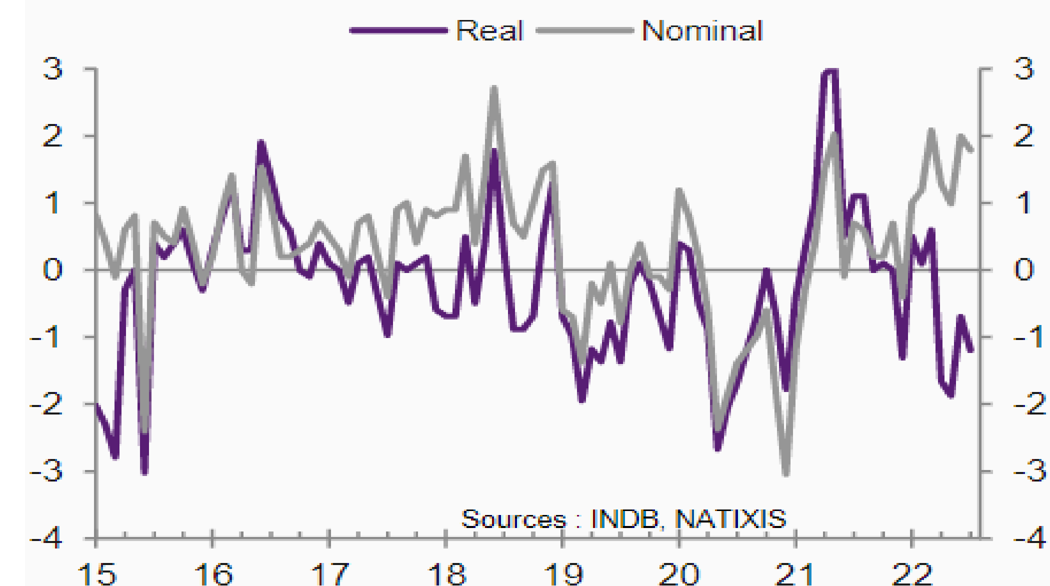
UK : Misery Mounts -2/2

- The gilt crash in the UK was not a repeat of the Eurozone sovereign debt crisis, but rather a liquidity-induced market accident that put financial stability at risk.
- As credit-default swaps for the UK did not follow the surge in sovereign yields, liquidity risk caused the movement in gilts, rather than credit risk.
- It was also not a financial dominance conflict between central banks and markets as the Bank of England acted as a backstop for and not against markets.
- In view of the high risk to financial stability will make more central banks likely to exert upward pressure on short-term rates while keeping long-term rates under control.

Japan : Different Dynamics

- Japan has long been struggling with deflation.
- Since 1994, core consumer prices inflation has largely remained below +1.0%, excluding the effects of consumption tax hikes.
- In 2013, Primer Minister Abe's main economic strategy, encapsulated in the three-arrow of Abenomics, was to raise inflation to 2%.
- Global inflationary pressures have finally pushed Japan's inflation beyond the Bank of Japan's 2% target. In fact, the nationwide core CPI increased by +2.8% y/y in August and the early indicator for the Tokyo core CPI points to further rise by expanding from +2.6% y/y in August from +2.8% y/y in September.
- However Japanese wages have remained stagnant, so that Japanese real wages have come down quite aggressively even when compared with the US.
- Hence Japanese inflation seems different in nature than that of the US or Europe in as far as it hits households' income aggressively due to a very weak Yen and stagnant wages. One could argue that such inflation is deflationary in nature.





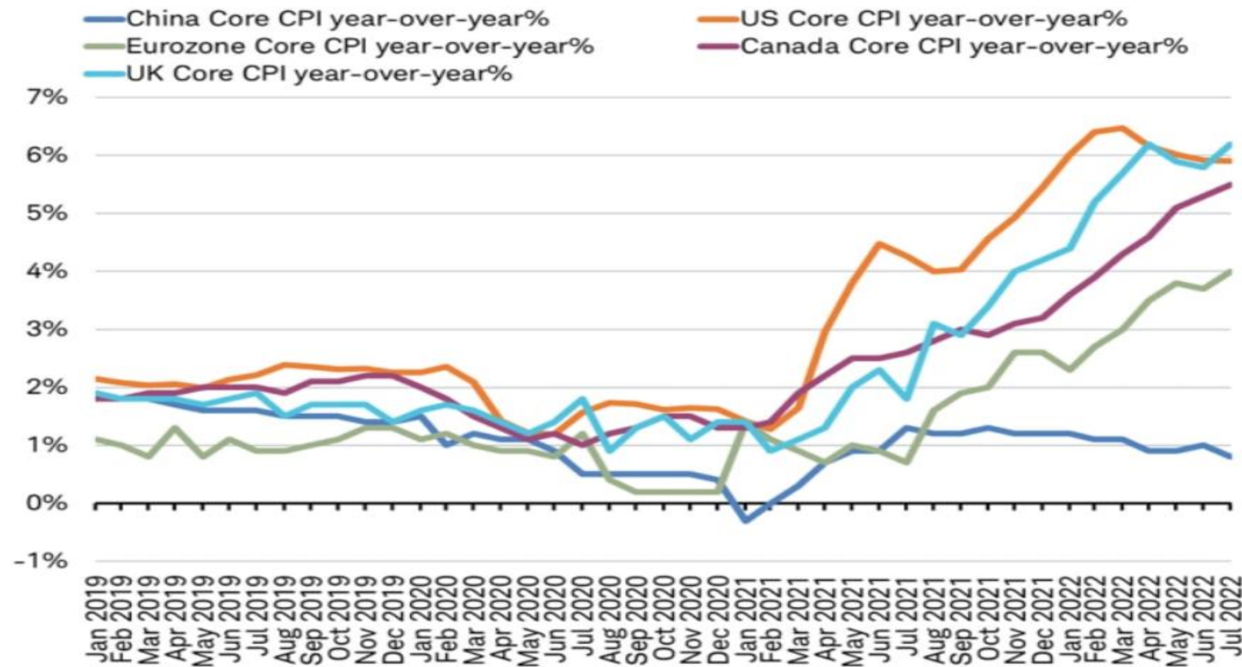
China : Its not Lehman moment - 1/2

- In August 2020, the Chinese government began a deleveraging campaign for property developers, called the "three red lines." To help control home prices, it reduced credit to the property sector in an effort to ensure a more stable financial system.
- This created a liquidity squeeze on some property developers, who fell behind on project completion.
- The COVID-19 lockdowns and restrictions from March through May contributed to a standstill in the property market, particularly for new sales, since consumers' mobility was hindered and construction activity was impeded.
- In response, China's policy makers have put forth efforts to get developers the funds they need to restart construction. Latest reports indicate the PBOC and finance ministry have instructed policy banks to lend up to 200 billion yuan ($29.3 billion) to ensure previously sold homes are finished, according to people familiar with the matter.
- While China's economy and stock market could remain volatile, there are no signs that a housing or Lehman-type crisis is imminent.

China : Its not Lehman moment -2/2

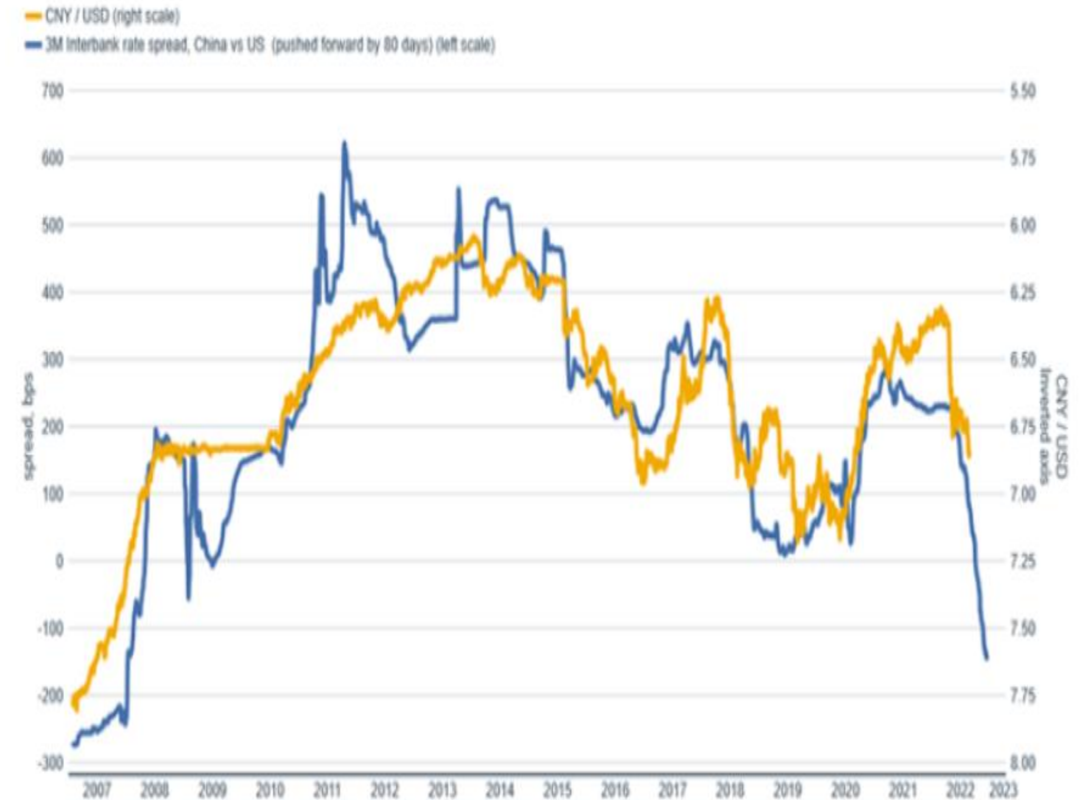
- There are a few key differences compared to what happened with Lehman:
  - Leverage – In China, there are no zero-down payment "NINJA" loans (no income, no job applicant) that were popular in the U.S. in the lead up to the housing crisis. Rather, a down payment of at least 30% for first-time buyers had been the standard in China until earlier this year. This up-front cash was the largest source of funding for Chinese property developers, even though delivery of units wouldn't be made until one to three years later.
  - Small share of market affected - Estimates by Bloomberg Intelligence indicate only about 4% of pre-sold housing property has been stalled in the construction process due to a lack of funds by developers and the rising cost of materials.
  - Small impact to portfolios - Lenders who have reported indicate less than 0.01% of their residential mortgage portfolios have been impacted by the mortgage payment boycotts, according to Fitch Ratings.

Inflation in China is going in a different direction



- China is battling deflation, while the rest of the world battles inflation. Deflation and the continuation of weaker-than-expected economic growth are the country's main economic risks.
- Both core and services Consumer Price Inflation (CPI) are below 1%. Property prices are also in decline.
- China needs lower interest rates and a weaker currency to battle deflationary pressures which can depress spending and weaken the economy while worsening repayment burdens for borrowers. In contrast, the main problem for the U.S. is elevated inflation, requiring higher interest rates and a stronger currency.

Chinese yuan to depreciate further?



- A look at the spread between the U.S. and China's three-month interbank rates points to the potential for China's yuan to drop 10% against the U.S. dollar.
- While these actions may aid China's efforts against deflation, it could reignite tensions with the U.S. over currency moves in an environment of weakening export growth.

Indian Bond Markets :

- Bank loans rose 16.4% on year in the fortnight ended Sep 23, the highest year-on-year loan growth in nearly nine year
- Liquidity in the banking system is currently estimated to be in a surplus of over 742.15 bln rupees .The surplus has narrowed due to outflows on account of excise duty payment
- Short-term debt rates have risen in tandem with overnight borrowing costs in the money market. Overnight rates in the tri-party repo segment have climbed towards the RBI's marginal standing facility rate of 6.15%, which represents the upper bound of the central bank's policy rate corridor.
- The government's spending on its recent public welfare measures is likely to derail its budget targets even as a better-than-projected tax mop-up may partly absorb the hit.
- Factoring in the current trend in expenditure and revenue, the government's fiscal deficit in the current financial year ending March to overshoot the budgeted aim by over 1 trln rupees. (Union Budget pegged the government's fiscal deficit at 16.612 trln rupees, or at 6.4% of the GDP, for 2022-23).

Indian debt market indicators

Indicators	Oct 7	Previous week	Trend
Call rate	5.00%	5.50%	↓
3-month CP	6.70%	6.65%	↑
1-year CP	7.60%	7.33%	↑
3-month CD	6.42%	6.30%	↑
1-year CD	7.32%	7.13%	↑
3-year AAA	7.57%	7.50%	↑
5-year AAA	7.67%	7.60%	↑
1-year G-Sec*	6.78%	6.74%	↑
3-year G-Sec*	7.34%	7.23%	↑
5-year G-Sec*	7.40%	7.31%	↑
10-year G-Sec*	7.47%	7.39%	↑
Forex reserves	$ 532.66 billion (Sep 30)	$ 537.52 billion (Sep 23)	↓

*Weighted average yield

Source: CRISIL Fixed Income database, RBI

Equity Markets : Domestic Holds the key

- Even as foreign investors remained net sellers, domestic institutional investors kept on buying domestic equities in their hunt for lucrative long-term bets.
- It was this buying by domestic funds that helped Nifty 50 and Sensex outperform other emerging market indices in 2022 so far.
- In September, domestic mutual funds and insurance companies net bought Indian equities to the tune of about 186 bln rupees.
- The domestic negative real yields are easing and hence this supportive flow might decelerate going forward
- Range 16800-17200 is likely to hold for the week

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