SYFX Treasury Foundation

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Weekly Market Update

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V Thiagarajan

thyagoo@syfx.org

Global Macros : Turning Positive ?

- Following a period where the discussion was not about if there would be a recession but how long and how deep it would get, focus has now turned to recession not being seen and in fact could be a mild re-acceleration of global growth.
- The main reasons are
  - Economic data has not been quite as bad as feared,
  - China has reopened earlier and faster than expected and
  - Mild winter weather has pushed down gas and electricity prices.
- It is supported by an increase in global PMI for January, a decent rise in some of the most leading surveys in the euro area (Euro Sentix, ifo expectations) and a broad improvement of what is"growth tax", which is a summary of the change in financial conditions and energy prices.
- Order-inventory balances have also turned higher in US, the Euro area and China. Hence, after a year with heavy clouds over the global economy, there have been some rays of light. The change in sentiment has underpinned a rally in equity and credit market since October with emerging markets and euro risk assets taking the lead.

Risk to the Narrative : Hawkish Central Banks

- The flip side is, though, that central banks will have to err on the hawkish side for longer.
- We did indeed see more signals over the past week from both the ECB and the Fed that more rate hikes will be needed to get inflation down - and keep it down. It led to a rebound in bond yields and in the middle of the week caused some headwinds to risk assets and metal prices.
- Last week saw another round of rate hikes from global central banks.
  - Reserve Bank of Australia (RBA) got the ball rolling with a 25 bps policy rate hike, to 3.35%. Given hawkish comments, we expect the RBA to follow up with 25 bps hikes in both March and April.
  - Sweden's central bank hiked rates 50 bps and signaled a further increase in the spring, while adding it would also start selling bonds to shrink its balance sheet at a faster pace.
  - Mexico's central bank surprised with a larger-than-forecast 50 bps policy rate hike to 11.00%, while the Reserve Bank of India also raised interest rates this week.

Risk to the Narrative : Depleting Savings

- Households’ pandemic savings are still large in both Europe and the US.
- These excess savings relative to consumption are largest in the UK and Spain at around 20-25%. In the US and Germany, however, they stand at less than 8%.
- The US stock of excess savings has been depleting fast with the reopening and the inflation surge: these savings could be fully depleted after the summer this year.
- In Europe, excess savings have not been spent as much as in the US, mostly because of the uneven distribution (the bottom 40% of households has virtually no excess savings while the top 20% has some form of extra savings between EUR 14,000 in Germany and EUR 33,000 in Spain) but also because they are mostly held in illiquid assets such as real estate.
- Recession fears, sticky high prices, and rising interest rates – as well as social protection reforms – mean that savings intentions are elevated in Europe, and even rising in Germany. Consumer spending will be the weak link in 2023.

US Economy : Light week

- Beyond Powell's interview on Tuesday, it was a light week for economic data.
- Powell's remarks largely reiterated the comments he made at the FOMC's post-meeting conference on February 1. FOMC to press ahead with 25 bps rate hikes at each of its next two meetings, although the exact amount of additional tightening is uncertain as the FOMC turns toward data dependency mode. Wherever the Fed funds target range peaks, the Committee may not begin easing policy until late 2024.
- Revolving consumer credit increased at its slowest pace since 2021 in December and year-ahead consumer inflation expectations jumped to 4.2% in February.
- U.S. trade deficit widened to $67.4 billion at the end of last year. Imports increased 1.3% over the month and exports declined 0.9%. Trade flows have been volatile on a monthly basis, but the deficit broadly narrowed over the course of last year, ending the year $20 billion smaller than it was in January 2022.
- Moderating economic growth abroad will likely continue to weigh on exports this year, while softening capex and consumer spending are set to be a drag on import growth.

… followed by Heavy week

- This week’s economic calendar will be far more robust and likely to garner heightened attention along with a Q4 earnings season that will continue in earnest.
- Markets will get the complete January inflation picture through the Consumer Price Index ,the Producer Price Index and the Import Price Index.
- Housing, with the NAHB Housing Market Index and housing starts and building permits joining the weekly read on MBA Mortgage Applications. Reads on business activity will come via Fed's industrial production and capacity utilization report, as well as the Empire Manufacturing Index and the Philadelphia Fed Index.
- Meanwhile, January retail sales, initial jobless claims for the week ended February 11, January's Leading Economic Index and business inventories are also slated for release.
- Fedspeak will again be heavy and likely to garner some attention as the markets continue to assess the Fed's recent policy moves and what the future may hold.

Global data : Mixed

- Last week's news on international economic activity were mildly mixed in tone. In the United Kingdom, Q4 GDP was flat on the quarter, unable to recover after a 0.2% quarter-over-quarter fall in Q3.
- The details within the report were mildly more encouraging as consumer spending eked out 0.1% gain and business investment rose 4.8%, though fall in exports and rise in imports ensured there was no growth in overall GDP in Q4.
- Separate from the quarterly figures, monthly data also suggested some loss of momentum as the quarter progressed. December GDP declined 0.5% month-over-month, a larger-than-forecast decline, as services activity dropped 0.8% and industrial output rose 0.3%.
- While the sharp drop in energy prices in recent months should make the U.K. economic contraction less severe than previously anticipated, we still expect some further decline in U.K. activity during the first half of this year.
- There was only a smattering of news from the Eurozone, but some of the more noteworthy data from that region were also soft in tone. Eurozone Dec retail sales fell 2.7% month-over-month, while German December industrial output fell 3.1% month-over-month.
- Finally, and in contrast to Europe, Canada delivered another blockbuster labour market report in January. Employment rose by 150,000 in January, even stronger than the 69,200 gain in December. The details showed a 121,100 gain in full-time jobs and a 28,900 gain in part-time jobs, while the unemployment rate held steady at 5.0%.

Innovation – Is this a gamechanger ?

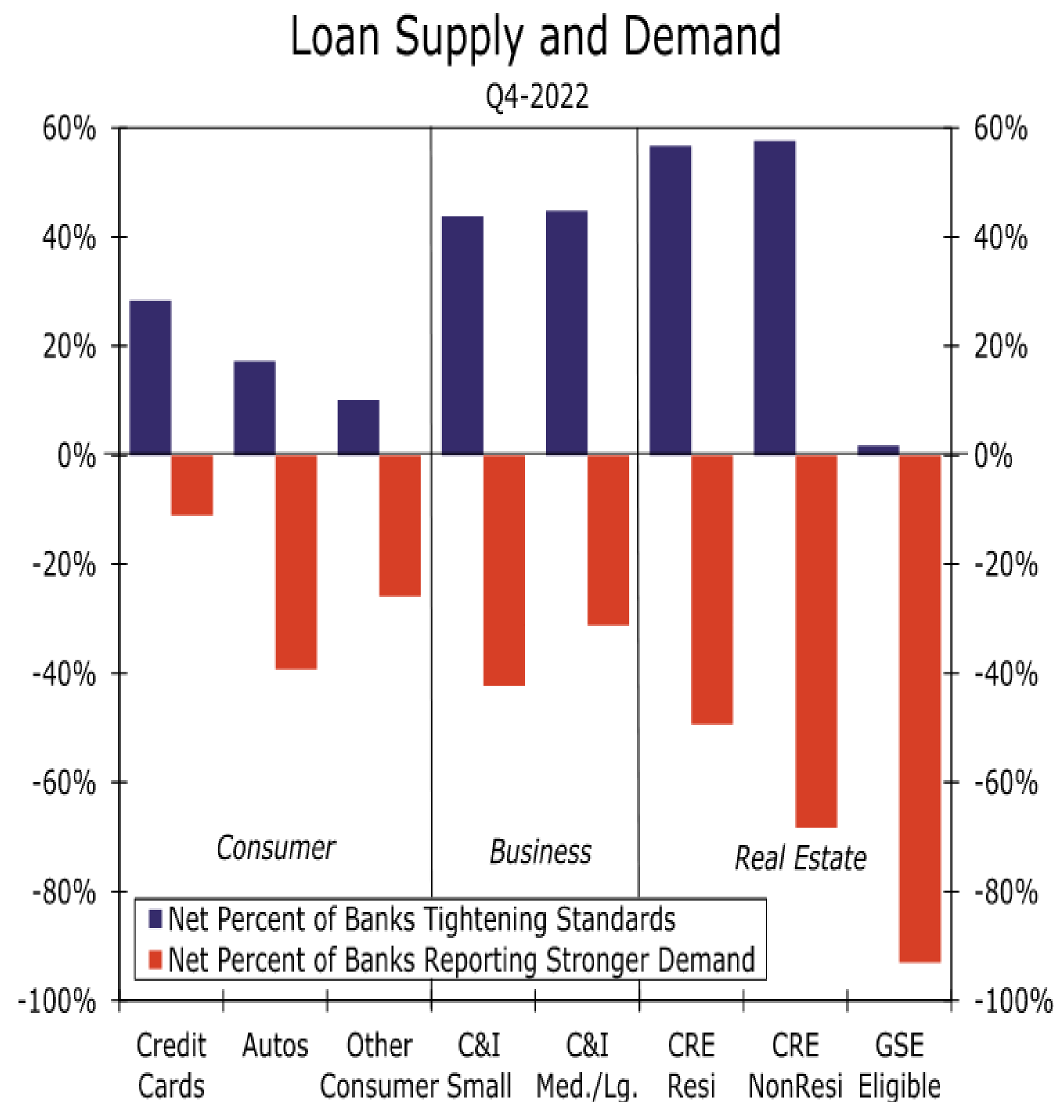
- This past week we also saw artificial intelligence (AI) and innovation once again make the headlines.
- Tech giants like Microsoft and Google both unveiled AI-powered search engines that featured enhancements to traditional search, including shorter, more concise results, higher efficiency, and even more humanlike interactions.
- The Microsoft-backed ChatGPT has already added 100 million active users, just two months into its launch, making it the fastest-growing app in history.
- More broadly, while there will be winners and losers as new technologies develop, the open-market competition between highly skilled tech players could lead to innovations that benefit all consumers.
- Particularly in U.S., which is home to an outsized number of large technology firms, more innovation can ultimately lead to higher productivity, which supports better potential economic growth rates over time.

Equity Markets : Struggling Earnings

- About 70% of companies in the S&P 500 have reported fourth-quarter earnings, and results have been mixed at best. Of these companies, about 70% have had positive earnings surprises, well below the five-year average of 77%.
- Earnings for the fourth quarter are expected to fall by 5.0% year-over-year, the first negative earnings quarter since 2020. The expectations for the next two quarters have also come down, with forecasts now calling for -5.1% growth in the first quarter of 2023, and -3.1% growth in the second quarter.
- This would imply three quarters of back-to-back negative earnings growth and full-year growth expectation of just 2.4%.
- While some of this may be due to companies resetting expectations lower, U.S. earnings will likely soften in the months ahead, which may also signal a broader economic cooling.
- Equity valuations have also been climbing this year, with the S&P 500 now trading at above-average forward price-to-earnings ratios. Markets may not be able to power ahead in this backdrop, although they could find firmer footing if they sense a bottom in earnings revisions ahead.

Credit metrics

- The latest Senior Loan Officer Opinion Survey (SLOOS) from the Fed sheds light on how banks and consumers are responding to a near year-long bout of interest rate hikes aimed at pumping the breaks on borrowing in a high inflationary environment.
- These responses are emblematic of the broader effects of monetary tightening beginning to take hold. Rising financing costs and tightening credit conditions squeezed business investment in the fourth quarter.
- Notably, 100% of banks that tightened C&I lending standards cited an uncertain economic outlook as an important motivation and over 70% expressed a lower risk tolerance.
- From Q3 to Q4, the net percentage of banks registering weaker loan demand from small businesses nearly doubled from 21.9% in Q3 to 42.2% in Q4
- . Demand deterioration was even worse among larger businesses, more than tripling to a net 31.3% from 8.8%.



China : Housing is what matters -1/2

- China’s housing sector has been contributing more than even external exports since GFC 2008 .
- A huge investment binge in infrastructure and real estate resulted in a policy push away from external product demand. Housing prices consequently shot up at the speed of light. China’s well-known high saving ratio, together with capital controls, have been instrumental in channeling funds to finance the real estate bubble.
- Chinese households invested up to 80 % of their wealth into real estate, and many bought up to several property units, depending on their ability to do so. Chinese households’ savings and wealth became intertwined more and more with a bloated real estate sector which was four times as big – in terms of developers’ assets – as anywhere else in the world
- Chinese regulators began to react to the ever-increasing housing prices and the related deterioration of housing affordability and income distribution. Mortgage boycotts emerged in the first half of 2022 as a direct consequence of households having deployed their savings for large down-payments on projects that developers with payment difficulties had not managed to complete

China : Housing is what matters -2/2

- It goes without saying that the structural weaknesses of China's real estate sector remain in place.
- Households are likely to remain wary of this and will probably not invest money as easily as in the past.
- This means that housing transactions will probably never recover to previous levels.
- Still, such lifting of regulatory pressure should offer some support for the sector in 2023, attracting speculative investors for the sector.
- The consequence of all of this, though, is that there will be more leverage to clean up eventually.
- It is not reopen momentum that matters – Its housing sector that matters for China

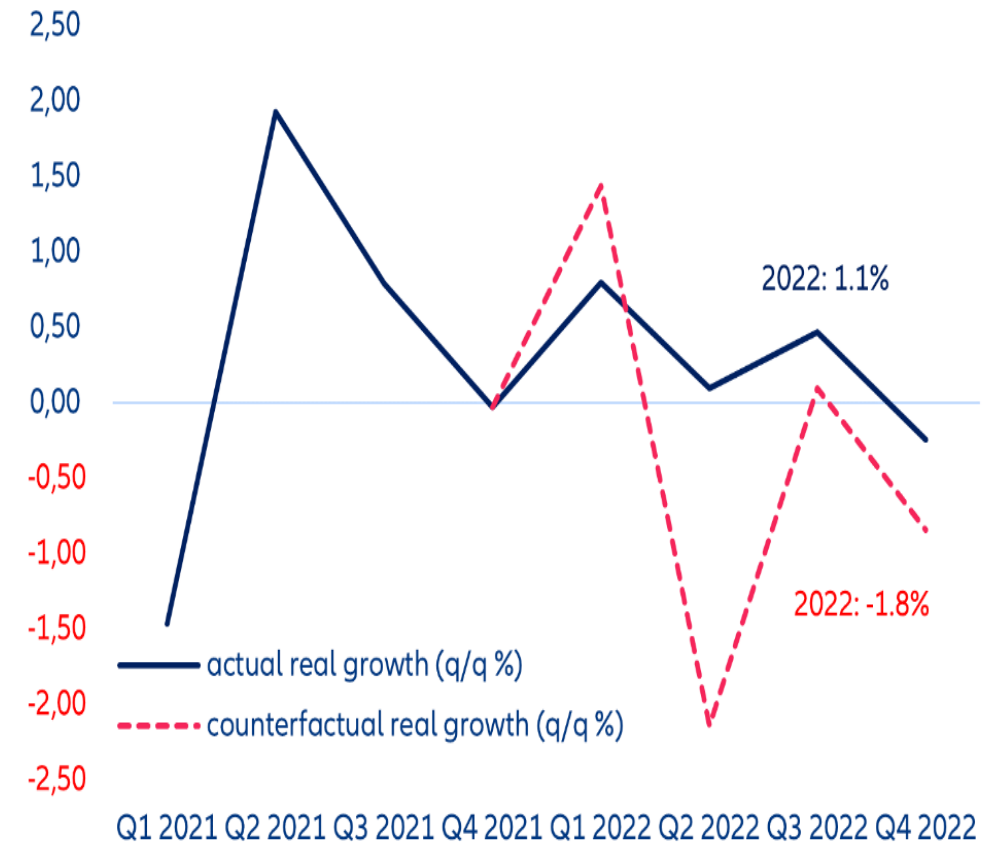
Europe : Fiscal push -1/2

- Earlier this year European leaders were quick to trumpet that there will be no recession, but the growth outlook is very much influenced by the scale of fiscal support.
- Governments have underwritten an increasingly expensive fiscal put option on real activity. Households and firms have simply become accustomed to being protected against the adverse impact of economic shocks, especially if they are (at least in part) induced by policy choices that have raised the cost of living and production — whether these are containment measures (constraining supply chains) or sanctions on energy imports from Russia (raising gas and oil prices).
- As corporate margins compress and real household incomes deteriorate, most of the current measures have been extended into Q1 2023 for a total of more than 3% of GDP on average, which is about half the size of the Covid-19 packages.
- With the energy crisis – and in turn the inflation hit to the private sector – not yet past the peak, EU governments to delay meaningful fiscal adjustment to next year.

Europe : Fiscal push -2/2

- Last year, in Germany, government spending lifted growth by 2.9pps from -1.8% to 1.1% after considering the second-order impacts on consumption and investment.
- Going forward, for the four largest Eurozone economies, government spending will contribute up to 40% to growth on average over the next two years – which is significantly above the long-term average of 22%
- While available fiscal support will soften the blow on demand, it can only partially compensate for the impact of the energy crisis. Consumption and investment plummeted during Q4 2022, suggesting that still-low business confidence and consumer sentiment are likely to delay the rotation back to private demand.
- Overall growth remains weak and it will be difficult for most countries to close the output gap over the near term. We still expect most of the large Eurozone economies to slip into recession during the first half of this year, followed by a shallow recovery next year

Germany: Real growth (2022, q/q %)



Europe : Its Geo Political risks that count -1/2

- In Europe, the realization is slowly dawning that the functioning of the economy is increasingly determined by geopolitical decisions, which often stand in stark contrast to the ideal of apolitical free trade .
- There is a risk that Europe will not be able to secure strategic autonomy on all fronts in the harsh reality of geopolitics, as we recently saw in the energy sector.
- Three conflated crises: 1) Europe's energy crisis; 2) a potential European 'twin deficits' balance of payments crisis; and 3) the balance of geopolitical power crisis behind them both.
- This development may be accompanied by a loss of European competitiveness, a sharp deterioration of the balance of payments and public finances, and ultimately even lead to partial deindustrialization, as part of the European industrial sector disappears or moves, for example, to the US.
- Risk of structurally higher input costs, reduced export opportunities, lower wage developments, and a balance of payments crisis with less room for fiscal and monetary easing.

Europe : Its Geo Political risks that count -2/2

- Warmer weather is literally seeing things look sunnier in Europe than a few months ago. However, luck and/or climate crisis is hardly the basis for sound policy - or economic modelling. Traditional economic models assume there is an easy way out of the mess described above: a lower exchange rate results in exports picking up relative to imports, allowing a differently structured economy to return back to near-trend growth
- In short, the tight European or UK labour market is presumed to result in workers simply shifting from the shrinking industrial sector to the growing services and export sectors, so both employment and the economy rebalance. Under the recent crisis, however, there is reason to question those assumptions.
- Importantly, these conventional models overlook the negative impact that a sudden, large-scale structural erosion of the manufacturing base have on the balance of payments and macro stability.
- This is where need to turn to the balance of power behind the balance of payments: is it cyclical, or permanently geopolitical?
- Can the economy push back against it in that dimension - There are clear examples of this not happening: self-inflicted, yes, but the post-Brexit UK has failed to see any gain in its net export performance despite a far lower nominal and real exchange-rate post-Brexit

RBI : Its not the final one

- RBI has been justifying that its present policy is an accommodative one, based on the premise that the real policy right now, as measured by repo rate minus the average inflation rate for the year ahead, is lower than pre-pandemic levels. By this metric, the real rate now stands at around 0.9%, as against around 1.9% before the pandemic.
- The journey from a CPI inflation print of 7.79% in April to a 12-month low of 5.72% in December was a painless one, aided by base effect, moderation in global crude oil prices, and a fall in domestic food prices. But from this point, an incremental fall in headline inflation is difficult unless the sticky and stubborn core inflation gives way. If core inflation remains stuck near 6%, a level from which it has not budged for little less than two years, one cannot expect the headline print to durably fall to 4%.
- Now, the only tool that works on core inflation is monetary policy and that too by curbing demand. So, a further fall in inflation would necessarily be at the cost of growth.
- RBI's Monetary Policy Committee, which decides on interest rates, voted five-one in favour of a 35-bps rate hike in December, and four-two for the rate hike on Wednesday, as the dissent from external members increased. Minutes of the last few meetings had showed RBI members leaning towards hawkishness and external members increasingly worried about hurting growth.
- The pattern is not surprising, considering that financial stability does not figure in the MPC's mandate, but is a key responsibility for the central bank. The dissent within the MPC will make it increasingly difficult for the RBI to push ahead with rate hikes.

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