Market comments 13 Oct 2022

USD may continue to rise, the discussion of "depreciation pressure" on the USD, and USD/JPY may towards 150

1. US economic fundamentals are "strong" and may support the dollar to continue to rise.

Data released in the past two weeks showed that the US manufacturing and non-manufacturing industries remained strong. In September, the US Institute for Supply Management (ISM) non-manufacturing employment index recorded 53.0%, higher than the previous value of 50.2%. The United States September ISM non-manufacturing new orders index recorded 60.6%, the previous value was 61.8%. US Markit Manufacturing Purchasing Managers' Index (PMI) registered 52.0%, and the previous value was 51.8%. The US ISM Manufacturing Purchasing Managers' index recorded 50.9% in September and 52.8% in August. US manufacturing PMI has remained strong above 50% (52.6%-64.7%) for over two years (since July 2020). The US ISM Non-Manufacturing PMI recorded 56.7% in September, compared to 56.9% in August, and indeed for the last two years (since July 2020), the US Non-Manufacturing PMI has remained strong above 50% (55.3%-69.1%), which indicates that the US economy is improving. The US unemployment rate was 3.5% in September, 3.7% in August. Since this year, it has been maintained below 4%, which is also near the lower level in the past 50 years. These generally positive economic data are the backbone of the Federal Reserve's courage to raise interest rates sharply. Inflationary pressure in the United States is still there. The Fed may continue to raise interest rates aggressively. The continued strength of the US dollar may continue to be an event with high probability.

The US non-farm payroll data for September was "healthy", supporting expectations of a 75 basis point rate hike by the Federal Reserve in November. Last Friday (7 October) evening, the US non-farm payrolls in September recorded 263,000, slightly better than the expected 250,000, and August was 315,000. At the same time, it was announced that the US unemployment rate was recorded at 3.5% in September, lower than the expected 3.7% and 3.7 % in August. The unemployment rate remains at its lowest in the past 50 years, reflecting a stable and moderately growing US job market. After the data was released, the US dollar got a boost, non-US currencies started to fall to varying degrees, and gold fell below US$1,700 an ounce again. According to federal funds futures data, the chances of the Fed raising interest rates by 75 basis points in November increased to 96% after the release of the September US non-farm payrolls data report, compared to the previously expected 87.8% chance. Underpinned by solid employment figures, even if the US September CPI data released tomorrow night (13 October) is lower than expected, it may not shift the market's bets on the Fed's determination to "aggressively raise interest rates to control inflation".

<u>The US dollar index has been "depreciating before rising" in the past two weeks, which corresponds to the decline of US stocks, gold and crude oil last week.</u> After the US dollar index depreciated to 109.90, it started to rebound and rise, and it is currently consolidating around 113.15. The rebound and rise of the US dollar index correspond to the decline of non-US currencies, the decline of US stocks, crude oil, gold and bitcoin. Since the beginning of 2022, the three major US stock indices, the Dow Jones, the S&P 500 and the Nasdaq, have fallen for three consecutive quarters. Among them, In Dow Jones was down for three consecutive quarters for the first time since 2015, and the S&P 500 and Nasdaq were down for three consecutive quarters for the first time since 2009, highlighting the strength of this round of dollar rally.

- EURUSD fell 300 pips (from 1.0000 to 0.9700), or 3.00%
- GBPUSD fell 580 pips (from 1.1500 to 1.0920), or 5.04%
- AUDUSD fell 320 pips (from 0.6550 to 0.6230), or 4.89%
- NZDUSD fell 260 pips (from 0.5810 to 0.5550), or 4.48%
- USDJPY rose 340 pips (from 143.50 to 146.90) , or 2.37%
- USDCHF rose 240 pips (from 0.9780 to 1.0020) , or 2.45%
- USDCAD rose 350 pips (from 1.3500 to 1.3850), or 2.59%
- USDCNH rose 1880 pips (from 7.0120 to 7.2000), or 2.68%

The fall in the three major US stock indices and the rise in the US dollar index "echoed" each other.

- The Dow fell 1,550 pips (from 30430 to 28880), or 5.09%
- The S&P 500 fell 230 pips (from 3800 to 3570), or 6.05%
- The Nasdaq fell 920 pips (from 11670 to 10750), or 7.88%

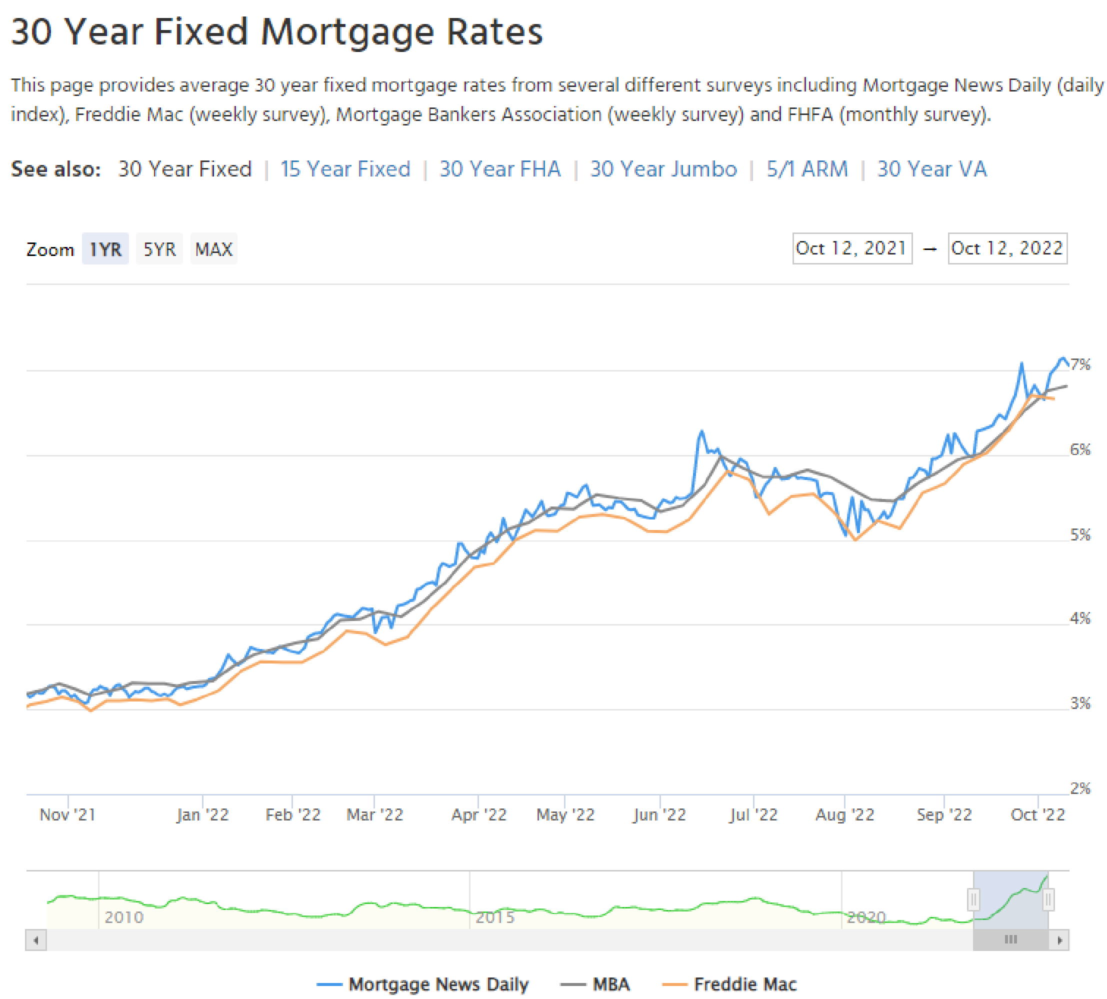
At the same time, the Asia-Pacific stock market, crude oil, gold and Bitcoin also started to decline in different degrees in response to the rise of the US dollar.

- CHINA50 fell 1170 pips (from 13470 to 12300), or 8.69%
- CHINAH fell 670 pips (from 6250 to 5580), or 10.72%
- HK50 fell 1760 pips (from 18170 to 16410), or 9.69%
- TWIX fell 45 pips (from 535 to 490), or 8.41%
- JP225 stock index fell 1100 pips (from 27400 to 26300), or 4.02%
- AUS200 fell 230 pips (from 6790 to 6560), or 3.39%
- Bitcoin fell 1,600 pips (from 20450 to 18850), or 7.82%
- WTI fell 580 pips (from 93.80 to 88.00), or 6.18%
- Brent oil fell 620 pips (from 99.70 to 93.50), or 6.22%
- Gold fell US$ 68 per ounce (from 1729.00 to 1661.00), or 3.93%.

2. Discussion on the "depreciation" pressure of the dollar.

① US recession risk and global slowdown and recession risk

<u>The US 10Y Treasury bond yield has exceeded 4% twice recently, driving mortgage rates soaring</u>. US 10Y Treasury yields have climbed nearly 250 basis points since the start of the year. As the "anchor for global asset pricing", the US 10Y Treasury bond yield is a significant benchmark interest rate for most borrowing costs. When the US 10Y Treasury bond yield rises, the interest rates of assets worldwide will increase. This spike in this rate may cause dramatic fluctuations in the financial markets. Bear the brunt, it has driven a rapid rise in mortgage rates. According to data from the mortgage website “Mortgage News Daily”, the average 30 Year fixed mortgage rate in the United States exceeded 6%, and reached a peak of 7.08% on 27 September, also the highest level in the past 20 years. The soaring mortgage rates in the United States have also driven up mortgage rates in developed countries that closely follow the United States. The pressure on the general public to pay mortgages may also limit the contraction in the buying and selling of real estate markets to the detriment of economic recovery in various countries and also provide some impetus to the depreciation of the US dollar.



Source: mortgagenewsdaily.com

<u>The US 10Y/2Y Treasury bond yield has been "inverted" since July 2022, indicating that the risk of an economic recession is still there.</u>

The US 10Y/2Y Treasury yield curve is inverted, often seen as the famous "contrarian indicator" that precedes recessions. The yield of 10Y US treasury bonds is regarded as the "anchor" of global asset pricing, which represents the long-term bond yield and reflects the future economic conditions of the United States. Because of its long-term uncertainty, long-term bonds usually have lower prices and higher yields. The 2Y US Treasury bond yield, which is a short-term bond, reflects the market's expectations for the Fed's trend and generally is relatively consistent with the expected trend of interest rates, that is, the same rate as the Fed's rate hike.

For example, if the Fed raises rates to 4.6% this round, the 2Y Treasury yield will fall to 4.6% finally. Short-term bonds are generally less risky and relatively expensive, with relatively low yields. Therefore, the US 2Y Treasury bond yield must be lower than the US 10Y bond yield under normal circumstances. Investors are pessimistic about the future economy when the US 10Y Treasury yield is lower than the 2Y Treasury yield. Former Boston Fed President Rosengren's view: "There are upside risks to the Fed's 4.6% peak interest rate expectation, and the US economy so far looks more resilient than he might have expected in light of the rate hikes already in place." That said, the top of the Fed's next round of rate hikes may not stop at 4.6%.

In fact, large banks, large securities companies and various fund companies of governments worldwide are involved in buying and selling US Treasury bonds. It is common for the funds to be traded to be tens of billions of dollars, so its impact is self-evident. Historically, every time there has been an inversion (a negative value) of the US 10Y Treasury yield minus the US 2Y Treasury yield, a recession in the US economy has occurred afterwards. As of 13 October, the yield on the 10Y US Treasury bond is around 3.92%, and the yield on the US 2Y Treasury bond is 4.31%, which 39 basis points have inverted. That's worse than the "inversion" in US Treasury yields that occurred before the recession triggered by the 2008 financial crisis.

② IMF recently cut its global economic growth forecast

In its World Economic Outlook report released on Tuesday (11 October), the International Monetary Fund (IMF) maintained its forecast for global economic growth of 3.2% in 2022 but lowered its growth forecast for 2023 by a further 0.2 percentage points to 2.7%. There is expected to be a 25% chance that the global economic growth rate will fall below 2% next year. Most areas of the global economy are expected to fall into recession next year, with risks to financial stability tilted to the downside. The International Monetary Fund has cut growth forecasts for many economies in 2023, stressing that "the worst is yet to come". The IMF cut its GDP forecast for US economic growth to 1.6 % in 2022 and only 1.0% next year, with countries such as Germany and Italy expected to contract in 2023. It was also mentioned that China's real estate crisis is worsening, and there is a growing risk of spillover to banks, local governments and companies.

③ Financial systemic risks are under pressure, and Credit Suisse is embroiled in "bankruptcy rumours" that are undermining confidence in economies around the world.

Credit Suisse, the second-largest bank in Switzerland, has recently been reported to be on the verge of bankruptcy or the risk of becoming the next Lehman Brothers. Shares in Credit Suisse tumbled, plunging 20% in September alone. Credit Suisse has posted three consecutive quarters of losses, including, in the fourth quarter of 2021, a loss of CHF 1.6 billion. By 2022, in time for the Fed's interest rate hike, Credit Suisse posted a loss of CHF 273 million in the quarter of 2022. In the second quarter of 2022, Credit Suisse's loss widened to CHF 1.59 billion, which widened 482% sequentially. Relevant data show that as of the end of June this year, Credit Suisse’s high-quality liquid assets were about US$238 billion, while its leveraged risk exposure was US$873 billion. In other words, Credit Suisse's existing liquidity funds can no longer cover the risk exposure. This is also the reason why Credit Suisse has been rumored to be "bankrupt" recently. This is a heavy blow to the confidence in the economic recovery of entire Europe and the world. Whether Credit Suisse goes bust or not, there is no escaping the reality that it needs a lot of liquidity to plug the holes. This also reflects the "dollar shortage" mentioned in the author’s previous article, i.e., the tightening of dollar liquidity.

④ Downward pressure on the stock market

Analyzing the past 40 years since 1980, the 10Y US Treasury bond yield has fallen for more than 40 years, and the US stock market has also risen for more than 40 years. For a long time, the "investment logic" of many stock market investors is “buy on dips " and " hold long enough ", and there is a high probability that they may make a profit. Entering 2022, this "investment logic" may no longer be valid. Since the beginning of 2022, the three major US stock indices, the Dow Jones, the S&P 500 and the Nasdaq, have fallen for three consecutive quarters. Among them, Dow Jones was down for three consecutive quarters for the first time since 2015, and the S&P 500 and Nasdaq were down for three consecutive quarters for the first time since 2009. This year, the S&P 500 index has fallen by about 25.52% (from 4800 to 3570).

JPMorgan Chase CEO Jamie Dimon said recently (10 October) that "Europe is now in recession, and "very severe" negative factors could push the US economy into recession by the middle of next year. The S&P 500 index will likely continue to fall, and the decline could drop another 20% from current levels." Michael Wilson, Chief U.S. Equity Strategist and Chief Investment Officer for Morgan Stanley, said in the latest report, "The S&P 500 will fall to 3,000, and the P/E ratio will fall further to 13 times before US stocks bottom out, and the bear market ends. US economic data could fall flat on its face after the mid-term elections, and US stock companies abandoning their earnings forecasts for next year means the pain will continue.”

⑤ US Debt Crisis

On 3 October, the US Department of the Treasury announced that the size of the US federal government’s debt had exceeded US$31 trillion, dramatically exceeding the US GDP of US$23 trillion in 2021. The US Congress passed legislation in December 2021 to raise the debt ceiling to US$31.4 trillion. At present, the "debt ceiling" in the United States may face the risk of being breached again, and the "debt pressure" of the US government is enormous. The "debt ceiling" is the maximum amount of debt that the US Congress has set for the government to borrow to meet "incurred payment obligations", and once this red line is reached, it means that the borrowing authority of the US Treasury has been largely exhausted. Therefore, the "strong dollar" may be more challenging to maintain in the future, and the peak of this round of the dollar's rise may not be far away.

⑥ The US mid-term elections are approaching, which may have a certain impact on the dollar's rise.

Two years after President Biden took over the White House, the United States will hold mid-term elections on 8 November this year. Mid-term elections are held every four years and elect new members of Congress. Although not a presidential race, the results of these elections could significantly impact the remainder of the current president's term in office and the presidential election two years later.

3. Discussions on upside risks to the US dollar

① Safe-haven demand still supports USD strength.

The Crimean Bridge bombing on 8 October led to the collapse of part of the bridge. It increased investors' fears that the "Russia-Ukraine conflict" would descend into a protracted war, leading to an escalation. The gas leak from the Nord Stream-1 pipelines, caused by "man-made explosive damage", has sparked fears of an escalating energy crisis in Europe. Since the new Prime Minister of the United Kingdom, Liz Truss, came to power, there has been a suspicion of "monetary policy chaos". The "tax cut scare", the "pension risk", and the introduction of policy doubling the "Emergency Program" to £10 billion, the previous "continue to raise interest rates" policy continues. With the "interest rate hike" to tighten policy on the one hand and the significant release of liquidity easing on the other, market concerns may not be lifted soon. In addition, the planned "independence referendum" in Scotland in October next year has also increased the risk of the UK facing a "split".

② The war caused by the conflict between Russia and Ukraine may have the risk of escalating sharply into a "nuclear war" recently.

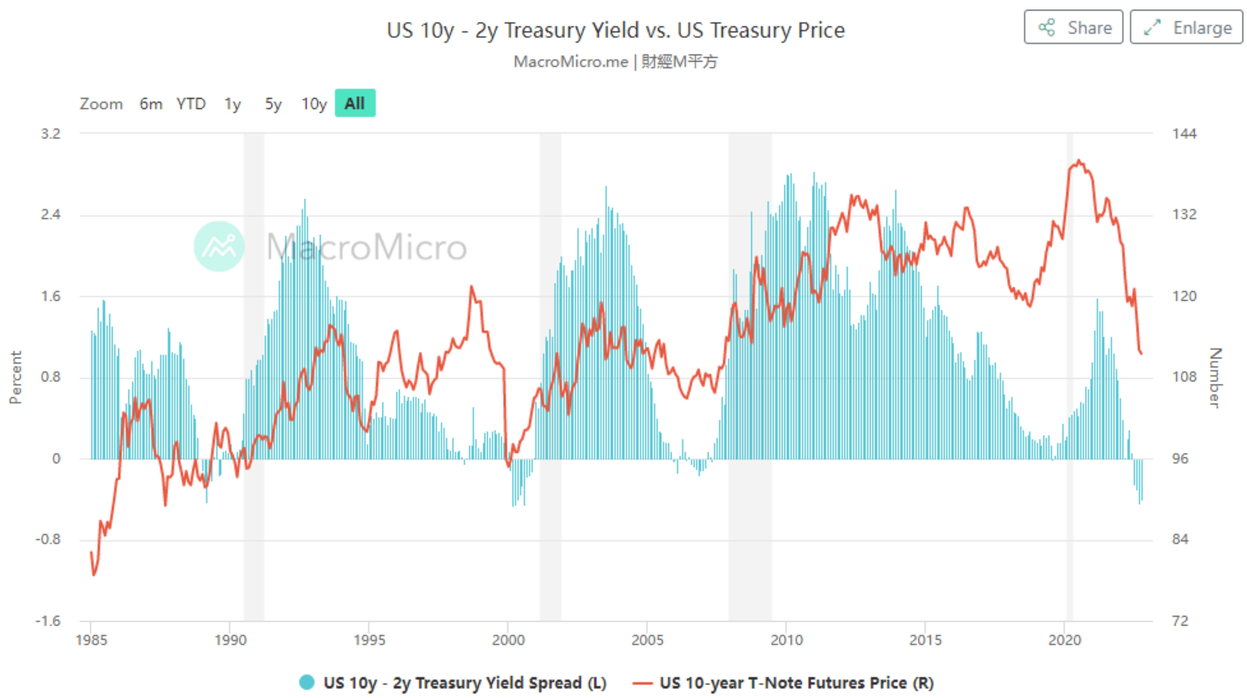
Biden warned of a "nuclear apocalypse" at a fundraiser on 6 October, saying that the situation could spiral out of control after the use of tactical nuclear weapons and "finally end up with Armageddon". "He’s not joking when he (Russian President Vladimir Putin) talks about the potential use of tactical nuclear weapons or biological or chemical weapons, Biden said.” We have not faced the prospect of Armageddon since Kennedy and the Cuban missile crisis." Biden's "nuclear apocalypse" comments have undoubtedly further fueled market concerns. Russian President Vladimir Putin also said on 21 September, "If the territorial integrity of our country is threatened, we will use all available means to protect our people. This is not a bluff!" His statement was interpreted to mean that Russia would not rule out the use of "nuclear weapons" to counter the ensuing military conflict.

③ Federal Reserve officials support "suppressing inflation", and supporting sharp interest rate hikes is the stance of most Fed officials.

Former Federal Reserve Chairman Ben Bernanke, who recently won the Nobel Prize in Economics, also supports sharp interest rate hikes, saying that "from a historical perspective, current interest rates are not high, pay attention to the risk of a surge in the dollar, and change the Fed's inflation target, undermining the target’s credibility". In addition, former US Treasury Secretary Summers said, “it’s important for the Federal Reserve to deliver on the further monetary tightening it has signaled, even in the face of financial risks stemming from its actions." Combined with the attitudes of many previous Fed officials and statements from heavy hitters such as Bernanke and Summers, I believe investors should not doubt the Fed's determination to continue to raise interest rates to fight inflation.

4. Treasuries may stage "The Return of the King".

US 10Y Treasury yields rose another 45 bps (from 3.55% to 4.00 %) to 4% and are now at 3.935 %; US 2Y Treasury yields rose 35 bps (from 4.00% to 4.35 %) to 4.35 %, currently at 4.315%. The yield on the US 10Y/2Y Treasury bond remains inverted by 39 basis points as market concerns about the risk of a US recession persist. Against tighter monetary policies in most countries around the world, increased expectations of a global economic slowdown and the still tense geopolitical situation due to the military conflict between Russia and Ukraine, the more defensive "bond investment" may become a relatively safe and stable investment choice. Since the beginning of this year, the yield of the 10Y US Treasury bond has risen sharply to 4.00% from 1.50% at the beginning of this year, and the yield of the US 2Y Treasury bond has risen sharply to 4.31 % from 0.75 % at the beginning of this year. US 5Y Treasury yields have risen sharply from 1.3% at the beginning of the year to a peak of 4.16%. The US 10Y Treasury yield, the anchor of global assets, has hit a high of around 4% twice recently (28 September and 11 October). Global asset interest rates have been at the highest level in the last decade or so. Interest rates and bond prices are inversely related, so bond prices are also at historically rare lows. If inflation peaks in the future, then the market interest rate is not far from the "top", which also means that there is a greater chance of "bonds rising". The strength of the US dollar may continue in the short term, and US dollar assets are expected to continue to be sought after. US government bonds are less risky and can more effectively resist recession risks. Investors trading with OANDA can focus on the next few years, it could be a good opportunity to invest in the medium-term US02Y T-Note, US05Y T-Note and US10Y T-Note (Symbols: USB02YUSD, USB05YUSD, USB10YUSD, respectively).



Source: MacroMicro

The blue bar in the figure shows the US 10Y-2Y Treasury yield spread, and the red line is the US 10Y T-notes futures price. From "the US 10Y-2Y Treasury yield spread", we can see the timing of investment in the bond market. When the long-term and short-term (10Y/2Y) government bond yields are inverted for too long, it indicates an increased risk of a US economic recession and a possible risk of a "financial crisis". So, when the situation improves or reverses, and when inflation tops out in the future, market rates are not far from the "top", meaning that the opportunity for "bonds to rise" may come.

5. USD/JPY breaks through 146 or looks towards 150.

The divergence between the Fed's fundamental monetary policy of "continuing aggressive rate hikes to control inflation" and the Bank of Japan's "continuing accommodative monetary policy" may support the dollar's rise against the yen. The continued depreciation of the yen has also forced the Japanese government to potentially move forward with "selling US bonds in exchange for dollar liquidity", and US bonds may continue to face pressure to sell off. As the BOJ continues to maintain an accommodative monetary policy, no change is expected until the end of Haruhiko Kuroda's term in March 2023. Unless the BOJ intervenes in the foreign exchange market again, continued weakness in the yen is inevitable in the short term as long as the dollar resumes its "strength". As of now (12 October), the USD/JPY has broken above the critical psychological level of 146, meaning that the BOJ's intervention, essentially, was ineffective.

<u>Minutes of the September meeting of the Federal Reserve Open Market Committee</u>

The US Federal Open Market Committee (FOMC) holds eight monetary policy meetings a year and publishes the minutes of its monetary policy committee three weeks after the Fed meeting. The minutes reveal the process of monetary policy decisions and the Fed's views on economic developments at home and abroad. The minutes of the September FOMC meeting, recently released last night, still reiterated that the current "rate hike and tightening" monetary policy should be maintained even if the unemployment rate rises, but at some point, the pace of rate hikes may be slowed. After the release of the minutes, the market reaction was muted.

Short term risk

Short-term risks: please focus on the release of the core CPI annual rate for September and the core CPI monthly rate for September of the US this Thursday evening (13 October), which is one of the most important measures of whether there is a "turning point" in the level of inflation. If the data is higher than expected, that will support the Fed's stance against inflation, and the stock market could sell off further. The data will strongly impact the movement of the US dollar and may make financial markets sharply higher or lower. It needs to be focused on.

At the same time, we need to pay attention to the 20th National Congress of the Chinese Communist Party, which starts this weekend. The 20th National Congress of the Chinese Communist Party will be held this Sunday (16 October) in Beijing. The conference is held every five years and is the most important forward-looking guidance of the Chinese government on economic development and people's livelihood planning for the next five years. The meeting will last for a week (16 October-22 October). It is expected to focus on optimizing the prevention and control policy on the "COVID-19 pandemic" (that is, whether to abandon the "Zero-COVID Policy"), which is the focus of the market and also the economic stimulus policies to support economic construction will be discussed. At the same time, it is widely expected that General Secretary Xi Jinping will break with tradition and may end the long-standing practice of "abolishing the life-long system of leadership positions for cadres" in order to seek a third term as "General Secretary", which would be of paramount importance to China's political stability. The conference is expected to attract the attention of the Chinese public as well as politicians worldwide who are "concerned about the world situation".

Sandy Wang,

11:50 am SGT time, 13 Oct 2022