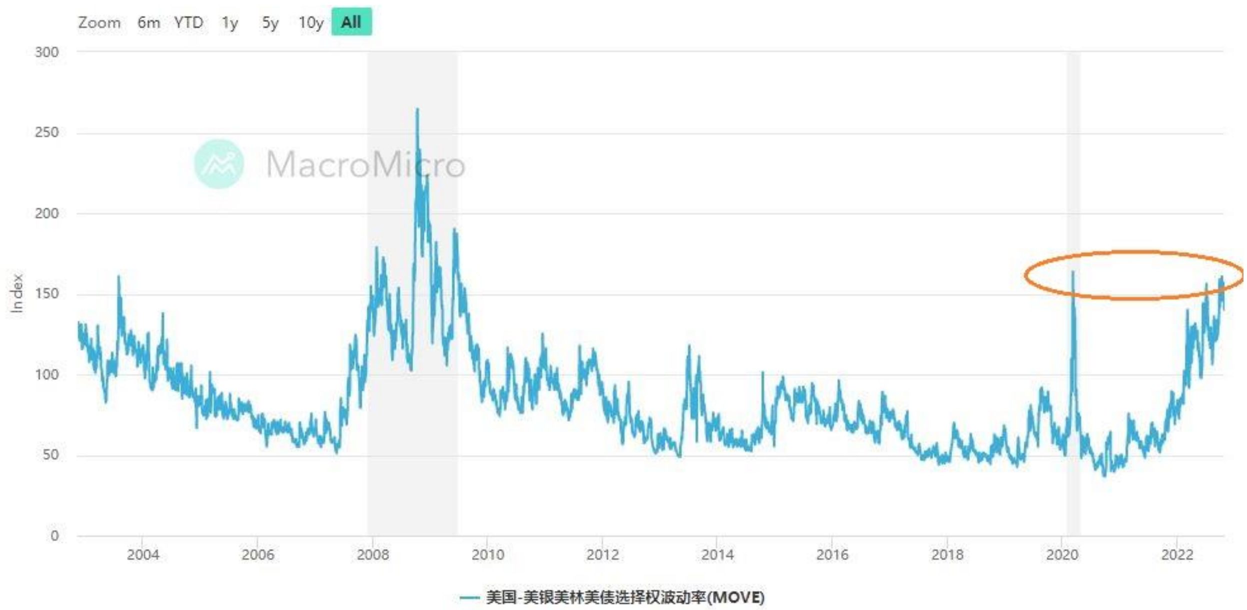
Market comments 02 Nov 2022

1. **"Fiscal QE" program will plan to buy back US Treasuries for the first time in 20 years, Fed may slow the pace of rate hikes.**

The US Treasury market is the equivalent of the "heartland" of global financial markets, and its liquidity is crucial. If there is a problem in the US Treasury market, the stock market, bond market, foreign exchange market and commodity market will all be affected, and a chain reaction will occur. In minor cases, a "stock market meltdown" will be triggered, as was the case at the beginning of the "COVID-19 pandemic" in March 2020, when international crude oil prices plummeted to US$15-20 per barrel and the US stock market experienced four meltdowns in eight consecutive trading days. In severe cases, this could lead to a financial crisis.

In October, MOVE, the indicator used to measure the liquidity of US Treasury bonds, has touched the level of the worst liquidity at the beginning of the "COVID-19 pandemic" around March 2020. US Treasury Secretary Yellen also recently (12 October) expressed concern about the US $24 trillion US Treasury market, " We are worried about a loss of adequate liquidity in the market, " and that "there could be a collapse in trading in the US Treasury market". And hinted that the US Treasury would take action, such as "repurchase US Treasuries", to maintain liquidity in the US Treasury market. As risks in the US Treasury market soar, the Fed may slow down market expectations of aggressive Fed rate hikes by the end of this year, which may drive a recovery in US Treasury bond prices, a fall in US Treasury bond yields, and a rally in risk assets. Investors need to pay close attention as the US Treasury will release details of the Treasury's "refinancing" this Wednesday at 8:30 am EST, just before the Federal Reserve's November interest rate meeting (FOMC meeting).



Source: MacroMicro, this indicator reflects the degree of volatility in US bond futures. It is considered to be an observable indicator of the term premium of US bonds (the long-short spread) and a key indicator used to measure the liquidity of US Treasuries.

The "Fiscal QE" is the "repurchase of US Treasuries", that is, the redemption of "outstanding debt", using new debt to exchange for older debt, releasing liquidity into the market and reducing financing costs. The last time this strategy was used was in 2000, over 20 years ago. At the moment, Wall Street, especially the "primary market makers" who hold a lot of "old treasury bonds" such as Goldman Sachs, Morgan Stanley and JPMorgan Chase, are looking forward to a "fiscal QE". The interconnectedness of global financial markets is actually very strong after years of "globalization", and many small problems in financial markets can trigger a "domino effect". Anything that goes wrong in the overseas dollar market, in any area, could eventually lead to the "heartland" of the US Treasury market. For example, the "UK pension crisis" at the end of September, the "dollar shortage" crisis at Credit Suisse, the Bank of Japan's two recent interventions in the "yen depreciation" and the massive sell-off of US Treasuries. Any problems in these economies, which are deeply tied to the US economy, could lead to problems in the US Treasury market through a knock-on effect. The following are discussions of the possible "liquidity" crisis in the US Treasury market.

1) The Federal Reserve and large domestic financial institutions in the United States "sold off US Treasuries."

The Federal Reserve is one of the leading forces selling US Treasuries, which is currently reducing its balance sheet at a rate of US$60 billion a month. Since the "COVID-19 pandemic" outbreak, the Federal Reserve has implemented massive QE, printing money and issuing Treasuries on a large scale, which has caused the Fed's balance sheet to reach around US$8 trillion. The Federal Reserve announced that it would officially start shrinking its balance sheet on 1 June this year. "Shrinking the balance sheet" is the process by which the Fed shrinks its balance sheet, sells assets such as US Treasury bonds to banks and the public, and withdraws liquidity from the financial system and society. The size cap is US$47.5 billion, doubling in three months. The reduction was capped at US$47.5 billion per month for the first three months (US$30 billion Treasuries + US$17.5 billion MBS) and increased to US$95 billion (US$60 billion Treasuries + US$35 billion MBS) after September. MBS, Mortgage-Backed Security, is a type of asset-backed security (ABS). Its cash flow to investors comes from the principal and interest generated by the asset pool composed of residential mortgage loans. According to the current rate of shrinking, it will reach the scale of US$5.9 trillion until 2025. Since the current inflation in the United States is 6%-7%, and the yield of the US 10Y Treasury is about 4%, if the high inflation in the United States continues, it will be "losing money" if the investor continue to hold US Treasuries. So, big US banks, insurance funds and pension funds are also selling US Treasuries.

2) Central banks around the world are selling US Treasuries

The national debt is backed by national credibility and is a relatively low-risk investment method. In fact, large banks, large securities companies and various fund companies of governments worldwide are involved in buying and selling US Treasuries. It is common for the funds to be traded to be tens of billions of dollars, so its impact is self-evident. The United States is the world's most significant economic and military power, and many countries also hold the national debt issued by the United States government. However, since the COVID-19 pandemic at the end of 2019, the QE policy of the United States, through continuous money printing, has reached an unprecedented record high in the scale of US debt. The value of US Treasuries may be "diluted". Inflation in the US remains high, and debt is at an all-time high. Moreover, since the "Russia-Ukraine war" outbreak, the tendency of "Deglobalization" has become more apparent. The United States has announced a freeze on the foreign exchange reserves of the Russian central bank in US dollars, and to avoid the risk, many countries have started to sell their US debt holdings to reduce the impact on their own countries. Since April 2021, China, Japan, the UK, Germany, France, Switzerland and many other countries have been selling massive amounts of US Treasuries to cut their losses.

3) The Bank of Japan intervenes in the foreign exchange market and sells US Treasuries.

Data show Japan has been the largest overseas holder of US Treasuries since June 2019. The Bank of Japan continued to sell US Treasuries sharply to achieve its control of the YCC Treasury yield curve. There has been discussion in the market about whether the Bank of Japan will undertake a step-by-step exit from its already long-held yield curve control (YCC) in the future. So it is also essential to be wary that any announcement by the Bank of Japan of a future or relaxation in the yield curve could drive a spike in JGB yields, as well as a spike in US bond yields, triggering both a US Treasury crisis and causing significant volatility in foreign exchange markets. Japan spent a record 6.3 trillion yen (US$42.4 billion) from 29 Sept to 27 Oct intervening in the foreign exchange market to stop the JPYUSD from falling sharply and to intimidate speculation, according to data disclosed by the Ministry of Finance Japan on 31 Oct. Japan, the world's top holder of US debt, has also continued to sell off the most significant amount of US Treasuries so far this year. According to the Japanese Ministry of Finance's balance sheet data Japan sold approximately US$52 billion of Treasuries in September. Japan sold US treasuries in exchange for more dollars so that it would have enough money to intervene in the foreign exchange market where the "yen was depreciated". "The worry is that even if the BOJ has cash for intervention now, the rate at which they are intervening will require them to sell more Treasuries for future interventions," said TD Securities strategist Gennadiy Goldberg. "That’s really what’s driving the fear.”

4) The risk of a sell-off in US Treasuries has been exacerbated by the highly leveraged UK pensions 'crash' and liquidity risks in the UK Treasury market.

From the end of September to the beginning of October, in the face of the British pension crisis, the new tax reduction policy of British PM Truss and Finance Minister Kwarteng failed to solve the problem. Also, it caused the pound to plummet to a 37-year low of around 1.0350 and the price of the UK 10-year bond to a record low of about 91.50, while the UK 10-year bond yield hit a record high of 5% and eventually, they were forced to resign. Over the past two decades, the LDI investing strategy, which has been highly respected in the UK market for over two decades, has become a significant source of "vulnerability" for the pension fiasco. For details, please refer to the article on 27 October, [“The Bank of Japan intervened again to the falling of the yen. The stock market and non-US currencies rebounded, and USDCNH broke above 7.3000”.] So, next, investors will pay close attention to how Rishi Sunak can save the UK pension market, which is crucial to the UK's medium and long-term economic recovery. According to a report on 01 November, the Bank of England began to try quantitative tightening, selling 750 million pounds of short-term government bonds while planning to sell 40 billion pounds of government bonds in the next 12 months. Other central banks are using "passive tapering", which means they do not continue to buy treasury bonds after they have matured. The Bank of England, on the other hand, is the first country to sell its treasuries in the current tightening cycle voluntarily. It is interesting to note that the UK is also issuing bonds at a record pace. On current trends, the UK will run a deficit of £170 billion in the 2022-2023 financial year, nearly twice the £99 billion estimated in the March budget this year.

5) Financial systemic risks come under increased pressure, and the Credit Suisse crisis reflects "dollar shortage" problem is severe.

Credit Suisse, the second-largest bank in Switzerland, has recently been reported to be on the verge of bankruptcy or the risk of becoming a second Lehman Brothers. Recently, on 28 October, Credit Suisse released its financial results for the third quarter of the year, showing a loss of CHF 4,034 million, well below market expectations of CHF 413 million. The stock plunged 20% at the opening of the day. And as of now, the fall in 2022 has been as high as 59%. Credit Suisse has posted four 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, losses of CHF 273 million and CHF 1.59 billion were recorded in the first quarter of 2022 and the second quarter of 2022, respectively. The relevant data shows that Credit Suisse's high-quality liquid assets stood at approximately US$238 billion at the end of June this year, while its exposure to leveraged risk was US$873 billion. In other words, Credit Suisse's existing liquidity funds are no longer able to cover its risk exposures. 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", i.e., the tightening of dollar liquidity.

2. The Bank of Japan kept its monetary policy unchanged in October, raised inflation expectations, and USDJPY continued to fluctuate below 150.

Critical points of BoJ's monetary policy statement on 28 October: BoJ maintains ultra-loose policy, BoJ sticks to its existing QQE (quantitative and qualitative monetary easing) framework of YCC (yield control curve) and continues to buy JGBs to keep the 10-year bond yield at around 0%. Implemented a policy rate of -0.1% on the current account balances of financial institutions with the Central Bank; lowered the real GDP growth forecast for FY2022 to 2.0% and raised inflation expectations across the board, raising the CPI growth forecast for FY2023.

FY2022 real GDP forecast revised from 2.4% to 2.0%; FY2023 real GDP forecast revised down from 2.0% to 1.9%.

FY2022 CPI ex-fresh food forecast revised upwards from 2.3% to 2.9% per annum.

FY2023 CPI ex-fresh food forecast revised upward from 1.4% to 1.6% per annum.

FY2024 CPI ex-fresh food forecast revised upwards from 1.3% to 1.6% per annum.

FY2022 CPI ex-fresh food and energy forecast revised upwards from 1.3% to 1.8% per annum

FY2023 CPI ex-fresh food and energy forecast revised upwards from 1.4% to 1.6% per annum.

FY2024 CPI ex-fresh food and energy forecast revised upwards from 1.5% to 1.6% per annum.

After two massive interventions by the Bank of Japan on 28 September and 21 October in the "depreciating yen" foreign exchange market, the market became highly calm, and the USDJPY was basically trading sideways between 145.50 and 148.90. Other non-US currencies also maintained a narrow sideways range, like USDJPY. Wait for the Fed's November interest rate meeting and the US non-farm payrolls report on Thursday and Friday this week.

As of today, China is still Japan's largest trading partner, with about 22% of Japan's exports and imports being China-related. USDJPY and USDCNH have generally tended to move in the same direction so far this year. With two significant interventions in the FX market by the Bank of Japan at the end of October, the USDJPY stayed in a sideways range below 150.00 after peaking around 151.90 this year (also a new high for the past 32 years). The USDCNH also trades sideways in a range below 7.35000 after peaking at 7.3750 for the year. USDCNH may also be able to stay at the 7.3500 level if the BOJ continues to defend the USDJPY level at 150 implicitly.

Source: tradingview, from 21 October to 25 October 2022, the USDCNH and USDJPY reached annual "peaks" of 7.3700 and 151.50, respectively. USDCNH may also be able to stay at the 7.3500 level if the BOJ continues to defend the USDJPY level at 150.00 implicitly.

3. RBA slows rate hike as expected, raises rates by 25 bps, and the Australian dollar is weak and consolidates sideways.

The Reserve Bank of Australia raised interest rates by 25 bps to 2.85 % in its November interest rate decision, in line with market expectations, which is also a more "moderate" tightening policy compared to the Fed. This is also the second consecutive month (October and November) since May 2022, when the RBA kicked off its rate hikes, slowing rate hikes and raising them by 25 bps, compared to the 50 bps hikes in June, July, August and September rate meetings respectively. Some in the market have taken the RBA's interest rate policy as a "weather vane" for a possible slowdown in interest rate hikes in the G7 countries as a whole. In other words, it is not far from the Fed slowing down interest rate hikes. After the RBA announced a 25-bps rate hike, AUDUSD fell about 20 pips in the short term and is now trading in a narrow sideways range between 6.6350-6.6520. The recently released Australian CPI average (annual rate) for the third quarter rose again and reached 6.1%, above market expectations of 5.5% and the previous value of 4.9%. The Australian retail sales data for September released recently also exceeded

expectations again, rising by 0.6% year-on-year, above market expectations of 0.5%. PPI also climbed again in the third quarter, growing at a 6.1% year-on-year rate, also above expectations of 5.6%. The outlook for climbing prices is worrying.
RBA policy statement highlights: The world economic outlook is deteriorating; high-interest rates and high inflation are putting pressure on the budgets of many households; the RBA has changed its view on inflation, raising its expectation for peak inflation to 8.0% from the previous 7.75%. Despite this, inflation is still seen to decline significantly in 2023. Medium-term inflation expectations remain positive; a return to target levels for CPI will require sustained supply and demand, with CPI expected to be around 4.75% in 2023; CPI is expected to be just above 3% in 2024. Further interest rate increases are expected in the period ahead; inflation is expected to reach around 8% later this year; GDP growth is expected to be about 3% this year and 1.5% in 2023 and 2024. Unemployment is expected to remain stable in the coming months. The labor market remains very tight, and many companies have difficulty recruiting workers; the evolution of labor costs and the pricing behavior of companies will continue to be closely monitored. Medium-term inflation expectations remain positive; Further interest rate increases are expected in the period ahead.

Short-term risk:

The market is currently waiting for the Fed's November interest rate decision at 2:00 am on Thursday (03 November) and the US non-farm payrolls report at 8:30 pm on Friday (04 November). At present, the market expects that the Fed's interest rate decision in November is expected to release a dovish signal about "slowing the pace of interest rate hikes". Suppose risk sentiment continues to rise towards the end of the year. In that case, the US dollar is expected to continue to trade sideways under the "pressure of the dollar's depreciation" and even experience a small shock downward movement. However, if the Fed sticks to its "hawkish and aggressive rate hikes" to fight inflation, it could spark another rise in the dollar index and a fall in risk assets. At the same time, investors also need to focus on the release of the US core consumer price index (monthly and annual rate) data for October next Thursday (10 November). Once inflation has fallen, or there are "signs of peaking", the market is expected to adjust its expectations for the 5% terminal rate, the US dollar index may fall further, and non-US currencies may continue to rebound.

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12:10 pm, 02 Nov 2022 SGT time