Market comments 9 Nov 2022

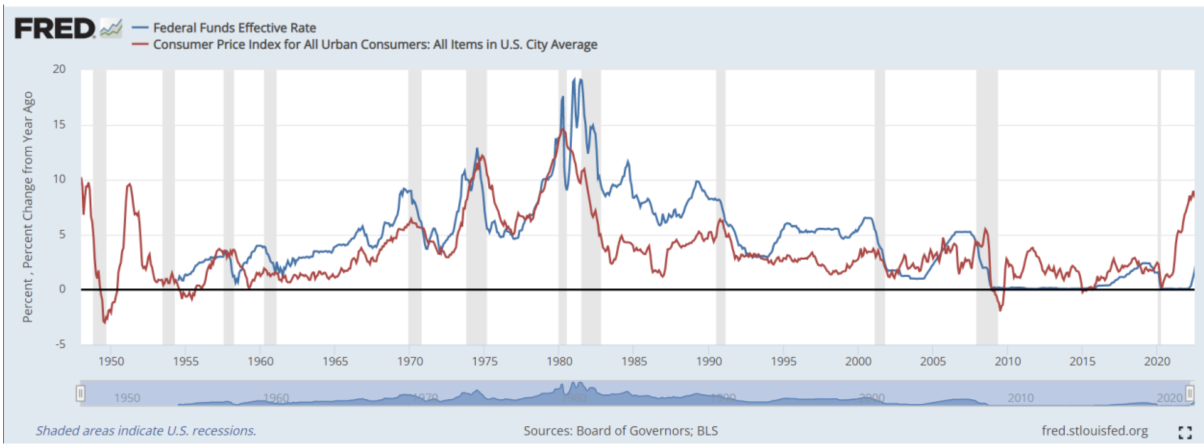
Fed may slow the pace of rate hikes from December. The terminal rate could reach 6% or higher. US midterm elections could fuel European and US stock market rallies.

1. After the Fed's November interest rate meeting, the US dollar was on a "rollercoaster" ride. How high can terminal rates go?

Last Thursday (3 November), the Federal Reserve interest rate meeting met expectations. It announced a 75-basis point rate hike, raising the target range for the federal funds rate to between 3.75% to 4.0%, the fourth consecutive significant 75 basis point rate hike and the sixth rate hike since March 2022.
At the press conference following the interest rate meeting, Fed Chairman Jerome H. Powell made a "hawkish" statement, and the market is currently discussing on the following key points:

1) *It is not the "pace of rate hikes" that matters, but the "terminal rate" and the "duration of restrictive rates", i.e., the tightening cycle will last longer, and markets will have to endure a more extended period of high-interest rate environment.*
2) *He stressed that the "terminal rate" would be higher than the previous expectation of 4.6% in September and that the market is currently discussing that it will reach between 5 and 5.25%. After the interest rate meeting, there was intense discussion in the market about the possibility of a terminal rate of around 5%, or even 6% or higher, for this round of Fed rate hike. Lawrence Summers, the former US Treasury Secretary, recently said that the "Federal Reserve needs to boost interest rates to 6% or higher to bring inflation under control, given a US economy that is still running strong".*
3) *The Fed may start discussing slowing the pace of rate hikes at its December meeting, with the market expecting a rise in the likelihood of a 50-basis point rate hike beginning in December. (It is worth noting that the RBA and the Bank of Canada have also been slowing the pace of rate hikes in the last 1-2 months.)*
4) *The "terminal rate" needs to be raised above the "inflation expectations" to control inflation enough to bring it back to the 2% target.*

The Fed's basic expectations for the fourth quarter: moderate economic growth, weaker real estate activity, slower consumer spending, and an extremely tight labour market, suggesting an increased likelihood of "peak inflation". Once there is more evidence of "peak inflation", the Fed's terminal rate may stay near 5% for extended periods. The core of “inflation control” is to suppress inflation expectations, which is the same logic as in the previous article, "The relationship between the RBA's interest rates and inflation" (For more information, please see the article: [USD close to the peak of the current cycle; AUD and NZD still weak, going long GBPJPY could be one of the best trades last week]). Powell stressed that the "terminal rate" needs to be raised above "inflation expectations" to be sufficient to control inflation and bring it back to the 2% target. Therefore, investors need to pay close attention to "inflation data" in the pace of interest rate hikes after the Fed has slowed the pace of interest rate hikes and after that.



Source: FRED. Analysing the United States over the past six decades or so, every time inflation has risen in the United States since the 1960s, the Federal Reserve has had to raise official interest rates to an annual rate more significant than the rate of increase in inflation before inflation could be brought down. The current round of inflation in the US is around 8%, and the current benchmark interest rate in the US is currently about 4%. So, the market is talking fiercely about the possibility of a terminal rate of around 5%, or even 6% or higher, for the Fed rate rise.

Technical analysis: The US dollar index pulled up to around 112.75 after the November interest rate meeting, and the three major US stock indices generally turned from recent gains to losses. The US 10YTreasury yield returned to 4% and touched around 4.22%. On Friday (4 November), at 8.30 pm, the release of US quarterly non-farm payrolls for October recorded an increase of 261,000, the smallest increase since December 2020 but significantly higher than the 200,000 expected, compared to 263,000 in September. In the last few weeks, the author repeatedly mentioned that the "depreciation pressure on the dollar" is significant. After the non-farm payroll data was released, the US dollar index started a decline mode (from 112.75 to 109.70). It may be that this "depreciation pressure" has been validated. This was accompanied by a general rally in non-US currencies and a rebound in US and European stock markets. Over the past week, market risk appetite "warmed up" as the three major US stock indices, the Dow Jones, the S&P 500 and the Nasdaq, rebounded after three consecutive quarters of declines. Non-US currencies also corresponded to the "fall of the dollar" and started to rise to vary degrees. The following is a record of the gains and losses of the past week.

- *DXY Index decreased 380 pips (112.80-109.00), or 3.37%*
- *Dow Jones surged 1650 pips (31700-33350), or 5.21%*
- *The S&P 500 Index rose 150 pips (3700-3850), or 4.05%*
- *Nasdaq increased 600 pips (10600-11200), or 5.66%*
- *EURUSD rose 360 pips (0.9730-1.0090), or 3.70%*
- *GBPUSD jumped 450 pips (1.1150-1.1600), or 4.04%*
- *AUDUSD increased 280 pips (0.6270-0.6550), 4.47%*
- *NZDUSD increased 250 pips (0.5750-0.6000) or 4.35%*
- *USDJPY fell 350 pips (148.50-145.00) or 2.36%*
- *USDCHF dropped 300 pips (1.0150-0.9850) or 2.96%*
- *USDCAD decreased 420 pips (1.3800-1.3380), or 3.04%*
- *USDCNH dropped 1850 pips (7.3550-7.1700), or 2.52%*
- *USDSGD fell 300 pips (1.4250-1.3950), or 2.11%*

However, it is perhaps too early to bet on a "dollar peak", as there is still room for the dollar to appreciate due to the following factors: 1) the safe-haven nature of the dollar; 2) the expected 5%-6% terminal rate for the dollar is still may on the way; 3) the "turning point" of the Fed's policy shift has not yet occurred, and 4) the dollar's main counterparts are the euro and the pound, but the current economic environment in the eurozone and the UK is significantly less robust than the US dollar's economic fundamentals, dragged down by the "Russia-Ukraine war". All these factors support the basis for the dollar to remain strong.

2. The US Treasury may launch a "fiscal QE" after May next year

Last Wednesday (2 November), the Treasury Department announced it would issue US$96 billion of long-term bonds in its fourth-quarter refinancing operation next week. No decision was made on the "buyback US Treasuries" that the market was expecting to improve the liquidity of the US Treasury market. Liquidity in the US Treasury market has deteriorated since October this year and has reached near its worst level since the outbreak of COVID-19 in March 2020. Although MOVE, the liquidity indicator for the US Treasury market, is already close to "crisis levels", there appears to be no pressure from the US official sector to move quickly to implement it, apart from the concerns expressed by US Treasury Secretary Yellen. No specific schedule has been given for the "bond buyback". The market currently expects that there will be no "buyback of US Treasuries" until May 2023.

3. German Chancellor Scholz's trip to China may open a new round of "China-Europe friendship" business cooperation.

Last Thursday, 3 November, German Chancellor Scholz led a delegation of 12 executives from Volkswagen, Siemens, BMW, Bayer, Adidas and other companies on a visit to China. It was the first G7 leader to visit China since the global outbreak of the COVID-19 pandemic. "With regard to China, is that this country, with its 1.4 billion inhabitants and its economic power will, of course, play a key role on the world stage in the future. " Scholz said in his speech. "Even in changed circumstances, China remains an important business and trading partner for Germany and Europe — we don't want to decouple from it. " It is to seek cooperation that is in the common interest of China and Germany. On 4 November, China Aviation Supplies Holding Company signed a major deal with Airbus to buy 140 aircraft worth US$17 billion.

Scholz's China trip, which took place against the backdrop of "geopolitical tensions" in the ongoing "Russia-Ukraine war", was a good start for Europe to re-embrace "multilateralism". German Chancellor Scholz said, "Because the Chinese government, the president and I were able to declare that no nuclear weapons should be used in this war, that alone made the whole trip worthwhile." The fact that the two great powers, "China" and "Germany", are both strongly opposed to "nuclear war" is an excellent inspiration to peace-loving people all over the world.

China's "trade surplus" worsens as demand from Europe and the United States has fallen. The recently released Chinese foreign trade figures for October stood at US$85.15 billion, compared to expectations of US$95.97 billion. Meanwhile, import and export trade weakened in October, with China's exports contracting by 0.3% year-on-year and imports by 0.7% in October. This was the first contraction in international trade since May 2020. Exports to Europe fell by 6% over the month, while exports to the US fell even more sharply, by 7.4%. However, it is worth noting that China's exports to ASEAN grew by 20% year-on-year, while imports grew by only 4.5% year-on-year, indicating a continued shift in supply chains away from mainland China to ASEAN. Meanwhile, last Wednesday (2 November), the National Health Commission held a meeting and reiterated that it would "unswervingly" adhere to the "dynamic zero-Covid" policy, the impact of which on services activity has been more significant than expected. The Caixin Services PMI continued to fall from 49.3 in September to

48.4 in October. China's Business Activity Index also continued to fall in October to 48.4, down from 49.3 in September.

A former Chinese pandemic control official recently (5 November) said that China would significantly change its current dynamic zero-Covid policy in the coming months. In addition, "rising risk sentiment" in the context of the "US midterm elections" has led to a recent rise in European and US stock markets. This, coupled with the trip of German Chancellor Scholz to China, is positive for the medium to long-term development of the Chinese and European economies. Reflecting on the financial markets, these factors have favored and boosted the RMB, the Euro, and the Chinese and German stock markets. The Hang Seng Index rallied the most, gaining 15.07 % (from 14,600 to 16,800) since the end of October. The following is a record of the gains and losses over the past one week.

- *CHINA50 jumped up 1110 pips (11120-12220), or 9.89%*
- *CHINAH rose 800 pips (4900-5700), or 16.33%*
- *HK50 rose 2200 pips (14600-16800), or 15.07%*
- *GER30 surged 700 pips (13000-13700), or 5.39%*
- *EURUSD increased 360 pips (0.9730-1.0090), or 3.70%*
- *USDCNH decreased 1850 pips (7.3550-7.1700), or 2.52%*

4. US midterm elections fuel a rally in European and US stock markets.

The results of the US midterm elections are due to be announced on this Wednesday, and the market is currently estimating that the Republican Party is on course to win. The Republican Party is also the party of the former President of the United States, Donald Trump. He has also recently announced that he would make a prominent announcement on 15 November. It is expected that he may want to run for the "2024 US presidential election". Economists at Deutsche Bank and strategists at Morgan Stanley have both made predictions of a "sweeping victory" for the "Republican Party". Some analysts believe that a "Republican Party" victory may result in a more favourable situation for Russia and may help to end the "Russia-Ukraine war". Historical experience shows that the "US mid-term elections" have a limited impact on stock markets but that stocks rally higher most of the time during this period. Japan, Singapore and Australia in the Asia Pacific region, as well as the UK and Germany in Europe, followed the US stock market and started to rally higher to varying degrees.

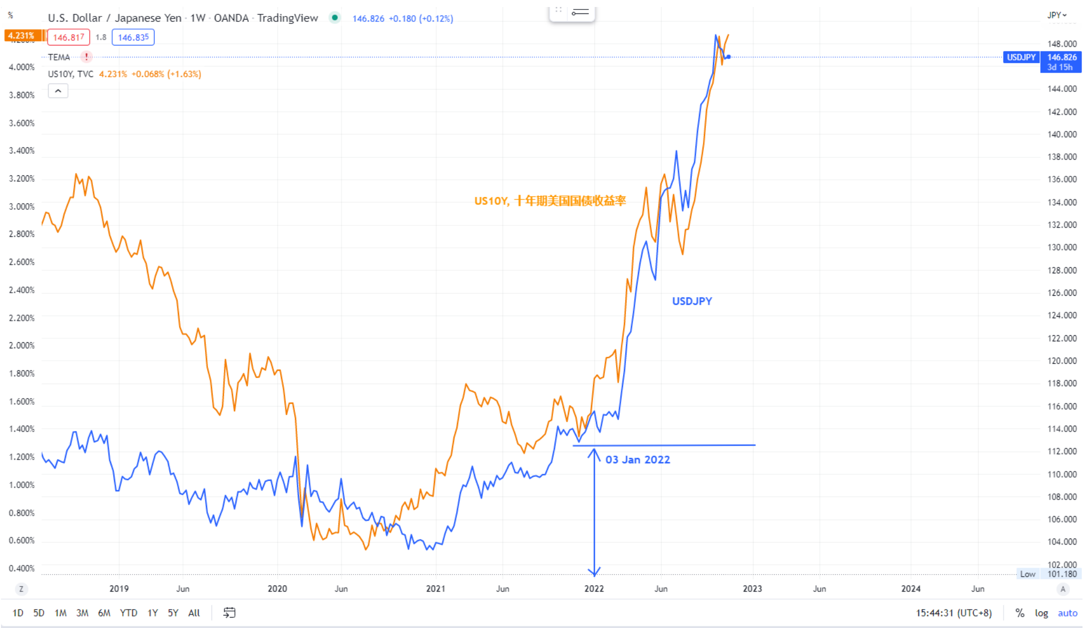
- *SING30 rose 950 pips (273.50-283.00), or 3.47%*
- *JP225 jumped 1,000 pips (27000-28000), or 3.70%*

- *AUS200 increased 210 pips (6770-6980), or 3.10%*
- *GER30 rose 700 pips (13000-13700), or 5.39%*
- *EU50 climbed 200 pips (3550-3750), or 5.63%*
- *UK100 increased 300 pips (7050-7350), or 4.26%*
- *NL25 climbed 30 pips (655-685), or 4.58%*
- *FRA40 rose 270 pips (6190-6460), or 4.36%*
- *CH20 climbed 230 pips (10620-10850), or 2.17%*
- *ES35 increased 210 pips (7790-8000), or 2.70%*
- *TWIX increased 32 pips (483-515), or 6.63%*

5. USDJPY may continue to follow the US 10Y Treasury yield movement.

After the Bank of Japan intervened in the foreign exchange market, the market is concerned that the Bank of Japan may intervene again at any time quietly to stop the yen slide. After about two weeks of sideways consolidation below 150, the USDJPY started a slight downward pattern, i.e., a slight appreciation of the yen. But fundamentally speaking, the "divergence" in interest rate policy between the Fed and the Bank of Japan still supports the USDJPY's rise. Please keep an eye on the direction of the US 10-year Treasury yield in the future, that is, the general direction of USDJPY. Non-US currencies have rallied recently, buoyed by rising risk sentiment. Still, the USDJPY may have limited gains, which may present an opportunity to go long on "non-US currencies against the yen". The following is the records of the past week's profits and losses in "non-US currencies against the US dollar":

- *USDJPY fell 350 pips (148.50-145.00) or 2.36%*
- *GBPJPY rose 400 pips (165.00-169.00), or 2.42%*
- *EURJPY rose 300 pips (144.00-147.00), or 2.08%*
- *AUDJPY rose 220 pips (93.00-95.20), or 2.37%*
- *NZDJPY rose 200 pips (85.20-87.20), or 2.35%*
- *CADJPY rose 200 pips (107.10-109.10), or 1.87%*
- *CHFJPY rose 270 pips (145.80-148.50), or 1.85%*



Source: tradingview. Since entering 2022, the USDJPY has closely followed the US 10-year Treasury yield trend. Please keep an eye on the direction of the US 10-year Treasury yield in the future, that is, the general direction of USDJPY.

Short-term risks:

Investors will also need to focus on the release of the US Core Consumer Price Index for October (monthly and annual rates) on Thursday (10 November) at 8:30 pm. The market is currently expecting a US inflation report for October, with headline CPI expected to rise 0.6% YoY and annual CPI growth expected to fall slightly to 8.0% from 8.2% in September. The monthly and annual rates of the core CPI are expected to be 0.5% and 6.5%, respectively. There may be signs of a "peak" once inflation has fallen. The market is expected to adjust its expectations for a 5% terminal rate, and the US dollar index may fall further. At the same time, non-US currencies may take advantage of the situation and continue to rally.

It is also important to keep an eye on the US retail sales (monthly rate) data for October next Wednesday (16 November) at 9.30 pm. Retail sales data is an important indicator often used to measure consumer spending, which is critical to the US economy, accounting for over 2/3 of overall economic activity, with retail sales, in turn, accounting for 1/3 of consumer spending, and is therefore considered an essential factor in the development of the US economy. The current market expectation is 0.8%. A better-than-expected data release would be positive for the US dollar. Please note that the dollar index has risen almost a year since the beginning of the year 2022 and is up by 21.16% (from 94.50 to 114.50). In the last two months towards the end of the year, the "depreciation pressure on the dollar" may always be there in the short term.

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