Market Comment_14Dec2022

Risk assets received boost as US inflation 'peaks' view has been reinforced.

1. US CPI rises modestly in November, dollar plunges, and risky assets soar.

US Consumer Price Index (CPI) rises moderately in November.

The US CPI report for November, released on Tuesday evening (13 November), showed a moderate rise in headline inflation in the US, which also recorded the smallest increase of the year. Core CPI (annual rate) rose by 6.0%, less than the 6.1% expected and the 6.3% previously reported. Core CPI (monthly rate) increased by 0.2%, less than the 0.3% expected and 0.3% previously; CPI (annual rate) increased by 7.1%, less than the 7.3% expected and 7.7% previously. CPI (MoM) rose by 0.1%, less than the 0.3% expected and the previous 0.4%. All data are less than expected, which may indicate that US inflation has begun to fall back faster than the market expected. US inflation data cooling, the market is expected that the Fed may end the current cycle of interest rate hikes early. US Treasury yields have recently fallen sharply, the US dollar has weakened, and non-US assets are in "rising pattern". Data released by the United States on Friday (9 December) showed that the annual rate of PPI in November was 7.4%, significantly lower than the previous value of 8.1% but more than the expected value of 7.2%; the core PPI (annual rate) excluding food and energy was 6.2%, again lower than the previous value of 6.7%, but higher than the expected value of 5.9%. In addition, the preliminary reading of the University of Michigan's consumer confidence rose to 59.1 in December from 56.8 in November and beating market forecasts for a reading of 56.9 and suggesting that the US consumer market remains resilient. All these data reinforce the view that inflation in the US may have "peaked" and will also ease the pressure on the Fed to fight inflation, reducing the need for the Fed to "raise rates sharply" and reinforcing the view that "the Fed pushes through a smaller rate hike".

Reflecting on the financial markets, the US dollar started a wave of significant losses, non-US currencies collectively rose to varying degrees, and gold, crude oil, and the three major US stock indices rose sharply. The following is a record of the ups and downs of the past week.

- *The DXY Index closed down 100 pips (105.30-103.30), or 1.90%, and is now at 103.60.*
- *The Dow Jones surged 1530 pips (33400-34930), or 4.58%, and is now at 34180.*
- *The S&P 500 index rose 210 pips (3920-4130), or 9.95%, and is now at 4030.*

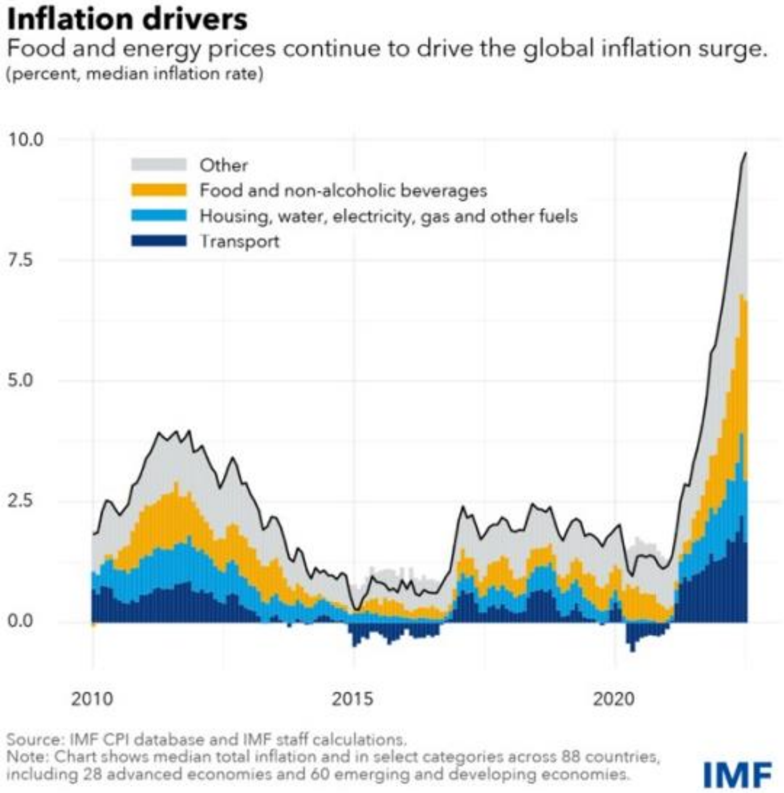
- *The Nasdaq closed up 800 pips (11420-12220), or 7.01%, and is now at 11850.*
- *XAUUSD closed up US$55 per ounce (1765.50-1820.50), or 3.12%, and is now at 1810.50.*
- *EURUSD closed up 200 pips (1.0450-1.0650), or 1.91%, now at 1.0625.*
- *GBPUSD closed up 340 pips (1.2100-1.2440), or 2.81%, now at 1.2350.*
- *AUDUSD closed up 220 pips (0.6670-0.6890), or 3.30%, now at 0.6830.*
- *NZDUSD closed up 200 pips (0.6300-0.6500), or 3.18%, and is currently quoted at 0.6440.*
- *USDJPY closed down 320 pips (137.90-134.70) or 2.32%, now at 135.50.*
- *USDCHF closed down 200 pips (0.9450-0.9250), or 2.12%, now at 0.9260*
- *USDCAD closed down 180 pips (1.3700-1.3520), or 1.31%, now at 1.3560.*
- *USDCNH closed down 550 pips (7.0000-6.9450), or 0.79%, now at 0.6935.*
- *USDSGD closed down 180 pips (1.3600-1.3420), or 1.33%, and is currently quoted at 1.3480.*
- *Bitcoin surged 1200 pips (16750-17950), or 7.16%, and is now at 17800.*

<u>A discussion on recent dollar's decline</u>

Since 2022 the US Dollar Index has risen by 21.16% (94.50-114.50). But in the last two months, October and November, the USD Index may have confirmed a "peak" in the current stages. The USD Index fell back 9.78% to a low of around 103.30 recently from 114.50, perhaps because of the following reasons: 1) US inflation finally fell more than expected in October. US inflation data in November again reinforced the view about US "inflation peaked" . The Federal Reserve Chair Powell also clearly implied that the pace of interest rate hikes will slow down, the market generally envisioned that the Fed slowed the pace of interest rate hikes in December. An interest rate cut is expected at the end of next year. The most considerable headwinds that have held back global risk assets over the past year may be waning. 2) China's recent series of new real estate policies, accommodative bank monetary policies and adjustments to its Covid-19 prevention and control policies have brought an end to the three-year "zero-Covid policy", which has brought more "positive factors" to China's economic recovery and global economic growth prospects. 3) The summit between China and the United States in Indonesia in November may open the way for the relationship between the world's two most extensive powers to return to stable and healthy development and also give new impetus to the stability of financial markets and the recovery of demand in all countries. 4) The sharp fall in the price of crude oil, natural gas and other energy sources has somewhat reinforced the conclusion that "inflation" has peaked and eased the pressure on some energy importers; 5) Towards the end of the year, risk appetite may be accompanied by a "Santa Claus Rally".

A discussion on the factors associated with "high inflation" in the US

The two main drivers of inflation across the globe are food and energy. As the US is the world's number one exporter of food and the world's largest LNG exporter, the impact on the 'food and energy' side is relatively small.

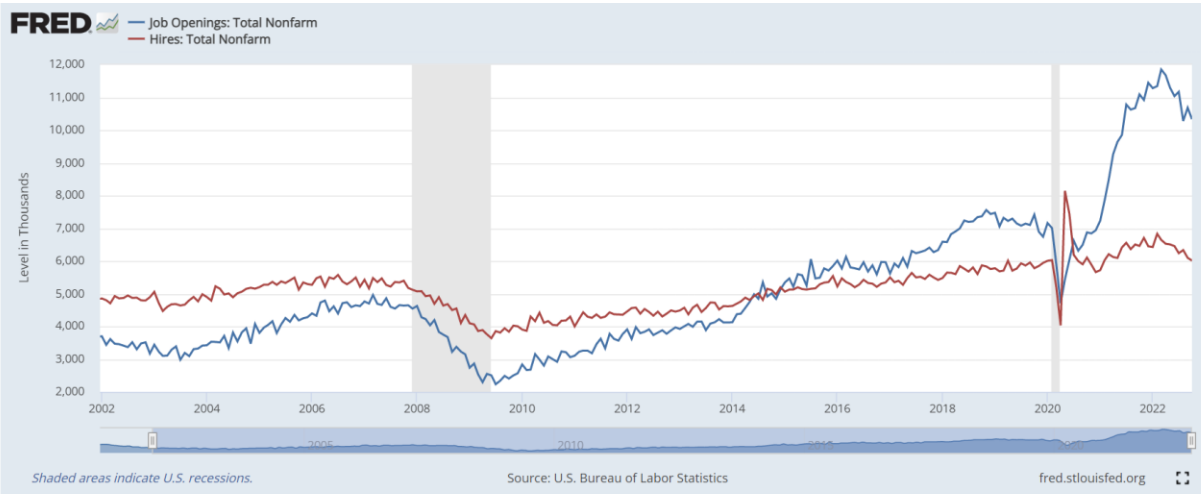


Source： IMF

There are four color areas in the graph; the yellow section is for food and drink prices; the light blue section is for the cost of housing, which also includes utilities and other fuels; the dark blue area refers to transport; the grey section is for other. It is clear from this chart that the main drivers of current global inflation come from food and energy. In a sense, this is the kind of inflation that we dislike the most, and it is the most irreplaceable component, as it brings with it an increase in the cost of living, and the impact on the general population is the most obvious. However, for the US, the inflationary impact of "food and energy" is relatively small.

The two main drivers of the current high inflation in the US are the high cost of core services and the severe labor shortage. (1) "Core services" usually refer to the cost of rent, medical care services, etc. As explained in my previous article

on, "sticky CPI" is actually the corresponding "core services", which is calculated by including a subset of goods and services that change in price relatively infrequently, such as rent, medical costs, transport, etc. Once the prices of these items have risen, it is tough for them to fall. As the prices of these goods and services change relatively little, investors consider them to be a better indicator of future inflation expectations than items with more frequently changing prices. With rents accounting for almost 40% of the weight of the core CPI in the US, the rapid rise in rents is one of the main reasons for the high inflation in the US.
(2) The labor market in the US is very hot. The chart below shows that there are far more job openings than people looking for work. Although we have seen many news reports recently about the "wave of layoffs" at major US companies, with Twitter, Facebook, Amazon, Salesforce and other major technology giants starting to lay off large numbers of people who may be engineers, the labor market is not only looking for "engineers" but also "blue-collar workers". On the other hand, the US labor force participation rate has remained between 62.1-62.4% since 2022, largely returning to near the 63% level it was at before the outbreak of Covid-19. This suggests that many people in the US are either working or actively looking for work. With a huge gap between "supply and demand", employers may have to raise wages further to find a solution to the vacancy problem, which will further lead to higher labor costs and thus put upward pressure on the prices of "core services".

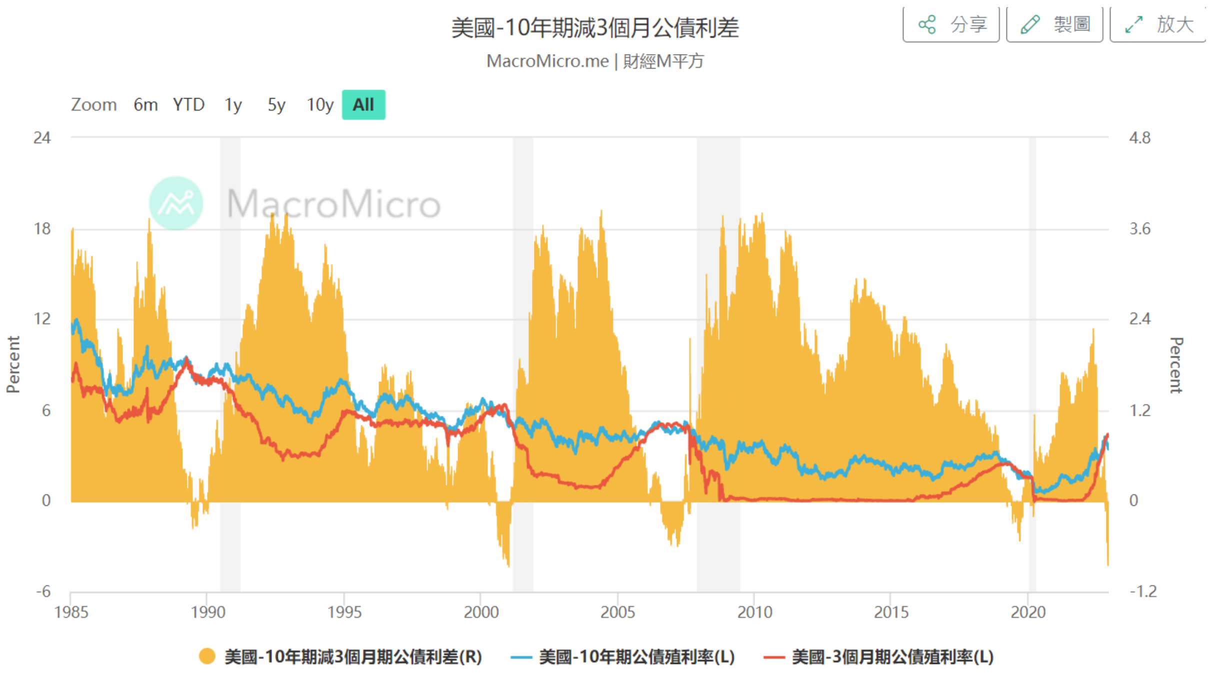


Source: FRED, the chart shows that there are far more job openings than people looking for work.

<u>A discussion on the risk of recession in the US</u>

There are ongoing concerns about a "soft landing" for the US economy. A "soft landing" means that the US may succeed in curbing inflation while avoiding a significant recession. Federal Reserve Chair Jerome Powell said in November this year that the window for a soft landing has narrowed. But United States Secretary of the Treasury Janet L. Yellen said in a recent statement (13 December): "First of all, shipping costs have come down — delivery lags, which were very long, those have shortened," "Gas prices are way down — I think we'll see a substantial reduction in inflation in the year ahead." "By the end of next year, you will see much lower inflation if there's not an unanticipated shock," "There's a risk of a recession. But ... it certainly isn't, in my view, something that is necessary to bring inflation down."

The US 10Year Treasury yield and the yield on the US 3Month Treasury yield have been inverted for over a month, signalling a much higher risk of recession in the US. Typically, short-term bonds are less risky, relatively more expensive and have relatively lower yields. Therefore, the US 3Month Treasury yield must be generally lower than the US 10Year Treasury yield. When the US 10Year Treasury yield is lower than the 3Month Treasury yield, investors are pessimistic about the economy's future. In fact, it is common for large banks, securities firms and funds of all kinds to be involved in the US Treasury market, trading with tens of billions of dollars of capital, so the implications speak for themselves. Historically (please refer to the chart below), every time the yield on the US 10Year Treasury yield minus the US 3Month Treasury yield has been inverted (i.e. negative), a recession has occurred in the US economy. The policy of aggressive interest rate hikes in the US not only affects the slowdown in the US economy but also indirectly and simultaneously affects the global economic slowdown. It may take more than a year for the impact of tightening financial policy to be transmitted to the labour market. At the same time, according to historical experience, a recession occurs 6-18 months after the spread between the "US 10Year Treasury yield" and the "US 3Month Treasury yield" is inverted.



Source: MacroMicro

The spread of the "US 10Y Treasury yield" minus the "US 3M Treasury yield" is a better indicator of changes in policy rates than the spread of the US 10Year Treasury yield minus the US 2Year Treasury yield and is one of the "leading indicators" used by the Federal Reserve in recent years to observe inversions in the yield curve and economic recessions.

In the chart, the yellow bars represent the spread of the "US 10Y Treasury yield" minus the "US 3Month Treasury yield", the blue line represents the US 10Y Treasury yield, the red line represents the US 3Month Treasury yield and the grey area represents the recession. It can also be seen from the chart that:

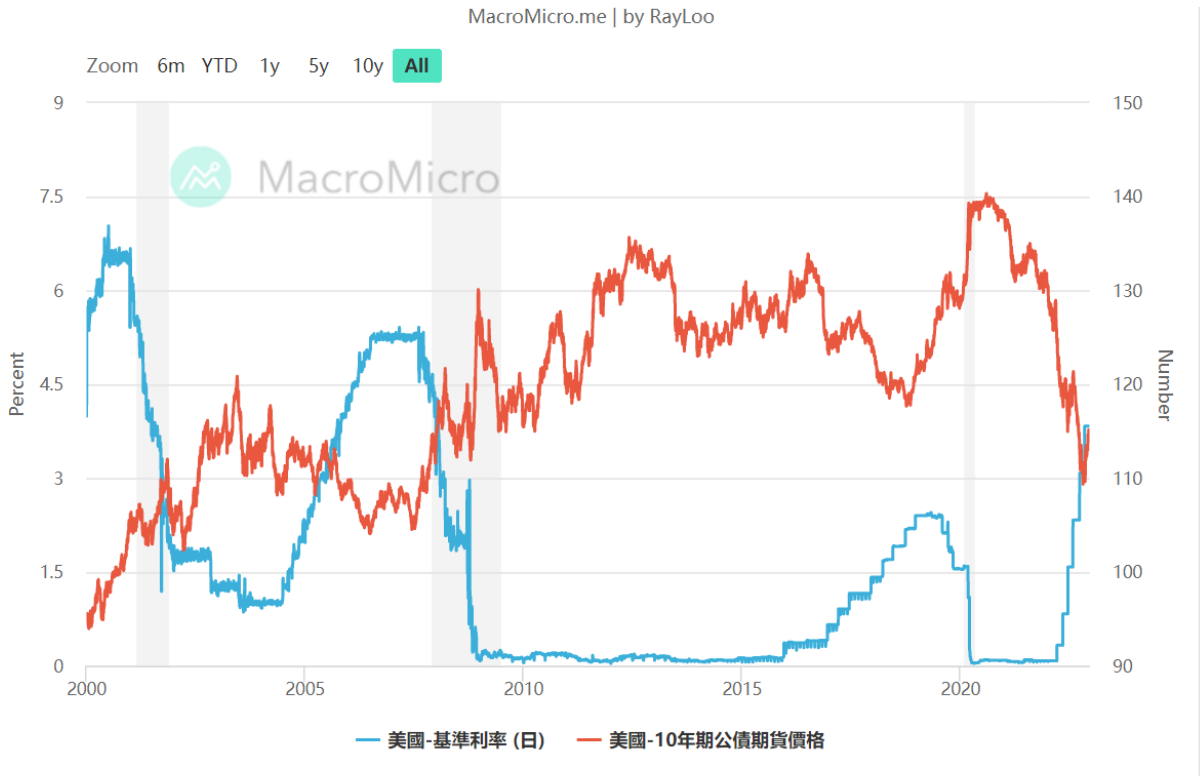
- *The yield curve inverted in June 1989, and a recession occurred in June 1990.*
- *The yield curve inverted in July 2000, and an economic downturn happened in March 2001.*
- *The yield curve inverted in Aug 2006, and a recession occurred in Nov 2007.*
- *The yield curve inverted in May 2019, and an economic downturn happened in Feb 2022.*

The impact of the Fed's monetary policy has a lag, so a recession in the US economy usually occurs 6-18 months afterwards. In the past, recessions in the US have generally occurred after the 'end of rate hikes or the 'start of rate cuts. The general scenario would be the Fed starts the rate hike cycle, then "the dollar rises, and all non-US assets generally fall", then the Fed stops raising rates, US 10Y/3M Treasury yields are inverted, while the US recession starts to show, then the Fed "starts to cut rates", followed by "the dollar falls and all non-US assets rise".

In the past, it was only after the Fed had "stopped raising rates" that the spread on the "US 10Y/3M Treasury bond yield" became inverted. This time it has already been inverted in November this year, but the Fed may have to continue to raise interest rates to suppress high inflation, which means that there could be a more severe recession in the US this time.

US Bonds may stage a "return of the king"

Against the backdrop of tighter monetary policies in most countries around the world, increased expectations that the global economy may fall into recession, and geopolitical tensions arising from the Russia-Ukraine military conflict that has not yet effectively ended, the more defensive "bond investment" may become a safer and more robust investment option. Since the beginning of this year, the US 10YTreasury note has risen sharply from 1.50% at the beginning of this year to 4.30% and has continued to fall since the formation of the "double top" technical pattern in October-November this year, and is currently quoted at around 3.50%. Treasury yields have an inverse relationship to the price of bonds, so after also hitting a rare historical low, the price of bonds has now risen slightly in line with the fall in the US 10Y Treasury yield. Now that the market is confirming and reinforcing the view that inflation in the US has peaked, market rates may not be far from the "top". This also means the chances of a "bond rally" are much more significant. The "strong dollar" may not continue as it did in 2022, and US government bonds are less risky and more resistant to recession risk. Investors trading on OANDA should note that the next few years could be an excellent opportunity to invest in US 02Y T-Note, US 05Y T-Note and US 10Y T-Note (symbols: USB02YUSD, USB05YUSD and USB10YUSD, respectively).



Source: MacroMicro

The blue line in the chart represents the US benchmark interest rate, the red line represents the US 10Y Treasury bond, and the grey area represents the period of the 'US recession'. From the chart above, we can see that when the Federal Reserve starts to "stop raising" or "start lowering" interest rates, it is generally the stage when the US 10-year Treasury bonds start to "bottom out and rise", and it is also the beginning of a recession in the US economy.

2. Chinese President Xi Jinping's Saudi visit boosts crude oil and offshore RMB.

Last week (7-10 December), Chinese President Xi Jinping attended the first China-Arab States Summit, where he said that in the next 3-5 years, China will work with the GCC countries in critical areas such as energy, finance, innovation and technology, aerospace and language and culture.

During the summit between the two countries, 34 investment agreements were signed for US$50 billion, covering a wide range of sectors, including green energy, green hydrogen, photovoltaics, information technology, cloud services, transport, logistics, healthcare, housing and construction of factories. Chinese President Xi Jinping attending the first China-Arab States Summit is China's most prominent and highest profile diplomatic initiative linked to the Arab world since 1949 and "another successful exercise" in Chinese diplomacy since the 20th National Congress of the Chinese Communist Party.

However, "whether the two countries can reach an agreement on the settlement of part of the crude oil trade in yuan" before the summit became the focus of attention from all walks of life around the world, but so far, there has been no expression related to "agreement on the settlement of oil in yuan" in the various official documents of both sides, which means there is no substantial breakthrough yet. This may be related to the fact that the RMB is still not a freely convertible international currency and is dependent on the US dollar system, although it has special drawing rights in the IMF.

The economic structures of China and the Arab countries are highly complementary, and economic and trade cooperation between the two sides has made great strides in the past ten years, especially in the field of infrastructure, with the Arab countries being an essential source of outbound contracting work for China. One of these projects, the Mecca–Medina high-speed railway, which China helped Saudi Arabia to build in the desert, was opened to traffic in 2018. When Saudi Arabia offered US$60 billion, no company dared to take it on, but only a Chinese construction company took on the difficult task of building a high-speed railway in the desert. With more than 60% of the world's combined mileage of high-speed rail, it is fair to say that China is now deservedly number one in both high-speed rail technology and the development and application of high-speed rail.

China has begun implementing a more relaxed version of its strict “zero-COVID” policy with the official announcement that travel codes will soon be taken offline and that both entertainment venues and tourist attractions will no longer require verification of the health QR codes. Also on Friday, the Ministry of Finance of the People's Republic of China announced its decision to issue 750 billion yuan of special treasury bonds to raise financial resources to support the development of the national economy and social undertakings. In November, China made two fundamental policy shifts in its zero-Covid policy and property market, which boosted market expectations for growth prospects in 2023.

<u>Oil prices may continue to rise in the short term but may fall back in the medium to long term.</u>

The OPEC meeting on 4 December said it would continue its current policy of cutting production by 2 million barrels of crude oil per day, or about 2% of global demand. On 5 December, an agreement between the EU and the G7 to impose a US$60 per barrel price cap on Russian crude oil came into force. Russia responded forcefully, saying it would rather cut production than supply crude under the price cap. At the same time, the recently announced US CPI growth rate for November was the lowest since nearly a year, which was good for “risk assets” risk assets to rebound higher and also helped oil prices to rebound. In addition, and more importantly, the relationship between the world's two largest powers is increasingly returning to a stable and healthy development after the US and China met at the leaders' summit in mid-November, which has also injected new momentum into the stability of financial markets.

These "good news" may continue in the short term, and it is expected that there may be some upside to crude oil prices in the short term. However, in the medium to long term, with the global economy falling into recession next year, especially in the US, it is likely to be a certainty, and with "electric cars" replacing "petrol cars" already an unstoppable trend, oil prices could fall back and look towards US$65/bbl.

With the gradual withdrawal of the Chinese government from the "zero-Covid policy", the recent introduction of new real estate policies and loose monetary policies by banks, adjustments to Covid-19 prevention and control measures continue to be made across China. With the easing outlook, market expectations for China's economic recovery have significantly improved, with investors showing a positive attitude towards the economic reboot and active market trading, which is conducive to restoring confidence and re-establishing a valuation system in the market. Meanwhile, the offshore RMB has been below the 7.00 level since early December on the back of a weaker US dollar, greatly stimulating renewed capital flows into the yuan. The Hong Kong stock market, the Chinese stock market, maybe brewing to resume its rally. The following is a record of gains and losses in the financial markets over the past week.

- *WTI Oil closed up 7.84% (70.50-76.50) and is currently quoted at 76.50.*
- *Brent Oil closed up 7.24% (76.00-81.50) and is currently quoted at 80.50.*
- *USDCNH closed down 500 pips (7.0000-6.9400), or CNH up 0.86%, currently quoted at 6.9630.*
- *CHINA50 closed up 700 pips (12600-13300), or 5.56%.*
- *CHINAH closed up 440 pips (6400-6840), or 6.88%.*
- *HK50 closed up 1600 pips (18500-20100), or 8.65%.*

Short-term risks:

In the coming two weeks' time, may focus on the Fed's interest rate meeting this Thursday evening (15 December). With recent comments from Fed Chair Powell interpreted as "dovish", bond traders have lowered their expectations for the Fed's terminal rate, with the market expecting that the "terminal rate" could peak below 5%. If Powell is "hawkish" and raises the terminal rate to 5.2% or more, it could drive the dollar stronger again, to the detriment of risk assets, non-US currencies, US stocks, and US Treasuries could fall again. On the contrary, of course, it is good for the Santa Claus Rally of the non-US assets. Also, please focus on US GDP data for the third quarter next Thursday (22 December) and the United States Durable Goods Orders for November and US Non-Defense Capital Goods Orders Ex Aircraft for November next Friday (23 December), which are forward guidance for measuring the US economy or forecasts of a future "recession".

By Sandy Wang,

12:30pm SGT time 14 Dec 2022