Market Comment_04Jan2023

The US dollar may have "peaked". Going long yen and gold could be one of the best trading opportunities in 2023.

SUMMARY: BOJ shocked markets by adjusting the "Yield Control Curve", the yen soared, and the discussion on the opportunity to short GBPJPY. Australian dollar may see an overall rise in 2023. The dollar may have peaked, and gold may continue to rise after stabilizing above 1800.

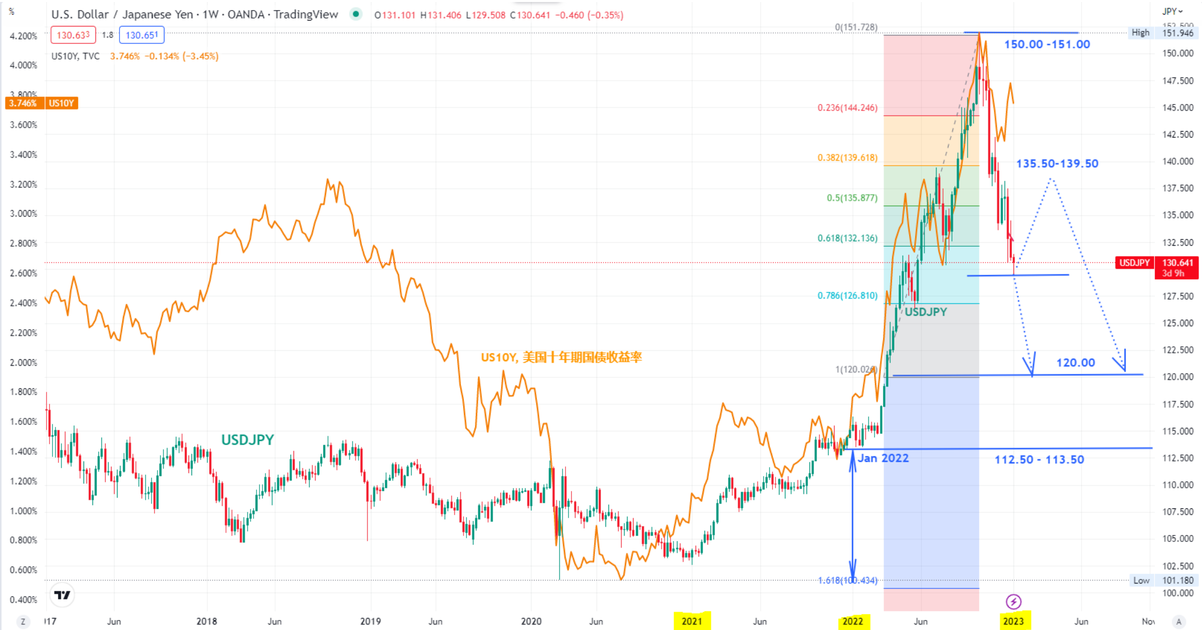
1. BOJ shocked markets by adjusting the "Yield Control Curve", the yen soared, and the discussion on the opportunity to short GBPJPY.

1) BOJ shocked markets by adjusting "Yield Control Curve" and sparking a sharp jump in the yen.

On 20 December 2022, the BOJ unexpectedly announced a relaxation of the range for the 10-year Japanese government bond yield, also known as the Yield Curve Control (YCC), from a "range of -0.25% to +0.25%" to a "range of -0.5% to +0.5%", as high as 0.5% from a previous cap of 0.25%. At the same time, The BOJ also decided to sharply increase monthly purchases of Japanese government bonds to ¥9 trillion per month from the previous ¥7.3 trillion, to be implemented in the first quarter 2023. The market generally interprets this as a disguised "interest rate hike" or the BOJ's first step in opening monetary tightening. Meanwhile, the recently released Japan core CPI (Ex. fresh produce and food) figure for November was 3.7% YoY, which was a record high since December 1981, compared to 3.6% previously. As of the end of November, Japan's CPI was at its highest annual rate in 30 years, up 3.8% year-on-year, compared to 3.7% previously. These figures further confirm the market's expectation that the BOJ will turn "hawkish".

Meanwhile, the minutes of the BOJ's monetary policy meeting in October showed that the BOJ board members, who are concerned that inflation may be getting worse, have begun discussing the possibility of exiting from "quantitative easing". The Governor of the BOJ is due to leave office in April 2023, and during his tenure, he has been paranoid about keeping the "yield curve" below the 0.25% ceiling. The tightening of the yen's monetary policy will bring a huge shock to the global financial system. The next one would be a real market "earthquake" if the BOJ were to start raising interest rates. The market generally discusses this action as the market credibility of the BOJ's "new successor" has yet to be established, and the "adjustment of the YCC curve" will be carried out by the outgoing Kuroda Toyonaka's central bank team, which will not have to bear the credibility risk.

Reflecting this in the FX market, within 24 hours of the BOJ announcement, the BoJ two-year bond yield breached 0% (the first time since 2015), and the Japanese 10-year bond yield jumped and came infinitely closer to reaching a new ceiling of 0.5%, while the JGBs were very volatile. USDJPY, on the other hand, launched a sharp 700 pip decline after the news (137.50 - 130.50). The market is currently traded at around 131.05.



Source: tradingview

Over the past year, the USDJPY has been high "positively correlated" with the US 10-year Treasury yield. However, since the end of December 2022, this is changing.

The "start of the tightening cycle by the BOJ" shocked the global financial markets. This is because the "yen carry trade" is an important part of the "world reserve currency" system, with the US dollar as the base currency. International investors borrow a lot of yen because the yen's exchange rate is low, and the interest rate of the yen is also low. After borrowing the Japanese yen, investors can do "foreign currency swaps" in the foreign exchange market, and exchange it for a slightly higher interest rate currency, such as the U.S. dollar, the euro, or the British pound, and then invest in U.S. Treasuries or European Treasuries. This is because the yields on government bonds in these places are much higher than those on Japanese government bonds. Therefore, the Japanese government can earn double profits; one is the difference between the government bonds yield and another one is the exchange rate difference from the yen's depreciation.

However, if the BOJ's policy reverses and changes from easing to tightening, the yen exchange rate will keep rising, and the Yen Carry Trade will be exposed to significant risks. This would cause the entire chain of trading in the financial markets regarding the yen to start reversing. As of November 2022 data, Japan is still the largest overseas holder of US Treasuries. In fact, it is Japan that has always been one of the largest buyers of US and European Treasuries, the BOJ's adjustment to the YCC curve is equivalent to raising the cost of financing yen-related funds while triggering yen-related funds to close out their positions in US and European bonds, triggering a large amount of funds to flow back to Japan. That is, investors sell US Treasuries or European Treasuries in exchange for US Dollars, British Pounds or Euros and then buy Japanese Yen, which leads to a further appreciation of the yen. The sell-off in the global bond market has continued over the past 1-2 years, leading to a further deterioration in the liquidity of US and European Treasuries. If a certain "critical value" is reached, it will trigger a correlation in the global financial markets and cause certain financial risks. The sharp depreciation of the USDJPY has already fueled the recent surge in gold to some extent.

2) One of the top trading opportunities for 2023 may be shorting GBPJPY.

Looking back to 2022, the world's major developed country central banks have started rate hikes, tightening monetary policy and only the Bank of Japan, independently and exceptionally, kept the easing unchanged. In particular, the divergence between the basic guidelines of the Bank of Japan and the Federal Reserve supported the USDJPY all the way up. Since the beginning of 2022, it has been rising until late October 2022, surprisingly rising 33.48% (113.50 - 151.50) before it started to fall. As of now, it has declined 13.86 % (151.50-130.50) and is currently traded at around 130.70. Shorting GBPJPY may be one of the top trading opportunities for 2023. Here are the record gains and losses of non-US currencies against the JPY over the past two weeks, with GBPJPY, CHFJPY, and EURJPY leading the way, with the GBPJPY gaining the most against at 1,350 pips.

- *USDJPY down 780 pips (138.30 - 130.50), or 5.64%*
- *GBPJPY down 1350 pips (169.00 - 155.50), or 7.99%*
- *EURJPY down 900 pips (146.50 - 137.50), or 6.14%*
- *NZDJPY down 650 pips (87.50 - 81.00), or 7.43%*
- *AUDJPY down 500 pips (92.00 - 87.00), or 5.44%*
- *CADJPY down 570 pips (101.20 - 95.50), or 5.63%*
- *CHFJPY down 950 pips (148.50 - 139.00), or 6.40%*
- *SGDJPY down 470 pips (101.50 - 96.80), or 4.63%*

In a recent interview with Bloomberg, former Japan's vice finance minister Eisuke Sakakibara, also known as "Mr. Yen", said that "the USDJPY will fall to 120 against the backdrop of further tightening by the BOJ". Eisuke Sakakibara is known as "Mr Yen" for his highly regarded management of the Asian crisis in the late 1990s. He had indicated earlier in 2022 that USDJPY could rise to 150, with the result that USDJPY eventually reached a peak touching around 151.50 in October 2022. He had also previously indicated that the BOJ could raise its yield curve control ceiling at its January 2023 meeting. This shows his ability to forecast the yen and BOJ policy with a high degree of accuracy. According to the views of leading British economists quoted by the British "Financial Times" on the 3rd, compared with other G7 countries, the UK will face the worst economic recession in 2023. John Philpott, an independent labor market economist in the UK, said: "The recession in 2023 will be worse than the impact of the new crown epidemic on the economy." If Mr. Yen's prediction of USDJPY may fall to 120.00 in the future is accurate, then shorting GBPJPY could be one of the good options this year.

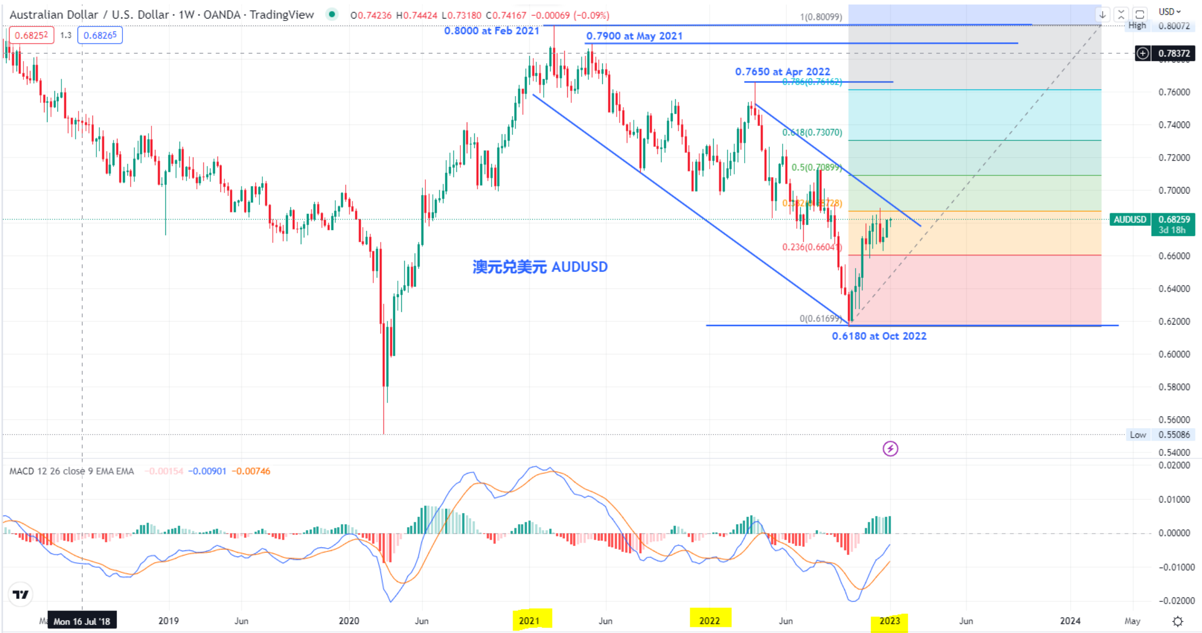
2. Australian dollar may see an overall rise in 2023.

Looking back to 2022, the RBA started raising interest rates in May and has increased rates by 50 basis points in each of the June, July, August and September rate meetings. In the third quarter of 2022, the RBA began to halt the pace of significant rate hikes, slowing them by 25 basis points for two consecutive months (October and November) to implement a more "moderate" tightening policy. Based on data at the end of 2022, the latest CPI was 7.1% year-on-year in the US and 6.9% in Australia. Although inflation remains high, the fundamentals of the Australian economy have been relatively strong, and a strong rise in the Australian dollar may be expected in 2023. As the global reserve currency of US dollar that dominates foreign exchange markets, the dollar's strong rally in 2022 might not continue in 2023. Since the fourth quarter of 2022, the "peak" of the current dollar rally has been largely confirmed. That said, the overall trend in the FX market in 2023 might be for the US dollar to fall, pushing non-US currencies higher, including the Australian dollar.

With the level of US inflation still at an all-time high of 7.1%, the Fed's 2% inflation target will not be achieved until the end of 2023 or 2024, after which monetary policy easing will be considered. The USD has already retraced 10.05 % (114.50 - 103.00) of its 27.22 % (90.00 - 114.50) surge over the last year or so (since the end of May 2021) in the fourth quarter of 2022. Heading into 2023, the dollar is expected to pull back higher in the first quarter of the year, but the pullback should be below the October 2022 high (114.50). In other words, no matter how much the Australian dollar falls, it will not fall below the lowest range touched in October 2022 around 0.6200-0.6300 (corresponding to the highest point hit by the US Dollar Index simultaneously).

In general, the dollar is still supported by the following factors: 1) the dollar can still play a safe-haven role in the context of the volatile geopolitical situation of the Russia-Ukraine conflict. 2) the US economy is relatively sound. 3) the basic attitude of the Federal Reserve: due to high inflation in the US, the Fed will continue to raise interest rates and remain at a high level for a more extended period, with a terminal rate of 5%-5.25% still to be confirmed. 4) The dollar has fallen 10% from its highs in the fourth quarter of 2022. The dollar index has shown signs of stabilizing and finding equilibrium at 103.50 over the past two weeks and may rebound to the 109.50-110.50 range if it can hold steady at that level. 5) According to the Fed's statements, a policy shift towards "interest rate cuts" will not likely occur until 2024. On when the Fed will stop "raising rates" or start "lowering rates", Fed Chairman Powell has mentioned the following three conditions will be met: a) to keep the US economy in a sustained period of below-trend growth (even as the economy slips towards a possible recession); b) Bringing the "supply and demand" of jobs into balance; and c) to see clear evidence that inflation is moving towards the 2% target.

RBA December monetary policy meeting minutes: RBA raised peak inflation expectations to 8.0% from 7.75% previously, but RBA still sees a significant decline in inflation in 2023. Medium-term inflation expectations remain positive; CPI return to target level requires sustained supply and demand, with CPI expected to be around 4.75% in 2023 and CPI expected to be just above 3% in 2024. The RBA is firmly committed to returning to the CPI target and will use all necessary means to do so; there is a great deal of uncertainty regarding the economic outlook and household spending; further interest rate hikes may be expected in the period ahead, raising rates further to balance demand and supply in the economy; however, there is no pre-determined path for rate hikes. GDP is expected to grow by 1.5% in 2023 and 2024, and the unemployment rate is expected to remain stable in the coming months. The labour market remains very tight, with many companies having difficulty recruiting workers.



Source: tradingview , AUDUSD, Heading into 2023, the dollar is expected to pull back higher in the first quarter of the year, but the pullback should be below the October 2022 high (114.50). In other words, no matter how much the Australian dollar falls, it will not fall below the lowest range touched in October 2022 around 0.6200-0.6300 (corresponding to the highest point hit by the US Dollar Index simultaneously).

3. Trade during the US recession and shorting the Dow Jones may be one of the best trades for 2023.

As heading into 2023, the IMF warns that a recession will hit one-third of the world's economies, and the world will face a "tougher" year than the last 12 months. It is believed that the threat of a bear market in US stocks remains. Although the Fed has raised interest rates several times, US inflation remains high, forcing the Fed to continue to maintain high-interest rates until inflation starts to fall significantly. It is foreseeable that interest rates will remain high in the first half of 2023, making it difficult for corporate earnings not to be hit harder, and the transmission mechanism triggered by the rate hike will be detrimental to the stock market.

In 2023 the Fed will continue to raise interest rates but slow the pace of increases and maintain high rates for an extended period, while the gap between market expectations of peak interest rates and the Fed's peak expectations will continue to affect the volatility of financial markets. Looking back to 2022, the Fed has initiated an aggressive rate hike policy to curb high inflation. Since the Fed's (FED) first rate hike in March 2022, the Fed has raised rates by a cumulative 425 basis points in 2022, increasing the target range for the federal funds rate from 0.00- 0.25% at the beginning of the year to the current 4.25- 4.50%. In particular, the Federal Reserve raised rates aggressively by 75 basis points on four consecutive occasions in June, July, September and November. At one point in June 2022, the annual rate of US inflationary CPI soared to 9.1%, the most significant year-on-year increase since April 1980. Although inflation has eased since September-October 2022 (currently at 7.3%), it still has a long way to go to reach the 2% target level. Going into 2023, the Federal Open Market Committee (FOMC) will also hold eight regular meetings.

The decline over 2022:

- *Dow Jones down 8,300 pips (36950 - 28650), or 22.46%*
- *S&P 500 stock index down 1360 pips (4810 - 3500), or 27.24%*
- *Nasdaq down 6,100 pips (16650 - 10550), or 36.64%*

The rally Q4 2022:

- *The Dow Jones surged 5,950 pips (28650 - 34600), or 20.77%, and is now traded at 33140*
- *The S&P 500 stock index rose 640 pips (3500 - 4140), or 18.29%, and is now traded at 3830.*
- *The Nasdaq gained 1,650 pips (10,550 - 12,200), or 15.64%, and is now traded at 10,891*

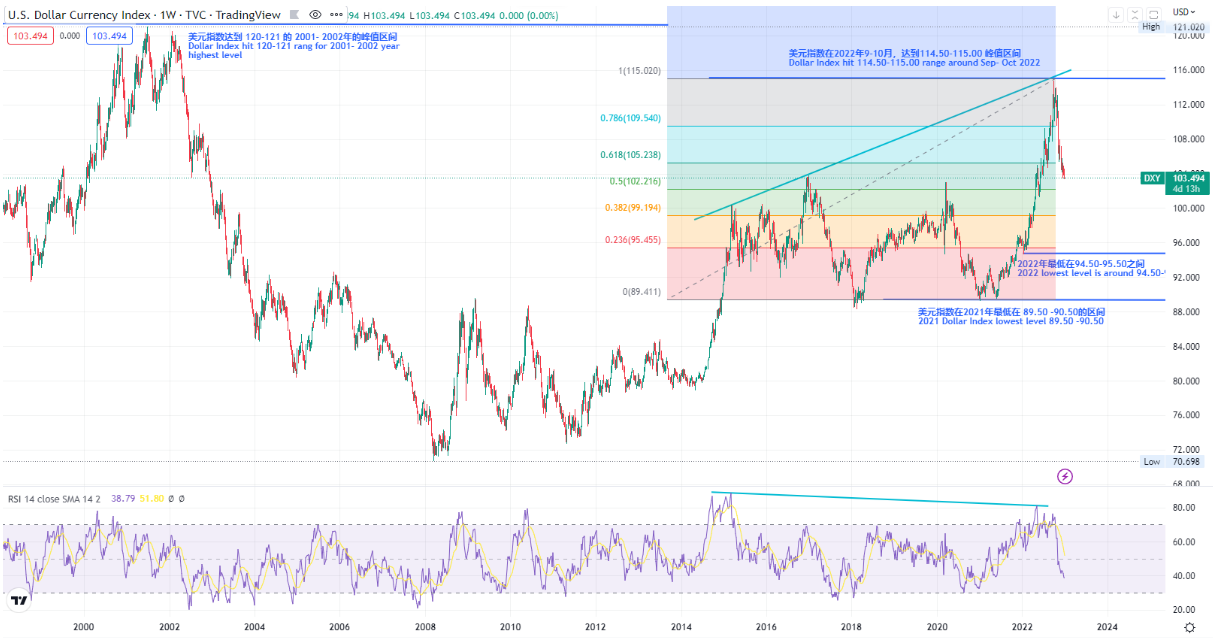
US stock markets generally plunged in 2022, with the technology-related Nasdaq, in particular, falling the most. The Dow Jones is down almost 22.46% in 2022, compared to a more significant decline of 36.64% for the Nasdaq and 27.24% for the S&P 500. It is worth noting that the Dow rallied 20.77% in the fourth quarter of 2022, close to 22.64% of the year's losses, meaning that the Dow recovered almost all of its 92.47% losses, while the Nasdaq and S&P 500 recovered 67.14% and 42.69% of their losses, respectively, in a relatively smaller rally. The Dow is currently experiencing resistance at the critical psychological level of 35,000, and shorting the Dow may be one of the best trades for 2023.

Source: tradingview.

Since mid-December 2022, the DJ index has shown an upward "shooting star candlestick" technical pattern, indicating that the DJ index may start to fall after 35000. The first target, the Fibonacci 23.6% retracement, has been reached at around 33800, and the second target may look towards the Fibonacci 38.2% retracement at about 33050. The third target may be the Fibonacci 50% retracement, which is probably around 32,500.

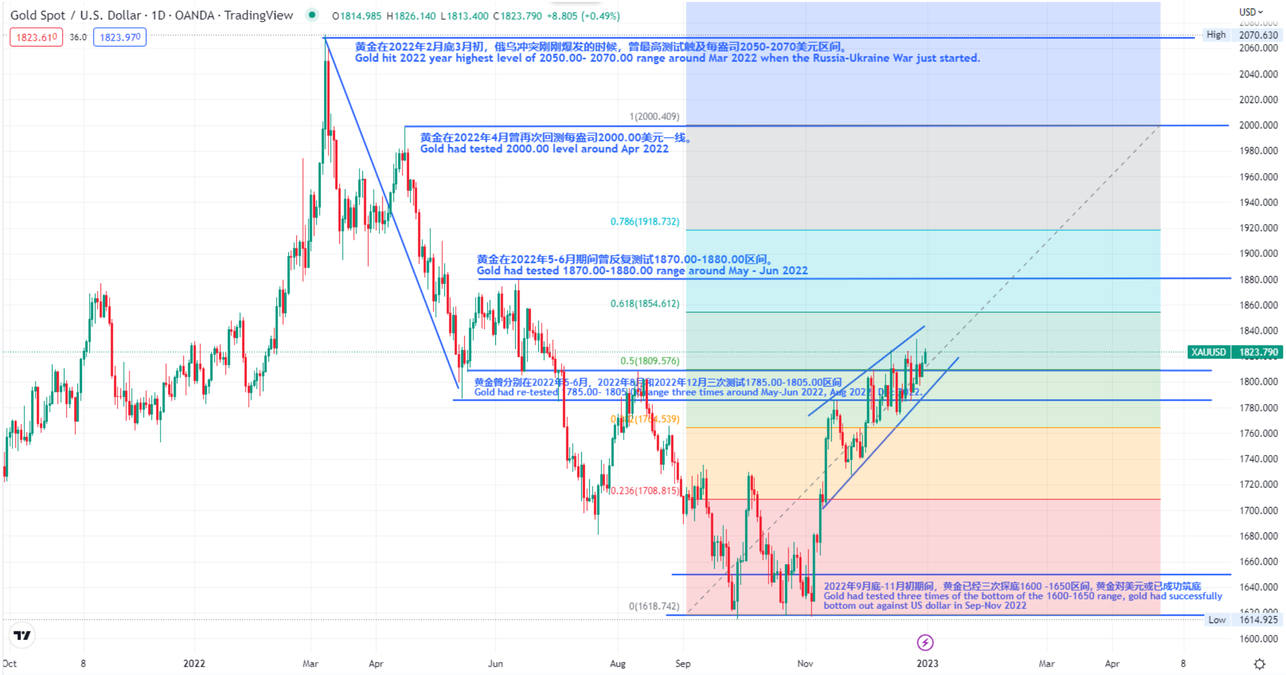
4. The dollar may have peaked, and gold may continue to rise after stabilizing above 1800.

The US Dollar Index has remained in the 103.00-105.00 range since December last year, as some market investors believe that US inflation is still need long time to coming back down to the 2% target level set by the Fed, suggesting that the Fed is expected to maintain interest rates above 5% throughout 2023 to fight inflation, and there may be a risk of a small rebound if the Dollar Index manages to hold on to the 103-105 range. It is currently traded at around 103.50. However, with the Fed nearing the end of its tightening monetary policy in 2023 and even a potential "turn", the overall decline in the dollar in 2023 may be irreversible. What's more, with the gradual decrease in the attractiveness of dollar reserves and dollar assets, coupled with sanctions against Russia in Europe and the US, and the potential for an "oil settlement" triggered by the Russia-Ukraine war, the dollar may be sold off, and holdings may be reduced. According to data, the US dollar's share of global central bank foreign exchange reserves has fallen from 65.46% in the first quarter of 2016 to 59.15% in the third quarter of 2022. As a result of the above analysis, gold's "monetary" and "investment" properties are expected to regain the attention of the market in 2023, and the likelihood of an overall rise in the market this year has increased significantly. At present, gold has repeatedly oscillated between 1765.00-1800.50 since December 2022 and has stabilized above 1765.00 per ounce for four consecutive weeks, suggesting that gold may be in the process of stabilizing at 1800.00 and start a larger wave of upward movement.



Source: tradingview, Dollar Index

Technical analysis: *The overall trend for the US dollar over the 2023 may be to the downside. Currently, the weekly candlestick and RSI oscillator of the US Dollar Index are in a classic "regular bearish divergence" pattern, signaling that the US Dollar Index is at a price high of October 2022 and the RSI oscillator has failed to exceed the previous high. The opportunity for a reversal of the dollar to open up the decline has arrived. The dollar index's reversal down since October 2022 may have confirmed that the dollar's "downward trend" may not be reversed in 2023. The first target, the Fibonacci 38.2% retracement, has been reached at around 105.50, and the second target may look towards the Fibonacci 50% retracement, at about 102.50. The third target, the Fibonacci 61.8% retracement, is probably around 99.50-100.50.*



Source: tradingview

Technically, as gold has tested the bottom of 1600 -1650 between late September and early November 2022, it is still in a strong upward trend, with a pullback or potential bullish opportunity for gold if it falls back. Looking back at 2022, gold had tested as high as touching the US$2050-US$2070 per ounce range in late February/early March 2022, just after the Russia-Ukraine war had just started. It then tested the US$2000.00 per ounce level in April 2022. Gold may have successfully bottomed out at US$1600-US$1650 per ounce between the end of September and early November 2022. In addition, the US$1785.00-US$1805.00 per ounce range was tested three times in May-June 2022, August 2022 and December 2022, respectively. It is currently traded at around US$1823.50 per ounce. That said, it is only advisable to be bearish on gold once it effectively falls through the 1785-1805 range level. If it continues to rise and may test the 1850 and 1900 resistance levels upwards in 2023, it is highly likely to challenge the 2000.00 level.

5. Short-term risks

Please pay attention to the minutes of the Fed's Open Market Committee meeting this Thursday (5 January), the US non-farm payrolls data for December this Friday (6 January) and the US core Consumer Price Index (CPI) data for December next Thursday (12 January), which is the critical data on the stability of the US labor market and whether inflation levels continue to cool. While China's economy may be expected to recover gradually in the first quarter after easing the Covid-policy, the rapid spread of multiple variants of the virus, the lack of vaccination of the population and the inadequate supply of commonly used drugs are putting the "China herd immunity" to the test and may also lead to other problems.

In the medium to long term, the author’s view is risk assets may face more volatility in the first half of 2023, and the US dollar index, which has a strong negative correlation with equity markets, may start a certain degree of rebound. As we head into the second half of 2023, the market gradually digests the Fed's slowdown in rate hikes and the expectation that it will start to look forward to possible future rate cuts, coupled with the gradual and rapid economic recovery in regions such as China and Europe, the US Dollar Index may enter a downward trend, and non-US currencies and equity markets may be able to see a sharp upward move.

By Sandy Wang,

11:20 am SGT time, 4 Jan 2023