Market comment_01Feb 2023

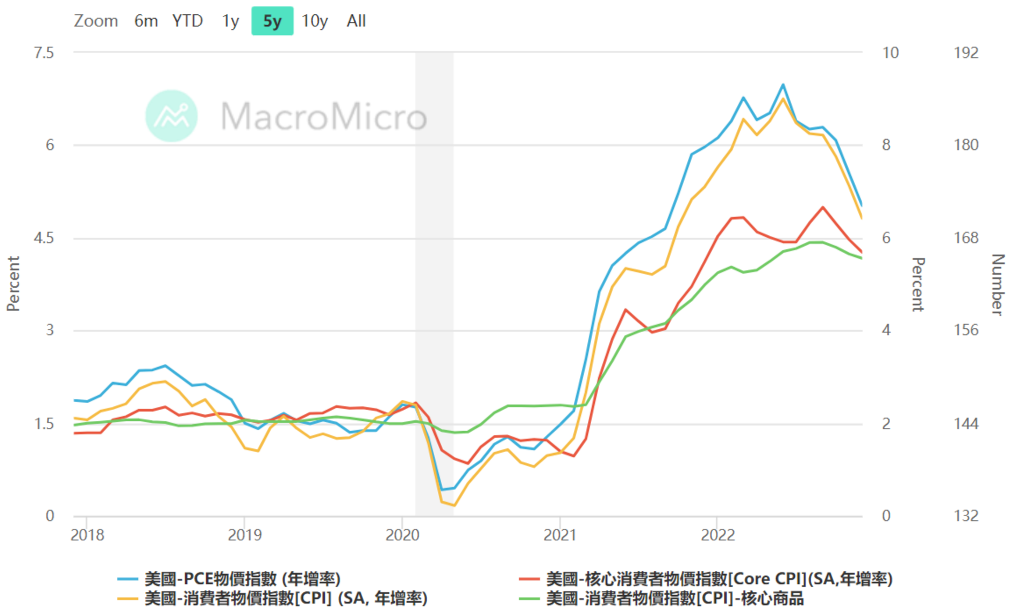
01 Feb 2023-11:50am SGT

IMF Raises Global Growth Forecasts; US Dollar poised to break out from recent 'tight range' after FOMC meeting.

Key Points: *The US dollar index continues to be weak and may continue to consolidate weakly and poised to break out of the recent "tight range" after this week's FOMC and US Non-Farm Payrolls data releases. Gold and the Australian dollar have recently highlighted their "positive correlation", rising and falling together; "inflation tops out in low growth environment", IMF raises global growth forecasts and USD rally may limit oil prices in the short term.*

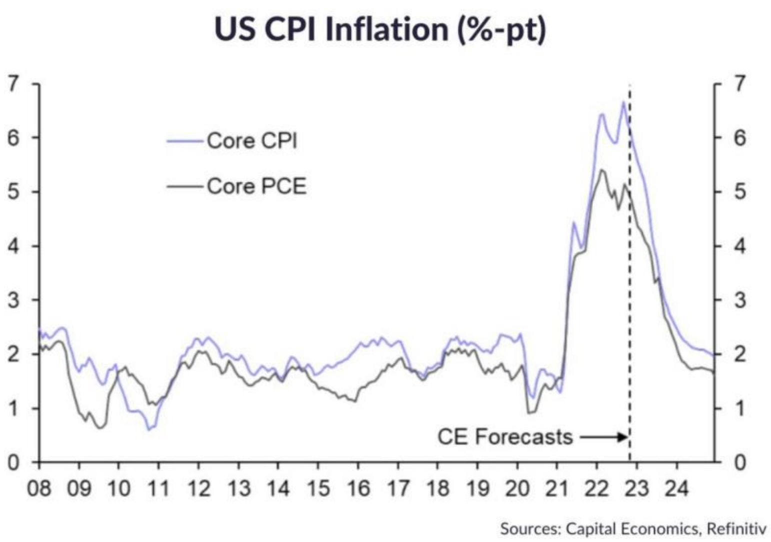
1. The US dollar index continues weak, it may break out from recent "tight range" after FOMC and US non-farm payroll data released

The US Dollar Index has repeatedly been moving sideways in the range of 101.10-102.50 for the past three weeks, with the overall weakness unchanged, as the continued cooling of CPI inflation data in recent months has supported market expectations of a "dovish" Fed policy in the coming months. The recently released US Core PCE Price Index (YoY) for December was recorded at 4.4%, in line with expectations and below the previous value of 4.7%, hitting its lowest level since October 2021. The Core PCE Price Index (YoY), released at the same time, fell to 3.9% in the fourth quarter 2022, slightly below expectations of 4% and down significantly from 4.7% in the previous quarter, the lowest level since the first quarter of 2021. Meanwhile, the recently released Michigan 1-Year Inflation Expectations in the United States for January fell to 3.9%, a new low since May 2021.



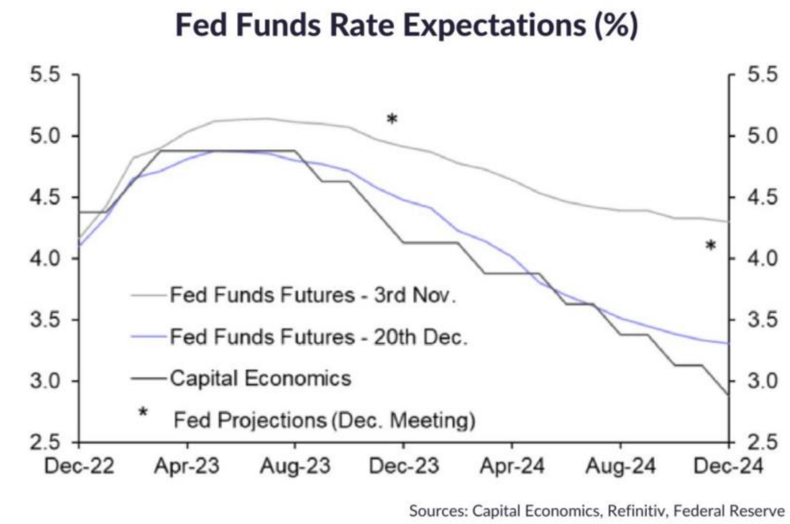
Source: MacroMicro, US inflation CPI has fallen for the past four consecutive months.

US inflation has been falling for the past four months in a row, with a continued cooling, and the latest (12 January) CPI (annual rate) for December 2022 recorded at 6.5%, but this is still far from the Fed's 2% target. So as of now, almost no Fed officials have spoken out in favor of a shift to rate cuts this year, and all remain in favor of continuing to raise rates. The market is widely expected to increase rates by 25 basis points to 4.5%-4.75% at the FOMC meeting this Thursday (2 February) 3 am-3:30 am.



Source: Capital Economics, Refinitiv, US inflationary pressures will ease substantially after entering 2023. If the economy does fall into recession, it may help to subside inflation. Inflationary pressures will reduce sooner than everyone *expects. Supply shortages are easing, inventory levels are rebounding, transport costs have normalised, and many commodity prices, particularly energy, are plummeting. The sharp slowdown in private measures of new lease agreements also points to a slowdown in core inflation next year.*

But a number of recent Fed officials have recently spoken in favour of raising rates to at least 5.25%. On 9 January, Atlanta Federal Reserve President Raphael Bostic said in an interview that the Fed's commitment to tackling high inflation makes it necessary to raise rates to a range of 5% to 5.25% to squeeze out excess demand from the economy. Interest rates will have to remain high for a long time, until 2024. On the same day, President and CEO of the Federal Reserve Bank of San Francisco, Mary C. Daly, said in an interview with the Wall Street Journal that a peak rate of 5%-5.25% is reasonable, but the terminal rate is unclear and will depend on recent data. Core services inflation has not fallen fast enough to meet the Fed's expectations, and changing the inflation target is simply not on the table. But according to the CME Fed Watch tool, the market currently expects the Fed's terminal rate to be 4.96%, slightly below 5%. It is also expected to fall to 4.53% by the end of 2023, which means the market is betting that the Fed may cut rates by more than 40 basis points later this year.



Source: & Capital Economics, Refinitiv, Fed Funds Rate Expectations. The Fed's terminal rate may reach around 4.75%-5.0% around mid-2023. As core inflation falls back to the 2% target, the Fed is expected to start cutting rates in late 2023, followed by more aggressive easing in 2024. On this basis, GDP growth will accelerate from 0.3% in 2023 to 1.2% in 2024.

The current "market expectations" are more dovish than the "attitude of Fed officials", which may be the reason for the continued weakness of the dollar index. This situation may end this week after the FOMC meeting and the release of non-farm payroll data. So investors need to pay close attention to the Fed's policy statement released this Thursday 3.00 am-3.30 am. Suppose Fed officials continue to make "hawkish remarks" to suppress "interest rate cuts" expectations and continue to emphasize the "unlikely to start cutting interest rates this year" signal. In that case, the dollar index may have the opportunity to slight rally for a correction. Conversely, there could be renewed pressure on the dollar to fall and usher in an even sharper decline. If the Dollar Index rallies, it may first look to the 102.50-103.50 area, and further gains may point to 105.00, but the overall upside retracement should be below the October 2022 high of 114.50. Conversely, if it falls below 101.00, it may face a sharper sell-off and point to the 100 psychological level.

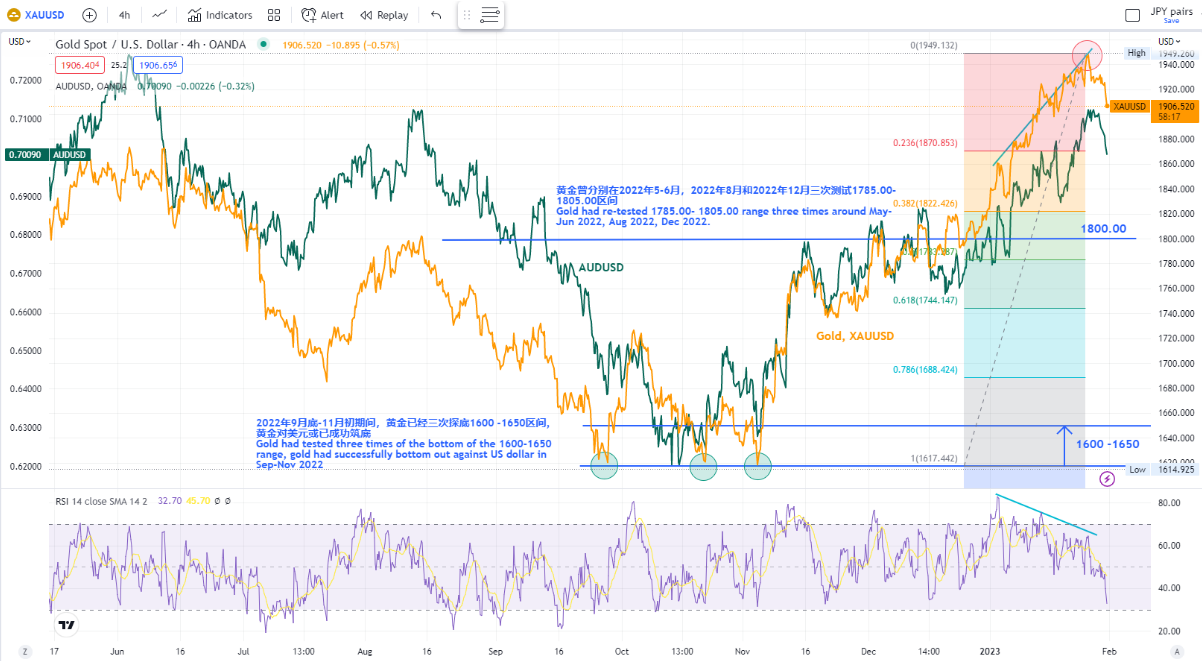
2. Gold and the Australian dollar have recently shown a positive correlation, rising and falling together.

Recently released data (25 January) showed that Australia's CPI reached an annual rate of 7.8% in the fourth quarter of 2022, the highest level since 1990, beating expectations of 7.5% and the previous value of 7.3%. Meanwhile, the CPI rose by 1.9% from the last quarter, exceeding expectations of 1.6%. These inflation figures suggest that Australian inflation has not yet peaked. And the RBA began slowing the pace of interest rate hikes in October last year in anticipation of inflation cooling off. Inflation levels that continue to reach new highs may force the RBA to reconsider initiating higher rate hikes again. The Reserve Bank of Australia (RBA) will likely raise the cash rate by 25 basis points per meeting as a matter of policy. It may take longer before it reaches a peak.

Generally, there is a positive correlation between the price of gold and the Australian dollar, while gold and the US dollar usually have a negative correlation. The Australian dollar is often referred to as a "commodity currency", and the price of commodities, particularly gold, has a significant impact on the Australian dollar exchange rate. Australia is export-oriented, producing gold, iron ore, copper, wool, etc. These commodities account for nearly two-thirds of Australia's total exports; therefore, the Australian dollar is usually influenced by the price trends of these commodities.

The positive correlation between the price of gold and the Australian dollar has been perfectly evident in recent movements. With the US Dollar Index recently consolidating at a low level for almost three weeks, the short-term direction of the US Dollar is uncertain, and the Australian Dollar is clearly following the decline in gold. According to data, gold has been one of Australia's main exports since the late 19th century. Australia holds 17 per cent of the world's gold reserves and has the largest proven gold reserves in the world. For the past decade, Australia has been the world's second-largest gold producer, excluding China, and in the two years since the slowed down of its economy in response to the Covid-19 pandemic, Australian gold production has been relatively unaffected by the pandemic and has had the best two years on record for Australian gold producers, with Australia having overtaken China as the largest gold producer for the time being. Reports indicate that Australia produced approximately 321 tonnes of gold in 2021, and production is expected to reach 379 tonnes by 2023. Analysis suggests that the gold sector will grow at a CAGR of 3.5% between 2021 and 2025 and is expected to grow at 8% over the next few years as production and existing mines expand.

It is important to note that this positive correlation between gold and the Australian dollar is not always valid. For example, in the event of a financial crisis, or extreme risk event, this correlation may be broken.



Source: Tradingview, gold and AUDUSD

When trading AUDUSD, the price of gold can be used as a secondary reference. The rise and fall in the price of gold can give some clues to the movement of the AUDUSD. The recent short-term fall in gold has also been evident in the fall in the AUDUSD. The 4-hour chart and RSI indicators from gold form a classic "regular bearish divergence" pattern. It signals *that the opportunity for a reversal to open up a decline in XAUUSD has arrived after the RSI oscillator failed* *to exceed the previous high after the price set a new high of around 1950. The first target is Fibonacci 23.6% retracement, probably around 1870.50. A second target might look towards Fibonacci 38.2% retracement, probably around 1810.50. Correspondingly, if AUDUSD effectively falls below 0.70, it may immediately fall towards the 0.6950-0.6850 range. If it returns above 0.7000, the short-term focus will be on the previous highs around 0.7150. Gold is currently quoted at 1904.50, and AUDUSD is quoted at around 0.7010.*

In the medium to long term, the AUDUSD will inevitably continue to rise, with S&P Global Ratings recently confirming that Australia is rated "AAA/A-1+" with a stable outlook and that the Australian economy will avoid recession and is expected to grow positively over the next three years. The AUDUSD will also strengthen as it continues to be boosted by rising commodity prices driven by growing market "optimism" over the reopening of China.

3. Inflation peaks in a low growth environment, IMF raises global growth forecasts, and a USD rally may limit oil prices in the near term.

In the latest World Economic Outlook report released on Tuesday (31 January), the International Monetary Fund (IMF) noted that inflation had peaked in a low-growth environment, that the global economy was growing more resiliently than previously expected, and that rate hikes by central banks to fight inflation in 2022 and Russia's war in Ukraine continued to be a drag on economic activity. However, since last October, the "downside risks" have eased somewhat. The global economy in 2023 will still be affected by central banks raising interest rates to combat inflation, the war between Russia and Ukraine and the progress of China's economic recovery, with the reopening of China's economy one of the reasons for the more positive outlook. The IMF has raised its forecast for China's economic growth from 4.4% to 5.2% in 2023. Global inflation is expected to fall from 8.8% in 2022 to 6.6% in 2023 and 4.3% in 2024 but is still above the pre-pandemic (2017-2019) level of around 3.5%.

<u>In terms of upside risks,</u> the release of pent-up demand in many economies is likely to provide a more substantial boost to growth; also, inflation is likely to fall more quickly. <u>In terms of downside risks</u>, the pandemic in China could hamper economic recovery if it has severe consequences for the population’s health; Russia's war in Ukraine could escalate, and a tighter global financing environment could exacerbate debt distress. In addition, an unfavorable inflationary situation could lead to a sudden repricing of financial markets, while further geopolitical fragmentation could hamper economic development. It is

worth noting that the IMF has stressed that the fight against inflation is not over and urged central banks to resist the temptation to turn policy.

Growth in developed economies is expected to fall sharply from 2.7% in 2022 to 1.2% in 2023 and rise to 1.4% in 2024, with the growth forecast for 2024 revised downwards by 0.2%. Growth in about 90% of developed economies is expected to slow in 2023. Growth in emerging markets and developing economies is expected to rise slightly from 3.9% in 2022 to 4.0% in 2023 and 4.2% in 2024, with forecasts revised up by 0.3% in 2023 and down by 0.1% in 2024. About half of the emerging markets and developing economies will grow at a lower rate in 2023 than in 2022.

The Consumer Confidence (by the Conference Board) released on Tuesday (Jan 31), fell to 107.1, compared to expectations of 109 and the previous value of 108.3. The slight fall in this data may reflect that market expectations for the US economy and job market are not very optimistic. With market expectations of falling inflation rising and the dollar continuing to fall, the author of this article expects the Fed's interest rate resolution to be released at 3 am this Thursday (2 February) to be "hawkish". Fed Chairman Powell is likely to re-emphasise his determination to "control inflation back down to 2%", and it also cautioned that interest rate cuts would not be considered in 2023 to fight the stickiness of inflation.

The recent decline in crude oil may suggest a good time to go long. The reopening of China has boosted a number of commodities, particularly oil, which I expect to rise in 2023 and point to a maximum of the 90-100 range.

Source: Tradingview

WTI oil prices continue to be constrained by the 82.00-83.00 resistance range above in the short term, and please be wary of oil prices testing $75.00 on the downside again, as well as the previous low of $70.50. Overall, I am optimistically bullish on oil prices in 2023, but need to be patient and wait for confirmation of signals that the decline has bottomed out in the short term.

Before the Fed resolution officially starts this Thursday, the market worries that the Fed's Powell is about to turn on the "hawkish" rhetoric. The market was expecting a much tougher stance compared to the Fed officials. The dollar rallied slightly, dragging down the price of WTI crude oil.

According to reports, Russian crude oil exports increased by 876,000 barrels to 3.8 million barrels per day as of the week ending January 13, the highest level since April last year. This news has put more significant downward pressure on short-term WTI crude oil prices. Meanwhile, EU member states announced last week that they would limit the price of diesel exports to Russia to between $100 and $110 per barrel, a proposal agreed upon by the G7 countries. The EU price limits on Russian refined oil products will be implemented from 5 February this year. Russian diesel exports to Europe in 2022 amount to 740,000 bpd, or 86% of all exports; Europe imports about 220 million bpd of diesel from the Russian side in 2022, accounting for half of the total imports. The market was expecting a possible imbalance between supply and demand in the diesel market following the implementation of the price limit, but no impact was seen in the short term.

Goldman Sachs said that the EU ban on Russian oil products could have a more significant impact than the EU ban on Russian seaborne oil and the G7 price cap on Russian oil. In addition, the EU, the G7 and other countries announced on 5 December 2022 the establishment of a price cap on Russian crude oil limited to $60 per barrel. When above this cap, imports of Russian crude oil will be banned, or services such as shipping insurance will be provided.

Russia launched countermeasures by announcing on Monday (30 January) that it would ban the supply of oil products to countries with price restrictions in place as of 1 February. WTI crude oil fell sharply this Monday (30 January) to a low of around 76.50, a new low for almost two weeks. If WTI oil prices can stand firm at about 75.00, it may be a bullish signal.

While there has been a lot of bearish oil price news recently, there are also factors that need to be noted that limit the downside of oil prices. For example, the reopening of China to boost oil prices, as mentioned in last week's article, as well as a more optimistic outlook for global economic growth from the IMF, which has also raised its global GDP growth forecast for this year.

4. Short-Term Risks

Please watch out for the Fed's FOMC meeting this Thursday morning from 3 am to 3:30 am. The market is widely expected to raise rates by 25 basis points to 4.5%-4.75%. The following policy statement will be closely watched, particularly for signals from Fed officials that a "shift in the rate hike cycle is imminent" or the like. There are increasing signals that US inflation may be reaching a "peak", with futures markets now expecting interest rates to peak around 4.9%. If the Fed is not more hawkish than the market expects, it may also pressure the dollar. Be wary of the US dollar index coming out of a "rushing high and falling" market. Also, look out for the change in US January non-farm payrolls at 9.30 pm this Friday (3 February) and also the University of Michigan Consumer Sentiment Index for February will be released next Tuesday (10 February).

In the medium to long term, gold and non-US currencies rallying remain the main trend for 2023. US inflation figures may fall sooner than the market expects. According to a recent IMF report, the probability of a recession in the US and Europe has been increasing, with the UK could be the only G7 country to fall into recession in 2023. The market generally expects the Federal Reserve to slow the pace of interest rate hikes further, possibly even a "shift to rate cuts" in the second half of the year, all of which are fundamentally unfavourable to the US dollar. However, the expected shift in the Federal Reserve's monetary policy has left equity markets optimistic about future market liquidity, especially for liquidity-sensitive technology stocks. The rally in US stocks has boosted global equity markets.

Written by Sandy Wang,
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