Market comment_15Feb 2023

US CPI was revised down slightly in January, and reflections on the underlying logic of governing "inflation."

Key points:

- *US CPI was revised slightly lower in January, US 2Y Treasury yield rose sharply.*
- *Discussion on the relationship between "employment data" and "inflation".*
- *Discussion on the relationship between "tapering" and "inflation".*
- *Crude oil rallied slightly recently.*

1. US CPI still was revised lower in January but less than expected overall. The US dollar has fluctuated slightly and increased.

US CPI data for January was released at 9.30pm on Tuesday (14 February), showing that core CPI (YoY) recorded an annualized rate of 5.6% in January, which was higher than the expected 5.5% but lower than the previous value of 5.7%, marking the fourth consecutive month of decline. Headline inflation in the US retreated less than expected in January, while the monthly rate of CPI in January (seasonally adjusted) also posted the most significant increase since June 2022. Looking at the CPI breakdown in January, the impact of "core services" on inflation remained the main driver of inflation in the four main subcomponents, at 4.19%, while the effects of food and core goods on inflation fell slightly, at 1.37 and 0.30% respectively. The impact of energy rebounded slightly, at 0.60%.

It is worth noting that the CPI data released by the US Bureau of Labor Statistics this time is the first data after the CPI weights were updated. The Department of Labor hopes to reflect the spending habits of Americans more accurately by lowering the weight of used cars and the weight of food and energy (gasoline) and slightly increasing the weight of housing costs. The "update" has been changed from "once every two years" to "once a year".

Meanwhile, recently released (10 February) data showed that the preliminary University of Michigan Consumer Sentiment Index recorded 66.4 in February, a

new high since January 2022, above expectations of 66.0 and the previous value of 64.9, and also higher for three consecutive months since November last year. This shows that the US consumer market remains resilient. After the release of the CPI data, which was "lower than expected" overall, the US dollar index initially experienced an "up-and-down, swing" trend, but 12 hours later, it remained "fluctuating slightly upward," and now reported at 103.40. After the data release, the federal funds rate futures market priced in the "terminal rate" of the Federal Reserve between 5% and 5.25%, and it is expected that the benchmark rate will not change much in 2023. The specific CPI data are as follows:

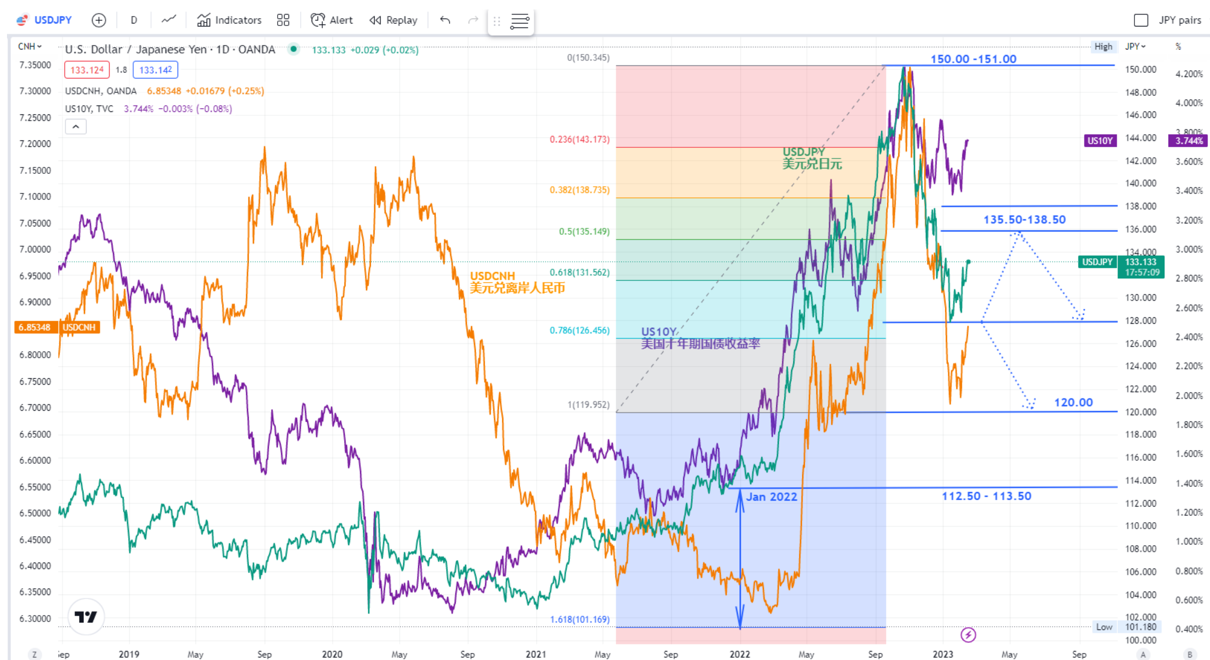
- *The US January core CPI (unadjusted) rose 5.6% YoY, higher than the expected 5.5% but lower than the previous reading of 5.7%, marking the fourth consecutive monthly decline.*
- *The US January CPI (unadjusted) rose 6.4% YoY, higher than the expected 6.2% but lower than the previous reading of 6.5%, marking the seventh consecutive monthly decline and the smallest drop since October 2021.*
- *The US January CPI (seasonally adjusted) rose 0.5% MoM, in line with the expected 0.5% and up from the previous reading of -0.1%, marking the most significant increase since June 2022.*
- *The US January core CPI rose 0.4% MoM, in line with the expected 0.4% and up from the previous reading of 0.3%.*

After the first FOMC meeting of the year, most Fed officials see a median federal funds rate of 5.1% this year, which implies a 25 basis point hike at the next two meetings in March and May. More than a third of officials expect to raise rates above 5.25%, implying another hike in June, and no officials expect to cut rates this year. In January, the overall inflation in the United States fell slightly lower than expected, leading to market expectations for further increases in interest rates. Currently, traders are betting that the Fed will raise rates to the peak of 5.27% in July, and they are no longer 100% expecting a rate cut this year. A 25 basis points rate hike in March and 25 basis points in May may be the "nail in the coffin", and the probability of a 25 basis point hike in June is close to 50%.

After the data release, the US dollar and bond yields experienced volatile movements. The yield of the US 2Y and 10Y Treasuries, which are sensitive to interest rates, rose sharply, the US dollar index rose slightly, and non-US currencies showed an overall and slight decline. The three major US stock indices also experienced small and volatile declines.

The US Dollar Index is currently consolidating around 103.32 after a sharp oscillation between 102.50-103.50. The US 2Y Treasury yield rose sharply by 21 basis points (4.43% to 4.64%) and now stands at 4.62%. The US 10Y Treasury yield has risen sharply by 17 basis points (3.63% to 3.80%). The US 10-2 Year Treasury yield spread further deepened to 85 basis points (-0.85), which may indicate growing concerns in the market about the risk of an economic recession in the US. US 2Y Treasury yield, which is short-term bonds, reflects the market's expectations of the Fed's movements and is generally relatively consistent with the expected trends in interest rates, i.e. with the Fed's rate hikes. For example, if the Federal Reserve raises rates to 5% this cycle, the 2YTreasury yield will fall to 5%.

Typically, short-term bonds are less risky, relatively more expensive and have relatively lower yields. The 10-year US Treasury yield is seen as the 'anchor' for global asset pricing, representing long-term bond yields and reflecting future US economic conditions. In contrast, long-term bonds are usually less expensive and have higher yields due to their long-term uncertainty. So, in general, the US 2Y Treasury yield must be lower than the 10Y Treasury yield. When the US 10Y Treasury yield is lower than the 2Y Treasury yield, investors are pessimistic about the economy's future.



USDJPY chart (Source: Tradingview)

The chart shows that the USDJPY and USDCNH are closely following the trend of the rise in the US 10Y Treasury yield.

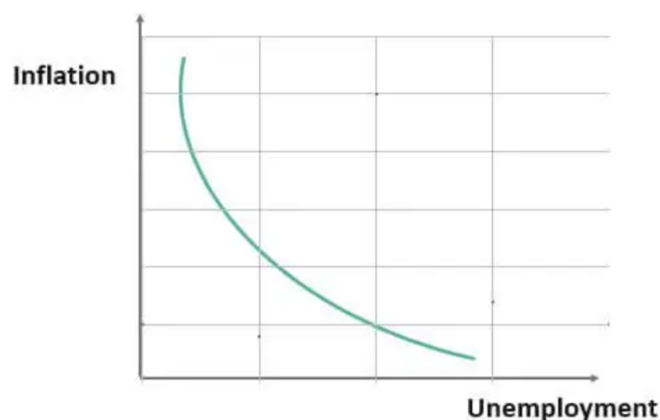
Against the backdrop of rising yields on the US 10-year and 2-year Treasury and a slight fluctuation in the US dollar index, the three major US stock indices and non-US currencies generally fluctuate in a range of 100-300 pips. USDJPY, USDCNH, and USDSGD have shown significant gains, while gold has fallen sharply. USDJPY closely follows the trend of the US 10Y (and 2Y) Treasury yields. It can be seen that the direction of USDJPY still depends on the development of the US economy and the trend of US Treasury yields. The following is the record of the ups and downs in the past two weeks:

- *The DXY index fluctuated within a range of 100 pips (102.50-103.50) and is currently trading at 103.40.*
- *The Dow Jones Industrial Average fluctuated within a range of 1000 pips (34500-33500) and is currently trading at 33970.*
- *S&P 500 oscillated in 120 pips range (4170-4050), now is at 4115.*
- *The Nasdaq index oscillated within a range of 600 pips (12200-12800) and is currently trading at 12513.*
- *XAUUSD has fallen by US$105 per ounce (1955-1850) and is currently quoted at 1851.55.*
- *USDJPY increased by 480 pips (128.50-133.30) and is currently trading at 132.95.*
- *USDCNH rose by 1420 pips (6.7050-6.8470) and is currently at 6.8472.*
- *USDSGD increased by 280 pips (1.3050-1.3330) and is currently trading at 1.3317.*
- *EURUSD fluctuated within a range of 150 pips (1.0650-1.0800) and is currently trading at 1.0725.*
- *GBPUSD oscillated within 300 pips (1.1950-1.2250) and is currently quoting at 1.2155.*
- *AUDUSD fluctuated within a range of 150 pips (0.6850-0.7000) and is currently at 0.6950.*
- *NZDUSD oscillated within a range of 100 pips (0.6280-0.6380) and is currently trading at 0.6310.*
- *USDCHF oscillated within 240 pips (0.9050-0.9290) and is currently quoted at 0.9227.*
- *USDCAD fluctuated within a range of 200 pips (1.3280-1.3480) and is currently trading at 1.3358.*

2. Discussion on the relationship between employment data and inflation

The Phillips Curve is named after the economist William Phillips. This curve shows a negative correlation between "unemployment" and "inflation". When the inflation rate is high, the unemployment rate is low, and when the unemployment rate is high, the inflation rate is low. In other words, high inflation and high unemployment rates cannot coexist. In other words, the economy tends to move from "high inflation, low unemployment" to "low inflation, high unemployment" and moves back and forth between the two.

Phillips Curve



The Phillips Curve reveals the economic logic between the inflation rate and the unemployment rate roughly as follows: If the economy is at the potential GDP level but total demand increases, there may be too much money and demand chasing after goods that exceed social production. In this case, the cyclical unemployment rate may be close to zero, and the overall unemployment rate may be low. However, due to this demand, wages are likely to be pushed up because of low unemployment rates. In the goods market, too much money may be chasing too few goods. Therefore, in a situation of full employment, it is more likely to trigger wage inflation and price inflation.

Conversely, when the economy is below potential GDP and in a recession, it means that unemployment is increasing or that "employment is insufficient." When there are a large number of unemployed people in society, workers compete for jobs, and wages remain low. In the goods market, there is even less money chasing too many goods, which may cause overproduction. In this case, it is almost impossible to have any inflation.

Through our understanding of the "Phillip Curve" perspective on "governing inflation", we can better understand why, this month (3 February), when the US Department of Labour announced that the US non-farm payrolls data for January

were "substantially better than expected" (January non-farm payrolls added 517,000 jobs, well ahead of expectations of 185,000 and the previous value of 223,000) and a record low unemployment rate (3.4% in January, less than the 3.6% expected and the previous value of 3.5%), has led to an increased "hawkish expectation" for the Federal Reserve's policy in the market. This is because a "hot" job market combined with "low unemployment" adds to the downward pressure on "inflation" and makes it more challenging to return to the Fed's 2% inflation target. So, in a way, allowing "recessions" to occur and "rising unemployment" to happen is one way to fight inflation effectively. Of course, at the moment, the Federal Reserve (and other central banks) is raising interest rates (rate hikes) and increasing taxes (for example, Singapore has raised its consumption tax to 8% this year and will raise it to 9% on 1 January 2024) are also ways to curb inflation.

3. Discussion on the relationship between tapering and inflation

3.1 Fiscal deficit and government debt

Fiscal deficit means that at the beginning of each fiscal year, the government of a country will always formulate a fiscal budget plan for the year. If the actual implementation results is that revenue exceeds expenditure, it is a fiscal surplus, and the economic phenomenon that expenditure exceeds income is called fiscal deficit.

Government deficits result normally from an excessive money supply, and the usual means of covering them is to issue debt. The government is usually the most significant single debtor. When debt is issued, it has to be repaid, and the government is under great pressure to repay it. "Fiscal deficits" and "fiscal surpluses" often correspond to the sources of funds and the accumulation of funds, with fiscal deficits dominating as government departments tend to spend more than they have surpluses. A fiscal deficit is when the government spends more money than it earns. In a "high inflation" environment, it is actually beneficial to the government to some extent, as high inflation dilutes part of the government's debt. Therefore, controlling the size of government spending, maintaining the level of the fiscal deficit and reducing debt issuance are ways to manage and avoid high inflation.

Government departments often need to finance the shortfall created by "fiscal deficits", which results in government debt. Recently (19 January), the size of the

US government debt has reached the US debt ceiling of US$31.4 trillion, and as of 2 February, the total US national debt has reached US$31.528 trillion. The federal debt to GDP ratio has exceeded 120%. Still, Yellen set initiatives to allow the federal government to pay its bills around June this year. Until then, lawmakers must agree to raise or suspend the debt ceiling for the government to take on new debt and meet its responsibilities. And the two parties in the US are divided into their response options, with the White House and Democrats wanting to raise the debt ceiling quickly and Republicans wanting to cut spending before raising the borrowing ceiling. So there is still a risk that it could escalate into a "debt crisis". According to a report on 29 January, US Treasury Secretary Janet Yellen said in an interview that the US would face a catastrophic debt crisis and a spiralling recession if lawmakers failed to raise the debt ceiling. It will also overdraw the United States' political credit, weakening the credibility of the US national debt and the reserve currency status of the US dollar. Federal Reserve Chairman Powell recently (2 February) also stated that no one would think that if the United States defaults on its debt, the Federal Reserve can protect the US economy. The only way out is for the US Congress to raise the debt ceiling. JPMorgan Chase also stated in a report sent to clients on 27 January this year that the struggle over the debt ceiling will be a significant issue facing the US economy in 2023. However, most economists believe that the likelihood of a US debt default is small, and it is expected that Republicans and Democrats will ultimately reach some kind of fiscal agreement related to raising the debt limit.

3.2 Tapering and inflation

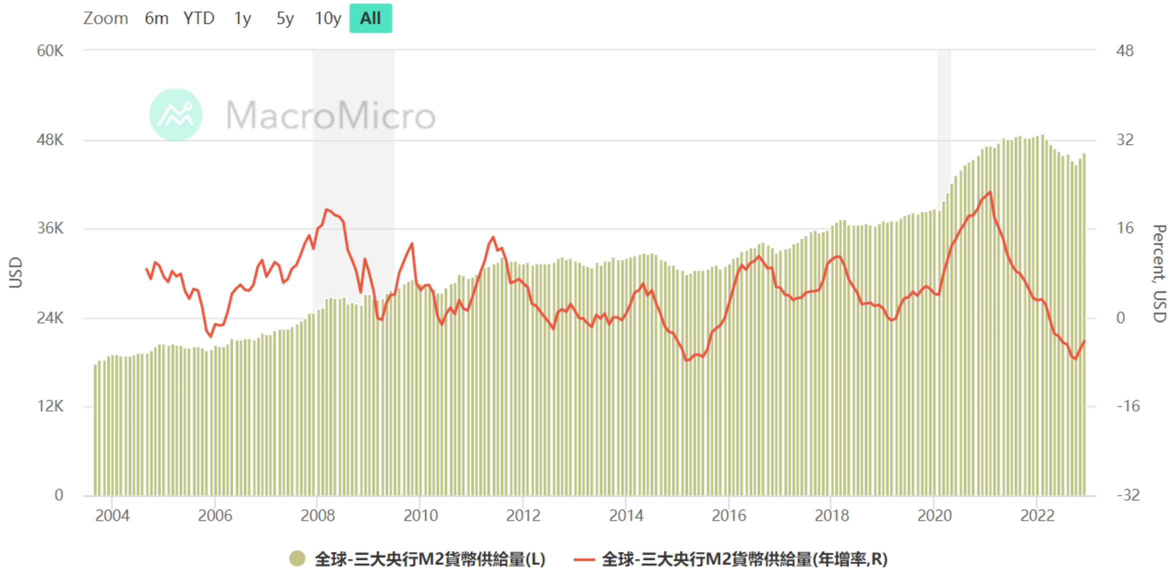
Tapering is the process of the Federal Reserve reducing its balance sheet and selling assets such as US Treasuries to banks and the public to withdraw liquidity from the financial system and society. It is also known as Quantitative Tightening (QT), which is the exact opposite of Quantitative Easing (QE). This is the practice of central banks tightening monetary policy to regulate an overheated economy or curb inflation.

Since as early as June 2022, the Federal Reserve has begun its official balance sheet reduction. It is currently stripping US Treasuries from its balance sheet at a rate of US$60 billion per month. With the current high inflation rate in the US at around 6.5% and the yield on US 10Y Treasury at about 3.7%, continuing to hold US Treasuries would result in "losing money" if the high inflation persists. As a result, large US banks, insurance funds, and pension funds are also selling off US Treasuries. Since the outbreak of the COVID-19 pandemic, the massive

QE, money printing, and bond issuances by the Federal Reserve have resulted in its balance sheet reaching around US$8 trillion. At the current pace of balance sheet reduction, it will take until 2025 to bring the balance sheet down to a size of US$5.9 trillion.

3.3 The impact of tapering

Tapering is a form of "austerity", just like "interest rate hikes", because the impact of "interest rate hikes" is usually more significant than that of "tapering". But we cannot ignore the effect of "tapering". First of all, "tapering" usually has a negative impact on the stock market. Under a tightening policy, the circulation of money is reduced, the reserve of financial institutions is reduced, the cost of financing is increased, and banks are more conservative and cautious in lending, which indirectly makes it more difficult for companies to borrow money and increases the cost of debt. As companies tend to reduce spending and investment, economic activity will slow down. As expectations grow that there will be a slowdown in economic activity in the future, valuations of future share prices will become more conservative. So, Michael Wilson, a strategist at Morgan Stanley, recently (in his latest report) believed that US stocks are ignoring the Federal Reserve's tightening stance and profit issues; the forecast of the timing of the Fed's pause in rate hikes is premature, and although short-term interest rates in the bond market have risen recently, reflecting market expectations that the Fed may maintain its restrictive policy for a more extended period, the stock market refuses to accept this; US stocks are ripe for returning to their decline; It is expected that the S&P 500 will be at 3,900 by the end of this year, more than 5% lower than its current level. Secondly, the impact of "tapering" on the bond market is also negative, leading to a decline in bond prices and an increase in government bond yields. Therefore, since the Fed started "raising interest rates" in March last year and "shrinking its balance sheet" in June, the yield on the US 10Y Treasury yield has risen overall, with the maximum increase being 4.6% (from 1.65% to 4.35%). Currently, it is around 3.7%.



Source: MacroMicro

The M2 money supply of the world's three largest central banks (US, Europe and Japan) is used to represent the liquidity level of the market, as it reflects changes in the total demand for funds in the market and future inflationary pressure conditions. M1 (narrow money) = cash + fixed deposits; M2 (broad money supply) = cash + fixed deposit + demand deposits

3.4 Tapering and money supply

The tapering is directly related to the "money supply", and here we need to understand how money is measured, M0, M1 and M2. M0 is "cash" (also known as "currency"). M1 (also known as narrow money) = M0 + demand deposits. M2 (also called "broad money") = M1+ fixed deposits. So M2 = cash + demand deposits + fixed deposits.

Recently (2 February), the Federal Reserve's first FOMC meeting of 2023 mentioned that it would continue to reduce its holdings of US Treasuries and mortgage-backed securities (MBS) as initially planned (proposed in May 2022), which means that "tapering continues". This means that the decline in M2 will continue downward, and even if the Fed stops raising interest rates in the future, it may continue to "shrink" the money supply, meaning that the global money supply will continue to contract. In the chart above (red line), we see that the money supply of the world's three largest central banks (US, Japan and Europe) is contracting, starting to rise in 2020, peaking in July and mid-August 2021, and

then beginning to fall, reaching a minimum around October 2022, and starting to increase again in November, but not yet to 2022 levels. In fact, both Europe and Japan are still practicing "accommodative" monetary policies, with the ECB planning to start tapering only in March this year, and mainland China has also been accommodative. It has not yet been indicated when it will "taper", but the overall money supply is falling.

Source: MacroMicro, US M2 money supply has been rising for the past 20 years, and the annual growth rate of US M2, which is above the "0" axis, has fallen below the "0" axis since December 2022 and currently stands at -1.31%.

M2 continues to fall, which means that the "money supply" is declining, while assets (especially the stock market) may continue to lose if they are currently at a high level. Therefore, I am not "bullish" on the stock market in the short term either. However, in the medium to long term, the US recession may not be as severe as we think, and the energy crisis in Europe has been well mitigated. It has also been over a year since the "Russia-Ukraine war", and there are likely to be no more severe developments (unless nuclear weapons are used). With China's reopening, the overall picture for 2023-2024 is "optimistic". Almost all major institutions are "optimistic" about China's growth rate in 2023. Goldman Sachs, Morgan Stanley, the IMF (International Monetary Fund) and even the UN(united nations). China's reopening is expected to result in a growth rate that is more than twice the global average. Therefore, the IMF has raised the growth

rate for all countries except the UK, and this upward revision is entirely attributable to "China's reopening" compared to the IMF's previous estimate. In the medium to long term, the outlook for "risk assets", such as "non-US currencies", the stock market, and the commodity market, especially gold, remains bullish.

3.5 Powell's "restrictive levels" as stated at the FOMC meeting

The Fed's FOMC meeting on 2 February mentioned that “the FOMC is discussing several more rate hikes to ‘restrictive levels’ before pausing and is not exploring the possibility of resuming rate hikes after the pause. If there is a need to return to the pace of rate hikes before December, the Fed will do so.” By "restrictive", Powell means that Fed policies such as raising rates to 5% (or higher) and later stopping rate increases and then holding rates here for an extended period and continuing to taper have had a disinflationary effect. At the same time, even if the dollar rate has reached 5% (or more), and if inflation rises afterwards, rates may rise again.

4. Kazuo Ueda is set to become the next governor of the Bank of Japan, but market reaction is muted.

On 14 February, Kazuo Ueda is set to become the next governor of the Bank of Japan. Kazuo Ueda, 71, is currently an economist at Kyoritsu Women's University and Professor Emeritus at the University of Tokyo, where he specializes in economics and finance. He studied mathematics at the University of Tokyo's Faculty of Economics and later obtained a PhD in economics from MIT. From 1985-1987, he was a Senior Research Officer at the Institute for International Monetary Affairs, Ministry of Finance. From 1998-2005, he served as a member of the Policy Board of the Bank of Japan, where he was involved in introducing zero interest rates and quantitative easing as a theoretical pillar of the Policy Board. After the news was announced, the USDJPY reflected tepidly until (14 February) at 9.30 pm, when the US January CPI data was released, opening up a big rally.

When asked about his views on monetary policy recently (10 February), he said that monetary policy must be based on current conditions, particularly the economic and price outlook. From that perspective, he thought the Bank of Japan's current policy was appropriate, and in any case, given the current situation, monetary easing must continue. When asked how he would implement policy as BOJ governor, he said it is essential to make decisions

logically and to explain them clearly. There were reports that he had warned the BOJ in an article published in July last year against raising interest rates prematurely simply because inflation was above 2% and that Japan had a long road to achieving 2% sustainable inflation. It also said that the BOJ must consider its strategy for exiting ultra-easy monetary policy and revisit its unconventional stimulus program at some point, and "At some point, we must seriously consider the future of the unprecedented monetary easing framework, which has continued longer than most would expect."

Some analysts also believe that Kazuo Ueta is actually an academic economist in the same vein as Bernanke or Yellen. Anyone who has studied Japan academically will know him. He is somewhat of a supply-side school but has not been very positive about Abe's economics from the start. Former US Treasury Secretary Summers called Kazuo Ueta "the Bernanke of Japan" and said he would not stick to yield curve control for long. In a recent interview with the media (14 February), "Mr Yen" Eisuke Sakakibara said that the new BOJ Governor Kazuo Ueda might be forced to "turn around" by the fourth quarter of this year, given the accelerating trend of inflation in Japan. He said if the Japanese economy overheats, Ueda will change the monetary policy, and the yen could strengthen. The USDJPY is expected to rise to around 120 from its current level of about 132.

In the future, the market widely expected new BOJ governor is likely to push monetary policy normalisation, further narrowing the spread between the US and Japanese Treasuries and pushing the yen stronger.

5. Crude oil rallied slightly recently.

Last Sunday (5 February), the EU and G7 countries began imposing price ceilings on Russia's oil supplies, with a maximum price of US$100 per barrel for diesel, aviation kerosene, and gasoline from Russia and a maximum price of US$45 per barrel for other low-quality petroleum products such as industrial fuel oil.

The supply-side shortage fears sparked by Russia's announcement last Friday (10 February) of a spontaneous 500,000 barrel-a-day oil production cut from March. Deputy Prime Minister of the Russian Federation Alexander Novak said the production cut would help restore market relations broken by the price cap and stop selling oil to buyers who comply with the Western-imposed price cap. The mechanism of price caps on Russian oil and oil products is an interference in

market relations and an extension of the West's collective destructive energy policy.

On Monday (13 February), the Biden administration announced the release of another 26 million barrels of Strategic Petroleum Reserve (SPR) crude oil from 1 April. Although the Strategic Petroleum Reserve (SPR) in the United States will drop to about 345 million barrels after the latest release of reserves, which could suggest a significant increase in future demand for SPR replenishment. In the short term, the release of SPR inventory has alleviated concerns about an oil supply shortage triggered by Russia's announcement last week of a production cut of 500,000 barrels per day starting from March.

The Organization of the Petroleum Exporting Countries (OPEC) released its monthly report for February on Tuesday (14 February), putting global oil demand growth at 2.3 million barrels per day in 2023, up from a previous estimate of 2.22 million barrels per day, and lowering its 2023 oil production forecast for Russia to 10.13 million barrels per day from 10.18 million barrels per day. OPEC raised its 2023 world growth forecast to 2.6% from 2.5% and its 2023 eurozone growth forecast to 0.8% from 0.4%. OPEC is now committed to a production-cut deal that will last until the end of 2023 but still stresses the need to watch out for signs of an economic slowdown.

The American Petroleum Institute (API) reported on Wednesday (15 February) that US crude oil inventories for the week ending on 10 February increased by a much higher-than-expected 10.507 million barrels, putting downward pressure on oil prices and suggesting a downward correction. Oil prices are expected to show a trend of low-level fluctuations and a short-term decline in crude oil.

Source: Tradingview

From a technical perspective, crude oil has maintained a pattern of "low-level fluctuations" and "slight increase" overall since the end of 2022, with WTI oil oscillating between 70.50 and 82.00 and Brent oil oscillating between 76.00 and 88.50. In 2023, WTI oil is expected to reach around US$95.00 to US$100.00 per barrel, and Brent oil is expected to reach around US$99.00 to US$105.00 per barrel.

6. Short-term risks

Due to the "significantly better than expected" US January non-farm payroll data recently released, the market's "overall risk sentiment" preference has been redefined. It has shifted from the previous expectation that the Fed would be more dovish in ending the current tightening cycle to the "hawkish rate hike continues" and "no rate cuts this year." Moreover, with the emergence of more robust economic data in the future, the expected terminal rate may be even higher. The US dollar index has been deeply declining since the fourth quarter of last year and may face an inevitable short-term rebound. After the short-term rebound of the US dollar, the critical direction of the market is expected to be a more significant depreciation in the medium and long term.

Please pay attention to the US GDP annual rate (Q4) data, which will be released next Tuesday (23 February), as well as the US core Personal Consumption Expenditures Price Index for January and the University of Michigan Consumer Sentiment Index for February, which will be released next Friday (24 February).

Also, pay attention to Japan core Consumer Price Index for January and the CPI excluding fresh food for January. These related data will be released next Friday (24 February), and the Reserve Bank of New Zealand's first interest rate decision meeting of the year will be held next Wednesday (22 February), as well as the Reserve Bank of New Zealand's press releases. The market expects the Reserve Bank of New Zealand to raise interest rates by 50 basis points further.

By Sandy Wang,

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