Market comment_22Feb 2023

Inflation is easy to rise but hard to fall, and the "low-interest rate era" may be hard to return.

<u>Key points:</u>

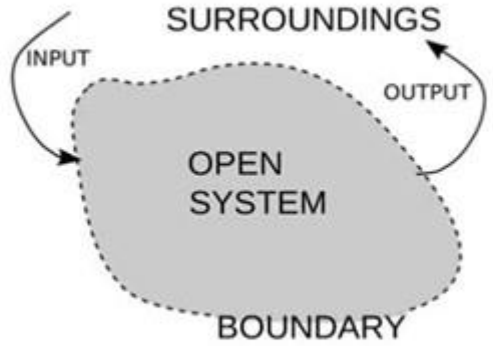
- *US inflation is easy to rise but difficult to fall, and the market expects an increase in interest rate hikes;*
- *RBA and RBNZ maintain an "aggressive rate hike" stance and failed to stop the weakness of the Australian dollar and New Zealand dollar.*
- *USDJPY has maintained a rising pattern over the past three weeks, and please pay attention to Kazuo Ueta's speech this Friday to early next week;*
- *China's central bank kept the prime loan rates unchanged.*

1. US inflation is easy to rise but difficult to fall, and the market expects an increase in interest rate hikes.

The US Producer Price Index (PPI) (MoM) was recently released (16 Feb) and rose strongly in January, up 0.7% MoM, beating expectations of a 0.4% increase and the previous 0.5% decline recorded. The US core PPI (MoM) also regained upward momentum, with the core PPI excluding food and energy rising 0.5% MoM, beating expectations of a 0.3% increase and the previous 0.1% increase. The latest January US Consumer Price Index (CPI), released on 14 February, also posted a modestly stronger-than-expected performance.

The CPI and PPI in the United States for January both exceeded expectations, which dashed market hopes for a rapid decline in US inflation and an interest rate cut by the end of this year at the earliest. It also highlights sustained inflationary pressure, which may further prompt the Federal Reserve to raise interest rates in the coming months. We have recently seen the Biden administration selling its Strategic Petroleum Reserve again in an attempt to curb inflation. It seems that inflation can easily be renewed. This is also related to the ongoing "deglobalisation" discussed in the previous articles, the shift in the "global commodity supply chain" from the "cheapest" to the "safest" commodity production model, and the "oil and energy crisis" that has triggered a shift in the global energy supply to "green and clean energy". We know that oil is the cheapest energy source currently in use. Other new "green and clean" energy sources are more expensive than oil, so the process will inevitably lead to higher global energy costs. This tension has been exacerbated by the Russia-Ukraine war. Even so, many countries are setting targets to become "carbon neutral" by around 2050, which will require trillions of dollars to drive.

Although US President Joe Biden has said that the United States will still need oil for at least the next decade, this transition to "green and clean energy" has inevitably affected the energy input to the "dissipative system" of the global economic system, leading to more incredible difficulty in the specialisation of the social division of labour and causing shortages in commodity supply. From this perspective, high inflation may become a medium to a long-term problem, and returning to the low-interest rate era may be challenging.



Source: Dissipative system

The dissipative system was developed by a scientist named Ilya Prigogine, who received the Nobel Prize in Chemistry in 1977 for his theory. The dissipative system can be used in chemistry, physics, economics and many other fields. When a system has a dissipative system, it can effectively combat entropy production (i.e. disorder) by continuously exchanging matter and energy with the external environment. When a certain parameter in the system reaches a certain threshold, it can transition from its original "chaotic and disordered state" to an ordered state in terms of time, space, or function. From an economic perspective, "input" can be understood as "energy related to oil," and "output" can be understood as a "socially ordered and specialized division of labor and commodity supply." The greater the energy of the input, the lower the cost, and the stronger the ability of the society to specialize and refine its division of labor in the output, which is also the driving force behind continuous economic growth.

Market expectations have increased that the Federal Reserve may raise interest rates by 50 basis points at its March rate meeting rather than the previously expected 25 basis points, which has put pressure on the market. President of the Federal Reserve Bank of Cleveland Loretta Mester and St. Louis Federal Reserve President James Bullard have both recently stated that they will consider raising the target range for the fed funds rate by 50 basis points at the end of March.

This rally in the US Dollar Index over the last two weeks, from 100.50 to a high of 104.50, started after the "non-farm payrolls" data and the first FOMC meeting of the year in early February and is currently quoted at around 104.05. A "Shooting Star" technical pattern has recently appeared on the daily candlestick chart, which is an obvious sign of a price top and highlights the lack of upward momentum in the rebound. This may be the market waiting for the impact of several heavyweight events to be released this Thursday and Friday, including the January Federal Reserve meeting minutes, the revised real GDP for the fourth quarter in the United States, and the US core PCE price index for January. These events may determine the further direction of the US dollar index, which is likely to test the 105.00 level or fall to 102.50 to find support. The answer may be given during this week.

US Dollar Index (Source: tradingview), A "Shooting Star" technical pattern has recently appeared on the daily candlestick chart, highlighting the rebound's lack of upward momentum. At some point this Thursday or Friday, it is likely that the US dollar index may test the 105.00 level or fall to 102.50 to find support.

Reflecting on the financial markets, risk aversion has been on the rise in recent weeks, with the US 10Y Treasury yield approaching 4% (note: it hit a high near

4.25%-4.35% in October-November last year and is currently quoted at 3.957%) and the US 2Y Treasury yield approaching 4.8% (note: it hit a high near 4.88% in November last year and is presently quoted at 4.683%). The US dollar index rebounded, while non-US currencies fell one after another. Gold and crude oil fluctuated at low levels, and the three major US stock indices all fell to varying degrees. The following are the record gains and losses to date at the beginning of February.

- *The DXY Dollar index rose from 100.50 to 104.30 and is now at 104.05.*
- *The Dow Jones Industrial Average fell 1400 pips from 34500 to 33100 and is now at 33175.*
- *The S&P 500 dropped 150 pips from 4150 to 4000 and now trades at 4003.*
- *The Nasdaq index fell 700 pips from 12750 to 12050 and is now at 12090.*
- *XAUUSD fell US$135 per ounce from 1955 to 1820 and is now at 1837.50.*
- *USDJPY rose 700 pips from 128.50 to 135.00 and is now at 134.50.*
- *USDCNH rose 1920 pips from 6.7050 to 6.8970 and is now at 6.8885.*
- *USDSGD rose 350 pips from 1.3050 to 1.3400 and is now at 1.3385.*
- *EURUSD declined 400 pips from 1.1000 to 1.0600 and is now at 1.0662.*
- *GBPUSD fell 500 pips from 1.2400 to 1.1900 and is now at 1.2130.*
- *AUDUSD dropped 300 pips from 0.7150 to 0.6850 and is now at 0.6950.*
- *NZDUSD fell 330 pips from 0.6530 to 0.6200 and is now at 0.6235.*
- *USDCHF rose 280 pips from 0.9050 to 0.9330 and is now at 0.9260.*
- *USDCAD increased 300 pips from 1.3250 to 1.3550 and is now at 1.3535.*
- *Bitcoin surged 3700 pips from 21500 to 25200 and is now at 24280.*

2. RBA's "aggressive rate hike" fails to stop the Australian dollar from continuing to fall.

At its first board meeting of 2023 on Tuesday morning (7 February), the Reserve Bank raised its cash rate by 25 basis points, increasing the cash rate from 3.10% to 3.35%, in line with market expectations. This is also the ninth consecutive rate increase since the RBA's first-rate hike in May 2022, and it has now accumulated 325 basis points of rate hikes. At the same time, the Reserve Bank of Australia issued a more hawkish policy statement and forward guidance that further rate hikes will be needed in the coming months. How much interest rates need to increase will depend on data and the global economy.

The Australia unemployment rate for January, released last Thursday (16 February), came in at 3.7%, higher than the previous figure of 3.5% and market expectations of 3.5%. The Labour Force Participation Rate also came in at 66.5%, lower than the previous and expected figure of 66.6%. Net employment fell 11500, compared to the expected increase of 20,000. Employment is weak, which could be good news for curbing Australia's high inflation.

The minutes of the RBA's February monetary policy meeting published on Tuesday (21 February): the Committee's inflation forecast is based on a technical assumption of a cash rate at 3.75%; the recent inflation data had suggested more breadth and persistence in inflation than had been expected; the longer inflation remains high, the greater the risk of a wage-price spiral; the cash rate remains lower than in many other developed countries; the medium-term inflation expectations remain favourable; cash rate is lower than that in many economies; the RBA committee agreed to raise rates further in the coming months, and at its February meeting the committee discussed both the 25 basis point and 50 basis point options, but the Committee saw a stronger case for a 25 basis point rate hike. The decision to raise interest rates by 25 basis points reflects the topping of inflation and falling wages. Australia will benefit more than many other countries from the reopening of China.

Key points from RBA Governor Lowe's speech: Want to keep the job market growing and will have completed a seven-year term of office. We are not on a predetermined path in terms of interest rates, there is a huge surplus of savings in the economy, and the expansion of the money supply and stimulus has played a role in driving inflation. If inflation is not brought under control, it will only become more painful and very costly if the wage-price spiral gets out of control. It will take 18-24 months for interest rate rises to have an impact on the economy; the impact of the tightening cycle will continue until 2024, interest rates have not yet peaked, and it is uncertain how high they need to go. There is a two-sided risk of not raising rates enough and too much, and we are trying to keep on a narrow path outlook with no intention of sending the economy into recession. If the pace of rate hikes needs to be slowed, we will do so and will reassess the state of the economy in a few weeks. The narrow (rate hike) path can be maintained if CPI expectations are kept in check, with wage growth currently under control. If inflation falls, rates may be cut next year and concerned about the possibility of further geopolitical events in the future and about the reversal of globalisation and world trade.

AUDUSD Chart (Source: tradingview)

From a technical analysis perspective, the "Daily Candlestick Chart" of AUDUSD shows that a "head and shoulders" pattern has formed, indicating a potential risk of a significant decline. The daily chart shows that AUDUSD reached a high of around 0.7150 in early February, the highest level since mid-August 2022. However, the exchange rate subsequently encountered resistance and fell back to about 0.6850, forming the "head and shoulders" pattern at the "neckline." If it falls below 0.6850, it may target the range of 0.6550-0.6000. On the other hand, it may move towards 0.7150, then 0.7300. It should be noted that the range of 0.6150-0.6200 is a "bottom" level that AUDUSD is unlikely to fall below (corresponding to the range of 114.5-115.00 for the US Dollar index).

3. RBNZ raises rates by 50 bps to 4.75%, and NZD weakness persists.

On Wednesday, 22 February, the Reserve Bank of New Zealand held its first interest rate decision meeting of the year and a press conference. The RBNZ raised rates again by 50 basis points to 4.75%, in line with market expectations. This is the tenth consecutive interest rate increase since the RBNZ started its tightening cycle. NZDUSD has risen in the short term, but its medium to long-term trend will still depend on the US dollar. Since the beginning of February, when the US dollar began this rebound, NZDUSD has fallen by 330 pips (from 0.6530 to 0.6200) and is currently trading at 0.6225.
The highlights of RBNZ interest rate resolution: Official cash rate expected to fall from Q3 2024, with peak cash rate expected to be at 5.5%. The economy is expected to be in recession from Q2 2023, with inflation expected to return to the target range in Q3 2024; short-term inflation expectations remain high.

Demand continues to exceed supply; employment continues to exceed maximum sustainable levels, and employment shortages continue to pose a significant constraint. Inflation is forecast at 7.3% in Q1 2023; initial signs suggest that price pressures have eased, but core inflation remains too high and monetary conditions still need to be tightened further. GDP is expected to contract by 0.5% QoQ in the second quarter of 2023 and 0.4% in the third quarter.

New Zealand's new Prime Minister, Hipkins, has also recently said that the government needs to do more to curb inflation. RBNZ Governor Orr said in a statement that demand must slow sharply, higher deposit rates would boost savings, and higher savings rates would reduce inflationary pressures.

Although the Reserve Bank of New Zealand has issued a "hawkish" interest rate outlook, the potential economic recession in the second quarter of this year and the continued upward trend of the US dollar since February continue to put pressure on the New Zealand dollar.

4. USDJPY has maintained its upward pattern over the past three weeks; Please focus on Kazuo Ueda's speech at the hearing of the House of Representatives.

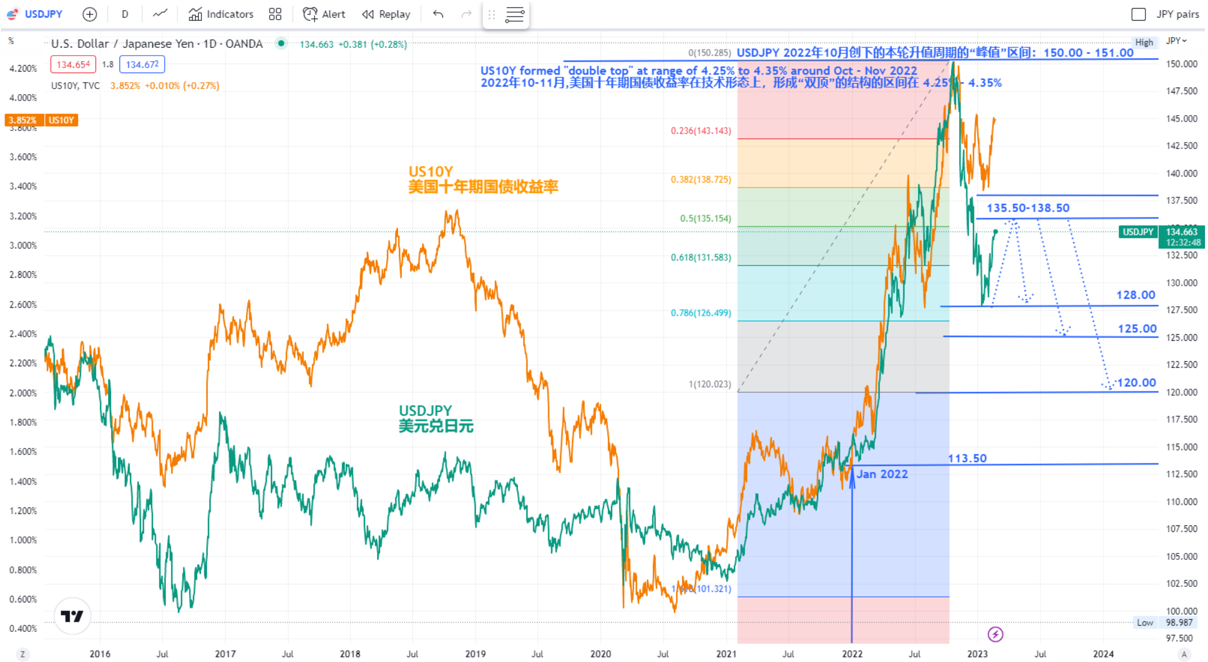
According to Japanese lawmakers, BOJ head nominee Ueda is to speak in the upper house on 27 February, and deputy governor nominees are to appear in the upper house on 28 February. Kazuo Ueda will attend the hearing at the National Diet (the lower house of the Japanese government) and give a speech, which may have a short-term impact on USDJPY. The new Governor of the Bank of Japan will take office on 8 April. Until then, USDJPY may temporarily continue to follow the US dollar until the new Governor effectively and fully communicates his policy framework to the market. Currently, the US 10Y Treasury yield has returned to above 3.80%, while Japan's 10Y Government Bonds interest rate remains around 0.50% under the YCC framework.

On 22 February, Japan's 10-year government bond yield breached the top end of the Bank of Japan's policy band for a second straight session, and the Bank of Japan announced unplanned bond-buying. At the same time, BoJ board member Naoki Tamura said the policy framework and inflation target need to be assessed at some point; time is still needed to assess the impact of the yield curve adjustment last December on the market; the risk that inflation will be higher than expected cannot be ruled out. Need for policy assessment at some point in the future; Continuation of accommodative monetary policy is appropriate at this stage.

In a recent media interview (Feb 14), "Mr. Yen" Eisuke Sakakibara said Kazuo Ueda understands the structure of the BOJ and is likely to keep monetary policy stable at the beginning of his tenure. Given the accelerating trend of inflation in Japan, the new BOJ Governor Kazuo Ueta may be forced to turn by the fourth quarter of this year, but this will also depend on the state of the Japanese economy at that time and whether inflation stays near the expected 2%. If the Japanese economy overheats, Ueda will change the monetary policy, and the yen could strengthen, with the USDJPY expected to rise to around 120 from around 132 at present, he said. When it comes to yield curve control, "Mr. Yen" said that holding financial assets is not a concern at the moment, and it is not possible to sell them at this stage.

Source: Pantheon

Japan's Manufacturing PMI for New Orders has been below 50 for 11 consecutive months, with a dismal reading of 46.6 in January. Despite the reopening of China, it is expected that Japanese exports will face difficulties in the coming months due to the continued global demand slump. Japan's annualised inflation rate reached its highest level since January 1991 at 4% in December last year, and annualised growth in the fourth quarter was 0.6%, less than the expected 2%. However, Japanese exports are expected to improve in the second half of this year, when global demand is likely to pick up moderately. Lower wage inflation relative to other developed economies should support Japan's export competitiveness. The trend of global reshoring industrial production could be beneficial for Japan.



USDJPY Chart (Source: Tradingview)

The USDJPY has been volatile since early February, rising from around 128.00 to around 135.10, primarily influenced by the recent strength in US 10-year Treasury bond yields. The trend of USDJPY still depends heavily on the movement of US bond yields, which have risen from 3.35% to 3.95% during the same period.

In the short term, the BoJ will likely maintain that its current accommodative monetary policy is appropriate for Japan's recovery. In the medium to long term, market speculation is that the new BoJ Governor, in the future, is likely to push for a normalization of monetary policy, further narrowing the spread between US and Japanese Treasuries and pushing the yen stronger. If the Bank of Japan really begins to tighten its monetary policy in the future, it will prompt significant capital inflows from Japanese investors.

5. China's central bank kept the prime loan rates unchanged.

On Monday (20 February), China's central bank announced that it would maintain the one-year and five-year LPR at 3.65% and 4.3%, respectively, in February, marking the sixth consecutive month that China's LPR rate remained unchanged. China Minsheng Bank chief economist Wen Bin believes that since the beginning of this year, the momentum of the economic rebound has emerged. Corporate financing costs have been in a continuous downward trend. The good beginning of January new bank loan data shows that corporate financing will be enhanced, and the current need to cut interest rates is not high. Some experts also analysed that the excess rollover of Medium-term Lending Facility (MLF) in February reflects the central bank's determination to maintain ample liquidity, which helps to supplement the long-term liquidity of the banking system and increase banks' lending capacity. There is still room for a downward adjustment of the Loan Prime Rate (LPR) of over five years.

China Merchants Securities said that after March, if the economic situation and the improvement of the real estate market are less than expected, there is a possibility of further reduction of the 5-year LPR. That said, the Chinese central bank may lower the benchmark LPR in March or April to boost the demand for domestic credit to the private sector.

Policy-driven infrastructure and industrial investment are likely to remain strong based on a large amount of long-term corporate lending in January, but private sector investment is likely to remain weak given the fall in exports and financing challenges for MSMEs. Consumer spending has begun to recover initially, but further policy support is needed to ensure sustainability.

Last week, the journal and news magazine of the Chinese Communist Party Qiushi published a speech by President Xi Jinping at the Central Economic Work Conference in December. He said that given the weak demand in China's three major export markets, there is a need to boost Chinese consumption and also called for the expansion of consumer credit to enhance the spending power of low- and middle-income groups with a high propensity to consume and who have been hit hard by the pandemic. Provide "maximum facilitation" for foreign investors to negotiate trade and investment in China, promote foreign direct investment and expand market access.

Since February this year, market risk aversion has increased as the expectation of the Federal Reserve's interest rate hike has strengthened. Both the Chinese stock market and the offshore renminbi have experienced varying degrees of decline. Here is the record of gains and losses in financial markets since early February.

- *USDCNH surged by 1950 pips (6.7050-6.9010) and is currently trading at 6.9015.*
- *CHINA50 fell by 170 pips (14420-14250) and is currently trading at 20356.*
- *CHINAH fell by 925 pips (7750-6825) and is trading at 6822.*

- *HK50 decreased by 2350 pips (22700-20350) and is currently trading at 20356.*

6.Short-term risks

The market has been relatively quiet in the first few days of this week, especially on Monday, the public holiday for "Washington's Birthday" in the United States, with banks closed and the US stock market closed for a day. However, several heavyweight risk events will occur this week on Thursday and Friday. At 3 am on Thursday, the US Federal Reserve will release its meeting minutes, and the market is expected to receive further guidance on the future path of interest rate hikes. On Thursday at 9:30 pm, the US will also release the revised data on actual GDP for the fourth quarter. On Friday, the Personal Consumption Expenditures (PCE) price index, a key inflation indicator, and the final report on the University of Michigan Consumer Sentiment Index, which reflects consumer sentiment, will be released.

Since both the US January Consumer Price Index (CPI) and Producer Price Index (PPI) released recently have exceeded market expectations, if the data for the PCE price index also shows similar performance, it will further indicate that the " US inflation's fall" slows down, which will undoubtedly strengthen the market's expectations of the Fed's further tightening of policies and increase the market's bets on the Fed's rate hike by 50 basis points in March. At that time, the US dollar may have the opportunity to rise again, with the US Dollar index breaking through the 105 level or falling to seek support below 103, and the answer may be found then.

Regarding Japan this week, in addition to paying attention to Japan's January CPI data on Friday, it is also necessary to focus on the hearing held by the Japanese House of Representatives on the nominations for the governor and deputy governors of the Bank of Japan, as well as comments made by the nominated governor, Kazuo Ueda, regarding the Bank of Japan's monetary policy. Dovish comments may further weaken the yen, while hawkish comments may boost the yen.

For Europe and the US, pay attention to the US January Durable Goods Orders on Tuesday (27 February), the US February ISM Manufacturing Index on Wednesday (1 March), the US February ISM Non-Manufacturing Index on Friday (3 March), the Germany February Consumer Price Index on Wednesday (1

March), remarks by Bank of England Governor Andrew Bailey, and the Eurozone February Consumer Price Index on Thursday (3 March).

For the Asia-Pacific region, pay attention to China's January Manufacturing and Non-Manufacturing Purchasing Managers' Index on Wednesday (1 March), Japan's January Retail Sales on Tuesday (28 February), and the Tokyo Core CPI for February on Friday (3 March). Also, Australia's January Retail Sales and GDP QoQ Q4 data on Wednesday (1 March) and New Zealand's Retail Sales Q4 data on Monday (27 February).

By Sandy Wang,

11:30 am SGT 22 Feb 2023