Market comment_01Mar 2023

The pattern of a strong US dollar remains unchanged, and when the Japanese yen will strengthen again is the focus of the market's attention.

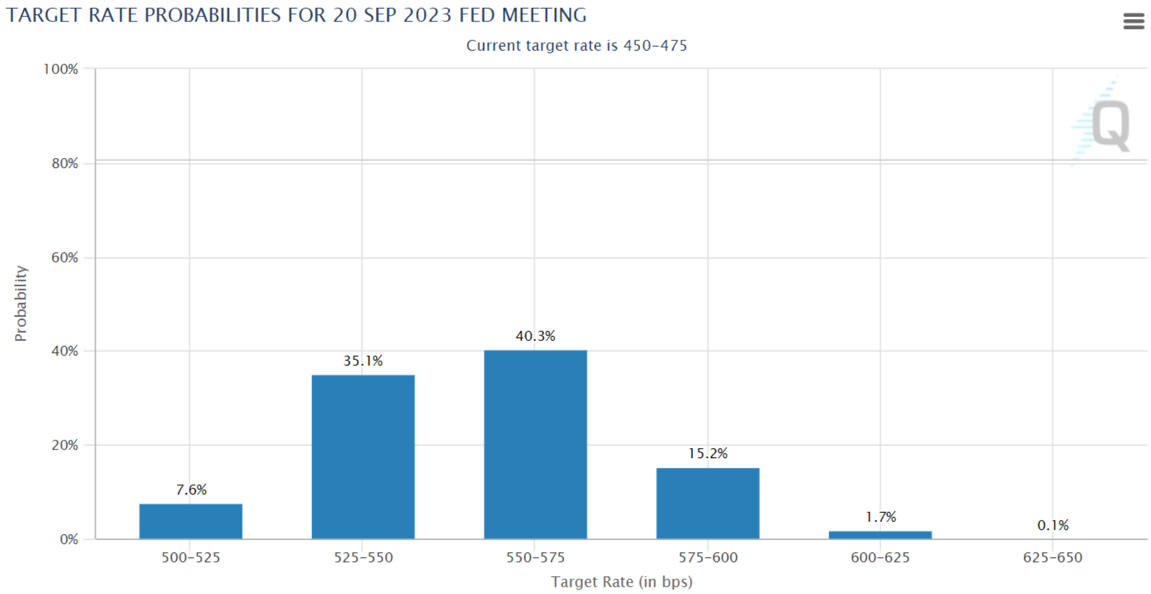
Key points:

- *US inflation is easy to rise but difficult to fall, the market expected the range of interest rate hikes would increase, and the US Dollar index broke above 105; the pattern of a stronger dollar remains unchanged.*
- *RBA and RBNZ maintained their "aggressive rate hike" stance, failing to prevent weakness in the Australian and New Zealand dollars.*
- *The reversal of Japan's arbitrage trading will be the biggest Black Swan event in the foreign exchange market in 2023.*
- *Recent economic data shows that the Chinese economy may have started a strong recovery, with Chinese stock indices quietly beginning to rebound and driving a slight strengthening of the offshore RMB.*

1. The US Dollar Index broke 105, and the pattern of a stronger US Dollar remains unchanged.

The Personal Consumption Expenditure (PCE) data released last Friday (24 February) was significantly higher than expected, which, combined with the recently released US CPI and PPI for January, both exceeded expectations, deflating the market's rosy expectations that "US inflation will fall rapidly and that interest rate cuts may begin as soon as the end of this year" and highlighting the ongoing inflationary pressures that could prompt the Federal Reserve to make further more aggressive rate hikes in the coming months. The US dollar continued its upward trend since the beginning of February this year, with the US dollar index breaking above 105.00 and hitting a high of around 105.30. The US Durable Goods Orders data released on Monday (27 February) recorded-4.5% in January, lower than the previous value of 5.1% and the expected-4.0%. Meanwhile, the recently released (Feb 28) US Conference Board Consumer Confidence Index for February fell for the second consecutive month, recording 102.90, less than the expected 108.5 and the previous value of 106.00, which to some extent dampened the momentum of the dollar's short-term gains, with the US Dollar index testing down to a recent low of around 104.50 and currently quoted at about 104.90.

The market expects the Fed to continue to raise interest rates at each of its next three meetings. According to the latest data from the CME Fed Watch tool, market expectations for the Fed's terminal rate continue to reach a new high of 5.50- 5.75%, with expectations for the end of the year also reaching a new high of 5.25-5.50%. And market expectations have pushed back the point at which the Fed rate peaks to September. In addition, although market expectations for the peak of interest rates by the European Central Bank have increased recently, it is only slightly above 3.8%, and this gap widened in February. Despite the persistent high expectations for interest rate hikes, the US dollar remains stronger, and the recent short-term dip in the US dollar index may be temporary.



Source: CME group

The market is now widely expecting the ECB to raise the deposit rate by 50 basis points to 3.00% on 16 March. The Fed may peak around 5.50-5.75% before September from the current 4.50-4.75%. Meanwhile, the ECB will also reach a terminal rate of 3.5%-4.0% before September. The difference between the terminal interest rates of the ECB and the US central banks has also led to the EURUSD trend or continues to be under pressure. The following are important financial data related to Europe and the US that have been released recently.

- *The US Core Personal Consumption Expenditure (PCE) (annual rate) recorded a 4.7% increase in January, significantly beating expectations of 4.3% and above the previous value of 4.6%.*
- *The US Core Personal Consumption Expenditure (PCE) (MoM) recorded a 0.6% increase in January, beating expectations of 0.4% and the previous value of 0.4%, marking the largest increase since August 2022.*
- *US Personal Spending (MoM) recorded at 1.8% in January, also above expectations of 1.3% and the previous value of-0.1%.*
- *US Durable Goods Orders excluding Defense (MoM) posted-5.1% in January, significantly worse than the previous reading of 5.6% and the expected reading of 0.1%*
- *US Durable Goods Orders (MoM) posted-4.5% in January, significantly worse than the previous 5.1%.*

- *Euro area January Core CPI YoY final value is 7.1%, up from the previous value of 7.0%.*
- *Euro area January CPI YoY final value is 8.6%, in line with expectations of 8.60% and up from the previous value of 8.50%.*

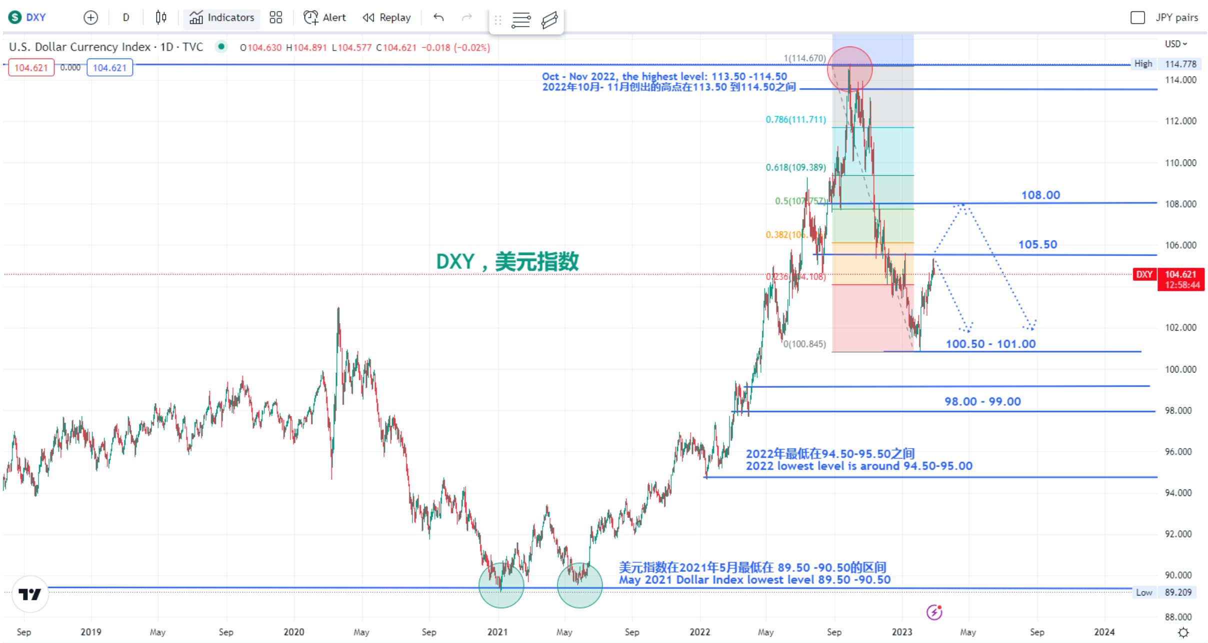
Multiple Fed officials have also recently reaffirmed their hawkish stance. President of the Federal Reserve Bank of Cleveland, Mester said “the new inflation data confirms the case for more Fed rate hikes going forward. The Fed needs to keep raising rates, raise the funds rate above 5%, and keep it there for a while until inflation trends decline”. St. Louis Fed President Bullard indicated that the perception that 'price spikes are temporary' undermines the Fed's reliability, and it is important to act quickly to protect the Fed's credibility. Boston Federal Reserve President Susan Collins said: “responding to excessive inflation will require the Fed to raise interest rates further, with the possibility of keeping rates unchanged for a long period in the future. Recent US data affirms the case for further rate hikes in the future.”

<u>A short-term rise in the US dollar followed by perhaps greater depreciation in the future is the market concern.</u> How long can this strong pullback in the US dollar last? It is difficult to make a judgement at this moment. Clearer guidance may not be available until the Fed stops raising interest rates and there is a relatively large downward adjustment in inflation-related data. Several fundamental factors have led to the "topping out" of the dollar wave and increased depreciation in the future as follows: 1) With the Fed's rate hike curbing inflation, it was only a matter of time before it had an effect, meaning that inflation was definitely on a downward trend and looking towards the 2% target. 2) In the medium to long term, excessive rate hikes are not conducive to economic recovery, and once US inflation falls to a reasonable level, the Fed's rate hike cycle is still bound to come to an end and start "rate cuts". 3) The US debt problem is serious, and the high "interest payments" on the national debt have increased the financial burden on the US government. In January this year, the size of the US government debt reached US$31.4 trillion under the US debt ceiling. As of 2 February, the total US national debt has reached a total of US$31.53 trillion, and the federal debt to GDP ratio has exceeded 120%. If the US federal funds rate is calculated at 5%, a debt size of US$31.4 trillion means that interest payments alone will be as high as US$1.57 trillion this year. There is a high probability that the US debt will be higher than the US$32 trillion debt size by the end of this year, which means that it will face an even more serious fiscal deficit problem. 4) The "Russia-Ukraine war" has been going on for a year now, and the willingness of the United States, Europe and the international

community to support military aid to Ukraine is getting lower and lower. The war is expected to end in 2023 with the mediation of a number of countries, which means that the risk aversion in favor of the dollar brought about by the war will eventually diminish.

<u>Highlights of the Fed's February monetary policy meeting minutes released last Thursday (23 February) are as follows</u>: Some Fed members favored a 50 basis point rise in interest rates, with a unanimous 25 basis point hike. All participants agreed that further increases in interest rates were needed to meet employment and inflation targets, and all favored further reductions in the Fed's balance sheet in line with current plans. The job market is very tight, with labor demand outstripping available supply, and continued labor market tightness will exacerbate inflationary pressures.

A less restrictive policy stance could hinder recent progress in moderating inflationary pressures, and restrictive monetary policy needs to be maintained until the Fed is confident that inflation will fall back to 2%, with 1-Year Expected Inflation final value at 4.1% and 5-Year Expected Inflation final value at 2.9% unchanged. There are downside risks to the economic outlook, and the prospect of a recession in 2023 would be even greater. Overall, the Fed's February meeting minutes consolidated the hawkish policy outlook for rate hikes, boosting the US dollar.



Source: Tradingview

The US dollar index may test 105.50 in the coming period, and if it can hold above this level, it may test the 106-108 range. On the other hand, it may continue to fluctuate between 104-105 until the release of US nonfarm payroll data for February on 10 March, which may provide further guidance.

Reflected in the financial markets, risk aversion sentiment has been increasing in recent weeks. The US 10Y Treasury Rate is approaching 4%, reaching a high of 3.985% (please note that the highest point reached last year in October-November was around 4.25%-4.35%, and it is currently quoted at 3.940%). The US 2Y Treasury Rate has reached a high of 4.86% (please note that the highest point reached last November was around 4.88%, and it is currently quoted at 4.80%). The US Dollar index continues to rebound, while non-US currencies have fallen one after another. Gold fluctuated at a low level, and the US stock market was also under pressure due to expectation of higher-interest rates. All three major US stock indices have fallen to varying degrees from the beginning of February until now. The following are the record gains and losses to date since the beginning of February.

- *The DXY index rose by nearly 500 pips (100.50-105.30) and is currently quoting at 104.65.*
- *The Dow Jones Industrial Average fell by 1950 pips (34500-32550) and currently stands at 32550. And a break below 32500 may trigger a larger decline.*
- *The S&P 500 stock index decreased 200 pips (4150-3950) and is currently trading at 3955. A break below 3900 may trigger a larger decline.*
- *The Nasdaq index down 850 pips (12750-11900) and currently stands at 11985. A break below 12000 may trigger a larger decline.*
- *Gold fell by $150 per ounce against the US dollar (1955-1805) and is currently trading at $1809.50.*
- *USDJPY rose by 820 pips (128.50-136.70) and is currently standing at 136.70.*
- *USDCNH climbed by 2850 pips (6.7050-6.9900) and is currently trading at 6.9570.*
- *USDSGD up 450 pips (1.3050-1.3500) and is currently standing at 1.3485.*
- *EURUSD dropped by 470 pips (1.1000-1.0530) and is currently trading at 1.0605.*
- *GBPUSD fell by 500 pips (1.2400-1.1900) and is currently trading at 1.2095.*
- *AUDUSD declined by 450 pips (0.7150-0.6700) and is currently standing at 0.6725.*
- *NZDUSD slipped by 400 pips (0.6530-0.6130) and is currently trading at 0.6150.*

- *USDCHF rose 370 pips (0.9050-0.9420) and is currently standing at 0.9370.*
- *USDCAD rose by 400 pips (1.3250-1.3650) and is currently trading at 1.3560.*
- *Bitcoin surged by 3700 pips (21500-25200) and is trading at 24000.*

2. When the Japanese yen will strengthen again is the focus of the market's attention.

Last week, Japan has officially announced that Kazuo Ueda will take the helm at the BOJ to replace Haruhiko Kuroda. Although it is not easy to tell whether the new BOJ governor, Kazuo Ueda, will be a "hawk" or a "dove", the trend of Japanese investors selling overseas bonds and buying Japanese government bonds will not stop, which will still put pressure on global bond markets. Meanwhile, the Bank of Japan's next move on yield curve control (YCC) could still be one of the biggest "Black Swan events" in global financial markets in 2023 and could further disrupt global debt and foreign exchange markets. On 20 December last year, the Bank of Japan unexpectedly relaxed the 10-year Japanese government bond yield range, also known as the Yield Curve Control (YCC). The upper limit of the yield target range was adjusted from the range of "-0.25% to +0.25%" to the range of "-0.5% to +0.5%". This move caused a shock in the global bond market, leading to a drop in US Treasury prices and an increase in the yield of the US 10-year Treasury bond (rising from 3.5% to 3.9%), as well as impacting the rise of assets such as the Australian dollar and gold.

Japan remains the largest overseas holder of US Treasuries as of November 2022 data. In fact, it has always been one of the largest buyers of US and European Treasuries. According to the latest data from the Japanese Ministry of Finance and the Japan Securities Dealers Association, Japan sold a record US$181 billion of overseas bonds last year and instead purchased 30.3 trillion yen (US$231 billion) in the size of Japanese government bonds. Recent statements by the new Governor, Kazuo Ueda, in maintaining YCC policy to the maximum extent possible have already led to renewed weakness in the yen. But this process of weakening is likely to be accompanied by a rise in the cost of hedging the yen exchange rate. The market is worried about the YCC policy shift, so when it comes to buying insurance against the yen exchange rate, the cost will become increasingly expensive, adding to the cost of hedging for investors. Even if the Bank of Japan limits the yield on Japanese bonds to 0.5%, Japanese domestic investment institutions still prefer Japanese government bonds. As a result, there is always an incentive to sell off further overseas bonds.

If Japan next lifts the yield on the Japanese government debt (YCC curve) cap, Japanese institutions could continue to sell off the more than US$2 trillion of overseas bonds still in their hands as Japanese government bond yields rise further. This includes over US$1 trillion in US Treasuries and other larger ones, including French, Australian and UK Treasuries.

Benjamin Shatil, a Forex strategist at JP Morgan in Tokyo, noted in a recent report: "Our forecast anticipates a sustained shift in Japanese portfolio flows this year from overseas to domestic debt", "This shift, we believe, is being prompted in part by a view that sustained price and wage rises will inform further relaxation of yield-curve control policy and greater BOJ tolerance for domestic yield rises." According to Shatil's estimates, Japanese investors were net sellers in about 70% of 20 major global fixed-income markets through late 2022, with the largest outflows in Europe and Australia.

Viraj Patel, a strategist at market research firm Vanda Research, said that global bond markets are already under pressure at the moment. Recently, investors' expectations for peak US interest rates have rebounded on factors such as the strong latest US non-farm payroll data. This concern has caused global bond yields, including US bonds, to climb again. Global bond markets could experience another policy adjustment from the BoJ, with rising inflation in Japan increasing the likelihood of a sudden and disorderly exit from the YCC policy. "The BOJ is on the verge of making the same 'transitory inflation' policy mistake that the Federal Reserve made 12 months ago," he said. "We're positioning for Japanese policy normalisation occurring sooner rather than later — and there's a non-trivial chance it happens before the much-touted April BOJ meeting."

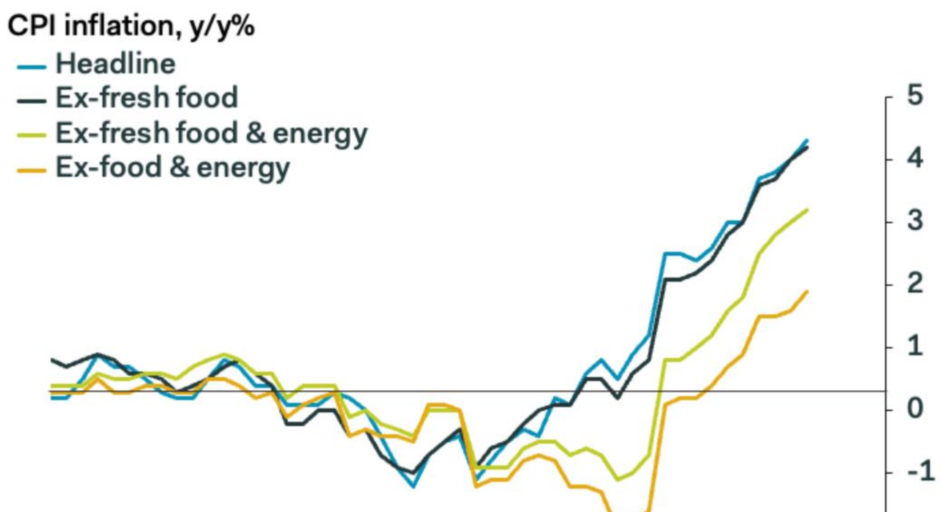
USDJPY Chart (Source: Tradingview)

USDJPY has oscillated higher since the beginning of February, from a low of around 128.00 to around 136.50, heavily influenced by the recent strength in US 10-year Treasury yields. It is still evident that the USDJPY's path closely follows that of the US Treasury yields (from 3.35% to 3.95% in the same time frame).

<u>The cost of forex hedging primarily depends on two factors.</u> The first is the interest rate differential in the currency market. For example, suppose the market expects the Fed to raise interest rates while the Bank of Japan's monetary policy is expected to remain largely unchanged. In that case, this will lead investors to believe that the interest rate differential between the US dollar and the Japanese yen will gradually widen. The second factor is the benchmark of cross-currency pairs driven by supply and demand. For example, the Fed's balance sheet reduction may stimulate demand for the US dollar, thereby expanding the basis cost of cross-currency pairs. Currently, both of these factors are pushing forex hedging costs higher.

The reversal of Japan's arbitrage trade could be the biggest Black Swan event in the forex market in 2023. At the earliest, there may be a significant change occur in a month around the new governor's appointment in April this year, and once this happens, the "trading chain" of yen arbitrage trades will reverse. If the Bank of Japan changes its YCC policy and pushes up Japanese government bond yields, the further increase in the relative attractiveness of Japanese bonds will inevitably attract large insurance companies and pension funds in Japan to accelerate the inflow into the Japanese bond market. The Bank of Japan's adjustment of the YCC curve also amounts to raising the funding cost of yen-related funds, triggering the unwinding of yen-related fund positions in US and European bonds and a massive capital inflow back to Japan. In other words, investors sell US or European bonds to exchange for dollars, pounds, or euros and then buy yen, leading to a further appreciation of the yen. In the short term, the Bank of Japan may retain its current accommodative monetary policy, which is suitable for Japan's fragile recovery. In the medium to long term, the market speculates that the new governor of the Bank of Japan may push for monetary policy normalisation, further narrowing the yield spread between US and Japanese bonds and pushing the yen higher.

At the hearing, the main points of the speech of Kazuo Ueda, nominee for governor of the Bank of Japan, are as follows. Inflation is peaking, and the BoJ could move towards monetary policy normalization if there is more evidence that a 2% inflation rate is foreseeable; a comprehensive review of the policy framework will be considered if needed; the BoJ would need to move towards monetary normalization. If trend inflation does not improve, the BoJ must consider ways to maintain the YCC while keeping an eye on market distortions; if the BoJ normalizes monetary policy, it may do so by raising interest on reserves held at the central bank; if the BoJ exits from easing, it must consider what to do with its ETF holdings, but this is not the time to do so; if the BoJ were to adjust the YCC in the future, shifting its target from 10-year government bond yields to shorter-maturity bonds would be one of the options. Monetary policy decisions may bring unexpected results, but efforts should be made to limit unforeseen factors as much as possible.



Source: Pantheon

Domestic inflation remains high in Japan but shows no sign of peaking. Japan's national CPI rose 4.3% YoY in January, up from 4.0% in December, driven mainly by food and energy prices, which contributed 3% to the 4.3% increase in CPI. This indicates that the foundation of inflation is still narrow. Core commodities contributed 0.6%, housing contributed 0.3%, and services contributed 0%. Overall, cost-push inflation persists due to the lagged effects of the weak yen and high import and energy prices that affect other production costs. Governor Kazuo Ueda said that the BoJ's decade of ultra loose monetary policy was "unavoidable" and that it is "appropriate" to continue easing, while seeking to mitigate the side effects. He indicated said that how the economic situation unfolds should dictate how and when monetary policy will be normalised. In other words, he will take a data-driven approach to deciding on policy shifts. Mr. Ueda also said that "we will have no choice but to review the yield curve control, or at least review it in the direction of normalisation" if the underlying price outlook continues to improve. He expects prices to continue rising, even though the headline CPI for January will be the "peak for the time being". One hint that the BoJ will seek to signal to the markets in advance of policy shifts is that Mr. Ueda said that when the BoJ can "foresee the realisation of 2% inflation" it will be able to take steps towards normalisation of monetary policy. Some analysts believe that Governor Kazuo Ueda may take time to consult with the government and reconsider the monetary policy framework after starting his term in April rather than making sudden changes.

3. AUD weakness remains and perfectly breaks the neckline of the "head and shoulders" pattern.

Several recently released Australian data show the potential strength of the Australian economy. The data showed that Australia ran a current account surplus of A$14.1 billion in the fourth quarter of last year, well ahead of market expectations of A$5.5 billion. In comparison, the previous quarter's figure was revised upwards from a deficit of A$2.3 billion to a surplus of A$0.8 billion. Australia's quarterly retail sales rose by 1.9% seasonally adjusted in January, beating expectations of 1.2% and the previous value of -3.90%.

However, recent GDP data releases suggest that domestic economic activity in Australia may be slowing. Australia's fourth quarter GDP was released on 1 March at a quarterly rate of 0.5%, below expectations of 0.80% and the previous value of 0.60%; Australia's fourth quarter GDP was released at an annual rate of 2.7%, unchanged from expectations of 2.70% and below the previous value of 5.90%. The Australian economy's weaker-than-expected GDP growth in the final quarter of last year hints that the multiple interest rate hikes by the RBA have or are beginning to affect economic activity and that rising borrowing costs may start to dampen domestic consumption.

It is important to note that Australia inflation remains high. Australia CPI (Consumer Price Index) for Q4 2022 was at an annualised rate of 7.8%, the highest level in 32 years. As well as the recently released (1 March) Australian CPI (MoM) for January came in at 7.4%, less than the previous 8.4% and the expected 8.0%. Despite this slight downward revision, Australia inflation figures have been fluctuating around the 6.8%-8.4% range since October last year, with no clear signs of a peak. The Treasurer of Australia, Chalmers, also commented that he was cautiously optimistic that inflation has peaked and will remain high for longer, confident that the worst of inflation is over. The market expects the RBA to raise interest rates further in response to rising inflation.

The Australian dollar's movement is usually more susceptible to global risk sentiment. Against the backdrop of market expectations for the Fed to "raise rates more and maintain high rates for longer," the current market "risk appetite" has cooled, which is also unfavourable for the Australian dollar.

Source: Tradingview, AUDUSD, The "head and shoulders" technical pattern on the daily candlestick chart of AUDUSD that the author warned of last week has now been perfectly broken. The downward momentum of AUDUSD has accelerated after breaking below the "neckline". Currently, AUDUSD is seeking support near the low point of 0.6700. If it continues to fall below this level, the next support range would be 0.6650-0.6550. On the other hand, a retest of 0.6800-0.6900 resistance levels is possible, with further attention to the previous high of 0.7000.

4. Recent data from China indicate a strong recovery, and USDCNH nearly broke through 7.0000 last Friday.

Recent economic data released by China indicates that the country's economy is recovering strongly. The Manufacturing PMI for February was recently released (1 March) at 52.6, above expectations of 50.5 and the previous reading of 50.1, and a new high since April 2012. China's Non-manufacturing PMI for February was also released at 56.3, above expectations of 49.7 and the previous reading of 54.4. China Caixin Manufacturing Purchasing Managers' Index (PMI) recorded 51.6 in February, above expectations of 50.2 and the previous reading of 49.2, marking the first time since last August that the index has risen into expansionary territory (above 50). With the continuous optimization of China's pandemic prevention measures and the steady emergence of the effects of economic measures, the level of China's economy has dramatically rebounded, and business confidence has risen to a new high in two years.

USDCNH (Source: Tradingview)

From a technical analysis perspective, the daily chart of USDCNH has confirmed the formation of a " Head and Shoulders Top" pattern between September and November 2022. It has also successfully broken below the "right shoulder" line at 7.0000 and fallen to around 0.6700. Since the rebound of USDCNH since February this year, there is a possibility of testing the 7.0000 level again. The key is to see where and when the peak of this round of US dollar strength will be reached. Afterwards, USDCNH may begin a larger downward trend, and the answer can still be found in the "Head and Shoulders Top" pattern. The first target is the Fibonacci 50% retracement level around 6.8500, the second target is the Fibonacci 61.8% retracement level around 6.7150, and the third target may point to the Fibonacci 78.6% retracement level around 6.5500.

USDCNH has been on the rise since early February this year, reaching a high of around 6.9900 last Friday, just a hair's breadth away from the important psychological level of 7.0000. This is still due to the US inflation being "easy to rise, difficult to fall" and the market's expectation of the Fed's increased interest rate and longer maintenance of rates at a high level. Under the dominance of the US dollar's rise, the offshore RMB also finds it difficult to "go it alone". However, as recent economic data shows that the China economy may have started a strong recovery, the Chinese stock market has quietly started to rebound since the beginning of this week, leading to a stronger offshore RM, it also had led to a slight rise in gold and crude oil. Reflected in the financial markets, here are the price movements of the past week:

- *USDCNH rose from 6.7050 at the beginning of February to around 6.9850 last Friday. It started this week with a downward trend of 600 pips (6.9850-6.9250) and is now trading at 6.9235.*
- *CHINA50 rose by 480 pips (13100-13580) and is now trading at 13560.*
- *CHINAH rose by 285 pips (6550-6835) and is now quoting at 6838.*
- *HK50 jumped by 770 pips (19650-20420) and is now at 20425.*
- *WTI oil up 400 pips(73.50 – 77.50) and now at 77.59*
- *Brent oil up 400 pips(80.50-84.50) and now at 84.55*
- *Gold rose $37 per ounce(1805.50-1842.50)and now at 1832.50*

5. Short-term risks

As the recently released US Consumer Price Index (CPI), Producer Price Index (PPI) and Personal Consumption Expenditure (PCE) data for January, have all exceeded market expectations, further suggesting the slowdown of the speed of “US inflation’s fall”, this strengthens market expectations of the "Fed's determination to further tighten policy" and increases market bets that the Fed may initiate a 50-basis point rate hike in March. The short-term focus of market attention turns to the upcoming US February ADP Employment Change on Wednesday (8 March), and the US February Non-farm payrolls change data on Thursday (9 March) at 9.30 pm**.** If the US Non-farm payrolls in February and CPI performance in February fall short of expectations, the market may bet on more rate hikes and a later "policy shift" from the Federal Reserve. The medium to the long-term focus of market attention is on the performance of inflation and employment indicators in the coming months, which will also provide the basis for the Fed's policy shift. But it is also important to be wary that when the market fully digests and fully prices in the Fed's tightening policy this year, “the dollar's decline” could come back at any time.

In Asia Pacific, please pay attention to the February Tokyo Core CPI data on Friday (3 March), Japan's Q4 GDP data next Thursday (9 March), and the Bank of Japan's interest rate resolution and monetary policy statement next Friday (10 March). Please pay attention to the relevant data of China's February Consumer Price Index (CPI) next Thursday (9 March), as well as the work report of the Chinese Premier and other key policy events in March, which may propose measures to promote consumption and stimulate economic growth. Also, please keep an eye on Australia January Trade Balance data on Tuesday (7 March) and the Reserve Bank of Australia's second interest rate decision and monetary policy statement for this year.

By Sandy Wang,

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