Market comment_22Mar2023

Xi's Trip to Russia; "Russia-Ukraine War" is Expected to be Resolved Peacefully.

Key points:

- *Market focus has shifted to the "degree of US dollar depreciation" and the "reversal of the expectation of Fed interest rate hikes";*
- *The expectation of US dollar depreciation is still strengthening;*
- *UBS Group acquires Credit Suisse.*
- *Xi's trip to Russia; the "Russia-Ukraine war", is expected to be resolved peacefully, improving market risk sentiment.*
- *The Japanese yen has risen sharply, driven by safe-haven sentiment and the rapid narrowing of the "US-Japan interest differential".*
- *International oil prices have plummeted, but a "bottom-out" may occur anytime.*

1. Market focus has shifted to the "degree of US dollar depreciation" and the "reversal of the expectation of Fed interest rate hikes".

The rally in the US dollar since early February this year has recently come to an end, and further gains and losses will depend on the Fed's subsequent policy guidance and the release of economic data. In the short term, the market's focus has shifted to the "degree of US dollar depreciation" and the "magnitude of the reversal of the expectation of Fed interest rate hikes". Driven by the "safe-haven sentiment" in the US banking crisis, the recent sharp drop in US bond yields may have ended. From last weekend until now, the "regular bearish divergence" pattern formed by the US 6-Month, 1-Year, and 2-Year Treasury yields and the RSI index last week has been fulfilled. After the bankruptcy of three major banks such as Silicon Valley Bank, in the near future, the yields of US 6-Month, 1-Year, 2-Year, 10-Year, and 30-Year Treasury bonds have respectively dropped from the "peak" of 5.30%, 5.27%, 5.07%, 4.08%, and 4.03% to rebound to 4.85%, 4.43%, 4.03%, 3.50%, and 3.68%. Last week's sharp drop in US bond yields also triggered an adjustment in the US-Japan interest differential (i.e., The Japan 10 Years / United States 10 Years Government Bond spread), which narrowed from a 45 basis point drop (from 3.50% to 3.05%) since the "US three major bank bankruptcy crisis" last week (from 9 March to 10 March) to the current 23 basis points (from 3.50% to 3.27%). This also led to a slight rebound in USDJPY by 1.30% (from 130.50 to 132.20).

Just a fortnight ago, on 7 March, Fed Chairman Jerome Powell expressed his "ultra-hawkish" stance at a Congressional hearing that the fight against inflation would be maintained to the end. According to the CME Fed Watch Tool at the time, market expectations for peak rates were in the 5.50-5.75% range, and expectations for year-end rates were still in the 5.50-5.75% range. Following the US banking crisis, around 12 March, the US government and the Federal Reserve introduced the Bank Term Funding Project (BTFP) to enhance bank liquidity and support normal bank operations. On 19 March, the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank are today announcing a coordinated action to enhance the provision of liquidity via the standing US dollar liquidity swap line arrangements to increase the supply of liquidity to the hardware. These measures are expected to be of great help in "easing the banking crisis".

Currently, the market's peak rate expectation for the Fed has been adjusted to a range of 4.75% to 5.00%. The Organization for Economic Co-operation and Development (OECD) recently adjusted its terminal rate expectations for the Fed to 5.25% to 5.5%. In comparison, the terminal rates for the European Central Bank and the Bank of England are both 4.25%. The significant adjustment of the market's terminal rate expectations for the Fed due to the temporary factors of the "bankruptcy events of three US banks" may be a bit impulsive, and the author agrees with this data. "Fighting inflation" is still the primary task for the Fed and most central banks in developed countries, and it will not be easily changed. Especially last Thursday (16 March), when the European Central Bank announced an unchanged interest rate increase of 50 basis points, it adhered to its own pace of interest rate hikes. It was not affected by the banking liquidity crisis in the United States and Switzerland. This has set an example and benchmark, which will also be a background factor for the Fed to continue raising interest rates to combat inflation. If the Fed pauses interest rate hikes at the March meeting, it may trigger more panic because it seems to imply that the "US banking crisis" may be worse than imagined. Therefore, the author believes that there is a high probability of continuing to raise interest rates by 25 basis points.

Expectations of "dollar depreciation" to continue to grow, and if the remarks of Fed Chairman Powell after the Federal Reserve's March interest rate meeting on Thursday make any comments related to a "dovish turn", it is expected that US bond yields will once again start a downward trend, which in turn will "assist" in further depreciation of the US dollar. On the other hand, it may limit the degree of depreciation of the US dollar.

US Dollar Index, which may tend to depreciate next, and the US dollar index at around 105.50 may become the highest level for this year. (Source: TradingView)

Reflected in the financial markets, under the overall sentiment of a weakening US dollar, non-US currencies have all experienced slight gains to varying degrees. After fluctuating in a sideways pattern, the three major US stock indices have currently started a slight upward trend, with the tech-heavy NASDAQ index experiencing the largest increase. The significant rise in gold prices and the recent sharp decline in oil prices may have ended. Meanwhile, Bitcoin has recently begun a solid upward trend. Here is a record of the ups and downs over the past two weeks:

- *DXY Index down260 pips (105.50-102.90) and now is at 102.90.*
- *Dow Jones -2050/+1000 pips (33500-31450-32450), and is currently trading at 32830.*
- *S&P 500 -270/+170 pips (4070-3800-3970), now at 3972*
- *Nasdaq -770/+920 pips (12450-11680-12600), and is currently trading at 12590*
- *XAUUSD up US$190 per ounce (1810-2000), now at 1965*
- *USDJPY down slightly -730/+185 pips (137.80-130.50-132.35) and is currently trading at 132.35*
- *USDCNH oscillated down by 1630 pips (6.9950-6.8320) and is currently trading at 6.8700.*
- *USDSGD down 220 pips (1.3570-1.3350), now at 1.3350*
- *EURUSD up 200 pips (1.0550-1.0750), now at 1.0750*
- *GBPUSD up 460 pips (1.1820-1.2280), is currently trading at 1.2250*
- *AUDUSD up 180 pips (0.6550-0.6730), now at 0.6680*
- *NZDUSD down 190 pips (0.6090-0.6280), is currently trading at 0.6190*

- *USDCHF -370/+180 (0.9440 -0.9070-0.9250), now at 0.9250*
- *USDCAD +550/-200 pips (1.3350-1.3850-1.3650), is currently trading at 1.3660*
- *Bitcoin up 8750 pips (19750-28500), now at 28017*

In the short term, the key focus is on whether the American public's " crisis of confidence " in banks can be alleviated through a series of emergency rescue measures led by US President Biden, as well as whether the bankruptcy waves among these banks can be resolved before the May interest rate meeting after the March interest rate meeting. If the US banking system can remain stable after a 25 basis point rate hike by the Federal Reserve in March, it will demonstrate the strength of the US banking system.

From a medium-to-long-term perspective, the unemployment rate rose slightly to 3.6% in February, which is slightly higher than the previous value of 3.4%, but still relatively low. In addition, non-farm payrolls increased by 311,000 in February, although not as high as the increase of over 500,000 in January. It is still higher than the market's expected increase of 200,000, indicating that the job market is still "hot." Powell's congressional testimony on 7-8 March emphasized the determination to "continue to raise interest rates and firmly curb inflation." In terms of inflation, the data for the next few months still need to be observed. The stubbornness of "inflationary pressure" still exists. The key observation will be the Core PCE (Personal Consumption Expenditures) index, which is due to be released at the end of March. If this data is significantly higher than expected, the market predicts that there may be another 75 basis point interest rate hike from May to July to fight inflation.

2. UBS's acquisition of Credit Suisse

The recent acquisition of Credit Suisse, Switzerland's second-largest bank, by UBS on 19-20 March, and the provision of 3 billion Swiss francs of liquidity support to Credit Suisse, may have prevented more "economic turmoil" in global finance. Credit Suisse is a heavyweight, world-class mega-bank, unlike small and medium-sized banks such as Silicon Valley, and "too big to fail" is a real thing, so the Swiss government stepped in to coordinate the acquisition. It should be noted that Credit Suisse belongs to Switzerland, not to the Eurozone, and its monetary independence also suggests that there is no direct logical relationship between Credit Suisse and the ECB rate hike. So we see that the USDCHF has not gone up or down in any extreme way but has oscillated and moved sideways between 0.9430 and 0.9080, which also shows that the impact of this event is limited. Under pressure from the US and Swiss banking crises, the ECB raised interest rates by a substantial 50 basis points. Judging from the ECB's reaction, the "US bank collapse" may not have had as much impact on the financial markets as we all thought.

It is worth noting that the combined UBS Group will have total assets of over US$1.5 trillion. Following the news of the acquisition, the UBS 1Y Credit Default Swaps (CDS) soared to nearly 1,000 from over 800 on 14 March, rising to an all-time high, with the UBS 5Y Credit Default Swaps hitting its highest level in a decade. The higher the CDS price, the more serious the default concerns of investors and the higher the probability of default. S&P also downgraded UBS's outlook from 'stable' to 'negative' and its rating to 'A-'. This has led to widespread concern from the Swiss government and the market.

On 19 March, the US Federal Reserve said it had joined with the Bank of Canada, Bank of England, Bank of Japan, European Central Bank and Swiss National Bank in a coordinated action to enhance the provision of liquidity through the standing US dollar swap line arrangements. At the same time, US authorities are weighing the possibility of guaranteeing all bank deposits. Currently, the Federal Deposit Insurance Corporation (FDIC) provides guarantees for recognized institutional deposits, with a maximum amount of US$250,000. The implementation of the "US dollar swap line arrangements" and the "merger of Credit Suisse and Swiss Bank" may gradually ease the short-term panic over the "banking crisis" in the market.

3. Xi's trip to Russia; the "Russia-Ukraine war" is expected to be resolved peacefully.

On Monday (20 February), Chinese President Xi Jinping arrived in Moscow to meet with President Putin, kicking off his "peace tour" and embarking on a three-day state visit to Russia. Many analysts believe that China's top leader may want to act as a "mediator" in the "Russia-Ukraine war" to resolve the dispute, significantly reducing geopolitical risks peacefully. On Tuesday (21 February), Chinese President Xi Jinping and Russian President Putin jointly signed the Joint Statement of the People’s Republic of China and the Russian Federation on Deepening the Comprehensive Strategic Partnership of Coordination for the New Era and a Joint Statement of the President of the People’s Republic of China and the President of the Russian Federation on Pre-2030 Development Plan on Priorities in China-Russia Economic Cooperation.

This also implies that both China and Russia are willing to strengthen cooperation further and hope to resolve the "Russia-Ukraine crisis" through negotiations and peace talks. The "safe-haven sentiment" triggered by the liquidity crisis in the US banking industry over the past week has significantly eased. As a result, the rising trend of the Japanese yen and gold came to an end from March 20 to the present, and they have each started to decline to a certain extent, while the CNH and China stock indices have risen slightly.

- *USDJPY rose by 1.76% (130.50-132.80), now trading at 132.59*
- *XAUUSD fell by 3.25% (2000-1935), now trading at 1943.40*
- *USDCNH fell by 400 pips (6.9050-6.8650), now trading at 6.8770*
- *CHINA50 rose by 340 pips (12800-13140), now trading at 13141*
- *CHINAH rose by 300 pips (6400-6700), now trading at 6690*
- *HK50 rose by 850 pips (18850-19700), now trading at 19700*

The People's Bank of China reduced the reserve requirement ratio for almost all banks by 0.25 percentage points. According to an announcement on the website of the People's Bank of China on 17 March, to promote the effective improvement of the quality and the reasonable growth of the quantity of the economy, it has been decided to lower the reserve requirement ratio of financial institutions by 0.25 percentage points (excluding financial institutions that have already implemented a 5% reserve requirement ratio) effective from 27 March, 2023. The weighted average RRR for financial institutions stood at around 7.6% after the cut. Against the backdrop of most central banks in developed countries tightening their monetary policies and the recent outbreak of the US banking crisis, the PBOC has released 500 billion yuan of liquidity to the market by lowering the reserve requirement ratio by 25 percentage points to 10.75%. This may be an attempt to cushion any potential negative impact from the global market turmoil. Since CNH usually follows the trend of the US dollar index, this reserve ratio cut is not expected to impact the USDCNH exchange rate significantly.

Source: TradingView

The trend of USDCNH is still suppressed by the technical pattern of "Head and Shoulders Top" formed between September and November 2022. If it is confirmed that the 7.0000 level cannot be broken, the next target may be the range between 6.8450 and 6.7000 as the USD index weakens.

The People's Bank of China, or the China central bank, has kept its benchmark interest rate unchanged. The People's Bank of China stated that the current interest rate is relatively appropriate, and it will maintain the 1-Year MLF at 2.75%, which is in line with expectations. If the growth driven by domestic demand loses momentum later this year, the bank will be prepared to increase policy support. Currently, the People's Bank of China may focus on providing targeted credit support to weaker areas, such as small businesses and private sectors, through the use of structural tools such as refinancing.

4. Yen rises on risk aversion and rapid narrowing of "the Japan 10 Years/United States 10 Years Government Bond spread".

The US dollar, Japanese yen, and gold are all safe-haven assets. After three US banks went bankrupt over the weekend last week, the JPYUSD appreciated, and XAUUSD also significantly rose, leading to a drop in the value of the US dollar. This is because investors tend to sell higher-risk stocks when market uncertainty increases. We can see this in the sharp sell-off of the three major US stock indices, the Dow Jones, S&P 500, and NASDAQ indices, which all fell by 6.12%, 6.63%, and 6.19%, respectively, in just a few days (from 8 March to 13 March). Investors turned to "historically low-priced" and "low-risk" US Treasury bonds, leading to a rise in prices for the US 2-Year, 5-Year, and 10-Year Treasury bonds by 2.97%, 4.74%, and 5.45%, respectively. This also pushed down US bond yields, dragging down the value of the US dollar, while the "The Japan 10 Years/United States 10 Years Government Bond spread" rapidly narrowed. As a traditional safe haven and financing currency, the Japanese yen benefits from investors selling off stocks as capital flows back to Japan. Not only did the US stock indices fall, but Japan's stock index, the JP225, also fell sharply by 7.50% in just a few days (from 8 March to 15 March), which also pushed up the value of the Japanese yen.

- *The Dow Jones Index -2050/+1000 pips (33500-31450-32450), now trading at 32830.*
- *The S&P 500 Index -270/+170 pips (4070-3800-3970), now trading at 3972.*
- *The Nasdaq Index -770/+920 pips (12450-11680-12600), now trading at 12590.*
- *USB02YUSD rose 300 pips (101.00-104.00), now trading at 102.90.*
- *USB05YUSD rose 500 pips (105.50-110.50), now trading at 109.70*
- *USB10YUSD rose 600 pips (110.20-116.20), now trading at 113.90.*
- *JP225 fell 2150 pips (28650-26500), 7.50%, now trading at 27245.*

<u>Key points from the Bank of Japan's March interest rate meeting:</u> With businesses continuously raising prices and wages, higher-than-expected inflation may continue, and the Bank of Japan must patiently maintain the loose monetary policy until its price target is achieved. In the second half of this year, Japan inflation is expected to slow to below 2%. The Bank of Japan must be vigilant about the risk of prematurely changing policies and losing the opportunity to achieve its price target rather than the risk of policy change being too late. Some officials have indicated that the yield curve control (YCC) policy may be adjusted. The functionality of the bond market is still deteriorating, so vigilance must be maintained.

<u>Weak global demand has dragged down Japan's export growth.</u> Japan Exports in February increased by 6.5% year-on-year, up 3% from January's growth of 3.5%. The growth in shipments to the United States and the European Union was greater than that to ASEAN and China. In February, exports to the EU increased by 9.2% to 18.6%, while those to the US increased by 4.5% to 14.9%. Shipments to ASEAN slowed by 3.1% to 6.2%, and exports to China in February fell by 10.9% year-on-year, the third consecutive month of decline. Given the bleak prospects for global demand growth and the moderate recovery of the China economy, Japan's export growth may remain weak in the first half of the year.

Source: TradingView

Since the news of the bankruptcy crisis of three major banks, including Silicon Valley Bank, broke out last Thursday, the Japanese yen has risen sharply, and USDJPY has fallen significantly due to the narrowing of the "US-Japan interest differential". From 9 March to 20 March, USDJPY fell by 720 pips (137.70-130.50) and is currently trading at 132.25.

5. International oil prices plunge and may "bottom out" at any time

The recent collapse of the three major US banks has caused "safe-haven sentiment" to permeate the entire financial market. The market is concerned about the risk of "economic recession", which may further reduce "potential demand". JPMorgan Chief Market Strategist Marko Kolanovic recently stated that the turbulence in the US banking industry has made a soft landing of the economy unlikely and increased the risk of a 'Minsky moment' in the market and geopolitics. Even if the central bank successfully contains the crisis, the credit environment will tighten more quickly due to market and regulatory pressures. Crude oil prices fell sharply, with WTI falling 19.58% (from 80.20 to 64.50) and Brent crude oil falling 18.78% (from 86.80 to 70.50) from 8 March to 20 March, the most significant weekly decline since February 2020.

However, crude oil prices have recently rebounded slightly since 20 March, possibly due to the "reduction signal released by Russia" and the "Xi’s trip to Russia". On Tuesday (21 February), Alexander Novak, Deputy Prime Minister of the Russian Federation, stated that Russia is close to achieving its commitment to reducing production by 500,000 barrels/day. Considering the current market situation, Russia has decided to maintain oil production at a lower level before July this year. It should be noted that Russia announced in February that it would reduce production by 500,000 barrels/day (about 5% of production level) from March in response to the G7's setting of price caps on Russian oil and oil products. Currently, since Monday (20 March), WTI has rebounded slightly from around 64.30 to 68.80, and Brent oil has rebounded slightly from 70.50 to 74.68.

- *WTI Oil -1590 /+ 450 pips (80.20-64.30-68.80), currently quoted at 68.88*
- *Brent Oil -1630/+ 415 pips (86.80-70.50-74.66), currently quoted at 74.75*

6. The Australian dollar is in the doldrums; RBA may discuss a "pause in interest rate hikes" at its next meeting.

The Australian job market is improving, with the seasonally adjusted unemployment rate in February at 3.5%, lower than the expected 3.60% and the previous value of 3.70%; employment in February was 64.6 thousand, higher than the expected 48.5 thousand and the previous value of -11.5 thousand. Due to the recent market risk aversion caused by the crisis in the US and Swiss banking industries, the Australian dollar is not favoured. Its trend depends largely on market risk sentiment and the Fed's interest rate expectations in March and beyond.

<u>The minutes of the Reserve Bank of Australia's meeting indicate that</u> it may be necessary to tighten policy further to lower CPI. Although overall CPI may peak in the fourth quarter, core CPI remains too high; policy is already at a restrictive level, and the economic outlook is uncertain; consumption prospects remain a crucial uncertainty factor. They agree to "reconsider" the reasons for suspending rate hikes at the next meeting. The time for pausing of rate hikes will be determined by data and economic outlook, which will give the RBA time to reassess financial expectations.

7. Short-term risks

The focus of the Federal Reserve may shift to "financial stability" instead of "combatting inflation" in the short term, and the market expects that the Fed may "slow the pace or even cut interest rates." All of these answers will be clarified this Thursday. Please pay attention to the March interest rate decision of the Federal Reserve at 2 am on Thursday (23 March). The Fed's hawkish interest rate policy over the past year has caused problems in the more vulnerable parts of the US financial system, leading to the collapse of three banks, Silicon Valley Bank, Signature Bank, and First Republic Bank. At the same time, the crisis at Credit Suisse has also heightened investor concerns. The market's expectation that the Federal Reserve will continue to push for interest rate hikes this Thursday has cooled somewhat, but a 25 basis point interest rate hike is still widely expected.

It is also essential to pay attention to the data on the US PCE Price Index on Thursday (30 March) and the US core PCE Price Index on Friday (31 March). This is because the improvement in inflation is the focal point of the Federal Reserve's policy-making.

Furthermore, before the May FOMC meeting, the market is expected to experience more volatility, and the "depreciation followed by an appreciation of the US dollar" needs to be closely monitored. The improvement of the US's inflation and the interest rate policies of the European Central Bank and other developed countries' central banks can serve as "demonstration" references.

The Federal Reserve's approach to fighting inflation through interest rate hikes will not change, or it will continue to support the appreciation of the US dollar, but "economic development and financial stability" require the depreciation of the US dollar. It is also essential to be aware that when the market fully digests and prices in the Fed's tightening policy for this year, the downward trend of the US dollar may become firmer, and the US dollar index at around 105.50 may become the highest for this year.

By Sandy Wang,

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