

Weekly Market Summary

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Yield Curve Extends Inversion; Japanese Yen Under The Pump; & More Of That Sweet, Sweet Cru
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As a tumultuous quarter approached its end, the theme of the 2022 Oscars was “Movie Lovers Unite (how ironic!)”. The theme in global markets was “Inflation In Plight”. From war in Ukraine, surging commodity prices, supply chain disruptions, the list of inflation triggers goes on. Central Banks shifted their focus from unemployment as a mean of assessing lockdowns damage and measuring the pace of recovery from the pandemic to the way inflation has been behaving. We witnessed the Fed, and other central banks wage a war on inflation by kicking off a global tightening campaign. That by itself spooked markets. This week, U.S. markets officially exited correction territory as we digested a heavy slate of U.S. economic figures, OPEC held its 27th meeting as Biden ordered ‘unprecedented’ release of oil reserves, and the Japanese Yen slid to the weakest in almost 7 years.

Last week we had talked about the flattening of the yield curve and its recession risks. It was all about different parts of the curve inverting. But on Tuesday, the most closely watched recession signal (2y10y spread) flashed red and two-year Treasury note yields rose above those of the 10-year for the first time since August 2019. Two-year yields, which move with interest rate expectations, rose as high as 2.45%, the highest level since March 2019. The two-year yield has risen by 1.64 percentage points this year as the US central bank has tightened monetary policy. The 10-year yield, which moves with inflation and growth expectations, fell below 2.30%. Investors argue, however, that the inversion may not be as reliable a recession indicator this time round because the Fed’s massive bond purchases during the coronavirus crisis have skewed the yields. The Fed, as part of its intervention in financial markets during the market collapse in March 2020, began buying huge swaths of US government debt to shore up the economy. The central bank this month ended that \$120bn-a-month bond-buying programme and as it has pulled back, the flood of Treasuries to the market has driven prices lower and yields higher. QT could well steepen the curve, but by raising long rates sharply, credit markets in the U.S. and elsewhere might be jeopardized. With the Bank of Japan recommitting to its intervention to keep 10-year yields low on Monday, it also promises to strengthen the dollar yet further, which will have further implications.

The Bank of Japan stepped up efforts on Wednesday to keep a key bond yield below a red line, offering to buy more government debt, including through ad-hoc purchases, to hold down interest rates against a pull higher by global yields. It offered to buy more than 2 trillion yen (\$16.40 billion) worth of JGBs, in addition to separate offers for unlimited purchases of 10-year JGBs at a fixed rate of 0.25%. “Each market operation doesn’t directly affect foreign exchange rates,” BOJ Governor Kuroda told reporters in Tokyo, signalling little concern that the central bank’s buying of bonds could be weakening the yen. The divergence in policy helped drive the yen beyond the ¥125 mark against the dollar earlier this week. The last time the Bank of Japan intervened overtly to curb excessive yen weakness was during the Asian currency crises of 1998. Fears of competitive devaluations weighed on the yen back then, while high U.S. interest rates and a soaring equity market encouraged one-way bets on the greenback. Yet, the impact of intervention has proved fleeting in the past. A study of 5 distinct interventions shows that the USD/JPY dived in the week following intervention, and by an average of 1.7%, with the trade-weighted exchange rate up 2.6%. But that was it. The average peak impact occurred after one week. A month later, the effect had waned, even with follow-up interventions. One-month trade-weighted changes averaged 1.7%. That is, the yen had declined 0.9% on average between 1-week and 1-month. So, yen interventions probably work through flushing out speculative positions. However, without an underlying change in fundamentals, the success doesn’t last, even with repeated yen-buying.

It is also worth noting that Japan's trade deficit has widened and its price-inelastic demand for dollars increased significantly as a result of the sharp rise in commodity prices. Judging by customs-cleared trade statistics for February (released on 16 March), which show a deficit for the seventh successive month on raw data and a deficit of more than JPY1trn on the seasonally adjusted data, Japanese importers have probably been partly responsible for the one-way demand for dollars. The price of commodities, such as fossil fuels, agricultural products, and industrial metals, for which Japan is heavily dependent on imports, has risen sharply since the outbreak of the Ukraine conflict. As items such as energy, foodstuffs, timber, and metals are essentials, Japanese importers have no option but to pay the asking price in order to source them from overseas, so it would hardly be surprising if they were responsible for much of the very price-inelastic demand for dollars. As of February, the deficit on Japan's balance of trade settled in dollars, had increased to more than JPY24trn and continued to outstrip the surplus settled in yen of just under JPY10trn. Therefore, there is probably little possibility of an end to Japan's commercially induced shortage of dollars.

In the US, investors were digesting a heavy slate of U.S. economic figures Thursday, including data on personal consumption and expenditures. The PCE core price index, the Fed's favored inflation measure, rose 5.4% year over year in February, up from 5.2% a month earlier. Consumer spending rose 0.2% in February, below forecast of 0.5%. Income rose by 0.5%, bumping the savings rate a bit, though disposable income dropped by 0.2%. The y/y rise in nominal spending dropped to 11.8% and should recede somewhat further as stimulus-related base effects fall out of the calculation; still, the current level of nominal spending growth is still super-high by historical standards, enforcing the notion that inflation is not simply a supply issue. Meanwhile, data on weekly jobless claims showed first-time applications for unemployment benefits rose 14,000 last week to 202,000. All three major U.S. stock benchmarks closed lower Thursday, with the Dow Jones Industrial Average, S&P 500 index and Nasdaq Composite booking their largest quarterly drop in two years.

Most importantly, another strong labor report heaps pressure on the Fed. Headline job growth was 431k, not too far from the economist median. Add in the 95k upward revisions to prior months, and you get even closer. More significantly, perhaps, the unemployment rate dropped to 3.6% and wage growth was a tick higher than expected at 5.6% y/y, though the month gain was in line at 0.4%. Labor force participation was in line with expectations at 62.4%, and the U6 unemployment rate plunged to 6.9%. Household employment rose by 736k, explaining the drop in the unemployment rate. The good news is that participation is ticking up, but the bad news for employers is that it simply isn't keeping up with labor demand. This is a strong report, and it will keep the upward pressure on inflation expectations as well as the Fed.

In oil markets, President Joe Biden announced a plan to release from the U.S. Strategic Petroleum Reserve 1 million barrels of oil per day for the next six months as part of the federal government's effort to fight inflation. "This is a moment of consequence and peril for the world and pain at the pump for American families," Biden said as he announced the release. "The bottom line is, if we want lower gas prices, we need to have more oil supply right now." Releasing 180 million barrels from the SPR is an unprecedented step. But it's unclear whether it will have a meaningful impact on oil prices. Oil prices are likely to remain on an upward trajectory as Biden's move to release about a third of America's strategic stockpiles is seen as a temporary measure until a credible long-term solution is found. Earlier Thursday, OPEC+ ratified a 432,000 barrel per day production increase as of May, but that increase is in line with the cartel's plan; it is not responding to oil consumers' calls for significant output boosts. Oil investors everywhere seem to be holding the line for only gradual production increases, despite the ongoing crisis in Eastern Europe. Oil slid below \$100 a barrel and is heading for the biggest weekly loss in almost two years.

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