Weekly Market Update

8 Aug 2021

US Economy : Substantial further progress

- Last week's economic calendar offered further encouraging data beginning with global manufacturing data early in the week, with the ISM Manufacturing Index decelerating slightly in July, but remaining robust and in expansion territory.
- Furthermore, the ISM Services Index accelerated in July to its highest level on record, while factory orders increased.
- Meanwhile, jobs data was also in focus but produced mixed results, beginning with the private sector payrolls, as reported by ADP falling well short of forecasts, before culminating with Friday's decisively upbeat nonfarm payroll report. Moreover, initial jobless claims for the week ended July 31 continued its downward trajectory and came in at a level of 385,000.
- In Summary , the economic data marked a big step down the road of "substantial further progress."
- The Treasury yield curved steepened, after several weeks of yields falling, as some upbeat sentiment from encouraging economic reports permeated the markets, and the U.S. dollar ticked up, while crude oil and gold prices fell sharply.
- The current week is set to bring about another action-packed agenda, headlined by a round of inflation reports for July in the form of the Consumer Price Index , the Producer Price Index and the Import Price Index.
- Meanwhile, employment is likely to remain in focus as the markets decipher the releases of the NFIB Small Business Optimism Index and JOLTS besides preliminary look at nonfarm productivity and unit labor costs for Q2 and preliminary UoM Consumer Sentiment Index.

Global PMI –Key takeaways

- Global manufacturing PMI edged down slightly, by 0.1 point to 55.4, but remains at a relatively high level (after having reached an 11-year high of 56.0 in May). The most eye-catching development was the widening of the divergence between developed markets and emerging markets .
- The aggregate manufacturing PMI for DMs rose back to the record-high of 59.8 reached earlier in May (June: 59.5), with a fresh record for the US Markit indicator (63.4). By contrast, the aggregate indicator for EMs fell back to a 13-month low of 50.7 (June: 51.2).
- The strength in advanced economies is arguably primarily due to their lead in vaccinations.
- The latest manufacturing PMIs also shed some light on inflationary (cost push) pressures, with the global sub-indices for input and output prices more or less stabilising at high levels.
- Earlier signals from China's producer prices also point to a stabilisation, partly reflecting some easing in commodity markets.
- That said, supply bottlenecks are still in play, with for instance container freight tariffs continuing to rise, and global PMI subindices for delivery times still at record lows (meaning record-long delivery times), particularly in DMs.

Global manufacturing PMIs show a widening divergence between DMs and EMs
Indices, 50 = neutral mark

Source: Refinitiv Eikon Datastream

Global PMI sub-indices point to stabilisation in cost-price pressures
Indices, 50 = neutral mark

Source: Refinitiv Eikon Datastream

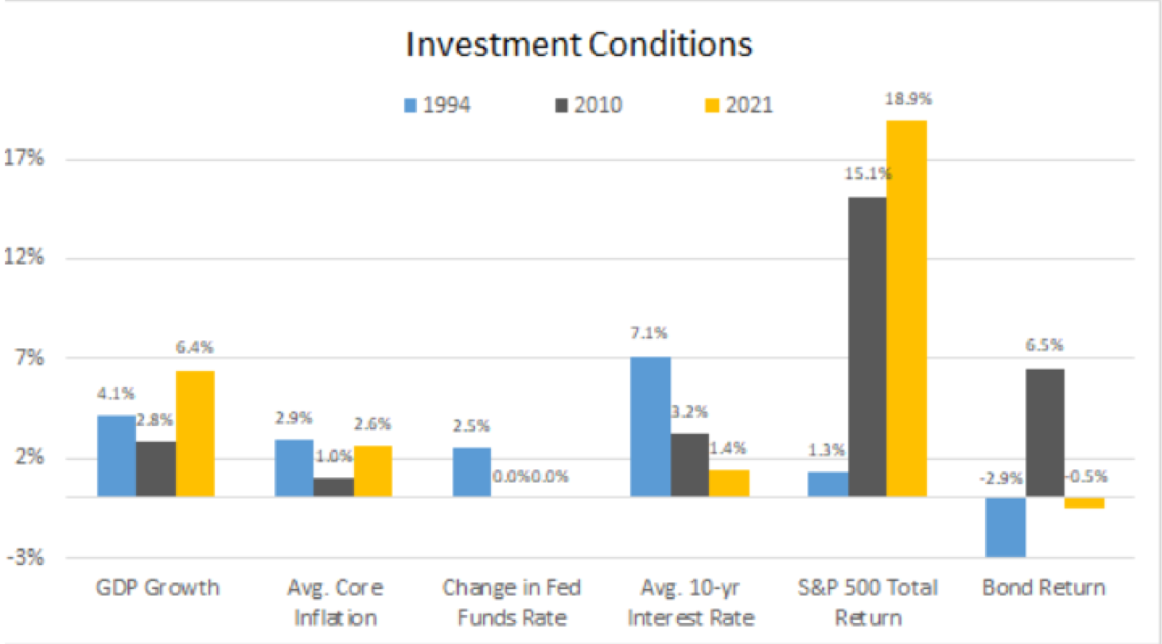
Expansions of the past

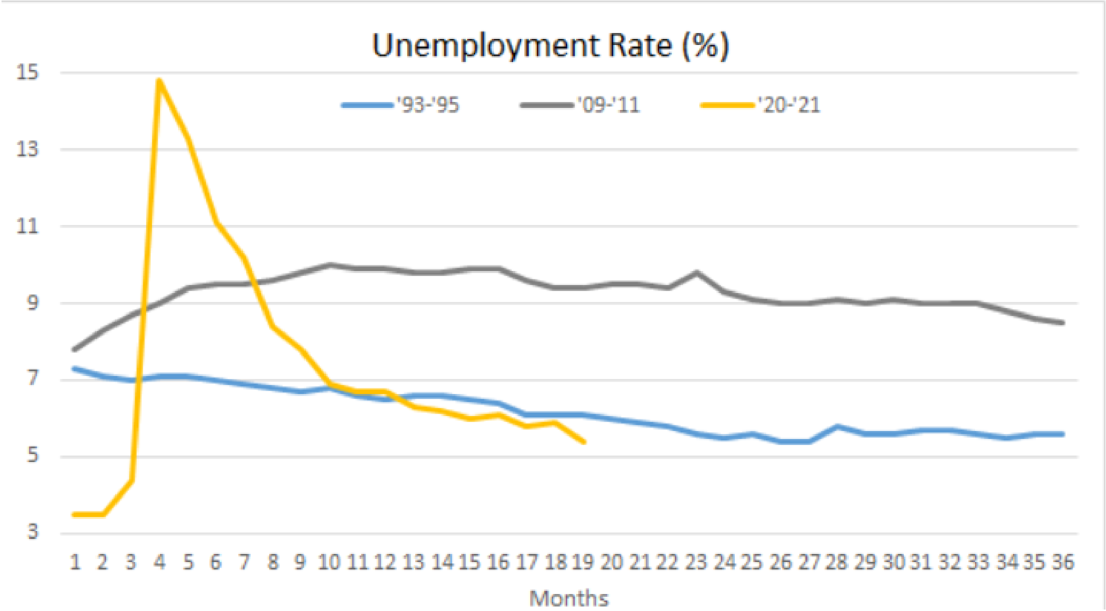
- Young expansions get scared from time to time. In 1994 it was a Fed scare. 2010 was scared by double-dip recession fears. At present, the rising delta variant, as well as rising inflation, has introduced the prospects for both to spook the market.

- **1994:** After stalling in 1993, GDP growth picked up handily in 1994 (quarterly average of 4.1%), with unemployment falling to 5.5% over the course of the year. This was accompanied by a jump in inflation, with headline CPI rising from 2.3% to 3% between May and September. Fed hiked rates six times in 1994 (and one more time in February '95), sparking worries that sharply tighter monetary policy would derail the expansion.

- **2010:** Emerging from the depths of the Great Recession, the economy gained some steam, posting two consecutive quarters of 3%-plus GDP growth (which only occurred two other times during the '09-'20 expansion). The unemployment rate was declining from its 10% peak and the lingering effects of the global financial crisis, fears of a double-dip recession emerged.

- **2021:** GDP growth has averaged 6.4% in the first two quarters of this year, supported by significant improvement in the labor market. This is consistent with the view that economic momentum will be sustained this year by a healing labor market. At the same time, with wages increasing at a strong clip, inflation worries would be concerning – and the implications of Fed tapering –back into focus. Delta variant's implications for the economic reopening will prompt some anxiety around the pace of GDP growth as well.





Equity Rallies of the Past

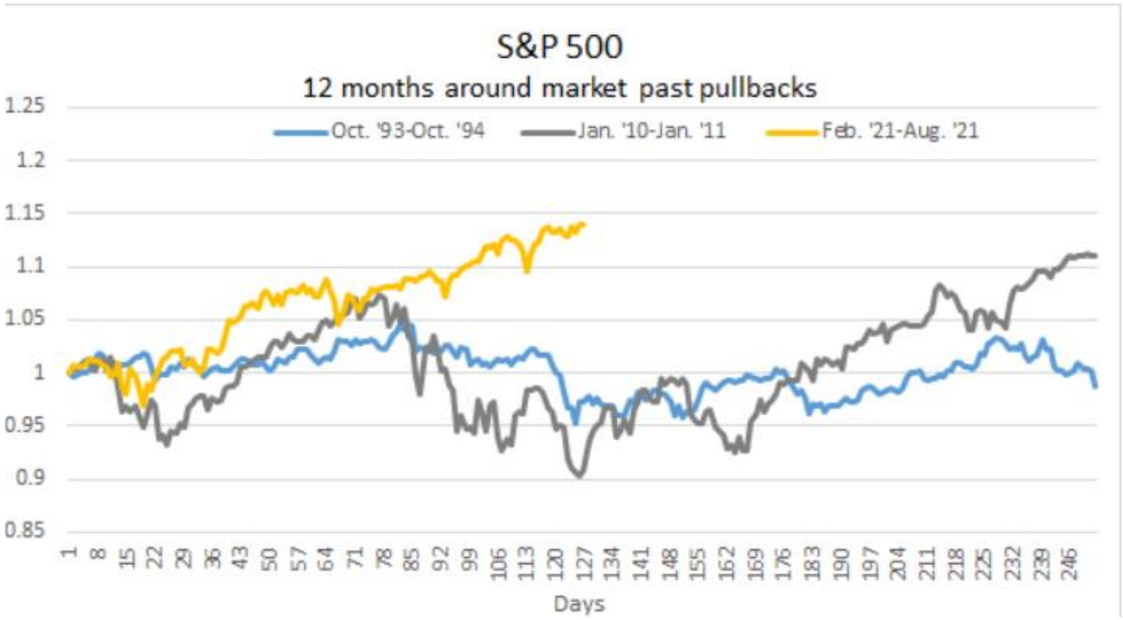
- Strong gains in equities coming into 1994 and 2010 were met with a jump in volatility, with markets experiencing a pullback as more pessimistic economic- and monetary-policy outlooks were priced in.

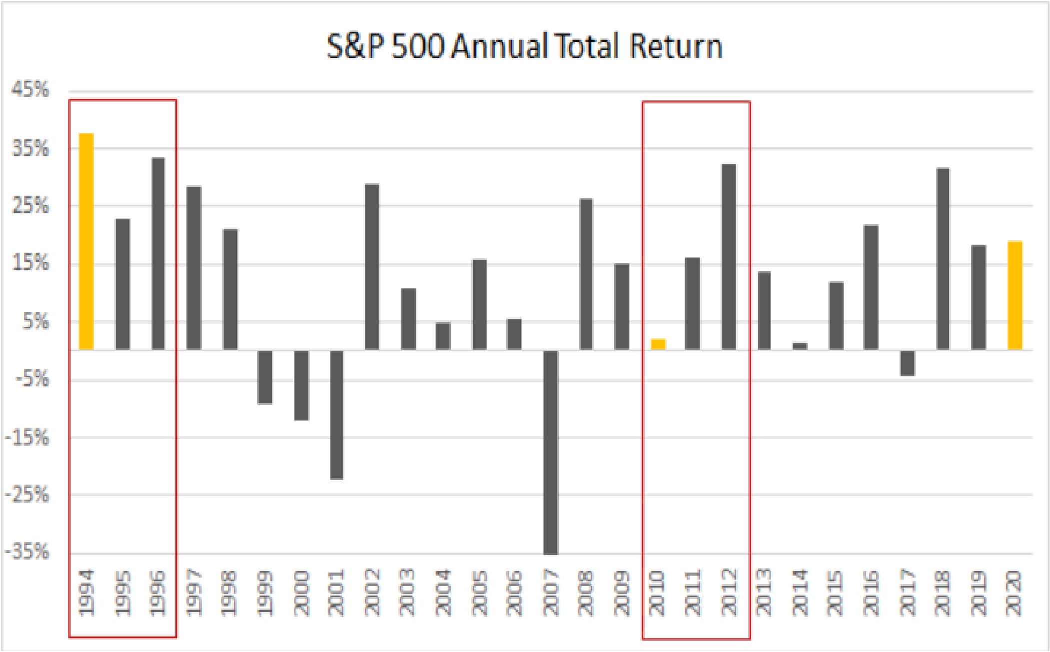
- Markets have been rather optimistic for much of this year, with U.S. stocks reaching a new record last week and interest rates still at historically low levels. This does not suggest a correction is imminent, but pullbacks are a normal part of sustained bull markets.

- **1994:** S&P 500 was up 63% from the 1990 low as economic conditions improved to start the decade. The shift in Fed policy and sharp rate hikes jarred both the stock and bond markets, with equities dropping 9% and bonds falling 5% during February and March.

- **2010:** U.S. equities rose 80% in the year leading up to April 2010, before dropping 16% over the course of May and June as double-dip recession fears gained steam..

- **2021:** The S&P 500 has risen 98% from the 2020 low, including an 18% increase year-to-date. GameStop and inflation concerns prompted dips of 4% in February and May, but the rally this year has largely been free of any persistent drama





Powell’s second term ?

- Powell’s current four-year term as chair expires in early February . While Fed chairs in the past have been renominated in the face of weak economic growth and underperforming labour markets, the political calculation of maintaining the status quo is very different in a country now feeling the daily pain of rising consumer prices.
- Biden’s political fate is intricately tied to whether Powell is right in calling inflation as Transitory , since the president's sweeping recovery plans depend on the Fed striking the right balance between a growing economy and controlling inflation .
- Markets have priced in a Powell renomination but in current dynamics more the Fed admits inflation will last longer than expected, the more we are likely to see markets lose faith in the return of Powell. Biden is not expected to decide whom to choose to lead FED until September at the earliest. The nomination would be subject to confirmation by the Senate.
- Brainard, a card-carrying Democrat considered a leading candidate to take over if Powell doesn’t get a second term, has dissented on many of the majority votes on bank regulation by Powell and Quarles. She had also voted against a handful of bank mergers the Fed approved in recent years.
- She has been categorical that Fed’s ultra-easy monetary policy could pose risks to the stability of the financial system and she would be “much more willing” than the central bank has been to use macro-prudential regulatory tools to try to prevent that from happening.
- It is no coincidence that Sen. Elizabeth Warren praised her stance on various issues . There has been strong support emerging from the influential political sections of both sides for the more regulatory-minded Brainard to head FED .
- What would a post-Powell Fed look like? With up to three other vacancies for Biden to fill, however, Fed Board is likely to end up at least not so dovish as it is now, may adopt a tougher line on financial regulation, and could also take more explicit steps to combat broader issues like inequality and climate change.

Consumer at Stress

- Previously ,consumer income and expenditure showed that the consumer economy is returning to normal
  - Real (inflation-adjusted) income and spending were both above pre-pandemic levels.
  - In June, even as government stimulus payments to households fell sharply, nominal income grew as more people worked and earned wages. However, relatively high inflation ate into wages and led to a decline in real disposable income.
  - Still, real household spending increased strongly as consumers saved less to spend more.
  - The personal savings rate fell to the lowest level since the pandemic began, although it remained relatively high
- Last week 's Consumer credit data showed consumer borrowing increased by USD 37.6 billion during June, above expected USD 23.0 billion increase while May's figure was adjusted upward to an expansion of USD 36.7 billion from the originally reported USD 35.3 billion.
- Non-revolving debt, which includes student loans and loans for vehicles and mobile homes, rose by USD 19.8 billion, a 7.2% y/y rise, while revolving debt, which includes credit cards, advanced by USD 17.8 billion, a 22.0% y/y rise.
- If both data points are read together , there is a discernible debt leverage in the household balance sheet on account of the surge in re open spending – hence Financial stress is now a bigger cause of anxiety for consumers than the virus

Fit for 55 : Implications

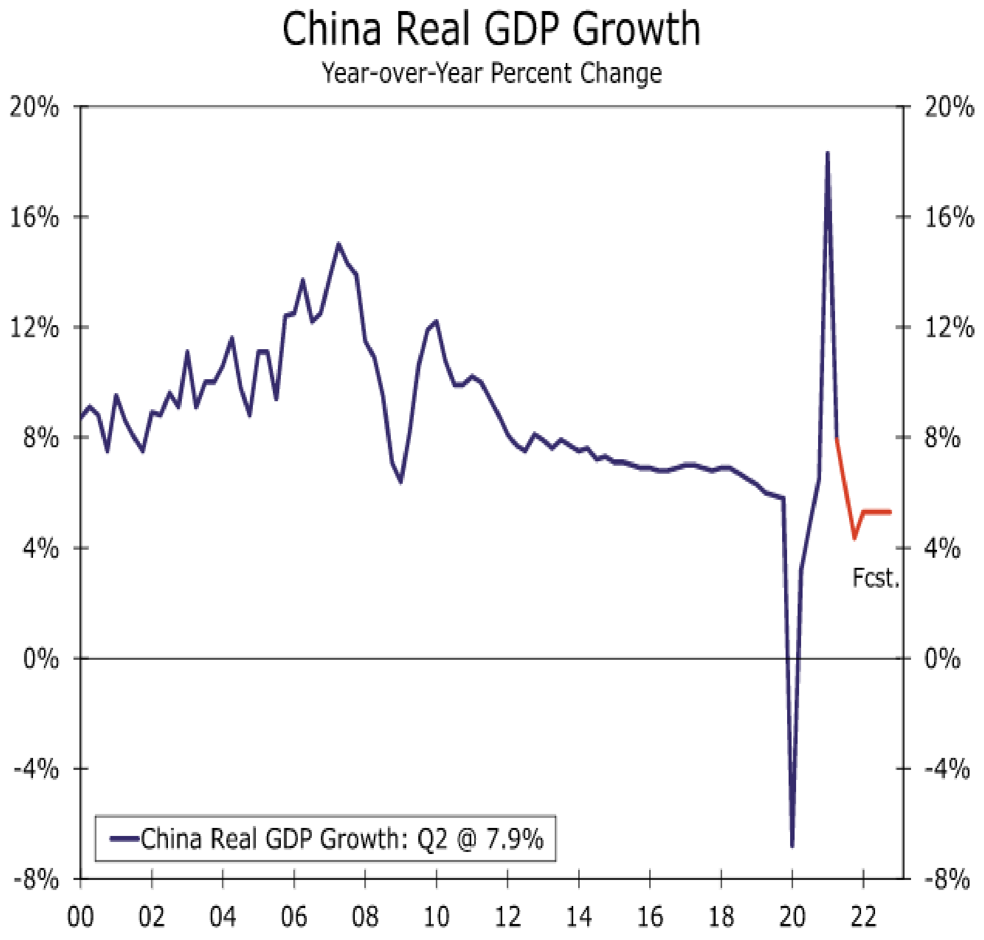
- Less than three weeks ago, European Union announced a historic raft of climate change proposals. 'Fit for 55' plans hope to cut greenhouse gas emissions 55 % by 2030 and establish Europe as the first carbon-neutral continent by 2050.
- The publication of the proposals couldn't be more timely: catastrophic floods ravaged Europe leaving over 200 people dead and hundreds still missing. As the historic storms swept through the region, scientists wrestled with climate change's role and questioned whether Europe was prepared for the realities of global warming.
- As a wealthy continent – out of the 25 richest countries in the world, 15 are in Europe – the EU carries enormous power to shape the global policy framework to adequately fight climate change.
- There has been strident criticism that EU Carbon Border Adjustment Mechanism (CBAM) was designed to raise revenue rather than reduce emissions. It is being widely seen as the "new form of protectionism", arguing that it would be better to incentivise countries to reduce emissions, rather than outright penalise them.
- In one of the worst-case scenarios, the EU's climate policies would exclude developing nations from international trade, forcing them to trade with each other, forming economic and environmental 'ghettos' whereby the wealthy Western world enjoys the benefits of free trade and clean energy, and developing countries lose their economic sovereignty while navigating increasing carbon emissions.
- What had happened to Palm oil in the recent past can well happen to other products from Emerging markets into Europe.
- However, even prior to the pandemic, leading economists long argued that Western countries were attempting to 'kick away the ladder' from developing nations trying to join the economic elite.

UK : More Hawkish BoE

- As widely expected, Bank of England left its main policy settings unchanged at its meeting this week.
- The MPC voted unanimously to keep its Bank Rate at 0.10%, where it has been since March 2020, and it reaffirmed its commitment to purchase up to £875 billion worth of government bonds and £20 billion worth of corporate bonds. At the current rates of purchase, these targets should be met in December.
- But, the MPC also said some modest tightening of monetary policy over its forecast period, which goes through mid-2024, is likely to be necessary if the economy evolves in line with its projections.
- In that regard, BoE revised its forecast for real GDP growth in 2022 to 6% from the 5.75% rate that it had forecasted in its last Monetary Policy Report in May. It also expects that CPI inflation will jump to 4% by Q4-2021, which is a sharp upward revision from its projection in May, although the BoE still suspects that the spike in inflation will largely prove to be transitory.
- In addition, policymakers indicated that the threshold for unwinding the BoE's quantitative easing purchases was lower than previously.
- That is, the MPC previously had said that its Bank Rate would need to rise to 1.50% before it would stop re-investing the proceeds from its portfolio holdings that had matured. That new threshold is now 0.50% "if appropriate given the economic circumstances.“
- In short, it appears that the MPC may start removing monetary accommodation a bit earlier than previously anticipated.

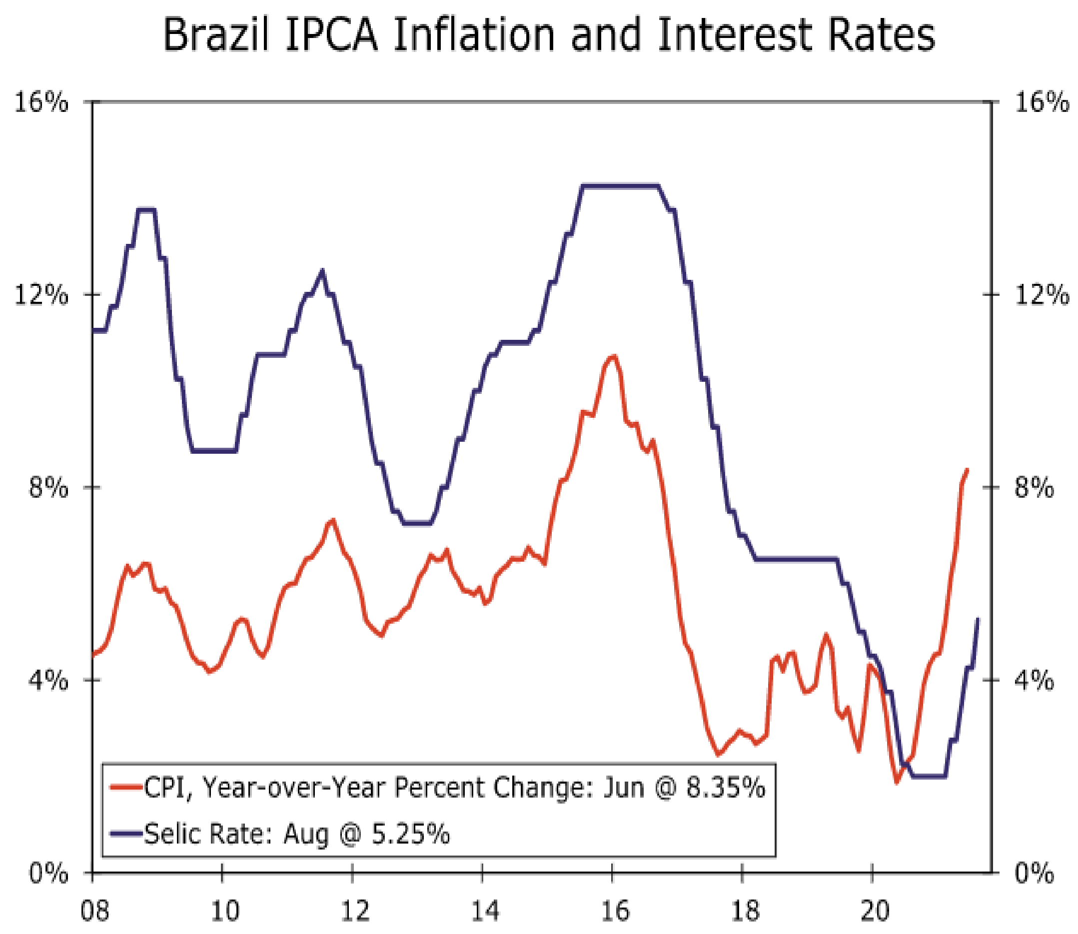
China : Slowdown concerns

- Multiple factors are at play in considering another downward Chinese GDP revision, most notably a COVID outbreak and harsh restrictions being put back in place. In addition, a nationwide flood and regulatory crackdown on certain sectors could also lead to loss of output.
- Local travel restrictions, including public transportation, have been shuttered in the hardest-hit areas, while quarantine requirements are back in place for foreign travelers. New restrictions are likely to have an impact on consumer activity nationwide.
- China's service sector, more formally known as the Tertiary Industry, and of which retail trade is a significant influence, accounts for close to 60% of China's economy. A major slowdown in retail activity could have a relatively large impact on the overall economy. On the other hand, given the renewed global spread of the Delta variant, China's export sector could slow as global demand dips.
- On a quarterly basis, Q3 GDP may slow in line with how the economy performed in Q1-2021, growth of just 0.40%, when China also responded to a COVID outbreak with restrictions. For now, Q3-2021 GDP could grow at 1.3% on a sequential basis; however, given the risks, there might be downward revisions to to Q3 growth forecast



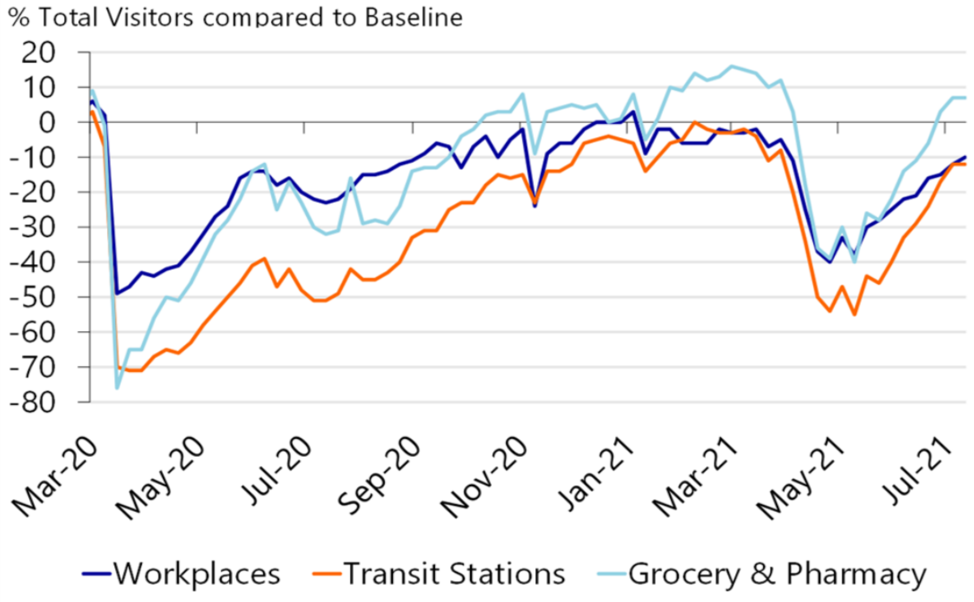
Brazil :Most Hawkish

- Brazilian Central Bank (BCB) maintained its place as one of the most hawkish central banks in the world this week. At its latest meeting, BCB policymakers opted to raise its Selic Rate 100 bps, lifting the main interest rate to 5.25%.
- While the hike was not a surprise, the official statement and accompanying hawkish language was more of a shock as the BCB signaled a more aggressive pace of monetary tightening in an effort to contain inflation.
- Inflation is expected to hit close to 9% in July, well above the central bank's target range, while policymakers also cited fiscal stimulus risk could result in a deteriorating inflation outlook.
- The proactive stance of the BCB should be a welcome development and enhance the credibility of Brazil's central bank; however, tighter monetary policy may not be all that effective against fiscal stimulus, the reopening of Brazil's economy and even higher commodity prices.
- In addition, Brazil has experienced weather-related developments such as extreme drought and even freezing temperatures that complicate the domestic inflation outlook as well

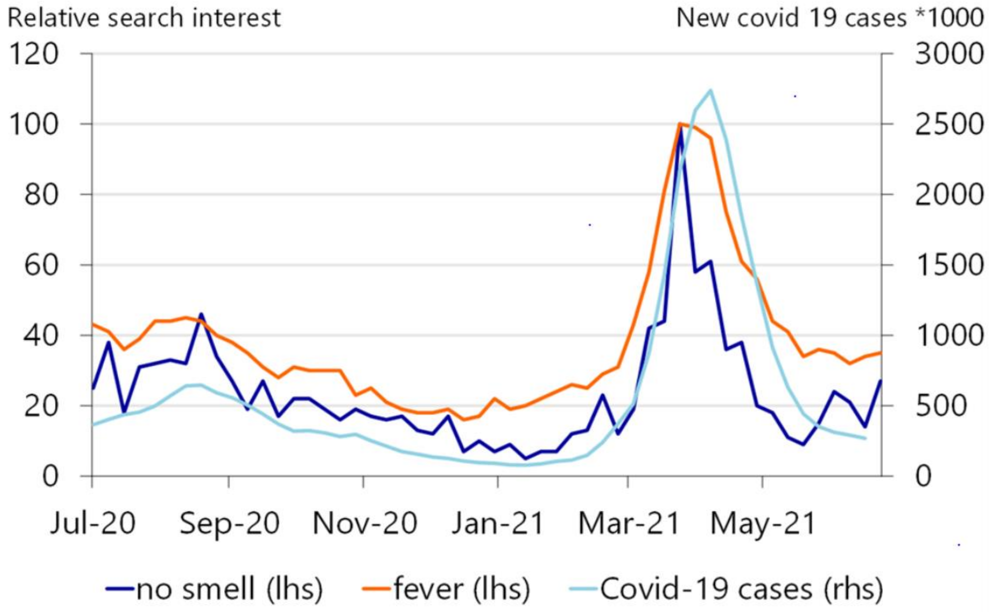


India : Better Backdrop

- It appears that the collateral damage has been much less than during the first wave last year. People have been able to learn, adapt and overcome the economic challenges linked to lockdowns, thereby limiting the economic impact.
- Mobility levels are approaching Q1 levels -which underscores expectation that the economic pain of the second wave will be concentrated in Q2.
- People might continue to be more cautious going forward, as many experienced the devastating medical impact of the second wave.
- Furthermore, a high frequency indicator showing Google search data on the search terms “no smell” and “fever”, which are highly correlated with new infection rates and a good proxy for penetration of the virus.
- There is no upward trend (yet), underpinning expectations that the risks of a large new outbreak in the coming weeks are limited.



Source: Macrobond, Google mobility tracker



Source: Google trends, WHO, RaboResearch

Inflation always a transitory phenomenon…

- MPC reiterated that the inflationary pressures seen during Apr-Jun are expected to be transitory. This allowed it to again look through the 6%-plus inflation prints seen in May and June. But the transitory nature of the current spike in CPI inflation was not enough to prevent a sharper-than-expected upward revision in inflation forecasts.
- Inflation is now seen averaging 5.7% in 2021-22 (Apr-Mar)–60 basis points higher than the view in June. Even in Jan-Mar, inflation is seen averaging 5.8%, 50 bps higher than previously expected. This is seen to qualify as a transitory rise in inflation.
- RBI's strategy to bring down inflation is increasingly resembling the government's glide path on fiscal consolidation.
- RBI seems to be engaging in some amount of policy obfuscation in its communication to meet its objective, which currently is to ensure bond market stability.
- For the second meeting in a row, findings of the RBI's inflation expectations survey were absent from the committee's statement.
- And for the second meeting in a row, the survey's findings, released after market hours, showed inflation expectations had jumped up sharply: three-months-ahead by 50 bps to 11.3% and one-year-ahead inflation expectations by 60 bps to 11.5%.
- The repeated use of "transitory" to allay fears about inflation, stretching the framework to the limit of its flexibility, not mentioning the alarming rise in inflation expectations in the resolution and fighting the market on what constitutes policy normalisation would continue to weaken the policy credibility

Liquidity deluge

- The hike in variable rate reverse repo auctions comes at a time when the capital inflows and the RBI's gilt purchases in the secondary market have led to an increase in the total absorption through reverse repos from a daily average of 5.7 trln rupees in June to 6.8 trln rupees in July, and further to 8.5 trln rupees in August so far.
- Apart from being high, the liquidity surplus is, in fact, expanding at a rapid pace and that too because of factors that are unlikely to fade out anytime soon. A major contributor to excess liquidity has been the RBI's government securities acquisition programme -Since April, RBI has purchased papers worth Rs1.4 trln under the scheme, and has committed to buying another Rs.800 bln worth of bonds by September.
- The steady source of another deluge has been the RBI’s FX forwards book. During Apr-July the central bank took the delivery of forward dollars (estimated size USD 25 bio), after several months of rolling over these contracts. Besides , Govt has considerably lightened its calendar of Treasury bill issuances in Jul-Sep, which has led to weekly net redemptions worth 110 bln rupees, causing a steady accretion to liquidity.
- As much as the RBI would want to maintain an accommodative monetary policy and ensure that banks are flush with cash, it needs to find a way to soak up the excess liquidity that is still flowing in. The yield curve management was the reason why the RBI was fine with abundant liquidity but if the market is suggesting that primary auction yields must go higher despite this, then RBI might gradually change its view
- The ideal instrument to address the issue would have been the market stabilisation scheme, which allowed the RBI to impound liquidity by selling short-term government securities. However, the Union Budget for 2021-22 does not contain any provision for issuances under the scheme.
- The next best option is for the RBI to increase the quantum and tenure of the variable rate reverse repo operations that it has been conducting since Jan 21

Bond market : Lack of Confidence

- RBI MPC unanimously voted to keep policy rates unchanged, but it's resolution to maintain an accommodative stance as long as necessary drew dissent from Jayant Varma, one of the external members of the panel. RBI also raised its headline inflation projection by a steep 60 basis points to 5.7%, and announced a staggered increase in the amount of liquidity it plans to absorb through its variable rate reverse repo operations.
- What the bond market heard was – inflation is high, MPC is showing signs of discomfort with prolonged accommodation, and the RBI is beginning to pull back the surplus liquidity it had provided as a means of monetary policy support.
- On the other hand, RBI Governor said that inflation was fueled by transitory, supply side factors, and warned about the hazards of a pre-emptive monetary policy response. Announcing the increase in reverse repo operations, he made it a point to emphasise that the move should not be construed as a reversal of the central bank's accommodative stance.
- Yet, bond yields climbed 2-7 basis points as a proof that traders were not entirely convinced by Das' assurances. Given that the net absorption of liquidity by the RBI is not changing much, the severe beating taken by short-term bonds today could prove to be unwarranted, or at least, overdone. The rejection of bids is seen as the central bank's discomfort with higher bond yields sought.
- Although Varma's dissent was disconcerting, it would be worth waiting to see exactly which aspect of the stance he disagreed on – was it the accommodative nature of it, or the commitment to maintain it as long as necessary, or something else altogether? After all, Varma has dissented before. In October, he had voiced his disagreement regarding the phraseology of the policy stance, which could well be the case now too
- There is no way to say for sure how close RBI is to the exit door of policy accommodation. Chances are that the central bank itself does not know.

Equity Markets : Lack of Fear

- India accounted for 2.60% of the world market capitalisation in June 2021, compared with the long-term average of 2.45%. The share had dropped to 2.05% in May 2020 when the first wave of coronavirus jolted global equity markets.
- India's stock benchmarks had a milestone week with bench mark indices hitting record highs.
- Although market sentiment is expected to remain buoyant, specifics on important indicators ranging from industrial numbers to inflation and manufacturing production will keep markets on their feet.
- The break out of the consolidation range might be proved false with a close below 15975 and revert back to testing 15450 – which has become the medium term bottom.
- However NIFTY   should stay between 15950 16250 in this week (Seasonally Mid August has always been tough for the markets)