Global Markets Monthly

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Global Macro – Emerging Markets

Stagflation trepidation – portmanteau of slowing growth and rising inflation – is top of mind for emerging markets. Risk sentiment has been on a rollercoaster ride for months, faced with a myriad of challenges such as continued COVID-19 headwinds, downside growth risks, rising inflation and inflation volatility, a less supportive global liquidity backdrop, the tapering of asset purchases by developed market central banks, a lower gear in China, a resurgent US dollar, inexorably high energy prices and a leg up in core bond yields. Our base case is for the going to be tougher in 2022, with tighter financial conditions across major emerging markets propelling rates higher and with it hampering economic growth.

EM ASSESSMENT: SPINNING THE WHEELS

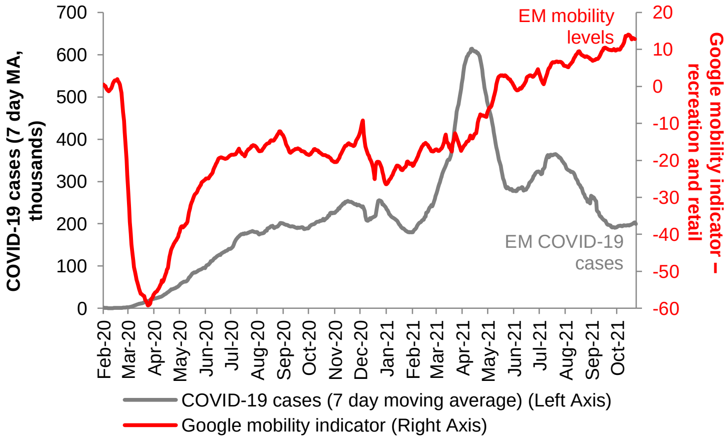
As we near the end of 2021, the emerging market (EM) growth outlook appears more challenging and also more heterogeneous than at the outset of the year. Monetary and fiscal policy have played a pivotal role in supporting EM growth since the onset of the pandemic but as policy is tightened, these tailwinds are turning into headwinds. Inflation has been driven sharply higher across many EMs by a confluence mix of higher commodity prices (energy and food), base effects, re-opening reverberations and fast-recovering developed markets (DM) demand.

The fear of stagflation – the worrisome mix of slowing growth and rising inflation – crept into conversations as inflation reaches ten year highs in many EMs, and comparisons with the 1970s are rife. Negative supply-side shocks, of which we are increasingly experiencing, are particularly taxing for EMs. The pressure continues to build against a backdrop of global trade tensions and virus-related disruptions in supply-chains, but also the spike in commodity prices – which are especially inflationary in EMs – and the tightening in global liquidity as DM central banks head towards normalisation of ultra-loose monetary policy.

Risks are firmly to the downside but we expect pockets of benign performance. Tighter financial conditions, subdued consumer confidence and peak exports all argue for caution with regards to downside growth risks. On the other hand,

EM MOBILITY RETURNED TO PRE-COVID LEVELS IN JUNE 2021 AND THE CASE COUNTS CONTINUES TO FALL

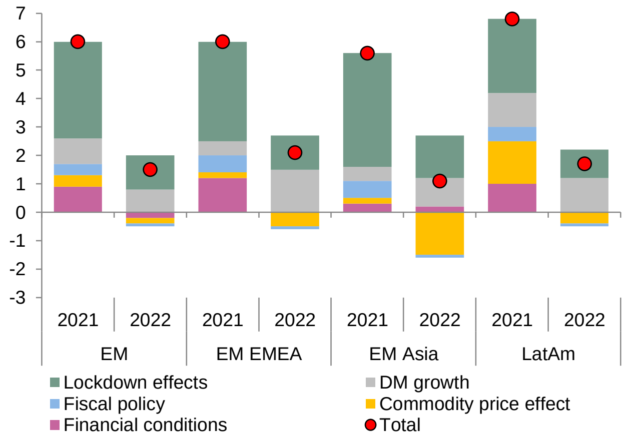
EM – GOOGLE MOBILITY IN RETAIL/RECREATIONAL SITES (BASELINE LEVEL 3 JAN – 6 FEB 2020) AND NEW VIRUS CASES (7 DAY MOVING AVG)



Source: Google, ourworldindata.org, MUFG Research

EM GROWTH IMPULSES ARE SET TO TURN LESS POSITIVE IN 2022

EM GDP GROWTH CONTRIBUTIONS FROM CORE DRIVERS, % POINTS



Source: Bloomberg, IMF, MUFG Research

significant cost side pressures, worsening inflation expectations and a narrowing output gap point to upside inflation risks. Hence, EM's growth-inflation mix is worsening rapidly. Having said that, despite our current bearish EM macro positioning, we still expect relatively decent growth in 2022, albeit with sticky inflation in parts of the EM space. On top of the macro picture, technical positioning is favourable. EM asset classes, particularly equities and some currencies are cheap by historical standards, positioning is light despite record inflows in 2021 and institutional investor cash levels are high indicating tactical trading within the EM complex.

ECONOMIC GROWTH: MULTIPLE NEGATIVE SUPPLY SHOCKS

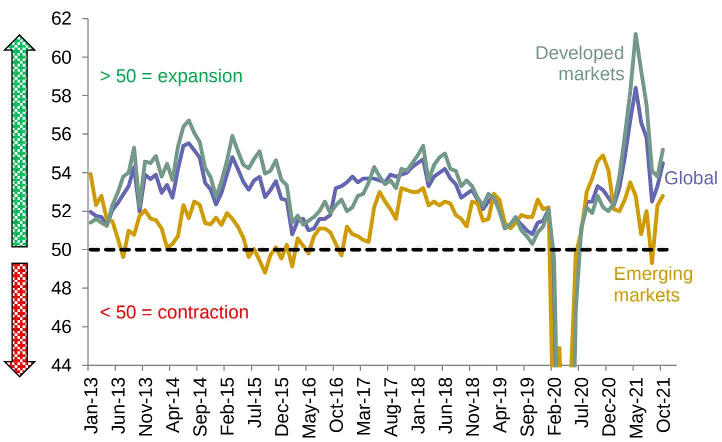
The global backdrop has turned sharply adverse since the summer as the fear of stagflation has taken hold of the market pulse. This warrants caution. Despite our expectations of EM real GDP growth running at 6.7% (consensus 6.4%) in 2021 from a contraction of 0.6% in 2020, we are cognisant of the lasting economic consequences of last year's slump on EMs and the economic burden that foregone growth, lost investment and higher levels of public debt represent.

EMs are fronting multiple supply-side shocks, which could ease the economic recovery in 2022 – our forecasts is for growth to ease to 5.3% (consensus 5.1%) next year. Such supply pressures are stagflationary for EMs with more volatile inflation dynamics, sizable funding requirements and relatively limited room to boost growth, notably at this point in the cycle. Whilst an imperfect comparison, markets are already drawing parallels with the 1970s, marked by a series of oil shocks, leading to sharp price rises, as well as disruptions to energy supply. At the current juncture, however, the negative supply shocks appear to be more broader:

1. Retrogressive globalisation trends and trade tensions. Long running trade frictions between the US and China which were already present prior to COVID-19, have the potential to cause higher production costs. Also, our examination suggests that there is a negative correlation between the level of trade openness and inflation, implying that the lower the level of trade openness (which has been the case for EMs as a whole over the last ten years), the higher the level of price pressures on average (given more integrated supply chains).
2. COVID-19 supply disruptions. There has been a shortages of both goods and labour across a broad range of EM sectors for many months, which has forced factories to halt production temporarily (such as Brazil and Vietnam), as well as extended the delivery times not only in DM but also in EM (as

GLOBAL PMI'S NOTABLY EM'S HAVE BEEN HIT HARD BY PANDEMIC-RELATED SUPPLY DISRUPTIONS

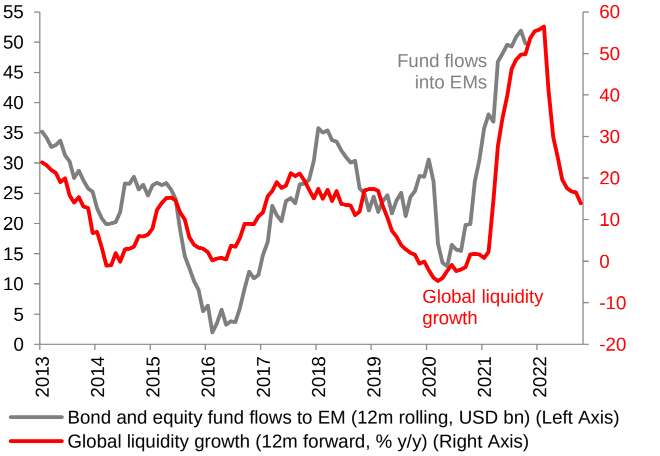
COMPOSITE PMI'S – GLOBAL, DM, EM (1-100; 100 = HIGHEST)



Source: Google, ourworldindata.org, MUFG Research

DECELERATING PACE OF GLOBAL LIQUIDITY GROWTH WILL BECOME LESS SUPPORTIVE FOR EM FUND FLOWS

GROWTH OF FED, ECB, BOJ AND BOE BALANCE SHEETS (% Y/Y) VS. EM FUND FLOWS (USD BN)



Source: Bloomberg, G4 Central Banks, IIF, MUFG Research highlighted in the latest PMI supplier delivery times component).

3. Rising commodity prices. Whilst higher commodity prices have been a boon for EM commodity exporters, an increasing risk lies in inflation and on external positions for energy importers given that the share of energy remains relatively high in CPI baskets.
4. From tailwinds to headwinds for monetary and fiscal policies. Monetary and fiscal policy played an important role in supporting growth in EM economies last year and the early part of this year. However, as this easing has begun to go into reverse, these tailwinds will turn into headwinds for most EMs, dragging on growth rates in 2022.
5. Less supportive global liquidity backdrop. The decelerating pace in global liquidity – measured by the growth in the balance sheets of the Fed, ECB, BoJ and BoE – will become less supportive for EMs through weakening capital inflows (with a 9 to 12 months lag according to our estimates), alongside tighter financial conditions and weaker economic activity.

On net, we believe that there remains significant room for "catch-up" growth. The pandemic has resulted in a significant loss of labour supply in many EMs, but this loss is being partly offset by productivity gains from changes in work practices. If there remains considerable "room to grow", then one questions why inflation has risen so sharply. In our view, such has been the speed of the recovery in aggregate demand in the past year, that it has outstripped the ability of supply to respond in the short run – as evidenced by widespread supply-chain disruptions.

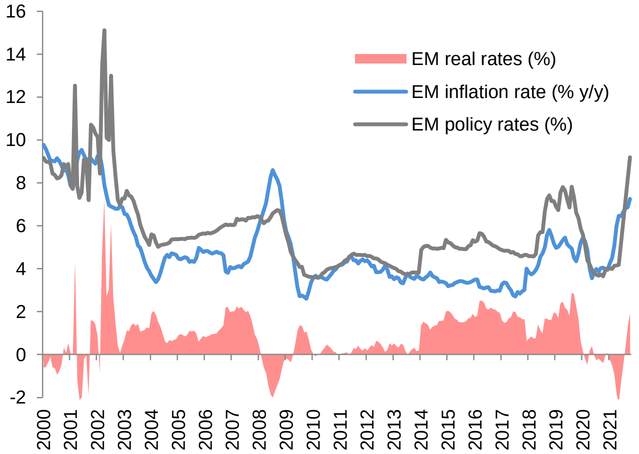
INFLATION: MARKEDLY HIGHER FOR MARKEDLY LONGER

Headline inflation rates have been driven sharply higher across EMs this year by a potent combination of higher commodity prices (both food and energy), base effects and re-opening reverberations (i.e., one-off price increases in the sectors that have been most affected by lockdowns). This has led CPI reaching its near-highest levels since 2010 for most major EMs, with the only real exceptions coming from Asia, where price pressures remain broadly muted, given the weaker consumption dynamics.

Going forward, our base case is for these factors to have only a transient effect and EM inflation rates are likely to decline from their elevated levels through 2022 and into 2023, with some signs of already easing cost-push inflation with expectations that supply disruptions will begin to ease. However, even if that were to be the case, we do not rule out the risk of higher and stickier inflation for two key reasons. First relates to EM inflation expectations, which appear to be much more adaptive compared to DMs. Second relates to closing output gaps, which whilst part of this is

EM INFLATION IS REGISTERING ITS HIGHEST READINGS IN A DECADE, PROMPTING ROBUST HIKING REACTIONS

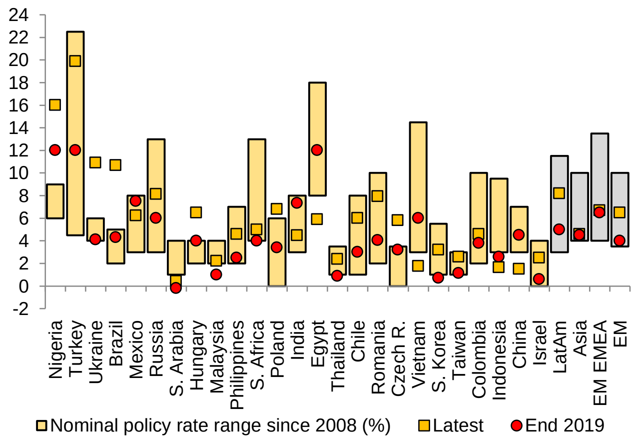
EM INFLATION (% Y/Y), EM POLICY RATES (%) AND REAL RATES (%)



Source: Bloomberg, EM Central Banks, MUFG Research

EM INFLATION REMAINS CLOSE/ABOVE TARGET –EM CENTRAL BANKS HAVE BEEN PROACTIVE TO HIKE

EM INFLATION (% Y/Y), CENTRAL BANK TARGET RANGE (%)



Source: Bloomberg, EM Central Banks, MUFG Research due to improving demand (hence welcome), other parts relate to a slowing potential growth rate. Moreover, whilst we view that external factors are the primary drivers of the inflation overshoot, any second-round effects via the inflation expectations channel risk transforming a transitory external shock into a persistent domestic inflationary problem. This risk is larger among EMs than DMs, given that EM central banks do not have as long of a track record of successful inflation targeting and lack institutional credibility.

MONETARY POLICY: MORE MATURE TIGHTENING CYCLE

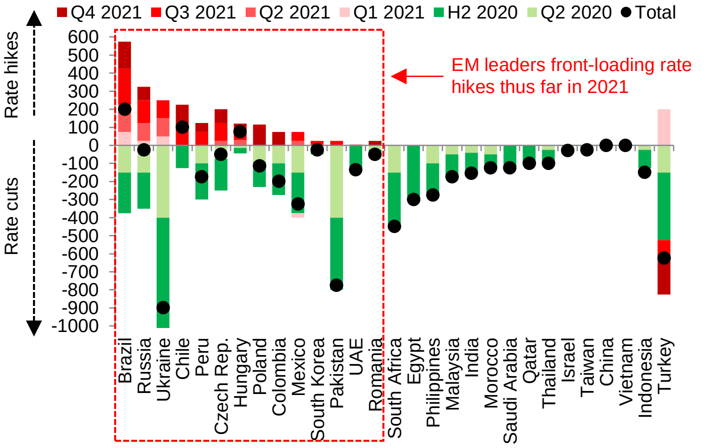
EM rates turned higher early in 2021, and over the past year we have witnessed a hiking cycle that has been faster and more front-loaded than previous cycles. Our EM inflation models signal that the (i) more commodity-intensive CPI baskets in EM relative to DM and; and (ii) less willingness of EM central banks to look through non-core inflationary pressures, is prompting additional hiking biases across the EM space. Concerns over rising inflationary pressures, the potential de-anchoring of inflation expectations and in some cases, market concerns over the sustainability of fiscal policy has been top of mind for EM central banks. We expect inflation in most EM to peak toward the end of 2021 or in early 2022 due to favourable base effects, lower commodity prices, and the fading impact of the reopening of economies as well as easing supply-side disruptions. With inflation above target in an increasing number of countries, several EM central banks were forced to hike proactively, even if they found it difficult to disentangle permanent and transitory shocks. In EMs with weak domestic demand, monetary authorities could afford to be patient (South Africa) or look through above-target inflation (Philippines).

It has already in some cases extended further than initially expected, and is increasingly broadening into EM Asia after being mostly focused on EM EMEA and LatAm for much of 2021. Even at this point, some of the early hikers – for example, Russia and the Czech Republic – continue to deliver large hikes as inflation releases persistently surprise to the upside. Thus, the peak in inflation, a necessary catalyst for a peak in rates, still appears muddy.

As a result of varying inflation dynamics and policy responses, EMs are on different paths with regard to the tightening (or loosening) of monetary conditions. We see Russia as the country approaching the end of its hiking cycle first, topping out at a policy rate of 8.00%. Mexico may follow suit by end-2021, but Banxico will likely remain cautious due to global spill-over risks. Elsewhere in LatAm, we view Brazil has a way to go in its hiking cycle, although much is already priced in by markets. Meanwhile, several LatAm economies are being forced to increase rates to counteract the stimulative effect of fiscal policies (Chile and Colombia), in contrast to

MONETARY POLICY NORMALISATION IS INCREASINGLY TAKING HOLD ACROSS EM'S WITH MARKED LEADERS

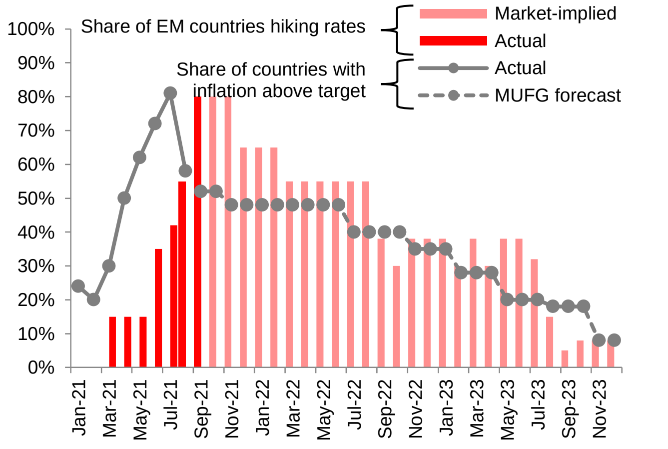
CHANGE IN EM INTEREST RATES BY TIME PERIOD (BASIS POINTS)



Source: Bloomberg, EM Central Banks, MUFG Research

PEAK EM INFLATION LIKELY TO COINCIDE WITH HIGHER MARKET-IMPLIED RISK OF MONETARY TIGHTENING

EM CENTRAL BANK HIKES AND INFLATION (% SHARES OF TOTAL)



Source: Bloomberg, EM Central Banks, MUFG Research

DMs where fiscal policy took advantage of low rates to support the recovery. In the CEE region, we expect continued aggressive rate action despite these economies being somewhat more insulated by the ECB, EU fund disbursements, and favourable current account dynamics (with the exception of Romania). Turkey is a separate case as the Central Bank of Turkey has begun to cut again despite inflation remaining elevated, whilst we believe the South African Reserve Bank is on the cusp of commencing its policy normalisation path. Finally, in contrast to most EM, we expect EM Asia central banks to maintain accommodative policies way into 2022.

EXTERNAL BALANCES: HEALTHY WITH ROOM FOR FX GAINS

Setting aside global factors, EM resilience at the current juncture is, in part, explained by the fact that, relative to much of the post-Global Financial Crisis (GFC) 2008-09 period, EM external balances are significantly healthier compared with most other times in the post-GFC era (even among many high-yielding countries that traditionally run current account deficits) and, therefore, the EM complex is less reliant on external financing. Also, we do not envisage EM external financing requirements going back to what they were before the 2013 taper tantrum. Crucially, the improvement in flows (the current account) has also translated into an improvement in the stock position – reserves coverage of external financing needs has strengthened in most major EMs (even among many high-yielding EMs that traditionally run current account deficits) and, therefore, the EM complex is less reliant on external financing. Indeed, there has been a sizeable improvement in structural current account balances in most major EMs over the last couple of years.

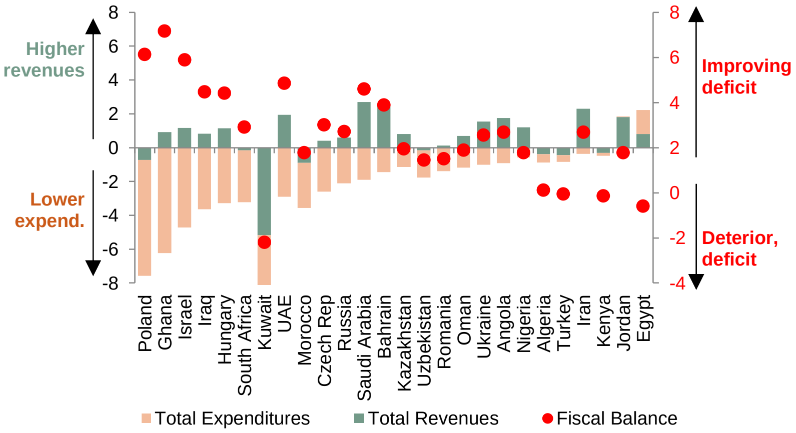
Even in economies where the current account deficit has always been a major source of concern, the improvement is quite stark. This is particularly true for high-yielding EM economies, such as Brazil, India, Indonesia, South Africa and Turkey. On balance, the structural side looks in much better shape particularly when compared to taper tantrum episode. While we expect current account balances to deteriorate on average in 2022, we expect them to remain generally above their sustainable levels. That said, the dynamics are clearly not uniform. Among EM low-yielders, we expect almost all EMs to keep or regain current accounts that are well above sustainable levels in 2022, leaving plenty of space for their currencies to appreciate as interest differentials rise.

FISCAL BALANCE AND DEBT: REDUCED FUNDING BUT SCARS

With EM economic growth improving this year as COVID-19 gradually moves into the

EM FISCAL DEFICITS WILL REMAIN SEQUENTIALLY TIGHTER IN 2021

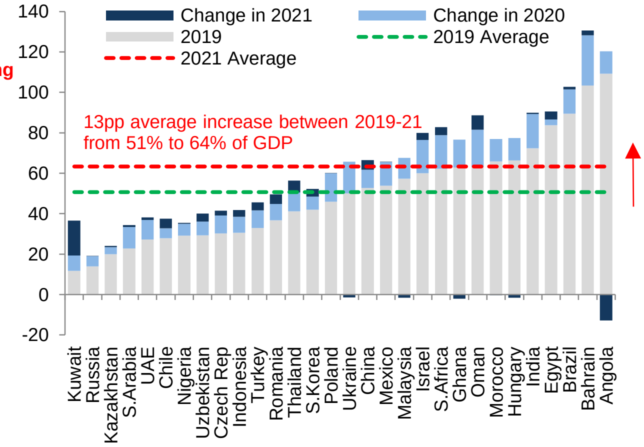
CONTRIBUTIONS OF EXPENDITURES AND REVENUES TO CHANGE IN FISCAL DEFICITS, PP CHANGE FROM 2020 TO 2021 (% OF GDP)



Source: Bloomberg, EM Statistical Offices, MUFG Research

EM DEBT PROFILE CONTINUES TO RISE WITH 2021 LEADING TO FURTHER INCREASES

EM PUBLIC DEBT 2019-21 (% OF GDP)



Source: Bloomberg, IMF, MUFG Research

rear-view mirror, fiscal financing needs are lower and fiscal risks have broadly diminished. In particular, energy commodity exporters of the GCC region has been the biggest gainers over the past year. Fiscal performance has also improved in other commodity exporters such as Russia, Nigeria and Ukraine, where the government budget balance has improved materially. Somewhat surprisingly, Turkey has witnessed the large improvement in its fiscal metrics over the last year, mainly driven by cyclical factors and high inflation. Similarly, Ghana's recent fiscal improvements masks the economy's fiscal as well as external vulnerabilities.

Whilst it would seem that the pandemic is gradually moving into the rear view mirror, the significant deterioration of fiscal balances and public debt build-up across EMs is a legacy that will confront markets and challenge policymakers for years to come. For most EM economies, returning fiscal balances to pre-virus levels is likely to be a multiyear endeavour. Reversing the sharp increase in debt will likely take even longer (if it ever happens). After all, the historical record shows that large fiscal expansions seldom fully mean-revert, increasing the EM risk premium commanded by investors. Granted, the probability of full-blown near-term EM debt crises is low and contained given below-neutral real rates and stronger external balances. Moreover, most of the increase in EM public debt has taken place in local currency, which reduces the risk of an abrupt external funding halt. However, most EMs will face a painful adjustment of fiscal balances in the aftermath of the virus and it is striking how wide the range of outcomes across countries is likely to be.

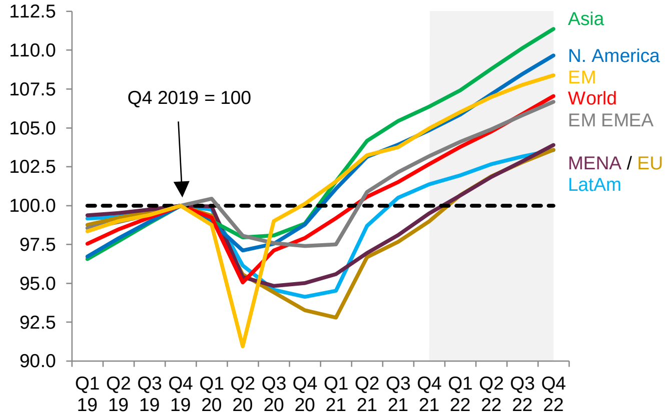
OVERALL ASSESSMENT: STAGFLATION SIGNALS EM CAUTION

Looking ahead, the strong, swift rebound from the pandemic has run out of steam in EMs, causing investors to recalibrate whether the fading of intense fiscal and monetary stimulus will lead to another lost decade for EM. There are important differences between the recovery after the GFC and the rebound from COVID-19 across EMs. First, the CRB Commodity Price Index has emerged from a 10 year bear market and it should not be susceptible to another bear market collapse while the world undertakes infrastructure spending and begins the transition to a more greener energy equilibrium. Second, the Bloomberg EMFX index, which dropped in tandem with commodities after 2011, has reached a record low point and should be supported by gains in terms of trade caused by rising commodity prices. On net, our conviction is one of caution for EMs as we head into 2022, with the rebound trajectory – which will be uneven and unbalanced across regions and sectors – being a function of (i) COVID-19 vaccine inoculation and with it the pace of reopenings; (ii) the degree of economic openness; and (iii) the easing of supply-chain disruptions.

Across EM EMEA, our core regional and country assessments going into 2022

EM LEADS THE GLOBAL RECOVERY BUOYED BY OUTPERFORMANCE IN ASIA

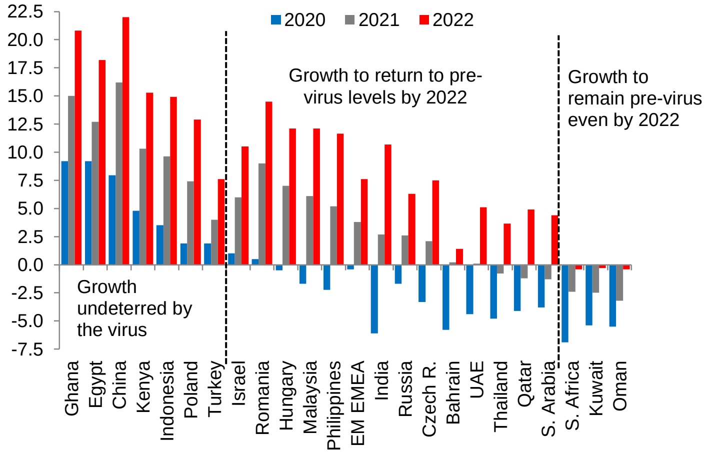
REAL GDP LEVEL, INDEX Q4 2019 = 100



Source: Bloomberg, IMF, MUFG Research

CONSIDERABLE HETEROGENEITY REMAINS ON THE GROWTH PROFILE ACROSS MAJOR EM'S

REAL GDP (% CHANGE VS 2019)



Source: EM Statistical Offices, IMF, MUFG Research are the following:

1. GCC region. Robust outlook anchored on three factors converging to provide significant tailwinds to economic activity, namely (i) re-opening effects with the return to pre-pandemic levels almost complete; (ii) regional developments such as the UAE's Dubai Expo 2020, Qatar's FIFA 2022 World Cup, and Saudi Arabia's "Riyadh Season" hosting 7,500 events in Q4 2021, as well as (iii) elevated oil prices and higher oil production providing greater fiscal space for investments and expenditures.
2. CEE region. We main upbeat on CEE, with the recent aggressive policy tightening a product of recovery success. Though, we have concerns that Poland's growth focus risks monetary policy falling behind and that fiscal policy in Hungary is out of line with central bank stability goals.
3. Russia. The domestic real economy has returned much closer to its pre-pandemic equilibrium than most other EMs. Though we estimate that GDP is still about 3% below the pre-pandemic trend, almost half of that is due to the oil sector, exogenously capped by the OPEC+ agreement. Also, fiscal policy has already tightened sufficiently to return the budget to the government's long-term fiscal rule, in our view.
4. Turkey. High inflation, currency depreciation, increased dollarisation and elevated risk premium remain front of mind. Policy is easing policy when output is above capacity and expectations are increasingly de-anchored.
5. South Africa. Economic recovery has been less V-shaped this year than other major EM peers, owing to more stringent pandemic-related lockdown measures and less fiscal policy support. The fact that output is still below pre-pandemic levels goes a long way towards explaining weaker inflation dynamics and also implies more room for "catch-up" growth near-term.
6. Israel. Despite most of the re-opening effects behind us, we expect growth to remain benign next year led by consumption and investment. Although we see upside risks to inflation from global developments in the near term, we view that a combination of Shekel strength and government reforms to reduce the cost of living will limit inflationary pressures.
7. Egypt. We continue to consider Egypt as one of the most compelling economic stories across EMs. This resilience is anchored on the well-coordinated IMF programe since 2016 wherein the country has moved from crisis (2013-16) to stabilisation (2017-18) to an EM darling (2018 – present).
8. Nigeria. Economic policymaking has focused squarely on targeting FX reserves in the context of a heavily managed FX regime and large balance-of-payment shocks both to oil production as well as prices.

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US Fixed Income: The taper 2.0 is not enough…

Macro Thoughts: It feels like the US economy is starting to pick up steam again post the slowdown experienced during 3Q21. The jobs market has improved again with a strong October NFP report and the back month's labor market data was revised higher as well. Meanwhile the real story is the hot inflation backdrop with both PPI and CPI annual levels for the month October at multi-decade highs.

However in the latest CPI reading saw most categories increase in price terms, where this broadening of inflation is happening is important as it's not just from sectors directly impacted by the reopening impulse. Meanwhile we keep a close eye on the housing shelter costs via owners' equivalent rent (OER) which is likely to remain high and put pressure on core CPI readings well into 2022.

Looking ahead, with real wages actually declining now given the high inflation readings, it's no surprise that consumer sentiment is at the lowest level in years. If it were not for the major fiscal transfers and all-time highs in stocks the consumer would be even depressed. This makes the holiday shopping season key to watch into year-end.

Fed Policy: With the release of the new open market operations schedule for USTs and MBS, tapering is clearly on its way. The Fed will be reducing its monthly purchases by $15bn per month for November and December, taking the run rate at the end of this mini cycle down to $90bn from $120bn per month. This pace will have the Fed end its QE purchases before June 2022. However by chance if the Fed needs to "accelerate taper" it will be a close call if they can do it at the December versus the January meeting. In my opinion if the Fed needs to move quickly, in order to raise rates, they could in January make the taper reduction speed $25bn per month in order to end before April (thus giving the Fed an option to hike rates in June). This by no means is our base case. We believe the Fed will, as they did with launching taper 2.0, drag things out as long as they can before lift-off (in our view its September 2022, or July at the earliest).

Our Views: US rates have had a rough time in 2021 after the initially quick rise in Q1. For the balance of the year it feels like many of the major rate moves (in either direction) were more a function of positioning adjustments versus a view on fundamentals. With the year coming to an end we doubt investors will use up risk capital to take big positioning stances. Instead we see asset allocation rebalances (post an epic rise in stocks in 2021) holding back how high rates should go. Lastly, in addition to positioning, reacting to one-off stories has also been a big driver in the macro space. Where it seems there are only so many themes we are able to focus on a weekly basis. So be mindful of the debt ceiling as it's still unresolved into year-end.

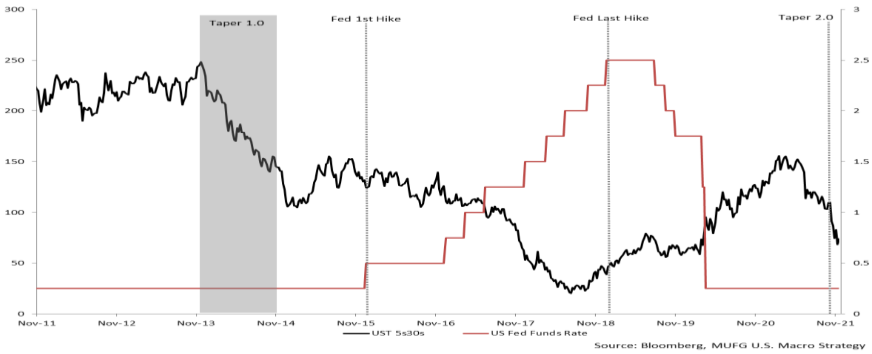
MACRO EXPRESSIONS ACT LIKE TAPERING IS TIGHTENING

We have been on the record a number of times stating that the active process of reducing liquidity can be viewed as tapering. Now, in all fairness during the actual process of tapering a central bank is still adding liquidity via its open market operations (i.e. QE) and that is where we receive the greatest amount of pushback.

However for us on the US strategy side, when a financial system becomes so highly dependent on ever increasing amounts of liquidity to justify market valuations and keep many corners of the system functioning smoothly, any sort of reversal of that can result in a response where markets begin to tighten financial conditions and add frictions back into the system, where the response to tapering will feel like tightening.

The other key aspect of tapering is the signal effect, especially in this environment of elevated inflation. Where market takes tapering announcements as a signal that actual tightening via higher short rate adjustments will also soon follow. This is what we see in this next chart. During taper 1.0, although rates out the curve were not rising (and in fact saw long periods of declines) the move up in belly rates was foreshadowing a hiking cycle that would begin in the next 2 to 3 years into the future.

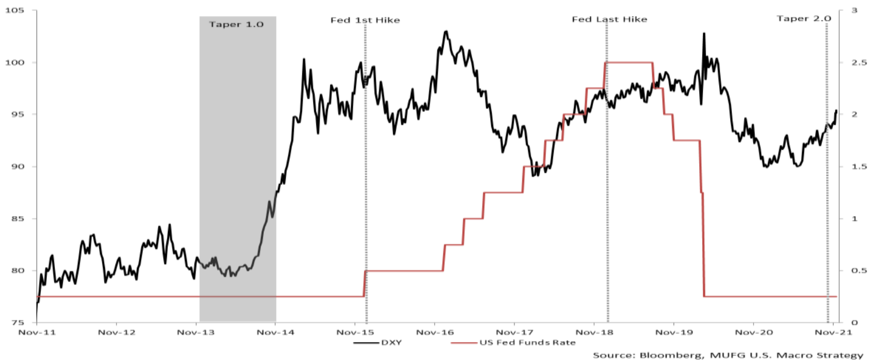
5/30 UST CURVE VS. FED FUNDS AND KEY EVENTS OF THE LAST 10 YEARS



Source: Bloomberg, MUFG U.S. Macro Strategy

However as with all things post the CV19 shock, markets price in future outcomes much faster than in the past. The US 5s30s curve has flattened to levels seen only when the Fed is actually hiking. Meanwhile unlike taper 1.0, the Fed will not have the luxury to wait 15 months before starting a glacial cycle (like back then). That could also be why the US dollar is now outperforming a number of currencies. It is possible, by the same logic used above, that all this future tightening gets priced in too quickly and the Fed never fully delivers a proper hiking cycle (that is my view). But while we wait we need to trade the trends presented and deal with the consequences later.

THE US DOLLAR VS. FED FUNDS AND KEY EVENTS OF THE LAST 10 YEARS



Source: Bloomberg, MUFG U.S. Macro Strategy

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The US dollar on a DXY basis broke higher this month and is now trading at year-to-date highs at levels not seen since July of last year. There are a number of factors to explain this and these factors could well persist for now pointing to further gains for the dollar over the short-term. Firstly, the big jump in annual CPI to 6.2% in the US has further unanchored short-term rates with the 2-year government bond yield hitting a new cyclical high. Pressure for the Fed to act more quickly could see yields drift further higher. Secondly, the economic outlook has deteriorated elsewhere. In the euro-zone COVID risks have escalated with new lockdowns announced in Austria and the Netherlands and further countries expected to follow. In the UK, where the economic outlook is somewhat better, EU-UK trade tensions have picked up which could lead to a sudden deterioration in economic conditions. Finally, China data remains mixed with property market weakness weighing on sentiment. These factors are unlikely to recede as risks and hence will provide the US dollar with support into year-end and through the early part of 2022.

BASE CASE EXPECTATIONS, JPY, EUR & CNY

USD/JPY – BULLISH BIAS

- **Range: 111.00-117.00**

We are maintaining our bullish bias for USD/JPY conveyed here last month and have nudged the range one big figure higher to reflect the prospect of Fed short-term rates potentially moving further higher, giving further upside impetus to USD/JPY. There are other factors too that for now might be helping weaken the yen further although these should prove more temporary.

The supply-constraint issues globally and the energy price surge hits Japan to a greater extent than many other countries and is certainly trade negative. Japan reported a 3.0% contraction (Q/Q SAAR basis) in GDP in Q3 and that reflected weak exports, which contracted by 2.1% and private consumption, which dropped 1.1% partly on weak auto sales and weak services consumption (due to COVID). Real export data underlined the hit from auto sector supply constraint problems with real auto and auto parts sales plunging 36% through August and September. This is important in terms of Japan specifically. Firstly, Japan auto-related exports account for close to 20% of total exports (average over last five calendar years). Japan's top 3 automakers – Toyota; Honda and Nissan account for around 17% of total global sales and one business consultancy has estimated USD 210bn of lost global auto sales due to supply constraint problems. That implies a sizeable yen negative flow.

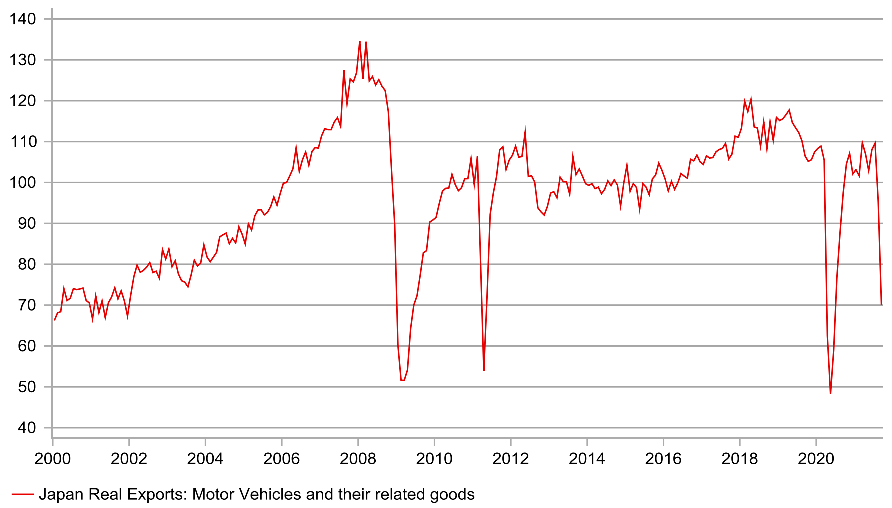
Similarly in relation to energy, the imports bill for Japan is impacted given nearly all of Japan's fossil fuel consumption is imported. So energy price surges tend to undermine Japan's trade balance notably. Over recent years, energy-related imports account for around 20% of total imports (again average over last five calendar years) so the impact is notable. Rising energy prices also help lift inflation expectations which can help drive real yields lower. This though admittedly is less influential on the yen given this is a global phenomenon presently.

So our bullish bias for the period ahead is based on these factors likely continuing as drivers over the short-term. Supply constrain issues and energy price gains will though start to recede we believe in 2022 and hence the upside from here for USD/JPY remains time specific. The topside of our range at 117.00 also ties in with a long-term trend resistance which we believe is unlikely to be breached. Monthly intra-day highs from 1990 (159.30) 2015 (125.86) comes in just above current spot at around 117.00 by year-end.

The turn lower in crude oil prices next year that we expect (we expect the market to turn to surplus by Q2 2022) and the probability that supply constraint issues will gradually ease means some of the catalysts for yen weakness will not persist beyond the next month or two.

In the meantime though and given the prospects of the US rates market to adjust further higher from here, there remains scope for USD/JPY to push further higher. We also await the details of the fiscal stimulus package from PM Kishida. We are somewhat sceptical though of this additional spending having a big impact on the markets. Much of the package is likely to be financed by surplus funds from previous fiscal packages and the history of these packages shows that large portions tend to be saved. But if the package revealed larger than expected fresh spending, it could help to lift inflation expectations and drive the yen weaker. Still, the window for yen selling is relatively limited from here.

JAPAN REAL AUTO EXPORTS PLUNGE ON A PAR WITH PREVIOUS CRISES



Source: Bloomberg, Macrobond, MUFG GMR

EUR/USD – BEARISH BIAS

- **Range: 1.1100-1.1650**

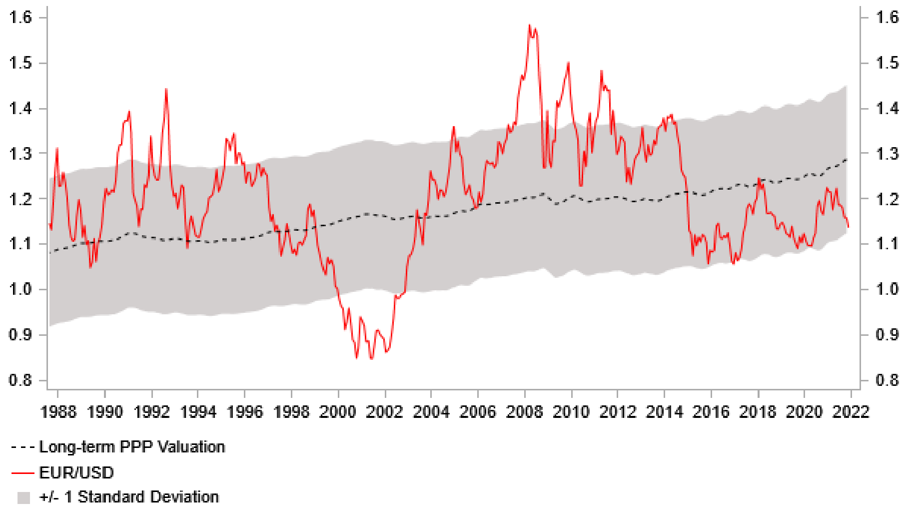
We are maintaining a bearish bias for EUR/USD for the sixth consecutive month. The pair has already fallen a long way by around 10 big figures from a peak of around 1.2350 in late May. We still believe that risks are tilted to the downside in the near-term although the risk/reward balance is becoming less attractive. The EUR is now trading at more deeply undervalued levels against the USD. It should make it more challenging for the pair to keep drifting lower in the month ahead. According to our own long-term PPP valuation model, the spot rate is currently around -12% undervalued. We expect the pair to find strong support at closer to the 1.1200-level which represents around one standard deviation below our PPP model estimate.

EUR/USD has tended to put in place a bottom at similar support levels over the past decade, and was trading between 1.1000 and 1.1200 prior to the COVID shock.

The euro has largely given back last year's initial COVID-related gains against most other G10 currencies as yields spreads have moved sharply against the EUR in recent months. Market participants have become more confident that other G10 central banks including the Fed will be much more active in tightening policy than the ECB which is expected to be laggard. Stronger and more persistent inflation in the US is already increasing pressure on the Fed to speed up QE tapering plans, and around 50bps of hikes are expected in the year ahead. In contrast, the ECB has been pushing back against market expectations for earlier rate hikes from as soon as next year. We see room for ECB-Fed policy divergence expectations to move further against the EUR heading into year end. However, there is a non-negligible risk that the ECB's dovish rhetoric is undermined by policy actions at the 16th December meeting when the ECB is set to outline QE tapering plans for next year. President Lagarde has signalled that PEPP is likely to end in Q1. We expect the ECB to significantly step up the APP to prevent a sharper slowdown in overall purchases. If the ECB disappoints those expectations, it could trigger a relief rally for the EUR and encourage the European rate market to further price in earlier hike expectations.

Bearish sentiment towards the EUR reflects building concerns as well over downside risks to the outlook for the euro-zone economic recovery. The euro-zone economy is on track to expand robustly this year by around 5% but market participants are concerned that growth could slow more notably heading into next year. Those concerns reflect a number of potential downside risks including: i) renewed COVID-related disruption in Europe from the sharp pick-up in cases over the past month. It has already encouraged some re-tightening of restrictions in Austria and the Netherlands although the negative impact of growth should be limited unless the situation deteriorates significantly over the winter given protection from the successful vaccine roll out in Europe, ii) the negative energy price shock has been more acute in Europe and will act to dampen growth, and iii) Europe is more exposed to external risks from the China real estate slowdown, a potential currency crisis in Turkey, and renewed tensions between Russia and the West. Overall it keeps risks titled to the downside for the EUR. While the bearish EUR trend is well established and becoming long in the tooth, Leveraged Funds' short EUR positioning is not yet excessive. It leaves room for further EUR selling in the month ahead.

EUR HAS BECOME DEEPLY UNDERVALUED



Source: Bloomberg, Macrobond & MUFG GMR

USD/CNY – BULLISH BIAS

Range**: 6.3700–6.4400**

China NBS just announced a mixed set of numbers for October key macro indicators, with higher growth of retail sales and industrial production, and weaker growth of FDI and property investment in October. With the implementation of policies which aimed to increase coal production and supply, coal production growth improved to 4.0%yoy in October up from -0.9%yoy in September. Still, further deceleration in FAI growth and property sector activities (i.e. larger contraction in floor space started, weaker growth of property sales and floor space under construction), as well as the low 1%yoy ytd infrastructure investment growth in October, suggested that the Chinese economy faced a persistent strong downward pressure in October.

Similarly, while growth of money and credit stabilized in October with the help of the stronger supply of government bonds and short-term & bill financing loans, new increased medium & long-term corporate loan in October was RMB192 billion lower than the size in same month of 2020. And trust loan decreased by a larger size in October compared with September. Overall the weaker-than-seasonality credit increase implied that demand of corporates for long-term financing needs remained low in October. And the further decline of M1 growth in October was another reflection of shortage of cash flow in the non-government sector, due to strong downward pressure on middle- and down-stream enterprises and real estate sector.

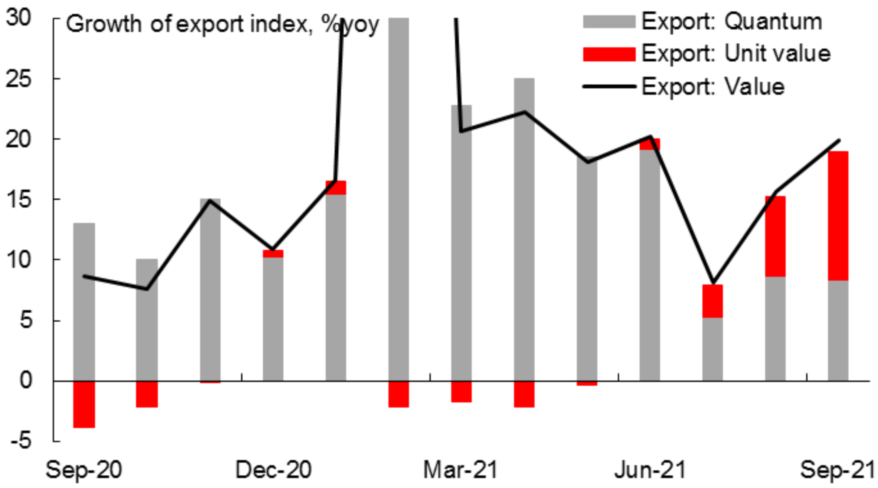
However, weak domestic activities didn't prevent CNY from appreciating by roughly 1% against US dollar since the beginning of October. The strength of CNY was largely supported by the strong exports and record trade surplus lately.

Exports (in USD terms) were up 27.1% in October from a year ago, and the trade surplus rose to a record high of USD84.54 billion. In 2-year CAGR terms, exports growth also accelerated by 0.3ppts to 18.7%yoy in October. The exports growth acceleration was mainly due to stronger labour-intensive products exports. Holiday related demand in US and Europe was the reason for their stronger contribution to overall China exports growth in October. The marginal increase in contribution to China's overall exports growth was also seen in China's exports to Japan, ASEAN and South Korea.

Given the record high October trade surplus, it is of particular importance to dive a little bit deeper into the details of trade statistics. We observe: in recent months, the quantity of exports has been making less contribution to overall exports growth, compared with the contribution from the unit price of exports. In fact, in RMB terms, out of the 19.9%yoy exports growth in September, exports price change contributed about 10.6ppts, accounting for roughly 53% of total exports growth, a stark contrast with exports price's 0.8ppts contribution to June's overall 20.2%yoy exports growth. The growth of exports quantity has been on a decelerating trend since March 2021, it only grew by 8.4%yoy in September.

We maintain a view at the moment that China near-term exports are likely to remain strong, due to slow recovery of supply and supply chain disruptions externally. With the assumptions of current high inflation and imbalance between supply and demand for goods being transitory in nature, and already existing pattern of declining growths of exports quantity, we see increasing possibility of some degree of exports growth moderation ahead. And continued weakness in domestic activity may also incur stronger short-term portfolio outflow, although it will be overwhelmed by the comparatively much stronger trade surplus. Given the considerations on potential marginally weaker trade prospects and capital flow condition, we have a bullish bias on USD/CNY in near term.

INCREASED CONTRIBUTION BY EXPORT PRICE CHANGE



Source: CEIC, MUFG GMR

KEY RISK FACTORS IN THE MONTHS AHEAD

- Positive momentum is with the US dollar at present after DXY broke higher and hence could well test and breach the year-to-date high of 114.70 set on 20th October. A break of that level could accelerate USD/JPY buying more than we expect. The downside risk for USD/JPY stems from global supply constraints and inflation turning to a much greater global growth concern that hits global equity markets and prompts a renewed downturn in global yields relative to Japan. The equity market correction would have to be severe enough (5%-10%) to hit monetary policy expectations. That in turn could see inflation expectations turn sharply lower and this combination would likely see JPY outperform.
- The main upside risk to our bearish EUR/USD view are posed by the EUR leg. There is a risk that the ECB policy meeting on 16th December disappoints market expectations for a significant step up in monthly APP purchases from EUR20 billion at present. PEPP purchases are currently running at around EUR70 billion per month and set to end in Q1. The EUR could stage a relief rebound if the ECB does not commit to a significant step up in APP purchases of say EUR20-30 billion after PEPP ends. It would undermine the ECB's efforts to talk down earlier rate hike expectations as well.
- The main risks to our modest bullish bias for USD/CNY may include stronger China's exports, stronger than expected easing policies including credit policies for real estate sector and property purchasers, to stabilize the downward economic pressure.

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U.S. Investment Grade Credit

Starting the month just 4bp off the all-time tights, the Bloomberg Barclays US IG Index moved 3bp wider to 87bp in October and remains in a historically tight range. Total return for October was 0.25% as flattening of the treasury curve (UST 30Y -11bp m/m) benefitted long-end IG returns. YTD IG total return closed October at -1% after bottoming at -5% amid the rates selloff in early March. When considering elevated risks related to China real estate, resurgence of the delta COVID variant, global supply chain and inflation concerns, volatile treasury markets and fear of the Fed turning more hawkish, a three 3bp move is rather benign and highlights the lack of volatility in the IG market.

IG INDEX SPREAD DATA BY SECTOR THROUGH OCTOBER

	All US IG	Basics	Comms	Cons. Cyclical	Cons. Non-cyclical	Energy	Financial	Industrial	Technology	Utilities
October Close	87 bp	113 bp	109 bp	77 bp	82 bp	107 bp	78 bp	82 bp	77 bp	96 bp
YTD MIN	80 bp	101 bp	97 bp	72 bp	76 bp	101 bp	71 bp	78 bp	66 bp	93 bp
YTD MAX	100 bp	123 bp	121 bp	96 bp	95 bp	138 bp	91 bp	104 bp	82 bp	109 bp
1M Δ	3 bp	3 bp	7 bp	(1 bp)	2 bp	2 bp	5 bp	(0 bp)	5 bp	0 bp
3M Δ	1 bp	7 bp	4 bp	(1 bp)	1 bp	(3 bp)	3 bp	(1 bp)	3 bp	(0 bp)
YTD Δ	(9 bp)	(9 bp)	(7 bp)	(17 bp)	(7 bp)	(30 bp)	(4 bp)	(15 bp)	3 bp	(11 bp)
1Y Δ	(38 bp)	(41 bp)	(33 bp)	(53 bp)	(29 bp)	(88 bp)	(33 bp)	(43 bp)	(19 bp)	(35 bp)

Source: Bloomberg

The Tech and Communications sectors were two underperformers in October. In the communications space, there was concern among credit investors that cable/broadband providers such Comcast (CMCSA) and Charter Communications (CHTR) would report slowing or even declining broadband net adds as pandemic demand tailwinds start to decline. Similarly, media producers/broadcasters such as Disney (DIS), Discovery (DISCA), ViacomCBS (CBS) underperformed as reopening trends allowed consumers to spend more time out of their homes. In the Tech space, Intel (INTC) was a key underperformer as it announced plans to significantly ramp up capex to build out its chip making capability which will diminish FCF over the next 2-3 years. Additionally, other triple-B semi credits were wider on general supply chain concerns. With the exception of the media credits, earnings late in October and early November have shown that concerns were perhaps overdone. The cable/broadband providers released better than consensus broadband net adds; INTC's plans have been given the vote of support from ratings agencies and semiconductor credits have announced strong earnings despite supply chain challenges.

Looking across ratings buckets, the October move wider was universal and the triple-B to single-A basis of 36bp remains near the tights. That relationship has been below 40bp since May 2021 versus ~60-70bp in 2019 and just before the pandemic.

In terms of tenor, according to the Bloomberg Barclays IG index data, IG credit curves flattened with the 1-3yr bucket 6bp wider and the 10+yr bucket just 1bp wider.

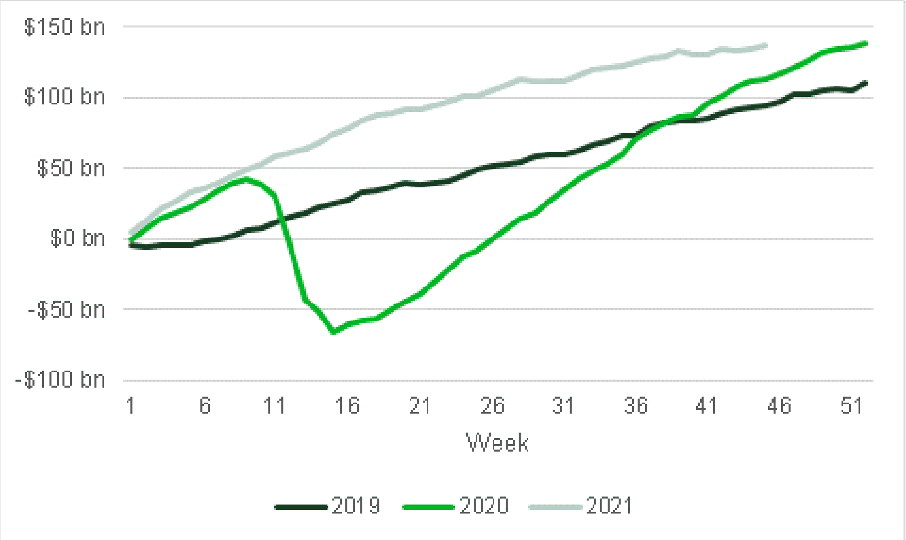
IG INDEX SPREAD DATA BY TENOR

	All IG	1 - 3 yr	3 - 5 yr	5 - 7 yr	7 - 10 yr	10+ yr
October Close	87 bp	38 bp	56 bp	72 bp	91 bp	123 bp
YTD MIN	80 bp	31 bp	50 bp	66 bp	84 bp	117 bp
YTD MAX	100 bp	47 bp	71 bp	85 bp	109 bp	144 bp
1M Δ	3 bp	6 bp	2 bp	3 bp	3 bp	1 bp
3M Δ	1 bp	5 bp	1 bp	(1 bp)	1 bp	0 bp
YTD Δ	(9 bp)	3 bp	(3 bp)	(5 bp)	(7 bp)	(17 bp)
1Y Δ	(38 bp)	(12 bp)	(31 bp)	(34 bp)	(41 bp)	(53 bp)

Source: Bloomberg

After widening to 100bp in March as rates sold off, the Bloomberg Barclays US IG Index quickly rebounded and touched all-time tights of 80bp on June 30 and is currently 87bp. Compared to recent non-COVID years, this 20bp range is exceptionally narrow for IG credit spreads. IG credit traded within a range of 85bp to 153bp in 2018 and 93bp to 157bp in 2019. While the post-COVID recovery of corporate earnings and balance sheets may be influential here, the primary factor remains the large inflow of cash into USD IG funds since the Fed announced its intervention into the corporate credit markets in March 2020. Since the last COVID panic outflow in early April 2020, Lipper Refinitiv fund flow data shows $347bn of net inflows into USD IG credit. In 2019, IG fund inflow was $111bn versus $144bn net inflow in 2020 (despite $109bn outflow in the Mar-Apr period) and YTD 2021 net inflow of $136bn. And this data only captures US mutual fund flow activity, thus ignoring the effect of robust global demand for US IG credit as sustained accommodative central bank monetary policies around the world prolongs the global search for yield.

CUMULATIVE IG MUTUAL FUND FLOW DATA



Source: Refinitiv Lipper; Bloomberg

PRIMARY ISSUANCE

After a massive September which saw $166bn of new issue volume, US primary IG corporate bond issuance continued with vigour and set a new October record of $121.2bn from 70 borrowers, comfortably beating the $90bn average volume estimate. Year-to-date USD US IG volume was $1.31tn at the end of October, down from $1.67tn through the first ten months of 2020. In October, new issues generally continued to tighten 20-25bp from IPTs, but there were some signs of indigestion as new issue concession (NIC) widened to 4-5bp after often coming with negligible NICs the past several weeks. Furthermore, there has been a divergence of new issue performance as high-quality credits have traded better after pricing whereas beta credits have underperformed. For example, the Texas Instrument (TXN: Aa3/A+) and Analog Devices (ADI: A3/A-) deals from September are trading ~7bp inside of new issue and the recent Taiwan Semiconductor (TAISEM: Aa3/AA-) new issues are 7-15bp tighter since pricing in October. Meanwhile, recent Charter Communications (CHTR: Ba1/BBB-/BBB-), Kyndryl (KD: Baa2/BBB-), and Micron (MU: Baa3/BBB-) are anywhere from 2-30bp wider from new issue.

Coming into November, the average estimate for the month was $96.9bn, with potential for volume to exceed $100bn in November for the first times since 2017. With just $45bn of new issue volume MTD as of November 12, there could be a very busy primary calendar ahead of Thanksgiving. On the other hand, with several M&A transactions scheduled to close before year-end, and with CFOs contemplating the potential for rising cost of debt in 2022, there could be above average new issue activity for the remainder of the year.

NEAR TERM OUTLOOK

Coming into November, earnings were in focus as investors looked for clarity related to supply chain issues, labour shortages, elevated commodity costs and general state of consumer demand with the delta variant continuing to impact consumer habits. The S&P500 had sold off 5% in September reflecting these macro concerns, but is +8% since earnings kicked off on October 13 as 81.5% of companies reported EPS beats and 68% reported revenue beats. More importantly, the outlook for 2022 earning remains constructive as CEOs, while admitting that cost inflation will be more impactful and longer-lasting than previously anticipated, provided a positive outlook on overall demand going into 2022. Furthermore, the Fed's latest comments related to tapering were anticipated and Fed language remains dovish, providing a solid footing for IG credit. While global central bank monetary policy is starting to turn less accommodative, the gradual tightening process should leave US IG in a relative position of demand globally, and continued inflows in to US IG funds are expected. Therefore, IG spreads are likely to stay in the tight range we've seen for much of the past few months as any moderate backup will likely be met with ample cash ready to be put to use at wider levels. However, a more dramatic spike in rates that leads to a sustained outflow from US IG credit could result in a more severe move in US IG spreads

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