Global Markets Monthly

MAY 2022

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Global Macro – Emerging Markets

Our 2022 EM outlook theme we advocated in January was anchored on stagflation trepidation – portmanteau of slowing growth and elevated inflation – remaining top of mind (see here). Recent events have reinforced this narrative.

Extensive negative supply-side disruptions, the war in Ukraine, rising commodity prices and a less supportive global liquidity backdrop have markedly deteriorated the inflation-growth trade-off across EMs. A drawn-out inflation challenge with more rate hikes, tighter financial conditions, sharply slowing growth and higher borrowing costs leaves a perplexing outlook for EMs, and favours a bottom-up selection process to pick out winners. We favour EMs with flexible policy manoeuvre, attractive risk premiums and commodity links – the GCC region, South Africa and LatAm stand-out as most favourable.

EM ASSESSMENT: TRAINING WHEELS ARE OFF

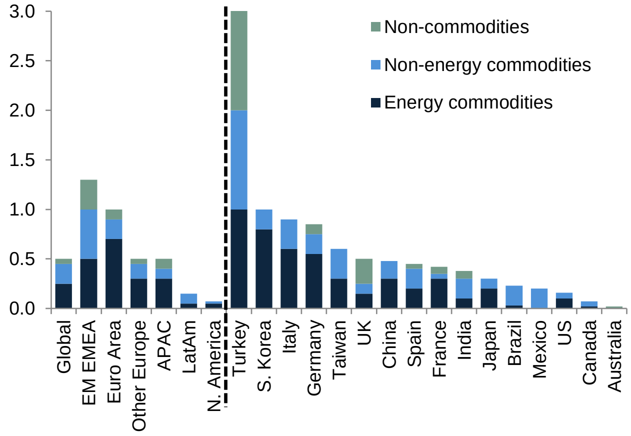
2022 has witnessed a lot and we are not even half way yet. It's seen the worst bond market performance since 1980, the biggest commodity outperformance since data began in 1960, and large moves within and between equity indices. It has seen an intense conflict in Europe, the re-emergence of the COVID crisis in China, and the first 50bp hike by the Federal Reserve in 22 years.

From an EM perspective, following the worst quarter in over a decade – bar the start of the pandemic – the outlook is in a state of flux. EMs were already pricing in a long streak of stagflationary shocks. This picture is now even more complicated given the war in Ukraine and all the near and long-term uncertainties it causes. This reinforces our EM 2022 outlook theme of a continued deterioration of EM's growth-inflation mix (see here).

Fed rate hikes and quantitative tightening still pose the biggest risk to EMs, while expectations about global inflation returning to more reasonable levels are fading. Significant cost pressures and continued supply disruptions argue for further monetary activism by most of the EM central banks. In the meantime, the sought-

VULNERABILITY FROM RUSSIA AND UKRAINE IS THE LARGEST FOR EM EMEA ACROSS THE EM SPACE

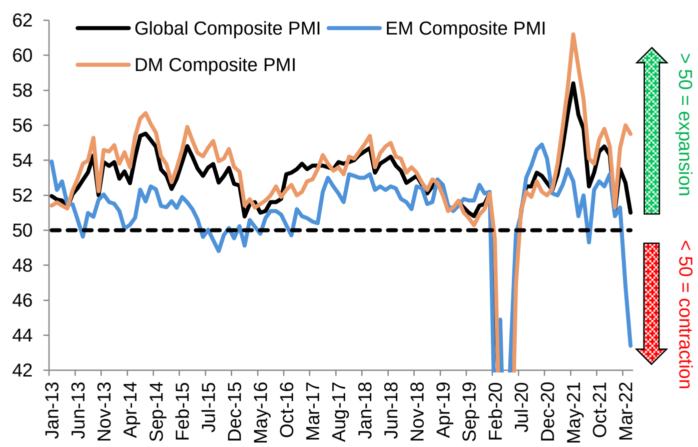
IMPORTS FROM RUSSIA AND UKRAINE, 2019 (% OF GDP)



Source: Bloomberg, IMF, UN Comtrade MUFG Research

WAR AND CHINA LOCKDOWNS HAS COLLAPSED EM ACTIVITY, WIDENING THE DIFFERENTIAL WITH DM'S

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



Source: Bloomberg, Markit, MUFG Research after support for EM from better Chinese growth is yet to materialise. There is little to support EM from a top-down global macro angle – if anything, the drags are garnering greater propulsion.

FUNDAMENTALS: STAGFLATION TREPEDIATION

Upside risks to inflation and downside risks to growth implies an unpleasant stagflationary backdrop. Given the level of uncertainty surrounding geopolitics, the pandemic and commodity prices, and an already weakening pace of activity globally, it is likely that stagflation, or at a minimum a deteriorating growth-inflation mix, will continue to be front and centre for the remainder of this year.

Although stagflation discussions made a fresh return, particularly in developed markets (DM) this time, it is nothing new for EMs. In the last few years, EM has faced significant negative supply shocks, including some reversal in globalisation gains, pandemic-related supply disruptions, rising commodity prices, and a less supportive global liquidity backdrop, which have all led to a marked deterioration in EM's inflation-growth trade-off. In a way, stagflation was reflected in EM asset prices throughout most of 2021, particularly during H2 2021, and more recently it has been more of an inflation worry than growth, albeit growth expectations were rather depressed.

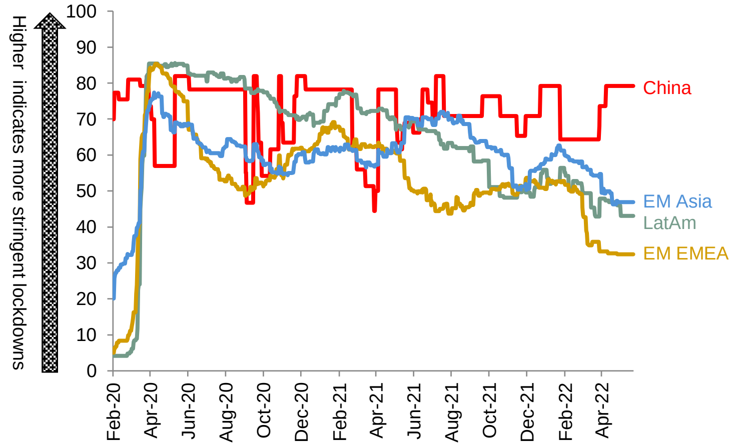
Economic growth risks to the downside

The war in Ukraine, risk aversion and global policy tightening are amplifying economic vulnerabilities across much of the EM complex with growth markedly slowing. The latest PMI readings suggest some further loss of momentum in economic activity, which based on our modelling analysis, suggests that after the significant decline from peak between mid-2020 to mid-2021, the probability of below trend EM economic activity over the next two quarters has risen considerably.

Despite the risks of slower activity, however, the recession probability remains low for the time being, as most of the economies are still recovering from the COVID pandemic and there is a reasonable carry-over effect on growth from last year's reopening in many parts of the world. Also, we see further Chinese monetary and fiscal stimulus and easing measures given the growth target, which should provide some support to EM activity in H2 2022. In line with the rising downside risks on economic activity, we have recently revised our 2022 and 2023 EM GDP forecasts to the downside as well, now expecting the economic activity to grow by 3.1% in 2022

CHINA'S ZERO-COVID STRATEGY HAS KEPT LOCKDOWNS STRINGENT – WEAKENING EM GROWTH

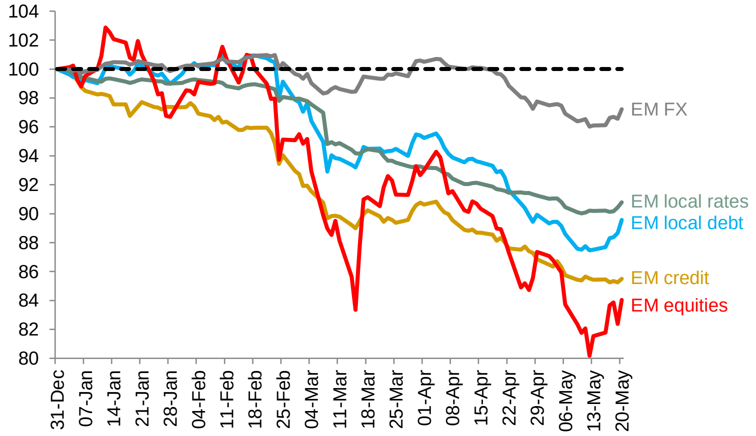
OXFORD UNIVERSITY STRINGENCY INDEX (0-100; 100 = FULL LOCKDOWN)



Source: Bloomberg, Oxford University, MUFG Research

SELL-OFF ACROSS ALL MAJOR EM ASSET CLASSES CONTINUES GIVEN CONFLICT AND THE HAWKISH FED

EM EQUITIES, FX, RATES, CREDIT AND DEBT (1 JANUARY 2022 = 100)



Source: Bloomberg, MUFG Research

(down from 4.9% prior) and 3.6% in 2023 (down from 4.3% prior) (see here).

Drawn-out inflation problem

Inflation data across the EM complex continues to rise and surprise to the upside. The vast array of inflation shocks in recent months may begin to have a damaging impact on inflation expectations with the persistence of core inflation suggesting that CPI may be more stickier than it might otherwise be given rising risks of wage pressures. After ending 2021 at 8.6%, the uptrend in EM inflation seems to have continued uninterrupted, with headline CPI reaching 12.3% as of April, the highest level since 1999. It's EM EMEA (16.1%) and LatAm (10.6%) have been leading the charge, with headline annual inflation surging to highest level since 2008.

With inflation relentlessly rising since the beginning of last year, the inevitable question to ask is the longevity of this trend. We think it is still too early to call the peak for aggregate EM inflation for two reasons:

1. Spike in commodity prices. The share of food and energy in EM CPI baskets are relative high, which increases the upside risks to EM inflation (see here). According to our modelling estimates, the accumulated pass-through from oil prices to EM CPI inflation is 0.36ppt (for a 10% rise in international oil prices in USD terms) over four quarters, with the impact peaking at the ninth quarter around 0.52ppt. For agricultural commodity prices, the accumulated pass-through to EM CPI is 0.19ppt (for a 10% rise in international food prices in USD terms) in four quarters, though the impact is longer lasting, with a peak of 0.73ppt at around the tenth quarter.
2. Enduring supply side disruptions. An examination of a host of metrics suggests that the easing of supply chain stress in recent months has now come to a halt, which combined with higher energy prices, could put further pressure on producer prices.

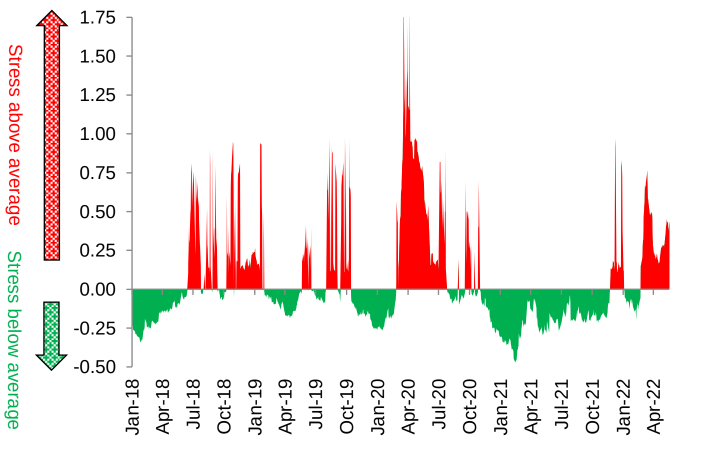
The upside inflationary risks has also led to revisions in our inflation forecasts. We expect price pressures to be much stickier, with headline EM inflation ending 2022 at 8.2% (from 5.3% prior). We also revise 2023 forecasts upwards to 6.1% (from 4.2% prior). Regionally, the upward revisions are highest for EM EMEA – as the epicentre of global volatility – where inflation is expected to remain in double-digits in 2022.

Upside inflation risks signals a faster and broader tightening

Upside inflation risks should also mean a faster and a broader tightening of monetary

FINANCIAL STRESS IN EM HAS WITNESSED A SHARP SURGE YEAR-TO-DATE ALTHOUGH LEVELS HAVE EASED

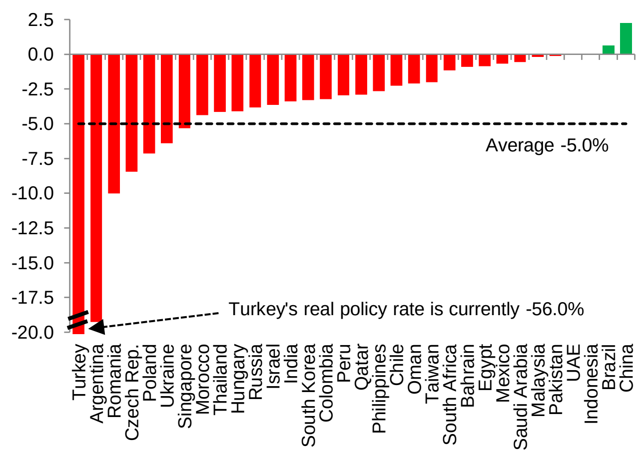
OFR EM FINANCIAL STRESS INDEX (>0 = STRESS ABOVE AVERAGE)



Source: Bloomberg, OFR, MUFG Research

IN REAL TERMS, THE ROOM FOR MANOEUVRE IS LIMITED WITH NO REAL RATE BUFFER IN MOST EM'S

EM REAL POLICY RATES (%)



Source: Bloomberg, MUFG Research

MUFG

policy across EMs. Rate hikes by EM central banks have already totalled ~2,100bp so far this year (vs 2,500bp in 2021), as inflation has become the overriding concern among policy makers, particularly in LatAm and EM EMEA.

We see an additional ~1,850bp of rate hikes in the remainder of the year, which, if realised, would make it one of the most aggressive tightening cycles in recent history. LatAm and EM EMEA regions are likely to continue leading the policy tightening efforts for the remainder of 2022, with substantial rate hikes expected from the likes of Egypt (200bp), Romania (150bp), Colombia (150bp), Hungary (100bp), Mexico (100bp), Poland (150bp) and Czech Republic (150bp). Moreover, we see the GCC economies hiking policy rates by a further 175bp as well this year, in lockstep with the Fed given the currency pegs.

A key point worth flagging, though, is that even with our expected rate hikes, the real policy rates in many places will likely remain in negative territory by end-222. This is particularly true for EM EMEA with deep negative rates in the likes of Czech Republic, Poland, Hungary and Turkey. This implies that the risks are for even higher rates within the region that what our forecasts imply. As we have catalogued in the past, even though EM central banks are expected to stick to the policy normalisation path, the real policy rates are unlikely to turn positive for many (see here). This means that the real policy rate cushion will remain quite small, leaving these economies vulnerable to increasing external headwinds and falling global liquidity.

Higher borrowing costs

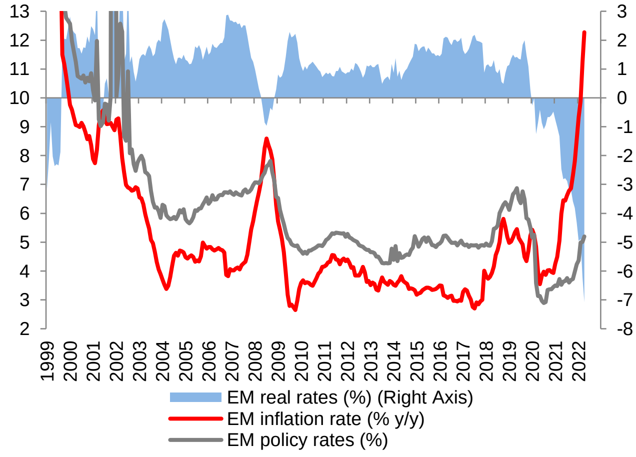
Higher rates, alongside sizeable borrowing requirements, should mean a pick-up in borrowing costs for EMs. Following the sharp increase in 2020, debt service ratios (DSR), which measures the availability of a country to meet current debt obligations, i.e. amortisations and interest payments, have remained at elevated levels in almost all countries in 2021, with EM's DSR coming down only marginally to 11.5% of GDP in 2021 from 2020's 11.6% of GDP. With the exception of a few, the room is very limited across EMs, and a higher public debt ratio is probably not desired at a time of rising global rates unless the ratio is at comfortable levels. Brazil, India and South Africa will be the most impact EMs from a rise in rates given high debt to GDP levels.

EXTERNAL ENVIRONMENT: NOTHING BUT HEADWINDS

The hawkish tilt by DM central banks, led by the Fed, is a major headwind for EMs as it poses significant risks to global financial conditions. Moreover, the war in Ukraine,

EM INFLATION IS AT 20 YEAR HIGHS, PUSHING REAL RATES INTO DEEP NEGATIVE TERRITORY

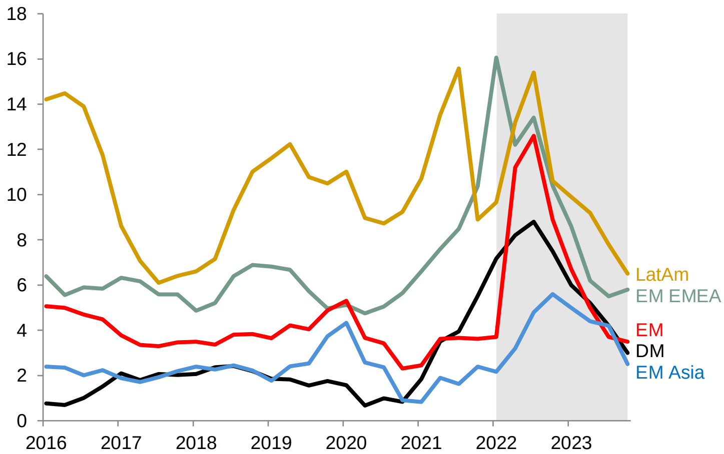
EM WEIGHTED AVERAGE RATES (%) VS INFLATION – EM CPI (% Y/Y)



Source: Bloomberg, EM Central Banks, MUFG Research

MARKED DIVERGENCE IN EM INFLATION BUT ALL BAR EM ASIA WILL LIKELY PEAK IN H1 2022 THEN MODERATE

HEADLINE INFLATION ACROSS EM REGIONS AND DM (% Y/Y)



Source: Bloomberg, EM Central Banks, MUFG Research and the associated volatility in commodity prices, is complicating the global macro backdrop even further impacting not only inflation but also economic activity. This implies that the two main drivers of EM returns, namely, the health of the global economic activity and looser financial conditions, are unlikely to be as supportive as they were back in late 2020 and parts of 2021. Add to the mix declining global liquidity and rising stagflation risks, and it is rather challenging to argue for a supportive global backdrop for EM assets, in our view.

Hawkish DM central banks

It is now evidently clear that DM central banks are pivoting to normalise policy rates even faster, as inflation proved to be stickier than previously had been expected. The Bank of England (BoE) is already leading the pack with four rate hikes, bringing policy rates up to 1.00% from 0.10% in November 202110. The Fed has also joined the BoE, hiking its policy rate for the first time since December 2018, by 25bp in March and followed through with a larger 50bp rise in April, while also announcing its intention to start reducing its balance sheet. The European Central Bank (ECB) is yet to begin its rate hikes, though it has also turned hawkish recently, announcing the end of open-ended QE, which was in place since November 2019, and a faster tapering of its asset purchases.

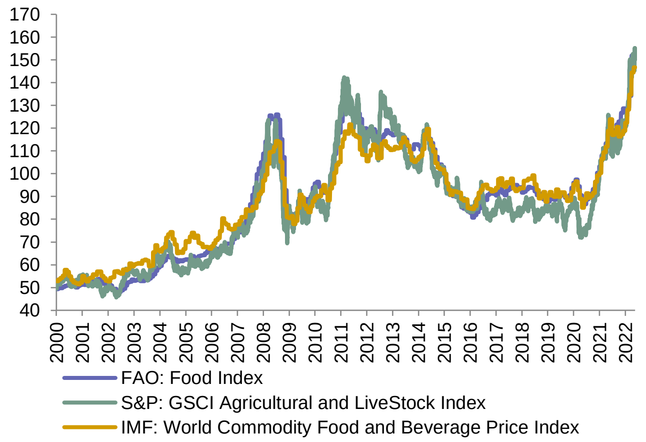
Headline CPI inflation in many DM economies have already reached multi-decade highs, due not only to pandemic and war-led supply-side constraints, but also due to tight labour markets and a revival of domestic demand. The recent spike in commodity prices implies further upside risks to headline inflation, even though the fallout from higher commodity prices might lead to some moderation in domestic demand via a real wage and income squeeze. With this one should not rule out an faster monetary policy normalisation path than currently priced into markets.

Risk premium in commodity prices

Notwithstanding some moderation in commodity prices over recent weeks, energy in particular, as the bearish forces of a slowing global backdrop and Chinese COVID lockdowns have come to the fore, we expect the additional risk premium on commodity prices to remain elevated. On top of the ongoing war in Ukraine, supply scarcity continues to mire the entire commodity complex with 18 out of 23 futures contracts in the Bloomberg Commodities (BCOM) index across the energy, metals and agricultural subgroups trading in backwardation – bullish structure signalling market tightness – to deliveries 12 months from now (see here).

GLOBAL PRICES IN CORE AGRICULTURAL COMMODITIES HAVE RISEN PAST THEIR PREVIOUS PEAK

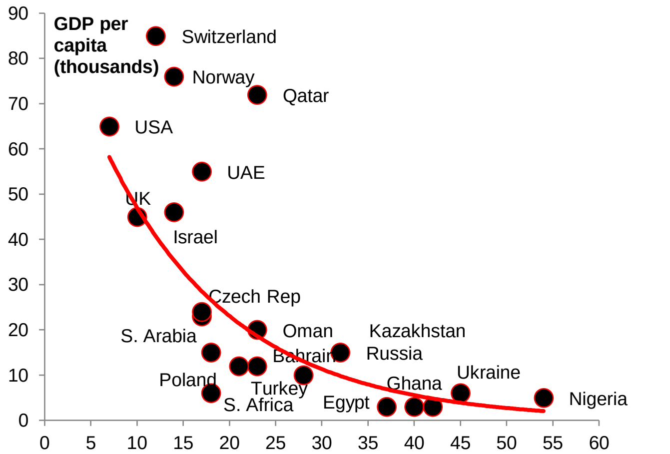
INDICES OF MAJOR GLOBAL FOOD COMMODITIES (INDEX)



Source: Bloomberg, FAO, IMF, S&P, MUFG Research

A HIGHER SHARE OF FOOD IN THE CPI BASKET IN EM GIVEN LOWER LEVELS OF ECONOMIC DEVELOPMENT

GDP PER CAPITA (USD, THOUSANDS) VS. FOOD WEIGHT IN CPI (%)



Source: IMF, National Official Sources, MUFG Research

Of particular concern is the tightness within the agricultural space. Food prices have reached new record highs, in nominal and real terms, with grain prices – wheat, corn and soybean – sharply higher driven by the Russia-Ukraine conflict, inclement weather, high input (energy and fertiliser) costs, shipping delays and labour shortages. Critically, in line with our thesis, hoarding behaviour has emerged as farmers across the world are endeavouring to secure tomorrow's supply themselves by precautionary inventory building today. This poses further upside risks to food price inflation which complicates policy choices for central banks globally (see here).

Tightening global liquidity

The deterioration in the global liquidity backdrop is likely to continue, given the ongoing normalisation in monetary policy by DM central banks. The pace of annual growth in global liquidity has already declined to single digits, as DM central banks ended their asset purchase programmes. With the quantitative tightening by the Fed now commencing, this trend should accelerate in the remainder of the year. Our estimations signal that the pace of annual growth will turn negative in Q4 2022 – given the strong two to three quarters lagged correlation between the pace of growth in global liquidity and fund flows into EM – which should be a major headwind for capital flows to EMs.

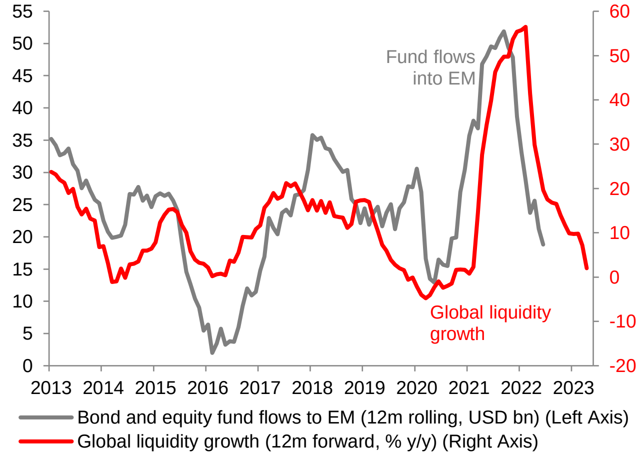
WHICH EM'S FARE BEST?

Looking ahead, the global macro backdrop has become ever more challenging for the world's central bank community. Transitory inflation is long forgotten, geopolitical tensions have reached secular highs, commodity prices are in a supercycle (see here) and, all the while, global supply chains and mobility restrictions have still not fully normalised. Despite the obvious downside risks these issues pose for growth, central banks are firmly in tightening mode with only a small minority beginning to acknowledge cracks in domestic demand. This uninspiring global backdrop is further complicated by EM's bleak local dynamics. The trade-off between inflation and growth has already been worsening pretty much since mid-2021, and the continuation of this trend looks likely for now.

It is fairly clear that the top-down investment backdrop has turned quite unpleasant for many EMs, given weak global business cycle, increasing external headwinds, upside inflation risks, and less supportive financial conditions. In such a state of flux

DM CENTRAL BANKS TAPERING OF ASSET PURCHASES HAS COLLAPSED EM CAPITAL INFLOWS

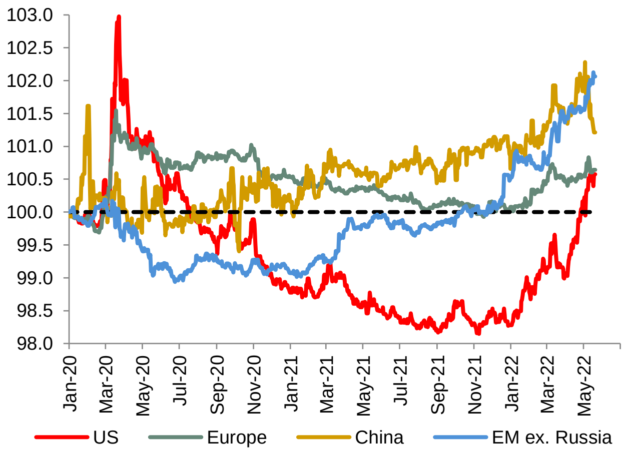
GROWTH IN BANK OF ENGLAND, BANK OF JAPAN, ECB AND US FEDERAL RESERVE BALANCE SHEETS (% Y/Y) VS EM FUND FLOWS (USD BN)



Source: Bloomberg, IIF, G4 Central Banks, MUFG Research

GLOBAL FINANCIAL CONDITIONS ARE TIGHTENING WHICH IS A CORE EM RISK (CAPITAL FLIGHT) IN 2022

FINANCIAL CONDITIONS INDICES (FCI) BY COUNTRY/REGION, REBASED 100 = JANUARY 2020



Source: Bloomberg, MUFG Research

with too many moving parts, we believe it is prudent to look at bottom-up narratives and take only selective, calculated risk in EMs for the remainder of the year. Our examination hones in on two questions. First, which economies have prudent macro policies, are more advanced in policy normalisation and more prepared to a tightening in global financial conditions. Second, which economies are likely to benefit from elevated commodity prices.

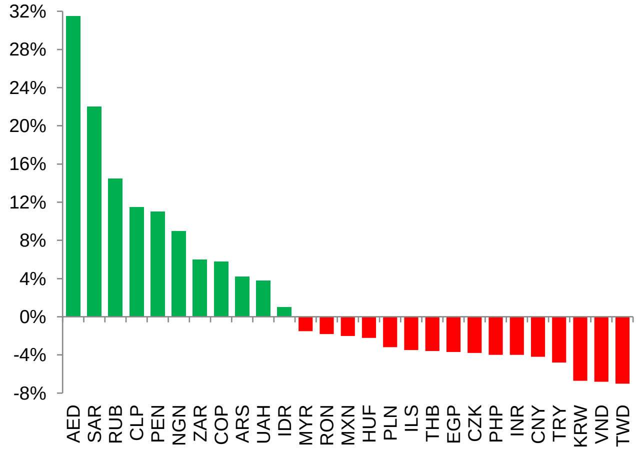
We stick to the winners from elevated commodity prices and to those with responsible macro policies, hence offering a sizeable risk premium. We note that whilst the share of commodities in total exports remains high in many major EMs, not all of them are commodity exporters on a net basis. This means that there will be relative winners and losers from elevated commodity prices even though geopolitical tensions are bad for any economy through the risk sentiment channel.

With this, the net commodity trade balance is the largest for countries in the GCC region, Latin America (notably the likes of Chile and Brazil), whilst key mining producing nation South Africa is also a relative winner. Indeed, on an absolute basis, South Africa has clearly benefitted from an acceleration in commodity prices, helping to drive its external assessment into positive territory – minimising the weakness in its growth assessment. In contrast, EM Asian economies broadly stand at the other end of the spectrum, with Vietnam, Korea, Taiwan, mainland China, and India having the largest negative net commodity trade balances after Turkey.

Overall, the investment environment is as tricky as ever for EMs since the top-down global macro backdrop is complicated further by a visible deterioration in the growth-inflation trade-off, led by the higher global rates, the war in Ukraine and the associated volatility in commodity prices. Therefore, it is difficult to argue for any support from the top-down global macro backdrop. That said, from a bottom-up perspective, there is a very divergent picture. On the one hand, we have the commodity producers and committed rate hikers – which could offer a decent real risk premium – that appear to be better positioned to this challenging backdrop. On the flip side, there are commodity importers and reluctant hikers, where markets would probably be looking for further evidence for them to get ahead of the inflation curve. Given so many moving parts, we prefer to take calculated EM risk, sticking to winners from elevated commodity prices, as well as to those that are making an effort to arrest the inflationary pressures and/or offering a sizeable risk premium.

NET COMMODITY EXPORTS ARE PREDOMINANTLY POSITIVE FOR THE GCC AND LATAM REGION

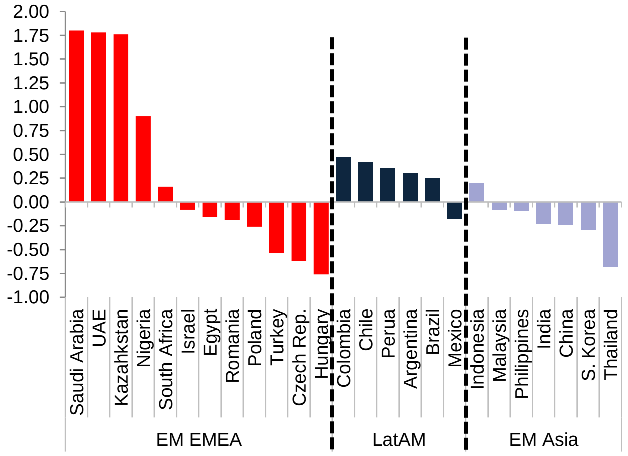
NET COMMODITY TRADE BALANCES (% OF GDP)



Source: Bloomberg, MUFG Research

EM WINNERS ARE MAINLY COMMODITY EXPORTERS WHILST MOST COMMODITY IMPORTERS WILL TRAIL

EM COMPARATIVE TRADE ADVANTAGES WITH RUSSIA-UKRAINE (UNITS)



Source: Macrobond, UN Comtrade, MUFG Research

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US Fixed Income: Inflation to Recession Fears?

Macro Review: That was fast, we went from inflation woes dominating to recession fears increasingly being the cause for concern. Perhaps we are just witnessing narratives becoming reality. Now, it's not preordained that we will have to fall into a recession (although it's our highest economic outcome, at nearly 50% chance over the next 18 months). Similarly, those that thought we would see a virtuous self-sustaining cycle because a.) it's hard to envision a business cycle ending so quickly and b.) because last year was strong and c.) what about all that pent-up demand, were also succumbing to narratives of the past. Speaking of pent-up demand, we have seen service sector growth return to prior trends but goods activity is still unnaturally high. We argue that as the effects of fiscal stimulus wear off and eventually supply chains get fixed, the goods side of the economy will come off and that will both a.) reduce growth potential and b.) reduce inflation.

Fed Policy: We expect another large 50bp move higher in the Fed Funds rate (bringing the top of the range to 1.5%) at the June FOMC meeting. This is a quarterly meeting so we will get rates "dots" updates too. June also starts QT. We maintain our view that the double-tightening of QT (quantitative tightening) and frontloaded hikes will tighten FCI (financial conditions index) in a material way into the 2nd half and exacerbate the US economic slowdown that lies ahead. This will ultimately result in the Fed taking a wait and see mode, especially if we get lucky and inflation starts to recede in 2H.

Rates Views: Given that the markets have largely priced-in a more aggressive frontloaded path, even if the Fed bumps up the dots more, in our view that would likely impact stocks more than bonds all else equal. It's possible that we have hit the cycle high for the 10yr (i.e. close to 3.25%) and that its more likely we continue to slide lower in L/T rates into the summer months. Our assumption remains that the Fed delivers two more 50 bps in the next two meetings. If risk markets can stage a bear market rally for a bit, that could see 10s back in a 3% range, if so we would view that as a buying opportunity.

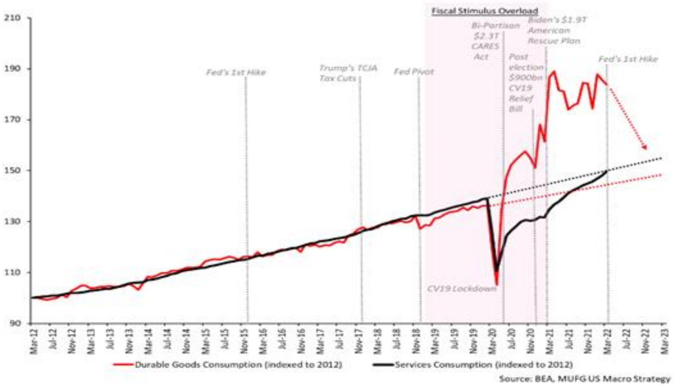
Credit Views: We believe that high inflation, softer first quarter earnings and guidance, supply chain disruptions, China COVID lockdowns, Russia's war with Ukraine, and the Fed both raising rates by 50 and plans to begin shrinking its balance sheet in June will continue to negatively impact the credit markets and we remain cautious on the IG sector. We may consider widening our spread range in the near future.

In High Yield, unsecured credit risk is now generically for sale with the underlying credit increasingly irrelevant. As discussed above, if rate risks morph into credit risks, high yield will likely need to further discount the more uncertain outlook.

US MACRO AND UPCOMING FED VIEWS

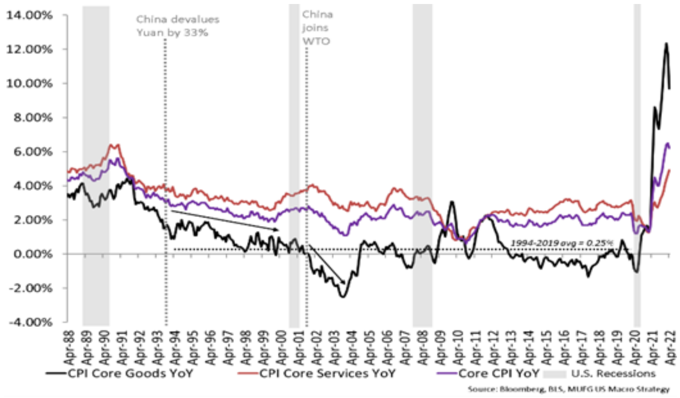
As seen in chart 1, where we index the service sector trends versus the durable goods sector of the US economy, the one that stands out as an anomaly was the outsized moves in goods (which was driven by fiscal stimulus overload). We argue that if all we do is get back to trend growth that will both a.) reduce GDP growth speeds going forward and b.) eventually take pressure off of inflation. If we look at chart 2, we see a similar extended move in the inflation of core goods. Historically, as globalization took hold (especially as China entered the global marketplace) core goods saw mild inflation/disinflation from 1994-2019. Post reopening it is likely that orders were double-booked and as supply chains normalize we'll see inventory glut reduce prices too.

CHART 1: FISCAL STIMULUS DROVE GOODS SECTOR



Source: Bloomberg, BEA, MUFG U.S. Macro Strategy

CHART 2: GOODS CPI IN PROCESS OF DEFLATING



Source: Bloomberg, BLS, MUFG U.S. Macro Strategy

June FOMC Meeting Expectations: We expect another large 50bp move higher in the Fed Funds rate (bringing the top of the range to 1.5%). This is a quarterly meeting so we will get rates "dots" update. Given how high inflation is running there is a heated debate about what is the real neutral rate and that the Fed needs to frontload more hikes. As seen in Chart 3, when adjusted for the Fed's latest inflation forecasts (which may also get updated at the next meeting) the real FF neutral terminal rates are still very low or negative. The risk is we see more dots adjustment. Also, the long-run dot could lift up given that new forecasters joined. On the dovish side, in the press conference chair Powell could start to bring up that at some point they may return to adjusting O/N rates higher in 25bps increments.

June FOMC Market Implications: Given that the markets have largely priced-in a more aggressive frontloaded path, even if the Fed bumps up the dots more, in our view that would likely impact stocks more than bonds all else equal. In chart 4 we index all of the hiking cycles since 1984. The average amount of hikes is 250bps and last for 8 meetings. If the Fed does three 50bps in a row, this would be the most frontloaded start to a hiking cycle since 1984. Given that the Fed is also starting to ramp up QT in June, this double-tightening (into a slowdown) will make delivering further rates hikes challenging as FCI tightens more. So, post the June hike we could see a long-end rates rally gain steam.

USTs vs Stocks performance? Outside a brief FTQ move in late Feb/early March when the RU/UKR war started, USTs haven't been a hedge for risk-off until now. The latest risk-off move, and what feels like episodes of bear market rallies in risk assets, has seen long duration USTs return back to their old correlation with equities (i.e. rising/falling in yields as SP500 rallies/sells off). Yet even post the recent rally in US bonds, amidst a breakdown in risk assets, the SPY/TLT ratio barely moved (clearly showing that bonds have performed so poorly year-to-date in 2022). We showcase that even with the stock market closing in on bear market territory, bonds have not been a hedge (to the chagrin of 60/40 portfolios). If risk assets see a series of lower lows/lower highs into bullish summer seasonals for bonds, rates can rally more.

Financial conditions update: We have been linking the medium-term path for US rates to the evolution of broader financial conditions (which also incorporates rates directly and indirectly in such calculations). Furthermore, the next moves for FCI is how risk markets response to the launch of QT. If stock market declines continue further ("wealth effect" in reverse – the blunt the tool the Fed is using to lower aggregate demand) this will reinforce the slowdown trend for the US economy.

US CREDIT – NEGATIVE PRESSURES AFFECTING MARKETS

IG Credit Market Summary: The recovery we saw in the IG market between mid-March and mid-April was short-lived, as equities sold off hard over the past month and IG spreads widened as markets grew cautious over continued signs of high inflation, softer first quarter earnings and guidance, supply chain disruptions, China COVID lockdowns, Russia's war with Ukraine, and the Fed both raising rates by 50 and plans to begin shrinking its balance sheet in June.

The S&P 500 equity index posted its worst April month return in over two years, losing 8.8%. Year-to-date return through April was -13.3%, marking the worst first four month return in 83 years. Equities continued selling off hard through late May and year-to-date the S&P 500 is down 19% (please refer to Chart 3 below).

Likewise, the IG bond market also declined, with the IG aggregate YTD excess return falling further from -1.93% on April 13 to -3.35% through May 19. For comparison, the IG Total Return YTD is -13.34%, down from -10.48% on April 13. It's interesting to note that since 1976, there have been only four years that the IG bond market has recorded annual losses, with 2022 on track to be the worst by far, with the next lowest return in 1994 of -2.9%, when the Fed raised rates six times for a total of 250bps. Aggregate IG spreads widened by 25 bps, from 123 bps to 148 bps, marking the widest spreads since June 30, 2020, still in the height of the pandemic.

First quarter earnings showing chinks in the armor: First quarter earnings also began reflecting some of the market concerns mentioned above. Many companies gave weaker guidance for the year due to the impact from inflation and continued supply chain disruptions. Sectors that were impacted the most include: Consumer/Retail, Technology, Media, and even certain credits within Healthcare.

The Consumer/Retail sector was particularly hit hard over the past month, with the S&P Consumer Cyclical equity index down 32.8% YTD, making it the largest underperformer (please refer to table below). This was partly due to some of the country's largest retailers reporting a mix of lower earnings and margins, and increased cash burn due to inventory builds. Some retailers saw consumers switching their purchases from general merchandise to food due to inflation.

Additionally, Moody's downgraded Retail and Apparel sector outlook to Negative from Stable, saying, "Inflation, geopolitical risks, supply chain challenges and falling demand point to broad profit declines, and operating margins will erode across every subsector…. as inflationary pressures continue, retailers' ability to pass further price increases to consumers to mitigate rising costs will be tested."

Some of the largest tech companies either missed earnings and/or lowered full year guidance partly due to supply chain disruptions and weakness in personal PC demand.

Even some weakness began showing up in the media sector, after two large companies said streaming subscriber estimates were weaker and costs higher due to the heating up streaming wars and lower demand after the pandemic surge.

The one sector that has outperformed this market swoon is Energy, with the equity sector index up a surprising 47% and on the credit side, the best YTD excess return of -2.6% compared to -3.35% for the total IG market (please refer to Chart 3 below). Obviously, the highest oil prices in 14 years drove the outperformance.

IG Spread Outlook: We believe that high inflation, softer first quarter earnings and guidance, supply chain disruptions, China COVID lockdowns, Russia's war with Ukraine, and the Fed both raising rates by 50 and plans to begin shrinking its balance sheet in June will continue to negatively impact the credit markets and we remain cautious on the IG sector. We may consider widening our spread range in the near future.

Sector Outlooks: In light of the continued market weakness and negative factors mentioned above, we are turning cautious on most sectors, but we remain constructive on the Utility and Pharmaceutical/Healthcare sectors.

Additionally, we have changed our outlook for Energy from cautious to constructive given the continued strength in oil and natural gas prices.

CHART 3 – IG SPREADS, RETURNS, AND EQUITY RETURNS (AS OF 5/19/2022)

OAS AND SPREAD CHANGES						Total Return		Excess Return	Spread Variance		S&P 500 Equity
Sector	OAS	1 Month	YTD	1 Year	YTW	MTD (%)	YTD (%)	YTD (%)	Sector vs Total	Sector 5 Yr Avg Diff	YTD Return
Total IG	148	22	55	61	4.40%	-0.69%	-13.34%	-3.35%	-	-	-19.1%
Financial Institutions	147	22	63	70	4.35%	-0.41%	-10.94%	-3.10%	-1	-8	-16.6%
Utility	154	23	47	57	4.54%	-1.21%	-15.73%	-3.66%	7	-1	0.1%
Energy	163	20	46	53	4.58%	-0.53%	-12.69%	-2.60%	15	38	46.8%
Basic	171	28	56	66	4.69%	-1.14%	-14.81%	-3.70%	24	30	-9.9%
Capital Goods	138	23	52	53	4.29%	-0.76%	-13.18%	-3.38%	-10	-10	-15.9%
Technology	131	22	50	57	4.22%	-0.50%	-13.28%	-3.12%	-17	-21	-26.5%
Communications	177	24	58	67	4.73%	-0.71%	-16.30%	-3.97%	29	27	-28.4%
Consumer Noncyclical	138	20	51	56	4.34%	-0.93%	-14.97%	-3.66%	-9	-8	-8.9%
Pharmaceuticals	118	17	43	48	4.13%	-0.62%	-14.35%	-3.11%	-29	-19	-8.9%
Food/Beverage	143	20	54	58	4.41%	-0.84%	-15.10%	-3.66%	-4	-4	-8.9%
Consumer Cyclical	133	24	55	59	4.21%	-0.75%	-12.43%	-3.28%	-14	-6	-32.8%
Transportation	150	25	52	52	4.49%	-1.24%	-16.11%	-3.78%	3	2	-15.9%

Source: Bloomberg, MUFG U.S. Macro Strategy

Increased Stock Buybacks: We've commented on the potential for increased stock buybacks this year, and it has apparently come to fruition. According to an article by Bloomberg on May 2, stock buybacks over the past 12 months have nearly doubled to $661 billion, compared with $358 billion in the year-earlier period. Cash balances among the S&P 500 companies have dropped 5% from the same period a year earlier. At that pace, it would be the biggest year-over-year decline since the start of 2019. (source: Bloomberg article, "Companies Raid Piggy Banks to Pay Shareholders: Earnings Watch", By Jeran Wittenstein and Tom Contiliano, May 3, 2022)

Secondary market trading trends: Market participants continue to be quite cautious and seem to be better sellers of longer duration and prefer shorter maturities. We have seen some continued buying out of Asia, albeit with smaller volumes. Anecdotally, it appears that larger mutual funds and insurance/pension funds have not been very active in the secondary market, perhaps due to some skepticism around the credit markets and also expected heavy new issuance. We believe the lower volumes of secondary trading are partly responsible for the widening of IG spreads. Some funds have not had outflows at this point but are boosting cash reserves just in case. However, on an aggregate basis, IG fund flows reflected investors' cautiousness, as YTD net fund outflows totaled $40.8bn, in stark contrast to last year's positive $91.0bn. For the week ended May 11, IG fund outflows totaled $8.2bn, the largest weekly outflow since April 2020, and the fourth largest on record.

New Issuance: IG new issuance for April totaled $107.2bn, understandably below March's near record of $230bn. So far, May has been quite lackluster, reflecting the concerns and issues mentioned above creating tighter issuance windows and many issuers postponing issuance until conditions stabilize. May's issuance through May 19 is only $73.4bn, far below the $135bn estimate, and below the $138bn from last year. Year to date new issuance totaled $634bn, 12% behind last year's $721bn. There are no estimates available yet for June and we begin to wonder if the full-year estimate will be reduced below the current range of $1.2 - $1.4 trillion range. Issuers have favored shorter maturities due to the flatter treasury curve. Also, as seen in the table below, new issue concessions have expanded to an average of 11bps compared to just 2 bps last year and for BBB rated credits, that concession has expanded to about 15bps.

YTD New Issuance

	Issuance ($ bn)	New Issue Concession	Books Times Cvd
2022	$634.0	11 bps	2.9
2021	$720.9	2 bps	3.0

High Yield Credit Market Summary:

High Yield total return continued negative with the HY index now yielding 7.8% with the OAS now +479. The composition of risk reduction is shifting from duration to credit as CCC underperformed and the yield on the CCC index now 12.26% +924.

Unsecured credit risk is now generically for sale with the underlying credit increasingly irrelevant. Risk reduction in troubled names was already in full swing; now healthier credits are for sale. Looming maturity walls are increasingly viewed as a challenge for all issuers and credits that have "outperformed" (widened less than index) represent good resource for cash harvesting.

MTD May new issue has been paltry with $2.2bn priced. With only six business days left, May new issuance is unlikely to hit the low end of syndicate estimates of $10-$15bn. Final April volume was $10.95bn (historical April average $28.83bn since GFC), following weak issuance in March $9.95bn and February $9.33bn

CHART 4 – HY SPREADS, RETURNS, AND EQUITY RETURNS (AS OF 5/20/2022)

HY OAS AND SPREAD CHANGES						Total Return	Excess Return	Spread Variance		S&P 500 Equity
Sector	OAS	1 Month	YTD	1 Year	YTW	YTD (%)	YTD (%)	Sector vs Total	Sector 5 Yr Avg Diff	YTD Return
U.S. Corporate High Yield	476.67	92.86	193.76	182.43	7.82%	-11.72%	-1.89%	-	-	-16.0%
Financial Institutions	447.51	79.38	182.37	165.92	7.46%	-11.14%	-1.80%	-29	-55	-12.2%
Utility	332.89	-17.94	83.64	72.48	6.40%	-10.85%	-2.06%	-144	-87	2.0%
Energy	406.25	44.69	79.00	-15.75	7.15%	-7.55%	-0.81%	-70	180	52.6%
Basic Industry	458.95	66.36	170.92	165.14	7.81%	-10.45%	-1.75%	-18	-4	-7.1%
Capital Goods	462.87	98.99	187.20	169.42	7.68%	-10.29%	-0.98%	-14	-49	-13.5%
Technology	457.54	93.26	213.32	187.87	7.63%	-11.64%	-1.94%	-19	-86	-23.2%
Communications	539.28	100.26	221.96	279.42	8.39%	-14.31%	-3.64%	63	-19	-25.9%
Consumer Non-Cyclical	511.74	135.88	261.52	257.42	8.16%	-14.40%	-2.32%	35	-8	-6.1%
Pharmaceuticals	878.77	385.30	538.15	574.22	11.72%	-23.43%	-2.65%	402	65	-6.5%
Food/Beverage	421.57	56.51	225.37	212.33	7.29%	-13.39%	-3.54%	-55	-78	-6.1%
Consumer Cyclical	505.30	117.33	236.77	223.52	8.04%	-12.36%	-1.52%	29	-20	-31.4%
Transportation	464.29	60.50	155.32	78.66	7.53%	-8.24%	-0.68%	-12	170	-13.5%

Source: Bloomberg, MUFG U.S. Macro Strategy

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The US dollar on a DXY basis advanced by around 4.5% to a peak of 105.0 this month over the period since the last Global Markets Monthly but has since reversed around half of that gain. The two key global factors remain in focus – the invasion of Ukraine by Russia and the impact of the covid outbreak on the economy in China. The uncertainty created by these two events for both growth and inflation has ensured elevated volatility persists. The softer US dollar of late is a reflection of US yields topping out. We are not convinced that US dollar appreciation has ended and there remains a high risk of a further tightening of financial conditions that lifts the dollar once again. A break lower in EUR/USD to new lows remains plausible in a scenario of tighter financial conditions. However, the scale of the sell-off of the dollar does highlight the limits to the bull-run from here and with so much Fed tightening priced, we still expect the US dollar to weaken more notably later in the year. For now it is all about financial conditions and with risks of renewed asset price declines, we are cautious over the extent the US dollar can weaken further from here over the short-term. We should probably expect better two-way flows though unless the risk-off turns more extreme than expected.

BASE CASE EXPECTATIONS, JPY, EUR & CNY

USD/JPY – BEARISH BIAS

- **Range: 122.00-129.50**

After running a bullish bias in each month in Q1 we switched to neutral in April and it is a close call whether to maintain that neutral bias or switch to a bearish bias. There is certainly some evidence that the clear positive USD momentum has faded with the ECB signalling clearer intent on hiking rates and ending negative rates sooner rather than later. In addition, comments from Fed officials like Fed President Bullard suggesting front-loaded rate hikes could be followed by a pause or even rate cuts in 2023 has taken some of the positive momentum away for the dollar. The longer US yields remain below the highs set in early May, the more vulnerable the US dollar will be to a further correction to the downside.

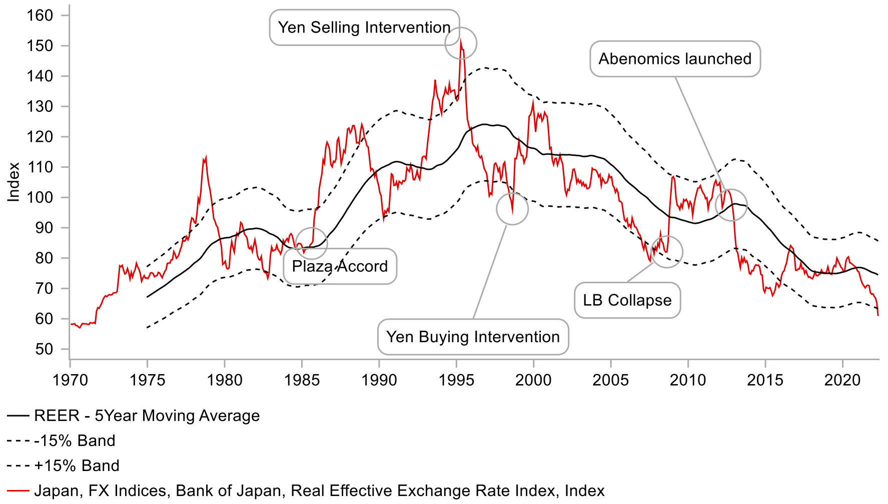
The turn in momentum does suggest a greater risk skew to the downside from here for USD/JPY. The dynamic does appear to be changing with the US dollar no longer deriving as much support from yield spread developments. This is a reflection of the lost momentum in US rates with so much already priced and that points to increased downside risks for USD/JPY. The Fed is likely to deliver at least one further 50bp rate hike and possibly two and hence a correction lower from here in USD/JPY is likely to be triggered by a further sell-off in risk assets that alters expectations on rate hikes further ahead.

The scale of the sell-off in US fixed income markets in Q1 helped drive USD/JPY higher but could also be a catalyst for a correction back lower in USD/JPY. The sell-off in the US Treasury market was one of the largest on record which underlines the losses suffered. When investors are suffering major losses and financial conditions tighten further, leverage tends to get cut back. From a G10 FX perspective, JPY is where the most leverage is. After breaking 117.00 in USD/JPY (key technical level), USD/JPY surged and analysis of IMM positioning data shows that in the four-week period following that break (mid-March), yen short positions amongst Leveraged Funds increased at its fastest rate in five years. Those positions remain mostly intact but the loss of momentum will likely fuel increased appetite for position liquidation.

The loss of momentum on the rates driver for USD/JPY also may allow for greater influence from a valuation perspective. The chart below highlights the extent of undervaluation now on a REER basis. The breach below the 15% divergence from the 5-year REER average is a rare occurrence and tends to signal a reversal – the one exception to that was when Abenomics was launched and the BoJ embarked a new aggressive framework of monetary easing. Admittedly, that ultra-easy stance still exists although the extent of easing is not in the same dimension as in the early years of Abenomics.

So the topping out of US yields, the prospect of a further tightening of financial conditions, positioning and valuation all point to the increased risks of a further correction lower in USD/JPY from here. Long USD/JPY is a crowded trade and the factors driving that positioning are beginning to change. Assuming we do not enter an extreme risk-off event, the correction lower from here should be orderly. We should also expect increased USD/JPY support at lower levels as Japan investors look to re-enter foreign bond markets after a period of near record selling of foreign bonds. Some of those flows could be on an unhedged basis, providing some support for USD/JPY and JPY crosses.

BREAKING INTO RARE UNDERVALUED TERRITORY



Source: Bloomberg, Macrobond, MUFG GMR

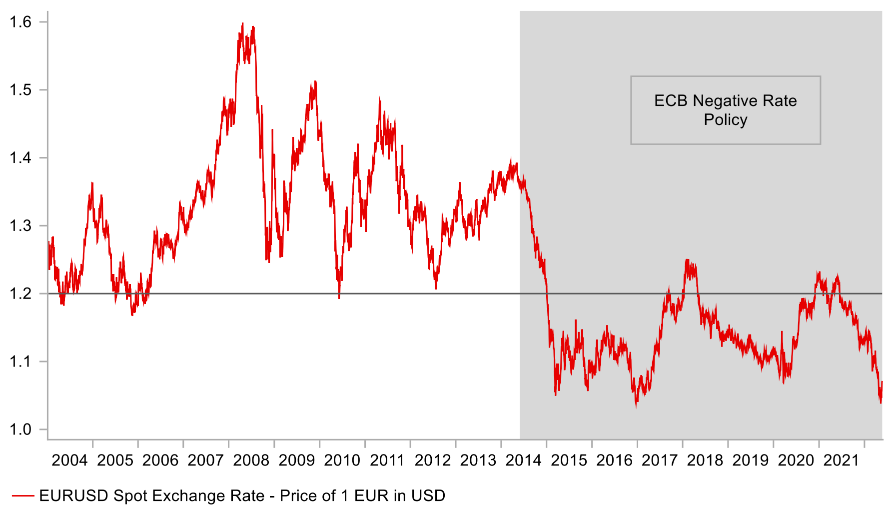
EUR/USD – NEUTRAL BIAS

- **Range: 1.0300-1.1100**

We are sticking to our neutral bias for EUR/USD in the month ahead. The ECB's recent hawkish policy shift has helped to provide some much-needed support for the EUR after it briefly tested and held support from the low in early 2017 at 1.0340. The EUR has since staged a relief rally moving back into the middle of our forecast range. The turnaround for the EUR has been reinforced by hawkish comments from President Lagarde signalling clearly that the ECB plans to speed up the pace of policy tightening in response to upside inflation risks. The ECB now plans to end QE in early July, and then quickly follow up with the first rate hike at 21st July policy meeting. In addition, President Lagarde signalled that the ECB wants to remove negative rate policy by the end of Q3. In line with these comments, we expect the ECB to raise rates by 25bps at both the 21st July and 8th September policy meetings. It would bring an end to negative rate policy in the euro-zone that has been in place since 2014. The removal of negative rate policy should provide more support for the EUR going forward given that it has proved effective at helping to keep the EUR weak by encouraging record capital outflows into foreign bond markets while it has been in place. It was more normal for EUR/USD to trade above the 1.2000-level in the decade prior to the introduction of negative rates. The euro-zone rate market is though already pricing in just over 100bps of ECB hikes by year end which creates a higher hurdle for further hawkish policy surprises. The ECB's upcoming policy meeting on 9th June should now be more of a non-event for the EUR and euro-zone rate market as upcoming policy moves have already been well telegraphed.

The EUR's ability to extend its recent advance much further on the back of the normalization of ECB policy remains constrained by ongoing downside risks from the Ukraine conflict. It appears increasingly likely now that the conflict will prove more prolonged than initially hoped and thereby increases the risk of a longer period of disruption for the euro-zone economy that will both dampen growth and keep inflation higher for longer. Russia has sent a clear signal over the past month that it is prepared to weaponize energy supplies to hit back at European countries by stopping gas supplies to Bulgaria, Poland and Finland. Gas supplies have also been partially halted to Germany. Market participants will remain nervous over the risk of further retaliatory action from Russia in the month ahead. It is still not clear how EU countries will meet Russia's demand for gas to be paid for in roubles. We are not expecting Russia to hurt themselves by significantly cutting supplies to their main customers in the euro-zone. The euro-zone economy is more sensitive as well to weaker than expected growth in China so far this year. The recent drop in COVID cases in Shanghai should allow restrictions to be eased in the month ahead and growth to pick-up heading into 2H 2022 help. If recent positive COVID trends continue in China it would further help to ease EUR selling pressures.

REMOVAL OF NEGATIVE RATES SHOULD PROVIDE SUPPORT FOR EUR



Source: Bloomberg, Macrobond & MUFG GMR

USD/CNY – NEUTRAL BIAS

Range**: 6.5000–6.9000**

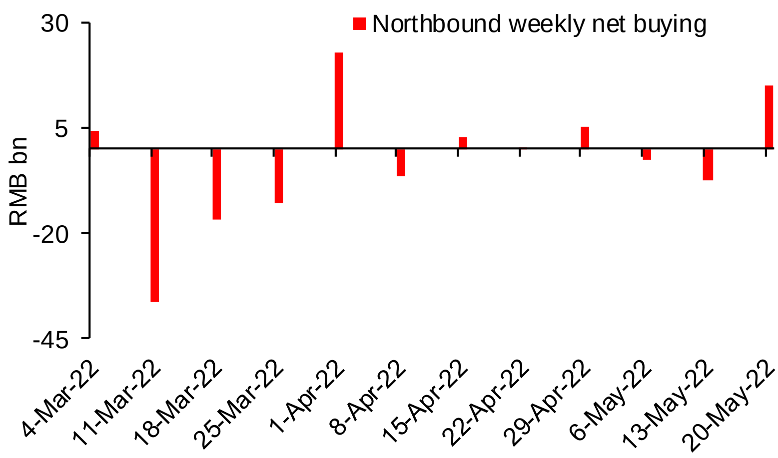
The CNY continued its depreciation into May with USD/CNY climbing above 6.8000 as of May 12th before reversing lower to the current 6.6670-level on May 24th. The recent movements of USD/CNY were mainly driven by two main factors, namely, China's Covid-19 containments situation and broader US dollar movements. To be exact, during the first 24 days of May, USD/CNY had a net change of +1% happening against a roughly 1% depreciation of the US dollar (DXY) index. Shanghai's plan of reopening in a gradual pace and reaching full openness by the end of June and the recent decline in overall China's new daily confirmed Covid-19 cases helped to ease some of the anxiety that market participates had towards to the economy and the currency. However, on May 23rd, the reiteration that the "Dynamic zero COVID-19" policy is sustainable and must be adhered to in the People's daily, the party media, showed no sign of near-term turn-around on current "Dynamic zero Covid-19" policy. And given the highly uncertain nature of the virus, we still see elevated uncertainty on the virus containments ahead. Recently released China's April key macroeconomic indicators gave a clear evidence of the negative impact on the economy due to Covid-19 controls. The strict lockdowns in certain cities and areas of China did not only cause off-line consumption to sink, but online shopping was deterred as well as logistics and deliveries became impossible. China's retail sales contracted by 11.1%yoy in April, negative growths were also seen in IP (-2.9%yoy), property investment (-10.1%yoy), property sales (-46.6%yoy) and etc. The labour market faced tremendous pressure in April with the youth (aged 16-24) jobless rate hitting a record high of 18.2% in April, and will face even more stress as that additional 1.076 million people will be graduating this summer and most of them haven't secure a job offer yet.

Th government has been rolling out various policies to stabilize the tumbling property market including the PBOC cutting the 5-year loan prime rate, a reference rate for mortgage rates, to 4.45% from prior level of 4.60%. Along with other easing measures, the government aims to jump start the economy and provide support to the stressed real estate sector by keeping the 1-year loan prime rate unchanged. But again, with elevated uncertainty in the virus and potential lockdowns due to current Covid-19 policy, corporates are likely to remain discrete in business expansion. It is unlikely to see a very sharp rebound in economic activities in near term.

Looking ahead, whether the US will remove and how it removes China imports tariffs likely becomes another key factor affecting USD/CNY movement in near term as President Biden said he would talk with Treasury Secretary Yellen about it after he returns back to Washington from his Asia trip. This Monday's appreciation of CNY showed that the market was sensitiveness to this matter, the CNY's appreciation was caused by Biden's mentioning he would review China import tax as consumer prices increase.

In summary, given conflicting factors, USD/CNY is likely to be volatile in near term rather than a one-side decline of USD/CNY, which is also consistent with our views that the recent pullbacks for USD should prove short-lived. We don't' think there has been a significant shift in fundamentals to justify a sustained reversal lower for the USD and many of the drivers behind USD strength remain in place including a Fed that is still committed to faster policy tightening, and more acute downside risks to growth outside of the US.

CHINA EXPERIENCED A NET INFLOW THROUGH STOCK-CONNECT IN MAY



Source: Bloomberg, MUFG GMR

KEY RISK FACTORS IN THE MONTHS AHEAD

- The main risk to our bearish outlook for USD/JPY would be if global growth concerns eased in the month ahead. A pick-up in China growth could be one potential trigger. The upward impact on global yields, commodity prices and a potential stabilization for global equity markets should encourage a higher USD/JPY even if the USD weakens more broadly. Yen weakness would be more evident though against high beta commodity currencies.
- The main downside risk for the EUR in the month ahead is posed by the emergence of evidence of a sharper slowdown in euro-zone growth. Those downside risks would be increased further if Russia takes further action to restrict energy supplies to major euro-zone economies. Heightened fears over the growth outlook in the euro-zone would prompt market participants to scale back ECB rate hike expectations. On the other hand, if the euro-zone economy continues to prove more resilient than feared in the month ahead and China's economy starts to pick-up as COVID restrictions are eased, the EUR could strengthen more than expected at a time when the ECB has clearly signalled that negative rate policy will come to an end soon.
- The main risks to our range-bound view for USD/CNY in near term surround China's Covid-19 breakouts and implementation of the country's "Dynamic zero Covid-19" policy. The upside risk for CNY could be a significant (partial) removal of China tariffs by the US. In contrast, downside risks for CNY are posed by China's exports and supply chain damage due to recent lockdown, and rising default in debt repayments in sectors including real estate sector. In addition, a more sustained weakening of the US dollar more broadly could be another downside risk to our USD/CNY outlook in near term.

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CERTIFICATION

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