Global Markets Monthly

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MUFG Bank, Ltd. & MUFG Securities EMEA
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Global Macro – European themes

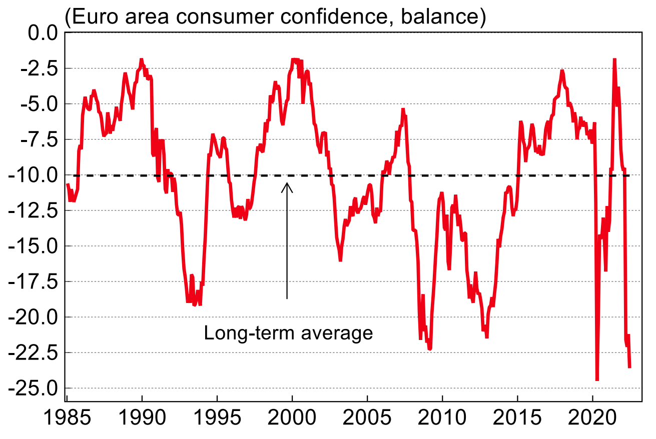
Global recession fears have increased in recent weeks and the storm clouds over Europe seem especially ominous. The prospect of energy rationing is weighing heavily on the outlook, while political uncertainty is adding to the sense of unease. This is prompting us to revise our forecasts lower – but some reasons for optimism remain.

PROSPECT OF ENERGY RATIONING WEIGHS ON OUTLOOK

The European economy is suffering from an energy-driven terms of trade shock that may get even worse. **We are lowering our GDP forecast for the euro area** from 2.7% to around 2.5% in 2022, anticipating **at least one quarter of contraction**. Weak economic activity at the end of the year would carry over into the 2023 annual average growth figure, which could easily be lower than 1%. It's a similar story for the UK with a Q4 GDP contraction seeming likely as household energy prices are set to soar (see here). UK annual growth in 2023 could average as little as 0.6%.

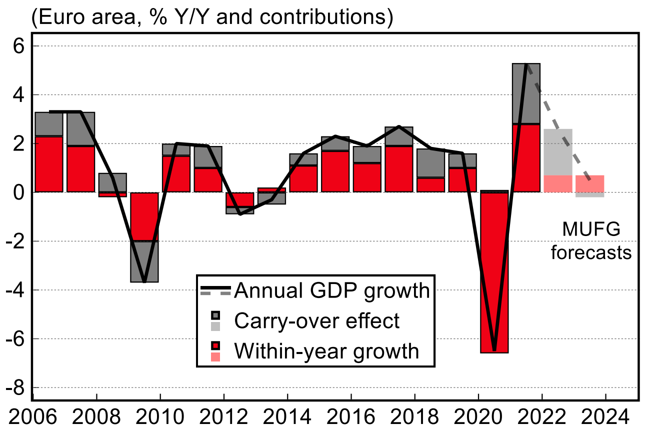
Cost of living pressures remain key to the outlook. Headline inflation has reached an all-time high of 8.6% in the euro area, and UK CPI at 9.1% is the highest in over 40 years. Various government policies have been introduced to ease the burden on households, such as subsidised public transport and lower taxation on fuel, but sentiment has still deteriorated sharply – euro area consumer confidence is now close to the low seen during the most acute phase of the pandemic, and worse than at any point during the global financial/sovereign debt crises. Business confidence has been relatively resilient in comparison, but there are now signs of deterioration as recession fears become more widespread. The euro area composite PMI has fallen to a 16-month low and various expectation gauges have sunk.

CONSUMER CONFIDENCE IS AT ALL-TIME LOWS



Source: European Commission, MUFG Bank ERO

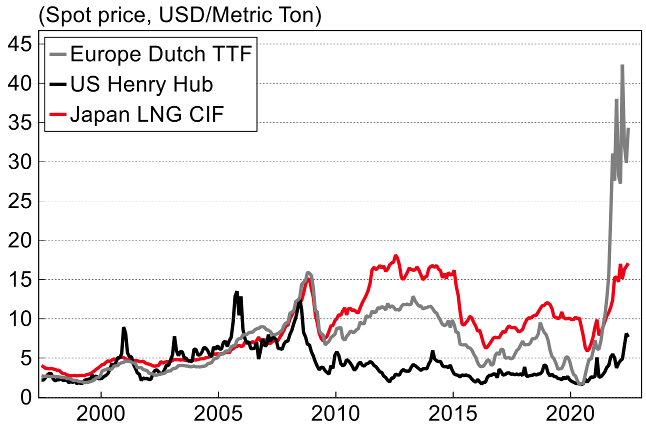
A CHALLENGING WINTER MAY DRAG ON 2023 GROWTH



Source: Eurostat, MUFG Bank ERO

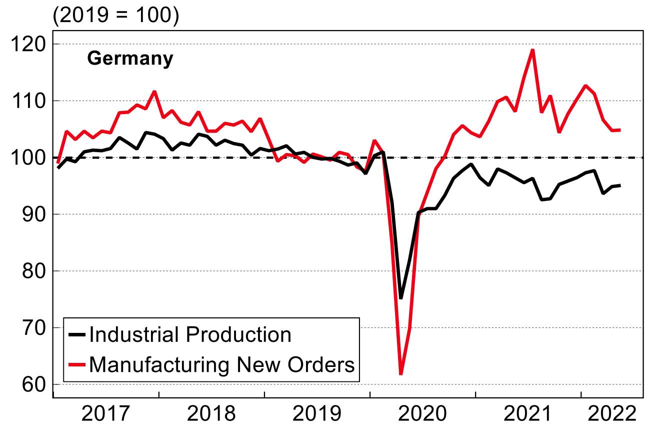
The surge in energy prices over the last year should already be considered a huge shock, especially in the context of significant and ongoing supply-chain disruptions, but it could get much worse. **The main risk to the outlook is Russia choosing to throttle gas flows to Europe into the winter**. Russian gas deliveries through the Nord Stream 1 pipeline were slashed by 60% in June and have now been halted completely for maintenance. It is not clear that flows will return to normal after the 10-day maintenance period which ends on 21 July. Gas withdrawals are now exceeding injections at some storage sites and the German government's target of 90% fill level by November looks increasingly hard to reach. Indeed, the IEA has warned that Europe needs to take steps now to reduce gas demand and put the saved gas into storage to "avoid the risk of major gas shortages and rationing". We assume that any energy rationing would firstly be applied to heavy industries (e.g. metals, cement) before industry more broadly, and households only in the case of a deep crisis.

EUROPEAN GAS PRICES – NO LET-UP IN SIGHT



Source: World Bank, MUFG Bank ERO

MANUFACTURING ORDERS REMAIN FAIRLY STRONG



Source: Destatis, MUFG Bank ERO

Euro area industrial production has proved to be more resilient than expected when gas prices soared in early March following the Russian invasion of Ukraine and some firms voluntarily cut production. Surveys continue to suggest a backlog of orders which may be fulfilled as supply-chain pressures ease. However, any government-mandated rationing would plainly be bad news. There would be direct effects on production (both Germany and Italy, with large industrial sectors, are heavily exposed to changes in the gas supply from Russia). But, the confidence channel would also be important, even in the case of very targeted rationing measures, if a feeling of 'crisis' intensifies with risks to investment and consumption more broadly.

POLITICAL UNCERTAINTY AN ADDITIONAL HEADWIND

There is certainly **a sense that the European outlook is becoming more clouded by the week**. Recent developments in Italy have added to this with PM Draghi poised to resign unless he can secure the backing of other political parties in the alliance. The risk of a snap election, which could be held in the autumn at the earliest, has increased substantially. Even if Draghi does stay or another PM is found to head a new unity government, hopes for some years of relative stability and useful policy reforms have faded.

Political crisis in Italy is a headache for the ECB, which is about to raise rates for the first time in over a decade. It is also poised to unveil its new anti-fragmentation tool. The aim of the 'transmission protection mechanism', as it's rumoured to be called, is to limit divergence in borrowing costs between the euro area's member countries. So far, the 10Y Italy-Germany spread has widened by a relatively small amount and remains below 2012 levels, but there could be larger moves if the details of the tool (or indeed lack of details) underwhelm market participants. In that case, fears about debt sustainability and banking sector health could rise sharply.

However, while there are a range of risks, it should be said **the European economy is not without its positives**. Unemployment rates are close to all-time lows, and government support meant that household and corporate balance sheets emerged from the pandemic in good shape. Germany has plenty of room for fiscal support if its manufacturing sector is hit hard by energy rationing, and Italy now has a longer debt profile than it did during the sovereign debt crisis.

More broadly, we also think that there is still a tailwind from pent-up demand following the pandemic. The euro area services sector appears to be in relatively good shape. The European Commission's confidence indicator improved again in June for the third straight month, with the number of firms stating that demand is a limiting factor well below the long-term average.

So, any downturn might be 'unusual'. Hospitality, leisure and other 'discretionary' areas of service consumption, which might normally be pared back when households are faced with a real income squeeze, could remain somewhat resilient. So **there are reasons to believe that any recession would be relatively mild.**

A TRICKY PATH FOR THE ECB TO NAVIGATE

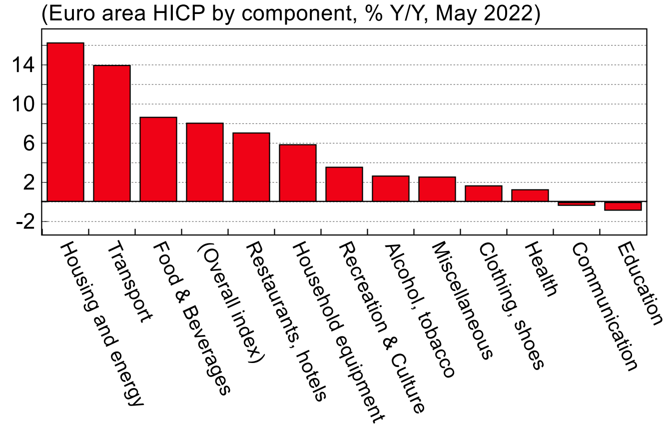
On inflation, **we still think that we are close to the peak now for euro area headline CPI**. As well as base effects and signs of declines in some non-energy commodity prices, the gloomy economic outlook seems increasingly disinflationary.

But the energy story is still a key component. Front-month TTF gas prices are now close to the highs seen in early March following the Russian invasion of Ukraine. This means that it may take longer for headline inflation rates to normalise. **We are increasing our forecast for average euro area inflation in 2023 to around 3% from 2.5% previously**. For the UK, the increase in the energy price cap (which could be in the region of 70%) means the peak is set to come in the autumn – we are pencilling in a high of 13% on a monthly basis.

It's a tricky path for central banks to tread. Unlike in the US, European inflation is still mostly supply-side driven. Despite the tight labour market, wage pressures have been relatively modest so far (negotiated wages increased by 2.8% in Q1 in the euro area with inflation averaging above 6%). The evidence from union wage rounds points to firms offering one-off payments and bonuses rather than increase base salaries in line with inflation. Survey based indicators of expected inflation over the longer term have also barely risen, again reducing the chances of persistently high price growth.

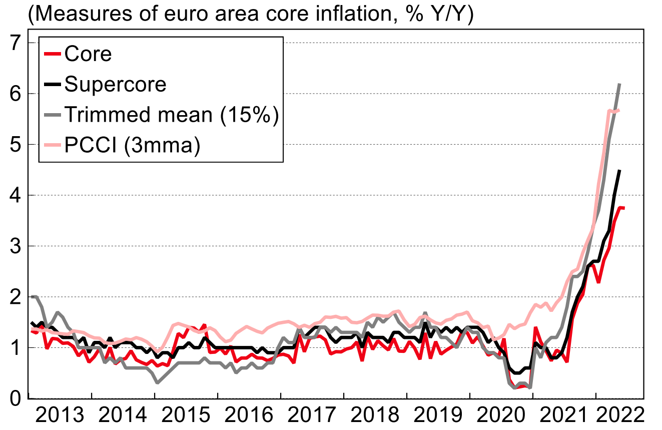
However, the risks of tipping the economy into recession to tame inflation may seem preferable to allowing a new era of entrenched higher inflation (especially after a global pandemic and war in Europe). So, our suspicion is that central banks may have a bias towards overtightening, if conditions allow. But, **with clouds gathering over the European economy, the window for rate hikes might close rapidly in H2 this year**.

ENERGY AND FOOD DRIVING INFLATION HIGHER



Source: Eurostat, MUFG Bank ERO

PRICE PRESSURES CONTINUE TO BROADEN



Source: ECB, Eurostat, MUFG Bank ERO

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US Fixed Income: Summer of discontent continues

Macro Review: Macro dominos have lined up and are wobbling. Forward indicators (like PMIs) have been early warning signals but now even more real-time measures are suggesting growth is stalling. Meanwhile there are few signs that inflation pressures are letting up (in fact we just had another peak, with headline CPI at 9.1% for June). The Fed is left with suboptimal choices. The Fed is clearly impacting aggregate demand (a lot of it via the negative wealth effect) thus the risks are high they overdo it. Fed speakers are trying to spin a positive story versus focusing on the risk the economy may fall into a recession. But it's possible that the US is already in a "technical recession" as seen by the negative Q2 Atlanta Fed GDP reading (and that is after a Q1 negative quarter).

Fed Policy: Our base case is that we get 75bps at the July meeting. The market briefly entertained a 100bps move but after various Fed speakers came out in favour of a 75bps move instead, markets have adjusted. Heading into the July meeting, if probabilities were to increase again, we would not be surprised of a 100bps move if its priced-in (the Powell doctrine is to not disappointment expectations). With blackout in effect, there should be no new guidance or urgency to signal (unlike last time). This is a non-quarterly FOMC meeting so there are no SEP forecast updates. We still think its too soon for the Fed to pivot as well. Thus, we expect this meeting to deliver on market pricing without being too dovish.

Rates Views: A 75bp hike in July get the upper band to neutral (~2.5%). Further down the line, we see the Fed likely reducing the size of hikes from 75bps to 50bps to 25bps and then zero, if they have enough runway to wind the hiking process down in an orderly manner. Ultimately the economic slowdown we forecast ahead (we have a 60% probability that US will fall into a recession) will see the Fed return to rate cuts too. We do not want to get ahead of ourselves, for now, these frontloaded large hikes will continue to keep front-ends elevated but, in our view, the intermediate sector of the curve will continue to perform as recession risks rise. The inverting of the curve will be with us for at least the coming weeks. We still believe we are in a peaking process for long-term rates.

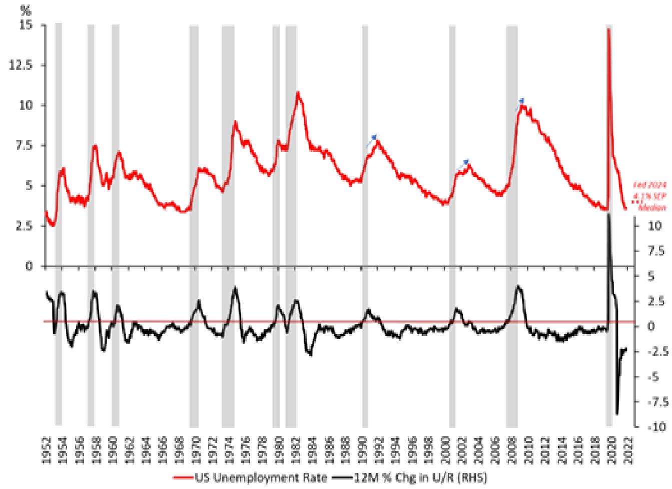
Credit Views: The pressure from risk-off moves as well as concerns over the macro backdrop has resulted in wider credit spreads and on-going losses. That said we argue IG is closer to being in the 7-8th inning but HY is in the 4-5th inning. We're tightening up our medium-term IG spread range to 125 – 175 bps, up from 100 – 175 bps. The top band was updated last month from 150 (a level that up until recently was support) to 175 bps. Additionally, we are adding a short-term spread range of 140 – 175 bps to reflect current conditions with an upward bias. If aggregate IG spreads fall below 140 bps, we will reassess our view. In High Yield we remain cautious spreads and don't believe we've seen the wides yet.

US MACRO AND UPCOMING FED VIEWS

Our conversations have moved from will the economy fall into a recession into how can we avoid it. And as a follow-on, questions than shift to, if we go into a recession will it be short and shallow or long and deep. On the avoid it part, it's possible that the stars align and some of the negative factors facing the economy fade (i.e. a quick and sustained reduction in commodity prices and supply chain improvements). The question will things turn around fast enough if that were to happen. Judging by regional PMIs probably not, as we may be facing a classic recession led by a build-up of inventories. That coupled with ongoing financial conditions tightening (via a strong USD, high rates and oil prices, falling stocks) suggests the die has been cast.

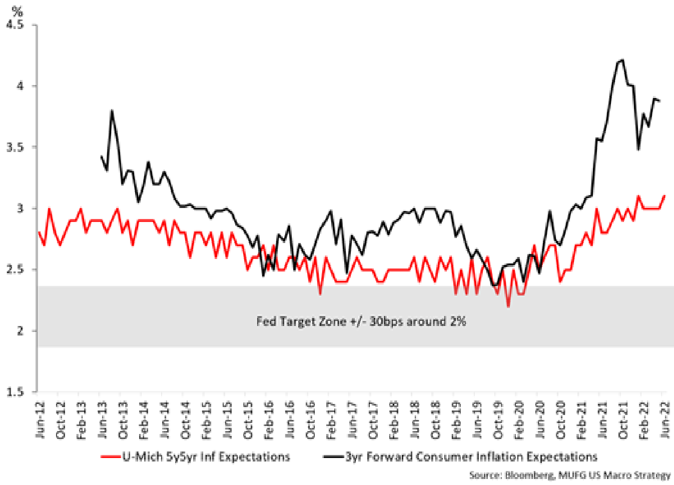
There are two factors that forecasters point to that may suggest we can have a shallow recession: the strong labour market and "cash" on the side lines argument. However, jobs data is a lagging indicator, and as seen in chart 1, whenever the unemployment rate has increased by 0.5% up from a local low, a recession follows.

CHART 1: UNEMPLOYMENT RATE VS 12M % CHANGE



Source: Bloomberg, MUFG U.S. Macro Strategy

CHART 2: MUST ANCHOR INFLATION EXPECTATIONS



Source: Bloomberg, MUFG U.S. Macro Strategy

July FOMC Meeting Expectations: Given that the June CPI print was a new high print, the 4th hike in the latest Fed tightening cycle is likely another 75bps (with the risk of 100bps if market pricing changes pre-meeting). With blackout in effect, there should be no new guidance or urgency to signal (unlike last time). This is a non-quarterly meeting so there are no SEP forecast updates. We expect this meeting to deliver on market pricing. Although this would be the 2nd in a row 75bps hike, we do not believe they will use the July meeting to pivot. As seen in chart 2, they need to sound convincing at fighting inflation and re-anchor consumer-based expectations. We would look for further forward guidance at either Jackson Hole (August 25-27) or at the September meeting for the criteria needed for the Fed to slowdown hikes and pause altogether. We see them reducing the size of hikes from 75bps to 50bps to 25bps (if they have enough runway to gradually wind this process down orderly).

July FOMC Rate Implications: A 75bp hike in July gets the upper band to neutral (~2.5%). The market briefly entertained a 100bps move but after various Fed speakers came out in favour of a 75bps move instead, markets have adjusted. Heading into the July meeting, if probabilities were to increase again, we would not be surprised of a 100bps move if its priced-in (again the Powell doctrine is to not disappointment market expectations). These frontloaded large hikes will continue to keep front-ends elevated but, in our view, the intermediate sector (7s thru 10s) of the yield curve will continue to perform well as recession fears rise. And with positive summer seasonals upon us, the yield curve will stay inverted, for at least the coming weeks. Overall, we still believe we are in a peaking process for long-term rates.

US IG CREDIT: A MIX OF INFLATION AND RECESSION FEARS

IG Credit Market Summary: Markets continued to be pressured by high inflation, Fed tightening, supply chain disruptions, and the Russia/Ukraine war. The S&P 500 ended June down 21%. The last time the index had fallen this much during the first six months of any year was in 1970. Markets recovered only temporarily on June 28 as China eased some of its COVID restrictions for travelers, but this was overshadowed by a consumer confidence report that hit a 16-month low.

Markets ended mid-July basically flat driven by a mix of both inflation and recession fears. The CPI report showed inflation grew 9.1% year-over-year, which spurred speculation of an even higher next Fed rate hike of 100 bps. In contrast, a weaker consumer spending report, showing the first decline this year, drove recession fears higher. By July 14, the S&P 500 YTD loss totaled -19.8%.

The IG bond market was a little more volatile than equities this past month, with aggregate IG spreads hitting 160 on July 5, the highest spread level since June 11 2020, at the height of the pandemic. But spreads quickly tightened by mid-July to 153 bps, partly due to attractive valuations as well as some relief that the new issue calendar opened up after two weeks of barely any deals.

Net change in IG spreads over the past month widened slightly from 144 to 153 bps. However, there was more drastic movements in the lower quality credit spectrum, with many BBB rated credits tightening by 15-20 bps by mid-July. YTD net change in IG spreads is 61 bps wider. On a returns basis, the IG bond market was mixed, with the IG aggregate YTD excess return declining slightly from -2.84% to –3.25% through July 14. The IG total return YTD is –13.87% vs -14.99% on June 16. Pease refer to the chart below for more details.

This market volatility shows that the primary market risks have not changed over the past 2-3 months and include: continued signs of high inflation; supply chain disruptions; China COVID lockdowns; Russia's war with Ukraine; potentially weaker second quarter earnings and/or outlooks; and the Fed both raising rates by 75 bps and beginning to shrink its balance sheet. Lower earnings guidance continued through mid-July and came from leading companies in both retail and technology.

IG Spread Outlook: We believe the issues mentioned above coupled with increased market uncertainty will continue possibly for the rest of the year and therefore we remain cautious on credit. We have seen this over the past 5 months with IG spreads spiking on a nearly monthly basis. We believe spreads may have another leg wider, especially once recession risks become more obvious. Therefore, we are tightening up our medium-term IG spread range to 125 – 175 bps, up from 100 – 175 (which the top band was updated last month). Additionally, we are adding a short-term spread range of 140 – 175 bps to reflect current market conditions with an upward bias. If aggregate IG spreads fall below 140 in any given month, we will reassess our view.

Sector Outlooks (Ahead of 2nd Quarter Earnings): In light of the continued market weakness and negative factors mentioned above, we remain cautious on most sectors, but we remain constructive on the Utility, Energy, Telecom, and Pharmaceutical/Healthcare sectors.

Below we offer our thoughts on the coming second quarter earnings season:

Utilities:

We do not expect utility earnings to show much variability from expectations but we expect the following topics to drive utility company earnings calls:

- The recent turn lower (although still elevated) in natural gas prices should provide some breathing room on customer bills. Recall that although natural gas prices (and power prices) are generally 'passed-through' to rate payers, regulators are increasingly sensitive to affordability and customer hikes.

- A renewed interest in the bad debt exposure with increasing concerns over the recession threat. While generally a 'recoverable' (socialized) expense, the topic received attention during the early days of COVID.
- Inflation impact on the relatively hefty capital plans given investment in grid hardening and energy transition toward renewables. We would not be surprised by a modest increase in spending budgets and debt issuance needs.
- Although the current wildfire season has been manageable, we would expect heightened focus on the topic.

Energy:

With average crude oil and natural gas prices higher in Q2, energy companies should post relatively strong earnings. We expect attention on conference calls to address:

- With commodity prices more than 20% off recent highs and increasing concern over a potential recession, we expect renewed interest in earnings sustainability in the sector. For producers, we expect discussions on portfolio productivity and inflationary pressures. Midstream management teams will similarly update growth project backlog amid rising costs.
- We generally expect more scrutiny on capital allocation plans. While commodity prices are still very supportive, the recent downward pivot could prioritize achieving balance sheet strength and liquidity objectives. We would not be surprised to see opportunistic issuance to address refinancing needs.
- We expect continued discussion on energy security and the industry's response to the ongoing energy crisis in Europe.

Tech, Media, Telecom:

Inflation is increasingly dampening consumer demand and that is seen in Q2 global PC shipments declining 12.6% year-over-year, according to IDC (International Data Corp). Therefore, TMT credits with more transactional, consumer end-market exposure are higher risk of missing earnings estimates and/or reducing guidance.

- **Telecom:** Although wireless providers could face consumer headwinds in the form of higher churn and lower ARPU, recurring monthly revenue profile should lead to steady, defensive free cash flow generation going into a slowing macro environment. In addition, the big three wireless credits remain in debt reduction mode after 5G spectrum investments. Tower REITs also benefit from sticky, recurring lease income.

- **Media:** Cable/broadband provider equities may be volatile with headline subscription net adds slowing after pandemic boom and increasing competition from telecom's FTTH (Fiber To The Home) and fixed-wireless offerings. But, like telecom credits, steady free cash flow should support credit risk. Meanwhile, content providers/networks could experience lower advertising revenue just as investment into streaming assets continues to pressure free cash flows.

- **Tech:** Across the diverse tech sector, semiconductor and subscription-based enterprise IT software credits should best withstand macro headwinds given secular growth trends. Also, semi capital equipment producers could see sustained demand due to on-going multi-year investment by chip fabs. We are more cautious on tech credits with consumer exposure such as memory chips and computer hardware manufacturers. In addition, tech distributors, especially those with high exposure to small and medium businesses could see a rapid slow-down in activity.

Healthcare / Pharmaceuticals:

We believe second quarter earnings for the Healthcare/Pharma sectors will be relatively stable, driven by strong demand, cost pass-throughs to customers, and the defensive nature of the sector.One concern we do have is in the hospital operator subsector. One competitor recently revised second quarter earnings down considerably due to lower patient volumes due to the decline in both COVID and regular patients, as well as higher labor costs from hiring part-time nursing staff. This could leak into other companies in the sector. In the pharma sector, we expect a large M&A deal to be announced near the end of July for over $40bn. This would be the first large pharma deal in over a year. It will be interesting to see how the FTC & DOJ handle the antitrust review, given the tougher stance on M&A.

Consumer / Retail:

Earnings will be trickier with Consumer and Retail names, and very company-specific. In general, we expect the food & beverage subsector to hold up better than retail, as basic consumer food items have stable demand and may even see a shift from dining out to eating at home in light of the high inflation and market uncertainty. Retailers however, particularly specialty retailers, may have a tougher quarter due to potentially lower demand and higher inventory levels leading to mark-downs and lower margins. We also wonder if the strong home renovation cycle that was fuelled by the pandemic may be slowing, given inflation and other household priorities.

CHART 3 – IG SPREADS, RETURNS, AND EQUITY RETURNS (AS OF 7/14/2022)

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	153	14	61	68	4.70%	0.60%	-13.87%	-3.25%	-	-	-19.8%
Financial Institutions	159	18	76	83	4.77%	0.23%	-11.85%	-3.36%	6	-8	-20.6%
Utility	156	12	49	60	4.75%	0.66%	-16.02%	-3.32%	3	-1	-1.2%
Energy	176	24	60	69	4.94%	0.36%	-13.79%	-3.05%	23	38	24.0%
Basic	193	36	78	89	5.10%	0.13%	-16.33%	-4.56%	40	30	-20.9%
Capital Goods	145	11	59	64	4.59%	0.58%	-13.94%	-3.49%	-9	-10	-18.5%
Technology	130	7	50	58	4.44%	0.85%	-13.39%	-2.62%	-23	-21	-25.1%
Communications	178	11	60	68	4.90%	1.19%	-16.46%	-3.53%	25	27	-30.0%
Consumer Noncyclical	138	10	50	56	4.54%	0.97%	-15.04%	-3.09%	-15	-8	-4.9%
Pharmaceuticals	110	4	35	40	4.27%	1.12%	-13.97%	-2.09%	-43	-19	-9.1%
Food/Beverage	139	8	50	54	4.55%	1.20%	-14.95%	-2.86%	-14	-4	-4.9%
Consumer Cyclical	130	2	51	56	4.43%	0.69%	-12.79%	-3.03%	-24	-6	-30.3%
Transportation	149	11	51	54	4.65%	1.15%	-15.90%	-2.97%	-4	2	-18.5%

Source: Bloomberg, MUFG U.S. Macro Strategy

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 opportunistic buying out of Asia, especially with the 2-year treasury above 3% and with credit spreads relatively stable. Volumes have been muted, however, along with limited liquidity. We believe one reason for buying interest may be the lack of new issuance supply coupled with investors growing cash balances. Overall, flows have been orderly and we haven't sensed any panic in the IG market so far. However, on an aggregate basis, IG fund flows reflected investors' cautiousness, as YTD net fund outflows totaled $77bn, in stark contrast to last year's positive inflows of $113bn.

New Issuance: Reflecting the ongoing market weakness and uncertainty, IG new issuance for June totaled only $69bn, well below the $105bn estimate for the month. We attribute this weakness to many issuers postponing deals as they wait and hope for some stabilization in rates. Anecdotally, we saw two mid-sized asset sales worth a combined $13bnin the consumer/retail sector get cancelled due to adverse market conditions and particularly difficult debt financing market. Also interesting to note that, according to CreditSights, the average IG new issue coupon is abiout 4.5%, the highest level since 2011.

Year to date new issuance through June 30 totaled $716bn, 16% behind last year's $850bn, and 13% lower than the 5 year average of $819bn. Issuance for the first half of July is $30bn, again below estimates. Consensus estimates for July and August is $75-80bn each followed by roughly $100bn monthly from September to November, then obviously a slower December, for a total of about $550bn for the second half of this year. That would place it about 14% below last year's second half total of $640bn, 4% below the 5 year average of $573bn and virtually flat with the 10-year average of $545bn.

Typically, issuance in the second half of the year is usually less than the first half, due to summer slowdown and then end of year holidays. Historical trends for new issuance have been on average 55% in the first half of the year followed by 45% in second half. It appears that consensus estimates for the full year are coming down, from about $1.4 trillion to about $1.2 trillion, which would place it about 20% lower than last year's total of $1.49 trillion. This year's $1.2 trillion estimate would also place it 14% below the 5-year average of $1.39 trillion but only 4% below the 10-year average of $1.25 trillion. As seen in the table below, new issue concessions have expanded to an average of 12 bps compared to just 2 bps last year.

YTD New Issuance - as of July 14, 2022

	Issuance ($ bn)	New Issue Concession	Books Times Cvd
2022	$746.1	12 bps	2.8
2021	$940.0	2 bps	3.0

US HY CREDIT: A CHALLENGING BACKDROP REMAINS

High Yield total return continued negative with the HY index now yielding 8.6% with the OAS now +526. The composition of risk reduction continued to shift from duration to credit as CCC underperformed the index with yield on the CCC index now 13.7% and the OAS +1046.

The high yield secondary slid steadily lower through the last month, even as UST rates remain below mid-June levels (UST 10y was 3.49% 06/14, now 2.91%). This leaves the few LBO/M&A issues that need to get done as possible candidates for coming to market over the next few weeks. It does not look like any of these bigger will opportunistically access the market.

The primary market continues to be challenged with July YTD global volume of $1.38bn equivalent, consisting of one US$ deal (1 tranche) for $350m and two non-US$ deal (three tranches) for US$1.03bn equivalent (€1.02bn). The year-to-date global volume is $85.5bn equivalent ($68.1bn and non-$17.4bn equivalent).

Announced M&A deals, including Tenneco $3bn and Citrix $7.95bn, are pre-marketing and issuers will weigh getting ahead of the Fed Meeting at the end of the month.

CHART 4 – HY SPREADS, RETURNS, AND EQUITY RETURNS (AS OF 7/14/2022)

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	526	88	243	231	8.59%	-13.66%	-1.89%	-	-	-19.2%
Financial Institutions	515	92	250	229	8.47%	-14.06%	-1.80%	-11	-53	-17.8%
Utility	336	49	87	63	6.73%	-11.67%	-2.06%	-189	-92	-1.0%
Energy	476	127	148	98	8.10%	-9.99%	-0.81%	-50	174	26.4%
Basic Industry	520	129	232	225	8.54%	-13.63%	-1.75%	-6	-5	-19.6%
Capital Goods	505	89	229	216	8.40%	-12.02%	-0.98%	-21	-47	-17.2%
Technology	481	69	236	201	8.15%	-12.35%	-1.94%	-45	-84	-23.8%
Communications	579	67	261	292	9.09%	-16.02%	-3.64%	53	-17	-28.5%
Consumer Non-Cyclical	558	67	307	285	8.96%	-15.98%	-2.32%	32	-8	-4.5%
Pharmaceuticals	918	100	577	539	12.55%	-25.38%	-2.65%	393	69	-6.8%
Food/Beverage	410	23	214	197	7.53%	-13.28%	-3.54%	-115	-78	-4.5%
Consumer Cyclical	547	88	278	268	8.79%	-14.20%	-1.52%	21	-18	-29.1%
Transportation	503	64	194	157	8.26%	-10.65%	-0.68%	-23	165	-17.2%

Source: Bloomberg, MUFG U.S. Macro Strategy

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The US dollar on a DXY basis hit another new high in July – on an intra-day basis, 109.29 was hit on 14th July – the strongest US dollar level since 2002. With EUR such a large weighting in DXY, the plunge in EUR/USD through parity was a key factor in the DXY performance with a host of risks weighing on EUR – which at this point is the worst performing G10 currency in July (-2.3%). We expect EUR/USD to revisit levels back below parity again. The natural gas supply uncertainty, the probable resignation of PM Draghi in Italy and the implications for fragmentation risks and the very cautious approach to monetary tightening by the ECB will continue to weigh on EUR performance. However, the reports today that the ECB is considering a 50bp rate hike on Thursday in contrast to the effective pre-announced 25bp hike would certainly help limit EUR/USD downside risks. While the US economy looks to be slowing as rate hikes begin to impact sentiment in housing activity, the Fed looks set to hike by 75bps next week which will provide support for the dollar. Only when the FOMC clearly signals a change in policy approach by pausing its tightening cycle will the dollar turn weaker. We see that happening in Q4 – hence USD selling at this juncture might not last.

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BASE CASE EXPECTATIONS, JPY, EUR & CNY

USD/JPY – NEUTRAL BIAS

- **Range: 134.00-141.00**

The USD/JPY rate hit new highs over the last month – on the same day as EUR/USD broke decisively through parity (14th July), USD/JPY hit an intra-day high of 139.39 and with the broader USD momentum set to remain positive we believe there is still the potential for a break above the 140.00-level. But whether to maintain the bullish bias has become a much closer call with the evidence of slowing economic growth and easing inflationary pressures becoming more common in the economic data flow from the US. While that suggests we may be reaching a peak in short-term rates, it remains more likely that the Fed will be slow to signal any shift in policy given how far behind the curve the Fed was in fighting upside inflation risks.

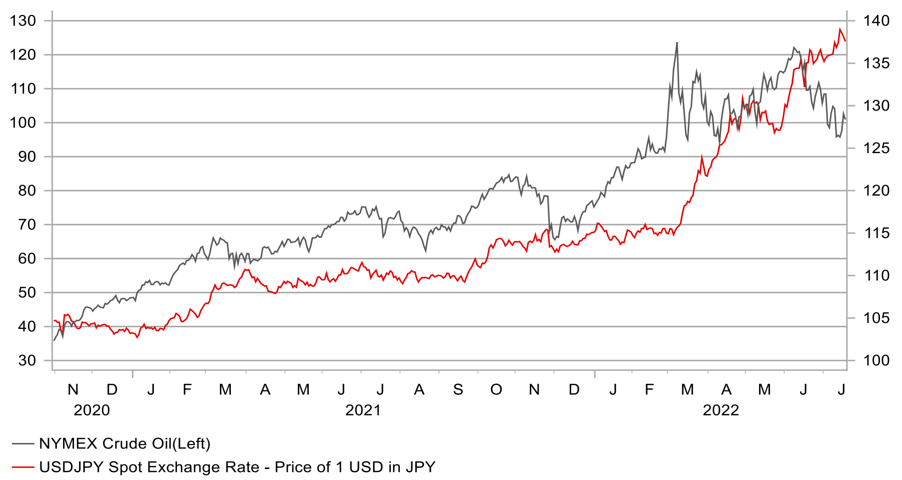
We also do not envisage any changes in the policy stance in Japan. The terrible assassination of former PM, Shinzo Abe, shocked the world but his influence in shaping the policy mix in Japan is likely to carry on for a period of time yet. PM Abe's choice of BoJ Governor – Haruhiko Kuroda – remains and his term will end in April 2023. It is now increasingly likely that Governor Kuroda will maintain the policy of Yield Curve Control through to the end of his tenure. The outright purchases of JGBs to maintain the 10-year JGB yield at or below 0.25% have slowed in line with the decline in global yields – purchases in July to date have totalled JPY 2,283bn, in contrast to the JPY 16,100bn purchased in June.

The BoJ will announce its policy decision on Thursday and we see no reason for the BoJ to alter its YCC framework at this stage. To make any alterations, even slight alterations, would only fuel further speculative selling of JGBs in anticipation of a more meaningful change. Governor Kuroda can see the global surge in inflation as having a clear impact in Japan and does not want to repeat the mistakes of the past. The BoJ raised rates in 2000 and 2006 but had to reverse those moves – on both occasions the hikes were just before a recession in the US. Some measures of inflation have turned notably higher. PPI YoY was up 11.4% in May, the highest level since October 1980. Imported goods inflation stands at 58%, the highest since May 1980. The point in which the BoJ would possibly consider a shift in policy stance would be evidence of a more compelling pick-up in wages. However, labour cash earnings have in fact slowed from 2.0% YoY in March to 1.0% in May. A break to levels over 2.0% (quite rare since Japan's bubble burst) would be required in order to convince the BoJ that inflation risks are shifting from the downside to the upside.

The stance of the BoJ will therefore persist and from an FX perspective, Japan's trade position is likely to remain a negative influence on the Japanese yen. MoF trade data for May revealed a trade deficit of JPY 2,386bn, the 2nd largest deficit on record. Two of the three largest trade deficits have been recorded this year and this deteriorating trade picture for Japan will remain a negative for the yen. It is also not just the surging price of food and energy lifting imports but also weak demand in China weighing on Japan's export performance. Exports to China are down 0.2% YoY in May in contrast to the growth of 17.5% for all of Asia.

The BoJ's stance, the unlikelihood of economic policy changing any time soon and the deteriorating trade backdrop all remain valid reasons to expect the yen to remain weak. But the catalyst for the next notable move is most likely to be global events and Fed policy direction in particular. The FOMC is likely to hike by 75bps next week and by 50bps in September. But US economic data is beginning to indicate rate hikes are biting (in particular in housing) while inventory levels suggest supply constraint issues will no longer be an upside risk factor for goods inflation. That suggests a peak in the cycle will come and at some point in Q4 a pause by the Fed could see rates correct lower and this would be a key catalyst for a turn in USD/JPY as well. While another lurch higher in USD/JPY seems plausible on the back of further hikes, we would argue that is well priced while the decline in crude oil prices and slowing economic activity and declining inflation breakeven rates lead us to a neutral bias given directional risks appear more evenly weighted now.

FED HIKE SUPPORT FOR USD/JPY OFFSET BY EASING INFLATION RISKS



Source: Bloomberg, Macrobond, MUFG GMR

EUR/USD – BEARISH BIAS

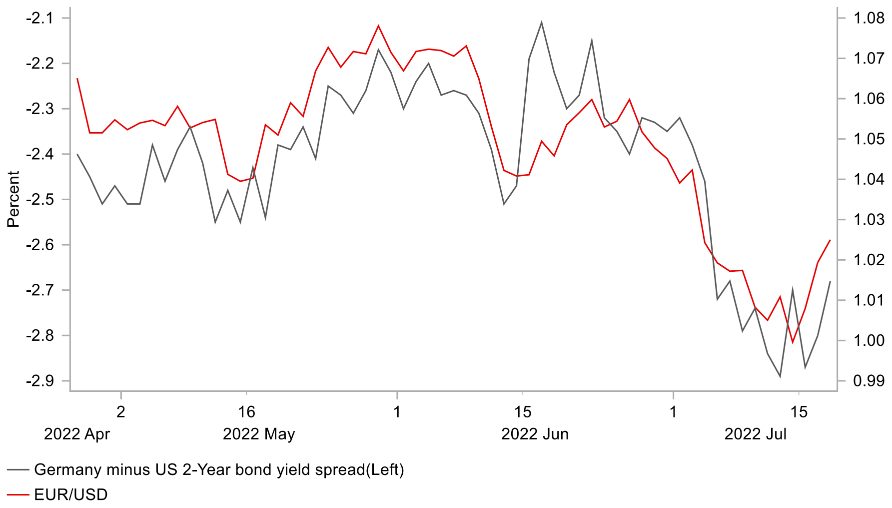
- **Range: 0.9800-1.0500**

The EUR briefly has fallen briefly back below parity for the first time since December 2002. There were two main fundamental triggers for the test of parity. Firstly, the USD has been boosted by market expectations for the Fed to deliver even more front-loaded tightening. In the immediate aftermath of the release of the stronger than expected June CPI report, the US rate market moved to price in the Fed delivering a larger 100bps hike at their upcoming FOMC meeting on 27th July. Those expectations have since been scaled back in recent days following comments from Fed officials including Governor Waller downplaying the need to deliver a 100bps hike. The sharp drop in the University of Michigan survey measure of 5-10YR inflation expectations amongst consumers has also helped to ease pressure on the Fed to deliver a 100bps hike. The UoM survey revealed that the 5-10YR measure of inflation expectations dropped back in line with the average over the last two decades. Nevertheless, the US rate market is still expecting more front-loaded Fed tightening. The Fed is now expected to deliver two more 75bps hikes in July and September before slowing the pace of hikes in November and lifting the policy rate to a peak of 3.50% by year end.

At the same time, the European rate market has been scaling back expectations for how far the ECB will need to raise rates. The imped yield on the December 2023 Euribor futures contract has declined by around 100bps since the peak from the middle of last month. Market participants now expect the ECB to lift the key policy rate towards 1.00% to 1.25% by the end of this year and 1.50% by the end of next year. In particular the scaling back of expectations for ECB rate hikes next year reflects intensifying fears over the risk of a sharper slowdown/recession in the euro-zone. Tightening energy supplies in Europe are increasing the likelihood that activity will be hit harder by higher energy prices and rationing. The price of natural gas has already surged higher by a further 100%+ over the past month or so. Market participants will be watching closely to see how much gas comes back on stream when the NordStream 1 pipeline resumes after the maintenance period is due to end on 21st July. We expect the ECB will stick to plans to bring an end to negative rates in Q3 after which the window for further hikes may quickly begin to close if recession risks intensify heading into the winter.

Political uncertainty in Italy has returned as an additional headache for the ECB when setting monetary policy. Prime Minister Draghi will resign if he is unable to secure full support from the ruling coalition government including the Five Star Movement after they abstained from backing fresh fiscal support measures from the government. If a stable government can't be formed with or without PM Draghi as the Prime Minister, it will result in snap elections taking place within 70-days. Italy has never held elections in the autumn when the government votes on passing the annual budget. Market participants would view snap elections unfavourably given they threaten to delay the passage of the budget and economic reforms required to access financial support from the EU Recovery Fund and potentially from the ECB's new anti-fragmentation tool. Furthermore, it will place upward pressure on Italian government bond yields resulting in financial conditions tightening and dampening the outlook for growth. It will be harder for the ECB to argue that the spread widening is unwarranted if triggered by political instability. On this topic, it is of crucial importance that the ECB's plans for the new anti-fragmentation tool are sufficient to help prevent spreads widening sharply as they continue to tighten policy. In these circumstances, we still believe that risks are titled to the downside for the EUR in the month ahead, and expect a more decisive break below parity.

ECB-FED POLICY DIVERGENCE REMAINS IMPORTANT DRIVER OF EUR/USD



Source: Bloomberg, Macrobond & MUFG GMR

USD/CNY – NEUTRAL BIAS

Range**: 6.6000–6.8000**

After roughly four weeks of range-bound trading around the 6.7000-level, USD/CNY moved up to 6.7448 in the past week, largely due to the strengthening of the US dollar and the rising negative sentiment in China's domestic market.

Last week, news about an increasing number of Chinese homebuyers threatening to stop paying mortgages for at least 100 unfinished construction projects in more than 50 cities damped the sentiment and weighted on the Chinese stock market. Market participants worried about the outlook of the real estate sector and speculated on the possibility of systematic risk should commercial banks be affected severely. We saw sharp stock price decline in listed banks recently, and China's CSI 300 stock market index declined by roughly 3% in past 6 trading days. Negative sentiment also caused a wave of dis-investment in the Chinese equity market by foreign investors. China recorded a net outflow of USD3,271 million by foreign institutional investors from China's stock market after weeks of net capital inflow.

While it is likely the event will continue to make the headlines and get even worse in near term, we don't see it turning into a systemic risk. The key resolution to the problem is to make sure those pre-sold buildings and units to be completed and eventually delivered to homebuyers. Various parties are acting on it. China Banking and Insurance Regulatory Commission (CBIRC) reiterated on the past Sunday that it will support local governments to promote home delivery and expressed that "all the difficulties and problems will be properly solved. Also, the Chinese government stepped up efforts in encouraging lenders to extend loans to qualified real estate projects as the beleaguered property sector faces risks of increasing mortgage-payment boycott on unfinished houses. And, a number of developers pledged to resume the housing projects and "guarantee the delivery of the building". Many attempts are being made, including selling projects, negotiating extension periods and setting up special accounts for housing projects.

At this stage, it is important to contain the anxiety from spreading. As of today, reported data suggests that banks' exposure to mortgages relating to these paused property projects still is limited, the proportion of household mortgage loans involving "loan break" incidents is around 0.01% of total loan book.

Last week, China reported much waited Q2 GDP growth. Real GDP contracted by 2.6%qoq in Q2 and delivered a 0.4%yoy for Q2. Both sequential and year-over-year GDP growths were weaker-than-expected. But the monthly data in June for major economic indicators were slightly better-than-expected and indicated that improvements were broad-based in June. Both y-o-y growths of IP and retail sales improved in June. Automobile sales & production and Infrastructure FAI were the two highlights of the month due to governments' stimulus policies.

Property activities remained weak in June despite a strong rebound from very low levels. The retail sales growth still was moderate and China's exports growth is unlikely to sustain the strong growth rate of 17.9% in June due to our house view of 60% probability of US entering a recession down the road. Having said this, even with headwinds, Q2 still is likely to be the trough of this recovery cycle. As we expect more measures and policies to be rolled out to stabilize growth and the re-establishing the expectation of a stable development of real estate sector activities, we think that Chinese economy has a good chance of delivering a faster pace of economic recovery in H2, we still maintain our expectation of a 3.8% GDP for 2022.

Although we have a more positive backdrop for CNY towards the end of this year, near-term, USD/CNY can still be volatile driven by the sentiment and the value change of the US dollar. We continue to expect USD/CNY to be range bound around 6.7000 and stay in the range between 6.6000-6.8000 for the month ahead.

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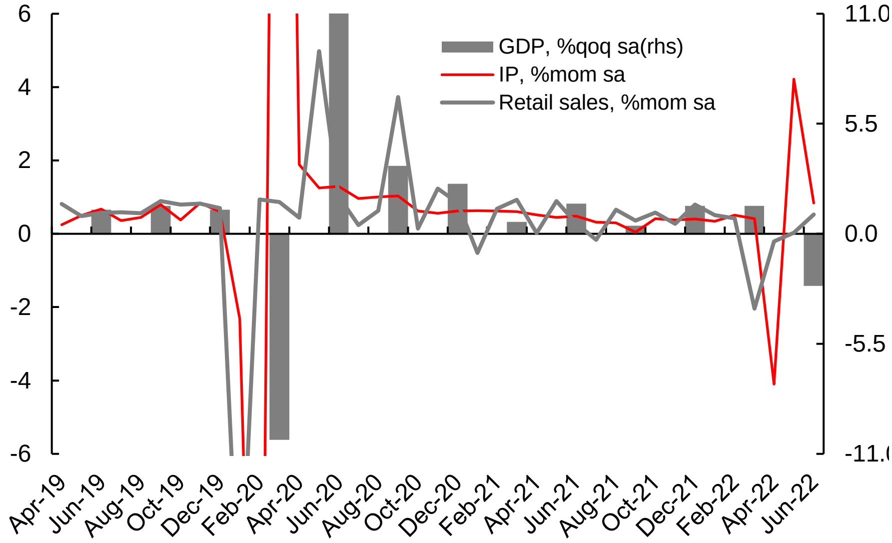
Q2 LIKELY TO BE THE TROUGH IN THIS RECOVERY CYCLE



Source: CEIC, MUFG GMR

KEY RISK FACTORS IN THE MONTHS AHEAD

- Risks in our view are more evenly balanced now for USD/JPY – but that is not to say further big moves are not possible. To the upside, the primary risk factor is that the FOMC next week signal the potential for further aggressive tightening in the months ahead. 75bps at both the July and September meetings is not fully priced and encouragement for the markets to price in more would likely see USD/JPY break above the 140-level quite easily. Equally, a faster turn in US economic data (that is now emerging) coupled with bad corporate earnings from the US over the coming weeks could see equities and rates fall more notably which would prompt a more substantial correction lower in USD/JPY.

- The main upside risk to our bearish EUR/USD bias could be triggered by a paring back of energy supply concerns in Europe. The EUR would receive a lift if natural gas supply from Russia returns to more normal levels after the NordStream 1 pipeline maintenance period comes to an end. The EUR could be boosted as well by more decisive policy action from the ECB. A combination of a larger 50bps hike this month and convincing plans to keep a lid on fragmentation risk would create a more supportive environment for the EUR especially if snap elections in Italy are avoided as well.
- The main risks to our range-bound view for USD/CNY in the near term still include China's Covid-19 breakouts and implementation of the country's "Dynamic zero Covid-19" policy. The development of homebuyers' "loan break" could be a near-term risk as well. The downside risk for CNY could be the worsening Covid-19 conditions, and adverse development of homebuyer's "loan break" could bring downside risks for the outlook for Chinese economy and the CNY. USD could be another main risk factor in affecting the movement of USD/CNY in near term.

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